

SMALL COMMERCIAL LINES

More and more we are asked: “What should be done, if anything, with small commercial lines business?” When an agency principal or owner asks this question, there are several other questions they are probably thinking of or want answered; such as: Should we establish a small commercial lines department? Is small commercial lines profitable for the agency? There is not a simple answer to these questions since each agency is different and the right answer for one agency is the wrong answer for another. This not only applies to the issue of small commercial lines business, but for almost every aspect of managing and operating an agency.

To assist agency principals and owners in addressing the ever more apparent issue of small commercial lines business, we have dedicated this edition of *The Agency Owner* to sharing our experience and knowledge on the subject. In particular, this edition discusses: 1.) issues to evaluate when considering a separate department for small commercial lines and 2.) the production and servicing costs of small commercial lines business.

HOW BIG IS SMALL?

As we all know, there are a variety of definitions for small commercial lines. Some of this is due to insurance carriers and how they have defined small commercial lines. However, this has very little meaning for agencies and each agency needs to establish their own definition. Typically, the larger the agency, the higher the premium break for small commercial lines business. This is mainly a function of larger agencies writing, on average, larger commercial lines accounts. This is not always the case, as some agencies have discovered once they analyze their commercial lines book of business.

When deciding what to do with small commercial lines and if it is appropriate to establish a separate department, one of the most important steps is to analyze the existing commercial lines book of business. An analysis of this type should determine how many accounts there are and the total commission amount for various premium breaks. In the course of performing this analysis, an agency also needs to evaluate the complexity of each premium break by determining the types of accounts there are at each premium level. Premium breaks agencies typically analyze are \$1,000, \$2,500 and \$5,000. In some cases, agencies analyze higher premium levels such as \$10,000. This analysis will assist you in defining small commercial lines and deciding if your agency should establish a separate department. Next, we share some helpful hints in establishing a separate department for small commercial lines business.

SMALL COMMERCIAL LINES

STRUCTURING A SEPARATE DEPARTMENT

One of the first steps to establishing a separate department for small commercial lines is to determine staffing. In particular, the number of service personnel. This is relatively easy since staffing can be estimated by using the results of the book of business analysis in conjunction with productivity measures. The most common measures used are commercial lines commissions per service person and commercial lines customers per service person. Table 1 below illustrates standards for small commercial lines service personnel productivity.

Table 1 - Small Commercial Lines Productivity

	Average Performance Standard	High Performance Standard
CL Commissions per CL CSR	\$140,000	\$185,000
CL Customers per CL CSR	280	360

Note 1: For these standards, small commercial lines is defined as accounts with premium less than \$5,000.

The number of service personnel for the department can be estimated by dividing the results from the book of business analysis by the productivity standards outlined in Table 1. Remember, the analysis includes results for various premium breaks so this calculation may need to be done using the sum of more than one of the premium break's results. In some cases performing this activity results in two different staffing numbers; one resulting from commissions per CSR and another from customers per CSR. When this occurs, your judgment is needed to determine the most appropriate staffing number for your agency. Going through this process not only estimates staffing, but will also define small commercial lines for your agency.

Staffing can be estimated using the productivity measures, however, it is common to make adjustments to justify a full-time equivalent of servicing personnel. These adjustments typically involve including less complicated accounts with a premium higher than the premium level used earlier to define small commercial lines such as BOPs.

The number of service personnel for a small commercial lines department also depends on the functions performed by these people. It is our recommendation that these service personnel have responsibilities similar to that of personal lines service personnel. In other words, the service personnel handle the account once it has been sold by a producer. These service responsibilities include:

1. rating and preparing the quote for new small commercial lines business.
2. placement and marketing of new and renewal business with insurance companies.
3. the day-to-day client service activities.
4. the day-to-day insurance company contact associated with client service activities.
5. act as a liaison with the insurance companies represented for small commercial lines.

A producer, on the other hand, is responsible for prospecting and selling small commercial lines accounts. This includes gathering the necessary information so the service personnel can rate and develop a quote which is then presented by the producer. In some cases, the quote is presented by the service personnel.

Once the account is sold, the producer should introduce the service person that will handle the account to the client. This is generally done in a cover letter sent to the client with the new policy. Occasionally, this done when the producer delivers the policy to the client. If the agency is exceptionally service oriented, the service person will send a letter with a business card that introduces themselves. Or, the service person will contact the client via the telephone to introduce themselves.

Discussing producer responsibilities naturally leads into how to compensate a producer for small commercial lines business. In larger agencies where a separate department for small commercial lines is more likely, producers should be compensated in a way which is similar to how they are compensated for personal lines. That is, pay producers a high new business commission rate such as 40% and nothing on renewals. (Or at least a very small percentage such as 10% on renewal business.) Compensating producers in this manner reinforces where they should be focusing their efforts - sales. As indicated earlier, the service personnel handle the accounts after they are sold by a producer.

