NCCI Profit Model

Review and Revisions
Why Review Profit Methodology?

• Existing methodology includes cost of capital (COK) and internal rate of return (IRR) analyses
  • Has been in use for approximately 30 years
  • Modest changes over time
  • Time is ripe for a review

• FL OIR has expressed concern over model dynamics
  • Specifically, cost of capital not adequately responsive as interest rates and investment yields declined
  • Result was increasing indicated underwriting profit provisions
Changes in Profit Methodology

• **Cost of Capital Analysis**
  - Eliminate DCF (discounted cash flow) model from analysis
  - Revise method of estimating CAPM (capital asset pricing model)
  - Include consideration of debt in insurer capital structure: i.e., calculate WACC (weighted average cost of capital) instead of cost of equity alone

• **Internal Rate of Return Model**
  - Incorporate dynamic assumptions regarding path of future interest rates and related variables
Impact of Methodology Changes

• Eliminate DCF model: Currently will reduce cost of equity estimates (DCF has typically been higher than CAPM) → lower UW profit

• Revise CAPM estimation method: Currently will reduce cost of equity (current interest rates and market risk premium lower than long term average) → lower UW profit

• Switch to WACC: Always will reduce cost of capital (cost of debt always lower than cost of equity) → lower UW profit

• Incorporate dynamic assumptions in IRR: Currently will reduce rate indication (increasing yield rates more than offset increasing cost of capital) → lower UW profit