Large Scale Analysis of Persistency and Renewal Discounts for Property and Casualty Insurance

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Abstract

In this paper, we study the issue of whether a price discount for renewal business is warranted for property and casualty insurance. The discount is motivated by the fact that new business with insurance coverage lapse, or new business in general, may perform worse than renewal business. The study is based on a total of 25 books of insurance business with a total amount of almost $29 billion of premium. The data cover all the primary property and casualty lines of business, including personal Auto and Homeowners as well as commercial Business Owners Policies, Auto, WC, GL and Property. The data do indicate that new business universally has a higher loss ratio and a lower retention rate than renewal business across all the 25 books of business. We will attempt to offer reasons as to why such difference exists between new and renewal business for insurance.

Keywords: Persistency discount, renewal discount, loss ratio, retention.

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1. INTRODUCTION

It may be known to the property and casualty insurance industry that new business possesses higher risk than renewal business. Stable and persisting insureds are generally bringing in more profits to insurers, while insureds who frequently switch from one carrier to another are usually poor risks [1]. For example, the research report by Conning [2] indicates that new business loss ratios can vary from 10% higher to more than 30% higher than renewal business, depending on the line of business and underwriting cycle. As a result, the industry may want to surcharge new business or award discounts to their renewal business.

One primary principle for insurance pricing is that "*A rate is an estimate of the expected value of future costs*" [3]. In other words, two risks with same characteristics should be charged the same rate. Therefore, such price differentiation between new and renewal business has caused some debate in the past because some people believed that insurance rates should not be unfairly discriminatory due to the length of an insured staying with a carrier. For example, in California, over the last decade, the new business surcharge or persistent discount debate has been one of the insurance regulation focuses. California regulators once barred automobile insurance companies from levying surcharges against new customers who drove without coverage [4]. After this bar was lifted later, consumer advocate groups also filed separate lawsuits against companies who use a customer's lack of prior insurance as a factor in determining premiums [5]. On the other hand, the insurance industry did propose to allow drivers who renew coverage with their current insurer to receive discounts on basis of the argument that actuarial evidence shows drivers who maintain insurance for an extended period of time with an insurer have lower loss costs [6].

Different states may have different regulations on such a new business surcharge or renewal business discount [7]. We conducted a survey with the department of insurance in various states. Regulations for some states are silent on the topic, while other states do not prohibit price differentiation as long as insurers can provide support for the discount. The survey result suggests that most of the states appear to allow the price differentiation. Table 1 in appendix summarizes the highlight of the responses from the departments of insurance we contacted.

There is a difference between persistency discount and renewal discount. The persistency discount rewards a lower rate to new business without prior insurance lapse. Hence, the discount essentially implies a surcharge to new business with insurance lapse. On the other hand, the renewal discount results in a lower rate for renewal business. Therefore, the renewal discount implies a surcharge to new business as a whole. Since insurance companies in general do not capture data well that can allow us to differentiation new business with or without prior insurance, our study focuses on the total new business.

Setting aside public policy and regulation considerations, the key actuarial and rating questions for the issue are:

- Is it true that new business in general performs worse than renewal business?
- If yes, what are the reasons for such a difference?

Several published studies before have noted that renewal business in general exhibits continuing improvement in loss ratio as the business has stayed with the same insurer for multiple terms [1,2, 8-10]. One study further attributes such improvement to the fact that as an insured stays longer with the same insurer, the insurer is able to obtain more information about the insured, including a verified loss history, the condition of the insured property and the degree of cooperation by the insured in settling claims [8]. This enhanced information about the insured enables the insurer to select desirable risks and thus improve the performance of its book. A persisting insured could also provide income over multiple terms and spread the acquisition cost and other underwriting costs over a long period of time to achieve lower average expenses per year, which provides savings to the insurer in addition to the improvement in loss ratio.

While the issue has a long history and several studies were published before on the issue, we believe that additional research, especially a study that utilizes the real industry data, can be done to help the industry gain a better understanding of it. Through our work on data mining and predictive modeling in past several years, we have studied a fairly large amount of data from a wide range of insurers. The data enables us to review the performance difference between new and renewal business in detail. In this paper, we will share our findings and knowledge on this issue based on our experience with the industry data in the past. In addition, we will bring in macroeconomic data for insurance exposures on drivers, vehicles, property, and business [11-13] as well as insurance industry data from AM Best [14] to compare with our finding. We believe by putting all the information and data together, we can offer in-depth insights on why new business and renewal business perform differently for the property and casualty insurance.

