Producing a Winner

Hard markets mean hard times for product development, but it doesn't have to be that way.

by Susan Rivera and James W. Macdonald

In the depths of the past two commercial-lines soft markets of the early 1980s and the 1990s, insurers and reinsurers desperate for premium dreamt up all kinds of new-fangled products, for better and for worse. In the early 1980s, for instance, residual value policies guaranteed the minimum value of 747s and other capital equipment 10 years into the future. A decade later, insurers strayed further into territory more suited to the capital markets, guaranteeing production costs for movies and insuring publicly held companies against lost profits. Maybe these seemed like good ideas at the time. But when insurers step far outside their core competencies—as they are prone to do amid fierce competition and rock-bottom prices—the results can be disastrous.

Product development thrives in a soft market, but the new products aren't always ill-conceived. Creative risk-taking during periods of excess capacity has produced many long-term winners. Municipal bond insurance, for example, allows the bond issuer to pay a lower dividend because the investor's principal is guaranteed. Cyber-security products provide protection against Internet viruses and hackers. To survive, new products need to create a commercial market value that is equal or greater than their risk value to the insurer.

Yet in today's world—when businesses face a landscape of increased peril and need creative solutions to complex problems—the new-product pipeline could slow to a trickle. Today's growing capacity crunch, more severe in some lines than others, will most likely limit the number of insurers willing and able to roll out new products, and the breadth of those new products will be narrow.

Sticking to the tried and true may seem the safe bet when insurers can get good prices for core products, but this cautious response can have severe consequences. Customers turn to captives and risk retention groups when the cost of products they really want is too high; but they also will shift to alternative market vehicles for the new products they really need when traditional insurers fail to provide innovative solutions that offer security in a new world of risk.

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Capacity Crunch

Although some may argue otherwise, today's market is more extreme than the hard markets of the 1970s or 1980s. In October, Swiss Re estimated that the global insurance and reinsurance market had suffered a 25% reduction of about $180 billion in capital since 2000 due to major losses, including the terrorist acts of Sept. 11, and poorly performing investment markets. Estimated surplus for U.S. insurers at year-end 2002—a measure of the property/casualty industry's underwriting capacity—dropped 15% from its peak in 1999 to $285 billion and is at its lowest point since 1997, according to A.M. Best figures. Vincent J. Dowling Jr., of Dowling & Partners Securities, estimates that on an economic basis—after adjusting for asbestos and reserve shortfalls—commercial-lines insurers are writing at a 2.5 to 3.2 ratio of premium to capital. Underwriters in the field for 25 years have never seen anything like this.

