

Making the Insurance Market Work for You

“The Basics of Understanding Market Cycles in the P & C Insurance Industry”

Introduction Understanding how market cycles work is an important educational work tool for any underwriter today. Since 2002, when the market was at an all-time high, many new underwriters and brokers have entered the industry. They have done so never having experienced the hardening of the market. This paper intends to provide a deeper understanding of how the market cycles work. The information can be valuable for the newer entrants in the market, and can also serve as a refresher for veterans in the business.

John Chace, CPCU, MLIS
Senior Vice President and Chief Underwriting Officer
OneBeacon Professional Insurance

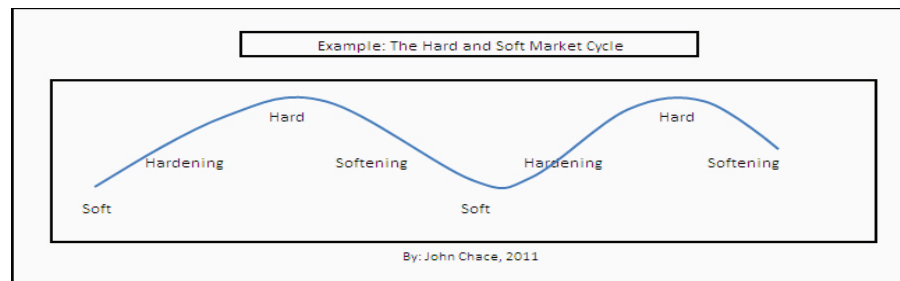
onebeaconpro.com/whatwedo

OneBeacon
PROFESSIONAL INSURANCE®

This paper will help the reader:

- Identify what stage of the cycle we find ourselves in today.
- Understand what drives the market cycles – both past and present.
- Explore various philosophies on how to underwrite profitable business throughout the market cycles.
- Understand the important Financial Ratios corporations use to monitor successful business strategies.

What is an Insurance Market Cycle? IRMI states: "Market cycles are market-wide fluctuations in the prevailing level of insurance and reinsurance premiums. A soft market, i.e., a period of increased competition, depressed premiums, and excess capacity, is followed by a hard market – a period of rising premiums and decreased capacity. Traditionally, each period has a causative effect on the other. For example, in a hard market, insurers' earnings are greater than during a soft market. Large earnings have the effect of increasing capacity. More capacity means more supply. When supply equals or exceeds demand, premiums go down, competition heats up, and earnings begin to shrink. Once earnings shrink to the point where the amount of capacity is reduced, the market hardens up, and the cycle starts all over again."⁽¹⁾

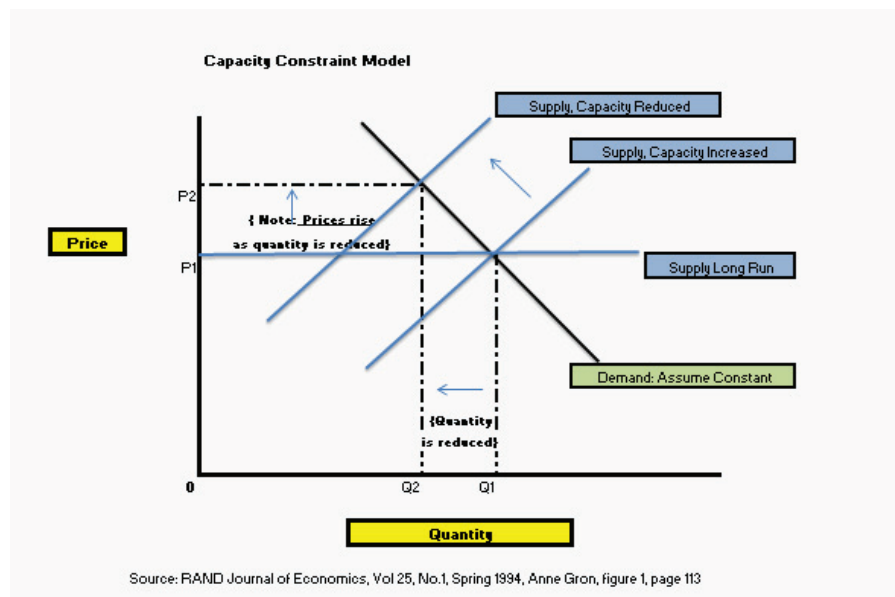


As you can see from the preceding chart, the insurance industry market cycle begins with a soft market. This is identifiable by a highly competitive environment with a significant amount of excess capacity. The next phase of the cycle is market hardening. Hardening occurs as companies have a need to collect additional premiums following unprofitable operating results. This generally leads to the hard market. In the hard market, insurance premiums will be at their peak for that time period. It is precisely at this stage that new market capacity is

attracted to the insurance market seeking high returns on their investment. As new competition rushes into the market to capitalize on the profitable results, the market will begin to enter a "softening" period. This "softening" is spurred on as current companies that have benefited from the good times now fight to keep their profitable business. The market then repeats itself.

