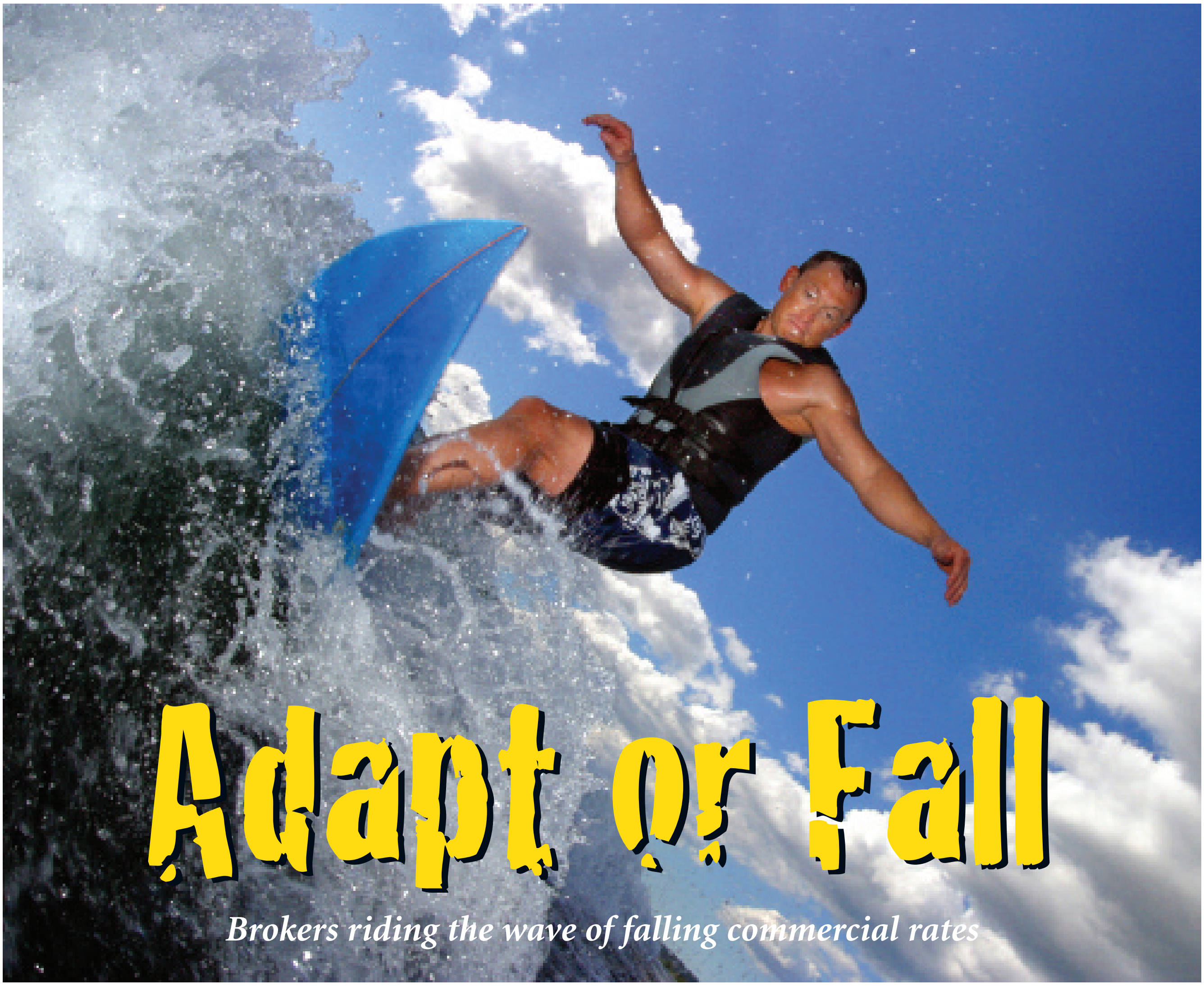

Adapt or Fall

Brokers riding the wave of falling commercial rates

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The Canadian property and casualty industry has seen a steady decline in rates within the commercial sector over the past two years. The trend appears to be continuing, even gathering momentum, into 2007. To some, this is an interesting phenomenon; for others, particularly brokers specializing in commercial lines, it is a concern.

