8. (1 point)

A company has a combined ratio of 125% in the first year of writing policies.

Explain two reasons why the company could be profitable in the long run without increasing rates.

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QUESTION 8	
TOTAL POINT VALUE: 1	**LEARNING OBJECTIVES:** A3, A4, A5

SAMPLE ANSWERS

The following are acceptable sample answers (need two for full credit):

- The company may have a very profitable long-term investment strategy with returns that will more than offset underwriting loss
- Company has high expense in operations and marketing for the first 1st year writing business and then those expenses will go down in the later years and company can make profit later on
- It's possible that the company over reserved and there will be downward development
- The company could be using asset share pricing, where they consider the long term profitability of a policy by considering persistency. They may be able to write the policy at a loss at first, knowing that they will eventually make a profit if the policy renews and persists with the company Some of the underwriting expenses may be higher for new business than renewal business. For example, commission is usually higher for writing new business. Hence the underwriting expense could be reduced going forward
- Company might not yet have proper claims adjustment expertise in lines where it is writing. If it hires better claims adjusters, loss ratio (and thus combined ratio) could decrease in long run without increasing rates
- If the CR doesn't include salvage and subrogation and the SS is sufficient enough to offset the high CR than could be profitable
- High combined ratio could be a function of low premium volume since this is a stat up. As they grow, volatility will decrease and company could be profitable w/o increasing rates
- In general, new business loss ratios are much higher initially and will go down as some policyholders leave. This is because those frequent shoppers are usually those that are more risky, while those that stay tend to do better
- Some insureds tend to become more profitable as they age and stay with the insurer longer. For example, a 17-year old driver that is considered risky can become more profitable in the long run
- As the book grows, underwriting can get a better handle on which policies are good and bad risks and create U/W guidelines that filter out the bad risks

EXAMINER'S REPORT

Candidates were expected to know the definition of the combined ratio and the reasons why starting a company and/or a new book of business may have a high combined ratio.

Candidates did generally well on this question.

Common mistakes included:

- Giving two reasons that were fundamentally the same / only giving one reason
- Giving a reason for why the combined ratio may decrease but not giving sufficient detail explaining why the reason actually puts pressure on the combined ratio

- Using "asset share pricing" without adequately explaining this concept
- Stating that investment income was expected to decrease the combined ratio
- Using examples which include changing rate or are fundamentally the same as changing rates (price per exposure)