



Spring 2000

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Trends in the P&C Marketplace

by Joy A. Schwartzman, FCAS, MAAA

As we enter the 21st century, recent events in the property and casualty insurance market suggest new trends that are emerging in the industry. Among those recently discussed in the media are:

- A flight to low-cost, high-value, high-service, financially secure insurance alternatives
- A move for companies to identify and focus on their core areas of expertise
- Continued strategic acquisitions to satisfy interest in global expansion, improve profit margins, and access alternative forms of distribution
- Growing use of the internet as a source of information and sales
- Insurers' commitment to multiple distribution channels
- Greater use of affinity groups to target market insurance products
- Changes in the fronting markets

This article focuses on three events that exemplify these trends:

- AIG's growth in the personal lines market
- ACE's acquisition of CIGNA's property and casualty insurance units
- Unicover

AIG's Growth in the Personal Lines Market

In the personal lines market, AIG came from nowhere in the early 1990s to its current status of 12th in the nation, based on direct written premium (see Table 1). The company defines its core business as mass marketing and specialty auto. The mass marketing operation, which accounts for the majority of premiums, sells insurance on a direct-response basis, while the specialty auto division focuses on nonstandard auto risks sold through independent agents.

A recent security analyst report on AIG notes: "The company started to build the business in the early 1990s. AIG was convinced from the beginning that, in order to be successful on a long-term basis in personal lines products, it had to be a low-cost, high-quality service provider. With the advent of technology, AIG was able to focus on building its direct-response operations."

AIG's personal automobile results speak for themselves (see Table 2). The expense ratio is now well below the industry's; and in 1998, the combined loss and expense ratio was seven points lower than the industry's.

Table 1

PRIVATE PASSENGER AUTO					
Rank	Company/Group	1998	% Market Share		
		Direct Premiums (\$ Millions)	1998	1997	1996
1	State Farm Group	23,200	19.7	20.5	21.4
2	Allstate Insurance Group	14,565	12.4	12.3	12.4
3	Farmers Insurance Group	6,899	5.9	6.0	5.9
4	Nationwide Group	5,053	4.3	4.3	4.2
5	Progressive Group	4,896	4.2	3.7	3.0
6	Berkshire Hathaway	4,061	3.5	3.0	2.7
7	USAA Group	3,536	3.0	3.1	3.1
8	Travelers PC Group	2,278	1.9	1.7	1.7
9	American Family Insurance Group	2,251	1.9	1.8	1.7
10	Liberty Mutual Insurance Cos.	2,155	1.8	1.8	1.8
11	Safeco Insurance Cos.	1,749	1.5	1.5	1.4
12	AIG	1,744	1.5	1.4	1.4
13	Hartford Insurance Group	1,681	1.4	1.3	1.3
14	California State Auto Group	1,433	1.2	1.3	1.3
15	CGU Group	1,353	1.1	1.2	1.2
Total	U.S. Companies	\$117,632	100.0	100.0	100.0

Source: *Best's Review*, October 1999

Table 2

PERSONAL AUTOMOBILE RESULTS			
Net Premiums Written (\$ billions)	1998	1997	1996
AIG	\$1.4*	\$0.8	\$0.7
Industry	\$117	\$114	\$108
Expense Ratios			
AIG	15.4%*	16.9%	15.3%
Industry	23.6%	22.7%	21.8%
Combined Ratios			
AIG	94.2%*	97.5%	100.4%
Industry	101.1%	99.5%	101.0%

* Includes the consolidation of 20th Century Industries for the third and fourth quarters.

Source: A.M. Best Company, Company Reports

Other AIG direct-response initiatives

Capital infusion into 20th Century

In 1994, the Northridge earthquake severely depleted 20th Century's capital through the losses on its homeowners policies. AIG responded with a capital infusion, which—through additional stock purchase—was converted into majority ownership of 20th Century. While the homeowners losses impaired the company's capital base, 20th Century's low-expense direct-response auto franchise remained in tact, making this an appealing investment for AIG.

Agreement with MBNA to underwrite auto, homeowners and personal umbrella insurance for MBNA customers

In January 1999, AIG reached an agreement with MBNA America Bank N.A. to underwrite auto and other personal lines insurance for MBNA customers. AIG projects to write in excess of \$1 billion of premiums through this arrangement, almost doubling its current auto premium writings.

