SPECIALIZATION - OPPORTUNITY FOR THE 1990's

(1990 Ratemaking Seminar Luncheon Address)

Wayne Fisher
Charles McClenahan

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It is a genuine pleasure to be here with you today. In late 1985, I accepted new responsibilities at Continental that effectively removed me from day-to-day contact with my actuarial colleagues. In my new job, I found myself attending a different set of industry meetings and missing virtually all of the contacts I had previously enjoyed with my fellow actuaries. A few days ago, I attended my first CAS Board meeting - for this term - so together with this meeting, the entire week constitutes something of a reawakening of my actuarial roots. It feels good.

I would like to spend the next few minutes sharing with you my thoughts on specialization and how it will create many opportunities for actuaries in the 1990's.

Institutional Investor, in its January 1990 issue, includes an article by Frederick Dannen entitled "The Incredible Shrinking Insurance Industry." In it, Mr. Dannen identifies two broad themes that will characterize our industry in the 1990's.

First, profits will be tough to come by in all lines of insurance. And, second, one way or another, through merger, insolvency or involuntary liquidation, there will be a continuing shakeout in the industry, with fewer companies at the end of the decade than there were at the beginning. Against that backdrop, he goes on to identify an area of opportunity for our industry in the 1990's. That area is specialization. The development of sharply focused, highly specialized operations will be a key strategy in the next decade for the most profitable and successful companies.

Standard and Poors, in their January 1990 "Outlook on Property and Casualty Insurance," identifies increased industry segmentation and specialization as one of three developments that will have an ameliorating impact on our industry's cyclical performance in the next decade. This trend toward greater specialization tends to offset the reliance on price competition characteristic of commodity businesses. Many large insurers are now carefully selecting and serving a series of discrete market niches instead of attempting to be "all things to all people."

The annual reports of many of the largest insurers confirms this developing trend. AIG, St. Paul, Chubb and Transamerica, for example, all set forth detailed plans to provide differentiated products and services to selected markets and customers. Frequently, these are products and services not easily supplied by others - such as medical and other professional liability, and coverage for pharmaceutical, biotechnological, electronic, entertainment, mining, construction and energy related firms, as well as a wide variety of accounts with a substantial environmental damage exposure.

Why does specialization frequently lead to success? We are in a mature, commodity-type business with some 3,500 competitors. Focusing on discrete market segments, either by geography, by class of insured or by line of business, allows for a concentration of expertise in underwriting. This focus, when coupled with a more homogeneous, larger and more statistically credible data base, leads to more refined class selection and pricing. On the other end of the insurance process, increased sophistication in loss control and claims can frequently lead to a reduction in incurred losses and provide real value to the customer.

More sophisticated management information enables actuarial analyses to be more relevant and provide meaningful direction for the specific business unit. This information provides insights into the business frequently lost in a broader, more diversified organization. Tailored services and employees with experience and knowledge in a specific business can add unique value to producers and insureds. But they're not the only ones to benefit from this strategy. Specialty companies frequently attain a leading market share and, consequently, a leadership position in their specific market segments which generally provides some welcome insulation during soft market cycles.

A look at the results for several leading companies in the last decade supports this observation. AIG, State Farm, Geico, Chubb, St. Paul, and Hartford Steam Boiler quickly come to mind as having consistently superior results and a specialty orientation. The stock market certainly reflects these results for the publicly traded companies in this group, as they typically command a price-to-book-value multiple in excess of one and a half to one versus one to one for companies perceived more as generalists. Even more interesting, though, are the results within the specialty-oriented companies, as their specialty units appear to outperform their standard lines business by up to 10 points.

But, why is this relevant to you, today, as we enter the 1990's? The reason is that this trend to further specialization greatly increases the opportunities for, and demands on, actuaries. In fact, in many ways, superior actuarial support is one of the key elements to a successful specialization strategy.

We've seen this quite clearly at Continental. The Special Operations Group, one of our three operating groups, comprises ten autonomous, highly-specialized business units, including organizations concentrating on medical professional liability, workers compensation in limited geographical areas, surety bonds and a wide variety of products for financial institutions, large Fortune 500-type accounts, short-line and specialty railroads, health insurance stop-loss coverage, and so forth.

What's truly remarkable, and what's certainly new the last few years, are the demands from the managers of these business units for dedicated, on-site actuaries to work as part of their management teams.

Why the increased demand? What role is to be played?

The first area concerns the critical importance to specialty organizations of relevant, meaningful, actionable data. The historic role and skills of the actuary in defining data needs serves us well in this regard. Typically, in a large company, our data has been organized from an accounting perspective, primarily for the annual statement and other financial reporting. This data, however, is generally insufficient for managing a specialty underwriting operation. Why? Concentration in a discrete area allows one to identify and pick up data elements particularly meaningful to that class, such as a true measure of exposure and information on the demographic profile of purchasers, detailed price monitors and changes in production sources. Further, data on limits distributions, attachment points, quote ratios, hit ratios, and retention ratios, for example, are essential and can be readily accumulated. These are elements which frequently can provide considerable insight into the pricing and performance of a focused book of business. Concentration also allows one to more effectively draw data from Industrial Accident Commissions, OSHA, Motor Vehicle Departments, and HLDI, all of which can provide valuable information when approached with actuarial insight and applied to the fairly discrete market segment addressed by a specialty business unit.

