The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

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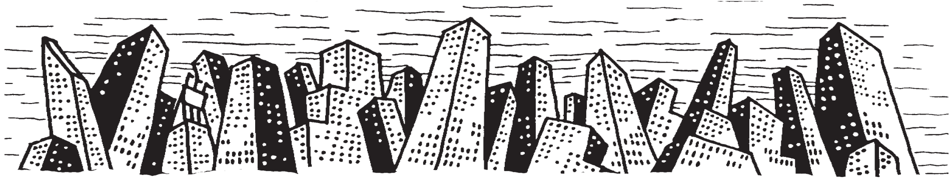

THE INSURANCE BEAT

Aon: Less is More

ON OCTOBER 5, AON UK announced some good news—or perhaps it was bad news. The company said that it had "embarked on a major restructuring of its UK insurance broking and risk management operations to realign its business more effectively around its clients' needs."

Aon UK emphasized that the restructuring was really good for its customers: it would allow the company to "provide improved client service" and "spend more time serving clients' needs." In addition, the changes would "ensure that all of Aon's clients worldwide gain better access to its global expertise."

How do you suppose that Aon plans to provide this improved service and expertise? Will it hire more people? Pay bigger salaries? Spend more on training? Not at all. The so-called improvements will be achieved by reducing the UK workforce from 6,800 to 6,050 over the next twenty-four months.

Those interested in management science may wonder how Aon UK can provide better service by getting rid of eleven percent of its workforce. (If reducing the workforce increases service, everyone would do it.) While the cuts may be viewed as a financial necessity, it's worth remembering that well-run insurance brokerages rarely need to lay off employees. Historically, the insurance broking business has been stable—practically recession-proof.

When brokers feel compelled to make layoffs, it is bad news for them and for their clients. Dumping a slew of employees will increase profits in the short term, but it is almost guaranteed to reduce service in the long term.

Bigger Loss

UPON LEARNING THAT A WIDOWER with an unhappy first marriage had quickly re-wed, Samuel Johnson quipped that the decision was a triumph of hope over experience. In the insurance game, hope often triumphs over experience.

In the wake of Hurricane Katrina, a major Wall Street firm published a research report that posed a seemingly easy question: "Is a bigger insured loss better for [insurance] stocks?" The answer—"Yes"—was quite a surprise.

The securities analyst was apparently of the belief that large catastrophe losses are a positive for stocks because insurance companies have to raise rates, thereby generating big profits in the future. The analyst wasn't alone in this thinking. In the last month or so, insurers and reinsurers proved just how hopeful investors can be by raising more than $5 billion. And there are billions of dollars more of deals in the pipeline.

If bigger losses were truly better for insurance stocks, then it would follow that smaller losses would be worse—and that no losses would be a total disaster. Huge losses result in higher rates, but all things being equal, rates remain higher only until carriers have recouped their losses.

Insurance—especially catastrophe insurance—is about supply and demand. Prior to Hurricanes Katrina and Rita, catastrophe insurers were flush. Many had raised capital after September 11, 2001, and almost all had made a lot of money during the last four years. The stock market's perception of value, however, is constantly changing. In early 2000, for example, IPC Re, a conservative Bermuda catastrophe reinsurer, was trading at about $10 per share, or roughly half its $20 book value. IPC had a clean balance sheet—virtually no liabilities—and its assets were easy to understand: about $20 per share of high-grade bonds. It didn't take a lot of figuring to understand that IPC was dirt cheap; it was in a decent business and was selling for half its net assets. Even if the company managed to lose a third of its net worth, investors would still own a company worth $13.33 per share. In short, there was negligible downside to investing in IPC. (Many other insurance companies had similar characteristics back then.)

In the ensuing years, investors rediscovered IPC, and its stock quadrupled to the low forties. (Its book value grew seventy-five percent.) Shortly before Hurricane Katrina, IPC was trading at about 120% of book value. That's not an outrageous valuation, but it's no bargain. If IPC earned a ten percent return on its capital, an investor would make an 8.3% return by buying the stock.

As it turns out, IPC's return was closer to negative thirty-five percent: it lost about a third of its capital in Hurricanes Katrina and Rita. Today, its book value is about $22. Yet hope has triumphed over experience. The stock is $26.80, about a twenty percent premium to book value.

We doubt that investors will achieve high returns at these price levels.

MHC Alert

IN THE LATE 1990S, many of the largest life insurance companies decided that rather than do traditional demutualizations in which their policyholders would be compensated, they'd demutualize in a way that screwed their policyholders and gave them nothing. The means to do this was something called the mutual insurance holding company (MHC) which, as of 1996, was not legal in any state. Accordingly, the insurance companies began spending money to remedy that, and were, in fact, having some success in getting state legislators to pass the laws they wanted. Although a couple of hundred billion dollars was at stake, there was no organized opposition. Then a small number of independent activists (we were one of them) began to stir up sentiment against this organized rip-off, and eventually managed to stop the giant insurers. The mutual-holding-company concept was discredited, and some of the largest mutuals did full demutualizations instead.

