# Briefing on the Property/Casualty Insurance Industry:

## *Function and Financial Overview*

**Maryland Economic Matters Committee**
**Maryland House of Delegates**
**Annapolis, MD**
**January 29, 2015**

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# Presentation Outline

- The Structure of the Property/Casualty Insurance Industry
  - Organizational & Marketing Structure of Insurers
  - Facts about the P/C Insurance Industry
- How Property/Casualty Insurance Works
  - Insurance Cycles
  - Drivers of, and Importance of, Profits
- P/C Insurance: Performance Overview

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# Structure Overview of the P/C Insurance Industry

## Very Diverse, Competitive & Innovative Industry

# How Many? What Types?

- 2,718 P/C insurance companies in US in 2013*
  - These 2,718 companies consolidate to 1,266 groups
  - Some larger insurance groups have dozens of subsidiaries
  - Baltimore Equitable is the 3rd oldest insurer in the US, est. in 1794 (George Washington was its president!)
- Most insurers are small, operate regionally
- A highly competitive business in most areas and for most types of coverage
- Lines of Business
  - Personal, Commercial, Multi-Line
  - Primary vs. Reinsurance

**Maryland in 2013**

- **820 insurers wrote $9.95B in P/C premiums in MD**
- **132 wrote pvt. pass. auto**
- **158 wrote homeowners**
- **284 wrote workers comp**

**Best's Aggregates and Averages, Property/Casualty*, 2014 Edition, p. 2.

# What is Reinsurance?



- Reinsurance is insurance for insurance companies
- Essential to helping spread risk globally
  - Very important in CAT risk
  - Critical for liability coverages, especially when large awards or settlements are possible
  - Stabilizes results of, and expands capacity of primary insurers
  - Especially important to smaller companies but used by all
  - Supplemented by “alternative” market which includes structures such as Catastrophe Bonds

# Organizational Structure of Insurers

- Shareholder-owned **(**Stock) **i**nsurers: 776 organizations
- Policyholder-owned insurers
  - Mutual companies: 397 organizations
  - Reciprocals: 70 organizations
- Business-owned insurers
  - Captive: Insurance subsidiary wholly owned by a single company whose primary business is not insurance
  - Risk Retention Groups: Businesses (or other organizations) in same/similar industry form and own an insurer
  - **Self-Insurance:** assumption of its own risk by a business
- Government-owned insurers: ~20 organizations
- “Partner”-owned insurers: (Lloyds): 11 US organizations

# Federal Government Insurance Programs Where Government Bears Risk

- Flood: National Flood Insurance Program
  - HO and most commercial policies exclude flood
- Crop: National Crop Insurance Program
  - Available for virtually all perils on most crops
  - Basically a federal subsidy to farmers
- Nuclear: Price-Anderson Act
  - Insures nuclear power facilities
- Terrorism: Terrorism Risk Insurance Act (TRIA)
  - Just reauthorized for 6 years through 12/31/20
- Political Risk: Overseas Private Investment Corporation
- Pensions: Pension Benefit Guarantee Corporation

# Differences in Focus and Strategy Among Insurers

- Personal Lines (many also sell Life)
  - Sells only/mostly auto and homeowners insurance
  - Examples: State Farm, Allstate, USAA
- Commercial Lines (some sell Life)
  - Sells only/mostly business insurance
  - Examples : AIG, CNA, ACE
- Multi-Line (many also sell Life)
  - Sells many different types of insurance
  - Examples : Hartford, Liberty Mutual, Travelers
- Mono-Line
  - Sells only 1 type of insurance
  - Examples: GEICO, Progressive, Zenith

# Why Do Strategies Differ?

- Some insurers believe that specializing yields certain advantages:
  - Underwriting edge/experience
  - Price advantage since can keep expenses low
  - Customer loyalty
- Some emphasize wide range of products
  - One brand for many customer needs
  - Product/customer diversification as a business strategy
- Some emphasize price
- Some emphasize quality (e.g., service, claims approach) over price
- Some emphasize long-term financial strength
- Distribution strategies may vary

# What Determines in Which Markets an Insurer Operates?

- Most insurers started as a regional/niche “player”
  - E.g., note “Farm” in many insurance company names
  - Note geographic reference in many company names
  - Note special nature of risk in name (Church Mutual)
- Some have local reputations—and do little advertising
- Risk Appetite
  - Different insurers are willing/able to accept varying amounts of CAT exposure (may depend on capitalization, expertise, etc.)
- Some insurers specialize in certain industries
  - E.g., Aviation, marine, energy, medical malpractice

# What Determines in Which Markets an Insurer Operates? (cont'd)

- Tort Environment
- Regulatory Environment
  - If viewed as onerous, rigid, capricious, unfair, hostile, or confiscatory, fewer insurers participate
- Size of Market
- Growth Opportunities/Demographics
- Synergies with Other Types of Products Offered

# How Is Insurance Regulated?

- States Remain the Principal Regulator of Insurers in the Wake of Dodd-Frank
  - Solvency, rate & form approval, licensing, product approval, consumer protection and education
- A Small Number of Insurers Have Received "Systemically Important Financial Institution" (SIFI) Designations
  - Their ultimate regulator is the Federal Reserve and are subject to more stringent capital requirements
- Federal Insurance Office (FIO) Is Not a Regulatory Agency

# The P/C Insurance Industry (as of year-end 2013)

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- **$467.9 billion in Earned Premiums**
  - About 51% personal lines, 49% commercial
  - An “earned premium” is a premium dollar for which insurance coverage has already been provided
- **$1.5 trillion in assets** (compared to $3.5 trillion for life insurers)
- **$663.3 billion in Policyholder Surplus** (in other industries, this would be called “Net Worth”)
  - Surplus is a primary measure of claims-paying ability because it is assets in excess of known obligations

# Economic Facts About the Insurance Industry in Maryland

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- Employment
  - Insurers employed 47,930 people in Maryland in 2013
  - Generated $3.7 billion in payroll
- Gross State Product
  - Insurers contributed $7.2 billion to Maryland GSP in 2012, accounting for 2.15% of total state GSP
- Taxes
  - Premium taxes alone totaled $429.4 million in 2013
- Claims Payouts
  - P/C insurers paid (or incurred) claims totaling $5.6 billion in 2
  - L/H claims and benefits paid totaled $8.7

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# Characteristics of the P/C Insurance Industry

## Cyclical and Sometimes Volatile, but Financially Conservative & Strong

# Profitability Peaks & Troughs in the P/C Insurance Industry, 1975 – 2016F

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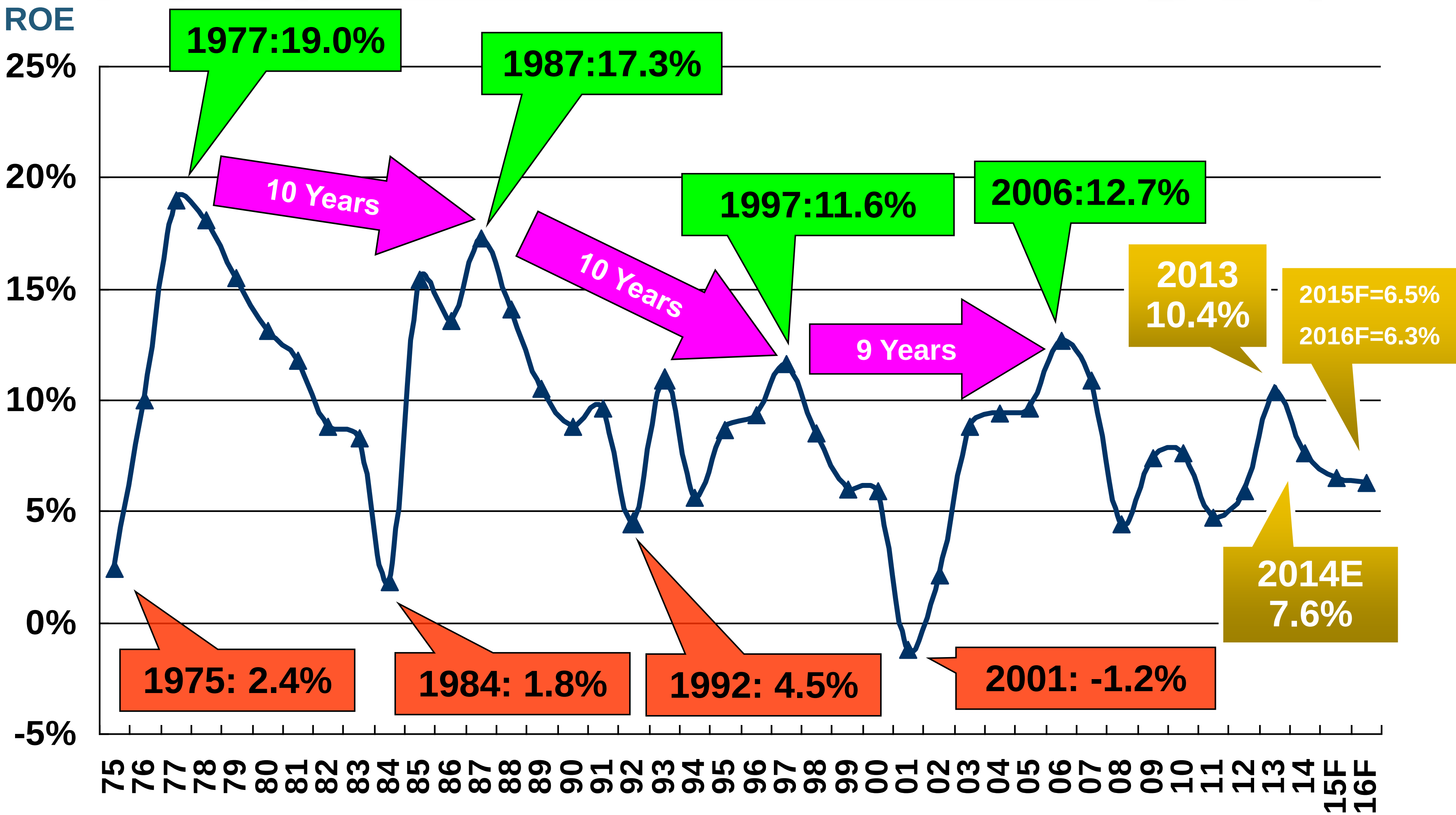
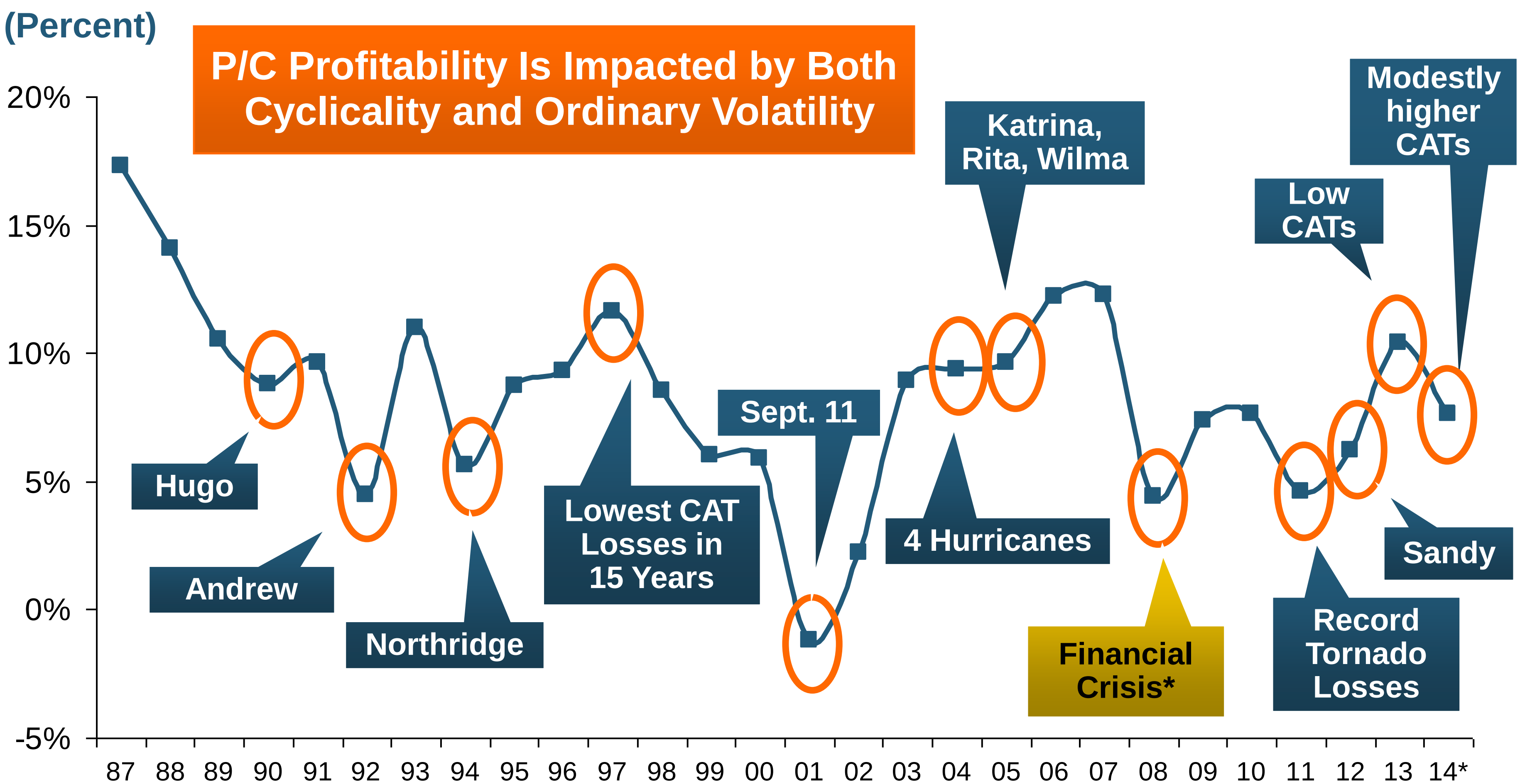



*Profitability = P/C insurer ROEs. 2011-14 figures are estimates based on ROAS data. Note: Data for 2008-2014 exclude mortgage and financial guaranty insurers.

