

**A BRIEF HISTORY
OF
UNDERWRITING CYCLES**

Stewart Economics, Inc.

Appendix to

**Cycles and Crises in Property-Casualty Insurance:
Causes and Implications for Public Policy**

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A BRIEF HISTORY OF UNDERWRITING CYCLES

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Introduction

This paper was commissioned by the National Association of Insurance Commissioners as part of its study of the underwriting cycle in property-casualty insurance and the implications for state regulatory policy. It examines underwriting cycles from a historical perspective to try to understand why they have recently become so disruptive.

For this paper, the term "cycle" is used loosely to mean the ups and downs in prices and profits in the insurance business. "Cycle" particularly refers to those ups and downs that are repetitive and which are driven more by forces within the insurance world than by forces outside.

Looking at the history of the American insurance industry as a whole, the cycles in the 19th century were violent and disruptive because they reflected large shifts of insuring capacity into and out of the insurance business following price wars and big city fires. Public concern with those cycles was so great that it led to a system of centralized price setting with accompanying controls over costs and underwriting. Under that system the cycles subsided into largely statistical phenomena. Recently, the central control arrangements lapsed and were replaced by open competition and freer movement of insuring capital. The markets for most coverages matured.

Today, one old line – general liability – exhibits many characteristics of an emerging one. It seems able to soak up as much capacity as is made available. Most important from a public viewpoint, after almost a century of stability, general liability shows a new line's predisposition toward unstable behavior. Cycles again are a matter of public concern.

The best way to see what has happened and to think about why is to examine the lines of insurance individually and to follow their development through time. This paper takes a historical view of the underwriting cycle. It begins with an explanation of the approach, then tells the story of each line, and then examines the histories for common threads and perhaps useful lessons.

I. A Historical Perspective

The underwriting cycle in the property-casualty insurance business is the recurring pattern of increases and decreases in insurance prices and profits. In recent years, the cycle has also been characterized by dramatic changes in the availability and quality of insurance.

Cyclicity is not unique to insurance. For over a century, economists have referred to the fluctuations in overall business activity as the "business cycle." Many industries besides insurance have had upturns and downturns in prices and profits accompanied by variations in product quality and supply.

Cyclicity can be analyzed from two perspectives. The first is the perspective of microeconomic theory. It involves the analysis of market characteristics, such as number of participants, market shares, nature of the product, and sources of supply and demand. Cycles are then explained in terms of how those factors interact to change prices and profits. Several studies of this kind have been done, some of them by the authors of this paper.

Among the elements of the economic theory of insurance cycles are the following. Supply, rather than demand, drives prices most of the time. In competitive markets, cycles are caused by changes in sellers' expectations. Rising prices are turned around by the entry of new competitors and other additions to supply. Falling prices are turned around by frightening, unexpected events. In markets with centralized pricing, cycles are caused by delays in adjusting prices to changing costs. In heavily regulated markets, whether competitive or centrally directed, the delays, and hence the cycles, are exacerbated by the time taken for the regulatory process.

Microeconomic theory deals with market conditions and behavior at one point in time. Although the analysis can be extended from one period to the next, it is necessarily static. The descriptive models can deal with only one market structure at a time.

Although the microeconomic analysis is static, it is a valid way of looking at the insurance business and, in fact, has great power to explain events. But for understanding a dynamic process such as underwriting cycles occurring over time, a view of the world which deals naturally with time and with change, both internal and external, is necessary. That view is historical.

The insurance business in the United States has gone through distinct stages of development. Cycles have occurred for different reasons at the different stages.

Following are brief histories of the markets for eight major lines of insurance in the United States. Grouped broadly as fire, marine, package and casualty, the lines are: fire,

ocean marine, inland marine, homeowners, commercial multi-peril, workers' compensation, automobile and general liability.¹

The history of each line is accompanied by graphs showing the line's underwriting profitability and premium growth for as far back as industry data are available. The graphs show that every line of insurance has had variable profitability and growth, usually regular enough to be called cyclical. The causes of the cyclicality were different, as suggested by the histories.

The histories are presented for two reasons. First, the individual lines have had their own development and particular concerns. Second, after one reads a few of the histories, they begin to sound familiar. The lines of insurance have followed, in a general way, a common historical pattern. The pattern is discussed in detail in a later section of this paper.

Fire

From its beginnings in the United States and throughout the 19th century, the fire insurance business was wildly cyclical. Insurers would compete fiercely for business, to be stopped only by panic or bankruptcy.

For many years, insurance companies wrote only in their own cities and towns. Price competition prevented them from setting aside reserve or surplus funds. With concentrated exposures and slender resources, many insurers would be driven out of business by a big fire. Surviving insurers would get together and agree to control rates and prevent the competition from occurring again. But the higher rates would attract new competition, and the cycle would start again.

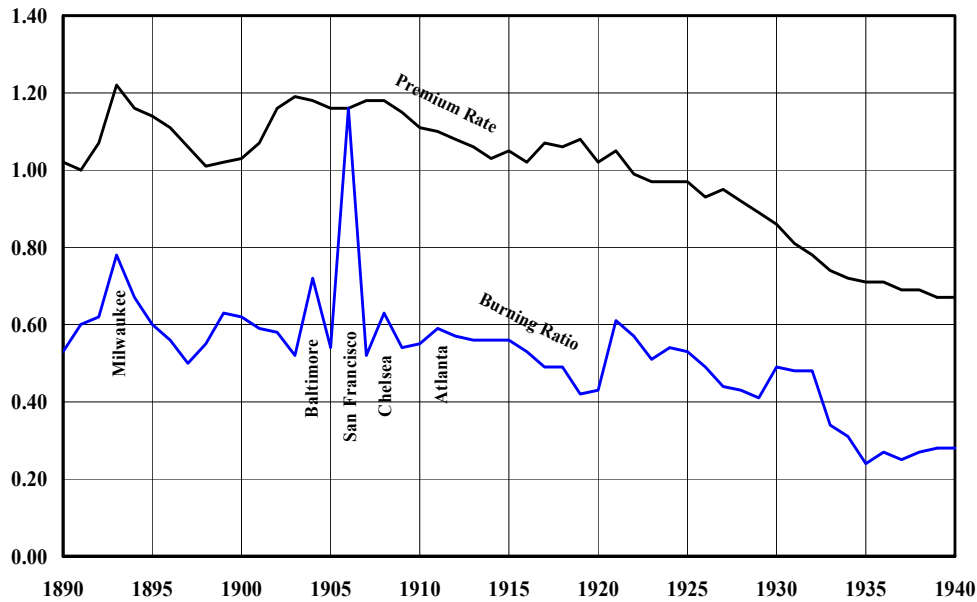
Toward the end of the 19th century, insurers' efforts to maintain rates were also thwarted by prevailing public attitudes in favor of competition. A number of states passed anti-compact laws to prevent insurers from jointly fixing rates.

Only after the San Francisco earthquake and fire of 1906, were the National Board of Fire Underwriters and its regional affiliates able to control rates, commissions and policy forms. Insurers' depleted financial condition after paying San Francisco fire losses led to rate increases. In New York, the Merritt Committee, appointed by the legislature to investigate those rate increases, concluded in 1911 that cooperative ratemaking under the supervision of the state was preferable to destructive competition. Many states adopted that position and repealed their anti-compact laws. Three years later a committee of the National Convention of Insurance Commissioners advocated recognition and regulation of ratemaking bureaus.

¹ This analysis is not intended to cover everything that property/casualty companies do, but rather to cover mainstream property/casualty insurance activities. Hence, insurance lines such as accident and health, credit, title and reinsurance are not included, nor are the bonding lines such as fidelity, surety and financial guarantees.

In the ensuing 30 years, the bureau system was strong and stable. Premium rates were not cyclical but instead gradually declined. Average fire rates are shown in Figure 1 below. Their decline followed the industry's improving loss experience. The experience improved with stricter building codes, greater use of fire resistant materials, better fire fighting techniques and more efficient spreading of insured losses.

Figure 1. Average Fire Rates and Burning Ratios



Average Rate of Premium is Percent of Premiums Received to Risks Written (Rate per \$100).
 Burning Ratio is Percent of Losses paid to Risks Written (without regard to Premiums).
 Source: *Aggregates & Averages* (1941), A.M. Best Company

Starting with the Southeastern Underwriters Association (SEUA) case in 1944, rate and form restrictions were loosened. Multi-line legislation in the late 1940s and then multi-peril policies, partial subscribership and deviations from bureau rates in the 1950s made it possible for insurers once again to compete on product and price.

In the 1960s, fire insurance growth stagnated and results worsened. See Figure 2 and Figure 3. As standard commercial and personal fire risks were taken into packages, mono-line fire and allied lines split into two narrow markets – a specialty market and a residual, substandard market.

The specialty market, typically large and highly protected industrial properties, had few providers with the requisite capital and underwriting skills. Market concentration brought stability from the late 1960s until the late 1970s, but then profitability came under pressure from competition within the specialty market and from self-insurance.

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The residual market developed a cyclical pattern as recurring competition in voluntary markets caused risks to move into and out of fire pools and other involuntary facilities.

