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Plenary 6
Recommendations for
General Insurer Risk Management
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Recommendations for General Insurer Risk Management:

1. Underwriting Capacity Budgeting
2. Scenario Planning
3. Increased Information Content in Pricing
4. Prudency Margins for Reserving
5. Benchmark Loss Ratios for Regulation
6. Overhead Expense Reserves
7. Idle Capacity and Franchise Value

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1. Underwriting Capacity

- Measure of aggregate ability to assume obligations
- Function of many factors:
  - Assets
  - Price adequacy
  - Reserve adequacy
  - Obligation volatility
  - Accumulation and diversification
- Must operate like a budget
- Must be able to monitor it
- Drill down and roll up
- Allocate it
- Have a finite total amount that is incrementally consumed by underwriting activity
- Portfolio improvement by allotting a total amount with a profit goal, then let local managers trade within those bounds

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1. Underwriting Capacity

- Point-of-sale risk management not forensic
- Beyond just nat cat
- Must demystify the non-linear mathematics
- Best approximation one can live with given organizational benefits
- Moving beyond modeling sophistication towards improvement of underwriting activities today
- From "capital allocated to" → capacity consumed by

2. Scenario Planning

- For most insurers, "The Plan" is a very detailed fictional account of one possible realization that will never come to pass
- Creates "lock-in" and self-fulfilling prophecy, acquires a momentum of its own
- Commitments to "making the numbers" flow up the ownership chain
- Encoded into performance goals and incentive bonus calculations
- Strong organizational incentives to force-fit reality to plan at all costs
- Actual price adequacy buried, only to surface later in reserve charges

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2. Scenario Planning

- Even rudimentary **multi-scenario planning** would be an improvement
- A **set** of less-detailed, higher-level plans, each for use in one of a selected handful of "market states"
- Example: prices up; price flat; prices down
- Portfolio actions pre-determined
- Desired (and rewarded) behaviors are **market state dependent**
- Monitoring determines which state we are in
- Plans are executed not fabricated

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3. High Information Content for Pricing

- Separate the components:
  - Loss costs
  - Expense loads
  - Profit margins
  - Frictional costs
- Transparency
- Increased disclosure
- Make the buyer suspicious of low pricing
- Teach them to extrapolate:
  - Low price, easy terms for ME
  - What the hell does the portfolio look like?
- Differentiating between Price and Value – can they pay?
- “Price” and “Product” → Membership Fee and Access Rights

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4. Prudency Margins for Reserves

- Explicit, excessive (by historic standards) required reserve margins
  - Based on poor predictability track record
- Mandated profit (!) release schedule
- Difficult ramp-up period only
- Steady-state should be like any vesting system
- Break out of the cycle of “a slate of long shots”
  - Incentive to chase the premium dollars regardless of price adequacy
  - No other way to generate profit
- Increase the reliability of the insurance system

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5. Benchmark Loss Ratios for Regulation

- Industry level, by line of business and underwriting / policy / accident year
- Any insurer booking an initial loss ratio more than X points below (or above!) is subject to additional scrutiny
- Why this doesn’t happen already in a more formal fashion is beyond me
- “Mark-to-Market”

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6. Overhead Expense Reserves

- Insurers are heavy with Intangible Assets – Intellectual Capital
  - Off balance sheet
  - Experts, proprietary databases, forecasting models, licenses, market relationships, …
- Represent substantial component of the franchise value of an insurer
- These Capital Assets require capital improvement investments
- They learn all the time
- Some of what they do today is tied to past or future revenue

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6. Overhead Expense Reserves

- Matching current year overhead expense with current underwriting period premium violates basic accounting principles
- The need to pay current year overhead may create incentive to chase inadequately priced business (forestalling shortfall)
- Perhaps an overhead provision could temper underwriting cyclicality

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7. Idle Capacity and Franchise Value

- Insurer is an inherently unstable equilibrium
  - Leverage, opacity, "receive-then-maybe-pay" proposition structure → susceptible to over-commitment and "blowing up"
- There is value in stability and persistence, and maybe in having buffer capacity that is "unused" or idle
- Franchise investment is intellectual
- Franchise can disappear in a "jump"

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7. Idle Capacity and Franchise Value

- “Extra” capital buffer
  - Has a carry cost…
  - …but may result in more future scenarios where franchise survives
- Given the crude market capacity measures (premium) and demonstrated track record of over-correction, there is real value is being able to withstand shocks then underwrite like hell
- Expanded notion of “efficiency” and “adequacy”

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Thank you for your attention

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