BROKER'S PATH

PERPETUATION PLANNING
OPERATIONAL EXCELLENCE
MOVING THE NEEDLE

Pathways Report

"Calamity Casualty"

"You sure you wanna do that?

As insurance carriers' illuminati migrate to their post Labor Day planning sessions, Independent Agencies everywhere would like to offer them some friendly advice. That is, before Marketing Reps materialize with *"2011 Results Expected"*.

Historically, the law of self preservation dictates what one can and cannot say to one's carriers. As a result, the chatter between carriers and agencies is limited to the daily rigors of pricing, underwriting, and servicing their mutual customers. Normally, that's a good thing. But, "normal" hasn't been on the menu for quite some time now. So, to all of you who rely upon agents and brokers to peddle your products; sit back, order-up a Ritalin smoothie, and concentrate on the state of your distribution system. "Blunt" is now on the menu compliments of this month's *Pathways Report.*

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Dear Calamity Casualty,

There's a lot of noise these days about returning to basic economic principles, so let's start there. First, and foremost, insurance agencies are your primary customers. I know, that's a pretty controversial position, but it is still, nonetheless, true. If you care to discuss this basic

precept call "What's his name", the guy (unisex term) who ran things before you… the guy who always went to bat for "his" agents, even as the whisper campaign against him grew louder in Home Office. He understood that his sales force (agents) were independent business owners more than they were insurance peddlers. He often left the actual business of "insurance" to those who didn't understand that distinction. His successors still issue polices but, back in the day, *he made policy!* Your customers, agents and brokers, miss that dude.

Ask yourself; if the agenda you just sent around to your planning meeting participants mentions agency perpetuation, cash-flow, new producers, negative growth rates, bank lines of credit, office building "lease-back" loans resetting, or the overall viability of your sales force? If not, then you best keep reading.

I suppose you could say: "That's not what our planning meetings are all about." Really? Why not? Could it be that Home Office believes that their RVP's are in the loop? Here's the deal: RVP's rely upon their Branch Managers to be aware of such things and Branch Managers rely upon Marketing Managers and Agency Councils. Well, with all due respect to Marketing Managers, that's a discussion they don't understand and asking your elite Agency Council members to discuss their structural challenges in a group setting is like asking Catholics to hold group confessions with their neighbors! The real juicy stuff will never come out!

Start by asking yourself one question. When was the last time you were shown your core agencies P&L? Come on, admit it. You haven't seen an agency's P&L since someone in the Eisenhower era appointed the agency a half century ago! That's why agents participate in exclusives like Assurex and Intersure. Yes, you talk to agencies when you gather in warm places (only to "1099" them when they attend). But, the conversations you have are nothing like the discussions your agents have amongst themselves during the breaks or in the bar when the truth serum starts flowing without you.

Agencies aren't giving you the unvarnished truth because "A"- they don't want to shake your confidence by revealing very private matters and "B"- you wouldn't know where to take that conversation if it actually occurred! Seriously, do you really think your best and brightest agencies want *that* discussion reaching your RVP? Moreover, Mr. /Mrs. Branch Manager, do you?! Now do you see why "what's his name" who ran the territory before you is so direly missed? He not only had those conversations with his sales force, those were the only conversations he had with his sales force! Who in your company is doing that now?

Every single minute of every single day agency owners are having those discussions with *their* sales force: Producers. That's what they do for a living. As a reminder, they're the folks who sell your legal contracts. They fund loss control and risk management services at great expense so that your expenses (claims) are reduced. Basically, they sell "you" in all of your manifestations. Which is weird, because selling insurance (and bonds… let's not forget bonds) is what you do, too. Only, you don't actually sell those policies yourselves. That is, unless you're Hartford, Zurich, Federated, or a growing number of Carriers who use the word "dabble" to describe direct competition. You rely upon other businesses to do your selling. I guess you could do it yourselves but, other than those who dabble, you don't. The reason is pretty simple.

