Why Great Loss Ratios are not the Goal of All Insurance Companies

by Chris Burand

Many agency owners take great pride in generating low loss ratios year after year. Maybe without even knowing it, this group has created a unique business model because my experience has been their growth is painfully slow, often their agencies are not managed closely otherwise, and they are often small. However, they are often very, very profitable. They are often the perfect cash cow in business school parlance.

These agency owners are not happy with many carriers who have de-emphasized loss ratios. They cannot fathom why any carrier would not LOVE their good loss ratios. The result has become stressed and fractured agency/company relationships.

These agency owners do not understand that loss ratios that are too low (and each company will define “too low” differently) are not in some companies’ best interests. How can too high of a profit margin be bad?

1. When loss ratios are too good, it may mean rates are too high resulting in too little growth. Companies, particularly stock companies, need to show growth especially after the softest market in industry history.
2. Similarly, if growth is too slow they may lose market share. Or their market share may be too low and they need to grow faster and capture more market share. Company management often has considerable pressure to attain specific market share.
3. Loss ratios too low may also mean that profit is not being maximized.

Maximizing profit is obviously important. Maximizing profit is not the same thing as achieving a high profit margin. The former is in dollars and the latter is in percentages. This is a crucial difference between running a company and an agency. Agency owners are well served to understand the difference. If a company wants to maximize profit, it must balance revenue generated by lower rates with higher loss ratios. For example, if a company has a 35% loss ratio and $100,000,000 premiums, its gross profit (excluding expenses) might be $65,000,000. However, if it decreased its rates and subsequently increased premiums to $125,000,000 at a 45% loss ratio, it makes $68,750,000 in gross profit.

Many agency owners would like to increase their books 25% and go from a 35% loss ratio to a 45% loss ratio too, but for agency owners focused on slow growth and low loss ratios, they probably will not get their share of that 25% growth but their loss ratios will still increase resulting in much lower contingency income.

Frustration greatly increases when companies price to a 55% , or higher, loss ratio. This is because profit sharing declines precipitously at these inflection points. The company still

makes plenty of profit at a 55% loss ratio (and if it does not, then the company has very serious expense issues that go far beyond the points of this article), especially if profit sharing expense declines. However, this group of owners makes most of their money in contingencies so their profit is eliminated. Their life style is curtailed. The value of their agencies is impaired. Their business model goes to shambles.

If a company is truly pricing to a loss ratio in the mid-50's or even higher, this group of agency owners might consider doing business with different carriers whose philosophies more closely match theirs. Easier said than done, obviously, so maybe a better solution is updating their business model. Growth is more important today to many carriers. Sitting on a cash cow annuity for a decade or more is not as feasible as it once was and wishing otherwise will not help.

Not all companies want to grow faster for market share or profit. They desire fast growth because:

1. Some key executive(s) bonus is tied to fast growth.
2. The company is being set up to sell.
3. The company has reserving issues and they need the extra premium to dilute the effect of a reserve increase. It is only a temporary solution but companies have done this forever. These companies are often the ones pushing growth most vigorously. Not only does fast growth temporarily hide their problem, it also makes the executive look heroic. Their fast growth is almost always created by low, unsustainable rates eventually resulting in higher loss ratios. The smartest executives are gone by then leaving their successors their mess to repair. Nonetheless, growth is initially far more important than profit.

Agents doing business with these companies may want to evaluate whether these situations create risks to the agency and its clients. If so, creating a plan to offset these risks can create excellent opportunities. Agents can fight these realities and fighting will feel good for masochists. An agency owner might have the luxury of only doing business with profit minded carriers, but very few won't be forced to do business with at least a few growth focused carriers. Don't keep telling carriers how short-sighted they are. Capitalize instead by understanding their perspective and using your resources to with the carriers you choose.

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December 2013