



Cookson Walker Consulting

Recognizing the Symptoms

At the end of January, Cookson Walker presented its annual industry conference on market conditions. After four years, the conference has become a popular kick-off for brokers gathering information to guide their actions in the years ahead. Cookson Walker has asked Aviva's Larry Harrington to summarize his presentation, offering some guidance on how to gain control over the current softening market.

By Larry Harrington

In our industry, the topic of the softening commercial market seems to come up in many day-to-day conversations, along with a view of how long it will last, how far it will go!

While this subject is interesting and timely, we need to look at and understand the behavioural factors that advance a softening market if we are actually going to gain some control over the possible slide to insanity that defines the worst of these markets.

The first obvious behavioural factor is the reaction of companies faced with the fact that they are reaping large profits that appear sustainable, at least for a while. "We are making money, let's grow 10 per cent to 15 per cent this year in policy count," becomes the rallying cry. Meanwhile, the current growth in the economy is 2 per cent. The link between the pressure to grow and rates that bear no resemblance to exposure often begins here.

The next factor is management's message to underwriters that "we need to grow," without any context. If the only tool available to the underwriter is price, guess what happens. Companies need to "create the conditions" that will generate submission activity for reasons other than price. Again, "go and grow" needs context.

It's easy to grow based on price alone. What we actually want is an underwriter to be empowered to assess and price one risk at a time, based on its merits and not be overly influenced by simpleminded messages like "we need to grow." The responsibility for growth rests throughout the company, which needs to create the conditions that will differentiate it in the market. If growth is placed wholly on the shoulders of the underwriter, without context and little support, the result will be growth but at greatly reduced price.

Another factor is the reality that underwriting skills are difficult to teach, which is why we can say that this is a fairly simple business yet difficult to execute. You could liken the job of underwriting to the checkout clerks in a store setting the price for groceries. What skill sets, support and information would the clerks need to be successful? Now tell them to increase sales by 10 per cent to 15 per cent without appropriate support. Next, consider how much more complex commercial underwriting is compared with retailing.

Some companies no longer take a long-term view of the market, with some shareholders often acting like they don't really understand the long-term nature of our business. We now have very tight control of expenses with immediate reaction if the plan is in doubt. If

a branch office does not grow according to plan or shrinks, the underwriters immediately foresee staff reduction. Pressure soon builds to decrease price in order to meet plan expectations.

When a branch office loses a few accountants, especially key ones, panic can set in.

Management really needs to be brave and look at the bigger picture of retention and close ratios. Usually, total retention numbers are in good shape, as ours are, for instance, in this current market. Management must take the time to review lost business for discussion with brokers and, in some cases, negotiation techniques with underwriters.

When brokers lose some accounts unexpectedly, especially key ones, they sometimes panic and start the "re-marketing" cycle. "The sky is falling" scenario comes to mind.

Brokers need to be leaders as well and keep a watch on the actual retention numbers. Re-marketing, loss of commission and loss of profit-sharing is a very high price to pay. Often, brokers complain of company pricing behaviour, and yet, they are also prone to mass re-marketing and to spreading the "lost business at crazy price" rumours.

I have analyzed many of the cases and more often than not, have found that the rumoured price was not the one issued and that many other factors were at play. However, without a doubt, I have seen some decisions concerning price in this market that make no sense by any standard.

Another factor is the use of lag indicators to measure performance. We are all well aware that today's results don't reflect business that is currently being written. They have been generated by business written well over a year ago, on average. Today's results certainly do not reflect the current real condition of rate versus inflation versus building costs. The proper use of lead indicators would consider these issues. Good leadership requires close assessment of lead indicators as good leaders are more often focused on the cause rather than on just the effects.

What, if anything, is different this time? With some exceptions, we have witnessed a fairly soft landing from a hard market to a softer one, which may indicate that we are in for better behaviour this time than in the last cycle. Investment returns are poor and, when coupled with building cost estimators at over 5 per cent a year and casualty inflation projected at more than 10 per cent, anyone exploring lead indicators can foresee disaster if rates do not stabilize. There is no room this time around for "cash flow underwriting."

Advancing a softening market seems to be a team play that hurts both companies and brokers. In addition, the customer suffers wild swings in price and the media gets grandstand about our large profits once or twice in every five or six years.

The bottom line is not to panic after some account losses and to keep the balance between rate and overall retention numbers. In fact, there is a great need to maintain a point of tension between rates and retention numbers.

