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Insurance Market Cycles: Insurers and Carriers looking to new manners[1]

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Abstract:

Much has been written about the insurance market conditions. This paper aims at understanding the reasons of insurance cycle and ways of stabilizing it. In this paper, author discusses the Trend of two main factors affecting the market: namely, underwriting results and investment returns and emphasizes on needs to adjust underwriters behaviors and relying more on analytical predictions and data mining in insurance industry. The paper argues that, the challenge for reinsures and insurers is to build, with each client, a comprehensive, mutual understanding of technical fundamentals of the reinsurance and insurance business.

Keywords: *insurance, reinsurance, soft and hard market, investment, underwriting, loss ratio.*

Introduction:

An overview of the Insurance Cycle

“Soft Market” and “Hard Market”, are terms that used to characterize the stages of the “Insurance Industry Underwriting Cycle”. The

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figure-1 shows net written premium (NWP) growth during the last 30 years. As the figure shows, during the period, we can see three Hard Market conditions, and remaining areas denotes Soft Market conditions.

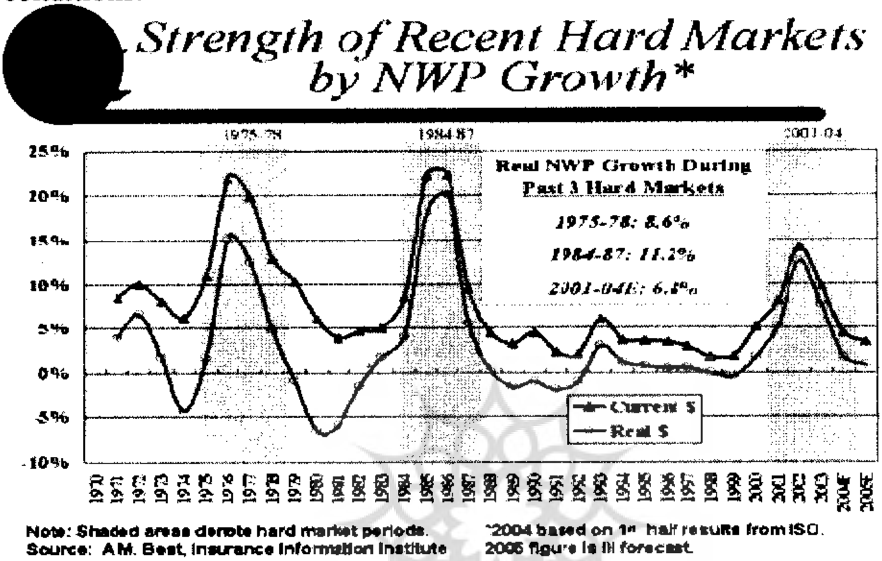

Figure-1

"Soft Market" is a term given to a condition in which insurance is relatively inexpensive and easy to obtain. Soft markets typically are marked by new entrants into the business, dropping prices, generous underwriting provisions, and aggressive discounting typically mark soft Markets. In a Soft Market underwriters are eager to write new business and to hold onto existing business and are likely to offer coverage improvement.

"Hard Market" is a condition of the insurance marketplace in which insurance is difficult to obtain and underwriters will often increase premiums and take back some of the coverage enhancements they provided during the Soft Market. Hard Market is when insurers are backing out of the market and market is characterized by shortage of capital and concerns about investment returns and reserve adequacy. A Hard Market is an effort for insurance and reinsurance companies to return to profitability, higher premiums and elimination of the policyholders that have had high losses, are the obvious actions under way.

Figure 2 and Figure 3 both refers to main reasons for the changes in market conditions.

