Regulatory capital pressure to diversify

The formulas embedded at the heart of evolving insurance regulations around the world, such as Solvency II or its equivalencies, have encouraged some Mutual insurers to consider exploring new lines of business or entering new territories. One reason is the potential benefit from diversification relief in regulatory capital calculations and more favourable consideration from rating agencies, so the time is right to consider some of the distinctive issues faced by Mutuals when contemplating diversification strategies.

Risk diversification is of course fundamental to any insurer, regardless of whether they are a Mutual or not; the common principle being the pooling of funds from many policies to pay for losses incurred by the few. Clearly a well diversified insurer has greater wherewithal to withstand a problem arising in one particular area of its operations.

With this in mind, insurers of all types regularly consider whether and how to expand outside of current business segments or geographic areas. For some, this may be the only route to achieve meaningful growth if their home market is already highly saturated. However while larger size may bring certain economies of scale, growth is not necessarily an appropriate end in itself for the mutual sector which exists, first and foremost, to support its members, and diversification should only be judged as successful if it is accretive to the overall strength of the organisation and value it can deliver to members. It is in evaluating these aspects that some fundamental differences between mutuals and non-mutual insurers emerge.

Mutuals tend to be specialised rather than generalist, and have the advantage over general insurers of a greater degree of focus and expertise in their particular field. This in turn can be leveraged to support better decision making, more informed underwriting and superior customer service, ultimately translating into better value for members. The disadvantage is that the mutual business model exposes them to geographic and homogeneous concentrations of risk, and with increased capital requirements under Solvency II or similar regulatory regimes there exists a prima facie case for diversification. However experience shows that diversification comes with other challenges and may not always be to the benefit of members.

Implications of diversification for mutuals

By definition new lines of business require capital to meet both one-off start-up costs and support the additional exposures to the balance sheet. Regulatory capital formulae may allow some offset for “diversification benefit”, nonetheless additional capital will need to be specifically allocated to support the expansion.

The first challenge posed by diversification then is essentially financial. The success or otherwise of diversification can be measured by the amount of additional capital required, the cost of raising that capital, the economic return achieved on that capital, and the opportunity cost of not deploying that capital elsewhere.

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1 Throughout this article we use the word “Mutual” as short-hand for any policyholder owned entity, including Co-operatives, Mutuals, Risk Retention Groups, Trusts, Reciprocals, Exchanges, Pools, Societies, Affinity and Group Captives, and any other form of policyholder or association owned insurance vehicle. We trust the reader will recognise the convenience of using a single term to cover all forms of policyholder owned insurance entities.
The equity capital of mutual insurers belongs to the policyholders and is inherently less flexible than non-mutual capital. Committing that hard-earned capital to new lines of business or new territories, especially where the organisation may only have limited expertise or experience, is intrinsically riskier for Mutuals given the relative importance of the capital at stake compared to non-mutuals, and this needs to be factored into the financial calculation. Moreover as we have seen, rather than relieving pressure on capital, diversification may, initially at least, require additional capital to be deployed. In this environment it behoves the mutual to proceed with caution and here reinsurance can assist, providing a more flexible form of capital than external debt or fresh equity, a “second set of eyes” on the business plan, and ideally some particular expertise in the specific area selected for expansion.

When it comes to underwriting specialist areas of insurance such as energy, medical malpractice, rural/agricultural risks and other classes where mutuals tend to operate, mutuals benefit from an informational advantage as a result of their close relationship with policy holders. This manifests itself in a superior quality of product and customer service, lower cost of distribution and more effective value added services such as loss prevention, adding up to a significant underwriting advantage for Mutuals over commercial rivals. The second challenge therefore is how to replicate these advantages when diversifying into new areas.

This was something that several doctor-owned mutuals found more difficult than they had anticipated, despite diversifying into related medical sectors. [See Case Studies]. As it transpired, the characteristics, motivation, management structures and decision making priorities of corporate medical providers such as hospitals and blood banks proved to be very different from their own doctor constituents. Quite simply doctor mutuals were unused to dealing with corporate risk managers who are conditioned to treat insurers as vendors rather than as business partners.

