The Cycle in Property/Casualty Insurance

Property/casualty insurance companies hold about five percent of all financial assets in the United States. Currently they are recovering from one of their worst cyclical downturns in the post-World War II period. The industry is divided about evenly between personal and commercial lines of insurance. It is very competitive with fairly easy entry and exit and there are now more than 3000 companies operating in the United States. The vast majority of property/casualty coverage is written by a few hundred of these companies. But no single company supplied as much as five percent of the $85 billion of coverage written in the first half of 1986. Deviations from competition tend to be the result of regulation, particularly rate regulation, which is extensive in personal and workers' compensation lines. Commercial lines other than workers' compensation, and especially commercial reinsurance, are the focus of the current problems in the industry. Reform efforts are introducing rate regulation into these traditionally less regulated lines as well.

This article focuses on the underlying reasons for the profitability cycle in the property/casualty industry. Changes in interest rates are the primary force behind the recurrent swings in the industry's profitability. After describing the link between interest rate fluctuations and the insurance cycle, we look more closely at the most recent cycle. Its relative severity was primarily the result of the industry's response to the unprecedented swings in interest rates over the past ten years. Consequently, the return of interest rates and inflation to more normal historical levels should eventually ease the "crisis" in the industry.

Interest rates and the insurance cycle
The cyclical behavior of the property/casualty insurance industry results from the extreme interest-sensitivity of the competitive price for insurance. The key to this sensitivity is the basic nature of the insurance product. Companies receive money (premiums) in exchange for promises to pay future claims. As interest rates rise, companies can lower premiums to meet the same future claims because the interest accumulated with premiums will be greater.

As a starting point for analyzing the insurance cycle, it is helpful to think of the insurance market as characterized by a fairly stable demand curve and a supply curve that shifts with interest rates. As rates rise, the supply curve shifts to the right, companies are willing to offer more insurance at the same price, and prices fall until enough new demand is induced and/or suppliers withdraw to clear the market.

This fundamental economic relationship between policy pricing and interest rates implies that insurance companies will raise prices when interest rates fall, and lower them when interest rates rise. The magnitude of these price changes will vary with the magnitude of interest rate changes. It is not a coincidence that the intense price competition of the late 1970s and early 1980s came at the same time as the unprecedented

The author would like to thank Paul Bennett for many helpful discussions while developing this article.
increase in interest rates. Likewise, the enormous premium rate increases of recent years have coincided with the large declines in interest rates.\footnote{Other factors besides interest rates affect insurance prices. The trends toward wider liability and higher settlements are obvious factors. Insurance prices declined despite these trends, when interest rates were at the high levels of the late 1970s and early 1980s. With interest rates lower now, the trend toward higher claims costs exacerbates the rise in competitive insurance prices. Policy measures to contain increases in the scope and size of insurance settlements could conceivably act as a partial offset to the interest rate pressure for higher premiums. Unfortunately, price data is not widely available. Constructing price data is difficult because there is no standardized unit of insurance. For example, deductibles can be increased and coverage limits lowered in lieu of raising the premium.}

The magnitude of these price changes also depends on how far competitive pressures push these firms beyond prudent underwriting practices when interest rates rise. Because the industry is quite competitive with easy entry and exit, it tends to overshoot the price level dictated by changes in interest rates.\footnote{See Paul J. Joskow, "Cartels, Competition and Regulation in the Property-Liability Insurance Industry," The Bell Journal of Economics, Vol. 4, No. 2 (Autumn 1973), for a discussion of competition in the property/casualty industry.}

Inflation also has an impact on the relationship between the competitive price of insurance and interest rates. If costs of settling claims are expected to rise through time, a higher premium or investment return will be necessary to cover future costs. To the extent that rising interest rates reflect anticipated inflation, they should not affect insurance premiums. The insurance company must therefore incorporate expectations of future inflation, or more specifically future claims costs, into its pricing policy.

