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Agency Clustering: A Method to Survive the 1990's as a Small Independent Insurance Agency

Donald L. Klein

AGENCY CLUSTERING: A METHOD TO SURVIVE THE 1990'S AS A SMALL INDEPENDENT INSURANCE AGENCY

DONALD L. KLEIN, B.S.

An Abstract Presented to the Faculty of the Graduate School of Lindenwood College in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration

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ABSTRACT

This thesis will focus on the study of the small independent insurance agent and a method to survive in the 1990's.

The small independent insurance agency is faced with a number of problems which may jeopardise the future existence of the independent system as we know it today. These concerns include: lack of market availability; higher premium volumes required by the insurance companies; intense competition from direct writers, captive agents, and national brokerage houses; increased office and operating expenses; and a perpetuation plan for the business in the event of death, disability or retirement.

Many agents feel that in order to survive, they need to represent more companies in their agency. They want to have enough volume with each company to develop clout. They desire better commission contracts and profit-sharing agreements. They would like to spend more time selling and less time servicing existing

accounts and managing the office. And, they would like to make more money.

The purpose of the present study is to investigate agency clustering as a method of operation to meet the needs and concerns of the independent agent. Specifically, it is hypothesized that agency clustering offers the benefits of expertise and financial reward. It should be considered a viable alternative for the survival of the independent agency system.

Six independent insurance agencies participated in the study. The subjects completed a questionnaire and data were obtained on basic agency organizational information; company premium volumes and loss ratios; gross revenues to the agency; physical plant; automation; and general concerns about current market conditions. Data were analyzed and compared to the 1988 Agency Performance Results Study.

Results of the analysis produced evidence to suggest that the hypothesis be rejected because the financial rewards of agency clustering are not as great as anticipated. There would be non-financial benefits to joining a cluster, while it is felt that only 20 to 30% of the independent insurance agencies would benefit from an agency cluster.

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COMMITTEE IN CHARGE OF CANDIDACY:

Assistant Professor Daniel W. Kemper,
Chairperson and Advisor

Professor James D. Evans, PhD.

Adjunct Assistant Professor Joseph Ancona

DEDICATION

I would like to dedicate this thesis to my mother and father, Ethel and Les Klein, who supported me throughout my studies. Without their help and guidance I would not have been able to pursue this degree.

I would like to thank my wife, Mary, for her support and love throughout this project.

And I also want to thank my two sons, Dave and Tom, who put up with me being gone to class so much.

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I also want to thank the six agencies who participated in the research study. The data they provided me was essential to compare and analyze current production figures; and to project potential revenues and expenses for the prototype cluster agency.

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CHAPTER 1

INTRODUCTION

Background

The insurance product is distributed or offered to the general public by insurance companies through several different methods. A company may use direct mail to solicit and sell policies. GEICO Insurance Company and USAA Insurance Company use this method quite extensively in dealing with the military market and eliminate the agent or middleman. A second method is the direct writer used by companies such as Allstate and Prudential. These agents are considered employees of the insurance company. Another method is the captive agent used by companies such as State Farm, Farmers Insurance Group and American Family Inusrance Company. These agents are considered independent contractors and not employees, but they can only write insurance policies for the insurance company they are contracted with. The final method of distribution used by many insurance companies is the independent agency system. Companies such as Hartford, Travelers, and Safeco distribute their policies using this system. An independent agent is an independent contractor who can negotiate contracts to represent as many insurance companies as he or she sees fit. The independent agent is an entrepreneur. As an independent agent writes a policy for his client, he maintains an ownership right in that policy. As the agent writes more policies he builds a 'book of business' and establishes a value for this business as a going concern. The customer list or policy expirations list is the independent agent's most valuable asset and would be comparable to a manufacturers or retailers inventory. The market value of the agency is important for two reasons. First, from an external viewpoint a banker would want to analyze the agent's balance sheet to determine financial strength. If a value is not assigned to expirations, the agent's financial position is not accurrately portrayed. And second, in order to sell an agency, it is difficult to determine the value which should be assigned to this valuable intangible asset. The scope of this research paper will focus on the methods of operation of the independent insurance agent.

In the past 10 to 12 years insurance companies have been requiring higher premium volumes from their agents in order to maintain their contracts to write business. Minimum volume requirements are rising even further as the insurance companies seek to pare down their agency plant to obtain greater efficiency. In his Points & Viewpoints column in the National Underwriter, Al Jaffe refers to a survey done by the Independent Insurance Agents of America with its members which dealt with the minimum quotas of commercial business placed upon agents as well as the minimum premium required of individual commercial risks demanded by most companies.

> A very large percentage of the smaller agents, typically those in rural areas or smaller communities, simply could not meet the minimum volume requirement, and also had many clients whose premium did not come up to the minimum premium standards. The minimum volume demanded ranged from $50,000 to $250,000 or more. Today, an agency with a premium volume of $1,000,000 is indeed a small agency. Take this guy with $1 million or less, of which maybe $300,000 or so is commercial. He has to have 3 or 4 companies. With most minimum quotas at $100,000 to $250,000...how can he possibly satisfy his companies and write any new business with them?
>
> And then there's the matter of minimum account premiums. While the largest number of these were set at $1000...very significant numbers of these minimums were set at $2,500 or $5,000 or more. Many small town 'Main Street' risks just don't develop that much premium, so that if a portion of our agent's book of business doesn't qualify, his chances of meeting the volume quota is that much slimmer (49).

Some companies are requiring volume commitments, while courting the business through their larger or more committed agents, and are seeking business through agents which have sales centers or who can generate high-end business. Where does this leave the small agent and especially one located in a rural community? Alfred Haggerty reports in a National Underwriter article that the plight of the small, rural agencies were examined at the annual convention of the Independent Insurance Agents of California. His coverage included a speech by Robert W. Reagan, president of Hales & Associates, Chicago, who indicated

> ...Statistics suggest there are real problems for small agents, and more and more of them going out business. Limited access to markets, limited ability to hire and develop staff and public perception are some potential weaknesses of small and rural agencies...(29)

The companies are realizing that 20% of their agents are giving them 80% of the business. So when it is decided to reduce or drop some agency contracts, they figure that 80% of their agents may not be worth keeping. Joe Quinn cited the following example in his address to the Independent Insurance Agents of America national convention

> Lumberman's in Massachusetts wanted to get down to about 50 agents. They were well over 500 agents in Massachusetts at one time. What they are doing is selecting the agent. They may select a small agent in a rural area and say "that $500,000 book of business we are getting is good and we want that agency." But I think they are going to look in the metropolitan areas, city areas in particular, and they are going to say, "We want a large agency, and we want the business to be developed the way we want or we don't want it at all." ("Agency Clustering" 122)

Many of the smaller agencies rely on Personal Lines business such as automobile and homeowners policies as their main lines of business. Consider a company which refuses to handle Personal Lines business altogether, for either an indefinite or a designated period of time. Others are terminating their small agencies, typically those who still depend on Personal Lines for the majority of their volume. In an article "In Search For Markets" Noreen Lupo illustrates this situation

> Cynthia Lewis, president of Mart Pioneer Insurance, Mart, Texas, a rural agency with a premium volume of $1.5 million, was prohibited by one of the agency's lead carriers from submitting new homeowners business for one year. Now, only two of her four carriers, one of which is a regional company, will handle both standard auto and homeowners buiness. And the other national carrier in the agency will accept auto but only under strict underwriting gudelines. (19)

Office Expenses

As with all businesses, the costs of operation are escalating all the time and the independent agent is constantly looking for ways to cut expenses. Rising rent, utilities, taxes and office payroll can quickly eat into the bottom line of the business. This is especially true during periods of a 'soft market' when the insurance companies are reducing premium, the net effect is reduced income to the agent. On a $10,000 premium account the average commission to the agency is 15% or $1500. If the insuance company reduces the premium cost down to $8000, the agent's commision is reduced to $1200, a loss of income of $300 on one account. This can be devastating to the agency when it realizes that a negative cash flow has developed. What possible ways are there of keeping expenses under control and within a manageable limit?

Competitive Markets

Competition is the name-of-the-game in insurance. There is a finite amount of business out there to write and each company wants to grow so that business has to be taken away from someone else. The direct writers such as State Farm, Allstate, and Farmers Insurance

Group have made tremendous progress from the mid-1950's to the present. Noreen Lupo illustrates this fact in her article.

> It is no news that the independent agency system gave up large chucks of market share to direct writers during the last hard market. And the effects are still being felt, with direct writers having strongholds in certain areas of the country that the agency companies had abandoned.
>
> John Kyes, president, Kyes Agency, Allegan, Michigan, says that the agency companies are having a rough time fighting off the direct writers in his area. The direct writers are coming in with premiums on six-month auto policies between $60 to $200 lower than what the agency companies are offering. As a result, he has lost some business to the direct writers. Only a couple of years ago, Keyes averaged 31 applications for every 100 leads; today, he is down to about 21 applications for every 100 leads. (20)

The direct writer distribution system accounts for about 65% of all Personal Lines business written in the country today but only about 25% of the Commercial Lines business. By keeping their expense ratios lower, they can promulgate a lower premium and be very competitive. The independent companies are trying to lower their expense ratios to be more efficient and they start by looking at their agency plant.

The small independent agent typically represents five or six standard companies on a direct contract basis. Some of the larger agencies and national brokerage houses may represent 40 to 50 companies and can compare prices and coverages to get the best premium rate for the client. Ten to twelve years ago the national brokerage houses wouldn't talk to an account that generated less than $50,000 of premium per year. Now they are soliciting business with minimum premiums of $20,000 per year. The direct writers have said they want to gain a 50% share of the Commercial Lines market and they are aggressively pursuing larger Commercial Lines accounts. So the small independent agent is in competition with the direct writers, the larger agencies and national brokerage houses, and other small agencies just like himself.

Perpetuation

And finally, how does a small independent agency perpetuate his business in the event of his death, disability, or retirement. He has worked a good portion of his life building a capital asset which is marketable to a willing buyer. If the owner is a one-man shop and he dies unexpectedly, is there someone available, a ready buyer, to continue the business and preserve the estate for the family?

Purpose

The purpose of this research project is to reflect on the problems and concerns faced by the small independent insurance agency. These concerns include: market availability and volume requirements, competition, increased office and operating expenses, and a perpetuation plan in the event of death, disability or retirement. Although there are several distribution methods available, this project will research the advantages and disadvantages of affiliating with an Agency Cluster.

CHAPTER 2

LITERATURE REVIEW

General Problem

The small-to-medium-sized independent agent faces a number of challenges. The insurance companies exert pressure on one side with requests for more premium volume. Agents with less than the minimum volume are having their contracts cancelled, or else the company is not allowing any new applications to be submitted. The agent is also experiencing higher operating cost within his own agency with increasing rents, utilities, and taxes. Fierce competition threatens the business of the independent agent, as aggressive direct writers, national brokerage houses, and other small agents solicit a finite amount of insurance business. And then there is the problem of perpetuating the agency to protect the capital investment for the agent's heirs. One possible solution to these problems is Agency Clustering.

