

Breaking Out of the Insurance Cycle

Speech held by

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This week's theme "Navigating Risk Today – Securing Business Tomorrow" could not have been more appropriate. Risk seems to be on everybody's mind, and the topic appears on nearly all of the conference programs that pass my desk. This is no surprise, given our socio-economic environment. The topic of risk also cuts to the core of our industry, and my colleagues and I look forward to the results of your discussions.

I've had many questions in recent weeks – from investors, analysts, brokers and customers – about whether I think the insurance industry has returned to "smooth sailing." While the turbulent seas that battered our industry in 2001 and 2002 may appear to have subsided, I would caution that we still have challenging sailing ahead. What we saw in 2003, and are continuing to see, is a blend of calmer seas and improved seamanship.

When I looked at the topics of this week's sessions, several caught my eye.

- Insurance Solvency in a Global Perspective,
- Managing Risk from Water Intrusion, Mold and Mildew,
- Barbarians at the Gate: Fiduciary Liability after Enron,
and, my favorite
- Taming the Mass Tort Beast

They represent some of the storms we have to navigate through.

But our industry is heading in the right direction. It may not always be a straight course and smooth sailing, but I believe that if we could develop a sound approach we will reach a mutually beneficial destination.

One of the obstacles we will have to overcome, and one that in large part is of our own making, is the “insurance cycle.” Obviously, the side you are on determines how you view the cycle. But, I personally believe we can benefit from a shared understanding. It is in this spirit that I would like to offer my thoughts on how, by working together, we can start breaking out of the insurance cycle.

In recent years we have been reminded – some of us perhaps painfully – that insurance is a notoriously cyclical business. It would be presumptuous to declare the end of the current phase of the cycle, and I am not going to do so. But, I would like to give some reasons why I believe that a better managed cycle will be a win-win proposition for everyone here.

Seen from the supply side, insurance cycles are largely capital-driven. We have observed this recently, when a sudden loss of capacity caused by rapidly declining equity markets, terrorism, large catastrophe losses and prior year developments drove prices up across the board and forced some companies out of business. We are now seeing how the inflow of new capital into excess lines of business is leading to a deceleration of rate increases. This kind of volatility is fundamental to any market-based system, and it would be misleading to suggest that anyone could remove it from the business equation.

Nevertheless, our obligation to serve our customers drives us to seek ways to moderate the cycle. I am not the first to say that insurers have a strong interest in such an exercise. At many insurance companies, shareholders were taken on a bumpy ride over the last couple of years or down a steep ski slope. If we want to continue to rely on their capital to support our business – which in turn we use to support you in your businesses – insurers must develop

and implement business models designed to generate more stable returns. That's why insurers must position themselves for more stable and sustained profitable growth – to better serve their customers and their shareholders.

In 2003, many insurers adjusted their business portfolios, reducing balance sheet risks and strengthening their asset and liability management. I am sure your companies were doing the same things. These measures were designed to reduce the adverse cyclical impacts on earnings that have been inherent in our business and lower our exposure to financial market fluctuations. This must be combined, however, with a commitment to sound pricing. The technically correct price is more sustainable than what the market will bear.

I believe it is fair to say that our industry has learned an important lesson from the recent cycle. The tools for better asset and liability management are being implemented more widely. They are integrated in a comprehensive risk management approach that also includes our customers. I continue to see realistic pricing, and the necessity to earn an underwriting profit is not disputed. The building blocks are in place for a better business model, one that may help us to break out of the stark cyclicity of the past. We now must assemble them correctly and put them to good use.

This brings me to you, the risk managers and our most important customers. There are many ways for you to benefit from a more moderate cycle. It primarily means that dramatic price swings – as many of you experienced in the last two years – may not be necessary. This would give you an opportunity to plan ahead and better manage your cost of risk.

A more moderate cycle should also reduce the need for sudden and radical changes in contract terms. After large loss events insurers have relied too often on restricting covers and introducing limits and exclusions to protect their bottom line. This is, as the cliché has it, like taking the umbrella away when it starts to rain, a practice, I understand, you are not especially fond of, and for good reason.

