ZURICH®

Understanding Commercial Insurance Premiums

Sustainable pricing for customers and shareholders

Opening the books

Risk and uncertainty are part of everyday life. There are some risks we are all prepared to take and some risks that may severely impact our lives and livelihoods.

The insurance industry exists to satisfy the fundamental need for people and businesses to protect themselves from those risks that are just too great to take.

The principle of insurance is, in itself, fairly straightforward:

- An insurance policy transfers all or most of the expense of a potential loss from customer to insurer, for which the insurer charges a fee or premium.
- The insurer pools all premiums from customers facing similar risks.
- It then pays for losses, its own expenses to understand risks and administer the business, and usually a broker for providing a customer with professional advice and choice.
- The insurer also attempts to retain a profit to deliver the expected returns to the shareholders who provide the capital to make all of this possible.

That said, the internal workings of an insurance company and its jargon are complex. That's not for any 'bad reason' or ulterior motive, it's simply complex to understand the variety of risks that face a wide range of businesses, set appropriate premiums, assess and attach reserves to claims… and set reserves for claims that may happen in 40 years' time that haven't even been considered at that point.

This booklet is designed to try to make the financial workings of the industry easier to understand by breaking down a typical commercial insurer's profit and loss. We hope this document is a help to understand how we go about calculating your premium, and understanding the trends and challenges affecting insurance premiums today.

Vinicio Cellerini

Head of Commercial Insurance
Zurich Insurance plc, UK

A commercial insurer's typical profit and loss

Income

Gross written premium (GWP)	£100m
Net earned premium (NEP)	£75m

Costs

Claims' costs		
Current year		% of NEP
– Attritional losses	£31m	42%
– Large losses	£4m	6%
– Catastrophe losses	£2.5m	3%
Prior year development	-£0.5m	-1%
Total claims	**£37m**	**50%**
Expenses	£15m	20%
Commission	£19m	25%
Total costs	**£71m**	**95%**

Profit/loss

Underwriting profit/loss	£4m	
Combined ratio		95%
Investment income	£1m	
Operating profit	**£5m**	

This example leads to a combined ratio of 95%, which for a typical mix of commercial lines business would lead to around 12% return on equity. However, this will vary by the mix of business.

Every insurer has a target combined ratio (CR) that delivers the expected return to shareholders.

These figures have been rounded for illustrative purposes only.

Commercial insurance jargon explained

Gross written premium (GWP)

This reflects the income the insurer expects to receive from all customers over the policy term (usually one year).

Net earned premium (NEP)

This is the income from which all expenditure is deducted. This figure reflects the amount of premium that the insurer has earned at a particular point in time. For example, a policy purchased on 1st January for £1,000 will have 'earned' the insurer £500 on 30th June the same year.

Claims' cost

Claims' costs can be categorised into three broad areas:

- Attritional losses: smaller and more frequent types of claims.
- Large losses: these happen less regularly but have a bigger impact on customers.
- Catastrophe losses: large scale incidents that normally impact a number of customers at the same time, for example, flood or storm.

The absence of large and catastrophe claims in any one year can lead to an over-estimation of profitability. Insurers, therefore, spread the expected cost of large and catastrophe losses across the longer-term and across all customers (the principle of pooling risk).

Additionally as wordings develop to meet customers' needs, wider cover invariably means we see more claims. Especially where there is request to extend cover to include non damage related payments or services the consequence is overall costs per claim increase as a result.

Prior year development

Not all claims are settled in the year that they are made. An adjustment is, therefore, made to the expected costs of claims made in prior years as costs become clearer or to reflect emerging trends. Prior year development will also be affected by newly-reported claims that occurred in historic years, for instance in disease cases. This amount can be positive as well as negative.

Personal Injury Discount Rate

Within claims' costs and prior development, we need to cater for losses that are settled over a period of time. The discount rate is an adjustment made to personal injury awards to take into account the return expected when invested as a lump sum.

On the 7th September 2017 the Lord Chancellor and Justice Secretary, David Lidington announced measures to change the way the discount rate is calculated. The proposal will have to be drawn up and approved by Parliament, so it is currently unclear when this will be implemented. However, if the new system were in force today the rate might be in the region of 0% to 1%. The current discount rate was implemented 20th March 2017 by the then Lord Chancellor, Liz Truss, who changed the original discount rate from 2.5% to -0.75%. This has had a significant impact to current injury claims' reserves and needs to be reflected in future casualty and motor pricing.

