12 Underwriting Cycle

**The Insurance Underwriting Cycle**

Insurance underwriting cycles consist of periods of rising premiums and profits followed by periods of falling premiums and profits. Because insurance prices and insurer profitability are, to a large extent, driven by this market phenomenon, insurers have tried to understand what factors cause the cycle to occur and to develop strategies to respond to its phases.

**The underwriting cycle, more accurately described as the profit cycle, is based on operating profitability and consists of hard-market and soft market phases. The cycle has been influenced by structural change in society and business, and the cycle has also created structural change.**

Insurers respond to the phases of the underwriting cycle with various strategies:

* **In soft-market phases, most insurers decrease premium rates, relax underwriting standards, and expand coverage**.
* **In hard-market phases insurers raise prices, restrict coverage, tighten underwriting criteria, and re-evaluate reserves**.
* Producers find coverage readily available in soft-markets; in hard markets, they must invest more effort in marketing accounts. Commissions also fluctuate with the changes in pricing, to which producers often respond by decreasing or increasing staff levels.
* Phases of the Cycle

**Phases of the Cycle**

“underwriting cycle” is commonly used term for describing a recurring rise and fall in profits and prices in the property-casualty insurance industry. The term “profit cycle”, measured by the operating ratios, is a more accurate way to describe this cycle for two reasons.

* The cyclical process is driven by profit expectations, not underwriting execution.
* The relevant profit expectations are for operating profits, which are the sum of underwriting and investment income, rather than underwriting profits alone.

The two phases of the profit cycle are the hard market and the soft market.

**In a hard market, insurer competition declines, buyers have difficulty finding coverage, premiums increase, and insurer operating profit rises. A market begins hardening when insurers start to increase premiums and to limit the risks they will insured. The hard market will continue until the point at which insurers start to reduce premiums or loosen coverage terms or both. At this point, a trough is created, and the market is said to be softening.**

**In a soft market, insurer competition is intense and is indicated by widely available coverage, lower premiums and decreased operating profit. During this phase, operating results may even turn to losses. The soft market will continue until the point at which insurers again start to increase premiums, restrict coverage terms, and limit the amount of insurance they are willing to write. This point creates another peak, and the hard market phase of a new cycle begins. To retain or hold the insurance market share**

The reasons why and the way in which cycles occur in any industry’s markets depend largely on three economic characteristics.

* The structure of the industry’s markets
* The demand for the industry’s products or services
* The supply of the industry’s products or services

What sets apart the profit cycle of property-casualty insurance is the nature of its demand and supply.

When expected profits in an insurance market are attractive, insurers attempt to increase their sales, and others enter the market. If demand does not change, then supply exceeds demand, and prices fall. Prices fall because the only way individual insurers can increase their sales is to increase their market share. To increase its share, an insurer must take sales away from others, and typically the only way to do that is to lower prices.

**Historical Perspective**

Historically, what has caused insurers to pull back from an increase in supply, and the resulting reduction in price, has been an unforeseen and devastating event that occurs when the market is soft. The event produces enough fear to cause a general withdrawal from the market. To put that fear in terms of an insurer’s profit expectations, the future becomes highly uncertain. What caused insurers to pull back was not the nature of the external shock – a severe catastrophe, runaway inflation, collapsing securities markets, or evaporating reinsurance – but the belief that they could not go on as before. Each time, the precipitating even made insurers believe that they needed far more capital to support the risks that they had accepted before the event occurred.

1950-s through most of the 1970’s, the industry’s profit cycles appeared to have a regular, six-year patter of three years of rising profitability and three years of falling profitability, influenced mainly by the automobile line.

In the late 1970’ and the 1980’s the industry’s profitability went through unusually sharp swings. A medical malpractice crisis occurred in the middle of the 1980’s as well as a general liability crisis that resulted in disruptions to the insurance market and influence the onset of a hard market phase of the underwriting cycle.

In 2001, following a long soft-market phase, the market began to harden after losses resulting from 9/11 terrorist attacks and a reduction in investment returns. Two to three years later, the market entered into a prolonged soft phase.

