

Insurance Executive Review

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

First Quarter U.S. Property Casualty Industry Financials Released

Suggest our Forecast for Cyclical Change in Market Conditions for Commercial Risks Later in 2012 is Still on Track!

The release by ISO of the consolidated U.S. P&C first quarter financials continues the basic trend of a gradual erosion of underwriting and overall earnings that will eventually lead to a cyclical correction next year. This assumes we don't have any further material natural catastrophe events or a European financial market contagion that spreads following a default (technical or otherwise) on Greek debt to other "PIIG" countries. In this analysis of earnings we will look at the influence of two segments, reinsurance and mortgage/financial guaranty business on the overall market result.

Underwriting Operations

The overall underwriting performance in the first quarter of 2011 was not unexpected as global (non-U.S.) catastrophe claims from late 2010 hit U.S. reinsurance companies and early 2011 cat claims hit both domestic primary and reinsurers fairly hard.

PROPERTY CASUALTY INDUSTRY RESULTS 2006 - 2011 NET INCOME

FIRST QUARTER

(Millions of Dollars)

	2011	2010	2009	2008	2007	2006
PREMIUM REVENUE						
Net Written Premium(NWP)	\$108,589 #1	\$104,894	\$106,490	\$110,386	\$111,315	\$110,482
Net Earned Premium(NEP)	\$104,831	\$102,735	\$105,640	\$107,925	\$108,517	\$106,580
UNDERWRITING OPERATIONS						
Underwriting Expense	\$30,379	\$29,533	\$28,748	\$30,258	\$29,284	\$28,243
Incurred Claims and Loss Adj. Exp.	\$78,459 #2	\$74,469	\$78,792	\$77,833	\$70,308	\$69,264
Policyholder Dividends	\$456	\$511	\$333	\$387	\$315	\$315
Total Underwriting Expense	\$109,294	\$104,513	\$107,873	\$108,478	\$99,907	\$97,822
Net Underwriting Gain (Loss)	(\$4,463)	(\$1,778)	(\$2,233)	(\$553)	\$8,610	\$8,758
INVESTMENT OPERATIONS						
Net Investment Income	\$12,561 #3	\$11,598	\$11,710	\$12,850	\$12,925	\$11,727
Other Income	\$512	\$421	\$22	\$243	(\$2,140)	(\$343)
Pre-Tax Operating Income	\$8,610	\$10,241	\$9,499	\$12,540	\$19,395	\$20,142
Net Realized Capital Gains	\$984	\$985	(\$7,987)	(\$412)	\$2,083	\$1,888
Pre-Tax Income	\$9,594	\$11,226	\$1,512	\$12,128	\$21,478	\$22,030
Federal Tax	(\$1,787)	(\$2,333)	(\$2,844)	(\$3,635)	(\$5,238)	(\$5,301)
Net After Tax Income	\$7,807	\$8,893	(\$1,332)	\$8,493	\$16,240	\$16,729
Select Financial Data						
Consolidated Industry Surplus	\$564,656 #4	\$540,318	\$437,751	\$514,210	\$495,642	\$439,116
Loss and LAE Reserves	\$560,795	\$551,707	\$554,846	\$536,887	\$515,954	\$502,982
Combined Ratio	103.3%	101.1%	102.2%	99.9%	91.7%	91.1%
Industry Catastrophe Losses (US claims)	\$1,900	\$2,600	\$3,300	\$3,600	\$1,300	\$1,500
Combined Ratio (excl. Mortg/Fin. Insurers)	102.2%	99.0%	98.5%	97.3%	N/A	N/A

Note #1: Increase in 2011 may be due to reinstatement premiums paid to US reinsurers resulting from 2010-2011 global catastrophes

Note #2: Some Foreign Catastrophe claims included in LLAE estimated at up to \$5 billion for reinsurance company market

Note #3 Includes \$1.4 billion dividends in 2011 from non-insurance subsidiary of National Indemnity acquired in 2010

Note #4 New record industry surplus level achieved in 2011

Source: Insurance Services Office (ISO)

Although industry written premium rose 3.5% it appears that it can be attributable to personal lines and foreign reinstatement premiums booked by U.S. reinsurers to reinstate limits of protection. If fact, ISO sees the year-over-year premium growth as follows:

First Quarter	2011	2010
Personal Lines Insurers.....	+3.8%	+2.2%
Balanced Insurers.....	+3.1%	-1.4%
Commercial Insurers*.....	+3.5%	-5.3%

* These include reinsurance carriers

The results also reflect the further release of claim reserves valued at \$4.5 billion this year against \$5.6 billion last year that helped to reduce the impact of the cat losses. It has been estimated that the industry has between \$20-25 billion of further reserve redundancy that will most likely be released in subsequent quarters. Given the calendar year financials it suggests that current policy-year business is being written at subsidized prices that will haunt some carriers before they can take advantage of the next cycle.