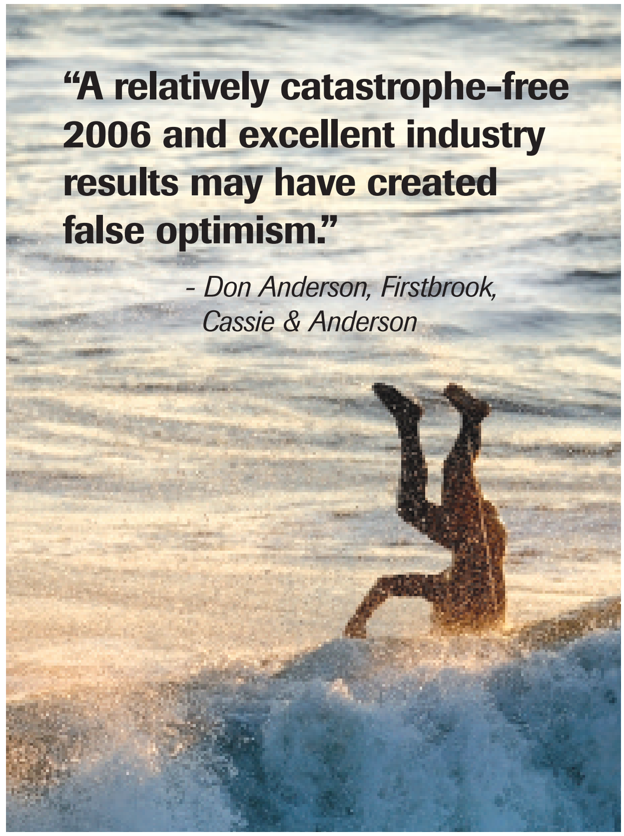
With this context in mind, Canadian Underwriter approached the Toronto Insurance Conference (TIC) to explore the outlook for the 2007 commercial market and its effect on TIC's 29 broker members. Since 1918, TIC has provided a forum for commercial insurance brokerage firms to address common issues. As a whole, TIC members offer a vast range of perspectives from different market segments, experiences and even geographical regions across Canada.

In a recent survey within the TIC, opinions regarding the current soft market were consistent. When asked what specific factors were creating and perpetuating the trend, they all described the trend as part of the classic insurance cycle. All agree the combination of excellent underwriting results and a need for insurers to maximize shareholder returns has been and continues to be the driving force.

PRICE COMPETITION

Kevin O'Reilly, vice president of Aon Reed Stenhouse Inc. in Toronto, says suppliers of capital can't just sit idle. "The cycle is fed locally by an over-supply of capital," he says. "New investors are attempting to come into the market in search of a return, only to meet with a response from those already writing business." That response includes sharpened rates and terms in order to maintain market share. O'Reilly says the Ontario and Canadian markets are attractive to investors because they are perceived as stable economic and geographic venues, promising a fairly robust investment return for providers of capital, despite a potential economic downturn to the south.

Patrice Vézina, the president and CEO, operations, of Vézina, Dufault Inc. in Québec, observes that insurer budgets for Gross Written Premium (GWP) are on the upswing. Therefore, insurers are



seeking increased market share to meet those budgets.

"With insurers searching for new revenue, we see not only price competition, but also we see them entertaining and even pursuing classes of business that they recently would not have considered," says Don Anderson, president of Firstbrook, Cassie & Anderson Limited in Ontario. "A relatively catastrophe-free 2006 and excellent industry results may have created false optimism."

According to Anderson, volatile sectors are attracting new participants that might not have access to full historical data in order to assess their real risk. Nevertheless, once the new entrants have selected their target sectors and begun to pursue them, there is substantial dislocation created among existing players, who are then pressured to respond in kind.

The collective opinion among TIC members is again consistent regarding exceptions to the general trend. O'Reilly and Vézina each note possible pricing challenges in casualty lines for some high-risk manufacturing sectors, and for properties located in the United States' catastrophe zones, where the risk of earthquake, windstorm, or flooding are higher However, these instances are infrequent; as of late, there are early signs of creeping rate competition even in these vulnerable coastal areas, as new capital arrives to take advantage of higher returns.

