2020 - Commentary on first half financial results

Insurance Industry

October 27, 2020

IN THIS ARTICLE

Highlights

The second quarter of 2020—which delivered the fastest descent into the steepest U.S. economic contraction since the Great Depression—was not nearly as tough for the financial performance of the property/casualty (P/C) insurance industry as we had expected, so the first half overall remains an attractive one.

- Compared to the first half of 2019, net premium written in the first half of 2020 rose (up 2.8 percent), and net premium earned did likewise (up 2.9 percent over 2019) while losses and loss adjustment expenses barely budged (up 0.8 percent).

- The industry posted net underwriting gains again ($4.6 billion), although down from the first half of 2019 ($5.4 billion).
- Net investment gains in 2020:1H ($24.1 billion) were significantly below 2019:1H ($31.2 billion) but still quite positive.
- Net income after taxes, while still strong ($24.3 billion), was down sharply from 2019:1H ($32.8 billion).
- Surplus—capacity to cover unexpected claims and expenses—rebounded from $771.9 billion at the end of the first quarter 2020, to $825.8 billion.

In most cases, trends in insurance premiums, claims and investments are generally associated with the economic activity that the insurance is bought to protect. That has not been the case in the second quarter of 2020 because the recession that started in March developed despite an otherwise-healthy economy a major part of which was suddenly shut down in order to cope with the spread of a massive severe public health threat, for which there was no prevention and little treatment.

Still, this analysis will track the economic developments, if only to indicate the path future P/C financial results might take as the economy moves to reopen in the second half of 2020.

Industry results for the second quarter and the first half of 2020 were released by ISO, a Verisk Analytics company, and the American Property Casualty Insurers Association (APCIA). A discussion of the key drivers of this first-half performance follows.

Underwriting performance

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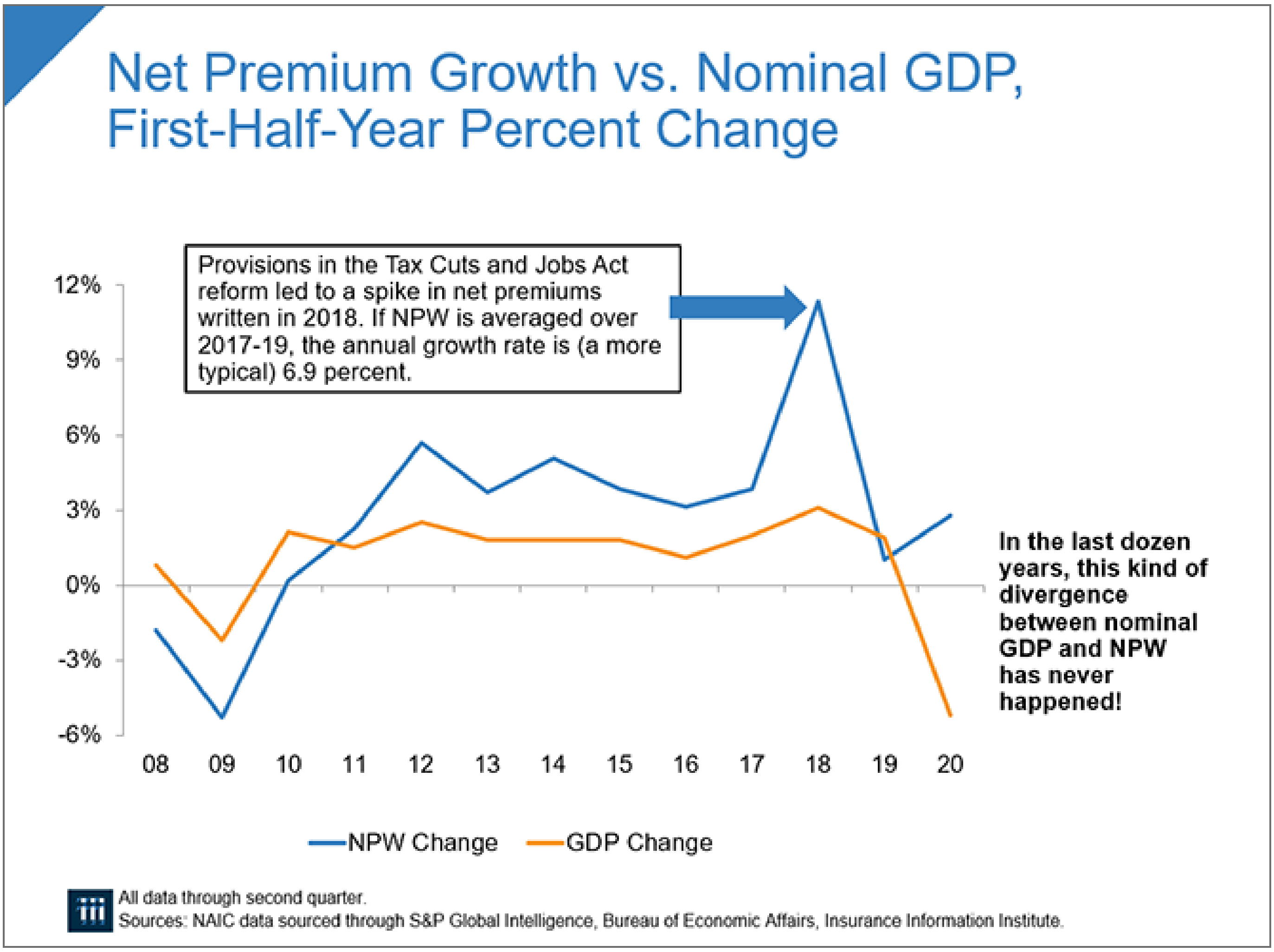
Premium income

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

In general, premiums may grow for several reasons. One is growth in the number of, and/or value of, insurable interests (such as property and liability risks). Another is a rate hike, which itself could be driven by increases in the frequency and/or severity of claims, and by increases in loss adjustment expenses and/or other expenses. A third is a change in the use of reinsurance, which would affect just net premiums written and net premiums earned.

Growth in the value of insurable interests could be driven by growth in the economy (such as new or expanded business or personal assets or income) and/or by price increases (inflation). For growth of the value of insurable interests including inflation an appropriate measure of U.S. economic growth is nominal (not inflation-adjusted) GDP (the orange line in Figure 1) which is highly correlated with changes in net premiums written (NPW). This connection was not the case in the second quarter of 2020. Nominal GDP contracted by 5.2 percent in the first half of 2020, compared to NPW growth at 2.8 percent.

