



FINANCIAL SERVICES

Price Governance: Managing Profitability and Underwriting Risk

KPMG LLP

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Price Governance: Managing Profitability and Underwriting Risk

Goals for the Session

- Why Address Price Governance
- Industry Backdrop: Past Industry Performance on Price Governance Issues
- Quantifying Price Changes: Overview of Approaches
- The Total Picture: Integrating with Company Risk Management Processes
- Significant Operational Improvements Can Result from Effective Price Governance
- Survey Results: What Is the Industry Doing?

Why Address Price Governance?

CEO discussion points:

- What new measures are we implementing/have we implemented to improve the way we monitor the profitability of the business we write?
- Can we demonstrate that our underwriters operate within approved guidelines? If not, why not?
- Are our reporting models reliable enough to enable us to estimate future financial results with a high degree of confidence?
- How can we evolve culturally to help instill a more effective governance framework?

From KPMG Frontiers
in Finance, October 2006



Why is Sound Price Governance Important?

- Balance sheet and income statement risk for Property/Casualty companies stems in large part from pricing risk. Effective price governance manages this risk
- The importance of price monitoring on accurate financial reporting is underscored by Sarbanes-Oxley compliance, Lloyds market bulletin, and recent rating agency actions
- Even companies' established price monitors can be inaccurate. Quality control is key, and gaps can prevent monitors from accurately capturing rate adequacy changes
- Integration of price governance with corporate planning is key for setting appropriate plans and objectives and setting goals to achieve them
- Integration of price governance with underwriting strategy is key for accomplishment of underwriting objectives
- Realizing the benefits of price monitoring requires effective management information systems delivering timely, actionable pricing information, enabling leadership to reach financial goals.



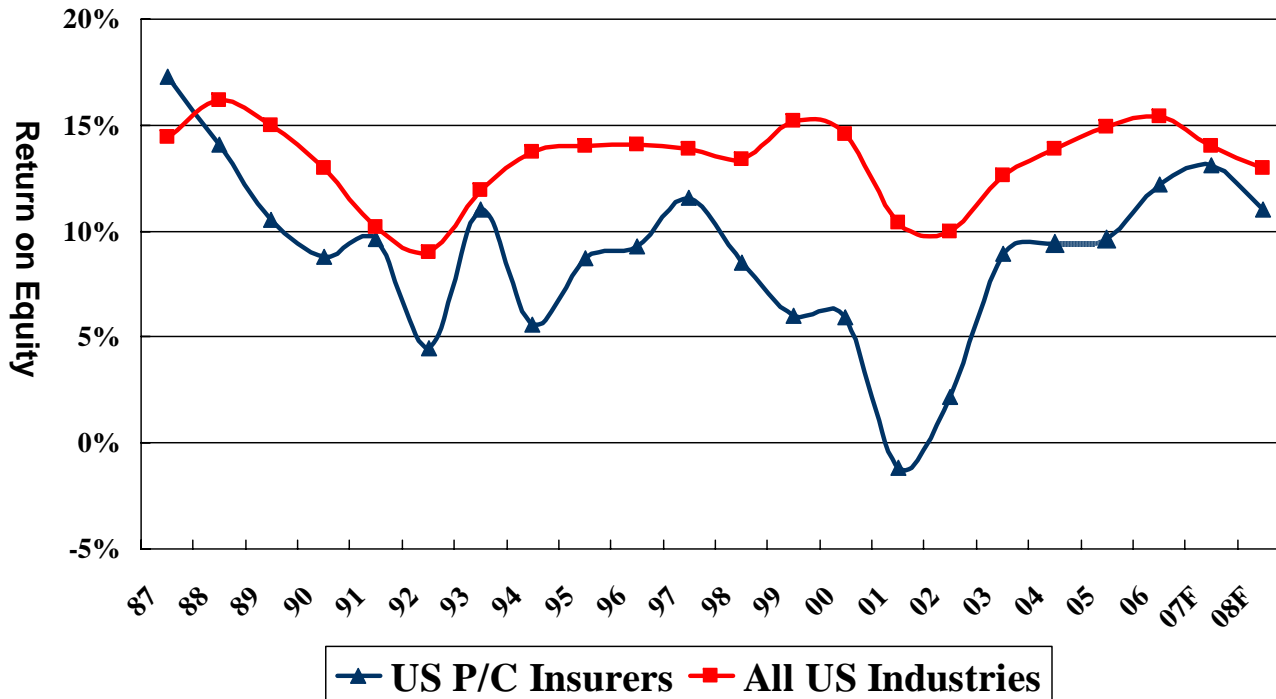
Industry Backdrop: Past Industry Performance on Price Governance Issues

Sources of Change in Price Adequacy

- Changes in use of credits
- Changes in quality of risk/underwriting quality
- Changes in distribution of business by class/product/line/coverage
- Changes in policy terms and conditions
- New vs. renewal mix of business
- Changes in reinsurance usage impacting net lines
- Changes in the external environment:
 - Judicial, court decisions, legislative, and regulatory
- Changes in economic trends such as inflation.

