

The Insurance Industry:

Why Wait for a Burning Platform to Change?

Our industry needs to change. It needs to change fundamentally and it needs to change quickly. It needs to change for the defensive reason that our clients derive less and less value from it and it needs to change for the offensive reason that there has never been more opportunity than there is today to add value to our clients.

By Bruce Carnegie-Brown

Change is difficult and painful, but it is a core belief of mine that change we make for ourselves is less painful than change imposed from outside. Arguably, change is already being imposed from outside. Those of us who work for U.S. headquartered brokers and underwriters have had significant change imposed on us by the N.Y. Attorney General. Those of us in business in the U.K. are still in our first year of regulation by the FSA, and no one doubts that regulation will bring change to our industry. For some, the platform is already burning. For all of us, the message must be that the pace of change needs to accelerate.

But the changes we need to make should not be driven by regulation. Rather, they should be driven by opportunity.

Risk is a growth industry, and if we do not seize the opportunity, others will. We all know that there are increased hazard risks in the world: from flood and drought, and from wind and fire; and we all know that there are significantly greater operating risks. For manufacturers and retailers these risks are reflected in fewer, larger manufacturing plants, just-in-time delivery, extended supply chains, a greater concentration of suppliers and increased product liability. For professional services companies, these risks are reflected in greater liability for the consequence of advice given – for instance, in pensions or mortgage misselling, money laundering, data protection, and intellectual capital.



Natural disasters like hurricanes Katrina and Rita sit alongside man-made threats such as the London bombings of July 7, 2005; the power of consumers, supported by the courts, has broadened and increased liability risks in all aspects of commercial activity; the power of regulation has dramatically increased the responsibility and accountability of business leaders for all activities of their enterprise – foreseen and unforeseen – and often with the benefit of hindsight, at the same time as the demands of shareholders have put more pressure on business by increasing the speed at which products need to move from the drawing board to the market; by extending our supply chains, as we search for the highest quality components at the lowest price across the globe; and by reducing the capital intensity of businesses, so making them more dependent on just-in-time delivery. All of these risks and many more confront our clients – personally, professionally, commercially – and they need help. They need our help. And to help them, we need to change our industry.

The changes we need to make fall into two broad categories: increasing our value proposition to clients and improving the efficiency of our business processes. The two are closely

connected: improving our processes will add value to our clients, and focusing more of our time and energy on adding value to clients will force us to re-engineer our processes.

Increasing Our Value Proposition

There are many drivers to adding value to our clients. I'd like to talk about two: innovation and data management.

Innovation

If the principal driver of pricing in our market is the supply of and demand for insurance capital, then we are in a commodities business. In fact this is true of all capital markets – all products commoditize over time as competitors copy them and compete on price to win market share. To offset this inevitable trend towards commoditization, we need to innovate.

One reason to innovate is to differentiate ourselves from our competitors. It was my experience in the banking industry that in many cases we would market very innovative ideas to clients, and clients would still end up buying the plain vanilla product at the end of the day. But we were still differentiating ourselves from other competitors in the marketplace and demonstrating that we'd thought about a huge variety of issues before coming back to some of the more tried and tested products that the client felt most comfortable with. Our market does a poor job of differentiation, and a greater focus on innovation can help to address this.

Another area of innovation I want to address is the trading of risks in our market. The insurance market today is still a cash market, where risks are traded once on renewal. This is sometimes supported by facultative reinsurance, and once a year insurers review their treaty reinsurance arrangements. But that is all. By contrast, in banking markets, when a risk is incepted it is then actively traded, sometimes in the case of foreign exchange transactions, minute by minute. Even in the case of a corporate bond issue, there will be several trades a day during the bond's early life.

If we look at the growth of banking markets over the last 20 years, we can see that underlying transactions are closely correlated with GDP growth and economic activity, just as they are for insurance. But there has been explosive growth in derivative activity related to these cash assets.



This derivative activity has attracted new specialist capital into the market focused on specific risk classes: currencies, interest rates, credit risk, mortgages, equities, etc., and this capital has improved the risk management tools available to investors (which are equivalent to underwriters in the insurance model) to change their risk position in between the inception and maturity of a risk.

The loan market is probably the part of banking that most closely resembles the insurance market. Fifteen years ago, banks engaged in the business of making loans could decide to be long credit risk or very long credit risk, just as insurance underwriters can decide to be long insurance risk or very long insurance risk. Today in banking, it is possible to be a very active participant in the lending business and yet to be short credit risk. These tools and techniques have offered immense growth to the banking industry and would offer similar growth to insurance markets as well as providing improved hedging tools for managing our risks.

