

# The Eighth Cycle

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Two years ago, insurance prices were in a free fall. Buyers were in the saddle. The economics of the insurance industry were at work without pity, wringing out excess capacity — financial and human.

Today commercial and industrial buyers are scratching for coverage. Towering price increases may not be enough. Insurers see ahead the returns on equity of seven years ago. Investment bankers rush to attract more capital for them to earn upon.

A curiosity of this tight market is that many people see it as an opportunity. They will return to most parts of insurance once prices seem right.

Before long, in much of insurance, price competition will resume. Too much financial and organizational capacity is still there. Much wringing out remains to be done.

But that is not true of all parts of the insurance business. In some, the withdrawal of capacity has been impelled not by price but by fear, not by knowledge that prices are too low but by ignorance of what prices should be. There the shortage of capacity should last long enough to render academic the question whether it is literally permanent.

Those areas include high excess general liability, professional liability and financial fidelity. Large amounts of those insurances are essential for manufacturers, professionals and financial institutions to function. Their functioning is, in turn, essential to our economy and society.

Private insurance is more important in America than in any other country. Normally its role is to enable other things to happen freely. Right now, it threatens more to prevent than to enable.

That is not to say insurers are behaving unreasonably or are pursuing some silly doctrine. But it is to say that this is not just a routine turn in the underwriting cycle. It has structural as well as cyclical causes. It will have structural effects. Insurers are behaving according to their nature, often a more radical force than doctrine.

Precedents exist for situations like this, and their resolutions have a pattern. It is happening for the eighth time in this century.

First, around 1900, big city fires repeatedly bankrupted many insurance companies. With companies gone, rates went up and profits improved. Insurers came back. Before long, price cutting resumed.

After enough of those gyrations, the makers of business and public policy concluded that the way to deal with recurring fire insurer insolvencies was to prevent them. That meant building surplus. It meant holding rates up in the good times to provide for the bad.

Simple price maintenance had been tried before but could not survive profitability. At the turn of the century, industry and government leaders decided that far more pervasive cooperation was needed — on rates, forms, commissions, statistics and fire fighting itself.

Thus, the 19th-century insolvency crises led to the establishment of the fire insurance cartel. It was a surprising departure from prevailing norms, coming at the height of general antitrust fervor. It was also of lasting importance. The creation, reign and decline of the cartel are the most significant events in the history of the American insurance business.

Second, around 1910, states required employers to pay injured workers. Manufacturers had to have workers' compensation insurance. The established fire and marine insurers would not sell such strange coverage or else would sell it only at prices which the manufacturers considered exorbitant.

Much of the need was met through the creation by those manufacturers of new, mutual insurance companies to write workers' compensation. The mutual liability insurance business was born.

Third, in the depression of the early 1930's, mortgage guarantee insurers went insolvent. That led to the bankruptcy of mortgage lenders and the loss of their depositors' money. States outlawed mortgage guarantee insurance.

Demand for home mortgage credit boomed after World War II. Returning servicemen with new families could not meet conventional credit standards. Without insurance, no loans. Without loans, no homes. Without homes, no suburbs.

Postwar America was urgently committed to the family in the house in the suburb. Its government did not pause to make private mortgage insurance legal again. Government just replaced it.

Fourth, after the war the boys laid down their rifles, picked up their cars and resumed killing people.

Auto insurance claim frequency went up. Loss reserves were left behind by the postwar inflation. The statute expired which had suspended the right to sue servicemen. Auto insurers faced heavy losses.

But postwar America was dedicated not just to the families in the suburbs but to the cars connecting them to work and leisure. Insurance let the cars move. Who dared cut it off?.

The dominant companies, with independent multi-company agents at arm's length, could and did. The direct writers could not. They had exclusive distribution systems to which they owed their very existence. They were not strong at the time. Their market shares were small. But they stayed in the market. They felt they had to. They never left.

Fifth, during the Korean war, the economy heated up. Consumer prices inflated. Factories were working at capacity. Workers got hurt. Workers' compensation loss frequency and severity went up. Reserves were inadequate. Established underwriters cut back. But there was a war on and manufacturers had to have coverage.

The result was the rise of regional workers' compensation specialists. They grew up where the guns were made. Competitive protection helped. In the arsenal state of California, they came forward just in time for a phenomenal surge in the regional economy.

Sixth, until the late 1960's, property reinsurance was largely controlled by brokers in London who arranged and allocated world capacity. After Hurricane Betsy, London cut back.

Concentrations of industrial property, built up in the postwar boom, were the heart of our economy. They needed big property insurance. Primary insurers needed big catastrophe reinsurance.

The reinsurance tail of the hurricane led primary insurers to create world reinsurance networks directly accessible to them. Lloyd's share of the reinsurance market began a decline which continues to this day.

The seventh market turn — the last before the current one — was in liability insurance ten years ago. In the inflation following the oil shock, loss reserves proved inadequate.

Changes in tort law rules and other kinds of social inflation added to insurers' worry and resentment. But economic inflation did the real damage on the liability side of insurer balance sheets. On the asset side, a stock portfolio crisis just made it worse. Panic was the rational response.

Insurers cut back on liability coverage. But corporations had to have it. Basic amounts were required by law, others by prudence. The response by corporate customers was the risk management movement—financing small losses, unbundling insurance services and pushing commercial insurers up to high levels. Brokers changed from salesmen for insurance companies to professional advisors for clients.

Now we are in another sharp turn in insurance availability and pricing. While at the moment it seems across the board, it is most powerful in the high excess and exotic kinds of liability insurance and in financial fidelity.

