# GIRO INSURANCE CONVENTION 2003

# CYNIC AND IDEALIST: TWO VIEWS OF THE INSURANCE CYCLE (and of the general insurance business)

## Martin White

ABSTRACT

Given the destruction of value achieved by so many insurers and reinsurers over recent years, how can leaders of companies convince investors they will manage through the cycle and make profits over the long term? This paper takes a deliberately simplistic look at the big questions facing general insurers in highly competitive markets.

A cynical view of the market is contrasted with that of an idealist. The cynic can see the problems clearly enough, but experience tells him things don't change much. The idealist can see a way of doing things differently, but thinks companies have to be courageous and operate very differently from their conventional peers if they are to avoid writing unprofitable business in soft markets and survive. He asks what behaviour he would like to see in a company, then devises a remuneration structure to encourage this behaviour. He also considers the messages necessary to convince the outside world that the company knows what it is doing.

This idealist's naive suggestions are difficult to put into practice, especially for an existing company. But if they do have any value, what part might the actuarial profession pay in developing them and persuading other market participants to give them a try?

KEYWORDS: insurance cycle; profit; shareholders; management incentives; underwriting management

CONTACT ADDRESS

M G White, B.Sc., F.I.A., Equitas Limited, 33 St Mary Axe, London, EC3A 8LL, UK
Tel: +44(0)20-7342-2883; Fax: +44(0)20-7342-2899;
e-mail; martin.g.white@equitas.co.uk

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**CONTENTS**

# 1.0 Introduction

This paper was written to accompany the work of the 2003 GIRO working party on the reserving cycle. It arose out of discussions at the working party meetings, and the comments and suggestions of the members of the working party have been valuable in the development of the paper.

Why does the underwriting cycle cause so much trouble, and how can companies manage through it? Our purpose is to explore some different views of the world and to ask whether companies could be run differently and if so how. None of the ideas are particularly original, and there is virtually no technical content. Readers can form their own views on the paper's technical merit.

The paper is organised as follows. After a brief introduction describing the status quo, we introduce two people, the cynic and the idealist. Both cynic and idealist have lived through at least one cycle in the commercial and international insurance markets. (This may limit the applicability of some of their arguments.) They start off in broad agreement on what currently happens and why. In particular they agree that whether a company can handle the cycle is almost the same question as whether an insurer can operate effectively at all. The cynic is not hopeful, whilst the idealist thinks he can see a way through. Past evidence seems to favour the cynic; it is up to the reader to judge whether to listen to the ravings of the idealist.

The cynic describes why the status quo is so entrenched, and why doing things differently is so difficult.

Then the idealist indulges in a highly simplistic vision of how things could be done differently, and develops this into a more detailed, but still simplistic, description of the main elements of the company's operation.

We then consider the merits of the idealist's ideas and ask whether, in practice, any of them could be implemented. And by whom - is it so difficult to change an existing large company that only a small company or even a new company could ever have a chance of implementing them? How do you keep the underwriters you want **and** run the company in

shareholders' long term interest? Is there anything the actuarial profession could do to persuade companies to do things differently? Is the best chance for change an education campaign for investors? Should the actuarial profession take this forward, and if so how? This paper doesn't pretend to answer these questions. There are plenty of issues for debate, and some time will be available for discussion in workshop sessions as well as in the short plenary session.

There is no complex actuarial analysis here. This paper is written for an actuaries' conference, but the subject matter is also aimed at a much wider audience including insurers and the investment community.

The most fundamental issues in managing insurance are not highly actuarial. They also apply to other industries. They include a realistic business model, having the governance to see it through and manage agency conflicts, correct incentives, etc. Insurance is perhaps special because things can go so spectacularly wrong.

The usual caveats apply. Male is intended to include female, and the views expressed in the paper are not necessarily those of the author's employers or even those of the author, of other members of the reserving cycle working party, nor of any other colleagues who have commented on the paper. Any comments you judge to be outrageous **may** have been included deliberately to provoke debate. It is important that the paper is not quoted out of context as representing any particular opinion. Finally, the author has used "we" throughout instead of "I", except for the acknowledgements at the end of the paper.

# 1.1 What is the status quo?

There are lots of good academic papers on economic cycles, and even on the insurance cycle. It is not our purpose to cover their ground. We want to stimulate debate about can / should be done and, for an actuarial audience, what the profession could be / should be doing in this area.

The economic cycle is a phenomenon that exists, to varying degrees, in almost all walks of life. Open and competitive insurance markets exhibit wide fluctuations in price over time, usually suffering significant losses at the trough of the cycle.

Markets for commercial risks tend to suffer wider swings in profitability than personal lines, due in large part to the greater uncertainty inherent in pricing and reserving for commercial lines.

In personal lines, there is an element of inertia, whereby customers do not all shop around at each renewal. This means that an insurer will anticipate more than one year's business with each new customer, and therefore will be prepared to follow the markets down to unprofitable levels in order to hold onto the prospect of future renewal profits after the market turns.