What makes the market dynamics work? Supply and Demand

The availability and price of insurance is governed by the economic principles of supply and demand. As we see in the example below, when capacity is reduced (the supply of insurance), prices tend to rise. Consequently, the opposite is true when supply increases (new capacity enters the market) prices tend to drop as demand remains constant. We see this very dynamic in today's market as there are fewer insureds (from consolidation or closure) and many insurers willing to compete for the business.



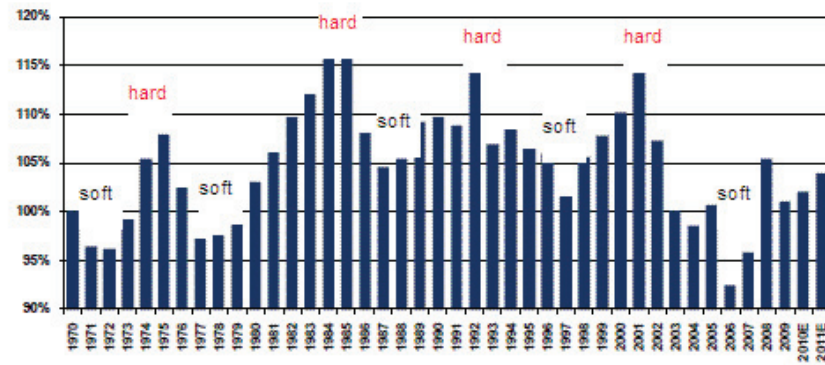
Historical Market Cycles: The Big Picture Is supply and demand a true industry dynamic? Has it always been this way, continually going up and down like a yo-yo? Looking at the past can help underwriters understand what can potentially take place in the future. In the following picture, derived from A.M. Best and KBW Insurance research⁽⁷⁾, we can see trends in the P & C industry over time.

Although the industry is not a perfect world (as the market is a dynamic phenomenon affected by both internal and external forces) we can get an idea of what has occurred and what may occur.

Let's look at an example (exhibit below)

Making the Insurance Market Work for You
 "The Basics of Understanding Market Cycles in the P & C Insurance Industry"

Exhibit 6: U.S. P&C Industry Historical Combined Ratio



Note: Includes only U.S.-based Insurers.
 Source: A.M. Best and KBW Insurance Research.

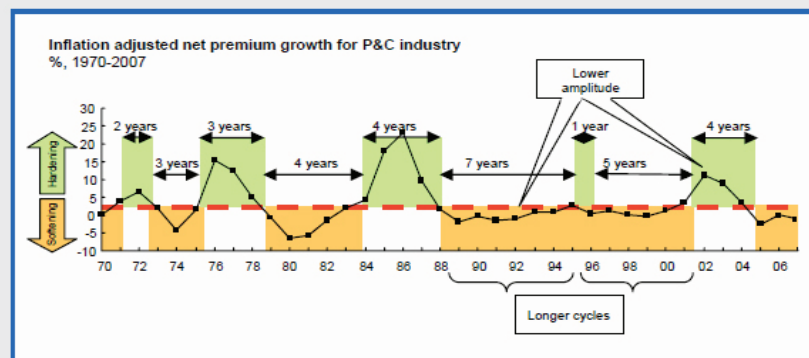
In reviewing the above graph, we note the following points:

1. Over the last 40 years, we can see four distinct hard markets.
2. Over the last 40 years, we can see five soft markets.

As a comparison, the McKinsey Study of 2008⁽⁵⁾, highlighted certain findings on the amplitudes and troughs over the last 35 years.