Investment Operations

The investment income was up for the first time since 2007 but there was a special circumstance where a carrier (National Indemnity) benefited from income of \$1 billion from a non-insurance (railroad) investment acquired last year and \$400 million special dividend from a foreign subsidiary. Absent these two items investment income would have continued lower then the prior year. The maturities of older investments with higher yields are not achieving nearly the same returns upon reinvestment. The investment portfolio of insurers has shown a marked bias toward municipal securities since 2003 and that now represents nearly 30% of assets and 60% of net worth (Surplus)

**Property Casualty Industry
Financial Asset Distribution
(\$ Billions)**

Financial Assets	2008		2009		2010		Change 2003 to 2010	
	Amount	%	Amount	%	Amount	%	%	\$
U.S. Treasury Securities	\$ 65.6	4.8%	\$ 88.5	6.4%	\$ 91.4	6.7%	-14.8%	\$ 26.70
Agency/GSE Backed Securities*	\$ 114.3	8.3%	\$ 116.2	8.5%	\$ 109.3	8.0%	9.0%	\$ (6.10)
Municipal Securities	\$ 381.9	27.8%	\$ 369.4	26.9%	\$ 369.8	26.9%	64.5%	\$ 145.60
Corporate and Foreign Bonds	\$ 267.5	19.5%	\$ 298.3	21.7%	\$ 299.2	21.8%	30.5%	\$ 80.30
Corporate Equities	\$ 193.3	14.1%	\$ 219.8	16.0%	\$ 228.1	16.6%	31.9%	\$ 49.70
Cash and Money Market Funds	\$ 60.7	4.4%	\$ 57.2	4.2%	\$ 55.4	4.0%	1.9%	\$ 2.60
Trade Receivables	\$ 86.7	6.3%	\$ 83.1	6.0%	\$ 83.7	6.1%	7.7%	\$ 4.40
Miscellaneous/All Other	\$ 137.1	10.0%	\$ 154.4	11.2%	\$ 166.5	12.1%	30.1%	\$ 40.50
Total Financial Assets	\$ 1,307.1	100.0%	\$ 1,386.9	100.0%	\$ 1,403.4	100.0%	29.6%	\$ 343.70

