INSTITUTE AND FACULTY OF ACTUARIES

EXAMINERS’ REPORT

September 2014 examinations

Subject SA3 – General Insurance Specialist Applications

Introduction

The Examiners’ Report is written by the Principal Examiner with the aim of helping candidates, both those who are sitting the examination for the first time and using past papers as a revision aid and also those who have previously failed the subject.

The Examiners are charged by Council with examining the published syllabus. The Examiners have access to the Core Reading, which is designed to interpret the syllabus, and will generally base questions around it but are not required to examine the content of Core Reading specifically or exclusively.

For numerical questions the Examiners’ preferred approach to the solution is reproduced in this report; other valid approaches are given appropriate credit. For essay-style questions, particularly the open-ended questions in the later subjects, the report may contain more points than the Examiners will expect from a solution that scores full marks.

The report is written based on the legislative and regulatory context at the date the examination was set. Candidates should take into account the possibility that circumstances may have changed if using these reports for revision.

F Layton
Chairman of the Board of Examiners

December 2014

General comments on Subject SA3

Consistent with previous examiners' reports, we would offer candidates two key pieces of advice – read the question properly and take the time to actually think about what is going on. Further to previous reports, we would stress that candidates do not need to score anywhere close to 100% to pass and there are significantly more points available for the majority of questions than there are marks. Time spent making sure that you are answering the question that is asked is therefore more valuable than a panicked rush to put down as many points as possible, regardless of whether they are relevant.

On the first issue, candidates should always work on the assumption that the question wording has been carefully chosen. It is therefore essential to read the question properly.

If something is not asked for then candidates will waste valuable time writing answers that will gain no marks. These broader answers may be a logical next step to the question and so may be appropriate for candidates to discuss in a professional context. This is an exam however with a finite number of marks available and so the scope must necessarily be limited and specifically defined.

If a question does specifically mention something, candidates should also assume that there are definitely marks available for this aspect of the question. During the exam setting process, any content that is superfluous will have been removed. A clear implication of that is that if there are numbers provided in the question paper then there are marks available for comment and consideration of those numbers.

Wording of question sections should also be considered in the context of the position within the overall question. Where new question information is provided between sections, candidates should recognise that this information is specifically relevant to the following section or sections. When answering preceding question sections, candidates should not consider any subsequent information in their answers (although may cover similar ground).

Various examples from this paper of recurrent failure to read the question are below.

On the second issue, candidates should note that SA3 is the key paper at which we test candidates' broader thinking. This is generally the final paper before qualifying as a professional. We consider a capacity for broader thinking to be one of the best indicators of a candidate's suitability to act in a professional capacity once qualified.

As such we aim to design exam papers so that it is difficult to pass without displaying some capacity for independent and broad thinking, as well as to heavily reward instances where these skills are displayed. When reviewing past papers, candidates should assume that the marks available for generic points are substantially less than those awarded for the more challenging points that would be the mark of high quality professional insight in a practising actuary. Marks available for list items from bookwork are lower still.

Even among passing candidates, this capacity for broader thinking is not always in evidence. We strongly recommend that candidates step back and take the time to thoroughly think about what is actually going on in question situations proposed rather than simply considering numbers to be analysed with standard techniques. For example, candidates might stop to think about what claims actually are for a particular class of business, considering factors such as what actually causes the claim, who brings the claim, how it is dealt with once brought, what makes one claim small while another is substantial etc.

This more grounded, real world perspective will help candidates to consider such things as practical issues, stakeholders involved and their potentially diverging objectives, wider impacts, regulatory or ethical issues, inappropriateness of certain actuarial techniques for the specific situation, current economic or cyclical effects etc. This is likely to lead to significantly broader point generation (and indeed reflects the thought processes of the examiners in drafting the questions and solutions) and a more rounded understanding of the underlying risks and dynamics which should also be of value to candidates when dealing with different stakeholders in their professional life.

Again, some examples of this failure to think more widely on the current paper are below.

