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THE STATE OF THE COMMERCIAL P&C MARKET

April 2012

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Executive summary

An underwriting loss in 2011 and very low interest rates are among the factors prompting insurers to push for rate increases. Premiums are edging higher in most lines of commercial P&C business, but policyholder's surplus – a measure of market capacity – remains near its all-time high. Rates are likely to continue to increase incrementally, but barring exceptional catastrophe losses in 2012, the type of hard market experienced in 2001-2003, when the average commercial lines premium shot up 50 percent, is unlikely.

Introduction

Insurers are breathing a sigh of relief as rate levels continue to inch higher in many lines of business, reversing an eight-year trend of falling premiums. Driven by record catastrophe losses in 2011, dwindling investment returns, and growing demand for insurance capacity as the economy improves, renewal premiums tracked by Advisen have been flat to slightly higher in property, general liability and workers' compensation in each of the past two quarters. While insurance executives hail the increases, which they claim are essential to maintaining the health of the property & casualty industry, the industry is very well capitalized, which could make the rally difficult to sustain. Catastrophe losses were principally responsible for a small drop in policyholders' surplus in 2011. However, at an estimated $563 billion as of the end of 2011,[1] surplus remains at a near-record level.

Insurers are breathing a sigh of relief as rate levels continue to inch higher in many lines of business, reversing an eight-year trend of falling premiums.

Insurance buyers can expect to see premiums continue to creep higher in 2012, though barring major catastrophe losses, the type of skyrocketing premiums that characterized the 2001-2003 hard market are unlikely. Among the factors that will influence the pace of change in the cost and availability of insurance coverage are further catastrophe losses, reinsurance capacity and rates, investment returns and the state of the overall economy.

With rising premiums and an improving economy come other changes in the market. As organic growth returns, insurers are more inclined to "stick to their knitting," or perhaps more precisely, to "return to their knitting." One outcome will be a slowing, and eventually a reversal, of the flow of premium from the nonadmitted market to the admitted market, which typically happens in a soft market as some standard lines insurers broaden their underwriting appetite to bolster the top line. Insurers also have looked to fast-growing emerging markets to offset falling written premium in industrialized markets, but globalization is a pervasive trend that will continue despite improvements in domestic markets.

The insurance pricing cycle

The pricing cycle has been a feature of the insurance market for as long as there has been a regulated insurance industry. It is therefore 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.

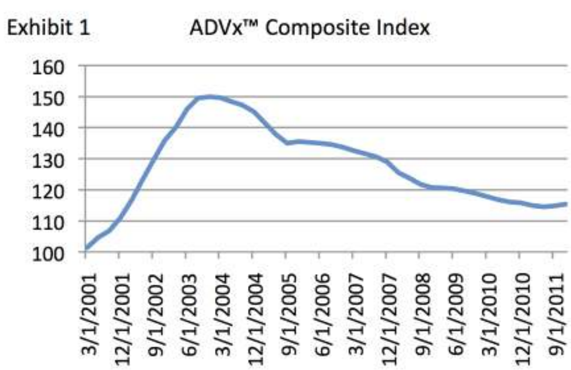
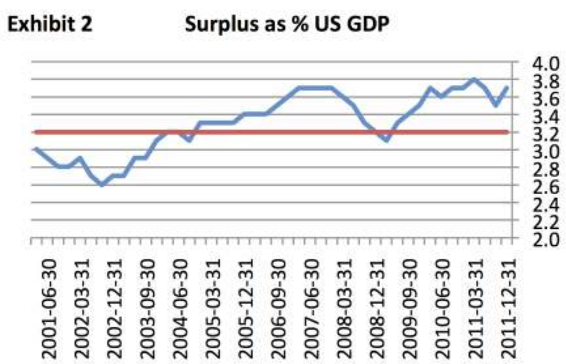


Exhibit 1, the Advisen ADVx™ Composite commercial lines pricing index, shows the change in the average commercial lines premium by quarter beginning the first quarter of 2001 (Q4 2000 = 100).[2] Typical of the commercial lines pricing cycle, the average premium increased sharply for a few years (2001-2003), and then fell at a more moderate pace until the fourth quarter of 2011, when it began to inch upward.

The market peaked at 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, and has since crept to 115 as of the end of 2011. Looking behind the aggregate index value at the individual components, both general liability and workers compensation average premiums remain below 2000 values.

