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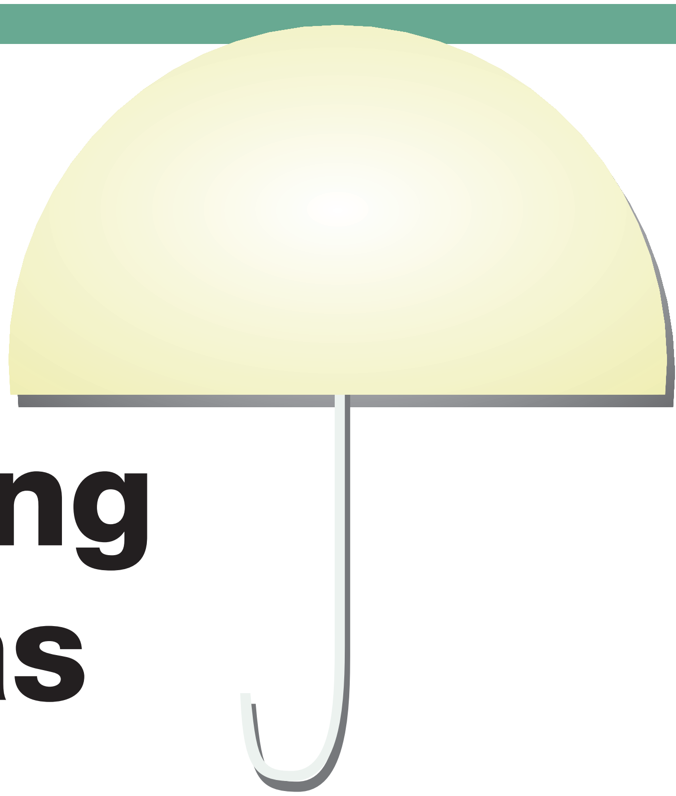

Leveraging Umbrellas

by Joseph S. Harrington

Benchmarks are emerging that can help companies determine whether they are getting the most from their umbrella programs.

Umbrella and excess liability policies create a dilemma for property/casualty insurers: Offering these programs is key to retaining the best personal and commercial lines accounts, but the meager premium volumes and volatile loss ratios on these heavily reinsured programs take a toll on the smaller carriers.

If companies don't offer these types of policies, they run the risk of losing their top customers to competitors that will provide umbrella coverage--in addition to the underlying auto, homeowners, commercial liability and other policies. But small to midsize carriers struggle to justify these programs in terms of their company's overall operating performance.

"Small, leveraged books of umbrella business typically produce inconsistent results," said Gary Myers, a vice president with Employers Reinsurance, Overland Park, Kan. "The sporadic and severe losses are very unpredictable."

But the industry is beginning to offer some tentative indications about umbrella/excess policies that might help insurers determine whether they are getting the most from their umbrella programs and whether they can improve their operating performance.

Getting the 'Gravy'

Theoretically, umbrella/excess policies should be "gravy" for the companies that write them, said John Easterday, a vice president with American Re-Insurance, Princeton, N.J. "You should pretty much understand your [existing] insureds and should be able to make money off [the excess coverage]."

Indeed, there can be several years when umbrella/excess premium will flow straight to the profit column. Although its personal umbrella business amounts to less than 1% of total group premium, Buckeye Insurance Group, Piqua, Ohio, wrote nearly $250,000 in premium on the product in 1999 with a loss ratio near zero, said President Doug Haines. Rockingham Mutual Insurance, Harrisonburg, Va., hasn't experienced a single loss in its personal umbrella program in more than 10 years, said Tom Mendez, vice president.

"Extremely low" single-year loss ratios are also common in commercial umbrella programs, said Martin Sheffield, chief operating officer of Ward Financial Group, a Cincinnati-based research firm that specializes

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in property/casualty operations.

However, inadequate pricing and excessive leverage often prevent companies from achieving superior operating results in umbrella lines compared with the underlying lines, said Dan Newsome, a colleague of Easterday's at American Re. "I've seen companies that write $10 million in gross premium write umbrella policies with $5 million limits," Newsome said. "Even if they cede almost all of that, they are really stretching themselves."

The excessive leverage extends to individual accounts, Newsome said. "Because of competition, some companies are providing large umbrella limits without requiring significant primary limits," he said. "This allows carriers to sell the entire package [primary and umbrella] for a competitive premium, but it is in companies' best interest to make sure the primary limits are sufficient to support the umbrella and provide adequate premium."

A single major loss can wipe out years of premium.

"It obviously takes a long time at [a typical premium of] $150 to fund one $1 million claim," said Myers of Employers Re.

Perhaps the first step to achieving stable, desirable results in an umbrella/excess program is to set a goal of producing an underwriting profit over every five-year period. Easterday said that goal is reasonable and attainable, given experience in personal and commercial programs over the past 20 years. "If you're not making money over five years, there's poor underwriting or your umbrella is priced too cheaply," he said.

Pricing Challenges

Since umbrella programs often produce several good years in succession, "pricing is often ignored until an unexpected loss comes up," Myers said. "This creates a 'catch-up' situation, which is often constrained by regulatory hurdles, given the small supporting numbers" that companies have to support a filing for an umbrella rate increase.

Myers cites two considerations as critical to pricing umbrella/excess policies:

• Choose the proper "attachment points." In other words, require underlying limits that will ensure that the umbrella/excess policy is truly a catastrophe layer. "It is very difficult to make up for the exposure from lower attachments with more premium," he said.

• Adjust your pricing regularly, even in the absence of losses, to at least keep pace with inflation.

