

# Insurance Executive Review

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

## US PROPERTY CASUALTY INDUSTRY NINE MONTH RESULTS ARE NOW OFFICIAL ... THE "PERFECT STORM" WAS BAD BUT NOT TOO BAD!

The insurance Services Office on December 16th released the third quarter consolidated financial results for the private insurance market from statutory statements filed with regulators. Keeping in mind that these statements covered the period ending September 30, 2008 when the financial markets tanked, the investment results are not pleasant but still "old news". In addition, the underwriting results which turned negative at the half year mark (see our newsletter Volume1, Issue 10) driven by Mortgage and Financial Guaranty insurers, have been escalating from a third quarter catastrophe season of unusual storm frequency. Couple these conditions with a competitive commercial market environment in tandem with an economic recession and historic low interest rates and you have the ingredients for the "Perfect Storm" scenario. Having lived through this period we knew the numbers would not be pretty!

### UNDERWRITING RESULTS

The underwriting diversity of domestic commercial, personal and reinsurance risks represented by this data is enormous, so looking at the consolidated data (shown below) does not tell the whole story as conditions in these different market segments has many variables. The insurance industry traditionally has been accustomed to recording an underwriting loss while investment income produced the real profits of the business. Since Hurricane Katrina in 2005, the market has produced underwriting profits but quarterly accident-year data shows that it has been steadily eroding as commercial lines pricing has been very competitive and driving down margins. Although competition has reportedly eased from double-digit to single-digit levels as of November, the un-

EXHIBIT A NINE MONTHS	PROPERTY CASUALTY INDUSTRY RESULTS 2005 to 2008 NET INCOME (Millions of Dollars)			
	2008	2007	2006	2005
<b>PREMIUM REVENUE</b>				
Net Written Premium(NWP)	\$335,965	\$337,394	\$337,556	\$321,322
Net Earned Premium(NEP)	\$330,401	\$329,157	\$325,146	\$310,528
<b>UNDERWRITING OPERATIONS</b>				
Underwriting Expense	\$89,459	\$89,297	\$87,481	\$81,487
Incurred Claims and Loss Adj. Exp.	\$258,803	\$219,157	\$212,266	\$230,027
Policyholder Dividends	\$1,008	\$1,174	\$1,092	\$749
Total Underwriting Expense	\$349,270	\$309,628	\$300,839	\$312,263
Net Underwriting Gain (Loss)	-\$18,869	\$19,529	\$24,307	-\$1,735
<b>INVESTMENT OPERATIONS</b>				
Net Investment Income	\$38,040	\$39,620	\$37,493	\$36,598
Other Income	-\$318	-\$2,196	\$214	\$6
Pre-Tax Operating Income	\$18,853	\$56,953	\$62,014	\$34,869
Net Realized Capital Gains	-\$9,713	\$8,157	\$1,474	\$4,299
Pre-Tax Income	\$9,140	\$65,110	\$63,488	\$39,168
Federal Tax	-\$5,074	-\$15,510	-\$17,359	-\$9,423
Net After Tax Income	\$4,066	\$49,600	\$46,129	\$29,745
Consolidated Industry Surplus	\$478,494	\$521,791	\$466,739	\$471,198
Loss and LAE Reserves	\$563,968	\$527,615	\$511,218	\$497,924
Combined Ratio	105.6%	93.8%	91.5%	99.9%
Net Industry Catastrophe Losses*	\$21.6	\$4.8	\$7.8	\$26.5

Source: Insurance Services Office (ISO)

\*after reinsurance recoveries from foreign reinsurers

derwriting results were still expected to suffer. Two new negative ingredients have been added to the mix: (1) escalating mortgage guaranty losses and (2) an exceedingly active natural catastrophe season that have masked the industry results. We will offer comment on these later.

## INVESTMENT OPERATIONS

The investment results in Exhibit A are not surprising as they were expected from the unusual financial market activity through September 30. The investment income stream (i.e. dividends and interest) have been weak as yields on invested assets continue to slide. The outlook into 2009 is a continuation of that trend as interest rate declines and economic profitability puts pressure on dividend receipts. The financial market collapse produced realized investment trading losses of \$9.7 Billion against a Capital Gain of \$8.2 Billion for the same period in 2007 or a swing of nearly \$18 Billion. This is on top of a substantial reduction in market value of investments still held in the industry's portfolio (see Surplus commentary). The financial markets have slid further in the fourth quarter so 2008 will be a poor year all around for investment returns!

## NET INCOME

The industry net income (after tax) was still positive at \$4 Billion but down very substantially from the \$49.6 Billion at nine months of 2007. The federal tax bite was much lower as both underwriting performance and investment trading losses substantially reduced taxable income.

## SURPLUS

The industry Surplus (i.e. Net Worth) has experienced a major decline this year as a result of the current financial market performance. We had raised the issue of an "overcapitalized" insurance market in our newsletters during 2007 so Exhibit B below looks at Surplus development.

