October 20, 2009

Planning for 2010:

The Recession Will Keep Commercial Insurance Premiums Under Pressure

An Advisen Briefing

Executive Summary

Five years into the soft phase of the insurance pricing cycle, near-record catastrophe losses and plunging stock markets decimated property & casualty insurers' 2008 financial results. Despite the dismal performance, soft market pricing continued undeterred into 2009. Stock markets have been recovering and no significant insured catastrophe losses have occurred through the first three quarters of 2009, taking some of the financial pressure off insurers. Ample insurance capacity combined with falling demand for that capacity due to the global recession assures that, in the absence of major catastrophe losses, insurance buyers will continue to enjoy favorable insurance pricing in 2010.

Introduction

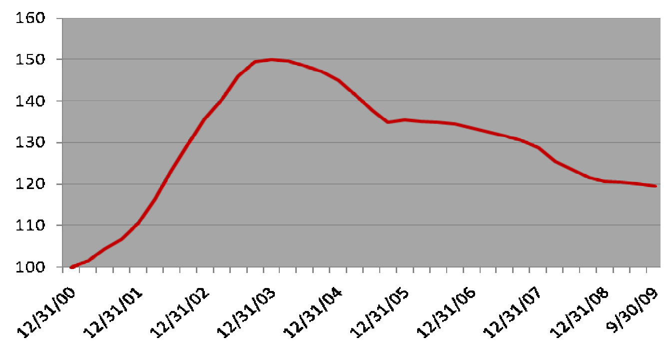
Like the zombies in the classic horror film, *Night of the Living Dead*, the soft insurance market should be dead and buried, but it continues to lurch on, terrorizing underwriters and brokers. Insurers have been plagued by poor results from both underwriting and investments, leading to a 59 percent plunge in net income for the first half of 2009. Policyholders' surplus rallied in the second quarter, but still is $56 billion less than at the beginning of 2008. Under more typical circumstances, this would be a catalyst for a turn in the pricing cycle, yet premiums in many lines of commercial property & casualty insurance continue to fall.

Turmoil in the world economy and in the commercial insurance marketplace is working in favor of insurance buyers. The recession has caused a fall in demand for insurance capacity, keeping downward pressure on prices. Property & casualty net premiums written fell 4.2 percent in the first half of 2009, according to ISO and PCI. Rates are firming in a few isolated segments of the market but, overall, buyers can look forward to favorable pricing conditions in 2010.

Premiums may rise or fall for individual insureds in 2010 due to economic factors other than the pricing cycle. As a result of broader economic forces, companies may experience changes in sales, payrolls and other measures used to calculate premiums and can expect corresponding changes in their insurance premiums. Economists forecast recovery in 2010, but the rate of improvement will vary by region and sector. Many companies are likely to see continued weak sales and falling payrolls in the coming months. In the aggregate, written premiums are almost certain to fall further in 2010 due to economic conditions, which is more bad news for insurers and, especially, for brokers already struggling with lower commission income.

The insurance pricing cycle

Exhibit 1 ADVx™ Composite Pricing Index



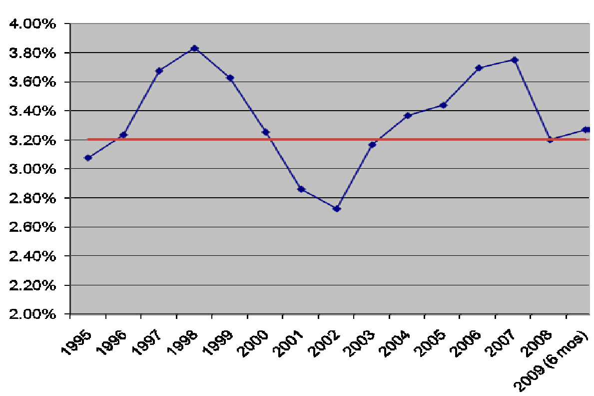
Commercial lines insurance pricing follows a cycle of sharply rising premiums for several years followed by a longer period of more gradually declining rate levels. (Exhibit 1) The cycle is inevitable – the outcome of supply-and-demand economics – but the timing and magnitude of changes in pricing throughout the cycle are subject to an array of forces that are often difficult to foresee and quantify.

When supply increases faster than demand, prices fall. Conversely, when supply constricts relative to demand, prices increase. Presently, commercial insurance prices are 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 greater the volume of insurance capacity. When insurers are overcapitalized, they compete to write policies 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 buy a full array of applicable policies, the need to buy more insurance is directly tied to growth, represented by the change in GDP.

Exhibit 2 Surplus as % GDP



Sources: III, ISO, BEA

Exhibit 2 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, 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, continued to fall in the first quarter of 2009, but crept back to 3.27 percent at the end of the first half. The market remains unsettled with conflicting forces pushing and pulling on both sides of the tipping point.

