

Domestic rating is a science

In the current market conditions, it has become critical to leave the old way of doing business (which allowed some bad risks to be sold together with some good risks because the good risks were subsidising the bad risks) and to focus on rating each risk correctly. However, this is easier said than done. I have two dear friends; both studied at university with me, both are professionals and directors of their very successful businesses. Demographically, they have almost exactly the same profile except they take different views to insurance. One lost a trout fishing rod in a house move and thought that it had been pinched by one of the movers. So he lodged a claim and was paid out. However, some six months later he found it when unpacking one of those boxes that loiter in the far corners of the house and immediately phoned the insurance company and arranged for the repayment of the claim amount. My other friend moved to a new house and did not like a tree that grew next to his wall. The tree looked relatively old so he telephoned his insurer and told them that he thought that the tree would be falling down and suggested that they contribute to removing the tree which they did. So whereas one friend saw insurance as a safety net, my other friend saw the insurer as a financial contributor, and yet on paper they appear to be much the same type of risk.

No longer can these two risks be packaged the same despite their outward appearances and that is where the complexity of actuarially based rating mechanisms has come to play. These complex matrices are built to profile an insured to take into account various factors which describe the risk of the item that is being insured (a laptop is more risky than a desktop) and the exposure of the risk to the insurer (a diamond ring of R1 million versus a cellphone). However, nowhere is the matrix more complex than when rating a motor vehicle. As everyone knows a new, young driver is not as good a risk as an older more experienced driver – however, a new young driver of, say, twenty who is behind the steering wheel of their first car being a 2nd hand vehicle with a small engine capacity is probably a better risk than a new but older insured of say forty years who has just begun driving and recently acquired their license but who is now behind the steering wheel of their first vehicle being a brand new, high powered speed machine. However, one should not have the rating mechanism penalise young drivers for having their license for a short period of time and additionally at the same time penalise them for being young. This would be “double prejudice” to the youth and so the rating structure needs to introduce the “loading for license period” only after the prejudice for loading the youth has expired. Then there is a similar interrelationship between the “power to weight ratio” (PWR) and the “expensiveness” of the vehicle because most vehicles are priced so that the bigger the engine capacity the more expensive the vehicle is; however, there are some vehicles which are more expensive than other high powered vehicles but that do not have their engine capacity or power. Of course, you cannot isolate these two factors (PWR and “expensiveness”) without considering how they relate to the average cost of repairing that vehicle, and so it is that the actuaries have built up these complex models that allocate different weightings to each of these factors so that they can begin to identify and rate each particular risk.

These factors only look at the risk in isolation which would mean that my two friends would be rated equally. The model needs to go further and look at the risk in relation to the claims experience of the risk user as well as the claims as experienced in general. Of course, the sooner the actuaries get the claims experience the sooner that they are able to readjust, even if only slightly, the complex and intertwined matrix that generates the best rate for that specific risk. The benefit to the brokers is obvious because they are able to target specific risk profiles safe in the knowledge that the

premiums being charged are the best suited for that risk and so those that deserve a better rate will be charged an appropriate rate, rather than having to subsidize the poorer risks.