

# Insurance Executive Review

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

## 2008 First Half Financial Results: The Good, The Bad ... and the Ugly!

The Insurance Services Office released the first half consolidated results for the US Property Casualty insurers on September 30, and the picture as expected was not very pretty. These results were marked by a continuation of the soft commercial pricing market, municipal and bond insurer problems, low interest rates, natural catastrophe losses, equity market volatility and credit/liquidity problems developing among many financial institutions. So as bad as these results may be, we already know that when insurers report their 3rd Quarter numbers the situation is going to be worse.

### PROPERTY CASUALTY INDUSTRY RESULTS 2006- 2008 NET INCOME

#### FIRST HALF

(Millions of Dollars)

PREMIUM REVENUE	2008	2007	2006
Net Written Premium(NWP)	\$221,922	\$223,268	\$223,107
Net Earned Premium(NEP)	\$217,693	\$217,837	\$214,824
<b>UNDERWRITING OPERATIONS</b>			
Underwriting Expense	\$60,173	\$59,842	\$57,812
Incurred Claims and Loss Adj. Exp.	\$162,428	\$142,834	\$141,376
Policyholder Dividends	\$727	\$623	\$615
Total Underwriting Expense	\$223,328	\$203,299	\$199,803
Net Underwriting Gain (Loss)	-\$5,635	\$14,538	\$15,021
<b>INVESTMENT OPERATIONS</b>			
Net Investment Income	\$25,823	\$26,198	\$24,513
Other Income	\$233	-\$1,462	\$152
Pre-Tax Operating Income	\$20,421	\$39,274	\$39,686
Net Realized Capital Gains	-\$1,067	\$4,150	\$881
Pre-Tax Income	\$19,354	\$43,424	\$40,567
Federal Tax	-\$5,421	-\$10,692	-\$11,132
Net After Tax Income	\$13,933	\$32,732	\$29,435
Consolidated Industry Surplus	\$504,972	\$512,770	\$444,694
Loss and LAE Reserves	\$546,730	\$519,177	\$505,497
Combined Ratio	102.1% *	92.7%	92.0%
Net Industry Catastrophe Losses(estimate)	\$10.3	\$3.6	\$6.5

Source: Insurance Services Office (ISO)

\* 99.2% excluding mortgage and bond insurers

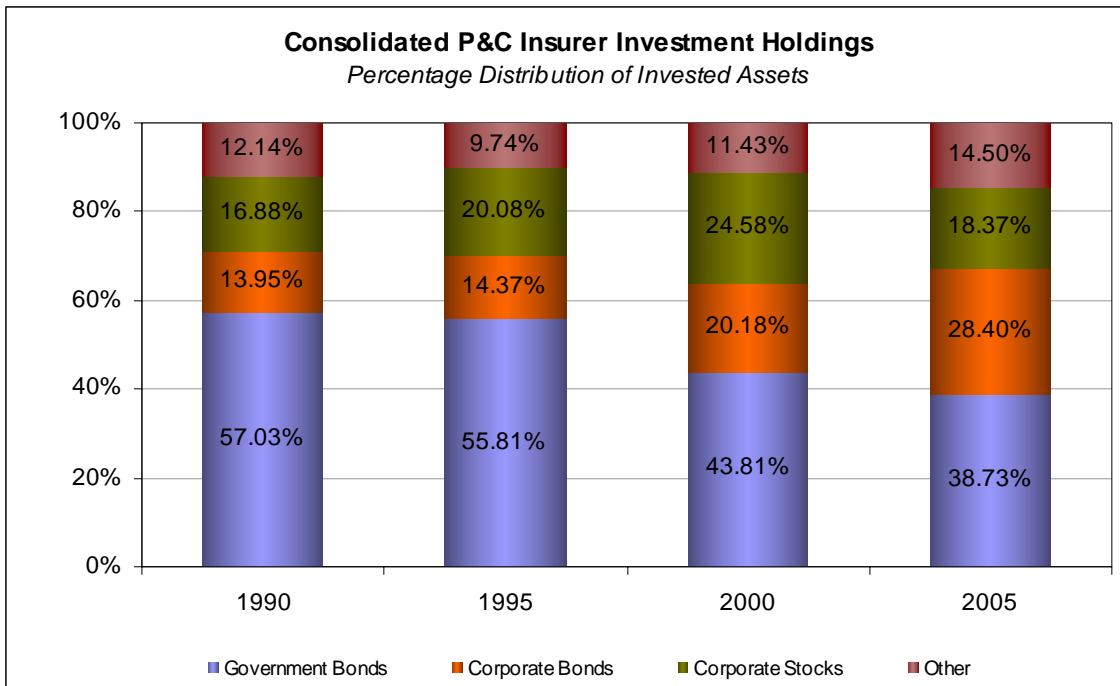
#### UNDERWRITING OPERATIONS

The financial data particularly underwriting losses were affected by results in the mortgage and guaranty insurers segment where premiums rose 5% to \$4.1 Billion but loss and loss adjustment expenses grew to \$10 Billion

an increase of 462.2% over the same period in 2007. The industry results show the lack of overall premium revenue growth as net premiums dropped by .6% (or .7% excluding mortgage segment) indicating that the soft market is still alive and well in the general insurance segments. Catastrophe losses at \$10.3 Billion were higher than all of 2007 and we already know that Hurricane Ike (although only a category 2 when making landfall) and Gustav will add \$9.8 and \$1.8 Billion respectively to this “insured damage” total in the third quarter. The Combined Ratio increased to 102.1% in the first half of 2008 but if we remove the mortgage/bond insurer results the ratio drops to 99.2%. So excluding the guaranty business, the industry made a \$1.6 Billion underwriting profit in the first half, so conditions from an underwriting perspective are not likely to signal a market turn—at least not yet!

