Loss Leader Accounts
By Chris Burand

A recent article in the *Wall Street Journal* noted that new surgical centers are incredibly profitable while simultaneously offering better treatment at better prices. They are succeeding so well at taking profitable business away from nonprofit hospitals that the nonprofits in some places are in danger of going bankrupt! Better service, at lower prices, and with huge profit margins - what is their key?

These surgical centers focus on treating patients with only one primary problem rather than a host of problems. The cost of treating these healthier patients is significantly less than treating the same problem in patients with multiple problems who also tend to be less wealthy or at least have less private insurance. Unfortunately, hospitals everywhere have priced treatments, to some extent, at one flat price regardless of the health of the patient. This strategy is also driven by the federal government who has set their Medicare/Medicaid reimbursement at one flat rate.

Provided the most healthy and the least healthy all have their surgeries done at the same hospital, this reimbursement average might be ok because the healthy subsidize the unhealthy. If you take away the healthy though, or even average more unhealthy to healthy people, the hospital will run into problems.

Could the same thing happen in independent insurance agencies? Absolutely! Agencies continually subsidize their small accounts with the profits of their large accounts. So if a competitor specializing in large accounts started taking large accounts from an agency that was sufficiently reliant on a few accounts to subsidize the rest of the agency, the competition could target those accounts and potentially get the rest later-for cheap! This is a very good reason to make sure your top ten accounts do not generate more than 20% of your total commissions. This is also why agencies that are too dependent on a few accounts are less valuable.

The problem is not necessarily that the other accounts are in and of themselves too small. This is a misnomer. The problem is they are not profitable, or not adequately profitable. There is a big difference between small accounts and profitable accounts – they are not the same thing. Some of the most profitable accounts any agency can write are personal lines accounts, provided they are serviced right.

If nonprofit hospitals charged the right amount for all surgeries based on the cost involved, they would not find themselves in such a precarious position. Agencies are in the same boat. Take an E&S account paying $500 premium each year. At 10% commission, the agency earns $50. If the producer is paid 40%, that is $20. The CSR is going to spend at least an hour on that account (the average commercial CSR spends an average of six hours per account per year so only one hour is gracious) which at an average wage is approximately $20. If benefits, any other employees' wages, and the applicable overhead are considered, the agency is easily losing money on this account.

Another way of looking at this is to consider your average cost per account. According to the

Academy of Producer Insurance Studies, the average $1 million to $2 million revenue agency spends $321 per account. How many accounts do you write that generate less than $321?

Agencies have three potential solutions:

First, limit the number of small accounts written. This option is worth considering, especially for the very small E&S accounts which carry significantly larger E&O exposures and are usually more expensive to service.

Second, charge more for your services. If an agency spends $321 to service an account, why not earn at least $321 on the account? Even if the agency could make $250 instead of only $50, the loss would be significantly less. This solution requires the agency to charge fees so if this solution fits your agency, you must absolutely obtain excellent legal counsel regarding the appropriate disclosures and procedures for doing so in your state(s).

Third, cut your expenses. Why pay a producer a commission on an account for which he or she does no work? Why pay a producer a commission on an account upon which the agency is losing money and the producer is doing no work? This is like the nonprofit hospitals paying commissions to salespeople to drag in as many unhealthy people as possible!

Have you ever watched the Sopranos? Sometimes they have a scene showing how the Mob makes some of its money by getting construction contracts that pay wages to workers that don't work. This is similar to paying producers for work they don't do.

Cutting 40% of your cost on small accounts can turn small unprofitable accounts into small and very profitable accounts. It strengthens the agency so that it is not so dependent on a few large accounts and it should create adequate incentive for producers to only write profitable accounts.

Some agencies have tried to cut their expenses by not paying renewal commission. This is a dangerous strategy though as a few virtually bankrupt agencies have learned after the fact. If only new commissions are paid on small accounts, will the producers write adequately good accounts? Will the accounts stick around for at least three or four renewals? The answer is very often "no" and if that is true for your agency, you are better off not writing these accounts at all. If the answer is "yes" with the right controls and underwriting, then install those controls and start generating profits! An agency can benefit from producers writing small accounts, provided those accounts are profitable.

Any business, including insurance agencies, that subsidize large classes of business with a few profitable classes risk being cherry picked to their death. The key is to make all classes of business profitable.

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