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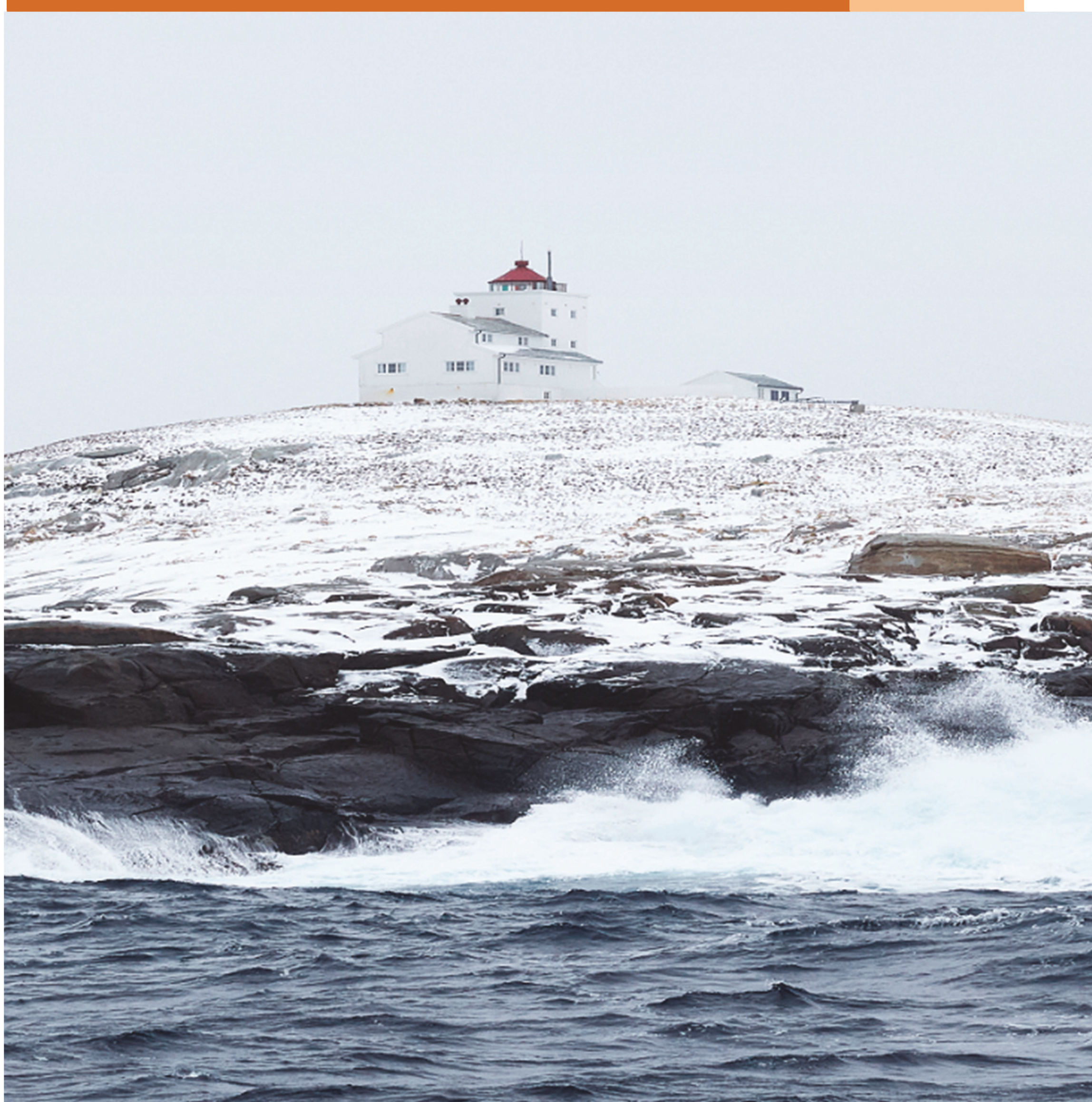
Commercial insurance underwriting strategy: The key to high performance



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PwC Financial Services

Top P&C insurance firms pull away from the pack, led by a sustainable underwriting advantage, according to PwC analysis.