Insurers Returns on Equity Compared to S&P All Industry

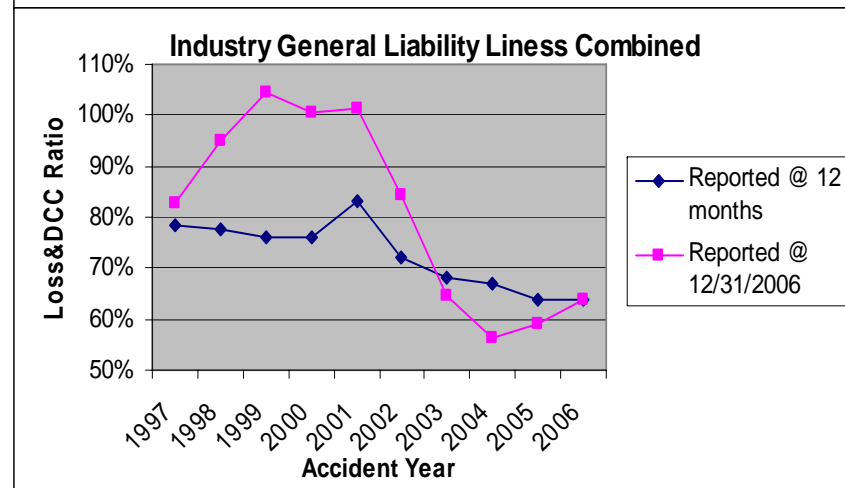
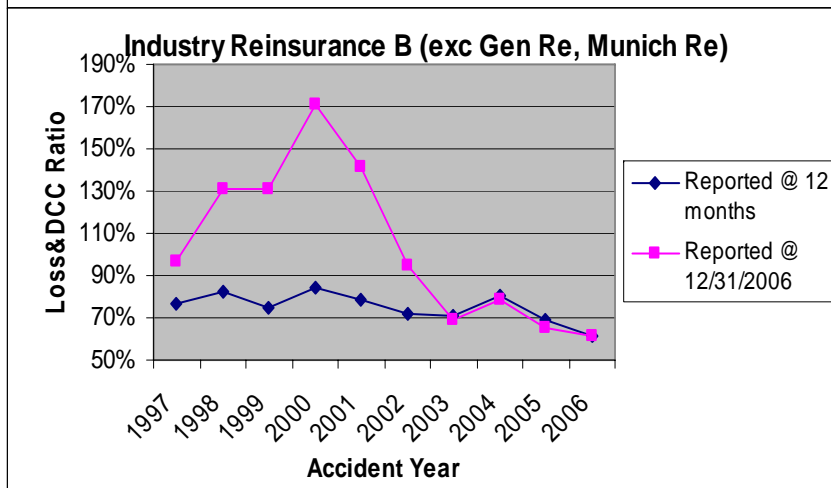
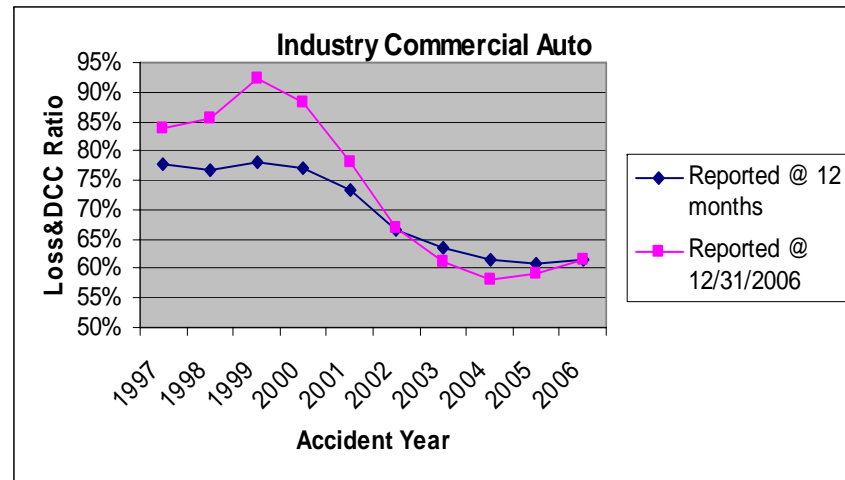
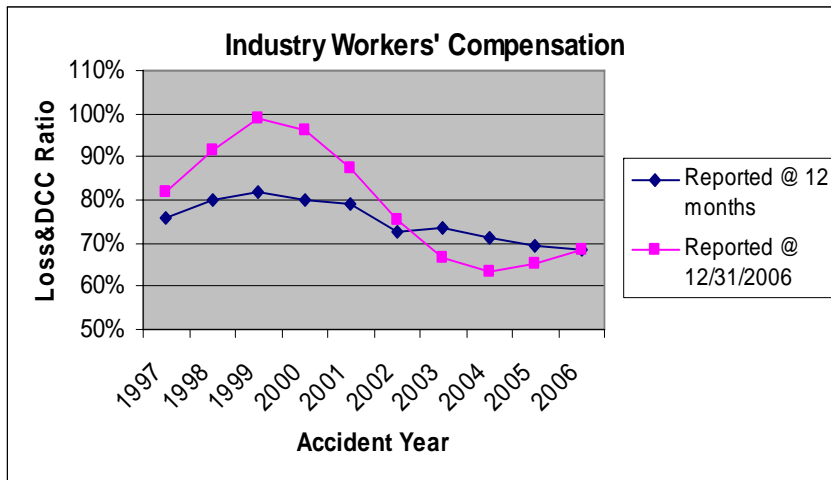
- CIAB Pricing Survey shows prices are declining in the last few years
- Yet III shows Industry consolidated ROE at 11% – Marginal even at the height of the cycle; below all industry average every year for past 18 years



