2013 - First Half Results

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Profitability in the property/casualty insurance industry rebounded sharply in the first half of 2013. The improvement was propelled chiefly by growth in premiums, a reduction in catastrophe losses and favorable prior year reserve development. The effect: the industry combined ratio fell to 97.9 in the first half of 2013 from 101.9 in the first half of 2012?leading to an underwriting profit of $2.3 billion?much needed in an era of persistent, ultra-low interest rates. The industry?s bottom line benefited commensurately as overall net income after taxes (profits) surged by 42.4 percent during the half to $24.5 billion from $17.2 billion in the year earlier period, pushing the industry?s return on average surplus up to 8.2 percent, up from 6.1 percent in the first half of 2012 and well above the 5.9 percent and 3.5 percent returns recorded for full-year 2012 and 2011, respectively. Top line growth is also a consistent and meaningful contributor to improved profitability. Net written premiums were up 4.5 percent during the half, up from 3.7 percent gain recorded in first half of 2012 and 4.7 percent in the second quarter, marking the thirteenth consecutive quarter of growth and the longest continuous period of growth in nearly a decade. Persistently low interest rates, of course, remain a challenge for the industry, with net investment income during the half slipping by $0.7 billion or 2.8 percent compared to the first half of 2012. Overall industry capacity rose to a record $614.0 billion as of June 30, 2013?up $34.7 billion, or 6.0 percent, from $579.3 billion as of year-end 2012.

The industry results were released by ISO, a Verisk Analytics company, and the Property Casualty Insurers Association of America (PCI).

It is worth noting that the federal government shutdown that began on October 1 will have no impact on property/casualty insurer claims or sales operations. In addition, property/casualty insurers are well positioned to ride out increased financial market volatility attributable to the shutdown as well as the looming debt ceiling debate in mid-October.

Profitability Improves: Catastrophe Losses Less of Drag on Earnings

The strong first half of 2013 is a welcome departure from the heavily catastrophe impacted results of 2011 and 2012. As noted earlier, the P/C insurance industry reported an annualized statutory rate of return on average surplus of 8.2 percent during the first half of 2013 (8.5 percent after excluding mortgage and financial guaranty insurers), up from 6.1 percent in the year earlier period (6.3 percent after excluding mortgage and financial guaranty insurers).

A discussion of the key drivers of performance through the first six months of 2013 follows:

Catastrophe Losses and Underwriting Performance
While the past two years (2011 and 2012) ranked among the costliest on record for catastrophe losses, direct insured losses from catastrophes during the first half of 2013 fell by $4.7 billion to $9.7 billion from $14.4 billion in the year earlier period, providing a meaningful lift to the industry?s bottom line. This year?s first-half catastrophe losses were close to the 10-year average for the first half of $9.2 billion, according to ISO?s PCS unit. The first half bore witness to a number of significant events, including the May 19 tornado in Moore, Oklahoma, and June wildfires in Colorado. Looking ahead, the third quarter of 2013 did not bring any major catastrophes. Historically, the third quarter is the most costly in terms of catastrophe losses. Hurricane activity remained subdued and far below expectations for an active season. Year-to-date tornado activity is also running far below long-run averages.

Favorable Reserve Development Strengthens
In addition to accelerating premium growth and lower catastrophe losses, favorable development of prior-year claims reserves totaled $8.5 billion in the first half of 2013, a material increase from $7.2 billion in the first half of 2012, according to ISO/PCI. Some of the reserve release is associated with lower than expected costs for Sandy claims, whereas much of the remaining sums released are associated with older events. Removing the effects of favorablereserve development results in a combined ratio of 98.5 for the half (versus 97.9 when the effects are included).

Combined Ratio Improves: Rare Underwriting Profit Recorded
The overall improvement in underwriting in the first half of 2013 was material and notable, with the industry?s combined ratio falling to 97.9 compared with 101.9 a year earlier (excluding mortgage and financial guaranty insurers the combined ratios for the same periods were 97.5 and 100.9, respectively).

Premium Growth: Top Line Growth Continues
Also contributing to improved underwriting performance was continued and steady premium growth, which rose 4.5 percent in the first half, nearly a percentage point above the 3.7 percent year earlier reading. Premium growth for full-year 2012 was up 4.3 percent. The first-half figure is composed of second quarter growth equal to 4.7 percent?a notable acceleration from 4.1 percent in the first quarter.

There are two principal drivers of growth in the property/casualty insurance industry: exposure growth and rate. Exposure growth?basically an increase the number and/or value of insurable interests (such as property and liability risks)?is being fueled primarily by the rebounding economy. Real (inflation adjusted) GDP in the second quarter accelerated to 2.5 percent from a first-quarter increase of just 1.1 percent, meaning that the property/casualty insurance industry likely benefited from a quickening in the overall economy in the April through June period.

Not all economic growth, however, leads directly to the formation of insurable exposures. Indeed, historically, the most important determinant in industry growth is rate activity. With auto, home and major commercial lines all trending positively, overall industry growth could outpace overall economic growth in 2013, as was the case in 2012.

