CAVIGNAC & ASSOCIATES
INSURANCE BROKERS

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The 2017 Insurance Market Forecast: **The Underwriter's Conundrum***

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During the 4th quarter of the year, many businesses are finalizing their budgets for the following year. Insurance is usually one of the larger expenses and we are often asked to project our clients' insurance costs. While this is an educated guess at best, we can make some predictions based on the current status of the market. The purpose of this article is to do just that - provide you with an idea of what will happen to insurance costs and availability in 2017.

Insurance companies, like any other for profit enterprise, are in business to make money for their shareholders. Insurance companies make money in one of two ways:

- Underwriting profits
- Investment income

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. If you look at **Table 1** (below) you will see that in the eight years ending in 2015, the industry generated an underwriting profit three times. If you average all 10 years in the table, it equals 99.85%. In other words, in the last 10 years, the industry has broken even on underwriting. Fortunately, the last three years have been profitable. This is primarily attributable to lower losses in general but catastrophic losses in particular have been light for those years. While insurance companies are not unhappy with their results in the last 3 years (the average return approximates 9%), most insurance company executives you talk to will tell you they would like to see their combined ratio under 95% and, ideally, 92.5% or lower (only achieved once in the last 10 years).

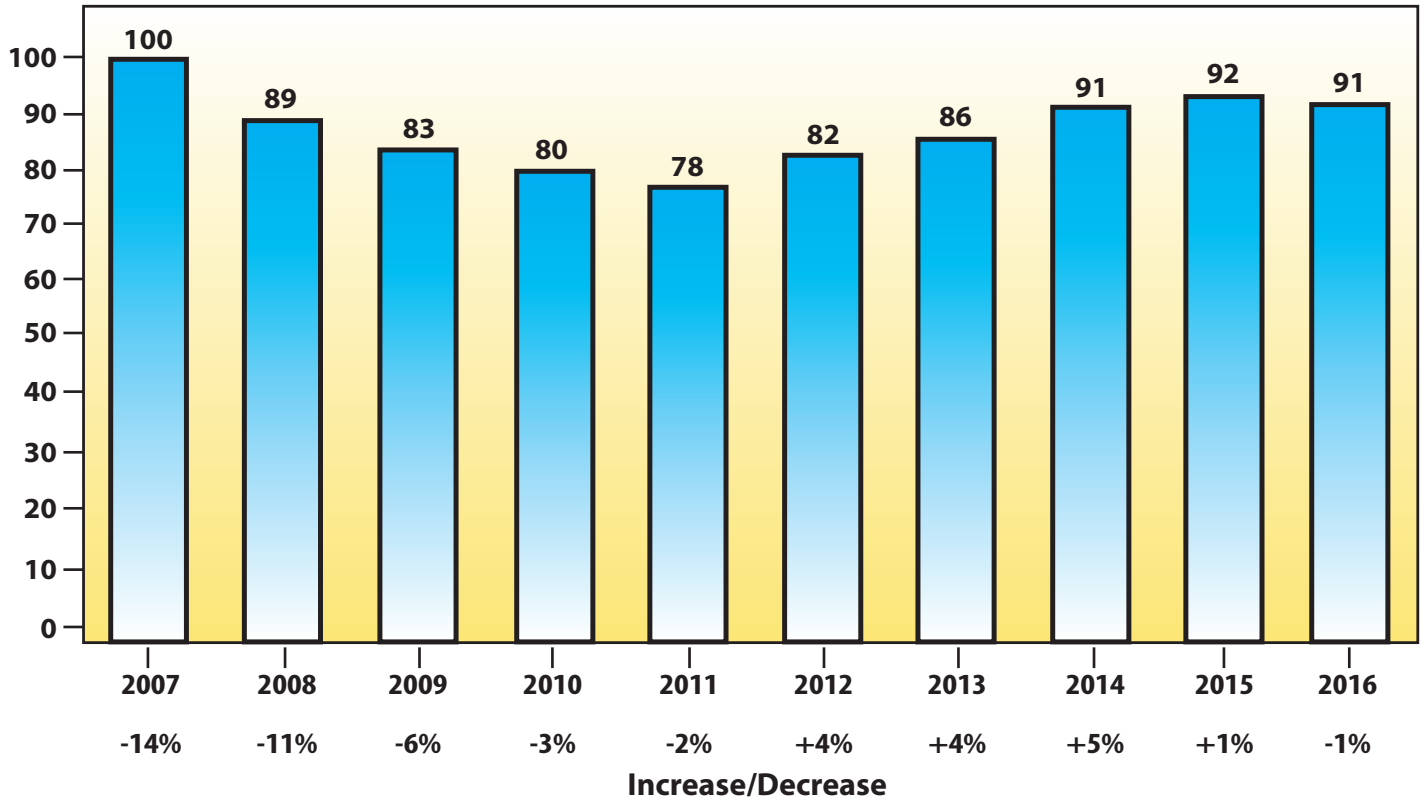
Table 1 - Insurance Cycle

$ in Billions

Description	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Net Written Premium	$443.80	$440.60	$434.90	$418.40	$423.80	$438.0	$456.90	$477.7	$487.6	$505.8
Combined Ratio	92.4	95.5	105	101	102.4	108.1	103.2	96.1	97.0	97.8
Investment Income	$52.3	$55.1	$51.5	$47.1	$47.6	$49.1	$48.0	$47.4	$46.2	47.2
Operating Income	$84.6	$73.4	$30.6	$45.0	$38.2	$15.4	$33.3	$64.3	$55.6	57.3
Policyholder Surplus	$447.1	$517.90	$457.30	$511.50	$556.90	$553.70	$586.8	$653.3	$674.7	$673.7
Return on Avg. Net Worth	12.7%	10.9%	0.1%	5.0%	5.6%	3.0%	5.1%	10.3%	8.4%	8.4%

Source: Insurance Information Institute (iii.org)

Table 2 - Average Property & Casualty Rate Changes



