



Expense Benchmarks for Municipal Trusts

by Brian Foley

Municipal trusts should emphasize their expense efficiency and the advantages this produces for potential members.

In the late 1970s, an increasing number of public entities began to join government-sponsored risk management programs, commonly referred to as "pools" or "trusts." There has been rapid growth in both the number of pools and their participating membership. A recent report entitled *Risk Pooling: Scope and Practices, 1994* estimated the number of pools nationwide at over 400.¹ Membership in these pools is thought to be 35,000 (out of approximately 80,000 public entities). Annual premium volume associated with these pools is in the vicinity of \$5 billion. Clearly, public entity pooling is a growth industry.

While there are a wide variety of pools, state-wide pools of municipalities — often called municipal trusts — tend to be the largest and most sophisticated. The scope and scale of operations of a municipal trust are similar to those of a small insurance company. Like others in the alternative risk market, these municipal trusts often compete directly with commercial insurers.

Many municipal trusts are reporting increased competition in the public entity insurance marketplace. A report in the May 16, 1994 edition of *Business Insurance* quoted Mark Ferrano of Johnson & Higgins, New York: "We are contacted on a weekly basis by insurance companies that are interested in developing new products for public entities."

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In a competitive bidding situation, municipal trusts are judged against established insurance industry criteria in order to demonstrate financial soundness. Rating agencies such as A.M. Best consider financial size and maturity (among many other criteria) when assigning a company its rating. A favorable rating and an acceptable combined ratio (losses plus expenses divided by premiums) are of paramount importance for an insurance company.

Such bases of comparison tend to give commercial insurance companies a competitive edge over municipal trusts. However, municipal trusts, particularly those with tax-exempt status, should enjoy expense advantages over their insurance industry counterparts.² Municipal trusts should emphasize their expense efficiency and the advantages this produces for potential members.

How can municipal trusts monitor expenses without adequate benchmarks to control costs and measure productivity? Up to now, they have been unable to do so — at least not as effectively as many would like. One group of municipal trusts recently shared data with

¹ "Risk Pooling: Scope and Practices, 1994" by Peter C. Young, Ph.D. is published by PRIMA (August, 1994).

² According to the Towers Perrin SEMTO study, the average property/liability municipal trust enjoys a 12 percentage point expense advantage over the average comparable commercial insurer.

Towers Perrin in a comprehensive expense benchmarking project. The support of the League of Minnesota Cities Insurance Trust (LMCIT) and the cooperation of its peer trusts was vital to the success of the Study of Expenses for Municipal Trust Operations (SEMTO).

This article explains the motivation for the project, shares a summary of results, and suggests how such benchmarking might help to develop top-quality municipal trusts.

Genesis of SEMTO

The recent dramatic downsizing and restructuring of several large insurers attests to the importance of expense management in the insurance industry. For many companies, expense control was the significant issue of the late 1980s, and this trend has continued into the 1990s. In 1989, the Tillinghast/Towers Perrin Study of Expenses for Property/Casualty Operations (SEPCO) was initiated as an annual survey to provide meaningful benchmarks for participating companies. The total written premium for insurers participating in the 1990 study exceeded \$22 billion (about 10% of the primary market). To allow valid intercompany comparison, participants were encouraged to adopt a common set of definitions in reporting expenses and staff levels.

Municipal trusts were formed under the theory that they can provide members with risk financing at a lower cost, but at the same time with greater emphasis on quality services. Just as commercial insurers were interested in meaningful benchmarks, many mature trusts are now very interested in peer group benchmarking of expenses to improve efficiency and help reduce members' cost.

Benchmarking Basics

Benchmarking* is a process of defining valid measures of performance comparison among peer organizations. Benchmarks are used to determine the relative positions of the peer organizations, ultimately establishing a standard of excellence.

Operational and organizational benchmarking help management pinpoint direct and indirect cost problems and determine their magnitude. *Operational benchmarking* focuses on productivity and direct cost structures by making peer group comparisons of the cost (input) required to perform a specific amount of work (output). For a municipal trust, an example of work output might be the various risk and loss control initiatives offered to members.

Costs encompass management, professional, technical, and administrative employees (regardless of where in the organization they work), and include salaries, wages, benefits, and other elements of total compensation, as well as personnel-related costs or cost allocations for items such as rent, telecommunications and computer expenses. Costs also include contractors' costs, since many functions continue to be outsourced. Staffing efficiency compares the relative labor intensiveness of similar functions.

Organizational benchmarking requires a "functional template" to which expenses and the employee counts of each municipal trust in the peer comparison can be assigned. Organizations' employment philosophies differ, of course, so care must be taken to ensure that the employee counts include all full and part-time regular employees, as well as the full-time-equivalent (FTE) employees of contractors.

