



Focus on: Pricing

Welcome to the Journal's latest interactive Hot Topic feature, where we aim to stimulate debate on an important industry issue, hoping that you will pitch in with your thoughts at our online forum. The topic this time is pricing and the insurance cycle, with all that entails in terms of fluctuating premiums, varying levels of competition, instability and uncertainty. On page 21 you'll find contributions from our panel of experts, all of whom are ready and able to respond to any queries, comments or contributions you might care to offer once you've read the main article and their thoughts. To participate, head to www.cii.co.uk/journalhottopics, where you'll find instructions on how to join the debate.

Kevin Pratt, editor, The Journal

INSURANCE IS A COMPLEX and multi-faceted, multi-national business, but in one respect – pricing – it adheres to the most simple and inescapable principle of economics: supply and demand.

When policies command robust premiums, the supply of capacity to underwrite those policies increases as more firms strive to secure a piece of the action. But increased competition, a consequence of eventual over-supply, depresses the prices firms can charge. Capital then generates less of a return, leading to disenchantment and, in some cases, withdrawal from the market.

As the supply of capacity reduces, a circumstance often triggered by a major claims event, so the intensity of competition eases, allowing premiums to rise again. And capital, being unsentimental and devoid of memory, ploughs straight back into the business, starting the whole process again.

Welcome to the insurance cycle, or at

least a vastly over-simplified explanation of it. It turns from “soft” rates, when prices are low, to “hard” rates, when they are more expensive. So does it offer a comfortable ride?

The cycle would seem to be an inherent part of the insurance market. It has turned with varying speeds and at varying intensity over the years, but it has been a constant feature. Many learned people have pondered long and hard as to whether it is a fundamental weakness of the way the market operates, and thus something that should be tackled, or whether it is something we cannot escape, and thus something we should factor into the way we do business.

For instance, there are those who crave pricing stability. But others rejoice in the fluidity and responsiveness of the market, using it to secure preferential terms.

Of course, there are various



→ complicating factors to take into account. For example, you cannot talk of supply and demand without acknowledging that the demand for certain types of insurance is pretty much constant, regardless of price. Motor insurance is mandatory in the UK, and there is no evidence to suggest fewer people drive when motor insurance is relatively expensive. That said, all companies are required by law to effect liability covers, and some of them may be put out of business by steep premium increases in a hard market.

Then we have the multi-faceted nature of insurance alluded to earlier. While the cycle ultimately impacts the whole sector, the various classes move at different speeds – and even in different directions. Why should aviation insurance, for instance, follow the same pricing path as domestic contents cover? Where you are in the market will radically affect your perspective of what is happening at any given time.

The prices charged to policyholders are also affected by what’s happening in the reinsurance market, where rates are especially sensitive to claims-laden catastrophes. The direction of prices can easily be affected by a vicious hurricane season in the North Atlantic.

More spice is added to the stew by the importance of investment returns to insurer finances. When insurance

company treasury departments can turn 10% or more every year by investing premiums, the Board may be tempted to tell its underwriters to take the foot off the pricing pedal. But when investment returns dry up, rates cannot be subsidised in this way, so they harden to technically more realistic levels.

Consider also that, when investment returns are low, it is likely that buyers are also feeling the economic sting, making them unwilling or unable to swallow higher prices.

Risk management has also influenced insurance economics in recent years as more emphasis has been given to loss prevention, loss control and business continuity. Policyholders who invest time, effort and resource into risk management, and who record fewer claims as a result, rightly expect to be rewarded with lower premiums, sucking more money out of the system.

So where are we now? How is the insurance market responding to the varied pressures brought about by a recession, a banking crisis and a dearth of investment returns?

It’s a complicated scene. The AA, in its capacity as a broker, recorded the biggest ever premium increases in its British Insurance Premium Index. It says motor insurance rose by more than 7% over last quarter of 2009 while both home buildings and contents also rose

sharply.

But surely competition for motor business is intense, fuelled at least in part by the voracious appetites of the recently-emerged price comparison websites? Shouldn’t this be forcing premiums down? Not so, says Simon Douglas of the AA: “Car insurance premiums have been rising at record rates over the past year, and they took their biggest ever upward jump during the last quarter of 2009. Our Shoparound premium – an index of the cheapest quotes – rose even more spectacularly, increasing by over 11%, which suggests fewer cheap deals on car insurance.”

Same goes for home covers: “Premiums here are also increasing, with the cost of buildings cover continuing to rise sharply, while a falling trend in the cost of contents premiums has been reversed.”

Douglas says that insurers have been struggling to overcome exhausted reserves while coping with sharp rises in settlement cost and frequency of personal injury claims: “Some commentators have said that average claims costs have seen payments outstripping premium income by up to 20%. Many insurers have been reporting significant rises in personal injury claims. Many people seem willing to pursue claims for even minor injuries,

Lloyd’s seven steps to managing the insurance cycle:

Don’t follow the herd

Insurers need to be prepared to walk away from markets when prices fall below a prudent, risk-based premium.

01

Invest in the latest risk management tools

Insurers must push for continuous improvement of these tools based on the latest science around issues such as climate change, and make full use of them to communicate their pricing and coverage decisions.

02

Don’t let surplus capital dictate your underwriting

An excess of capital available for underwriting can easily push an insurer to deploy the capital in unsustainable ways, rather than having that capital migrate to other uses such as hedge funds and equities, or returning it to shareholders.

03

Don’t be dazzled by higher investment returns

Don’t let higher investment returns replace disciplined underwriting. Notionally, splitting the business into insurance and asset management operations, and monitoring each separately, is one way to achieve this.