Insurance companies collect premiums and set aside reserves to pay future claims. These funds, known as *surplus* generate investment income. If you look at 2015 on **Table 1** (previous page) you will see that the industry earned a 2.2% underwriting profit and their overall Return on Average Net Worth equaled 8.4%. The difference (6.2%) is attributable to investments. During periods of substantial investment returns, insurance companies are willing to tolerate inferior underwriting results because they make it up on investments. Recently, however, insurance company investment returns have been fairly modest mainly due to the returns received on the fixed income investments that by law must make up the vast majority of their portfolios.

The Importance of Surplus

A critical component that drives the economics of the insurance industry is surplus. As mentioned above, surplus includes money which is 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. This is why the insurance industry is "supply driven." Although demand for insurance will ebb and flow depending on the economy, these swings are relatively modest. Supply, or surplus, is another issue. If surplus goes down, insurance companies must write less insurance and this causes rates to go up. Similarly, if surplus goes up, rates tend to go down. The industry's surplus has increased nearly 50% in the last seven years and is currently at an all-time high. This bodes well for the insurance buyer.

The Underwriter's Conundrum

In order to increase surplus, insurance companies need to attract investors. Recognize that the insurance industry competes with every other business in the world for capital. In order to attract investment dollars, the insurance industry has to demonstrate an acceptable return on equity. Most investors want to earn 10%-12% or more. Although historically the insurance industry has averaged just shy of 10%, the last 10 years have generated a meager 6.95%. During that time, the S&P 500 has averaged over 9% (nearly 30% higher). At the same time that the industry needs to increase their returns to shareholders, they need to continue to grow their top line. As mentioned above, however, surplus is at an all-time high and the business is competitive. If underwriters price their policies where they know they can achieve the

profits they want, they risk being undercut by aggressive competitors seeking to acquire market share. And therein the conundrum lies. It's a balancing act between charging a reasonable premium and generating an appropriate investment return. So what does this mean for the commercial insurance buyer in 2017?

