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The economic and insurance impact of an avian flu pandemic

There are news reports everywhere on the subject of H5N1 avian influenza, or "bird flu." Reports track the progress of the virus, its chance of becoming transmissible among humans, and the possible response from government and the medical community. What is sometimes left unreported is the economic impact of a pandemic. The SIR (Society of Insurance Research) Spring 2006 Workshops and Seminars had a panel discussion on avian influenza in its "Insurance Hot Topic" session. The panel included experts in public health, economics, life insurance, health insurance, and property-casualty insurance.

Historical pandemics

During the 20th century, there were three influenza pandemics: the Spanish flu of 1918-1919, the Asian flu of 1957-1958, and the Hong Kong flu of 1968-1969. Of the three, the Spanish flu was the most severe. According to a December 8, 2005, Congressional Budget Office report, *A Potential Influenza Pandemic: Possible Macroeconomic Effects and Policy Issues*, there have been between 10 and 13 influenza pandemics (or possible pandemics) since 1700. While far from a rigorous study, these data suggest a 3% to 4% probability of a flu pandemic in a given year.

The economic impact of a pandemic can manifest in many ways. An immediate impact will be the increase in demand for health care services. Hospitals and doctors' offices will have an influx of patients. Soon thereafter, health care workers themselves may be exposed and become ill, reducing the number of people able to provide care.

Travel, especially international travel, is likely to decrease significantly, decreasing revenue for transportation, lodging, and related industries. People will avoid going to locations known to have an outbreak, but also may avoid any travel as a way to eliminate the close contact with others that is typical in airplanes and other modes of transportation. Travel to Hong Kong during the April 2003 SARS outbreak (biologically unrelated to influenza) decreased two-thirds from its level in March.

Nonessential activities likely will decrease as people avoid public places such as theaters, sports arenas, restaurants, and

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Competitive intelligence

A new way to better decision-making

More insurers are turning to competitive intelligence (CI) operations as a way to improve their understanding of competitor actions. Currently, CI structures and their focus are developing in different directions, except that insurers and their CI practitioners are looking to increase their professional skills. It is not yet clear if insurers' new/renewed interest in CI is a cyclical response to softer market conditions or a more enduring answer to the need to increase precision in results. However, the movement to CI can enhance the competitive advantages of efficient insurers that have more desirable product features.

The goal of CI is to improve decision-making

More insurers, particularly property-casualty insurers, are building internal CI practices within their organizations. As evidence of the insurance industry's recent attention, the SIR (Society of Insurance Research) included CI in its Spring 2006 Workshops and Seminars—its third seminar in a row to feature CI. Judging by the continued support of these workshops and by comments from participants and presenters, more insurers will be developing or redeveloping this function as a vital part of their operations in the coming months and years.

Why are insurers investing in CI? At its core, the goal of a competitive intelligence practice is to improve decision-making by providing insights about competitor activities and capabilities. Data

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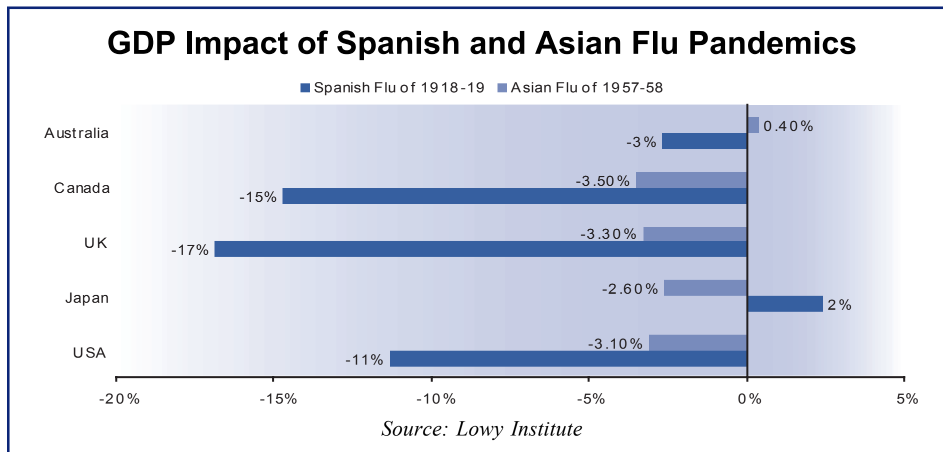


