THE ROLE OF UNDERWRITING AND MARKETING IN PRICING

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GENERAL COMMENTS

Pricing in the global sense means the actuarial, marketing and underwriting process by which manual premiums are determined. Just as pricing is not restricted to the members of the actuarial department, so too are marketing and underwriting efforts not restricted to the employees in those departments. All employees of an insurance company should direct their efforts toward selling, for without a sale, there is no company but the emphasis must be towards selling at a profitable level. Likewise, underwriting cannot be divorced from the pricing process, because prices are not constructed in a vacuum, but rather with specific kinds of insureds in mind.

Rather than just talking about the roles of underwriting and marketing in the personal lines pricing process, I'd like to outline the various phases that can occur while pricing personal lines in a "typical" company and to explore with you along the way, the role of the actuary in all of it.

THE PROCESS OF PRICING

Only part of the pricing process is pure actuarial ratemaking, and often the subtleties of that are not largely appreciated in departments outside of actuarial (Are we the Rodney Dangerfields of insurance, we don't get no respect?). To see how this process works, let's go through what many companies may engage in as the extended pricing process.

Often the process begins in the actuarial department with the preparation of an analysis which includes some information on the rate level indication. Let's focus first on the calculation and presentation of the rate level indication as prepared in the actuarial department. Most readers of the actuarial analysis inside the insurance company probably consider the production of the actuarial rate level indication to be the objective, formula-driven part of the pricing process. However, things may not be as straightforward as one might think.

Does the actuary prepare a rate review with indications that derive straight from some formula which includes a 5% underwriting profit margin, largely ignoring the impact of investment income? Or does she reflect the underwriting profit margin that management would find "acceptable" thus covertly reflecting investment income? Does the actuary reflect budgeted expense provisions? Or does she reflect regional differences in expenses? Or does she rely on the coming year's planned expense provisions instead of relying on the last three year's average from the IEE? How is loss development selected -- is it consistent with that under-lying the company's financial loss reserves, or does it derive from some other system which may not operate in parallel?

All of this suggests that the actuary has an incredible amount of influence before this so-called "objective" document is even released from the actuarial department. Some companies may even go so far as to produce two sets of indications, one reflecting the most they can hope to get by the regulators and one reflecting what management might be happy to settle for under the pressures of regulation, the goals of the marketing department and the financial outlook they are committed to.

Once the actuarial rate level indications are determined, they are usually included in a package with other relevant statistics such as renewal rates, growth statistics, and a general profile of the current insureds with respect to rating characteristics.

The actuarial department prepares these indications and all of the relevant statistics to serve as a LENS through which all of the activities of the company can come into focus for one purpose, projecting them into the future and thereby selecting the appropriate premium. Sometimes, it's like the "ghost of Christmas past". Rarely are future changes in marketing thrust, underwriting criteria, expense control, or general management reflected directly in the actuarial document. And I'm not suggesting that they should be, for they are largely unquantifiable.

The rate level indication in the strictest sense is an estimate of the needed rate change in order to attain the target profit underlying the calculation assuming that there is no change in the way the company currently operates. It is a static picture as just described.

The second part of a typical rate review package includes some type of rate comparison with the perceived competition. I say "perceived", since that company whose rates are lowest is usually perceived to be the current competition. Often the rate level indications are reviewed cursorily by those involved in making the pricing decision, and then all attention is focused on the market comparisons. I am assuming here that it is more than the actuarial department who is involved in making the price-setting decision, regardless of where ultimate authority may rest.

It is an important part of the pricing process to consider the market conditions. This seminar teaches cost-based pricing in several of its sessions, but a free economy tells us that if the cost-based price of the product is $700 and responsible companies are selling the same product at $600, it really doesn't matter what the actuarial indications are. The problem cannot be solved by setting the price at the $700 premium and trying hard to sell all of those "intangibles" that are peddled -- such as better policyholder service, better claims service, account billing (as if get-ting one single, outrageously large bill is better than two separate moderately large bills), readable policies (who reads them at the point of sale anyway??). After all, a $100 difference in price is $100!

