CAVIGNAC & ASSOCIATES
INSURANCE BROKERS

Oct 2011

Commercial Risk Management Newsletter

The Insurance Cycle

What to Expect in 2012

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The insurance industry marches to its own economic drum. Historically it has fluctuated between what are called hard and soft markets. A hard market is characterized by reduced capacity or surplus, stricter underwriting, reduced coverage and increased prices. A soft market conversely has increased capacity, looser underwriting, broader coverage and lower prices. For the last 7 years, insurance rates nationally have been decreasing . Note that this is a national average across all lines of property and casualty coverage. Because insurance is a supply driven industry, the more surplus the industry has, the more insurance it can write. If supply goes up and demand stays constant, rates go down. If you look at Table 2, specifically Policyholders Surplus, you will see a dramatic increase in surplus; this is the main reason for the significant decrease in rates.

The last hard market ended in 2002 or 2003 depending on who you talk to. Since 2002, policyholder's surplus has increased nearly 200%, going from 285 billion to 557 billion—an all time high! During that time the average premium has decreased 39%. The market has been so competitive and rates have gone down so far, that the industry is now losing money on underwriting. For every dollar the industry takes in as premium, they spend $1.024. The industry offsets the underwriting loss with investment income (money earned on the surplus). This helped the industry achieve a 5.6% return on net worth in 2010, which was actually an improvement over 2009 (4.7%). Unfortunately the insurance industry competes with ever other industry for capital and the average return on net worth for the Fortune 500 in 2010 was 13.6%...8% higher than the insurance industry. Needless to say, money isn't pouring in to the insurance industry's coffers, and this concerns insurance industry executives.

Average Commercial Rate Changes		
Month/Year	Percent Change	Cumulative Change
Aug-04	4%	1.00
Aug-05	<6%>	0.94
Aug-06	<7%>	0.67
Aug-07	<14%>	0.75
Aug-08	<10%>	0.68
Aug-09	<5%>	0.64
Aug-10	<4%>	0.62
Aug-11	<2%>	0.61

Table 1

Every insurance underwriter we talk to today, wants 5—10% higher rate on renewal, and some lines of coverage or underwriters may want or require substantially more. Unfortunately for the underwriters—and fortunately for those who buy insurance—the industry's robust surplus is keeping rates on preferred accounts from increasing. If an underwriter increases prices too much, or at all, they will lose market share. It is

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Table 2

Description	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Net Written Premium	$327.8	$369.1	$403.80	$421.10	$425.90	$443.80	$440.80	$434.90	$418.90	$422.1
Combined Ratio	115.9	107.3	100.1	98.1	100.9	92.4	95.5	105	101	102.4
Investment Income	$37.1	$37.2	$38.7	$39.6	$49.7	$52.3	$55.1	$51.5	$47.0	$47.2
Operating Income	<$13.8>	$5.3	33.7	44.1	45.1	84.6	73.4	30.6	44.9	$37.8
Policyholder Surplus	$289.6	$285.2	$347.0	$391.4	$425.8	$447.1	$517.9	$457.3	$511.5	$556.9
Return on Avg Net Worth	<1.2%>	2.2%	8.9%	9.4%	9.6%	12.7%	10.9%	0.1%	4.7%	5.6%

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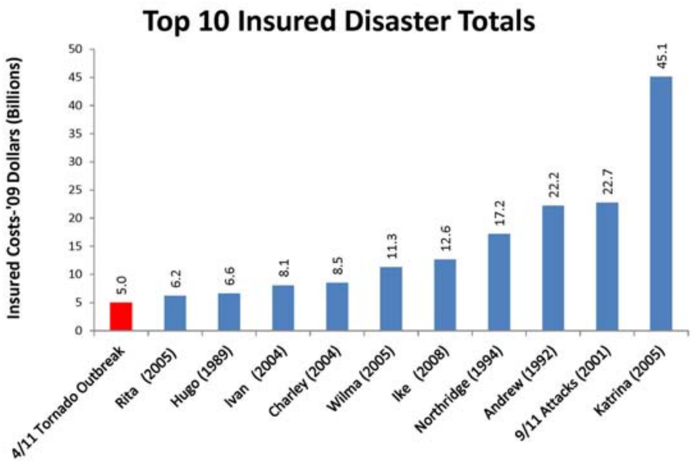

