The State of the Commercial Property/ Casualty Insurance Market

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Executive Summary

As New York, New Jersey and Connecticut continue to recover from the ravages of Superstorm Sandy, catastrophe modeling firms are refining their estimates of insured losses and insurers and reinsurers begin to tally their claims. Insured loss estimates now exceed $20 million, making Sandy one of the largest insured loss events. Nonetheless, the losses probably will not be sufficient to propel sharply higher premiums for a sustained period of time. Although premiums may trend upward in the short term – especially for property business in catastrophe prone regions – the property/casualty insurance market remains abundantly capitalized, which should cushion the financial impact and avoid the type of hard market conditions seen in 2001 and 2002.

Introduction

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When Superstorm Sandy made landfall, wind speeds had fallen below hurricane level. Nonetheless, due to the enormous size of the slow-moving storm, unusually high storm surge, and the fact that the most powerful area of the storm targeted the most populous segment of the United States, the scope of the destruction was massive. Estimates of insured losses are as high as $30 billion.

Whatever disruptions Sandy may cause in the insurance market are taking place within the context of a market that might best be characterized as "transitional." Average premiums are rising in many lines of insurance. However, even with Sandy losses, conditions do not appear ripe for a sustained hard market. Policyholders' surplus – a measure of insurance capacity – is near a record high – a scenario typically associated with a highly competitive market. Underwriting losses, low interest rates, rising demand for insurance capacity and the impact on capacity resulting from the adoption of the RMS 11 catastrophe model all have been suggested as contributing factors in the upward pricing trend. At this point, however, it is not clear that these factors will continue to prevail against the stiff headwind of overcapacity.

The same forces that drive the pricing cycle impact the commercial insurance market in other ways. During the most competitive phase of the cycle, some insurers broaden the scope of the coverage granted in their policies in certain lines, which can compound the impact of rate decreases. Additionally, to offset the impact of falling rates on the top line, some insurers more aggressively seek growth. They may expand their risk appetites and broaden underwriting criteria, launch new products, or enter into new lines of business or new territories. All of these behaviors have been evident during the recent soft market.

Of course, insurers create new products and venture into new markets throughout every phase of the market cycle – the soft market only provides incentives to accelerate the pace of these activities. Like other parts of the business world, the insurance industry is being shaped by powerful forces including technology, globalization, increased regulation, climate change and shifting demographics. These forces are transforming the risk profiles of policyholders, requiring insurers to rethink underwriting standards and to develop new products to respond to emerging risks. A hard market may lead some insurers to tighten underwriting criteria and reconsider certain growth strategies, but it seems nearly certain that many changes over the past several years are now imbedded within the competitive landscape of the insurance industry in ways that will outlast a change in the market cycle.

The impact of Superstorm Sandy remains to be seen, but based on early estimates from catastrophe modeling firms, Sandy will be an earnings event and not a capital event.

Overview of the property/casualty insurance industry

Property/casualty insurers and reinsurers were battered by catastrophe losses in 2011. Through the first half of 2012, however, published results were generally more favorable. According to the Insurance Information Institute, net income after taxes was $16.4 billion, up from $4.8 billion for the same period in 2011. Policyholders' surplus stood at $567.8 billion, just shy of the record $570.7 posted the prior quarter, but still up 3.2 percent over year end 2011. Net written premiums were up 3.6 percent through the first half of 2012.[1]

The impact of Superstorm Sandy remains to be seen, but based on early estimates from catastrophe modeling firms, Sandy will be an earnings event and not a capital event. In other words, Sandy will negatively impact earnings, but it will not be large enough to cause the industry to dig into surplus to pay claims. The impact of Sandy, however, will vary by insurer, depending on their concentration of business in the Mid-Atlantic and Northeast. Since Sandy is not likely to cause a reduction in surplus – a proxy for the supply of insurance capacity in the industry's supply-and-demand equation – the event probably will not have much of a long term impact on pricing trends.