2. DATA

We have studied a total of 25 books of business with a total amount of premium of $29 billion. The 25 different books are from a wide range of carriers, including national, multi-line carriers as well as regional, mono-line carriers, and they cover all the major primary lines of business for property and casualty insurance, including personal Auto and Homeowners, as well as commercial BOP, Auto, Property, GL, Package, and Workers' Compensation. The data as a whole spans across the last underwriting cycle from late 1990 to mid 2000. Tables 2 in the appendix shows some details of the data used in this paper. Tables 3-5 shows the performance difference in several characteristics between new business and renewal business for these 25 books.

In addition, Tables 6-9 show the historical macroeconomic data for the drivers, vehicles, homes and businesses [11-13]. The data indicates the underlying exposure information for the U.S. property and casualty insurance industry. Finally, Table 10 shows the historical industry premium data for different lines of business from AM Best [14].

3. RESULTS AND DISCUSSION

Table 3 indicates that new business show a higher loss than renewal business. The data further indicates that all of the 25 books of business under study show such result. On average, the new business loss ratio is 13 points worse than the renewal business. The fact that new business has a higher loss ratio than renewal business is the primary reason why insurance companies are interested in offering a price discount for their renewal business.

Our experience further indicates that as the renewal business continues to age, the loss ratio will continue to improve. The renewal business' loss ratio will be close to the overall average loss ratio around 3 to 5 years after the business is on the book. In other words, insurance carries need to invest a couple years on a new business before the business turns into profit. It also suggests that long-time, loyal customers bring in the highest share of profit for the carriers. Such loss ratio-policy age pattern we have seen in our data is consistent with the study result by D'Arcy [8].

Another result given in Table 3 is that new business appears to have a higher turnover rate than renewal business. Similar to the loss ratio result, all of the 25 books are showing a lower retention rate for the new business. On average, renewal business has a 6 point higher retention rate than new business.

In general, there are three reasons why an insured is not retained by a carrier. First, the insured's exposure stops to exist, for example, termination of business operation or discontinued ownership of a car or a property. The second reason is because the insured voluntarily switches insurance from one carrier to another. Multiple factors may trigger an insured to switch its carrier, and they may include price shopping, dissatisfaction of the service, agent's action etc., to name a few. The third reason is because the carrier terminates the policy due to its own action. For example, insurer carriers always take underwriting action to manage the poor risks on their book, and the action may includes terminating the insurance contract, raising the price, limiting the coverage, restricting the selection of payment plan, etc. Such underwriting action inevitably will result in some risks leaving the carrier to seek another carrier. We can expect that the latter two reasons, insured's voluntary switch from one carrier to another and the action by insurance carriers, are the primary reasons for the fact that new business has a lower retention rate than renewal business. Later, we will bring in additional macroeconomic data and other insurance statistics to further explain the retention difference between new and renewal business.

While Table 3 clearly indicates that loss ratio for new business is worse than renewal business, it may not support the fact that new business has more risk or higher pure premium than renewal business. This is because insurance companies may need to offer low, competitive price in the market place in order to compete for new business. However, for the data used in this study, it is not possible to compare pure premium between new and renewal business. Therefore, we have come up with another analysis to address this issue and question, and the result is given in Table 4.

For personal insurance, the rate is less flexible, so it is hard to manipulate price to compete for new business. On the other hand, the price for commercial insurance is fairly flexible because typical commercial line pricing contains several subjective and flexible price components. Commercial carriers can apply these flexible components compete for new business price. One commonly used flexible price component is scheduled credit/debit or individual risk modification factor, IRPM. Analyzing how commercial insurance carriers apply scheduled credits and debits will allow us to understand their pricing strategy in the market place for new business. In Table 4, we show, by the major commercial lines of business, the average percentage of policies receiving credits vs. debits between new and renewal business. Table 4 indicate that, while the result is somewhat mixed for policies receiving credits, the new business appears to receive less debits than renewal business. The result does suggest that insurance companies may charge less for new business than renewal in order to compete for new business. Such pricing strategy for competing new business may partially contribute to the fact that new business has a higher loss ratio than renewal business. However, the magnitude of credit and debit difference in Table 4 does not seem to be large enough to account for the loss ratio difference in Table 3.

