

Insurance Executive Review

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

INDUSTRY OUTLOOK DURING THE GREAT RECESSION OF 2008-2012

As promised in our Newsletter #30 we will provide the detail behind our 2009-2012 U.S. private insurance industry financial projections. In order to give some historical perspective we will show actual detail back to 2004. These projections are based upon our model following decades of industry data with an overlay of economic statistics. Our outcomes are based on the conditions we expect to see develop and took the "road less traveled" by suggesting a longer recessionary recovery than the quick "V shaped" return expected by many. That means underwriting losses could extend into 2012 depending on catastrophe losses or other significant events.

Underwriting Performance Outlook

We essentially see a period of industry-wide underwriting losses for the market as both rates and exposure push revenues lower with only a modest recovery by 2012. We need to recognize, as pointed out in our previous communications, the significant negative impact of the Mortgage and Financial Guaranty segments that accounted for the majority of underwriting losses and lower operating profits between 2007 and 2009. This influence will still be apparent but will be of much less significance over the next two years.

PROPERTY CASUALTY INDUSTRY RESULTS NET INCOME 2004-2012 Projected (Millions of Dollars)

Year End Results (Underwriting Only)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|------------|-----------|-----------|-----------|------------|-----------------|-----------------|-----------------|-----------------|
| PREMIUM REVENUE | | | | | | Estimate | Estimate | Estimate | Estimate |
| Net Written Premium(NWP) | \$424,089 | \$425,500 | \$443,460 | \$440,583 | \$434,608 | \$417,200 | \$415,500 | \$420,300 | \$430,500 |
| Net Earned Premium(NEP) | \$413,777 | \$417,635 | \$435,484 | \$438,908 | \$438,123 | \$425,904 | \$416,350 | \$417,900 | \$425,400 |
| UNDERWRITING OPERATIONS | | | | | | | | | |
| Underwriting Expense | \$106,845 | \$110,083 | \$117,120 | \$120,149 | \$118,166 | \$118,404 | \$115,700 | \$118,850 | \$116,650 |
| Incurred Claims and Loss Adj. Exp. | \$300,948 | \$311,624 | \$283,846 | \$297,012 | \$339,210 | \$318,500 | \$314,250 | \$321,500 | \$316,500 |
| Policyholder Dividends | \$1,721 | \$1,856 | \$3,403 | \$2,443 | \$1,956 | \$1,850 | \$1,750 | \$1,650 | \$1,750 |
| Total Underwriting Expense | \$409,514 | \$423,563 | \$404,369 | \$419,604 | \$459,332 | \$438,754 | \$431,700 | \$442,000 | \$434,900 |
| Net Underwriting Gain (Loss) | #1 \$4,263 | (\$5,612) | \$31,115 | \$19,304 | (\$21,209) | (\$12,850) | (\$15,350) | (\$24,100) | (\$9,500) |
| Combined Ratio | 98.3% | 100.9% | 92.4% | 95.5% | 105.1% | 103.0% | 103.7% | 105.8% | 102.2% |
| Catastrophe Losses | \$27,500 | \$61,900 | \$9,200 | \$6,900 | \$21,800 | \$10,000 | \$10,000 | \$15,000 | \$10,000 |
| Notes: #1 | | | | | | | | | |
| Mortgage and Financial Guaranty Insurers Included as follows: | | | | | | | | | |
| Combined Ratio* | 75.8% | 71.5% | 77.9% | 220.5% | 268.1% | 210.3% | 136.4% | 115.0% | 93.0% |
| Core P&C Market as amended: | | | | | | | | | |
| Core Combined Ratio* | 98.8% | 101.5% | 92.9% | 94.5% | 99.3% | 101.4% | 103.5% | 105.0% | 102.9% |

Source: ISO Actual Data to 2008; other data by CR Market Strategies Inc

*based on NWP

- Written Premiums- lower rates via competition for an economically suppressed and shrinking market (commercial and personal) will combine to drop year-over-year premiums from 2009-2011 with only a modest 2.5% increase in 2012;

- Underwriting Expenses- underwriters will curtail expenses to the extent they can but claims remain higher than the 2004-2008 average of \$307 billion with at least one year (2011) above the natural catastrophe 12 year average of \$10 billion;
- Underwriting Losses- will be substantial with the outlier guaranty markets becoming less of a factor by 2011 and thereafter. Regulatory surveillance on individual carrier security should prevent any large number of failures but insurers who become too aggressive (assuming the recession is not already over in 2009) may quickly become impaired;
- Claim Reserves- the continuing release of "prior year" reserves have helped earnings reports but will become exhausted for many carriers during this period.

