TRI-CYCLES IN HONG KONG

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The Underwriting Cycle

The underwriting cycle is a phenomenon well known to insurance practitioners around the world. Being no exception, Hong Kong has been through one complete cycle of underwriting profit-loss-profit in the last 10 years. The cycle is relatively short, but is perhaps consistent with the speed at which business moves in Hong Kong and the fact there are over 150 general insurers serving a population of around seven million people.

The Economic Cycle

In part, the underwriting cycle illustrated in Figure 1 was related to the economic cycle. Growth in insurance premiums is strongly correlated to the general economy (Figure 2). During the economic downturn, premium growth slowed and insurers competed harder for scarce new business, mostly through lower premium rates and higher commissions.

The second impact of the economic slowdown was on expenses (Figure 3). Like other industries in Hong Kong, insurance companies hired staff, gave double-digit salary increases, and paid relatively high rents during the good times leading up to 1997. In the following years, while premium volumes fell quickly, it took companies a few more years before they were able to bring expenses under control and renegotiate rental agreements. As part of the move to improve profit margins, direct commissions were also put under pressure.

However, while the economic cycle influenced the demand for insurance, it was perhaps the supply of insurance and reinsurance capacity that had a larger impact. The remainder of this article examines how insurers' appetites for risk and tolerance for financial losses changed across the cycle. We examine this for the compulsory lines of business—employees' compensation (known as workers' compensation in some countries) and motor insurance—where the underwriting cycle was most obvious.

Employees' Compensation Insurance (ECI)

The ECI underwriting cycle in Hong Kong can be mostly attributed to construction risks, although certain other risk groups (such as restaurants and hotels) and large accounts have also seen dramatic swings in premium rates. Also, ECI market is mature, and after 1995, the movements in premium volumes in Figure 4 broadly reflect movements in premium rates.

In 1993, a few key players made the decision to refrain from a competitive ECI market. Premiums rates rose in 1993 and 1994, resulting in better underwriting results reported in 1994 and 1995.

FIGURE 1

UNDERWRITING MARGINS OF HONG KONG DIRECT INSURERS

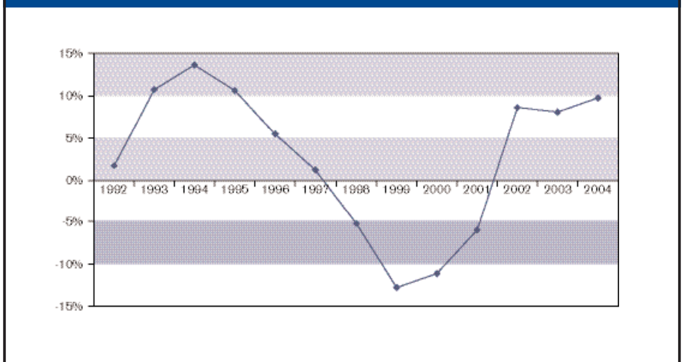


FIGURE 2

COMPARISON OF GROWTH IN DIRECT GROSS WRITTEN PREMIUMS AND GDP

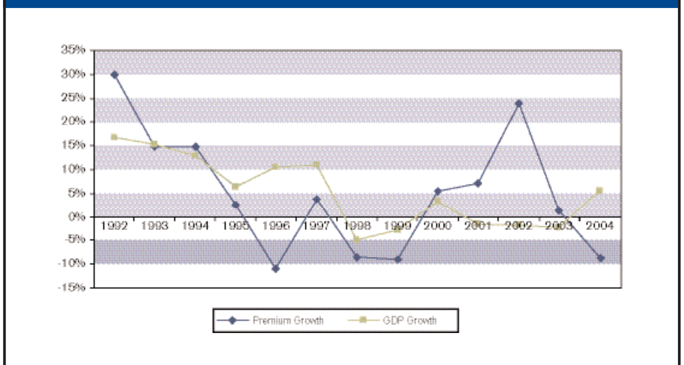
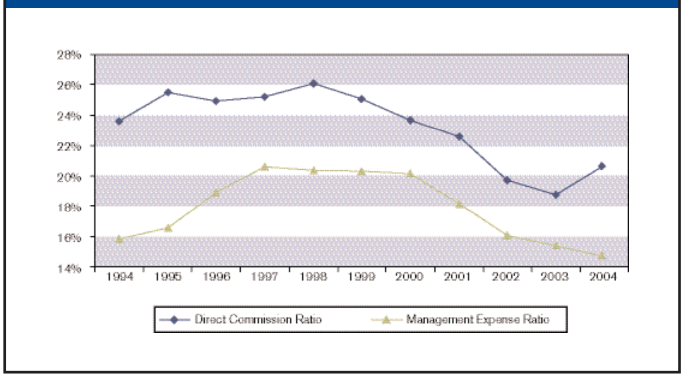


FIGURE 3

TRENDS IN MANAGEMENT EXPENSE AND DIRECT COMMISSION RATIOS



However, direct premium rates quickly came down again in 1996 and 1997, following the improved results and ample reinsurance capacity in the market. Gross underwriting results were worse than indicated in Figure 4 as a disproportionate share of losses was absorbed by reinsurers.

The years following 1999 were eventful due to a confluence of events contributing to a continuous hardening of direct and reinsurance premium rates and better underwriting results until 2003.

- The extent of losses from aggressive underwriting decisions made in prior years was now obvious.
- The failure or closure of an ECI under-writer in almost every year from 1999, the most significant being HIH in 2001.
- Underwriting restraint exercised by a small circle of influential ECI underwriters.
- Increases in reinsurance rates and tightening of terms beginning in 1999, precipitated by the events of September 11.
- Better risk management and improve-ments in safety at construction sites

Premiums rates fell significantly again in 2004. The actual 2004 underwriting performance may ultimately turn out to be worse than that currently reported.

