Performance and Profitability:

An Insider's Look at the Insurance Cycle

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Good morning. I am delighted to be here and I would like to thank Ralf Oelssner and his team for inviting me to your symposium. I am flattered, given the distinguished list of recent keynote speakers. It is also a special honor for our company, and together with my colleagues from Zurich I am particularly impressed that you should invite an insurer from distant Switzerland.

Today I would like to invite you to examine with me the insurance cycle. In the last three years, our industry has experienced dramatic events. It began with the tragedy of September 11, followed by the hurricanes and floods at the end of 2001 and in early 2002. The impact these catastrophes had on our industry was amplified by the near-meltdown of the global equity markets, which further impaired the industry's capacity to absorb shocks.

The combination of these developments amounted to a "perfect storm." Undoubtedly, each event on its own could have been absorbed by our industry. But the cumulative impact resulted in severe pressure on the industry's profitability. US Property and Casualty insurers, for example, recorded a loss of 7 billion dollars in 2001 compared with a net income of 20.6 billion dollars the year before. It should not come as a surprise that this dramatic swing in profitability led to an equally dramatic decline in the market value of insurance companies. After our industry had outperformed the stock market in the late

1990s, the insurance sector as a whole began to seriously underperform in 2001. As far as I can tell, there is still no full recovery in sight.

But that's not the end of the story. In the wake of disappearing insurance capacity, general insurance premiums began to rise, and they did so quite dramatically in certain lines of business. It was little consolation that similar rate increases had been experienced in previous periods. Customers felt the impact of higher rates, and they shared their resentment about these rate increases with shareholders who had seen the value of their investments tumble.

While I cannot be responsible for the volatility of share prices, the impact of widely fluctuating insurance rates must demand the attention of any CEO. We must take seriously the concerns of our customers. I believe they are entitled to an answer to their question: "Is this the way to run an industry?"

I am the last one to claim that there are easy answers. But I believe we can benefit from a shared understanding of the forces at work. To the extent that the insurance cycle is of our own making, we have it in our hands to dampen its amplitude in the future. I believe this would be in the interest of both our customers and shareholders. Customers could benefit from a more predictable and presumably also more stable development of their total cost of risk, while shareholders should be attracted by a potentially smoother path of earnings.

It is in this spirit that I would like to offer my thoughts on the insurance cycle by discussing three fundamental questions. What is driving the ups and downs in our industry? Where are we in the cycle? And what are the lessons to be drawn from the recent experience?

At first look, the question "what is shaping the ups and downs?" can be answered simply. Like any other business, the insurance industry responds to incentives. When rates of return are promising, companies expand capacity and compete for additional business. Eventually, this will drive prices down. Profitability becomes compressed; insurers become more selective and announce that they are prepared to forgo business that appears to be unprofitable. They will do so until unfilled demand drives up prices again.

This behavior is not atypical in many industries. It is well known to students of economics. In fact, the pattern described is called “hog cycle” by our friendly practitioners of the dismal science. I leave it up to you whether this name suggests a compliment or an insult.

What I just described – that the insurance cycle is driven by changes in profitability – leaves out many explanatory details. Now this is not the place to discuss the factors determining our industry’s bottom line. For today’s purpose it must suffice to say that poor management and a lack of clear focus would seem to be behind the recent cycle. Lured by high returns on financial assets insurance companies neglected to pay proper attention to the underwriting side of their business. If anything, they must accept the blame for not properly sticking to their knitting and honing the skills that are at the core of our industry.

Perhaps it is the privilege of the outsider to make innocent comments. Of course, after more than two years in the business I cannot claim to be an outsider anymore. But when I joined Zurich and analyzed the profit and loss statements of our company and the industry, one thing struck me as paradoxical. This was an industry driving on a business plan with built-in losses. Over the last 20 years US property and casualty insurers recorded a combined ratio of 108%. In other words, they incurred on average 108 dollars in underwriting losses and expenses for every 100 dollars of premiums collected.

These figures are staggering. To be crystal clear: combined ratios of more than 100% are sustainable only as long as losses from underwriting can be recouped with comparatively high investment returns. Obviously, our industry was banking on financial market returns, a bet that had to turn sour as we now all know with perfect hindsight. Indeed, the recent years provided a sober awakening. Today, no one is questioning the necessity of reducing the industry’s dependency on financial market returns. The only proven way to do so is by making an underwriting profit, by properly managing, allocating and collateralizing balance sheet risks, and by driving the combined ratio to below 100% over the whole cycle.

But that’s not enough. Making an underwriting profit is only the first step towards ensuring that we are adding value to the economy. Simply put, we must earn a return on equity that covers the cost of capital. If we fail to do so, we are not going anywhere fast. That's why our survival in the market depends on our ability to develop and implement a business model that is designed to generate stable and profitable returns.

Now I am quite aware that profitability is often seen as a dirty word. But we could easily delude ourselves. If we are not profitable, we will lose the support of our shareholders and we will fail to meet our obligations towards our policyholders. Why should shareholders give us their capital if we cannot reward them properly? Of course, we know the answer. They will not do so; they will rather seek out other investment opportunities.

But that is not the end of the story, because if we are not profitable, we will also fail to accumulate the reserves necessary to pay for the claims filed by our customers. We would lose out on our essential role in society. The mitigation of risk depends on our ability to honor the promise given to our customers – that we're there when they need us in distress.

