

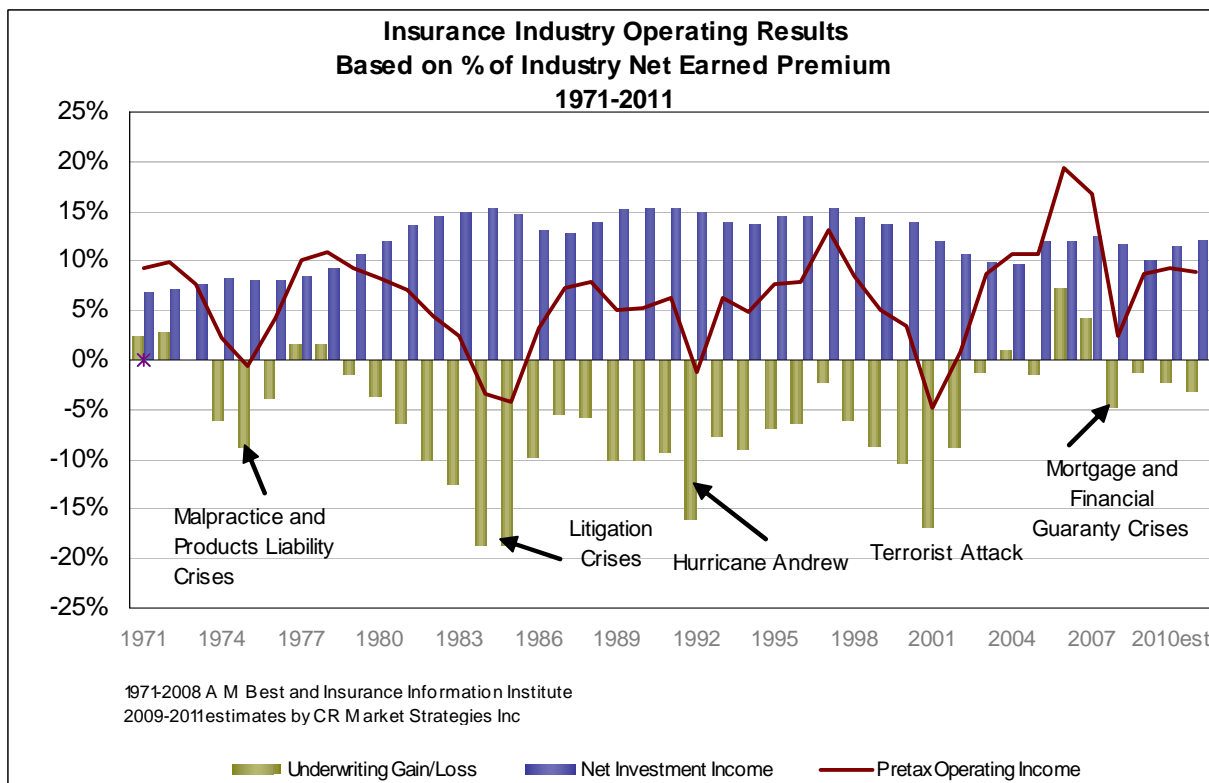
Insurance Executive Review

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

MEASURING PROPERTY CASUALTY INDUSTRY UNDERWRITING PROFITS

Looking for the upturn in market rates....when and how much?

The question being raised here seems to be a simple one. As underwriting profits erode it might be expected that market rates would rise in following periods to restore underwriting profits. If underwriting profit is deteriorating, when could we expect rates to increase? But not so fast! There was a time when insurers could survive with underwriting losses without increasing insurance market rates. Just look at the cycle of underwriting losses below.



These were periods where investment returns (i.e. investing claim and premium reserves) were more than sufficient to overcome underwriting deficits even for decades. That model is no longer applicable in the current market with huge investment asset losses being sustained and low interest rates bringing poor investment yields. So rates might need to rise but in the face of this deep recession that is nearly an impossible task and is not likely to happen.

But we are getting ahead of ourselves.....how do we measure underwriting profit? Is it sufficiently depressed to cause an increase in rates? Would increases in rates hold in the face of competition or will it be just wishful thinking?

U S Property Casualty Market- The Buyers

It is important to acknowledge some basic attributes of this market in terms of those who buy insurance products and those who provide insurance protection. On the buy side we have two main groups, individuals (i.e. Homeowners, private passenger autos, watercraft, etc.) and commercial entities consisting of commercial business firms, professional partnerships, associations, public entities and institutions. For the purpose of this paper we are going to limit discussions to the commercial entity sector.

