2019 - Commentary on first quarter financial results

Insurance Industry

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Overview

For the property/casualty (P/C) insurance industry, the first quarter of 2019 generally went well. Although there were some bumps in the road—claims rose somewhat faster than premiums—most measures of financial results (premiums, underwriting results, investments, surplus growth and profitability) were positive, and some even reached recent or historical peaks. The industry results were released by ISO, a Verisk Analytics company, and the American Property Casualty

Insurance Association (APCIA). A discussion of the key drivers of the quarter's performance follows.

Premiums

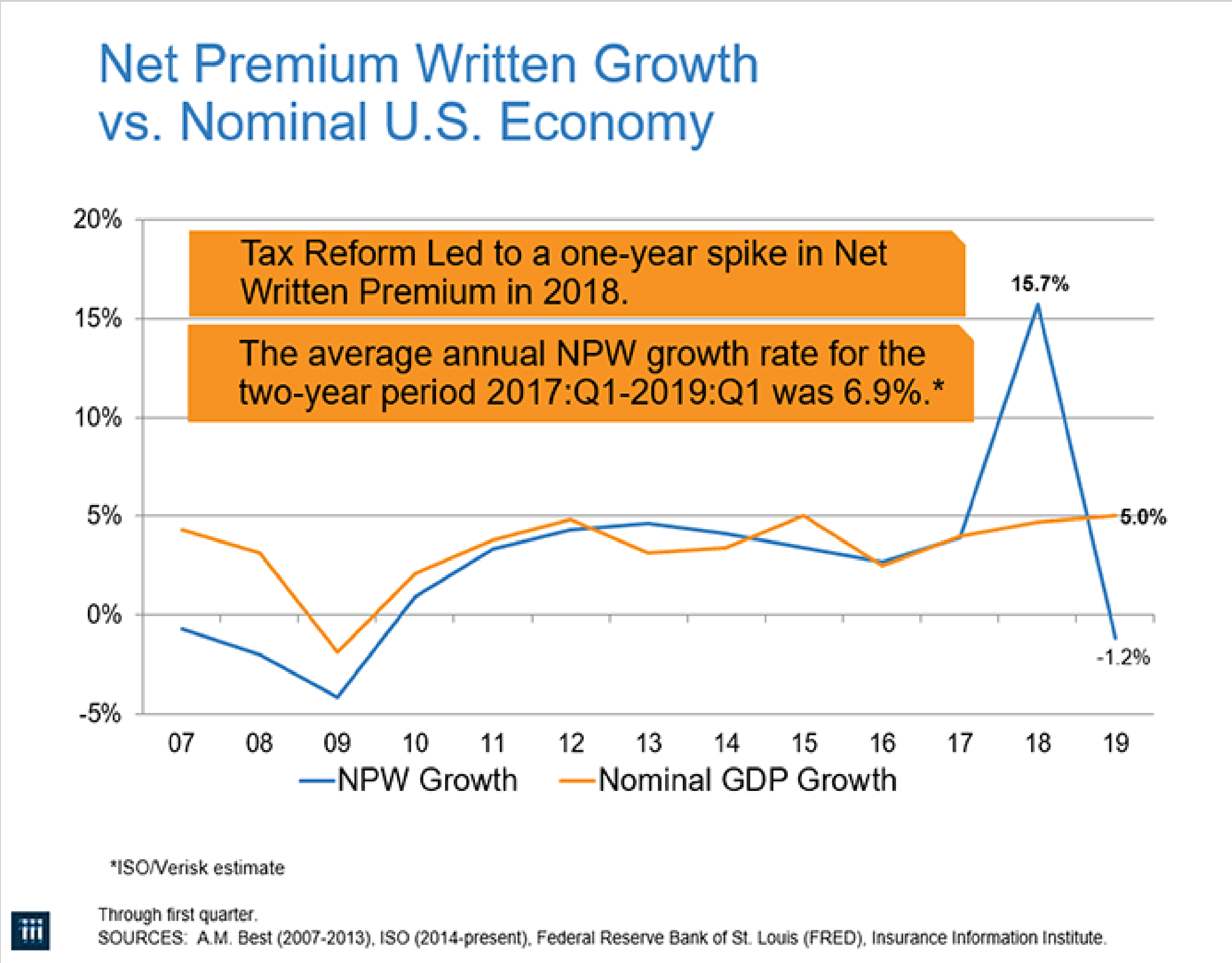
P/C insurers measure premium income in three ways, each of which gives a different insight into industry activity. *Direct premiums written* are the amounts that policyholders pay for insurance. This is a basic gauge of "retail" activity. *Net premiums written* are calculated by subtracting the amount insurers pay for reinsurance from direct premiums and are therefore a simple gauge of the net amount of risk that insurers plan to assume. *Net earned premiums* are derived by adjusting net premiums written to reflect the insurance that was provided. Direct premiums and net premiums written are forward-looking measures, while net earned premiums are a backward-looking concept.

