How Will This Underwriting Cycle End?

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Two hundred years ago competition for fire business in England got so fierce that companies gave policies away. We are not there yet. But we seem to be trying.

These are not easy times for anyone in property and casualty insurance. Competitive price cutting for most commercial business is relentless. Profits from all sources are being squeezed.

Preaching the destructiveness of competition, however, will not make it stop. For what is happening in the industry today is not the result of madness, stupidity or greed.

We are not dealing with a problem in abnormal psychology. We are dealing with a problem in economics.

Property and casualty insurance is specialized and complex. Yet the industry yields to simple economic analysis. The economics of our present competitive situation will tell us how that situation must end.

Let's begin by examining the economic forces behind the competition and what will make those forces change. Then let's test that analysis against the record of past cycles. At that point it should be possible to predict how the present cycle will end.

Here are the economics. Competitive price cutting in the industry today is the result of insurers' having more to sell than buyers want to buy. We usually refer to that situation as "excess capacity." Put more simply, it is the classic textbook case of supply exceeding demand.

In any business, when sellers want to sell more than buyers want to buy, sellers must fight for customers.

If buyers see no difference among what different sellers have to offer, they will tend to favor the seller with the lowest price. So, when supply is greater than demand, prices fall.

Today the amount of coverage insurers want to write exceeds the amount buyers think they need. Insurers must fight for customers. How? In most markets, buyers do not differentiate among insurers; they seek the lowest price. Therefore, if insurers want to protect their position in the market, they must cut prices.

Falling prices, then, are the result of too much supply. This underwriting cycle cannot end until the excess supply goes away.

Having the ability and desire to sell more than the market needs and wants is a problem neither unique nor new to insurance. Years ago, several industries, including our own, met the problem head on with a very effective solution – the cartel.

A cartel's success in fixing prices depends on its ability to control supply. Oil prices would not be where they are today if OPEC did not have production quotas.

Consider how the old fire insurance cartel dealt with supply – limits on the ratio of premiums to surplus, limits on office locations, monoline rating laws, licensing requirements for companies and agents, standards for admitted reinsurance, surplus lines laws, filing requirements, statutory accounting and an overriding emphasis on solvency. Many of those devices may not have been primarily intended to limit supply, but they had that effect, and rates could not have been kept in line without them.

If we could only manage supply the way we did in the good old days. For now, without the cartel, only the economics of competition can deal with the problem of excess supply.

There is more to the word "competition" than what your competitor did to you yesterday. The economic definition of competition concerns the structure of an industry – how many firms there are, their market shares, whether or not they sell an undifferentiated product. If an industry has a competitive structure, no one seller can influence the price or the action of other sellers by altering his own supply.

The insurance industry has a competitive structure – many firms, small market shares, undifferentiated products. An individual insurer cannot control his price any more than a wheat farmer can. His supply is too small relative to the total to have any effect on the market. Price is controlled by the total of what is available (supply) and the total of what buyers want (demand).

It all sounds so simple, and it is simple. But it leads to two important, related conclusions.

First, the industry cannot talk itself into higher prices. Insurers are price takers, not price makers, and as long as there is too much supply, prices just have to fall.

Second, this underwriting cycle will end only when there are not enough insurers who will write at the going price. Only when supply contracts relative to demand can prices rise and profit margins expand once again.

How does supply contract? The process usually takes a lot of time and a lot of pain.

Statistics do not explain how underwriting cycles turn. There is no statistical trigger or automatic timing device that makes sellers of insurance contract supply at regular intervals.

Now, the industry's overall profitability does display a regular, six-year cycle, and that is probably the basis for so many forecasts of a supply correction and price firming in 1981 or 1982. But that all-lines, six-year underwriting cycle is misleading for the present situation in commercial insurance. The six-year cycle is largely the reflection of a six-year automobile underwriting cycle. Making up 40% of premiums, auto results move total results.

But automobile cycles are unique. They are not an appropriate model for what is going on in commercial lines today. Automobile insurance has many vestiges of the cartel.

Most automobile insurers either use bureau rates or else set their own rates in a steady relationship to the bureau level. Auto insurance rates are pretty much the final prices. Hence, the practical result of bureau actions, emphasized by regulatory approval where necessary, is to post prices for most of the industry.

Once auto insurance rates change, it takes several years for costs to catch up and for bureau and regulatory action to post a new set of prices. No wonder the automobile cycle is very regular.

If we dig beneath the industry's overall profit statistics, we will find that underwriting cycles in the major commercial lines are anything but tidy six-year events. For example, measured from peak to peak on the combined ratio, or from worst point to worst point, the last general liability cycle was 16 years long, the last workers' compensation cycle 15 years, the last ocean marine cycle 11 years and the last commercial multiple peril cycle 9 years.

