July 2020

Burand's Insurance Agency Adviser

Resources and Information for the P&C Insurance Industry

Volume 25, Number 7

~ For a printable PDF version, click here. ~

In this issue...

Chris Burand,
Certified Business Appraiser

Burand & Associates, LLC
215 S. Victoria Ave., Suite E
Pueblo, CO 81003
719/485-3868
chris@burand-associates.com

Visit us at:
burand-associates.com

Education is more than attending a class

Education is learning, taking away knowledge that will make your life better. If you are interested in insurance knowledge that will enhance your life and help you better protect your clients' livelihoods, check out Three Dimensional TrainingÂ® at www.burandeducation.com/three-dimensional-training

Pandemic/Isolation Factors

When dealt a hand of cards, the goal is to play them as best you can. In other words, be constructive. The COVID-19 virus has given agents a wonderful opportunity to rethink insurance in general and their operations specifically. I'm going to start with a brief synopsis of what insurance is designed to protect.

Many writers have written that the pandemic is a Black Swan event (a few creative writers have stretched for more exotic animals, but a Black Swan is more applicable to insurance). Black Swan events were brought to the financial world's attention through Nassim Taleb's book, *The Black Swan,* that gained considerable popularity for its seemingly prescient prediction of the Credit Crisis. Mr. Taleb considers how luck, uncertainty, randomness, and risk all coincide and how, as the subtitle suggests, *The Impact of the Highly Improbable*, can be managed.

The pandemic was absolutely expected by the scientific community if not by regular citizens and politicians. I think one might conclude insurance carriers expected it too because of the exclusions they built into their policies. Insurance is designed for Black Swan events, but in many ways carriers, agents, and the public have lost this perspective. Insurance is designed to restore the policyholder to the financial status (a balance sheet position) they enjoyed immediately prior to the unexpected loss. Insurance would not be affordable if the losses were expected. Those are maintenance policies.

Moreover, insurance would not be affordable if the events were unexpected but occurred frequently. A really good example of how insurance companies have lost track of this point is in my home state of Colorado. For some reason, insurance company after insurance company has opened up in this state for property without realizing that hail happens all the time in all of the major population centers. Hail should be expected to impact a large number of properties on a fairly regular basis, if on an irregular schedule.

A good play to make with poor cards is to simply rethink and go back to the basics of what insurance is designed to do. Then, build your agency and value proposition to clients from there. Insurance is a fantastic tool for reinstating a person's wealth to its position immediately prior to a highly unexpected and relatively rare event. While auto crashes occur all the time, auto crashes per capita are relatively rare, and, outside of fraud, always unexpected.

E&O claims often occur because agents fail to address unexpected and rare events. Business income coverage is a great example in this environment. Claims are virtually always unexpected and relatively one of the rarer insurance claims. Insureds are, therefore, less likely to recognize this exposure as an important insurance coverage. Agents are less likely to recognize it too (ignoring for the moment most agents' lack of adequate understanding of this coverage). If both parties fail to recognize its importance, the odds of an insured having adequate coverage if an unexpected business income claim occurs is low.

I read a quote from a business owner who had their pandemic related business income claim denied. He said something to the effect of, "But that is what I thought insurance was for! That is what I thought I'd bought." I don't know anything about that particular claim but my guess is that he never read his policy and maybe even if he did read it, he did not understand the need for pandemic business income coverage and there is no reason to expect he should have.

Humans have an incredibly difficult time understanding the unknown. Humans do not have a great ability to appreciate the importance of Black Swan events (I encourage you to read Mr. Tableb's book *The Black Swan* and also his book on fragility, *Antifragile: Things That Gain From Disorder*). Yet insurance is designed for Black Swan events. Arguably insurance is designed for larger probability events than Black Swan events but still at the tail end of the normal curve. This is why actuaries are employed. This is also why claim stories are so much fun and fascinating and often earn the sobriquet of, "You can't make this stuff up!" You can't make up the claims stories because they are rare and unexpected.

This re-established insurance foundation provides the cornerstone for helping manage the agency, remotely or otherwise, helping clients, and navigating insurance distribution going forward. There are two classes of insurance agents -- "order-takers" and "professionals." Agents who are orderâ€'takers work from the assumption or presumption that the insured knows what rare and unexpected claims they want insurance to protect. The insured orders these coverages and the agents obtain those coverages to the best of their ability. It's pretty simple except that most insureds have a limited knowledge of what the unexpected events are for which they are likely to need coverage, and in my experience, most order-taking agents are even less knowledgeable. The blind leading the blind is a great combination for eventual disputes, unhappy clients, and E&O claims.

Going forward then, managing the agency should perhaps start with deciding whether your agency will be an order-taker or a professional agency. Once you make this decision, you can then best determine how to manage your agency and help your clients. Since, as an order-taker, you will not be making thorough coverage recommendations, if any recommendations at all, the key is going to be speed and low cost.

