Burand's Insurance Agency Adviser

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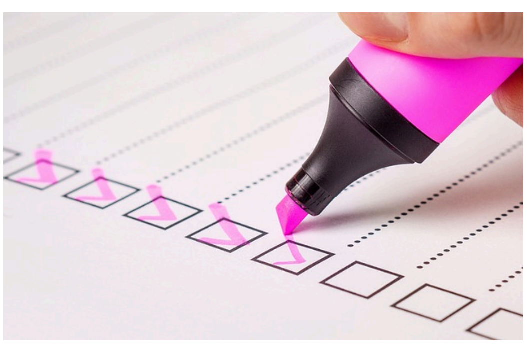

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Wait! There's more...

With E&O, Prevention Really is the Best Medicine

E&O loss exposure is a major concern for most agencies, and rightfully so. Many steps can be taken to greatly reduce an agency's risk of an E&O suit.

As an approved E&O auditor for Westport and Utica, Chris Burand conducts a comprehensive review of an agency's procedures from an E&O perspective and provides recommendations for minimizing E&O exposures while better serving the needs of the agency's customers.

While no recommendation, procedure, or process can totally eliminate the possibility of an E&O claim, agencies can take steps to minimize their exposure to E&O incidents.

A Burand & Associates' E&O Procedures Review provides the framework every agency needs to start taking preventative measures to minimize their E&O exposures!

Contact Chris today to get started: chris@burand-associates.com.

NOTE: The E&O Procedures Review contains a framework and recommendations which should allow your firm to minimize its exposure to E&O claims and incidences. No recommendation, procedure or process can totally eliminate the possibility of an E&O claim or incident. Therefore, Chris Burand and Burand & Associates, LLC neither guarantee nor suggest that the recommendations in an E&O Procedures Review will eliminate the possibility of an E&O claim or incident and should not be relied upon as such.

Recommended reading:

Fred Fisher's recently published book, "Claims-Made Insurance - The Policy That Changed the Industry," is a valuable resource for insurance professionals. Fred truly has a wealth of knowledge and this book covers the history and important details of claims-made policies.

Fred's book is available on Amazon at: Amazon.com: Claims-Made Insurance - The Policy That Changed the Industry: A Deep Dive, Review, and History.

Fredrick J. Fisher, J.D., CCP, is President of the Fisher Consulting Group Inc. (www.fishercg.com).

A few interesting questions...

...at least for me, for agents, brokers, and regulators regarding certain companies' results:

1. How does it make sense that virtually every single year a company's realized investments are negative, but their unrealized investments increase significantly in value?

2. Why only cash out the losing investments every single year?

3. How does it make sense for a company's admitted assets to decrease almost every year while its surplus, supported by unrealized asset appreciation, increases annually? Which is more important, admitted assets or surplus?

4. How does a carrier who materially underperforms its peers in underwriting, loses a considerable amount in underwriting annually, has losses in its realized investments annually, and never materially grows somehow outperforms its peers by a huge amount in the appreciation of unrealized investments, especially unrealized affiliated investments?

5. The odds are arguably long that a company otherwise so inept can achieve the best results, by far, in this one specific but vital category. I wonder what a hard-nosed audit of specific assets by a truly independent third-party with no interest in appeasing the carrier would value those appreciated assets?

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Additional Insureds and Unintended Consequences, by Bill Wilson

If you work in commercial lines, you've seen these...requests for additional insured (AI) status where the list of additional insureds is longer than the AI endorsements used to add them. For example:

> "XYZ Catering, Inc. (d/b/a XYZ Creations), ABC Sports & Entertainment LLC, ABC Holdings LP, the DEF Center, their respective principals, members, officials, officers, directors, shareholders, employees, and agents, their respective parent and affiliate companies and their respective Successors or Assigns as now or hereafter may be constituted and the Centennial Authority, the City of Raleigh, North Carolina, the State of North Carolina and their departments, divisions, commissions, and boards and their respective principals, members, officials, officers, directors, shareholders, employees, and agents have been named as additionally insured's [sic] under said policy with respect to any legal liability arising out of the Licensee's performance hereunder."

