

Measuring Up: Benchmarking Underwriting and Loss Performance

By Bruce Thomas

Most managers feel ambivalent about benchmarking. While they find it useful to compare cost and performance information about their suppliers and subordinates, they are often reluctant to apply such metrics to themselves. It is human to want to hide our shortcomings, and we can all find good reasons why benchmarking may not be totally effective in our unique situations. Moreover, this type of effort cost money and consumes resources, and if there were any *real problems*, we would already know about them! Putting the bluster aside, most of us know that actively seeking information about our strengths and weaknesses is a key ingredient of successful people and prosperous companies.

Professional athletes are benchmarked every time they compete, leading to a higher level of performance for the players and the sports in which they participate. In essence, athletes are constantly being told how they rank versus their peers, what they need to do to be competitive, and if they should start considering other fields of endeavor. Of course, performance feedback for businesses is not as immediate, as straightforward, or as easy to get. This is especially true in the insurance industry.

D for Data

The greatest hurdle to effective benchmarking in the insurance industry is getting good data. While surveys can be helpful for measuring certain things such as customer satisfaction, it is difficult to get good response rates and the questions are often highly subjective. Too often, what passes for benchmarking is merely a summary of anecdotes compiled from agents, employees, competitors, and news items. Even when insurers do a top-notch job of collecting their own data, they often find they have no relevant industry data to compare against. In short, hard insurance data is hard to get.

Another problem with benchmarking is that it requires a sustained, long-term commitment. Benchmarking is useless if management does not view it as an integral part of their company's strategic and competitive analysis. Why go to the trouble of ranking your company, if there is no intention to act on the analysis, to follow-up periodically, or to determine if performance has been maintained or improved?

Annual and quarterly financial reports provide a convenient overall assessment mechanism, but insurance company managers need much more detailed information. Was good performance the result of an investment strategy that paid off or was it brought about by superior distribution, underwriting, or claims paying? Were poor profits the product of too much overhead or did they result from charging lower premiums and using smaller deductibles than the rest of the industry?

Extra Credit

IndexCo, LLC¹ has just completed a study benchmarking U.S. homeowner insurers' exposure and atmospheric loss data² over the period July 1996 through January 1998. This study is unique because it is based on premium and loss records collected by Zip code across the United States. Most insurers typically benchmark against data compiled for much larger geographic areas. Given how standardized the policy forms are and how competitive and highly regulated the homeowners insurance market is, one might think that there would not be enough variation between insurers to make this effort worthwhile. Nevertheless, results varied widely from company to company.

