2010 - Year End Results

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IN THIS ARTICLE

The property/casualty (P/C) insurance industry reported an annualized statutory rate of return on average surplus of 6.5 percent for 2010. The year?s result compares favorably with 2009?s rate of return of 5.8 percent and the recession battered 0.6 percent rate of return in 2008. Overall net income after taxes (profits) for the year increased by $6.0 billion to $34.7 billion from $28.7 billion in 2009. Positive premium growth for the year?at 0.9 percent?is the first since 2006 and confirms that the era of mass exposure destruction in the property/casualty insurance industry is finally over, with demand for insurance now beginning to stabilize and recover in the aftermath of the ?Great Recession.? While underwriting losses deteriorated marginally, the industry is still operating on a close to ?breakeven? basis with a combined ratio of 100.8, after excluding mortgage and financial guaranty insurers. As has been the case since mid-2009, virtually all of the improvement in the industry?s financial performance came from a massive reversal in asset values, which allowed the industry to realize $5.7 billion in capital gains during 2010 compared to a $7.9 billion realized capital *loss* a year earlier. Looking ahead to 2011, the U.S. P/C insurance industry will remain very strong financially despite enormous catastrophe losses abroad, the vast majority of which will be borne by foreign insurers and international reinsurers. The industry results were released by ISO and the Property Casualty Insurers Association of America (PCI).

Policyholders? Surplus (Capital/Capacity) Hits a New Record

In 2010 property/casualty insurers demonstrated a resilience unique in the financial services industry. By the end of the first quarter the industry had fully recouped all of the claims paying capacity (as measured by policyholders? surplus) that had been eroded away by the financial crisis?even as hundreds of banks continued to flounder. Policyholders? surplus growth during the remainder of the year was strong, increasing by $45.5 billion or 8.9 percent to a record $556.9 billion as of December 31, 2010, up from $511.4 billion at the end of 2009. Even after adjusting for a unique transaction, the figure stands at $534.4 billion?up 4.5 percent for the year (the adjustment involved a first-quarter contribution of $22.5 billion in capital to one insurer by its parent to absorb a major non-insurance acquisition).

The record $556.9 billion in surplus as of December 31, 2010, now exceeds the pre-crisis high of $521.8 billion set during the third quarter of 2007?a difference of $35.1 billion or 6.7 percent. The bottom line is that the industry is and will remain extremely well capitalized and financially prepared to pay very large scale losses, if necessary. One commonly used measure of capital adequacy, the ratio of net premiums written to surplus, currently stands at 0.76, its strongest level in modern history. Given positive stock market gains in the first quarter of the current year, the industry is all but certain to reach another record in policyholders? surplus as of March 31, 2011.

A BOTTOM LINE RECOVERY

Profit Recovery Is Impressive but Incomplete

Net income after taxes (profit) totaled $34.7 billion in 2010 compared to $28.7 billion in 2009 and just $3.0 billion in 2008, during the height of the global financial crisis. The sharp rebound in profits is yet another demonstration of the resilience of the P/C insurance industry.

As mentioned earlier, the impact of higher profits in 2010 was to push the industry?s annualized return on average surplus in the period to 6.5 percent (compared to5.9 percent in 2009 and 0.6 percent in 2008).

It is worth noting that mortgage and financial guaranty insurers, which account for just 1.4 percent of industry premiums but ran a *negative* 36.6 percent annualized return on average surplus in 2010, continue to exert a disproportionate impact on industry profitability. Excluding these classes of business (which are written by only a small minority of insurers) provides a truer picture of performance, with the resulting return on average surplus rising to 7.5 percent in 2010, up from 7.4 percent for 2009, according to ISO/PCI.

Still, the current profit recovery must be kept in perspective. While net income is once again growing, even a 7.5 percent rate of return is inadequate for many insurers. The U.S. property/casualty insurance industry?s equity cost of capital stood at approximately 10.4 percent in mid-2010. This means that there is about a 2.9 percentage point gap between the actual rate of return and the rate of return that investors in the industry expect to earn given the risks they are being asked to assume. Failure to earn the cost of capital over an extended period of time could result in the exit of capital and, more importantly, difficulty in raising capital after a major ?capital event.? In dollar terms, insurers are earning far less than they did immediately before the crisis. The industry?s net income exceeded $60 billion in both 2006 and 2007, compared to a combined *total* of $31.3 billion in 2008 and 2009. Indeed the combined profits from 2008, 2009 and 2010 only slightly exceed what the industry earned in 2007, immediately before the global financial crisis. The accumulated profits in the years immediately prior to the financial crisis helped cushion the impact on P/C insurers. It is abundantly clear today that widespread criticism of insurer profits in those years was misguided.

