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2015 Insurance Trends:

Looking Backward to Predict What's Ahead

By Stephen B. Paulin, CIC

In ancient Roman religion and mythology, Janus is the god of beginnings and transitions, and thereby of gates, doors, passages and time. He is usually depicted as having two faces, since he looks both into the future as well as the past. January derives its name from this Roman deity.

January is considered the month of reflection. We look back at the year behind us, bemoaning our regrets and celebrating our successes. And then, looking forward to the future year, we contemplate the opportunities and challenges, make resolutions and hope for the best.

In the spirit of Janus, here is my look back at the significant insurance and risk management highlights of 2014, with an eye toward how these and other emerging influences will shape the market in 2015 and beyond, and impact your insurance program.

Cyber Risk

Clearly, data breaches rose to become business owners and top executives greatest emerging exposure and operational threat. These unauthorized intrusions result in loss of personal information, intellectual property, assets, and reputation. A hack puts businesses in the cross hairs of local, state and federal authorities resulting in fines, penalties, and compliance costs, all of which redirect a significant amount of internal capacity, ultimately impacting the financial statement and lost profit.

The most notable victims from last year include Home Depot, J P Morgan, Ebay and the most recently, the highly publicized Sony hack. This continues a trend of breaches at high profile companies, which saw Target experience a loss of 110M records in late 2013. The top ten breaches alone accounted for over 380M exposed records. The number of stolen records doesn't necessarily correlate equally to a resulting financial loss. For example, Sony had less that 40,000 records breached, but suffered significant loss of income at the box office as well as reputation due to threats of violence and leaking sensitive emails.

While the large, publicly owned businesses receive significant press for their incidents, experts agree that it's not a matter of if, but when your business will experience a data breach. With threats cutting across companies of all sizes, small and mid-market business owners recognize they must address the risk. The cat and mouse game of intrusion and protection is constantly escalating, with hackers having the advantage. As businesses that can afford to spend millions of dollars on IT security, become harder to break into, hackers are turning their sophisticated intrusion technology toward organizations with lower barriers to entry.

Earlier in the month President Obama proposed data protection initiatives. He is asking Congress to consider better cybersecurity measures through legislation including a federal standard for data breach notification, modernizing law enforcement to better combat cybercrime and increasing cybersecurity information sharing.

Recognizing this trend, seven years ago, I wrote a white paper, Privacy Protection - A New Threat to the Balance Sheet, predicting what has become a reality. (click link to read) Since then, a few insurers took the lead to offer coverage. Terms, conditions and pricing have evolved today where many insurers either offer a comprehensive, stand-alone cyber liability policy, to basic coverage embedded in the property policy. There is no standardized coverage – every form is different with regard to what and how the various perils are covered. Premiums are all over the board.

If educating yourself about cyber liability is on your 2015 "to do" list, I recommend you meet with your broker to determine your organization's specific areas of exposure, and understand the scope and depth of coverage available to meet your need. There are three primary areas of coverage:

1. Compliance with State / Federal laws and statutes
2. Direct property loss
3. Third Party liability

Each of these is explained in the paper mentioned above.

The following websites offer further details and insight.

www.privacyrights.org

A compendium of information along the spectrum of privacy, including a chronological list of reported breach beginning in 2005.

www.norse-corp.com

An eye opening look at live attacks around the world.

http://www.ponemon.org/blog/ponemon-institute-releases-2014-cost-of-data-breach-global-analysis

This connects to the 2014 Cost of Data Breach report, as well as a resource for past and ongoing research.

Terrorism Risk Insurance Act (TRIA)

Sometime things aren't a problem until they are. One such example was the unexpected failure of the US Senate to pass legislation extending the Terrorism Risk Insurance Act (TRIA), the federal government's terrorism insurance backstop beyond its 2014-year end expiration. While the magnitude of this was lost to many in the public, it sent shock waves through the insurance market as brokers and insurers scrambled to find substitute coverage for renewals beginning January 1, 2015. Significant disruption was caused for many businesses that were out of compliance with lending covenants. Workers' compensation policies were affected the most, as state statutes require terrorism as a covered peril.

Fortunately, Congress immediately addressed this when it convened on January 6. The House's 416-5 vote in favor was quickly followed by the Senate's approval, thereby circumventing additional disruption, re-establishing the status quo.

As it now stands, the new legislation decreases the government's exposure by gradually increasing the trigger at which the program starts to cover terrorist acts up to $200M in losses, an increase from the previous $100M initially established in 2002. Additionally, when that threshold is met, the government's share of catastrophic losses would be gradually lowered from 85% to 80%. Further, for a loss to be considered terrorism, the act must be certified as such by the Secretary of the Treasury, in concurrence with the Secretary of State and Attorney General.

