Excelling at Account Management

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Welcome

To complement the online course, this course book is designed as a study aid. The online course provides the richest, and fullest, M-AB 133 course experience and best allows students to master the material and prepare for the credentialing exam.

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Index 1

How Can You Cultivate Your Selling Skills?

1

Educational Objectives

- Develop strategies for acquiring and reinforcing relationships with personal and commercial clients.
- Create a personal production plan.
- Explain how insurers analyze loss data and forecast trends.

Outline

Developing Your Selling Skills

Creating a Plan for Success

Analyzing Loss Data and Forecasting Trends

Summary

How Can You Cultivate Your Selling Skills? 1

DEVELOPING YOUR SELLING SKILLS

Knowing how to process policy sales transactions and answer customers' coverage questions will only get you so far. Real success as an insurance producer is generated from conjuring up new customers out of thin air and developing long-term relationships with them.

Agents and brokers succeed by growing business organically. Selling policies and answering questions is just the beginning. The most important thing that a producer can do is gain a customer's trust as a risk consultant or subject matter expert and develop a deeper, ever-expanding relationship with that person.

What Do You Know?

What does it mean to grow a business organically?

Feedback : Organic growth is the product of using a business's internal resources to expand sales and increase profits. Inorganic growth, on the other hand, results from merging with or purchasing another entity. The hallmark of a successful agency or brokerage is its ability to grow organically—by adding new clients, developing new business from existing clients, or both.

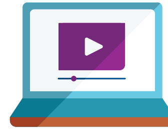
So how can producers find new clients and cultivate them to establish long-lasting relationships that are beneficial to both parties? Let's take a look.

Cultivating Personal Clients

Of course, paid advertising and marketing efforts should be part of any agency or brokerage's arsenal of tools for generating new business—but they can be expensive. Producers need other, less-costly strategies to get clients in the door.

Every social situation producers find themselves in should be treated as an opportunity to make an impression on potential clients. The more involved a producer is in community activities, clubs, and associations, the more potential clients they'll encounter. This doesn't mean producers should give prospects the hard sell every chance they get, but rather seek out opportuni-

ties to establish trust, offer advice, and build rapport with them. This opens the door to business relationships.



Learn more from an expert in the online video.

Producers also benefit from taking a tactful and nuanced approach to social media. This involves avoiding overtly promotional messages and instead, shining the spotlight on the producer's risk management expertise. Ways to attract business using platforms like Facebook, Twitter, Instagram, and LinkedIn without making an overt sales pitch include:

- Be social and educational—Most people don't use social media to see promotions. They want to connect with loved ones and read and share interesting stories. Give the people what they want. Talk about local customers you've helped save money, avoid a devastating loss, or gain peace of mind with a new purchase. Just make sure you have customers' permission to use their names and photos first.
- Talk about what's new—Chances are if someone is following you on social media, they're already a customer. Rather than relay information they probably already know, highlight any new products or discounts you're offering and—most importantly—why they're so beneficial.
- Answer questions—Search for insurance, financial, and risk-related questions people are asking, then answer them. Encourage people to share the answers with others who may benefit.
- Talk about growth—Have you expanded into a new office, updated equipment, or hired someone recently? Share the news. It says you're successful.
- Post pictures of unusual items you helped insure—Show customers the variety of things you can help them protect by posting pictures of jewelry, four wheelers, boats, recreational vehicles, and anything else that isn't a house or car that you've helped cover.
- Ask, "Are you covered?"—When news breaks about a disaster or catastrophe, it's a good time to remind customers to make sure they're prepared, should a similar event strike locally. You don't want to take advantage of anyone else's plight, but it can be important to share the pain of coverage gaps.

Learn more from an expert in the online video.

Every interaction a producer has with prospects and clients is a chance to listen, learn, and enhance the customer experience. Engaging prospects in conversations about their lifestyles, interests, and hobbies can help producers determine whether prospects have coverage gaps or are generally dissatisfied with their current coverage or producer.

Producers shouldn't pass up any opportunity to address customer needs. Coverage gaps can develop at any time, so it's important for producers to maintain records of interactions with both customers and prospects so that they can most effectively follow up. It's also important to contact customers whose policies are about to renew to conduct a needs assessment. Simply processing the renewal can result in missed **up-selling (account upgrading)** and **cross-selling (account selling)** opportunities.

Up-selling (account upgrading)
Sales activities such as increasing an account's limits or adding coverage to existing policies to better cover the client's needs.

Cross-selling (account selling)
Selling new types of insurance products to existing clients.

Apply Your Knowledge

How can you up-sell and cross-sell to existing personal lines clients?

Feedback : Let's say a client called you to add a vehicle to her auto policy. Traditionally, she has only purchased the minimum liability limits required by her state. However, during the conversation, she reveals that she has a new job and paid cash for a relatively new car. Based on this information, you could recommend that she increase her liability limits and even add physical damage coverage to her policy so she wouldn't have to pay out-of-pocket to repair or replace her car after an accident. This is an example of up-selling.

Now let's say you contact a customer to discuss renewing his homeowners policy. Your notes say that the customer is a dog lover and has mentioned wanting to breed dogs at his residence. He is also an avid hunter. Because dogs and firearms can be significant **liability loss exposures**, you could mention that his activities may warrant the purchase of an **umbrella policy** to increase his liability coverage. In addition, if the customer plans to breed dogs for business purposes, you could mention that would likely warrant the purchase of a business policy. This is an example of cross-selling.

Liability loss exposure
Any condition or situation that presents the possibility of a claim alleging legal responsibility of a person or business for injury or damage suffered by another party.

Umbrella policy
A liability policy that provides excess coverage above underlying policies and may also provide coverage not available in the underlying policies, subject to a self-insured retention.

Cross-selling and up-selling should benefit both the producer and customer. Producers benefit from increased profitability and improved customer retention because customers tend to keep their business with an agency longer once they've consolidated policies with that agency. Customers benefit from improved convenience (with a single producer handling multiple types of coverage) and reduced risk (the producer has a more complete picture of the customers' coverage needs).

A key goal for producers is improving customer retention. This is because long-term customers are much more profitable than new ones; it costs a lot more to identify, solicit, analyze, and place a new piece of business than to renew, up-sell, or cross-sell an existing account.

So this raises the question: What drives customers to leave? One big reason is price. Because insurance is simply a promise, an intangible, many consumers don't recognize its value unless they have to file a claim. So they want to pay as little for it as possible.

So how can producers increase retention, if they don't always have the lowest price? By communicating with customers regularly, responding to their inquires in a timely manner, making them feel important, focusing on their needs, conveying the value of their insurance policies, and sharing risk management expertise. To learn more, see " Ways to Keep in Touch With Customers."

Ways to Keep in Touch With Customers

- Call (or send a letter or email) to thank customers for their business and to ask if they have questions.
- Send e-newsletters explaining loss exposures, coverages, and ways to reduce premiums.
- Offer to quote other lines of business, and explain the premium savings that can result from placing multiple coverages with one insurer.
- Send seasonal greeting cards, birthday cards, or congratulatory cards.
- Complete an annual policy review with insureds to make sure their coverage is adequate.
- Send out "Getting to Know You" surveys to learn about customers' interests and needs.

See the corresponding online video.

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Cultivating Commercial Clients

Many of the same strategies that apply to cultivating personal clients also apply to cultivating commercial clients. However, when trying to grow a commercial book of business, it's especially important to build relationships with prospects and nurture those relationships after prospects become clients.

Commercial customers tend to be busy and usually have a reasonably satisfactory relationship with another producer. Additionally, many dislike change because it's disruptive. These are all factors producers must overcome to make a sale.

It's important for producers to understand that a prospect's request for a quote is not the same as an intention to change producers or insurers. Most commercial customers will periodically obtain quotes before renewing their

policies. This allows them to compare prices and service and also use competitive quotes to negotiate more favorable terms with their current producer.

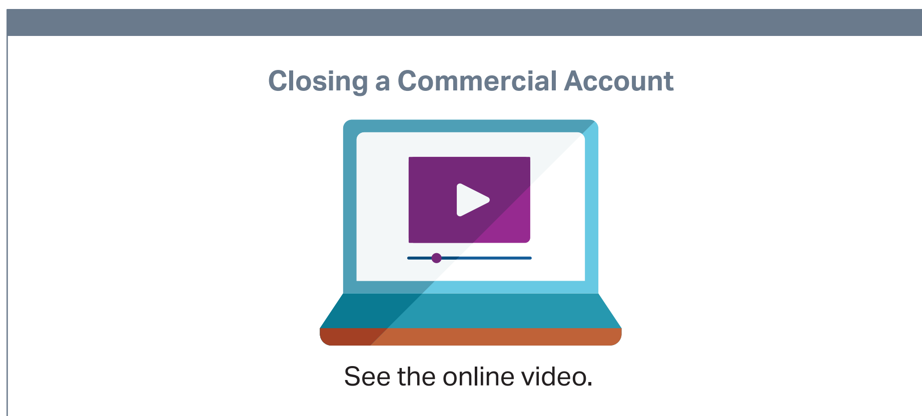
Producers are therefore most likely to be successful at making sales if they identify areas of pain in prospects' current producer relationships or coverages and then demonstrate to those prospects how they can reduce that pain.

Apply Your Knowledge

What might you ask a client that could reveal potential pain points?

Feedback : Asking leading but not intrusive questions of prospects can help producers identify areas of pain and opportunity. A leading question, for example, might be, "What areas of concern does your current producer typically focus on when you meet to go over your loss results?" This gives the prospect an opportunity to indicate, for example, that he or she doesn't meet regularly with his or her producer.

Closing the sale should be pursued from the first contact until the signed agreement is in hand. When a quote is delivered to a prospect, the producer should directly ask for the sale. To learn more, see "Closing a Commercial Account."



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Learn more from an expert in the online video.

CREATING A PLAN FOR SUCCESS

Selling requires more than a great combination of products, knowledge, service, and people skills. It also requires a solid plan for how to put each of those factors to use to maximize results.

It may sound cliché, but it's true: Selling successfully requires a plan.

Winging it may work for a little while but won't lead to sustained success. To achieve lasting results and continuous improvement, producers must thoroughly understand how to create a sales plan (also referred to as a **personal production plan**) that describes what they will sell, how they will sell it, and when they will sell it.

Personal production plan

A written document developed by a producer that describes what the producer will accomplish, how it will be accomplished, and when it will be accomplished.

Producers and their managers must work together to create individualized sales plans that include goals, milestones, and oversight. Plans should be detailed, documented, and aligned with the overarching goals of the agency (or brokerage). Each producer should be held accountable to the plan he or she has helped create.

Develop Goals

Goals are a producer's final targets for the planning period. The typical production (or sales) planning period is one year and should usually coincide with the agency's fiscal year.

An effective sales plan seeks to drive growth—for both the producer and the agency. Each producer's plan should contain multiple goals, and each goal should be SMART. To learn more, see "What Are SMART Goals?."

What Are SMART Goals?

- Specific—Well-defined and narrowly focused
- Measurable—Trackable with clear-cut metrics at defined intervals
- Achievable—Challenging but attainable with the tools and resources provided
- Relevant—Aligned with the long-term objectives of the individual and organization
- Time-bound—Tied to target dates and deadlines

See the corresponding online video.

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Let's see what SMART goals look like. They are:

- Specific—For example, "I will generate $100,000 in homeowners insurance premiums."
- Measurable—For example, "I will generate 15 percent more in commissions for commercial property insurance this year than I did last year." Some goals, such as customer service goals, may not seem measurable but can often be quantified through customer satisfaction surveys or retention rates.
- Achievable—To be effective motivators, goals must be realistic. For example, "I will acquire one new large commercial account each month" is likely achievable; "I will sell a commercial policy to every business in town" is not.
- Relevant—A producer's goals should be tied to the goals of the agency. For example, if the agency wants to increase referral business, then the goal, "I will generate $30,000 in commissions from referrals between January 1 and December 31" is relevant.
- Time-bound—For example, "I will sell five new automobile dealer accounts by June 30."

Ideally, producers should establish goals in every area in which they're accountable. This might include professional development, training, and supervision. By clearly establishing goals and prioritizing them, producers can manage their time effectively.