The heart of the matter

Commercial insurance firms face a turbulent, highly-competitive market. But according to PwC's Insurance Performance Measure a sustainable underwriting advantage clearly leads to outperformance. Top property and casualty (P&C) insurers have pulled away from the pack by strategically diversifying their underwriting portfolio and fueling cross-functional collaboration while keeping an eye on expenses.

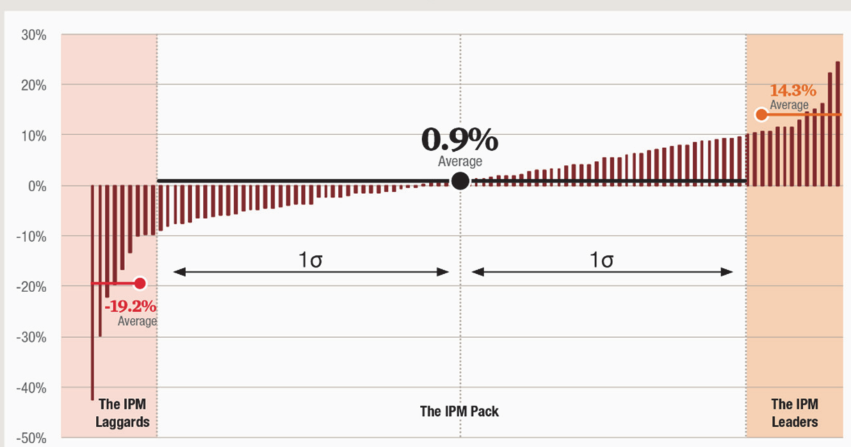
Savvy underwriting has long been critical to an insurance company's success. That's especially clear today. In a challenging market with declining profit margins and rising loss ratios, property and casualty (P&C) insurers should make strategic choices about how they'll stay ahead of their competitors.

We analyzed the top 100 commercial lines P&C insurers in the US using PwC's Insurance Performance Measure (IPM), which gauges an insurer's operating performance while accounting for the volatility of its results.[1] We divided the insurers into three groups based on how they performed over the five years from 2013 to through 2017:

- *The IPM Laggards*: the companies whose performance was one standard deviation below the mean, or more
- *The IPM Pack*: those who fell within one standard deviation of the mean
- *The IPM Leaders*: those whose performance exceeded the mean by at least one standard deviation.

Exhibit 1

Insurance Performance Measure for top 100 insurers (average, 2013-2017)



Source: S&P Global Market Intelligence, PwC analysis.
Note: "The IPM Pack" includes companies whose IPM performance falls within one standard deviation of the mean.
The IPM Leaders and The IPM Laggards have IPM performance that is at least one standard deviation above or below the mean, respectively.
Each bar represents the IPM performance of the 100 insurers included in the study, ranked from bottom to top IPM performance.

[1] IPM is a proprietary metric that offers carriers a picture of profitability. For a fuller explanation, please see page 8.

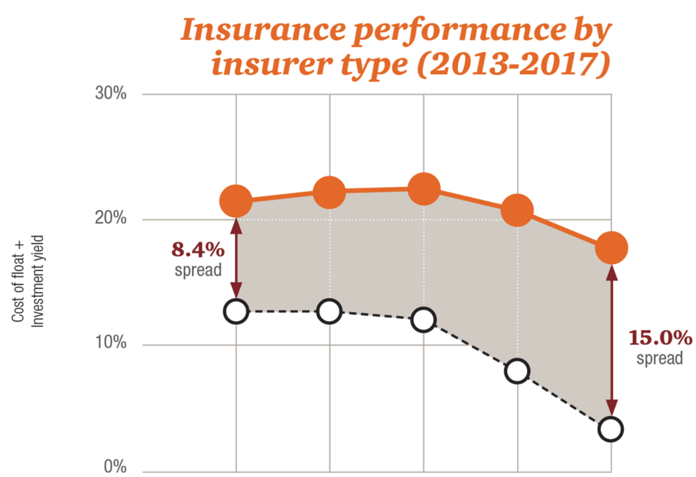
IPM assesses a company's operating profit (net cost of float plus investment yield) minus its cost of equity. Looked at another way, it shows the interplay of underwriting, reinsurance, and investment performance, normalized to account for the volatility of company results.