Moreover, a moderated cycle should reduce the need to expand and contract capacity for specific lines of business. From the industry's perspective, it follows that well capitalized insurers will always have meaningful capacity to meet their customers' needs over the cycle. Indeed, in a world characterized by both increased risk and heightened risk awareness, an insurer's financial strength should be a desirable asset for corporate customers. You, as risk managers, rely on insurers capable of fulfilling their promises, and the financial strength of our industry is the foundation on which the fulfillment of these promises is built. The expectation of more moderate price fluctuations, a uniform application of terms and conditions over the cycle, and the capacity to meet your long-term needs are clearly goals for which we can all aim.

In this context, I believe that you would be willing to pay the "right" or technically correct price for the exposures you wish to cover. For these reasons, I also believe that working to moderate price fluctuations in the insurance cycle is in the best interest of all of us and will have a positive impact on everyone's bottom line.

The industry needs to recognize the vital role you risk managers play and insurers need to hold their relationship with you in great esteem. We must listen to you. We know that first and foremost, our industry must offer you clear and measurable value. We understand that you want to work with insurers that offer superior solutions including risk management services, differentiated claims handling and consistent and meaningful capacity. Insurers must do this by partnering with you to help you to reduce the cost of risk and to manage the cycle.

Our industry does not operate in a vacuum. The political and regulatory framework has a tremendous influence on the outcome of our activities. That's why it is crucial for our industry to maintain a constructive and active dialogue with regulators and legislators. We must be part of the solution, and we must contribute to the setting and shaping of the regulatory agenda. We should bear in mind, however, that too many checks and balances lead to imbalance and ultimately checkmate.

In this context, I believe that insurers and risk managers share a common interest. When regulation becomes excessive or when certain practices tend to impose an undue burden, joining forces is desirable. I believe this is the case with respect to the U.S. tort system. The U.S. insurance industry is exposed to the most aggressive litigation system in the world. Tort costs amount to more than 2% of national income. This imposes a “shadow tax” on individuals and the business sector that threatens to impair the essential function of our industry – the mitigation of risk. The “tort tax” has truly become usurious. We are – and I mean more than just our industry – in dire need of a more balanced tort system. Reforms need to address the rights of those who are truly injured, while weeding out frivolous claims. The tort liability system must be repaired as a matter of urgency.

Let me conclude with a few reflections on what I believe will be other primary challenges facing our industry in the years ahead. When you look at the underwriters that have been consistently performing well, you will notice that the class of winners consists of companies that outperform their peers in key metrics, such as combined ratios and return on capital. You will also find that they rate high on customer satisfaction. They were above average in the past, and they continue to perform above average today. In contrast, the companies that performed below average in the past continue to perform below average or have been acquired or no longer exist.

That’s why we must perform to the highest standards. Only insurers that deliver top tier results, earn more than their cost of capital and create economic value in the long term will be capable of providing rewarding opportunities for their employees and creating lasting valuable relationships for their customers, brokers, and shareholders. Insurers must improve their delivery mechanisms. We must better integrate our business and services capabilities, and we must increase the efficiency of our processing. Sharpening competitive positions through product design, segmentation, best-in-class pricing, and superior claims handling will underscore the industry’s commitment to its customers.

I have been told this is not the place to do a commercial. So, I will tread softly, and hope they don't kill the microphone. At Zurich, we are striving to be a superior performer, recognizing our obligation to our customers, and we aspire to be the company you choose to help you to mitigate the risks you face. Knowing the fundamentals required, I have no doubt that we've been doing the right things at Zurich. Two weeks ago, we presented our future strategic direction. I am sure you will have plenty of opportunity to learn about by talking to our representatives here at RIMS.

Together, we understand that there is some challenging sailing ahead. But, the best ships are those manned by the best crews. In risk management, the crews must include all parties: insurers, brokers, and particularly risk managers. Underwriters, the top performers, are ready to be part of the winning crew, and we invite you to join us. We offer our skills and talent in combination with our operational strength. We are confident that we can find the best way to successfully navigate through the rough waters ahead.

Thank you, once again, for this opportunity to speak to you.