CLIENT ADVISORY

State of the Property Market - March 2012

Entering 2012, we find the U.S. Excess and Surplus Property market in transition, but is this the onset of a hard market? Over the last 25 years, there have been only two or three true hard markets. The last hard market occurred in 2006 and lasted roughly six months. During the 2001 hard market, rates were initially rising by 20 – 30% and sustained some level of upward, or at the very least, flat movement for 24 months. By comparison, our current market only began to see pricing changes in Q3 and Q4 2011, and those were only slight rate increases. For a real turn, there must be four factors in the market: a sustained period of large underwriting losses, a material decline in industry capacity, a sharply contracting reinsurance market, and a return to underwriting and pricing discipline.

A Sustained Period of Large Underwriting Losses

Generally, a hard market follows combined ratios in excess of 110%. In 2011, catastrophe losses, and in the U.S. particularly, non-traditional (heartland) catastrophe losses resulted in combined ratios of over 100%, from a healthy 95% in 2010. But the question is whether these ratios are a trend or an unusual outlier. Until these prove to be a sustaining trend, markets may tend to discount the experiences of 2011 as an outlier year. Time will tell, and Q1 2012 should be watched closely.

A Material Decline in Industry Capacity

Despite a lack of investment income, poor combined ratios, the lack of reserve redundancy, and RMS 11.0, available cash remains at unprecedented levels. In fact, with interest rates at an all-time low, investors are turning to the insurance marketplace – even for single digit returns – creating an abundance of available capacity to support many underwriting vehicles.

In 2012, the downgrade of the U.S. credit rating could reduce policyholder surplus while an increase in interest rates could reduce capacity. For example, because of the way carriers must invest and record their surplus funds, it is estimated that a 1% increase in interest rates would eliminate more than $100 billion, or 10%, of industry capital because of the inverse relationship between bond yields (where most industry surplus is parked) and bond values. That hasn't happened yet, but is a looming mitigator for overcapacity concerns.

A Sharply Contracting Reinsurance Market

Despite a relatively quiet hurricane season in the U.S., prices have increased due to the more than $350 billion in global catastrophe losses in 2011 as well as the unusual non-traditional catastrophe losses across inland America. Coming off of one of the largest reinsurance renewal dates (40% - 50% of U.S. catastrophe programs renew on 1/1) we saw U.S. catastrophe pricing increase, on average, between 10% - 15%. In 2012, outside of catastrophe property, we expect reinsurance pricing to eventually increase due to the above mentioned combined ratio issues, but at a much slower and steadier pace than if there was actual contraction in the reinsurance marketplace. While reinsurers are focusing on price discipline, there has not been any major contraction in that reinsurance marketplace to date.

A Return to Underwriting and Pricing Discipline

As we enter into 2012, U.S. carriers are returning to underwriting and pricing discipline across most property lines. Primarily due to the impact of RMS 11.0, increases are currently most noticeable in catastrophe-exposed programs or in programs with poor loss experience. RMS 11.0, which began impacting the market in Q2 2011, has affected carrier accumulations/aggregates and has contributed to higher rates for many CAT-exposed risks. In addition, market leader Lexington has taken a stand to reduce its own aggregates and increase pricing with both moves creating a ripple effect across most multi-carrier placements. We expect to see this trend carried into at least the first and second quarters of 2012 to account for those programs that renewed before RMS 11.0 took effect last spring.

It appears that underwriters have had the most success in pushing price increases with the larger insureds, when there are fewer competitors and program structures tend to need participation from many markets (thus limiting options for alternative programs). However, underwriters that push rates on non-catastrophe-exposed programs are, in some cases, finding that they are losing business to other markets still aggressively trying to deploy capital in (or re-deploy capital to) less catastrophe-exposed areas.

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What This Means for 2012

For catastrophe-exposed property, larger schedules are most impacted because of 1) their need to utilize worldwide capacity, and 2) major primary participants, such as Lloyd's and Lexington, cutting capacity and reducing aggregates (bringing their portfolios more in line with RMS 11.0). We expect to continue to see small to middle market, three to four participant placements, being churned between carriers and restructured with new capacity, which will, for the time being, result in more modest increases.

Conclusion

While the factors above are conspiring to drive pricing upward, we do not foresee a full blown, extended hard market until we experience capital impairment combined with a restriction of new flow of capital into the business, both of which would result in real, market-wide, reduction of capacity. In the short term, some risks will be significantly affected by the aforementioned factors while others can slide through with minimal increases. We are concerned that, without any contraction in available capital, any more significant movement than we are now seeing would signal a more dramatic, but very brief, turn driven more by carriers attempting to reduce price increase without sustainable underlying economics - similar to what we experienced in the first half of 2006. What we do see so far, is a more controlled and managed firming of the market brought on principally by the poor underwriting results of the past few years, 2011 in particular.

How will this affect your property accounts? On recent renewals, we've seen incumbent markets pushing rate increase, but often the still more than adequate capacity in the marketplace is allowing us to restructure programs in order to minimize these effects on all but the largest accounts. On small/middle market placements we have been able to achieve minimal increases or, in some cases, particularly if they are minimally impacted by RMS 11.0 changes, flat renewals. The larger accounts and insureds with poor specific loss results will be less nimble, and likely to face a more challenging renewal. This is where it is key to utilize creativity and market clout to minimize impact for your insureds.

Jon Danile authored this article. Jon is an Assistant Vice President with AmWINS Brokerage of New York and a specialist in property coverages.