Pricing of umbrella/excess coverage has been constrained by the lack of published public data for premiums, losses and expenses, but better data is beginning to emerge. Larry Thill, manager of statistical services for the American Association of Insurance Services, said companies have begun to report far greater volumes of umbrella/excess premiums and losses since statistical plans were expanded in the mid-1990s. AAIS, based in suburban Chicago, is a national advisory organization and one of only two national property/casualty statistical agents that collect premium and loss data on a "unit transaction" basis to support development of loss-cost rating information.

In the data reported to AAIS, paid losses totaled about 57% of written premium on personal and commercial umbrella and excess policies from 1994 through 1998, a ratio that compares favorably with published figures for the underlying personal and commercial lines, but with greater volatility from year to year.

Of course, the more policies that are sold, the less volatile the results will be. But again, few insurers have goals specifying what percentage of

their personal and commercial accounts should have umbrella/excess coverage as well.

Ward Financial Group, however, offers figures that may indicate whether companies have the potential to increase the number of umbrella/excess accounts. Sheffield said 2.53% of all the homeowners and personal accounts in his company's proprietary database also have personal umbrellas; 6.4% of the commercial lines accounts have an umbrella/excess policy.

Although the figures are not benchmarks, they both fall in line with what reinsurers offer anecdotally, and they indicate that companies that report less than a 1% penetration of an underlying book of business may well have the potential for profitable growth in the umbrella/excess program written over it. "Almost every insured written by a standard company is at least a candidate for an umbrella," said Ken Green, vice president in the Chicago office of General Cologne Re. Green added that companies may be able to write personal umbrellas for 5% or more of their homeowners accounts without sacrificing adequate pricing and sound underwriting.

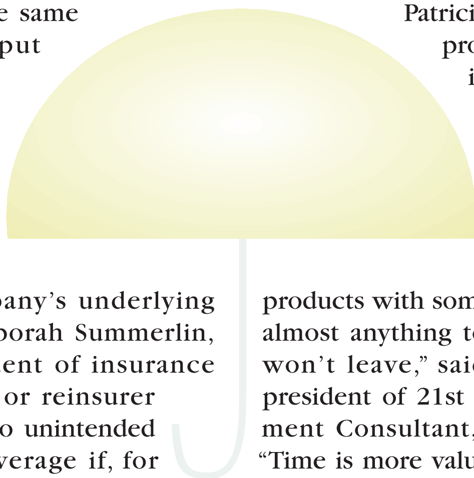
"Companies that really foster and promote an umbrella program have a materially better penetration than those that maintain it as just another commodity," Sheffield said. "Companies attain double or triple the average penetration by pushing the product."

A Standard Approach

Even with strong penetration of personal and commercial accounts, an umbrella/excess program will produce a low premium volume relative to the underlying lines. So it is critical that companies spend as little as possible to implement and maintain their umbrella/excess policies. Haines at Buckeye Group said his company's personal umbrella is written "almost like an endorsement" to personal lines policies. Mechanically, an umbrella/excess policy should work like an endorsement, fitting seamlessly onto the underlying policies at minimal cost.

New standard policy forms can help companies cut their costs of developing and maintaining umbrella/excess programs. AAIS and the Insurance Services Office Inc., New York, have developed personal and commercial umbrella forms, which now serve as industry standards. Until now, this type of coverage was long written on several diverse and independent forms. In addition, AAIS has developed a farm-umbrella program that includes two alternatives: a farm-personal and a farm-commercial umbrella.

Apart from eliminating the need to maintain company forms, the new standard programs can reduce uncertainty and save time by having insurers, reinsurers, agents, brokers, risk managers and insureds literally working "from the same page" as they put together a policy.



Perhaps even more important, an umbrella policy should fit with the most current language in a company's underlying policies, said Deborah Summerlin, AAIS vice president of insurance lines. An insurer or reinsurer may be exposed to unintended "drop down" coverage if, for example, its umbrella form has not been updated to reflect exclusions or limitations added to the underlying policies. Drop-down coverage refers to situations in which an umbrella policy responds to a claim directly (above the self-insured retention), with no underlying coverage in place.

"In general, umbrellas haven't gotten the regular review that underlying policies have," Summerlin said.

The AAIS personal and farm umbrella forms feature strict "follow form" construction to avoid assuming exposures that are not covered and priced in the underlying policies. Follow-form construction means that the umbrella policy relies on and responds to terms and coverages in the underlying policies. (A key exception is the provision of drop-down coverage for personal liability injury in the personal umbrella.) The AAIS commercial umbrella is structured differently but still has a strong follow-form orientation.

"Umbrella policies today are mostly written as 'excess of limits,' or follow-form, than designed to pick up extraneous exposures," Sheffield said. "There is very little coverage beyond what is in the underlying policies."

A more aggressive approach to improving the operating results of an umbrella/excess program does not detract from its importance as a means of retaining good accounts.

"When you cross-sell products to an account, your chance of retaining that account improves," said Patricia Saporito, senior property/casualty industry consultant in the New York office of NCR Corp.

"When you have certain number of products with someone, you can do almost anything to them and they won't leave," said Lynn Thomas, president of 21st Century Management Consultant, Waltham, Mass. "Time is more valuable than money today. People don't feel they have the time to re-create their financial relationships."

Thomas said a 5% increase in customer retention can lead to 35% to 50% greater profitability in two to three years.

It pays to take a longer view, though, said Saporito, who urges insurers to consider "customer lifetime value" when setting underwriting guidelines and pricing coverage. Umbrella policies can play a key role in tying a customer to your company, but the measurement of the benefit requires a shift in focus from yearly results by line to long-term results from individual accounts.