

2009 Market Survey

Property & Casualty



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William Gallagher Associates annual survey of the insurance market examines coverage, rates and highlights specific risk and exposures to be aware of in the coming year. The survey identifies key trends in the overall property, casualty and executive risk marketplace. This year, we hope to provide our best estimates in light of the overall economic uncertainty as well as the potential impact the new administration may have on the insurance industry.

We are still early on in this year and many of the 2009 headlines within the insurance industry may have already been written. First up is the impact of the mortgage and banking industry failures and the apparent fraud of the Madoff funds. Together, these assaults on financial institutions and the insurance markets are starting to take their toll. Litigation against mortgage banks, brokers, investment banks, and investment advisors are on the rise. Underwriting standards within these market segments are tightening. We predict insurance prices will increase, and with a push for better internal risk management standards.

In Washington, health insurance reform is high on the agenda for 2009. Most of the leading proposals are quite similar to the Massachusetts Health Care Reform plan where it was recently announced that the number of uninsured persons has again dropped to below 3% of the population. President Obama has the potential to demonstrate his oft-spoken desire for a new kind of politics by engaging Congress, the business community and the health care industry. If Massachusetts remains a model, then the impact on the Health Insurance industry will be quite positive – more underwriting concessions, yes, but more business overall. Health insurers look to be winners but the numbers will not show up until 2010 at the earliest.

The newly signed federal stimulus package will also prime the pump of public works construction projects. The President's goal is to switch on "shovel-ready" projects for renovating roads, bridges, schools, wi-fi networks, and medical IT systems. However, while federal and state authorities have a long list of projects, most will require surety bonding. Surety could end up being the governor on the engine of the financial stimulus. While qualified contractors may have the opportunity to double or triple their work, their sureties are unlikely to support what would likely become reckless growth by multiplying insured work programs. Insurers may well be criticized for slowing down the economic recovery.

The fourth big headline concerns the financial results of Property and Casualty insurers. Four years of decreasing rates for most risks coupled with balance sheet losses due to declining stock and real estate asset values will lead to higher insurance rates across the board as 2009 progresses. Already, rates across many lines have flattened out and, in some cases, have begun to rise.

This leads to the fifth and probably the most actionable headline: "Diversification Required". The most vexing question for insurance buyers in 2009 will be their choice of insurers. With the failure of major rating agencies to assess the risks of mortgage-backed securities fresh in our minds, to whose balance sheet do I want to transfer my biggest risks?

William Gallagher Associates is a leading provider of insurance brokerage, risk management and employee benefits services to firms with complex risks and dynamic needs, within industries that include technology, life sciences, healthcare, financial risks, aviation, energy and environmental services, with offices in Boston, MA; New York, NY; Hartford, CT; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

Safety used to be found in the largest financial institutions, the ‘too big to fail’ theory. This gives little comfort in 2009. Large buyers of insurance, in particular, need to have diversity in their insurance programs. That means not just multiple insurers but also using insurers from all major markets – domestic, London, Bermuda, and European insurers. Of course, there are downsides to having complex, layered insurance programs with multiple insurers. Claims negotiations are difficult. There is much more paperwork and much more negotiation time. However, a mix of highly-rated insurers in a program at least serves to mitigate the potential of negative surprises of the sort that seemed standard during the last quarter of 2008.

The last hard market cycle began with the September 11, 2001 disasters. This cycle began with a dramatic tightening of capacity across literally every major type of insurance from Property to Casualty, Workers Compensation to Directors’ & Officers’ Liability (D&O). This tightening was driven by reinsurers who had suddenly discovered a tremendous aggregation of catastrophic exposures that had been transferred to their balance sheets by retail underwriters. More sophisticated modeling emerged allowing both retail insurers and their reinsurers to more effectively understand the financial implications of risk aggregation by type, geography and class of business.