Direct premiums. Most personal direct premiums and some commercial direct premiums are required by law or by terms of commerce (as homeowners insurance to protect a lender's mortgage). Therefore as a general rule, direct premiums follow the changes in the number of drivers, homes, and businesses—essentially a measure of growth of the U.S. economy. This is a loose relationship; it is more a year-by-year than a quarter-by-quarter correlation.

The U.S. economy in the first quarter of 2019 was surprisingly strong (+3.1 percent real growth at an annual rate), especially for this late in the business cycle and when compared with the three prior first quarters (+1.5 percent in 2016; +1.8 percent in 2017; and +2.2 percent in 2018). Nominal (i.e., not inflation-adjusted) GDP growth in 2019:Q1 was 5.1 percent. ISO estimates that direct premiums for all lines of P/C business grew at 4.3 percent in the first quarter of 2019, slower growth compared to 6.2 percent in the first quarter of 2018.

Net premiums written. As we (and others) have written before, one significant effect of the Tax Cuts and Jobs Act of 2017 for the P/C insurance industry was to boost calculated net premiums written by incentivizing insurers to reduce their reinsurance with non-U.S. reinsurers. Thus the 2018 first quarter net written premium growth was unusually high (+15.7 percent). In contrast, the first quarter 2019 net written premium change was -1.2 percent (*Figure 1*). But as an indicator of industry revenues, this negative net written premium growth rate is misleading; ISO suggests that if one takes the base for growth as the 2017:Q1 level, the average annual net written premium growth over the two years is 6.9 percent per year.

Fig. 1



Net premiums written growth for the major subsectors of the industry moved in the same direction, but to different degrees. For insurers writing predominantly personal lines, premiums rose by 8.2 percentage points (vs. a growth rate of 5.7 percent in the same quarter, prior year). For those writing mainly commercial lines (excluding mortgage and financial guaranty insurers), premiums spiked by 34.7 percentage points (vs. 2.5 percent growth in 2017:Q1). And those writing balanced books of business posted net premium written growth 4.8 percent higher than the year-earlier quarter.

Net premiums earned. Net premiums earned for insurance that was actually provided in 2019:Q1 were $149.6 billion, up 4.6 percent over 2018:Q1. Although this was a solid increase, it fell short of the 9.4 percent growth in 2018:Q1 over the first quarter of 2017. As noted above, these growth rates are a product of a one-time effect; to get a more indicative picture, note that the average annual growth in net premiums earned over the two years from 2017:Q1 to 2019:Q1 was 7.0 percent, according to ISO.

LLAE and Expenses

There are two main drivers of underwriting performance: losses and loss-adjustment expenses (LLAE), and other expenses (for marketing, underwriting and general administration).

