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# Underwriting Trends

Volume 15 Number 3 January 2004

## Tidbits from the Top

by Frederick R. Parcells, CPCU, ARM, ARe

It's been an honor and a privilege to have served you as section chairman for the past two years. Your committee has been very busy during that time working to better serve your needs. In 2002, we accomplished the following:

- Surveyed you, our members, about what benefits and services you wanted to get from your section.
- Introduced our interactive section web site, which offers a wide array of useful features.
- Developed the highly acclaimed Annual Meeting seminars "Toxic Mold—Don't Let It Overgrow Your Bottom Line" and "The 21st Century Underwriter: Armed & Ready to Make Profit."
- Conducted the annual Underwriting Section Luncheon at the Annual Meeting and Seminars, providing members with informal networking and educational opportunities.
- Achieved the Bronze level Circle of Excellence Award.

In 2003, we created two more Annual Meeting seminars—"Working With the Excess & Surplus Lines Marketplace" and "Catastrophe Modeling—Predicting the Future." We held the Underwriting Section Luncheon and also plan to introduce a series of interviews with senior underwriting executives. Check the web site and future issues of *Underwriting Trends*—you won't want to miss them! These activities and others earned us the Silver Circle of Excellence award.

It's now time for me to pass the baton on to your new chairman, David S. Medvidofsky, CPCU. Dave has been instrumental in creating, developing, and enhancing the Underwriting Section web site—a web site that was the model for other sections to emulate. I have full confidence that Dave's energy and vision will take us to the next level—the *Gold* in 2004!

In closing, I encourage all of you to consider taking a more active role in section participation. You know the old saying—a chain is only as strong as its weakest link. You don't need to be a section committee member to participate. For example, you can become the section liaison to your local chapter. If you speak to a group of students about careers in insurance, you can do so on behalf of your section. If you volunteer at your local I-Day, you can do so on behalf of your section.

As chairman, I heard from many people—some new, some old acquaintances from prior employers, etc. Insurance is a people business. You never know whom you may encounter or communicate with on any given day. We only live once. Make the most of your life! ■

### What's in this Issue?



## Message from the Editor

■ **U.K. "Rick" Becker, CPCU, CLU, ChFC,** is underwriting/product director for Nationwide Insurance in Richmond, Virginia. Becker attained the CPCU designation in 1984.

During the next several editions of *Underwriting Trends*, we hope to feature some thoughts and comments from leaders in the insurance industry.

Much of the industry leadership points to the need for improved results, especially as we compete with other industries for capital and fall well below the 15 percent rate of return that equity investors typically desire. The insurance industry's return on surplus has fallen from 13.7 percent in the 1970s, to 10.3 percent in the 1980s, to only 8.7 percent in the 1990s according to information from Insurance Services Offices, Inc. (ISO). In the first three years of this decade, the

*Continued on page 2*

# Message from the Editor

*Continued from page 1*

industry's rate of return has averaged under 3 percent.

High annualized rates of return have been realized in the past, especially the late 1980s, but not through strong underwriting as combined ratios were still well in excess of 100 percent. To achieve a 15 percent rate return, current estimates would require a combined ratio under 95 percent. For 2003, ISO projects a combined ratio of 102.9 percent, a significant improvement over prior years, but still well above levels needed to give adequate returns.

Although the industry has seen significant premium growth during these past years, growth rates have declined in more recent years.

Given the industry's history, as growth rates decline and results improve we get closer to increased competition to gain market share? Let's hope not. The industry continues to pay dearly with lower rates of return for failing to adhere to disciplined underwriting and cost-based pricing.

Another sign pointing to the renewed focus on growth versus profitability has been an increase in insolvencies. Insolvencies among property and casualty companies increased an average of 33 per year this decade, compared with 12 in the 1970s and 27 per year in the 1980s and 1990s.

Lloyd's chief executive, Nick Pretlejohn, speaking at the Chartered Insurance Institute's Annual Conference, urged the insurance industry to take urgent action to secure a profitable future. In order to achieve long-term improvements, we need a strong underwriting focus. He stressed the need to improve efficiency within the market and the industry in general. The question is, "Are we willing to learn and act on the lessons of our history?"

