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Résumé de l'article

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An insurance company's response to inflation : a chief financial officer's point of view[1]

by

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Two or three decades ago in the United States it was fashionable to deride inflation as the problem of other countries. Except for the dislocations of two World Wars and the Korean War the history of the country did not contain any prolonged period of high inflation. The Federal budget was roughly in balance, monetary growth was not large and in the balance the United States economy was not dependent upon foreign exports or imports to any meaningful extent ; we were a net exporter of oil and petroleum pro-

(1) M. Matthews a bien voulu permettre de faire paraître dans notre Revue l'excellent travail qu'il a présenté à l'*International Insurance Seminar*, à Toronto, le 28 juin 1982, sur l'inflation et les compagnies d'assurance.

ducts. The U. S. dollar was the unquestioned international standard of value. In the minds of many, the United States economy was too large and too diversified, productivity was growing too fast and demand for social services was growing too slowly for inflation ever to take a meaningful hold.

Since the early 1960's that scenario has come completely apart. From a rate of .6% in 1961 inflation has risen steadily with few interruptions ever since culminating in a rate of 12.4% as measured by the Consumer Price Index in 1980. Inflation has fallen since then and is projected generally in 1982 to be at the annual rate of 6 to 7%. Yet many observers, myself included, do not believe this is the beginning of a long term deflationary trend but rather only an interruption brought on by the present economic recession of the basic secular inflationary trend. Most importantly, the United States does not now stand apart from other nations – several countries including Switzerland, West Germany and Japan have a lower inflationary rate. The economic outlook for the United States has become closely interwoven with the rest of the world – its interest rates and responses to inflation impact not only its own economy but that of most other countries as well.

It is not the purpose of this paper to examine why inflation in the United States and most other countries is as high as it is or to examine whether the economic policies of their respective governments are appropriate responses to the problem and will dampen inflation in the long run. Rather it is my purpose to set forth the responses of one large international insurance corporation to the current inflationary environment who must combat the problem in virtually every major country in the world. In particular, I want to focus on the investment implications of dealing with inflation. Mr. Kingsley is examining for you the problem that inflation causes the life insurance industry and I shall confine my remarks to the problems inflation causes the property and casualty industry.

It is hard to imagine an enterprise that is more severely impacted by inflation than an insurance company. Manufacturing and distribution companies are, to be sure, also impacted adversely by this phenomenon but they have one major advantage over insurance companies in that regard ; almost without exception when their product is sold, the costs are known and the impact of inflation on costs, however adverse, has been largely felt. But for an insurance company the period of uncertainty is just beginning. The expenses incurred by an insurance company up to the time the product is

sold are but a small fraction of the total that the company will incur. The claims costs will be incurred at some time in the future. Depending upon the class of business these claims can be paid relatively rapidly or deferred to many years into the future. Since first party or property related coverages tend to be paid quickly while casualty or third party coverages may be deferred to many years into the future, the impact of inflation is magnified in casualty insurance. Casualty coverages are coming to represent an increasingly large portion of total insurance premium income in the United States. In 1961 casualty insurance represented only 44.76% of total premium income while by 1981 casualty insurance had increased to amount to 47.00% of total premium income. The environment in which the claim is paid may differ materially from the environment in which the policy was priced not only with regard to general price levels but also with regard to the legal and social environment in which the claim will be settled. Perhaps the most pernicious effect of inflation is the heightened level of uncertainty that accompanies it. We do not know whether inflation will continue to rise or diminish but the claimant will assert the worst and more often than not will win a settlement based on the worst.

