THE STATE OF THE COMMERCIAL PROPERTY/ CASUALTY INSURANCE MARKET: MAY 2014

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Executive Summary

Heading into mid-2014, commercial property/casualty insurers are doing well, with profits reaching a post-financial crisis high. Nonetheless, they face a number of challenges as the year progresses. A sustained period of rising rates may be coming to an end as competition heats up. This growing pressure on rate levels is despite a low interest rate environment, which makes it necessary for insurers to drive down their combined ratios to achieve acceptable returns. Government backing for terrorism insurance is likely to be renewed, but the present level of uncertainty makes strategic planning and policymaking difficult.

For insurance buyers, market conditions will generally be favorable for the remainder of 2014. Rates have increased overall during the past couple of years, but at a moderate pace. The rate of increase is declining in a number of lines, and has reversed on average for property business. Capacity is more than adequate in most lines, and competition assures that policy terms and conditions are generally advantageous.

Overview of the property/casualty insurance industry

Property/casualty insurers fared well in 2013. With a 10.3 percent average return on surplus, profitability was at a post-financial crisis high. This compares to 6.1 percent in 2012 and 3.4 percent in 2011, according to the Insurance Information Institute (III). Policyholders' surplus rose to a record $653.3 billion. This notable performance was due to the aggregate impact of low catastrophe losses, modest premium growth, higher investment returns, and reserve releases.[1]

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First quarter industry results have not yet been tabulated, but based on a sampling of reports from major insurers, 2014 appears to be off to a solid start. While overall less profitable than 2013, many insurers and reinsurers are reporting good outcomes for the quarter.

Improved profitability combined with record policyholders' surplus – a measure of insurance capacity – typically would be a recipe for a highly competitive marketplace. Thus far, however, the trend towards higher rates that began in 2011 continues in most lines, though at a slower pace. The notable exception is large account property, which now on average is experiencing erosion in rate levels. Underwriters will increasingly be battling the stiff headwinds of overcapacity in the coming months, which could mean the end of the current rate rally.

Higher rates were responsible in part for a 4.6 percent increase in written premium in 2013. Also contributing to premium growth was an increase in exposures units as the economy improves. Wages and salaries, for example, grew 3.1 percent between 2012 and 2013, according to Bureau of Economic Analysis statistics. This results in more written premium for lines and classes that use payroll as an exposure base such as workers compensation and general liability.

Capacity and pricing

The fact that the insurance pricing cycle exists is undisputed. Why it exists remains a matter of debate. Since there has been a pricing cycle for as long as there has been a regulated insurance industry, it is perhaps surprising that there is no universally accepted explanation as to why pricing is cyclical. One widely accepted theory is called the capacity constraint theory. This theory asserts that negative net worth shocks caused by such things as large natural catastrophes lead to rapid price increases (a hard market), which then erode slowly as net worth adjusts (a soft market).

The capacity constraint theory is essentially an application of supply-and-demand economics. When the supply of insurance capacity increases faster than the demand for that capacity, prices fall. Conversely, when supply constricts relative to demand, prices increase. Major events such as natural catastrophes can rapidly deplete policyholders' surplus, causing capacity (and therefore supply) to constrict and premiums to rise. As policyholders' surplus is replenished, supply grows and premiums fall.

Typical of the commercial lines pricing cycle, the average premium increased sharply for a few years (2001-2004), and then fell at a more moderate pace until the third quarter of 2011 for large companies and the first quarter of 2012 for middle market companies.

The Advisen ADVx™ Composite commercial lines pricing index, shows the change in the average commercial lines premium by quarter beginning in the first quarter of 2001 (Q4 2000 = 100). Typical of the commercial lines pricing cycle, the average premium increased sharply for a few years (2001-2004), and then fell at a more moderate pace until the third quarter of 2011 for large companies and the first quarter of 2012 for middle market companies. The average premium subsequently began to rise. The change in average premium has largely stabilized for large companies, but continues to increase for middle market insurance buyers.

The current period of rising premiums – even though at a moderate pace – seems to defy the capacity constraint theory. Since capacity, as represented by surplus, is at an all-time high, there should be significant downward pressure on rates. The most likely explanation for rising rates in this environment is the combined impact of a number of factors unrelated to the volume of policyholders' surplus – factors such as underwriting losses, low interest rates, and increasing demand – which collectively put sufficient upward pressure on premiums to overcome the influence of overcapacity. However, the influence of these factors has largely abated, or has disappeared altogether, suggesting that downward pressure on rates will increase.

