Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 10/2006 – "Commercial & Workers Compensation Insurance Outlooks for 2007" October, 2006

State of the Insurance Market Report:

Commercial Insurance Outlook for 2007

By Jeffrey W. Cavignac, CPCU, RPLU, CRIS

Many of our clients begin their annual budgeting process in the fourth quarter of the year. We're frequently asked *"In regard to premium costs, what can we expect in 2007?"*

Although every client is different, and every estimate balances the individual characteristics of each client, some generalizations can be made that should help you understand what you can expect in 2007.

It's important to know a little bit about the economics of the insurance industry. If you've read newsletters from previous years, some of this may be redundant, but it's helpful to review here. I'll be referring to the chart on page two to give you an idea of where the insurance industry is in the underwriting cycle.

Insurance companies make money in one of two ways:

- Underwriting profits
- Investment returns

An underwriting profit is achieved when losses plus all expenses are less than premiums. When you divide the former by the latter, you come up with what is called the "combined ratio." A combined ratio of less than 100% means there is an underwriting profit, and a combined ratio of more than 100% means there is an underwriting loss. In the last five years, there has only been an underwriting profit once.

Insurance companies collect premiums and set aside reserves to pay future claims. This money, along with what is also known as "surplus" (money the insurance company must set aside in order to write a certain amount of premium) generates investment returns. During periods of substantial investment returns, insurance companies are willing to underwrite to a loss because they make it up on the investment side. You'll note that investment returns have increased by over 30% in the last five years.

Another important factor in the economics of an insurance company is surplus. As mentioned earlier,

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surplus is basically equivalent to the amount of money set aside to pay future claims as well as any additional capital held by the insurance company. Specific ratios determine how much premium can be safely written given a certain amount of surplus. If the ratio of premium to surplus gets too high, the insurance company's credit rating (as quantified by the A. M. Best Company and other rating agencies) could ultimately impair the insurance company's ability to operate.

It is important to understand that the insurance industry is "supply driven." I studied economics in college, and if I remember anything, it's this: If supply goes up, and demand stays the same, price should come down. The insurance industry is no exception. The industry's surplus has increased by over 50% in the last five years, which has had a positive impact on pricing (downward).

Lastly, I should point out that the insurance industry competes with every other industry for capital. In order to attract investment dollars, the insurance industry has to demonstrate an acceptable return on equity. Most investors seek approximately 15%. Historically, the insurance industry has underperformed this objective. As recently as 2001, the industry lost money. However, it has rebounded, and in the last two years has returned slightly over 10%. Nevertheless, it is still not at the level that many investors prefer.

What Does All This Mean?

The good news is that despite the massive hurricanes in 2005, the industry is healthy. The combined ratios are reasonable; surplus has increased significantly, and net income (which is related to return on surplus) has rebounded nicely since 2001 (the only year on record that the industry lost money).

To reiterate, insurance is a supply-driven industry. Because surplus has increased, pricing in general has come down.

Have Rates Really Come Down?

In general rates have decreased – in some cases, quite significantly. MarketScout.com is an electronic insurance exchange that measures the average

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Investment Gains Help Returns

U.S. Property/Casualty Insurance Industry Year-end Statutory Results ($Billions)

Description	2005	2004	2003	2002	2001
Net Written Premium	$431.3	$427.4	$409.3	$375.0	$327.8
Combined Ratio	101.4%	98.5%	100.2%	107.0%	115.6%
Investment Income	$50.8	$40.4	$39.8	$39.8	$38.7
Net Income	$46.3	$38.4	$30.4	$9.7	<$5.8>
Return on Surplus	10.9%	10.1%	9.3%	3.3%	<-1.9%>
Policyholders Surplus	$443.9	$403.9	$359.5	$292.3	$295.3

Source: Highline Data LLC

change in rates for the property and casualty business in the United States. Although this is merely an average across the entire country for all lines of coverage, it is still a good barometer of the current market.

In July of 2003, rates were increasing dramatically – on average by 18%. In 2004, the average increase had subsided to 5%. In 2005, rates were actually decreasing by an average of 5%. Through July of 2006, the average percent of decrease has increased to 7%. The question now is whether or not rates will continue to go down, or if the market will stabilize.

