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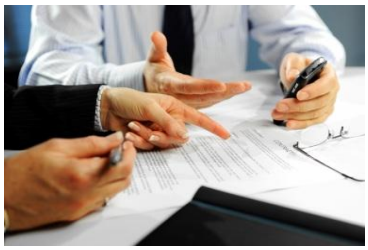

Selecting Agencies for the Future

Now is the Time

DEC 4, 2012

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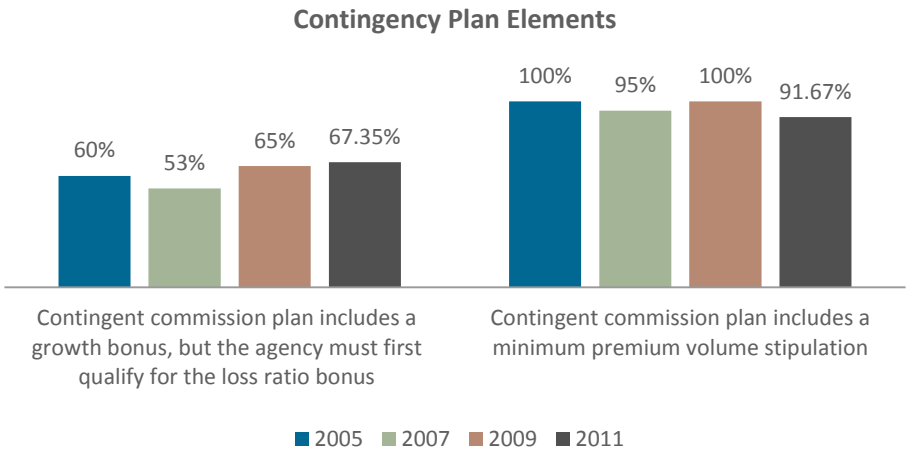
As the property-casualty insurance industry progressed from 2001 to 2007, independent agencies were near their most stable and financially fit point ever. Profits were strong, insurance rates were higher, the economy was growing and a level of viability had been established. At the same time, insurance companies distributing through independent insurance agencies benefited from the strong performance of the agencies.

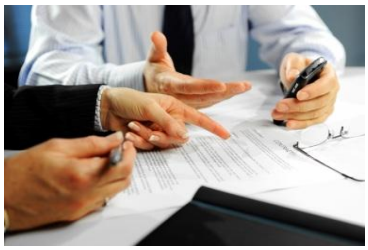
But things changed. The contracting economy, soft market conditions and increasing catastrophe losses reduced commission revenue for most independent agencies. Many agencies were forced to cut expenses, reduce staff, consolidate carrier appointments or even sell or close the business. With disparity among independent agencies and the suggestions that a true "hard market" is not in the P&C industry's near future, it is important now, more than ever, for insurance companies to properly select and align with the right agencies to meet future growth and profitability goals.

Measuring Agencies – The Traditional Way

Traditionally, companies have measured an independent agency's performance using premium volume, loss ratio and growth (policy or premium; more commonly premium growth). These metrics usually tie into the contingent commission plan for determining profit sharing payments as illustrated in Chart 1 or awarding agency trips. Companies rely on the contingent commission and/or trips as the primary way to reward and recognize top agencies.