Internet online price quotes

In the fall of 1999, AIG announced that its internet site would offer price quotes for individuals and small businesses. An October 19, 1999 *Wall Street Journal* article opined that this move would likely pressure other insurers to speed up their internet efforts.

Direct-response auto program in Japan

AIG is the first company in Japan to receive a license to sell rate-differentiated direct-response auto insurance coverage. Fifteen percent of its one million Japanese auto policies are already written through the direct operation.

What trends does this event exemplify?*Tomorrow's winners will be the low-cost, high-quality service providers*

AIG became a low-cost, high-quality service provider by cutting out the independent agent to reduce its expense ratio and using technology to deliver information.

A recent *Wall Street Journal* article announcing Allstate's launch of online sales of auto and homeowners insurance quoted Allstate Chairman and Chief Executive Edward Liddy saying, "It's a very competitive marketplace out there right now. The industry leaders nowadays are those that have the lowest cost structure."

Many insurers will offer multiple distribution channels

AIG uses direct response for preferred auto business while they use independent agents to write their nonstandard business. Progressive, a highly successful independent agency company, recently introduced Progressive Direct, representing sales via direct mail, the internet, the telephone and to affinity groups.

Companies such as Allstate, Nationwide and Farmers use alternative distribution to complement their captive agency force. In fact, enhanced distribution was the objective of several acquisitions announced or completed in recent years, such as Nationwide's purchase of the Allied Group.

Finally, the financial services reform bill, S900, which eliminates the Glass-Steagell bank/insurance restrictions, will no doubt accelerate the distribution of insurance products through banks.

The internet will grow as a source of information and sales

The AIG website offers price quotes for personal lines business. AIG is also advertised on the website of Autobytel, which facilitated the sale of 1.3 million cars in 1998. Autobytel.com advertises automobile insurers and provides a direct connection to AIG's personal lines website.

Another example is Progressive's website, which provides information, offers price quotes for Progressive (and up to three other competing auto insurance companies), and sells insurance online.

And, in November 1999, Allstate announced its direct-sales initiative, using the phone and the internet.

Greater use of affinity groups to target market insurance products

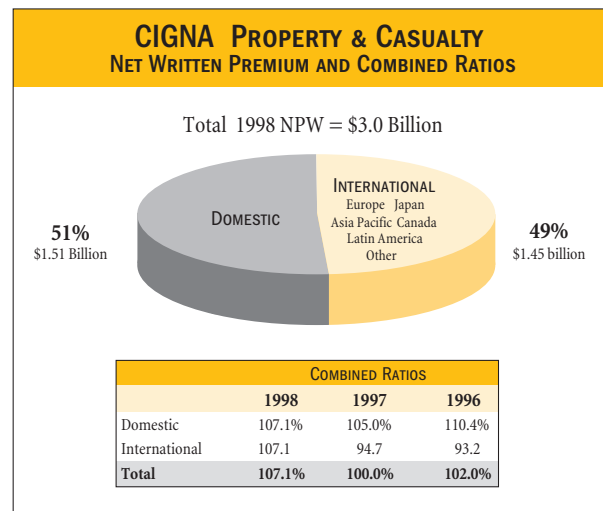
The AIG/MBNA personal lines agreement is one example. If it proves successful, it may be expanded to sell SunAmerica's savings and other retirement products. (AIG purchased SunAmerica in 1998.)

Other examples are: Travelers marketing its insurance products to Citibank credit card customers, and the Hartford Insurance agreement to sell personal lines insurance products to Juno Online's customers.

ACE's Acquisition Of CIGNA's P&C Insurance Units

In July 1999, ACE Ltd. of Bermuda acquired the U.S. and international P&C insurance business of CIGNA Corporation for \$3.45 billion. The purchased CIGNA companies comprise about \$1.5 billion of U.S. commercial business and \$1.5 billion of international business (see Table 3). CIGNA's interna-

Table 3



Source: CIGNA Corporation, December 31, 1998, Form 10-K

tional operations are large in Europe, Canada, South America, Japan and other Asian countries.

