



# IN THE

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## Commercial Insurance Market Outlook 2009 Transitions and Tipping Points

### Where We Are Now

In December of 2007, we suggested that the 2008 commercial insurance market would be an extension of the trend in 2007 - - with a few possible twists. In our 2008 Market Outlook we stated *“Consequently, an insurance company looking to its investment portfolio to bail it out of bad pricing or underwriting decisions may be disappointed.”* It turns out the events in the investment markets over the third and fourth quarters may have made our prediction a bit of an understatement.

The second half of 2008 produced some significant disruptions in the insurance market. AIG was essentially nationalized by the government. Although it is important to point out that the core insurance subsidiaries of AIG have been and continue to perform well. It was the financial products division and its Credit Default Swap activity that created the financial storm for AIG. The Hartford Insurance Company found itself in similar circumstances with its investments and its life insurance and annuity products forcing it to seek a \$2.5 billion capital investment from German financial conglomerate Allianz Group. Subsequently, Hartford sought to acquire a Florida based Federal Trust Corp. a thrift holding company, and convert Hartford to a Savings & Loan Holding company to access between \$1.1 and \$3.4 billion from the Treasury under the TARP program. Our point here is not to pick on Hartford or AIG, but rather to illustrate the full impact of structural changes in the investment markets are yet to be realized for insurance company balance sheets. It appears the “excess surplus” the insurance industry enjoyed over the last few years may have been an illusion. Industry surplus fell 9% in the first nine months of 2008 for the first time since 2002.

Compounding the negative effects of the investment markets for insurance companies is the deterioration of earnings and increasing loss ratios. After-tax profits for the U.S. property casualty industry declined almost 92 percent from the same period a year ago. Note this does not take into account the additional drag on earnings due to prospective negative investment returns for the fourth quarter of 2008. The combined ratio, a key statistic of losses and expenses per dollar of premium, worsened to 105.6 percent in the first nine months of 2008 compared to 93.8 percent for the same period in 2007. Essentially the industry paid out over \$1.05 for every \$1 it took in. Whether insurance company investment portfolios ultimately add or subtract surplus, it appears at a minimum they will not aid in subsidizing underwriting losses.

Another key indicator is loss reserve adequacy. It is not uncommon for insurance companies to “harvest” loss reserves from prior years deemed redundant and bring those reserves into current year’s income. It’s analogous to a company pulling the excess funding from an over-funded pension plan into current year’s earnings. The problem is, you never really know what is truly “redundant” until well after the fact. Insurance companies are more prone to harvesting alleged reserve excesses when negative loss ratios appear. While loss reserves appear to be adequate at present, there may be an indication that the ability of the industry to continue harvesting prior year reserves to shore up deteriorating loss ratios may be coming to an end.

If the financial market activity in the second half of 2008 has illustrated anything, it is planning for the unexpected.

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## What's Likely

Years of compounding soft market pricing, along with negative investment returns and significant loss reserve harvesting would seem to set the stage for a “snap back” effect on pricing upward. Yet loss reserves appear still reasonably adequate and an economic recession has the macro effect of reducing demand for insurance while the supply of insurance has not materially changed. These factors will probably mitigate or forestall a severe change in commercial insurance pricing in 2009. At the aggregate level, we would expect rates to stabilize or nominally increase throughout the year for most clients. We also expect more emphasis on underwriting and acceptability of risk by insurance companies. Those clients who have loss problems or whose rates have been pushed far below what is perceived as adequate will find underwriters responding by saying “thanks, but no thanks” when their account is presented to them for consideration. As a result, fewer insurance company choices will be available for those types of clients which will produce the effect of increased pricing as the supply of insurance available to them specifically will be significantly reduced. 2009 will likely be a year of transition for the insurance industry as it shifts from a soft pricing market to stabilization, setting the stage for some level of price increases in the future. Yet at the same time, it teeters at the edge of significant change possible in pricing and underwriting terms.

That said, there are rapidly emerging problem areas developing that may see material price changes upward. The area of executive protection coverage may become troublesome. The unprecedented activity in the financial markets will no doubt spawn a host of new Directors and

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Officers (D&O) litigation. Economic recessions produce increased layoff activity which sparks Employment Practices Liability activity. Defined Contribution 401K plan participant balances have been devastated and we expect Fiduciary liability claims to pick up. And in the case of 401-k plans, it is imperative that clients be aware of their obligations under section 404 (a) and (c) of ERISA to help mitigate their fiduciary exposure.

## What Could Go Wrong

While core underwriting profitability is not as weak as in prior market cycle changes, we need to be on the lookout for potential rogue waves changing our assumption of gradual transition. Any event or combination of events, which materially affect the level of surplus in the insurance industry, could change 2009 from one of quiet transition to chaotic change. Continued negative returns in the investment markets begin to drain surplus, rather than just fail to shore up poor underwriting. Weather catastrophes above historical trend lines will drain surplus from the system. Financially weak insurance companies forced into consolidation will reduce supply, whether it is at the primary insurance company or reinsurance company level. The potential onset of significant inflation as a result of the various economic stimulus programs and actions by the Federal Reserve is not factored into the present loss costs by insurance companies. This would have the effect of driving loss ratios much higher than anyone anticipates and adversely affecting insurance company surplus.

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**We're here for you.**

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