

# THE TIPPING POINT



## 2007 YEAR-END REVIEW

**WARNING:** This article addresses some tough issues about the future of the Canadian p&c industry and may upset some people. These views reflect the serious concerns of others, especially brokers.

By Brenda French

I'm predicting that 2007 will be seen as a pivotal transition year and the tipping point for many in the p&c industry. The last 12 months have been about control — who is gaining control, who is losing control and what the winners of the control will do with it.

Many in our industry are sleepwalking their way into a competitive and consumer revolution. Some domestic carrier executives do not believe that a sea change is taking place and, as a result, do not have strategies in place to protect their business or that of their partners. On the distribution front,

many brokers are failing to plan and lack any proactive processes.

Thoughtful, concerned innovators in the p&c industry encounter overwhelming resistance when they attempt to address the industry's structural problems. Some of our domestic insurers are hamstrung by legacy cultures that are controlled by vested interests and stakeholders at all levels who vigorously reject any substantive change. Brokers who are unlikely to survive this industry upheaval obstruct change at every step and hold innovative strategies hostage to their stubbornness.

Innovation and progress is taking place with several carriers and these achievements need to be acknowledged. However, incremental change when our domestic industry is in upheaval won't and can't make enough of a difference.

The domestic industry is in a box and has been for so long that most cannot envision another way of doing things. Changes are made to reinforce the box (improve internal processes, centralizing or decentralizing claims) but never take business strategies outside the box, where the real competition is taking place (direct writers, banks, competitive pricing and branding, enterprise technology solutions that include the distribution arm, etc.).

Reinforcement of the status quo maintains control and ends up being an artificial distraction that stands in the way of real change.

### Multinationals, Canadian banks

Conversely, the multinationals and the Canadian banks are seizing the opportunities left open to them by the domestic p&c players. Insurance is global and these major players are using their size to leverage economies of scale, implement more stringent underwriting guidelines, improve risk management capabilities and achieve expense savings. These strategies are working and each is performing well.

Profitable market share is "king" in our new, globally integrated flat world. Acquiring more market share means gaining more control. Here are some tactics they are executing today:

- Multi-channel distribution (ING, R&SA, Aviva).
- Getting involved with direct writers; e.g. ING and Belair and Grey Power, Aviva and President's Choice.
- All of direct writers, including those owned by the banks, are extending their reach each year and have now entered semi-rural areas. They offer: Auto products 15 per cent to 30 per cent lower than the broker channel, depending on the trading territory; Sophisticated marketing and branding — and lots of it.
- Purchasing brokerages at multiples not affordable by brokers and moving this business to their call centres (ING, R&SA through Johnson).
- Offering interest-free loans and other

incentives to brokers who are looking to make acquisitions in exchange for 25 per cent of their business.

- Including right of first refusal in renewal contracts.
- RBC is opening insurance branches beside its bank locations to make a point about what it sees as unfair regulation.

All of these are good examples of how the leading multinationals are gaining control at the distribution level. In a variation of this theme, ING executed its acquisition and integration of Canada BrokerLink beautifully. With close to 40 per cent of brokers expected to retire in the next five years or so (Cookson

### TREND WATCH

- The industry is doing well and there is capital available, which means that consolidation will continue, especially via brokerage acquisitions.
- According to a KPMG survey, 81 per cent of carriers with more than \$500 million in premium are actively seeking to acquire.
- Multiples are going way up, especially for the larger brokerages.
- HUB International sold in February of 2007 to a private equity firm at the eye-popping multiple of 3.5 times commission. Private equity interest in large consolidators is expected to continue.
- Brokerages are getting much larger and many will pass the \$100-million mark in the next few years.
- In a Cookson Walker survey, 4 per cent of brokers reported that they plan to retire in the next five years, putting \$2.5 billion in play.
- Toyota has announced its intention to distribute auto insurance in Canada in 2008. It will be underwritten by a carrier the car manufacturer controls in Japan and administered through a local partner. Toyota sells 200,000 cars and trucks in Canada today and expects that to jump to 250,000 by 2010.

