The property/casualty industry is similar to the banking industry. That’s the reason the underwriting cycle is unavoidable. Here’s an explanation.

The underwriting cycle is a real phenomenon that seems to be shrouded in a mystical haze. During soft markets, insurance executives and shareholders are stressed by surging underwriting losses and weak financial returns even as policyholders relish the competitive premium rates. These periods are inevitably followed by hard markets when the positions are flipped—the industry’s profits are strong while policyholders grimace as premium rates escalate. What drives this see-saw performance?

For more than half a century, both academic and industry observers have tried to bring clarity to the discussion.¹ To many in the industry, the wide swings in underwriting performance reflect irrational market behavior, an irrationality that is baffling because the industry seems incapable of correcting its behavior.² Key themes have included “cash flow underwriting,” “excess capacity,” “cutthroat competition,” and “building market share.” In contrast, most of the academic studies focus on developing and testing theoretical models aimed at


²The underwriting cycle exhibits characteristics often attributed to financial bubbles. Much of the academic literature on financial bubbles has focused on explaining why financial market bubbles are consistent with rational investor behavior. See “Bubbles, Financial Crises, and Systemic Risk,” Markus K. Brunnermeier and Martin Oehmke, National Bureau of Economic Research (NBER) Working Paper 18398, September 2012, for a recent survey of this literature.
explaining why the underwriting cycle is consistent with rational behavior. Perhaps it is possible to reconcile these disparate points of view.

Some Simple Observations

An outline of some basic characteristics of the underwriting cycle provides a useful framework for our quest to understand why the underwriting cycle is unavoidable.

First, on a line-by-line basis, the timing of underwriting cycles—whether measured by industry financial performance or the pattern of premium rate changes—is common to all lines of P/C insurance. There are occasional departures. Workers compensation, for example, was stuck in a soft market rut for most of the 1980s, arguably due in part to most states having administered pricing that prevented the industry from responding to market forces. Similarly, it was common for the swings to be less pronounced in short-tail lines. The typical pattern, however, suggests that all lines were responding to common market pressures.

Second, it appears that all hard markets follow economic recessions, and soft markets develop during periods of strong economic recovery. This suggests that the underwriting cycle is somehow linked to the business cycle.

Third, each hard market appears to have been triggered by the industry’s weak financial performance. In the year prior to the start of each hard market, the reported by-line operating gains (underwriting profits and investment gains) and the industry’s total return on surplus were negative or near zero. This suggests that there were cyclical imbalances in the industry’s financial performance.

Exhibit 1 tells us just about everything we need to know about the key components of the industry’s profitability as measured by returns relative to surplus. The blue line indicates that investment income was stable from year-to-year. The common patterns in the black and green lines confirm that underwriting is the source of the volatility in total returns to surplus. This is a picture of the underwriting cycle.

But why a cycle? This is where the banking analogy becomes helpful.

Property/Casualty Insurance Companies Are Financial Intermediaries

In discussions about the financial sector, the P/C insurance industry is typically termed a “financial intermediary,” putting it...
THE ROLE OF UNDERWRITING AND CLAIMS ADMINISTRATION IS TO MANAGE THE P/C FIRMS’ COST OF FUNDS. THESE FUNCTIONS ARE NOT SECONDARY; THEY ARE ESSENTIAL. THIS IS A MUCH MORE DIFFICULT TASK THAN THAT FACED BY BANKS MANAGING THEIR COST OF FUNDS.

in a category that includes banks, savings and loan associations, and credit unions. This may sound confusing. The other institutions accept deposits—a financial transaction—while the P/C industry sells insurance. These seem like very different activities. However, this comparison helps to explain the role of underwriting in managing the financial performance of the P/C industry.

In the most basic business model, banks take on liabilities in the form of deposits and then convert them into income-generating assets (primarily loans). The interest paid on the deposits is the banks’ cost of funds. Following this framework, P/C companies take on liabilities by selling insurance policies and then converting them into income-generating assets (primarily stocks and bonds). Underwriting losses are the cost of funds for the P/C industry.