Exhibit 2 shows US policyholders' surplus as a percentage of US GDP over time. As previously noted, policyholders' surplus is a measure of insurance supply while GDP can be viewed as representative of demand since in mature economies economic growth is the principal driver of the need for more insurance. Increasing values mean that growth in supply (policyholders' surplus) exceeds the growth in demand (GDP), ultimately leading to falling premiums. Conversely, when values are decreasing, it means that supply is shrinking relative to demand (or demand is increasing faster than supply), and premiums eventually will rise. Historically, surplus equal to 3.2 percent of GDP (red line) represents the approximate point at which supply and demand are in balance. When the ratio rises above that point, the market typically moves into the soft phase of the cycle, and vice versa.



Sources: A.M. Best, III, U.S. BEA

Based on A.M. Best's estimate of year-end surplus,[3] the ratio is 3.7 at year-end 2011, only slightly below the all-time high of 3.8 recorded in the first quarter of 2011. This suggests that rising premiums still are facing the stiff headwind of overcapacity.

The commercial property/casualty insurance market, of course, is comprised of a number of segments defined by line of business, industry and geography. Not every segment always moves in unison with the overall market trend. Insurers allocate capital according to where the greatest profit potential exists at any point in time, and may elect to cut back in, or altogether discontinue their participation in, unprofitable segments. An example is financial institution (FI) D&O, which saw premiums skyrocket in 2009 in response to claims arising from the credit crisis. This sort of sector-specific hardening, however, tends to be comparatively short lived. In an otherwise well-capitalized market, rising rates attracts capital back into the segment. Additionally, the factors causing claims to rise often are temporary.

Some of these factors will contribute to a further decrease in capacity or an increase in demand, and therefore will support the current firming trend.

Forces at work on the insurance cycle

Among the factors that are influencing the pricing cycle, or that may influence it in the near future, are:

- The economic recovery,
- Catastrophe losses,
- Interest rates,
- The bull stock market,
- New capital, and
- Loss reserve adequacy.

Some of these factors will contribute to a further decrease in capacity or an increase in demand, and therefore will support the current firming trend. Others, however, are likely to contribute to surplus growth, which will help keep rate increases in check.

The economic recovery

As the economy grows, the demand for insurance capacity increases, which should contribute to higher rates.

What is now widely known as the Great Recession began in December 2007 and ended in June 2009, according to the National Bureau of Economic Research, a private panel of economists. Recovery is underway, but growth is moderate compared to the severity of the downturn. The consensus outlook among economists is for slow, but accelerating growth in 2012,[4] though some are less optimistic. Goldman Sachs economist Jan Hatzius, for example, expects U.S. economic growth to diminish somewhat due to spillover from the European sovereign debt crisis and the impact of fiscal restraint measures coming from Washington.[5]

Catastrophe losses

An unusually active year for natural catastrophes around the world resulted in insured losses of about $108 billion in 2011 according to reinsurance broker Guy Carpenter & Company.[6] These events included earthquakes in Japan and New Zealand, floods in Thailand and Australia, a record breaking tornado season in the United States and Hurricane Irene making landfall along the U.S. east coast. A.M. Best estimates accident year insured catastrophe losses of $44.1 billion for U.S. insurers.[7] Catastrophe losses were the principal contributor

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to an underwriting loss for the year: A.M. Best estimates a 2011 combined ratio for the P&C industry of 107.5 percent, up from 101.0 in 2010.[8]

Large catastrophes, or an accumulation of smaller ones, can destroy excess capacity and be the catalyst for sharply higher premiums across the entire commercial lines insurance market. However, even the extreme events of 2011 were insufficient to drain any meaningful amount of excess capacity: A.M. Best estimates that policyholders' surplus fell only 1.4 percent in 2011.[9]

Although not sparking a surge in rate levels, underwriting losses resulting from catastrophe claims undoubtedly have been one of the drivers of incrementally higher premiums in the second half of 2011 and into 2012. Property premiums in catastrophe-exposed areas have seen the largest increases, though only about 10 percent more on average than non-catastrophe premiums for January renewals. According to Marsh, catastrophe-exposed risks experienced an average increase of 5.7 percent, while non-catastrophe exposures rose 5.2 percent on average.[10]