These are the benefits you will thrive upon because these are the benefits best appreciated by this class of customers. You will want to hire people focused on speed and efficiency. You will want to invest in technology that emphasizes speed and low cost. Going forward, the entire agency must be focused on speed and low cost.

This may mean online quoting systems. It may also mean hiring employees who can process emails, calls, paper, etc. at a fast pace, but are not skilled in insurance coverages. The technology used is different from the technology of professional agencies because coverage analysis, intimate meetings with clients, "close" work in other words, is unnecessary in the order-taker environment. Employees who fit the order taker environment will have a different personality than those who focus on coverages. Hiring specific to your model is vital.

From an E&O perspective, the historic middle ground is being eliminated due to the pandemic. The lines are being drawn more clearly than ever. Agents need to choose to operate as one type of agency or the other because the middle ground has become a dangerous trap. The best way to play this hand of cards is to fold on the strategy of following the middle ground.

The professional agent will focus on hiring people who have excellent communication skills, great insurance technical knowledge, and critical thinking skills. These three skills are mandatory for "close" client work at the professional level. These people will educate clients on their exposures. Exposures are common and identified. The question is whether, once a client understands their exposures, they want to buy insurance for the unlikely event that an accident (unexpected) occurs relative to that exposure. The education required for this kind of service is challenging and not everyone has the skills or patience to achieve it.

The technology required for a professional agency is different from order-taking agencies because quality Zoom like meetings will be far more important. The agencies will probably want to train their people on Zoom backgrounds, voice delays, and other improvement protocols and will likely find ways to meet in person with clients when possible. These agencies will, more than ever, focus heavily on insurance technical training.

No universal answer exists to this paradigm change other than deciding which kind of agency you will be going forward. Just like a hand of cards -- other than the fact that every hand needs to be played -- no universal answer exists. Be constructive and decide who you will be going forward. Decisions become much, much easier when you know your point of origination.

[Back to Top]

Professional independent agencies had better explain their value...

Or else better marketers will convince consumers they are more ethical than you. A recent story caught my attention and ire. The story was a press release from an Insurtech start-up. What first caught my eye was how the start-up measured success in coverage placed, i.e., total policy limits rather than premiums or commissions, to make themselves look successful. For people who don't know the difference, it was impressive that a 12-person start-up agency could place $2 billion in coverage in four years! The average 12-person agency only has $1.2 to $1.6 million in revenue. This Insurtech is outperforming the average agency by 1,430 times!

$2 billion in coverage at $1 million in liability only, is just 2,000 policies. Assuming there is some auto and comp and whatever else in there, let's say 1.5 policies per customer, that is only 1,333 customers or in other words they basically wrote one account per day over four years. Those kinds of policies average around $500 commission each which may be generous but I'll use that figure. That amounts to $667,000 in revenue. Divide that by 12 people and the result is $55,000 revenue per person.

Insurtech is supposed to be about scale. The definition of scale, in all directness, is doing more with fewer people. Scale is nothing else. $55,000 in revenue per person is not scale.

What next caught my attention was their statement that the traditional insurance model incentivizes agents to sell customers policies they don't need or contain inflated coverage limits. I'd really like to see solid proof that this regularly occurs. I don't know the captive agent world well so maybe it happens there, but I doubt it. I know the independent agency world extremely well and I have rarely seen this happen.

The system actually works the opposite of their statement. In the traditional agency model, for many complex and intertwined reasons, agents actually have more incentive to sell clients less coverage than they need even though they are threatened with E&O suits for doing so! I have seen a large number of agents sued for not selling adequate limits or the right coverages. In the COVID-19 world, has anyone seen an agent sued for selling too much Business Income?

For 25 years I have been cajoling, arguing, demanding, yelling and screaming at agents to use coverage checklists, and yet agents are no more likely to use coverage checklists today than 25 years ago (I'm a failure!). It has been proven over and over in E&O studies that using coverage checklists to ensure clients are offered adequate coverages is the best solution for both clients and agents!

I have only seen one suit brought in the independent agency world for selling too much insurance and the suit was aimed at the carrier because it was the carrier's practices, not the agencies' practices, that allegedly resulted in excessive and unnecessary limits. I've never even heard of an agent being sued for selling clients too much insurance.

This Insurtech advised that their model works because they make up the difference with finance fees. Their story sounds great to a large proportion of consumers. Consumers do not know how much insurance they need because no agent has ever educated them on how much insurance they need. I teach a lot of insurance classes and have conducted a lot of E&O audits; few people ever discuss the importance of drop down UM coverage on an umbrella policy (in fact many agents and CSRs don't even talk about the importance of an umbrella policy). Selling unnecessary coverage is really, I mean really, really hard when most agents do not even offer necessary coverage. I was with a retired family member who had paid off his mortgage and wanted to drop his homeowners' insurance. I explained he would lose his liability coverage. This is an extremely smart person and yet not one single agent in 40 years had ever explained the importance of liability coverage to him!

