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Is the current market "déjà vu all over again" or a "brave new world"?

Underwriting Discipline in a Softening Market

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"Future profitability of the industry will be determined by current competitive characteristics, not past ones. Many managers have been slow to recognize this. It's not only generals that prefer to fight the last war. Most business and investment analysis also comes from the rear-view mirror."

1982 Letter to Shareholders, Warren Buffett

In the first quarter of 2005, two things appear certain for the ever-cyclical commercial property-casualty industry: (1) pricing is becoming more competitive, and (2) the mantra of virtually every insurer and reinsurer is that "underwriting discipline" will be the key to its success. According to *ISO Marketwatch*, the latest hard market began in mid-1999, peaking at an overall average rate increase of 12.9 percent in July 2002.[1] Over the past 2 years, we have seen a steady downward trend. In the fourth quarter of 2004, the Council of Insurance Agents and Brokers survey reports an average large commercial lines rate decrease of 10 percent.[2]

Clearly, the property-casualty roller coaster is once again headed downhill. Although rates still appear actuarially adequate in many commercial lines, the depth and duration of the current softening market are growing concerns.[3] The current CEO focus on "underwriting discipline" is pervasive. In some 2003 annual reports, references to "improved discipline" are so numerous that one can only wonder: Is this a prayer or a reality?[4]

If we reach back a decade or more, we find that "discipline" was also the panacea cited by senior property-casualty managers prior to the last major market downturn. Consider for example, the 1992 Annual Report of the ill-fated Continental Insurance Company.[5] Despite devastating losses from both Hurricane Andrew and Hurricane Iniki, senior management counterintuitively assured investors that 1992 "marked the beginning in the long-awaited turn around in our underlying performance, a product of many years hard work at reducing exposures, maintaining underwriting discipline, pushing for price increases, developing new market niches and shifting our mix of business."[6]

The too-oft-stated goal of blending lower exposures with higher premiums in a softening market, salted with new "mixes" and peppered with "niches," sounds like a salad that is too good to be true. What do CEOs really mean when they cite "disciplined" underwriting as the key to their success? Can the domestic property-casualty market avoid the extreme depths of the last two competitive markets? Is the insurance industry an endless, repetitive cycle driven by the simple ebb and flow of supply and demand?

Is the industry destined, as Warren Buffet warned us over 20 years ago, to once again "fight yesterday's war"? Or are there important differences between current market conditions and prior market downturns that suggest a different outcome may be possible? Are we headed toward a "brave new world" or is this simply a case of Yogi Berra's "déjà vu all over again"? In this article, the author provides his personal perspective as an employee of an insurer and, formerly, of a reinsurer, broker, and managing general agent.

The Meaning of the Mantra

Let's begin by considering what CEOs mean when they align their corporate fate to "underwriting discipline." There are three critical components to the answer: pricing, risk selection, and terms and conditions. We will consider each.

Pricing

To most insurers, underwriting discipline *means* pricing integrity. In a hardening market, a "rising tide lifts all boats." In a softening market, achieving adequate prices on individual accounts and books of business is far more difficult. Particularly in specialty commercial lines, success requires a fine balance between the judgmental underwriting "art" and the actuarial "science" in each line of business.

Today's pricing challenge is compounded exponentially by what Donald Rumsfeld might call "known unknowns." On the immediate horizon, "known unknowns" include the impact of Sarbanes-Oxley, the durability of state tort reform in medical malpractice and workers compensation, and the future of litigation relating to obesity or cell phone electromagnetic radiation. In addition, we are challenged by the continuing evolution of "known knowns," including such issues as asbestos, environmental, and now, silica and mold claims.

Terrorism insurance presents quite possibly the greatest pricing problem of all. With no credible actuarial experience available, terrorism pricing must instead be based upon factors such as the cost of capital combined with market and regulatory acceptability (as opposed to what constitutes an "actuarially fair" premium).

Risk Selection

Pricing is based mainly on the actuarial assumption that the past will be predictive of the future. In contrast, risk selection embraces the future. It asks the question, "Where is this industry or this insured going?" rather than, "Where has it been?" To outperform the market, underwriters need to understand the business trends of their customers (and even of their customer's customers). This is particularly true of workers compensation and medical malpractice, where success hinges on individual state and industry-segment strategies.

In lines relying on the truth and accuracy in financial statements and other material representations (such as directors and officers [D&O] and environmental insurance), underwriters need much more than complete and accurate applications. Ideally, they need to understand the business, values, and even the corporate culture of their customers. This is the thinking behind industry "practice groups" or industry-focused specialty units in major insurance companies and brokerage firms.

One of the major errors of some insurers in recent soft markets has been to rely too much on inflexible risk-selection strategies. The important "lesson learned" from the early 1980s and 1990s is that "a good risk at a bad price is a bad risk." As commercial package underwriters have discovered many times, even underpriced businessowners policies for shoe stores can produce disastrous losses. However, the converse is also true: A marginally "bad risk" for a good price (combined with some improved terms and conditions) can become a "good risk" (as we see in the long-term performance of nonstandard markets). The key is to know the difference.

Terms and Conditions

In many commercial lines, insurance policy wordings have become so commoditized that pricing and risk selection are frequently the only real underwriting decisions. It was not always this way. Back in the early 1970s and prior, for example, there were no standard commercial general liability (CGL) or commercial umbrella policies. Underwriters and producers needed to separately negotiate limits and terms for each liability coverage part (e.g., manufacturers and contractors liability or owners, landlords and tenants liability; the breadth of "care, custody and control" property coverage; products and completed operations; and contractual liability).

