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In this issue...

When a Carrier Increases Rates by 22%

Why People Make Poor Decisions

Carriers and Socialism

Bait and Switch

Want to improve underwriting profitability?

If you are, this article will be of interest: "Barriers to Underwriting Accuracy & Profitable Flexibility." It is the second of a series of three articles about the role of accuracy in underwriting judgement.

https://deepcc.com/2023/11/08/barriers-to-underwriting-accuracy-profitable-flexibility/

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When a Carrier Increases Rates by 22%

What does it really mean when a carrier says they need to increase rates by so much? Let me translate: It means they screwed up.

They either need better actuaries or, assuming the actuaries made the appropriate rate recommendations in the preceding three years, their management team needs to listen to the actuaries. The fact is someone screwed up. It might be worth asking who got fired when the carrier announces these kinds of rate increases.

Why would a carrier need a 22% rate increase? For losses? Don't be so sure of this regardless of what the carrier states. Look up or have them give you the loss ratio for the applicable line of business for your state, even your metropolitan area. I recently provided an analysis to a client of their carrier's loss ratio, and it was 42% over the last ten years (with 36% last year). Where in the world does a 20%+ rate increase come from? A 20% rate increase indicates a loss ratio of 75% or higher.

An alternative possibility is that TIVs are a problem, and the carrier is trying to get rate to cover their TIV exposure. But the correct approach is to insure the property correctly at the existing rates. If this is the situation, then again, the carrier is incompetent because instead of calculating and insuring property correctly, they are cutting corners.

A result of cutting corners on TIVs is that insureds with the proper coverage will incur a rate increase and so will the insured with inadequate coverage. Both insureds will be screwed. The former will over-pay and the latter still won't have adequate coverage! The result is that the best insureds will shop and the ones with inadequate options will stay. And 22% is not enough to cover poor risks. An adverse selection toilet whirlpool is created.

But, most often, the real story in many of these situations is that the carrier is out of operational surplus, and they need accounts to leave.

Adequate surplus is always a ratio between premium and dollars reserved to pay claims (surplus) in extremely over-simplistic terms. When a carrier runs out of surplus but prior to insolvency, they can either find new sources of capital (loans, selling new stock, buying more reinsurance, or inflating the value of their assets--but that's not legal so I'm sure no one ever does this). Or, as quite a few carriers are discovering, new capital is too expensive so they MUST layoff premium. If they are really desperate, they will do whatever it takes, even eliminating high quality accounts, extremely profitable books, and if the situation is a little less worse, they will raise rates enough to drive business away.

It's a short-term fix, which explains the level of desperation, because the business that sticks won't be as profitable, even with a 22% rate increase unless they can somehow deploy a 22% rate increase without any material retention reductions (by account, not premium).

Additionally, the tail will usually hit. Agents should therefore expect a reduction in retention, more work, and reduced profit sharing.

Not all carriers have these problems. And some carriers that have these problems deny they have these problems. Some who deny do so because they really cannot publicly admit to their situation for fear of the equivalent of a bank run. Others though seem to be run by management teams that truly do not understand the situation. I have seen them swear they don't have a surplus issue the week prior to

borrowing millions with fairly steep interest rates because they had no other option other than eliminating profitable books, which they started doing a few months later because it turned out they couldn't borrow enough.

Agents have it tough in these situations. The best solution is to avoid these carriers from the beginning or at least minimize the amount of business placed with them in good times. I'm pretty good at identifying such carriers years in advance so this is not a crap shoot. But as many people have pointed out, most agents cannot sell anything but price so what's the point of aligning mostly with the strongest carriers? Valid point and therefore, I imagine these agencies find themselves in a tough spot today. So what now?

Move what you can. Get educated so you can better deal with these carriers and not exacerbate the problem by trying to convince them they're making a mistake. That's a pretty much pointless exercise in futility. Work to find the best accounts a better home on a proactive basis. Work to make the marginal accounts better by being sure you are providing correct information such as property dimensions, ITVs, usage (auto), and so forth. And accept you only have so much time and it is best spent on the better accounts. Let the other accounts, accounts that might otherwise stay, leave.

Then, most importantly, if you own the agency or are in top management, be a leader. No reason exists that going forward, producers and CSRs should focus on price. Doing so is an abdication of leadership. Many carriers definitely have their leadership issues, but so do many agencies and brokers. Elevate your agency or brokerage above the rest by offering your clients a professional level of service.

[Back to Top]

Why People Make Poor Decisions

An analysis of a U.S. intelligence operation failure concluded a key cause of that failure was, "We all have this tendency to look for information that confirms our beliefs and to ignore what conflicts with them. It's very hard to give somebody information he doesn't want to hear, and the more senior they are, the worse it is." --Peter Sichel

This is another way of saying, "Don't tell the emperor they are not wearing any clothes."