Chart I

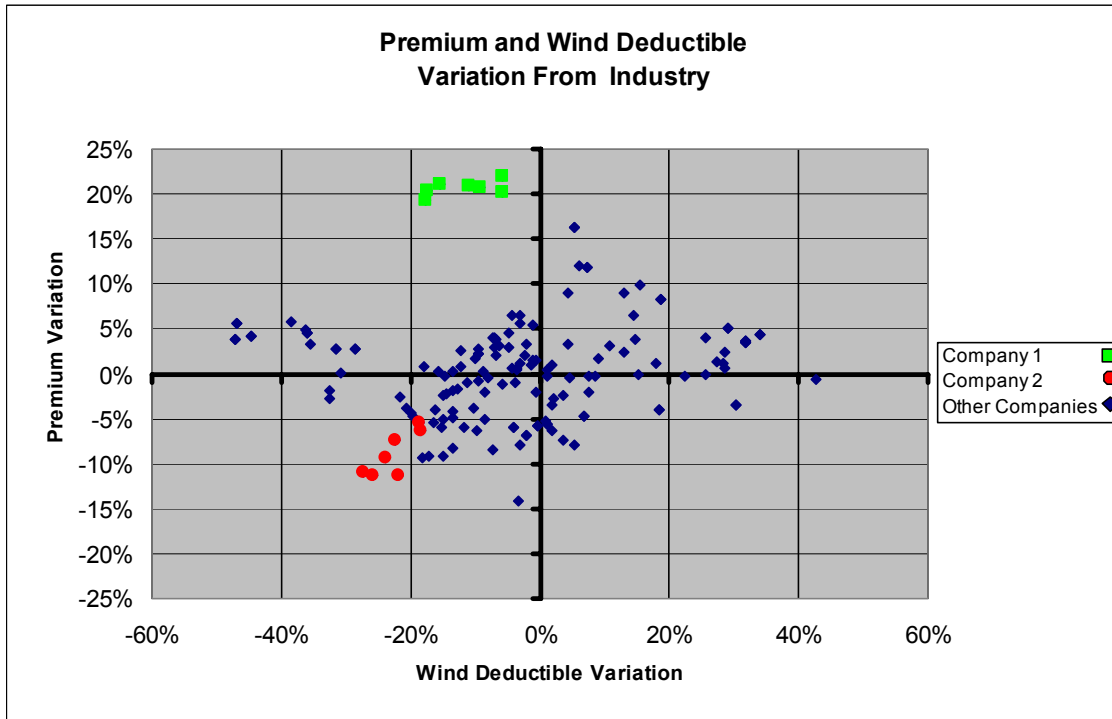


Chart I compares the premiums that each insurer charged and their respective policy wind deductibles per dollar of insured coverage against the industry average by Zip code across the US. Each point represents one company's underwritings at six-month intervals. If each of the companies were average, all of the data points would be concentrated in the center of the chart. While it is easy to see how companies might show different results within a single Zip code, it is remarkable to see how varied each company's insured writings were from average across all the geographic areas where they did business.

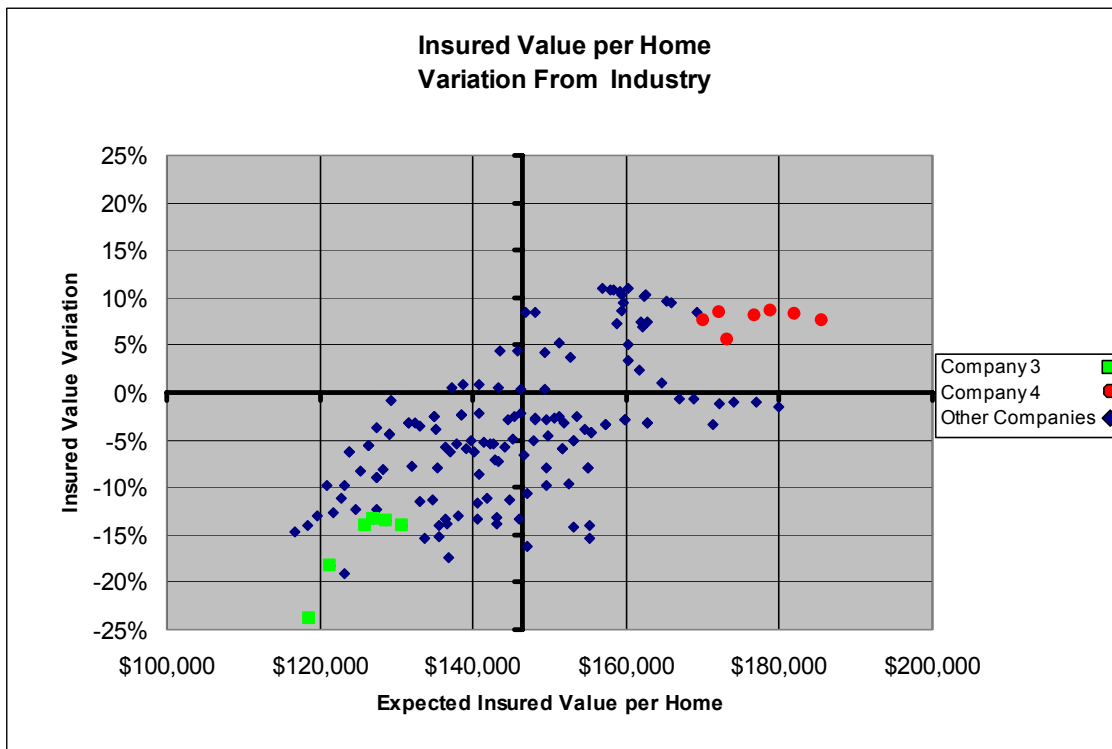
¹ IndexCo, LLC is a subsidiary of Guy Carpenter & Company and is the publisher of the Guy Carpenter Catastrophe Index.

² Claims with a cause of loss coded as wind, hail or freeze.