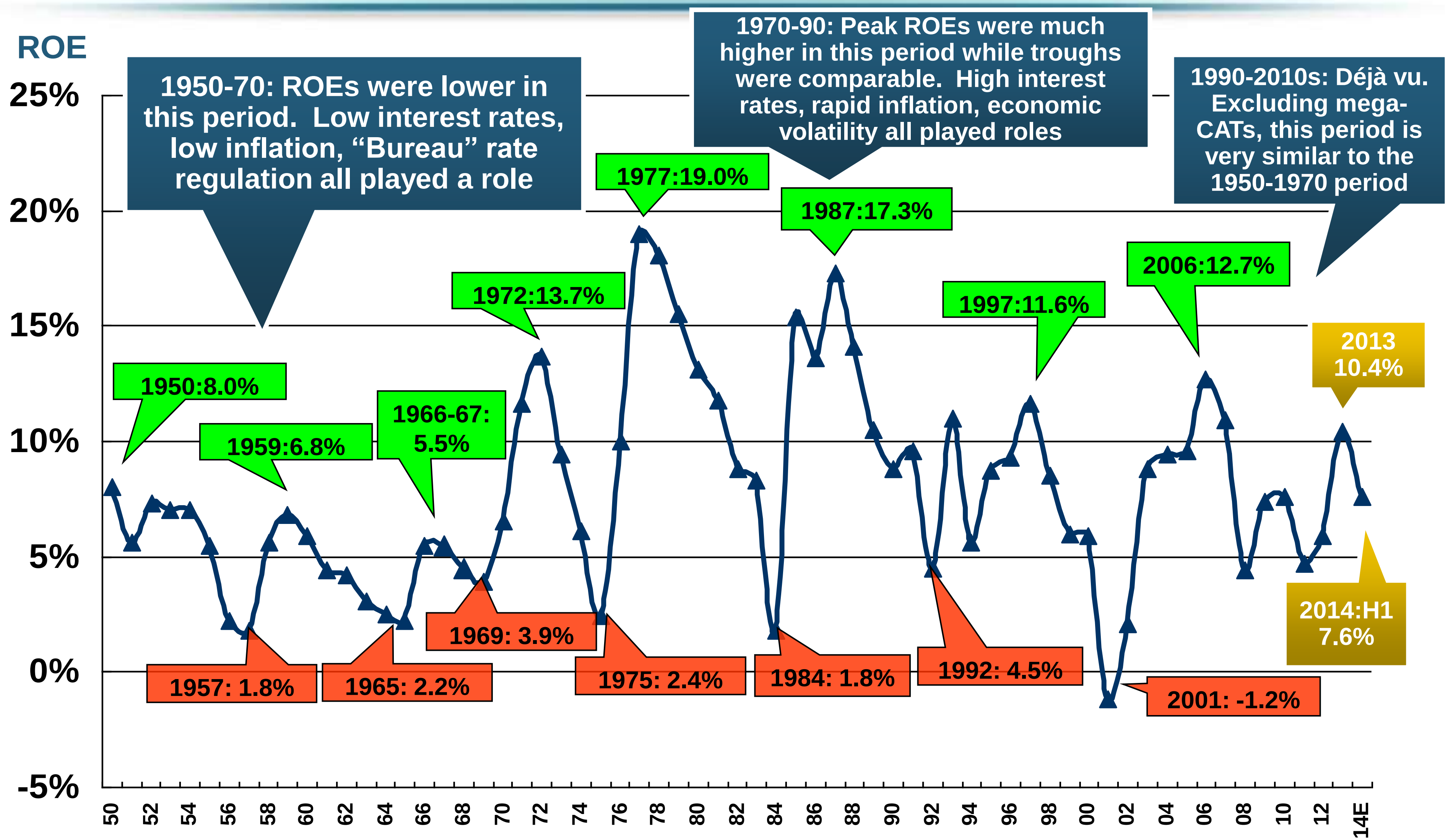
Source: Insurance Information Institute; NAIC, ISO, A.M. Best, Conning

# ROE: Property/Casualty Insurance by Major Event, 1987–2014E



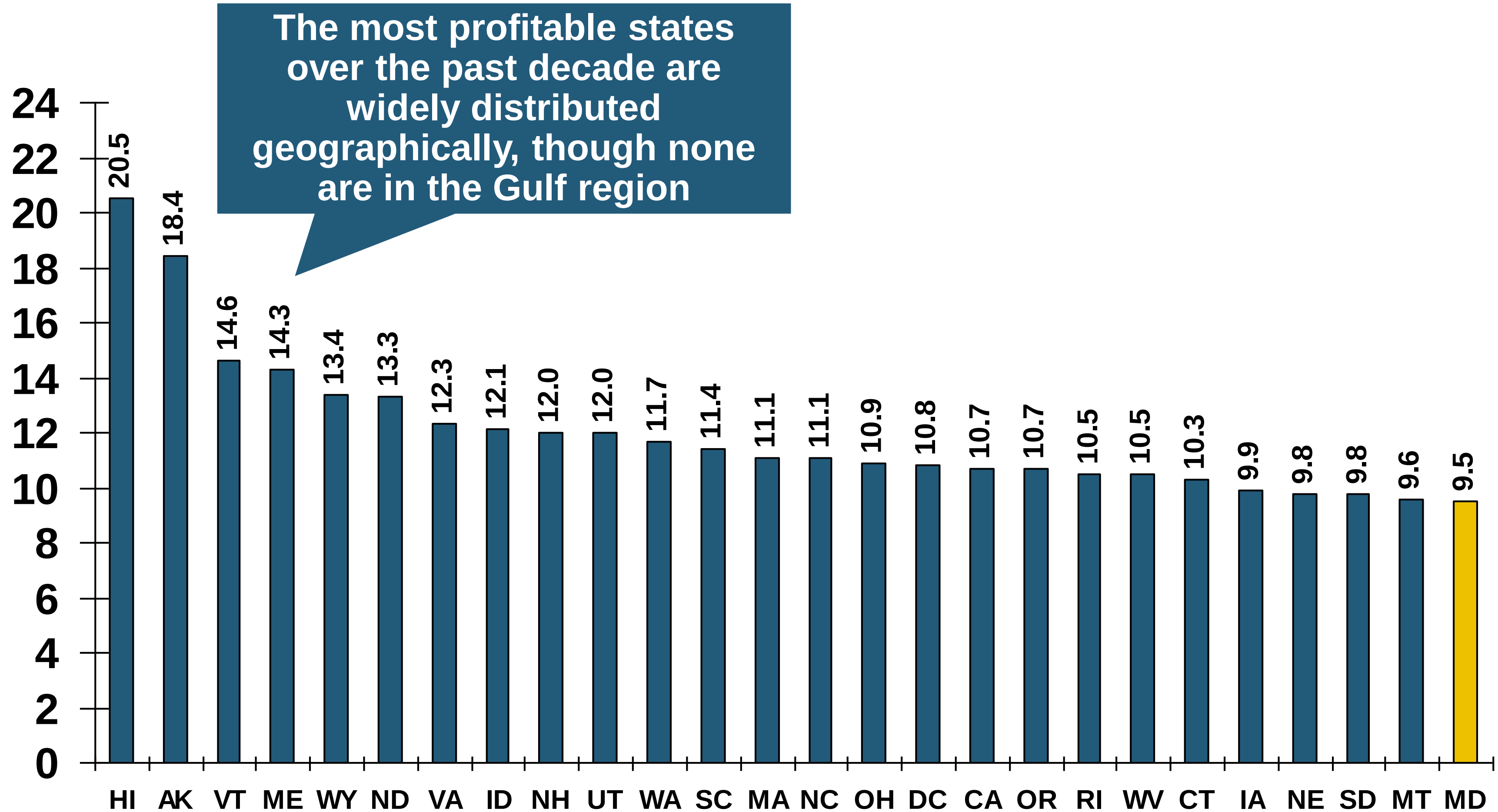

* Excludes Mortgage & Financial Guarantee in 2008 – 2014. 2014 figure is through Q3:2014.
Sources: ISO, *Fortune*; Insurance Information Institute.

# Back to the Future: Profitability Peaks & Troughs in the P/C Insurance Industry, 1950 – 2014*



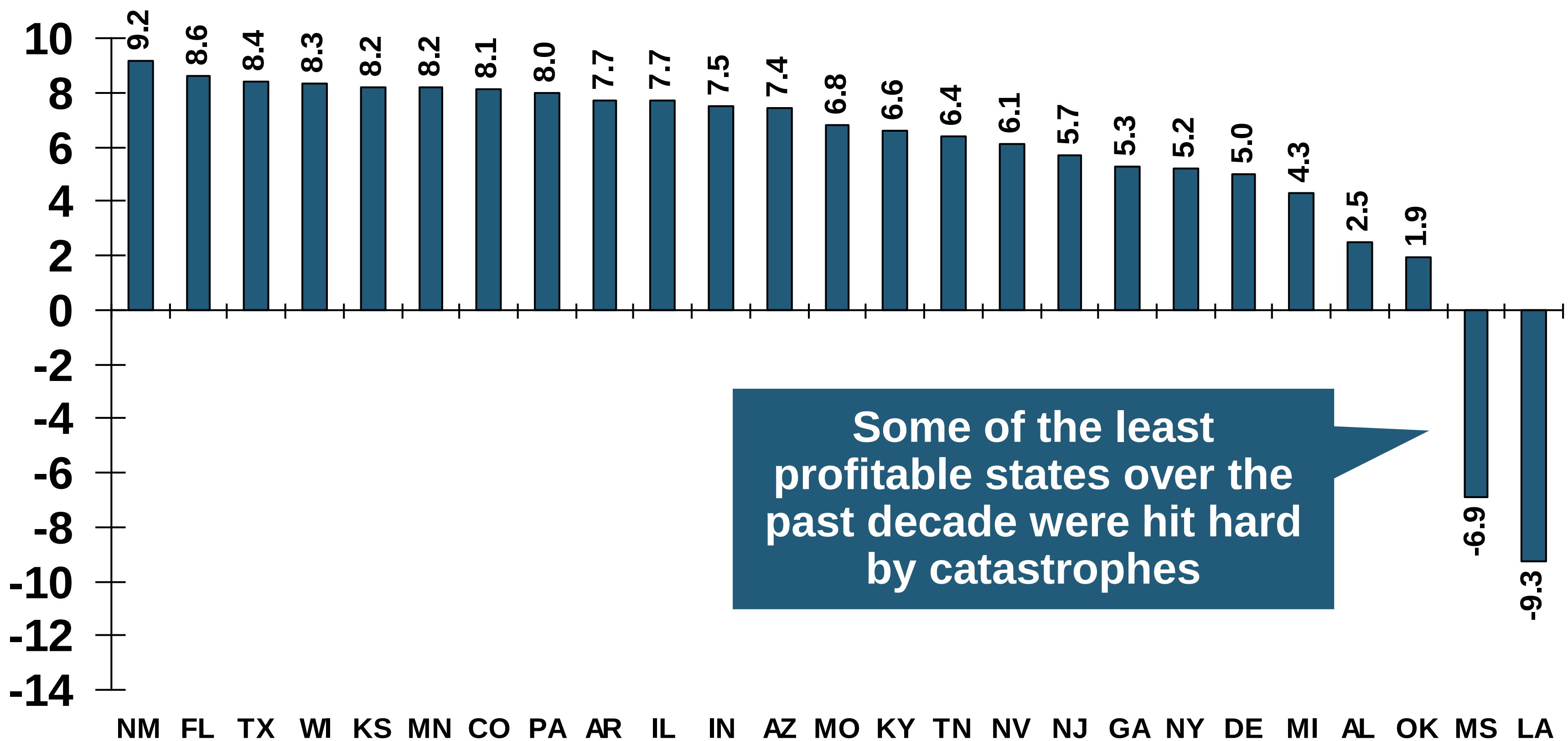

*Profitability = P/C insurer ROEs. 2011-14 figures are estimates based on ROAS data. Note: Data for 2008-2014 exclude mortgage and financial guaranty insurers. 2014 figure is through Q3.
Source: Insurance Information Institute; NAIC, ISO, A.M. Best.

# RNW All Lines by State, 2004-2013 Average: Highest 25 States




Source: NAIC; Insurance Information Institute.

# RNW All Lines by State, 2004-2013 Average: Lowest 25 States




Source: NAIC; Insurance Information Institute.

