

**COMMERCIAL LINES PRICING:  
UNDERWRITING AND MARKETING  
CONSIDERATIONS**



COMMERCIAL LINES PRICING: UNDERWRITING & MARKETING CONSIDERATION

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DURING THE NEXT FEW MINUTES, I'D LIKE TO TALK ABOUT COMMERCIAL LINES PRICING, PAYING PARTICULAR ATTENTION TO THE VARIOUS UNDERWRITING/MARKETING AND OTHER CONSIDERATIONS THAT INFLUENCE THE FINAL PRICING DECISIONS THAT COMPANIES LIVE AND DIE BY. I WILL BE FOCUSING SPECIFICALLY ON WHAT I FEEL IS THE ACTUARY'S ROLE AND WILL BE RELATING MUCH OF IT TO MY PERSONAL EXPERIENCES AT THE ROYAL (AS WELL AS AREAS WHERE I BELIEVE WE AT THE ROYAL CAN DO A BETTER JOB). ALSO, I WILL BE TALKING ABOUT BUSINESS THAT IS MORE OF A CONVENTIONAL NATURE RATHER THAN THE VERY LARGE, JUMBO NATIONAL COMMERCIAL ACCOUNTS.

WHEN WE SPEAK OF COMMERCIAL LINES PRICING, THERE ARE AT LEAST 2 DIFFERENT SITUATIONS THAT I THINK EACH MERIT SEPARATE DISCUSSION BECAUSE THE ACTIVITIES ARE ENTIRELY DIFFERENT:

1. JUDGMENTAL RATING - THIS IS WHERE WIDE LATITUDE EXISTS FOR THE UNDERWRITER TO CREDIT/DEBIT MANUAL RATES SO THAT HE/SHE CAN COME UP WITH VIRTUALLY ANY PRICE HE/SHE DESIRES.
2. CLASS RATES - THIS IS WHERE MANUAL RATES ARE FILED AND WHERE THERE IS NO (OR MINIMAL) FLEXIBILITY TO CHARGE OTHER THAN THE MANUAL RATE. EXAMPLES ARE BUSINESS OWNER POLICIES, NONFLEET AUTOMOBILE ACCOUNTS.

LET'S FIRST TALK ABOUT THE FIRST CASE, THAT IS WHERE THE PRICE IS ACTUALLY DETERMINED BY THE DESK UNDERWRITER WHO HAS A GREAT DEAL OF FLEXIBILITY VIA INDIVIDUAL RISK RATING PLANS TO CREDIT/DEBIT MANUAL RATES. THIS BUSINESS REPRESENTS A LARGE PART OF THE COMMERCIAL ARENA AND HENCE MERITS A GOOD DEAL OF OUR ATTENTION FOR THIS BUSINESS. WE WORK DIRECTLY WITH THE FIELD UNDERWRITING MANAGERS TO SET OVERALL PRICING GUIDELINES. THESE GUIDELINES CAN BE EITHER IN THE FORM OF CREDITS OFF MANUAL OR PRICE CHANGES ON RENEWAL BUSINESS. LATELY, WE HAVE BEEN GEARING THE GUIDELINE TO TARGET RENEWAL PRICE CHANGES, AS WE FEEL THAT THE MANUAL RATES AND HENCE CREDITS OFF MANUAL HAVE BECOME SOMEWHAT VOLATILE AS A RESULT OF THE CONVERSION TO ISO SIMPLIFIED; RENEWAL PRICE CHANGES, ON THE OTHER HAND, ARE MUCH MORE OF A CONSTANT IN THAT THEY DEAL WITH DOLLARS ON RENEWALS VS. DOLLARS ON EXPIRING POLICIES.

THE FIRST THING WE DO IS TO LOOK AT SOME PAST EXPERIENCE, MAKING ACTUARIAL ADJUSTMENTS TO PROJECT THE LOSS COSTS INTO THE FUTURE AND THE PREMIUMS TO CURRENT PRICE LEVELS. FROM THIS, WE DETERMINE WHAT THE ACTUARIALLY INDICATED ADEQUACY IS OF THE CURRENT PRICE LEVELS, OFTEN EXPRESSING THIS AS A RANGE RECOGNIZING CREDIBILITY, AND OTHER CONSTRAINTS THAT EFFECT THE PREDICTABILITY.