Many industry leaders faced with rising costs, increased pressure, and uncertainty, especially related to increase in natural and man-made catastrophes, mold, asbestos issues, and fraud are touting the need to get back to basics. However, a willingness to forgo growth and reliance on investment gains and instituting a strong underwriting focus and cost-based pricing to achieve improved rates of return is still debatable.

■ *Although the industry has seen significant premium growth during these past years, growth rates have declined in more recent years.*

Tony Markel, president of Markel Corporation, gave an insightful presentation at a recent CPCU Society Richmond Chapter meeting regarding the state of the industry, which gets at the heart of these issues.

Tony was kind enough to share his presentation from which I have included some of the exhibits. I only hope I do justice to what he shared at the recent meeting. ■

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# The Case for an Extended Hard Market

**Editor's note:**
The comments to the presentation slides represent my views and understanding of the presentation made by Tony Markel, president, Markel Corporation, at the CPCU Society's Greater Richmond Chapter meeting held on September 4, 2003, rather than a direct reflection of the presentation. My thanks to Mr. Markel for the use of the presentation exhibits.

The heart of the presentation at least as I hear it, goes right to the issue of our industry's willingness to learn and act on lessons of our history. There is increased concern that as growth rates decline and shareholders demand on short-term results, we will lose our focus on underwriting profits.

Growth can be achieved through investments or underwriting profits. So, when interest rates are low, you can make a better underwriting profit through better pricing and selection. (See Figure 1.)

However, as you see that the industry's ability to improve underwriting gains has not been very impressive, it is easy to see why focus on investment gains become heightened. (See Figure 2.)

ISO projects the need for a trade combined ratio under 95 percent for a realistic chance of achieving a 15 percent rate of return. As you can see, it has been quite some time since we achieved those kinds of underwriting results. (See Figure 3.)

We need to understand that we don't just compete with others in the insurance industry for capital—we compete with all U.S. industries for available capital. (See Figures 4 and 5.)

Although the industry has made a slight recovery from low .95 net premiums written to policyholder surplus ratio, results remain well below those in the 1980s. In order to achieve After Tax ROE, an underwriting profit is required. (See Figure 6.)

