Topics Concerning Buyers of Commercial Insurance

MSP C 10/2010 – "The 2011 Insurance Market — What It Means to You" October 2010

Commercial Insurance Update Newsletter

The 2011 Insurance Market

What It Means to You

By Jeffrey W. Cavignac, CPCU, ARM, RPLU, CRIS, President / Principal

I started working in the insurance business in 1980. I was an underwriter trainee for Industrial Indemnity Company ($13,200 a year). An "underwriter," I was told, evaluated a prospective insured's exposure to loss (likelihood they would have a claim) and determined an appropriate premium for that account. What I quickly realized, however, was that the insurance industry was in the middle of a raging soft market (I had no idea what a "soft market" was). Instead of intelligently selecting the right price for new and renewal business, it was more like, *"How low can you go?"* Now, at the end of 2010, we are again in the middle of a soft market, and what I learned 30 years ago is again very relevant.

A soft market is characterized by excess capacity in the insurance industry. Capacity, or what is referred to as "Policyholders Surplus," is basically the insurance companies' current reserves to pay future claims as well as their other capital. The more surplus a company has, the more premiums it can write. If more companies want to write more premium, competition ramps up.

In 1980 I was a recent college graduate with a major in economics. I have to admit I didn't remember much of what I learned, but I did know that when supply went up and demand stayed the same, prices went down. That essentially is what happens in a soft market. In an effort to write more premium, insurance companies slash prices to the bone, write accounts they might not usually pursue, and provide coverages and terms that would otherwise be generally unavailable.

As insurance companies compete feverishly, results deteriorate and loss ratios go up. The "Combined Ratio" equals losses paid out and expenses incurred divided by premiums. If the combined ratio is less than 100%, an insurance company is making an underwriting profit. If it is above 100%, it is losing money on underwriting.

Note that historically the insurance industry's combined ratio has been about 100%. The reason the industry can survive at this level is because it also makes money on investments. During periods of substantial investment returns insurance companies

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TABLE 1
Dollars in Billions

Insurance Industry's Critical Finance Indicators

Description	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Net Written Premium	$327.8	$369.1	$403.8	$421.1	$425.9	$443.8	$440.8	$434.9	$418.9	$212.5
Combined Ratio	115.9	107.3	100.1	98.1	100.9	92.4	95.5	105.0	101.0	101.7
Investment Income	$37.1	$37.2	$38.7	$39.6	$49.7	$52.3	$55.1	$551.5	$47.0	$23.6
Operating Income	<$13.8>	$5.3	$33.7	$44.1	$45.1	$84.6	$73.4	$30.6	$44.7	$19.2
Policyholders Surplus	$289.6	$285.2	$347.0	$391.4	$425.8	$447.1	$517.9	$457.3	$511.5	$530.5
Return on Average Net Worth	<1.2%>	2.2%	8.9%	9.4%	9.6%	12.7%	10.9%	0.1%	4.7%	3.1%

*First Half

2011 Market *(continued from page 1)*

will even accept modest (and sometimes not so modest) underwriting losses because they can make it up on their investments. The problem is that during a prolonged soft market, prices get bid too low, the rate of return deteriorates, and at some point the industry must raise prices, restrict its underwriting appetite, and reevaluate the coverages it offers.

This is exactly what happened back in the mid eighties. The industry had lost too much money, rates of return had plummeted, and the industry, as it typically does, over-reacted. Premiums began to increase, and then increase dramatically. Prices were going up on average 25-50% and in some cases 100% or more… if you could even buy the appropriate coverage.

TABLE 2

Month / Year	Amount of Change	Cumulative Change
August 2004	4%	1.00
August 2005	<6%>	.94
August 2006	<y%>	.67
August 2007	<14%>	.75
August 2008	<10%>	.68
August 2009	<5%>	.64
August 2010	<4%>	.62

Table 1 reflects the Insurance Industry's critical financial indicators for the last 10 years. 2001 was the worst year in the Industry's history. The combined ratio was 115%, surplus was depleted, and the industry actually lost money for the first time ever. The industry reacted. Prices went up, combined ratios improved, and surplus took off. By 2004 rates had started to come down. If you look at Table 2, you will see that on average commercial rates have dropped 38% since then (workers compensation in California dropped a lot further but more on that later).

