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Equity Risk Partners

State of the Insurance Market – The Corleone Edition

State of the Market 2013: The Corleone Edition

No matter how hard I try to get out of writing the State of the Market Letter, our clients, prospects and partners keep pulling me back in!

Around this time every year, we give you one chance to ask us about our business affairs. One. So here it is. Let's hope that this State of the Market letter is more like *The Godfather* (no. 2 movie of all time) or *The Godfather: Part II* (no. 3 all time), and not *The Godfather: Part III* (a waste of time.)

Insurance companies are our partners in this process. We value them and appreciate the benefit that they bring to our clients. Our clients, however, are *family*, and any Equity Risk Partners colleague will tell you that we value family above all else. We have seen firming of pricing across almost every line of coverage, in every geographic area, and every industry segment. On behalf of our private equity clients and portfolio companies we would say - *"Insurance companies, we love you. But don't ever take sides with anyone against the Family again. Ever."*

Property / Casualty and Overall Market Conditions: *"Mr. Corleone is a man who insists on hearing bad news immediately."*

Overall, the market is firming. Insurers are non-renewing unprofitable business, raising rates for high risk clients and imposing stricter underwriting standards for almost everyone.

Property/Casualty insurers initial terms at renewal include rate increases in excess of 15 percent. This is an ongoing reaction to years of rate deterioration and investment losses by insurers, as well as, a pressure test of what the market will bear. The extent of the increase is determined by the class of business, location of the business and individual's loss experience.

It is difficult to focus only on incumbent insurers and get the best results. The renewal process is long and intense and usually includes competitive pressure from other interested insurers. For example, the initial 15 percent increase that we obtained from the incumbent insurer is typically negotiated down to 0-7.5 percent.

Weather-related global disasters have more than tripled since the 1980s, with property losses in 2011 and 2012 exceeding all previous records. As a result of the 2011 and 2012 catastrophic losses, insurers have revised their risk analysis and modeling to more accurately reflect the change in weather patterns. The results of Superstorm Sandy, recent tornadoes in the Midwest and flooding in Eastern Europe which caused billions in dollars of damage, will affect property insurance pricing in 2013 and 2014.

In the first half of 2013, natural catastrophes and man-made disasters caused insured losses of $20 billion, with floods as a major contributor to that total.

Workers' Compensation: *"It's a Sicilian message. It means Luca Brasi sleeps with the fishes."*

Premium and rate increases are a foregone conclusion on Workers' Compensation and are very difficult to negotiate down - especially if the company in question has had a poor loss history, not complied with loss control recommendations or is in a high risk industry. Guaranteed Cost Workers' Compensation programs can be especially problematic if the losses are poor.

Workers Compensation claim frequency continued to decline during 2012. Lost time claim frequency declined during accident year 2012. That comes after a frequency decline in 2011 and an increase for 2010. Workers fearful of losing their jobs during the recession may have postponed filing workers compensation claims, but then became less hesitant as the economy improved.

In addition, health care reform is affecting pricing in a big way. It is difficult for insurance companies to quantify the impact at this point.

Medical Insurance: *"I'm gonna make him an offer he can't refuse."*

Every discussion about Medical Insurance includes an in-depth analysis of the Affordable Care Act, aka Obamacare. Topics such as faulty websites and implementation delays dominate the conversation.

President Obama has already signed 14 laws that amend, rescind or otherwise change parts of the Affordable Care Act. He has also taken several independent steps to delay the Affordable Care Act on his own. This is exacerbated by the fact that some members of Congress refuse to let go of efforts to de-fund or repeal the law outright.

The most significant delay came back in July when the White House and the Treasury Department announced a one-year delay in a major provision that would have required employers with at least 50 full-time workers to provide health insurance or pay a penalty beginning in 2014.

All of the change and uncertainty surrounding the Affordable Care Act's implementation has made it very difficult for companies to understand what exactly they are planning for. Employer focus has turned towards 2015 compliance and concerns over potential cost impact.

Medical benefit plan cost trend rates continue to decline and are currently forecast at lowest projected levels in more than a decade (8-9 percent). Accounting for plan design changes, total health benefit cost per employee are projected to increase 5 percent in 2013.

Since January 1st of this year, two new taxes have begun to creep into medical insurance renewals. The Health Insurance Tax and the Transitional Reinsurance Fee will result in an additional 4 percent cost pass-through from employers to insurers to the Federal Government. These taxes are only applicable to 2014 premiums but, in some cases, insurers are applying the charges to plans that span 2013-14 on a pro-rata basis.

Despite continued deceleration, healthcare costs continue to outpace increases in workers' earnings. With lower rate increases, employers are doing less cost shifting to employees, but deductibles and out-of-pocket cost sharing provisions continue to increase as employers look towards lower cost plan options and as Consumer Directed Health Plan type products continue to gain traction.

Cost mitigation efforts are turning focus towards wellness and health promotion initiatives (e.g., health risk assessments, biometric screening, smoking cessation, health coaching and dietary counseling) and employers are beginning to contemplate moving from Defined Benefit to Defined Contribution plans.

The “Big Four” – Aetna, Blue Cross Blue Shield, Cigna and UnitedHealth – continue to dominate the middle-market employer segment.

Executive Risk: *“Consigliore of mine, I think you should tell your Don what everyone seems to know."*

Executive Risk underwriters are offering renewal terms with a 10-25 percent rate increase, which after extensive negotiation, typically results in an increase of 5-10 percent. Flat rates or reductions are very difficult to come by in this market.

