

Scientific Underwriting and the Broker

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In recent years along with the advent of direct insurance plays in the South African market, has come the introduction of scientific underwriting at the point of sale and at renewal. Whilst direct operators have tended to systematise their underwriting via computerised quoting engines, brokers have embraced the notion that there is a fair amount of art mixed in with the science of underwriting and this should not be left to a computer system alone.

There are arguments both for and against the scientific approach, but it cannot be denied that, when the volumes involved are large and the time available to underwrite is limited, a scientific approach as a basis for underwriting run-of-the-mill risks is necessary.

There are a variety of actuarial approaches to the method of scientific underwriting, the most desirable of which is the approach that determines a required premium based upon the peril to which each risk is exposed. This entails establishing probabilities for each element of the risk and converting their product to a rate to be charged for each peril. The premiums for each peril are then aggregated and a loading for commission, insurer overhead and margin are then added yielding the premium for the risk. All of these calculations are typically embodied in a computerised “rating engine”.

As the risk profile for each individual risk is different, so will the probability of the various peril exposures differ for each individual risk, hence differentiated premiums between risks.

This brings one to the question: “why would one want to differentiate between insureds?”

Why, if, as a group, the premium collected from all the insurer’s risks is sufficient to pay the claims, pay commission and expenses, and leave sufficient profit remaining for the carrier, would one want to differentiate the premium between risks?

Viewing the population of risks as a whole without differentiation, some condone cross-subsidisation. Cross-subsidisation in this context means that relatively good risks pay the same premium as relatively poor risks.

Cross-subsidisation is a dangerous strategy as it opens the door to price competition. If one’s book is heavily cross-subsidised, it exposes the book to competition from a carrier who does differentiate. The result will be that risks that are subsidized (typically the poorer risks) will tend to “stick around”, and the risks that are subsidizing others (typically the better risks) will come under pressure to move due to lower premiums being offered by differentiating competitors.

The net result of this activity on the book is that there will be fewer better risks to subsidise the poorer risks and the effect will be felt in the loss ratios. Pressure then comes

from the carrier either to lift the rate for the book or, if the situation is irredeemable, to cancel.

The objective of the broker, as the agent of the insured, is to secure the best deal for his client. One might say that brokers should therefore seek out carriers who do not differentiate in their pricing. However, this strategy is bound to be short-lived for the reasons mentioned above and can only lead to an undesirable situation.

Brokers pride themselves on the relationship they hold with their clients, and they need to leverage upon this relationship. Brokers should use their unique position not only to promote differentiation between their clients' risk profiles, but they should strive to use their unique knowledge of their clients to seek out further rating factors not known or asked for by the carrier when underwriting their clients. The effect of this unique knowledge can typically be made manifest by the use of a discretionary loading or discount wielded by the broker. This approach can be used to great benefit when thwarting the onslaught by direct carriers who do not have the intimate knowledge of their clients that brokers do.