The unsettled market we expect in 2009 will be driven in part by retail insurers looking to recover from years of a competitive soft market and dramatic declines in investment portfolios as noted but also by reinsurers whose own financial results have been buffeted by the turmoil in the credit markets and the need to bolster capital. The three major reinsurers have each begun increasing rates starting with the January 1, 2009 treaty renewals and are expected to continue this trend for the April 1 and July 1 treaty renewals. Reinsurance treaties are the lifeblood of any retail insurers; we can expect that they will reflect their increased cost of protection in the renewal pricing of their policyholders.

As noted we expect this upward trend to be gentle. We also expect it to be specific to certain exposures such as catastrophe exposed property along the Southeast coast and California earthquake areas. Certain industries will face greater scrutiny of their practices and procedures with poor performers penalized. Early starts to the renewal and risk differentiation (amongst peer group and by type) will help to mitigate the effects of the turning market, at least for 2009. Continued understanding and delineation of supply chain risks and the emerging use of enterprise risk management techniques for mid-sized employers will lead the way.

Property

Our expectation for the property market throughout 2009 is that companies with non-catastrophe exposure will see rates flatten out or even see some slight rate increases. We are seeing companies currently renew anywhere from -5% to +15% and expect that to move towards flat to +15% in 2009. Clients with losses should expect to see even higher rate increases. For companies with property in catastrophe exposed areas, we expect to see rate increases ranging from +10% to +20%. As a peril, *wind* is tougher to place than *earthquake* these days. The tri-county areas of Broward, Dade, & Palm Beach, Florida are the toughest to place coverage, due to aggregation of exposure. The Tampa area is also running out of capacity. Frame & Joisted Masonry construction is also getting very expensive. Insurers also have long memories. As a result, Louisiana flood is still a tough coverage to place; and California earthquake depends on specific location. Areas where aggregation is an issue will be tougher than lesser aggregate zones. We see deductibles for all placements generally holding.

Coverage enhancements will continue to be an area of focus as rates deteriorate. If you are going to pay more for your insurance, you should be getting more in terms of coverage. We continue to focus our efforts on supply chain and revenue stream risk management and exposure identification. With growing

dependency on outsourcing, Contingent Business Interruption (CBI) and Extra Expense coverage is needed more than ever.

The heightened focus on supply chain risk that we described in 2007 will become increasingly ingrained in general business culture, particularly with the interdependence of operations and continued emphasis on just-in-time inventory management. We expect that the insurance industry will begin to respond to the indirect exposures to loss created by the changing nature of business in 2008. To date, there has been little, if any, coverage available for loss of income related to causes other than direct physical damage to a company's own facilities or operations (outside of limited coverage available for CBI). As the risks to the supply chain become better understood, the creation of capacity for non-physical damage Business Interruption would be a welcome addition to a company's insurance portfolio.

The Marine market continues to be quite competitive. This is largely attributable to Marine insurer's use of non-filed rates and forms. We're seeing markets still willing to amend terms and conditions as well as compete on pure price alone. Spoilage continues to be a challenge though; and there remains only a handful of markets that can offer meaningful capacity. We're also seeing the Locations & Processing sections of Stock Throughput policies still being competitive. This might be particularly important for companies to make note of if they have substantial raw materials/work-in-process/finished goods values at such locations. If this type of property is covered by their insurer, consideration should be given to a Stock Throughput program as these markets continue to offer aggressive rates, cat perils coverage, and lower deductibles.

The political risk aspect of Marine insurance may heat up given recent piracy activity. There is a specialized coverage available, offered by specialized markets; it might be something to consider discussing if your company is potentially exposed.

It is anticipated that the volume of Terrorism Coverage will increase as we move further into 2009 and as a result capacity in the major cities could be harder to find which might lead to prices hardening in these areas. Also, as a result of the terrorist attacks in Mumbai, the interest level in terrorism coverage is likely to increase, especially in major cities. This will put pressure on capacity. Which could include hardening prices for such coverage.

