

THE UNDERWRITING CYCLE

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BY DAVID SKURNICK

CAS UNDERWRITING CYCLE SEMINAR
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IN 1985, PAUL INGREY, PRESIDENT OF F&G RE DESIGNED AN INSURANCE CLOCK, TO MEASURE THE UNDERWRITING CYCLE. IT DESCRIBES THE CYCLE IN TERMS OF PRICING, PROFITS, REINSURANCE, MGA'S, CASH FLOW, ETC. THE TONE IS LIGHT, BUT IT IS A SERIOUS AND USEFUL DESCRIPTION OF A TYPICAL CYCLE. YOU CAN READ THE CHART AT YOUR LEISURE. IN SUMMARY,

1:00 - PRICING STARTS TO DROP
2:00 - COMPANIES COMPETE TO INCREASE MARKET SHARE
3:00 - PRICES FALL DRAMATICALLY
4:00 - PROFITS SLIDE
5:00 - RESULTS HORRIBLE
6:00 - PRICING CANNOT GO LOWER
7:00 - A. M. BEST WRITES THIS DECADE'S "LETTER OF CONCERN"
8:00 - CRUNCH
9:00 - PRICES UP SHARPLY
10:00 - CAPACITY BECOMES EXPENSIVE
11:00 - ALL COMPANIES FLOURISH
12:00 - EUPHORIA!
1:00 - PRICING STARTS TO DROP
ETC.

HOW DOES THIS CHART FIT THE LAST 8 YEARS? I'D SAY, "VERY WELL."

IN THE NEXT FEW MINUTES I WILL DISCUSS THE FOLLOWING QUESTIONS:

1. WHAT FACTORS CREATE UNDERWRITING CYCLES?
2. WHAT DO THESE FACTORS TELL US ABOUT THE TURN IN THE CYCLE?
3. WHAT DOES THE INSURANCE CLOCK SAY ABOUT A TURN IN THE CYCLE?
4. WHEN WILL THE CYCLE TURN?

WHAT FACTORS CREATE UNDERWRITING CYCLES?

1. DIFFICULTY OF BUILDING A BOOK OF BUSINESS - DISCOURAGES PROMPT ACTION, WHEN RATES GO DOWN. A COMPANY WANTS TO KEEP ITS STAFF, ITS PRODUCTS, ITS MARKETS, AND ITS AGENCY PLANT.

2. RISE AND FALL OF SUPPLY AND DEMAND - SUPPLY IS MEASURED BY INDUSTRY SURPLUS AND DEMAND BY PREMIUM. PERSONAL LINES DEMAND IS EXTREMELY STABLE. COMMERCIAL LINES DEMAND IS MORE STABLE THAN IN MANY OTHERS INDUSTRIES, BUT IT IS AFFECTED BY THE OVERALL ECONOMY AND BY THE USE OF ALTERNATIVE MARKETS. IT IS INTERESTING THAT AT THE POINT IN THE CYCLE WHEN PRICES START TO RISE, THE DEMAND (AS MEASURED BY THE PREMIUM TO SURPLUS RATIO) APPARENTLY INCREASES, WHICH TENDS TO PROVOKE MORE INCREASES.

3. PROFIT AND LOSS - CORPORATIONS ARE DRIVEN BY REPORTED OPERATING PROFIT AND RETURN ON EQUITY. BOTH MUTUALS AND STOCK INSURANCE COMPANIES MUST BE CONCERNED WITH SURPLUS. PROFIT DIRECTLY ADDS TO SURPLUS. ALSO, A PROFITABLE COMPANY WILL HAVE ACCESS TO THE CAPITAL MARKETS. PROFIT ALSO INFLUENCES MANAGEMENT PSYCHOLOGY.

4. CASH FLOW - ULTIMATELY, IF NOTHING ELSE TURNS THE CYCLE, CASH FLOW WILL. IF COMPANIES RUN OUT OF MONEY, THEY MUST RAISE PRICES.

5. RESERVE ADJUSTMENTS - IN THE LAST CYCLE, MANY COMPANIES STARTED USING "EARNED BUT UNBILLED PREMIUM" TO INCREASE EARNED PREMIUM. LOSS RESERVES CAN BE ADJUSTED BY MEANS OF FINANCIAL REINSURANCE CONTRACTS OR BY MORE OPTIMISTIC CLAIMS RESERVING AND IBNR RESERVING.

