

# Guy Carpenter Views

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## Some Improvements Registered In Casualty Reinsurance Market



**Pricing, capacity, and coverage terms vary among the different segments of the casualty market. Guy Carpenter Views speaks with Peter Zaffino, head of the Worldwide Casualty Specialty Practice, about 2003 market conditions and some of the possible developments he expects to see going forward.**

### Workers Compensation

#### Capacity and Pricing

**Guy Carpenter Views:** How would you describe the current capacity and pricing of workers compensation business? What are some of the key drivers of the cost and availability of this coverage?

**Peter Zaffino:** The workers compensation catastrophe segment currently has approximately \$500 - \$600 million of available market capacity, and more reinsurers may be entering this area based on the attractiveness of present conditions. The market is still seen as very attractive despite pricing being down 10 percent at 2003 renewals, and a similar rate decrease expected in 2004.

The key components of rates and availability in the workers compensation catastrophe segment continue to be total subject premium, California exposure, along with heavy concentrations of employees in urban areas such as New York and Chicago.

In the per person exposed layers, however, variables such as rampant medical inflation, the increased severity of indemnity claims, along with poor investment results have rendered results unstable. Consequently, reinsurers have become more conservative about writing layers below \$5 million, and capacity in this segment has decreased from since before 2001. There is a strong possibility that pricing for this component may remain firm throughout 2004.

#### Claims Severity

**GCV:** Has the severity of workers compensation claims continued to spiral?

How are reinsurers protecting themselves?

**PZ:** The average severity of both the medical and indemnity portions of workers compensation claims continues to increase. This does not have a major impact on the pricing for workers compensation catastrophe business, where ample capacity is available, but it certainly affects reinsurance layers that are per person exposed.

Reinsurers have thus reduced their overall workers compensation capacity in the layers below \$5 million, maintaining that associated loss costs in these per person exposed layers are too difficult to predict and may not be known for many years. Rather than invest in these layers, reinsurers are deploying capital to workers compensation catastrophe business or to other reinsurance lines that they feel produce better returns. As prior accident year results begin to stabilize and margins even out, additional reinsurance capacity may become available in this segment, although this may take six to 18 months.

## Professional Liability

### Overall Conditions

**GCV:** Can you briefly describe overall conditions in the professional liability primary and reinsurance markets? Has the hard market continued? Have terms stabilized?

**PZ:** Over the past 12 months, the professional liability primary and reinsurance markets have experienced major changes in all segments.

The primary market continues to harden as insurers seek to recoup past losses and to prepare for further adverse development on their portfolios. This is particularly the case in the directors & officers (D&O) and medical professional liability (MPL) segments. New primary market entrants have started to write D&O and errors & omissions (E&O) products, and existing markets have capitalized on increasing rates and tightening terms and conditions by growing their portfolios significantly over this period of time.

The professional liability reinsurance market has stabilized, although D&O aggregations and a shortage of capacity could occur if reinsurers reduce their participation at signs of a softening market. Reinsurance terms have remained steady for existing ceding companies, but are increasingly tight for new entrants to the reinsurance marketplace.

### Directors and Officers Liability

#### *Drivers of Current Conditions*

**GCV:** What are the key drivers of current D&O market conditions?

**PZ:** The key drivers of current conditions in this market include:

- A 137 percent increase over the past seven years in the frequency of loss,
- A 459 percent increase over the past seven years in the severity of loss,
- A 184 percent increase over the past six years in the risk of an accounting restatement, and
- A 198 percent increase over the past six years in the risk of bankruptcy.

These dramatic increases are the result of a major upsurge in SEC class action lawsuits. In 2002, 280 such lawsuits were filed; with 503 in 2001 and 223 in 2000 (the 2001 figure is skewed by 303 "laddering" claims). The median settlement value of these suits was \$6.3 million in 2002 (with an average settlement value of \$23.3 million), up from \$5.2 million in 2000 and \$5.1million in 2001. With an estimated 1,200 open claims still in the courts, future loss potential is significant.

### *Pricing*

**GCV:** How have pressures in this market affected the pricing of both primary and reinsurance D&O business?

**PZ:** Primary D&O pricing has experienced triple digit increases over the past two years across all market segments. Rate increases have been more significant on large commercial D&O risks (Fortune 1000).

As some D&O programs have been written on a pro rata basis, reinsurers have directly benefited from higher primary rates. Going forward, however, insurers are trying to avoid turning over a large chunk of premium to reinsurers. Consequently, many ceding companies are looking to increase net retentions and are thus pursuing more leveraged treaty structures.

Overall, it is anticipated that D&O reinsurance prices will increase modestly in 2004.

