A Macroeconomic View of the Insurance Marketplace

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This paper will illustrate how the insurance marketplace is characterized by relatively fixed demand and has many of the aspects of a commodity market. It will also discuss how this leads to the pricing cycles that are characteristic of commodity markets.

There is Relatively Fixed Demand for Insurance

There is relatively fixed demand for insurance because so many people buy it out of a need that (nearly) absolutely must be met. They buy it because it is required by law, as is the case in personal automobile insurance, workers compensation, and commercial auto. They may buy it because they are required to by a lender. For example, homeowners insurance, personal automobile physical damage, and commercial property are all coverages that lenders require borrowers to purchase. Some coverages for businesses, such as general liability, are not required by law or any third parties, but not buying them could result in a drain on a company's financial resources and concomitant shareholder lawsuits if claims occur. So there is a certain amount of insurance that will be bought whatever the price is. That creates a demand curve that is relatively flat with respect to price. Thus, supply, in the form of the statutory surplus of insurance companies, effectively determines the price of insurance.

The Commodity Nature of the Insurance Marketplace

Insurance may be viewed as a commodity because, in many respects, all insurance companies selling a particular line of insurance are selling the same thing. Regulation has mandated that, in many lines such as workers compensation, the coverage forms that are purchased are identical from company to company. Even in lines that are less strictly regulated, such as commercial property and general liability, there is often a propensity to use standardized bureau forms. That can lead customers to believe that all insurance companies' products are identical.

De-commoditizing Insurance Products

In a commodity market, individual sellers have no control over price. Since having no control over price can depress profits, companies will seek to create 'brand names' for their products. In a sense, brand names are created when product suppliers succeed in creating special, beneficial attributes of their individual products that distinguish their product from those of other product suppliers. Examples of insurance product attributes that can create a brand name would be: the extent to which coverage will be extended by the claims department for marginal claims, the extent to which the insurer offers coverage extensions in the policy that other companies do not; the financial strength of the insurer; the insurer's flexibility in customizing insurance programs to meet individual customer's needs; the ability of the insurer to successfully fight third-party claims; the accessibility of the insurer's claims department, and the quality of the loss control offered by the insurer.

One result of branding is that the customer may view one insurer's products as more valuable than those of another insurer. This causes different insurers to have different demand curves. Those with higher demand curves are able to command a higher price.

It is important to note that different insurance companies have different supply curves overall. That is primarily because of underwriting selection. Claims (losses, in the actuarial lexicon), form the lion's share of the costs of supplying an insurance product. While one customer's future claims are relatively fixed, the claims associated with a portfolio of insurance policies can be reduced considerably by only selling to those customers that are expected to have few claims. Conversely, the costs of supplying an insurance product can be reduced considerably by refusing to sell to customers that are expected to have an above-average frequency or severity of claims. The costs can also be reduced by applying some form of loss control or a form of claims adjusting or claims management that reduces claims costs. This results in the paradoxical truth that selling to low claims cost insureds at a lower price (at least compared to the average price for all insureds) can lead to a greater proportion of sales to low claims cost insureds, and hence selective price reductions can lead to greater profitability. In fact, the ultimate result of that basic truth of insurance underwriting is the establishment of more and more refined risk classification systems.

Parenthetically, the other share of the costs of supplying insurance is the cost of company expenses, taxes, and commissions. Different insurers have different degrees of success at controlling expenses. Further, when all insurers use the same degree of underwriting classification and selection, and no branding is present (a very hypothetical case), control of expenses is the primary success factor for insurance suppliers. To the extent that insurance is a pure commodity, expense control is very important.

The Result of the Commodity Market is a Business Cycle

The result of the commodity-type nature of the insurance marketplace is a business cycle. The cycle begins when the vicissitudes of the market place result in low supply. The root cause of the low supply may be (and usually is) the result of the cycle itself resulting in insurers losing money. Insurers may then raise prices and a period of high profitability results. The high profitability of insurance as a product results then in many new firms entering the market. The large number of new firms creates 'excess capacity' in the marketplace and prices are consequentially depressed. The falling prices yield low profitability, so firms leave the market. After that, there is low supply, and the cycle starts again.