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

The present global recession adds several levels of complexity to the basic supply and demand model outlined above. The credit crunch that sparked the recession and the recession itself impact both the supply of and the demand for insurance capacity. Both supply and demand have been falling, with the relative rates of decline influencing how much longer the market will remain in the soft phase of the cycle.

On the supply side of the equation, policyholder surplus has been significantly reduced by losses in insurers' investment portfolios. US P&C surplus decreased $62 billion in 2008 (12 percent), though it recovered nearly $6 billion in the first half of 2009, according to ISO and PCI. The principal cause of surplus erosion was unrealized capital losses. While surplus is growing again, it may not rebound to pre-recession levels until 2011.

Typically, demand for insurance is considered uncorrelated to the broader economy, as a certain level of insurance is critical, and is required in many cases. However, the extent of the economic crisis, being dubbed the Great Recession by journalists and pundits, has indeed more than dented demand. Over the past year, downsizing has reduced the need for insurance capacity, and firms across the board have scurried to reduce costs wherever possible.

Surplus destruction, equating to a material loss of insurance supply, has largely been matched by a decrease in demand for insurance capacity. As a result, the loss of $56 billion in policyholders' surplus has only slowed the pace of decline in insurance rates.

The recession has a direct impact on insurance premiums aside from its influence on rate levels. As the economy slowed, many policyholders saw premiums fall as a result of reduced exposure units such as payroll and sales. The impact has been most dramatic in workers' compensation, where premium is directly a function of payroll. Workers compensation written premium fell in 2008 to its lowest level since 2000, the outcome of both lower rates and significantly reduced payrolls, according to A.M. Best. Payrolls continue to plummet in 2009 with unemployment reaching a 26-year high in August. While the economic outlook is brighter, recovery will be slow and will vary by region and business sector.

Other factors

Catastrophe losses. Though lacking a marquee event like 2005's Hurricane Katrina, 2008 was the third worst year on record for catastrophe losses worldwide. Catastrophe losses contributed to an overall underwriting loss for 2008, and led to rising property insurance premiums in some catastrophe exposed regions. In contrast, 2009 has thus far been a comparatively benign year for catastrophes. A massive event could be the catalyst for a sudden return to hard market conditions, but a year with no major catastrophe events will encourage further competition.

Impaired insurers. Several large insurance holding companies – most visibly AIG and Hartford – were rocked by losses from investments tied to subprime mortgages. The subprime mortgage market crashed spectacularly in 2007, leading to more than one trillion dollars in writedowns of securities based on the performance of those mortgages. AIG's losses, which led to a takeover of the company by the US government, originated in a small financial products unit, and had no direct impact on the financial condition of the insurance subsidiaries. Nonetheless, many nervous AIG policyholders sought alternative quotes for their AIG policies, flooding the market with AIG renewals.

Some of AIG's competitors accused AIG insurance companies of competing irresponsibly to retain business. An Advisen survey of brokers, the results of which were confirmed by a GAO study, found that AIG was competing aggressively, but not irresponsibly relative to other insurers. The Advisen survey found, however, that the “feeding frenzy” set off by a wounded AIG may have contributed to continuing soft market conditions as insurers competed vigorously to win AIG business. This phenomenon appears to be abating, and probably will not be a significant factor in 2010.

New capacity. Frozen credit markets, skittish investors and the general economic malaise have combined to deter new investments in the insurance market. Additionally, a significant source of capital for insurance and insurance-related risks of the past several years, the hedge fund sector, seems to have lost some of its enthusiasm for insurance and reinsurance. The situation is thawing, and several insurers have raised money recently, principally in the equity markets. ISO reports $2.2 billion in new capital raised during the first half. However, overall weak results and poor prospects for a market turnaround in the near future will discourage a massive influx of new capital.

Loss reserve releases. Insurers maintain massive cash reserves for losses that have been incurred but not yet paid. During 2008 and 2009, insurers released (“harvested”) loss reserves deemed redundant by actuaries, which offset losses from other parts of the financial statement. According to Moody’s, during 2008 the P&C industry (excluding financial guarantors and mortgage insurers) released approximately $14.3 billion in reserve redundancies from 2007 and prior accident years. Redundancies now have been almost fully harvested, which means insurers no longer have an important cushion against adverse developments. This could contribute to upward pressure on rates in 2010 and beyond.

Economic recovery and the commercial P&C market

"From a technical perspective, the recession is very likely over at this point," Federal Reserve Chairman Ben Bernanke was recently quoted as saying by the Associated Press. Economists generally agree that the recession has ended and the North American economy will slowly improve. However, the impact on the commercial P&C industry will be uneven, leading to further complexity and uncertainty as concerns capacity and pricing.