Top Line Growth Returns to P/C Insurance After Three Years of Decline

Net written premiums were up 0.9 percent in 2010 (+1.1 percent excluding mortgage and financial guaranty insurers). While such sluggish growth is usually not cause for celebration, the increase represents the first gain on an annual basis since 2006. The improvement is evidence that the property/casualty insurance industry is benefitting from early-stage growth in the American economy, which is translating into insurable exposure growth. On a quarterly basis, premium growth has been positive since the second quarter of 2010, placing the industry on a favorable growth trajectory for 2011.

The nascent stabilization in premium growth comes none too soon. If the industry had recorded negative growth in 2010?a scenario that seemed very likely as the year began?it would have marked the fourth consecutive year of decline in premiums written. The last time net premiums written contracted for four consecutive years was during the Great Depression (1930 through 1933), after peaking in 1929, though the declines then were much larger.

While any growth is welcome after three years of decline, the 2010 figures are undeniably anemic. Premiums in 2010 were held back in part by continued soft market conditions, primarily in commercial lines, which continued to grip the industry for a seventh consecutive year. The economy was also a factor (details below), though the massive exposure losses that plagued the industry in 2008 and 2009 are much less of a factor today. Indeed, the era of ?mass exposure destruction? is over as the economic recovery continues to pick up momentum. Although the nation?s real (i.e., inflation adjusted) gross domestic product (GDP) actually began to expand during the second half of 2009 and further expanded, by 2.9 percent, in 2010, growth in property/casualty insurance exposure usually lags behind economic growth by a year or more. This is because the early stages of economic recoveries are always led by productivity gains rather than additions to fixed investment (e.g., plants, equipment) or hiring (which would add to payrolls). Fortunately, the economy is now on a sustained growth trajectory. Despite extreme economic pessimism through much of 2010, the economy avoided a much feared ?double-dip? recession. Real GDP growth will average more than 3 percent by late 2011, according to Blue Chip Economic Indicators.

Softness in commercial insurance pricing remains a persistent problem for insurers. Although the magnitude of price decreases gradually diminished from the 13.8 percent drop recorded in the first quarter of 2008 to a decline of 5.4 percent in the fourth quarter of 2010, renewals over the past year have remained anchored in a range between negative 5 percent and 6.5 percent, according to Council of Insurance Agents and Brokers (CIAB) data. Other commercial lines price indexes confirm that pricing continues to trend downward, though at a somewhat slower pace than the CIAB survey indicates. On the personal lines side, auto insurance premiums were up approximately 5 percent on an annualized basis in the nine months, according to consumer price index data. Home insurance prices were up about 2.5 to 3 percent.

Lingering economic weakness cut into the demand for most types of insurance during the first half of 2010, with some increases in demand becoming more noticeable in the second half of the year. Lines such as workers compensation have benefited from the fact that the economy added 1.435 million private sector workers in 2010, adding tens of billions of dollars in payroll, which is the exposure base for this large and compulsory line of coverage. The unemployment rate declined from its 2010 peak of 9.9 percent in April to 9.4 percent in December. More than a half million additional private sector jobs were created during the first quarter of 2011, which bodes well for workers compensation payroll exposures, as the unemployment rates continued to fall to 8.8 percent in March.

Over the past three years the weak economy has had a disproportionately large impact on commercial insurers due to rising unemployment (slicing payrolls and eroding the exposure base for workers compensation premiums), reduced construction and manufacturing activity, a surge in business bankruptcies and weakness in new business formation and expansions. The latter is in part due to lingering problems in credit markets and at financial institutions servicing small and medium sized businesses. These so-called ?middle-market? customers are essential to any recovery in commercial insurance exposure and are core to the operating model of many commercial insurers.

There are some early signs of recovery in property/casualty insurance exposures:

- **New Housing Starts:** Bottomed out at 550,000 units in 2009, down 72 percent from 2.07 million units in 2007. The drop affected home insurers and insurers with books of business serving the construction, contracting and home supply industries. The recovery in housing will be painfully slow. New housing starts rose in 2010 but to a still depressed level of 590,000 units. Starts are expected to rise to 660,000 in 2011 and 860,000 in 2012, but it is highly likely that these estimates will be revised downward.
- **New Car/Light Truck Sales:** Fell to 10.3 million vehicles in 2009, down 39 percent from 16.9 million vehicles in 2005, but rebounded to 11.6 million units in 2010. The current forecast is for new car/truck sales to rise to 13.2 million vehicles in 2011 and 14.0 million in 2012. Surging gasoline

prices could impact sales adversely if high prices at the pump persist.

