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Managing the New Normal: Five Facts and Five "Do's" and "Don'ts" for Sustainable Underwriting

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Summary

- As the current economic situation remains unstable, there is no doubt we are now operating in a completely new market environment and, as a result, our approach to underwriting needs to change.
- The "new normal" in underwriting can be described in terms of five facts: underwriting profit is difficult to get, combined ratios are yielding lower equity returns, fast capital is present in the market, the cost of catastrophes is rising, and a "permafrost economy" is making new business difficult to find.
- Insurers have two choices in this new environment. Either keep doing business as they are and lower their target return on equity, which is what some banks have done recently. Alternatively (and rightly) they can take a new approach to how they underwrite.
- What does this new approach to underwriting entail? Clearly, higher investment returns cannot compensate for poor long-term underwriting performance. Our investment objectives must be to protect and maintain balance sheet strength.
- Good portfolio management is equally as important as good case underwriting in the new normal. Similarly, underwriters need to take control of their own pricing strategies and recognise that mother nature can no longer be relied upon to provide a helping hand.
- Finally, real competitive advantage exists for firms that can capture and analyse data to get a more sophisticated view of the business they are writing. As individual companies, we need to develop a long-term vision of the value that good data will deliver for us in the future.

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CII Introduction: There are two things in the insurance industry that seem as reliable as the phases of the moon. One is the inevitability of the insurance cycle. The other is the unwritten rule that CEOs will call, at regular intervals, for underwriting discipline. Given the volatility of industry results, it could be concluded that these exhortations have not been successful. Instead we need to get used to underwriting in a 'new normal'. In this Thinkpiece, Andrew Kendrick of ACE European Group sets out what he believes this new normal looks like.[1]

It is not the intention of this article to add to routine calls for discipline in this sector. However, it is important to understand "the new normal" in general insurance underwriting, and how to respond. As the current economic situation remains unstable, I am in no doubt that we are now operating in a completely new environment and, as a result, our approach to underwriting needs to change.

What is this "new normal" in underwriting and what does it look like?

It can be described many ways, but can perhaps best be summarised in five key facts. Where robust statistics for many markets are elusive, I will use the US Property & Casualty (P&C) industry as a proxy for global data.

Fact one: underwriting profit is increasingly difficult to come by

These three bullet points on historical trends are self-explanatory:

- 1920–1980: the US industry recorded a combined ratio of under 100%.
- 1980–2004: underwriting profits all but disappeared.
- 2000–2012: just four years of profit have been recorded so far.

[1] This article was adapted from an Insurance Institute of London presentation on 21 Mar 2013. CII members can download a recording: http://bit.ly/11Zcdli

Fact two: a combined ratio of 100 isn't what it used to be

- In 1979, a combined ratio of 100% generated a return on equity of 16%.
- By 2010, this had fallen to around 7.5%.
- In 2012 it was estimated to have fallen to 7%.[2]

What's going on? Clearly, one of the recent factors is the record low base rate that has been so persistent, and punishing for long-term savers, including insurers. Financial markets aren't pricing in a one percentage point rise in the UK until 2021,[3] so businesses that fail to underwrite properly will not last much longer.

Looking at current accident year results in the market, one is left wondering whether reserves booked now will prove adequate when the reality of today's market and economic climate comes to fruition.

This is despite a seemingly healthy London market in 2012, probably flattered by reserve releases over recent earnings seasons. These are now widely expected to taper off, and the reserves are now almost dry. Looking at current accident year results in the market, one is left wondering whether reserves booked now will prove adequate when the reality of today's market and economic climate comes to fruition.