Agency Clustering

Clustering can be defined as a grouping of two or more individual agencies for the purpose of consolidating certain operating and/or marketing functions. Its principal purpose is to improve or maintain market share, either through the reduction of expenses or by increasing the amount of premium volume so that minimum volume requirements can be met, sometimes resulting in a bonus. A cluster is a joint venture which allows agents to maintain their own identities while affording them an opportunity to generate more income. It can take over certain administrative functions, thus allowing producers to concentrate on sales of new business. Even though some or all of the resources are pooled, each agency owner retains the equity in his or her individual agency. A new entity, which may be a partnership or corporation, is owned by the participating agencies.

There are basically three types or categories of clusters.

1. The Informal Cluster - in this design the members usually cluster in a central office and share the rent, utilities, secretarial and clerical costs.

Each agency maintains its own individual identity and independence. Customers who visit the office enter a common waiting room and are then directed to the agency that handles that account. This basic model for agency clusters was described by Morrison and Bakst in their 1965 classic, "Agency Purchases and Mergers". Morrison and Bakst called their cluster the 'Worcester Plan', and described it as a 'factory' in which the internal operations of several operations are consolidated ("The Agency Cluster" 1984).

2. The Formal Cluster - the members may or may not cluster in a central office but the main difference is that a management company is set up to handle the processing and day-to-day decisions of the cluster. The agency cluster is managed by an agency manager who is responsible for internal operations. The manager is an employee of the cluster and is responsible to the Board of Directors, composed of the principals of the participating agencies. He or she may or may not be a principal in the cluster. The manager's compensation is determined by the Board of Directors, and depends on the overall performance of the cluster. The management company sets up the contracts and volume commitments with the insurance carriers. The expenses and operating

costs of the cluster can be handled in one of two ways or a combination of both. First, the management company is compensated by overriding commissions and a share of Profit-Sharing commissions. Second, all members pay a set percentage of their commission income to the management company to offset operating expenses. All member agencies retain their own non-cluster contracts. A formal written agreement should be drawn up between cluster members covering operating cost, personnel, management services, and ownership of expirations.

3. The Complete Cluster - this type of cluster arrangement includes elements from the informal and formal clusters. There are some additional formalized agreements which could include:

A. Buy-sell agreement between the cluster and member agents.

B. Procedure for allowing new participants into the cluster.

C. Agreements for removing participating agencies.

D. Perpetuation agreements.

The difference between a Cluster and a Merger is: a cluster member retains his own book of business and his own identity. A new entity (the cluster) is formed as a partnership or corporation and is owned by the participating agencies. In a merger, the ownership of two or more agencies are consolidated and a complete new entity with a new identity is formed. Roy Lindhardt and his partner Hank Ford of the Ford Agency in Southfield, Michigan, favor merging with or acquiring agencies in order to grow.

> Management of clusters is too complicated and agent/principals who were formerly independent have to relinquish their control. Furthermore, the agencies involved must be compatible or the cluster will work inefficiently. For example, agencies that do not seek new business aggressively do not contribute to the cluster because they are essentially looking for an easy way to remain stable. ("Clustering: The Debate" 48)

The difference between Clustering and a Franchise is: a franchise operates very close to a cluster, but normally the franchise is an independently owned company and is not owned by all member agents. An agent would join a franchise by paying a franchise fee and then a percentage of his monthly commissions are paid to the franchise. In return the member would receive such things as: agency management expertise, internal operations systems, sales management guidance, competitive products, risk analysis assistance, and a valuable image identification. They do not usually provide services like accounting and processing. Although the member retains his own book of business and independence, he affiliates himself with a national image such as Century 21 and ERA have done in the real estate industry. In a 2-year study done by Russell Miller, Inc, it was concluded that "The franchise is the only business structure which combines the financial and marketing advantages of unity with the strength and success of ownership independence" ("Franchises And"). Three franchise groups which have gained nationwide prominence are: ISU/Insurorsgroup located in San Francisco, CA; Pridemark, Inc, in Costa Mesa, CA; and Marketforce out of Kansas City, MO.

Benefits of Clustering

Clout with the companies. Clout is the amount of influence that an agency may have with a particular company. An agency that has $1,000,000 of premium volume and a low loss ratio will receive more underwriting and premium concessions than a smaller agent with $100,000 of volume. But clout should be used diplomatically because an arrogant attitude may be harmful to the cluster no matter how good it is.

Better commission contracts. Some companies can offer an agency with a $1,000,000 of volume a better contract on commissions paid to the agency. The average commission rate is 15%. But a larger volume agency may receive between 1% and 5% more commission depending on the additional services provided by the agency. Mississippi Insurance Managers do some policy writing and underwriting functions and they are paid a couple of extra points of commission ("Agency Clustering" 114). Karl Gebhart relates an incident whereby a major national carrier pulled out of all their small agencies in Delaware. The marketing representative approached the cluster a year later and wanted to get back into the state and offered 2 1/2% additional commission if they could get $500,000 of personal lines business ("Agency Clustering" 124).

Better profit-sharing agreements. In conjunction with the better commissions is better profit-sharing. If the premium volume of an agent exceeds a minimum level and if his overall loss ratio is lower than a maximum level, the agent may share a percentage of the profits. This is typically on a graded scale basis whereby the larger the volume and the lower the loss ratio, the greater the share of profit. Some additional factors which can be negotiated with the companies are: reasonable stop-loss amounts; no loss carry-over to succeeding years; and an equitable loss expense ratio. Twig Branch of the Iroquois Group states in his taped interview with George Nordhaus, the president of Insurance Marketing Services, that their cluster is made up of 200 small, rural agents in upstate New York and Pennsylvania. Their success has come from a low loss-ratio system which pays them a better-than-average profit sharing bonus each year. Branch indicates that the loss ratio of the Iroquois Group is 30% better than any one of their company's loss ratios ("Clusters and Other Agency Cooperative Groups").

Sharing of expenses. There are possibilities of reduced expenses when the management company can negotiate volume purchases for the member agencies on everything from computer equipment to office supplies. John Pryor notes in his article that savings on printing costs are especially inviting. When purchases are increased from 2,000 or 5,000 units to 10,000 units or more, the unit cost drops markedly. Another expense savings could be joint advertising where the cluster coordinates the entire advertising program for its members. And finally, one agency may find the cost prohibitive to purchase and maintain a rating program on its own. But by sharing the cost among four or five cluster members, the system may be affordable (84).

Sharing of expertise. Clustering can bring individuals together who have knowledge or abilities in technical areas such as life and health, manufacturing risks, the bonding exposure, etc. Or they may have abilities in financial management, sales management, marketing, etc. The expertise contained in the cluster will make that cluster more valuable to its members and insurance companies. Bill Anderson of Total Insurance Services states:

> One of the great strengths of a cluster is that it enables a group of agents to benefit from one another's expertise. For example, one of our members, Robert Lamb, is a real numbers person. Naturally, he's treasurer of the corporation and serves on the finance committee. Another cluster member, Robert Key, knows a great deal about computers. We are highly automated...thanks in no small part to this person. ("Joining Forces" 21)

<u>Availability of more markets.</u> The smaller agents participating in the cluster may have access to additional markets from the other cluster members. The insurance companies may not want the small agent but as a cluster member that small agency can preserve most of its independence and acquire the market stability needed to survive. Typically, a small independent agency represents between three or four standard companies on a direct contract basis. After the cluster is formed, the agency suddenly has access to between 12 and 15 insurance carriers. A. H. Morelos touches on this subject in "Clustering: An Insider's View." He states:

> Although the ability to represent more insurance companies was not the primary concern of our original agencies, as the market tightened it became an important concern, as well as the most significant reason that other agents later chose to join our cluster after the original formation. When we came together as Affiliated, each of us individually represented one or two major carriers. Even though several of us had contracts with the same companies, we ended up with a total of eight companies in the cluster. As new agents were admitted, new companies were added and other deleted until we now have representation through 12 majors and numerous specialty carriers. This gives our producers a very broad spectrum and we feel, a competitive advantage that we did not enjoy previously. (1)

When the cluster is formed, one of the steps is to create an inventory of companies represented and the premium volume with each company. The number of companies to be retained should be small enough to guarantee a sufficient volume to each company to make the cluster important to that company. The clustering agents can then negotiate with the chosen companies to determine if more favorable contracts and other forms of assistance can be obtained ("The Agency Cluster" 4).

Improved management systems. Every agency goes through the process of managing, selling, and servicing within its operation. In a small agency these processes may fragment the principal's time resulting in inefficiency and substandard performance. With the formation of the cluster, one member may be appointed sales manager to oversee production of the cluster. This individual will assist in preparing a unified business plan which is essential for proper forecasting and budgeting. Sales meetings are set up to discuss sales objectives and make producers accountable for production goals. If done properly this sales management system will produce more consistent results. The insurance companies appreciate this, especially if the cluster sales goals correspond to their programs or market niche.

A second management system is underwriting and claim control. If all applications are submitted to the cluster service center prior to submission to the insurance company, the accuracy and completeness can be checked by the placer. Anderson highlights the importance of this function in "Joining Forces"

> Our insurance companies really like the fact that two experienced placers are controlling the quality of the applications coming out of the cluster. The companies know they are not going to have to incur the expense of rejecting applications that are either incomplete or submitted for risks that are improperly classified. They are recognizing that when something comes in with our name on it, it flows right through. (56)

The quick and efficient processing of claims make for a class agency. The client wants to be contacted promptly and treated fairly when he as a claim. With the service capabilities of the cluster, a separate claim department could be set up to process claims quickly.

The third management system is an automation network of computers linked from satellite offices to a central processing unit. If the cluster sets up a central accounting system, production reports and accounts current can be produced for each member agent who in turn pays the net premium minus the commission to the cluster. The cluster then makes one payment to the insurance company. As the cluster grows and builds its automation system, it may add wordprocessing and marketing capabilities which would not be possible for the smaller agent. And finally, an automated rating function could be added to the system. This would allow comparative rating between the various companies in the agency and establish consistent accuracy of the quotations. George Frazier, president of Insurance Advisors, Inc. in Hope, Arkansas, lists automation as one of the most important benefits of clustering.

> Lack of automation creates a situation where the disadvantages are particularly acute. Agents are aware that survival is questionable unless they automate, but the size of their agency and the cost of equipment make automation an unaffordable luxury. The absence of computer capability aggravates all of the other problems since small and mid-sized agencies probably can't compete without

> automation; yet unless they can compete and grow, they can't afford automation. In addition, the long range plans of most companies in the independent agency system include communicating electronically with agents in all phases of operations. Thus, any agent not in a position to be a part of a computer network will be, in time, less desirable to its companies. Clustering gives the small and mid-sized agency the same opportunity to succeed as the large all-service agency. Computer capability, accomplished by a hook-up between the core and each member agency, therefore becomes affordable, helps reduce the costs of doing business, and, by freeing producers time, allows for volume expansion with additional expense.(2-4)

<u>Perpetuation of the agency.</u> The cluster provides a buyer for a member who wants to retire. If a member agent dies, his equity can be preserved in the cluster with buy-out proceeds being paid to the family or estate. This is especially important to the small rural agent because there may not be another local independent agent who is interested in buying his business when he is ready to sell. The cluster buy-out provisions eliminate this uncertainty.