- **Employment/Underemployment:** Unemployment peaked at 10.1 percent in October 2009 but remained stubbornly high throughout 2010?averaging 9.6 percent during the year. That being said, the economy finally began to add jobs for the first time in more than two years. During 2010 private sector employers added 1.435 million jobs. This means that workers compensation insurers are already seeing some benefit from the economic recovery. High unemployment, of course, saps payrolls, the exposure base for workers compensation. Underemployment is also a problem. Many people who would like to work full time are working part time. Adding those individuals to the unemployed plus so-called ?discouraged workers? (people who have looked for work so long they have stopped searching) the proportion averaged 16.8 percent of the potential labor force in 2010. In other words, nearly one in six workers was either unemployed or underemployed last year, compared to about one in 12 in the months before the recession began in 2007. All told, workers compensation insurers should continue to see a modest and possibly accelerating recovery in payroll exposure in 2011.
- **Industrial Production and Capacity Utilization:** ***Industrial production increased by 5.2 percent during the third quarter of 2010, on the heels of a pair of 7.1 percent gains the first and second quarters.*** Industrial production had plunged by as much as 17.6 percent in the midst of the financial crisis during the first quarter of 2009. Capacity utilization?at 76.3 percent in February 2011 (latest available)?is now well above its recession low of 68.2 percent recorded in June 2009 but remains well below the long-run 80.9 percent average from 1972 to 2008). Weakness in both of these metrics indicates less demand for insurance needed in the production process as well on the goods produced. Nevertheless, continued improvements in these figures should help to increase demand for many types of insurance.

Investment Performance: Strong Gains Continue

Total investment gains (which include investment income plus realized capital gains and losses) rose sharply in 2010, up $13.7 billion, or 35.2 percent, to $52.9 billion from $39.2 billion in 2009.

Breaking down the individual components of last year?s investment gain is revealing. Net investment income (primarily interest earned on the industry?s bond portfolio plus stock dividends) was basically flat, increasingly slightly to $47.2 billion from $47.1 billion in 2009. However, bullish stock market conditions through much of 2010 helped propel realized capital gains, which totaled $5.7 billion last year compared to a realized capital *loss* of $7.9 billion in 2009. Falling interest rates into late 2010 helped push bond prices higher, providing insurers with additional opportunities to realize capital gains. Approximately two-thirds of the property/casualty insurance industry?s investment portfolio is invested in bonds. Stock market volatility remained a concern for insurers in 2010 but by year?s end the S&P 500 index was up 12.8 percent. Through April 15, 2011, the S&P 500 was up ***11.6 percent***?virtually assuring a strong performance for realized investment gains in early 2011.

Interest rates on the safest of assets plunged in late 2008 and remained low through 2009 and 2010, though longer-term yields began to creep up during the fourth quarter of last year. The Federal Reserve cut its key federal funds rate on multiple occasions in 2008. At the beginning of that year, the federal funds rate was 4.25 percent. On December 16, 2008 the Fed cut rates below 1.00 percent for the first time ever, targeting a range between zero and 0.25 percent, where they remained throughout 2009 and 2010 (and where they remain as of this writing).

Interest rates in 2010 were also held down by subdued inflationary expectations and concerns through much of the year about the durability of the current economic recovery. Indeed, fears of a double-dip recession were foremost on investors? minds well into the third quarter. The combination of persistently high unemployment and low factory utilization means that there is plenty of slack in the system to absorb future growth without sparking inflation. One of the best measures of inflationary expectations is interest rates on intermediate and long-dated Treasury securities. The average yield on 10-year U.S. Treasury securities in 2010 was just 3.22 (4 basis points *lower* than in 2009) while the average yield on 30-year bonds was 4.25 percent (compared to 4.08 in 2009). For interest rates to be so low suggests little concern on the part of investors about inflation. Indeed, investors and the Federal Reserve through much of 2010 were more concerned about the possibility of *deflation*. Consequently, the Fed embarked upon a ?quantitative easing?program in an effort to keep longer term interest rates down, reduce borrowing costs and thereby stimulate the economy. Although there are now mounting concerns about inflation, the Fed?s quantitative easing program is expected to run through June 2011.

What Does Reduced Investment Income Mean for P/C Insurers?

The combination of low interest rates and smaller dividends means that P/C insurers are earning less from their investment portfolios than in the past. The implications are both profound and immediate because there can be no guarantee of a reversal in these trends. The only guarantee is that insurers will continue to face losses from claims that are as large as or larger than in the past. The bottom line, therefore, is that insurers will need to earn more in premium through higher rates to compensate for lower investment earnings. All else being equal, robust investment returns allow insurers to charge less than they would otherwise need to charge. Investment earnings are factored into rate need expectations. Buyers of insurance and regulators will have to accept the fact that insurers will need to charge higher rates in order to meet expected losses that are little changed despite the weak economy and depressed investment environment. A major hurricane striking the coast of Florida in 2010 would cost no less, and would probably cost more, than the same storm before the crisis. In the future, more of those losses will necessarily be paid through premiums and less from investment earnings.

