2020 - Commentary on first quarter financial results

Insurance Industry

July 28, 2020

IN THIS ARTICLE

2020 first-quarter data in comparison to both the previous quarter and the first quarters of prior years, gave little hint of the shock that was to follow in 2020's second quarter. Indeed, for the property/casualty (P/C) insurance industry, the first quarter of 2020 generally went well. Although there were some bumps in the road—policyholders' surplus fell by $75 billion, or -9.0

percent, from the 2019 year-end level—most measures of financial results (premiums, underwriting results, investments, surplus level in relation to net written premiums, and profitability) were positive. 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

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P/C insurers measure premium income in three ways, each of which gives a different insight into industry activity. *Direct premiums written* (DPW) reflect the amount that policyholders pay for insurance. This is a basic gauge of "retail" activity. *Net premiums written* (NPW) 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 premiums earned* (NPE) are derived by adjusting NPW to reflect the insurance that was provided. Direct premiums and NPW are forward-looking measures, while net earned premiums are a backward-looking concept.

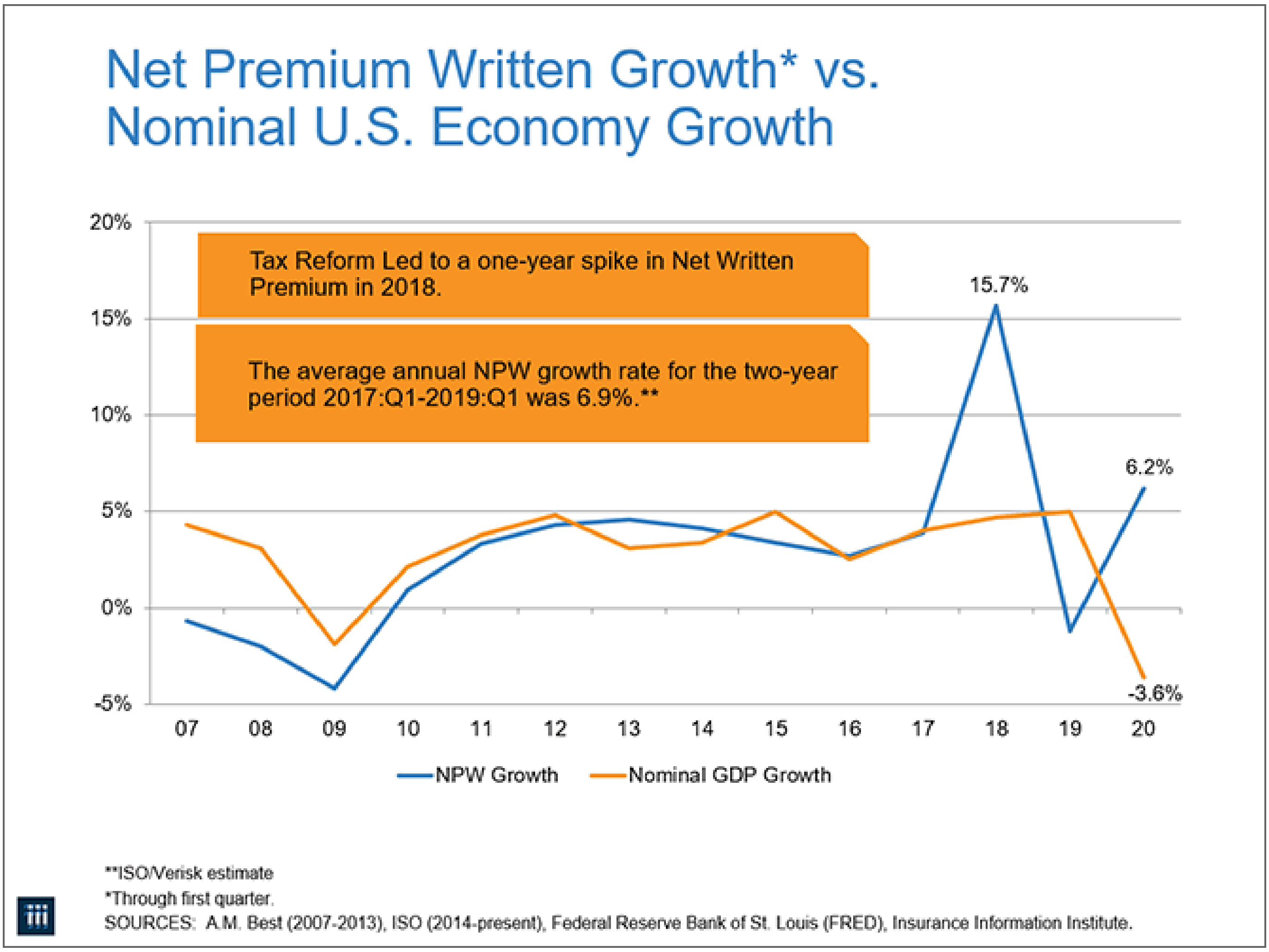
Direct premiums. Most personal direct premiums and some commercial direct premiums are required by law or by terms of commerce (such as homeowners insurance to protect a lender's mortgage). Therefore, as a rule, direct premiums follow the changes in the number of drivers, homes and businesses—essentially 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 2020—up to the middle of March—was surprisingly strong, considering that it extended the longest expansion (since the end of the Great Recession in June 2009) in modern U.S. economic history. But the recognition of the spread of the COVID-19 pandemic brought the expansion to a screeching halt, plunging the U.S. economy into one of the steepest recessions it has ever seen. The result was a drop in real GDP at a 5.0 percent annual rate.