GDP Impact of Spanish and Asian Flu Pandemics

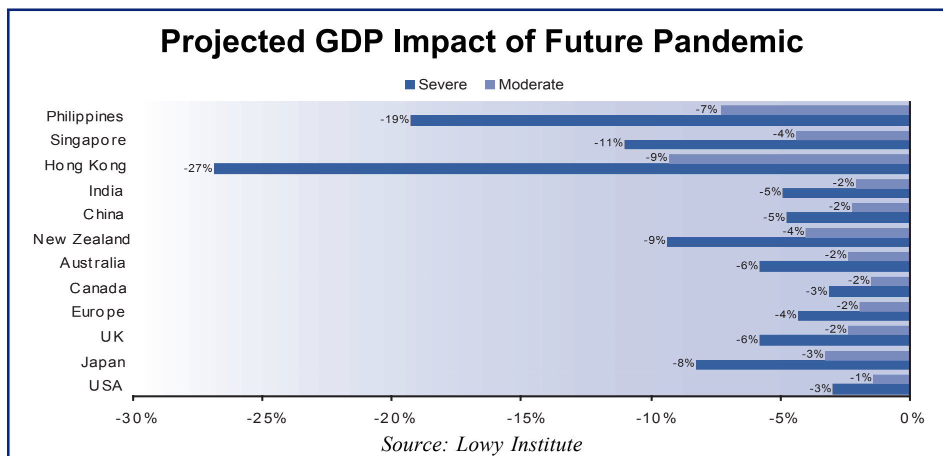
Source: Lowy Institute

shopping malls. In-home entertainment activities will likely experience a boom, as people turn to television, movie and game rentals, and other more solitary activities. Demands on telecommunications systems, including telephone, video conferencing, and Internet resources, will increase as these methods replace face-to-face contact and as workers telecommute to reduce workplace interactions.

Modeling possible future pandemics

An influenza pandemic is likely to produce a "shock" to the economy, comparable to the "oil shocks" from the 1970s, although obviously affecting individual economic sectors differently. In February 2006, the Sydney, Australia-based Lowy Institute for International Policy published a study, *Global Macroeconomic Consequences of Pandemic Influenza*. The study estimates the possible overall effect on the economy by analyzing influenza pandemics in the 20th century and their effects on GDP in several countries. The graph above shows the GDP loss in 1919 and 1958 compared to the prior five years for several countries.

The SARS outbreak has been studied as a model for the possible economic impact of an influenza pandemic. According to various studies of Hong Kong's economy, the SARS outbreak is estimated to have reduced GDP growth by 2.6 percentage points in Hong Kong, 1.1 percentage points in China, and 0.5 percentage point in Singapore and Taiwan. The Asian Development Bank estimates that SARS resulted in $60 billion in lost business revenue due to travel restrictions, quarantines, government-imposed building closures, and other business disruptions. An August 2005 study by BMO Nesbitt Burns studied the effect of SARS on the Toronto area and concluded that economic activity declined about 3% during the second quarter of 2003. A KPMG study reported that Canadian tourism reduced almost CAD 1 billion, increased Canadian health care expenses by approximately CAD 1 billion, and overall GDP growth for 2003 was only 1.7%, 150 bps less than was expected. Full economic recovery did not occur until the fourth quarter of 2004, about 18 months after the April 2003 outbreak.



Projected GDP Impact of Future Pandemic

Source: Lowy Institute

The long-term economic impact of an influenza pandemic will depend on many factors, including the rate of infection, the lethality of the virus, and the ages of those most affected. The Asian and Hong Kong flu pandemics disproportionately affected the very young and the very old. The effect on people in the workforce was lower, resulting in the economic impact being relatively mild and short-lived. In contrast, the Spanish flu epidemic affected many in their prime working years, and thus resulted in a longer-term economic impact.

The Lowy Institute projected the overall effect of an influenza pandemic on GDP for various countries. As shown in the graph below, the "severe" and "moderate" scenarios suggest a projected decline of 300 bps and 140 bps on the U.S. economy, which is the smallest impact of the countries analyzed.

The CBO also modeled the economic impact of a possible influenza pandemic. Under the "mild" scenarios, the CBO projects a negative 150 bps effect on GDP, while the "severe" scenario predicts a negative 500 bps effect. As mentioned earlier, a possible pandemic will affect different sectors of the economy in different ways. The projected effects on demand in individual sectors range from severely negative, to neutral, to mildly positive.

Interest rates and inflation may also be affected. The Lowy Institute report projects the possible impact on these items in the table on the opposite page.