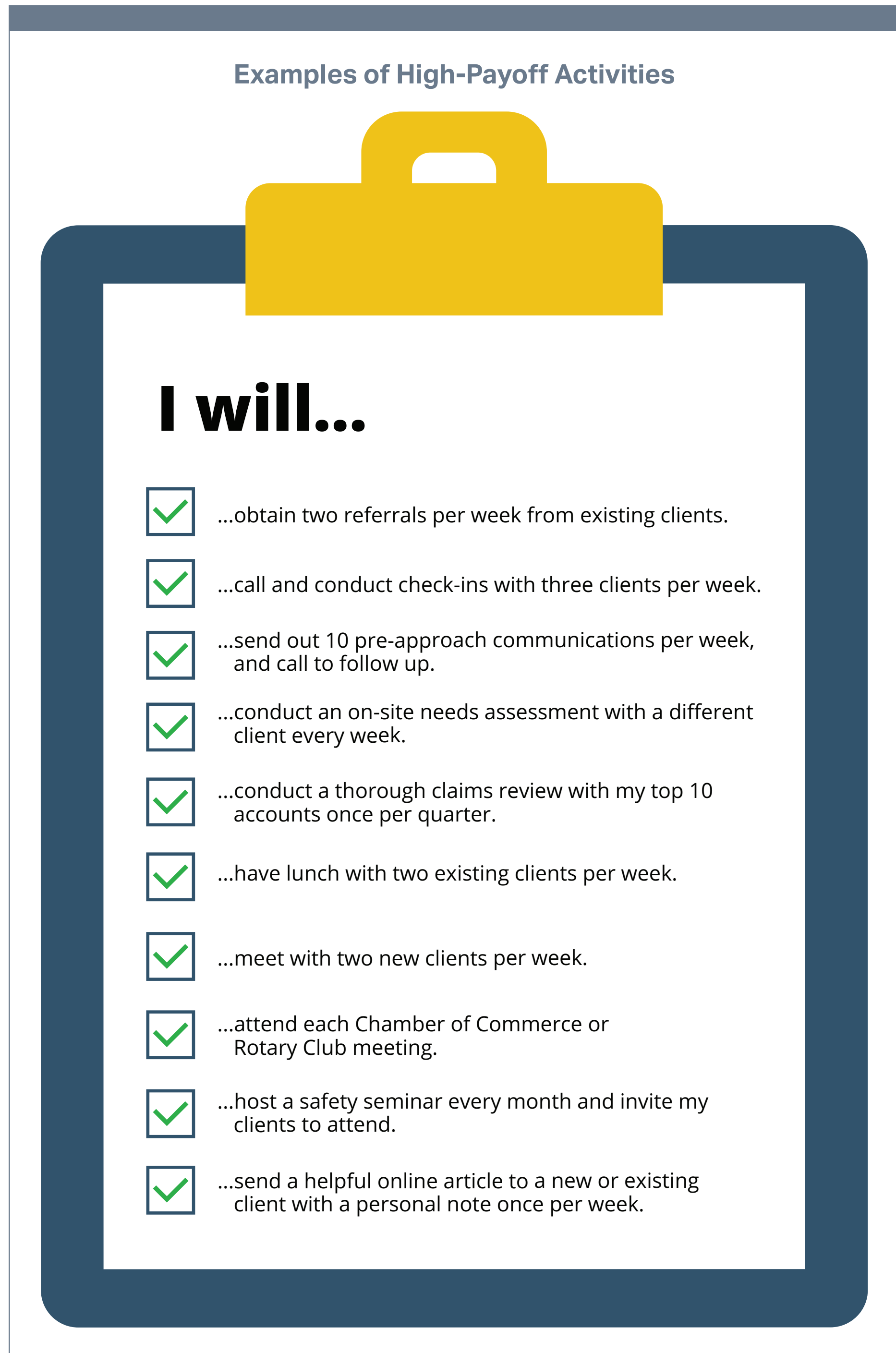
Develop Milestones

All goals are the result of a series of well-defined, high-payoff activities that are linked together in a chain. The larger the goal, the longer the chain. By identifying the specific activities that are needed to achieve the larger goal, producers' chances for success increase. To learn more, see "Examples of High-Payoff Activities."

Think of these activities as milestones one must hit before reaching the final destination (attainment of the overall goal). Like goals, these milestones should be SMART and attached to a specific goal. To learn more, see "Establishing Effective Milestones."

Key to a sales plan's success is allocating enough time to complete all of the activities listed. It can be all too easy to underestimate the time commitment needed for each activity.

Producers and their managers should discuss how long an average call, lunch, or appointment takes and budget time appropriately. Committing to more activities than a producer can reasonably accomplish can lead to burnout—and a need to revise the plan earlier than anticipated.



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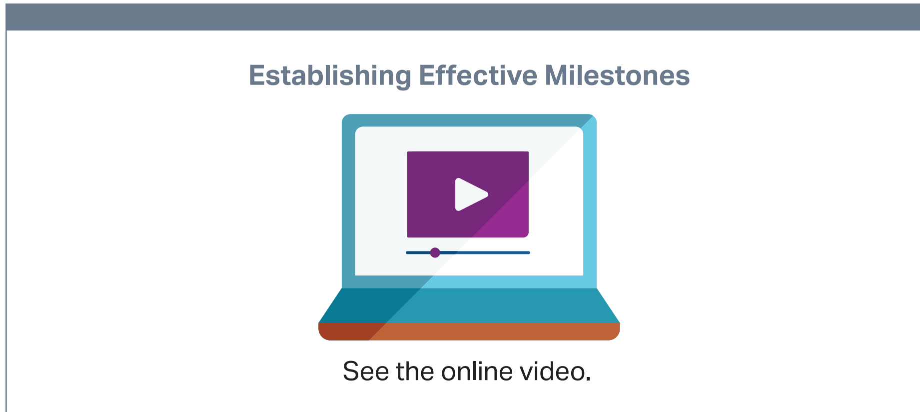
Monitor the Plan

Sales plans don't have to be, and typically shouldn't be, set in stone. Success often comes from adjusting the original plan. As a result, plans should be



Establishing Effective Milestones

See the online video.

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monitored throughout the planning period, with performance tracked against milestones and goals.

Managers should meet with producers to review performance on a daily, weekly, monthly, quarterly, or annual basis. The goal is to determine what actions (if any) need to be taken to maximize the producer's performance.

For example, if the producer is vastly exceeding expectations in a particular area, it's possible the goal was set too low. On the other hand, if a producer is underperforming in a particular area, maybe the goal is too aggressive or the producer needs additional resources from the agency.

While ultimately, producers must be held accountable for achieving their sales goals, managers and producers should work together to look for areas in which plan adjustments can be made to improve the chances for success.

Learn more from an expert in the online video.

ANALYZING LOSS DATA AND FORECASTING TRENDS

A small regional insurer is struggling to compete with national insurers on homeowners insurance. Because the insurer is located in the western United States, it's concerned about the increase in wildfires and the corresponding higher claims it has been paying, which are reflected in its loss ratios. The insurer's management does not want to implement a flat rate increase for all its homeowners policies because the significant rate increase would drive many of its best customers to other, larger insurers. However, management does not immediately see a way to improve profitability.

What Do You Know?

Analysis through predictive modeling could reveal potential strategies the insurer may pursue to improve its profitability. What do you think are the main categories of data the insurer would use to develop and refine its modeling?

Feedback : Categories of data on which the insurer would base its predictive analysis include its own loss and loss expense data—including its **loss ratios**—along with industry data and current trends. It would also incorporate loss frequency trends and loss severity trends and compare loss frequency and loss severity among groups.

Loss ratio

A ratio that measures losses and loss adjustment expenses against earned premiums and that reflects the percentage of premiums being consumed by losses.

Insurers can find new correlations between granular customer data and loss exposures when empowered by access to continuously growing data sources and advances in data analytics. Often, modeling reveals relationships and trends that affect an insurer's loss ratio, allowing the insurer to improve underwriting guidelines and more closely match its premium charges to its loss exposures.

Basic Forecasting Variables: Loss Frequency and Loss Severity

First, let's examine the fundamental elements of the data insurers use to analyze losses and forecast trends—loss frequency and loss severity. To learn more, see "Loss Frequency and Loss Severity."

Insurers analyze claim data by product, coverage, geographic area, risk classification, producer, branch or region, and year. They compare the frequency and severity of losses among these different groups and use the results as the basis for establishing rate relativity factors.

Beyond the Basics: Other Forecast Variables

Sophisticated, machine-learning based models go beyond these basic variables, however. An analysis of homeowners losses and trends, for example, would include traditional rating variables for each covered home, such as year built, construction type, and location. It would also consider the attributes that enable finer distinctions among risk groupings, such as the age of a home's electrical system. Machine learning can discover patterns and relationships that will greatly benefit an insurer. To learn more, see "Machine Learning Applied to Homeowners Policy Attributes."

Loss Frequency and Loss Severity

Predictive models that help insurers forecast trends that affect their profitability begin with an analysis of loss frequency and loss severity.

Loss frequency is the number of losses that occur within a specified period. The period is often described in terms of exposure units, such as losses per hundred cars in a given year, depicted as car-years, or losses per thousand houses in a year, or house-years. This approach enables insurers to make meaningful comparisons regarding the number of losses for a line of business, risk classification, or coverage from year to year.

	Fire Losses	÷ House-Years	Loss Frequency per 100 House-Years
Year 1	401	10,000	4.01%
Year 2	487	10,500	4.64%
Year 3	529	11,000	4.80%

In this depiction of three years' worth of an insurer's homeowners data, the number of house-years and fire losses increase each year, indicating an increasing loss frequency.

Loss severity is the amount of loss, usually measured in dollars, for a loss that has occurred. Loss severity trends refer to the average size of losses for a rating class over time. Large losses for individual loss exposures are relatively rare in personal auto and residential property insurance. Although an insurer's potential exposure can equal the limits of a policy, most claims involve much smaller amounts. To set rates commensurate with the insurer's real exposure, insurers average the claim payments.

	Total Paid Losses	÷ Fire Losses	Fire Loss Severity
Year 1	$1,478,040	452	$3,270
Year 2	$1,323,520	517	$2,560
Year 3	$1,360,900	439	$3,100
Year 4	$1,253,750	425	$2,950
Average severity			$2,970

This loss severity dataset indicates that as the amounts for total losses paid in a given year increase and the number of fires increase, the fire loss severity for the insurer's homeowners product increases. The result is an increase in the average severity. This analysis allows the insurer to identify trends and predict the cost of future losses. As with frequency, actuaries try to identify the cause of any significant variance in loss severity and may choose to exclude amounts from any event that results in misleading severity data. For example, a large loss reserve posted in a previous year is reversed in a subsequent year.

See the corresponding online video.

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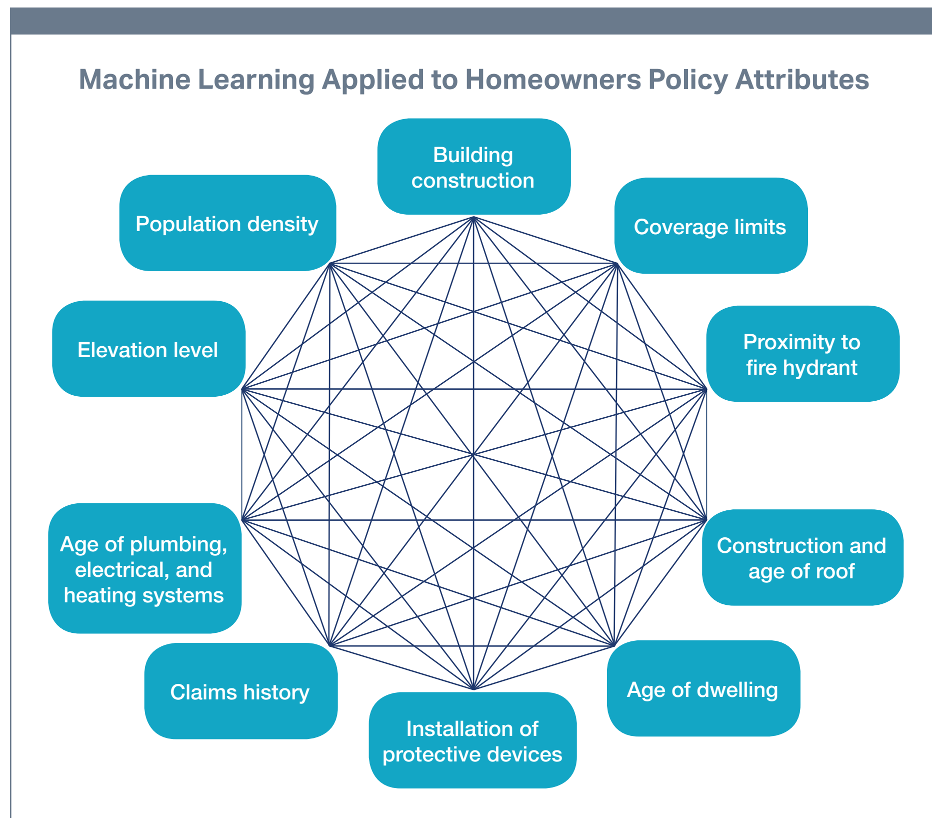

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Apply Your Knowledge

Think about the small regional insurer we discussed earlier. What additional variables do you think it might use to analyze the losses and forecast trends associated with its wildfire-related profitability problem?

Feedback : The insurer might consider data about underbrush, relative wind speeds, distance between the home and fuel, and other location-specific information to help it better understand the increasing wildfire-related claims. It could also obtain data about the region from a governmental wildfire agency.

SUMMARY

Producers shouldn't just strive to just sell policies or answer questions. They should position themselves as risk consultants and subject matter experts. Every social situation is an opportunity to listen, learn, and enhance the customer experience. Engaging personal lines prospects in conversations about their lifestyles, interests, and hobbies can help identify their coverage needs.

Growing a commercial book of business often entails identifying pain points for the prospect and finding ways to eliminate that pain through a combination of risk management techniques and insurance coverage.

To be a successful salesperson, you need a sales (or personal production) plan. Every effective plan includes goals, milestones, and oversight. Goals should be SMART, milestones are the specific activities needed to achieve a goal, and oversight requires monitoring a sales plan to see whether adjustments can be made to improve the chances for success.

Insurers analyze loss and loss expense data along with industry data and current trends to predict future losses. Portfolio managers must understand how loss frequency and severity trends affect the insurer's rates, how loss frequency and severity among various groups relate to rate making, and the ultimate effect on the insurer's business portfolio.

How Do You Measure an Insurer's Strength?

2

Educational Objectives

- Demonstrate how an insurer can measure its success at meeting established goals.
- Differentiate among the core and supporting functions performed by insurers.
- Evaluate a property-casualty insurer's Annual Statement by calculating capacity ratios.
- Evaluate a property-casualty insurer's NAIC Annual Statement by calculating liquidity and profitability ratios.
- Explain how A.M. Best Company evaluates the financial strength and capacity of property-casualty insurers.

Outline

Measuring Insurer Performance

Functional View of Insurance

Insurer Annual Statement Capacity Ratios

Insurer Annual Statement Liquidity and Profitability Ratios

A.M. Best Financial Strength Ratings

Summary

How Do You Measure an Insurer's Strength?

2

MEASURING INSURER PERFORMANCE

Determining an insurer's success requires reviewing performance measures that are specific to the industry.

Measuring an insurer's performance typically involves determining how successful it is at meeting profitability goals, customer needs, legal requirements, and social responsibilities.

As with any assessment, some measures (such as financial calculations and compliance with legal requirements) are objective, while others (such as how well an insurer meets customer needs and social responsibilities) are more subjective.

What Do You Know?

