UNDERWRITING

Cycles, Confidence & Consistency

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March 2015
“Cycles are created and driven by the actions and behavior of management and underwriters.”

A huge inventory of articles about the underwriting cycle and the feast or famine nature of the Property/Casualty insurance business currently exists. Much of the literature attributes cycles and the inevitability of cycles to economic factors, specifically the availability of capital and other external pressures.

This article is an update of one that I wrote in 2004 about underwriting cycles since much of it holds true today. If we can change management and underwriting behavior from basing decisions on external pressures to making decisions based on one’s best judgment, we can significantly blunt the ruinous impact of the underwriting cycle.

The Property/Casualty insurance industry’s cyclical nature can be seen in Chart 1, which depicts changes in industry capital (as measured by surplus). Surplus is eroded when underwriting results are poor. Today the industry’s capital stands at record levels, attracting alternative capital, pension and hedge funds to insurance. Excess capital, coupled with slow organic growth and record low interest rates, is generating increased merger and acquisition activity, and creating another source of uncertainty.

A common measure of cycles has been the relationship between premium growth and underwriting results. After rates go up and results improve, the temptation to write more business increases.

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An interesting relationship between interest rates and underwriting results exists, originating the phrase “cash flow underwriting.”


While it is accurate to say that these economic factors encourage or incubate poor underwriting results, they don’t have to drive cycles. Cycles are created and driven by the actions and behavior of management and underwriters.

**Historical Perspective**

The importance of understanding cycles and how to manage them has increased significantly over the past 25 years. Historically, the major Property/Casualty markets in the world were tariff markets. In the 1950s, the rating bureaus established the fire tariffs in the United States to protect companies from undue competition. The same was true in Germany until the mid-1990s and Japan until the late 1990s. In all three markets, the tariff effectively leveled the talent playing field. A company that had excellent underwriting skills and tools really couldn’t differentiate its results.

Today everything has changed. The opening up of market economies and reductions in barriers to free trade has created a truly competitive global marketplace. The impact on the insurance industry is profound. The need for underwriting skills—and more importantly an underwriting culture—is critical. What else has changed?

- Interest rates remain at historic lows.
- Capital is fluid and without boundaries—it moves where the opportunities are.
- The insurance business is a global business.
- The barriers to entry are extremely low.
- Insurance buyers are much more sophisticated about their businesses when making decisions to retain and cede risks from their portfolios.
- Our notions about correlations between various risk classes and geographies are changing.
- The pace of technological change is increasing dramatically.

What hasn’t changed? The external pressures to follow the market are enormous.

- Senior managers do not want to “disappoint” owners and analysts who prioritize the growth/premium volume dial.
- It is hard to ignore what competitors are doing.
- Brokers and agents sell price most of the time.
- Nobody wants to lose an insured/client.
- Clients want recognition for the low frequency, low Cat environment we have experienced during the past few years.

There is always the question of short-term loss costs vs. longer-term exposures. As an industry, we owe our clients consistency. Today’s external pressures and stimuli make understanding management and underwriting behavior absolutely critical.

**Management Behavior**

Management behavior is influenced, if not driven, by external factors, including analysts’ expectations, owners’ short-term vs. long-term time horizons, share price and growth. Since management behavior ultimately drives underwriter behavior, all the underwriting processes, initiatives and controls in the world will fail if focus, messaging or the compensation system is flawed.
Cycles will exist until senior management teams refrain from:

- Setting premium volume goals or “budgets”
- Undermining underwriting decisions
- Underestimating parameter and model risk
- Underinvesting in skills

**Underwriter Behavior**

Cycles will exist until underwriters make rational economic decisions on each and every risk they underwrite as well as making rational portfolio or book of business decisions. Confidence is the critical element—the bedrock. Underwriters must develop the confidence and emotional fortitude to make rational economic decisions in spite of the global uncertainty, external pressures and management inconsistencies that can create confusion. Confidence requires discipline on the part of each underwriter, relentlessly reinforced by management to create, nurture and live an “underwriting company.” So how do we build and sustain the institutional resolve, the underwriter confidence and the emotional fortitude to break away from the pack, to make rational economic decisions? How do we change behavior in a business where the outside stimuli are very strong? It is all about building and sustaining confidence. Confidence will let us sell a more consistent product that in the end is better for consumers.