Exhibit 2

The cycle is lengthening; amplitude is decreasing



Sources: Conning & Company; Standard & Poor's; Insurance Information Institute; McKinsey team analysis

The McKinsey study⁽⁵⁾ revealed these notable results. Specifically;

1. **“Hardening markets thereafter have lasted as long as before, but softening markets are longer (exhibit 2).”**
2. Speaking about soft market lengths: **“In the 70’s and 80’s these lasted three to four years, whereas the two softening cycles of the 90’s stretched much longer (five to seven years).”**

What do these facts reveal to underwriters and brokers today? Does it show that insurers need to be diligent in their underwriting practices to sustain profitable results? If an insurer is not diligent, a company can end up impaired.

The study showed – from a historical perspective – why the cycle that started in 1976 was longer than normal. The author writes; **“A traditional rule of thumb for the property/casualty cycle is three years up and three years down. The most recent cycle was three years up and six years down, bottoming in 1984. What made the downturn so long and sharp?”**

“Five factors seem to account for the severity of the recent cycle and suggest that the recovery phase will also take longer than usual...”

- **the unusually large swings in interest rates over the last 10 years,**
- **the relatively worse cyclical performance in long-tailed commercial lines,**
- **the unexpectedly rapid growth in claims costs,**
- **the 1979 entry of captive insurers into third party business for tax reasons, and**
- **the large inflow of foreign reinsurance capital.”**

Why is knowing cycles important? The potential for impairment

According to A.M. Best, “Impairment” has been defined⁽⁴⁾ as a situation where the insurers:

- Ability to conduct normal insurance operations is adversely affected;
- Capital and surplus have been deemed inadequate to meet legal requirements; and/or
- General financial condition has triggered regulatory concern.

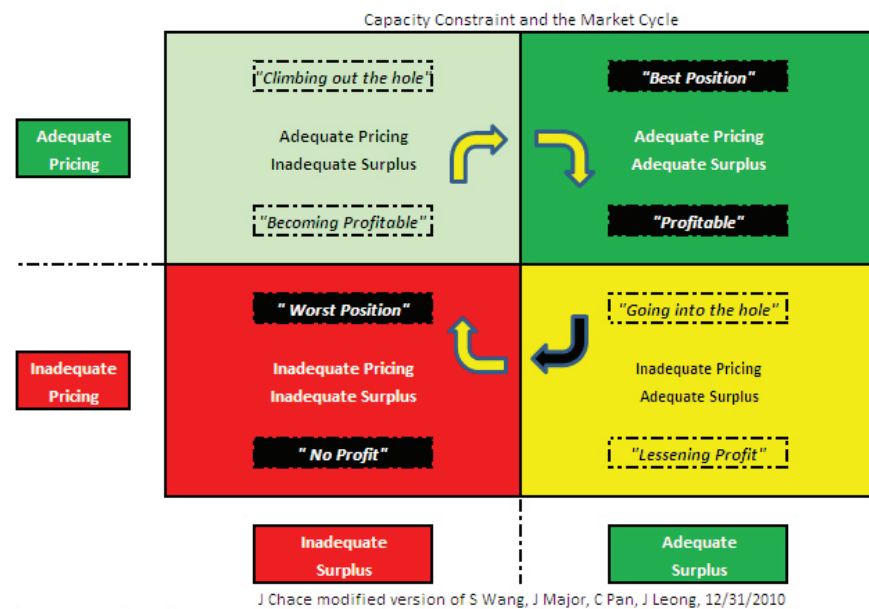
Many of these impaired carriers cannot be rehabilitated and are forced to shut down, downsizing personnel, and leaving the carriers’ obligations for their insureds to be handled by state guarantee funds.

What are the potential causes for Impairment? A.M. Best Company conducted a study over the years 1969-2010⁽⁴⁾ of property and casualty carriers that became impaired. Appendix B of their study noted the following causes of impairment:

1. Deficient loss reserves (inadequate pricing).
2. Rapid Growth.
3. Alleged Fraud.
4. Investment Problems (overstated assets).
5. Other categories including significant changes in business, reinsurance failure, catastrophic losses.

The above list is telling in that it reflects mismanagement as a key contributor to carrier results. In fact, the same sources have presented the connection between the increases in frequency of impairment with the downturn in market results. One of the most recognized sources recently stated: **"A.M. Best has found over the 41 years covered by this study that the number of FIGs... and the financial impairment frequency... typically rise during and shortly after periods of economic and financial stress."**⁽⁴⁾

The following slide shows the various phases carriers may find themselves in during the soft and hard markets. This revised slide represents the upswings and lows.



What does the above information tell us about having a knowledgeable management and sound underwriting philosophy? The results would point out that knowledgeable leadership and financially sound business strategies (based on profitable metrics targets) are the key for a successful organization.

