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## Commentary on Full-Year 2005 Results

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The property/casualty insurance industry reported a statutory rate of return on average surplus of 10.5 percent in 2005, marginally above the 10.4 percent average return recorded during calendar year 2004. The results were released by the Insurance Services Office, Inc. (ISO) and the Property Casualty Insurers Association of America (PCI). Excluding a special, non-recurring dividend one insurer received from an investment subsidiary, the industry's return on average surplus was 9.8 percent. The *Fortune* 500 group of companies, in contrast, turned in a 14.9 percent return on equity in 2005. This means that the property/casualty insurance industry as a whole has underperformed the *Fortune* 500 group every year since 1987.

### **2005 in a Word: Resilience**

The financial performance of the property/casualty insurance industry during 2005 provided tangible proof of the resilience of the industry in the face of unprecedented adversity. Rocked by record catastrophe losses of \$57.7 billion arising from more than 3.3 million claims, the industry nearly broke even from an underwriting perspective with a combined ratio coming in at a surprisingly low 100.9. This means that for every dollar of premium income that came in the door in 2005, about \$1.01 exited in the form of claims payments, claims reserves and expenses—with nothing left over for profit from underwriting operations. Indeed, property/casualty insurers sustained a statutory underwriting loss of \$4.1 billion in 2005, following a \$6.0 billion underwriting profit in 2004—the first since 1978. Insurers did, however, benefit from rising interest rates and a small stock market gain to generate \$59.2 billion on their investment portfolio, enough to tip the balance toward a 10.5 percent return on average surplus (a \$56.0 billion gain and 9.8 percent return on average surplus after excluding the \$3.2 billion special dividend paid by one company's investment subsidiary).

It should be noted, however, that profitability in the industry is still low considering the extraordinary risk insurers assume, coming in well below the 14.9 percent return for the *Fortune* 500 group of companies last year. Prior to Hurricane Katrina the industry was on a trajectory to record its highest level of profitability since 1987. Contrary to some media reports, the property/casualty insurance industry did not even come close to

experiencing record profitability in 2005. Indeed, the 9.8 percent adjusted return on average surplus in 2005, in addition to falling well below the average *Fortune* 500 return of 14.9 percent, is also insufficient when measured relative to virtually risk-free alternative investments such as 10-year U.S. Treasury securities or 12-month FDIC insured certificates of deposit, both of which now yield five percent or better. A more detailed explanation of financial reporting and the calculation of profits in the property/casualty insurance industry is available at: <http://www.iii.org/media/industry/additional/financials/>.

Most importantly, insurers need to generate adequate rates of return not only to compensate investors for the risk they assume and preserve their claims-paying capital, but also to maintain their financial strength and credit ratings and to avoid regulatory sanctions. A financially weak insurance industry is no use to anyone, including policyholders, millions of whom depend on the industry to pay hundreds of billions of dollars in claims each year.

#### **Insurer Profits: Each Line and Each State Must Stand on its Own**

The insurance industry is regulated at the state level. By law, insurance rates in each state must reflect the actual and expected loss experience in that state and that state only. Consequently, each line of insurance—such as auto and homeowners coverage—needs to stand on its own in terms of profitability. Profits in auto insurance or workers compensation coverage, for example, cannot be used to subsidize losses in homeowners insurance that arise from hurricanes or other natural disasters. Likewise, insurance markets in each state must be profitable in their own right and cannot be subsidized by profits in other states. Hurricane-related losses to homes in a state like Florida, for example, cannot be subsidized from profits generated by profits earned by homeowners insurers in Minnesota. Conversely, Florida homeowners cannot, and should not, be called upon to subsidize severe winter storm losses in Minnesota.

#### **Where Does Resilience in the P/C Insurance Industry Come From?**

The ability of property/casualty insurers to weather record catastrophe losses of nearly \$58 billion in 2005 fresh on the heels of record losses of \$27.5 billion in 2004 derives from four main sources:

- Strong underwriting performance (ex-catastrophes)
- Sound risk management
- Heavy use of reinsurance
- Record claims-paying capacity
- Investment income

Each of these factors is discussed below both in context of the 2005 results and the prospects for the industry going forward.