This kind of customer loyalty or inertia does not exist to the same degree in commercial lines. One would therefore think that the commercial cycle(s) would be less pronounced. However, in underwriter-driven markets, the personal interactions between brokers and underwriters appear to play an important part. The following two factors seem to have a more powerful effect than the possibly more logical "renewal inertia" driver in personal lines. First is fear of exclusion from new or renewal business. Second is the inherent uncertainty in expected loss costs, which works with a tendency to optimism (how often have you heard "*actuaries couldn't be underwriters - they are so cautious they wouldn't write anything*"?).

# 1.2 Need an insurer be a "victim" of the cycle?

This paper has a degree of London Market bias, reflecting the background of the author. It is possible that the open and highly competitive and international nature of the London Market, which makes it such an attractive place to buy insurance and reinsurance, also serves to reduce long term returns to capital providers and consequently to increase the level of cynicism. There are plenty of "victims" to point to.

And yet… We wouldn't be writing this paper if we believed the answer to this question was a definite "yes". There is evidence that a small minority of insurers is able to survive through, and perhaps even profit from, the cycle. These insurers, which include some Lloyd's syndicates, make small profits or possibly small losses in the bad years, followed by

large profits in the good years. One could argue that their profits are the result of naive competitors retiring hurt (or worse) after the bad years. New capital inevitably flows in after losses in anticipation of profits, but there is generally a period of good profits nevertheless.

# 1.3 Need investors suffer from the cycle?

Here perhaps we should be more pessimistic. Those entities that have shown they can manage through the cycle successfully seem to be the exceptions rather than the rule.

If we look at the London insurance and reinsurance market, which is arguably the most diverse in terms of the business written, the recent picture looks something like this. There were massive losses in the period 1989-1991 followed by recapitalisation, and profits in the period 1993-1995 followed by losses in 1997-2001. At the time of writing (2003) only part (half?) of the capital lost in the latest downturn has been replaced and rates are still profitable. Since investment markets are harsh (prices of equities well below peak levels, fixed interest yields low, inflation low) and many insurance and reinsurance companies around the world are suffering ratings downgrades, the lost capacity is only being replaced slowly. Profitable rates may therefore persist for longer than usual. On the other hand, there are suggestions that conditions are softening already, so optimists could soon be disappointed.

Over the last couple of cycles, investors in the international commercial insurance and reinsurance markets have generally lost huge amounts of money, with losses in the bad years outweighing the profits achieved in the good years. Why then do investors continue to bother?

There's no simple answer. Hope springs eternal… The management stories will include “this time's different”, “we've learned from our mistakes”, and “we're only writing for profit now”. But selecting managers who will carry out what they promise is not easy. Part of the problem may be that investors have unrealistic expectations, and managers may try to tell investors what they want to hear, rather than address the huge task of educating investors in what is possible.

# 2.0 Introducing the cynic: why is the status quo so entrenched?

In this section we explore the cynic's perspective. So this section is a presentation by the cynic. The cynic believes it's all inevitable; you can't do much about it. He admits there's a circular problem. Do you blame managers or shareholders? Or do you blame someone else? There does seem to be an element of everyone blaming everyone else.

We've already introduced the insurance pricing cycle. The fact that pricing cycles happen is no surprise, but the fact that the market cannot cope with them (witness the size of the pricing-driven losses) is quite remarkable.

In the paragraphs below, we will look at the position of each of the types of market participant, explaining why the cynic is so pessimistic about the potential for change. Sometimes it's the cynic speaking, other times the market participant, albeit usually one with a cynical perspective.

# 2.1 Broker

The insurance market is very competitive, and clients all know they can get brokers to bid for their business. So, whilst the broker in commercial markets will frequently advise on risk management and help design the insurance or reinsurance programme, he will be under instructions to get the best price within any security constraints imposed by the client. If this involves switching (re)insurer or leading (re)insurer in the case of the subscription market, a switch is likely to happen.

Broker: "It is difficult to blame the broker for the pricing cycle - it is up to underwriters what prices they are willing to accept."

Insurance brokers are close to the client, and owe their livelihoods more to the client than to the insurer. Control of the client relationship is an important source of value. The broker can wield considerable influence over the underwriter, who relies on the broker to bring him business. It is not surprising that, generalising admittedly, brokers tend to be more

profitable than insurers. They also have the advantage of requiring much less capital to operate.

# 2.2 Underwriter

Underwriters' decisions determine the cycle. So surely the solution is in their hands?

Underwriters have a very difficult task. They are expected to develop an expertise in certain types of risk, in which they specialise, and to develop relationships with brokers in order to be shown business. They go through a business planning process before the start of an underwriting year, in which targets will be set for premiums and profitability.

When presented a risk by the broker, whether a renewal or a new case, the lead underwriter will propose a price. The broker may than negotiate, if he has views what the rate should be. The broker may approach more than one potential lead underwriter. The broker will be under pressure to complete the risk at the lowest price, and will place pressure on underwriters to help him, but if he drives too hard a bargain, there may be difficulty placing 100% of the risk. Following underwriters have the choice of accepting and taking a share, rejecting the risk, or suggesting terms on which they **would** be prepared to participate. A lead underwriter has a difficult juggling act: too low a price and he will both lose followers and lose money; too high a price and he won't see many risks.