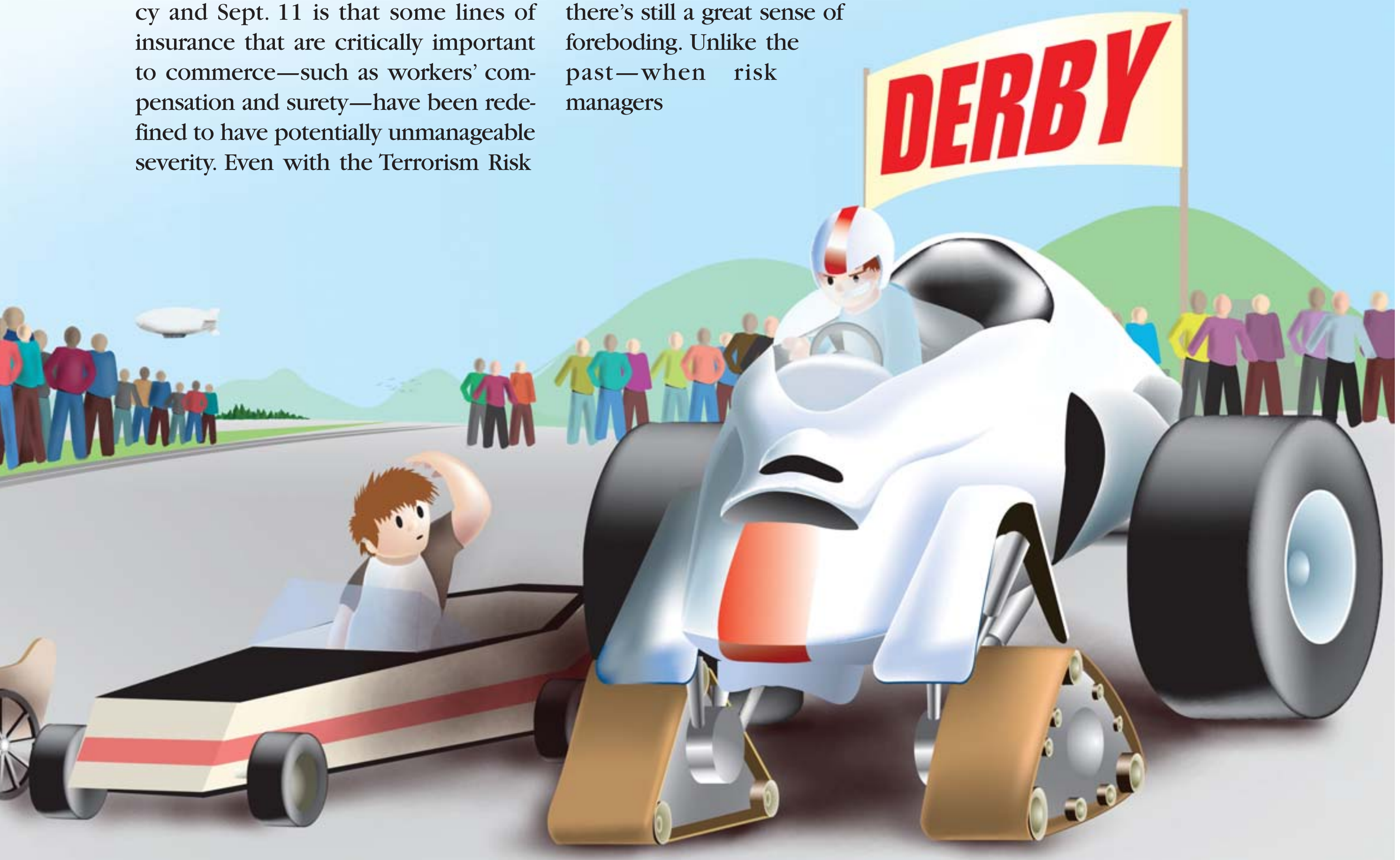
Critical issues distinguish capacity concerns in this hard market from others. The legacy of the Enron bankruptcy and Sept. 11 is that some lines of insurance that are critically important to commerce—such as workers' compensation and surety—have been redefined to have potentially unmanageable severity. Even with the Terrorism Risk Insurance Act, the financial hit from a terrorist attack could impair all but the strongest insurers.

It's not just the quantity of available capital that is in question; quality is a major concern. The downward spiral of the stock market, combined with declining interest rates and increasing loss reserves, has had an adverse impact on the capital structure of many insurers. In the past two years, A.M. Best downgraded the ratings of almost twice as many property/casualty companies as it upgraded, and the number of "secure" property/casualty companies (B+ or higher) keeps falling.

Insurers also have grave concerns about the long-term financial stability of their reinsurers. A ripple of fear runs through the industry when a major reinsurer announces a multibillion-dollar reserve increase while European reinsurers flee the U.S. market en masse. Since Sept. 11, 2001, the reinsurance industry has received an infusion of some $24 billion, about a third of which went into Bermuda. And while that new capital offers some relief, there's still a great sense of foreboding. Unlike the past—when risk managers looking for long-term stability for the insurance they needed put up the money to create the first wave of Bermuda insurers—new capital today comes primarily from opportunistic investors seeking a short-term, high rate of return. It remains to be seen if that capital will stay when returns are not as attractive.

Today's hard market is also distinguished by increasing senior management attention to risk-adjusted return on capital of each separate line being underwritten. This risk analysis technique evaluates higher risk projects differently from less risky ones. Regardless of man-made or natural catastrophe losses we may or may not see, risk-adjusted return on capital will be the key driver to the uneven waters of affordability and availability in each commercial line over the foreseeable future.

It's evident the situation is severe when insurers abandon entire business segments when prices are climbing, at last restoring hope of profitability. Aon, GE and Citigroup all decided



