ROUTE TO:

THE RHA REVIEW

Vol. 6, No. 4, Third Quarter 2000

A publication of Robert Hughes Associates, Inc., an international litigation support, actuarial, risk management and insurance consulting company.

A HARD DAY'S NIGHT

By Robert N. Hughes, CPCU, ARM

With apologies to the Beatles, I had no choice this issue but to write about the "H" word. You know, that little four-letter word that we have all forgotten ... the "hard" market word. It amazes me how long "soft" has been the operational word used when speaking of the insurance market. After all, weren't we all taught (at least those of us over thirty) that the insurance market was cyclical ... that every few years the market moved from a position of a glut of capacity with attendant low premiums and high negotiability to a period of almost no capacity, skyrocketing premiums and no coverage enhancements available? Yes, we were, but it hasn't worked that way in years.

The last really disastrous hard market was in the mid-80s. I recall that in late 1984 one major insurer fired 6,000 employees overnight, and one major player in the energy market sent cancellation notices to every single one of its oil and gas accounts. Umbrella attachment points went up, and primary limits went down. The prices for everything went only one way ... toward the sky. Many of my clients faced premium increases of as much as 1,000 percent, and most suffered "gaps" where the "suspenders" of their excess coverage failed to reach the "belt" of their primary layers, exposing some very vulnerable financial tummies. Insurance companies failed in record numbers, and policyholders are still trying to recover from those failures.

"The word on the street is 'Hard Market.'"

Fortunately, things improved quickly, and, with their new-found profits, insurers quickly backed off the rather stringent coverage restrictions that they had imposed ... claims-made, retroactive dates at inception, limited personal injury, high excess attachment points, etc. As a matter of fact, by the end of the decade we actually saw renewals in which insurers "cured" the sins of the past by picking up the claims-made tail in new-occurrence policies, thus wiping the slate clean.

"Could it happen again?" we asked. Well, at that time many of us who made our living from observing the market and giving advice said, "Sure." That was because we thought we knew what the influences were that produced this up-to-then predictable cycle. "Simple," we said. "Just watch 'underwriting loss' and 'net investment income' and when the former begins to exceed the latter, duck." In other words, when the industry's combined ratios began to outstrip their investment income, they were in trouble.

The predicted flame point was reached again in 1992. Total operating income dropped into the negative range due to a severe increase in loss ratios coupled with a flattening of investment income. Strangely, however, although company failures peaked again as in the past, neither prices nor coverages seemed to be affected. It was pretty much "business as usual." All that the wizened gurus could do was mumble and scratch their heads. The insurance cycle, it seemed, was no more.

The 1992 crisis having passed

(**HARD**, continued inside)

IN THIS ISSUE:

- *Hard Day's Night*
- *From Near and Far*

(**HARD**, continued from cover)

without real reaction, insurers' operating income began a steady climb, peaking in 1997 with all-time HIGH investment income and total operating income levels. Income

> ***"Policyholders are now rushing to examine the cancellation provisions in their multiyear policies and checking their state laws."***

dipped in 1998, again due to increased losses and flattened investment income, but the graph was still well into the positive range. Price reductions at renewal were still the norm. Amazing coverage enhancements were the rule. Pollution, discrimination, trading risk – no longer bad words to underwriters seeking more and more premium.

"But hold, sweet friends. Hark! What sounds arise from yonder pit? Couldst these be wails and sighs, yea, even gnashing of teeth?" (Not real Shakespeare, but close, don't you think?) The point is, the word on the street is "Hard Market." Everywhere you turn, the word is out. Take a look at "riskmail," a very professional site visited regularly by risk managers. Here are a few of the latest comments:

> "THE MARKET HAS DEFINITELY HARDENED." (Emphasis in original.)
>
> "The market has hardened! Our carrier had a three-year guarantee cost policy with us and is now refusing to renew for the third year."
>
> "My carrier decided to non-renew their entire public entity business."
>
> "We had a contract for three years, which the carrier is now ignoring."
>
> "They used the promise of the three-year guarantee to secure the business from their competitors. Then they revoked the promise."

Policyholders are now rushing to examine the cancellation provisions in their multiyear policies and checking their state laws. Companies are apparently canceling multiyear policies and refusing to renew long-time customers. Can wholesale cancellations be far behind? Who knows? One major energy broker has advised its policyholders that they should expect at least 40 percent increases in their renewals this year, and some lines of coverage may not be available at all. (The control-of-well market has taken it on the nose for several years running.)

"Companies are apparently canceling multiyear policies and refusing to renew long-time customers."

Meanwhile, the companies' street is not all sweetness and light. Word has it that many companies and underwriters have not yet filled their July 1 reinsurance renewals. One well-known reinsurance broker tells us that her desk is currently covered with unfilled orders. If this situation is not resolved soon, insurers will have to resort to means other than reinsurance to limit their net retentions. This means, inevitably, that excess limits will be restricted, attachment points will go up, and primary limits will be reduced. Could we see another "buffer" market develop where risk-takers are able to ask and get premiums equal to more than 100 percent on line? Maybe.

Now, for those readers of the generation that missed the 1980s, a brief tutorial. You know, of course, that insurance is inherently leveraged. Insurers are permitted to write premiums as a multiple of their surplus – 3:1, for example. In other words, a company with $1 million in surplus could write $3 million in premiums. (Not many insurers are actually leveraged that highly, but I'll use 3:1 for exemplary purposes.) Let's assume further that the company

> ***"Word has it that many companies and underwriters have not yet filled their July 1 reinsurance renewals."***

makes a net operating return equal to 10 percent of earned premium. (Again, not likely, but easy math.) So they

(**HARD**, continued on opposite page)

(**HARD**, continued from opposite page)

make $300,000 on $3,000,000 in earned premiums. That is equal to 30

> ***"A.M. Best Company, Inc., reports that 'The industry's weak results were most notable in the reinsurance segment because of increased global catastrophe losses, adverse loss development and continued soft pricing.'"***

percent of surplus. The next year they have a surplus of $1.3 million and can write $3.9 million in premiums ... and so on.