It is a corollary of inflation that interest rates also rise in tandem with inflation. This is not surprising since lenders will want a rate of return that protects the purchasing power of their capital as well as earns interest. In a perfect market the interest rate charged by a lender should reflect the sum of 1. the riskless rate of interest, 2. the premium attached to the credit risk and 3. the premium due to inflationary expectations. Studies done by the Federal Reserve Bank of St. Louis have shown that for a "riskless investment" (U.S. Treasury securities) the real rate of return is generally about 3%. Studies done on British consuls have tended to corroborate this finding. Thus the interest rates in the United States and Canada are explained – or are they? Why are U.S. Treasury securities yielding 12 to 14% when the current rate of inflation is only about 6 to 7%? Perhaps we should add a fourth component of that interest rate – the suspicion premium. Lenders are telling us they do not believe that inflation will stay at its current rate and until convinced otherwise will insist on a high rate. Thus insurance companies have come to realize the current high interest rate environment is likely to be with us for some time to come.

As casualty insurance with its long tail reserves has become more important in the overall mix of fire and casualty business, the

contribution of investment income to overall fire and casualty operating income has increased. The ratio of the sum of unearned premium and loss reserves to capital (policyholders' surplus) has increased from 1.1 in 1961 to 2.5 in 1981 as measured by Best's Aggregates and Averages. As interest rates have risen over the past twenty years, the return on equity earned by investing these reserves has grown faster than has the underwriting losses. A study done by Conning & Co. of Hartford, Connecticut, a leading insurance industry analyst firm, has attempted to compare the return on equity earned by the insurance industry with that of the Standard & Poor's 400 for the last thirty years. During the low interest rate environment that prevailed in the 1950's and 1960's the industry earned an average 7% on equity barely half that of the S&P 400. Since 1970, with the exception of the disastrous underwriting years of 1974 and 1975, the industry has earned about 12% to 14% on capital, roughly equal to that of the S&P 400. Conning also computed what combined ratio the insurance industry would have had to achieve in those years in order to earn a rate of return equal to the S&P 400. Not surprisingly with higher reserves and higher interest rates, the underwriting ratio needed has risen and conversely the required underwriting profit has fallen. In 1951 the combined ratio required was 85.3 while the industry actually achieved a 97.1 while in 1980 the combined ratio required was 103.5 which was the actual combined ratio.

Sometimes, it seems as if nearly everyone in the insurance industry has read this article or made similar calculations and is practicing what has become known as "cash flow underwriting" or bluntly put: forget underwriting, just get the premium dollar today, enjoy the high interest income today and worry about the claims tomorrow. We do not believe that making the desired underwriting ratios a function of the level of interest rates will ever work in the volatile environment we expect in the future. We like all other large companies have hundreds if not more than a thousand people with the power to make underwriting commitments on our behalf. We believe we have taught them the skills necessary to set a premium rate necessary to make an underwriting profit but we have not found a way to teach them how to vary that rate with this week's Treasury bill levels. The simplistic "cash flow" approach to underwriting totally ignores the fact that high interest rates are a corollary of inflation and inflation particularly in long-tail business has a habit of making a shambles of today's reserves. Also this calculation infers that all the reserves are invested at today's

high rates. Of course the investments that back today's reserves are a composite of many years investing, most of which were invested at rates well below today's rates. A bond with an interest rate well below market interest rates has a market value well below its amortized or carrying value. Thus insurance companies cannot realize the benefits of today's interest rates without selling their low coupon bonds at substantial losses that will erode their capital. For the industry as a whole it is estimated that losses on the bond portfolio at the end of 1981, if realized, would amount to $37.3 billion reducing industry statutory capital from $53.8 billion to $16.5 billion. Realization of losses of this magnitude are unthinkable for it would place the industry in an extended position to carry today's business much less tomorrow's business. It seems we have forgotten that another corollary of inflation is the inflationary growth of insurable values and exposure to loss. Just to stand still and maintain their present book of business without participating in the growth of the economy, insurance companies must add capital at a rate equal to the inflation rate. But for the industry as a whole, that's not good enough. We must also add capital equal to the real growth in the economy in order to continue to serve the insurance needs of our clients.