***Underwriting: Strength Derived from Discipline***

The property/casualty insurance industry entered the 2005 hurricane season from an extraordinarily strong underwriting position. Indeed, the industrywide combined ratio was just 92.7 through the first six months of the year, down from 98.3 in calendar year 2004, 100.1 in 2003, 107.2 in 2002 and 115.7 in 2001. Thus, in less than four years, 23 points had been chopped off the combined ratio.

The improvement in underwriting over the past several years is the result of a painful but necessary across-the-board effort by insurers to reassess risk that has led to a much better match between risk assumed and price charged as well as a general tightening in the terms and conditions of coverage. This effort is of obvious importance in an era of record catastrophe losses, but is in fact equally crucial in the day-to-day management of the business in all lines of coverage, including liability lines of insurance unaffected by catastrophes that were extremely unprofitable a few years ago but today provide a reasonable return on investment.

The fruits of these efforts allowed insurers in 2005 to limit the overall underwriting loss to a manageable \$5.9 billion. In 2004, the industry recorded its first underwriting profit (i.e., combined ratio under 100) in 26 years. The commitment to disciplined underwriting remains in place in 2006 and is one reason insurers continue to limit their exposure to hurricane-prone areas along the Gulf and Atlantic coasts. The urgency of insurer actions in some areas has also been affected by a lack of willingness by regulators to grant insurers sufficient flexibility to adjust rates to reflect higher risk and higher reinsurance costs going forward, leaving insurers few options but to scale back their presence in many of these areas.

A strong underwriting performance is needed and expected in 2006. The Insurance Information Institute's Groundhog Survey of industry analysts indicates an expected combined ratio of 97.7 in 2006, assuming a return to "normal" catastrophe loss levels.

***Spreading the Risk: Reinsurance and Residual Market Mechanisms***

Reinsurance, which is insurance purchased by insurance companies, is the principle means by which insurers spread risk on a global scale. Many major insurers, particularly those with significant commercial lines operations, cede 10 to 30 percent of their premiums to reinsurers. Smaller insurers often cede much more. Cession rates for catastrophe-prone business can be even higher. These facts came together in 2005 to produce a significant benefit to primary insurance companies with exposure to the hurricane ravaged Gulf and Southeast Atlantic coasts, with some insurers having upwards of 60 percent of their gross losses covered by reinsurance. While painful for reinsurers, the global spread of risk through the use of reinsurance (and retrocessional markets) is *the* principal means by which large-scale catastrophes are financed. It is likely that reinsurers will ultimately bear more than half the losses associated with Hurricane Katrina just as they did in the wake of the September 11, 2001 terrorist attacks. ISO estimates that foreign reinsurers alone, who account for the bulk of reinsurance protection sold in the United States, reduced gross catastrophe losses of

\$57.7 billion in 2005 by \$14 to \$19 billion, implying a net decrease of up to 33 percent, inclusive of domestic reinsurers the number is higher still. Given the fact that 2005's catastrophe losses continue to develop upward (with the majority of those losses falling to reinsurers) and the fact that large offshore energy losses (which are not included in the ISO catastrophe loss figures) tend to be heavily reinsured, reinsurers' total share of 2005 catastrophe losses will almost certainly rise. Two successive years of record catastrophe losses have taken their toll and a handful of smaller reinsurers have gone into run-off. The Florida Hurricane Catastrophe Fund (FHCF), a state-sponsored reinsurer of hurricane risk, would also be insolvent were it a private insurer. However, the FHCF has sufficient bonding authority to allow it to cover its immediate obligations and continue to operate during the fast approaching 2006 hurricane season, though repayment of the debt will result in assessments on virtually every property and casualty/liability insurance policy issued in the state (all lines except workers compensation and medical malpractice).