04

Don’t rely on “the big one” to push prices upwards

The spectacular insured loss should not be used as an excuse to raise prices in unrelated lines of business. Regulators, rating agencies, and analysts, not to mention insurance buyers, are increasingly resisting such behaviour.

05

Redeploy capital from lines where margins are unsustainable

There is little that individual insurers can do to alter overall supply-and-demand conditions. But insurers can set up internal monitoring systems to ensure that they scale back in lines in which margins have become unsustainable and migrate to other lines.

06

Get smarter with underwriter and manager incentives

Incentives for key staff should be structured to reward efficient deployment of capital, linking such rewards to target shareholder returns rather than volume growth.

07

such as mild whiplash pain that in the past they wouldn't have bothered claiming for.

"This is encouraged by personal injury claims lawyers whose marketing urges people to make claims and whose costs, as well as compensation for the claim, are met by the third party insurer. This is becoming increasingly embedded in British culture and, ultimately, feeds back to premiums. Many insurers are reporting record underwriting losses. The situation is unsustainable and the inevitable result is that premiums increase, despite the extremely competitive nature of the market."

And it seems the competition engendered by price comparison sites may be forcing premiums to harden, when the reverse might be expected: "The nature of these sites means customers are less like to be loyal," says Douglas. "They will shop around when their premium is due for renewal. Insurers are aware of this and are less likely to offer generous introductory rates because there's little chance they'll retain the customer at what they think of as a realistic renewal premium."

But if motor insurance buyers have fallen on hard times, other policyholders might still have access to softer rates. Marsh, the broker, has said that UK corporate insurance rates, for both property and casualty risks could fall

Car insurance premiums have been rising at record rates over the past year, and they took their biggest ever upward jump during the last quarter of 2009

by up to 10% in 2010. Tim Pritchard, the firm's head of placement for large corporate accounts, says competition for good risks remains strong, with plentiful capacity in both sectors: "Insurers are looking to retain market share and are competing aggressively for good, well-managed risks. Combined with plentiful insurance capacity, rates in many classes of business have now fallen to the levels they were pre-2001. Having fallen 5% and 7% respectively in 2009, we expect UK property and casualty rates to fall by up to 10% in 2010."

Marsh has seen more insurers enter the market for casualty business. For example, it says the stand-alone employers' liability insurance market now has 11 insurers writing business, compared to three in 2003.

Pritchard cites improvements in loss prevention as a reason why rates are relatively soft: "Insurers acknowledge

that their loss ratios are lower because risk management within companies has improved. But while we expect 2010 insurance rates to remain soft, a mix of claims inflation and a diminished ability for insurers to release reserves means that the outlook for 2011 and beyond is tougher. Buyers would be well advised to embed, and be able to demonstrate, their risk management proficiency in order to maximise their ability to achieve the best possible deal from insurers."

While a soft market might help a hard-pressed policyholder, those who seek pricing stability continue to seek ways to eradicate the cycle. In 2007 Lloyd's published *Managing the Insurance Cycle*. It contains seven steps "for ensuring that the industry becomes less unpredictable and underwrites on a sustainable basis for the benefit of both policyholders and insurers".

Now, you might not agree with Lloyd's arguments. You may even think that such effort to correct or remove the cycle is inappropriate or doomed to failure. But the breadth and ambition of the recommendations does give a flavour of the issues which the market must either confront or learn to live with, through good times and bad.

To paraphrase Forrest Gump, insurance is a box of chocolates – some hard centres, some soft... And you never quite know what you are going to get. J



Matthew Donnelly

Matthew Donnelly
Managing Director

Griffiths & Armour Insurance Brokers

"While the market has been talking up the need to increase rates for some time, there is little evidence of this taking place. Perhaps on the back of the recent economic recession, the perfect storm was never going to take place. The traditional hard/soft market cycle may not exist anymore.

"As the data which the insurers hold becomes ever more sophisticated, so too should their ability to accurately underwrite both market sectors and individual risks. As a consequence, we may increasingly see a series of mini cycles with some areas/lines of business hardening and some softening all within their own timescales."



Nick Hankin

Nick Hankin
Technical Underwriting Director, RSA

"2010 presents an opportunity for underwriters to provide sustainable pricing and value for their customers, brokers and shareholders. The strategic challenges for insurers remain to provide an adequate return on capital for their shareholders while ensuring pricing levels ensure their ability to meet claims. "The banking crisis provides graphic evidence of what happens when pricing and capital risk is understated or misunderstood and when short-termism (in terms of market share growth or technically unjustified discounting) leads to stress in individual institutions and, more catastrophically, systemic risk.

"This is disastrous for shareholders, and also customers who suffer reduced choice, uncertainty and higher prices. For underwriters and actuaries the challenge is to understand our data, how the risk mix is changing and to work effectively with marketing and sales colleagues to provide coherent pricing strategies."



Adrian Ballardie

Adrian Ballardie
Chief underwriting officer, Tokio Marine

"While technical pricing of insurance products is an actuarial and probabilistic function for most lines of insurance, the commercial reality is that, particularly for the more commoditised lines like motor and household business, economic factors of supply and demand dictate the fluctuation in prices offered as in any other business.

"In soft market conditions, prices are driven down and in hard markets they go up.

"The underwriter must be aware of how the market pricing is deviating from his technical pricing at any point in the market cycle, and ensure that the business written will produce profit taking into account investment income, expenses and other producers of revenue and costs for the whole business the insurer is undertaking."