**Structural Change**

Insurance underwriting cycle occur in the context of structural change in business and society, and they also contribute to structural change.

Structural changes in society and business that have influenced the profit cycle include these:

* An increase in litigation heightened the demand for liability insurance in the 1970’s. and 80’s from malpractice exposures.
* New competition arose from the rise of giant corporations and their need for “all-risks,” multiple location coverage.

**Structural changes in the insurance industry that have resulted from the profit cycle include these:**

* **Increased diversification**
* **Insurer exits from the market**
* **Consolidation of insurers**
* **Growth of the nonadmitted market**

**Insurer Underwriting Strategies**

Strategies used by insurers vary with the phase of the market cycle and insurers’ underwriting and operating philosophies.

**When the insurance industry enters a soft market in response to increased competition from new and existing companies, some insurers lower their prices to avoid losing market share. Price reduction might take the form of reduced rates, but also it usually includes other activities, such as increasing the use of rate credits, broadening terms of coverage, and loosing underwriting standards.**

**Other insurers are more conservative and are willing to sustain a loss in market share to avoid pricing that they view as inadequate. These insurers will exercise underwriting discipline and maintain their rates and their underwriting criteria.**

Underwriting strategies in soft markets also include either an increase or a decrease in underwriting expenses. Increases in commissions or advertising may increase premium at desirable prices, while decrease in underwriting expenses will reduce the expense ratio and thus the combined ratio.

**During hard markets, most insurers increase premiums and restrict the amount and type of business they will write. Some insurers also restrict the producers who represent them in order to obtain high-quality business. Insurers typically strengthen their loss reserves during hard markets, and they often add staff as both premiums and losses increase.**

**Another strategy insurers use during hardening markets is re-underwriting. Which involves reviewing and evaluating existing policyholders and imposing surcharges, deductibles, or non-renewals based on policyholder’s claim history or other experience.**

Agents and brokers must also adapt to the changing phases of the underwriting cycle. In a soft market, agents and brokers find it relatively easy to obtain markets for accounts. However, the competition for accounts with other producers is intense.

**Financial Factors Influencing the Underwriting Cycle**

Various financial factors affect the profitability of individual insurers as well as the insurance marketplace.

“Underwriting cycle” is a commonly used term or describing a recurring rise and fall in the profits and prices in the property-casualty insurance industry. The term “profit cycle” is a more accurate way to describe this cycle, and the terms “profit cycle” and “underwriting cycle” can be used interchangeably.

It is important to understand the financial factors, including these, that determine insurer’s profitability and, in turn, influence underwriting cycles:

* Investment Income
* Capacity
* Return on Equity
* Cash flow

**Investment Income**

**Insurers invest the premiums they receive until needed to pay for policyholders’ losses. Insurer investment income has been a key factor effecting changes in the underwriting cycle since the mid-1970s, when interest rates and insurer investment income increased significantly. Higher interest rates make it possible to earn more investment income, which offsets reduced premiums. The increase in investment income contributes to soft phases of the underwriting cycle when insurers reduce prices**.

When investment income decreases, the reduction needs to be offset by improved underwriting results or insurer profitability will decline. With declining profitability, as some point the cycle will turn from a soft-market phase to a hard-market phase.

**Capacity**

An insurer’s capacity is based on financial capital. An insurer’s capital theoretically stands behind all of the business it writes. For regulatory purposes in the US, an insurers’ capacity is based on its policyholders’ surplus. Regulators typically require a capacity ratio lower than 3:1 of premiums written to surplus. Supply differs from capacity in that capacity reflects the total amount of risk that insurers can assume relative to their surplus, regardless of their willingness to do so. Supply reflects the aggregate willingness of insurers to assume risk, as measured by the written premium-to-surplus ratio.

**Return on Equity**

Insurers expect a certain return for the use of their equity, and they generate this return through their underwriting and investment operations. Insurers will use their available capacity to support increased sales of insurance as long as the expected return exceeds the insurers’ return-on-equity threshold. Insurers typically provide capacity with the hope of obtaining an adequate return on equity (ROE) in the future.