Claimants should absolutely get a fair settlement of claims following an injury, but the decision to change the discount rate from 2.5% to -0.75% on 20 March 2017 has had implications in terms of the cost and affordability of insurance.

Zurich is a financially-strong global insurer and this change won't diminish our ability to pay claims. However, this is a double whammy for insurers and their customers on top of the Government's successive changes to Insurance Premium Tax and is likely to negate any savings from planned whiplash reform. This is also against an unavoidable backdrop of now commonplace low investment returns – historically the tool insurers used to help lower premiums.

Below are a couple of examples designed to illustrate how the change in rate from 2.5 to -0.75 in March 2017 has impacted the value of the claim, this is purely for illustrative purposes. In practice this is very much case specific and depends entirely on how the claim is settled.

Consider a customer with an open employers liability claim valued at £200,000 with a male claimant aged 44. Using the Ogden discount tables, the component of the claim with Ogden related damages would increase by 69%. Assume that the damages are split 50:50 between loss of earnings and pecuniary loss (including cost of care) and that of the £200,000 claim, £40,000 of the claim is Ogden related. Moving from an Ogden discount rate of 2.5% to -0.75% results in an impact of approximately £27,000.

Consider a customer with an open motor injury claim valued at £4,000,000 with a male claimant aged 30. Using the Ogden discount tables, the component of the claim with Ogden related damages would increase by 106%. Assume that the damages are split 50:50 between loss of earnings and pecuniary loss (including cost of care) and that of the £4,000,000 claim, £2,500,000 of the claim is Ogden related. Moving from an Ogden discount rate of 2.5% to -0.75% results in an impact of approximately £2,650,000.

Expenses

Like all companies, an insurer has a variety of operating costs in order to run its business. These costs include assessing and underwriting risks, handling claims and estimating the reserves needed to pay claims in the future. This is in addition to the functions that all large businesses need – HR, Legal, Marketing etc.

Commission

The majority of customers use a broker or intermediary to help them understand their insurance needs and to place their risks. These services can be paid for via a fee from a customer to a broker or via an insurer paying commission from the premium.

Underwriting profit/loss

This is the NEP minus the total costs. As with any business, an insurer is seeking to make a profit from its day-to-day activities. This underwriting profit is added to any investment income earned to give the total operating profit. It is becoming increasingly important to maximise underwriting profit as investment returns in the financial markets continue to decline.

Combined ratio (CR)

CR is the total cost divided by net earned premium. It is the primary measure by which an insurer's operational performance is judged. A CR below 100% means that an underwriting profit has been made. A CR above 100% means that the insurer is making an underwriting loss.

Investment income

Insurers invest premiums received which adds to any underwriting profit made. Different lines of business have different claims' payment patterns e.g. Employers' Liability is a 'long tail' line, meaning that claims' payments are spread over a longer period and, thus, the investment income on the premium is greater.

Historically, investment income was used to help lower the cost to customers of insurance. We've been in a period of lower investment returns for several years meaning this level has less influence than it once did.

Insurance Premium Tax (IPT)