What do insurers do with the premium dollars they collect before paying for losses or providing dividends to owners?

Feedback : Insurers make investments with the premium dollars they collect with the goal of receiving investment income. Investment income is then used to pay for unexpected losses, fund operations, and/or provide dividends to owners.

Meeting Profitability Goals

The primary sources of revenue for insurers are insurance premiums (paid by insureds) and investment income. When determining expenses, insurers face a special challenge compared with other organizations: The largest portion of their expenses involves losses that will occur in the future and are difficult to project because they won't equal past or current expenses. Insurers estimate these future expenses and set aside the funds needed to pay for them through reserving.

Key components of insurer profitability include premiums, investment income, underwriting performance, and overall operating performance. Reviewing these factors is key to calculating profitability.

Premiums and Investment Income

An insurer's profits depend heavily on the premium revenue it generates. Insurers use rates based on the insured's loss exposures to determine the premium they charge.

Insurers must charge premiums to have the funds necessary to make loss payments and earn investment income. Investment income is critical because premiums alone may not always cover losses. For example, an insurer may spend 80 cents of every premium dollar on losses and 25 cents on other expenses—creating a need for the insurer to generate investment income to make up for this 5 percent difference.

Insurance operations also generate substantial amounts of investable funds from loss reserves, loss adjustment expense reserves, and unearned premium reserves. Loss and loss expense reserves are especially significant for insurers that write liability insurance because the long delay inherent in the liability claims handling process generates very large loss reserves.

Measures of insurer profitability based on premiums consider premium growth issues and the rate of growth that is sustained over time. Premium growth isn't always a positive indicator of an insurer's success. An insurer should achieve premium growth by writing new policies rather than depending solely on insurance rate increases or inflation. Premium growth, or the lack thereof, must be evaluated in light of current market conditions. During periods of intense competition, significant premium growth is difficult to achieve. However, rapid premium growth may be undesirable and could indicate lax underwriting standards or inadequate premium levels. Premium growth that results from relaxed underwriting can lead to reduced profits if losses begin to exceed premiums collected. When estimating profitability, an insurer should consider whether growth resulted from a competitive advantage, relaxed underwriting, inadequate insurance rates, or a combination of these factors.

Establishing reasonable rules by which to measure the adequacy of premium growth is difficult. Growth that is slower than the industry average usually indicates a problem. Likewise, a growth rate that is substantially higher than the industry average might indicate changes that could be unfavorable in the long term.

Underwriting Performance

Insurers can measure their underwriting performance in terms of net underwriting gain or loss. This is an insurer's earned premiums minus its incurred losses and underwriting expenses for a specific period. Incurred losses include loss adjustment expenses (LAE). Underwriting expenses include acquisition expenses, general expenses, taxes, and fees. Because net underwriting gain or loss ignores investment income and investment expenses (or losses), it represents the extent of the insurer's profit or loss derived strictly from the sale of insurance products.

Insurers use three specific ratios to measure their underwriting performance: the loss ratio, the expense ratio, and the combined ratio. The combined ratio is often considered the most important of these because it's a more comprehensive measure of performance. To learn more, see "Measuring an Insurer's Underwriting Performance."

Measuring an Insurer's Underwriting Performance

The loss ratio compares an insurer's incurred losses with its earned premiums for a specific period. The figure for incurred losses includes loss adjustment expenses (LAE). The loss ratio calculation:

Loss ratio = Incurred losses (including LAE) ÷ Earned premiums

The expense ratio compares an insurer's underwriting expenses with its written premiums for a specific period. The expense ratio calculation:

Expense ratio = Incurred underwriting expenses ÷ Written premiums

The combined ratio combines the loss ratio and the expense ratio to determine insurance underwriting performance. The combined ratio calculation:

Combined ratio = [Incurred losses (including LAE) ÷ Earned premiums] + [Incurred underwriting expenses ÷ Written premiums]

The simplified combined ratio calculation:

Combined ratio = Loss ratio + Expense ratio

When the ratio for any of these calculations is more than 100 percent, the insurer is losing money. When it's less than 100 percent, the insurer is making money.

See the corresponding online video.

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Apply Your Knowledge

Calculate the loss ratio, expense ratio, and combined ratio for an insurer that has incurred underwriting expenses of $5,000,000, incurred losses of $14,000,000, loss adjustment expenses of $230,000, net written premiums of $22,500,000, and earned premiums of $21,500,000. Next, explain whether its underwriting operations are profitable.

Feedback : The insurer's loss ratio ($14,230,000 ÷ $21,500,000 = 0.66) is 66 percent, its expense ratio ($5,000,000 ÷ $22,500,000 = 0.22) is 22 percent, and its combined ratio (0.66 + 0.22 = 0.88) is 88 percent. The insurer has earned a 12 percent profit from its underwriting operations.

Overall Operating Performance

Another way to measure an insurer's profits is through overall results from operations. An insurer's overall gain or loss from operations is its net underwriting gain or loss plus its net investment gain or loss for a specific period. This figure gives a more complete picture of an insurer's profitability because investment income generally helps to offset any underwriting losses.

After an insurer pays losses, expenses, and taxes and reserves money to pay additional (future) losses, the remainder is net operating income, which belongs to the company's owners. The owners (stockholders or policyholders) may receive a portion of this as dividends. Any amount left after dividends are paid is added to the policyholders' surplus. The increase in policyholders' surplus enables the insurer to expand its operations in the future and provides a cushion against future losses.

Insurers may lose money on their underwriting activities (that is, when the combined ratio is more than 100 percent) and yet still generate a profit because of investments. Ideally, investment income is more than enough to offset any underwriting loss so that the insurer has an overall gain from operations.

Insurers use three specific metrics to measure their operational performance: the investment income ratio, overall operating ratio, and return on equity. To learn more, see "Measuring an Insurer's Overall Performance."

Measuring an Insurer's Overall Performance

The investment income ratio compares the amount of net investment income (investment income minus investment expenses) with earned premiums over a specific period. The investment income ratio calculation:

Investment income ratio = Net investment income (investment income - investment expenses) ÷ Earned premiums

The overall operating ratio, the combined ratio minus the investment income ratio, is used to provide an overall measure of the insurer's financial performance for a specific period. Of all the commonly used ratios, the overall operating ratio is the most complete measure of an insurer's financial performance. The overall operating ratio calculation:

Overall operating ratio = Combined ratio – Investment income ratio

Return on equity is determined by dividing net income by the average amount of total owners' equity (policyholders' surplus) over a specific period. This measure gives investors a figure they can use to compare the potential return from an investment in the insurer with other potential investments. The return on equity calculation:

Return on equity = Net income ÷ Owners' equity (policyholders' surplus)

See the corresponding online video.

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Estimation of Loss Reserves

One of the biggest problems in measuring insurer profitability arises from errors in estimating loss reserves. Loss reserves are generally the largest liability on the insurer's balance sheet and can have a significant effect on the insurer's profitability. Insurers establish loss reserves for reported claims, for losses that have occurred but that have not yet been reported (known as incurred but not reported [IBNR] losses), for losses that have been reported but for which established case reserves are inadequate, and for claims that have been settled and then reopened.

Errors in estimating the final cost of claims can distort the insurer's reported profits. This is true for both the year in which inaccurate estimates were originally made and the year in which corrections are made to the estimates.

For example, if reserves are initially underestimated, then net income and policyholders' surplus will decrease when the understatement is recognized. Also, because the insurer's pricing relies on historical loss data, inadequate reserves can result in inadequate premium revenues, which can lead to a shortfall in the funds necessary to pay claims.

Conversely, if loss reserves are overestimated (higher than the ultimate loss payments), premiums may be unnecessarily inflated for new and existing risks. Although the reserve estimates may be decreased later, in the interim, these artificial results can cause the insurer to be less competitive in pricing, its financial strength ratings could be lowered, and the insurer's profitability may suffer. A pattern of underreserving or overreserving may ultimately lead to insolvency.

Meeting Customer Needs

These are some of the factors that can be used to determine whether insurers meet customer needs:

- Complaints and praise—All insurers receive complaints, and each complaint should be evaluated. In some instances, a real problem exists that the insurer should address. In other instances, customers have expectations that the insurer hadn't intended to fulfill. Insurance producers can be a source of information for evaluating an insurer's success in this area, as they are in frequent contact with customers.
- Customer satisfaction data—Many insurers emphasize a customer focus to maintain and raise levels of customer satisfaction with products and services. Insurers often use surveys (typically conducted online and over the phone) to determine whether customers feel properly treated. Insurers can also conduct customer focus groups or interviews to determine how well a new or an existing product meets customers' needs.
- Retention ratio and lapse ratio—Two particularly telling measurements of customer satisfaction are the retention ratio and the lapse ratio (sometimes called the cancellation ratio). The retention ratio is the percentage

of expiring insurance policies that an insurer renews, and it can be measured by policy count, premium volume, or both. The lapse ratio is calculated by dividing the number of policies that lapse during a period by the total number of policies written at the beginning of that period. A lapse is defined as a point in time when a policy has been canceled or terminated for failure to pay the premium, or when the policy contract is void for other reasons. These ratios can indicate the number of policies a company is losing.

- Insurer-producer relationships—Insurers that market products through independent agents and brokers usually view this network of producers as their customers, in addition to the ultimate insurance customer. These insurers recognize that many other insurers are available to producers and that a competitive marketplace exists for the producers' services. Insurers can survey or meet with producers to measure their satisfaction with the insurer or to reveal unserved needs the insurer might be able to meet.
- State insurance department statistics—Several state insurance departments tabulate complaints they receive and publish lists showing the number of complaints received for each insurer. The number of complaints might indicate one insurer's customer relations success or failure relative to other insurers in the industry.
- Consumer reports—Consumers Union periodically surveys its membership to determine its level of satisfaction with the performance of auto and homeowners insurers. The results are published in its magazine, *Consumer Reports*, including a list of insurers rated as most satisfactory and least satisfactory.

Meeting Legal Requirements

The number of criminal, civil, and regulatory actions taken against the insurer is an indication of how well the insurer is meeting legal requirements. These actions are automatically brought to the attention of management and should be evaluated carefully to see whether they result from a consistent disregard of legal requirements. Most states publish a listing of regulatory actions against insurers. This information can show how one insurer's compliance efforts compare with those of competitors.

State insurance departments monitor the treatment of insureds, applicants for insurance, and claimants, and they oversee four insurer operational areas: sales and advertising, underwriting, ratemaking, and claim settlement. This regulatory oversight, called market conduct regulation, exists in addition to the states' role in solvency surveillance.

Meeting Social Responsibilities

Meeting social responsibilities is the most difficult of the major insurer goals to evaluate because there are no standards for judging an insurer's perfor-

mance in this area. However, many insurers use their websites to indicate their participation in home and workplace safety programs, support of community projects, and involvement in other social programs. Another possible indicator of social responsibility is the benefits that an insurer provides for its employees.

Many insurers contribute to associations that do research and raise public concern for safety. Contributions to medical, welfare, and educational institutions and programs are another indication of humanitarian efforts and social responsibility. In addition, green initiatives are emerging for many insurers as they recognize their responsibility to preserve the environment.

Learn more from an expert in the online video.

FUNCTIONAL VIEW OF INSURANCE

Before an insurance professional can aid an insurer's business operation, he or she must know the various functions the insurer performs and where he or she fits into the organization.

Many people are needed to carry out an insurer's operations, and each employee performs specific functions, which often require special technical knowledge.

What Do You Know?

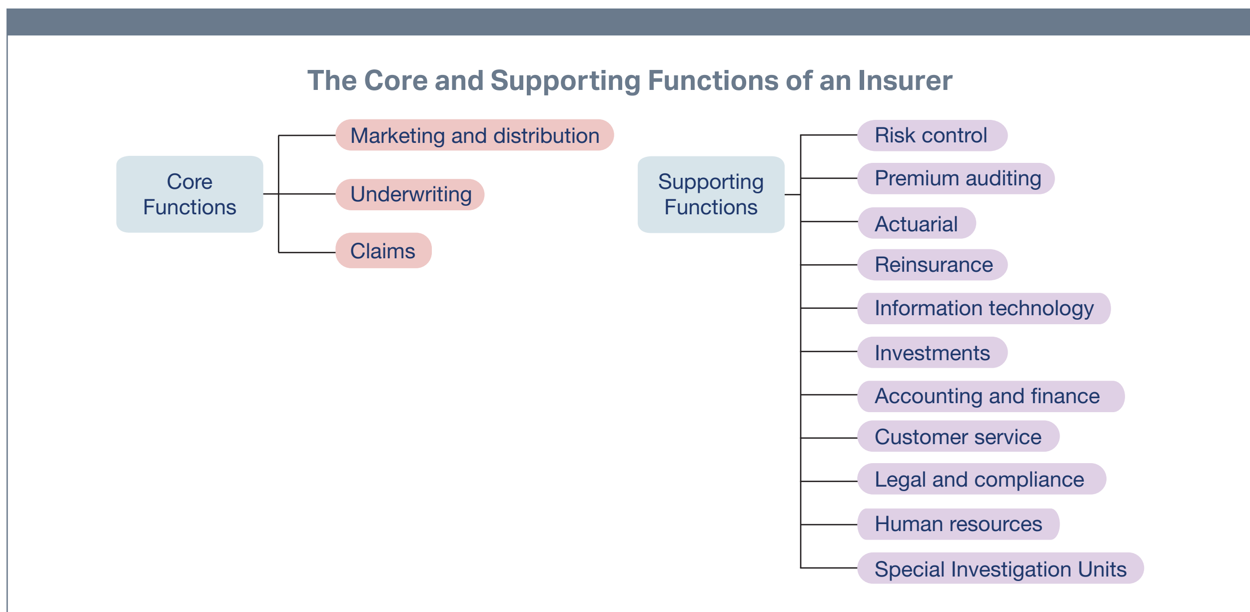
What are the core functions of an insurer? Name as many as you can.