Two companies are highlighted to illustrate the fact that, by choice or happenstance, insurers routinely occupied a certain spot on this chart relative to their peers. Company 1, represented by the green points, habitually charged 20% more premium per dollar of insured value than average, but its wind deductibles were approximately 10% less than average. While it makes sense that there would be a tradeoff between premiums and wind deductibles, Company 2, represented by the orange points, shows a counterintuitive relationship between these policy factors. This insurer charged premiums that were 10% below the industry average on policies with wind deductibles that were 20% below average.

Regardless of the market niche they carve, companies must implement a strategy over a long period of time before it will generate appreciable returns. Chart II shows that insurers, consciously or unconsciously, wrote insurance on certain types of homes in certain types of areas.

Chart II

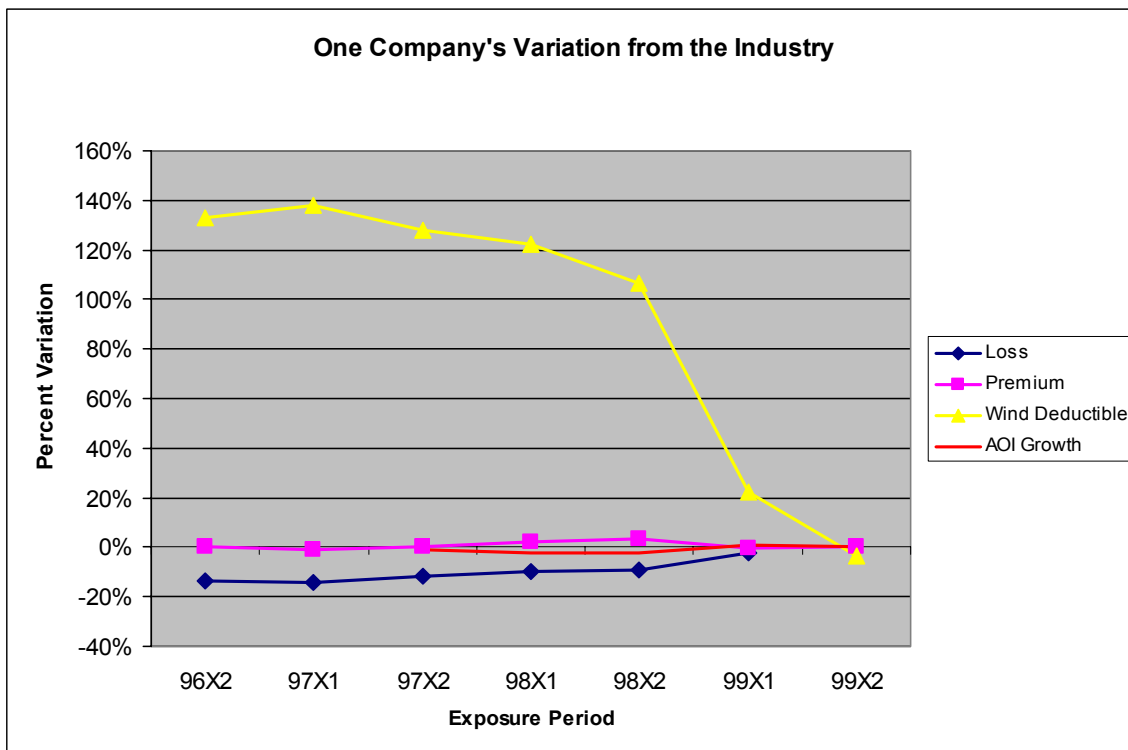


While the average home was insured for approximately \$147 thousand during the period of this study, most companies were far from average. Company 4, depicted by the red dots, underwrote homes in ZIP codes where the average insured value was \$180 thousand. Furthermore, this company insured homes with 8% more insured value than average. In other words, it insured the better homes in the better neighborhoods. By contrast, Company 3, represented by the green squares in this chart, wrote less insurance than average on homes in zip codes with below average home values.

Any worthwhile strategy involves a great deal of self-assessment and an in-depth knowledge of your strengths and weaknesses. Based on this understanding, a particular competitive focus is chosen and tradeoffs are made to enhance this emphasis over a long period of time. Benchmarking insured exposures and loss experience against the industry enables companies to better understand their competitive position and plan a course to superior profitability and growth.

By issuing policies with wind deductibles that were over 100% higher than the industry average and charging average amounts of premium, the insurer depicted in Chart III achieved loss experience that was 10% to 15% better than average. However, its premium growth rate was approximately 2% below the industry average. Although paid loss data was not available for 1999, at the time this study was done, it is interesting to see how quickly this company's deductible, loss, and growth rates reverted to the industry average.