Investment Income and Operating Profit

There should be sufficient investment income from interest and dividends to keep the operating performance positive but well below recent historical levels.

PROPERTY CASUALTY INDUSTRY RESULTS NET INCOME 2004-2012 Projected (Millions of Dollars)

Year End Results

(Continuation from previous chart)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 Estimate | 2010 Estimate | 2011 Estimate | 2012 Estimate |
|------------------------------|------------|------------|------------|------------|------------|------------------|------------------|------------------|------------------|
| INVESTMENT OPERATIONS | | | | | | | | | |
| Net Investment Income | \$39,966 | \$49,729 | \$52,309 | \$55,052 | \$51,178 | \$47,100 | \$46,500 | \$49,000 | \$51,250 |
| Other Income | (\$267) | \$1,028 | \$1,183 | -\$993 | (\$73) | (\$100) | (\$100) | (\$100) | (\$100) |
| Pre-Tax Operating Income | \$43,962 | \$45,145 | \$84,607 | \$73,363 | \$29,896 | \$34,150 | \$31,050 | \$24,800 | \$41,650 |
| Net Realized Capital Gains | \$9,125 | \$9,701 | \$3,524 | \$8,921 | (\$19,799) | (\$12,250) | \$3,250 | \$4,950 | \$8,250 |
| Pre-Tax Income | \$53,087 | \$54,846 | \$88,131 | \$82,284 | \$10,097 | \$21,900 | \$34,300 | \$29,750 | \$49,900 |
| Federal Tax | (\$14,586) | (\$10,691) | (\$22,354) | (\$19,788) | (\$7,718) | (\$10,250) | (\$10,950) | (\$8,750) | (\$10,100) |
| Net After Tax Income | \$38,501 | \$44,155 | \$65,777 | \$62,496 | \$2,379 | \$11,650 | \$23,350 | \$21,000 | \$39,800 |

We are also forecasting a benign equity and bond market environment without any major upside/downside movement during this period. Major points of interest would include the following:

- Reductions in cash flow given the revenue/expense factors mentioned earlier, will contain returns to levels realized in 2005 as invested assets remain below historic levels;
- Dividend income is expected to remain at low levels as organizations will be reluctant to dispense with cash while the recessionary aspects of the market linger;
- Interest rates will surely rebound from current levels but that is expected to be gradual and will have a material impact to value of fixed income securities;
- Economic improvement will be slow as recovery remains constrained while unemployment and under-employment is sluggish over the near-term;
- Realized capital gains forecast suggests that after facing some encumbered asset values in 2009, losses should not persist in 2010-2012 as insurers will take modest equity gains in order to help overall income objectives but bond prices will fall;
- Federal tax will reflect the expected earnings level for the period with 2011 taking catastrophe losses into account at above average levels.

In all, the investment returns should be below historic levels but sufficient as in the past to turn underwriting

losses into operating profits but at an ROE below the recent past and disappointing to investors.

Market Capacity- Industry Surplus or Capital Support

A traditional view of the market capacity has been to accept risk transfer business (i.e. insurance risk) as a measurement of the ratio that market net worth (Surplus) bears to the market premiums. Unfortunately market premiums at any given point in time may reflect a different relationship to the underlying risks being written. For example, during a competitive “soft” market, reductions in rates when applied to exposure (i.e. rating basis), may produce lower market premiums and when related to surplus, may indicate an industry oversupply of capacity placing further pressure on rates. Therefore, the risk exposure insured will be understated (in term of premium) relative to the surplus supporting the market. Similarly, during rising rates (without exposure change) and escalating premiums, the market may be perceived as being undercapitalized for the business written. On an industry basis, we have not yet found a simpler (or better) capacity utilization method for measuring total market risk-to-surplus. Regulators use a more sophisticated Risk Based Capital (RBC) analysis to measure an individual insurers overall capital adequacy requirements that is difficult to apply industry-wide. Generally a 3:1 ratio of premium to surplus would be a technical (regulatory) maximum applicable to individual insurers but surplus is not fungible and market constraints would occur at a 2:1 ratio.