But when market conditions don't turn out to be as expected in the plan, there is not much the underwriter can do about it. It's easy when conditions are better than expected, but when the converse applies what options does he have? His role is essentially passive. (Remember, this is the cynic speaking.)

The underwriter is usually given a target premium to write. He may have had to consider overheads in putting together the business plan and may feel under pressure to "cover the overheads". He may have arranged a reinsurance programme in advance with minimum and deposit premiums, which will go "wasted" if he doesn't write a certain amount of gross premium.

Then there is the uncertainty over the expected losses from any risk that may be written. Where the margin between profit and loss may be tight, of the order of 10% on the premium rate, it is easy for judgement to be swayed on what is the right rate for a risk, thus pushing the business into expected loss. Is it reasonable to give much credibility, say, to the unusually high losses experienced on a risk three or four years ago?

From the underwriter's perspective, it is important not to understate the power of the broker.

# 2.3 Senior management

Senior managers and leaders of most companies will generally have quite different motivation from the shareholders. They may be more interested in achieving results quickly than in making a safe return for the shareholders over the longer term. And the City expects steadily rising profits and dividends, not nasty shocks.

"Since the managers who were responsible for the last mess have now gone, it is clearly sensible for us as the current managers to sit down and work out how to do it differently. Better underwriting must be the solution. Avoid the bad risks and all will be well. But we want to start off with a clean slate, so it would be best to take the hit on all the past years of under-reserving. Perhaps a financial reinsurance would be a good way of stopping past years from ruining the future years for us.

Of course, in the end there's always a chance that the tail may come and hit us. But we've probably got 5 or 6 years of good results ahead; our share options mostly mature before then and we'll have done a really good job for the shareholders in the meantime.

Now we have to be realistic. Certain lines will be bad from time to time, and won't be able to meet their share of the overheads. So we'll have to move staff around, and possibly cut some staff when their lines of business don't look promising. This will help credibility with shareholders, particularly if we take corrective action before our competitors. We've got to be straight with staff about this, and in return, we'll have a generous cash bonus scheme for senior and middle management when we declare good profits."

Now will this attitude encourage staff loyalty? The prize is to secure a senior position if you can, make your money and move on. Are not most staff right to be cynical?

# 2.4 Investor (investment community)

## 2.4.1 Fund manager's perspective

"In managing the portfolios for our clients, we have to consider the specific benchmarks we have been set and will be judged against. We cannot afford to depart far from the benchmark because we are penalised more heavily for under-performance than we are rewarded for out-performance. And we can't afford too much short term under-performance or we are kicked out. We can of course go slightly under/overweight in insurance stocks - great gains can be made in insurance when the market turns, but you have to get in and out early.

We are not a very large shareholder in any one insurance company, and we don't make any special effort to talk to the management. You can never find out what's really happening anyway. We don't like insurance much as a long term investment - the performance has been poor over the years - and we value highly the ability to buy and sell whenever we want, so we must make sure we don't have any inside information. We may vote our stock, but we usually don't bother - although it looks as if we may have to change this policy in response to the corporate governance movement. We'll have to outsource the voting of all our stocks to a corporate governance service - our cost base won't permit anything pro-active.

If other "relationship" investors[1] were to get involved with one or two insurance companies in order to improve their long term performance, we'd probably increase our weightings to those specific companies without changing our weight in insurance as a whole.

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[1] A few pension fund managers, for example, will seek large holdings in target companies and play some part in the governance of those companies. Such managers exist in both the US and the UK.

We do have some in-house research capacity, but rely heavily currently on broker research. We don't think much of the quality of investment research into insurance companies. As well as companies not being forthcoming, it's a huge amount of work to understand an insurer's financial position, for general business as well as life. We're more happy we can understand personal lines companies but there aren't any really large quoted personal lines specialists – one interesting company is a subsidiary of a bank. Understanding reinsurers and commercial lines companies is a nightmare."

### 2.4.2 Trustee's view

"We employ a number of investment managers for the pension fund, and we are guided in investment manager selection by XYZ consultants. We employ a mix of managers with different specialisations and mandates, and our funds hold insurers in two ways. First is through the tracker fund, and second is through our managed Equity portfolio. We take our responsibilities seriously, and change investment managers when they don't perform."

### 2.4.3 Investment analyst's view

"The investment manager said most of it above. A very important part of our job, in that it generates trades and therefore commissions, is to advise hour by hour on the impact of news as it develops. Insurance shares can move up and down sharply, and most people do regard them as trading opportunities rather than long term investments.

It's difficult to get decent information, and even then it's difficult to justify the analysis required to judge a company's prospects. Also, good prospects can be thrown away so easily if the managers go astray, which generally happens if ever they decide to go for growth."

### 2.4.4 Private investor's view

Private investors who hold stocks directly will be either active or passive. Many investors will have held individual stocks for years, and sometimes will have inherited them. To them insurers may have been worth holding for earlier generations, but perhaps it wasn't so sensible to hold them in

more recent years. The active investor thinks very much like the investment analyst - can't understand what's going on in insurers, don't trust the management, worth a punt now and then after a crash.

