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How to price in a recession

Recession working party:

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Simon Black
James Hillon
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Introduction

- History
- Implications
- Observations
- Discussion

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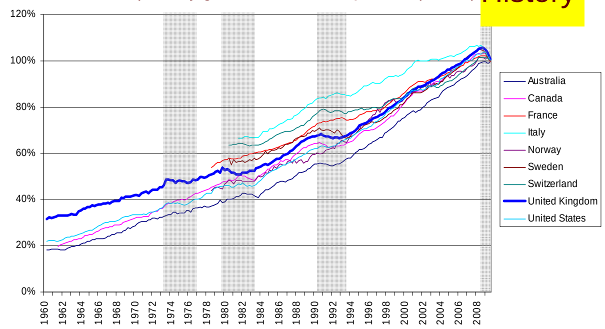
History

Cumulative quarterly growth indexed on Q2 2009 (OECD)



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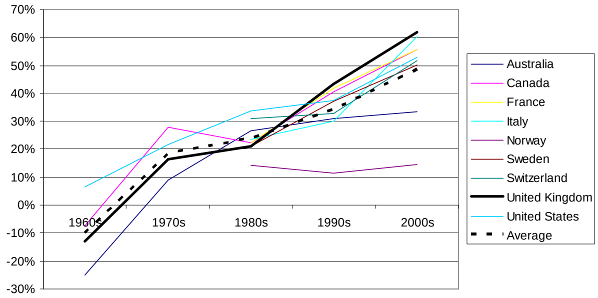
Un-weighted average correlations of quarterly growth by decade (OECD)



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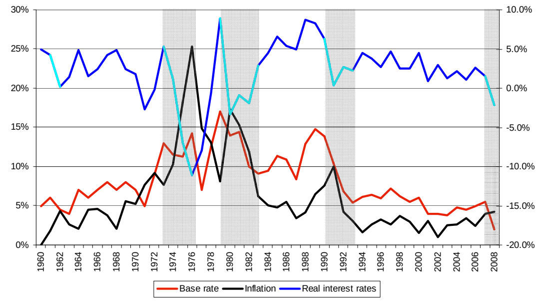
UK economic measures



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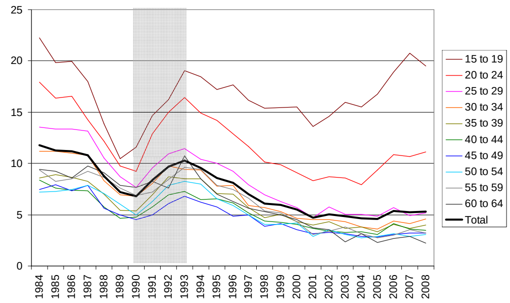
UK unemployment rate in workforce by age (OECD)



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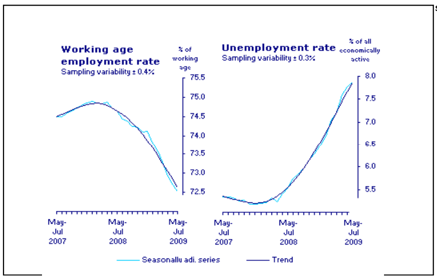
UK Employment & Unemployment Rate 2007 - 2009



Source: Office for National Statistics (Published on 15/08//2009)

UK unemployment hits 14-year high of 2.47min September 2009

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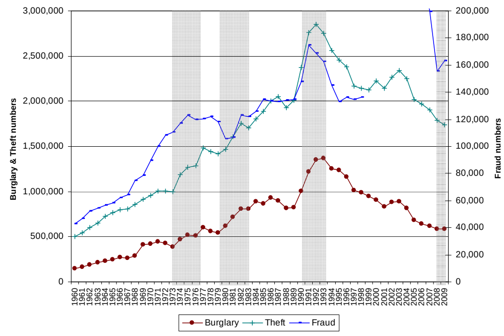
UK reported crime 1960-2008



