Assurances

Goodbye to Technical Profit?

Klaus Gerathewohl

Volume 51, Number 3, 1983

URI: https://id.erudit.org/iderudit/1104326ar
DOI: https://doi.org/10.7202/1104326ar

See table of contents

Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

Explore this journal

Cite this document

Gerathewohl, K. (1983). Goodbye to Technical Profit? *Assurances*, *51*(3), 313–323. https://doi.org/10.7202/1104326ar

Article abstract

Sous le titre de « Goodbye to technical profit ? », le Dr Klaus Gerathewohl a donné une conférence sur la question du profit technique en réassurance, à la réunion du 2 mars 1983 des City Financial Conference Services, à Londres. La conclusion de l'auteur est très précise. Il est inadmissible, note-t-il, que les cédantes améliorent leur situation en demandant des commissions de réassurance exagérées, le paiement des primes avec un long retard et d'autres conditions déraisonnables, à un moment où le réassureur subit de coûteuses pertes techniques.

Goodbye to Technical Profit ?*

by

Dr KLAUS GERATHEWOHL
du groupe de la Munich Re & Victory

Sous le titre de "Goodbye to technical profit ?", le Dr Klaus Gerathewohl a donné une conférence sur la question du profit technique en réassurance, à la réunion du 2 mars 1983 des City Financial Conference Services, à Londres. La conclusion de l'auteur est très précise. Il est inadmissible, note-t-il, que les cédantes améliorent leur situation en demandant des commissions de réassurance exagérées, le paiement des primes avec un long retard et d'autres conditions déraisonnables, à un moment où le réassureur subit de coûteuses pertes techniques.

~

Looking at the negative underwriting results in most markets of our Western industrialized countries – but not only in these markets –, one might be tempted in view of the losses generated for years in many classes of business to replace the question mark after the title of this paper by an exclamation mark.

In the light of this situation it is all the more surprising that in recent times an increasing number of experts have sought to justify these dismal figures[1]. As an example, it is stated more and more often that the underwriting results are no longer an appropriate yardstick for measuring a company's success in the insurance business and should therefore be replaced by the combined results of a company's underwriting and non-underwriting business.

---

*Written version of a paper presented on the subject of « *Changing World Insurance Markets – Whose Industry is it ?* » at the Third Strategic Conference of the City Financial Conference Services in London, on March 2nd 1983. Revised and supplemented by footnotes before going into print.

[1] Cf., for example, *I.L. Rushton*, Changing World Insurance Markets – Whose Industry is it ? Goodbye to Technical Profit ? The Perspective of a Major Composite Company, paper given at the Third Strategic Conference of the City Financial Conference Services on 2 March 1983, Documents of the first session, pp. 1-12. *J. Howard*, Royal Insurance 'will not write unprofitable business', in : Financial Times, 19 April 1983. Cf. also the summarizing report by *L.B. Lyons* in : National Underwriter, 22 October 1982, pp. 1, 65.

While it is certainly appropriate to discuss this subject — which has become a basic issue for insurers in many countries — in an open and straightforward manner, it would be equally inappropriate and indeed hazardous to regard an entirely turnover-orientated underwriting policy neglecting underwriting profits from the very beginning as a legitimate solution[2].

An analysis of the market situation

How the current situation was able to develop in nearly all important insurance markets has been described in numerous studies and publications[3]. The recessive trend of the economy since about 1973 has slowed down the demand for insurance coverage virtually all over the world, in some cases even causing demand to stagnate[4]. Increasing inflation rates in recent years have at the same time resulted in higher claims expenditure, overheads and expenses[5].

Many direct insurers have endeavoured to combat these negative trends by producing business and premiums at all costs. Taken together, therefore, these two factors — recession and inflation —

[2] Cf. in this context the study recently published by *D. Farny*: Nichtversicherungstechnische Erträge und Prämienbedarf in der Schaden / Unfallversicherung oder: Versuche und Versuchungen des Cash flow-Underwriting (Non-Underwriting Income and the Premium Required in Property Damage / Accident Insurance or: Attempts at and Temptations of Cash Flow Underwriting), in: Versicherungswirtschaft 1983, pp. 398-403, 476-485 with numerous further references.

[3] Cf. in this context the general survey in: Where is the Insurance Industry Headed?, in: World 1982 (No. 3), pp. 24 ff. On the specific problems of reinsurance, cf. *S. Boerhout*, Reinsurance, past, present and future, in: Quarterly letters from N.R.G., April 1981, No XXIV / 95, pp. 1-20. *P.C. Perrenoud*, Who's Blaming the Energy Crisis?, in: Reinsurance, April 1981, pp. 682-688. Cf. also Crise de la réassurance ou crise des réassureurs? (A Crisis of Reinsurance or a Crisis of Reinsurers?), in: Argus 1982, pp. 1955-1968.