LLAE in 2019:Q1 totaled $101.8 billion, net of reinsurance recoveries, up by 5.9 percent over the $96.2 billion in the first quarter of 2018. Commonly LLAE includes the effect of changes in reserves for future payment of previous claims that are still not finalized—that is, current-year effects of prior-year claims. In the first quarter of 2019 insurers released $4.5 billion from reserves previously set aside for prior claims but after reevaluation, are not needed for that purpose. As ISO/APCIA notes in its comments on first quarter results, if we exclude the reduction in loss reserves in the first quarter, "net LLAE grew $2.7 billion, or 2.6 percent, to $106.3 billion from $103.6 billion in first-quarter 2018." This adjusted percentage better indicates the latest quarterly growth in LLAE—lower than the growth in earned premiums.

To put 2019:Q1 reserve releases in recent historical perspective, note that for the first quarter of 2018, the industry reported releases of prior year claims reserves totaling $7.4 billion; $5.5 billion in 2017:Q1; and $4.4 billion in 2016:Q1. Reserve releases contribute to underwriting profit; reserve strengthening would subtract from it.

It can be useful to subdivide LLAE into claims that result from catastrophes and those that do not. In the first quarter of 2019, catastrophe-related claims were $4.8 billion, nearly the same as the $5.0 billion in 2018:Q1. The first quarter is not normally a high-catastrophe-loss period but in its commentary on the 2017:Q1 catastrophe claims ($7.7 billion), ISO/APCIA noted that except for the Northridge earthquake claims in 1994:Q1, for the prior 68 years (from 1950 through 2017), the only other time that catastrophe losses topped $4 billion in the first calendar quarter was 2016:Q1, at $5.0 billion. Now it seems like a new first-quarter CAT-loss trend is emerging, with four consecutive years of first-quarter catastrophe LLAE of $4.8 billion or more.

Setting rates at levels adequate to cover both catastrophe and non-cat losses is challenging enough but is more so now that catastrophe claims seem consistently to be a larger percentage of the total, given that catastrophe claim distributions are more skewed than are claims from non-catastrophe origins.

