

Capital and finance: Bigger is not always better

Motor (or Auto for our American brethren) insurers are suffering from claims inflation. BRAVE Partners comments.

AUGUST 28, 2011

Many of us who have worked in both the UK and USA can see some cultural differences that are clearly defined by the adverts on television. It is interesting to speculate what a group of little green men that had recently crashed their UFO into a living room might make of: the UK where every second advert is for cheap car insurance; the USA where every second advert is encouraging an individual to speak to their doctor about taking a certain medication for a particular ailment, most of which seem to affect men of a certain age. Discretion prevents us from divulging more, but some of the adverts, available on YouTube (eg <http://www.youtube.com/watch?v=NyMXahpRVV4>), are self explanatory.

Regardless of what a bunch of Martians think of the different cultures in the UK and the USA, the point is that the car insurance Market in the UK is highly developed and highly competitive. It is therefore a shock that premiums are rising rapidly in the face of shrinking economic activity and a generally soft insurance market.

Claims management

Rising premiums in a highly competitive market must reflect rising claims. This is supported by recent news from Admiral. The Insurance Insider reported on August 24 that Admiral's shares fell by 12% due to fears over claims. This was precipitated by a shift in the business' combined ratio from 82.8% to 90.4%.

Rising claims rates in economic downturns are well known to insurers and factored into pricing, but what has been happening in the UK motor insurance market is unprecedented.

Cashing in

Rising insurance claims in a deteriorating economic environment is a well known phenomenon. Some policyholders might take the view that their insurance premiums are a little like a savings account. Motor insurance is suffering particularly badly. Some of the BRAVE Partners had an interesting discussion with the management of a major motor syndicate in Lloyds at a reception a couple of months ago. There were stories of a whole coach party making a claim for whiplash injuries, but various videos of the incident made it tough to believe the story. In fact, it could have been that the people making the claims were not even on the coach that had had the bump. From the description, it is hard to even call the event a crash. All of it does drive claims rates higher for sure. Moreover, a recent TV documentary investigated a gang that were systematically arranging and staging crashes for insurance claims. At the

very least, such activity will drive loss adjustment expenses higher, but, with systematic fraudulent claims being made - some will get through undetected.

Inflation

However, increasing claim rates cannot be fully to blame. The news is also abound with stories about rising inflation rates. The prices of commodities almost relentlessly rise, apart from a few brief periods

Insurers do not seem to analyse the factors driving their liabilities and invest their assets accordingly. This is the basis of good asset liability management.

where the markets, perhaps prematurely, announce the end of the world. The prices of coal and iron ore, and therefore, steel continue to rise. On the energy side of its business, BRAVE Partners continues to develop a number of transactions that are driven by a mid-term view that UK electricity prices will continue to rise. A quick review of the supply and demand data shows rising demand and falling supply. More expensive materials and energy will drive up the cost of

repairs. Moreover, rising inflation will mean higher liability payments when these are settled through the courts.

Future Premiums

Some argue that rising inflation is good for casualty insurance businesses because future premiums will rise and these will cover future claims. To BRAVE Partners this is an absurd argument. It would seem to ignore the fundamentals of the profit generation of an insurance business. The profit of an insurance business is driven by taking in premiums and investing any unearned premium reserve or loss reserves until these are paid out as claims or realised as profit. If an insurance business has to rely on future premiums to cover claims, then it is fundamentally unprofitable.

Asset Liability Management

The issue amounts to asset liability management (ALM). Within the insurance industry ALM is really seen as the domain of the life insurance business. Life insurance is usually seen as the poor, possibly illegitimate, cousin of the property and casualty business (it is all about mucky assets and life actuaries telling you when people will die!). To be realistic, apart from the word insurance there are not that many similarities between the two business. However, ALM is one thing that the casualty business could learn from the life business.

The lightning strikes 12:01

A good friend of the BRAVE Partners tells a great story about one property insurance business that he started. The largest exposure on their books was the local town hall. The cover inception at midnight (12:00) on January 1. At 12:01 that day, one minute into the cover, lightning struck and the building burned down. Short tailed property business is not amenable to ALM. The assets are held for a short and unpredictable time period. Market fluctuations could play havoc with this type of business if it had to realise large volumes of assets in times of Market stress. Asset management for short term property business is all about liquidity management. Investments should be in near cash investments, available to pay claims as needed.

A casualty of the industry

Casualty business is different to property. It is called long tailed for a reason. Claims take years to be settled, but during that process the exposures and the drivers of those exposures are known and information improves and develops. At the very least casualty claims will grow with inflation. More specifically, in a soft market environment with increasing competition, casualty insurers should begin to develop ALM strategies to boost income. Relying on future premium flow is selling tomorrow's profits to pay for today's mistakes.

BRAVE Partners' services

BRAVE Partners excels where clients are seeking advice on transactions that lie outside the ordinary. The partners have advised a major US industrial firm on hedging their exposure to healthcare cost inflation. The firm has developed and arranged a number of transactions for insurance companies to hedge against the risk of rising commodity prices and other forms of inflation in both the non-life and life industries. The firm is committed to developing this business.

Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on commentary@bravepartners.com

If you would like to comment on the content of this piece, then please send an E-Mail to discussions@bravepartners.com

- Economic conditions are driving claims in the UK motor market, pushing down profits and pushing up premiums.
- The relationship between a weak economy and increase claim rates is well known.
- BRAVE Partners believes that insurers could better assess the impact of inflation, GDP and commodity prices on their business.

- The BRAVE partners have a track record in advising on and arranging transactions for esoteric risks.
- BRAVE Partners can work with casualty insurers to devise and execute an asset strategy to match their liability exposures.

enquiries@bravepartners.com

www.bravepartners.com

OFFICE: +44 844 997 0271