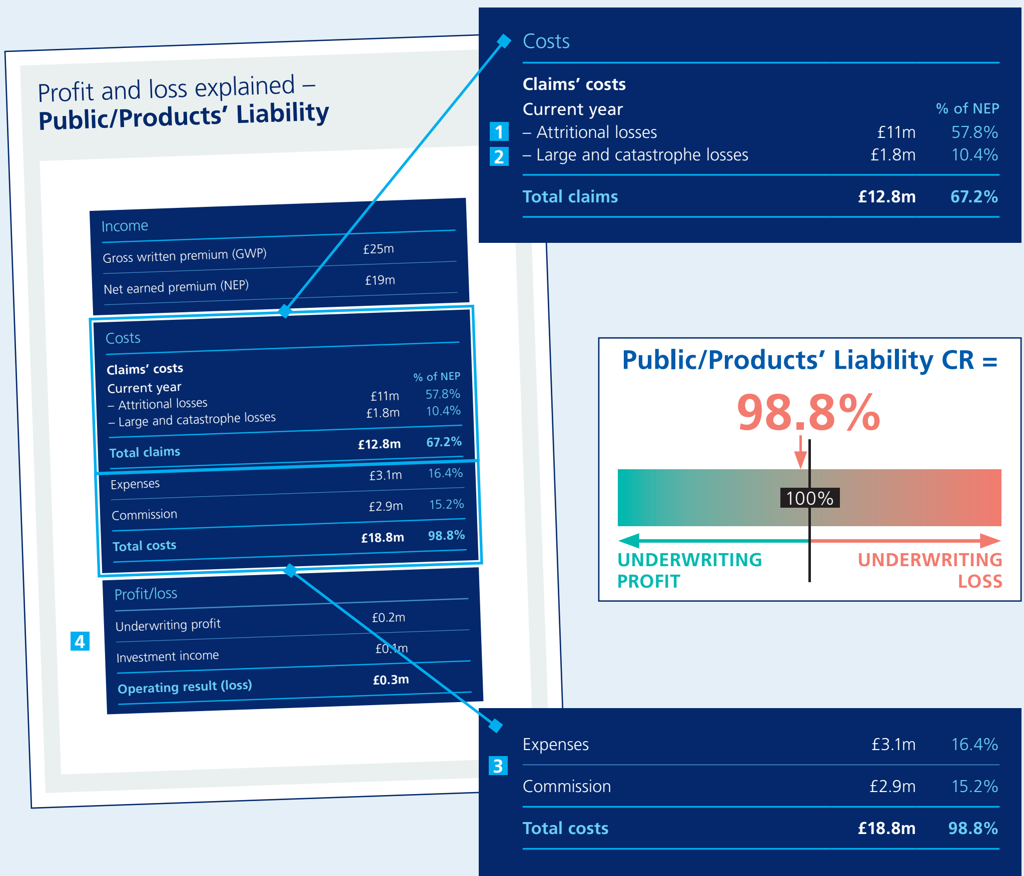
Insurance Premium Tax is applied to the purchase price of most types of insurance premium. It's similar to the way VAT is levied on goods and other services.

The Government has announced a number of increases to Insurance Premium Tax in the United Kingdom since November 2015, meaning that IPT will have doubled in less than two years. This comes as a challenge for customers large and small who are trying to manage their spending more than ever, as well as the costs on insurers to implement changes.

Profit and loss explained – **Public/Products' Liability**

Characterised by the increasing volume of smaller claims as the focus of claims management companies has moved from other areas and where investment income was historically a major factor when setting premiums.

The latest market figures show the combined ratio (CR) for Liability was 98.8% (Source: Verdict Financial 2016 report) – a breakdown representative example for illustrative purposes is shown below.



These figures are shown for illustrative purposes only.

1 Attritional losses

Changing behaviours

The introduction of the Legal Aid, Sentencing and Punishment of Offenders (LASPO) Act has been a success in reducing the costs associated with small claims and increased the speed of access to justice for claimants. However, claims management companies and claimant lawyers have turned their attention to finding new ways to bring claims outside of the portal and fixed cost legal regime.

Claims' inflation

The average annual claims' inflation for bodily injury is low single digit and significantly higher (double digit) in the event of catastrophic personal injury. The average life expectancy continues to rise along with the future costs of care and the combination has an impact on the overall claims' costs.

Latency

This is the need to price for future uncertainty in order to cover claims that are yet to be discovered from unknown exposures. For example, the advances in medical diagnosis mean that liability is getting easier to pinpoint. For instance, some law firms are beginning to report a surge in the diagnosis of chronic back pain and injury related psychological conditions. Also the advances in technology may bring as yet unknown exposures in terms of impact on future health.

Impact of legislation and legal judgements

Legal liability is ever-changing and can impose additional liabilities, particularly if courts apply today's standards retrospectively. Relatively small legislative changes can increase claims frequency, combined with an increased cost of claims, can lead to insurers having to increase their reserves by millions of pounds.

2 Large and catastrophe losses

Large and catastrophe loss inflation

For serious injuries, inflation is much higher and can be double digit. Multiple injuries or severe property damage from a single event can add to the size of the loss. Claims' costs continue to rise in line with healthcare and care costs.

Risk management

Premiums can be reduced if effort and focus is spent on risk management. Risk management plays a key factor in our pricing and our Risk Engineering teams work closely with our customers to discuss and implement.

Periodic payment orders (PPOs)

PPOs can be awarded to the claimant for them to receive a regular payment as opposed to a lump sum.
This trend to keep claims open for the entirety of a claimant's life rather than paying a lump sum up front means an increased exposure to inflation uncertainty.

The courts are increasing the use of PPO's for claims settlements and especially for claims involving minors. The consequence of this is that insurers need to keep claims open for the entirety of a claimant's life rather than paying a lump sum up front and thereby increasing additional uncertainties to the overall costs as insurers have to make assumptions for life expectancy and future claims inflation.

