

The Commercial Insurance Market in 2007

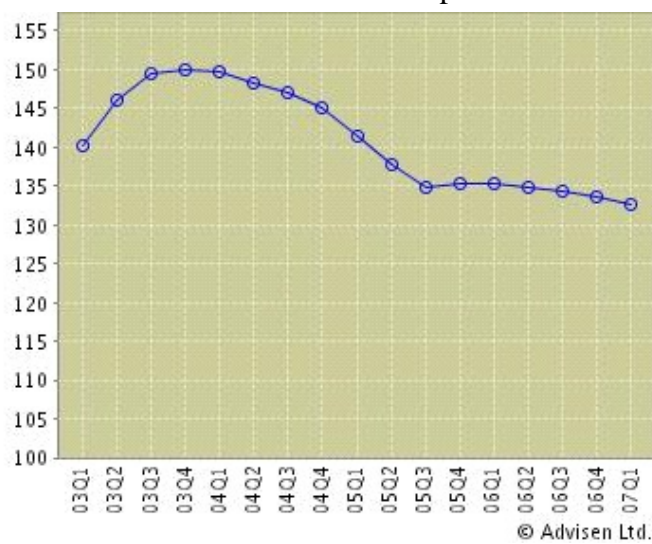
An Advisen Briefing

Essence: Like every other industry, the insurance industry is subject to the law of supply and demand: when supply exceeds demand, prices fall. In the current market, aggregate policyholders' surplus – supply in the insurance supply- and-demand equation – is growing strongly, leading to heightened competition and downward pressure on rate levels. Unless catastrophe losses in 2007 are unusually severe, cutting deeply into aggregate policyholders' surplus, it is likely that commercial insurance buyers will enjoy sharply lower premiums in most lines of insurance throughout the year and into 2008.

Commercial property & casualty insurance pricing is notoriously cyclical. Typically, a comparatively short period of rapidly escalating rates, often in the wake of a major catastrophic event, is followed by a longer period of slowly eroding rate levels. Premiums skyrocketed between 2001 and the end of 2003, more than doubling in some lines of insurance such as directors & officers liability and fiduciary liability. Since the beginning of 2004, rate levels have been deteriorating and the market is now well into the soft phase of the cycle.

Record-shattering losses from Hurricanes Katrina, Rita and Wilma in 2005 did not reverse the soft market in 2006, as some insurance industry analysts had predicted. Those losses triggered skyrocketing property premiums in coastal areas – some risk managers reported premium hikes in Florida of more than 500%, and some companies complained

Exhibit 1 ADVx™ Composite Index



that adequate coverage was unavailable at any price – but premiums for property insurance in other regions, and for most other lines of insurance, continued their downward march. Buoyed by sharply higher property catastrophe rates, Advisen's ADVx™ composite premium index fell only 1.3% over the course of 2006 (Exhibit 1), but underlying that modest decrease were much lower average premiums in workers compensation and liability lines of insurance, as well as lower premiums for property insurance in non-catastrophe exposed regions.

Advisen's ADVx™ index values are relative to Q4 2000 (=100). A value of 125 means, on average, premiums are 25% higher than they were the fourth quarter of 2000. At the peak of the hard market, in the final quarters of 2003, average composite pricing was approximately 50% above the Q4 2000 level. As of the first quarter of 2007, the market had lost about 35% of the 2001-2003 gains.

As Exhibit 1 also shows, the rate at which the composite average premium index fell accelerated over the course of 2006 and into the first quarter of 2007. While higher property premiums in catastrophe exposed regions continued to buffer the fall of the composite index, the impact has diminished with the completion of the first full round of renewals following Hurricane Katrina.

Advisen estimates that Hurricanes Katrina, Rita and Wilma cost the insurance industry \$66 billion dollars, more than twice the record set only one year previously. Despite the record-shattering catastrophe losses, the property & casualty insurance industry reported a very respectable \$44 billion profit in 2005, an indication of continued strong rate levels following the sharp run-up in premiums between 2001 and 2003. The above-average season for hurricane frequency and severity predicted by meteorologists for 2006 never materialized and, despite deteriorating rate levels, the P&C industry produced record net income of \$64 billion for the year, according to ISO. These profits increased aggregate policyholders' surplus – the measure of "supply" in the insurance supply-and-demand equation – stimulating competition, and further driving down rate levels in 2006.

Competition has continued unabated into 2007, with the composite ADVx™ index for the first quarter showing the largest single quarter drop since 2005. A series of severe catastrophes could bring the soft market to a screeching halt, but if 2007 is a mild year for catastrophes, there is a risk that rate levels in some lines of insurance may go into a freefall.