Uncertainty about the inflation outlook can amplify the cycle in premium pricing by widening the range of inflation expectations. Firms with lower than average expectations about future inflation will price policies more cheaply than those that expect higher rates of inflation. The lower price will draw an increasing market share to companies that anticipate low inflation, unless other firms match their prices. In either event, prices will tend toward the level dictated by a lower than average inflation outlook.\footnote{This assumes that there is adequate capacity among firms expecting low inflation to absorb more market share. Firms with a low-inflation outlook and capacity to write more business will be among the most aggressive price cutters.}

If the average level of inflation expectations is more near the mark, prices will end up too low and the extent of the ultimate industry shakeout will vary directly with the gap between actual inflation and the lower range of inflation expectations.

A corollary to the basic inverse relationship between interest rates and competitive premium pricing is greater volatility of premiums in longer-tailed lines of insurance (e.g., general liability) versus shorter-tailed lines (e.g., auto liability). Tail length refers to the amount of time between the premium payment and the expected claims payout. Other things equal, the longer the time between the premium payment and the expected claims payout, the bigger the effect of interest rate changes on the competitive price of insurance. This corollary helps explain why certain insurance lines are more cyclical than others. It also provides a theoretical basis for the greater cyclicality of reinsurance compared with primary insurance. Reinsurers typically have a longer tail length or emergence pattern in their claims payments than primary insurers.\footnote{Reinsurance is insurance for insurers. It allows them to cede parts of the risk they assume to other insurers. Emergence patterns show the time path of the cumulative claims associated with policies written at a particular time. For example, if 10 percent of the claims ultimately made on a set of policies are paid out each year over a ten-year period, the emergence pattern would show 10 percent after one year, 20 percent after two years, and so on, reaching 100 percent at the end of the tenth year.}

**Combined ratios and the interest rate-insurance cycle**

Property/casualty companies’ profitability is divided into two broad categories—underwriting profits and investment income. Rising interest rates increase the investment income from each premium dollar. As discussed earlier, this higher investment income allows firms to charge a lower premium for the same level of coverage. Premium cutting due to rising interest rates erodes underwriting profits.

Underwriting profitability is judged by a measure called the combined ratio. This measure adds together the ratio of losses incurred over premiums earned and the ratio of commissions and other expenses incurred over premiums written and multiplies the result by 100.\footnote{Premiums written include earned premiums and an unearned premium reserve. The earned portion of premiums written is the property of the insurance company and is based on the expired portion of the policy period. For example, an annual premium of $400 paid in advance would initially be allocated to the unearned premium reserve. After six months, $200 or half the payment would remain in the unearned premium reserve.}

It shows the cash outflow from underwriting operations relative to the cash inflow. When the combined ratio is greater than 100, it means underwriting expenses exceed revenues. Unless investment income makes up the difference, the firm will lose money.

A practice called “cashflow underwriting” relies on investment income to meet part of underwriting expenses and causes the combined ratio to exceed 100. Traditionally, this practice has been regarded as unsound. Investment income, in this view, is considered a buffer against unexpected underwriting losses, not a source of cashflow for anticipated claims costs. Property/casualty company aversion to cashflow underwriting was seriously
undermined by the unusually high level of interest rates in the late 1970s and early 1980s.

The combined ratio is very cyclical and moves (with varying lags) according to interest rate movements. Cyclical peaks in the combined ratio are usually associated with interest rate peaks. As rates decline, the combined ratio tends to decline (Chart 1).

Because premium income is weighted toward the present compared with investment income, the trade-off of current (premium) income for improved future (investment) income raises the combined ratio, as current expenses rise relative to current underwriting income. Furthermore, because gains in investment income occur with a lag, expenses also rise relative to total revenue. Thus, declining underwriting income is associated with declining total income (Chart 2).

