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# IRU, Inc.

*Intermediaries & Reinsurance Underwriters Association*

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## IRU FALL CONFERENCE SEPTEMBER 14-16, 2003

### CONFERENCE HIGHLIGHTS

Timing is everything, so they say! If there was ever any truth to that adage, it was evidenced by the timing of the IRU's Fall Conference at the Hyatt Regency Chesapeake Bay on September 14-16 which barely preceded Hurricane Isabel which hopefully spared the beautiful hotel any serious damage.

As it happened and despite the rains (unrelated to Isabel) which dampened activities planned for Monday afternoon, conference attendees were blessed with great weather, not to mention the customary excellence of the venue and the program which were attributed to the IRU's Executive Director, Mary K. Clancy, and the IRU's new Program Chair, Bill Jewett.

IRU President, John Reinman, opened the conference with his customary words of welcome to IRU members, both new and old, including such distinguished guests as Steve Bolland of Gill & Roeser and Mike Kurz of Zurich North America whose companies will hopefully become new IRU members in the near future. John also pointed out that the well attended conference included representatives from 55% of member companies which reflects the increasing importance of these gatherings to industry professionals.

Bill Jewett then took charge of the proceedings, and introduced the opening presentation which focused on a "**Private Equity Perspective of the Insurance & Reinsurance Industry**" by Gary Colton of Fisher Capital Corporation which is an affiliate of Kohlberg Kravis Roberts (KKR), the largest private equity firm in the world.

Distinguishing characteristics of private equity investing include the length of commitment which averages a "hold" time of more than 7 years; the generally illiquid nature of the investment; the importance of management commitment; and the fact that management is the investor's partner during the relationship.

In describing today's investment climate, Mr. Colton commented that the "hot money" invested by the Class of 2001 has begun to exit the insurance industry in search of greener pastures, and that the merger market is rather quiet. He went on to quote industry pundit, V.J. Dowling, who further characterized the industry as being in a "restoration" phase, with a lingering "hangover" in coping with such issues as asbestos and

environmental claims, a prior decade of inadequate pricing, and exposure to the depressed equity markets.

Regardless of difficulties impacting the insurance community, opportunities do emerge from those problems which may enhance the prospect for additional investment in the months ahead.

Tom Johnson, of Signal Capital Group, followed up with his own perspective on the **“Changing Landscape of Mergers and Acquisitions in the Insurance and Reinsurance Industries”** which included an historical review of industry performance. That perspective contained the following conclusions drawn from his analysis:

- High investment returns have been “fleeting.”
- Both insurance and reinsurance trends have been cyclical in nature.
- Reinsurance results have been more volatile than insurance performance.
- Investment returns have traditionally compensated for poor underwriting results.
- Recently poor investment results have exerted pressure for better underwriting returns.

Despite being in the doldrums right now, Mr. Johnson believes things will pick up and that M&A activity will resume, with the drivers likely to be:

- Low premium growth rates
- Pressure on publicly traded companies to grow
- Interest rate environment
- Access to capital
- Capital costs
- Operating issues
  - Economies of scale & scope
  - Reserve Adequacy
  - Catastrophic events
- Strategic Issues

In general terms, M&A activity is inversely tied to premium growth rates. As a result, when growth begins to flatten out, M&A’s will likely increase.

Shifting gears somewhat, Anthony Miscioscia of the White and Williams law firm, addressed the issue of **“Cyber Risk Exposures Under Traditional Insurance Policies,”** including the differences between Coverages A & B of a CGL policy with respect to the treatment of advertising liabilities. With specific regard to cyber exposures, the more common claims involve:

- Domain name issues
- Use of hyperlinks, metatags, banner ads
- Defamation

- Use of patented business methods such as “single-click” method of purchasing
- Privacy claims, including spamming and unlawful use of cookies

Additionally, a broad range of liabilities emanates from

- Anti-Cybersquatting
- Antitrust violations
- Internet Tax Freedom Act
- Product liability claims
- Contract claims (e.g., enforceability of click-wrap agreements)
- Digital Millennium Copyright Act
- Communications Decency Act
- Publishing rights disputes
- Children’s On-Line Privacy Protection Act

During the course of his presentation, Mr. Miscioscia reviewed a number of examples which demonstrated the difficulties in dealing with a wide range of issues in this complex area of exposure.

