

Insurance Executive Review

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

2010 Industry Results

The financial data for the private Property Casualty industry was recently released by the Insurance Services Office (ISO) and in many respects the insurance industry did very well in 2010. The absence of severe catastrophe losses in 2010 was a material contributor to underwriting performance as was the release of \$9 billion in claim reserves. The material catastrophe losses in 2010 and the first quarter of 2011 have all been outside the U.S. being absorbed by local foreign insurers, global reinsurance carriers and government entities. Although the global investment market has improved, the U.S. economy is still in a timid recovery as the headwinds from the real estate market, unemployment hangover and deficit spending concerns are causing ongoing difficulties.

We should remember that when looking at the data below the “consolidated industry” represents some 900 holding companies or groups with 2000 operating insurance entities writing insurance in a market comprised of two distinct groups (personal and commercial risk buyers) each requiring different marketing, risk solution products and service delivery. We often think of this as “one market” when it is actually a very diverse group so “industry numbers” don’t often tell the whole story.

OVERALL FINANCIAL PERFORMANCE

The Exhibit A below shows the private P&C Insurance Industry performance for 2010 that on the surface was considered to be strong results comparable to 2009.

Year End Results	NET INCOME 2004-2010 (Millions of Dollars)					EXHIBIT A	
	2010	2009	2008	2007	2006	2005	2004
PREMIUM REVENUE							
Net Written Premium(NWP)	\$422,065	\$418,365	\$434,930	\$440,583	\$443,460	\$425,500	\$424,089
Net Earned Premium(NEP)	\$420,506	\$422,302	\$438,316	\$438,908	\$435,484	\$417,635	\$413,777
UNDERWRITING OPERATIONS							
Underwriting Expense	\$119,557	\$117,013	\$119,571	\$120,149	\$117,120	\$110,083	\$106,845
Incurred Claims and Loss Adj. Exp.	\$309,109	\$306,286	\$337,953	\$297,012	\$283,846	\$311,624	\$300,948
Policyholder Dividends	\$2,270	\$1,984	\$1,965	\$2,443	\$3,403	\$1,856	\$1,721
Total Underwriting Expense	\$430,936	\$425,283	\$459,489	\$419,604	\$404,369	\$423,563	\$409,514
Net Underwriting Gain (Loss) #1	(\$10,430)	(\$2,981)	(\$21,173)	\$19,304	\$31,115	(\$5,612)	\$4,263
INVESTMENT OPERATIONS							
Net Investment Income	\$47,246	\$47,057	\$51,466	\$55,052	\$52,309	\$49,729	\$39,966
Other Income	\$1,018	\$907	\$352	-\$993	\$1,183	\$1,028	(\$267)
Pre-Tax Operating Income	\$37,834	\$44,983	\$30,645	\$73,363	\$84,607	\$45,145	\$43,962
Net Realized Capital Gains	\$5,688	(\$7,904)	(\$19,813)	\$8,921	\$3,524	\$9,701	\$9,125
Pre-Tax Income	\$43,522	\$37,079	\$10,832	\$82,284	\$88,131	\$54,846	\$53,087
Federal Tax	(\$8,852)	(\$8,407)	(\$7,789)	(\$19,788)	(\$22,354)	(\$10,691)	(\$14,586)
Net After Tax Income	\$34,670	\$28,672	\$3,043	\$62,496	\$65,777	\$44,155	\$38,501
Selected Financial Data							
Consolidated Industry Surplus	\$556,852	\$511,397	\$457,294	\$517,876	\$486,231	\$427,138	\$391,294
Loss and LAE Reserves	\$557,710	\$551,572	\$555,351	\$532,319	\$513,482	\$504,404	\$464,026
Catastrophe Losses	\$13,800	\$10,600	\$27,100	\$6,900	\$9,200	\$61,900	\$27,500
Combined Ratio	102.4%	101.0%	105.0%	95.5%	92.4%	100.9%	98.3%

Notes: #1 includes Mortgage Guaranty and Financial Guaranty Insurers
Source: ISO

The private P&C insurance industry added substantially to its capital position (see EXHIBIT B below) while at the same time returning near record dividends either directly to individual shareholders or upstream to their holding company parent. The historic \$556.9 billion of surplus is a mixed blessing given that if put to full use will only pressure market prices lower at a time when stable to increased prices might be needed.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS

Exhibit B

2004-2010

Billions of Dollars

	2004	2005	2006	2007	2008	2009	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	\$37.8
Realized Capital Gains (Losses)	\$9.1	\$9.7	\$3.3	\$8.9	(\$19.8)	(\$7.9)	\$5.7
Federal Income Tax Paid	(\$14.7)	(\$10.7)	(\$24.2)	(\$19.7)	(\$7.8)	(\$8.3)	(\$8.8)
NET INCOME AFTER TAXES	\$38.3	\$44.1	\$63.7	\$62.5	\$3.0	\$28.4	\$34.7
BALANCE SHEET ADJUSTMENTS							
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$24.1)	(\$16.7)	(\$31.1)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$12.9	\$6.5	\$27.4
Unrealized Capital Gains (Losses)	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$52.9)	\$23.1	\$15.6
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	\$1.1	\$13.0	(\$1.1)
NET BALANCE SHEET ADJUSTMENTS	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$63.0)	\$25.9	\$10.8
NET CHANGE TO SURPLUS	\$44.1	\$35.9	\$60.6	\$32.3	(\$60.0)	\$54.3	\$45.5
ENDING SURPLUS	\$391.2	\$427.1	\$487.7	\$517.3	\$457.3	\$511.4	\$556.9
Average Annual Surplus	\$369.2	\$409.2	\$457.4	\$502.5	\$477.7	\$484.4	\$534.2