[4] For general comments on the influence of the overall economy on the insurance business, cf. *R. Schwebler*, Versicherungswirtschaft und Konjunktur (The Insurance Business and the Economy), in: Versicherungswirtschaft 1983, pp. 214-222. Cf. also Konjunktur und Versicherung (The Economy and Insurance), in: Zeitschrift für Versicherungswesen 1982, pp. 58-59. *R. Schmidt*, Weltweite Probleme der Individualversicherung (Worldwide Problems of Individual Insurance), in: Versicherungswirtschaft 1982, pp. 544-554 (546 f.). On the situation in the Federal Republic of Germany, cf. *W.G. Seifert*, Industrieversicherer vor schweren Zeiten? (Industrial Insurers Facing Hard Times?), in: Versicherungswirtschaft 1982, pp. 1368-1377 (1368).

[5] The term "inflation" is to be understood here in a monetary and social sense. On the concept of "social inflation", cf *K. Gerathewohl* et al., Reinsurance — Principles and Practice, Vol. II, Karlsruhe 1982, p. 799 with further references.

have created fierce competition. Since, due to the poor state of the economy, there was no real demand for the increased supply of insurance, premium rates — and, accordingly, underwriting results — have inevitably gone down.

The overcapacity or, more appropriately, the excessive supply of insurance coverage in the direct insurance market has been accompanied by an excessive supply of reinsurance making competition even keener. Basically, the reasons for this overcapacity are the same as in direct insurance. In addition to this a lot of new reinsurance capacity has also become available — provided in particular by direct insurers who, by assuming reinsurance, try to compensate for the stagnation of their direct business[6]. The fact that this capacity was "uninformed" in many cases, i.e. capacity provided although the insurers involved were often unaware of the risks concerned and the loss potential they were assuming, contributed considerably to reinsurance prices having gone down below the level required. This, in turn, allowed direct insurers to reduce their premiums once again, albeit at the expense of reinsurers.

Further momentum was added by the unprecedented interest rates which, on account of inflation, were at a very high level until just a few months ago. In the light of these interest rates, insurers appeared to be able to accept ever-increasing underwriting losses ; at the same time they appeared to justify an underwriting policy neglecting the results of the insurer's underwriting business itself. The result was excessive cash flow underwriting which, in addition to the fierce competition already described, caused the underwriting results of direct insurers and reinsurers to further deteriorate.

Underwriting results have always been cyclical in nature. A new factor, however, is that the negative cyclical phases are apparently becoming longer and the slumps deeper. This applies in particular to the downward phase of the cycle most Western insurance markets are currently going through, the "bottom" of which has apparently not yet been reached[7].

---

[6] Cf. The World Reinsurance Market, in : International Insurance Monitor, October 1982, pp. 9-10. *P. Franklin*, Insurance : An Industry in Structural Change, in : Financial Times, 14 September 1982.

[7] *P.B. Walker*, Mounting a Concerted Attack on the Underwriting Cycle, in : Best's Review, October 1981, pp. 24-26, 115-118. Further references under footnotes 8 and 10.

The relative significance of non-underwriting income

Generally, cash flow underwriters justify their business policy by referring to the increasing significance of non-underwriting income.

It cannot be denied that there have indeed been structural changes of the insurance business in recent decades. This is shown quite clearly by Best's examination of the North American market in January 1982[8]. While, due to shorter policy terms, unearned premiums in the United States had gone down by about 45% in relation to the earned premium since 1954, claims reserves had more than doubled due to the larger share of long-tail business with its long settlement periods. As a result, the non-underwriting income of US insurers expressed in percent of premium income has increased almost continuously to three times the amount in 1951 – which, naturally, is also due to the higher interest rates. The situation has been similar in other industrialized countries.

This US example also shows most impressively what problems this development may create. In the present cycle, due to the increase in underwriting losses, the high point of the overall results of US insurers after non-underwriting income was only + 12% in 1978. This means that despite the extremely high interest rates paid at the time, the overall high point was by no means significantly above those in former cycles – for example in 1953 and 1972 –, when the high point reached about + 11%[9].

The low points of these cyclical fluctuations, on the other hand, are constantly decreasing and reached the absolute minimum so far in 1975 when the overall results of US insurers were down to zero. Given the continuous deterioration of underwriting results in the USA, it is quite possible that in the current cycle the overall results of US insurers will even drop below zero[10].