We found that, according to this metric, IPM Leaders have pulled away from the IPM pack in recent years. They have established a sustainable underwriting advantage by constantly fine-tuning the way they allocate capital, harness expertise across the value chain, and build this expertise into processes, controls, and analytics. As a result, IPM Leaders now outpace the industry average for IPM by 15 percentage points, up from 8.4 in 2013.[2] (See Exhibit 2.)

Underwriting isn't the whole story, of course. Above-average expense management and superior investment returns certainly boost overall performance. But those haven't been the key drivers for the IPM Leaders, according to our analysis. Strong underwriting provides the biggest competitive advantage, and we expect it will likely remain the key to steady outperformance in coming years. By looking at the choices that these companies have made, other carriers may gain valuable insights into how they can refocus their efforts toward programs that can set them apart from their peers.

Exhibit 2

IPM Leaders extend their lead over industry average



Insurer type	2013Y	2014Y	2015Y	2016Y	2017Y
The IPM Leaders	21.1%	22.3%	22.5%	20.7%	17.9%
US P&C industry	12.7%	12.5%	12.2%	7.7%	2.9%
Spread	8.4%	9.8%	10.3%	13.0%	15.0%

The IPM Leaders   US P&C industry

Source: S&P Global Market Intelligence, PwC analysis.
Note: The IPM Leaders have IPM performance that is at least one standard deviation above the mean of the 100 insurers included in the study.

[2] Source: S&P Global Market Intelligence data and PwC Analysis.

An in-depth discussion

In the face of several market and management challenges, the operating profit for commercial insurers fell to 2.9% in 2017 from a peak of 12.7% in 2013.[3] Some carriers have improved their underwriting and bucked the downward trend. But many firms have been unable to get the results they want and face tougher times.

The current commercial insurance market is now unforgiving for several reasons. Policyholder surplus, or a carrier's assets minus its liabilities, rose to a record US$765 billion in 2017 from US$295 billion in 2002, according to S&P Global Market Intelligence and PwC analysis. Premiums didn't grow at the same pace, resulting in an industry premium-to-surplus ratio dropping from 1.2 to 0.72 over the same period.[4] With so much overcapacity, it's not surprising to see a resurgence in competition on price and policy terms. But investment returns have continued to be anemic, with soft markets on both sides of the balance sheet. And now, loss ratios are soaring, after various catastrophes pushed up P&C losses to a record US$52.9 billion in 2017, or more than double the figure for 2016, according to an estimate by A.M. Best.[5]

Management challenges are daunting as well, extending across underwriting, cost containment, and investment performance. In underwriting, evolving business models have blurred the lines across different classes of risk. Carriers should try to adapt to new business models as quickly and efficiently as possible. Medical malpractice insurers, for example, should consider how nurse practitioners increasingly fill in for doctors in routine care. Pharmacies now house medical clinics.

And companies that manufacture fitness trackers have melded software and services in new ways. These evolving business models bend traditional industry classifications and may present new types of risk. In response, carriers should rethink their product offerings and the ways they classify and assess risk. They should also build capabilities to monitor and adapt as the world around them changes at a quicker pace.

