The loss ratio:

Net Incurred Losses and LAE
Net Contributions

This week's spotlight formula is the loss ratio. Net Incurred Losses and LAE Net Contributions The loss and LAE ratio (or simplified as just "loss ratio") is a pool's net incurred losses and loss adjustment expense (LAE) relative to its net contributions, usually presented on a calendar year basis. As with many benchmarks, the loss ratio is calculated net of reinsurance.

For example, a pool with $500,000 in net incurred losses, $100,000 in LAE, and $800,000 in net contributions has a 75 percent loss ratio. When the pool's expense ratio of about 20 percent is factored in, it would have a combined ratio of 95 percent.

Losses and their associated costs (LAE) are the largest expense component of any pool or insurer. A typical insurance industry range of loss ratios in recent years is between 75-90 percent, although certain coverage lines may vary widely from this range. Monitoring loss ratios over time is important in assessing all aspects of pool operations (including pricing) and financial stability. To fully understand your pool's loss ratio results over time, there are many factors to consider, including but not limited to, the period of time over which losses are paid, the frequency and severity of the lines of coverage being offered, the adequacy of pricing, the amount of loss control measures, and other nuances in a pool's operation.

Losses for longer-tailed coverages, such as workers' compensation, usually take longer to develop and are paid out over many years. This longer payout cycle means an insurer or pool can anticipate investment income to offset loss costs. In recent years, workers' compensation coverage has typically operated with a loss ratio around 90 percent.

In comparison, property coverages typically operate with loss ratios closer to 55 - 60 percent. This is because the pool needs to assure adequate funding to manage the volatility associated with this coverage and the short-tailed nature of the line does not afford much investment income to offset loss costs.

Confidence level calculations can have a big impact on the loss ratio. Pools may also choose to fund with contributions set at a 75 percent confidence level, preferring to err on the side of caution. This pricing preference would naturally increase the contribution (i.e., the denominator of the ratio), and thus create a smaller loss ratio compared to those pools that fund contributions at the expected level (i.e., 50-55 percent confidence level).