Although Sandy most likely will not result in sharply higher premiums over the long term, rates were already trending higher in many lines of business – a phenomenon that is examined in detail below. This gradual increase in premiums comes on the heels of a soft market that began in late 2003. In addition to falling rates and broader coverage, the typical effects of a soft market include:

- Migration of business from the non-admitted market to the admitted market,
- An increase in product innovation, and
- A quest for less competitive markets.

Surplus lines market

Surplus lines carriers typically experience premium erosion in the soft phase of the cycle as admitted insurers expand their risk appetites and broaden their underwriting criteria. According to a report issued by the Surplus Lines Stamping Office of Texas, excluding New York, which processed a large amount of prior-year filings, the total number of items processed by the remaining 13 U.S. surplus lines stamping offices decreased 3.4 percent in 2011, while total premium was nearly flat.[2] This compares to a decrease in premium of 4.8 percent in 2010[3], and a 7.9 percent decline in 2009.[4] As the market firms and premium volume increases, standard lines insurers are less inclined to fish in the surplus lines pond.

Also excluding New York, premiums processed by stamping offices through June 2012 increased 11 percent compared with the first half of 2011. The number of filings, however, decreased suggesting that the surplus lines market is benefitting from higher premiums, but not from an increase in the volume of business written.[5] A full-fledged hard market would trigger a surge of premium back into the non-admitted market from the standard market.

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Innovation

A competitive market encourages underwriters to develop new products and to redesign existing ones, making them more appealing to a broader cross section of insurance buyers. This cyclical trend has been augmented by a need to respond to material changes in the risk profiles of many insureds, suggesting that the present surge in product innovation will outlive the soft market.

Insurers are introducing new products and enhanced coverages in virtually every segment of the commercial lines market, but one area that has been a hotbed of innovation is cyber-related insurance products. Companies increasingly are recognizing the depth of their data security and privacy exposures, and more are seeking out insurance solutions as part of an overall risk management program. Zurich-sponsored surveys of risk managers in 2011 and 2012, administered by Advisen, found that the number of companies buying cyber-related insurance products increased from 35 percent to 43 percent in the course of a single year. In recent years, insurers have introduced policies providing a broad package of first and third party coverages, including coverage for the costs to recover from a data breach.

Another area that has benefitted from innovation in recent years is products for multinational companies. Fast-growing emerging economies, advances in information and communication technologies, and liberalized trade policies throughout much of the world have made doing business abroad not only increasingly possible for a larger range of companies, but a competitive necessity for many. As companies expand outside their home countries, they look to their brokers and insurers to provide the coverages they need wherever they do business. Insurers have responded with products designed specifically for transacting business in a global business environment. These products provide necessary protection in ways that comply with local insurance regulations and minimize adverse tax consequences.

New markets

The credit crisis of 2008 and the ensuing recession fueled an already-highly competitive insurance market. As businesses scaled back or shuttered their doors, insurers found that they were battling for a shrinking pot of premium dollars. Premium written by U.S. insurers fell in .6 percent 2007, 1.3 percent 2008 and 3.7 percent 2009.[6] This situation sparked a quest for growth in underdeveloped and less competitive markets.

For example, hand-in-hand with the evolution of cyber-related insurance products has been a rapidly-growing number of insurers entering the cyber liability market. This is one of the few segments of the commercial insurance market to have shown strong growth in recent years and has significant potential for yet more growth in years to come. Advisen estimates that, once fully mature, the cyber liability market will represent about $4 billion in written premium. At present, the market is less than one quarter of that. The desire to take advantage of this explosive market already has attracted approximately 40 carriers.

Another segment that displayed solid growth in an otherwise constricting property/casualty market is directors & officers liability insurance (D&O) for private companies. While the credit crisis and ensuing recession suppressed demand for many lines of commercial P&C insurance, it may be one reason that demand for D&O insurance by private company directors and officers has been growing. Financial stress has been a factor in an increased number of claims against directors and officers by employees, creditors and others. Charges filed with the Equal Employment Opportunity Exchange, for example, skyrocketed from 83,000 in 2007 to nearly 100,000 in 2010.[7] Additionally, agencies such as the Federal Trade Commission, the National Labor Relations Board and the Department of Labor have stepped up enforcement activities, and private company directors and officers increasingly find they are in the crosshairs of regulators.