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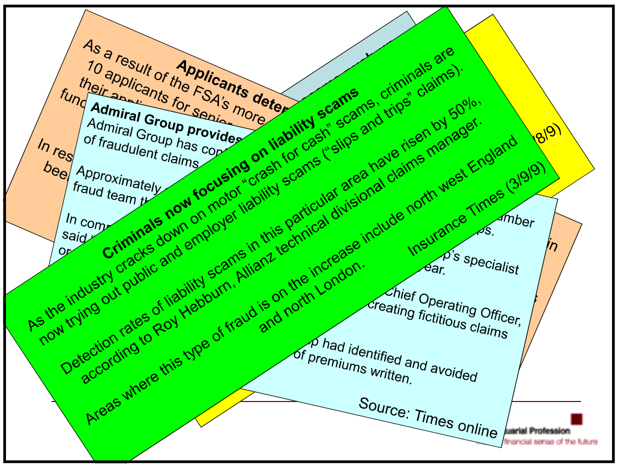

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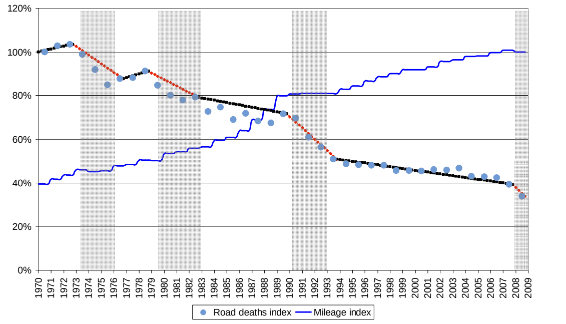
GB road deaths and total annual mileage (GB Road Transport Statistics)



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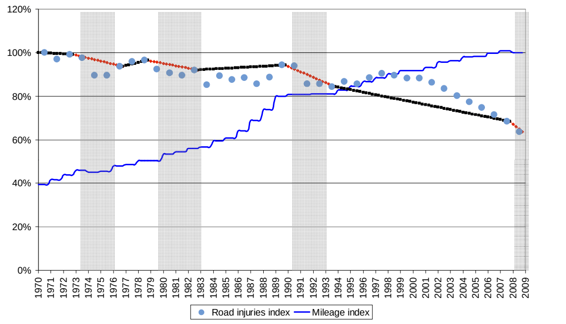
GB road injuries and total annual mileage (GB Road Transport Statistics)



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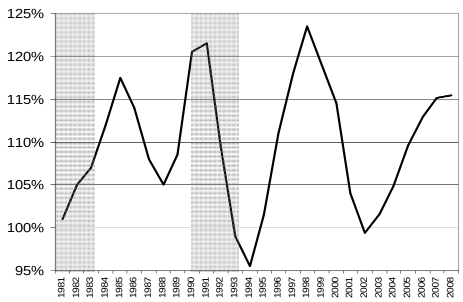
Accident year COR% UK personal motor



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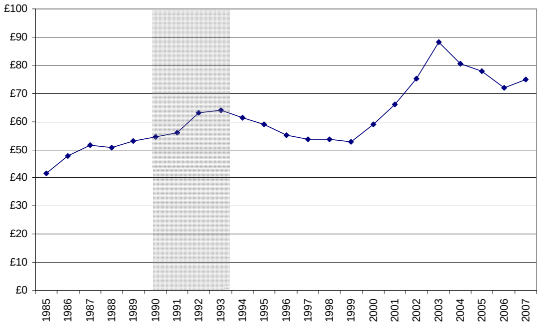
UK non-life premiums (£bn in 2008 £ terms) (OECD)



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Why this recession is unlike the last one for non-life? (2008 money terms)

Additional insurance claims leading into the recession:

- 1990 storms ~ £3bn
- Subsidence 1989-91 ~ £2bn
- Mortgage Indemnity ~ 600,000 repossessions 1990-93 ~ £3bn

- Additional losses of around 12% of one year's GWP
- Last time 40% of additional claims were not recession linked

Sources: Council of mortgage lenders, Article by Palutikof, National statistics

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History - key messages

- Initial insurance conditions have considerable impact
- Last time GWP held up
- UK increasingly correlated to world economy
- Moral hazard increases
- Threat of prolonged deflation
- Not just the usual suspects

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Implications

- Consumer behaviour
- Capital availability and target return
- Claims costs
- Investment market
- Competitor strategies and appetite for risk
- Stakeholders e.g. colleagues, regulator, suppliers etc.