Figure 1

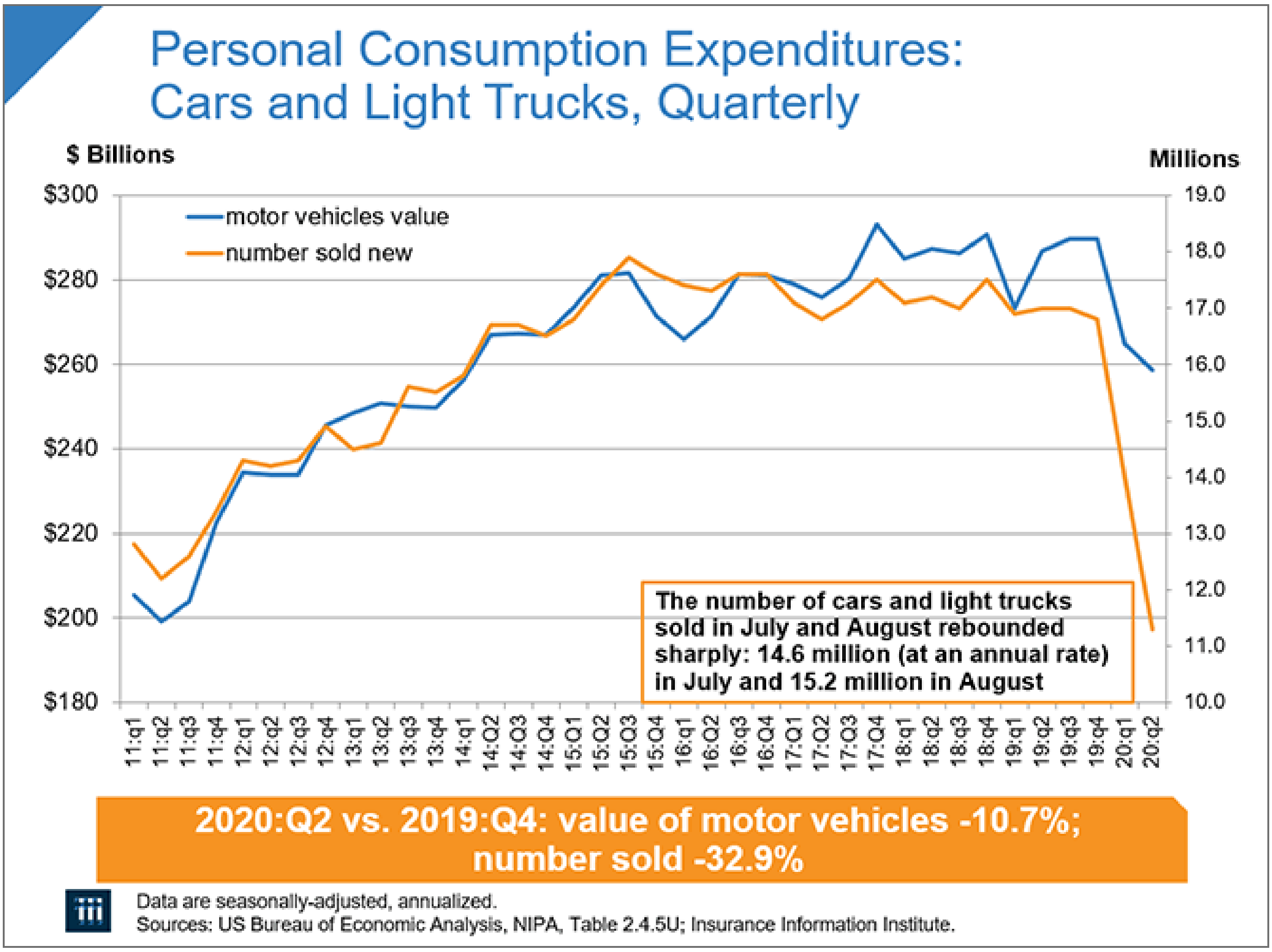


ISO estimates that direct premiums written grew by about 2.1 percent in the first half of 2020 compared to 4.5 percent growth in the first half of 2019. The first half of 2020 was apparently the result of two different quarters in 2020. First-quarter 2020 direct premiums written grew 4.5 percent, but second-quarter direct premiums written declined 0.2 percent.

Net earned premiums (for insurance that was actually provided) in 2020:1H grew by 2.9 percent (to $312.7 billion), compared to growth of 3.8 percent (to $304.0 billion) in the same period in 2019.

Economic output in the second quarter of 2020 was quite uneven. Figure 2 shows that the number of new cars and light trucks (including SUVs and minivans) sold plunged (the orange line, right scale), but spending on motor vehicles fell only slightly (blue line, left scale), suggesting a shift to more expensive vehicles (a function no doubt of low interest rates and the low price of gasoline), which is a plus long term for the personal auto line of business because more expensive vehicles translate to higher premiums.

Figure 2



Figures 3 and 4 show spending patterns that affect the homeowners (HO) line of business. Figure 3 shows that in May and June of the second quarter in 2020, the number of new homes sold spiked, some of it making up for the slump in April. This continued into July and August. Each new home is additional insurable value for the HO line.

Figure 4 shows spending on home remodeling and purchases of furniture and major appliances, both of which continued rising through the 2020 recession. So, despite the 2020 recession, these two graphs show that insurable values for homes have been rising.

The drop-off in purchases of new vehicles was reinforced by a sharp reduction in driving to which many insurers reacted by refunding or crediting premiums. ISO noted that "insurers… specific course of action …[depended] on legal, regulatory, and operational constraints." As implied by the activity in Figures 3 and 4, Homeowners premiums stayed positive, so that net premium written growth for insurers writing mostly personal lines was +1.1 percent in first-half 2020.

