2013 - First Nine Months Results

December 23, 2013
Profitability in the property/casualty insurance industry rebounded sharply in the first nine months of 2013 putting the property/casualty insurance industry on a firm trajectory for what will assuredly be its best year in the post-crisis era. 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 95.8 in the first nine months of 2013 from 100.7 in the first nine months of 2012?leading to an underwriting profit of $10.5 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 54.7 percent through the first three quarters to $43.0 billion from $27.8 billion in the year earlier period, pushing the industry?s return on average surplus up to 9.5 percent, up from 6.5 percent in the first nine months 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 4.2 percent during the nine-month period, up from 4.1 percent gain recorded in the same period 2012, marking the fourteenth 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 first nine months slipping by $1.0 billion or 2.9 percent compared to the first nine months of 2012. Overall industry capacity rose to a record $624.4 billion as of September 30, 2013?up $45.1 billion, or 7.8 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).

Looking ahead, there is no question that 2013 fourth-quarter performance for the property/casualty insurance industry will be far superior to 2012. This is because last year?s fourth quarter includes the impacts of Hurricane Sandy, which resulted in $18.8 billion in insured catastrophe losses. No event in the fourth quarter of 2013 comes remotely close. In addition, property/casualty insurers will benefit from a strong performance in financial markets during the final quarter of the year.

Profitability Improves: Catastrophes Much Less of a Drag on Earnings

The strong first nine months 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 9.5 percent during the first nine months of 2013 (8.9 percent after excluding mortgage and financial guaranty insurers), up from 6.5 percent in the year earlier period (6.8 percent after excluding mortgage and financial guaranty insurers).

A discussion of the key drivers of performance through the first nine 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 through the first nine months of 2013 fell by $4.5 billion to $11.7 billion from $16.2 billion in the year earlier period, providing a meaningful lift to the industry?s

bottom line. This year?s nine-month catastrophe losses were far below the 10-year average for the first nine months of $20.0 billion, according to ISO?s PCS unit. The first three quarters of 2013 did bear witness to a number of significant events, including the May 19 tornado in Moore, Oklahoma, and wildfires in Colorado and several other states. However, the third quarter is historically the most costly in terms of catastrophe losses, primarily because August and September are peak months for tropical activity. But hurricane activity remained subdued in 2013 despite predictions for an active season. Tornado activity also ran far below long-run averages. According to PCS, through mid-December 2013, Oklahoma led the country with $2.0 billion in insured catastrophe losses, followed by $1.5 billion in Texas and $0.9 billion in Colorado.

Favorable Reserve Development Strengthens

In addition to accelerating premium growth and lower catastrophe losses, favorable development of prior-year claims reserves totaled $13.9 billion in the first nine months of 2013, a material increase from $8.4 billion in the first nine months of 2012, according to ISO/PCI. Reserve releases are generally associated with lower-than-expected costs for claims occurring in past accident years. While early in 2013 some of the reserve releases were associated with Hurricane Sandy claims, much of the growth in reserve releases is attributable to favorable development within the mortgage and financial guaranty (MF&G) lines, which had been hit hard during the financial crisis but have now largely recovered. Excluding these insurers, favorable reserve development totaled $10.8 billion through the first nine months of 2013 compared with $10.1 billion in the same period a year earlier. Removing the effects of favorablereserve development altogether results in a combined ratio of 97.4 for the nine-month period (versus 95.8 when the effects are included).

Combined Ratio Improves: Rare Underwriting Profit Assured for 2013

The overall improvement in underwriting in the first nine months of 2013 was material and notable, with the industry?s combined ratio falling to 95.8 compared with 100.7 a year earlier (excluding mortgage and financial guaranty insurers the combined ratios for the same periods were 96.6 and 99.8, respectively).

Premium Growth: Top Line Growth Continues

Also contributing to improved underwriting performance was continued and steady premium growth, which accelerated slightly to 4.2 percent in the first nine months from 4.1 percent for the year earlier reading. Premium growth for full-year 2012 was up 4.3 percent. The nine-month 2013 figure is composed of growth in the first, second and third quarters of 4.1 percent, 4.7 percent and 3.8 percent, respectively.

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 third quarter accelerated to 4.1 percent from 2.5 percent and 1.1 percent, respectively, in the first and second quarters of the year, meaning that the property/casualty insurance industry likely benefited from a quickening in the overall economy in the July through September 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 1.681 million private sector jobs during the first nine months of 2013 (and 2.091 million through November). Combined with modest increases in the hourly earnings of employees, payrolls expanded at an average annual pace of $259.0 billion through September 30 relative to the same period in 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. Workers compensation is likely to remain the fastest growing major property/casualty line of insurance in 2014 if economic growth and hiring accelerate as projected.

