Atypical Growth Challenges Conventional Underwriting Strategy

By Fritz Yohn

Arguably one of the most influential perceptions of late in the commercial insurance industry is that of a shrinking business sector – and the resulting decline in number of customers for commercial lines coverages. As sculpted by the "dot-com" recession and the ensuing "jobless recovery", this image has served to heighten concerns about the threat posed by softening insurance rates.

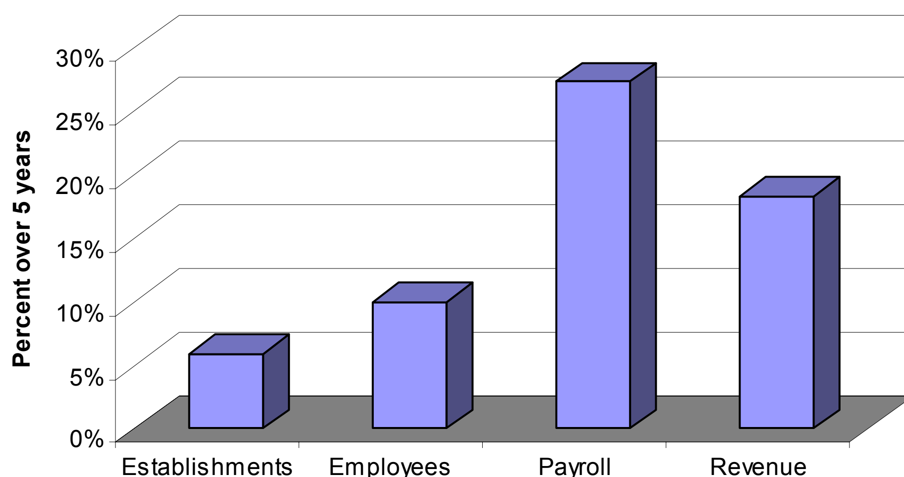
In fact, data just released by the Economic Census of US Business show a different picture. And, as is often the case in these columns, taking a closer look at varying industry trends in account and revenue growth can help carriers avoid deteriorating underwriting results in the coming months.

The new Economic Census information shows that US businesses actually managed to record appreciable growth on balance over the 1997- 2002 period. Employment growth during the five year period averaged 2.2 percent annually – only 0.4 percent per year less than during the heady rebound from the 1998-1999 recession. In point of fact, business payrolls rose at a faster pace in the recent period than during the period of faster economic growth between 1992 -1997.

If recent economic performance has indeed been so close to par, how could the tenor of the business sector be so bad? A large part of the gap in perception and reality is attributable to the marked disparity between economy-wide results, such as those cited above, and the recent experiences of individual industries. As shown in Chart 2, employment growth experience over the 1997-2002 period varied greatly between major industrial sectors. During this period, very strong growth was recorded in industries such as educational services and information services. Indeed, employment in some of these "new economy" industries expanded at rates averaging from two-to-four times the 2.0 percent annual employment growth registered by the overall economy during this period.

In contrast, significant employment declines were registered in some traditional industries, such as mining and manufacturing, no doubt accounting for much of the negative perception of business conditions. Commercial lines writers focusing on classes in these two industries almost certainly have experienced considerable contraction in market potential that will become more apparent as recent hard market conditions in commercial lines continue to unwind.