* Government Sponsored Enterprise

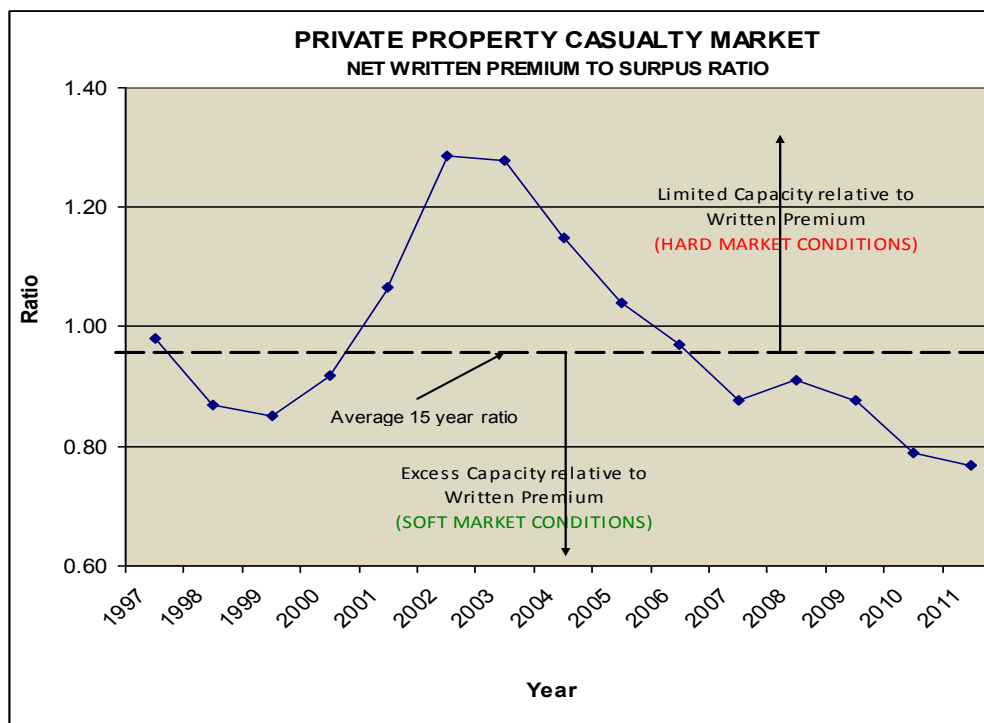
Source: Federal Reserve March 10, 2011

With municipal governments facing very difficult budget constraints (see Newsletter #58) there is some concern that insurers may be exposed to rating downgrades on their holdings and some potential for defaults. These look limited but with an economy stalled, insurers don't need another problem developing in their earnings or balance sheets!

Industry Surplus (Net Worth) sets a new record....again!

The surplus position of the industry is at an all time high notwithstanding the significant stock buy-back programs that have been announced since 2009. Although a fair amount of capital has been removed it tends to be

at the holding company level rather than at the operating insurance subsidiaries. We have repeatedly suggested that the “premium-to-surplus” ratio as a good measure of general market conditions. Insurers can actively manage the written premium side of this ratio through the purchase of reinsurance (although this creates a potential credit risk) but during difficult hard markets reinsurance may be expensive just as it might be cheap in soft markets relative to retaining the insurance risk. The chart below looks at recent conditions as measured by this ratio.



Source: ISO

The record \$564.7 billion of Surplus at 3/31/11 improved substantially from 2008 when surplus dipped to \$457 billion and the thoughts of a pricing change away from the soft market seemed imminent. This is contrast to the surplus low point of \$285.4 billion in 2002 when market premiums were at \$369.7 billion (see chart above) the height of the last hard market.

COMPONENTS OF PROPERTY CASUALTY INDUSTRY SURPLUS
2004-2010

Billions of Dollars	2004	2005	2006	2007	2008	2009	2010	1st Qtr. 2011
PRIOR YEAR-END SURPLUS	\$347.1	\$391.2	\$427.1	\$487.7	\$517.3	\$457.3	\$511.4	\$556.9
INCOME/LOSS FROM OPERATIONS								
Operating Income (Loss) See Note #1	\$43.9	\$45.1	\$84.6	\$73.3	\$30.6	\$44.6	\$37.8	\$8.6
Realized Capital Gains (Losses)	\$9.1	\$9.7	\$3.3	\$8.9	(\$19.8)	(\$7.9)	\$5.7	\$1.0
Federal Income Tax Paid	(\$14.7)	(\$10.7)	(\$24.2)	(\$19.7)	(\$7.8)	(\$8.3)	(\$8.8)	(\$1.8)
NET INCOME AFTER TAXES	\$38.3	\$44.1	\$63.7	\$62.5	\$3.0	\$28.4	\$34.7	\$7.8
BALANCE SHEET ADJUSTMENTS								
Dividends to Stockholders	(\$14.1)	(\$15.2)	(\$24.5)	(\$32.0)	(\$24.1)	(\$16.7)	(\$31.1)	(\$5.7)
New Funds	\$8.8	\$15.1	\$3.6	\$3.2	\$12.9	\$6.5	\$27.4	\$1.5
Unrealized Capital Gains (Losses)	\$10.6	(\$3.4)	\$20.1	(\$0.5)	(\$52.9)	\$23.1	\$15.6	\$3.8
Miscellaneous Surplus Changes	\$0.5	(\$4.7)	(\$2.3)	(\$0.9)	\$1.1	\$13.0	(\$1.1)	\$0.4
NET BALANCE SHEET ADJUSTMENTS	\$5.8	(\$8.2)	(\$3.1)	(\$30.2)	(\$63.0)	\$25.9	\$10.8	\$0.0
NET CHANGE TO SURPLUS	\$44.1	\$35.9	\$60.6	\$32.3	(\$60.0)	\$54.3	\$45.5	\$7.8
ENDING SURPLUS	\$391.2	\$427.1	\$487.7	\$517.3	\$457.3	\$511.4	\$556.9	\$564.7

As noted above surplus has been increased by \$107.6 billion since the end of 2008 whereas net market premiums have dropped by \$12.9 billion (annualized) over the same period. A clear indication that there is an imbalance in the market feeding competition for business.

