Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 10/2003 – "Insurance Outlook 2004 (including California Workers Compensation)" October, 2003

Insurance Outlook 2004 What to Expect

By Jeffrey W. Cavignac, CPCU, RPLU

The good news is that 2002 was a dramatic improvement over 2001, which was the worst year in the United States insurance industry's recorded history (a negative $7 billion in net income). The industry returned to profitability in 2002, with a net income of $2.9 billion, although this still generated an anemic rate of return on equity (about 2.2%, up from –1.2% the prior year).

The main concern with the 2002 financial year's performance was the fact that surplus still dropped $4.4 billion, and insurance is predominantly a surplus-driven business.

Basically, insurance is a classic example of "supply and demand." Supply, which is generally variable, drives demand, which is usually constant. If supply goes down, rates go up, and vice versa. For the past several years, supply has gone down dramatically. This has been a function of several factors, including:

- Underwriting losses
- Weak financial returns
- September 11th (really a subsidiary of underwriting losses)

In order to attract new investors and thus increase supply, the industry has to perform at a level that attracts those investors. This requires a minimum return on equity of about 10%. In order to generate this level of return, the industry will have to continue to increase its premium base and control its losses.

This is apparently happening. A.M. Best reports that net written premiums in the first six months of 2003 increased approximately 12.6% over the comparable period in 2002. The combined ratio during that time improved from 103.7% to 99.3%. This is the first time in years that the industry has reported a combined ratio (losses plus expenses divided by premiums) below 100% at mid-year.

Remember, however, that the industry needs to provide approximately 10% return on equity to attract investors. In order to do this, given the present weak financial markets, the industry's combined ratio will have to improve even more, possibly to as low as the mid-90's.

What Can You Expect in 2004?

Let's look at this topic on a line by line basis.

Insurance 2004 *(continued on page 2)*

In this issue . . .

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Insurance 2004 *(continued from page 1)*

Commercial Property, Liability and Automobile

It appears as though the standard commercial property, liability and automobile marketplace may have stabilized. The premium increases achieved over the past several years have brought the market back to where it needs to be in order to underwrite business profitably. Of course, this varies by account, and will be affected by your loss history and other unique characteristics of your company.

Our conservative advice is to project a 5% to 10% rate increase over 2003.

Contractors General Liability

The general liability marketplace for contractors in Southern California, especially those doing residential work, remains in turmoil. There is really no telling where rates will go in 2004, since no one really knows who will be writing these accounts.

In general, residential contractors this year received increases of anywhere from 50% to 500%. (some couldn't get coverage at all). Preferred commercial contractors, in general, received rate increases of 25% to 50%.

At this point in time, it is critical that contractors be working with their insurance agents to attempt to project costs for next year. Much of the work that is now being bid will flow into next year, and it is essential that these increased costs be worked into over–head.

Unfortunately, due to the disparate nature of the construction operations, no one can predict what an "average" rate increase might be. In the case of a preferred commercial contractor, it could conceivably be flat, but in many cases rates will continue to go up.

Coverage continues to be curtailed as well. The number of additional exclusions (in addition to those in the basic policy) can easily number ten to twenty. Certain additional insured endorsements are becoming hard to get, and many underwriters are trying to totally exclude prior work. Because of this, it is critical that you carefully review your proposed coverage.

Residential Wrap-Ups (Owner Controlled Insurance Programs)

This marketplace remains extremely challenging. Several of the major players have entered and exited the market, and policy terms and conditions are extremely weak. Typical exclusions include subsidence, mold, asbestos, and property during construction.

Deductibles are going up, and defense costs are usually included within the coverage limit. Premiums tend to be out of sight. It is not uncommon to see minimum premiums in the $400,000 range for $1 million of coverage.

Professional Liability

Professional liability insurance for architects, engineers, accountants and attorneys remains in a moderately hard market. Preferred firms in each of the classifications are seeing rate increases on renewal in 2003 of approximately 20% to 25%. There are exceptions. Any firm with adverse loss experience will see dramatically increased pricing, and architects and engineers doing a lot of residential work will experience higher increases as well. We are predicting rate increases of 5-10% for preferred firms in 2004.

Attorneys practicing in the areas of class action, plaintiff work, securities, and real estate are, in some cases, seeing increases of 400% to 500%, if coverage is available at all. We are predicting rate increases of 10-15% for preferred law firms in 2004.