Figure 3

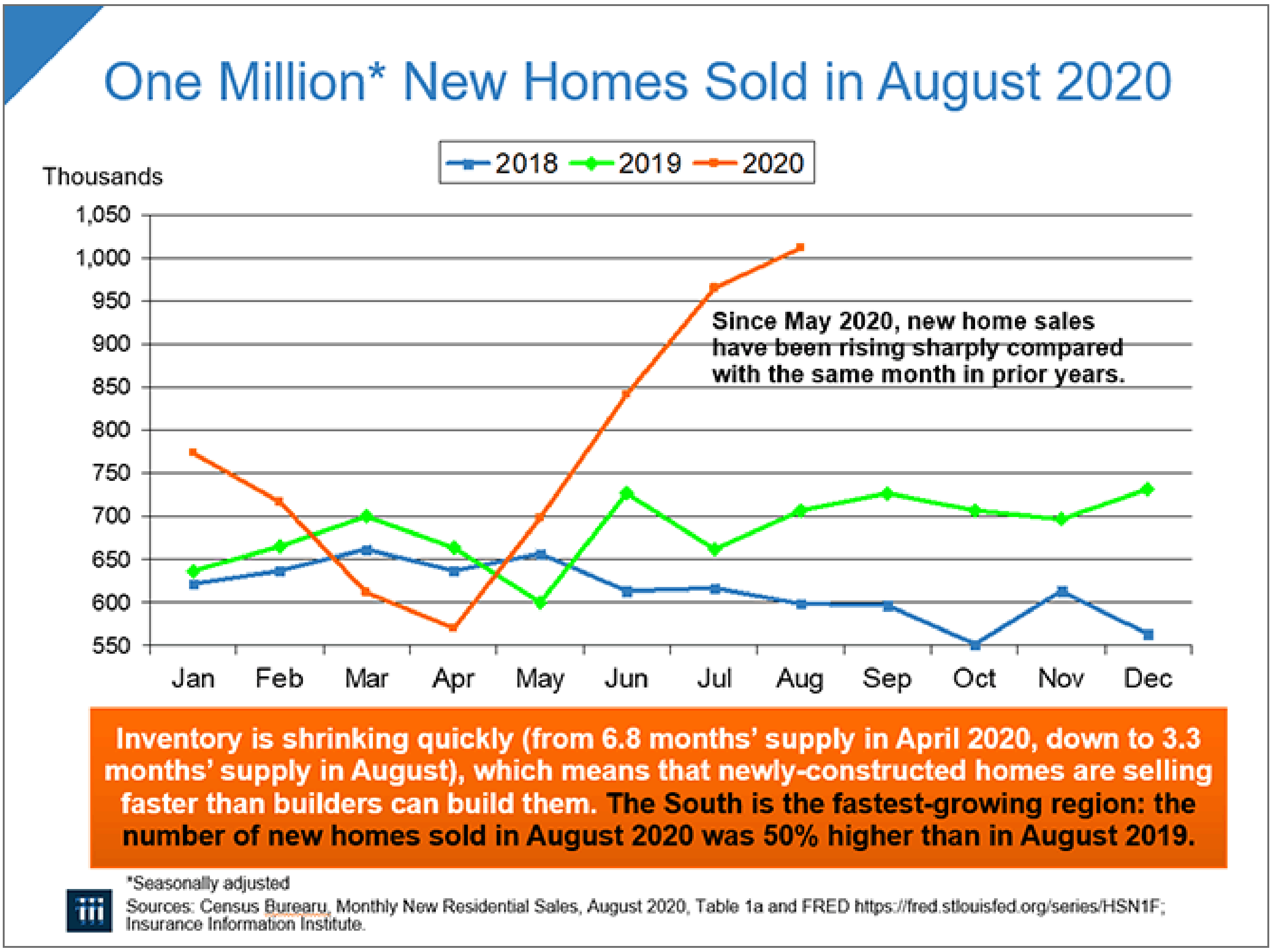

One Million* New Homes Sold in August 2020
2018
2019
2020
Thousands
1,050
1,000
950
900
850
800
750
700
650
600
550
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Since May 2020, new home sales have been rising sharply compared with the same month in prior years.
Inventory is shrinking quickly (from 6.8 months' supply in April 2020, down to 3.3 months' supply in August), which means that newly-constructed homes are selling faster than builders can build them. The South is the fastest-growing region: the number of new homes sold in August 2020 was 50% higher than in August 2019.
*Seasonally adjusted
Sources: Census Burearu, Monthly New Residential Sales, August 2020, Table 1a and FRED https://fred.stlouisfed.org/series/HSN1F; Insurance Information Institute.

Figure 4

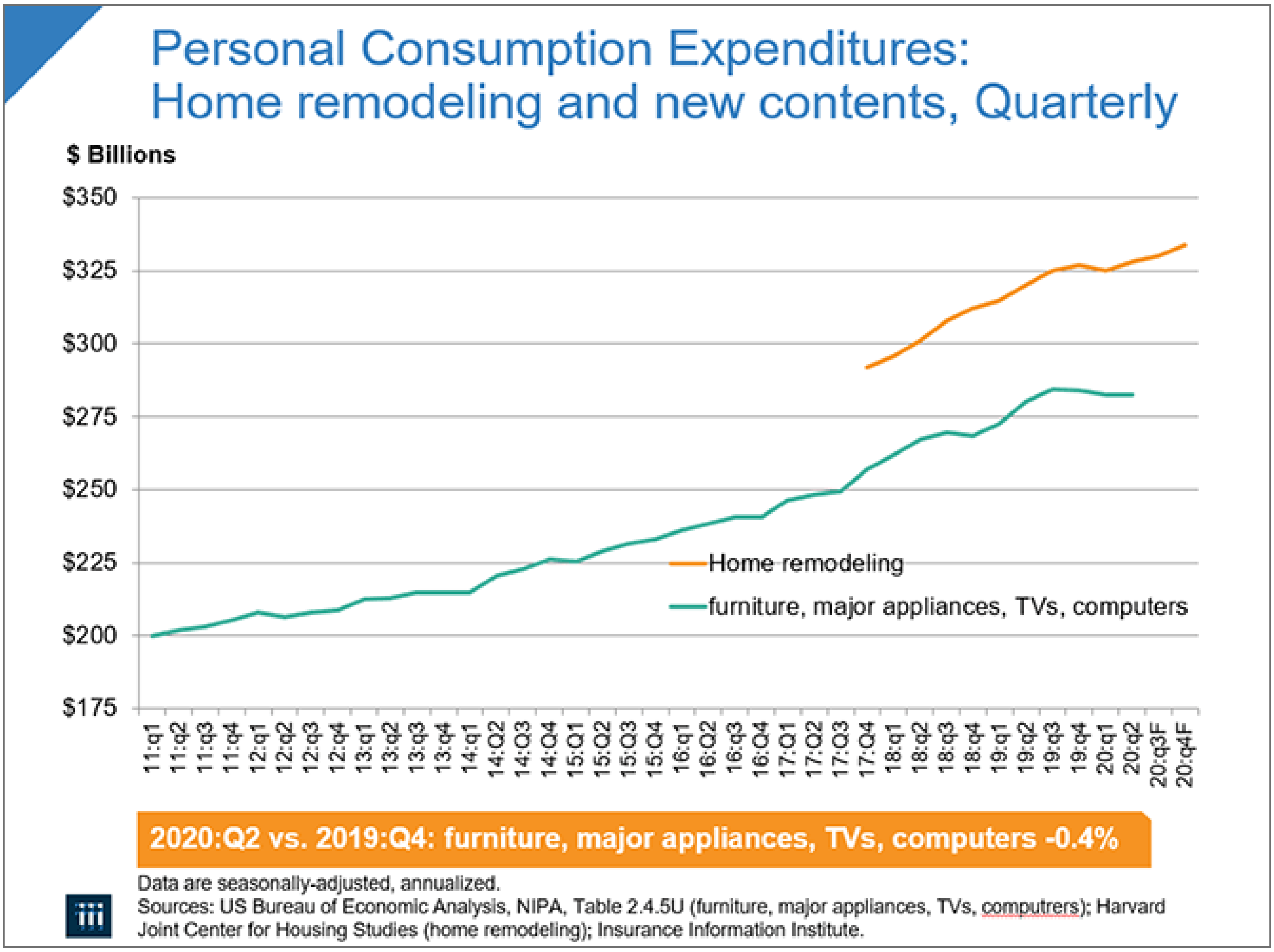
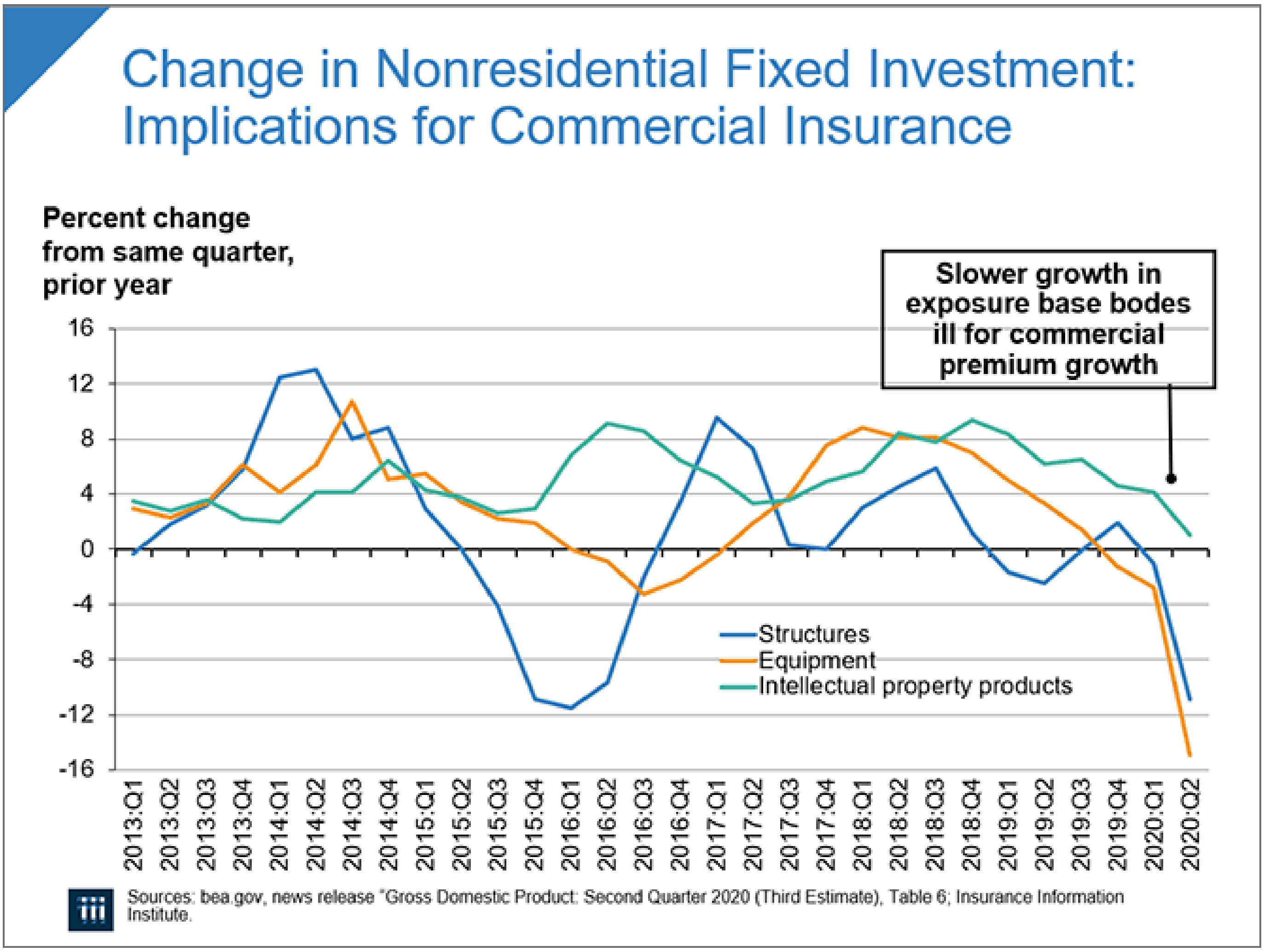