Eventually, however, as investment income increases, total income should improve. But if underwriting standards deteriorate in response to competitive price pressure, the improvement in investment income will be insufficient to service the increased claims associated with taking on greater underwriting risks. If the price cutting is excessive, total income will deteriorate despite the rise in investment income. Only when losses force more prudent underwriting and an industry shakeout occurs does the cycle reverse and income improve.

The significance of interest rate movements for underwriting performance has increased dramatically in the past 25 years. Until the protracted rise in interest rates that began in the late 1960s, interest rates had fluctuated around a sufficiently low level that investment income remained a much less important source of cashflow than it became in the 1970s. As the level of interest rates rose through each successive business cycle, the importance of interest income for cashflow increased threefold. In 1967, premium income was only eighteen times interest income. By 1985, this ratio had dropped to less than seven.

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Footnote 6 continued:
emerge later on average and therefore the combined ratio continues to deteriorate for a longer time. Special factors associated with the most recent cycle are discussed in more detail below.

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Chart 1
Three Month Treasury Bill Rates and Combined Ratios for Property/Casualty Insurers

<table>
<thead>
<tr>
<th>Combined ratio</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>125</td>
<td>16</td>
</tr>
<tr>
<td>120</td>
<td>14</td>
</tr>
<tr>
<td>115</td>
<td>12</td>
</tr>
<tr>
<td>110</td>
<td>10</td>
</tr>
<tr>
<td>105</td>
<td>8</td>
</tr>
<tr>
<td>100</td>
<td>6</td>
</tr>
<tr>
<td>95</td>
<td>4</td>
</tr>
<tr>
<td>90</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Best's Aggregates and Averages

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Chart 2
Property/Casualty Income as a Percent of Policyholders' Surplus*

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>Total</th>
<th>Underwriting</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>-40</td>
<td>-20</td>
<td>-30</td>
</tr>
<tr>
<td>1988</td>
<td>-30</td>
<td>-10</td>
<td>-20</td>
</tr>
<tr>
<td>1989</td>
<td>0</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>1990</td>
<td>20</td>
<td>30</td>
<td>40</td>
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<tr>
<td>1991</td>
<td>30</td>
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<td>50</td>
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<tr>
<td>1992</td>
<td>40</td>
<td>50</td>
<td>60</td>
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<tr>
<td>1993</td>
<td>50</td>
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<td>70</td>
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<td>1994</td>
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<td>70</td>
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<td>1995</td>
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<td>90</td>
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<tr>
<td>1998</td>
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<tr>
<td>1999</td>
<td>110</td>
<td>120</td>
<td>130</td>
</tr>
<tr>
<td>2000</td>
<td>120</td>
<td>130</td>
<td>140</td>
</tr>
</tbody>
</table>

*Policyholders' surplus is the net worth of an insurer as reported in its annual statement.

Source: Best's Aggregates and Averages
If the disinflation-induced decline in interest rates over the past four years marks a return to more normal historical levels, premiums will rise simply because interest income will cover a much smaller part of the overall costs of insurance. If the current low-inflation scenario persists, the combined ratio for property/casualty companies could return to the lower average levels that prevailed prior to the 1970s. Also, if the sharp interest rate fluctuations of the late 1970s and early 1980s are replaced by the milder fluctuations of earlier years, the cyclicality of the industry could diminish.

Maturity structure of claims and the interest rate-insurance cycle

The effects of interest rate fluctuations on premiums should be greater in lines of insurance with longer intervals between the receipt of premiums and the payment of claims. Consequently, the combined ratio for long-duration lines of insurance should move more than the ratio for short-duration lines over the interest rate cycle, and the mix of insurance by lines will affect the timing and volatility of the property/casualty cycle.

The duration of the claims payout is illustrated by emergence patterns (Chart 3). For example, automobile liability insurance claims are generally settled sooner after the insured event than general liability or workers’ compensation claims, which might not even be reported until years after the premiums are paid. In asbestos claims, executive responsibility for the employment of a claimant is known to be an average of 20 years after an injury is sustained. Within three years of occurrence, about 75 percent of automobile liability claims have been paid, while only about 25 to 40 percent of general liability and workers’ compensation claims have been paid. Even after nine years, only about half of workers’ compensation claims have been paid out.

