

Insurance Executive Review

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

Insurance Industry 2008 Results

On April 9 the Insurance Services Office released the year-end financial result and there was not much to celebrate except that insurers performed better than the banks and other financial institutions in 2008. A competitive commercial lines market lowered market premiums by \$6 Billion nationally, catastrophe losses were \$15 Billion higher than 2007, low interest rates and dividend cuts reduced Investment Income by \$4 Billion and declining asset values cut into capital (Surplus) to the tune of \$73 Billion....other than that, it was a good year compared to banking!

Underwriting Performance

The year suffered from competitive pricing that drove down premiums written while Earned Premiums were flat with 2007. Incurred Claims saw a substantial rise of \$42 Billion most of that from \$22 Billion of catastrophe claims in 2008 primarily Hurricane Ike (\$10.7 Billion).

PROPERTY CASUALTY INDUSTRY RESULTS NET INCOME 2004-2008 (Millions of Dollars)

Year End Results

	2008	2007	2006	2005	2004
PREMIUM REVENUE					
Net Written Premium(NWP)	\$434,608	\$440,583	\$443,460	\$425,500	\$424,089
Net Earned Premium(NEP)	\$438,123	\$438,908	\$435,484	\$417,635	\$413,777
UNDERWRITING OPERATIONS					
Underwriting Expense	\$118,166	\$120,149	\$117,120	\$110,083	\$106,845
Incurred Claims and Loss Adj. Exp.	\$339,210	\$297,012	\$283,846	\$311,624	\$300,948
Policyholder Dividends	\$1,956	\$2,443	\$3,403	\$1,856	\$1,721
Total Underwriting Expense	\$459,332	\$419,604	\$404,369	\$423,563	\$409,514
Net Underwriting Gain (Loss) #1	(\$21,209)	\$19,304	\$31,115	(\$5,612)	\$4,263
INVESTMENT OPERATIONS					
Net Investment Income	\$51,178	\$55,052	\$52,309	\$49,729	\$39,966
Other Income	(\$73)	-\$993	\$1,183	\$1,028	(\$267)
Pre-Tax Operating Income	\$29,896	\$73,363	\$84,607	\$45,145	\$43,962
Net Realized Capital Gains	(\$19,799)	\$8,921	\$3,524	\$9,701	\$9,125
Pre-Tax Income	\$10,097	\$82,284	\$88,131	\$54,846	\$53,087
Federal Tax	(\$7,718)	(\$19,788)	(\$22,354)	(\$10,691)	(\$14,586)
Net After Tax Income	\$2,379	\$62,496	\$65,777	\$44,155	\$38,501
Consolidated Industry Surplus	\$455,571	\$517,876	\$486,231	\$427,138	\$391,294
Loss and LAE Reserves	\$555,601	\$532,319	\$513,482	\$504,404	\$464,026
Combined Ratio	105.1%	95.5%	92.4%	100.9%	98.3%
Catastrophe Losses	\$21,800	\$6,900	\$9,200	\$61,900	\$27,500

Notes: #1 includes Mortgage Guaranty and Financial Guaranty Insurers with \$20 Billion Underwriting Loss in 2008 and \$10 Billion in 2007

Source: ISO Actual to 2008

As noted in previous Newsletters the underwriting result is somewhat skewed due to the disastrous performance of the Mortgage & Financial Guaranty insurers that account for 2% of industry premiums but nearly \$20 Billion of underwriting losses. Here is how the Combined Ratio might be viewed:

	2008	2007
Industry Combined Ratio	105.1%	95.5%
Deduct:		
Mortgage/Financial Guaranty Segment	-4.1%	-1.9%
(Above) or Below Average Catastrophe Losses*	-1.7%	0.9%
Adjusted Combined Ratio	99.3%	94.5%

Note: Long term average Cat Losses expected at \$10 Billion

So there is still deterioration in the underwriting performance driven by non-catastrophe loss increases coupled with product price erosion. Not as bad as first glance but still not good except for the policy-holders.

Investment Performance

It was in the investment portfolio where the industry took a major hit in 2008. The Investment Income stream from interest and dividends saw a decline of \$4 Billion as interest rates declined along with the yield in Treasury securities and dividend cuts. This was combined with Realized Capital Losses of \$19.8 Billion in 2008 a 12 month swing of \$28.7 Billion an unprecedented record. If this wasn't bad enough the decline in asset values still held by insurers (Unrealized Capital Losses) hit the Balance Sheet pretty hard. This was not a year for "cash flow underwriting" in 2008 as investment returns would not warrant taking on inadequate risk priced business so premiums could be invested....in fact, 2009 doesn't appear to be a good time for that strategy either.

