

The Hard Market is Coming (But Don't Hold Your Breath)

An Advisen Special Report

Executive Summary

A five-year soft market, fueled by chronic overcapacity, is coming to an end. Following two years of record profits, losses from both underwriting and investment activities are destroying excess insurance capacity, signaling that the bottom of the commercial insurance pricing cycle is near.

Average rate levels for commercial insurance will level off by the second quarter of 2009 and will begin to creep higher beginning the fourth quarter of 2009 or the first quarter of 2010. However, a deepening global recession may delay the return of hard market conditions by suppressing demand for insurance. In the absence of major natural catastrophes, which could trigger skyrocketing premiums, the hard market will be more gradual, and also more prolonged, than has been the case in recent cycles.

Economic recession and the commercial insurance pricing cycle

The commercial insurance pricing cycle is a function of the law of supply-and-demand: when the supply of insurance – as measured by the capital held by insurers to support underwriting – grows faster than the growth in demand for insurance, rates fall. Between the fourth quarter of 2003 and the second quarter of 2008, capital to support underwriting grew rapidly, driven by underwriting profits and strong investment returns. The rapid accumulation of risk capital fueled competition, driving down rate levels.

In mature economies such as the U.S., Canada and Western Europe, the demand for insurance grows roughly at the same pace as the growth in the overall economy. Until the collapse of the U.S. subprime mortgage market thrust the global economy into a recession, economic growth was robust, though the increase in insurance supply far outstripped the growth in insurance demand.

The present economic crisis impacts both the supply of and the demand for commercial property & casualty insurance. On the supply side of the equation, plummeting stock markets, frozen credit markets and, in some cases, investments in “toxic” mortgage-backed assets, caused many insurers to post investment losses in the third quarter. These investment losses are on top of underwriting losses driven by five years of price cutting, higher than average catastrophe losses (\$24.9 billion, higher than the full year totals for both 2006 and 2007), and reserves for directors and officers liability (D&O) and errors and omissions liability (E&O) claims resulting from the subprime mortgage meltdown and the subsequent credit crisis (\$9.6 billion in ultimate losses over accident years 2007, 2008 and 2009, according to Advisen forecasts). Through nine months of 2008, the U.S. property & casualty industry's net income after taxes fell 85 percent to

\$7.3 billion according to A.M. Best. After-tax return on equity (return on surplus), was only 1.4 percent for the nine month period; down from 9.5 percent for the same period of 2007. Best projects the first full-year underwriting loss since 2005.

Advisen estimated the property and casualty insurance industry was roughly \$100 billion overcapitalized as of the end of 2007. In other words, policyholders' surplus – statutory accounting terminology for the capital supporting underwriting operations – needed to be reduced by about \$100 billion through losses, dividends, share buy-backs or other means to bring insurance supply in line with demand. U.S. policyholders' surplus declined \$36.8 billion, or 7.0 percent, for the 12 months ended September 30, 2008, according to A.M. Best. Consultancy Towers Perrin forecasts as much as an \$80 billion decrease in surplus by the end of 2008.

While \$80 billion represents a significant chunk of the \$100 billion in excess capacity – and moves the market much closer to the bottom of the soft market cycle – the demand side of the supply-and-demand equation also has changed since the end of 2007. According to the International Monetary Fund, the global economy is now in a recession, with growth projected at 2.2 percent for 2009, down from 3.7 percent projected for 2008. The IMF projects that advanced economies as a group will contract 0.3 percent, with the U.S. contracting 0.7 percent.

As companies downsize, the demand for insurance not only decreases, it decreases at a pace faster than the contraction of the overall economy. While going without insurance is not an option for most companies, many will look for ways to slash their insurance bills. An obvious option is to raise retentions (though perhaps a short-sighted one in a soft market, when some policies are priced below cost). The use of captives and other alternative risk financing mechanisms will increase. More companies will gravitate to low-cost providers, even if it is necessary to loosen financial security criteria. These are typical responses to hard market conditions, but it is likely companies will resort to them even before the market turns as they are squeezed by a deteriorating economy. All these factors will help prolong the current soft market.