Reinsurers' combined ratio for 2005 was 129 according to the Reinsurance Association of America, worse than the 124 in 2004. Many medium and smaller reinsurers lost 25 percent or more of their shareholder equity due to record catastrophe losses in 2005. Several have discontinued operations and have gone (or are likely to go) into run-off. The significant hit suffered by reinsurers over the past two years—and predictions of above average hurricane seasons for the next several years—is forcing reinsurance prices sharply higher in 2006. Large increases will generally be confined to property catastrophe reinsurance backing of residential and commercial property lines exposed to East and Gulf Coast hurricane risk as well as the energy and marine sectors. In addition to rising prices, reinsurers may require higher attachment points or offer lower limits of coverage. At the same time, the retrocessional market has become extremely tight. Many reinsurers have found it necessary to raise additional capital to patch holes created by this year's storms and other catastrophes abroad. Moreover, a number of new reinsurers have been formed in the wake of Hurricane Katrina in order to capitalize on higher prices, short supply and strong demand. The issue of capital raising and start-ups will be addressed in the section on capacity below.

### *Residual Market Mechanisms*

Most coastal states operate residual markets plans—markets of last resort—that insure properties that are theoretically uninsurable in the private sector. The losses paid (and premiums collected) by residual market facilities are typically not included in the financial statistics describing the private insurance industry.

Residual market plans are especially important in coastal states threatened by hurricanes. But because states tend to undercharge for coverage offered through the plans and have only lax underwriting standards, many operate at deficits even in good years. Not surprisingly, the state-run plans in Florida and Louisiana are broke. Florida's plan, Citizens Property Insurance Corporation, levied assessments totaling more than half a billion dollars following the 2004 storm season and will need to assess

again in order to offset a deficit of approximately \$1 billion incurred from Hurricane Wilma. The assessments will be levied on virtually every residential property owner in the state, irrespective of who the property owner is insured by. Louisiana's plan finds itself in a similar predicament in the wake of Hurricanes Katrina and Rita and faces a deficit of some \$750 million, which will result in assessments of 15 to 20 percent. Insufficient rates and inadequate cash reserves are the proximate cause of the problems in Florida, Louisiana and other states, but the tendency of regulators to suppress rates in the private sector is a major contributing factor to a pull-back by private insurers in many coastal areas, which leads directly to more property owners seeking coverage through the state's residual market facility.

Another contributing factor to residual market growth is that, despite rising risk and known insurance availability problems, local communities continue to zone and permit more growth in vulnerable areas that are almost certain to be impacted by one or more major hurricanes in the relatively near future. These communities depend on such growth to generate tax revenue, infrastructure improvement and jobs. State-backed insurance schemes guarantee insurance will be available (probably at subsidized rates) no matter how poorly sited the project, and government aid afterwards helps to offset the cost of any damage that does occur.

Notably, the National Flood Insurance Program suffers from many of the same defects as state-run property insurers. The difference is that the \$20 billion-plus deficit incurred by the NFIP as a result of Hurricane Katrina will be deficit-financed—meaning taxpayers across the country, including those who live thousands of miles from any coast or have yet to be born, will be footing the tab (plus interest) for decades to come.

***Claims-Paying Capacity: Hurricanes Were Not a "Capital Event"***

As noted by ISO, policyholder surplus—the broadest measure of claims-paying capacity—actually rose by 9.2 percent in 2005, from \$391.3 billion at year-end 2004 to \$427.1 billion as of December 31, 2005. The increase was not expected. In fact, most analysts expected policyholder surplus for the whole of 2005 to remain roughly flat for the year. The majority of the \$35.8 billion increase in 2005 was associated with \$43 billion in after-tax profits (net income) and \$14 billion in new capital. These inflows were partially offset set by \$15.2 billion in shareholder dividends, \$3 billion in miscellaneous charges against surplus and \$3.2 billion in unrealized capital losses on investments. Again, the figure reflects the broad spread and syndication of risk through heavy use of reinsurance, much of it foreign. Consequently, a significant share of the impact on surplus associated with the storm season of 2005 will wind up on insurance industry balance sheets in countries like Switzerland, Germany, Great Britain, France and Bermuda.