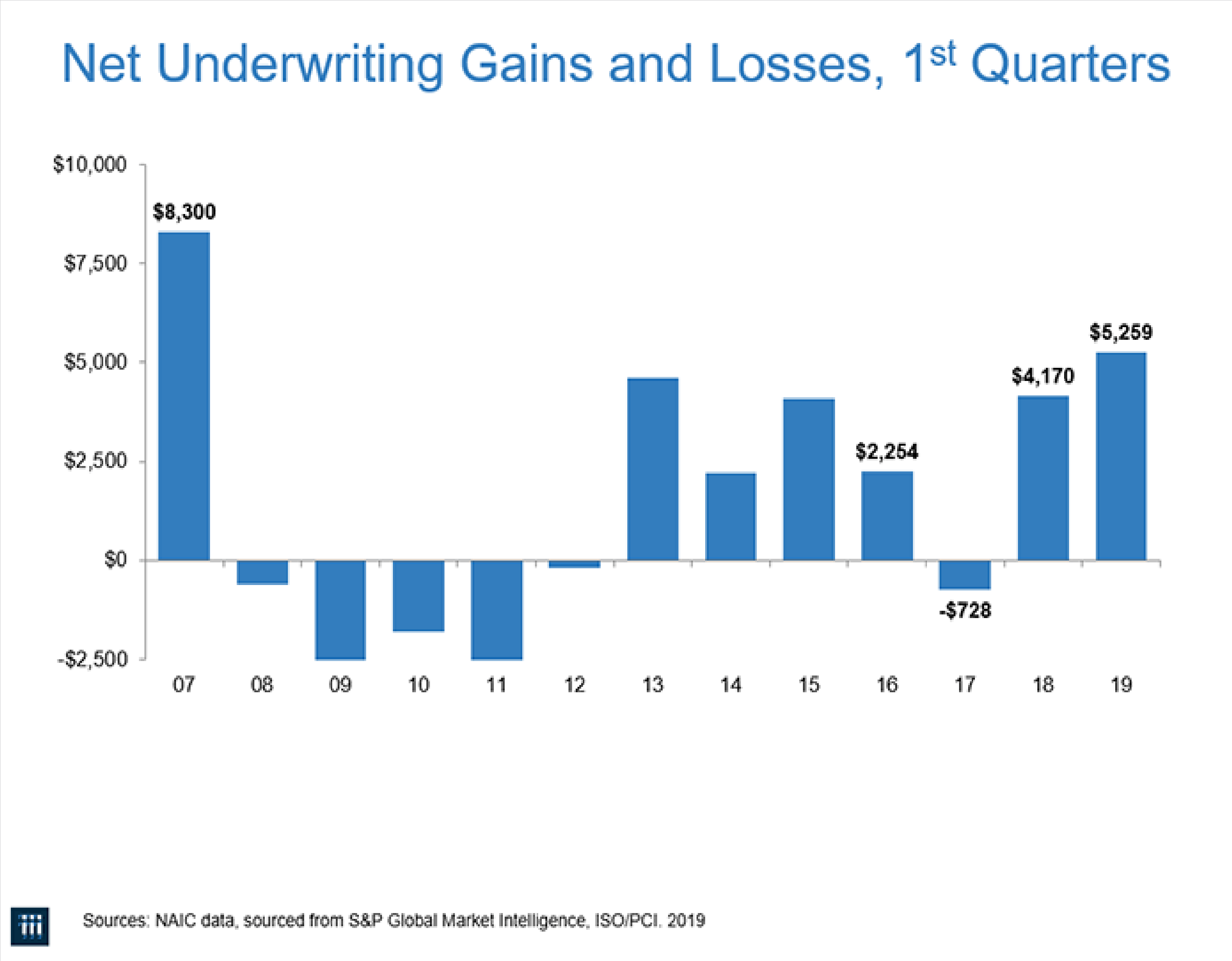
Net losses for non-cat claims increased by $5.8 billion, to $97.0 billion from $91.2 billion in 2018:Q1—rising by 6.4 percent. In the absence of other forces at work, one would expect non-cat LLAE to rise at the same rate as the extent of protection provided—as measured by net premiums earned. However as noted above, in 2019:Q1 net premiums earned rose by a smaller percentage: 4.6 percent, over the year-earlier quarter.

General expense growth was virtually flat compared to 2018:Q1. At $41.8 billion (compared to the year-earlier $42.0 billion), expenses were down by 0.5 percent. Obviously, as a smaller percentage of premiums, flat expenses help to raise profit.

Insurance Operations

Overall insurance operations performance (excluding investment performance) is the difference between net premiums earned and the sum of incurred losses, expenses and dividends to policyholders. The first quarter of 2019 produced a net underwriting gain of $5.3 billion on net premiums earned of $149.6 billion. This means that six out of the last seven years registered first quarter underwriting gains; however, this string followed four years of equally large first quarter underwriting losses (*Figure 2*).