That's the problem we financial officers face in the designing of a financial and investment structure that will 1. recognize the inflationary environment in which we operate, 2. recognize the extra volatility and uncertainty that are a product of it, 3. recognize the increased susceptibility to inflationary pressures on reserves that have accompagnied the swing to increased percentage of casualty business, 4. provide for the necessary safety of funds that are held for the benefit of our policyholders and still provide a satisfactory current return to our shareholders and the growth in capital necessary to keep our current business and obtain our share of additional business resulting from the growth of the economy.

Designing such a structure is a tall order and it seems well in trying to accomplish it to remember that our capital can be risked in three ways. I have chosen to call these three ways 1. operating leverage ; 2. financial leverage and 3. investment leverage. Operating leverage is derived from the ratio of our insurance business to capital or policyholders' surplus as measured both by the ratio of premium writings to capital and the ratio of unearned premium and loss reserves to capital. The current depressed level of pre-

mium rates makes the ratio of premiums written to capital probably a poor measure of operating leverage. I consider the ratio of total reserves to capital a better measure of our risk exposure in our basic business. As a financial officer I always want my company to be in a position to maximize its operating leverage when the opportunities for profitable business are there. Therefore financial and investment leverage must always be subordinate to operating leverage.

Financial leverage I define as the traditional ratio to debt equity. The insurance industry has not been a substantial user of debt and I believe that to be a prudent choice. With regulatory constraints always a factor in the availability of dividends from operating companies to parent companies, large fixed charges should be avoided. I regard our low debt ratio at American International Group as one of the most precious corporate assets for it means that we have substantial additional capital potentially available if attractive business opportunities become available. We will not be faced with the necessity of selling common stock regardless of the level of our stock price.

Lastly, investment leverage I define as the risk profile of our invested assets relative to our capital. The insurance industry has traditionally regarded its investment in common stock as the measure of its risk in relation to its capital but I suggest that in their recent eagerness to embrace more esoteric investments in their desire to increase their capital, they have not properly evaluated the additional risk that this entails. Most important of all, we must remember these risks or leverages are cumulative. In 1974 the industry saw what could happen when these risks cumulate. A severe stock market decline combined with highly unsatisfactory underwriting results nearly decapitalized many companies. A broad stock market rebound in the next two years combined with regulatory tolerance of extended ratios of writings to surplus and a return to underwriting profitability enabled the industry to restore its operating ratios. In this cycle the industry has wisely not increased the common stock component of its investment leverage, and common stocks to surplus ratios are generally in the area of 60% compared to over 100% in the 1973-75 cyclical downturn. We don't have a computer program to balance these three forms of leverage or risk taking but simple prudence should indicate that when operating leverage exceeds a rate of 3 to 1 for premiums to surplus or 2.5 to 1 for total reserves to surplus, the use of debt capital is unwise and

further exposure in common stock investment or other risk investments should be cut back.

The heart of any insurance company's investment strategy is its bond portfolio and for years it was the least managed. With stable and low inflation rates, interest rates on bonds were also predictably low and stable. Bond rates also followed what is called a positive sloping yield curve, that is the shortest maturities had the lowest yield and yields rose as did maturities producing a yield curve that consistantly moved higher with maturity length. Insurance companies frequently took the longest maturities to maximize yield since with stable interest rates, capital value changes did not occur. Once the investment committee chose the requisite quality level, issue selection was routine. Virtually all tax-exempt bonds were general obligations, revenue bonds were unusual and industrial revenue bonds unheard of. In the words of Wall Street, tax exempt bonds traded "by appointment only" so portfolio turnover was rare. Since the need to change strategy was unlikely, managing the bond portfolio did not attract the best talent and bond manager salaries were well below those of common stock managers.