- **Underwriting losses.** The U.S. P&C industry posted a $33.6 billion underwriting loss in 2011 and a $16.7 billion underwriting loss in 2012, according to the III. Insurance executives agree that an underwriting profit is necessary to produce an acceptable return in the current low interest rate environment. The industry posted a $15.5 billion gain in 2013, which may dampen some of the momentum behind the current round of rate increases.

With capacity growing, profitability increasing, and interest rates inching higher, underwriters will face heightened resistance to further rate hikes.

- **Low interest rates.** Investment returns on the assets held by insurers are a critical component of insurer profitability. In the current low interest rate environment, insurers must lower their combined ratios to maintain the same level of profitability. According to a Swiss Re analysis, a percentage point decline in interest rates lowers property & casualty insurers' return on equity by about 2 percentage points.[2] Some forecasters expect interest rates to increase modestly in 2014, which will provide insurers with some relief.[3]

- **Increased demand.** The demand for commercial lines insurance capacity fell during the recession as businesses scaled back or closed their doors altogether. As the economy recovers, demand increases, which should put upward pressure on prices. At the present time, however, the growth in insurance capacity ("supply"), as measured by policyholders' surplus, is largely offsetting the impact of increasing demand.

With capacity growing, profitability increasing, and interest rates expected to inch higher, underwriters will face heightened resistance to further rate hikes. Resistance will increase further as an improved rate environment attracts new capacity to the market, thereby increasing competition.

Other market factors

Property catastrophe losses

The wildcard in any forecast of insurance market conditions is property catastrophe loss experience, typically natural catastrophes. A very large catastrophe can drain capacity from the market, potentially causing rates to skyrocket not only in property lines, but in almost all property/casualty lines. The market has been so heavily capitalized over the past decade, however, that even record-shattering catastrophe losses – such as back-to-back record-setting years for hurricane losses in 2004 and 2005 – have not been enough to trigger a sharp market correction. The last genuine hard market was 2001-2003 when, on the back of a decade-long soft market, an equities market crash combined with insured losses from the September 11 terrorist event sparked a roughly 50 percent increase in the average commercial property/casualty insurance premium, according to Advisen's ADVx™ Composite Premium Index.

Advisen estimates that U.S. property/casualty insurers would have to sustain more than $100 billion in catastrophe losses in a single year in order to trigger a surge in rates similar to the 2001-2003 hard market. To put that into perspective, the largest single insured loss event is Hurricane Katrina, which cost the insurance industry around $41 billion.

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One reason for falling catastrophe reinsurance premiums is overall positive loss experience in the United States – no hurricanes made landfall in 2013 and there were no major earthquakes.

The reinsurance market

Reinsurers frequently shoulder some of the blame for rising property insurance premiums following a natural catastrophe. The logic is that rising property catastrophe reinsurance premiums in the wake of a hurricane or earthquake drive up the cost of the related insurance protection. Property catastrophe reinsurance premiums have been plummeting, and the shoe is now on the other foot. Florida insurers, for example, have been under pressure from regulators and lawmakers to reduce premiums based on the same reinsurance leverage arguments some had used to justify rate increases in years past. Personal lines insurer Castle Key Insurance Co., for example, after filing for a 12.2 percent average increase, was approved for a 5 percent decrease, which was justified by regulators by falling reinsurance costs.[4]

One reason for falling catastrophe reinsurance premiums is overall positive loss experience in the United States – no hurricanes made landfall in 2013 and there were no major earthquakes. Another is new capacity entering the market in the form of catastrophe bonds and other types of insurance linked securities. Cat bonds, which are an alternative to traditional property catastrophe reinsurance, tap into the enormous financial resources of the capital markets. At $1.2 billion, cat-bond issuance in the first quarter of 2014 was more than double the year-earlier period, and second-quarter issuance is anticipated to exceed $3.5 billion, an all-time high, according to Willis Capital Markets & Advisory.[5] Extreme catastrophe losses could chase this new capacity away, but at the present time it appears that the capital markets will continue to be a viable source of catastrophe capacity, which will further exert downward pressure on traditional catastrophe reinsurance pricing.