Insurance is extremely important to commercial buyers as it's basic function of transferring risk for a premium allows these organizations to take the every day risks of running their operation knowing that should the unexpected event occur the financial consequences to them are often protected. However, commercial buyers in the past found some periods of insurance market pricing corrections to be accompanied with some very severe dislocations. These included periods when the insurance they needed was unavailable or available at very steep cost increases. This gave rise to buyers seeking "alternative risk financing" that included self-funding, captive insurance, risk retention facilities either alone or with similarly affected organizations. These facilities expand and contract their risk participation depending upon the commercial insurance conditions on availability and affordability. It has become the buyers "relief valve" to upward insurance market product pricing getting out of control.

U S Property Casualty Market- The Providers

The market participants are very diverse but basically fall into three (3) main camps;

1. Personal Lines Insurers- write insurance to cover needs of individuals and households;
2. Commercial Standard Lines Insurers- write insurance to cover basic property casualty needs of commercial organizations under industry standard forms;
3. Commercial Specialty Lines Insurers- write specialized classes of risks requiring special underwriting and claims support operations often on unique forms and rating.

The capacity to undertake the risk financing needs of US commercial organizations comes from licensed (at least one state) primary insurers in the US supported by reinsurers who take part of the primary carriers risk for a negotiated percentage of the premium. These reinsurers are primarily foreign based including Lloyds of London and companies in United Kingdom, Continental Europe and Bermuda.

There are about 900 insurance groups doing business in the US comprising more than 2000 individual insurance (standard and specialty companies) and reinsurance companies....some operate in a single state while others are national in scope. Some have sister companies within the holding company that operate internationally. This market is considered to be a competitive environment based on economic standards. The fragmentation is such that individual insurer attempts at upward price movements can be frustrated by other carriers taking market share. Pricing views can be somewhat different based on carriers risk selection, lower operating cost, coverage variations or other factors.

There are many strategic factors that can distinguish carriers that appear to operate in the same space yet produce variations in underwriting results. These may include the following:

- Industry Segmentation- insurers will try to concentrate activity and expertise (product/risk selection) toward specific industry classifications (i.e. SIC codes) such as manufacturing, retail, transportation, habitation, public entity, and many others;
- Market Segmentation- this will generally be defined as small, middle market and jumbo risks with each having different characteristics depending upon risk capacity needs, delivery platform, product sophistication and similar factors;
- Geographical Dispersion- insurers may look for diversification on a national or regional basis or simply confine marketing to a few selected states;
- Product Selection- insurers may wish to offer a broad range of property casualty products where a package strategy approach may provide some competitive advantage. Alternatively a preference for concentration of product such as property insurance may require management of natural catastrophe exposure whereas casualty risks may pose exposure to third party litigation management.

These are but a few of the factors underwriters need to consider in selecting their operating strategy platform along with general considerations of looking at market competitors, distribution channels, pricing knowledge and service delivery including claims management.

It is safe to say that very few insurers (if any) have the identical market footprint in terms of mix of business given the combination of strategies that could be employed.

Underwriting Profitability

Historically the standard approach to measuring underwriting profitability has been looking at the “Combined Ratio” which is a calculation that indicates, for an individual carrier or the market as a whole, the ratio of all expenses incurred to premium. A ratio less than 100 indicates profitability while over 100 indicates a loss on underwriting. Insurers financial statements are prepared using Statutory Accounting Procedures (SAP) as required by state insurance regulators and may also produce statements using Generally Accepted Accounting Procedures (GAAP) such that some modest variation in calculating the combined ratio exists between SAP and GAAP approach.

It might be assumed that this “combined ratio” measurement would be a good indicator of potential movements in market prices if the current industry ratio is moving toward 100 or above. However, this ratio based on an aggregation of industry-wide financial statement data may be misleading as a general indicator of rate adequacy or inadequacy in the pricing of current insurance purchases. Consider the following:

- Catastrophe Ratio- included in losses and claim expense is the cost of catastrophe losses that directly affects property markets with these exposures. Such losses may certainly move rates and capacity in property but not necessarily other segments. We could eliminate catastrophe losses but a better view might be to set aside only the “above long term average” portion in measuring profitability but this is virtually impossible for individual insurer data;
 - Specialty Market Ratio- included in the industry’s aggregation of data are specialty markets that may be finite in relative size but may overly influence the aggregate industry ratio. Such was the
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case in late 2007 and all of 2008 when Mortgage and Financial Guaranty Insurance carriers had disastrous results that skewed the overall market indicators;

- **Claim Development Ratio-** this is the ratio that measures the impact of past claims' reserve estimates relative to current actual settlement cost or amendments in the reserve amounts carried. To the extent prior reserves were too low the past deficiency correction would increase current loss amounts and if the prior reserve was too high it would be deducted from current losses. This has the effect of obscuring the loss ratio on currently written business. If we eliminate the effect of claim development we can better judge current rate adequacy which changes our "Calendar Year" ratio to "Accident Year" ratio.