Nominal (i.e., not inflation-adjusted) GDP shrank in 2020:Q1 by -3.6 percent. ISO estimates that direct premiums for all lines of P/C business grew at 4.6 percent in the first quarter of 2020, slightly faster growth compared to 4.4 percent in the first quarter of 2019. Premium rates and exposure levels were set long before the 2020 recession struck, so it is no surprise that the drop in nominal GDP didn't match the rise in DPW.

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 NPW by incentivizing insurers to reduce their reinsurance with non-U.S. reinsurers. Thus the 2018 first quarter net premium written growth was unusually high (+15.7 percent). In contrast, because it was compared with an unusually high prior quarter, the first quarter 2019 net premium written change was -1.1 percent (*Figure 1*). But as an indicator of industry revenues, this negative net premium written growth rate is misleading; ISO suggests that if one takes the base for growth as the 2017:Q1 level, the average annual net premium written growth over the two years is 6.9 percent per year. Using that average as a baseline, the NPW growth for 2020:Q1 was 6.2 percent—essentially on trend.

Fig. 1



NPW 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 3.0 percentage points (vs. a growth rate of 4.5 percent in the same quarter, prior year). For those writing mainly commercial lines (excluding mortgage and financial guaranty insurers), premiums spiked by 12.1 percentage points (vs. -9.3 percent growth in 2019:Q1). And those writing balanced books of business posted net premium written growth 3.2 percent higher than the year-earlier quarter.

Net premiums earned. NPE for insurance that was provided in 2020:Q1 were $157.7 billion, up 5.4 percent over 2019:Q1. This was a solid increase, surpassing the 4.6 percent growth in 2019:Q1. However, note that the average annual growth in NPE over the two years from 2017:Q1 to 2019:Q1 was 7.0 percent, according to ISO.

LLAE and Expenses

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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 2020:Q1 totaled $105.4 billion, net of reinsurance recoveries, and were up by 3.5 percent over the $101.8 billion in the first quarter of 2019. 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 2020 insurers released $3.7 billion from reserves previously set aside for prior claims but after reevaluation, were not needed for that purpose.

To put 2020:Q1 reserve releases in recent historical perspective, note that for the first quarter of 2019, the industry reported releases of prior-year claims reserves totaling $4.5 billion; in 2018:Q1, $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 2020, catastrophe-related claims were $5.8 billion, up $1 billion from 2019: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 five consecutive years of first-quarter catastrophe LLAE of $4.8 billion or more.