What are the Key Operating Ratios for today's profitable Insurance Companies? Insurance company operations today need not just survival tactics but must have plans in place that are designed to make the company profitable for its owners. Companies will survive, become profitable or insolvent based on how they manage and monitor their financial statements, underwriting results, claims handling practices and actuarial modeling. But as far as ratios are considered, what should insurance and reinsurance professionals be knowledgeable about when observing results of a particular insurance company? Let's take a quick refresher course.

1. Combined Ratio (CR) – “A measure of profitability used by an insurance company to indicate how well it is performing in its daily operations. A ratio below 100% indicates that the company is making underwriting profit while a ratio above 100% means that it is paying out more money in claims that it is receiving from premiums. The combined ratio is comprised of the claims ratio and the expense ratio. The claims ratio is claims owed as a percentage of revenue earned from premiums. The expense ratio is operating costs as a percentage of revenue earned from premiums. The combined ratio is calculated by taking the sum of incurred losses and expenses and then dividing them by earned premium.”⁽⁶⁾

Calculated as: $CR = \text{Incurred Losses} + \text{Expenses} / \text{Earned Premium}$

2. Operating Ratio (IRIS) – “Combined ratio less the net investment income ratio (net investment income to net premiums earned). The operating ratio measures a company's overall operational profitability from underwriting and investment activities. This ratio doesn't reflect other operating income/expenses, capital gains or income taxes. An operating ratio of more than 100 indicates a company is unable to generate profits from its underwriting and investment activities.”⁽¹¹⁾

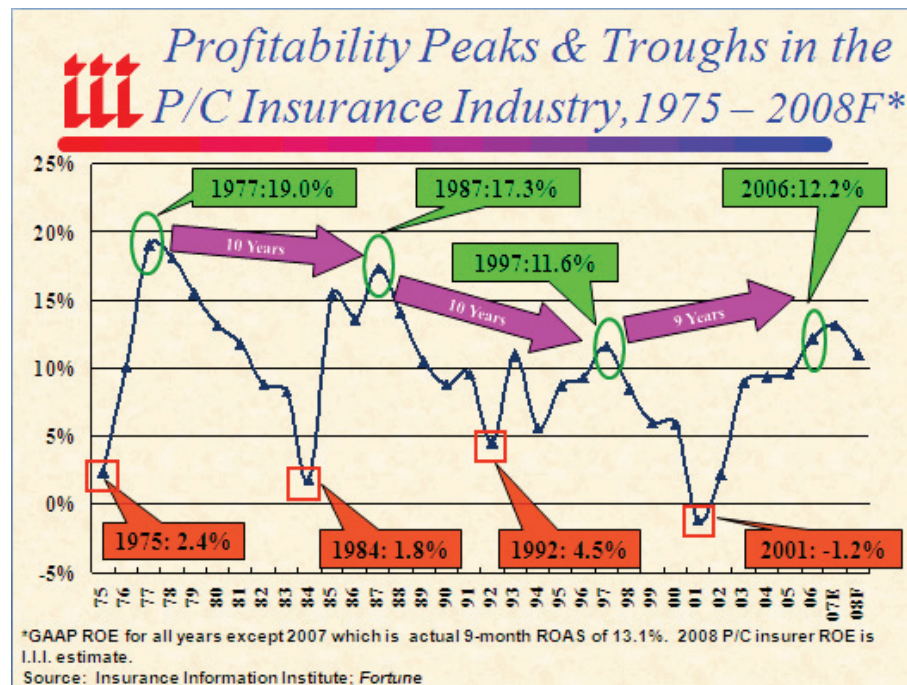
Calculated as: $OR = CR - \text{Net Investment Income Ratio}$

3. Return on Policyholder Surplus (Return on Equity) – “The sum of after-tax net income and unrealized capital gains, to the mean of prior and current year-end policyholder surplus, expressed as a percent. This ratio measures a company’s overall after-tax profitability from underwriting and investment activity.”⁽¹¹⁾

Calculated as: $ROE = \text{Net Income} / \text{Shareholder's Equity}^{(6)}$

How well a carrier performs relative to its Return on Equity, Combined Ratio and Operating Ratio results during hard and soft markets infers the level and quality of leadership, underwriting, claims and actuarial talent.