Casualty

The previously stable general casualty market will likely begin to harden in 2009. While trends such as the positive impact of tort reform on loss experience and generally improving risk profile continue to benefit our client base. The industry is continuing to see decline in profits, due in part to a deteriorating loss ratio, but more importantly to loss of investment income, as a consequence of the global financial crisis. This will cause underwriters to hold and eventually increase rates. The underwriters have seen rates decline for the last 16 quarters and senior management is telling field underwriters to resist further rate reductions.

We expect the market for Workers Compensation, Automobile, General Liability and Umbrella/Excess Liability coverage lines to remain competitive through 2009 but at a different level than the past four or five years. There is still sufficient capacity in the market but the underwriters may not quote on business that they deem to be inadequately priced.

The impact of the economy will also factor into the equation. Payroll, sales and other exposure bases may decline but the underwriters are concerned with increasing their “rate”. Therefore while exposures may decrease over the prior policy period, the premium may remain about the same, which will represent an increase to the client. Individual risk characteristics, such as hazardous or high risk operations or poor loss experience, will influence underwriters more now than in the recent past. Certain risks may see increases in premiums, retentions/deductibles, or both as the market changes.

Optimal terms and pricing will be achieved through risk differentiation and completeness of exposure data, in submissions to underwriters. Risk control and claims management tools will also be important in achieving an optimal result. Underwriters will want to maintain market share, though it is likely some underwriters will look to shed business which does not meet minimum pricing requirements as the calendar year progresses. Underwriters will have to balance the desire to write new business and retain existing business with the new corporate philosophy regarding pricing and profitability. Underwriters are also aware of the financial issues impacting some of the insurers. They are no longer willing to match the lowest price, if they appear to be a stronger financial entity. Financial strength will be used as leverage rather than lowering price.

Workers Compensation costs during 2009 will likely reflect the pricing trends of the overall industry except in certain jurisdictions and/or industries. However, State rate setting agencies often lag behind the current market trends and may not adjust rates until later in the year. Carriers are still benefitting from several years of decreasing loss frequency and resultant lowered costs. This drop in loss frequency is a result of improved safety measures and an acknowledgement that risk control can indeed lead to lower frequency. Medical cost management has also had an impact in reducing what had been steady and significant growth in the medical cost component of loss. However, medical cost continue to escalate and will eventually impact the Workers Compensation rates.

Underwriters may not use all of the available credits as they have in the past, as a means to offset rate inadequacy. Over time this may affect the ability of Guaranteed Cost programs to be competitive at higher premium levels making loss sensitive programs, such as large deductible plan, an attractive option. For clients with premiums under \$500,000 (the traditional threshold for loss sensitive programs) guaranteed cost programs may not offer the large reductions that have been available in the past few years. However, these same clients may be able to take advantage of loss ratio dividend plans that will reward good experience. While companies with significant aggregation exposure, such as those with significant payrolls in large metropolitan areas, may face more stringent underwriting.

For General Liability and Umbrella / Excess Liability, clients will experience rate stabilization. The risks in lower hazard industries such as financial services, real estate, technology and light manufacturing will fare the best and there may be modest competition for clients and result in some rate reduction. Clients in higher risk industries will likely not have as much competition and will have to prepare for increases for the first time in many years.

Automobile Liability will also see rate stability and it will continue to be carefully underwritten. This is one of the lines of business whose pricing still reflects the impact of the reinsurance market. Beginning in 2007, some insurers retained risk that they may have reinsured in the past, because they felt that the reinsurers were not being competitive. However, the reliance on reinsurance may become more popular if underwriting results deteriorate; this will add to the cost of the premium. Underwriters still consider Automobile a very volatile line of business. A single accident can become a multimillion dollar loss. Primary insurers will continue to try to keep their limits to \$1,000,000 or \$2,000,000. At the same time many excess underwriters want to attach above \$5,000,000 or higher primary limits on larger fleets. This will maintain the need for auto buffer layers. All of which may increase the rates and premiums. Individual risk characteristics and risk control factors remain important underwriting considerations.