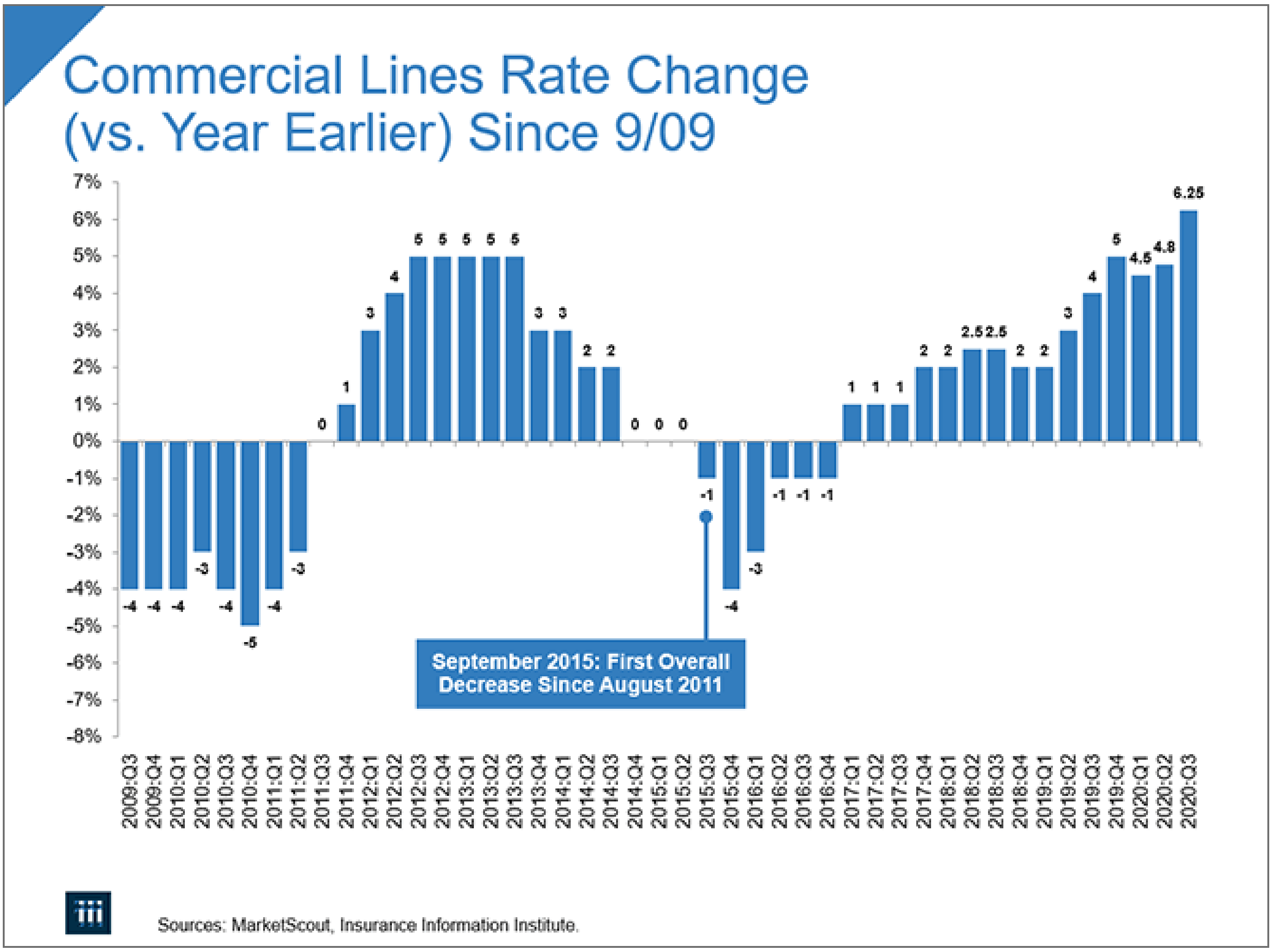
Figure 5 shows three types of business investments, all of which are trending down in the current recession, which would imply decreases in the purchase of commercial insurance., As a result, we can expect commercial premiums to grow more slowly or even decrease. The figure shows that investment in structures (blue line) and equipment (orange line) both went negative in both the first and second quarters of 2020, and investment in software and other intellectual property products (green line) continued its downward trend but remained positive (at 1.0 percent in the second quarter) in the first half of 2020. However, net premium written growth for insurers writing predominantly commercial lines (excluding mortgage and financial guaranty insurers) increased to 6.1 percent in first-half 2020 after falling 3.2 percent in first-half 2019.[i]

Figure 5



Another reason why premiums change is rate changes. Figure 6 shows the rising rate trend that began in 2017 and continued in 2020 through the recession that began in March.

