

Insurance Executive Review

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

PROPERTY CASUALTY INDUSTRY FIRST QUARTER 2009 FINANCIAL RESULTS NO REAL SURPRISES BUT CONCERNS LOOM AHEAD

On June 29 the Insurance Services Office released first quarter consolidated earnings for the private property and casualty market that confirmed much of what we suspected from earlier reports by individual insurers. The industry is suffering from problems that are contributing to underwriting deterioration, hemorrhaging from declining investments and substantial declines in the underlying capital that supports its risk-taking operations. While these all follow very similar conditions as existed in 2008, we have concerns that it could get worse before it can get better.

Reported Industry Underwriting Operations

The first quarter of 2009 compared to prior years (see below) shows the impact of some major issues confronting the industry that if not reversed, could adversely affect the solvency of some markets.

FIRST QUARTER	PROPERTY CASUALTY INDUSTRY RESULTS 2006 - 2009 NET INCOME (Millions of Dollars)			
	2009	2008	2007	2006
PREMIUM REVENUE				
Net Written Premium (NWP)	\$106,383	\$110,386	\$111,315	\$110,482
Net Earned Premium (NEP)	\$105,577	\$107,925	\$108,517	\$106,580
UNDERWRITING OPERATIONS				
Underwriting Expense	\$29,071	\$30,258	\$29,284	\$28,243
Incurred Claims and Loss Adj. Exp.	\$78,722	\$77,833	\$70,308	\$69,264
Policyholder Dividends	\$329	\$387	\$315	\$315
Total Underwriting Expense	\$108,122	\$108,478	\$99,907	\$97,822
Net Underwriting Gain (Loss)	(\$2,545)	(\$553)	\$8,610	\$8,758
INVESTMENT OPERATIONS				
Net Investment Income	\$11,731	\$12,850	\$12,925	\$11,727
Other Income	\$355	\$243	(\$2,140)	(\$343)
Pre-Tax Operating Income	\$9,541	\$12,540	\$19,395	\$20,142
Net Realized Capital Gains	(\$7,987)	(\$412)	\$2,083	\$1,888
Pre-Tax Income	\$1,554	\$12,128	\$21,478	\$22,030
Federal Tax	(\$2,863)	(\$3,635)	(\$5,238)	(\$5,301)
Net After Tax Income	(\$1,309)	\$8,493	\$16,240	\$16,729
Consolidated Industry Surplus	\$437,097	\$514,210	\$495,642	\$439,116
Loss and LAE Reserves	\$554,413	\$536,887	\$515,954	\$502,982
Combined Ratio	102.2%	99.9%	91.7%	91.1%
Net Industry Catastrophe Losses	\$3,100	\$3,600	\$1,300	\$1,500

Source: Insurance Services Office (ISO)

The most obvious concerns are the following:

- Net Written Premium (NWP) decline of 3.6% or \$4 Billion was the weakest performance on record led by continuing soft commercial lines rates....good for buyers bad for insurers;
- Inclusion of Mortgage and Financial Guaranty sector results skews the overall profit performance but if eliminated still has NWP down by 3.1%;
- Speculation that commercial rate declines are moderating against a recessionary economic environment will not bring increased premiums....we expect NWP to finish 2009 down 2%;
- Incurred Claims expense was virtually flat with prior year partially due to slightly lower catastrophe losses but reports by individual carriers showing prior year reserves are being brought down into income is a cause for concern (see our Newsletter issue #20);
- Underwriting losses for first quarter 2008 and 2009 are materially off 2006 and 2007 levels due almost entirely to "catastrophes"....one being natural events and other being collapse of financial leverage !

Core Industry Underwriting Operations

Although there are substantial concerns about these underwriting results we can't lose sight of the enormous impact of the Guaranty market segment.

PROPERTY CASUALTY INDUSTRY RESULTS 2008 - 2009 NET INCOME

FIRST QUARTER

(Millions of Dollars)

	2009			2008		
	Industry	Outliers*	Core P&C	Industry	Outliers*	Core P&C
PREMIUM REVENUE						
Net Written Premium(NWP)	\$106,383	\$1,500	\$104,883	\$110,386	\$2,100	\$108,286
Net Earned Premium(NEP)	\$105,577			\$107,925		
UNDERWRITING OPERATIONS						
Underwriting Expense	\$29,071	N/A		\$30,258	N/A	
Incurred Claims and Loss Adj. Exp.	\$78,722	\$5,700	\$73,022	\$77,833	\$4,800	\$73,033
Policyholder Dividends	\$329			\$387		
Total Underwriting Expense	\$108,122			\$108,478		
Net Underwriting Gain (Loss)	(\$2,545)	(\$4,200)	\$1,655	(\$553)	(\$2,700)	\$2,147
INVESTMENT OPERATIONS						
Net Investment Income	\$11,731	N/A		\$12,850	N/A	
Other Income	\$355	N/A		\$243	N/A	
Pre-Tax Operating Income	\$9,541	N/A		\$12,540	N/A	
Net Realized Capital Gains	(\$7,987)	N/A		(\$412)	N/A	
Pre-Tax Income	\$1,554	N/A		\$12,128	N/A	
Federal Tax	(\$2,863)	N/A		(\$3,635)	N/A	
Net After Tax Income	(\$1,309)	(\$3,709)	\$2,400	\$8,493	(\$3,507)	\$11,900
Consolidated Industry Surplus	\$437,097			\$514,210		
Loss and LAE Reserves	\$554,413			\$536,887		
Combined Ratio	102.2%	299.6%	98.4%	99.9%	268.2%	96.8%
Net Industry Catastrophe Losses	\$3,100			\$3,600		

Source: Insurance Services Office (ISO)

Note: "Outliers" represent Mortgage and Financial Guaranty Insurer's financial results as estimated by ISO

The chart above attempts to remove certain financial data that ISO attributes to the Mortgage and

Financial Guaranty market that is dominated by a handful of players that until recently had minimal impact on the P&C industry data. In 2008 and 2009 the enormous losses suffered by these outlier markets has demonstrated just how large that impact has been. Eliminating these outlier markets changes the headline news:

- The Underwriting Loss in first quarter 2008 and 2009 becomes an Underwriting Profit of \$2.1 Billion and \$1.7 Billion respectively;
- Net After Tax Loss of \$1.3 Billion in 2009 becomes a profit of \$2.4 Billion and data for 2008 changes a profit of \$8.5 Billion to \$11.9 Billion;
- The Combined Ratio moves from reported at 102.2% in 2009 to 98.4% while 2008 is 99.9% reported to 96.8% core business.