AT THIS POINT, WE BEGIN THE DISCUSSIONS WITH OUR FIELD MANAGERS AND TAKE INTO ACCOUNT THE REAL WORLD PRACTICAL IMPLICATIONS OF THE MARKETPLACE AS WELL AS VARIOUS UNDERWRITING/MARKETING ISSUES. THE FIRST QUESTION WE ASK IS: WHAT IS OUR STRATEGY IN THE GEOGRAPHIC AREA WE ARE TALKING ABOUT - I.E., IS IT AN AREA WHERE WE HAVE ASPIRATIONS TO INCREASE OUR MARKET SHARE AND SEE LONG TERM PROFITABILITY OR IS IT AN AREA WHERE WE ARE CONTENT TO HOLD OR GO DOWN SLIGHTLY. WE THEN LOOK AT VARIOUS PRODUCTION MEASURES TO SEE HOW WE ARE DOING. WE CONSIDER THESE TO BE A GOOD MEASURE OF THE RELATIVE COMPETITIVENESS OF THE PRICING, ALTHOUGH THERE ARE ADMITTEDLY OTHER PHENOMENA THAT ALSO AFFECT PRODUCTION. A KEY INDICATOR WE LOOK AT IS RENEWAL RETENTION (LAST YEAR WE DEVELOPED AND IMPLEMENTED, THROUGH THE PRICING ACTUARIAL DEPARTMENT, A NEAT SYSTEM THAT ALLOWS THE FIELD TO EFFICIENTLY TRACK RENEWAL RETENTION AND SUMMARIZE IT IN A NUMBER OF MEANINGFUL WAYS). WE LOOK FOR 75-80% AS BEING A REASONABLE RENEWAL RETENTION RATIO - ANYTHING OVER 80% IS EXCELLENT AND SUGGESTS OUR PRICING (AND OTHER RELATIONSHIPS) IS COMPETITIVE - ANYTHING LESS THAN 70% SUGGESTS WE HAVE PROBLEMS. WE ALSO LOOK AT NEW BUSINESS WRITINGS. UNDER NORMAL CONDITIONS, NB SHOULD BE ABOUT 25% OF ALL THE BUSINESS WRITTEN SO AS TO BACKFILL NORMAL RENEWAL ATTRITION. IF WE ARE DOING SIGNIFICANTLY MORE OR LESS, IT TELLS US SOMETHING ABOUT

THE COMPETITIVENESS ON THIS BUSINESS. I SHOULD NOTE THAT IN ALL OF THIS, THERE CAN BE ABERRATIONS IN THE PRODUCTION NUMBERS DUE TO LARGE ACCOUNTS THAT ARE WRITTEN OR LOST, DELIBERATE UNDERWRITING ACTIONS, ETC. THIS IS WHERE FIELD MANAGEMENT NEEDS TO HAVE INPUT INTO THE ANALYSIS. FINALLY, RECENT PRODUCTION MEASURES ARE A REFLECTION OF RECENT MARKETPLACE CONDITIONS - IN AGREEING TO A GUIDELINE, THERE MUST BE A CONSCIOUS ASSUMPTION ABOUT WHAT THE MARKET WILL DO IN THE NEAR FUTURE FOR WHICH WE ARE SETTING GUIDELINES. AGAIN, FIELD HAS GOOD FEEL FOR THIS, ALTHOUGH THE ACTUARY'S FAMILIARITY WITH THE MACRO SITUATION, HAVING DONE THE PRICING EXERCISE WITH MANY OFFICES, OFTEN IS INFLUENTIAL IN THIS PART OF THE DIALOGUE WITH THE FIELD MANAGER.

SO, TO SUMMARIZE, FROM DISCUSSIONS REGARDING ACTUARIAL INDICATIONS, FROM OUR STRATEGY, FROM OUR RECENT COMPETITIVENESS (PER PRODUCTION MEASURES), WE AGREE TO AN OVERALL GUIDELINE FOR THE TERRITORY. THE TERRITORY WILL THEN TAKE THIS AND REAPPORTION IT IN A VARIETY OF WAYS: BY AREA WITHIN THE TERRITORY, BY CLASS, BY PRODUCER SOURCE, ETC.

A FEW FINAL POINTS ON THIS PART OF THE TALK.

- 1) IT IS CRITICAL TO HAVE GOOD MONITORS IN PLACE TO TRACK ACTUAL PRICING PERFORMANCE VS GUIDELINE - NO MONITOR IMPLIES NO PROGRAM.

2) FIELD MANAGEMENT, AFTER YOU EARN THEIR CONFIDENCE, REALLY WELCOME THIS TYPE OF PRICING DISCIPLINE. THEY WANT TO BE GUIDED TOWARDS HOW TO PROPERLY PRICE THEIR BUSINESS AND WANT ALL THE HELP THEY CAN GET. IN THE PROCESS, HOWEVER, THE ACTUARY HAS TO BE PRAGMATIC AND PRACTICAL, WILLING TO LISTEN AND UNDERSTAND THE FIELD'S POSITION AND THE DYNAMICS OF WHAT HAPPENS OUT THERE - ALSO, NEED TO BE RIGHT MOST OF THE TIME!