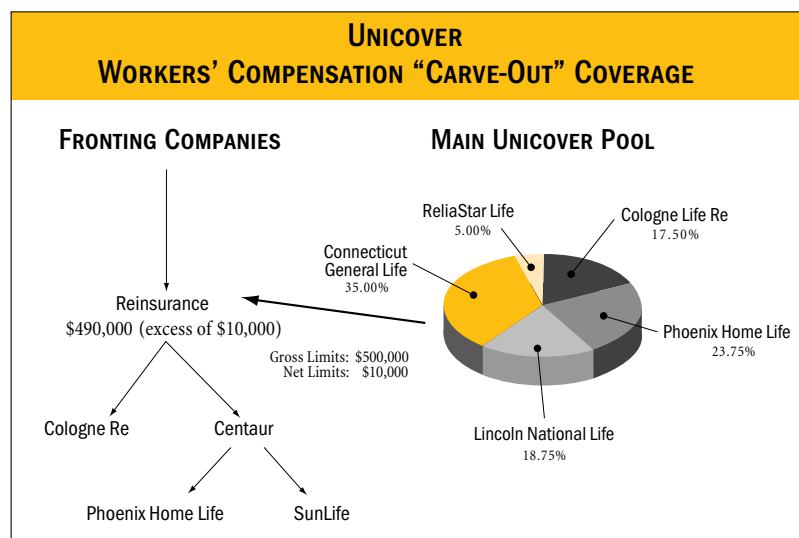
In conjunction with closing this transaction:

- ACE committed to reducing CIGNA's expense ratio from 38% to 30%. (One source of expense savings will be a 10-year agreement with IBM Global Services to manage the information technology integration for CIGNA's U.S. business.)
- ACE purchased a \$1.25 billion stop loss treaty from Berkshire Hathaway's National Indemnity Company to protect CIGNA's runoff operations.
- And, in October 1999, ACE announced the sale of renewal rights to the CIGNA middle market Commercial Insurance Services (CIS) business to a unit of Liberty Mutual.

What trends does this event exemplify?*A move to focus on core business segments*

CIGNA sold its P&C business to concentrate on its core businesses—health insurance and employee benefits. This is the same reason Aetna sold its P&C business to Travelers several years ago, and why Travelers sold its health business.

Table 4



Source: *Property/Casualty Best Week*, March 8, 1999, and *Dowling & Partners Securities, L.L.C. IBNR Insurance Weekly #9*, February 28, 1999

ACE's plan to sell the middle market U.S. business renews reaffirms that companies are taking steps to focus on their core business, which for ACE is large corporate clients and specialty niches. Further, St. Paul and CNA Financial Corp. are both divesting their personal lines operations to focus on their core business, commercial lines and specialty operations.

Continuation of strategic acquisitions

With the CIGNA acquisition, ACE became a global insurance concern with a highly profitable international franchise. With a soft, nongrowing U.S. P&C market, companies will continue to look for strategic acquisitions that satisfy their interest in global expansion, provide access to new distribution systems, and help them produce better profit margins, in many instances by reducing expenses.

A move to low-cost, high-service alternatives

ACE's expense cuts and commitment to lowering CIGNA's expense ratio is further evidence that, to be a viable competitor, an insurer must be a low-cost alternative. Other examples include the ongoing efforts of St. Paul and CNA to create more efficient operations following their acquisition of USF&G and Continental, respectively. To improve returns, both companies announced staff reductions in 1998.

Maintaining a strong balance sheet

The \$1.25 billion stop loss treaty on the CIGNA runoff business reaffirms the necessity of a strong balance sheet to compete in today's insurance market. Companies cannot afford the earnings drag, balance sheet impairment and possible financial rating downgrade associated with adverse-reserve development from old business.

Unicover

Unicover is a reinsurance facility offering workers' compensation carve-out coverage through its pool of five life insurance companies and through fronting companies (see Table 4). The pool wrote gross limits of \$500,000 and then reinsured the insurance layer above \$10,000 to Cologne Life Reinsurance Co., Phoenix Home Life Mutual Insurance Co. and Sun Life Assurance Company of Canada.

There is an estimated \$8 billion of workers' compensation gross premium utilizing this reinsurance facility. Cedants encompass all major workers' compensation insurers including AIG, Safety National, Liberty Mutual, Fremont General and Great American, among others.

The attraction of this reinsurance was its low cost. The \$490,000 excess of \$10,000 layer covered over 50% of total workers' compensation loss dollars for roughly 25% of total premium. Thus, under reasonable assumptions, even if workers' compensation business was running an 80% loss ratio, this layer would run a 160% loss ratio. The Unicover reinsurance facility stopped accepting business in 1999 after significant unexpected premium growth and the prospect of large underwriting losses led pool members and retrocessionaires to withdraw.

