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# Insurance Executive Review

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

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## ECONOMIC OUTLOOK WILL CAUSE MAJOR IMPACT TO U.S. COMMERCIAL PROPERTY CASUALTY MARKET DURING 2010-2012 PERIOD

The outlook for the U.S. Property Casualty market in the near term looks grim based upon our projections of economic growth upon which the market depends for organic growth. This assumes that the “new normal” economic environment will not produce the expected “V shaped” recovery that usually accompanies the recovery period following a recession. Nor do we expect the double-dip “W shaped” recession that has been suggested by some market observers. Rather, we think the economic outlook suggests more of a “U shaped” recovery where we will have a sustained period of recessionary pressures before any material recovery will be apparent via the traditional market indicators. Our basis is described below followed by how this would translate to P&C insurance industry financial expectations for the market as a whole. Market participants will show individual variances substantially different from the general market depending upon their profile of business written and market position.

### Our Current Economic Outlook

The US economy has many moving parts and is subject to change based upon how government, business and individuals react to changes or future events. As we see conditions now developing the “U shaped” theory has real potential.

- Consumer spending is under severe constraints of accumulated household debt and loss of household wealth that is unprecedented in modern times;
- Credit availability to individuals and business organizations is still severely constrained in spite of federal efforts as government transformed lots of private debt into public debt;
- Commercial real estate appears to be following the difficulties of the residential market as vacancies and delinquencies rise and form the “second wave” of pressures on the banking and financial markets including CMDO security holdings;
- The problems associated with the “too big to fail” financial institutions has only gotten bigger through merger accommodations arranged via federal intervention but without any new regulatory system in place;
- Civil Employment prospects are still wanting as business organizations find they have the ability to manage their affairs at current demand and actually show improved margins with fewer people;
- US dollar policy has had negative implications on trade policy and foreign holders of increasing US debt obligations while not generating the expected level of US exports;
- US equity markets looking for positive indicators of recovery have rebounded based on improved profit margins but not business sales growth.

The sum and substance of these and other economic conditions have weighed on US recovery from the recession and will have resulting implications for the US property casualty market. The chart below suggests what we might expect from this “U shaped” economic recovery in terms of economic activity.

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These economic indicators point to a “U shaped” outlook in the U.S. with the likelihood that foreign markets see

#### SELECTED ECONOMIC OUTLOOK DATA

	<-----Forecast Period----->				
	2008	2009	2010	2011	2012
<b>PRODUCTION</b>	ACTUAL				
Real GDP	0.4	-2.4	1.5	2.2	3.6
Consumer Spending	-0.2	-0.7	1.1	2.1	2.9
Nominal GDP	2.6	-1.2	2.8	3.4	4.2
<i>Billions of 2005 Dollars</i>					
Inventory change	-25.7	-117.7	3.3	9.3	31.5
Net Exports	-494.3	-349.9	-340.2	-324.1	-365.1
<b>INFLATION</b>					
GDP Price Index	2.1	1.3	1.1	1.4	2.4
CPI (all items)	3.8	-0.4	0.6	1.1	2.2
<b>FINANCIAL</b>					
Fed Funds Rate	1.86	0.13	0.25	2.01	3.11
90 Day T Bill	1.39	0.15	0.20	1.34	2.35
<b>OTHER INDICATORS</b>					
Savings Rate	2.7	3.9	4.8	5.1	5.5
Unemployment	5.8	9.4	10.2	9.5	8.2
Housing Starts (millions)	0.9	0.57	0.65	0.75	0.9
Motor Vehicles Sales (millions)	13.2	10.3	11.2	12.5	13.5
Civilian Employment Growth	-0.5	-3.6	-1.2	0.9	2.1
Industrial Production	-2.2	-10	-3.5	2.3	3.1

Source: 2008 US Commerce Dept; 2009-2012 CR Market Strategies Inc.

recovery earlier. The “new normal” means we can’t assume the same recovery rate as prior downturns as this one was very different. The individual consumer spend and resulting business expansion was extensively based on the rapid appreciation of assets, a false sense of actual wealth and the readily available access to credit that fueled the entire process. All of these conditions have retreated and we can no longer “pass GO and collect \$200” as we did before.