---

[8] Review and Preview, in : Best's Insurance Management Reports, Perspectives, Property / Casualty, 4 January 1982, pp. 1-12 (2).

[9] Best's Insurance Management Reports, loc. cit., (footnote 8) p. 2.

[10] 1981 Underwriting Results by Line of Business, in : Best's Insurance Management Reports, Statistical Studies, Property / Casualty, 29 March 1982, p. 1-4 (4). Review and Preview, in : Best's Insurance Management Reports, Perspectives, Property / Casualty, 3 January 1983, pp. 1-10 (2, 3). United States Underwriting in 1982, in : International Insurance Monitor, January / February 1983, pp. 17-21 (17). *D.P. Clark*, The Reinsurance Market in the United States in 1980, paper given at the 1980 September Rendez-vous, Monte Carlo.

Problems and hazards of a sales-orientated underwriting policy

Considering this development exemplified particularly clearly by the USA but by no means limited to that country alone, one finds it very difficult to accept arguments claiming that an underwriting profit is dispensable in the long run with non-underwriting income providing the necessary balance for underwriting losses sustained. True, there is certainly a definite link between underwriting and non-underwriting business, and it would be wrong to completely neglect the return on investments when judging an insurer's underwriting results[11]. Given the significance that such non-underwriting income has now gained due to the increase in claims reserves and the high interest rates that followed in the wake on inflation, it is indeed out of the question to return to the "old days" in which underwriting and non-underwriting results could be judged entirely separately. But acknowledging the significance of non-underwriting income today does not mean accepting the concept of cash flow underwriting. On the contrary. Due to the greater significance of the investments made by an insurer, it is more important than ever before to realize and appreciate the risks run by the cash flow underwriter.

In particular, one should not forget that the terms and cycles of underwriting business differ from those of non-underwriting business — and that this in itself creates dangers[12]. While underwriting results are long-term orientated, investment income may well be subject to short-term changes. Just how quickly such changes may occur is once again shown by developments in the USA : US treasury bills, which still yielded 16% in 1981, were down to 13% by June 1982 and dropped further to an interest rate of just 7.5% by November of the same year[13].

It would be illusory to assume that the terms and conditions of underwriting business could be adapted even roughly to such abrupt fluctuations of the interest rate. This is shown very clearly

[11] For the same opinion, see also *D. Farny*, loc. cit., (footnote 2) pp. 402, 484 f., who rejects the "irregular, undifferentiated and uncontrolled perspective" of cash flow underwriting.

[12] Cf. *W. Zajdlic*, Insurance Investment Activities, in : Reinsurance, November 1982, pp. 394-402 (396).

[13] *B.D. Stewart*, Interest Rates' Decline Won't End Competition, in : National Underwriter, 5 November 1982, pp. 65-68 (65).

by the difficulties insurers experience when required to rehabilitate a market in the even of imminent or even manifest operating losses. Even under the most favourable circumstances, it will take two or three years until suitable measures have been resolved, implemented and produce positive effects. In some cases the rehabilitation period required may be far longer, for example when an increase in rates can only be introduced slowly due to a large share of long-term policies in the existing portfolio.

The cash flow underwriter therefore speculates in two ways. First, he hopes to cover the underwriting losses which he accepts
318 from the very beginning by way of his investment income, although he cannot calculate his investment income in advance due to the constant change in interest rates and although he realizes that as a rule he will not be able to adjust his premiums quickly enough to a decline in interest rates. Second, he hopes that he will be able to control the development of losses and expenses whithin a certain margin[14]. Despite their positive aspects in the short term, higher investment income and, in particular, inflationary interest rates increase this speculation risk, as they appear to extend the loss threshold still acceptable on the underwriting side and make overall results increasingly dependent on interest rates remaining at a high level.

The cash flow underwriter wrongly presumes that he will be able to forecast future underwriting losses with sufficient accuracy. If at all, he will be able to do so in classes of insurance where the general trend of claims frequency and average claims amounts can be anticipated with relative accuracy in advance. This, however, will only be the case with "simple" business – and even here only if one neglects the influence of disasters such as earthquakes or storms. In classes of business such as aviation, marine, industrial fire and engineering, on the other hand, which are subject to a substantial large loss potential, nobody can forecast underwriting results with sufficient accuracy and take prompt corrective measures in the event of a negative trend. An example of this situation is industrial fire business in the Federal Republic of Germany, which has proven so difficult to rehabilitate in practice. In this short-tail

---

(14) *H.K. Jannott*, Bericht des Vorstandsvorsitzenden vor der Hauptversammlung der Aktionäre (Address given by the Chairman of the Board of Management to the General Meeting of Shareholders), 3 December 1982, publication of Munich Re, pp. 3-39 (6 f.). Cf. also *D. Farny*, loc. cit., (footnote 2) p. 398.

