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**