So clearly the Mortgage and Financial Guaranty market has had a material negative impact as further discussed in our Newsletters Issue #14 and #18 available on our website.

Investment Operations

Investment Gains (i.e. interest/dividend income and asset trading) has traditionally provided income supplements to the property casualty market especially during periods of soft market underwriting cycles. In fact, investment returns for decades (1979-2003) turned negative industry underwriting results into positive after tax income (see page 1 of Newsletter issue #20). The steady decline in interest rates coupled with the recent collapse of the financial and credit markets has taken its toll in the Balance Sheet as well as the Income Statement. As a result industry surplus (i.e. net worth) has diminished from \$517.3 Billion at the end of 2007 to \$437.2 Billion as of March 31, 2009.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS

2004-2009

Billions of Dollars	2004	2005	2006	2007	2008	1 QTR. 2009
PRIOR YEAR-END SURPLUS	\$347.1	\$391.2	\$427.1	\$487.7	\$517.3	\$456.0
INCOME/LOSS FROM OPERATIONS						
Operating Income (Loss) <i>See Note #1</i>	\$43.9	\$45.1	\$84.6	\$73.3	\$29.9	\$9.5
Realized Capital Gains (Losses)	\$9.1	\$9.7	\$3.3	\$8.9	(\$19.8)	(\$7.9)
Federal Income Tax Paid (Credit)	\$14.7	\$10.7	\$24.2	\$19.7	(\$7.7)	(\$2.7)
NET INCOME AFTER TAXES	\$38.3	\$44.1	\$63.7	\$62.5	\$2.4	(\$1.1)
BALANCE SHEET ADJUSTMENTS						
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$23.3)	(\$2.1)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$12.2	\$0.9
Unrealized Capital Gains (Losses)	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$52.9)	(\$16.4)
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	\$0.3	(\$0.1)
NET BALANCE SHEET ADJUSTMENTS	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$63.7)	(\$17.7)
NET CHANGE TO SURPLUS	\$44.1	\$35.9	\$60.6	\$32.3	(\$61.3)	(\$18.8)
ENDING SURPLUS	\$391.2	\$427.1	\$487.7	\$517.3	\$456.0	\$437.2
Average Annual Surplus	\$369.2	\$409.2	\$457.4	\$502.5	\$477.1	\$446.6
Industry Written Premium*	\$424.1	\$425.5	\$443.5	\$440.5	\$434.6	\$425.9
Premium to Average Surplus Ratio	1.15	1.04	0.97	0.88	0.91	0.95
Investments & Trading- Capital Gains or Loss	\$19.7	\$6.3	\$23.4	\$8.4	(\$72.7)	(\$24.3)

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

*2009 Premium is annualized assuming first quarter negative growth rate moderates to -2%

Source:2004-2009 Insurance Services Office Reports

So asset valuations represented by Realized and Unrealized Capital Losses has cost the industry \$97 Billion of lost capital through the 15 months since December 31, 2007. When you factor in another \$1.1 Billion reduction in Investment Income in this most recent quarter, the hit to investment operations is substantial. Market valuations improved in the second quarter but dividends have been cut by a wide range of companies to preserve capital so investment income is not likely to improve any time soon. Underwriters looking to alternative investments to bolster yields must be careful not to expose their company to further unnecessary risk.

Conclusion

The industry has some financial difficulties ahead. We don't expect the traditional earnings support from investments as that has turned out to be a catastrophe for insurers and more unpredictable than ever. The economic conditions have contributed by shrinking exposures (i.e. valuations, payrolls, sales, etc.) upon which insurance premiums are based. The uncertainty of natural catastrophe losses looms ahead as the third quarter is typically the worst period of the year. Traditional forecasting sources are now predicting a less intensive hurricane season (see Newsletter #22) that would be welcome relief for earnings. The broader commercial lines market has come off the peak "soft market" pricing points but still has some softness left to go. Underwriters are still taking down prior year claim reserves into current year earnings but the ability to continue that trend is clearly near an end. We would be concerned with individual company solvency issues if that trend continues beyond the third quarter.

At this point the private P&C industry remains strong from a capital perspective relative to the traditional measure of Net Written Premium to Policyholder Surplus Ratio that stands at .97 at 3/31/09 compared to year-end data for 2004-2008 (see previous chart). This is significant as there is less capital globally available should the industry need it. More importantly, the ratio of Claim Reserves to Surplus is more critical as a 10% change in reserves deletes surplus by a like amount raising solvency vulnerability. Chart below based on March 31, 2009 data

We remain concerned with individual insurers on this issue then for the industry as a whole. Inadequate claim reserves have historically been the most often cited reason for individual carrier insolvency. This coupled with uncertain catastrophe conditions, a poor global economy and hostile investment environment suggests a "proceed with caution" strategy.

	2009
NWP/Surplus	0.974
Claim Reserve/Surplus	1.268
With 10% Claim Change	1.598
Change in Ratio	26%



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