MANY BUSINESSES SWITCH TO MORE FAVORABLE ACCOUNTING TREATMENTS DURING A DOWNTURN, BUT INSURANCE HAS GREATER SCOPE FOR CONTROLLING RESULTS, DUE TO THE RESERVES. THE PRACTICE OF UNDER-RESERVING DURING BAD YEARS AND STRENGTHENING RESERVES DURING GOOD YEARS SERVES TO MODERATE THE CYCLES AND THEREFORE TO EXTEND THEM.

6. REINSURANCE AVAILABILITY AND COST - PRICES AND TERMS SWING MORE FOR REINSURANCE COMPANIES THAN FOR PRIMARY COMPANIES. IT IS BELIEVED THAT THE REINSURANCE CYCLE CAN DRIVE THE PRIMARY CYCLE.

7. FINANCIAL REINSURANCE FOR CATASTROPHES - SERVES TO EXPAND CAPACITY. HOWEVER, THE FINANCIAL ACCOUNTING STANDARD BOARD HAS PROPOSED FAS 113, WHICH COULD CHANGE THE RULES ON THIS PRODUCT, THEREBY REDUCING CAPACITY.

8. INTEREST RATE CHANGES - HIGH INTEREST RATES ENCOURAGE PRICE CUTTING, BECAUSE INVESTMENT INCOME IS HIGHER.

9. UNRECOGNIZED GAIN OR LOSS IN THE BOND PORTFOLIO - IN 1917, THE NAIC DECLARED THAT BONDS SHOULD BE VALUED AT

AMORTIZED OR BOOK VALUE, RATHER THAN MARKET. AS A RESULT, WHEN INTEREST RATES DROP THERE IS AN UNRECOGNIZED GAIN IN THE BOND PORTFOLIO. SIMILARLY, THERE IS AN RECOGNIZED LOSS WHEN INTEREST RATES RISE. (HOWEVER, FASB JUST ANNOUNCED A REVISION IN THIS PROCEDURE. CERTAIN BONDS WILL BE HELD AT MARKET.)

IN THE EARLY 80'S INTEREST RATES BECAME HIGH AND BONDS WERE UNDER WATER. INSURANCE COMPANIES COMPETED WILDLY FOR CASH FLOW, NOT ONLY FOR THE HIGH YIELDS, BUT ALSO TO AVOID HAVING TO SELL THE BONDS AND REALIZE A LOSS OF SURPLUS AND A DROP IN EARNINGS.

10. NAIVE CAPITAL - DEFINED, AFTER THE FACT, AS ANYONE WHO INVESTED DURING THE DOWN CYCLE, LOST MONEY THEN WITHDREW WHEN PRICES WENT UP. THESE COMPANIES INCREASE SUPPLY, PROLONGING THE DOWN CYCLE.

11. MANAGEMENT BY HIRED HANDS, NOT OWNERS - A COMPANY PRESIDENT WHO DOESN'T OWN MUCH STOCK MAY HAVE LESS LOYALTY TO THE BOTTOM LINE THAN TO THE CONTINUED EMPLOYMENT OF HIS FELLOW EMPLOYEES AND HIMSELF.

12. CALENDAR YEAR RESULTS VS POLICY YEAR ACTIONS - ALTHOUGH MANY ORDINARY DECISIONS MAY BE BASED ON ACCIDENT YEAR OR POLICY YEAR PROJECTIONS, THE REALLY BIG DECISIONS, THE ONES MADE AT THE HIGHEST LEVEL, ARE MORE LIKELY TO BE BASED ON CALENDAR YEAR RESULTS, RESULTING IN A DELAYED RESPONSE. THIS DELAY PLUS THE OTHER DELAYS MENTIONED EARLIER HELP CREATE THE CYCLE. FOR EXAMPLE, HERE'S HOW A HYPOTHETICAL 11 YEAR CYCLE COULD OCCUR.

