News and Insight > News and features > Corporation News

Underwriting, fast and slow

Share

Markus Gesmann shares his thoughts on what might distinguish successful underwriters. It's about embracing basic hygiene factors and a systematic approach to reviewing underwriting assumptions.

Everyone can make money in a hard market. It is a little more difficult in a soft market. Not every risk is as good as it might seem at first glance.

Thinking, fast and slow

Daniel Kahneman, a psychologist who received the Nobel Prize for Economics in 2002, offers some insight in what might distinguish successful underwriters in a soft cycle.

Much of Kahneman's work is about the psychology of judgment, decision-making and behavioural economics; aspects that are very relevant in a fast paced face-to-face market place like Lloyd's.

In his bestselling book "Thinking, fast and slow", Kahneman offers explanations on how humans think, make decisions and act. He demonstrates how easily our intuition can trick us and that sceptical reasoning, although time and energy consuming, can help.

Thinking fast doesn't take much energy; it is our intuition that answers: 2+2 = 4. You don't have to think about it. 12×17? This is a little more difficult and most of us would stop what we are doing to concentrate on the task and check our answer.

Kahneman describes two modes of thinking, which he labels System 1 and System 2.

- *System 1* operates automatically and quickly, with little or no effort and no sense of voluntary control.
- *System 2* allocates attention to the effortful mental activities that demand it, including complex computations. The operations of System 2 are often associated with the subjective experience of agency, choice and concentration.

At which point do we switch from believing in our intuition and start to actually think?

I believe that in a soft market we need to think and work much harder. As an underwriter you have to be more sceptical with the information provided by brokers and clients than in a hard market. And that's why experience is so valuable; it allows you to recognize situations in which mistakes are likely and try harder to avoid significant mistakes when the stakes are high.

I have a few examples here that you can use to test your own intuition and that of your underwriters. When do you switch from fast to slow thinking? Is your level of scepticism well calibrated?

Read the following puzzle, which is a taken from Kahneman's book with the labels changed. Try not to solve it, but listen to your intuition.

A fire and flood cover cost £110. The fire cover costs one hundred pounds more than the flood cover. How much does the flood cover cost?

What do you think? £10? That's most people's response. But does it add up? If the flood cover costs £10, the fire cover will be £110, as it is one hundred pounds more expensive, together this is £120. Hence, the flood cover must be only £5.

Here is another example from Thinking, fast and slow. Again, memorise your intuitive answer first.

Hit and run accident

A cab was involved in a hit and run accident at night. Two cab companies, the Green and the Blue, operate in the city. 85% of the cabs in the city are Green and 15% are Blue. A witness identified the cab as Blue.

The court tested the reliability of the witness under the same circumstances that existed on the night of the accident and concluded that the witness correctly identified each one of the two colours 80% of the time and failed 20% of the time.

What is the probability that the cab involved in the accident was Blue rather than Green knowing that this witness identified it as Blue?

If you were in the jury, would you consider the 'Blue' company as guilty?

Your intuition might let you believe that there is enough evidence. However, if you do the maths, you realise it is only 41%. The main reason for this figure to be below 50% is that the witness' error rate is higher than the proportion of 'Blue' cabs.

The next example brings me back to insurance. Please don't be offended if you are a casualty underwriter. It is illustrative and can be replaced with any other class of business and differently worded context.

Hit and run ... away from your tail

There are two kinds of casualty underwriters, the skilful ones and the ones who run away from their tails. Suppose historical market data would reveal that only 15% of casualty underwriters are skilful and 85% are running away from their tails, i.e. change job before their true performance is known.

A CEO employs a new casualty underwriter. The CEO believes that she can identify the skilful underwriter from the one that runs way from her tail with 80% confidence.

If you were the hiring CEO, what is the probability that you selected a skilful underwriter?

Well, all figures in this example are the same as in the previous example. Hence, the answer is again only 41%.

Finally, let me show you an example from the context of business planning.

Chances of entering new classes of business successfully

A syndicate is planning to enter a new class of business, where historically only 15% of the syndicates met its planning loss ratios and 85% failed. The syndicate has a track record of meeting its business plan loss ratio 4 out of 5 years (80%).

How much confidence would you have that this syndicate can achieve its planning loss ratio in the new class of business?

Perhaps, this looks like a sensible proposal, but by now you will have noticed that the figures and structure in the statement above are the same as in the previous examples. Therefore, the answer is only 41% again.

Of course, this is an artificial example and there is always more to a story in real life than the facts provided here. However, without doing the maths and just relying on people's intuition I don't believe everyone would come to the same conclusion.

That's why Lloyd's developed the Planning Support Tool. It uses syndicates' historical data to assess the business plan assumptions, similar to the previous example. The tool allows Lloyd's to quickly identify planning assumptions that look unrealistic, based on historical performance.

Of course this doesn't mean that plans that have been highlighted as having unlikely or very unlikely planning assumptions cannot be approved, but Lloyd's will certainly require more of a story from the syndicates and why its plan should be approved.

Indeed, the tool's main purpose is as an exception report, to slow down and challenge the thinking of the reviewer, to actively encourage the person to shift from System 1 to System 2.

So what?

Establishing processes to record assumptions, such as benchmark price and risk adjusted rate changes and to review the assumptions regularly might sound tedious. But they enable underwriters and Lloyd's to find anomalies, spot risks that look good only at first glance and may help to avoid significant mistakes.

Much of this can be seen as hygiene factors. However, it is the better hygiene today that has made the biggest impact on our longevity.

Similarly, I believe that embracing hygiene factors in respect of underwriting controls and oversight will increase a syndicate's survival chance through the soft market cycle.

Lloyd's Copyright 2017

Lloyd's is a registered trademark of the Society of Lloyd's. Lloyd's is authorised under the Financial Services and Markets Act 2000.