As mentioned above, the insurance industry's surplus is currently at an all-time high. At the same time, after five years of modestly increased premiums as seen in **Table 2**, (previous page), rates have begun to decline. While most underwriters are trying to hold the line on rate, it is anticipated that pricing on preferred accounts will continue its modest downward trend. This will, however, differ by client and line of coverage. Preferred risks in desirable industries with profitable loss histories may see rate decreases of 5% or more while challenging accounts in high hazard classes with poor loss records can still see substantial rate increases. Here are our projections by line of coverage.

Property, General Liability, Auto and Umbrella (aka Allied Lines)

- Preferred property risks as expected are receiving the largest decreases but even challenging accounts benefit from somewhat relaxed underwriting and increased competition. The same can be said for Catastrophe ("Cat") driven accounts (risks exposed to earthquake, wind and flood). The additional capital in the market has to be deployed somewhere and the recent favorable "Cat" loss history is driving rates down for this line. Regardless there are those that see the pricing decreases moderating and it is anticipated that property pricing will not drop much further.

- General Liability is also seeing overall rate decreases. Not surprisingly the companies that have the best risk management programs and positive loss histories are seeing the largest decreases. More challenging accounts, those that haven't invested in risk management and have the loss runs to prove it, are seeing flat and sometimes increased pricing on renewals.

- Automobile rates on the other hand are going up across the country. Poor profitability in this line is increasing the average cost per vehicle anywhere from 5-15%. Differences amongst insurers is also greater in this line, which means this coverage is being shopped more frequently than other lines. Increased focus on Fleet Safety is critical to managing Auto Insurance Premiums.

- Excess Liability (umbrella) remains reasonably competitive. Pricing is usually based on underlying policies. If those premiums go up, excess will increase. As mentioned above, we are seeing auto pricing start to escalate and this would increase excess pricing.

- Professional and Pollution Liability Insurance
  This area remains very competitive and there are a number of new players looking for business. However, don't be deceived. Not all offerings are the same. Coverage can differ dramatically as can risk management services and claims handling. Preferred risks should experience rate decreases from 5-15%.