HERE IS THE HEADLINE ANALYSIS FOR 2010

Looking at the industry results there are a lot of positive signs that the competitive commercial market has not caused too much damage while the financial market recovery has restored industry investments to pre-recession levels. The often cited positive aspects of 2010 were stated to be:

- Growth in Net Written Premium was first increase since 2006 although Net Earned Premium declined as lower prior period premiums became earned;
- Incurred Claims grew by less than 1% although catastrophe losses were higher than the prior year and only slightly higher than the long term average;
- The industry underwriting loss for the past several years has been influenced by extensive losses in the Mortgage and Financial Guaranty segments that distorts the overall industry numbers;
- Investment Income remained stable avoiding the declines of prior years due to reduced interest rates;
- Realized and Unrealized Gains showed a reversal after 2 years of Losses during the previous recession years;
- Surplus as an indicator of capital strength increased by \$45 Billion over the prior year and established a new record for the industry;
- Overall industry financial strength is now stated to be \$1.3 trillion.
- These are stated to be impressive results for an industry suffering from heavy competition during a period of weak economic conditions that has seriously reduced the demand for insurance and lowered the stream of investment income.

HERE ARE SOME OF THE ISSUES THAT ARE BELOW THE SURFACE

A closer look at the details behind the headline numbers might suggest a less rosy picture. We are not suggesting that the industry is in financial trouble but rather that in an effort to promote some positive news, some reports have overlooked troubling signs buried within the data. So here we offer some points worthy of note;

- Premium growth has not been universal especially for commercial risk underwriters as a breakdown of writ-

ten premium shows the following growth rates:

	2010	2009
Personal Lines Carriers	+3.3%	-0.5%
Balanced Carriers	+2.1%	-3.6%
Commercial Risk Carriers	-2.7%	-7.5%

- Incurred Claims expense has benefited from the continued release of prior year claim reserves that in 2010 totaled \$9 billion against \$11 billion the prior year. There are serious questions about how much additional reserve redundancy remains in carrier's reserves. A recent report by A M Best states that a majority of the 11 P&C insurers that became financially impaired in 2010 was due to inadequate claim reserving. We are likely to see more in 2011;
- The Underwriting Expense which includes acquisition costs (broker/agent commissions) is showing a worrisome trend in spite of significant reduction in personnel since the start of the recession. This cost of doing business is becoming a serious burden on underwriting profits;
- This expense as a percentage of net written premium is in the wrong direction;
- The Mortgage and Financial Guaranty segment posted an aggregate \$33 billion in underwriting losses in the 4 year period 2007-2010 that has caused "industry" numbers to be somewhat opaque. We will try to clear the air on this later in this commentary;
- The slight upward movement in investment income can be traced to a special acquisition transaction that produced \$1.3 billion of income. So in reality investment actually fell (again) to \$45.9 billion from \$47.1 billion in 2009. The longer term impact on the industry with low yielding portfolio will be a serious problem in supporting income growth;
- Net Surplus growth in 2010 at \$45.5 billion was below the record amounts of \$54.3 billion last year to stem the prior reduction of investment values and the \$60.6 billion in 2006 (the year after Katrina). About 85% of the new funds of \$27.4 billion was the direct result of a Berkshire Hathaway non-insurance entity acquisition placed in the portfolio of their insurance company National Indemnity. So 50% of the total 2010 change came from one transaction;
- The dividends of \$31.1 billion from Surplus helped some of their parent holding companies to buy back shares from investors as the apparent glut of capital some insurers are having difficulty putting to work effectively;
- Finally, industry observers have been focused on the overall strength of the private insurance market that is stated to be \$1.3 trillion as a measure of its' ability to withstand catastrophe type events. Their figure is comprised of:

Surplus	\$556.9 billion
Claim Reserves	\$557.7 billion
Unearned Premium Reserves	\$199.0 billion

We have great difficulty with that approach as it seems they are trying to count claim reserves twice. Since these represent amounts already set aside for actual and reasonable estimates of expected claims of policyholders or other claimants. As such, these funds are already on call for ultimate payment so can't be counted again.

CONCLUSION

We should not be misled by headline numbers as the industry is still in a difficult period. We hear insurer

CEO's commenting in the press that they are walking away from business or are seeing positive pricing changes on their renewals or new business. That has not been broadly confirmed by the reported data or recent 2010 surveys taken by the Council of Insurance Agents and Brokers ("CIAB") or the Risk management Society ("RIMS") looking at conditions in the commercial sector. This market has been suffering from competitive pressures, low economic activity, subdued investment income yields, regulatory uncertainty and excess capital that can't be put to better use than writing more questionably priced business. The rash of recent global catastrophe losses has already hurt foreign insurance and reinsurance carriers but is not likely to change conditions especially here in the U.S. The April tornadoes in the southeast with early estimates of \$5 billion in losses will hurt second quarter numbers especially for personal lines writers but will not cause any abrupt change in market conditions.



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