**In an insurers’ return on equity falls to low levels, management usually reacts by increasing rates, restricting the amount of business written or both. If only one insurer experiences this, that insurer will lose market share and may go out of business.**

**Most insurers usually have similar experiences at the same time for the same reasons, such as increased losses (from catastrophes or litigation trends) or decreased investment returns (as a result of lower interest rates or poor stock market performance). When the majority of insurers increase rates and tighten underwriting criteria, the cycle turns, and a hard market begins**.

**Cash Flow**

Although some businesses can function on negative cash flow on a periodic basis, insurers cannot function on negative cash flow. Negative cash flow almost always precedes and insurer’s insolvency and will quickly trigger a change in pricing. It is often the result of inadequate loss reserves for previous years. Understating reserves creates inaccurate surplus amounts and artificially increases capacity, which keeps rates at lower levels for longer periods of time than retrospective analysts would indicate was appropriate.

**Negative cash flow can sometimes require selling assets at less than book value in order to pay losses, destroying an insurers’ investment strategy. The insurer’s management reaction is usually to institute an increase in pricing, expense reductions, measures to eliminate unprofitable accounts from the book of business, and strict underwriting guidelines.**

When the majority of insurers experience negative cash flow (because of the lower prices of a soft market, inadequate reserves for the prior year’s losses, a catastrophe, a reduction in investment income, or a combination of these), a hard market phase of underwriting cycle usually results.

**Effects of Supply and Demand on the Underwriting Cycle**

The microeconomic theory of supply and demand contributes to an understanding of property-casualty insurance underwriting cycles.

Because changes in the underwriting cycle are precipitated by changes in the price of insurance, many insurance industry analysts have studied cycles in a microeconomic context – that is, how the behavior of individuals and companies determines supply and demand, and how price interacts with supply and demand. This economic perspective suggests that underwriting cycles are a consequence of a competitive insurance market.

**Theory of Supply and Demand**

Supply and demand exist for insurance just as they do or other products, such as automobiles, concert tickets, or video game consoles. Therefore, the fundamental supply-and-demand dynamics that apply to other products and services in the economy also apply to insurance.

**For any product, demand is inversely proportional to its price**:

* **The higher the price, the smaller the quantity that consumers are willing to purchase**
* **Alternatively, the lower the price, the greater the quantity that consumers are willing to purchase**
* **The opposite is true for supply: The higher the price of a product, the greater the quantity that sellers are willing to offer, and vice versa.**

Combining the supply and demand curves on one graph reveals that there is a point at which the two curves intersect. At this point, referred to as economics as market equilibrium, demand and supply are equal. Market equilibrium is reached at equilibrium price (P\*) and equilibrium quantity (Q\*).

Market equilibrium can be attained in a free market without constraints on price or quantity. In market equilibrium, all sales transactions occur at equilibrium price (P\*). Any price that is higher than the equilibrium would generate a supply greater than demand and would result in an over-abundance of the product. With an over-abundance of a product, the price declines back toward P\*. Similarly, any price lower than the equilibrium price would generate a shortage, because demand would be greater than supply. With a shortage, the price rises back toward P\*, and the amount supplied will return to Q\*.

Within the competitive structure of property-casualty insurance markets, individual insurers do not have the power to control insurance prices. Rather, insurance prices are the products of decisions made by many sellers and buyers. Prices are determined by two primary factors:

* How much buyers want to buy (demand)
* How much sellers want to sell (supply)

**Supply of Insurance**

The supply of a tangible product is simply the number of product items available. An insurer, selling a promise of service that may be needed in the future, knows only some of the productions costs, such as underwriting expense. The losses and loss adjustment expenses are not known with certainty at the time the price (premium) is set. This causes the supply of insurance to vary; it can change dramatically over a short period.