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Large insurers also are looking to fast-growing emerging economies as engines of growth. One large reinsurer notes that the rate of non-life premium growth slowed a bit in emerging markets in 2011, but remained "at a much higher level than industrialized markets."[8] As a result, insurers increasingly are looking to Asia, Latin America and Eastern Europe for growth opportunities. While expansion into developing markets may be motivated in part by a desire to grow during a soft market, it is a trend that is likely to maintain momentum throughout all phases of the market cycle. A recent survey by insurance equity analysts by Accenture found that an emerging market expansion strategy is perceived as critical to earning a "Buy" rating.[9]

Capacity and pricing

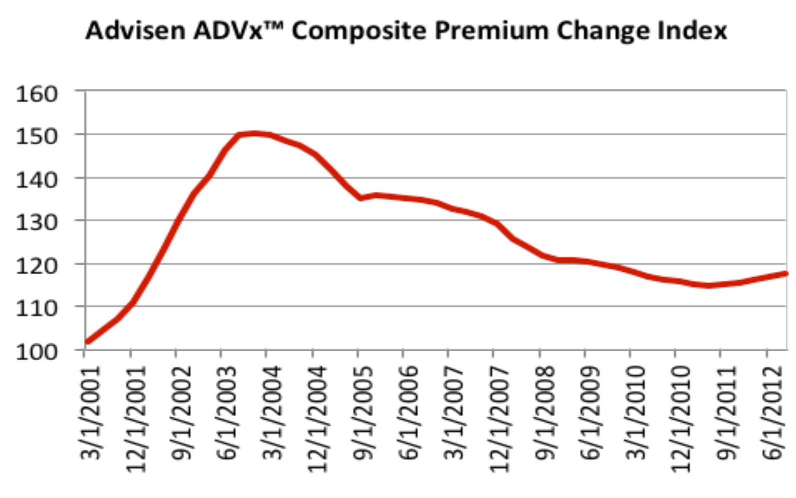
Along with "death" and "taxes," the "insurance pricing cycle" perhaps should be added to the list of life's certainties. Given that there has been a pricing cycle for as long as there has been a regulated insurance industry, it is perhaps surprising that there is no universally accepted explanation as to why the cycle exists. An increasing number of researchers now subscribe to the "capacity constraint" theory, which 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).

Seen through the capacity constraint lens, the insurance pricing cycle can be viewed in terms 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.

Exhibit 1, the Advisen ADVx™ Composite commercial lines pricing index, shows the change in average commercial lines premium by quarter beginning the first quarter of 2001 (Q4 2000 = 100). Typical of the commercial lines pricing cycle, the average premium increased sharply for a few years (2001-2003), and then fell at a more moderate pace until the third quarter of 2011. Over the past year it has slowly inched upward.

The market peaked at nearly 150 in the fourth quarter of 2003, meaning that the average commercial lines premium shot up 50 percent between the fourth quarter of 2000 and the fourth quarter of 2003. The value at the second quarter of 2011 was 114.4, and has since crept to 117.3 as of the third quarter of 2012.

Exhibit 1



Investment returns on the huge pools of assets held by insurers are a critical component of insurer profitability.

The current period of rising premiums – even though at a comparatively moderate pace – seems to contradict the capacity constraint theory since surplus remains at very close to an all-time high. The most likely explanation is that the combined impact of a number of factors unrelated to the volume of policyholders' surplus is putting upward pressure on premiums. Some of the factors that may be exerting upward pressure on rates include:

- **Underwriting losses.** The U.S. P&C industry posted a $33.6 billion underwriting loss in 2011, up from a $10.5 billion loss the prior year.[10] The increase was due substantially to property catastrophes, but they occurred against a backdrop of rate levels that, for some lines of business, had fallen to levels below those in 2000, the depths of the last soft market. P&C insurers reported a $7.0 billion underwriting loss through the first half of 2012.[11]
- **Low interest rates.** Investment returns on the huge pools of assets held by insurers are a critical component of insurer profitability. In the current low interest rate environment, lower investment income puts pressure on insurer results. 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.[12] Net investment income fell to $23.7 billion in the first half of 2012, as compared to $24.8 during the same period in 2011.[13]
- **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. Demand, however, has not increased enough for this factor alone to account for the upward trend in pricing. U.S. Gross Domestic Product, a good proxy for insurance demand, grew about 12 percent since the end of 2009, but policyholders' surplus, representing supply in the insurance supply-and-demand equation, grew about 10 percent over the same period.
- **Impact of RMS 11.** Some insurance industry executives have suggested that adoption of the influential RMS 11 catastrophe model has effectively reduced the capital to support underwriting activities even though there has been no reduction in actual policyholders' surplus. Under RMS 11, expected losses for many hurricane scenarios increased. The model implies that insurers and reinsurers need to allocate more capital to hurricane exposed business, thereby reducing the capital available to support other lines of business. RMS 11, however, has not been universally and unequivocally adopted by the P&C industry, and this factor alone seems unlikely to account for price increases.

These various factors encourage underwriters to push pricing higher, but the question remains whether the rate increases are sustainable. Absent the impact of Sandy, the answer probably is "no." Despite underwriting losses and low interest rates, the industry continues to be profitable – the return on average surplus was 5.9 percent during the first half of 2012. Considering that the industry is also overcapitalized by some measures, underwriters may find it difficult to maintain upward pressure on rates.

A rough measure of underwriting capacity is the ratio of policyholders' surplus, representing the supply side of the supply and demand equation, to US GDP, a proxy for demand. Presently, surplus stands at about 3.6 percent of GDP, down from a high of 3.8 percent in 2011, but still very strong. Historically the tipping point between hard and soft markets is roughly 3.2 percent. As previously noted, losses from Sandy most likely will hurt earnings, but not eat into surplus. The P&C industry most likely will enter 2013 in a very strong capital position.

Planning for 2013 and beyond

Although the P&C industry is very well capitalized, which typically puts downward pressure on premiums, Sandy likely will be a catalyst for short term rate hikes, especially for property in catastrophe exposed regions.

Although the P&C industry is very well capitalized, which typically puts downward pressure on premiums, Sandy likely will be a catalyst for short term rate hikes, especially for property in catastrophe exposed regions. Sandy's losses will support the current upward trend in premiums driven by underwriting losses, low interest rates, growing demand and the influence of RMS 11. Nonetheless, unless Sandy losses are much larger than currently estimated, the U.S. P&C industry is likely to end the year with a modest profit. Policyholders' surplus probably will hold steady, but it is vulnerable to the performance of the equity and fixed income markets. While a last minute agreement was reached by U.S. lawmakers to avoid plunging over the "fiscal cliff," which threatened to spark another recession, an imminent battle over raising the U.S. debt ceiling still could wreak havoc on financial markets.

Assuming the Republican House and the Democratic Senate and Administration can overcome their differences and pass legislation that keeps the economy on track, insurance buyers can expect the upward premium trend to subside in most lines. The lingering impact of Sandy may keep modest upward pressure on rates in some segments of the property market, and unsustainable workers' compensation loss ratios may drive premiums higher in some states, but for many lines of business, rate increases are likely to flatten as excess capacity overwhelms those factors that presently are pushing premiums higher.

Of course, the wild card every year is catastrophe losses. A single mega-catastrophe, or a series of smaller events, could destroy enough surplus to send rates higher. However, it should be kept in mind that the insurance industry has proved to be remarkably resilient. Back-to-back record-shattering years of hurricane losses in 2004 and 2005 had almost no long-term impact on rate levels outside segments of the property market. The catastrophe-driven underwriting losses of 2011 most likely is one factor in the current round of rising premiums, but since those losses did little to reduce excess surplus, their long-term impact is likely to be muted at best.

NOTES:

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