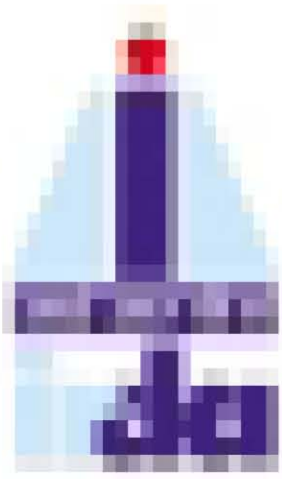

Journal

Right Selection and Classification

The Touchstone of Underwriting

बीमा विनियामक और विकास प्राधिकरण

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Underwriting in a Detariffed Market

- Impact on the Cross-Subsidization Phenomenon

'Underwriting requires a kind of discipline which can exist only if all the insurers work collectively towards a common interest - that of a healthy bottom-line' writes Meena Nair.

Introduction

There is an often-heard debate in the insurance industry. Is underwriting a science or an art? While there is no conclusive answer to this, the fact that it is heavily reliant upon statistics and data, tilts the scales towards it being a science. While the collecting of data and analyzing it is a science, the art of applying this analyzed information into insurance underwriting is an art. In this article, we go on to discuss whether it is getting its due care i.e. is underwriting being done after studying the risk, and more specifically what impact de-tariffing would have on the phenomenon of cross subsidization .

What is underwriting?

Underwriting is the expertise required by the insurer in acceptance of a risk, weighing all the pros and cons in analyzing the risk. The terms, conditions, deductible etc. would need to be well analyzed for arriving at the premium rate chargeable and the risk accepted by the insurer.

What is the present state of underwriting?

Underwriting generally works in cycles of hard (where demand exceeds supply) and soft (vice versa) markets. For instance, following the 9/11 tragedy, the terrorism market had hardened and the number of insurers willing to accept the risk of terrorism was on a decline. The terrorism market is now soft.

Underwriting requires a kind of discipline which can exist only if all the insurers work collectively towards a common interest - that of a healthy bottom-line. In a newly 'opened-up' market like India, discipline would naturally take second position to top-line (premium) growth till the players establish themselves and reach a stage of maturity. As a result, the market has seen various hues of underwriting discipline at various stages - starting from an 'at-any-cost' scramble for large, attractive corporate risks; to a cooling off and re-alignment towards more profitable lines and retail markets by some insurers.

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One of the more interesting phenomena of underwriting in a liberalized yet tariffed market has been the concept of cross subsidization.

What is Cross-Subsidization?

Every risk has a 'pure-risk' rate of premium that an underwriter basically recommends as a sound and viable rate. Commercial considerations may then prevail (for instance, the marketing team's eagerness to retain an important client); and the final rate charged may be far lower than the "pure-risk" rate. In a tariffed market, this reduction could only have been extended to Non-Tariff products like Health, Accident, Marine, Miscellaneous etc.

Cross subsidization is basically the acceptance of a Non-Tariff risk at less than the "Risk-Rate" recommended (read: accepting a loss portfolio) because it is being offset by a significant volume of Tariff Premium from the same customer. In effect, the "profitable" tariff lines are subsidizing the "unprofitable" non-tariff lines - leading to a cross-subsidy across product lines.

During recent years, we have all heard cases of Marine being quoted at nominal rates (almost as a free add-on cover) and Group Health policies getting renewed at as low as 50-60% of average claims paid over the last 2-3 years. These are clearly examples of commercial considerations over-ruling underwriting principles.

On a macro level, if you ignored the fact that a particular line was doomed for consistent underwriting losses, cross subsidization was a Win-Win proposal for both the insurer and the customer. Thanks to a high-priced and rigid Tariff rate, the insurer was making an 'obscene' profit from around 60-80% of the customer's premium portfolio. Companies with sound risk management practices and favourable loss records felt, perhaps justifiably, that they deserved commensurate benefit somewhere else. Insurers, on their part, were naturally eager to oblige in

the non-tariff area, so long as the overall customer portfolio was profit-making (in effect, the insurer was collecting a 'higher than pure risk' rate on the Tariff component and a corresponding 'lower than pure risk' rate on the Non-tariff component.