The next analysis we have performed is that we selected 3 books from Table 2, all of them commercial, and for each book, and we split the data into 2 groups. One group contains the risks that were retained for the next term with the same insurer, while the other group contains the risks which were not retained. Then, between the two groups, we measure and compare two characteristics: loss ratio and business financial credit score. The result is given in Table 5.

The first characteristic for comparison is loss ratio. We find that the group which was retained for the next term has a lower loss ratio than the group which was not retained. This suggests that insurance companies appear to retain more of their "profitable business" than their "unprofitable business".

In addition to loss ratio, we also compare a financial credit score between the 2 groups. The financial credit score data we use is developed by Dunn and Bradstreet. The score is a measurement of the likelihood for a business to fulfill its future financial obligation, such as payment on time. The score we use for comparison has a scale of 1 to 100, and the higher the score, the better the financial condition. Table 5 shows, again, a better average credit score for business retained than business not retained.

From the loss ratio and credit score comparison, we can see that the quality of the retained business is better than the quality of non-retained business. This is consistent with the fact that insurance companies do take underwriting action to manage poorer risks on their books. It also suggests that as the non-retained business becomes new business for another carrier, the quality of the new business is worse the renewal business for the carrier.

Another result given in Table 3 is that on average, the new business accounts for 20% of the total business for the 25 books under study. We can expect that an insurer's new business should compose two different portions of risks. The first portion is the first-time insurance buyers, for example, first time drivers with a new drivers' license, a new vehicles, a first-time home owner or property owner, or a newly established business or property that need insurance coverage, etc. In other words, from the perspective of the insurance industry as whole, this portion of risks is the "true" new business. The second portion is the risks which did not renew their insurance with prior insurance carriers. In other words, while they are "new business" for the insurer, the business is from other carrier's renewal book. .

In order to research the two compositions of the new business, we bring in additional macroeconomic and insurance data. Tables 6 to 9 show the 20 years of statistics, from 1986 to 2006, for drivers, vehicles, homes, property, and business in the U.S. The statistics indicates the underlying exposure information for the overall US property and casualty insurance industry, and it shows that the growth rate in the overall exposure is fairly minor, much less than the average of "20%" new business for the 25 books under study.

In addition, Table 10 shows 10-year history of premium dollars for the personal lines, commercial property lines and commercial casualty lines combined from AM Best. Again, the total industry premium growth rate over the last 10 years has been very mild and is less than the average new business percentage for the insurance data used in this study.

Another fact about insurance carriers in accepting and underwriting their new business is that typically they are tougher on the "truly new exposures", such as newly established businesses or drivers who just obtained their driver licenses. For example, to our knowledge, many commercial line carriers will not accept a commercial risk with less than 3 years of history, or if they accept, they will apply their higher priced company or restrict their schedule credits. Therefore, many commercial line carriers have very few first time established businesses on their books. Similar experience can be applied to personal auto carriers, whose books typically have very few first-time youthful drivers.

From the macroeconomic statistics for the overall industry exposure data, the total industry premium data, and the standard insurance industry practice on accepting new business; we can conclude that the majority of an insurance company's new business comes from other insurance company's renewal business, and not from the truly new business as a first time insurance buyer.

Let us put together the performance comparison results and the industry exposure information from Table 3 to Table 10, and we can then begin to describe the dynamic process of new and renewal business for insurance companies. Such a dynamic cycle can make us understand why there is a difference in performance between new and renewal businesses.

