Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 10/2005 – "Commercial Insurance Outlook for 2006: What Can You Expect?" October, 2005

Commercial Insurance Outlook for 2006:

What Can You Expect?

By Jeffrey W. Cavignac, CPCU, RPLU, CRIS

Background

It is the time of year when many of our clients begin to prepare their 2006 operating budgets. For many businesses, insurance is a major expense item. The purpose of this article is to provide some insight about the current state of the insurance market and how this may affect your renewal pricing in 2006. I'll also outline other coverage or risk management issues that may impact your firm in the coming year.

To understand where the insurance market is today, we need to review where it's been. Historically, the industry has cycled through what are known as "hard" and "soft" markets. A hard market is characterized by reduced industry capacity or surplus, restrictive underwriting terms, and increased pricing. The last hard market peaked between 2002 and 2003.

A soft market is characterized by increased industry capacity or surplus, broader coverage terms and underwriting appetites, and decreased pricing.

The industry cycles are driven by "policyholder surplus." This is basically the sum of all unassigned surplus and capital.

An insurance company's policyholder surplus determines how much business it can write. An increase in surplus usually precedes a soft market, and similarly, a decrease in surplus precedes a hard market.

As you'll see in the following table, industry surplus actually decreased from 2001 to 2002. This was the heart of the last hard market. Surplus rebounded dramatically in 2003, which has been one of the major factors in driving down rates over the past several years.

Insurance Industry – Critical Indicators

Description	2004	2003	2002	2001
Net Written Premium*	$429.0	$409.5	$375.1	$327.8
Combined Ratio	98.1%	100.2%	107.0%	115.6%
Return on Surplus	10.3%	9.3%	3.3%	<1.9%>
Policyholders Surplus*	$416.2	$359.8	$292.5	$295.4

** in billions*

Have Rates Really Come Down?

For the most part, rates have come down, but once again we need to look back in time to understand the present situation. MarketScout.com, an electronic insurance exchange, measures the aver-

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age change in rate for the property and casualty business in the United States. This, of course, is merely an average across the entire country for all lines of coverage, but it is a good barometer of the current market.

Two years ago (July 2003) average rates were increasing 18%. Last July, they were increasing only 5%. This year, on average, rates are decreasing 5%. In other words, the market has turned. The questions are how soft will it get, and how low will prices go.

Industry Outlook for 2006

It is important to point out that all of the experts who have analyzed the insurance industry at the time this article was written have issued caveats to their projections. The qualifier reads something like "barring any abnormal catastrophic activity in 2005, the industry should…." The majority of the prognostications that I've read to date were done prior to the Hurricane Katrina catastrophe.

The impact of what will certainly be the largest insured natural disaster in our country's history remains to be seen. The ultimate economic impact of Katrina has been estimated to be $100 - $125 billion. Insured losses are likely to be in the $25 - $60 billion range. This is significantly higher than the previous record-setting storm, Hurricane Andrew in 1992, which caused nearly $21 billion in insured losses in today's dollars. Nor can we forget 2004. 2004 was one of the worst hurricane seasons ever. Collectively, the four major hurricanes that hit the southeastern United States cost the industry approximately $25 billion.

Despite the magnitude of these losses, the National Association of Insurance Commissioners (NAIC) has said that the industry has sufficient liquidity to withstand claims arising from Hurricane Katrina. Other than the ultimate impact from Katrina, the insurance industry is actually quite healthy.

Net written premium increased 4.8% in 2004. This is down from 9.2% in 2003, and reflects the current rate decreases being seen on most renewals. Policyholder surplus has grown over 40% since 2001, and is currently at an all-time high. The industry's Combined Ratio (loss payments plus expenses divided by premiums) dropped under 100% (to 98.1%) for the first time in decades. In other words, the industry actually earned an underwriting profit in 2004. Finally, return on surplus improved to 10.3%. The higher the return on surplus, the more capital that can be attracted to the industry.