A pick up in the pace of economic activity, strong growth in the workers compensation line, recovery in the residential construction sector and strength in the manufacturing sector (including motor vehicles) are just a few of the reasons why moderate growth is likely to continue into 2014. Among carriers writing predominantly personal lines, premiums written accelerated by 5.3 percent through the first nine months, compared to 3.1 percent in the same period in 2012. Carriers writing predominantly commercial lines, however, experienced a deceleration as premium growth slowed to 2.9 percent through the first nine months, down by half from 5.8 percent in the year-earlier period. Insurers with a more balanced mix of business saw growth change only slightly, dipping to 4.0 percent, down from 4.2 percent a year earlier.

Investment Performance: Interest Rates Edge Upwards

For the first three quarters of 2013, net investment gains (which include net investment income plus realized capital gains and losses) rose by $2.1 billion (5.4 percent) to $40.4 billion, compared to $38.3 billion in the first three-quarters of 2012. The gain was powered by strength in realized capital gains, which more than doubled in the year?s first nine months.

Net Investment Income
Net investment income has basically two elements: interest payments from bonds and dividends from stock. The industry?s net investment income for the first three quarters of 2013 was $34.3 billion, compared to $35.4 billion in the first three quarters of 2012 (down 2.9 percent). Most of this income comes from the industry?s bond investments, which are mainly high quality corporates and municipals.

Corporate bond market yields in the first five months of 2013, as captured by Moody?s AAA-rated seasoned bond index, averaged 3.85 percent. The January-May yields were roughly the same as in the first half of 2012. In June yields jumped to average 4.27 percent with yield in the third quarter rising higher still, averaging 4.51 percent.

Although the U.S. economy is improving (with real GDP growth reaching 4.1 percent during the quarter), it still is beset by the same forces that have driven interest rates down for the past few years: unused capacity (in both capital resources and high unemployment) compounded by cautious consumer and business spending. The small spike in interest rates in June through September appears to have been a premature response to belief that the Federal Reserve would soon begin to ?taper off? its program of buying long-maturity Treasury and agency bonds. Importantly, however, in December the Fed did announce that it would begin a gradual tapering in January 2014. The announcement pushed intermediate and longer-term interest rates higher with the 10-year Treasury rising from an average 2.81 percent during the third quarter to nearly 3 percent immediately following the announcement. It is important to note that the Fed indicated that although it is allowing a normalization of longer-dated securities it intends to keep short-term interest rates low for an extended period of time.

The other significant source of net investment income (besides bond yields) is stock dividends. In the first three quarters of 2013 stock dividends were highly volatile. Net dividends paid by publicly traded companies in the U.S. during the first quarter of 2013 ran at a seasonally adjusted annual rate of $763.8 billion, in the second quarter at a $1,037.3 billion seasonally adjusted annual rate, and in 2013:Q3 at an $857.6 billion (preliminary estimate) annual rate. (For comparison, net dividends in 2012 were $770.3 billion. But stock holdings in general represent roughly only one-sixth of the industry?s invested assets.

Realized Capital Gains/Losses
Only realized capital gains and losses affect insurer net income; unrealized capital gains and losses affect policyholders? surplus. Realized capital gains from the first three quarters of 2013 were $6.0 billion, more than double the $2.9 billion recorded through the first three-quarters 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 three quarters of 2013?the S&P 500 rose 10.0 percent in the first quarter, 2.4 percent in the second quarter, and 5.6 percent in the third quarter?and so ended the first three quarters of 2013 up roughly 17.2 percent (and was up by more than 25 percent through December 20). The outlook for inflation remains quite tame, with the consumer price index and other measures of inflation expected to remain near 2.0 percent in both 2013 and 2014. Relatively high unemployment, remaining underutilized industrial capacity and generally weak consumer demand all continue to point to inflation (and, therefore, interest rates) remaining low for the foreseeable future.

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

Policyholders? surplus as of September 30, 2013 stood at $624.4 billion, up 7.8 percent or $45.1 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 in 2012) 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 in 2014 and beyond despite the fact that insurers paid catastrophe losses in 2011 and 2012 that were 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 0.78, close to its strongest level in modern history.

SUMMARY

The property/casualty insurance industry turned in a sharply improved performance in the first nine months 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. Profitability surged amid lower catastrophe losses and strong prior-year reserve releases?even investment gains were up as strength in realized capital gains overcame weakness in investment income, in large part due to historically low yields on fixed income securities. 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 nine months of 2013 follows.

NINE-MONTHS 2013 FINANCIAL RESULTS*

($ Billions)

Net Earned Premiums	$348.3
Incurred Losses	235.6
(Including loss adjustment expenses)	
Expenses	100.9
Policyholder Dividends	1.3
Net Underwriting Gain (Loss)	10.5
Investment Income	34.3
Other Items	0.9
Pre-Tax Operating Gain	45.7
Realized Capital Gains (Losses)	6
Pre-Tax Income	51.7
Taxes	8.7
Net After-Tax Income	$43.0
Surplus (End of Period)	$624.4
Combined Ratio	95.8**

*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 96.6.