The cycle is exacerbated when underwriters (and hence the insurance firms employing the underwriters) are not aware of the true claims costs created by their insureds. Insurance claims for some lines of insurance are not paid until long after the policy is sold. If a company takes an overly optimistic view of the claims costs it is assuming when it sells policies, it will continue selling insurance when it is not making a profit. That exacerbates the period of excess supply of insurance (the 'soft market').

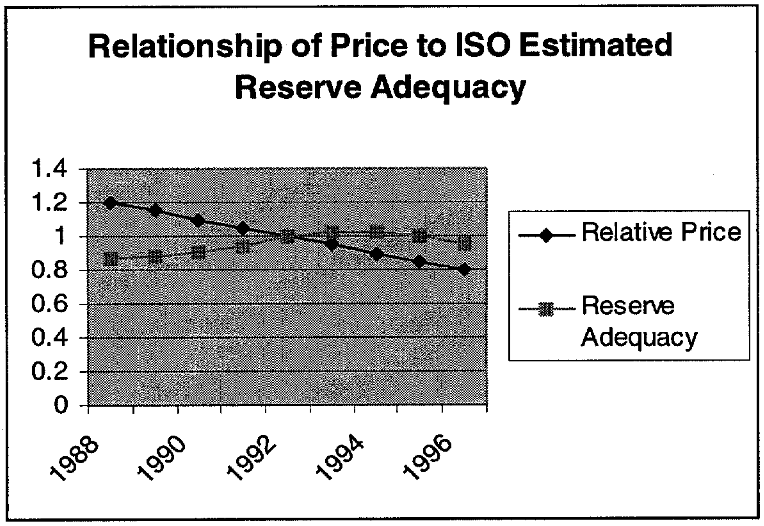
Insurance is Easy to Enter and Exit

The length of the cycle is shortened somewhat by the ease of entry and exit in the insurance business. Insurance does not involve many highly expensive manufacturing facilities as assets; rather the primary assets are highly liquid stocks, bonds, and real estate. Stocks and bonds may be sold immediately at the going market price. Real estate is buyable and sellable within a reasonable timeframe. Only data processing systems, furniture, and the intangible 'goodwill' are illiquid. Fortunately, data processing systems and furniture are only a small part of an insurance company's assets. Goodwill may be more substantial. The result is that it is relatively easy to start or shut down an insurance company.

There are non-financial considerations that could conceivably delay an insurer's exit from the insurance business. Regulators will either require a loss portfolio transfer with assumption of liabilities to transfer the loss and loss adjustment expense liabilities to another company with surplus, or else require the exiting company to maintain some level of capital and surplus until the liabilities are paid off. Also, some regulatory jurisdictions, especially unprofitable personal auto jurisdictions, may erect some form of regulatory hurdle in an attempt to maintain availability in conjunction with inadequate rates. Further, if an insurance company has based its brand on willingness to provide service to agents or policyholders, no matter whether it is profitable or not, there will be marketing implications for any related lines of business if an insurer only withdraws from some lines of business. So, there may be some delays or roadblocks to insurer exit, with the degree of delay being inversely related to an insurer's willingness to accept some consequences.

Reserve Management Extends the Cycle

Reserve management refers to the tendency of insurance companies is to overreserve (or increase understated reserves) during profitable periods, thus lowering reported profits. Conversely, when insurance is unprofitable, reserves will be stated less and less adequately. The graph below illustrates this. It compares the reserve adequacy (1.0 = exactly adequate) as estimated by the Insurance Services Office[1] to a declining price line over the period 1998-1996. Undoubtedly, prices did not decline in an absolutely linear fashion, but most actuaries would agree that prices consistently declined over that period, and that 1988 prices were higher than 1989's, and so forth.



As the graph shows, reserve adequacy increases (additions are made to reserves, beyond the current year's costs) when prices (and hence profits) are high, and reserves are progressively less adequate when prices are low.

Note that prices will only respond to deteriorating profits if company underwriters (who make account pricing decisions) and capital providers (who start and shut down companies) are aware of the true profitability of the insurance product. Reserve management has the effect of extending the cycle by causing profits to be reported when the business is no longer profitable. This acts to prolong periods of profit and loss, extending the cycle. The result is a very long cycle.

Bibliography

1) 'Loss and Loss Adjustment Expense Reserves at Year End 1996: Technical Analysis', Insurance Services Office, October 1997, p. 9