The introduction of the new CGL in 1986 by Insurance Services Office (ISO) shifted the focus of liability underwriting toward a more singular focus on pricing and risk selection. Nevertheless, in today's market, the negotiation of terms and conditions is still critical to an insurer's success, particularly in specialty lines like D&O and errors and omissions insurance. Encouragingly, recent investment research reports are focusing on terms and conditions almost as frequently as pricing.

In a recent discussion of domestic property-casualty outlook, for example, Goldman Sachs researchers state "There are three primary drivers of loss costs: severity, frequency, and terms and conditions." The analysts astutely conclude:

> We believe that terms and conditions have actually been one of the single biggest drivers to favorable loss cost trends. For example, the simple rise in deductibles has kept many small losses out of the insurance industry, improving frequency. In addition, deductibles and smaller limits have also mitigated the severity of loss. Until the market becomes more aggressive in loosening these tight terms and conditions, we do not expect to see any immediate acceleration in loss cost trends.[7]

Quantifying and Balancing Underwriting Competencies

Of the three critical underwriting disciplines, only pricing changes are easily quantified. Terms and conditions and risk selection are, at best, subjectively quantified at a high level. New niche market entries frequently receive optimistic initial "expected loss ratio" estimates based on the exhortations of underwriters to actuaries. In a hardening market, this means that the nominal rate changes reported in industry surveys understate the "effective rate change" that is actually being achieved. The converse is true in a softening market. The nominal rate changes in almost all reports are limited by the fact that only one of the three drivers to underwriting success is usually captured.

Regardless of market conditions, the essence of disciplined underwriting is managing the balance of these three critical competencies in every underwriting decision on every account. Only time clearly distinguishes rhetoric from reality. In the interim, there is no consensus on where the industry is headed. Underwriting discipline is critical, but it is not the only factor determining which insurer will survive and which will thrive. Simply stated: timing matters! At the property-casualty card table, there are times when you have to "know when to hold 'em and when to fold 'em."

Let's consider the reasons why many argue with some cogency that the coming years could very well be as perilous as the past.

Three Simple Rules for the "Déjà Vu" Perspective

There are at least three key indicators for determining whether the insurance market is headed for trouble. All of these indicators are as true today as they have been in the past.

1. Too Much Capacity

Pricing trends are determined by the industry's financial capacity to write business. In insurance accounting, "capacity" is measured by the size of the industry's combined capital base, called policyholders surplus (PHS).[8] In his 1986 Letter to Shareholders, Warren Buffet provided a classic, plain-language explanation of why excessive insurance capacity is a prelude to unprofitable times:

> Pricing behavior in the insurance industry continues to be exactly what can be expected in a commodity-type business. Only under shortage conditions are high profits achieved, and such conditions don't last long. When the profit sun begins to shine, long-established insurers shower investors with new shares in order to build capital. In addition, newly formed insurers rush to sell shares at the advantageous prices available in the new-issue market (prices advantageous, that is, to the insiders promoting the company but rarely to the new shareholders). These moves guarantee future trouble: capacity soars, competitive juices flow, and prices fade.
>
> It's interesting to observe insurance leaders beseech their colleagues to behave in a more 'statesmanlike' manner when pricing policies. 'Why,' they ask, 'can't we learn from history, even out the peaks and valleys, and consistently price to make reasonable profits?' What they wish, of course, is pricing that resembles, say, that of *The Wall Street Journal*, whose prices are ample to start with and rise consistently each year.
>
> Such calls for improved behavior have all of the efficacy of those made by a Nebraska corn grower asking his fellow growers, worldwide, to market their corn with more statesmanship. What's needed is not more statesmen, but less corn. By raising large amounts of capital in the last two years, the insurance industry has, to continue our metaphor, vastly expanded its plantings of corn. The resulting increase in 'crop' — i.e., the proliferation of insurance capacity — will have the same effect on prices and profits that surplus crops have had since time immemorial.[9]

If the Oracle of Omaha is right, the latest reports from A.M. Best suggest that we should keep our collective seatbelts fastened. In the insurance industry, the balance of "supply" and "demand" is normally considered to be the ratio of net written premium (NWP)(demand) to PHS (supply). When this ratio is less than 2 to 1, many industry analysts conclude that there is too much money chasing too small a market. According to the latest annual *Review/Preview*, there is an abundance of "corn" in the current property-casualty market with no relief in sight.[10] A.M. Best estimates that the market's capacity will increase as we approach 2006, with the ratio of NWP to PHS sinking to 1.07 to 1 in 2005. (See Exhibit 1.)

Note that in 2002 (when pricing increases peaked), capacity was still quite ample at a ratio of 1.3 to 1. This suggests that the simple supply and demand indicator is less than reliable. In the author's opinion, estimating future market direction with this indicator is meaningless from a strategic perspective. Overall industry averages or quarterly total-market-

Exhibit 1

Property-Casualty Industry Results ($ in Billions)

	2000	2001	2002	2003	2004E	2005E
Ratio of NWP to PHS	0.94	1.12	1.31	1.17	1.12	1.07
NWP	$305.0	$330.8	$379.3	$415.3	$435.2	$440.4
NWP Growth	4.70%	8.50%	14.70%	9.50%	4.80%	1.20%
PHS	$323.0	$295.4	$290.6	$353.8	$387.5	$411.5
PHS Growth	–5%	–8.6%	–1.6%	21.8%	9.5%	6.2%

rate-change surveys mask important differing trends within separate insurers, lines of insurance, and customer segments.