You can't come close to selling your legal contracts as cheaply as agents do it for you. They burn through ninety cents of every dollar they get selling your stuff (if they're good at it). Your cost of sales is 13.6% on average (commissions) plus profit-sharing. Which, is one of the reasons AM Best says your surplus is just fine. Meanwhile, your agent's balance sheets are quickly eroding! There's a disconnect, and I think I know what it is…

Willy Loman Risk Services…
(Death of a Salesman)

"Agents have it made, alright. Meanwhile, Calamity Casualty is pulling back on everything. We're facing another round of cutbacks. Our salaries are frozen. Last month, Home Office shut down another branch office. But, from the looks of things, every agent I call on is doing just fine! Agents are a bunch of under-dressed, rich dudes with multiple homes and personalities; if you ask me. I should have become an agent when I was younger. I'd be set. The Willy Loman Agency… Expensive cars, a place at the beach, I'd be set if I had just made the move. I came close, once… making the switch from company life to the good life. There was this small shop in St. Louis. They needed a Producer. I couldn't make sense of it at the time, straight commission and all. You know, kids and the wife… I stayed with the company. But, man, if I had made the move, I would' a killed them in St. Louis!"

(The defining reason why many (not all) carriers fail to recognize the tenuous situation amongst their sales force: They (you) believe agents *still* have it made.)

"The Future Ain't What It Used To Be"
(Yogi Berra)

The value of agencies has fallen dramatically. Agency cash-flow is tight. Your sales force is doing more with less and has less to show for it than at any other time in their career. *Their* clients can barely pay their invoices. As a result, succession planning; the core fundamental of agency life, is not the priority. At the opposite end of the discussion; M&A has basically cratered. The combined effect results in the average age of your sales force going up. History offers you a glimpse of what that means when this happens.

When a British tobacco company (B.A.T.) sold/merged Farmers Insurance (Truck Exchange, et al) into Zurich, the average age of Farmer's agents was 45 years old (1998). Fast forward a dozen years and the average age is now 55½. Farmer's recruitment of younger agents tailed off for a variety of reasons, but Zurich didn't pick up the slack because of an inherent conflict. Some believe that conflict was your agency force: their independent sales force, who might object to Zurich training more competitors.

And so, Farmer's distribution system aged. In response, Zurich/Farmers juiced their personal lines holdings the only way they could. They bought it from AIG. They expanded Ohio State Life (direct) sales. They juiced "Zurich Direct". They expanded Universal Underwriters (direct sales) auto dealers program. Recently, Zurich opened its doors on 50-classes of small commercial to non-appointed agencies. Farmers (not Zurich) now services Zurich's bell-weather small commercial lines unit. Zurich is responding to the times and, so they should. Both Farmers and Zurich are fine companies, in fact very fine. But, the lesson of history is unmistakable. The Great Depression, the San Francisco fire, six recessions, world wars, famine, and totally lame Major League Baseball commercials didn't materially affect the make-up of Farmer's sales force. Over time, the trend away from youthful producers did.

History is nothing if not repetitious.

New Producers in independent agencies are now the urban legends of yesteryear. If this perpetuation killing response lasts a few more years, which it probably will, your distribution system won't be the same even if it looks the same to you, which, candidly, underscores the problem. Read *Perpetuation 102:* Broker's Path Article .

In the immediate future, cash-flow underwriting will continue and probably get worse. As a result, companies will continue to load-up policy freebies and give away coverage. Loss ratios will continue to go up which, by definition, means contingencies checks will continue to go down. Eventually, Home Office will blame the results on you, because they are, after all, *your results.* That's when you'll turn to your Marketing Manager and demand that he/she tell you what's wrong with this picture. Gravity is less predictable and yet, most carriers haven't a clue what's happening to their sales force and by extension, to themselves.

"The INTER-Dependent Distribution System"

Six out of ten agencies/brokerages are Sub-Chapter "S" Corporations which means that their corporate taxes pass through to the agency owners. In the past, contingency checks (due by March 21st or you can't expense them in the prior year) were used to file your agent's estimated taxes due on March 15. Agents often used bank lines when the profit-sharing lottery didn't pay off as expected. These days, a "bank line" is a Latin word bankers no longer speak. So, your sales force will be going from plan "B" (bank) to plan "C" (as in "see" if the owner's spouse will sign a personal guarantee on agency debt). It's a corporate "S" storm brewing on the horizon and it affects everything you do as a carrier. And yet, only a handful of carriers we regularly speak with have ever talked about their agencies in these terms.

If you can't literally "lend" a hand, agencies will strike deals with those who will… Great deals and preposterously dumb deals to be sure. Ask "the old guys" who CIGNA or INA were (long gone) and then ask them what COMPAR was when the perfect Sub-Chapter "S" storm came along during the Carter Administration. Does Norm Blake's USF&G ring a bell? (He copied the COMPAR strategy. Both flopped.) If you have no idea who these companies were and what

they did then, by definition, you simply have no idea what can and, is about to happen again. Carrier consolidation and realignment is also following history. What do you think Liberty Mutual's IPO is all about?!