More generally, we would also advise candidates to employ basic exam techniques such as well structured answers and effective time management.

Comments on the September 2014 paper

In Q1, many candidates seemed to struggle to think through market dynamics, and gave answers that completely missed the concepts that consumers would simply switch to cheaper options if there was standardised flat rate coverage. This was most likely not helped by a failure to read the question with a number of candidates not picking up on the standardised flat rating elements in the earlier parts of the question.

As with any question where there is a significant amount of pre-amble text to give details on the situation, we cannot emphasise strongly enough how important it is for candidates to read that text properly and make sure they have understood it. The text will in most instances be carefully designed to set a scenario where a significant proportion of the generic answers one might give will be inappropriate to the situation.

In Q2, a relatively under examined area of the course was asked. Candidates who had comprehensively revised had the opportunity to score very well with the high bookwork content in this section, candidates who had spot revised clearly were at a loss with this topic. Many candidates failed to pick up the application based marks in the second half of the question, for example talking about reinsurance strategy rather than about the proposals & comments.

1 (i) Premiums will be lower (and so more affordable) for motorists currently paying above average premiums

Groups benefitting are likely to include young people, males, and people with poor claims experience (or other relevant examples)

Premiums will be higher (and so less affordable) for motorists currently paying below average premiums

Groups paying more are likely to include older people, females, and people with good claims experience (or other relevant examples)

It is unclear whether the groups paying higher premiums will find the new rates affordable

For example, older drivers who are on low incomes may not be able to afford higher premiums (or other relevant example)

It may be the case that most people pay premiums that are close to the average rate, with only a small number paying very high (or low) rates

In this case, the additional cost to the majority of subsidising the (high cost) majority will be low

It is therefore possible that the Minister is correct, and insuring a car will be affordable for all

The average premium rate may not be affordable to all (or even to most)

Affordability is affected by other factors including economic conditions, and no remotely reasonable rate may be affordable for certain people

Perhaps the level of bodily injury compensation in Motorland is too generous, and this is the reason for high premiums

Alternatively, perhaps the insurance sector is not competitive enough (or other possible reason)

The proposal is only to regulate motor bodily injury premiums, however property damage cover will still be risk rates

Many motorists will want to buy property damage insurance, as there is the potential for large claims to occur

Motorists being charged high motor bodily injury insurance premiums may also be charged high property damage insurance premiums, because many risk factors are common to both products

Because property damage insurance is risk rated, motor insurance may remain unaffordable for some.

Lack of flexibility may cause insurers to raise rates across the board, decreasing overall affordability.
. . . depending on the competitive nature of the market

Alternatively may change property damage rates to cross subsidise (although would expose to competition / anti-selection)

May charge more in any case
. . . e.g. for capital, marketing costs, regulatory costs, selection risks, reinsurance etc.

May be expense savings from simplicity

May increase overall size of market with related economies of scale

May impact some marketing / cross selling or other strategies

Some insurers may need to charge an above average rate for bodily injury if they have a portfolio mix more skewed to high risk groups
. . . potentially impacting business volumes and forcing a company out of the market, reducing overall competition

Some insurers may take the risk of charging a lower than average rate if they have a portfolio mix skewed to low risk groups
. . . but may struggle to manage demand / may be impacted materially by mix change if people switch insurer

If there is an MIB equivalent to cover uninsured driver costs, this may be reduced or removed if insurance cover is more widespread, reducing a subsidy and hence costs for insured drivers

[8]

(ii) Insuring a car does not make it any safer, only provides a means of compensation in the event an accident occurs

But changes may affect mix of people driving

Some "high risk" uninsured motorists may decide to purchase insurance, now that premiums are lower.

However, some motorists may choose to remain uninsured

If any groups of motorists experience higher premiums under the new proposal, they may decide to drive uninsured in future

Whether anyone will choose to drive uninsured will depend on various factors related to "Motorland": whether people in Motorland likely or not to break the law, the penalties if caught, how easy it is to be caught based on what info is available to the authorities,etc.