Some management troubles are self-inflicted. As experienced underwriters retire and low complexity activities are automated, the ranks of professional underwriters will likely shrink 12% from 2014 until 2024, according to the Bureau of Labor Statistics.[6] Despite the brain drain, many carriers aren't budgeting enough for entry-level underwriting jobs and mentoring. Most haven't adapted the onboarding curriculum to account for changing needs and expectations of the millennial workforce or the need for greater flexibility, more sophisticated problem solving, and increased use of technology and analytics. Many firms also fail to transfer knowledge effectively from retiring staff, so they lose the hard-won, valuable expertise that they've built over decades.

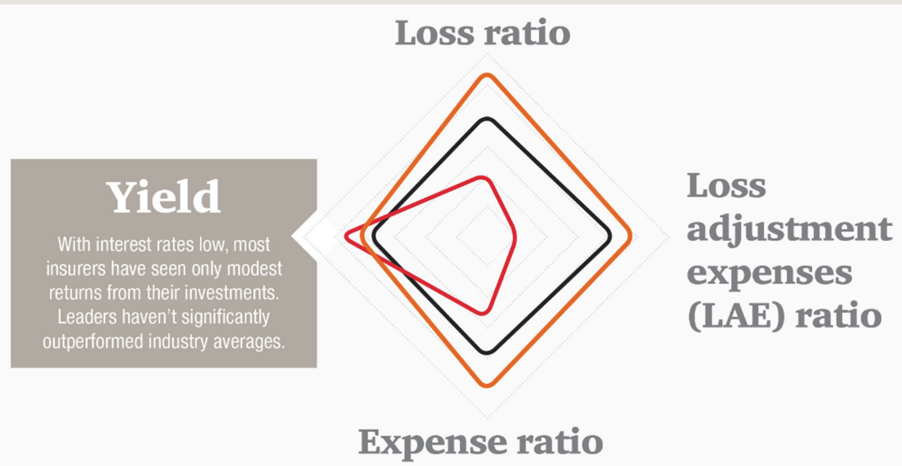
[3] Source: S&P Global Market Intelligence data and PwC Analysis.
[4] Ibid.
[5] "Best's Special Report: Preliminary 2017 Underwriting Results for U.S. P/C Industry Reflect Toll of US$53 Billion Cat Loss," *A.M. Best Company,* March 19, 2018, accessed on Factiva on March 20, 2018.
[6] Bureau of Labor Statistics, "Industry-occupation matrix data, by occupation," December 2015, www.bls.gov.

Commercial insurers have also struggled to curb operational expenses. During the past two decades, their loss-adjustment expense (LAE) and underwriting expense ratios haven't improved.[7] Some distributors often push for higher commissions as the price for access to certain opportunities. Meanwhile, many carriers still spend heavily on fragmented and inefficient technology platforms.

Finally, several years of record-low interest rates have crimped everyone's asset management performance. Investment results haven't varied significantly among the top 100 US P&C companies we analyzed. The average yield for IPM Leaders for the years 2013 to 2017 was 2.9%, barely higher than the average for the top 100 insurers.[8] Obviously, this is not where top performers are gaining an advantage today. (See Exhibit 3.)

Exhibit 3

Relative drivers of performance: 2013 to 2017



	Loss ratio	LAE ratio	Expense ratio	Yield
The IPM Leaders	45.4%	11.7%	27.0%	2.9%
The IPM Pack	53.0%	12.5%	30.4%	2.8%
The IPM Laggards	63.5%	16.6%	34.4%	3.0%

The IPM Leaders The IPM Pack The IPM Laggards

Source: S&P Global Market Intelligence, PwC analysis.
Note: "The IPM Pack" includes companies whose IPM performance falls within one standard deviation of the mean.
The IPM Leaders and The IPM Laggards have IPM performance that is at least one standard deviation above or below the mean, respectively.

[7] Source: S&P Global Market Intelligence data and PwC Analysis.
[8] Ibid.