Although the "science" of benchmarking is still evolving, this tool has already become an important element in strategic planning and performance management. Indeed, the performance level of the entire municipal trust industry can improve if every trust focuses on becoming the best in its peer group. ■

* Towers Perrin recently produced a monograph entitled *Standards of Excellence* that describes the link between benchmarking and value creation; excerpts have been used in this article. Please call (914) 745-4000 if you wish to receive a complimentary copy of the monograph.

Claims administration was the highest cost functional area, while brokerage and governance tended to have the lowest cost.

in-house is an important consideration for many municipal trusts. To provide meaningful statistics in this area, each municipal trust was asked to identify expenditures and FTE employee information by functional area for both in-house and outside contractor services.

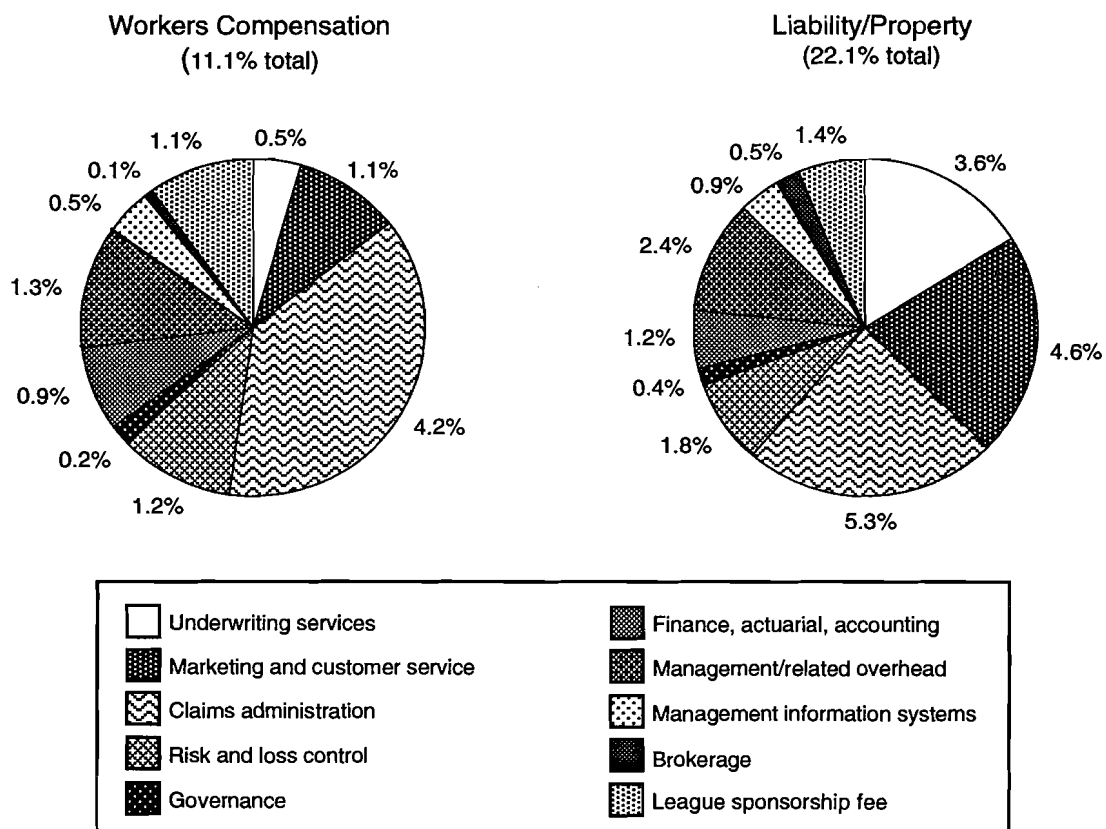
The last part of the survey form gathers information designed to identify appropriate benchmarks for allowing comparison of expense and FTE employee measures among municipal trusts. This information includes gross and net contributions volume, number of claims,

the number of members, and various exposure base measures (e.g. members' payroll, population and expenditures).

SEMTO Study Summary Results

Figure 2 illustrates the SEMTO average expenditure (in terms of percentage of gross contributions) allocated to each of the ten functional areas for workers compensation and liability/property trusts, respectively. Claims administration was the highest cost functional area, while brokerage and governance tended to have the lowest cost.

Figure 2
Expenses as a Percentage of Gross Contributions*



* All SEMTO participants combined

Figure 3 demonstrates the average level of staffing (in terms of FTEs per \$100 million gross contribution) by functional area for workers compensation and liability/property trusts, respectively. The average level of staffing for municipal trusts tended to be somewhat lower than that of the average commercial insurer in the SEPSCO study.

