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Overview of Recent Developments in Residential and Commercial Property Insurance

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Executive Summary

The following summarizes our key findings based on our review of the most recent trends and developments in residential and commercial property insurance in the U.S.

Homeowners Insurance

<u>Pricing</u> (U.S. Trend)

- From 1990-2002, the cost of home insurance for urban consumers lagged behind the cost of all other items relating to housing. However, the most recent data indicate that the pace of insurance rate increases accelerated in 2002 – the price of home insurance increased 5.5 percent versus increases of only 3.0 percent for the owners' equivalent of rent and 2.3 percent for the overall CPI. This pattern continued in early 2003.

<u>Average Premiums</u> (U.S. and State Trends)

- The cost of home insurance and its rate of increase vary considerably by region and state. Home insurance expenditures as a percentage of dwelling expenditures have varied by region. Since 1992, relative expenditures on insurance have increased in the Northeast and West, remained stable in the Midwest and declined in the South.

- From 1996 to 1999, the average homeowners insurance premium in the U.S. for homes valued between $175,000-$200,000 increased only 1.4 percent ($559 to $567). By state, some price changes were quite significant - Illinois' average premium increased by 9.8 percent ($377 to $414) and Hawaii's average premium decreased 18.6 percent ($624 to $508).

- From the 1st Quarter of 1997 through the 3rd Quarter of 2002, the average premium per home in the U.S. increased 39.9 percent ($452 to $632). The rate of increase by state varied significantly, ranging from a low in the District of Columbia of 7.6 percent ($496 to $533) to a high in Texas of 112.8 percent ($544 to $1,157). This measure does not control for the value of homes, as does the measure summarized in the preceding bullet point.

- Other recent surveys reveal sharp increases in the cost of home insurance within the last one to two years in a number of states. A survey of state insurance departments found that three states experienced an average home insurance rate increase in excess of 30 percent in 2002, seven states had an increase of 20-29 percent, 12 states had an increase of 15-19 percent, and 14 states had an increase of 10-14 percent.

Availability

- Availability is more subjective and difficult to measure than price and also depends on the quality of the coverage options available. When the availability of insurance tightens, more homeowners are unable to obtain a policy from an insurer they would prefer. The coverage provisions available to some homeowners also may become more restricted. Finally, some homeowners will be forced into a state FAIR Plan (if their state has such a mechanism) that typically offers more limited coverage and some homeowners will not be able to obtain coverage from any source. Though limited, the data that can be obtained, combined with other information, indicate that there has been a significant constriction in the availability of insurance in at least some states.

- In 2001 (the latest data available), the percentage of homes insured in most of the 30 state FAIR plans was relatively small, i.e., less than two percent.

- However, there have been sharp increases in the number of homes/policies insured in some state FAIR plans from 1992-2001. These states include California (68.6 percent), Georgia (101.7 percent), Louisiana (1,836.8 percent), Massachusetts (71.3 percent), Minnesota (64.4 percent), and Ohio (89.4 percent). In Florida, the number of homes with full coverage in the state's residual market mechanism jumped from 67,200 in 2000 to 206,300 by the end of 2002.

- Use of FAIR Plan data has the following limitations:
  - Since 2001 is the most recent year for which data are available (with the exception of Florida), the data do not reflect the most recent experience;
  - The data do not reflect the extent to which homeowners have been forced to switch to insurers they prefer less; and
  - The data do not reveal anything about the states that do not have FAIR Plans.

- We expect to see further growth in some state FAIR plans in 2002 and 2003.

- In Texas, which only recently established a FAIR Plan, there has been significant movement of insureds from "regulated" insurers to "unregulated" insurers. The unregulated sector tends to have higher rates, so the movement to this sector has probably required most of the affected insureds to pay higher premiums.

- According to an industry survey, the number of households without home insurance increased from 3 percent in 2000 to 8 percent in 2001.

Loss Costs

- There is a need to look at long-term trends in loss costs due to spikes in losses that arise from significant weather-related events and other random occurrences.

- The NAII-ISO Fast Track Data on the average loss per insured home from the 1st Quarter 1997 to the 3rd Quarter 2002 show that average loss costs are generally increasing in most states and the rate of increase appears particularly pronounced in certain states, such as Missouri, Nebraska and Texas.