Chart 1





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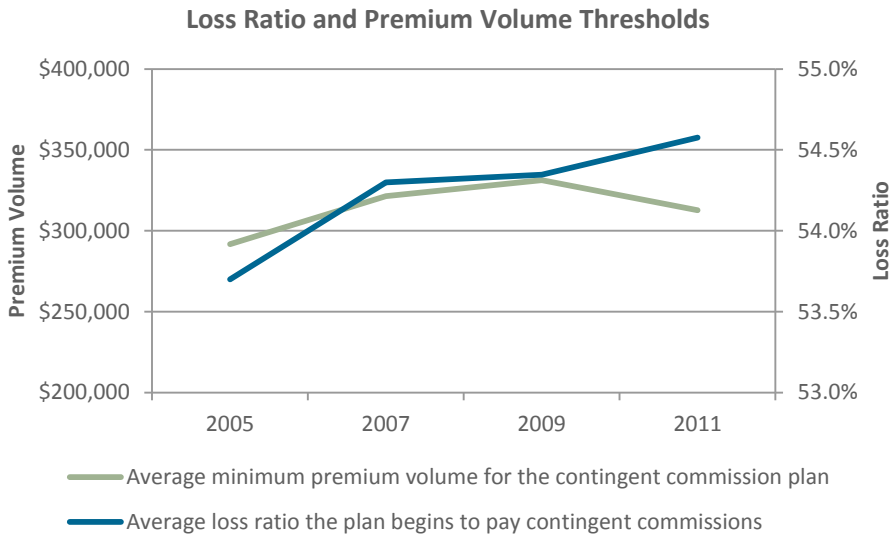
The loss ratio and premium volume an agency must attain for a contingency payment has changed slightly since 2005. As illustrated in Chart 2, the starting loss ratio for earning contingent commission increased about 1% since 2005 and was 54.6% in 2011. The minimum premium volume necessary to be eligible for a contingency payment went from $290,000 to $330,000, but dropped to $313,000 in 2011.

Chart 2



Many suggest that the contingent commission payment is the most effective way to reward performance among the best performing agencies. If this is the case, companies and agencies have performed poorly, despite efforts to improve rate adequacy and risk selection. The reality is that the results reflect difficult market conditions and catastrophe activity. Chart 3 shows a comparison of the actual percentage to budget for the most "recent year" and the anticipated budgeted percentage for the "current year." The budget percentages have steadily declined since 2007 and the actual amount paid out was less than the target in both 2009 and 2011. There are two factors that may have contributed to this decline:

1. Fewer agencies were eligible for contingency payments because they did not meet the premium volume, loss ratio or growth targets or any combination
2. The same number of agencies met the eligibility criteria but hit a lower target within the contingency plan, thus receiving a lower contingency payment

Regardless of the reason, the financial impact for declining performance has directly affected independent agency compensation.

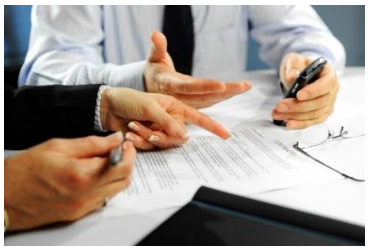


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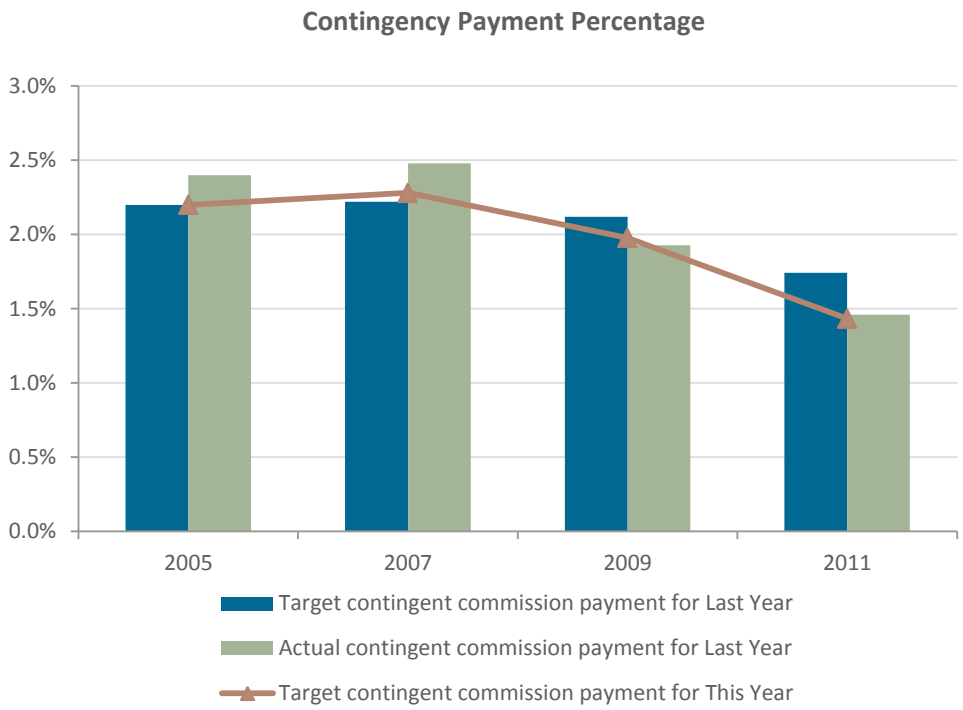
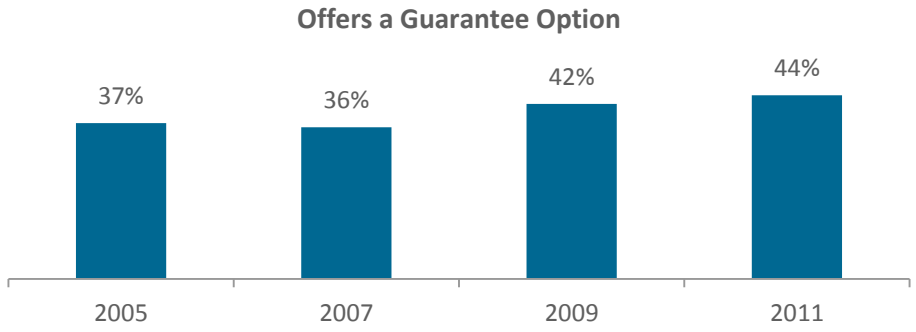
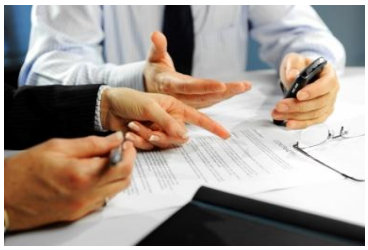
Chart 3



