

A Briefing on

# The Property/Casualty Insurance Industry

for the Maryland Senate Finance Committee  
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## 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

## The Issue of Coastal Exposure



## P/C Insurance Underwriting and Ratemaking

- What is Underwriting?
- How are Rates Determined?
- The "Combined Ratio"

## The Effect of Disasters on the P/C Industry

Investments

Regulation

Conclusion



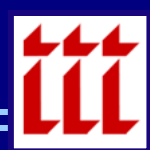
## Life/Health Insurers

- Insurance that pays when a person is unable to function or has expenses related to that inability
- Examples: life insurance, annuities, pensions, medical expense, disability, long-term care insurance

## Property/Casualty Insurers

- Insurance that covers **direct and indirect loss from damage to property or arising from legal liability**
- Examples: auto, home, medical malpractice, products liability
- Historical Exception: workers compensation

# The Structure of The Property/Casualty Insurance Industry



# How Many? What Types?

2,358 P/C insurance companies in US in 2005\*

- These companies consolidate to 972 groups
- Some larger insurance groups have dozens of subsidiaries

Most insurers are small, operate regionally

A highly competitive business in many areas

Lines of Business

Personal, Commercial, Multi-Line

Direct (or primary) vs. Reinsurance



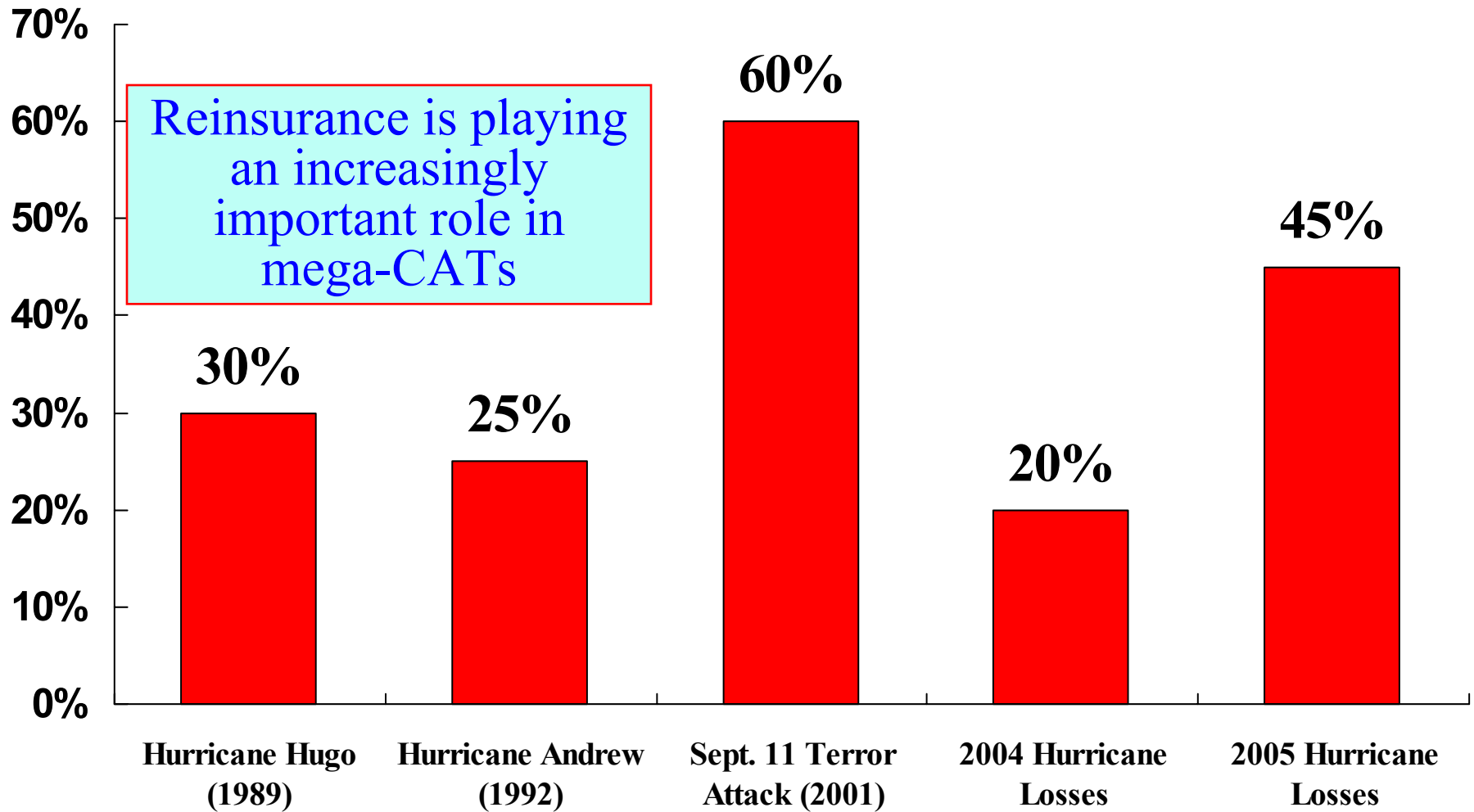
## Reinsurance is insurance for insurance companies

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, direct insurers
- Especially important to smaller companies



# Share of Losses Paid by Reinsurers, by Disaster\*



\*Excludes losses paid by the Florida Hurricane Catastrophe Fund, a FL-only windstorm reinsurer, which was established in 1994 *after* Hurricane Andrew. FHCF payments to insurers are estimated at \$3.85 billion for 2004 and \$4.5 billion for 2005.

Sources: Wharton Risk Center, Disaster Insurance Project; Insurance Information Institute.



# Organizational Structure of Insurers

Shareholder-owned (Stock) insurers: 574 organizations

Policyholder-owned insurers

- Mutual companies: 315 organizations
- Reciprocal: 53 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): 10 US organizations



## 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 Extension Act

- Expires 12/31/07; Coalition seeking extension

## Political Risk: Overseas Private Investment Corporation

## Pensions: Pension Benefit Guarantee Corporation

***There is no federal natural disaster program***



# Differences in Focus and Strategy Among Insurers

## Personal Lines (243 groups; many also sell Life)

- Sells only/mostly auto and homeowners insurance
- Examples: State Farm, Allstate, Nationwide, USAA

## Commercial Lines (781 groups; some sell Life)

- Sells only/mostly business insurance
- Examples : CNA, Chubb, ACE, Cincinnati Ins Cos.

## Multi-Line (many also sell Life)

- Sells many different types of insurance
- Examples : AIG, Hartford, Liberty Mutual, St. Paul 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 no advertising

Risk Appetite

- Some insurers do not want much CAT exposure or have inadequate capital to compete in CAT markets
- Many companies shy away from coastal zones

Some insurers specialize in certain industries

- E.g., Aviation, marine, medical malpractice



Tort Environment

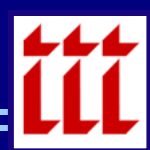
Regulatory Environment

- If viewed as onerous, rigid, capricious, unfair, hostile, or confiscatory, fewer insurers participate
- E.g., MA Auto, NJ Auto (until recently), TX Home

Size of Market

Growth Opportunities/Demographics

Synergies with Other Types of Products Offered



## **\$421.3 billion in Earned Premiums**

- About 48% personal lines, 52% commercial
- An “earned premium” is a premium dollar for which insurance coverage has already been provided

**\$1.4 trillion in assets** (compared to \$4.4 trillion for life insurers)

## **\$437.7 billion in Policyholder Surplus**

(in other industries, this would be called “Net Worth”)

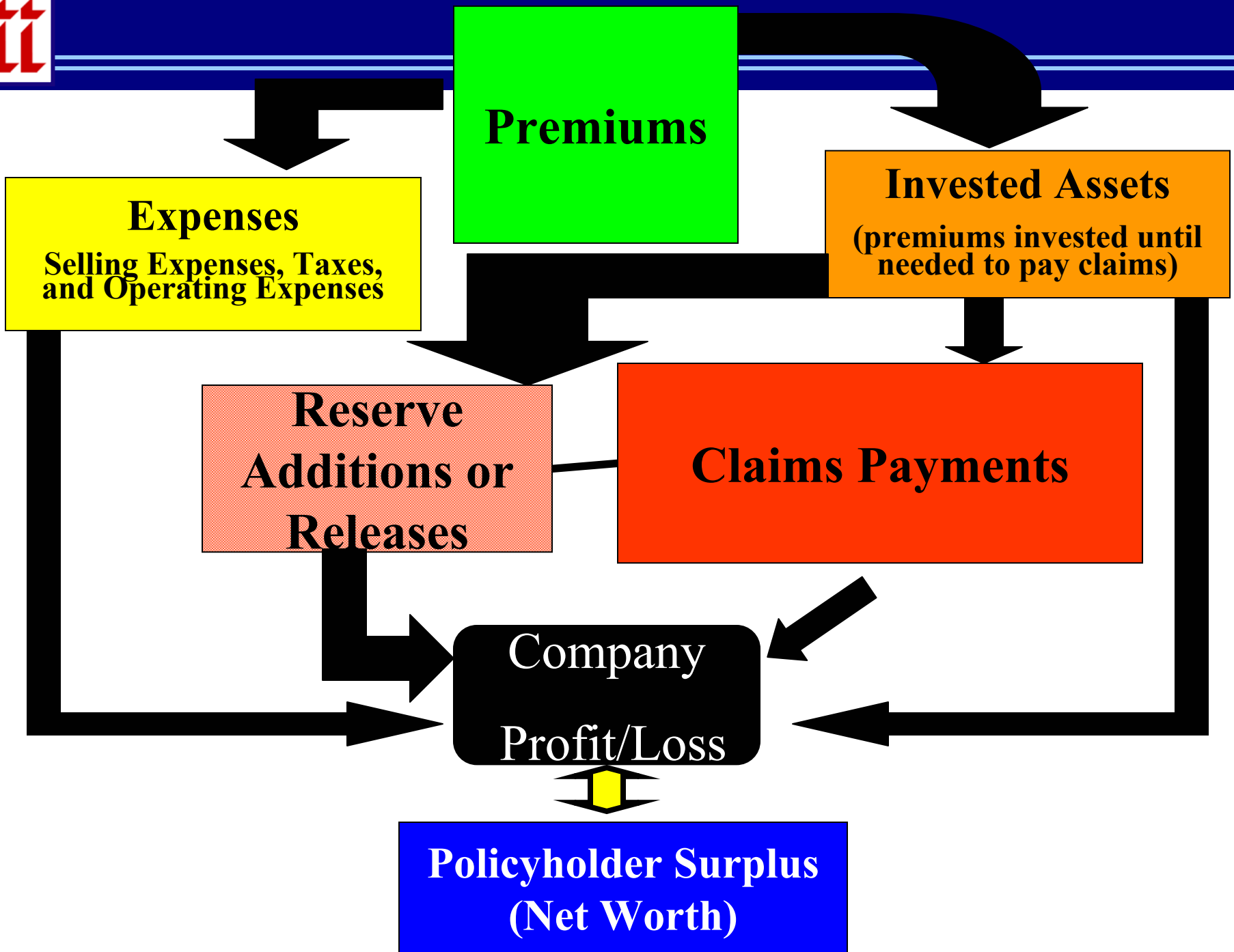
- Surplus is the primary measure of claims-paying ability because it is assets in excess of known obligations