For professional liability in general, most underwriters have tightened up on the embellishments they used to provide freely, such as multi-year policies, aggregate limit deductibles, shared expense and dollar one defense. In addition, many now insist on significantly higher deductibles; 1% of gross income is a common benchmark.

Directors & Officers Liability and Employment Practices Liability

Premiums for both of these areas of coverage continue to rise, and depending on the nature of the risk, in some cases dramatically. For budget purposes, I would assume a 25% rate increase for a preferred accounts in 2004.

Workers Compensation

Due to the magnitude of the changes in the workers compensation market and its impact on our clients, we have created a separate article dealing with this issue. See the following article entitled "California Workers Compensation Market — What's Going On?"

Surety

Surety underwriters, like insurance underwriters, are actually starting to underwrite. They look closely

Insurance 2004 *(continued on page 3)*

Insurance 2004 *(continued from page 2)*

at contractors' operations and financial statements in an effort to avoid any hint of potential trouble. Some are very rigid and will decline anything that falls outside their neatly-drawn guidelines.

Most of the larger underwriters have taken at least one price increase this year, averaging around 15%. Some have imposed a second increase of an additional 15% for a 30% total rate increase.

Most sureties are also trying to eliminate many of the concessions they granted during the recent soft market, such as waivers of personal indemnity. As the full impact of the recession hits, many surety professionals are anticipating that the market will get worse before it improves.

Conclusion

The industry has made some progress, but it still has a long way to go. It is approximately $50 billion shy of the surplus it enjoyed at its peak in 1999 ($339 billion), and it still needs to knock about six or seven points off its combined ratio (and/or achieve higher investment returns) in order to obtain a return on equity acceptable to most investors.

Ultimately, the best way to control your insurance premiums is to control your underlying costs. Your broker should be able to work with you to devise strategies to do that.

For budget purposes, any specific questions should be addressed now. Although there is no iron-clad method to predict the future, solid estimates based on educated assumptions are possible.

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.*

California's Workers Compensation Market

What's Going On?

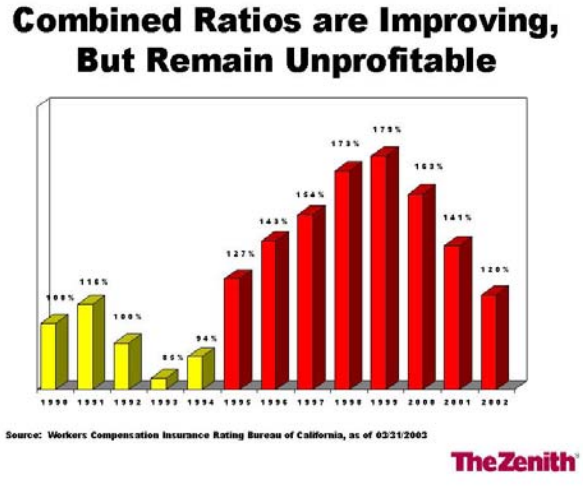
By Jeffrey W. Cavignac, CPCU, RPLU

History

Workers compensation is a mandatory coverage required of all employers. It was established in California in 1914. From then until 1995, minimum rates were established by the Workers Compensation Insurance Rating Bureau (WCIRB). An insurance company could not charge a lower rate than what was specified by the WCIRB.

In the early 1990's, California's workers compensation system was in crisis. Premiums continued to go up dramatically each year. In an attempt to address the problem, the minimum rate law was abolished, and "open" rating was allowed. In other words, insurance companies were free to charge whatever rate they felt was appropriate.

For the next five years, intense competition for increased market share resulted in substantially decreased pricing. Numerous insurance companies entered the California market place. In some cases, rates plunged by as much as 50% or more. Not surprisingly, underwriting results deteriorated rapidly. The combined ratio (loss costs plus insurance company expenses divided by premium) in California increased from 84% in 1993 to over 179% in 1999.

