2011 - First Quarter Results

June 22, 2011

In a quarter marred by megacastastrophes around the globe, the U.S. property/casualty (P/C) insurance industry reported an annualized statutory rate of return on average surplus of 5.6 percent during the first quarter of 2011, down from 6.8 percent from the year earlier quarter and 6.5 percent for all of 2010. Profitability receded despite a $1 billion improvement in investment earnings during the quarter and a surprising 3.5 percent surge in net premiums written, the strongest quarterly growth since the fourth quarter of 2006. Overall net income after taxes (profits) for the quarter decreased by $1.1 billion to $7.8 billion from $8.9 billion in first quarter 2010. It is important to note that the decline in profitability had nothing to do with the recent devastating tornadoes impacting the Midwest and Southeast this spring, virtually all of which occurred during the second quarter. However, some $2 billion to $5 billion in loss and loss adjustment expense?almost certainly a record?did wind up on the books of U.S. insurers that cover, reinsure or otherwise assume risk from catastrophic events abroad, including the March 11 Japanese earthquake and tsunami, the February 22 New Zealand earthquake, and severe flooding in Australia in January and February. In the U.S., insured catastrophe losses totaled $1.9 billion during the first quarter. However, this figure will be dwarfed by some $15 billion or more in insured catastrophes for the second quarter, according to recent PCS estimates.

In one of the most positive developments for the industry since end of the financial crisis, premium growth now appears to be on a sustained upward trajectory, rising for four consecutive quarters. This sustained growth confirms that the era of mass exposure destruction in the property/casualty insurance industry is now over, with demand for insurance having stabilized and, in fact, growing in the aftermath of the ?Great Recession.? Underwriting losses, however, continued their sequential deterioration, with the combined ratio for the quarter rising to 102.2, after excluding mortgage and financial guaranty insurers (103.3 including them), compared to 99.0 a year earlier and 100.8 for full-year 2010. Ironically, premium starved insurers potentially find themselves with their best growth opportunities in five years but in an underwriting environment that is potentially worse than any experienced in nearly ten years. This means that insurers will have to underwrite cautiously with the risk assumed being carefully matched with the premium charged. If they fail to do so, they risk simply writing more business at a greater loss.

The industry results were released by ISO and the Property Casualty Insurers Association of America (PCI).

Policyholders? Surplus (Capital/Capacity) Hits a New Record: At Cyclical Peak?

Policyholders? surplus hit a new record as of March 31, 2011?the fourth such record in the past five quarters?rising by $7.8 billion or 1.4 percent to $564.7 billion from $556.9 billion at year-end 2010. It is all but assured that first quarter 2011 policyholder surplus represents a peak in the industry?s capital position. High catastrophe losses and poor equity market performance in the second quarter, combined with a likely continued deterioration in non-catastrophe underwriting performance virtually guarantee a drop in policyholder surplus as of June 30, 2011. The only question is whether that drop is a singular and temporary occurrence caused chiefly by surging catastrophe losses, or whether it is the beginning of a sequence of declines whereby excess capital is expunged from property/casualty insurer balance sheets as core (non-cat) underwriting losses mount and the ability to release prior-year reserves into the earnings stream diminishes. Historically, the latter has presaged a firming of markets whereas the former would suggest that soft market conditions could potentially linger into and possibly through 2012.

The record $564.7 billion in surplus as of March 31, 2011, now exceeds the pre-crisis high of $521.8 billion set during the third quarter of 2007 by 8.2 percent?a difference of $42.9 billion. Irrespective of the prospect of shrinkage in policyholders? surplus in 2011 following a first-quarter peak, the bottom line is that the industry is and will remain extremely well capitalized and financially prepared to pay very large scale losses, as necessary. One commonly used measure of capital adequacy, the ratio of net premiums written to surplus, currently stands at 0.75, its strongest level in modern history.

THE BOTTOM LINE RECOVERY: WHERE DO WE GO FROM HERE?

Profit Recovery: On Hiatus

Ever since plunging by 96 percent during the height of the global financial crisis, net income after taxes (profit) has rebounded fairly steadily and robustly as asset prices recovered, underlying claim frequency and severity trends remained relatively subdued and the release of prior year reserves bolstered the bottom line.

