Executive summary

The commercial lines insurance market has been pummeled by the combined impact of depressed rates and declining written premiums resulting from the global recession. Nonetheless, insurers will post a profit for 2009 and capacity remains abundant. Insurance buyers are likely to enjoy another year of favorable pricing, but brokers will continue to struggle with lower commission income.

Introduction

Economists generally agree that the Great Recession has ended, but recovery will be slow. Unemployment hovers at about 10 percent, and business bankruptcies are well above long-term averages. As a result, the commercial lines insurance industry has seen revenue fall with little hope of a material rebound in 2010. Additionally, the soft phase of the insurance pricing cycle shows few signs of loosening its grip. The average commercial lines premium fell about 2 percent in 2009, and likely will fall by a similar amount in 2010. Brokerage firms, which derive most of their revenue from commissions on insurance premiums, have been especially challenged by declining written premium. Organic growth turned negative during the first three quarters of 2009, though profitability remained relatively stable for the largest firms.

With several noteworthy exceptions, property & casualty insurers were largely unscathed by investment losses directly attributable to the meltdown of the subprime mortgage market in 2007. However, plummeting stock markets, an outcome of the ensuing global credit crisis, combined with deeply eroded rate levels and $26 billion in insured catastrophe losses, wiped out tens of billions of dollars in policyholders’ surplus and led to a 96 percent plunge in profitability in 2008. Resurgent stock markets and a year devoid of large natural catastrophes helped to replenish surplus and re-inflate profits in 2009. According to Fitch, most of the 52 insurers and reinsurers tracked by the rating agency reported double-digit returns on operating capital and an aggregate 28 percent increase in GAAP equity. GAAP equity is another measure of insurer financial strength and capacity, similar to policyholders’ surplus.

Commercial lines insurance buyers can plan on a competitive insurance market for 2010. Capacity is abundant in most lines, and demand for that capacity has been stunted by the recession. However, the seeds of the next hard market have been sown,
and above-average catastrophe losses could contribute to a reversal of the market cycle.

**The insurance pricing cycle**

Commercial lines pricing typically follows a cycle of sharply rising premiums for several years followed by a longer period of gradually declining rates. Exhibit 1 shows the change in the average commercial lines premium by quarter beginning the first quarter of 2001 (Q4 2000 = 100).

The cycle is inevitable – the outcome of supply-and-demand economics – but the timing and magnitude of changes in pricing throughout the cycle are subject to an array of forces that often are difficult to foresee and quantify.

When supply increases faster than demand, prices fall. Conversely, when supply constricts relative to demand, prices increase. Presently, the insurance pricing cycle is in the "soft" phase, with prices falling due to an abundance of insurance capacity relative to wavering demand.

Supply in the insurance supply-and-demand equation is a function of the amount of capital insurers hold to support underwriting – "policyholders’ surplus,” or simply “surplus,” in US insurance jargon. The more capital insurers hold, the more capacity they have. Insurers are overcapitalized during soft markets, and they compete to put the excess capacity to work.

In mature economies like North America and Western Europe, Gross Domestic Product (GDP) can be seen as a proxy for demand – or rather, the change in GDP represents the change in demand for insurance capacity. Since most companies already are fully insured, the need to buy more insurance is directly tied to growth, represented by the change in GDP.
Exhibit 2 graphically shows US policyholders’ surplus as a percentage of US GDP over time. Increasing values mean that growth in supply (policyholders’ surplus) exceeds the growth in demand (GDP), ultimately leading to falling premiums. Conversely, when values are decreasing, it means that supply is shrinking relative to demand (or demand is increasing faster than supply), and premiums eventually will rise. Historically, when the ratio of surplus to GDP crosses the 3.2 percent mark (purple line), either up or down, the market changes directions within the next 12 months or so. The ratio fell to about 3.2 percent at the end of 2008. However, an increase in policyholders’ surplus in the second half of 2009 driven by improved investment income and capital gains forced the ratio back above the 3.2 percent threshold. The market remains well capitalized, with few indications that that rates will materially firm in the short term.

The credit crisis, the recession, and the P&C insurance market

The credit crunch that sparked the recession and the recession itself impact both the supply of and the demand for insurance capacity.

