Deflation and Its Effect on the P-C Industry

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Deflation Basics

Definition

Deflation is

- A falling general price level
  - Note: this is different from
    - A fall in *the rate of increase* of the general price level;
      - This is called **disinflation**
    - A fall in the prices of some items or category of items
- For a prolonged period
- That is expected to continue indefinitely

Sources: http://www-personal.umich.edu/~alandear/glossary/d.html; http://en.wikipedia.org/wiki/Deflation; I.I.I.

Primary Causes and Major Bouts of Deflation

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Deflation results from some or all of

- A surge in productivity, generally from technological innovation
- A steep and prolonged drop in the money supply
- A steep and prolonged recession
  - Note: this is different from a fall in *the rate of increase* of the price level

Major US Bouts of Deflation

- 1920-22
- 1930-33

Sources: http://www-personal.umich.edu/~alandear/glossary/d.html; http://en.wikipedia.org/wiki/Deflation; I.I.I.

Broad Impact of Deflation

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Deflation causes…

- Consumers to delay buying things
  - They expect to buy those things later at lower prices
- A drop in the level of aggregate demand, from the delay in consumption
- A transfer of wealth
  - From borrowers and holders of illiquid assets
  - To savers/lenders and holders of liquid assets and currency
- A drop in the level of business investment
  - Following the drop in aggregate demand
  - Slack in capacity if the economy is in recession
  - Increased likelihood of lower profits or losses as selling prices drop below costs

Sources: http://en.wikipedia.org/wiki/Deflation; I.I.I.

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What History Teaches Us About Deflation and the P-C Industry

1920-1950: Inflation, Deflation and the P-C Industry's Combined Ratio*

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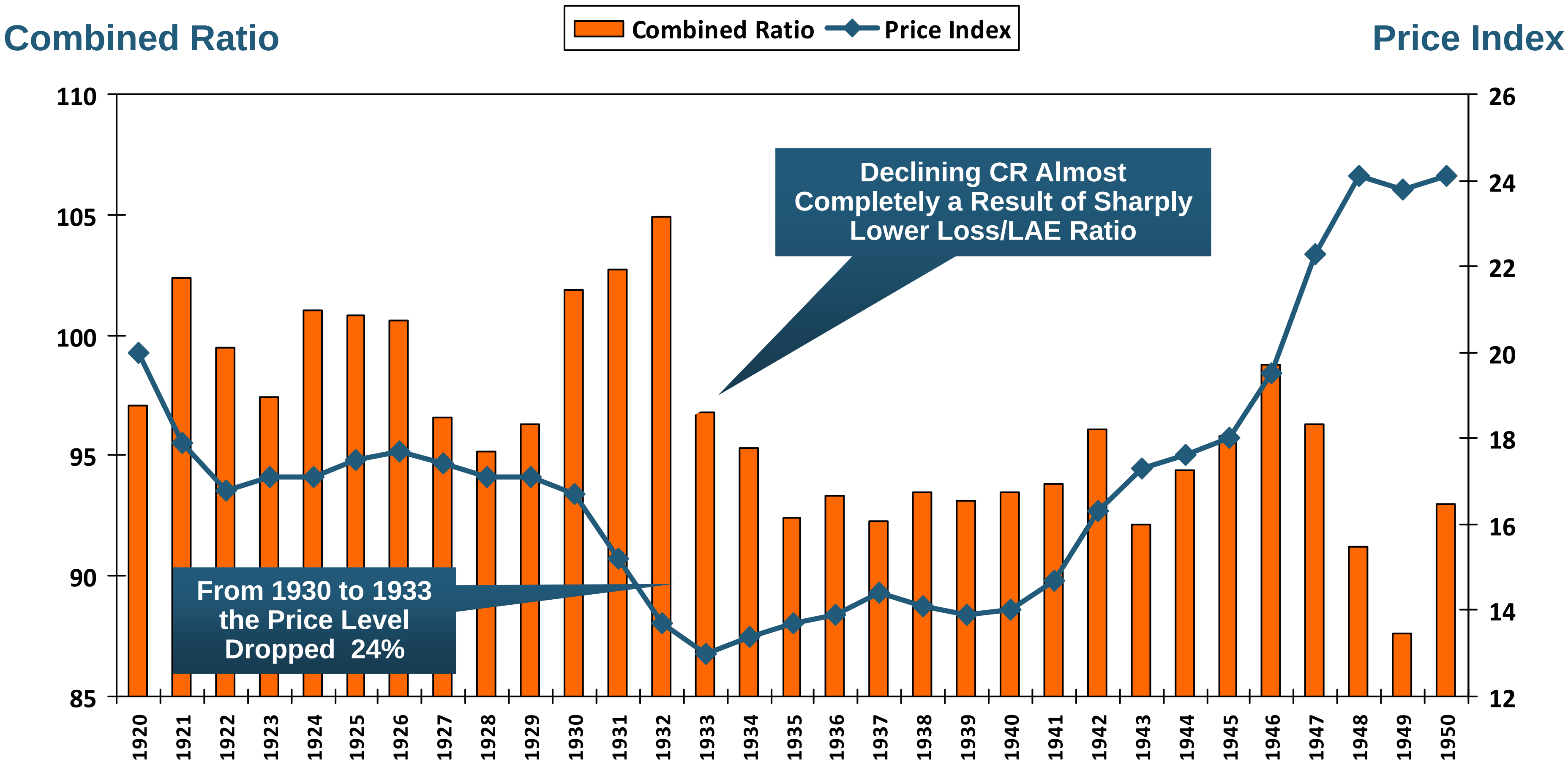

From Year-end 1929 Through 1932, the Industry's Combined Ratio Rose from 96.3 to 104.9 as the CPI Dropped. But from 1933 into the 1950s, the Combined Ratio Remained Below 100 Even as Prices Slowly Rose, Then Shot Up after WWII.