The role of underwriting and claims administration is to manage the P/C firms’ cost of funds. These functions are not secondary; they are essential. This is a much more difficult task than that faced by banks managing their cost of funds. Most bank deposits have a fixed term and a fixed rate of interest; for those with variable rates, there is a clear link to the rates on the bank’s assets. Claim costs, on the other hand, are remarkably uncertain and vulnerable to economic, regulatory, and environmental shocks.

But Why the Cyclical Pattern in Underwriting?
As with all financial intermediaries, the challenge in managing P/C financial performance lies in achieving a balance between the cost of funds and the return on investments. And the returns on the investments of the P/C industry follow the business cycle. This can be seen in Exhibit 2, which tracks two versions of the return on invested assets. The embedded yield reflects the actual returns on the industry’s investment portfolio. The new money yield indicates what that portfolio would be expected to earn if invested at current market returns. Following the recessions of 2001 and 2007–09, new money yields fell below the embedded yields. This means that the industry would have to take steps to reduce its cost of funds, namely underwriting losses, to offset the decline in expected returns on new investments.

![Exhibit 2: Embedded Yields vs. New Money Yields](chart)

A primary management action available to P/C companies reacting to declining returns on investments is to tighten underwriting standards. This is the reason that the residual market grows during hardening markets. Another management tool is to increase premium rates on retained risks. When the business cycle moves into a period of strong recovery, interest rates typically rise. This clearly happened with the new money yield during the housing bubble expansion in 2006 and 2007, a period when the residual market share shrank and underwriting results weakened in response to declining premium rates. This explains why the underwriting cycle follows the business cycle.

---

By definition, a financial intermediary is a middleman, collecting and pooling funds from, for example, savers and then lending or otherwise investing those funds with borrowers. The pooling typically provides risk sharing on both the asset and liability sides of the intermediary’s balance sheet.

One advantage of the P/C industry is that when investment potential is low, it actually has the ability to earn a profit on its source of funds. At today’s low interest rates, many banks pay virtually nothing on deposits, earn a bit by holding balances in the Federal Reserve, and try to earn a small profit by charging fees for banking services.
Managing the cost of funds for the P/C industry is a daunting task. The industry has performed well in absolute terms and astonishingly well compared to other financial intermediaries. The thrift industry (savings and loans and mutual savings banks) has been bankrupt at least twice since the 1970s. The 2008 federal bailout of the banking industry was seen by many as a black eye for both bankers and their regulators. In contrast, the P/C industry just keeps on doing business as usual—financial crises, environmental trauma, underwriting cycles, and all.

The ultimate measure is the return on surplus. Exhibit 1 clearly indicates that through both the trends and cycles of the marketplace, the P/C industry has handled its challenge well. The balance between underwriting performance and investment gain has generated a long-term average for the industry’s return on surplus in excess of 10%. But in the short term, the key driver of changes in the cost of funds for the P/C industry is the response of premium rates to changes in potential investment income. As long as interest rates change over the business cycle, the underwriting cycle will be unavoidable.

Harry Shuford, PhD, is an NCCI practice leader and chief economist with NCCI’s Actuarial & Economic Services Division. His research has addressed workers compensation-related issues in corporate finance and trends in loss costs, with particular focus on medical utilization and the underwriting cycle.

DON’T OVERLOOK THE TRENDS IN P/C FINANCIAL PERFORMANCE

The dotted lines in Exhibit 1 depict key financial performance trends that are largely hidden by the strong cyclical patterns in the annual results. Over the past 25 years, underwriting losses relative to surplus have been trending toward zero. This has been necessary to offset the steady downtrend in investment gains relative to surplus.

Two less obvious trends underlie this downtrend in potential investment income: reserves are the primary source of investible funds, and the reserve-to-surplus ratio has been falling. In addition, interest rates, and therefore the potential return on investments, have been trending downward from a peak during the high inflation period of the early 1980s.

The dotted line in Exhibit 3 shows that the long-term average for the industry’s return on surplus has been in excess of 10%. This is confirmation that, over the past 40 years, the industry has successfully addressed the challenge of managing the financial performance of the P/C industry by maintaining a balance between the cost of funds and the return on invested funds.

EXHIBIT 3 Return on Surplus: Offsetting Trends in Underwriting and Investment Returns
P/C Industry Underwriting and Investment Contributions to Surplus

Source: Best’s Aggregates & Averages