O'Reilly admits he might have expected the directors and officers (D&O) and executive risk classes to defy the downward trend. "But even that has taken a slight turn toward softer rates over the past four months," he says. "Risks have not necessarily abated, but once again the over-supply of capital searching for a home is driving the market."

In western Canada, the pattern of reduced rates is consistent, but other economic factors also play a role. According to Edmonton's Marshall Sadd, president of Lloyd Sadd Insurance, Alberta is experiencing a dramatic softening of commercial rates similar to Ontario. "Every insurer is extremely aggressive on new business and is willing to move rates on renewal business with little or no resistance to a request by a broker," he says. "They will do anything not to lose an account."

In Alberta, however, with the economy as strong as ever, clients have more revenue and assets to insure. Given that construction costs are rising at a rate of about 1% per month, insurance to value is a big issue, Sadd says. "If we can educate our clients to increase their building values by 10-12%, coupled with the additional assets and revenue, we can, at best, accomplish revenue neutral levels after the rate reductions," he says. "As such, we are focusing our efforts on insurance to value, proper limits of contents, and increased revenues to help offset the sliding rates."

TIC members are observing price fluctuations in proportion with account size, with the greatest percentage of reductions available to the largest purchasers. In the small business area, Paul Martin, the president and chief operating officer of KRG Insurance Brokers Inc. in Ontario, describes a less dramatic decline. "There are clear variations in the market between small, mid-market and large accounts," he says. "Small business tends to be renewed on a more 'as-is' basis, with slight decreases and pressure on values to keep pace with inflation. This keeps premiums at a relatively consistent level." Martin says he has observed some competition between small business writers, with premiums declining 20% in the past two or three years.

On the other hand, Anderson and O'Reilly agree that while the soft market in the commercial area is applicable across a broad spectrum, the largest insurance buyers (those exerting the greatest financial leverage) are realizing the greatest savings and coverage grants. Insurers seeking to meet goals for their total GWP are most willing to sacrifice rate, assuming they will still add substantially to their monthly premium tallies.

EFFECTS OF PRICING

How will current market conditions affect brokerage operations, sales management and projections for the future? Given decreasing premiums, it is clear that brokers would see a proportionate loss of income. In addition, there may be pressure on the broker to reduce a commission percentage in order to lessen the client's overall cost. Furthermore, the stepped-up competition in the marketplace means all renewals are vulnerable.

Organic growth – business expansion through increasing premium and product sales, for example, as opposed to mergers and acquisitions – is difficult in this climate, says Rick Messier, vice president of Moore-McLean Corporate Insurance Limited in Ontario. "We must write more new business than expected just to see single digit growth," he says.

According to Vézina, brokers first and foremost need to make sure they are retaining renewals and reviewing actual terms and conditions on key accounts to make sure they are within the market band. "As revenues are declining," he adds, "we have to stimulate new business more aggressively and manage expenses to offbalance the trend."

Anderson agrees that brokers must analyze their own costs and seek new operating efficiencies. After drastic premium cuts on a labour-intensive account, the remaining commission income may not suffice to cover the actual servicing overhead. Brokers must make deliberate choices. They must either reduce operating costs, perhaps by making new use of technology, or generate additional income to counter the revenue drop. As the ultimate last resort, brokers need to recognize the point at which it is no longer economically viable to service a particular account.

In the past, some brokers have proposed moving to fee-based business. But many are not good at pricing their own value; consequently, this approach did not work at all well in the small to medium, mid-market sectors. "Market cycle is something that I do not see disappearing anytime soon," says O'Reilly. "Like other markets, supply and demand take over; each participant must adapt their business model accordingly, while still continuing to meet the ever-increasing demands of the client."

To maintain income levels, the brokerage operation must find even more new customers in order to grow. "This is a very friendly new business market and we have to focus on being in front of the opportunities that will help us achieve our corporate goals," says Sadd. "Producers will be very busy with new business activities, more than they have ever been in their insurance career."