What trends does this event exemplify?

Focus on core areas of expertise

Unicover's downfall demonstrates why insurers should only write business they understand and can evaluate. Life insurers justified writing this business because of their expertise in health and disability insurance. Yet this certainly did not translate into an understanding of workers' compensation coverage, pricing and profitability.

In the wake of Unicover, Connecticut life insurers are now prohibited from writing workers' compensation carve-out coverage.

Pressure for fronting insurers to evaluate insurance exposures

The fallout from Unicover could significantly impact the business of fronting. Until now, the key issue in evaluating a fronting transaction was the security of the reinsurers. In this instance, for the companies that fronted for Unicover, the security of the reinsurers was unquestionable—all reputable life insurers.

Yet the rules of the game may change, now that several of the life insurers involved have started legal proceedings against Unicover to rescind their reinsurance contracts. If these companies are successful, the fronting companies may end up retaining the highly unprofitable underwriting results. This, in turn, implies that the fronting company must evaluate the rates and terms of the fronted business along with the financial security of the reinsurers.

Looking Ahead

Clearly, to be successful in tomorrow's property and casualty insurance marketplace, companies must find ways to satisfy customers' growing expectations concerning cost, quality, financial security and service. They must identify their core areas of expertise and exit businesses that are a nonstrategic fit with their long-term strategy. Personal lines writers will offer their products through multiple distribution channels, and there will be a continued increase in the use of affinity marketing. Companies will be on the lookout for strategic acquisitions that will globalize their business, improve profitability, and enhance their distribution channels. In the wake of Unicover, we are already seeing signs of a hardening workers' compensation market. And, like every other business, companies will seek ways to use the internet to market their products and enhance their bottom line.

The contents of this article are taken from a presentation by Ms. Schwartzman at the Dresdner Kleinwort Benson Insurance Conference in New York on Nov. 16, 1999. For more information, contact Ms. Schwartzman at (212) 279-7166.

Joy Schwartzman is a principal and consulting actuary in the New York office of Milliman & Robertson.

Ramifications of California's Lifeline Pilot Program

by Julia Chu, ACAS, MAAA

In another attempt to curb the rate of uninsured motorists in California, Gov. Gray Davis signed into law (on Oct. 10, 1999) legislation that will create low-cost auto insurance for qualified low-income drivers. The Lifeline Pilot Program (Lifeline) is a result of the state's mandatory auto insurance policy and the lack of available, economical coverage in urban areas. How will this program affect California's current uninsured population? What about the underinsurance issue? And will other states with situations similar to California's follow suit? This article sets forth the provisions of Lifeline and explores the possible ramifications as indicated by the posed questions.

Background

The legislation, SB-171 and SB-527, requires all admitted auto liability insurance providers who also participate in California's Auto Assigned Risk Program to offer a low-cost, minimal-coverage policy to low-income good drivers. Tax credits will be given to those companies participating in the program.

Lifeline defines low-income eligibility as 150% of the federal poverty level. Program eligibility further requires a designation of "good driver" or "very good driver" (a zero or one driving violations in the previous

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Inquiries may be directed to:
Marsha Kuykendall, Editor
1301 Fifth Avenue, Suite 3800
Seattle, WA 98101-2605
(206) 624-7940

PCperspectives@milliman.com

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three years). The policy offered will have limits of \$10,000 for bodily injury per person, \$20,000 aggregate bodily injury per accident, and \$3,000 for property damage liability (10/20/3). There is no provision for pain and suffering. Lifeline, which will be effective Jan. 1, 2001 to Jan. 1, 2004, sets the premium of such policy at \$450 for Los Angeles area residents and \$410 for San Francisco residents. Drivers ages 19-26 pay a 25% surcharge (i.e., \$563 or \$513); drivers under 19 are not eligible.

In reaction to the bill's signing, State Sen. Martha Escutia said, "It is a fundamental social responsibility that we provide affordable auto insurance for low-income drivers, so we don't make people criminals for the mere fact of driving to work in Los Angeles County." The stated primary purpose of Lifeline is to provide affordable coverage to insureds in high-rated areas who cannot pay for the basic coverage auto insurance currently required by law. Sponsors of the bill claim that, as a peripheral benefit, the cost of uninsured motorist and collision premiums currently paid by non-Lifeline consumers will decrease.