The insurance industry is at the cusp of dramatic change. Some days I am depressed when I see another announcement or article touting vaporware as the great solution. Or when I see some sales guru pushing a sales strategy that leaves consumers with worse coverage and increases agencies' E&O exposures. Or when I see consultants selling solutions that make agents' situations worse, not better, but agents will not know the difference until it is too late.

In every single case, these entities are telling agents, carriers, investors, and the public what they want to hear. They are confirming beliefs and ignoring contradictions.

On other days, like yesterday, a client emailed me with huge success stories based on actually solving problems for clients and how the clients had coverage they otherwise would not have possessed had my client not provided great advice in a manner where the client listened. I live for those stories because, like all humans, I want to hear stories that confirm my belief that agents and brokers who truly care about clients can make a huge difference in their lives. As another saying goes, "You always know who your real friends are when times get really tough." No one needs an agent when times are good, except to sell them the right coverages and advice for when times are bad.

I live to make life better for my clients and their clients. It is what gets me up in the morning. Every day, I see potential clients being led down the primrose path of siren delivered messages, and I wonder if there is anything I could say or write that would have saved them.

In full disclosure then, I love to work with people in the insurance world who desire to make a major difference in their clients' lives, their employees' lives, and their agency/brokerage and are willing to focus on the tasks, ignoring the shiny silver lures and toys so appealing to people. I love to work with people determined to make the world a better place through true, practical, real world risk management and insurance. A world that will abide by rebating and licensing rules. A world that will acknowledge E&O exposures. A world that will engage with clients deeply.

If you are in the insurance world in any capacity and are willing to do the hard work to win, and by winning, I mean doing the hard work to make the world a better place for your clients, your employees, your organization, contact me. I'd love to work with you.

I'll close with one of my favorite life quotes:

"The will to win is not nearly as important as the will to prepare to win. Everyone wants to win but not everyone wants to prepare to win. Preparing to win is where the determination that you will win is made. Once the game or test or project is underway, it is too late to prepare to win. The actual game, test or project is just the end of a long process of getting ready, in which the outcome was really determined. So, if you want to win, you must want to prepare to win. Once you prepare to win, winning is almost anti climatic." --Bobby Knight

[Back to Top]

Carriers and Socialism

Socialism involves minimizing the value of merit. In the world of insurance, where is the value of performance if every single agency gets exactly the same commission rate regardless of merit?

Historically carriers partially mitigated their socialistic commission schedules with profit sharing. But today, with so much aggregation, whether through networks or acquisitions, distributor books are so large that statistically, their loss ratios should mimic the carriers' loss ratios. Additionally, while virtually no carrier will admit it, one of the goals of predictive modeling is to achieve a balance between X% growth and Y% loss ratio. This means eliminating low loss ratios because low loss ratios correlate to low growth, eviscerating the balance. And the loss ratio goal is around 55%, too high for-profit sharing in most contracts.

Therefore, the mitigating effect of profit sharing is dead, but the industry is still pretending merit matters. Playing along with a carrier who still wants to believe their company emphasizes low loss ratios, consider the following actual results of an agency's book with one such carrier:

- Premium equals $10,000,000.
- Five-year loss ratio is 40%.
- Profit margin, all else being equal using the carrier's own expense ratios, is 30% on this book.
- Their standard profit margin is 12%.
- The profit sharing and any extra overrides equal 6% of premiums which is four percentage points higher than the carrier’s average (2% vs 6%). At a 14% commission rate, they are making 20% on $10,000,000 or $2 million.

- The carrier is making 18 percentage points more and only offering the agency four percentage points.
- The agency could easily double this book to $20,000,000 (this agency has excellent organic growth) and increase the loss ratio to 50%. Using an average 14% commission and the average 2% profit-sharing/override, they would make 16% of $20,000,000 or $3.2 million.

Which is the better deal for the carrier? They are making 18% on $10 million or $1.8 million. Or they can make 8% on $20 million which equals $1.6 million. Which option is best?

Yep, that's why socialism fails. It incentivizes marginal to poor results simply by failing to adequately incentivize quality results. At a 50% loss ratio, this agency would still be outperforming the company overall.

Most carriers are hyper focused today on expenses rather than loss ratios. This focus makes sense. My own studies show material correlations between expense management and carrier success, but only to the degree that expenses are not minimized in a manner that increases the overall combined ratio. A carrier arguing they cannot afford to pay more for an excellent combined ratio is cutting their nose off to spite their face.

I have designed a lot of compensation plans for carriers, networks, and producers. Compensation plans focused on merit drive better results. A carrier hyper focused on expenses will never achieve success with a socialistic commission schedule because there is no incentive for distributors to help the carrier decrease its expense ratio.