What Does This Mean to You?

Each line of business is different, and each individual account is rated based on various factors. Two companies in the same industry can have dramatically different rates depending on that firm's loss history and business and safety practices.

The "Standard Market"

The standard markets – Property, General Liability, Automobile, and Excess Liability – collectively comprise what the insurance industry calls the "standard market." The standard market is made up of companies such as Chubb, St Paul Travelers, Hartford, Fireman's Fund, Safeco, Golden Eagle and others. All of these companies generally write insurance on an admitted basis.

This market segment has been competitive for over a year now. Underwriters are diligently doing their best to maintain market share and also write

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new accounts. Although we are not seeing dramatic price cutting as we did in the last soft market, it is not uncommon to see rate decreases in the 5-10% range.

Most insurance companies are still maintaining a high degree of underwriting discipline. In other words, they are rewarding those firms with good lost histories as well as solid business and safety practices. It is anticipated that this market will remain competitive at least though 2006 and possibly 2007.

Developers and Contractors General Liability

Developers and contractors general liability is basically split into two different areas, commercial and residential. On a composite basis, commercial contractors have seen rates come down approximately 7% over the last year. Experts anticipate the downward trend in rates to continue over the next 12 months, mainly due to the fact that four or five quality insurance companies are now interested in insuring commercial constructors.

Residential construction is entirely different. Although we are not seeing the sharp increases in rates that we have seen over the previous years, nor are we seeing any rate decreases. Most underwriters are trying to retain their current rates.

At the same time we continue to see coverage restrictions. In addition to exclusions in the standard coverage form, it is not uncommon to see additional exclusions retaining to prior damage (Montrose), multi-family housing, subsidence, mold, silica, EIFS – the list goes on. Carefully evaluate each prospective program to make certain you understand the coverage that is being offered.

In addition, contractual liability and additional insured endorsements continue to be redrafted. The preferred additional insured form (CG2010 11/85) provided coverage to an additional insured for both ongoing and completed operations, and basically extended coverage to the additional insured as long as liability was remotely connected to the work of the named insured. In certain situations, this provided coverage for the additional insured's sole negligence.

Today it is becoming increasingly more difficult to get additional insured status for completed operations. The current endorsements being offered by most companies are restricted to ongoing operations.

Some underwriters are starting to realize that they provide broader coverage under contractual liability provisions than they do under additional insured endorsements. As such, contractual liability is starting to be rewritten to track with additional insured endorsements. In other words, underwriters are starting to delete completed operations under the contractual liability coverage part. It is important to evaluate both the additional insured endorsement and the contractual liability coverage of the subcontractors with whom you are working.

Multi-Family Housing

Almost all general liability policies in the market today for developers and contractors contain multi-family housing exclusions. The only way to insure these projects is with an Owner Controlled Insurance Program (OCIP) policy (also known as a "wrap-up" policy).

Typically these policies cover the developer, general contractor and all subcontractors on a project. On occasion, these policies extend to the project design professionals as well. Recognize that this is a general liability policy. It only covers the design professional for negligent acts, errors and omissions that result in either bodily injury or property damage. It does not cover issues of pure economic damage, such as cost over runs, delays, etc.

In other words, even if you include the design professional on an OCIP policy and there is no professional liability exclusion, this type of policy is not a substitute for professional liability insurance.

Ideally the OCIP provides coverage through completion of construction plus the statue of limitations. In fact, however, most underwriters today provide a 120-month extension (ten years). While this approximates the statue of limitations, it may not be exact.

OCIPs are heavily underwritten and require a commitment to engage insurance company appointed loss control and quality control programs. In order to get a full market response on an OCIP, you should allow at least 30 days from the time you submit a complete application.

We recommend that you obtain an indication of cost early in the planning stages of development.

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The premiums are often so significant that they can have a material impact on the cost of a project, and actually can be a deal breaker, depending on the size of the development.