Fact three: the industry will be awash with 'fast capital'

- Dedicated reinsurance capital reached a record level in 2012—more than $190bn—despite 2011's record losses.[4]
- Non-traditional capacity is queuing up for a piece of the action.
- The alternative sector now accounts for 15% of the global property catastrophe reinsurance market and is set to increase further.[5]

[2] Insurance Information Institute, 'Overview and outlook for the P/C insurance industry', 6 Dec 2012

[3] This is Money, 'When will interest rates rise?', 12 March 2013

[4] Guy Carpenter, 'The route to profitable growth', 3 January 2013

Institutional investors, such as pension funds and other contingent capital, are traditionally remote from the property cat sector. Now they see the market as a viable way of earning returns less correlated with the wider economy.

We are in an era of 'fast capital', with unprecedented levels of mobility and deployment speed: and the London market cannot ignore this

Some talk about hot money, others about naïve capacity. Either way, we are in an era of 'fast capital', with unprecedented levels of mobility and deployment speed: and the London market cannot ignore this trend. The entry of Nephila into Lloyd's is a good and welcome example of the dynamic at play here. The sector needs to get used to more variable and generally higher levels of fast capital in the new normal.

Fact four: the cost of cats for the insurance industry continues to rise

- The *number* of catastrophes has been on an upward trajectory over the past 30 years.[6]
- Similarly, their *impact* on the insurance industry has increased: five of the top 14 global insured cat losses occurred in last three years. [7] And 10 of the 12 most costly hurricanes have hit during the last eight years.[8]
- At the same time, insurance penetration has increased, especially in emerging market regions.

This means that since around the time I started in the industry, insured losses as a proportion of GDP have grown 5.3% a year[9]. Evidence suggests that this pace will continue[10] and is something we'll have to get used to in the new normal.

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[5] Conning & Co, 'Insurance-Linked Securities', 5 March 2013

[6] Munich Re, 'Global natural catastrophe update, Jan 2013

[7] Insurance Information Institute, 'Overview and outlook for the P/C industry', 6 Dec 2012

[8] Insurance Information Institute, 'Overview and outlook for the P/C industry', 6 Dec 2012

[9] Munich Re, 'Global natural catastrophe update, Jan 2013

[10] Aon Benfield, 'Annual global climate and catastrophe loss report, Jan 2013

Fact five: new business is increasingly difficult to find in a *permafrost* economy

- Most western economies appear to be in a low-growth stop-start economic cycle.
- Premium growth linked to growth in exposures will remain difficult for the London market to secure.
- Risk managers are being asked by their companies to do more with less resource.

So, what is the sum of these parts? First, we will be operating in a *permafrost* economy here in Europe for the foreseeable future. Second, while predictions about the future of pricing are not the aim of this article, one can argue that business plans should be based on *permasoft* market conditions rather than holding out for 'the big one' to drive wholesale change. Third, as an industry, it's likely we will need to target a combined ratio in the low- to mid-90s to meet our cost of capital.

Reacting to the new normal: the five do's and don'ts of sustainable underwriting

Insurers have two choices in this new environment. Either keep doing business as they are and lower their target return on equity, which is what some banks have done recently. More generally, it seems that investors might be more willing to accept lower returns in exchange for less volatility. However, is this realistic for companies in the risk business?

Insurers have two choices in this new environment. Either keep doing business as they are and lower their target ROE, which is what some banks have done recently. Alternatively (and rightly) they can take a new approach to how they underwrite

The alternative, and in my view the correct choice, is to take a new approach to how we underwrite.This is certainly about underwriting discipline: taking a consistent approach and showing more grit and determination when making tough decisions. But it is more than this. It's about doing things differently in a world where the 'normal' has changed, and taking a positive approach to the future. Perhaps we need to move beyond the rather vague set of aspirations we

call "underwriting discipline". After all, it sounds rather negative and 'schoolmasterish'. Instead, we should work towards a broader and more inspiring vision of "sustainable underwriting". What might that look like in practice?

Number one: do get smarter at capital allocation

There is little we can do to alter overall supply and demand. But I believe that the industry can get better at internal modelling and monitoring to ensure our capital is effectively redeployed.