Fig. 2



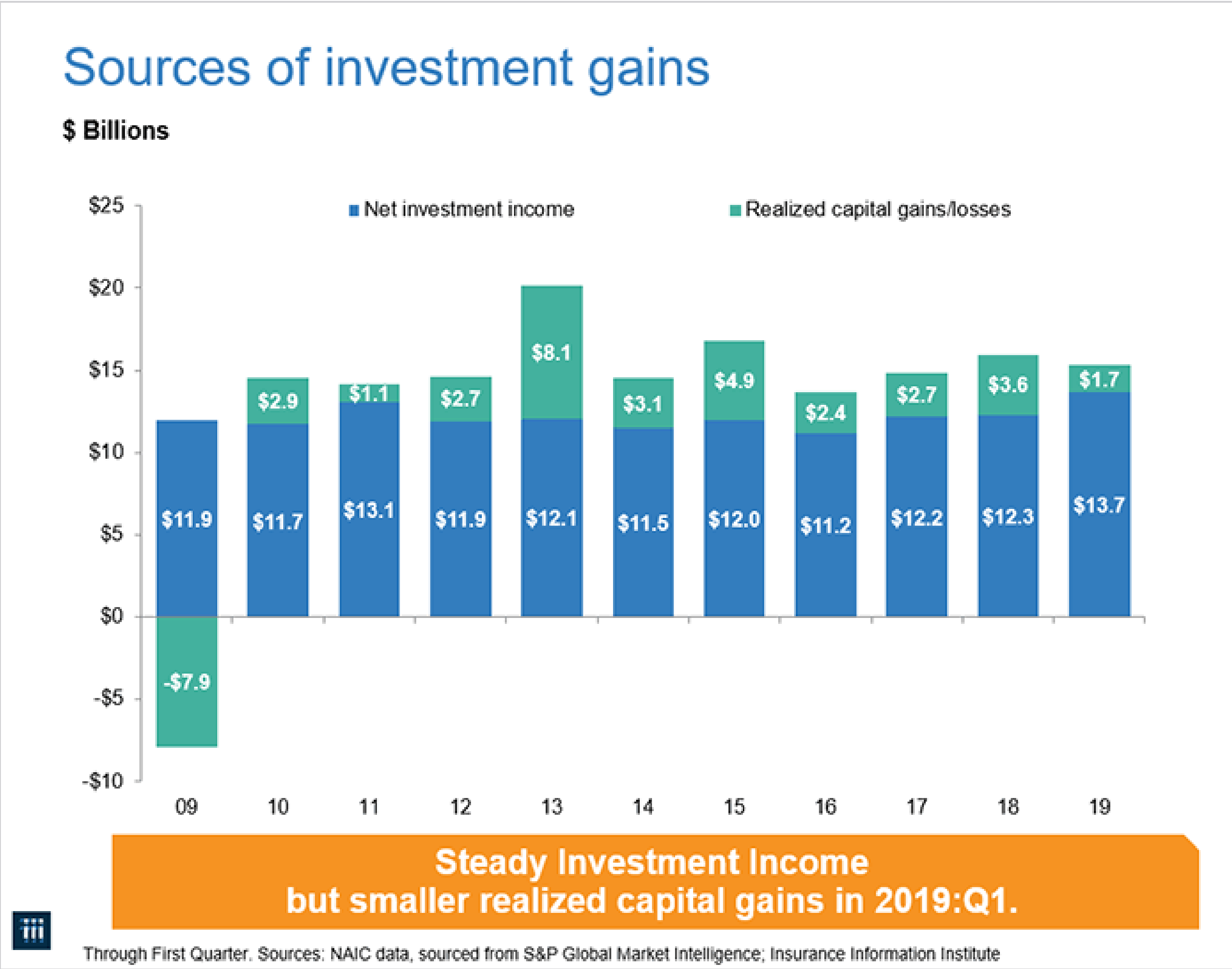
A widely used industry metric for gauging overall insurance operations is the combined ratio. This ratio is the sum of three percentages: losses and loss adjustment expenses as a percent of net earned premiums; policyholder dividends as a percent of net earned premiums; and other expenses as a percent of net premiums written. In 2019:Q1 this ratio was 95.6, deteriorating slightly from 94.6 in 2018:Q1. (A lower ratio means better performance.)

Combined ratios for the major subsectors of the industry moved in the same direction, but to different degrees. For insurers writing predominantly personal lines, the combined ratio deteriorated by 0.6 percentage points, to 94.8 percent. For those writing mainly commercial lines (excluding mortgage and financial guaranty insurers), the combined ratio dropped by 2.7 percentage points to 96.6. And those writing balanced books of business posted a combined ratio of 96.7, 1.3 percentage points worse than in the year-earlier quarter.

Investment performance

For the first quarter of 2019, net investment gains (which include net investment income plus realized capital gains and losses) were $14.7 billion, down $0.6 billion from 2018:Q1. 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. Recent patterns in these two components are shown in *Figure 3*.

