The Insurance Industry After 9/11: Planning for the Future

by Frank Caruso

Throughout the insurance industry, it is ***not*** business as usual. The attacks on the World Trade Center on September 11, 2001, sent shock waves through society and the business community that will significantly impact the availability and cost of insurance for years to come. An in-depth analysis of the consequences of these events and the resulting market will hopefully enable consumers to more accurately anticipate, plan, and budget for insurance costs.

PRE–SEPTEMBER 11, 2001

Prior to September 11, the insurance industry was heading into a "hard" (as opposed to "soft") market cycle. During the mid-1990s, insurance providers were aggressively writing and pricing business so that premium income could be invested in the financial markets. Underwriting profits were not as important as bottom-line results. In 2000, as investment income disappeared and the flow of loss activity continued, underwriters realized that if they were to survive they needed to adjust their pricing upward, restrict coverage terms, and cancel those accounts that were unprofitable. Many insurers were counting on 2001 as the beginning of a return to normalcy.

In the Tennessee/Kentucky region, we were beginning to feel these exact changes. Rates were increasing, primarily based on the class of

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business, the loss history, and the line of coverage. A 15 percent to 20 percent increase was not out of the norm. We saw several accounts with poor claims experience and severe exposure experience premium increases of 50 percent or more. Non-renewal notices began showing up more frequently than anticipated. Workers Compensation Insurance led the way for most carriers to take the appropriate underwriting action in order to maximize rates. Pre-9/11/01, the hard market had arrived, but it was a gradual build up of price increases and changing terms and conditions. Many underwriters still listened to the agents' case and made some attempts to adjust their own positions.

THE TRAGEDY OF SEPTEMBER 11

September 11, 2001, was a loss no one could conceive. As of March 2002, cost estimates ranged from $30 billion to $72 billion. As noted by Morgan Stanley, it will be the largest workers compensation loss in history (by multiples); the most expensive aviation disaster in history (by multiples); one of the largest property losses in history; the most expensive business interruption loss in history (by multiples); the largest life insurance catastrophe loss in history (by multiples); and potentially one of the largest liability claims in history. In insurance circles, this is referred to as a "clash" event – where multiple losses, in different lines of coverage, arise from the same underlying cause. Clash events are outside of an insurance carrier's normal actuarial assessment of its aggregate loss exposures, so the catastrophic impact is exponential.

According to *Business Insurance* magazine, the financial shock will leave most insurers and reinsurers damaged, but solvent. The extent of financial damage will depend on the ultimate industry-wide loss. As this number increases, greater is the risk of insolvencies. According to Standard & Poors, however, the industry likely has the capability to manage itself out of the problem. Should the costs rise above $50 billion, the outlook would indeed change with regard to the solvency of insurers.

One of the problems that will grow as losses escalate is unrecoverable reinsurance, though it should not prove crippling for most insurers. At the very least, insurers may face delays on reinsurance recoveries as disputes arise over coverage terms. Now brewing is the debate over whether each plane that crashed into the World Trade Center constitutes a separate loss occurrence. Combined, the towers had insurance limits of $3.5 billion, however each 9/11 occurrence on the actual building complex coupled with property loss is being estimated at over $10 billion. Therefore, resolution of issues such as this will be critical to the industry's financial well-being. As the size of the loss grows, these disputes will grow. For some reinsurers, the resolution will determine their business survival.

The current major concern is the possibility of another terrorist attack or a natural calamity such as an earthquake, hurricane, or flood. The insurance industry's financial resources are finite and the impact of September 11 has hit carriers' balance sheets hard.

WHAT DOES ALL THIS MEAN?

- Reinsurance capacity will shrink significantly. Retail carriers will buy from only the most creditworthy reinsurers. Their "approved" list will be shorter and scrutinized more regularly. At the same time, fear and greater recognition of higher risk factors will result in reinsurers being less willing to assume and retain certain types of risk. Additionally, capital markets will only be willing to reinvest their money in the large and financially strong reinsurers, thereby drying up the capacity previously provided by the mid- and smaller-sized reinsurers.