The simple fact is that the property-casualty business is highly segmented both in terms of the size of insurers and in their specialty areas. Consolidated capital bases of insurance groups range from less than $1 million to in excess of $20 billion. Of over 1,100 insurers, state funds, captives, and risk retention groups writing $1 million or more of property-casualty premium in 2003, over 800 have less than $100 million in consolidated PHS.[11]

In 2003, the total domestic property-casualty industry reported all-lines direct written premium (DWP) of $455 billion and a combined ratio after dividends of 98.7. Commercial lines comprised $237 billion of the DWP with a combined ratio of 99.3.

Personal lines represent about half of the property-casualty premium and capital base. In personal lines, State Farm and Allstate dominate the market, giving them more pricing power than we see accruing to most insurers in the commercial sector. The personal lines sector is also mostly direct-written ($131 billion of $196 billion in 2003 NWP) compared to the agency and brokerage focus of commercial lines ($138 billion of $206 billion in 2003 NWP).[12]

Within the commercial sector, we find significant differences. The largest single line, workers compensation, improved DWP by 15 percent, with $42 billion DWP in 2002 increasing to $48 billion DWP in 2003. The workers compensation combined ratio decreased from 114.5 in 2002 to 107.4 in 2003. In another struggling line, medical malpractice, we see an approximate 10 percent increase in DWP with an increase from $8.9 billion DWP in 2002 to $10.1 billion DWP in 2003. The combined ratio improved from 142.3 in 2002 to a still very high 128.9 in 2003. Other lines show the extreme variance in 2004 commercial results: products liability DWP was $3.9 billion with a striking combined ratio of 179; commercial auto liability showed $29.6 billion DWP and a combined ratio of 95;[13] commercial multi-peril, fire, inland marine, and other shorter-tail lines show modest growth but solid underwriting profitability.

The strategic message seems clear: The commercial property-casualty industry sails forward not as one oil tanker but more like as a flotilla of independently captained large and small ships, frequently navigating entirely different oceans. To understand where we are headed, each ship needs to be separately evaluated.

2. Ease of Market Entry

Industry analysts frequently cite the ease of market entry as a main reason for concern, particularly when it is clear that a broad-based upswing in market entry is in progress. It is difficult to disagree with this key indicator: insurance and reinsurance are indeed relatively easy businesses for naive (or informed) capacity to enter. Over the last three decades, high interest rates, bull stock markets, or simple market timing have induced many new underwriters to enter the property-casualty market, too often for short-term gains. The problem is that insurance, and particularly casualty insurance, is inherently a long-term, "marry in haste, repent in leisure" commitment.

Ease of market entry has been facilitated by the robust growth of the "alternative market" throughout the last three decades. Today, there are an estimated 4,500 risk retention groups and captive insurers serving the global needs of single parents, association members, agents, and traditional insurers.[14] Domiciles range globally from Honolulu to Dublin, with a concentration of such companies in Hamilton, Bermuda.

In the soft market of the early 1980s, at least three factors combined to create the property-casualty market's "perfect storm":

1. historically high interest rates, approaching 20 percent in 1981 to 1983, that encouraged the highly controversial practice of what was labeled "cash flow underwriting;"[15]

2. the requirement that captive insurance companies write unrelated third-party business in order to protect the tax deductibility of the premiums paid by their parent or member insureds; and

3. far less rigorous regulatory and rating agency monitoring of insurance company gross profitability and use of non-admitted reinsurance than we see in the current market. (See Exhibit 2.)

The result was the property-casualty industry's historically high combined ratio, reaching 118 in 1984.

The industry's return on equity (ROE) sank from a high of 18 percent in 1978 to only 2 percent in 1984.[16] Although interest rates dropped to single digits in the 1990s, the roaring equity market encouraged many new and traditional underwriters to look to insurance and reinsurance as a source of invested assets. Increasingly undisciplined underwriting practices produced the second highest ever industry combined ratio of 115.9 percent in 2001 (with the events of September 11 adding about 3 points to the ratio). We also saw the first ever *negative* ROE of minus 3 percent as combined investment gains failed to offset devastating underwriting losses.[17]

Much is different in the current market. Insurers and rating agencies have never been as concerned about reinsurer credit risk as they are now. New attention is also centering on insurers' "gross profitability" as opposed to the net perspective of prior decades. This should make the practice of surviving soft markets by ceding off business to reinsurers (called "fronting"[18]) increasingly unlikely. Nevertheless, there is no doubt that this second key indicator still applies today. One recent market report from a major reinsurance broker, for example, cites growing hedge fund interest in the uncorrelated losses and returns available from natural catastrophe reinsurance.[19]

