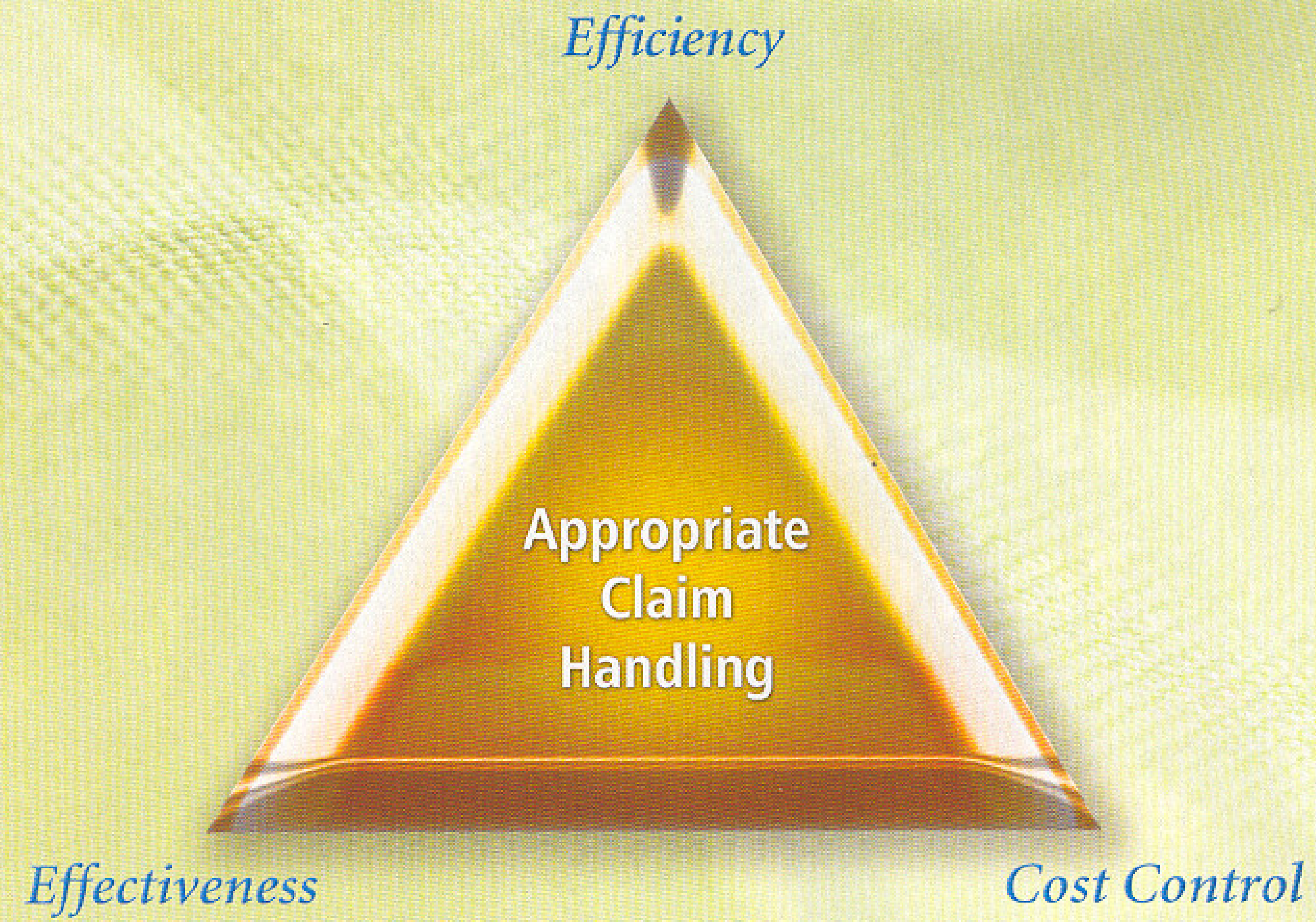

KEEPING SCORE:
Efficiency and Effectiveness in Claim Handling

BY DEAN K. HARRING

Performance measures are intended to encourage employees to behave in such a way that an organization's objectives are achieved. That being said, I have seen some claim performance measures recently that are of questionable value when viewed against the major objectives of any claim organization: managing total loss costs.

Typically, the measures are conceived by management staff outside the claim organization, such as the CEO, CFO, or COO, who develop them by wondering aloud about topics such as:

- When is Claims going to get expenses under control?
- Why can't Claims significantly reduce legal expenses?
- Why can't Claims increase productivity by 5 percent (or more) annually?
- Why can't Claims close cases more quickly?

I had never really understood why these folks felt comfortable setting performance measures for their claim organizations until I read an article about Daniel Kahneman, the 2002 Nobel Prize winner in Economics, and what he describes as System 1 and System 2 thinking.