Improving labor market conditions in 2013 are also critical to top line growth in the P/C insurance industry. Job growth benefits the entire economy, of course, but the associated expansion of payrolls benefits workers compensation insurers in particular. The United States economy added 1.206 million private sector jobs during the first half of 2013 (and 1.485 million through August). Combined with modest increases in the hourly earnings of employees, payrolls expanded at an average annual pace of $216.5 billion during the half relative to the first half of 2012, which will contribute to billions of dollars in new premiums written being earned by workers compensation insurers in 2013. Indeed, workers compensation, hit hard during the recession by a soft market and a precipitous drop in payrolls, has within the span of just a few years transformed itself from the fastest contracting major property/casualty line to the fastest growing, with direct premium growth in 2013 up by approximately 10 percent.

Strong growth in the workers compensation line, recovery in the residential construction sector and stronger car sales are just a few of the reasons why moderate growth is likely to continue through the remainder of 2013. Among carriers writing predominantly commercial lines, premiums written rose by 3.8 percent in the first half of 2013 (actually down from 5.3 percent in a year earlier) compared to 5.0 percent for insurers writing predominantly personal lines (up from 3.0 percent a year earlier) and 4.3 percent for those with a more balanced mix of business (up from 3.4 percent a year earlier).

Investment Performance: Low Interest Rates Had Expected Effect

Net investment gains (which consist of net investment income plus realized capital gains net of realized capital losses) rose by $1.5 billion, or 5.9 percent, to $27.1 billion in 2013?s first half, up from $25.6 billion in the first half of 2012.

Net investment income (primarily interest earned on the industry?s bond portfolio plus stock dividends) fell by 2.9 percent to $23.2 billion during the first half, versus $23.9 billion for the first half of 2012. Most of this income comes from the industry?s bond investments, which are mainly high quality corporates and municipals.

Corporate bond yields in the first half of 2013 were dismal. Moody?s AAA-rated seasoned bond index yields averaged between 3.73 percent and 3.89 percent from January through May, then jumped to average 4.27 percent in June. The January-May yields were roughly the same as in the first half of 2012.

The forces that affected interest rates in the first half of 2013 are the same ones that have been at work for the past few years: unused capacity (in both capital resources and high unemployment); slack in the economy and low near-term future expectations for the economy, leading to an unwillingness to lend/borrow and invest; and Federal Reserve actions to keep both short-term and longer-term interest rates low, all of which contributed to low inflation expectations. The small spike in June was a response to the Federal Reserve indicating that it is preparing to ?taper off? its program of buying long-maturity Treasury and agency bonds, depending on its view of the strength of the recovery, although the Fed was clear that it intends to keep short-term rates low for a substantial time even after the bond-buying program ends.

The other significant source of net investment income (besides bond yields) is stock dividends. Contrary to the experience of bond yields, dividends grew strongly. Although net dividends sank by 12.0 percent in the first quarter of 2013, they rose by 40.3 percent in the second quarter over the first quarter. For the first half of 2013, net dividends were 19.6 percent higher. But stock holdings (and therefore dividends) in general represent roughly only about one-sixth of the industry?s invested assets.

Only *realized* capital gains and losses affect insurer net income; unrealized capital gains and losses affect policyholders? surplus. Realized capital gains from the first half of 2013 were $3.9 billion, compared to $1.7 billion in the first half of 2012. As in the past, the downtrend in interest rates that constrains investment income pushed asset values of older bonds up, providing opportunities for capital gains on those bonds.

The broad stock market did quite well throughout the first half of 2013?the S&P 500 rose 10.0 percent in the first quarter and 2.4 percent in the second quarter?and so ended the first half of 2013 up roughly 12.6 percent for the year to date. The outlook for inflation remains quite tame, with the consumer price index expected to remain near 2.0 percent in 2013 and 2014. Consequently, in the near-term price increases are not expected to push interest rates and bond yields up.

Policyholders? Surplus (Capital/Capacity): New Record High Demonstrates Industry Strength and Resilience

Policyholders? surplus as of June 30, 2013 stood at $614.0 billion, up 6.0 percent or $34.7 billion from year-end 2012. Policyholders? surplus has generally continued to increase despite high catastrophe losses over the past few years. The fact that the industry was able to rapidly and fully recoup its losses to surplus even in the event of disasters like Sandy (which produced $18.8 billion in insured losses) is continued evidence of the P/C insurance industry?s remarkable resilience in the face of extreme adversity.

The bottom line is that the industry is, and will remain, extremely well capitalized and financially prepared to pay very large scale losses through the remainder of 2013 and beyond despite the fact that insurers have paid catastrophe losses in each of the past two years that are more than 40 percent higher than the $23.9 billion average over the past decade. One commonly used measure of capital adequacy, the ratio of net premiums written to surplus, currently stands at 0.77, close to its strongest level in modern history.

SUMMARY

The property/casualty insurance industry turned in a sharply improved performance in the first half of 2013 in terms of underwriting performance and overall return on average surplus (profitability). In addition, policyholders? surplus reached a new all-time record high. Although profitability surged amid lower catastrophe losses and strong prior-year reserve releases, overall investment gains were flat despite bullish stock market conditions, in large part due to historically low yields on fixed income securities pushing down investment income. Premium growth, while still modest, is now experiencing its longest sustained period of gains in a decade.

Fundamentally, the P/C 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 half of 2013 follows.

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