The industry continued to improve in 2005 and 2006. 2006 was probably the best year the insurance industry ever had. The combined ratio dipped to 92.4%, surplus continued to grow, and return on surplus hit 12.7% (the highest in recorded history). As surplus continued to grow, however, competition became fierce. Prices continued to go down, insurance companies entered lines of business they didn't really understand, and losses started piling up… combined ratios began to rise. Although 2007 returned a solid 10.9%, for many reasons 2008 was a disaster (a lot had to do with natural disasters that year) returning a meager .1%. 2009 was a little better, returning 4.7%, but still way under what investors want.

For the first six months of this year results have actually improved, with return on average policyholders' surplus increasing from 2.6% to 6.3% – this despite the fact that the combined ratio actually increased from 100.8% to 101.7%. This is reflective of a better investment climate. It is, however, still far below the 13.9% long term investment average of the Fortune 500, and the 9.4% average annualized first-half rate of return for the insurance industry based on data going back to 1986.

So where are we today? As you start budgeting insurance premiums for 2011, what should you expect?

Property and Casualty Other than Workers Compensation

As mentioned above, rates have dropped significantly since 2004. Most underwriters will tell you today that they want to hold rate on their preferred business (not lower prices) and ideally would like 5-10 points of relief. Unfortunately for them, there is still too much surplus in the market and too many competitors. Preferred accounts can therefore expect flat rates in 2011 and conceivably modest

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Published by

Cavignac & Associates
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TABLE 3 California Workers Compensation Rate Filings

Date of Rate Change	Workers Compensation Insurance Rating Bureau	Department of Insurance
01/01/04	-2.9% to +5.3%	-14.9%
07/01/04	-13.0% to +15%	-7.9%
01/01/05	+3.5%	-2.2%
07/01/05	-13.8%	-18.0%
01/01/06	-15.9%	-15.3%
07/01/06	-16.4%	-16.4%
01/01/07	-6.3%	-9.5%
07/01/07	-11.3%	-14.2%
01/01/08	+5.2%	0%
01/01/09	+16.0%	+5.0%
01/01/10	+22.8%	0%
Cumulative through 01/01/10		**-63.7%**

2011 Market *(continued from page 2)*

discounts. More challenging accounts, either because of what they do or their loss history, may not be as fortunate. Regardless of whether or not you are a preferred account, it is prudent to start the renewal process early and lock down terms well in advance of your renewal if possible.

An exception to what otherwise should be a decent year to renew insurance programs is "Executive Risk," aka directors and officers (D&O) liability and employment practices liability (EPL) among other coverages). Not surprisingly, D&O as well as EPL have had adverse loss experience in the recent poor economy, driving costs up in these lines.

You should also be wary of a new competitor entering the market. An insurance company can only establish market share in four ways.

1. They can provide broader coverage. This is difficult to do in today's soft market.
2. They can provide better claims handling. Not many new entrants can afford to invest in a claims department.
3. They can provide better loss control and education. Once again not many new entrants are willing to invest in this area.
4. They can provide a cheaper price.

Not surprisingly, most new companies opt for Option 4. Unfortunately these "newbies" don't have the actuarial data that experienced insurance companies have, and the likelihood of them surviving long term is remote. This can leave insureds without an insurance company just when they need them the most – during a claim.

It is tempting to save some money in the short run and take the low dollar alternative; however, insurance is like many things in life – you get what you pay for!

Workers Compensation

Nationally, workers compensation has been relatively stable. Although results vary by state, in general outside of California there should not be any huge surprises. Regardless, if you have a preponderance of your payroll in a state other than California you should look in to the results for that state in order to budget appropriately.

In California rates will go up. California operates as an "open rating" state. The Workers Compensation Insurance Rating Bureau (WCIRB or the "Bureau") recommends pure loss costs for each of the numerous classifications. These are reviewed by the Insurance Commissioner, who comes up with his or her own rate recommendations. Regardless of what the Bureau or the Commissioner recommend, insurance companies are free to choose whatever rates they want. Most insurance companies, while not in lock step with the recommendations, will generally follow fairly close to the recommended rates.