The industry Surplus account based on the above income projections would be as follows:

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS

2004-2009

| Billions of Dollars | 2004 | 2005 | 2006 | 2007 | 2008 | ESTIMATE 2009 | ESTIMATE 2010 | ESTIMATE 2011 | ESTIMATE 2012 |
|---|----------------|----------------|----------------|-----------------|-----------------|------------------|------------------|------------------|------------------|
| PRIOR YEAR-END SURPLUS | \$347.1 | \$391.2 | \$427.1 | \$487.7 | \$517.3 | \$457.0 | \$446.6 | \$445.6 | \$450.1 |
| INCOME/LOSS FROM OPERATIONS | | | | | | | | | |
| Operating Income (Loss) See Note #1 | \$43.9 | \$45.1 | \$84.6 | \$73.3 | \$29.9 | \$34.1 | \$31.0 | \$24.8 | \$41.6 |
| Realized Capital Gains (Losses) | \$9.1 | \$9.7 | \$3.3 | \$8.9 | (\$19.8) | (\$12.3) | \$3.2 | \$4.9 | \$6.0 |
| Federal Income Tax Paid | (\$14.7) | (\$10.7) | (\$24.2) | (\$19.7) | (\$7.7) | (\$10.2) | (\$10.9) | (\$8.7) | (\$10.1) |
| NET INCOME AFTER TAXES | \$38.3 | \$44.1 | \$63.7 | \$62.5 | \$2.4 | \$11.6 | \$23.3 | \$21.0 | \$37.5 |
| BALANCE SHEET ADJUSTMENTS | | | | | | | | | |
| Dividends to Stockholders | (\$14.1) | (\$15.2) | (\$24.5) | (\$32.0) | (\$23.3) | (\$22.0) | (\$25.0) | (\$21.0) | (\$18.0) |
| New Funds | \$8.8 | \$15.1 | \$3.6 | \$3.2 | \$12.2 | \$4.2 | \$5.0 | \$6.0 | \$10.0 |
| Unrealized Capital Gains (Losses) | \$10.6 | (\$3.4) | \$20.1 | (\$0.5) | (\$51.9) | (\$3.1) | (\$2.1) | (\$2.6) | (\$4.1) |
| Miscellaneous Surplus Changes | \$0.5 | (\$4.7) | (\$2.3) | (\$0.9) | \$0.3 | (\$1.1) | (\$2.2) | \$1.1 | (\$3.3) |
| NET BALANCE SHEET ADJUSTMENTS | \$5.8 | (\$8.2) | (\$3.1) | (\$30.2) | (\$62.7) | (\$22.0) | (\$24.3) | (\$16.5) | (\$15.4) |
| NET CHANGE TO SURPLUS | \$44.1 | \$35.9 | \$60.6 | \$32.3 | (\$60.3) | (\$10.4) | (\$1.0) | \$4.5 | \$22.1 |
| ENDING SURPLUS | \$391.2 | \$427.1 | \$487.7 | \$517.3 | \$457.0 | \$446.6 | \$445.6 | \$450.1 | \$472.2 |
| Average Annual Surplus | \$369.2 | \$409.2 | \$457.4 | \$502.5 | \$477.6 | \$451.8 | \$446.1 | \$447.9 | \$461.2 |
| Industry Written Premium* | \$424.1 | \$425.5 | \$443.5 | \$440.5 | \$434.6 | \$417.2 | \$400.5 | \$384.5 | \$369.1 |
| Premium to Average Surplus Ratio | 1.15 | 1.04 | 0.97 | 0.88 | 0.91 | 0.92 | 0.90 | 0.86 | 0.80 |
| Investments & Trading- Capital Gains or Loss | \$19.7 | \$6.3 | \$23.4 | \$8.4 | (\$71.7) | (\$15.4) | \$1.1 | \$2.3 | \$1.9 |

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

*2009 Premium is annualized assuming first half negative growth rate is maintained at -4%

Source:2004-2009 Insurance Services Office Reports

We need to keep in mind that the industry of 2,000 insurance companies are each focused on different market segments such that every risk can usually find a willing underwriter..... but not always. In 2004-2005 the overall market had sufficient technical surplus but catastrophe exposed property risks found a difficult underwriting market as compared to casualty business.

In addition to the growth to surplus from operations income (underwriting and investments) discussed earlier, the other sources of major surplus change come from balance sheet adjustments. One constant outflow item is shareholder dividends paid upstream to holding companies or directly to shareholders of stock insurers from surplus. New funds can add to surplus through capital raising efforts of existing insurers needing to bolster their financial position or new insurers that may enter the market. Nearly \$23 billion of New Funds were con-

tributed following the disastrous hurricane seasons of 2004 and 2005 with over \$12 billion in 2008 during this recession. The third major component comprises valuation changes in invested assets to reflect market pricing conditions particularly bond values that will decline with rising interest rates. This has been somewhat volatile during this period ranging from adding \$20 billion in 2006 to removing \$52 billion in 2008.

Our forecast is that surplus after declining by \$10 billion this year to \$446 billion, will see gradual increases over the period. With our forecast of depressed premium growth, the market capacity as expressed by premium-to-surplus ratio is not expected to contract but should remain sufficiently stable to keep insurance products competitively priced.



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