

Insurance Executive Review

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

Outlook for Commercial Risk Market Change ... When will it come?

Much has been written about the commercial insurance market in the U.S., including comments on the current prolonged soft market that has seen rates decline then turning negative in late 2003.

The terror attack of 9/11/01 was seen by many as the catalyst for a market upturn in rates but in reality the deterioration in underwriting was causing rate increases prior to that event. Capital quickly flooded the market in anticipation of an extended period of rate escalations, as market capacity was compromised by underwriting and investment losses. This surge in supply only served to shorten the period of rate increases. The catastrophe losses from the Atlantic basin hurricanes in 2004-2005 which brought even more capital to the market, did not alter the downward direction in commercial risk rates except for properties in coastal areas. Rates continued to slide in the second half of 2000 even during the period of the Great Recession and notwithstanding the difficulties of a market leader like AIG that many speculated would be a market moving event. It was not, as rate declines only moderated but did not disappear. The speculation now is that we are on the very edge of a turn in the market but we are not yet there. Will it be 2012 or the following year? What will tell us when it is near?

U.S. Commercial Market.....it is not just about Underwriting Performance

The fundamental economic principle driving the property casualty market is the view of overall financial performance and the positive outlook for future profitability. On the core underwriting operations the market rates are driven by factors based on the balance between the buyers demand for risk protection and the ability of the insurance market resources to supply it. As we stated in our last newsletter there is both a quantitative (technical) aspect to this demand-supply ratio as well as a qualitative (profit expectation) requirement. All insurers (particularly life companies) derive earnings from both direct underwriting as well as investment of cash flows, reserves and capital funds and thus places insurers as significant participants in the financial investment market. At the end of 2010 the U.S. property casualty market had financial invested assets of \$1.4 trillion whereas the life companies had \$5.2 trillion of invested assets.

Property Casualty Industry
Financial Asset Distribution
(\$ Billions)

Financial Assets	2006		2007		2008		2009		2010	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
U.S. Treasury Securities	\$ 75.8	5.7%	\$ 55.1	4.0%	\$ 65.6	4.8%	\$ 88.5	6.4%	\$ 91.4	6.7%
Agency/GSE Backed Securities*	\$ 122.0	9.2%	\$ 125.8	9.2%	\$ 114.3	8.3%	\$ 116.2	8.5%	\$ 109.3	8.0%
Municipal Securities	\$ 335.2	25.2%	\$ 368.7	26.8%	\$ 381.9	27.8%	\$ 369.4	26.9%	\$ 369.8	26.9%
Corporate and Foreign Bonds	\$ 277.0	20.8%	\$ 285.6	20.8%	\$ 267.5	19.5%	\$ 298.3	21.7%	\$ 299.2	21.8%
Corporate Equities	\$ 227.0	17.1%	\$ 235.3	17.1%	\$ 193.3	14.1%	\$ 219.8	16.0%	\$ 228.1	16.6%
Cash and Money Market Funds	\$ 66.0	5.0%	\$ 53.8	3.9%	\$ 60.7	4.4%	\$ 57.2	4.2%	\$ 55.4	4.0%
Trade Receivables	\$ 87.0	6.5%	\$ 85.4	6.2%	\$ 86.7	6.3%	\$ 83.1	6.0%	\$ 83.7	6.1%
Miscellaneous/All Other	\$ 139.3	10.5%	\$ 163.9	11.9%	\$ 137.1	10.0%	\$ 154.4	11.2%	\$ 166.5	12.1%
Total Financial Assets	\$ 1,329.3	100.0%	\$ 1,373.6	100.0%	\$ 1,307.1	95.2%	\$ 1,386.9	101.0%	\$ 1,403.4	102.2%

* Government Sponsored Enterprise

Source: Federal Reserve March 10, 2011

Due to the characteristics of the business, the P&C and Life insurers have different requirements for investments with some driven within regulatory constraints while others may depend upon an insurers sensitivity to investment risks such as duration, interest rates, counterparty and liquidity. At any given time the conditions existing in the underwriting market may be very different from those in financial markets. For example, back in the very early 1980's the market was suffering from a prolonged soft pricing condition in casualty lines while claim settlement inflation was growing. Countering this trend was extremely high interest rates at or above 17% that provided exceptional yields on invested assets/cash flows that kept competition for business (cash in-flows at virtually any price) very intense. At one point the CEO at a very large national insurer publicly stated that they would no longer chase business at lower rates.....the competition proceeded to "eat their lunch" taking a substantial portion of his market share in the process before he was forced to abandon his strategy of "talking up the market rates". There were just too many competitors who saw the market opportunity differently but when interest rates dropped the casualty market fell into a crises mode resulting in carrier insolvencies on a national scale and Federal investigations.