As the direct result of inflation induced changes in interest rates, the design of a bond portfolio today has changed dramatically. Short-term investments frequently yield more than long-term investments producing a negatively sloping yield curve. Portfolio managers are no longer penalized for staying short. Moreover, underwriting results have changed with great suddeness, producing first taxable underwriting profits in the early 1970's, followed by three years of underwriting losses, then three more years of substantial underwriting profits and now, including the current year, three years of record underwriting losses. The bond portfolio manager must work closely with the tax manager to use most expeditiously the tax credits being produced by the underwriting losses. Many insurance companies have chosen to maintain as a permanent portion of their portfolio at least 10% in U. S. government securities generally of two year maturity or less. The heavy reliance placed by the U.S. government on the sale of two and four year notes has made this maturity attractive for purchase. Currently two year treasuries yield 14.5% and four year treasuries yield 14.7%.

With few exceptions, the bulk of any insurance company's portfolio is still in tax-exempt bonds. The variety of instruments offered today is, however, much broader than that offered twenty

years ago. Many states and municipalities have chosen to create independent agencies to fund capital investment in revenue producing services outside their general obligation debt limit. These entities, not enjoying the power of taxation, must be judged exclusively on the revenues they produce. Bond managers must read prospectuses carefully to discern differences in credit. Many bond managers are learning to their sorrow there is a world of difference between the bonds that have as their security Washington Public Power Supply System Plants 1, 2 and 3 and the bonds that have as their security Plants 4 and 5. The creation of municipal industrial revenue bonds have created a hybrid creature, a tax-exempt bond with an industrial corporation as the sole source of credit. Also many banks now routinely issue ten year irrevocable letter of credits to bolster the credit of what otherwise might be medium or lower grade industrial revenue bond credits. This is a surprising use by the banks of what was once an instrument of foreign trade. The total volume of tax exempt financing has increased substantially creating liquidity when none existed before. The ability of the computer to search portfolios for issues in demand by the market with yield anomalies have created new opportunities for portfolio managers. In this new and challenging environment the salaries for competent bond managers have risen sharply and now exceed salaries for common stock managers.

The average life of tax-exempt portfolios too has undergone a sharp downward turn. Fire and casualty insurance companies that routinely bought thirty and forty year bonds have moved their purchases downward to twenty years or less. At American International Group we never purchased maturities that long but we, too, have shortened our time horizons from fifteen to twenty years to five to ten years. Shortening portfolio maturity will not insulate against effects of inflation or guarantee a real rate of return in excess of inflation but will give you the flexibility to change direction. In highly volatile markets that flexibility to take advantage of opportunities is a key and long-term bonds rob you of that flexibility. The regulatory authorities have become alert to the danger very long bonds present to policyholder funds and a recent report commissioned by the NAIC attempted to create a mechanical match of asset and liability maturities as one of the early warning tests. Although the particular test may have lacked general applicability, the concept has considerable merit and a more flexible measure may yet emerge.

The fire and casualty insurance industry has always been a purchaser of preferred stocks of corporations, primarily public utilities. Since preferred stocks have the benefit of the inter-corporate dividend exclusion, the dividends when received by fire and casualty corporations have been very lightly taxed at effective rates of about 7%. Prior to 1978 preferred stocks were required to be carried at market value and some of their high income allure was lost. Furthermore, at that time almost all preferred stocks had no sinking funds and thus could be considered to have perpetual life. If thirty to forty year bonds are a risk to flexibility, perpetual preferreds carry the ultimate risk in this regard. In 1979 the NAIC published a new regulation effective as of 1978 that distinguished between sinking fund and perpetual preferreds and permitted sinking fund preferreds to be carried at amortized value. The Wall Street investment banking community responded to the new opportunity and encouraged the issuance of large quantities of sinking fund preferred stocks having average lives ranging downward from twenty to five to seven years. Industry holdings of preferred stocks increased from $2.7 billion at the end of 1976 to $8.6 billion at the end of 1981. A note of caution, although sinking fund preferred stocks have many trappings of debt, they are not debt and should not be viewed as a debt substitute in the drive for higher yield to compensate for inflation. In 1975 we at American International Group invested $2 million in the private placement of sinking fund preferred stock of a major United States industrial corporation with a high credit rating and record earnings. Fortunately for American International Group $2 million is not a large investment for the corporation was International Harvester and our investment is now suspect.

