PURCHASING INSURANCE FOR AFFILIATED ENTITIES: MEASURING THE VALUE OF A COORDINATED APPROACH

I. INTRODUCTION

The purpose of this paper is to establish that affiliated, analogous entities can, in nearly all cases, benefit from the coordinated purchase of insurance. These benefits are the direct result of the reduced risks and improved efficiencies achieved by insurance underwriters. Diversification of the insurer’s risk portfolio along with more effective use of underwriting resources will allow insurance companies to provide better pricing and potentially improved terms to consortiums than to separate purchasers.

II. ECONOMIES OF SCALE

How economies of scale relate to the purchase of insurance is difficult to discern without a careful examination of the underwriting process employed by insurance companies.

The notion of economies of scale is a very old concept. The advantages inherent in economies of scale are most closely associated with fixed capital, particularly the lowering of production costs as capacity increases. However, sizeable inefficiencies in the insurance market can benefit from the savings that economies of scale can produce.

Before underwriting any policy the underwriter must:

- Devote resources to understanding the nature of the insured’s business and assessing the associated risks
- Allocate valuable manpower to the negotiation and refinement of the terms and conditions acceptable to all parties
- Make the necessary preparations to properly service any claim associated with the policy

By writing multiple policies for affiliated, analogous entities, insurance companies reduce the costs associated with understanding, negotiating and servicing those multiple policies. The greater the number of entities, the greater the potential cost savings. To truly understand the scale of those potential savings we must further parse the segments involved in the underwriting process.

A. UNDERSTANDING – INSURERS CAN REDUCE COSTS ASSOCIATED WITH ANALYZING A CONSORTIUM’S RISKS

Prior to underwriting, an insurance company will complete an analysis of the risks associated with a specific entity. Large insurers with multiple offices routinely handle similar customers in separate offices in order to spread the current workload, for internal political reasons or simply because one office is geographically more convenient. Such allocation of work might be practical in the absence of affiliated parties seeking similar coverages, but in the case of similar entities, the result is the duplication of work in various offices, especially in terms of analyzing risk that has already been
evaluated. This inefficiency could be reduced by the insurer recognizing that affiliated analogous entities are similar enough in their risk profile that the only required analysis is an examination of deviations from the consortium’s norm. (Note that most large insurers do have “specialists” in most major industries, and their expertise is relied upon by the underwriters; however, a single underwriter is not always given authority over a larger group of diverse, geographically or otherwise, group of analogous institutions.) By centralizing the process of assessing and harmonizing the risk exposures across like entities, duplication of efforts is eliminated, thereby producing substantial savings, and conflicting, risk-based conclusions between divisions, departments and offices across an organization can be neutralized.

While every institution has risks that are unique to their circumstances, the larger identifiable risks will be virtually identical for affiliated analogous entities. For example, community banks face similar risks to other community banks; furthermore, community banks of similar size lending to similar customers have even more closely correlated risk profiles.

In fact, if the entities in question are financial institutions, the effort required to perform an adequate risk analysis has another even more demanding element. As one of the most highly regulated industries, financial institutions require underwriters and analysts to devote substantial time and resources to understanding the peculiarities of their accounting⁵ and to staying current on ever-changing regulatory requirements⁶. Duplicating underwriting expertise and experience with an industry’s unique accounting and regulatory issues in various offices is costly, even for the most sizable insurers.

We estimate that by simply centralizing the analysis associated with the underwriting risks, insurers can save approximately 3-5% of the cost associated with underwriting analogous entities.

**B. NEGOTIATION – STANDARDIZED POLICY FORMS PRODUCE SUBSTANTIAL SAVINGS FOR INSURERS**

Perhaps one of the most manifest opportunities for cost savings in the insurance underwriting process is the negotiation of policy terms. Instead of tediously negotiating separate policy terms with numerous counterparties, often including costly legal review, insurance companies recognize the benefit of using a standardized policy. Therefore, insurers create standard policy templates and over time establish a library of approved endorsements or amendments deemed acceptable under given circumstances. However, we estimate that over half of all financial institution executive risk policies require customization, or manuscripting, even beyond the pre-approved endorsements. These alterations from the standard policy require legal oversight and such review is expensive. Costs for extensively modifying policies can quickly eat into the returns for underwriting a risk. Alternatively, passing such legal cost to the insured can make the premium unacceptable.