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a fine line and a classic balancing act. This is also being impacted by what is shaping up to be a lousy 2011. Munich Reinsurance Company is estimating that 2011 will be the worst catastrophe year of all time! There was significant flooding in Australia, the earthquake in New Zealand and the tsunami and nuclear challenges in Japan. Domestically, it is estimated that the tornados that hit the South in April will total about 5 billion in insured losses. The recent hurricanes to hit the east coast could equal that as well. Although some people feel the insurance industry is one big disaster away from a hard market, it is important to put these losses into perspective. Recognize that a $5 billion dollar disaster is less than 1% of the industries surplus.

So what will happen to your insurance rates in 2012? It really depends on your individual risk profile as well as which line of coverage you are considering. Here is our best estimate of what you can expect.

The Property and Casualty Market

The market in general should be relatively flat, although **property risks** in wind prone areas will see some increases as a result of the recent hurricanes and tornados. Capacity could also be an issue, so if you have a significant property portfolio in these areas you will want to start working on your renewals sooner than normal. **General Liability and Excess Liability** are anticipated to be flat. **Auto rates** could actually come down. This has been one of the most profitable lines recently.

Professional Liability is all over the board. The poor economy has adversely affected some lines. Real estate attorneys, for example, are seeing increases as are attorneys specializing in intellectual property. Law firms in general as well as the accounting profession should see stable renewals. Competition for architects and engineers is as intense as it ever has been. Seven to eight years ago, there were at most 10 companies competing for this business...today there are over 40! Many of these companies don't have much experience in this line, so the only way they can compete is on price. It is anticipated that these "newbies" will not be around long, so it is prudent to evaluate a prospective insurer on factors in addition to price, such as their commitment and experience with the industry. The competition has already forced some of the experienced underwriters to withdraw. They are simply not willing to match the undisciplined pricing offered by the new entrants.

Medical Professional is also intensely competitive due to favorable loss experience caused by lower claims frequency, increased focus on patient safety, and some reserve reductions.

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RISK MANAGEMENT SEMINAR SERIES

Risk Control—Measuring Safety for Your Bottom Line
Friday, November 11, 2011
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Program: 8:00 am - 10:00 am

Sexual Harassment Prevention Training
Friday, December 2, 2011
Registration: 7:30 am
Program: 8:00 am - 10:00 am

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* Reserve early / seating is limited!