With its equity capital, an insurance company has the luxury of considering a broader range of alternatives since they are dealing with their own money rather than policyholders' money. Equity capital is, of course, essential to provide the necessary margin of safety for policyholders, but in general a higher degree of risk can be tolerated. In the low inflation environment in which fire and casualty insurance companies used to operate, common stocks were considered virtually the only way to invest for capital growth and inflation protection. Unfortunately when the test came and inflation soared in the late 1970's, the record of common stocks in this regard failed dramatically. The Dow Jones Industrial Average which peaked in 1973 at 1051.7 is as of this writing of this paper

below 800, providing even after dividends a negative return. Even over the five years, 1977 through 1981, the Standard & Poor's 500 has provided after adjustment for dividends only a return of 8.1% below the inflation rate of 8.9% for the same period. Nevertheless a sound common stock portfolio has its place in any diversified investment program. What needs to be quantified is how much, what percentage of surplus is appropriate? At American International Group we constructed an interesting model five years ago. We examined under various assumptions of growth and underwriting profitability what was the maximum percentage of common stock investment we could tolerate if the stock market declined 20% per year for two successive years without impairing our ability to accept further insurance business. The answer was impacted very much by our starting point but in a way at that time we were typical of the industry. Our capital was adequate but not excessive. Our premium volume was growing rapidly and the business was quite profitable. Under those circumstances we determined that our maximum percentage of common stocks to statutory policyholders surplus should be not more than 60%, a revolutionary conclusion at the time when 80% to 100% or more was considered the norm. Now 60% is considered a full position and many companies, ourselves included, operate at levels well below that. We found that establishing this maximum tolerance level had a very desirable side effect. Our common stock portfolio managers were able to operate freely and not suddenly be faced with insurance-dictated restrictions at a time when stock market conditions favored purchase. For American International Group the exercise had a particularly happy outcome. Our common stock portfolio performance, including dividends as well as realized and unrealized gains, has averaged 16.6% over the past five years, a rate well in excess of inflation over that period. Common stock investment has fulfilled the role we had assigned to it, that of providing a substantial portion of the growth in capital necessary to meet inflation influenced growth in our insurance business.

Over the years real estate has been considered the classic inflation hedge. Life insurance companies early on recognized the value of real estate and made substantial investments in many forms of real estate. The property and casualty insurance industry has been slow to recognize these advantages of real estate. In part this was due to a very real concern on the part of top management over the lack of liquidity in real estate investment. Fire and

casualty business does require more liquid investments than does life insurance. On the other hand, fire and casualty companies have not been alert to the investment appreciation and cost control potential in owning real estate. I have found that in many fire and casualty insurance companies the real estate department does not report to the chief financial or chief investment officer but rather to the chief administrative officer. We suggest that in such a situation the investment implications will clearly be lost. We prefer to invest in commercial office buildings where we will occupy initially 25% to 30% of the building so that space will become available at the time when our growth projections indicate we will need the space. Moreover, we will be able directly to influence our cost control by charging rentals that reflect changes in operating costs rather than being influenced by rental levels that fluctuate widely with market demand. Of course, in the balance of the building we are able to obtain inflationary increases in rentals from our outside tenants. Is real estate illiquid ? Certainly, but if you analyze the total leverage of the company as I suggested earlier, real estate investment is but one part of investment leverage and can be accommodated in greater or lesser amounts dependent upon the amount of other risk investments undertaken. If a company is willing to reduce its common stock exposure, real estate investment has a real place in a total portfolio.