The personal lines insurance market is characterized by a lack of product differentiation and by ease of entry into the market. This means that price competition is keen and the buyer will often comparison shop. This is especially true in states such as Texas where the state mandates the maximum rate and the product is a standard one. The buyer of insurance need only know how much the insurer deviates from the state rate to determine which policy to buy.

Getting back to the $700 indicated premium versus the $600 marketplace premium -- something must be done in this situation in order to make the product saleable. The actuary has to work with the underwriters and marketers in reaching logical solutions which will allow the product to be sold at market or near-market rates. And in that process the actuary must be faithful in telling the underwriters and marketers the expected effect on the profitability of the company if certain actions are taken.

Let's first consider the role of the underwriter in this process. Generally speaking, the personal lines underwriter does not have the individual pricing discretion available that the commercial lines underwriter has at his disposal. He must either accept or reject a risk according to a list of underwriting criteria and cannot change the rate in the manual. In the sense that there is this (sometimes unwritten) list of underwriting criteria by which the underwriter either accepts or rejects or places the risk in the preferred, standard or non-standard company, the under-writing criteria are definite extensions of the classification ratemaking that actuaries engage in. The actuary creates a class rate for, say, all drivers who are over 25 years old. The underwriter perceives that this class is not homogeneous and further imposes his judgment as to whether a given risk belonging to this group is better or worse than the average of the group. Criteria such as occupation, length of time in the current job, marital status, number of

speeding tickets, become further sub-classes into which he subdivides the classification.

Needless to say, if the underwriting selection criteria have changed since the time of the gathering of the data under-lying the actuarial ratemaking calculation, then something must be done to put the two in sync. Because the actuarial indication derives from historical experience and is based on the kinds of insureds written in times past, it will apply effectively in the future only if future risks have the same expected underlying costs as in the past. If suddenly this changes, the actuarial indications could be worthless. It is extremely important that this relationship be kept uppermost in the minds of all who are involved with pricing. The underwriting department is often known as the sales-prevention department, and it is in the business of declining risks. For this reason the underwriter tends to be the advocate for higher premium levels.

Speaking of advocates for a higher rate, let's do a 180 degree turn and speak about the marketing department.
These are the people who must actually go out there and try to market the product either to the agents who will in turn sell to the insurance-buying public or who have direct responsibility for selling to the public. Their jobs are a lot easier if rates are lower and since many of them are judged on number of units of sales rather than on a properly constructed loss ratio in conjunction with unit sales, the pressure is on. And their concerns about price are very real. If the actuarial indication is for $700 and the market is operating at $600, what are they to do? The marketplace drives the price in a free economy. And yet the actuarial rate must be attained if the company is to make a profit.

While recognizing that the concerns are real, we actuaries cannot be too eager to believe their arguments for why the future will not be like the past. How many of these arguments have you heard from the marketing folks about why the future will be better? If you have never heard them before, you better prepare yourself with some answers, because you will probably hear them soon if you are involved with personal lines pricing.

* "We're not writing that kind of business anymore. The quality of the business we are going to write will be much better." Somehow the empirical evidence that we have compiled over the years which shows that the loss ratio of new business is worse than the loss ratio of aged business gets lost in this argument.

* "We've changed our emphasis in sales to writing the more expensive home, and more expensive homes are simply better risks. We used to write tar-paper shacks, but now we write only mansions." What they mean here is that there exists such a thing as the objectively "good" risk and that it is totally unrelated to price. At some price every risk is a good risk and at some price, even the best risk is a bad deal. They forget, too, that when the tar-paper shack burned, it didn't cost a lot to replace it. The mansions that burns costs millions.