A Closer Look at SEMTO Benchmarks

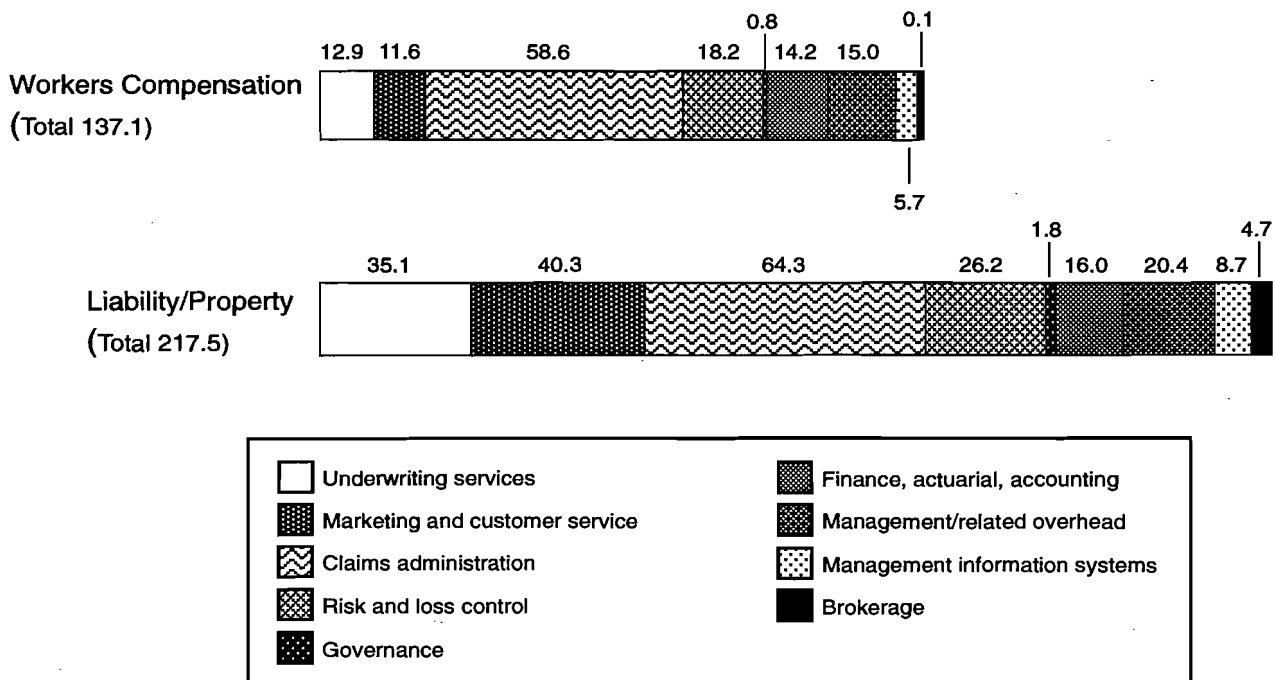
SEMTO contains two sets of industry benchmarks. First, a property/casualty insurance company benchmark is derived, using data from P/C insurance industry companies; second, a benchmark from the peer group of municipal trusts is developed. In most cases, the following benchmark statistics are calculated and displayed for comparison purposes:

- **Name of Trust** - The statistic for the individual municipal trust
- **Two Lowest Participants** - Average statistic of participants with two lowest results (lower quartile)
- **SEMTO** - A straight line average of all eight participating trusts
- **Two Highest Participants** - Average statistic of participants with two highest results (upper quartile).

The following list illustrates some of the more important SEMTO benchmark statistics.

- The cost of each functional area (as a percentage of contributions)
- Staffing levels (in terms of FTEs assigned to each functional area)

Figure 3
Full Time Equivalent (FTEs) per \$100 Million of Gross Contributions*



* All SEMTO participants combined

SEMTO provides an analysis of the expense component of each contribution dollar.