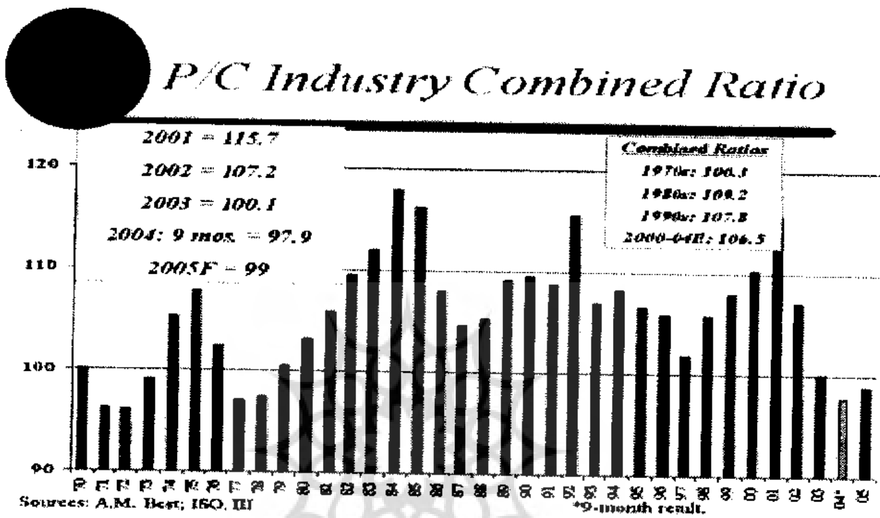

Figure-2

Figure 2 shows the property/casualty industry combined ratios and Figure 3 shows underwriting results (Gain and Loss) during last 30 years. A Soft Market starts when carriers recognize that they have improved their results, achieved their profit goals and know that if they write more volume, they should be able to make a higher return if they can hold their expenses reasonably constant, anticipate cost of claims and simply add more written premium to the equation.

What happens then is that pricing gets lower and companies do not make enough net income, thereby increasing the combined ratio to an unacceptable level. Some carriers may get concerned that if they do not cut prices even more, they will lose market share. The spiral continues until there is no more room to cut prices and the "Hard Market" starts.

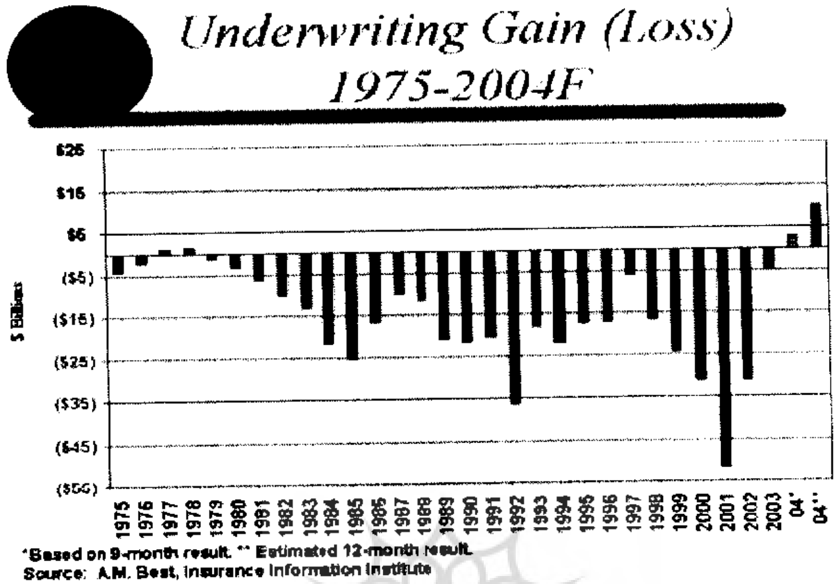

Figure-3

What happened during the 1990s Soft Market?

During the Soft Market, which lastly took place 1988 to 2001, many carriers were forced to constantly lower premiums and provide broader coverage enhancements. This aggressive underwriting, which took shape in the mid 90s reared its ugly head in 2003 and companies were in a better position to evaluate the losses due to the closing or maturing of claims that were filed during 1998 to 2000. For many carriers, loss ratios of 125% to 250% and more have been commonplace. These percentages are compared to a benchmark standard in the insurance industry equaling approximately 90% (including the company's operating cost).

During the long and severe Soft Market, rising insurance capacity and fierce price and market –share competition led to widely available coverage and low premium rates. Underwriting results declined in all major markets, birdjing the gap between deteriorating underwriting profitability and providing a small improvement to net income, investment returns worsened after 1999 as interest rates bottomed out and stock markets stalled, setting the stage for the hardening of the market.

Investment returns:
An important role

The key to insurers' profitability in the late 1990s was extraordinary investment performance. At the beginning of the decade, interest rates were high by historical standards but declined during the decade, producing capital gains. The equity markets with the exception of Japan, boomed. Investment income increased in importance to insurers, with net investment results rising from about 13-15% of net premium in 1995 to about 18-20% in 1999/2000. Strong investment performance fueled both excess capacity and aggressive pricing, a classic case of "cash-flow underwriting". In 2001, investment income contracted sharply in the major markets, reflecting low interest rates and the poor performance of the stock markets.