Risk rating insurance may have provided an incentive for safe driving practices

For example, by charging higher premiums following an accident

For example, by driving cars with high levels of safety equipment (or other example)

If there is no premium consequence from poor driving that may reduce incentives, although this is unlikely to be core motivation for safe driving

Since all motorists pay the same premiums under the proposed system, the roads may be less safe.

[3]

(iii) The premium rate charged by insurers will likely be similar to the current industry average premium rate

Charging the same premium for everyone means that premiums will be inadequate for some groups

For example, young people,

However, premiums will be more than adequate for some groups, which will be paying higher premiums than before

For example, older people, females

Because BI insurance is compulsory, all the "good" and "bad" risks will need to purchase cover

There will be significant cross subsidisation between different groups of policyholders

The challenge for insurers is to balance their portfolio, and encourage as many "good" risks as possible to become customers.

Insurers could lose money if they attract a relatively high proportion of customers for whom premiums are inadequate (for example, a higher than average proportion of young people)

Conversely, insurers with a high proportion of "good" risks could make higher profits under the new system than the current system

Insurers must therefore be careful about how they promote their products, to make sure they avoid the poorer risks

For example, advertising in magazines aimed at over 50s, rather than young people with high-performance vehicles

Insurers with a good portfolio of risks (lots of old people) could lower their premium rate in order to attract more business.

The insurer would need to keep its premiums competitive to retain the good risks

An insurer with low premiums rates would attract would be just as likely to attract new customers with low claim costs as customers with high claim costs

Since insurers cannot discriminate against people applying for cover, claim costs (and premiums) will therefore tend to increase to the average over time.

Insurers with worse than average risks (a large proportion of young people insured) will need to increase premiums to cover costs (noting that everyone will still pay the same premium)

An insurer charging significantly more than its competitors would write very little business, since its customers can get cheaper insurance elsewhere.

Therefore an insurer cannot continue in business with a portfolio of poor risks.

Motorland insurers may currently target particular niches, for example, young drivers, older drivers.

A business model targeting only customers with higher than average claim costs would not be sustainable under the proposed new regulations

Insurers writing loss-making business would not necessarily become insolvent

But such insurers would need to charge uncompetitive prices to remain solvent, and so potentially lose all their motor bodily injury business

Alternatively, depending on the nature of the business, exiting motor bodily injury may improve solvency

In moving to a "community rated" market, government may need to legislate a "risk equalisation" arrangement, where insurers of people with lower than average claim costs subsidise insurers with younger customers

Alternatively, the government could make other changes to the solvency assessment criteria

Alternatively, the government could mandate a customer swap between different insurers, to balance up their portfolios before implementing the system.

In order to avoid becoming insolvent insurers' revenue must exceed their costs over the longer term.

There is no reason why insurers can't operate profitably under this form of regulation, but the nature of their operations may need to change

However, issues may need to be addressed as part of the transition from risk rating to the new system

There are examples of "community rated" motor insurance in many countries, for example, Australia, New Zealand

There may be some savings for insurers in moving to this new environment

For example, avoid cost of developing expensive rating structures, avoid underwriting expenses (or other relevant example).

However, the cost savings are likely to be marginal.

After initial changes, BI rates may converge on a market average

Speed of trend will depend on how quickly insurers are available to adjust rates

Could lead to accusations of collusions and cartels

Uncertainty of first few years could add to underwriting risk, affect mix and ability to meet fixed costs

May be changes to number of market participants and overall competitiveness

In some situations, insurers do charge premiums less than claims, but the business is profitable due to investment income.

Investment income may be significant for motor bodily injury insurance, as claim payments may be made many years after an accident.

In general, however, premiums need to be higher than expected claim costs to cover the insurer's expenses and profit requirements.

Other example of why insurer may not become insolvent (e.g. exit business, profits from other classes of business, add-ons and cross selling, large free reserves to wait for market to stabilise, investment returns, prior year reserve releases etc.)

