

SilverStone Group

RISK MANAGEMENT

Risk Financing

Underwriting Feels the Pinch Economy Tightens its Belt

by Adrian Bento



“A billion here, a billion there...pretty soon it adds up to real money,” or so stated Senator Everett Dirksen in the 1960s. In these days of trillion-dollar federal budget deficits, we have become desensitized to the magnitude of millions or billions of dollars. But the reality is that for smaller institutions, a billion dollars still represents a significant amount of money.

A case in point is the insurance industry

For the past five years, this sector has experienced a substantial downward trend, which typically runs counter-cyclically to the swings in the broader economy. The root cause of this unusually prolonged and pervasive trend has been the large inflow of capital-seeking assets that might provide strong rates of return in what was an otherwise tough investment environment. Rapid capital expansion—22 percent in 2003, 13 percent in 2004, 8 percent in 2005, 14 percent in 2006 and 6 percent in 2007—led to an unseemly scramble for market share among most industry participants.

To meet the lofty premium growth targets and spur greater demand for individual products in what is essentially a zero-sum game, insurance carriers vied with each other to provide the most competitive terms. The intensity of the competition was made worse by the long and deep recession that began in 2008. In more normal economic times, the growth in Gross Domestic Product (GDP) is sufficient to meet the insurance industry’s demand for new premium. However, with the recent contraction in GDP, the aggregate premium dollars available to the industry have actually shrunk, reducing by 1 percent in 2007, 1.4 percent in 2008 and 3.6 percent in the first quarter of 2009.

Underwriting woes

The compounded effect of five years of decreasing rates means that underwriting results (losses and expenses divided by net premiums) have gone from 91.1 percent in the most profitable year to 105.1 percent for 2008. And, the word on the street is that these results were held in check by conjuring up some new and overly optimistic projections about the ultimate outcome of future payments on losses that have already occurred but are awaiting settlement. These rosy projections allow carriers to draw down on the reserves maintained on their balance sheets and mitigate the impact of losses from the current true underwriting year.

Draw-downs on reserves to mask deteriorating underwriting results are, at best, a short-term alternative to disciplined underwriting; at worst, they risk the future financial viability of the carrier.

The final insult to the carriers’ current tough predicament is the sad state of the financial markets. Insurers invest their reserves in a multitude of financial instruments and rely heavily on both yields and capital appreciation in order to bolster any deficiency in underwriting activities. However, the past eighteen months have proven to be nothing short of disastrous for investors.

Billions and billions...

For the insurance industry, this translates into realized losses of \$23.7 billion and unrealized losses of a further \$69.3 billion for the five quarters since the start of 2008. When this downturn to investment portfolios is added to the \$23.7 billion in pure underwriting losses sustained during the same period, the result is a significant erosion of the capital base (net worth) of the industry. Carriers had \$532 billion in surplus at the end of the third quarter of 2007. By the end of the first quarter of 2009, this surplus had dropped to \$437 billion, a reduction of some \$85 billion.

The capital that flowed into the industry over the last few years will likely begin to reverse itself if current economic conditions remain for any length of time. From an investor’s perspective, the 2008 return on equity for the industry was ten percentage points below the cost of capital.

When you add up all these factors, it becomes painfully obvious that the present underwriting trend is not sustainable. We are already beginning to see selective rate hardening in some classes of business—specifically, those that have sustained the greatest losses. This tendency is likely to become more pervasive in the next few months.