Successful strategies

Companies outperform the market over the long term by sustaining superior underwriting profits through hard and soft markets. Some have managed to keep this **underwriting advantage** for as long as 20 years. But success is due to *more* than just underwriting. We found that the IPM Leaders successfully used a combination of techniques:

- Strategic diversification
- Effective management across business units
- A lean operating model, including an emphasis on expense management

Strategic diversification

Through vigilance and flexibility, IPM Leaders tend to target growth opportunities across their business segments. They seek diversification and increased balance between volatility and expected return. They closely track the correlation among lines of business, industry segments, and geographies. They also understand how to make the most efficient use of capital, weighing the volatility and returns of individual business units and their relationship to the overall portfolio.[9]

Berkshire Hathaway exemplifies the value of attentive portfolio management. It owns GEICO, the high-growth auto insurer that focuses on high-frequency/low-severity risks. It also holds National Indemnity, which insures cargo, garages, and other low-frequency/high-severity risks. Berkshire is eighth in our IPM ranking. Similarly, by acquiring Chubb in 2016, ACE complemented its focus on industrial, commercial, multinational, and upper middle market companies with strength in the small and mid-market segments.[10] The combined firm, known as Chubb, is an IPM Leader.

And ProAssurance became a leading medical malpractice (medmal) insurer through a series of strategic portfolio decisions aimed at diversification. Responding to medmal market pressures, ProAssurance expanded geographically, broadened its product line, and offered dividends and reward plans. It also offered risk management services for clients, extended its reach through acquisitions, and ventured into new types of risk based on size and industry type. As a sideline, ProAssurance provides underwriting services. The company is in the top quintile in our IPM ranking.[11]

Effective management across business units

Top performing insurers tend to identify and seize on the most promising growth opportunities. They reduce unforeseen risk exposures/concentrations by aligning functions in ways that improve underwriting insights. They do this by harnessing market expertise wherever it exists in the organization (such as distribution, underwriting, risk control, claims, and actuarial).

With the right information, they can fine tune their strategy, carefully managing their risk appetite, terms and conditions, and pricing to acquire and retain the most profitable business. Then, when the market turns, they're able to leverage their market position to command superior pricing at favorable terms and conditions.

9 Source: S&P Global Market Intelligence data and PwC Analysis.
10 "Chubb Reports Better-Than-Expected Results; Operating profit and net premiums written in third quarter beat expectations," *The Wall Street Journal,* October 25, 2016, accessed on Factiva on September 18, 2018.
11 Source: S&P Global Market Intelligence data and PwC Analysis.

Travelers, for example, uses data-driven risk measurement and underwriting to "out-select" its rivals. In "hard" markets (high demand/low supply), Travelers has the data, analytics, and confidence to raise prices sooner than its rivals. It also can quickly alter policy terms and recalibrate its risk selection. Travelers is 13th in our IPM ranking.

A lean operating model

Industry leaders create cross-functional coordination and efficiency by deliberately adopting operating models with clear lines of accountability and appropriate levels of automation. Even at the upper end of the market, where human processing and judgment is particularly prevalent, digital technology can help improve coordination and decision making in underwriting and across company operations.

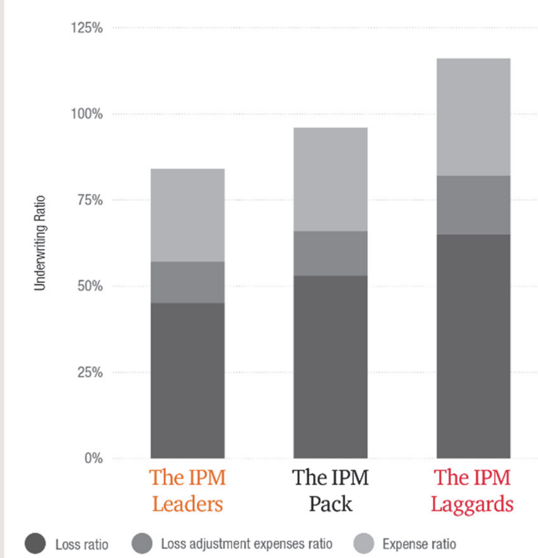
This isn't a one-size-fits-all proposition. The "right" technology to manage expenses may depend on a carrier's concentration of business across market segments. For instance, commercial insurers with many small accounts may realize more value by using machine learning and automating underwriting. Alternatively, firms with many large accounts may derive more value from blockchain technology and automating the process of providing bordereaux to its reinsurers.