Possible impact on the insurance market

While insurers may take solace that *demand* for their services is not projected to decrease, that obviously does not mean the insurance industry will be unaffected by a pandemic. Just like every other business, insurers will have to react to increased absenteeism, requests for family medical leave, voluntary or mandatory

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Avian flu from p. 2

travel restrictions, and other disruptions.

Health insurers, obviously, will see increased claims associated with the pandemic, but other claim patterns will be disrupted as less urgent care is postponed. Disability insurers will see increased short-term disability claims and, if the pandemic is severe, long-term disability claims also may increase.

Life insurers will see increased death claims, but also may see an increase in sales due to heightened public awareness of life insurance needs. If equity market values decline, annuity writers with significant living benefit riders may see these riders become operative as they did in during the 2001 equity market declines. If those annuitants then die, annuity writers will have to make good on the minimum death guarantees.

Property-casualty insurers will see a variety of impacts. Business interruption claims may increase in response to quarantines and the closing of buildings. The recent experience with Hurricanes Katrina and Rita may shed light on possible claims in a pandemic.

For other coverages, however, the situation is less clear. Workers' compensation provides coverage for work-related illnesses, but it may be quite difficult (with the exception of the aforementioned health care workers) to prove that the influenza infection was contracted at work. Likewise, commercial general liability requires that the illness be the result of the policyholder's negligence, also difficult to prove. Unless there is damage to property, no claim can be filed under property coverage. For poultry businesses, destruction of flocks may be covered, but the specific terms of the policy will need to be reviewed.

Insurance companies as employers
Apart from the product-specific impact of a pandemic, insurance companies are also employers. Just like any other business, insurers should be creating contingency plans to respond to a pandemic. There is a variety of resources available to assist in creating contingency plans. The federal government's Department of Health and Human Services (especially the Centers for Disease Control and Prevention), Department of Commerce, and Department of Homeland Security all have information to help prepare. International organizations such as the World Health Organization and IMF (International Monetary Fund) are also resources to tap. The IMF, in particular, has information tailored to financial institutions. While focused on the actions central banks and governments can take to minimize the disruption to the world's financial system, the information may provide insights and help individual companies with their own preparations, particularly for companies highly dependent on the financial system, such as insurers.

The insurance industry is built on managing risks, preparing for contingent events, and responding once an event occurs. A recent LOMA survey indicated that only one-third of North American life insurers have plans in place to address a pandemic, compared to more than half elsewhere. The insurance industry (life and property-casualty) has the opportunity to lead by example by preparing itself for a pandemic, in addition to helping its clients prepare. The economic and human impact of a pandemic will remain unknown until it occurs. Regardless of its severity, however, calm preparation before the event is far preferable to an unprepared reaction during a crisis.

Terence B. Martin, FSA, MAAA

Projected Impact on Economic Measures

	Severe Scenario	Moderate Scenario
Inflation	+1.4%	+0.8%
10-year government bond yields	–8 bps	–4 bps
Short-term interest rates	–50 bps	–18 bps

Source: Lowy Institute

Commercial lines predictive modeling
Challenges to wholesalers and MGAs

Wholesale agents have a long history of filling three important roles in the commercial lines property-casualty industry. First, they are a distribution channel for insurers specializing in excess and surplus lines. Second, they also underwrite, especially where the insurer delegates extensive authority to an MGA (managing general agent). Third, they are an aggregator of business scattered across many small agents who have no contractual relationship with a given insurer. In all three of these value propositions, the expected growth of predictive modeling in commercial lines is a substantial threat.

Modeling expanding from personal to commercial lines
Predictive modeling, with credit scoring as a linchpin, has revolutionized the personal lines industry over the past dozen years. Insurers have become more precise in assessing risk and assigning actuarially sound prices. Market leaders have simultaneously grown quickly and achieved large profit margins. Now, according to a Conning survey of commercial insurers and modeling vendors, many insurers are eager to bring such a revolution to commercial lines. While some benefit is expected in claims, premium audit, and marketing, the greatest hopes among survey respondents lie with underwriting functions, such as risk assessment and pricing.

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Insight notes on … economic trends

Commercial auto premiums still growing

Economic growth is translating into insurance exposure growth that is larger for commercial automobile than indicated in GDP. The new commercial heavy truck (14K+ gross vehicle weight) sales increased 19.0% year-over-year as of March 2006. Unit sales of 536,293 in 2005, up 22.4% over 2004, indicate unit growth as well as replacement. Real GDP grew 3.5% in 2005. Growth could flatten if conditions worsen with escalating oil prices, which could be exacerbated by geopolitical concerns.