Our business may be simple in principle yet due to its complexities in execution, it requires more depth and insight than ratemaking through a few actuaries manipulating

historic data. As important as actuarial pricing is, a total focus on pricing only is a “one-trick pony” that will ensure you lose in the end.

Companies really do need to insulate the underwriting process and create the conditions necessary to attract and retain business. Underwriters require ongoing management support and clear direction through management’s involvement as well as feedback at the transaction level. Small rate changes up or down are easier to fathom for the customer than large ones. Stability equals credibility to the customer.

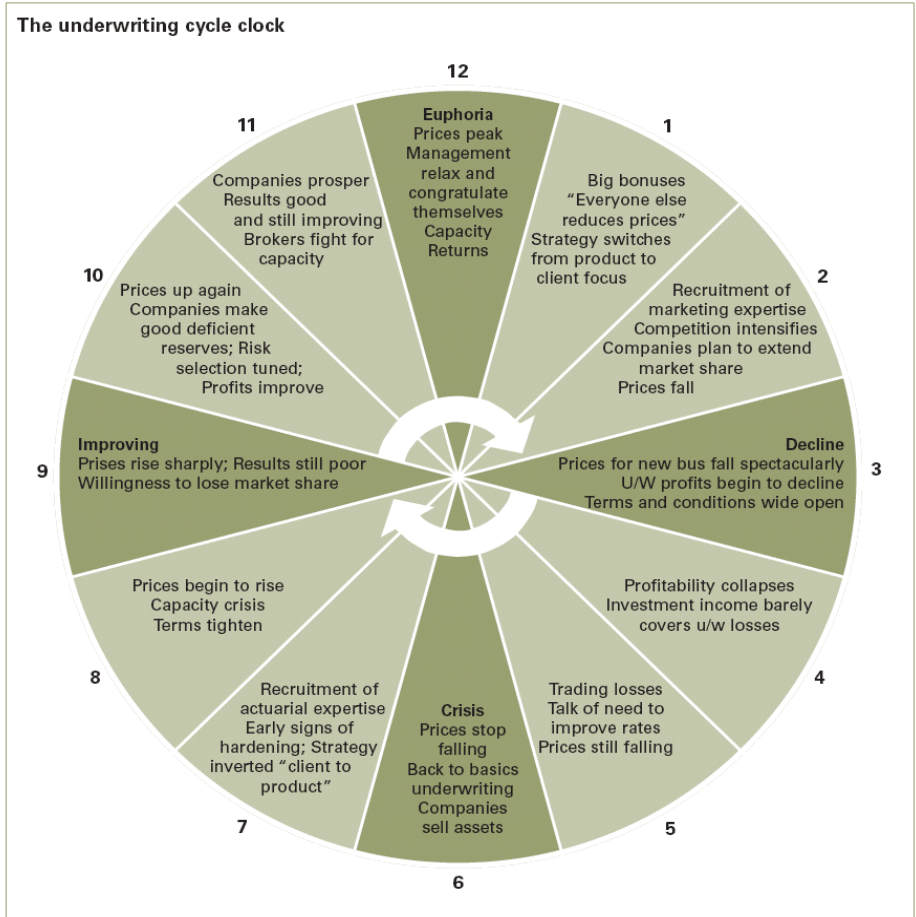


Chart 2: Based on an idea by SG Warburg

And finally, be thankful if you are blessed with a knowledgeable shareholder who understands market cycles and the importance of a steady hand in the application of growth targets and expense expectations. Low-cost operation may make sense in personal auto but it likely won’t support a robust investment strategy in commercial over the long run.

Keep in mind...

- ◆ Poorly managed companies (including brokerages) cave in quickly and chase business by chasing rates down. They think that’s all they can sell.
- ◆ Poorly managed companies tend to ask four questions on a commercial application and then say go ahead and bind.
- ◆ These are the same companies that will be re-underwriting again in a couple of years. What do these actions end up costing companies, brokers and consumers?
- ◆ Good leadership utilizes lead indicators, invests adequately in its business and utilizes “transaction level” techniques to understand and manage at the cause level.
- ◆ The quality of the organization and its leadership is a direct reflection of the company’s ability to manage the cycle.

- ◆ Except by some magical process, will “go and grow” actually translate into lots of profitable growth at the expense of competitors?
- ◆ Underwriters well versed in execution skills make a difference.
- ◆ The Canadian market cycle lasts 5.6 years on average. This cycle has happened over and over again. One definition of insanity is doing the same thing over and over again and expecting the results to be different.
- ◆ The behaviour of the market overall is spooked by whispers and influenced by rumours, and “one off” situations can become the norm.

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