# Insurance Industry Employment

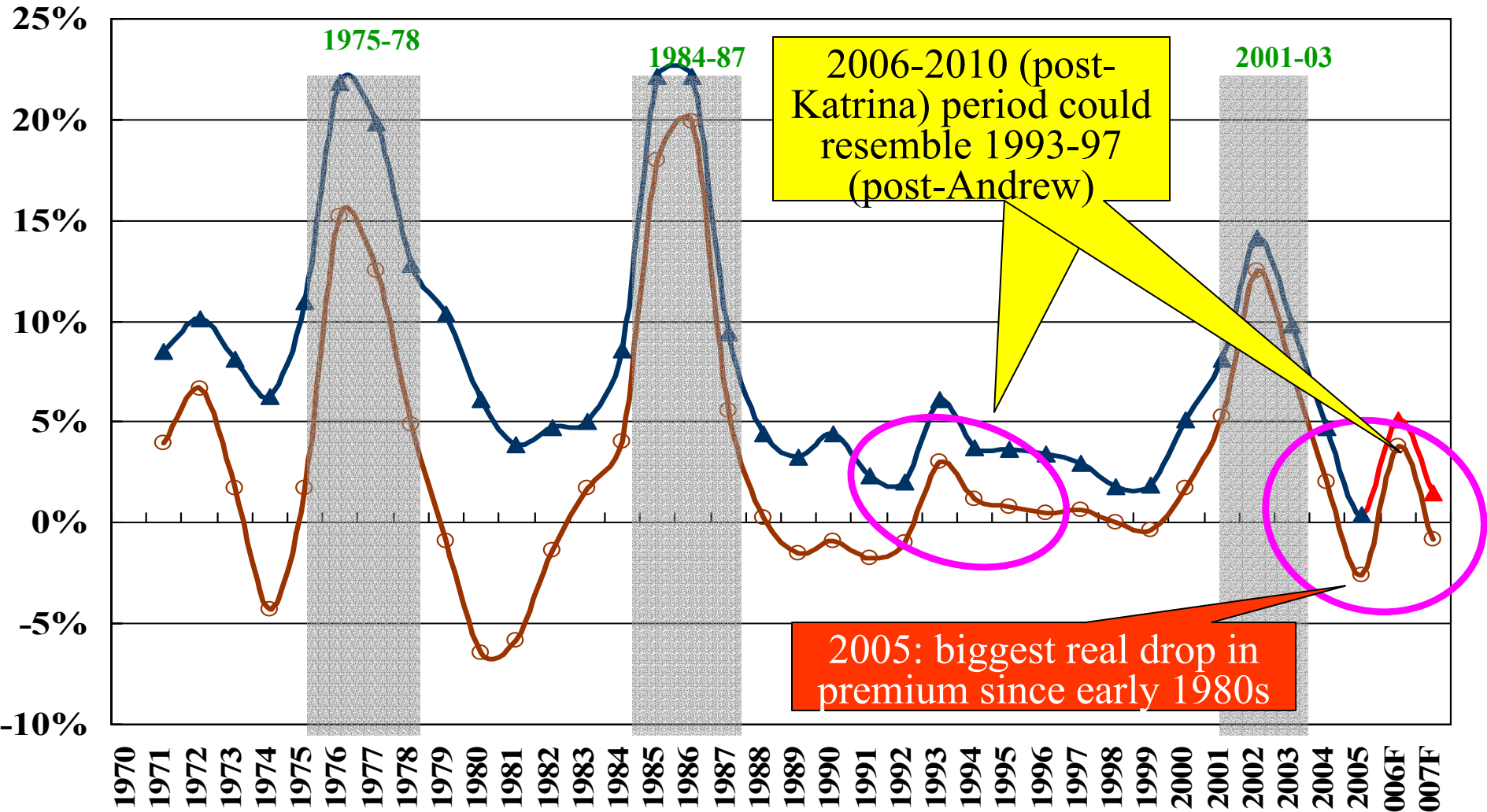
	U.S. (May 2005)	Maryland (2004)
Insurance carriers	1,290,000	21,759
Insurance agencies, brokerages, & related	647,500	14,812
Other	222,500	3,686
Total	2,200,000	38,536

# How Property/Casualty Insurance Works





# Net Premiums Written, 1970-2007: P/C Insurance is a Cyclical Industry\*

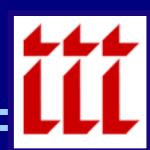


2006-2010 (post-Katrina) period could resemble 1993-97 (post-Andrew)

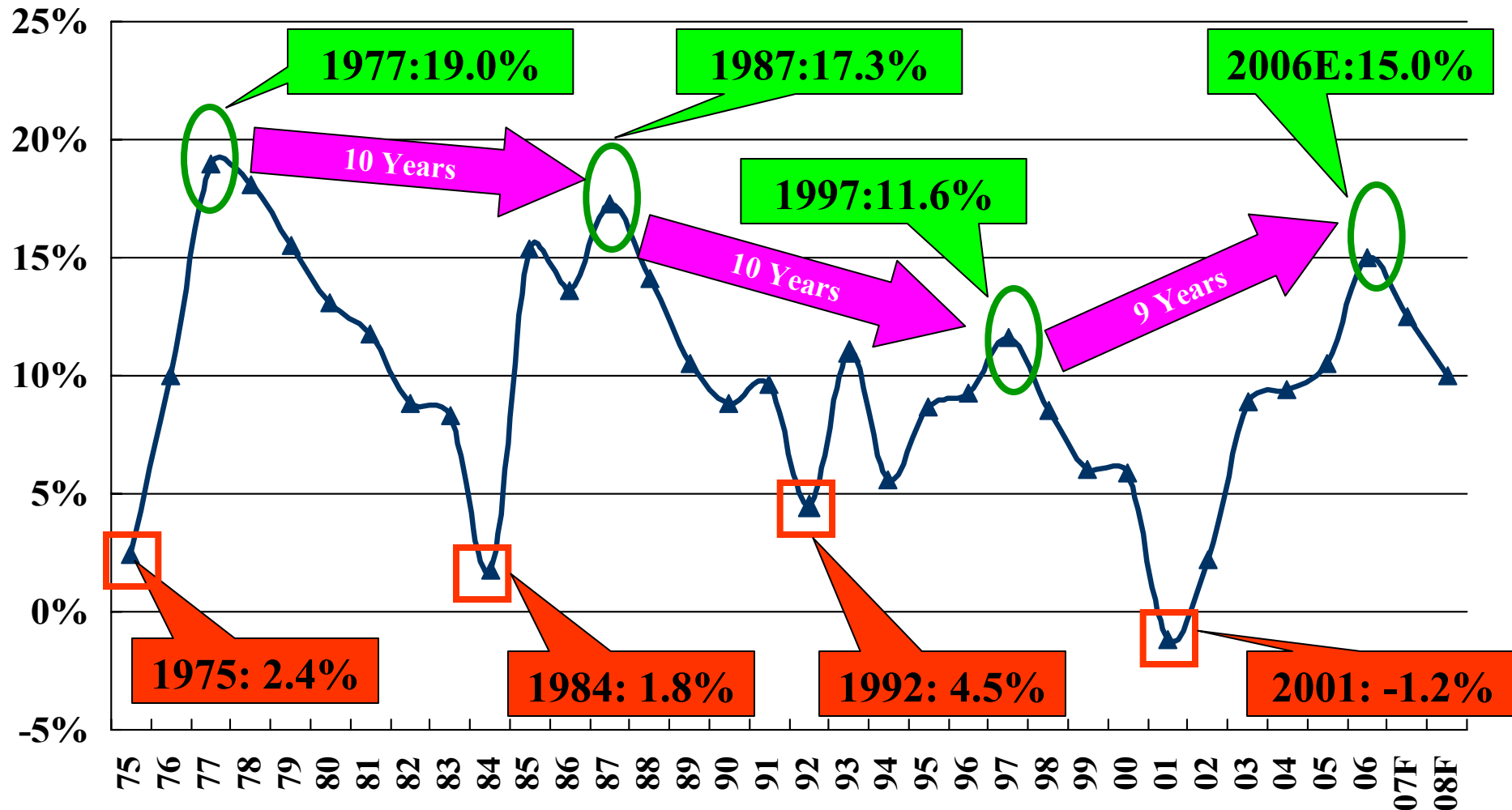
2005: biggest real drop in premium since early 1980s

\*2006-10 figures are III forecasts/estimates. 2005 growth of 0.4% equates to 1.8% after adjustment for a special one-time transaction between one company and its foreign parent. 2006 figure of 2.9% is based on 2006:H1 data.

Note: Shaded areas denote hard market periods.  
Source: A.M. Best, Insurance Information Institute



# P/C Insurance Industry Profitability Peaks & Troughs, 1975 – 2008F



\*2006-8 P/C insurer ROEs are I.I.I. estimates.

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



## Characteristics of the cycle's peak

- Insurers must earn significant profits during the cycle's peak to carry them through the cycle's long trough
- The cycle's peak represents a restorative period during which insurers' claim paying resources are rebuilt



## Underwriting Results – insurance operations

- Many companies lose money on insurance operations, especially from catastrophic claims

## Investment Results – 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



# The Importance of Profits

## Reward for bearing risk

- Profits compensate shareholders for the assets they put at risk

## For mutual companies, the main source of new capital

- Profits allow mutuals to grow their surplus = increased capacity
  - To take on additional risks
  - To better cope with mega-catastrophe outcomes from risks already “on the books”

## Profitable companies

- can access capital markets under favorable terms after mega-CATs or if market conditions are poor (e.g., post-9/11)
- Others will fail or are acquired



## Profits enable investments...

- in the future of the enterprise (in new/upgraded technology, training for current staff or hiring more people, etc.)
- to seize upon new opportunities (expansion to new states or countries, new lines of business, mergers/acquisitions, etc.)