# 2.5 Insurance buyer (customer)

“We keep our insurance broker on his toes. We find he gives us a good service and is able to shop around for the best price for us. He also advises on risk management, some of which we pay a fee for, and on the insurance we need to buy. Our objective is, first and foremost, to protect the company from events we can't control and which could kill the company, such as a major fire, or a flood in our below-sea level factory. We find it frustrating that, even with the efforts of our broker, premium levels vary so much from year to year, and we can't always get precisely the same cover year after year. We won't waste money - if we can afford to take small risks we may choose not to insure them, especially if the rates look high. Sometimes insurers throw in additional cover for almost nothing, though, and we take advantage when we think it's a really good deal. We're becoming increasingly concerned about the security of some insurers, so we ask our broker to advise on how to manage that problem.”

# 2.6 Regulator

“The regulator's main job is protecting insurance buyers from companies who can't deliver on their promises. Security and solvency are therefore our main concerns. If the company's assets are sufficient we allow them to trade, and if not we close them down. It's not quite as simple as that, of course, but those are the basic principles we apply. Companies have to raise more capital from time to time in response to pressure from us, but we don't broadcast our discussions with individual companies.

We've become increasingly clever in defining the responsibilities of insurance companies to conduct risk management exercises, and think that the improved management information must have the impact of reducing the severity of the peaks and troughs of the insurance cycle. This is a new initiative. It will be a number of years before we can judge its impact, and even then we will only be able to guess.”

The cynic reluctantly accepts that the regulators may be doing some good – providing they don't drive business away entirely, of course.

## 2.7 Tax authorities

"We are concerned that companies don't hide their profits, and pay tax on them at the proper time. If a company makes a massive loss, we only allow them a limited amount of carry-back; our job is to raise revenue and we can't afford the risk of a large payment from the exchequer back to taxpayers. We do allow carry-forward of losses, but that doesn't risk a payment back from the exchequer."

## 2.8 Actuary - consulting

An outsider can't get enough detail to see what is really going on. He may be influenced by the spin of the managers and underwriters. He doesn't want to upset clients and damage future fee earnings, so allows "lower end of the range" estimates in a soft market. Finally, being away from the action, he is reliant on what happened in the past, not what is going on now.

## 2.9 Actuary - employed

The employed actuary is under too much pressure to release reserves when things look tricky. He won't see much of underwriters when rates are soft, as they do not want management to know how bad the rates really are. He is also likely to be subject to the same mis-aligned incentives as the rest of management.

## 2.10 Development of the status quo - what is happening re each of the above?

As ever, we are hearing "this time's different". Are things really changing, or is this just another stage in the working through of the cycle? There is a suggestion that the regulators can change the climate considerably. Some of the most heavily regulated markets have been the most profitable. However, the trend world-wide is for more open

markets; perhaps internationally the cycle will become more pronounced and financially damaging for insurers!

## 2.11 Cynic's summing-up

The insurance business is easy to get into. It is even easier for existing insurers and reinsurers to increase their volumes if demand increases. Insurance is one of very few types of business where the product is sold well in advance of delivery and where the cost of delivery is highly uncertain.

All of this indicates that prices can fluctuate widely, with individual insurers unable to do much to influence price levels. That implies enormous discipline is needed by each insurer to avoid writing loss-making business, even if this exposes the fact that the overheads still have to be paid.

But do we see any discipline? Maybe a little after big losses. But then memories fade quickly. Capital comes in, and there are attractive jobs available for those who make the right promises.

And then the conflicts start working through. We've heard about the mindsets of all of the key players. What the senior management really want is the chance to become rich. Much richer than they could become from their salaries. The answer: share options or something similar. And these are granted, on the argument that “it's OK for the shareholders to share their good fortune in good times, and share options don't cost anything in the bad times”. Share options are so universal that everybody asks for them and you can't get good people without them.

The investors want to hear good news. Why? Because it boosts the share price. And share price is what it's all about.

The managers' interests aren't so different. They need a high share price if they are to make their millions on their share options. Remember Independent Insurance; “Nothing is more important than the share price”.

So everybody goes on deluding themselves until it all ends in tears. Never mind - another group of lucky managers has made fortunes in the meantime. They can afford to retire and forget about insurance.

Do investors lose? Generally they do. Some can make money through buying and selling at the right times but they must, by definition, be dwarfed by the losers. In theory, of course, investors could take control and make managers do things differently. But there's a host of reasons why this doesn't happen:

- If one (big) investor were to put in the necessary effort and commitment, then all of the other investors in the company would get a free ride.

- The investor becomes an “insider” and can no longer trade in and out of the shares. If disaster strikes he won't have the option of bailing out quickly.

- To get in and out quickly you can't have too much of a stock, or the market will move against you as you trade. This is another incentive not to become big enough to want, or be able, to exert real influence on a company.

- The existing managers in the industry don't think in the right way, and staff frequently have more loyalty to “the market” than to the company employing them at the time.

- The institutional framework, the entrenched attitudes within the insurance market, the lack of effective role models; all these reduce the chances of doing anything.