Of great interest in the wake of Hurricane Katrina was the ease and rapidity with which many insurers and reinsurers were able to raise capital. As of December 1, 19 existing insurers announced plans to raise \$10 billion in fresh capital. Additionally, 14 new insurers and reinsurers are being formed with an initial capitalization of \$8.7 billion. Thirteen of the 14 start-ups will be domiciled in Bermuda while one will take up

residence in the Cayman Islands. Lloyd's syndicates in London have also announced nearly 2 billion dollars in new capacity for 2006. Altogether, it is likely that about \$23 billion dollars in new capital will be raised, or roughly 60 to 65 percent of the after-tax losses suffered by the industry overall during the 2005 storm season.

This is an extraordinary sum to be raised so quickly, which at least initially appeared to have a material impact in terms of muting the return of significantly harder market conditions in some segments. But most of the start-up entities were not a major factor for the January 1 renewal season. Moreover, relatively little of this capital will ever make its way directly into homeowners insurance markets in catastrophe-prone areas, which will continue to experience acute supply and demand imbalances and rising prices in 2006. The source of capital varies and includes traditional equity capital as well as private equity and hedge fund money.

Popular with hedge funds are a new type of special purpose vehicle known as *sidecars*. According to the reinsurance broker Benfield, sidecars allow third-party private investors (such as hedge funds) to collaborate to provide additional underwriting capacity to reinsurers for property catastrophe retrocession and other short-tail lines of business.

Investor interest in the property/casualty insurance and reinsurance industries is high because certain insurers (existing and start-up) and some industry segments offer the prospect of attractive returns going forward—albeit in exchange for assuming significant risk. Investments in the insurance sector are particularly attractive to non-traditional sources of capital such as hedge funds because insurance risk is generally uncorrelated with traditional financial risks. For example, the frequency and severity of hurricanes is uncorrelated with interest rates movements or fluctuations in foreign exchange rates risks typically assumed by hedge funds — making them attractive investments because they lower the volatility of the hedge fund portfolio while providing potential high rates of return. These sources of capital also tend to be less risk-averse than traditional investors.

Wall Street investors certainly have high expectations for insurers and reinsurers in the wake of record catastrophe losses during each of the past two years. Property/casualty insurer stocks on a market cap weighted basis finished 2005 up 9.3 percent, compared to a gain of only 3 percent for the S&P 500 index. Reinsurer stocks—which were down by 5 to 6 percent through most of 2005—ended the year down just 0.5 percent, reflecting investor expectations for tighter reinsurance markets in 2006. Broker stocks, which had been in negative territory ever since New York Attorney General Eliot Spitzer's allegations of bid-rigging surfaced in October 2004, finished the year strongly, up 13.3 percent on expectations of higher commissions but also due to a "relief rally", with the settlement of most major cases against the sector's top players.

*Capacity and the Debate Over Whether the Federal Government Should Be Involved in the Financing of Natural Disaster Risk*

Some regulators, legislators and insurers have cited the 2004 and 2005 storm seasons and the prospect of more mega-sized natural disasters in the future as a reason the federal government should play a role in the financing of natural disaster in the future. The property/casualty insurance industry's financial performance over the past two catastrophe-wracked years has fed directly into this debate. Indeed, legislation has already been introduced in the U.S. House of Representatives that would create a federal reinsurance mechanism for natural catastrophes.

Proponents of a more active federal role argue that such events are only likely to become more frequent and more expensive over time and are already reaching the limit of insurers' ability to offer insurance in disaster-prone areas. The National Association of Insurance Commissioners (NAIC) has formally unveiled a plan that calls for a layered approach to financing natural disaster losses. Within the context of an "all-risks" policy offered by private insurers (i.e., including flood and earthquake), the NAIC proposes a layered approach. The first layer would attempt to maximize the resources of the private insurance and reinsurance industries. The second layer would consist of a system of state or regional catastrophe funds while the third layer would be a federal reinsurance mechanism. Several bills have been introduced into Congress that authorize the federal government to sell or auction-off reinsurance to state catastrophe plans. The proposal also calls for changes to U.S. tax law that would allow insurers to accumulate catastrophe reserves on a tax-preferred basis (presently the IRS only allows for post-event reserving) and would encourage individuals to establish tax-free personal catastrophe savings accounts.

