

WHY THE SOFT MARKET SHOULD BE

**OVER**



*A Berkshire Hathaway Company*

**W**hen one sells a product like insurance where the true cost is unknown for many years if not decades, it is very easy to let emotion trump intellect. Most of the influences and incentives in our business (implicit as well as explicit) are emotional. Recent market conditions are a prime example. A softening market that began back in 2003, and granted has been complicated by the global recession since 2008, has dragged on for more than eight years.

Ignoring human behavior and the emotional pulls of the insurance marketplace, and looking purely at the fundamentals in an objective, rational manner—the answer becomes obvious—the soft market should be over.



*Franklin (Tad) Montross is Chairman and CEO of General Re Corporation. He began his career with Gen Re in 1978 as a casualty facultative underwriter. Since then, Tad has held a number of positions of increasing responsibility, both in the U.S. and internationally. In 1992 he was promoted to Chief Underwriter for the treaty business. In 2001 he became a member of Gen Re's Executive Committee and the group's President and Chief Underwriting Officer, with management responsibilities including treaty underwriting, actuarial and claims. In 2008 he was appointed Chairman and CEO. He can be reached at +1 203 328 5575 or at [fmontros@genre.com](mailto:fmontros@genre.com).*

The constant refrain that the insurance industry is over-capitalized and therefore rates are coming down at the January 1 renewal is just market banter.

## Consider three points.

- 1** First, had Hurricane Earl tracked 100 miles to the West, the industry pundits would be saying that the industry is under-capitalized.
- 2** Second, industry technical pricing is predicated on risk-based capital or economic capital not the actual (i.e., accounting) capital held.
- 3** Third, if the industry is over-capitalized, that is a capital management issue to be settled with the owners. Capital levels should have no bearing on the technical pricing of risk.

The real headline for the renewal should read,

**“Why the soft market should be over.”**

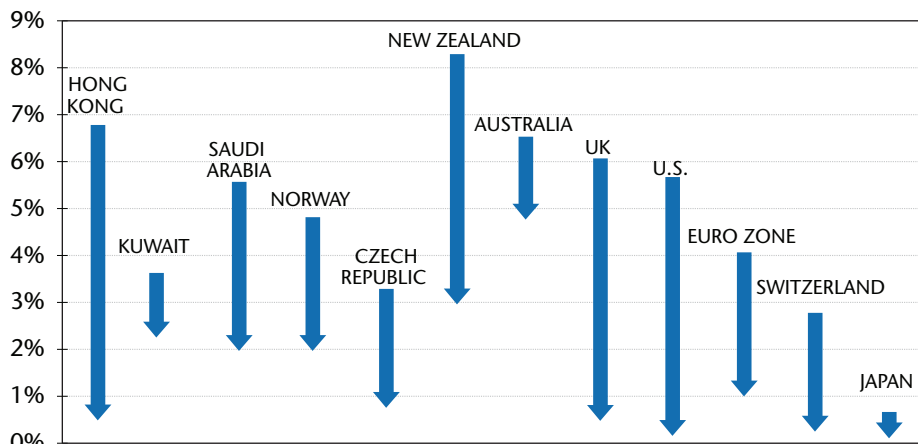
*The underwriting cash flow for the industry was negative in both 2008 and 2009. The last time it was negative was 2001.*

## The Fundamentals

Interest rates are at all time lows around the globe and the rate of descent since 2007 has been remarkable in response to the global financial crisis and the subsequent threat of depressions in most countries.

### Interest Rates

August 2007 – October 2010



Source: Bloomberg

The 10-year Treasury note in the United States is yielding 2.5%. In contrast during the last soft market of 1999–2001, the 10-year yield was between 5% and 6%.