Net losses for non-catastrophe claims increased by $2.6 billion, to $99.7 billion from $97.1 billion in 2019:Q1—rising by 2.7 percent. In the absence of other forces at work, one would expect non-catastrophe LLAE to rise at the same rate as the extent of protection provided—as measured by net premiums earned. However as noted above, in 2020:Q1 NPE rose by a larger percentage: 5.4 percent, over the year-earlier quarter.

General expenses grew by 10 percent to $46.0 billion vs. the $41.8 billion spent in 2019:Q1. The size of this increase might be a timing matter; note that the change from 2018:Q1 to 2019:Q1 was a drop of 0.5 percent. To put expenses into context, we compare them to net premiums earned. This yields 29.1 percent in 2020:Q1, 27.9 percent in 2019:Q1 and 29.4 percent in 2018:Q1.

Insurance Operations

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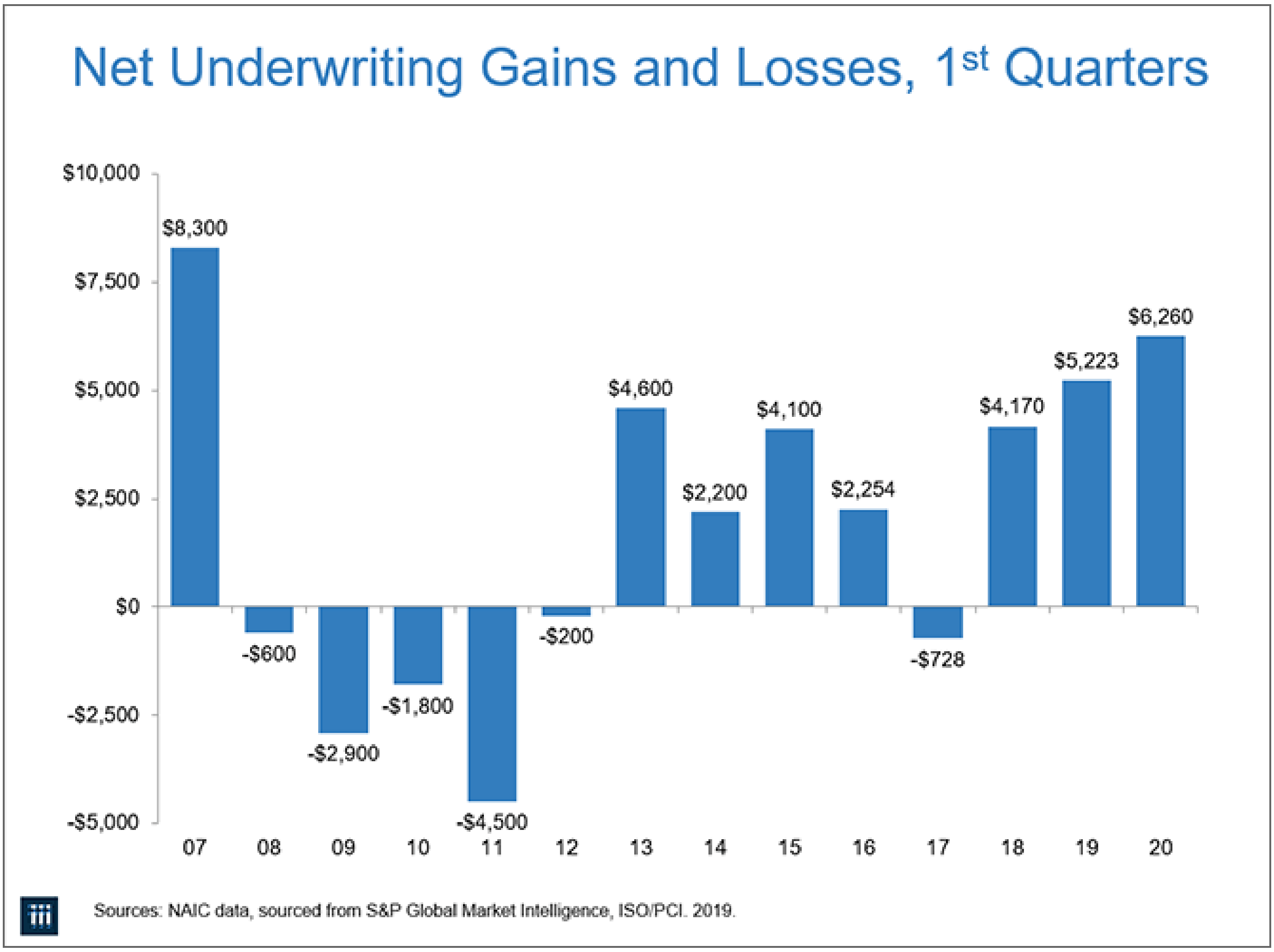
Overall insurance operations performance (excluding investment performance) is the difference between NPE and the sum of incurred losses, expenses and dividends to policyholders. The first quarter of 2020 produced a net underwriting gain of $6.3 billion on NPE of $157.7 billion. This means that seven out of the last eight 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 NPE; and other expenses as a percent of NPW. In 2020:Q1 this ratio was 94.9, improving slightly from 95.6 in 2019: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 improved by 2.7 percentage points, to 92.2 percent. For those writing mainly commercial lines (excluding mortgage and financial guaranty insurers), the combined ratio rose by 1.3 percentage points to 97.7. And those writing balanced books of business posted a combined ratio of 95.8, 1.3 percentage points better than in the year-earlier quarter.