**Figure 1**

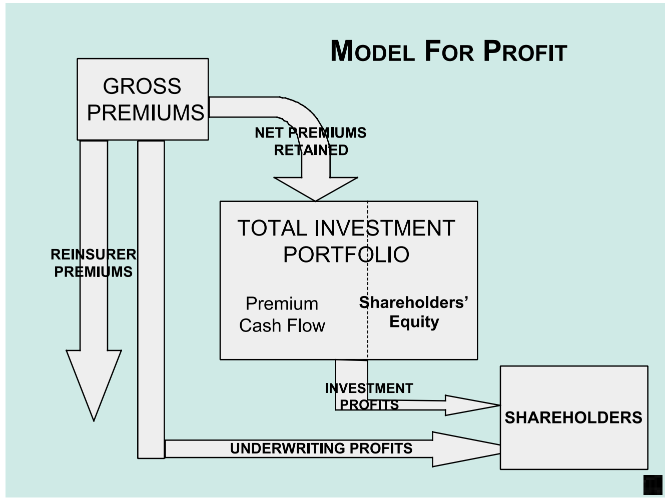



**Figure 2**

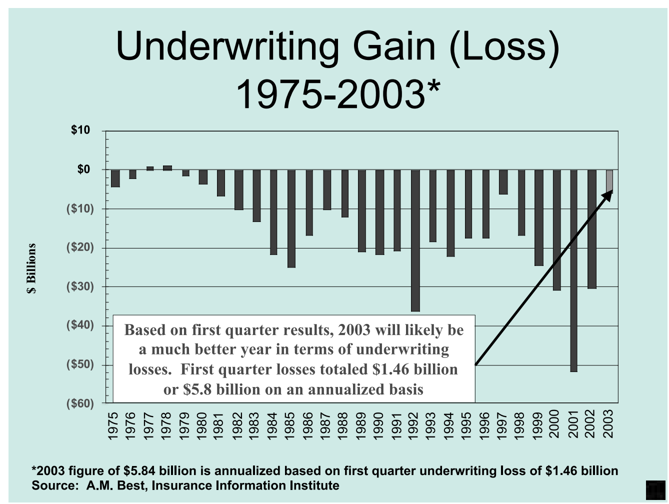



**Figure 3**

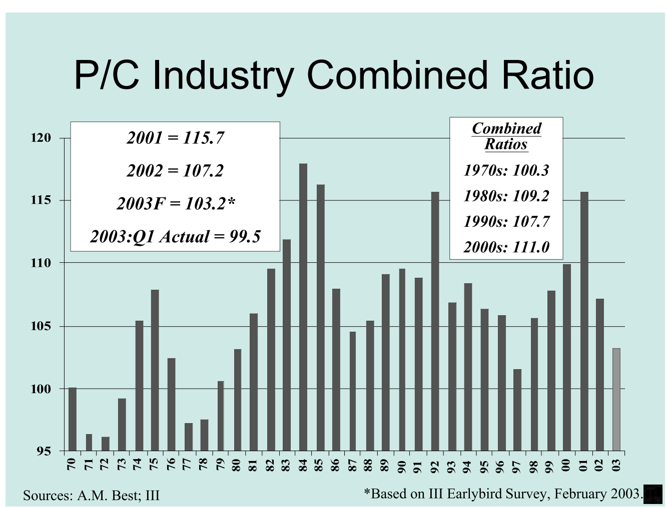


**Figure 4**

## P & C Industry Performance

"Since 1980, the U.S. P & C industry has collectively lost $439 billion in its underwriting and has managed to underperform consistently in relation to other industries…."

– Julian James, Director of Worldwide Markets for Lloyd's

Source: *Business Insurance*

**Figure 5**

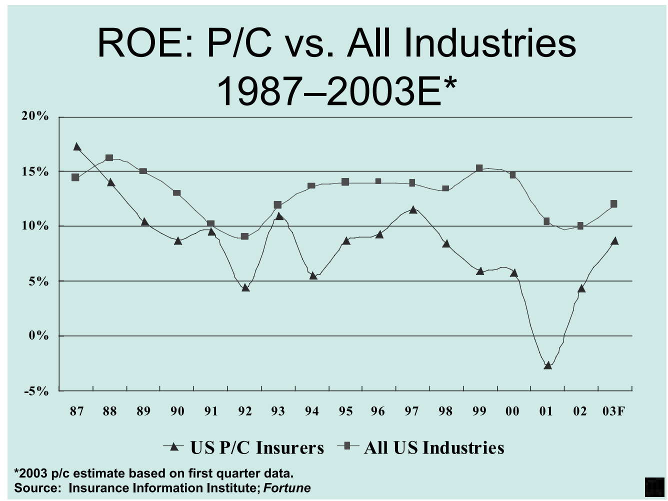



**Figure 6**

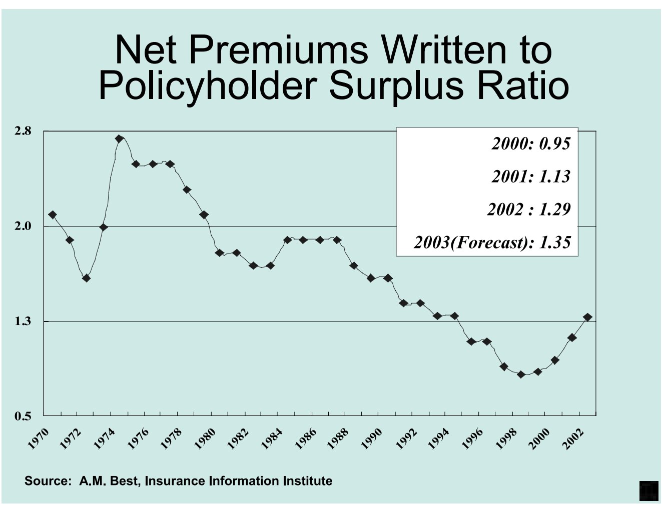
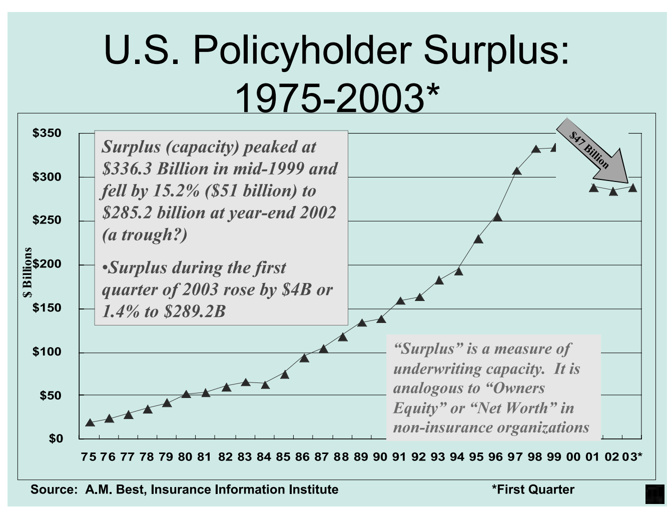