Figure 6



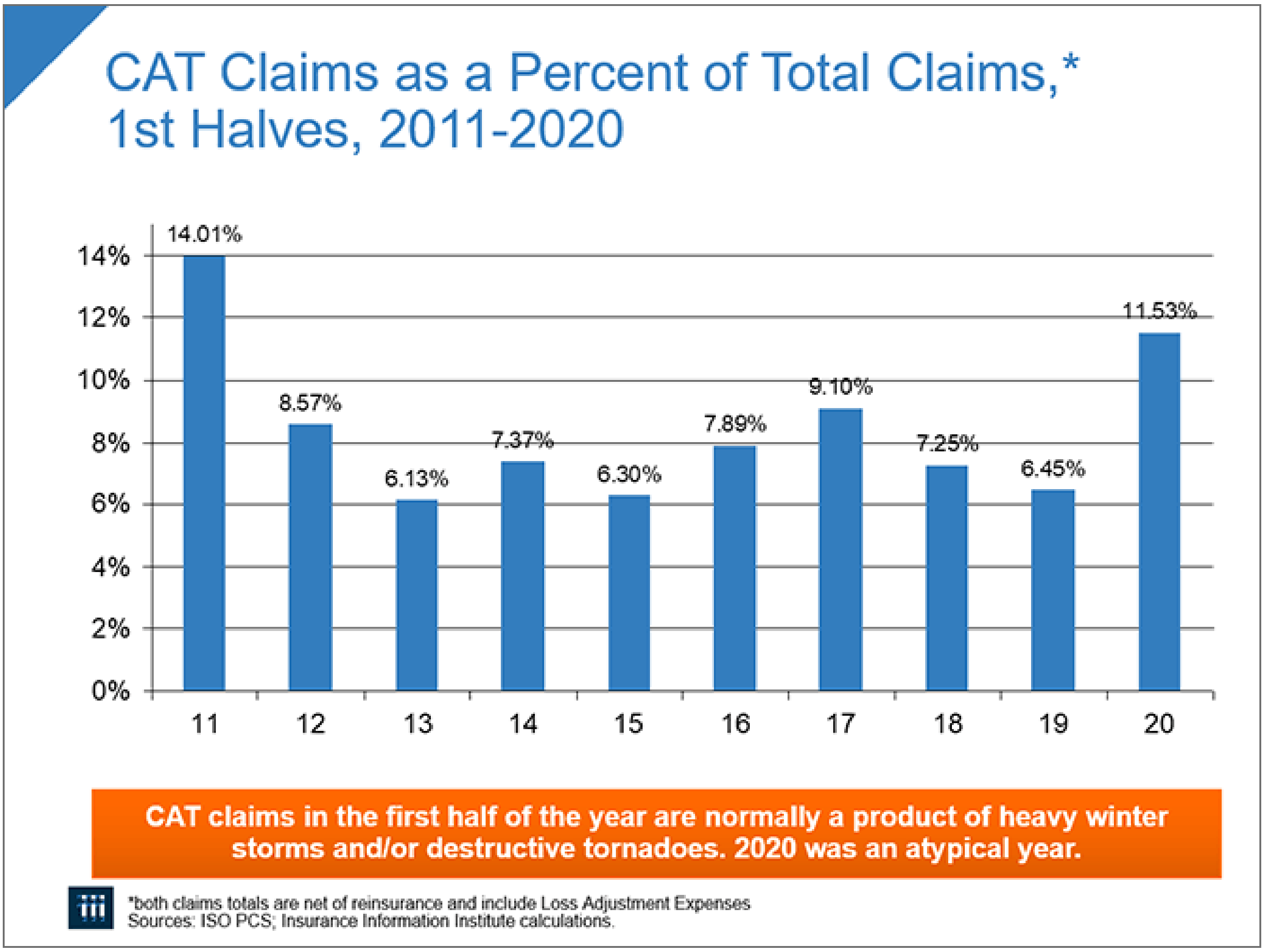
Incurred claims

Incurred losses and loss-adjustment expenses (LLAE) in 2020:1H rose by 0.8 percent (to $214.3 billion) versus the comparable prior period in 2019:1H. This tiny increase might be attributed in part to the drop in driving in the spring that sharply reduced auto crashes. Note that these numbers are net of reserve releases, discussed in the next section.

Incurred claims can be classified as catastrophe-related and non-catastrophe-related. The first half of 2020 was an expensive year for catastrophe-related claims. Net LLAE from catastrophes jumped $10.9 billion to $24.7 billion for first-half 2020 from $13.8 billion in first-half 2019. Net LLAE for losses other than catastrophes fell $9.2 billion, to $189.6 billion, in first-half 2020 from $198.7 billion in first-half 2019.

In most years, as Figure 7 shows, catastrophe-related claims in the first half of the year are between 6 percent and 9 percent of total claims, but they can be quite volatile. This is in part because the second calendar quarter is the prime season for tornadoes, so an active tornado year can spike catastrophe claims. But tornadoes were not the cause of a claims spike: there were 600 tornadoes in the second quarter of 2020, 2,649 major hailstorms, and 7,051 major windstorms but these were smaller numbers in each of these categories than in the second quarter of 2019.

Figure 7



In the first half of 2020, catastrophe-related losses were 11.53 percent of total claims—the second-worst such year in the past decade. However, as with any fraction or percentage, the result can be driven by changes in the denominator as well as in the numerator. In this case, it is possible that the plunge in auto insurance claims in the second quarter of 2020 (vehicle miles traveled dropped by 16.6 percent compared to the second quarter of 2019) shrank the denominator in this fraction and so caused the 2020 bar in Figure 7 to rise.

Reserve releases

Reserve releases are generally associated with new estimates of expected costs for unsettled claims from past years. Overall inflation continues to be unexpectedly low, likely contributing to these new lower estimates. For the first half of 2020, the industry reported releases of prior-year claims reserves totaling $4.5 billion, down from $5.7 billion released in the first half of 2019.

Combined ratio and underwriting profits

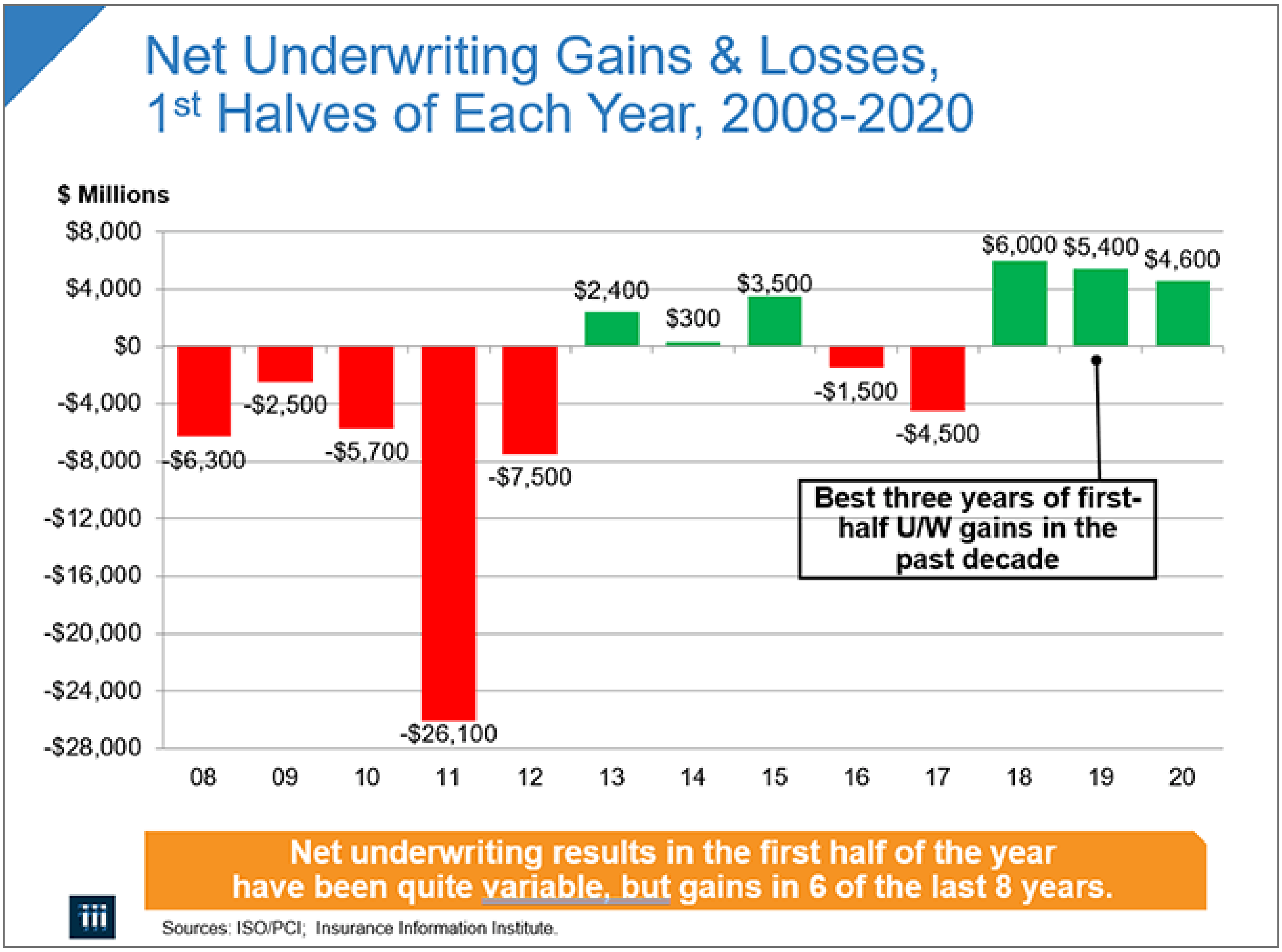
The broadest conventional measure of underwriting results is the combined ratio—the percentage of losses, loss-adjustment expenses, and all other non-investment expenses—outgo—to premiums—income. A ratio more than 100 means insurance operations were unprofitable; one under 100 indicates profit. For the first half of 2020, the P/C industry combined ratio was 97.5. The comparable figure for 2019 was 97.3.