The accumulation of major losses (including September 11), and the decline of equity markets reduced the industry's capital base in all major markets. All losses by 2002 declined about US$ 180 billion or 25% from the peak of global non-life capital funds of US$ 700 billion reached at the end of the year 2000. Despite various capital- raising and capital- saving initiatives, the shareholder's equity of top insurers decreased on an overall basis.

New millennium: Downgrading!

The tight capital situation was reflected in the increasing number of downgrades of major insurers by rating agencies. In the US, the share of AAA- rated capital funds were declined to 19% in 2002, from 38% in 2000. The year 2001 was for many markets one of the worst years in insurance history. Profitability suffered due to a combination of weak investment results, inadequate rates, the need to strengthen reserves and unprecedented catastrophe losses.

The insurance cycle had begun to turn in 2000/2001, prior to september11. Commercial lines and reinsurance rate increases led the market, while personal lines lagged by one or two years. The catastrophic results of 2001, coupled with the fall in capacity, accelerated the price in- creases in the commercial- insurance and reinsurance market. Insurers raised rates for three years in a row beginning in 2001, thereby driving margins, and profits, up substantially. Figure-4 shows the monthly commercial insurance rate increases.

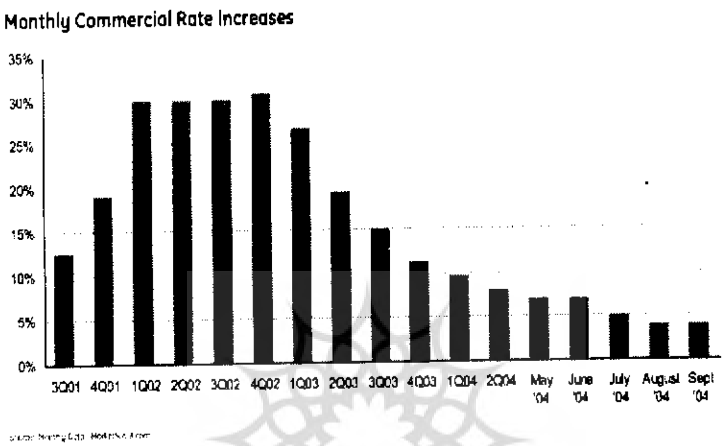

Figure-4

This newly profitable industry caught the attention of outside capital which wanted to jump in on the action.

Hard market again started:
This time underwriting reason

Much has been written during the last 5 years about the Hard Market and the reasons for it. Hard Markets can come from a variety of reasons. The Hard Market of 1985-87 was a capacity market. Results were so bad that companies literally had to shed accounts because they did not have "Policyholder's Surplus" to support the writing of any more business. With the increase in price that individual accounts were getting, carriers had to shed accounts to keep other accounts. This was really bad situation for certain insureds, especially those with "tail" exposures since these were the accounts that were cancelled first. The Hard Market of 2000-2004 was caused by underwriting. Accounts that did not have good loss ratios were cancelled or had incredible price increases, while profitable accounts received "healthy" price increases. There was no surplus problem so carriers could write as much business as they wanted. They were just extremely selective in what they wrote. Market begun to regain some of the ground lost during the Soft Market cycle of the late 1990s. Market rates for most lines of reinsurance moved towards technical profitability and in many cases reached sustainable levels, particularly in certain areas of property catastrophe and in aviation. However, competition, rather than profit, continued to drive underwriting decision making in some markets and lines.

Alternative market: New attention

During the Hard Market period the alternative market got new attention, as insurers take a closer look at their options in the face of reinsurance rates. This movement, in fact, is increasing the momentum of a trend that has been changing the risk– financing landscape for a number of years already. With hardening of the insurance market, alternative markets became even more attractive.

The Alternative Risk Transfer (ART) market has been profoundly affected by the hardening of the traditional market. During times of tight capital funds, there is a need for extra capacity and hence the ART products developed during this phase tend to make better use of insurance capacity. Examples of products that were developed to increase capacity include captives, finite insurance and catastrophe-related capital market solutions, or catastrophe bonds.

The Hard Market of early 1990s stimulated the demand for capital market insurance solutions as a substitute for CAT reinsurance. After starting of Soft Market reinsurance premium rates declined to levels so low that capital market insurance solutions were less competitively priced. With the hardening of the market in 2001 and 2002, demand for these instruments again improved.