If you look at Table 3, you will see that workers compensation rates have plummeted since 2004, dropping over 63%. Table 5 shows the average rate per $100 of payroll. This is a result of improved surplus, some favorable legislation, and too many

TABLE 5 Average Insurer Rate per $100 of Payroll

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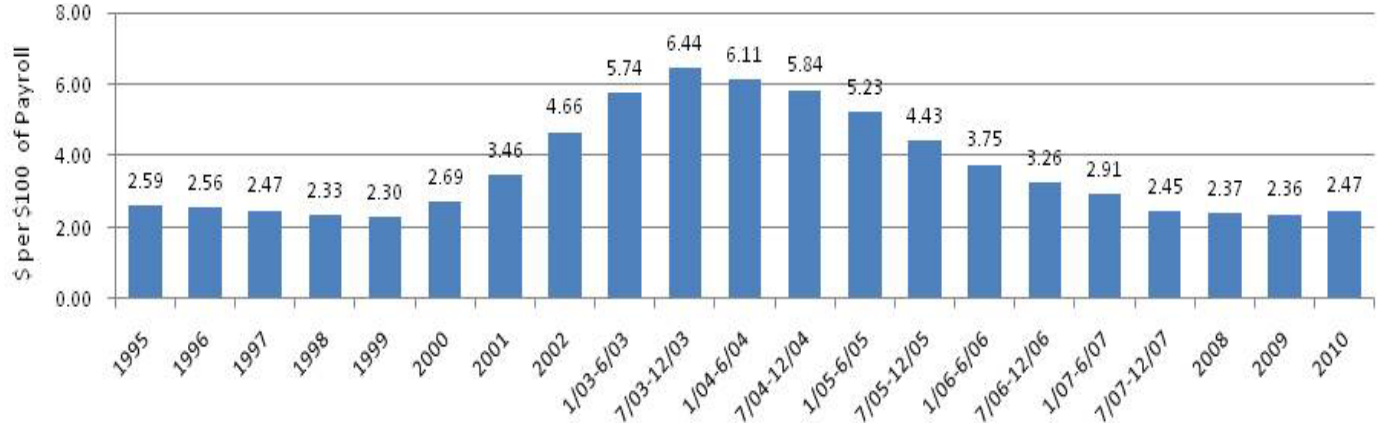