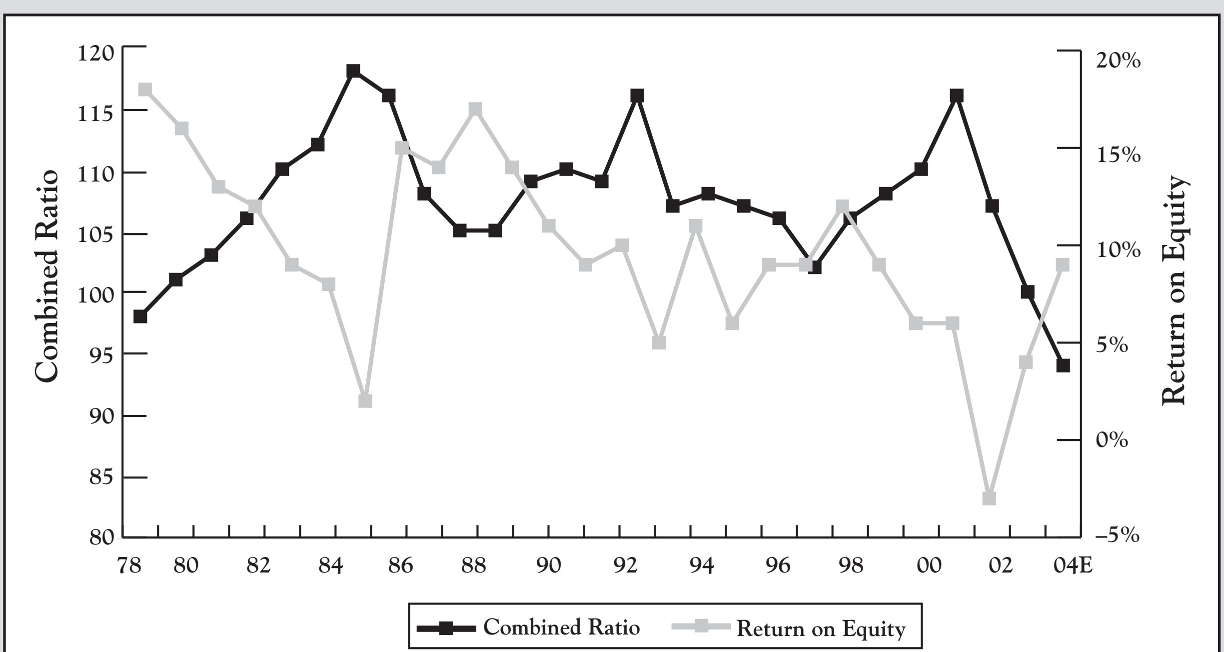
An important point is that not all new market entrants are short-lived and naive. If we take a broad historical look at the creation of sustained new insurance capital, we see that many of today's captives and risk retention groups are best understood as new versions of yesterday's mutuals and reciprocals. Particularly in specialty commercial lines, many of today's "traditional insurers" have their roots in the long tradition of customers developing their own insurance solutions with their own capital, particularly in times of market crisis.[20] In the event that the Terrorism Risk Insurance Act of 2002 (TRIA) is allowed to expire at the end of 2005, alternative market capacity could become critical if the industry is going to replace the current $100 billion in federal terrorism backstop protection currently available for insurance covering foreign terrorist acts on U.S. soil.

3. Lag Time in Calendar-Year Earnings

The third key indicator is the significant lag time between underwriting-year pricing improvements and calendar-year earnings improvement. As noted

Exhibit 2

U.S. Property-Casualty Industry Market Cycle



in a recent Goldman Sachs report, "Pricing in the last up-cycle peaked in 1986 and eventually deteriorated for the next 13 years. However, absolute earnings (excluding catastrophe losses) did not peak until 1997, or 11 years after pricing peaked."[21] The analysts explain that this peculiar "anomaly" of the property-casualty industry is driven by four factors: "(1) a lag in revenue recognition, (2) diminishing reserve deficiencies, (3) increasing reserve redundancies, and (4) growing invested assets that drive investment income growth."[22] In a real sense, this gap between pricing increases and earnings improvement produces marquee headlines that, in turn, are a magnet for naive capacity. We saw this in 1994 when medical malpractice was considered one of the most profitable commercial lines despite at least three years of aggressive rate-cutting.[23] There is no reason to believe this will not happen again.

In total, these three key indicators present a compelling argument for concern over the property-casualty market's outlook. Let's consider four good reasons to believe otherwise.

Four Reasons to Anticipate a "Brave New World"

There are at least four reasons to believe that the next few years will be driven by new challenges never faced by prior generations. The first three we will discuss are well known and in the media on an almost daily basis. The fourth is less obvious, but no less important.

1. Low Interest Rates: One of Underwriting Discipline's "Best Friends"

The first reason to believe that insurance history will not repeat itself is the continued low-interest-rate environment. Despite the five consecutive increases by the Federal Reserve totaling 125 basis points, the current level of interest rates is still well below the double-digit levels of the early 1980s. If we look at the history of property-casualty profitability in the decades prior to the mid-1970s, we find decades of consistent underwriting profitability. Between 1939 and 1974, the property-casualty combined ratio after dividends was below 100 in 26 of 35 years. The highest combined ratio in these decades was 103.5 in 1957. The lowest combined ratio was 88.3 in 1949. Clearly, there was no "cycle" prior to 1974 (when the combined ratio reached 105.9).[24]

Two well-known factors drove these results: low-single-digit interest rates and state-regulated *minimum* insurance rates. Minimum-rate rules began to disappear in the 1960s and today are almost entirely gone.[25] Although a spike in inflation could change the short-term future, history tells us that rates in low single digits are one of underwriting discipline's "best friends."

2. Extreme Event Risk: "Prepare to Be Surprised"

Natural and man-made catastrophes (now frequently called "extreme events") are quite arguably as important a variable as interest rates in shaping the commercial insurance market's near-term future. Some historical perspective helps us understand why addressing this problem is now more urgent than ever before.