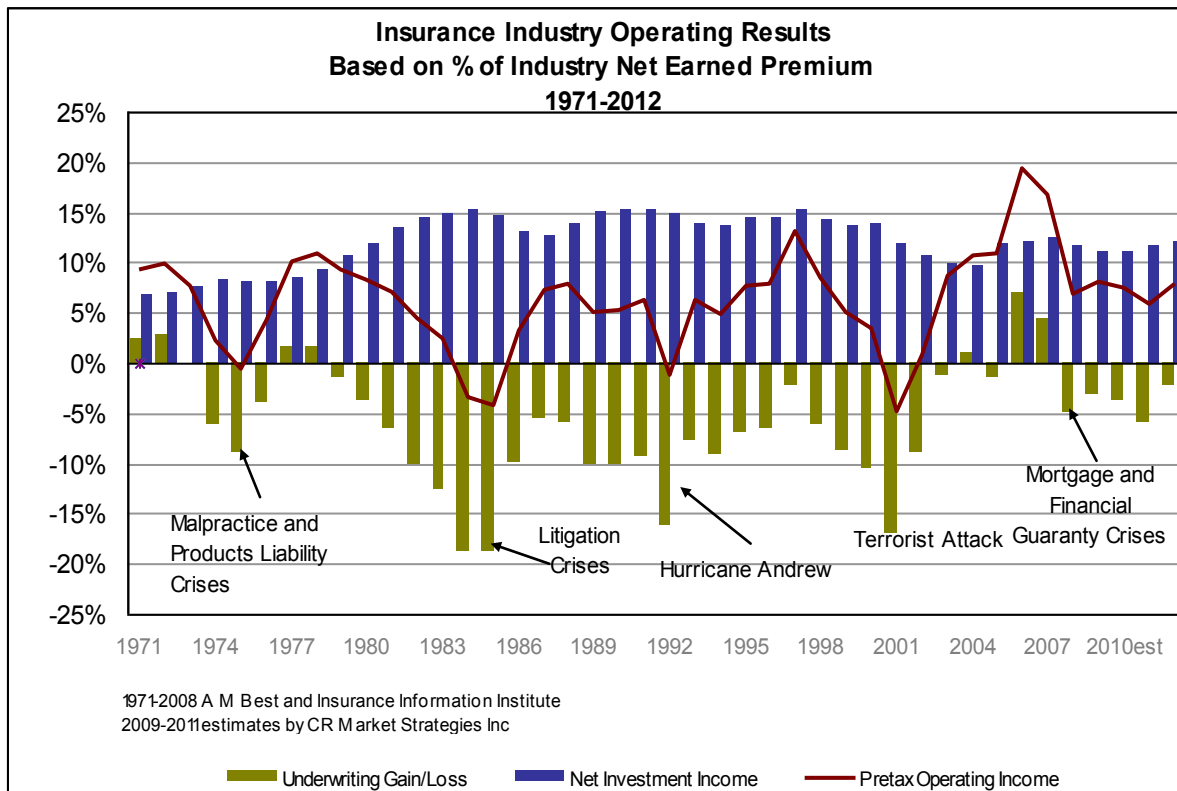
The U.S. insurance underwriting and intermediary market are caught in this economic downdraft just as expectations a year ago were suggesting to some that firming of commercial insurance rates was soon to be at hand. Those prospects have changed now that the commercial risk buyer (those still in business) has less exposure upon which insurance premiums are based and has the opportunity to leverage insurance market competition for their business (i.e. same insurers chasing fewer market premiums). Insurers will look to hold market share if they assume (incorrectly) that a “V shaped” recovery will quickly restore premium levels in the short term. Buyers under economic pressure will be looking to trim all discretionary insurance spending that is not mandated (by lenders, regulatory agencies or others) or deemed essential to avoid a catastrophe risk. Insurers dropping their rate on line to hold business and/or increase market share in anticipation of a short term rebound will be disappointed with the results.

#### The Insurance Industry Outlook

Given the economic environment that the U.S property casualty will likely face with a “U shaped” recovery from recession, a period of underwriting losses should be expected for the period 2010-2012. This should be coupled

with declines in cash flow and low/very modest interest and dividend income. The industry has suffered from similar periods of poor underwriting results as suggested from the chart below (detail financials in next issue).

The operating results for the industry will be modest over this time horizon due to stagnated aggregate premium growth of less than 5% over the forecast period 2009-2012. We expect the Mortgage and Financial Guaranty market segments to be of minimal impact going forward following the disastrous results of 2007-2009 that piled up nearly \$40 billion of underwriting losses. We have included modest weather related loss events to



the extent of \$10 billion per year\*aside from an above-average estimate included in 2011. Any material variation could substantially alter our results to more negative outcomes.

