Commercial Insurance Update

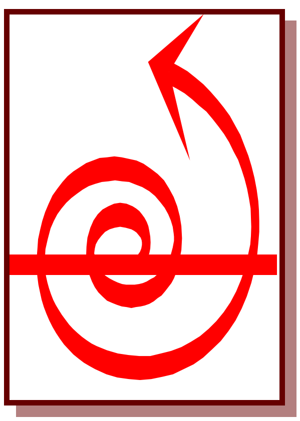
Topics Affecting Buyers of Commercial Insurance

MSP C 08/00 – "State of the Current Insurance Marketplace" August, 2000

State of the Current Insurance Marketplace

By Jeffrey W. Cavignac, CPCU, RPLU

In October of 1980, I began my insurance career as a casualty underwriter for Industrial Indemnity Company. I was trained in the art of underwriting. Underwriting involves evaluating a risk from a quantitative standpoint and selecting a premium that, while competitive, generates an underwriting profit, which is defined as a combined ratio (losses plus company expenses divided by premiums) of under 100 for the company.



In theory, this is how underwriting is supposed to work, but what I did not know, and what I soon learned, was that 1980 was the beginning of a "soft" market cycle.

During a soft market cycle, underwriting rules, guidelines and rates are basically thrown out the window. Companies scramble to write as much business as they can at prices that are often dramatically lower than the cost of paying claims and covering expenses, let alone providing a profit. This is also known as "cash flow underwriting." From the policyholder's perspective, it is a buyer's market.

In contrast, poor insurance company results, increased pricing and reduced availability characterize a hard market cycle. Terms become more restrictive, and some types of coverages disappear altogether.

Historically, the insurance industry has been characterized by fairly regular six- to eight-year cycles. A cycle is usually composed of three or four years of upward or increased pricing (hard market) followed by three to four years of downward or decreased pricing (soft market). Underwriting cycles are affected by various factors having to do with the profitability of the insurance industry, the economy, and other considerations.

In October of 1983, I joined an agency, and, like clockwork, the market changed. Rates began to climb dramatically. It was not uncommon for us to have to deliver 50% to 100% premium increases. This hard market cycle nearly put some of our clients out of business, and caused a number of our clients to go "bare" (in other words, they dropped their cover-

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age) on certain critical but not legally required coverages. Take this dramatic example:

Sometime in the mid-1980's, our agency was awarded the Price Club account, and the first thing we did was to renew its $20 million excess liability coverage. In a hard market, it was tough to buy $20 million of coverage, especially on a risk like the Price Club. Fortunately, we were able to place it; however, our client was not impressed. Its premium had gone from $20,000 to $400,000.

The hard market that began in 1983 or 1984, depending on how you measure it, lasted until about 1988, when prices began to decline. By the time I started my own agency in 1992, prices had declined about 25%. It had been three or four years since the peak of the hard market, and it seemed to me as if the cycle would harden and prices were ready to rebound. WRONG!

Since our agency started in 1992, rates have plummeted. Just when it seemed the market couldn't go any lower, it did. Although underlying losses came down as well, they did not come down nearly as fast as the premiums. This has resulted in an insurance marketplace today which is firm at best and borderline chaotic most of the time.

Workers Compensation

The workers compensation market in California is in a state of turmoil. Estimates are that in 1998 the industry as a whole had a combined loss ratio of 141%. In other words, for every dollar the industry took in, $1.41 was paid out. It is anticipated that 1999 will prove to have been just as bad.

This adverse loss ratio is not a surprise. In 1995, California went from a minimum rate law (where the State set the minimum rate that an insurance company could charge) to an open rate law (in which insurance companies could file their own rates).

The last minimum rates were published in October, 1995. They had already decreased dramatically (20% to 30%, depending on classification) since January, 1993. But when open rating hit, rates fell even further: 40% to 50% over a period of several years.