These types of issues are less likely to arise where diversification is viewed purely as a commercial undertaking, and evaluated coldly as an investment rather than as an extension of the original mutual vision. The subsequent successful development by doctor mutuals of distribution arrangements for “non-core” insurance products illustrates the point - rather than seeking to recreate the mutual in a culturally different environment, why not review how existing advantages can be leveraged to provide additional products or services for existing members?

Likewise, with their “shrink to grow” approach, AEGIS London explicitly recognised that diversification outside core lines is best achieved on a commercial basis. [See Case Studies]. This is behind their offer to extend protection to non-members when, and only when, they can command a superior underwriting return. AEGIS make it clear to such customers they will have no hesitation pulling back when such returns are no longer available. This is in sharp contrast to traditional mutuals who don’t like to leave members and policyholders in the lurch. It is also contrary to the behaviour of most non mutuals, particularly publicly traded insurers who are typically reluctant to give up top line or market share. So while many understandably struggle with this hard headed approach, the logic of treating customers in a purely commercial manner remains impeccable.

The third case study underlines how underwriting issues such as limited expertise and the volatility associated with expanding the product line offering for existing members can be addressed with the support of reinsurance.

What lessons can be drawn from these very different experiences? In considering whether and how to diversify, among the questions mutuals should ask themselves are the following:-

1. What is the motivation for diversification? Is there a discrete and identifiable problem or gap in the market which needs to be resolved, or is the motivation primarily to achieve growth, economies of scale, rating agency approval or capital advantages etc.?
2. Does the target customer group recognise and share our mutual values and uniqueness? If not, what do they have in common?
3. Have opportunities to provide non-core products and/or services to existing policyholders been fully explored?

4. As diversification proceeds, how is equity between members to be achieved in terms of pricing and affordability given different exposure characteristics and loss experience?

5. What are the implications of pulling back or withdrawal?

There are no right or wrong answers to the above and each case is different. In addressing these types of questions in the context of diversification, many successful mutuals chose to adhere closely to their original mission. Others adopt hybrid approaches, maintaining their core capacity and financial equity within the original mutual vehicle, while providing agency or distribution based solutions to members, or establishing a for-profit subsidiary. A third category comprises mutuals that have chosen to diversify more generally. Such examples attest to the inherent value and flexibility of the mutual model, and helps explain the increasing significance of mutuals in the wider insurer marketplace.

How can Reinsurance help?

There is much that well designed and executed reinsurance can do to support capital preservation; reducing an organisation’s peak exposures and hence protecting existing capital. These benefits can form a robust rebuttal to pressure exerted by rating agencies and regulators to diversify simply for the sake of capital relief.

In cases where diversification is an organisational imperative, reinsurance can play a key role in releasing capital from other areas of the organisation. In addition to reducing or ameliorating the need to seek external capital to support expansion, reinsurance can act as a flexible and cost effective substitute for an organisation’s own capital. This provides stakeholders with increased certainty that existing core business will not be adversely impacted by planned development.

The reinsurance market has considerable experience in addressing practical and commercial challenges in multiple lines of business and territories. As can be seen in the diversification of a US Professional Lines mutual [See Case Studies] such experience can be leveraged by a Mutual to replicate the informational advantages they enjoy in their core lines of business.

Additionally, and in its most traditional incarnation, reinsurance can be an invaluable tool in minimising the capital demands of a new line of business or territorial expansion, and supporting the results of a fledgling undertaking.

Conclusion

Publicly-traded insurers display an immediate sensitivity to analysts’ opinions and their strategy tends to anticipate the reaction of the financial markets as a first priority in running their business. Consequently for-profit insurers are more inclined to operate in an opportunistic and short term manner, as they serve a range of different constituents and may shortly be shifting out of one area and into another depending on market conditions or received industry wisdom.

Mutuals on the other hand offer a refreshing longer term view. However the qualities of focus, homogeneity, service and commitment to policy holders can only be maintained if the pitfalls of a “for-profit” strategy are avoided. A key lesson is to pursue diversification only where it is in line with the long-term aims of the organisation, stands a reasonable chance of being profitable, and does not come at the expense of a loss of focus on other aspects of business.
In the three case studies that accompany this paper we highlight three very different experiences of diversification. The example of Doctor Mutuals provides a stark warning as to the consequences of ill-considered diversification, and the capital impairment that resulted from this. It also provides a very positive model for how some of the member benefits from diversification (such as a richer choice of coverages) can come from a Mutual opening its distribution channel as an alternative to putting its own capital at risk.