Chart 1

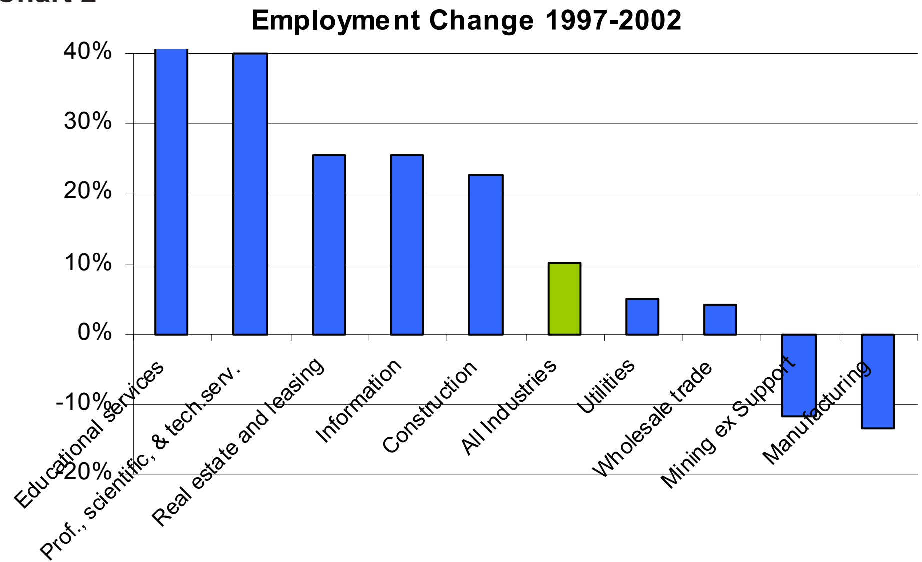


It is tempting to conclude that refocusing on risks in high growth industries will provide a safe haven from the market softening now gathering steam. However, since business growth can arise from many factors – some of which expand prospects, some that boost premiums and others that inflate risk – it's important to understand how much growth can differ. The following chart (3-digit NAICS detail on fast growth industries) provides a sense of this.

While each of the industries recorded 40-plus percent revenue growth during the 1997-2002 period, the composition of this growth varied considerably. In three industries – broadcasting and telecommunications, performing arts & spectator sports, and professional scientific and technical services – substantial growth experienced in the number of accounts complemented the significant growth in average revenue per accounts. This type of balanced growth is consistent with most popular images of economic growth.

In contrast, several of the other industries shown in Chart 3 experienced exceptionally strong gains in revenue per account and only modest growth in number of accounts.

Chart 2



Indeed in the health and personal care stores industry, strong revenue increases were coupled with a decline in number of accounts during the 1997-2000 tracking period.

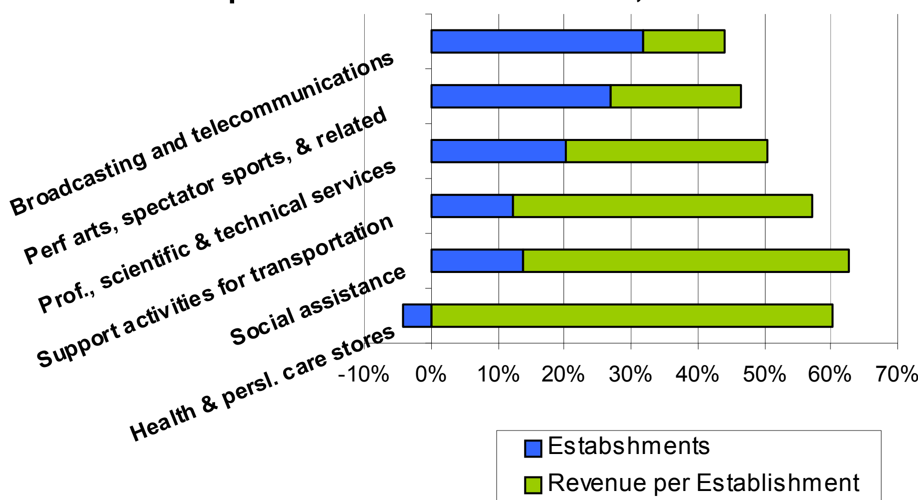
Such unbalanced growth tends to place added stress on under-writing results. First, the limited number of additional accounts created does little to dissipate the competitive pressures that typically rise as hard market conditions abate. Second, extremely rapid growth in per-account revenue is apt to boost exposures – and with it, losses – faster than audit processes are able to collect additional premiums. The result, of course, is deteriorating underwriting experience.

Lest the careful reader think that the mixes of revenue and account growth cited above are atypical, Chart 4 shows the combinations of growth in revenue per account and number of accounts for all 3-digit NAICS industries. Simply put, the growth combinations are all over the map.

