

**The paradoxical nature of marine
underwriting**

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The Paradoxical Nature of Marine Underwriting

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By Neil Hiller

Thankyou for allowing me the opportunity to talk to you today.

My talk comprises of a series of questions relating to apparent contradictions that exist in the field of marine underwriting.

These are questions about our understanding of the role of the underwriter. Hopefully, it offers some ideas on how Marine insurers can better understand the perspective of clients and, to some extent, I hope it will provide you with some insight into the difficulty and complexity of the underwriter's task.

Prior to 1945, Marine premiums equated to more than 50% of the global insurance markets premium income. We are all aware that this figure has steadily reduced. For many in insurance, Marine is now regarded as little more than a relatively minor niche insurance product.

Needless to say, I am very relieved to have found an audience that might be sufficiently interested to listen to what I have to say!

Marine premiums now account for less than 5% of total Australian insurance revenue. It appears to many that the separate Marine insurance market that we know, is destined to shrivel up & die in Australia.

There are many reasons why this decline has occurred; I will not go into these here other than to say that there is a future for Marine insurers if they better understand and redefine the 'product' they can offer to a broader marketplace.

The issues discussed here today may have some relevance to other classes of insurance but the subject of my talk is mainly confined to Marine underwriting, that is Cargo and Hull insurances.

The starting point of my presentation is a brief reflection on the roles and functions of Marine underwriters. More accurately, it is a look at what they say they do and the 'product' they say they sell.

By way of comparison, one needs to briefly exam what underwriters *actually* do and, what they *don't* do.

If there are real discrepancies between the marketing language and the experiences of Marine policyholders; "why"?

Mentioning the title of this talk to a few underwriting colleagues, you will not be surprised to learn that they were slightly alarmed; actually they were more confused! In the context of my subject, I think that the best definition of paradox is: "... a person or thing that combines contradictory features or qualities".

My talk is essentially about the conflicting nature of the underwriter's task and the objectives that the underwriter is typically required to achieve. It highlights the difficulties that marine underwriters face in reconciling policyholder needs with insurance company shareholder needs.

The talk is certainly not aimed at eliciting sympathy for underwriters but I do hope it generates amongst the audience today a little more understanding of the predicament underwriters so frequently, and usually unconsciously, face.

I would stress that my comments are derived from personal observations over almost 3 decades in this industry. They are not necessarily the views of my employer and not intended as criticism of colleagues, competitors or friends.

Is there an inherent conflict between the needs of the policyholder and the purpose of the underwriter? Are their motives for formulating an insurance contract so far removed from one another that that they make conflict inevitable?

Of course insurance is like no other product; intangible, invisible and based upon something sometimes described as a “promise to pay something, if something unlikely happens in the future”. It is hardly surprising that sellers and buyers have differing perspectives of what it is they are entering into.

To better understand these perspectives it is worthwhile looking at the language of the insurers’ marketing materials and websites. If they are believed then insurers fully understand the needs of their clients and have little difficulty satisfying their needs.

Clearly, insurers are there to transfer risk and they are able to do this by assessing risk probability. Presumably, policyholders realise this and purchase cover expecting to get a claim paid when a loss occurs. This does not always happen and we all know of occasions when there is intense disappointment when they discover that they are not covered at all, or to an extent that is less than they expected.

Perhaps some would consider this a natural state of affairs; the courts are testimony to a significant proportion of disgruntled policyholders, or disillusioned underwriters. A comparison with customer satisfaction surveys of Japanese auto makers would make interesting reading!

To answer some of the questions it is necessary to re-look at accepted underwriting principles, and examine some of the qualities & skills of successful underwriters.

Is there anything paradoxical about the Marine underwriter’s role?

The contemporary view of an underwriter’s role has altered very little over the last few hundred years. A Chartered Insurance Institute textbook states that the function of insurance is:

- “Risk transfer
- “Creation of a common pool”
- “Calculate equitable premiums”

It follows that underwriters need to sell many policies to create a pool and to do this they need to attract clients by offering to transfer risk. Presumably, they keep these policyholders by making them reasonably happy with their service or product. Not all policyholders have claims so it is not always clear how they make them happy; except by charging low premiums of course!

