



Canadian Insurance Magazine – May 2005
The Insurance Cycle and How to Tame the Beast
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Like the weather, everyone talks about insurance (profitability) cycles, but no one does anything about it. Here are my analyses of the causes and some suggested remedies for the problem.

News flash! **The insurance cycles are caused by decisions made by insurance company CEOs.** Certain CEOs decide that they want their respective companies to grow rapidly, at a rate significantly exceeding the average growth rate of the whole market. They start the process by lowering prices to uneconomic levels, in what we all know is a very price sensitive market. Why they cut prices ranges from “live for today” opportunism to faulty forecasting.

Other CEOs, seeing that their companies are losing market share, react by lowering their company’s prices even further. Return on equity (ROE) of these and all other companies is eroded, to well below anything that shareholders can accept, until pure unadulterated fear on the part of CEOs and/or their boards of directors causes a halt. Then, suddenly, ROE (and perhaps survival) becomes more important than market share. As these market changes are often driven by emotions rather than logic, we overreact on both the price lowering and price raising components of the cycle.

We know that our business is a very competitive one. Competition is normally the consumer’s best friend. However, car and home insurance represent a significant and often mandatory purchase for consumers. The vast majority of consumers work on very tight monthly budgets. Their budgets cannot easily cope with a 15% to 20% increase in the cost of a major non-discretionary item like insurance.

So, even though consumers benefit from the years of hyper-competition that lead up to the massive “correction” in pricing, consumers do not thank the insurance industry, because the pain of the upward adjustment more than erases whatever pleasure there was from stable or reducing premiums in previous years. We know that our industry, over a multi-year average, does not earn as much as other industries earn. But guess what? Consumers don’t really care about the averages!

Consequently, the extreme nature of our industry’s profit cycles is bad for the insurance industry itself, because it alienates our policyholders. Therefore, it is critical that all industry players and stakeholders work to reduce the amplitude of future cycles.

First, we all must accept that longer-term return on equity truly matters far more to company owners than size or growth (despite what they may say!). Several studies of the property & casualty industry have strongly suggested that there are few economies of scale to be had, once an insurer reaches even a modest size (probably the top of the bottom quartile). In any event, size gained through price cutting alone is illusory. What you have “won” are the most price sensitive policyholders and brokers. They will quickly leave your company for the next “loss leader” offering. Size gained at the expense of return on equity is very unfair to shareholders, certainly our most important stakeholders after policyholders.

Here are a few practical ways to have at least some positive impact on the “cycle”:

For insurance company boards of directors:

- Don’t set or expect from management unrealistic growth goals. Growth rate goals above the expected average for the industry must be supported by a viable business plan, which does not depend on significant price cutting.

- Do incentivize your CEO on the basis of longer-term (say a three-year rolling average) return on equity, relative to the industry average.
- Don't be afraid to return excess capital (i.e. that part of an insurer's capital which cannot be effectively deployed to earn the target ROE and is not truly required for a potential catastrophe) to your shareholders, by way of dividends or return of invested capital.
- Insist that your CEO invest at least \$1,000,000 in the company's stock (or phantom stock in the case of a mutual). It is important that the stock be in the company he or she is responsible for and not the foreign parent or conglomerate holding company. If the CEO does not have the funds, the company can facilitate a loan against good security, like the CEO's house or an assignment of their pension plan proceeds. Upon retirement (voluntary or otherwise), the shares can be re-purchased from the CEO at their then market value.
- Do consider having a Chief Accounting Officer who reports directly to the board of directors and who is rewarded for keeping accurate financial statements and records.

For insurance company CEOs

- Do make longer-term ROE your number one priority.
- Do set realistic goals based on accurate forecasts. CEOs need good information to make good decisions. Forecasts must attempt to accurately predict the amount and timing of claims payments as well as investment returns. All disciplines within the company must be involved in the forecasting process and "group think", such as "all gung-ho for growth", must be avoided.
- Do make plans to keep your company growing, but base those plans on one or both of i) delivering better products and services at a reasonable price, or ii) through acquisitions.
- Don't chase market share at "too cheap" pricing, but be prepared to downsize your organization and return capital to shareholders when market conditions won't provide your target ROE.

For legislators and insurance company regulators

- Do keep automobile coverages current, through periodic legislative reviews.
- Don't allow staff actuaries to certify insurance company claims reserves.
- Do keep track of all consulting actuaries' ability to keep company reserves at adequate levels (i.e. slightly redundant) and publish the scores.
- Do regulate rates that are "too low" as effectively as you regulate rates that are "too high".
- Do force companies proposing unproven business plans, based on aggressive pricing, to put up additional capital prior to launching their plan. (Can anyone spell Markham General?)

For brokers and agents

- Do stress to clients the non-price benefits of buying insurance from stable insurers, which deliver better policy and claim services.

- Do keep a multi-year “price index” on individual policyholder accounts, to demonstrate that “over the years” premium increases have not been out of line with other costs.

For broker associations

- Do invite the CEOs of the companies with the highest three-year average ROEs to man (person?) the “What’s up with the industry?” panels at your annual conventions.

If we implement as many of these suggestions as possible, the hard market/soft market transitions will be muted and we all can live happier, less stressful lives. Policyholders will thank us!