The Contribution Approach in Practice

The expression of profitability by policy class in contribution format rather than using traditional "underwriting profit" methods has considerable advantages, namely:

1 Investment income (on technical reserves) is included on an explicit basis making results on long-tail classes much easier to interpret.

2 Overall expenses include a large proportion of costs which are not strictly allocatable between the various policy classes. The contribution method does not incorporate an arbitrary and often grossly misleading split of these costs between classes.

A theory has been developed whereby the overall required contribution to fixed expenses (as unallocatable expenses are largely those that are fixed) is, say, 10% of premium (to cover the aforementioned fixed expenses) plus an additional, say, 6% of premium to give an acceptable return to shareholders. To demand 16% from all classes would be to split implicitly the fixed expenses between the classes by premium income which has already been stated to be undesirable. It is accepted therefore that market pressures will to some extent dictate the achievable contribution from each class of business. These will be considered acceptable provided the contribution from all classes amounts to 16% of premium.

The theory is also amenable to marginal costing arguments. Providing fixed expenses are not increased by writing a one-off large block of new business, it is quite reasonable to write this business at 6% contribution. The fixed expenses remain covered and the 6% margin of profit is maintained.

There are, however, two problems within the theory which have caused difficulties and on which discussion is invited:

1 Consider the marginal costing argument. Assuming level market pressures, one might restate the required contribution as 16% from existing business and 6% from business comprising <u>real</u> growth ie non-inflationary growth. At the end of the first year the required overall contribution may have fallen to 15% because of the real growth. Does one then require 15% from all business or is it possible to persist with the 16%/6% differential contributions? In the former case, it is necessary to explain the 10+% increase in real premium levels required on the new block of business. In the latter case, how long can one maintain the existing/new business split: how long does the new business remain new?

2 At what level should the margin for profit be set? The 6% described above is based on a 15% return on a notional solvency margin of 40% of premium. This is over and above a supposed gilt return on the solvency margin which is not included in the investment income figure used in arriving at contribution. The additional return is obviously to reward shareholders for the risky nature of their investment but what level of reward do they deserve or should they expect?

Mark Allen
21.8.84