



Proven Factors



Insurers must validate information before granting discounts.

by Charles Schaefer

Insurance premium is determined by numerous factors, based upon the class of business. Insurance companies use external rating bureau classifications and schemes, proprietary rating schemes or a combination of the two methods to determine premium. Information to determine premium is provided by the insured, the agent and the information bureaus. The process is complex and prone to error and misinformation.

An insurance company is open to adverse risk selection based upon

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information it receives. Premium and renewal errors based on inaccurate information tend to favor insureds more frequently than they favor insurers. Moreover, insureds have new Internet tools available to them through which they can renew policies with the lowest rate obtainable. Internet-based rating systems allow consumers to explore various coverage combinations and manipulate key rating factors to arrive at an optimal premium.

In other words, insureds can game the system. This is especially true when there are apparent rewards available for doing so, such as discounts.

To combat this, insurers need to do whatever they can to assure the

LOSS POTENTIAL: Many homeowners insurers offer discounts for residences with deadbolt locks, fire extinguishers and alarm systems. However, many carriers neglect to ask for verification of these factors upon policy renewal, which can lead to lost premiums.

- ▶ **At Issue:** Misinformation from policyholders and agents can cost home and auto carriers billions of dollars in lost premium.
- ▶ **The Significance:** Insurers lose premium because they depend too heavily on a manual process that relies on the veracity of customers and agents.
- ▶ **Watch For:** Insurers to request that data be submitted in an electronic format, or be validated by a third party, before determining discounts.

accuracy and completeness of the information they use in determining risk acceptance and pricing.

Auto and homeowners insurance discounts originated as a means to



identify a preferred-risk pool of policyholders. Prior to the predominance of computers, personal lines ratings were manually processed by individuals using basic algebraic computations. Because calculations were manual, the number of ratings factors was severely limited.

With early underwriting information difficult to obtain and classify, insurance companies sought methods to segment risk by increasing the number of ratings factors. The advent of the computer saw the number of ratings factors increase considerably. For instance, motor vehicle report data was being recorded at the state level and became electronically accessible by insurance companies. In the late 1970s, GMAC Insurance began providing auto insurance discounts using information culled from the vehicle identification numbers of automobiles. The VIN numbers provided verification of seat belts, daytime running lights and anti-theft devices, all of which provided the policyholder with a discount. More recently, insurance credit scores and student data also have been used to determine auto premiums.

With the increased number of ratings factors, homeowners insurance rate determination likewise has become more complex. Visual inspection of homes revealed basic rating factors such as roof type (slate, asphalt, etc.), construction type (frame, masonry, block, etc.) and foundation (slab, crawlspace, basement, etc.). Current automated data includes territorial segmentation, claims history, respondent fire company capabilities and insurance-to-value cost estimators. Property discounts are offered for deadbolt locks, age of home, fire extinguishers, smoke alarms and alarms monitored by fire, police or security companies.

Reliable Sources

Because of the increase in rating factors, insurers are using complex computer programs to determine premium charges. These additional

factors are determined through collection of electronically available data, independent inspections or by the self-reporting of the insured and/or the agent.

The first two information sources tend to be highly reliable and accurate. Unfortunately, the insured is not considered an accurate or reliable source for vital information. Inaccuracies often occur in statements of discount eligibility and ratings verifications.

“ Premiums are lost because many ratings factors and discounts are applicable at new business, but not always at renewal.”

According to Quality Planning, an Insurance Services Organization unit, misinformation from insureds and agents resulted in \$16 billion of lost auto premium in 2007. Although many industry observers would assume that the problem is primarily one of intentional misrepresentation, it is likely as much due to changed circumstances that go innocently unreported.

In addition, many ratings factors and discounts are applicable at new business, but not always at renewal. An alarm system that may have been active at policy issuance may be inactive, for various reasons, at time of renewal. Miles driven to work by the insured may change dramatically during the initial policy period. Good student discounts, if verified at all, are manually intensive, with report cards that are difficult to interpret or impossible to authenticate.

One way to address this dilemma is to add only factors and discounts that can be captured or verified automatically through means independent of the insured. As an example, companies that use the Internet as their primary distri-

bution channel are requiring that rating information be verified and automated. Carriers that can independently capture and verify such important discount-related underwriting information will leave less premium money on the table and likely avoid many unacceptable risks.

Validation Is Key

The administration of policy premium involves validating the rating factors and discounts to calculate the premium. Validation is accomplished in various ways by the insurance company.

Statements of verification from the agent and the insured, and proof of discount eligibility, are commonly used. This proof may take the form of an alarm installation certificate or paid invoice from the provider in the case of a homeowners policy.

For good-student auto insurance discounts, report cards or transcripts are submitted. Unfortunately, such paper-based, manual approaches are slow, costly and open to error and fraud. Many insurance companies image the paper records they receive, index the image to the insurance policy, and update the policy administration system with evidence to support premium audits and to eliminate misinformation.

Even when underwriting information is available through automated processes, such as motor vehicle records and subsequent claims information, the insurer does not always access updated information at renewal. The initial underwriting information is sometimes used to determine the renewal premium, which means some companies are basing renewal premium on outdated information. Other companies use renewal questionnaires to update ratings information prior to renewal. This is a manual process that again relies on the veracity of the agent and/or insured.

Some companies require that proof of ratings factors and discounts be sent to their respective policy processing departments where this information is validated and updated



through its processors. Although more reliable, this approach tends to be slow and costly.

Future Trends

With increasing amounts of automated ratings and discount information, actuarial soundness will become a more prominent differentiator of insurance companies' ratings accuracy and risk selection.

An excellent example of fast and accurate electronic access to data, combined with appropriate technology to capitalize upon industry data, is the recent rollout of "pay-as-you-drive" auto insurance.

This competition-changing concept involves the installation of a monitoring device in a vehicle, which records the actual mileage driven by the insured.

The fewer the miles driven by an insured, or the less recklessly the insured drives, may give the policyholder with a PAYD plan a significant

usage discount compared to aggressive or high-mileage drivers.

For example, GMAC Insurance offers a low-mileage discount to some OnStar subscribers who drive less than 15,000 miles a year. This is offered in 35 states but the eligibility, benefits, discounts and coverages vary. According to the company's Web site, other discounts also are available to drivers whose cars are equipped with the Onstar monitoring system.

In cases where important risk data is still not available electronically, paper information is being converted to electronic information for delivery to insurers. The goal is to ensure its validity by having it come to the insurer directly from sources such as high schools and colleges for the good-student discount or alarm companies for the monitored alarm discount.

Here again, the Internet allows the information to be easily accessed and

updated quickly in the insurer's policy administration system, with the correct premium subsequently calculated.

Likewise, reconstruction costs for houses can be updated frequently via the Internet to reflect regional market fluctuations in building materials and labor.

Through electronic means, commercial property insurers can be notified immediately if alarm or sprinkler systems are taken down for any reason. The more insurers can quickly access valid, risk-related data in an electronic format, which is easily incorporated into their rating systems, the better these companies will perform.

Those carriers who optimize these processes will be the industry leaders.

Excellence in risk selection and pricing has always been the key to success in insurance. Now, excellence rests on quick access to reliable information. **BR**