

Pinnacle News

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From The President



Steven G. Lehmann

Risk classification in personal lines continues to evolve.

The Florida Office of Insurance Regulation (FOIR) recently released a report concluding that occupation and education have a demonstrable correlation to income level and ethnicity for underwriting and rating personal auto insurance.

The report, based primarily on a hearing conducted by FOIR last February, also suggests that the legislature should consider allowing FOIR to restrict using such variables.

The use of rating variables like occupation and education has also been questioned by legislators in New Jersey. Our experience with these variables is that they are, in fact, predictive and even more so when credit is restricted or not allowed.

Meanwhile, predictive modeling applications are spreading rapidly to the commercial lines. We are seeing many companies implementing underwriting scorecards and other rating innovations for BOP and commercial auto and for a variety of claims applications for both personal and commercial lines.

As always, please feel free to contact me directly with any feedback regarding Pinnacle. You can reach me at (309) 665-5010 or slehmann@pinnacleactuarial.com.

Risk Transfer in Reinsurance Contracts Will Require Actuarial Review

Expect to hear more about risk transfer testing for reinsurance contracts. Regulators and auditors, in response to past abuses with finite reinsurance contracts, are encouraging actuaries to take a more active role in the risk transfer testing process.

This change is coincident with a 2005 statutory filing requirement called the Reinsurance Attestation Supplement. It requires a company's CEO and CFO to attest to the economic intent and legitimacy of risk transfer in their reinsurance contracts. Contracts excluded from the scope of the Reinsurance Attestation Supplement are those with no amounts recoverable, those effective prior to Jan. 1, 1994 or those where risk transfer is "reasonably self-evident."

In our view, the new standard for risk transfer testing will be the Expected Reinsurer Deficit (ERD) rule. ERD is the method recommended by the Casualty Actuarial Society Research Working Party on Risk Transfer Testing, which was in response to a recent study requested by the National Association of Insurance Commissioners (NAIC). We believe ERD is superior to other testing methods.

For years, the only tool commonly used to assess risk transfer was the "10/10 rule." It holds that a reinsurance contract exhibits risk transfer if there is at least a 10% chance of a 10% or greater loss for the reinsurer. Most agree the 10/10 rule has

Examples of Contract Features Necessitating a Risk Transfer Analysis

- loss ratio caps
- loss corridors
- multiple-year features
- contracts with experience-based premiums
- contracts where the premium approaches the present value of provided coverage

major shortcomings. For example, contracts with self-evident risk transfer features, such as high-level property catastrophe or quota share agreements with loss ratio caps, cannot pass the test.

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New Pinnacle Seminar Will Address Regional and Niche Insurer Challenges

Pinnacle will be offering seminars this fall that provide solutions to the unique challenges faced by regional and niche insurers.

"Flourishing in a Sophisticated Insurance Market: Solutions for Regional and Niche Insurers" will cover topics including current industry trends, strategic planning, competitive positioning and the use of more sophisticated pricing techniques. Speakers will also cover base pricing, risk segmentation using predictive modeling,

and personal and commercial vehicle and territory rating. The seminar will focus on both personal and commercial lines of business.

The seminars take place Sept. 25 - 26 in Chicago; Oct. 9 - 10 in Las Vegas and Nov. 7 - 8 in Atlanta. The cost of the seminar is \$750 for early registration and a block of hotel rooms will be reserved.

For more information, contact Daisy Pritchard at (309) 665-5010 or dpritchard@pinnacleactuarial.com. ▲

Michigan Medical Malpractice Claims Decrease, Litigation Costs Rise, Pinnacle Finds

Medical malpractice claims in Michigan declined significantly, while average defense costs were on the rise, according to a Pinnacle analysis of claims closed between 2000 and 2005.

Like many other states, Michigan instituted a mandatory medical malpractice claims reporting form to give state insurance and medical professional regulators the means to evaluate changes in the number and magnitude of professional liability claims. The Michigan Office of Financial and Insurance Services

(OFIS) selected Pinnacle to review these forms.

The study had many significant findings. During the period of 2000 to 2005, claim frequency steadily declined for closed claims (-9.4%) and reported claims (-13.2%). Frequency and severity trends also varied by county and district court regions. Meanwhile, self-insurance programs covered more claims in 2005 than in 2000.

Michigan also experienced a shift toward

requiring a verdict for claim resolution and away from settlements. Allocated loss adjustment expenses – mostly defense costs – became a larger portion of overall claims costs. Non-economic damage caps also appear to be contributing to a trend toward economic damages making up a larger percentage of total indemnity payments.