In the example above, the requestor that this language appear on the certificate of insurance was a venue hosting an event where the vendor who was required to name all of these entities as AIs was a guy pushing a hot dog cart.

A similar request was made a few months ago by a tenant wanting to be an AI on a landlord's CGL policy. While it's more common for a landlord to insist on being an AI on a tenant's CGL policy, a tenant with more clout or a better bargaining position may insist on being an AI on the landlord's CGL policy. This was the case in a claim that was brought to my attention where the tenant wanted itself and a laundry list of others, including employees, added as AIs on the landlord's CGL policy.

The claim consisted of a lawsuit by a customer of the tenant who was run over in the parking lot by an employee of the tenant. The landlord was being sued allegedly for an obstruction that that contributed to the accident. The landlord had no auto insurance of his own, only a CGL policy. The landlord's CGL policy included this 'auto' exclusion, identical in language to the ISO CGL policy:

> This insurance does not apply to "bodily injury" or "property damage" arising out of the ownership, maintenance, use or entrustment to others of any aircraft, "auto" or watercraft owned or operated by or rented or loaned to any insured."

If the exclusion is read solely from the standpoint of the landlord as the insured, the auto in the accident was not "owned or operated by" or "rented or loaned to" the insured (landlord), so there would be coverage for the landlord under his CGL policy. However, the tenant's employee had been added as an AI on the landlord's CGL policy, so the auto was "owned or operated by" 'ANY insured,' thus triggering the exclusion for all insureds under the landlord's CGL policy.

In this scenario, by adding the tenant's employees as AIs, the landlord removed coverage for himself under his own CGL policy for auto exposures involving "any insured" (including

AIs), something probably not contemplated by anyone when the AI coverage was effected. The term “any insured” appears 25 times in the current ISO CGL policy.

Understanding insurance policy language can be difficult. When you consider such language in the context of claim scenarios, understanding the implications of coverage (or lack thereof) can be even more difficult.

Published with persmission from the author:

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Fast Money

Humans have always been attracted to fast money like moths to flames. Nothing is new in human behavior, at least in this regard. The difference today though is how technology can now measure how strongly attracted the moths are to the flames.

An old-fashioned analysis of a gold rush is a good example of people chasing easy, fast money. This example is very relatable versus discussing financial engineering, huge debt loads that are not really debt but sort of is debt, derivatives, cyber currencies, and so forth. In an old-fashioned gold rush, the Klondike is maybe the most assessable example because the old photos show the gold rush so plainly: a stark dark grey line of men going straight up a white mountain. Thousands of men with no mining experience gave everything they had, including their lives, for the potential of becoming insanely rich for nothing but their labor and whatever grubstake they could gain and spend. They had to climb that huge mountain multiple times because the Canadians posted guards at the top not letting the men go further until they had packed enough materials to meet the Canadian asset requirement. This requirement was designed to prevent the miners from starving because once at the mountain top, they still had to walk and float down rivers for hundreds of additional miles. It was arduous and the journey claimed many lives.

Almost none of the miners got rich and few made any material money. Who made money? Those mercantilists selling them the gold pans, shovels, saws, axes, rafts, and food. Some significant fortunes were made by these retailers. People selling their claims for high prices, land that didn’t have any gold did all right too. Sometimes these were honest sales where in a seller’s market, the seller took advantage of the buyer’s short-sighted greed. In other cases, the seller salted the claim and took even greater advantage of the buyer’s greed. The saloons and alcohol sellers did well too, as did some of the steamship owners. All these entities made much more than 98% of the miners.

Gold fever was a good name for this kind of lust for fast riches.

Most of the time though, measuring the intensity of this lust has historically been difficult to impossible. One of the great things about the internet is the ability to count views. Of course, valuing a company based on views is ridiculous. However, measuring the interest in subjects and with the right technology, even identifying why interest exists (i.e., the social media interest-based algorithms), is possible.

What does all this have to do with insurance? We have new short-term, fast money interests coming into the industry that probably are not going to be healthy.

The new, fast money is related to investors either propping up new carriers or starting new carriers in difficult markets, such as cyber. Please do not read the following as throwing every such entity under the bus because I'm not. Some of the new markets are being developed by people more capable than many of the people running regular insurance companies. Quite a few of these entrants are not only more capable, but they're also after fast money.