### EXHIBIT B

#### COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS 2004-2008

Billions of Dollars

	2004	2005	2006	2007	2008 9 Months
<b>PRIOR YEAR-END SURPLUS</b>	\$347.1	\$391.2	\$427.1	\$487.7	\$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	\$18.8
<b>Realized Capital Gains (Losses)</b>	\$9.1	\$9.7	\$3.3	\$8.9	(\$9.7)
Federal Income Tax Paid (Credit)	\$14.7	\$10.7	\$24.2	\$19.7	(\$5.1)
<b>NET INCOME AFTER TAXES</b>	\$38.3	\$44.1	\$63.7	\$61.8	\$4.0
<b>BALANCE SHEET ADJUSTMENTS</b>					
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$17.8)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$7.0
<b>Unrealized Capital Gains (Losses)</b>	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$31.1)
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	(\$1.5)
<b>NET BALANCE SHEET ADJUSTMENTS</b>	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$43.4)
<b>NET CHANGE TO SURPLUS</b>	\$44.1	\$35.9	\$60.6	\$31.6	(\$39.4)
<b>ENDING SURPLUS</b>	\$391.2	\$427.1	\$487.7	\$517.3	\$477.9
<i>Industry Written Premium(annualized)</i>	\$424.1	\$425.5	\$443.5	\$440.8	\$436.2
<i>Premium to Surplus Ratio</i>	1.1	1.0	0.9	0.9	0.9
<b>Investment Trading- Capital Gains or Loss</b>	\$19.7	\$6.3	\$23.4	\$8.4	(\$40.8)

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

Source:2004-2008(Nine Months) Insurance Services Office Reports

We had observed that a fair number of stock insurers were engaging in stock buyback programs in order to shed this excess capital. Those programs were discontinued in mid 2008 as economic stress gripped the US and world markets. The depletion of industry surplus through September 30 of \$39.4 Billion is the largest reduction on record. As big as it is, the industry surplus at September 30 of \$477.9 Billion is still \$50 Billion more than we had at year-end 2005 but industry premiums are but \$12 Billion higher. There does not seem to be evidence that the premium-to-surplus ratio will cause a “supply side” escalation pressure on prices in 2009 although individual carriers may have these capacity or rating agency issues depending upon how aggressive their investment portfolio strategy may have been.

### UNDERWRITING OPERATIONS REVISITED

In Exhibit A we repeated the publication format for the “industry” results but as we noted there were two issues of including mortgage/financial guaranty results and extraordinary catastrophe losses in these numbers. While we wouldn’t suggest ignoring these two events, the fact that mortgage guaranty insurance represents such a small segment of the market and cats were excessive, we thought looking at the results absent these situations might be appropriate. In other words, did they skew the results in a significant way? Look at Exhibit C:

EXHIBIT C		PROPERTY CASUALTY INDUSTRY RESULTS				
		2007 vs. 2008 NET INCOME				
NINE MONTHS		(Millions of Dollars)				
	2008	Mortgage Guaranty	Excess Catastrophe*	Adjusted 2008	2007	
<b>PREMIUM REVENUE</b>						
Net Written Premium (NWP)	\$335,965	\$ 6,400		\$329,565	\$337,394	
Net Earned Premium (NEP)	\$330,401	\$ 6,320		\$324,081	\$329,157	
<b>UNDERWRITING OPERATIONS</b>						
Underwriting Expense	\$89,459	\$ 1,224		\$88,235	\$89,297	
Incurred Claims and Loss Adj. Exp.	\$258,803	\$ 17,900	\$ 9,300	\$231,603	\$219,157	
Policyholder Dividends	\$1,008	\$ -		\$1,008	\$1,174	
Total Underwriting Expense	\$349,270	\$ 19,124	\$ 9,300	\$320,846	\$309,628	
Net Underwriting Gain (Loss)	-\$18,869			\$3,235	\$19,529	
<b>INVESTMENT OPERATIONS</b>						
Net Investment Income	\$38,040	\$ 303		\$37,737	\$39,620	
Other Income	-\$318			-\$318	-\$2,196	
Pre-Tax Operating Income	\$18,853			\$40,654	\$56,953	
Net Realized Capital Gains	-\$9,713			-\$9,713	\$8,157	
Pre-Tax Income	\$9,140			\$30,941	\$65,110	
Federal Tax	-\$5,074	\$ (3,500)	\$ (1,100)	-\$9,674	-\$15,510	
Net After Tax Income	\$4,066			\$21,267	\$49,600	

Source: Insurance Services Office (ISO)

\*excess above historical average and after reinsurance recoveries

We isolated most of the related financial aspects of the mortgage guaranty market including the estimated federal tax credit, which most would agree is a “one-off” event. In the case of natural catastrophe events we had an extraordinary number this year such that we only removed the amount in excess of the \$12.3 Billion historical nine month average over the past 20 years.

So what is suggested here is that the basic property casualty market is more profitable than the published “industry” data would indicate, although favorable conditions are being eroded. Insurers face

challenges in 2009 in product profitability as well as investment yields.....some are well positioned but others are not.

Look for our next newsletter on financial “catastrophe” issues.



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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.

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