Retail diesel prices have been volatile and high, increasing to a national average of $2.92 by mid-May 2006. This was an $1.08 increase (59%) since the end of December 2004. Most trucking firms have been able to increase freight charges to prevent erosion of profit margins. However, some independent truckers have been squeezed by the prices. Persistently increasing transportation prices to offset fuel costs could suppress overall transportation demand by making the cost of delivered goods too expensive for the market. Higher fuel prices also may continue the demand for larger vehicles to increase transportation cost efficiencies. Class 8 (33K+ GVW) led new truck sales in 2005 with a 24.4% increase. The rate of growth began decelerating in 2006 with a 17.2% increase through March. The sales of these extra-heavy vehicles are still over 47% of all heavy truck sales, increasing the relative mix of extra-heavy vehicles to total commercial automobile exposures. This could contribute to an overall decrease in loss frequency and increase severity of losses for the industry if larger trucks are used for larger, but fewer deliveries.

The improved economy has driven the unemployment rate lower. The average unemployment rate dropped to 4.8% for February 2006 (5.1% for all of 2005). Unemployment rates lower than 5% have been associated with a shortage of drivers, high driver turnover rates, and increases in losses; trucking firms began reporting a shortage of drivers in 2004 and have continued to report a tight driver market through 2005 and into the first quarter of 2006.

The CPI for hospital and related services, indicating the price consumers pay for out-of-pocket medical expenses, rose at a rate of 5.3% for 2005 and 5.6% year-to-date through February 2006. However, insurers' cost increases are larger than indicated in the CPI. Based on current National Healthcare Expenditure trends, the cost of medical care per person increased 6.8% in 2004. Conning estimates this cost will increase near 6.3% annually in 2005-07. The 2005 increase for the automobile body shop CPI was 3.3% (2.6% for 2004).

Investment opportunities have a minor impact on commercial automobile strategies because of the "short-tailed" claims development relative to other liability lines, such as general liability. Bond yields are increasing in 2006, but ten-year Treasuries are still 0.9 to 2.3 points less than the 6.0% to 7.5% book yields received in the late 1990s. Economists forecast ten-year Treasury yields of 5.2% and 5.3% for the ends of 2006 and 2007, respectively. Bond investments average 65% to 80% of the industry's investment holdings. Increases in yields can lead to reduced asset values, increased book yields, and lower premium pricing strategies.

Homeowners market cooling

Rising mortgage rates and a cooling real estate market will have several effects on homeowners insurers. These include a mix of gradual and more immediate influences, mostly negative in nature.

Mortgage rates, as tracked by HSH Associates, have increased significantly in recent months. The standard 30-year fixed mortgage (HSH blends regular and jumbo rates) ran in the 5.75% to 6.00% range for most of the January 2004 to September 2005 period. The rate has jumped to 6.63% as of April 2006. The 15-year fixed mortgage and one-year ARM have jumped by more than 70 bps since September 2005. Rising rates slow the pace of loan transactions, for both purchases and refinancing of existing loans. For example, the inventory of single-family homes on the market has swollen from 4.0 months of supply in March 2005 to 5.3 months in March 2006, according to the National Association of Realtors. In the past, mortgage officers have helped insurers achieve better insurance-to-value, as the lender wants to see coverage limits at least equal to the lender's equity. Transactions tend to push those figures higher. Fewer transactions means less beneficial pressure on insurance-to-value, a longstanding challenge for insurers. This impact will be negative but gradual.

Homes on the market for an extended period could pose an immediate owner neglect problem. No one may be at home for days or weeks at a stretch if a relocated employee is bouncing between two locations. Theft and undetected burst pipes are two heightened risks. A moral hazard may arise in extreme cases, such as with highly leveraged flippers with poor market timing. (Flippers are speculators who buy homes in metros with rapidly escalating prices and immediately place them back on the market, hoping to make a fast buck.)

The National Association of Realtors reports decelerating price increases for existing home sales, year over year, and actually a small decrease from 4Q2005 to 1Q2006. PMI projects that, of the top 50 metro areas in the country, 14 have more than a 50% chance of declining home values over the next two years. That projection is based on 2005 data and thus does not reflect the recent run-up in mortgage rates, which will escalate the chances for a drop in prices. This is another gradual negative development for insurance-to-value initiatives, and, by extension, premium growth.