There are two buy-out alternatives, the first of which is where the cluster actually buys the agency and distributes the business to the various members of the cluster. And the second alternative is where another member agent enters into an agreement with the selling agent to buy the business. Typical cluster buy-out clauses may call for the agent who wishes to sell his/her business to offer it to the cluster entity first. The cluster core or Board of Directors may make an offer to the agent to buy out the business if it so desires. If the selling agent feels the figure is too low, the business can be sold outside the cluster. There may be a requirement that the cluster entity be given the opportunity to match anyone else's higher offer. If the cluster core declines to do so, the business is sold and leaves the cluster. ("Agency Cluster" NAPIA. 10)

The perpetuation arrangement in a cluster is explained by Carol Hammes of the Middleton Group as follows:

> Another common use of clusters to facilitate ownership perpetuation is to provide an opportunity for a group of agents to enhance the value of their individual agencies and their attractiveness to a third party buyer. The agents can merge their operations while maintaining individual ownership of their business until such time as an outside buyer purchases all of their books of business jointly. Most such arrangements provide for the cluster to buy their business upon retirement, death or disability in case the outside sale is not consummated by then. (34)

John Pryor, an associate in KIA Insurance Associates in Bakersfield, CA, addresses the perpetuation plan as follows:

> Part and parcel of a cluster agreement should be a soundly conceived "buy and sell" agreement in the event of a participants premature death or long-term disability. It can also provide for agency transfer in the event of retirement; however, this is a transfer that functions with the sellers full participation. An agreement can be made with other producers to assume ownership of their agency in the event of death or disability. This can be outside of the cluster contract because the cluster contract typically will permit such specific arrangements between individual members of the cluster. (85)

Increased profits. The cluster can offer a menu of services and benefits for the member agency such as: clout; sharing of expertise; more markets available; improved management systems; and perpetuation provisions. But the bottom line is to determine if each member agent has the opportunity to increase their profits and make more money for themselves. The "profit factor" will be determined by : commissions contracts being offered by the companies to the cluster; better profit-sharing agreements; and the sharing of expenses to utilize the economies of scale.

Possible Concerns of Clustering

Loss of independence. An agency principal may have started his agency a number of years ago and during this period he has had complete authority and responsibility in making business decisions. When this agency principal joins a cluster he finds that decisions must be made and voted on by the executive committee of the cluster entity. If his philosophy or idea differs from the majority of the executive committee members, chances are his idea will not be implemented. However, loss of some independence might mean gaining more independence in a different way. An agency principal may feel chained to his desk as the owner of his business even though he longs to be out selling. The cluster may free the member agent to engage in more selling ("Agency Clusters" 2).

Loss of identify. The agency principal has spent time and money developing the identity of his individual agency. Now he is affiliating with a cluster entity with two or more other member agents. Depending on the method used to advertise, a member agent's name may be lost in the list of other members. This can be especially confusing where 3 or 4 agencies cluster under the same roof and advertise on a sign listing each agency name.

Expensive start-up costs. Ray Marcum, president of Cumberland Insurance Group, indicates that it took 13 months of preparation with two or three meetings per month to make Cumberland Insurance Group a reality. In order to offset the initial expenses for attorneys and accountants to draw up the corporate by-laws and capitalization plans, each member was levied $200 per month. A total of $80,000 in capital has been contributed by the stockholders of Cumberland Insurance Group. With 10 stockholders, this is $8000 paid by each (Marcum 1-2). When asked how much it takes to start a cluster, one cluster expert said that when you determine a figure for the start-up costs, you should double it!

Personality conflicts. The compatibility of the cluster members may create obstacles. If one member likes to have martini's for lunch, stay out late at night and come to the office late in morning, and the other members are more conservative and family-oriented, the chances are there will be a personality conflict. Roy Phillips says you need to find people you know, like, trust, and respect. There has to be a psychological fit--a chemistry--or problems can result ("Producer Perspectives"). In "Agency Clustering" Tom Clarke believes trust is absolutely the most imperative issue in putting together the group of people you are going to cluster with (119).

Differing business philosophies. One overall philosophy must prevail in the cluster. The members must agree on their marketing attitudes -- whether they will be very aggressive using a telemarketing approach, direct mail, newsletter, billboards, and yellow page advertising. Or will they use a more passive approach and rely on referrals to build their business. If the cluster does not have direction it may be pulled in too many different directions and ultimately fold. The management philosophy undertaken by the cluster is critical. There are more personalities involved, not just the member agents. There may be other non-owner producers and clerical staff who are brought together must now be able to work together as employees of the cluster entity ("Agency Clustering" 6).

Poor experience. Losses are a fact of life for any insurance agency but some agencies are consistently profitable whereas others are constantly unprofitable. There are several reasons why any agency may be unprofitable, such as being hit by a catastrophic peril like a tornado or hail storm, a couple of large fire losses, or a large liability claim brought against an insured. Of more concern is the agency which has a large number of smaller claims which is referred to as a frequency problem. This type of agent may be writing marginal business with its carriers and the loss ratio reflects this fact. The bad actions of one member agent will affect the whole cluster. It is imperative that all member agents reveal their last 5-year loss ratio figures prior to entering into the cluster arrangement.

Insurer doubts. When the cluster is formed, it is possible that not all companies currently represented by the individual agencies will be represented by the cluster. Some companies believe that the cluster concept represents a brokering type of transaction which they are not attracted to. Of the 5 or 6 agencies forming the cluster, there may be 1 or 2 who are not acceptable to a particular company; therefore, that company will resist representing the cluster. There is concern that any company, not a part of the cluster, but still represented in one agency, will feel left out and selected against when the business is written. In "Agency Clustering" Joe Quinn mentions several companies concerns and requirements.

> The Aetna has about 12 clusters outstanding throughout the United States right now, and they treat each situation as being different. The only thing they want is that the cluster agreement be approved by their legal department. The CIGNA has several cluster agreements, probably three or four throughout the country right now. They have a couple of really hard-nosed criteria. They want 70% of all the business of the cluster, and it has to be written through the cluster agreement. They also would like to have only one other insurance carrier with the cluster, in addition to themselves. CNA wants all members of the cluster to be High-Performance agencies...Fireman's Fund seems to have no

> concern at all as to the legal aspects, but they like to talk about who they know in the cluster, and they do it mostly on the basis of what the branch manager knows about the members of the cluster; who they are and ow long they've represented the Fund. Hartford thinks this one of those things that comes and goes, and not get excited about. The Royal is very tough. They want $500,000 from each member of the cluster to go through the cluster agreement. They want a minimum of $5 million from the cluster, and all agency members must have Safecom's data processing system. Travelers is on a region-by-region basis. The only thing they demand is that whenever the cluster agreement is drown up, their regional lawyers review it and okay it before the appointment is made. (121)

Cluster failure. In order to avoid any misunderstandings, the cluster needs a formal agreement and procedures to allow the orderly withdrawal of participants from the cluster. Because each agency is a separate entity at all stages of the cluster organization, leaving the cluster can be readily accomplished. The cluster contract should include both non-piracy provisions and appropriate advance notice if a member wants to terminate. In the case where office space is shared, the description will be noticed but it should be minimal. Anderson explains the withdrawal provisions in the Total Insurance Services contract.

> Any member of our cluster has the right to simply withdraw and resume business as a conventional independent agency. Provisions for an orderly termination are contained in the service contract. Anti-piracy and non-

> compete agreements would protect remaining members of the cluster. (60)

The statement is made in "Agency Clusters: A Guide to Profitability"

> The absolute worse that can happen is the cluster dissolves and everyone goes back to being individual agencies. Some explanations to the customers and companies will be needed, but this is not the end of the world. (Concerns-4)

<u>Contract Considerations</u>

There are a variety of ways that the cluster can be set up and each prospective member agent must determine if the cluster contract meets their individual needs. Consideration must be given to organizational structure, chain of command, standard operating procedures, company relationships, E & O (Errors and Omissions) exposures for the cluster and its members, and perpetuation.

<u>Organization.</u> The cluster can be set up as a joint venture, partnership, or a corporation, but it is an entirely new entity separate from the participating agencies. As a joint venture or partnership each participant enters into a multi-party contract specifying the terms of the relationship. When a corporation is created, each agency becomes a stockholder in the cluster corporation and serves on the

Board of Directors. Anderson maintains that Total Insurance Services has 10 stockholders who capitalized the cluster service center and each stockholder owns an equal share of stock. The service center is run by a Board of Directors on which all 10 stockholders sit. Policy-making decisions of the service center are made by standing committees which include a finance committee, marketing and underwriting committee, rules committee, and executive committee. The service center has the usual officers of president, vice-president, and treasurer (20).

Equal ownership simplifies the voting on financial and other questions that come up from time to time, but there are exceptions to this basic rule of thumb. If one agency in the cluster has a book of business that represents 50% of the total book of the cluster, while four or five other agencies represent the other 50%, it may be justified to depart from equal ownership.

<u>Chain of command.</u> The cluster is a separate entity from each agency and will deal with issues of policy through the standing committees. The service center is set up within the cluster to handle the day-to-day operations and workflow of the cluster. The service center can be governed by officers of the cluster, a standing committee or a service center manager. In

"Agency Clustering" Ned Mitchell, of Mississippi Insurance Managers, Inc., states that there has to be a manager or a management team that runs the cluster. In fact one manager is needed. If one of the agency principals serves as the service center manager he will be giving a lot of time to the cluster operation and he may face a financial sacrifice for the good of the group. He needs to be properly remunerated (116). In the same article Tom Clarke, of Montana Insurance Managers, says that one of the key items in their partnership agreement was the designation of a managing partner. There has to be somebody who is going to be designated as the leader of the group, even though there may be equal percentages of ownership (117-118). And Joe Quinn, president of Allen Walker & Co, Inc., indicates that somebody has to have the responsibility to be responsive to the insurance companies, responsive to other cluster members and make the day-to-day decisions (120).

Bill Anderson explains how Total Insurance Services is set up.

> Recognizing the need to put someone in charge of the clusters daily operation, we created the position of general manager. The person filling this function is hired by the board of directors and reports to the president. Chuck Zamek, one of our stockholders, currently is our general manager. In his agency, he

> primarily worked "inside" and really has a talent and liking for staff organization and management. Chuck turned over part of his book of business to his partner in his corporate agency so he could function as a full-time general manager. He's compensated for his work by the service center. Based on our experience, I would say it's crucial for clusters to have someone function as an overall administrator, as Chuck does for us. In talking with agents forming clusters in various parts of the country, perhaps the most common problem I've witnessed is the failure to put someone in charge. (56)

Handling a common account needs to be addressed by the cluster since a large amount of commissions could weigh in the balance and hard feelings may develop between two cluster members. A common account is one where two agents are vying for the rights to write the insurance of one business account. This problem is addressed in the study made by the Academy of Producer Studies titled "Alternative Marketing Systems"(36).

> The problem of two cluster members being involved with one account is to be expected. Solutions to this problem varied widely according to the circumstances of particular clusters. Methods employed to alleviate this problem included:
>
> 1. A 50/50 commission split between associates.
> 2. The account becomes a cluster management account.
> 3. The first one onto the account is the controlling associate.
> 4. There is an agreement not to solicit another associates accounts.
> 5. The management organization has the power to resolve the control problem.