3 Expenses/Commission

Expenses/Commission

A percentage of the premium is required by the broker and insurer to provide expert risk transfer plus administration costs.

4 Investment income

Investment income

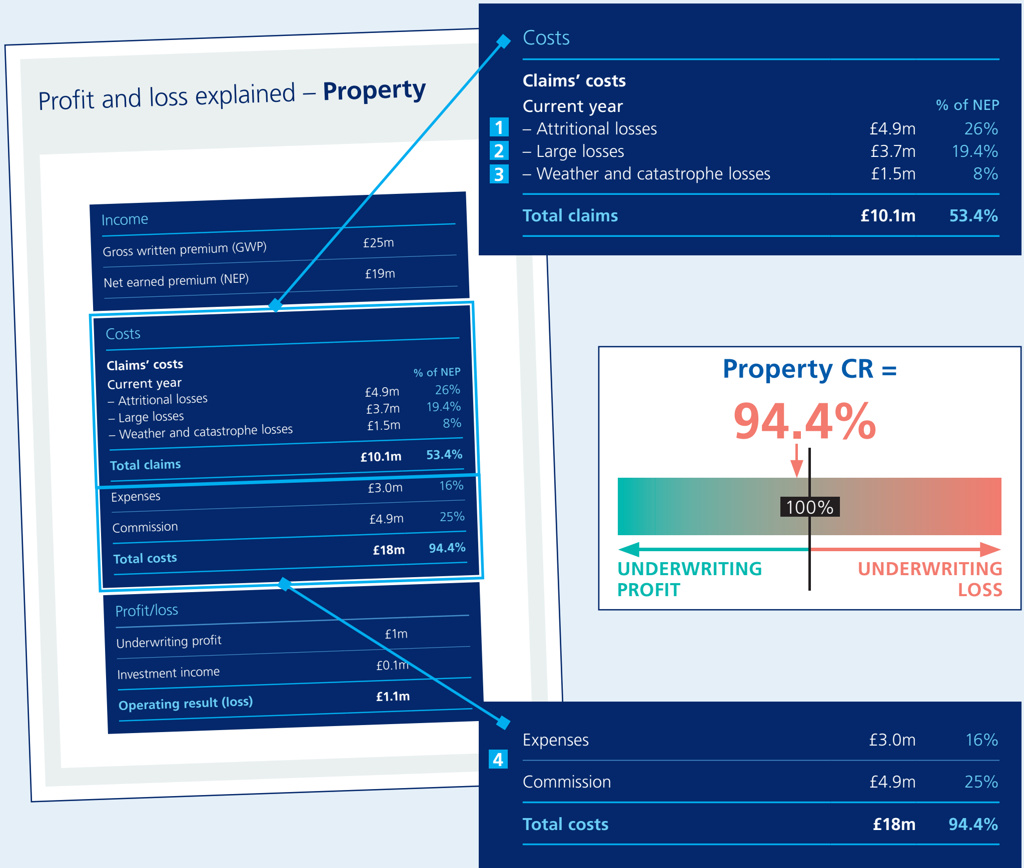
Historically investment income has made a very significant contribution in the calculation of Employers Liability premiums as insurers would be able to make money by investing the premium before claims were settled. In periods of high investment returns insurers could make an underwriting loss but still meet the costs of claims and return the required level of profit overall.

The current and prolonged low interest rate environment means insurers have to now make an underwriting profit to ensure adequate reserves to meet future claims and deliver target returns, therefore premiums have to be increased to offset the loss of investment returns.

Profit and loss explained – **Property**

Large loss provision is critical to pricing property risks. Failure to cost for these leaves the claims' pot underfunded when they do occur.

The latest market figures show the combined ratio (CR) for Property was 94.4% (Source: Verdict Financial report 2016)– a representative example for illustrative purposes is shown below.



These figures are shown for illustrative purposes only.

1 Attritional losses

Average cost per claim
Following the recession, many businesses were forced to cut back on risk management expenditure leading to increased losses and larger claims.

Escape of water (e.g. from burst pipes)
Nearly one in five claims made on buildings and contents insurance is for damage caused by escape of water.

Deductibles and excesses
This is the contribution to a claim that is made by the customer. In recent years, this has not increased in line with inflation leaving insurers to pay proportionately more.

Crime spike
Increased volume of unoccupied properties has added to the risks faced by insurers. Theft (especially metal), arson and fly tipping events continue to increase. This is driving up costs and premiums to the customer.

Fraud
Fraudulent claims increase costs to the ordinary policyholder.