If we turn our attention to ROE’s for the moment we can view how the P&C insurance industry has fared over time. In the following picture from the Insurance Information Institute⁽⁸⁾ we can see that ROE’s have dropped for the Industry. Since 1975, the highest ROE’s were in 1977, 1987, 1997 and 2006 respectively. Correspondingly, the lowest ROE periods were in times of economic stress – 1975, 1984, 1992 and 2001.



Interestingly, another smaller study, by Richard Lord and Stephen Koca, on market cycles⁽¹²⁾, reflected how the release of prior year reserves can affect the overall combined ratios of insurance company calendar

year results. The chart (Figure 3 on the report) captured years 2004 to 2009 results for a small population of medical malpractice carriers. For instance, in the year 2005, the results for combined ratio would have been approximately 110%, however, after prior year reserve releases the calendar year results came in under 100% (approx near 98% or less). Far telling were years 2008 and 2009, where the combined ratios for both years were in excess of 100%, however, after prior year reserve releases the results hovered around an astounding 80%.

This understanding of how companies can improve calendar year results with reserve releases is a must for any underwriter, particularly reinsurers evaluating new reinsured opportunities. A company on an accident year basis may be in a worse position than the ratio reveals.

So, should we look at calendar year results or accident year results when studying market cycles and profitability? Sean Fitzpatrick wrote the following when analyzing profitability in insurance companies:

“It is crucial to understand, in this context, that insurance companies measure profitability from several viewpoints – most importantly from the perspectives of “accident year” and “calendar year” results. In an “accident year” analysis losses are matched to the premiums written in the year those losses arose. In “calendar year” analysis, however, losses incurred (that is, paid or reserves) in a given year are netted against premiums earned in that same year, irrespective of when the losses being paid first arose. Simplistically speaking, an underwriter or actuary will look to accident year results to determine how profitable a line of business has been, while a chief financial officer or a shareholder will look to calendar year results to determine how a company is doing from a purely financial perspective in the current period.”

In essence, underwriters and brokers need to understand both results – calendar and accident year, for an appreciation of the entire monitoring of profitability with any carrier results.

How Management and Underwriting Philosophies guide the company results. Each carrier we work for has its own underwriting philosophy and business strategy. It is up to each insurer and its leadership to find the right philosophy to guide the company through the hard and soft market cycles to survive and thrive.

Insurance and reinsurance professionals need to understand how their companies intend to meet operating and underwriting goals/objectives so that the carrier will be able to fulfill its policy holder obligations.

The industry tells us there are two basic philosophic models that are employed in managing business results. These are:

- a. “Conserve Capital or Profitability Model”.
- b. “Maintain Market Share Model”.

In the Conserve Capital or Profitability Model, the carrier will allow the loss of market share and business in soft markets if it means sustaining or obtaining an overall profitable book of business. The emphasis here is on the underwriting results in addition to the operating results for a company very focused on profitable returns regardless of market position.⁽³⁾

In contrast, in the Maintain Market Share Model, the carrier is willing to be more risky and tolerant of supporting underpriced business to keep its share of the market. Some industry observers believe this philosophy of maintaining market share at all costs can lead to supporting the continuance of the soft market as rates continue to drop. As new business comes in the door of the company, senior management may become overconfident. This overconfidence can lead to results being propped up by reserve take downs until the company hits poor returns. This model can lead to insolvency should various factors come into play.⁽³⁾

So which of the two Models is the correct Model? McKinsey & Company had a great response:

“In some respects, both sides are right. We believe that the best way lies between these two extremes. Understanding and tracking the macroeconomic drivers that influence cycle behavior can help carriers to better understand and anticipate future market directions”⁽⁵⁾

Closing the Loop: Where are we today? Since 2002, the industry has been on a downward slope. Today we find ourselves in a soft market. According to a recent Advisen report: ***“The insurance industry is overcapitalized, which fuels price competition. Insurers look to put excess capital to work, which results in a glut of insurance capacity and a highly competitive market.”***⁽⁹⁾

What is contributing to this soft market besides more competition?
The Advisen article further states: **“contributing to the soft market is the Great Recession. The economic slowdown meant there was less to insure as companies downsized or went out of business. As a result, the demand for insurance capacity tumbled, and insurers have competed vigorously for their share of a shrinking market.”**⁽⁹⁾

One of the leading consulting firms, Conning Research & Consulting, started off their more recent reports stating: **“Industry premium growth has been adversely affected by the weak economic environment. Rates, while up in personal lines, continue to be soft in the commercial lines. Distributors are pressured by reduced revenues due to premium declines, competition from nontraditional competitors, and increasing competition from a consolidating industry.”**⁽¹⁰⁾

The Factors that Matter: Internal and External Forces There are however certain internal factors as well as internal factors that can affect the cycle and the profitability of each insurance carrier. This list is not at all inclusive.

