

# Insurance Executive Review

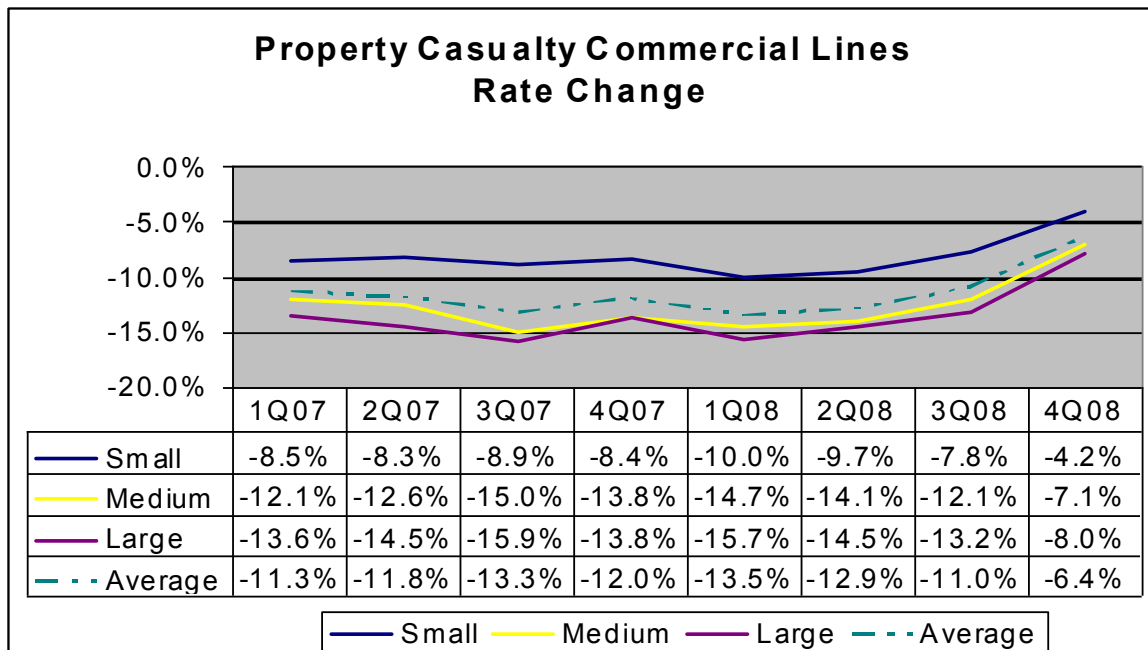
Market Commentary on Current Developments within the P&C Insurance Industry

## P/C Market Forecast: Looking Forward Against Severe Headwinds

The consolidated P&C market statutory financial result for 2008 will not be released until April but we already know a sufficient number of details that will influence the market going forward this year. The stage has been set for a difficult year for insurers as they must deal with numerous factors that will not only determine their financial wellbeing in 2009 but perhaps for the rest of this decade.

### SOFT MARKET

We have witnessed slippage in commercial risk price reductions (see chart below) in the third and fourth quarters of 2008 from prior years' that has suggested the end of the "soft market". However, it has not suggested a broad move to higher pricing except perhaps in certain classes/sectors that have experienced severe negative experience.