6. The insured elects which associate is to be agent of record.
7. There is a formula for the purchase of an account from each associate.
8. There is a mutual agreement to back off if one associate finds that another associate in the cluster already has the account.
9. All walk-in business is assigned weekly to a specific cluster associate.

These methods should be addressed in the cluster contract so that all members are aware of the method to handle a common account.

<u>Standard operating procedure.</u> When the cluster is formed, a number of different people are put into a position of working together or changing their work methods and conform to a common method of operation. The marriage of personalities can be overcome with management techniques to merge people together with the least amount of conflict. Another obstacle is to determine a method of operation under which all member agents will conform. People will resist change and this could lead to some real management problems. For instance, if four agencies are computerized and one is not, then the one non-computerized agency may have to make substantial changes in their methods of operation in order to conform to the operating procedures of the cluster. Roy Phillips of Houston, Texas, states

> A cluster involves changed methods, new ground rules for all employees. This is very

> difficult when all employees are at one location...less a problem when offices have their own help at separate locations. ("Producer Perspectives")

Besides the personnel considerations, the cluster must determine the standard method of accounting. In all cases reviewed, the cluster service center pays each company net premiums due based on an agency generated account current each month. Each cluster member would then pay the service center one check for any agency billed items due that month. This makes each cluster member responsible for his or her own account receivables. On direct billed business, the insurance company sends a net commission check to the cluster for all premiums which have been collected by the company. The cluster can then distribute the commissions to each member agent.

Paying the expenses of the cluster service center will be a primary contract consideration and will be a part of the standard operating procedure for each cluster member. Total Insurance Services is set up to pay operating expenses as follows:

> The cluster service center provides support to cluster members in such areas as accounting, claims, file management, and placing business. It also holds the leases on the cluster's three offices and computer system, pays all utility bills, purchases Errors and Omissions insurance and employs all the staff. The only

> significant expenses the members of the cluster have are those related to sales, such as salaries or commissions of their producers; transportation; and the cost of advertising. In return for these services and facilities, cluster members pay the service center a percentage of their commissions that varies from 42% to 50%. All members pay the same percentage which can be adjusted by the service center's Board of Directors. At present, the charge is 45%. (20)

The fees for Cumberland Insurance Group are set up quite differently. All stockholders and associates pay a $1200 membership fee and a $200 monthly operating fee. In addition, stockholders pay a fee equal to 1% of their total monthly volume, regardless of whether sales are placed through the cluster, up to a maximum of $800 per month. Thus a stockholders monthly expenses could equal $1000. Associates members, in addition to the monthly assessments, remit one to five points from their commissions on business placed through the cluster only. The cluster obtains an override ranging from 2.5% to 5% from most of their carriers. The cluster also receives excellent contingency bonuses from each company. Mega Group has a fee schedule based on total premium volume subject to an annual minimum fee of $3,500 billed monthly (Marcum 3). Seatree Marketing Group covers its expenses from overrides from its carriers but it is stipulated in the contract that each agency member may be required to contribute a few points of their commission to the cluster. This commission split is determined by company, line of business, amount of service provided by Seatree, total premium and average premium per risk, and profitability (Ryan 2).

And finally, a standard operating procedure must be established for submissions to the companies such as new business applications, endorsements, and claims. Some clusters will be set up so that everything is sent through the service center which makes each member resemble a sales office rather than a service office. For new business the service center may provide a placer who will review the application for completeness and market it to the company or companies who have the best rates and coverages. Endorsements for coverage enhancements could be processed through the service center. A claims specialist could handle all incoming claims through the service center and make sure that all claims are handled as expeditiously as possible. The cluster may also receive additional underwriting authority from some of its carriers because of a strong service center.

Company relationships. With the cluster arrangement involving a number of agencies it is very likely that one company will be represented by several agencies but it is also likely that only one company will be represented by one agency. If the cluster decides not to continue representing that particular company and move the volume to another carrier there may be some hard feelings because of the relationship developed with that company's underwriters. The idea is to deal with enough companies to allow market comparisons but limit the number so that the cluster could enjoy more clout with insurance companies than the members could individually. William Branch of the Iroquois Group makes the following statement about markets.

> In a successful cluster, agents must be willing to replace some of their markets and take on new markets and new commitments. (1)

Total Insurance Service handles the company issue as follows:

> As agencies joined our cluster, the service center usually took on those of their carriers interested in doing business with the cluster. At one point, we represented about 30 companies, including some we had very small volume with. Today, after much culling, we represent about 20 carriers. We'd like to lower that figure to 15. ("Joining Forces" 60)

<u>Errors & omissions exposures.</u> Every active insurance agency faces the potential of making an error or omission which would cause a financial loss for a client. Human error may be responsible for failure to

add a coverage to a policy when the insured has specifically called and asked for the additional coverage. An omission is where the agent fails to tell the insured of an exclusion or limitation in the policy and after a loss, the insured finds out that the loss is not covered or only partially covered. A legal action may result against the agent and agency for errors or omissions of coverage. In a cluster, each agency maintains its own identity and is its own entity and the cluster is a separate entity so coverage is needed for the cluster and all of its member agents. This can be accomplished with a master policy in the name of the cluster with each member agency listed as an additional insured. Ray Marcum relates how the Cumberland Insurance Group E & O policies are set up.

> The contract requires each associate member to have its own E & O policy through a program offered by the Insurors of Tennessee or to convert to that program upon renewal. The policy is required to have minimum limits of $1 million. The E & O company, Employers Reinsurance, also insures the cluster. Following the recommendation of that carrier, all agencies list Cumberland Insurance Group as an additional insured on their policies, and we've added each agent to the cluster's policy as an additional insured. Should an E & O claim arise from a given agency, in all likelihood both it and the cluster would be brought into the suit. There would be no conflict among E & O carriers since just one covers both parties. (3)

Perpetuation. Having a ready buyer for the agency should a member agent want to get out of the business because of retirement, disability, or death is a primary contract consideration when putting the cluster together or in attracting new member agents. The contract will contain all of the details concerning a buy-out arrangement. The buy-out could be between two member agents or the cluster may buy out a member's book of business and then distribute it to the remaining cluster members. A final option would be to an outside party.

Bill Anderson explains the perpetuation plan of Total Insurance Services:

> An agent who wishes to sell his or her business must offer it to the service center first. The service center obtains an independent appraisal of what the business is worth and presents it to the agent. If the agent feels the figure is too low, he can put the business up for sale outside the cluster. If the agent receives a higher offer, the service center must be given the opportunity to match it. If the service center declines to do so, the business is sold and leaves the cluster. A selling agent cannot force the cluster to take an outside buyer, although the cluster could extend membership to the buyer if it wished. An agent does have the right to bring in family members to perpetuate the agency. If an agent decided to sell his agency to an offspring, sibling or even more distant relation, the cluster would be required to do business with that person. If the service center bought a member's business, it would sell it immediately to any interested

> cluster member. If no individual agencies wanted to buy the business, each agency would be required to purchase a percentage of the book equal to its percentage of the cluster's total volume. (62)

Insurance Company Goals

When an insurance company is reviewing a cluster for a possible contract there are four basic areas of consideration which will determine the company's attitude.

Target market. Companies try to identify the geographic areas in which they want to do business and then they will look at whether the cluster in that geographic area offers them the greatest opportunity for profit. If the cluster is in a geographic area in which the company does not want to grow, then chances are they they are not going to be very helpful, except to develop specialty lines and specific programs ("Agency Clusters" 1).

Agency portfolio Companies will look at the portfolios of the agencies operating in those geographic areas where growth is being sought. They must make a decision on which agencies best fit their marketing profile. Those agencies identified as the ones a company wants usually are offered a special program which involves a commitment from both sides ("Agency Clustering" 1). For instance, EBI Insurance writes workers compensation and when they entered the state of Montana in 1983 they began seeking agency appointments through major agencies located in more metropolitan areas of the state. EBI sought the largest agents who probably had a greater number of clients with larger employers, and they were looking for a way to be able to penetrate eastern Montana. In May of 1984 EBI contracted with Montana Insurance Managers because it liked the cluster arrangement even though the agencies on an individual basis would not have been contracted ("Agency Clustering"-117).

Agency development. As an agency or a cluster of agencies grows in volume with an insurance company, that company may grant additional responsibilities to that agency in terms of underwriting or claims authority. If the cluster has a strong service center in place, the company may allow them to issue their own auto and homeowners policies. This would by-pass the normal underwriting process. Likewise, some companies allow their agents to settle small claims up to $1000 in damages. This takes some of the load off of the claims department in settling processing small claims. For a strong cluster with the proper expertise, the company may increase this authority to $2500, $5000, or even $10,000. Clustering can be a way for an agency to become one of those key agents with a special contract, with underwriting authority, and with a company that will bend over backwards on borderline cases. Clustering allows a group of small-to-medium sized agencies to develop all those things that make a larger agency so attractive to companies. The cluster enables effective use of automation, allows for greater volume, and increases the technical expertise available to the operation ("Agency Clusters" 3).

Expense reduction. Companies with a portfolio of small and medium agencies giving them a profitable book of business do not want to throw these agencies away. But they are looking for vehicles that can make managing those smaller agencies more cost effective. The day of the special agent going out and calling on 25 or 30 or 40 small agents in a given area is a thing of the past. The companies will be talking to their agents electronically in the near future. Smaller agencies need to put themselves in a position to deal with the companies in this manner. The pressure is on the companies to reduce their expense ratio and, instead of dealing with 10 or 15 smaller agencies, they can benefit from expense reduction by dealing with one entity - the cluster ("Agency Clusters" 3).

The insurance company wants to do business with the most professional insurance agents in the area. If the cluster makes a presentation to a company and shows the opportunities for grouwth and profit, the company may be willing to do business with the cluster even if they are located in a geographic area where they don't want to do business. Perhaps the company will open up that market with a list of products they might offer just through the cluster. The company can help a cluster with intial financing needs for personnel and office space, automation equipment and system expertise. If the cluster wants to do something that tracks with the marketing plan of the insurance company, they should be able to work out a deal ("Agency Clusters" 5).

In summary, agency clustering can be set up in several different ways based on the desires and needs of the participating memberts. Clustering offers agents the advantages of: additional clout with the insurance companies; more money and increased profits resulting from better commission contracts and profit-sharing agreements; less expenses (overhead) based on the economies of scale; more insurance markets to choose from; shared knowledge with other participating members;

better and improved management systems; and a formal perpetuation for the member agents. But there are some drawbacks and limitations to clustering. Some of the disadvantages of clustering are: loss of independence and identity; the enormous expenses to start up a cluster and keep it going; a difference in business philosophies and personality conflicts between member agents; poor loss experience; and insurer doubts about the cluster set-up.

Agents interested in a cluster arrangement must consider a number of items in the contract to determine if clustering is the best way for them to continue doing business. These considerations are: the organizational set-up of the cluster; the chain-of-command and standard operating procedures which the cluster will follow; which companies will be represented by the cluster; how the Errors and Ommissions exposures will be handled; and the details of the formal perpetuation plan offered by the cluster.