Chart III



Did the company depicted in Chart III truly understand its competitive position and the strategic tradeoffs it was making? Did it consciously change its strategy? Only the company can know for sure.

State Data - Fun House Mirrors

Why do companies exhibit so much variation from the industry average? While it is highly likely that different distribution mechanisms and marketing strategies play important roles in risk selection, the counterintuitive results of some of the companies in the study would tend to indicate that some other force is exerting its influence as well.

Perhaps the answer derives from the fact that insurer market share is not uniform across geographic areas within states. Thus, a company whose exposures are clustered in high loss areas may think it charges higher than average premiums and deductibles when it compares its insured writings to industry aggregates for large geographic areas such as counties or states. Using such data, insurers may be misled into thinking they are performing better or worse than they are, causing them to seek market share growth in areas where they are under-performing and to pull back from profitable areas.

Chart IV

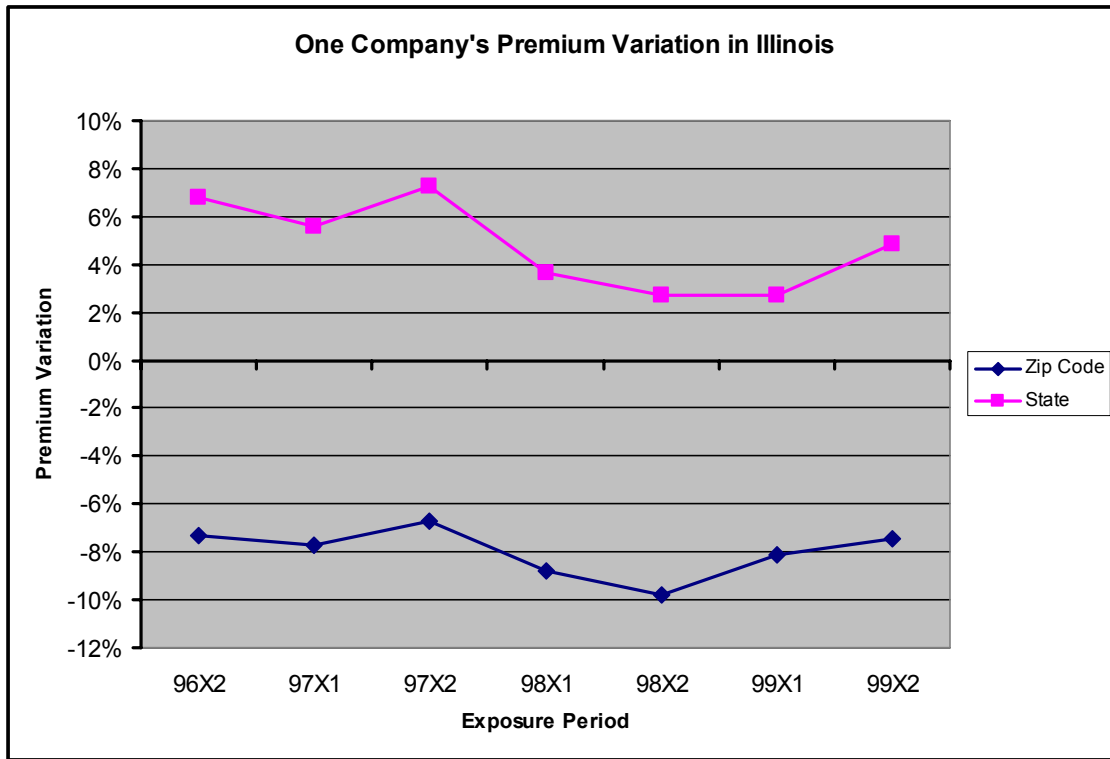
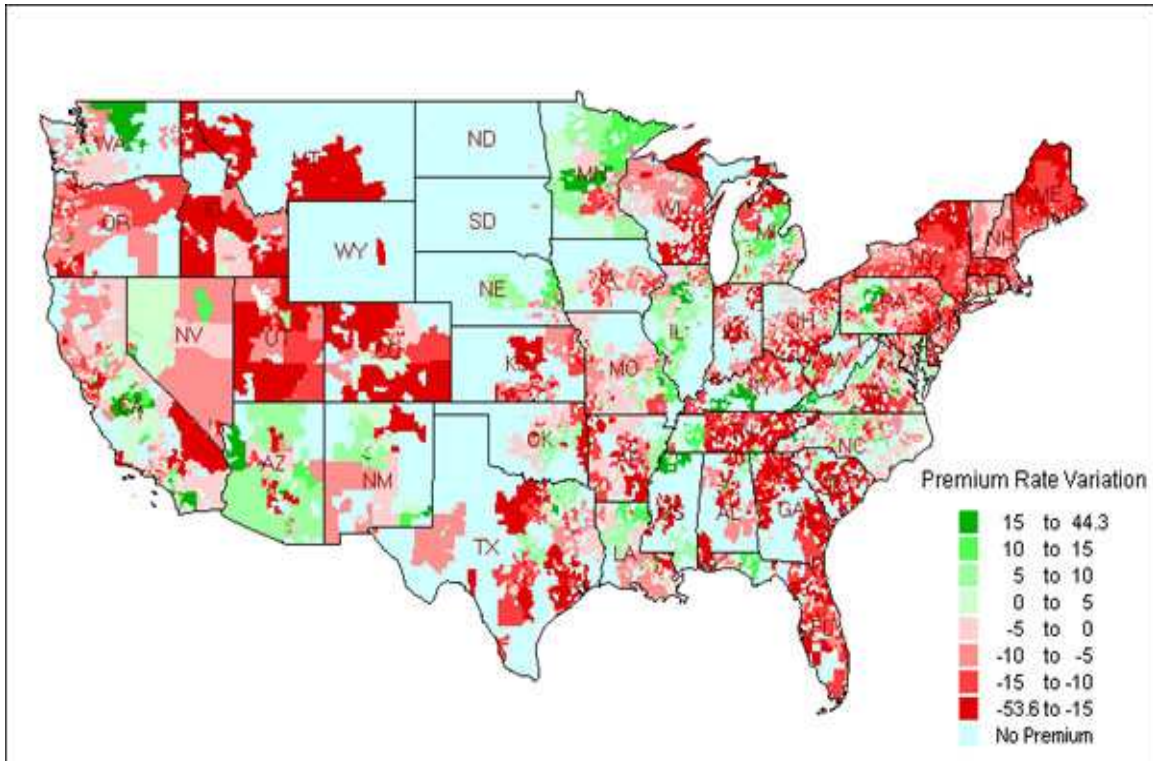