Directors’ & Officers’

M&A activity continues to be a major driver of claims on both public and private risks. The long tail on claims related to the financial crisis are beginning to trail off, but underwriters are still taking a hard look at the financial condition of current and potential insureds. Underwriters have addressed this exposure through limits management, stricter terms and increased deductibles.

Organizations involved in consumer products are seeing Product Liability exclusions added to their policies. This is usually an absolute exclusion for claims against the entity, and is a significant restriction that must be specifically addressed in each negotiation. The potential additional premium associated with removal of this exclusion can prove to be money well spent in a claim situation, as these claims tend to be costly. The increase in government watchdog groups have led to an increase in the number of product related claims against the Board of Directors and the entity itself.

Organizations involved in governmental contracting are receiving more scrutiny than they have historically. Those companies involved in this space should review their policies carefully to avoid restrictive governmental action related exclusions.

Employment Practices Liability (EPL)

EPL continues to lead the pack among Financial Transactional insurance placements in the frequency of claims. The severity of these claims has also increased in recent months due to the poor job market. Individuals looking for work can become incentivized to pursue litigation as a means to make ends meet during the sometimes long periods of unemployment.

Coverage for California businesses is especially challenging for insurance carriers as the state continues to have some of the most employee friendly employment laws in the country. Several carriers have changed their underwriting appetites to exclude writing EPL for organizations based, or with employees, in the state. Others have managed the amount of limit they have exposed on any one insured. Nearly all carriers have increased the deductibles either across the board or added a California specific deductible to their policies.

Crime

Economic downturns always lead to an increase in the frequency and severity of Crime claims. Underwriters are taking a long, hard look at current and prospective insured’s internal controls. Often times we have seen “supplemental crime questionnaires” required prior to receiving a formal quote. Close attention is being given to separation of banking duties and vendor controls, as these have been the most active areas of employee theft incidents. We have not seen significant increases in premium for this line, rather underwriters are choosing to require appropriate controls and applying higher deductibles.

A gray area has come to light over the past 12-18 months at the intersection of Traditional Crime and Cyber Crime. Several carriers have introduced mandatory exclusionary language that clarifies the intent of a traditional Crime form so that it does not respond to Cyber Crime.

Foreign operations are a major focus of Crime underwriters. As more and more insureds expand operations overseas, they are finding it difficult to apply consistent enterprise wide internal controls. The result has been a spike in the frequency of foreign claims, and a commensurate return to stricter analysis of organizations with foreign operations and their controls.

Kidnap and Ransom
Pricing remains competitive even though the number of carriers providing this coverage on a stand-alone basis has declined. Terms and conditions also remain broad.

Travel schedule and security precautions remain the biggest premium drivers here.
Generally, the Middle East, Central and South America and certain parts of Central Africa continue to lead the pack in terms of the most dangerous places to visit.

General Partnership Liability: *"Tom, can you get me off the hook? For old time's sake?" "Can't do it, Sally."*

There is a lot of capacity in the market. However, GPL has hardened due to an increase in claims since 2007. The upwards claims trend is due to several factors, such as:

- Distressed portfolio companies/bankruptcy
- Government investigations (e.g., SEC, DOJ, Attorneys General)
- Public-to-private transactions (e.g. share price)
- Increased regulatory oversight

In 2013, Equity Risk Partners renewal experience has been as follows:

- 5-15 percent increases for GPL renewals with favorable profiles
- Funds with several distressed portfolio companies and claims are seeing larger increases
- Expiring broad policy terms and conditions have been maintained in most cases. Although some carriers are starting to restrict terms and conditions that have been offered in the past
- The majority of clients are renewing with their incumbent carrier, although change is common if there are large premium discrepancies

Specialty Products: *"Leave the gun. Take the cannoli."*

While the rest of the market is firming, the specialty lines coverages stand on their own, making it easier to obtain competitive pricing, terms and conditions relative to previous years. Those lines of coverage include Cyber Liability, Medical Malpractice and Cargo.

Cyber Liability, for instance, is becoming more popular as big name companies and agencies fall victim to cyber attacks (e.g., Sony, J.P. Morgan, US Department of Defense, Living Social, TJX, etc.). Smaller organizations are just as prone to these types of attacks as large organizations, especially since network security at smaller organizations is usually not as robust as their larger counterparts.

Pricing continues to be the largest obstacle for smaller organizations. Many have trouble reconciling the cost of coverage with their perceived level of exposure. Healthcare, financial institutions, retail, and other organizations that collect large amounts of personal information of their customers see the largest losses in this space.

Cyber is following a similar pattern to EPL when it was originally introduced to the market. We typically heard comments like, *"Why do I need EPL when I have a full time HR professional on staff,"* while typical Cyber counterarguments are *"Why do I need Cyber when I have a 'state of the art' IT platform and a full-time IT professional on staff?"* Now that EPL is an established product in the market, most companies view it as a vital coverage. We believe Cyber will assume that role in the 12-24 months.

Conclusion: *"There are negotiations being made that are going to answer all of your questions and solve all of your problems. That's all I can tell you right now."*

This concludes our annual review of **The State of the Insurance Market.** We hope you found it helpful and informative. Please contact your Equity Risk Partners professional for more information. As always, we appreciate the opportunity to be of service and thank you for your continued support of Equity Risk Partners.

Cordiali saluti,
Michael Marcon
CEO, Equity Risk Partners

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