Currently, affiliated analogous entities, even those whose insurance is underwritten by the same insurer, may be negotiating with underwriting staff in different offices, and, depending on the quality of the broker or representative, may receive substantially different policies. This inequitable result can be eliminated by such like institutions agreeing to a standard policy that is acceptable to the underwriter with few, if any, endorsements permitted.

One standard policy is not a practical solution for different types of corporations or institutions. The risks associated and the necessary policy adjustments simply make such uniformity impractical. However, many in the insurance industry recognize that a large
degree of the customization done, even between entities with extremely similar risks, unnecessarily adds substantial costs to the underwriting process.

We estimate that by standardizing the policy and negotiation process insurers can save approximately 5-10% of the costs associated with underwriting analogous entities.

C. SERVICE – CENTRALIZING SERVICE AND STANDARDIZING THE POLICIES WILL REDUCE CLAIM MANAGEMENT COSTS FOR INSURERS

Although underwriters perennially hope to limit claim payments to a minimum, they must plan for claims being submitted and the processing of those claims. This means hiring claim staff and attorneys to negotiate with claimants and other relevant parties. Such a state of readiness is costly. Familiarizing staff with the business and features of the insured claimant may represent a serious burden and an unnecessarily duplication of efforts. A single point of contact and claim assistance (familiar with the nature of the claimant’s business, risk profile and nuances of insurance issues impacting the type of business in question) for affiliated analogous entities is simply more efficient. This focused effort can mean time savings and potentially better service for the insured. Quantifying the savings involved in centralizing claims for analogous customers is not simple because the amount of effort in familiarizing the team with the risks and claims specific to each industry or sub-industry can vary widely. (Litigation claims against securities companies can be radically more complex than simple tort claims against a restaurant.)

We estimate that by making the necessary organizational changes to centralize claim servicing of analogous entities, insurers can improve their customer service while reducing costs between 2-6%.

III. CONCENTRATION VS. DIVERSIFICATION

An axiom of finance is that risk can be increased by concentration and reduced by diversification.

A. CONCENTRATION

Underwriting insurable risks for affiliated analogous entities creates a concentration issue for insurers. The scale of that problem is primarily determined by two factors: 1) The scope of the underwriting in relation to the magnitude of the market, and 2) the homogeneity of the insureds. Parallels can be found in the investment market. An investor that purchases all the stock of a small startup company faces one type of concentration issue, while an investor that owns only semiconductor stocks may not have a dominant stake of the total market; however, his entire portfolio shares a similar set of risks.

In either form of concentration (too large a share of too small sample or too similar a stake in a larger sample) investors or underwriters face the risk that the entire portfolio will move in very close correlation. Such correlation amplifies risk, as well as the potential for returns and losses.
With an insurance portfolio composed of a large number of analogous insureds the underwriter faces increased risk through close correlation and will consequently demand a higher return on the total portfolio, unless that risk is somehow offset by other factors.

B. DIVERSIFICATION

Risk can be diversified in various ways. Generally affiliated analogous companies are either competing for the same business or have assigned segments of a broader market. When affiliated companies assign segments of the market geographically, the underwriter of such a portfolio realizes an important benefit – geographic diversification. By limiting the potential that a single localized event will impact a large segment of their portfolio, underwriters naturally reduce their overall risk. While many risks cross broad geographic regions, many risk events that are not inherently geographical in nature may be limited to certain locations. With careful analysis an underwriter can determine which risks are mitigated and which are not by various types of diversification.

Affiliated analogous entities frequently offer underwriters the opportunity to diversify their portfolios. The nature and extent of the diversification may vary widely, but the diversification acts to offset, in whole or in part, the correlation (and therefore the increased risk) that results from the concentration similar enterprises.

For purposes of this paper we will focus on the benefits of geographic diversification, although other varieties of diversification exist among affiliated analogous entities.

IV. AN EFFICIENT INSURANCE PORTFOLIO

EXPECTED RETURNS

Insurance buyers sometimes fail to appreciate that insurance companies view their policies just as any financial institution views its investments. Insurance companies, like banks or hedge funds, are eager to make a large enough investment in any given opportunity to minimize the costs associated with each dollar of investment while not exceeding the limits of their appetite for any particular risk.