2 Large losses

Modern methods of construction
Well-designed, fire-resistant properties will not require additional terms or premium. However, more combustible materials will incur cost and properties using these types of modern construction materials are increasing.

Impact of legislation
Changes to the deployment of fire services mean fires in buildings now often result in a total loss, increasing costs. New regulations mean that insurers must hold more capital to write business, and this increases premiums.

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Business interruption
As supply chains become more global, specialist machinery sourced internationally adds pressure to the size of loss.

Large loss trends and influences
We have seen large losses arising from the waste sector and listed buildings. The pace and change of the UK economy over recent years has impacted on the investment income and the fall in sterling value has led to increased costs of goods from overseas.

Underinsurance
Correct setting of the sum insured is key to both Material Damage and Business Interruption covers. Underinsurance is a major factor in many property losses and poses a significant risk for customers.

3 Weather and catastrophe losses

Weather, climate change and catastrophic losses

Ongoing climate changes are likely to lead to natural disasters becoming more frequent and more intense. The events during 2015/2016 resulted in insurance losses of circa £662million. This means premiums have increased to counter the cost and to fund for future weather events.

Reinsurance costs

The price of the reinsurance cover has risen due to the increased uncertainty in exposure due to factors such as global extreme weather events.

4 Expenses/Commission

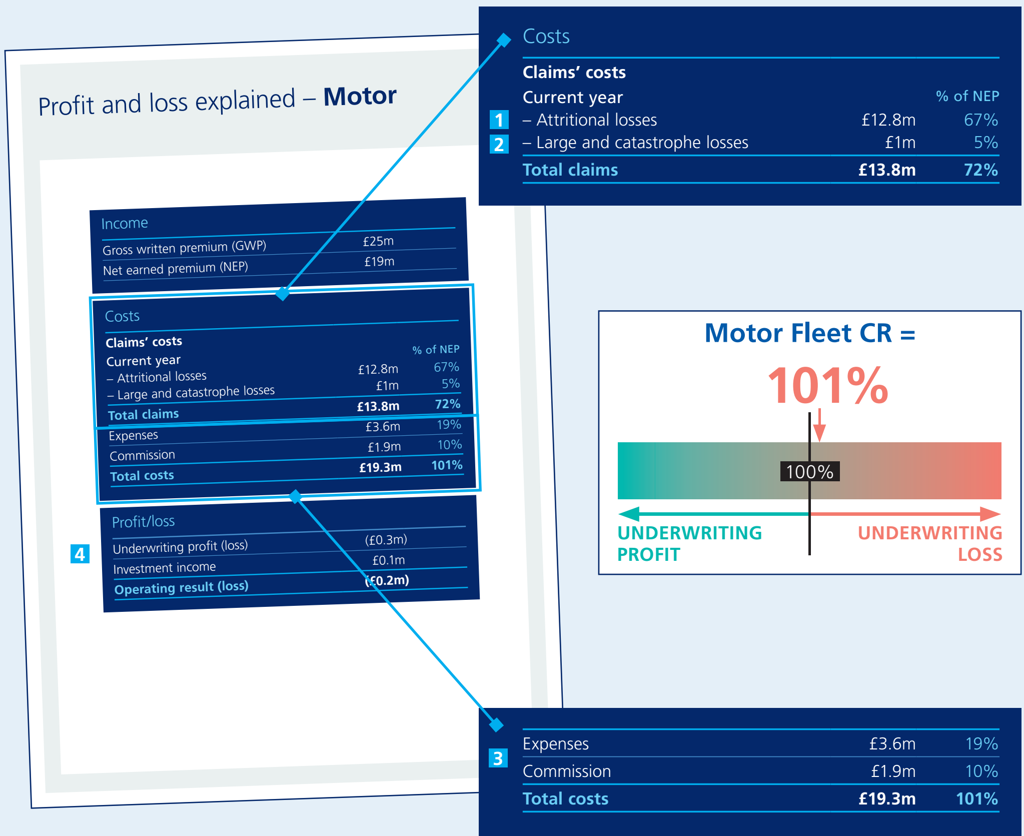
Expenses/Commission

A percentage of the premium is required by the broker and insurer to provide expert risk transfer plus administration costs.

Profit and loss explained – **Motor Fleet**

Third party claims' frequency, increasing number of claimants per claim, fraud, credit hire and whiplash claims are key features in recent Motor pricing.