A SECOND MAJOR ACTIVITY RELATIVE TO PRICING IS WITH REGARD TO MANUAL RATES. THESE MANUAL RATES ACTUALLY SERVE AS THE PRICE ON THAT BUSINESS WHERE JUDGMENTAL SCHEDULE RATING IS NOT APPLICABLE - ALSO, AS RESPECTS RISKS WHERE SCHEDULE RATING FLEXIBILITY EXISTS, THESE MANUAL RATES ARE THE STARTING POINTS FROM WHICH THE UNDERWRITER APPLIES THE VARIOUS INDIVIDUAL RISK RATING PLANS. AS RESPECTS THE LATTER, I USED TO THINK THE MANUAL RATES WERE SOMEWHAT ACADEMIC AS THE UNDERWRITER COULD GET WHATEVER PRICE HE/SHE WANTED, GIVEN THE WIDE LATITUDE OF FLEXIBILITY AVAILABLE TO SCHEDULE CREDIT/DEBIT. I HAVE CHANGED MY THINKING SOMEWHAT ON THIS, HOWEVER, AS I TEND TO THINK THAT INCREASES/DECREASES TO MANUAL RATES WILL GENERALLY FLOW INTO THE FINAL PRICES AS THERE IS A GENERAL MINDSET AMONG SOME UNDERWRITERS ABOUT CREDITS. IN OTHER WORDS, A PARTICULAR AN UNDERWRITER MAY HAVE A MINDSET THAT HE SHOULD BE UNWILLING TO DISCOUNT A MANUAL RATE BY MORE THAN 50% OR FEEL THAT 25-30% REPRESENTS LEVELS THAT SHOULD BE AVERAGED OVER THE BOOK - RIGHTLY OR WRONGLY, THIS MINDSET GENERALLY EXISTS WITH RESPECT TO WHATEVER THE MANUAL RATES ARE, BE THEY BUREAU OR BUREAU LESS 20%. SO, IN TERMS OF THE PRICING DISCIPLINE, WHERE THE MANUAL RATES ARE SET IS AN IMPORTANT PART OF THE WHOLE PROCESS.

FOR EACH OF THE COMMERCIAL LINES OTHER THAN WC, ISO RATES ARE GENERALLY A REFERENCE POINT. AS RESPECTS THE PRELIMINARY ANALYSIS, WE GENERALLY DO TWO THINGS. FIRST, WE LOOK AT THE COMPONENTS OF THE ISO INDICATION AND MAKE OUR OWN EVALUATION AS TO WHETHER OR NOT THE INDICATION IS APPROPRIATE. FOR EXAMPLE, FOR SOME LINES, WE LOOK AT THE BASE ISO RATEMAKING EXPERIENCE AND USING PROJECTION FACTORS THAT SEEM MORE TYPICAL OF OUR INTERNAL EXPERIENCE, EVALUATE IF THERE ARE MARGINS IN THE RATE. ALSO, IN STATES WHERE WE HAVE REASONABLE CREDIBILITY, WE CONDUCT A TRADITIONAL ACTUARIAL REVIEW USING OUR OWN DATA. FROM THIS, WE ATTEMPT TO ESTABLISH IF ANY MARGINS EXIST.

A SECOND PART OF THE EXERCISE IS A COMPETITIVE ANALYSIS. GENERALLY, THIS IS DONE BY OUR FIELD OFFICES. THE COMPETITIVE ANALYSIS IS GENERALLY A SPREADSHEET OF MAJOR COMPETITORS AND WHERE THEY ARE RELATIVE TO ISO (I.E., AT ISO, DEFERRED LAST CHANGE, ADOPTED WITH A 15% DEVIATION, ETC.).

ALSO, THE GEOGRAPHICAL AREA, THE STRATEGY FOR THE AREA AND THE LONG TERM PROFIT POTENTIAL COME INTO PLAY AS WELL, SO THAT THE DECISION OF WHETHER TO DEVIATE OR NOT IS A BALANCED ONE BASED ON PROFITABILITY AS WELL AS MARKETPLACE CONDITIONS AND LONGER-TERM STRATEGIES.



ANOTHER POINT - IF A DEVIATION IS INTRODUCED, I THINK IT MAKES SENSE TO PERIODICALLY DIARY (SAY EVERY 3-6 MONTHS) AND RE-SURVEY THE MARKETPLACE. A DANGER THAT EXISTS IS THE FILING OF A DEVIATION AT SOME POINT IN TIME AND LEAVING IT IN PLACE WHEN MARKETPLACE CONDITIONS AND REQUIREMENTS MAY HAVE CHANGED, CAUSING THE DEVIATION TO BE OUTDATED.