Although the market for OCIPs has improved over the past year, they are still extremely expensive. Rates on these programs are generally in the 1.5-2% of sales cost range for a $2 million limit, and are subject to minimum premiums that are about half the limit offered. In other words, the minimum premium for a $2 million policy would be approximately $1 million. At a rate of 2%, you would need to generate $50 million dollars in sales to hit the minimum premium.

Recently, a few new underwriters have entered the OCIP field. Some are offering lower minimum premiums on smaller projects. In addition, some underwriters are now allowing selected developers to combine several projects under one policy, which will lower the per unit cost for the insurance.

Professional Liability Insurance

Professional liability rates have leveled off, and on preferred accounts have started to decrease. However, rates are not dropping dramatically. We consider a 5-10% decrease to be favorable.

The marketplace for **architects and engineers professional liability insurance** remains competitive. There are a number of solid companies offering preferred programs, and coverage remains fairly broad. Although we are starting to see mold exclusions appear in some professional liability policy forms, this is not the norm, and you should seek to avoid this exclusion if at all possible.

Most architect and engineers professional liability policies do not include residential exclusions (although some do, so read your policy carefully). Nevertheless, underwriters are not keen on writing firms that specialize in residential construction. Almost all underwriters are willing to take on varying degrees of this risk, but if residential work exceeds a certain percentage (usually 20-25%), many underwriters will not be interested. Because of this, it is imperative that design professionals monitor the amount of residential work they do, especially multi-family housing.

Lawyers professional liability insurance also remains relatively competitive. Although we are not seeing the rate decreases that we're seeing on the design professionals' side, most underwriters are not increasing rates.

Professional liability insurance is underwritten as closely as any other line of coverage. Applications go into great detail about a firm's general business practices as well as areas of practice, and in most cases applications are also warranted to the policy. It is imperative that applications accurately reflect the attributes of the firm. Accurate preparation of professional liability applications is critical to obtaining favorable renewal terms from underwriters. (See the July 2005 issue of our *Professional Liability Update* newsletter at http://www.cavignac.com/pdfs/AEE0705.pdf for more information.)

Employment Practices Liability, Directors and Officers Liability, and Other Lines of Coverage

Once again, increased competition has had a moderating affect on rates in these lines of coverage. Last year at this time we predicted flat rates to up 10%, and this year it's flipped – flat rates to minus 10%.

Note that all these policies are manuscripted. In other words, there are no standard forms, and because of this it is imperative to carefully review the policy form to see exactly what is being offered.

Workers Compensation Insurance

The workers compensation market in California continues to improve, and rates have come down significantly. Several years ago many of our clients had no other option than the State Compensation Insurance Fund. Today most clients have alternatives. A lot of this has to do with lower underlying losses, which has attracted more competition to the industry.

The organization in California responsible for workers compensation is the Workers Compensation Insurance Rating Bureau (WCIRB), also known as the Bureau. The Bureau is a private, unincorporated, not-for-profit insurance industry trade organization. Its primary functions include:

- Publishing, advisory, and pure premium rates

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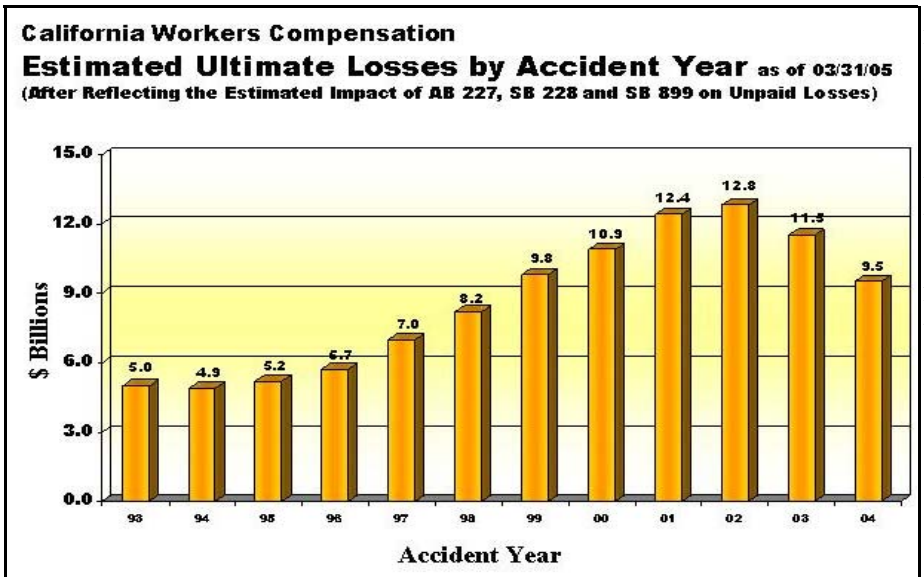

Figure 1

rates will decline significantly in January 2006.

Regardless, the market historically has not followed lockstep with the commissioner's recommendations, and are usually several points above what the commissioner has recommended. If you renew within the first six months of 2006, you should see relatively significant rate decreases. It's possible that this could be in the 15-25% range.

Remember, though, that every insurance company uses its own rates, and every account is subject to the insurance company's experience modification as well as specific debits and credits the underwriter may apply.

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- Calculating and issuing experience modifications

Once the Bureau publishes its recommended rates they must be approved by the insurance commissioner. The commissioner doesn't always agree with the pure premium rates provided by the Bureau and has the option of amending them. Regardless of what the commissioner recommends, the rates are advisory. Insurance companies have the option of choosing whatever rate they would like. In addition to base rates, the company also files for available deviations, which can be applied based on the attributes of each account.

Effective July 1, 2005 the commissioner recommended a rate decrease of approximately 18%. Most insurance companies felt this was too high, and on average rates were decreased 12-14%.

The Bureau subsequently published its rate recommendations for January 2006. It recommended an additional 5.2% rate decrease, but subsequently increased it to 15.9% When you add the proposed January 2006 decrease to the July 2005 decrease, it is likely that base

Why Has the Workers Compensation Industry Improved?

Losses have declined, mainly due to legislation and focus by employers on safety and loss prevention, and results have improved (see Figure 1).

This attracts more insurance companies to the market, which has a downward impact on pricing . As mentioned earlier, rates have continued to decrease since 2004 (see Figure 2).

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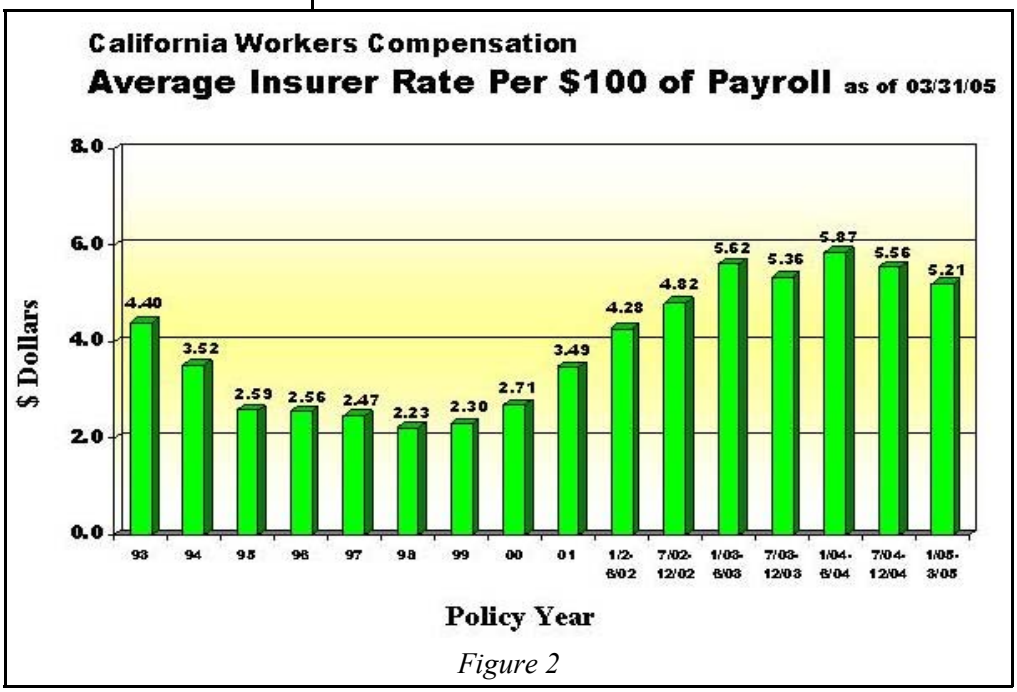


