

Insurance Executive Review

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

2010 Industry Results ... Digging a Little Deeper

We made extensive comments on the Industry Financial data for 2010 in our last Newsletter looking at both the income Statement data as well as the make-up of changes to the underlying capital or Surplus account. Having already pointed to the consequences of the Mortgage and Financial Guaranty market segment and its' negative impact on the "industry" data, we thought it prudent to comment on three other aspects of last years' events. More specific analysis on Fourth Quarter numbers, the impact, if any, of the domestic reinsurance market financials on industry data and finally any grass roots information on market rates from recent survey data.

FOURTH QUARTER SHOWS GREATER SIGN OF WEAKNESS

The Fourth Quarter financial data is shown below and to some extent mirrors the full-year earnings report. The exceptions show a relatively higher underwriting loss as indicated with the Combined Ratio at 105.9% and a smaller capital gains return leading to lower net after-tax earnings then the previous year.

EXHIBIT A Fourth Quarter	PROPERTY CASUALTY INDUSTRY RESULTS 2006-2010 NET INCOME (Millions of Dollars)				
	2010	2009	2008	2007	2006
PREMIUM REVENUE					
Net Written Premium(NWP)	\$98,918	\$97,641	\$98,609	\$103,244	\$105,904
Net Earned Premium(NEP)	\$106,063	\$104,964	\$107,756	\$109,795	\$110,339
UNDERWRITING OPERATIONS					
Underwriting Expense	\$29,428	\$28,908	\$28,432	\$28,585	\$27,327
Incurred Claims and Loss Adj. Exp.	\$79,655	\$74,861	\$79,702	\$79,070	\$71,580
Policyholder Dividends	\$1,162	\$1,008	\$952	\$1,262	\$2,312
Total Underwriting Expense	\$110,245	\$104,777	\$109,086	\$108,917	\$101,219
Net Underwriting Gain (Loss)	-\$4,182	\$187	-\$1,330	\$878	\$9,120
INVESTMENT OPERATIONS					
Net Investment Income	\$12,221	\$11,146	\$13,208	\$15,129	\$14,816
Other Income	\$639	-\$290	-\$383	\$26	-\$1,343
Pre-Tax Operating Income	\$8,678	\$11,043	\$11,495	\$16,033	\$22,593
Net Realized Capital Gains	\$1,254	\$1,672	-\$10,087	\$768	\$2,051
Pre-Tax Income	\$9,932	\$12,715	\$1,408	\$16,801	\$24,644
Federal Tax	(1,939)	(568)	(2,725)	(4,260)	(4,996)
Net After Tax Income	\$7,993	\$12,147	-\$1,317	\$12,541	\$19,648
Consolidated Industry Surplus	\$556,852	\$511,464	\$457,294	\$517,869	\$486,231
Loss and LAE Reserves	\$557,710	\$552,908	\$555,357	\$533,409	\$513,482
Catastrophe Losses (Quarter only)	\$410	\$220	\$280	\$170	\$140
Combined Ratio	105.9%	101.9%	103.7%	100.9%	95.0%

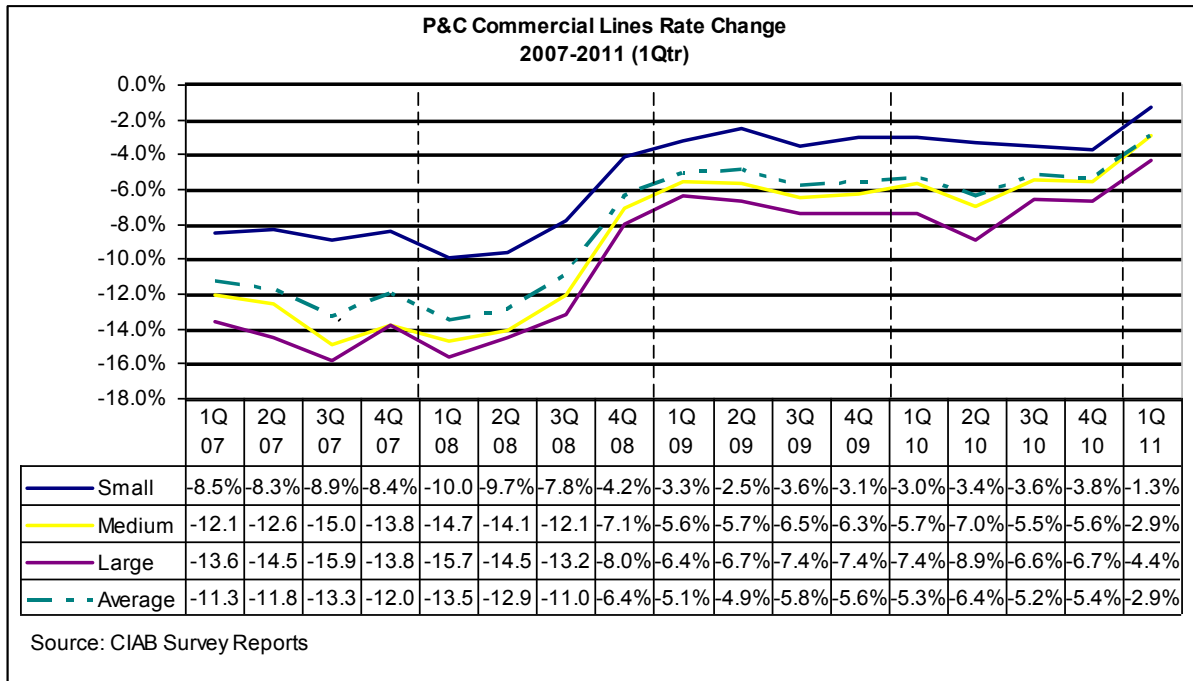
Source: ISO/NAII

With this fourth quarter earnings deterioration and the early negative catastrophe outlook for the first half of 2011 already in play the industry earnings look grim for the remainder of the year.