Conclusion: Company must be better than average to earn a return that is equivalent to peers in other industries

Source: Insurance Information Institute.

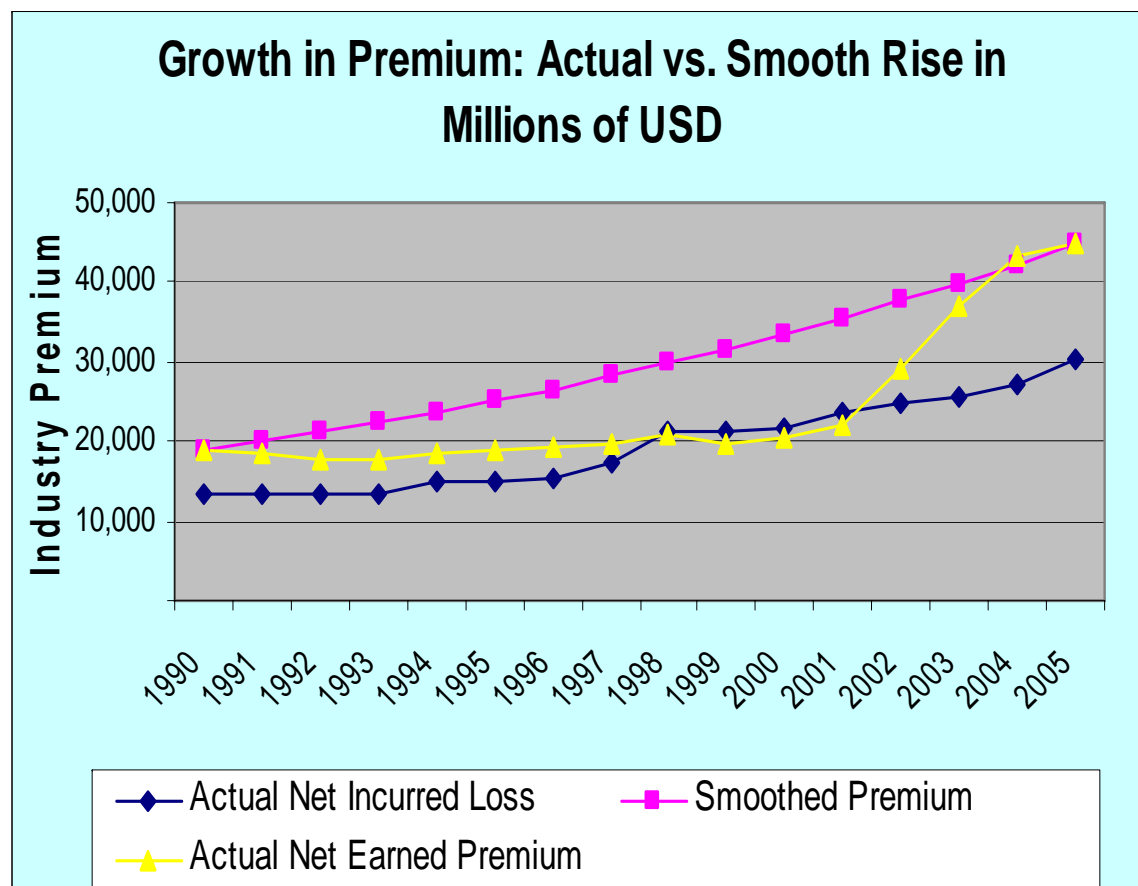
Why is Price Monitoring Important? Historical Reported Industry Results at 12 Months Compared to Actual Results



Source: AM BEST Aggregates and Averages composite Schedule P.