The hard property-casualty (P/C) market of the years 2000-2003 brought triple-digit rate increases in some lines of coverage and capacity shortages in others, sparking the formation of captives. Captives are traditionally the children of a Hard Market. The last

Hard Market led to a great deal of increased interest in captive insurance. in particular, more insurers have focused on new risk-transfer mechanisms, increasingly looking to access the capital markets to expand their pool of reinsurance coverage. Also some insurers increased retentions to use their own capital more effectively as reinsurance rates were increasing.

Year 2004: Satisfactory results

During the year 2004 the world experienced a considerable increase in the number of natural catastrophes and the year was closed with "Asian tsunami". Despite previous year of extreme losses, the reinsurance industry managed to weather the storm in good shape. The major established markets have been able to repair their balance sheets and are again producing satisfactory results. Capital continues to be attracted to this profitable market. During 2004, S&P and other rating agencies revised their opinion of the reinsurance industry from a negative to stable outlook. The Hard Market made the carriers profitable again. It increased their desire to write more premiums, so the Soft Market started again.

New cycle of Soft Market:
Market share is the main concern

Despite concerns about price adequacy overall for liability business, reinsurers, old and newly formed, have mostly given up talk of price rises. The peak for this segment has probably now passed, although a full- scale softening is not in the current cards, especially because of losses incurred to insurers and reinsures from hurricane Katrina and hurricane Rita in US.

Each time when a Soft Market begins, management will always feel that they will not make the same mistakes that were made in the past. In theory, the change from Hard to Soft Markets is in a controlled fashion and some carriers can be extremely successful at the outset. The problem occurs when this phenomena takes on a life of its own and more and more carriers feel the same pressure to increase premium volume. Even with an expanding economy, the amount of risks and insureds is generally finite. Some carriers may get concerned that if they do not cut prices even more, they will lose market share. They will have to choose a strategy which finds a balance between sustaining market share and maintaining current levels of profitability, that is not easy subject. The worst that can happen to a reinsurer and it has actually happened to many, is the combination of bad underwriting results and bad investment returns.

Underwriters and carriers: Looking to new manners

The current Soft Market condition raises issues within insurance carriers, regarding discipline. Carriers are adjusting their evaluations of underwriting process in the current Soft Market and a strong desire is growing in them not to do a traditional response to Soft Market pressures. It means there is some signals that they do not want to fall back on the market-following behaviors that have taken place in previous Soft Markets. Ofcourse this does not seem to be good news for buyers.

Analytical predictions and focus on data mining to see what has happened in the past and using the data that is available for predicting what the loss ratio will be in the future , nowadays, is extremely valuable for carriers. Emphasizing on education and dedication to sound underwriting have important role to fostering success, even in Soft Market condition. Regardless of market conditions, underwriters need to maintain a strong basis for success, and a solid foundation of underwriting education will help build this success.

The challenge for reinsurers is to build with each client a comprehensive, mutual understanding of technical fundamentals of the reinsurance business. When terms and conditions are sufficient to provide insurers with affordable risk transfer and reinsurers' shareholders with a desireable return, the stability should return to the reinsurance environment, easing outrageous price fluctuations.

Conclusions:

Soft Market and Hard Market terms are used to characterize the stages of the insurance industry underwriting cycles. During the last 30 years there have been three Hard Market conditions. A Hard Market is an effort for insurance and reinsurance companies to return to profitability, higher premiums and elimination of policyholders that have had high losses are the obvious actions underway. A Soft

Market starts when carriers recognize that they have improved their results and achieved their profit goals so they try to write more business and cut the prices. Some carriers may get concerned that if they do not cut prices even more, they will lose market share.

As this paper shows, underwriting results and investment returns during the last 30 years played important role to drive insurance cycle. During the Hard Market condition, the Alternative Risk Transfer (ART) market gets more attention. So, hard market of early 1990s stimulated the demand for capital market insurance solutions as a substitute for catastrophe reinsurance and also, after the Soft Market of late 1990s, with hardening of the market in 2001 and 2002, demand for these instruments again improved.

As this paper analyzes, the current Soft Market condition raises issues within insurance carriers, regarding discipline. They are going to adjust their underwriting behavior and relying more on analytical predictions and data mining in insurance industry. In the short-term, the Soft Market condition is an attractive market for buyers and they enjoy it. But, sellers hope it ends soon. Everybody knows that Soft Market condition and continuing the price reduction and increasing loss ratio will drive the next Hard Market. In the long-term, everybody seeks for the insurance market's stability. The challenge for reinsures and insurers is to build with each client a comprehensive, mutual understanding of technical fundamentals of the reinsurance and insurance business.

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