

Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

First Quarter 2008 Industry Results

On June 24, 2008 the Insurance Services Office released the first quarter consolidated results of the US Property Casualty Industry which clearly confirmed the effects of the competitive market pricing that has spread to most lines of insurance since last year. The industry's Net Income (after tax) fell nearly 50% from \$16.2 billion to only \$8.2 billion with a comparable drop in the rate of return on average net worth from 13.4% to 6.4%. This first quarter result is significant since historically it is usually the best quarter for insurer results but the numbers show it to be well below the average return over the past 23 years. Factors such as the competitive commercial risk pricing market, increase in claim settlement costs, above average catastrophe losses, weak fixed income yields, reduced cash flow and lower equity values all contributed to this poor showing.

Insurance Underwriting Income

The insurance underwriting performance was a major disappointment lead by decline in written premiums over the prior year making it the fourth straight quarterly decline in revenue growth. Meanwhile aggregate claim expense grew by 11% with non-catastrophe losses accounting for 8.3% and catastrophe losses doubled to \$3.4 billion from prior year of \$1.3 billion. It is expected the future quarters will continue to show a continuation of this deterioration in underwriting well into 2009 and could accelerate if catastrophe losses maintain their current (through June) above average pace.

Investment Operations

The earnings from investments were very disappointing as dividend and interest income fell 2.1%. Although average holdings in cash and invested assets raised by 3.8% this was more than offset by a decline in annualized yield from 4.25% to 4%. With these invested assets aggregating \$1.27 trillion that differential in yield translates to \$3.1 billion of annualized lost investment income. Trying to regain a better investment yield in the face of underwriting results going negative usually means taking a more significant risk of principal in duration, credit quality or other risk characteristics. A move not recommended for the faint of heart in this period of financial uncertainty. During the first quarter the industry also recorded Realized Capital Losses of \$472 million, a swing of \$2.5 billion from

PROPERTY CASUALTY INDUSTRY RESULTS 2006 - 2008 NET INCOME (Millions of Dollars)

FIRST QUARTER	2008	2007	2006
PREMIUM REVENUE			
Net Written Premium (NWP)	\$110,528	\$111,315	\$110,482
Net Earned Premium (NEP)	\$107,918	\$108,517	\$106,580
UNDERWRITING OPERATIONS			
Underwriting Expense	\$30,065	\$29,284	\$28,243
Incurred Claims and Loss Adj. Exp.	\$78,029	\$70,308	\$69,264
Policyholder Dividends	\$385	\$315	\$315
Total Underwriting Expense	\$108,479	\$99,907	\$97,822
Net Underwriting Gain (Loss)	-\$561	\$8,610	\$8,758
INVESTMENT OPERATIONS			
Net Investment Income	\$12,653	\$12,925	\$11,727
Other Income	\$243	-\$2,140	-\$343
Pre-Tax Operating Income	\$12,335	\$19,395	\$20,142
Net Realized Capital Gains	-\$472	\$2,083	\$1,888
Pre-Tax Income	\$11,863	\$21,478	\$22,030
Federal Tax	-\$3,629	-\$5,238	-\$5,301
Net After Tax Income	\$8,234	\$16,240	\$16,729
Consolidated Industry Surplus	\$515,583	\$495,642	\$439,116
Loss and LAE Reserves	\$537,469	\$515,954	\$502,982
Combined Ratio	99.9%	91.7%	91.1%
Net Industry Catastrophe Losses (estimate)	\$3,400	\$1,300	\$1,500

Source: Insurance Services Office (ISO)

last years gains.

Net Worth

Industry surplus declined from year-end 2007 by \$2.3 billion mostly on Investments both as realized and Unrealized Capital Losses reversed several years of good gains. Now that underwriting losses in operations have appeared in several quarterly results without any sign of competition abating, the pressure on investment returns may take center stage. The current environment for improvement in investment returns may prove as difficult to achieve as a return to underwriting profits.....both have extremely difficult negative market factors to overcome.

Outlook

It seems that we have the worst possible scenario working against maintaining insurance industry profitability.

1. Intense competition is forcing down rates in virtually every commercial risk sector of the insurance market (even some shoreline exposed property) while insurance costs continue to rise;
2. Economic conditions are at recession levels which makes it likely insurers will experience negative organic growth. Competing for a piece of a smaller US market economy, will only foster more rate cutting;
3. Catastrophe losses particularly from west coast fires and Midwest tornadoes and floods are mounting causing especially difficult earnings consequences for regional insurers with risk concentrations in these markets;
4. Interest rates and unsettled credit markets continue to be a drag on investment operations causing at best, stagnation of investment income from debt securities as dividends get cut on equity holdings. Thinking about making up lower underwriting margins via more aggressive investment strategy can be a recipe for disaster as history has shown all too often;
5. Equity market well into a bear market has caused both realized and unrealized investment losses that will drain some of the excess capital from the market. This pain may not be evenly distributed so some will be hurt more than others so watch for rating agencies announcements on carrier reviews.

The above all makes for the insurance industry's "Perfect Storm" in looking forward toward the end of this year and into 2009-2010. Depending on the further deterioration in these factors and duration, we could see commercial risk soft market pricing stabilize in early 2009 but we will need the next two quarters of results to measure the level and scope of financial pain. Remember the insurance risk market has many diverse suppliers and participants from regional to national and global companies. The financial "pain threshold" has historically been very high. Stay tuned.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS 2004-2008(First Quarter)

	2004	2005	2006	2007	1st Qtr. 2008
PRIOR YEAR-END SURPLUS	347.1	391.2	427.1	487.7	519.3
INCOME/LOSS FROM OPERATIONS					
Operating Income (Loss) <small>See Note #1</small>	43.9	45.1	84.6	72.6	12.6
Realized Capital Gains	9.1	9.7	3.3	8.9	(0.5)
Federal Income Tax Paid (Credit)	14.7	10.7	24.2	19.7	3.6
NET INCOME AFTER TAXES	38.3	44.1	63.7	61.8	8.5
BALANCE SHEET ADJUSTMENTS					
Dividends to Stockholders	(14.1)	(15.2)	(24.5)	(32.0)	(6.4)
New Funds	8.8	15.1	3.6	3.2	4.4
Unrealized Capital Gains (Losses)	10.6	(3.4)	20.1	(0.5)	(9.9)
Miscellaneous Surplus Changes	0.5	(4.7)	(2.3)	(0.9)	1.4
NET BALANCE SHEET ADJUSTMENTS	5.8	(8.2)	(3.1)	(30.2)	(10.5)
NET CHANGE TO SURPLUS	44.1	35.9	60.6	31.6	(2.0)
YEAR END SURPLUS/FIRST QTR.	391.2	427.1	487.7	519.3	517.3
Total Investment Trading Gains or Losses	19.7	6.3	23.4	8.4	(10.4)

Note#1 Operating Income includes Underwriting and Investment Income

Source:2004-2008 Insurance Services Office Reports



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