Over the past 10 years, the combined ratio for general liability insurance has risen more than for automobile liability insurance when interest rates rose, and has fallen more when rates fell. Since general liability is the longer tailed line, this is consistent with the notion that lines with a slower emergence pattern will be more interest-sensitive.

Other factors can complicate this principle. For example, workers’ compensation lines are long-tailed, but their combined ratio does not behave as the increased interest-sensitivity principle would suggest. Among the incentives that workers’ compensation insurers offer to promote safety is the return of premium dollars to employers with a favorable loss record.

As a result, workers’ compensation insurers pay a large part of all the dividends property/casualty insurers return to policyholders each year. Since the combined ratio is based on premium income before distribution of dividends, underwriting performance in this line is often less favorable than the combined ratio would indicate. Furthermore, regulation is much more stringent in workers’ compensation than in general liability insurance, perhaps restraining competitive excesses.

In past cycles the differences in performance between commercial and personal lines, primary insurers and reinsurers, and long-tailed and short-tailed lines within

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Chart 3

Emergence Patterns by Line of Business

<table>
<thead>
<tr>
<th>Percentage of ultimate loss payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
</tr>
<tr>
<td>1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Line of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobile liability</td>
</tr>
<tr>
<td>Workers’ compensation</td>
</tr>
<tr>
<td>General liability (including medical malpractice)</td>
</tr>
</tbody>
</table>

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Explanatory notes

1 Emergence is defined as the sum of two items
   (1) claims outstanding at the end of each report period and (2) the cumulative payments that have been made up to the end of that report period

2 The ratio of emergence to ultimate loss payments is expressed in percentage form and is plotted for each report period shown

3 The usual range of points is 0 percent at inception to 100 percent (ultimate), a point which is reached after many years or report periods

Source 1980 Reinsurance Association of America Loss Development Study

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For more on special factors affecting various insurance lines, see 1985-86 Property Casualty Fact Book, Insurance Information Institute
these categories were much less pronounced. But sharp differences arose with the unusually high and volatile level of interest rates during the past 10 years. For example, the performance of commercial lines deteriorated markedly in relation to personal lines over the past several years. Commercial insurance was very aggressively priced in the last cycle and has experienced some of the biggest rate increases in the past two years. Both the longer tailed nature of the business and rising costs of insurance settlements have contributed to this volatility.

Likewise, reinsurers' performance deteriorated much more than the overall performance of primary insurers in the last cycle. An important difference between reinsurers and primary insurers is the large amount of "excess-of-loss" coverage they retain. That is, reinsurers are more exposed to claims that exceed large deductibles or some limit that another insurer is responsible for. Thus reinsurance is longer tailed since the excess-of-loss component of losses is generally slower to develop. As a result, premiums in these lines are more interest-sensitive.

Beyond the cyclical issue there is also an important longer term issue. There has been a secular lengthening in loss emergence across lines. For example, the claims payout on many reinsurance lines has slowed substantially in recent years. Claims are coming later and in bigger amounts than actuarial calculations based on historical experience would indicate. As a result, loss reserves have generally been inadequate in recent years. Whether this is due to the changes in legal and social attitudes toward insurance or to other factors, it implies that the industry is more sensitive to interest rate fluctuations than in the past. To reduce this long-tailed exposure, insurers have begun to write more coverage on a claims-made basis. Claims-made policies make the industry less sensitive to interest rate fluctuations.

**Stages of the cycle**

Table 1 shows how the interest rate sensitivity of premium pricing translates into the stages of the property/casualty insurance cycle. The upturn (stage 1), where the industry is now, is the recovery stage when prices move back into line with costs and availability of coverage is a problem, as bigger risks are dropped. For the consumer, this is the problem phase of the cycle. For the insurer, it is the improvement phase. It generally coincides with falling interest rates.