Since each insurer will have a single premium rate, customers will find it easy to compare different insurer's prices.

It will be apparent to customers if an insurer is charging significantly more than competitors, and that insurer may be able to write very little business

Insurers charging very low rates could similarly expect to attract lots of business. If the rates are inadequate, the insurer could expect significant losses and, in an extreme case, become insolvent.

Insurers are still able to risk rate the motor property damage.

Therefore a successful strategy might involve offering attractive combined PD and BI rates to attract good risks.

Better drivers prefer comprehensive cover so may be attracted to a good PD offering which could alter portfolio mix

Insurers with a good portfolio of risks (lots of old people) might encounter challenges in retaining their existing good risks without attracting bad risks for which their current average rate would be insufficient

Those with existing good portfolios may be unable to continue using aggregators as they would be exposed to significant mix change with no ability to differentiate by targeted advertising

Other example of why insurer may not become insolvent (e.g. exit business, profits from other classes of business, etc.)

The outcome also depends on the propensity for loyalty/price sensitivity in Motorland.

At one extreme, if everybody changes to the insurer offering the lowest rates it is likely that this insurer is charging uneconomic rates and with the large amount of uneconomic business may become insolvent.

Other extreme: all stay with current insurer and those with highest proportion of high risk drivers may lose money

New insureds are probably going to go to the insurer with lowest rate – same argument as before about likely to be unprofitable plus new drivers likely to be higher risk

Note that having a single rate per insured makes comparison between insurers much more transparent than when using multiple rating factors.

This proposal does not seem to be relevant for reinsurance pricing, but if there is a link then there may be some form of impact.

[18]

(iv)

Option	a	b	c	d
Insurer base rate	800	1000	1200	5000
Insurer min rate	600	750	900	3750
Insurer max rate	4940	5000	5060	6200

[2]

(v) 20% of motorists currently pay less than $500 per year.

Any example of a motorist who might be in this group (e.g. older driver and/or no claims for many year and/or low risk vehicle)

The business is likely to be profitable

The minimum rate of $750 is much higher (at least $250 higher) than the current premium being charged to the motorist (or other appropriate reason)

5% of motorists currently pay more than $6,000 per year.

Any example of a motorist who might be in this group (e.g. younger driver and/or many previous claims and/or high risk vehicle)

The business is likely to be unprofitable

Maximum rate of $5,000 is much lower (at least $[1],000 lower) than the current premium (or other appropriate reason)

[4]

(vi) <u>General points</u>

Given Speedysure has specialised in high-performance vehicles, it may continue to attract large numbers of these risks even if its prices are uncompetitive for this segment

Conversely, lower risk drivers may be reluctant to insure with Speedysure, even if it has the lowest premiums

This demonstrates a more general problem with the Speedysure brand under the new environment

A brand that attracts people with higher than average claim costs is only of value when you can set premiums which reflect the risk

Brands which are attractive to safer drivers will be particularly useful under the new regulations, as these groups will be highly profitable.

Might need to rebrand to reflect market conditions
. . . Would have associated costs of rebrand which would need to be funded
. . . . Might also impact distribution & volumes while rebranding
Would be targeting to remove the higher risk portfolio / shift mix, so would have transitional phase with above average new business percentage and associated expense costs

More generally, the profitability of any strategy depends on the prices adopted by competitors
And the strategies followed more generally
For example, choice of distribution methods

Advertising and branding
Loss leader / market share / cross sell
And whether or not the industry is currently profitable

And the extent to which insurers price / market bodily injury and property damage insurance together

And the extent to which any other product / service is bundled with the insurance, e.g. motor club membership

While the table shows the average, max and min premiums, the rating structure used between the max and min prices will also have an impact on profitability

The average rate is only the expected average based on expected mix, Speedysure may be able to produce a very different average rate using their own appropriate rating factors if mix is different to expected, although this may be only a short term solution

Profitability also depends on factors such as:

Expenses, tax, reinsurance, cost of capital, large loss experience, …

<u>Option a, $800 base rate</u>

The proposed average rate of $800 is lower than the current industry average premium of $1,000
. . . , so on average Speedysure's premiums may be too low.
. . . Unless they are actively targeting a lower risk market segment

The insurer's average rate of $800 compares to the current industry average premium of $[1],000, so on average Speedysure's premiums may be too low.