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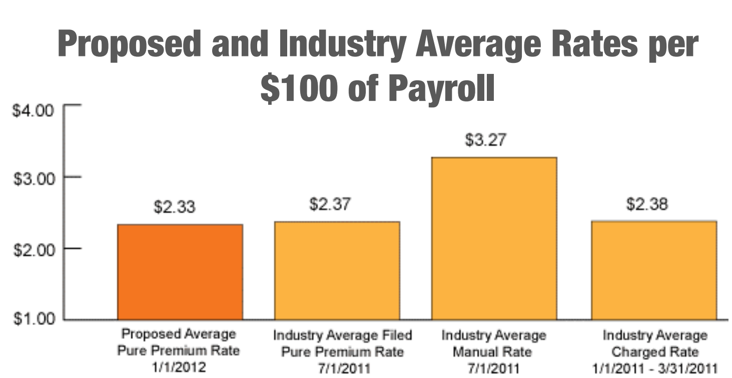
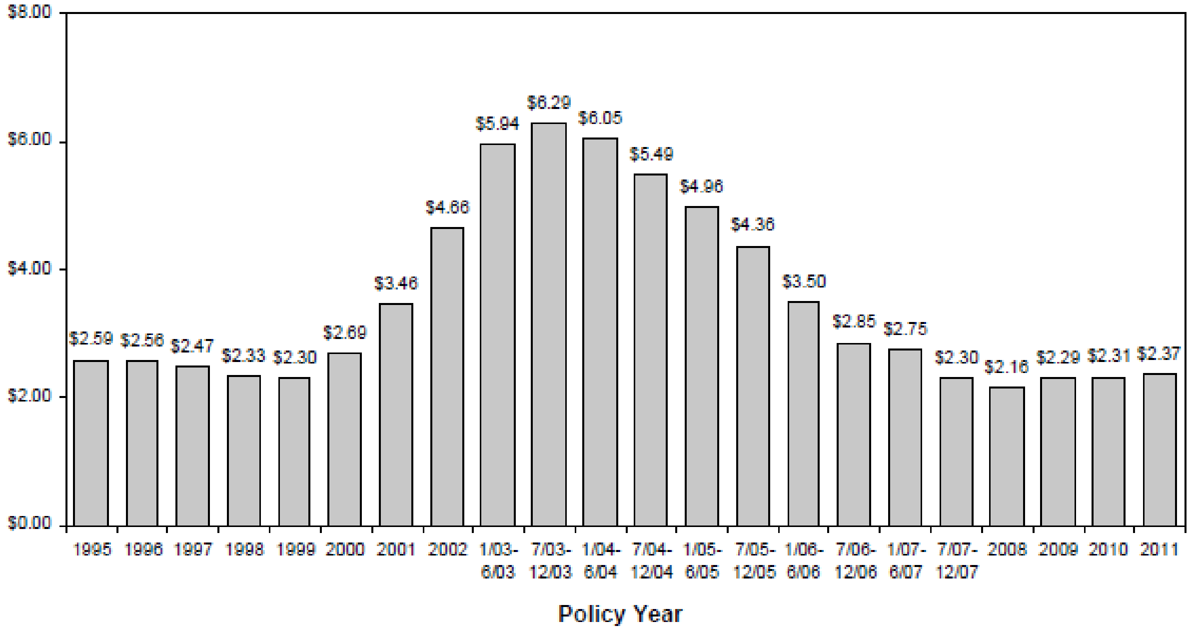
Contact **Darcee Nichols** at **dnichols@cavignac.com** or call **619-744-0596**

* NOTE: **Due to the popularity of our seminars and limited space available, we regret we cannot provide refunds or credits with less than 72 hours advance notice of cancellation.**



Average Insurer Rate Per $100 of Payroll



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Directors and Officers Liability—While pricing on average has been stable, this line is seeing increased loss ratios. This is a reflection of the economy; when companies due poorly, there are more lawsuits against the Directors and Officers. Accounts are being underwritten more carefully, specifically companies heavily involved in M&A (mergers and acquisitions) activity.

Employment Practices Liability—This line is experiencing price increases on average of 10-20%. As with directors and officers liability, the poor economy is causing an increase in lawsuit (claim) frequency and several companies have withdrawn from the market due to lousy results.

Workers Compensation

Nationally, conditions in the workers compensation marketplace continue to deteriorate. This is attributable to poor underwriting results, declining premiums due to decreased payrolls, an increase in claims frequency and an uncertain regulatory environment in many states. The combined ratio (losses + expenses/premiums) increased 5 points in 2010 to 115, which is the highest it has been since 2001. Despite increased investment income, the line suffered a 1% pre-tax operating loss. The last time this happened was 2002.

In California, things are worse. Rates in California remain near an all time low. As you can see from Table 4, the average insurer rate per $100 of payroll is $2.37. This is down 62% from the July 2003 rate of $6.29; however accident year combined ratios in 2010 replicated 2009 at 128%. Despite the lousy results, the Workers Compensation Insurance Rating Bureau (the Bureau) is recommending an average rate decrease of 1.7%. It is important to point out that the rates proposed by the Bureau are advisory only. Insurance companies are free to charge whatever they want. Interestingly, the Bureau's proposed pure premium rate (the anticipated cost of losses and loss adjustment expenses) is actually slightly less than the industry average filed pure premium rates. The average Bureau "proposed" rate is $2.33 and the actual filed rate is $2.37. It should also be noted that the industry average manual rate is $3.27. This includes the insurance companies' overhead as well as losses and loss adjustment expenses. The actual industry average charged rate was $2.38. In other words after all credits are factored in to the manual rate, the actual rate charged is almost exactly the same as the pure premium rate. It is no wonder the industry is not making any money!