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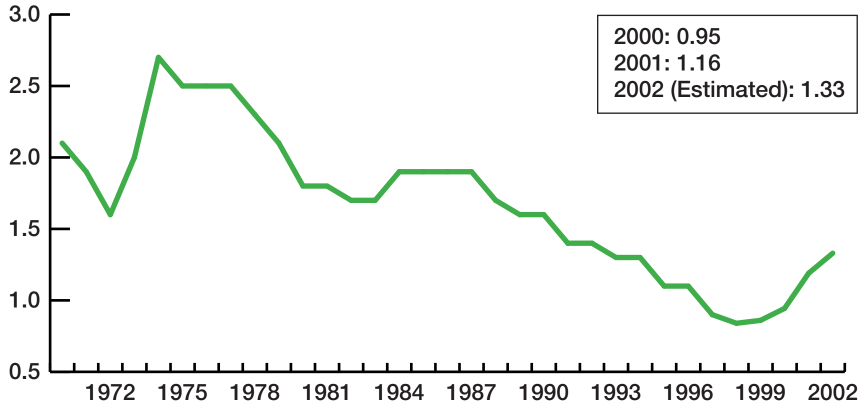
Net Premiums Written to Policyholder Surplus Ratio

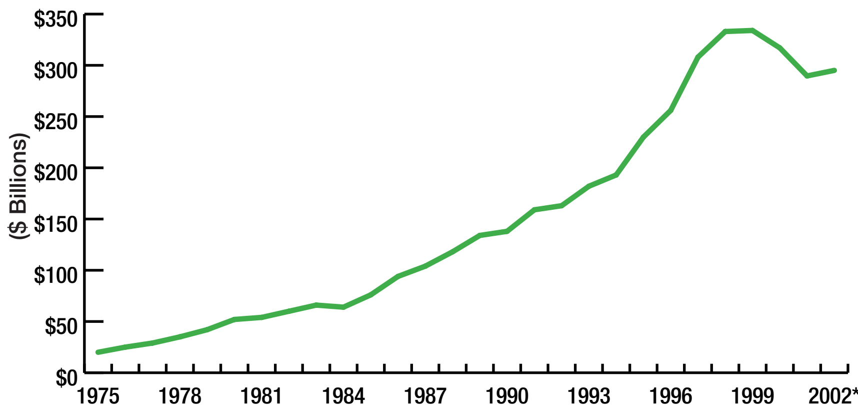
Between 1997 and 2000 the industry's ratio of net premiums written to policyholder surplus hovered below 1. When insurers write twice as much premium without requiring more capital, the result is a low return on earnings. In turn, this leads insurers to create new products to offset declining earnings from core products.



Source: A.M. Best, Insurance Information Institute

Policyholder Surplus

With policyholder surplus, or what is called net worth in the non-insurance world, dropping 15% from its peak in 1999, insurers are retreating to selling their core products and avoiding the risk of developing new ones.



*2002 estimate as of January 2003
Source: A.M. Best, Insurance Information Institute

recently that property/casualty insurance is not a core business. The St. Paul Cos. walked away from the medical malpractice business at the end of 2001, ending more than 30 years of leadership and leaving a huge void in the market. GE clearly stated its reason for wanting to spin off or sell Employers Reinsurance Corp.: the volatility of projected long-term earnings.

No More Extras

With capacity so tight, the number of insurers capable of rolling out new products will be limited. Most insurers launching a new product don't want to risk their surplus until they have a good feel for how it will play out. Until then, they typically retain just a small percentage of the risk, sometimes just 10%. Restricted reinsurance capacity closes this door.

The shortage of reinsurance capacity leaves those insurers with the largest capital base and willingness to retain the risk as the best candidates to develop truly "new" products. But even large insurers will probably focus on those product lines offering the most certain risk-adjusted return on capital. Not exactly a recipe for creativity and innovation.

A return to basics is already happening. Products and product enhancements developed during the soft market are disappearing. Only a year ago, policies with multiyear fixed rates were fairly common, and now they are almost impossible to negotiate. After a meltdown in the directors and officers line, most insurers no longer agree to include the entity itself and all employees in the policy. The exclusion for "failure to maintain insurance" is back, along with other restrictions removed from most policies during the last soft market.

In medical malpractice, the managed-care errors and omissions product has all but disappeared, with the market essentially limited to two carriers, according to a recent report on the state of the industry issued by broker Willis Group. Controversial late 1990s enhancements such as errors and omissions coverage for Medicare and Medicaid billings, which insurers added for little to no additional premium, also are gone or very limited.

Remember the hype about integrated products? Though buyers are still interested, the types of blended products pushed in the 1990s compromised insurers' ability to maintain underwriting discipline for each coverage in the bundle. And from the insurer's perspective, why waste hours upon hours writing a complicated manuscript for a blended policy when underwriters could spend that time writing profitable business one line at a time?

Product Development's New Face

While the hard market dampens interest in product development, it won't shut it down completely. With little incentive for inventiveness, insurers will take existing approaches and apply them in unconventional ways.

