

# Insurance Executive Review

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

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## THE U.S. ECONOMY HAS BEEN DESCRIBED AS THE “NEW NORMAL” ...

### *WHAT DOES THIS MEAN FOR THE U.S. PROPERTY CASUALTY MARKET?*

We can view the current economic environment, in late October 2009, as showing evidence that the recession is behind us or we might adopt the position that we still have a long way to go. Regardless of which position we take, most (but not all) market watchers would agree that the outlook going forward will be a “new normal” for the economy. Not long ago there was considerable debate about the future of capitalism but now we seem too focused on capital requirements. The insurance industry growth and profitability has been dependent on a robust economy that expands as the capital assets of business/institutions and the personal wealth of individuals grows. Both have suffered a setback of significant size that may take a decade to recover.

### THE CAPITAL ASSET VALUATIONS

The financial crises had many aspects but the overinvestment and over speculation might have produced a more modest correction if it had not been so extensively fueled by borrowed money. Here are some interesting statistics:

- Global wealth declined from 2008 through 2Q 2009 by \$30 trillion in global equities and \$11 trillion in residential values;
- US household wealth increased from \$42.1 trillion in 2001 to \$63.9 trillion in 2007 only to fall to \$51.1 trillion in 1Q 2009;
- At end of 1Q 2009 some 14 million U.S. households (27% of mortgage-holders) owed more than their homes market value;
- Savings rates for U.S. households declined from 8% of disposable income (1950- 1967) to an average of 2.7% (2002-2007).

In order to restore household wealth to the long term average it would require repayment of \$1.4 trillion of debt that at the present savings rate would take until the end of 2012 to accomplish. With the prospect of further increases in unemployment and reduced wages for those employed workers (outside of Wall Street) it may take even longer to get improvement in household balance sheets.

Given the more modest position of household spending the drive of this “new normal” economy has implications for insurers in the years ahead as the decades of a consumption driven economy disappears into the history books. The decade ahead may suffer from this adjustment to the “new normal” that will have a significant impact to many businesses including insurance.

The “new normal” economy is not likely to be driven by consumer spending, at least not to the degree we saw in the past decade. It is likely to last longer than we think and take longer for a robust economy to emerge. How will business organizations fair during a period of restraints on consumer spending? There should be little doubt

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that the level of business activity on Main Street America will suffer from taking any early position on a recovery of consumer spend. The cautious optimism will restrain new equipment purchases, expansion of operations or inventory additions as business organizations await clear evidence of consumer demand and economic recovery. Business firms have found greater productivity with fewer workers as employees concerned with job security are able to increase the number of tasks they can undertake in order to prove their value to their employer. The National Federation of Business recent September survey revealed only 4% of members citing credit as their biggest problem compared to 32% citing weak sales.....as a result capital-spend is at a 35-year low.

### **INSURANCE IN THE “NEW NORMAL” MARKET- PERSONAL LINES**

As the entire economy adjusts to the new environment it will have a material impact on the U.S. property casualty business. The decline in home values for example, might suggest lower insurance valuations in homeowners insurance but this is only true if it is coupled with a drop in raw materials pricing (i.e. lumber, etc.) and labor costs. The latter factors more directly contribute to determining replacement cost of dwelling structures than market/sales values that include land, other uninsured property and local real estate conditions. Since our current recession has in fact produced sharp declines in commodity pricing and labor costs, the current replacement cost values of dwellings nationwide is in decline. A drop in insured values means a decline in homeowner insurance premium to the market. In addition, the wide spread home foreclosures means that premiums are flowing to the bank's commercial insurer and away from the traditional homeowner personal lines insurance markets.

Other factors in the personal lines insurance market include the decline in the number of registered automobiles as the unemployed and “underemployed” households adjust their transportation needs to fewer autos per family. In addition, the reduction in sales of new vehicles means that the average age of vehicles of the road will increase. These material changes have implications for auto insurers as it relates to both premium income and expected losses.

Finally, the amount of discretionary insurance purchases on personal articles, watercraft, recreational vehicles, personal umbrella limits, etc. will all suffer some pullback by the homeowner causing premium declines as a result a fall in demand.

### **INSURANCE IN THE “NEW NORMAL” MARKET- COMMERCIAL LINES**

The commercial lines market will see a decline in insured property replacement costs for similar reasons that reductions in building supplies and labor costs have brought these values down. Business interruption insurance shows declines directly related to business income valuations and in some cases may become a discretionary purchase the firm can no longer afford to maintain. In addition, equipment repair or replacement may be postponed, lower inventory values of finished goods will be maintained or exposure to vacant or unoccupied building might increase, all contributing to lower premium income and/or higher exposure to loss.

Business casualty risk premiums are frequently based upon “sales” or “payroll” data that we know are lower today and with the expected rise in unemployment or lower pay-rates will continue downward pressure on casualty premiums.

Other business related insurance products are under similar pressure and if discretionary (not deemed critical to firm survival) may be dropped or reduced in the scope of protection in order to lower cost. This does not even consider business firms no longer around.....it's the unemployment data, stupid!

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**CONCLUSION**

The “new normal” economic environment presents a significant challenge to the insurance market. The overall lower level of demand for insurance brings down premium income at a time when most thought the soft pricing cycle was about to end and an increase in rates was at hand. There is still ample supply of capital (surplus) so we see a period of several years of underwriting losses through 2012 before the economic recovery will provide any upside premium relief. The bottom line is that the insurance industry faces future cost inflation that will be combined with a delayed rate adequacy scenario producing a period of underwriting pressures that are similar to the late 1970’s when incurring underwriting losses was the norm for a sustained period of time. We see a similar event in the period 2010 to 2012.

***Our next Newsletter will look at our long-term view of the financial outlook for insurers as a result of this forecast!***



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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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