Now rates are going up, and, in some cases, going up a lot. On January 1, 2000 our former Insurance Commissioner, Chuck Quackenbush, announced an advisory rate increase of 18.4% (the Commissioner cannot dictate a rate increase, but merely suggest one). Most of our insurance companies took this rate increase, and some raised rates

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Pricing Trends

Pricing trends are evident as shown by the following:

- Insurance company failures were up nearly 60% in 1999. According to Standard & Poor's, 35 insurance companies failed last year, compared to 20 in 1998. The rating service attributed the failures primarily to continuing competitive pressures that have led to inadequate pricing and weakened reserve positions.
- Combined ratios are up. A. M. Best reported that the property/casualty industry's combined ratio rose to 107.7 in 1999, up from 105.6 the year before. The number for commercial lines was even higher: 109.6 in 1999. The reason, according to A. M. Best? "Years of deterioration in industry pricing."
- Combined ratios are expected to continue to climb. The Insurance Services Office, Inc. (ISO) is predicting that the property/casualty industry's combined ratio will rise to 111.7 this year, and potentially to 136.2 by 2005.
- Property/casualty's net income plunged 28% in 1999. According to the Insurance Information Institute, the industry's net income after taxes came to $22.2 billion in 1999, $8.6 billion less than 1998's $30.8 billion.
- Premium growth is not keeping pace with other economic indicators. According to an article in ***Best Week,*** premiums grew 38% in the 1990's while the gross national product swelled by 69%. That amounts to about 3.3% in premium growth a year, far below the average annual growth of the 1970's (12.1%) and 1980's (8.7%).
- Other property/casualty insurers are looking to shore up their pricing, especially in commercial lines. In a recent article, the ***Wall Street Journal*** singled out AIG, Travelers Property and Casualty, Hartford Financial Group and St. Paul Companies as among the firms that have raised prices 5% to 15% in some of their commercial lines.

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even more. Regardless, for some insurance companies, it was too little, too late.

Early in 2000, the California Department of Insurance seized Superior National, the largest private writer of workers compensation insurance in the state, and top executives were terminated. A. M. Best downgraded Fremont Indemnity, another of California's largest private writers of workers compensation (which in prior years had acquired Industrial Indemnity), from an A- to a B++. In the second quarter of 2000, the revered State Compensation Insurance Fund of California also was downgraded from A- to B++ as well.

Property / Casualty

Rates in the property and casualty market have decreased dramatically over the past 12 years. Although combined ratios have not been as bad as for workers compensation, they have still been in the 110% range. Companies are not making money and prices are starting to rise.

Most of the major companies writing coverage in this country are looking to raise premiums 5% to 15% on their commercial lines business. Certain sectors of this business, such as excess coverage, are going up even more.

What does this mean to you?

First of all, the cost of your insurance program will, in all likelihood, go up. How much is dependent upon the nature of your account and the type of business you're in. Regardless, when budgeting insurance premiums, you should discuss this with your insurance broker.

You should also realize that while rates may be dramatically higher than they were last year, they are still well below the level they were at, say, five years ago.

You may wish to consider whether it is appropriate to shop your insurance account. Although people are more inclined to shop when rates are going up, it may not be the best move.

A key advantage in remaining with the same company is that most companies reward loyalty; if you've been a good customer for a number of years, and then have a bad year, you are less likely to be dropped than if you have a history of "leapfrogging" from company to company. The worst case scenario is to be non-renewed by an insurance company that competed only on price, and not be able to find replacement insurance at a feasible rate (this happened in the last hard market cycle).

Just as important is striving to become a good risk. Underwriters reward clients with well-written safety programs, policies and procedures that will lower their exposures to loss. It is also critical to use the services of a professional insurance broker who understands your business from an insurance perspective and can market your account effectively.

Conclusion

How long will this new hard market cycle last? How high will prices go? It's difficult to say. Apparently, the old six- to eight-year cycles are now gone (the last soft market cycle lasted 12 years). It's really anyone's guess as to where the market will go, but the insurance industry has been losing money, and this has been manifested in lower stock prices. When stock values dip, shareholders notice, and they will insist on a better return on their investments if they are going to continue to support the insurance business.

From a policyholder's perspective, you need to focus on those factors that make your firm an attractive risk from an underwriter's perspective. Having proactive safety and loss prevention programs, managing contractual liability exposures, and trying to resolve problem situations before they become actual claims are all positive steps toward managing your risk. ✧

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