A small start in this direction would be to increase our ability to quote for multiple-year transactions. Well over 90% of all insurance contracts have a one-year term. This may create an annual opportunity to reprice the product, but it also compounds the impact and volatility of changing market prices. A clear goal for our industry must be to reduce the high volatility of prices and capacity in the insurance market. If the volatility of the insurance market itself is greater than the volatility of the underlying risks it is designed to protect, then the value of buying insurance is greatly diminished.

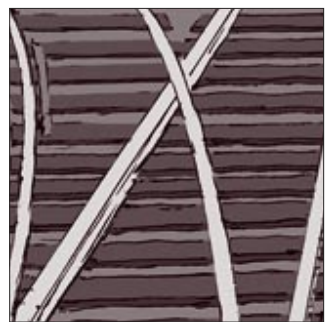
So how do we reduce this volatility? Longer dated contracts would reduce the risk for both insurers and insured of sudden changes in market pricing. Participants could reduce their risk

by extending the average duration of their insurance contracts, a concept well understood by investment professionals (many of whom work on the asset side of insurance companies' balance sheets). Furthermore, offering contracts of two, three or four years also increases choice. In the insurance market this would be a valuable innovation. Not only would we be offering more choice to clients, we would learn more about our clients' risk appetite. It would also create a risk-pricing curve which would enable a forward market in insurance risks to develop. Out of forward markets come futures markets, and a derivative market would be born. This would enable insurance underwriters to price and manage their capital across the cycle more efficiently, as well as having a beneficial impact by reducing the volatility of insurance prices.

The answer usually given for why this has not happened is that reinsurance markets generally quote only one-year prices, which means that primary insurers cannot lay off longer-term risks should they choose to. Another reason is that when longer dated contracts were offered in the past, clients, aided by their powerful brokers, broke these deals when the market moved against them. Yet another reason offered is that the underlying risks are dynamic and policies need constant amendments and endorsements which change the risk, and therefore the pricing, over time. I recognize these issues, but it is well within the capabilities of the insurance market to address them, and the prize is certainly worth investing in.

Another reason why the development of derivative technology and the more active trading of insurance risks is not only desirable but is a necessity for the insurance industry, is to reduce its capital intensity.

Every day of the week, the insurance industry prices its products without knowing its cost of goods sold. Most obviously, this has been true to the detriment of the industry in the case of asbestos, where a price earned for the product in the 1970s still has cost attaching to it today in terms of increasing provisions for claims, which continue to rise four decades after the



product was priced. In lending banking, in the most extreme and rare example, a bank may lose 40 or 50 times the revenue it has earned on a loan. However, the amount of the loss is at least capped by the amount of the loan. You cannot lose more than the principal you have put at risk. This is not true for insurance, where the facts are that in 2004 the U.S. property and casualty industry made an underwriting profit for the first time since 1978. Put more starkly still, the industry has collectively lost \$439 billion through its underwriting activities since 1980.

To reduce the capital intensity of their activities, banks have not only traded their capital more actively, thereby generating higher returns, they have also diversified their activities into fee-based services. Year over year banks have consistently reduced the percentage of their revenues which are earned from balance sheet and capital-intensive activities, such as loans, and have increased their revenues from fee-based activities, such as asset management, securities clearing and settling, and mergers and acquisitions advice.

Today, insurance underwriters' revenues continue to be derived exclusively from two sources: underwriting risk and interest income earned on the premiums paid. In a low interest rate environment, these interest earnings account for a smaller percentage of revenue than they did 15 years ago. In other words, the insurance industry is as capital intensive today as it was 20 years ago. By contrast, despite the fact that the banking market is allocating increasing capital to traditional products as a result of regulation, banking is much less capital intensive today than it was 20 years ago.

Data management

A second area where the industry – brokers and underwriters – needs to focus to increase value is data. This industry suffers from a lack of independent and objective data. Data is the lifeblood of the banking industry. In a banking environment you can very quickly measure the value creation, or destruction,

of things that you have done and of events beyond your control by the reaction of a share price, of a bond price, of a movement in foreign exchange rates, etc.

In stark contrast, our industry relies on anecdotes and broad cycles. We talk about softening or hardening markets. These are very imprecise terms that need to be supported by accurate data which would both improve the quality of what we do within the industry, and would help our clients in their understanding of the value proposition represented by the insurance market.

Let me share an example. I was talking to a senior executive who runs one of the leading auto insurers in the U.K. He told me that the number (not the amount) of claims in the automobile sector in the U.K. has fallen from 25% of premium written to 16% of premium written in the last five years. And he didn't know why.