Figure 2. Fire and Allied Lines Combined Ratio

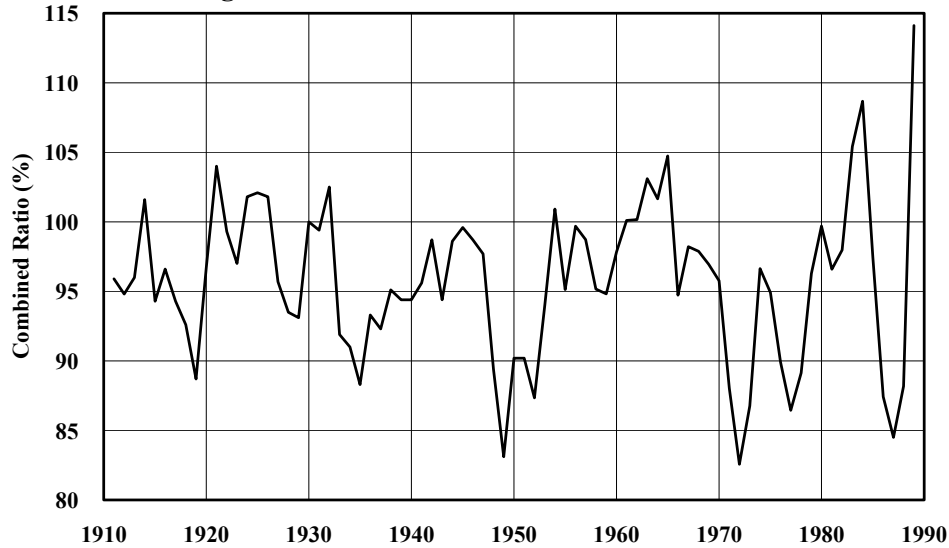
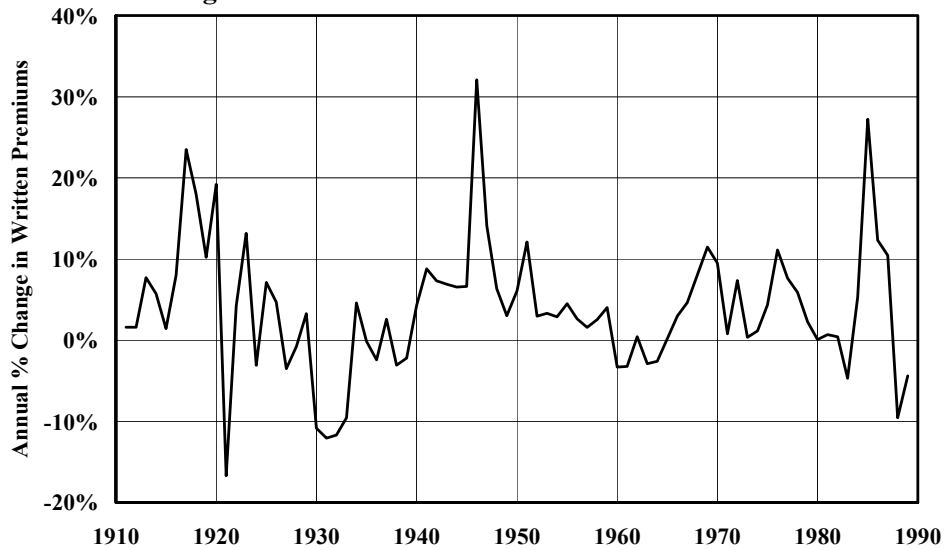


Figure 3. Fire and Allied Lines Premium Growth



1911-1950 Stock Fire Companies (All Lines for Combined Ratio; Fire only for Premium Growth)

1951-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

Ocean Marine

In the early years of the United States, marine insurance came mainly from Lloyd's. But a few American marine insurers got a strong start during the War of 1812. After the fighting ended and the British re-entered the market, price wars broke out.

Beginning in the 1840s and up to the outbreak of the Civil War, American marine insurers prospered. It was the era of the great wooden clipper ships, which by 1861 carried three quarters of U.S. foreign trade. American marine insurance grew along with the American merchant marine.

Fortunes reversed beginning with the Civil War. By the end of the 19th century, American marine insurance had almost disappeared. One cause was the loss of ships and disruption of trade routes in the war. Another was that British ships with iron hulls and steam power replaced American ships of wood and sail.

Lloyd's played an important part in diminishing U.S. shipping, and hence U.S. marine insurance, by applying inferior rate classifications to wood, sail and non-British flag vessels. Finally, in the 1870s, British and other foreign insurers entered the U.S. market, cut rates and drove out many of the Americans.

By the turn of the century, only a quarter of America's trade was covered by American marine insurance. The few U.S. companies left writing the business were fire insurance companies with incidental marine underwriting departments.

In the early years of World War I, British wartime policy so interfered with U.S. trade and insurance that after the war was over, Congress passed legislation to foster an American merchant marine and American marine insurance industry. The Merchant Marine Act of 1920 exempted marine insurance from the antitrust laws to permit the formation of the American Hull Syndicate. The syndicate enabled American marine insurers to provide big capacity without reinsuring abroad.

Joint efforts by government and industry continued during World War II, with the formation in 1939 of a private marine reinsurance pool, the American Cargo War Risk Exchange. The pool provided unlimited war risk coverage until 1942, when the War Shipping Administration took over as the insurer. Figure 4 shows the sharp decline in U.S. marine insurers' premiums at that time.

After the war the government continued to support the American marine insurance industry. Owners of ships mortgaged under or chartered by the Maritime Commission were required to place 75 percent of their hull insurance in the American market, a requirement that stood until 1988.

Figure 4. Ocean Marine Premium Growth

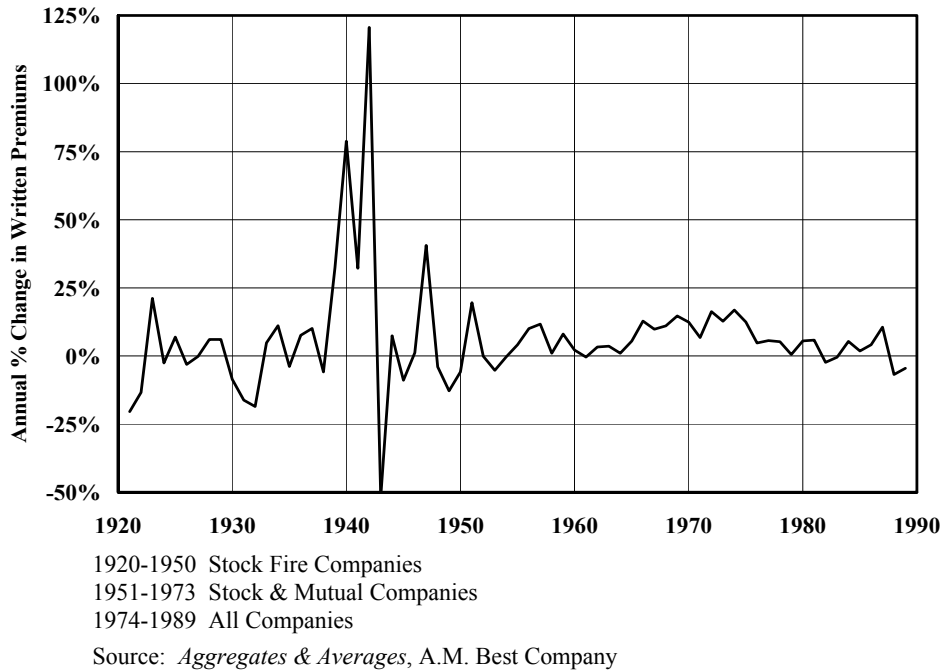
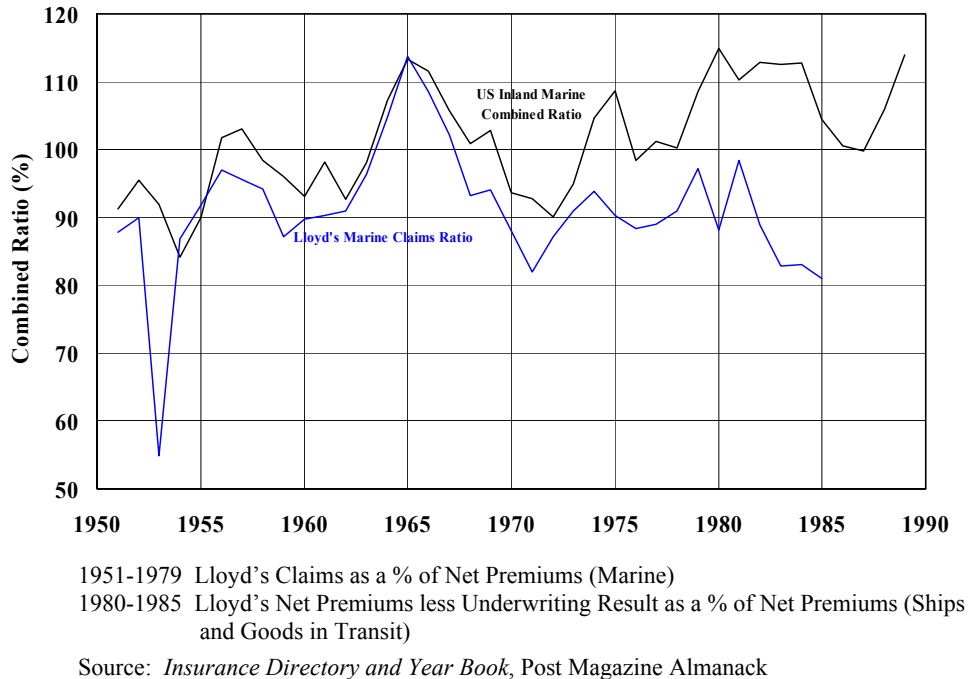


Figure 5. U.S. Ocean Marine Combined Ratio and Lloyd's Marine Claims Ratio



The American merchant marine began to decline in the 1950s with competition from ships registered under the flags of other countries. Many of those countries had their own insurance requirements, so the demand for American marine insurance declined too.

Since ocean marine insurance was structured in the 20th century on a noncompetitive basis, the American market has not had internal competitive cycles. Rather, cycles of prices and profits have reflected conditions in the international marine insurance market. Demand has fluctuated with worldwide shipping activity, while insuring capacity in the United States and abroad has continued to increase. American ocean marine cycles have followed those of the London and European marine markets. See Figure 5.

Inland Marine

Inland marine insurance became important in the early decades of the 20th century with the changing character of American business. The local plant and family store gave way to the giant manufacturer and chain retailer with many factories and stores and with moving, fluctuating inventories. The local, standard, rigid fire insurance business could not respond. Although some fire companies tried to provide multi-location coverage with adjustable values, rating bureau restrictions were too cumbersome.

Marine underwriters here and at Lloyd's met the needs. They were unregulated as to rate, form and location. They were used to all-risk coverage, fluctuating values and property on the move. They were oriented toward brokers in financial centers rather than agents in towns.

Marine contracts were worded to provide all-risk fire and casualty coverages even where the transportation exposures were minor. While inland marine was especially well suited to covering property at many locations, it also covered such things as bridges and tunnels, jewelry, fine art and merchandise sold on the installment plan.

Inland marine was so well suited to the needs of the time that in the 1920s, inland marine premiums more than doubled while fire insurance premiums stayed flat. Many fire and casualty companies denounced the competition, but some joined in and set up inland marine subsidiaries. Commission competition became rampant. The fight over business led to characterizations of the market in the late 1920s as a "mad scramble."

Two things happened. First, in 1931 the Inland Marine Underwriters Association was formed to set rates and commissions. The desire to bring order to the market was clear from statements by the Association that the participation of the major fire companies was crucial. Although a few companies refused to comply, the industry leaders were able to hold the organization together.

