

Insurance Executive Review

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

U.S. Property Casualty Market Capacity Driving Competition For Business ... There Is Just Too Much Excess Capacity

The ongoing market pricing of commercial lines has been result of the imbalance between the demand for risk protection in insurance products and the capacity of the insurance market to underwrite those risks. With demand being down during and following the great recession, we have had an oversupply of capacity with the combination forcing down prices in a competition for the available business. We have seen the deterioration of the underwriting performance (see Newsletter #51) so now we turn to looking at market capacity in an effort to judge the extent of the excess capacity and what if anything insurers are doing in the wake of perpetual weak demand.

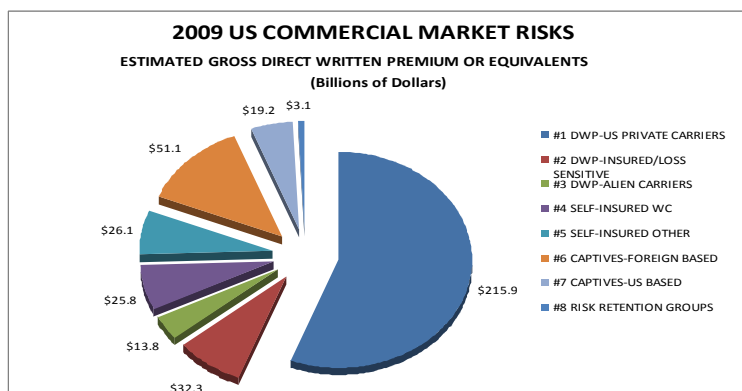
Looking at the Question of capacity for U.S. Commercial Risk Business

The U.S. market for property casualty commercial insurance products has traditionally been the largest global market for consumption of insurance among the developed nations. It has therefore attracted a capacity to supply insurance from a variety of worldwide sources:

Domestic Markets- this primarily includes commercial insurers and reinsurers domiciled within the U.S. as well as “special purpose” private insurers (i.e. captives and RRG’s) and government sponsored organizations (i.e. flood program; terrorism reinsurance; etc.);

Foreign Markets- the sheer size of the U.S. economy draws interest from Global Insurers from around the world. Virtually all of these markets* participate as reinsurers of domestic U.S. carriers who accept portions of the underlying business. There are a number of types of reinsurance plans but they most often take on risks excess of what the ceding carriers is comfortable retaining for their own account either against specific account events or an aggregation of multiple exposed accounts.

* notable exception is Lloyds of London who also write direct U.S. business



With the above overview in mind, it is important to think of “market capacity” in global terms as U.S. risks are ultimately spread into the world market via different facilities within the U.S...

There is a substantial amount of statistical information available on the carrier capacity that is domiciled in the U.S. but less centralized sources of information on the balance of the world marketplace. We will look at the U.S. here then the global market in the next issue.

Measuring Domestic Sources of Insurance Capacity

The commercial property casualty insurance market is followed by a number of rating agencies and industry organizations particularly the Insurance Information Institute. There are also organizations that follow the captive market (both onshore and offshore), self-insurance organizations and Risk Retention Groups that sometimes overlaps with captives. Since the commercial insurer technical reported capacity (i.e. policyholders' surplus or net worth) is shared between the personal lines and commercial lines market segments, it is not possible to segregate the specific amount of capacity devoted to supporting each segment. In many instances we will be looking at total private insurance industry numbers as many carriers write business in both personal and commercial lines space.

Firstly, we can look at the component factors that contribute to the change in policyholders' surplus over time that are essentially due to (1) financial results of operations (net after-tax income or P&L items) and (b) structural changes in the Balance Sheet accounts. Secondly, we will look at comparing Surplus to various other data as a means of trying to measure the extent of an undersupply or oversupply of the industry net worth position.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS

Surplus Account 2004-2010 (9 months)