Figure 2

Insurance 2006 *(Continued from page 5)*

The only way to accurately forecast your 2006 workers compensation cost is to sit down with your broker, work though a projected 2006 experience modification, and discuss with your insurance underwriter what rates will be applicable for your specific classifications.

Workers compensation insurance is more of a financing tool than an insurance product. Ultimately, through the use of your experience modification you will end up paying your own claims. Because of this, the only way to control your premium in the long run is to manage your underlying cost. There are numerous strategies you can employ in the areas of audit, experience modification, injury prevention, and injury management to effectively manage your total cost of risk.

Summary

The current insurance market could be called a buyers market. The industry is earning a profit and making a decent return on equity; it has adequate surplus and ample competition exists.

Assuming a firm has a decent lost history and is otherwise acceptable from an underwriter's perspective, it should see flat to modestly decreasing rates on its 2006 renewal premiums (0-10%). In the case of workers compensation, these decreases could be even greater.

Recognize, though, that every account is different. We recommend that you sit down with your insurance broker and walk though each line of coverage to arrive at a reasonable cost estimate for 2006.

Jeff Cavignac is President and a Principal of Cavignac & Associates.

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.*

Our greatest glory is not in never falling, but in rising every time we fall. — Confucius

Neither fire nor wind, birth nor death can erase our good deeds. — Buddha

Our lives begin to end the day we become silent about things that matter. — Martin Luther King, Jr.

Cavignac Staff Reaches Out to Katrina Victims

By *Sue Marberry*

Cavignac & Associates raised over $7,400 for hurricane relief efforts in the Gulf Coast states. Jeff Cavignac announced that employee contributions would be matched first by the agency and then again by the three principals, Scott Bedingfield, Jim Schabarum, and himself.

Within a few hours the employees had already pledged $1,500, and this amount ultimately grew to nearly $2,500 with contributions from every employee. Previous personal donations to the Red Cross were included in the match as well.

Over $6,400 went to the Bush-Clinton Katrina Relief fund (www.bushclintonkatrinafund.org), the umbrella organization chaired by former presidents George H. W. Bush and Bill Clinton to assist in the long-term recovery plan for the states affected by Hurricane Katrina. $1,000 was given to the San Diego Humane Society (www.sdhumane.org), which sent two teams to aid in animal relief efforts in the Gulf Coast.

Cavignac & Associates maintains a charitable donations fund to which employees contribute by payroll deductions to provide holiday meals and gifts to seniors, the homeless, battered women and others each year. This fund is expected to reach $7,500 by the end of this year; the Hurricane Katrina relief collection was an additional effort.

Sue Marberry is the Office Manager of Cavignac & Associates.