In addition to the responsibilities of service personnel and how producers should be compensated for small commercial lines business, there are other similarities to personal lines that are worth mentioning. First, the number of carriers represented for small commercial lines should be a select group of insurance companies, say 3-5. As a result, service personnel are more knowledgeable of each carriers underwriting requirements and, in turn, are more productive. Second, an agency should put as many policies as possible on direct bill. This will reduce the staffing needs of the department as well as allow the service personnel to focus on their primary responsibility - customer service.

One last area where small commercial lines is similar to personal lines is in the area of automation. Due to the simplicity of small commercial lines policies (which is like personal lines), more and more agencies are relying on their automation system for retrieval of information and client service activities. This means all small commercial lines information such as customer data, general policy information and detailed policy information like location(s), coverages, deductibles is input and maintained in the agency's automation management system. This also lends itself nicely to using transactional filing for small commercial lines business. This is especially true when the agency defines small commercial lines as premiums less than \$5,000.

The concepts discussed to this point are with the intent in making a small commercial lines department profitable. However, comparing production and servicing costs of two agency groups based on average commercial lines account size also highlights important factors that can contribute to the

profitability or unprofitability of a small commercial lines department.

SMALL COMMERCIAL LINES COSTS

To determine the costs an independent agent incurs to produce and service small commercial lines business, small commercial lines business was isolated from all other commercial lines business in MARSH/BERRY's extensive IMPAC-3 database. This was accomplished by using the IMPAC-3 ratio called *Commercial Lines Commissions per Customer*, which is commonly referred to as the average commercial lines account size of an agency.

The premium level used for this study was \$5,000 of premium for small commercial lines business, which translates to approximately \$700 of commission income per account. Therefore, an average commercial lines account size of \$700 was used to separate the IMPAC-3 agency subscribers and their corresponding results into two groups; 1.) those agencies with an average commercial lines account size **less than \$700** and 2.) those agencies with an average commercial lines account size **greater than \$700**. It should be pointed out that this ratio is the average commission income an agency receives on a commercial lines account. In other words, an agency that has an average account size less than \$700 almost definitely has individual commercial lines accounts with commission income greater than \$700.

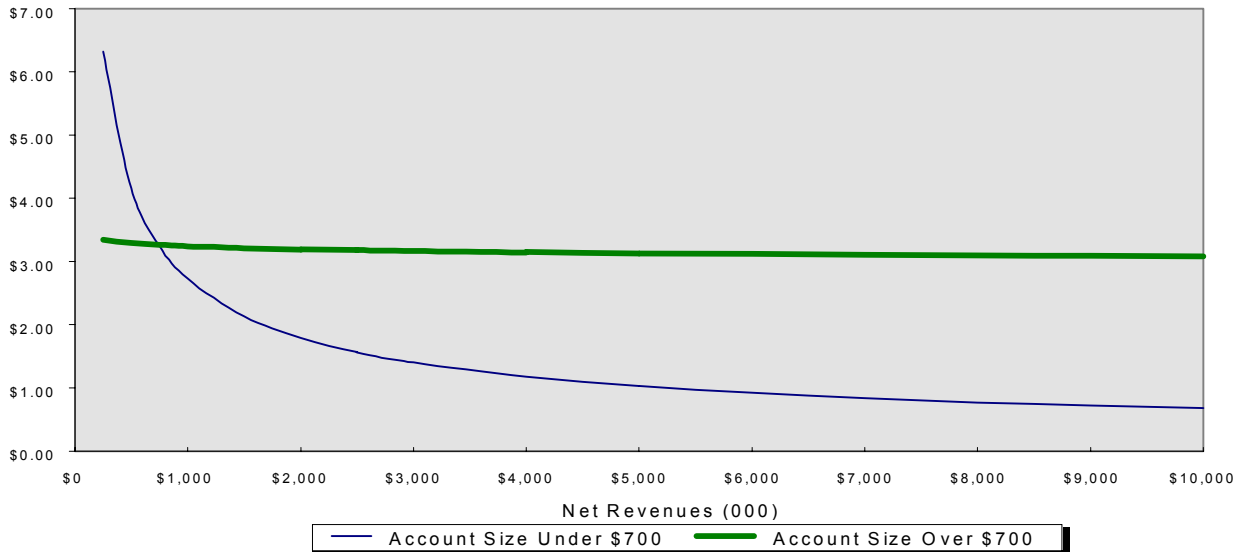
Once the entire data base was separated into two groups, each group was then divided into six net revenue ranges to identify and analyze any trends that may exist. The six revenue groups were:

Under \$750,000	\$2.5 - \$3.5 million
\$750,000 - \$1.5 million	\$3.5 - \$5.0 million
\$1.5 - \$2.5 million	Over \$5.0 million

For illustration and comparison purposes, the results for agencies with an average account size less than \$700 extend beyond \$5 million in net revenues, even though there were no agencies with an average commercial lines account size less than \$700 with revenues over \$5 million. In other words, all the agencies with revenues more than \$5 million have a commercial lines account size greater than \$700.

