



THE INSURANCE MARKET IN 2011

Rising Rates Battle Near-record Capacity

An Advisen Special Report Sponsored by Swett & Crawford

November 2011

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Executive summary

Rising premiums during the third quarter is good news for property/casualty insurers, which have endured eight years of soft market conditions. Rate increases, however, may not yet be sustainable. Capacity is at near-record levels despite one of the worst years ever for catastrophe losses. Underwriters undoubtedly will try to push rate levels higher, but it will be an uphill fight against excess capacity, which encourages competition.

Introduction

For the first time in nearly eight years, three of the four lines of business comprising the Advisen ADVx Composite Pricing Index increased during a quarter. For Q3 2011, property, general liability (GL) and workers' compensation all increased, albeit modestly. Only the D&O index trended lower.

Many insurers have confirmed that rates are rising. For example, Chubb reported a 4 percent rate increase on its standard commercial business in the third quarter, ACE saw property and casualty rates rise 3.2 percent in its US retail business and the Commercial Division of CNA reported an overall 2 percent rate increase in the quarter. Few insurance company executives, however, are breaking out the champagne and declaring the soft market dead and buried. Capacity, as measured by policyholder surplus, is at a near-record high. By some measures, the commercial lines insurance market is significantly overcapitalized, which does not bode well for a sustained rate rally.

The current round of rate increases appears to be driven as much by market psychology as by market economics. Just as stock markets can be in the grip of “irrational exuberance,” the insurance market can be driven at times by underwriter enthusiasm overpowering market fundamentals. The insurance market is not necessarily behaving irrationally – a case can be made for why rates should increase – but sustainable hard markets typically require one or more extreme events that decimate insurer results and destroy excess capacity. Globally, 2011 has been close to a record-breaking year for catastrophe losses, but as of the end of the second quarter, US insurers had managed to eke out a profit and policyholder surplus – a measure of market capacity – was at near-record levels. The pain may not yet be sufficiently intense to motivate a lasting change in insurers’ behavior.

Profits and Losses

Despite the catastrophe losses, US insurers managed to be profitable.

Insurers and reinsurers around the world have incurred near-record catastrophe losses as a result of the cumulative impact of earthquakes, floods, hurricanes, tornados and wildfires. For the first nine months of 2011, global catastrophe losses reached \$76 billion, of which two thirds are tied to catastrophes in Japan, New Zealand and Australia, according to a report from reinsurance broker Guy Carpenter & Company.¹ In the US, insurers have paid sizeable sums for unusual events such as the extremely rare EF5 multiple-vortex tornado that struck Joplin, Missouri, and Hurricane Irene, whose path of destruction ran from the Caribbean to Atlantic Canada. Through the first six months of 2011, US insurers racked up nearly \$20 billion in catastrophe losses, with Hurricane Irene likely to contribute an addition \$3 billion to \$4 billion in the third quarter.²

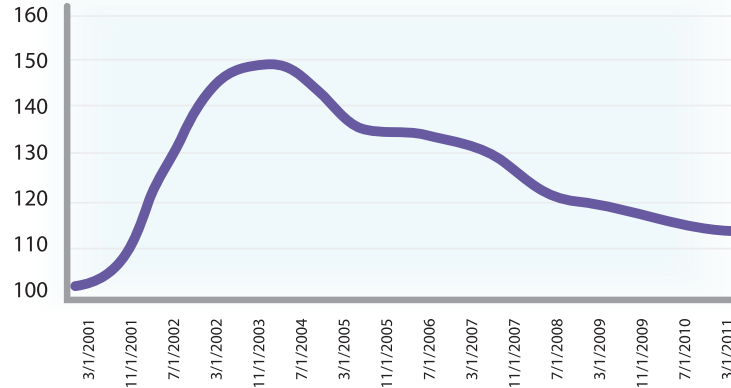
Despite the catastrophe losses, US insurers managed to be profitable. Net income, after tax for private US property/casualty insurers was \$4.8 billion in the first half of 2011, according to the Property Casualty Insurers Association of America (PCI), the Insurance Information Institute (III) and ISO. While net income was far below the \$16.8 billion recorded for the same period in 2010, it was nonetheless a tolerable performance in a challenging and unusual year. Annualized statutory rate of return on average surplus was 1.7 percent. Perhaps most significantly as concerns the market cycle, the quarter ended with capacity virtually unchanged — down just 1 percent—from the record set in the prior quarter. Policyholders’ surplus totaled \$559.1 billion as of June 30, 2011, falling by just \$5.6 billion from the all-time record of \$564.7 billion at March 31, 2011.³