No.	External Factors	Internal Factors
1	The Economy – the impact on demand in market downturns – less insureds	Pricing the Product – Is the product priced properly by management for loss costs, expenses as well as other factors – IBNR, Trend etc.
2	Interest Rate Returns – returns from Stocks and Bond for financial portfolio of the carrier	Governance Risk and Operational Risk – how adequate is management team. Does the company have effective Enterprise Risk Management teams
3	State Regulatory Actions	
4	Catastrophic Results – shock losses as well as frequency of natural losses	
5	Litigation trends – New methods for exploring liability	
6	Technology – the increases in costs	

Predicting the future: Where do we go from here? The Greek philosopher, Heraclitus of Ephesus (C.535 BC-475 BC), once stated **“Everything flows, nothing stands still.”**⁽²⁾

Let’s face the facts – the industry is in constant flux. Results are impacted by those factors listed above, but they do not tell the

whole story. There is also a psychological impact on personnel as far as the energy needed for the entrance of a new product line, for exiting an unprofitable line, for new mergers and/or acquisitions of carriers, for management changes, for technological changes and for the possibility of insolvency and impairment. So, when all these factors are considered, when will the next shift in the market cycle take place? It will happen when the excess capital is depleted from the market which will, in turn, eliminate price pressure.

The Insurance Market in 2011 (an Advisen Special Report) states it best: ***“The most likely scenario for 2011 is continued soft market conditions. Economic sluggishness will keep demand for insurance capacity in check, and, as a result, the market will remain over-capitalized.... A large catastrophe, or an accumulation of smaller catastrophes, could dry up excess capacity and cause the market to turn abruptly at any time. In the absence of large catastrophe losses, however, the most likely scenario is that the soft phase of the cycle will eventually bottom out – perhaps in late 2011 or 2012 – as underwriting losses due to inadequate rate levels begin to gnaw at policyholder’s surplus. Rates subsequently will begin to increase, but the sudden and severe premium hikes that characterized the 2001-2004 hard market are unlikely to be repeated. Rather, rates are more likely to rise slowly and erratically.”***

Reference Material (Sources)

- (1) <http://www.irmi.com/online/insurance-glossary/terms/m/market-cycles.aspx>.
- (2) <http://en.wikiquote.org/wiki/Heraclitus>.
- (3) Page 6 of 8, The Impact of the Insurance Economic Cycle on Insurance Pricing, Joseph Boor, FCAS,MAAA, Second Edition, August 2004, <http://www.casact.org/library/studynotes/boor5.2.pdf>.
- (4) A.M. Best Study, Page 18, Appendix B: P/C Financially Impaired Companies (FICs) – 1969-2010, Best’s Special Report, U.S. Property/Casualty, May 2, 2011. Also Page 3, 9 (exhibit 6)
- (5) Managing Through the P&C Cycle, July 2008, McKinsey & Company, Catlin, T, Peters, J, Walker, P. (exhibit 2).
- (6) <http://www.investopedia.com/terms/c/combinedratio.asp>.
- (7) http://www.riskandinsurance.com/userpdfs/12_10_KBWpropertycasualtyOutlook.pdf, December 13, 2010, Keefe, Bruyette and Woods.
- (8) Slide 41, Robert P. Hartwig, PH.D., CPCU, President, Insurance Information Institute, June 4, 2008, “Trends & Challenges in the P/C Insurance Industry”, “Challenges Amid the Economic Storm”. ISO PAAS Forum, Miami, FL.
- (9) The Insurance Market in 2011: The Lingering Effects of the Recession Fuel Competition, An Advisen Special report”, December 2010. Page 1, 10.
- (10) Conning Research & Consulting Insurance Segment Report, Property-Casualty Distribution, Year-End 2010, Page 1.
- (11) A.M.Best, Glossary of Insurance Terms, <http://www.ambest.com/resource/glossary.html#0>.
- (12) “Understanding the Market Cycle: Profitability reigns – but for how Long?”, Richard Lord, Stephen Koca, Page 26., Physician Insurer, Third Quarter 2010.