Insurance companies constantly trade and swap risks between themselves. Most of the new business for an insurance company comes from other insurance companies' renewal book. Since every insurance company underwrites its book and takes action against the poorly performing risks, one reason for insureds to leave their carriers and seek insurance for another company is due to the result of the underwriting action by the existing company, such as non-renewal or increase in renewal price. Of course, they may also voluntarily change insurance carriers due to a wide range of other reasons, such as shopping for cheaper rates or not being satisfied with their carriers for service. No matter what the reasons are for insureds to leave their insurance carriers, our study shows that overall, they possess worse characteristics, such as higher loss ratios or worse credit scores, than the insureds who stay and renew their policies with their existing insurance carriers. After leaving the existing insurance carriers, they most likely become another company's new business, unless their exposure stops to exist. Since the new business in general possesses poorer risk characteristics, our study shows that for all the 25 different books of data under study, the new business' performance for loss ratio and retention is universally worse than the renewal business. Sometimes, insurance carriers' business strategy of using flexible pricing components to compete for new business will worsen new business' loss ratio even more. Such a dynamic cycle suggests that renewal business is subsidizing new business for the property and casualty insurance. It is due to such differences in loss ratio, retention, and risk quality that the insurance industry is interested in deploying a price difference in their rating between new and renewal business.

4. CONCLUSIONS

We believe that the data underlying this research is very credible and can represent the general result for the property and casualty insurance industry. Our study clearly shows that for property and casualty insurance carriers, the new business performance is worse than the renewal business. The new business appears to have higher loss ratios and worse retention than renewal business. Our experience further indicates that as renewal business ages, its performance will become even better.

We believe that the reasons why new business performance is worse than the renewal business is two fold: (1) The first time insurance buyers are less experienced in dealing with managing their insurance risks, and (2) Those who are not the first time insurance buyers but seek new insurance carriers, typically have worse risk characteristics and may be price shoppers. Actuarially, new business surcharges or renewal business discounts appear to be justifiable by the data in this study.

While we believe that new business surcharge or renewal business discount can be justified, there is still an issue: if a new risk and a renewal risk are the same in their characteristics, why can they be charged differently just because one risk is a new business and the other one is a renewal business? One key reason is because insurance carriers have more knowledge of their renewal business than their new business.

When a risk has been with a carrier for several years, the carrier will know the risk's loss experience with the carrier. The carrier also knows many other details about the risk, such as its premium paying history, its coverage change and endorsement records, etc. When the risk leaves the carrier and become a new business to another company, some of the important information may not be known to the new company because such information is not captured during the new business writing and binding process. Even if the new company does collect some of the information, it is in a way that is not verifiable or can be manipulated by the insured. Also, for writing new business, there is a balance of gathering more information verse "ease to do business". Gathering too much information when writing new business may cause undue burden on agents or brokers.

For example, for commercial insurance, while many insurance companies will ask for prior loss runs for new business and will use the loss run to underwrite the new business, the data on the loss run typically is not passed to the data system and therefore is not captured in the pricing database. Therefore, prior loss history of a new business is subsequently lost after the new business is written. Unless the insurance industry enhances its information gathering practice and collect much more information for new business underwriting and pricing, the industry probably will continue to experience worse performance for their new business than their renewal business.

5. REFERENCES

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Appendices

Table 1: Summary of the Survey Responses on Price Differentiation between New and Renewal Business

State	Response from the Department of Insurance
AZ	There should be no difference in the premium that is charged between new business and renewal business if all the risk characteristics are the same
CA	Persistency is a permitted rating factor for personal auto in California
FL	It would be very unusual for companies to file a different price for new versus renewal.
IL	We do not have a rating law in Illinois. A lot of personal lines insurers give renewal discounts. Commercial rates are not filed at all.
LA	Louisiana law does not prohibit insurance companies from offering discounts for renewal policies
MO	The rating laws do not delineate between new and renewal business, rather they speak to rates in general.
NC	Does not prohibit difference for new and renewal business.
ND	We do allow companies to file renewal discounts
NJ	The NJ regulations do not prohibit companies from charging higher premium for new business versus renewal business or offer discounts for renewal business.
NM	We do allow carriers to charge more for new policies.
NY	We do allow renewal discounts and they are heavily used. These are often tied to "claim free" discounts.
OH	If a company provides support that there is a cost difference between new and renewal business then they can reflect the difference in their rates.
OR	An insurer can charge more for new business, or offer a persistency discount, provided the difference is supported statistically.
PA	If a company has reasonable, actuarial support that demonstrates the appropriateness of "lower" rates for renewal business than for new business (i.e., lower expenses and/or lower losses), rates based upon this support would be acceptable.
TX	There isn't anything that speaks directly to new business vs. renewal business for property and casualty insurance but any price difference between the two would be subject to the rate standards in the statutes.
WA	Renewal discounts are permitted in Washington, as there is no statute or regulation prohibiting them

