Whence Comes Insurance Company Pricing?
By Chris Burand

"Do insurance rates really have an actuarial basis?"

An insurance client might respond, "They damn well better have an actuarial basis!" A company person might think, "Of course they do. That is why we pay actuaries." And, depending on their point of view, an actuary might say, "Absolutely! Actuarially based rates are the solid foundation upon which the entire insurance industry is built!" or an actuary might say, "Nope. Not even close."

On a very macro level, consider this: commercial rates have jumped by 30%-200% the last two years (depending on the line). Insurance companies have been insuring the same roofers, nursing homes, manufacturers, and contractors for the last twenty years. Therefore, they have an adequately sized population upon which to base rates. They also have strong loss trends, so they should be able to fairly accurately predict losses. Logically too, it would seem these loss trends would, if graphed, show a fairly smooth line and definitely not one where losses jump 30%-200% for a specific two-year period. After all, we are dealing with the law of a large sample where some years results will be slightly better than indications and in other years results will be slightly worse but the overall trend will resemble a relatively straight line (barring very large catastrophe losses).

The industry-wide consensus seems to be that the significant increase in rates was caused by historical underpricing. What, then, caused the underpricing? Two distinct possibilities exist:

1. If prices were based on actuarial work, then the actuarial work must have been poor.
2. Or, prices were not primarily based on actuarial work.

Most agents have encountered the situation where a competitor was trying to take away a client with a 60% five-year loss ratio by offering a rate 20% less than their prior year's premium. My bet is that companies, for all practical purposes, abandoned actuarially based sound pricing during the soft market.

I recently wrote an article about how an agent convinced a company their pricing on an entire class was 75% too high. The agent did so without even using a competitor's price as an example. The agent simply showed the company their own profit margin on the class. Another agent responded that it seemed very unlikely a company would have missed its actuarial basis by 75%. This is a good point which leads me to wonder if companies did not base their rates on actuarial basis in a soft market, what makes anyone think they are doing so in a hard market?

I strongly believe market capacity and appetite are much more important to pricing than actuarial basis. Given the long history of our markets, if prices were based primarily on actuarially sound logic and the honest desire to make an underwriting profit, we would not have such drastic price changes. But we do have huge highs and low lows and since the industry has not made an underwriting profit for decades, perhaps it is time to face the truth. Insurance should not be treated any differently than other products whose prices are based on the market. The market determines the price of gasoline, toys, and cars. The market, not actuaries, determines the price of insurance too.

Agents that understand insurance company rates are not set by actuaries can use this knowledge to pro-actively manage their companies and clients. Agents can determine which companies are in the best position to thrive given the pricing environment. For example, under the current pricing environment, where price increases are moderating, the most stable companies will be those that do not need rates to continue increasing to maintain their rating or to even survive. Why those companies? First, as the market softens, these companies can withstand lower rates without endangering their well-being. Second, their financial status will be adequately strong so they will not be forced to implement operational changes to maintain their financial well-being. They can maintain their course, maintain capacity, and not cut commissions. Weaker companies will have to cut costs drastically if rates do not continue increasing sufficiently to generate substantial profits at their current cost level.

Avoid those companies that cannot withstand lower pricing. Begin moving business from these companies slowly so that when they begin cutting commissions, selling parts of their companies, or even worse, being significantly downgraded, your agency will not be caught by surprise. You will already have begun moving business.

Markets, and sometimes crazy competitors, set prices in all industries. Keep this in mind and use it to your advantage.

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