## Profitable companies

- have higher financial strength and credit ratings
- can help support research and socially beneficial public policy objectives

## Preferred treatment by reinsurers



## 70 companies/groups writing HO ins in MD in 2005

Combined market share of

Top five writers – 70.4%

Next five writers – 14.8%

Writers 11-20 – 7.8%

The other 50 – 7.0%

## 97 companies/groups writing WC ins in MD in 2005 (includes some captives)

Combined private sector market share of

Top five writers – 51.4%

Next five writers – 18.4%

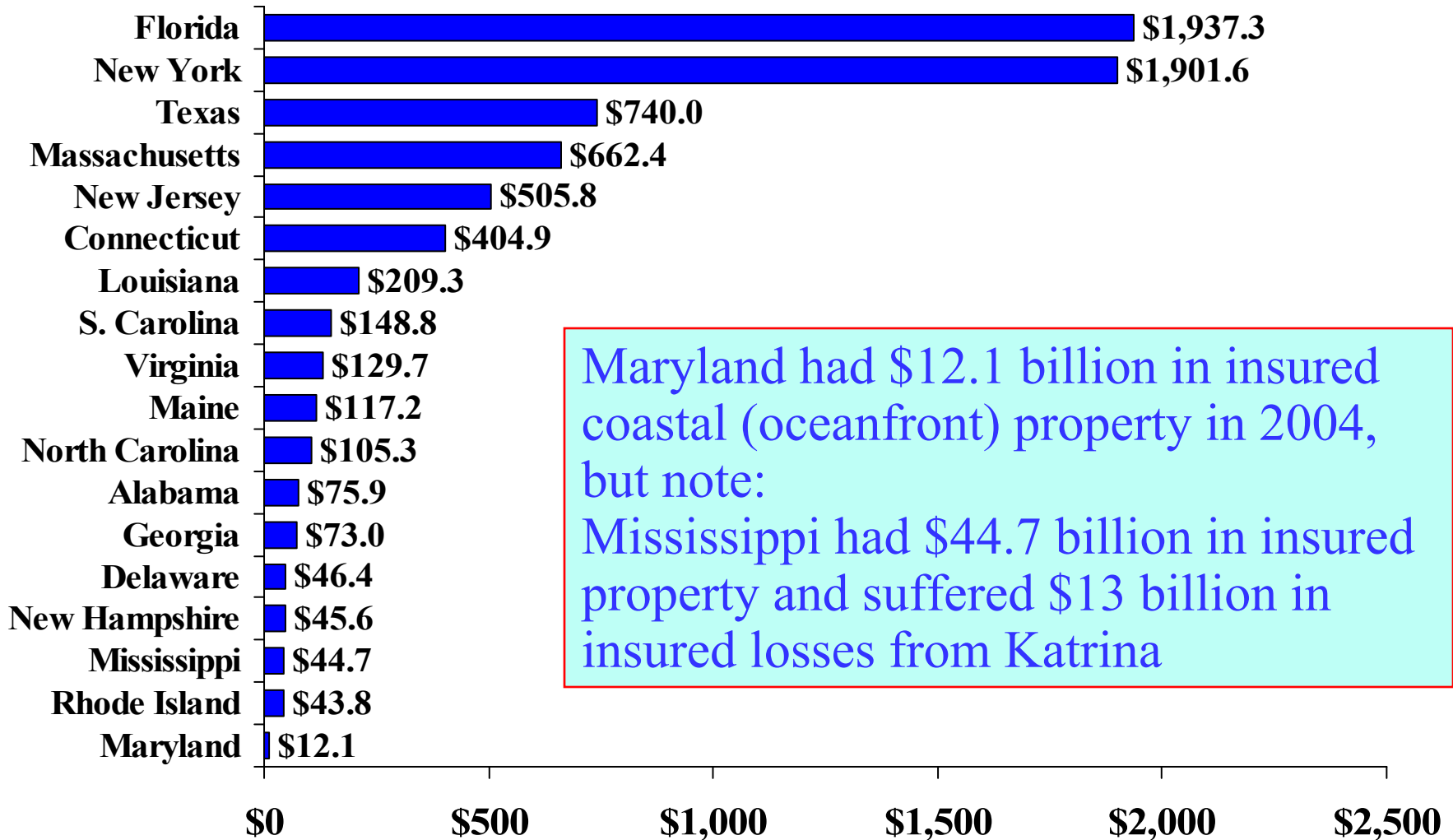
Writers 11-20 – 17.1%

The other 77 – 13.1%

# Coastal Exposure

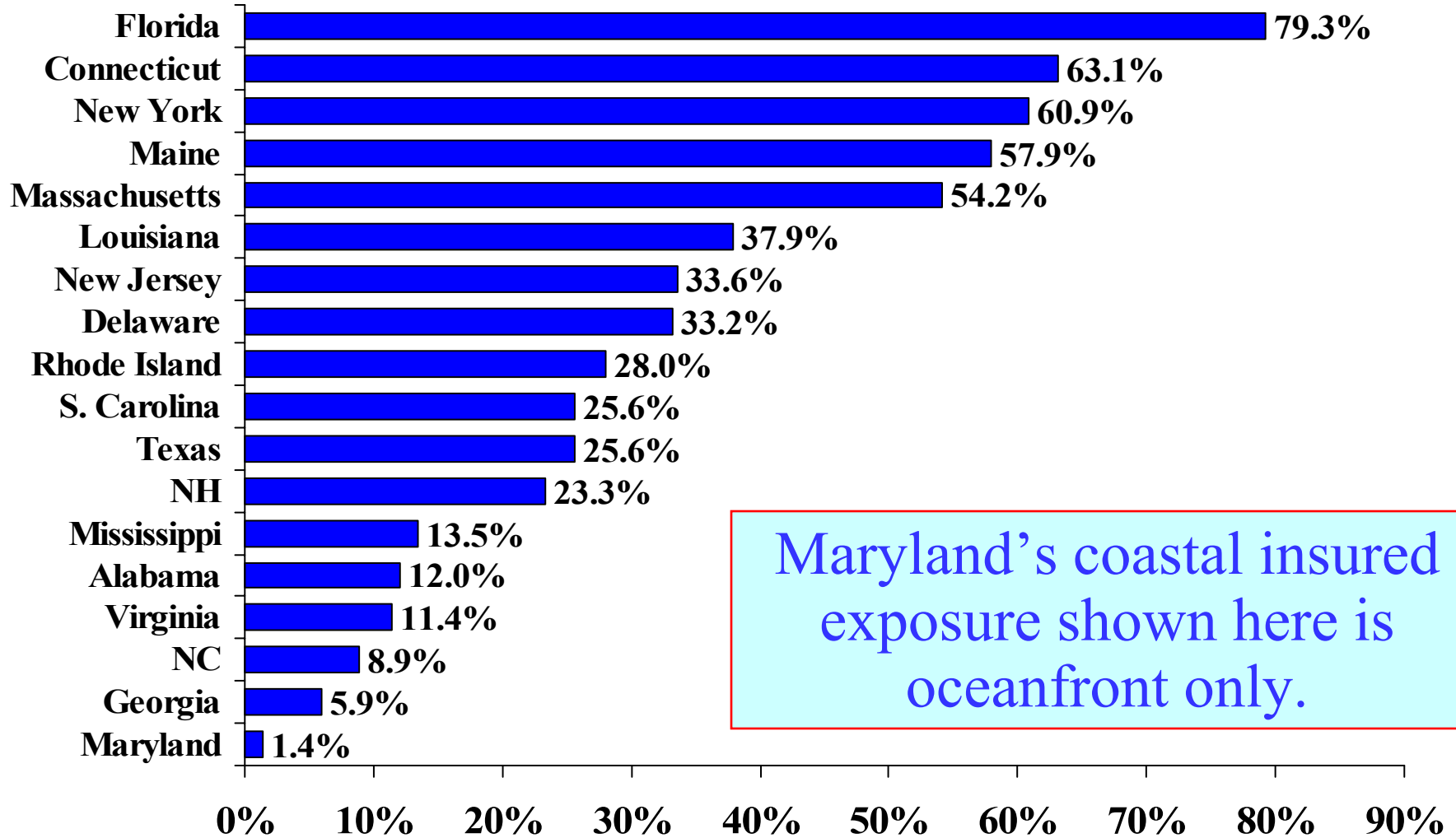


# Value of Insured Coastal Exposure (in \$Billions), 2004



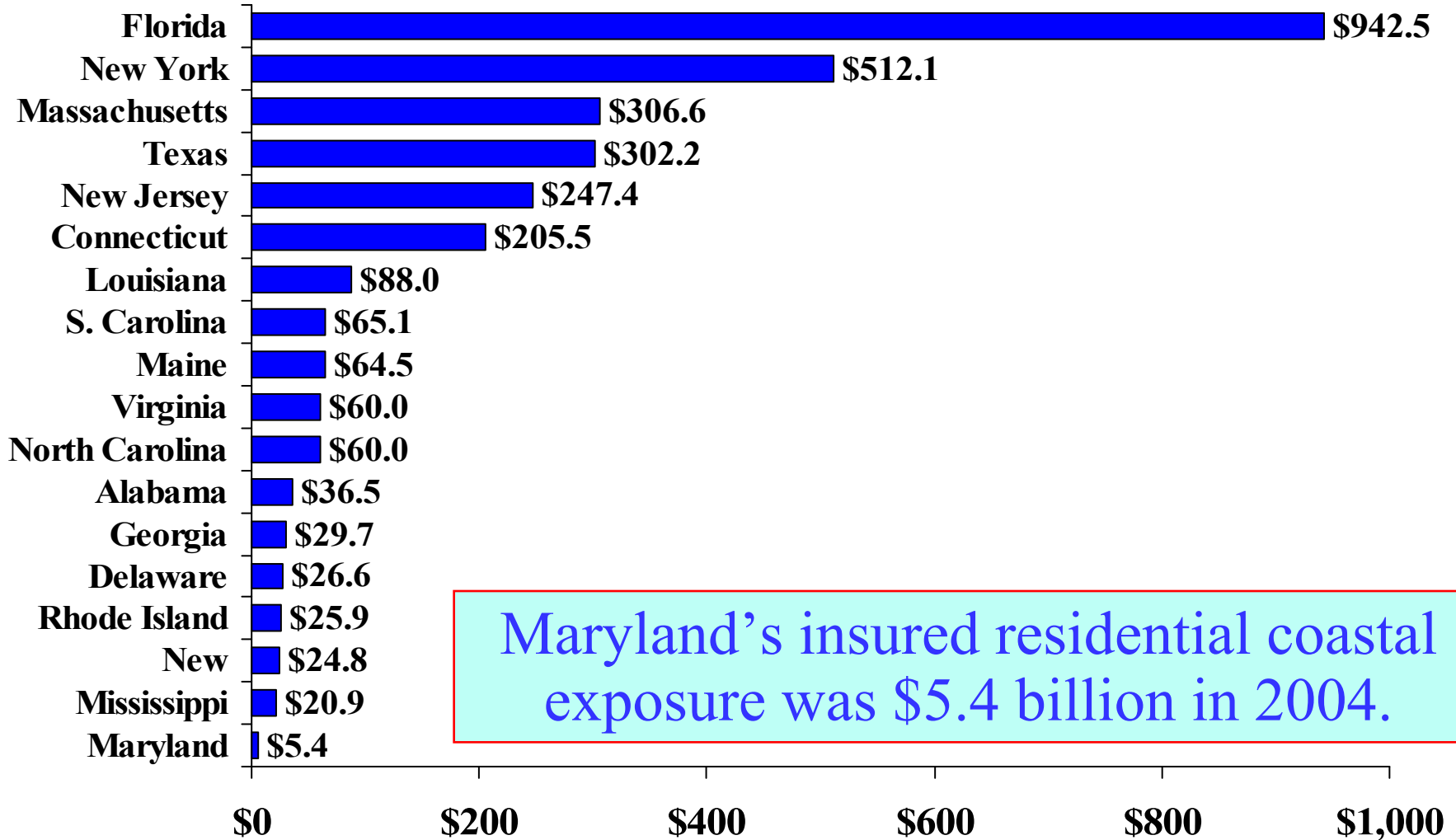


# Insured Coastal Exposure as a % of Statewide Insured Exposure, 2004





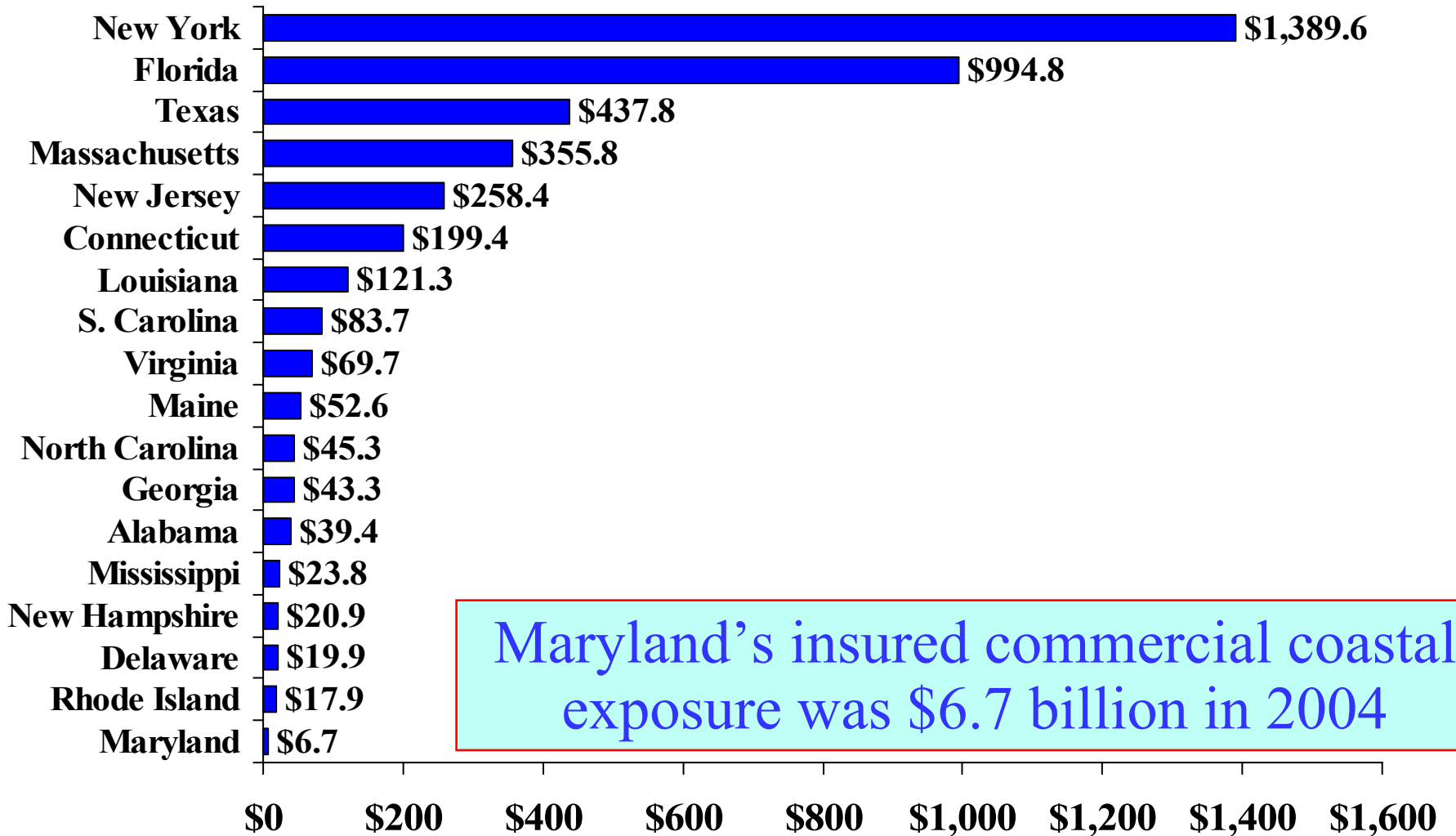
# Value of Insured Residential Coastal Exposure, (in \$Billions) 2004



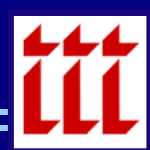
Maryland's insured residential coastal exposure was \$5.4 billion in 2004.



# Value of Insured Commercial Coastal Exposure, (in \$Billions) 2004



# Underwriting and Ratemaking



# What is Underwriting?

Underwriting – the process by which an insurer determines whether a policy should be issued and on what terms

## A Complex Process

- Many market and individual factors considered
- All relate to riskiness/likelihood of loss

## Insurers All Use Underwriting Guidelines

- Helps keep insurers focused, solvent, disciplined