Most businesses work their way out of losing cycles by selling more products/services and achieving greater profits. But wait. What happens if the net operating income line of an insurer dips below the dreaded "zero"? Then it works something like this. The company loses 10 percent, or $300,000. Its surplus is cut to $700,000. It cannot write more premium but less – only $2.1 million. So increasing writings is out of the question, and the company has to try to make the $2.1 million that it can write as profitable as possible. That means the company must restrict the number of risks that can be written. This is known in the industry as a "capacity crunch," and we haven't seen one for some time.

I recall during the 1980s one particularly pompous Lloyd's leading underwriter pronouncing, "There is no capacity crunch, only a pricing crunch." This intimates that all an underwriter must do to bail out of a down cycle is increase the price. As you can see from the previous example, this just doesn't work very well. That underwriter, by the way, retired with his syndicates in disarray.

Two questions remain ... what caused this "crunch," and what does a policyholder do about it? As to the first, certainly loss ratios had to play the greatest part. Investment income is at an all-time high. The difference this time, however, is that the hardening of the market is being driven by reinsurance. Reinsurers recorded a poor 114.8 combined ratio for 1999. Even more telling, however, is the final quarter's results, which produced a combined ratio of 125.8. A. M. Best Company, Inc., reports that "the industry's weak results were most notable in the reinsurance segment because of increased global catastrophe losses, adverse loss development and continued soft

> ***"Weather oracles predict an even worse storm pattern for 2000 and beyond. Perhaps even worse, just as pollution and asbestos claims seem to be waning, other baddies are creeping out of the walls, some literally."***

pricing." Weather oracles predict an even worse storm pattern for 2000 and beyond. Perhaps even worse, just as pollution and asbestos claims seem to be waning, other baddies are creeping out of the walls, some literally. Sick buildings, MTBE and cyber-sabotage are only a few of the new hazards facing industry and, ultimately, underwriters.

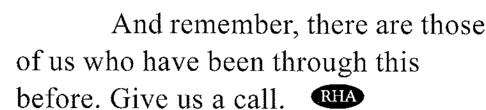
As to what one must do to combat the adverse market turn, the

> ***"Sick buildings, MTBE and cyber-sabotage are only a few of the new hazards facing industry and, ultimately, underwriters."***

list is long. I do not have enough space in this article to expand beyond the list, but here goes:

(1) Don't take anything for granted.
(2) Begin renewal discussions at least six months before expirations.
(3) Identify problem areas and make plans to resolve them.
(4) Be realistic about your loss history and plan for underwriters' reactions.
(5) Expect to assume more risk and prepare management accordingly.
(6) Begin serious studies of the formation of a captive vehicle.
(7) Begin now to examine the credentials of outside consultants.
(8) Confer with your brokers at least quarterly regarding the state of the market and their responses to it.
(9) Demand personal contact with your major underwriters. Go see them. If they or your brokers refuse, find new ones.

And remember, there are those of us who have been through this before. Give us a call.



Robert N. Hughes is founder and president of Robert Hughes Associates, Inc.

ROBERT HUGHES ASSOCIATES INC.
508 TWILIGHT TRAIL, SUITE 200
RICHARDSON, TEXAS 75080
(972) 980-0088 FAX (972) 233-1548

ADDRESS SERVICE REQUESTED

PRSRT STD
U.S. POSTAGE
PAID
RICHARDSON, TX
PERMIT NO. 1380

FROM NEAR AND FAR

In May, forest fires in New Mexico burned for as long as three weeks, causing close to $100 million in insured losses. The fires were the result of a "controlled burn" that got out of control. Insurers are expecting more than 6,000 claims.

At press time we have not yet seen any major hurricanes this year, but, according to *Business Insurance*, researchers at Colorado State University are predicting at least 12 named storms to hit either the Atlantic or Gulf coasts. The researchers are estimating that eight of the storms will develop into hurricanes. CSU experts are also estimating that four of the hurricanes will become major hurricanes with sustained winds over 110 miles per hour.

Governor Gray Davis of California appointed a retired judge to the post of insurance commissioner. Harry Low, a former judge in the appellate court, has insurance dispute experience and will serve out the two remaining years of Chuck Quackenbush's term. Quackenbush resigned recently under a cloud of doubt over his handling of settlements made by some insurers.

The crash of an Air France Concorde shortly after takeoff on July 25 killed all 113 passengers and crew on board and also four persons on the ground. According to estimates in *Best Week*, the total loss will be less than $200 million. The aging aircraft had an agreed insured value of only $30 million.

THE RHA REVIEW

Publisher .... Robert N. Hughes
Editor .... John R. Oakley
Assistant Editor .... Alice H. Oakley

The RHA Review is published quarterly by Robert Hughes Associates, Inc. — an independent international litigation support, actuarial, risk management and insurance consulting company based near Dallas, Texas, with offices in Houston, Texas, and London, England. The purpose of this publication is to offer insurance-related information and critical comment pertinent to the clients, friends and fellow professionals of Robert Hughes Associates, Inc. This publication is available free to interested parties. The information contained in this publication is intended to be general in nature; readers should obtain professional counsel before taking any action on the basis of this material.

For more information, contact
John R. Oakley, Editor
508 Twilight Trail, Suite 200
Richardson, TX 75080
Tel. (972) 980-0088.

Copyright © Robert Hughes Associates, Inc., 2000. All rights reserved.