First we must remember that we are selling a product that we do not know the cost of today. We use various tools and models; we make assumptions about risk and exposure; and ultimately make judgments, underwriting judgments about the trade-off between risk and reward. How do we build the requisite confidence in those judgments? And, just as importantly, how do we guard against overconfidence in our decision-making and underwriting judgments? To quote Confucius, “To know that we know what we know and that we do not know what we do not know, that is true knowledge.”

Robert F. Conger and Stephen P. Lowe of Tillinghast wrote an excellent article, “Managing Overconfidence,” which articulated the importance of process and feedback loops to pricing and underwriting. Their work was based on the work of J. Edward Russo and J. H. Paul Shoemaker and their book “Decision Traps.”

Professors Russo and Shoemaker explore the differences between primary knowledge, facts and concepts that we know to be true, and metaknowledge, “an understanding and appreciation of what we don’t know.” Those with good metaknowledge understand the uncertainty of their estimates and predictions, and the ambiguity inherent in their premises and world views. It is a fascinating area of psychology and of great importance to underwriting execution since underwriting demands an intense focus on both feedback and accountability to ensure decision quality is understood and managed.

The related discipline of behavioral finance explores biases and decision traps around investing and financial decisions. Some of the findings of the Nobel Prize winner for Economic Sciences, Dr. Daniel Kahneman include:

- We tend to respond too conservatively to new information.
- We believe the law of large numbers applies to small samples.
- We are risk averse once we have a gain.
- We are risk seeking (i.e., willing to double down) when we have a loss.
- We have a tendency to adopt conspiracy theories—blaming others for our mistakes.

A good understanding of behavioral financial theory is required to make good underwriting decisions. This is particularly true in a softening market where the outside negative stimuli are so pervasive and challenge the confidence/overconfidence equation.

**Challenges in a Soft Market**

There are a number of soft market phenomena that challenge our confidence or encourage overconfidence and impact underwriting execution, underwriting principles and ultimately even underwriting culture.

1. **Calendar Year vs. Accident Year Results**

The complexities of insurance accounting and scorekeeping (calendar year vs. accident year) can lead to significant misinterpretations of book performance. Obviously calendar year results (the official scoreboard) are impacted positively and negatively by prior accident year reserve movements. These variations can be significant at the line of business and account level and can be difficult to interpret. In a soft market, the psychology is to manage the income statement in the short term vs. managing the balance sheet for the long term. A rigorous “numeric” approach to the analysis of results is the only defense.

The interplay between accident year and calendar year results and accident year trends must be clearly understood and the
impact on underwriting behavior minimized. A thorough understanding of results is critical to maintaining confidence and avoiding overconfidence.

2. Actual vs. Normalized Result

Actual loss experience often bears little resemblance to “normalized” experience where we define normalized as the “correct” technical price for the exposures insured. As an aside, years ago an insurance executive quipped, “The insurance business is an easy business, all you have to do is charge the right price.” Unfortunately, there is no “right” price, but that doesn’t translate into “any price is the right price.” Insurance is a technical business—not rocket science—that requires sound mathematical and statistical knowledge and skills. Risk assumption is not a marketing business; it is an analytical business, not dissimilar from investing where the confusion between marketing and decision analytics is common.

Since actual results can be misleading, a benchmark and/or “walkaway” technical pricing discipline is helpful to avoid rationalization during soft markets. Establishing a floor price tied to an exposure price that is not influenced by recent results or the market price for risk establishes a technical discipline that will help counter the herd mentality to follow the market down.

Dissecting results into the frequency, severity and catastrophic components is equally important. All too often short-term shifts or “anomalies” (that are statistically rational) in frequency, severity or catastrophic experience drive behavior anchored to current experience, resulting in pricing below the technical rate.

Confidence in the technical or expected results must be maintained in spite of the challenges of a soft market.