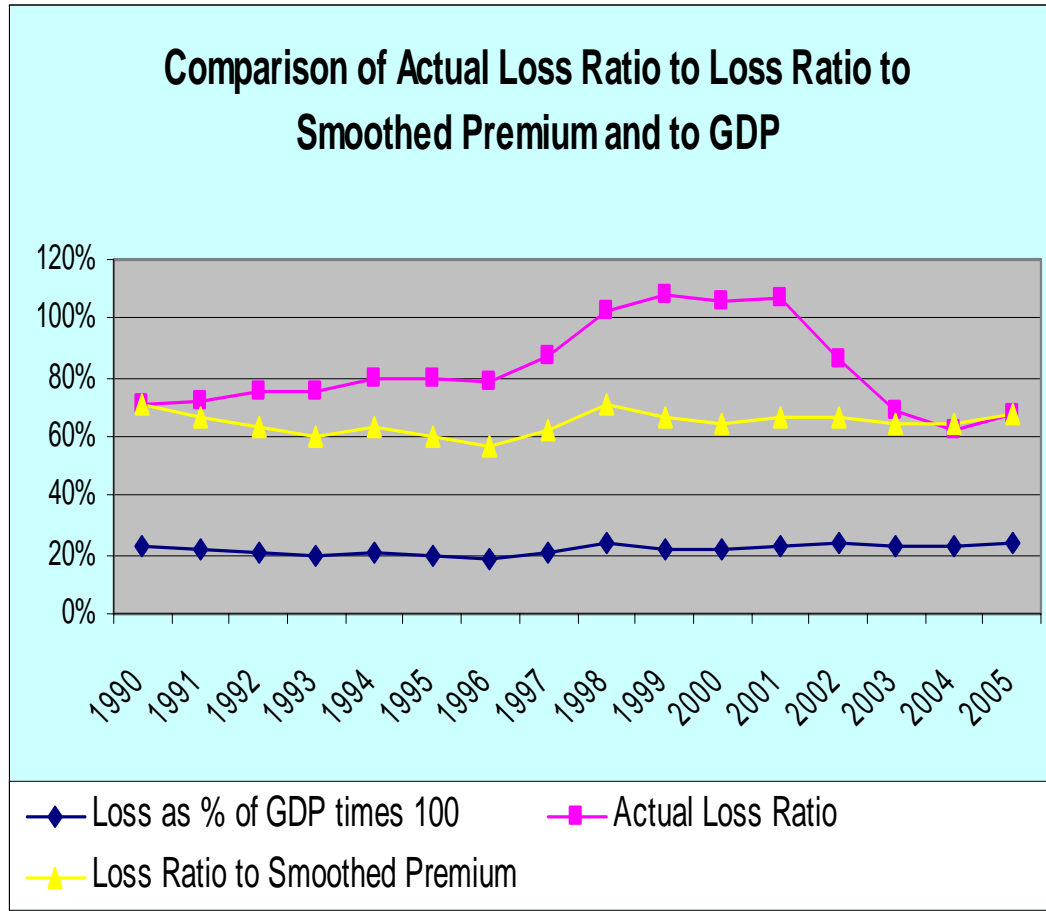
Chart 1: General and Products Liability in the United States Actual Charged Premiums Compared to Smooth Growth Premiums



Year	Actual Net Earned Premium	Smoothed Premium	Actual Net Incurred Loss
1990	18,767	18,767	13,238
1991	18,315	19,886	13,285
1992	17,730	21,072	13,259
1993	17,692	22,329	13,389
1994	18,611	23,661	14,851
1995	18,811	25,072	14,947
1996	19,240	26,568	15,199
1997	19,861	28,152	17,359
1998	20,785	29,831	21,263
1999	19,489	31,611	21,085
2000	20,535	33,496	21,741
2001	22,206	35,494	23,632
2002	28,964	37,611	24,983
2003	37,018	39,854	25,448
2004	43,496	42,231	27,229
2005	44,750	44,750	30,278

Source: Industry Composite Schedule P from Highline Data Services, or from AM BEST for years prior to 1996.

Chart 2: General and Products Liability in the United States Loss Ratio to Smoothed Premium and Actual Premium, and Losses to GDP