### Interest Rates

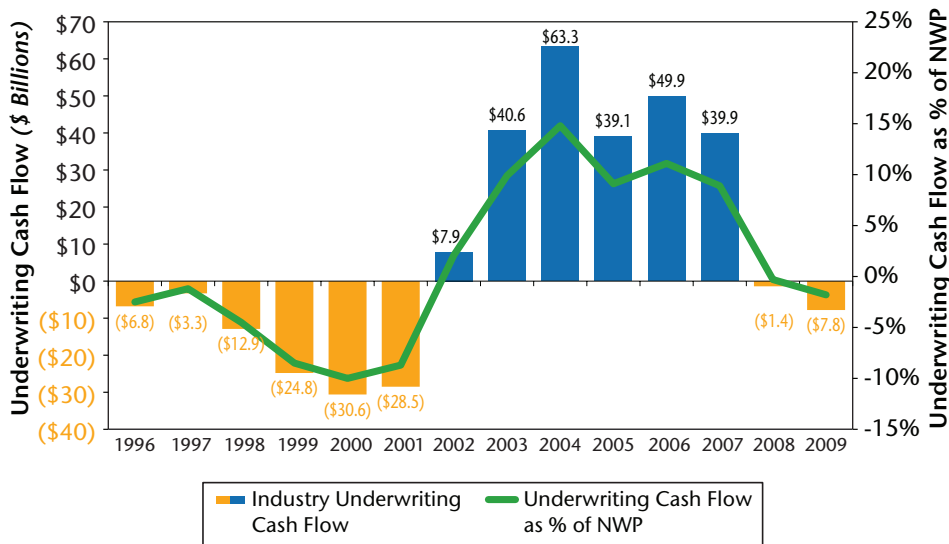
10-Year U.S. Treasury Yield



Source: Bloomberg

Cash flow is a good indicator of the health of any business. The underwriting cash flow for the industry was negative in both 2008 and 2009. The last time it was negative was 2001. The industry generates income on its reserves and capital as well, but in the current low interest rate environment, overall returns will be anemic if the underwriting account produces losses.

### Industry Underwriting Cash Flows

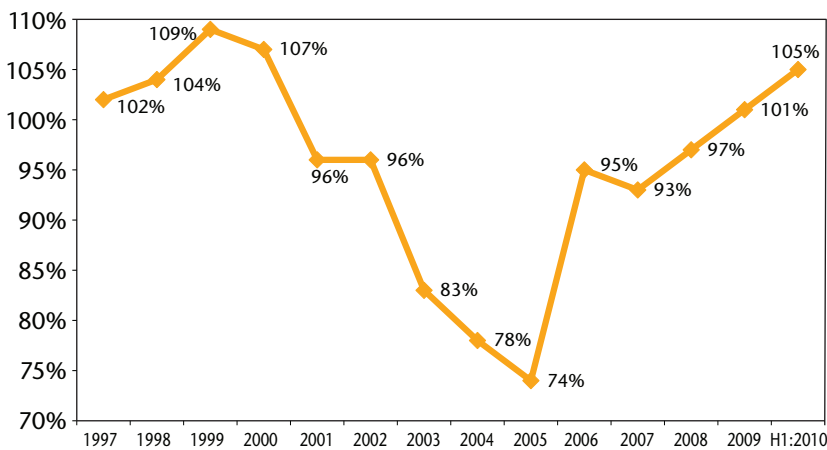


Source: Highline Data

We can look at the relationship of paid to incurred losses which was 74% in 2005. In 2010 it jumped to 105%, exactly where it was back in 1998.

While the relationship of paid to incurred can indicate a change in mix of business at the company level, at the industry level it more likely indicates what some call “the cheating phase,” where current accident year reserves develop adversely. We will then see higher accident year loss ratios and less redundancy in the prior year loss reserves.

