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Insurance Convention

MAKING MONEY FOR SHAREHOLDERS

Workshop paper for GISG 1994

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This paper is intended to stimulate discussion. Accordingly, the views expressed in it do not necessarily represent the views of the contributors' employers or of any particular contributor.

> Insurance is a wonderful business to invest in. You put in some capital and get the investment return on that. As well as any profits from underwriting, you get the investment income on the premiums. All you have to do is keep the overheads low and be careful what you write.
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> Insurance is an awful business for the shareholders. Every now and then the directors come to us saying they have learned their lesson, and could they please have some more money. They then proceed to pay part of it back in dividends (on which we pay tax) and lose the rest. This is known as the cycle. We peddle insurance, but get nowhere.

Introduction

This paper resulted from a suggestion that there were some lessons to be learned from the financial performance over nearly 30 years of the US insurance and investment company Berkshire Hathaway. To form the basis of a useful workshop discussion, we have attempted to cover the subject more fully than just one success story. We intentionally take a simplified, even naive, view.

Is insurance worth investing long term money in and, if so, in what circumstances?

Making money for shareholders is the same thing as maximising shareholder value, the present value of the expected future cash flows that could be paid to shareholders. A paper on shareholder value analysis (SVA) was presented to GISG in 1992 by Field and Lomax. It is worth reading, and we find ourselves repeating some of the themes of that paper. These themes make good common sense even without any reference to financial theory, measures of risk, or betas. Here are some of their conclusions.

- It is easier to destroy shareholder value than to create it.
- Your performance measures are [usually not helpful].
- You can make money out of the cycle.
- Actuaries must participate fully in the value creation process. Actuarial thinking and practice in general insurance should be directed more towards this.
- Game theory may be a more useful tool in the creation of shareholder value than the stochastic modelling of claims distributions.

Where are we today?

In the UK, the composites are beginning to declare better results, and 1993 is believed to have been a profitable year for the London Market. Nevertheless, the industry overall has lost a good deal of its investors' capital in recent years.

The European market is slowly opening up, and home country based companies are beginning to face more competition.

There is no evidence that pricing and profitability have stopped moving in cycles. Large amounts of capital have recently been raised at Lloyd's and in Bermuda in response to improved profit expectations. In the UK, personal lines business is undergoing massive change, the catalyst being the success of telephone based sales techniques. Many companies must be asking themselves whether they have a future at all. Perhaps some will find ways of exiting the business and returning the maximum amount of capital to shareholders.

Traditionally, insurance business has not been run on the basis of a sound strategic framework. Instead of analysing what are the drivers of long term success and competitive advantage, performance measures are used which tend to result in the cycle being the master, rather than a phenomenon to be taken advantage of. Not many companies are run as if they were owned by the managers.

The industry seems to have learned many of the lessons, but whether they will be forgotten again in the future remains to be seen.

The nature of the business

You are offered the following gold mine

There is a mine with a maximum annual production of 10,000 ounces of gold. The marginal cost of production is £100 per ounce, which is the same whether 10 or 10,000 ounces are produced. The marginal cost of production can be determined fairly accurately in advance, and tends to move in line with the general price level. You can assume your production costs are comparable with those of your competitors and will remain so. The current price of gold is £95 per ounce. This price has a history of fluctuating severely, but the underlying trend is in line with the general price level.

Two other factors. First, there are no overheads, but the mine is confiscated if you fail to pay an annual tax to the government of £1000, increasing with the general price level. Second, the mine is inexhaustible and can go on producing forever at the rate of 10,000 ounces in any year.

Q: What is it worth?

A: I don't know. A lot. But running it is easy enough.

The similarities to insurance should be obvious. Insurance has an advantage over even the above gold mine, namely that the client pays before we deliver the goods.

The fundamental differences are also obvious enough. The marginal cost of insurance is difficult to assess, and it has to be assessed in advance. The maximum (sensible) production is related, among other things, to the level of capital employed in relation to the potential accumulations - perhaps even more difficult to assess in advance.

These factors, together with the competitive nature of the business, lead to the conclusion that, whilst good management information is vital to get a competitive advantage, this information should be directed towards a business strategy led by game theory, not the conventional measures of insurance company results. To contribute to the process to their full potential, actuaries need to think of themselves as engineers in control of the process, first understanding and then managing the machine to generate the maximum output of cash over the long term.

Underlying causes of failure

We suggest that a primary cause is the failure to understand the basic simplicity of the business. To reach this understanding, you may need to understand the complexities first.

If the management do understand the basic simplicity of the business, than failure to manage the business effectively for the shareholders will be due to one of two causes.

- laziness, and comfort with the status quo
- they are not managing the business with the shareholders' interests uppermost

Managing effectively could, in certain circumstances, include winding down, selling off, or closing the business altogether. History suggests that buying other businesses is not always a good use of shareholders' money.

[This paper is intended to stimulate discussion!]

The shareholders are not without blame either, but paradoxically the insurance industry overall and the closely related fund management industry tend to be the controlling shareholders in UK plc...

Who does win

Insurance company managements get paid even if they destroy shareholder value. From the shareholders' point of view, in spite of the intensely competitive nature of the industry resulting from the ease of entry, there are a few successful businesses. The key seems to be management who are sufficiently smarter than the competition. So there is plenty of scope.