Fig. 3



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 quarter of 2019 was $13.2 billion, up sharply—11.7 percent—from 2018:Q1 at $11.8 billion. Most of this income comes from the industry's bond investments, which are mainly high-quality corporate bonds and municipal bonds.

Corporate bond market yields in the first quarter of 2019, as captured by Moody's AAA-rated seasoned bond index, fell, averaging 3.83 percent for the quarter. Even so, these yields were slightly above comparable bond yields in the first quarter of 2018, which averaged 3.75 percent. The yields in 2019 continued to shave income off the industry's bond portfolio despite its growing size. This is because most bonds that are maturing now and being reinvested command lower yields than the bonds they replace. For example, 10-year AAA bonds bought in the first quarter of 2008 averaged 5.46 percent.

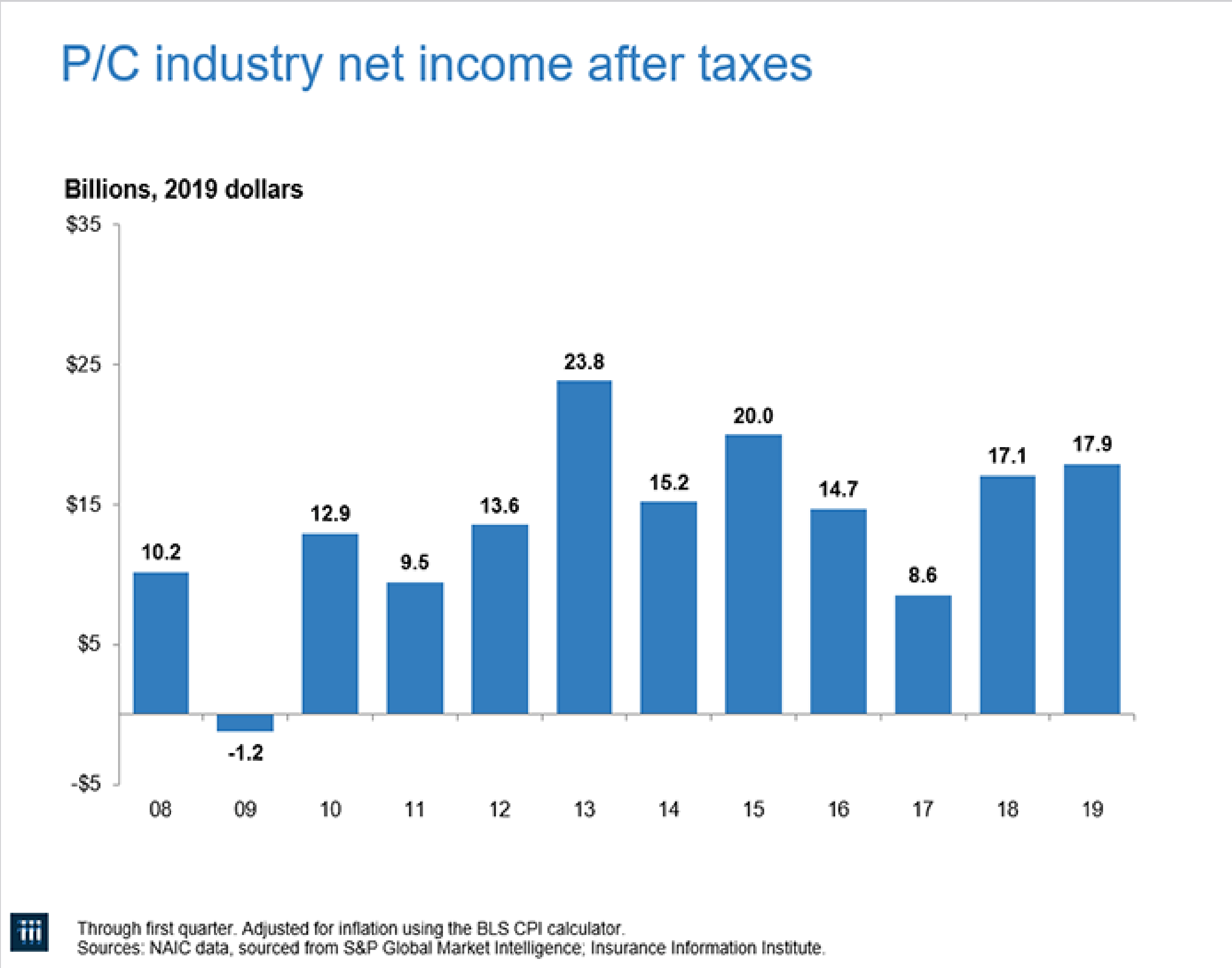
The other significant source of net investment income (besides bond yields) is stock dividends. Seasonally adjusted, net dividends in the first quarter of 2019 rose by 2.2 percent compared to the same quarter in 2018. Stock holdings in general represent roughly only about one-fifth of the industry's invested assets.