### Paid to Incurred Losses

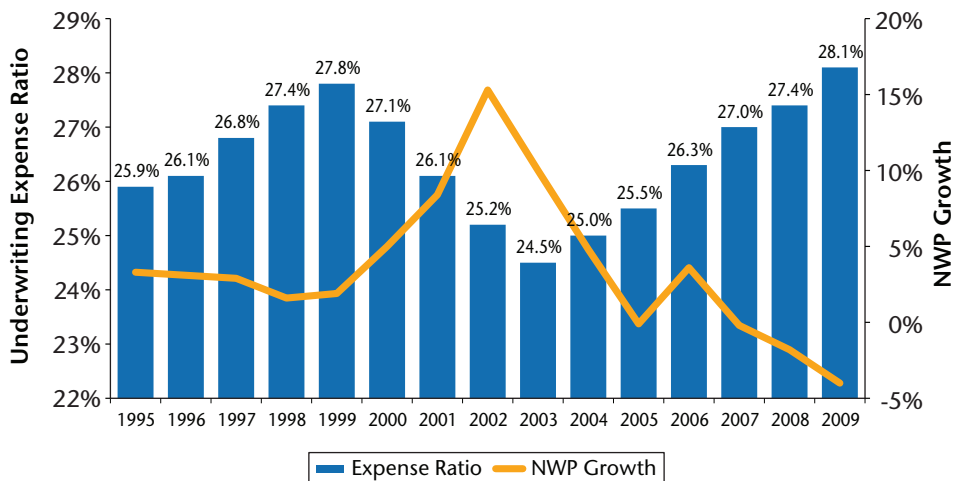


Source: Dowling and Partners, IBNR Weekly #39, Vol. XVII

*In most soft market years, the developed loss ratios will be worse than the initial accident year selections.*

Underwriting expenses climbed to 28.1% in 2009. They had reached a peak of 27.8% in 1999. Premium growth has been negative three years in a row in the United States.

### Underwriting Expenses

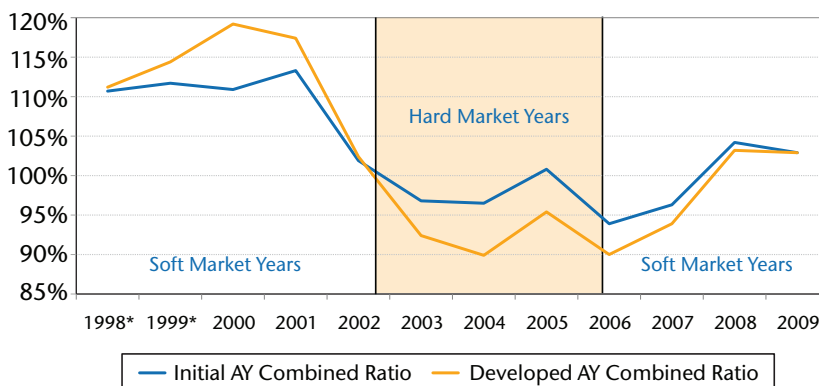


Source: Dowling and Partners, IBNR Weekly #39, Vol. XVII

Calendar year combined ratios have been better than the current accident year combined ratios in the past couple of years as they have benefited from positive prior accident year reserve run-off. As the good news from prior years dissipates, and we quite possibly see adverse development on the more recent accident years, calendar year results will deteriorate. In most soft market years, the developed loss ratios will be worse than the initial accident year selections.