Walker survey), it is conceivable that many brokerages will also end up in the hands of the direct writers.

As independent brokerages disappear, so go the broker carriers. This means loss of control and market share at both levels.

The multinationals have clearly stated goals of consolidation and growth and are executing their plans systematically. Brokers are dismayed when they hear some domestic carrier executives state that this is just part of the industry's business cycle and brokerage sales and consolidation will settle down in the next year or so. The other view is that the foreign-controlled companies may accelerate their plans. Canada's economy is strong, insurers are making money and the soaring Loonie is amplifying profits. Why stop?

Size and control go hand in hand. The direct companies are well received by consumers everywhere, have lower operating costs and can easily be adapted and updated depending on market conditions. Their business model gives them total control of manufacturing and distribution with a fully integrated business strategy. As brokers often point out, the direct writers still need to improve their claims management but they will get that right in time as well.

Today, broker companies control 62 per cent of the marketplace while the direct writers have 31 per cent (*CI Statistical Issue* — 2006 data). Five years ago, broker companies dominated more than 75 per cent of the marketplace — a loss of 13 per cent. Looking deeper, broker companies only control half of the personal lines market.

The cumulative effect is that the multinationals and the banks are steadily gaining market share and control, primarily through distribution and at the expense of independent brokers. Industry analysts say that when a carrier reaches 20 per cent of market share, it effectively has control. It is estimated that ING is at or near 15 per cent today.

### Reducing expense ratios

Change is taking place with several of the domestic carriers but it is glacial and often does not address the lack of competitiveness on the distribution front. Canceling contracts with brokerages in which the multi-nationals have purchased

### HOW TO LEAD A LARGE SCALE TRANSFORMATION

1. Articulate a clear, focused strategy for change, including the factors that are driving the reorganization.
2. Senior management and key stakeholders must be aligned and committed.
3. Aggressive, enterprise-wide targets should be set, eventually becoming the game plan.
4. Commit to speed, lead by example, and don't shirk making tough decisions when necessary.
5. Build in best practices along with cost cutting.
6. Set people up for success and celebrate early wins.
7. Start early and build in rewards.
8. Make sure that communication is proactive and ongoing.
9. Look at improvement as a continuing process.
10. Manage resistance — it is the key to success.

an equity stake is an appreciated show of support for independent brokers; however most would prefer to see this support translated into proactive strategies.

Today, brokers are disadvantaged in the marketplace; they do not have the tools they need to compete against the best in the industry. At a minimum, brokers need innovative products, priced competitively with the direct writers and supported with marketing and branding. Technology is a whole other topic in and of itself; brokers are seriously handicapped by broker management systems that are under-funded and not evolving fast enough, plus the lack of an enterprise technology strategy between manufacturing and distribution. Brokers need "one and done" as soon as possible.

The direct writers operate at expense ratios ranging from 20 per cent to 23 per cent, compared with 28 per cent to 33 per cent for the traditional industry (*CI Statistical Issue* — 2006 data). If the domestic broker carriers and brokers are to survive this competitive revolution, this gap must be narrowed. This means dealing with structural problems and eliminating duplication and unnecessary costs.

