Why Insurance Companies Do Dumb Things

RECENTLY, JARED DIAMOND, the author of the Pulitzer Prize-winning nonfiction work *Guns, Germs, and Steel: The Fates of Human Societies*, gave a lecture in which he discussed why civilizations collapse. Diamond identifies what he believes are the major categories of egregious errors that rulers and politicians make when dealing with resource management. The text of this lecture can be found at www.edge.org.

While Mr. Diamond's remarks are focused on societies and civilizations and how they decide to use natural resources, the substance of his lecture is applicable to organizational, as well as societal, decision-making. The types of errors he identifies exist in the executive suites of insurance companies as well as in national capitals.

Mr. Diamond identifies four categories of fatal errors:

1. Failure to anticipate the problem before it arrives
2. Failure to perceive the problem after it arrives
3. Failure to address the problem after it is recognized
4. Failure to solve the problem

I'll discuss how each of these four categories affects the insurance industry, and give examples of how each has occurred.

1 FAILURE TO ANTICIPATE THE PROBLEM

One reason for the failure to anticipate the problem is lack of prior experience with it. Although the problem may have occurred in the past, if the decision-makers have no personal experience with a historical episode, they're likely to fulfill Santayana's dictum that "those who cannot remember the past are condemned to repeat it."

For instance, some life insurance companies loaded up on variable annuities in the late 1990s and in 2000. When the bear market arrived (as it always does), the fee income from variable annuities dropped along with the underlying equity values. The extended bull market in equities apparently made executives forget the lessons of 1929 or even the more general lessons regarding concentration of risk.

Another reason why problems aren't foreseen is that historical conditions may not provide sufficient indications of developing problems. Anticipating problems or issues of this nature is fiendishly difficult since it implies an understanding of the material causal factors of the problems. An instance of this is the improvement in longevity in the first half of the 20th century due to medical and sanitary improvements. This drop in mortality wasn't something that was indicated by any historical precedent; rather it was the result of changes to significant underlying factors—a "chaotic" event.

Although this shift was a boon to companies selling life insurance, it was a problem to companies selling payout annuities. This unanticipated shift in longevity meant that payout annuities that were sold based on prior ideas of longevity were unprofitable. This problem was limited in the United States, but in some European countries it was disastrous.

Anticipating this sort of problem may be impossible. If so, the only protection is a regular review of risk concentrations combined with actions to insure that the risks remain appropriately balanced.

2 FAILURE TO PERCEIVE THE PROBLEM

The second class of error is the failure to perceive the problem after it's arrived. For insurance companies, and other financial institutions, perhaps the most frequent cause of this class of error is a slow trend concealed by short-term and intermediate-term volatility. That is, a long time-line is required in order to discern any underlying secular trend.

The implosion of the individual disability market in the mid-1990s is perhaps an example of this sort of error. Disability insurance is a long-tailed coverage subject to short-term fluctuations that can mask secular trends. Several major disability carriers had liberalized their underwriting and policy benefits over the course of the 1980s as a way to increase their market share. This was accomplished without any apparent short-term adverse results until the early 1990s, when the profitability of this line of business dropped noticeably. In fact, several insurers

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found that they had to increase their reserves by hundreds of millions of dollars.

What happened? Apparently the short-term fluctuations, which were favorable for much of the decade of the 1980s, concealed any underlying long-term deterioration in morbidity. As the short-term items entered the adverse portion of their cycle, profitability was suddenly much worse than anticipated, indicating that the long-term cycles were adverse. It's still not clear how much of the market implosion was due to the reversal of short-term cycles and how much was due to long-term deteriorations, but it is clear that disability morbidity is worse now than before.

Another common reason for failing to recognize problems is the distance of managers from the business they're managing. Executives who have geographically diverse divisions or subsidiaries may manage these remote operations only on an exception basis. In other words, they attend to them only when things become too bad to ignore. This is a reason that becomes more acute in our industry as companies consolidate and become more far-flung.

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3 FAILURE TO ADDRESS THE PROBLEM

Jared Diamond believes this is the most common and widespread class of egregious error. Executives may not address a problem for several reasons. The first reason is a manifestation of the agency problem. Executives may have interests that are misaligned with other company stakeholders (shareholders, employees). The same problem was clearly manifested in the cases of Enron and WorldCom (and more recently HealthSouth).

This type of behavior may be more common than we'd like to believe. The "winners" are typically concentrated and are motivated by enormous, immediate profits; the "losers" are dispersed and they receive a relatively small and distant profit from unwinding the selfish behavior of the few. (It's interesting to note here that class-action lawsuits work because they create a concentrated class motivated by the potential for enormous, immediate profits, even though those who have been harmed typically receive only a small benefit that may not be immediate.)

Another reason for failure to address problems after they're recognized is the tension between short-term goals and long-term goals. While executives may recognize problems, they may not take any effective actions because short-term concerns are perceived as more urgent, more critical, than long-term concerns.

For instance, an executive who has to meet quarterly earnings targets or lose his job won't have much focus on potential long-term reserve insufficiencies. Long-term insufficiencies are a problem for another quarter, or even for the executive's successor. Likewise, an executive who has to cut costs by 40 percent won't have any incentive to emphasize innovation, new products, or customer service, even

though these actions are clearly necessary for long-term survival and growth.

A third reason for failure to address problems is psychological denial. It's always uncomfortable to admit mistakes, but an executive whose policies have caused financial disaster may be unable to admit his mistakes because admission will have such a damaging effect on his sense of self and self-worth.

4 FAILURE TO SOLVE THE PROBLEM

The most obvious reason why an organization fails to solve a problem is that the problem is simply insoluble by the organization, either because of lack of resources or because existing conditions prevent any solution.

One example may be private medical insurance. Indemnity of medical insurance coverage has all but disappeared, except in the form of very high deductible policies. It has been replaced by managed care in its various incarnations.

Why has this evolution occurred? In the United States the voting public by and large considers health care to be a right, something the government should guarantee. Although the public's viewpoint isn't exactly consistent (witness the reaction in the early 1990s to Hillary Clinton's nationalized medical care legislation), the viewpoint is strong enough to have created all sorts of mandated coverages and legislative imperatives resulting in more expensive insurance.

In addition, the aging population has meant that health care, on average, has become more intensive (and more expensive). These cost pressures mean that private insurance is unaffordable to many people without some form of subsidy (employer subsidies in the case of wage earners, and government subsidies and government mandated subsidies in the case of Medicare).

Given this public policy perspective of health care, it remains an unanswered question whether a capitalistic, for-profit organization of medical care funding can survive. As Peter Drucker points out (*The Effective Executive*, page 117), nationalization occurs when critical industries are unable to attract sufficient private capital. If private health care insurance is unable to find a way to provide a reasonable return to those who provide capital, and to deal with the problems posed by evolving public policy, then private medical insurance will no longer be viable.

Conclusion

Major errors in business can be classified in four categories: (1) failure to anticipate problems; (2) failure to recognize problems; (3) failure to address problems; and (4) failure to solve problems. Success, unfortunately, is more complex than simply avoiding problems. Success consists of doing enough of the right things while avoiding enough of the major errors to continue as a going concern. ●

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