Riding the cycle: Keeping one step ahead of the competition

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Non-life insurance rates are continuing to soften, exerting further downward pressure on margins and profitability. However, the dip in the underwriting cycle could also enable insurers with more effective pricing strategies, market intelligence and control of expenses to capitalise on their competitive advantages. Jean-Bernard Crozet and Jan-Huug Lobregt examine how the cycle is evolving and how two experienced industry professionals are seeking to manage the impact in a more proactive and competitive way.

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In 2007, the accident year combined ratio for the UK private motor insurance market reached 113%, an increase of 3% from the already high percentage of 2006. These figures provide a clear indication of a sector that has been struggling to sustain profitability in the face of mounting competition, excess capacity and the resulting softening of premium rates across large parts of the non-life insurance market.

In 2008, premiums have come under further pressure in insurance classes, ranging from motor and property to more specialised wholesale lines. Although the peaks and troughs in the underwriting cycle have always tended to be most pronounced in the UK and the US, Continental markets have become increasingly cyclical as the market globalises and competition intensifies. With the current economic landscape leaving less investment income to fall back on, 2008 could be an especially challenging year for the non-life sector.

Force of nature

In a perfectly rational market there would be no cycles; capacity would be swiftly adjusted to match demand and insurers would stop underwriting business once it becomes unprofitable or subject to unacceptable risk. Yet, despite efforts to improve market intelligence and underwriting discipline, there have always been some companies prepared to undercut rates and unknowingly lead the market down to unsustainably unprofitable depths. ‘In the past, insurers have simply accepted the insurance cycle, seeing it as a force of nature with an uncontrollable impact on their business’, said Rolf Tolle, Lloyd’s franchise performance director, at the launch of a report into how to improve cycle management in December 2006.

Cycle movements are to some extent driven by market forces. In a typical cycle, a decline in profitability leads to a reduction in capacity and supply, and hence an increase in rates. As these higher rates fuel increases in profitability, capacity re-enters the market and rates begin to soften. Within the property market, the latest cycle began in the aftermath of Hurricane Katrina, as severely affected insurers either withdrew cover from catastrophe-exposed regions or raised prices to recoup their losses. This was a good time to enter the market, with opportunistic investors moving in to take advantage of the shortfall in supply and hardening of rates. During 2007, capacity continued to increase and premiums began to fall back.

However, these market forces are only part of the story. Although companies would naturally avoid underwriting unprofitable business if at all possible, they may choose to do so to maintain a valued customer relationship. Others may want to establish or sustain market share, although such a strategy could severely erode bottom-line growth and shareholder value. It is notable that the bonuses of many underwriters continue to be based on short-term metrics rather than longer term value measures. The temptation to follow the market down is especially marked within subscription business and highly competitive segments.

Information lag

Even companies that are willing to scale back capacity to sustain profitable margins may be slow to respond, especially as it can take two years or more for corrective rating action to feed into the profit and loss (P&L) account.

1. Post Magazine, 10.07.08, based on Financial Services Authority (FSA) returns (the accident year combined ratio excludes the release of reserves and therefore provides a more accurate indication of the trading position than the reported combined ratio).
2. Lloyd’s press release to launch ‘Seven steps to managing the cycle’, 07.12.06.
For many insurers, the first indication that business has been written at a loss only comes when claims are submitted, which can take months or even years in some cases. The company can then undertake pricing analysis and make appropriate recommendations to underwriters. However, they will still need to wait until the renewal season to enact price rises, which in turn takes some time to earn through P&L. Even then, competition will typically limit rate increases, especially if there is no ‘big event’ such as Hurricane Katrina to prompt a sudden turn in the cycle.

For this article, we interviewed Frank Strobbe, who divides his time between heading the business intelligence unit of InG Insurance Services and working as a senior actuary in the non-life department of Nationale-Nederlanden (NN), a subsidiary of ING. ING now actively uses the underwriting cycle in its pricing process for motor insurance. However, the business used to be managed on the basis of the combined ratio. If the ratio was decreasing, there was room to increase premium levels; if it increased, then premiums were reduced. ‘The problem was that it could take more than a year for the company to adjust premiums. This is still the case for most companies in the Dutch market’, said Mr Strobbe.

The potential problems created by ‘information lag’ were further highlighted in PricewaterhouseCoopers’ recent survey of enterprise risk management (ERM) in the insurance industry. Less than one-third of participants strongly agreed that they have a clear strategy to respond to a softening market. Less than a quarter strongly agreed that their underwriters track and aggregate deviations from indicated prices or that their process for identifying the stage in the cycle is credible enough to drive business decisions. It would appear that like supertankers, many insurers are slow to turn, even when they find themselves in hazardous waters, a problem compounded by the delays in getting relevant messages to the bridge.

Damaging impact
As insurers face falling returns in a softening market, many analysts will look closely at whether reserves are being released to smooth reported earnings, and if so to what extent. Depleting their capital could leave insurers more vulnerable to the impact of a major loss. Their susceptibility to risk may be heightened by the more favourable policy terms and conditions that tend to go hand in hand with declining rates as companies seek to sustain business.

