INSOLVENCIES OF PROPERTY/CASUALTY COMPANIES IN THE UNITED STATES:

Lessons for Australia

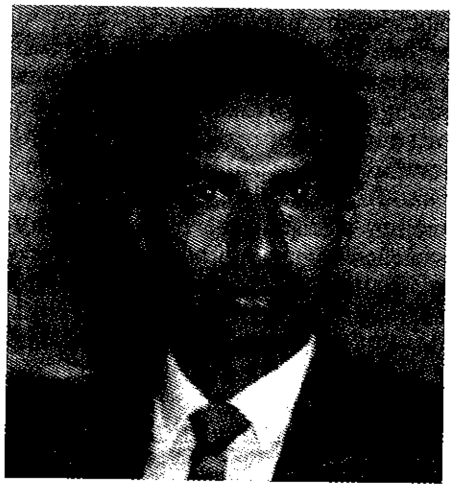
by Tapen Sinha

THE recent spate of events involving Regal and Occidental and other features have created concern in the Australian insurance industry about solvency of insurance companies.

It is therefore timely and of interest to consider developments in the US. A recent study commissioned by the AM Best Company involved data on 372 US property/casualty insurance company insolvencies over the last 22 years (1969-1990).

Although the circumstances, legislation and other factors are somewhat different in the US, the pattern of insolvencies and the factors underlying the insolvencies give us valuable lessons for the future of insurance companies in Australia.

The annual number of insolvencies from 1969 to 1990 is illustrated in the diagram (page 28). Note that 1969 was a watershed in the property/liability insurance in the US because a system of guarantee fund was introduced in almost all states.



Not surprisingly, most of the insolvencies coincide with the business cycles. There were two recessions in the US in the period: in the mid-1970s and in the 1980s. In 1975, there were 29 insolvencies, representing 1.0 per cent of all property/casualty companies and 0.3 per cent of total industry's premium written. In contrast, the 1985 peak produced 49 failures representing 1.4 per cent of all property/casualty companies and 1.0 per cent of the industry's premium volume.

Cost of insolvencies

Most of the insolvent companies were relatively small. Only 11 had payouts over $100 million. The total cost was estimated at $4.4 billion. However, the cost during 1969-1983 was less than $1 billion. Most of the large insolvencies occured in the late 1980s. Who bears the burden of guarantees? To a large extent, the

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PROFITABILITY

The rewards to the bottom line will be there for the companies which take these steps. It requires a team effort involving marketing, underwriting, investment and claims areas in the process. Managers will need to be educated. Managers need to have influence over the factors that contribute to performance targets.

- **The author, until recently principal, Ernst & Young ABC, is now actuary at QBE.**

INSOLVENCY LESSONS

policy holders of the insolvent companies face the short run problem with immediate cash flow contraints due to the insolvencies. However, state guarantees make other surviving companies pay for the losses. Thus, in the long run, it is largely passed on to the future policyholders of property/liability insurance in the form of larger insurance premiums.

There are two broad economic factors affecting insolvencies of property/liability insurance companies: inflation and interest rates. Higher than expected inflation causes costs to run ahead of premiums. Similarly, an unexpected fall in interest rates causes profit squeeze.

The primary causes are shown in the table. The surprising aspect is how much of the failures are attributable to what I call 'management failure'. Inadequate pricing and rapid growth accounted for half of the insolvencies.

Primary Causes of Insolvencies: 1969-1990

	%
inadequate pricing	28
rapid growth	21
alleged fraud	10
overstated assets	10
significant change in business	9
reinsurance failure	7
catastrophic losses	6
miscellaneous	9

Obviously, for many insolvencies, there was more than one cause. In the table, I have categorised the most important as the primary cause.

Can insolvencies be predicted?

One of the indicators of the state of a property/liability insurance company is its rating. As the risk of insolvency increases, typically, the rating gets lower. However, the rating agencies methods are not foolproof.

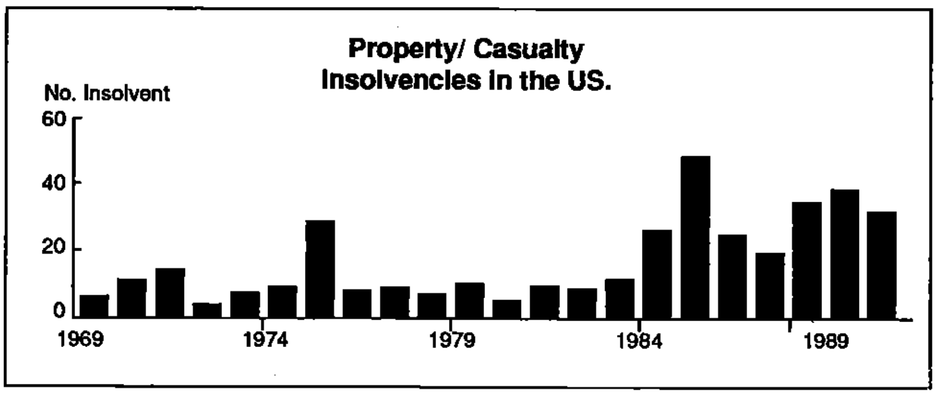
Two hundred and twenty of 372 companies were rated by AM Best's ratings (others either refused to be rated or did not provide sufficient information for ratings to be completed). Of the 220, 22 had a B or A rating, even during the year they were insolvent. In other words, there is a better than one in ten chance of the rating being higher than what it should have been. Not a comforting thought.

Lesson for Australia

Property/liability insurance in Australia is not as widespread as in the US. However with future growth in this area, we are likely to encounter problems similar to those in the US. Clearly, there are lessons for management and the Insurance and Superannuation Commission. The increasing demands on the ISC in relation to superannuation and other factors could affect supervision of other areas of insurance.

Therefore, the need for closer monitoring of the Australian insurance industry will be increasingly critical in the coming decade and executives will need to be ever-vigilant.

- **The author is Associate Professor of Finance, School of Business, Bond University.**



PEOPLE

Ken Boag has been appointed managing director of Tower Life Australia, the Australian arm of insurance and investment group Tower Corporation of New Zealand.

Mr Boag, has had more than 20 years in the insurance sector and was previously general manager – superannuation with Westpac Financial Services in Australia.

An actuary, Mr Boag previously worked with the Australian Mutual Provident Society and the Munich Reinsurance Company of Australia.

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Ernst & Young's national insurance group has appointed **John Hanks** director of regulatory services.

For the past four years, Mr Hanks worked on policy with the Insurance and Superannuation Commission in Canberra. He held the position of assistant commissioner, general insurance

Switzerland General Insurance has appointed **Bruce Bowlby** as Victorian Manager for the Workcare division. As a solicitor, Mr Bowlby was previously a partner with Coltmans, practising in the areas of workers' compensation, personal injuries and industrial relations/employment law.

As a claims administration agency for Workcare in Victoria, Switzerland Insurance employs a team of 170 people.

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