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STUDENT OF THE INDUSTRY PARTING SHOT

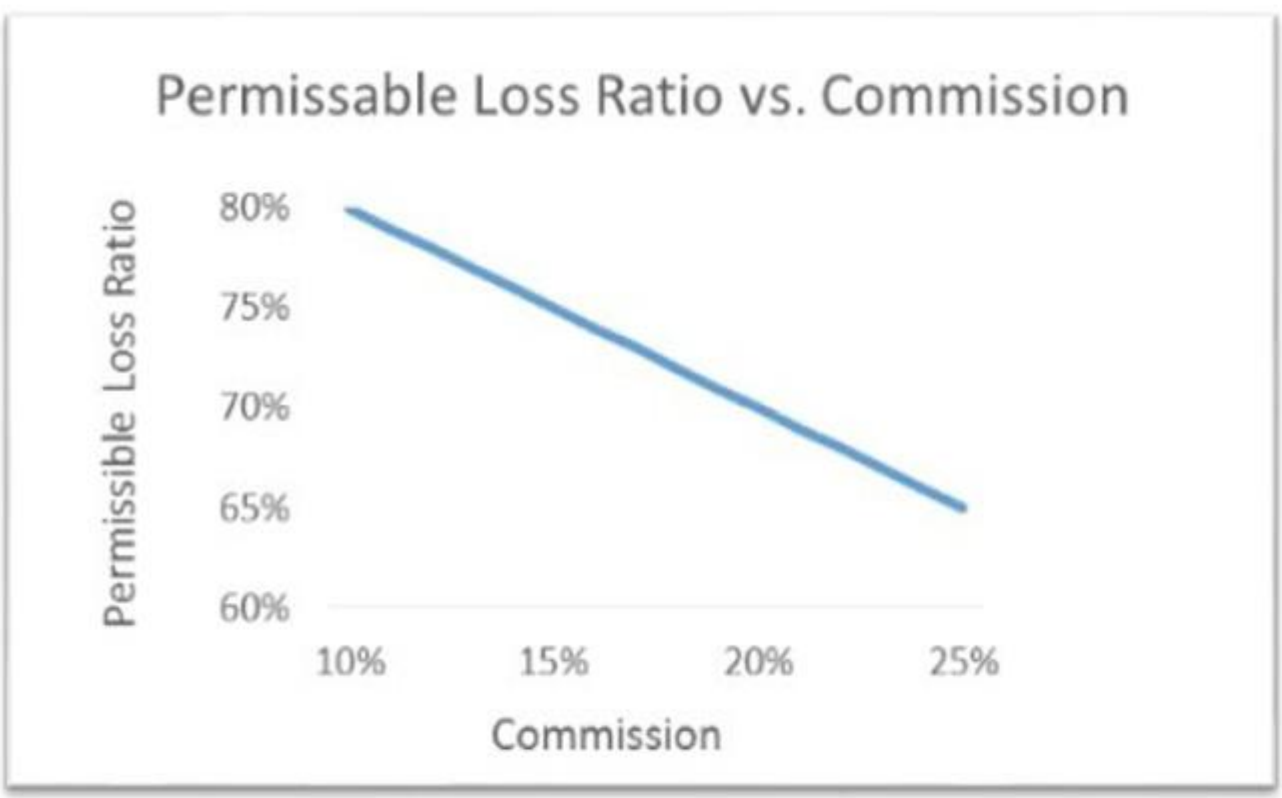
Rate Indications #2: What is a Permissible Loss Ratio?

By Paul Buse, President of Big I Advantage®

Last week we looked at Rate Indications and where they come from. The example was a book of business that had an estimated loss ratio of 70% and a ***Permissible Loss Ratio*** (PLR) of 65%. This resulted in a needed rate increase, or "Rate Indication," of about 8%. But what's the PLR and why is it important?

$$Rate\ Indication = \frac{(Loss\ and\ Adjusting\ \% + Fixed\ Expense\ \%)}{(1 - Variable\ Expense\ \% - Profit\ \%)}$$

In the above formula the denominator (in red) is the **permissible loss ratio** or PLR. The math is basically saying when loss and adjusting expenses plus insurer fixed expenses (the numerator) are equal to a one (1.0) less acquisition costs, premium taxes and an insurer profit load, no rate change is needed. As usually the biggest component of variable expenses is commissions, below is the resulting impact on the PLR as commissions increase from 10% to 25%.



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Graph Assumptions: Fixed Expenses of 10%, Insurer Profit of 5% and Non-commission Variable Expenses of 5% (Premium taxes plus other acquisition-related)

So why is this important? Well, the higher the PLR, the lower the premium. If expenses are higher, rates charged must be higher to generate the same return. Insurers must always assess what brings the most to their value proposition for consumers. Speaking of expenses and value in the insurance equation, the figures for 2015 are in and A.M. Best ***Aggregates & Averages*** have arrived. In a week or two, we'll look at total advertising spending in 2015 and compare that to commissions.