For more information, contact Rob Walling at (309) 665-5010 or rwalling@pinnacleactuaries.com. ▲

Florida Tort Reform Reaps Mixed Results, Pinnacle Finds

Florida tort reform has achieved some but not all of its goals, according to an analysis conducted by Pinnacle on behalf of the Florida Office of Program Policy Analysis and Government Accountability (OPPAGA).

In 1999, the Florida legislature made comprehensive modifications to Florida's civil justice system with the goal of improving the predictability, uniformity and fairness for all parties involved. The provisions included measures to increase jury use and alternative dispute resolution, provide new deterrents for frivolous claims actions and implement reforms affecting products liability, punitive damages, and joint and several liability.

These reforms impacted most casualty insurance lines including personal auto, commercial auto, professional liability, general liability and products liability.

Pinnacle analyzed trends in claim frequencies, severities, claims handling expenses, insurer profitability, rate levels and market competition using data from sources including closed claims from the Insurance Research Council, Insurance Services Office, the Florida Medical Malpractice Closed Claims database and insurer annual statement data from A.M. Best.

For many insurance lines, there were fewer claims subsequent to 1999 and higher average costs per claim. Many

lines also had longer settlement delays and more attorney involvement with consequently higher claims handling costs. The medical malpractice analysis examined both the 1999 and 2003 reforms in Florida. The 1999 reforms appear to have lowered average loss adjustment expenses while decreases in average indemnity payments coincided with the 2003 reforms. The analysis of completed operations coverage results appears to show a dramatic increase in loss costs, potentially showing the impact of construction defect claims.

For more information, contact Rob Walling at (309) 665-5010 or rwalling@pinnacleactuaries.com. ▲

Pinnacle Webinars

Apex Discussion Series

Online registration opens monthly and space is limited.

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| June 21 | "Actuaries as Expert Witness" |
| July 19 | "Rating Territories – What You Don't Know Might Hurt Your Results" |
| August 16 | "Risk Transfer" |
| September 20 | "Catastrophe Ratemaking Challenges" |
| October 18 | "Vehicle Symbols" |
| November 15 | "Effective Captive Applications: Actuarial Do's and Don'ts" |

For more information on Pinnacle's webinars, visit <http://www.pinnacleactuaries.com/pages/services/ApexDiscussionSeries.asp>

Ten Sure Signs Your Company Needs Strategic Planning

With the advent of more sophisticated underwriting, pricing, product offerings and customer access, companies must re-evaluate even successful growth strategies. Too many companies are not realizing their potential because they lack a strategic approach to new insurance market realities.

Here are 10 sure signs a company needs to engage in strategic planning:

1. **Performance looks good, but profits don't.** The leaders are comfortable and performance appears acceptable across the organization, but profits are inconsistent.
2. **Customers don't buy, or buy very much, even with good prices.** Without heavy price discounts, customers go elsewhere.
3. **A few competitors are a nagging reminder that growth and profit are still possible in the same year.** Successful companies addressing today's realities with sophisticated pricing models and/or enhanced customer access methods have above average growth with combined ratios under 100.
4. **Middle managers are lost in the trees instead of seeing the forest.** Middle managers

are busy addressing functional challenges and results, not strategic performance.

5. **The company's performance measures just don't work.** The company has new challenges, but most or all of its performance measures still lag financial ones.
6. **Market penetration is just not happening.** Market penetration, perhaps the ultimate measure of company success, is flat or on the decline.

Strategic planning is a journey, but one worth taking.

7. **Managers only read their favorite reports.** The official set of balanced performance measures for the organization doesn't exist or it isn't being used. Besides, why read unflattering reports when managers can pick their favorites?
8. **The top leadership team is not on the same page (or even close).** Try this quick "priority test." During one-on-one sessions with top leadership team members, ask each leader

to first identify and then rank the organization's top three priorities. The results will probably be surprising.

9. **Most employees don't understand what the company's top priorities are, let alone their own role in achieving company success.** Conduct the same simple "priority test" with employees. Most likely, there will be more surprises.
10. **The leadership team discusses their golf swing more than company strategy.** Strategic discussion is infrequent. Even the annual planning conference quickly becomes tactical in nature or is merely a review of future major projects.

Most companies have a planning process, but this ritual is often more tactical in nature and more akin to an annual budgeting process. It is essential for companies to regularly look back at their strategic roots, confront today's realities and reassess how their once successful value proposition might satisfy future customers. Strategic planning is a journey, but one worth taking.

For more information about Pinnacle's strategic planning services, contact Terry Pemberton (434) 806-4100 or tpemberton@pinnacleactuaries.com.

