

PROCEEDINGS

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LESSONS FROM ADVERSITY

PRESIDENTIAL ADDRESS BY NORTON E. MASTERSON

In 1956 the national economy attained new statistical heights in gross national product, personal income, and expenditures. It was a year of great prosperity, full employment, and new high levels in production. Most U. S. industries and commercial enterprises prospered. However, the 1956 records attained by the fire and casualty insurance business were far from satisfactory. Thus, this must be a most unusual presidential address or report, since our Society embraces a segment of our national economy which had one of its worst years in history.

Four unusual losses occurred in 1956, coming with a suddenness to serve as dramatic headlines in a most unusual insurance year. The crash of two airliners over the Grand Canyon, the sinking of the liner Andrea Doria in collision with the steamer Stockholm, the Brooklyn waterfront fire, and the West Coast forest fires were startling events in widely diverse branches of the insurance business. These spectacular catastrophes got the headlines, but it was a steady increase in costs of the general run of claims which plagued most insurance lines.

Historically, cyclical trends have always characterized the fire and casualty insurance business, with periods of unsatisfactory operating results being followed by favorable results due to corrective actions, such as tighter underwriting, better rating practices, adequate rates, and a return to a level of actuarial balance.

One adverse situation was the lack of financial benefit from multiple line operation. Usually, some of the major underwriting classes are profitable and some unprofitable in any given year, but 1956 was completely abnormal as to financial balance by multiple line operation. All classes of business, with few exceptions, were in rising loss cycles during 1956. The fact that adverse underwriting results were not limited to one class of business, one type of company, or one section of the country suggests causal factors of a broad over-all nature.

In multiple line operation there is the temptation to average and standardize underwriting and financial management of the two classes—fire and casualty—to the extent that each loses significant differentiating characteristics.

The business has operated for almost ten years since the expiration of the moratorium period on January 1, 1948 following the SEUA decision of 1944. During that same period we have seen the growth of multiple line underwriting, with a consequent vigorous competition and a growing necessity for fire insurance companies to write casualty lines, and vice versa.

Our Society has the range and scope, both by its constitution and by-laws, and by its diversity of membership to ferret out and appraise those factors which affect all lines of insurance. It becomes a challenge to casualty and fire actuaries to analyze any and all common causes of underwriting losses and separate them from independent causes peculiar to a single line of business.

While the casualty and fire companies felt the full impact of adverse results in 1956, a review of past experience indicates that the trend toward higher losses began in 1955. Taking a broad view of the casualty and fire business, the adverse experience resulted from inadequate rates, insufficient insurance to value, intense competition, broadened coverage without corresponding rate increases, a general wave of carelessness, plus a general inflation in claim cost due both to the decreased purchasing power of the dollar and increased claim consciousness on the part of the public and claimants.

Adverse experience resulting from inadequate rates characterized most of the casualty and fire lines. Being based on past experience, rates do not adequately reflect the effects of today's increased frequency and claim costs. Inflation, increased frequency, increased severity of claims, and higher jury awards have produced an inadequacy of serious proportions in rates for auto bodily injury coverage on private passenger automobiles. Automobile comprehensive coverage also suffered excessive loss ratios because of very high new car and repair costs due to design and construction, particularly new body styles and windshields. Decreased rates on some classes, plus a tendency of amounts of insurance to lag behind higher replacement costs, have plagued fire and allied lines.

A significant contribution to rate inadequacy was a factor not revealed by past statistics. It was an accumulated effect of broadening of coverage, more liberal interpretation of coverage, and changes in laws which, in the aggregate, increased the company liability without corresponding rate adjustment.

We have seen the rapid introduction of so-called package policies—those clever merchandising creations, some of which confound both actuarial laws and geometry, with the result that the "whole becomes less than the sum of its parts!" It is most fortunate that our Society embraces both casualty and fire insurance as only an actuary could "divide the indivisible" premium in this new branch of cut-rate geometry!

Aside from actuarial considerations and financial problems, the most serious national problem confronting our business was the loss of life and property resulting from the operation of a growing number of automobiles on crowded highways. Over 40,000 people were killed in automobile accidents in 1956—more than we lost in three years of the Korean War.

Some serious financial problems are developing in group insurance, other than life, because the very existence of insurance has tended to promote a greater number of claims, and increased medical and hospital costs, with a continuing lag between premiums and sky-rocketing losses.