And finally, a cluster must fall within the insurance company's marketing plan. The companies are constantly reviewing the geographic areas of operation; the type of business written by each particular agency; to what extent an agency can develop and grow; and ultimately how the company can reduce its expense ratio.

<u>Hypothesis</u>

Agency clustering offers the benefits of expertise and financial reward. It should be considered a viable alternative for the survival of the independent agency system.

CHAPTER 3

METHODS AND EVALUATION

Independent insurance agents are looking for ways to survive in an economic climate which is seeing increased expenses eating away at profits; insurance companies requiring more volume, while cutting commissions to their agency force; and bonuses and profit-sharing checks going to the preferred agents (those with high volumes of business with that company).

The purpose of this research will be to take real financial data from independent insurance agencies and analyze that information in this section. These data will then be combined in the Results Section to form a hypothetical cluster agency. The agencies will be compared with themselves as individually operated agencies versus cluster operated agencies. This comparison will involve not only financial benefits but other derived non-financial benefits as well.

Independent insurance agents in central Illinois participated in the study. Although exact numbers are not known, it is estimated that this geographic area houses 100 to 150 independent agents with volumes ranging from very small to large agencies doing in excess of $10 million in annual sales. The independent agency is typically contracted with four or five standard insurance companies; works strictly on a commission basis; and, by contract, owns the expiration rights to the business he puts on the books. Eliminated from the survey were direct writing agents and captive agents, as their methods of operation and organization are different from those of the independent insurance agent.

Measures

A group of 25 agencies were first selected from the central Illinois area who were known by the author to possess the following criteria:

1. Premium volume of between $1 million and $3 million.
2. One or two man operations working full time in the insurance business.
3. A minimum of three standard companies represented in the agency.
4. A mix of personal lines and commercial lines business equal to 50% for each line.
5. Solid, well-respected agencies within their community.

Of the 25 agencies originally listed, six agencies were picked at random to participate in the survey. The survey was limited to six agencies because it was felt that the compilation of financial data from six agencies would be easy to work with in forming the hypothetical cluster agency. None of these agencies were in close proximity to each other and would not typically be in competition with other agencies participating in the survey. This was done to maintain confidentiality of each participant.

Data Obtained

Each of the agencies provided research data based on an Agency Questionnaire (Appendix A). The following data were obtained:

1. Basic agency organizational information.
2. Individual company premium volume and loss ratios.
3. Gross income to the agency.
4. Licensing information about each agency.
5. Automation equipment currently in place.
6. Physical plant information.
7. Office equipment information.
8. Concerns about current market conditions and the effects on each agency.

The questionnaire was completed by the individual agent and returned by mail. The agents were able to provide accurate data from individual company production records which included premium volumes and loss ratios for the past calendar year.

Data Analysis

The agencies surveyed have a combined total premium volume of $8,200,000 or an average of $1,400,000 per agency. The smallest agency has a premium volume of approximately $700,000 and the largest agency writes a little over $3,000,000 in premium. The average income per agency computed at $205,000.

Companies. A total of 17 standard companies are represented by the six agencies surveyed. Seven of these insurance companies would be classified as national stock companies (S) who operate in all 50 states. Eight companies would be classified as regional companies (R) who are usually licenced in a few states and located in a certain geographic area. Two of the insurance companies are farm mutuals (F) which usually write in one area of the state and their writings are limited to the farm market. The companies have been code-named to protect the confidentiality of the agencies surveyed. The companies and premium volumes are illustrated in Table 1.

Table 1

List of Carriers (Research Agencies)

	Prem Vol	Loss Ratio	Bonuses
Epsilon Co (R)	$875,000	54%	$22,880
Beta Co (R)	871,000	35%	2,000
Alpha Co (R)	718,000	60%	11,150
Omega Co (S)	532,000	17%	15,000
Gamma Co (R)	290,000	98%	1,200
Lambda Co (S)	290,000	85%	
Phi Co (S)	272,000	60%	
Psi Co (S)	270,000	58%	
Eta Co (R)	236,000	76%	2,180
Delta Co (F)	198,000		
Zeta Co (S)	177,000	40%	
Kappa Co (R)	165,000	60%	2,000
Iota Co (S)	150,000	40%	
Sigma Co (R)	126,000	141%	
Chi Co (S)	53,000	79%	
Theta Co (R)	51,000	111%	
Upsilon Co (F)	37,000	6%	

Premium Volumes. The combined premium volume of all participating agencies equals $8,200,000. This consists of $5,300,000 of standard property & casualty business; $1,900,000 of sub-standard or specialty line business; and $1,000,000 of premiums from life, health, or group insurance.

Commissions. The six participating agencies generate an annual gross income of $1,230,000. Revenues are calculated on all income generated from the insurance operations. Any side operations, such as real estate or bookkeeping services, are not included in this revenue figure.

Bonus/Profit-Sharing. A total of $56,400 of bonus money was paid to the agencies (Table 1). This bonus amount equals 4.8% of the combined gross income level.

Loss Ratios. The combined losses equal $2,830,000 compared to the combined standard premium volume of $5,300,000. This evaluated to a combined loss ratio of 53%.

Organizational Information. Five of the agencies are formed as corporations while one agency operates as a partnership. All six agencies are owned by one or two principals and all of the owners are the primary agents. Only one agency reported that they had a non-owner producer, but most indicated that their inside customer service representatives were licensed producers. Four of the six agencies do maintain a non-resident license with the State of Missouri. Five agencies belong to the Independent Insurance Agents of Ilinois, an insurance association, and all five procure their Errors & Ommissions insurance from Employers Reinsurance which is an association sponsored program. One agent belongs to to the Professional Insurance Agents association and they utilize the Errors & Ommissions offered by the PIA. Annual premiums for E & O coverage averages $2200 with deductibles ranging from $1000 to $2500.

Automation. One agency indicated that they are fully automated with accounting, word processing, rating, and policy infromation all maintained in-house. Two agencies report no automation in their office and three agencies are partially automated, having an in-house computer to handle accounting and work-processing functions.

Buy-Sell Agreement. Three agencies report having a formal buy-sell agreement and each of these agencies are two-person operations. Three agencies indicate that they have no perpetuation agreement, but one of these agencies has an informal agreement with one of the employees in the agency.

Physical Plant. All of the agencies indicated that the agency rented their office space. The principals from three agencies own the office buildings they are located in, but lease the office space back to the agency. Two agencies report that they lease their telephone system, but all other office equipment is owned such as: furniture, copy machines, FAX machines and computers.

Market Conditions. None of the agencies indicated a problem obtaining competitive quotes at this particular time which revealed a soft cycle. A soft cycle occurs when companies have the capacity to write more business and will apply various credits to reduce the premium allowing them to beat the competition and write the business. All of the agencies reported on the questionnaire that they are not having any problems retaining current company appointments, but attracting a large stock company contract is difficult because of the required premium volume. Each agency responded that they are having trouble finding time to manage the office and also sell new accounts plus service existing accounts. Ironically, only two agencies reported that they dislike duties involving personnel management. One agent commented that he doesn't like to discipline an employee. Out of the six participating agencies, only one agent indicated that he might have a problem sharing decision-making issues with other agents. The main overriding problem indicated by all of the participants is that they spend too much time in management functions, and this limits their time to sell and service which restricts or limits growth. One agent commented that there seems to a continued loss of market share to the direct writers and he is being forced to handle more non-standard business.

Agency Productivity

Table 2 is a comparison of the average of the six participating agencies and the 1988 Agency Performance Results Study conducted by the Academy of Producer Insurance Studies. The revenues from the six agencies average $205,000. In this comparison, the revenue range of $150,001 to $250,000 was used.

It is felt that comparing these agency productivity items reflects the operating efficiency or inefficiencies of the agency. The APRS standard is only a guideline or road map to indicate if an agency is operating above or below the standard. This information is much more useful than looking at an agency's profit-and-loss statement.

Table 2

Agency Productivity (Individual Agencies)

	APRS Standard	Research Agencies
Number of Agency Owners	1.4	1.7
Number of Agency Support Staff	2.7	1.7
Revenues per Person	$40,483	$60,294
Compensation per Person	$23,533	$35,049
Compensation per Support Staff	$13,754	$22,574
Pre-tax Profit per Person	$3,643	$5,426
Avg C/L Commission per Account	$356	$322
Avg # of C/L Accounts	236	270
Avg P/L Commission per Account	$75	$93
Avg # of P/L Accounts	1160	970
Avg # of P/L Accts per CSR	936	830
Avg commission per P/L CSR	$70,527	$77,190

As can be seen in Table 2, the average of the six participating agencies comes out better than the APRS standards which were figures generated by agencies throughout the midwestern region in this national report. In the Results Section, the comparison will be extended to reflect a revenue range of $1,200,001 to $2,000,000. The prototype cluster agency will generate revenues in this range.

CHAPTER 4

RESULTS

The research data were gathered from the six participating agencies and analyzed as individually operated businesses. After combining all of the data under a cluster format, the Agency Productivity figures will be compared to the APRS Standard for agencies in the revenue range of $1,200,001 to $2,000,000. The combined revenue of the six research agencies is $1,230,000. Table 3 reflects the agency productivity of the combined clustered agency.

In comparing the APRS standard figures to the clustered agency column, there appears to a large difference in the number of agency owners on the clustered agency side. But it must be remembered that all of the cluster members are the primary producers and that there are no outside non-owner producers. The APRS Standard shows 3.1 owners but a category not listed is that this size of agency normally has 5.7 non-owner producers. This would bring the figures closer together. The next item is the number of agency support staff. The individual clustered agents can process the same amount of work with 2/3 as many people. The comparisons run very close until the line for the average commission per Commercial Lines account. The clustered agents run an average commission of about 1/2 of the APRS Standard ($322 versus $630). This would indicate that the clustered agents are writing a larger number of small commercial accounts which do not generate the very large premiums.

Table 3

Agency Productivity (Clustered)

	APRS Standard	Clustered Agency
Number of Agency Owners	3.1	10
Number of Agency Support Staff	15.0	10
Revenues per Person	$63,516	$60,294
Compensation per Person	$39,788	$35,049
Compensation per Support Staff	$18,788	$22,574
Pre-Tax Profit per Person	$5,124	$5,426
Avg C/L Commission per Account	$630	$322
Avg # of C/L Accounts	1,352	1,650
Avg P/L Commission per Account	$94	$93
Avg # of P/L Accounts	3,849	5,600
Avg # of P/L Accounts per CSR	939	830
Avg Commission per P/L CSR	$88,438	$77,190

The six agencies have been analyzed individually as a $200,000 revenue agency, and combined as a cluster group operating as a $1,200,000 revenue agency. Each has been compared to the APRS Standard for agencies of the same size. The bottom-line profit to each member agent would not change dramatically, and, in fact, because of the start-up costs, the bottom-line profit will probably be reduced to the members if the agencies continued to operate in the same fashion. But the potential for long-term financial growth and non-financial benefits make the cluster an exciting method of operation for independent insurance agents. In order to demonstrate the growth potential of the cluster, a prototype cluster will be developed on paper with income goals and the action plans necessary to achieve these objectives (see Appendix B for the 3 Year Business Plan).