This seems logical and is fairly straightforward for a mutual insurer but is it true for an insurance company?

Shareholders of insurance companies invariably aim to gain significant profit and the bigger, the better. In the real world of Marine insurance that I know, a 'good' Marine underwriter identifies risk, particularly the most hazardous, and seeks to avoid it!

It is generally understood that policyholders, or their risk managers, look to avoid or mitigate 'down side' risk. Not surprisingly, they look to transfer the most hazardous of risks.

The fundamental question is: "no matter how hard an underwriter tries, can a Marine underwriter keep a client happy and the boss happy, at the same time"?

So what is it Marine insurers offer their clients?

Take a selection of local Marine insurer websites that provide a mixture of confident reassurances that whatever a prospective client is looking for, the insurer will deliver it:

- "we understand the risk"
- "a range of products to meet your needs"
- "whatever your needs"
- "delivers peace of mind"
- "specialists offer broad experience"
- "promises stability"
- "meet identified needs of customers"
- "provide total customer orientated solutions"

When analysed, cynics may claim that typical insurance marketing jargon is mainly unimaginative or perhaps meaningless. The more cynical might complain that they are almost deceptive.

Certainly there is no detailed explanation in these slogans as to what it is that Marine underwriters offer the Marine insurance buyer.

What are policyholder needs?

In my experience as an insurance broker, when asked, clients most often repeat the insurers publicity stating that they want "peace of mind" or that they require "value for money".

Interestingly, very few Marine insurers actually make a studied examination of what policyholders require insurance for.

Because Marine insurance is largely an intangible 'product', very few clients manage to articulate exactly what 'value for money' means except to say that it is ideally: "widest coverage at the most competitive (not necessarily the cheapest, but thereabouts) premium".

There have been some efforts to interpret that most popular phrase: 'peace of mind'. For many it means that insurers *should* provide:

- Genuine transfer of risk (removes worry concerning exposures)
- Certainty (when an event occurs, no doubt that insurers will pay)
- Business continuity (bad events do not mean company failure)
- Disruption reduction (insurers help smooth things if a loss occurs)
- Rapid resolution of claims (quick insurer action to solve problems)

For a Marine insurance client, the need is obvious: "if my cargo gets lost or damaged I would like the insurer to quickly give me the money to replace or repair it".

Very few Marine insurers that I know have seriously discussed with their policyholders, or prospective policyholders, what their fundamental needs are. Perhaps it is because they assume that brokers know this and if insurers were wrong, the brokers would tell them. Yes, there may be the occasional "how can we improve our service" survey but nothing that questions the underlying need of a an importer, an exporter of a shipowner.

A more insightful question is: "why buy Marine insurance instead of not buying insurance"? With the advent of Alternative Risks Transfer solutions in the last 20 years, the responses are likely to be less obvious.

A 1997 Oxford University study at Templeton College raised doubts about traditional perceptions. Clients do not necessarily buy insurance to simply get cash to replace damaged assets. Increasingly the preoccupation of management is to protect shareholder value. There is a significant difference.

The study found that senior management is now more focused on protecting share price rather than the worth of physical assets of the company. This is important bearing in mind that share price is determined more by future income expectations rather than asset value or historical financial performance.

Researching the share price of a group of corporations that had been directly affected by major physical catastrophes occurring over the last few decades, the study found that invariably share prices reverted to very near their former level within 50 days of the event; irrespective of whether the company had insurance coverage or not. In contrast, Marine insurance is intensely focused on historical results and causes of loss.

But what is the reality of the experience for insureds? Are there necessarily better off than not insuring?

Dr Alan Punter a statistician and researcher and head of Aon's Alternative Risk division based in London points out that all the evidence suggests that Insurance does *not* appear to deliver:

- Clarity of cover: don't understand the extent or limitations of cover
- Certainty of payment: don't know if they will be paid
- Certainty of timing: don't know when they will be paid
- Certainty of amount to be paid: don't know how much will be paid

He insists that policyholders are not sure what they have bought until post event; after a loss has occurred. Logically, if a claim does not occur the client remains ignorant of the extent of their coverage throughout the currency of the policy.

