The Global Challenge for Insurance

by Jens Erik Christensen

There are a number of themes or challenges such as The global crisis in long-tail liability insurance, US asbestos liabilities, Whiplash claims, Compensation culture, Insurance pricing and they are all centered around core disciplines inherent in the insurance business. Unfortunately we have as an industry had a sort of inferiority complex with the banks, not least in terms of the question of distribution power, and we have been struggling so much with heavy costs that we have forgotten the basic focus and discipline to any business

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In the last few years it has been evident that the value creation in insurance – general as well as life – has been inferior to other financial sectors and the markets in general, with the TMT sector being the only one having a worse performance.

This has happened despite the hardest market in general insurance for both insurers and reinsurers in years. The reason for the poor performance is underreserving for long-tail liabilities such as asbestos and D&O, but foremost the global downturn in investment returns. Within three years, the insurance industry has gone from being overcapitalised to being undercapitalised or thinly capitalised. For a long time the insurance industry has relied on investment income to make up for underwriting losses in general insurance, and in life insurance heavy exposure in equities has proved to be a strong mismatch with the guaranteed benefits to the policyholders.

Solvency issues are high on the agenda as are questions about risk management and management of the assets and liabilities. Many companies are trying to raise capital through rights issue, cutting of dividends, and in life insurance reducing payouts to policyholders, and shedding assets, i.e. selling operations not core to the business. *The real challenge is of course to make the insurance operation profitable and in a sustainable way*. In ge-

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neral insurance the combined ratio (claims + expenses divided by premiums) should be brought below or well below 100% through substantial rate increases and changes in terms and conditions. In life insurance there is a strong need of innovation and of sharing the investment risk between companies and policyholders. Just to introduce the concept of „true" profitability in the life insurance industry will be a first revolutionary step.

The insurance industry *is* a major industry as part of the overall financial system. The global insurance industry had premium revenue in 2001 of USD 1,439bn from life insurance and USD 969bn from general insurance and financial assets about USD 12,500bn (Sigma, Swiss Re, June 2002). If a major insurance company – life or general or reinsurance – would go bankrupt, it would no doubt be a shock to the financial system and could have a domino effect.

There are a number of themes or challenges that dominate the insurance industry, and I shall try to give my view on them as far as *general insurance* is concerned.

The global crisis in long-tail liability insurance

The fundamental nature of insurance is risk transfer from the policyholders to the insurer and the ability and capability of the insurer to manage risk in a predictable and controllable way. Technically speaking, by pooling (homogeneous) risks it is possible „collectively" to diversify a considerable part of the „individual" risk and the residual non-diversifiable risk can be managed in a reasonably predictable way. This is, if you like, the theory based on the law of large numbers etc., but in real life things are not that easy. The main reason for this is the long-term nature of many lines of business, in particular the liability lines of business with a long and uncertain claims settlement process.

The main challenge with long-tail line of business is to recognize and quantify the superimposed inflation, i.e. inflation over and above CPI or wage-index related inflation.

We see for almost all general insurers substiantial reserve upgrades. For those companies that have actually gone bankrupt this can almost always be attributed to *massive underreserving* and significant underpricing with high and unsustainable growth. Despite massive underreserving it is possible for those insurance companies to have positive cash flow for many years before running out of cash abruptly leading to collapse.

There are endless debates on the proper recognition of the long-tail line of business in financial reporting (IAS) ranging from concepts of fair value to prudency and from discounting of liabilities to augmenting reserves with market value margins. Whatever the outcome there is no doubt a need for a sort of revolution in how to assess and report long-tail liability risks. It is in this context strange how little attention analysts pay to the question of reserve adequacy, at least they seldom perform any thorough analysis of this issue. In fairness this may be ascribed to the scarcity of information on run-off performance given by the insurance industry.

To me it seems obvious that the management of the companies that have gone bankrupt in recent years due to massive underreserving did not have any idea of the nature of the insurance business and in many instances the local regulatory body neither. The bankruptcies in the insurance industry are not of the Enron or Worldcom type failures best described as corporate malfeasance. Unfortunately, the discussion on corporate governance is very much based on these cases and not what would be more important for the insurance industry to prevent future collapses: better means of assessing and reporting long-tail liability risks.