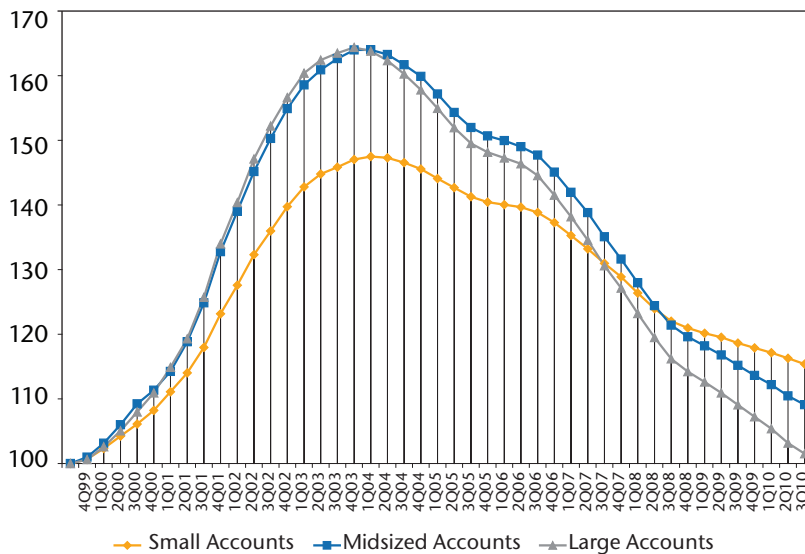
### Combined Ratios

*Industry Initial vs. Current Accident Year Combined Ratios*



Excludes Financial Guaranty and Mortgage Guaranty in 2008 and 2009.  
 \* 1998 is developed through 2007, and 1999 is developed through 2008.  
 Source: Highline Data

## Rate Levels



Source: The Council of Insurance Agents and Brokers. Chart prepared by Barclays Capital Equity Research

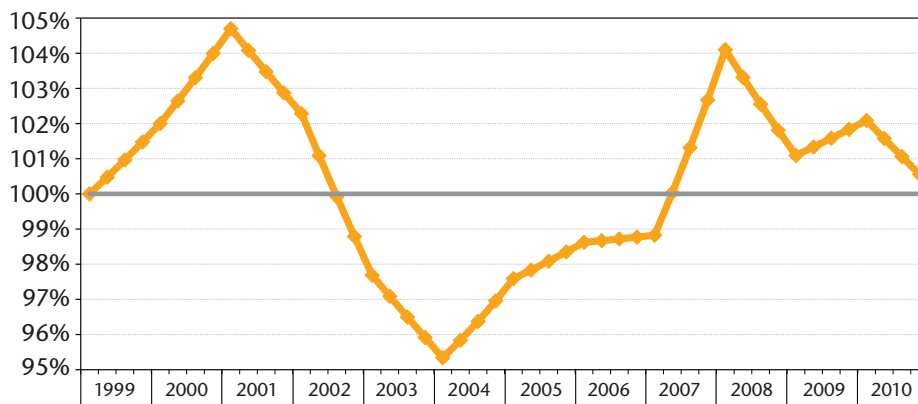
This brings us to what has happened to rate levels over the past decade. We can see that we are basically back to the levels of 2000. It varies for different size/accounts, but directionally we are in the same neighborhood. We can all remember what the accident year loss ratios were back in 2000. But, results seem OK today. Why is that?

In the past decade, the catastrophe component of the property line has increased dramatically in response to the hurricanes of 2004, 2005, Midwest storms and other cat activity. In low cat years, this additional cat premium masks deteriorating results.

In addition, loss trends have been dynamic during the past decade. Generalizing, we have seen a tale of negative frequency and positive severity. Frequency and severity vary dramatically by line and geography, but basically negative frequency has offset positive severity in many lines of business. We were seeing an uptick in loss costs beginning in 2007, but then the recession took hold driving loss costs back down as evidenced in the graph below.

## Loss Cost Index

U.S. Property / Casualty Industry Commercial Lines



Commercial Lines include: General Liability, Commercial Auto, Commercial Property, Workers' Compensation  
Sources: Highline Data, Gen Re Analysis