Professional agents will lose if they don't educate their clients as to why they need more coverage. They will lose to agents who actually advise those same clients, who do not have enough insurance, that their incumbent agent has actually sold them too much coverage! Pay for what you need they say, but the consumer has no idea what they need!

A huge proportion of producers exacerbate this problem when their client asks, "How much liability should I purchase?" The producer frequently answers, "As much as you can afford." What is the difference between this "professional" advice and Insurtechs' advertising, "Buy as much as you can afford." It's the same advice! The correct response is to help your customer figure out what they can afford to lose and then recommend that they buy an appropriate limit.

The Insurtech's press release articulates so much of what I see as wrong and unfair in this industry. Yet, the failure of agents to educate their clients, offer the right coverages and their own lack of knowledge about coverages has opened the door wide for this kind of upside down and sideways marketing pitch to actually make sense to consumers. A low down payment with significant finance fees has been a successful business model for a long, long time.

One other possibly dubious claim is that insureds will still save 35% because carriers are willing to reduce their price because the Insurtech agent is so efficient. This claim may be true in some instances because reducing acquisition cost is a huge goal for carriers today. However, a 35% savings? Let's do the math on this:

The industry average loss ratio has been 61% over the last five years. The average profit margin is around 10% including investment income. Independent agents are paid an average of around 13% including comp. So, no matter what an agent does, the most carriers can save is 13% by eliminating agency compensation. An argument may exist relative to some additional savings relative to frictional costs but not enough. The carriers' average total expense ratio is around 28% excluding LAE. If I remove the commission of 13%, that only leaves 15%. A 35% reduction in expenses is impossible.

Additionally, using a 61% loss ratio and if the rate is 35% less, the loss ratio would be 96%, all else being equal. Even if all commissions are eliminated, the loss ratio is still 83%. An 83% loss ratio is not sustainable.

Now, maybe the quoted 35% savings is meant to mirror other disingenuous price saving advertising such as, "The average customer who switched saved $350!" That is an entirely pointless, but quite effective ploy. Let's say 1,000 people shopped that carrier's site and 990 stayed with their existing carrier. The remaining ten saved an average of $350. The people who did not switch may have saved an average of $350 by not switching so they did not switch! Only counting one side of a ledger is illegal in finance and perhaps advertising rules should be revised along the same lines. Either way, advertising that carriers are offering lower rates when it is just a math gimmick is mixing and matching in a manner that is highly questionable.

A true 35% savings from the same carrier requires special filings by that carrier or the use of a special purpose PUP company with previously filed deviated rates. That is an awful lot of work for a start-up agency that has so little commission they announce sales in total policy limits.

As has been scarily evident throughout the COVID-19 pandemic, journalists may be journalists because they seem incompetent at math. Always check the math on stories like this one. More importantly, sell the right coverages, educate your clients on how much coverage they actually need, and show them you won't sell coverages they do not need. Don't let firms like this Insurtech beat you.

[Back to Top]

What is Business Income coverage?

Business Income (BI) coverage is not like other insurance coverages for many reasons. One of these reasons is producers do a poor job selling BI to clients, much less selling it correctly. I make this statement based upon my E&O audits and file reviews. Producers do not understand the coverage or how to deal with the worksheets, so they skip it out of fear of losing the entire account.

BI is different in that it provides coverage for intangibles -- it covers an income stream versus a building. Most producers can relate to buildings, to workers' compensation, to tangible factors. Income streams are for finance majors and valuation experts and private equity. Yet, an income stream is almost always more important to protect than a building.

BI is a forward coverage versus a backward coverage. In other words, BI pays for what would have been earned in the future rather than the past or even what the replacement cost was on the day of the loss. Not only is it intangible, but it is an estimate or a prediction of the future making the coverage even more difficult to quantify.

Writing BI well requires, honestly it does, some accounting knowledge. Most other coverages and insurance forms do not require knowledge of accounting. This is a problem for producers because the vast majority of producers have never taken an accounting class, much less a quality finance class. BI is an accounting and finance coverage.

Producers find BI difficult to grasp because it is so complex and intangible. I often argue that all insurance forms are complex when done well, but BI is especially complex. Furthermore, is hard for all involved to design the right coverage angles well.

There is no such thing as a "best BI form". One of the stupidest questions I have ever heard a producer ask is, "What is the best BI form?" Sure, all clients' needs and situations and claim events are always identical, right? Even if the entire world had only one BI form, how that form is applied to different clients would vary significantly because the best form and application of that form, is the one that fits a specific client's needs. The right form is really the equivalent of the right advice and the right advice will be based on any given client's specific situation.