To help mitigate surprises at the end of the year, more companies have implemented the guarantee option in the contingent commission contract. The guarantee option allows the agency to guarantee their contingency commission payment after 9 or 10 month's results, usually with a reduction in the amount paid. The increase in the popularity of this option is illustrated in Chart 4.

Chart 4





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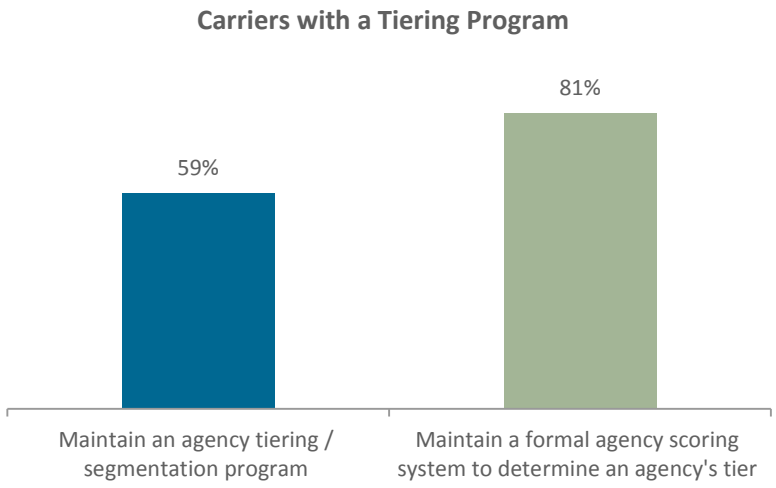
Agency Segmentation

Contingent commissions and profit sharing plans are an effective way to reward agencies who contribute to the success of the company. However, companies should be much more analytical in identifying agencies that outperform peers. Agency tiering is the most effective approach to segmenting the performance of agencies and identifying where to focus resources.

Chart 5



To determine the "best" agencies, a majority of insurance companies score and tier agencies (Chart 5). In most cases agencies are evaluated simply on total premium, growth and loss ratio. The evaluation may include other criteria such as responsiveness or customer service. Many companies feel they are very objective in their view of agency performance and manage accordingly. In reality, subjective issues like agency tenure, relationship with the principal or non-business items drive agency management decisions. Often the premium volume of the agency dictates how a company manages the agency with little regard for performance. The bigger the agency, the better it is treated.

