

Leveling the Playing Field: Structural Analysis of Corporate Insurance Purchases

It's amazing that most businesses don't think twice about engaging legal counsel to review and negotiate a lease for a two person sales office, but are willing to rely exclusively on an insurance agent/broker to optimize their risk management program -- the corporate safety net. Although the following pages may seem self-serving, the reality is: without qualified, independent risk counsel, how can you be assured your best interests are being met?

Over the years we have met many extremely capable and perceptive C-levels (CEOs, CFO, etc) who feel they can handle the insurance process without independent risk counsel or a professional risk manager. Time and time again, we see that their decision-making focuses on three items: price, limit and deductible (probably a function of how the industry presents proposals). Although these are key metrics, there's more to the picture than meets the eye.

In our engagements, we often take a "systems thinking" approach (for more information, see www.systemdynamics.org) to deliver the optimal solution for our client-partners. In this article we will apply systems thinking to unveil the insurance purchasing process and the forces that undermine the objectives of the Corporate Business Risk Professional (the actual individual responsible for insurance) in building the appropriate corporate safety net.

It may seem counterintuitive, but insurance is not a service industry; rather, it is an industry of financial product manufacturers. One can easily draw an analogy that insurers are the industry's "Manufacturers" and the agents and brokers are "Intermediaries" or independent distribution channels for the manufacturers. Case in point, in order for the insurer to grow it must develop new products (R&D) for sale. When a new product is initially put into the marketplace, the insurer risks their capital to obtain event (claims) data. As their data collection activities grow, coverage offerings are modified in light of the aggregated data. Coverage offerings begin to broaden, albeit under the guise of the insurer's robust data experience. If the broadened offerings reduce the insurers return to an unacceptable level, then premiums are increased, coverage is restricted, or both (think D&O marketplace). Conversely though, if coverage broadening continues without effect on the insurers' return, insurers will be hard pressed to grow their business, as buyers are not likely to continue to purchase the coverage (remember Record Retention insurance?). Similarly situated are the Intermediaries who run their business on a negotiated percentage of the premium placed (plus others based on loss ratio) with the Manufacturer (the insurer). To optimize their business, they need larger premium volume, lower insured losses and/or decreased transaction costs.

While we have no qualms as each of these businesses optimize their business models, we do feel that for Insurance Buyers to accomplish their goals they need a better understanding of the system within which they must navigate.

Primary Concern:

A structural analysis of the corporate insurance purchase reveals a common theme where the Insurance Buyer must purchase insurance products with incomplete or biased information and with insufficient time to make good decisions. For instance: do you feel that the materials and information the Manufacturer (insurer) or Intermediaries (agent/broker) provide are designed to make you a savvy and well-informed insurance buyer? Also, ask yourself, why can't the agent/broker/insurer provide renewal terms 30 days in advance (rather than a couple days before), given that your renewal occurs on the same day every year?

The System – An Approaching Insurance Purchase:

The corporate insurance purchase process follows a predictable series of steps which result in the Insurance Buyer being placed at a disadvantage.

- Buyers observe published headlines regarding large losses or events and react by asking themselves how their own insurance would apply.
- Manufacturers funnel “information” to their Intermediaries that there is a “solution” for such losses or events.
- C-levels query their designated Corporate Business Risk Professional regarding the observed published headlines or events, who responds with the “information” provided by the “system”.
- C-levels ask the designated Corporate Business Risk Professional to react to change the insurance coverage according to the agents/brokers/insurers “information”.
- Buyers depend on the “system” to inform them of the possible “solutions” to this perceived need.
- Since agents/brokers are compensated based on a percentage of the premium paid by the Buyer, all possible solutions presented involve the “solutions” from the Manufacturer.

Since Buyers feel that the dynamic of the system cannot be overcome (they are legally required to carry some level of insurance), they do not feel a sense of urgency to change the source of “information” (broker relationship) and “solutions” (insurers) without a system shock (e.g. getting “screwed”). It is this inertia that allows a closed-circuit system to thrive.

