MARKET BULLETIN

REF: Y4191

Title	Lloyd's Underwriting Management Standards: provision of additional guidance
Purpose	To provide the market with additional information regarding the meeting of Lloyd's Underwriting Management Standards, in particular relating to pricing
Type	Event
From	Rolf Tolle, Franchise Performance Director Extn 6743 rolf.tolle@lloyds.com
Date	1 October 2008
Related links	Lloyd's Underwriting Management Standards and related guidance are accessible via lloyds.com:- www.lloyds.com/Lloyds_Market/Performance_management_framework/Franchise_Standards/Underwriting_management

Background and Purpose

Lloyd's Underwriting Management Standards, which apply to all business in the Lloyd's market, are reviewed by Lloyd's each year liaising with the LMA Underwriting Committee to ensure that they continue to represent suitable standards for the market. Following the recent review we have concluded that the Underwriting Principles and Minimum Standards remain appropriate, although the accompanying guidance notes require updating. It is recognised that the Pricing and Rate Monitoring section remains the market's most significant challenge and the market's actuaries committee (CALM) has prepared additional guidance which it is hoped will be helpful to managing agents. This new guidance also considers Lloyd's Performance Management Data Project (PMDP) requirements. New content will be published on lloyds.com following release of this bulletin.

Additional Guidance Notes

Each of the areas of current guidance has been reviewed and will be updated, or will have new material added to the content currently available via lloyds.com where noted below:-

Principle 1 Underwriting Strategy and Planning

- Updating of Additional notes relating to Strategy and Strategic Plan Horizon, as current content is out of date

Principle 2 Underwriting and Controls

- Competition Law and the European Commission inquiry - the BIPAR High Level Principles are being included within this section as additional guidance, with reference to Market Bulletin Y4153 which explained the Lloyd's market position
- Under Pre-Bind Quality Assurance, specific reference to ensuring that reinsurance slip conditions and related wordings are clear and complete, taking account of market slip review activity
- Within the Contract Certainty notes providing a link to the Market Reform website for easy access to relevant information and documentation

Principle 3 Delegated Authority

- No additional content, following review with Lloyd's Delegated Authority Team and LMA Delegated Underwriting Committee

Principle 4 Pricing and Rate Monitoring

- Additional guidance from CALM regarding Benchmark Pricing, please see Appendix

Principles 5-7 Exposure Management, Reinsurance, Data Quality

- No additional content

Further enquiries
Please address enquiries regarding this bulletin to Kieran Flynn, Franchise Performance, Lloyd's extn 5739 kieran.flynn@lloyds.com

Enquiries to the LMA Underwriting Committee can be made via Mel Goddard, Market Liaison Director, LMA extn 8334 mel.goddard@lmalloyds.com

Enquiries to the Committee of Actuaries in the Lloyd's Market (CALM) can be made via Andrew Hitchcox, Group Chief Actuary & Risk Officer, RJ Kiln andrew.hitchcox@kilngroup.com

Appendix - Principle 4, Pricing & Rate Monitoring
Additional guidance from CALM regarding Benchmark Pricing

The LUMS sub-group of CALM have reviewed the requirements and current guidance relating to Principle 4, Pricing and Rate Monitoring, as set out in Lloyd's market bulletin Y3844 dated 6 July 2006 confirming 'Lloyd's Underwriting Management Standards' (LUMS). Discussion has taken place with Franchise Performance, Lloyd's and with the LMA Underwriting Committee during the development of these additional guidance notes.

Managing agents are required to demonstrate compliance with LUMS. The introduction to bulletin Y3844 states Lloyd's position as follows:

- "The Franchise Standards have been produced in consultation with the Lloyd's Market Association, representing all Lloyd's franchisees"
- "Guidance notes which accompany the Minimum Standards have been developed with extensive market involvement and support. These provide a more detailed explanation of the general level of performance expected"
- "These Guidance notes are intended to provide reassurance to franchisees as to approaches which would certainly meet the minimum standards. However, it is appreciated that there are other options which could deliver performance at or above the minimum level and it is fully acceptable for franchisees to adopt alternative procedures as long as they can demonstrate that the required minimum standards can be achieved or exceeded"

CALM prepared these notes for Lloyd's to use as an addition to their published Guidance notes:

- They represent good practice, relevant to an agent demonstrating that it meets or exceeds the minimum standards.
- They are based upon expert practitioner feedback.
- They describe more detailed variations in practice.
- In CALM's opinion, they should assist managing agents to ensure that they are meeting the LUMS, as they suggest extra materials to be supplied by managing agents in evidencing of the implementation of their pricing policies.

These notes, set out under the following headings, should be read in conjunction with the existing guidance notes already provided on lloyds.com in support of Principle 4, Pricing and Rate Monitoring:

1 Level of Granularity At Which Benchmark Pricing Is Managed
2 Options For Pricing Approaches May Vary By Type Of Business
3 Feedback Loop From Emerging Experience To Inform Pricing Models
4 Allowance In Pricing For Future Trends

<u>1. Level of Granularity At Which Benchmark Pricing Is Managed</u>

As part of the Performance Management Data Project (PMDP), an update letter from Lloyd's FPD of 5th August 2008 requires managing agents to record contract level information relating to pricing performance on all contracts bound on or after 1st January 2009.