On the income statement, the other significant source of net investment gains is *realized* capital gains. The broad stock market, as measured by the S&P 500, gained 13.0 percent in the first quarter of 2019, providing extensive opportunity for cashing gains. Yet the industry realized only $1.6 billion in capital gains in 2019:Q1, compared to $3.6 billion in the first quarter of 2018.

Profits

As *Figure 4* shows, the P/C industry has posted positive net income after taxes in each first quarter for the past 10 years. First-quarter profits have varied from year to year, averaging $15.3 billion per year over that span. And as Figure 5 shows, the main source of that variation is underwriting gains or losses. Overall profit in 2019:Q1 was above average, thanks to the strongest first-quarter underwriting gains in the past decade.

Fig. 4


P/C industry net income after taxes
Billions, 2019 dollars
$35
$25
$15
$5
-$5
10.2
-1.2
12.9
9.5
13.6
23.8
15.2
20.0
14.7
8.6
17.1
17.9
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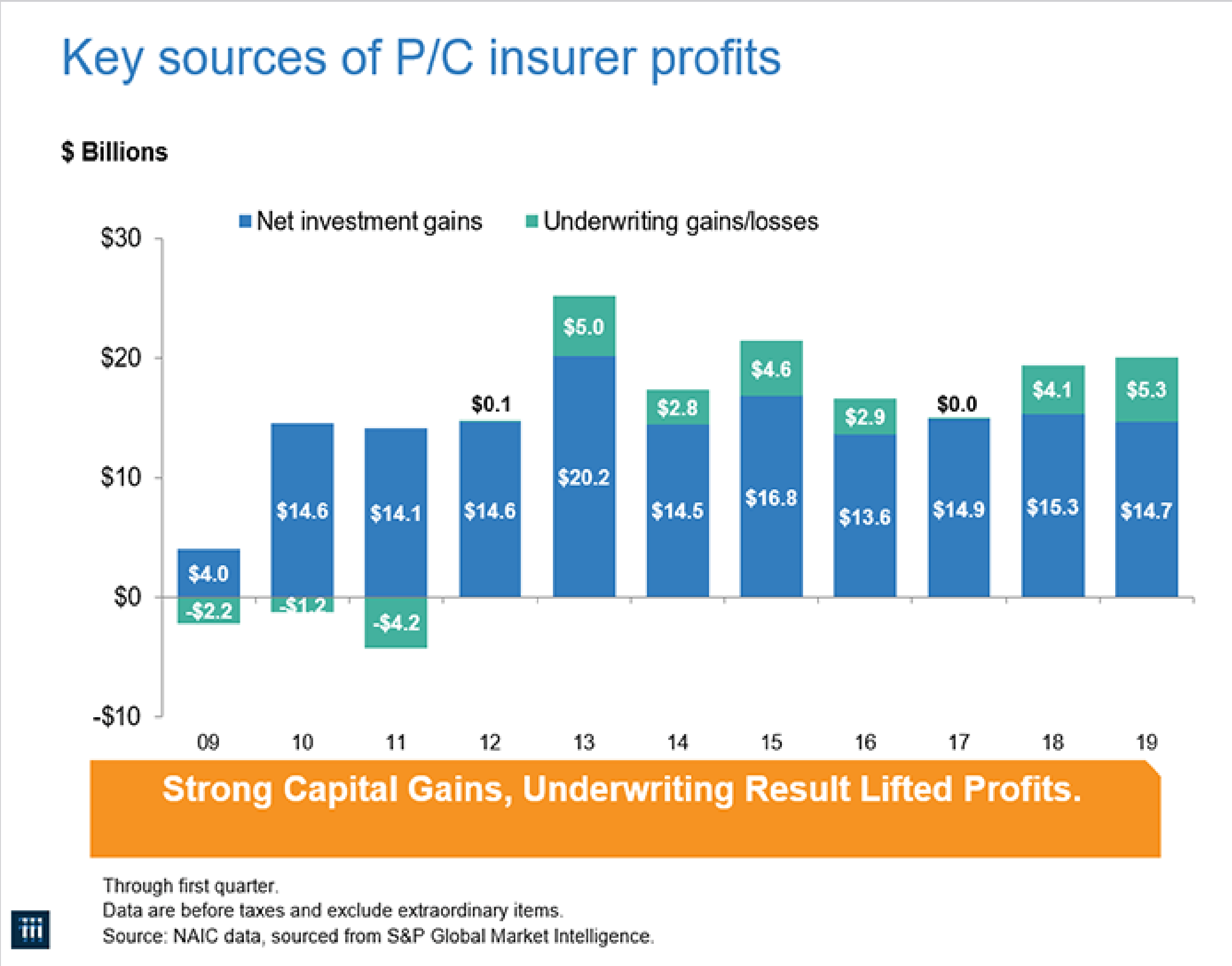
Through first quarter. Adjusted for inflation using the BLS CPI calculator.
Sources: NAIC data, sourced from S&P Global Market Intelligence; Insurance Information Institute.

