To moderate extreme swings in the cycle, insurers must develop consistency and stability. This calls for development of goals for each area of the company—goals that remain consistent through all phases of the cycle.

Managing for Consistency

BY MARTIN M. SIMONS

Now that the property/casualty industry is returning to profitability, it is time to look at the underwriting cycle and develop ways to temper its effects. Although such examinations are made each time this point in the cycle is reached, some of today's concerns far outweigh those of the past. In addition, each successive underwriting cycle tends to have a shorter profitable phase and a longer unprofitable one. The results, should this process continue, must be obvious to all. Adding to the problem, insurance company executives take control only when the cycle reaches its upper or lower extremes. The rest of the time the cycle itself is in control, leaving those same executives at its mercy.

As stated in my earlier article, it is important to adjust rate level increases for the ameliorative effects of other actions. Without such adjustments, experience certainly will turn around, but the delay in the effects of those actions, combined with higher-than-needed rate increases, will create an extreme upward swing toward profitability. When a point is reached where competition becomes the driving force, companies once again will accuse each other of being the culprit in a price-cutting campaign over which they have no control. The industry then will shift from being controlled by underwriting to being controlled by marketing.

It seems strange that as the industry becomes profitable, the credit goes to the underwriter, but, typically, when profits diminish to an intolerable level, blame is aimed at the marketing department. In reality, the company that maintains consistency and stability is the most likely to have long-term success. Stability must be maintained in several areas, including the following:

- Sought-after lines of insurance.
- Treatment of agents and insureds.
- Claim handling and reserving.
- Pricing in relation to underwriting.
- Capacity relative to individual risks.
- Relationship of changes in rates and practices to the economy.

The shift from an emphasis on un-

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derwriting to marketing places adverse constraints on the ability of employees and agents to perform their duties adequately and intensifies the frictions between marketing and underwriting. In addition, in the long run, inconsistent behavior is detrimental to all segments of the industry.

In an atmosphere of inconsistency insurers find themselves alternately expanding and contracting their operations. Underwriters who have been amenable to most of their agents' requests during the competitive part of the cycle are forced to become tightfisted enemies of those same agents when management's directives change. The agents then lose respect for the company, whose rules and desires seem to have changed overnight.

ARE WE AT WAR?

Field marketing people, who are viewed as helpful and an integral part of the insurance company during the competitive part of the cycle, suddenly are considered little more than a company expense when the thinking shifts. Even at the insurer's home office, the marketing and underwriting departments act as if they were at war with each other. Due to their seemingly disparate objectives, each carries a hidden agenda into each decision-making process.

To avoid this scenario, goals should be established for each function in the company, and these goals must remain consistent through all phases of the underwriting cycle. For example, in addition to their production goals, marketing people should be accountable for the education of producers and for maintaining an atmosphere of trust between the sales force and the other company departments. They also have responsibility for the overall quality of the agency plant with which they deal. The success or failure of marketing in a given territory is directly monitored by measuring the percentage of agents, or of premiums from agents, that display profitable results. Such a measurement then becomes the basis of the goals for the marketing department.

Meeting these goals does not necessarily mean that an underwriting profit has been made. Depending on the line of business, investment income must be considered in relation to funds held on behalf of the insured, and expected results must be viewed on a total-return basis.

Underwriting goals should be established on a claim-frequency basis, since claim frequency directly correlates to the underwriters' performance of risk selection. The pricing authority must be monitored to determine how well the insurer's prices relate to its underwriting standards compared with those of other insurers.

The basic standard by which to monitor the field claims department is to view the average paid-claim cost. In many companies, field claims personnel are given goals that relate claim

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payments to reserves. However, the current atmosphere of high potential tort liability, coupled with a fear of bad faith actions, may result merely in increased reserves, and in correspondingly increased claim payments.

Again, a goal relating average paid-claim costs to industry data for that line and territory will provide a more valuable basic standard for overall corporate profitability. Corporate claims people must be responsible for consistency in the development of loss reserves. The large and catastrophic loss, however, must be excluded from individual goals and be included as a corporate factor based on long-term experience.

For a system like this to be truly effective, there must be substantial overlap in the expertise used to develop the goals. In addition to the aforementioned goals, a company must monitor its expenses through the traditional results versus budget process and, as stated previously, through loss reserve adequacy, stability and premium levels.

Rates must be established with an awareness of changes in the way marketing, underwriting, claims and administration are accomplishing their own objectives as well as changes, or expected changes, in the external environment. Goals set in this manner will provide a means of analyzing the component parts of the loss ratio, which can be expressed as follows:

$$\frac{\text{claim frequency} \times \text{average claim}}{\text{average rate}}$$

Hence, this goal system allows a company to measure each functional component of the loss ratio with regard to the relationship of the work done to the loss ratio itself. And while departments within the insurance company will be dependent upon each other, each individual functional area will be able to see more directly the result of its own actions and how those actions affect the other areas of the company. This information will tend to lessen intracompany friction and foster a more cooperative atmosphere within the company.