Consider Aetna C&S, once the largest carrier in the land. On the east coast, you couldn't process oxygen without an Aetna appointment. It had no equal. In exactly the same kind of marketplace we see today (economic dumpster fire and insane policy pricing) Aetna's CEO: Bill Bailey sent a letter to every Aetna agency announcing that he would single-handedly put an end to cash-flow underwriting and begin to raise rates. The "Bailey Letter" brought-on adverse selection against Aetna in epic proportions. History left its mark. Carriers all move in unison now… down.

Aetna's official "time of death" came in the form of a Traveler's rescue of Aetna's asbestosis claims. Unofficially, the "cause of death" was when cash-strapped Independent Agencies had to choose between "mother Aetna" as it was called, or the dozens of regional carriers who could and would do anything for their cash-strapped agencies.* The small regionals without "tail" exposures ate Aetna's lunch. Agents broke ranks with mother Aetna. That precise scenario is, once again, occurring because carriers can't see what's happening to their distribution system. (*Incentives like: "The Pen"; Exclusives; Programs; Agency Loans; New Producer Loans that were forgiven; Temporary lines of Credit; Marketing Reps with insane underwriting authority; Underwriters in shops completing applications for things called "bordereaux" book transfers; Producer trips and vacations that made Roman Festivals look like catholic communion.).

As a percentage, the largest tax increase in America's history will take effect in 90+ days as of this writing. It may not happen (uncertainty squared) but, if it does, agency owners will pay 18% more (from 33% to 39%); which is fine because they're rich, right? But, they're not alone. The agency's receptionist's tax will go from 10% to 15%. That's a 50% increase. Every agency employee in America will pay substantially more tax as things look now. November may bring a new outcome, but if it doesn't then funding those taxes will come at the expense of something else: agency perpetuation.

The "Affordable" Healthcare Act prohibits agencies (all employers) from increasing employee cost sharing by more than 5%. Further, if employers increase co-pays and/or deductibles 15% more than medical inflation (officially 8% per the Feds) (23% total) then the employer (your partner agencies) loose the "grandfathered" protection of their health plans. Increasing a $20 co-pay to $25 (25% increase) could conceivably blow-up the agency's plan. Meanwhile, healthcare insurers are rolling-out significant increases in order to rat-hole surplus for the oncoming erosion of that surplus. If your agents don't eat the increases, they're in trouble. If their clients don't buy group plans through those very same agencies, they're really in deep do-do.

Nationally, Benefits revenue makes-up 14% of an agency's top line. That Benefits revenue falls to the bottom line at a much higher percentage when compared to P&C revenue which explains why your agents peddle the stuff. How on earth could this issue not be on your

fall planning agenda? Those Benefits revenues play a huge role in funding the perpetuation of your sales force!

I know, "Cry me a river." Agents are rich and everyone knows it. They'll do just fine… So, how's that gonna play out when the Feds takeover the states' Insurance Commissioner's duties? The legislation is about to be brought to the floor of the Congress. "Bipartisan support" is how they're selling that one. It wouldn't surprise me a bit. Insurance, what you do for a living, is now deemed to be in the "systemic risk category" by TurboTax Tim at the Treasury. And, let's face it. You are by definition, in a pretty risky business, I suppose. So, guess who is about to get a new daddy?! (Cry me a river.) Not on your agenda either, huh?

Workers Compensation is a little something most employers buy to keep from going to jail. In speaking to a Comp Carrier all of you know, I was told that they would react to the healthcare legislation the same way they did when Canada converted to a national health plan, which is nice. I like Canada. It's beautiful there. But, did you know that after your neighbors to the north implemented healthcare legislation, suddenly every claim became "work related"? Docs and providers got paid better and claimants didn't have to wait weeks to get-in. Losses soared for Comp carriers. Eventually, Insurers pulled the plug (Note to self: look into that if you or your agents sell Comp.)

Let's suppose that there's an orderly uprising and Obama Care (as it's called) is defunded or repealed. Let's suppose a new Congress unwinds the financial reform act(s) which effect how insurers (you) are regulated. Let's further suppose Congress extends the Bush tax cuts and resets the capital requirements on toxic bank assets so that they will lend again. Let's even suppose that the 50% inheritance tax is repealed so that agencies don't have to abandon their perpetuation plans. OK? So, now imagine any of those things landing on the Resolute Desk in the Oval Office for signature. You can't possibly believe the President won't veto every last one of those things given the lack of a supra-majority to override his veto! The carriers who draw close to their agencies will survive regardless what does or does not happen.

