

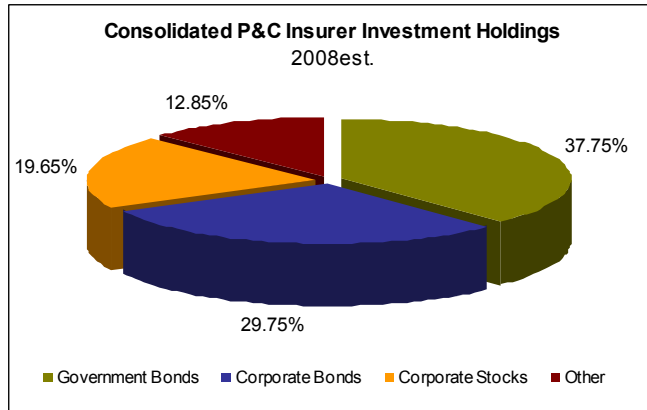
Insurance Executive Review

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

The Soft Commercial Lines Market Is Now Over ... Or Is It?

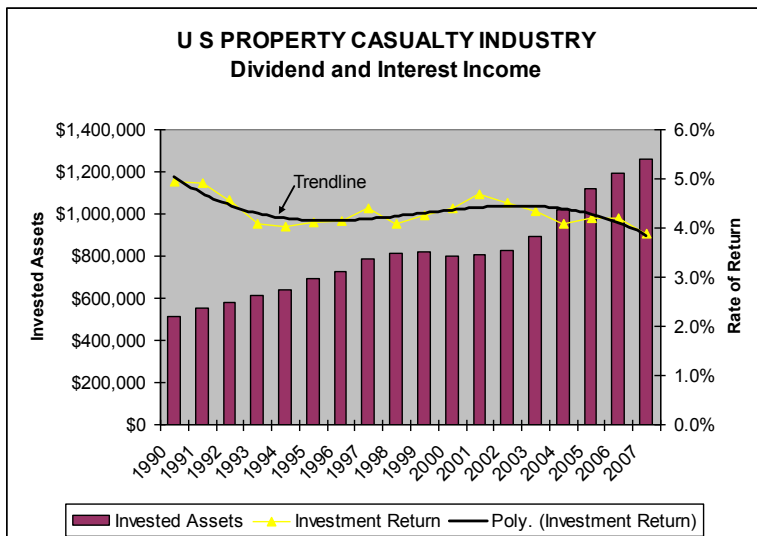
PART II: The Investment Component

It has been a well established fact that the Property Casualty business has endured very long and difficult soft pricing markets at times on the back of robust investment operations in what has been a capital intensive business that generates long-tail claim reserve opportunities on a significant amount of its business. The interest and dividend income generated from these investments provides current operating income support for underwriting losses which at times has delayed insurance product pricing changes. Additionally, as asset market valuations would change the underlying capital base of the insurance enterprise would increase/decrease as assets are liquidated via Income Statement (i.e. Realized Capital Gains or Losses) or held on the Balance Sheet (i.e. Unrealized Capital Gains or Losses). With aggregate invested assets now reaching \$1.2 Trillion (2007) the amount of change in current income and potential investment gains or losses have an enormous effect on insurance company operations.



Current Investment Earnings Review

The period through earlier this year saw slower growth of investment income from interest and dividends has seen the effect of lower interest rates, a decline in cash flows from the general trend in competitive pricing of insurance products and a mixed growth in asset valuations.



The latter has generated a decade long shift in investment strategy away from fixed income government obligations (as we have demonstrated in past newsletters) and into corporate instruments including convertible bonds, preferred stock, common stock and alternative investment vehicles to bolster returns. The actual investment returns from dividends and interest are shown in the exhibit below for the 17 year period (1990-2007) indicating a slower trend in the yield curve over the last 4 year period prior to 2007.

If we look at the most recent period we see the effects of the financial markets reaping

Realized Capital Gains in 2004-2007 followed by steep Realized Capital Losses from impaired and liquidated

assets in 2008 and 2009 of nearly \$8 Billion. That is our best guess given first half 2008 results but these numbers may be light based on carrier reports for the third quarter.

	2009est.	2008est.	2007	2006	2005	2004
INVESTMENT OPERATIONS						
Net Investment Income	\$47,250	\$48,950	\$54,641	\$52,309	\$49,729	\$39,966
Other Income	\$300	(\$250)	-\$993	\$1,183	\$1,028	(\$267)
Pre-Tax Operating Income	\$51,800	\$36,565	\$72,672	\$84,607	\$45,145	\$43,962
Net Realized Capital Gains	(\$1,500)	(\$6,255)	\$8,971	\$3,524	\$9,701	\$9,125
Pre-Tax Income	\$50,300	\$30,310	\$81,643	\$88,131	\$54,846	\$53,087
Federal Tax	(9,250)	(\$7,900)	(\$19,703)	(\$22,354)	(\$10,691)	(\$14,586)
Net After Tax Income	\$41,050	\$22,410	\$61,940	\$65,777	\$44,155	\$38,501

Note: the above income figures include results of Underwriting Operations in Part I

Given the P&C Industry underwriting losses (see Part I of this series) as well as the reduction in total realized investment results, the industry will still have positive income although it will down significantly this year. Not very surprising but not enough to change the earnings outlook that would trigger future product pricing escalations. The decline in retained invested assets (i.e. unrealized capital losses) also needs to be considered, as this directly impacts industry surplus or net worth that supports the ability to underwrite risks being assumed.