Billions of Dollars	2004	2005	2006	2007	2008	2009	9 Months 2010*
PRIOR YEAR-END SURPLUS	\$347.1	\$391.2	\$427.1	\$487.7	\$517.3	\$457.3	\$511.4
INCOME/LOSS FROM OPERATIONS							
Operating Income (Loss) See Note #1	\$43.9	\$45.1	\$84.6	\$73.3	\$30.6	\$44.6	\$29.2
Realized Capital Gains (Losses)	\$9.1	\$9.7	\$3.3	\$8.9	(\$19.8)	(\$7.9)	\$4.4
Federal Income Tax Paid	(\$14.7)	(\$10.7)	(\$24.2)	(\$19.7)	(\$7.8)	(\$8.3)	(\$6.9)
NET INCOME AFTER TAXES	\$38.3	\$44.1	\$63.7	\$62.5	\$3.0	\$28.4	\$26.7
BALANCE SHEET ADJUSTMENTS							
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$24.1)	(\$16.7)	(\$19.5)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$12.9	\$6.5	\$23.8
Unrealized Capital Gains (Losses)	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$52.9)	\$23.1	\$3.1
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	\$1.1	\$13.0	(\$0.6)
NET BALANCE SHEET ADJUSTMENTS	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$63.0)	\$25.9	\$6.8
NET CHANGE TO SURPLUS	\$44.1	\$35.9	\$60.6	\$32.3	(\$60.0)	\$54.3	\$33.5
ENDING SURPLUS	\$391.2	\$427.1	\$487.7	\$517.3	\$457.3	\$511.4	\$544.9
Average Annual Surplus	\$369.2	\$409.2	\$457.4	\$502.5	\$477.7	\$484.4	\$528.2
Investments & Trading- Capital Gains or Loss	\$19.7	\$6.3	\$23.4	\$8.4	(\$72.7)	\$15.2	\$7.5

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

Source:2004-2010 Insurance Services Office Reports

The above exhibit shows the contributions to the change in Surplus from the beginning of 2004 to September 2010 or some \$200 Billion (\$ 544.9 minus \$347.1 billion) but along the way we note the components of change varied rather significantly:

Income from Operations swung from a high of \$60+ billion (2006-2007) just before the Great Recession to a low of \$3 billion at our economic low point of 2008;

New Funds brought above average fresh capital from investors following the worst catastrophe years (2004/2005) for natural events and the Great Recession year of 2008 as AIG stumbled. In 2010 we had a single \$23 billion transaction of Warren Buffet placing a railroad acquisition in his insurance company portfolio so it was not a wide inflow of capital;

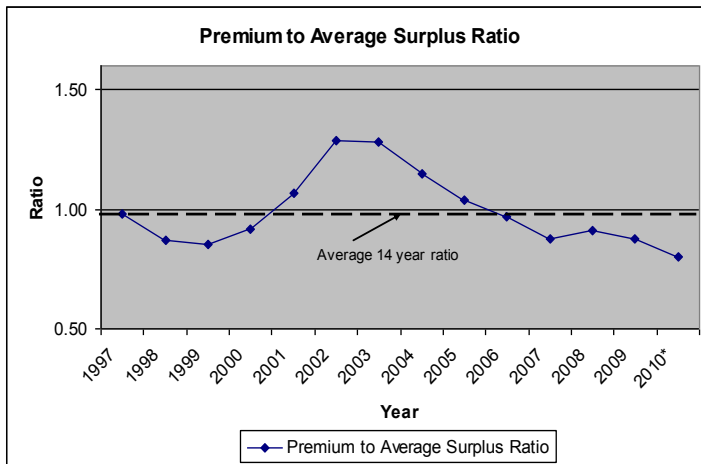
Large investment losses (Realized and Unrealized) hit insurers in 2008 with only a partial recovery since then;

Shareholder dividends are above average in three quarters of 2010 but that reflects increased share repurchasing activity by their respective holding company parents. More on this later.

Looking at the change in Surplus over this time horizon gives us a view of direction but in isolation it will not be indicative of an over-supply or under-supply unless it can be measured against some other data that can tell us something about the relative size of insurance demand and/or the relative profitability risk of the business that is in fact available to be written. Insurance underwriting is a capital intensive business as it must be prepared to respond when events take place outside the assumed expectation levels when the business was first written. For property insurance risks that could mean unexpected catastrophes (natural and man-made) while in casualty risks it might be an unexpected aggregation of the number of claims or their subsequent indemnity value. So although underwriters set aside claim reserves for known or expected claims, surplus represents funds committed to absorbing any unexpected circumstances.

