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Commercial Insurance Update – The Economics of the Insurance Industry and Why It's Important to You!

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The Economics of the Insurance Industry and Why It's Important to You!

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The insurance business like most industries is cyclical. It is affected by the general business climate but ebbs and flows subject to unique factors. The simplest way to understand the industry is to look at the critical indicators that drive the industry's results (Table 1 below). Probably the single most important factor is Policyholder Surplus. This is the money the insurance companies have in the bank to basically pay future claims. Surplus is critical since it factors into the ratios that rating agencies use to evaluate the financial viability of a specific insurer. The more surplus a company has, the more premiums they can write. When the industry is flush with surplus, the insurance marketplace becomes competitive. This means lower premiums, relaxed underwriting and expanded coverage. This is referred to as a soft market. Historically the industry can only endure a soft market for so long. Ultimately the lower prices adversely affect underwriting profits. The industry's Return on Average Net Worth begins to deteriorate and the industry cannot attract capital. Surplus suffers and prices start to go up, underwriting tightens and coverage is restricted. This is known as a hard market.

So where in the cycle are we now? The answer is not clear. What we do know is that after 7 years of rate reductions, prices have stopped declining and on average have started increasing (Table 2 above). We also know that the industry's Return on Average Net Worth is sub-par. After 5 solid years of returns (2003-2007), the industry's results have deteriorated significantly. In order to continue to attract capital, insurance companies need to earn 10% returns or better. In the last four years the industry has averaged about 3.35%. The poor returns are reflective of poor underwriting and meager investment income. The Combined Ratio is a measurement of underwriting results. Basically it equals losses paid plus expenses incurred divided by premiums. If the Combined Ratio is under 100 it means the industry is making an underwriting profit. If it is over 100 as it has been for the last 4 years and will be again this year, then they are losing money on underwriting. In the past, insurers have been able to more than make up for poor underwriting with robust Investment Income.

Unfortunately, interest rates are at historic lows and investment returns have never been thinner. This places increased importance on underwriting results and that's where we are today. The industry needs 5-10 points of

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What makes the current cycle different from previous cycles, however, is that this cycle is predominantly driven by the income statement and not the balance sheet. Historically, "hard markets" suffered from both poor returns and depleted surplus. While surplus took a modest dip in 2011, it is still near an all-time high. The insurance business has always been supply driven (demand stays relatively constant). When supply is up, prices tend to go down. So while individual insurers want and need rate increases, there is still substantial competition due to the large surplus. Underwriters have to perform a unique balancing act, seeking to obtain increased rates while not losing the accounts they worked so hard to acquire.

So what can you expect in 2013?

General Liability/Excess Liability – For preferred accounts, rates for General Liability are anticipated to be flat to +5%. For accounts with recent claims history or what are considered hazardous exposures, however, rates will likely increase 5-15%. Underwriting also continues to evolve, with underwriters seeking more information about an applicant's financials, business operations and loss ratios. Additional exclusions are not uncommon as underwriters seek to narrow coverage. Excess prices will track primary pricing; however, we are seeing some excess carriers insist on higher limits for underlying programs.

Property/Inland Marine – 2011 was one of the worst years ever for insured property disasters. The earthquake in New Zealand, the tsunami in Japan and the U.S. tornados contributed to the industry's worst combined ratio since 2001. Despite the lousy results in 2011, the standard property market (non-catastrophe) is only seeing rate increases of 5-10%. Catastrophe exposed accounts, however, are seeing increases of 10-25% or more. Coastal windstorm remains the biggest challenge. The market for earthquake remains fairly stable.

Automobile – Like the balance of the market, auto is seeing modest increases in general, although smaller fleets (less than 10 autos) are seeing larger increases than larger fleets.

Professional Liability – Professional Liability remains competitive. The market for the most part is oversaturated and the "long-tail" claims that drive results in this sector have yet to fully materialize. Regardless, the prolonged decreased pricing is starting to take a toll and it is anticipated that many of the inexperienced insurance companies who have driven down the prices in this sector will soon exit the market. For preferred risks flat pricing to 5% rate increases should be anticipated. Needless to say, tougher classes and risks with poor loss experience will see higher increases and decreased availability.

Executive Risks – Executive Risks include Directors and Officers Liability, Employment Practices Liability and Fiduciary coverage. Both public and private D&O are seeing rate increases; however, non-profit D&O is fairly stable. Financially troubled companies and those in the financial services or real estate sectors continue to find coverage available on restricted terms and at higher rates. Employment Practices Liability is going up, and in some cases significantly. The poor economy has dramatically increased the frequency of these types of claims and results have deteriorated accordingly. Results vary by state, but California (no surprise) is among the worst when it comes to underwriting this line. You can expect 10-25% increases for this coverage. Fiduciary Liability coverage remains fairly stable.