**GCV:** What has been the impact of hard market conditions on recent results?

**PZ:** Hard market conditions and the resulting rate increases have caused both the primary and the reinsurance D&O market to grow considerably over the past two years. Gross D&O insurance premiums are estimated at \$8.08 billion for 2003.

### *Limits and Terms*

**GCV:** How have reinsurers reacted to evolving D&O exposures and the upsurge in claim frequency and severity? Have they cut back on the limits and terms that they are willing to offer?

**PZ:** In response to evolving D&O exposures, many reinsurers have decreased their overall limits considerably. Although coverage terms have not changed significantly for existing clients, reinsurers have tightened their terms for start-up companies that have not purchased reinsurance previously. This is because reinsurers are attempting to reduce their aggregate exposure by using their limited capacity to support only a select number of cedents.

## **Medical Professional Liability**

### *Current Market Conditions*

**GCV:** How would you characterize current conditions in the MPL market? What are some of the key developments contributing to the present state of the market?

**PZ:** The medical professional liability insurance and reinsurance lines remain under stress. The average MPL jury award has increased more than 400 percent in the past 10 years, and the pricing and availability of this coverage have shown extreme fluctuations.

The American Medical Association has identified 12 states where the lack of medical malpractice coverage has caused a "crisis" entailing either the closure of healthcare facilities or restrictions in medical procedures. Large metropolitan hospitals in difficult jurisdictions (e.g., Chicago, Philadelphia, Detroit, Las Vegas) have suffered from a severe shortfall in market capacity. Physicians have also been

hit hard with rate increases, with OBGYN, Internal Medicine, Emergency Medicine, and Neurosurgeon specialties under tremendous pricing pressure.

These poor market conditions have led to the emergence of alternative risk transfer vehicles as doctors and hospitals look for affordable insurance coverage. The size of the alternative medical professional liability market—which includes such products as captives, large SIR or deductible plans, trust funds, and state-sponsored JUAs—is estimated to be almost 70 percent as large as the traditional marketplace. Additionally, new entrants have targeted excess hospital business, thereby decelerating the massive rate increases that were being achieved in this segment.

#### *Pricing and Terms at Renewals*

**GCV:** What happened at 2003 renewals in terms of the pricing and terms of MPL coverage?

**PZ:** Reinsurance renewals at January 1, 2003, saw double- to triple-digit rate increases for physicians and surgeons, with much higher rates continuing for some specialties. Depending on their size and location, hospitals experienced 50 to 100 percent increases. In addition, there were restrictions in terms and coverages. As the underlying business improves, reinsurance terms may ratchet down accordingly; however, given the long tail nature of this business, this could take some time. As a result of the dramatic rate increases attained over the past two years and the tightening of terms and conditions, there has been an increase in reinsurer interest in select MPL segments.

Several new players entered the medical professional market on or around July 1, 2002, with most carriers emphasizing excess hospital professional liability business as a target class, due to ease of market entry and high premiums per transaction. This increased competition has started to slow the rate of increase for the excess layers.

#### **Errors and Omissions**

##### *Pricing and Terms*

**GCV:** Can you comment on current conditions in the E&O market? What changes are you seeing in rates and terms of coverage?

**PZ:** The errors and omissions (E&O) reinsurance market is much more diverse than other professional liability reinsurance lines, and a definite segmentation exists based on the size of the exposures in the treaty.

Rate increases have been in the 10 to 50 percent range, class dependent, which lag behind those for D&O and MPL coverages.

For treaties covering large accounts or higher hazard classes, terms have remained steady, but available capacity has shrunk. If historical results continue to deteriorate, adjustments will continue to be made.

For treaties covering smaller accounts, ceding companies are seeking ceding commissions that allow them to adequately cover their expenses. Other terms and conditions have remained largely unchanged. There is not the sort of capacity crunch in this area as there is for larger accounts, such as large law and accounting firms.

## Bermuda's Role in the Casualty Reinsurance Market

**GCV:** What role does Bermuda play in the casualty reinsurance market?

**PZ:** Bermuda has played a key role in providing workers compensation catastrophe capacity, and in 2003, some Bermuda markets began considering layers below the catastrophe level.

In addition, Bermuda actively participated in medical malpractice placements during 2003 and late in the year began providing support on D&O business. As Bermuda reinsurers continue to expand their role in the global market and look for diversification, casualty business will become a more meaningful percentage of their overall portfolio.

## The Future

**GCV:** What changes do you expect to see in this market going forward?

**PZ:** Many distressed lines of casualty business have historically poor financial results; and, as outlined above, although they are improving, these segments still have significant obstacles to overcome. For example, certain lines face capacity issues and uncertainty in predicting future results, which has led to a spread between asking and offered pricing, terms, and conditions. Consequently, we expect that the casualty reinsurance segment will face numerous challenges in 2004.

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