Now, it's extraordinary to me, that with the millions of motor cars that are out there, with the millions of insurance policies attached to them, which creates a significant number of data points in a homogenous market, the number of incidents can decline by a third and we don't know the cause. In a bank a one-percentage-point movement in a market of this type would be enough to prompt a detailed inquiry into the causes of such a move and whether this would create opportunities or threats to the market's development. But in the insurance market we are left speculating as to whether air bags or speed cameras or weight of traffic or higher deductibles have contributed to a consistent reduction in the number of claims. The industry's poor use of statistics and poor understanding of data can only serve to reduce its value to its clients. Framed more positively: there is enormous opportunity for our industry if we collect and analyze market data – not just for our pricing engines – but to share with clients and to provide objective benchmarks and measures of performance. If innovation and data management are two examples of where we might focus



to add value to clients, it is improved business processes that will increase our ability to innovate and this is the second area of change I would like to discuss.

Improving the Efficiency of Business Processes

If I look at the components of improved efficiency, they are largely based around technology. But it's too easy just to use the word technology as some kind of a panacea. Our industry has been poor at adopting and understanding technology – what it can and cannot do. But I think it's also been an issue of all participants in the insurance markets – brokers and underwriters – protecting things that we believe are proprietary. First, most of what we do is not as proprietary as we think it is, and, secondly, if we shared it with the rest of the market and used it to create protocols and standards, the growth of the market as a whole would be much greater than it will be with any one of us trying to look after our own particular corner.

Common standards and protocols

The industry has been a slow adopter of technology, not because of a lack of investment, but because of a failure to agree upon industry-wide standards – again the contrast with banking protocols on securities settlement or swap market master agreements is notable. For Marsh, and I believe for the industry too, this means that too many of our processes are subject to error and duplication, have to be reworked and rekeyed into different systems, deliver inadequate management information, and contribute to an unsatisfactory control environment. This inefficiency both increases the cost for our clients and reduces the clients' perception of our value because of our poor execution of administrative tasks.

To address this, we need to automate and standardize all parts of the insurance process which offer individual insurer and broker participants no competitive advantage and create

no value or differentiation for clients. In another example of the close connection between the efficiency of our business processes and our value proposition, the issue arises because of the lack of product development and service differentiation among insurance market participants. This means that we all spend our time trying to compete on less important issues – and inevitably our focus becomes exclusively one of price rather than value creation.

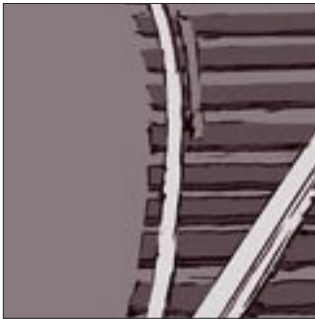
Too often, we fail to differentiate between those activities which we perform which add value and those which are purely administrative. Thus, for brokers, too often we content ourselves with sitting in between our clients and our markets and being very busy on a number of activities without regard to the relative value of those activities.

When we analyze the time spent by our brokers on their work, too much of it is taken up with the administrative functions of trying to agree on wordings and policy amendments and chasing up the issuance of policies. We fail to understand that our clients regard it as surprising that we are unable to issue policies at the inception of a risk contract and regard our subsequent efforts to issue the policy as remediation rather than value added. This reduces the time we allocate to strategic risk issues and undermines the willingness of CEOs and CFOs to engage with us in a fuller discussion of their risk management needs. We are too often perceived to be part of the risk rather than part of the management of the risk. Therefore, our failure to execute basic processes well reduces our credibility in front of our clients when we want to engage them in higher value risk management discussions.

Contract certainty

The twin objectives of value creation and more efficient business processes intersect at the crossroads of contract certainty. Contract certainty encompasses many of the elements which are critical to value creation and business process improvement. Fundamental to the value of insurance is the promise to

pay valid claims in a full and timely manner. And certainty of contract is the best guarantee of that promise. If our clients do not believe that their valid claims will be paid, then the efficacy of the product is damaged and its value proposition is reduced. Key to improving our business processes is achieving the goal of issuing policies at the inception of the risk. The practice of issuing cover notes before policies are issued increases the administrative burden on the industry; the delay between negotiation of the slip and negotiation of detailed policy wordings increases the resources necessary to get the job done. Both activities increase friction costs in the industry. Neither adds value to clients.



Another important issue is the difficulty in standardizing the terms of insurance contracts and the certainty of the contract itself. Insurance brokers and underwriters argue that, particularly for large commercial risks, contracts are specifically tailored to each client. Thus, they are not capable of the standardization necessary to commoditize the underlying units of risk (and, therefore, referring back to my earlier comments on innovation, it is not possible to trade them). Again, I make a comparison with banking. In banking, the credit markets have made significant progress in standardizing contracts. As an example, bond indentures for investment grade debt issuance are remarkably similar. The banking industry has also created standard agreements governing activities in the swap markets. In the credit derivatives markets, participants have expended considerable effort in overcoming difficult definitional issues. For example, what is a 'credit event' which would trigger payments under credit derivatives contracts? Is it when a company actually defaults on payments on its outstanding debt obligation? Is it when a restructuring is announced? What constitutes a restructuring announcement? All of these are at least as complex as contract definitions in insurance. And even when these definitional issues have been addressed and rating agencies have categorized credit risks into different ratings from AAA to BBB-, for investment grade debt, few would argue that all single-A credits are the same. Their risk characteristics

vary from industry to industry and even within industries. This is reflected in the way they trade in the market. But none of these issues has prevented the development of a vibrant market in credit derivatives, which, according to the International Swaps & Derivatives Association (ISDA), was worth a total of \$12.4 trillion at the end of June 2005, a rise of 128% compared with a year earlier.