Feedback : An insurer's core functions are typically marketing and distribution, underwriting, and claims. Insurers perform additional functions that are designed to support these three core functions. An insurer carries out these additional functions to facilitate risk transfer, promote efficiency, and meet its financial and nonfinancial goals.

This section provides an overview of major insurer functions. However, insurers might not perform all of these functions, some may combine or separate functions, and some may use different names for them. Specific types of products might also drive an insurer's functional needs—for example, an insurer that offers surety bonds might have a surety bond function. Regardless of these differences, each function is closely linked to all the other functions, and none is performed in a vacuum. The interaction of these core and other functions is vital to an insurer's survival and success.

Core Functions

Although insurers may use varying organizational structures, three core functions exist within the structure of a typical insurer. These core functions—marketing and distribution, underwriting, and claims—form the basis of an insurer's business. Let's discuss these core functions and those that support them. To learn more, see "The Core and Supporting Functions of an Insurer."



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Marketing and Distribution

Marketing and distribution involves determining what products or services customers want and need, advertising the products (communicating their value to customers), and delivering them to customers. The marketing and distribution function contributes significantly to an insurer's goals of earning a profit and meeting customers' needs.

The goals of the marketing and distribution function must be aligned with those of the insurer's other functions. For example, if the insurer has targeted specific regions or lines of business as growth areas, the marketing and distribution function needs to focus its efforts on increasing new business and customer retention in those areas. Misalignment between marketing and distribution's goals and the goals of any other department can reduce efficiency.

Underwriting

Once the marketing and distribution function has developed a relationship with potential customers, the **underwriting** function must determine

Underwriting

The process of selecting insureds, pricing coverage, determining insurance policy terms and conditions, and then monitoring the underwriting decisions made.

whether and under what conditions the insurer will provide insurance products and services to those potential customers. The goal of underwriting is to write a profitable book of business for the insurer, which it accomplishes by developing appropriate underwriting guidelines underwriters can use to evaluate risk and avoid **adverse selection**. Avoiding adverse selection helps an insurer remain profitable and keeps premiums reasonable.

Adverse selection

In general, the tendency for people with the greatest probability of loss to be the ones most likely to purchase insurance.

Claims

An insurance policy is a promise by the insurer to make a payment to, or on behalf of, the insured if an event covered under the policy occurs. The purpose of the claims function is to fulfill this promise. This function is staffed by employees who are trained to evaluate and settle claims and to negotiate or litigate the settlement of claims by or against insureds. It's often considered the primary service provided by an insurer.

The claims handling process is designed to achieve a fair settlement in accordance with the provisions of the insurance policy. Claim settlements that exceed the amount payable under the policy increase the cost of insurance for all insureds. Settlements that are less than the coverage amount deprive insureds of benefits they're entitled to under the policy. Insurers have developed expertise in claims handling in all categories of loss exposures.

Learn more from an expert in the online video.

Supporting Functions

To support the core functions of marketing and distribution, underwriting, and claims, insurers provide a variety of supporting functions, including risk control, premium auditing, actuarial functions, reinsurance, and information technology. Although most insurers are able to provide these supporting functions in-house, many are available through third-party providers as well. These functions are not only necessary to the efficient operation of insurers, but they are also used by a variety of other risk financing organizations, such as captives, pools, risk retention groups, and self-insurers:

- Risk control—The risk control function provides information to the underwriting function to help select and rate risks. This function also works with risk managers and commercial insureds to help prevent losses and to reduce the effects of losses that cannot be prevented. Insurers may also market their risk control services as a stand-alone product.
- Premium auditing—Although the premium for many types of insurance is known and guaranteed in advance, for some lines of insurance the premium is variable and cannot be precisely calculated until after the end of

the policy period. For example, the premium for workers compensation insurance policies is calculated using wages paid during the policy period. Other commercial insurance policies may use rating variables such as sales or revenue to calculate the premium.

- Actuarial—Actuarial functions include calculating insurance rates, developing rating plans, estimating loss reserves, and providing predictive modeling services. The actuarial function also conducts sensitivity analysis to determine an insurer's financial security, and it coordinates with the Accounting and Finance departments to develop reports for regulators to ensure that the insurer is adhering to all regulatory requirements.
- Reinsurance—When an insurer accepts a risk that is larger than it's willing or able to support, it can transfer all or part of that risk to other insurers through reinsurance transactions. Many insurers have a separate Reinsurance Department that arranges reinsurance.
- Information technology—The information technology function provides the infrastructure that supports an insurer's internal and external communications, daily operations, marketing efforts, underwriting processes, investing, and claims handling. Information systems are especially important to insurers because of the vast amounts of data associated with insurance operations.
- Investments—Investment operations enable an insurer to earn investment income on funds generated via underwriting activities. The nature of the insurance risks that an insurer takes on is a factor in determining the types of investments it makes. For example, liability losses are paid out over a longer period than property losses. So, liability policies can often support more long-term investments, such as corporate bonds with long maturity periods, whereas property policies need to be supported by more liquid and short-term investments. An insurer that assumes only moderate underwriting risks might be able to assume greater investment risks with potentially higher investment yield, and vice versa.
- Accounting and finance—The primary responsibilities of the accounting and finance function are to ensure that funds are available to meet the insurer's obligations and to fairly and fully disclose the financial position of the insurer in conformance with generally accepted accounting principles (GAAP). Insurers, like all other types of businesses, use accounting to record, analyze, and summarize their financial activities and status.
- Customer service—The customer service function can include an array of responsibilities that vary among insurers. Some insurers have customer service personnel assigned to specific work areas, such as customer billing, claims services, underwriting support, customer support, agency relations, agency technology support, and information technology support services for internal users.
- Legal and compliance—The legal and compliance function provides legal counsel, support, and service to other functions and ensures that statutory and administrative requirements are met. It may also oversee and

manage litigation, manage corporate legal requirements, and participate in legislative activities. Large insurers may have legal counselors specifically assigned to their claims function.

- Human resources—The human resources function involves selecting, training, and dismissing employees. It maintains employee records, supervises employee introduction to colleagues, completes performance reviews, performs compensation management, conducts orientation and ongoing training, and administers employee benefit programs.
- Special investigation units (SIUs)—These units combat insurance fraud, which includes any deliberate deception committed against an insurer or an insurance producer for the purpose of unwarranted financial gain. SIU personnel investigate suspicious circumstances that affect claims.

Apply Your Knowledge

Which function of an insurer determines whether and under what conditions the insurer is willing to provide insurance products and services to potential customers?

Feedback : The underwriting function makes these determinations. It's one of the three core functions of an insurer, along with claims and marketing and distribution.

INSURER ANNUAL STATEMENT CAPACITY RATIOS

An insurer's capacity is a key indicator of its long-term health, exposure to potential losses, and ability to supply insurance. Therefore, insurance professionals, regulators, and investors need to know how to evaluate the capacity of an insurer using its **National Association of Insurance Commissioners (NAIC) Annual Statement**. This is done by calculating various ratios using information found in the Annual Statement.

Analysts evaluate an insurer's current and past performance, solvency, and financial health by calculating and analyzing ratios based on data from the insurer's NAIC Annual Statement, which is also referred to as its Statutory Annual Statement because it's based on **statutory accounting principles (SAP)**. The ratios are then compared to industry or peer group norms in a process known as **benchmarking**. Ratios that fall outside accepted ranges require further examination to determine the underlying cause for the deviation. Ratios are also tracked over time to determine trends or to establish internal company benchmarks.

NAIC Annual Statement
The primary financial statement prepared by insurers and required by every state insurance department.

Statutory accounting principles (SAP)
The accounting principles and practices that are prescribed or permitted by an insurer's domiciliary state and that insurers must follow.

Benchmarking
The process of comparing results to industry standards or best practices.

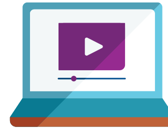
Capacity

The amount of business an insurer is able to write, usually based on a comparison of the insurer's written premiums to its policyholders' surplus.

Liquidity

The ease with which an asset can be converted to cash with little or no loss of value.

Ratio analysis of an insurer focuses on three areas: **capacity**, **liquidity**, and profitability.



Learn more from an expert in the online video.

This discussion focuses on calculating and assessing capacity ratios because of their importance to evaluating an insurer's operating results, its ability to take on new business, and its exposure to potential losses.

Let's say you want to evaluate whether property-casualty insurer Barnley Insurance Company (a hypothetical company) is operating at a prudent capacity level. You may need to do this for a number of reasons. For example, you may work for Barnley or have a client who is considering purchasing a large policy from it, and you need to assess its ability to supply insurance. You may also need to analyze the risk of investing in the company or how well it's meeting solvency regulations.

Premium-to-surplus ratio, or capacity ratio

A capacity ratio that indicates an insurer's financial strength by relating net written premiums to policyholders' surplus.

Reserves-to-surplus ratio

A financial ratio that provides a measure of the ability of an insurer's surplus to absorb increases in reserves.

Two capacity ratios you'll need to calculate and analyze for Barnley are its **premium-to-surplus ratio** and its **reserves-to-surplus ratio**. These ratios are calculated based on Barnley's Annual Statement data. To learn more, see "Barnley Insurance Company Statutory Annual Statement."

Premium-to-Surplus Ratio

The premium-to-surplus ratio is net written premiums (written premiums minus premiums ceded to reinsurance) divided by policyholders' surplus. The higher an insurer's premium-to-surplus ratio, the more aggressive the insurer is in terms of using its surplus to leverage writing new policies and the lower its additional capacity is to write business. The NAIC considers premium-to-surplus ratios over 3 to 1 to be problematic.

This ratio is also a measure of the insurer's exposure to risks associated with underwriting. For example, if policies aren't priced correctly, the insurer's surplus could be depleted, placing the insurer at risk of being unable to meet its financial obligations to policyholders. The ratio shows how much capacity the insurer has to withstand such pricing miscalculations.

Barnley Insurance Company Statutory Annual Statement

Net Admitted Assets	Current Year	Prior Year
Bonds	9,896,202,985	9,002,546,937
Stocks	4,878,637,485	4,559,625,237
Cash and short-term investments	59,638,273	53,796,358
Real estate	215,472,135	237,736,214
Total cash and invested assets	15,049,950,878	13,853,704,746
Interest due and accrued	295,547,215	186,369,875
Agents' balances	324,399,447	288,234,156
Accrued retrospective premiums	495,644,210	487,892,359
Amounts recoverable from reinsurers	442,109,862	230,478,216
Other assets	126,484,399	204,873,159
Totals	16,734,136,011	15,251,552,511

Liability, Surplus, and Other Funds	Current Year	Prior Year
Losses	7,454,854,932	6,498,965,327
Loss adjustment expenses	894,582,592	779,875,839
Unearned premiums	405,879,251	359,873,546
Policyholder dividends declared and unpaid	25,568,247	17,891,258
Provision for reinsurance	335,720,641	257,753,296
Other liabilities	591,872,631	756,657,258
Total liabilities	9,708,478,294	8,671,016,524
Common capital stock	45,215,698	45,215,968
Surplus notes	0	0
Gross paid in and contributed surplus	2,595,895,634	2,595,785,643
Unassigned funds	4,384,546,385	3,939,534,376
Surplus as regards policyholders	7,025,657,717	6,580,535,987
Totals	16,734,136,011	15,251,552,511

Underwriting and Investment Exhibit

Statement of Income Underwriting Income	Current Year	Prior Year
Premiums earned	5,634,695,482	5,386,256,843
Losses incurred	5,071,225,934	3,770,379,790
Loss expenses incurred	608,547,112	452,445,575
Other underwriting expenses incurred	1,126,939,096	1,077,251,369
Net underwriting gain or (loss)	(1,172,016,660)	86,180,109
Investment Income		
Net investment income earned	165,597,635	150,564,218
Net realized capital gains or (losses)	78,399,584	105,587,326
Net investment gain or (loss)	243,997,219	256,151,544
Net income before dividends and taxes	(928,019,441)	342,331,653
Dividends to policyholders	50,546,926	34,469,327
Federal and foreign income taxes incurred	(139,202,916)	51,349,748
Net income	(839,363,451)	256,512,578
Net written premium	5,726,879,562	5,435,546,832

Note: The preceding illustration is not an exact replica of and does not include all the information contained in the NAIC Annual Statement blank.

Adapted from the NAIC Annual Statement blank. [DA06475]

Various factors affect an insurer's policyholders' surplus and therefore its premium-to-surplus ratio, including these:

- Underwriting results—If losses and loss adjustment expenses (LAE) exceed earned premiums, the insurer must draw on its policyholders' surplus to meet its obligations, which increases the ratio by lowering the denominator.
- Premium growth—Rapid premium growth increases the ratio by increasing the numerator and lowering the denominator. The latter is because of the SAP requirement that policy acquisition expenses be immediately recognized and the associated premium revenue be deferred.
- Reinsurance programs—Ceded reinsurance lowers the ratio because it lowers net written premiums and therefore the numerator, while the ceding commission (amount paid by reinsurer to cover part or all of the policy acquisition expenses) helps offset the lower surplus because of the mismatch in recognizing policy acquisition expenses and the associated premium revenues.
- Investment results—Net investment gains (or losses) increase (or decrease) the denominator.

Barnley Insurance Company Premium-to-Surplus Ratio

Let's take a look at Barnley's premium-to-surplus ratio. The premium-to-surplus ratio can be calculated by dividing net written premiums by policyholders' surplus. Barnley's premium-to-surplus ratio was a conservative 0.83 in the prior year and 0.82 in the current year. Generally, a ratio of 3 to 1 or less is considered an acceptable premium-to-surplus ratio.

However, this also depends on the underwriting profitability of the underlying business and the type of business being written. Insurers writing predominantly long-tail lines which are less predictable, should have relatively lower premium-to-surplus ratios because of unpredictability in setting loss reserves.