Implications

Consumer behaviour
- Household / business budgets under pressure
- Add-ons
- Reduced mileage
- Non-disclosure at point of sale
- Commercial risk management

Claim cost
- Higher unemployment / budgets under pressure
- Lower inflation
- Less upkeep on properties
- Lower business profits
- Disconnect between exposure measures and underlying risk

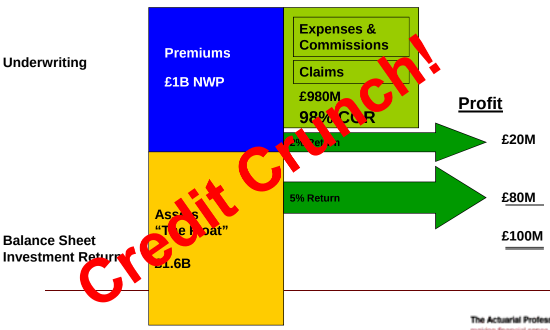
Investment markets
- Cash / near-cash assets yielding near zero
- Dividends cut & reduced / stagnant equity values
- Increased incidence of corporate bond default
- Low inflation / interest environment

Other stakeholders
- Suppliers
- Regulators
- Colleagues

Competitor strategy
- Tough decisions to be made
- Starting from a different place
- In a dynamic market the implications of any decision could be profound

Capital availability
- Damaged balance sheets
- Depends on requirement to rebuild solvency
- Access to capital reduced…is boring good?
- Solvency II implications.

How do we make money?



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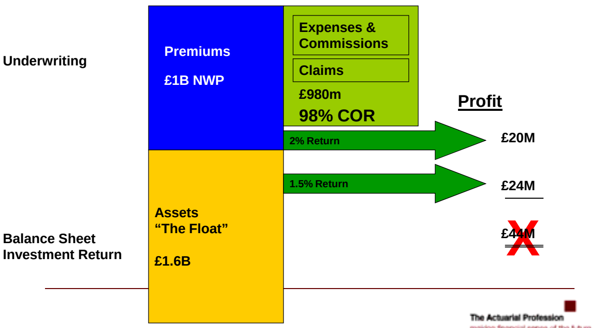

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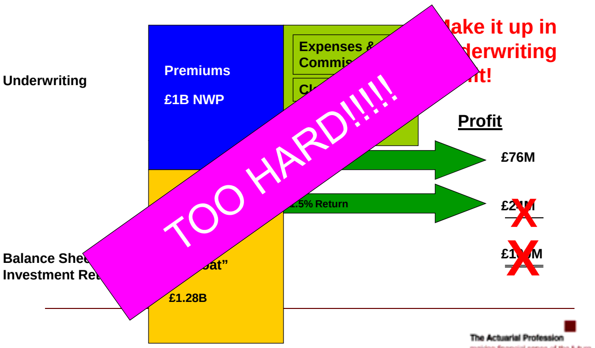

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Three strategies will be seen in the market

"Back to basics" Risk / Return pricing	"Shareholder focus" Return on capital	"Recovery" Rebuild capital base
▪Technical pricing lead ▪Prices to long term required level ▪Underwriting risk management ▪Consider growth opportunities on risk / return basis ▪Shrink unprofitable underwriting areas ▪Continued risk tolerance	▪Increased short term thinking delivering improvements to 2009 annual accounts ▪Significant, targeted price rises above long term requirements ▪Reduced risk tolerance ▪Reserve releases ▪ROC performance against other insurers key	▪Prices up arbitrarily across board ▪Hope that rest of industry does the same ▪Reduced risk tolerance ▪No growth considered and will contract if large profit margin unachievable ▪Capital raising considered ▪Asset sale considered