Fig. 5



Policyholders' surplus (capital/capacity)

Policyholders' surplus is the excess of assets over liabilities—what in other industries is called "net worth." Both in dollar terms and in relation to insurance activity, it is a valuable indicator of the strength and capacity of the industry to handle the risk it has accepted. Policyholders' surplus as of March 31, 2019, rose to $779.5 billion, up $31.7 billion from the end of the first quarter of 2018. Most of the rise in surplus in the first quarter compared to year-end 2018 could be attributed to *unrealized* capital gains.

One commonly used measure of capital adequacy for insurers, the ratio of net premiums written to surplus, currently stands at 0.78, close to its strongest level in modern history (a lower ratio means greater capacity). The bottom line is that the industry is extremely well capitalized and financially prepared, if necessary, to pay very large scale losses in 2019 and beyond.

Summary

The P/C insurance industry turned in a profitable performance in the first quarter of 2019, buoyed by continued premium growth and good investment results. Policyholders' surplus hit a record level. 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 quarter of 2019 follows.

To view the full report from ISO and PCI, click here.

First quarter 2019 financial results*

($ billions)

Net Earned Premiums	$149.6
Incurred Losses (Including loss adjustment expenses)	101.8
Expenses	41.8
Policyholder Dividends	0.8
Net Underwriting Gain (Loss)	5.3
Net Investment Income	13.2
Other Items	-0.5
Pre-Tax Operating Gain	19.0
Realized Capital Gains (Losses)	1.6
Pre-Tax Income	20.6
Taxes	2.7
Net After-Tax Income	**$17.9**
Surplus (End of Period)	$779.5
Combined Ratio**	95.6

*Figures may not add to totals due to rounding. Calculations in text based on unrounded figures.
**Includes mortgage and financial guaranty insurers.

Back to top