At the peak (stage 2), profitability for the insurer is highest, setting the stage for the decline (stage 3) as new capital comes in and price competition reverses the profit cycle. Higher interest rates, should they emerge, would provide further impetus for price cutting at this stage. In the crisis stage, price cutting gets out of control and companies begin to fail (stage 4). The most recent cycle began stage 1 from a trough in 1975, rose to a peak around 1978, and began a decline that continued into 1984. During the declining phase, prices in some commercial lines went down 50 percent or more. Personal lines were not as seriously affected. Some firms attempted to raise rates in the declining phase but lost market share as a result. By 1984, price increases and the recovery phase had begun. The big price increases have been in the lines where competition was most excessive in the crisis stage.

The rate of return on property/casualty companies' capital tracks this cycle quite closely. The peak in profitability around 1978 attracted many new firms into the industry, setting off the price wars (Chart 4).

**What made the recent cycle different?**
The cycle that began in 1976 was longer than usual and more pronounced. A traditional rule of thumb for the property/casualty cycle is three years up and three down. The most recent cycle was three years up and three down.

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*A claims-made policy covers only claims initiated during the policy period. Traditionally, coverage has been on an occurrence basis, so that an insurer covering the policy period 1987 would still be liable for claims filed in 1995 based on damages arising out of incidents occurring in 1987. Under a claims-made policy, any claims would have to be initiated by the end of 1987.*
six down, bottoming in 1984. What made the downturn so long and sharp?

Five factors seem to account for the severity of the recent cycle and suggest that the recovery phase will also take longer than usual:

- the unusually large swings in interest rates over the last 10 years,
- the relatively worse cyclical performance in long-tailed commercial lines,
- the unexpectedly rapid growth in claims costs,
- the 1979 entry of captive insurers into third party business for tax reasons,\(^{10}\) and
- the large inflow of foreign reinsurance capital.

The magnitude of interest rate changes alone would have guaranteed a longer and sharper cycle since 1975. Because the peak phase of the insurance cycle generally does not occur until interest rates have begun their cyclical upswing, the recovery phase of the current property/casualty cycle will probably be extended by the unusual behavior of interest rates in the present general business expansion. Normally interest rates would have begun to rise this far into an expansion. If rates are in a secular return to a more normal pattern, the insurance recovery phase may be extended as firms continue to raise premiums to offset falling investment income.

\(^{10}\) Captive insurers are set up by firms to provide themselves with in-house insurance services.

The relatively greater severity of the last cycle in long-tailed commercial and reinsurance lines also works to prolong the recovery phase of this cycle. Claims associated with policies written in the aggressive price-cutting phase of the last cycle (1978-83) will continue to haunt insurers well into the future. To some extent companies have prepared for this by holding large loss reserves. But the general consensus seems to be that the industry has insufficient reserves for the future claims arising from coverages written in the last cycle.\(^{11}\)

Besides the usual cyclical fallout from poor underwriting, the unexpectedly rapid growth in claims costs in the long-tailed commercial and reinsurance lines has exacerbated the situation. A recent Rand Corporation study blames the rising costs of the personal injury system rather than the volume of cases for the inflation in insurance losses. According to this study, damage awards and insurance settlements in personal injury cases have increased on average twice as rapidly as inflation during the past five years.\(^{12}\) The volume of lawsuits filed increased an average of only 3.9 percent a year during this period, according to the study. In essence, the high nominal interest rates of recent years were insufficient to protect insurers against rising claims costs. The unusually high level of inflation in the late 1970s and early 1980s meant that the real return on insurers’ investments was much lower than the nominal return. The even greater rate of increase in claims costs made the problem that much more severe.

Many analysts also attribute the severity of the last cycle to the special role of captive insurers. In 1979, captives were forced to seek third party business to maintain their special tax status as insurers. Some claim these relatively inexperienced insurers pushed prices too low by aggressively bidding for outside business.