As Figure 8 shows, the net underwriting gain for 2020:1H was $4.6 billion. Although down from the first halves of both 2018 and 2019, it is still the third largest in a first half in the last dozen years and the sixth in the past eight years. However, to put this in historical perspective, quarterly underwriting gains are rare. Underwriting losses have been the norm over the past several decades. According to ISO, underwriting profits have occurred in only about 1 in every 6 calendar quarters since 1986, when ISO's quarterly data began.

Different segments of the industry had different underwriting experiences. The combined ratio for insurers writing mainly personal lines (mostly auto and homeowners insurance) was 93.6, a notable improvement from 97.2 in 2019:1H. The reason for the improvement in auto insurance is the huge cutback in driving in the spring of 2020 due to pandemic shutdowns, which sharply cut crashes. The improvement in the homeowners line is likely also a reaction to the pandemic, since many people changed to working from home and/or overseeing schoolchildren who were, in effect, working from home to counteract spread of the virus in the pandemic.

The combined ratio for insurers writing mainly commercial lines excludes mortgage and financial guaranty insurers and was 100.6, substantially worse than in the comparable prior period, at 96.2.

Figure 8



Investment performance

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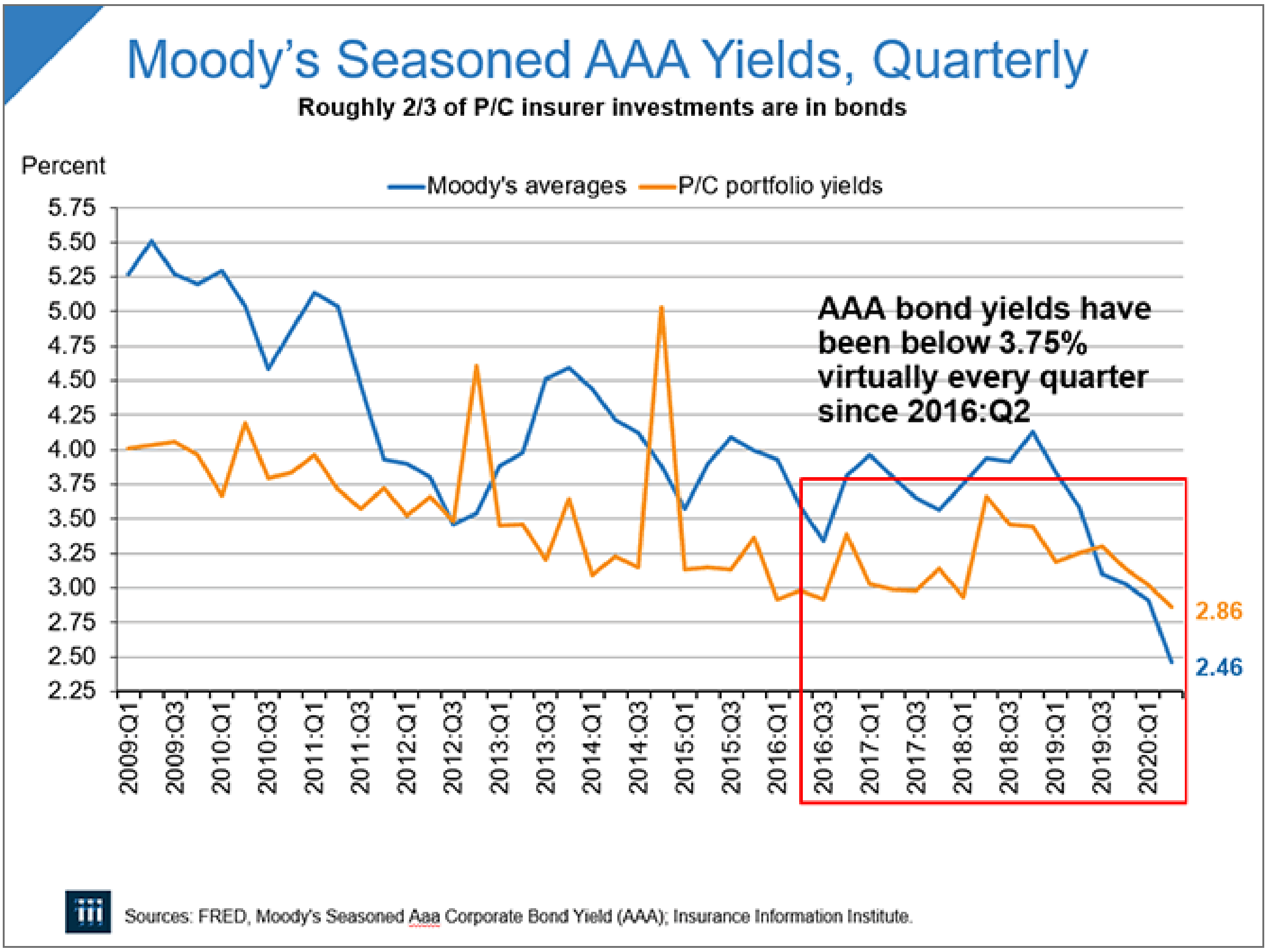
In measuring insurance company net investment gains, accounting rules recognize two components: (i) net investment income, and (ii) realized capital gains or losses. Unrealized capital gains or losses are not considered income but affect surplus on the balance sheet. For the first half of 2020, net investment gains were $24.1 billion, compared to $31.2 billion in the first half of 2019.

Net investment income

About two-thirds of investments of P/C insurers are in bonds, of which roughly 95 percent are investment grade. As Figure 8 shows, yields on seasoned AAA bonds, the highest quality, have since mid-2014 ranged between 3.3 percent and 4.1 percent but have dropped in the most recent four quarters for which we have data. The portfolio yields obtained have tended to run about one-half to one percentage point lower than the prevailing AAA yields, but this relationship reversed since 2019:Q3.

Figure 9



The industry's net investment income for the first half of 2020 was $25.5 billion, just $1.4 billion less than in the first half of 2019. Net investment income itself has basically two elements—interest payments from bonds and dividends from stock. As shown in Figure 9, bond yields dropped throughout 2020:1H.