- Armed with this understanding, what will the intelligent investor do? He won't get closely involved with any companies. But he will look for opportunities to profit from stupid share prices, which occur from time to time, and will avoid regarding insurers as worth holding for long periods. That's for mugs.

Last but not least, we should consider the employees as a whole, as we haven't heard much about them for a while. There's apparently a permanent skill shortage so there's a career in insurance for those with the

right education and skills. That seems to be the case whether the industry as a whole makes money over time or not. The prospects for less skilled employees seem less good. Processes are constantly being streamlined, and overseas outsourcing is beginning to make a difference. That's a feature of the wider economy, though.

Should individual employees have much loyalty to the employer? Maybe some, but the cynic doesn't recommend too much. Whatever companies say, they'll cut staff sharply when they consolidate, or if they decide to cut a line of business. So opportunities to progress in terms of skills and experience should be taken, particularly if the current employer has kamikaze tendencies when the cycle turns down.

# 3.0 Introducing the idealist

The cynic's viewpoint should be captured in the material above. This section is a presentation by the idealist of his alternative vision.

The idealist believes it is possible to run an insurance company profitably, taking advantage of the cycle. He believes it is possible within a company to overcome the (entrenched) attitudes described above and to change the culture so that it is supportive of the “right” behavioural responses to changing degrees of price competition from competitors. (He may, sadly, be too good for this world.) To support his claim for at least some sanity, he does argue that the cycle won't go away and that all you can do is learn to live with it.

# 3.1 The idealist's views in summary

This section is written from the idealist's viewpoint. In summary, however, the idealist's main ideas are as follows:

- It is possible for a company to manage through, even profit from, the cycle.
- To achieve this, major changes are needed to incentives and philosophy throughout a company.
- These changes only happen if management gives the right message in actions and words, as seen from both inside and outside the company.
- Management with this vision and sufficient confidence to communicate it in public can easily convince the shareholders to support them - if there are any such managers already in place.
- But the vision requires managers not to be greedy. Change may have to be led by the shareholders.
- What hope is there that shareholders will drive the necessary change? Without education of shareholders, or leadership by a few highly influential shareholders, the hope is a forlorn one. But it's not impossible.
- Here is a good opportunity for the actuarial profession to make a difference and capitalise on our experience built up over the last few years
- The message involves unpalatable lessons for some and is therefore controversial - will we have the courage to be controversial?

We have all seen this kind of waffle in magazines. Where's the detail?

# 3.2 Getting the incentives right

The current typical remuneration structure within a London Market insurance operation (whether within or outside Lloyd's) is basic salary

plus bonus plus, possibly, share options or similar. Bonuses are small or zero when profits are low or negative, and high when large profits are declared.

Bonuses and share options, whilst well-meaning, do not necessarily encourage what we would call the "right" behaviour throughout the organisation, something we will discuss in detail below.

Just as important a question for many employees is "What **behaviour** do we need to adopt firstly to keep our jobs and secondly to advance in them?" There is nothing wrong in this, but the organisation needs to signal clearly what behaviour it wants. We now need a diversion to decide what behaviour we want.

# 3.3 What behaviour and why?

Let's look at an "ideal" underwriting organisation, see what commercial actions it takes and deduce the actions of the individuals within it, their capabilities and their motivations.

## 3.3.1 Lines of business (what markets are we / do we want to be in?)

The lines of business this company writes / specialises in are all judged to permit profits after expenses over the underwriting cycle (using a strategy of almost total withdrawal when the business is loss making on a risk-adjusted basis) and are within the expertise of the underwriting team.

## 3.3.2 Risk control

The company keeps a continual watch on its accumulated exposures. It does not write occurrence liability business unless the assureds agree to a single limit over time. Worst case liability exposures are watched just as carefully as property catastrophe exposures. The exposure questions (Do we understand it? Is the total downside to the whole company still acceptable after writing this risk?) have to be answered satisfactorily before the price is considered.

## 3.3.3 Pricing decisions

An individual piece of business is only written when there is an expected marginal profit of a set minimum amount, and where it is also sufficient to justify the incremental impact on the company's downside risk. It is vital that the underwriters can make their own judgement of the expected loss from a risk and record their judgement at the time of writing. This absolute rate adequacy approach contrasts with underwriting using relative adequacy only.

### 3.3.4 Line size and reinsurance

The line size should be meaningful in the markets in which the company specialises. Lines will be bigger than those of competitors with similar capital, subject to acceptability with the client / broker. In general, the company prefers fewer, larger risks. Reinsurance will generally not be purchased, except when required to protect the capital base against large loss events which would impair the company's financial strength. Financial strength of reinsurers will be viewed pessimistically, since large reinsurance claims are most likely to be made when the industry as a whole is in some difficulties. Going back to shareholders from a position of weakness is something the management and shareholders both wish to avoid at all costs.

This attitude to reinsurance means that the idealist's ideal company is relatively large; it's certainly not a small player. (How large does an insurer have to be to be able to follow the idealist's lonely route?)