When Hurricane Hugo struck the United States in 1989, it produced the largest domestic insured loss ever at $5.9 billion (in constant 2001 dollars). Only three years later, Hurricane Andrew tripled this milestone with a new record insured loss of over $19 billion. Most sobering about Andrew was that the relatively small city of Homestead, Florida, was the epicenter of the loss. Underwriters and analysts started asking the obvious questions: What if Andrew had hit Miami or Tampa (or how about Boston or New York City)? The potential losses seemed incalculable. In December 1992, Hurricane Iniki delivered the first major insured catastrophe loss (at $2 billion) to Hawaii in over 26 years.

The natural catastrophe losses between 1989 and 1992 seemed to defy rational explanation. In early 1993, the author attended the annual shareholder meeting of one large insurer. Surprisingly, the CEO blamed "bad luck" for his company's significant losses. In fact, he not only blamed Mother Nature for one bad year, he presented a bar chart showing *five consecutive years* of what he labeled continuous "bad luck from Mother Nature."[26]

In the months and years that followed Hurricane Andrew, it became clear that something unusual was happening. The Northridge earthquake that struck southern California on January 17, 1994, was the first earthquake to strike an urban area since the 1933 Long Beach earthquake.[27] New underwriting questions emerged: What would the total losses (including workers compensation) have been if the quake had hit at 2 p.m. in the heart of Los Angeles, rather 20 miles northwest of Los Angeles at 4:30 a.m.? Once again, the potential insured loss seemed beyond calculation and certainly beyond the capital abilities of private insurers.

To use a baseball metaphor, the events of the 25 years after Hugo made it seem like Mother Nature was on steroids. New "home run records" in the realm of extreme events have been challenged or exceeded almost every year since 1989. The sobering new reality is that the largest 10 catastrophes ever have occurred in the last 15 years. As we see in Exhibit 3, domestic insured catastrophe losses have become a significant variable to insurer profitability, greatly challenging each insurer's capital management skills.

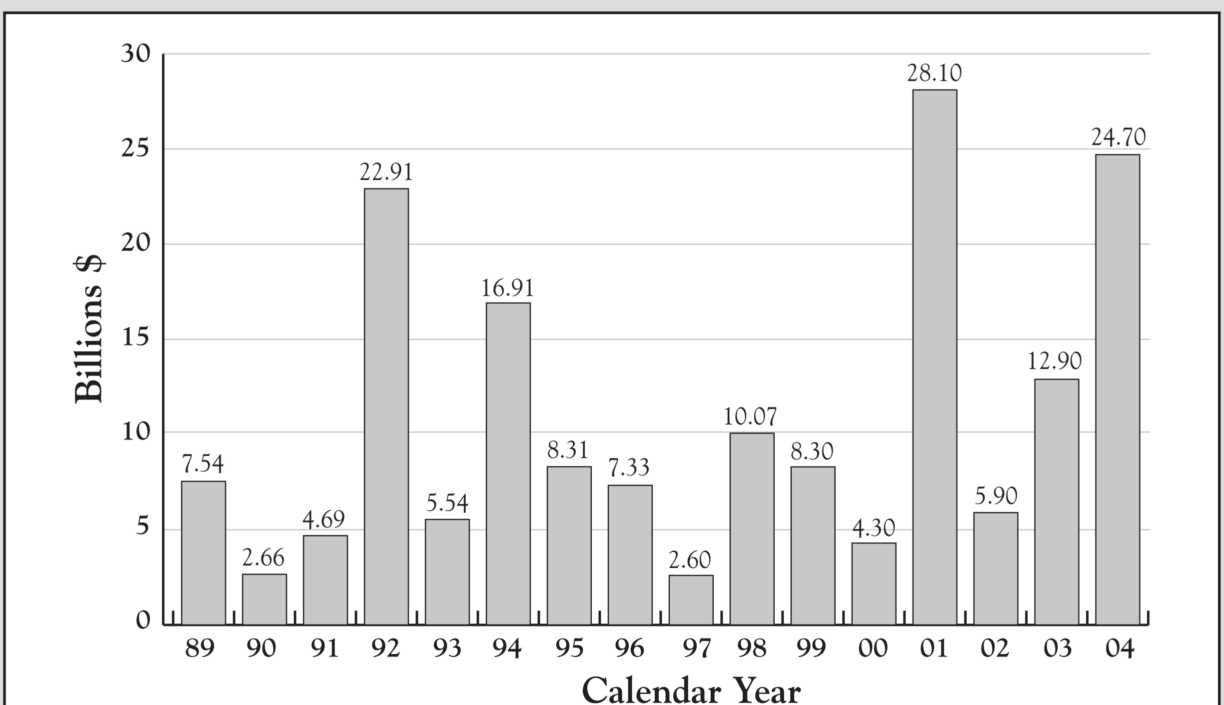
After Northridge, underwriters recognized that they needed to start monitoring their workers compensation catastrophe exposures. To do that, they would need employee information at almost every location. No one had ever requested this information before and no rating agencies had considered it necessary. What would it take to get producers, rating authorities, and insureds to agree that underwriters need this new information?

