2014 - First Half Results

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Overall net income after taxes (profits) in the property/casualty (P/C) insurance industry increased by $1.6 billion or 6.4 percent in the first half of 2014 to $26.0 billion from $24.4 billion in the year earlier period. Over the same period, overall industry capacity (as measured by policyholders' surplus) increased by $58.1 billion or 9.4 percent. However, because industry capacity (or capital) increased at a rate faster than that of profits, the industry overall rate of return (profitability) on that capital fell slightly in the first half of 2014 to 7.8 percent from 8.1 percent in the first half of 2013. The seeming paradox of rising profits but falling profitability was just one of several interesting crosscurrents impacting industry performance in the first half of 2014. Sharply higher catastrophe losses (up 24 percent) and lower investment income (down 1.4 percent), for example, were largely offset by a surge in realized capital gains (up 85.4 percent). Net written premium growth, on the other hand, was largely unchanged over the past year, rising 4.0 percent in the half of 2014 compared to 4.3 percent in the first half of 2013. The marginal change in profitability is in part a reflection of relatively stable underwriting performance. The industry's combined ratio rose 0.9 points to 98.9 during the first half of 2014 compared to 98.0 a year earlier. Maintaining combined ratios below 100 is absolutely essential in order for the industry to maintain reasonable levels of profitability in a still-challenging interest rate environment. While low interest rates are likely to continue to present a challenge well into 2015, a stronger economy presents the industry's best opportunity for growth, as the nation's real GDP growth surged by 4.6 percent in the second quarter of 2014.

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

Profitability Drivers: Winter, Spring Weather Took Their Toll; M&FG Reverses a Trend; Slight Dip in Taxes Help

The industry's performance in the first half of 2014 was positive but bore the effects of an extreme winter and several outbreaks of severe spring weather. As noted earlier, the P/C insurance industry reported an annualized statutory rate of return on average surplus of 7.8 percent in the first half of 2014, down from 8.1 percent in the year-earlier period.

Ever since the housing bubble burst in 2008, the Mortgage & Financial Guarantee sector of the P/C industry has disproportionately weighed down the overall industry's results, and because this line of business is written by only a few companies—some of them monoline carriers—it became common to report industry results in two ways, one including and one excluding M&FG data. In the first half of 2014, however, the reverse occurred. The annualized rate of return for this sector for 2014's first half is estimated at 13.4 percent, compared to a *negative* 7.5 percent return for the sector for the first half of 2013. These results boosted the overall industry results reported above; excluding them from the P/C industry's results for the first half of 2014 results in a 7.7 percent annualized rate of return.

A discussion of the key drivers of the quarter's performance follows:

Catastrophe Losses

Some of the deterioration in underwriting performance in the first half of 2014 can be attributed to higher catastrophe losses relative to the year-earlier half. Although the insured damage from extreme cold and winter storms in early 2014 did not break the records set in the mid-1990s, 2014 will go down in history as one of the five costliest years on record for winter damage claims. Spring storms, including a number of severe hail and modest tornado and wildfire events in the drought impacted West added to the tally of claims, pushing total insured catastrophe losses through June 30 to $12.4 billion, up 24 percent from $10.0 in the first half of 2013, and up 21.6 percent from the 10-years average first-half total of $10.2 billion, according to ISO's PCS unit.

Reserve Releases

Reserve releases are generally associated with new estimates of expected costs for claims occurring in past accident years. Overall inflation continues to be remarkably low, likely contributing to these lower estimates, although prices for some items that comprise claims payouts have been increasing at higher rates. For the first half of 2014, the industry reported releases of prior-year claims reserves totaling $7.9 billion, down slightly from $8.3 billion in the first half of last year.

Combined Ratio: Underwriting Profits Continue

The industry's overall underwriting profit of $284 million on a combined ratio of 98.9 in the first half actually consisted of an underwriting loss of just over $2 billion in the second quarter and an underwriting gain just above $2.2 billion in the first quarter. In a long-term historical perspective, underwriting losses are the norm over the past several decades. Quarters with an underwriting profit have occurred only 21 times in the 114 calendar quarters—28 years plus two quarters—since ISO's quarterly data began.

Premium Growth: Top Line Growth Continues

Also contributing to positive underwriting performance was continued premium growth, which decelerated slightly to 4.0 percent in the first half of 2014 from 4.3 percent in the first half of 2013.

There are two principal drivers of premium growth in the property/casualty insurance industry: exposure growth and rate activity. Exposure growth—basically an increase in the number and/or value of insurable interests (such as property and liability risks)—is being fueled primarily by economic growth and development. Although real (inflation-adjusted) GDP in the first quarter of 2014 actually declined at an annual rate of -2.1 percent (in part due to the effects of the harsh winter, drawing down of inventories, and other one-time factors), economic growth snapped back in the second quarter, with real GDP expanding at a robust 4.6 percent annual clip. Growth in key areas of the economy such as new vehicle sales, multi-unit residential construction, and consistent employment and payroll growth are clearly benefitting the P/C insurance industry. For the remainder of 2014 and into 2015, the consensus forecasts call for real GDP growth to hold steady at about 3 percent.