Table 2: Summary of the Data

Line of Business	Number of Books	Total Premium, in Billions	Data Period
BOP	4	$4.9	1995 to 2004
Commercial Package	3	$4.7	1996 to 2004
Commercial Auto	4	$3.6	1998 to 2005
General Liability	2	$1.1	1995 to 2004
Commercial Property	3	$1.7	1995 to 2002
WC	4	$3.9	1996 to 2004
Personal Auto	3	$2.0	1997 to 2005
Personal Home	2	$6.8	1997 to 2003
Total	25	$28.7	1995 to 2005

Table 3: Comparison of Loss Ratio and Retention between New Business and Renewal Business

Line of Business	Number of Books	Average % of New Business	Average of Loss Ratio Difference, New – Renewal*	Average of Retention Difference, New – Renewal*
BOP	4	19%	18%	-5%
Commercial Package	3	19%	9%	-7%
Commercial Auto	4	19%	15%	-5%
General Liability	2	22%	7%	-8%
Commercial Property	3	17%	17%	-8%
WC	4	27%	11%	-3%
Personal Auto	3	16%	12%	-3%
Personal Home	2	23%	15%	-19%
Total	25	20%	13%	-6%

* For all the 25 books under study, the loss ratio is higher and the retention is lower for the new business than the renewal business.

Table 4: Comparison of Percentage of Policies Receiving Schedule Credits or Debits between New and Renewal Business for Commercial Lines

Line of Business	Number of Books	Average Percentage of Policies Receiving Credit		Average Percentage of Policies Receiving Debit	
		New	Renewal	New	Renewal
BOP	4	15%	16%	3%	8%
Commercial Package	3	16%	18%	5%	11%
Commercial Auto	4	20%	14%	2%	9%
General Liability	2	30%	29%	12%	23%
Commercial Property	3	29%	30%	5%	12%
WC	4	7%	7%	1%	1%

Table 5: Comparison of Loss Ratio and Financial Credit Score between Retained Business and Non-Retained Business for 3 Selected Commercial Books:

Line of Business	Total Premium	Loss Ratio Difference, Non Retained - Retained	Difference in Business Financial Score, Non Retained – Retained *
BOP	$690 Millions	+4 points	-5
General Liability	$533 Millions	+4 points	-2
Commercial Property	$345 Millions	+7 points	-3

* The business financial credit score used is published by Dunn and Bradstreet. The score is on 1-100 scale, and the higher the score the better the financial credit.

Table 6: US Licensed Drivers Statistics

Year	Total Licensed Drivers	Annual Growth
1986	159,487,000	1.7%
1987	161,818,461	1.5%
1988	162,853,255	0.6%
1989	165,555,295	1.7%
1990	167,015,250	0.9%
1991	168,995,076	1.2%
1992	173,125,396	2.4%
1993	169,968,825	-1.9%
1994	175,409,447	3.2%
1995	176,634,467	0.7%
1996	179,539,340	1.6%
1997	182,709,204	1.8%
1998	184,980,177	1.2%
1999	187,170,420	1.2%
2000	190,625,023	1.9%
2001	191,275,719	0.3%
2002	194,295,633	1.6%
2003	196,165,667	1.0%
2004	198,888,912	1.4%
2005	200,548,972	0.8%
2006	202,810,438	1.1%