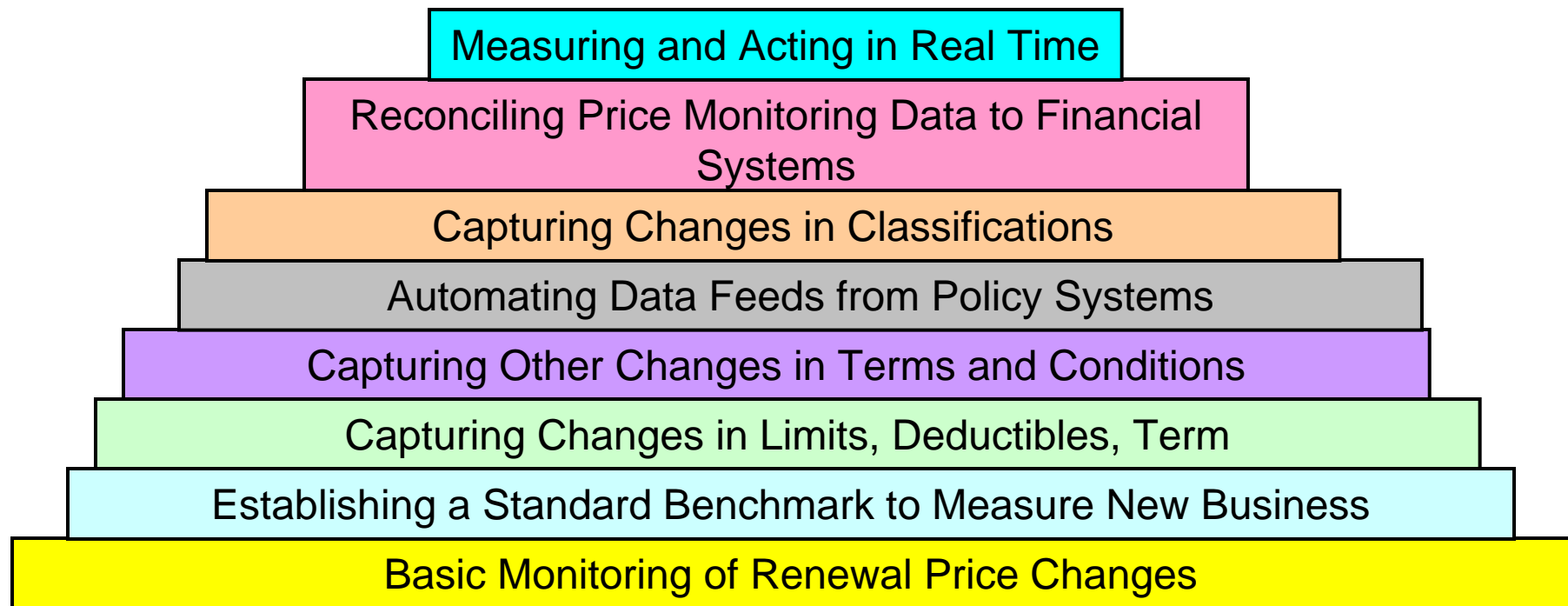
Year	Loss as % of GDP Times 100	Actual Loss Ratio	Loss Ratio to Smoothed Premium
1990	23%	71%	71%
1991	22%	73%	67%
1992	20%	75%	63%
1993	20%	76%	60%
1994	21%	80%	63%
1995	20%	79%	60%
1996	19%	79%	57%
1997	20%	87%	62%
1998	24%	102%	71%
1999	22%	108%	67%
2000	22%	106%	65%
2001	23%	106%	67%
2002	24%	86%	66%
2003	23%	69%	64%
2004	23%	63%	64%
2005	24%	68%	68%

Source: Industry Composite Schedule P from Highline Data Services, or from AM BEST for years prior to 1996.



Quantifying Price Changes: Overview of Approaches

Climbing the Continuum: Various Stages of Rate Adequacy Capabilities



Climbing the Price Monitoring Pyramid!