Low-hanging fruit. Most insurers will and should focus on "low-hanging fruit" by finding new customers for proven products. Progressive insurers

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with strong capital bases will develop new forms of distribution and recast existing products to fit them. Despite the dot-com bust, insurers are pursuing focused e-commerce initiatives and looking for new ways to sell through Internet platforms, particularly to consumers and smaller commercial accounts. They will also continue to tweak proven products to target the growing number of affinity groups.

Problem-solver hybrids. In hard markets, insurers will blend a new coverage approach into an existing product. In this way, they can provide a sound, long-term process for underwriting a product profitably. In the early 1970s, for example, medical-malpractice writers faced problems with stacking limits and claims that were reported late. In the hard market of 1975 to 1979, St. Paul Cos. introduced the "claims-made" coverage approach into medical-malpractice policies for the first time, addressing both of these problems. "Claims-made" policies pay only for those claims reported during the policy period, regardless of when the event occurred. Earlier policies, typically written on an "occurrence" basis, were always vulnerable to old losses reported long after the policy expired.

In 1986, during the next hard market, the Insurance Services Office introduced the professional-liability claims-made approach into traditional commercial general-liability policies, addressing concern about the industry's exposure to latent injury claims. In subsequent years, innovative excess-liability underwriters developed new approaches somewhere between traditional occurrence and claims-made products with a variety of options, including "sunset provisions" on claims reporting, multiyear batch clauses and new "occurrence" definitions.

Frequently the boldest solutions come from the nonadmitted or alternative market players, who are most free to pioneer new policy wordings and rating schemes. One West Coast trust of some 10,000 physician members, for example, underwrites an affordable "claims-paid" indemnification contract that technically is not "insurance" and is not subject to state insurance regulation.

Legal. Changes in state and federal law are the most powerful forces driving new product development regardless of the state of the commercial market. The examples are endless.

As states enacted laws holding bars and restaurants responsible for injuries caused by drunken patrons, insurers responded with liquor-law liability policies. The Employment Retirement and Income Security Act of 1974 created the market for ERISA liability insurance, which protects companies accused of breaching their fiduciary responsibility. The federal Superfund law and the Resource Conservation and Recovery Act fueled the market for environmental-liability insurance in the early 1980s, though it took about a decade to mature. In the early 1990s, the first monoline employment-practices liability policy grew out of the Civil Rights Act and passage of the Americans With Disabilities Act. Newer variations on employment-practices liability and environmental-impairment liability products include fee-based loss-control or mitigation services bundled or cross-sold with policies. The cross-selling of proactive services with insurance presents untapped possibilities for successful new product rollouts.

Socioeconomic. Social and economic changes also can spur insurers to develop new products in a hard market. Economic changes led to the recent development of insurance products that provide computer security in the Internet age and protection against infringements on intellectual capital. Over the past three decades, the range of professional-liability policies has exploded with the growth of the service economy. Insurers targeted new products to travel agents, real-estate agents, even police and firefighters. Regardless of the market cycle, smart insurers recognize that professional liability offers unlimited new growth potential in the emerging service economy, just as products liability did in the manufacturing economy.

Future Challenges

Burned by inadequate pricing for so long, insurers seem quite content now to stick to their knitting. The most speculative and risky new products won't see the light of day amid so much uncertainty about the quality of capital and the potential for extreme catastrophic losses.

Yet even in times like these, no industry can afford to stand still. The extreme aversion to risk today is reasonable, but it can be costly. If traditional insurers don't step up to the plate, buyers will find other alternatives. Nearly 75% of brokers surveyed by the Council of Insurance Agents and Brokers said they were placing more business in the alternative market. At the World Captive Forum in November, David Mair, immediate past president of the Risk and Insurance Management Society, described the risk to insurers succinctly: Risk managers will have to consider the full range of possible options in managing risk exposures, including finding alternatives to insurance.

Underwriters need to remember that many of yesterday's boldest and most controversial ideas are today's core products. The integrated product movement includes some stunning success stories. Too often, it's the broken pipes that get all the attention. Critically important integrated innovations include commercial umbrella (combining automobile liability, employers liability and commercial general-liability with some marine and aircraft coverage), the commercial general-liability policy (combining premises, personal injury and products liability) and commercial package policies (combining a wide range of property and casualty coverages).

Times of great challenge present great opportunities. Insurers today have a tremendous opportunity to demonstrate they are able to reinvent the value proposition to customers and to shareholders. What does it take? A novel idea with a champion, and an organization that knows how to listen. BR

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