With the above thoughts in mind we tried to get a view of current profitability of commercial risk underwriters by taking their first quarter earnings release through a Combined Ratio Analysis in the section that follows.

First Quarter 2009 Combined Ratio Analyses

Since the aggregate industry data does not necessarily tell us how individual companies are doing, we wanted to see more creditability on how much variability exists among individual insurer underwriting profit (via combined ratio) data. We collected commercial lines data from eight property casualty markets based on release of financial statements, in press releases and in some case the 10K securities filing documents. None of these carriers were involved in the mortgage or financial guaranty business so we only had to deal with the issues of catastrophe losses and claim development issues. In regard to catastrophe losses we had insufficient data on individual companies to separate "above average" claims so we looked at the data with and without total catastrophe losses.

Insurance Company Combined Ratios-Commercial Lines Business

Notes	Components of Combined Ratio	Company A	Company B	Company C	Company D	Company E	Company F	Company G	Company H
	Pure Loss Ratio	56.6	52.3	55.3	55.0	50.8	54.4	55.5	57.1
	Loss Adj. Exp Ratio	9.6	10.2	8.7	8.1	7.8	8.6	8.9	9.4
#1	Calendar Year Loss and Exp	66.2	62.5	64.0	63.1	58.6	63.0	64.4	66.5
#2	Prior year development (+/-)	3.8	4.1	3.2	2.6	2.3	5.2	2.2	3.3
#3	Accident Year Loss and Exp	70.0	66.6	67.2	65.7	60.9	68.2	66.6	69.8
#4	Catastrophe loss ratio (-)	-3.3	-4.2	-3.2	-1.4	-1.1	-2.3	-1.1	-1.5
	Accident Yr Loss and Exp. X Cats	66.7	62.4	64.0	64.3	59.8	65.9	65.5	68.3
#5	Acquisition Expense Ratio (+)	12.5	11.7	12.8	11.1	11.5	11.3	12.3	11.3
#6	Underwriting Expense Ratio (+)	20.5	21.2	20.5	20.5	22.1	20.3	21.1	20.6
	Accident Year Combined Ratio X Cats	99.7	95.3	97.3	95.9	93.4	97.5	98.9	100.2
	Calendar Year Combined Ratio X Cats	95.9	91.2	94.1	93.3	91.1	92.3	96.7	96.9
	Accident Year Combined Ratio	103.0	99.5	100.5	97.3	94.5	99.8	100.0	101.7
	Calendar Year Combined Ratio	99.2	95.4	97.3	94.7	92.2	94.6	97.8	98.4

#1 Ratio of all Losses and Loss Adjustment Expenses to Earned Premium in current Calendar period

#2 Ratio of current favorable changes in costs of claims from estimates in prior years relative to current Earned Premium

#3 Ratio of Losses and Loss Adjustment Expenses only on policies in force during the period to Earned Premium

#4 Ratio of catastrophe losses incurred during the period to Earned Premium

#5 Ratio of intermediary commissions/marketing expenses (net of reinsurance ceding commissions) to Written Premium

#6 Ratio of underwriting/administration expenses to Written Premium

Although the above reflects a relatively small part of the commercial market industry data (i.e. about 15%-18%) it is representative of what we expect to be the underlying accident year profitability of the entire commercial lines segment. While the bottom-line Calendar Year Combined Ratio was not over

100 for any of the companies in our sample, the effect of favorable prior year claim development if removed (i.e. added back) pushed only 4 of the 8 companies to over 100 as an Accident Year Combined Ratio. The erosion of profitability in the currently written business is clearly showing but has not yet reached the level of causing a broad upward movement in commercial rates. The soft market cycle may pause and is likely to remain stagnant for the remainder of the year especially in the face of the current economic activity forecast. This does not preclude selected segment increases that should remain modest.

We do remain concerned with the insurance companies relying on prior year claim development to assist with favorable earnings reports for the remainder of this year. The leading cause for insurer insolvency has historically been a case of inadequate claim reserves that has too often been preceded by too aggressive write-down of reserve values into income. We think there are more safeguards today with actuaries, auditors and regulatory oversight for this to be a broad industry problem but individual companies might still be tempted to deplete reserves to borderline levels. So commercial rates should remain at current levels and coupled with lower economic exposures should keep industry written premiums (i.e. commercial) at between 5-6% lower than 2008.



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