A major risk is therefore that Speedysure makes a loss due to inadequate premiums, even if the mix of business is favourable.

If the low rates mean that Speedysure attracts lots of business, the amount lost could be very large.

Having a lower average premium rate allows Speedysure to set a low minimum rate.
An insurer setting its average rate at the market average rate ($[1],000) could charge no less than $750. Speedysure's minimum rate of $600 is significantly lower than this.

Speedysure is therefore likely to be attractive to low risk drivers

Low risk drivers are expected to be profitable at a premium of $750, noting 20% of drivers currently pay less than $500.

Underwriting large numbers of very good risks could mean Speedysure is profitable, even if the average premium is low.

Lower volatility for good risks (less spiky)

May impact reinsurance costs and capital requirements

Lower volatility in any case for large volumes

Comparing the various options, option a ($800 average) has the lowest maximum premium, at $4,940.

Customers paying the maximum rate under the new system would typically be paying less than the maximum under the current system

Speedysure would expect to make a loss on these policies

Being competitively priced for the least attractive customer therefore creates the risk of losses

However, the maximum premium rate is around $5,000, regardless of whether the average premium is $800, $[1],000 or $[1],200.

Unless customers purchase solely on price / are very price sensitive, option a is unlikely to result in underwriting all the worst risks

The overall profitability of the strategy will therefore depend on the relative number of very low and very high risk customers attracted

<u>Option d, $5,000 base rate</u>

It's likely that almost any driver could get a lower rate with another insurer.

The minimum rate of $3,750 is more than three times the likely average rate of most other insurers (since current industry average rate is $[1],000)

Unlikely to underwrite any of the worst risks, since others have a far lower maximum rate

Almost no chance of writing the best risks, given the minimum rate

Strategy unlikely to be profitable because no business (or almost no business) will be written

[15]
[Total 62]

2 (i) P&I clubs = Protection and Indemnity clubs

These are mutual insurers of marine risks.

A mutual insurer is an insurer owned by policyholders to whom all profits (ultimately) belong.

P&I clubs were originally formed to cater for certain types of marine risks that could not be covered at an acceptable price under a commercial marine policy, for example:

- indemnity of liability in respect of claims for loss of life or personal injury resulting from accidents
- indemnity of liability for damage to harbours, wreck removal and pollution

Today, insurance for many of these risks may be found in the commercial market. However, their mutual nature and technical expertise mean that the P&I clubs still provide about 90% of the world's shipping coverage against liability claims.

Some clubs write fixed premium business where, in exchange for a higher premium, the shipowner knows the maximum premium

In common with all other providers of insurance (except possibly the State), a P&I club does not have unlimited resources.

Almost all of the P&I clubs are members of the International Group of P&I Clubs.

Each loss above a fixed amount is pooled amongst the members in accordance with an agreed formula depending on claim history.

The group also operates a captive to share some risks above the pooling arrangement.

Any risk in excess of the pooling arrangement is reinsured in the market. Often at competitive prices due to the scale of the international group

Some clubs also buy their own market reinsurance below the pool attachment point.

The members of the clubs are the commercial shipowners.

The majority are exposed to unlimited joint and several liabilities.

[6]

(ii) The phrase "own funds" refers to assets in excess of technical provisions and subordinated liabilities.

These are split into basic and ancillary own funds, which are then tiered based on specific criteria.

Basic own funds is broadly capital that already exists within the insurer.

Ancillary own funds is capital that may be called upon in certain adverse circumstances, but which does not currently exist within the insurer (e.g. unpaid share capital).

The capital is tiered based on its loss absorbency and permanency.

Tier 1 capital is the most loss absorbent and permanent form of capital (e.g. paid up ordinary share capital); Tier 3 the least (e.g. subordinated debt).