Investment markets may tumble again before a sustained recovery sets in. As a result the insurance industry may see some further surplus erosion, but the worst is seemingly over. After posting a $19 billion loss in policyholders’ surplus in the first quarter, unrealized capital gains drove a $5.7 billion increase in surplus by the end of the first half of the year, according to ISO and PCI. Underwriting losses are likely to continue to mount due to inadequate rate levels, but investment income and capital gains will offset those losses, and policyholders’ surplus will accumulate.

Recovery will impact various segments of the economy neither evenly nor at the same time. Unemployment is forecast to increase into 2010, and bankruptcy filings also are expected to be well above average. A growing number of economists are forecasting a W-shaped recovery, meaning there will be another round of economic decline following a brief recovery before a sustained recovery begins. Under almost every scenario, demand for insurance capacity will continue to be weak in 2010.

Some economists are forecasting a period of high inflation beginning in 2010 or 2011, an outcome of the massive economic stimulus package and money creation by the Federal Reserve. Inflation would lead to larger claims, and could put insurers’ current reserves for loss payments under stress. The result would likely be upward pressure on premiums, though the impact probably will not be felt until 2011 at the earliest.

The coming hard market.

The recession has delayed the return of the hard market, but rates eventually will begin to rise slowly across the commercial lines insurance market. Shifting rates of change in the various elements of the insurance supply-and-demand equation, driven substantially by political, economic and regulatory forces, favor a modest increase in insurance demand by the end of 2010. Average premiums most probably will move in small fits and starts – initially dipping lower, then oscillating between small increases and small decreases – before finally settling into a pattern of slowly but steadily rising rates. This is due to the fact that, while insurance demand will increase as the economy improves, insurance supply will increase as well. Underwriting losses will nibble away at surplus, but capital gains and investment income will offset those losses. Materially higher rate levels most likely will have to wait at least until 2011.

While erratic movement towards a general firming is the most likely scenario, other scenarios could lead to a revival of fierce rate competition. That is a possible outcome if investment markets improve much faster than the overall economy. Rapidly growing policyholders' surplus not matched by growing demand for insurance capacity could once again throw the supply-and-demand equation out of equilibrium and spark a new round of pricecutting.

In prior hard markets, rising rates attracted new capital, which eventually flooded the market with capacity, choking the pricing rally. The coming hard market will certainly lead to an influx of capital – insurers already are successfully raising money in the equity markets and elsewhere – but gradual and uneven price increases are unlikely to generate much enthusiasm among investors. Additionally, hedge funds, which were an important source of reinsurance capacity and various sorts of alternative capacity such as cat bonds, appear to have lost some of their appetite for insurance risk. As a result, the hard market, which may be slower to develop, also may be longer in duration than was the case in the prior several market cycles.

The expectation of a slowly developing hard market assumes no major natural catastrophes. Well into the 2009 hurricane season, no significant storms have made landfall in the US, but the season is not yet over. Of course, a major earthquake could happen at any time. A single very large catastrophe loss, or a series of smaller losses, could jump start the hard market – not only for property insurance but, if the event is large enough, for all commercial lines. Under that scenario, it is likely that rates would rise far more sharply, though decreased demand would dampen the effect.

Outlook by line of business

Commercial insurance rates on average continue to drift downward, though at a much reduced pace compared to a year ago. Some categories of insureds, however, especially those highly exposed to natural catastrophes or which have been badly bruised by the meltdown of the subprime mortgage market and the ensuing credit crisis, have seen premiums increase in certain lines. In some sublines, such as D&O for companies in the financial sector, premiums have increased sharply.

Looking ahead to 2010, those categories of insureds that have seen sharp average premium increases in certain lines likely will see premiums stabilize and, in some segments, begin to drift lower. Other policyholders can expect to see little change in average premiums due to changes in insurance rates, though their outlay for insurance may increase or decrease as a result of other economic factors.

Property. On average, property insurance premiums have been flat to moderately lower in areas not highly exposed to natural catastrophes in 2009. Underwriters have pushed up premiums in some coastal areas, but if the 2009 hurricane season passes with no major storms making landfall in the US, premiums in those areas are likely to stabilize and soon afterward begin to fall. 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 and rebuild damaged property has not materially declined. Lower earnings could contribute to a reduction in the business interruption component of property premiums.

General liability. Except for a brief moment of irrational exuberance by underwriters immediately following Hurricane Katrina, when many insurers expected a widespread hardening of the market, general liability premiums have been relentlessly falling since 2004. The rate of decrease now is abating, but additional small decreases in the average general liability premium due to falling rate levels are likely over the next several quarters. The average general liability premium now has surrendered all the gains of the 2001-2003 hard market.