That means being braver at scaling back from unprofitable and non-core lines. But in doing so, insurers have a chance of increasing the market value of equity, even if overall revenues decline. The ultimate objective should not be revenue growth, but maximising returns. My colleagues will not go into areas we do not understand, nor trade margin for market share.

Among other things, smart capital allocation requires thinking about how we can add value to the world's growth markets. Today, many emerging markets across our region, from Turkey to Poland, suffer from excess competition. Adding blind capacity clearly won't help. But there are still many ways that London can contribute real value, share technical expertise, and help them build out in new lines as their economies mature.

Insurers can also drive more consistent returns by allocating capacity to business areas that are not so highly correlated with each other

At the same time, insurers can also drive more consistent returns by allocating capacity to business areas that are not so highly correlated with each other. I'm not exactly predicting the return of the composite, but if I may use ACE European Group as an example, our Accident & Health, personal lines and life business is today probably as significant a driver of revenue and profit as P&C, overall.

So, in the new normal, the winners will be the underwriters who:

- **Invest effort in more sophisticated capital modelling:** leading to better underwriting, pricing and entry and exit decisions
- **Balance specialism and diversification:** allowing them to ride the ebb and flow of the market, while maintaining meaningful presence in core lines

Number two: a word of caution: don't risk the asset side of your balance sheet

One recent article in *Insurance Insider* suggested that a 3% fall in investment returns, the likes of which we've experienced in the last few years, is equivalent to a $100bn insured loss every year.[11] It is a "hidden catastrophe" larger than Hurricane Katrina, every twelve months.

A 3% fall in investment returns, the likes of which we've experienced in the last few years, is equivalent to Hurricane Katrina-sized event, every twelve months.

Clearly, the current investment environment will continue for longer than we ever thought possible, even a few years ago.

However, I firmly believe that insurers must not be tempted to pursue higher returns in more risky and exotic markets. AM Best has shown that those companies that enjoy higher net investment returns, typically generate lower overall returns.

The analysts talk today of a "great rotation" taking place in the financial markets. If recent stock market trends are anything to go by, they could be right. Our own sector is certainly not immune to temptation. For example, I've read lately of reinsurance carriers introducing or increasing allocations to various asset classes at the more volatile end of the spectrum. This includes equity as well as emerging market and high yield debt in an attempt to improve total investment returns.

As we consider this, one thing we have to remember as insurers is that the client is buying our balance sheet security. Why would you put that at risk? And

[11] Insurance Insider, '(Re)insurers to position investment portfolios for 2013 challenges', 6 Feb 2013

why would you expect a client to transfer their risk to you when you put your own balance sheet at risk? If you damage that, you might as well turn the lights off.

Number three: don't wait for a mega-catastrophe to execute your pricing strategy for you

The 'upside' of large cat losses on pricing has become noticeably less pronounced in recent years. A quick look at Guy Carpenter's global rate online index tells you all you need to know.

The index shows a leap in rates in the US, UK and Europe after Hurricane Andrew. But since the mid-90s, UK rates have generally been stuck below 1990 prices. European rates have also been trending downwards over the last decade. Certainly, neither market has seen the spikes the US industry experienced following cat losses there over the last decade.

Underwriting cycles in different lines and geographies are almost certainly less correlated than they used to be. Any pricing impact now tends to be confined to the locality and the product area where the event had its greatest impact.

Frankly, I wonder whether I will see another truly hard market during my career. It could be precipitated if a major earthquake in California or Japan was swiftly followed by a damaging windstorm or tough hurricane season… or alternatively, if we saw ten years of under-reserving in the casualty sector finally catching up with the industry.

Regulators, analysts and rating agencies are all demanding more transparency in pricing and looking for evidence of profitability.

But our stakeholders, quite understandably, are increasingly resistant to the industry using exceptional losses as an excuse to raise prices in unrelated classes or geographies. Regulators, analysts and rating agencies are all demanding more transparency in pricing and looking for evidence of profitability. Indeed, insurance buyers may even welcome risk-based pricing as an alternative to the arbitrary pricing swings of the past.