IN ALL OF THE PROCESS DESCRIBED, THE ACTUARY IS THE ONE IN OUR COMPANY WHO IS THE FOCAL POINT TO THE ENTIRE PROCESS AND AS SUCH HAS A KEY ROLE.

I'D LIKE TO MAKE A BRIEF COMMENT ON WC, WHICH IS ESSENTIALLY A LINE WHERE ADMINISTERED BUREAU PRICING EXISTS. ON WC, A MAJOR VEHICLE BY WHICH COMPANIES COMPETE IS IN THE PARTICIPATING DIVIDEND PROGRAMS. I FEEL THE ACTUARY IS UNIQUELY QUALIFIED AND SHOULD BE AT THE FOREFRONT IN THE DEVELOPMENT OF THESE PROGRAMS. SPECIFICALLY, ACTUARIES UNDERSTAND LOSS RATIO DISTRIBUTIONS, INSURANCE CHARGES AND THE NEED TO HOLD BACK A PORTION OF ANY PROFITS GENERATED BY RISKS THAT GENERATE A PROFIT IN ORDER TO FUND FOR UNRECOUPABLE LOSSES ON THOSE RISKS WHICH ARE EXPECTEDLY GOING TO GENERATE LOSSES. I BELIEVE THAT ACTUARIES HAVE THE DISCIPLINE TO PRODUCE A REALISTIC DIVIDEND PLAN, WHEREAS OTHER DISCIPLINES WILL NATURALLY TEND TO BE OVERLY OPTIMISTIC AS RESPECTS THE TREATMENT OF INSURANCE CHARGES.

SO AS NOT TO RAMBLE ON, I'D LIKE TO MAKE JUST A FEW MORE REMARKS AT THIS POINT.

- ACTUARIES RESPONSIBLE FOR PRICING SHOULD GET THEMSELVES INVOLVED, EITHER DIRECTLY OR INDIRECTLY, IN THE PLANNING PROCESS. IN OTHER WORDS, ANY PREMIUM VOLUME TARGETS THAT SERVE AS A FOUNDATION AROUND WHICH COMPANIES PREPARE THEIR BUDGETS, SHOULD BE REALISTIC AS RESPECTS ASSUMPTIONS RELATIVE TO PRICING. ORGANIZATIONS ARE NOT WELL SERVED BY SETTING OVERLY AMBITIOUS PREMIUM TARGETS BECAUSE OF OVERLY AMBITIOUS PRICING ASSUMPTIONS - MID-WAY THROUGH THE YEAR, THEY WILL FIND THAT THE ONLY WAY TO ACHIEVE THE PREMIUM TARGET WILL BE TO CUT PRICES FURTHER SO AS TO WRITE MORE BUSINESS - THIS DAMAGES THE COMPANY IN THE LONGER TERM WHEN THE UNPROFITABILITY FROM THE LOW PRICES EMERGES, AS IT INEVITABLY WILL.
  
- RECOGNIZE THAT UNDERWRITING CYCLES AND CHANGING MARKETPLACE CONDITIONS ARE A FACT OF LIFE. IN TERMS OF THE PRICING EXERCISE, DON'T BE NAIVE AND ASSUME THAT ACTUARIES CAN CHANGE THE MARKET - WORK TO OPTIMIZE THE PRICING OVER TIME, BALANCING ALL OF THE OTHER RELEVANT FACTORS IN ADDITION TO THE PURE ACTUARIAL INDICATIONS.

- VISIT SOME FIELD OFFICES AND/OR TALK TO FIELD MANAGEMENT AND UNDERWRITERS TO UNDERSTAND THE DYNAMICS OF WHAT HAPPENS AT THE DESK. THESE ARE THE FOLKS WHO HAVE TO SELL THE PRODUCTS AND PRICES.
  
- OUR PROFESSION IS UNIQUELY QUALIFIED TO OVERSEE THE PRICING. ALSO, WITH THE DEBACLE OF THE LAST CYCLE STILL FRESH, I BELIEVE SENIOR MANagements WILL BE LOOKING MORE THAN EVER TO YOU FOLKS TO KEEP THE BALANCE DURING THE NEXT CYCLE. I BELIEVE THIS CREATES OPPORTUNITIES FOR ALL OF US, AS ACTUARIES, TO FURTHER ENHANCE THE CONTRIBUTION OF OUR PROFESSION TO OUR ORGANIZATIONS.

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