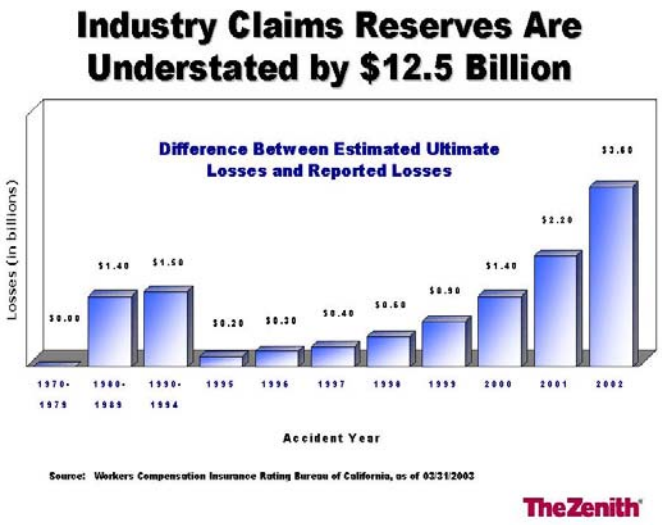


To compound the problem, it became clear that California's workers compensation insurance industry was under-reserved by billions of dollars. This means

California Workers Comp *(continued on page 4)*

California Workers Comp *(continued from page 3)*

that the insurance companies have set reserves that are lower than what they will ultimately pay for claims. It also means that the industry is actually in more trouble than the combined ratios imply. California's WCIRB currently estimates that workers compensation insurers are under-reserved by approximately $12.5 billion.



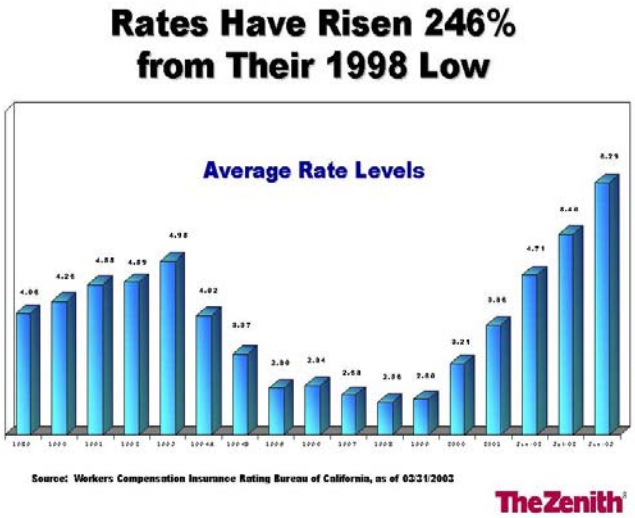
In 2000, rates began to increase, but unfortunately for some companies, it was too little, too late. A number of California specialty insurers either went out of business or simply ceased underwriting in California, and many large national insurance companies decided to leave the California market as well.

Along with the insolvencies and departures came financial downgrades on a number of companies. The State Compensation Insurance Fund of California was not exempt. ***Best's Insurance Rating Guide*** dropped the State Fund from a rating of A- to a B+, and subsequently to a B-. Rather than be considered a B- carrier, the State Fund elected to withdraw its Best's rating so that, in actuality, the State Fund is now rated NR-4 (not rated by company request).

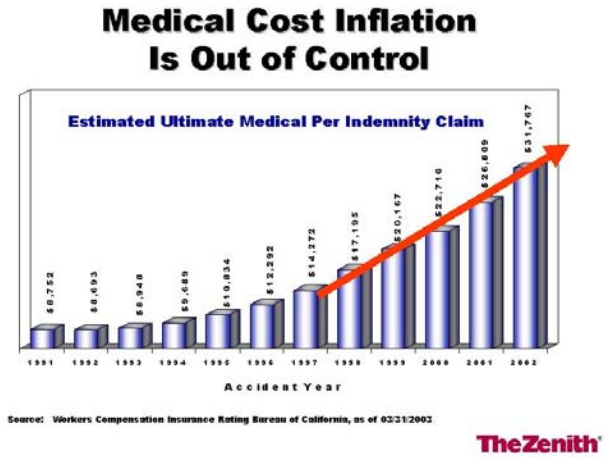
During the past several years, there have been only a handful of private market insurance companies willing to compete with the State Fund. In that time frame, the State Fund's market share has increased to nearly 60%. The next largest writer of workers compensation in California only controls 5% of the market.

There is concern that the State Fund has grown too fast, and that its surplus does not support its premium writings. Because of this, California Insurance Commissioner John Garamendi has attempted to take over the State Fund. The State Fund feels that Garamendi is usurping his power as commissioner, and has filed suit to restrain him from assuming command.

As previously mentioned, rates have been increasing .This has caused the combined ratio to decrease. As recently as 1999, the insurance industry was paying $1.79 for every dollar it took in. In 2002, the combined ratio is predicted to be $1.20. However, the industry is still losing 20 cents on every underwriting dollar.



