The insurance pricing cycle is driven by the law of supply and demand. For the past several years, the supply of insurance capacity has exceeded the demand for that capacity, forcing prices down. Before a sustainable hard market can happen, either demand must skyrocket, which is unlikely, or roughly $74 billion of excess capacity must be drained from the US property & casualty market. Some insurers are reducing capacity through share buyback programs, but most of the excess capacity probably will be destroyed through underwriting losses – either suddenly as a result of a massive natural catastrophe or gradually through underpriced business.

**The Insurance Pricing Cycle**

Exhibit 1, the Advisen ADVx™ Composite commercial lines pricing index, shows the change in the average commercial lines premium by quarter beginning the first quarter of 2001 (Q4 2000 = 100). Typical of the commercial lines pricing cycle, the average premium increased sharply for a few years (2001-2003), and has since been falling at a more moderate pace (2004 to the present).

The market peaked at 150 in the fourth quarter of 2003, meaning that the average commercial lines premium shot up 50 percent between the fourth quarter of 2000 and the fourth quarter of 2003. As of the fourth quarter of 2010, the index value was 116, meaning that the average commercial lines premium is still 16 percent above the fourth quarter of 2000. Looking behind the aggregate index value at the individual components, however, both general liability and workers compensation average premiums are below fourth quarter 2000 values.

**Market Cycle: Supply & Demand**

The supply and demand dynamics of the P&C insurance industry can be represented by the relationship of policyholders’ surplus, a critical component of aggregate capacity, and GDP, a proxy for demand. Since in the US most companies already are fully insured, the need to buy more insurance is directly tied to growth, represented by the change in GDP.

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1 The ADVx™ Composite index is the weighted average of changes in average premiums for commercial property, general liability, workers compensation and directors & officers (D&O) liability. It is compiled from renewal information provided to Advisen by risk managers and brokers.
Exhibit 2 shows US policyholders’ surplus as a percentage of US GDP over time. Increasing values mean that growth in supply (policyholders’ surplus) exceeds the growth in demand (GDP), ultimately leading to falling premiums. Conversely, when values are decreasing, it means that supply is shrinking relative to demand (or demand is increasing faster than supply), and premiums eventually will rise. Historically, surplus equal to about 3.2 percent of GDP (red line) represents the approximate point at which supply and demand are in balance. When the ratio rises above that point, the market typically moves into the soft phase of the cycle. Conversely, when it falls below 3.2 percent, the market is poised for the hard phase.

The ratio plunged to about 3.2 percent at the end of 2008, largely the result of capital losses as stock markets crashed. It reached 3.1 percent by the first quarter of 2009, suggesting that the cycle was on the verge of a change. Policyholders’ surplus, however, increased sharply in the second half of 2009, driven substantially by capital gains as stock markets rebounded. The ratio of surplus to GDP surged above the 3.2 percent threshold, where it remains. Contributing to overcapitalization are the lingering effects of the Great Recession, which cut into demand for insurance capacity as businesses downsized or shut their doors.

As of the third quarter of 2010, US GDP was $14.8 trillion dollars and US policyholders’ surplus was $544 billion. Assuming no imminent and material change to the demand side of the equation, policyholders’ surplus needs to be reduced by roughly 0.5 percent of GDP, or $74 billion, to bring supply and demand into equilibrium. Hard market conditions would be triggered by the loss of materially more than $74 billion of policyholders’ surplus.

Other factors

The timing, magnitude and duration of the coming hard market will be influenced by new capital. Capital entering the market during the soft phase in anticipation of higher rates could delay the turn, while capital rushing in to take advantage of rising rates in a hardening market could smother the rally. Looking at new capital raised in Bermuda following major loss events in the past, $8.7 billion flowed onto the island to capitalize the “Class of 2001,” formed to take advantage of sharply higher premiums triggered in part by the September 11 terrorist attacks, and $5 billion was raised following the record-shattering 2005 hurricane season.

Through nine months of 2010, P&C insurers operated at essentially a break-even underwriting basis, posting a combined ratio of 99.7, after excluding mortgage and financial guaranty insurers. Reported results have been buoyed by releases of redundant loss reserves, principally accumulated during the 2002 through 2007 accident years. According to an A.M. Best report released in September, insurers’ remain only slightly redundant in loss reserves after adjusting for a $13.7 billion asbestos and environmental deficiency and a $22.5 billion statutory discount. Reported results for 2011 and 2012 will not have the benefit of significant reserve releases from prior years, and will be more reflective of highly competitive market conditions. Additionally, in the current very low interest rate environment, diminished investment income will put additional pressure on reported results; net investment income fell by 2.5 percent during the first nine months of 2010, and likely will continue to slip throughout 2011.
Conclusions

The property & casualty market is roughly $74 billion overcapitalized, substantially an outcome of surging supply (policyholder's surplus) as equity markets rebounded coupled with diminished demand for insurance capacity brought on by the Great Recession. One unprecedented mega-catastrophe, or several very large catastrophes in close succession, could destroy the excess capacity and trigger a turn in the market, but the more likely scenario is slow, painful hemorrhaging of capital as deeply eroded rate levels take their toll. Insurers will have limited ability to offset rising underwriting losses with reserve releases, and investment income will decline as insurers are forced to invest in low-yield fixed income instruments.

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Advisen’s data, analytics and news offerings are game-changers for 100,000 commercial P&C professionals. For Underwriters, Reinsurers, Brokers and Risk Managers, the resources of Advisen provide productivity and insight into underwriting, marketing, broking and purchasing commercial insurance. Configurable applications allow Advisen to customize each solution and/or craft special offline delivery, too. Our result is a measurable increase in your book of business and more favorable insurance transactions. Visit us at www.advisen.com or contact support@advisen.com to learn more.