Approaching mid-2011, all three of these factors seem less capable of turbocharging the bottom line than in the recent past. Higher catastrophe losses add another headwind. As noted earlier, the P/C insurance industry reported an annualized statutory rate of return on average surplus of 5.6 percent during the first quarter of 2011 (6.5 percent after excluding mortgage and financial guaranty insurers), down from 6.8 percent from the year earlier quarter and 6.5 percent for all of 2010. Overall net income after taxes (profits) for the quarter slipped by $1.1 billion to $7.8 billion from $8.9 billion in first quarter 2010. For the industry to match its mid-year 2010 performance, return on average surplus would need to rise to 6.7 percent with net income of $16.5 billion?impossible given the second quarter?s financial market performance and surging catastrophe losses.

It is possible that property/casualty insurers could see a rebound in profits in the year?s second half, assuming predictions of an extremely active hurricane season this year turn out to be incorrect.

One factor that is capable of helping the bottom line on a sustained basis would be a firming in the pricing environment. While pricing in personal lines (which account for approximately half of all premiums written) has been trending positive for several years, commercial lines pricing remains in negative territory. According to the Council of Insurance Agents and Brokers (CIAB), the average rate change for commercial accounts renewing in the first quarter 2011 was negative 2.9 percent. This is substantially less negative than the 5.3 percent decline noted in the same quarter of 2010, but is negative nonetheless. In fact, the CIAB survey indicates that commercial renewals have been negative for an astonishing 29 consecutive quarters?dating all the way back to the first quarter of 2004. The overall commercial lines price level today is equivalent to where it was in late 2000. In other words, the cost of insurance sold to businesses today is basically the same as it was more than a decade ago.

Top Line Growth Surprises to the Upside

Net written premiums were up a surprising 3.5 percent in first quarter 2011. 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 the remainder of 2011 despite the recent ?soft patch? in economic growth.

While any growth is welcome after three years of decline (2007 ? 2009) and anemic growth (+0.9 percent) in 2010, the first quarter figures are undeniably a welcome respite and hopefully a positive omen. 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 recover?albeit somewhat fitfully and unevenly. 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 and the first half of 2011, the economy has so far avoided a much feared ?double-dip? recession. Although real GDP growth came in at a disappointing 1.8 percent during the first quarter, it is expected to rise to 2.6 percent in the second quarter and to just above 3 percent in the third and fourth quarters, according to Blue Chip Economic Indicators.

As discussed in the previous section, softness in commercial insurance pricing remains a persistent, though somewhat less severe, problem for insurers. Lingering economic weakness also remains a problem, restraining the demand for many types of insurance. However, lines such as workers compensation have benefited from the fact that the economy has added 2.3 million private sector workers from January 2010 through May 2011, adding tens of billions of dollars in payroll, which is the exposure base for this large and compulsory line of coverage.

Investment Performance: Gains Continue But For How Long?

Total investment gains (which include investment income plus realized capital gains and losses) were up by $0.9 billion (7.6 percent) in first quarter 2011 to $13.5 billion, from $12.6 billion in first-quarter 2010.

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) increased by $1 billion or 8.3 percent to $12.6 billion during the first quarter. As noted by ISO/PCI, bullish stock market conditions during the first three months of the year helped propel realized capital gains, which totaled $1.0 billion during the quarter, essentially unchanged from the year earlier period. Low interest rates have also helped keep bond prices high, 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 clearly remains a concern for insurers in 2011. The S&P 500 Index, which was up by 5.5 percent through March 31, was up just 1.1 percent through June 17.

SUMMARY

The property/casualty insurance industry turned in a mixed performance during the first quarter of 2011. Although profitability declined amid deteriorating underwriting performance, premium growth accelerated, investment earnings rose and policyholders? surplus achieved a new record high. Yet the outlook for the remainder of the year is a cautious one given exceedingly high second-quarter catastrophe losses, the prospect of high underwriting losses associated with non-cat losses and more uncertainty in the investment markets.

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 the first quarter of 2011 follows.

FIRST QUARTER 2011 FINANCIAL RESULTS*

($ Billions)

	$
Net Earned Premiums	$104.8
Incurred Losses (Including loss adjustment expenses)	78.5
Expenses	30.3
Policyholder Dividends	0.5
Net Underwriting Gain (Loss)	-4.5
Investment Income	12.6
Other Items	0.5
Pre-Tax Operating Gain	8.6
Realized Capital Gains (Losses)	1.0
Pre-Tax Income	9.6
Taxes	1.8
Net After-Tax Income	**$7.8**
Surplus (End of Period)	$564.7
Combined Ratio	103.3**

*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 102.2.

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