Number four: do get your hands dirty, and dig deeper into your portfolios

Being a good case underwriter of individual accounts is very important. But so is being able to take a "bird's eye view", and make meaningful connections between risks in the context of the wider portfolio.

Portfolio management allows underwriters to identify areas of profitable growth – and increase their clarity around risk appetite.

Good portfolio management is certainly about being able to identify problems and to fix them. For example:

- Understanding which accounts are really 'core' to a portfolio and which can be let go more easily when prices fall;
- Being prepared to re-underwrite or even shrink parts of the book; and
- Letting go of those emotional attachments to trophy accounts (where the bouquet of the premium masks the smell of the risk)

However, portfolio management should not be seen as a negative concept. Just as importantly, it allows underwriters to identify areas of profitable growth – and increase their clarity around risk appetite. For example, by asking:

- In what segments and trades do we offer real competitive strength compared to our peers?
- Where can we better leverage our relationships across related lines to cross-sell more effectively?
- And to what new countries, and which emerging markets, can we export our knowledge and experience gained elsewhere?

Case underwriting and portfolio management are different skills but, in the new normal, they are equally important. My colleagues and I have therefore been embedding a very robust portfolio review process across our region – and across the company. We build specialist, cross-functional teams that include underwriters, actuaries, claims professionals and our own risk engineers and we look in turn at different lines in different countries.

Our expectations of our underwriters have therefore changed. Portfolio management is now embedded as part of their business as usual. The test of success is really quite simple. We expect our underwriters to be able to articulate clearly what's in their book at granular detail and what new profitable segments they are targeting. If they can't, they don't know their portfolio, and they aren't practising sustainable underwriting.

Another important part of the process is building greater synergy between underwriting and sales teams. Communicating risk appetite to business partners and clients is critical, and requires clarity and a more consistent approach to telling the market what you're good at, and about the business you want – and don't want.

And finally, number five: do make more of your data

As insurers, we have access to an ever expanding volume of data. Today, any skilled underwriter can use a large number of different inputs to analyse their portfolio using a whole host of different metrics – whether by getting more granular about occupancies and trades, categorising portfolios by premium bands or by insurable values, or analysing by different distribution sources. The consultants talk of us living in a new era of "big data" and they are right.

Real competitive advantage exists for those firms that can capture and analyse data to get a more sophisticated view of the business they are writing

Of course, underwriters can only achieve this with the right infrastructure. Many insurance companies still remain hampered by old-fashioned and unconnected legacy systems. US technology provider Guidewire estimated a few years back that system-related constraints act like a "performance tax"… equivalent to a reduction of at least five points of combined ratio for the majority of US P&C insurers.[12] Our industry does not exactly have a great track record of success on big technology projects, and I'm certainly not going to propose another one.

[12] Guidewire, Overcoming the top 5 challenges to achieving underwriting excellence', 2009

But the point I want to make is this: as individual companies, we need to develop a long-term vision of the value that good data will deliver for us in the future. For multi-line global players in particular, the opportunities to share learning across geographies and across divisions through predictive modelling, for example, should be considered.

In the new normal, real competitive advantage exists for those firms that can capture and analyse data to get a more sophisticated view of the business they are writing.

Conclusion

I have no doubt whatsoever that we are now operating in a new normal. Our approach to underwriting needs to change. Discipline is of course vital but, more than this, we need to embrace sustainable underwriting.

A *permafrost* economy, and a *permasoft* insurance cycle, mean that the insurance industry now needs to target a combined ratio in the low to mid 90s to deliver adequate returns.