### 3.3.5 Attitude to volatile results

The company is unconcerned at volatile results in terms of profit and loss account. This sets it apart from most of its competitors. Tax losses so large that they would not be fully relieved against available current profits and available loss carry-back would be distinctly annoying but no more. Losses from bad claims experience are acceptable, as are loses arising from overheads when insufficient profitable business was written to absorb them. Losses from insufficient premiums are not acceptable. Losses from volatile investment returns are not a major concern, providing that the investment strategy does not risk the high solvency margins the company wishes to maintain.

### 3.3.6 Reserving decisions

These are very simple. Cautious and consistent over time. No pressure to smooth earnings. Reserve deficiencies are to be avoided if at all possible. Reserve surpluses are OK. Since not all earnings are distributed, thin reserving helps only the taxman.

### 3.3.7 Communications to shareholders

This is the feature which, from the perspective of the outside world, most distinguishes the company from its peers. The company's philosophy is fully communicated to shareholders, who in consequence are prepared to regard the company as a “buy and hold” investment, rather than a gambling chip to be bought and sold in response to the insurance cycle and to the mistakes of other investors. Among the shareholders are a small number of large investors who are represented on the board, and who ensure the company stays on the straight and narrow as regards executive and staff remuneration.

There is no pressure to write for premium, and no expectations regarding growth. The company takes advantage of opportunities as they arise - which is expected to achieve growth in the long term, but in a sporadic and unpredictable manner. The shareholders do not call for a high distribution policy, but expect low and reasonably sustainable dividends. On the other hand, they do not expect the company to need to raise capital from time to time, but to grow the capital base from retained earnings and to maintain sufficient financial strength to permit sharp increases in writings when market conditions permit.

The shareholders do not expect profits each year. They recognise that there can be times when the overheads are largely uncovered, and also that insurance losses can vary sharply, and that a large underwriting loss is always possible. They do expect the company to keep them informed about market conditions, volumes of writings, and impact of disaster scenarios, etc.

### 3.3.8 Communications to brokers and customers

The company has real expertise in the lines in which it specialises, and has low turnover with high quality people who are comfortable with the

company's ethos. It is able to offer service at least as good as its competitors. Brokers and customers understand that the company will on no account write at below expected cost, even after a period of high profits. There is no “payback”. If a client wants continuity through a very soft market, it will have to pay above the market rate, but multi-year deals are available occasionally. On the other hand, when there is a hard market, the company will charge existing customers less than its competitors, which tends to encourage customer loyalty. In time a close working relationship has been built up with the larger and more loyal customers.

Though discussions with rating agencies do take up management time, once they have understood the company’s attitude to volatile results, the agencies are generally supportive, and this helps relations with both brokers and customers.

There is one aspect which potential customers frequently have problems with. It derives from the company's strong aversion to exposing itself to a future liability catastrophe. Whilst tolerant of highly volatile results, the shareholders insist on an extremely low risk of ruin. The company will therefore not accept the accumulation of occurrence limits in lines such as product liability, and either will not write certain risks at all or imposes rolling limits of liability. For example a client buying product liability cover of £100m in one year will, on renewal, be given cover of £100m inclusive of any losses arising on the previous year. On conventional policies, the maximum payout would be £100m for EACH year.

This of course means that a client will value its first year of coverage more highly than the renewal years and a lower premium will be charged on renewal. For some clients, this is attractive, and leads to good persistency. It also means that the decision to offer cover for the first time to a new assured is a big one, which will be carefully underwritten and also that the assured's risk management and safety procedures have to be continually monitored. The cost associated with this means that the company will not write this business for small clients, only large ones. As well as underwriting and risk management costs, there are material legal costs incurred in keeping the policies as well proofed as possible against courts rewriting and reinterpreting policy conditions.

### 3.3.9 Long term business strategy

This has largely been set out in the paragraphs above. The lines of business chosen will be a function of underwriting expertise, but investing in, developing and maintaining underwriting expertise and market knowledge will be a core strategy. The risk of loss of key staff is always present in the insurance business. Remuneration structures will be designed to mitigate this (see later); as will a policy of ensuring that no individual becomes completely "key" in any area.

In some ways the business strategy is "not to lose money and to keep our capital intact". But as far as clients are concerned the strategy is to offer insurance cover, with good associated service and advice (to the extent relevant in the lines concerned) at fair but not low prices, and to reward long term clients by not hitting them unduly when the insurance cycle peaks.

Unlike most insurers there is no fear of loss of market share. If underwriters are not reasonably confident that a risk is priced to make an expected profit, they are not permitted to write it. There is a good budget to entertain brokers, etc during soft markets.

In conventional insurers, underwriters fear losing their jobs if they are not writing risks. In this case underwriters lose their jobs if they cannot demonstrate why they expected risks written to make a profit, and frequent review meetings are held to ensure this.

Underwriters are required to be flexible enough to carry out research and development when markets are soft. If they have the necessary skills, they need not fear loss of their jobs whenever the company decides to exit a line of business. A number of underwriters are actuaries. Lines of business are only exited when they are not believed to offer profits across the cycle, even allowing for withdrawal in the bad years. This decision will take into account line sizes available, expenses, the extent to which the type of business exposes capital across the cycle, and investment of management time.