The closed-circuit payment structure allocates revenues, costs, and assets as follows (simplified):

- **Manufacturers**
 - Revenues: premiums collected, investment income
 - Costs: claims paid, company/service expenses, and broker compensation
 - Assets: investment capital (premium revenues less costs)

- **Intermediaries**

- Revenues: commission based on premium collected, and investment income
- Costs: client service and maintenance
- Assets: client relationship

- **Insurance Buyers**

- Revenues: claims paid
- Costs: premiums and loss retention
- Assets: appropriateness of risk transfer (depth & breadth of “solution” purchased)

From this framework, there are four principal ways for risk-bearing entities (Manufacturers) to increase their profits:

1. Increase premiums collected while holding constant or decreasing claims paid
2. Decrease claims paid while holding constant or increasing premiums collected
3. Gain better returns on invested assets
4. Decrease broker commissions and services

Items 1 and 2 are at the direct expense of the Insurance Buyer. Item 3 increases credit risk to the Buyer, as chasing higher returns carries higher risk (volatility) for the Manufacturer. The fourth is again at the expense of the Buyer in that lower commissions correlate directly to lower services from the Intermediaries, which increases the risk profile of the Buyer’s enterprise.

A simple analysis illustrates that Manufacturers follow the first two approaches by partnering with Intermediaries to control the flow of information to the Insurance Buyer. By setting the Intermediaries’ compensation (commissions, contingencies, profit sharing, etc.), the insurer aligns the Intermediary’s incentive with its own, effectively eliminating the Insurance Buyer’s chance of obtaining independent advice from the “system”.

The Importance of System Knowledge - Driving the Knowledge Gap:

Now that you see the implicit value of system knowledge, let’s examine how the insurance industry structure works in favor of the Manufacturer at the expense of the Corporate Insurance Buyer. A key concept is the gap in system understanding between the Manufacturer and Intermediary and then between the Intermediary and the Buyer. As we will illustrate, this gap permits control and exploitation by the Intermediary of the insurance purchase negotiation. This drives economic surplus to the Manufacturer, increasing the returns to their system understanding. Insurance Manufacturers make significant investments in their understanding of the system, further reinforcing their “system advantage” (Figure 1).

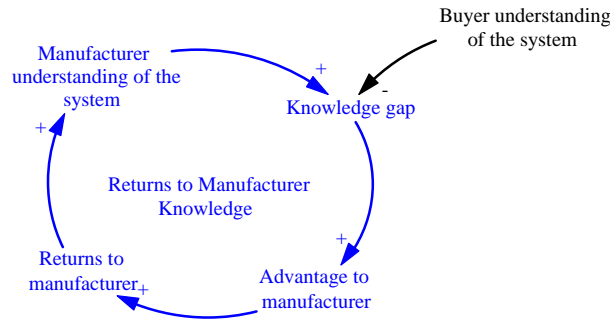


Figure 1

Learning from Experience...Or Not:

Left alone, the situation would correct itself (Figure 2). The knowledge gap would lead to a series of bad experiences for the Buyer which would encourage the Buyer to learn from those experiences, increasing the Buyer’s understanding of the system, reducing the gap and limiting the Manufacturer and Intermediary’s ability to exploit the Buyer next time. The resulting process should balance the system, limiting the reinforcing process described in Figure 1.