Five key take-aways in the "new normal" for sustainable underwriting:

- Smarter capital allocation;
- Protecting the asset side of the balance sheet;
- Taking control of our pricing strategies;
- Better portfolio management; and
- Making more of the age of 'big data'

It's a tall order, but sustainable underwriting is not rocket science. Fundamentally, what it comes down to is having a long-term vision, and a greater sense of determination and purpose. The good news is that we have better information and tools to help us than ever before.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

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ACE European Group is is one of the world's largest multiline property and casualty insurers. With operations in 53 countries, ACE provides commercial and personal property and casualty insurance, personal accident and supplemental health insurance, reinsurance and life insurance to a diverse group of clients. ACE Limited, the parent company of the ACE Group, is listed on the New York Stock Exchange (NYSE: ACE) and is a component of the S&P 500 index.

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Recent articles in the series:

No.96: **The Great British PPI Truth and Reconciliation Scandal: Outcomes and Lessons**, by Teresa Perchard (7 June 2013).

A case study of the payment protection insurance experience from the perspective of the consumer group that first published the report that eventually led to the OFT, FSA, Competitition Commission and High Court actions. While the current issues in the wider general insurance are nowhere near the scale of PPI, readers should be mindful of that experience, and why consumers had to suffer for so long before the appropriate safeguards were triggered.

No.95: **Supporting Strategic Objectives or Another Compliance Exercise? Understanding Corporate Risk Culture in Insurance,** by Dr Simon Ashby, Dr Tommaso Palermo and Professor Michael Power (20 May).

Looks at some preliminary findings from a CII member survey, drawing some conclusions regarding cultures and attitudes towards corporate risk management in the insurance sector. It is part of a wider study on risk culture in insurance.

No.94: **General Insurance in the Twenty-First Century: Meeting the Challenges,** by Robin Spencer (13 May).

An insurer perspective of some of the challenges facing the GI sector. The CEO of Aviva UK starts by acknowledging that the social value of insurance is being lost in the lack of trust. He explains that rising to this will help the industry confront other issues such as emerging technology and dealing with public policy themes such as flood risk, reform to personal motor insurance and fraud.

No.93: **Hitting a Home Run in Retirement: The Unlocked Potential for Housing Equity in Later-Life Income Planning**, by Stephen Lowe (4 Feb).

Stephen Lowe of Just Retirement discusses the results of the UK's largest research study into consumer attitudes towards housing equity withdrawal and the steps needed to make it a viable option for current and future generations of retirees.

CPD Reflective Questions

Reading this Thinkpiece can count towards *Structured CPD* under the CII CPD Scheme, if you consider any of the Learning Objectives below to be relevant to your professional development needs. The Reflective Questions are designed to help you reflect on the issues raised in the article. Please note that the answers to the questions are not required for CPD records purposes.

Learning Objectives

Having read this Thinkpiece, readers will be able to:

- name the five key characteristics of underwriting in the current economic and business environment;
- identify the implications of this economic and business environment on the insurance market; and
- summarise the various responses – specifically do's and don'ts – that underwriting functions can adopt as a strategy.

Reflective Questions

1. What are your views on the author's "new normal" in underwriting, particularly the five characteristics he gives of the economic and business environment? Are these the same observations that you would make of developments from your perspective? How do his views differ from yours? Would you add any of your own?

2. In describing the economic environment, the author states that "one can argue that business plans should be based on *permasoft* market conditions rather than holding out for 'the big one' to drive wholesale change." What do you think the author means about "permasoft market conditions"? Do you think he is correct in saying that insurers are "holding out for the big one"?

3. Earlier this year, we published two *Thinkpieces* about the current GI business environment that might be worth re-examining and comparing with this article. The first was entitled **General Insurance in the 21st Century** by Robin Spencer (Thinkpiece 94: http://bit.ly/118xDMS), the other was **Supporting Strategic Objectives or Another Compliance Exercise?** by Simon Ashby et al (Thinkpiece 95: http://bit.ly/13FtGoj). Upon comparing and contrasting the issues raised in relation to this article, what observations can you draw overall?