Prototype Cluster Agency

Hometown Agencies, Inc., will be set up as a complete cluster with a management company set up to handle the day-to-day decisions and committees to handle policy-making decisions. The formal written contract will include a buy-sell agreement between the cluster and member agents; and procedures to allow new members to join the cluster and methods to remove participating agencies.

In forming this cluster, the general assumption is that all of the participants are compatible and agree on a business philosophy under which to operate. After setting up the organizational structure of the cluster agency, a 3 Year Business Plan will be formulated to illustrate the goals and action plans necessary to achieve the growth objectives, and then an Agency Productivity comparison will be presented showing the APRS Standard versus Hometown Agencies, Inc. The cluster contract for Hometown Agencies can be reviewed in Appendix C.

Organizational Structure

Hometown Agencies, Inc., will be set up as a not-for-profit corporation with each member agent owning 1/8 of the cluster (although our research agencies reflected 10 owners, 2 of these owners are retiring). A certain number of shares of stock will be held in reserve as Treasury Stock for future members. Each member agency will maintain his current office location; current personnel; and each agency will maintain their own individual name but they will be an affiliate of the cluster. For instance, one agency may be "John Smith

Insurance Agency, an Affiliate of Hometown Agencies, Inc." The cluster will consist of a management corporation or service center headed by a marketing manager. This manager will not be an owner or producer in any of the member agencies to prevent a conflict of interest or favoritism to any one agency and he can devote full time to managing the cluster. The service center will have the responsibility of maintaining company contracts, placing business with the various carriers, maintaining the automation network, and overseeing the accounting function for payment of accounts. These items will be covered in more detail later in this section.

The agency cluster will be governed by the Board of Directors which consists of the eight stockholders. Each member of the Board will serve on the four standing committees: the Executive Committee, the Finance Committee; the Marketing and Underwriting Committee, and the Rules Committee. Any policy-making decision will be brought before the appropriate committee and voted on by the Board of Directors.

Standard Operating Procedure

Each agency will operate as before providing sales and service support. Each office will maintain its own files, report claims to the companies, invoice agency-billed items to their customers, and place personal lines business. Each agency will pay their employees, hire and fire personnel, rent their own offices, and pay all occupancy costs. All expenses of sales, such as salaries or commissions to outside producers, transportation costs, and advertising will be paid by each individual agency.

The cluster will purchase and pay for the master Errors & Ommissions policy which includes all member agencies as sub-agents for the cluster. The cluster will also obtain and pay for a master group health plan for all of the principals, producers, and office employees. The cluster will pay for its own occupancy costs and salaries for personnel of the service center. And, the cluster will pay the costs of setting up the automation network and the maintenance costs. The service center will coordinate the marketing plan for the cluster which will include a direct mail solicitation program in personal lines and commercial lines.

All of the insurance carriers will send their monthly statements with direct bill checks and accounts current statement for agency billed items to the cluster service center. It will be the cluster's responsibility to reconcile the accounts and remit payments back to the insurance company for premiums due. The cluster will then distribute the direct bill commissions to each member agent. Any bad debts from clients are the responsibility of the member to which they apply.

Any commercial lines submissions (business accounts) will be placed by the cluster service center. The placer, located in the service center, will intially be the marketing manager. This individual will review the applications for completeness and market it to the company or companies who have the best rates and coverages. Smaller accounts will be rated internally by the placer and a quote provided to the producer.

The cluster service center will obtain an Excess and Surplus lines license and obtain contracts with carriers specializing in hard to place risks. This Excess & Surplus unit will consist of the marketing manager and he will attempt to place all business of the member agents and he will also solicit brokerage business from other independent agents, captive agents, and direct writers who have a need to write specialty coverages. This profit center will operate as a Managing General Agent and will earn the full commission on business placed by the members. For outside agents who write business with the Excess & Surplus unit, the writing agent will receive 50% of the commissions paid by the company.

The independent insurance agent typically does not do a very good job of soliciting and selling life, health, or group coverages within his agency even though he has numerous prospects in the form of current clients. The cluster members have agreed to hire a life manager to solicit and sell life, health, and group to clients of each individual agency. A good life man can earn a substantial income for himself and the member agents will reap the benefits of override commissions with very little effort.

Companies

The six agencies represent a total of 17 standard companies. Two of these carriers write farm business and it is agreed that these 2 carriers will stay in the cluster because of the special coverages that they write. The cluster principals want to retain 9 standard carriers (5 regional carriers and 4 stock carriers). Another general assumption is that all of the business written with a company to be dropped can be rewritten with one of the other carriers. Table 4 represents the revised list of carriers with Hometown Agencies, Inc.

Table 4

List of Carriers (Hometown Agencies, Inc)

	Prem Vol	Loss Ratio
Epsilon Co (R)	$875,000	54%
Beta Co (R)	871,000	35%
Alpha Co (R)	718,000	60%
Omega Co (S)	532,000	17%
Lambda Co (S)	467,000	68%
Gamma Co (R)	455,000	84%
Phi Co (S)	422,000	53%
Eta Co (R)	413,000	100%
Psi Co (S)	323,000	63%
Delta Co (F)	198,000	
Upsilon Co (F)	37,000	

With the movement of the premiums volumes, there are now 9 standard carriers with the largest carrier at $875,000 and the smallest at $323,000 (the 2 smallest carriers write the farm business). More clout has been created with several carriers and within the 3 Year Business Plan projection period, the top 3 carriers will be in excess of $1,000,000 of premium volume and the lowest standard carrier will approach $500,000 of premium.

Automation

Hometown Agencies will utilize the Agency Manager automation network supplied by Applied Systems in all six of its offices. This system is a policy base system where all policy information is kept on the computer and practically all policy service is done by entry into the computer. The system allows each member agency to keep their own set of accounting records, but all of the figures are combined on the host computer at the service center to give an overall financial picture. This system provides word processing to allow aggressive marketing techniques and all applications, binders and certificates are completed on the computer. And finally, a personal lines rating program will be used allowing each member agent to quote auto and homeowners coverages by entering the basic information and all company programs are quoted and premiums compared.

Service Center Expenses

The service center will be paying the Errors & Ommissions premium; the group health premium for all employees; automation and data processing expenses; occupancy costs; and salaries for personnel of Hometown Agencies. It is estimated that each member agent will pay 10% of their commission income to pay these expenses. The total income of Hometown Agencies is $1,230,000 so 10% of this amount is $123,000 which will be used to pay the expenses of the service center. Approximately 3% to 4% of the expenses are for automation and group health insurance which the member agents will not have to pay individually. So 6% to 7% will be additional expenses for the the service center. An aggressive marketing plan in personal lines and commercial lines, the addition of a life producer, and setting up an Excess and Surplus Lines profit center will help offset the expenses of the service center to the individual members. Since the cluster is a not-for-profit corporation, any excess funds at the end of the year will be returned to the cluster stockholders.

Growth

The members of the cluster have agreed on a plan which will see total premium grow from $8,200,000 to $14,000,000 over the next 3 years. The growth will be in the following areas:

Standard Property & Casualty

Premium Volume: $5,300,000 incr to $8,500,000

Commission Inc: $ 840,000 incr to 1,275,000

Excess & Surplus Lines

Premium Volume: $1,900,000 incr to $3,000,000

Commission Inc: 190,000 incr to 350,000

Life, Health, & Group

Premium Volume: $1,000,000 incr to $2,500,000

Commission Inc: 200,000 incr to 500,000

It has also been agreed that no new members would be accepted into the cluster until the organization has been in operation for 3 years. The addition of new cluster members will distort the growth figures for the original cluster. After that time frame, they will consider one new cluster member each year. The figures projected above are based on an aggressive business plan which outlines the methods and procedures necessary to achieve these goals (see Appendix B). With revenues projected in excess of $2,000,000 after the 3 year time period, an agency productivity comparison is made in Table 5 showing Hometown Agencies versus the APRS Standard.

Another category titled "Average Number of Agency Producers" has been added to this table. These are non-owner producers listed in addition to the 8 primary cluster members. The marketing manager and the life manager who both work out of the service center account for two of the four non-owner producers. It is anticipated that two additional producers would be added among the cluster members.

Table 5

Agency Productivity (Hometown Agencies, Inc)

	APRS Standard	Hometown Agencies
Avg number of Agency Owners	4.9	8.0
Avg number of Agency Producers	8.3	4.0
Avg number of Support Staff	36.1	18.0
Revenues per Person	$72,706	$71,733
Compensation per Person	$45,602	$44,427
Avg Comp per Support Staff	$20,285	$24,119
Pre-Tax Profit per Person	$6,546	$6,375
Avg C/L Commission per Acct	$1,085	$557
Avg # of C/L Accounts	2,081	2,400
Avg P/L Commission per Acct	$94	$91
Avg # of P/L Accounts	6,650	7,500
Avg # of P/L Accts per CSR	873	833
Avg Commission per P/L CSR	$82,295	$75,556

As each line category is compared, it is found that there are no big discrepancies between the cluster agency and the APRS Standard. It still appears that the cluster agents are writting smaller commercial accounts because of the lower average commissions per account.

And finally, the Agency Productivity will be compared as individual agencies (from Table 2), as a clustered agency (from Table 3), and as Hometown Agencies, Inc. after a 3 year time frame (from Table 5). Table 6 represents this comparison.

Table 6

Agency Productivity (Comparison)

	Individ	Cluster	Hometown
# of Agency Owners	1.7	10	8
# of Support Staff	1.7	10	18
Revenues per Person	$60,294	$60,294	$71,733
Cpmpensation per Person	$35,043	$35,043	$44,427
Comp per Support Staff	$22,574	$22,574	$24,119
Pre-Tax Profit/Person	$5,426	$5,426	$6,375

The productivity figures between the individual agencies and the clustered agency are the same since the same production figures were used. With the marketing plan outlined in Appendix B, the productivity figures are higher which would relate to higher profits for each individual member of the cluster.

APPENDIX A

AGENCY QUESTIONNAIRE

Agency Code Name: ______________________________

Location: Central Illinois

Corporation _____ Partnership _____ Sole Prop _____

# of Principal Owners _____

# of Non-Owner Producers _____

# of Employees: Personal Lines CSR _____

Commercial Lines CSR _____

Claims _____

Secretarial _____

Other _____

Do you have any branch offices or other locations?

Yes _____ No _____

Agency Premiums & Commissions

Total Premiums: ___________ (Last Fiscal Yr)

Total Commission: __________ (Last Fiscal Yr)

Breakdown:

	Prem	# of Policies
P/L	_____	__________
C/L	_____	__________
L/H	_____	__________

Total # of Accounts/Clients

P/L __________

C/L __________

Direct Billed Policies:

P/L __________%

C/L __________%

List of Standard Carriers

		Written/Earned Prem	Loss Ratio
1.	____________________	__________________	__________
2.	____________________	__________________	__________
3.	____________________	__________________	__________
4.	____________________	__________________	__________
5.	____________________	__________________	__________
6.	____________________	__________________	__________
7.	____________________	__________________	__________
8.	____________________	__________________	__________
9.	____________________	__________________	__________
10.	____________________	__________________	__________

* Are you aware of any special commission contracts available to high volume agents?