Investment performance

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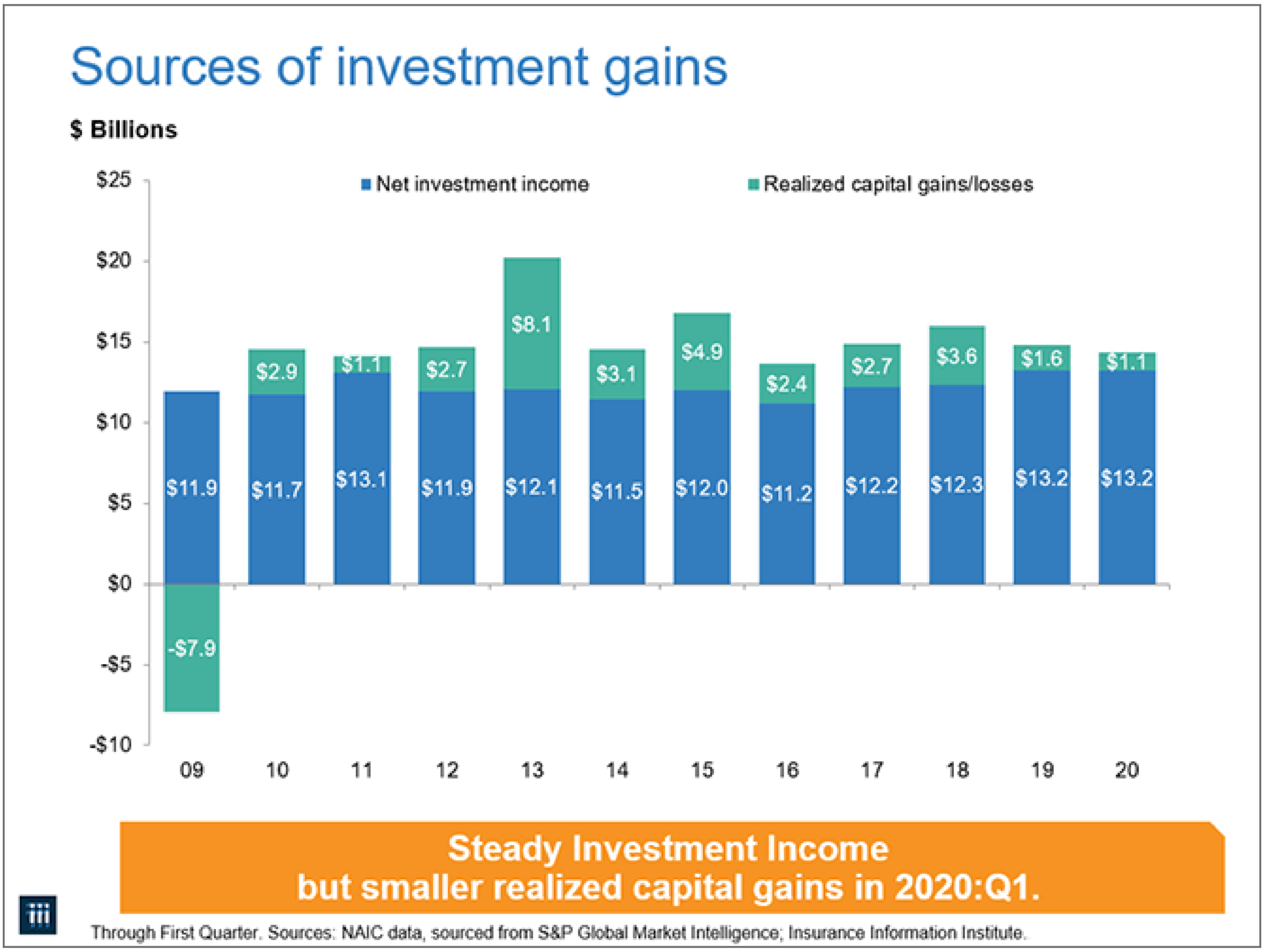
For the first quarter of 2020, net investment gains (which include net investment income plus realized capital gains and losses) were $14.3 billion, down $0.5 billion from 2019:Q1. In measuring insurance company net investment gains, accounting rules recognize two components: (i) net investment income; 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 2020 was $13.2 billion, basically flat—up by $0.02 billion—vs. 2019:Q1. Most of this income comes from the industry's bond investments, which are mainly high-quality corporate bonds and municipal bonds.