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Implications for us

Understand exposure:
- MI essential to spot trends early
- Review feedback mechanisms……and take action
- Consequences of exposure measures
- Underwriting fraud

Think about targets
- Corporate ROE target
- Competitors under different pressures

Claims management:
- Fraud detection
- Cash settlement vs supply chain
- Commercial – reduced settlement for cash
- Review claims ethos
- Rebalance resource cost against indemnity spend

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Implications for us

Consumer dynamics:
- Price optimisation - balance margin and volume
- Care needed if chasing excess return
- Clear opportunities

Pricing & underwriting:
- Back to fundamentals
- Increased sophistication
- Fraud prevention of increased importance
- More dependence on "good" judgement

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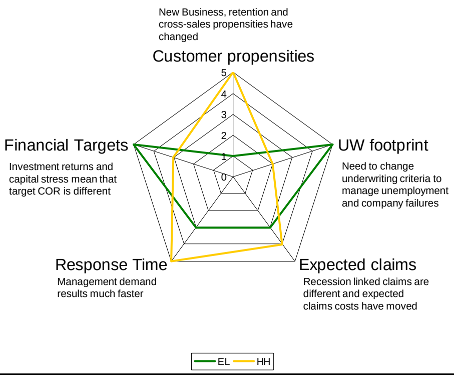
Prioritisation Web



Implications - key messages

- Investment landscape has put real pressure on COR
- Financial targets will diverge creating competitive advantage
- Difficult trade off between short and long term considerations
- Upward pressure on rates
- Customers more promiscuous – aggregator facilitated
- Challenge to the broker consolidation model
- Back to fundamentals – then build on it
- Need to refresh propensity models…rely less on history
- Rely less on proxies - think hard about the risk
- Opportunity for innovation – product, pricing and underwriting
- Demands on pricing increased, timescales reduced

Culture

Observations

- Volatility/unreasonableness of targets
- Patience in short supply
- Risk appetite – board structures, nationalised banks/insurers
- Risk directors making their presence felt
- Short-term vs long term - knee jerk prices vs sophistication
- Reputational risks – for the company/profession?
- Resource constraints, more expected in shorter time frames from pricing
- Closer scrutiny from regulators
- We will need to think differently under Solvency II

International

- Rationale for cross border expansion has changed
- Fire sales may create opportunities
- Exchange rates
  - Fluctuations distort reported profits
  - Claim costs in Euros, premiums in local currency
- Fraud
  - Different cultures have varying attitudes to fraud so if we think fraud will increase in a recession then the rate of increase will vary from country to country
- Multinational insurers need to treat each territory separately

Overall - key messages

- Initial insurance conditions have considerable impact
- Last time GWP held up
- UK increasingly correlated to world economy
- Moral hazard increases
- Threat of prolonged deflation
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- Investment landscape has put real pressure on COR
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You only find out who's been swimming naked when the tide goes out

Warren Buffett

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Questions for you - discuss

1. Should actuarial science or underwriting art take the lead in pricing?
2. How do actuaries communicate the dangers of short-termism?
3. Who's been swimming naked?
4. Is insurance recession proof?
5. Is deflation good for insurance?
6. Will multiple rating structures undermine decisive rating action?
7. Does recession really drive innovation?

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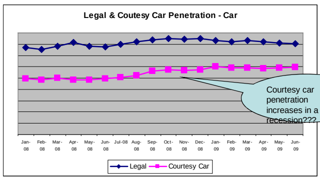
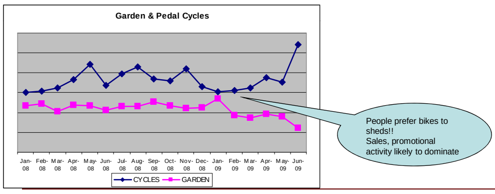
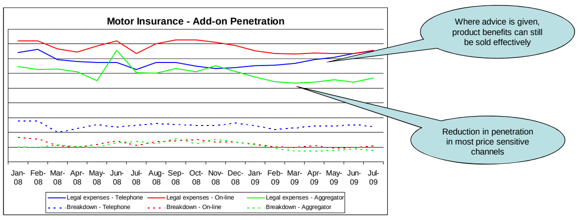
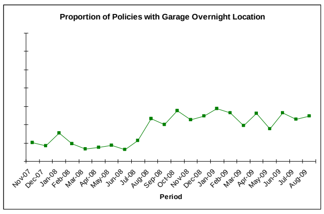
Appendix