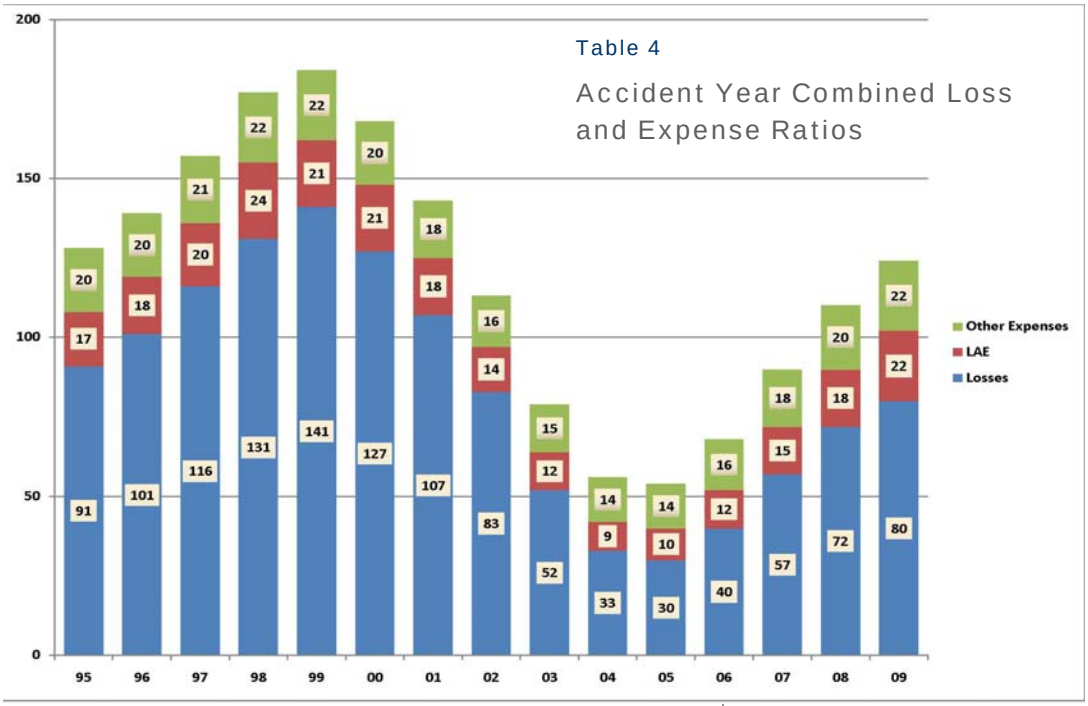

were still in business in December 2009 — a 31.9% failure rate. The failure rate for startups was even higher — 37.9%.

Following significant losses earlier in the decade, the surety industry "returned to the basics" of sound underwriting, exposure management, and project analysis. These actions stabilized capacity by restoring profitability and preserving the capital necessary for sureties to stand the test of time. Moreover, the excellent results posted by the surety industry in 2005-08 positioned surety companies to ride out the current economic downturn.

With the residential slowdown in 2008, then the late 2009 slowdown in non-residential construction, and now the shrinking backlogs, sureties don't expect to see growth return until at least late 2011, despite the federal economic stimulus recovery act. Anticipating the completion of public works projects and continued limited public funding for new projects, we expect the construction market to remain competitive. The very best contractors should have no trouble obtaining bonds. However, marginal contractors will have difficulty. Contractors need to tighten their operations to emerge through the difficult economic conditions.

Sureties are looking more closely at onerous contract terms and conditions such as consequential damages, delay damages, hold-harmless obligations, efficiency guarantees, and extended maintenance and warrantee requirements. Contractors may experience changes in their bonding programs due to more disciplined underwriting factors.

Small contractors may encounter challenges in meeting the more demanding underwriting requirements. Several surety companies have developed programs for emerging contractors, while other companies specialize in the small contractor market. The U.S. Small Business Administration Surety Bond Guarantee Program may become a popular option for those unable to obtain bonds by traditional means. New and emerging contractors will need to provide well thought-out business plans, more frequent CPA prepared financial statements, and higher quality information about their company more often and in a more timely manner than in the past.

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competitors. While the good news for insurance buyers is that rates have dropped by nearly two thirds, the bad news is they went too low. As Table 4 reflects, the combined ratio dropped to 54% in 2005, but since then it has more than doubled, hitting 124 in 2009! You will not stay in business long if you are paying out $1.24 for every $1.00 you take in. Granted a big part of this problem is the State Compensation Insurance Fund, which had a 160% combined ratio, but even when you pull it out of the formula, the industry is still around 110%.

Earlier this year it was rumored that the Bureau would recommend a 30% rate increase effective January 1st 2011. It actually came in at 27.6%. The Commissioner has yet to provide his recommendation. Interestingly, the Bureau recommended 22.8% on January 1st 2010 and the Commissioner recommended 0. No telling what the Commissioner will rule this year, but regardless of what the ruling is, most insurance companies will, in my opinion, take a rate increase of 10-25%.

If you are estimating your 2011 workers compensation costs, you should make certain you have projected your 2011 experience modification and discussed rates with your current workers compensation insurance company. It is only by understanding both your experience modification and possible rate changes that you can accurately forecast your costs.

Surety

The latest figures from ***BizMiner*** confirm the economic trend effects on contractors. Of the 1,424,124 companies operating in 2007, only 969,937

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All contractors should accurately assess their own capabilities. It is important to look at operating profitability and maintain a history of completed contracts profitability. Complete, accurate and timely job costing and financial reporting is mandatory in today's environment.

Communicate good and bad news real time to your surety business partners. The most important thing a contractor can do is keep the surety informed when problems arise. If approached in a proactive manner, many surety companies will work through a problem with the contractor.

Construction is cyclical, and contractors should prepare for the pent-up demand that will build during a recession. While contractors must retrench during these lean times, they also need to protect their core resources and be ready to bid work when the economy rebounds. The surety is a critical partner through good times and bad, and can help owners and contractors manage the changing economic climate.

