2014 - First Quarter Results

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Profitability in the property/casualty insurance industry retreated modestly in the first quarter of 2014, reflecting higher underwriting losses (in part related to elevated catastrophe claims arising from this year?s ?polar vortex?) and an abrupt drop in U.S. economic activity that resulted in a deceleration in premium growth and lower investment income. Despite these headwinds, the industry registered a respectable return on average surplus of 8.4 percent in the quarter, compared to 9.6 percent in the first quarter of 2013 and 10.3 percent for all of 2013. Higher underwriting loss and expense and slower premium growth contributed to a 2.4 point deterioration in the industry?s combined ratio to 97.3 (versus 94.9 during the first quarter of 2013) and a halving of underwriting profits (net of policyholder dividends) to $2.2 billion, down from $4.5 billion a year earlier. The industry partially offset higher underwriting losses by realizing capital gains, which were up 111 percent during the quarter to $2.9 billion. Altogether, net income after taxes (profits) during the quarter, at $13.8 billion, was 4.0 percent lower than the $14.3 billion in the year-earlier period. Top line growth eased in the first three months of the year, mirroring a slowdown in the overall economy. Net written premiums rose 3.6 percent in the first quarter versus the year-ago first quarter. Persistently low interest rates remain a challenge for the industry, with net investment income for the quarter slipping by $233 million (-2.0 percent). Overall industry capacity rose to a record $662.0 billion as of March 31, 2014?up $8.7 billion, or 1.3 percent, from $653.3 billion as of year-end 2013.

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

Profitability Drivers: Winter Takes a Toll; M&FG Reverses a Trend

The industry?s performance the first quarter of 2014 was positive but bore the effects of an extreme winter in the U.S. As noted earlier, the P/C insurance industry reported an annualized statutory rate of return on average surplus of 8.4 percent in the first quarter of 2014, down from 9.6 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 quarter of 2014, however, the reverse occurred. The annualized rate of return for this sector for 2014?s first quarter is estimated at 16.5 percent, double the 8.3 percent return for the sector for the first quarter of 2013. These results boosted the overall industry results reported above; excluding them, the rest of the

P/C industry?s results for the first quarter of 2013 would be an 8.2 percent annualized rate of return.

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

Catastrophe Losses and Underwriting Performance

Some of the deterioration in underwriting performance in the first quarter of 2014 can be attributed to higher catastrophe losses than in the year-earlier quarter. Although the insured damage from extreme cold and winter storms in 2014 did not break records set in the mid-1990s, 2014 will likely rank among the five costliest on record for winter damage claims. ISO/PCI estimates that direct insured catastrophe losses in the United States were $3.0 billion (versus $2.8 billion in the comparable quarter in 2013, up 7.1 percent). But higher non-catastrophe losses also affected underwriting performance. ISO/PCI estimates that first-quarter 2014 non-cat losses and loss-adjustment expenses rose by $5.7 billion, or 8.0 percent, to $77.6 billion compared to $71.9 billion in first-quarter 2013.

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 quarter of 2014, the industry reported releases of prior year claims reserves totaling $5.5 billion, roughly the same dollar amount released in 2013. Removing the effects of favorable reserve development for both the first quarter of 2014 and the first quarter of 2013 results in a combined ratio of 101.9 for 2014?s first quarter versus 99.9 for first-quarter 2013.

Combined Ratio: Underwriting Profits Continue

Even though the overall industry?s combined ratio for the first quarter of 2014 deteriorated compared to the year-earlier quarter, it was still a profitable quarter (after including the effect of reserve releases, as noted above). In long-term historical perspective, this is unusual: a quarter with an underwriting profit has happened only 21 times in the 113 calendar quarters?28 years plus a quarter?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 3.6 percent in the first quarter of 2014 from 4.3 percent in the first quarter of 2013.

There are two principal drivers of premium growth in the property/casualty insurance industry: exposure growth and rate. 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. Real (inflation-adjusted) GDP in the first quarter of 2014 actually declined at an annual rate of -2.9 percent, although most economists believe that when reports on the second quarter are in, they will show strong growth?in part due to rebounding from the effects of the harsh winter, drawing down of inventories and other one-time factors. Despite those factors, first quarter strength in key areas of the economy such as new vehicle sales, multi-unit residential construction, and consistent employment and payroll growth clearly benefitted the P/C insurance industry. For the full-year 2014, most forecasts currently see nominal GDP growth ranging between 3.5 percent and 4.2 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 is challenging to foresee the interplay of all of these factors as well as 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 U.S. economy added 1.07 million nonfarm jobs in the first five 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 quarter of 2014, net investment gains (which include net investment income plus realized capital gains and losses) rose by $1.3 billion (+10.3 percent) to $14.1 billion, compared to $12.8 billion in the first quarter 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:Q1

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 2014 was $11.2 billion, compared to $11.4 billion in the first quarter of 2013 (down 2.0 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. For example, the average yield on 10-year U.S. Treasury Notes in January 2014 was 2.86 percent; in January 2004 it was 4.15 percent.

Corporate bond market yields in the first quarter of 2014, as captured by Moody?s AAA-rated seasoned bond index, averaged 4.4 percent, compared to 3.9 percent in the first quarter of 2013. This reflects a mid-2013 jump in interest rates that followed the Federal Reserve Board?s announcement that it would consider tapering off its bond-buying program (the tapering began in December).

Although the U.S. economy is improving slowly, it still is 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. Stock dividends have been quite volatile lately. Seasonally adjusted, net dividends in the past four calendar quarters (vs. the immediately preceding quarter) rose by 35.8 percent in 2013:Q2, fell by 17.3 percent in 2013:Q3, rose by 10.5 percent in 2013:Q4 and fell by 9.4 percent in 2014:Q1. Stock holdings in general represent roughly only about one-sixth of the industry?s invested assets.

Realized Capital Gains

Realized capital gains in 2014:Q1 were $2.9 billion. This is a relatively strong result, at least by recent historical standards. Realized capital gains in the first quarter of 2011-2013 were $1.0 billion, $0.7 billion, and $1.4 billion, respectively.

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

Policyholders? surplus as of March 31, 2014 stood at $662.0 billion?a new record and up $52.2 billion (+8.6 percent) from the year-earlier quarter. Policyholders? surplus has generally continued to increase despite 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 quarter of 2014. In addition, policyholders? surplus reached a new all-time record high. Despite an unusually costly winter, 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 quarter of 2014 follows.

FIRST QUARTER 2014 FINANCIAL RESULTS*

($ billions)

Net Earned Premiums	$117.9
Incurred Losses (Including loss adjustment expenses)	80.8
Expenses	34.2
Policyholder Dividends	0.7
Net Underwriting Gain (Loss)	2.2
Investment Income	11.2
Other Items	0.4
Pre-Tax Operating Gain	13.7
Realized Capital Gains (Losses)	2.9
Pre-Tax Income	16.6
Taxes	2.8
Net After-Tax Income	**$13.80**
Surplus (End of Period)	$662.00
Combined Ratio	97.3**

*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 97.4.