Source: Council of Insurance Agents and Brokers

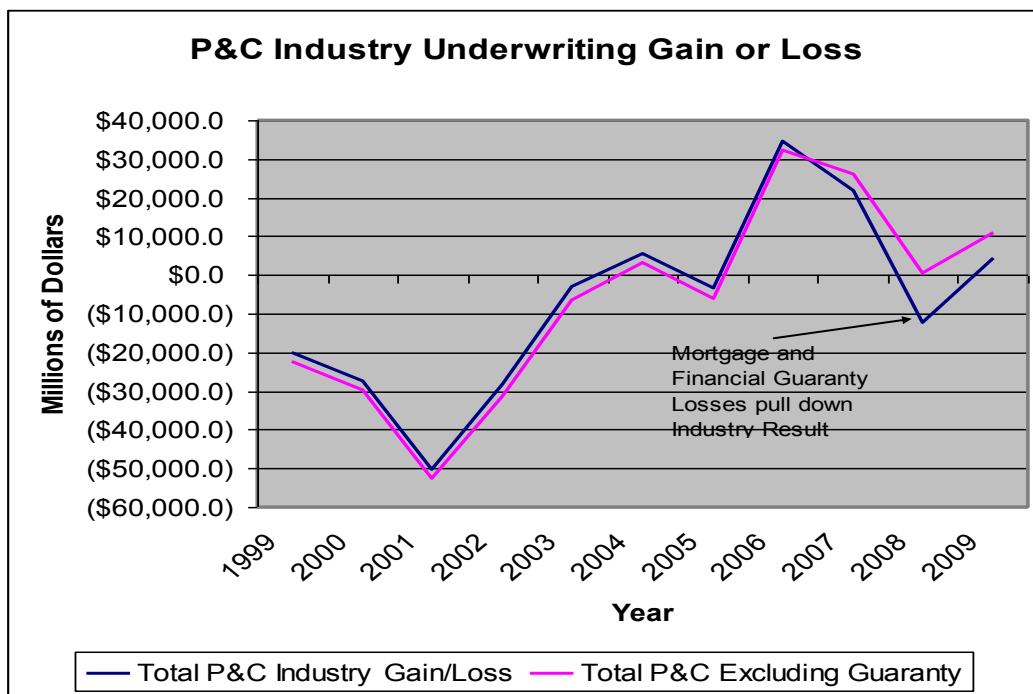
The financial market sector and D&O risks (except Side-A risks) are two prime examples of where availability and pricing changes have already emerged. The balance of the market should see a mar-

ket of subdued competition with insurers still under pressure to achieve premium gains in a climate where rating exposures (i.e. values, sales, payroll, etc) are shrinking in a period of economic recession. Individual carrier earnings release continues to show profitable underwriting result in broad segments of small, middle market and specialty lines except as noted above.

Personal Lines insurers are still facing pressure in homeowners insurance after a poor catastrophe year in 2008 and market/regulatory pressures to refrain from rate increases. The State Farm petition to withdraw from the State of Florida is a clear example of these difficult conditions where prior rate approval declination can leave limited alternatives. Private Passenger Automobile is still a competitively sought after segment for underwriters in most states.

**OPERATING EARNINGS**

We have previously commented on industry earnings when reviewing the 3rd Quarter industry financial data (see Vol. 1 Number 10) that highlighted the enormous affect of the Guaranty market and catastrophes on underwriting performance. Mortgage and Financial Guaranty insurance segments make up a relatively small part of the total market with about \$8.5 Billion of premiums



Source: Insurance Information Institute

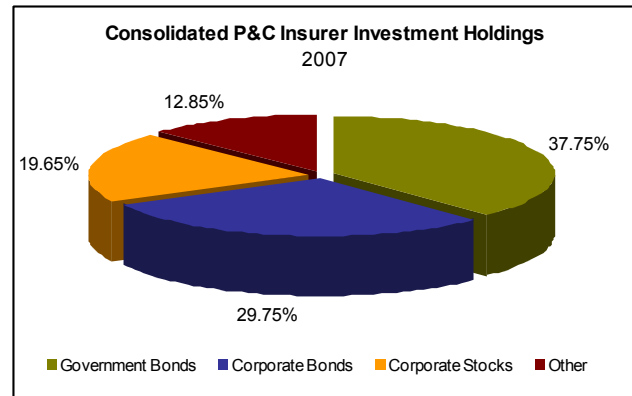
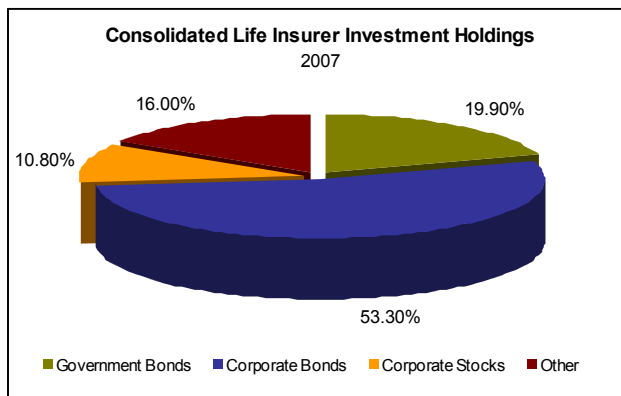
written. More than 90% of the business in each segment is written by fewer than 8 companies with their results not being a material impact on the industry until 2007. This coupled with a high frequency of catastrophe losses makes the overall industry look more unfavorable than it is.