ASSUME THAT PREMIUM RATES BECOME TOO LOW IN YEAR 1. THEN, BAD LOSS RATIOS SHOULD BE REPORTED IN CALENDAR YEAR 2. WITH OPTIMISTIC RESERVING, ACCOUNTING CHANGES, FINANCIAL REINSURANCE, AND BY SWAPPING BONDS, THE REPORTED BAD RESULTS MIGHT BE POSTPONED UNTIL YEAR 5. DURING YEARS 2 THROUGH 5, RATE ADEQUACY CONTINUES TO FALL. IN YEARS 5, 6 AND 7 MANAGEMENT TAKES MODERATE REMEDIAL STEPS, WHICH DON'T WORK. FINALLY, IN YEAR 8, THE TOP MANAGEMENT ORDERS DRAMATIC RATE INCREASES, NO MATTER WHAT THE EFFECT ON VOLUME. RATES BEGIN TO IMPROVE DURING YEAR 8 AND BECOME REDUNDANT BY YEAR 9. RESERVE STRENGTHENING KEEPS CALENDAR YEAR RESULTS BAD UNTIL YEAR 9 OR 10.

MEANWHILE, OPERATING MANAGEMENT UNDERSTANDS POLICY YEAR RATE ADEQUACY, SO THEY BEGIN REDUCING RATES SOME TIME IN YEAR 9. AS REPORTED RESULTS IMPROVE, RATES CONTINUE TO FALL. BY YEAR 12, THE RATES HAVE REACHED A LEVEL OF INADEQUACY COMPARABLE TO YEAR 1.

13. RATE REGULATION - CAN REGULATORS HELP TO SMOOTH THE CYCLE? MAYBE. EVEN WHEN REGULATION IS POLITICALLY

MOTIVATED, IT ADDS INERTIA. PERSONAL LINES REGULATION IS BURDENSOME ENOUGH TO ADD INERTIA. AN INSURANCE COMPANY WOULD BE FOOLISH TO CUT PERSONAL LINES PRICES, BECAUSE THE REGULATORS MIGHT NOT LET THEM RAISE THE PRICES. DURING THE LAST TEN YEARS, PERSONAL LINES PRICES HAVE BEEN FAR MORE STABLE THAN COMMERCIAL LINES PRICES.

14. CATASTROPHES - HURRICANE BETSY TURNED THE UNDERWRITING CYCLE IN THE MID-60'S. SOME OBSERVERS BELIEVE THAT ANDREW WILL DO THE SAME TODAY.

15. CHANGES IN LOSS TRENDS AND LOSS DEVELOPMENT - SOMETIMES LOSS PATTERNS REALLY DO CHANGE. WE SAW MEDICAL MALPRACTICE WITH EXTREME TRENDS FROM PERHAPS 1965 TO 1985. SINCE THEN, TRENDS HAVE MODERATED. TODAY, GL SEEMS TO HAVE MODERATED AND WC IS A BEAR.

16. PSYCHOLOGY - THERE IS A WONDERFUL OLD BOOK, WRITTEN IN 1841, CALLED EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS. THIS BOOK VIVIDLY DESCRIBES VARIOUS PERIODS OF ECONOMIC "MADNESS", SUCH AS THE TULIPOMANIA IN HOLLAND IN 1636, WHEN A SINGLE TULIP BULB COULD BE BOUGHT OR SOLD FOR A LIFETIME'S EARNINGS.

INSURANCE MANagements ARE HUMAN BEINGS. WE DON'T ALWAYS MAKE RATIONAL DECISIONS. WE'RE UNDULY INFLUENCED BY RECENT EVENTS, EVEN WHEN WE'RE MAKING PLANS BASED ON THE LONG-TERM ODDS.

I WENT THROUGH A DOWN CYCLE AS HEAD OF UNDERWRITING AT ARGONAUT INSURANCE COMPANY DURING THE EARLY 80'S. WHEN THE COMPETITORS CUT THEIR LIABILITY AND COMMERCIAL PACKAGE PRICES 25%, WE DID THE SAME. WE THOUGHT WE HAD GOOD REASONS, BASED ON THE STRONG INVESTMENT INCOME AND STRONG SURPLUS OF THE COMPANY AND THE DESIRE TO MAINTAIN MARKET SHARE.

OF COURSE, OUR THINKING WAS INCOMPLETE. OUR BIGGEST MISTAKE MAY HAVE BEEN FAILING TO REALIZE THAT THE HOLDING COMPANY WOULD DEMAND DRAMATIC ACTION.

SOME COMPANIES DIDN'T MONITOR RATES AND USE ACTUARIAL INPUT. WHAT'S SIGNIFICANT IS THAT WE PERSISTED IN SELLING EVEN THOUGH WE MONITORED RATES AND PRICES AND WE KNEW WE'D LOSE MONEY.

