Businesses urged to prepare for tighter insurance market

by San-Antonio-Biz-Journal

The effects of the financial crisis of 2008 are winding their way through the property and casualty insurance markets. With this, the economyâ€™s impact on the availability and cost of coverage is beginning to emerge. All indications are that it is time to prepare for another hard insurance market.

Insurers rely on their surplus to underwrite new business. Surplus is the amount of capital they maintain in excess of the reserves they have posted to pay for insured losses. Enhanced surplus capacity allows the insurance company to take on more risk and earn more premiums. Their surplus is governed by solvency requirements of various state departments of insurance. Additionally, ratings agencies such as A.M. Best, Fitch and S&P evaluate the financial condition and operations of most insurance companies and then assign a rating, which serves as a measure of the carrierâ€™s financial strength, quality of management and claims-paying capabilities.

The importance of an insurance companyâ€™s ratings is twofold: businesses prefer to place their insurance coverages with highly rated companies and lenders require their loan holders to place their insurance with highly rated carriers. Therefore, the ability of an insurer to attract and write new business is governed by their surplus capacity, the statutory solvency requirements and their need to maintain superior ratings.

The property and casualty insurance industry has steadily increased its surplus capacity since the events of Sept. 11, 2001. The industry has experienced dramatic growth during this period in spite of suffering five of the 10 most costly insurance losses ever recorded including three events in one year â€" the staggering losses caused by Hurricanes Katrina, Wilma and Rita in 2005, according to the Insurance Information Institute. The insurance industry has been able grow surplus capacity to record levels in part through the returns they were able to achieve from their investment activities. The enhanced return on their investment resulted in increased surplus which enabled the carriers to write more business and further invest those premiums. In their quest to grow market share and invest the premiums, insurers slashed the rates they were charging over the past few years. This phenomenon is referred to as the soft insurance market.

Several factors have recently converged to create the perfect conditions for the formation of a hard insurance market. The industry suffered record losses again in 2008. Munich Re, one of the worldâ€™s foremost reinsurers, calculates that the total insured loss of $45 billion worldwide in 2008 was the second highest on record, falling only behind the $107 billion of insured loss posted in 2005. These losses in combination with the declining rates from intense competition and the recent decline in the economy have taken a toll on insurance surplus capacity industrywide.

The economic slowdown has had a profound impact on insurersâ€™ balance sheets. In its report, â€œReview and Outlook 2008-2009, U.S. Property-Casualty Insurance,â€• Fitch Ratings said the soft market cycle, high catastrophe losses and poor investment performance combined to cause a projected 83 percent decline in statutory earnings and a 10 percent drop in statutory capital for 2008. The report notes that â€œasset classes favored by property casualty insurers â€" including equities, corporate bonds and tax-exempt securities â€" were affected by the contagion from the mortgage market collapse in the last few months.â€• The last quarter of 2008 brought a precipitous decline in the value of their investment portfolio which, in turn, has reduced surplus and their ability to write new business. The decline in the price of their shares as publicly traded companies has also adversely impacted their financial position. In addition, the impaired capital markets have withdrawn their support on the reinsurance side and this has forced many insurers to retain more primary risk against their declining surplus. This will likely create more problems for the industry if natural catastrophes such as hurricances again take a toll in 2009.

Similarly, the slowdown has had an adverse impact on their policyholdersâ€™ balance sheets. Businesses are posting lower sales results and they are significantly reducing their payroll costs. These measures of business activity are considered by insurance companies to be good measures of exposure and are traditionally used to calculate insurance premium. The reduced exposure basis will result in lower premium volumes even after the carriers raise their rates. The insurers for the construction, financial, manufacturing, automotive and retail sectors will very likely experience significant erosion in their books of business. There is also declining demand for insurance as businesses downsize and look for ways to reduce their expenses. Declining economic

conditions may also produce elevated moral hazard such as increased incidence of arson, staged accidents and insurance fraud.

The combination of mounting underwriting losses together with soft market rates and inadequate premium reserves, declining surplus, reduced asset base, poor return on investment and the downsizing trend by current policyholders has created unsettling conditions for the insurance industry. Insurers will likely come under greater scrutiny by regulators, rating agencies and lenders in the first half of 2009. To comply with the statutory surplus requirements and maintain their credibility and ratings, insurers will redefine their risk appetite, strengthen their underwriting standards, redeploy their capacity to the best in class, raise their rates and lower their exposure. These actions will likely increase the incremental cost of insurance for most businesses in North America â€” creating what is referred to as a hard insurance market.

What to do

Business owners, financial officers and risk managers should begin to prepare for the changing market conditions now. Align yourself with a qualified and competent insurance agent or broker and work together well in advance of your renewal to:

â€¢ Compile five years of historical financial data including sales and payroll data.

â€¢ Perform an audit of your prior loss history for the past five years paying close attention to claims trends, loss frequency, large claims and open reserves.

â€¢ Implement meaningful accident prevention and safety initiatives to address claims frequency issues.

â€¢ Prepare narratives to describe the circumstances surrounding larger claims and discuss what you have done to mitigate the possibility of a similar large claim occurring again.

â€¢ Meet with claims adjusters to discuss open claims and determine if reserves are accurate. See if the amount on reserve can be lowered.

â€¢ Maintain a current written safety and accident prevention plan and ensure it is fully implemented and management activities in this area are well documented.

â€¢ Where applicable, maintain a documented fleet safety plan, establish authorized driver criteria and maintain current driver records on file.

â€¢ Maintain a current and well documented certificate of insurance program.

â€¢ Consider and be prepared to discuss inherent or unique hazards associated with your business activities and your products or services.

â€¢ Consider and be prepared to discuss concentrations of risk â€” supply chain, sole supplier, lead customers, property concentrations, employee concentrations, other asset concentrations, impact of loss to key processes, exposure to hurricanes, tornados, hail and other catastrophic losses.

â€¢ Prepare a thorough, honest and accurate appraisal of your business operations and activities. Include your detailed analysis of those factors which distinguish your exposures from those of other similar operations. Emphasize the strength and stability of management, stable financial condition and how your organization adheres to best practices.

â€¢ Select appropriate carriers and submit your account to them no later than 60 and preferably 90 days in advance of your renewal date.

â€¢ If possible, arrange face to face meetings with underwriters to discuss your operations.

â€¢ Be prepared to receive last minute quotes and arrange contingencies for restrictive terms, higher deductibles and higher rates.

How quickly the market will change and how high the rates will go waits to be seen. One thing seems almost certain though â€” this hard insurance market will very likely last longer than those of the past. Where the capital markets have historically participated heavily in the creation of new insurance capacity during past hard markets, the capital markets will continue to withdraw from providing additional insurance capacity until they are able to get their own houses back in order. This process will likely take some time. Your best bet is to be prepared for the long haul.

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