Three large barriers exist though to creating a merit-based commission schedule. From a regulatory perspective, rates include commissions and it is easier to include a flat commission applicable to all agencies in a rate filing than to include a variable commission schedule. But making this happen is why actuaries get paid the big bucks. If a carrier can employ 500 variables in their rates, they can surely address a variable commission schedule.

The second is simply accepting within the carrier that a variable commission schedule makes sense. The time has come. True, it means the company will need to talk to its agents to explain it. The shoe is kind of on the other foot here because this is what agents must do in explaining the huge rate increases.

The third is accepting the reality that a lot of agents will scream bloody murder. If you are an under performer being paid in excess and now someone takes away the excess unless you begin performing, humans naturally scream. Everyone wants a free ride and psychologically, no one thinks they are a free rider. I have had so many of these meetings that I can now clock each stage of the argument. Kubler-Ross's five stages of grief is an excellent model for how the meeting will go.

But this industry works on the Pareto curve. 80% of the production derives from 20% of the agencies (or if in an agency, the producers). You'll have more screamers than applauders, but the applauders are the ones that matter. Giving voice to poor performers is a mistake.

And if carriers do not begin better rewarding performance, adverse selection will accelerate. Many estimates suggest a majority of all commercial premiums are already in the Alternative Risk Transfer market (ART). Why wouldn't a great distributer decide that if a carrier is not going to treat them any better than poor performers, effectively resulting that agency subsidizing their competitors, not take that book to the ART market? This is already happening at the highest levels. But now, market mechanisms are making it easier and easier for agents and brokers to move smaller books and smaller but quality accounts into this space. The capital exists too because the providers recognize the opportunity primary carriers are ignoring or taking for granted.

Commissions should be based on performance. The agencies that generate the growth, or a reduced new business acquisition cost or (if the carrier wants high retention--not all do) high retention or whichever performance metric is most important, should be rewarded accordingly. Whether in business or national economies, socialism causes results to be worse than what the mean otherwise would be because the incentive is to lag and that's what the current commission structure emphasizes. If you want to be a winner, reward merit.

[Back to Top]

Bait and Switch

So much traditional insurance advertising is designed to imbue confidence. Whether the word "trust" or symbols of trust are used, the message is you can trust us with your insurance, which implies trust us to settle your claims fairly and well. In turn, this means we'll provide you with the coverage you need. This logic chain is not to be disputed unless, in arguing, you are suggesting that some part of this trust chain has a weak link upon which, should not be trusted.

And it turns out, a weak link does exist. In fact, the industry time after time has dared insureds to pull the chain only to see that link break. That weak link is the case law standard of care that says insureds must read their policies, and by implication, understand their policies. By implication, this means insureds must also understand their risk exposures so that when they read the policies, they know what coverage is lacking and they are therefore motivated to call their agent and request the missing coverage.

In a nutshell, coverage is promised but when questioned, the industry asks the insured if they've read their policy and ascertained whether the coverage provided is adequate. Isn't it oxymoronic to say, "Trust me, and you still need to very carefully read and thoroughly understand your policy because you might not have the coverage you need"?

If I go to an attorney, I don't pretend to have a law degree. I'm hiring an attorney to assess my situation and advise of the best solution. I don't hire an attorney to give me a boilerplate answer that necessitates me to research the law, understand the law, understand all the legal language, and so forth. But that is what the insurance industry does when it is selling legal contracts.

I don't need a trusted advisor that when push comes to shove asks, "But did you read your policy?" I've taught insurance to agents for 30 years and most agents don't know their coverages well enough, often by a long measure, so the standard for insureds to understand their policies is not a fair standard. At the basic level, using personal lines, should they identify the address, vehicles, drivers, and whether they want $100,000 or $300,000 coverage? Absolutely. Should consumers understand the in's and out's of UM/UIM per the various forms and case law? I don't think so.

Someone told me today that I am wrong because by telling fake stories and suggesting coverage that does not exist, he has world class sales. Many people today do this and then hide behind the standard of "read your policy."

This industry would do itself a favor if it outlawed the bait and switch of telling people to trust us but then requiring them to read their policies in full detail to assess their coverage needs and the coverage afforded. If an agent says, "I will be your trusted advisor," then they should be doing the policy reading with the insured and completing a thorough risk assessment. Doing so leads to more sales and better relationships.

Otherwise, bluntly, agents selling coverage without assessing coverage needs are only worth 9% commissions. Sooner or later, carriers are going to figure this out.

[Back to Top]

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Burand has more than 35 years' experience in the insurance industry. He is a featured speaker across the continent at more than 300 conventions and educational programs. He has written for numerous industry publications including *Insurance Journal*, *American Agent & Broker*, and *National Underwriter*. He also publishes *Burand's Insurance Agency Adviser* for independent insurance agents.

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