In addition to premium decreases due to falling rates, many insureds have seen lower premiums as a result of reduced exposures. General liability is priced using a number of different units of exposure, depending on the nature of the business. Some exposure bases, such as sales and payroll, are sensitive to economic conditions, and have fallen for many companies as a result of the recession. Economic recovery eventually will lead to increasing exposure bases and higher premiums, but policyholders are more likely to see general liability premiums stay the same or fall in 2010 as a result of reduced levels of business activity.

Workers' compensation. Workers' compensation insurance is the most heavily regulated of commercial property & casualty lines. As a result, movements in average premium are influenced significantly by changes in workers' compensation legislation, which vary materially by state. Workers' compensation reform in large states such as Florida, Texas and, especially, California drove down average premiums over the past several years, with California employers, on average, seeing rates fall by more than 50 percent. A long-term trend towards lower claim frequency – a well-documented but not well-explained phenomenon – also has contributed to lower premiums. Nationally, the average workers' compensation premium is now at 2001 levels, approximately where it was at the start of the last hard market cycle. Falling rates combined with declining payrolls as a result of the recession resulted in a 14.4 percent decrease in workers' compensation written premium in 2008, according to A.M. Best.

The outlook for 2010 varies substantially by state. The National Council on Compensation Insurance recently recommended a 6.8 percent average decrease in Florida workers' compensation rates, while California's Workers' Compensation Insurance Rating Bureau has recommended a 22.8 percent increase. The California recommendation is driven by rising medical expenses, along with anticipated cost increases stemming from recent California Workers' Compensation Appeals Board decisions.

Slowly increasing economic activity in late 2009 and 2010 will not immediately translate into larger payrolls and higher workers' compensation premiums. In fact, falling payrolls are expected to continue to tamp down workers' compensation written premiums in the short run. The jobless rate will reach 10 percent in 2010 according to White House projections, up from the current 9.7 percent. Some economists believe unemployment could reach 11 percent.

Directors & officers liability (D&O). The public company D&O market is typically divided into two segments, Financial Institution (FI) and Commercial. The FI D&O segment has been rocked by losses arising from the meltdown of the subprime mortgage market and the ensuing credit crisis. In response, rates have increased sharply for FI insureds – more than 30 percent on average over the past twelve months according to Advisen statistics. Commercial insureds, on the other hand, have enjoyed generally favorable claims experience and abundant capacity, leading to steadily lower average premium. Private company and non-profit D&O rates also have been falling.

In the public company D&O market, underwriters are increasingly concerned about defaults on corporate debt and bankruptcies, which are linked to increased claims. Financially stressed companies and highly leveraged companies are likely to see higher premiums, and some may have trouble finding adequate coverage. Other companies, however, can expect to see premiums continue to fall into 2010, though at a much slower pace. FI insureds that already have absorbed large rate increases most likely will not see premiums again increase sharply unless there are other underwriting concerns, but the FI market overall will continue to experience upward pressure on rates.

Planning for 2010

Insurance buyers should enjoy another year of competitive insurance pricing in 2010, while insurers and especially brokers will continue to be mauled by depressed premiums. Average rate levels most likely will flutter about with no clear direction for much of the year, but written premiums will almost certainly fall due to the ravages of the recession on sales and payrolls. The impact of the recession on premiums will vary by region, sector and line of insurance.

Brokers will feel the pain of falling premiums more so than insurers. Improving investment markets will benefit insurers through increased investment income and capital gains. Brokers, on the other hand, have far fewer assets to invest. Depressed premiums cut into brokerage income, and policyholders that compensate their brokers on a fixed fee basis may be motivated by cost cutting pressures to push for reductions in fees paid.

Among insurers, those with a high concentration of workers' compensation are likely to see the top line shrink again in 2010 as unemployment continues to grow. Insurers with large books of general liability and excess and umbrella business also are likely to see top line erosion as written premiums wither because of dwindling exposure bases and lower rates. Property insurers can expect relative stability in both the top and bottom lines, barring major catastrophe losses. Commercial D&O top line premiums are not highly sensitive to economic changes, but further rate erosion is likely. The small number of insurers with significant books of financial Institution D&O have seen very large premium increases since 2007, but further large increases are unlikely.

Essentially flat rates is the most likely scenario for 2010, but as previously noted, rapidly improving investment markets, particularly combined with lower top line premiums, could spark renewed competition. While this would be a bonanza for insurance buyers, and insurers would muddle through thanks to increased investment income and capital gains, a new round of price cutting would certainly cause deepening problems for brokers already battered by lower commission income.

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