## BUSINESS RESULTS: FIVE-YEAR HISTORY

	DIRECT WRITERS	TRADITIONAL INDUSTRY	
		Broker Companies	Brokers
<b>In 2000</b>	<ul style="list-style-type: none"> <li>Control 25% of the business</li> <li>Average loss ratio 85%</li> </ul>	<ul style="list-style-type: none"> <li>Control 75%* of the p&amp;c market</li> <li>Traditional markets are moving into multiple distribution channels</li> </ul>	<ul style="list-style-type: none"> <li>Wrote 78% of the business</li> <li>Competition is neighbouring brokers</li> </ul>
<b>Today</b>	<ul style="list-style-type: none"> <li>Control 32% of the business</li> <li>Expense ratios average 20%-23%</li> <li>Average loss ratio 65%</li> <li>More competitors: RBC, Belair, GreyPower, President's Choice, TD Meloche Monnex, groups &amp; programs, etc.</li> <li>Toyota and others on their way</li> </ul>	<ul style="list-style-type: none"> <li>Control 62% of the market</li> <li>Expense ratios average 28%-33%</li> <li>Average loss ratio 58%</li> <li>Traditional partners are purchasing brokerages at multiples not affordable by brokers and moving the business to call centres</li> <li>Fewer carriers</li> </ul>	<ul style="list-style-type: none"> <li>Write 62% of the business but only 50% of personal lines</li> <li>90% of brokers are losing client count every year</li> <li>Lost business is going to the new directs</li> <li>Almost 40% of brokers plan to retire in the next 5 years and most have no perpetuation plan</li> <li>Fewer brokers</li> </ul>
<p>* Percentages do not add up to 100 (reinsurers, mortgage insurers, etc.)            * All stats are as of December 2006, <i>CI Statistical Issue</i></p>			

Unless expense ratios come down, pricing is problematic and this is where changing structure becomes imperative. It is also where resistance to change is greatest.

Carriers have said in the past that they will not give up underwriting control, as this is one of their core competencies. However, the cost of maintaining this duplication is unsustainable. If we assume that one underwriter is worth about \$80,000 per year (salary, benefits, overhead) and can manage an average book of business of \$4 million of premium, then reducing the number of underwriters means a huge cost savings. It means that expense ratios come down and the cost savings can be passed on to the consumer. Moreover, with a HR crisis (retiring boomers, contracting labour pool), these skilled resources could

easily be absorbed by other parts of the industry.

Progressive brokerages already have underwriting discipline and risk selection as a core competency and deliver profitable business results to their markets. This means that a core competency like underwriting discipline can be learned and is not limited to one group. Carriers should move up to an audit position and hold progressive brokers accountable for delivering profitable results.

It is usually at this point that the forces protecting the status quo — and control — jump in with all the reasons why delegating underwriting control to profitable brokers bogs everything down (or any other structural change that is addressed). The ensuing tug-of-war wastes energy that would be better put into figuring out how to effectively implement structural change that

reduces expense ratios and gives brokers the tools they need to compete.

### Critical juncture

This is a tough message that some readers may feel is unfair on certain issues. Yes, strategic change is taking place with some domestic carriers: Economical is investing heavily in replacing its legacy system, which will position it well in the future; Gore Mutual is implementing a steady stream of improvements for brokers via its broker council; York Fire has a gateway portal that allows straight through processing; CAMIC is investing in EDI and building a gateway portal, and more.

Not all multinationals are the same. Axa is not a multi-channel distributor in Canada and has come out with a two-year auto policy that is very competitively priced. Aviva has come out with a strategy to wage the so-called war for distribution. Plus all carriers are assisting brokers with financing for acquisitions. All of these are important initiatives and many other carriers and brokers are also investing in their businesses.

But it's not enough. No one appears to be connecting the dots, envisioning a different way or willing to develop a coalition of key stakeholders to re-design the business model. Very simply, if it isn't in the rear view mirror it doesn't exist. As a result, it also can't exist in the future.

When we net it all out, three harsh facts remain:

- Domestic p&c carriers have a debilitating, costly business structure that is no longer competitive because the direct writers are doing it cheaper and better.
- Domestic carriers and brokers are losing market share.
- Independent brokers are being bought at multiples not affordable by other brokers.

There comes a tipping point for all businesses where, because business leaders didn't see the trends or act when they should, they can't recover. We are near that point today and need a big, audacious enterprise-wide strategy that transforms the domestic carriers and their broker partners into world-class competitors. It's time to take a leap of faith and "just do it." ∞

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