business with comparatively small underwriting reserves, investment income has been far too low to provide a balance for the 15% market loss sustained in each of the last four years. Whenever there is a surplus in the supply of insurance and reinsurance, however, the pressure caused by excessive competition and the irrational hope that "everything will work out all right" – especially after years without large losses – are obviously stronger motive for reducing premiums than the level of interest rates, particularly in classes of business subject to considerable fluctuations in results on account of large losses[15]. This creates the risk – not only in the German market – that the cyclical decline will only come to an end when, due to underwriting losses, the supply of insurance and reinsurance decreases to such an extent that both direct insurers and reinsurers can increase their prices without having to give up a large amount of the business in their portfolio.

Apart from the problem of having to match underwriting and investment cycles, the cash flow underwriter must also realize that he is hardly using his investment income for its primary purpose, that is to provide a balance for inflation and the declining value of his capital investment. Because in insurance as in other lines of business, investment income should serve in the first place to preserve the substance of the insurer's investments and increase his solvency margin on account of inflation[16]. In many markets, however, underwriting losses have now reached a magnitude which hardly allows insurers to use their investment income for this purpose.

Particular aspects for the Reinsurer

Considering the risks emanating from cash flow underwriting, one must also make allowance for the particular situation of the reinsurer.

True, the investment income of reinsurers has also increased considerably in the course of recent decades. Relative to his pre-

---

[15] Cf. *G.E. Doty*, Cash Flow Underwriting : A Broader View, in : Best's Review, December 1982, pp. 16-18 and 115-117. *B.D. Stewart*, loc. cit., (footnote 13) pp. 65-68.

[16] Cf. *D. Farny*, loc. cit., (footnote 2) pp. 402, 476. The uncommitted assets required are often underestimated, as a decreasing level of premiums shows a better ratio of uncommitted assets versus the premium income than uncommitted assets versus the insurer's actual exposure in terms of sums insured. Cf. *W. Zajdlic*, loc. cit., (footnote 12) p. 400. *M.F.W. Jenkin*, Cash Flow Underwriting, in : Canadian Insurance / Agent & Broker, May 1982, pp. 28, 41-42 (28).

mium income, the reinsurer may also have larger underwriting reserves than most of his cedants. Indeed, this follows inevitably from the larger underwriting risk borne by the reinsurer and, as a results, from the greater susceptibility of his portfolio to fluctuations[17].

Despite this situation, however, reinsurers have less investment income on average than direct insurers. This is due to the simple fact that reinsurers do not receive the accounts for most of their business until the expiry of the accounting period agreed with the direct insurer, which is usually each quarter or half-year. The

premium shares due to the reinsurer are also set off immediately against the losses paid and reinsurance commissions. A further drawback is that these accounts and the transfer of balances are often substantially delayed in practice. In contrast, however, the reinsurer is generally obliged to pay for major losses immediately by way of cash payments.

Yet another factor is that reinsurers writing foreign business are often required to deposit underwriting reserves with their direct insurance clients, such deposits usually bearing interest at an inadequate rate. While the reinsurer is therefore deprived of his investment income, the net income of his direct insurance client will increase accordingly, thus allowing the direct insurer to reduce his premiums once again largely at the expense of the reinsurer, if he is reinsuring a major share in the risk.

Life is made more difficult for the reinsurer by the fact that direct insurers sustaining underwriting losses will tend to take out a greater share of reinsurance, i.e. they will generally neither adjust their retentions to the rate of inflation nor make full use of retention margin at their disposal. In times of stagnating premium growth, direct insurers also tend to write more risks by themselves (i.e. not by way of coinsurance with other direct insurers) in this way making maximum use of the capacity provided by reinsurers. Both of these phenomena mean that reinsurers will receive more business in the negative phases of an underwriting cycle, which will

---

[17] This results, inter alia, from the homogenization of the direct insurer's portfolio; cf. *K. Gerathewohl*, loc. cit., (footnote 5) and Vol. I, 1980, pp. 21 ff. with further references.

make it more difficult for them to achieve a balance of their results in the course of time[18].

One last factor still remains to be mentioned. It has already been stated that in the cyclical fluctuation of underwriting results the negative phases are now longer than the positive ones. Also, the low points are deeper than in the past. Given this situation, the reinsurer now has the additional burden that these cyclical fluctuations have run largely parallel all over the world since about 1973[19]. Obviously, this worldwide trend makes it more difficult for the reinsurer to achieve a geographic balance, although this is precisely what he requires with his business being subject to a greater fluctuation of results than the business of his direct insurance clients.