Supply – policyholder surplus – was decimated by investment losses in 2008 and the first quarter of 2009. US P&C surplus decreased $62 billion in 2008 (12 percent), and lost a further $19 billion (4.2 percent) in the first quarter of 2009, according to ISO. Of the $19 billion lost in the first quarter, more than $16 billion was due to unrealized capital losses. With the rebound of the equities markets, surplus has increased, growing nearly $54 billion during the second and third quarters of 2009, according to the Insurance Information Institute.

The wholesale destruction of surplus in 2008 and early 2009, equating to a huge loss of insurance supply, was offset by the decrease in demand for insurance capacity. Downsizing and bankruptcies reduced the need for insurance capacity, and firms across the board have scurried to reduce costs wherever possible. As a result, the loss of $81 billion in policyholders’ surplus only slowed the pace of decline in insurance rates. As
surplus is replenished by recovering equity markets, downward pressure on rates increases.

The credit crisis and the recession also have had an impact on claims. Fraudulent claims have increased: the National Insurance Crime Bureau reports that "questionable" insurance claims rose 14 percent in 2009. Employment practices claims have surged in response to layoffs. Equal Employment Opportunity Commission (EEOC) claims jumped 15 percent between 2007 and 2008. EEOC claims fell off slightly in 2009, though they remained well above the long-term average. Financial institutions were frequently targeted in lawsuits sparked by the meltdown of the subprime mortgage market and the subsequent credit crisis. Financial firms account for about half of securities-related suits filed since 2007.

At least in theory, economic slowdown has a positive effect on claims experience in some lines. Lower transport miles, for example, should translate into fewer commercial auto claims. Workers compensation claims are subject to both positive and negative influences. Higher unemployment translates into lower claims frequency, but also may encourage more fraudulent claims from employees concerned about job security.

Other factors

A number of market developments and insurer actions are likely to have an influence on capacity and pricing in 2010 and beyond.

Catastrophe losses. Due substantially to the unusual breadth of the damage caused by Hurricane Ike, whose path of destruction extended as far north as Ohio, 2008 was the fourth worst year on record for insured catastrophe losses worldwide. Catastrophe losses were a major component of an overall underwriting loss for the year, and led to rising property insurance premiums in some catastrophe exposed regions. In contrast, 2009 was a benign year for natural disasters, which increased downward pressure on premiums, even in some coastal areas.

Early indications are that 2010 will be an expensive year for insurers and reinsurers. According to Swiss Re, insured natural catastrophe losses worldwide could reach as much $110 billion if the first few months of this year are an indication of things to come. Thus far, an earthquake in Chile caused an estimated $8 billion in insured losses and winter storm Xynthia racked up insured damages of about $3 billion, largely in France and Germany. Early forecasts call for an active 2010 hurricane season. Dr. Philip Klotzbach and Dr. William Gray of Colorado State University foresee “an above average Atlantic basin tropical cyclone season in 2010 and anticipate an above-average probability of U.S. and Caribbean major hurricane landfall.” A high volume of catastrophe losses – whether from a single mega-event or an accumulation of smaller events – could soak up capacity and accelerate the reversal of the market cycle.

New capacity. Frozen credit markets, skittish investors, falling premiums and the general economic malaise combined to deter new investments in the insurance market in 2008
and much of 2009. In the later part of 2009, however, several insurers successfully raised capital in the equity markets. New capital continues to flow into the market in the first quarter of 2010. Specialty insurer Torus, for example, recently announced $185 million in new equity capital. The Hartford raised $3.3 billion from debt and equity offerings to repay federal bailout funds. Lloyd’s of London is offering a record $36.7 billion in capacity in 2010, up 29 percent from 2008.

New capital is flowing into the market at the low point of the pricing cycle when capacity already is high relative to insurance demand. Additional capacity can prolong and deepen the soft market. The availability of new capital at this point in the cycle also suggests that once the market shows signs of firming, yet more capital will rush in to take advantage of rising premiums. This could suppress the market rebound.

**Loss reserve releases.** Insurers maintain cash reserves for losses that have been incurred but not yet paid. During 2008 and 2009, insurers released (“harvested”) loss reserves for prior years losses deemed redundant by actuaries, which offset losses on other parts of the financial statement and boosted reported results. Redundancies now have been largely harvested, which means insurers have lost an important cushion against adverse developments. Additionally, reported results for 2010 will not have the benefit of significant reserve releases from prior years, and will be more reflective of current none-too-favorable market conditions.