Separating Reinsurance and Mortgage/Financial Guaranty Segments

We have attempted to separate the financial drivers from two market segments that have had undue influence on the overall industry data. From the data released by ISO we have separated these two segments from the first quarter financial data in the chart below.

PROPERTY CASUALTY INDUSTRY RESULTS 2010 - 2011 NET INCOME (Millions of Dollars)

FIRST QUARTER

	2011	2011	2011	2011	2010	2010	2010	2010
	Total Industry	Reinsurance	Mrtge & Fin. Guaranty	Core P&C	Total Industry	Reinsurance	Mrtge & Fin. Guaranty	Core P&C
PREMIUM REVENUE								
Net Written Premium(NWP)	\$108,589	\$7,101	\$1,300	\$100,188	\$104,894	\$6,397	\$1,200	\$97,297
Net Earned Premium(NEP)	\$104,831	\$6,035	\$1,500	\$97,296	\$102,735	\$5,717	\$1,600	\$95,418
UNDERWRITING OPERATIONS								
Underwriting Expense	\$30,379	\$2,002	\$400	\$27,977	\$29,533	\$1,885	\$300	\$27,348
Incurred Claims and Loss Adj. Exp.	\$78,459	\$6,101	\$2,300	\$70,058	\$74,469	\$4,161	\$3,400	\$66,908
Policyholder Dividends	\$456	\$0	\$0	\$456	\$511	\$0	\$0	\$511
Total Underwriting Expense	\$109,294	\$8,103	\$2,700	\$98,491	\$104,513	\$6,046	\$3,700	\$94,767
Net Underwriting Gain (Loss)	(\$4,463)	(\$2,068)	(\$1,200)	(\$1,195)	(\$1,778)	(\$329)	(\$2,100)	\$651
INVESTMENT OPERATIONS								
Net Investment Income	\$12,561	\$2,192	\$500	\$9,869	\$11,598	\$1,303	\$700	\$9,595
Other Income	\$512	\$91	\$0	\$421	\$421	(\$64)	\$0	\$485
Pre-Tax Operating Income	\$8,610	\$215	(\$700)	\$9,095	\$10,241	\$910	(\$1,400)	\$10,731
Net Realized Capital Gains	\$984	(\$256)	\$150	\$1,090	\$985	\$1,808	(\$550)	(\$273)
Pre-Tax Income	\$9,594	(\$41)	-\$550	\$10,185	\$11,226	\$2,718	(\$1,950)	\$10,458
Federal Tax	(\$1,787)	(\$59)	\$1,050	(\$2,778)	(\$2,333)	(\$285)	(\$150)	(\$1,898)
Net After Tax Income	\$7,807	(\$100)	\$500	\$7,407	\$8,893	\$2,433	(\$1,800)	\$8,260
Select Financial Data								
Consolidated Industry Surplus	\$564,656	\$107,554	\$12,100	\$445,002	\$540,318	\$101,285	\$12,300	\$426,733
Loss and LAE Reserves	\$560,795				\$551,707			
Combined Ratio	103.3%	129.30%	176.9%	101.2%	101.1%	102.2%	231.5%	99.3%
Industry Catastrophe Losses (US claims)	\$1,900				\$2,600			
Combined Ratio (excl. Mortg/Fin. Insurers)	102.2%				99.0%			

Source: Insurance Services Office (ISO)

These two segments only account for 7.7% of industry premiums in 2011 (1Qtr.) but represent a disproportionate share of the following:

- They account for 73.2% of the reported underwriting losses (\$3.3 billion part of the \$4.5 billion reported);
- Their investment income accounts for 75.1% of the total industry gains (\$692 million part of \$963 million);
- The amount of surplus represents 21.2% of the total industry;
- The Combined Ratio of the industry at 103.3 drops to 101.2 without these segments and was below 100 (99.3) at the same time last year.

So the core industry looks to be a bit more profitable if these "outlier" segments are removed as each beats to a different marketing drum within the overall market. The reinsurance segment is more globally focused as risk diversification is an essential risk management practice. The Mortgage and Financial Guaranty markets are directly tied to the legacy of the subprime market including extensions into MBS and CDS securities that helped perpetuate that asset bubble. They were clearly major facilitators that are now paying the ultimate price.....when the hangover lasts longer then the party!

The take-away here is that the "core" market is not as distressed in terms of underwriting results as the broader market view would have you believe. That is not exactly good news but in the effort to time the market cycle change, it becomes very important.



Charles L Ruoff CPCU

CR Market Strategies
crmarketstrategies.com

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.