If the estimated savings of 10-21% outlined above hold true for underwritten coalitions, then insurance underwriters should be motivated to seek out affiliated analogous entities. Savings will raise the return the underwriter achieves for each separate member of the affiliation. When calculating an underwriter’s return, the costs associated with the transaction are subtracted from underwriter’s revenues. The resulting gross revenue number must be reduced by the amount of any claims filed under the insured’s policies. The resulting net number can then be used to calculate the insurance company’s earning.

In determining whether to make an investment, or underwrite a risk, investors and insurers calculate the ‘expected return’ on each risk within a portfolio. Expected return is defined as the anticipated gain or loss calculated by taking the average of the probability distribution of all possible returns for a given risk asset. Note that nothing guarantees that the actual return and the expected rate of return will be the same. While investors in securities may use technical charts, complex models such as Black-Scholes, or value analytics to estimate the expected return of a portfolio of securities, insurers tend to use actuarial tables, historical data and, in property matters, sophisticated weather analysis. However, the goals are identical – to create an efficient portfolio, one that maximizes return within the risk-taker’s risk appetite.

Underwriting affiliated analogous entities with reduced costs and offsetting diversification and concentration considerations produce improved expected returns for insurers. Expected return of a portfolio is one of the key drivers of pricing for insurance risk.
V. CONCLUSIONS

Underwriting insurance risks of closely associated enterprises can produce demonstrable savings by eliminating duplication and unnecessary costs. While insurers may express concern about the risk of portfolio concentration, much of that risk is mitigated by the diversification that generally naturally accompanies such affiliated entities. While the range of the savings may vary, the potential is substantial; the key remaining question is: How will the savings be distributed between insurers and insured?

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2The law of diminishing returns dictates that at some point insurers will reach a point where there is no more efficiency to be gained by simple expansion and improved allocation of resources. This “law” is really a generalization economists make about the nature of technology when it is possible to combine the same factors of production in a number of different proportions to make the same product. The law states: When increasing amounts of one factor of production are employed in production along with a fixed amount of some other production factor, after some point, the resulting increases in output of product become smaller and smaller.

3“The quality of an underwriting decision reflects the quality, quantity, and relevance of information gathered before the decision is made.” www.aicpcu.org/comet/programs/intro/assets/docs/IntroUW.pdf

4E.g., Chubb Insurance has over 50 offices throughout the United States.

5The Office of the Comptroller of the Currency has one section of its website dedicated to the various accounting topics of interest to banks and federal savings associations. http://www.occ.gov/topics/bank-operations/accounting/index-accounting.html

6Bank regulations and rules change almost daily. The American Bankers Association has started a “Dodd-Frank Tracker” simply to keep bankers informed about the enormous number of new rules and regulations being issued in connection with this single Act.

7http://socsci2.ucsd.edu/~aronatas/project/academic/science.pdf

8There are various means of diversification. A review of such methods is beyond the scope of this paper, but a simple list of the major methods of diversifying risk includes: Across Asset Class, Within Asset Class, Geography Wise, Across Capitalization, Across Time, and Across Style.

9While “affiliated” and “competitor” generally imply polar opposites, we frequently see associations composed of ‘friendly’ competitors. Industry associations often consist of extremely similar entities.

10Affiliated entities most often divide the market by geography, although other criteria, such as employment, or association affiliation are also employed.

11Bank failures are an example of a risk that is not intuitively geographical, yet in the midst of the financial crisis from 2008 – 2012, Georgia had 76 bank failures while neighboring Tennessee had none. http://www.thestreet.com/stock-market-news/10607062/bank-failure-map.html

12This 10-21% range comes from totaling the estimated savings for analysis (3-5%), negotiation (5-10%) and servicing (2-6%).

13This “net revenue” number is prior to taxes, depreciation and extraordinary items and therefore represents what is commonly called EDITDA.

14For example, the estimated returns for a particular risk might state that the opportunity has a 10% chance of a 100% return and a 70% chance of a 50% return. The expected return is calculated as:  
Expected Return = 0.1(1) + 0.7(0.5) = 0.45 = 45%.