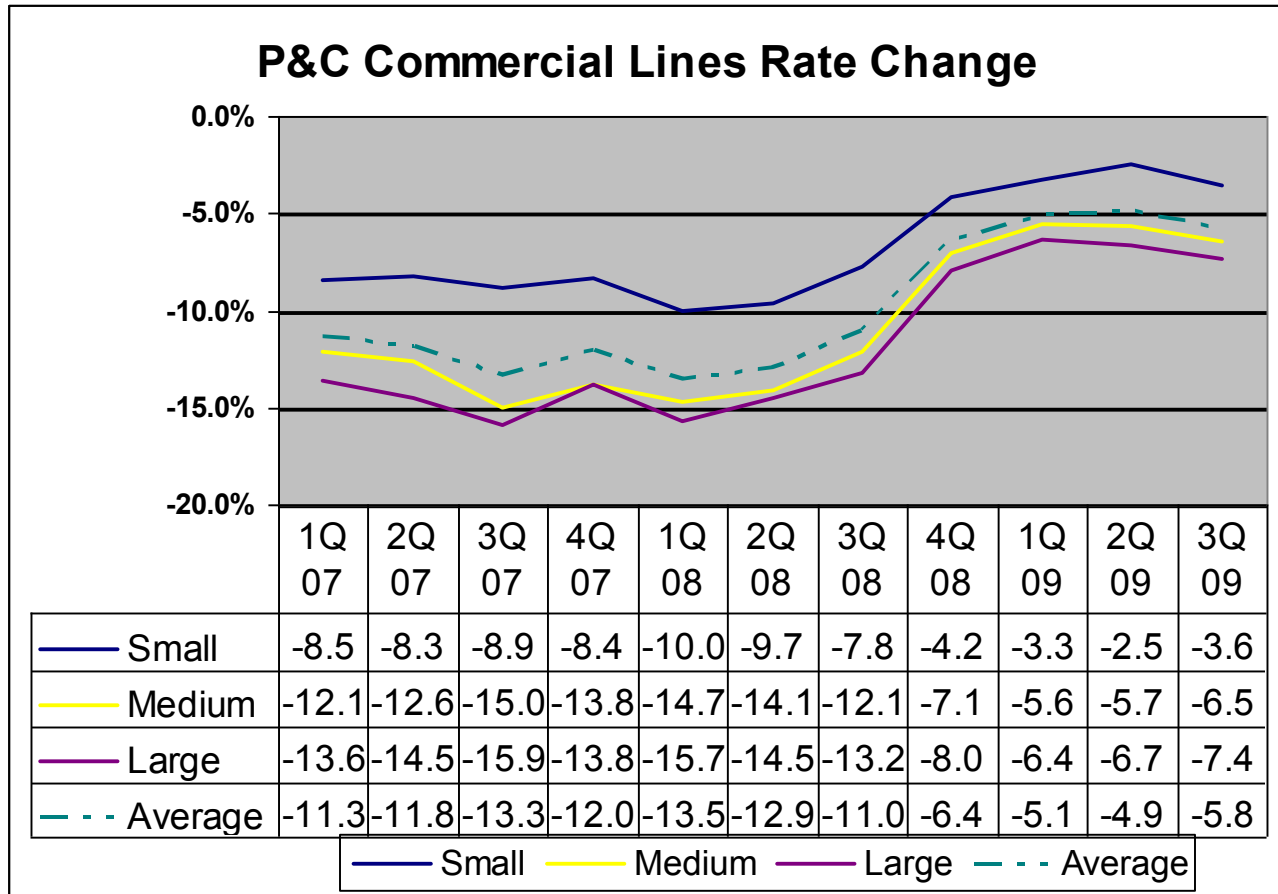
Although we see negative underwriting returns the gains in investment portfolios and trading is expected to add only modest amounts of realized and unrealized gains over the period. Sources of new capital will be limited as the market will not be able to show the potential for upside in rates that traditionally attract new capital inflows. The industry should be able to provide more than sufficient capital to meet the reduced demand that will contribute to market competition...excess industry surplus chasing fewer/lower insurance risk transfer dollars. We do not expect equilibrium in this supply and demand equation to occur until the second half of 2012.

*\*the amount of \$10 billion is the 11year (1998-2008) average annual natural catastrophe loss excluding Katrina*

**Early Evidence of the New Normal Market Effect**

The commercial insurance market has already shown early signs of an imbalance in supply and demand as insurers reported their third quarter financial results as written premiums are declining from the prior year and reports of lower exposure values are common. In addition, the report of the Council of Agents and Brokers

(CIAB) who monitor market rates showed a dramatic turn in the third quarter reporting by agents and brokers around the country (see the chart below).



Data source: Council of Agents and Brokers

After several years of soft market pricing the brokers in the second quarter of 2008 started to report a reversal with rate reductions moderating across all commercial buyer segments. This new trend has continued until the third quarter of this year when competition for business and market share (of a shrinking market) has renewed rate reductions across all segments. It appears we are on our way to a very tough period where only those with a plan will not have to ask...”what the heck just happened?”

*Next issue we will provide the financial detail by year behind this 2010-2012 outlook!*



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