There is no particular regularity to most underwriting cycles. Today's cycle will not end just because 1975 plus six equals 1981.

Nor will this underwriting cycle end just because profit margins get squeezed. There is no question that the industry's financial condition is deteriorating. Premium growth is falling behind growth in losses, cash flow is shrinking and asset values are depressed by rising interest rates.

So what? Who wants to pull out of the market? Who is going to step aside as rates of return come down? Only those who have no intention of coming back in. Only they will cut their losses and get out.

Which participants today would take that route? Probably not the leading stock and mutual companies whose stake in the business is well established. Probably not the new captive insurers whose cost savings to their sponsors may outweigh temporarily poor returns on outside business. Probably not the foreign insurers whose activities in this country are part of the internationalization of business generally.

Who then? Perhaps individual investors who have no strong tie to the business will, for example, sell their holdings of small, regional companies or withdraw as names at Lloyd's. But raising prices requires a lot more than taking out a few impatient investors.

Financial results alone cannot end this underwriting cycle. They cannot because insurers in general do not tune their entry to and exit from markets according to their most recent financial statements. It would be silly and self-destructive for them to do so. Instead, insurers look to the future.

Insurers get into and out of markets on the basis of their expectations. Insurers have rational expectations. They are willing to continue writing at lower and lower prices as long as they still expect to make a profit, if not immediately, at least in the future.

The insurance business has a long history of cycles in its prices and profits. Knowing that, the rational insurer will take the long-term view and conclude that in times like these it pays to match or undercut competitors to hold onto one's customers. Why give up market position if prices will eventually turn anyhow?

One lesson of 1975 was that to leave a market temporarily because prices are too low can mean leaving it permanently. Not wanting to lose again, insurers will remain in markets and tolerate low margins. That is rational economic behavior. It occurs in many industries.

The widespread expectation today that the market will turn is why declining profits will not convince enough insurers to withdraw.

Expectations are what count. Supply will not contract – this underwriting cycle will not end – until expectations change. And that is the problem. Changing the expectations of a lot of competitors is never a quick or easy matter.

As competition squeezes margins tighter and tighter, an insurer here and an insurer there will indeed let business go rather than take an unacceptable price. But those insurers will not close their doors entirely; they will invest their resources in other insurance markets.

As parts of the industry switch attention and resources from one area to another, they will switch the price competition from one area to another. What started three years ago in commercial property and is now so spectacular in commercial excess liability will simply turn up somewhere else.

The competition could go on for a long time with results getting worse and worse. As competition kept prices down and losses continued to rise, cash flow would slow to a trickle. As rates of return fell lower and lower, in time disappointed insurers would give up and pull out.

But history suggests it will not happen that way. Cycles do not end in slow deaths. Our profits are noted more for their violent swings, following drastic changes in expectations.

What makes expectations change radically and suddenly? What makes competitors decide to withdraw before a long and painful attrition finally wrings out the excess supply? What makes underwriting cycles end?

The economics and history of the insurance industry suggest that cycles end as follows.

Competition stretches the industry tighter and tighter. Then another and separate problem hits it suddenly. Strain and hope give way to shock and fear.

Insurers see the new situation as too dangerous to permit any further competition for business. They pull back from suddenly frightening markets. Supply, at last, is withdrawn. Prices climb.

What are the characteristics of those events that turn underwriting cycles?

Often the precipitating event is an external shock – an economic inflation, severe catastrophe or stock market collapse. Sometimes it is an internal surprise – under-reserving, inadequate reinsurance. Usually it is a combination.

The event that changes expectations so suddenly may not by itself be cataclysmic. But it has the ability to shock the industry because profits are already so badly squeezed by the competition that there is no remaining cushion against adversity.

The event is not isolated. It presents an indefinite as well as an immediate threat. The event creates an open-ended problem when the industry is in no shape to bear one.

It is sometimes so disruptive that even our own rules of prudence seem to work in reverse. As prices climb, so do premium to surplus ratios. What we were happy to write at a low price yesterday we are afraid to write at a high price today.

That is the analysis. Now, let's look at some past cycles.

In 1974, as the stock market collapsed, taking surplus with it, no one could foresee how far the decline would go. The reserving crisis was equally frightening. Who could be sure that the people who reserved too little in earlier years were now doing it right? It was impossible to judge whether social and legal changes affecting the liability business were just about over or just getting started.