U.S. Commercial Market.....the competition is everywhere!

We touched on the subject of competition in our previous newsletter as we tried to identify the supply of risk capacity both domestic and global. The U.S. domiciled property casualty market has the following competitive market characteristics:

- There are 2,000 U.S. domiciled P&C insurance companies operated by some 900 insurance groups or holding companies;
- The commercial lines market share of the top markets is considerably less than in personal lines however, some carrier groups have a more dominating position in certain classes or lines of business;
- Market specialization is the norm as competing companies vary by target business class such as geographical region, coverage type or size of account;
- Competitive advantage is difficult to sustain as coverage terms and rates can be duplicated by a competitor, therefore price often becomes the deciding factor;
- Alternative risk financing vehicles both domestic and foreign (RRG's and captives) have emerged as viable safety valve against excessive rate escalations or coverage restrictions by private commercial carriers;
- Economic growth, inflation and changes in tort liability generally defines the level of demand for insurance in terms of exposure units of risk;
- Certain insurance purchases are dictated by regulatory agencies, lending facilities, lessors or others while some risk situations remain "optional protection" that the business or organization must make a judgement on whether to transfer or retain them.

Property Casualty Market Segmentation

There have been many signs over the past year showing the deterioration of underwriting performance in the U.S. industry data. We should remember that this data includes both the commercial and personal lines business segments each representing about 50% of the total market. Some insurers operate in both segments but market concentration is dispersed. Although both segments are competitive, the commercial sector tends to have more market participants because of favorable market entry requirements and generally less regulation particularly in product pricing. As noted in the chart below the personal lines market has an average 65% share among the top ten carriers compared to only a 43% concentration in commercial. The underwriting erosion in commercial lines has been less than obvious because the release of "excess claim reserves" has clouded the real policy year financial performance. These release of reserves will come to an end at some point in the future and along with other escalating costs will cause a period of continuing underwriting losses with the additional cloud of uncertainty as to catastrophe events that can take place.

We should remember that the history of the U.S. property casualty market had an extensive period of time (1978-2003) when an underwriting loss became the annual ritual. It was only the stream of investment gains during that period that allowed for Operating Profits in most of those years. It was in 1984, 1992 and 2001 that Operating Income first reversed that previous trend of investment aided profitability. These became the turning points in the cyclical process from a soft/competitive market to a hard/restricted market in commercial lines. The chart below clearly shows these inflection points including our suggestion that the next one is early 2012.