Generally speaking, competition is a desirable economic tool for commodities, but leaves much to be desired as a regulator of insurance rates. Price competition in the insurance transaction is not the same as that of the market place. This current cycle of rate inadequacy re-emphasizes the characteristics of insurance prices mentioned in my presidential address a year ago. We deal in future contracts, determining our prices prior to performance; while in most other businesses, the product is delivered prior to payment. As between the company and policyholder or claimant, future financial solvency is more important than current net price because the contract has yet to run at time of sale.

Obviously, the 1956 picture was discouraging for our classes of business. Rate increases will give some relief in 1957, but only to the extent that such increased rates are earned and to the extent that they keep pace with adverse developments on pending cases and any increased claim costs that we shall incur in 1957.

There are several lessons to be learned from the adverse results in 1956. Of interest to us are those which relate to the actuarial function and those which can be used by actuaries to urge a return to fundamentals in the future operation of casualty and fire insurance companies.

We have learned that multiple line underwriting is not an automatic financial device for averaging insurance results. We must be alert to the fact that the inter-relationships among separate lines of insurance may be greater and more far-reaching than variations and cyclical trends in individual line loss ratios. In other words, multiple line underwriting may intensify financial problems during certain years or cycles rather than serve as a balancing or hedging mechanism. Inflation causes similar adverse results which cut across definitions separating major types of casualty and fire business. Inflation causes increases in prices, goods, services, and labor required to replace all types of insured property covered by insurance. At the same time, inflationary factors increase the insurance company costs for the various kinds of insurance covering injuries or death to persons, by reason of higher costs for medical care, loss of time, and rehabilitation.

We have seen inflation in actual operation in the casualty and fire insurance business. It is much more pleasant to listen to lectures on

and to study about inflation in the college classroom than it is to experience it. It all seems so logical and matter-of-fact as an academic subject in economics. It usually works out in the same textbook manner in the long run, but it is hard for a nation of millions of individuals to realize what is taking place in the short run. I would suggest that one of our bright young Fellows, well trained as an economist, but who now has to make his living as an actuary, delve into this subject and produce a significant paper for the Society.

Inflation strikes the casualty and fire insurance in ways not typical of price inflation in the usual economic sense relating to goods and services. In most casualty and fire lines, rates are regulated and fixed for annual and longer policy terms, making them relatively rigid and not possible of change on short notice. Even when rates or insurance prices run the gamut of delayed statistics and approvals, such increases on annual policies are not fully earned for two years. Such is the effect on the premium income but the hazard of inflation on the outgo for losses and expenses is also serious. Delays in settlements and prolonged medical care and rehabilitation intensify the effect of inflation after the insured event occurs. In a manufacturing business, there is a constant spiraling interplay between wages and other costs of production, and prices to the buyer, but such inflationary effect does not extend beyond the time of contract or sale. In fact, an inventory of unsold finished products can be protected by up-pricing. However, an "inventory" of unsettled claims remains exposed to the ravages of spiraling costs for several years.

Thus, we need actuarial factors not only to bridge the gap between the indications of our statistics of the past and the present, but also between the present and the future policy period and through the extended settlement period.

If we look back over the period just prior to the problem year of 1956, there is evidence to support the well-known but usually forgotten underwriting theory that we sow the seed for our bad loss ratio years in prosperous years. Favorable underwriting results lead to unsound competitive practices and loose underwriting; and most important of all, a complacency sets in which blinds us from observing and doing something about indications of adverse trends which are bound to grow but which are overshadowed by current rosy financial results.

We have learned the lesson of keeping underwriting independent of investment operations. Unusually favorable accounting results, in the form of unrealized capital gains, should not influence considerations of corrective changes in underwriting operations.

There must be constant expense control within the expense provision of rates. Any tendency to ascend to higher expense levels during a temporary period of low loss ratios serves only to intensify the financial problems when we have high loss ratios.

While some unfavorable factors are still crowding us in 1957, we should ponder well these lessons of adversity and chart a course of actuarially sound rates and rating plans, intelligent responsive reg-

ulation of rates, sound competitive practices, and a constant awareness of future financial hazards where the ultimate course of current results is still subject to future changes.

As individual members of this Society, we can play limited roles only, in solving these problems. We can give advice and counsel in our own companies, bureaus, or insurance departments. But because of the nature of the casualty and fire insurance business in the United States, many of these problems must be solved by joint cooperation and action in bureau jurisdictions and in state insurance departments.

This is a non-partisan professional Society composed of executives and actuaries of insurance companies, rating bureaus, state insurance departments, and consulting actuarial firms. We do not have official powers as an organization but we should carry out the object of this Society, which is the promotion of actuarial and statistical science as applied to the problems of casualty, fire and social insurance. We can establish a favorable *climate* for positive action and solution of some of our problems through official channels.