

The INSURANCE Winter

By John J. Kollar

As we move through a time of general economic uncertainty,

the property and casualty insurance business in particular continues to face financial difficulties. Speculation about a rebound notwithstanding, my analysis indicates primary insurers' financial results continue to deteriorate by nearly every measure except premium growth, according to the best estimates of the Insurance Services Office (ISO).

At \$20.2 billion, net income after taxes for 2000 is down more than 7 percent from 1999. Premiums grew 5.1 percent for 2000, but losses and loss-adjustment expenses grew faster, at 8.7 percent for the year.

The industry's combined ratio in 2000 worsened, climbing to 110.5, up 2.8 points from 1999. Normalized for 2000's unusually light catastrophe losses, the deterioration in results is even worse: 111.8.

The industry's poor underwriting results are compounded by slowing investment income. Unrealized losses have begun to mount. The ISO analysis indicates that insurers suffered \$18 billion in unrealized capital losses in 2000, in contrast to the unrealized capital gains they enjoyed the prior five years. A truer picture of how well insurers' portfolios performed last year emerges when realized and unrealized figures are combined. That number shows overall capital losses of \$1.1 billion—a far cry from \$14.9 billion in overall capital gains in 1999.

What happened is no mystery. After nearly a decade of uninterrupted gains, the financial markets sharply reversed course last year. The S&P 500 fell 10 percent, the tech-heavy NASDAQ fell nearly 40 percent, and the Dow was off more than 6 percent. At the same time, insurers felt pressure on their bond portfolios as the average yields on Treasury securities rose in 2000, reducing market values.

ISO concludes that property/casualty industry surplus fell 4.5 percent at year-end 2000, as unrealized capital losses and dividends to shareholders exceeded the industry's net income after taxes. The decline in surplus was the first since 1984, when surplus fell more than 3 percent at the bottom of the worst underwriting cycle in the industry's history.

For the past four years, operating cash flow, too, has been in a steep decline, from \$31 billion in 1997 to \$16 billion in 1998 to less than \$8 billion in 1999—below the level posted in 1984, the deepest cycle's deepest year. Last year's \$5.7 billion in operating cash flow was even lower—the lowest in 20 years.

ISO's analysis of operating cash flow by type of insurer tells us the cash-flow squeeze has been most severe among commercial writers. For year-end 1999 (the most recent figures available), per-

INDUSTRY'S of Discontent

A financial snapshot of the insurance industry shows that it's not immune from the woes that plague the rest of the world economy.

sonal lines writers' operating cash flow was 5 percent of premium; multiline writers' 3 percent of premium; and commercial lines writers posted virtually no operating cash flow at all.

Amid such stark evidence of financial decline the question is: Is the cycle really turning?

There are signs—anecdotal, to be sure—that commercial pricing, at least, is going up. A spring 2001 Conning & Co. survey of brokers and agents in primary markets reported average pricing in every commercial line was rising. The greatest price increases were in workers' comp at 14.8 percent, general liability at 12.4 percent, and commercial auto at 11.4 percent. Commercial property, multiperil, excess and surplus, and umbrella lines were all between 10 percent and 11 percent.

Indications are that the primary market has been hardening gradually rather than suddenly, as it did in the mid-1980s. Some may read the market's slow improvement as bad news. But in the long run, the industry may benefit from gradual price increases that won't drive business to alternative markets, such as self-insurance and captives.

Moreover, the market now believes insurers' prospects for profits and profitability are brightening. The S&P 500 declined 10 percent in 2000, while the S&P property/casualty index rose nearly 53 percent, although recently insurance stocks have given back a portion of their outsized gains. Investors may have embraced rumors of price firming, but it's even more likely they're also fleeing the dot coms, or see insurance stocks as surrogates for bonds and anticipate further reductions in interest rates by the Federal Reserve.

Reinsurers' underwriting results also continued to slide in 2000. According to the Reinsurance Association of America, net income for 2000 was \$1 billion, down more than \$300 million from net income of \$1.4 billion for 1999. In 2000 written premium was up 17.2 percent to \$24.9 billion, from the \$21.2 billion in 1999. But losses and loss-adjustment expenses were also up—18.4 percent to \$20.3 billion from the \$17.1 billion in 1999.