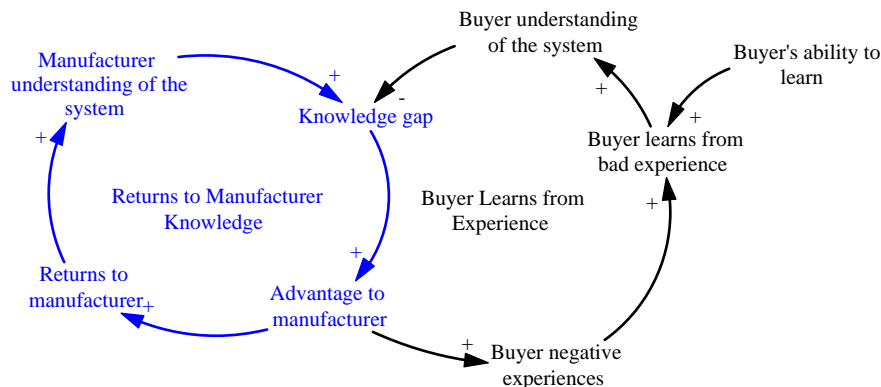


Figure 2

However, the insurance industry works hard to perpetuate their advantage, making independent learning quite a challenge. By limiting the Buyer’s ability to learn from those experiences (by limiting the Buyer’s sources of independent information), the Manufacturer can keep the system from balancing out, thereby retaining all the advantages in the purchase negotiation (Figure 3). You can think of these various

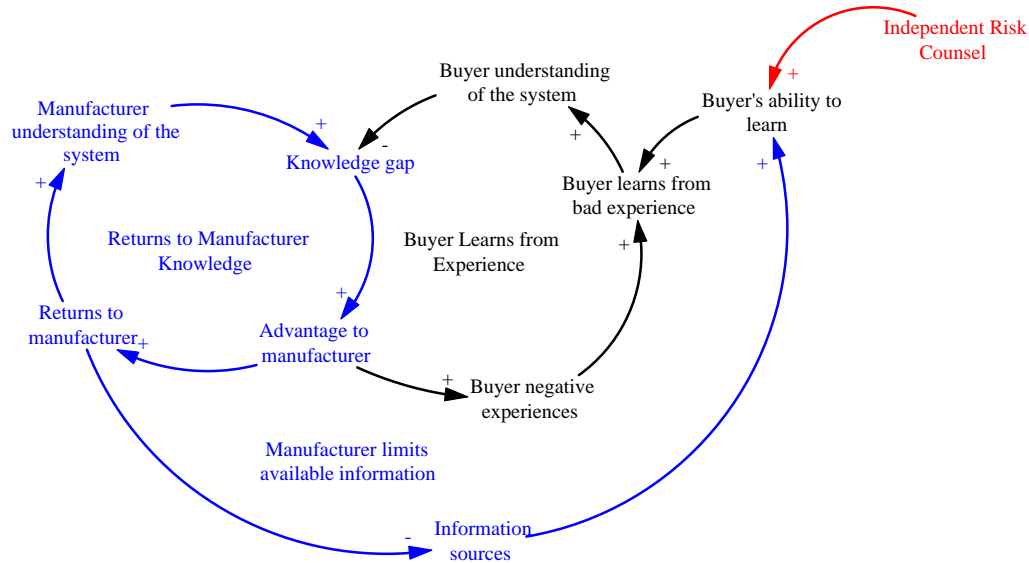


Figure 4

In the above illustration, the Manufacturer’s knowledge relative to the Insurance Buyer’s permits exploitation during the purchase negotiation. We would expect this to lead to the Buyer learning from bad experiences, developing understanding of the system, and shrinking the gap to prevent future exploitation. The trouble is, of course, that Insurance Buyers never learn of the bad experiences in the aggregate, so they learn *very slowly*. The Manufacturer, which has the data of a large number of corporate Buyers, observes many instances of claims “events” and learns *very quickly*, thus creating a very uneven playing field.

Whereas if knowledge were shared equally between Manufacturer and Buyer, aggregate premiums would approach aggregate claims paid, resulting in limited profit for insurers (the true socialization of risk). Because they learn faster than Insurance Buyers, Manufacturers know more about the expected value of the corporate Buyers’ risk (more importantly what portion they are actually accepting) than the Buyers themselves and use this knowledge to artificially increase demand and price for their products (coverage).