Conclusions

The concept of cash flow underwriting neglects the fact that the connection between underwriting and investment business varies in the individual classes of insurance[20]. If at all, certain underwriting losses may be accepted in the light of a prudent assessment of investment income in those classes of business in which underwriting results may be largely anticipated and thus controlled. In aviation, marine, industrial fire and engineering, on the other hand, that is classes of business which depend greatly on the random occurrence or non-occurrence of large losses, the insurer must have the benefit of positive cyclical phases.

This applies even more to the reinsurer whose portfolio consists mainly of heavy risks more exposed to large losses and catastrophes. As a rule, therefore, the reinsurer does not have the same "blend" of simple and hazardous business as the direct insurer. Hence, he must rely on his investment income from underwriting reserves as a safety margin crucial to the maintenance of his financial capacity.

---

(18) A typical example is industrial fire insurance in the Federal Republic of Germany, which has generated bad results for the last few years (estimated loss in 1982 : DM 350 million). Currently, about 80% of this business is reinsured ; cf. Schultze-Heesch in : Zeitschrift für Versicherungswesen 1983, p. 114.

(19) For further details, cf. *K. Gerathewohl*, Der deutsche Feuer-Rückversicherungsmarkt (The German Fire Reinsurance Market), in : Zeitschrift für Versicherungswesen 1982, pp. 7-10 (7, 8).

(20) Cf. *D. Farny*, loc. cit., (footnote 2) pp. 401 and 485.

The need for positive cyclical phases in those classes of direct insurance subject to substantial fluctuations as well as generally in the reinsurance business should determine also the criteria for judging the success of insurance in these classes and in reinsurance. The combined loss/expense ratio remains the only reasonable criterion for judging the profitability of a market or a company[21]. The crucial factor insofar is the insurer's gross underwriting result, even though this is overlooked far too often. Even when reinsuring (and having to reinsure) a large share in his business, the direct insurer should write his gross risks as if he were retaining a 100% share for himself.

To ensure that these requirements are properly appreciated and observed in practice, both direct insurers and reinsurers must adopt an appropriate policy in their respective markets. First and foremost, classes of business which have been generating losses for years must be rehabilitated without delay and with a lasting effect.

The task that falls to reinsurers is to make sure that an inadequate level of premiums is also reflected in the ceding insurer's net underwriting results. Reinsurers must therefore insist on direct insurers increasing their retentions accordingly and make sure in particular that these retentions are actually carried by the direct insurers concerned. As regards the terms and conditions of reinsurance, it is obviously an unhealthy situation to have ceding insurers improving their net results by way of exaggerated reinsurance commissions, a delayed payment of balances and too low cash loss limits, while at the same time reinsurers are already suffering underwriting losses. And whenever reinsurers are required to deposit underwriting reserves with foreign ceding companies, these deposits should be established in securities or — if they have to be set up in cash — bear adequate interest rates in line with market conditions.

These measures and requirements are not only in the interest of the reinsurer. Rather, they may also serve to effectively support direct insurers in their efforts to rehabilitate the market. If these efforts are successful, there will be no "Goodbye to Technical Profit". The fact that this issue, which used to be taboo, is now dis-

[21] Cf. *M. Greenberg*, Reinsurance in a Period of High Interest Rates, in : Reinsurance, October 1982, pp. 300-306 (303).

cussed openly with all its consequences is indeed an initial step in this direction. It gives us the opportunity to shed a clearer light on the true significance of investment income and the interaction between such income and the underwriting results in the insurance industry. And in many markets this can now only mean one thing : to realize that the utmost limit of what can be tolerated has already been exceeded in numerous classes of insurance.

De meilleurs résultats en vue en 1983

Statistique Canada donne les chiffres suivants pour l'assurance des biens et risques divers durant le premier trimestre de 1982 et de 1983 :

1er trimestre	**1982** (000)	**1983** (000)
Primes nettes acquises	$ 1.522.829	$ 1.726.935
Bénéfices d'exploitation	– 283.806	14.977
Bénéfice net	– 20.105	228.862

Les résultats de 1983 s'annoncent donc beaucoup plus favorables que ceux de 1982, grâce à des augmentations de tarifs, au fait que, durant le premier trimestre, on a pu éviter de coûteuses catastrophes et que, dans l'ensemble, semble-t-il, la fréquence des sinistres ait été moindre. Il faudrait éviter que, devant cela, la concurrence sauvage des dernières années ne reprenne : ce qui permettrait aux assureurs d'obtenir de meilleurs résultats d'ensemble, tout en consolidant leurs réserves.