	Current Year	Prior Year	
Net Written Premiums	$5,726,879,562	$5,435,546,832	(*a*)
Policyholders' Surplus	$7,025,657,717	$6,580,535,987	(*b*)
Premium-to-Surplus Ratio	a / b = 0.82	a / b = 0.83	

Online video transcript

[DA06476]

The premium-to-surplus ratio is limited by the fact that it's based on net written premiums for only the most recent year, while other measures of capacity

use data covering more than one year. To learn more, see “Barnley Insurance Company Premium-to-Surplus Ratio.”

Apply Your Knowledge

Woodwill Insurance Company’s Annual Statement shows that it has $76,500,000 in net written premiums, $75,000,000 in earned premiums, $68,000,000 in losses incurred, a net underwriting gain of $2,000,000, and policyholders’ surplus of $41,250,000. Calculate Woodwill’s premium-to-surplus ratio, and explain what it reveals about the insurer’s capacity.

Feedback : Woodwill’s premium-to-surplus ratio is 1.85 (Net written premiums/policyholders’ surplus). This is well within the acceptable range for this capacity ratio. As a result, Woodwill appears to have enough capacity to take on new business, as well as withstand fluctuations in underwriting results, premium growth, the amount of ceded reinsurance, and investment performance.

Reserves-to-Surplus Ratio

Insurance leverage
An indication of the extent to which policyholders’ surplus can support a given level of reserves.

An insurer’s reserves-to-surplus ratio measures **insurance leverage**. This is an indicator of capacity because the ratio shows the dollar amount of reserves that must be supported by each dollar of policyholders’ surplus. This ratio is the total of loss reserves, loss adjustment expense (LAE) reserves, and unearned premium reserves all divided by policyholders’ surplus.

An insurer with a high level of risk is considered highly leveraged. The higher an insurer’s reserves-to-surplus ratio, the more leverage it has and the more impact reserve underestimation errors have in reducing its policyholders’ surplus. Meanwhile, an insurer with a low reserves-to-surplus ratio (low leverage) could withstand relatively large underestimation errors without significantly depleting its policyholders’ surplus. To learn more, see “Barnley Insurance Company Reserves-to-Surplus Ratio.”

No well-established benchmark exists for an appropriate value for the reserves-to-surplus ratio, although a higher ratio (high leverage) is usually associated with long-tail liability coverage, such as products liability. This is because long-tail losses are generally paid out over many years, with the associated loss reserves maintained for many years after a policy is written.

An insurer’s reserves-to-surplus ratio should be evaluated in conjunction with its premium-to-surplus ratio.

Based on this analysis of Barnley’s capacity ratios, it appears the insurer has sufficient capacity with which to take on new business and comfortably withstand significant swings in the performance, accuracy, and predictability of its underwriting, investment, and reserve practices.

Barnley Insurance Company Reserves-to-Surplus Ratio

The reserves-to-surplus ratio is calculated by adding loss and LAE reserves to unearned premium reserves, and dividing the total by policyholders' surplus. In the prior year, Barnley's reserves-to-surplus ratio was 1.16, and in the current year, it is 1.25. Based on these numbers, Barnley appears to be able to withstand relatively large upward revisions to reserve estimates without depleting policyholders' surplus.

If Barnley has been mostly accurate in establishing its reserves in the past, it's probably operating within reasonable bounds. However, if Barnley has a history of underreserving by significant amounts, it may be close to its maximum acceptable level for this ratio.

	Current Year	Prior Year	
Loss and LAE Reserves	$8,349,437,524	$7,278,841,166	(*a*)
Unearned Premium Reserves	$405,879,251	$359,873,546	(*b*)
Policyholders' Surplus	$7,025,657,717	$6,580,535,987	(*c*)
Reserves-to-Surplus Ratio	(a + b) / c = 1.25	(a + b) / c = 1.16	

Barnley's reserves-to-surplus ratio was 1.16 in the prior year and 1.25 in the current year. Barnley appears to be able to withstand relatively large upward revisions to reserve estimates before policyholders' surplus would be significantly depleted. If Barnley has been reasonably accurate in establishing its reserves in the past, an analyst could be confident that Barnley is operating within reasonable bounds. However, if Barnley has a history of underreserving by significant amounts, it may be close to its maximum acceptable level for this ratio.

Online video transcript

[DA06477]

Apply Your Knowledge

SwiftRisk Insurance Company's Annual Statement shows that it has policyholders' surplus of $357,500,000, loss reserves of $1,215,750,000, LAE reserves of $205,500,000, a provision for reinsurance of $55,500,000, and unearned premium reserves of $61,250,000. Calculate SwiftRisk's reserves-to-surplus ratio, and explain what it reveals about the insurer's capacity.

Feedback : SwiftRisk's reserves-to-surplus ratio is 4.15 [(Loss reserves + LAE reserves + Unearned premium reserves)/Policyholders' surplus]. This shows that the insurer may be too highly leveraged to withstand significant reserve underestimation errors without depleting its policyholders' surplus.

INSURER ANNUAL STATEMENT LIQUIDITY AND PROFITABILITY RATIOS

An insurer's liquidity and profitability need to be measured and evaluated to determine the organization's ability to meet its financial obligations and achieve sustained growth. To fully assess the health of an insurer, industry professionals, regulators, and investors must understand how to use the insurer's National Association of Insurance Commissioners (NAIC) Annual Statement (statutory statement) to calculate and analyze its liquidity and profitability ratios.

An insurer's survival and long-term health depend greatly on its capacity to take on new business, its liquidity of invested assets needed to pay liabilities, and its profitability. By calculating and analyzing ratios in these areas, analysts can evaluate an insurer's health, diagnose problem areas, and forecast future results.

This discussion focuses on calculating and analyzing liquidity and profitability ratios because of their importance in evaluating an insurer's capability to make obligated payments to policyholders and to achieve sustained growth.

What Do You Know?

Amir, a financial analyst, is assessing the financial health of AmberRock Insurance Company for a prospective investor. Amir determines that AmberRock has a combined ratio of 104 percent for the prior year. Explain what this number indicates about the insurer.

Feedback : A combined ratio of 104 percent indicates that AmberRock had an underwriting loss for the year. This loss could have been caused by a number of factors, including that AmberRock's losses or loss adjustment expenses (LAE) exceeded its estimates in those areas. However, this does not mean that AmberRock didn't earn a net profit for the year. For example, the organization could have earned enough investment income to overcome its underwriting loss and generate a net profit.

Let's say you are asked to evaluate whether Barnley Insurance Company, a hypothetical property-casualty insurer, has sufficient liquidity and is positioned to earn a profit in the near future. The purpose of this evaluation may be to ensure that Barnley is capable of paying all covered losses a large commercial property policyholder may incur, or to determine whether a financial investment in Barnley is likely to produce positive returns. The liquidity and profitability ratios you'll need to complete the evaluation are based on Barnley's NAIC Annual Statement data. To learn more, see "Barnley Insurance Company Statutory Annual Statement."

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Adapted from the NAIC Annual Statement blank. [DA06475]

Liquidity Ratio

Liquidity refers to an organization's ability to raise cash to meet its financial obligations as they become due. One way to measure an insurer's liquidity is to compare its highly liquid assets to its obligations to policyholders. An insurer's high-grade marketable securities, its cash, and its interest due and accrued are highly liquid assets. An insurer's loss reserves, loss adjustment expense (LAE) reserves, and unearned premium reserves are estimates of its current obligations to policyholders. If the combined value of its highly liquid assets equals or exceeds the combined value of its loss, LAE, and unearned premium reserves, the insurer's liquidity position is satisfactory. However, an insurer that needs relatively illiquid assets to satisfy its obligations to policyholders may lack sufficient liquidity.

The **liquidity ratio** compares an insurer's liquid investment assets to its largest liabilities: unearned premium reserves, loss reserves, and LAE reserves. A value of 1.0 or greater for this ratio is desirable, because it indicates that the insurer could immediately liquidate investments and have sufficient cash to pay all of its obligations to policyholders. To learn more, see "Barnley Insurance Company Liquidity Ratio."

Liquidity ratio
A ratio that measures the extent to which an insurer can meet its obligations as they come due and is the sum of cash plus invested assets (market value) divided by unearned premium reserve plus loss and loss adjustment expenses.

It's important to note that the loss reserves appearing in the denominator of the liquidity ratio are subject to estimation error. If an insurer is too aggressive (optimistic) in valuing its reserves for losses and LAE, its actual liquidity may be very different from that indicated by the ratio's value. Similarly, the value of the liquidity ratio depends on the market prices of the securities held in the investment portfolio.

Profitability Ratios

Profitability is essential to an insurer's survival and growth. It provides surplus to support additional sales and growth in premiums. Past earnings retained by an insurer usually make up the largest portion of its policyholders' surplus.

Several profitability ratios are used for property-casualty insurers. The most common is the **combined ratio**, which measures underwriting profit or loss. Other profitability ratios examine underwriting and investment profitability together or examine investment profitability alone.

Combined ratio
A profitability ratio that indicates whether an insurer has made an underwriting loss or gain.

Combined Ratio

The combined ratio measures an insurer's underwriting profit or loss. It's called the combined ratio because it combines the loss ratio and the **expense ratio**. If total losses and expenses exceed premium, the combined ratio will be over 100 percent, signifying an underwriting loss. A combined ratio under 100 percent signifies an underwriting profit.

Expense ratio
An insurer's incurred underwriting expenses for a given period divided by its written premiums for the same period.

Barnley Insurance Company Liquidity Ratio

To calculate Barnley's liquidity ratio, cash and invested assets should be added and then divided by unearned premium reserve and loss and LAE reserves. In the prior year, Barnley's liquidity ratio was 1.81, and it is 1.73 for the current year. Real estate investments are not included because they are not considered to be liquid.

Barnley is comfortably above the desired level of 1.00 for this ratio. An analyst might also examine Barnley's cash flow statement to evaluate the annual cash flows that Barnley might expect over the coming years.

	Current Year	Prior Year	
Bonds	$9,896,202,985	$9,002,546,937	(*a*)
Stocks	$4,878,637,485	$4,559,625,237	(*b*)
Cash and Short-Term Investments	$59,638,273	$53,796,358	(*c*)
Interest Due and Accrued	$295,547,215	$186,369,875	(*d*)
Loss & LAE Reserves	$8,349,437,524	$7,278,841,166	(*e*)
Unearned Premium Reserve	$405,879,251	$359,873,546	(*f*)
Liquidity Ratio	(*a*+*b*+*c*+*d*) / (*e*+*f*) = 1.73	(*a*+*b*+*c*+*d*) / (*e*+*f*) = 1.81	

Note that real-estate investments are not included because they are not considered to be liquid. Barnley is comfortably above the desired level of 1.00 for this ratio. An analyst might also examine Barnley's cash flow statement to evaluate the annual cash flows that Barnley might expect over the coming years.

Online video transcript

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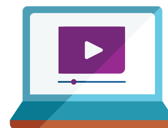


Learn more from an expert in the online video.

An insurer's expense ratio gives a general indication of the amount it costs the insurer to acquire, underwrite, and service policies. Comparing expense ratios for successive time periods can reveal trends, with an increasing expense ratio potentially highlighting the need for more effective expense controls.

An insurer's loss ratio indicates the quality of business the insurer writes and might also provide insight into how adequate the insurer's rates are. Loss ratios are typically less predictable than expense ratios, and certain lines

produce more volatile loss ratios from year to year than others. Reinsurance programs also affect loss ratios because the premium and loss amounts used for the calculation are net of reinsurance (minus the amount paid to reinsure the policies). To learn more, see "Barnley Insurance Company Statutory Combined Ratio."

Barnley Insurance Company Statutory Combined Ratio

Let's examine Barnley's combined ratio, which is calculated by adding, or combining, its loss ratio and expense ratio. Remember that a combined ratio over 100 percent signifies an underwriting loss, and a combined ratio under 100 percent signifies an underwriting gain. In the prior year, Barnley's loss ratio was 78 percent and its expense ratio was 20 percent.

Therefore, its combined ratio was 98 percent, indicating a small underwriting profit. In the current year, Barnley's loss ratio is 101 percent and its expense ratio is again 20 percent. The result is a combined ratio of 121 percent, which is an underwriting loss, and analysts should investigate this unusually large increase in loss ratio from one year to the next.

		Current Year		Prior Year	
Loss Ratio	(Incurred Loss & LAE) / Earned Premium	$5,679,773,046 / $5,634,695,482	101%	$4,222,825,365 / $5,386,256,843	78%
Expense Ratio	Underwriting Expenses / Written Premium	$1,126,939,096 / $5,726,879,562	20%	$1,077,251,369 / $5,435,546,832	20%
Combined Ratio	Loss Ratio + Expense Ratio		121%		98%

Online video transcript

[DA06479]

Operating Ratio

The **operating ratio** measures overall pretax operating profits, including both underwriting income and investment income. It's calculated by subtracting the **investment income ratio** from the combined ratio. The investment income ratio measures the income earned from the investment portfolio per dollar of earned premium.

An operating ratio below 100 indicates that an insurer is able to generate a profit from its core operations. Because other operating income and expenses such as finance and service charges, capital gains, and income taxes are omitted from the calculation, though, an operating ratio below 100 does not necessarily indicate positive net income. To learn more, see "Barnley Insurance Company Operating Ratio."

Operating ratio
A ratio that measures an insurer's overall pretax operational profitability from underwriting and investment activities and is calculated by subtracting the investment income ratio from the combined ratio.

Investment income ratio
Net investment income divided by earned premiums for a given period.

Barnley Insurance Company Operating Ratio

Now, let's turn our attention to Barnley's operating ratio, which is calculated by subtracting the investment income ratio from the combined ratio. An operating ratio below 100 indicates a profit from core operations. In the prior year, the 98-percent combined ratio minus the 3-percent investment income ratio equaled a 95-percent operating ratio.

In the current year, the combined ratio of 121 percent minus, again, a 3-percent investment income ratio equals a 118-percent combined ratio. Because the investment income ratio was the same at 3 percent in both years, it was insufficient to offset the current year's underwriting loss.