Capacity Ratio Indicators

There are a number of methods that can be used to measure the general level of market capacity. A few will focus on technical constraints while others are based on profitability indicators that will lead underwriters to write more or less business. For example, regulators use a 3:1 ratio of Net Written Premium to Surplus in a series of potential financial impairment tests, as it is considered the maximum leverage a competent underwriter should never exceed. A look at this ratio over an extensive period of time is shown below:



Source: Insurance Services Office

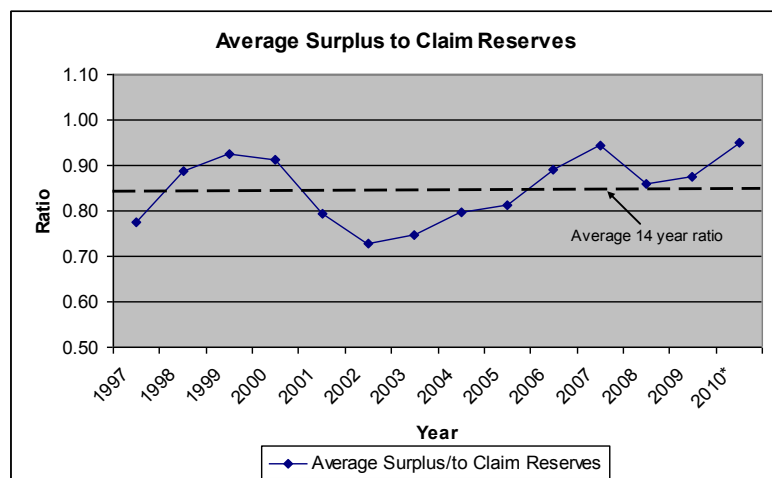
The U.S. insurance market is operates at a ratio close to 1:1 on average so the use of surplus leverage is not as efficient as it could be by regulatory standards. The chart shows periods of soft market....to hard market....back to soft market based on surplus utilization. The annualized ratio of .80 in 2010 indicates the lowest point on record and a huge technical capacity to write more business so the competition to do so keeps market prices low.

Another measure of market capacity might look at a ratio of industry surplus to claim reserves. If

a prime purpose of surplus is to potentially absorb abnormal claim conditions including adverse claim development, then a ratio to measure the relative size of surplus levels to claim reserves would reveal the ability of surplus to contain such aberrations.

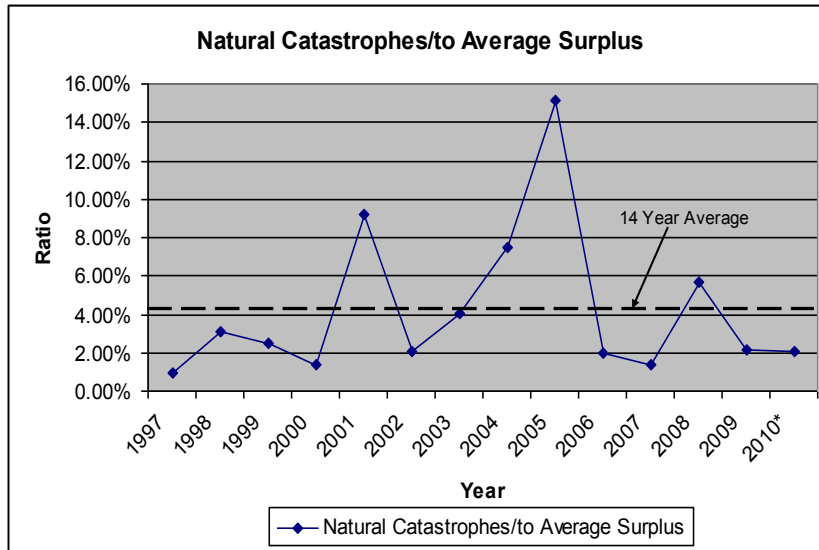
Source: Insurance Services Office

In this chart the lower the ratio value suggests that changes in claim reserves would have a greater relative impact on surplus while higher ratios suggest that changes in reserves would have a smaller effect on surplus. In other words the higher the ratio the greater the ability of surplus to absorb or contain the adverse claim reserve changes. The year of the terror attack (2001) and subsequent years through hurricane period of 2004-2005 put a



strain on this ratio that dipped again from the 2009 recession. It now is recovering nicely suggesting a strong surplus position.