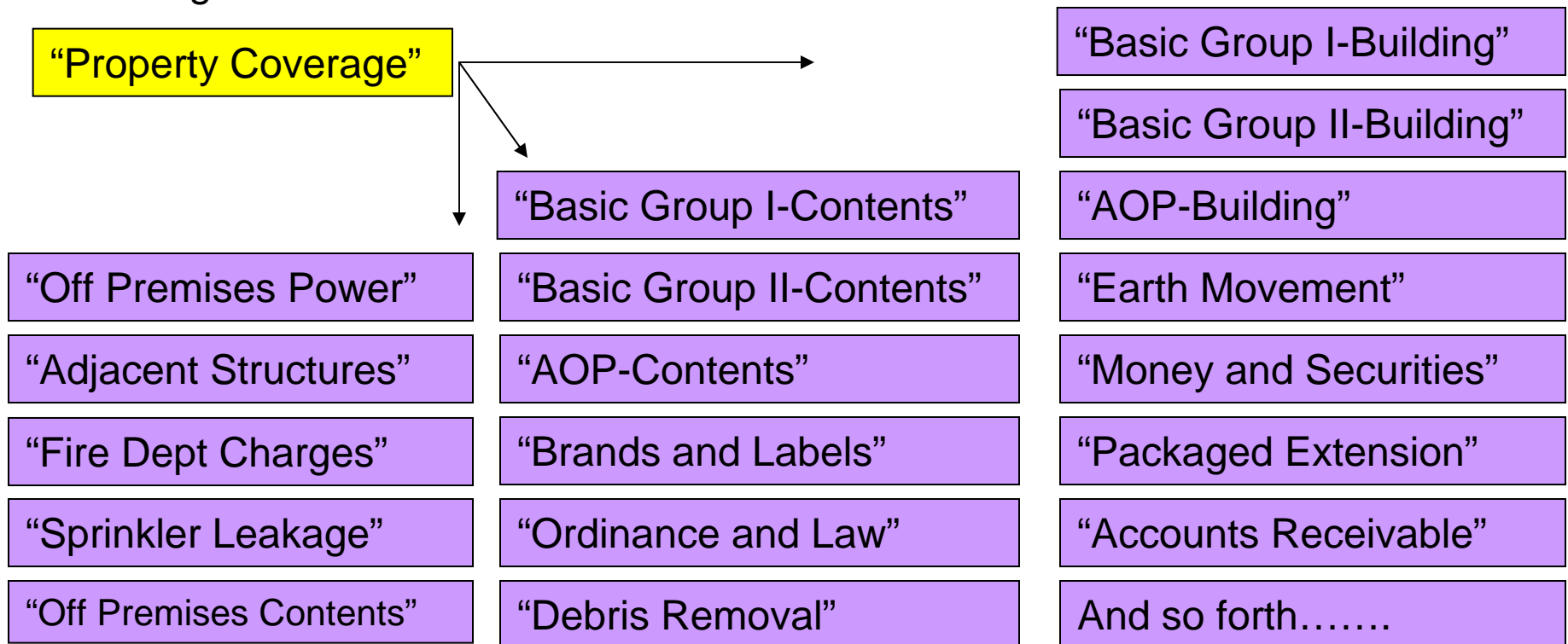
Quality of Risk Within Class

- Standard underwriting execution is key:
 - Reasonable authorities and delegations
 - Data and risk validation
 - Field audit schedules
 - Self-audit and management reviews
 - Strong field and home office referral processes.
- Underwriting audits should include data quality:
 - Exposure information, coverage additions if not considered in the price monitor.
- Rating plan refinements may be needed:
 - Any recognition of variation of loss cost within a rating segment is candidate for new rating variable
 - If no manual rating differential, needs to be segmented and tracked.

Capture of Complete Information Aids Accuracy of Measurement Line of Business and Coverage – Basic Property Example

- Perform calculations at the coverage level so you can include or exclude coverages depending on renewal status:

Instead of one coverage: Treat each coverage at each location as separate calculation.



Normalize Policies to Correct for Changes in Terms and Conditions

Expiring Coverages

Renewing Coverages

Sprinkler
Leakage

Package
Extension

Groups I and II
Coverage 100K

Deductible Buy-
down to \$250

Wind
Deductible

AOP Extension

Ordinance
and Law

Sprinkler
Leakage

Package
Extension

Groups I and II
Coverage 100K

No Buydown

Normalize Policies to Correct for Changes in Terms and Conditions (continued)

Expiring Coverages Renewing Coverages

	Wind Deductible
	AOP Extension
	Ordinance and Law
Sprinkler Leakage	Sprinkler Leakage
Package Extension	Package Extension
Groups I and II Coverage 100K	Groups I and II Coverage 100K
Deductible Buy-down to \$250	Deductible Buy-down to \$250

 Red coverages are rerated or “normalized.”

Option I: Rerate to expiring coverages

Benefit: Not “making up” expiring premium and then measuring change from fictional Premium.

Normalize Policies to Correct for Changes in Terms and Conditions (continued)