		Current Year		Prior Year	
Combined Ratio	Loss Ratio + Expense Ratio		121%		98%
Investment Income Ratio	Net Investment Income / Earned Premium	$ 165,597,635 / $5,634,695,482	3%	$ 150,564,218 / $5,386,256,843	3%
Operating Ratio	Combined Ratio – Investment Income Ratio		118%		95%

Online video transcript

[DA06481]

Investment Yield Ratio

Investment yield ratio

A profitability ratio that indicates the total return on investments for an insurer's investment operations.

The **investment yield ratio** focuses on investment results rather than underwriting results. Unlike the investment income ratio, the investment yield ratio measures investment returns relative to the invested assets that actually generated the investment income. This calculation uses not only the amounts earned on the investment portfolio as interest, dividends, and rent payments (net investment income earned), but also includes the net realized capital gains from the sale of investments. This makes it a much broader measure of investment performance. To learn more, see "Barnley Insurance Company Investment Yield Ratio."

Return on Policyholders' Surplus Ratio

Return on policyholders' surplus ratio

A profitability ratio that shows the rate of return an insurer is earning on its resources.

The **return on policyholders' surplus ratio** facilitates comparisons between insurers because it eliminates problems caused by differences in premium volume, underwriting results, and investment gains by summarizing overall after-tax operating success relative to the insurer's net resources (assets minus liabilities). To learn more, see "Barnley Insurance Company Return on Policyholders' Surplus Ratio."

Based on this analysis of Barnley's liquidity and profitability, it appears the insurer has sufficient liquidity. However, the increase in losses from the previous year to the current year, the low return on policyholders' surplus, and the low investment return may be alarming to potential customers or investors.

Barnley Insurance Company Investment Yield Ratio

	Current Year	Prior Year	
Net Investment Gain (Loss)	$243,997,219	$256,151,544	(*a*)
Total Cash and Invested Assets	$15,049,950,878	$13,853,704,746	(*b*)
Investment Yield Ratio	a / b = 1.6%	a / b = 1.8%	

Barnley's investment yield dropped slightly, from 1.8 percent in the previous year to 1.6 percent in the current year, as realized investment income declined while invested assets grew. This is a very low investment return for both years.

The analyst should examine Barnley's specific investments. Perhaps it has a large portion of its investments in stocks that pay no dividends and short-term bonds with a relatively low yield.

The analyst should also examine Barnley's unrealized capital gains and losses. This would provide additional insights into Barnley's investment performance during the year.

See the corresponding online video.

[DA06482]

Barnley Insurance Company Return on Policyholders' Surplus Ratio

	Current Year	Prior Year	
Net Income	($839,363,451)	$256,512,578	(*a*)
Policyholders' Surplus	$7,025,657,717	$6,580,535,987	(*b*)
Return on Policyholders' Surplus Ratio	a / b = 0%	a / b = 3.9%	

Barnley's return on policyholders' surplus was 3.9 percent in the prior year and fell to 0 percent in the current year (negative net income is considered to produce a 0 percent return). The results for both years are very low.

Despite the negative net income, policyholders' surplus increased from the prior year to the current year. This could be due to items such as an increase in unrealized capital gains or changes in nonadmitted assets, which are not included in net income and instead are direct adjustments to policyholders' surplus.

See the corresponding online video.

[DA06483]

Apply Your Knowledge

For the current year, Golden Board Insurance Company has $950 million in earned premiums, $1.3 billion in written premiums, $650 million in losses, $125 million in LAE, and $150 million in underwriting expenses. Calculate Golden Board's loss ratio, expense ratio, and combined ratio.

Feedback : Golden Board's loss ratio is 81.6 percent [(losses + LAE)/earned premiums], its expense ratio is 11.5 percent (underwriting expenses/written premiums), and its combined ratio is 93.1 percent (loss ratio + expense ratio).

A.M. BEST FINANCIAL STRENGTH RATINGS

Whether you're looking to purchase an insurance policy or invest in an insurer, you want to know that the insurer you're dealing with is financially strong and stable. Independent financial ratings help insurance professionals, investors, and consumers evaluate the financial health of insurers.

A.M. Best Company assigns such highly influential ratings to insurers and insurance groups, identifying those with strong financial standing and ones that could be vulnerable. Let's explore how those ratings are developed.

A.M. Best produces what is essentially a report card on an insurer's financial health. Best's Credit Rating Methodology (BCRM) is its building-block approach for determining ratings. It's a transparent process that applies a series of tests, ratios, and reviews to an insurer's financial and business information.

What Do You Know?

True or false: An insurer that has an A.M. Best financial strength rating (FSR) of B is considered financially secure.

Feedback : False. A B rating indicates that an insurer is financially vulnerable to adverse changes in underwriting and economic conditions, according to the BCRM.

A.M. Best uses different categorizations to convey an insurer's financial strength. These include an FSR and accompanying scale, and a financial size category (FSC).

Financial Strength Rating

A.M. Best's rating process begins with a detailed review of an insurer's balance sheet strength, operating performance, business profile, enterprise risk management (ERM) approach, and rating lift/drag (when applicable).

Because an individual insurer may be part of a larger group with which its financial fortunes are intertwined, A.M. Best refers to all subjects of its

reviews as rating units. This allows the same standards that are applied to independent insurers to be applied across insurance groups. However, it also allows the financial influence of holding or parent companies to be taken into account when rating an insurer. When an organization contains more than one rating unit, the unit that is considered to be the most important to the organization will be designated the lead rating unit.

Balance Sheet Strength

A rating unit's balance sheet shows its ability to meet its financial obligations. When A.M. Best evaluates the strength of a rating unit's balance sheet, it analyzes the rating unit itself, the financial flexibility provided by the holding company or ownership structure, and any additional financial or regulatory risk presented by the country in which the insurance rating unit is located. It also considers the extent to which the rating unit's capital relies on reinsurance programs, diversification and quality of assets, and liquidity.

When A.M. Best evaluates a lead rating unit owned by a holding company, the holding company's financial health could affect the lead rating unit's evaluation because the holding company's capital could give the lead rating unit more financial flexibility. Similarly, the holding company's liabilities could limit the lead rating unit's flexibility.

Operating Performance

Consistent operating performance is critical to earning and maintaining a favorable rating. Consistently strong earnings allow a rating unit to take chances in new markets or with new products, providing financial flexibility and the ability to handle an emergency expense or economic downturn. While the analysis of operating performance can significantly affect the unit's overall rating, the possible negative effect is greater than the possible positive effect.

Areas A.M. Best reviews when analyzing a rating unit's operating performance include underwriting, investment returns, capital gains and losses, and total operating earnings. Beyond these financials, A.M. Best may also review management reports to gain a better understanding of the rating unit's earning trends and how they could affect the unit's financial standing in the future.

Business Profile

Insurers that receive the highest rating usually separate themselves from other insurers by the strength of their business profiles. A strong profile can provide long-term financial strength, drive future operating performance, and (most importantly) help the rating unit meet its financial obligations to policyholders.

Several factors can influence the strength of an insurer's business profile, and therefore its FSR, including the quality of its management team and the diversification of its business mix. The strength and competitiveness of

the market in which an insurer operates, as well as its geographic reach, also play a role. If an insurer operates in a highly competitive market that is very limited in scope, it could receive a negative rating that might counteract its otherwise strong operating performance and balance sheet.

One factor that has become increasingly important in A.M. Best's assessment of an insurer's profile is innovation. Because the insurance industry is undergoing significant change, A.M. Best views an insurer's ability to innovate as a key indicator of its long-term financial health. As a result, part of its business profile evaluation is determining whether a company's innovation efforts have had a positive, negative, or neutral effect on the company. To learn more, see "A.M. Best's Evaluation of an Insurer's Ability to Innovate."

A.M. Best's Evaluation of an Insurer's Ability to Innovate

A.M. Best defines innovation as "… a multi-stage process whereby an organization transforms ideas into new or significantly improved products, processes, services, or business models that have a measurable positive impact over time and enable the organization to remain relevant and successful. These products, processes, services, or business models can be created organically or adopted from external sources."

A.M. Best's evaluation of an insurer's innovation involves assessing these components:

- Leadership—Is there buy-in at the senior management level? Are the company's mission and innovation strategies aligned? Does the company's leadership have experience driving innovation?
- Culture—How entrenched are innovation projects throughout the organization? How is innovation being communicated?
- Resources—Are resources being allocated to foster innovation?
- Processes and structure—Is the innovation process replicable?

"DRAFT: Scoring and Assessing Innovation," Best's Methodology and Criteria, September 13, 2019, A.M. Best, www.ambest.com/ratings/draftmethodology/DRAFTScoringInnovation.pdf (accessed February, 25, 2020). [DA13368]

The review of a business profile also includes factors such as distribution channels, data quality, pricing quality, product risk, and risks presented by the regulatory environment and country in which the insurer is based.

Enterprise Risk Management

An efficient ERM program can show that an insurer takes risk recognition and management seriously. During the rating process, an analyst looks for an ERM program that helps manage an organization's exposure to financial or market volatility while simultaneously maximizing the organization's value to its stakeholders.

An established ERM program should reach into every facet of an organization. Every level of management should consider potential risks during decision making and incorporate practices to manage them into documented processes whenever possible.

Rating Lift/Drag

After the initial review, the rating given to an insurance rating unit that is part of a larger group could receive a lift or drag from the group's lead rating unit.

For example, if Bellington Insurance is considered to be strong and is given a fairly secure rating, but its parent company (the lead rating unit) is given an even more secure rating, Bellington's rating could receive a boost (lift). If the situation were reversed, Bellington might receive a penalty (drag) against its final rating. Rating units that receive a large lift often hold a financial guarantee or a net worth maintenance agreement from their parent company.

Apply Your Knowledge

Senior management at Bellington Insurance wants to improve the insurer's FSR by strengthening its business profile. What factors should be assessed?

Feedback : Several factors can influence the strength of Bellington's business profile, and FSR, including the quality of its management team, the diversification of its business mix, the strength and competitiveness of the market in which it operates, its geographic reach, its ability to innovate in a way that generates a positive impact, its distribution channels, its data quality, its pricing quality, its product risk, and risks presented by the region in which the insurer is based.

Best's Rating Scale

FSRs fall into two broad categories: secure and vulnerable. The FSRs are further measured by a scale that ranges from A to D, with ++, +, and - modifiers to further differentiate insurers within those categories. Secure ratings range from A++ to B+, while vulnerable ratings range from B to D. A special category, S, is used to identify insurers whose FSR has been suspended because of sudden and significant events that have not been fully evaluated.

Best's ratings may be accompanied by one or more modifiers, indicated by lowercase letters. The modifier *u* means that the rating is under review, which may indicate that either a positive or negative change is forthcoming. Affiliation codes identify companies whose assigned ratings include consideration of a group (g), pooling (p), or reinsurance (r) affiliation with other insurers.

A.M Best assigns a rating outlook of positive, negative, or stable to an FSR to indicate its potential direction over the intermediate term (generally 36 months).

Financial Size Category

A.M. Best's FSC indicates an insurer's size. It assigns insurers an FSC along with an FSR to provide a more all-encompassing look at an insurer's financial position. This is because many insurance buyers and investors feel more comfortable dealing with large insurers they perceive as having more capacity to take on new business or unexpected losses.

SUMMARY

Insurers' success is often measured by how well insurers meet profitability goals, customer needs, legal requirements, and social responsibilities.

An insurer's core functions are marketing and distribution, underwriting, and claims. Other supporting functions include risk control, premium auditing, actuarial functions, reinsurance, information technology, investments, accounting and finance, customer service, legal and compliance, human resources, and SIUs. While insurers vary regarding their structure and the exact role of each functional area, the interaction of the core functions and the supporting functions is vital to insurers' survival and success.

An insurer's capacity is a key indicator of its long-term health, exposure to potential losses, and ability to supply insurance. The premium-to-surplus capacity ratio measures the insurer's relative exposure to underwriting risks, and its reserves-to-surplus capacity ratio measures its insurance leverage (the extent to which policyholders' surplus can support increasing or decreasing reserves). These ratios are calculated based on data from the insurer's NAIC Annual Statement.

An insurer's liquidity and profitability ratios provide valuable information regarding the organization's ability to meet its financial obligations to policyholders and achieve sustained growth. These ratios are calculated based on data from the insurer's NAIC Annual Statement. The liquidity ratio compares an insurer's liquid investment assets to its unearned premium reserves, loss reserves, and LAE reserves. The most common measurement of underwriting profit or loss is the combined ratio. Other profit ratios measure underwriting and investment profitability together or separately.

A.M. Best provides insight into the financial health and stability of insurers by using different categorizations. These include an FSR and accompanying scale, and an FSC. BCRM is A.M. Best's building-block approach for determining its ratings. It applies a series of tests, ratios, and reviews to an insurer's financial and business information.

How Do You Maximize Customer Touchpoints?

3

Educational Objectives

- Explain how insurance agencies support customer transactions with an insurer.
- Recommend strategies agencies can use to increase sales to existing customers.
- Recommend ways agencies can leverage sales opportunities during the policy renewal process.
- Apply effective negotiation techniques.

Outline

Effectively Supporting Customer Transactions

Increasing Sales to Existing Agency Customers

Leveraging Policy Renewal Opportunities

Negotiating Effectively

Summary

How Do You Maximize Customer Touchpoints?

3

EFFECTIVELY SUPPORTING CUSTOMER TRANSACTIONS

By effectively supporting all customer transactions, insurance agencies and brokerages can best provide superior customer service. Such transactions typically involve marketing and sales, claims, and accounting.

By keeping customer service goals and strategy in mind when organizing these critical functions and assigning staff, an agency can optimize its value to customers and its use of funds. Agency management systems can automate many of the tasks, store and organize data, and provide workflows required to carry out these functions.

Sales and Marketing Transactions

Let's take a look at how an agency can ensure customer-focused sales and marketing transactions.

New Business

New business accounts are typically a top agency priority. They must be generated continually and placed on an agency's books to replace lost accounts and grow revenue.