US asbestos liabilities

Asbestos is perhaps the most extreme example of long-tail risks. Asbestos litigation has cost US business some USD 275bn and generates about 50,000 claims a year (American Insurance Association). To understand asbestos you not only have to have a good understanding of actuarial methods, but also of many behavioural issues such as how age affects the willingness to sue over asbestos and peculiarly the new asbestos risks that emerged in 2002 such as non-product exposures. We have already seen lawsuits where non-impaired claims – where plaintifs are lacking symptoms of asbestos-related ailments – are getting sizable settlements.

Whiplash claims

There is an ever increasing incidence of whiplash claims. In the UK about 80% of all motor personal injury claims relate to whiplash conditions. There is also a growth in claims based on post-traumatic stress disorder. Whiplash injuries now affect 1 in 200 people every year with 250,000 claims per year [source: ABI].

Whiplash is an injury that can neither be seen nor revealed by x-ray, and hence it is difficult to dispute or disprove the injured's version of events leading to the injury or of the recovery time needed. Medical experts also readily take the injured's accounts at face value. Fraud and exaggeration is consequently endemic to whiplash claims.

Compensation culture

There are two concepts that are key in insurance, and they are often confused, namely *mutuality* and *solidarity*. Mutuality is the principle of private, commercial insurance, whereby individuals enter the insurance pool for sharing losses and pay premiums according to the best estimate of the risk of the individual (this applies to all insurers whether organised as a plc or a mutual company). Solidarity is the sharing of losses in a similar fashion, but with payment according to some scheme, e.g. tax. It is essential that the scheme is compulsive and comprehensive. State social insurance is a good example of solidarity.

Only mutuality involves assessment of risk. In order for mutuality to work it is extremely important that it is based on the principle of *utmost good faith*, i.e. each side declares all it knows about the risk.

However, we see a huge spread of a compensation culture which very much violates this principle. This disease started in the US and has spread to UK and increasingly to other countries in Europe. Compensation culture is often referred to as ‚blame and claim' and refers to the willingness of individuals to take legal action against whoever they think is resonsible for injury or damage.

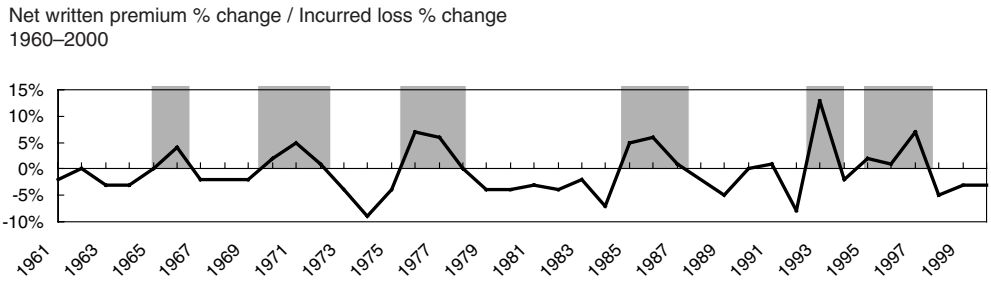
In the US the compensation culture actually is a threat to US business' ability to compete. Examples of ridiculous damage awards are:

- an 81-year old won $ 3m damages against McDonalds after spilling hot coffee on her lap,
- a shoplifter being arrested was awarded $3.2m against Wal-Mart for the trauma of being handcuffed in front of her children.

The legal system in the US does support this compensation culture as it is rare for the losing side to pay the other side's legal fees (therefore no incentive for defendants to avoid litigation). Moreover, damages are decided by a jury (and not a judge), and often punitive damages are being awarded. Unfortunately, in Europe we see the introduction of no win, no fee arrangements making it easier to sue than ever before.

To add insult to injury the final bill for this compensation culture typically ends up with the insurer.