* "We just appointed a lot of new agents and they are going to give us much better business than our current agents." This is a slight variation of the first example I gave, aimed here

at the producer rather than the insured him-self. The rationale here is usually based on the loss ratios of the prospective agents and comes from their experience with carriers usually already in the agent's office. It's impossible to tell if the new company will get the same business as the current companies or if it is being slated for the left-over business. Another problem is that no mention is generally about the agents remaining with the company. They don't just disappear in general.

* "Except for the two large losses two years ago the experience of this state would be good. You can't let that determine the price level." This kind of comment illustrates that there is a lack of understanding that single, large losses in fact don't drive the rate level indication. But I have never heard the obverse of this statement, namely, "Gee, we were lucky last year that there were no large losses, so I guess the rates should be increased a little to reflect that".

* "We need to keep the homeowners rates lower so that the higher prices we charge for auto will produce a combined price that is competitive." This is the parallel argument to "We better keep the auto rate low so that the combined package with homeowner added in will be competitive." Not a bad argument, but not be applied concurrently!

* We cancelled all our bad agents and so the business we are

going to get will be better". This is similar to the first argument of getting rid of all the bad business, but now they just concentrate on the bad agent. This argument is often used as a reason for adjusting the indications prior to filing them with the regulatory authority. This way, the decrease in rates will be actuarially justified and the regulator will not question the solvency of the company and the adequacy of rates. Of course, carrying this concept through to its ultimate conclusion, I'd like to suggest that the regulator might be just a bit upset that so many agents were cancelled.

* "Our sales reps are better trained this year and are more capable of focusing on the service aspects of our product rather than just the price. And our marketplace is now for the upper income people who don't care so much about the price and are more interested in service". Upper income people didn't get to be upper income people by not caring about how much things cost. Especially one that is undifferentiated in their minds and kind of a pain to have to buy.

* "How can the actuarial indication be so high for homeowners insurance. I just looked at the last 8 months of producer calendar year experience and the loss ratio was great. This isn't reflected in your indications which are all outdated". This argument suggests that the marketing staff needs more education in the area of understanding actuarial indications.

* My own personal favorite was always, "You actuaries live in an ivory tower and so of course you have no concern for the problems we face out there in the real world." Where do we actuaries live? In hyper-space?

And I'm sure that many of you could add to this list. I don't want to make light of these issues. Nor do I wish to trash the marketing departments in general. They have real issues, real concerns in the pricing of their products. It is the actuary's challenge to use her available resources to help in the solution of the problem, not contribute to it.

Before I end this presentation, I'd like to say that there are a couple more aspects to pricing that we have to deal with besides the marketing and underwriting concerns. One could be the planning department which often has made plans or forecasts without the advice of the actuarial department about attainable rate levels for the coming year and the attendant effects on the unit sales and hence the written premium. There can occur a problem if the "plan" becomes ensconced as a part of the culture and worshipped and begins to drive the process.

Another, often overlooked area within the insurance company that has an incredible affect on the pricing posture of a company is the claims department. The actuary must make the claims department aware that the actions they take today will be reflected in tomorrow's prices, and any change they make in procedures should be communicated to the actuarial department so they can be quantified prior to development of a premium level indication.

The other challenge comes from regulators, who must rely on the objective standards of actuarial ratemaking and who must make decisions when sometimes faced with requests for decreases when increases are actually indicated. (This is always the dilemma of the pricing actuary. The indication, usually for a territory, is for an increase and the marketing department wants to decrease the rates. But for another territory with similar indications they want to raise the rates sky-high. How on earth do you accomplish they and still maintain integrity in the pricing system?) Clearly the public would like to have lower insurance premiums, but the solvency of the insurance companies must be preserved or the low premiums will do them no good.

Whatever the source of the pressure, be it underwriting, marketing, planning, or regulation, the actuary must attempt in his role not to be the advocate of anything except the TRUTH.

In conclusion, let me leave you with this thought about the marketing departments of many insurance companies. They often entertain and serve wine at their receptions. Do you know that the favorite wine (whine) in the marketing department is:
"Why do the rates have to be so high?"