Once a **prospect** has been through an agency's screening process, the producer sends a submission to an underwriter requesting coverages and premium quotes. Agency management systems may be used to complete and submit applications for qualified prospects to multiple insurers. A customer service representative (CSR) then confirms with each carrier that the applications have been received and that the agency represents that market.

Prospect
An individual (or organization) from whom a producer solicits business.

From there, the CSR works with an agency producer and the carrier's underwriter to prepare a client proposal, typically using standardized wording from the agency management system. This proposal includes more than a premium quote; it also includes a total services package and recommendations.

For large accounts, several insurer quotes may be presented to the prospect, along with a spreadsheet showing their similarities and differences.

Apply Your Knowledge

How do you think the information in a client application that becomes a proposal can be repurposed effectively?

Feedback : With only minor changes, an insurance proposal can serve as an insurance review form, which the producer uses to update information and order the renewal. Because policy information is updated in the agency's database whenever it changes, these documents accurately reflect the status of the insured's account at any given time.

Binder

A temporary written or oral agreement to provide insurance coverage until a formal written policy is issued.

When the producer receives the insurance placement order (with proposed changes, if any, as agreed upon), **binders** are prepared. Many agencies deliver invoices with these binders; others bill when the policy itself is delivered.

CSRs review new policies for accuracy by checking rating, classification, and coverage information against the original application, the proposal, and the binder and verifying policy limits and premiums. Errors and omissions (E&O) claims can result when policies do not provide all the insurance coverages outlined in the initial proposal.

Renewals

Because of processing costs for new business applications, higher first-year commissions, and higher attrition rates for new business, an agency's profitability is tied to the percentage of business renewed.

The renewal process begins when policy expiration lists are generated and distributed. Most personal insurance policies, including automobile and homeowners, are directly billed and automatically renewed through the insurer. The agency should review any personal insurance policies that are not automatically renewed and all commercial insurance policies.

Assigned agency staff should contact insureds before renewal to review coverages. Some agencies enter information from checklists into their coverage databases to generate automatic recommendations for policy coverages.

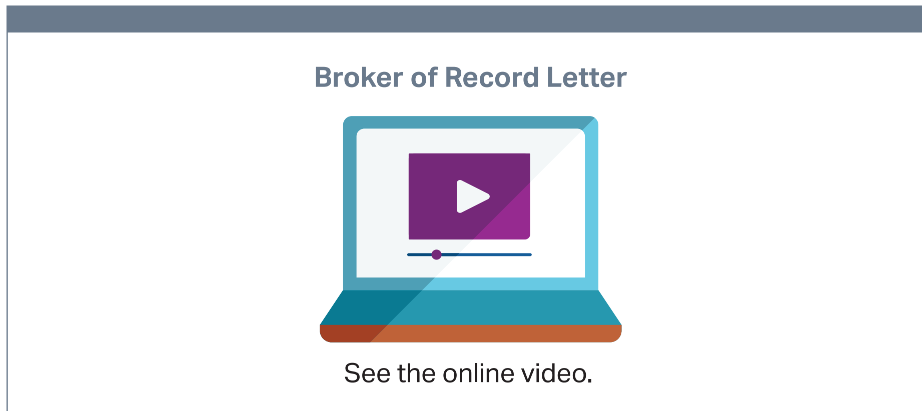
After the customer has been contacted and renewal decisions have been made, the renewal policy is ordered from the insurer. Preparing a binder and an invoice may be necessary if the policy is not issued by the renewal date.

To efficiently manage renewals, an agency should carefully follow expiration procedures and avoid inadvertent nonrenewal of policies.

To learn more, see "Broker of Record Letter."

Endorsements and Adjustments

Endorsements and adjustments are another type of marketing and sales transaction. During the policy term, customers may request endorsements to their policies, acquire new homes and vehicles, change addresses, or require differ-



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ent coverages. Some commercial accounts may have a reporting form policy (requiring periodic reports on the policy's loss exposure basis) or be subject to audits, both of which can lead to premium adjustments.

Policy changes may involve a number of transactions, such as completing change request forms, sending form letters to the customer, issuing binders or certificates of insurance, and producing invoices. Although most of these processes may be automated through agency management systems, data must be entered accurately, and all transactions must be documented in the system.

Communication between the customer and CSR and between the CSR and producer, as well as sound procedures and workflows, can help ensure accuracy when a policy is changed. When working with a customer, a CSR should notify the producer if an endorsement or adjustment to an insured's policy significantly changes the risk or presents a possible new business opportunity.

Claims

Insurers typically handle claims, but claims reporting can occur in a variety of ways.

Some insurers have separate claims offices to which insureds report claims directly, many direct writers and exclusive agents have claims offices, and independent agencies and brokerages typically receive initial claims reports and forward them to the insurer for processing. And although unusual, some large commercial insurance agencies are authorized to handle certain types of claims internally.

Agency personnel who handle claims must remember that customers submitting claims may be upset. Even minor claims are important to the insured or claimant. So good customer service requires treating each claimant with sympathy and concern.

Learn more from an expert in the online video.

Although producers are not typically involved in claims, they should be kept informed of the status of their insureds' claims involving large or complex losses, lawsuits, questionable coverage, or other unique circumstances. And occasionally, they may need to intercede with the insurer's claims representative on the insured's behalf.

When an insured notifies an agency of a claim, the applicable policy should be located and the coverage verified. For example, if the person is reporting a homeowners loss and the agency carries only automobile coverage for the customer, the customer should be directed to the proper insurer as soon as possible.

Agency management systems can automatically trace a claim's progress for anyone accessing the customer's electronic file to see.

The agency claim file can be closed after the claim has been settled on behalf of all involved parties. An agency that sends the claim payment to the customer might include a letter explaining anything that may be unclear. If the insurer sends the payment, the agency can contact the insured to confirm that the claim was handled satisfactorily.

Accounting

No sale is complete until the agency has recorded and collected the premium and commission for business sold. Most agency accounting is automated within the agency's management system, which coincides with the carrier's system and agency's bank. Some systems allow for electronic transfer of commissions.

What Do You Know?

Agencies use three systems of billing: agency bill, direct bill, and premium finance plans. Which system is used for all personal lines accounts?

Feedback : All personal lines accounts and many commercial lines accounts use the direct bill system.

Agency Bill System

Independent agencies and brokerages still use the **agency bill system** for a portion of their business, especially if they focus on large commercial accounts.

Agency bill system

An insurer billing system that requires the agency to perform certain premium handling tasks, including invoicing and crediting, collecting premiums, investing premiums, and remitting premiums, to companies (less any applicable commissions).

Agencies using this system issue invoices and credits and collect, invest, and remit premiums, often through an automated system. They are responsible for paying the insurer any premium not yet collected from the insured. More specifically, if a premium has not been received after 30 days, the producer typically must ensure that the premium is paid; any unpaid premium may be deducted from that producer's future commissions.

Agency billing allows the agency to generate additional revenue from investing premium dollars while they are in the agency's possession. Insurers usually do not expect the agency to remit the premiums until 30 or 45 days after policy or endorsement issuance. If the premiums are collected on time or even ahead of the effective date, the agency may invest premiums for as long as two months or more. This arrangement is called **premium float**. Some large agencies add as much as 5 percent to their annual gross income through prompt collections and premium float investment.

Premium float

An arrangement that allows an agency to collect insurer premiums; invest the premiums and generate earnings on the premiums payable to the insurer; and forward premiums, minus any earnings generated, to the insurer when the insurer account is payable.

Agencies usually pay monthly premiums (minus any commissions due to the agency) to insurers, submitting them along with either an insurer-prepared statement or the agency's own statement, called an account current. With either remittance method, agency personnel must verify that the insurer's and the agency's records agree.

Direct Bill System

The **direct bill system** relieves agency personnel from invoicing, tracking, collecting, and remitting premiums, which can be both costly and time-consuming. It also places the risk of an uncollectible receivable with the insurer, not the agency.

Direct bill system

A payment procedure in which the insurer assumes all responsibility for sending premium bills to the insured, collecting the premium, and sending any commission payable on the premium collected to the producer.

A disadvantage of the direct bill system is that it eliminates the premium float and can therefore affect an agency's cash flow. Additionally, a direct bill system can create extra work for agency personnel when it is not functioning properly or when insureds send their payments late. However, the time the direct bill system saves agencies probably outweighs its disadvantages, particularly if an agency has a large personal lines book of business.

Unlike the agency bill system, the direct bill system doesn't require agencies to create invoices or make payments to insurers. Instead, insurers send the agencies statements once or twice a month with checks for the commissions due.

Premium Finance Plans

Most insurers offer premium finance plans that allow insureds to pay large premiums in installments. Some states allow agencies to set up their own premium finance plans. Banks and other financial institutions also offer such

plans, and independently owned premium finance companies operate nationally or regionally.

At the time of the sale of a policy (or sometimes as part of the proposal), the producer and customer decide whether the premium will be financed and then sign a contract. The premium finance plan may offer several alternatives for the size of down payments and length of the financing term.

Generally, the agency must collect the premium down payment and submit it to the insurer with the insurance application and premium finance plan contract. After that, the agency is no longer responsible for collecting premiums (unless it is an in-house finance plan) or remitting premiums to the insurer, because the finance company handles these tasks. Either the finance company or insurer sends commissions to the agency and can do so in advance for the entire year or as each premium installment is received.

Accounting Reports

Generating accounting reports used to process and record financial transactions is an important aspect of the accounting function. The records on which accounting reports are based are also used to generate financial and management reports, which are given to agency principals and managers.

Although many of the reports do not directly affect the management of customer services, two standard reports do:

Statement of account

A monthly statement providing the customer with a summary of the outstanding premiums owed to the agency.

Aged accounts receivable report

A report used to determine which customers are behind in paying their premiums; usually generated in thirty-day past-due increments.

- **Statement of account**—Customers may have questions about or dispute their statements of account. Responding to questions and resolving disputes promptly and amicably are part of good customer service.
- **Aged accounts receivable report**—The aged accounts receivable report is not sent to the customer. Analyzing aged accounts receivable can identify collection problems before the agency develops bad debt on accounts that accrue earned but uncollectible premiums.

INCREASING SALES TO EXISTING AGENCY CUSTOMERS

Adding new customers typically isn't the easiest or most profitable way for agencies to grow. Often, the best opportunities for growth are already on the books: existing customers. By refining their efforts to increase sales to these customers, producers help their agencies thrive.

The greatest prospect is the customer you already have. Chances are, you've already gained that customer's trust and confidence, making it cheaper and easier to secure future sales from that person rather than from new prospects. To learn more, see "Advantages of Targeting Sales to Existing Customers."

Advantages of Targeting Sales to Existing Customers

See the online video.

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All insurance agencies have existing customers who are ideal prospects for additional products and services. Producers can identify these prospects and increase business with them in a variety of ways.

What Do You Know?

Which existing customers are optimal prospects for account expansion?

Feedback : Producers should seek out personal and commercial lines customers who have a monoline account or only one policy. These are ideal customers for account expansion because they tend to lack important coverages or have insurance policies through other agencies.

Commercial lines customers are also good prospects for personal lines products because they've already demonstrated confidence in the producer or agency.

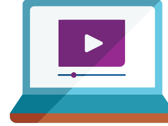
Other good prospects include those with minimum liability limits on auto policies, as well as commercial policyholders with no indirect loss coverage (such as business income coverage).

A producer can employ several techniques to increase sales with existing customers. Let's examine some of these.

Suggest Insurance to Value

The cost of building materials and court awards tends to increase over time. As a result, personal and commercial accounts should be reviewed periodically to determine whether property and liability limits are still appropriate given current property values, replacement costs, and liability judgments. Limits may need to be increased from time to time to keep up with inflation.

Additionally, agencies should review customers' limits in relation to the insureds' current assets, activities, and overall loss exposures.



Learn more from an expert in the online video.

Propose Broadening Coverage

Due to pricing competition and customers' desire to find the lowest possible price, producers may feel pressure to limit coverage recommendations to basic coverage options.

However, broadening coverage is an effective way to increase sales to existing customers. In fact, there are numerous advantages to writing broader coverage:

- Claim denials are reduced as coverage is created for claims that would not otherwise be covered.
- Errors and omissions claims against the agent are minimized because customers have fewer gaps in coverage.
- Profits are increased almost in direct proportion to the size of the commission because coverage can be broadened at no administrative cost to the agency.

Apply Your Knowledge

What are some ways a producer can broaden an insured's coverage?

Feedback : The producer can sell the insured an open-perils (or all-risks) policy. This would require the insurer to provide coverage for any type of loss that was not specifically excluded under the policy. The producer could also sell insureds a difference in conditions (or DIC) policy, which fills gaps in the insured's existing coverage.

Offer Additional Policies

By continually seeking new and additional policies and products that customers may need or want, producers help grow existing business as well as ensure that they're meeting the evolving needs of their customers. Examples of such policies include personal and commercial umbrellas, employment practices liability, directors and officers liability, and pollution liability.

What Do You Know?

Agencies and producers often use the term "account rounding." What does it mean?

Feedback : Account rounding involves identifying personal or commercial lines customers who have needs that are not currently being met through the agency and finding ways to engage those customers in the agency's products and services that can meet their needs. In short, it's a way of deepening the agency's relationship with existing customers.

Ideal candidates for account rounding are customers who have loss exposures that are not insured through the agency and/or are purchasing additional policies from other agencies. A producer can contact these customers when their existing policies are nearing expiration to solicit additional business from them—perhaps even offering to review the policies they've purchased from other agencies, using the producer's own insurer and risk management providers' policies as a comparison to identify superior coverage provided by the agent's insurers.

When it comes to offering additional products to customers, one major factor works in producers' favor: Customers prefer to do business with one producer at a time rather than spreading their insurance coverages across multiple agencies. By providing the coverage necessary for all identified loss exposures, a producer minimizes coverage overlaps and gaps, resulting in better security for customers.