Executive Risk

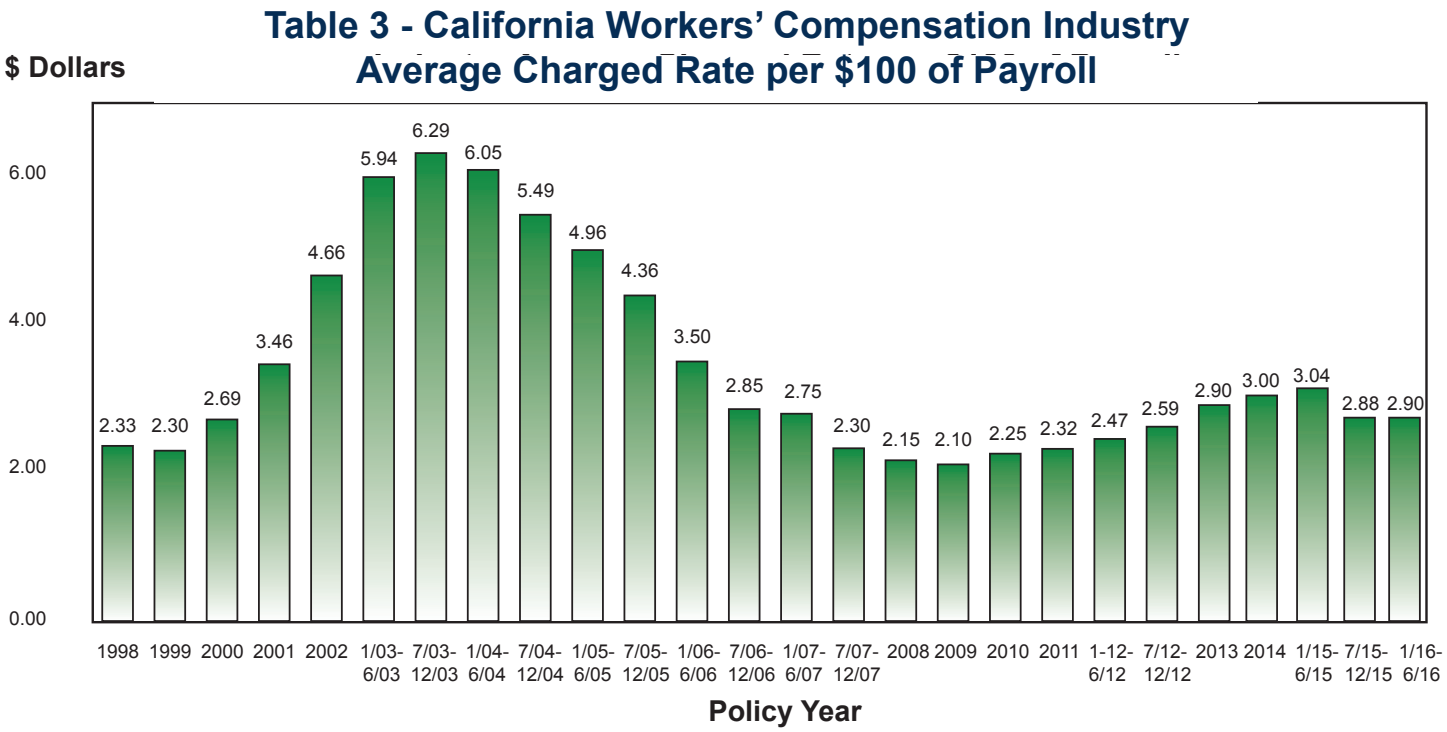
Executive Risk, which includes Directors & Officers Liability, Employment Practices and Fiduciary Liability, remains fairly consistent, but is carefully underwritten. This coverage also varies significantly by industry. Cutting edge bio and tech companies can expect to pay more for this coverage than you standard main street business. Adverse loss experience or poor internal controls will also impact pricing. As much or more than most exposures, these areas lend themselves to being proactively managed. It is also important to understand the coverage you are buying. Every policy is different and coverage differences can be significant.