Executive Risk

Our prediction for a positive Directors' & Officers' Liability market for publicly held companies, with the notable exception of the Financial Services sector, was realized by most companies in 2008 as they continued to improve their overall programs through a combination of enhanced terms and lower premiums. What we failed to see in our crystal ball, however, was the impact sub-prime mortgage based financial instruments would ultimately have on the Property & Casualty industry as a whole. Here is an outline of the key issues that transpired in the latter half of 2008 which will continue to shape the Executive Risk market contours in 2009:

1. The near toppling of AIG into bankruptcy in mid-September due to the Credit Default Swaps sold by one of its non-insurance businesses, Financial Products. While the U.S. government stepped in to save AIG, and AIG's insurance results remain strong, most companies are re-evaluating their aggregate "exposure" to AIG, and to other insurers as well. Diversified insurance portfolios have now become an integral factor of a company's overall risk management approach.
2. The downgrading of several insurers by various financial security ratings agencies. In addition to AIG (A+ to A) and XL (A+ to A), A.M. Best put Hartford's A+ under a Negative Outlook.
3. Federal Securities Class Actions, fueled by litigation against large financial services firms, increased to 210 for 2008 (up from 176 in 2007 and 116 in 2006).
4. Insured D&O/E&O losses related to the "credit crisis" are now predicted to hit \$9.6B; up from a Q1 2008 estimate of \$3.6B. Add an estimate of another \$1.8B from the Madoff ponzi scheme and it's close to \$12.5B.
5. Last, but not least, the U.S. Property & Casualty industry is expected to incur an annual underwriting loss for '08; its first full-year loss since '05. That estimate is coupled with an 85% drop in net income (after taxes) for the period through Q3 '08 compared to same period for '07.

As we enter 2009 what does all of the above mean for buyers of public D&O liability insurance? Will the market harden overnight with 20% plus premium increases across the board? There is no doubt that financial services companies with virtually any exposure to the credit crisis/Madoff scheme will be encountering many, if not all, of the "attributes" (significant double digit premium increases; higher retentions; less capacity; restricted terms; lots of underwriting questions) of a hard market. However, it is very doubtful D&O underwriters will apply a "one size fits all" approach to their 2009 renewals. Premium decreases, however, will be fewer and shallower than in 2008.

Historically, the D&O market cycle has resembled a wave of V's more than U's, but the current D&O market differs from prior markets in three notable ways: 1. more overall aggregate capacity, 2. more insurers providing that capacity, and 3. a more analytical, disciplined underwriting approach. Moreover, while the "supply" side of the market equation may be steady, the overall "demand" side is down. This inequality in the equation is having a moderating impact on the ability of underwriters to accelerate the hardening of the market cycle. Insurers with higher financial security ratings, however, are attempting to collect a "premium" from policyholders who want the added comfort of their financial security.

How can a company determine how it will be viewed by underwriters? The foremost concern of underwriters will continue to be the financial viability of companies – do they have sufficient funds to continue current operations for at least the next 18 months? Underwriters will also be focusing on industry sectors which are either underperforming the market and/or displaying "greater than market" share price volatility.

Before we move toward an overview of what to expect in 2009 for other Executive Risk exposures, there are a few D&O takeaways for consideration:

1. Just as it will not be "business as usual" for most companies in 2009, it will certainly not be "business as usual" for insurers. Companies need to have a realistic understanding of where they are on the D&O insurers' radar screens. They need to make well prepared presentations for/to underwriters in which positives are stressed and potential weaknesses addressed. Start the renewal process early.
2. D&O programs should be balanced and diversified as to insurer participants.
3. Continued focus on Side A Excess DIC. Given the declining strength of many corporate balance sheets and the significant increase in personal and corporate bankruptcies, this coverage is more important than ever for individual directors/officers.
4. Consider dedicated insurance for retiring/retired Independent Directors.
5. Foreign exposures. Companies operating outside the U.S. should equip themselves with an understanding of the issues surrounding indemnification, local insurance requirements, local practices, and tax implications.