A common example is when someone starts or invests in a company and then charges that company a service fee. Usually, this fee is around 20%. Insurance carriers' total underwriting expenses including reinsurance and commissions needs to be less than 30% if they have a hope of surviving (some exceptions exist in specialty lines). If the charge prior to commissions is 20% and commissions average even 10%, there is no money left for carrier salaries, reinsurance, IT, or anything else. But the investor gets their 20% of premiums anyway, slowly eating up surplus unless the carrier can achieve a superb loss ratio, which most don't achieve. And if the carrier goes bust, the investor does not have to return the 20% of annual premiums for the years they collected. And frankly, in analyzing some of these service agreements, I can't figure out what they are providing that is worth 20%.

The damage is especially problematic if the investor gets their hands on surplus and pulls that surplus out of the carrier, leaving the carrier in a precarious position. I hope the insurance commissioners are watching these developments carefully.

Enough carriers are weak after making horribly bad investing decisions (who would have ever thought interest rates might increase from historic lows?) that they need significant capital contributions. We have geographies that have serious insurance deficiencies. Sharks see the easy prey perhaps like the hucksters who took the steamboats to the goldfields getting there prior to the miners climbing the enormous mountain.

The miners' greed made them culpable even if the fraudsters committed the actual crime. And the greed among agents is significant. We can measure how many people read articles that address the opportunity to make fast money versus the number who read articles related to how to increase a firm's value or increase operational efficiency or anything that requires effort. If this article was about getting rich quick: "The 3 things that will generate $100,000 in new sales this month," it would be read by 100 times more people. A sensational article on sales would be fake, but the lust for riches creates focus on fake.

My grandmother told my grandfather that if he wanted to be a gold miner, he needed to learn how to be a miner and how to mine profitably. He obtained a degree in mining engineering, a difficult degree especially before computers when all the math had to be done manually. People generally would rather roll the dice to try to get rich quick rather than working for a better probability of making good money methodically.

But the people and firms that work methodically make so much more money over time and usually simultaneously build something good for society. One of the reasons methodical-work is more assuredly successful is there is less competition. If everyone is chasing the same pot of gold at the same relative speed, only a few can ever succeed because the competition is too intense. With fewer people working methodically, less competition exists.

The miners making multiple trips over Chilkoot Pass in the Klondike were desperate, stupid or simply so consumed with gold fever they became desperate and stupid. And at every stage someone more methodical was willing to take advantage of them.

Only a few people will read this article but the probability of the people who do read it being methodical in nature is high. My suggestion is to build a strategy that works in the long term by taking advantage of the myriad mistakes people with get rich quick minds will make. But always beware not to fall into this trap yourself. Gold fever can be contagious!

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E&O and the Hard Market

This is the hardest market since 1987-1988 and that was a casualty hard market. I do not have any idea when such a hard property market existed in history.

Hard markets are always caused by a shortage of surplus. Hard markets are not caused by one or two years of poor loss ratios. In 2023, insurance companies made record profits. Lack of profits is not the problem, no matter what your carrier is telling you, unless your carrier is especially incompetent.

When companies run short of surplus, agents' E&O exposures increase for many reasons. An obvious reason is agents must do so much more work with the same staff. Increasing workloads materially naturally increases error rates.

And hard markets are a tough time to hire and train new people, which are tough to find anyway. Agents might then be hiring slightly less qualified people and training them in a tough environment, which is going to increase error rates too.

The additional exposure is also increased when the agency tries to save their clients money. When switching carriers, a careful coverage comparison is required. If any coverages are reduced or eliminated, the agency needs to advise the client correctly and preferably in writing. Then give them the choice rather than making the choice for them as to which policy they prefer. Failure to take these extra steps increases E&O exposures significantly.

This exposure is especially large if the agency moves a client to surplus lines. Even if surplus lines is absolutely the only solution, if coverages are reduced or lost, the agency must explain the lost coverages. Then, in surplus lines, the agency must advise the client of the extra risks relative to surplus lines such as the lack of a guaranty fund and options to reduce coverages without notice.