- Examples: no risks within 5 miles of coast, no high-rise construction risks, no limits above \$1 million

## Underwriting Tools

- Objective is to improve accuracy of loss forecasts
- Creates a more fair, equitable rating system for all
- Premium is more closely associated with risk



# How are Rates Determined?

**Historical Information:** to identify trends in data

- Actuaries use a variety of statistical techniques; get base rate

**Territorial or Class Rating**

- Data are adjusted for geographic, industry-specific factors or other factors statistically correlated with risk of future loss
- E.g. Urban zip codes = greater accident frequency

**Individual Risk Rating**

- Policyholder-specific risk factors are taken into account
  - E.g., Model of car; wood frame vs. masonry home; office worker vs. construction worker

**Experience Rating**

- Adjustments made to premium based on policyholder's past claim filing activity

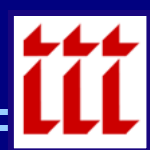


## The “combined ratio”

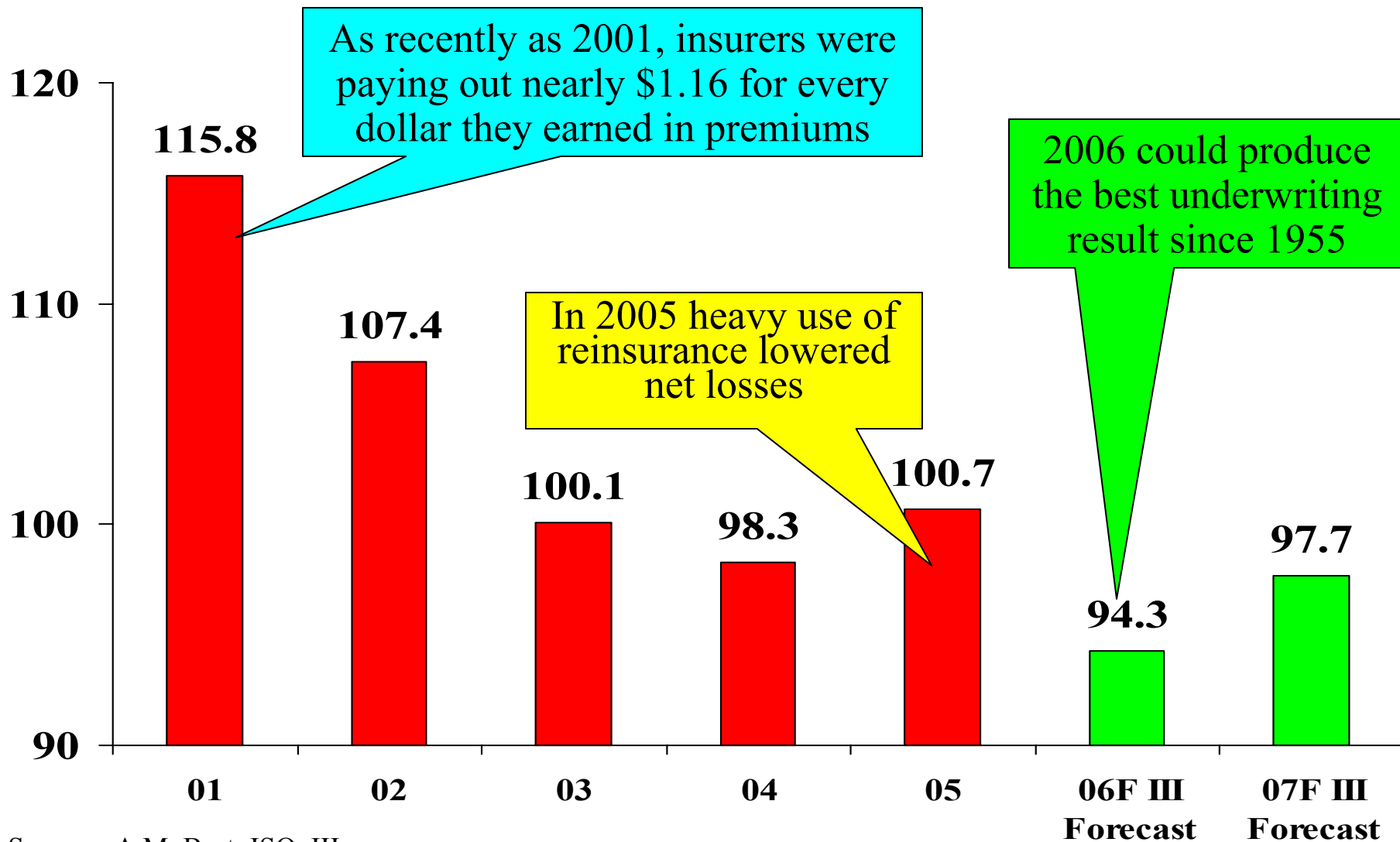
- Numerator: claims paid plus loss adjustment expenses plus operating expenses
- Denominator: earned premiums (premiums for insurance already provided)

A ratio of 100 (really 1.0) means all insurance outlays exactly equalled insurance income

- A combined ratio over 100 means rates were insufficient to anticipate all claims and expenses
- A combined ratio under 100 means rates were more than sufficient to anticipate all claims and expenses



# P/C Industry Combined Ratio: (losses paid + expenses paid)/earned premiums



Sources: A.M. Best; ISO, III.

