The ups and downs of the insurance market cycle
A conversation with Clive Tobin

THE CYCLICAL NATURE OF THE INSURANCE INDUSTRY is a constant topic of debate. How can insurers, brokers, and their clients prepare themselves for the hard and soft market periods? Clive Tobin, Chief Executive of Insurance Operations for the XL group, answers questions about managing the risks of insurance market cycle.

How would you describe the market cycle?

Clive: In very general terms, the industry views a hard market as a period of capacity shortage, increased pricing, and more restrictive terms and conditions. A soft market, on the other hand, is characterized by excess capacity, increased competition, and declining premiums.

In the mid-1980s, the industry experienced the most severe hard market that it had ever seen. The speed and severity of reserve deterioration from asbestos and environmental liabilities resulted in a significant loss of capital and a number of insolvencies. This caused an acute capacity shortage, especially for liability coverage. This situation resulted in the emergence of new capital and companies like XL Capital to address the needs that could not be met.

In the early 1990s, the market experienced Hurricane Andrew and the Northridge Earthquake which were, until 9/11 and Hurricane Katrina, the most costly disasters for the insurance industry. This resulted in the creation of a new generation of Bermuda cat companies providing capital to meet demand for higher limits and lost capacity. It was the start of the capital markets moving quickly to replace capital and limit the severity of hard markets. The speed of raising new capital has been an important development to stabilize the market and bring greater security to insureds.

So from the mid-eighties to the mid-nineties we had a hard and stable market. In the late nineties, however, we saw the industry spiral into a long, very soft market. There were several factors causing this. We had no major natural catastrophes and excess capital started to build resulting in increased capacity. At the same time we had a hot investment market so companies chased cash flow on casualty business and pretty much ignored technical underwriting.
Then what happened?

Clive: This all came to a grinding halt in 2001. 9/11 brought the largest catastrophe loss to the industry at the time, the investment market crashed with companies carrying large unrealized losses on their equities and the severe under-pricing on casualty business was emerging with large prior year loss reserve developments. According to Dowling & Partners, the difference between the initial and ultimate loss estimates on their composite portfolio of (re)insurers was $59 billion for 1998-2001. What was different about the end of this soft cycle was that poor results were prevalent across just about every line of business unlike the asbestos situation in the mid-eighties and natural catastrophes that occurred in the early nineties. Enter the next hard market and another wave of new companies.

What factors drive the insurance market cycle?

Clive: The two major factors driving the insurance market cycle are capital and investment returns. In today’s low interest rate environment we see companies much more focused on technical underwriting rather than cash-flow underwriting. This drives a more stable market which I believe is good for both insureds and insurers. A liquid capital market is also important in maintaining this stability. After Katrina, insurers were able to raise significant additional capital which lessened the impact of reduced capacity on our clients. The ability of our industry today to withstand events such as 9/11 and Katrina without the market falling apart, as it essentially did in the mid-eighties, is a major step forward.

How have the rating agencies, regulators and Sarbanes-Oxley contributed to today’s market dynamics?

Clive: Rating agencies are more extensive in their review of insurance companies, as are regulators. There is much greater analysis of performance metrics, volatility and risk management control. Failure to perform within expected parameters could have an impact on a company’s ratings and capital requirements. This deters companies from taking outsized market positions in relation to their capital.

Sarbanes-Oxley has placed greater responsibility on management for oversight of controls and financial reporting. This means the financials reflect performance more clearly and show where we are in the cycle in a much more transparent way. Results cannot be influenced to the extent they were previously by things like the widely publicized use of finite reinsurance.

How has this changed the market cycle?

Clive: Overall, I believe these factors will create a more stable environment and cycles will be shorter and less severe. In general, there are more controls in place and greater access to capital to manage market dynamics. In addition, we see increasing consolidation amongst insurers and with their bigger balance sheets they are less dependent on reinsurance to manage the cycle.
Where are we now in the cycle?

Clive: There is no question that rates have peaked and are softening somewhat but I still see a very responsible market. With the two largest catastrophes in history having occurred in the past six years and the ongoing threat of terrorism there is a sense of caution from sellers and buyers. There is often a greater concern for capacity over price. However, it’s amazing what a difference a year makes. 2005 saw record losses and capital raising while 2006 saw record profits and insurers looking at how they will deal with excess capital. It will be interesting to see what impact this has on the market in 2007.

What does this mean for insurance clients?

Clive: The good news is that there should be more capacity in the market in 2007 than there was in 2006 but in a broader sense it means that clients are dealing with companies that are better capitalized, more stable and responsible. Insurance companies are not going to be rewarded for some of the market share growth activities that we may have seen in the past. Industry analysts, clients, investors and other stakeholders are looking for responsibility in the market.

What can brokers do to help clients manage the cycle?

Clive: Clearly the broker has to listen and understand what a client’s needs are. Do they want long-term partnerships to manage through the cycle or are they price driven and content to take their chances on available capacity? Providing clients with a clear perspective on different strategies is important and then, of course, the brokers must be able to find the markets to execute. For those clients more concerned with certainty of capacity and the quality of their insurance partner, we’ve seen a strong interest in multi-year policies with highly-rated carriers, which I think bodes well for both sides.

What can clients do to manage the risks of the market cycle — even those that are shorter and less severe?

Clive: Certainly a client who demonstrates strong commitment to good risk management practices will be viewed favorably. Risk quality will always be more important than price for any responsible insurer. In addition, a risk manager who is proactive in building close and long-term relationships with insurers to improve the underwriters’ understanding of their risk will fare better throughout the cycle.