In 1966, the year after Hurricane Betsy, Lloyd's switched to more rigorous rating systems, including rating on line. The effect was to increase reinsurance prices sharply. But higher premiums would have put many syndicates in violation of their line limits; they had to cut back. Domestic companies were hit in their reinsurance departments by retrocessions from Lloyd's, and many of them also cut back. Primary insurers suddenly could not buy enough reinsurance.

In 1951, a weary industry had finally gotten rates and values adjusted for the inflation following World War II. Then came the Korean War and prices shot up again.

Inflation was not the only problem. Wartime production increased the frequency of industrial accidents by 20%. Inflation and expanded benefits compounded the problem. Workers' compensation results, uncommonly good for sixteen years, suddenly sank to depression levels.

In 1946, as servicemen returned to their jobs and Detroit resumed making cars, insurers were overwhelmed by demands for coverage and by losses. Price controls were lifted, and exposures in all lines went up. Premium writings started to go up sharply. Just then the stock market took a lot of surplus away and put many insurers in fear of the accepted solvency ratios.

Back in the nineteenth century, insurers wrote property close to home. Every conflagration was a scary reminder that their town, and hence their company, could be next. And in those days, insurers could not pass large and concentrated exposures on to reinsurers. Over and over, a big city fire preceded yet another attempt to set up a durable fire insurance cartel.

What ended the competitions of the past were events that not only cost money, but also instilled fear beyond their occurrence. The future became frightening and uncertain. Insurers could not be sure they had enough resources to withstand the future, so they had to withdraw.

It is ironic that the industry tends to regard a troublesome environment only as damaging and disruptive to the business when time and time again a bad external shock saved the industry from extended misery.

The essential economic role of soaring inflation, terrible weather, crashing stocks and rioting cities has been to deal the final blow to competitive price cutting.

How will this underwriting cycle end? Surely like the others. In a situation already fundamentally unsound, something will happen to make us afraid to go on.

By definition, the end cannot be a tidy affair. What precipitates the end must be generally frightening. If only a few are touched or all touched only lightly, not enough supply will be withdrawn for prices to rise.

For markets to contract sharply, the event that ends the competition must frighten or discourage almost everyone. Hopeful expectations defeat themselves. Consensus counter-cyclical strategy is a contradiction in terms.

An event sufficient to create such a general alarm today may have to be quite a thrill. For despite our dismay over widespread price cutting, we may be hard to frighten. There is no mystery why.

First, we still have plenty of financial resources to withstand adversity. Some 60% of the business, namely automobile and workers' compensation, with investment income is still very profitable. Those results must be permitting, if not encouraging, the price cutting elsewhere.

Second, we tend to judge our strength on what was, not on what is. Our measures of investment income and underwriting profit lag reality. They reflect the prices of yesterday, not today.

Third, we feel secure because we are so well braced for the problems which frightened us the last time. Just ask any company how adequate its reserves are, how insulated it is from a stock market decline and how much it indexes insurance values to inflation.

We are prepared for what we know. If we think we can deal with it, a disaster brought on by the economy, weather, lawyers or securities markets could not shock us out of this cycle. A hurricane could only change this market if it wrecked the reinsurance network, brought on a cash panic or hit the Greenbrier right now.

Expectations are what count. Most of us are looking over the valley, past the present difficulties, to the next rise in prices. As long as we think that way, we will stay in markets and tolerate poor profit margins, and supply will never contract and prices never rise.

If this cycle is not to end after a long and frustrating period of depressed profits, then it will have to end with a terrible scare.

Such an ending event will have to change our view of the future. It will have to make us lose confidence, create a problem we cannot manage. It will have to throw into question our cost estimates, our market choices and our financial strategies and make us see only worse to come.

It will have to make the short term take precedence over the long term, and leave us saying that if we cannot solve the short-run problem, then in the long run we are all dead.

Now we can summarize what is going on and how it will end. Competitive price cutting today is the result of too much supply, and only when supply contracts relative to demand will prices and profits rise again. For supply to contract, expectations must change. Expectations change only with a great deal of anguish. This cycle is not likely to end any more gracefully than earlier ones did.

It is in the nature of an industry whose structure is competitive and whose conduct is driven by supply to have cycles that only end badly. Calls for statesmanship and responsible competition not only are of no avail. They ignore the economics of the business.

The cycle will end only after price cutting becomes excessive and, even then, only after an event which hurts and frightens us.

It works that way not because insurers take a short view but because they take a long view as long as they dare. It works that way not because insurers do not learn their lessons, but because they do.

We are acting exactly as economic theory says intelligent participants in competitive markets ought to act.

We compete because we have to. We have to compete because we are free to. We want freedom to compete, and we have got it. Too bad that competition, when truly free, has not among its virtues the moderation or the manners we remember or imagine from another time.

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