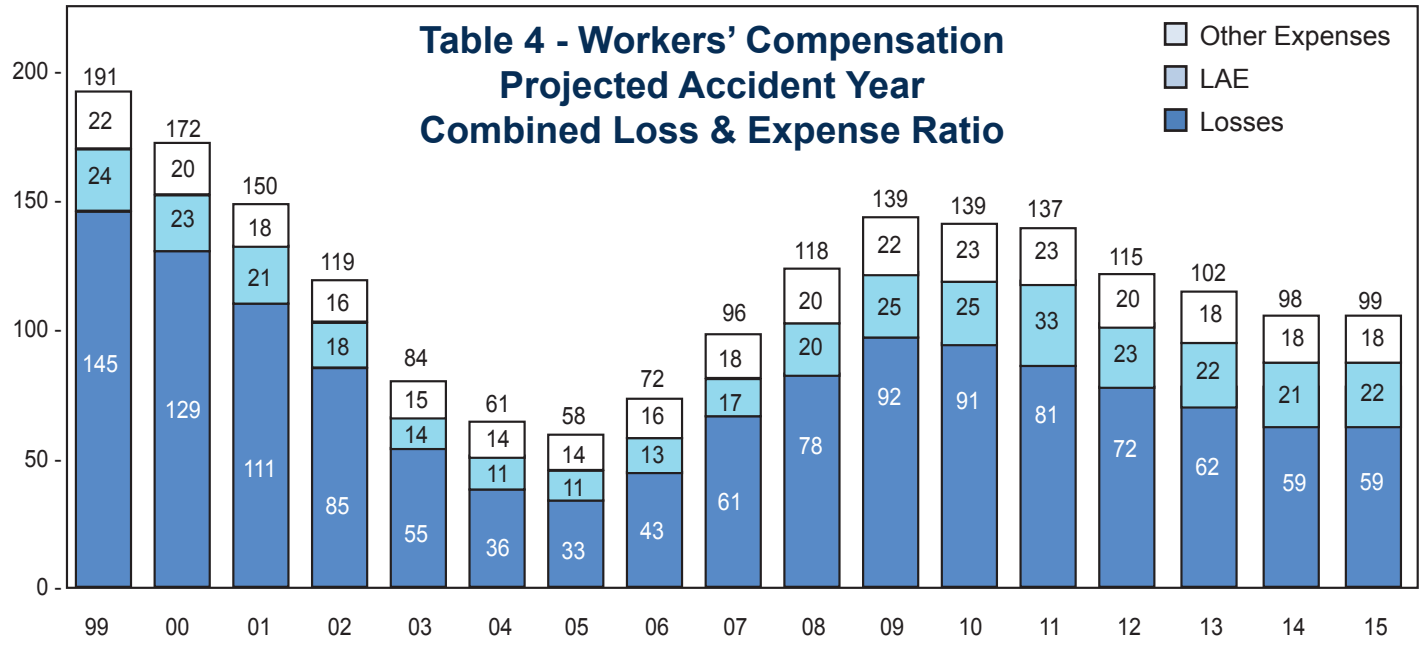
Cyber Coverage

Cyber Coverage is the fastest growing insurance product but it is still under purchased. Every business has cyber risk. Managing these exposures goes beyond locking down your computer systems. Cyber Extortion and Social Engineering (aka Cyber Deceit) among other types of crimes continue to grow. It is our opinion that every business owner should consider this coverage. The application process, even if you don't buy the insurance, will serve as a self-audit on your exposures and alert you to areas that can be improved.

Workers Compensation

Workers Compensation continues to improve across the country as well as in California. Rates in California reached an all-time high in 2003, when the "Average Charged Rate per $100 of Payroll" was $6.29 as seen in **Table 3** (next page). Rates dropped nearly 67% to 2.10 in 2009. Unfortunately this was well under what was needed for profitability and combined ratios (losses and expenses divided by premiums) inflated to 140%! From 2009 to June of 2015, rates increased 44% to 3.04 (still less than half of the 6.10 charged in 2003). This





increased pricing generated the first underwriting profit for the industry since 2007. While the combined ratio of 99% as seen in **Table 4** (above) equates to a modest 1% profit, it is nonetheless in the black. Note that the balance of the country enjoyed a 94% combined ratio according to the National Council on Compensation Insurance.

While California continues to have on average the highest workers compensation insurance rates in the country, since June of 2015, rates have dropped on average 5%. It is anticipated that rates on average will continue to decrease in 2017. Our estimate is 5-7% but there are several caveats. First, regardless of what the Insurance Commissioner or the California Workers Compensation Insurance Rating Bureau recommend, they are only recommendations. Every insurance company files their own rates and the market leaders base these rates predominantly on their own loss experience. Secondly, individual accounts will be directly affected by their experience and

risk profile. Experience Modifications in 2017 may be even more volatile due to a significant change in the way Experience Modifications will be calculated in California. This has to do with the new "Split Points" that now apply. The Split Point is the threshold between a primary loss and an excess loss. While the Bureau has stated that on average mods will be similar utilizing the new split points, our experience is that mods will go up. If you want to learn more about the new Split Points, you can access our blog post on the topic by clicking HERE.

Surety Outlook 2017: Staying the Course!

The Surety industry in the United States will continue to realize growth in overall premiums with likely a modest increase in loss activity in 2017.

The total direct written premium for the calendar year of 2015 was $5.62 billion with an 18.3 loss ratio (the surety industry breakeven loss ratio is generally 34%). This record-breaking pace continued thru 2Q 2016, with more than $2.98 billion in total direct premium written and an 18.4% loss ratio (slightly higher compared to 2Q 2015).

