



Clear Skies Ahead for Property/Casualty Coverage

by Christopher M. Treanor

The soft market that began in 2004 shows no signs of abating in the near term. Short of a catastrophe or economic event that broadly impacts the entire property and casualty industry, current market conditions should last well into 2010 and perhaps beyond. At the same time, the cycle has clearly passed its peak and we are now on the beginning of the downside. All measures point to a slight weakening in the underlying fundamentals of the industry marking the beginning of the march towards the bottom of the cycle. But while the good times last, it is time for buyers to take advantage of the favorable market conditions.

Analyzing Market Trends

In terms of financial performance, 2006 was a banner year for the insurance industry. The P/C industry's combined ratio of 92.4% was the best since 1948. Between 2002 and 2006, the industry added over \$200 billion in surplus, rebuilding the capital lost during the last soft market, the events of September 11, 2001, the "Enron Era" of corporate scandals and the back-to-back record Atlantic storm seasons of 2004 and 2005. The \$32 billion profit generated by the industry in 2006 was the best on record by far.

While 2007 was certainly another good year, there are clear signs that profits are starting to slip in 2008. According to A.M. Best, the U.S. P/C industry reported its second consecutive underwriting profit—the first time it has done that since 1977-78. The profit of \$22.1 billion was 30% lower than the previous year's record \$32 billion but nonetheless was robust enough to contribute to a policyholder surplus increase of \$34.7 billion. This 7% increase puts U.S. P/C policyholder surplus at a record \$527.5 billion or 3.71% of U.S. GDP, according to Advisen. This is approximately the same level it was in 1998 when it began its decline towards the market bottom in 2001. A closer examination of the data reveals some important trends:

Net written premium is down. For the first time since 1949, net written premium in the U.S. P/C industry declined year over year. This decline of \$3.8 billion or 0.9% compares to an increase of 14.9% in 2002 and 4.3% in 2006. This reduction can be attributed to both a rapidly declining rate environment and the slowdown of the U.S. economy. As the economy weakens, buyers tend to purchase less insurance as a way of moderating up-front expenses. In addition, the underlying exposures that drive premium (property values, payrolls, revenue and fleet counts) usually decline or grow at a slower pace than during stronger points of the economic cycle. This premium drop manifested itself in the latter part of the year as price decreases

accelerated and the economy weakened. The majority of the reduction came from the U.S. reinsurance market, which faced an 11.9% decline, but even the commercial segment registered a 0.4% decline in net written premium. There is no reason to believe that this phenomenon will reverse itself in 2008.

Combined ratios are deteriorating. While still highly favorable, the combined ratio in the commercial segment deteriorated from 91.3% in 2006 to 93.7% in 2007. As previously noted, the industry has not seen back-to-back profitable underwriting years since the late 1970s. This strong performance is a result of a benign storm season, favorable development of prior-year losses and a rate environment that is still far from the bottom of the cycle. A.M. Best forecasts that the industry will have at least one more year of profitability in the commercial segment, with the commercial P/C combined ratio further deteriorating to 97.5% in 2008.

Prior year reserve development is down. According to A.M. Best, 77% of insurers reported positive prior year reserve development totaling \$6.8 billion in the aggregate. Best is concerned that some of this reserve released is premature. If that is the case, insurers will need to bolster reserves later, which would increase combined ratios.

Surplus growth is slowing. From 2001 to 2006, gross written premium grew an average of 16% per year from \$272 billion in 2002 to \$494 billion in 2006. This rate decelerated to just 7% in 2007.

Return on equity is declining. As surplus growth slowed, return on equity on industry capital declined from 15% in 2006 to 13% in 2007. While this is still healthy and well above historic averages, A.M. Best predicts this return to decline to 9.8% in 2008. As return on equity deteriorates over time, capital will leave the market as it finds more attractive return alternatives elsewhere.

Unusually low losses in North America. According to ISO, the United States experienced only \$6.7 billion in insured catastrophic losses in 2007. This was one of the lowest levels on record and was 27% below 2006, which was itself a light year. This was largely due to a very mild North Atlantic hurricane season. According to Swiss Re, the two largest insured losses in the United States were not hurricanes but the April Nor'easter that slammed the Atlantic Coast and the California wildfires in July.

The rest of the world was not so fortunate, however. The largest global losses in 2007 were in Europe where winter storm Kyrill struck in January and heavy flooding plagued England in June and again in July. These three events led to insured losses of more than \$10 billion. In addition, Japan experienced a magnitude 6.6 earthquake in June that caused \$12.5 billion in damage, although only \$300 million were insured losses.