Industry Outlook for 2007

In my opinion, barring any unforeseen catastrophic losses, 2007 will be a good year for the insurance buyer. Part of this is based on the critical indicators discussed in this article, and some of it is subjective. As an insurance broker, we can tell how interested companies are in writing business by how often they call on us. All of our major markets want more business at this time.

What will happen to your premiums in 2007? A number of factors will impact this; however, we can make some educated guesses as to where the market will go.

The "Standard" Insurance Market

The standard market is generally comprised of coverages such as property, general liability, automobile and excess liability written for preferred-type accounts. The standard market is made up of companies such as Chubb, Travelers, Hartford, Fireman's Fund, Safeco, Golden Eagle, and others who operate on an admitted basis in the State of California.

The standard market remains competitive. In 2007, you can probably expect similar pricing to what you now pay, and in some cases, decreases of 5% and possibly 10%. It is important to note that general liability and automobile lines are considered more favorable at this point as opposed to property. Property was dramatically impacted by the catastrophic losses of 2005, and property underwriters are still paying the price. If you have a large property schedule, especially if it is in a geographical area subject to wind-driven losses, you should get early estimates and quotations on your property insurance program.

It is also interesting to note that although most of the catastrophes in 2005 were wind-driven losses, this has leaked over onto the earthquake side and thus significantly increased the pricing of earthquake coverage as well. (Many of the insurance companies that provide coverage for wind-driven losses also provide coverage for earthquake losses).

Developers and Contractors General Liability Market

The construction field can be basically split into residential construction and everything else. Residential construction remains a challenge for the insurance industry. A handful of companies are willing to provide coverage, but often under very restrictive terms. Multi-family housing will almost always be excluded, and in addition to the exclusions in the standard general liability form, numerous other exclusions are added. It is common to see exclusions for prior work or damage, subsidence, mold, silica, EIFS –the list goes on. It is important to carefully evaluate each prospective program you are considering to make certain you understand the coverage that is being offered.

It is also extremely difficult to obtain the broad Additional Insured Endorsement that many clients require – usually the CG 2010 (11/85) form. Before you agree to provide a specific additional insured form, you should make certain that your insurance company will offer it. Many will not.

Some underwriters realized that they provide broader coverage under contractual liability than they do under their additional insured endorsements. Contractual liability is beginning to be endorsed to track with the coverage provided by the additional insured endorsements. It is critical that you understand the contractual liability coverage provided under your policy.

In the "all other" class, contractors are doing pretty well. Like the rest of the market, we are seeing "flat" premiums and, on some preferred accounts, rate decreases up to 10%.

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Owner-Controlled Insurance Programs (OCIP) aka "Wrap-Ups"

Every general liability policy I've reviewed in the last three years written for a contractor doing residential work has had a residential exclusion of some type. Some of them exclude only condos, but others go much further, extending to apartments, single-family homes, and just about any other building in which someone may lay their head down for the night.

Because contractors don't have coverage under their "practice" policies, most multi-family housing projects are being built under what are known as Owner-Controlled Insurance Programs (OCIPs) or "wrap-ups." Typically these policies cover the developer, the general contractor and all the subcontractors on a project. On occasion, they can be extended to protect design professionals as well. Recognize, however, 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. Such a policy does not cover pure economic damages, such as cost overruns, delays, etc. In other words, an OCIP is not a substitute for the design professional's practice policy.

Ideally, the OCIP provides coverage through completion of construction plus the statute of limitations. OCIPs are heavily underwritten, and require a commitment to engage insurance company appointed loss control and quality control programs. OCIPs are also extremely expensive. The premiums can be so significant that they can have a material impact on the cost of a project, and can actually be a "deal breaker," depending on the size of the development.

The market for OCIPs, like the rest of the insurance market, has improved over the last year, but it still remains relatively tight. Rates for these programs generally approximate 1.5% to 2% of sales for a $2 million limit, and they are subject to substantial minimum premiums. Most underwriters want a premium equal to half of the limit offered. In other words, the minimum premium for a $2 million policy is approximately $1 million. Note as well that defense costs are included within this limit of liability.

There are several new underwriters in the field claiming to have lower minimum premiums, but so far reasonable terms have been scarce. In addition, one carrier, Quanta, which was writing an OCIP policy wedded to a homebuyer's warranty, has gone from an A- rating to "not rated," and appears as though it may go out of business. This will leave buyers of Quanta policies uncovered – which underscores the importance of placing coverage with financially capable carriers (in its heyday Quanta was only rated A- VII).