Current reserve levels appear adequate, but reserve errors often do not become evident for a number of years. Furthermore, inflation – which presently is not a significant issue, but may become more important in the coming years – can have an adverse impact on reserve adequacy. If insurers were overly aggressive in harvesting reserves, and reserve levels for prior years prove inadequate, profitability will plummet, accelerating a change in the market cycle.

**Developing markets.** Rapid economic growth combined with low insurance density make China, India and other developing economies attractive to insurers and brokers. Developing markets are especially attractive since premium growth has stalled in mature insurance markets such as North America and Western Europe. The total premium income in China grew 31 percent in 2008, compared to an overall global decline of 2 percent, according to Swiss Re. The Indian Insurance Regulatory and Development Authority forecasts compound annual growth rate of 10 percent over the next five to six years for the Indian insurance sector.

Mature insurance markets will experience no more than low single digit annual growth in premium volume for the foreseeable future. As a result, developing economies will continue to attract insurance capacity. While not a significant factor for 2010, as more insurers allocate capital to developing economies, it may help relieve overcapacity in the US and Western Europe. Spreading capital over a larger base also would likely modulate to some degree swings in the market cycle.

**New products and markets.** As rates soften and written premium declines, many insurers actively seek new areas of growth. One predictable outcome is a decrease in premium
volume to the surplus lines market as admitted insurers expand their underwriting appetite to include business previously entertained only by non-admitted carriers. According to a report issued by the Texas Stamping Office, surplus lines premiums for fifteen states fell from $11.37 billion in the first half of 2008 to $10.3 billion in the first half of 2009, a 9.4 percent decline.

The soft phase of the insurance cycle is a prime time for the introduction of new products. Cyberliability policies, for example, have been sold for years, but declining premium volume in core lines of business has encouraged more companies to enter the cyberliability market, a segment widely perceived as on the verge of rapid growth. New products and market segments can provide new revenue streams for insurers, but they also potentially increase the volatility of insurer results. Mounting losses from ill-conceived forays into unfamiliar territory have presaged market turns in prior soft market phases.

*New risk management challenges.* As the risk landscape evolves in response to changes in the economy, business practices and technology, insurers are called upon to respond with new products and services. A current example is supply chain risk management, which has become a critical issue for many companies due to increasingly far flung networks of suppliers coupled with just-in-time inventory management. Other examples include liability exposures associated with emerging green technologies and with nanotechnology.

In some cases, such as supply chain risk management, insurers can reposition familiar products to address new risk management needs. Genuinely new exposures, such as nanotechnology, demand new products or, at least, new underwriting and pricing criteria for existing products. Most insurers shy away from novel exposures such as nanotechnology, but the lure of premium in a down market can entice some to be more adventurous. As previously noted, significant commitments to unfamiliar exposures can increase volatility of insurer results.

*Insurer risk and capital management.* In recent years many insurers have become more sophisticated in managing certain types of risk as well as managing the capital to support risk assumption. Managing catastrophe accumulations with computerized models, for example, has become standard operating procedure for most insurers that write property business in catastrophe-exposed regions. Enhanced risk management practices are mandated, or at least strongly encouraged, by rating agencies, insurance regulators and the federal Sarbanes-Oxley Act for public companies. Managing risk and capital more effectively should help modulate volatility in insurer results and theoretically will dampen swings in the market cycle.

**By-line developments and forecasts**

*General liability.* The average general liability premium now is at 2000 level, having lost all the gains of the 2001-2003 hard market. Rate levels continue to fall, and likely will
continue to soften throughout 2010. Additionally, some exposure bases for calculating general liability premium, such as revenue, have been trounced by the global economic recession, leading to further loss of written premium. As the recession abates, written premium will grow, but no significant improvement is expected in 2010.

Workers’ compensation. Workers’ compensation written premium has plummeted as a result of the recession. Workers compensation written premium fell 14.2 percent in 2008, the outcome of both lower rates and lower payrolls. Payrolls continued to fall in 2009 with unemployment reaching a 26-year high in September.

