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A Different Take on Insurance Price Optimization

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Bill Gausewitz, Esq., recently published an intriguing article in *Carrier Management t*hat supports insurers using "price optimization" approaches (http://www.carriermanagement.com/features/2015/05/19/140110.htm)to make profits. He pits "…business goals of growth and profit…. (and) what may be reasonable from a business perspective" against what "will still be scrutinized by regulators who look for clear ties between pricing and risk or expense".

The idea of buying insurance based on "how much is it worth to you to be protected from some awful hazard one cannot afford to self-insure" makes as much sense as buying a drug based on the same premise, i.e., how much is it worth to you to save your life. The concept collides with the basic insurance concept of pooling homogeneous "insureds" so as to have the means to protect those few in the pool that suffer a loss from what is to be protected.

Gausewitz's article appears to rely on four assumptions to support his views:

1. Regulators seem to use "price optimization" to refer to setting rates with an eye on business considerations other than losses or expenses.
2. The controversy stems from regulators' belief that "price optimization involves rating based upon factors with no legitimate connection to the cost of providing insurance such as "higher premiums based on whether a consumer is less likely to notice, shop around or object or that loyal customers will be charged higher rates because the insurer concludes it can do so without losing the customer."
3. There are too many differing state definitions of price optimization.
4. It is neither unusual nor derogatory to say that insurers want to maximize profits.

While much thought has gone in to his analysis, there may be more to consider, both from a regulatory perspective, and the efficacy of corporate desire to maximize profitability.

Regarding points 1 and 2, customer service is key, and included in allocated loss adjustment expense that is part of actuarial pricing analysis. The importance is more subtle. A broker is selling how a company responds when needed. In essence, insurers are selling how the Gausewitz's (given his defense counsel status.) of the world respond. It's the service he provides to an insured that is the product being sold. That's not to say that some insurers and service providers are better than others, or that some insurers may charge more than others, but quite often, the notion of you "get what you pay for" becomes hauntingly true.

Regulatory oversight on pricing generally applies to admitted insurers and the coverages sought to be placed on that basis. There is no such pricing review or policy form review when policies are written on a non-admitted basis. The actuarial role then becomes more of a guidance: "never go below this, but see if you can get more" is more akin to what may be in line with the author's credo. But market forces in a competitive environment (together with re-insurance pricing) seem to still dictate pricing philosophy. Making a profit is thus a result of being consistent with, and staying inside the actuarial model. That goal is achieved by providing the service and claims response expected and tweaking the model when necessary. Pricing based on consumers' price sensitivity is unscientific and fraught with danger given most consumers would like to pay nothing and get everything.

Point 3 has some justification, but any regulatory definition used would suffice if pricing is determined by traditional actuarial analysis. Regulators are wise to express concerns that insurers were shifting away from cost-based ratemaking and toward consumers' price sensitivity. Rightly so, given that insurance pricing is a combination of premium minus loss and loss expense equaling a predicted profit. It is not something that can be driven necessarily by other business mantras relying on the much-perverted concept of "adding to shareholder value."

Supporting point 4 is the thought that "If an insurer is considering raising its prices, it is going to analyze its book of business." Nothing is truer in that an actuarial model can be significantly upended by the simple stroke of an Appellate pen. The impact of a price change on profitability is certainly going to impact decisions, yet in a scientific manner that protects the insurer more than the consumer. Making a profit is a result of being consistent with, and staying inside the actuarial model as opposed to the uncertainties that would result from seeing what one can get away with or that the consumer will neither challenge but accept instead.

Gausewitz's article also suggests "charging different rates for different risks is discriminatory, in the sense that it discriminates between different risks, but it is not considered to be unfairly discriminatory. Indeed, this type of discrimination is the essence of insurance pricing." This is not entirely accurate if those reviewing pricing remain true to the tested adage that pricing be based on the concept of pooling *homogeneous* "insureds" so as to have the means to indemnify (putting them in the same position they were in before the loss) those few in the pool that suffer a loss from what is to be protected. To do otherwise, and create a pool that is not considered homogeneous would in fact be discriminatory and actuarially unsound, thus justifying the reaction that " regulators will be skeptical and will scrutinize these factors aggressively".

A welcome reception honoring the new CEO of a major insurance conglomerate offered an example of misplaced business strategies in this regard. He espoused the fact that significant capital (surplus) was being allocated to the underwriting divisions, and was expecting a "reasonable rate of return" on that capital allocation. While he seemed reasonable in order to be "profitable", did this CEO know he was an insurer rather than an internal banker? Not once was the word "insurance" used. Would prospective insureds, in making decisions to spend thousands of dollars to buy their products, care that the insurer wanted a reasonable rate of return on the capital allocation? Or would the prospect care more about the company standing behind the product purchased, and providing the indemnity sought when and if needed?

In 1981, Jack Welch gave a speech at a business luncheon where he espoused the soon to be perverted concept of "adding to shareholder value," a process he said is achieved by creating the best products and providing the best service compared to anyone else in the marketplace. This lost concept was amplified by Welch's March 2009 statement where he said a quarterly focus on profit and share price gains was "the dumbest idea in the world".

Vast amounts of capital are coming into the insurance and reinsurance industry. Much of the source of funding may be from hedge funds and private equity companies. There are several models for successful equity investing and M&A transactions. Other models could also end up destroying the very culture and expertise that made an acquisition or an investment attractive in the first place. Often, a misguided desire for short-term returns motivates those who seek immediate ROI irrespective of how that is to be achieved.

Those who seek immediate return (so as to be able to spin off the investment in 3-5 years) may care little as to the ups and downs of insurer profitability, given the unstable nature and lack of consistent predictable results. The simple stroke of an appellate pen can alter profitability significantly. This is something private equity investors care little about, requiring nothing more than increased sales and revenues (which isn't the profit center), resulting in possibly under reserving of claims, and hardened coverage and settlement positions (ignoring that the claims department *is* the profit center when following the actuarial model). For production and brokerage organizations, margins and revenue become more important than quality of coverage.

The result: profit and revenue becomes the focus, instead of providing financial security to those who are customers and thus seeking just that. When profit becomes the focus, claims department quality and attractive internal cultures may become diminished by the exodus of talent. Profitability becomes impossible when the claims department acts or engages in expensive coverage litigation, which was not incorporated into the actuarial model.

Of course, isn't that what this regulatory debate on price optimization is about?