Professional Liability Insurance Market

Professional liability rates have leveled off. Whether you are an architect, engineer, accountant or attorney, assuming your firm is a preferred risk, you should see flat pricing and possibly a decrease.

As far as architects and engineers are concerned, residential projects remain the biggest challenge. A majority of underwriters are unwilling to entertain risks that do over a certain percentage of condominium work – most draw the line at 20% to 25%. Geotechnical engineers are also facing tough market conditions. The nature of their services is such that whenever the land moves, they seem to be involved in litigation.

Surety Market

The surety market operates independently of the insurance marketplace. The state of the surety market and how it will impact our surety clients will be addressed in our November Construction Update Newsletter.

Workers Compensation Market

The workers compensation marketplace, specifically in California, seems to march to its own drum. We have addressed workers compensation in a subsequent article included in this newsletter.

Summary

The insurance market remains what the industry calls "soft." The industry is now in relatively solid

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financial condition, it's earning a fair profit, and prices on average are coming down. Recognize that this will change. Historically, the industry has cycled back and forth between "hard" (high premiums/ limited supply) and soft (lower pricing/increased supply) market cycles. It will not always be soft (those of you who have been buying insurance for ten years or more certainly understand this).

In addition, every account is different. Your risk profile and loss history will significantly affect what you pay next year. We recommend that you sit down with your insurance broker and go through your program line by line in order to arrive at a reasonable cost estimate.

Insurance is only one component of what you pay for risk. As a matter of fact, it's been estimated that insurance premiums can be less than half of your total cost of risk.

In the long run, the only way to lower the cost of risk is to lower the losses that drive the cost. To do this, it is imperative that you develop a formal Loss Control and Risk Management Program. It is also critical that you develop effective Post-Accident Response Training in order to deal with claims that do happen. You should align yourself with the right insurance company (not necessarily the cheapest) who can help you effectively manage and control your losses.

Finally, you should make certain your insurance broker is able to quarterback your efforts and help you drive down your cost of risk in order to drive up your bottom line.

Jeff Cavignac is President and 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.*

"Near Miss"

An Accident That Almost Happened

By Stuart Nakutin, CSM, ASP, AIC, WCCP, CDMC

Webster defines a "near miss" as *"a result that is nearly, but not quite, successful."* What does this mean to industry? A serious accident ***almost*** occurred. Someone trips over a pallet, but doesn't fall. Two forklifts almost collide at a corner. A tool is dropped, but toes are missed… ***this*** time.

For every 300 near misses there is one serious injury. According to the Bureau of Labor Statistics (BLS), 6.1 million injuries occurred in 1995. If we multiply each injury by 300, the result is 1.8 *billion* near misses for 1995 alone.

If you reduce the number of near misses, you will then reduce the number of injuries that happen. The same things that cause accidents cause near misses:

- **Unsafe Acts** — Improper lifting; walking under overhead loads; cutting, grinding, or chipping without safety glasses, etc.
- **Unsafe Conditions** — Poorly maintained equipment, oily or greasy floors, trash/boxes left in hallways, etc.
- **Hurrying and Taking Risks** to get a project done faster, or to wrap up a job at quitting time.
- **Near Misses Are Warnings!** Report them ***before*** they become accidents.

Unreported near misses leave opportunities available for serious accidents to occur. Correcting these actions or conditions will enhance safety within your facility. Don't allow your employees or yourself to become statistics – require that every near miss be reported ***immediately***.

State of the Insurance Market Report:

Workers Compensation Outlook for 2007

By Jeffrey W. Cavignac, CPCU, RPLU, CRIS

The good news is that workers compensation rates have decreased dramatically. Rates peaked in July 2003, averaging $6.47 per $100 of payroll (see Figure 1). Through the first quarter of 2006, rates were down to an average of $3.75 (a 42% decrease in less than three years).

Why Have Rates Come Down?

In order to understand why rates have decreased, you need to understand a little bit about the workers compensation industry, specifically as it pertains to California (insurance is state regulated and differs in every state).