The result is increased profit for the Manufacturer and Intermediary, as shown in Figure 5:

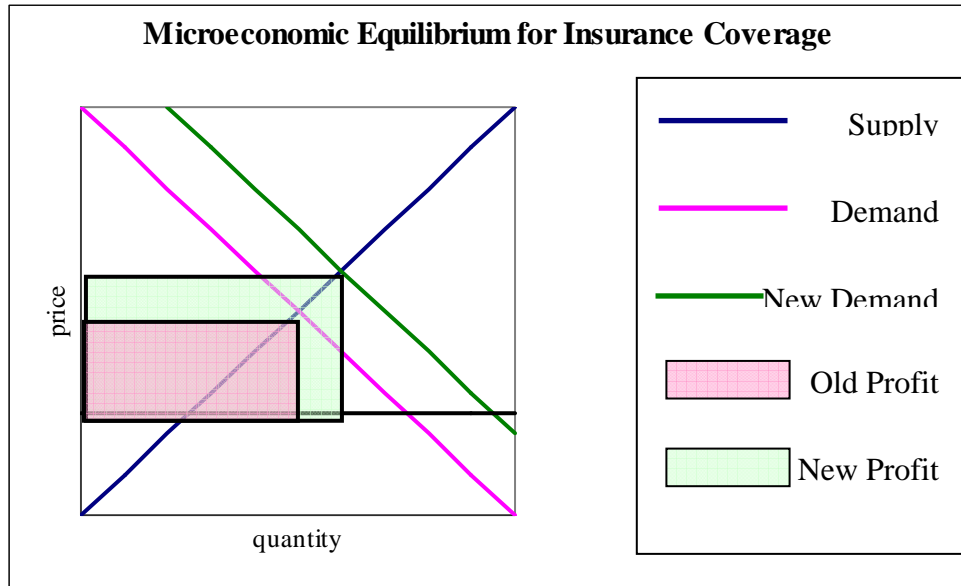


Figure 5

How Can We Measure It?

How do the inefficiencies and inaccuracies in the Insurance Buyer’s insurance purchase decision process affect the Corporate Business Risk Professional’s ability to optimize their position? One way to look at it is to determine the real value of the risk transfer mechanism or what we call Coverage Value™.

Coverage Value definition:

$$\frac{\text{Coverage}}{\text{Cost}} = \frac{\text{Relevant Breadth} * \text{Relevant Depth} * \text{Insurer Propensity to Pay} * \text{Insurer Ability to Pay}}{\text{Premium}}$$

Notes:

- “Relevance” or “Appropriateness” of Coverage Breadth and Coverage Depth is central to the Coverage Value concept. This suggests that the Premium should scale with the Insurance Buyer’s risk exposure and tolerance.
- “Relevant Breadth” reflects coverage/non-coverage of a given needed coverage.
- “Relevant Depth” includes both extent of protection within a given coverage and the limitations within that coverage.

Systems Thinking Takeaway:

By controlling the “information” with which the Insurance Buyer acts, Manufacturers and Intermediaries can artificially increase the purchase of coverage (and premium). Because the Insurance Buyer’s risk (and therefore the insurer’s expected claims payout) is unchanged by the insurance purchase, this uncertainty increases the insurance purchased relative to the risk exposure. This shift increases the Manufacturer’s profit at the expense of the Insurance Buyer.

At the end of the day, the business model of Insurance Manufacturers is to charge the highest premium for the narrowest coverage without losing the Buyer (cash flow). Even when this is achieved, they can further improve their profit flows by extending the time line of outflows (claims/return premium). The Intermediary model, because compensation is tied directly to premiums paid and losses incurred, is slightly different in that it seeks to “provide” the Buyer with the most coverage (whether relevant or not) at the highest premium. And then there’s the Insurance Buyer, who must navigate these system forces to optimize their risk transfer purchases.

Remember a system shock can come from many sources, like for example, when you inform your Intermediary that you are going to engage an independent risk advisor to work with you and they say “we do that”, “are you questioning our work” or “we don’t work with advisors”. If they truly represent your best interests, why then are they so unenthusiastic about your decision to seek independent information and assistance in navigating the system and leveling the playing field?

While we hope you will engage ARI to leverage the dynamics of the system, we highly recommend you engage a qualified independent risk advisor. There is no substitute for independent risk knowledge.