

Price Monitoring for Commercial Insurers

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Agenda

- Governance Issues
- Practical Pricing Issues Faced
- Traditional Approaches
- Alternative Framework

Governance Issues

- Risk Management
- Underwriting Cycle
- Solvency II Pillar 3
- Lloyds' Directive

Lloyds' Expectations

- Transparent pricing policy.
- Price Charged v Book Price.
- Expiring Premium v Renewal Premium.
- Guidelines on price movement categories.
- Price Movements recorded by Underwriters.
- Ability to assess the impact that pricing movements and new business have on the loss ratios.
- Director responsible needs to be appointed

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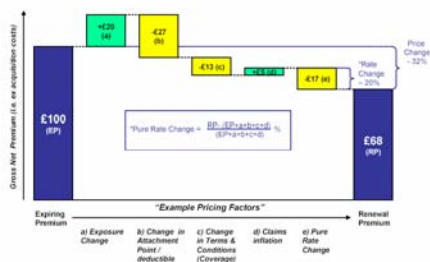
Practical Pricing Issues

- Not all information captured on systems
- Rate books do not adequately explain prices charged
- Much of the company's "intellectual capital" lies with the senior underwriters and this is lost if they move.
- Limited basis from which to measure rate adequacy
- Limited basis to calculate Technical Rates.

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Traditional Approaches

Identifying "Pure Rate Change" for an Individual Renewal

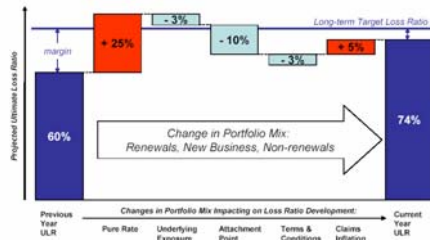


Source - Lloyds Market Bulletin Y3318 (May 2004)

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Traditional Approaches

Mapping Change in Portfolio Loss Ratio



Source – Lloyds Market Bulletin Y3318 (May 2004)

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Weaknesses in Traditional Approaches

- Reconciles premium from one year to the next.
- Factors tend not to be justified.
- Highly judgmental – does not act as a governance mechanism over the pricing structure.
- Only works on renewing business
- Only attempts to measure changes in rate adequacy – does not solve any of the other issues.

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Alternative Governance Framework - Objectives

- Obtain operational buy-in.
- Allow some of the “Intellectual Capital” to be captured and analysed.
- Effective for renewal and new business.
- Deliver management information to benefit most functions of the business.
- Allow insight towards Technical Rating.
- Flexible for additional uses.

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Alternative Governance Framework - Warnings

- There is NO quick fix.
- There is NO “off the shelf” solution.
- Time needed to capture relevant data.
- Management Information quality will improve over time.
- Implementation will need to be in a staged process.
- Underwriter “buy-in” will develop as information back to underwriter improves.

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Alternative Governance Framework – Staged Implementation

- Stage 1 – Rating Factor Collection
- Stage 2 – Build MI Reports
- Stage 3 – Build Rating Model
- Stage 4 – Rate Adequacy Review
- Stage 5 – Technical Rates
- Stage 6 – Additional Options

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Stage 1 – Rating Factors

- Factors used in Premium Setting
 - Rate Books
 - Survey of Underwriters
- Factors used in Risk Assessment
 - Underwriting Guidelines
 - Survey of Underwriters
- Identify all major T&C
 - Review of Standard Contracts
 - Survey of Underwriters

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Stage 1 – Rating Factor System

- Design system which captures -
 - Pricing Factors
 - Risk Assessment Factors
 - Variable T&C
 - Financial Information (Commissions, Taxes, Premiums etc.)
- System would provide underwriter with feedback on the range of premiums charged for a similar risk.
- Can be undertaken immediately.

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Stage 2 – Build MI Reports

- Designed immediately.
- Data will take time to be available.
- Assess things such as:-
 - Rate Adequacy Movements
 - Retention
 - Hit Rates
 - Performance/Claims Activity
 - T&C trends
- Reports should be at a high level and down to individual rating factor.

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Stage 3 – Build Rating Model

- Analysis of collected data
- Rating algorithm describing current rates and practices.
- Does not comment on Rate Adequacy.
- Not Technical Pricing Model.
- Starts to capture the “Intellectual Capital”.
- Draws a “line in the sand” for future analysis.
- Historic price indication can be given to underwriters.
- Can be performed after the first renewal period.

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Stage 4 – Rate Adequacy Review

- Analyse changes in Rate Adequacy.
 - Understand the change in Rate Adequacy.
 - Understand how this is occurring, e.g. Changes in T&C, changes in limits, changes in general rate levels.
- Analyse areas in the rating structure that are most being impacted by market changes.
 - Is it isolated to specific risk characteristics?
- Allow company to have a pro-active response.
- Analysis would tend to be performed leading up to the 2nd major renewal.
- True premium movement from the previous year would automatically be calculated (including new business).

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Stage 5 – Technical Rates

Commercial Insurance is:-

- Highly Volatile – low volume, high average cost.
- Susceptible to large claims and events.
- Difficult to segment – metal works factories are not all the same.
- Claims handling considerations and T&C cover can vary substantially.

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Stage 5 – Technical Rates

Current Statistical Methodologies used in Personal Lines are not necessarily applicable to Commercial Insurance.

We do **not** advocate solely using Statistical Models to rate Commercial Insurance products.

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Stage 5 – Technical Rates

- Full Technical Review requires a number of years of claim experience.
- Suggested Timeline:
 - Year 1 – Identify clear weaknesses in the current premium rating structure from emerging experience. Discuss weaknesses and agree action.
 - Year 2 – Analyse experience using traditional one-way or two-way analysis. Develop a first-cut of technical rates by using credibility methods (e.g. Bridgstock Method).
 - Year 3 – Full statistically based technical rate review could be performed for some classes.
- Provide Underwriters with clearer estimates of Rate Adequacy as they assess risks.

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Stage 6 – Additional Options

- Allocation of Capital to individual risks.
- Development of capital budgets and profit maximisation.
- Redesign underwriter performance measurement – not based on profit.
- Shift underwriting decisions to more junior staff in areas where the model has low volatility.

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