Second, in the early years of the Depression as premiums fell along with the general economic decline, fire companies complained to the insurance commissioners that inland marine companies were taking unfair advantage of their greater freedom to reduce rates. The result was a 1933 industry agreement, under regulatory auspices, to limit marine insurers' writings. It was formalized in the "Nationwide Definition and Interpretation of the Insuring

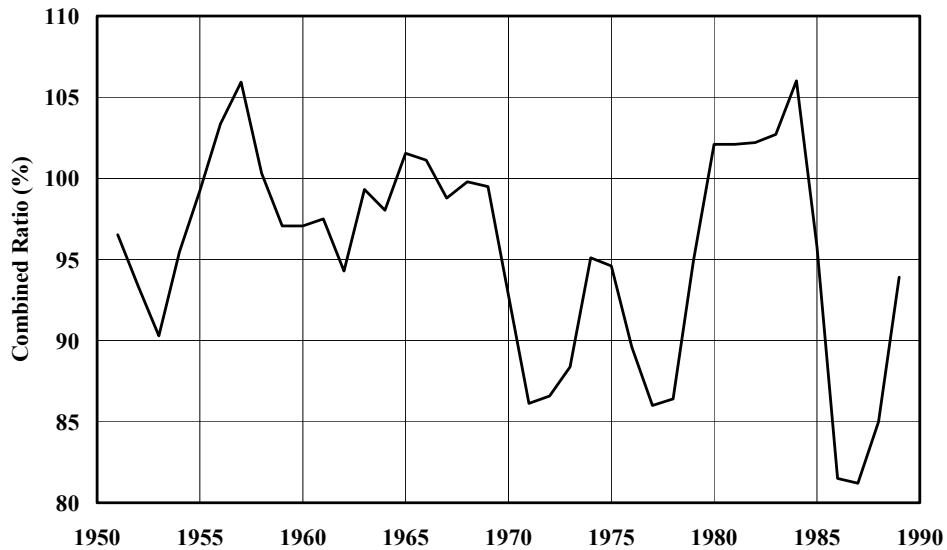
Powers of Marine and Transportation Underwriters," which was enforced by a "Joint Committee on Interpretation and Complaint."

What ultimately ended the inter-line competition, however, were the loosening of restrictions after SEUA and the McCarran-Ferguson Act, multiple-line underwriting powers in the late 1940s and package policies in the 1950s. The Inland Marine Underwriting Association and the Joint Committee retreated to the roles of advocating rate freedom and monitoring changes in the marine definition.

Competition shifted to package business. Insurers used the unregulated inland marine portion to compete on price. As main-street inland marine was absorbed into packages, mono-line inland marine became a specialty market of contractors' equipment, bridges and tunnels, jewelry, fine arts, pleasure craft, truck cargo and other miscellaneous risks.

In recent years, the specialty nature and small size of the inland marine market have kept it from being as competitive as other, larger and more easily entered markets. Growth and profits have been better than average. Although price competition hit inland marine along with other lines in the early 1980s, the line was profitable after including investment income. Figure 6 shows the underwriting profitability of inland marine, and Figure 7 the growth of inland marine premiums.

Figure 6. Inland Marine Combined Ratio

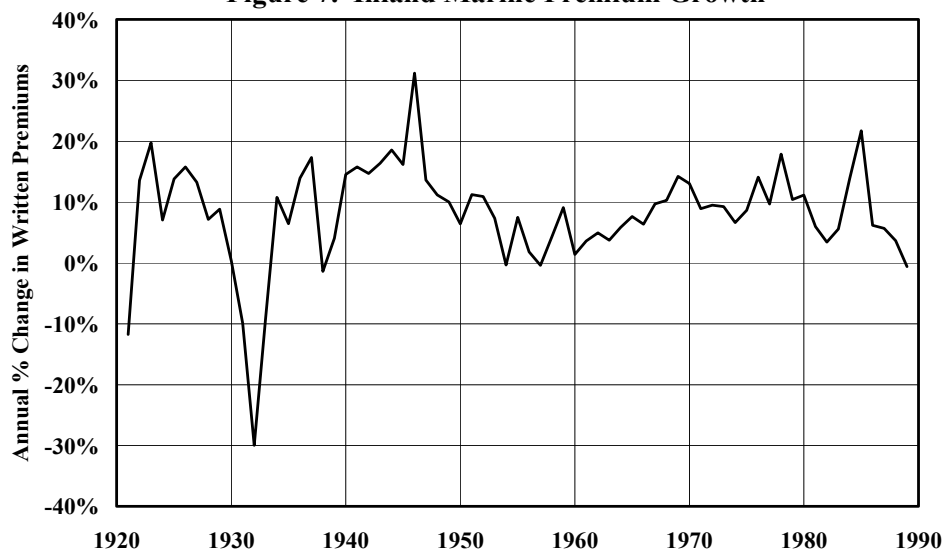


1951-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

Figure 7. Inland Marine Premium Growth



1920-1950 Stock Fire Companies

1951-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

Homeowners

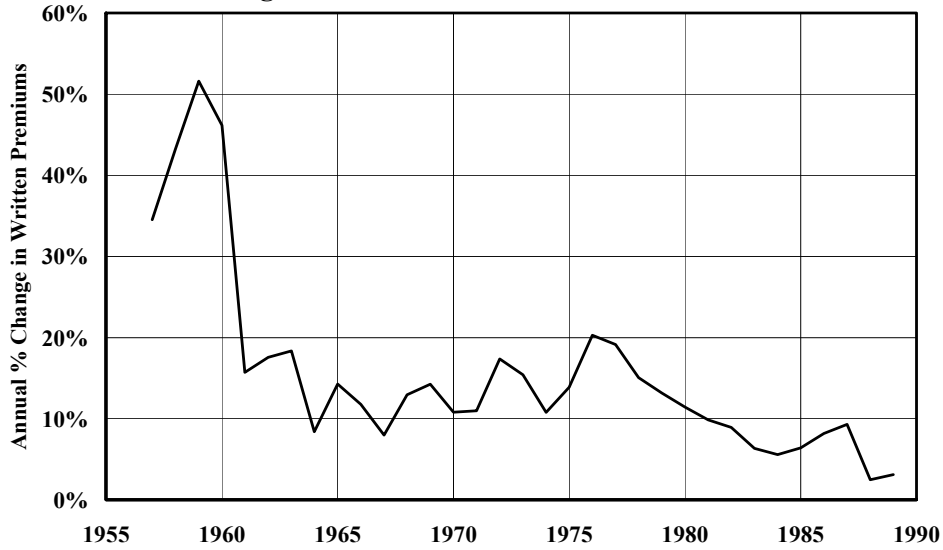
After World War II, home building boomed, and mortgagees required insurance. The buyers were on tight family budgets. Dwelling fire insurance rates were redundant as to losses, but companies could not make money on small, mono-line personal transactions. Most people were underinsured in relation to value in fire and absolutely in inland marine and liability. States were enacting multiple-line laws authorizing a single company to write more than one of the major lines of insurance.

It was a perfect setting for multiple peril personal insurance. The Insurance Company of North America (INA) introduced the homeowners policy in August 1950. By autumn, work had begun on a rating bureau for the new line. But INA's policy had fixed relationships among the amounts of the various coverages and had a single, overall premium which was not divided among component coverages. That sat badly with the dominant fire companies and the mono-line rating bureaus. Reduced percentage commissions (on the larger dollar sale) sat badly with agents. But the broader coverage and 20 percent price cut below the sum of the component coverages appealed to the market.

Early sales were sensational as INA and its competitors penetrated the expanded market for the first time. Premiums went from zero in 1950 to \$68 million in 1955, and then to \$1.5 billion in 1965. How rapid growth was in that period is shown in Figure 8. From the mid-1950s through the mid-1960s, the compound annual growth rate was 36 percent, whereas

fire and allied lines premiums did not grow at all. Combined ratios were in the mid-90s in the early years, and supply and price were steady.

Figure 8. Homeowners Premium Growth

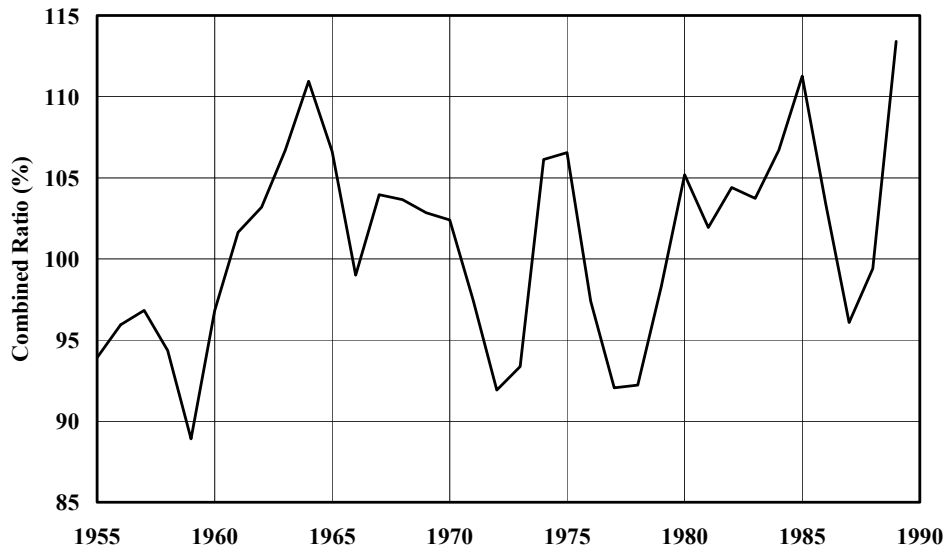


1955-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

Figure 9. Homeowners Combined Ratio



1955-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

Competition intensified, even as the line began to lose money. Immediate financial returns were not the decisive consideration. The conflict over fixed coverages and indivisible premiums was deep, and the competitors had strategic stakes in market share and in reinforcing their ties to the growing family market. The price war which started in the early 1960s was accompanied by a fight among the rating bureaus which otherwise might have restrained it. Growth continued, but profits disappeared for the rest of the decade – see the combined ratio in Figure 9.

There was never a violent swing in price and availability, most likely because low cost direct writers were still profitable and able to take share from agency companies. For the same reasons, there was not an extended period of bureau control, which is unusual for a new line.