**Figure 7**

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# The Case for an Extended Hard Market

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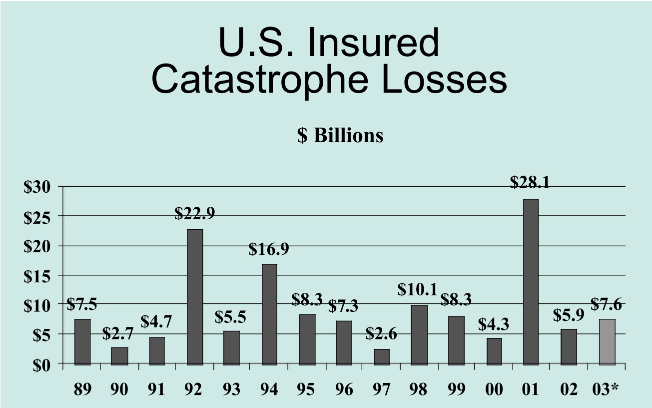
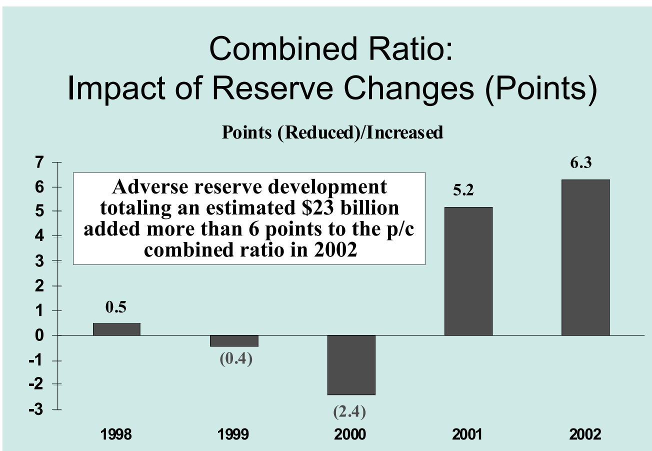
**Figure 8**




*Through August 2003.
Note: 2001 figure includes $20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims.
Source: Property Claims Service/ISO; Insurance Information Institute

**Figure 9**




Source: ISO, A.M. Best, MorganStanley, Insurance Information Institute.

**Figure 10**

## Reserve Increases in 2002

| | |
|---|---|
| ACE | Expanded asbestos reserves by $2.2 B (1/03). |
| AIG | Increased reserve by $2.8 B. |
| Allianz | Reserve increase of $750 M. |
| American Re | Boosted total reserves by $2 B. |
| Chubb | Increases net pre-tax asbestos reserves by $75 M (year-end 2002). |
| Converium | Adds $59.6 M to reserves in Q3 2002. |
| Employers Re | Adding $3.5 B to reserves in 2002. |
| Fairfax | Could lack $5 B in reserves. |
| Hartford | Increased asbestos reserves by $2.5 B (1/03). |
| Munich Re | $500 M in reserve increases. |
| SCOR | $428.8 M loss for 2002 due to increased reserves and investment losses. |
| Travelers | Boosts asbestos reserves by $2.9 B. |
| Zurich | Increased reserves by $2 B. |

Surplus peaked in mid-1999, but quickly fell with events of 2001. Although surplus rose in early 2003, the 2003 storms likely negated any gains in surplus. (See Figure 7.)

Catastrophic losses continue to have a major impact on not only insurer results, but drain capital in anticipation of ongoing concerns for future losses. Hurricane Isabel and the California wildfires further deteriorated the 2003 results. (See Figure 8.)

As a result of the storms and deteriorating trends, we continue to see the need for adverse reserve development to account for reserve shortfalls and the impact of asbestos claims and investment shortfalls. (See Figure 9.)