Naturally, not everyone shares my view of the struggles independent agencies face. Chief amongst those who say "yeah' but" do so for the simple fact that some agencies are still doing better than "OK" and the majority are still holding their own.

OK, fair enough. Let's break that down, shall we?

Doing Well:

This band of over-achieving, highly profitable, manically obsessed with growth folks is doing just fine, not like before, but they're doing OK. That's because they are big. They chew up competitors, the weak and the infirmed. They're sort of a Darwin-like necessity that helps cull your agency force for you. They waste no time eating their young if they don't produce, as well. Basically, they don't give a rat's ass about any obstacle in their way. Knowing that from

experience, you avoid being an obstacle. Better that, then to watch their Sales Manager run over your plaque in their parking lot on YouTube.

On the bright side, their President is one of your best buds. It's the rest of his shop that drives you and your underwriters bat snot. If you step-up and help a struggling competitor or, god-forbid, help a cross-town rival "steal" an account away from Goliath General Agency, you'll screen your calls for a week until Goliath's Prez, your bud, unceremoniously jams a countermanding Broker of Record letter under your windshield wiper. "Your front tire was already flat when I got there," he'll answer when you call. The next month you'll lose two long-term renewals as a reminder of who's really in charge. Eventually, you'll get Home Office to throw Holy Water on a deal that guarantees Goliath a flat percentage of "contingencies" regardless of loss ratio or growth. What choice do you have? Besides, they are the only agency you know who hired a young producer last year.

OK. You have that going for you… which is nice.

Holding Their Own:

These folks are generalists; which means that they are generally nice to do business with. They generally have single digit loss ratios, generally get profit-sharing checks, and generally post very little growth, even in rock-and-roll times. They've cut back on expenses, which means, Ol' Joe kept his Tahoe when the lease came up. He's drawing a little less too. That's about it. Small commercial, personal lines and Producers on guaranteed salaries is their mainstay. When your RVP came to town, you took him/her there. (Goliath was busy that day.)

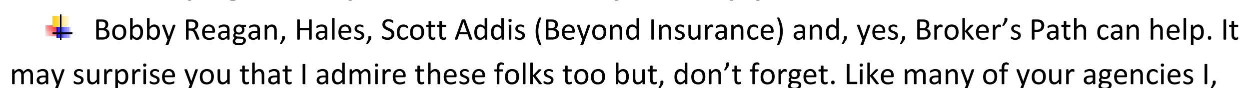
Last month, this generally nice agency sent you digital pictures of their annual summer picnic. Meanwhile, Goliath sent you five rush quotes, two new-biz orders to issue, and their assigned underwriter crying down the hall.

The generally nice agency, holding their own, will meet the coming cash-flow crunch by shrinking, combining two "producers" into one, and distributing 100% of the proceeds to owners who already own the place. Then, as Robert Frost reminds us; "way leads on to way." The generally nice agency owners will eventually announce that they are selling to a national outfit or to the kids… anyone, but Goliath who has already taken the accounts they want.

Such is the state of affairs for those doing OK or better. The story for the remaining 50% of your sales force isn't quite as peachy.

"Let's Work On That Meeting Agenda, Shall We."

1. **Help agents help themselves so they can help you-**



- Bobby Reagan, Hales, Scott Addis (Beyond Insurance) and, yes, Broker's Path can help. It may surprise you that I admire these folks too but, don't forget. Like many of your agencies I,

too, hired these outfits during my "run". I founded Broker's Path because I believe we compliment what these folks do. We are operational experts having lived in the trenches just like your bud at Goliath General Agency (I flatly deny those rumors about a flat tire incident). You should invite us over for coffee but if you're not sure, then go to one of these other firms for help because you're not currently driving this conversation within your culture and you need to! Offer Broker's Path to your Agency Council members under the "expense reimbursement" provision Home Office doesn't have to approve!

2. **Revenue: Contingencies-**

- Your checks are shrinking. Make them go up or your sales force will go away.