BI's complexity means producers must work to understand the different forms and the applications of those forms, along with understanding different types of businesses' exposures. To me, one of the most intriguing and interesting aspects of insurance is how different businesses have such distinct BI needs and exposures. I am fascinated by how income streams change in varying scenarios for different kinds of businesses. A good producer who works hard to understand these forms and applications could probably make a living just by focusing on BI.

BI coverage does not cover every BI exposure. A property policy more or less, excluding DIC situations, covers a building. A BI policy may exclude major BI exposures. This is especially true within the cyber liability context, but it is also true for many common kinds of claims. Yet, coverage is usually available for these exclusions if a producer will, again, work hard to find such coverage. Lloyds markets are usually good places to begin the search.

Never, ever, forget to find contingent BI coverage.

BI is quite a different coverage for an unusual reason. Insurance was initially invented to protect banks. Banks wanted their borrowers to buy insurance so if the building burned down, the insurance company would pay off the loan. In a sense, it was a way of cost shifting. Most property insurance still works that way to varying degrees, excluding government mandates for workers' compensation. BI is a form of insurance that it is designed to protect the business owner, not the bank.

BI is continuously ranked by CFO's and CEO's as one of the most important coverages their businesses need. Businesses want proper BI coverage. Yet, 90% of producers do a poor job designing BI coverages, and the coverage needs to be designed, for each specific client. If every producer does a poor job finding BI coverages, the clients don't have a choice but to choose between dumb and dumber. When that 10th producer calls and shows them what they truly want to see, quality BI, which is always one of their top three most desired coverages, accounts move.

What is a secret to sales success? Give the customer what they want.

If you want to learn BI, in depth, you may want to consider our incredibly in-depth BI education program.

[Back to Top]

Another reason E&O Audits are good for your agency

Reason #465: If something goes wrong, i.e., an E&O claim occurs, and depositions/testimony is required, what will you and your staff say? Understand this: if you are a deposition/testimony virgin, the opposing council's job is to make you contradict yourself, make you look bad, make you stumble and definitely make you suffer.

Their job is to cause you to question why you are even worthy of an insurance license. Their job is not to find the truth. Discovering or developing the real history and solution has absolutely nothing whatsoever to do with the proceedings. No one really usually cares an iota about constructive development. Some attorneys may even abhor constructive development of the case because it will cause them to charge fewer hours. Finding construction simply is not always, If ever, their goal at this stage.

If you are not a masochist, you probably want to avoid these horrible experiences where maybe the only positive later is, "Whatever does not kill you, makes your stronger so I must now be stronger."

Meanwhile, these situations almost inevitably lead to loss of sleep, agitation, extreme anxiety, loss of confidence, and an inability to concentrate on other tasks to name a few side effects.

An E&O audit may not be fun or even cheap. An E&O audit is far, far easier than a deposition though and far better than a trial. And an audit is considerably less expensive in time and resources.

Another benefit is this: If you are making mistakes or being inconsistent, the safety of an audit environment is far better than a legal environment. E&O auditors (unless the situation is extremely extreme and maybe fraud is suspected on the agency's part) are generally on the agency's side. They are trying to help the agency discover its own weakness which is materially better than a plaintiff's attorney helping discover those same weaknesses. If a weakness is to be identified, do you want someone that is there to help you or someone there to hurt you? Think of it this way: Do you want a doctor helping discover your illness and help you remedy yourself or do you want a trial attorney attacking you for your illness?

The illness is present either way. You may live with it a long time without suffering ill effects or catastrophe may strike overnight. If you think you will never be sued, buy lottery tickets too because if you are that lucky, you will probably win at least a small fortune playing scratch tickets. Otherwise, seriously consider having an E&O audit.

[Back to Top]

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, 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.

Burand has more than 30 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 Advise*r for independent insurance agents.

Burand is a member of the Institute of Business Appraisers and NACVA, a department head for the Independent Insurance Agents and Brokers of America's Virtual University, an instructor for Insurance Journal's Academy of Insurance, and a volunteer counselor for the Small Business Administration's SCORE program. Chris Burand is also a Certified Business Appraiser and certified E&O Auditor.

NOTE: The information provided in this newsletter is intended for educational and informational purposes only and it represents only the views of the authors. It is not a recommendation that a particular course of action be followed. Burand & Associates, LLC and Chris Burand assume, and will have, no responsibility for liability or damage which may result from the use of any of this information.

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.

A complete understanding of the subjects covered in this newsletter may require broader and additional knowledge beyond the information presented. None of the materials in this newsletter should be construed as offering legal advice, and the specific advice of legal counsel is recommended before acting on any matter discussed in this newsletter. Regulated individuals/entities should also ensure that they comply with all applicable laws, rules, and regulations.