Advisen forecasts that the present soft market will have a “soft landing” in the second quarter of 2009. In the absence of very large insured natural catastrophes, underwriting losses combined with anemic investment returns should begin to exert upward pressure on rates by the fourth quarter of 2009 or the first quarter of 2010. One or more large catastrophes could accelerate the process. Conversely, deeply deteriorating economic conditions could delay the turn in the market.

The AIG effect

“AIG has intensified its efforts to increase its market share, or at least preserve it,” complained Liberty Mutual Group chairman, president and CEO Edmund F. Kelly during a conference call with analysts. “In fact, it's fair to say they are doing some very stupid things in the market.” Kelly isn't alone in his criticism of American International Insurance Group insurance companies. Senior executives from several other companies made similar observations to analysts.

After narrowly averting bankruptcy in September, AIG has had to reassure nervous policyholders that the insurance operations are viable while fending off attacks by newly emboldened competitors. With an 11 percent market share, AIG is the largest commercial lines insurer in the United States. If the company were to slash premiums to retain market share, the short term impact would likely be an intensification of soft market conditions. However, based on a recent Advisen poll of 17 commercial lines

brokers, AIG appears to be competing vigorously, but not irresponsibly. Brokers generally concurred that AIG should not be singled out for driving down rates – other insurers also are fueling the soft market. One broker commented that some insurers are so obsessed with winning AIG customers that they, not AIG, are more responsible for cutthroat competition.

A weakened AIG battling for renewals could prolong soft market conditions in some competitive sectors. AIG is perceived by its competitors as vulnerable. As a result, competition for its clients will remain intense. This heightened level of competition may keep price levels in some segments of the commercial lines market depressed after economic factors indicate the market should be hardening.

The coming hard market

One or more very large catastrophe losses could trigger a sudden and sharp increase in insurance prices. If, however, catastrophe losses are mild-to-moderate in 2009, average commercial insurance prices will begin to slowly creep higher in the fourth quarter of 2009 or the first quarter of 2010. Not every line of business will increase at the same pace. Premiums already have increased for financial institution D&O and E&O, where claims are up sharply because of the meltdown of the subprime mortgage market and the ensuing credit crisis. The reinsurance market will firm up sooner than the overall primary insurance market, placing upward pressure on heavily reinsured lines such as excess liability. Workers compensation, which saw premiums fall steeply as a result of reforms in several large states in 2005 and 2006, has largely stabilized and is likely to see premiums begin to drift higher by mid-2009. Property insurance pricing will remain soft through 2009, with premiums in some catastrophe-prone regions, which experienced triple digit increases in many cases after the 2005 hurricanes, continuing to fall into 2010 if there are no major loss events.

Typically, rising premiums attract new capacity to the insurance market. Business-friendly offshore domiciles – especially Bermuda – make it comparatively simple to quickly launch new insurance and reinsurance companies to take advantage of higher rates. Between 2000 and the end of 2003, for example, investors pumped over \$20 billion into new companies in the U.S. and Bermuda formed specifically to capitalize on the perceived opportunities of a hardening market. Additionally, new forms of short-term capacity such as catastrophe bonds and reinsurance sidecars attract opportunistic investors that may not be interested in longer-term commitments of capital to traditional insurance companies.

The influx of new capacity, though intended to take advantage of rising premiums, increases competition and eventually chokes the hard market. In the current economic environment, however, skittish investors, dysfunctional credit markets and deleveraged hedge funds may mean that much less capital will be available to fund new insurance and reinsurance companies or for investments in alternative sources of capacity. As a result, the coming hard market may last longer than has been typical of past cycles.

This Advisen Special Report was written by David Bradford, Executive Vice President, 917-445-3088, dbradford@advisen.com

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