Did you qualify for any Profit-Sharing or Bonus last year?

		Amount
1.	____________________	___________
2.	____________________	___________
3.	____________________	___________
4.	____________________	___________
5.	____________________	___________

* Is P-S based on Profit?_____Growth?_____Retention?_____

Do you have any Non-Resident Licenses? Yes____ No____

If yes - What states? ___________________________

Do you have an Excess & Surplus License? Yes____ No____

Do you belong to: IIAA____ PIA____ Other

List______________

Does your agency broker business with other agents?

Yes____ No ____

Do you broker business for other agents?

Yes____ No____

Do you carry E & O coverage? Yes____ No____

If yes - company ______________________________

Premium $____________ Deductible $____________

Are you currently automated? Yes____ No____

If yes - system ______________________________

To what extent: Accounting Yes____ No____

Word Proc Yes____ No____

Rating Yes____ No____

Policy Info Yes____ No____

Do you have a Buy-Sell Agreement in force?

Yes____ No____

Physical Plant

Do you own or rent your office building?

If you own - Is ownership in corporate name?

Total square footage of building ________

Total square footage occupied by agency _____

If you rent - Do you rent under corporate name?

Total square footage occupied by agency ____

Office Equipment

	Own	Rent/Lease
Furniture	___	___
Telephone	___	___
Copy Mach	___	___
Fax Mach	___	___
Rating Computer	___	___
In-house Computer	___	___

1. Are you having trouble attracting and retaining company appointments because you do <u>not</u> have enough premium volume to commit to them?

Yes _____ No _____Comments_________________________

2. Are you having trouble getting competitive quotes?

Yes _____ No _____ Comments _______________________

3. Has a review of your profit-sharing agreements and agency contracts revealed that you cannot meet volume requirements for the more lucrative bonus levels?

Yes _____ No _____ Comments _______________________

4. Has your contingent income averaged less than 6% of your total revenues over the past 3 years?

Yes _____ No _____ Comments _______________________

5. Are you having trouble finding time to manage the office and still maintain the necessary level of sales and servicing?

Yes _____ No _____ Comments _______________________

6. Do you dislike handling personnel management duties?

Yes _____ No _____ Comments _______________________

7. Would you like to add a producer but cannot afford to support one?

Yes _____ No _____ Comments _______________________

8. Do you have an ownership perpetuation plan and/or potential candidates for ownership?

Yes _____ No _____ Comments _______________________

9. Divide total revenues by total number of employees encluding owners. Is this number less than $50,000?

Yes _____ No _____ Comments ______________________

10. Is office payroll (everyone except salespeople and owners) higher than 20% of total revenues?

Yes _____ No _____ Comments ______________________

11. Are your total operating expenses (rent, utilities, telephone, data processing, P/C insurance, professional fees, taxes, dues, supplies, printing, postage, outisde services and equipment costs) more than 18% of your total revenues?

Yes _____ No ______ Comments _____________________

12. Do you have more office space than you need, or are you running out of space?

Yes _____ No _____ Comments ______________________

13. Do you feel that, after having run your own agency for these past years, you could share decision-making on common issues with other agency owners?

Yes _____ No _____ Comments ______________________

APPENDIX B

BUSINESS PLAN

for

HOMETOWN AGENCIES, Incorporated

MISSION STATEMENT

Our Purpose:

A. To provide a wide range of insurance coverages for our clients through the independent agency system.

B. To recommend appropriate coverages to our clients to protect them from severe financial loss.

C. To provide enough revenues to cover overhead and pay the owners a reasonable income for services rendered.

D. To conduct all business activities in an ethical manner.

Public Awareness:

A. We want to become the best known agencies (whether cluster or individual) in our market territories.

B. With our cluster affiliation, we want to be thought of as capable, all-lines agencies and the first thought of for property and casualty coverages and for financial services in our respective communities.

Business Objectives

1. We want attain a growth pattern of approximately 20% per year and achieve total revenues of $2,125,000 at the end of 3 years. Premium volume will grow from $8,200,000 to $14,000,000.

2. We will seek to increase our client base from 5600 to 7500 Personal Lines clients; and from 1650 to 2400 Commercial Lines clients at the end of 3 years.

3. Our marketing efforts will be directed in each of the following areas:

   Personal Lines
   Commercial Lines
   Life, Health, and Group
   Excess and Surplus Lines

4. We will utilize the Lanny Aiken method of direct mail advertising to put each cluster members name in a large number of households and businesses.

Marketing Plan

Goal #1: Increase revenues in Personal Lines as follows:

Current Year:	$340,000
Year 1:	380,000
Year 2:	440,000
Year 3:	530,000

Action Plan: The revenue increase from current year to end of year 1 is $40,000. Assuming loss of accounts of 5% due to death, moves from the area, and competition, an additional $17,000 of revenue must also be generated for a total of $57,000 new P/L revenues. Assuming an average of $93 commission per P/L account, it is estimated that 613 new accounts must be written to achieve the goal. This calculates out to 102 new accounts per agency per year. If each agency attempted to write 120 new P/L accounts per year or 10 accounts per month, the goal would be achieved.

Implementation: (1) Each agency will select 3000 households in their marketing territory consisting of higher valued homes in subdivisions where they want to solicit business. These areas will be sorted by carrier route in order to obtain the lower mailing rate.
(2) Divide the 3000 households by 6 weeks = 500 households per week.

(3) Approximately 500 agency brochures will be mailed each week based on the carrier sort to households addressed to "Resident".

(4) After 6 weeks, start the mailings over to the same households. In one year, those 3000 households will have heard from the agency about 8 to 9 times.

(5) Continue the same mailings for 18 to 24 months. After 24 months change neighborhood locations.

<u>Responsibility:</u> Since this program utilizes customer call-ins, the Personal Lines CSR's will rate, quote, and sell these prospects. This is ideal for cross-selling other lines of coverage. CSR will complete an activity report each month on calls received and sales made.

<u>Monitor:</u> Each agency owner will review the activity reports each month compaleted by the CSR's to determine if their agency goal is being met.

<u>Control:</u> These activity rerports will be forwarded to the cluster service center to determine if the cluster's goals are being met.

<u>Sales Activity:</u> Based on contact with 3,000 households, if the agency receives a 10% inquiry response and sells 4%, the 120 new account goal will be met.

Cost Analysis: Cost of printing, handling, and mailing is \$.18 per piece. This computes to \$90 per week (500 x .18) for a total of \$4680. This will range from 2% to 4% of gross revenues depending on individual agency size.

<u>Goal #2:</u> Increase revenues in Commercial Lines as follows:

Current Year:	$500,000
Year 1:	570,000
Year 2:	650,000
Year 3:	745,000

<u>Action Plan:</u> The revenue increase from current year to the end of year 1 is $70,000. Assuming a loss of accounts of 5% due to closing of businesses or competition, an additional $25,000 of revenue must be generated for a total of $95,000 of new C/L revenues. Assuming an average of $350 commission per C/L account, it is estimated that 271 new accounts must be written to achieve the goal. This calculates to 45 new accounts per agency per year. If each agency attempted to write <u>48</u> new accounts per year or <u>4</u> new accounts per month, the goal would be achieved.

<u>Implementation:</u> (1) Each agency will select 400 local or area businesses that they would like to solicit. A listing will have to be provided by each agency owner.

(2) Divide the 400 businesses by 2 so that 200 mailings will be made every 3 weeks utilizing bulk mail rates.

(3) Every 6 weeks each business will receive an agency brochure so during a 12 month period the business owner will have hear from the agency about 8 or 9 times.
(4) Contiue the same mailings for 18 to 24 months. After 24 months change to a new set of businesses.

<u>Responsibility:</u> This program is designed for the C/L producer which in most cases will be the agency owner. Each month an activity report will be completed and sent to the marketing manager in the service center.

<u>Monitor & Control:</u> The activity reports will be reviewed monthly at the service center to determine if goals are being met.

<u>Sales Activity:</u> Based on 400 businesses being contacted, the agency producer will need to receive a 20% response and sell 12% in order to achieve 48 new accounts.

<u>Cost Analysis:</u> Cost of printing, handling, and mailing is $.25 per piece. This computes to $50 every 3 weeks for a total of approximately $867 per year. This will range from .5% to 1% of gross revenues depending on individual agency size.

Goal #3: Increase revenues in Life, Health, and Group as follows:

Current Year:	$200,000
Year 1:	270,000
Year 2:	345,000
Year 3:	500,000

Action Plan: The revenue increase from the current year to the end of year 1 is $70,000. This is figured strictly on new business and is not considered the same as property and casualty business. Assuming an average commission of $400 per life, health, or group sale, this computes to 175 new accounts written to achieve the goal or 15 new accounts per month.

Implementation: The life manager will implement sales activity as he or she sees fit. It is anticipated that the manager will work in each agency one week out of six and rotate. He will work with the local cluster member to determine potential prospects and then he will send out letters and make telephone calls to secure appointments.

Responsibility: The life manager will complete a sales activity report each month and submit it to the service center.

Monitor: The service center manager will review the activity reports to determine if the goals are being met.

Control: The service center manager will forward the activity reports to the cluster members so they can see how the life operation is doing in their area.

Sales Activity: It is anticipated that the life manager will make 2 sales out of every 10 calls he makes. He will have to make about 75 calls per month in order to achieve his goal of 15 sales per month.

Cost Analysis: The life manager will work on a commission basis and if his goals are met he should make approximately $50,000 on new sales in the first year. The balance of $20,000 would go to the cluster owners as override commissions.

Goal #4: Increase revenues in Excess & Surplus lines as follows:

Current year:	$190,000
Year 1:	230,000
Year 2:	280,000
Year 3:	350,000

Action Plan: The revenue increase from current year to the end of year 1 is $40,000. It is assumed that 10% of these accounts will be lost to businesses closing or competition, therefore, an additional $19,000 of revenue will have to be generated for a total of $59,000. Excess & Surplus lines can be personal lines such as low-valued dwellings and sub-standard suto which generates smaller premiums, or they can be commercial lines such as restaurants and taverns, liquor liability, truckers, umbrellas, or professional liability which generates high premiums. We are going to assume an average commission of $150. This computes to 393 new accounts to the cluster. If each agency wrote 70 new accounts or 6 accounts per month in the E & S market, then the goal would be achieved. This market could be opened to agents outside of the cluster to generate operating income.

Implementation: The marketing manager in the service center will contract with appropriate E & S markets; keep members abreast of the types of risks which can be written; obtain quoes for producers; and send flyers to outside agencies concerning market availability.

Responsibility: The service center manager will prepare activity reports on a monthly basis of E & S business quoted and written.

Monitor & Control: The activity reports will be forwarded to the various cluster members for review and to determine if goals are being met.

Sales Activity: It is anticipated that all cluster members will utilize the E & S unit in their daily activities.

Cost Analysis: The service center manager will be paid on a salary basis so increased sales by the E & S unit will offset operating expenses and excess will go back to the cluster members as a dividend.

APPENDIX C

CLUSTER AGREEMENT

THIS AGREEMENT made this _____ day of _______, 19 __, by and between Hometown Agencies, Inc. (CLUSTER) and [Name of Agency] (AGENT).