Impact of De-tariffing on Cross Subsidisation

Most insurers have different goals. While one may want top line growth, the other may yearn for underwriting profits. Yet another may be aggressive only in particular lines of business; and another may try his best to balance both, the top line and bottom line. Until now, with 70% of the market falling under the tariff, there was no sufficient reason to suspect that there would be an imbalance in the acceptance of risks in the industry. There is a possibility that in the market post Jan 1st, 2007; this balance could be in jeopardy, at least initially. It would be only a price game with almost all the insurers keen on volumes. Consequently, there could be a sharp drop of about 20-25% in the prices of hitherto "tariffed" lines. In the areas of Fire, followed by Engineering, being considered as the more 'profitable' businesses; all insurers would vie to have the icing on the cake **at any cost**. With the IRDA opening the door only for freedom in pricing (freedom to negotiate clauses, terms and conditions etc will be allowed only in 2008), a price war is a near-certainty.

What then will happen to the above-mentioned Non-Tariff products? Will they continue to enjoy any subsidies at all?

The commonly-held belief is that Cross Subsidies will slowly but surely come down. With the progressive drop in prices of Fire and Engineering covers as outlined above, insurers will have to start pricing their Health & Marine portfolios more realistically and follow the underwriters' guidelines.

In effect, companies which enjoyed ridiculously low Marine rates and Group Health renewal prices; will be well-advised to prepare for a hike in their outflow. At the same time, customers with large Tariff premiums (eg: large well-managed manufacturing & construction companies) are expected to have a net benefit (with a drop in tariff and hike in non-tariff premium). Others like IT & services Companies (where health & marine premium dominate) are expected to suffer a net increase in premium pay-outs.

An intermediary's role in a detariffed regime

A de-tariffed market would certainly enhance the role of the broker. Both, the insurer as well as the customer would need the services of a professional broker.

The brokers would not merely participate in the price war but would need to give quality submissions to the insurers conveying all the material and non material aspects of the risk to be covered. He would be the catalyst between the customer and the insurer and assist in guiding the competition along healthy lines and ensure the sustenance of the parties involved. He will play the role of a consultant in the true sense; and risk management in the true sense would require to be advised.

Corporates with sound risk-management practices stand to benefit in the long run; and all medium and large companies would be well-advised to focus on this aspect of their operations instead of merely negotiating a short-term price advantage.

To get the best rate from the insurer he would need to

- Have knowledge of individual risk peculiarities and the industry as a whole.
- Be able to assess as to what could be the maximum potential losses that the risk & a peril could produce.
- Estimate the customer's capabilities for prevention and minimization of losses.
- Suggest the indicative rates, terms, and conditions and deductibles.
- Assess the moral hazard relating to the customer.

The quality of the homework done by the Broker; and the data on losses and quality of risk collected and submitted by him will go a long way in pricing the risk scientifically. Where non-tariff premium is shooting up, the Broker can advise on loss control mechanisms to avoid a steep increase (eg: analysis of Health claims and designing a more cost-effective coverage for employees and dependants).

Conclusion

All indications point to a price war for Tariff lines to begin with, with a gradual cooling off over a year or two. As the market stabilizes, and insurers move from "top-line" to "bottom-line" focus, underwriting practices are expected to improve.

The effect of all this on Cross Subsidies remains to be seen - large, well-managed companies will continue to ask for a portfolio-based, and not a line-wise, pricing model. And insurers will continue to oblige. Corporates with sound risk-management practices stand to benefit in the long run; and all medium and large companies would be well-advised to focus on this aspect of their operations instead of merely negotiating a short-term price advantage.

As India Inc. moves towards improved corporate governance in other areas, it is hoped that de-tariffing and the consequent improvement in underwriting practices, will provide the much-needed impetus for corporates to adopt better risk management practices.

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