Based on these reserve shortfalls, industry results in prior years were likely understated. And, if current estimates of reserve inadequacies are anything near accurate, the industry has an even greater need to focus on improving results, not lowering pricing to achieve further growth. (See Figures 10 and 11.)

Past capabilities to make up for modest/poor underwriting results through investments are much more difficult with current yields. (See Figure 12.)

Combining the increase in catastrophic activity, under reserving, and significant reductions in investment yields has led to a significant increase in property and casualty company insolvency rates that put further strains on the industry. Highlands Insurance Group, Frontier, Kemper, Reliance, and Trenwick are just a few examples of recent insolvencies. Reliance is the largest insurer liquidation in history, according to the Insurance Information Institute. Increased pressures from asbestos, “toxic” mold, medical malpractice, and security exposures to name a few will continue to challenge the industry. (See Figure 13.)

Many companies are also faced with rating downgrades, which further supports the need for improved underwriting results and stability.

What's being done? Many insurers have made significant management changes. Companies have changed or withdrawn from writing specific classes of business or types of operations. Industry reserves have been strengthened. Is it enough? And more important, will the industry act on lessons learned from the past or look to glamour and short-term pressures for growth?

As CPCUs, what role should we play in securing the future for the insurance industry? Your thoughts and comments would be very welcomed! Send them to Ulrich K. Becker, CPCU, CLU ChFC, at beckerr@nationwide.com. ■

**Figure 11**

"A quick look at reserve adequacy suggests that the industry as a whole is deficient by about $18-24 B. . . We note that the estimated deficiency incorporates only the past ten accident years and thus does not account for a possible shortfall for old year liabilities such as asbestos and environmental related liabilities."
– *Merrill Lynch, September 2, 2003*

"IBNR has sunk to startling low levels – approximately 60% of the historical norm . . . Recognition of deficiencies in 1997-2001 reserves should reduce commercial lines profitability by 5% to 10% annually for the next five years."
– *Cochran, Caronia, & Co., June 10, 2003*

**Figure 12**

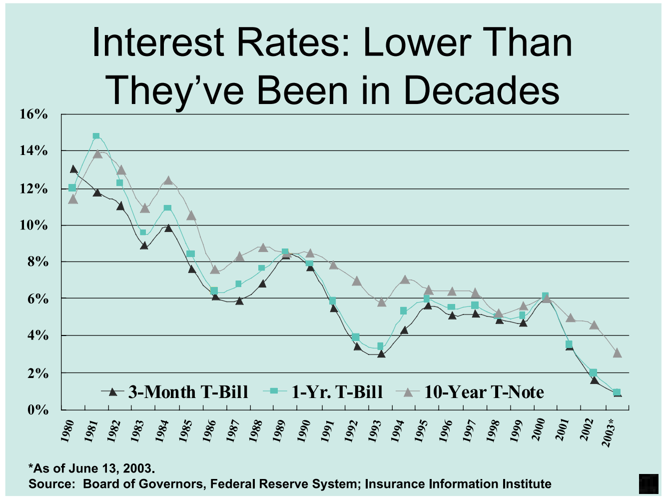
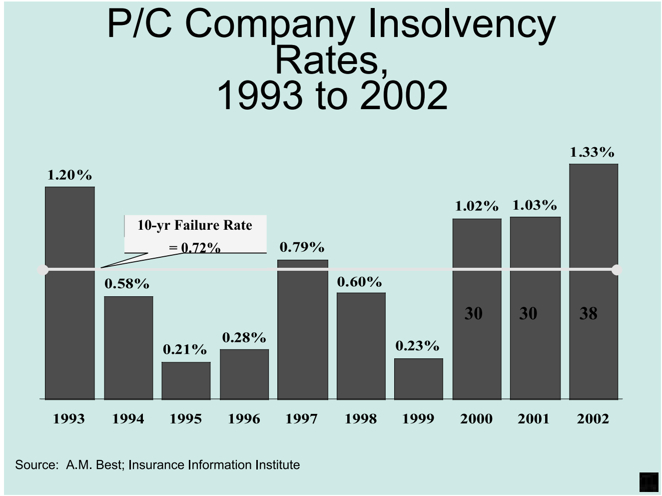



**Figure 13**




# Save the Date!

Plan now to attend the 60th Annual Meeting and Seminars **October 23-26, 2004,** in Los Angeles, CA.

Look for future issues of *UT* for more information about Underwriting Section-sponsored seminars.

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