Workers Compensation – The Workers Compensation market is a mess. Nationally, the combined ratio in both 2010 and 2011 was 115%. California is far worse (see side story on California Workers Compensation). This has created a renewed emphasis on both underwriting requirements and pricing. On average you can expect about 5-20% base rate increases in 2013. Employers are also being impacted by a major change in how experience modifications are calculated. The primary/excess threshold is being increased from $5,000 to $10,000 effective January 1st 2013. The experience modification formula has always penalized frequency and discounted severity, and this change exacerbates that. 100% of all dollars up to $10,000 will now goin to the formula (California raised their threshold from $2,000 to $7,000 last year). This will adversely affect employers with high frequency of employee injuries.

Surety – For the past several years, surety underwriters have been waiting for results to deteriorate and that is now starting to happen, especially in Southern California. Public works projects, in particular, have been

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[illegible] about getting paid on current projects. Despite this glum outlook, 2012 should still be slightly profitable for the surety industry. Regardless, underwriters are being more cautious and paying closer scrutiny to financial statements with special emphasis on cash flow, work in progress, realization of estimated profits and overhead. While there is some modest competition on preferred accounts, it is anticipated that surety credit will continue to tighten in 2013 as losses continue.

Health Insurace – Medical insurance costs in 2012 trended between 7-10%, and most companies received a high single digit increase on their health insurance plans. This was good news for all, but how long will it continue?

The Patient Protection and Affordable Care Act, (PPACA) also known as "Healthcare Reform" or "Obama Care," is ending its third year as law. On June 28, 2012, the United States Supreme Court upheld the constitutionality of most of PPACA in the case *National Federation of Independent Business v. Sebelius*.

The Supreme Court, in an opinion written by Chief Justice Roberts, upheld the individual mandate to buy health insurance as a constitutional exercise of Congress's taxing power. A majority of the justices, including Chief Justice Roberts, agreed that the individual mandate was not a proper use of Congress's Commerce Clause or Necessary and Proper Clause powers, but they did not join in a single opinion. A majority of the justices also agreed that another challenged provision of the Act, a significant expansion of Medicaid, was not a valid exercise of Congress's spending power, as it would coerce states to either accept the expansion or risk losing existing Medicaid funding.

2013 may be a very interesting year for medical insurance rates. The presidential election will be a major determining factor on the future of PPACA and will have an impact on medical insurance rates. 2013 is not a big year on the PPACA implementation calendar, but insurance carriers are frantically preparing for 2014. Mandates, health insurance exchanges, CLASS Act provision, essential benefit requirements and an excise tax on health insurers all are expected to add to the cost of insurance. We will be sending out a post election newsletter with information and updates on the future of PPACA and projected 2013 rate increases.

Employers who are taking a proactive role in implementing and supporting workplace wellness are seeing positive effects which include lower healthcare costs and increased productivity. Wellness plans with a focus on providing employees with information and tools to improve their health (and that of their families) have resulted in higher productivity, improved employee engagement and a reduction in absenteeism and presenteeism. This results in lower healthcare costs and drives dollars to the bottom line. Employers who focus on providing employees with detailed information concerning how to use their benefits have realized higher employee satisfaction and a reduction in administrative burden.

Other employee benefits: dental, group term life insurance, long term disability and vision insurance rank very high in importance to employees considering offers of employment and contributes significantly to the over-all satisfaction in benefits of current employees.

Best Practices

There is no substitute for effective Risk Management strategies. It is critical that you identify your exposures to loss (what can go wrong) and implement procedures to reduce the frequency and severity of those losses. Only then should you approach the insurance marketplace. A timely, well-articulated underwriting submission is crucial to obtaining favorable terms. Insurance premiums will rise and fall depending on the insurance cycle and there is nothing you can do about that. What you can do however is proactively manage the claims that drive your insurance costs.

California Workers Compensation

If Workers Compensation results nationally are poor, results in California are horrific! The industry was thriving from 2003 to 2007 (Table 3), with five straight years of underwriting profits. Arguably, 2004 and 2005 may have

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prices dropped, loss ratios increased and the combined ratios in California for the last 3 years have been 136% or higher!

The market is starting to react, but it is reacting slowly. In the last 3 years, rates have increased about 16%, but they need to go a lot higher. In the meantime, the Workers Compensation Insurance Rating Bureau (WCIRB) is throwing out a confusing message. Initially, they were recommending a 12.6% rate increase to be effective January 1, 2013. Then after the Senate passed a reform bill (SB 863), they indicated that they would not be recommending an increase at all – this despite the fact that it appears the reform bill may only shave expenses 1-2%.

The Bureau’s recommendation really doesn’t matter, however, since California is an open-rating state and each insurance company can charge what they want. Filings are public and every filing posted so far is an increase over the existing rate. While the average increase is probably 10-20%, we are seeing some north of 40%. This isn’t surprising since based solely on the combined ratios posted the last 3 years the industry needs about 45 points to get where they need.

To complicate things, the Bureau also changed the experience modification formula to further penalize claims frequency. While the Bureau claims the effect is employer-neutral across the state, we are seeing significantly more increases than decreases in experience modifications. It is recommended that you start early on your renewal.

Make sure you estimate your experience modification as soon as your losses are filed with the Bureau and open discussions with your underwriter 3-4 months out to determine what has happened to your base rates. Workers Compensation more than any other line should probably be marketed this year.

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.

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