1. Mark E. Ruquet, “Asia Catastrophes Account for Bulk of Cats in 2011,” *PropertyCasualty360.com*, November 1, 2011, <http://www.propertycasualty360.com/2011/11/01/asia-catastrophes-account-for-bulk-of-cats-in-2011?t=reinsurance>

2. “2011 - First Half Results,” *Insurance Information Institute*, <http://www.iii.org/articles/2011-first-half-results.html>

3. *Ibid*

Exhibit 1: ADVx™ Composite Premium Change Index



The insurance pricing cycle

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).⁴ Typical of the commercial lines pricing cycle, the average premium increased sharply for a few years (2001-2003), and then fell for a longer period at a more moderate pace. In Q3 2011 the composite index posted its first increase since Q4 2005, when sharply higher property premiums in reaction to Hurricane Katrina caused a one quarter bump in the index. In the third quarter of this year, the index increased slightly from 114.42 to 114.68.

The market peaked at about 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. As of the third quarter of 2011, the index value was 114.68, meaning that the average commercial lines premium is still about 15 percent above the fourth quarter of 2000. Looking behind the aggregate index value at the individual components, however, both general liability and workers compensation average premiums are below 2000 values.

The pricing cycle has been a feature of the insurance market for as long as there has been a regulated insurance industry. Perhaps surprisingly, there is no universally accepted explanation as to why the cycle exists. An increasing number of analyst now buy into 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). The following description of market dynamics assumes the capacity constraint model accurately describes the market cycle.

4. The ADVx™ Composite index is the weighted average of changes in average premiums for commercial property, general liability, workers compensation and directors & officers (D&O) liability. It is compiled from renewal information provided to Advisen by risk managers and brokers.

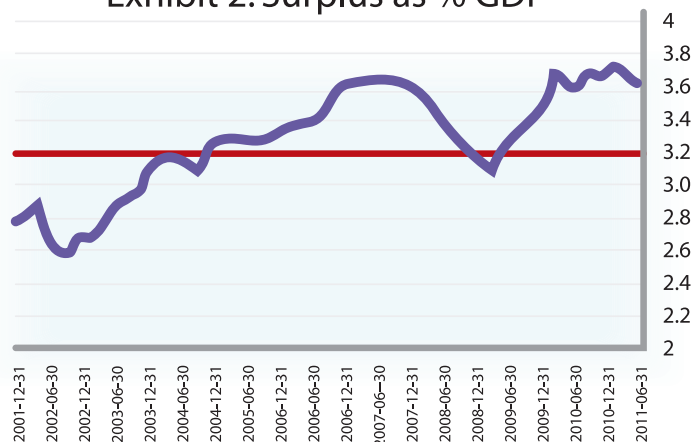
The insurance pricing cycle can be viewed in terms of supply-and-demand economics. When the supply of insurance capacity increases faster than the demand for that capacity, prices fall. Conversely, when supply constricts relative to demand, prices increase. During the “soft” phase of the cycle, prices fall due to an abundance of insurance capacity relative to wavering demand. While the cycle is inviolable, the timing and magnitude of changes in pricing throughout the cycle are subject to an array of forces that often are difficult to foresee and quantify.

Supply in the insurance supply-and-demand equation can be viewed as a function of the amount of capital insurers hold to support underwriting – “policyholders’ surplus,” or simply “surplus,” in US insurance jargon. The more capital insurers hold, the more capacity they have. Insurers are overcapitalized during soft markets, and as a result, they compete to put the excess capacity to work.

In mature economies such as North America and Western Europe, Gross Domestic Product (GDP) can be seen as a proxy for demand – or rather, the change in GDP represents the change in demand for insurance capacity. Since most companies already are fully insured, the need to buy more insurance is directly tied to growth, represented by the change in GDP.

Exhibit 2 shows US policyholders’ surplus as a percentage of US GDP over time. Increasing values mean that growth in supply (policyholder 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 about 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. Conversely, when it falls below 3.2 percent, the market is poised for the hard phase.

Exhibit 2: Surplus as % GDP



Sources: III, US Bureau of Economic Analysis

The ratio plunged to about 3.2 percent at the end of 2008, and reached 3.1 percent by the first quarter of 2009, suggesting that the cycle was on the verge of a change. However, an increase in policyholders' surplus in the second half of 2009 driven largely by capital gains forced the ratio back above the 3.2 percent threshold, where it remains. This suggests the market is well capitalized, and tens of billions of dollars in capacity need to be removed from the equation before a sustained hard market is likely to take hold.

Forces at work on the insurance cycle

The Federal Reserve has lowered its forecast for economic growth to 1.7 percent for 2011, down from a forecast of 2.7 percent issued over the summer.

