

Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 10/2004 – “Insurance Outlook for 2005”

October, 2004

Commercial Insurance Outlook for 2005 What You Can Expect

By Jeffrey W. Cavnac, CPCU, RPLU, CWCA

Background

In order to understand the insurance industry's results and how they impact your premiums, you need to understand the economics of the insurance industry.

Insurance companies make money in one of two ways:

- Underwriting profits
- Investment returns

An **underwriting profit** is achieved when losses plus loss adjustment costs plus other expenses are less than premiums. When you divide the former by the latter, you come up with what is called the “combined ratio.” A combined ratio less than 100% means that there is an underwriting profit; conversely, a combined ratio of more than 100% means that there is an underwriting loss.

Insurance companies collect premiums and set aside reserves to pay future claims. This money is invested (subject to statutory rules) and generates **investment returns**.

The amount of money set aside to pay future claims as well as any cash left in the till is called **surplus**. Specific ratios determine how much premium can be safely written given a certain amount of **surplus**. If this ratio gets too high, it will affect the insurance company's credit rating (as quantified by the A.M. Best Company's ratings) and could ultimately impair the insurance company's ability to operate.

It is important to note that the insurance industry is “supply driven.” **Supply** varies up or down depending on the industry's profitability and surplus, while **demand** is relatively constant. In other words, if supply goes down (as it did after the turn of the century), rates go up, underwriting requirements tighten, and we experience what is called a “hard market.” Conversely, when supply goes up, rates usually decrease, underwriting relaxes (which

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makes coverage easier to get), and we experience a “soft market.”

Finally, the insurance industry competes with every other industry on the planet for investment dollars. In order to attract investment dollars, the insurance industry has to demonstrate an acceptable return on equity, which is approximately 15%. Historically, the industry has underperformed this objective.

That’s enough of “Insurance Economics 101.” Here’s what’s happening in the insurance industry today.

Insurance Outlook for 2005

At this time last year, I wrote, “2002 was a dramatic improvement over 2001.” The industry lost money in 2001 for the first time in its recorded history. In 2002, net income approximated \$3 billion. In 2003, net income jumped to \$29.9 billion!

Equally as important, the industry’s surplus (money set aside to fund future claims) increased by nearly 22% to \$347 billion. The \$61 billion increase followed a cumulative decrease in surplus for the prior three years (2000-2002) of \$49 million. In other words, 2003 made up for the prior three years and then some.

In addition, the first quarter results of 2004 (second quarter results are not yet available) produced an underwriting profit for only the second time since the tracking of quarterly results began in 1986. Return on equity, which was an anemic 2% in 2002, approached 10% in 2003.

These positive returns directly impacted premiums paid by policyholders. As of July 2004, average rate increases, as measured by Market Scout™, were at 5%. At this time last year average rate increases were at 18%. In other words, the rate of increase has been decreasing.

What Does This Mean to You?

What can you expect in 2005? In general, we expect pricing to be flat. Some lines of coverage will continue to experience rate increases, while others will decline. In addition, an individual insured’s underwriting profiles and loss histories will

directly impact the premiums they pay. The best way to break this down is by line of coverage.

Workers Compensation

Workers compensation is a topic that deserves its own article, which follows this one.

Property, General Liability, Auto and Excess

In the insurance industry these lines of coverage for preferred businesses are known as the **standard market**.

This area is starting to heat up. Companies have returned to profitability, surplus is increasing, and now these carriers want to write more insurance. This is creating a competitive environment. As you’ll recall from the discussion about supply and demand, if supply goes up and demand stays the same, price will come down. This is what we’re beginning to see.

We haven’t seen flagrant price cuts like those in the industry’s last soft market, though. Underwriters appear to be underwriting intelligently and trying to pick the best accounts.

It’s also too early to tell what impact the four hurricanes that hit Florida will have on the industry’s capacity. Collectively, the losses there are estimated at \$22 billion. To give you some perspective, in 1992 Hurricane Andrew caused \$18 million in losses, and in 2001 the World Trade Center caused losses estimated at \$35-40 billion.