With market capacity growing and a surprising number of new players entering the industry, the supply for surety bonds continues to outgrow the demand. Although we have seen an increase in the number of carriers, the lion's share of premium remains with the top five largest surety companies: Travelers, Liberty Mutual, Zurich, CNA and Chubb (recently acquired by ACE LTD Group). These top carriers write 50% of all premiums. In fact, the top 10 surety companies control 63.1% of the overall surety market. Despite the top-heavy make-up of the market, the U.S. surety industry remains very competitive with the market now frequently softening underwriting terms and conditions to acquire and retain good, solid contractors.

With clear skies overhead, most contractors today are enjoying healthy backlogs and a return of acceptable profit margins (the "telltale" sign of a true economic recovery). However, there are clouds and grey skies on the horizon that will inevitably be upon us all. While times are good (not great) today and for the near future, prudent contractors are studying the "elements", properly "manning and provisioning", and regularly "charting their destinations" to be disciplined on "Staying the Course"!

Health Insurance Outlook for 2017

The major change with the Affordable Care Act (ACA) in 2016 was the definition of "small" and "large" employers. President Obama allowed the individual states to set the definition of employer size and California adopted 2-99 employees as a "small" employer. Therefore, all California companies with less than 99 employees will be age rated and the plans must match the metallic values (Platinum, Gold, Silver and Bronze) set by the Federal Government through the ACA.

Rates for all "small" employers will be based on the employee and their dependents' individual ages, plan design and location of the company. For example, a family of five will pay for each family member based on each individual's age and the plan they select. Some younger employees or families with one child may realize lower premiums. All of the small group plans have changed to conform with the law and most have higher deductibles and copays, therefore employees will have to pay more when they use the services.

The actuaries at all the major insurance companies have determined that, to stay in compliance with the ACA's metallic tier guidelines, they must change plan benefits every year. The ACA guideline gave a percentage requirement for each tier - 90% equals Platinum, 80% equals Gold, 70% equals Silver and 60% equals Bronze. So as costs increase, the value of the percentage changes and plan benefits will also change. Using the Platinum Plan as an example: if the actuarial value of a plan this year was $1,000, then the Platinum Plan has to cover 90% ($900) and pass 10% ($100) to the plan member. In the second year, if the actuarial value goes up to $1,100, 10% or $110, can be passed to the plan member and the benefits will change. This will always be a moving target, until the values are fixed or the law is changed.

There is a prediction in the employee benefits industry that, before President Obama leaves office, he will finalize the regulations for non-discrimination in the ACA. This could have been rolled out years ago, but would have a negative effect for most employers and was tabled. If this takes effect, the contribution an employer pays for benefits must be equal throughout each company. All employees from top to bottom must receive the same contribution and same benefit choices.

The provider networks are still changing and are offering a lower number of choices for doctors and medical groups. The industry calls them "skinny networks". Often the price looks good, but your employees will have very few choices for doctors. Be sure to run a disruption report to compare current providers to those associated with the programs you are considering. Insurance carriers continue to seek greater discounts from hospitals, medical groups and doctors and are offering patient exclusivity in return. Some insurance carriers will allow "skinny networks" to be offered side by side with "full networks", with the price and contribution being set by the employer to favor one or the other.

2017 will see 0 – 10% rate increases and benefit changes for "small" employers and 5-15% for "large" employers.

Captives, self-funding and partially self-funded plans are becoming more popular and should be considered for companies with over 50 employees. Industry trust plans for all size employers could lower the overall cost and stabilize the benefits.

Best Practices

The current insurance marketplace, with the exception of health insurance, is favorable for the insurance buyer. The industry has abundant surplus and has experienced reasonably decent results. Most businesses will be able to negotiate flat rates and some businesses may even see rate reductions. Insurance premiums, however, need to be kept in perspective. They are only one component in the cost of risk. It is estimated by OSHA, among others, that the indirect cost of risk actually exceeds premiums paid. This includes money spent managing risk, training employees to be safe, dealing with claims, funding uncovered claims and a number of other costs.