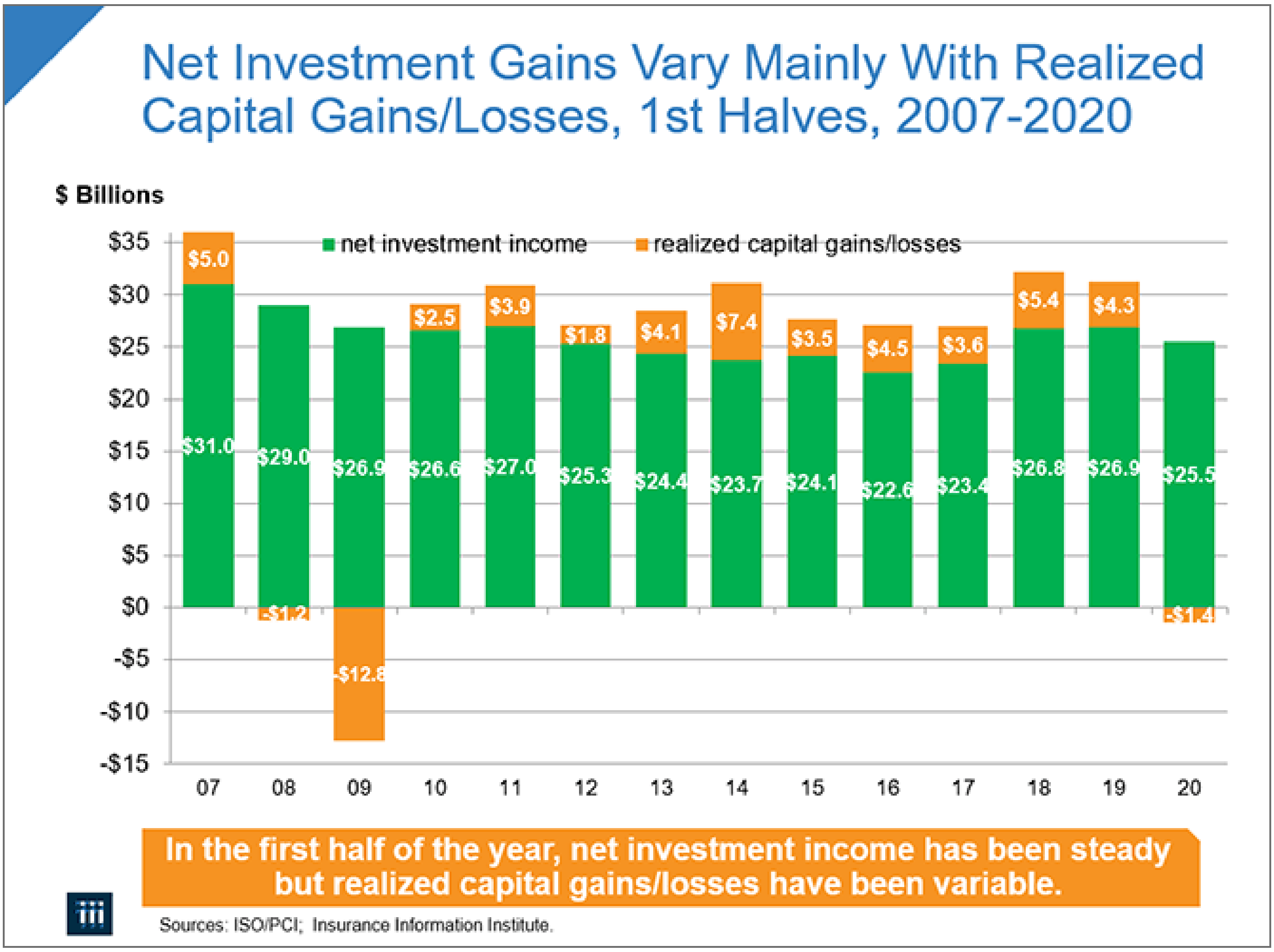
Stock holdings represent roughly about one-fifth of the industry's invested assets. In the first half of 2020, stock dividends were down slightly compared to the first half of 2019.

Realized capital gains

The industry realized $1.4 billion in capital losses in 2020:1H. This is $5.7 billion below the 2019:1H result, which delivered capital gains. As Figure 10 shows, a $1.4 billion loss for the first half of the year is only the third time in the last dozen years (and the first since 2009) for the industry to have booked a capital loss.

Since the stock market plunged in the last part of the first quarter and nearly made up the entire plunge in the second quarter, one might assume that the realized losses occurred in the first quarter and were partially offset in the second quarter. However, that is the reverse of what happened. The industry realized capital gains of $1.1 billion in the first quarter and capital losses of $2.5 billion in the second quarter.

Figure 10



Profit performance

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Figure 11 shows the relative contribution to profits (before taxes) of the underwriting aspect of the business and the investment aspect.

