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Would You Trade Increased Volatility for a Chance to Break 100?

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You may have read about some standard lines companies deciding to swim with the sharks in the E&S property ocean. This begs the question, what could compel an established, traditional insurance company to enter the E&S space? Why now? What do they know that I do not? Should I be thinking about how this could improve my results?

These are the recent questions we have been fielding from a variety of clients and prospects. The answers are not simple, because there are two competing issues that companies grapple with: the economics and the emotional attachment to the status quo.

The Motivation

The economics behind these decisions are the easiest part of our answer. But even with the economics in hand, it is tough to supplant the visceral reaction to the quintessential standard lines company entering the E&S property space. They have stayed the course for their entire long and storied existences. But the historical course is not yielding their desired results.

Digging a bit deeper, we find that the economics explain both the numbers side and the emotional side of these questions. The bottom line is standard lines companies are becoming frustrated – they can do everything right and still run at a 100% net combined ratio. They thoughtfully analyze their business to identify problems and adjust their strategy, they cautiously grow their business by adding new lines and/or expanding into new territories, they build loyalty with their producers and policyholders and they add to surplus in most years. Even with these purposeful actions, they run around 100% net combined ratio. This is the main element that is pushing them to rethink their strong desire to stay the course.

Competition in the standard lines market has created a long-term environment that makes it difficult to write non-cat exposed business at anything less than a 60% loss ratio. When you overlay the cost of catastrophe reinsurance, albeit on the smaller side given the nature of the business, and a reasonable expense ratio you get to around a 100% net combined ratio.

The Options

A non-cat focused E&S property book can run better than a 60% loss ratio, but that is a tricky business that requires a significant investment to do well. If you have local market knowledge, spend the money on inspections and third-party data sources, and stick to a line guide, you can produce a 47.5% expected loss ratio. But if you get one of these three things wrong, that figure can easily double.

Catastrophe focused E&S business is a different ball game. A single office with 5 people can build and grow that business. However, expertise makes a huge difference in this arena as well. You need specialist expertise in catastrophe modeling and underwriters who recognize the need to wear three hats: risk selection and pricing, attachment point selection, and capital management from a marginal PML perspective. Writing a new HO policy in a given territory may not move the needle on your overall capital or catastrophe reinsurance needs, but the same cannot be said for a shared and layered program in the Southeast.

Some companies are choosing to enter the E&S property space by supporting specialist MGAs. In part, this is because bona-fide specialist underwriters are moving to the MGA space, bringing their credibility and relationships with them. Wholesale brokers are also building in-house MGAs to capture a bigger share of the wallet with respect to the business flowing through their organizations. But again, this option has risks. Some of these risks can be mitigated by ensuring interests are aligned properly between all parties. The MGA space is not a world to dabble in without building controls and formulating a sound plan.

The Rewards

Even with the risks identified, the rewards of success are tempting. If you get everything right with a cat-exposed E&S property portfolio, whether you build it or partner with a 3rd party, you can run at an expected total loss ratio of around 50% on that book. Of course, there is no free lunch. The PMLs associated with a book of this nature tend to be around 225% of what a typical standard lines book produces. This means additional volatility for the carrier as you are now exposed to different types of natural peril events and your downside risk is increased.

Where the math gets very interesting is when you contemplate adding a $30m book of E&S property to an existing standard lines book of $150m. If the new exposure is non-correlated with the existing book, your overall catastrophe reinsurance needs do not increase. You pay more for the first few layers because they become exposed to more types of events, as is your net retention. But on an expected basis, we estimate the overall group combined ratio pick goes down by about 3-points for this scenario. In a year without a major hurricane or earthquake, we calculate the difference to be a 6-point improvement in the overall net combined ratio.

With the economics laid out, ***the question to ask yourself is: are you willing to make the investment and accept increased volatility in exchange for the chance to run at a 94% net combined ratio in a good year?*** Some of the country's most traditional companies are answering that question with a resounding yes.

BMS Re can help you determine if one of these approaches could improve your results. Contact us to learn more:

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