### 3.3.10 Pricing strategy

Whilst there is a clear and inflexible policy to reject risks which are below a minimum target price, the company is not too greedy. Part of the deal with the insureds and brokers is that when market rates are very high the company will not impose the full increases on existing clients. The company is aggressive in chasing new business in these situations, however, preferring a large line at below the market price to a smaller line at the market price.

Where the company participates in a risk as a co-insurer, there is obviously less flexibility to offer different terms – you are either on the slip or not. Over time, however, the company as leader has attracted a number of followers who are prepared, for example, to renew slips in strong markets at below current market rates.

### 3.3.11 Core capabilities and unique features (these are most valuable if difficult to replicate)

The most important features of the company will be its focus on profitable business only, its structure, its technical ability to carry out its objectives, its relative resilience to potential staff defections and the support of the shareholders. From an investor's perspective, the company needs to reassure them that its culture is such that it will not change its character in future years.

(Actuarial interest in this field to date has focused on risk analysis and pricing – what a rate "should" be as opposed to what price is obtainable in the market. This is a developing area. But for us to really add value, the company must want to know.)

## 3.4 Incentives to achieve the above

The most important incentive for management and staff to work effectively to the right objectives is a clear understanding of and belief in those objectives throughout the organisation. This is somewhat circular, somewhat wet, and doesn't get us far. And it's not good enough unless the financial incentives point the right way too. Not everyone responds to financial incentives but many do, and the wrong incentives are fatal.

The company's and shareholders' objectives are set out above. We'll summarise the key points before describing the incentives designed to serve them.

- Long term wealth creation, not too concerned about any one year's profits
- Control of downside / exposure control
- Don't write under-priced risks
- No under-reserving; admit problems as soon as they become apparent
- Retention of staff
- Build underwriting and other relevant capabilities

Overall levels of incentive may not be completely proportional to profit, particularly if the amount of capital employed per employee is very large. Otherwise there would be an incentive for employees, particularly those without large equity holdings, to go for growth.

# 3.5 Management incentives

Overall ethos is get rich slowly.

No share options.

Basic salary nothing special. The right people will be attracted by the ethos of the company. Not everyone, of course, but at least the wrong people should be discouraged. Overall earnings should be good, however, if the company is successful.

Cash bonuses, half of which have to be used to purchase shares in the company in the open market. (If the company is not quoted, we have a tricky problem to solve. The shareholders are not prepared to have their holdings diluted.) The shares bought in this way each year to be held in trust and released to the employee five years after leaving the company (or say 10 years after date of grant, whichever is earlier), dividends to be

paid to the employee in full and not held within the trust. New shares will not be issued to anyone.

A share in underwriting profits (which must exclude investment return on shareholders' capital) will be paid on a deferred basis.

Shares of underwriting profit will not be paid immediately, but will be held in a pool contingent on subsequent results. The pool will be dribbled out over time. The operation of the pool is complex. A bad year could wipe out the pool. The pool can go negative; if so, interest will be added. Employees who leave lose some of their entitlement, but not all, to payouts from the pool. If there is a massive loss just after they go, their payments are wiped out anyway, as are everyone else's. Run-off reserving losses are heavily penalised, but not initial losses. Initial results for the purposes of the pool are cut two years (say) after the end of each underwriting year. If, say, the pool gets 5% of underwriting profits it could get more than 5%, and increasing each year, of reserve deficiencies emerging in subsequent years. There is consequently no pressure to under-reserve.

# 3.6 Underwriter / team incentives

As management, but proportion of cash bonus / underwriting profit share will vary.

Team includes whole company.

# 3.7 Undesirable, or counter-productive incentives

Any incentive that runs counter to the shareholders' determination not to lose money in the long term will not be permitted. Most damaging of all are share options, which encourage managers to try to manipulate share prices by distorting earnings and misleading shareholders and themselves. The knowledge that future cash bonuses will be used (to different degrees, depending on the seniority of the employee) to buy shares in the market will encourage managers to try to ensure a fair price in the company's shares, not an unreasonably high price. Such managers might

be tempted to try to suppress the price in the short term – unlikely perhaps, but no system is perfect.

Any incentive to suppress bad news should be avoided.

# 3.8 Pressures on reserving

We need incentives to defer release of profits and accelerate recognition of losses. The remuneration structure does this.

# 3.9 Tactical toolkit (being able to implement the strategy)

All of this only works if the right people are employed. Sufficient insurance experience is clearly required, but more important when selecting staff are their abilities, their potential, and their enthusiasm for the company's ethos. People who regard their career as being "in he market" and who are not passionately involved in the success of the company can work elsewhere. High basic salaries will not be necessary to attract suitable staff. (So says the idealist, anyway.)

Underwriters frequently have extremely high salaries and egos to match, and would not take kindly to deferral of earnings. Finding individuals to train as underwriters who do not have typical market expectations and who are prepared to operate as team members is one of the most difficult challenges facing the company.

The other aspect of the tactical toolkit is having infrastructure and systems that are efficient and, at the least, do not give the company a cost disadvantage.

# 3.10 Implications for capital requirements / cost of capital

If the shareholders had a required rate of return there would be a problem, because there would be pressure to achieve a certain underwriting result. Shareholders in the company will ideally be those who are prepared to

invest in something different, and to be patient. So “cost of capital” is not an issue. A charge for risk will, however, be part of the pricing methodology.