- Water damage (e.g., mold) appears to be a significant cost driver in certain states, such as California and Texas. Other weather-related perils appear to be significant cost drivers in a number of states, especially in the Midwest. The threat of hurricanes continues to be a significant issue in southern coastal states and territories.

Profitability Indicators

- Insurers' profitability declined significantly from 1997 through 2001. With respect to homeowners insurance, insurers profit on insurance transactions (as a percentage of premiums) steadily dropped from +5.4 percent in 1997 to -10 percent in 2001. The imputed return on equity (ROE) dropped from +12.4 percent to -7.2 percent.

- For the period 1991-2001, the average profit on insurance transactions was negative in 36 states. Several states (Florida, Hawaii, Kansas, Minnesota and North Dakota) experienced annual average losses in excess of 25 percent.

- Early reports indicate that profitability in homeowners insurance began to improve in late 2002 and the first quarter of 2003. This is likely due to the rate increases that insurers have implemented, along with other possible factors.

Market Structure Changes

- For the period 1991-2001, market concentration had increased in most states (94 percent). This is likely due to high merger activity over the decade that increased concentration at the group level, as well as the withdrawal or retrenchment of some insurers from the homeowners market. However, concentration has not increased to a level that would undermine competition.

Market Beginning to Soften

- There are some early indications that the supply of home insurance may be beginning to increase and its price plateau or decrease in some states where insurers perceive that market conditions have improved. However, there may be continued pressure on prices and availability in other jurisdictions.

Commercial Insurance

Prices

The price of commercial property insurance began to rise in the latter part of 2001 and accelerated rapidly through the third quarter of 2002. Most businesses appear to have paid premium increases in excess of 10 percent and increases in the area of 30-50 percent or more were common. Beginning in the 4th quarter of 2002, price increases began to decelerate and some businesses are starting to see premium decreases.

Availability

Hard data are limited, but the evidence indicates that the availability of commercial property insurance was constricted as the market hardened. A significant portion of property owners/managers surveyed indicated that their insurance coverage was cancelled or non-renewed in 2002-2003 and they were forced to obtain coverage from another carrier, often at a higher premium. Terrorism coverage was unavailable after September 11, 2001 and prior to the enactment of the federal terrorism reinsurance program. Initially, this coverage has been relatively expensive and many businesses declined to purchase it. This may change somewhat as the price of terrorism coverage begins to fall. Also, most property owners/managers reported that they did not have coverage for mold.

Profitability Indicators

Insurers' profitability in commercial lines that include property coverages has been better than in homeowners insurance, but profits have been significantly below a reasonable rate of return. We expect to see improved profitability when 2002 data become available, due to rate increases and tighter underwriting.

Market Structure Changes
Commercial insurance markets have become more concentrated due to mergers and acquisitions and the withdrawal/retrenchment of some insurers from these markets. However, concentration has not increased to a level that would undermine competition.

Factors Influencing Market Conditions

Underwriting and Coverage Issues

- Mold is a significant issue in Texas and California and has received attention in other states. Insurers are modifying contract provisions to either exclude or limit coverage for mold or price for it.

- The risk of hurricanes and earthquakes continues to be a significant problem in areas that are most vulnerable to these events. Important issues concerning this risk have not been resolved.

- Terrorism is not perceived as a significant risk for most homeowners. The notable exceptions are individuals who have residences in New York City and the District of Columbia. Concern about terrorism risk varies for commercial structures, depending on their location and profile.

- The use of credit scoring and prior claims history in underwriting home insurance has received considerable criticism. Insurers have not adequately explained why these practices are valid and appropriate. States are beginning to enact or contemplate rules governing the use of such information and competition should motivate insurers to refine their methods.

Pricing and Investment Income

- Economic theory and the empirical evidence do not support the allegation that insurers are charging excessive prices to recoup losses from poor investment choices. Insurers' investments returns have fallen with the decline of financial markets and this has necessarily decreased the discount of insurance prices to reflect income on invested reserves.

Reinsurance

- Reinsurance markets are affected by many of the same factors that affect direct insurance markets. The supply of reinsurance has tightened and its cost has increased since 2000. This has contributed to hard market conditions in residential and commercial property insurance. There are some early indications that the price of reinsurance has begun to plateau.

Regulation

- Economic theory and empirical studies indicate that regulation has not reduced insurance rates or provided any other benefits to consumers. At best, rate regulation has been ineffective. At its worst, regulatory attempts to suppress rates have caused severe market problems.

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