Peter Drucker, in his recent book The New Realities, writes about the information-based organization and how it will evolve in the coming years. He defines information this way: data endowed with relevance and purpose. In order to obtain this information, he says the information-based organization will require far more specialists than do the organizations we are accustomed to now. Moreover, the specialists Drucker envisions work in operations rather than in staff jobs at corporate headquarters. It's the interaction with management that provides specialists with the insights to create information.

This leads to a second trend, one of a demand for on-site, dedicated actuaries working with the specialty business units as part of the management team. Such an assignment provides close, day-to-day communication with underwriting, marketing and claims. And, with the profit center manager directly footing the bill, this relationship almost always leads to an increase in the relevance of your activities to the business units' problems and opportunities. Actuarial skills are particularly necessary in these assignments. More broadly based manual rates are frequently less important in these units since they typically target a subset of a broader class. For example, on workers compensation coverage for contractors in the five counties surrounding Cook County in Illinois.

We actually have a company focused like that - Casualty Insurance - which is one of the largest workers' compensation carriers in Illinois. However, it concentrates its writings in five counties, with a further concentration in a few classifications. In such an organization, we have much more reliance on the experience of their book and their individual accounts. Actuaries are intimately involved with their rates, as well as their independent rating plans, insuring that credibility measures, risk loadings, insurance charges, premiums for loss limitations, and assigned risk surcharges are factored in appropriately for the different categories of business.

In our business unit which focuses on large, Fortune 500 type national accounts, actuaries are deeply involved in crafting rating plans for individual accounts, and also in determining appropriate reserves or accruals for retrospectively rated policy premiums, dividends, payroll audits, profit sharing and other GAAP items required to properly state and, understand our results.

Other actuaries work on a day-to-day basis in departments writing railroads, for example, in our surplus lines operation, or medical malpractice in our health care unit.

A third area of increased involvement for the actuary is in planning. Actuaries can help make this usually frustrating annual exercise a valuable opportunity to review and refine business plans. This too works best in the more narrowly focused operations where, with on-site support and more meaningful data, comprehensive models can be developed. For example, changes in the pricing and composition of the book can be more readily ascertained, and assumptions made on the impact of new underwriting programs or actions to refine production sources. The more detailed, yet homogenous data available within a specialty unit creates an opportunity for the actuary to provide invaluable guidance.

The involvement in planning also circles back to the management information system design, which must contemplate monitoring the key assumptions and actions critical to achieving the plan.

A fourth area tailor-made for actuarial involvement is evaluating the performance of these business units and setting an appropriate risk loading in the rate-making formulas. Frequently, the products of a specialty unit include a number of lines of business - such as general liability, automobile and workers compensation. This makes it difficult to apply traditional guidelines for a line of business to the aggregate results of the unit. At Continental, we've found that an actuarial total rate of return approach works best. This method reflects the prospective variability of underwriting results, the uncertainty in loss reserves, and anticipated investment earnings ... three pieces of data critical to the optimal allocation of capital and to deriving a required risk loading. This approach, when integrated in the planning process, allows management to evaluate alternative growth strategies and set pricing and underwriting goals.

From a broader perspective, beyond specialties, I believe the next decade will bring an increased emphasis on back-to basics rate making in the actuarial profession. The 620 of you registered for this seminar, representing a 65% increase over last year, certainly underscore this trend. The eighties seem to have been the decade of the loss reserve specialist, as the rash of company insolvencies and unprecedented development of liability reserves from the seventies brought that side of our profession squarely into the limelight. However, the pendulum is now swinging back.

Earlier this week, I had the opportunity to meet with the chief property/casualty actuary for the insurance department of one of our larger states. The subject was the need for actuarial certification of loss reserves in the convention statements. Somewhat surprisingly, he suggested that from his perspective, an actuarial opinion, or certification, in a rate filing was more important - for company solvency - than were reserve certifications. It's perfectly obvious, of course, that inadequate rates - coupled perhaps with poor underwriting - can and will put a company in the tank. Reserve certifications come in after the fact. And, as additional companies establish specialty operations - especially in the more exotic, long-tailed lines - adequate pricing and a realistic, current evaluation of results will continue to take on increased importance.

To briefly summarize, in the 1990's we will see a real emergence of specialization as a key operating strategy of many of our most successful companies.

And, actuaries will have a critical role to play in the successful execution of these strategies. The nature of the demands on many of you will change. The fundamental operating characteristics of speciality business units provide the opportunity for us to develop and use much more sophisticated actuarial data bases and analyses to greatly enhance the more intuitive underwriting and pricing processes.

Successful execution of these strategies - whether the formation of independent, specialty companies or the establishment of narrowly focused, entrepreneurial business units in larger companies - will moderate our historic underwriting cycle and enable us - the insurance industry - to provide more stable pricing, coverage and capacity to our customers. In turn, these results will lead to increased shareholder values and a much needed boost to our industry's public image.

Thank you for inviting me to speak to you.