Opponents to a more active federal role believe there is sufficient private sector capacity for even very large catastrophes and fear the federal government will crowd out private capital and stifle innovative private sector solutions for managing catastrophic risks.

***Investment Returns: Fed Rate Hikes Continue to Boost Conservative Portfolios***

Investment income rose by 15.8 percent in 2005 after adjusting for special dividends (23.7 percent before adjusting). This compares to nearly stagnant growth of 2.4 percent in 2004. Growth in investment income (which consists primarily of interest income generated from the industry's substantial bond portfolio) had been tepid (or even declined) despite stronger cash flow because of declining interest rates over the past several years which remained low throughout 2004. Indeed, the average yield on 10-year Treasury securities during 2005 was 4.29 percent, not significantly different from calendar years 2003 and 2004, at 4.01 percent and 4.27 percent, respectively, the lowest in 40 years. By year's end, however, the 10-year note was yielding 4.5 percent. Given recent tightening by the Fed and strong economic growth, insurers, like most institutional investors, believed that long-term rates would have headed higher many months ago. They didn't. Instead the yield curve simply flattened as short-term yields rose in response to the Fed's actions while long-term rates stayed flat or declined.

Long-term rates have only recently started to trend upward, with the 10-year Treasury note in mid-April 2006 exceeding 5 percent for the first time since June 2002.

Fifteen rate hikes by the Federal Reserve since June 2004 have pushed the federal funds rate up by  $3\frac{3}{4}$  points to 4.75 percent (the highest level since April 2001) from 1.00 percent (a 46-year low), forcing money market rates and rates on short-term securities upward. The last two hikes occurred during the first quarter, pushing rates up by a total of 50 basis points (0.5 percentage points). (The second hike was the first under the leadership of Benjamin Bernanke, who assumed the Fed chairmanship after 18 years under his predecessor Alan Greenspan.) Ordinarily, such an increase would have only a marginal impact on insurer investment earnings, but insurers have for several years now been accumulating significant assets with very short maturities in a bid to minimize interest rate risk and because the flat yield curve afforded virtually no premium for investing long. In addition to investing short, insurers are investing more. According to ISO/PCI, insurers' average holdings of cash and invested assets grew at a brisk 9.2 percent in 2005.

Fed rate hikes are expected to continue at least through May 2006 but are also widely expected to end, perhaps as soon as the June meeting of the Federal Reserve Open Market Committee. An increase at the May meeting would see the federal funds rate pushed up to 5.0 percent. While it is unlikely that the Fed will chart a radically different course under its new chairman, the current cycle of interest rate hikes has nearly run its course. For insurers, this means that the era of easy gains on low risk, short-term securities will be over. Rising long-term rates may provide attractive yields going forward, but interest rate risk will become more of a concern.

Insurers' investment return in 2005 was bolstered by \$9.7 billion in realized capital gains, an increase of 6.3 percent over 2004. The S&P 500 index was up just 3 percent in 2005 and the specter of rising rates may have spooked some insurers into locking in gains in both their stock and bond portfolio (bond prices move opposite to interest rates and stocks become a relatively less attractive investment as interest rates rise). Looking ahead, 2006 could be a good year for Wall Street. The S&P 500 was up 3.3 percent through April 14. Strong corporate earnings and an end to Fed rate hikes could buoy stocks still further. Importantly, the overall economy is expected to remain healthy, despite rising energy prices.

### **Premium Growth: A Weak Spot**

Aside from record catastrophe losses, the major disappointment in 2005 was extremely sluggish growth in net written premiums, which according to ISO increased by just 1.8 percent after adjusting for \$6 billion in premiums and loss and loss adjustment expense ceded from one insurer to its foreign parent (and only 0.4 percent before the adjustment). The growth is the slowest since the 1.5 percent increase posted during the heart of the last soft market in 1999. The figure is in line with a February 2006 survey of industry analysts by the Insurance Information Institute, which estimated 1.0 percent growth for full-year 2005. The survey does, however, predict that in the aftermath of

2005's active hurricane season and the likelihood of another in 2006, the pace of premium growth will rise to 3.8 percent as prices firm.