The Under-Reserving Cycle

The underwriting cycle in Figure 4 was exacerbated by an under-reserving cycle. ECI outstanding claim reserves were largely inadequate prior to the introduction of mandatory actuarial reserve reviews at the end of 2001. Also, there were long delays in court hearings making reserving for ECI liabilities more challenging. Effective steps to speed up proceedings were taken in 1999.

During the "boom" years, continually increasing premiums exceeded claims. The underestimation of claim liabilities led to the underestimation of premium rates, perhaps unbeknown to senior management. However, claims continued to grow even when premium volumes started to decline in 1996. In other words, the poor underwriting results in 1999, for example, do not necessarily reflect the profitability of policies issued in that year, but also reflect adverse developments in claim reserves for business written in prior years. Eventually, the combination of these "exaggerated" losses, hardening reinsurance rates, and the financial impact of actuarial reserve reviews led to dramatic increases in premium rates.

One could say under-reserving and perhaps a poor understanding of true underwriting profitability led to a delayed reaction, and consequently drastic corrective measures. Not surprisingly, the public and political image of the Hong Kong general insurance industry has been somewhat tarnished in the last few years.

It would appear that in the last few years, with improving margins, some insurers may have started to hold higher reserves. We may see some of these reserves released when underwriting results begin to fall below expectations.

Motor Insurance

The underwriting cycle for motor insurance is less dramatic in comparison, mostly because it is easier for insurers to ascertain their true underwriting margin, at least for the short-tailed property damage component of this coverage. However, from conversations with a few motor underwriters, the variation in motor premiums rates were rather more limited than that implied by the swings in underwriting margins illustrated in Figure 5. This suggests there was also an under-reserving cycle, probably due to difficulties in assessing the liability claims.

Underwriting margins were at their highest in 1993 and 1994 as the result of premium rate and deductible increases following a spate of car thefts in the preceding years. At the same time, tighter border controls (the

FIGURE 4

ECI EARNED PREMIUMS AND UNDERWRITING MARGINS

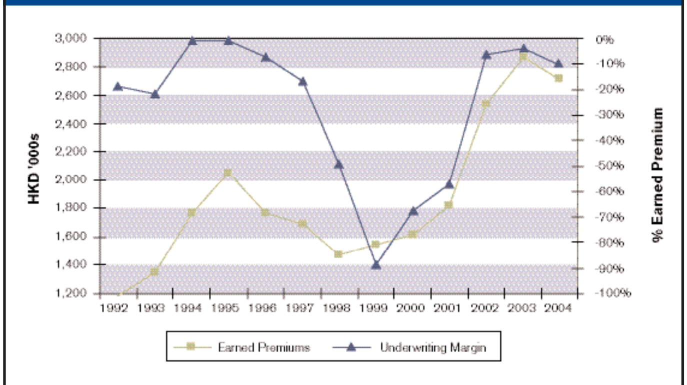
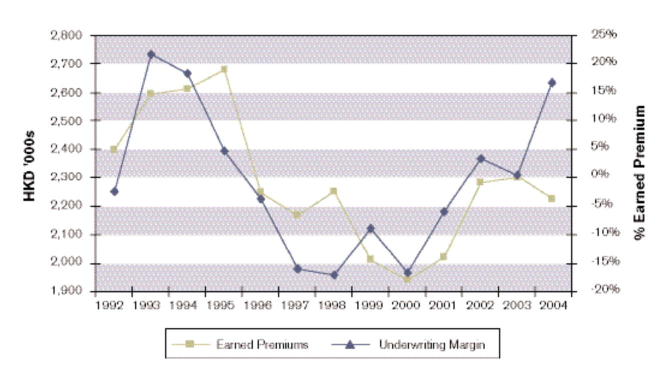


FIGURE 5

MOTOR INSURANCE EARNED PREMIUMS AND UNDERWRITING MARGINS



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stolen cars were headed for China) led to lower than anticipated claims, leading to record high underwriting margins.

Competition ensued shortly thereafter. The slowing economy after 1997 led to fewer new cars on the road, policyholders switching from comprehensive to third-party coverage (where underwriting margins are lower), and ultimately a smaller motor insurance premiums. Insurers competed through reduced deductibles and premium rates and to an extent, higher commissions, even while expense ratios continued to creep upward.

The situation only started to turn around after a few years of sustained losses and increasing reinsurance rates prompted a number of key players to reconsider their underwriting positions. As with ECI, the further hardening of reinsurance rates following September 11 and the anticipated introduction of actuarial reserve reviews at the end of 2001 had a significant impact.

The reader should note that the underwriting margin reported in 2004 is artificially high, and results from a significant reduction in claim reserves.

Lessons Learned?

Perhaps not. ECI and motor premiums have started to fall again, particularly in the second half of 2004. In some cases, ECI premium rates dropped by 50% or more.

At the same time, government construction projects that to an extent supported the industry have tapered off.

ECI and motor are mandatory coverages and commodity products that will always be subject to price competition. But how crazy will it get? The use of actuaries and the effective steps taken in 1999 to reduce waiting times for court hearings will certainly help provide insurers with a surer footing when trying to understand their liabilities and the profitability of the policies they are about to issue. Perhaps this time around, the industry will do a better job of demonstrating to the public that it is composed of professionals who quantify and manage risks.

The insurance statistics in this article are from the Office of the Commissioner of Insurance.

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