Insurance Market Economics and the Underwriting Cycle

Insurance rate levels tend to rise and fall with the ebb and flow of insurance capital. As the aggregate capital supporting insurance underwriting activities (“policyholders’ surplus”) increases, rates tend to fall, and vice versa. When insurance capital is abundant, underwriters compete for business to put that capital to work. Competition forces rates down – ultimately to the point that prices are inadequate and underwriting losses eat into policyholders’ surplus. Once sufficient surplus has been destroyed, rates begin to increase. It is classic supply- and- demand economics in action. In the current market, policyholders’ surplus is growing strongly, putting downward pressure on rate levels (Exhibit 2).

Typically, rate levels in all lines of commercial insurance move up and down, more-or-less in unison, through the course of the cycle, though the magnitude of the changes varies by line. The typical operation of the insurance cycle was disrupted by the unprecedented scenario in 2005 of record- shattering catastrophe losses combined with near- record profitability for the property & casualty industry. In response to the hurricane losses – and to new minimum capital standards established by rating agencies for companies writing catastrophe- exposed business – many insurers and reinsurers withdrew capacity from catastrophe- exposed regions, forcing up premiums in those areas. The capacity withdrawn from catastrophe- exposed business was redeployed to other lines and regions, which were already experiencing falling premiums due to rising capacity.

Aggregate policyholders’ surplus – the supply side of the supply- and- demand equation – has been rising briskly since 2002. But the U.S. economy is also expanding, meaning there is greater demand for insurance coverage as well. Using Gross Domestic Product (GDP) as a proxy for demand, Exhibit 3 shows the

Exhibit 2. Aggregate Policyholders’ Surplus

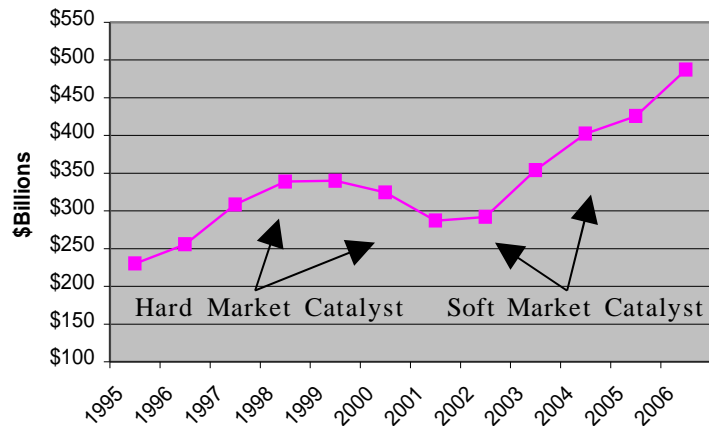
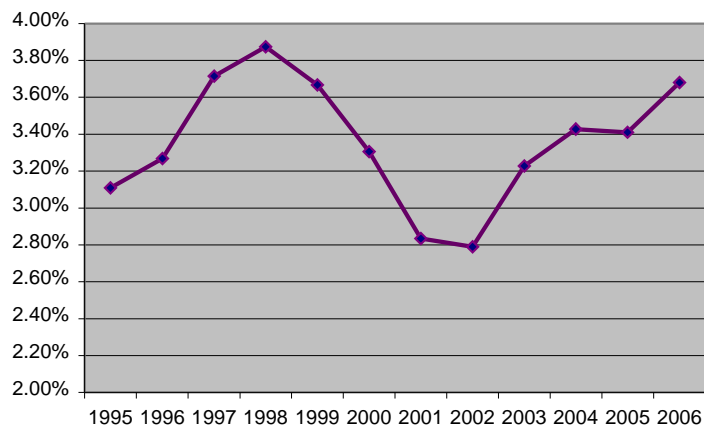


Exhibit 3 Surplus as %GDP



supply of insurance (surplus) relative to demand for insurance coverage (GDP). Surplus as a percentage of GDP is rapidly increasing – meaning that the growth in supply is outstripping the growth in demand – and is approaching the peak set in 1998, the height of the last soft market. The implication is that the current soft market, if not interrupted by major catastrophes or economic dislocations, will continue through 2007, and may have several more years to run.

Also contributing to heightened competition is more than \$30 billion in new capital that flowed into the industry in expectation of higher rate levels in the wake of the 2005 hurricane losses. Some of that money was used to strengthen companies hard hit by hurricane losses, but a significant amount has gone to capitalize new reinsurers in Bermuda and other offshore domiciles, with much of the capital earmarked for property catastrophe capacity. Additional property catastrophe capacity was created by the Florida legislature, which in January of this year doubled the capacity of the state-sponsored catastrophe reinsurance fund, essentially injecting a further \$12 billion to \$16 billion of new capacity into the market.

