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KNOWING WHEN TO WALK – A CASE STUDY IN PRICING AND RETURN ON CAPITAL

A significant insurer, having successfully capitalised on the upswing of the underwriting cycle after 9/11, has positioned itself to navigate successfully the inevitable downswing. In particular it has:
- developed a basis for identifying the point at which underwriters should walk away from business offered to them so as to ensure that the company achieves its target for long-term return on capital;
- provided underwriters with an understanding of the total system of financial dynamics, rather then just the loss ratio on which they previously focused ;
- identified a better way to interpret loss ratios , to help underwriters identify the walk-away point

The company
The company is one of the leading independent insurance businesses currently operating in the London market. It writes a wide range of marine, non-marine and aviation business It has regularly outperformed the market year on year since the mid-1980s.

The issue
Following 9/11, premium rates for most business increased substantially. Like many Insurers, the company did very well out of this. Between 2003 and 2004, its profit before tax rose by a substantial margin

The Insurer's CEO and its Chief Actuary were well aware that that this level of profitability was not sustainable. The cycle would inevitably turn and premium rates begin to drop again. To maximise profits across the cycle, underwriters needed to know when to decline risks on the basis of inadequate pricing to ensure that the business met its targets on long term return on capital.

The company had already done some work in this area, to make underwriters aware, when they wrote business, what ultimate loss ratio would be needed to get an adequate return. They had also carefully tracked pricing strength and projected expected price movements into the coming years. In a hard market, underwriters could often target lower loss ratios but, as conditions changed, the challenge was to determine at what point to let the business go – never an easy decision.

The Analysis
A conversation with Stewart Coutts and John Murray of TGP Management Advisers suggested to the CEO and the Chief Actuary that a better approach might be possible. The TGP consultants talked about the 'walk-away' price point below which business written destroys value, and how this theoretical concept could be operationalised.

'Business lost may always be regained, but money lost is gone forever' said TGP's John Murray.

The TGP approach involved ensuring that the results achieved across the duration of the underwriting cycle were at or above the required long term return on capital.

The project was focused on a single class of business, with a view both to making the project manageable and to developing techniques that could be adapted to other lines later.

The business itself was rated either by the use of independently produced statistical data or by the use of customer-generated information, where the customer was of sufficient size for its own database to be credible. In certain cases a hybrid methodology was utilised, the underwriters using independent data to overlay customer-produced statistics.

This approach was applied equally to business directly underwritten, reinsurance inwards and business transacted by way of binding authorities or similar arrangements.

As a first step, the TGP consultants worked with the client to understand the rate of return contribution required for the class of business by reference to selected capital density, the planning methodology employed, the historic business performance, the allocated and direct costs relating to the line, the reinsurance dynamics, any line of business interdependency and the pricing methodology adopted by the Underwriter.

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Observations were taken using historic data and the dynamics of pricing, costs and Insurance Operating Return to test the rate of return at different levels of pricing. This provided measures that allowed the client to determine a pricing floor. This process was designed to be integrated within the standard pricing techniques employed.

During the analysis, one point that was illustrated to the client was that although the desired end result is to optimise return on capital, focusing directly on this measure can be dysfunctional. Instead it can be better to use a measure which, provided that the capital density does not change, remains the same irrespective of movements in expense ratios or the level of allocated investment income.

A key concept that helped bring the idea alive for the company was a banking analogy. Across the cycle, there will be years when the return achieved is above the required long term target return, and a technique was developed to facilitate smoothing of earningsover a defined cycle period. . It should be stressed, for completeness that there are other, equally valid, walk away point measures.

Critical to the success of the project was the active involvement of the Underwriter. This was necessary to secure the Underwriter's faith in the approach adopted so that there was the confidence to make the hard walk away decisions that the process mandates.

Previously, the Underwriter had focused solely on the loss ratio. The project has made it clear that the Insurance Operating Return, and hence the return on capital achieved, is dependent on all the items that make up the insurance return loop, such as expense levels and cash-flow. As a result, the Underwriter now has a holistic approach instead of just looking at pure loss ratios

Outcomes

The project successfully produced a fully understood methodology, appropriate to the line of business, capable of producing a pricing floor for the Underwriter and the Underwriter's team.

In addition, it provided the ability to identify, for management purposes, infractions of the parameters produced by its application. Not only is this information valuable for Underwriters, but it will be required by relevant businesses to comply with Lloyds Circular Y3318.

After the project was completed, the client's CEO said; "This work has had real added value for us. We now have a good understanding of what walk away pricing really means, plus we have a methodology that we can extend to other areas."

"This is a great example of how a consultancy project should work. There has been real knowledge transfer to us from the consultants. We can now leverage our investment in this project by rolling the methodology to other lines of business."

Key issues

Achieving target long term rates of return on capital depends upon having a methodology for determining walk-away prices.

Developing such a methodology requires the active involvement of the Underwriter if it is to be employed in practice

Underwriters need to focus on more than the loss ratio and include all of the aspects of the insurance return loop

Tracking the outturn over the years of a cycle,and constant monitoring of actual and expected pricing strength, is a key part of the approach.

Pure loss ratio is not always the most effective measure for ensuring that target long term rates of return are achieved.

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