The supply of insurance capacity, as represented by policyholders' surplus, relative to the demand for that capacity is the factor exerting the greatest long-term influence on the insurance market cycle. Elements that presently are, or soon may be, influencing either the supply of, or demand for, insurance capacity include:

- The economic recovery,
- Catastrophe losses,
- Investment gains,
- The stock market/unrealized capital gains and losses,
- Insurer loss reserve adequacy, and
- New capital

Recession and recovery

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 – some might say anemic – compared to the severity of the downturn. The Federal Reserve has lowered its forecast for economic growth to 1.7 percent for 2011, down from a forecast of 2.7 percent issued over the summer.

Written premium volume fell during the recession years as companies downsized and went out of business. Lines of business such as general liability and, especially, workers compensation, which base premiums on factors such as revenue and payroll, were especially hard hit. The subdued level of economic activity during the recovery has kept premiums depressed, but the tide is turning: written premium increased over five consecutive quarters through Q2 2011. Although growth is underwhelming – just 2.6 percent in the first half of 2011 – five consecutive quarters of growth confirms that the demand for insurance is slowly beginning to increase.⁵ Greater demand may be a contributing factor, though certainly a small one, to rising rates in the third quarter.

Insurance supply – policyholders' surplus – took a beating from investment losses in 2008 and the first quarter of 2009. According to statistics reported by ISO and the Property Casualty Insurers Association of America (PCI), and analyzed by the Insurance Information Institute, US P&C surplus fell by nearly \$85 billion (16.2 percent) between the fourth quarter of 2007 and the first quarter of 2009. Much of the staggering loss of surplus was due to unrealized capital losses from plummeting stock markets. With the rebound of the stock markets, surplus increased sharply. Surplus also was boosted by falling interest rates: since yields and bond prices move in opposite directions, bond investments in insurers' portfolios increased in value as interest rates fell. As of March 31, 2011 surplus had surged to a record \$564.7 billion, falling only 1 percent to \$559.1 billion in the catastrophe-laden second quarter.

Catastrophe losses

In an analysis of loss reserve adequacy, Fitch notes that statutory reserves remain adequate overall

Global catastrophe losses for 2011 have already surpassed total losses for 2010 and 2009 combined, according to Guy Carpenter, and are approaching the 2005 record. Topping the list at \$33 billion in insured losses is the Tohoku earthquake and tsunami in Japan.⁶

Some \$3 billion to \$5 billion of loss from cat events abroad wound up on the books of US, according to the Insurance Information Institute. Additionally, the US has experienced 10 catastrophe events of greater than \$1 billion in economic loss including Hurricane Irene in September and several major tornado outbreaks including the devastating Joplin tornado in April.⁷ Through the first six months of 2011, US insurers racked up nearly \$20 billion in catastrophe losses.

A major catastrophe event can be a catalyst for hard markets. Thus far, the impact of the 2011 catastrophes has been muted. Globally, property insurance rates increased sharply in some affected areas, and catastrophe-exposed property programs not affected by losses typically renewed between flat and up 10 percent during the third quarter, according to Marsh.⁸ Property catastrophe reinsurance premiums also are rising, but the market overall has absorbed these losses without the reflexive across-the-board rate hikes that sometimes follow large catastrophic events. As previously noted, through the first half, US policyholder surplus was down only about 1 percent, meaning that the catastrophes had a meaningful impact on earnings, but virtually no effect on capacity. Nonetheless, the cumulative impact of these events on combined ratios almost certainly is a factor in the gradual increase in prices now being reported. The combined ratio for US property/casualty insurers for the half was 109.4, after excluding mortgage and financial guaranty insurers, compared to 100.2 a year earlier.⁹

5. III, "2011 - First Half Results"

6. *Asia Catastrophes Account for Bulk of Cats in 2011*

7. "NOAA's National Weather Service taking action to build a 'Weather-ready' nation," NOAA, August 17, 2011

8. "Global Insurance Market Update — Third Quarter 2011," Marsh

9. III

Investment returns

Investment gains/losses generated by the enormous pools of assets held by insurers are a critical component of insurer profitability. Investment gains are the sum of net investment income and realized capital gains (or losses) on investments.

In the current very low interest rate environment, lower investment income could put pressure on insurer results and ultimately contribute to higher rates. 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.¹⁰

Surprisingly, despite low interest rates, investment income was up through the first half of 2011, growing \$1.1 billion, or 4.5 percent, as compared to the same period in 2010. Net investment gains (which include realized capital gains and losses in addition to investment income) were up 10.0 percent. Investment gains offset underwriting losses, and are one reason that policyholder surplus remained largely unchanged through the first half despite the unfavorable combined ratio.

Though insurers are far more heavily invested in bonds than in stocks, the market crash nonetheless erased tens of billions of dollars of policyholder surplus.

