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Insurers fear the return of stagflation

Double whammy of inflation and recession would drive premium prices down

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As concerns about a possible recession rise, industry observers say deteriorating economic conditions would prove trying to insurers, while risk managers may continue to enjoy soft market conditions.

Because of "the coincidence of the soft market with the recession," risk managers could "probably be able to get some lowering of rates," said Steven N. Weisbart, vice president and chief economist for the insurance industry-backed Insurance Information Institute.

Insurers, on the other hand, would have to deal with diminished demand for their products at a time when claims could rise.

But analysts also caution that the insurance underwriting cycle and the business cycle don't always coincide.

"The insurance cycle is not necessarily the same as the economic cycle," said Mark Lane, principal and equity research analyst with William Blair.

Of course, the economy is not in a recession yet, despite fears of pending downturn fueled in part by an erratic equities market in recent weeks. A recession is generally defined as a period of at least two consecutive quarters of negative economic growth. The U.S. has not witnessed a single quarter of economic contraction in years.

The current turmoil in the equities markets-driven by the subprime mortgage crisis and other credit-related concerns-probably won't have a significant direct impact on insurers, say analysts.

"I don't think it will have a major impact," said Cliff Gallant, an analyst with Keefe, Bruyette & Woods. The subprime losses could cause more claims for some professional liability coverages like directors and officers liability, he said.

But in general, Mr. Gallant believes the capital position of the industry is relatively strong. "The primary impact is going to be within the investment portfolio," said Mr. Lane, noting that some insurers' portfolios are exposed to the mortgage-backed and asset-backed market.

In addition, he noted that the industry invests substantial amounts in the municipal and corporate bond markets. "As the credit environment continues to deteriorate and credit losses go up, that's going to put pressure on their investment portfolio, but we don't view it as a major drag on capital adequacy."

Like Mr. Gallant, Richard Kerr, chief executive officer of electronic insurance exchange MarketScout, predicts that even if the current economic turmoil doesn't turn into a recession, D&O insurers, as well as some other professional liability underwriters, are likely to feel the pinch. "We do believe the professional liability market will be impacted by the trickle down of the subprime mortgage crisis," he said.

Previous recessions have tightened the market somewhat, said David Cummins, professor of risk management, insurance and financial institutions at Temple University. "Any investment downturn could tighten the market," he said.

"If there was a prolonged slump in the stock market or if bond defaults began to go up, this is going to tighten the market," he said. He added, however, that insurers generally hold very high-quality bonds.

Some observers warn if current conditions deteriorate into a full-fledged recession, insurers could be hit by a double whammy of price stagnation and spikes in some claims.

The hit on revenue would be obvious, said Jim Auden, managing director of Fitch Ratings. "Unemployment's up, so you're selling less workers compensation," he said. Revenue from commercial property insurance would also drop, because "there's less construction and values aren't going up."

And insurers would be hard-pressed to make up the difference, he said. "We're in the midst of a soft market now, so they're challenged to find revenue growth as it is."

Recession "could trigger declines in investments, and it could also affect claims," said Temple's Mr. Cummins. "The research on the correlation between claims and economic conditions is not very clear."

"On the commercial side, you'd see some impacts because workers compensation premiums are linked to employment," said Sean Mooney, chief economist at Guy Carpenter, a reinsurance brokerage unit of Marsh & McLennan.

In addition, "you see a direct impact" on coverage related to sales and inventory because of decreased demand.

Mr. Auden added that the nature of any future recession could have a considerable affect on what insurers experience. A downturn accompanied by inflation, termed "stagflation," could "work very adversely because of claim cost escalation and it gets harder to predict claim costs. You get a bump up in inflation; it's hard to keep up."

"Is this a recession where we have stagflation?" asked Myron Picoult, an independent insurance consultant. "I don't think anybody's got the answer."

"Inflation has clearly crept up," he said, and "any pick up in inflationary pressures doesn't help the business, because it seems to bring into question the adequacy of reserves." *-Business Insurance*