# The Effect of Disasters on the Property/Casualty Insurance Industry



# U.S. Insured Catastrophe Losses\*

\$ Billions



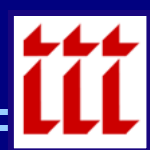
...a \$100 billion CAT year is coming

2005 was by far the worst year for insured catastrophe losses in the US, but...

\*Excludes \$4B-\$6b offshore energy losses from Hurricanes Katrina & Rita. \*\* As of Sept. 30, 2006.

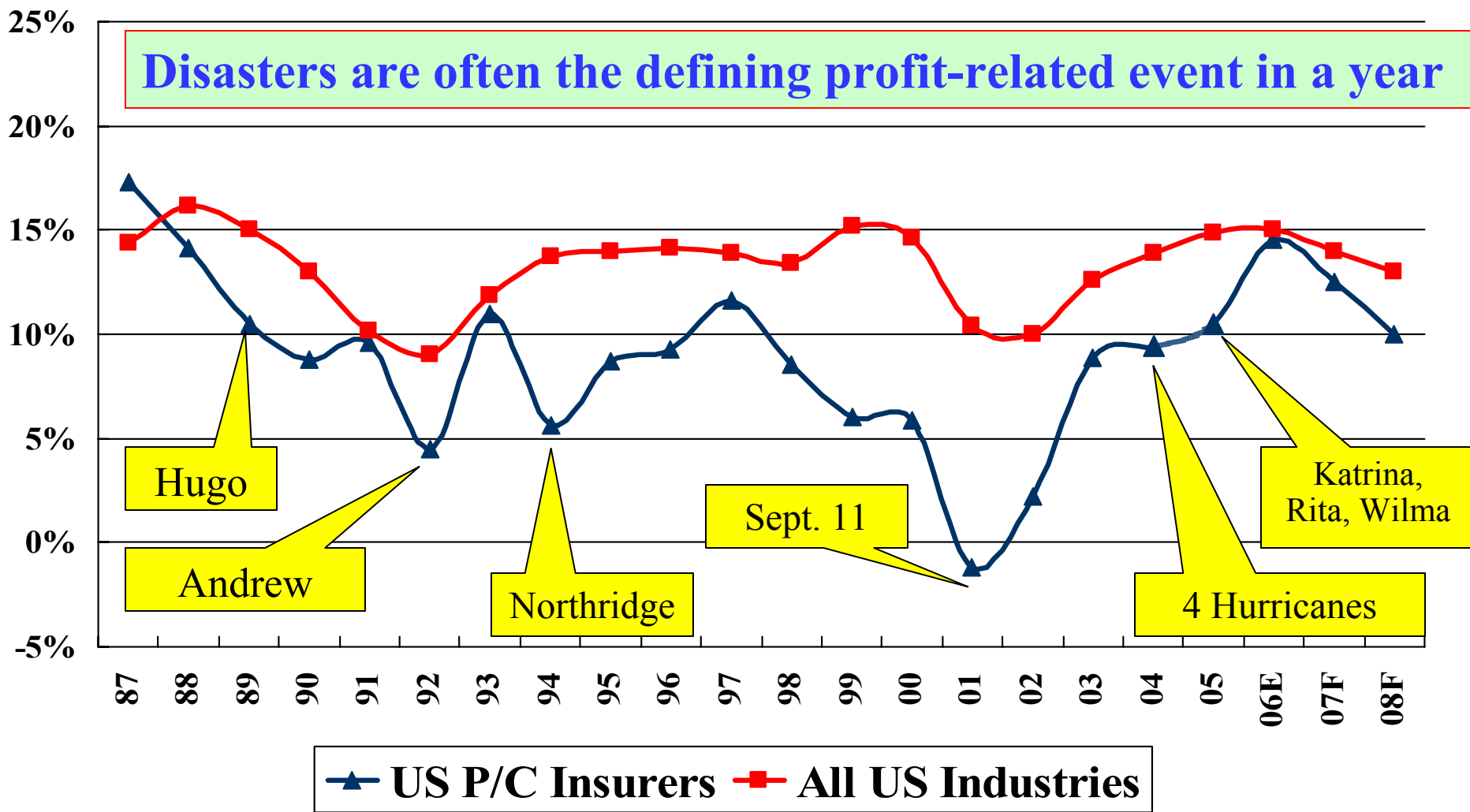
Note: 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = \$12.2B.

Source: Property Claims Service/ISO; Insurance Information Institute



# Profit (ROE): P/C vs. All Industries 1987–2008E

**Disasters are often the defining profit-related event in a year**



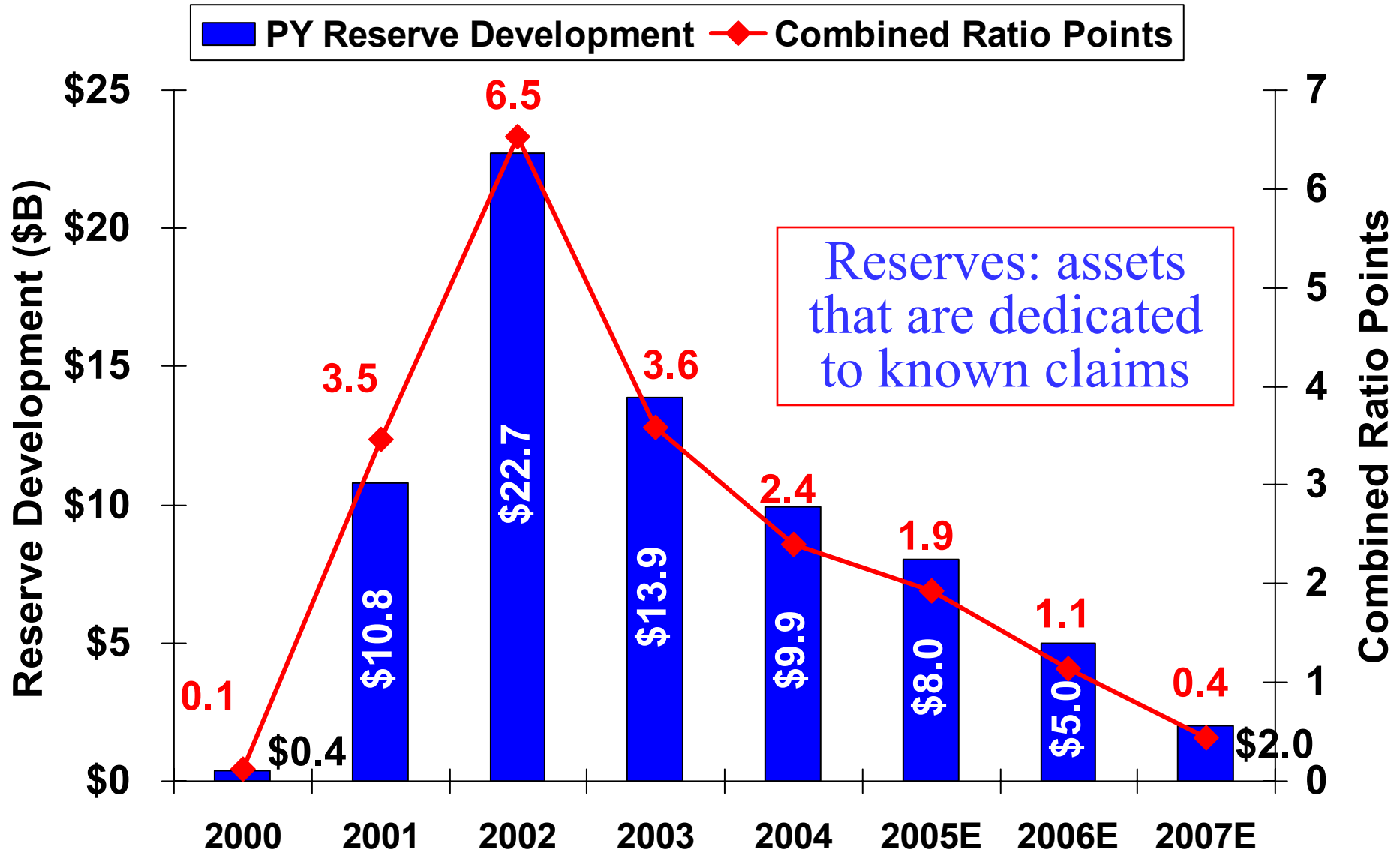
▲ US P/C Insurers ■ All US Industries

\*2006-8 P/C insurer ROEs are I.I.I. estimates.

