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Analysts Predict Strong Pricing Won't Be Enough to Boost P/C Industry

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NEW YORK (January 15, 2003) - The property/casualty industry is in the midst of a hard market – that part of the insurance cycle where demand outpaces capacity, allowing for price increases and greater returns for the insurers. But some industry observers say this time it's a little different – while pricing is favorable, many insurers are going to have a hard time meeting expectations on returns.

What's more, equity analysts say they were surprised by the speed and severity with which economic forces such as deteriorating equity markets and low interest rates brought European insurers their knees – a phenomenon that will have ripple effects for mergers and acquisitions in the United States and for European strategies.

Speaking at the annual Property/Casualty Insurance Joint Industry Forum in New York City, a panel of equity analysts cited dampened equity markets, insufficient new capital inflows and a depressed mergers-and-acquisitions market as some of the reasons insurers aren't going to get as much out of the current hard market as they might have thought.

"During the hard part of the market, there is the implication that companies can get 20% to 30% return on equity," said Morgan Stanley's Alice Schroeder. "We don't think they're going to achieve the returns they think, partly because of the state of the equity markets, but also because there is so much more transparency in the market this time."

Greater demands from investors – and regulators – for information have forced insurers to become much more conservative in their strategic and investment decisions, said Schroeder.

As they have taken a battering in their investment portfolios via stock-market weaknesses, insurers have had to refocus on underwriting discipline, added Michael S. Pritula, a director with McKinsey & Co. "Underwriting execution is more important in this cycle, where the feedback loops – in terms of self-correcting mechanisms – have been shortened. I think we're going to see prices come back down to earth more quickly."

Vincent J. Dowling Jr. of Dowling & Partners Securities LLC added that, according to his firm's calculations, the property/casualty industry needs an overall combined ratio – losses and expenses as a percentage of premiums – in the low 90s to achieve underwriting profitability. That's not likely to be achieved, given historical trends, he said. "In addition, we are seeing some very low interest rates, which have come down very quickly," said Dowling. "If those rates suddenly go up again, you're going to see some big hits on balance sheets."

In terms of pricing, 2002 was a strong year for the industry, said Dowling, but in some lines price increases haven't been nearly enough. "Some of those lines have been going down for so long, they

needed a big bounce off the bottom to get to where they should be," he said. "I still think there's a long way to go to get to where we should be in some areas."

Pritula said it's more difficult now for insurers to pinpoint what is necessary in pricing. "With years of underlying exposures coming up and the increased creativity of the plaintiffs' bar – what is necessary is a very tough question," he said.

Regulators have reacted unevenly to pressures on the industry, dampening some of the momentum, Pritula said. "There are some statehouses in some states that have responded to the underlying loss-cost issues," he said. "But there are other states where we still don't have that enlightened stewardship to respond to the environment."

Schroeder said there is also concern that the industry has not "put up a lot of reserves" in line with the price increases of the past two years. "There is still a lot of work to be done there," she said.

Pointing to Travelers Property Casualty Corp.'s (NYSE: TAPa) announcement that it was adding \$2.55 billion to reserves for asbestos-related exposures, Schroeder said insurers are making a greater effort to disclose existing exposures. "Clearly, Travelers has set a new industry standard for disclosure on the asbestos issue," said Schroeder. "The information has been out there all along, but with its announcement, Travelers is moving to catch up. I would expect other insurers will act to get everything out there."

The Travelers announcement raised the predictable question of whether there was any new development to prompt its boost to reserves, or whether it arose from a re-examination of existing information, said Pritula. "I think the betting is that it was just a re-analysis, so I think others will have to do the same," he said.

Seán F. Mooney, chief economist and research director for Guy Carpenter & Co., raised the question of whether the property/casualty industry as a whole is even solvent, given exposures to much greater potential losses after Sept. 11, the weakness of investment portfolios and inadequate supplies of new capital.

"We're looking at an industry that's writing at a 2.5 to 3.2 ratio of premium to capital, so it's our thesis that there is no excess capital in the industry," said Dowling. "So the Travelers announcement is going to bring that information forward. What this will mean is that there's going to be more action on the commercial side to get those premium numbers up to cover some of those holes."

Perhaps the biggest insurance story in 2002 – and the one that analysts didn't see coming – was the "implosion of Europe," said Dowling. "The biggest mistake I, personally, made was what was going to happen in Europe," he said. "If you look at those implications, most of what the Europeans have in the United States is for sale today, and there are no buyers. They can't get the deals done."

Dowling said the situation facing European insurers today is similar to that of U.S. insurers in 1972-73, when companies were leveraged in equity stocks that they suddenly had to unload to bring reserves up. "U.S. companies hadn't made that mistake again, but the Europeans did," he said.

"Europe was a shock," added Pritula. "The declining capitalizations of those companies over the past 12 months has been just shocking. What's even more impressive in a negative sense is the inability of those management teams to fight their way out of these problems. They have less of a degree of freedom.

"The turbulence in the world is picking up, and management teams have to be able to react to that," Pritula said. "The Europeans are a little hamstrung there."

A.M. Best Co.'s ratings of the Travelers Property Casualty companies range from A++ (Superior) to A (Excellent).

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