# Three Key Drivers of Profits

- Underwriting Results – Insurance operations
  - Companies sometimes lose money on insurance operations, especially from catastrophic losses
- Investment Results – Earned on money held until needed for claims or expenses
- Adequacy of Reserves and Capital/Surplus –
  - Reserves -- assets dedicated to known/expected claims
  - Capital/surplus -- assets dedicated to unknown/unexpected claims
  - Insurers may need to use profits to strengthen reserves and/or build surplus

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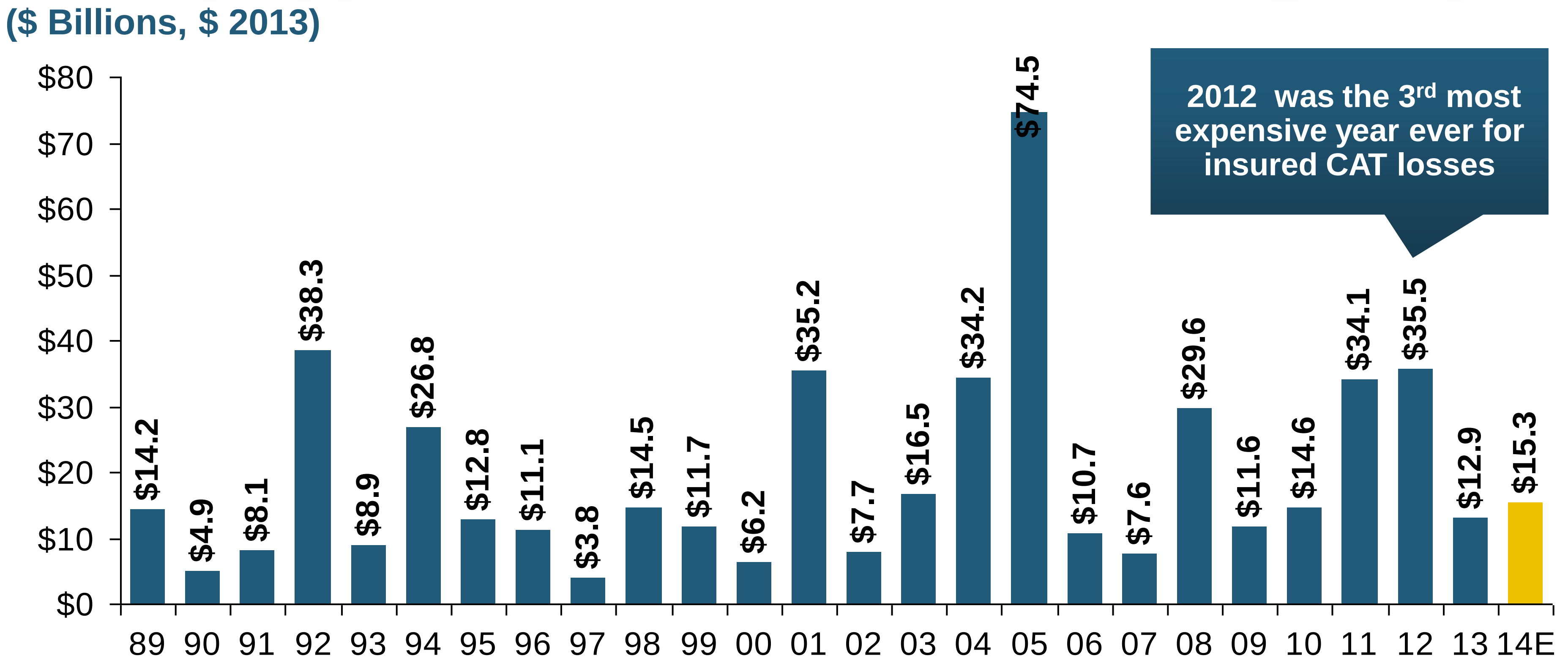
# U.S. Insured Catastrophe Loss Update

## 2014 Experiencing Below Average CAT Activity Following a Welcome Respite in 2013 from Very High CAT Losses in 2011/12

# U.S. Insured Catastrophe Losses



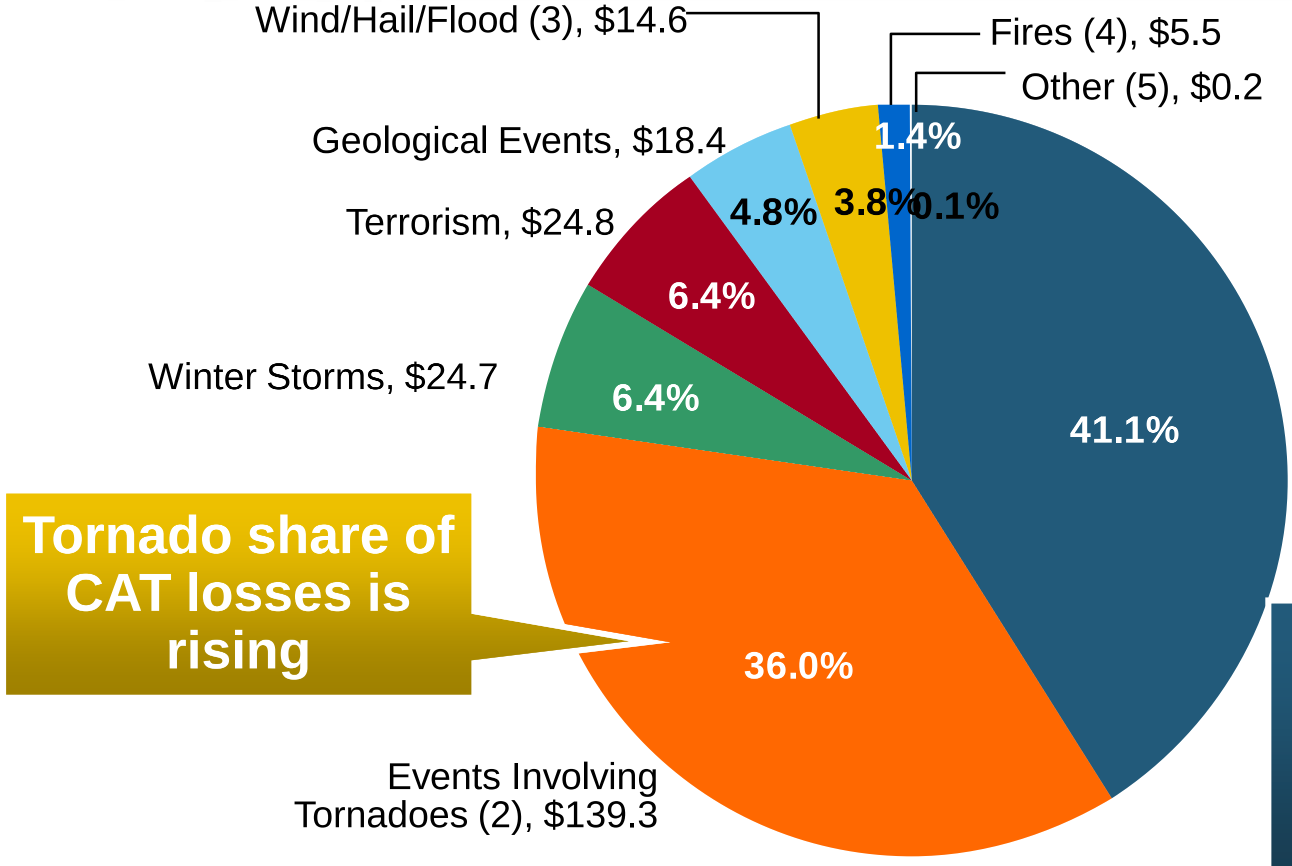

**2013 Was a Welcome Respite from 2012, the 3rd Costliest Year for Insured Disaster Losses in US History. Longer-term Trend is for more—not fewer—Costly Events**

*Through 12/31/14.

Note: 2001 figure includes $20.3B for 9/11 losses reported through 12/31/01 ($25.9B 2011 dollars). Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = $12.2B ($15.6B in 2011 dollars.)

Sources: Property Claims Service/ISO; Insurance Information Institute.

# Inflation Adjusted U.S. Catastrophe Losses by Cause of Loss, 1994–2013[1]




**Insured cat losses from 1993-2012 totaled $386.7B, an average of $19.3B per year or $1.6B per month**

**Wind losses are by far cause the most catastrophe losses, even if hurricanes/TS are excluded.**

1. Catastrophes are defined as events causing direct insured losses to property of $25 million or more in 2013 dollars.
2. Excludes snow.
3. Does not include NFIP flood losses
4. Includes wildland fires
5. Includes civil disorders, water damage, utility disruptions and non-property losses such as those covered by workers compensation.

Source: ISO's Property Claim Services Unit.

# Top 16 Most Costly Disasters in U.S. History

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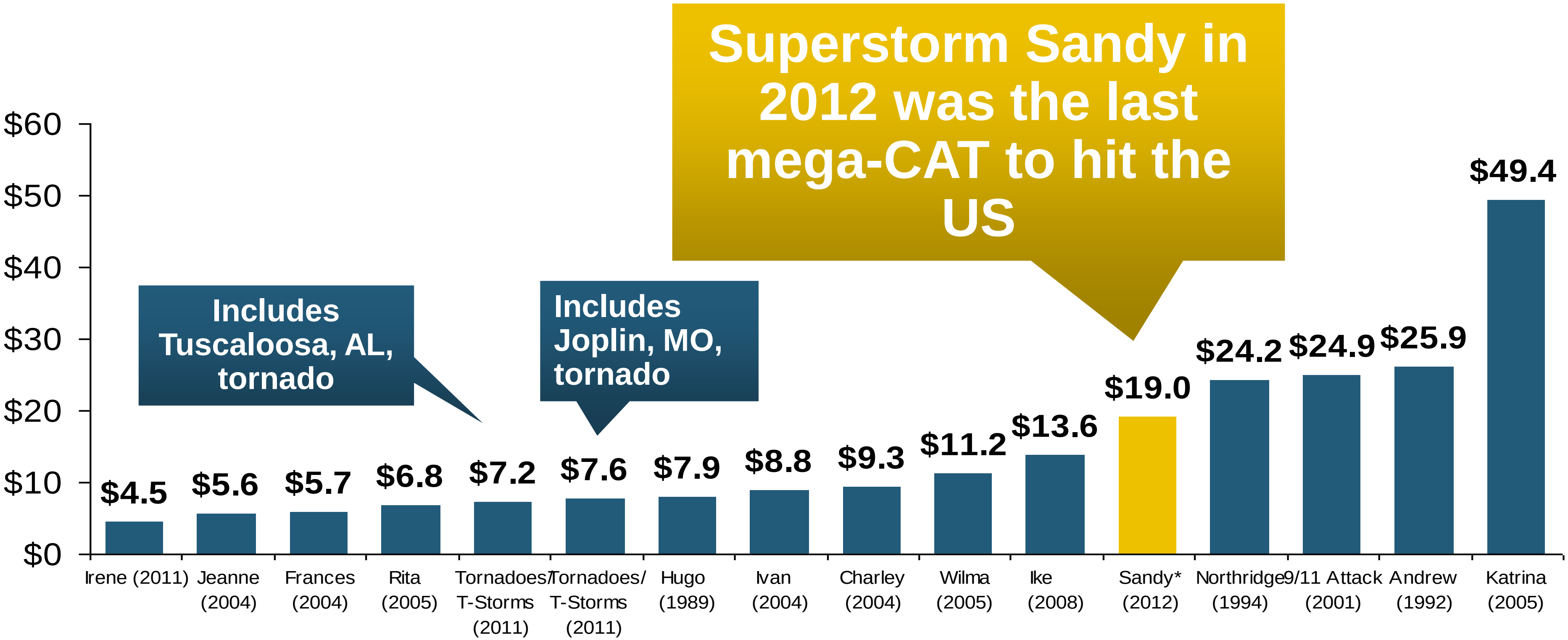
(Insured Losses, 2013 Dollars, $ Billions)




**12 of the 16 Most Expensive Events in US History Have Occurred Over the Past Decade**

Sources: PCS; Insurance Information Institute inflation adjustments to 2013 dollars using the CPI.