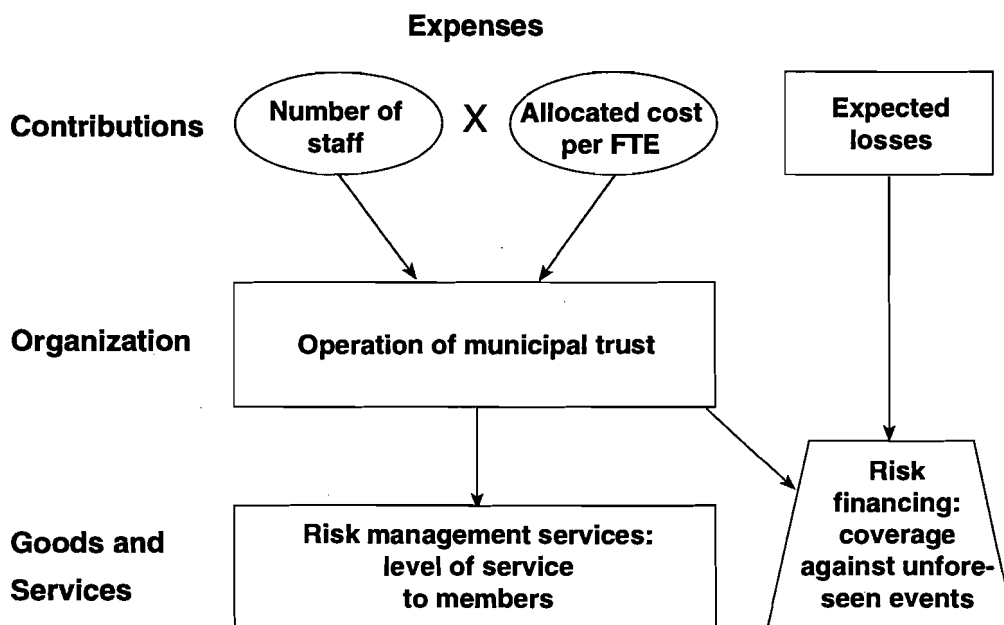
The typical structure of a municipal trust is illustrated in **Figure 1**. A municipal trust organization receives member contributions, which fund expected losses and the expenses of running the organization. In exchange, municipal trusts provide economic benefits in the form of risk management services and risk financing to members. SEMTO concentrates on the measurement of operational efficiency of municipal trust organizations in providing these services. In other words, SEMTO provides an analysis of the expense component of each contribution dollar.

Municipal trusts need help in determining best practices regarding target levels of expenses and the optimum level of service for members. Until now, the financial statements of comparable municipal trusts represent the only available basis for comparison, but the level

of detail in these financial statements is insufficient for this purpose in many vital areas.

The SEMTO benchmarks are designed to assist management by indicating where attention may be warranted and where opportunities for improvement exist. SEMTO develops expense and staffing information that enables management to perform an organizational self-analysis, based on peer group comparisons. Often, this analysis also helps management to determine elements that fall outside of municipal trust norms and gain insight into the possible reasons for particular results. But this quantitative analysis is only a starting point. Qualitative analysis is also necessary to determine why certain expenses fall outside the norm and what the best remedy might be.

Figure 1
Structure of a Municipal Trust



The 1993 SEMTO benchmarking study included eight participating municipal organizations. Each of these organizations sponsored at least two trusts, one for workers compensation and one for property/liability risks.³ Total gross contribution volume and expense dollars for all SEMTO participants combined are as follows:

| All SEMTO Participants Combined (\$ millions) | | |
|--|-------------------------------|-----------------|
| | Gross Contribution | Expenses |
| Workers Compensation | \$213.8 | \$20.0 |
| Liability/Property | \$136.0 | \$27.3 |

The Functional Template

The SEMTO benchmarking process starts by assembling all the financial, operational, and statistical information necessary to perform a thorough statistical analysis. To accomplish this, Towers Perrin developed a comprehensive survey form and accompanying instructions. One particularly noteworthy section of the form and instructions establishes operational definitions by functional area.

The functional template was constructed by identifying all the tasks associated with the operation of a municipal trust. A series of associated tasks was parcelled into a broad echelon known as a "functional area." Ten separate functional areas covering the range of municipal trust operations were identified. By emphasizing the

tasks in each functional area, the participants focused on making "apples-to-apples" comparisons. Ensuring consistency was not a simple matter, since internal budget data and external service provider contracts are constructed differently. In the future, participants may consider tracking data and constructing budgets in a format similar to that of the functional template.

The ten areas in the functional template are as follows:

- Underwriting services
- Marketing and customer service
- Claims administration (unallocated loss adjustment expense, or ULAE)
- Risk and loss control
- Governance
- Financial, actuarial, and accounting
- Management and related overhead
- Management information systems
- Brokerage
- League sponsorship fee.

SEMTO participants were instructed to complete a survey form from a functional — not an organizational — perspective. Participants were asked to identify the annual expenditures for each of the functional areas. Full-time equivalent (FTE) employee counts by functional area (including those associated with contracted services) were captured.

