You Can Do Better Than Profit-Sharing

Revenue for most agencies consists of commission and company profit-sharing. Profit-sharing is a beautiful thing -- typically a no-risk, up-side only bonus paying up to 5% of annual premium written. However, there is a way to earn a much larger bonus – one that is not capped at a certain percentage of premium. This is possible through an **agency captive**.

A captive gives an agent access to forms of revenue typically enjoyed exclusively by carriers – “underwriting profit” and “investment income.” These arrangements are not without risk, but for agents with the proper profile, a captive facility can offer a dramatic enhancement to the agency’s revenue stream and value proposition.

How does an agency captive work?

An agency captive is a reinsurance company that an agency controls. Through an agreement with a fronting carrier, the agency captive receives a share of all premiums written and has an obligation to pay its share of claims. The agency typically engages a captive manager to create the captive facility and oversee ongoing operations. The fronting carrier usually handles underwriting and provides specific and aggregate loss protection. This creates a finite “worst case scenario” for the captive. These key relationships – captive manager and fronting carrier – limit the financial risk and administrative burdens on the agency. Agency captives create a truly unique relationship between the agent and the carrier. All interests are aligned -- appetite, risk-selection, pricing, loss control, claims management. Success, or failure, is shared.

For the agency’s producers, CSRs and customers, the captive is largely invisible. The customer gets a normal “first-dollar” policy backed by the financial strength of the fronting carrier. The sales and service experience for the customer and agency personnel are like normal. Commission levels and payments to the agency are the same and not affected by the results of the captive.

Not just revenue – exclusivity!

An agency captive can give you a product that no one else has. The facility can be branded and bundled with other services offered by your agency. Typically, policyholders are notified on the quote proposal that the agency has a risk-sharing relationship with the fronting carrier. Some agents decide to take this further and use the captive facility as a sales tool and point of differentiation.

> “*Because our agency takes underwriting risk on your business you can be assured that we will give you the highest level of risk management service.*”

Imagine how difficult it will be for competitors to sell against this unique value proposition.

Does a captive make sense for you?

An agency captive can be owned by any type of agent. Thus, a retailer can write generalist (heterogeneous) accounts in their facility, while an MGA or Program Administrator can write program (homogeneous) business in theirs. While in theory an agency captive can be used for any line of business, most focus on some combination of BOP, Package, GL, E&O, WC and Auto.

Agents should be prepared to write at least $5M into their captives within the first three years. Achieving critical mass is necessary in order to weather the effects of shock losses and enjoy the benefits of the law of large numbers.

To own a captive an agency needs to have a high tolerance for risk. Unlike with company profit-sharing plans, <u>you can lose money</u> with an agency captive. Even with good risk selection, adequate pricing, critical mass, aggressive claims management, etc., an adverse outcome is always possible.

Additionally, in order to have a captive an agency needs to have capital and patience. Agency captive profits do not start paying out for several years. Also, because the maximum obligation of the agency is potentially greater than the captive's share of the premium ("loss fund"), the fronting carrier will require the unfunded liability to be collateralized. Depending on how much premium is written into the program, the collateral requirements can be significant -- often reaching seven figures. The good thing is that all of the agency's money – loss funds and collateral -- can be earning investment income while it is encumbered.

Selecting a carrier.

There are not many insurance companies that offer these risk-sharing opportunities to agents. Some carriers that do so limit themselves to Program/MGA relationships. Very few are willing to allow a retail agent share risk on a generalist book of business. There are many factors to consider when selecting a carrier.

- Financial strength/rating
- Level of commitment to the captive model
- Internal "channel conflict"
- Products – forms, pricing ability, state filings, billing options
- Technology and systems
- Services – UW, claims, loss control
- Level of "captive infrastructure"

- Sophisticated reinsurance accounting?
- Dedicated actuarial support?
- A plan for closing/commutating old years?
- Good choices for collateral – cash option with guaranteed interest?
- A sponsored captive manager and/or cell facility?

Agents interested in a captive should seek a customized proforma from their prospective fronting carrier that includes an actuarial analysis of the target book of business and modeling of various loss ratio outcomes.

Conclusion.

Company profit-sharing is a significant revenue source for most agencies. It should certainly be kept in place for the majority of an agency's business. However, for the agent's most-profitable accounts, a captive can lead to a much higher level of income while creating a competitive advantage that truly distinguishes the agency in the marketplace.

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