# Total Value of Insured Coastal Exposure in 2012

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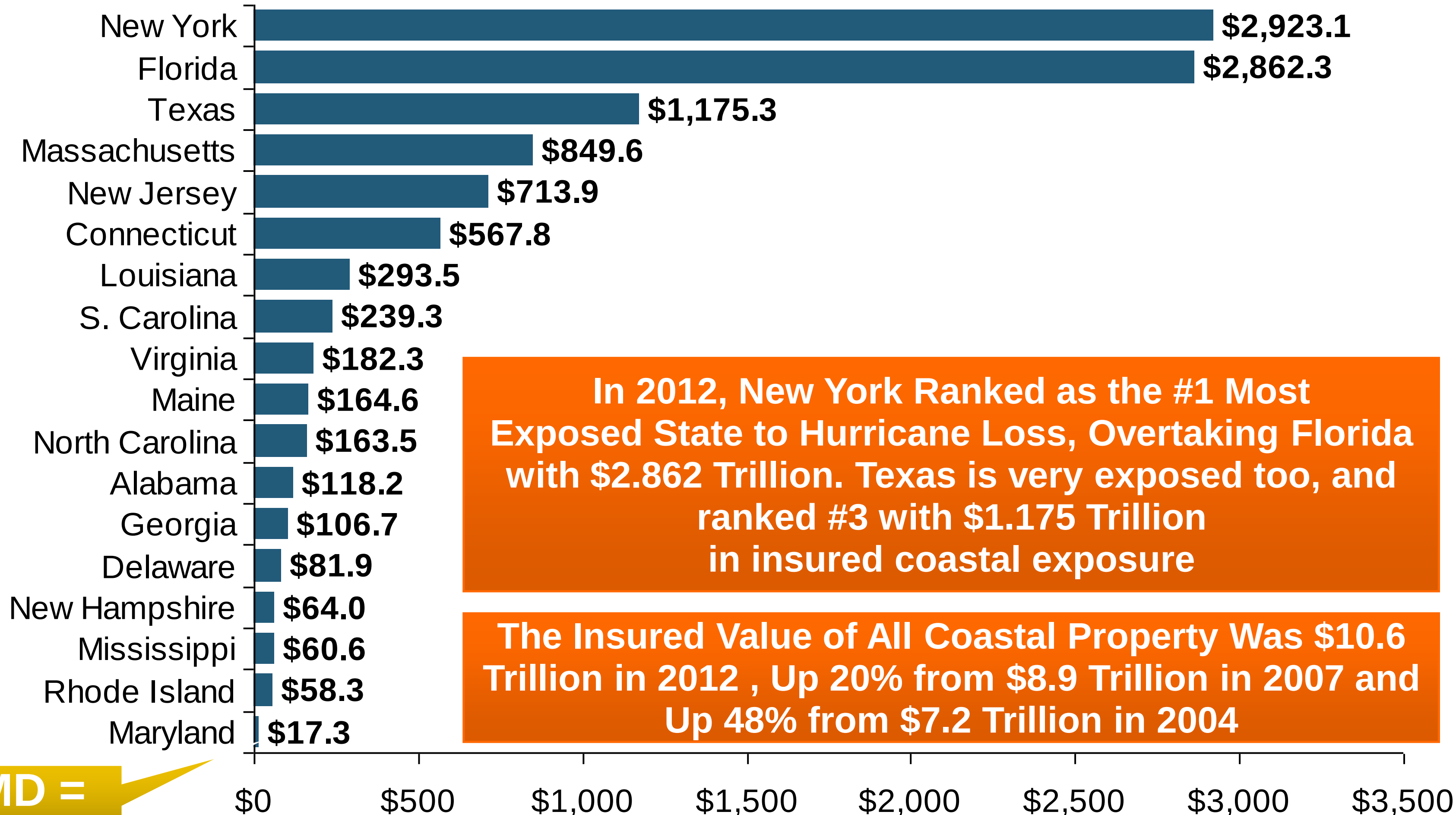
**(2012, $ Billions)**




**In 2012, New York Ranked as the #1 Most Exposed State to Hurricane Loss, Overtaking Florida with $2.862 Trillion. Texas is very exposed too, and ranked #3 with $1.175 Trillion in insured coastal exposure**

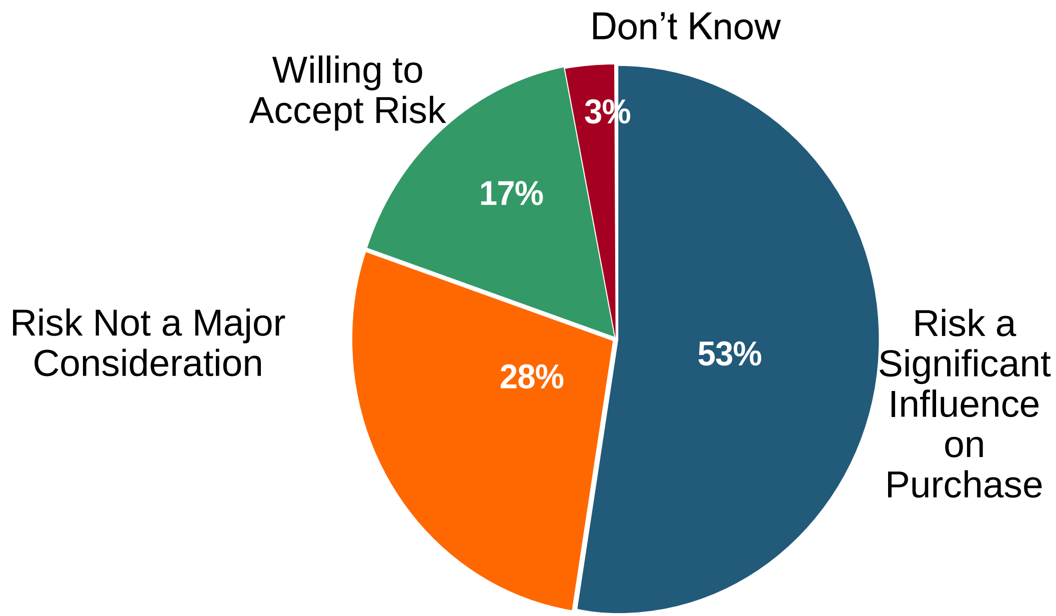
**The Insured Value of All Coastal Property Was $10.6 Trillion in 2012 , Up 20% from $8.9 Trillion in 2007 and Up 48% from $7.2 Trillion in 2004**

**MD = $17.3B**

Source: AIR Worldwide

# I.I.I. Poll: Homes Near Hazards

**Q. If you were to purchase a home today, which of the following summarizes your views on that home's risk of damage from natural disasters . . . and your decision to purchase that home?**




**More Than Half of the Public Would Be Significantly Influenced by Risk of Damage from Natural Disasters. Close to a Third Do Not Regard Such a Risk To Be a Major Consideration.**

Source: Insurance Information Institute Annual *Pulse* Survey.

# Federal Disaster Declarations Patterns: 1953-2014

## Disaster Declarations Set New Records in Recent Years

# Number of Federal Major Disaster Declarations, 1953-2014*

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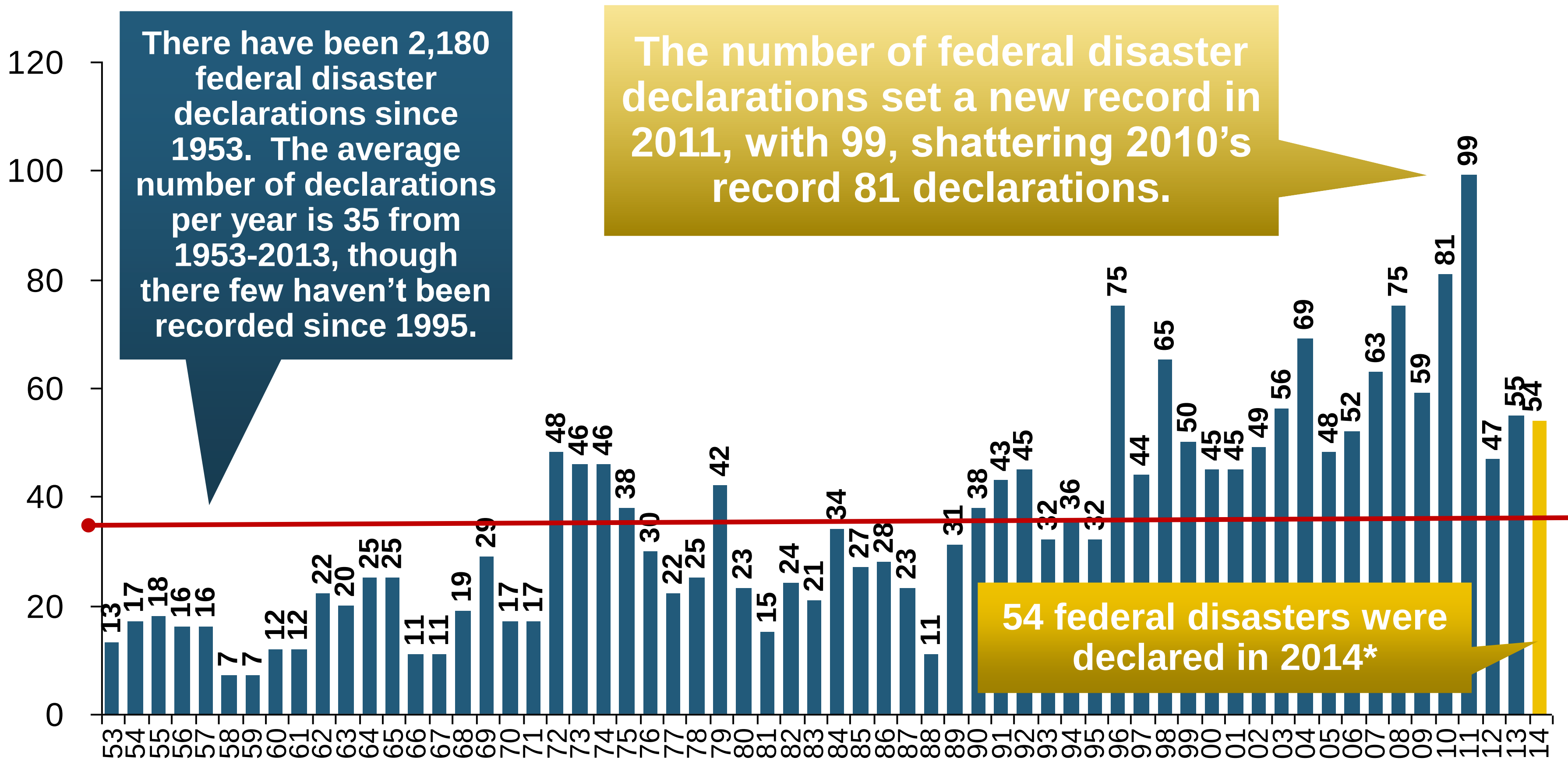
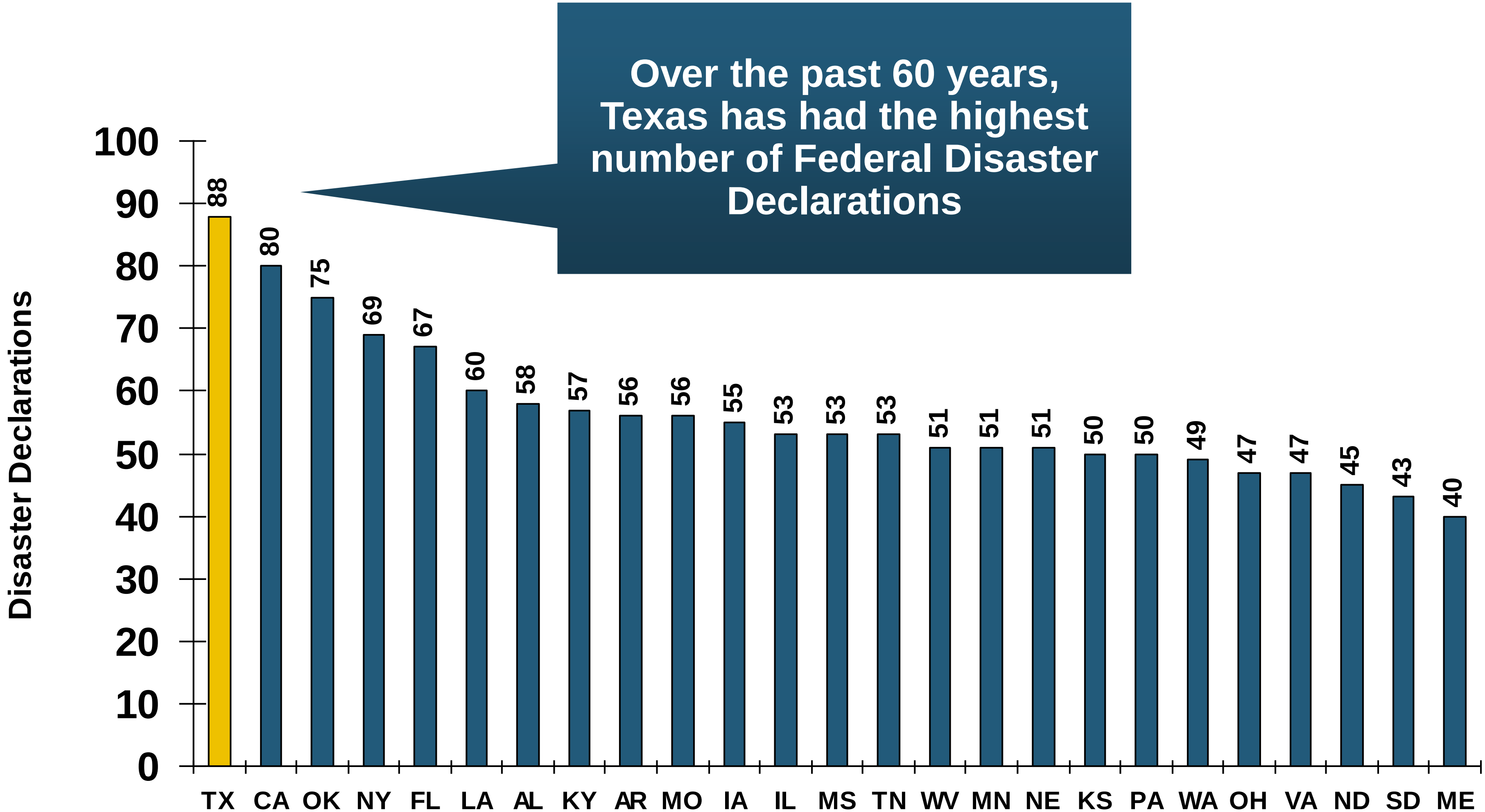



**The Number of Federal Disaster Declarations Is Rising and Set New Records in 2010 *and* 2011 Before Dropping in 2012-2014**

*Through December 31, 2014.

Source: Federal Emergency Management Administration; http://www.fema.gov/disasters; Insurance Information Institute.

# Federal Disasters Declarations by State, 1953 – 2014: Highest 25 States*




*Through December 31, 2014. Includes Puerto Rico and the District of Columbia.

Source: FEMA: http://www.fema.gov/news/disaster_totals_annual.fema; Insurance Information Institute.