Another test relative to the above would look at natural catastrophe losses relative to surplus as these are high value loss events that in the aggregate for any one year can vary significantly.



Source: Insurance Services Office

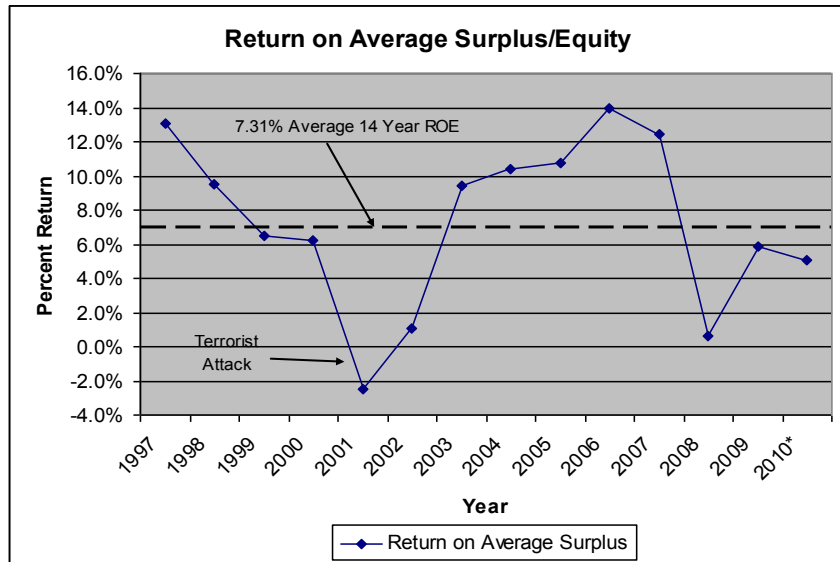
We used only natural catastrophes as these events (hurricanes, tornadoes, wild fires, winter storms, etc.) that take place with some frequency but can vary with location and intensity. If we had included man-made catastrophes the terror attack of 2001 would have skewed the analysis but note that even natural events of that year were not insignificant. There were only 4 years when the impact to surplus exceeds the long term average. As we look at the current period the relative impact has been below average for four of past

five years and can give the market a sense of security adding to a competitive bent to the market.

Finally, we look at the Return on Equity for the market over this same period keeping in mind that private market insurers must compete for capital from investors who have many choices about business investment opportunities. We chart below the insurance industry ROE values.

Source: Insurance Services Office

The average ROE over the period needs to be compared with other industry sector investments so at various times insurance investments provide attractive returns. These periods usually followed significant



market events, leading to increasing product pricing power of underwriters. This is obvious for the period of 2001 to 2006 in the above chart. The question now with extensive competition and economic drag, is whether the industry has too little earnings power relative to the amount of surplus it is carrying? The market appears to be willing to shed capital they can not effectively put to use.

Stock insurance companies (usually through their parent holding companies) can reduce capital via dividends or stock buyback and the latter has been the avenue of choice for most carriers. It offers management more flexibility to discontinue or alter the plan. While this does not always produce an immediate reduction in the surplus of the insurance subsidiaries if buybacks are paid from holding company excess funds, it may need divi-

dends from these operations to fund a long term program. Below is a list of buyback programs announced during 2010.