The second case study illustrates how a utilities sector mutual has been successful in driving group diversification through the use of a commercial subsidiary.

The final case study explores how a professional lines mutual has utilised reinsurance capital to manage the potential downside of a diversification, while leveraging reinsurers’ wider commercial view to better serve members’ evolving needs.

While reinsurance alone is not a complete panacea to the challenges highlighted in this article, well executed reinsurance certainly offers significant benefits to mutuals in managing the process of diversification. To do so efficiently reinsurance design, from planning through to implementation stages, should recognise and reflect the unique nature of the relationship between a mutual and their members’ capital.
Case studies

Doctor mutuals

Following the withdrawal of virtually all mainstream commercial carriers from the medical malpractice line in the late 1970’s, independent practicing doctors in the USA found themselves unable to purchase liability insurance at any cost, bringing healthcare services to a virtual standstill in states such as California. A solution was needed fast and before too long various doctor-owned mutual insurers emerged under the auspices of local medical societies. Most have since enjoyed considerable success, challenging and overturning some of the more egregious aspects of the US tort system, improving the safety and efficacy of medical practice, reducing the incidence of adverse medical outcomes for patients, and keeping the cost of liability insurance for doctors affordable. Similar doctor-owned mutuals have also been formed in the UK, France, Spain, Australia and elsewhere.

Inevitably success led in time to the return of competition from for-profit carriers seeking to re-enter the marketplace they had previously abandoned. This attack was reinforced by commission hungry insurance brokers all too eager to depict doctor owned mutuals as small, unrated and therefore financially vulnerable, forcing mutuals in turn to acquire their own ratings.

Confusing specialist focus with vulnerability, by the mid 1990’s insurance regulators and rating agencies started encouraging mutuals to diversify both geographically and by line of business. Several expanded across state lines, some successfully, others less so. However the most damaging forays were into quasi-medical disciplines beyond their core area expertise, the “underwriting” of individual doctors and surgeons. Areas where some became unstuck included hospitals - where the sheer limits needed unbalanced their portfolio; doctor’s premises, which in some locations came with exposure to hurricane or earthquake risk; blood banks, where multiple losses arose from contamination and spread of hepatitis and HIV/AIDS; and Plastic surgery, where losses arose from several sources such as bariatric surgery, liposuction and faulty breast implants. Inevitably management’s attention became distracted, while the costs of correcting or exiting from these incursions into non-core areas mounted and proved in some instances to be insurmountable, ultimately leading to the demise of formerly successful mutuals.

A more successful form of diversification undertaken by some doctor mutuals both in the USA and elsewhere has been to leverage their excellent distribution system and member relationships to address members’ peripheral as opposed to core insurance needs, for example in the areas of personal lines, life insurance, specialist covers and financial products and more recently patent data privacy protection coverage. Recognising that this was not their area of particular expertise, the mutuals have mainly elected to operate as risk free “distributor” rather than as the risk taking “manufacturer”, using their buying power to negotiate significant discounts for members. In other cases they limit their risk taking participation by use of reinsurance.

In general the doctor mutuals have stuck closely to their original mission, have been prepared to grow and where necessary adjust in response to member needs rather than vanity projects, and continue to serve their members successfully.

Energy and utilities

Associated Electric and Gas Insurance Services (AEGIS) is one of the largest and most successful mutual insurers in the world. Like the first doctor mutuals AEGIS, and other energy mutuals such as OIL, NEIL and EIM, was formed at a time when it was difficult to obtain insurance for energy and utility risks. AEGIS operates to the classic mutual model, aiming to provide members with the lowest cost long term insurance cover, setting pricing at a level that allows it to pay losses and expenses and grow surplus modestly over time, while returning part of its underwriting and investment profits to members in the form of premium credits.
Initially the focus was mainly in the US, but to better support members’ emerging global operations a London subsidiary was established in 1999. Unlike the parent company, AEGIS London also provides cover to policyholders who are not AEGIS members. This is done on a purely commercial basis and such policyholders do not participate in the premium credit program. Expanding coverage to include other lines such as non marine property/casualty, contingency, etc, has helped AEGIS London diversify the portfolio away from peak exposure zones such as the Gulf of Mexico; this in turn has benefited the majority of onshore members against catastrophic loss.