The search for inflation hedge assets on the part of fire and casualty insurance companies to assist in capital growth has broadened even further in the last few years. With the exception of the last year, "hard" assets have consistently outperformed financial assets in terms of increases in value. Real estate that we have just discussed is the most prominent of these. Precious metals and critical raw materials, such as oil and timber, are other examples. Direct ownership of productive assets such as airplanes, rail cars, and offshore oil drilling vessels are further examples. In each case that I have named, fire and casualty insurance companies are looking at and finding ways to invest in ownership of these assets to gain the inflation protection that these assets should provide. It is difficult to generalize on such a diverse group of assets, but the common theme stems from a feeling that the common stock markets are not giving proper weight to the growth in asset values that these companies are producing. We have frequently seen resource rich companies sell at huge discounts at underlying values but when valued in a purchase by other companies, they sell at prices that approach

their underlying value. Why not then invest directly in these assets ? Skillful financial people have devised structures for fire and casualty insurance companies to joint venture with oil and gas companies in the exploration and development of these natural resources. Others have devised lease methods for insurance companies to own and lease productive equipment. These transactions tend to rely heavily on the benefits they provide in reduction of federal income taxes as well as growth in residual value. They promise large rewards but the skill needed to analyze them is not normally found in the investment departments of fire and casualty companies. Yet some companies have publicly indicated they consider the purchase of natural resource reserves an appropriate substitute for bonds in the investment of policy reserves. I suggest this indicates a lack of appreciation of the risks involved. I firmly believe these investments are equity substitutes and rank at the high end of the risk spectrum. Properly structured the rates of return can be comensurate with the risk involved. At American International Group we have invested in several oil and gas partnerships and leverage lease transactions of airplanes and specialized rail equipment. But we have invested substantially in specialized expertise and computer based transaction analysis. Even so, these investments amount to less than 5% of our United States invested assets and we have no plans to increase that percentage.

I have so far confined by remarks to dealing with inflation from an investment point of view in the United States. Of course, American International Group is a United States corporation and a large part of its assets and net worth are located in the United States. However, more importantly the United States capital market is large and diversified with a variety of financial instruments available to be assessed for their performance at varying levels of inflation. It is possible to construct very different portfolios depending upon your own perception of the economic and inflation outlook and risk assessment. But American International Group does do business in approximately 130 countries outside the United States including our host country, Canada. These countries range from low inflationary countries such as Switzerland and Japan to hyper-inflationary economies as defined by FASB-52 such as Brazil and Argentina. Capital markets in these countries range from highly sophisticated to fairly rudimentary. In most countries the choice of maturity for debt instruments that exists in the United States does not exist abroad. Ten years is considered a long-term

obligation and in hyper-inflationary economies ninety days may be the longest available instrument unless the instrument is formally linked to an inflation index such as the ORTN in Brazil (Government bonds which accrue monetary correction in addition to a basic interest rate). Therefore, the liquidity and flexibility which I urge as a policy preference in the United States may be the only alternative available. Clearly, too, real estate is a highly desirable investment and we have emphasized it strongly in those countries where our accumulation of capital is of sufficient size to permit prudent consideration of the inclusion of real estate. Condominiumization of office buildings, a practice almost unheard of in the United States, is highly advanced in many countries of the world. We have chosen to build our own buildings wherever possible and own the condominium floors where that is not possible. We thereby achieve better control over our rental operating costs and gain inflation protection over the long run. If the laws of the host country permit it, we will engage in cross currency hedges. It may be possible to buy bonds of the host country government denominated in strong Euro-currencies such as dollars or deutschmarks and still hold them as reserve assets in the host country. This type of risk requires an extensive knowledge of relative trends in currency values and introduces a new risk to the equation. We usually only engage in this type of investment where we have concluded we have an imperfect match of host country assets and liabilities and are exposed to loss through currency devaluation.

In summary then, inflation has created a new and more volatile environment calling for a more flexible investment policy on the part of chief financial officers. We must pay attention to capital values, both loss of value from erosion in bond portfolios, and potential appreciation of values from common stocks, real estate and other hard assets. We must do all this in a framework that properly evaluates risk and recognizes that investment and financial risks must always be subordinate to the risks we willingly undertake in our insurance business for that is our basic business.