



Cookson Walker Consulting

The Capacity Crunch

What Brokers Need to Know

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Everyone is struggling with capacity. Over the last year in particular, brokers and underwriters have used capacity as the explanation for rising rates and a loss of appetite for business. But often the explanation is vague, not altogether accurate and sometimes misleading. Underwriters need to be able to explain to brokers and brokers to their clients carefully and accurately the situation the industry is currently in.

The step most often missed in the explanation is the first step. Regulators control the financial performance of insurance companies for the protection of the consumers of Canada. This regulation process stipulates the amount of money an insurance company must have on hand to meet financial obligations.

This fact should be the first offered to consumers, as they are often relieved that someone is looking out for their interests and guaranteeing their claims will be paid. (Communications experts often teach the need to use outside authoritarian figures, like government regulators, to satisfy that 25 per cent of the population who never believe the person they are talking to!)

Regulators use a number of indicators to assess the financial condition of an insurer. Several involve a correlation between reported premiums of different types, such as written, unearned, etc., to capital. These indicators are regulated to ensure minimum ratios or percentages are met. This is the starting place for all definitions of capacity.

Arguably, insurers individually decide where and how they want to use this capacity they have but they are not alone when they make the determination -- more on that later. Nevertheless, a glance through annual reports will show that the formula for the successful use of capacity is not an easy one to achieve.

Brokers struggle to understand how there can be a capacity crunch when most have never seen premiums so high. In our regulatory framework, rising premiums exacerbate the shortage of capacity because of the time it takes to actually move from the premium income column to capital. In the short term, regulatory indicator ratios actually worsen, thus reducing insurer capacity further. In an undercapitalized industry, rising premiums actually ties the proverbial knot tighter!

Reinsurance environment

Several critical elements affect this rather simplistic view of capacity. One element that brokers and underwriters need to understand is that reinsurance is a financial tool

allowing insurers to do several things, including leveraging their capacity by buying reinsurance. Subject to certain guidelines, the regulatory framework will allow an insurance company more capacity when they have transferred their risk to a reinsurer.

Actually, reinsurance provides several valuable functions to the industry. Consequently, the motives underlying the reinsurance activities of insurers can vary considerably from one company to another. Through the reinsurance mechanism, an insurer can transfer both physical exposures and financial liabilities to professional reinsurers, as well as to other business centres within its own organization. Caution must therefore be exercised when comparing the reliance different insurers place on reinsurance, as the underlying transactions can be quite complex.

However, it is interesting to look at the relative significance of and dependence upon reinsurance from one carrier to another. For reasons that will be elaborated on, carriers that rely most on reinsurance may possibly be facing more constraints than insurers that purchase only a little reinsurance.

Hard market blues

This past reinsurance renewal season, the second in this continuing distressed market, was one of the most challenging that insurers have ever seen. With reinsurance markets battered and bruised from under-rated business and escalating losses incurred over the preceding decade, insurers in Canada -- and indeed, worldwide -- quickly learned that higher rates and tighter conditions were again unavoidable.

Canadian reinsurers were collectively burdened with a combined loss ratio of 119 per cent in 2001. They could be facing 110 per cent for 2002. It is fairly obvious that virtually all classes of reinsurance continue to be under-priced. Given the general adverse reserve development and lagging investment performance, there was only one way for renewal rates to move.

During this past renewal season, reinsurers (and reinsurance brokers) were about as popular with insurance companies as a mosquito carrying the West Nile virus at a nudist colony. Yet the alternatives were few. The message was evident and unavoidable: If reinsurers couldn't expect to earn a reasonable profit on business they were being asked to write for 2003, then they simply weren't interested in adding that exposure to their portfolios.

This philosophy toward 2003 business was non-negotiable. Underwriting jobs -- and, in some cases, even the ongoing viability of the reinsurer itself -- were at stake.

Underwriting standards

In preparing for their consideration of 2003 renewals, reinsurers developed a precise set of revised criteria against which all offerings would be evaluated. It was a rare market that did not rely heavily upon a complex, internal actuarial analysis before quoting renewal terms. As a result, the entire renewal process involved more people and took considerably more time to complete than in prior years.

Reinsurance underwriters and their actuaries demonstrated an almost unquenchable thirst for information and background data. Many insurers were surprised at the amount of detail that reinsurers requested about their portfolios, underwriting procedures, operating plans and financial results. This will undoubtedly put more pressure on brokers to prepare the perfect submission for new risks, particularly the complex ones.

The paramount objective for 2003 was underwriting profitability. If the bottom line results of a proposed treaty could not reasonably be expected to produce a profit, then reinsurers were not interested in supporting the cover. Reinsurers refused to be satisfied with some vague promise that the primary carrier knew what it was doing and that its results would eventually generate profits for its partners. The facts had to clearly demonstrate the likelihood of profitable results.

In response to alarming loss trends in the U.S., Canadian reinsurers imposed new exclusions and treaty occurrence limits on our market this year. Interestingly, the terrorism and data exclusions, introduced a year earlier, are no longer controversial and have simply become "normal" or expected exclusions. Reinsurers are trying to manage their overall exposures and further cap their potential liabilities.

Press releases and other publications from such major reinsurers as Munich Re, Partner Re, SCOR Re, and Swiss Re indicate that insurers are paying, on average, at least 10 per cent more for their reinsurance covers in 2003. These costs -- together with the coverage restrictions referred to above -- will obviously have to be passed on to the public by insurers, as they also seek to produce a profit on their business.

Impact on capacity

Overall, insurance capacity has declined, if only marginally. However, for some classes, capacity shortages have become acute due in part to the regulatory framework and the reinsurance environment.

Some markets have withdrawn from problem lines and even from specific geographical areas. The higher standards of selectivity being practiced by primary insurers and reinsurers alike, coupled with declining industry capitalization, continues to present a real challenge to the retail insurance broker and their customers.

Brokers are not responsible for the poor results achieved when prices were low and will not be credited with a turnaround now that premiums are high. Consumers should be able to rely on brokers for clear concise answers. Brokers should have available a clear strong explanation starting with consumer protection and must ensure that all their staff can adequately give this information to the public. Brokers need to explain the underwriting capacities of their insurers without having to make excuses for them.

To accomplish that, and as part of an annual plan of regular contact with their carriers, brokerage staff should meet underwriters on a regular basis to gain accurate information about capacity, restrictions and limits. Underwriters hoping to keep broker relationships intact during another year of rising rates should give accurate information to minimize the mistrust and resentment from their broker network.

And brokers should make a quarterly visit to the OSFI Web site. The financial data now publicly available will assist you in updating your assessment of the financial strengths of the carriers you represent. Your customers will be happy you did!

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