While the bulk of this Executive Risk summary has focused on public D&O insurance, here is some insight into other Executive Risk related lines:

Fiduciary Liability – This area requires significant attention from all companies in 2009. Given the significant declines in most 401(k) funds along with widespread layoffs, litigation is bound to be on the rise; and we expect premiums to increase for most companies. Not to be forgotten is the potential impact of the 2008 Supreme Court decision (LaRue vs. Dewolff, Boberg & Associates) allowing employees to sue for 401(k) losses; which prompted many companies to focus on tightening up both their loss prevention measures and Fiduciary Liability insurance policies. Insurers have made it clear that they will be seeking higher premium for 2009 renewals; particularly for companies with; Employee Stock Ownership Plans, Employer Securities under the Plan, unstable corporate financials, and/or underfunded Plans.

Private D&O – While capacity remains abundant, insurers will be scrutinizing the financial results and viability of all companies. We anticipate a much more rigorous underwriting process in '09 coupled with premium increases for most companies.

Employment Practices Liability (EPL) – With work force reductions as the norm for many companies in 2009, EPL is more important than ever. There will continue to be price and/or deductible pressure for larger companies and those in the Financial Services sector, but most companies should see a relatively flat market in the absence of individual client loss history. It is more likely that underwriters will seek higher deductibles if they cannot get what they deem to be appropriate premiums. Insureds that can demonstrate superior HR risk management policies will find themselves in a more favorable position. Procedures and training will continue to have an important advantage in negotiations with underwriters. Coverage terms and conditions are as broad as at any time in the past 5 years with, in general, significant enhancements available at each renewal, some providing sublimits for FLSA claims. The emerging coverage battleground is for Wage & Hour claims. At this point in time, very few insurers are willing to provide.

Crime – Crime Insurance, specifically ‘commercial’ (non financial institution crime) continues to exhibit traditionally fairly stable characteristics and loss ratios are still favorable for the insurers. Plenty of capacity and supply and no particular change in demand lead to a favorable environment for buyers of crime coverage. Insurers, however, are watching the impact of losses with the downturn in the economy and volatility in certain industry sectors. The prevalence of ISO filed forms makes this a relatively homogeneous product line even though tailoring via endorsement is still necessary especially given insurers desire to differentiate to gain market share. New ERISA rules on crime bond thresholds should not be overlooked on a coverage line that tends often to have ‘roll over’ renewals. We continue to see the trend of crime claims occurring at international subsidiaries of U.S. parent companies and vendor fraud claims. Large financial institution losses and an expectation of a spike in crime loss resulting from a weak economy and losses paid by insurers in 2008 can, of course, erode some of the profitability in this sector. It may also affect how insurers view their need to maintain profitability, perhaps precluding more meaningful rate cuts. Capacity is still abundant with a few new entrants into the marketplace.

Kidnap, Ransom & Extortion – The overall market remains stable with premiums remaining low. Key areas of concern where insurers have responded to losses include Mexico, Columbia and the Middle East - insurers have specifically mentioned that they received an increase in extortion claims on this product line. Multiyear (prepaid) policies are readily available and clients coming off this type of program may see a modest increase if exposure in high risk countries has increased. In general, however, there is a continued appetite to write this class of business even though Insurers are obviously increasingly cautious in their analysis of corporate foreign travel and exposures and are expected to take an increasingly thorough approach to underwriting accurate risk profiles.

Employed Lawyers Liability – Insurers continue to target Employed Lawyers Liability as a line of business which they want to grow. Loss ratios and profitability have been favorable to the insurers as the interest and penetration of the product has expanded significantly over the past few years. In 2008, most risks either had a rate reduction of 5 – 10% or a flat renewal. In 2009, we expect a “stabilization” of premiums (for clients without claim experience). Insurers will be cautious in their underwriting of Securities Exposures and larger publicly traded company risks in general.

Disclaimer: While these predictions apply to broad market trends, it is important to note that individual accounts may have varied outcomes given their individual risk profiles.