The federal government reports a drop of 8.2% in new home sales in 1Q2006 versus a year earlier. Housing starts also show signs of a slowdown, as April 2006 single-family starts were 8.6% below April 2005. While weaker construction activity may depress premium growth slightly, it could remove upward pressure on the cost of labor and materials in claims settlements. As contractors and construction workers shift from new construction to remodeling and repairs, the additional supply against steady or declining demand results in lower costs for homeowners and a near-term positive influence for their insurers.

Fewer buying cash-value life insurance?

Nonfarm payroll employment reached 135 million in March 2006. This is an increase of 590,000 jobs since the start of the year. Average hourly wages also increased by 3.4% over the twelve months ending in March. However, it is not all good news.

Since 2003, inflation has outpaced wages by an average of 1.1 percentage points. With inflation outpacing salary growth, consumers have less discretionary income to save or with which to buy life insurance. The 2004 Survey of Consumer Finances, published by the Federal Reserve in 2005, showed the percentage of households saving any part of their income declined from 59.2% to 56.1% between 2001 and 2004. What does this mean for cash-value insurance?

During this three-year period, the Survey reports a significant drop in the percentage of families owning any form of cash-value life insurance (whole, variable, or universal) from 28.0% to 24.2%. The cash value of these policies also declined from an average in 2001 of $10,700 to an average of $6,000 in 2004. Overall, the ownership of either cash-value or term life insurance declined from 69.3% to 65.4%.

Significantly, the Survey found that, among those owning any form of life insurance, term ownership increased while cash-value ownership declined. Conning's analysis of term life sales in 2004 and 2005 confirms this trend. Term life accounts for approximately 45% of new policies issued and 70% of the new amount of insurance issued. For families facing the tough decision of how to allocate shrinking discretionary income, purchasing cash-value life insurance may be a luxury fewer and fewer are willing to buy.

Medical inflation poised to accelerate

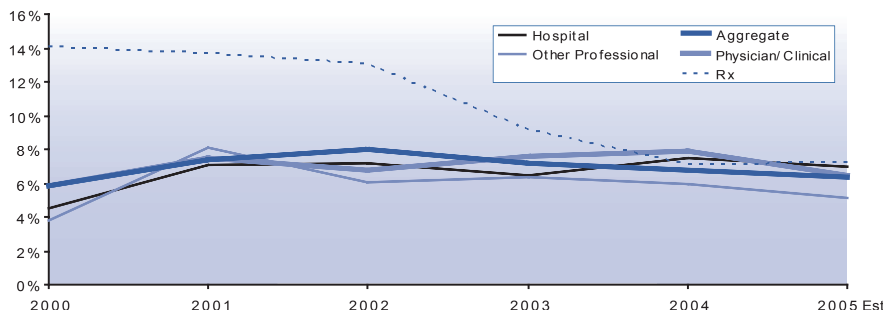
After several years of slowing health care cost increases, future increases may be higher.

In April, Aetna reported a first-quarter profit that was 3.2% higher than the first quarter of 2005; revenue was up 15%, and membership was up over 4%. However, its stock price decreased almost 20%. According to stock analysts, the stock price decrease was because it also reported a 1.5-percentage-point increase in its medical cost ratio.

The health insurance industry has had several good years. Medical inflation rates have slowed, although they are still higher than the general inflation rate. In this environment, health insurers have been able to raise insurance premiums faster than medical cost increases, thus increasing profits.

Some analysts are interpreting Aetna's increased medical cost ratio as a possible signal that medical inflation will heat up again. Recent changes in per capita National Health Expenditures show the recent declines may be leveling out, especially in prescription drug costs. In the past few years, several common prescription drugs have reached the end of their patent protection periods, allowing lower-cost generic drugs to replace them. Some are speculating that the recent progress in taming health care inflation may have been more a result of these one-time events

With their recent record earnings, consumers and regulators may be unwilling to allow health insurers to increase premiums enough to keep pace with medical inflation, with reduced margins the logical outcome.



Source: Centers for Medicare and Medicaid Services

CMP premium growth driven by exposures

Current economic trends indicate an increase in exposure growth for CMP that will drive premium growth. Inflation of loss cost drivers will pressure loss ratios. Investment yields have increased, particularly for short-term bonds. However, the level of increase is unlikely to affect premium rates for this line of business.

The value of new public and private nonresidential construction (as a proxy measurement of commercial property growth) increased 10.7% year-to-date as of January 2006. The increase was 9.0% for 2005. Exposure growth is larger for commercial property than indicated in GDP, as businesses have become more comfortable with expectations of sustained economic expansion.