The answer came seven years later. The terrorist attacks of September 11, 2001, escalated the challenge of catastrophe management to an entirely new level. A new corporate discipline was born: enterprise risk management. Insured losses from the September 11 events are now estimated by Insurance Information Institute at $31.7 billion.[28] No underwriter ever imagined that one event would create the largest loss ever simultaneously in workers compensation, property, business income, and aviation insurance. The challenge of managing what now needs to be understood as correlated risks is entirely new to the current market cycle. Managing aggregate multi-line exposure to terrorism risk could become as important a factor as policyholders surplus in determining the availability and cost of insurance capacity.

Not surprisingly, the dominant focus of A.M. Best, the other rating agencies, and analysts is now on capital management. The opening lines of A.M.

Exhibit 3

U.S. Insured Catastrophe Losses



Best's annual *Review/Preview* are timely and on point: "Expect the best, plan for the worst, and prepare to be surprised."[29] Concerns will continue to grow as we approach the possible expiration of the Terrorism Risk Insurance Act at the end of 2005.

3. Reinsurance: Profitability Is Key

Although a full discussion goes beyond the scope of this article, it is clear that long-term changes have occurred in the reinsurance market. Too many industry analysts assume that the new capital infusion to reinsurance since 2001 means the basic business model is healthy. In their 2004 defense of numerous reinsurer downgrades, Standard & Poor's emphasized that the most important concern is profitability, not capital. The analysts noted: "Although reinsurers are becoming increasingly sophisticated in the way they analyze risks, the frequency and severity of large insured losses according to many commentators are increasing. Year to year profitability is likely to become more volatile, thus necessitating a higher long-term return." Their key conclusion is that "the trend in long-term profitability appears to be downward."[30]

Consider the exodus:

- U.S. property-casualty insurers departing this business (in some cases after many decades of significant involvement) include Allstate, PMA, CNA, Zurich, TIG, the Hartford, St. Paul, and numerous medical malpractice insurers.

- Departing life insurers include CIGNA, MONY, Prudential, and Aetna. The events of September 11 totally eliminated what had been a competitive and ample market for workers compensation catastrophe reinsurance.

- European reinsurers played an important role in the domestic property-casualty market in the 1970s through the 1990s. Many are now gone. Important departures include AXA and SCOR Re (both from France), Gerling Reinsurance (Germany), and Converium (Switzerland). The only major European reinsurers maintaining leading roles in the United States are Hannover Re, Swiss Re, Munich Re (American Re), and Lloyd's. The obvious reasons are the losses sustained from U.S. casualty business.

There are some additional, long-term, possible reasons for European departures. In the mid-1980s, during a visit to Munich, a senior German reinsurance officer (with the Cold War and the threat of a Soviet incursion still a daily concern) offered the author a different perspective: "After the Second World War, we decided to deploy our capital globally, and significantly in the United States, for three reasons: First, after being wiped out by two world wars in this century we had to assume it could happen again. Second, we viewed the United States as the safest political environment in which to invest our assets. And third, the United States presented the most robust GDP [gross domestic product] in the world and the best chance for *long term* growth." Defining "long term," he emphasized that Europeans weigh these decisions over many decades, not just years. Seen in this perspective, at least two of the three original reasons to invest capital in the United States are quite arguably now gone (especially considering alternative, reasonably secure countries with robust GDP growth, such as India and China). The reinsurer's message was clear: *capital preservation* is critical. In short, it may take more than class-action and other tort reforms to attract this capital back to the United States.

The center of the reinsurance industry is now generally considered to be Bermuda.[31] The new market leaders include Renaissance Re, Platinum, Axis, Endurance, Montpelier, Arch, XL, Allied World, Everest Re (transplanted from the United States), Partner Re, and ACE. A.M. Best reports that since September 11, 2001, these reinsurers have amassed over $20 billion in new capital. Many have "non-legacy" balance sheets beginning after 2001.[32]

Reinsurance practices will also likely be seeing important changes. The use of "finite" reinsurance (originally developed in response to the horrific losses of the early 1980s) will likely be more limited, with new accounting and structural changes.[33] The practice of "fronting" will also see important changes, enforcing increased discipline by issuing insurers. Despite the apparent ample capacity, insurers remain deeply concerned over the lack of available or affordable reinsurance for terrorism attacks involving nuclear, radiological, biological, or chemical weapons of mass destruction.

4. "Shrinking to a Profit": Okay for Now

The fourth reason to believe that the coming market will be unlike prior ones is less obvious than the prior three but no less important. Simply put, there are times when growth is a bad idea. A full analysis goes beyond the scope of this article, but it appears clear that virtually every commercial insurer or reinsurer that tried to grow aggressively between 1995 and 2000 either failed or was salvaged by a "white knight" acquisition (in some cases, at well below book value).

In the 1990s, leading property-casualty analysts used to state emphatically at industry speaking engagements that any insurer strategy based on "shrinking to a profit" was "completely unacceptable." The quarterly pressure on publicly traded risk-takers to show constant growth was enormous.[34]

The late 2001 decision by St. Paul to withdraw totally from the medical malpractice market was a "sentinel event" in the history of specialty lines. From the middle 1970s through all of the hurdles of the next two and a half decades, St. Paul was the largest and easily the most progressive of the traditional malpractice insurers. Its leadership included almost every niche within the health-care provider continuum: hospitals, clinics, physicians, and nursing homes. The St. Paul decision to "fold 'em" resonated through the property-casualty industry.