For companies with an agency tiering program, the average program has four tiers. The percentage of agencies in each tier is illustrated in Chart 6 below and shows agency performance within the tiering programs has declined, illustrated by the shifting of the percentage of agencies in tier 2 to tier 3 from 2005 to 2011 (more than a 15% shift!). Top tier agencies are a company's strongest allies and should be considered true "partner agencies." This top group remained relatively the same during the recent weak economy and soft market.

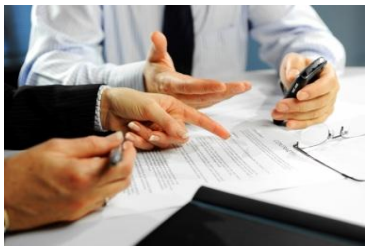


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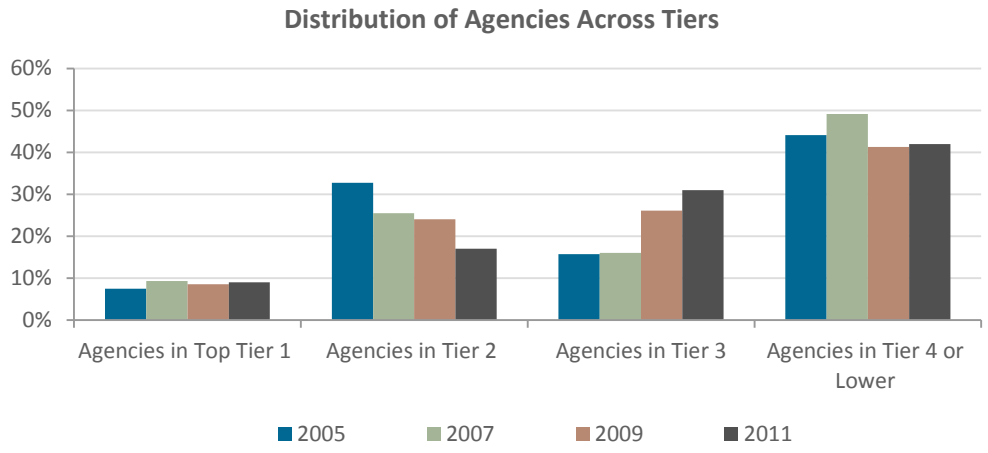
Chart 6



Managing Agency Performance

Agencies in the top tier 1 are typically easily managed. Agencies in the middle tiers 2 and 3 are more difficult since carriers are challenged to identify the agencies that are "up and coming" and those agencies that may need corrective action. Carriers can more effectively manage middle tier agencies by defining objectives for improvement and outlining goals. But, goals are not enough. Effective execution of actionable items that are targeted and individualized by agency is key to improving performance. Actionable items should include activities for both agency and company field representative that will be accomplished to achieve each goal. Monitoring and reporting of the completion and status of actionable items is also critical to the improvement process.

Carriers also struggle to manage agencies included in the bottom tier 4 that are below average or underperformers. Agencies in the bottom tier can include small profitable agencies or large premium agencies with high loss ratios, each requiring a very different response from the carrier. On one hand, small profitable agencies may need action to cultivate greater premium growth. On the other hand, the carrier is faced with a decision to rehabilitate or terminate the relationship with the large unprofitable agencies. By culling out underperformers, carriers can focus resources on building relationships with the best agencies and improve operating results for the entire organization – the quicker, the better. The average company can improve the combined ratio by 3 – 5 points by managing the bottom tier more efficiently.

It is interesting to note that the number of insurance companies that inform the agency of their ranking or tier continues to decline (Chart 7). How can a carrier expect an agency to improve if they do not have honest discussions about performance?