Some failures and successes

failures

- Liability business. Without a cast iron protection against the tail, it is debatable whether writing certain types of liability business is in shareholders' interests. Problem: uncontrolled accumulation risks and risk of severe under pricing.

- Over-exposures to catastrophes. Problem: insufficient technology to relate cash available to pay claims to potential accumulations of claims.
- Mortgage indemnity. Problem: lack of awareness of accumulation risk.
- European takeovers. Size and market share for its own sake.

it is easy to be wise after the event

successes

- GEICO in the US. Personal lines for selected government employees with good control of expenses.
- Direct Line in the UK. Careful selection of risks, without the cost or other constraints of intermediaries.
- Berkshire Hathaway in the US. Determination not to write business at prices less than expected marginal cost plus, most notably, a successful investment strategy.

Some possible ingredients of success

- Determination not to write any risks at unprofitable rates i.e. at below expected marginal cost
- Determination not to waste shareholders money in any other way.
- Long term focus and lack of concern with volatile results - vital in cyclical markets.
- Clear management objectives, clearly communicated to shareholders.
- Recognition that good long term performance of the investment portfolio, especially where shareholders' funds are high compared to technical reserves, is vital to the creation of shareholder value.

Why don't more managers focus on shareholder value?

- They go for market share.
- They go for volume.
- Their shareholders expect steady (declared) profits.
- Their shareholders are stupid so high (declared) profits today are sufficient to keep up the share price.
- Their shareholders are stupid so high dividends today are sufficient to keep up the share price.
- Managers are concerned about the share price in the short term.
- Their important shareholders are fund managers who are sacked if they under-perform in the short term.

- Their shareholders would not understand if they changed the focus from writing insurance business to creating shareholder value.
- Managers have never thought of shareholder value and wouldn't understand it.

Conclusions - some solutions

The above list is somewhat light-hearted. But there are some underlying problems in corporate governance. The important stakes in quoted businesses are controlled by "professional" investors looking after other people's money. The target for these professional investors is keeping the job. The penalty attaching to under-performance outweighs the rewards for out-performance. Thus their investment policy is defensive, with lots of holdings each of which justifies only a little time. There is virtually no incentive to take an active part in the governance of any of these holdings, as the resulting gains would be so small.

It is interesting to consider that the typical industrialist will want his investors to get off his back and think long term, but he will expect the investment manager of his pension fund to outperform each quarter or each year. The actuarial profession may just have played a part here.

One way of attacking these conflicts may be to try changing the incentives for some fund managers towards a high reward for long term out-performance with nothing for under-performance - with controls to prevent excessive risk taking. There is scope for all branches of the actuarial profession to encourage such changes.

Getting back specifically to general insurance business, managements who do embrace the objective of making money for shareholders in the long term - maximising shareholder value - are likely to be supported and rewarded by their shareholders, providing they explain clearly what they are doing and why. Scope again for the actuarial profession, providing we can communicate the message to management.

Actuaries in general insurance should not be content with just doing a good technical job in reserving, control of exposures, or underwriting support. If they have a good understanding of how to create more value (or lose less) for shareholders, they have a duty to apply it.

For further entertainment, please turn to the Appendix.

Appendix: notes on Berkshire Hathaway

This company is interesting because it provides a unique example of clearly focused management. It has been under the control of one man, Warren Buffett, for nearly 30 years. The company's purpose is to maximise the wealth of the shareholders. This has been achieved principally through clever selection of investments. The company pays no dividends. The main business is insurance, through which most of the investments are held. This has proved a cheap, or even negative cost, way of borrowing money to finance investments. The investments are mostly in a few large holdings, such as 48% of GEICO and 7% of Coca-Cola.

The book value per share increased in the 29 years to 1993 from $19 to $8,854, or 23.3% per annum. Shareholders funds at 31.12.93 were $10.4bn. An article in Reactions Magazine, August 1994, estimated total worldwide non-life insurance capital to be just $250bn.

The annual report comes without pictures and is a lesson in communicating to shareholders about the business. It is also used to praise publicly the managers of the various businesses. Extracts are not reproduced here for reasons of copyright, but the report can be obtained from the company on payment of the postage.

Here are some of the rules by which the insurance business operates.

- No business is written if the price is wrong.
- Large exposures to catastrophe business are written if the price is right - the resulting volatility is not a concern. The exposures are large compared to earnings but small compared to the free assets.
- Reinsurance tends not to be purchased

Each annual report contains a recital of "owner-related business principles", some of which are summarised below.

- The shareholders are viewed as partners in the business.
- The directors own large amounts of the company.
- The basic goal is to maximise shareholder value in the long term.
- The company tries to own businesses or parts of businesses with sustainable competitive advantage.
- Accounting consequences of decisions are virtually ignored.
- There is very little gearing.
- Money will not be wasted on overpriced acquisitions.
- Dividends will not be paid unless the shareholders could invest the money profitably elsewhere.
- No dilution - new stock is virtually never created.
- Capital will not be used to prop up sub-par businesses.
- Candour in reporting to shareholders.