- Pricing will rise significantly. Hank Greenburg, chairman and CEO of American International Group (AIG), warns that insurance buyers can expect to see rates "going up by leaps and bounds." Premium increase estimates are now predicted to range from 15 percent—30 percent or even higher depending on risk factors and loss experience. In specialty lines such as earthquake insurance, directors and officers liability and workers compensation costs could soar by 50 percent—75 percent because:

  1. Underwriters are now fearful of new types of risks and larger potential losses.
  2. The amount of premium that is required to support insurance risk is greater than previously understood. Add to this skyrocketing reinsurance costs.
  3. The industry's liquidity needs are also greater than previously envisioned. Investors and stockholders are demanding profitable underwriting results and greater than the historical three percent return on their investment.

The interaction of supply, demand, and price will be dramatic.

- Insurance carriers are re-evaluating and re-pricing their catastrophic loss exposures in earthquake, flood, and hurricane zones as well as in high-risk operations or products. Already some carriers have either withdrawn from the market or cut back their limits and increased their pricing. Depending on what happens with reinsurance renewals in 2002, insurance consumers may not be able to purchase limits or coverage enhancements maintained previously.

  This year, expect to receive "Notices of Non-Renewal," 60- to 90-days before policy expirations. Even though carriers may be willing to renew coverage, they will issue these letters to avoid regulatory renewal restrictions such as capping premium increases at 25 percent.

- More coverage restrictions will be imposed and greater underwriting focus will be instituted. In a soft market, underwriters attempt to attract business by offering broad coverage terms and high limits without asking many questions. This has now changed. Here are some examples:

  - *We expect reinsurers will exclude terrorism coverage in their 2002 renewals.* The concept of a federally-backed reinsurance pool for terrorism and war risk-related losses has positive support throughout the insurance industry and within the government. Nothing has been solidified yet, but it appears that there will be a vehicle created to protect business and property owners against such risks.
  - *Underwriters will be cautious about writing risks with a high concentration of property values.* Probable Maximum Loss (PML) and Maximum Foreseeable Loss (MFL) estimates are no longer credible to underwriters. For example, in the case of the World Trade Center, the PML was around five percent and the MFL was about 20 percent.
  - *Property replacement cost values and loss of income estimates must be verified.* In many cases, underwriters will require some form of property appraisal or business income worksheet to make certain the risks they write are insured to their full insurable value.
  - *Blanket limits may no longer be offered.* This feature historically has provided clients a great deal of protection from under-reported values but has exposed carriers to losses far greater than they had anticipated.
  - *Deductibles will increase.* Not too many years ago a $100 deductible was the norm. In recent years this increased to $1,000. We now expect underwriters will request $5,000 or $10,000 *minimum* deductibles. Applications now must provide far greater detail as to the ownership, operations, and exposures of a risk. Five-year "hard copy" loss runs must be provided prior to binding.
  - *Carriers will entertain new business but may refuse to quote if they feel the account is being shopped.* Adequate lead time will be necessary for their loss control consultant to do an underwriting inspection *before* they release their quote.
  - *Carriers will demand loss control commitments from clients.* They will non-renew accounts who fail to curtail unsafe operations or exposures.

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- Distribution channels will be restricted. With their limited capacity, carriers will cut back the number of brokers with whom they will do business. This will benefit an organization such as Gallagher but will seriously hurt smaller local brokers.

- Rating agencies such as A.M. Best and Standard & Poors will closely monitor the financial performance and liquidity of insurance carriers and there will be a number of downgrades. Lenders and others will also pay close attention to these changes, as it may affect their loan security or contractual provisions. Ideally, they will be understanding of current market conditions.

CONCLUSION

This author has been in the insurance business for more than 25 years and has seen soft and hard markets come and go. However, it is no longer business as usual and the industry is now fighting to preserve its financial integrity. No one expects a quick fix.

While there may not be much good news right now in the insurance industry, the author's hope is that this information will provide better insight as to what has or will be changing and the reasons why. REI