# Federal Disasters Declarations by State, 1953 – 2014: Lowest 25 States*

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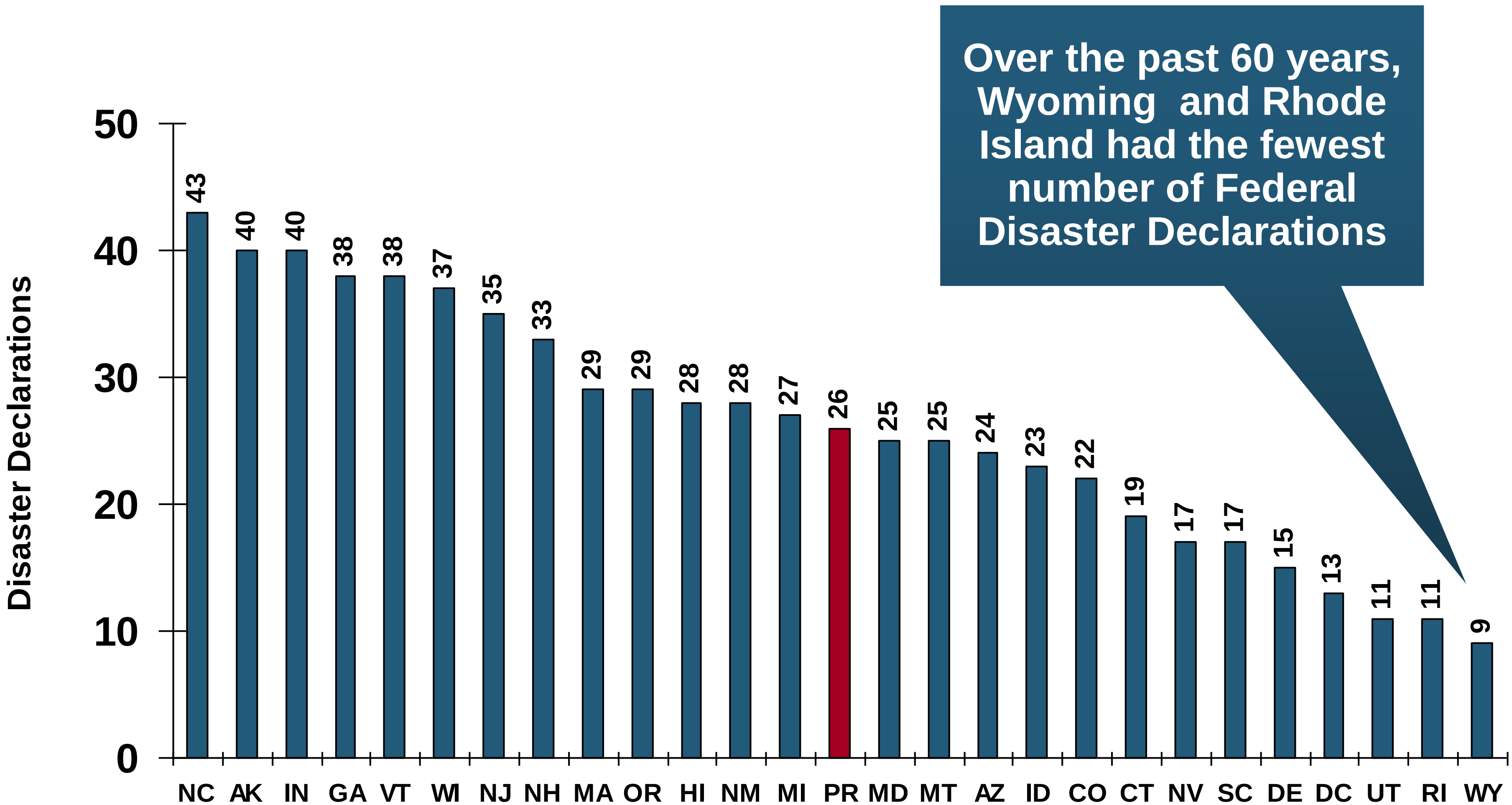


*Through December 31, 2014. Includes Puerto Rico and the District of Columbia.

Source: FEMA: http://www.fema.gov/news/disaster_totals_annual.fema; Insurance Information Institute.

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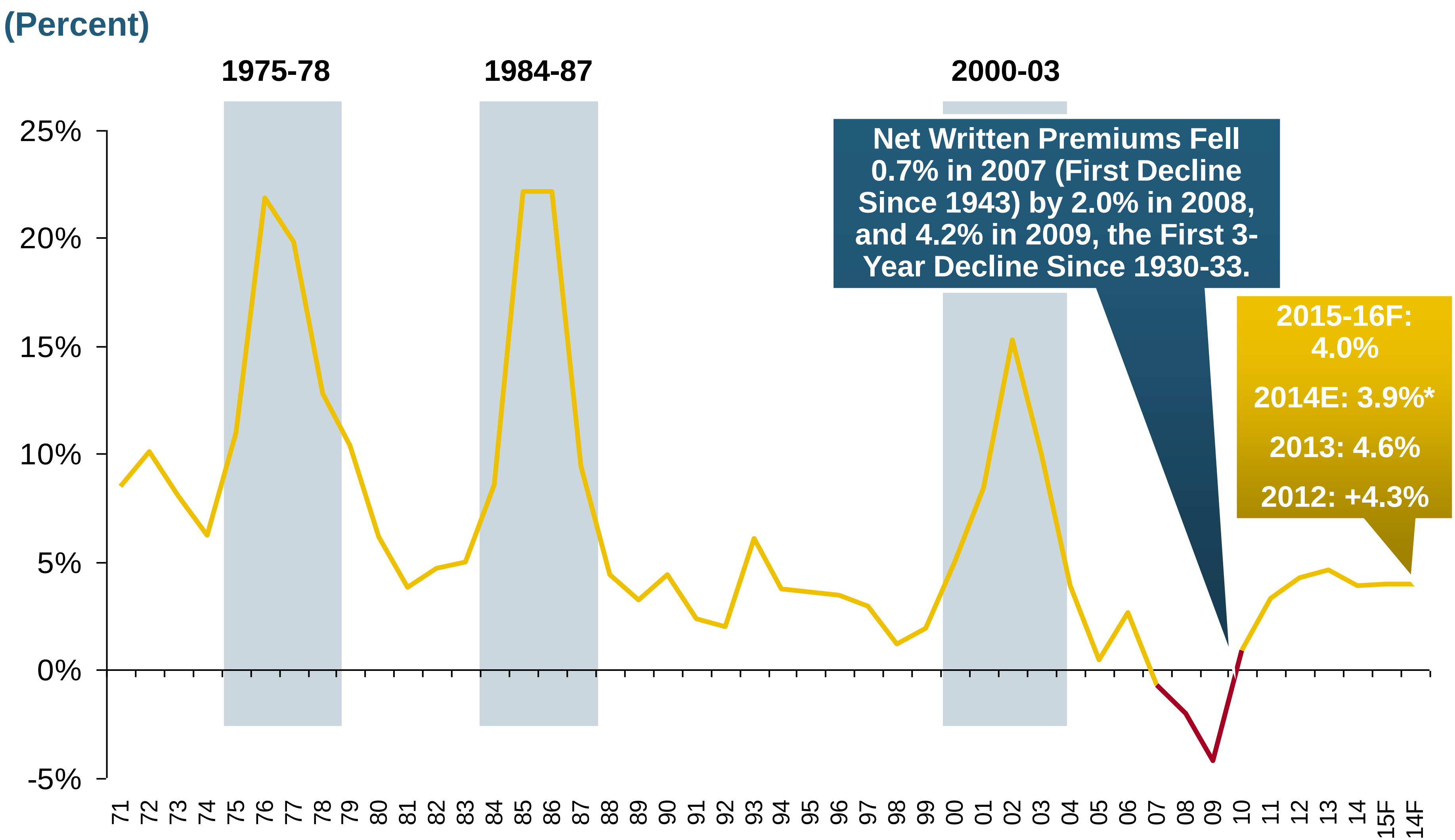
# GROWTH & CAPACITY

## P/C Insurance Industry Is Growing Modestly and Capacity Is Increasing

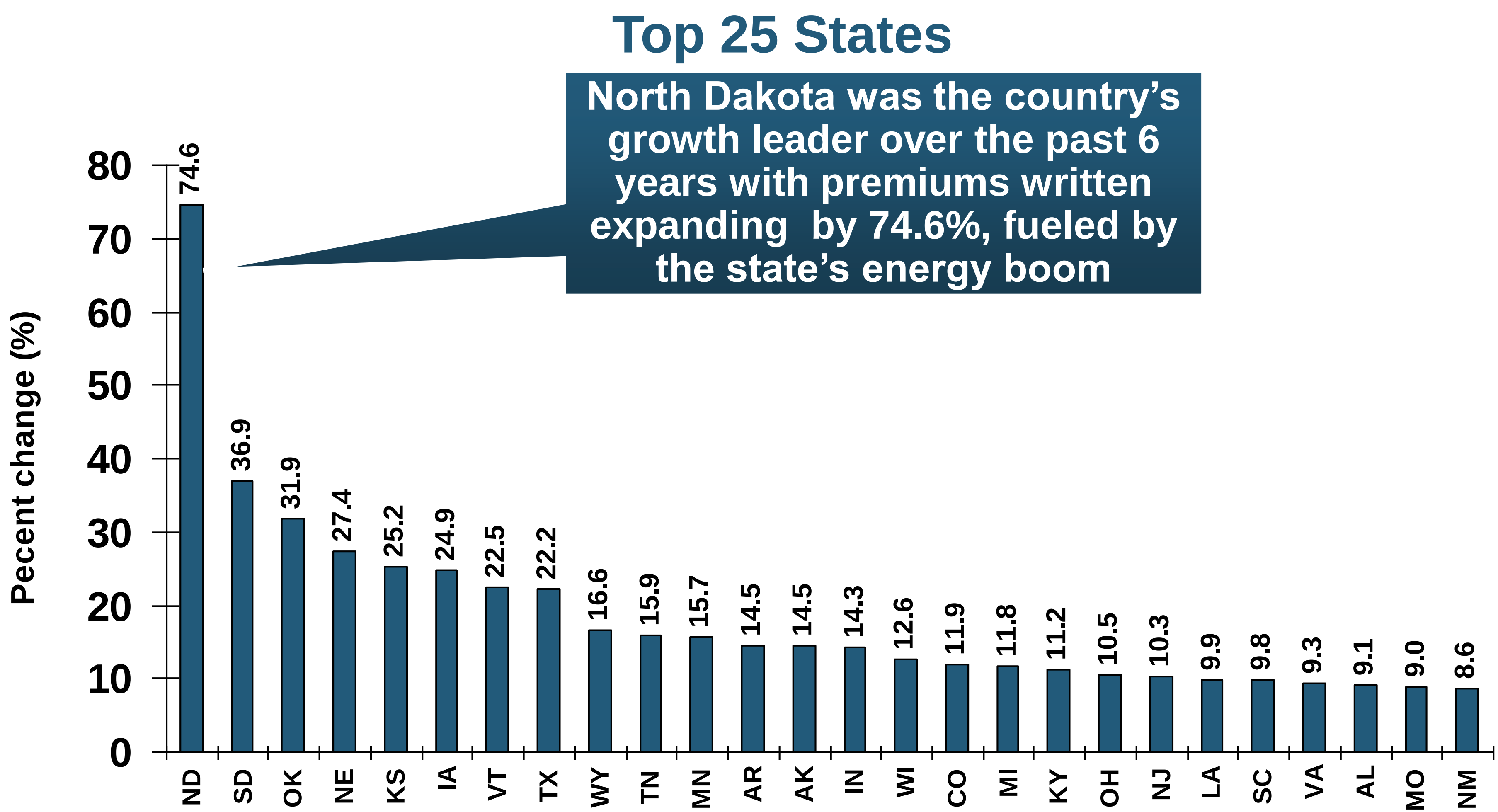
# Net Premium Growth: Annual Change, 1971—2016F






*Actual figure based on data through Q3 2014.
Shaded areas denote “hard market” periods
Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute.