Let's test your system thinking: A baseball bat and a ball cost $1.10. The bat costs $1 more than the ball. How much is the ball?

Many people answer, "10 cents," without hesitation, although the correct answer is five cents. Why? Because they use what experts like Kahneman call System 1 thinking, or intuition. They consider the problem, it looks like a no-brainer, and they apply a style of thinking that is fast, effortless, and emotional to solve it. Unfortunately, System 1 thinking can provide the wrong answer when a problem is more complex or convoluted than it appears to be.

If the same people are told, when the baseball and bat problem is posed, that it is complicated, System 2 thinking (reasoning) likely would kick in. They would consider the question carefully, consciously, and deliberately before coming up with an answer. Most would get it correct.

New Challenges

Claim handling is a complicated business. Claim executives today must confront a wide range of operating challenges, but one of the most nettlesome involves ill advised or inappropriate performance measures because of the impact that they can have on operational behavior.

Consider the difference between efficiency and effectiveness. An efficient process minimizes waste, expense, and effort. An effective process produces a desired outcome. What is more important in a claim operation, efficiency or effectiveness? Somehow, as an indicator of claim success, efficiency has emerged as more popular and prevalent than effectiveness. As a result, claim performance goals tend to focus on expense control and production efficiency, rather than on claim outcomes and total loss costs. How could that happen?

For those without a good understanding of what is involved in managing loss costs, it happens quite easily. It is a classic System 1 solution. Efficiency sounds important, it is simple to measure and, emotionally, productivity should increase and expenses should always be controlled, right? The problem is that any performance standard tied to only one component of a complicated process is incomplete by definition, and may do more harm than good.

Take the case of "chicken efficiency," described in Mark Brown's book *Keeping Score.* Managers at a fast-food chain were compensated based upon their abilities to minimize the amount of chicken discarded when the store closed each evening. How did the managers react? Toward the end of the evening, they cooked chicken only after it was ordered. Customers began to complain about how long they had to wait to get their meals. The stores had unhappy customers and they were losing business, but the managers were hitting their efficiency targets.

It is the same story in a claim department. Faced with objectives dominated by efficiency and expense control, claim managers are likely to do whatever is necessary to limit expenses and increase claim closings. They will hold vacancies, increase workloads, launch settlement operations, limit the use of vendors, avoid litigation, and otherwise make their departments appear more efficient by increasing production (claim closings) while holding costs down. They will control expenses, but total loss costs may increase as a result. They will hit their targets, but will likely fail to do what they are supposed to be doing: managing total loss costs.

So what should be measured? Let's approach the question using System 2 thinking. Claim organizations exist to manage loss costs. After all, as the old story goes, if loss costs could manage themselves, insurers would send out a blank check with every policy and let insureds fill them in when losses occurs.

Loss costs have three major components: unallocated expenses (salaries, rent, etc.), allocated expenses (outside attorneys and appraisers, etc.), and loss dollars paid to insureds or third parties. As to the relative dollar cost of each component, at most companies, the expenses stack graphically into a triangle. The top of the triangle (the smallest part) represents unallocated expense, the middle represents allocated expense, and

FIGURE 1

CATEGORY	POSSIBLE MEASURES
Loss Cost Management	• Loss cost leakage • Allocated unit costs • Unallocated unit costs • Subrogation recovery • Staffing (adherence to staffing model) • Impact of cost containment programs
Production and Inventory Management	• Closing ratio • Cycle time • Aged pending distribution • Reopening ratio
Relationship Management	• Satisfaction levels (agents, customers, underwriters) • Vendor sourcing and management • Regulatory compliance
Knowledge Management and Communication	• Timeliness and effectiveness of communication with underwriters, risk control, actuaries, regulators, and rating agencies. • Reserve adequacy and accuracy
Capital Management (Human, Information, and Organization Capital)	• Culture • Data accuracy and reliability • Employee retention • Promotions from within • Employee commitment

the bottom represents loss dollars paid.

Managing loss costs means managing all three components in the loss cost triangle and, therefore, appropriate performance measures must address all three components. The components are interrelated so, for example, fewer dollars spent on unallocated expense may translate into more dollars in allocated or loss expenses. Fewer dollars spent on legal defense may increase loss dollars paid to third parties. If the challenge is to manage total loss costs, a claim manager needs to incur the most effective combination of unallocated and allocated expenses in order to produce the most appropriate level of loss payments to insureds and third parties.

Loss Payments

What is the most effective level of expense? Because expenses are incurred to generate the most appropriate level of loss payments, let's look at loss payments first. The best gauge of appropriateness of loss payments that I have seen is the degree of loss cost leakage (loss dollars paid in error due to breakdowns in claim handling) identified through reviews of closed claim files. Loss cost leakage, expressed as a percentage of loss dollars paid, tells the story of how effective an organization is at managing loss costs by providing an answer to the question, "Are we paying the correct amount on claims?" According to the experts, best-

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in-class companies operate with loss cost leakage levels of less than 5 percent.

