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A Client Service from Stephen B. Paulin, CIC

If It's 7 o'clock, it Must Be a Hard Market

By Stephen Paulin, CIC

While reorganizing my office recently, I was struck with nostalgia when I ran across an issue of Time magazine dated March 24, 1986. Flipping through the pages brought back memories of long gone institutions and businesses such as, First Interstate Bank, Compaq Computers and Western Airlines, as well as recognizable brands like Smirnoff, Xerox and AT&T, which continue to be relevant. My reason for retaining this one issue has less to do with offering my twenty-something year old children a view of mid 80s commercialism, but specifically for the 10-page feature article that headlined the cover, "Sorry, America, Your Insurance Has Been Canceled."

The article details how businesses across all industries were dealing with the severe sticker shock of rapidly increasing commercial insurance rates that commonly reached as high as 300% above the expiring coverage. I relived my first experience with a turn from a "soft" (buyers) to "hard (sellers) market that occurred eight years into my insurance career. This shift occurred between similar events stretching from 1975-78 and 2001-04. While serendipitous, my magazine find comes at a time when market conditions indicate an imminent change to another cycle of increasing rates, which most likely will be led by California workers' compensation.

Historically, the shift from one pricing cycle to the next has been compared to a swinging pendulum. A better visual analogy to explain how and why the insurance market shifts is the hours on a clock. Market events at each hour affect how conditions progress. Regardless of the line of insurance coverage, a set of common factors affect different stages of the pricing cycle.

The following synopsis using the clock analogy illustrates how these factors influence the various stages of the cycle. Property, liability and automobile increases will follow.

How prepared are you to mitigate the forthcoming workers' compensation rate increase?

- **1 o'clock:**
  Insurance companies put more emphasis on gaining market share. Premiums are reduced on better classes of business. Capacity grows, more funds is more plentiful in anticipation of profitable returns. Financial results are good across the board.

- **2 o'clock:**
  Policy pricing continues to drop to generate new business and income, and rate cutting expands to include more classes of business. As competition heats up, insurance companies cut rates more aggressively in order to retain renewals and maintain market share.

- **3 o'clock:**
  Insurance companies look for ways to develop more new business to support their quest for additional market share through agreements with Managing General Agents (MGAs), who are given authority to rate, underwrite and issue policies, as well as to adjust claims. This decentralized underwriting and authority contributes to increasing loss ratios.

- **4 o'clock:**
  Because of the competitive conditions, the excess and surplus lines market begins to lose business. Policyholders with more hazardous exposures find rate relief in the standard market. Policy forms become broader, so insurance companies take on more risk at a lower cost. The drive for market share is in full swing as prices drop, and the push continues for more new business.

- **5 o'clock:**
  The pricing for business loses all credibility as carriers accept risks at deep discounts. Underwriting fundamentals are abandoned with no accountability or criteria due to the need to expedite quotes. Pre-inspection of risks is non-existent, and loss control of current business is not enough. Loss ratios deteriorate, and some insurance companies indicate that they will "no longer play this game."

- **6 o'clock:**
  Prices hit bottom, and the insurance companies begin to pull back MGAs' authority. A trend toward instilling underwriting fundamental emerges. Insurance companies' stocks begin to rise as the equity markets anticipate a return to profit.

• 7 o'clock:

Loss ratios are exceptionally poor, and insurance companies' earnings are at a low. The battered reinsurance market starts to raise its rates. Capacity begins to dry up as sources of capital flee the market and search for better rates of return in other investments. Policy forms, terms and conditions are tightened as insurance companies attempt to reduce their risk of loss.

• 8 o'clock:

High premium to surplus ratios and the shrinking reinsurance supply restricts carrier growth. This results in wholesale cancellation of unprofitable policyholders, and limits new policyholders to businesses that are performing better than average. This pushes rates up even higher. Buyers are unhappy.

• 9 o'clock:

Financial results are still poor, but loss ratios start to improve as prices increase sharply. Buyers look for options to help control their costs such as large-deductible programs, captives, and self-insurance. There are indications that some insurance companies did not turn the corner soon enough, and there is fear of insolvencies.

• 10 o'clock:

Carriers move from a gain market share mentality to an emphasis on profits, and high-risk business continues to reverse the flow back to the excess and surplus marketplace where more capacity is available. However, that capacity is still expensive.

• 11 o'clock:

Insurance companies flourish, and earnings multiply. The average combined ratios put carriers in a profitable position, and stock prices peak.

• 12 o'clock:

High noon brings euphoria to the industry. Prices stop rising. There is a balance between the price charged and the accepted risk. New lines of insurance begin to open up. Equilibrium is reached as carriers employ sound underwriting practices and appropriate loss control measures to control claims. Industry hiring expands.

Right now, the workers' compensation market stands at 5:30. The most recent Workers' Compensation Experience Rating Bureau (WCIRB) report shows insurance companies paying $1.27 for every $1.00 in premium collected in 2009. 2010 is expected to exceed this amount, with the trend continuing this year. The number of insurers competing for new business is steadily decreasing, and the deep discounting is slowing. The level of deteriorating loss ratios combined with the other previous noted 6 0'clock conditions indicate a move towards 6 o'clock.

Drawing from my experience with the 2001-04 hard market, I see similarities to today. The market was progressing through 6 o'clock conditions during the first eight months of 2001. 9/11 was the tipping point for transitioning to 7 o'clock, with 8 o'clock quickly coming in the first quarter 2012, because of higher reinsurance rates effective on January 1. Losses from 9/11 presented what was considered a unique and highly remote circumstance. To avoid the possibility of accepting too much exposure in any one area, reinsurers diversified their underwriting and spread risk among numerous, seemingly unrelated lines of coverage, such as aviation, property, excess liability, workers' compensation, earthquake, etc.

Unfortunately, 9/11, and the Twin Towers specifically, was the worst-case scenario. Diversification became the recipe for disaster as reinsurers became responsible for paying claims on multiple lines of coverage from one catastrophic experience. At $30 billion, the second largest single catastrophic event in history shook the industry to its foundation, and catapulted the property and casualty rates into a three-year hard market.

Recent events are contributing to a similar effect on rates today. The New Zealand earthquake and the Japanese Tsunami, estimated to be $45 billion in insured losses, are a major concern to property and casualty insurers. Certainly, there will be a huge negative financial effect on reinsurers' near term earnings. There could be devastating financial results from the understanding there is the possibility of additional catastrophes occurring within the next nine months, including hurricane season, which traditionally develops a large percentage of annual losses.

Business owners are wise to assess what the future may hold, and how it will effect operations. The cost of commodities, changing credit market, evolving consumer demands all impact tactics, strategies, planning and goals to maximize profit. Similarly, understanding at what point the insurance cycle exists on the clock, whether it is trending toward a hard or soft market, and the velocity of change impacts the structure and type of insurance program.

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