Source: Insurance Information Institute; *Fortune*



# Insurers Strengthened Loss Reserves Every Year This Decade



Source: A.M. Best, Lehman Brothers for years 2005E-2007F



# Key Messages on Capacity

The *respite* in hurricane-related losses in 2006 will allow insurers to *rebuild* their claims paying resources, *reinvesting* in the future of the industry

Policyholder surplus will likely exceed \$475 billion by year-end 2006

- The vast majority of this capacity was generated by and is held to pay claims in states and in lines of insurance not impacted by hurricane losses

States vulnerable to catastrophic loss

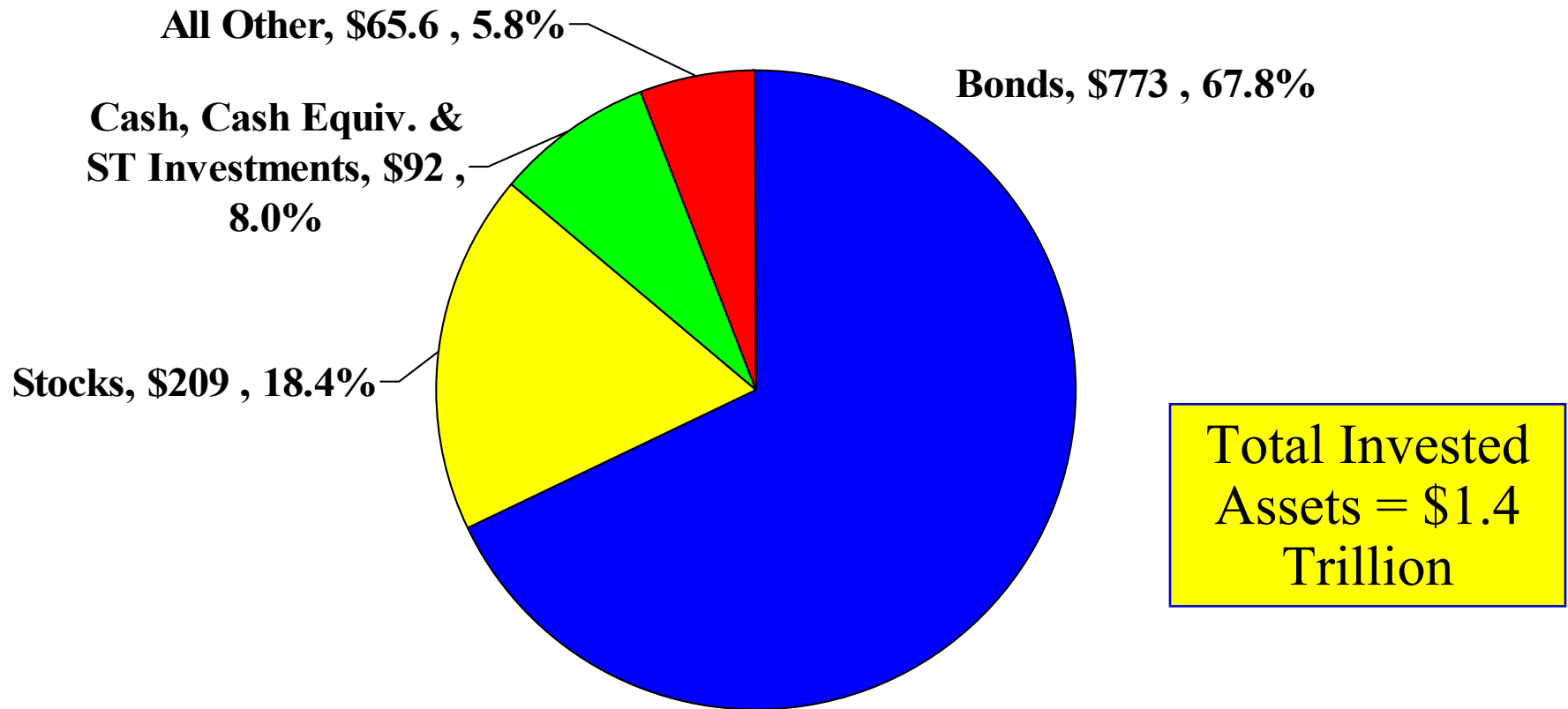
- have no special claim on insurer claims paying resources
- *by law cannot be subsidized* by profits generated in other lines and *from other states*

**Investments:**

**No Substitute for Sound Underwriting**

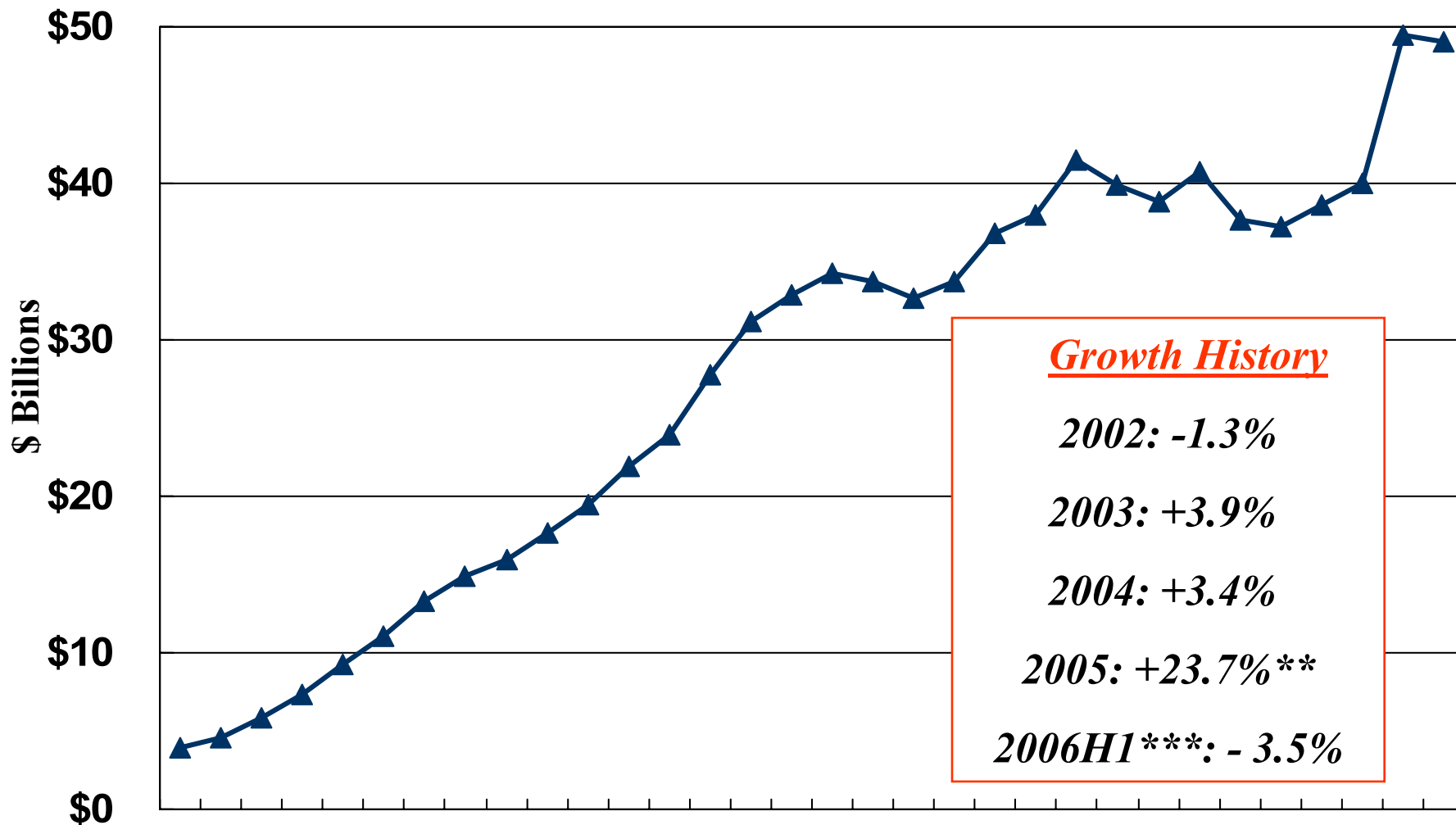


## \$ Billions





# Net Investment Income



75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06

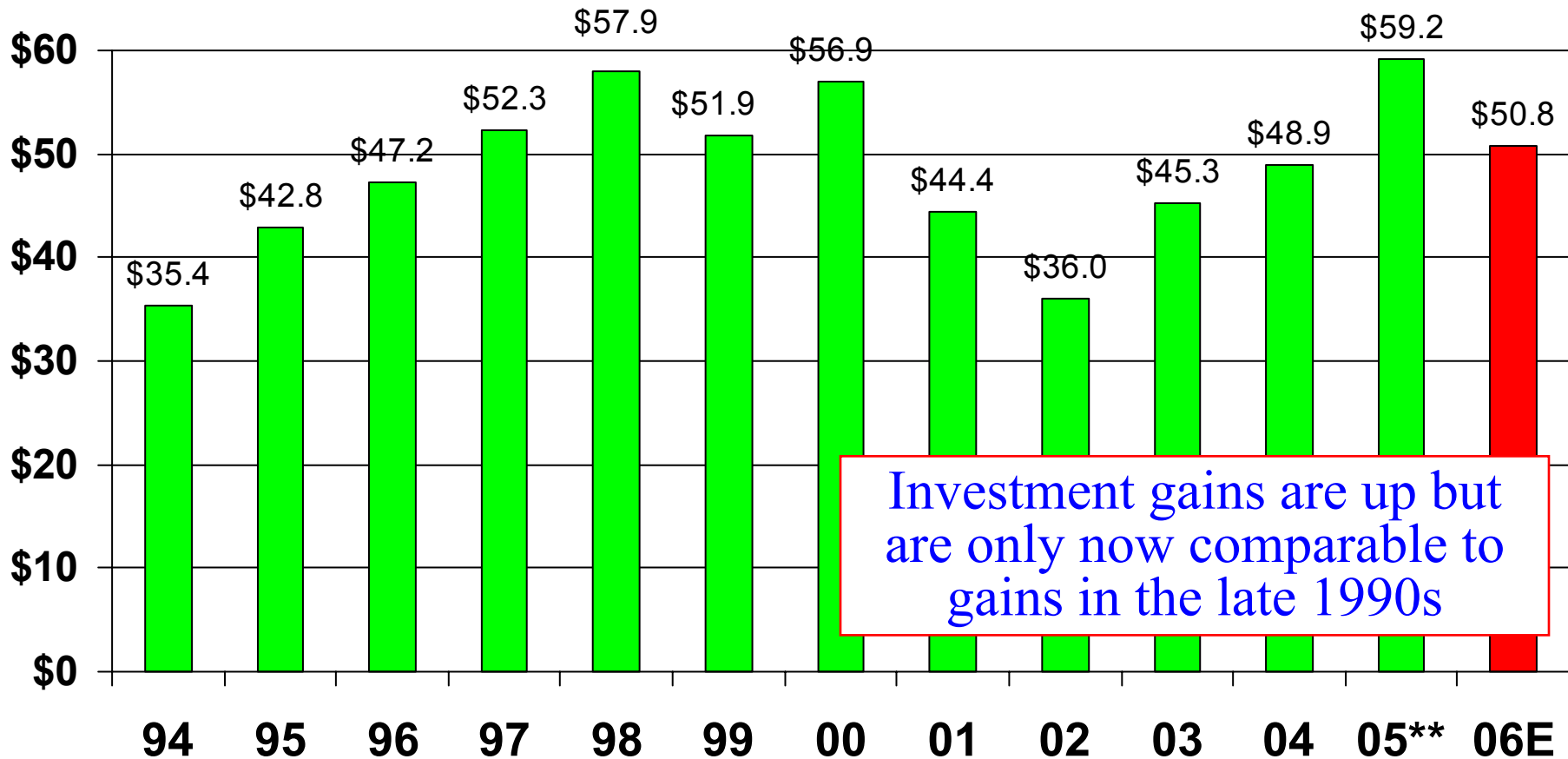
Source: A.M. Best, ISO, Insurance Information Institute;

\*\*Includes special dividend of \$3.2B. Increase is 15.7% excluding dividend. \*\*\*Annualized H1:06 figure.