Whereas economic inflation drove the casualty insurance crisis of the mid-seventies, the current one is driven by terrible events and by changes in liability law,

coming after a protracted insurance price war partly caused by the dissolution of the fire insurance cartel.

After such product crises as asbestos, after such professional crises as medical malpractice and after the weekly thrills in high finance, it is no wonder that insurers fear the unknown and pull back from it.

The crises run across whole industries and the wide distribution of products. Insurance has met liability problems before. These are liability disasters. No exclusion is reliable, no excess level out of reach. Covers pay rarely but they pay big.

A couple of years ago, with few losses, insurers felt safe. They could drive rates as low as they wanted without contradiction. Now the same covers and levels have been hit and hit hard. The same lack of statistics means that no rate can be proven too high. Ignorance and fear, the horsemen of insurance panics, run wild.

Most frightening is the insurance of economic activities in which someone says "trust me" to someone else. Whoever makes pills, emits fumes, gives opinions or takes deposits is saying "trust me" to someone or everyone. When those activities go wrong, the law now calls for recompense and more, without regard for diligence or extenuation.

At this early stage, insurers do not welcome the enlargement of their role in the general liability payments mechanism. The reason is they never took in the premiums.

Perhaps one day they will welcome it, because being assigned a larger role is how the insurance industry has grown in the past. But that is for later. Right now, they just cut off coverage.

Liability law and insurance do more than spread risk. Through premiums they bring back to activities, visibly and in advance, costs of those activities which might otherwise be shifted silently to society as a whole.

Hence the availability, security and price of liability insurance can deter certain kinds of conduct. How serious that is depends on the importance of the conduct and the strength of the deterrent. If they are important and strong enough, insurance itself changes. Existing insurers may not give in and, individually, they may be right. But from a larger and longer perspective, insurance changes.

In seven previous episodes, when established insurers could not or would not meet an essential demand, the demand was met some other way. Usually it was met by a new institution. The moral of the seven stories is that really serious insurance needs do not go unmet.

It was true of solvent fire insurers, which let us build cities and live together. It was true of workers' compensation, which made the workplace more humane. It was true of mortgage guarantees and personal automobile insurance, which rewarded veterans with

families in green suburbs. It was true of the property insurance which let us amass great industries.

Let no one imagine that the denial of insurance could have stopped economic and social movements of such power.

The same will prove true for excess and professional liability insurance and fidelity bonds, alone or along with the underlying laws. They are at the fine edges of science, production and finance. The question is not whether it will be done but by whom, on what terms and at what cost to the established insurance business.

If we accept that the insurance need will be met, there are three kinds of people to meet it. First, the leaders of the insurance business. Second, customers banding together. Third, a new participant. Let's take them one at a time.

Looking back, we see that the established insurance business has responded well to many past crises. Those crises have been amenable to price increases and rationing of supply.

Where price and routine supply are the problem, they are the solution. The insurance industry solves such problems both because it can and because the insurance business is there. It has first look and, after all, insurers are in business to insure.

Government is usually part of that response. Regulation is a reactive activity. The existing business is what it reacts to.

Both business and government have techniques for dealing with the noisiest crises of today. Taverns, day care centers and even municipalities can be handled with such familiar tools as surplus lines, market assistance plans, underwriting associations or just letting the market calm down and get prices in line with costs.

But the big economic and social problems we are concerned with here are not like those of bars or bad drivers. Settled insurance companies and their regulators are unlikely to solve those big problems. Not that they do not want to. They do not know how.

If there are three possible rescuers — establishment, customers and newcomers — what about the second?

Customers uniting are the great success story of the insurance business. Many famous names began that way. Insurance has been a wonderful business for the little guy, particularly if he started by wanting to buy some and found that in order to buy some he had to sell some.

The customers did it again in the risk management movement. They created about twenty percent of the commercial insurance business out of whole cloth or, rather, out of the overhead costs, the fears and the financial attitudes of the established insurance business.

## THE EIGHTH CYCLE

Can the customers once again solve their problem? Is it like the imposition of new compensation law or an unjustified panic among the insurance establishment? What is the problem we are setting out to solve?

The problem is that new physical, social and legal standards are being imposed on people who hold themselves out as special. That goes for advisors and for the makers of pills. “Trust me” is being taken seriously and called upon aggressively and for unimagined amounts of money.

That is not good news for customer cooperatives, at least as we now know them. At the high liability levels where we are suffering today, customer cooperatives have a lot of the same problems as conventional companies. Captives may do better at new latitudes than at new altitudes.

For the conventional captive, predictability, service and routine finance were the idea ten years ago. They are not the idea now. Ten years ago, excess and reinsurance readily supported risk management. Today their absence is the problem. Now we need capitalists, perhaps from among customers, but capitalists nonetheless.

Most likely, therefore, is the third possibility — that our present problem will be met by a newcomer barging in and rewriting the rules of the game. It may look like an association captive daring new heights. It may be a fund to compensate without fault, but as an exclusive remedy, those inevitably injured by, say, an approved new drug. It may look entirely new.

Whatever its form and however great or small its novelty, the next solution will for the eighth time in this century certainly display one characteristic — the determination to make coverage happen. Coverage always happens. Insurance needs as essential as ours today always get met.

Most likely the answer will be, in a sense, like the others. Someone will meet the need because he has to. His clients will come easily because they need him. Potential competitors will not believe his success because few statistics mean low credibility. They will sincerely declare he is doing it with madness or mirrors during the few precious years he needs to get entrenched.

Through this simple process, he will get rich. So it has worked seven times before.

Seven cycles have changed insurance. Each was born of fear and need and a lack of alternatives.

Just now it may be good for practical people to know what is to be read and seen in the past. For every condition is present again. Perhaps the eighth cycle is at hand.