Criteria	*Tier 1*	*Tier 2*	*Tier 3*
Subordination	Must rank after the claims of all policyholders, beneficiaries and nonsubordinated creditors.	Must rank after the claims of all policyholders, beneficiaries and nonsubordinated creditors.	Must rank after the claims of all policyholders, beneficiaries and nonsubordinated creditors.
Loss absorbancy	Immediately available to absorb losses. Absorbs losses at least on SCR breaches. Should not cause or accelerate insolvency.	Not necessarily immediately available to absorb losses. Should not cause or accelerate insolvency.	Should not cause or accelerate insolvency.
Sufficient duration	Undated or minimum 30 years maturity at issue. Contractually locked in or replaced at least equivalently on breach of SCR.	Undated or minimum 10 years maturity at issue. Contractually locked in or replaced at least equivalently on breach of SCR.	Undated or minimum 3 years maturity at issue. Contractually locked in or replaced at least equivalently on breach of SCR.
Free from incentives to redeem	Only redeemable at the option of the insurer or reinsurance undertaking.	Only redeemable at the option of the insurer or reinsurance undertaking; limited incentives to redeem are permissible.	Only redeemable at the option of the insurer or reinsurance undertaking; limited incentives to redeem are permissible

Criteria	*Tier 1*	*Tier 2*	*Tier 3*
No mandatory fixed charges	Suspension of redemption provided and coupons/dividends can be cancelled in case of breach of SCR.	Suspension of redemption provided and coupons/dividends can be cancelled in case of breach of SCR.	Suspension of redemption provided in case of breach of SCR. Deferral of coupons/dividends on breach of MCR.
No encumbrances	Unconnected with other transactions and no restrictions, charges or guarantees.	Unconnected with other transactions and no restrictions, charges or guarantees.	Unconnected with other transactions and no restrictions, charges or guarantees.

[10]

(iii) General features

A particular feature of the cover provided by the P&I Clubs is that mutual calls (premiums) are not fixed and that members (insureds) remain liable for supplementary calls in the event that underwriting or investment experience is adverse in any individual policy year.

Under the terms of the Rules (contract of insurance) of each P&I Club the member remains contractually liable for further (supplementary) calls until the policy year is closed (normally after three years).

Supplementary calls can be either paid or unpaid

Supplementary calls – Paid

Called up funds (Supplementary calls already notified to members) are available to fully absorb losses on both a going concern basis and in the event of a wind-up.

As cash is already received, would be expected to be eligible as core capital for the purposes of Solvency I.

Suggestion of appropriate tier – e.g. Called up funds could therefore be classed as Tier 1 capital

Supplementary calls – Unpaid

Called up funds (Supplementary calls already notified to members) are theoretically available to fully absorb losses on both a going concern basis and in the event of a wind-up.

Cash not actually received however, so an appropriate allowance should be made for uncollectable amounts.

Responsibility to provide the funds is not contingent on any other conditions or events however, so therefore have the same characteristics of other insurance debts.

They may be considered available as core capital as not contingent

. . . Alternatively may not be considered available as core capital as they are not received

Suggestion of appropriate tier – e.g. Called up funds could therefore be classed as Tier 1 capital or unpaid called up funds could be not considered as Tier 1 as unreceived

Any reference to latest guidance saying officially tier 2 capital

<u>Future Supplementary Calls</u>

Future Supplementary Calls are not immediately available to absorb losses and therefore lack some of the characteristics of Tier 1 capital.

They are however subordinate to claims of all policyholders, beneficiaries and non-subordinated creditors.

And they are callable on demand

They could be therefore considered as Tier 2 capital

... subject to a deduction for the members' creditworthiness or their ability or willingness to pay.

These funds are not a liability on the balance sheet and therefore are:

...undated

...free from redemption to redeem.