Punter questions the 'value for money' and 'peace of mind' propositions indicating that for many insureds' their actual experience may be something completely different because insurance:

- has a high frictional cost and actual cost may exceed the benefits
- cost & capacity varies: cyclical fluctuations in rates/cover availability

He further suggests that insurers are inherently risk averse. By this he means that insurers look to avoid or exclude identified risks rather than assume risk.

Is there is any merit in this argument that insurers look to avoid risk and helps explain why policyholders often express disappointment?

To answer this question it is necessary to first consider the objectives of a Marine underwriter.

Apart from "meeting client expectations" (a favourite along with "exceeding expectations") it is, I think, generally accepted that underwriters strive to make a profit. Post the HIH debacle, most policyholders concede that it is imperative that Marine insurers make a profit; realising that it is needed if an insurer is to stay in business (but that is not to say that policyholders would be happy that insurers make a profit on *their* particular policy).

This raises an interesting issue: policyholders resent the idea of subsidising those other policyholders that are more prone to risk or who act carelessly. In which case, it could be argued that a Marine insurer should endeavour make a profit on each policy.

Should each policy 'stand on its own two feet'?

This may not sound feasible but anyone who is familiar with the way Cargo account premiums are calculated will be aware that premiums are calculated to produce a profit on each policy: premiums are calculate to exceed claims.

When I was a trainee Cargo underwriter I was told that the underwriter is the trustee of the premium pool. It was therefore my task to protect that pool by screening out more hazardous risks; declining or excluding coverage.

The underwriter's task is further complicated by the need to grow the premium pool. On the one hand, there is an advantage for existing policyholders in that the bigger the pool the more able it is to continue after sustaining large losses. On the other hand, there is real danger in a competitive market that growth is often achieved at the expense of compromised underwriting standards & prices.

Few would deny that an underwriter's job is a confusing, if not difficult, job!

Taking cargo insurance as an example, how does a Cargo underwriter avoid making an underwriting loss on the entire book of business?

Compared to a Motor or Property portfolio, a Cargo account consists of a huge number of heterogeneous, unknown, risks. There are an unlimited variety of cargoes; from an underwriter's viewpoint these travel across the World facing unknown & unseen perils. It is not practical to accurately identify and measure the level risk an individual cargo is exposed to during the course of any one transit.

I have already mentioned that there are a limited number of options available to a Cargo underwriter wishing to maintain a profitable loss ratio:

- Ensure that policyholders' premiums exceed their claims
- Identify risks and avoid those that are more likely to have claims

For the reasons mentioned (complexities involved in producing 'correct' technical rates) the former is very difficult and the implications of risk acceptance can be intimidating for an underwriter. The latter option (reject/exclude cover) is an easier option for a Cargo insurer.

The Marine underwriting function is therefore often reduced to a basic choice: risk acceptance or risk avoidance. Recent examples of risk identification and exclusion include:

- Institute Radioactive Contamination/Chemical Weapon Exclusions
- Institute Cyber Attack Exclusion
- 'Y2K exclusions'

Most astute clients would want to insure specific risks that are particularly susceptible to damage. Rust damage on hot rolled steel for example. In our insurance market, most believe that an expert Cargo underwriter is one that excludes such risks. Conversely, few would argue against the notion that a less expert underwriter, an inexperienced or stupid one, will not realise the nature of the risk, and is more likely to insure these risks.

In my mind, this example illustrates the paradox that exists in the modern era of Marine underwriting: a client may find the prospect of dealing with an inexperienced underwriter as more attractive than an expert one.

It might be observed that Marine underwriters, protecting the premium pool, increasingly only look to underwrite risks that barely exist, or do not exist, or where they can be certain that the premium they charge a policyholder is more than the claims that they pay out.

It occurs to me that policyholders might progressively recognise that there is not much point in this exercise called Marine insurance and the premium pool will continue to diminish accordingly.

Marine underwriters need to have much deeper knowledge about their clients' needs, expectations & objectives. Only when we begin to reassess our role, re-define our product, work with our clients in managing risk and then fully embrace risk, shall Marine insurers be able to re-establish a meaningful position in the global insurance marketplace.

Thank you for your time