The amount of shareholder capital will have to be comfortably in excess of the minimum regarded as viable in the market and will also need to be able to bear the company's annual expenses in the absence of premiums. Consistent with its long term philosophy, the company's structure will be designed to minimise the tax cost to the shareholders of keeping capital in the company; this may require establishment of the main holding company outside the EU. In particular, the company will wish to avoid, as far a possible, paying tax on unrealised capital gains.

A vital element in the company's success is keeping the investors happy and patient, particularly as much of the capital may be seen for much of the cycle as “just sitting there doing nothing”. This requires frequent and clear communication and is an important drain on senior management.

“Agency costs” is a term occasionally used to describe the impact on investors of having to trust managers to look after their wealth for them, in recognition of the conflicts of interest between managers and shareholders. The governance and remuneration structure of the company is designed to minimise these costs.

# 4.0 Discussion: can the different positions be reconciled?

Now that the cynic has had his say, and the idealist has stopped raving, we should consider what merits there are in their arguments. The idealist’s suggestions sound good in theory, if a little dull (get rich slowly), but can they be put into practice? Surely, if it were easy there would be more than a handful of really successful insurance companies?

The cynic, it will be remembered, has explanations for why things are the way they are - and therefore how each player can make the best of the situation. His advice would lead to little change. He seems happy with his investments in brokers, but can't be bothered with insurers.

The big contrast is that the idealist can see a way in which things could be different, and believes in this vision. The major disagreement between the two is whether change is possible, and whether it is worth trying. It's more about practical politics than about the technical merit of the argument.

It's now time to set out a number of questions. We give some thoughts on some of them, but the idea is to stimulate a discussion. In order to focus our discussion on **how** to manage an insurer through the cycles, we are keen **not** to focus on **why** the cycles occur.

- Whilst we believe there are truths in all of the points made by both cynic and idealist, which points have they either got wildly wrong, or missed?

- Where in your experience are companies today along the cynic / idealist line? We believe some are striving towards the ideal and have bought the principles, but that they are the exceptions.

- Where is the actuarial profession along the cynic / idealist line? Are we out of touch with our clients? Should we be trying to influence them?

- **Assuming there is a will among the senior management,** what are the practical problems of implementing the idealist's vision at existing companies. Can a company change direction given the existing management's remuneration packages? Do these ideas represent too much of a challenge to the way of thinking of seasoned insurance people?

- Once an underwriter has established himself as successful, will he be prepared to continue to "get rich slowly"? And on what terms? Is underwriting such a scarce skill that the bulk of the added value goes to employees rather than to external shareholders?

- How relevant is this analysis to dfferent types of insurer in different types of market? Our London Market focus is surely part of the pessimism, since London has done worse than average in the most recent years. Its great success is attracting capital after losses.

- Can a small insurer change direction more easily?
- How essential is the idealist's attitude to reliance on reinsurance? Can we point to a few Lloyd's following underwriters as examples of insurers who have effective strategies for handling the cycle? Are such insurers too small to represent meaningful opportunities for the investor / fund manager?
- The cynic has suggested some ideas for managing, or at least mitigating the risk of liability catastrophes. What do you think of these? Is some sort of strategy needed to attack this problem? Do you have any further ideas or improvements to suggest?
- The idealist suggests that investors should keep well clear of insurers unless there is a clear identity of interest with management, such that managers are shareholders and do not hold options. Is this sensible advice?
- What advice would we, as actuaries, give fund managers about investing in (general) insurers? Would we use some of the idealist's suggestions?
- What advice would we give to boards of insurers conducting a strategic review of their business in wholesale markets such as London. What opportunities do we get to give such advice in the first place?
- Should we be putting a message out to investment analysts, and if so what?
- Is this an area in which the profession should be pro-active, or would this be naïve, simplistic, dangerous, or all of these?

# 4.1 Some concluding thoughts

We all know about the cycle - there's lots of good analysis about it, but perhaps less about what to do about it.

The typical “state of the market” article looks at past results, at today's position, and then concludes “premium levels need to rise by x% for the market to return to satisfactory profitability”. Whilst the analysis, and its educational content, may be excellent it doesn't really get us anywhere as it is unlikely to be the trigger leading to corrective action.

Many market speeches boil down to “please can everyone else raise their prices because we'd like higher prices and preferably a higher share too.”

In this paper we suggest that companies and investors should at least consider a radical approach to managing through the underwriting cycle, If companies are not afraid of volatility or of losing business, they can settle down to focus on making profits on an expected basis.

One fairly easy suggestion is that it could do no harm to get remuneration better aligned with long term shareholder objectives. How to achieve this is a major challenge. A linked issue is how investment managers are remunerated, and there is plenty of room for radical suggestions in this area[2].

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[2] This was one of the issues discussed in the 1994 GIRO paper “Making money for shareholders” – see references. This paper suggested that part of the problem should be laid at the profession’s door as we influence the typical mandates given to fund managers.

# References and acknowledgements

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Martin White, September 2003