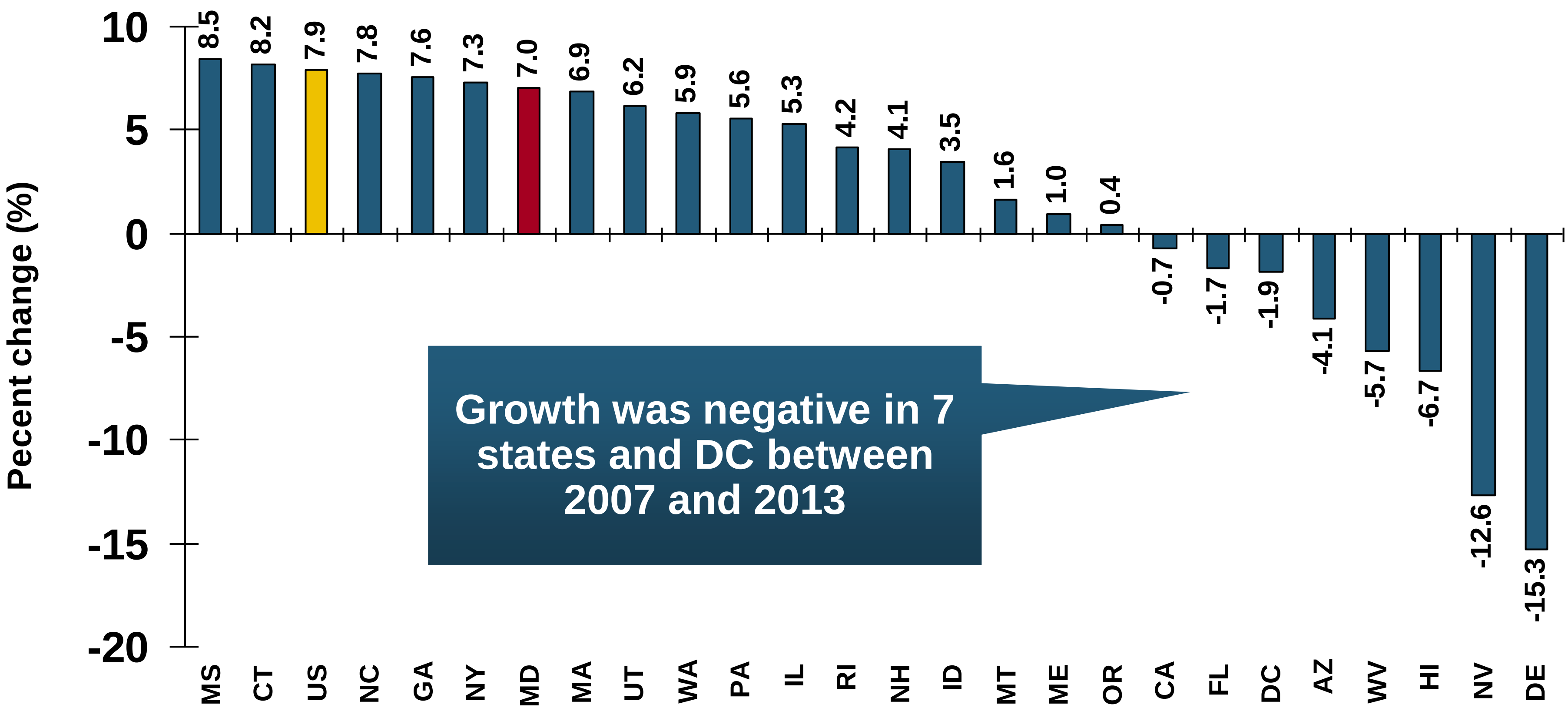
# Direct Premiums Written: Total P/C Percent Change by State, 2007-2013




Sources: SNL Financial LC.; Insurance Information Institute.

# Direct Premiums Written: Total P/C Percent Change by State, 2007-2013

## Bottom 25 States




Sources: SNL Financial LC.; Insurance Information Institute.

# US Policyholder Surplus: 1975–2014*

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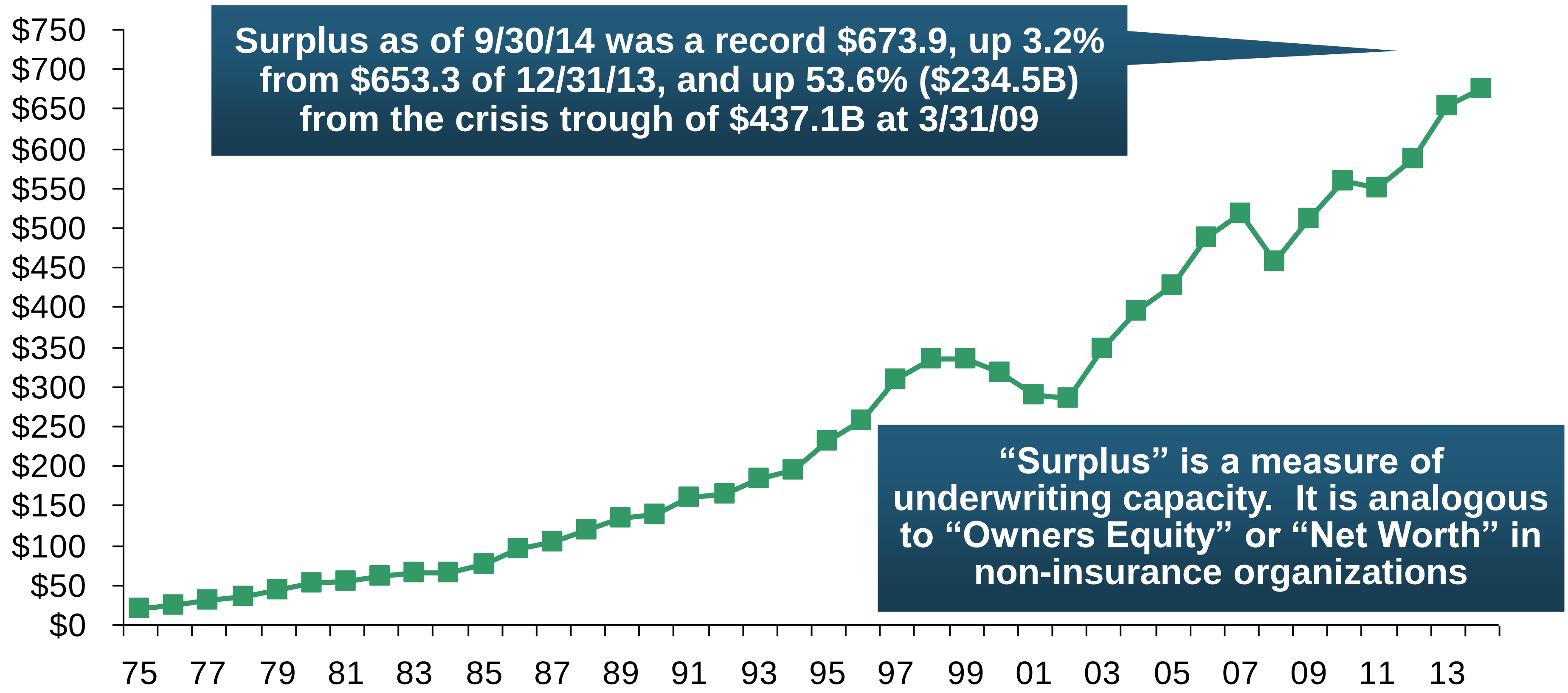
($ Billions)




**The Premium-to-Surplus Ratio Stood at $0.73:$1 as of 9/30/14, a Near Record Low (at Least in Recent History)**

* As of 9/30/14.

Source: A.M. Best, ISO, Insurance Information Institute.

# Catastrophe Bond Issuance and Outstanding: 1997-2014

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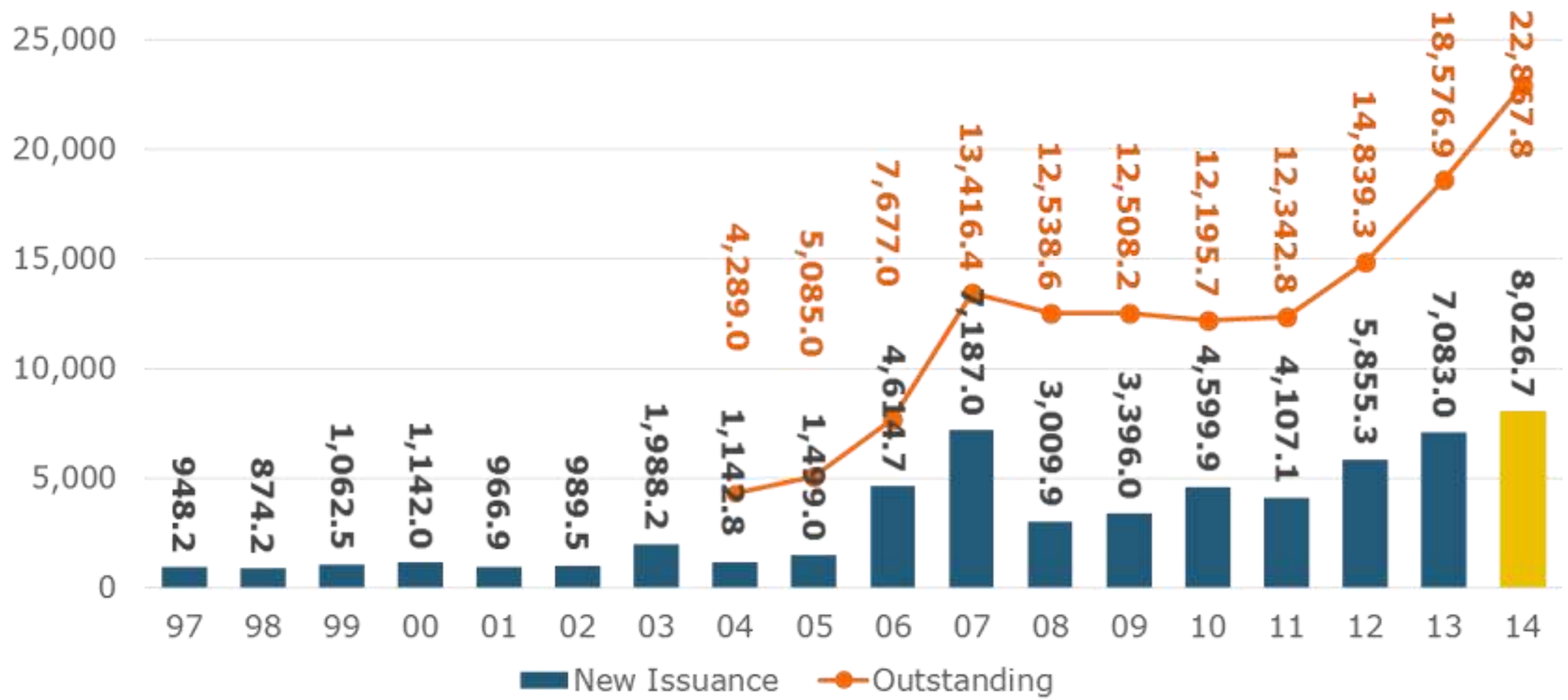
## Risk Capital Amount ($ Millions)




**2014 Has Seen the Largest Cat Bond Ever - $1.5 Billion (Florida Citizens). Bond Issuance Set a Record.**

Source: Guy Carpenter.

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# INVESTMENTS:
# THE NEW REALITY

## Investment Performance is a Key Driver of Profitability

## *Depressed Yields Will Necessarily Influence Underwriting & Pricing*

# Distribution of Invested Assets: P/C Insurance Industry, 2013

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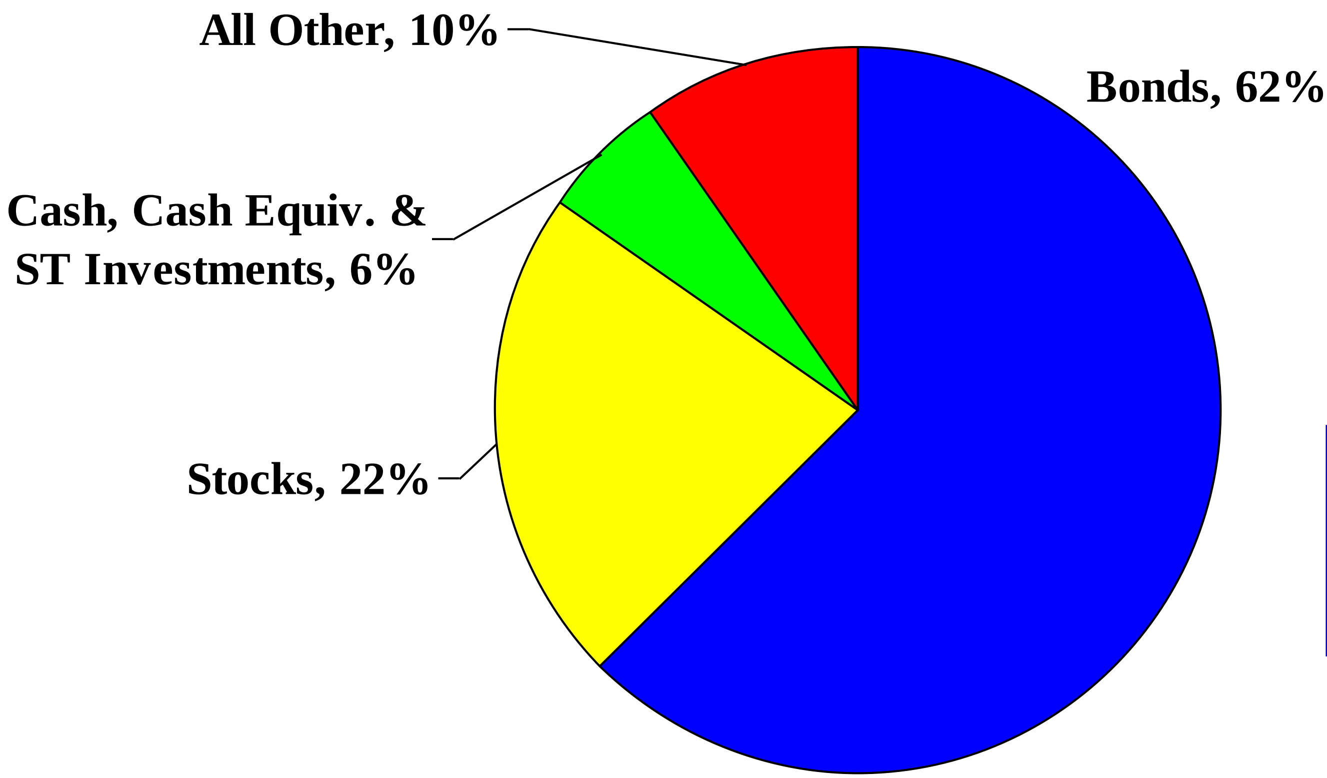
## $ Billions




Total Invested Assets = $1.5 Trillion

Source: Insurance Information Institute *Fact Book 2015,* A.M. Best.