And reinsurers' combined ratio at 114.2 percent this year is 0.4 points worse than the ratio of 113.8 in 1999.

Taking a longer-term perspective, reinsurers' profitability exceeded that of the entire property/casualty industry in all but two years of the 1990s—in 1995 and 1999. In 2000 reinsurers' rate of return on year-end surplus fell to 4.3 percent—two full points below the rate of return for the industry overall (and 1.4 points below reinsurers' rate of return for 1999).

While the numbers aren't good, some signs are promising—and only time will tell whether we're truly at the start of the long-awaited rebound.


Mature Reinsurance Market

Conditions in the U.S. marketplace are demanding. Consolidation, globalization, and convergence of financial services and technology are transforming the industry.

Mergers and acquisitions in the property/casualty insurance industry are down following record-setting activity. In 1998, the industry posted an all-time-high 117 deals valued at more than \$55.8 billion. In 1999, the number declined to 63 deals worth \$19.1 billion, and last year we witnessed 53 deals worth \$8.9 billion.

But M&A won't go away. Overcapacity, the drive to increase revenues, and the quest to achieve advantage through economies of scale continue. And, of course, international competitors remain on the prowl for promising U.S. acquisitions and further expansion in the huge U.S. market.

Like the primary insurance market, the global reinsurance



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market has become mature and consolidated. In the early 1990s, more than 100 reinsurers served the U.S. marketplace. Now there are only about 30. What's more, securitization through the \$30 trillion U.S. capital markets is poised to become a competitive threat.

How will the industry respond to the challenges ahead, and what will it take for competitors to come out on top? Specialization and niche marketing have become dominant themes of the new insurance landscape, with insurers increasingly tailoring their business to appeal to special classes of business, often while retaining their multi-line character. AIG's acquisition of Hartford Steam Boiler is a good example.

The Gramm-Leach-Bliley Act (GLB), the financial services modernization measure enacted in late 1999, follows a blurring of the lines between banks, securities firms, and insurers—lines spectacularly blurred by the 1998 Travelers-Citicorp

merger. Even in the Congress, the House committees have been consolidated into one—the House Committee on Financial Services. Insurers are now starting thrifts, even as banks are getting into insurance. State Farm, AIG, and Nationwide, to name a few, are already competing with banks.

As a result of financial industries' convergence, many facets of government face new and intense pressure for change. The National Association of Insurance Commissioners is considering a speed-to-market mechanism that would allow insurers to compete on an equal footing with their new banking and securities competitors. Banks don't face regulatory approval for filings from 50 individual state regulators as insurers do.

Target Market

All insurers are increasingly forced to seek out new ways to harness technology to achieve cost reductions by automating all phases of their operations. Most successful companies are way ahead of the pack. But tomorrow's technology challenge is to achieve strategic advantage through portals, business-to-business applications, and application service provider systems.

Electronic commerce has become an essential tool for taking cost out of reinsurers' business, as well. Swiss Re America, for instance, injected \$70 million into its Web-enablement technology to increase its administrative efficiency.

Insurers' e-commerce strategies vary and are based on the insurance industry's unique operational needs and limitations. Insurance sales through the Internet have shown little promise to date, but insurers are more aggressively adapting to business-to-business Internet applications.

But the benefits that even the best technology can deliver are limited to the quality of the information it gathers, processes, and ultimately produces. In our industry, a company's survival will depend on its ability to efficiently access, analyze, and apply information to address its own needs and the needs of its customers.

Today, information products address reinsurers' pricing challenges by giving reinsurers a credible framework to evaluate and rate risks based on analysis of a current and credible database of loss experience.

Another breakthrough insurance technology—dynamic financial analysis (DFA)—provides an integrated, holistic framework for measuring all of the financial risks that insurers face. A critical part of DFA is the ability to measure the amount of underwriting risk, because it helps to determine how much capital is needed overall for allocation to each line of insurance and determine profitability, pricing, and other targets.

When all is said, there's no avoiding it—ours is an industry in transition. Despite ups and downs in pricing cycles, we see no signs that competition will let up, or that the volatility in today's market will diminish. The information you depend on to make business decisions will determine whether you win the competitive race, run straight into a barrier, or wake up to find competitors aiming at your markets. ●

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