3. Experience vs. Exposure Pricing

Related to benchmark pricing is the debate over the appropriateness of experience (loss cost) vs. exposure rating methodologies. The debate is centered on the credibility of a loss cost vs. the appropriateness of an estimate of the average distribution of losses for pricing insurance and reinsurance. The debate is of particular importance in excess layers.

Underwriting is a mix of science and art. Good underwriting will be largely based on science (various mathematical and statistical models), but also requires judgment (i.e., art). The challenge is to get the mix right. Historically, the art side dominates in soft markets—often to the point of decisions becoming detached from any sound analytical framework, i.e., pure guessing or rationalization that trumps expertise and reason. Experience rating is only appropriate where the loss experience is credible and reliable. Unfortunately, our perspective of credibility changes during the cycle and the

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quality and reliability of loss information deteriorates in soft markets. I like to say that good underwriting is 80% science and 20% art. Keeping a similar relationship in mind forces the underwriter to deal honestly with the credibility challenges associated with exposure and experience rating approaches.

A sound perspective and confidence in our rating tools must be maintained in the soft market.

4. Inflection Points and Trend

Inflection points are the nemesis of the insurance industry. Changes in trend, either severity or frequency, both positive and negative, are difficult to detect until they have affected several accident years. A reserving philosophy must be driven from the top. Senior management must encourage a forward-looking, conservative approach to setting reserves. The actuarial reserving processes must be unbiased, sensitive to the uncertainty around point estimates and mindful of the historic misestimation bias. The anecdotal, “results are good on this account,” “OK to renew as expiring,” overlooks many factors. For example, an account where the premium was “right” for exposure last year, in a world with a trend of 5% renewing at expiring means falling behind on an inflation-adjusted basis. Underwriting must be proactive not reactive. It should focus relentlessly on exposure, not just recent experience.

Insurance is a numbers business—the financial as well as the underwriting aspects of the business must be managed in a numeric fashion that includes tracking current frequency and severity trend.

Economic inflation can be estimated and, while not perfect, those estimates are fairly reliable. Insurance inflation is more difficult to measure. It is a combination of economic, social and medical inflation. In recent years both economic inflation and insurance inflation have been low.

Identifying, analyzing and selecting trend assumptions and embedding them into a disciplined underwriting process is critical. Establishing trend assumptions in an improving environment is just as critical as in a deteriorating, inflationary environment—here, inflection points must be treated with great care. Overall, trend assumptions should be established by selecting an appropriate realistic trend and taking the uncertainty around trend selection into account in risk loads.

Confidence in our assumptions—particularly trend assumptions—is critical to maintaining discipline in a soft market.

5. Wordings

Wordings and contract documentation always suffer in soft markets. How many industries would make a commitment of a hundred million dollars without a signed contract that has been carefully reviewed by both parties? Can you imagine walking into a bank, asking for a loan and suggesting the contracts be signed at some date in the future? How do you think bankers would react to the “NAIC Nine-Month Rule?”

Confidence in our decision processes, particularly contract documentation, must be maintained in a soft market. Similarly, terms and conditions and breadth of coverage are an important part of structuring an economically rational transaction. Contract language and drafting are an integral part of the underwriting process and must be done by underwriters, not brokers.
Confidence Equals Consistency

The market, competitors’ actions and client expectations may be constraints to a company’s top-line growth. They do not have to determine underwriting profitability, but they can create challenges to making rational economic management and underwriting decisions.

Cycles destroy confidence. The confidence void erodes discipline, creating many challenges that can only be countered with supreme commitment to an underwriting culture, a set of underwriting principles and consistent execution—which means disciplined thinking, decision-making and processes.

Cycles will impact revenues, but don’t have to drive underwriting results. In the long run, clients of both insurance and reinsurance companies are better off with consistency of product. Confidence requires a fundamental approach to the business—pricing for exposure and disciplined underwriting irrespective of the market, competitor actions and clients’ short-term wishes.

Endnotes
1 Emphasis 2003/3, Tillinghast-Towers Perrin.
3 More reading about this topic can be found in “Choices, Values and Frames” edited by Daniel Kahneman and Amos Tversky (New York: Cambridge University Press and the Russell Sage Foundation, 2000).