As captured by the Bank of America Corporate AA-rated seasoned bond index, corporate bond market yields fell in the first quarter of 2020, averaging just above 2 percent in the first three months of 2020, down more than a full percentage point from the first quarter of 2019. The yields in 2020 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 AA bonds bought in the first quarter of 2010 averaged 3.6 percent.

The other significant source of net investment income (besides bond yields) is stock dividends.

Seasonally adjusted, net dividends in the first quarter of 2020 (of nonfinancial domestic corporate business) plunged from $499.0 billion in 2019:Q1 to $288.0 billion in 2020:Q1. 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, fell by 20.0 percent in the first quarter of 2020, although virtually all of that occurred in the last two weeks of the quarter, providing little opportunity for cashing gains. Despite this, the industry realized $1.1 billion in realized capital gains in 2020:Q1, compared to $1.6 billion in the first quarter of 2019.

Profits

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As *Figure 4* shows, the P/C industry has posted positive net income after taxes in each first quarter for the past 11 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 2020:Q1, was above average at $17.9 billion, thanks to the strongest first-quarter underwriting gains in the past decade.

Fig. 4

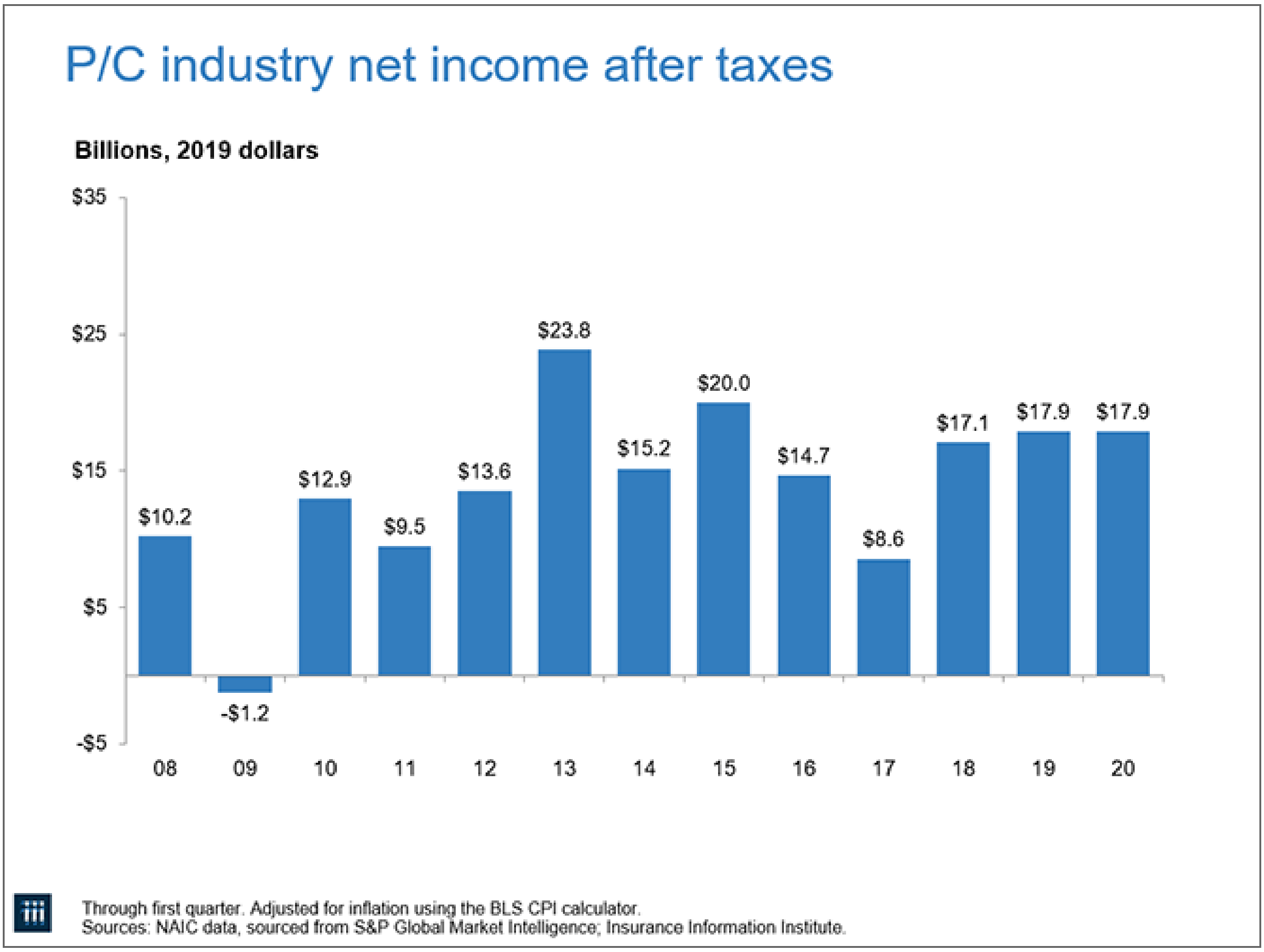
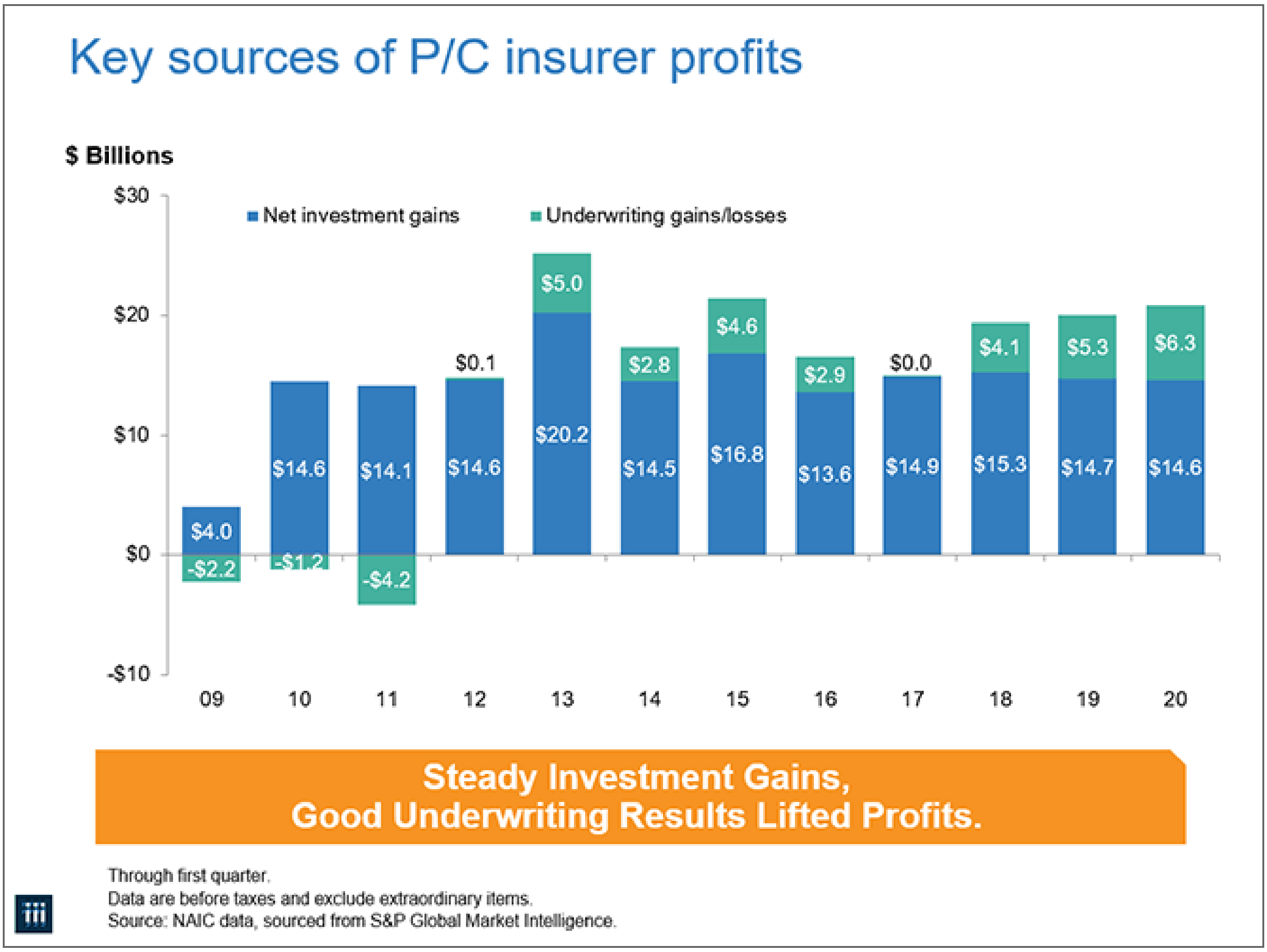