Price leadership in homeowners has gone to the low cost providers. Profits usually lead to coverage extensions rather than price cuts. The shift of functions from agent to company reduces total costs but also shifts them from variable to fixed, which rewards growth in sales.

Commercial Multi-Peril

In the early 1950s, shortly after the successful introduction of homeowners personal multi-peril insurance, commercially oriented stock insurers introduced commercial multi-peril (CMP). The package could include fire and allied, general liability, inland marine, theft, glass and other miscellaneous coverages.

The policy was sold partly on breadth of coverage, but mainly it was sold on price. The first packages were a means for cutting rates for preferred classes of risks. A subclass that appeared to have redundant rates would be broken out and coverages for it packaged at a lower rate.

Bureau opposition to the packages was intense, although not as fierce as in the homeowners episode. Ironically, many commercial packages were created by bureau companies filing on their own. State regulators' acceptance of package policies and their success in the market soon led the bureaus, working together in the Inter-Regional Insurance Conference, to develop their own package program, the Special Multi-Peril (SMP) policy, in the early 1960s.

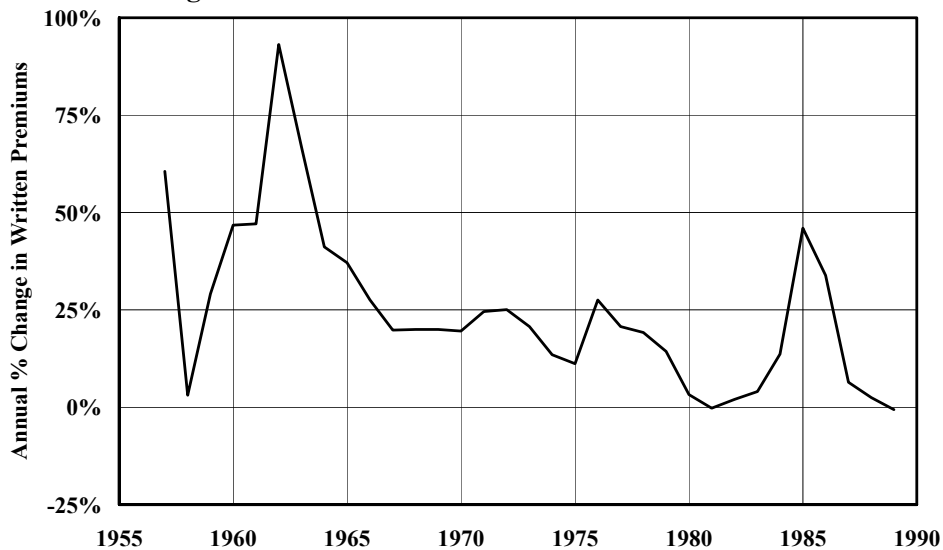
Competition for CMP business soon became severe. Companies were accused of selling at any price to increase market share. Stories of the time tell of quotes 50 percent apart. The premium modifications were largely a matter of judgment. Deductible plans, credits for multiple locations, and schedule credits and debits went far beyond any used in fire insurance rating.

Many agents were against the packaging movement. They objected to the lower rates, to filings by some independents that included premium adjustment factors for lower commissions, and to upsetting the familiar sharing of business among agents.

The independent filers had the competitive edge. The bureau programs were slower to adapt to market needs. Whereas the independents could use underwriting restrictions to write preferred business, the bureau policies were not underwritten on an individual risk basis but were written and priced on "eligibility rules", i.e., the definition of classes of insured (such as pharmacies or hardware stores) eligible for the coverage.

Growth was rapid during the early years, averaging more than 40 percent per year from 1956 through 1966 – see Figure 10.

Figure 10. Commercial Multi-Peril Premium Growth



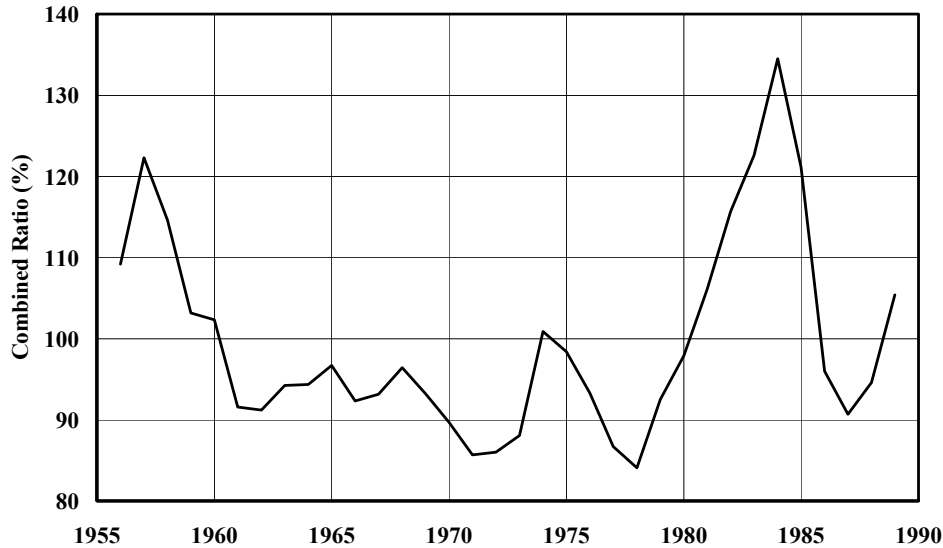
1956-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

In the first three years, commercial multi-peril reported big losses, mainly because of the statistical lag of earned premiums in a new and rapidly growing line. But for the next 20 years, the line was very profitable. Even though bureau companies increased competition when they entered the market wholeheartedly, nearly everyone made money. The best risks were being converted from monoline fire and allied lines to the package. The combined ratio is shown in Figure 11.

Figure 11. Commercial Multi-Peril Combined Ratio



1956-1973 Stock & Mutual Companies

1974-1989 All Companies

Source: *Aggregates & Averages*, A.M. Best Company

Growth slowed to about 20 percent a year in the late 1960s and 1970s. Profits were excellent, except during 1974 and 1975 when prices in the general economy shot up following the removal of price controls. CMP premiums soon caught up with loss costs, and results improved.

Starting in 1980, growth slowed and underwriting became unprofitable. There seem to be three reasons. First, the market became saturated. Having begun with only preferred classes, eligibility rules were gradually expanded so that by 1977 nearly all businesses could buy a commercial multi-peril package. The market was also limited by the product, which was best suited to small businesses. Second, the direct writers entered the market with lower costs, quickly taking market share from the agency companies. Third, while initially considered a property coverage, commercial multi-peril was taking on more and more liability exposure. In recent years, the liability component in many classes has accounted for well over half of the premium.

Today commercial multi-peril follows the cycles in commercial general liability and property, while remaining under price pressure from low cost providers for the smaller risks.

Automobile

The automobile insurance policy was introduced at the turn of the century, with a liability policy in 1898 and a fire policy in 1902. In the early years the market was chaotic. Because automobile was a new form of insurance, there were no statistics and companies had

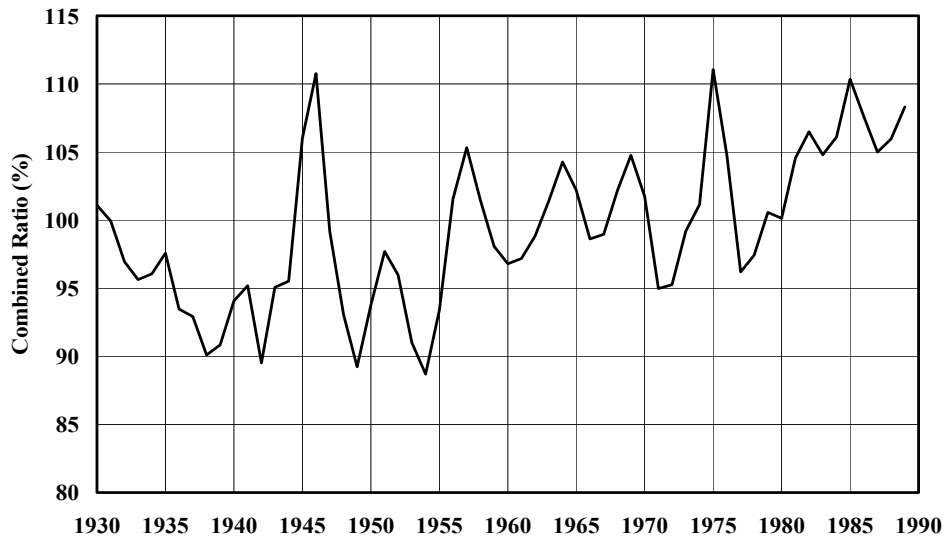
no agreements regarding rates, policies or underwriting methods. Insurers underbid one another and usually lost money. Rates were subject to frequent and violent change.

It did not take long for insurers to get together to agree on rates and policy forms. In 1909 a group of New York stock fire insurance companies formed an automobile insurance ratemaking association. Around the same time, the stock casualty companies in the Liability Conference began making auto rates. The mutuals initially followed the stock bureau rates and forms, but later set up their own bureau.

The establishment of uniform rates by the stock companies reduced the volatility of the business. But it also provided a competitive opportunity to companies, particularly mutuals and reciprocals, which did not use independent agents and underwrote more selectively. Because the stock agency companies agreed not to compete on rates, they competed instead for the favor of agents by bidding up commissions. Mutuals and reciprocals, which used their employees or exclusive agents, had lower expenses and thus were able to charge lower prices, usually by means of policyholder dividends. Lower cost insurance attracted customers and thus permitted direct writing mutuals and reciprocals to underwrite more selectively.

Despite the steady shift toward the direct writers, the business was profitable. The spread of the automobile kept demand growing for everyone. Cyclical volatility was moderate and not seen as a problem. See Figure 12.