We also see evidence in the year-end financial reports of carriers a continuing theme of combined ratios holding below 100 (meaning underwriting profitability) but in a number of cases this was greatly influenced by the release of prior year loss reserves. Reserves on prior (accident) year claims that subsequently prove to be excessive, can upon reduction contribute to improving the current (calendar) year results. While this is normal, we worry about excessive reliance upon loss reserve

becoming a crutch to current earnings....remember "insufficient loss reserves" is historically the most often cited cause for property casualty insurer impairments and failures.

**INVESTMENT OPERATIONS**

The real estate market collapse and the resulting global credit market implosion have caused the highly leveraged financial market to see a liquidity freeze and material decline in asset values. There is no point here to repeat the list of institutions and organizations affected by what has been described as a plunge in confidence and reliability of the financial institution, banking and global trading network. The declines in investment income from interest and dividends have pushed yields to historic lows while investment asset values have plunged causing both realized and unrealized investment losses. This issue has been dramatically more significant for life insurers than property casualty companies as the former have had a higher percentage of assets in corporate investments as well as marketing billions of dollars in annuity products that guaranty principal and/or a minimum return.



The growing petition to regulators is that year end statutory filings of life insurance companies should include changes in the variable annuity cash flow test (a/k/a "AG39") and allowance of deferred tax assets as admitted assets for benefit of surplus (net worth). There are about a dozen life companies who seek to qualify for Federal TARP funds, as they have federally chartered bank holding affiliates, but word from Treasury recently was negative on that idea. P&C insurers have seen significant surplus declines via realized and unrealized capital losses but not sufficient to cause a "supply"\* issue. Those with life company affiliates however, may be further exposed to shifts in capital allocation that concerns rating agencies. Investment operations have long supported the core underwriting business of insurers but now appear to be a cause for concern about stability of the market and capital drains. \*see volume 1 issue 14 on our website

**REGULATORY ACTIVITY**

There has been a significant amount of government and regulatory activity over the past year that will continue this year with the potential to significantly alter the way in which the insurance business will be regulated in the future\*\*. The exclusive oversight of insurance by the various states is under attack as new avenues of regulatory consolidation of the current fragmented financial services industry is being developed at the Federal level. The state insurance regulators had a chance to have oversight of CDO's as "insurance" several years ago but took a pass on that opportunity.

The creation of the Office of Insurance Information within the Department of Treasury may be merely a first step of dividing the regulatory responsibility over insurance between Federal and State

\*\* see volume 1 issue 8 and 11 for discussion of Federal vs. State regulation on our website

authority. The Federal Government could assume oversight over federally chartered domestic insurers writing only commercial risks including reinsurance companies and alien market carriers doing business in the U.S. This could also facilitate the creation of the U.S. Insurance Exchange that could attract global capital markets to provide a central risk sharing clearing house for catastrophe risks. This could be a much more efficient mechanism than the creation of individual Catastrophe Bond facilities of recent vintage. A guaranty fund similar to the FDIC system would protect smaller commercial policyholders against insolvency of domestic companies much as the current state guaranty system. The individual states would continue to regulate personal lines insurers licensed by state, particularly as to fairness in rate, form and claims settlement practices with state guaranty fund protections remaining in place.

Regulatory overhaul is in the air!

## CONCLUSION

It would be foolish to cling to the notion that the insurance business will emerge on the other side of this financial and economic crises the same way that it entered it. The financial services market has already undergone significant change and intervention by the federal government is a position of being the "lead dog". While state regulators can point to and take most of the credit for stability of insurance entities let us remember that they got there only after the threat of federal involvement was imminent. But the limited reach of state regulation as in the case of AIG, reveals that beyond the insurance entity the state regulators can be kept in the dark and are virtually powerless. Keeping the status-quo in financial market regulation appears to be no longer an option. But states will fiercely guard their regulatory position in insurance as it is position of power and revenue. In similar fashion the federal government is printing huge amounts of money to stabilize the financial system and it is not likely to let the insurance business be a de-stabilization factor even if this is considered very remote. It will be an interesting year!

*Our next issue of the Insurance Executive Review later this month will be Part II of Predictability in Insurance-Sharing the Risk in Catastrophe Losses.*



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Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.

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