OPPORTUNITY KNOCKS

Despite their obvious negative impact on revenue stream for commission-based business (keeping in mind that fixed costs are predominant), soft markets nevertheless do create opportunities, O'Reilly notes. They can be advantageous, for example, for brokers that stay current with market movements and have the ability to clearly communicate the benefits to current and prospective clients.

On the whole, TIC members fully expect brokers to adapt and to leverage their inherent business creativity to find ways to augment their revenue sources and offer clients additional value-added services. Only those who evolve will survive and grow.

Surveyed members were also unanimous in their view that the soft market would continue at least through 2007, barring the occurrence of a world-scale catastrophe. Many see the trend persisting over the next three years, until the commercial insurers start to experience dramatic reversals in their loss results. Although some deterioration of auto results may suggest a move to stabilization in that sector, persistence of profitability over the past year, coupled with an absence of large catastrophic losses, suggest the soft market will continue.

The competition for market share is heightened in Canada, where there is a relatively small commercial market. However, brokers conducting international business are seeing the same cycle – with Canada and Australia leading the way. "We normally lag the United States trend," says O'Reilly, "but this situation flip-flopped in early 2006, with the U.S. market maintaining its hard stance following the severe storm losses of 2005."

O'Reilly says the United Kingdom and European situations are still uncertain, although it is notable that the aviation market is seeing price reductions out of London. "I expect to see a similar softening cycle in the U.K. and U.S. by mid-2007, although recent winter storms may have an impact," he says. "In fact, the reductions are underway on the property class."

Some feel that with the perspective gained from previous cycles, this soft market will lead to an equally soft turnaround.

"If we're doing anything right this time, I feel that we have not sacrificed underwriting," says Martin. "For the first time in many years, I continue to see underwriters focusing on understanding the risks, assessing exposures, and still diligently following up on information to grasp the realities of exposures. This may or may not reflect adequate pricing, but I think as long as we maintain this underwriting integrity, we may have a chance of breaking the highs and lows of the cycle and making it more moderate in its swings."

Others disagree. They see little underwriting discipline behind anecdotal reductions of up to 50%. Critics of the rate-cutting believe some of the deep rate cuts for short-term gains in market share have done little to help the industry's credibility – especially when the substantial increases of recent years are still a fresh memory. "Try explaining a 50% decrease in premium with 25% growth in revenue to a client that just came out of a hard market," says Messier. Some say increased underwriting discipline would be welcome.

RIDING THE WAVE

Despite their discussions about 'managing the cycle,' brokers say they cannot dictate the market's high and low tides. Instead, they prefer to concentrate on managing those elements of the business that are within their control. Producers ought to avoid dwelling exclusively on reduced pricing, some say. Indeed, brokers have a critical responsibility to educate clients regarding the cycle. Their experienced advice regarding market fluctuations is invaluable to a client's decision-making. Beyond providing the obvious short-term benefit of premium savings, brokers can assist clients to distinguish between insurers and their offerings – particularly in volatile sectors, where new entrants or products may not endure once market availability restricts.

Sadd emphasizes the broker's role is to guide clients through the soft market with as little friction as possible, and with positive results. He encourages clients to take advantage of the broader coverages and higher limits that are now available at reasonable premiums, all of which will help them to reduce their total cost of risk.

Above all, TIC members say, brokers would be well advised to emphasize the additional value they provide, exercise creativity in devising new client services, and ensure that they supply the greatest possible customer benefits. "Unfortunately, the industry does not deliver, as a whole, exceptional service," Martin says, "an area we need to continue to work on." Brokerages need to stay in tune with their clients' expectations for service levels, remembering that the demand for the delivery of additional risk services increases with account size. Some TIC members feel that this extra pressure on broker performance helps to separate the transactional brokers from those who deliver full advisory services.

One way or another, as with all businesses, brokers must find ways to separate themselves from their competitors. They need to be diligent in producing real value for the client, and can't be reticent about promoting the benefits they add to the insurance process. The current soft market, with its unique characteristics and lifespan, is simply the latest challenge in the insurance business cycle. Those who are most successful will use it as an opportunity to construct advantages for long-term growth. CU