THIS AGREEMENT is made with reference to the following facts:

(a) The parties are each corporations, duly organized and existing under and by virtue of the laws of the State of Illinois, each with principal place of business in the County of __________, State of Illinois and each duly licensed and engaged in business as an insurance agency.

(b) In order to enhance its product line and compensation arrangements, AGENT desires to combine its agency business with that of CLUSTER so as to offer a larger volume of business to present and prospective carriers in exchange for agency agreements on the most favorable terms available.

NOW THEREFORE, in consideration of the recitals, covenants, conditions and promises herein contained, the parties agree as follows:

1. Transfer of Accounts:

For valuable consideration, receipt of which is hereby acknowledged, AGENT here by sells, assigns and transfers to CLUSTER, effective upon the close of business __________, 19 ___ (Transfer Date), all its right, title and interest in and to the insurance accounts of AGENT (except for all business brokered to AGENT), together with all expirations and related books and records, and the exclusive right to use the name [Agency Name] or any variation thereof in the conduct of the insurance agency business of CLUSTER.

2. Warranties:

AGENT warrants to CLUSTER as follows:

A. It is the lawful owner of all of the assets sold, assigned and transferred pursuant to this Agreement. All said assets are free from encumbrance. It has the right to sell the assets. None of the insurance accounts to be transferred to CLUSTER were brokered into it by any other party. AGENT will warrant and defend the foregoing against the lawful claims and demands of all persons. AGENT hereby assigns to CLUSTER any and all rights, claims and causes of action it has against any insurance company, agent or broker or any other party involving the ownership of insurance accounts and agrees to cooperate with CLUSTER in the prosecution of all such rights, claims and causes of action whether in its name, that CLUSTER or that of any assignee of CLUSTER.

B. All accounts current rendered to AGENT by any and all insurance companies are paid in full up to the Transfer Date, or will be paid in full by AGENT within 30 days after the Transfer Date, and will not in any event be or become the responsibility or obligation of CLUSTER.

C. On or before the Transfer Date, AGENT will procure the written assurance of [Present Carriers Represented by Agent] that they, and each of them, will appoint CLUSTER its agent.

D. AGENT has never heretofore divulged its customer list or other confidential records to any other party.

Covenants:

The parties covenant to each other as follows:

A. AGENT will assist and cooperate with CLUSTER during the transition period following the Transfer Date in order to enable CLUSTER to perform the functions and achieve the objectives contemplated by this Agreement. Without limiting the generality of the foregoing, AGENT will inform its insureds by mail of the transfer of accounts and will assist CLUSTER in obtaining new licenses and agency agreements by which to conduct business with the accounts here transferred and under the business name here assigned.

B. Subject to the provisions of paragraph 8, AGENT will not, directly or indirectly, except on behalf of CLUSTER, solicit or accept any insurance business of any kind or nature from any of the insurance accounts being sold, assigned and transferred pursuant to this agreement, nor will it, directly or indirectly, assist or be employed by any other party in soliciting or accepting insurance business of any kind or nature from any of those accounts.

C. All information concerning the insurance accounts being sold, assigned and transferred pursuant to this Agreement, including without limitation the customer list expiration dates in connection with them, is confidential information and will be treated as such by the parties. Subject to the provisions of paragraph 8, AGENT will not hereafter, directly or indirectly, except on behalf of CLUSTER, make use of any such information for its own benefit or reveal the customer list or other confidential records to any other party.

4. Services:

The parties shall provide services for their mutual benefit as follows:

A. CLUSTER will be and remain, throughout the term of this Agreement, duly licenses by the State of Illinois to solicit and broker all lines of life, disability, property and liability insurance. Except to the extent the parties agree to the contrary, it will procure agency agreements with each carrier now represented by AGENT and will seek such additional agency agreements as the parties believe will broaden its product line, heighten its competitive posture in the marketplace and raise its commission and contingency compensation to the most favorable terms available. CLUSTER will collect AGENT-billed premiums and remit them the appropriate carriers as provided by the pertinent agency agreements.

B. Except as provided above, AGENT will continue to sell and service the accounts transferred to CLUSTER under this Agreement, but will do so on behalf of and under the business name adopted by CLUSTER for the conduct of its insurance agency business. AGENT will renew all existing business and submit all new business solely in the name and for the account of CLUSTER, unless renewal or replacement of any such accounts or lines is expressly declined by the CLUSTER Executive Committee, acting with AGENT abstaining.

C. Notwithstanding the duties described above, the officers, directors, employees and agents of each party are free to fully exercise their own judgment and discretion with regard to the performance of the duties assumed under this Agreement. This is not a contract of employment, and nothing contained in it will be construed to create the relationship of employer and employee between the parties; each is an independent contractor as contemplated by this Agreement.

D. Any expenses incurred by CLUSTER or AGENT in the performance of their respective duties hereunder will be paid by the party incurring the expense, and that party will hold the other harmless from them.

5. Compensation:

The compensation of the parties will be determined and paid as follows:

A. CLUSTER will segregate on its books and records the accounts received from AGENT and those AGENT later procures on its behalf in order to clearly distinguish such accounts from all other business of CLUSTER. CLUSTER will account to and pay AGENT monthly, throughout the term of this Agreement, commencing [Effective Date of Agreement], for the calendar month next preceding.

In addition, the Executive Committee will periodically determine and authorize payment to AGENT of a fractional interest in and to contingency income of CLUSTER. All actions of the Executive Committee taken with respect to AGENT will be by majority vote determined with AGENT abstaining. That fractional interest may be, but need not be, a sum equal to the ratio of the gross commission income the measured period from accounts transferred to CLUSTER by AGENT - excluding business brokered in or out - to the total of such commission income earned and unearned by CLUSTER.

B. CLUSTER will retain 10% from gross commission income as its total compensation for the services it provides under this Agreement.

C. All commission earnings will be based on net commissions (gross commissions less returns).

6. Quality Control Measures:

CLUSTER will cause AGENT to be appointed to the Executive Committee of its Board of Directors. The Executive Committee shall, by majority vote, make all determinations with respect to insurance accounts to be accepted or declined, the carrier or carriers to be utilized for a particular account, and those accounts to be placed with other - unrepresented - carriers through brokerage sources. It is understood by the parties that the guiding principles in that process are, first, to use the most competitive market available, second, within that constraint, to earn the highest commission and contingency compensation possible, and third, to consider the impact of historical and projected claims experience of each account in order to enhance contingent, experience-based compensation.

7. Term of Agreement:

The term of this Agreement will commence on __________ , 19 ___, and will continue until terminated as provided at paragraph 8.

8. Termination Agreement:

This Agreement will terminate on the first to occur of the following:

A. The written agreement of the parties.

B. The dissolution, bankruptcy or insolvency of either party. Upon the occurrence of such a condition, the dissolved, bankrupt or insolvent party will provide written notice to the other party and may concurrently terminate this Agreement, whereupon compensation will be paid only to the date of termination.

C. Termination for cause as here provided: in the event that during the term of this Agreement either party violates any of the provisions set forth herein or fails to perform competently the duties assigned pursuant to it, the nondefaulting party may provide written notice of that default to the other party and in the event the default is not cured within five days following receipt of the notice, the nondefaulting party may immediately thereafter terminate this Agreement upon second notice to the defaulting party, whereupon compensation will be paid only to the date of termination.

D. At any time, either party may provide to the other two week's written notice of termination.

E. Concurrently with the termination of this Agreement, CLUSTER will exercise the Stock Repurchase Option held under a separate written agreement, will promptly deliver to AGENT all expiration records and data associated with existing insurance accounts originally transferred to and those subsequently placed with CLUSTER by AGENT during the term of this Agreement and will cease the use of the name [Name of Agent] and any confusingly similar variation thereof.

9. Release and Indemnity:

In view of the allocation and delegation of major legal and accounting responsibilities, as well as sales and administrative functions, the parties agree to assume sole responsibility for their respective obligations. Accordingly, each, for itself, its legal representatives and assigns, fully and forever releases and discharges the other party, its agents, representatives, employees, legal representatives, successors and assigns, and each of them, of and from any and all claims, demands, actions, causes of action, suits, controversies, agreement, promises, representations, damages and demands whatsoever, in the law or in equity, however arising, directly or indirectly, without respect to time but arising from business operations of the releasing party.

This is intended as a full and complete release of all such persons and entities of and from any and all liability of any nature whatsoever for all damage, injury, loss, expense, including any consequential expense, loss or damage, whether known or unknown to the parties, expected or unexpected by the parties, or whether they have appeared or developed, and all rights under Article 1542 of the Civil Code are hereby waived and relinquished.

Each releasing party will protect, indemnify, defend and hold harmless the other party, its legal representatives, successors and assigns, from and against all debts, liabilities, obligations, loss, damage, cost or expense (including but not limited to attorneys' fees), accruing or based upon or arising from facts or events occurring prior to the date of this Agreement and connected with the facts underlying any claims described above.

Whenever any party learns, through the filing of a claim or the commencement of a legal proceeding or otherwise, of the existence of any liability for which another party is or may be responsible under the terms of this agreement, such party will notify the other promptly and furnish such copies of documents (and make originals of them available) and other information as such party may have which may be used or useful in the defense of such claims, and will afford the other party full opportunity to defend them in the name of any party, and will generally cooperate with the other party in the defense of such claims.

10. Remedies:

The parties acknowledge that their services under this Agreement are unique and of an intellectual character endowing them with peculiar value, and that in the event of any breach of this Agreement, the nonbreaching party may be caused irreparable injury. Accordingly, the nonbreaching party may seek equitable relief in preventing a breach of this Agreement or any portion of it, and such relief will be in addition to any other rights or remedies available to the nonbreaching party.

11. Attorney's Fees:
In the event any action is brought to enforce any provisions of this Agreement, there will be allowed to the prevailing party, to be included in the judgment recovered, reasonable attorney's fees to be fixed by the court.

12. Agreement to Perform Necessary Acts:
Each party agrees to perform any further acts and execute and deliver any documents which may be reasonably necessary to carry out the provisions of this Agreement.

13. Authorization:
The Corporation is authorized to enter into this Agreement by virtue of the resolution adopted at its organizational meeting of incorporator.

14. Notices:
Any notice required or permitted to be given will be in writing, either personally served or sent by United States mail and will be deemed given when so served or deposited in the United States mail, registered or certified, with postage prepaid and properly addressed.

15. Time:
Time is of the essence with respect to this Agreement.

16. Benefit:
The covenants, conditions and promises contained in this Agreement will inure to the benefit of and bind the legal representatives, successors and assigns of the parties.

17. Entire Agreement:
The parties acknowledge that this Agreement, except for those agreements contained in the Stock Repurchase Option executed concurrently with it, contains their entire agreement. No representations, promises, conditions or agreements with reference to its execution were made or entered into between the parties other than as here expressly provided.

18. Captions:
The titles or headings for the paragraphs of this Agreement are not a part of it and will have no effect upon the construction or interpretation of its terms and provisions.

IN WITNESS WHEREOF, the parties have executed this Agreement the day and year first above written.

HOMETOWN AGENCIES, Inc.

by ______________________
President

[Name of Agency]

by ______________________
President

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