An encouraging consensus among insurers, rating agencies, and analysts seems to be emerging: When pricing hits inadequate levels, organic growth or aggressive expansion into correlated underpriced lines is a prescription for disaster. Smith Barney, for example, leads a February 2005 bullish assessment of one major insurer with the assertion that the insurer's slower premium growth signals that the insurer "is exercising underwriting discipline as competition intensifies."[35] A Goldman Sachs research report encourages insurers and reinsurers to focus not on capital appreciation but on "total return" (including increased shareholder dividends as a means of returning "excess" capital). They emphasize that this is the best alternative to the "irrational growth" witnessed in prior market cycles.[36]

Survivors from the depths of the last soft market are generally those who stuck to their core business and regional franchise or grew in uncorrelated lines with a different sustainable value proposition. An example is AIG's enormous 1990s diversification into life insurance, annuities, and direct-written personal auto.

In summary, there are at least four solid reasons to believe that the future of the commercial property-casualty sector will not repeat the excesses of the early 1980s and 1990s. Additional factors may be the well-publicized legislative and regulatory issues that are now in progress, including the impact of Sarbanes-Oxley, the possible expiration of TRIA, recent class-action reform, and the movement for improved industry transparency. Although important, the exact impact of most of these reforms is still unclear.

"Luck Is for Rabbits!"

The epic journey of the Titanic taught us that even the best-disciplined sailors cannot prevent disaster when a ship is sailing too rapidly through dark and dangerous waters. Although the insurance industry has had a record of repeating the errors of the past, there are solid reasons to believe that we are now entering a "brave new world." Underwriting discipline will be a critical success factor, differentiating the winners from the losers. To be effective, however, underwriting discipline in 2005 is best understood as going beyond traditional pricing, risk selection, and terms and conditions. In the current market, underwriting discipline is an enterprise-wide responsibility. Long-term profitability through market cycles is not based on home runs or even on grand slams. It is the sum of all of our business practices, large and small. It is as much about the hotels and flights we book and the icebergs we avoid as it is about the policies we underwrite.

Particularly for professional risk-takers, September 11 changed everything. We need to restore our collective confidence as we address the seemingly unlimited range of possible threats.

A television commercial for a major airline that aired well over a decade ago seems especially poignant today. Based on the author's best recollection: Gershwin's "Rhapsody in Blue" is playing in the background. Looking very much like Peter Sellers, an investment banker (or CEO) is hurrying to a passenger entrance. Through a large window next to the door, we see what looks like a Boeing 747 in the distance. An obsequious off-screen voice says: "Good luck on your trip, sir!" The CEO is shocked. The music stops. The CEO focuses on the middle of the screen. We see that Pink Panther investigator stare, at once angry and bemused. "Ha!" he yells, "Luck is for rabbits!" He then pivots sharply, turning his back to us, and marches enthusiastically to the awaiting plane.

For those of us in the business of taking risk, this commercial takes on new meaning. The critical issues to our success are now more than ever our individual and collective confidence, our willingness to reach out and collaborate with all stakeholders (including policyholders and government), and our determination to do everything we can to never be surprised again. Luck is indeed for rabbits.

Endnotes

1. Murray, Michael R., "Surviving the Soft Market," American Society of Workers Compensation Professionals, *AMCOMP Views Spring Edition* (2004): 5-6.2. The Council of Insurance Agents + Brokers' January 24, 2005, press release states: "The Council's quarterly Commercial Market Index Survey showed a significant softening in pricing during the period between Oct. 1 and Dec. 31, 2004… Large accounts also were paying significantly less for their insurance coverage. Only 4 percent experienced no change in premium rates, but 44 percent of the large accounts were down 1-10 percent. An additional 34 percent were down 10-20 percent, and 6 percent down 20-30 percent. The average large account premium was down by 10 percent during the 4th quarter." See: http://www.ciab.com/Template.cfm?Section=The_Councils_Market_Survey&CONTENTID=2281&TEMPLATE=/ContentManagement/ContentDisplay.cfm.
3. Goldman Sachs Investment Research, "Investing for 2005: Insurance: Non-Life USA," (1/3/2005): 1. "We believe there are two important trends that investors should not overlook when considering the impact of price changes: (1) The declines are coming off of extremely high rate levels, and (2) the absolute rate levels in many lines are still strong enough to generate more than adequate rates of return."
4. In a random survey of 2003 annual reports, the author found the "discipline" commitment in the St. Paul Travelers 2003 annual report 12 times. The struggling reinsurer Converium assures investors of their discipline six times, Safeco and the Hartford eight times each and, interestingly, AIG four times and Berkshire Hathaway and ACE only twice each.
5. After devastating hurricane losses in 1992, Continental Insurance Company had a positive year in 1993. Unfortunately, winter storm losses in the first quarter of 1994 and significant bond portfolio losses (from what Continental employees facetiously called "Hurricane Greenspan") resulted in a financial tailspin by mid-1994. A year later, in May 1995, CNA Financial purchased Continental for $20 per share, approximately $4 per share less than the Continental statutory book value.
6. "Letter to Shareholders," *Continental Insurance Company 2002 Annual Report*, (2002): 3.
7. "Investing for 2005: Insurance: Non-Life USA," Goldman Sachs Investment Research (January 3, 2005): 6.
8. "Policyholders surplus" is a statutory accounting equivalent of what in other businesses normally is considered "shareholder's equity" or "net worth."
9. Buffett, Warren, "Letter to Shareholders," *1986 Berkshire Hathaway Annual Report* (1986). See: http://www.berkshirehathaway.com/letters/1986.html.
10. A.M. *Best Company, Review/Preview, Property Casualty Edition* (January 2005).
11. A.M. *Best Company, Key Rating Guide, 2004 Edition* (2004).
12. A.M. *Best Company, Aggregates & Averages, 2004 Edition* (2004): 344.
13. Ibid: 358-363.
14. Geisel, Jerry, "Insurance Crunch Driving Broad Gains in Captives," *Business Insurance* 38, No. 11 (March 15, 2004): 10. Number of captives based on *Business Insurance* survey. Total excludes credit life insurers in Turks & Caicos Islands.
15. The current definition of this practice is interestingly value-neutral: "Cash Flow Underwriting: An underwriting practice where coverage is provided for a premium level that is actuarially less than necessary to pay claims and expenses. The insurer that engages in cash flow underwriting believes that it can make an investment profit on the premiums to compensate for the underwriting loss." See: http://insource.nils.com/gloss/GlossaryTerm.asp?tid=1098.
16. Combined Ratio: A.M. *Best Company, Aggregates & Averages 2004 Edition* (2004): 346. ROE: Insurance Information Institute, Robert Hartwig, "The Property & Casualty Industry Today: An Overview & Outlook," presentation to Association of Professional Insurance Women (November 2004).
17. Insurance Information Institute, Robert Hartwig, ibid, slide 16.
18. Fronting is generally understood to mean: "An agreement by an insurer to issue a policy on behalf of a reinsurer, captive insurer, self-insurer or another insurer. This fronting insurer assumes little or no loss exposure; instead, financial arrangements are made to guarantee claims administration and payments. The fronting insurer is usually paid a percentage of the premium. Fronting is done for a number of reasons, but is increasingly disfavored by regulators who contend