Fig. 5



Policyholders' surplus (capital/capacity)

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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, 2020, fell $75.9 billion to $771.9 billion, from the end of 2019. Most of the fall in surplus in the first quarter compared to year-end 2019 could be attributed to *unrealized* capital gains.

One commonly used measure of capital adequacy for insurers, the ratio of NPW to surplus, currently stands at 0.83, a very strong position (a lower ratio means greater capacity). The industry is extremely well capitalized and if necessary, financially prepared to pay very large-scale losses in 2020 and beyond.

Summary

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The P/C insurance industry turned in a profitable performance in the first quarter of 2020, buoyed by continued premium growth and favorable investment results. Policyholders' surplus fell but remains at a high level. Fundamentally, the P/C insurance industry remains quite strong financially.

A detailed industry income statement for the first quarter of 2020 follows.

To view the full report from Verisk/ISO and APCIA, click here.

First quarter 2020 financial results*

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($ billions)

Net Written Premiums	$164.4
Net Earned Premiums	157.7
Incurred Losses (Including loss adjustment expenses and reserve adjustments)	105.4
Expenses	46.0
Policyholder Dividends	0.8
Net Underwriting Gain	6.3
Net Investment Income	13.2
Other Items	0.0
Pre-Tax Operating Gain	19.4
Realized Capital Gains	1.6
Pre-Tax Income	20.6
Taxes	3.0
Net After-Tax Income	**$17.9**
Surplus (End of Period)	$771.9

*Figures may not add to totals due to rounding. Calculations in text based on unrounded figures.

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