ANOTHER HUMAN TRAIT IS A TENDENCY TO FOLLOW THE CROWD. I'LL NEVER FORGET IN 1971 REPORTING TO THE PRESIDENT OF INA THAT IBNR WAS DEFICIENT BY \$140 MILLION. HE PAID CAREFUL ATTENTION TO MY PRESENTATION, WITH ITS MANY WORKSHEETS, EXHIBITS AND CHARTS. FINALLY, HE SAID TO ME, "WHAT'S TRAVELERS DOING?"

MOST OF YOU ARE OLD ENOUGH TO HAVE GONE THROUGH THE LAST 10 YEARS. REMEMBER THE PAIN OF THE EARLY 80'S? THEN WE HAD THE CRUNCH IN 1984, THE RATE INCREASES IN 1985 AND '86 AND GREAT RESULTS STARTING IN 1986. IT RAINED MONEY. THE QUESTION ON EVERYONE'S LIPS IS, "HOW LONG DO WE HAVE TO WAIT FOR THE NEXT DRAMATIC CYCLE TURN? HERE ARE SOME FACTORS THAT POINT TO A TURN IN THE CYCLE:

1. ACCORDING TO MANY OBSERVERS, HURRICANE ANDREW WILL TURN THE CYCLE. AS A RESULT OF THIS STORM, PROPERTY CATASTROPHE REINSURANCE IS SCARCE AND EXPENSIVE. PRIMARY CAPACITY IS SHARPLY REDUCED IN COASTAL AREAS.

2. COMPANIES' BOND PORTFOLIOS HAD SHARP GAINS DUE TO INTEREST RATE DROPS OVER THE PAST TWO YEARS, BUT MUCH OF THIS GAIN IS GONE. MANY COMPANIES REALIZED THE GAIN IN ORDER TO OFFSET LOSSES FROM HURRICANE ANDREW. INCIDENTALLY, IF INTEREST RATES WERE TO RISE, OUR BONDS WOULD BE UNDER WATER, AND WE MIGHT SEE THE KIND OF PANICKED COMPETITION THAT TYPIFIED 1982-84.

3. THE INDUSTRY IS UNDER-RESERVED. ACCORDING TO ISO, AT YEAR END 1991, THE UNDISCOUNTED LOSS RESERVE WAS UNDERSTATED BY \$38 TO \$50 BILLION.

4. THE INTRODUCTION OF RISK BASED CAPITAL, PERHAPS AS OF YEAR-END 1994, IS INTENDED TO BE A MORE ACCURATE MEASUREMENT OF CAPACITY AND ALSO MORE CONSERVATIVE. EVEN THE EXPECTATION OF RISK BASED CAPITAL MAY BE MODERATING GROWTH PLANS RIGHT NOW.

5. ASBESTOS AND POLLUTION ARE MAJOR WORRIES. ACCORDING TO A STUDY BY TILLINGHAST, GIVEN THE CURRENT SUPER-FUND LAW, THE COST TO INSURANCE COMPANIES COULD EVENTUALLY AMOUNT TO HUNDREDS OF BILLIONS OF DOLLARS.

6. FASB 113 WILL REDUCE THE ABILITY TO USE FINANCIAL REINSURANCE TO CREATE SURPLUS AND TO PROVIDE CAT REINSURANCE.

ON THE OTHER HAND, HERE IS A LIST OF FACTORS OPPOSING A TURN IN THE CYCLE:

1. THE INDUSTRY SURPLUS IS AT A RECORD HIGH OF \$164 BILLION. WITH PREMIUM VOLUME AT \$230 BILLION, THE PREMIUM TO SURPLUS RATIO IS AT A ROCK SOLID 1.4 TO 1.

2. ALTERNATIVE MARKETS ARE GROWING BY LEAPS AND BOUNDS. IN WORKERS COMP, PERHAPS 1/3 OF THE BUSINESS IS NOT IN THE INSURANCE MARKET. THE HUGE ASSIGNED RISK CHARGES ARE PUSHING CUSTOMERS INTO USING DEDUCTIBLES, CAPTIVES, AND SELF-INSURANCE. TO SOME EXTENT, OTHER COMMERCIAL COVERAGES MOVE WITH THE COMP. THIS IS A

REDUCTION IN DEMAND, OR, LOOKED AT ANOTHER WAY, AN INCREASE IN SUPPLY, AS THE CUSTOMERS BECOME INSURERS.