The other important determinant in industry growth is rate activity. Rates tend to be driven by trends in claims costs, conditions in the reinsurance market, marketing and distribution costs, and investments in technology, among other factors. Although it's challenging to foresee the interplay of all of these and macroeconomic factors, it is certainly possible that overall industry growth in net written premiums could keep pace with overall economic growth in 2014.

Improving labor market conditions in 2014 will also affect 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 1.68 million nonfarm jobs in the first eight months of 2014; if that rate is sustained through the rest of the year, there will be over 2.5 million more workers than at the end of 2013. Combined with inflation-level increases in the hourly earnings of employees (as has been the case for the past few years), payrolls are expected to continue growing, resulting in billions of dollars in new premiums written being earned by workers compensation insurers in 2014. 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. Workers compensation is likely to remain the fastest growing major P/C line of insurance in 2014 if economic growth and hiring behave as projected.

Strong growth in the workers compensation line, continued growth in the residential construction sector, and strong new car sales are just a few of the reasons why moderate premium growth is likely to continue through 2014.

Investment Performance: Improvement but Interest Rates Remain Low

For the first half of 2014, net investment gains (which include net investment income plus realized capital gains and losses) rose by $3.0 billion (+11.0 percent) to $30.1 billion, compared to $27.1 billion in the first half of 2013. In measuring insurance company net investment gains, accounting rules recognize two components: (i) net investment income, and (ii) *realized* capital gains or losses. Unrealized capital gains or losses are not considered income and affect only surplus on the balance sheet.

Net Investment Income in 2014:1H

Net investment income itself has basically two elements—interest payments from bonds and dividends from stock. The industry's net investment income for the first half of 2014 was $23.0 billion, compared to $23.3 billion in the first half of 2013 (down 1.4 percent). Most of this income comes from the industry's bond investments, which are mainly high quality corporates and municipals. The drop in income mainly reflects the reinvestment of longer-term maturing bonds at lower prevailing interest rates than the previous investments paid.

Corporate bond market yields in the first half of 2014 were slightly higher than in the first half of 2013, but they were still low by historical standards. Moody's AAA-rated seasoned bond index yields averaged 4.49 percent in January 2014, then slowly receded to 4.16 percent in May before recovering to 4.25 percent in June. In contrast, yields in January-May 2013 held mainly in the 3.7 percent to 3.9 percent range, then "spiked" to 4.3 percent in June 2013. (The spike was a response to the Federal Reserve Board indicating that it was preparing to "taper off" its program of buying long-maturity Treasury and agency bonds; tapering began at the end of 2013.) And although the U.S. economy is slowly improving, the Fed has reiterated that it intends to keep both short-term and longer-term interest rates low for a substantial time even after the bond-buying program ends later in 2014.

The bond market is still beset by the same forces that have held interest rates down since the Great Recession ended (officially, in June 2009): unused capacity (in both capital resources and higher-than-normal unemployment); cautious consumer and business spending, low near-term future expectations for the economy; and Federal Reserve actions to keep both short-term and longer-term interest rates low, all of which contributed to low inflation expectations (and thus, low nominal bond yields).

The other significant source of net investment income (besides bond yields) is stock dividends. Seasonally adjusted, net dividends in 2014:Q1 fell by 9.0 percent (compared with 2013:Q4) and in 2014:Q2 were basically unchanged from 2014:Q1 (specifically, -0.1 percent). Stock holdings in general represent roughly only about one-sixth of the industry's invested assets.

Realized Capital Gains

Realized capital gains in 2014:1H were $7.2 billion. This is a relatively strong result, at least by recent historical standards. Realized capital gains in the first half of 2012 and 2013 were $1.7 billion and $3.9 billion, respectively.

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

Policyholders’ surplus as of June 30, 2014 stood at $671.6 billion—a new record and up $58.1 billion (+9.5 percent) from the year-earlier quarter. Policyholders’ surplus has generally continued to increase in recent years as industry profits rose and as assets held in the industry’s investment portfolio increased in value in the wake of the financial crisis and “Great Recession.” It is worth noting that surplus increased despite very high catastrophe losses in 2011 and 2012. 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. One commonly used measure of capital adequacy, the ratio of net premiums written to surplus, currently stands at 0.73, close to its strongest level in modern history.

SUMMARY

The property/casualty insurance industry turned in a profitable performance in the first half of 2014. In addition, policyholders’ surplus reached a new all-time record high. Despite an unusually costly winter and a number of costly springtime catastrophes, rising non-cat losses, and persistently low interest rates, the industry posted another profitable quarter aided by capital gains and reserve releases. 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 2014 follows.

FIRST HALF 2014 FINANCIAL RESULTS*

($ billions)

Net Earned Premiums	$237.80
Incurred Losses (Including loss adjustment expenses)	168.1
Expenses	68.5
Policyholder Dividends	0.9
Net Underwriting Gain (Loss)	0.3
Investment Income	23

Other Items	0.7
Pre-Tax Operating Gain	23.9
Realized Capital Gains (Losses)	7.2
Pre-Tax Income	31.1
Taxes	5.1
Net After-Tax Income	**$26.00**
Surplus (End of Period)	$671.60
Combined Ratio	98.9**

*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 99.0.

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