A discussion on the costs associated with each group and related trends follow.

Graph 1 - Commercial Lines Production Cost per Dollar of New Commercial Lines Business

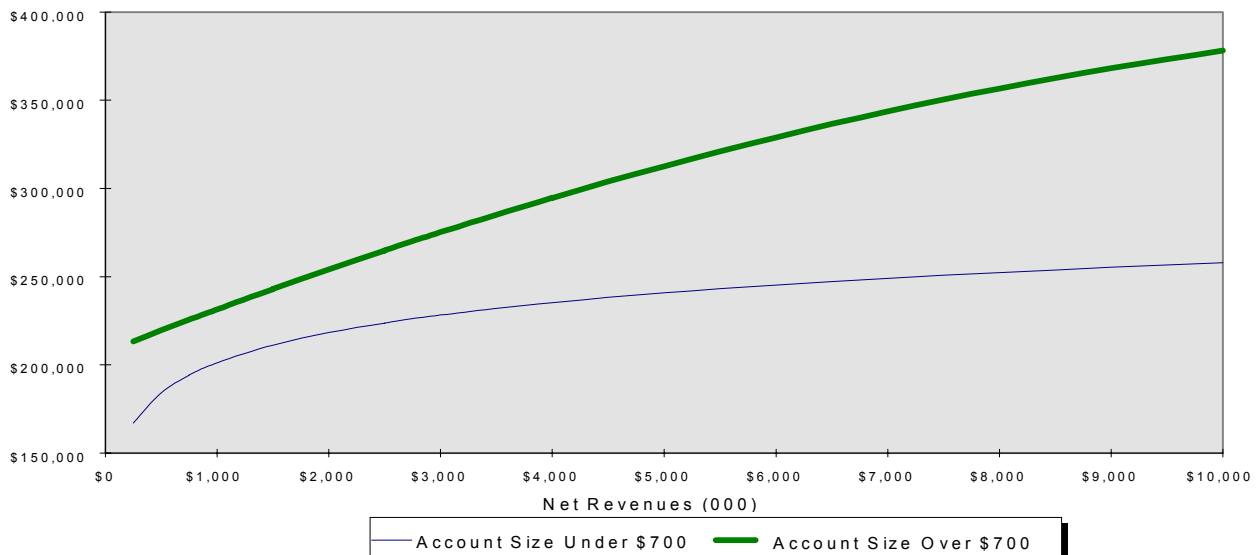


Production Costs

In regards to the costs associated with producing new commercial lines business, the production cost per dollar of new business (Graph 1) for those agencies with an average commercial lines account size greater than \$700 is flat as revenues increase and is higher than the agencies with an average account size less than \$700 once revenues exceed \$750,000. The production cost per dollar of new commercial lines business for those agencies with average account size less than \$700 decreases dramatically in the smaller revenue agencies and then tapers off as an agency's revenue size increases.

The higher production costs for the agencies that have an average account size **over \$700** is the result of pushing (delegating) more of the servicing responsibility down to the level of the customer service representative. These agencies create a supportive infrastructure of servicing professionals who enable producers to concentrate on production. As a result, producer/owners in these agencies spend more time (and money) to produce business. However, these producer/owners handle a larger book of business as illustrated in Graph 2 below - P&C Commissions per Producer/owner. In other words, these agencies spend money to make money.

Graph 2 - P & C Commissions per Producer Owner



There is a dramatic decrease in production cost per dollar of new business for agencies with average account sizes under \$700 from revenues ranging from just under \$500,000 to about \$1.5 million. This is due to a significant increase in the number of new customers these agencies write as a percentage of their total commercial lines customers. New customers as a percentage of total commercial lines customers increases from about 7% for agencies with revenues under \$500,000 to around 10% for agencies with revenues over \$1.5 million. This decrease occurs even though the average commercial lines account size is relatively the same and with only a slight increase in production costs.