In addition to rapidly growing capacity, soft pricing also has been encouraged by improving loss experience in some lines of insurance. In workers compensation, sharply falling average premiums are substantially attributable to the impact of legislation in states such as California and Florida, where workers' compensation reforms have resulted in reduced loss costs. According to A.M. Best, workers' compensation will record its lowest combined ratio in 34 years in 2006 and an underwriting profit for the first time since 1995, in part attributable to an estimated 8.3-point decrease in the loss and loss-adjustment expense ratio. In directors and officers' liability, the frequency of securities class action suits – the principal source of claims against public companies – fell sharply in 2005 and 2006, a phenomenon that some analysts attribute to heightened transparency and improved corporate governance as a result of the Sarbanes-Oxley Act.

Forecast

The hard market of 2001-2003 was sparked when policyholders' surplus fell below 3.2% of GDP, and the current soft market began when surplus rose above 3.2% of GDP (see Exhibit 3). In order for policyholders' surplus to again fall to 3.2% of GDP, nearly \$65 billion of surplus must be destroyed. Assuming, in the absence of extraordinary catastrophe losses, the insurance industry would produce \$40 billion in net income in 2007 – a very conservative estimate considering that catastrophe-ridden 2005 produced \$44 billion in net income – \$105 billion (\$65 billion + \$40 billion) in extraordinary catastrophe losses would theoretically be required to reverse the market. Forecasters at Colorado State University's Tropical Meteorology Project predict nine hurricanes and 17 named storms in 2007, with higher-than-average landfall probabilities. Of the nine hurricanes predicted, three are expected to be intense or major. However, \$105 billion in catastrophe losses is nearly 60% higher than the 2005 losses – the worst year on record. The probability of natural catastrophe losses, including a combination of hurricane and earthquake losses, exceeding \$105 billion in 2007 is very low.

While surplus equal to roughly 3.2% of GDP was the tipping point for the last two turns in the market cycle, one or two exceptionally severe catastrophes producing less than \$105 billion in losses could be sufficient to turn the market under a couple of scenarios. One scenario contemplates a period of very rapidly falling rate levels prior to the catastrophe(s). Losses from catastrophic events could jar already alarmed underwriters into a hard market mindset. However, the resulting pricing rally could be short-lived if the industry was still overcapitalized. Another scenario posits the combined impact of large catastrophe losses and a major correction in the stock market – not a wholly unlikely scenario considering that the Dow Jones Industrial Average is at an all-time high. The soft market of the 1990s came to an end under the combined impact of the stock market crash of 2000 – which brought a sudden halt to capital gains that had been subsidizing deeply inadequate rate levels – and losses arising from the September 11 terrorist attacks. In the current market, insurance company profits are not as dependent on investment income and capital gains to nearly the same degree as was the case in the late 1990s. In fact, the insurance industry posted a rare underwriting profit in 2006. However, a large correction in the stock market would undercut the financial resiliency of the insurance industry, and could hasten a turn in the market.

Most likely, 2007 will see rate levels falling at an accelerating pace in most lines of insurance as the hurricane season gets underway. A moderate- to-heavy year for natural catastrophes could produce a repeat of 2006, with insurers and reinsurers further withdrawing capacity from catastrophe-exposed business and redeploying it to other regions and other lines of insurance. This would perpetuate, and perhaps accelerate, soft market conditions everywhere except for catastrophe-exposed property business, which could see yet another round of price increases. Eventually – probably sometime in 2008 – rate levels will erode to the point that they are producing significant underwriting losses, and even a moderate year for natural catastrophe losses may be sufficient to stem the tide of falling premiums, though perhaps not reverse the market. The process will most likely be hastened by the propensity of risk managers to lower retentions when insurance prices fall below cost, thereby transferring even more under-priced exposures to insurers.

Insurance executives and some analysts rail that underwriters lack discipline when premiums tumble. But the economic reality is that it is the market, not individual underwriters, that determines pricing levels. Like every other industry, the insurance industry is subject to the law of supply and demand – when supply exceeds demand, prices fall. Unlike some other industries, however, there are few safety valves in the insurance industry to stem cutthroat competition during periods of excess capacity. Solvency regulations make it difficult for insurers to redeploy excess capital – capital (and therefore supply) is essentially trapped in insurance companies. Some insurers are now using excess capital to buy back stock, but in general below-cost pricing, which essentially returns excess capital to policyholders, is the usual correction mechanism. Typically, it is only when enough capital has been distributed to policyholders in the form of losses in excess of depressed premiums that the market will reverse course. As a result, unless catastrophe losses are unusually severe, it is likely that commercial insurance buyers will continue to experience sharply lower

premiums in most lines of insurance, and may even get relief for catastrophe-exposed properties, throughout 2007 and into 2008.

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