Employee Benefits

There is no way to sugar coat it: Employee Benefits-Health care costs continue to rise. Medical costs are going up, and health care reform has not appeared to help. The intent of the Patient Protection and Affordable Care Act, (PPACA) also known as "The Reform" or "Obama Care," is to improve the healthcare system for all Americans. The extent of the impact to employees and employers has not yet been realized.

What has been realized, well before 2014, is the impact the medical carriers have placed on premium rates to cover the new regulations set forth by the PPACA, such as Adult Child Coverage for all children under the age of 26, the removal of the Lifetime Maximum, No Co-pay or Co-Insurance associated with annual preventive visits, No Pre-Existing Conditions or Limitations for children under the age of 19. The medical carriers, along with their actuaries, have decided these benefits have a greater risk and must be addressed by increasing renewal premiums by as much as 7%. It is anticipated that small (50 or less) to medium (50-500) employers will see 15-25% rate increases in 2011.

HMO rates are expected to increase at a higher percentage than PPOs in 2011, mostly due to contract renegotiation with providers. To offset this, HMOs will increase co-pays and pass more of the cost to the end user. The High Deductible Health Plans (HDHP) saw very large increases in 2009, and in 2010 appeared to settle at the PPO medical trend percentage increase, 15-20%.

Risk Management Seminar Series

450 B Tower, 450 B Street, Suite 1800, San Diego, CA 92101-8005

Upcoming Seminars

- Victims, Villains, and Heroes (HR)
  Friday, November 19, 2010 7:30-10:00 am
- Sexual Harassment Prevention Training
  NOTE: This will be the LAST 2010 SHPT Training Class!
  AB 1825 Compliant
  Friday, December 3, 2010 7:30-10:00 am
- Workers Compensation 101 and Post Accident Response Training
  Friday, December 17, 2010 7:30-10:00 am
- OSHA 300 and Safety Issues in the Office
  Friday, January 14, 2011 7:30-10:00 am

For more information about upcoming seminars

Click here to view our seminar list and individual flyers

To sign up for upcoming seminars

Contact **Darcee Nichols** at **dnichols@cavignac.com** or **619-744-0596**.

All training sessions available to our clients
Reserve early / seating is limited! *

* **NOTE:** Due to the popularity of our seminars and limited seating, we regret **we cannot provide refunds or credits with less than 72 hours advance notice of cancellation**.

Employers continue to look for any way they can to moderate the magnitude of the inevitable rate increase they face on renewals. HRAs, HSAs, HMO Deductible plans and employer contribution changes are being considered to help offset increases.

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Conclusion

The insurance market will transition and costs will eventually go up. This is already happening in workers compensation. Although you can do some things to prepare for and survive in a hard market, your Cost of Risk really needs to be looked at from a long term perspective. In fact, insurance is just one of the elements in your Cost of Risk – for many companies, it is less than half the total. Other costs include:

- Your time spent analyzing and managing risk
- Money spent on uncovered losses or deductibles
- Your time and your employees' time spent dealing with losses

The reason for mentioning this is because whether or not the insurance industry is in a hard or soft market cycle, well-run companies will always be looking for ways to effectively manage their risk. Risk Management is not a seasonal or "one and done" exercise, it needs to be a vital part of your company. It is only by lowering the frequency and severity of the losses which drive your premiums that you can lower those premiums in the long run.

As a final comment, this article is written from a general perspective. Our prognostications are based on assumptions that could change. In order to more accurately estimate your insurance costs in 2010, you should discuss your specific situation with your insurance broker and underwriters.

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.

Cavignac & Associates Wins

IIABA "Best Practices" 2010 Agency Award

Cavignac & Associates has been selected to continue its participation in the Independent Insurance Agents & Brokers of America (IIABA) "Best Practices" study group as part of an elite group of independent insurance agencies across the United States.

Every year since 1993, the IIABA has joined forces with Reagan Consulting, an Atlanta-based management-consulting firm, to study the country's leading insurance brokerage agencies in six revenue categories. The agencies comprising the study groups are selected every third year through a comprehensive nomination and qualifying process before being awarded a "Best Practices" Agency designation. The selected "Best Practices" agencies retain their status during the three-year cycle by submitting extensive financial and operational data for review each year.