Account rounding offers several benefits. For example, it increases the lifetime value of the customer, decreases the likelihood that a customer will leave (the deeper and more complex the relationship is, the harder it is to walk away), and deters competitors from trying to steal customers.

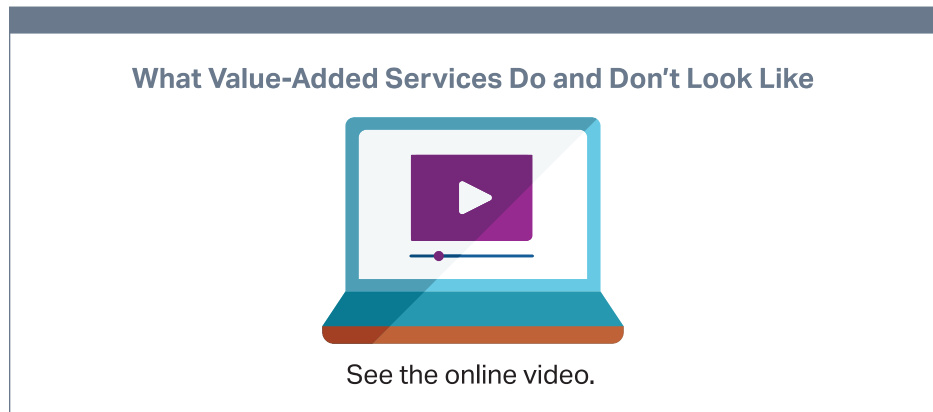
Learn more from an expert in the online video.

Offer Value-Added Services

If an agency already offers the broadest coverage options at extremely competitive prices and has outstanding customer service, what else can it do to stand out? The answer: Offer services that customers can't get from other agencies and that show the agency truly cares about its customers.

These additional services are called value-added services. They are add-ons to (not replacements for) the core products and services of the agency. They can

be anything that customers might want or need that helps bolster the agency's portfolio of offerings. To learn more, see "What Value-Added Services Do and Don't Look Like."



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While an agency can create and deploy its own value-added services, it may wish to seek assistance from the insurers with which it conducts business. Certain insurers may offer value-added services that their agency representatives can pass along to their customers. To learn more, see "Sample Value-Added Services Menus."

Since these are add-ons to the standard insurance services offered by an agency, it may be appropriate to sell some of them to an existing customer for a fee. However, states have regulations governing how and for what services an agency can charge fees.

Agencies must check with regulators or agents' association before implementing fee-based services. And where fees are permitted and appropriate, producers should disclose any fees charged to the customer.

Sample Value-Added Services Menus

Personal lines:

- Email disaster-preparation checklists to customers before major storms.
- Photograph customers' possessions and save the photos to simplify claims handling.
- Provide accident-reporting kits to keep in vehicles.
- Perform home safety and efficiency inspections.
- Create a guide to smart home devices.
- Provide smart home devices for free or at a discount.
- Send monthly check-in emails.
- Send birthday and holiday cards.

Commercial lines:

- Help a business develop a disaster recovery or business continuity plan.
- Provide risk management consulting.
- Establish a safety committee.
- Conduct driver-safety training.
- Host risk management or safety conferences.
- Email monthly newsletters tailored to a customer's business/industry.
- Provide smart/connected devices for free or at a discount.
- Conduct quarterly account reviews/needs assessments.

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LEVERAGING POLICY RENEWAL OPPORTUNITIES

The policy renewal process is an ideal time for producers to increase customer retention and sales. Policy renewal gives producers a logical reason to connect with customers, and it provides them with an opportunity to show customers the value they and their agency can provide.

What Do You Know?

What are some ways agencies can use the renewal process to increase sales?

Feedback : Agencies can use the renewal process to identify customers' new or untreated loss exposures, cross-sell or upsell insurance coverage, and review the value-added services the agency can provide. In addition, agencies can include marketing materials and messages with the renewal notice to introduce new products, services, or agency personnel.

Let's discuss the strategies and tools agencies can use to increase sales during the renewal process while also conveying to customers the agency's professionalism and concern for their well-being.

Effective Renewal Strategies

No matter how satisfied customers appear to be with their current coverage, the renewal process should entail more than sending a renewal notice and receiving payment from policyholders. If it doesn't, agencies are missing opportunities to forge deeper relationships with their customers and potentially increase revenue.

Agencies can implement these strategies in their renewal process to help build relationships and increase sales:

- Segmenting—Agencies with many accounts may be unable to provide special treatment to every policyholder, so they may choose to focus on their VIP accounts. Basic analytics can identify an agency's most valuable accounts, such as those in the top 20 percent of average premium revenue for personal and/or commercial lines. Then the agency can craft a more intensive and personalized renewal engagement strategy for those customers.
- Connecting early—Competitors may be able to find out when insureds' policies are up for renewal and then try to solicit them with attractive offers, so it's important for producers to engage existing customers in the renewal process weeks, if not months, in advance of policy expiration. The sooner producers engage customers in the process, the less likely those customers will be to pursue opportunities with competitors.
- Fitting premium to budget—Some customers have a very limited budget, so it's important that producers are prepared to discuss potential cost-cutting measures (such as increasing deductibles, reducing coverage, or implementing loss controls) to preserve the relationship. If customers decide to reduce their coverage to save money, it's important that producers carefully communicate the exposures this creates. Producers can protect themselves from potential errors and omissions (E&O) claims by asking customers to sign off on the coverages or endorsements being eliminated.
- Marketing the renewal across insurers—Insurers may be more willing to underwrite certain risks or offer more competitive rates after producers have a more established relationship with policyholders and can provide greater detail about their risks. So rather than simply renewing a customer's policy, producers may benefit from shopping policies with multiple insurers to look for new bundling opportunities and discounts. Even if the effort doesn't result in a reduced premium, producers can foster customer loyalty by explaining how they tried to help the policyholder.
- Being transparent about price—When a policy premium is set to increase, it's important that producers are prepared to address the reason

for the increase, why it's appropriate, and any price shopping that they conducted. Producers can also remind their customers about the value-added services the agency provides.

Potent Communication Tools

Every type of communication and touchpoint between an agency and its customers can be leveraged to increase sales. Renewal notices are no exception.

Producers often use several forms of renewal communication, including emails, letters questionnaires, and phone calls.

Renewal Emails and Letters

Some producers consider the time they spend writing emails and letters as important as the time spent making cold calls and following up on referrals.

The primary purpose of renewal emails and letters is to inform customers that their policy is up for renewal and to provide the premium statement. But to increase sales, producers can also include in these emails and letters information about the benefits of expanding coverage.

For example, producers may inform all professional customers whose auto insurance is up for renewal about the professional liability insurance the agency can provide. Similarly, producers may inform commercial lines customers about the benefits of a cyber insurance policy.

Renewal emails and letters can conclude with a request for customers to take a specific action (such as going to the agency's site for an online quote or contacting the producer to review additional coverage options) or information about the action the producer intends to take (such as contacting the recipients by phone or email to set up an appointment).

Apply Your Knowledge

What are some effective ways to personalize a renewal email or letter?

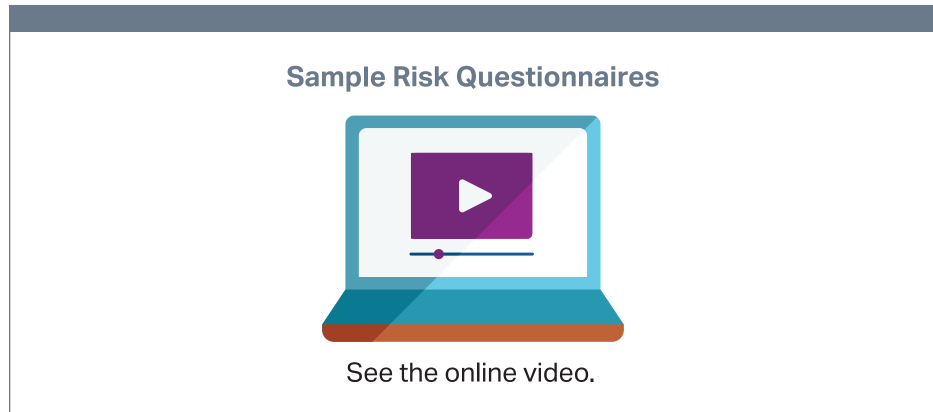
Feedback : The simplest way to personalize a renewal email or letter is to address the recipient by name. However, it's important that producers are careful to not address policyholders with whom they have been on a first-name basis for years by "Mr. Smith or Mrs. Smith." This type of error can occur when producers aren't involved in addressing the recipients.

Emails and letters can also be personalized by including a reference to the customer's specific occupation or policy. For example, when touting professional liability insurance, an email could incorporate information about current liability issues affecting the recipient's profession.

Another way to add a personal touch is by personally signing each renewal letter that will be mailed.

Questionnaires

To deepen customer engagement, identify untreated loss exposures, cross-sell or upsell insurance coverage, and encourage customers to schedule an appointment to review their insurance needs, producers can include risk questionnaires with renewal notice communications. To learn more, see "Sample Risk Questionnaires."



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Such questionnaires can also be posted on an agency's website or social media page. They should request that those who complete them provide their email address or other contact information so that a producer can follow up with personalized coverage recommendations.

Phone Calls

Producers may not have time to call every customer at renewal time, but it's often beneficial to call VIP customers, those with evolving exposures, and those with significant changes in premium.

These groups often want and appreciate an explanation regarding how and why there are changes in their coverage, needs, and costs. In addition, these customers can be the most vulnerable to sales pitches from competitors—either because of the revenue they can generate or their desire to price shop—so it's important that producers communicate with them directly to foster increased loyalty.

NEGOTIATING EFFECTIVELY

Negotiating effectively creates a win-win situation in which both parties are satisfied. The long-term benefit of this outcome may be a mutually positive ongoing relationship.

Few skills are as valuable as the ability to negotiate. Although the term is often interpreted as securing the best possible deal from another party, negotiations actually seek an outcome that benefits both parties.

Basic negotiation rules and techniques include knowing the other party, avoiding single-issue negotiation, not pushing the advantage, and delivering more than promised.

What Do You Know?

If a producer capitalizes on the difficult position of one party during a negotiation, he or she is:

a. Delivering more than promised.
b. Pushing the advantage.
c. Engaging in single-issue negotiation.
d. Separating the person from the problem.

Feedback : b. If a producer capitalizes on the difficult position of a client during a negotiation, he or she is pushing the advantage.

Knowing the Other Party

Knowing the other party in a negotiation requires determining their style of doing business and their goals. Some people are confrontational; others aren't. Some are easygoing; others are rigid. Some are talkative; others want to get straight to the point. Knowing the other party's style of doing business helps the producer determine how to negotiate. Failure to recognize the negotiating style deemed appropriate by the other party in the negotiation can doom a negotiation from the outset, especially if the other party has alternatives.

For example, if the other party is highly competitive and wants to win at everything, the producer should be prepared to exert more pressure during negotiations. Conversely, dealing with an easygoing, noncompetitive party who has a relaxed way of conducting business might require a tamer approach.

Effective negotiation also involves understanding the other party's goals. For example, when asked what every customer is seeking, one may respond, "a low price." But although this may be true for many, it is not always the other party's top priority.

Avoiding Single-Issue Negotiation

A single-issue negotiation often produces a "win-lose" outcome.

For example, producers may procrastinate discussing premium until the end of their negotiation with a potential client. However, discussing it last invites the single-issue trap: If the parties have agreed on everything else, one party

may spend a considerable period of time locked in a zero-sum game trying to convince the other of the value for the cost—or of the excessiveness of it.

Apply Your Knowledge

What two determinations are key to knowing the other party before starting a negotiation?

Feedback : Knowing the other party requires determining the other person's style of doing business and the other person's goals.

Not Pushing the Advantage

Another negotiation technique involves not pushing the advantage, especially for parties who are engaged in a long-term relationship that will extend beyond the current deal.

Suppose a business prospect has had difficulty obtaining insurance coverage at a reasonable price because of a series of property losses that occurred at one of many locations they own. In the course of negotiations, an insurance producer recommends that selling the troubled property might help the prospect secure a lower price from an insurer. This suggestion puts the prospect in a difficult position, forcing the prospect to choose between:

- Reduced costs but potentially lowered output, and therefore revenue, which could force the prospect to reduce their workforce.
- Continued higher costs, but coupled with steady output and revenue, as well as job security for employees

Even though the producer's suggestion may provide a short-term advantage, and a win-win outcome in the moment, pushing it could later create resentment by the prospect and ultimately cause the prospect to seek another producer.

Delivering More Than Promised

In quality management, the concept of delivering more than promised is expressed as "always seek to exceed customer expectations." Giving something more than promised after negotiations end creates an important advantage in future negotiations with the same customers.

A customer may remember an unexpected bonus (such as a gift, a framed first policy, or better terms of coverage) far more than the details of the negotiation. Such a bonus does not have to be extravagant or costly, just unexpected and welcomed. Exceeding the customer's expectations can facilitate subse-

quent negotiations, and using other negotiation techniques can create lasting business relationships.

Apply Your Knowledge

Identify the benefit of giving something more than promised after negotiations end.

Feedback : Giving something more than promised after negotiations end creates an important advantage in future negotiations with the same customer.

SUMMARY

Customer service in an agency involves marketing and sales transactions, claims, and accounting. Handling all of these appropriately will result in superior customer service and improved agency efficiency and growth.

Agencies can increase sales to existing customers by suggesting they maintain insurance to value, broadening their coverage, offering additional policies, using account rounding, and offering value-added services.

Strategies producers can use during the renewal process to increase revenue include segmenting, connecting with customers early, fitting premium to budget, marketing across insurers, and being transparent. When issuing renewal notices, producers can use emails, letters, questionnaires, and phone calls to foster deeper relationships with customers.

Important negotiating rules and techniques include:

- Knowing the other party
- Avoiding single-issue negotiation
- Not pushing the advantage
- Delivering more than promised

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