Inflation is affecting both CMP liability and building repair costs. The PPI for construction materials increased 5.0% in 2005 and 4.4% as of January 2006. Construction industry hourly earnings increased 1.2% in 2005 and 2.2% year-to-date as of February 2006. Severe natural catastrophe losses are likely to keep construction costs from decreasing in 2006.

Bond yields are increasing in the first half of 2006, especially for short-term maturities. One-year Treasury bill yields increased from 4.4% in January 2006 to 5.0% in the first part of May. Although an improvement over the 3.4% in May 2005, yields are still substantially less than the 6.4% in May 2000. Insurers rely on investment income to produce or enhance operating profit. The improved yields are unlikely to accelerate premium rate reductions because CMP is a short-tailed line. Half of the CMP exposure in property and the general liability exposures eligible for this product are usually less severe than those written as monoline general liability.

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Competitive intelligence from p. 1

gathering about competitor companies, as the SIR workshop presenters emphasized, does not fulfill the potential value of a CI practice. Insurers can gain an advantage in the market when they are able to see patterns in information from disparate sources and are able to understand the implications of competitor actions within the context of the company's position in the market. This understanding of implications can help guide informed market decisions and increase confidence in the insurer's ability to predict the success of outcomes for alternative actions.

CI is a flexible practice. It can guide project offensives for market expansion or defensive responses to competitor offensives. Insurers can develop and use their insights for tactical and/or strategic actions. The breadth of CI capabilities depends on the resources available, the CI structure, and the skills of the practitioners.

CI in the insurance industry is still evolving

CI is not a standard function in the insurance industry. CI structures and even their focus are evolving. If there is a commonality among insurers, it is to assure professional results.

The use of in-house CI operations is not new for the insurance industry. However, discussions among the SIR workshop participants revealed that many insurers had only recently started CI as a unit or defined CI as a specific job function. More seasoned CI professionals noted that some individual insurers had discontinued CI units in the past and they now have begun to rebuild them. One insurer, after having dismantled its market research unit more than five years ago, has created a standalone CI unit in 2005, but it has not rebuilt its market research unit.

Even insurers with defined CI units were still defining the focus and structure of these units. Two of the SIR workshops addressed these evolutionary struggles. The first one explored methods of structuring a CI unit—home or field office or both, tactical or strategic focus. The second workshop examined a similar issue of understanding and balancing the demands of multiple customers, each with different needs and differing views of what CI is.

For some insurers, CI is part of the organizational structure—a standalone unit. For others, it is a function that resides within another structure, often a separately defined CI unit within market research. Indeed, a 2006 SIR survey of its insurer members noted that some respondents identified themselves as CI practitioners and some identified themselves as being in market research, with CI as part of their job description.

The commonality among these insurers and workshop participants is the desire to build/increase the structure and the professional skills of the practitioners around the function. Given the current different approaches among the insurers, the structures are likely to remain dissimilar.

Is the interest in CI cyclical or enduring?

Industry observers can support either view that CI growth is part of the soft market cycle or that it is needed to provide more precise information.

Insurers' interest in CI may be part of the insurance cycle. The fact that insurers have dismantled and later rebuilt these functions appears to indicate situational interest in CI. As competition for business increases, more insurers are likely to look for any competitive advantage. If insurers' interest is cyclical, more will develop CI in 2006 and 2007. Property-casualty insurers have been facing a softening marketplace since 2004. Large catastrophe losses in 2005 resulted in a reversal of what was developing into substantially falling prices for property exposures. However, prices were generally softening in the first quarter of 2006, except for adjustments in locations with severe catastrophe exposures. Conning Research forecasts generally increasing competitive conditions into 2007, assuming catastrophe losses normalize near or below $20 billion.

Insurers' trend toward requiring increasing underwriting precision supports the view that insurers will recognize CI as a critical function. Insurers, their investors, and even rating agencies are now demanding increased precision in insurers' ability to predict losses. Many are turning to sophisticated and often expensive underwriting and pricing models to support these efforts. The need for reliable and precise CI becomes more critical to assure the success of these model-assisted processes. This may be one reason that "anecdote no longer passes muster," as noted by one of the CI workshop presenters. Other industries, such as consumer goods, have gone down this path already. They have developed formal CI organizations with sophisticated tools to gather information, analyze findings into key actions, and effectively communicate them.