"Our results are a reflection of our entire company," said Managing Principal Jeff Cavignac. *"My three partners – Jim Schabarum, Scott Bedingfield and Patrick Casinelli – would agree that the only way an agency can consistently be a 'Best Practices' Agency is if everyone*

Best Practices *(continued on page 7)*

Best Practices *(continued from page 6)*

rows together toward a common goal." Added Cavignac, *"As the country's largest network of independent insurance brokers, the IIABA has provided our agency with valuable resources over the years to help us strengthen our carrier relationships, expand our capabilities, and ultimately better serve our clients."*

Founded in 1896, IIABA is the nation's oldest and largest national association of independent insurance agents and brokers, representing a network of more than 300,000 agents, brokers and their employees nationally. Its members are businesses that offer customers a choice of policies from a variety of insurance companies. Independent agents and brokers offer all lines of insurance – property, casualty, life and health – as well as employee benefit plans and retirement products.

The Best Practices Study was initiated by IIABA as the foundation for efforts to improve agency performance. The annual survey and study of leading independent insurance agencies documents the business practices of the "best" agencies and urges others to adopt similar practices. The agencies are nominated by either an IIABA-affiliated state association or an insurance company, then qualified based on their operational excellence.

More than 1,200 independent agencies throughout the United States were nominated to take part in IIABA's annual study, but only 224 agencies qualified for the honor. To be selected, an agency must be among the country's 35-40 top-performing agencies in one of six revenue categories.

Cavignac & Associates has been an IIABA "Best Practices" Agency since 2007. Founded in1992, the firm is focused on identifying and managing exposures to loss in order to lower its clients' total cost of risk.

Article courtesy of Cavignac & Associates Employee Benefits Department

LIVE WELL, WORK WELL

Curb the Urge

Quitting smoking is not easy, but the urge to smoke typically only lasts three to five minutes. So when you're really craving a cigarette, try and wait it out. You can redirect your attention to something different and interesting in many ways to help you curb the urge to smoke. These tips will help:

- Keep other items on-hand to keep you busy instead of cigarettes: try sunflower seeds, raisins, carrots, apple slices or sugar-free gum.
- Do the dishes or take a shower when you're really craving a cigarette. When you're not at home, wash your hands or drink a glass of water.
- Where you are and what you're doing can make you crave a cigarette. Try a change of scenery – go for a walk outside or take a few trips up and down the stairs at your home or office.

- Never have "just one." Satisfying your craving with a cigarette will only undo your progress toward quitting thus far.
- Remember why you're quitting in the first place. Thinking about why it's important to you to quit smoking will help when a craving hits.

Community Bulletin Board

"Neighbors helping neighbors in San Diego"

San Diego Humane Society and SPCA

- Event Calendar
- Web Site

Senior Community Centers

Mission:
To provide quality and compassionate services for the survival, health and independence of seniors living in poverty

- West Wellness Center
- Web Site

DOWNTOWN YMCA

500 West Broadway, Ste. B, San Diego 92101 619-232-7451

- Web Site
- Questions? Contact **Alicia Gettys** by phone at **619-232-7451** or e-mail at **agettys@ymca.org**

SAN DIEGO POLICE FOUNDATION

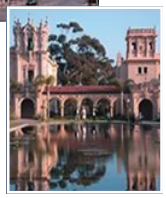
The San Diego Police Foundation supports the men and women who "protect and serve" by raising community awareness of important unbudgeted or "discretionary" needs that will improve crime-prevention and law enforcement efficiency. The Foundation puts your tax-deductible contributions to measureable work in local communities.

- SafetyNet Wins Cybersecurity Award
- Web Site
- For more information, contact **info@sdpolicefoundation.org**

Monarch Schools

- Teacher of the Year Advances to State Level
- Web Site

SDAF SAN DIEGO ARCHITECTURAL FOUNDATION



- Web Site
- Orchids & Onions
- Questions? E-mail **info@SDArchitecture.org**

Society for Design Administration

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The Society for Design Administration advances management and administrative professionals in the A/E/C industry through education, networking and resources.

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