One concrete way to see that disciplined underwriting and pricing will be important in the years ahead comes from an historical examination of periods of similar underwriting performance relative to profitability. The industry?s 100.8 combined ratio (excluding mortgage and financial guaranty insurers) in 2010 resulted in a 7.5 percent return on average surplus. In 2005, however, the nearly identical (full-year) 101 combined ratio produced a 9.6 percent rate of return. Back in 1979, the industry?s combined ratio was 100.6 while the overall return was 15.9 percent. Given that the underwriting performance in each of these years was virtually identical, what explains the radically different profitability figures? The answer is the investment environment and the prevailing level of interest rates in particular. Lower interest rates, which are becoming embedded in insurer portfolios as higher yield bonds mature and are replaced with lower yielding securities, make it extremely difficult, if not impossible, for most insurers to earn a risk appropriate rate of return without improving their underwriting performance through increased rates, lower claims cost, lower expenses or some combination of the three.

Underwriting Performance and Catastrophe Losses: Discipline, Good Fortune or Both?

Profits in 2010, although an improvement over 2009, were adversely impacted by an underwriting loss of $10.4 billion after policyholder dividends?the largest since 2008?on a combined ratio of 102.4 (including mortgage and financial guaranty insurers). The period?s underwriting performance was marginally worse than the 101.0 recorded in 2009, which was associated with an underwriting loss of $3.0 billion.

Weakness in commercial lines was in 2010 and remains today the greatest challenge to industry underwriting performance. Catastrophe losses?at $13.8 billion?were up $3.2 billion from $10.6 billion in 2009, according to ISO?s PCS unit. Given the very active 2010 hurricane season, insurers were extremely fortunate that no major storms made landfall in the United States. It should be noted that the Deepwater Horizon explosion and oil spill in the Gulf of Mexico in April 2010 is estimated to have cost insurers between $3 billion and $4 billion. The majority of these losses, however, will be borne by foreign insurers and reinsurers and therefore have little impact on the results of the reported results of the U.S.

property/casualty insurance industry. Likewise, it should be noted that losses from the March 2011 earthquake and tsunami in Japan will have little impact U.S. property/casualty underwriting performance. As mentioned earlier, the vast majority of these losses will be borne by Japanese domestic insurers, the Japanese government and global property catastrophe reinsurers, most of which are domiciled outside the United States.

Mortgage and Financial Guaranty Insurers Continue to Distort Results

It is important to bear in mind that the full-year 2010 results remain somewhat skewed by the disastrous performance of many mortgage and financial guaranty insurers. This segment accounted for just 1.4 percent of industry premiums written in 2010 but ran a combined ratio of 194.4 for the year, up from 191.8 for 2009. According to ISO, exclusion of the mortgage and financial guaranty segment knocks 1.6 points off the combined ratio, leaving it at 100.8 in 2010, up from 99.3 in 2009. Because the mortgage and financial guaranty segment so profoundly distorted the overall industry results, the combined ratio of 100.8 (rather than 102.4) is probably the best to use for comparative purposes as most insurers are not involved in this specialized business. ISO also reports that exclusion of mortgage and financial guaranty insurers increases the industry?s net income by $4.2 billion to $39.0 billion in 2010 and the associated average return on surplus from 6.5 percent to 7.5 percent.

SUMMARY

The property/casualty insurance industry?s performance continued to improve in 2010. Increased profitability and rising capacity during the year were primarily attributable to improved investment market conditions, stable underwriting results and a lack of megacatastrophes. At the same time, persistent soft market conditions and lingering but receding effects of the deep recession continued to impact growth. While insurers remain cautious about the economy and financial market conditions, there is guarded optimism that both will remain stable, if not continue to improve, in 2011. Indeed, there it is now quite likely that the P/C insurance industry will show two consecutive years of positive premium growth (2010 and 2011) for the first since 2005 and 2006.

Fundamentally, the property/casualty insurance industry remains quite strong financially, with capital adequacy ratios remaining high relative to long-term historical averages.

A detailed industry income statement for 2010 follows.

Full-Year 2010 Financial Results

($ billions)

Net Earned Premiums	$420.50
Incurred Losses	309.1
(Including loss adjustment expenses)	
Expenses	119.5
Policyholder Dividends	2.3
Net Underwriting Gain (Loss)	-10.4
Investment Income	47.2
Other Items	1.0
Pre-Tax Operating Gain	37.8
Realized Capital Gains (Losses)	5.7
Pre-Tax Income	43.5
Taxes	8.9
Net After-Tax Income	$34.7
Surplus (End of Period)	$556.9
Combined Ratio	102.4**

*Figures may not add to totals due to rounding. Calculations in text based on unrounded figures.
**Includes mortgage and financial guaranty insurers. Excluding these insurers the combined ratio was 100.8.

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