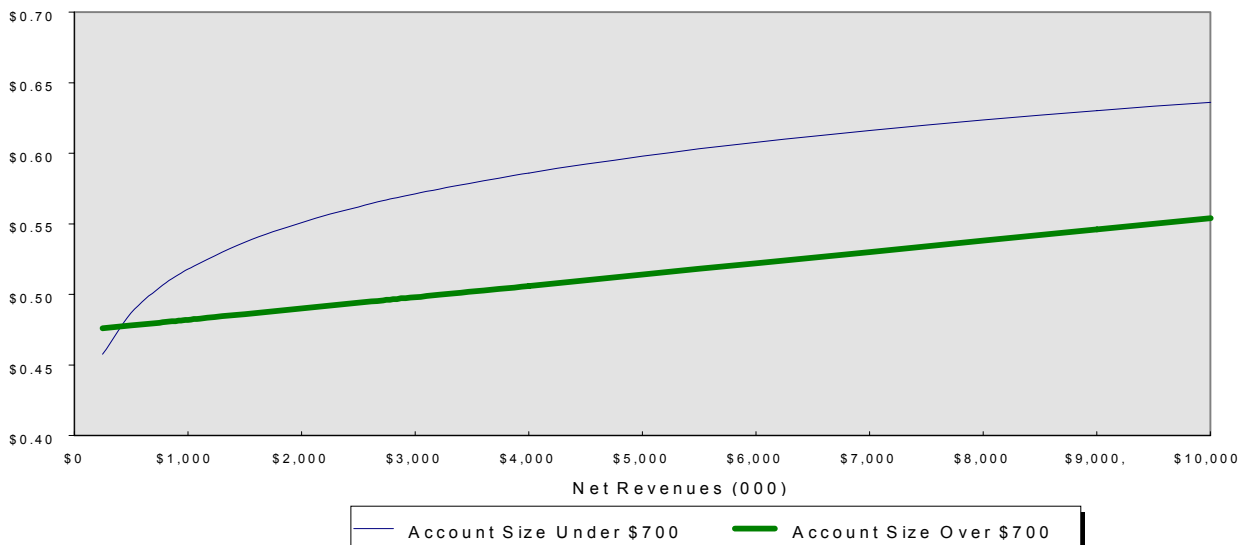
Both new customers as a percentage of total customers and producer productivity (P&C commission per producer/owner) levels off for those agencies with average commercial lines account sizes under \$700 and revenues greater than \$2 million. This is the result of producers continuing to service commercial lines accounts and not delegating this responsibility to a higher level, more professional servicing staff. As a result, there is less new business in these larger agencies and production cost per dollar of new business levels off. This is the main reason there are no results in the over \$5 million revenue range for agencies with an average commercial lines account size less than \$700.

Servicing Costs

For both groups, the servicing cost per dollar of renewal commission increases as agency revenues increase. Makes sense. However, the results for the agencies with an average account size over \$700 is, in general, less than those agencies with an average account size under \$700. (See Graph 3.) How can that be? The answer lies in commercial lines commissions per commercial lines CSR. Graph 4 on the next page shows that the CSRs in agencies with an average account size over \$700 are significantly more productive than the CSRs in agencies with an average account size under \$700. As a result, servicing cost per dollar is less in agencies with an average account size over \$700.

The decrease in commercial lines commissions per commercial lines CSR (Graph 4) for both agency groups as revenues increase is a reflection of our earlier discussion regarding production costs. For agencies with an average account size over \$700, more and more of the responsibility for servicing commercial lines accounts is being delegated to a more professional servicing staff as agency revenues increase. This results in a steady decline in CSR productivity, but a steady increase in producer/owner productivity, as we saw earlier. The trend for agencies with an average account size under \$700 shows a hint of this, but it is not to the degree of the agencies with average account size over \$700. Remember, the producers in the agencies with an average account size under \$700 assist the service personnel in servicing accounts.

Graph 3 - CL Servicing Cost per Dollar of CL Renewal Commission



There is one other aspect that needs discussed which is operating expenses per CSR. Operating expenses per CSR were basically flat for agencies with an average account size over \$700 (just over \$29,000), while operating expenses per CSR for agencies with an average account size under \$700 decreases from around \$25,500 to around \$23,300. Why? The decrease for agencies with an average account size less than \$700 is partially due to the fact that the producers in these agencies are subsidizing the CSRs by being heavily involved in servicing activities.

Therefore, as agency revenues increase for this group they require proportionally fewer CSRs than the agencies do that have an average account size over \$700. The typical agency realizes some savings in operating expenses per CSR as revenues increase, but not a significant savings. The decrease is also an indication that agencies with an average account size less than \$700 are investing proportionally less in the agency infrastructure as agency revenues increase.

Graph 4 - Commercial Lines Commissions per Commercial Lines CSR