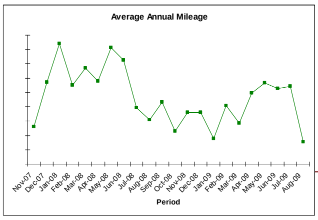
- Add-on penetration
- Commercial trends
- Implications - detail
- So what do we do - detail





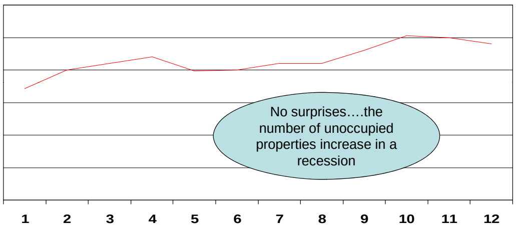






Evidence of non-disclosure?

Unoccupied Properties



Implications for product design and pricing…the detail

Consumer behaviour	Capital availability and target return	Claims costs
Investment market	Competitor strategies and appetite for risk	Stakeholders e.g. colleagues, regulator, suppliers etc.

Impact on consumer behaviour

Effect	Implication
Household budgets under pressure	▪Increased shopping around – aggressive advertising by aggregators leveraging demand for reduced prices ▪Un-insurance levels increase ▪Lower product sales (particularly warranty) ▪Lower incidence of subsidence claims ▪Average vehicle age of portfolio increasing
Business budgets under pressure – lower levels of capital investment	▪Assets mothballed or laid up ▪Commercial vehicle and fleet ▪Increased levels of self-insurance ▪More use of captives ▪Lower retention levels due to increased insolvency levels ▪Reduced fees (Surveyors, Solicitors etc.) could mean lower PI premiums ▪Reduce profits effect BI revenues
Reduced mileage	▪Lower exposure to risk (personal lines) ▪Lower exposure to risk (fleet and commercial vehicle)
Non-disclosure at point of sale	▪Increased importance of fraud detection techniques (claims <u>and</u> front-end underwriting)

Impact on claims costs

Effect	Implication

Higher unemployment / budgets under pressure	▪ Increased frequency of
	  ▪ Theft - largely opportunistic
	  ▪ Arson
	  ▪ Payment protection claims – dump cars
	  ▪ Fraud
	  ▪ Fabricated / exaggerated claims
	  ▪ Staged accidents
	  ▪ Small claims
	  ▪ Professional indemnity claims
	  ▪ Fidelity Guarantee/Employee Dishonesty claims
	▪ Homes more likely to be occupied during the day – reduces theft / fire risk
	▪ Increased commercial property un-occupancy
	▪ Increased preference for periodic payments

Lower inflation / car prices	▪ Replacement cost of items (e.g. white goods) lower – subject to supply chain contract! ▪ Salvage values falling ▪ Lower wage inflation
Lower repairs / up-keep on properties	▪ Increased incidence of water claims ▪ More wear and tear repudiations
Lower business profits	▪ Increased Fidelity Guarantee/Employee Dishonesty claims ▪ Value of assets lower - commercial claims cost reduced ▪ Business failures - increase D&O claims ▪ Increased litigation - effect on PI claims ▪ Reduction in spend on Risk Management