As the opening speaker on the second day of the conference, Richard Palczynski, Senior Vice President of Hartford Financial Services, discussed **Terrorism Risk Funding from a Workers’ Compensation perspective**. In addition to reviewing the various aspects of the Terrorism Risk Insurance Act of 2002 (TRIA), Mr. Palczynski offered the following reflective comments:

- At current prices, industry capacity in Workers’ Compensation builds slowly, and only if there are no events for an extended period.
- Funding decisions should consider the amount of expected terrorism losses at various levels of probability.
- TRIA has a very significant funding role today
- It will take many loss-free years to build significant capacity through premium funding
- Extending TRIA is critical to all insurers, but the Treasury Department will look for private market solutions.
- The Workers’ Compensation industry is studying options that include a terrorism pool with the primary objective of better positioning the industry in the TRIA extension debate.
- To fully utilize industry capacity, commercial reinsurers should have a role.
- Support among the 14 Steering Committee companies is not uniform. There are still issues that must be resolved, and concerns that may block industry-wide consensus.
- A consensus was reached to continue the design effort, but the implementation target was pushed off beyond January 1, 2004.
- Federally backed terrorism pools have been created in 12 other countries. All have been created or amended since the World Trade Center event.

Mr. Palczynski concluded his remarks with the following observations:

- TRIA renewal is critical, particularly in Workers' Compensation where terrorism coverage cannot be excluded.
- The industry cannot build capacity fast enough at affordable prices to absorb the terrorism risk alone in the foreseeable future.
- The Treasury Department may agree, but likely at higher retentions and simpler terms.
- Pooling of risk has the potential to use industry capital more efficiently, both to fund the risk retained under TRIA and to access reinsurance market capital.
- We don't have much time. Policies issued in January, 2005 have exposure beyond the current TRIA expiration.

For his part, Dennis Mealey, Chief Actuary of NCCI, reviewed **Industry Experience and Trends in Workers Compensation**, including some good news and bad, as follows:

- WC premium is in its 3<sup>rd</sup> consecutive year of growth.
- WC calendar year combined ratio declined in 2002.
- Low WC investment returns continued in 2002.
- WC results in 2002 improved over 2001.
- Accident Year (AY) combined ratio improved relative to record highs in recent years.
- WC reserve deficiencies have grown larger in recent years.
- Most recent AY reserves have increased from first report.
- Average approved bureau rate/loss costs have been increasing for the most recent years.
- Rate of changes in WC indemnity claim costs has accelerated since 1995
- WC medical claim cost trends continue to accelerate.
- Frequency of lost-time claims has continued to fall through 2002.
- WC residual market pool premium volume is on the rise.
- Residual market WC insurance plan market shares are also on the rise.
- WC residual market combined ratios are holding steady.

With respect to the Terrorism Risk Insurance Act, NCCI has responded as follows:

- EQECAT was engaged to model terrorism in February 2002
- Terrorism filing was made December 20, 2002
- NCCI has simultaneously shared modeled results with independent workers compensation rating bureaus
- NCCI filing is currently effective in all of NCCI's jurisdictions.

In summary, Mr. Mealy listed the following observations of a positive nature:

- Results are improving.

- Frequency continues to decline.
- Residual market burden is manageable.

On the negative side,

- If investment results do not improve, there will be downward pressure on ROS.
- Medical severity continues at double digit rates.
- Additional solutions are needed to manage terrorism catastrophe exposures.

During his remarks on **Company Perspectives and Market Opportunities in the Workers Compensation area**, Ray Jacobsen of the Windham Group discussed the impact of Cumulative Trauma Disorders (CTD); e.g., carpal tunnel syndrome, etc. on the increase of indemnity and medical claims. As a solution to this increasing problem, Mr. Jacobsen suggested a corporate need to consider a re-design of workstation environments to their employees.

Following their individual presentations on WC issues, Messrs. Palczynski, Mealy, and Jacobsen joined together as a panel, and offered the following commentary in response to audience questions:

- The downturn in loss frequency masks the need for reform.
- A decline in loss frequency is not universal by state.
- The impact of the “pharmacy” component in claims is increasing dramatically.
- Mandatory terrorism pools will be necessary if TRIA is not extended.

Rounding out the IRU’s educational program was a very informative presentation by Robert Reville, of the RAND Institute for Civil Justice, who discussed the Institute’s program for **improving Terrorism Risk Management Policy**. During his remarks, Mr. Reville contrasted the increasing incidence of the “new” terrorism characterized by greater violence and death mandated by ideological beliefs, with the more “traditional” terrorism which has a lesser focus on violence and death. As part of their charge, RAND will present options to the Treasury Department and Congress with respect to the extension of TRIA beyond 2005, and will also provide policy-makers with the result of their research and analysis of terrorism compensation and related liabilities.

In closing the very successful conference, President Reinman reminded the membership to make the IRU aware of new member candidates and to reference the IRU website for more detailed information on conference presentations, as well as the locale for next year’s Spring meeting.

Paul Walther, Editor  
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