

State of Insurance in 2005 And How It Affects This Industry

Slowing of Property and Casualty Premium Growth

Dr. Robert P. Hartwig, Ph.D., CPCU of the Insurance Information Institute (III,) of New York in an Earlybird Forecast for the United States indicated each year III invites a panel of Wall Street stock analysts and industry professionals to review the prospects for the industry in the current and coming year. The 2005 survey reveals that the industry's effort to recover from its worst-ever performance in 2001 ran into hurricane force headwinds in 2004, as the quartet of storms that struck the southeast coast transformed what would have been the industry's best year in decades into a breakeven performance. In 2005, analysts expect little change from 2004, though on a catastrophe-adjusted basis it is clear that the cyclical deterioration in underwriting performance will begin to make its presence known. The poll also shows that analysts uniformly expect premium growth to slow in 2004 (to roughly half of what it was in 2003, on average) and for that deceleration to continue in 2005.

Premium Growth:

Slowing, Slowing, But Not Quite Gone

The average forecast calls for an increase in net written premiums of 3.4 percent in 2005, down from an estimated 4.8 percent in 2004. The 2004 figure itself represents more than a halving of the 9.8 percent increase in 2003. It is also worth noting that premium growth in 2004 came in well below even the pessimistic of analysts' expectations from a year ago. In last year's Early Bird survey the consensus estimate was for net written premium growth of 8.1 percent and the lowest estimate of the 13 respondents was 5.2 percent, nearly a half point above the current estimate of 4.8 percent. In contrast to previous years, when gains were chiefly the result of higher rates, the sharp weakening in the pricing environment over the past year means that current gains are more directly related to increased exposure growth and higher demand associated with the current economic recovery. Until 2004, exposure growth was concentrated on the personal lines side, as low interest rates propelled new home construction to record levels while at the same time boosting auto sales. During 2004, however, business investment and hiring finally began to perk up, pushing up demand for commercial insurance.

Combined Ratio: Much Better than it Appears

The combined ratio, which is the ratio of losses and expenses to premiums, for 2005, is projected to be 99.0, little changed from the 100.0 estimated for 2004 and the 100.1 recorded in 2003. Nevertheless, the forecasts are vast improvements over the terrorism-impacted 115.7 results in 2001. Were the combined ratio in 2004 or 2005 to come in under 100, it would mark the first underwriting profit in the property-casualty insurance industry since 1978. Moreover, had catastrophe experience in 2004 been "normal" (insured losses for the four hurricanes that struck during the third quarter of 2004 are estimated at \$20.5 billion) the year's combined ratio would have been in the neighborhood of 95—its lowest level since 1972.

While the survey results show some expected improvement, the bottom line is that the industry will still be paying out almost exactly the same amount in claims and associated expenses as it earns in premiums, thereby increasing the importance of investment earnings. Given the current low yield, high volatility investment environment, it is clear that Fortune 500-level returns on equity in the neighborhood of 13 to 14 percent cannot be generated without a contribution from underwriting.

2005: Looking Relatively Good, But Concerns are Mounting

What are the biggest potential downside risks for 2005? High on the list is a loss of pricing and underwriting discipline. Differing views on the likelihood of pricing discipline being maintained likely explain the disparity among analysts' forecasts for net written premium growth in 2005, which range from 1.1 percent on the low end to 6.0 percent on the high side. So far, pricing is clearly easing but cannot yet be characterized as destructive.

Among major external risks, tort costs remain among the factors that most significantly affect insurer financial performance. The failure of class action, asbestos and medical malpractice reform legislation was among the industry's biggest disappointments in 2004. At a minimum, Congress will likely revisit the issue of class action reform in 2005, which fell short of passage by a single vote in the Senate in 2004. The failure to get the Terrorism Risk Insurance Act extended in 2004 was also a major disappointment. Many commercial policies (with the exception of workers compensation) with inception dates

after January 1, 2005 will now include terrorism exclusions in the event that the Act...currently scheduled to sunset at the end of 2005 is not extended.

While not directly impacting the operating performance of insurers, 2004 is likely to be remembered as the year in which New York State Attorney General Eliot Spitzer initiated an investigation of some insurance industry practices. The ultimate impact of this investigation, which has resulted in at least two dozen additional probes launched by state attorneys general and insurance departments around the country, is still unknown. However, insurer (and broker) expenses are certain to rise in 2005 as compliance costs increase as new regulations come online and fines and penalties are levied and paid.

Auto Injury Claims are Common Despite Lower Auto Accident Rates

More than one in four auto accidents resulted in bodily injury liability (BI) claims in 2003, according to a recent study by the Insurance Research Council (IRC). The study, "Trends in Auto Injury Claims, 2004 Edition," reveals that BI claim rates have remained high even though IRC research suggests that auto accident rates and the seriousness of auto injuries have decreased in recent years. IRC's recent study uses the ratio of BI claims for every 100 property damage liability (PD) claims to measure the likelihood that BI claims will be filed in auto accidents (PD claim rates approximate auto accident rates in the United States). In 1980, 17.9 BI claims occurred for every 100 PD claims—in other words, slightly fewer than one in five auto accidents produced BI claims that year. By 2003, the BI to PD ratio increased to 26.4. The 2003 ratio is an improvement over the ratio in 1995, however, when 29.5 BI claims occurred for every 100 PD claims.

The report documents changes in auto accident and injury claim rates for the nation and each state from 1980 through 2003. The study also examines total injury claim costs for the country and each state from 1987 through 2001.

Insurance Industry Rebounds From Hard Market

There's a collective sigh of relief coming from businesses everywhere. After two or three years of steep premium increases, additional exclusions and even some canceled policies, the insurance market has stabilized. While the industry continues to face volatility from one quarter to the next, it is considerably better off in 2005 than three years ago.

The premium increases of the past few years have helped the industry rebuild its reserves and reestablish profitability and threshold for claims. Events that

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would have set the industry on its side a few years ago can now be taken in stride. National carriers continue to feel a pinch from the string of four hurricanes in Florida, but the losses are manageable and had....

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