More broadly, the fluctuations in the cycle may discourage investment in the industry as a whole. For this article, we also interviewed John Seaton, who until recently was UK director of underwriting at Norwich Union and is now underwriting director of MMA UK. Although Mr Seaton believes that cycle fluctuations stem from a number of factors, some of which may be beyond insurers’ control, the plain fact is that ‘analysts simply see the cycle as evidence

3. ‘Does ERM matter? Enterprise risk management in the insurance industry’, a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance.
of an industry that cannot manage itself. ‘This is fair to a point,’ he believes, ‘many insurers have not taken a long enough view by investing in the right tools to monitor performance and seeking to structure rewards appropriately.’

Evolving cycle

In recent years, consolidation has eased the pressure of competition in some markets. Advances in modelling and analysis have led to improved lead indicators and more precise technical pricing. Regulators, including the Lloyd’s Franchise Board and FSA in the UK are seeking to impose greater price and risk management discipline. In theory, these developments should make the impact of the cycle less pronounced. However, far from disappearing, the cycle has simply become flatter and more prolonged overall, particularly for UK private motor.

Figure 1 highlights the change in cycle shape of the UK private motor class relative to the UK household class.

In the UK, the rapid increase in insurance sold via internet price comparison sites (aggregators) is sharpening price competition. Although the impact is especially marked in the motor market, where aggregator-instigated private vehicle insurance accounted for just under a quarter of all new business in 2007, household insurance is beginning to follow suit. Recent research carried out by confused.com, a leading aggregator, found that customers could save an average of around €150 on their home insurance and €160 on their car insurance by using its site.

With reductions like these, it is more than likely that the aggregator model and its impact on prices will eventually take hold on the Continent. John Seaton describes aggregators as ‘commoditisation taken to its ultimate degree’.

Other factors that may be prolonging the cycle include the variety of different labels and channels through which large groups now market insurance products, which can make it harder to formulate and coordinate an appropriate response to market movements. A series of relatively mild winters have also reduced motor claims and spurred price reductions.

Turning the cycle into an advantage

Insurers could simply choose to withdraw as competition, commoditisation and declining rates make certain business classes unprofitable. However, they would still need sufficiently timely and reliable information upon which to base their decision on exactly when to pull out, while ensuring that the enterprise is nimble and disciplined enough to respond in an appropriately swift, decisive and coordinated way. In some high-volume classes, such as motor or buildings cover, a leading insurer may also find it difficult to scale down without losing critical mass. The challenge is therefore how to maintain price competitiveness, while sustaining profitability and investor confidence.

For John Seaton and Frank Strobbe, this is an opportunity for well-run companies to steal a march on their more vulnerable competitors through more prospective market analysis and more proactive underwriting strategies.

‘Understanding the point in the cycle and where the market is going over the next two to three years should be a fundamental part of the strategic agenda’, says John Seaton. While price is the key driver for customer choice, he believes that there has to be a
• Investment in good people with experience of previous cycles, who understand the economics of their business and the financial dynamics of the market.

The underlying basis for success is the ‘discipline, professionalism and market understanding needed to build the demands of the cycle into the DNA of the organisation’, says John Seaton. For many companies, this is as much of a cultural as a technical challenge as they seek to change the way underwriters judge performance and the basis upon which they are rewarded. For example, it could be difficult to convince an underwriter that they are meeting the overall objectives of the company by accepting very little business at a low point in the cycle.

Frank Strobbe also recognises the importance of bringing the underwriting cycle into the forefront of business planning. ING is one of the few companies in the Netherlands that actively uses the cycle in its pricing strategy. His business intelligence unit analyses the competition, ING’s position in the market and developments in key risk factors on a monthly basis. A particular focus is the motor market, which is especially competitive in the Netherlands, along with fire insurance, which is becoming increasingly commoditised through a rapid increase in internet sales. ‘We have moved from a reactive approach to more proactive monitoring and analysis capable of predicting the trajectory of market movements and responding accordingly’, says Frank Strobbe.

ING has just launched new motor insurance through its Postbank label. The Dutch motor market is at a low point in the cycle. However, by understanding the trajectory of the cycle and carefully managing costs, ING can successfully introduce the Postbank motor insurance product. Belgium is at a different point in the cycle as rates begin to climb down from their current peak, enabling ING to launch a new motor policy at a relatively favourably priced premium. ‘The main advantage of our cycle analysis is that we are aware of the reward profile and how it is likely to develop and can therefore judge our strategic timing and expectations accordingly’, says Frank Strobbe.

Knowing the score
Far from disappearing, the underwriting cycle is becoming more prolonged and unpredictable and spreading to markets that had until recently been relatively stable. While some insurers may continue to passively accept the cycle as an ‘uncontrollable force of nature’, the challenges it presents could provide an opportunity for well-informed and well-managed insurers to manage market movements more proactively and realise the competitive advantages of keener pricing, lower losses and more sustainable underwriting strategies. This approach could in turn help to enhance market confidence and alleviate the fluctuations in returns that have deterred investment in the sector.

Success depends on the ability to define a walk-away price and ensure that this is competitive through effective cost and risk management. Insurers also need reliable forward-looking indicators and tight discipline so they know when this line in the sand is likely to be breached and can ensure that underwriters scale back business accordingly. According to John Seaton, the ultimate aim is a business that is capable of ‘competing on knowledge’.

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