Regardless, on average, “preferred” commercial accounts should see flat rates or modest decreases on renewal (up to 15% on some lines of coverage).

Developers and Contractors General Liability

Developers and contractors general liability (especially residential construction) continues to experience a challenging market.

➤ **Residential** – Coverage for developers and contractors doing residential work remains tight. The number of insurers interested in this type of work is limited, coverage is expensive, and terms are restrictive.

Usually this coverage is written on a standard Insurance Services Office (ISO) form with

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numerous additional exclusions. If coverage is not written on an ISO form, the manuscripted forms need careful review. Typical exclusions added to the policy include:

- Prior damage (Montrose)
- Multi-family housing (condominiums, townhouses, attached homes and occasionally apartments)
- Mold
- Silica
- Subsidence
- EIFS

The list goes on. These policies need to be thoroughly analyzed and understood.

The type of additional insured endorsement that an insurer offers also needs to be evaluated. Many developers continue to ask for the ISO endorsement CG 20 10 (11/85), which extends to completed operations as well as ongoing operations. Unfortunately, this endorsement has pretty much disappeared from the residential construction marketplace.

On renewal each year, it's a good idea to make certain that your key clients can live with the more restricted additional insured endorsement you can provide.

As far as pricing goes, it is all over the board for residential coverages. On average, assuming a firm has a decent loss history, we've been seeing flat to increased pricing up to 25%. Not many underwriters are willing to decrease their rates. In addition, underwriters are looking for solid loss control and risk management.

- **Commercial** – Commercial developers and contractors are in slightly better shape, but it is still a seller's market. The merger of the Travelers and St. Paul insurance companies turned two players into one, which in turn lowered supply.

In addition, Travelers has a different underwriting philosophy from St. Paul, and some of the St. Paul policyholders are receiving significant increases on their renewals.

Once again numerous exclusions are being added to policy forms, and coverage needs to be carefully reviewed.

On average, commercial developers and contractors are seeing a flat to 15% increase in rates. Note that this can be higher if an insured

is currently with St. Paul and will be renewing with the new St. Paul/Travelers Insurance Company.

- **Multi-Family Housing** – Every general liability policy we are aware of in the market today for developers and contractors contains a multi-family housing exclusion. The only way to insure these projects is with an Owner-Controlled Insurance Program (OCIP) policy, also known as a “wrap-up” policy.

The market for wrap-ups remains limited, with only a handful of companies offering coverage. Terms and conditions vary, and correctly administering a wrap-up policy is challenging. It is imperative that you work with a broker that is experienced with this type of product.

Typically these policies cover the developer, general contractor and all subcontractors on a project. Occasionally, these policies extend to the project's design professionals (but even if they do, the coverage provided by a wrap-up is not a substitute for a professional liability policy).

Ideally, wrap-up coverage extends through the close of escrow of the last unit. This triggers the reporting period, which ideally extends through the applicable statute of limitations.

The minimum premium for a wrap-up policy with a \$1 million per occurrence/\$2 million aggregate limit (and defense costs included within the limits) is approximately \$500,000 plus taxes and fees, and premiums go up from there. Wrap-ups are heavily underwritten, and often require a commitment to engage insurance company appointed Loss Control and Quality Control programs.

The key to obtaining the best coverage available at the lowest possible cost is to start early and submit a complete application. You should also obtain indications of cost early in the planning stage of development. For many smaller projects, the cost of the insurance program can be a “deal breaker.”

Professional Liability

In general, professional liability rates have leveled off. Every profession is different, however,

and it is a good idea to stay in touch with your broker so you don't have any surprises on renewal.

- **Architects & Engineers Professional Liability** – This marketplace has seen major changes in the past year:
1. DPIC merged into XL and is now known as XLDP. The good news is that XL has maintained DPIC's original focus on education, proactive claim resolution and only dealing with knowledgeable brokers.
 2. Kemper Insurance Company went out of business, but most of its professional liability personnel went to St. Paul, who entered the market.
 3. Westport vacated the business.
 4. RA&MCO severed its ties with Great American, and subsequently was acquired by and will now represent Houston Casualty.
 5. Arrowhead Design Insurors and Liberty agreed to disagree and went their separate ways. Arrowhead partnered with Hudson Bay, while Liberty decided to remain in the game and will now write direct.