By trimming costs in low value/low profile areas, firms open up several strategic options to invest where spending can make a difference. With more resources, carriers can acquire more underwriting expertise, build up differentiating capabilities, or offer more value-added services. They may also tolerate a higher loss ratio than their rivals. (The loss ratio often drives the spread in performance between firms. But IPM Leaders have both lower LAE *and* lower expense ratio, giving them greater operational efficiencies which they can re-invest elsewhere.)

Our IPM analysis shows that, for top-performing insurers, **investment performance** hasn't been nearly as powerful a force for growth as effective underwriting. Indeed, the IPM Leaders from 2013 until 2017 generated an annual average return of 2.9%, barely differentiated from the whole P&C industry average.[12] This may change, however. Comparative performance will probably widen as a decade of cheap money gives way to forecasts of rising interest rates and greater market volatility. Many of the 100 firms we studied are vulnerable to such shifts. They're heavily invested in stocks, high-yield debt, and alternative investments like private equity, and they haven't hedged sufficiently against higher rates. We may see investment return becoming a key differentiator once again.[13]

Exhibit 4

Underwriting ratio components: Average from 2013 to 2017



Ratios	The IPM Leaders	The IPM Pack	The IPM Laggards
Loss ratio	45%	53%	64%
Loss adjustment expenses ratio	12%	13%	17%
Expense ratio	27%	30%	34%
Underwriting ratio	**84%**	**96%**	**115%**

Source: S&P Global Market Intelligence, PwC analysis.
Note: "The IPM Pack" includes companies whose IPM performance falls within one standard deviation of the mean. The IPM Leaders and The IPM Laggards have IPM performance that is at least one standard deviation above or below the mean, respectively.

12 Source: S&P Global Market Intelligence data and PwC Analysis.
13 Non-traditional investment strategies may offer some opportunity to generate higher yields on a countercyclical basis. Such strategies are most appealing for well-capitalized carriers. They may not fare as well under certain market scenarios, so modeling will be important.

What this means for your business

Although commercial insurance companies face sizable obstacles, the path forward is clear. Establishing an underwriting advantage—both for day-to-day activities and as part of broad strategic portfolio management—is increasingly vital for outperformance.

Firms should pinpoint the most promising sources of profitable growth across existing and prospective business segments. They should find the best alignment between volatility and expected return. They should attune all phases of underwriting, enabling information sharing and cohesive decision making across units. And they should seize the benefits from automation, data analytics, and artificial intelligence.