As we have seen in the first half of 2008, this global loss trend was not a fluke. Already, two enormous global tragedies have occurred: the Nargis cyclone in Burma and the magnitude 7.9 earthquake in China. While neither event will create enormous insured losses, it reminds us how vulnerable the world is to natural catastrophes. AIR estimated that if the Chinese earthquake's epicenter had been in

the nearby city of Chengdu, the loss would have been \$115 billion.

At the same time, worldwide catastrophic losses have been steadily increasing over time. According to Munich Re, the world experienced some 400 catastrophes in the 1980s, 630 in the 1990s and 730 during the last 10 years. While the United States has been spared over the last two years, that trend is unlikely to continue.

Securities litigation is on the rise. According to the Stanford Law School Securities Class Action Clearinghouse, the second half of 2007 saw an increase in securities litigation, largely due to the subprime crisis. While the total number of 176 cases is still the second lowest since 1996 (the year immediately following the Public Securities Litigation Reform Act), this level is well above the 117 cases of 2006. Whether this is a one-time surge that will quickly work its way through the D&O market or something that will plague the industry in 2008 and beyond remains to be seen. It is clear, however, that the subprime crisis will impact profitability in the D&O marketplace, particularly for those firms underwriting financial institutions.

Rate reductions continue to accelerate. Price reductions accelerated in all lines and customer sizes in 2007, according to the Council of Independent Agents and Brokers (CIAB). In 2006, the simple average of the rate reductions posted by the CIAB on a quarterly basis was -5.1% across all lines and account sizes. In 2007, that average rate reduction increased to -12.1%.

Based on the CIAB data, rates for large commercial insureds are at approximately the same level as they were in the third quarter of 2001 just after 9/11, according to Lehman Brothers. If this pace continues, within two or three years the industry should be back to the same relative pricing level as in the end of 1999, which was when the last hard market turn began. Advisen and MarketScout also registered accelerating rate reductions throughout 2007.

Coverage and capacity is increasing. While we tend to focus most of our attention on rates, it is important to watch how capacity increases impact the overall market. As the cycle continues, insurers offer higher limits, higher sub-limits, lower retentions and broader coverage. In recent months, we have witnessed Lexington Insurance offer up to \$1.5 billion in property capacity on select risks, substantially higher than the maximum of \$250 million offered previously and the \$25 million offered three years ago. Likewise, insurers including Zurich and Travelers have increased capacity of up to \$500 million, and the London insurer Beazley is offering \$150 million in property capacity. These capacity increases can dramatically increase industry supply as the insurers and their reinsurers look to put excess surplus to work.

The First Half of 2008: The Trend Continues

As mentioned, the 2007 rate reductions have continued and accelerated into 2008. The CIAB reports that during the first quarter of 2008, rates declined an average of 13.5%, which is down from both the fourth quarter (12%) and full-year 2007 (12.1%). These rate decreases are more consistent across all industry segments and account sizes than in prior years. Furthermore, in the CIAB survey, no respondents reported price increases in any line of coverage with the exception of medical malpractice. Insurers are preemptively offering 10%-15% reductions in order to avoid competition that could spur ultimate reductions in the 30%-40% range depending on line of business and account specifics. The impact for major lines is as

follows:

Property. Across all lines, the largest area of decrease in the CIAB study was in commercial property at 14.8%. This is consistent with other industry studies for the first quarter of 2008. Property rates rose dramatically after the hurricanes of 2004 and 2005 and, as a result, began declining later than other lines. These reductions are averages, and as in the past, individual accounts can experience reductions of 40% or more. Reductions are typically most pronounced in catastrophe-prone areas where new capacity tends to move in search for excess return. Nevertheless, with the arrival of hurricane season, capacity in some high-risk areas (like Florida) has begun to subside and rates are firming.

Casualty. Casualty rates have been declining consistently since 2004. According to the CIAB, rate reductions have been between 11% for automobile liability and 13.6% for general liability for the first quarter of 2008. Beyond rate reductions, the most remarkable phenomenon in casualty is that standard market carriers are expanding their risk appetites into what have traditionally been considered nonstandard lines. Tough construction classes, liquor liability, difficult habitational real estate and products liability are all becoming the purview of admitted markets. These classes tend to have higher hazards, be more difficult to predict and, over time, get the standard market into trouble.