Source: Office of Highway Policy Information, Highway Statistics Publications

Table 7: US Motor Vehicles Statistics

Year	Private & Commercial Vehicles	Annual Growth	Publicly Owned Vehicles	Annual Growth	Total	Annual Growth
1986	172,763,183	2.4%	2,937,156	0.9%	175,700,339	2.3%
1987	175,998,790	1.9%	2,997,857	2.1%	178,909,773	1.8%
1988	181,322,995	3.0%	3,069,679	2.4%	184,392,674	3.1%
1989	184,197,489	1.6%	3,158,617	2.9%	187,356,106	1.6%
1990	185,540,912	0.7%	3,257,002	3.1%	188,797,914	0.8%
1991	184,829,525	-0.4%	3,306,944	1.5%	188,136,469	-0.4%
1992	186,960,290	1.2%	3,401,938	2.9%	190,362,228	1.2%
1993	190,642,869	2.0%	3,420,613	0.6%	194,063,482	1.9%
1994	194,531,748	2.0%	3,513,617	2.7%	198,045,365	2.1%
1995	197,941,202	1.8%	3,588,819	2.1%	201,530,021	1.8%
1996	202,713,708	2.4%	3,651,448	1.8%	206,365,156	2.4%
1997	204,079,162	0.7%	3,674,498	0.6%	207,753,660	0.7%
1998	207,840,942	1.8%	3,775,611	2.8%	211,616,553	1.9%
1999	212,474,300	2.2%	3,834,323	1.6%	216,308,623	2.2%
2000	217,566,789	2.4%	3,908,384	1.9%	221,475,173	2.4%
2001	226,646,079	4.2%	3,782,247	-3.2%	230,428,326	4.0%
2002	225,772,196	-0.4%	3,847,783	1.7%	229,619,979	-0.4%
2003	227,475,999	0.8%	3,913,999	1.7%	231,389,998	0.8%
2004	233,266,291	2.6%	3,976,325	1.6%	237,242,616	2.5%
2005	237,139,650	1.7%	4,054,324	2.0%	241,193,974	1.7%
2006	240,059,464	1.2%	4,106,222	1.3%	244,165,686	1.2%

Source: Office of Highway Policy Information, Highway Statistics Publications

Table 8: US Total Housing Inventory Statistics

Year	Estimated Total Housing (000s)	Annual Growth
1986	99,318	2.0%
1987	101,811	2.5%
1988	103,653	1.8%
1989	105,729	2.0%
1990	106,283	0.5%
1991	107,276	0.9%
1992	108,316	1.0%
1993	109,611	1.2%
1994	110,952	1.2%
1995	112,655	1.5%
1996	114,139	1.3%
1997	115,621	1.3%
1998	117,282	1.4%
1999	119,044	1.5%
2000	119,628	0.5%
2001	121,480	1.6%
2002	119,297	-1.8%
2003	120,834	1.3%
2004	122,187	1.1%
2005	123,925	1.4%
2006	126,012	1.7%

Source: US Census Bureau, Housing Vacancies and Homeownership

Table 9: US Business Statistics

Time Period	Initial Year Establishments	Percent of Net Growth
1995-1996	5,878,957	1.6%
1996-1997	5,970,420	2.5%
1997-1998	6,120,714	1.1%
1998-1999	6,187,599	1.0%
1999-2000	6,248,411	0.8%
2000-2001	6,297,423	0.8%
2001-2002	6,345,890	0.6%
2002-2003	6,386,609	1.1%
2003-2004	6,455,018	1.4%

Source: US Census Bureau, Statistics of U.S. Businesses

Table 10: AM Best Statistics for US Property& Casualty Insurance Industry

LOB	Year	Premiums earned (in $1,000)	Growth Rate
Total US Personal Lines	1996	123,722,772	
	1997	129,529,545	4.7%
	1998	134,910,240	4.2%
	1999	139,053,922	3.1%
	2000	146,442,174	5.3%
	2001	155,377,660	6.1%
	2002	171,055,476	10.1%
	2003	189,414,491	10.7%
	2004	204,074,773	7.7%
	2005	212,766,944	4.3%
	2006	217,629,797	2.3%
Total US Commercial Property	1996	5,639,304	
	1997	5,893,398	4.5%
	1998	5,937,140	0.7%
	1999	6,205,553	4.5%
	2000	6,459,054	4.1%
	2001	7,617,844	17.9%
	2002	7,528,501	-1.2%
	2003	10,110,915	34.3%
	2004	10,430,080	3.2%
	2005	11,138,340	6.8%
	2006	11,976,705	7.5%
Total US Commercial Casualty Lines	1996	104,742,557	
	1997	105,914,101	1.1%
	1998	105,305,898	-0.6%
	1999	103,930,114	-1.3%
	2000	110,111,876	6.0%
	2001	120,055,783	9.0%
	2002	141,695,628	18.0%
	2003	159,335,190	12.5%
	2004	174,887,038	9.8%
	2005	176,755,172	1.1%
	2006	181,148,749	2.5%

Source: AM Best