Expiring Coverages Renewing Coverages

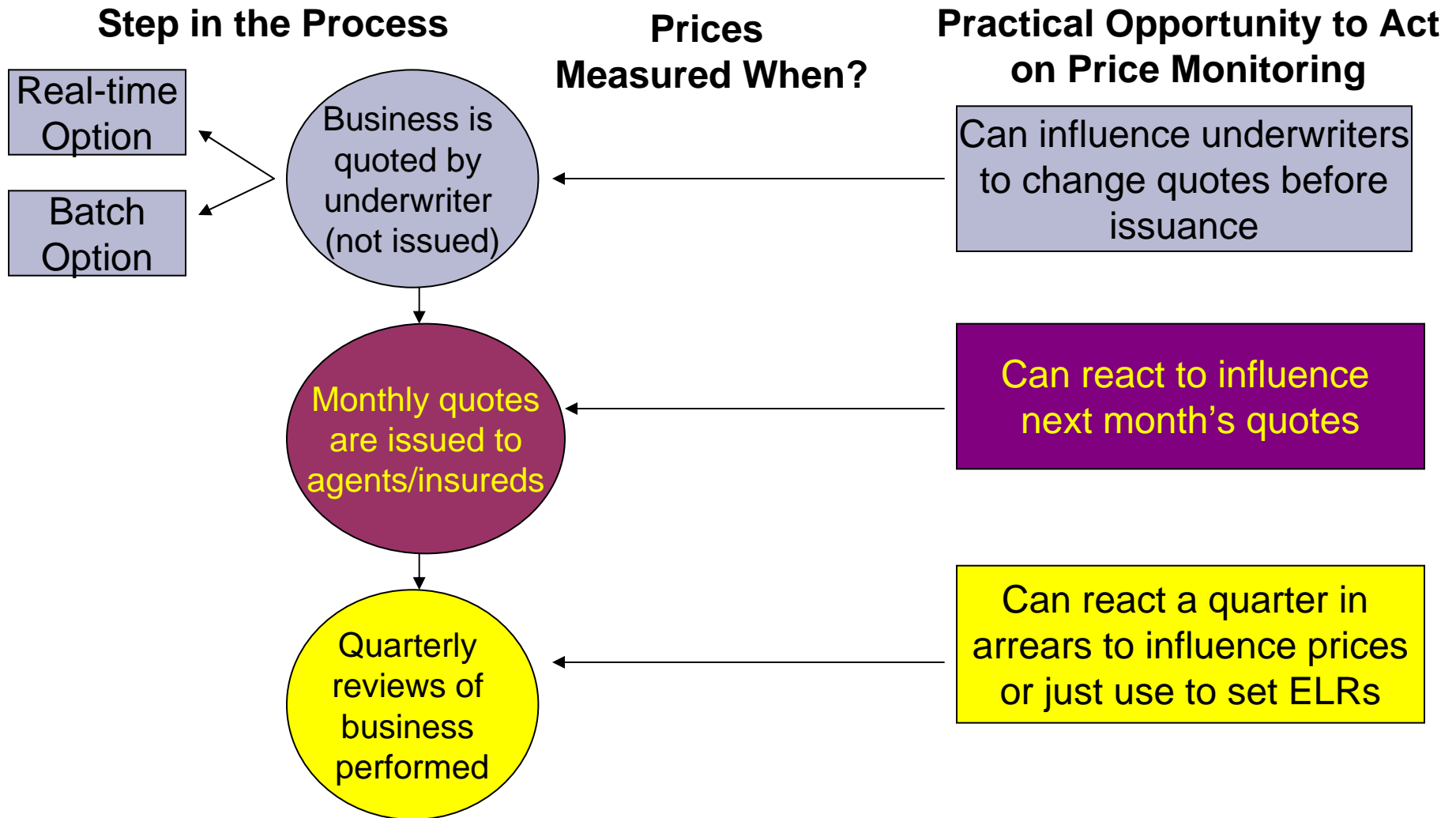
Wind Deductible	Wind Deductible
AOP Extension	AOP Extension
Ordinance and Law	Ordinance and Law
Sprinkler Leakage	Sprinkler Leakage
Package Extension	Package Extension
Groups I and II Coverage 100K	Groups I and II Coverage 100K
Deductible Buy-down to \$250	No Buydown

Option II: Rerate to renewal coverages

Benefit: Capturing all renewal coverages, but at the cost of adding fictional coverages to the expiring

Purple coverages are deleted
 Red coverages are rerated or "normalized"