*From 1920-1934, stock companies only
Sources: Best's Aggregates & Averages; http://www.rateinflation.com/consumer-price-index/usa-historical-cpi.php?form=usacpi

1920-1950: Inflation, Deflation and P-C Industry Profitability*

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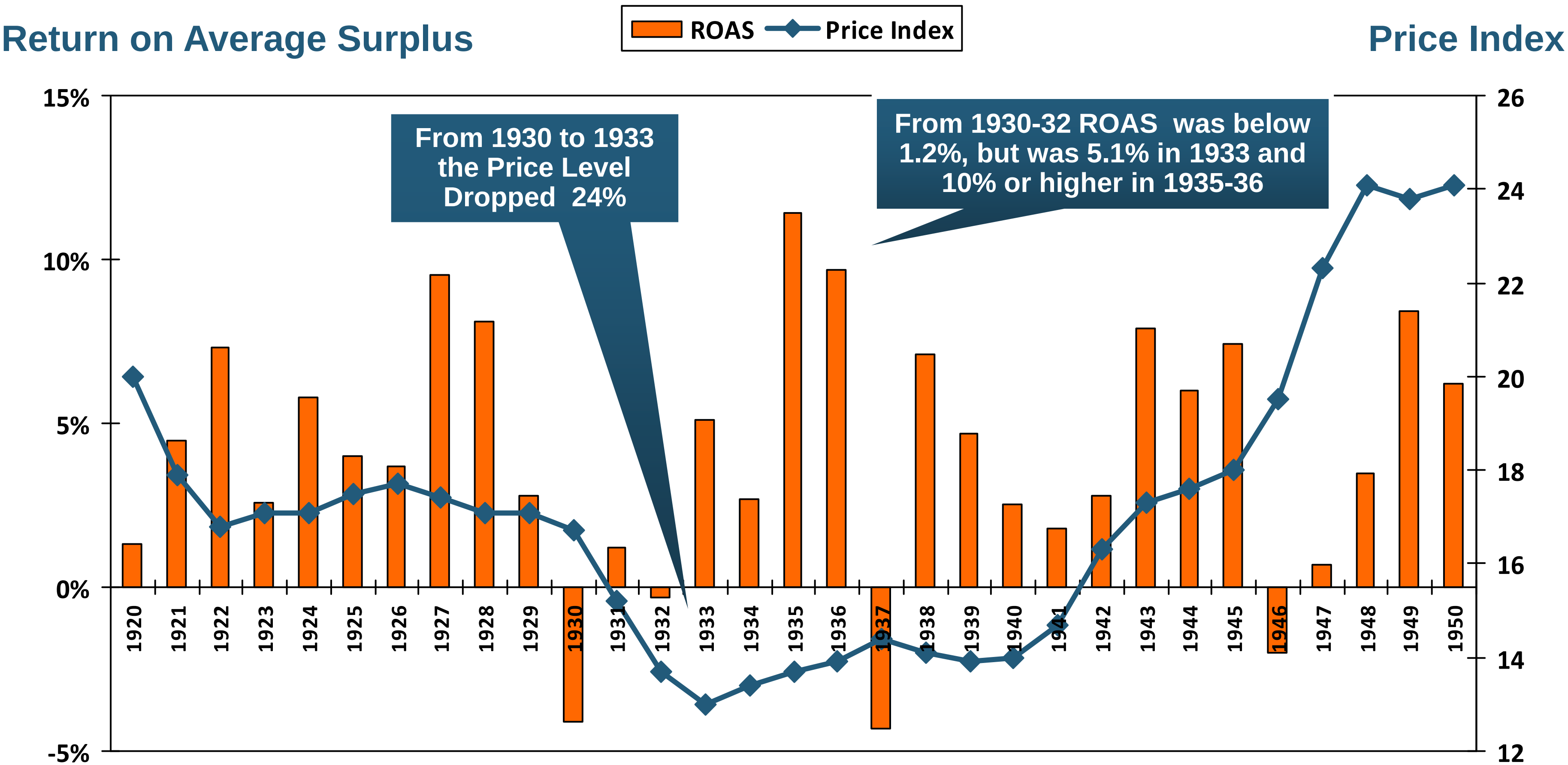

The Significant Deflation from 1930-32 Punished the Industry's ROAS, But an Improving Economy (and Slight Inflation) Helped Achieve ROAS in Double Digits in 1935-36.

*stock companies only

Sources: Best's Aggregates & Averages; I.I.I.; ; http://www.rateinflation.com/consumer-price-index/usa-historical-cpi.php?form=usacpi

Deflation's Effects on the P-C Insurance Industry

- **Lower Claim Severities**
  - Particularly for property claims, severity drops for many items that insurers pay for
- **Rate contingency margins increase**
  - At least until rate construction reflects persistently declining claims severity, margins will be higher than otherwise due to high trend assumptions arising from use of historical data
- **Reserve Releases?**
  - Reserves may develop beneficially to become "redundant"
- **Lower Claim Frequency as Fewer Claims Reach Deductible, Retention Levels**
- **Less Use of Reinsurance**
  - Lower costs ➔ risks burn through their retentions less quickly, reaching policy limits less quickly

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Thank you for your time and your attention!