Here the ratemaker plays a major role. Classical ratemaking takes into account the effects of rate changes and loss trends in order to bring results up to an "alleged" current level. This is not enough. Rate revisions also must take into account expected changes in experience that already are incorporated into the company's plan of action. These include, but are not limited to, the effects of the following:

- A change in loss-reserving practices.
- A change in underwriting standards.
- Termination of agencies or blocks of business.
- Revised IRPM or similar schedule rating plans.
- Revised commissions.
- Altered expenses resulting from employee reductions and other activities that cut or increase expenses.

This, of course, means that various departments within the insurance company must depend upon each other not only to establish objectives but to develop a structure that will enable them to achieve those objectives successfully. Underwriters, agents, claims, marketing and actuarial personnel must trust one another.

It is easy for a claims adjuster faced with a large payment to see why a specific piece of business should not have been written or for the underwriter of that business to question the need for a high claim payment. And the typical marketing representative will have a

negative view of the underwriter who rejects a piece of business from one of his "best" agents.

With goals that are distinct, and yet interdependent to the extent that they must contribute to the overall corporate goal of long-term profitability and consistency, each of the individual insurance company functions can view its activity as part of that larger corporate objective. Claims people become more aware of the need to accept business; underwriters see the need to maintain consistency in claim activities; and marketing people gain a broader view of the effects of their actions on the other functions and on overall profitability. Perhaps when the marketing staff is judged on the basis of which of its agents are profitable, the market person will change his view of who, in fact, are his best agents.

Once the goal system is established and the interdepartmental relationships have developed to a satisfactory level, a company can bring consistency into its operations. Revisions in the goals eventually must become merely a fine-tuning effort if that consistency is to be maintained.

THE APPLICATION

Consistencies apply to several different areas. For example, agents who are presented with rates that are above the midpoint of the company's competitors still can sell the product if the underwriting standards are commensurate with those rate levels, providing consistency between functions. An agent can deal with a company that is selective regarding lines of business written as long as the company shows consistency over time and does not continually change its desires.

Finally, that agent can sell rate increases with little or no problem when those increases are moderate and are in conjunction with economic and environmental changes, which shows consistency within the environment.

Underlying the establishment of goals is a concept that eludes many who are responsible for developing those goals or analyzing the results. When the final results are known, the following questions must be answered: Did environmental or other uncontrollable criteria behave as expected? Were the underlying assumptions reasonable in light of actual occurrences since the goals were established? With the benefit of hindsight, were the goals reasonable?

In answering these questions, one becomes aware that the entire process of goal establishment and monitoring, not just the comparison of results to expectations, is beneficial.

Most important, as more insurers become more consistent in their dealings with agents and the public, the underwriting cycle will be tempered. And it is the cycle itself that causes regulators and the public to view insurance companies in a negative light.

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It would appear that actuaries, or others in a ratemaking or reserving position within the company, can do little in the development of company consistency—that is, little more than underwriters or marketing or claims people. In the typical property/casualty company, however, the ratemakers must take a large part of the blame for the historical lack of consistency in the industry and a large part of the challenge to develop and maintain such consistency.

An old, worn-out marketing philosophy states, "Nothing happens until something gets sold." It takes little thought to see the truth in that adage. Marketing people and agents are dealing on a day-to-day basis with the results of corporate decisions. Their input is a valuable asset and a necessary ingredient in consistency. When the rates established are inconsistent with a company's underwriting standards or commission levels or with the way the company is viewed on the street, the marketing staff will be the first to know.

Historically, actuaries have considered information from the underwriting department to have more value than information from the marketing department has. This leads to a negative bias. Marketing information should be considered in order to temper this negativism. The current effect of this underwriting-dominated view is to overstate the need for rate increases. Adjustments should be made to account for what is transpiring out in the street—in the agents' offices.

INHERENT CHALLENGES

Inherent challenges underlie these concepts. In regard to the marketing department, for example, the challenge is to become analytically aware of the effects of marketing actions on other disciplines within the company and to temper marketing plans when necessary.

Underwriters and ratemakers, for their part, must view their own duties in light of corporate objectives and must recognize that optimism is a basic attribute of marketing people. Viewed as an asset, optimism can be channeled more adequately than it has been in many insurance companies. All functions within the insurance company must understand that the claims department is actually an integral part of their company, and not a separate entity whose sole function is to spend their hard-earned money.

The challenge to the executive in charge is to foster—in fact, to demand—dialogue between functions and to direct the company based on suggestions derived from the collective, as well as individual, ideas of those functional executives.

This does not mean that the effects of external forces do not play a part in the adverse activities of the cycle, as insurers have claimed. Certainly there have been some pressures on insurance company experience because of increases in court-mandated payments and the like, but this pressure has been present and has been intensifying for many years. Increasing court awards play a very small role in erratic insurance company results.

Effective management could deal with the long-term influence of the tort system if that management were based on long-term consistency. We must keep in mind that during much of the period when tort system pressures were increasing, insurance companies were competing actively for liability business, often by reducing premiums. Unless industry executives strive for and succeed in bringing about a longer-range and more consistent picture of results, they are in for another round of an all-too-familiar battle with each other. □