Market Capacity-Surplus Valuations

This consideration does not focus on current profitability issues but more on the technical capacity of the insurers to underwrite risks after asset portfolio values decline. I did view the insurance market earlier this year as continuing to have excess capital being put to work chasing ever lower priced business. Some insurers recognized this condition and publicly traded insurers put stock repurchase programs into effect back in 2006 and 2007. Although it is not our view that excess capacity alone will drive pricing, it is a very important contributor to cyclical conditions in terms of duration. As in passed soft market cycles change came not only from continuing poor underwriting performance but that it reached the point of becoming a threat to the financial viability and even the solvency of a broad sector of the market. In our case today it is the precipitated drop in asset values that could remove a meaningful amount of capital support for current market pricing. We decided to look at how far we may have come on that issue and created the exhibit below.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS

Billions of Dollars	2004-2009							
	2004	2005	2006	2007	1st Half 2008	2nd Half 2008	2008	2009
PRIOR YEAR-END SURPLUS	\$347.1	\$391.2	\$427.1	\$487.7	\$517.3	\$504.4	\$517.3	\$498.1
INCOME/LOSS FROM OPERATIONS								
Operating Income (Loss) See Note #1	\$43.9	\$45.1	\$84.6	\$72.6	\$20.4	\$16.1	\$36.5	\$51.8
Realized Capital Gains (Losses)	\$9.1	\$9.7	\$3.3	\$8.9	(\$1.1)	(\$5.2)	(\$6.3)	(\$1.5)
Federal Income Tax Paid (Credit)	\$14.7	\$10.7	\$24.2	\$19.7	(\$5.4)	(\$7.9)	(\$13.3)	(\$9.3)
NET INCOME AFTER TAXES	\$38.3	\$44.1	\$63.7	\$61.8	\$13.9	\$3.0	\$16.9	\$41.0
BALANCE SHEET ADJUSTMENTS								
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$11.9)	(\$4.1)	(\$16.0)	(\$14.1)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$3.9	\$7.5	\$11.4	\$6.2
Unrealized Capital Gains (Losses)	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$18.5)	(\$12.5)	(\$31.0)	(\$5.5)
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	(\$0.3)	(\$0.2)	(\$0.5)	(\$0.6)
NET BALANCE SHEET ADJUSTMENTS	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$26.8)	(\$9.3)	(\$36.1)	(\$14.0)
NET CHANGE TO SURPLUS	\$44.1	\$35.9	\$60.6	\$31.6	(\$12.9)	(\$6.3)	(\$19.2)	\$27.0
ENDING SURPLUS	\$391.2	\$427.1	\$487.7	\$517.3	\$504.4	\$498.1	\$498.1	\$525.1
Industry Written Premium	\$424.1	\$425.5	\$443.5	\$440.8			\$436.2	\$435.1
Premium to Surplus Ratio	1.1	1.0	0.9	0.9			0.9	0.8
Investment Trading- Capital Gains or Loss	\$19.7	\$6.3	\$23.4	\$8.4	(\$19.6)	(\$17.7)	(\$37.3)	(\$7.0)

Note#1 Operating Income includes Underwriting and Investment Income(i.e. interest and dividends)

Source:2004-2008(First Half) Insurance Services Office Reports;2008 Second Half and 2009 CR Marketing Strategies estimate

The assumptions used for the above show a decline in surplus of \$37.3 Billion for 2008 moderating to a decline of \$7 Billion in 2009. With the expected levels of industry premiums, the “premium to surplus ratio”* is maintained at the same levels as the 2006-2007 time periods. We therefore are unable to see a scenario that would support a broad market pricing change based on these assumptions. We will make a reality check when actual industry results for the third quarter are released.

While at this writing the financial markets appear to be re-gaining some value, insurers will need to employ greater risk management discipline in their investment strategy with fixed income yields likely to remain at low levels. Safety, liquidity, duration and market transparency are among the watch-words going forward.

*Note: “Premium to Surplus Ratio” is a general measure of the ability of the market to support the underwriting of risks as the statutory maximum ratio is 3.0 when each \$1 of capital can support \$3 of premium...a ratio of 1.0 or less is considered adequate capital to support a price competitive market.



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