Surplus (Net Worth) Position

The industry has suffered a significant set-back in its capital structure as insurance is a capital intensive business and not leveraged through borrowing. The combination of \$19.8 Billion of Realized Capital Losses in 2008 along with \$52.9 Billion of Unrealized Capital Losses produced the worst drain on Surplus ever recorded.

Our view in 2006 and 2007 was that there was too much capital committed to the P&C business that was helping to drive down prices in this supply and demand market. Insurance companies, who had been keenly aware of profitability issues in deploying this capital in a chase for market share, were pursuing stock buyback programs until 2008. Some had overcommitted repurchasing shares at those higher market prices of 2006-2007 only to seek capital during 2008 having to sell shares at much lower prices. Capital raised (from holding companies or investors) of \$11.2 billion was second only to the capital raised in 2005 following Hurricane Katrina. The 2008 year-end statutory capital position of \$434.6 billion was still nearly \$30 billion more than 2005 and although Premium-to-Surplus ratio rose to 1.14 in 2008 it was still lower than the post multiple hurricane years of 2004-2005. So while industry capital adequacy is not a problem, some individual carriers are under more capital constraints than others.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS
2004-2008

Billions of Dollars

	2004	2005	2006	2007	2008
PRIOR YEAR-END SURPLUS	\$347.1	\$391.2	\$427.1	\$487.7	\$517.3
INCOME/LOSS FROM OPERATIONS					
Operating Income (Loss) See Note #1	\$43.9	\$45.1	\$84.6	\$73.3	\$29.9
Realized Capital Gains (Losses)	\$9.1	\$9.7	\$3.3	\$8.9	(\$19.8)
Federal Income Tax Paid (Credit)	\$14.7	\$10.7	\$24.2	\$19.7	(\$7.7)
NET INCOME AFTER TAXES	\$38.3	\$44.1	\$63.7	\$62.5	\$2.4
BALANCE SHEET ADJUSTMENTS					
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$23.3)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$11.2
Unrealized Capital Gains (Losses)	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$52.9)
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	\$0.3
NET BALANCE SHEET ADJUSTMENTS	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$64.7)
NET CHANGE TO SURPLUS	\$44.1	\$35.9	\$60.6	\$32.3	(\$62.3)
ENDING SURPLUS	\$391.2	\$427.1	\$487.7	\$517.3	\$455.0
<i>Industry Written Premium</i>	<i>\$424.1</i>	<i>\$425.5</i>	<i>\$443.5</i>	<i>\$440.5</i>	<i>\$434.6</i>
<i>Premium to Average Surplus Ratio</i>	<i>1.33</i>	<i>1.23</i>	<i>1.12</i>	<i>1.06</i>	<i>1.14</i>
Investments & Trading- Capital Gains or Loss	\$19.7	\$6.3	\$23.4	\$8.4	(\$72.7)

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

Source:2004-2008 Insurance Services Office Reports

Conclusion and Outlook

The above results were not unexpected given third quarter results and the monitoring of the economic, investment, monetary and financial markets through the close of 2008. Much of the economic pain of last year continued into 2009, so the first quarter of this year will not show any improvement except for slowing of mortgage and financial guaranty losses and low catastrophe losses usual to the period. We expect the full year 2009 to have the following characteristics:

- Economic conditions will overhang the P&C market making it difficult to achieve broad increases in rates due to lower exposures. Release of prior year claim reserves helped the 2007-2008 underwriting result but carriers may be running “near empty” to continue this benefit any longer;
- Market capacity remains strong relative to commercial insurance demand so rates should be competitive for most lines of business. Exceptions will be coastal properties, financial institution liability risks and professional liability;
- Investment income appreciation and capital gains are expected to be disappointing relative to historical levels but modestly positive compared to 2007-2008 period;
- Security ratings of companies will decline in the face of lower earnings outlook in underwriting and investment operations;
- Catastrophe insured losses are an accepted part of the property insurance market but must stay near the historic long-term average of \$10 billion if the industry is to breakeven in underwriting for 2009;
- P&C carriers with life insurance affiliates may come under pressure for reallocation of capital to

these entities that have suffered heavily from equity market declines and have come under regulator scrutiny over capital adequacy guidelines.

Although policyholders (except as noted above) should not see any material price escalations in 2009, they will need to monitor the carriers they use on their insurance coverage very carefully as this is clearly a period where market security should be at the top of the selection criteria list. Successful carriers should be promoting themselves to the market (i.e. not just to brokers and agents) in demonstrated ways that buyers can understand their superior attributes such as....**financial strength....continuity of commitment.....breath of knowledge....responsive performance.** This doesn't mean buyers will simply pay more for the insurance but they can make value judgments on who is better prepared to supply it.



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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.