In evaluating our performance in both adding value to clients and in improving our business processes, I have made frequent reference to the banking market, and you may have gained the impression that I believe the banking market is a role model for the insurance industry. In fact, my view is that in many cases that the value we provide in the insurance industry is much greater than the value provided by the banking industry to its clients.

My reason for saying this is really relatively simple: When I look at the balance sheets of our clients and the risk that is transferred from those balance sheets to the insurance market, it is much greater than the risk which is transferred from the balance sheets of our clients to the balance sheets of banks.

By most measures – revenues, market capitalization, balance sheets – the banking industry is considerably larger than the insurance industry. Aviva, the largest of the U.K.'s insurance companies, is smaller than the top five banks in the U.K. The smallest of these five, Lloyds TSB, has a market value of \$39 billion, compared with Aviva's market cap of \$25 billion. In fact, there are 14 banking groups in Europe that are larger than Aviva. Even the largest insurance companies, such as Allianz or AIG that rival the largest banks in size, are few in number compared to the number of large banks.

However, today, banks do not knowingly take significant risk. Proprietary trading risks are generally very short term, being measured in days rather than months. Most long-tail risks are syndicated, sold or securitized. On retained risks, if a commercial bank experiences loan losses greater than about 2% of its

assets, its profits come under significant pressure. The volatility of banks' earnings is also much less than that of insurance companies', making their earnings much more predictable and allowing them to operate with higher leverage than insurance companies. A bank only makes a loss if it has made a mistake. By contrast, insurance companies, even in a good year, pay out on average 70% of the premiums received in claims. In short, on a risk-adjusted basis, and to the extent it is possible to make comparisons across multiple classes of risk, much more risk is transferred from corporate balance sheets to the insurance industry than is transferred from corporate balance sheets to bank balance sheets.

But that is not reflected in the value recognized by our industry's clients, and this has a direct impact on the industry's return on capital. For the global insurance industry, the return on capital has averaged 8.5% per annum since 1980, compared to, say, the U.S. banking industry where the return has been 15% per annum. Indeed, the fifth largest U.K. bank, Lloyds TSB, is today generally regarded as an under-performer in the U.K. banking sector, yet it still enjoyed a ROE of 23% in 2004.

If my assertions are correct, that our industry takes on more risk than the banking industry, then why is it valued less highly than other professional services industries, and the banking industry in particular?

The answer is that we have let the inefficiency of our processes get in the way of our value proposition to our clients.

We're supposed to spend our time on the areas where we add the greatest value. But in our industry, we spend a disproportionate amount of our time on our processes, confusing clients as to what our value proposition is. And because we spend so much time on the process, we ourselves have become confused about how we create value in our industry. We believe that because we work enormously hard, both as brokers and underwriters, on the process, and because it takes a huge amount of our time, we must be adding value. And when we

get to the end of the process we rather expect our clients to congratulate us for having delivered on this process. But we are often disappointed in their reaction, and they are often disappointed in us.

Given their experience in other professional services areas, our clients expect that when they've actually transferred the risk from their balance sheets into the marketplace, that this will be followed swiftly by the agreement of wordings, the issuance of a policy, and the settlement of claims that subsequently arise. But the effort that we have to go through to make those things happen not only detracts from spending time on more valuable issues, but also confuses the client as to the value that we provide.

An example of this would be wordings: I think wordings for complex risks are a high value activity. It is crucial to the issue of contract certainty; defining the terms of the cover that we provide is material, both to insurer and to insured. But it's the process that is low value, and it's the process that occupies too much time. So the value around the issue of defining terms and getting terms agreed is undermined by the length of time it takes – too often we do not reach agreement, decisions are deferred and client deliverables such as cover notes and policies are delayed as a result.

Conclusion

So why wait for a burning platform to change? Because if it's not already burning, it will be soon. We know what the issues are we have to address. In my view, the only missing ingredients are self-confidence in our value proposition and a sense of urgency. I have tried to show (and I, for one, am convinced) that the value our industry provides to our clients is huge. It is at least equivalent to the value provided by the other professional and financial services industries. But they will not make that argument for us. We need to make it for ourselves. Let's be more ambitious for what we can achieve, and let's begin to fulfill our value proposition by fixing our processes and by focusing on selling the real value of what we do for our clients.

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