Workers’ compensation is the most regulated of all lines of commercial insurance and, consequently, is less subject to the supply-and-demand forces that drive pricing in other lines. Workers’ compensation average premium has plunged in recent years, but that is due at least as much to legislated reforms as it is to marketplace forces. Most of the premium reductions due to reforms in large states such as California and Texas have now be realized. California, in fact, now faces the need for premium increases. Florida, on the other hand, saw premiums further reduced in January as a consequence of a 2003 reform package. Changes in average premium due to rate increases or decreases will vary state-by-state.

Property. Though still mired in the soft phase of the pricing cycle, property insurance premiums, on average, showed greater stability than most other lines in 2009. However, a year devoid of major natural catastrophes may encourage some insurers to step up competition despite early forecasts of an active hurricane season in 2010. Threatened reinsurance rate increases did not materialize in 2009 – in fact, average reinsurance premiums have been inching downward – which may further encourage competitive pricing.

Written premium volume for property has been less impacted by the recession than premium for other lines such as workers’ compensation and general liability. In theory, falling real estate values across the country should translate into reduced property insurance premiums even with no change in rates, but in practice the impact is muted by, among other things, the fact that the cost to repair or rebuild damaged property has not materially decreased.

Directors & officers liability (D&O). The D&O market was neatly cleaved in two in 2009. Continuing a trend that began in 2008, the financial institution (FI) sector saw premiums rise, while other segments of the D&O market, collectively called commercial D&O, experienced continued erosion in average premium. The net effect was essentially no change in the overall average premium. Rate increases for FI business were driven by a surge of claims resulting from the meltdown of the subprime mortgage market in 2007 followed by the global credit crisis. Subprime and credit crisis claims fell off sharply in the second half of 2009, and pricing in this segment is showing signs of stabilizing. The most likely scenario for 2010 is steadily eroding premium on average for the commercial segment of the market with the FI segment flat to slightly lower.
Brokers

Insurers are benefitting from stronger equities markets, but brokers continue to take a beating from depressed written premiums. Many brokers saw negative organic growth in 2009, though Fitch reports that profitability for the largest brokers remained comparatively stable. Falling brokerage income has been substantially offset by streamlining operations and reducing headcount. The recent decision by New York to again permit the largest brokers to collect contingent commissions from insurers – an important source of income relinquished under pressure from former New York Attorney General Eliot Spitzer – will provide some financial relief, though Marsh & McLennan recently announced that its insurance broker unit Marsh will not accept contingent commissions on placements for US clients served by the firm's core broking operations.

Financial pressure is likely to fuel consolidation in the brokerage sector as stronger companies scoop up struggling competitors at bargain prices. Mid-tier brokers will continue their “roll-up” strategy to grow market share in the middle market. The largest brokers, Marsh and Aon, both are looking to grow through acquisitions – Aon largely in specialty areas, and Marsh in the middle market. Aon’s chief executive, Greg Case, recently announced the company expects to spend $200 to $250 million annually on acquisitions. The ability to now collect contingent commissions also will help the largest brokers in the race to acquire smaller firms.

The coming hard market

The most likely scenario for 2010 is continued soft market conditions. The recession will suppress demand for insurance capacity and, as a result, the market will remain comparatively overcapitalized. Some policyholders will see modest rate increases, but on average rate levels will erode slightly in most lines.

The inevitable hard market may begin to emerge as early as 2011. In the absence of large catastrophe losses, however, the sudden and severe premium hikes that characterized the 2001-2003 hard market are unlikely to be repeated. Rather, rates will rise slowly and erratically. How high rates rise, and how long the hard market persists, will depend in part on how much new capital is attracted to the market. Insurers already have successfully raised funds in the depths of the soft market, suggesting that abundant capital is waiting in the wings.

The wild card in the market cycle, as always, is catastrophe losses. One mega-catastrophe, such as another Hurricane Katrina, or an accumulation of smaller catastrophes could soak up excess capacity and contribute to a turn of the market in all lines of business. Thus far 2010 is shaping up as an active and expensive year for natural catastrophes. Nonetheless, it would take an exceptional level of catastrophe losses to trigger the type of sudden and sharp market rebound that was seen in 2001-2003.
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