Figure 12. Automobile Combined Ratio

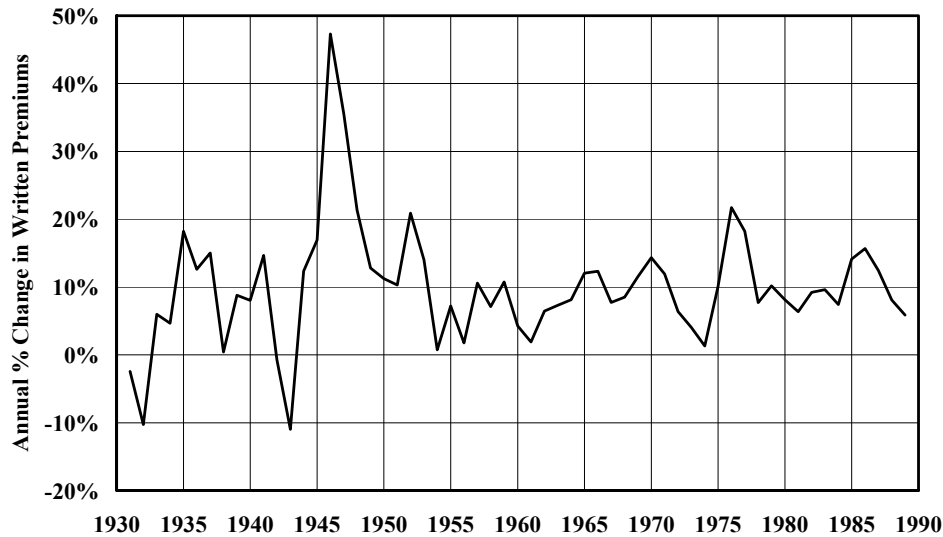


1930-1950 Stock & Mutual Casualty Companies
 1951-1973 Stock & Mutual Companies
 1974-1989 All Companies (Private Passenger lines only)

Source: *Aggregates & Averages*, A.M. Best Company

After World War II, demand and losses surged. Postwar inflation, repeal of gasoline rationing, lifting of a moratorium on lawsuits against servicemen, and resumption of normal economic activity led to greater volume and higher rates. Premiums more than doubled between 1945 and 1948. The increases at that time stand out in Figure 13.

Figure 13. Automobile Premium Growth



1930-1950 Stock & Mutual Casualty Companies
 1951-1973 Stock & Mutual Companies
 1974-1989 All Companies (Private Passenger lines only)
 Source: *Aggregates & Averages*, A.M. Best Company

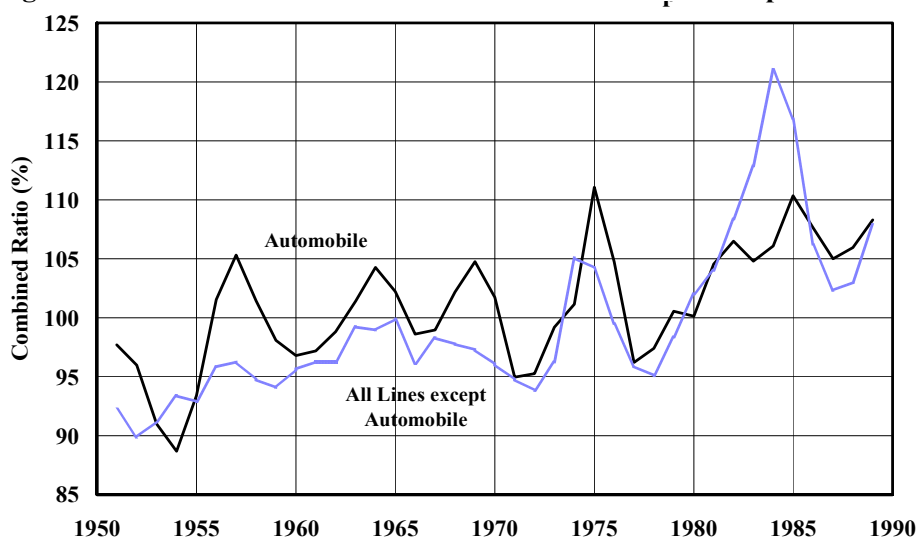
The surge in premiums put an enormous strain on insurers' surplus. Many independent agency companies cut back. The direct writers stayed in. Most of them did not have other lines of insurance to support their employees and exclusive agents.

The market share of the direct writers continued expanding in the postwar years. Many had rural and suburban origins and thus benefited from the postwar growth of the suburbs. Generally, though, direct writers won share on price. Once partial subscribership to bureaus and deviations from bureau rates were permitted, the market became fully competitive. The lower cost direct writers had the advantage.

Prior to passage of the McCarran-Ferguson Act, there was little regulation of automobile insurance rates outside of New York and Texas. State rate regulation following McCarran brought a much more pronounced cyclical pattern to automobile insurance. Regulators often sought to hold down increases in insurance rates, which were rising with general economic inflation, litigation, population density and highway congestion. Bureau ratemaking had always lagged behind costs. Now procedural and political delay made it lag even more.

As a result, beginning after the war and extending through the mid-70s, auto insurance developed a regular six-year cycle of three years of rising profits and three years of declining profits. Because automobile accounted for almost half of industry premiums, its cycle gave a misleading appearance of regular, predictable cycles to the entire property-casualty business. Figure 14 shows that underwriting cycles for all lines excluding automobile have been different from automobile cycles. From 1950 through 1970, all lines except automobile had only one full cycle, while automobile had three.

Figure 14. Combined Ratio of Automobile and All Lines except Automobile



1950-1973 Stock & Mutual Companies
 1974-1989 All Companies (Private Passenger lines only)
 Source: *Aggregates & Averages*, A.M. Best Company

The cycle in automobile insurance has been largely statistical, reflecting bureau or regulatory lag in adjusting prices to costs. Because the dominant, low cost direct writers have an almost insurmountable competitive advantage in a commodity market which is now mature, there is little room for new entrants. Without new supply to depress prices, a competitive price war is unlikely.

In states where the market is attractive, however, competition has become a stronger force than statistical delay in moving prices or holding them down. The three-up-three-down cycle did not persist in the 1980s. As shown in Figure 14, the most recent profit decline in automobile insurance lasted eight years and the recovery two. During this period, many agency companies resolved not to lose more share and did not raise rates as much as they might have done when in earlier years they went for higher returns and ignored share.

Workers' Compensation

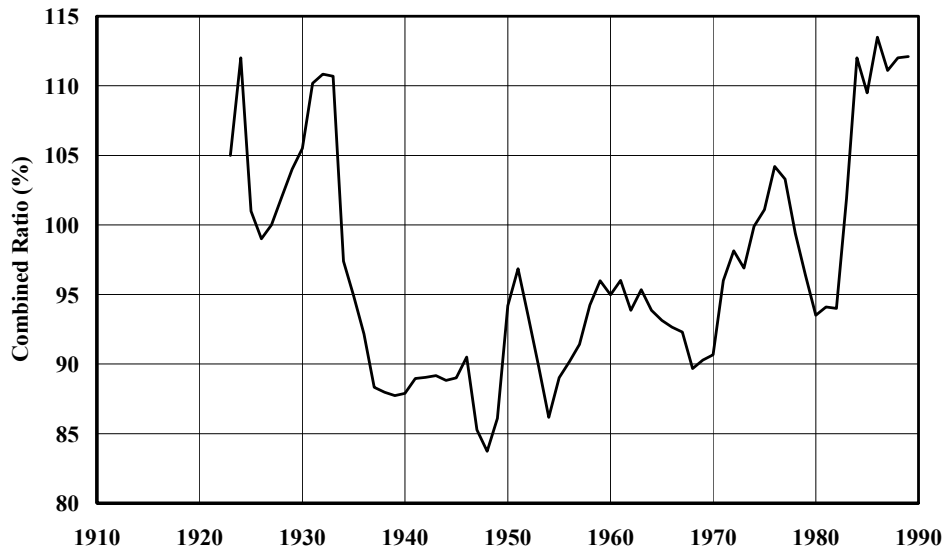
Beginning in 1911, states passed workers' compensation laws to replace employer liability as the means for compensating injured workers. Many of the laws required insurance regulators to approve classifications, manuals and rates. Rating bureaus quickly emerged. Membership was either required by statute or extended by regulatory pressure. In 1922, a national bureau, the National Council on Compensation Insurance, was formed by the industry in cooperation with the NAIC to develop rating plans for a number of states.

Bureau rating was adopted and enforced not just to ensure equitable distribution of costs, but also to deter insurers from competing with one another. The stated fear was that competition would drive insurers out of the market and this necessary coverage would not be available.

Workers' compensation was quite profitable in its early years, partly because the ratemaking process was not well developed but mainly because greater industrial production during World War I increased payrolls faster than industrial accidents.

At the end of the war, rates were sharply reduced. Insurers lost money for most of the 1920s. Industrial activity picked up, greater mechanization increased hazards, medical costs rose and workers' compensation laws were liberalized. Regulators in the large industrial states were slow to permit rates to catch up. Losses widened in the early years of the Depression as wage scales and payrolls declined and costs continued to rise.

Figure 15. Workers' Compensation Combined Ratio



1923-1973 Stock & Mutual Companies

1974-1989 All Companies (Private Passenger lines only)

Source: *Aggregates & Averages*, A.M. Best Company

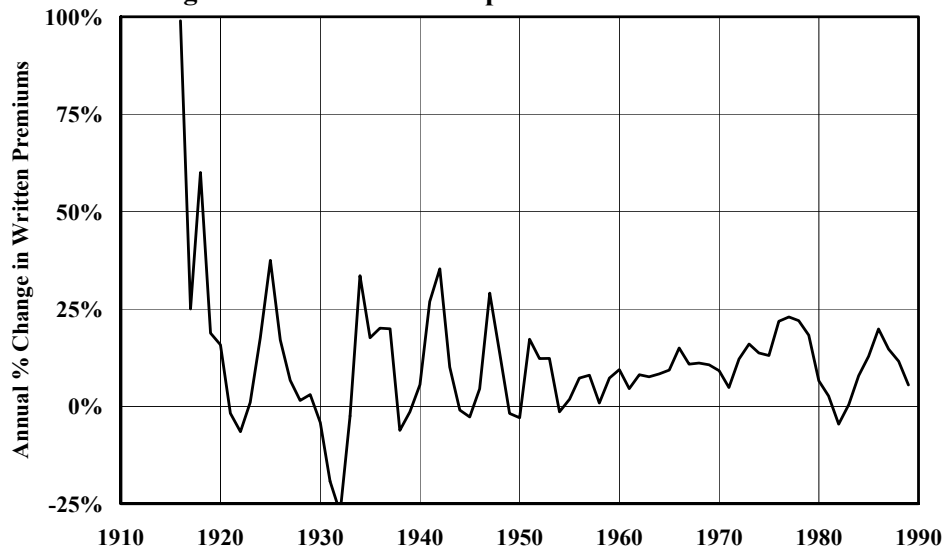
Emergency rate adjustments in the early 1930s restored profitability. Profits stabilized at a comfortable level until the inflation following the Korean War. Movements in the combined ratio are in Figure 15.