D&O/E&O. In the aggregate, CIAB reports that D&O rates dropped 8.4% in the first quarter of 2008 primarily due to exposure to the subprime crisis. In many cases financial institutions are receiving rate increases in both D&O and E&O as a result of the subprime meltdown. Rate increases of 20%-30% are not uncommon and can be substantially larger for those institutions with significant exposure to subprime issues. Again, it remains to be seen how long this situation affects the market and how wide its impact becomes. Should the credit issues begin to infect commercial insureds, the impact on the D&O industry could be much more significant than it has been thus far.

Where Do We Go from Here?

All evidence points to the fact that this soft market will not end soon. While the best guess is 2010 before the market changes, it could be later. How quickly the market hits bottom depends on several factors. Specifically:

Subprime crisis. As of now, the subprime crisis has not significantly affected insurer results, with the notable exception of AIG, Swiss Re and XL. According to Moody's, the overall industry has very limited subprime exposure in its investment portfolios. The more likely concern is that the credit issues hurting commercial insureds will lead to an influx of D&O suits. Most estimates of the overall impact of subprime on the D&O/E&O marketplace range from \$2 billion to \$10 billion or more.

Economic downturn. Beyond subprime, it is generally accepted that the economy is headed into a recession. An economic downturn will alter results by raising loss costs and reducing investment returns.

Catastrophic losses. NOAA's Climate Prediction Center says that the chances of a near or above normal Atlantic hurricane season are 90%. For 2008, the outlook indicates a 60%-70% chance of 12 to 16 named storms, including six to nine

hurricanes and two to five major hurricanes (Category 3, 4 or 5 on the Saffir-Simpson Scale). At the same time, according to the Uniform California Earthquake Rupture Forecast, there is a 99.7% chance California will experience at least a magnitude 6.7 earthquake in the next three decades.

A major hurricane or earthquake will certainly impact the property market as it did in 1998 and 2005, but will not necessarily impact the broader market as many insurers do not cover either exposure. It will take some excess capital out of the market, however, and move it towards the bottom more quickly.

Exodus of capital. In today's environment, insurance capital is much more fluid than in the past. Catastrophe bonds, sidecars and other structures allow capital to quickly move towards excess return opportunities. As those opportunities dissipate, capital can leave the market almost as quickly. Ultimately, a capital exodus would shorten the insurance cycle.

Rating agency discipline. All evidence points to the rating agencies increasing their vigilance over P/C insurers. If effective, this will certainly shorten cycles as insurers will have to monitor underwriting results more closely in order to maintain ratings. In late May, S&P indicated that their outlook for the P/C sector was stable, but warned that if price declines continue at the current pace they are likely to revise the sector outlook to negative later in 2008.

What Should You Do?

Although the long-term forecast calls for more stormy weather, the soft market is the time to tune up insurance programs and secure enhancements that will benefit the company in the coming years. While many focus their attentions on obtaining the maximum rate decreases, other things are more important. Specifically:

Coverage. The purpose of insurance is to pay claims in the event of a loss. The broader the coverage, the more likely a loss will be covered by insurance. When a large loss is reported, no one cares how much the insurance cost just whether the loss is covered or not. As the market softens, insurers will be willing to trade coverage extensions for rate decreases. Lower deductibles or self-insured retentions, deleted exclusions and liberalized wording all benefit insureds at the time of the claim. As results deteriorate, however, insurers will become even tougher on claims negotiation. Relying on relationships with insurers in a tough claims negotiation only goes so far. It is much easier if the coverage is broad and there is little to no ambiguity.

Insurer solvency. Financial strength is always paramount in choosing an insurer and, as the market softens and options increase, it is particularly important in choosing catastrophe coverage. Windstorm, earthquake and terrorism losses can impact even the strongest insurers, depending on their overall exposure to the catastrophic loss. When insuring these perils, focus both on the financial security of the insurer and their overall exposure. Any credible broker can help assess overall exposure to specific categories of risk.

Multi-year contracts. In this environment, insurers are often willing to lock in terms for up to three years in order to avoid the prospect of further rate decreases next year. For a particularly advantageous program, securing a multi-year rate guarantee

or three-year policy may be a good idea.

Price and payment terms. In addition to negotiating simple price reductions, look for improvements in payment terms as well. In this environment, insurers are more willing to offer installments. Also, make sure the policy does not have a high minimum premium. As the economy turns down, exposures may decrease and, ideally, premiums will reduce accordingly. Never accept high minimum and deposit premium levels if at all possible.

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