The Workers Compensation Insurance Rating Bureau ("Bureau") is a private, unincorporated, not-for-profit insurance industry trade organization. Its primary functions include:

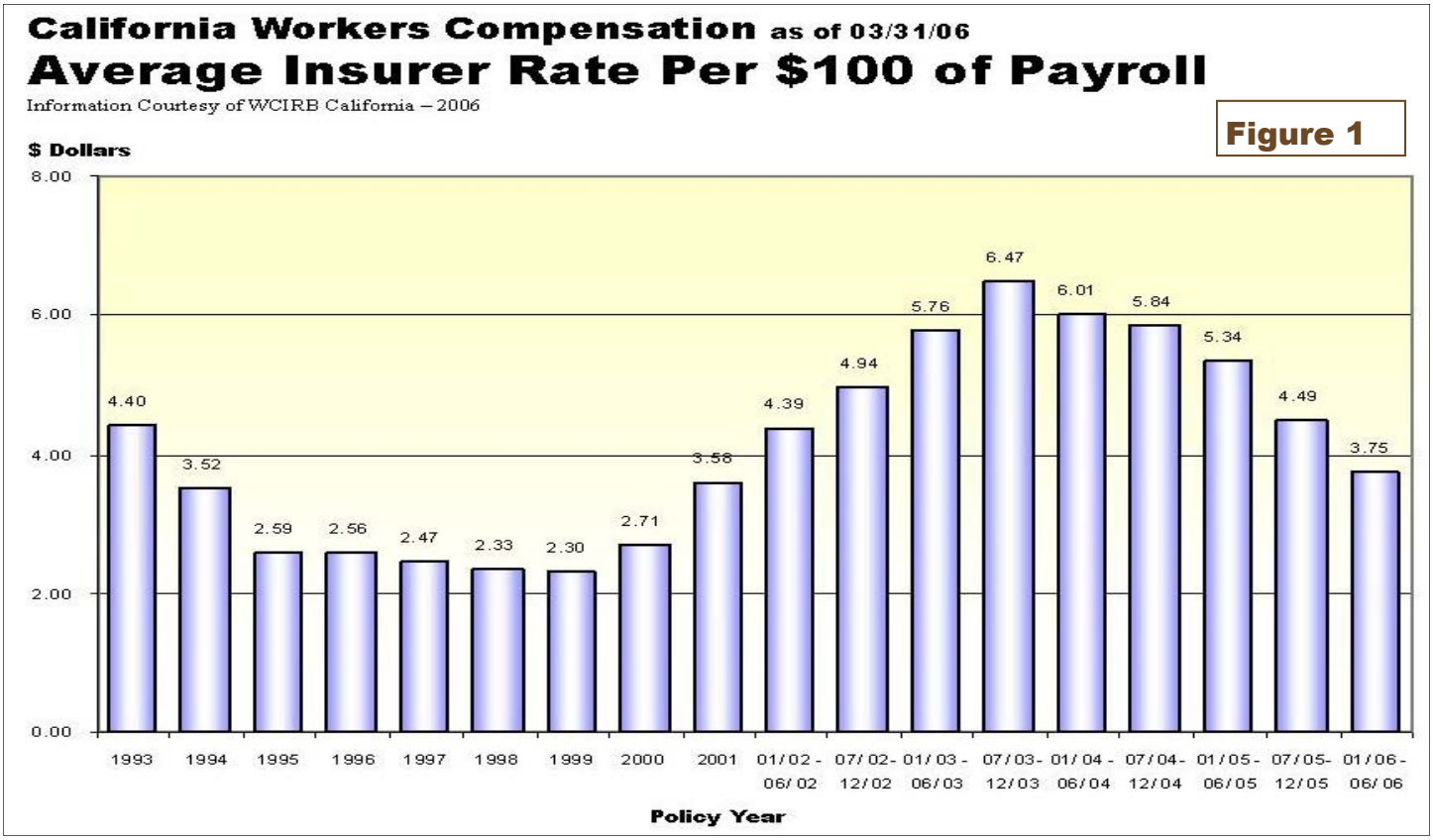
- Publishing advisory and pure premium rates
- Calculating and issuing experience modification factors
- Enforcing California's classification procedures

Every six months the Bureau publishes and recommends loss costs for each classification. Loss costs do not include an insurance company's overhead. The Insurance Commissioner has an opportunity to review these "pure premium" rates and come up with his own rate recommendation. Regardless of what the Bureau or the commissioner decide, these rates are advisory. Insurance companies have the option of choosing whatever rate they want.