In the late 1930s, competition increased with the introduction of retrospective rating plans. While the plans were closely regulated in some states, they were not in others. On large accounts with locations in several states, insurers would issue policies in a less regulated state and give retrospective credit for experience in all states. They would also include experience on casualty lines other than workers' compensation.

Rebating, misclassification and miscalculating payrolls also occurred on large accounts. Bureau expense loadings were proportional to premiums and thus did not reflect the scale economies of serving those customers.

The expense saving on large accounts was the primary reason the NCCI and other bureaus eventually adopted more flexible rating plans. If the savings had not been given back, the large accounts would simply have self-insured. A major push for such change came during World War II when the War Department required competitive bidding on National Defense Projects. The bids had to include liability and workers' compensation coverages and give explicit recognition to dividends. The NCCI's retrospective rating Plan D, which was adopted in many states right after the war, explicitly included experience from general liability, automobile liability and other lines in the workers' compensation rating formula.

Figure 16. Workers' Compensation Premium Growth



1915-1973 Stock & Mutual Companies
 1974-1989 All Companies (Private Passenger lines only)
 Source: *Aggregates & Averages*, A.M. Best Company

Although it was relaxed in those ways, the highly structured rating system still dominated the market. Profits were cyclical but good for all participants. Profit cycles were more a reflection of rates catching up with costs than they were a reflection of competition or shifts in capacity. As shown in Figure 16, premium growth steadily rose from the mid-1950s through the late 1970s, reflecting the steady rise at that time in wages, number of workers covered and legislated benefits.

In recent years, workers' compensation has taken on the characteristics of a cyclical, commodity business. Since deviations are more widely permitted, insurers can compete directly for workers' compensation business rather than only by undercharging for an account's other coverages. Open competition has been adopted in some states. Demand has declined as buyers have opted for self-insurance. The situation in workers' compensation is now one of excess capacity. There are, however, marked exceptions in those states where rate suppression has discouraged insurers from writing more business and has caused some to leave the market.

General Liability

Prior to the 1880s, tort liability was not insured in the United States. In 1886, insurance was introduced for an employer's liability to his workers. Insurance for public liability or general liability (to everyone except employees) began shortly thereafter to be endorsed onto the employers liability coverage, first for owners and tenants of business premises and then for the dangerous street railways.

Public liability insurance for bodily injury grew rapidly, something like 40-50 percent a year between 1887 and 1924. Products liability was introduced in 1910, property damage in 1922, and comprehensive liability (all causes of liability covered unless excluded) by the late 1920s. The data is sketchy but shows the line to have been profitable throughout the early period.

In 1905, the 27 companies writing employers liability and the ancillary lines agreed, as members of the Liability Conference, upon standard rates and forms for employers, public, auto and elevator liability. They also agreed upon commissions and various ways of securing conformity, evidently on the model of fire insurance.

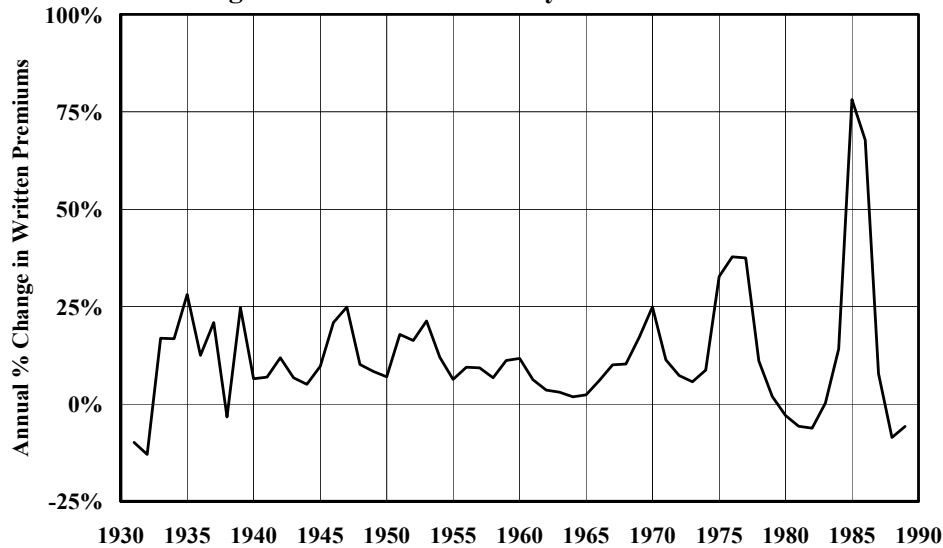
Workers' compensation supplanted employers liability, and automobile insurance and streetcar insurance went their own ways. The Liability Conference disappeared, though its rates and forms remained. General liability was without bureau statistics and control until the National Bureau of Casualty Underwriters (NBCU) took it on in the 1920s.

As a casualty bureau, the NBCU was more statistical than coercive, but a large body of statistics has strong attraction, especially in pricing a new line. While general liability had stock-mutual divisions, it had no real presence of independents. The result was stability

around the bureau rates, reinforced by growing demand, safer industry and consistent rules of tort recovery.

With only a few exceptions, the years from 1930 through 1966 showed rapid growth (10 percent a year compounded) and high profit (92 percent combined ratio on average). See Figure 17 and Figure 18. Growth and profit are understated by some unknown amount, as general liability prices were used to subsidize the more structured workers' compensation rates for desirable accounts.

Figure 17. General Liability Premium Growth



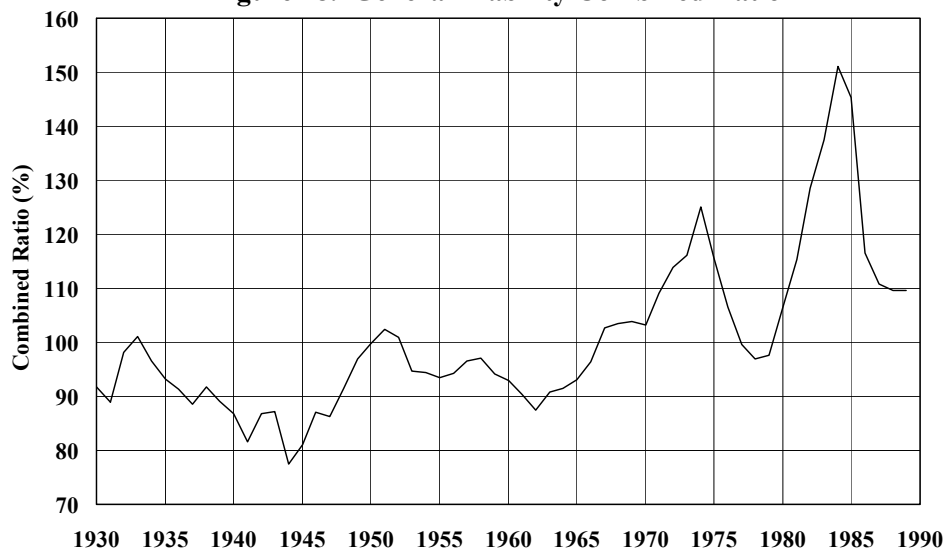
1930-1973 Stock & Mutual Companies
 1974-1989 All Companies (Private Passenger lines only)
 Source: *Aggregates & Averages*, A.M. Best Company

Just as it looked consistently profitable and stable, general liability had virtually a new beginning. Liberalizations in the underlying tort law as to duties of care, presumptions, sufficiency of proof, admissibility of evidence and accessibility of defendants began to show in the insurance results. The common law changes were reinforced by rising technological expectations, by novel liability statutes and by broad interpretation of policies.

Since 1966, the general liability line has had few good years and several disastrous ones. Considerable investment income has not made up for compounding adverse changes or for uncertainty about the future. Attempts to limit underlying costs or to limit coverage have not succeeded as hoped by the industry.

Yet twice since the adverse loss pattern was recognized, there have been price wars (1979-83 and beginning in 1987). The market's reversal in 1985 was so disruptive of price and availability as to create the concern with the cycle which dominates business and public policy today.

Figure 18. General Liability Combined Ratio



1930-1973 Stock & Mutual Companies
 1974-1989 All Companies (Private Passenger lines only)
 Source: *Aggregates & Averages*, A.M. Best Company

II. The Historical Pattern

From these histories emerges a pattern in the evolution of insurance markets in the United States. Each line of insurance went through four stages of development. We call the four stages emergence, control, breakdown and reorganization.

Each stage was a reaction to the one preceding it. Certain stages were longer or more pronounced in some lines of insurance, but the general pattern has held. Cyclicity occurred in each stage, but to different degrees and for different reasons.

The section of the paper looks at the evolution of insurance markets through the four stages of development, the reasons they occurred and the cyclicity they produced.

Stage 1: Emergence

An emerging insurance market is typically unstable. Although demand grows rapidly as more buyers recognize a need, prices and premiums are erratic. New markets hold the promise of limitless growth and profits. As sellers rush in, supply grows rapidly, quickly exceeding demand, and price wars begin.

Every line of insurance began with fights over market share. In early ocean marine, inland marine, homeowners and commercial multi-peril, the fight was against established companies writing the same coverage or one that was being replaced. In fire, automobile and

general liability, the fight was for position in an entirely new field. Either way, the main weapon was price.

New insurance markets are by definition ones in which insurers have little experience. Statistics are not yet available. The nature of the exposure and the scope of coverage may not be understood.

In emerging markets, pricing is more guesswork than science. Although some insurers advocate a high price to deal with the uncertainty, many use the lack of information itself to rationalize careless underwriting and pricing.

When pricing and risk selection in a competitive emerging market turn out to be wrong, they usually turn out to be very wrong. The subsequent correction is abrupt and severe. After careless underwriting has let bad risks into a book of business, it is difficult to identify and cull them out. Price increases and broadside restrictions are easier.

As claims exceed premiums, bankruptcy and fear cut into supply and drive prices up. Higher prices give off profits, attracting competitors, and the cycle repeats. If entry is easy and costs are not known, cycles of glut and shortage, low and high prices can go on for years, as they did for over a century in fire.

Stage 2: Control

The disruptive effects of competition lead to efforts to keep it from happening again. Suppressing competition requires more than agreeing on prices. It is also necessary to control supply, which is done by restricting entry, stabilizing market shares and standardizing product.

