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The Plan Feedback Loop – An Indispensable Management Tool

By John Murray FCII

We have come a long way from the days when the business plan was filed away at the end of the planning round and taken out again only when the annual result was known. Nowadays progress against plan is monitored on a regular basis. But the practice of constantly revisiting the dynamics behind the plan, to ensure better direction of the business, is still being developed.

No two insurers will go about their planning in exactly the same way but all will seek to predict, over the planning period, the key numbers: premiums, claims, commission, expenses and investment income, the latter split between income on the insurance funds (technical reserves) and shareholders' funds. This exercise will be done for all lines of business and the total result carried through into a putative balance sheet so as to determine, inter alia, likely availability of profits for distribution and projected solvency cover.

Many insurers will produce a phased plan, whereby the expected annual result is logged quarterly or monthly (individual aspects, such as premium volumes and reported claims, may be the subject of more frequent monitoring). It is also good practice to produce a number of 'case' scenarios, indeed this may well be a regulatory requirement, but eventually one realistic plan needs to be selected to provide a performance benchmark.

Sitting behind the plan numbers will be many detailed assumptions that provide their underpinning. For example, the premium figure will usually be an amalgam of anticipated number of units of exposure and expected pricing. The claims figure may be the product of a detailed assessment of expected exposure units, claim frequency and average cost, or may derived from a chosen loss ratio based on anticipated future claims trends versus assumed pricing strength. Predicted cash-flows will be used to determine future investment income; views will be taken on the development of earlier years' run-off.

Unfortunately in most insurers' offices these key assumptions are spread around amongst individual underwriters, actuaries and accountants with no central logging. Their systematic collation is a tedious process but well worth the effort because it provides an invaluable tool for management.

Now that the basic structure is in place it is possible to activate the feedback loop.

This is much more than simply comparing outturn with plan or looking at a

number of key performance indicators. It is easy enough, for example, to spot premium running ahead of plan, but what is important is to know the reason for it. If achieved pricing is stronger than expected, then that is one thing. If, on the other hand, more units of exposure are being written at the expense of pricing strength, that is something else.

In both cases a reforecast will need to be done at an early stage to reset the loss ratio and work out the effect on the balance sheet. If the exercise shows underwriting conditions to be particularly propitious and there is the solvency strength for it, consideration may be given to expanding the book more rapidly if this can be done without compromising the business quality.

If the feedback shows that the underwriters are sacrificing pricing strength for the sake of growth, however, a different response will be indicated. Managing the often-conflicting demands for both growth and profit at different stages of the cycle is one of the enduring challenges of the insurance business – and one that analysts and journalists frequently fail to understand (remember the Independent?). Difficult decisions may be required here but the most important point is that if pricing strength data is not being continuously captured and compared with plan, then the insurer's management will be unaware of any problem – they may even be pleased about the above-plan growth – until adverse loss ratios start to emerge at a later stage. This underlines the importance of logging the plan assumptions in addition to the numbers themselves.

Most insurers monitor cash-flow in one form or another but in many cases it is omitted from the underwriter's thinking, which often does not go beyond an assumed investment income (or discount) figure in the pricing formula. But within the same class of business differently sourced risks can have very different cash flow characteristics. These should be factored into the planning and actively applied to the risk selection process; particularly important where capacity is an issue. Again it is important that the underlying assumptions are there to be set against what actually happens.

While most of the attention will be focussed on the current underwriting year, earlier years are of significant importance. This is not just from the standpoint of how their development may affect the financial year's trading result (important enough) but also how the dynamics behind their development, perhaps longer reporting times or higher average claims cost, impact the assumptions behind the current plan. It is bad enough to have to strengthen earlier years' reserves but matters will be far worse if the underlying causes are not reflected in current pricing and policy terms.

The various dynamics behind any business plan are far too numerous to be catalogued here; reinsurance has not been mentioned, for example. What matters is to have mechanisms that enable the key assumptions to be recorded centrally – this alone will give senior management a crucial insight into the current thinking at operational level – and to have constant feedback to coming in via the loop. Reported variances can then be used to determine tactics and to guide corrective action before serious problems develop.

It may seem like a blinding glimpse of the obvious to say that an insurer is in the underwriting business, yet many decisions on, say, IT or HR operations are made

without any account being taken of the underlying business environment. The planning loop needs to be applied to all decision making areas otherwise it is possible that a decision may be made to go for growth to support the increased expenditure at the worst possible time from an underwriting standpoint.

One can hardly close an article such as this without at least some reference to regulation and the holy grail of transparency. Senior management control of operations, through knowledge of what is happening at the front end, is one of the regulator's primary concerns. A fully developed plan feedback loop, with evidence of management actions being based on what it shows, will go a long way to meeting these.