It wasn't that long ago that the California workers compensation industry appeared to be on the verge of collapse. Combined ratios (losses + expenses ÷ premiums) peaked in 1999 at 187% (for every dollar written, $1.87 was paid — see Figure 2). In 2002, the combined ratio was still at $1.15.

Significant legislation was passed to curb underlying losses. These changes have been effective, and in 2003, the industry saw a combined

WC Outlook 2007 *(continued on page 7)*



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ratio under 100% for the first time since 1994. Loss ratios dropped further in 2004 and 2005, with both years predicted to be profitable from an underwriting standpoint. This increased profitability, coupled with insurance companies' run-up in surplus, has created a competitive market for workers compensation in California.

The current marketplace, which can be considered a buyer's market, will not last forever. If you look at Figure 3, you'll see that written premium decreased from 2004 to 2005. Although losses have stabilized,

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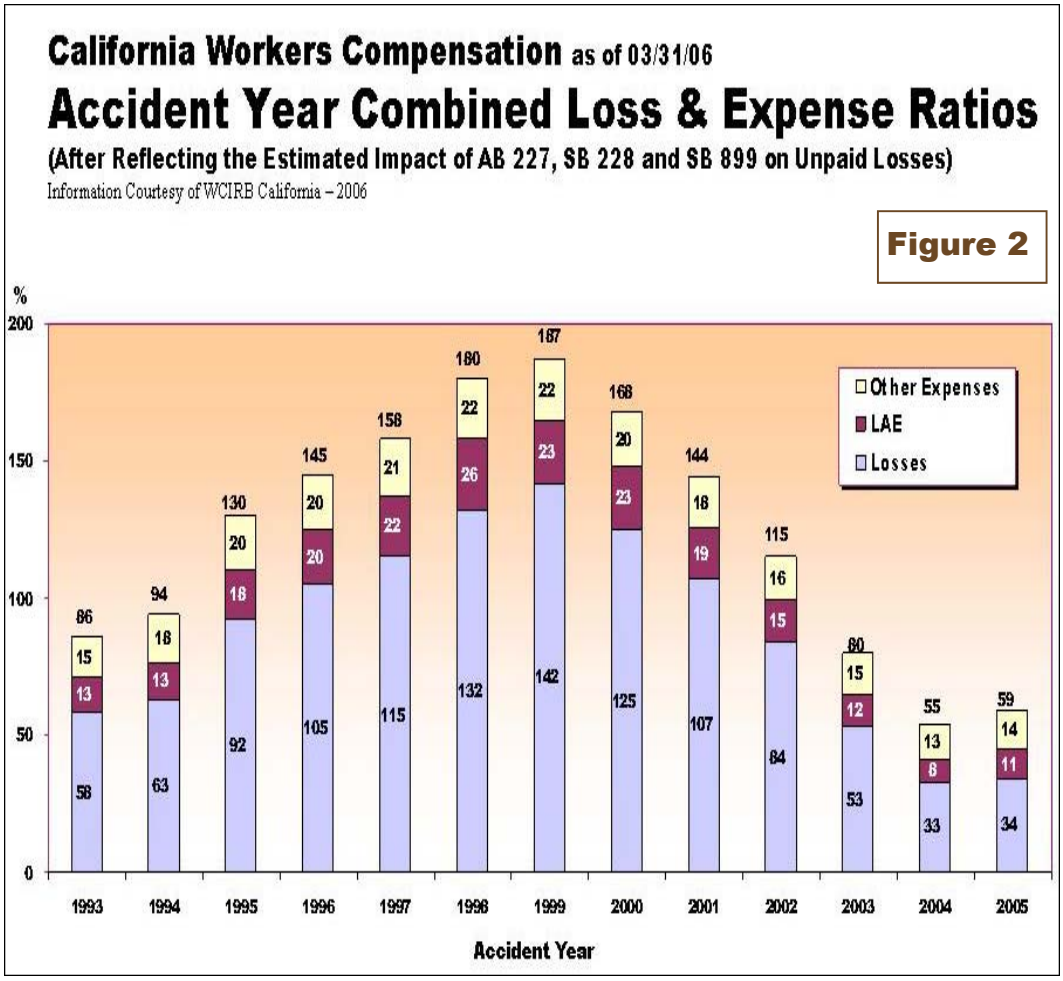