Reserve adequacy

Insurers maintain cash reserves for losses that have been incurred but not yet paid. Since 2008 insurers have been steadily releasing loss reserves for prior years losses deemed redundant by actuaries. These releases offset losses on other parts of the income statement and boost reported results. The III notes that billions of dollars of insurer profits reported over the past several years were actually the result of downward revisions in loss reserves.

US insurers continue to release loss reserves in 2011, which has benefitted the bottom line. The pace of reserve releases, however, is declining. During the first half of the year, prior-year reserve releases fell to \$7.3 billion from \$9.1 billion in first-half 2010.¹¹

In an analysis of loss reserve adequacy, Fitch notes that statutory reserves remain adequate overall, but the current level of favorable reserve development is most likely unsustainable.¹² A.M. Best, on the other hand, believes insurers have "crossed that line" and reserves are now slightly deficient.¹³ 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.

10. *Global Insurance review and outlook 2011/12*, Swiss Re, December 2010, p.6

11. III

12. "Fitch: U.S. Property/Casualty Industry Loss Reserves Adequate," Fitch, Inc, Aug 22, 2011

13. "Perspectives: Murmurs About Commercial Rate Changes Abound in Third-Quarter Earnings Calls," A.M. Best

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 policyholder surplus. Stock markets have since rebounded strongly, replenishing surplus. The Dow has had its ups and downs in recent months, but it is hovering around 12,000 as of the writing of this report.

Economic uncertainty, especially as concerns the sovereign debt crisis in Europe, has contributed to market volatility. Bad news could trigger another crash in the near future. Massive capital losses on top of catastrophe losses could be enough to trigger sharply higher premiums. The combined impact of the market crash of 2000-2002 and massive insured losses from the September 11 terrorist attacks often is cited as the catalyst for the 2001-2003 hard market, during which the average commercial lines premium increased 50 percent, according to the Advisen ADVx™ Composite premium change index.

The timing, magnitude and duration of the coming hard market will be influenced by new capital.

New capital

The promise of rising rates is likely to attract new capital into the market. Already, new capital is beginning to trickle in, notably by star hedge fund managers. Daniel Loeb, founder of Third Point LLC, recently launched Bermuda-based Third Point Re, with about \$500 million in capital. Steven Cohen, who runs \$14 billion SAC Capital Advisors, has announced he plans to launch SAC Re, a reinsurer also based in Bermuda, early next year.

The timing, magnitude and duration of the coming hard market will be influenced by new capital. Capital rushing into the market to take advantage of rising rates 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.

Many Moving Parts

Average premiums crept higher in the third quarter, but it is far from certain that this is a harbinger of a sustained hard market. An elevated combined ratio due substantially to catastrophe losses and a modest increase in demand for insurance capacity may have motivated underwriters to push for higher premiums, but the market remains very well capitalized, which keeps downward pressure on rates.

A number of factors – none of them pleasant to contemplate – could individually or in combination drain enough capacity to spark a genuine hard market. A very large catastrophe could destroy enough surplus to trigger large rate hikes in most lines of business. Similarly, a stock market crash could generate capital losses sufficient to spark higher premiums.

If the entire commercial lines market fails to move into the hard phase of the cycle in the short term, sector-specific hardening remains a possibility. Further catastrophe losses could result in sharply higher property premiums in catastrophe-exposed regions. Workers' compensation has been plagued both with falling premiums and rising claims frequency (following an average decrease of 4.3 percent per year since 1990). In 2010, the NCCI characterized the state of the workers compensation industry as "precarious," and the situation has not improved in 2011. Deep losses to banks, hedge funds and other financial firms resulting from the European sovereign debt crisis could drive up financial institution D&O premiums. Sector-specific hardening, however, is rarely sustainable over the long haul if the market is otherwise well-capitalized.

Perhaps the largest wild card at the moment is the European debt crisis. The crisis could drive up premiums for financial institution D&O, but a default by a EU member nation, which could plunge the world economy back into recession, could usher in a new round of rate decreases for the rest of the market. As was the case in the recent recession years, diminished demand for insurance capacity resulting from decreased economic activity would spark competition among insurers anxious to maintain top line growth. An alternative scenario is that a default would trigger a deep and sustained stock market crash, resulting in capital losses that would wipe out excess capacity and be the catalyst for sharply higher premiums.

The large number of factors in play at the present could move the market in either direction. The most likely scenario, however, is that the soft market has indeed bottomed out, but rates will bump around in the trough until something dramatic happens to wipe out excess capacity and trigger a hard market. The overall trend may continue to be upward, but most likely it will be at an erratic pace as underwriters' desire to raise rates battles the stiff headwind of excess capacity. ■

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