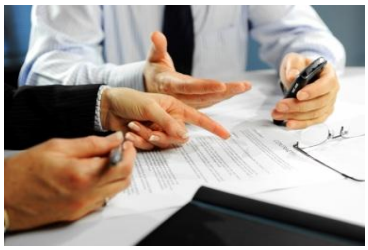


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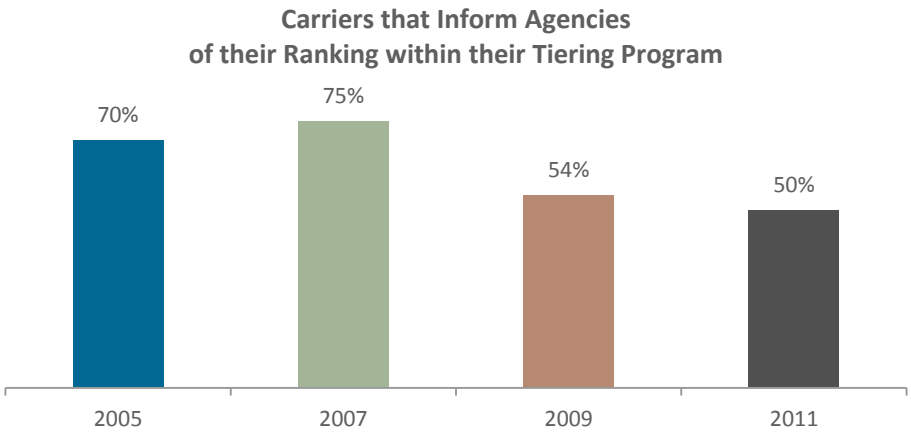
Chart 7



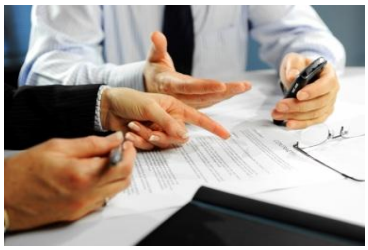
Implementing an Effective Scoring and Tiering Program

Although many companies have a formal method for scoring and tiering their agencies, few take a true statistical approach to developing a score for their agency force and creating tiers based on that score. An effective scoring and tiering process includes:

- Selecting objective metrics that effectively measure agency performance and support the company's performance goals
- Appropriately assigning the importance and weighting of each metric for the purpose of calculating an overall agency score
- Using the most suitable method for determining each agency's share of each metric's weighting
- Establishing proper thresholds for premium volume and agency score for appropriate distribution of agencies across tiers
- Analyzing and comparing tier performance using metrics selected for scoring, plus other pertinent metrics for monitoring improvement, incentives, benefits and service offerings
- Properly aligning incentives, resources, benefits and services with each tier

Selecting the appropriate metrics is an important step in establishing an effective agency scoring and tiering process. The metrics selected should be credible, reliable and fairly measure agency performance. Typical metrics include total premium volume, growth, claims frequency, claims severity, new business volume, retention and loss ratio, among others. But questions still need to be addressed in selecting the best metrics, for example:

- Are growth and retention based on premium growth or change in policy count?



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- Should the loss ratio be the current year, 3 year, 5 year loss ratio or some combination?
- Does the loss ratio include or exclude large losses?
- Should a new metric be calculated that is more in-line with the company's goals?

Do not include metrics that have a short historical base or little experience to draw upon to determine level of performance. Also, avoid metrics that are suspicious due to inconsistencies related to data collection. These metrics can be added later once credibility and reliability is established, but any metric chosen should clearly support the company's performance goals.

The next step is to determine the importance of each metric to the overall agency score. This is done by assigning a weighting to each metric and determining a value for the total agency score for the "perfect agency". Then allocate the total value among the selected metrics so when summed, they equal the total. It is not unusual to come back to this step to redistribute the weightings once agency scores can be calculated and tiers can be created.

A method is also needed for determining each agency's performance within the weighted metric. Is each agency's score determined by their ranking within a standard deviation or is it better to score between a minimum and maximum value? No matter what is chosen, a method must be established that will be used each year going forward for determining how each agency is fairly allocated their share of the weighting for each metric. Once this is determined a financial model is built to calculate an overall score for each agency. With each agency having a score using objective criteria, agency ranking and tiers can be established easily and used as an effective management tool.

Summary

Although many insurance companies have a formal method for scoring and tiering their agencies, not all of them take a true statistical approach to measure their agency force. The subjectivity in managing a company's agency force should be minimized to more effectively evaluate and communicate an agency's value and contribution to company performance. An objective and statistical approach is needed to provide credibility to the management process, consistency for evaluating agency performance and, thus, establishes a trust in the process across all departments within a company. When performed correctly, a company can lower the combined ratio 3 to 5 points and drive sustainable long-term value.

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Source for Charts: Ward Group Agency Management and Compensation Practices Study.