While it is important that you understand the economics of the insurance industry and how this can affect your business, there is nothing you can do about it. The market is the market. What you can control is how your company manages risk. Risk Management is "market agnostic." It needs to be front and center all the time. In the long run, the only way to reduce the cost of risk is to reduce the frequency and severity of claims that drive the cost. An effective risk management program coupled with a proactive risk management oriented insurance brokerage and the right insurance company is the key to lowering your total cost of risk. Investment in risk management will produce great returns and directly impact your bottom line.

**Conundrum - a challenging puzzle or problem. Also, one of the labels from the Wagner family of wine.*

All insurance companies are not the same. When the insurance market is flush with surplus, insurance companies look for ways to deploy their capital. Many companies will forgo investing in their key competencies and will pursue lines of coverage they may not be familiar with. New entrants into any line of insurance coverage need to underwrite a critical mass of profitable business in order to be successful.

There are only four ways an insurance company can distinguish itself:

1. **Coverage**
2. **Claims**
3. **Risk Management**
4. **Price**

In general, there are not to many ways a new entrant can provide broader coverage than what is currently being offered. As well, most new entrants don't have enough business and enough claims to invest in quality in-house claims team. They tend to outsource their claims to Third Party Administrators (TPAs). While there are some excellent TPAs, our experience has been that in general they are not as good as an in-house claims team. Since most of these companies are new to a given line of coverage, they have rarely invested in risk management either.

So if you can't provide broader coverage, better claims handling or offer risk management assistance, there is only one way you can write business and that is to price your coverage less, in some cases significantly less, than the experienced underwriters who know where the price needs to be for long term success. Needless to say, this is not a business model that has enjoyed a great deal of success and it underscores the importance of selecting the right insurance company.

October 2016

LIVE WELL WORK WELL

Health and wellness tips for your work and life—

Prevent Backpack-related Injuries

According to the U.S. Consumer Product Safety Commission, over 5,000 children under the age of 19 suffered backpack-related injuries last year. The vast majority of these injuries were caused by overloaded and incorrectly fitted backpacks.

While you may not have complete control over the weight of your child's backpack, you can purchase a well-fitting, comfortable backpack. When shopping for a backpack, search for:

- The proper size (never wider or longer than your child's torso, never hanging more than 4 inches below waist)
- Padded back and shoulder straps
- Multiple compartments and a waist or chest strap to help balance the weight
- Reflective, lightweight material

Purchasing a good backpack for your child is just the first step in preventing backpack-related injuries. Be sure to encourage them to always use both straps when carrying their backpacks and to only pack what is absolutely necessary to carry.

Halloween Safety Tips

For some Americans, Halloween is one of the most anticipated holidays. Unfortunately, it can also be rather dangerous. Use the following suggestions to help keep your child safe this year.

Costume Safety Tips

- Choose fire-resistant costumes, wigs and accessories.
- Avoid potentially dangerous props, like hard swords.
- Opt for non-toxic face paint or makeup instead of masks.
- Decorate costumes and treat bags with reflective tape if your child will be out after dark.

Trick-or-treating Safety Tips

- Accompany children under 12 at all times.
- Insist that trick-or-treating only be done in familiar areas.
- Plan a route if older children are going alone.
- Designate a specific time for children to return home.
- Instruct children to never enter a stranger's car or home.
- Remind children to always look both ways before crossing a street, to be aware of their surroundings and to use sidewalks whenever possible.
- Tell your children not to eat any treats until they return home.
- Discard treats that appear to be open or tampered with.

For more tips on how to celebrate Halloween safely, click here.