# Property/Casualty Insurance Industry Investment Gain\*



\$ Billions



Investment gains are up but are only now comparable to gains in the late 1990s

\*Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2006 estimate based on actual annualized 2006:H1 result of \$25.375B.

\*\*2005 figure includes special one-time dividend of \$3.2B. Source: ISO; Insurance Information Institute.



Insurers must be prepared to liquidate significant investment holdings to pay large claims without notice

- Insurers invest primarily in safe, highly liquid but relatively low-yielding instruments
- More than 2/3 of invested assets are held as bonds; 8% is held as cash or very short-term investments
- Just 18.4% of invested assets are held as stocks

# The Regulation of Property/Casualty Insurance Companies



## Objective: Solvency, not profitability

Regulated by each state; mostly uniform across US  
National Assn. of Insurance Commissioners (NAIC)

- Provides services to insurance departments (e.g., model laws)
- No actual regulatory authority

Use statutory, not GAAP accounting

Make sure insurer isn't overextended

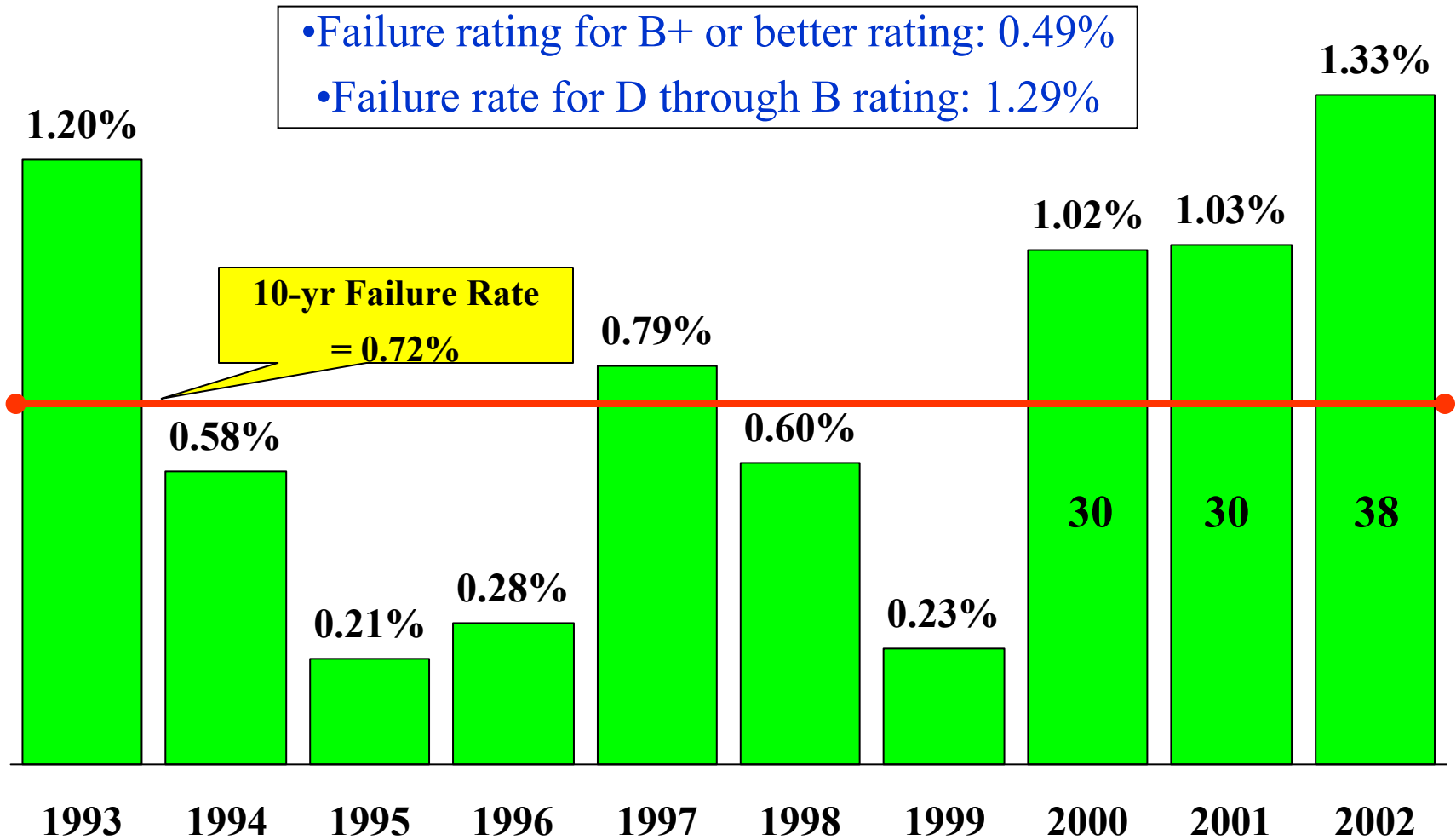
- Examine premiums relative to claims-paying resources
- Growth rates
- Liquidity
- Investment quality

Risk-Based Capital (RBC)

- System that forces insurers to account for riskiness in their insurance and investment portfolios
- "Charges" larger depending on riskiness of asset
  - E.g., US Treasuries = no charge; Junk Bonds = High



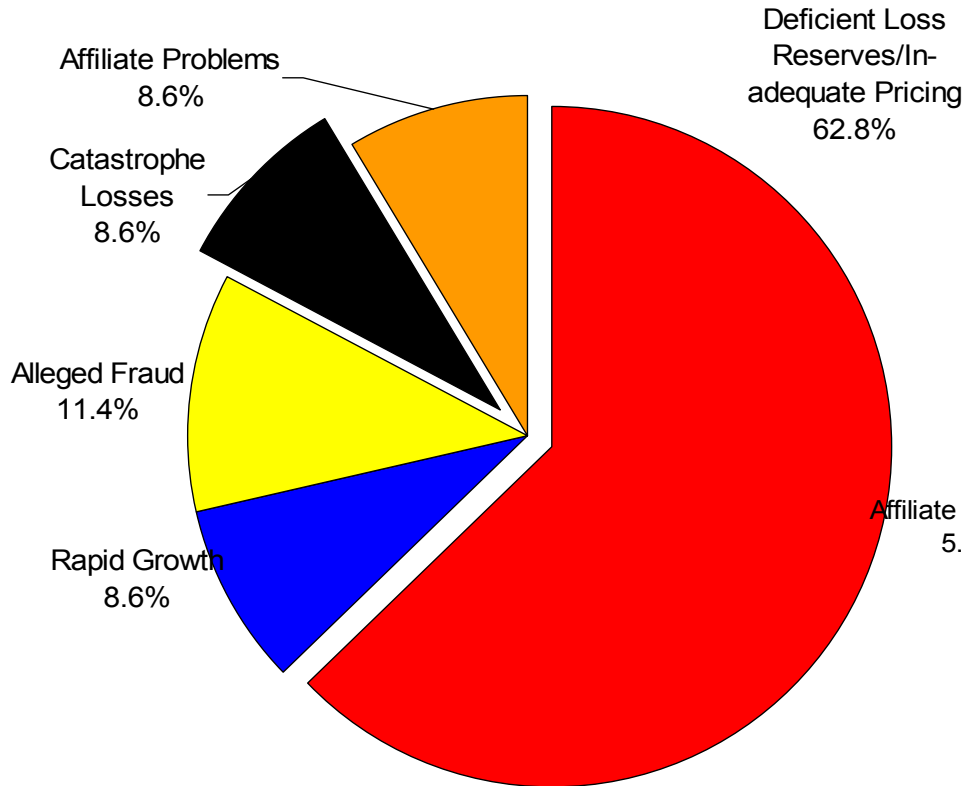
# P/C Company Insolvency Rates, 1993 to 2002



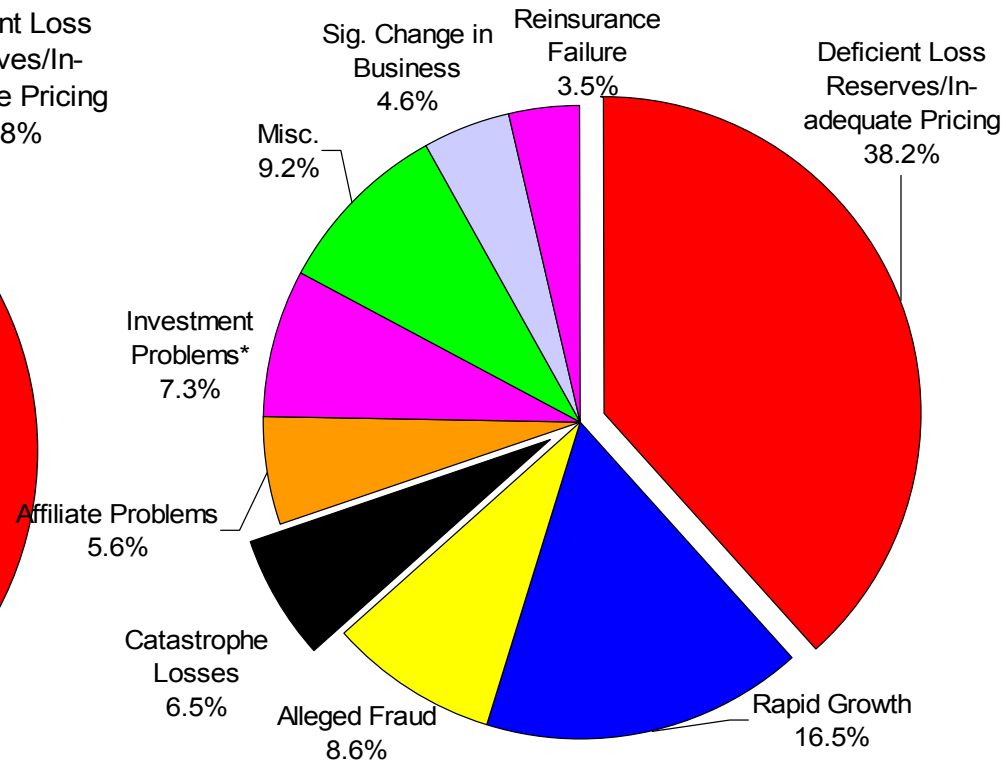


# Reasons for US P/C Insurer Impairments, 1969-2005

## 2003-2005



## 1969-2005



\*Includes overstatement of assets.