So what will happen to workers compensation rates in 2012? If you believe the Bureau, they will be flat. If you look at the combined ratios, however, you will conclude that they have to go up. This applies in both California and the balance of the country. We are already seeing some insurance companies withdraw from this line and we are seeing others increase rates, in some instances significantly. For budget purposes, assuming your experience modification remains unchanged, I would figure on a 10-15% increase. In order to avoid surprises, it is prudent to project your experience modification seven months into your policy term (the losses and payrolls that comprise your mod must be filed within the 6th month after policy expiration). The sooner you know what your modification might be, the sooner you can plan for it. Your published modification is usually available 30-90 days prior to expiration. You should also check with your insurance company 90 days out to see if they have or intend to amend the base rates that apply to your policy and whether there are any other changes that will impact your program.

Surety

The Surety Bond Market is nervous, to say the least,

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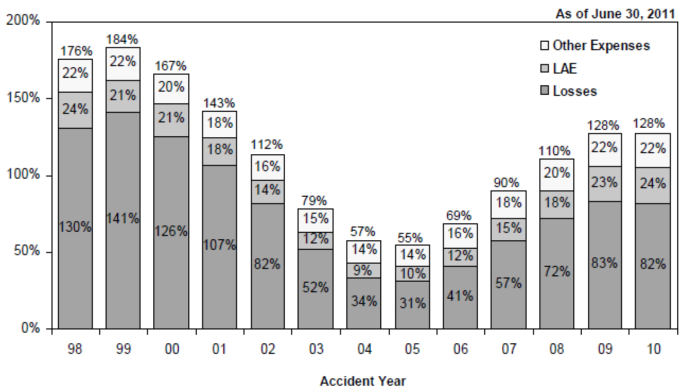
California Workers' Compensation

Accident Year Combined Loss and Expense Ratios



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although 2011 should be a profitable year. The concern arises out of a continued stagnant construction market and razor thin profit margins. Most surety experts feel that performance bond claims will increase in 2012 and 2013. Contractors are being closely underwritten and surety underwriters are looking for strong cash flow, realization of projected profits, and reasonable overhead as a percentage of volume. Debt loads, owner financing and contract terms are also considerations. For a more thorough discussion of the Surety Marketplace, see our 3rd Quarter Construction Newsletter on the topic.

Benefits

The double digit increases continued for the first three quarters of 2011, but the fourth quarter presented the first single digit increases we've seen in many years. Should this give us cause to celebrate?

The Patient Protection and Affordable Care Act, (PPACA) also known as "Healthcare Reform" or "Obama Care", is ending its second year as law. A majority of the states, and numerous organizations and individual persons, have filed actions in federal court challenging the constitutionality of PPACA. As of September 2011, federal appellate courts are almost evenly divided on the constitutional issues raised in this litigation; at the district court level, three judges upheld the constitutionality of PPACA and three declared it unconstitutional in part. Several other challenges were dismissed on technical grounds such as jurisdiction and plaintiffs lacking standing. The Supreme Court may review the matter as early as the end of 2011.

While PPACA waits on a Supreme Court decision, the law regulation and implementation calendar continue to get pushed forward. We watch this process very closely and will inform our clients as necessary.

We are cautiously optimistic in our 2012 forecast. Medical insurance rates for both HMO and PPO plans will see single digit increases in 2012. Health Savings Accounts (HSA) and Health Reimbursement Arrangements (HRA) have settled in at high single digit/low double digit increases. California has admitted a new insurance carrier SeeChange, that is rolling out Health Incentive Arrangements (HIA). These plans incentivize employees to complete health risk assessments and biometeric screenings in exchange for a richer benefit plan (less out of pocket).

Wellness plans and a focus on employee productivity, employee engagement and absenteeism/presenteeism will lower the human capital cost and drive dollars to the bottom line. Employee education on insurance best practices continues to improve employee satisfaction and lessens the administrative burden.