Historically, hard markets have been short lived and have not always led to sustained underwriting profits



Source: McKinsey

Underwriting cycles

More or less irregular cycles of underwriting results are apparently a structural characteristic of the general insurance business. Cycles can vary significantly between countries, markets and lines of business although very often being masked by smoothing of published results. Among the causes behind these cycles are factors like

- time lag effect of price changes
- trends, cycles and short-term variations of claims (and claims inflation)
- fluctuations in interest rate and market value of assets

and not least the interaction of each of these factors. Above is shown for the American market an example of these cycles.

The interesting feature is that the hard markets have a much shorter duration than the soft markets. Why are the insurers not interested in making decent profit or rather only make decent profits for short periods followed by longer periods of mediocre results? Probably because the insurance industry has attracted too much (cheap) capital, hence being overcapitalized leading to overcapacity and silly premium levels. Fortunately it seems as if we p.t. are entering a period where there is less overcapitalization and in many instances shortage of capital.

Basically, underwriting cycles – life profit fluctuations in other industries – reflect competition, i.e. the interdependence of rival firms. Customer loyalty and demand inelasticity (at country or market level) ensure comfortable returns for incumbent firms, but on the other hand the apparent ease of entry into insurance, the lack of market concentration (in most markets) and the difficulty of monitoring the prices of competitors make it impossible to make excessive profits. This keeps the market in disequilibrium with ongoing price fluctuations.

How to beat the underwriting cycle and achieve decent returns on capital through the cycle? And given the market conditions, is it at all feasible? That is of course a major challenge for any insurance company.

Insurance pricing

Below is shown for the US market how it is possible to sustain a better profitability across the underwriting cycle.

These are indeed very impressive facts and encouraging news for well-run insurance companies. What is not shown on this graph is that the better performance has not been achieved at the expense of growth.

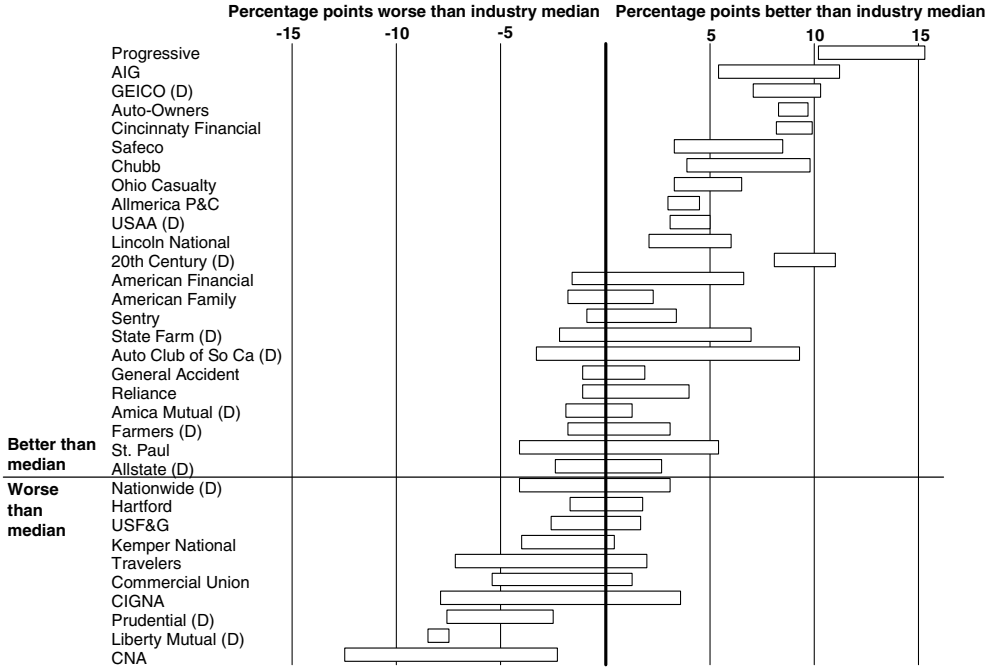
A key issue for the better performers has no doubt been a strict underwriting discipline, but I would like to point out for personal lines business as well as SME in commercial insurance there is much to be achieved by better pricing through a much more sophisticated approach than is typically the case.

Many insurers manage profitability on a total portfolio rather than on a segment-by-segment basis. A sophisticated company has huge scope to beat the competitors consistently by *correctly assessing the risks* and *leveraging the customers' price sensitivity* (elasticity).