One possible solution is that, like many other aspects of an industry that is not monolithic, CI will turn out to be both a cyclical response and an enduring change.

Industry implications of CI

The insurer's choice to explore and develop CI is focused on how CI can provide an advantage over competitors, although the exact return on this investment is difficult to measure. As more insurers employ this function, the use of CI may have several industrywide implications.

- It does not appear that ubiquitous use of CI results in a zero sum game among insurers. Understanding and communicating key differences in product offerings, features, and prices benefit the more efficient insurers with more desirable product features.

- CI can speed the response time in product development as insurers learn more rapidly which products and features customers are willing to pay for.

- More thorough communication of product comparisons creates a more informed customer, who can find and choose preferred products/services.

Clint Harris, CPCU, ARP, ARe

*A special note of thanks for assistance in preparing this article to **Edward Budd**, Executive Director of Research at Allstate; **Andre Burke**, Manager of Business & Competitive Intelligence at Zurich; **Richard Marchetti**, Director of Competitive Intelligence, P&C Strategic Research, at The Hartford; and **Herb Sauer**, Director of Market Strategy at MetLife Auto & Home.*

Predictive modeling from p. 3

Underwriting appetites could widen
Traditionally, most standard insurers have avoided higher-hazard accounts or the most problematic lines within an otherwise acceptable account. Much of the reluctance has stemmed from a lack of confidence in underwriting skills beyond the more common low- to medium-hazard risks. Tougher risks have gravitated to surplus lines insurers. Because of their specialized market focus and lean infrastructure, these niche insurers often have MGAs act as outsourced branch offices—underwriting, issuing policies, arranging for inspections, etc. However, as standard insurers gain confidence in lower-hazard business models, some may be tempted to branch into more hazardous accounts. Retail agents will embrace the new market availability, as the commission scale should be higher (not split with the MGA), the premium may become eligible for contingent commission, the paperwork should be simplified, and they should have more control. Further, the standard insurer may have more name recognition with the client, leading to an easier sale.

Note that broadened appetite has been one of the major effects of predictive modeling in personal automobile. Many long-time preferred insurers have used their ever-evolving models to expand into sub-standard/nonstandard market segments.

A related threat—more technical in nature—concerns the use of nonadmitted insurers. Excess and surplus lines business often falls to nonadmitted carriers—insurers that are only lightly regulated by the states. The lack of regulation gives the underwriter more flexible pricing and coverage authority to structure a suitably conservative program for high-hazard risks. Admitted, or fully regulated, insurers may be unable to offer a quote that is simultaneously adequate and compliant with regulatory constraints. Typically, states require the originating agent to make a *bona fide* attempt to place the account in an admitted market before defaulting to a nonadmitted insurer. Usually, this attempt is documented by an affidavit listing the requisite number of admitted insurers that declined to quote on the account. If admitted insurers become more venturesome with modeling success, completing the affidavit could become a problem. Wholesalers could lose some business opportunities even when the nonadmitted market has more favorable terms for the buyer. Attempts to complete the affidavit by steering around viable admitted markets risk regulatory sanctions.

> *In the past, many standard insurers have shunned small agencies ... With efficient Internet service technologies, insurers can justify appointng small agents ...*

Mathematical formulas could replace some traditional underwriting
As predictive modeling penetrates some market segments and lines of business within the realm of business insurance, the role of subjective human judgment could become less important, or even considered an impediment if field underwriters routinely attempt to override the model's indications. This undermines some of the value of the wholesaler (particularly the MGA) in the eyes of the insurer. The insurer may no longer want to pay as generous a commission if the middleman is seen as simply pushing through the application. The wholesaler may need to replace veteran underwriters with lesser-skilled processors to maintain a profit margin.

Insurers with commercial models could appoint thousands of small agents
In the past, many standard insurers have shunned small agencies, due to unfamiliarity with the agency's ability to pre-underwrite accounts. Some of those insurers have been more comfortable distributing through a well-established wholesaler, who acts as a pre-underwriter and has dealings with the smaller agents across a broad spectrum of represented insurers. As insurers place more trust in their predictive models, the risk screening function of the retail agent becomes less important. With efficient Internet service technologies, insurers can justify appointing small agents as part of the expanded distribution plan.

As mentioned earlier, the agent would perceive transacting directly with the insurer as preferable to the wholesaler route because the commission scale is higher, etc. This is true whether the appointing insurer was using wholesalers before or it just has an overlapping underwriting appetite. The wholesaler or MGA faces both a reduction of new business flow and a renewal retention problem as the retail agent seeks to maximize revenue on each account.

