

Due Diligence Limits Surprises,

BY JAMES L. GUERIN AND GEORGE P. LAGOS

Specialty program business can provide a noncorrelated source of profitable commercial premium for companies looking for top-line growth or to supplement their core books of business. If not done properly, however, it can be the source of unanticipated losses and unwanted surprises.

A comprehensive initial due diligence undertaken in advance of creating the delegated authority relationship, together with an ongoing professional audit and review process, will greatly improve the opportunities for success.

Recognizing that the process is considerably more involved than what can be described in a brief article, we outline some of the key aspects from a risk capital provider's perspective below.

• **Look Inward:**

To be successful in the program arena, the underwriting company must be properly positioned to conduct program business.

The first step is to look internally to evaluate structure, process and resources dedicated to developing and managing program operations. The company must be organized and resourced to enable it to support and manage multiple programs in various business segments, while at the same time objectively monitoring profitability, performance and compliance.

If the company lacks experience or capability in the program area, it is extremely unlikely that it will achieve desired results. Many companies either underestimate the internal resource required or overestimate the program administrator's capabilities, resulting in gaps that typically lead to adverse consequences.

Program business should be viewed as a long-term business strategy. It takes time to identify and attract good programs and to undertake the appropriate due diligence to eliminate false starts and identify possible problems at an early stage.

Once a program relationship is initiated, a sustained willingness to work with program administrators to fine-tune pricing and coverages through hard and soft markets is critical to long-term success.

• **Evaluating The Program:**

The most obvious and important way to measure the program's success is underwriting profitability. Does the program have a documented track record of results supported by reliable statistics on premium, losses and pricing?

There are many programs which would be very profitable but for a couple of large losses, a particular coverage, or one or two problem states. There is sometimes a fine line between a program that is profitable and one that could be profitable.

It is essential to confirm what the program is about and to closely examine the basis for believing or expecting that it can and will deliver a particular insurance product or service better than the standard commercial market or other competitors in the same market space. In other words, what is the value proposition—"the hook?"

Is it specialized coverage? A unique rating approach? Preferred distribution? Claims expertise? How does the program compare to similar offerings from other program administrators?

Specialty programs must demonstrate a unique character and competitive advantage which is not easily replicated in order to be successful over the long term.

Lastly, how does the program fit with the insurance company's structure, administrative capabilities and risk appetite?

It is important to consider all aspects of the program such as what lines of business are involved, whether the business is short-tailed or long-tailed, admitted or nonadmitted, or national or regional. What percentage of the book fits within the insurer's underwriting box?

The answers to these questions will impact profitability analysis, implementation timeframes, referral activity, the ability to make coverage or rate changes down the road if and as required, statistical and data capture requirements, and the identification of other administrative obligations which have to be met.

• **Evaluating The Program Administrator:**

What is the character, capability and credibility of the program administrator, and what is its reputation in the marketplace?

Program business requires delegation of underwriting and other authority, including authorization to act in the company's name and on its behalf. From a credit risk perspective, program administrators will typically act as a fiduciaries, controlling millions of

dollars moving between policyholders or subproducers and the company.

This relationship requires the highest degree of confidence in the integrity and professionalism of those to whom the business will be entrusted. If there are any problems with reputation, financial condition, payment history, litigation, errors and omissions claims, corporate records or regulatory compliance, it is critical to identify them at the outset in the initial due diligence of the program administrator.

Is the program administrator properly resourced for the business it is doing, and does it have processes and controls in place appropriate for the business it does?

Does it have in-house systems capabilities front end to back end for rating, quoting, issuing, billing, accounting and data capture? Is the process automated and integrated?

Smaller programs may be family-run operations, while multiline, countrywide programs may be structured similar to an insurance company operation.

Regardless of size, the determination must be made as to whether the resources and capabilities of the program administrator match the requirements of the program and whether or not there is any reliance on the current carrier for performance of these functions.

The reduction of transaction costs by leveraging the capabilities of each entity in a program relationship is a key component to eliminating redundancy and optimizing expense management. Often, operations which appear to be well run at first look reveal material deficiencies upon close scrutiny which, if left uncorrected or unresolved, will inevitably lead to problems down the road.

It is essential that the program administrator and the company have an alignment of interests. Important criteria are: shared responsibility and participation in underwriting performance, willingness to expand or shrink the book depending on market conditions, and a commitment to a long-term relationship.

A program relationship has been compared to other more intimate societal institutions, and there are many analogies which might be made. To the extent there is a disparity in objectives or philosophies, either real or perceived, the relationship will inevitably deteriorate over time, resulting in a "lose-lose" proposition or divorce.

Program business has been the source of profitable results for those companies which are properly structured and resourced and maintain management discipline and oversight on an ongoing basis. There are many components and considerations to structuring a successful program business operation. The issues outlined above touch upon some but not all of the areas which require examination.

From the outset, an objective due-diligence process is critical in providing the company with validation that the program and program administrator meet all requirements necessary for a successful business relationship. The significant delegation of authority inherent in program relationships require the highest level of scrutiny to confirm that all is as it appears to be.

Finally, on an ongoing basis, it is essential that the company continues to stay close to the business and pays attention to the details. A system of periodic operational, financial, underwriting and compliance audits is required not only to assure that the business stays on track, but to identify potential operational improvements on a continuous basis.

This approach will go a long way to assuring the mutual success of the parties.

James Guerin and **George Lagos** are principals of GL Insurance Partners LLC (www.glinsurancepartners.com), an insurance consulting and services firm focusing on specialty commercial program business issues. They may be reached at james.guerin@glinsurancepartners.com and george.lagos@glinsurancepartners.com.