Insurance Company Strategic Success

By Chris Burand

The various investigations into contingency income that began in 2004 were rumored (according to an article in *The Economist*) to have been sparked by an insurance company executive whispering in the ear of a regulator that a problem existed. Why would a company do this? They might do it because they were morally upset that such activities were occurring in their industry. Or, they could have done it because they had lost leverage in their negotiations with major brokers and could not determine another way to regain their leverage.

I don't have the inside scoop on what really transpired, but the possibility that an insurance company might be frustrated with their loss of leverage is very real. The major brokers are big, bigger than many insurance companies. They are so big and important that some carriers cannot afford to pull their contracts when a broker does not perform as the carriers might desire. The ability to pull a contract, as they might with smaller agents and brokers, is huge leverage. Many carriers have entirely lost their ability to walk away from very specific brokers and agents, and they have in turn lost their negotiating leverage.

Several months before the contingency investigations swept the industry, I wrote an article which appeared in the June 2004 issue of *Best's Review*. The article described how agencies and brokerages were using their size to gain undue compensation and to get risks written that should not be written. In the article, I discussed how the insurance carriers were already having a difficult time learning how to deal with it and they were "pushing for their own demise" by pushing agencies to grow their books larger and larger with limited, and sometimes no, consideration of underwriting profit. As a result, agents and brokers got bigger and bigger through consolidation and with each consolidation, the carriers' negotiating leverage decreased in two ways. First, the bigger the book, the harder it is to walk away only to watch it be handed to your competitors. Second, with each consolidation, there are fewer agencies and brokers to turn to as alternatives.

This is a mature industry in a mature economy so high growth expectations (in effect, trying to make insurance company stocks into growth stocks) does not make a lot sense. With good underwriting though, there really is no limit to the amount of money one can make. Growth stocks may be exciting, but the competition between acquiring versus practicing good underwriting is a hare and tortoise situation.

The situation is growing worse still today because the loss of leverage is increasing at a faster pace. The world has been awash in plentiful supplies of cheap money for many years now (which has contributed to low interest rates and minimal carrier investment yields). The money supply has fueled the desire of many to buy a lot of insurance agencies, wrangle good deals out of carriers, and go public. Whether or not they attain the ultimate goal of going public is not as important as the fact they are continually scoring partial victories simply by buying one agency after another. Even if they never sell out, these consolidators will still achieve some consolidation that probably will never be undone, leaving carriers to deal with ever larger agencies and brokers who possess more leverage.

Additional pressure will be felt by carriers if more banks who have purchased a lot of agencies begin running their insurance locations as a large agency or broker would.

Sometimes this situation is addressed by the companies merging with one another, but given the market's perspective of P&C carrier mergers, this is an unlikely solution. Some mergers will occur, but not enough to offset the agency and broker consolidation.

An excellent alternative does exist if carriers really desire to offset the impact of agent/broker consolidation. The solution is to help agencies and brokers remain independent and perpetuate their businesses internally. Companies can take two strategic actions to achieve this. First, emphasize underwriting profitability over book size/growth and second, assist agencies in gaining the tools they need to perpetuate their agencies internally.

Underwriting Profitability

Agencies can only grow organically (versus through acquisitions which, again, does not solve the companies' problems) so fast in a mature economy in a mature industry. What could an insurance company be thinking when they demand extra growth from an agency that already has almost 100% market share in their area, especially when the agency is not necessarily profitable? Why would a company want more unprofitable business and even demand more when there is no more to be had?   (This is a true story.)

Many contingency contracts provide incentives for more unprofitable business. Some contingency contracts pay more for unprofitable books growing quickly than really profitable books barely growing. Again, why would a carrier want to increase their unprofitable books, especially if it forces agencies to consolidate? These are good examples of carriers pushing their own demise.

Focusing on underwriting profitability makes more sense. By focusing on underwriting profitability, something virtually every agency of any size can achieve, a carrier expands its potential distribution force, increases its negotiating leverage, and increases its profitability. It may actually also increase its growth rate (as several of the carriers I consider top underwriting companies have achieved).

Maintain Independence

Helping agencies stay independent increases a carrier's options. While I believe it is an agency's own responsibility to gain adequate education for perpetuating their agencies, developing new producers, managing their agencies more professionally, and finding financing for internal buyers, it is in a carrier's best interest to assist them. Some carriers are already supporting this strategy, especially for the development of producers. Several have opened their own producer development schools for their agents and/or are helping key agents pay for the schools. Other carriers are helping agents in other strategic areas but for the most part, carriers are not taking an active role.

Companies that make agents aware of the company's support for the agency's internal perpetuation rather than making them believe they will lose their appointment if they do not grow, in and of itself will benefit the company. Pro-actively building agencies with the ability to remain independent is much better for the entire industry than taking a reactive position when few other alternatives exist. If the rumor about how the investigations began is true, it also serves another lesson regarding why a proactive and positive approach is a better choice. The reactive approach sometimes backfires. The executive who made the call to the regulators probably never guessed so many companies would be paying fines, facing new restrictions, and losing key executives.

Working together, agents, brokers, and companies can build a better, more profitable industry for everyone while improving the products and services they provide to their clients.

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NOTE: Burand & Associates, LLC is an advocate of agencies which constructively manage and improve their contingency contracts by learning how to negotiate and use their contingency contracts more effectively. We maintain that agents can achieve considerably better results without ever taking actions that are detrimental or disadvantageous to the insureds. We have never and would not ever recommend an agent or agency implement a policy or otherwise advocate increasing its contingency income ahead of the insureds' interests.

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