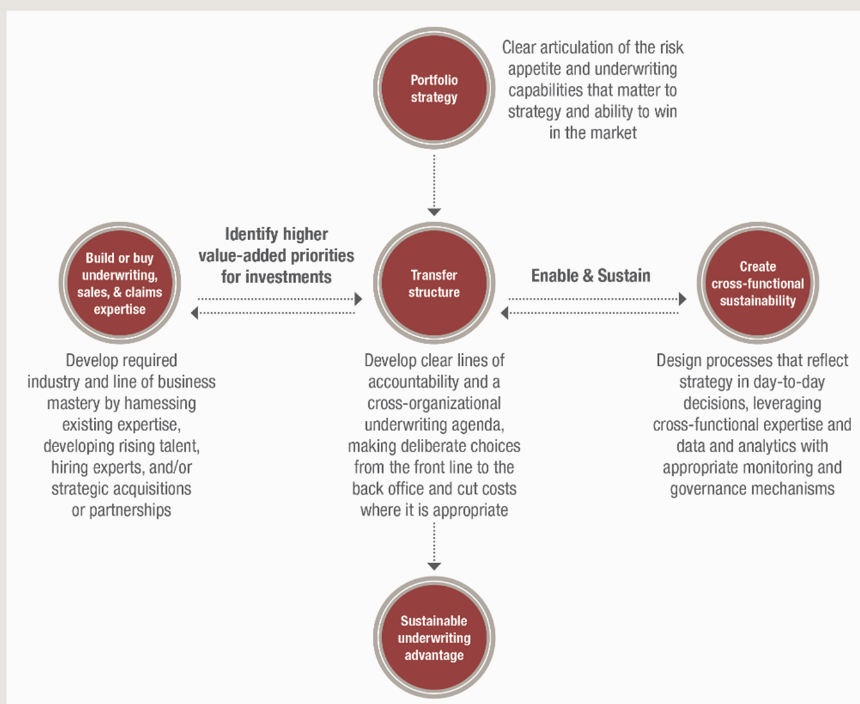
Expense management matters, but not for its own sake. In fact, across-the-board cost cutting can backfire if it doesn't coincide with sharpening an underwriting advantage. The cost base of the entire industry *is* too high. This leaves an opening for carriers that can strategically cut "run-the-business" costs to build differentiating capabilities, offer value-added services, and/or compete aggressively on price to pick up market share.[14]

These steps may appear challenging, especially in an environment with limited opportunities for investment return. But they're available to all. Managing underwriting expertise, using expense management to generate growth, and enhancing governance are strategies that firms at both the bottom and top of the market can use.

The underwriting cycle is likely to remain soft, and we expect that industry leaders will widen their advantage over the rest of the industry in coming years. But, we also see opportunities for other companies to jump ahead by using similar strategies to create a sustainable underwriting advantage.

Exhibit 5

Managing strategically to creating a sustainable advantage for P&C insurers



Source: PwC analysis.

[14] PwC, "Shifting cost curves to stay in the commercial insurance race," January 2018

Understanding PwC's Insurance Performance Measure (IPM)

IPM is a proprietary metric that offers carriers a fuller picture of profitability than standard metrics such as the underwriting ratio. It combines the three drivers of performance—underwriting, reinsurance, and investment return—and shows how they interact. Insurers can use it to uncover weaknesses and sharpen oversight in specific operations. They can also use the IPM to identify trade-offs from decisions and help in drawing up business strategies.

Investment returns and reinsurance results are a key part of P&C performance, but typical assessments emphasize underwriting and claims. IPM adjusts investment returns for the costs of float and reinsurance, allowing companies to understand the value they create relative to their hurdle rate.

The IPM formula:

IPM = [$\mathbf{r_1}$ + $\mathbf{K_o}$ – $\mathbf{K_R}$] – **h**, where
$\mathbf{r_1}$ is the investment return
$\mathbf{K_o}$ is the cost of float [(100 + risk free rate) – underwriting ratio]
$\mathbf{K_R}$ is the cost of reinsurance [% of premium reinsured * (100 – reinsurance underwriting ratio)]
h is the hurdle rate

For additional information, see Joseph Calandro, Jr., and Scott Lane, "*The Insurance Performance Measure (IPM): Bringing value to the insurance Industry*," *Journal of Applied Corporate Finance,* Volume 14 Number 4, Winter (2002), pp. 94-99.

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For a deeper conversation, please contact:

Francois Ramette
Partner
+1 (312) 298-2046
francois.ramette@pwc.com

Joseph Calandro
Managing Director
+1 (203) 906-6595
calandro.joseph@pwc.com

Katie Klutts
Director
+1 (202) 255-0843
kathryn.klutts@pwc.com

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