1988 CASUALTY RATEMAKING SEMINAR

1988 CASUALTY RATEMAKING SEMINAR

PRICING EXCESS OF LOSS TREATIES

"WHAT SHOULD BE INCLUDED IN A SUBMISSION"
(INTRODUCTORY COMMENTS)

BY MICHAEL PINTER

From the period between 1980 thru 1984, the insurance industry in the United States was in the midst of a period of extreme price competition. This competition was fueled by unusually high interest rates which suggested that market share and cash flow would more than overcome any statutory price inadequacies. Unfortunately, the drive for market share and cash flow took on a life of itself, resulting in radical price discounts, which time has proven that even the originally anticipated high interest rates could not sustain. To make matters worse, interest rates fell dramatically which quickly spotlighted the folly of the market share/cash flow principle, at least for commercial lines of business.

Meanwhile, the reinsurance marketplace in the United States was emerging from its adolescence in 1980. Results for reinsurers thru the 1970's, apart from natural catastrophe years, were quite good, or at least they appeared to be. As a result, more capacity came into the market, much of it coming from non-traditional sources. Reinsurance was viewed as an easy way to enter the insurance marketplace, which did not require large staffs, major distribution facilities or huge support systems, in order to generate cash flow to take advantage of the interest rate climate. Traditional markets ultimately got caught up as well. All this provided further fuel to the competitive cycle in the primary insurance industry.

There were other contributing factors too. The result, as we all know, led to the overall market reaction of 1985. At that time, reinsureds found that reinsurers, rebounding from a series of unacceptable results, were no longer willing to rely merely on hand-shake agreements without proper examination of exposure. Since that time, the marketplace has stabilized, but reinsurers continue to be selective in their acceptances and require more information from prospective reinsureds. While it's true that a more competitive environment exists in the marketplace today than we have seen in quite some time, it is also true that reinsurers have become more sophisticated. Current technology and analytical methods provide reinsurers with tools to more adequately assess the underwriting risk and hopefully resist the temptations of investment return.

Ultimately, both parties to the reinsurance agreement benefit when the reinsurer is provided with proper and sufficient information to adequately price the reinsurance product. Lack of proper information leads to improper pricing. Extrapolation of improper pricing at the reinsurance level to the entire property and casualty insurance industry leads to one inevitable conclusion: irresponsible competition and repetition of the disaster of the early 80's.

We need to focus on exactly what type of information is necessary for fair and honest pricing of the reinsurance product. We should not forget that the most sophisticated pricing technique is useless, unless the required underlying information is made available.

Reinsurance underwriters today take much more comfort in reinsuring a company which demonstrates a knowledge and ability to price the whole risk from the ground -- Why? Because not only can a good quantitative assessment be made from the underlying information and data available but also a good qualitative assessment can be made on the depth and breath of this information. This is certainly preferable over the company from whom this information is either unavailable or extracted only with great difficulty.

Insurers and reinsurers alike load their pure risk transfer costs for expenses, contingencies and profit. The contingency loading in any pricing -- is designed to be reflective of the degree of uncertainty of the expected outcome. This uncertainty only increases when information is limited or incomplete. Getting a handle on the basic underlying information should increase the efficiency of excess of loss pricing, which in turn should reduce the effects of swings in cycles and lay the foundations for more solid relationships between reinsureds and reinsurers.

OUTLINE OF DATA AND INFORMATIONAL REQUIREMENTS

I. Brief but thorough background on the reinsured and on the business to be reinsured.
   A. History of the company
   B. Types of business written
   C. Business to be reinsured

II. Supporting Reports
   A. Most recent Statutory Report
   B. Most recent Annual Report to stockholders
   C. CPA Audit Opinion
   D. Actuarial Reserve Certification
   E. Actuarial reports (either internal or by consultants) on the gross pricing of the underlying business. Actuarial reports on the associated loss reserving.

III. Underlying Underwriting
   A. Risk selection guidelines
   B. Rating -- Independent of Bureau?
   C. Rate Deviations
      1. Deviations from bureau rates
      2. Schedule Credits deviating from Company's manual rate
      3. Field deviations
      4. Overall deviation impact on rates: magnitude and frequency of deviations

IV. Underlying Business
   A. Policy Limits Profile: Within each category to be reinsured, the distribution of business by each policy limit issued.
      1. Is the distribution on a sample or the universe?
      2. Are the limits gross or net of facultative or other inuring reinsurance?
      3. Are limits expressed on a "from ground up basis" or are they excess of a deductible or retention?
      4. Are the limits on a risk, occurrence, or aggregate basis?
      5. Is allocated loss expense inside the limit?
      6. Exactly to what underlying policy limits is the reinsurance policy exposed?
   B. Composition of the business
      1. By line
      2. Personal vs. Commercial
      3. Geographic Distribution
      4. Tort vs. No-Fualt
      5. General Liability Exposures by type
         a. Form: OL&T, M&C, CGL Premises & Operations, Products
         b. Severity: Low, Medium, High
      6. Worker's Compensation Mix
         a. Distribution by State
         b. Within State, distribution by hazard group
         c. Excess Comp policies? How does the underlying retention affect the reinsurer's exposure?

OUTLINE OF DATA AND INFORMATIONAL REQUIREMENTS

C. Rates
   1. How are the underlying basic limits and excess rates determined?
   2. What is the expected gross loss ratio under the current rating scheme? Does the company rate for their gross line or their net line?

D. Experience
   1. Complete development history (evaluated at equal intervals) on all losses (separately for paid, outstanding, and alae) in excess of one-half the primary retention for the past 5 to 10 years. Did the policy limits censor these losses and to what extent?
   2. Corresponding history of subject premium and projections for the immediate future periods. Has the definition of subject premium been unchanged? Can the subject premiums be restated on current rate level?
   3. Has the company performed any analysis of frequency and severity trends?

V. Proposed Reinsurance Program
   A. Reinsurance Slip
   B. *Contractual Considerations*
      1. How will the reinsurance attach? On a risk, occurrence, or aggregate basis? How is each defined? Risk Attaching or Loss Occurring basis?
      2. Will allocated loss expense be shared and how?
      3. What is the ceding commission and brokerage fee?
      4. Is there a swing plan? What are the parameters? Has the company done any study of the gross aggregate loss distribution? Is there any data available for a loss distributional analysis.
      5. Is the definition of subject premium clear? How will the subject premium be determined? If subject premium is any other than gross underlying premium, how will the gross premium be allocated under the definition?
      6. How does the existence of a primary policy aggregate effect the attachment of per risk or per occurrence reinsurance?

VI. Other Miscellaneous Underwriting Considerations