## Consumer Protection

- Market conduct
- Consumer education/information
- Licensing
- Product Approval

## Rates & Forms



The property/casualty insurance industry is highly competitive

It's a highly cyclical/volatile business

P/C insurance operations, by themselves, are rarely profitable

Many factors influence price (rate) and availability

- General & individual risk rating factors
- Nature of regulation has significant impact on competition, consumer choice, and price

Major changes could be ahead for insurance regulation



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# The Legal Liability and Tort Environment



## Best States - Overall

Delaware  
Nebraska  
North Dakota

## Worst States - Overall

Alabama  
West Virginia  
Mississippi

### Maryland Rankings – Overall #23

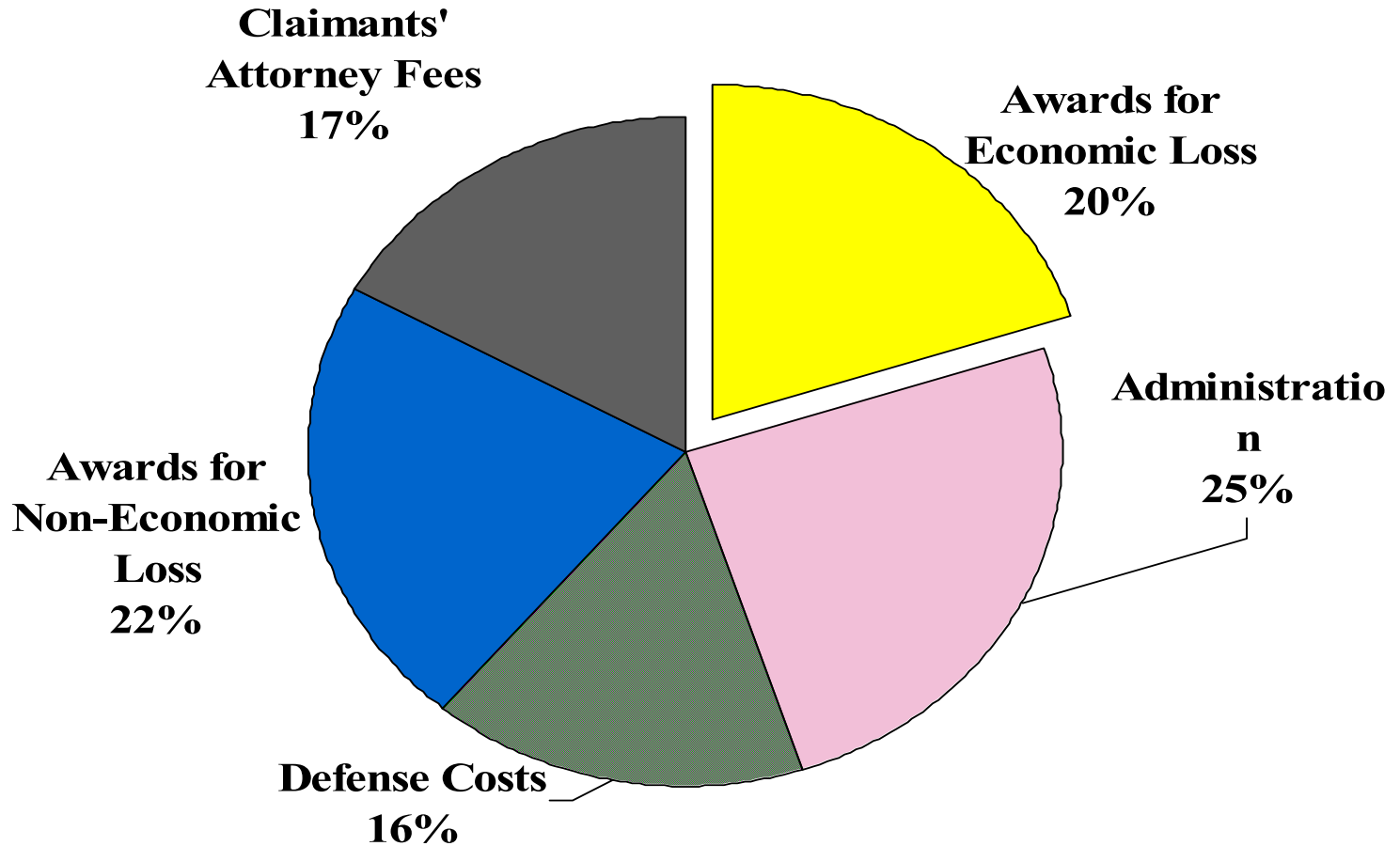
Tort and Contract Litigation, Overall	26	Judges' Impartiality	21
Treatment of Class Action Suits	29	Judges' Competence	25
Punitive Damages	23	Juries' Predictability	18
Timeliness of Summary Judgment/Dismissal	23	Juries' Fairness	25
Scientific and Technical Evidence	26	Discovery	26



# Where the Tort Dollar Goes (2000)

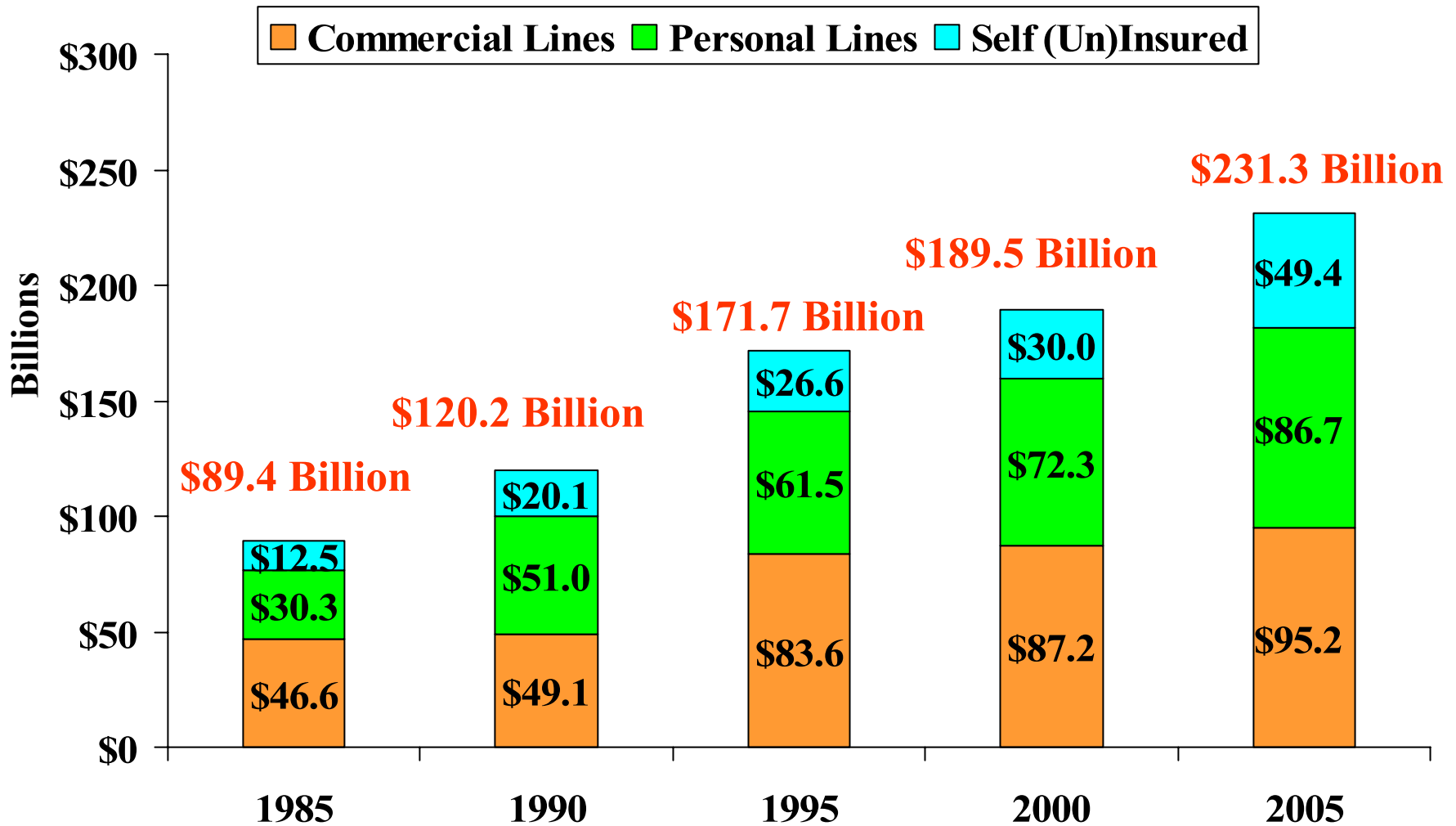
Tort System is extremely inefficient:

- Only 20% of the tort dollar compensates victims for economic losses
- At least 58% of every tort dollar never reaches the victim





# Insurance Incurred Tort Costs & Self [Un] Insured Tort Costs\*



\*Excludes medical malpractice  
Source: Tillinghast-Towers Perrin



# Cost of U.S. Tort System (\$ Billions)

Tort costs consumed 2.1% of GDP in 2005