Catastrophes, Profitability and Rates

These three elements are inextricably tied together. Over the past 40 years, the insurance market has followed a pricing cycle alternating between long periods of declining rates, referred to as a soft market, accompanied by numerous insurers competing for business underwriting. These periods are separated by a shorter time frame of acute rate increases, significantly limited number of alternatives, and insurers employing strict underwriting practices. For details read my article*, High Noon in the Property & Casualty Market.*

Catastrophes play a large role in insurer profitability and how insurance coverage is priced. The 9/11/2001 terrorist event was responsible for the transition from a soft to hard market, which lasted four years. A particularly onerous hard market from 1985-88 preceded this. Then, 2011 recorded $107B in total insured catastrophic losses, making it the second highest in history, and surpassing 2010 by close to three times. The result was a modest hard market in general, which showed signs of rate reductions this past year. The one caveat being California workers' compensation, which I will address separately.

Even with a more active Pacific tropical storm season, 2014 was a quiet year for natural disasters. This continuing trend, beginning in 2012, has caused property rates to decline. This reduced claim activity, along with moderate premium growth during the economic recovery has allowed insurers time to repair their balance sheets and become profitable again.

A growing trend of alternative capital is causing an oversupply, which will drive rates down. Insurance linked securities, such as catastrophe bonds, offer a higher return than other instruments. Some hedge funds have also started offering reinsurance to help share the insurance burden of hurricanes and natural disasters, stealing business from traditional insurers. Experts prognosticate that under these new conditions it would take a single $50B to $100B event to move the needle.

Travelers Insurance Company, a member of the Dow Jones Index, and bell weather for the property & casualty industry recently released its favorable 4th Quarter and annual 2014 financial results. For the year, net written premium, total revenue and operating income all increased, outperforming estimates. As insurer profitability increases, rates decline for coverages across the board. This is evidenced with the declining cost for liability, automobile and excess liability policies. After successive large double digit rate increases, Employment Practices insurance costs have moderated, but will take a bit longer to fall.

Visit the Council of Insurance Agents and Brokers website to view the results of its quarterly Commercial Insurance Market Index. The survey tracks pricing trends, underwriting practices, and availability by regions of the country and size of business.

California Workers' Compensation

For many businesses workers' compensation is the most expensive of any property and casualty policy it must procure to protect its operation. It is often one of a company's highest corporate expenses. Any condition that causes rates to increase only exacerbates that cost, reducing profit. During the current hard market, workers' compensation increases have mirrored the other lines of coverage. However, with California's propensity to distinguish itself from other states with how it operates, the workers' compensation environment is more volatile. A recent study shows California workers' compensation rates to be the highest in the country, averaging $3.48 per $100 of payroll. This is 188% above the median, surpassing Connecticut, the next in line by 33 points.

While many insurers are seeing their workers' compensation Combined Ratios (claims + expenses / premiums), a basic indicator of profitability, drop below 100% for the first time since 2010, California results have not reached that level. As such, this year state businesses will experience a 2% - 6% rate increase. Not only is this a welcome relief from the succession of mid double digit increases, this moderating reflects stabilization between exposures and cost and portends a rate reduction in 2016.

Senate Bill 863 (SB 863) was enacted in 2012 for two purposes. First, to increase permanent disability benefits paid to injured workers to compensate them for the lasting effects of work- related injuries. These were determined to be too low as a result of a previous legislative reform. Second, to contain costs associated with providing medical treatment and benefits to injured workers and administering workers' compensation claims that had begun to rise significantly. In order to achieve this trade off, it was agreed; where possible the required savings would be from making the work comp process more efficient.

Labor and management agreed that in order for benefits to be increased, costs would have to be decreased where possible. They also agreed that the workers' compensation process should be made more efficient. The bill addresses changes to job displacement vouchers, independent bill review, liens, and adjustments in fee schedules for certain services.

Unfortunately, many of the intended savings are not materializing. Further, continued legal challenges, some dating back to the earlier reform when Schwarzenegger was in office, have disrupted key provisions, with the potential to cause further setbacks. These are primarily coming from Applicant (injured employee) attorneys who are litigating

claims. This “gaming of the system” has exploited loopholes and gained additional traction through successful legal challenges over turning certain provisions.

The WCIRB is working to file regulations with the Insurance Commissioner effecting how experience modifications are calculated. While the proposed changes will not be effective until 2017, this move represents the second change since 2010 aimed at making the calculations more accurate, while lessening the volatility that a single claim can have. At this point, we are taking a wait-and-see attitude, until more information is available from sample test calculations.

Certainly, these external influences and uncontrollable factors, such as the legislature’s involvement to shape workers’ compensation present a challenge to operating an efficient and effective program. The experience of the last four years has created an understanding that the best way to navigate this inefficient system and gain some modicum of control to achieve desired outcomes, reduce costs and increase profit is understanding and managing the controllable factors within the organization. Such examples include, management’s commitment to a culture of safety, new hire screening processes, compensation, training, and return-to-work programs all support high employee engagement and productivity. My article, The Process is the Solution, offers further insight.

Though not as dramatic as the drop in gas prices, property and casualty rate reductions are a welcome change to the past four years. California workers’ compensation pricing is trailing other lines of coverage, but clearly heading in that direction.

While insurance rates fluctuate, and can even be volatile at times, the risks of loss businesses face are dynamic and ever changing. Some are more predictable than others, and there are those risks that are rare but inflict catastrophic consequences. Understanding what those are, assessing your organization’s vulnerability and risk tolerance for each, and determining how to best avoid or mitigate a loss is a continuing challenge.

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