

# Bumps in Insurance Markets

## Smoothing Out



2000 ushered in the first truly hard market since the mid-1980s

We've broken into another year, and looking back on the bouncing stock market and slumping economy of past years, one wonders whether this year will bring positive change for the commercial property casualty insurance consumer, or if the challenges of the past few years will continue in 2004. A look at past events and future trends may help answer this question.

But first, a little background. The business cycle for insurance markets is called the underwriting cycle and usually is defined as either a soft or hard market. In a soft market, premiums may not increase from one year to the next and actually may decrease by 10%. In a true hard market, on the other hand, premiums generally increase about 40% on average.

When profits are up, insurance companies want more market share, so they lower their premiums and price aggressively, many times without strict underwriting guidelines. During the 1990s, insurance companies turned a healthy profit, even though they reduced their prices, because the stock market was going strong and their return on investments were positive.

However, 2000 ushered in the first truly hard market since the mid-1980s. Under this hard market, insurance companies have seen their investment returns fall and their profits drop accordingly. In response, companies have increased their premiums to cover past losses and reduced coverage to eliminate future exposures to loss.

### Falling on Hard Times

The economy has direct impact on the cost and product offerings of the insurance industry. And while the economy has taken a

hit in the aftermath of September 11, 2001, and amidst ongoing terrorist threats and activities around the world, these events aren't the sole reason for increases in insurance rates.

Rather, the financial forces that have propagated this hard market derive from a combination of factors: a litigious society, natural catastrophic losses, skyrocketing medical expenses, accounting and analyst scandals, an overall economic slowdown, the dot-com crash and the poorly performing stock market of past years, which had been subsidizing the insurance market.

In a soft market, an insurance company can afford to lose money when claims outpace premiums, because it can make up the difference with investment income, if rates of return are in the double digits. In a hard market, however, an insurance company cannot afford to lose money from underwriting operations when investment income doesn't at least provide an offset.

As a result of the current hard market, many insurance companies have completely withdrawn from certain markets, and some have even gone out of business, because they leaned too heavily on >>>

investment income, then ran into trouble when they priced their services too low and didn't reserve enough to cover claims.

### Tracking the Money

Insurance agents, brokers and consumers rely on rating agencies such as A.M. Best, Standard & Poor's, Moody's, Fitch, and Weiss Research to monitor whether insurance companies can pay out claims. Two financial ratios commonly are used to assess an insurance company's financial status: combined ratio and operating ratio.

The combined ratio focuses on incurred losses plus expenses; if these two factors equal 100, the company is considered a breakeven operation. The operating ratio uses the same formula, but also factors in investment income. When either the combined or operating ratio exceeds 100, the company stands to

pay out more in claims than it has money coming in, and consumers should take heed and further research the company.

When telcos review the financial report of their insurance company, an important item to monitor is the company's surplus, which is a measure of underwriting capacity and can be compared to the owner's equity or net worth in noninsurance terms. Since many insurance companies have been collecting more money than they have been paying out in years past, surplus should increase in 2004.

If an insurer's surplus is not increasing or at least stabilized, the telco would do well to dig deeper into the insurance company's balance sheet. However, a surplus that is exceedingly higher than in past years is not necessarily cause for alarm, either. Many insurance companies have built up their reserves to cover such costly and potentially recurring claim items as

asbestos, mold and construction defects, and such new claim areas as electromagnetic field exposures.

### Things to Come

The Risk and Insurance Management Society (RIMS), and the National Underwriter Co. predict the following trends in commercial insurance and risk management for 2004 (barring any significant economic changes or major company insolvencies):

- Prices will stabilize in most lines, especially for consumer companies that are well managed and maintain low losses. These companies are likely to see only a slight inflationary increase of 2% to 3%. Customers that have high losses will continue to see an increase in premiums.
- Workers' compensation rates (much like other health insurance plans) ▶▶▶

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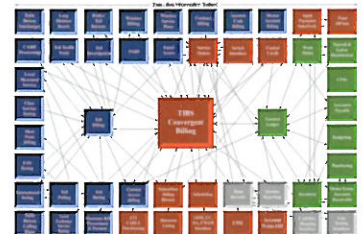
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will continue to rise, but with smaller increases than in the past two years.

■ It is likely that prices will increase for products liability and D&O/EPLI (directors and officers/employment practices liability insurance). Lawsuits and class

action suits claiming unfair practices under the newly revised Fair Labor Standards Act, violations concerning the Uniformed Services Employment and Re-employment Act, COBRA violations, and leaves of absence under the Family

Medical Leave Act and the Americans with Disabilities Act are key areas where claims are likely to occur.

■ Increasingly, human resources personnel will take over safety responsibilities, such as training, workplace violence, workers' compensation and accident investigation.

■ The insurance agent or internal risk manager will be a resource for insurance management in many organizations. This includes risk assessment, loss control, safety training and trend analysis to predict and reduce exposures and losses.

Experts predict that increases in premiums, lower levels of catastrophes and underwriting restrictions will result in an improved combined ratio for the insurance industry this year.

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## The Good News

The financial markets seem to be improving, which gives confidence to investors and businesses that the economy is starting to improve. As insurance companies raise more capital and improve their ratios to a profitable level, they can begin to expand and compete again.

Increasing interest rates should help increase investment income. And, in theory, with improved operational and financial statuses, insurance companies can focus on market share.

Provided the economy continues to improve, the property casualty insurance market seems to be on the road to a slow recovery in 2004. And that, ultimately, is good news for the consumer. ■

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