Note that several major insurers are making or seeking new commercial agency relationships. This is a reprieve for many agencies with just a couple of producers. Previously, they faced limited ability to place business on a full commission basis. Commissions had to be split with a wholesaler or a friendly larger agency.

A silver lining for wholesalers and MGAs
Larger wholesalers and especially MGAs do have at least one opportunity to offset these modeling threats—to make money as an aggregator of data. In market segments where the firm has many years of expertise with several insurers, the wholesaler or MGA may be in a position to collect and collate unique data sets around underwriting characteristics. The firm then could bargain with insurers, trading data access for exclusive distribution rights. Even grander in scope, the firm could perform modeling of the data sets, with the help of a vendor, and present itself as an irreplaceable black box underwriter to several insurers. This strategy may require an infusion of capital to support the technology, new skill sets among central office staff, and vendor costs.

Conning's soon-to-be-released Strategic Study on commercial lines predictive modeling contains more analysis on how modeling is likely to unfold, influencing insurers, independent agents, regulators, vendors, and other stakeholders.

Bruce Hale, CPCU

Conning's New and Upcoming Releases

Banks in Life-Annuity and Property-Casualty Insurance. Banks have had years of opportunity to penetrate the insurance industry since the removal of major regulatory obstacles. With Citigroup's sale of Travelers Life & Annuity to MetLife, it is clear that banks are unlikely to be major "manufacturers" of insurance and are likely to focus on distribution. This study examines where banks have succeeded and failed with regard to customer segment, product line, and functionality (manufacturer or distributor). It considers the factors that have focused banks on certain arenas and whether environmental changes might cause banks to refocus, leading to challenges for insurers.

Life Settlements—The Concept Catches On. With increasing information on mortality differences and increasing pressures to find attractive investments in the world of hedge funds, investment pools, and mutual funds, life settlements have emerged as an opportunity for attractive returns—and perhaps as a threat to the life industry. Life settlements provide an opportunity for insureds to sell accumulated life insurance benefits for an amount that exceeds the surrender value, by transferring ownership and beneficiary rights to a third party. The effect on life insurers is to significantly affect lapse assumptions and potentially change the assumed economics of the business. This study analyzes the growth and increase in sophistication in this market and explores some of the challenges being presented.

Property-Casualty Investment Survey & Analysis—Emerging Cycle of Opportunities. Investment risk is the other principal operational exposure for property-casualty insurers after underwriting risk. What are the exposures and results of recent practices? Conning examines how property-casualty insurers have structured their investment strategies and analyzes the results from 2000 through 2004. Asset allocations and gross investment income returns are presented for the industry in total and for major "peer" groups. Questions relating to asset/liability management strategies, stochastic modeling, and the use of hedging or alternative investment strategies are explored. The study also explores potential changes in the environment that could cause insurers to reconsider their strategies.

Mergers & Acquisitions and Public Equity Offerings—2006 Edition. This annual study examines insurance industry mergers & acquisitions and public equity offerings for 2005 and historically. Conning analyzes trends within each of the major insurance sectors, identifies their key underlying drivers, and uses these drivers to forecast trends in M&A activity in 2006 and beyond. Conning explores merger goals and merger measurements in property-casualty, life-annuity, health, and distribution sectors to identify the attributes of successful transactions.

Penetrating the Middle Market—Clearing the Distribution Hurdle. The middle market is seriously underserved for life sales, with retirement funding and the potential need for long-term care coverage adding to the problems. As capital builds up for life companies, effective expansion into the middle market presents one alternative for employing some of that capital. Lack of cost-effective distribution alternatives gets most of the blame. Several distribution alternatives for life products have been attempted, but with less than remarkable success. Using insight from major companies, Conning will look at the reasons behind the lack of success, seeking to identify those niches where results appear to be better than average. Increased use of technology to identify potential buyers and to streamline the sales process will be explored.

Long-Term Care Insurance—Opportunity Knocks—Again? While the aging population and many public policy issues should support growth in this business, long-term care insurance continues to be a troubled line. Market penetration remains disappointing, and profitability is generally weak or nonexistent, while risk and volatility remain high. As such, many significant participants in the industry avoid or have withdrawn from this business, and it is largely relegated to specialists. Some promising product developments and regulatory changes may be altering the picture to one of some hope. This study reviews the current experience and identifies some of the emerging opportunities that may yet make this line more attractive to more participants in the industry.

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