Risk Transfer in Reinsurance Contracts *(Continued)*

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ERD is a more robust approach to documenting the presence of risk transfer while maintaining some useful features of the 10/10 rule. It uses discounted cash flow testing to determine whether there is a 1% or greater probability of the reinsurer realizing a loss.

The relevant accounting pronouncements (FAS 113) and regulatory guidance (SSAP

62) require the following conditions for risk transfer:

1. The reinsurer assumes significant insurance risk under the reinsured portion of the underlying insurance agreement; and
2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

It is too early to predict what impact the new risk transfer testing protocols will

have on the reinsurance marketplace. We do expect, however, that the lack of data for start-up reinsurance carriers will inhibit a ceding carrier's ability to adequately document the risk transfer features of such contracts to the standards.

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Pinnacle News Briefs

Pinnacle Adds New Consultant

Jonathan Matthews, FCAS, MAAA, has joined Pinnacle as a Consultant in the Bloomington office. He earned a Bachelor of Science degree in Mathematics from Rose-Hulman Institute of Technology in Terre Haute, Ind. He also has extensive pricing experience including: commercial multi-peril, homeowners, rental programs, other personal lines and commercial auto.



Jonathan Matthews

Pinnacle Provides Commercial Lines Predictive Modeling Expertise

Pinnacle Principal **Rob Walling** recently presented on commercial lines predictive modeling at three conferences. *Practical Applications of Predictive Modeling in Commercial Lines* was offered at the National Association of Mutual Insurance Companies' Commercial Lines Underwriting Seminar. At the World Research Group's 4th Annual Predictive Modeling Implementation for Worker's Compensation Conference, Rob's session was *Workers' Compensation Product Management Applications of Predictive Modeling*. Another presentation, *Trends in Predictive Modeling*, was presented at the National Independent Statistical Service (NISS) Board Meeting.

For more information, contact Rob Walling at (309) 665-5010 or rwalling@pinnacleactuarials.com.

Pinnacle Provides Independent Analysis on Florida Tort Law

Pinnacle Principal **LeRoy Boison** testified last March at a special Florida House Committee Workshop that was considering the economic impact of repealing the state's no-fault law.

Pinnacle had conducted an independent study on this issue in March 2006 on behalf of Floridians for Lower Insurance Costs. The study showed that repeal of no-fault would save approximately \$260 per year on the liability coverage for a typical two-car family.

During the latest legislative session, Pinnacle was asked to estimate the economic impact of eliminating Personal Injury Protection coverage on the health care system. In a study published in February 2007, Pinnacle concluded that only about 4% of the total PIP claims would not be covered by any insurance system.

Last month, the Florida legislature adjourned

without changing the sunset provision. Unless action is taken in special session, the no-fault system will sunset in October 2007 and return to a tort environment.

For more information, contact LeRoy Boison at (516) 746-7149 or lboison@pinnacleactuarials.com.

Pinnacle Sponsors Rising Pro Golfer

Don't be surprised if you see the Pinnacle logo when watching the Nationwide Golf Tour this year. Pinnacle is sponsoring Tim Pemberton, one of the nation's top developing professional golfers, as he tours communities across the country and helps raise money for charity on the PGA-sponsored tour.



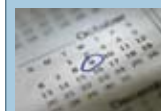
Tim Pemberton

Pemberton is the son of Pinnacle management consultant Terry Pemberton.

Pinnacle Consultants Speak at CAS Ratemaking Seminar

Four Pinnacle consultants spoke at the Casualty Actuarial Society's Seminar on Ratemaking last March in Atlanta.

Principal **Shawna Ackerman** spoke at a session called, *California Automobile, Proposition 103 Revisited*. **Roosevelt Mosley**, also a Pinnacle principal, moderated the discussion, *GLM Practical Applications*. Principal **Rob Walling** covered the subject of *Scoring for Small Business Owners*. Consultant **Chris Carlson** participated on the panel on *SUV Auto Insurance Costs/Other Make/Model Symbol Issues*. ▲



Come Join Us!

- ✓ **National Underwriter ACE Conference**
June 25 • Las Vegas, Nev.
Presentation
- ✓ **Ken Smith Financial Regulator Program**
June 26 • Illinois State University
Presentation
- ✓ **VCIA Annual Conference**
August 7-9 • Burlington, Vt.
Exhibit
- ✓ **ACIC General Counsel Seminar**
August 8-10 • Las Vegas, Nev.
Presentation
- ✓ **IRES Career Development Seminar**
August 12-14 • Pittsburgh, Pa.
Presentations
- ✓ **NAMIC Annual Convention**
September 17 • Grapevine, Texas
Presentation and Exhibit