Fudge

Bias in Group Pricing in South Africa

Disability has proven to show volatile loss ratios for group insurers in recent years. While socioeconomic forces play a role, overuse of certain pricing approaches can also contribute. We liken this phenomenon to "fudging", or the practice of taking mental shortcuts to adjust pricing assumptions. The result seems sweet, but can carry a bitter cost.

To understand why actuaries fudge, only consider today's high-stakes, high-pressure business environment. Far too often, individuals selectively credit evidence that confirms a desired conclusion, while discrediting evidence that does not – an often unconscious decision-making process called motivated reasoning.

One doesn't need to look far for examples: consider ardent sports fans from two opposing teams. Despite watching the same game, both sides believe that the umpire is biased. How many times have you kindly offered the umpire your glasses? Perhaps some decisions truly are *unbelievable*.

As noted earlier, when it comes to the group insurance market, misleading – or fudged – pricing decisions can deliver bitter results. **Here are nine decidedly unsweet pricing fallacies to avoid:**

Table Mountain Error

Large claims can distort experience analysis, so it is all too tempting to adjust by either completely removing the large claims from a group, or capping them at a historical average. Beware of allowing expectations to influence judgment. A large claim loading should also be applied because the full cost will still need to be covered across the book of business. Alternatively, use a credibility formula that takes into account claim incidence and amounts.

Herd Pricing

A frequent argument for providing a certain rate, underwriting levels, or terms is that another insurer is currently offering this. Clearly one needs to keep the competition in mind; other offers should be balanced against risk. The danger? Exceptions quickly become the norm, and the market as a whole races to the bottom. Good examples include free rate guarantees, very low underwriting, and overly generous disability terms.

Narrow Period Selection

Pricing is typically based on experience across the last five years. While it is important to look for trends, one needs to be careful that this doesn't result in cherry picking time periods that provide the cheapest rate. A quick test: would you only use the last two years if this suggested a negative trend?

Overweighing a Light Year

A big concern for any insurer arises when the experience on an existing group is unusually light in the latest period. This creates the opportunity for competitors to take a gamble that this positive experience may persist. The problem is that the latest period is often highly uncertain; it's an incomplete year, heavily reliant on outstanding claims reserves. Positive recent experience can seem to carry a greater weight in predicting future results than it deserves.

Reversion Expectancy

When a group's experience is notably different over more recent periods, there is the temptation to retain a prior view. For example, it is common to assume experience is going to return to a previous level. This can lead to under-pricing (ignoring upward trends) or losing business (ignoring a downward trend). It is very difficult to manage this expectation due to the uncertain nature of recent claims experience; the opposite extreme is The Overweighing a Light Year error (see above).

Artificial Credibility

Credibility can often be used to target a premium rate or generate additional discount (i.e., weighting the overall rate in the direction that provides the lowest cost). A common error is 'rounding up' the credibility to much higher levels than calculated for small schemes with no or few claims. This over-weights premiums to low credibility experience, something exacerbated where this is not also done for small groups where claims are higher than expected. In this case, the information of 'very few claims' is seen to confirm the view that this is a low-risk group, and credibility artificially changes to reflect this.

Duration Shorting

Disability income pricing is complex, with uncertainty driven by reserving. One particular bias emerges where a group has very good termination experience in the first 12- to 24-months following disablement. When pricing such groups, it is tempting to limit claims in the more recent periods on the assumption that they will repeat the same pattern. The potential error? Average termination assumptions are applied to claims beyond 24 months. The reality is that, if you override the termination model by assuming shorter durations for some claims, you should also apply longer durations to the claims that go beyond the shorter period. In other words, you can't strip out the short-term claims and still use the average for all other claims.

Price Anchor

When reviewing the price of an existing scheme or considering a new group where the price is known, it is hard to escape being anchored by the current premium rate. Ideally one should set a best estimate range, and then consider how to commercially move forward with the rate. The group market has done well to shift out of this mindset recently, with large increases being successfully implemented on many disability arrangements.

Outstanding Claims Reserves

When the latest period has seen a high level of claims, it is tempting to reduce outstanding claims reserves to 'balance' to expectations. While there is a thread of merit to this as reserves can over-respond and reporting patterns do change, such a scenario highlights the caution needed when relying heavily on such a recent period. Adjusting reserves to align experience with expectations doesn't necessarily provide additional pricing information.

All nine fallacies present alluring temptations, and discipline is key. While the pressure to remain competitive is a reality, the industry should guard against unconscious bias and motivated reasoning when pricing group business. Contact RGA South Africa to learn more.