**As insurance prices increase, insurers become more willing to accept risk. A change in the supply of insurance can affect the underwriting cycle. An increase in supply can have a softening effect on the market as pries decrease, and a decrease in supply can have a hardening effect as prices increase.**

Many factors affect the supply of property-casualty insurance:

* Reinsurance
* Ease of entry
* Difficulty of exit
* Regulatory environment
* Dedicated capital
* Profit expectations

Purchasing reinsurance expands an insurer’s capacity. Reinsurance, in addition to reducing the risk of potential losses through risk transfer and underwriting guidance, can also provide surplus relief because of the insurer’s ability to recognize the reinsurers’ ceding commission immediately as revenue. By increasing the capacity of many insurers, reinsurance usually increases the aggregate supply of insurance. However, if the supply of reinsurance decreases, reinsurance prices increase, or reinsurers do not pay claims as previously anticipated by primary insurers, the supply of insurance can decrease.

There are a few barriers to entry into the insurance market. Capital requirements have traditionally been small. Independent agents, internet offering, and direct marketing can provide immediate customer access and delivery systems. The entry of new companies increase competition and the supply of insurance,

Entry into the market is easy, exit from the market can be difficult. There are regulatory constraints on a primary insurers’ ability to cease operations, such as requiring an insurer to withdraw from all lines of business in a state if the insurer wishes to withdraw from one unprofitable line.

There are also regulatory constraints on the supply of insurance through business practices regulation and price regulations.

* State regulations prescribe the minimum financial requirements that an insurer must have to transact business in that state.
* State regulators have the power to regulate insurance rate increases and the underwriting factors used in setting premiums for many lines of business.

Multi-industry conglomerates can reallocate capital to take advantage of opportunities with greater profit potential. However, insurers are required to support the premiums they have written with capital.

The amount of an insurers’ surplus increases or decreases with loss reserve adjustments. Under reserving artificially inflates surplus, thereby increasing capacity and the supply of insurance.

**The supply of insurance changes with sellers’ expectations of profits. If it appears that acceptable profits can be earned in a market, existing insurers are encouraged to sell more insurance, more insurance companies enter the market, and the supply of insurance increases. Expectations of unacceptably low profits, or of losses, do the reverse. Insurers want to sell less of leave the market, others are not willing to enter it, and the supply of insurance decreases**.

**Demand for Insurance**

Demand is the willingness and ability to buy a product. As price decreases, the quantity demanded increases represented by a movement along the demand curve. Significant changes in overall demand, such as an uptick in the economy, can shift the cure itself.

The profit cycles in most US industries, such as manufacturing and retailing, are determined by elastic demand. For example, if a product such as a television, costs several hundred dollars, relatively few people may buy it. However, if the price drops a few hundred dollars, many people may buy it. Therefore, a reduction in price will increase the amount demanded, and an increase in price will have the opposite effect.

The opposite of elastic demand is inelastic demand. For example, because the need for food does not tend to vary significantly, the demand for many agricultural products will remain consistent regardless of whether the price rises or falls. The demand curve for inelastic demand has a steeper slope.

**However, insurance demand is relatively inelastic when compared with the demand for many other goods and services for two reasons:**

* **Buyers do not have much choice but to buy because the majority of insurance purchased is required by law or by a third party such as a lender.**
* **Insurance is an intangible financial product with an expiration date that cannot be stored up in the way that products such as automobiles or televisions can be held for longer periods of time without replacement when prices increase.**

The price elasticity of insurance can change. In some commercial markets, alternatives to traditional insurance through various risk financing techniques have become available to buyers. **The ability to substitute makes insurance demand in the commercial market more sensitive to price increases and reduces overall demand**.

**Application of Supply and Demand Theory to the Underwriting Cycle**

The underwriting cycle, more accurately described as the profit cycle, in property-casualty insurance is dominated by supply, which is highly variable. Variations in the supply interact with relatively inelastic demand to increase and decrease market equilibrium prices and profitability. The insurance profit cycle can be defined as the recurring rise and fall of profitability that results from contractions and expansion of the supply of insurance in competitive markets.

The insurance industry is different than most other industries. Since supply, not demand, is more important in influencing insurance prices and profits, insurance profit cycles usually do not coincide with general business cycles.