The year already has seen unusual activity with early season tornados in the U.S. that caused up to $2 billion in insured losses across five states.[11] However, Philip Klotzbach and William Gray, Colorado State's highly-regarded hurricane forecasters, are predicting a below-average probability for major hurricanes making landfall along the United States coastline and in the Caribbean during 2012.[12]

Interest rates

Investment returns on the huge pools of assets held by insurers are a critical component of insurer profitability. In the current very 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.[13] Excluding a $2 billion increase in dividends one insurer received from a major noninsurance operation acquired in early 2010, net investment income declined by $0.8 billion, or 2.2 percent, through the first nine-months of 2011.[14]

In a sampling of interest-rate forecasts for 2012 by Barron's, the consensus was the yield on the benchmark 10-year Treasury note has no further room to fall and will be headed higher. The magazine notes, however, that also was the consensus a year ago — before Treasury yields plunged to previously inconceivable low levels.[15] As of the end of February, yields on

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10-year Treasury notes fell to 1.89 percent, down from the year's high of 2.09 percent on January 23, according to data compiled by Bloomberg. The yield averaged 2.76 percent in 2011 and 3.19 percent in 2010.[16]

Low interest rates are eating away at insurer return on equity, but they have contributed to the growth in policyholders' surplus since 2009. Surplus is boosted by falling interest rates since yields and bond prices move in opposite directions. Conversely, if interest rates rise, they will improve insurers' net income, but would reduce the value of the bond portfolio comprising the largest portion of policyholders' surplus.

Stock markets

Between October 9, 2007 and March 6, 2009, the Dow Jones Industrial Average fell from 14,164.43 to 6,443.27. Though insurers are far more heavily invested in bonds than in stocks, the market crash nonetheless erased tens of billions of dollars of policyholders' surplus. Stock markets have rebounded strongly, replenishing surplus. In March both the Dow Jones Industrial Average and the S&P 500 hit highs not seen since before the stock market collapse of 2008. Rising stock prices contribute to higher policyholders' surplus and therefore to more competitive pricing.

New capital

How high rates rise, and how long the hard market persists, will depend in part on how much new capital – and therefore new capacity – is attracted to the market. The relative ease of forming new insurers and reinsurers in Bermuda and other locations with business-friendly tax and regulatory environments has increased the efficiency of the insurance market: new capacity can be quickly created to take advantage of rising premiums and gaps in capacity. However, capital rushing in to take advantage of rising rates in an already well capitalized market could smother the rally. Looking at new capital raised in Bermuda following major loss events in the past, $8.7 billion flowed onto the island to capitalize the "Class of 2001," formed to take advantage of sharply higher premiums triggered in part by the September 11 terrorist attacks, and $5 billion was raised following the record-shattering 2005 hurricane season.

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Reserve adequacy

Insurers maintain cash reserves for losses that have been incurred but not yet paid. During 2008-2011, insurers released loss reserves for prior years losses deemed redundant by actuaries. These releases offset losses on other parts of the financial statement and boosted reported results. The Insurance Information Institute notes that billions of dollars of insurer profits reported over the past several years were actually the result of downward revisions in loss reserves. Fitch reports that, of the 47 publically traded insurers in their sample, some reported 2011 reserve deficiencies, but overall loss reserve redundancies reduced the aggregate group loss ratios by 3.3 percentage points for the year.[17]

Once reserves are at the level of expected future loss payments, insurers lose an important cushion against adverse developments. Reported results will not have the benefit of reserve releases from prior years, and will be more reflective of actual competitive conditions in the market. Companies that have been overly aggressive in releasing reserves will be compelled to correct the deficiencies. Standard & Poor's warns of "greater susceptibility to adverse reserve development for long tailed commercial lines" in 2012.[18]

Other market characteristics

The market cycle is defined in terms of pricing, but it has other characteristics. These include the volume of business written in the nonadmitted market, the relative attractiveness of business produced by program administrators and managing general agents (MGAs), the pace of mergers and acquisitions, and the relative attractiveness of emerging markets. These characteristics are driven by pricing and capacity issues typical of the market cycle, but some of these characteristics also have been influenced by recent economic developments.

During soft markets insurers often seek out additional sources of premium to prop up sagging top lines. This soft market has seen written premium volume take an even larger hit because of reduced demand resulting from the recession. Some insurers have sought to increase written premium are by acquiring books of business or by expanding their underwriting appetite, which may include business usually written in the nonadmitted market.