Exacerbating the situation further, some carriers are greatly increasing deductibles. It seems reasonable that if they take away coverage, rates should decrease but that is not happening. This causes more frustration resulting in clients doing more shopping. This means more work at renewal to keep clients. After all, what happens when a client's deductible is significantly increased and the agency does not offer better options or at least a good explanation?

The size of these deductible increases creates an ethical issue too. I believe agents owe, on an ethical level and not just an E&O prevention level, an explanation of the trade-offs between roof deductibles, for example, and affordability. Some of these deductibles are now so high that financially, it's a toss-up as to whether insurance is worth the price. This is especially the case where roof coverage is limited to actual cash value, a de facto huge deductible.

These coverage reductions, including sky high deductibles, has reversed 75 years of coverage progress. Agents used to have a find a property market and then marry that coverage to a separate liability market, even in homeowners. They earned 20%-25% more commission too. At 12%-15% commission, agents are going to have to do the same thing. Difference-in-Conditions (DIC) policies will be required. Whether it is wind/hail coverage as one policy and a property policy that provides normal coverage, other than wind/hail, or maybe wildfire coverage (which has existed for decades in California), agents combining different property coverages is the inevitable solution. Regular carriers have announced plenty loudly that they are giving up on insuring natural catastrophes.

Combining different forms creates complexity, and complexity leads to E&O exposures. And combining the different forms at lower commission ratios creates additional pressure. Pressure correlates to mistakes.

Returning to the subject of guaranty funds, I suggest agents become familiar with their state's guaranty fund limitations. Most states' guaranty funds have severe limitations. To qualify for coverage from the fund, clients must meet specific requirements, usually size requirements. These requirements have not been updated in decades so many more clients will be excluded today from guaranty fund coverage than 20 years ago. When clients are placed with carriers that go insolvent (insolvencies are correlated with hard markets) and they do not get the claims paid, they often have no choice but to sue their agents and hope they get money. If they are excluded from coverage because they're too big, or if the guaranty fund is too underfunded, or simply if they take too long (five years to make a payment is not unusual in my experience), they may have a reason to sue because the agency failed to do adequate due diligence on their client's carrier and/or failed to explain that while the agency placed the client with an admitted market, it might as well have been surplus lines from the guaranty fund angle because the client was too large to qualify for guaranty fund payments.

This is especially true as more and more accounts are placed in surplus lines and exotic markets. Agents will need to do thorough due diligence on these markets. I encourage readers to research some of the articles in *Forbes* online and the *Insurance Journal* regarding insurance frauds, real and/or possible in the eyes of some, that have caused significant problems and lawsuits over the last three years.

Hard markets create E&O exposures for all these reasons and possibly one more reason: Carriers tend to not pay claims as easily or at least initially rejecting otherwise legitimate claims. I am definitely hearing this is the case from just about 100% of all the agents with whom I've spoken on this subject. Friction like this causes insureds to get angry and sue.

Take care and remember that one of the best ways to avoid many of these situations is to place business with the most financially solid carriers, carriers truly looking to grow. Take steps to improve your procedures and verify your employees are following those procedures. Be sure to provide clear caveats and disclaimers to your clients. And check those policies!

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Insurance Company Inanity

My research suggests insurance companies are in far more trouble than is being made public. Just think about these recent actions taken by insurance companies:

- A $10 million book with a 32% five-year loss ratio "must be moved".
- A $7 million book with a 37% loss ratio that was so bad, so horribly bad (satire here), that the carrier could only afford to write it directly (although it did not appear like they wrote it directly because of the hidden ownership of the agency to whom they wanted it moved).
- A statewide book with a 42% loss ratio that needs a 20% rate increase.

What other industry, besides banking for similar reasons, throws away multi-million-dollar revenue streams with 25% profit margins and ROIs that exceed 20%? Only two explanations exist, and both are plausible. The first is sheer stupidity, which is the cause in some of these scenarios.

The second though is desperation. The three carriers noted above, based on my financial analysis, are in such severe trouble, they must eliminate premium to the point that their reduced surplus becomes adequate. In other words, instead of raising capital, which they cannot do in the short term, they must reduce premium to attain an adequate surplus to premium ratio.