3. FINANCIAL REINSURANCE SERVES TO INCREASE CAPITAL AND PROVIDE CAT REINSURANCE. IT IS NOT CLEAR WHAT CAN BE DONE AFTER FASB 113 IN EFFECT.

4. TODAY RESERVES ARE A HIGHER PER CENT OF PREMIUM THAN ANY PAST CYCLE; THERE IS PLENTY OF ROOM FOR MORE UNDER-RESERVING.

5. LIABILITY LOSSES ARE DEVELOPING FAVORABLY, ON BOTH AN INCURRED AND A PAID BASIS. THIS HAS PRODUCED GOOD CALENDAR YEAR RESULTS AND IMPROVED OPTIMISM.

6. CAPITAL IS COMING IN TO THE INDUSTRY. SEVERAL COMPANIES ARE BEING ESTABLISHED TO DO PROPERTY CAT, WITH CAPITAL IN THE HUNDREDS OF MILLIONS. IT'S AMAZING HOW MUCH CAPITAL IS AVAILABLE. INSURANCE STOCK PRICES ARE HIGH, FACILITATING SALES OF EQUITY. A NUMBER OF NEW COMPANIES HAVE BEEN GROWING VERY RAPIDLY IN CASUALTY BUSINESS. TIME WILL TELL IF THEY WERE WISE OR NAIVE. IN ANY EVENT, THE EFFECT IS THAT COMPETITION HAS INCREASED AND RATES HAVE BEEN HELD DOWN.

7. FINALLY, MOST IMPORTANT, PSYCHOLOGY - I JUST DON'T SEE PANIC OR DESPAIR. THE INDUSTRY SEEMS TO HAVE ABSORBED ANDREW. EXECUTIVES SAY, "I KNOW THINGS ARE TOUGH, BUT WE HAVE AN APPROACH THAT'S WORKING." ONE EXECUTIVE TOLD ME THAT PRICING ISN'T WHAT IT SHOULD BE, BUT HIS COMPANY INTENDS TO GROW THIS YEAR TO IMPRESS THE SECURITIES ANALYSTS." IN THE LAST CYCLE, THE INDUSTRY WAS ALREADY PANICKED IN 1982, BUT PRICES DIDN'T GO UP UNTIL 1985. THIS IS BAD NEWS, AS IT SUGGESTS THAT THE TURN COULD BE YEARS AWAY.

NOW LET'S SEE WHAT PAUL INGREY'S INSURANCE CLOCK TELLS US. WHAT TIME IS IT RIGHT NOW?

IT SEEMS TO BE SOMEWHERE BETWEEN 1:00 AND 7:00.

TODAY, UNDERWRITING "PENS" AND MGA'S ARE THRIVING, LIKE 1:00.

PROFITS HAVE LEVELED OFF, AND MOST COME FROM INVESTMENTS AND INVESTMENT INCOME. LIKE 3:00.

REDUCTIONS IN FORCE ARE OCCURRING, LIKE 4:00. (AT USF&G THE STAFF CUT IN THE LAST TWO YEARS WAS OVER 25%.)

COMPANIES ARE SELLING ADDITIONAL SHARES IN THE EQUITY MARKET, LIKE 7:00. (E.G. USF&G RAISED \$300 MILLION THROUGH A PREFERRED STOCK OFFERING A YEAR AGO. SEARS JUST

ANNOUNCED AN EFFORT TO RAISE OVER \$2 BILLION BY SELLING UP TO 20% OF ALLSTATE STOCK IN AN INITIAL PUBLIC OFFERING.)

IF EACH "HOUR" REPRESENTS 6 MONTHS TO A YEAR, THEN THE INSURANCE CLOCK WOULD PREDICT A SHARP PRICE INCREASE POSSIBLY AS EARLY AS 1994, OR AS LATE AS SEVERAL YEARS AWAY. ON AVERAGE, THE TURN DOES NOT APPEAR CLOSE.

MANY OBSERVERS PREDICT A MAJOR RISE IN PRICES BEGINNING IN LATE THIS YEAR. I WISH I COULD AGREE. HOWEVER, MOST OF THE FACTORS DISCUSSED EARLIER AND THE INSURANCE CLOCK ARE NOT ENCOURAGING. I PREDICT THAT THE CYCLE TURN IS 2 YEARS AWAY.

(OF COURSE, THIS PREDICTION MAY BE ONLY WORTH WHAT THE CAS PAID ME FOR PRESENTING IT.)

THANK YOU FOR YOUR ATTENTION.