Finally, the U.S. has traditionally been a net importer of reinsurance from Western Europe, with about one-fourth of reinsurance coverage supplied from abroad. In the late 1970s high returns to capital in the property/casualty industry compared with other industries attracted an inflow of European capital that put additional competitive pressure on premiums and contributed to the severity of the cycle.

**Capital adequacy and failure**

The amount of policyholders' surplus (capital or net worth) in the property/casualty industry more than


\(^{12}\) See James S. Kakalik and Nicholas M. Pace, "Costs and Compensation Paid in Tort Litigation: Testimony Before the Joint Economic Committee of the U.S. Congress," Rand Corporation, Institute for Civil Justice (July 1986).
doubled as it rose from the cyclical low point of 1974. The standard regulatory measure of capital adequacy is the premium-to-surplus ratio. A company with a low ratio is in a position to write additional business. Although it has increased somewhat as more leverage has been accepted over the years, the rule of thumb is a ratio of three- or four-to-one. Regulators may consider a company with a higher ratio to be overextended and not in a position to write new business. Of course, the significance of any particular premium-to-surplus ratio depends on other factors as well. For example, a company with ample loss reserves is in a better position to expand its business prudently than a company with inadequate reserves. Basically, the underreserved company has overstated its true capital.

Problems with the premium-to-surplus ratio as an indicator of capital adequacy arise because the volume of premiums is an imperfect measure of potential loss exposure. The same amount of premiums could reflect either a large amount of coverage at a low price or a small amount of coverage at a high price. Obviously, the latter situation is less risky than the former. In the current recovery phase of the cycle, with prices high and coverage hard to get, premiums have risen relative to the amount of coverage. A high premium-to-surplus ratio is less worrisome under these conditions.

While there is wide variation in the premium-to-surplus ratios of individual companies, the aggregate ratio for the industry declined through the last cycle until 1983. The recovery phase of the insurance cycle is marked by a capacity shortage while this ratio increases and companies are constrained from writing new business. This helps the recovery of prices.

The premium-to-surplus ratio masks another important dimension of risk. Two companies may have the same premium-to-surplus ratio, yet one may have a much shorter average tail length on its policies than the other. Companies with longer tailed business will generally carry a larger proportion of loss reserves to assets than companies with shorter tailed business. Their capital is more leveraged as a result. To measure this aspect of capital adequacy, analysts use the ratio of loss reserves to surplus. This measure shows the size of expected losses in relation to capital or surplus. It has more than doubled over the past 20 years. The increase in the ratio of loss reserves to surplus is the primary factor behind the declining capital-to-asset ratio in the industry.

The reserve-to-surplus measure of capital adequacy is also imperfect. If a firm deliberately underreserves, it will appear to be in better shape than it actually is. But as a rough indicator this ratio is useful. Firms generally reserve within a sufficiently close margin of their actual needs to make large differences between firms’ reserve-to-surplus ratios useful for comparison purposes.

There is wide dispersion in the ratios of loss reserves to surplus among property/casualty companies. A company with a high ratio has less margin for error in its loss reserve computation. For example, a firm with a two-to-one ratio, underreserves by 10 percent, would have 20 percent less capital than reported, while a firm with a five-to-one ratio, underreserves by 10 percent, would have 50 percent less capital than its accounts would show. Because there is a general consensus that firms are underreserved for the claims likely to result

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The idea behind the premium-to-surplus ratio as an indicator of capital adequacy is straightforward. The presumption is that the amount of risk that may be safely assumed by an insurance company should be related in some way to its net assets. Policyholders' surplus is the capital cushion firms have to pay policyholders' claims if premiums prove insufficient to cover future claims costs.