Frequently, municipal trusts depend on outside contractors to provide services for many of their day-to-day functions, although the extent to which individual trusts rely on outside contractors varies considerably. The potential cost savings of moving the various services currently provided by outside contractors

The potential cost savings of moving the various services currently provided by outside contractors in-house is an important consideration for many municipal trusts.

³ A minority of participating organizations had separate property and liability trusts, but in most situations these coverages were combined in a single trust. To ensure the most comprehensive database possible, any separate liability and property trusts were combined.

- Expense per FTE by functional area
- FTEs per \$100 million contribution
- The comparative cost of in-house versus contracted services
- Number of claims per claims administration FTE.
- What are the sources of the efficiencies enjoyed by premier municipal trusts? How can we match or beat them?
- To what extent do the premier municipal trusts gain advantages from their organizational structures or cultures? How can we close performance gaps in specific functional areas?

There are several other SEMTO statistics, and each municipal trust will have its own areas of particular interest. Municipal trust management needs to identify specific areas that can lead to a more efficient operation. Each individual SEMTO participant's report highlights any salient statistics outside of peer group norms.

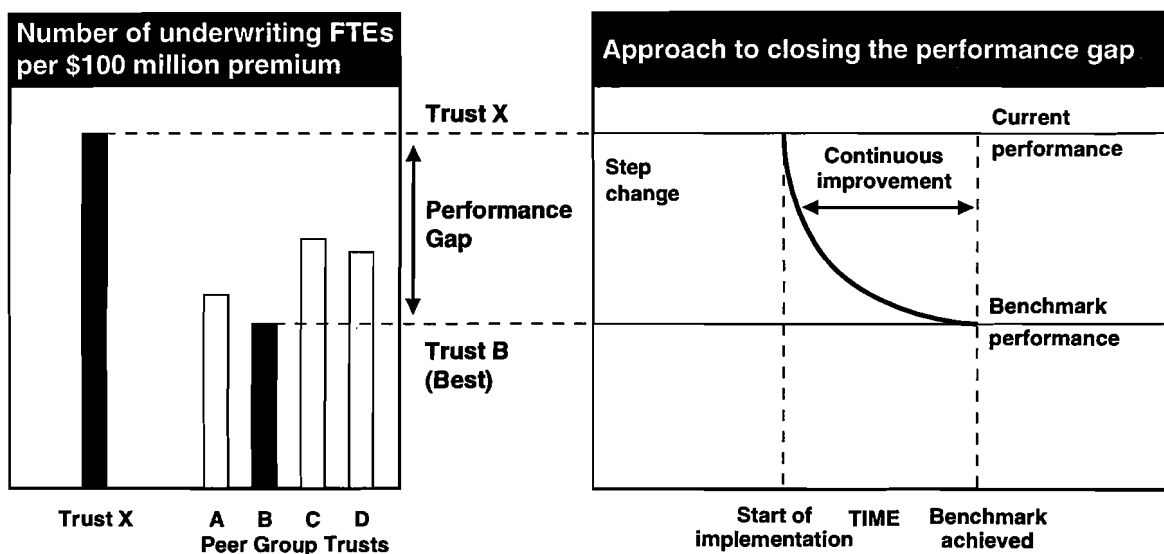
Using the SEMTO Results

To make best use of SEMTO, municipal trusts should look for answers to the following kinds of questions:

- What does it mean to be a "premier" municipal trust?

Figure 4 shows how a benchmark for a specific functional area can be used to set a performance improvement goal. This approach can be adapted to remedy a particular perceived performance gap. Municipal Trust X believes it can achieve the desired level of service in the underwriting functional area at the staff level of Municipal Trust B. Figure 4 shows the performance gap, represented by the difference between the current staffing level and the desired staffing level. An action plan is implemented designed to close the performance gap over a planned time period. At the end of this period, Municipal

Figure 4
Using Benchmarking to Close Performance Gaps



Trust X should be as efficient as the premier municipal trust in the underwriting functional area.

Conclusion

Individual municipal trusts are struggling to find norms against which to compare themselves in order to determine whether specific types of expenses and levels of service are in line with the industry, and whether investments in risk management functions are cost-effective. The SEMTO study was developed to address a need identified by many municipal trusts (or pools) that has not been formally addressed by the industry.

The successful municipal trusts of the future will be those that are acutely sensitive to their competitive strengths and weaknesses and can learn from—and overtake—the best of their peers. The SEMTO study provides a road map for continued progress towards each municipal trust's goal of providing value-added services to its members. ■

For more information on the Study of Expenses for Municipal Trust Operations (SEMTO), contact Brian Foley at (212) 351-4187 or Jenny Emery at (203) 843-7029.

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