The existing wordings from LUMS Principle 4 are as follows:

- Page 24: “able to demonstrate the expected loss ratio for each risk (calculated at individual risk, portfolio or other appropriate level)”.
- Page 25: “an effective rate monitoring process is likely to contain the following:

    - it records the various elements of the pricing calculation for each risk (calculated at individual risk, portfolio or other appropriate level).
    - it monitors the difference between the benchmark price and the actual price at suitable levels (e.g. per risk, risk code, class of business)”.

As a valid approach to meeting the requirements of the PMDP, agents need to record at risk level, in addition to the actual price charged (amount of premium) either:

a. The Benchmark Price for the risk, or,
b. At least one of the technical loss cost or the expected loss ratio for the risk.

In order to complete the requirements of LUMS, the agent’s pricing policy must contain clear statements as to:

a. The process the agent adopts to manage the reporting of syndicate performance against benchmark price at some higher summary level; for example, line of business, risk code level, sub-portfolio, or any other grouping that is relevant to the way they manage their business would be acceptable.
b. How they manage the total of the groupings against the relevant SBF plan loss ratios.
c. Which groupings they use in this process.

In addition, the pricing policy must clearly state the level of granularity [grouping and/or choices of sub-portfolios] the agent uses to manage loadings for expenses, cost of reinsurance and profit margins against targets. The following extract from LUMS is relevant to this requirement:

- Page 26: “In considering pricing methodology, all of the elements of the pricing calculation are expected to be included. For example expected loss cost, CAT load, internal expenses, profit & acquisition costs, the actual price charged and the resultant level of profit anticipated”.

Note that it is a requirement of the PMDP with effect from 01/01/09 that, even if agents do not <u>record</u> the benchmark price at risk level, they must be able to <u>report</u> on it at risk level. For example, if a price of $75,000 is recorded with an expected loss ratio of 62.5% when the SBF plan loss ratio is 65%, then enough information must be recorded in the agent’s systems to be able to calculate the benchmark price for the risk of $72,115, for the purposes of submitting the PMDP returns.

<u>2. Options For Pricing Approaches May Vary By Type Of Business</u>

LUMS requires agents to have appropriate pricing methodologies which are transparent and consistent for each class of business.

Typically, pricing methodologies can vary in their mathematical formulation more by type of business acceptance than by class of business. It is also commonly observed that pricing methodologies can vary more by type of loss [cat, large loss and attritional] than by class of business. There are many different types of business acceptance that a syndicate may write, including but not limited to:

- Primary / personal lines risks.
- Direct & facultative (D&F) / specialty commercial risks.
- Binding authority / delegated authority business.
- Inwards treaty reinsurance, both proportional and non-proportional business.
- Inwards retrocessional business.
- Life insurance risks (typically only risk transfer policies such as term assurance, and not investment or savings business).

It is not feasible for one approach to pricing techniques and methodologies to cover all of these types of loss or type of business acceptance. A managing agent's pricing policy should describe clearly:

a. for which types of loss and/or business acceptance it is appropriate to adopt different pricing methodologies and approaches, explaining why this is the case, and,
b. what their approaches are to pricing each of these different types.

The following extract from LUMS is relevant to this requirement:

- Page 26: "An appropriate pricing methodology will be dependent upon a number of factors including the historical record of the syndicate(s) managed, the size of the franchisee, the experience of the underwriters, the availability of relevant loss and exposure data, the complexity of the class of business and the speed at which pricing calculations need to be carried out".

<u>3. Feedback Loop From Emerging Experience To Inform Pricing Models</u>

When a benchmark pricing process is first formulated for a class of business it may be based on historical data, external data, or simply on rates that have been in informal use previously. Whatever method is used to derive rates initially, it is vital that a strong feedback loop exists such that emerging experience can be used to refine rates over time.

A comparison of:

- Emerging results versus the business plan, and
- Actual prices versus benchmark prices,

for each prior year will indicate whether benchmark prices are indeed sufficient to achieve the planned levels of profit, and the reasons for any significant variances.

The managing agent's pricing policy should describe exactly how this feedback loop operates for each class of business. A good process would address the following issues:

- How regularly the analysis is performed.
- The level of granularity.
- How much credibility will be applied to emerging experience versus the data used to derive rates initially.
- How much credibility will be applied to emerging experience in small or volatile classes.
- The extent of involvement of underwriters, actuaries and others.
- The frequency and extent of communication of the results to the managing agency board, who are ultimately responsible for meeting LUMS.

The nominated director responsible for Underwriting Standards should ensure that a robust and documented process is followed.

4. Allowance In Pricing For Future Trends

Benchmark prices are often based on historical data, from either internal or external sources. When this is the case, those responsible for deriving rates for future use should have regard to changes in the claims environment for which adjustments need to be made.

Such changes could include:

- simple trends such as inflation or the propensity to claim, taking account of the wider economic environment
- others may be more sudden, such as legislative changes or judgements that set new precedents for coverage
- additionally, changes in coverage or terms being introduced for commercial reasons

When considering different types of inflation, the effects on both premiums and claims, which could be different, should be considered.

The managing agent's pricing policy should explain the process by which possible future changes are identified and allowed for when using historical data to derive benchmark prices.