### **TRIA Extension: A Two-Year Reprieve**

Property/casualty insurers, already battered by record catastrophe losses, continue to be concerned by the possibility of large-scale terrorist attacks. In mid-December 2005 the U.S. Congress passed a two-year extension of the Terrorism Risk Insurance Act, which had been scheduled to sunset on December 31. President Bush signed the bill, without ceremony, on December 22. Extension of TRIA is a positive for the insurance industry despite the fact that the government significantly reduced its own exposure at the expense of private insurers and reinsurers. The extension of the act will help to stabilize insurance markets in the event of another major terrorist attack on U.S. soil. The extension significantly scaled back the role of federal government, however, shifting billions of dollars of risk to private insurers. Moreover, insurers and business interests will have to work very hard to get another extension or permanent solution in place by the time the Terrorism Risk Insurance Extension Act (TRIEA) expires at the end of 2007. Time is limited and there is opposition in both Congress and the White House.

Major features of the legislation are summarized below:

- Two-year extension, expiring December 31, 2007;
- Trigger for certification of terrorist act rises from \$5 million under the current bill to \$50 million in 2006 and \$100 million in 2007;
- Individual company deductibles rise from 15 percent of direct earned premiums currently to 17.5 percent in 2006 and 20 percent in 2007;
- Industry aggregate deductibles are raised from \$15 billion currently to \$25 billion in 2006 and \$27.5 billion in 2007;
- Requires study on long-term solutions to be completed for Congress by September 30, 2006. A finding of progress could lead to extension for a third year;
- Industry co-share percentage for amounts exceeding the industry deductible remains at 10 percent for 2006 but rises to 15 percent in 2007;
- Newly excluded as covered lines from TRIA are commercial auto, professional liability, surety, burglary and theft and farmowners multiperil.

### **Summary**

The financial and underwriting performance of the property/casualty insurance industry during 2005 was much better than expected. Although buffeted by record catastrophe losses, insurers managed to nearly break even from an underwriting perspective and finish the year with a modest underwriting loss. Investment gains propelled the industry to an overall profit. The results are evidence that insurers are doing a good job of spreading risk on a global scale, largely through extensive use of reinsurance. At the same time, the industry remains attractive to investors, who have poured more than \$20 billion into new and existing platforms post-Katrina.

The storms of 2005 were not solvency-threatening to the industry as a whole, nor did they cause a net reduction in aggregate claims-paying capacity. However, record catastrophe losses in 2004 and 2005 did take their toll on profitability. Return on equity in both years would have been in the 13 percent to 15 percent range each year—on par with the *Fortune* 500 group—had catastrophe losses been anywhere near “normal.” On a catastrophe-adjusted basis, 2005 likely represented the peak in the current cycle in terms of underwriting and profit performance. Combined ratios, however, are likely to drop in 2006 if catastrophe activity subsides even modestly.

One cause for concern overshadowed by recent events is the fact that top line growth in 2005 was an adjusted 1.8 percent and is, in fact, negative on an inflation-adjusted basis. Record catastrophe losses in 2004 and 2005 and the outlook for more of the same in the years ahead are leading to significant price impacts on residential, commercial property and property catastrophe reinsurance prices. The aftermath of this year’s hurricanes will push net written premium growth upward, but the effects will be focused on the Southeast and Gulf coast areas.

A detailed industry income statement for 2005 follows:

## Full Year 2005 Financial Results\*

--(\$ Billions)--

Earned Premiums	\$417.7
Incurred Losses (Including loss adjustment expenses)	311.4
Expenses	110.3
Policyholder Dividends	<u>1.9</u>
Net Underwriting Gain (Loss)	-5.9
Investment Income	49.5
Other Items	<u>+0.9</u>
Operating Gain	44.5
Realized Capital Gains/Losses	<u>9.7</u>
Pre-Tax Income	54.2
Taxes	<u>-11.2</u>
<b>Net After-Tax Income</b>	<b>\$43.0</b>
Surplus (End of Period)	\$427.1
Combined Ratio	100.9

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

Sources: Insurance Services Office; Property Casualty Insurers Association of America; Insurance Information Institute.