The cooperative arrangements, rules and restrictions that the industry developed to control competition in fire insurance are in a technical sense the same as those of a cartel. As with cartels generally, non-competitive arrangements are hard to hold together. What is needed is an enforcement mechanism.

In insurance, the enforcement often came from government. Not until New York (the Merritt Committee) endorsed and supervised cooperative ratemaking were the various local boards of fire underwriters and agents able to control prices and commissions. Rating bureaus that developed in other lines, particularly in automobile and workers' compensation, also succeeded in holding back competition. States encouraged or even required bureau membership and then enforced adherence to the rates. In ocean marine, the enforcement came through control of reinsurance by a tight group of insurers which had the support of the federal government.

The market's stabilization by the bureau system lasted a long time. Even after the SEUA case and the ensuing legislation loosened bureau restrictions, many insurers hung onto

the ways of conformity and cooperation. They had been the guiding principles of the business for over a century. It is not surprising that it took 30 years more to sweep them aside entirely.

Stage 3: Breakdown

Control mechanisms have trouble dealing with change. They are complex because the economic activity they are set up to control is complex.

There are many ways to achieve a competitive edge, so prohibiting one kind of non-conformity can easily lead to its equivalent somewhere else. To prevent that from happening, a cartel or other market ordering system necessarily molds itself into the structure and patterns of the market when it is created. It reaches further and becomes more rigid as new ways of escaping have to be dealt with, but by doing so the system becomes increasingly vulnerable to new competitors and to external events.

External change can come from new law or from the emergence of new needs and new ways of meeting needs. Change typically opens the way for competition against the controlled firms on some different basis. Examples in insurance include inland marine in the 1920s when unregulated marine insurers were able to provide all risk, multi-location coverage; automobile insurance starting in the 1920s when direct writers were able to underprice stock agency companies; and package policies in the 1950s which pulled the best risks out of fire insurance.

Initially, the new competitors take business from the controlled firms, exploit new opportunities, grow faster than the others and enjoy ample, non-cyclical profits. Unless the industry or government forces the new competitors to conform, the pressure on the growth and profit of the controlled firms tempts many of them to break away too.

For example, the first multi-peril policy that was filed after the passage of multiple line laws was an automobile manufacturers' output policy developed not by an independent but by one of the leading bureau companies. Other bureau companies followed later with their filings for commercial multi-peril policies. The bureaus themselves, with their inherited bias toward uniform rates and forms, were slow to adapt. By the time they did, the big profits were gone and some of their members had tasted the rewards of breaking away early.

The regulatory system which enforced the bureau system also gave way to external change. By the end of the 1960s, individual insurance departments and the NAIC took the position that open competition was preferable to prior approval. Their support of competition confirmed what had already happened in the marketplace.

Stage 4: Reorganization

When control arrangements come apart, companies continue for a while to act as though the old rules and restrictions were still in force. Inherited from the years of stabilization and control are beliefs that the market is big enough for everyone, that prices will be set at adequate levels, and that redoubled efforts will restore lost market share. The market forces that have been unleashed are usually underestimated.

After the breakdown stage, the old controls over entry and market shares are gone. Ambitions to grow and expand can be freely exercised. Supply increases. But if demand does not keep up, prices will surely fall.

Price competition is anathema in a controlled market, but after the breakdown of control it is legal and unrestrained. Speeches about appropriate prices have no effect. With market forces at full rein, prices and profits fall. Firms face the choice of meeting competitors' price cuts or losing business. For most insurers, losing business for any length of time is a disagreeable prospect. It would require them to shrink their organizations to reduce expenses to track the drop in volume. Getting smaller has never been a popular goal in any business.

As margins fall, insurers turn to unfamiliar fields to maintain sales. They may diversify into new lines of property-casualty insurance, out of property-casualty insurance or out of insurance entirely. In the late 1960s, after a decade of poor returns, property-casualty insurers used their "surplus surplus" to diversify into life insurance, credit cards, real estate and other businesses. In the early 1980s, poor returns sent old-line fire insurers into casualty markets, particularly into reinsurance and the excess layers of general liability. The abundance of cheap reinsurance, which drove the price war of the early 1980s, owed less to marginal offshore entities, which had such notoriety, than to newly opened reinsurance departments of large, old carriers.

Poor margins in old lines and unexpected trouble in new ones eventually force some firms to retrench, some to go under and some to merge. Some may just stay on a subsistence basis. Margins can get squeezed to a level which is not satisfactory to anyone or only to the most efficient providers.

Where coverage is a commodity, that is, interchangeable from the customer's point of view, low cost providers have a powerful competitive advantage. They can take both profit and market share, regardless of whether or not the market is centrally controlled. After the breakdown of control, the market often reorganizes around them.

Overcrowding and poor margins also lead firms to try to differentiate themselves. Some are successful and some are not. Differentiation efforts tend to segment the market and may permanently change it. A broad product market may become several smaller customer markets. Examples are programs of coverage tailored specifically for public entities and high

income households, as well as the separate provision of risk management services that had been bundled in the insurance product.

The market is also segmented by the new competition with its new ways of organizing the market. Examples are the packages which transformed fire and inland marine into specialty markets defined by the business of the buyer.

Segmentation and new leadership bring order to markets. Niche specialists and low cost providers are hard to attack. But reorganization is just another stage in the evolution of markets. The new configuration and practices may themselves be challenged by outside forces, which lead to another stage. Markets are not static.

Similar Patterns Elsewhere

The four stages of development in insurance emergence, control, breakdown and reorganization have occurred in other industries. Analogies are particularly strong in regulated industries such as transportation, communications and securities. The closest parallel is in banking.

The early days of banking in the United States were also extremely competitive. It was easy to enter the business, and failures were frequent. They were the days of "wildcat" banking. Control was eventually imposed by a complex regulatory system that finely compartmentalized the business and stabilized its cost of funds. The system included national and state regulation, controlled sources of liquidity, a ban on interstate banking, and restrictions on related activities and on lending, investments and interest.

The stabilizing forces in banking also gave way to change. New, non-banking competition, such as commercial paper and money market funds, skimmed off the safest loans and cheapest deposits. Banks sought and obtained fewer restrictions on lending and interest. Competition for deposits, for customers and for higher yielding uses of funds are altering the structure of the industry.

Banking and insurance have in common that they are crucial to the development of a modern economy. They also have in common a need for stability and a tendency for business failures in them to be unusually disruptive to others. As a result, they have in common that at a fairly early stage the prevailing public policy has been to tolerate and even promote anti-competitive arrangements in the interest of stability. Finally, they have in common that when the stabilizing arrangements come undone, the industries find themselves overpopulated and confronted with a competitive situation beyond their experience.

A Natural Pattern for Insurance

The pattern of early competition and then control is natural in insurance because of the characteristics of the business.

Insurance markets tend to become price competitive very early, even while demand is still expanding at a rapid pace, because entry to the business is easy. Statutory capital requirements have always been small. For many years there were no capital requirements at all for mutual companies.

Much of the capital entering insurance markets is not from outside the industry but belongs to established insurers which are diversifying into other lines. Established insurers bent on expansion often have more than enough capital to support their present operations. Applying what they already have to the new activity is mainly a matter of saying so. Explicit allocations of capital are rare in insurance because of the insuring principle of diversifying risk. Capital is not dedicated to specific lines or markets, but is seen as supporting all risks in the enterprise.

The only limits on expansion, aside from the ability to get business and service it, are simple rules of thumb that permit considerable growth at the levels at which they are usually applied. For example, a premiums to surplus norm of three to one would let an insurer writing at the industry average of two to one expand its writings 50 percent before it looked capital constrained.

Another reason why price competition is inevitable in insurance markets is that insurers have not been able to patent, copyright or franchise their product. Differentiated products and niche markets have been hard to develop and protect.

For all those reasons, the emergence stage of a line of insurance is marked by instability. Aggregate growth in premiums is usually not matched for long by profitability for individual insurers. Competitors start looking for ways to stabilize the market. There are two reasons why non-competitive arrangements are natural in insurance.

First, there is general public aversion to disruptions in an essential service. Cooperation is advocated particularly in times of emergency. For example, the marine insurance business was specifically protected to make sure that in wartime the United States would not have to rely on another country to protect its maritime trade. The strong fire insurance bureaus followed the San Francisco earthquake.

Second, cooperation is a natural outgrowth of the insuring activity. Insured risk can be diversified by pooling individual exposures. Insurers have to cooperate to provide capacity for large risks. Equity in ratemaking is widely considered to follow from uniform rates. Actuarial ratemaking, in its reliance on large bodies of statistics, thrives on sharing information.

The instability of emerging markets and the recurring desire to bring them stability through control have important roots in the particular nature of the insurance business. The next two stages, breakdown and reorganization, are natural for any business that has a marked control stage.

III. The Situation Today

We have traced four stages of development in the individual lines of insurance in the United States – emergence, control, breakdown and reorganization.

When a new market or line emerges, price competition is fierce. Wildly unstable prices and supply lead to efforts to control the competition. Control requires elaborate systems to define and enforce conformity. The rigidity of such systems makes them unable to deal with change, so they ultimately break down. When the control systems break down, so does order in the market. Insurers shaped in the mold of control may not be fitted for competition. In that new setting, the quest for advantage reorganizes the markets into smaller, differentiated segments or around leaders with compelling cost advantages.

This sequence of events helps explain why the cycle has become so abrupt and violent. The discussion which follows deals with commercial insurance because that is where the greatest disruptions are. In personal lines, the current dissatisfactions have to do with the level of premiums and with the way costs and benefits are allocated, not with cyclical swings.

Most commercial lines are mature, with participants struggling to hold onto share. There is one important exception: commercial general liability. After stabilizing early and remaining stable for a long time, general liability has again become a new, emerging line with all the disruptions of that initial stage.

Competition in the mature markets and competition in the new general liability market are feeding on each other. Insuring capacity sloshes back and forth between them. That has led to cyclicity in both markets, but it has been far more violent in the liability market. Understanding the coexistence, even the symbiosis, of those two kinds of market also helps explain why the total commercial insurance market can have too much capacity and too little capacity at the same time.

Mature Commercial Markets

Markets for most commercial lines have all the characteristics of a business experiencing a shakeout of excess capacity. There are too many companies chasing too little business. Excess capacity has developed for two reasons.

First, just as any non-competitive structure protects inefficient producers, so did those arrangements when they existed in insurance. Uniform, gross pricing shielded a lot of companies and layers of intermediation.