fronting is not a true risk transfer." See: http://insource.nils.com/gloss/GlossaryTerm.asp?tid=2614.

19. Benfield Group Limited, "Industry Analysis & Research," *Outrageous Fortune* (January 2005): 6. "Capacity is ample in virtually all [reinsurance] classes and additional capacity from hedge funds is seen by some as a potentially destabilizing factor."
20. Some obvious examples include ACE and XL (originally formed in 1985 to meet the D&O and excess liability needs of large corporate founders), AEGIS (formed by utilities in 1980 to meet their liability needs), and the many physician- and hospital-owned insurance companies formed mostly in the markets of the mid-1970s and mid-1980s.
21. "Investing for 2005, Insurance: Non-Life United States," Goldman Sachs Investment Research (January 3, 2005): 5.
22. Goldman Sachs Investment Research, ibid.
23. Conning & Company, "Challenges in Medical Malpractice" (1994): 7.
24. A.M. *Best Company, Aggregates & Averages 1988 Edition* (1988): 84.
25. California eliminated its workers compensation minimum rate rule in 1995. This contributed significantly to the huge insurer losses that resulted in 2004 reforms.
26. There are at least two professors from Georgia State University who would probably agree with this CEO. In their recent draft exposure paper, Tyler Leverty and Martin Grace assess insurer failures using detailed mathematical models. They conclude in their abstract: "While good management as we measure it is related to performance, bad luck is still an apparent reason for a significant number of property-liability insurer insolvencies." See: Leverty, Tyler, and Martin Grace, "Dupes or Incompetents? An Examination of Management's Impact on Property-Liability Insurer Distress" (January 24, 2005). Available for download at: http://nber.org/~confer/2005/insw05/program.html.
27. See: http://www.data.scec.org/chrono_index/northreq.html.
28. Hartwig, ibid.
29. See A.M. *Best Company, Review/Preview* (January 2005).
30. Standard & Poor's (ClassicDirect),"Profitability, Not Capital, Is the Driver Behind Recent Reinsurer Downgrades" (September 29, 2003).
31. Standard & Poor's, "The Benefits in Bermuda," Global Reinsurance Outlook 2003: Famine in the Midst of Plenty (December 4, 2002).
32. "Non-legacy" balance sheets generally mean the balance sheets of those insurers or reinsurers that include little or no loss reserves or potential liabilities for losses occurring prior to the date of their capitalization. The phrase is normally a reference to the new insurers and reinsurers formed in the aftermath of September 11, 2001. Examples include Axis, Endurance, Quantum, Arch, and Allied World.
33. "Finite" reinsurance defined in one insurance glossary as "An insurance or reinsurance contract that transfers financial risk of loss from an insured to an insurer over a specified period of time, subject to an ultimate limit of liability, and which usually includes a profit-sharing feature. The insurer holds large sums belonging to the insured in some form of savings account and a part of the investment income is rebated to the insured." See: http://insource.nils.com/gloss/GlossaryTerm.asp?tid=2414.
34. The inventory of insolvencies from the 1990s is heavily weighted with regional workers compensation specialists (due to regulatory limits on pricing and escalating medical cost inflation) and aggressive growth insurers, particularly those focused on medical malpractice. Significant examples of the latter include Frontier, PHICO, PIE Mutual, and MIIX. See: Standard & Poor's (RatingsDirect), "Insurer Failures Rise Slightly in 2002 Despite Firmer Pricing Environment" (February 23, 2003).
35. Frank, Ronald, Citigroup Global Markets, Smith Barney research report on ACE (February 3, 2005).
36. Goldman Sachs Global Investment Research, "Using capital management to unlock value" (January 3, 2005): 13.

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