**TOP TEN CARRIERS BY MARKET SHARE
2009 Direct Written Premiums**

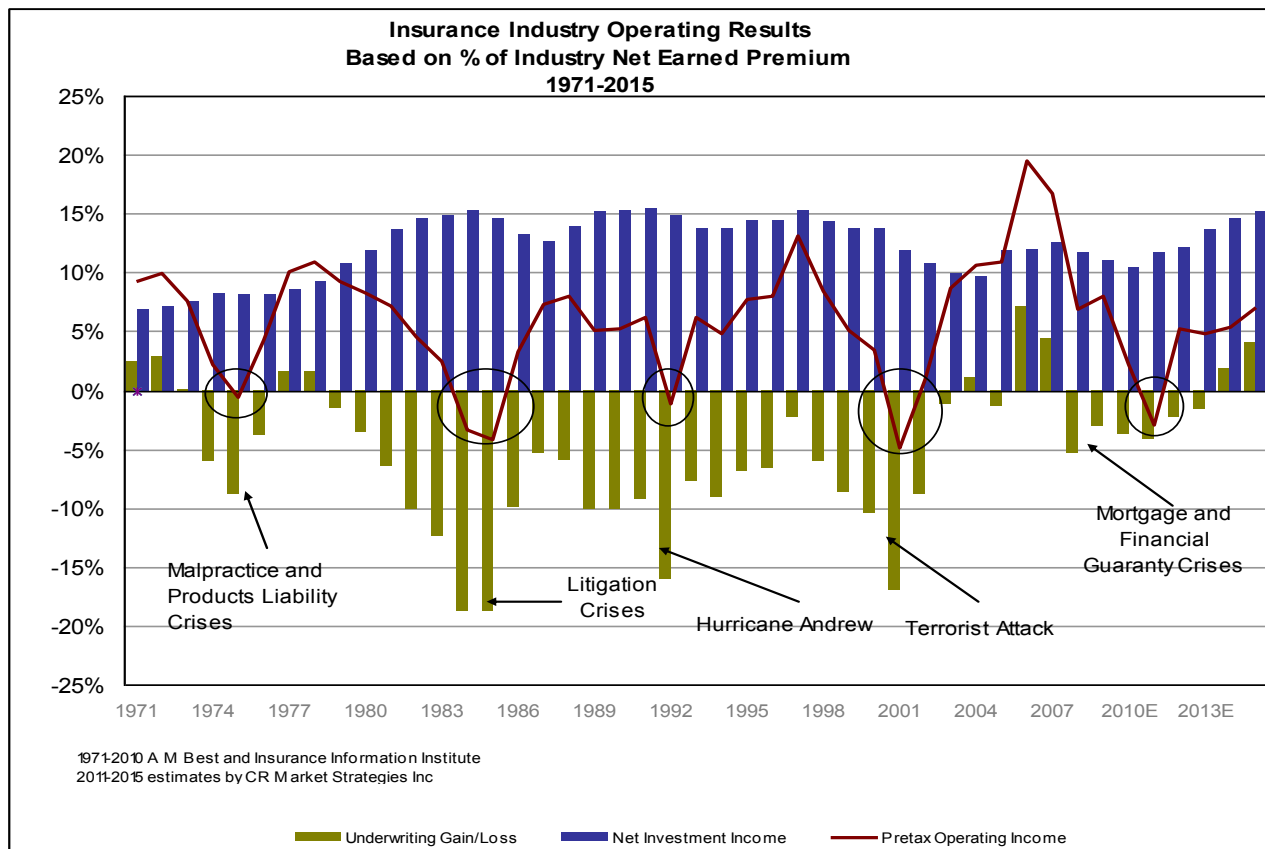
	Commercial Lines	Personal Automobile	Homeowners and Renters
American International	9.1%	2.7%	
State Farm		18.3%	21.7%
Travelers	6.4%		4.5%
Allstate		10.8%	10.8%
Berkshire Hathaway		7.6%	
Zurich	5.7%	5.4%	7.2%
Liberty Mutual	6.0%	4.4%	5.0%
C N A Financial	3.2%		
Nationwide	2.1%	4.6%	4.4%
ACE Ltd.	3.1%		
Chubb	3.0%		2.9%
USAA		3.8%	4.1%
Hartford	2.9%		1.7%
Allianz(Fireman' Fund)	2.1%		
Progressive		7.1%	
American Family		2.1%	2.2%
Total-Top Ten Markets	43.6%	66.8%	64.5%

Direct Written Premiums (Billions of Dollars)	\$238.80	\$161.56	\$67.44
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Source: Insurance Information Institute

While catastrophe events played a role in 1992 and 2001 market turns, they

were not the singular event that turned the market cycle. Rather, it was years of profit erosion across a broad product line that could no longer be covered by investment operations. It was that uncertainty about future prof-



its across a wide spectrum of market participants that turned the market. We are currently witness to the same type of deterioration in market fundamentals that suggests a change is not far away. The previous cycles have shown the operating profit trough-to trough period to be in an 8-9 year window of time.....our forecast for the next change would place 2012 within a 10 year window.

So what might the market experience in the next cycle change? Will it be any different from prior market price corrections? Will the price and restricted coverage conditions be broad-based or more restrictive to certain sectors? How can buyers and brokers position themselves to minimize the impact of this market change? How will underwriters be able to maintain or improve their market position in the longer term in their preferred markets?

While we might remember the comment "The future isn't what it used to be?" (Mr. Yogi Berra) the real question is whether the market at the other end of this cycle correction will look anything like the aftermath of previous cycles or if it will be truly different? In future issues we will offer some suggestions based on real-life experiences as we have lived through all of the prior cycles!



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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.