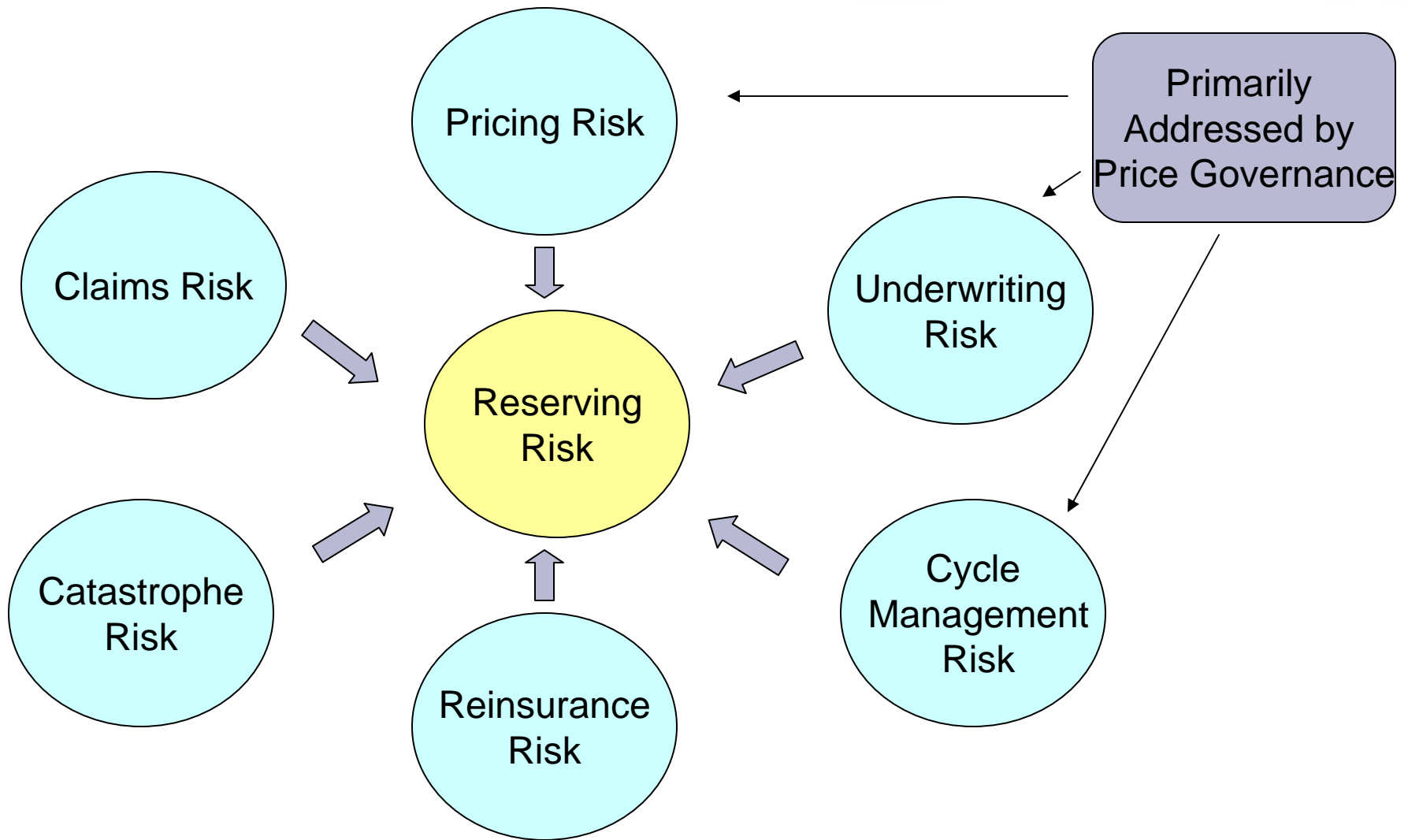
Price Monitoring and the Quote/Issuance Renewal Cycle





The Total Picture: Integrating with Company Risk Management Processes

Reserving Risk is Highly Related to Other P&C Insurance Operational Risks





Survey Results: What Is the Industry Doing?

Are Pricing Controls Important Under S-O – The Survey Says...

Which of the following control areas do you consider important to ensure correct reporting?

90% Controls ensuring case reserving philosophy is being followed

75% Controls ensuring claims processing changes that affect reporting are tracked and effects quantified

95% Controls ensuring correct coding and reporting of data used in reserving

70% Controls around the Reserve Committee and sign-off process for final selections

100% Controls ensuring the selected reserves are those recorded in financial statements

65% Controls ensuring the company has information quantifying the pricing levels resulting from current underwriting activities

75% Controls ensuring underwriting guidelines are in place and being followed

90% Controls ensuring actuarial methods used are appropriate and selections are reasonable

90% Controls ensuring the data used in reserving is balanced and sufficiently detailed

35% Controls validating company ratemaking processes produce an adequate indicated manual premium level

Price Monitoring and Lines of Business – The Survey Says...

If you write the line of business, do you perform price monitoring?

Yes	No	
100%	0%	Standard Commercial
100%	0%	Middle Market Commercial
82%	18%	Large or Complex Commercial
80%	20%	Excess Reinsurance
94%	6%	Personal Lines

What is the frequency of price monitoring at your company?

4%	Real Time
4%	Weekly Reporting
58%	Monthly Reporting
31%	Quarterly Reporting
4%	Annual Reporting

How Do Companies Approach Price Monitoring – The Survey Says...

What is the scope of your price monitoring activities?

- 72% Monitor change in renewal premiums matching specific renewals to the expiring policy
- 48% Monitor adequacy of new business by measuring against a benchmark. If so, what is that benchmark?
 - 24% - Manual rate
 - 3% - Average expiring rate
 - 10% - Bureau loss cost
 - 14% - Other (specify)
- 48% Adjust for change in terms and conditions. If so, which changes? (Check all that apply)
 - 38% - Deductibles
 - 38% - Limits
 - 21% - Other endorsed coverage changes
 - 21% - Some other endorsed coverage changes
 - 0% - Essentially all endorsed coverage changes
 - 24% - Changes in classification
 - 41% - Changes in exposure
 - 3% - Other (specify)

How do Companies Approach Price Monitoring – The Survey Says... (continued)

Do companies perform a reconciliation of your price monitoring data to financial data reported in the general ledger? (% of those that monitor)

- 4% Yes
- 56% No
- 40% No, but we reconcile to a source that is reconciled to the general ledger

What is the source of price monitoring data? (% of those that monitor, allows repeat answers)

- 28% Financial data systems
- 64% Policy processing systems
- 20% Manual logs
- 8% A mixture of the above, please explain
- 8% Other, please explain

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