**Possible Effects On the
Current Uninsured Population**

According to a recent state report, the percentage of uninsured drivers in California is about 23%. However, this figure varies substantially by location, with certain zip codes above 80%. Further, research shows that the typical uninsured motorist is an 18- to 24-year-old male with an annual salary below \$20,000, who lives at the same address for shorter periods than do insured motorists. If we consider such a driver living in the highest uninsured neighborhood, South Central Los Angeles, his premium would be between \$1,278 and \$5,972 (according to the California Department of Insurance 1998 Auto Insurance Survey) for a basic coverage policy in today's market. This basic coverage provides slightly higher liability coverage (15/30/5) than Lifeline and also includes an uninsured/underinsured motorist provision.

At first glance, the appearance of the reduced limits of liability coverage and the absence of uninsured/underinsured coverage may justify some of the savings under Lifeline, but closer examination shows the significant rate decreases are not actuarially justified. The uninsured coverage portion of a basic coverage policy is about 3% to 20% of the overall premium charged. Based on the increased limits factors for auto liability, we deduce that the losses from coverage limits 10/20/3 is about 93% of the losses from coverage limits 15/30/5. Based on simple arithmetic, the proposed policy appears to violate the "rate not to be inadequate" guideline set forth in the Casualty Actuarial Society's Statement of Principles and the California Insurance Code. Table 1 is an example of using dollar amounts for the insured described above.

The lower end premium of \$950 is almost twice the amount charged under Lifeline for the same insured. Note, however, that this amount is based on optimistic assumptions, such as lowest competitive limits premiums and a higher portion of basic premium from the UM coverage. More realistic assumptions would result in even greater premium disparities.

What remains to be seen is how many currently uninsured drivers will actually purchase a Lifeline policy. Considering that 150% of the federal poverty level is currently \$12,360,

Table 1

Premiums	Low	Medium	High
With BIPD limits 15/30/5 and UM coverage	\$1,278	\$2,816	\$5,972
For UM	256	563	1,194
Eliminated from lowering BIPD limits	72	158	334
Needed for BIPD coverage limits 10/20/3	950	2,095	4,444
Charged for Lifeline BIPD coverage limits 10/20/3	563	563	563
Difference	\$387	\$1,532	\$3,881

these motorists may view a premium of \$450 or \$410 as still unaffordable. Complicating matters is the possibility that currently insured "good" or "very good" drivers who meet the low-income definition will switch to a Lifeline policy. If this is the case, the shifting of policies will create a loss of premium to the insurance system. Reducing the premiums without a reduction in losses will either cut into insurers' earnings or result in other insured motorists subsidizing the Lifeline policies.

Uninsured vs. Underinsured

Uninsured coverage provides recovery funds to injured persons when the party causing the injury does not have insurance. Underinsured coverage applies when the party causing the injury does not have sufficient insurance to satisfy the claim(s) being made. Lifeline attempts to address the uninsured motorist issue by lowering premiums, but it does not consider the issue of underinsurance. In fact, it may create a deterioration on this front. Uninsured is a one-dimensional matter, related to how many do not have insurance. However, the matter of underinsurance is more complex, involving comparisons of distributions between the limits of liability purchased and the severity of accidents. Lifeline may achieve its intended goal of lowering the number of uninsured motorists, but it may also increase the number of underinsured motorists.

Forerunner For Other States?

According to the American Insurance Association, nearly 14 of every 100 motorists are uninsured in the United States. Uninsured motorists have always been an issue for insurance commissioners. Resolutions are moving toward either a no-fault system or mandated affordable insurance. California will be the first state to apply the latter approach. Other states will be watching the consequences of California's program, particularly those with high insurance costs and compulsory insurance laws. If a no-fault system proves impractical, these states may resort to a low-cost program similar to Lifeline.

Conclusion

It will take time before the effects of Lifeline are evident. The program may ultimately temper, rather than eliminate the issue of uninsured motorists. Worse, it may simply shift the problem to areas such as underinsured drivers. Nevertheless, auto insurance providers will be examining how Lifeline affects the industry.

Julia Chu is an associate actuary in the New York office of Milliman & Robertson.