Other employee benefits: dental, group term life insurance, long term disability and vision insurance rank very high in importance in employee job selection and satisfaction.

Conclusion

The insurance marketplace will fluctuate depending on various factors including surplus, return on equity, and the economy in general, and there is nothing you can do about it. You need to focus on what you can control, and what you can control is the frequency and severity of the claims and losses that drive your insurance costs. Companies that allocate resources to effectively manage risk are going to be more profitable than those that don't. Who is in charge of managing your risk? How confident are you that the risk management process you have in place is working? These are crucial questions that need to be addressed if you want to lower your Total Cost of Risk.

Total Cost of Risk

For many companies, the Cost of Risk is one of their largest expenses. The Cost of Risk includes factors such as:

- Your time spent analyzing and managing risk.
- Money spent on uncovered losses or deductibles.
- Your time and your employees' time spent dealing with losses.
- Productivity costs due to time lost by injured workers.
- Cost of training new workers.
- In cases of bad publicity, the cost to your brand or reputation.
- Loss of market during the time your business is shut down.
- The cost of insurance (less than 50% of the Cost of Risk in many cases).

***Our prognostications about the industry are general in nature. The industry is fluid and factors are constantly changing. In order to more accurately estimate your insurance costs in 2012 you should review your specific situation with your insurance broker.**

Articles courtesy of Cavignac & Associates Employee Benefits Department

LIVE WELL, WORK WELL

Are You Packing Safe Lunches?

Did you know that the lunches you pack at home could be increasing your chances of getting sick?

Most brown-baggers don't have access to a fridge during the day, so their bagged lunch sits unrefrigerated all morning. Perishable foods – such as leftover casserole, a turkey sandwich or cut vegetables - can warm to unsafe temperatures during that time, even if you use an insulated lunch bag or ice packs. Warmer temperatures allow bacteria to breed, which could cause upset stomachs or even food borne illness.

Heed the following tips to keep unrefrigerated bagged lunches safe during the day:

- If you're using an insulated lunch bag, put it in the freezer overnight so that it is cooler to start off the morning.
- When using ice packs to cool your lunch, use two and put one on either side of perishable foods. If using a paper bag, double-bag it.
- Swap perishable foods for ones that don't require refrigeration, such as a peanut butter sandwich instead of deli meat, or an apple in lieu of melon.
- Freeze sandwiches overnight to help them stay cold.
- Foods found on a shelf at the store, such as applesauce or fruit cups, are generally also safe for an un-chilled lunch bag.
- Pack only the amount of food that will be eaten, to avoid leftovers that will be left out unrefrigerated for the rest of the day.
- When preparing lunches, always wash your hands and the counter thoroughly before beginning. Many people forget this step, but it may be the most important for keeping your lunch free of bacteria that can cause illness.

Step Your Way to Better Health

Walking more each day can help you lose weight, reduce your risk of disease and improve overall health, but it can be hard to get in the habit. For some extra motivation, buy a pedometer to count your daily steps. Pedometers make it easy to measure and track your progress each day, particularly for those who struggle to regularly set aside blocks of time for walking.

Start by tracking your steps during a normal day, and set goals to increase your steps each week. Experts recommend striving toward 6,000 to 10,000 steps each day for maximum health benefits. That may sound like a lot, but you don't have to do it all at once! Here are some tips to increase your daily steps:

- Park farther away in parking lots, or a couple blocks from your destination. On a bus or train, get off a stop early.
- Walk around the house while on the phone.
- Take a 10-20 minute walk each day after lunch.
- Always take the stairs instead of the elevator.
- Get up and walk around during television commercial breaks.
- Plan activities around walking. Suggest taking a walk with a friend instead of your typical coffee meeting. Take your children, nieces or nephews to the zoo, museum or park.
- Walk while listening to a podcast or audio book – or your favorite music.
- Walk around the mall if the weather is bad. And leave your wallet at home to resist spending temptations!

- Find a walking buddy and hold each other accountable for scheduled walks.

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