Why are the results still so poor? The main reason is that losses continue to increase. Accident year losses in 2002 are higher than they have ever been. In addition, the average cost of an indemnity claim in 2002 is 123% higher than it was five years earlier.



Furthermore, benefits were increased effective January 1, 2003 by Assembly Bill 749. AB 749 basically provided for maximum benefits paid to employees for work related injuries to be increased incrementally over a 4 year period from the current $409 per week to $840 per week in 2005. This will ultimately cost the industry

California Workers Comp *(continued on page 5)*

California Workers Comp *(continued from page 4)*

$3.5 billion annually, and increase benefit costs by approximately 22%. This was done in an effort to increase California's anemic benefits, which have typically been some of the lowest in the country.

Where Are We Today?

Next to California's recall election, workers compensation is probably the most oft-talked about political topic. You read about it almost daily. Because of this, landmark workers compensation legislation was recently passed. Commissioner Garamendi stated that this legislation was an "outstanding" first step toward bringing lower premiums to California's struggling employers.

Garamendi seems to think that the reforms will save $5 billion to $6 billion of costs annually (about 20% of the total premiums written in the state), but there are others who are not convinced. *"The legislation proposed today will stop the absurd increases that employers have seen in the last year, and produce savings that will continue on an annual basis,"* Garamendi said. *"The individual impact of these changes will vary per employer, but I'm confident that we can bring immediate relief for many."*

Some of the reforms in the proposed legislation include:

- Establishment of an official medical fee schedule for out patient surgical centers, indexing it to 120% of Medicare.
- Mandatory adoption of interim utilization guidelines governing medical treatments.
- Limits on chiropractic and physical therapy treatments to no more than 24 per claim.
- Requires dispensation of generic drugs unless a brand name has been specifically prescribed.
- Repeals existing vocational rehabilitation statute, replacing it with a new supplemental job displacement benefit for injuries on or after January 1, 2004.
- Increases the maximum fine for workers compensation fraud from $50,000 to $150,000.
- Certainly these reforms will help, but more needs to be done.

What Can You Expect from Your 2004 Workers Compensation Renewal?

On July 1, 2003, average rates were once again increased 7.2% for any companies renewing after that date. It was also predicted that rates would have to go up an additional 12% effective January 1, 2004. Note that this was on top of the July increase, which meant a total increase for those firms renewing in January 1, 2004 of approximately 20%.

Because of the workers compensation legislation mentioned above, however, instead of a 12% rate increase, the WCIRB is recommending a 2.9% rate decrease. Firms renewing in the first half of 2004 would, on average, face an increase of approximately 4.3% (the July increase of 7.2% less the projected rate decrease of 2.9%). Firms renewing in the second half of 2004 could actually see rates decrease.

At this point in time, it is really too soon to say, with any certainty, what will happen to average rates in January of 2004. In addition to the base rates themselves, underlying credits can change, and of course any changes in payroll and/or a firm's experience modification factor will affect ultimate premiums.

Assuming that payrolls and experience modification factors remain the same, I project an approximate 5% to 10% increase over January 1, 2003 rates for those firms renewing in the first six months of 2004. If your firm renews in the second six months of 2004, I project a flat to 10% increase.

In addition, I strongly encourage you to have your broker project your experience modification factor as early as possible (generally, the earliest time it makes sense to do this is six months after policy expiration, since that is the valuation date of the claims that affect your subsequent years' experience modification factor).

Workers compensation is more of a finance tool than an insurance product. Ultimately, you will pay your workers compensation costs. As such, the only way to control your premiums is to control the underlying expenses. There are a number of things you can focus on in the areas of audit, experience modification, injury prevention and injury management. This article does not lend itself to going into great depth on any of these strategies, but we would welcome the chance to discuss them with you at your convenience.

Summary

To summarize, you will, in all likelihood, get another bump in your workers compensation premium in 2004, albeit less than it might have been prior to the landmark workers compensation legislation. Hopefully the market will stabilize, but no one is banking on it. The most important thing you can do is to adequately manage your risk. By focusing on educating your employees, continuing to focus on your loss prevention efforts, enhancing your injury management strategies, and aligning yourself with a knowledgeable insurance broker who can captain all of these efforts, you can effectively control your risk and lower your costs.