# Property/Casualty Insurance Industry Investment Income: 2000–2014[1]

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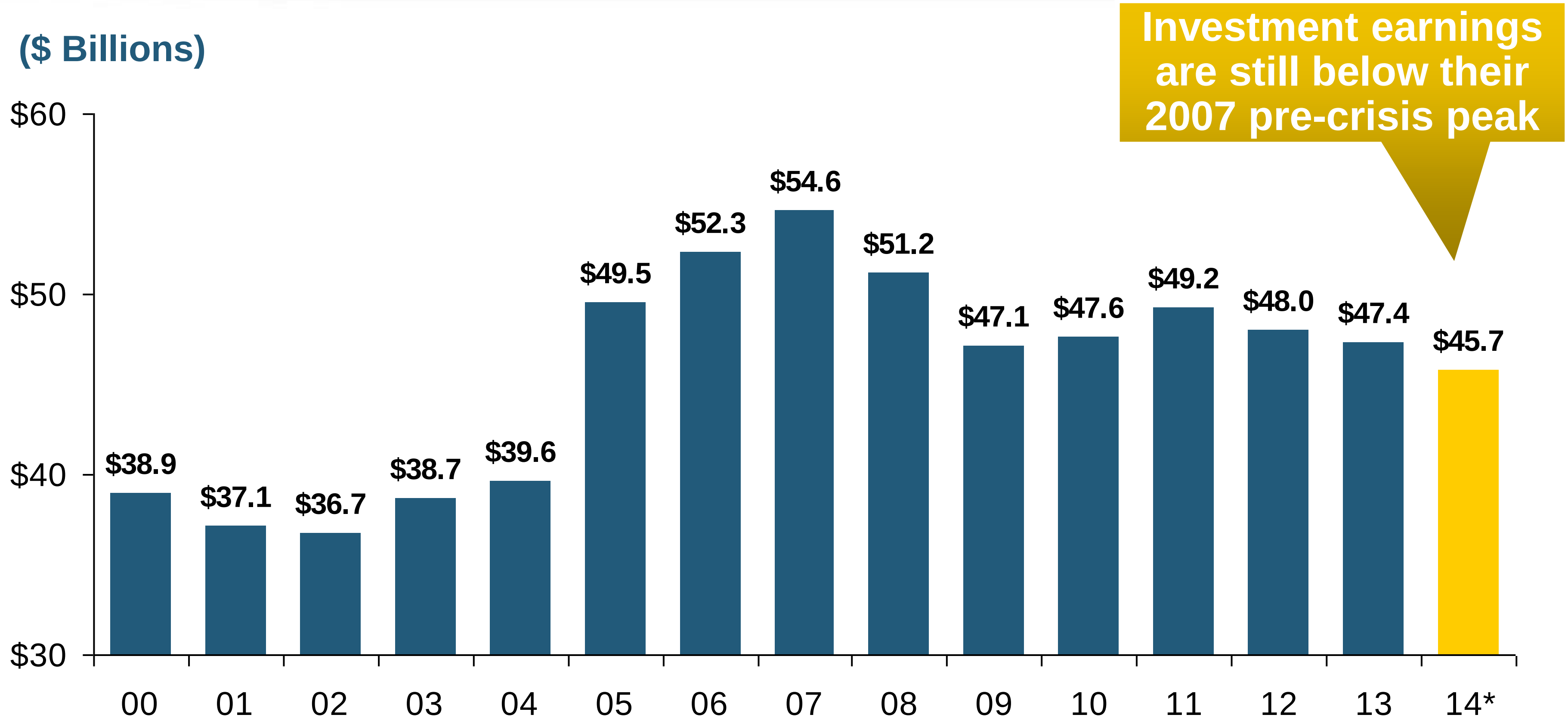


**Due to persistently low interest rates, investment income fell in 2012, 2013 and 2014.**

[1] Investment gains consist primarily of interest and stock dividends. *2014 figure is estimated based on annualized data through Q3.
Sources: ISO; Insurance Information Institute.

# U.S. Treasury Security Yields: A Long Downward Trend, 1990–2014*

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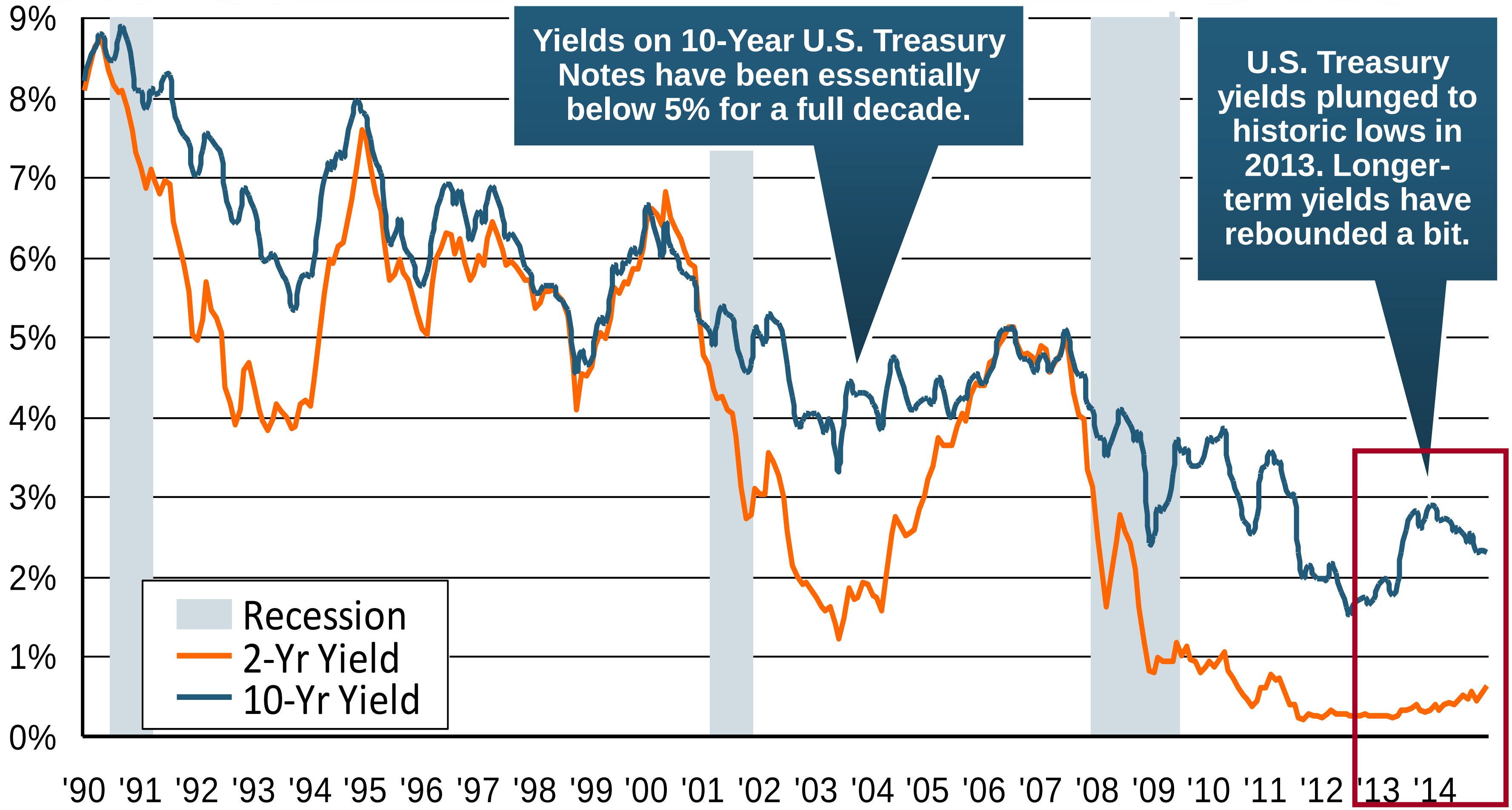
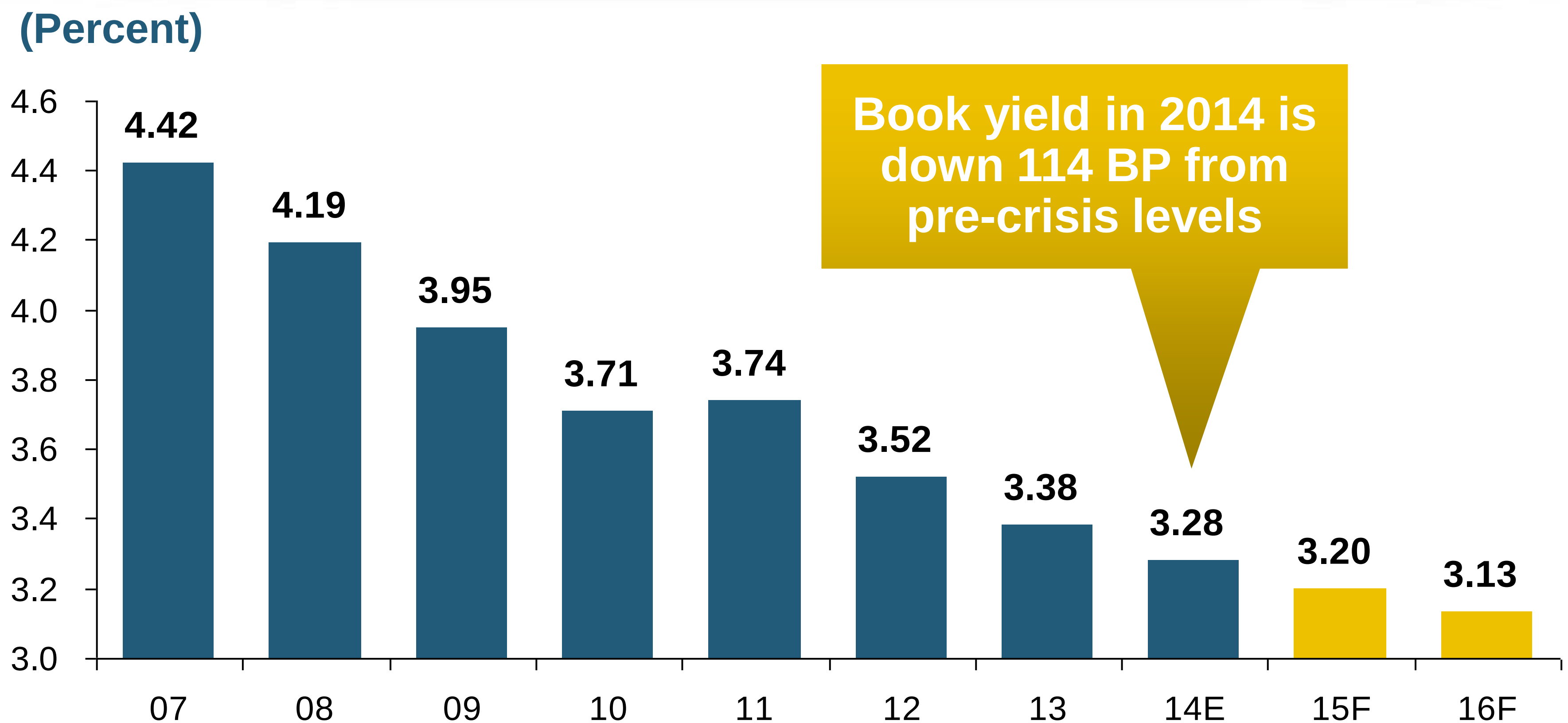



**Since roughly 80% of P/C bond/cash investments are in 10-year or shorter durations, most P/C insurer portfolios will have low-yielding bonds for years to come.**

*Monthly, constant maturity, nominal rates, through Dec. 2014.

Sources: Federal Reserve Bank at http://www.federalreserve.gov/releases/h15/data.htm. National Bureau of Economic Research (recession dates); Insurance Information Institute.

# Book Yield on Property/Casualty Insurance Invested Assets, 2007–2016F




**The yield on invested assets continues to decline as returns on maturing bonds generally still exceed new money yields. The end of the Fed's QE program in Oct. 2014 should allow some increase in longer maturities while short term interest rate increases are unlikely until mid-to-late 2015**

Sources: Conning.