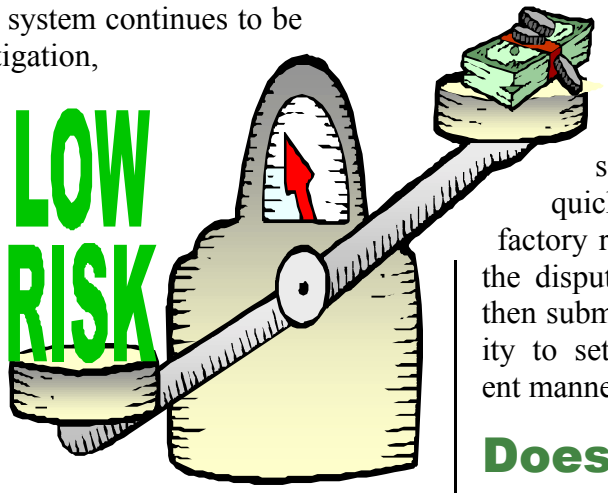
Collectively Bargained Workers Compensation

Lowering Your Cost of Risk

By Chris DeSales and James P. Schabarum II, CPCU, AFSB

Collectively Bargained Workers Compensation (CBWC) insurance programs can significantly reduce the Total Cost of Risk for union employers.

The statutory workers compensation system was once a model no-fault system. Despite recent reform efforts, the system continues to be plagued with litigation, restrictive processes, inadequate medical care, and inflated costs.



In 1993, California passed SB 983. Among other things, this legislation gave unionized construction-employers the ability to use the collective bargaining process to modify the conventional workers compensation system. In 2003, the passage of SB 228 further expanded the use of CBWC to different types of unionized employers.

This legislation amended California Labor Code §3201.5 and §3201.7 to include the specific requirements for the creation of CBWC programs, also known as Alternative Dispute Resolution (ADR) or "carve-out" programs, used for the delivery of workers compensation benefits to union employees.

CBWC programs have three major components:

- Exclusive medical networks agreed upon by labor and management
- Alternative Dispute Resolution process
- Specific, agreed upon time frames for dispute resolution

Under a CBWC program, labor and management agree upon an exclusive medical network from which the injured worker receives medical care. If a dispute arises, the employer and injured employee must utilize an agreed upon Alternative Dispute Resolution process. Instead of utilizing the traditional Workers Compensation Appeals Board (WCAB) and applicant attorneys, disputes are initially routed to an ombudsman who works informally and proactively to address all questions and concerns. The majority of claim issues are resolved at this level quickly and fairly.

Those disputes that cannot be resolved at the ombudsman's level escalate quickly to a mediator who presses for a satisfactory resolution within a specific time frame. If the dispute cannot be successfully mediated, it is then submitted to an arbitrator who has full authority to settle disputes in a judicious and expedient manner.

Does ADR Work?

In practice, the ombudsman resolves most disputes with a small number of disputes going to mediation and fewer still going to arbitration. Since the law became effective in 1995, less than 2% of all claims have gone to arbitration. And while there have been several legal challenges to the validity of the law, to date none of the challenges have been sustained.

As an example, in early 2004 SeaBright Insurance Company performed an analysis of claim results for its CBWC policyholders. SeaBright compared those findings with a sampling of its own non-CBWC policyholders and those from a study conducted by the California Workers Compensation Institute. The SeaBright study showed overwhelmingly positive attributes of the CBWC system as compared to the statutory workers compensation system.

Under the statutory workers compensation system, over 30% of all settled indemnity (lost time) claims involved attorneys and associated legal expenses. In contrast, only 4% of SeaBright's study claims closed under CBWC programs had attorney

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Lowering Cost *(Continued from page 7)*

involvement. Not only was there a significant reduction in the average legal cost of the SeaBright CBWC claims compared to the statutory system, but the average cost of a claim was approximately 35% less.