In 2000, Deutsche Bank Alex Brown released a white paper, *The Insufferable $23 Billion Property Casualty Claim Process*. The paper suggested that claim organizations struggle with the balance between efficiency and decision-making intelligence. The authors concluded that too much efficiency in a claim organization can lead to poor decisions and higher loss and expense. In other words, the answer is not efficiency, it is efficiency *and* effectiveness.

If the loss cost leakage number is a good indication of loss cost management effectiveness, the most effective level of expense is that which minimizes the loss cost leakage number while allowing the operation to meet customer needs and comply with regulatory requirements. An organization operating with leakage in the 10 percent range, for example, has problems. Maybe workloads are out of whack, or staff is not sufficiently trained, or the most appropriate practices are not in place, or claims are being overpaid to avoid litigation, or claims are not being investigated in order to save allocated expense. Whatever the reason, the high leakage number says that the operation is not effective, so performance goals aimed at increasing efficiency are not appropriate. Instead, it may be necessary to invest (incur additional expense) in the organization to get it to an acceptable level of effectiveness.

In a claim department, the time to focus on gaining efficiency is after effectiveness has been demonstrated. After all, why strive to become more efficient at something you are not doing effectively in the first place? If a claim organization is operating with loss cost leakage levels below 5 percent, it makes sense to become more efficient at doing the things that are generating the low loss cost leakage numbers. How? The usual change levers are people, process, and technology.

People Russ Rogers, a professor at DePaul University in Chicago, defines organization effectiveness as the degree to which ability and willingness are engaged such that goals are accomplished. The most effective people, then, are those who have the right combination of knowledge, skill, and will to perform.

Once the right people are employed in the right jobs, and they are performing effectively, how do you enable them to become more efficient? How do you make it possible for them to resolve more claims per month than they have been resolving, with no loss of effectiveness? Usually, through improvements in process and support from technology.

Process A process may be effective, producing the desired results, but there always is a chance that it could be simplified, strengthened, or, perhaps, even performed at lower cost, either internally or by someone outside the organization. That being said, business process improvement generally is not something that most people dream of doing. In his book about IBM, *Who Says Elephants Can't Dance?*, Lou Gerstner describes reengineering as difficult, boring, and painful. "It's like starting a fire on your head and putting it out with a hammer," he wrote. It is a compelling image, but his point that re-engineering produces self-inflicted pain is a good one. Process improvement requires a willingness to implement disruptive change.

A good example of disruptive change within claims is the movement, over the past many years, toward claim centers that specialize in high-frequency, low-complexity claims. The premise was simple: segment incoming claims based upon complexity, exposure, and service intensity, and direct the low-complexity claims (almost 70 percent of the claims at many commercial companies) to an operation staffed with lower cost, entry-level claim staff trained specifically to handle those claims.

The result was lots of pain, resistance, and disruption initially, but the payback for the companies that made the leap came in the form of significantly lower unit costs of claim handling on a major segment of their incoming claim volume, with no increase in loss cost leakage. In other words, gains in efficiency with no loss of effectiveness.

Technology If applied correctly, technology can help streamline the claim-handling process, lower costs, support better decision making, improve data accuracy, and increase productivity. Automatic diary systems, business rules that prompt claim handlers to perform tasks, automated fraud and recovery screening, event tracking, and easier interactions with vendors not only free up time, they also help claim handlers minimize loss cost leakage.

The point is that it takes investment and creative changes in people, processes, or technology to produce genuine, sustainable improvement in claim-handling efficiency. In the absence of such investment and creativity, performance measures tied to increased efficiency will produce fake efficiencies. Managers make short term moves to make their operations appear more efficient, but the improvement is neither sustainable nor permanent, and the moves may adversely affect total loss cost management effectiveness.

Measures of claim performance ought to take a balanced look at the entire claim-handling process, although they can be weighted to focus on key strategic objectives. Measurement categories should be tied to the critical processes within the claim department that help the organization deliver on its value proposition to customers. Some examples are shown in Figure 1.

Obviously, it is not easy to establish performance measures in some of these categories. Beware of the trap that awaits, however. We often assume that things that can be measured are important, and those that cannot are not important. Einstein said, "Not everything that can be counted counts, and not everything that counts can be counted."

Measurability is not a reliable indicator of significance. If it is a critical process, it can be measured, although developing such measures will require System 2 thinking. The payback is the establishment of performance measures that actually encourage employees to behave in such a way that organizational objectives are achieved. ▲

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