**INVESTMENT OPERATIONS**

Industry cash and invested asset in the first half of 2008 grew by 2.1% but the annualized yield dropped to 4.1% from 4.3% in the first half of 2007. Additionally, with the S&P 500 dropping 12.8% during the first half, concerns over corporate debt and market liquidity issues the industry had \$1.1 Billion of Realized Capital Losses plus and additional asset value write-down of \$18.5 in Unrealized Capital Losses that hit the balance sheets. Investment profile of the Property Casualty market has changed over the years with greater portion of assets in corporate debt and equity positions. With the S&P 500 falling another 13.6% between June 30 and September 29 the outlook for the third quarter will not be very good at all!



**SURPLUS (NET WORTH)**

For some time we have suggested that excessive capital was the root cause of the competitive commercial lines pricing cycle. The market conditions over the past 12 months has produce underwriting profits that have at least validated that prior rate levels were somewhat excessive. The historical nature of these market cycles is that they tend to continue their trend (either up or down) well beyond reaching a point of price/risk equilibrium. When catastrophe strikes (i.e. terrorist attacks/massive hurricanes) risk capital flooded into the market in anticipation of price driven profits. Unfortunately insurance company managements have limitations on pulling capital out of the system as shareholder or upstream dividends carry limitations as presented in the recent AIG case when the

parent needed liquidity.

### COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS

2004-2008(FirstHalf)

	2004	2005	2006	2007	1st Qtr. 2008	2nd Qtr. 2008	Half-Year 2008
<b>PRIOR YEAR-END SURPLUS</b>	347.1	391.2	427.1	487.7	517.3	514.8	517.3
<b>INCOME/LOSS FROM OPERATIONS</b>							
Operating Income (Loss) <a href="#">See Note #1</a>	43.9	45.1	84.6	72.6	12.6	7.8	20.4
<b>Realized Capital Gains (Losses)</b>	9.1	9.7	3.3	8.9	(0.5)	(0.6)	(1.1)
Federal Income Tax Paid (Credit)	14.7	10.7	24.2	19.7	3.6	(9.0)	(5.4)
<b>NET INCOME AFTER TAXES</b>	<b>38.3</b>	<b>44.1</b>	<b>63.7</b>	<b>61.8</b>	<b>8.5</b>	<b>5.4</b>	<b>13.9</b>
<b>BALANCE SHEET ADJUSTMENTS</b>							
Dividends to Stockholders	(14.1)	(15.2)	(24.5)	(32.0)	(6.4)	(5.5)	(11.9)
New Funds	8.8	15.1	3.6	3.2	3.9	0.0	3.9
<b>Unrealized Capital Gains (Losses)</b>	10.6	(3.4)	20.1	(0.5)	(9.9)	(8.6)	(18.5)
Miscellaneous Surplus Changes	0.5	(4.7)	(2.3)	(0.9)	1.4	(1.7)	(0.3)
<b>NET BALANCE SHEET ADJUSTMENTS</b>	<b>5.8</b>	<b>(8.2)</b>	<b>(3.1)</b>	<b>(30.2)</b>	<b>(11.0)</b>	<b>(15.8)</b>	<b>(26.8)</b>
<b>NET CHANGE TO SURPLUS</b>	<b>44.1</b>	<b>35.9</b>	<b>60.6</b>	<b>31.6</b>	<b>(2.5)</b>	<b>(10.4)</b>	<b>(12.9)</b>
<b>YEAR END SURPLUS/FIRST QTR.</b>	<b>391.2</b>	<b>427.1</b>	<b>487.7</b>	<b>517.3</b>	<b>514.8</b>	<b>504.4</b>	<b>504.4</b>
<b>Investment (Income/Trading) Gains or Loss</b>	19.7	6.3	23.4	8.4	(10.4)	(13.5)	(23.9)

Note#1 Operating Income includes Underwriting and Investment Income

Source:2004-2008 Insurance Services Office Reports

So putting excess capital to work can extend the competitive downward cycle even further. But surplus in the P&C industry is in a modest decline after peaking in mid 2007 at \$521 Billion surplus has lost \$17 Billion all of it from balance sheet adjustments. Investment operations have produced nearly \$24 Billion of lost value from realized or unrealized capital losses in the first 6 months of 2008. Considering the third quarter conditions, lots more red ink will be appearing as individual companies release their numbers in the coming weeks. That is when it is likely to get ugly!



**Charles L Ruoff CPCU**

CR Market Strategies  
crmarketstrategies.com

#### About the Author

CR Market Strategies Inc. ("CRMS") was formed in January 2003 by Charles L. Ruoff, CPCU. Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.