Figure 11

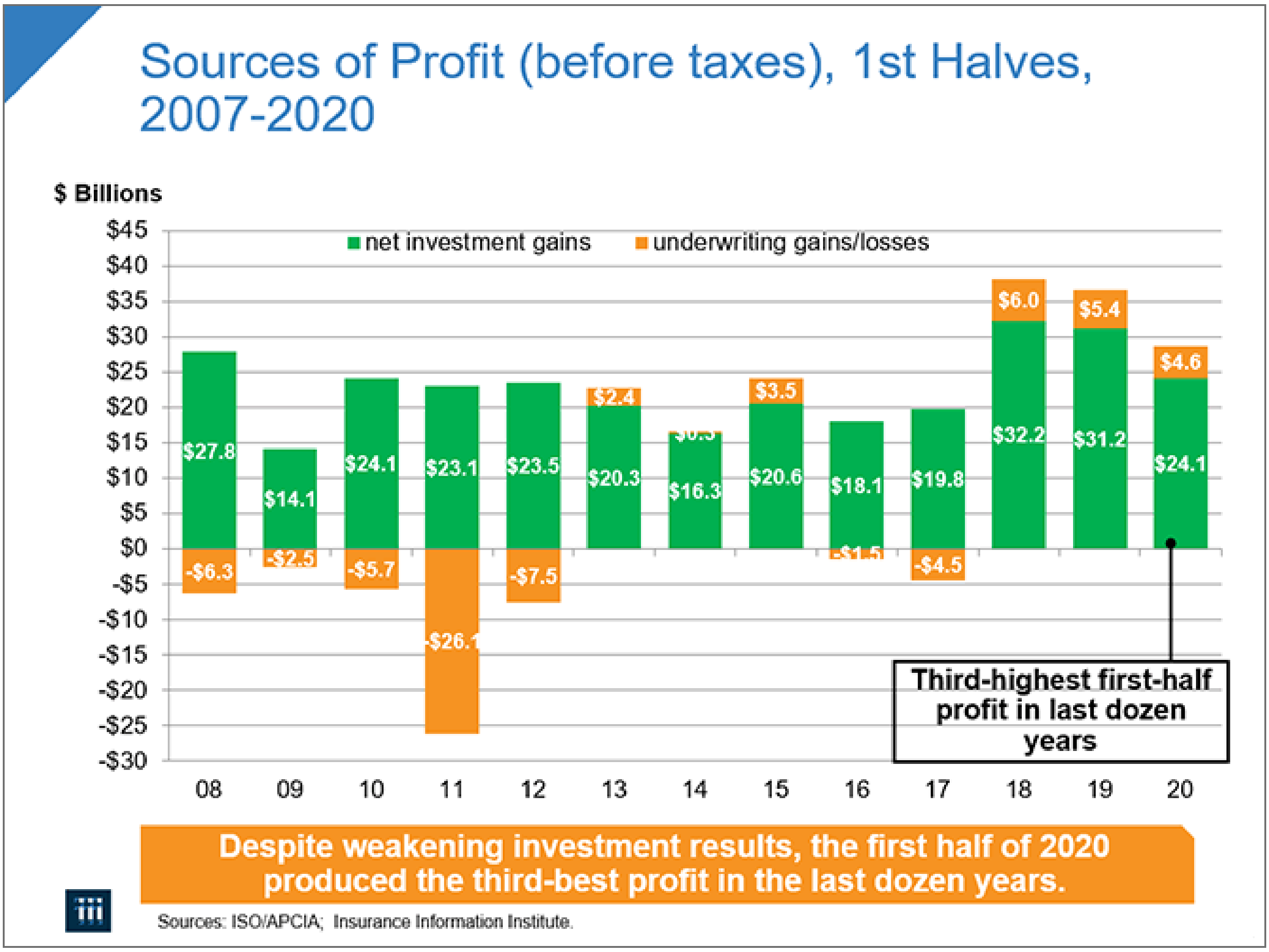
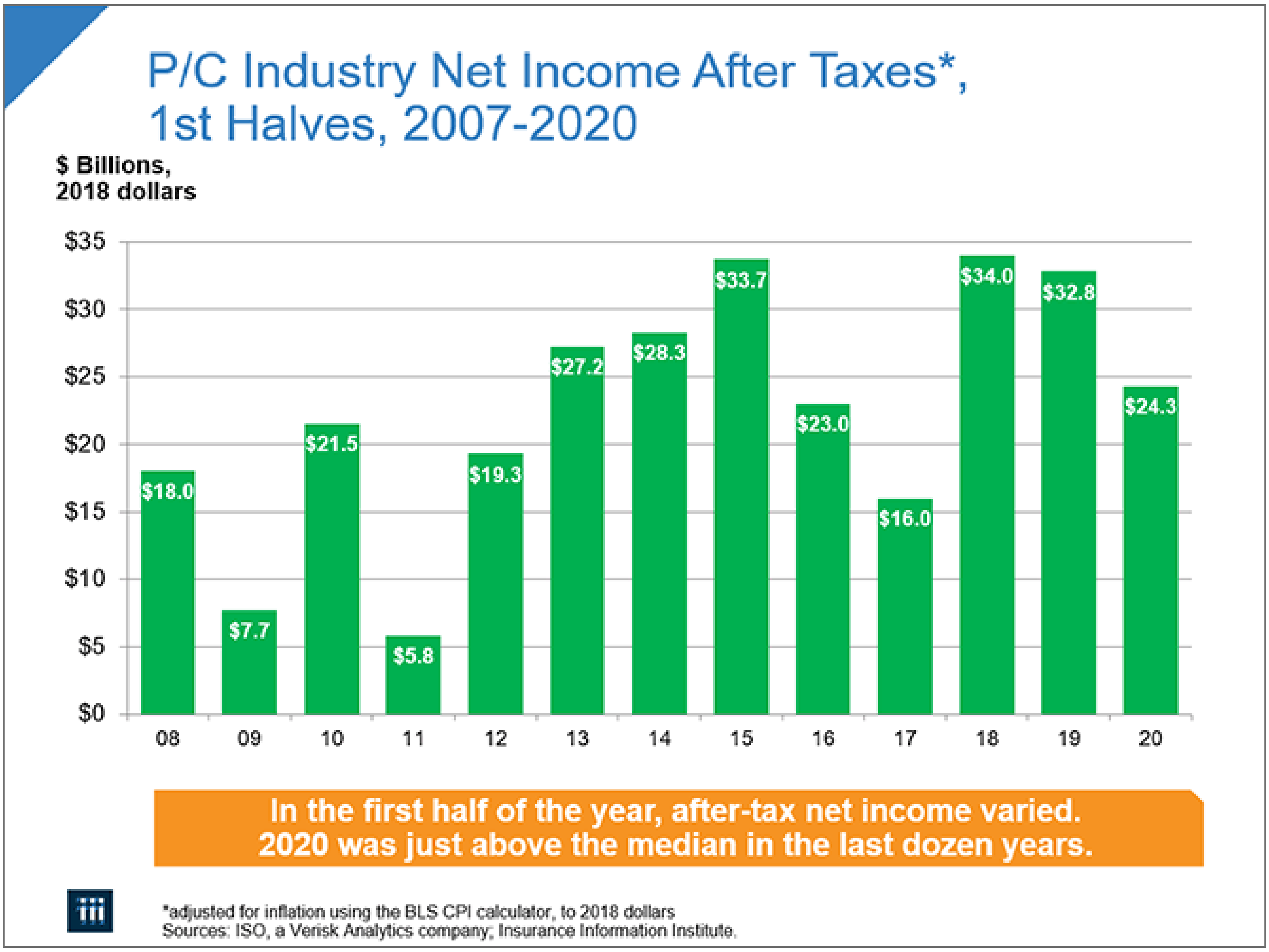


Figure 12



Policyholders' surplus (capital/capacity)

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Policyholders' surplus is the excess of assets over liabilities. Liabilities include both claim reserves and unearned premium reserves. Surplus, therefore, is a buffer that absorbs demands for claims and/or returned premiums that are beyond expectations.

As of June 30, 2020, policyholders' surplus stood at $825.8 billion—up $23.5 billion from the year-earlier period. Policyholders' surplus has generally continued to increase in recent years as the industry generated profits, and as assets held in the industry's investment portfolio increased in value.

Summary

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Last quarter we wrote that the first quarter of 2020 generally went well for the P/C industry, although the last two weeks in March, when major sectors of the economy were shut down to halt the spread of the novel coronavirus, indicated that the second quarter likely would be very different.

Fortunately, that expectation was incorrect—at least in its severity, and in some cases in its direction. The first half of 2020 was by most measures financially successful for insurers writing P/C insurance. Two measures of the industry's health—revenue and capital—rose in 2020:1H.

Net premiums earned grew by 2.9 percent for the half and incurred claims grew by only 0.8 percent. Policyholders' surplus—what in other industries would be called net worth—rose by $23.5 billion over its level at the end of the first half of 2019.

The industry is extremely well capitalized and financially prepared to pay out very large-scale losses for the rest of 2020 and beyond. One commonly used measure of capital adequacy, the ratio of net premiums written to surplus, currently stands at 0.78 to 1.00, close to its strongest level in modern history (a lower number represents greater strength).

The bottom line? Net income after taxes was $24.3 billion in the first half of 2020. Although this is below the two recent strongest first halves, it is above the median of the past dozen first halves.

The P/C insurance industry turned in a profitable overall performance in the first half of 2020. Policyholders' surplus reached a near-record high. Premium growth 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 2020 follows.

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

To view the press release from ISO, Click here.

First Half 2020 Financial Results*

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Net Earned Premiums	$312.7
Incurred Losses (Including loss adjustment expenses)	214.3
Expenses	89.4
Policyholder Dividends	4.4
Net Underwriting Gain (Loss)	4.6
Investment Income	25.5
Other Items	0.1
Pre-Tax Operating Gain	30.2
Realized Capital Gains (Losses)	-1.4
Pre-Tax Income	28.8
Taxes	4.5
Net After-Tax Income	$24.3
Surplus (End of Period)	$825.8

Combined Ratio	97.5**

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

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[i] Premium growth in 2019 was suppressed, especially in commercial lines, by significant changes in reinsurance arrangements in 2018 which resulted from provisions in the tax reform act passed in late 2017.

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