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Union Central Life and National Grange Mutual are both in the late stages of converting to MHCs, and both seem to believe that it's best to keep the process as quiet as possible. For example, neither company's website contains any of the thousands of pages of documents that go along with the conversions. Both companies have held special meetings at which policyholders vote for or against the plans. Since the documents both companies sent their policyholders were deceptive, it was a given that policyholders would, for the most part, vote for these conversions, even though doing so was against their self-interest. Both companies, for example, urged their policyholders to vote for the conversions, but neither informed them of an essential piece of information—that they would get nothing from a mutual holding company conversion, whereas, in a full demutualization they would receive considerable value.

To date, no regulator has objected to this bait and switch.

S.U.V.s: Big and Bad?

One of our subscribers, a fellow we'll call Barton Keyes, is the chief actuary of a large and successful auto insurer. After reading our September 9 issue, which included an article entitled "How the S.U.V. Ran Over Auto Safety: Big and Bad," he decided he could not refrain from sharing his thoughts with us.

"Your chart showed that the number of driver deaths and other deaths was higher for S.U.V.s than for most cars," he wrote. "I believe that the differences would not be so dramatic if the figures were adjusted for the number of miles driven, demographics of the driver, and the likelihood of passengers being in the vehicle. The number of highway deaths per driver has dropped over the last fifteen years, and insured frequency is also down over that time. Given the significant shift from cars to trucks in the overall fleet of American cars during that period, there is at least some reason to question the assertion that S.U.V.s have sacrificed safety.

"With respect to my company's underwriting experience, after normalizing for the effects of such things as driving characteristics and use, our data show that S.U.V.s deserve a surcharge for liability and a discount for physical damage. We use ISO symbols, so the discount could be a reflection of an ISO propensity to have too high a symbol for S.U.V.s. If ISO is setting the symbol too close to the new vehicle price value, then a discount would be warranted. These vehicles tend to be quite expensive, but their likelihood of a total loss is lower. Thus the relationship between the price and the insurance rate will be lower than for a less expensive vehicle. (This is also true for expensive sedans.) Still, the S.U.V.s show significant discounts for physical damage, with the only exception being the comprehensive rates for large S.U.V.s that tend to be high theft targets, especially the Toyota/Lexus and Cadillac vehicles."

Keyes also disagreed with our thought that, eventually, cars would be equipped with sophisticated monitoring devices that could send information back to insurance companies in real time, allowing underwriters to make more sophisticated analyses: "Until the day insurance pricing is unregulated, the feeling that the use of different data will soon revolutionize auto rating is premature, at best. It is true, as you say, that a driver's age, gender, address, etc. have no direct bearing on how the driver drives. However, they do correlate with traffic density, personal responsibility, and such things that do directly affect how the driver performs. It is probably true that a better rate could be developed by analyzing when and where a driver drives, his speed, and such. We do, however, already have proxies for this information—age, gender, garaging address, driving record, and vehicle type. I doubt that the better detail would give more than an incremental change in rating accuracy. By definition, most people are not going to have an accident in any year. Even those driving to bars in the evenings are not going to have an accident every year, on average.

"If I really wanted to have the best rating system," Keyes continued, "I would interview the drivers on a policy to get a sense of their characters. Then I'd do a follow-up every time each one got in the car, to see what his emotional state was. I'd also want to know when the driver was having personal problems, illnesses, and anything else that might distract him, as well as how many passengers were in the vehicle on each trip.

Then, in addition to the normal rating variables, we would rate based on some emotional scale, character scale, and something that measures the driver's susceptibility to distraction for each trip. This system would be great—except that it would be an intrusion into the lives of the customers. It would also dramatically increase the cost of writing insurance because the overhead would be extraordinarily expensive. I don't think that the benefits would justify the costs. Some form of change is probably inevitable, but I don't think that it is going to be revolutionary."

Keyes makes some interesting points, but we disagree with him. It would be intrusive to do what he suggests, but an insurance company doesn't need to monitor a driver's emotional state every time he gets behind the wheel, and many drivers may not find other information particularly intrusive—for example, where a car is going, when it is being driven, how fast it's going, who is driving it, and how it's being driven. Perhaps such information will be voluntary. Maybe preferred risk drivers will allow the monitoring in exchange for potential discounts. Perhaps an onboard black box will provide drivers with other features that they will find useful.

New information constantly becomes available, and technology improves the ways that information can be used. If technology or information is available that has the potential to change underwriting significantly, it is more likely than not that it will used. It's hard to stop progress.