COMMERCIAL MARKET RATES STILL SHOW NEGATIVE TRENDS

We have already seen market reports that the commercial risk portion of the market continues to have difficulty

in achieving an overall positive insurance rate environment following years of declining market rates from an overcapitalized market chasing an economically weakened demand for insurance. The April report from Market Scout indicates an overall average commercial rate reduction of 4% in the first quarter while the Council of Agents and Brokers (CIAB) report is included below as a moderating but continuing trend from prior periods.



Even if commercial rates turn upward now it will be too late to have any meaningful impact on the negative trend in underwriting performance that is based on earned premiums for 2011.

MARKET STATISTICS SUPPORTS CONCERN FOR WHAT IS AHEAD

The U.S. insurance market is very diverse as between personal and commercial lines, direct writers and agency markets and as between primary and reinsurance carriers. All of these segments make up the U.S. Private P&C Insurance Industry. At times there are unique factors at work in selected segments that can distort the “industry” result. In addition, certain measurement tools don’t always tell the whole story. Let’s look at a few:

- Mortgage and Financial Guaranty market....a case of tail wagging the dog. This small segment (1.4% of market) has distorted industry results making years look materially better or worse than the reported numbers....see below:

	2010	2009	2008	2007	2006	2005	2004
Reported Underwriting Gain (Loss)	(\$10,430)	(\$2,981)	(\$21,173)	\$19,304	\$31,115	(\$5,612)	\$4,263
Mtg/Fin. Guaranty Market Und.	(\$4,200)	(\$9,143)	(\$21,093)	-\$3,201	\$2,455	\$2,518	\$2,243
Net Underwriting Adjusted	(\$6,230)	\$6,162	(\$80)	\$22,505	\$28,660	(\$8,130)	\$2,020

- Underwriting Expense costs escalating.....in spite of personnel reductions costs are going up as a percent of earned premium. Are acquisition costs (broker and agent commissions) in competition for business taking a bigger slice of that pie?....see below:

	2010	2009	2008	2007	2006	2005	2004
Underwriting Expense % NWP	28.3%	28.0%	27.5%	27.3%	26.4%	25.9%	25.2%

- Prior Claim Reserve Changes hides effect of current pricing.....the recent “favorable” reserve changes have distorted the profitability of currently priced business as underwriting is based on calendar year results that includes adjustments from prior years. Historically underwriters have over-reserved in high priced “hard market” conditions only to take down these reserves to stabilize income during “soft market” periods. This hides the amount of losses attributable the current book of business via these adjustments. The difference in Loss Ratio can be material....see below:

	2010	2009	2008	2007	2006	2005	2004
Incurred Claims and Loss Adj. Exp.	\$309,109	\$306,286	\$337,953	\$297,012	\$297,012	\$311,624	\$300,948
Prior Claim Reserve Change	-\$13,000	-\$16,000	-\$14,600	-\$9,500	-\$6,700	\$2,000	\$3,000
Net Policy Year Claims/Exp.	\$322,109	\$322,286	\$352,553	\$306,512	\$303,712	\$309,624	\$297,948
Calendar Year Loss Ratio	73.51%	72.53%	77.10%	67.67%	68.20%	74.62%	72.73%
Policy Year Loss Ratio	76.60%	76.32%	80.43%	69.84%	69.74%	74.14%	72.01%
Ratio Difference	3.09%	3.79%	3.33%	2.16%	1.54%	-0.48%	-0.73%

- Industry Combined Ratio is only a general indicator of underwriting performance.....this ratio has been the norm for measuring the overall profitability of the industry but contains some of the same possible distortions we discussed above. In addition, it contains the full impact of catastrophe losses that are so variable as to make the ratio vulnerable to wide fluctuations. Removing catastrophe events would not be reasonable but removing the extreme excess over the long-term average would provide a better trend indicator.....see below:

	2010	2009	2008	2007	2006	2005	2004
Reported Industry Combined Ratio	102.4%	101.0%	105.0%	95.5%	92.4%	100.9%	98.3%
Remove effect of:							
Mortgage/Financial Guaranty Segment	-1.60%	-1.9%	-4.1%	-1.9%	1.4%	1.6%	2.1%
Prior Year Claims Development	3.1%	3.8%	3.3%	2.2%	1.5%	-0.5%	-0.7%
(Above) or Below Average Catastrophe Losses*	0.8%	2.1%	-1.7%	1.1%	1.9%	-4.2%	-1.9%
Adjusted Policy Year Combined Ratio	104.7%	105.0%	102.5%	96.9%	97.2%	97.8%	97.8%

Note: Long term average U.S. Cat Losses expected at net \$12 Billion (excluding Katrina as a one-off event)

CONCLUSION

While we have long pointed to excess capital in the market as a driver of competition it should be understood that it is not evenly divided among participants. There are a substantial number of carriers that wished they suffered from that condition. The above suggests that parts of the insurance industry will soon be rapidly trending toward a very difficult period where some commercial carriers find that they have exhausted previous claim reserve cushion, written too much additional business at depressed rates, acquired strategic operations that do not offer the robust returns anticipated, entered new markets or segments with inadequate resources and must now post life-threatening operational losses. Commercial rate change in 2012 is all but assured!



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