Participation in CBWC programs is open to employers who are signatory to collective bargaining agreements with labor unions. Each agreement is negotiated on an individual basis. The programs that are currently available are all in the building trades, but it is anticipated that new programs outside of the construction industry will be established in the next year due to the passage of SB 228. Existing programs for the building trades include:

- NECA/IBEW Workers Compensation Trust (Electrical Contractors)
- Operating Engineers Workers Compensation Trust (Heavy Equipment)
- SMACNA (Sheet Metal and Air Conditioning Contractors)
- Masonry and Cement Workers Trust
- Carpenters and Contractors Workers Compensation Trust
- Laborers Workers Compensation Trust
- Plumbers and Pipefitters Trust
- Bridge, Structural, Ornamental and Reinforcing Ironworkers
- Painting and Decorating Contractors Association

If you would like more information about Collectively Bargained Workers Compensation, please contact Cavignac & Associates.

Chris DeSales is the National Director of Product Development for SeaBright Insurance Company. Jim Schabarum, Executive Vice President and Principal of Cavignac & Associates, heads the Agency's Construction and Surety Department.

Spotting Workers Compensation Fraud:

Red Flags You Should Know

By Stuart Nakutin, PHR, AIC, WCCP, CPDM

Workers compensation is one of the most expensive coverages a business owner must carry for his or her company. Workers compensation also has one of the highest incidences of fraud. Unfortunately, these two are closely related.

Many insurance companies have special units dedicated to catching and dealing with workers compensation fraud, but they can only do so much. As an employer, there are things you can do to help reduce fraud in your company and to recognize potential fraud when it occurs.

There are basically three types of workers compensation fraud:

1. Employee Fraud
2. Doctor / Lawyer Fraud
3. Employer Fraud

Since this article is dedicated to helping employers become better risk managers, I will not discuss the third source. Also, an employer is not generally in a position to identify doctor or attorney fraud. Insurance companies are good at this – and getting better.

The business owner can do the most to eliminate or recognize the first and most common type of fraud: bogus injuries.

The Red Flags

Here are some red flags you can look for that often indicate a fraudulent workers compensation claim:

- The employee is never accessible, even by telephone
- The incident was not witnessed by other employees, managers or was only witnessed by friends

Red Flags *(Continued on page 9)*

Red Flags *(Continued from page 8)*

- The incident occurred just prior to a layoff or termination
- The employee was on some kind of disciplinary action
- The accident was not reported timely
- The details of the accident are vague or contradictory
- There are no visible injuries – all injuries are subjective
- The injured employee is new

Of course, the presence of only one of these red flags may mean nothing. If any two or more are present, however, you should promptly notify your workers compensation carrier of your suspicions. Most insurance companies have a fraud hotline for this specific purpose.

Helping Prevent Workers Compensation Fraud

There are also actions that you, as an employer, can take to help prevent fraud before it occurs.

1. Always check employee references carefully. Was the employee "accident prone" on his prior job?
2. Train your staff on how to properly report workers compensation injuries.
3. Post your insurance company's fraud hotline number prominently.
4. Take workplace safety seriously and communicate that to your employees.
5. Make workers compensation training a part of your overall training. Make sure your employees understand the issues – you can't be everywhere at once.

Workers compensation coverage is a growing expense for all businesses. A major reason for the expense is the high degree of fraud. If we all do our part to help reduce fraud, we can all help keep our costs in line.

Stuart Nakutin, PHR, AIC, WCCP, CPDM, is the Director of Safety, Claims and Human Resources for Cavignac & Associates.

Health Tips

from Our Employee Benefits Department

If the average American would burn at least 150 calories per day, we would see a significant reduction in the occurrence of heart disease, high blood pressure, diabetes, colon cancer, anxiety, and depression.

Eating well and exercising can help you feel better, think more clearly, and live a longer, healthier life. Living a healthy lifestyle will also aid in preventing life-threatening and costly diseases. And, exercise can even be fun!

Remember, you're never too old or too young to become physically and nutritionally fit.

Below are a few examples of how easy it can be to burn 150 calories:

Volleyball	45 minutes
Gardening	30-45 minutes
Walking	35 minutes
Basketball	30 minutes
Bicycling 5 miles	30 minutes
Stair climbing	15 minutes

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