Ordinarily, the bottom of the pricing cycle represents a prime opportunity for stronger companies to grow by acquiring weaker rivals. That has not proved to be the case in this cycle. Insurance M&A came to a near-standstill in 2009 and has only been gradually picking up.

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According to Deloitte, insurance company M&A activity has been undercut by "uncertainties about the U.S. and global economies, regulatory reforms, tax reform, accounting reform and other concerns."[19]

According to a Conning study, of the limited M&A taking place, "targeted bolt-on acquisitions of specialized units" have been the focus of many acquiring companies. Alternatively, insurers are seeking to acquire portfolios, renewal rights, and marquee underwriters.[20] Some insurers have set their sights on acquiring MGAs as a way to grow premium volume. The appetite for program business in general typically increases in a soft market as more insurers see programs as an avenue for growing premium and market share.[21] As compared to buying another insurer, purchasing an MGA can be much cheaper with fewer regulatory considerations and without the legacy claims issues that often plague insurers. MGAs with expertise in good performing niches are especially desirable targets. This will become a less attractive option as the economy improves and rates increase.

Surplus lines carriers typically experiences premium erosion in the soft phase of the cycle as business flows from the nonadmitted market to the admitted market. 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.[22] This compares to a decrease in premium of 4.8 percent in 2010[23], and a 7.9 percent decline in 2009.[24] As premium volume increases, standard lines insurers are less inclined to fish in the surplus lines pond. A full-fledged hard market would trigger a surge of premium back into the nonadmitted market.

Depressed written premium volume also has been a catalyst for insurers and brokers to expand into fast-growing emerging markets. Swiss Re 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."[25] As a result, insurers increasingly are looking to Asia, Latin America and Eastern Europe for growth opportunities.

A rousing hard market would take some of the pressure off insurers and brokers to expand into emerging markets, but the long term trend clearly is towards globalization. Even without the impact of the soft market and the recession, insurance markets in mature economies such as the U.S. and Western Europe are not expected to grow more than low single digits. Most companies are fully insured, so premium growth is driven principally by an increase in exposure units as the economy grows. In contrast, overall economic growth is coupled with increasing insurance density in many emerging markets, leading to robust growth in written premium.

One or more major catastrophic events could drain enough capacity to trigger sharply higher premiums across the commercial lines market, as was seen in the 2001-2003 hard market.

Conclusions and outlook for 2012 and beyond

The current firming trend is likely to prevail through 2012, but barring one or more extreme events, an overabundance of capacity will keep the size of rate increases in check. Poor underwriting results in 2011 and the prevailing low interest rate environment are encouraging insurers to push for higher rates, but near-record policyholder's surplus will assure a competitive marketplace. After an overall decline in written premium over the past several years, growth is returning to the market due to both rising rate levels and an improving economy. This will take the pressure off some insurers to grow the top line through measures such as acquiring books of business and broadening their underwriting appetite. Despite more attractive domestic market conditions, however, expansion into emerging markets will increase as many insurers and brokers view these markets as long-term engines of growth.

One or more major catastrophic events could drain enough capacity to trigger sharply higher premiums across the commercial lines market, as was seen in the 2001-2003 hard market. However, these would necessarily be extraordinary events. Even $44 billion in insured catastrophe losses barely dented U.S. surplus in 2011. An important difference between 2001 and the present is that surplus as a percentage of GDP was below 3.0 in 2001 – indicating the market was comparatively undercapitalized – whereas at the end of 2011 the ratio was approximately 3.7, close to an all-time high.

Other than catastrophe losses, excess capacity could be drained by capital losses from investments. Capital losses from the crash of equity markets were largely responsible for an $85 billion plunge in policyholder's surplus in 2008 and early 2009. No major correction is anticipated in the near future, however.

Some sector-specific hardening is always possible – similar to the surge in rates in financial institution D&O triggered by the credit crisis in 2008 – and, in fact, some segments of the current market are experiencing more rapidly rising premiums. However, the types of shocks that cause segment-specific increases are usually difficult, if not impossible, to predict. The most likely scenario is that rates will continue to edge higher for a while, but until some negative net worth shock sends premiums sharply higher, insurance buyers will continue to experience a favorable pricing environment. ■

NOTES:
1 "P/C Insurers' Combined Ratio for 2011 Estimated at 107.5%, Insurance Journal," Feb 20, 2012 http://www.insurancejournal.com/magazines/features/2012/02/20/235816.htm
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