The latest market figures show the combined ratio (CR) for Motor Fleet was 101% (Ernst & Young Nov 2016) – a representative example for illustrative purposes is shown below. A CR of above 100% is not sustainable and the insurer in this example would be making an underwriting loss.



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1 Attritional losses

Changing behaviours

The UK's legal framework, a proliferation of claims management companies and a perception of 'easy' compensation have led to an increase in claims frequency.

Changing landscape

There are currently more cyclists on the road which has resulted in an increased likelihood of severe personal injury losses. In 2014, 3,401 cyclists were killed or were seriously injured and 21,287 injured (Source: RoSPA Report Dec 2015).

Inflation

Average annual claims' inflation for bodily injury is at 4% (Source: Ernst & Young report 2016). The average cost of an injury claim is £11,500. Third party property damage is 5% and own damage claims is 8%. Reasons for own damage claims inflation, increased technology in vehicles and due to fluctuation in the exchange rate making new car cost and cost of parts more expensive.

Claims' culture

There is an increased propensity to claim for whiplash which has seen the industry receiving approximately 1,500 claims per day. This costs the industry £2billion per year or £90 per policy vehicle.

Third party damage claims

Inflation continues to rise due to increased costs of parts/labour and rising vehicle costs. Another important factor is the growth of the credit hire market, which is worth in excess of £1.2billion per year. Credit hire is the provision of a replacement vehicle to the non-fault motorist, following an accident.

2 Large and catastrophe losses

Large loss inflation

Average annual claims' inflation for bodily injury is at 4% per year with serious injuries often in excess of 10%. For the very largest claims, severity inflation in excess of 20% is common.

Periodic payment orders (PPOs)

PPOs can be awarded to the claimant for them to receive a regular payment as opposed to a lump sum. This trend to keep claims open for the entirety of a claimant's life rather than paying a lump sum up front means an increased exposure to inflation uncertainty.

The courts are increasing the use of PPO's for claims settlements and especially for claims involving minors.

The consequence of this is that insurers need to keep claims open for the entirety of a claimant's life rather than paying a lump sum up front and thereby increasing additional uncertainties to the overall costs as insurers have to make assumptions for life expectancy and future claims inflation.

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4 Investment income

Investment income

Low interest rates have had a negative impact on investment returns and investment income can no longer be relied upon to balance the account, driving more focus on appropriate pricing.

Profit and loss explained – **Employers' Liability**

The 'longest tail line' of the main lines of business and where investment income has historically been a major factor when calculating premiums.

The 2016 reported figures from Verdict Financial (2016) are that the market remains unprofitable and has not made an underwriting profit since 2005.

A representative example for illustrative purposes is shown below. A combined ratio (CR) of above 100% is not sustainable and the insurer in this example would be making an underwriting loss.

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1 Attritional losses

Economic uncertainty

The slow and patchy recovery from the economic downturn has had an impact on the claims' environment with the limited growth in the market impacting on potential premium income growth.

Claims' frequency

After several years of sharp increases the number of accident and disease Employers' Liability (EL) claims recorded has started to reduce since 2015 largely due to the long awaited decline in noise-induced hearing loss (NIHL) claims, and continued improvements in workplace health and safety.
The frequency of large losses has not reduced in line with this trend however and the large loss provision is being an increasingly larger part of the premium.

Claims inflation

Claims inflation continues to outpace rate increases been applied to premiums. Whilst inflation for smaller claims initially reduced following the introduction of the LASPO reforms and fixed cost legal costs, increases have now started to come through again driven by increases in damages, wage inflation, and increase legal costs.

Latency – disease

There is often an extended period between a policy being underwritten and a claim being made. A period of up to 40 years is not uncommon. Even today, Asbestos claims are continuing to rise in number. Economic uncertainty makes predicting inflation difficult. There is a need to price for these claims alongside future unknown illnesses and disease.

Impact of legislation and legal judgements

Legal liability is ever-changing and can impose additional liabilities on insurers often at short notice and particularly when courts apply today's standards retrospectively. Small legislative changes can increase claims frequency, combined with an increased cost of claims, can lead to insurers having to increase their reserves by millions of pounds.

Medical improvements

The advances in medical diagnosis mean that liability is getting easier to pin point. For instance there has been an increase in claims for chronic pain syndrome and injury related psychological conditions driven by advanced medical diagnosis.

2 Large and catastrophe losses

Large and catastrophe loss inflation

For serious injuries, inflation is much higher and can be above 10% driven by increasing care and legal costs combined with longer life expectancy.

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Zurich Insurance plc

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