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Impact on investment market

Effect	Implication

Cash / near-cash assets yielding near zero	▪ Depends on investment portfolios and degree to which investment return is critical to overall performance
	  ▪ Cash / near-cash unaffected by asset price crash and may benefit from competitor flight to safety
	  ▪ Bonds relatively unaffected to date but default risk increasing. Much depends on credit rating of individual holdings
	  ▪ Equities clearly suffered most from falling asset prices. Long term outlook depends on pressure to sell related to cash flow and risk appetite of Board to "ride out the storm"

Dividends cut & reduced / stagnant equity values	
Increased incidence of corporate bond default	
Low inflation / interest environment	▪ Overall yields lower than assumed than in pricing model ▪ Lower inflation in staff costs / other direct costs ▪ Downside risk to Ogden discount rate / increased likelihood of periodic payment settlements

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Implications for other stakeholders

Stakeholder	Implication

Suppliers	▪ Re-negotiate terms versus putting them out of business
	▪ Risk of third party suppliers ceasing trading - more serious than in the past due to extensive outsource arrangements
	  ▪ Customer facing
	  ▪ Software / systems
	▪ Credit risk on reinsurers or premium credit

Regulator	▪ Regulator under increased scrutiny ▪ Legislation / intensity of focus only going to increase ▪ Solvency II?
Colleagues	▪ Morale low ▪ Staff turnover lower through fewer job opportunities – lower recruitment costs and increased level of experience

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Implications on competitor strategy…detail

- Insurers making difficult decisions
  - price, product, target markets, ROE targets and repairing balance sheets
- Everyone starting from a different place and doing things differently
  - Some have less balance sheet / ROE pressure
  - New entrants are well placed IF they can raise capital (contrast rapid growth of Direct Line in 1990s)
- In such a dynamic market the implications of any decision could be profound

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So, what do we do about all this…?

1. Understand your exposure:

- MI essential to spot trends early
  - Internal - customer mix / claims….
  - External – male < 25 unemployment rate / GDP….
- Review feedback mechanisms……and take action
  - Distribution channels / consumer buying behaviour / purchase objections
  - Claims management - peril trends / fraudulent claims
- Consequences of exposure measures
  - Wage roll / turnover / hull and properly values
  - Is it a “true” measure of exposure?
  - SI values when index linking indices go negative?

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So, what do we do about all this…?

2. Think about your targets:

- Corporate ROE target
  - Increasing to offset pressures elsewhere?
  - Implications of short-termism on existing customer base – aggregators make this time around different
- Competitors are under different pressures

3. Claims management:

- Fraud detection
- Review whether risk mis-declared
- Cash settlement Vs supply chain
- Commercial – reduced settlement for cash

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So, what do we do about all this…?

4. Consumer dynamics:

- Upwards pressure on rates - claims / investment outlook
  - Risk losing customers to competitors / un-insurance
  - Balance cost of acquisition of new customers (high, even in current environment) Vs. risk of existing customers leaving
  - Aggregator proposition forcing prices down
- Price optimisation - balance margin and volume
- Care needed if chasing excess return
- Clear opportunities
  - Price, strip products down, increase excesses, add new covers
  - Heightened need to communicate product / cover changes
  - Innovative product design - telematics, optional perils, multi-year guarantees
  - Flight to reduced underwriting risk - less competition in some areas
  - New entrants - no legacy claims / system issues but need capital!!
  - Recession proof trades - pawn brokers, pizza delivery, debt counselling
  - Leverage Government investment in infrastructure projects

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So, what do we do about all this…?

5. Pricing & underwriting:

- Back to basics
  - Postcode reviews may have been deferred for some time and / or focused on natural perils
    - Geographic risk from current recession may differ from previous recessions (white collar Vs blue collar)
  - Make sure underwriting footprint is consistent with risk appetite
  - Relativities – to change or not to change?
    - More pragmatism - only got 6 months data how do you use it?
    - More sophistication – cleverer / better ways
- Increased sophistication
  - Price optimisation / Credit scoring
  - Factors that reduce emphasis on rating factors open to non-disclosure – data validation
- Fraud detection of increased importance
  - At point of sale given non-disclosure risk e.g. links to CUE etc.

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