To avoid this pitfall, rather than settling for whatever combinations of growth its current book provides, carriers can adjust underwriting appetites to avoid some of the more challenging classes. For example, heightened concern over intensifying com-petition for existing accounts might lead some carriers to give wide berth to classes of business reporting sharp declines in account numbers. Three fairly obvious candidates for this list are apparel manufacturing, leather products and textile mills (respectively, NAICS 315, 316 and 313).

At the other extreme, carriers might opt to steer clear of classes reporting excessively rapid expansion in per-account exposures. From the 1997-2002 period, business classes that

Chart 3



might fall into this category include real estate, social assistance, transportation support activities, and publishing industries. Each of these recorded per account revenue growth in excess of 35%.

Quite a few classes have displayed strong but balanced growth over the 1997-2002 period. Among these "sweet spot" business classes are: waste management; education services; general contracting, and profes-sional, scientific and technical services. In each case, significant growth in number of accounts offers some respite from intensifying competition, while moderately strong revenue growth does not threaten to push exposure growth and losses to the point of outstripping premium.

The composition of business growth also has specific implications for workers compensation profitability. As shown in Chart 5, the payroll growth in some industries has been almost entirely composed of increases in pay per employee, with little or no growth in number of employees. Apart from an impact on indemnity loss costs, this type of payroll growth has only very modest effect on occupational accident frequency. As a result, such payroll growth tends to improve underwriting experience by increasing premiums collected significantly more than losses incurred.

In contrast, industries such as information services, education services and social assistance have registered strong, but more balanced growth in both employment and pay per employee during the 1997-2002 period. In this case, the impact on indemnity costs is more moderate; however the strong growth in employment is likely to have boosted accident frequency – and had a deleterious impact on incurred loss experience.

The new data on business growth should provide encouragement to those girding for softer market conditions. Beyond this, however, the notion of considering the composition of that growth in adjusting appetite and underwriting criteria to changing market conditions should provide some practical bottom line benefit.

Frederick Yohn, PhD, is the developer of the MarketStance market analysis tool for the U.S. commercial property-casualty industry. MarketStance is a registered trademark of IntelliStance, LLC., in Middletown, Connecticut. www.marketstance.com. 888-777-2587.

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Chart 4

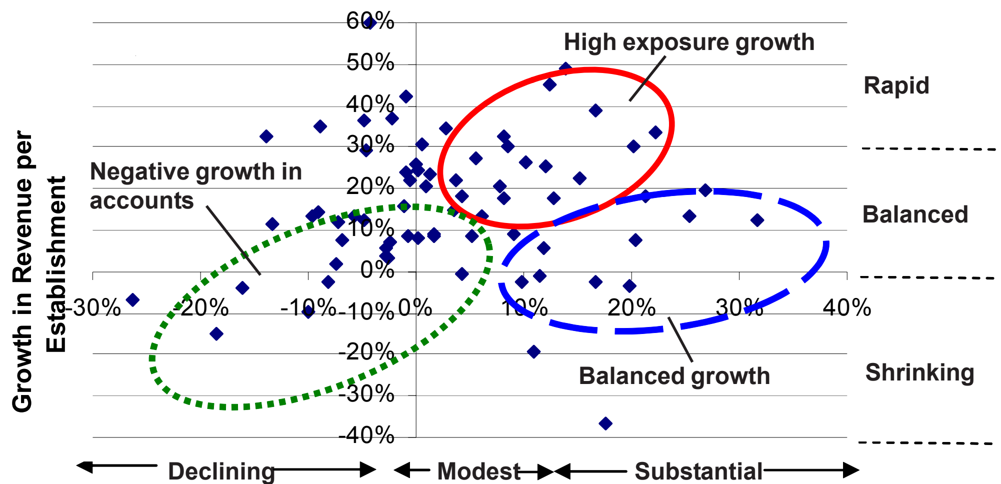

Chart 5