Insurance Industry Share Repurchase Authorizations

Past 12 Months

Company+	Symbol	Date	Price*	# Shares (millions)	Estimated	Remarks
					Amount** (millions)	
Transatlantic Holdings	TRH	12/21/09	\$51.54	3.9	\$200.0	open market
Aspen Re	AHL	01/05/10	\$28.95	6.9	\$200.0	Authorized and completed
Aspen Re	AHL	02/09/10	\$28.95	13.8	\$400.0	open until Feb 2012
Max Capital Group	MXGL	02/09/10	\$22.98	4.4	\$100.0	increase to \$250 million
Platinum Underwriters	PTP	02/22/10	\$45.14	3.7	\$167.0	million
Everest Re	RE	02/25/10	\$84.68	5.0	\$423.4	add to previous 8.5 million shares
Partner Re	PRE	02/25/10	\$77.73	8.0	\$621.8	
Hanover Insurance	THG	02/26/10	\$47.08	2.1	\$100.0	
Montplier Holdings	MRH	02/26/10	\$19.00	6.9	\$131.1	Private transaction
Hanover Insurance	THG	03/31/10	\$43.19	2.3	\$100.9	to previous 100M shares
Navigators	NAV	04/05/10	\$51.12	1.3	\$65.0	addition to 2009 \$35M plan
Erie Indemnity	ERIE	04/21/10	\$63.17	1.6	\$100.0	re-authorized
Platinum Underwriters	PTP	04/29/10	\$45.10	1.0	\$47.0	
RLI Group	RLI	05/06/10	\$51.66	1.9	\$100.0	
Allied World Assurance	AWH	05/06/10	\$59.82	8.4	\$500.0	
Flagstone Re	FSR	05/18/10	\$12.64	50.0	\$632.0	
Renaissance Re	RNR	05/18/10	\$62.21	8.0	\$500.0	Increasing prior authorization
HCC Holdings	HCC	06/01/10	\$28.46	10.5	\$300.0	
Chubb	CB	06/01/10	\$57.50	14.0	\$805.0	
Platinum Underwriters W R	PTP	07/22/10	\$45.14	4.5	\$203.0	
Berkely	WRB	08/03/10	\$27.00	10.0	\$270.0	
Allied World Assurance	AWH	08/09/10	\$50.00	5.0	\$250.0	Purchase from Goldman Sachs
Endurance	ENH	08/12/10	\$46.04	7.0	\$322.3	
White Mountain AXIS	WTM	08/26/10	\$327.00	0.6	\$196.2	Additional
Capital	AXS	09/24/10	\$36.38	20.6	\$750.0	
Platinum Underwriters	PTP	11/02/10	\$45.14	5.5	\$250.0	Reauthorize
XL Capital W R	XL	11/02/10	\$21.70	46.1	\$1,000.0	
Berkely	WRB	11/03/10	\$27.28	10.0	\$272.8	
Validus Holdings	VR	11/02/10	\$30.00	7.9	\$237.0	
Allstate	ALL	11/09/10	\$31.31	31.9	\$1,000.0	
Aspen Re	AHL	11/10/10	\$28.95	6.4	\$184.0	
Pro Assurance	PRA	11/10/10	\$61.59	3.2	\$200.0	
Primis Guaranty	PRS	11/11/10	\$4.97	2.0	\$10.0	
Lincoln National	LNC	11/10/10	\$28.00	4.5	\$125.0	Common Shares over 15 months
Lincoln National	LNC	11/10/10	N/A	all	\$150.0	Preferred Shares
Erie Indemnity	ERIE	12/07/10	\$63.00	2.4	\$150.0	
Chubb	CB	12/09/10	\$59.00	30.0	\$1,770.0	Prior plan 6/1/10 completed
Navigators	NAV	12/10/10	\$51.12	1.3	\$65.0	
TOTAL					\$12,898.5	

+ stock repurchase of the Holding Company may not necessarily reduce the Surplus in operating insurance units

* price based on recent market value but repurchase authorizations may be at a defined price

** Amounts may include both acquired shares as well as authorized but not yet transacted

These purchases take up a small portion of the excess U.S. capacity. The repurchase of stock has the benefit of reducing the capital base which in a soft market producing sluggish returns tends to support the share price while improving the earnings per share. Insurers may need to attract more capital in the future when conditions change but at this moment it is difficult to see exactly when that will be.....surely it will not be anytime soon.



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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.