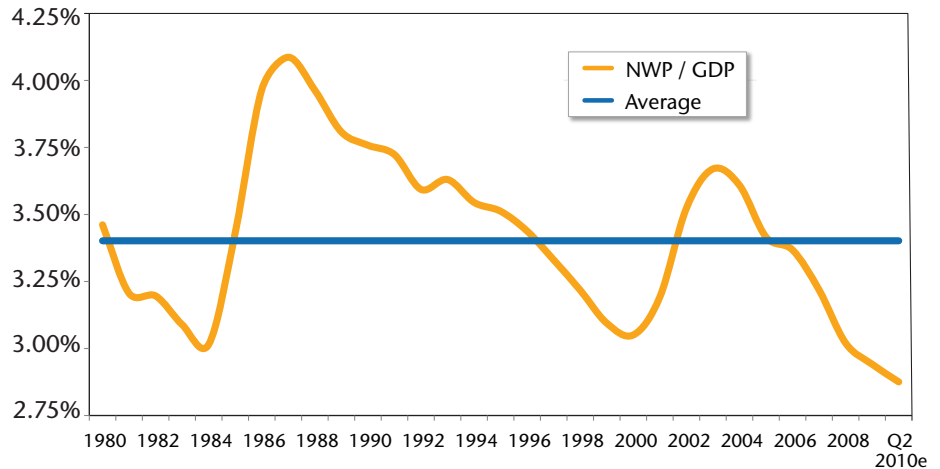
In an attempt to relate the industry written premium to a proxy for exposure we have mapped it to GDP. Albeit a crude measure, we can see that when the ratio of the industry's premiums to GDP drops below the long-run average of 3.4% of GDP, we have had very poor underwriting results. Today we are below 3.4% and well below the levels of the soft markets of 1980–1984 and 1997–2000.

To anyone that has been in the industry for a couple of decades, a combined ratio below 100% has been considered a pretty good result. The current reality is very different. In today's world with low interest rates and greater capital requirements, much lower combined ratios are required to achieve double digit ROEs. A 99% combined ratio in 2009 produced a 7.3% ROE for the industry. The actual combined ratio for 2010 in North America is likely to be well over 100%, which will produce a low single digit ROE. To produce double digit ROEs, the industry has to generate combined ratios in the low 90s, a good 10 points below the current level.

Given the current interest rate levels, there is increased talk about reducing target ROEs. While tempting in an effort to hang on to business, it ignores the fact that interest rates are being artificially suppressed and that the subsequent risk of inflation (possible severe inflation) within the next five years is enormous.

While no one indicator is perfect, in aggregate, the fundamentals suggest that this soft market should be over.

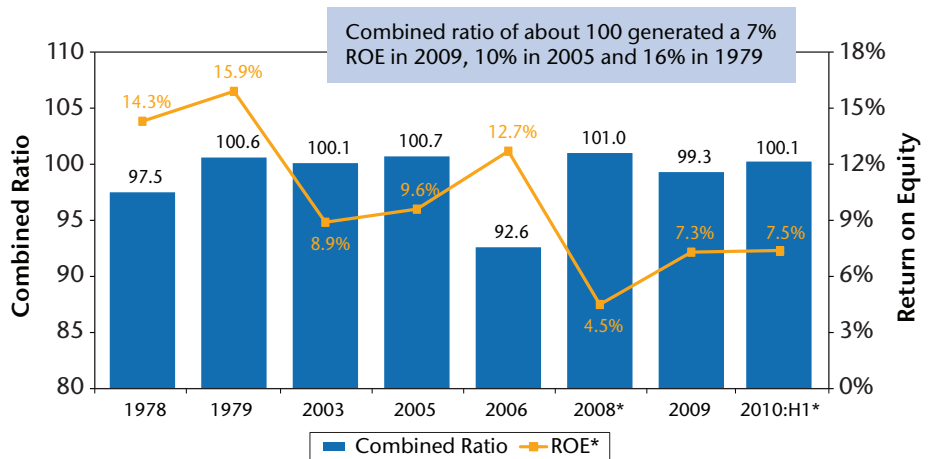
### Net Written Premium / Nominal GDP



Sources: U.S. Bureau of Labor Statistics, A.M. Best Aggregates and Averages, ISO

### Combined Ratios

#### Industry Initial vs. Current Accident Year Combined Ratios



\* 2009 and 2010: Q1 figures are return on average statutory surplus. 2008, 2009 and 2010: H1 figures exclude mortgage and financial guarantee insurers.

Sources: Insurance Information Institute from A.M. Best and ISO data



The people behind the promise.

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