Sophisticated insurers use 40-50 variables to price a simple auto or homeowner's policy. Continuous pricing pilots give these insurers the ability to check the behaviour of consumers and to trade off profit margin against volume.

Leading P&C companies have managed to sustain a combined ratio advantage over time

Percent, 1979–1998



Note: Median for industry over 5-year period 1979–1983, 1984–1988, 1989–1993, 1994–1998; (D)=Direct writer
Source: McKinsey analysis

Sophisticated insurers also monitor closely the development of the real rate of interest (based on the true underlying claims inflation) to make sure that the technical price (as set by actuaries) is adequate.

Running a successful insurance company depends more on the effectiveness in your pricing (or underwriting) than on efficiency in your various administrative processes and your acquisition costs.

Risk based capital

Improved capital management – or just start to try to manage your capital – is a key challenge for general as well as life insurers. In the past assets and liabilities have been managed in strict separation and by different functions within companies. ALM (Asset-Liability Management) techniques are now if not commonplace then not a completely alien concept in life insurance.

There has recently been much focus on the volatility of having equities in your investment portfolio. A little piece of warning: bond risk is asymmetrical – you could go bust, but no one is ever likely to double in price, as a share could!

In general insurance concepts of risk based capital have been introduced in many insurance companies. Risk based capital is the amount of capital that should be held to counterbalance the risks being assumed by the insurance company. To quantify the RBC there needs to be an assessment of the inherent statistical variability of the financial return. Expected losses can be allowed for in the pricing of the product, but additional capital is needed to cover unexpected losses. One way of defining RBC could be as the capital needed to make sure with 99% probability that the Capital to NPW ratio will not fall below, say, 25% within a five-year period.

The real value in the TBC concept is of course when applied to a particular line of business or customer segment and to make it an integral part of the pricing of that line or segment based on the required return on RBC (over and above the cost of this capital).

RBC concepts apply of course to life insurance as well.

RBC systems have taken the best part of a decade to catch on in the banking sector. Banks have for a long time attributed capital to individual lines of business and have been monitoring performance at these levels (risk in bank = risk of default on loans).

One important technique to work with in general insurance is DFA modelling (DFA = dynamic financial analysis). A DFA model is a stochastic model of the main financial factors of an insurance company, comprising such risks as

- pricing/underwriting of risks (risk of inadequate premiums)
- reserving risk (risk of insufficient reserves)
- investment risks
- catastrophes (e.g. windstorms)

A good DFA model makes it possible i.a. to assess the impact of varying reinsurance strategies/coverages to the financial result and stability of an insurance and hence an important tool in the overall risk management of an insurance company.

Risk Management

Insurers probably trail at least 10 years behind banks when it comes to risk management systems and practices.

Even though the main drivers of risks with general insurance are liabilities and various insurance events (catastrophes) and assets are the main drivers of risk in banks (and life insurance), the same principles of risk management should apply.

At the heart of risk management is of course governance. A model commonly found in banks is based on three lines of defense:

1st line	the business unit & divisions where risk identification, measurement and control are actually carried out
2nd line	a risk function, advising on standards and challenging the business on risk matters
3rd line	an independent internal audit function.

In most insurance companies the second line of defense, an independent risk function, is often missing or poorly defined. To establish proper risk management is also key to improve the financial performance as it ensures – not least in underwriting – a necessary, strict discipline.

Concluding remarks

I have just touched upon a few challenges that I believe are facing the insurance industry (particularly the general insurers) worldwide. Much is centered around core disciplines inherent in the insurance business. Unfortunately we have as an industry had a sort of inferiority complex with the banks, not least in terms of the question of distribution power, and we have been struggling so much with heavy costs that we have forgotten the basic focus and discipline needed to run any business. High level strategic thinking, particularly in distribution, and strategic consolidation issues have distracted a lot of insurance business from the (boring) operational issues on execution.

As a profession we need to reestablish a proudness about our work and our important contribution to society and make sure we do that job in a professional manner and thereby live up to our social responsibility in society which is mainly to make sure we run profitable businesses! – Insurance is actually a wonderful business embracing very many aspects of our societies.