Workers compensation market improvements

Workers' compensation results and issues vary widely by state. Overall, workers' compensation had been one of the most distressed P&C lines in recent years, culminating in a 115 combined ratio in 2011, according to the NCCI. The past two years have seen sharply improving results: calendar-year combined ratio for private workers' compensation carriers was 101 in 2013, a seven-point improvement from 2012 and a 14-point improvement from the dismal 2011 results.

Because workers' compensation is the most highly regulated line of commercial property/casualty insurance, it is less susceptible to broader market forces. Nonetheless, it is far from immune to the ebb and flow of capital and capacity, which influences premium levels despite regulation. An improving workers compensation market could encourage some insurers to commit more capacity to the line, or even spark the formation of new insurers to capitalize on the improving profit picture. The increased competition could slow or even reverse the current improvements in workers' compensation results.

While the overall trend is towards greater market share, the surplus lines market tends to gain and lose business relative to the overall insurance market cycle.

Surplus lines market

A 2013 A.M. Best analysis of the surplus lines market found that surplus lines insurers were gradually increasing their market share over time, from 11.1 percent in 2002 to 13.4 percent in 2012.[6] While the overall trend is towards greater market share, the surplus lines market tends to gain and lose business relative to the overall insurance market cycle. As the market softens, some standard lines insurers broaden their underwriting appetite to maintain top line growth, pulling business from the non-admitted market. Conversely, as rates increase, those same insurers may decide they can reach premium targets with their core business, releasing "fringe" business to find its way back to the non-admitted market.

Since 2011, as rates in the admitted market began to rise, surplus lines insurers have seen business flow back into the non-admitted market. This is a healthy development for both the standard market and the surplus lines market since much of this business is better suited for the non-admitted market, which has much more flexibility as concerns rate and policy terms. The surplus lines market also is benefitting from the Nonadmitted and Reinsurance Reform Act of 2010, part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which streamlines non-admitted insurance transactions. Nonetheless, pessimism permeates the surplus lines market, according to Milliman's Joy Schwartzman. Some executives are concerned that both the standard and surplus lines markets are overcapitalized, and that the fragile rate increases of the past couple of years will not hold in the face of competition.[7]

Terrorism risk insurance

The 12-year old federal terrorism risk insurance program (originally the Terrorism Risk Insurance Act, or TRIA), formed in the aftermath of the September 11 terrorist attacks, expires at year end. While it seems increasingly likely that the program will be renewed, it will undoubtedly undergo material changes.

Uncertainty concerning the renewal of the program is wearing on both risk managers and underwriters. Demand for terrorism insurance remains strong and, according to a recent report from Marsh, the federal terrorism risk insurance program plays a key role in making coverage available and affordable. The Marsh report affirms the conclusion of a recent report to Congress by the President's Working Group on Financial Markets, which found that private insurers could not fill the terrorism risk insurance gap that would be created if TRIA is not renewed.[9]

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Conclusion

The property/casualty insurance industry may be a victim of its own success. Following a solid 2013, and with 2014 beginning well, the modest rate rally of the past couple of years may be in peril. Policyholders' surplus, a measure of capacity, and therefore of supply in the insurance industry supply-and-demand equation, is at an all-time high. Other factors that had supported higher rates, such as low interest rates and underwriting losses, are abating or have disappeared altogether.

An intangible, nearly impossible to quantify factor, is underwriting discipline. The industry has never been known for maintaining its resolve in the face of overcapacity, but underwriters have been comparatively steadfast in pressing for more rate under conditions that may have produced a very different outcome in the past. Some executives attribute this focus on rate in a highly competitive market to improved information and analytical tools, which provide insight into the factors driving the market and a clearer view of the true profit picture.

The big unknown is catastrophe losses, which have the potential to disrupt the entire market. However, at the current level of capitalization, it would likely take unprecedented losses to spark a sustained hard market. The most significant catastrophe risks are posed by earthquakes and hurricanes, but terrorism could represent an even larger threat in 2015 and beyond, depending on the outcome of current negotiations over the future of the federal terrorism insurance backstop.

For insurance buyers, absent very large catastrophe losses, 2014 will remain a favorable year. Thus far, rate increases have been moderate, and they are likely to taper off, or even to reverse in some lines, as the year progresses. Capacity is more than adequate in most lines, and policy terms and conditions are generally competitive. While it is too early to make a meaningful forecast for 2015, it seems nearly certain that the commercial property/casualty market will remain highly competitive for the foreseeable future. ■

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