By 1970, uniform pricing had lost its force in the marketplace. Bureaus still made rates, but they were advisory only. When interest rates rose in the late 1970s, knowledge of new money investment yields and the duration and amount of asset float became crucial for pricing, especially in liability insurance. Bureau rates, which were based on underwriting profit alone, were hardly useful even as a guide.

Second, just when the old bureau restraints were losing force, aggregate market growth in the mature lines was slowing. Most markets were saturated. Demand for insurance came to depend on the growth of the general economy. Starting in the 1960s, economic growth slowed too.

Sluggish growth meant that insurers had to battle each other for market share. Heavy competition began in the early 1970s but was interrupted by a burst of inflation in 1974. That inflationary surge hit both the asset and liability sides of insurers' balance sheets. Stock prices fell, and claims rose. The industry's surplus shrank 25 percent in one year. Frightened insurers immediately cut back writings and raised prices right across the board.

Those price increases were so sharp that in the next few years some 30 percent of commercial insurance demand moved out of the established insurance market into other forms of risk management. Much of what moved was business with a significant investment component but yet with stable loss frequency, the lower layers of workers' compensation and commercial automobile insurance.

At the same time demand left the market, supply continued to build. Price increases restored surplus, and the insurance workforce grew. The imbalance of supply and demand started the worst price war since the 19th century. To understand why it was violent, it is necessary to look at general liability more closely.

The following discussion is in terms of commercial general liability insurance, whether written as primary, excess or umbrella. The phenomena under discussion are clearest there, and all the causes are at work. The analysis holds somewhat for general liability included in a package, as in commercial multi-peril, for special liability such as malpractice, and for personal excess liability.

Emerging General Liability Market

Beginning in the early 1970s, commercial general liability also became highly cyclical, but for different reasons than applied in mature markets. After many years of predictable and ample profits, insurers became alarmed at the rise in losses, particularly in products liability and medical malpractice. What had happened was that an increasingly

litigious society greatly expanded the need for insurance to cover liability suits and judgments. Demand was showing up first in calls on the coverage, that is, in losses.

Then came the big inflation in 1974. Casualty loss reserves, which had been made on assumptions of 3 percent to 4 percent inflation, had to be raised to reflect 10 percent to 12 percent inflation. How big the adjustment was can be seen in a simple example: a loss payment due in 10 years is twice as large compounded at a 10 percent inflation rate than at a 3 percent rate.

Prices skyrocketed. Much of medical malpractice moved into self-help and government-mandated facilities. For a short time, a lot of general liability as well as medical went to Lloyd's and the company market in London and on the continent. Captives and other risk management arrangements drew away some demand, but in the late 1970s they were used less for general liability than for workers' compensation and automobile. Prices came down. The loss of demand to alternative markets was a minor reason. The major reason was a big increase in supply.

Insurers could not grow as fast as they wanted in mature markets, so they turned to general liability. Foreign reinsurers playing favorable currency exchange rates and captives diversifying for tax reasons found general liability an easy market to enter. Unlike the older, mature markets, general liability promised plenty of growth if the product were priced low enough.

What distinguishes general liability from mature markets is its price elasticity. Demand for property, workers' compensation and even automobile insurance is not very sensitive to price. Because those coverages are now mandatory or are considered essential, buyers can only marginally reduce their purchases when prices increase. Nor do the coverages attract new buyers when prices decrease. Their market penetration is already nearly total, and coverage needs have absolute limits.

The opposite is true of general liability. Lower prices attract more buyers because needs and perception of needs are still expanding. In addition, buyers who already have coverage will purchase more, usually in the form of higher limits, as prices decline (and as underwriting relaxes). It is at the higher layers that entry is administratively easiest for insurers.

When prices rise, demand for general liability falls, but not by a commensurate amount. Some buyers do without or make other arrangements, but many adjust to the higher price. Coverage once bought because the price was right tends to become essential as people come to fear lawsuits more. This lack of symmetry in the response of demand to higher and lower prices has made each general liability cycle more disruptive than the one before. As demand grows, disruptions in supply affect more buyers who view the coverage as essential.

In many ways, the general liability market today resembles the emerging fire insurance market of the 19th century. Demand is growing. Costs are unknown. Loss spreading techniques are unreliable, witness the rudimentary sharing of primary coverage then and the troubled collection of reinsurance now. Buyers' cooperatives, county and factory mutuals then, captives and risk retention groups now compete with established insurers. Markets are segmented, by geography then and by customer now. Segmentation concentrates markets and gives entry and exit a big impact on prices. Sentiment favoring control is great.

Interaction of Mature and Emerging Markets

The shakeout in mature markets is now fueling the competition in the general liability market.

In the mature markets, costs are well known. Great bodies of statistics have been collected and exposures studied over many years. Patterns are stable even where payouts extend over a long time. Underwriters can delude themselves only so long before they know they are losing money.

Rather than pursue growth in a price war in a mature and saturated market, many companies prefer to enter markets that are rapidly growing in the aggregate. Such a market is general liability. There, costs are not well understood, and it can take a very long time for losses to catch premiums. Pricing is what individual insurers want to charge to get the business. No central body tells them what to do.

In the past 20 years, insurers became impatient with mature markets and newcomers sought markets with room for them. Capital poured into general liability. On two occasions, it was frightened out. Many insurers went "back to basics," to the old, mature markets where they once again squeezed each other and set the stage for a later mass return to general liability.

The common complaint that the cycle is shorter today most likely reflects the brevity of full pricing in mature markets, just as the complaint that the cycle is more violent today reflects the instability of general liability.

The Outlook

In summary, the violent cycles in commercial insurance in recent years are the result of the breakdown of control in mature markets and the emergence of general liability as a new market.

The problem in the mature markets is that they are suffering from chronic overcapacity. There is not enough business to go around. Yet insurers stay in because they want to write risks they understand and for which their organizations are equipped. The problem in the emerging general liability market is that its perils are expanding, mysterious

and open-ended. Entrants need to be careful, but many are so accustomed to years of bureau control that they go into it merely following someone else.

The next question is where insurance markets go from here.

For the mature lines, the stages of development suggest that the next step is reorganization. It could mean market exits and consolidation. It could mean greater operating efficiency and the dominance of low cost providers. It could mean market segmentation by specialists. Probably reorganization will bring all three developments, and there are signs of all three already.

What about the new general liability market? If the line is indeed at an early stage of a new life, then it might proceed through the other stages. That would mean more or less repeating what happened in the past, that is, years of instability with control imposed eventually.

It might happen that way. The desire for stability is strong enough. But general liability is so flexibly and judgmentally priced and underwritten that moderate efforts, such as government statistical services, flex rating or prior approval would not do the job. The pervasive and remorseless control exerted by the old fire insurance cartel would be unacceptable today and illegal under present law. Radically stabilizing costs, by shifting power over policy form drafting, coverage dispute resolution and underlying liability law, is unlikely, given the immense interests vested in the present system.

More likely than a return to control is that general liability will continue changing and evolving over time. Change occurs as participants react to what happened before. Buyers and sellers learn and adapt. If a product or service is essential to buyers' activities, they will seek reliable arrangements to replace unstable ones. The squeeze on established insurers in the mature markets will convince some of them that a better choice is to persevere with the challenge of general liability.

Change also comes from outside the industry, from new market leaders, from new kinds of competitor, from new technology and from change in the legal and economic environment. It is heartening to remember that the fire insurance business was transformed from cyclical to stable not just by the bureau system but also by technology and law which reduced the peril of fire itself.

IV. Implications For Regulatory Policy

This brief history of underwriting cycles has used a definition of "cycle" meaning simply the ups and downs of prices and profits. The history reveals cycles, so defined, of three types. The types are not mutually exclusive and more than one can characterize an

episode, but they are identifying. They are data cycles, expectation cycles and structural changes, as described in the body of this report.

First, the data cycles. As costs inflate, rates become inadequate. It takes time for that fact to show in experience statistics, time for the experience to be gathered into the form of new rates and, where regulatory approval is required, time for the new rates to be approved.

Data cycles occur where rates are based on recent experience statistics and where there is pricing leadership. They are indeed cyclical in the strict sense of being regular and repetitive, symmetrical, predictable and homing, that is, tending to return the industry to where it was before. Today data cycles occur in personal automobile, homeowners and workers compensation.

Second, the expectation cycles. Here the economic explanation is most useful: price and supply depend upon sellers' expectations of profit. Expectations can involve simple, linear projections of the past into the future, or more complex and indirect motives, as with cross-subsidies and strategic moves into and out of markets.

Cycles based on expectations are irregular and inherently unpredictable, as the turn at the bottom is usually brought about by a bad surprise. All that can be seen in advance is that the industry's profits and confidence are stretched so thin as to make it susceptible to a scare.

Expectation cycles are common today, particularly in fire insurance, commercial multi-peril, personal excess liability, ocean and inland marine, and commercial automobile.

Third are structural changes, particularly as a new line emerges or as it moves from one phase to another. Such change is not really cyclical at all. Structural change has led to the most disturbing kind of instability today, specifically in general liability, which is in the emergence phase for the second time.

Structural instability has been seen before. Up through the late 19th century, price wars marked the emerging fire insurance business. Big city fires led to insolvencies and unpaid claims. When business and the public had had enough, the rating bureau system brought fire insurance into its control phase. In auto insurance in the 1950s and 1960s, the displacement of independent agency companies by low-cost, preferred-risk direct writers led to unstable market shifts, availability crises, outcries about claims practices and the first reforms of the accident compensation system. As evidenced by recent events, this reorganization phase is still under way.

It is easy to mistake a structural phase change for merely cyclical behavior, and we often speak of "the cycle" in just that way. Doing so invites public and private remedies which might be useful for data cycles or expectation cycles. Such remedies include better data, speedier government review of rates, legal limits on the magnitude of changes, more conservative accounting by companies and anti-trust measures to head off herd behavior.

A BRIEF HISTORY OF UNDERWRITING CYCLES

Remedies of those sorts may be useful for dealing with data and expectation cycles or with other problems in the insurance market. But they are not effective against the market instability which accompanies structural changes. The only responses that have proven effective for structural changes in the past have been strict control (fire) and letting competitive forces work themselves out over time (automobile).

Perhaps the best practical uses of a brief history of underwriting cycles are, first, to reveal that each line is somewhat different and, second, to lead to the conclusion that public and private action to deal with the consequences of "the cycle" has to be based on an accurate view of what kind of instability we are addressing.

Stewart Economics, Inc.
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