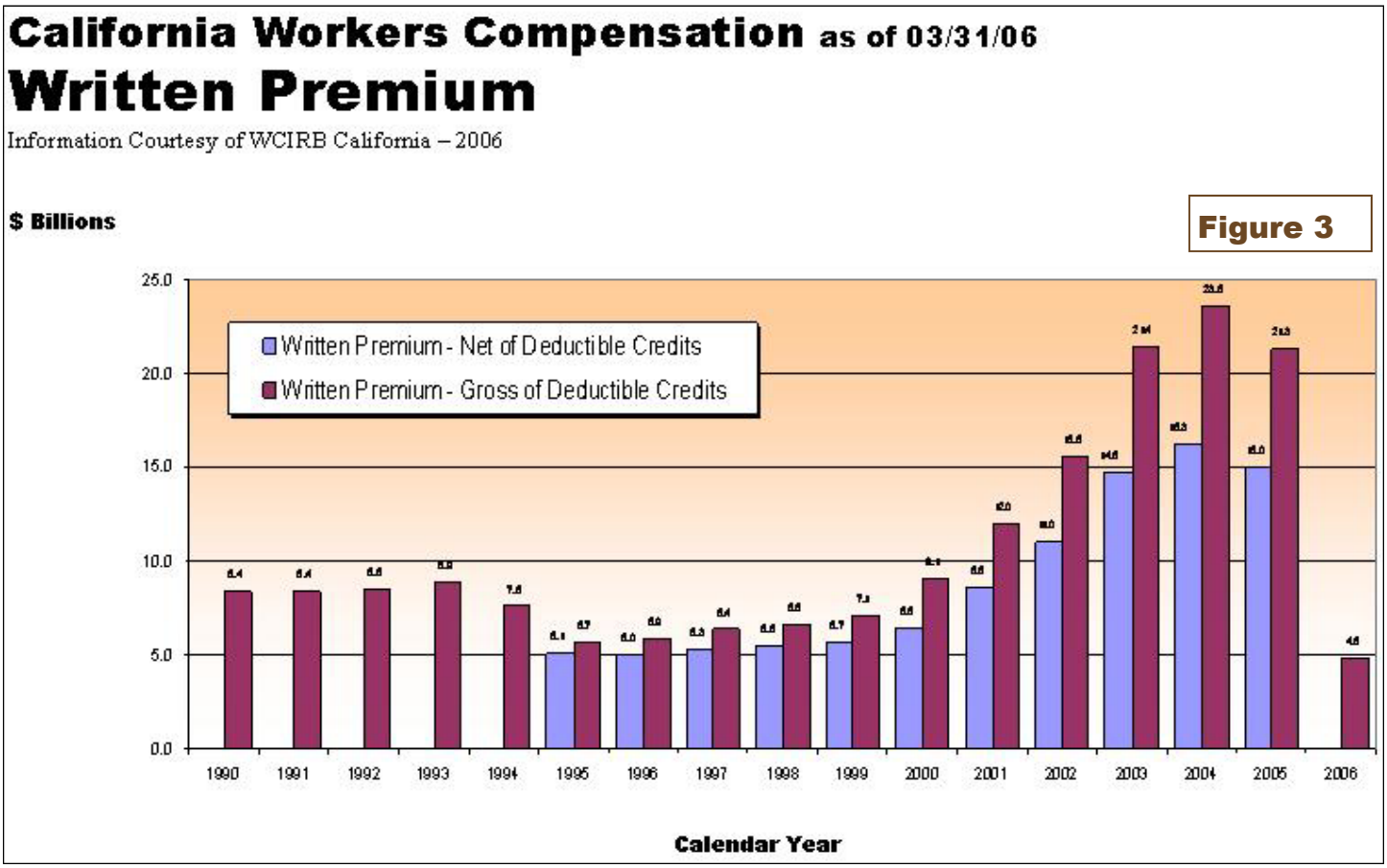

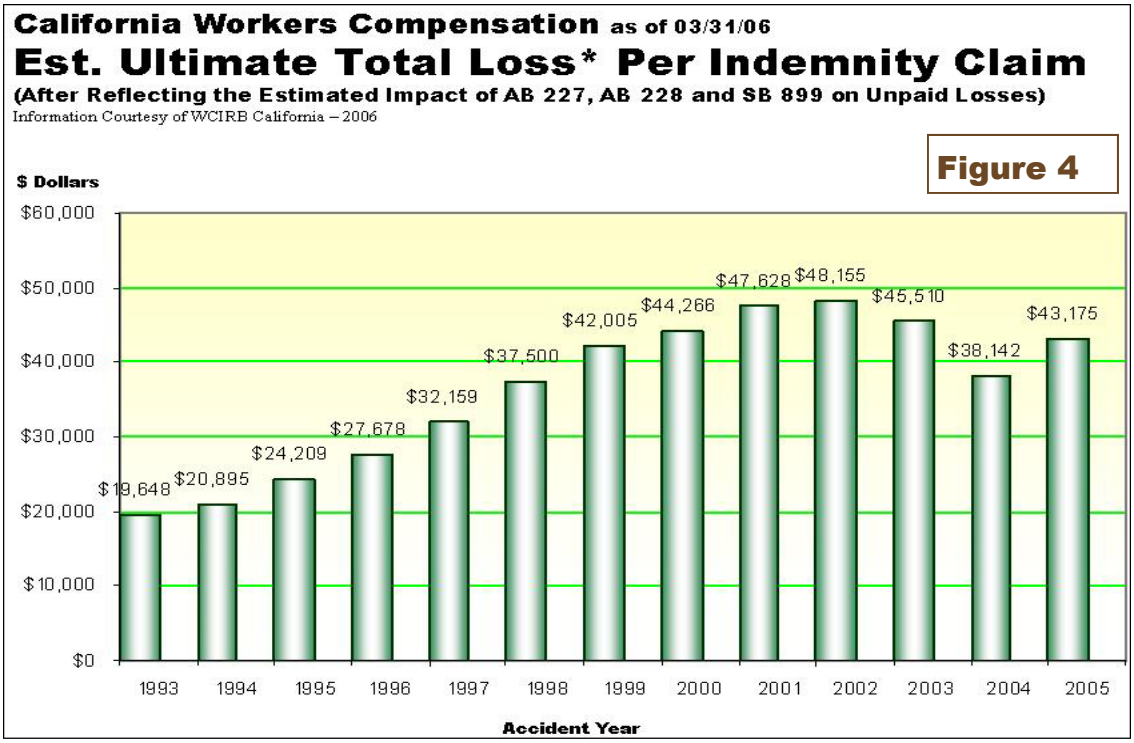

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additional legislation is pending that could increase underlying benefits.

Historically, the insurance market has vacillated between "soft" market cycles (a "buyer's" market, such as the one we're in now) and "hard" market cycles ("seller's" market). It is inevitable at some point that the marketplace will cycle back, and we'll see a period of increased pricing and less availability.

What Can You Expect in 2007?

The Bureau normally amends its recommended rates twice during the year, usually in July and in January. If your renewal is between July 2006 and December 2006, you should benefit from the January 2006 and July 2006 recommended rate decreases. Collectively, these totaled 31.7% (15.3% and 16.4% respectively).

Your specific insurance company might not have taken this exact decrease, but most insurance companies followed the market. If they didn't match this, they came reasonably close. As such, the majority of our clients (assuming a constant experience modification factor) are seeing rate decreases in the 20% to 30% range, and some even higher.

If you renew in the first half of 2007, you should benefit from the July 2006 recommended decrease as well as the January 2007 recommended decrease. The July 2006 recommended decrease was 16.4%.

The Bureau recently came out with recommended rates for January 2007, which call for a 6.3% rate decrease. Although most companies will generally follow the recommended rates, each company will be different. All other things being equal, we expect to see rate decreases in the 15% to 20% range.

Lastly, in addition to "base rates," net premium is affected by your experience modification factor as well as other credits or debits an insurance company may apply. These "average" rate decreases are spread across all classifications. It is also important to remember that each classification can vary up or down depending on the individual losses tied to that classification.

Conclusion

The only way to accurately forecast your 2007 workers compensation insurance cost is to sit down with your insurance broker and work through a projected 2007 experience modification and premium projection.

As I've mentioned in previous newsletters, workers compensation insurance is more of a finance tool than an insurance product. Ultimately, through the manifestation of your experience modification factor, you end up paying for your workers compensation costs. Because of this, the only way to control your premium cost is to control your underlying losses (claims).

There are a number of different strategies you can use in the areas of audits, experience modification, injury prevention and injury management to effectively control your underlying losses. It is only by lowering the underlying losses that you can ultimately lower your cost of risk.