Consider a flat rate of two percent over a million on small commercial and personal lines and you'll pass the New York Insurance Commissioner's recent ruling on "volume" based incentives. Add ½% point (on the total) for every million thereafter, capped at 5% max ($7 million total). That comes to 5% or $350,000 on business that simply prints cash for you! Lay this next to your standard calculation as an option to the long-term profitable firms who can't meet the thresholds. Then cap the total at some number that won't send your actuaries into rehab. Then, bring back the option to "insure" the check for a price each September if the agency chooses the old formula. That, or fire the IBNR guys in the basement (inside baseball term for P&C guys).

This single maneuver will help your agencies more than you can imagine. It will offer predictability at a time when there is none. It will counter the downward trend on agency stock values because evaluators can't argue contingencies are "fuzzy" and hence discounted. Tempered stock movements mean the younger folks will continue to buy agency stock from the older folks and you might just save your sales force. It's a *City Slicker's* maneuver… as in "*The One Thing*" you can do to rebalance your world. Ignore this advice and watch small regional Carriers do this and more, as they've done in the past to you, because they can and they will.

3. **Revenue-**

- Actually pay commissions owed. It's a personal pet-peeve of mine.
- Pay annualized commissions to the extent you can.
- Actually issue the policy within thirty days (long list of cash-flow reasons implied).
- Send Marketing Reps to Underwriting school, give them real authority, hold them

accountable, and watch their favorite shops write a ton of business. It worked in the past.

- Create an account whereby agents can pay-in anticipated E&O deductible expenses.

Pooled together, this could be a fairly large fund that could generate some returns to these agencies. It also salts away expense dollars needed for unforeseen contingencies. If you balk at that whole "unforeseen contingency" notion, tell me again why you have IBNR guys in the Home Office basement?

- Co-sign working lines of credit with the agency's bank. Use contingencies, agency stock, or equity warrants as collateral. You'd be amazed at how a $250,000 cushion will bring back the love and materialize in net growth for you next year. (Hint: don't assign this to your Bond Managers. They are…well, Bond Managers for goodness sakes!)
- Dust off your old Producer Funding manual. It's the one with the word "Checkbook" on it. Then toss the Producer Sales Training Manual you dug up from storage. People who've never sold insurance can't teach someone who has never sold insurance. They can teach them coverage and they should. That whole scenario needs to come back damned soon.
- Consider reducing the number of shops you have appointed. (You won't do this) It will force market responses between stronger and weaker agencies which always results in you keeping the volume, perhaps even more, under a merged agency name. Your expenses get reduced and your "franchise" value will go up at a time when the trend is away from "loyalty" carriers towards the unwashed masses of cashflow underwriters. (You still won't do this, will you? You'll be even more dependent on Goliath, won't you?)

4. **Expense-**

- You train bright people to work in your CSU's don't you? So, why is it that you can't train an agency's CSR/ Account manager/ Customer Service new-hire?
- Revamp your renewal process. Better yet, re-underwrite every last renewal every single year and deny that you ever offered multi-year policies (non-auditable under $25,000 GL premiums as well.) It's job security after all.
- CSU's are not profit centers for you. They exist to induce volume so stop increasing the costs to your volume providers (agencies) and roll back the cost! You'll get more volume!
- Keep firing Loss Control employees and push that expense evermore onto your agent's P&L's. Soon, there won't be much difference between you and that cut-rate regional who doesn't offer risk management either…
- Negotiate with internet, phone, and cell providers to create a lower-cost buying pool.
- Help agency owners refinance their buildings/offices as they are all coming due.
- Offer miscellaneous financial guarantees (bonds) at low costs when agency owners retire in exchange for re-papering their repayment schedules to more favorable terms.
- Do you remember a time when you hired the agency owner's daughter as an Underwriter trainee? Two things: first, the daughter finds work which is no easy feat these days and the owner owes you big time. Secondly, when the daughter migrates back to the agency she'll be trained, smart, and valuable to the agency and eventually put 50% of the agency volume with you. Just out of curiosity, why did you stop doing that?
- Invite Broker's Path to come pay you a visit.

Carriers: *{Please accept this in the spirit it is intended. Your agents love you, well… most of them do so drop the "independent" stuff and go with "co-dependent" instead.}*

Agents & Brokers*: {Please forward this to whomever you wish and drop us a note if you think we're nuts or spot-on. We hope you enjoyed this month's Pathways Report. If something's on your radar screen, drop us a note. We love hearing from you.}*

To one and all*: {Going forward Broker's Path will issue one-page alerts on a weekly basis and a monthly small article. On a quarterly basis, we will produce a report such as this in length and scope on issues you've asked us to address. If you like what you see here, check out the web page.}*

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