RISK-ADJUSTED BENCHMARKING: AN ALTERNATIVE VIEW OF MARKET RATE CHANGES

Risk-adjusted benchmarking is a significant step forward in capturing the trends underlying insurance market pricing behavior. Conceptually, risk-adjusted benchmarking contemplates changes in a company's insurance program structure and risk profile in conjunction with the resulting changes in price that the company pays for insurance. This allows for a more complete picture of industry price changes as compared to traditional benchmarking, which considers only the change in price paid for insurance.

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CHANGES IN PROGRAM STRUCTURE

Structural changes to a company's insurance program occur with any changes to retentions and/or limits. This can result from both insurance market dynamics and/or changes in a company's own risk appetite or profile. Because program-structure changes occur frequently, companies that experience them can provide a rich source of benchmarking information.

Traditional benchmarking includes only peers that have static retentions and limits from one policy period to the next. Risk-adjusted benchmarking includes all samples, including those with structural program changes. As a result, risk-adjusted benchmarking allows for the inclusion of many more peer companies in the analysis of insurance market behavior.

CHANGES IN RISK PROFILE

Changes in an organization's risk profile occur for a variety of reasons. Mergers and acquisitions, expansions into new states, and changes in product offerings may drive changes in a particular risk profile.

Intuitively, it is clear that insurers must factor such change into underwriting so as to appropriately align premium with exposure. However, traditional benchmarking makes no similar allowance. Risk-adjusted benchmarking incorporates risk profile changes into the measurement of price change and, therefore, offers an enhanced alternative to traditional benchmarking in this important regard.

DIFFERENCES IN BENCHMARKING APPROACHES

	TRADITIONAL BENCHMARKING	RISK-ADJUSTED BENCHMARKING
Clients Included in Benchmarking	Only includes clients with the same program structure year over year.	Includes clients with or without changes in program structure year over year.
Limits	Only includes renewals that did *not* have a change in limits.	Includes all renewals.
Retentions	Only includes renewals that did *not* have a change in retention.	Includes all renewals.
Changes in Risk Profile	No adjustments made for changes in risk profile.	Adjustments made for changes in risk profile.

HOW IT WORKS

Appropriately adjusting insurer prices for changes in retention, limit, and risk profile requires an understanding of the quantitative impacts of such changes. For example, it is clear that (under normal circumstances) if an organization decreases its insurance retention, it can expect to pay a higher amount of premium while insuring to the same limit. But the amount by which the company should expect premium to increase is not at all clear without a detailed understanding of what that decrease in retention means to the insurer in terms of additional, expected sustained losses.

This example can be extended to all types of changes in program structure and company risk profile. By translating this into changes in expectation of insured losses (and expenses), a price can be derived that would put the company on equal economic footing with where it stood in the prior policy period. By comparing that theoretical price with the price actually charged by the insurer, a risk-adjusted rate change can be determined.

Generally speaking, making appropriate risk adjustments in the context of benchmarking is not simple. These adjustments should be based on large quantities of individual company transactions as well as on aggregated industry data.

IMPLICATIONS AND CONCLUSIONS

Traditional benchmarking provides a valid view of insurance market pricing. However, it requires the peers compared to maintain the status quo in their respective insurance program structures, and it does not contemplate underlying changes in risk profiles.

Risk-adjusted benchmarking addresses these factors and provides a clearer picture of pricing activity against current market conditions. It allows for a broader set of peer companies to be included in the measurement of price changes. Most importantly, it can increase the relevance and potential uses of the results. Companies can now use risk-adjusted benchmarking to make more informed decisions on alternative program structures with a new perspective on how insurers will react to those alternatives.

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