More generally the strategy has also helped AEGIS in navigating the perils of a softer marketplace and improve its overall portfolio. Central to the strategy is to have capital available to support members at the right time, particularly in the aftermath of a traumatic or market turning event. As Managing Director Stuart Davies puts it “There is no point in a member putting in a risk with us that is underpriced so we lose money on it. What happens is our group surplus goes down”. The key question for Davies is how to protect capital between such events, so as to be in a position to accelerate and use it at the right time. Given current market conditions, if members can obtain cover from other insurers at prices that are below loss cost, that’s fine according to Davies who refers to the concept of “shrink to grow”. Diversification into non-core lines has assisted the process by allowing AEGIS to worry less about premium volume and more about profitability. Davies points to the power utility account, which has reduced by more than 50% since 2007. “There are not many chief executives who would be happy saying they have reduced their largest account by that amount” says Davies, “but as a mutual we were able to do it and do it successfully”.

US Professional Liability (Errors and Omissions)

A capacity crisis in US Professional Liability market in the late 1970’s occurred as a result of the withdrawal of commercial carriers. In response to this, a mutual was formed by a group of professionals with a common occupation to fill the gap in commercially available cover. Its sole objective is to meet the needs of its owner insureds both in terms of providing both extensive coverage and claims and loss prevention services. Since the mid 1990’s it identified and responded to increasing requests from some though by no means all of its members for ancillary insurance coverages – specifically Employment Practices Liability and Management Liability (and subsequently a combination thereof). Developing these coverages was not driven by a desire for diversification for commercial reasons, or to satisfy regulators and rating agencies. Rather, they were developed firstly to meet the evolving needs of certain members, and secondly as a defensive move to counter efforts by a resurgent commercial market to compete for the mutual’s core E&O coverage.

In looking to develop these ancillary coverages, the mutual recognised that it was not expert in these fields and so approached reinsurers for assistance, not just for the purpose of managing the exposure of its capital to a new line of business (a classic use of reinsurance), but just as importantly to tap the experience of reinsurers to help develop underwriting, policy forms and pricing – another valuable role that reinsurance can play for a mono-line mutual. This approach has the benefits of allowing the mutual to learn about the class, while maintaining a relatively small net exposure (and consequent modest exposure to its capital), while during the developmental stages of the new lines, the underwriting results are somewhat ‘owned’ by the reinsurers, so if results are adverse, they have to accept them more readily than in more typical arms-length reinsurance relationships. Moreover, by protecting and to some extent ring-fencing the underwriting results, the mutual has succeeded in protecting the embedded capital of those members that choose not to purchase the ancillary line, so addressing issues of equity between members.
Biographies

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John is based in the Willis Re’s London office. In addition to managing individual client accounts, he is also responsible for advanced (re)insurance product design and development, with a particular emphasis on mutual insurers and professional liability. Prior to joining Willis Re in 2009, John was a Director of Carvill London Ltd, a specialist international reinsurance intermediary, where he held several positions in both a management and a client capacity. John commenced his professional career in 1982 as a management consultant with Andersen Consulting (now Accenture), with consulting and project management responsibility for clients in the marketing, financial services and technology sectors. He graduated with a BA (Honors) degree in PPE from Oxford University.

Robin Swindell, Executive Vice President
Robin is based in the Willis Re’s London office. Since joining Willis in 1989, Robin has been involved in Japanese, Asian, North American and Global treaty reinsurance. His experience includes the placement of reinsurance programs for Property Casualty and Specialty lines for Market Pools, P&C companies, as well as Mutual Insurers. He is a senior member of Willis Re’s Energy practice group, responsible for the Property and Casualty reinsurances of several major market participants. Robin is also involved in Willis Re’s internal and external training, covering a range of Casualty and Property subjects.

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