To close my comments on profitability on a positive note, I believe it is fair to say that our industry has learned the lessons from the recent cycle. In 2003, many insurers adjusted their portfolios to focus even better on the core of their businesses. They reduced balance sheet risks and strengthened their asset and liability management. 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. The industry also returned to a more realistic pricing with a clear commitment to sound underwriting. Clearly, the building blocks are in place for a better business model, one that may help us to break out of the stark cyclicality of the past. We now must assemble them correctly and put them to good use.

This brings me to the second point I would like to address, to the question of where we are in the cycle. Clearly, our industry has turned the corner. Net income in the US P&C industry was close to 30 billion dollars in 2003 and we expect the industry to record an underwriting profit in the current year. That would be the first underwriting profit since 1978.

Given these developments, the question whether prices have peaked and whether our industry is in for a "soft market" appears to be legitimate. Indeed, double digit rate increases across the whole spectrum are a thing of the past. In our US liability business, for example, rates increased between 5% and 10% in the 12 months ending on June 30. In property they went up about 5% overall, although there were some decreases for the largest property risks.

On closer inspection, however, the answer is becoming more complicated. Can this industry really afford an irrational pricing cycle that would defy the first principles of investment and precautionary reserving that I described only a couple minutes ago?

Clearly, the answer is no. This is also supported by general market conditions. The socio-economic environment continues to be fragile. Risks abound, and there is a premium on having access to protection. At the same time we must prepare our businesses for a prolonged period of comparatively low investment returns. Financial markets continue to be in an unstable equilibrium, and the recent oil price shock has put a damper on the growth prospects of the global economy. As we speak, we see the devastating impact of the third tropical storm in less than one month. And we're still counting; the hurricane season is not over yet. But people in these parts of the world count on us to help them get their lives back in order. That is why we need financially sound and strong insurers. This is an environment where insurers cannot lose sight of their primary obligation to underwriting profitability. It would be premature to relax pricing discipline now.

Let me add another reason why I believe that the insurance industry would be well advised to pursue a rational pricing policy. It has to do with the tort system and the burden it places on our industry and our economy. The US economy and the insurance industry in particular are exposed to the most aggressive litigation system in the world. Per capita tort costs are expected to rise to 1,000 dollars by 2005, up from 720 dollars in 2001. This will amount to a staggering 2.4% of national income, more than double of the average of industrialized countries.

We are – and I mean more than just our industry – in dire need of a more balanced tort system. Insurers are at a point where unpredictable and erratic court decisions directly impact their reserving. On the other hand the public suffers from an inefficient system. Only 20 cents of every tort dollar actually compensate the victims for economic losses, while another 20 cents go to non-economic awards. In contrast, nearly 60 cents of every dollar are eaten up by attorney fees, defense costs, and administration purposes. They never reach the victims. Reforms need to address the rights of those who are truly injured, while weeding out frivolous claims. The tort system must be repaired as a matter of urgency, and we must prevent its proliferation beyond the United States.

Let me now step back and draw one final lesson from the recent cycle.

The other day the "Wall Street Journal" quoted the Chief Risk Officer of Danone, the French manufacturer and distributor of dairy products. "Yeah," he said, "You can buy insurance on price. But at the end of the day you will want to rely on an insurer that is there when you need him. An insurer that will honor our claims, and will do so efficiently, and with no great fuss."

I couldn't have said it better. Our industry should not be judged on pricing alone. Of course, this makes our life more difficult, because it requires us to develop a comprehensive approach to underwriting and make the offering understood by our customers. But if we are to succeed in the long run, we must deliver integrated business and services capabilities, and we must increase processing efficiency. We must also sharpen our competitive positions through product design and ever finer customer segmentation. But first and foremost, we must serve our customers, and I believe that there is room for improvement in all of these areas.

I know that your Symposium is not the place to do a commercial, but I hope you will forgive a short plug for our company. As we progress on our transformation at Zurich, we are striving to do exactly these things. In spring we aligned our structure to become the superior global performer you can rely on whenever and wherever you need us. We recognize our obligation to you, our customers, and we aspire to be the company you choose to help you to mitigate the risks you face. Our recent performance is a testament to our strengths and capabilities, and I am confident that we have a solid platform in support of profitable growth going forward. End of commercial.

Clearly, insurers must partner with their customers if they want to succeed in helping them to reduce the cost of risk and to better manage the impact of the cycle. But partnership builds on a two-way interaction. If the public does not develop a more realistic understanding of the role our industry plays in the economy, we are bound to lose. This is particularly true with respect to the regulation and supervision of our industry.

Unfortunately, there are too many examples where politics intervenes with little knowledge of economic or demographic factors affecting our business. Let me be polite and refer only to the home country of our company. In Switzerland we are faced with life insurance regulation that is neither in sync with current low investment returns nor the increased longevity of the Swiss population. But I am sure my German colleagues could add their examples to the list, and so could my colleagues in the UK or in the United States.

The recent insurance cycle has affected the industry, its shareholders and you, the insured. I believe we would all agree that our industry has an important role to fill. Without insurance, businesses cannot assume the commercial risks that come with entrepreneurial activities, and without insurance, households cannot protect their assets against the randomness of catastrophes. But we can meet our social obligation only if we add economic value. Our activities must be based on a business model that ensures underwriting profitability over the cycle. I believe this would be a crucial step towards breaking out of the cycle and providing a stable environment for our customers to do business and our shareholders to invest in.

A world where the insurance cycle has lost its bite is a win-win proposition for everyone. I hope that we can work together towards achieving this goal.

Thank you.