Noting that called funds are not returned but excess funds may be used to subsidise future calls/premiums only at the discretion of the insurer.
...no fixed charges as unlike debt/equity there are no coupons/dividends

...unencumbered with no restrictions or charges or guarantees

In terms of members willingness to pay it is of note that:
Policy holders and members of the club are one and the same and it is these same members (and policyholders) that are liable to pay any future supplementary calls.

There is therefore a commonality of interest

There is also a strict liability on members to pay any future supplementary call that may be levied under the contract of insurance.

In the past members of the International Group have made supplementary calls on members representing a multiple of their existing capital resources and these have been fulfilled

Supplementary calls could potentially be given more favourable treatment than other forms of unpaid capital. The ability of a member to make recoveries under his insurance contract is dependant upon his having fulfilled his obligations to the P&I Club.

Payment of supplementary calls is one such obligation.

In the event that a member fails to meet his obligations to his P&I Club he will find himself with no insurance cover;

Nevertheless, in the event that a significant number of members were to default, the Club would make further calls on the remaining members.

[15]

(iv)

	Scenario 1	*Scenario 2*	*Scenario 3*
Option 1	£5,000,000	£10,000,000	£0
Option 2	£5,010,000	£5,100,000	£50,000
	(=£5m+1%*£1m)	(=£5m+1%*£10m)	(=1%*£5m)

[2]

(v) + Easy to administer

+ To the extent more premium represents more risk it is equitable

+ Reinsurance premium cost is likely to be related to overall gross written premium

+ Members are happy to share costs of claims in direct proportion so sharing premiums is commensurate with this approach.

+ Avoids any one member facing substantially increased/unsustainable costs following a large claim/series of claims.
Unclear if this is this year's premium or last year's.

+ Using last year's means costs known at start of year
Consistent with pooling of risks, fundamental principle of insurance

– However, will be unequitable if member writes substantially different premium volumes from one year to the next

– Members might write different risk profiles...

...those writing larger risks are more likely to benefit from reinsurance so should pay proportionately more
. . . or other features that might impact severity distributions, e.g. CAT, territory, cover etc.

If reinsurance not on risks attaching basis, may be unfair for newer or growing members who would have larger written premium than previous earning through

– Underwriting performance of clubs not taken into account...
...clubs with better underwriting results may feel overcharged
or better claims management

[4]

(vi) The director is correct to state that:

- they have to pay a portion of large claims from other P&I clubs that are a member of the mutual pool.

- If these clubs therefore exhibit poor underwriting they therefore have to bear the cost of this

- . . . Along with poor underwriting also exposed to poor risk selection, T&C, claims handling, accumulation management etc.

- ...as qualifying large losses are shared between clubs in accordance with the terms of the Agreement by which clubs reinsure each other for claims in excess of £5m

The director is correct that large claims can impact the future reinsurance costs and that these are shared across the other P&I clubs.

The director is incorrect in stating that there is no benefit to being a member of the mutual pool.

Whilst a P&I club is a mutual which can pool losses across its members, this pooling is far less substantial than the pooling across the mutual pool.

Specifically:

- They will benefit on claims of their own over £5m as they can share the costs with other members.

- This allows them to write bigger risks than they could otherwise accept

- This reduces their capital requirements

- By reducing volatility in the net claims ratio

- They are effectively taking a small line size on all risks written by members of the pool which whilst it exposes to bad underwriting it also

- creates enormous diversification of the portfolio

- Without the underwriting and administrative burden of accepting these risks individually

Depends on market share whether the 1% contribution is a good deal or not

And on limit / loss / exposure profile relative to market

May have access to other benefits, e.g. Expertise, competitive reinsurance, regulatory influence, compliance support, etc.

Members can be protected from poor underwriting of other clubs through:

- a group agreement which could include mechanisms to:

- regulate the manner in which clubs can accept risks, including those risks who wish to move their insurance from one member to another.

- specifies how clubs may quote rates and the information which they should obtain before quoting premium rates.

- The formula used to share pooled claims which reflects historical claims experience

[7]
[Total 44]

END OF EXAMINERS' REPORT