tgp management advisers llp
65 new cavendish street
london W1G 7LS
t: 01483 503658
f: 01483 457630
w: tgpadvisers.com

THE TGP NEWSLETTER: ISSUE 1 - FEBRUARY 2005

Negative Growth – the Challenges

Lloyd's recent announcement that premium capacity will be less for 2005 than it was for 2004 will have come as no surprise to most observers. With rates expected to come down, Lloyd's is set to receive less premium for the same risks, and a growth in income in such circumstances would mean a real growth in underlying exposure but at less adequate prices. Companies are not generally subject to premium limits in the same way as Lloyd's syndicates, but the principle is there in the observance of solvency requirements, which are themselves, a product of premium volumes.

If the FSA is serious about imposing tough operating rules on companies too, then it should expect to see company premiums dropping in 2005 as well as those at Lloyd's. For some companies this will represent an interesting challenge.

Aside from major corporate restructurings, following the exiting of territories or significant lines of business, there has generally been an assumption in the company market that year on year premiums should grow. Indeed, in many companies so deeply embedded is this attitude that any business plan that does not display top line growth will be looked at askance. A number of reasons may be found for this view. One is the (often unspoken) belief that 'a business simply has to grow'. Quite why this opinion is held is not altogether clear. A new business has, of course, to reach a point known as 'critical mass', otherwise it will not meet even its fixed costs and can never generate a profit. In insurance, in addition, it is important to have a book of sufficient size to permit the operation of the law of large numbers, on which the business depends.

The matter of critical mass aside, however, the pursuit of growth for its own sake, when market conditions are adverse, will end in tears, as we have seen over and over again. So why do companies do it?

One reason is that negative growth is difficult to manage. This is particularly true where companies have built up significant overheads in the form of weighty non-front line departments (Group IT, Group Purchasing and the like) the costs of which just seem to keep on increasing. Another is adverse impact on cash-flow, as premium volumes drop but claims still need to be paid. Sometimes growth appears to be mandated by the need to keep the expense ratio constant following the authorisation of a big spending project.

But going for growth in softening market circumstances only seems like a solution – it is almost certain to create a long-term problem. Has the company market really learned its lesson this time? We shall see.

Regulation, again

Shirley Beglinger's newly published book on this subject* cannot be criticised on the grounds either of a lack of forthrightness or of being insufficiently radical. Some commentators have questioned the practicality of certain of her proposals and we would not demur from their view. That said, the author makes a number of telling points, not least in relation to the inadequacies of current and proposed methods for measuring exposure; the dangers of trying to read across from banking regulation to insurance and the lack of front line P/C experience to be found both within the regulators themselves and at the top of a number of insurers.

The stock response of regulators to insurance failures, that of requiring insurers to hold increasing amounts of capital ('wonga' as Ms Beglinger describes it), seems to us to carry more than a few dangers. One of these is knowing how much more is enough. It is worth remembering that, in the pure air of insurance theory, if an insurer could always be assured of obtaining sufficient premium for the risks that it writes, it would never need any capital at all. While we would not advocate the total abandonment of capital requirements, simply pushing insurers to hold more capital does not address the question of premium adequacy and can give rise to at least two practical problems.

The first of these comes from the need to make a return on this higher capital. In theory this should lead simply to higher premiums, upsetting no one other than buyers of insurance. But the competitive dynamics of the market may render the raising of prices to the levels dictated by the higher capital requirements impractical. Premium growth can then be achieved only by the acquisition of more business at prices lower than the holding insurer's and thus increasing exposure (which we still are not measuring effectively, at least not at regulatory level) above the amount that the premiums alone would suggest.

The second potential problem comes in relation to larger risks, where the need for capacity alone may restrict the ability to trawl too much of the market. But large buyers of insurance are sophisticated beasts that understand return on capital well enough. No need to tell them about alternative insurance mechanisms and at what point they become viable. So one effect of higher capital requirements may be to drive more business to the less stringently regulated area of alternative loss funding. And all will not necessarily stop there, because of the propensity of captive insurers to become involved in non-related risks (usually with grim results).

Waiting for the regulators to come up with meaningful exposure calculations, premium adequacy measures and risk management methodologies is no solution: Godot will certainly turn up first. It is up to insurers themselves to solve these problems if regulation is not to drive them to the limits of endurance.

*'Regulation of the non-life insurance industry. Why is it so damn difficult?' by Shirley Beglinger (CSFI). Available from centralbooks.co.uk

Newsletter information

This newsletter is issued approximately bi-monthly by TGP Management Advisers llp (http://www.tgpadvisers.com)

To subscribe, email subscribe@tgpadvisers.com. To unsubscribe, email unsubscribe@tgpadvisers.com
Alternately you may visit www.tgpadvisers.com/newsletter.htm , enter your email address and specify subscribe/unsubscribe.

All comments, feedback and other queries to feedback@tgpadvisers.com

Archives at www.tgpadvisers.com/newsletter