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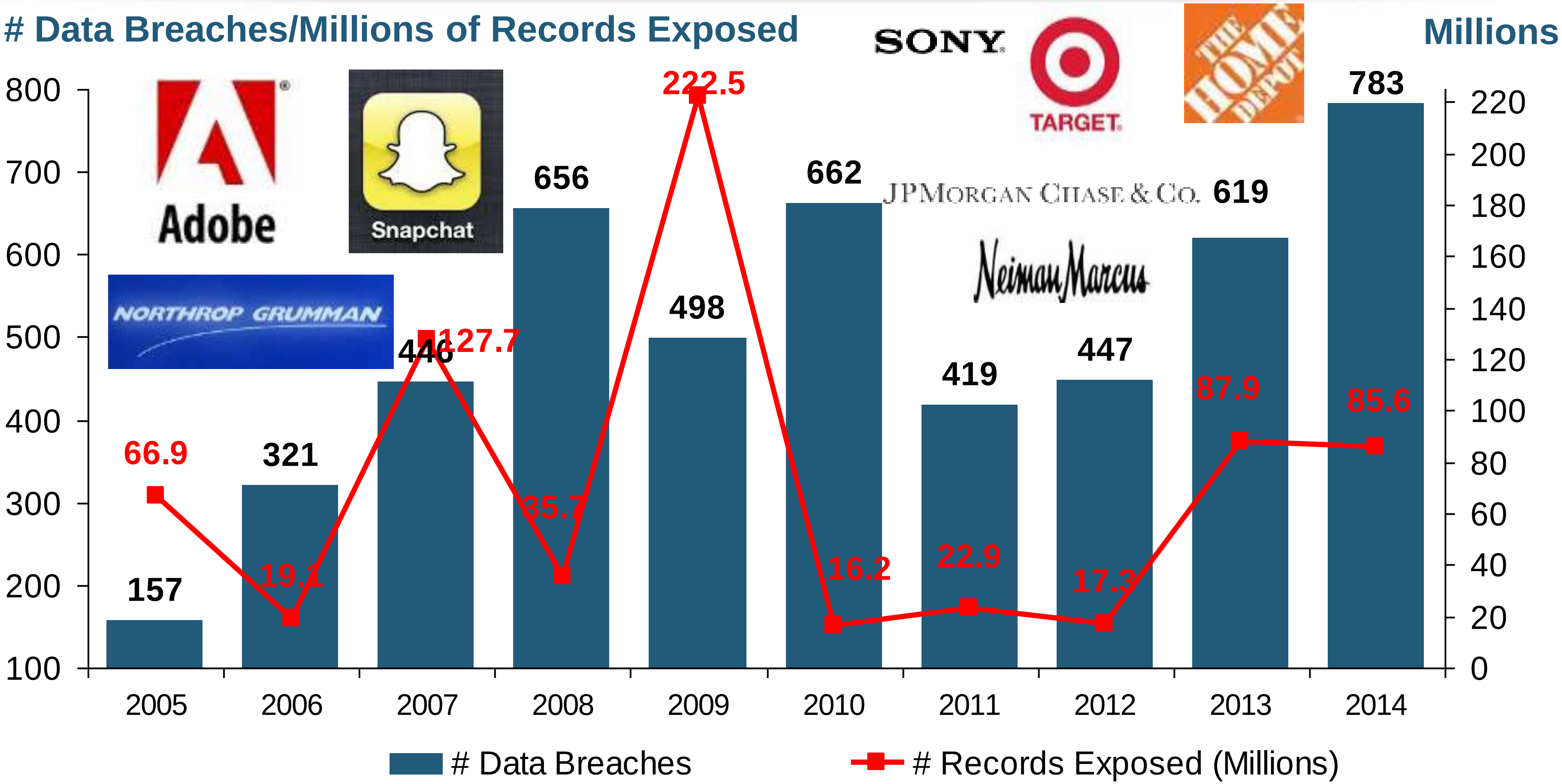
# CYBER RISK & CYBER INSURANCE

## P/C Insurance Is an Innovative Industry

***Cyber Insurance Is a Recent Example***

# Data Breaches 2005-2014, by Number of Breaches and Records Exposed

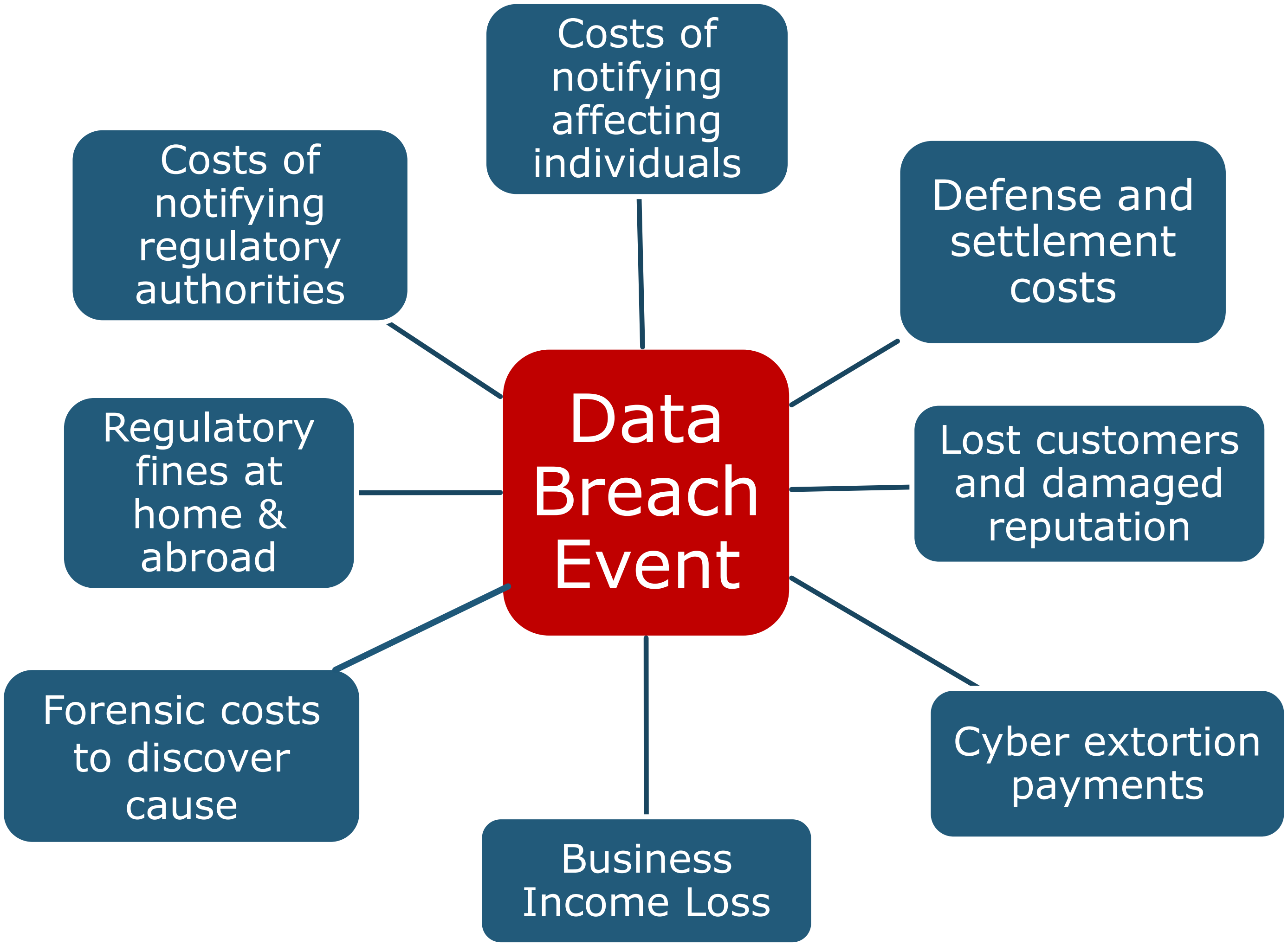



**The Total Number of Data Breaches Rose 28% While the Number of Records Exposed Was Relatively Flat (-2.6%)**



* 2014 figures as of Jan. 12, 2014 from the ITRC.
Source: Identity Theft Resource Center.

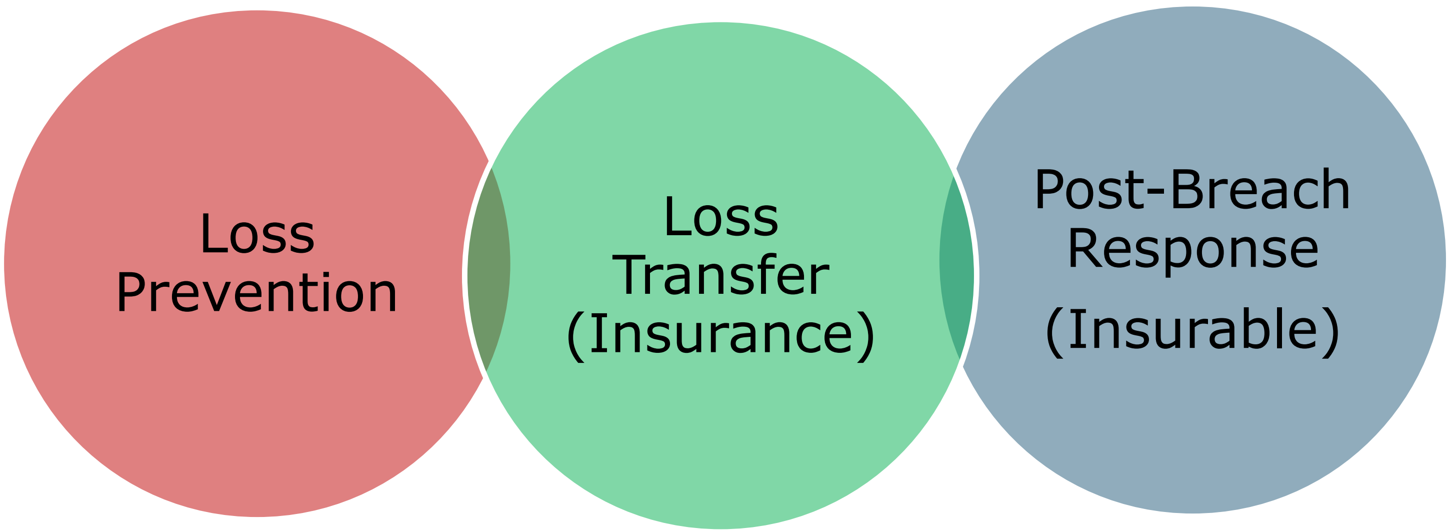
# Data/Privacy Breach: Many Potential Costs Can Be Insured




Source: Zurich Insurance; Insurance Information Institute

# The Three Basic Elements of Cyber Coverage: Prevention, Transfer, Response






**Cyber risk management today involves three essential components, each designed to reduce, mitigate or avoid loss. An increasing number of cyber risk products offered by insurers today provide all three.**

Source: Insurance Information Institute research.

# I.I.I. Released its Second Cyber Report in 2014: *Cyber Risk: The Growing Threat*

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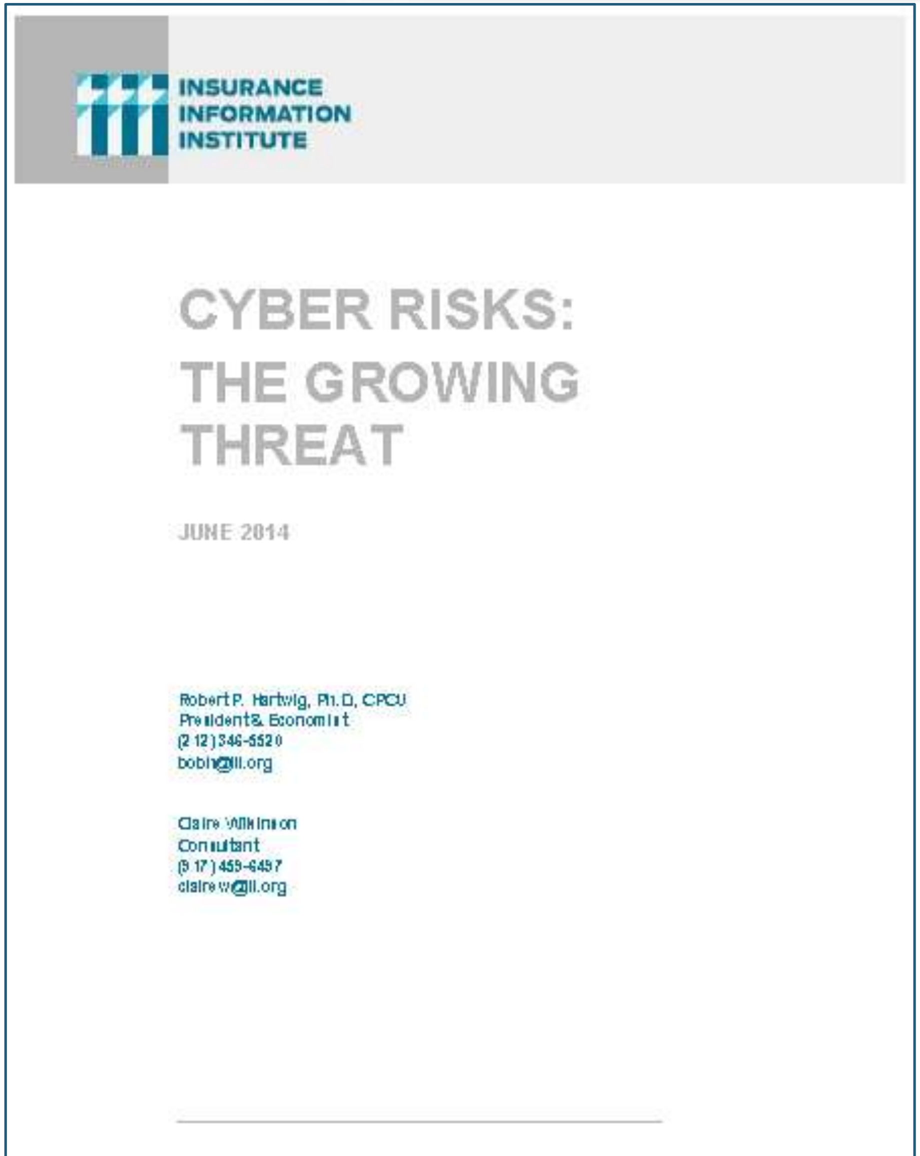
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CYBER RISKS:
THE GROWING
THREAT

JUNE 2014

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- **I.I.I.'s 2nd report on cyber risk released June 2014**
- **Provides information on cyber threats and insurance market solutions**
- **Global cyber risk overview**
  - **Quantification of threats by type and industry**
- **Cyber security and cost of attacks**
- **Cyber terrorism**
- **Cyber liability**
- **Insurance market for cyber risk**
- ***3rd Report in Q2 2015***

# Conclusion

- The P/C insurance industry is highly competitive
- It's a highly cyclical/volatile business
- The industry is financially very strong
- Profitability depends not only on claims activity but also investment returns and other factors
- Many factors influence price (rate) and availability
  - General & individual risk rating factors
  - Nature of regulation has significant impact on competition, consumer choice, and price

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# Q & A

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