Chart IV shows how a company can be led astray by comparing its aggregate premium rates against industry aggregates at a state level. Using aggregate data for Illinois, the company would have assumed that its premium rates per dollar of insured value were 3% to 7% higher than average. However, if it had benchmarked its premium rates by Zip code, it would have realized that its rates were actually 7% to 10% *below* the industry average. In short, benchmarking against industry aggregates for large geographic areas is like making dieting decisions by looking in a fun-house mirror.

Impacting the Bottom Line

Benchmarking against poor data sources may cause companies to suffer significant financial losses over time. Map I shows one insurer's lower than average premium rates in red and higher than average premium rates in green for every ZIP code in the country. Although this Map is a good way of identifying areas where the company's premium rates are inferior to the industry and zooming in on trouble spots, ultimately the insurer will want to know the cost of under-performance in dollar terms.

Map I: One Company's Variation from Industry Premium Rates



The company depicted by Map I could have earned \$46 million more in 1999 if it had charged average premium rates on the houses it insured. Furthermore, if its loss experience were average over the period 1996 through 1998, it would have earned \$2 million more per year. Of course, when the benchmark is raised to the top quartile of industry performance, the potential improvement increases dramatically. After all, who wants to go through all this analysis just to be average?

On Your Mark

The starting point for any worthwhile benchmarking program is collecting detailed data that can be used to measure individual company performance over time. Such self-assessment is a vital part of determining a workable strategy to remain competitive in a crowded field. However, most insurers are not yet using this technique to their best advantage because they only benchmark against aggregate data for large geographic areas. Since insurers' exposures are not uniformly distributed across states, comparing

company exposure and loss data with the industry can be significantly misleading. Such comparisons may cause insurers to believe that their premium rates and deductibles are average or above average when they are in fact seriously inadequate.

Without good information to benchmark against, insurers run the risk of serious under-performance over time. Their financial results will suffer and dramatic action will become necessary. However, without a clear understanding of the problem, it is quite possible that the wrong action will be taken.

Author's Note:

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