They cannot tell agents this. So they develop some of the most cockamamie explanations possible leaving agents wondering if the carrier executives have lost their minds. I feel for one or two of these carrier executives who know what they're saying is ridiculous and their morals are such they really struggle with the rationale they are giving.

Like a bank, an insurance company requires $X of surplus (defined as: an estimate of the amount by which an insurance plan's assets exceed its expected current and future liabilities, including the amount expected to be needed to fund future benefit payments, per lawinsider.com) to support $Y of premium.

Those assets vary significantly from company to company, and within an individual company, they vary in quality. It is a myth that insurance companies must maintain their surplus in high-quality bonds, high-quality stocks, and cash. Some carriers invest heavily in junk bonds as an example.

Let's assume though for the following example that this carrier's surplus is all high-quality pure cash (which it never is):

A carrier (I am using real numbers here) has $1.5 of surplus supporting $1 in premiums. What virtually no carrier seems to publish in press releases is that quite a few lost 10%-25% of their surplus in 2022 due to bad investments. Investment losses were far worse than any increase in claims for many carriers, but some who lost their investments also had high loss ratios too. These carriers are really hurting.

The example company's surplus, after investment losses, is now $1.13, but rates increased 10% so premium is now $1.20. That is a huge reversal in their surplus to premium ratio. This company cannot likely survive without fixing that ratio. They have three choices:

- Raise capital to increase surplus and they can generally achieve this through these primary methods:
  - Sell equity
  - Borrow money
  - Buy reinsurance
- Reduce premiums
- Achieve some combination of the first two options

Capital in all three forms (equity, debt, reinsurance) is expensive today and who wants to invest in an insurance company needing to shrink significantly? Growth then must be below 0% to survive. Eliminating profitable books is not smart, but an act of desperation. To eliminate such profitable books is a red flag as to how desperate the situation is.

The executives that do not understand the root of the problem, a problem that has been building for years and that I predicted with high accuracy carrier by carrier years ago, will likely screw it all up again. One such executive told me, “But we have $100 million in cash.” And I said, "but you lost $500 million." He will make the same mistake again if he does not retire first. But my point might be my envy. I looked up his salary. I wish I was paid that much for losing $500 million. He must be right.

Other carriers will learn from their mistakes and some did not make these mistakes. They are in the proverbial catbird’s seat. They are in an enviable position that will give them a permanent increase in market share.

If you are running an agency or brokerage, what do you do? I consult for many agencies and brokers specific to this question. Often the first response to my initial suggestion, to eliminate weak carriers, is that producers do not care if a carrier is strong or weak. They just sell price, so why bother addressing these points?

It’s time to be a leader. Are you leading the agency or following your producers? A leader is going to lead the agency/brokerage in a direction that partners with strong vendors providing value beyond the next sale. Control how and where business is placed. Focusing on the stronger carriers is better for your clients too so your interests are aligned with your clients’ interests.

Your producers are selling price with weak carriers for one of four reasons:

- The producer is incompetent relative to coverage and quality.
- They are lazy.
- Management lets them get away with putting themselves ahead of the welfare of their clients and the agency.
- It's the only carrier left!

How are any of the first three reasons good other than building something for someone else to clean up? Unless the agency itself is desperate.

Agents contribute to the inanity of carriers by placing business with carriers lacking strong operating surplus (not solvency surplus, which, simplistically, can be created by eliminating good books of business).

This market is going to weed out some carriers and the best returns are to align with the strongest carriers even if you must force your producers to do so. I encourage you to be the leader your organization needs to align with the future.

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Chris Burand is president and owner of Burand & Associates, LLC, a management consulting firm that has been specializing in the property/casualty insurance industry since 1992. Burand is recognized as a leading consultant for agency valuations and helping agents increase profits and reduce the cost of sales. His services include: agency valuations/due diligence, producer compensation plans, expert witness services, E&O carrier approved E&O procedure reviews, and agency operation enhancement reviews. He also provides the acclaimed Contingency Contract Analysis® Service and has the largest database and knowledge of contingency contracts in the insurance industry.

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Regulated individuals/entities should also ensure that they comply with all applicable laws, rules, and regulations.