The market has also firmed. The price increases of the past three years have increased profitability and the number of available competitors has kept the market healthy. Nevertheless, this line of coverage is still being underwritten carefully. Carriers are apprehensive about condominium or residential work in general, and risk management and loss histories are carefully evaluated. Underwriters also encourage insureds to “*get more involved in the game*” (translation: higher deductibles!) At this time, 1% of gross fees appears to be the minimum most underwriters want to see.

Long-term relationships with the right insurance company will pay dividends. We also recommend that insureds start the renewal process early. Given a decent loss history and a pre-

ferred underwriting profile, rates should be -5% to +10% for 2005, although actual rates will be determined based on the attributes of each firm.

- **Lawyers Professional Liability** – Although lawyers' professional liability insurance rates continue to increase, they are rising less drastically than last year. However, certain specialized practice areas (which include intellectual property, personal injury, and securities and class action litigation) will experience more restrictive coverage and higher-than-average premium increases.

Nevertheless, aggressive risk management programs and long-term relationships with the right company will be rewarded.

Employment Practices Liability / Directors & Officers Liability

Like most of the other coverages discussed, this market has firmed, although not as much as most. Flat rates to 10% rate increases are not uncommon, but this line is heavily driven by loss experience. Policies for these coverages are all manuscripted forms, so it is imperative to work with an experienced broker who can guide you to the best value.

Conclusion

The economics of the insurance industry directly affect what a policyholder pays for coverage. What a firm pays for its insurance is only a portion of its “Total Cost of Risk” (TCOR). In addition to premiums and deductibles, money spent on risk management, loss control, the losses a firm chooses to retain, and the hours spent administering all these things can really add up.

Businesses need to focus on lowering their TCOR, and the only way to do that is to reduce claims. An effective Risk Management Program will accomplish this and drive more dollars to your bottom line. ✨

California's Workers Compensation Market What You Can Expect in 2005

By Jeffrey W. Cavnac, CPCU, RPLU, CWCA

The California workers compensation market remains a challenge. Although significant legislation was passed in an effort to curb underlying costs, other legislation actually increased benefits provided, which increases underlying costs. Although in general we expect flat pricing for first and second quarter renewals in 2005, actual net rates will depend on specific classifications as well as individual account underwriting profiles and loss history.

Background

Written premiums in California have exploded over the last five years. Since 1998, premiums have risen from \$6.6 billion to \$21.4 billion in 2003. Rates (and this will come as no surprise) have also increased dramatically during that time frame. Average rates in 1998 were \$2.35 per \$100 of payroll. They peaked in 2003 at \$6.37. Through the first quarter of 2004, they dropped to \$5.89.

Since 1998, the industry has lost a lot of money. Combined ratios (total expenses divided by premiums) have ranged from 117% in 2002 up to 181% in 1999 (2003 is really too soon to estimate at this time). The average combined ratio in that five-year period was a whopping 156%. Is it any wonder that over 25 workers compensation-focused insurance companies went out of business in California?

The good news is that loss ratios have significantly improved. 2003 could actually bring something close to an underwriting profit. This, in turn, creates interest from other insurance carriers. In addition to workers compensation reform, which impacts underlying medical costs as well as benefits, what the industry really needs is competition. The insurance industry is supply-driven, and as supply increases, costs come down.

Ultimately, though, what determines premium for individual risks is underlying costs. The average

cost of an indemnity claim in the last ten years has nearly tripled. Assembly Bill 227 and Senate Bill 228, as well as Senate Bill 899 are directed specifically to cut the underlying costs. Everybody agrees that they will provide a mitigating factor, but at this point it's too early to tell just how much.

To understand where net rates might be in 2005, you need to understand how rates are set.