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PERFECT PUMPKIN PANCAKES

2 cups flour
6 tsp. brown sugar
1 Tbsp. baking powder
1¼ tsp. pumpkin pie spice
1 tsp. salt
1 egg
½ cup canned pumpkin
1¾ cup low-fat milk
2 Tbsp. vegetable oil

PREPARATIONS

1. Combine the flour, brown sugar, baking powder, pumpkin pie spice and salt in a large bowl.
2. In a medium bowl, combine the egg, canned pumpkin, milk and vegetable oil. Mix well.
3. Add the wet ingredients to the flour mixture and stir just until moist. The batter may be lumpy.
4. Lightly coat a griddle or skillet with cooking spray and heat on medium.
5. Pour ¼ cup of the batter onto hot griddle or skillet. Cook until bubbles begin to burst, then flip pancake and cook until golden brown. Repeat with remaining batter.

Makes: 12 pancakes, one pancake per serving

Nutritional Information (per serving)

Total Calories	127
Total Fat	3 g
Protein	4 g
Carbohydrates	21 g
Dietary Fiber	1 g
Saturated Fat	2 g
Sodium	115 mg

Source: USDA

Breast Cancer Awareness Month

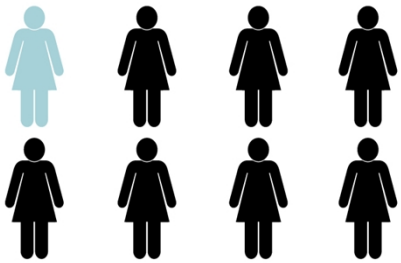
Breast cancer is the second most common type of cancer and the second leading cause of cancer deaths for women in the United States. Top risk factors include getting older, race and family history of breast cancer, which are things you cannot change.

Regardless of your personal risk factors, you can use these prevention strategies to reduce your risk of breast cancer:

- Maintain a healthy weight.
- Exercise regularly.
- Avoid exposure to carcinogens and radiation.
- Abstain from drinking alcohol or limit intake to one drink per day.

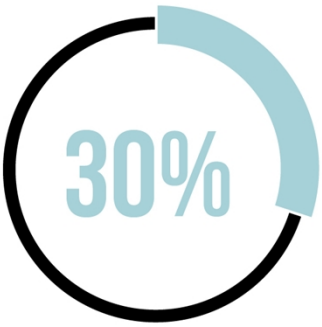
In general, living a healthy lifestyle can help lower your risk of developing cancer and increase your chances of surviving cancer. If you are concerned about your personal risk of developing breast cancer, call or visit your doctor.

For more information on risk factors, prevention tips and breast cancer screening, visit www.cdc.gov/cancer/breast/.

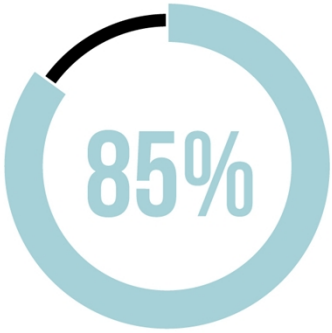


1 IN 8

U.S. WOMEN WILL DEVELOP INVASIVE BREAST CANCER DURING HER LIFETIME.



OF ALL NEW CANCER CASES EACH YEAR ARE BREAST CANCER.



OF BREAST CANCER DIAGNOSES OCCUR TO WOMEN WHO HAVE NO FAMILY HISTORY OF BREAST CANCER.

Spotlight On

Cavignac & Associates is proud to support local and non-profit civic organizations, including Casa de Amparo.

Casa de Amparo

MISSION:
To support those affected by and at risk of child abuse and neglect, through a range of programs and services that promote healing, growth, and healthy relationships.

VISION:
Casa de Amparo is recognized as a major force in the field of child abuse prevention. Partnering with the greater San Diego community, we ensure that children and their families receive unique and innovative services for healing, for stopping child mistreatment of any kind, and for ending generational cycles of abuse. The result is a community where child abuse and neglect are not tolerated, and where child abuse awareness and prevention are priorities.

For more information about Casa de Amparo, go to www.casadeamparo.org