A few words about property/casually accounting conventions may be useful at this point. A major liability on the books of property/casualty companies is loss reserves. Property/casualty loss reserves are fundamentally different from loss reserves at life insurance companies or other financial institutions like banks. Property/casualty loss reserves are set up after events causing losses have occurred. Life insurance and bank loss reserves are set up in anticipation of events causing losses.

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Chart 5
Involuntary Retirement of Property/Casualty Insurers and Combined Ratios

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Source: Best's Aggregates and Averages, Best's Management Reports

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FRB NY Quarterly Review/ Autumn 1986
from coverage written in recent years, firms with high ratios of loss reserves to surplus deserve special attention.

Failures or involuntary retirements in the property/casualty industry generally move with the combined ratio. This has been especially true in the high interest-rate environment of the past 12 years. The two most recent cyclical low points (1975 and 1984) coincide with peaks in the number of failures in the industry (Chart 5).

Outlook
The industry is currently enjoying a sellers' market. Surplus increased substantially over the past year, mainly as a result of equity issuance and capital gains from the stock and bond market rallies. Earnings also contributed to surplus as firms continued to increase premiums and stopped writing coverages in areas where legal uncertainties preclude sound actuarial evaluation of risks.

Availability of coverage problems are confined primarily to product liability, directors' and officers' liability, professional liability, and environmental damage coverage. In these lines coverage above certain amounts is now often written on a claims-made rather than an occurrence basis. This eliminates the longer tailed exposure by confining insurance company losses to claims made during the policy period.

A look at the distribution of property/casualty company ratings also suggests that the worst of the industry's problems may be over (Chart 6). The steady deterioration from 1981 to 1985 stabilized in 1986, and the strong earnings reported this year suggest the 1987 distribution of ratings will show some improvement.

The most vulnerable area of the industry is reinsurance, where high claims awards have hit hardest. This less regulated area has also been the focus of fraud in the industry which, as in other financial industries, is an important cause of insolvencies. Unfortunately, these problems have created uncertainty about the quality of reinsurance on the books of many primary insurers. The adverse consequences of uncollectable reinsurance which erodes surplus and limits capacity to write new business should reinforce the effects of lower interest rates in prolonging the recovery phase of this cycle. Partly offsetting this, however, are the exceptional opportunities for new entrants and those firms that escaped the worst consequences of the last downturn.

The combination of unusually high and volatile interest rates with the other factors cited earlier—the relatively poor performance of long-tailed lines, the growth in claims costs, the role of captives, and the inflow of foreign reinsurance capital—seems to account for the severity of the recent recession in the industry. Consequently, the next downturn should be less severe if...
three current trends continue. First, the return of inflation to low and less volatile levels should clarify the outlook for future claims costs. High and volatile inflation rates mask the real cost of future claims, making it more likely that some firms will price insurance inadequately to meet future obligations. Competition pressures other firms to make the same mistake. By reducing uncertainty about future costs, price stability eliminates one important source of volatility in the industry.

Second, and critically related to the inflation outlook, stability in interest rates around lower, more normal historical levels will reduce the pressure for excessive cashflow underwriting. The relationship between premiums and claims is less variable when rates are stable. Market determined prices are more likely to match the costs of providing coverage when the cloud of interest-rate uncertainty is lifted.

Finally, the legal uncertainty surrounding future claims costs is also a barrier to efficient pricing. The broadening of the legal concepts of liability and damages over the past 25 years is associated with an ever-growing share of national output devoted to insurance losses (Chart 7). More than 30 states have adopted elements of tort reform to stem this long-run increase in the real burden insurance costs place on the United States economy. These reforms incorporate recommendations from consumer groups and the insurance industry. Similar efforts are under way at the federal level. The unexpected claims costs associated with the broadening scope and size of insurance settlements contributed to the severity of the most recent down cycle. Successful reform efforts should mitigate the next down cycle.

Taken together, these trends, along with the shift of extraordinary risks to claims-made policies, should aid the industry as it continues to improve its financial condition.

Robert T. McGee