How Rates Are Set

The Workers Compensation Insurance Rating Bureau (WCIRB) is a private, unincorporated, not-for-profit insurance industry trade organization. Its primary functions include:

- Publishing advisory pure premium rates
- Calculating and issuing experience modifications

It's important to note that the pure premium rates recommended by the WCIRB must be approved by the Insurance Commissioner. The Commissioner doesn't always agree with the pure premium rates provided by the WCIRB, and he has the option of amending them.

It's also important to note that the rates the Commissioner ultimately approves are advisory as well. Insurance companies have the option of literally choosing whatever rate they would like. In addition to the base rate, they also have some flexibility in what credits they can apply to arrive at what is ultimately a base rate.

For the previous two filings (July 1, 2004 and January 1, 2004), the Commissioner approved substantially lower rates than those recommended by the WCIRB. Collectively, these two rate decreases totaled nearly 22%. Remember that these were advisory rates. Most insurance companies did not take the full advised rate decrease. The base rate de-

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crease was probably closer to 5% to 15%, depending upon the insurance company and classification.

Effective January 1, 2005, the WCIRB has recommends a **3.5% increase**. This is an advisory increase over the previous 21% decrease recommended by the Commissioner in 2004. This increase is intended to make up for the deficiency between the rates it previously calculated as necessary, and the lower rates actually approved by the Insurance Commissioner.

You should be aware that the recommended 3.5% pure premium rate increase is an average. The WCIRB also recommends specific changes for each of more than 400 classifications. Some will go up; others will go down.

Taken into consideration for 2005 is the impact that the various reforms over the past several years will have on pricing. The WCIRB determined that, without reforms, a 50% pure premium rate increase would be necessary. As the WCIRB sees it, employers are actually receiving major reductions in “comparative rates” despite the nominal increase.

The WCIRB bases its calculations on what impact it feels the reforms will have, and it takes a conservative approach. The most significant aspects of the reforms will come from new regulations and benefit schedules which are due to be adopted by the Division of Workers Compensation (DWC) effective January 1, 2005.

Because those regulations and schedules are still being evaluated, and will certainly be challenged in court, the WCIRB feels that the ultimate changes and benefits are simply too speculative to build into its current rate recommendations at this time. On the other hand, additional benefit increases, which were part of Assembly Bill 749, take effect on January 1, 2005. These can be quantified and are included in the WCIRB's projection.

What the Commissioner ultimately decides to approve remains to be seen. It is almost certain that he will not approve an increase. Speculation is that you might see a modest, single-digit decrease. However, remember that it is up to the individual insurance company as to what rate will ultimately be charged.

What Should You Expect in 2005?

Rates are generally recalculated every six months, on the first of January and July. If your workers compensation policy renews in the first six months of 2005, you would benefit from the rate decrease that most insurance companies took in July 2004.

Although the decrease varied dramatically by insurance carrier (on average 0-15%), a good average is 7% (this is what the State Fund adopted). Assuming a 7% decrease, and taking into consideration the WCIRB's recommended rate increase of 3.5% effective January 1, 2005, you could figure an approximate net rate decrease of 3.5%. As previously mentioned, it is anticipated that what the Insurance Commissioner approves will ultimately be lower than that, but this is a pretty good “ball park” estimate.

In all likelihood, rates will change once again in July 2005. Whether they go up, down, or remain the same is anyone's guess at this time.

The only way to accurately forecast 2005 workers compensation insurance costs is to sit down with your broker, work through a projected 2005 experience modification, and discuss with your insurance company what type of rates will be applicable for your specific classifications. A little work done up front will reduce a lot of uncertainty on the back side.

As I've mentioned in previous newsletters, workers compensation insurance is more of a finance tool than an insurance product. Ultimately, through the manifestation of your experience modification, you end up paying for your workers compensation costs.

Because of this, the only way to control your premiums is to control your underlying expenses. You can focus on a number of strategies in the areas of audits, experience modification, injury prevention and injury management. This article does not lend itself to going into detail on any of these strategies, but they should be part of your overall risk management program. ✨

Disclaimer: This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.
