

## GROUNDHOG FORECAST 2007

### Special Report

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### *Survey of Analysts Projects Slower Premium Growth, But Underwriting Profit in 2007 and 2008*

Each year before Groundhog Day, the Insurance Information Institute invites a panel of Wall Street stock analysts and industry professionals to come out of their holes, look around for their shadow and forecast the outlook for the industry. Legend has it that if Punxsutawney Phil sees his shadow, there will be six more weeks of winter. While Phil didn't see his shadow in 2007, most insurance industry analysts predict slower P/C premium growth for 2007. This year's survey results indicate that the respite in catastrophe losses in 2006, combined with a strong performance in virtually all other major lines of property/casualty (P/C) insurance, will, in all likelihood, propel the industry to its best underwriting performance since 1936. Analysts further expect the industry's profitability to continue in 2007, albeit with an underwriting performance that generates a much smaller underwriting profit; the trend of decreasing underwriting profits is expected to continue in 2008. The poll also shows that analysts uniformly expect premium growth to become even more sluggish in 2007 and 2008. This apparent paradox—a peak in industry profits, but stalling premium growth—is a clear reminder of the cyclical nature of the property/casualty business, and the fact that the industry's financial fortunes are influenced by a number of factors.

### *Premium Growth: Stuck in Neutral, But Insurance Buyers Benefit*

The average forecast calls for an increase in net written premiums of just 1.8 percent in 2007, a substantial slowdown from the 3.3 percent estimated for 2006. The 1.8 percent increase in premium growth that analysts forecast for 2007 would be the third slowest rate of growth for P/C insurers since 1998, during the depths of the last soft market. It represents a near halving of the estimated figure for 2006. The deceleration in premium growth in 2007 is a direct result of an across-the-board softening in the personal and commercial lines pricing environment; the sole major exception to this general trend is hurricane-exposed coastal property insurance coverages, where insurers are looking to charge premiums that are commensurate with the substantial risks they assume. For 2008, the average forecast calls for an equally modest increase in net written premiums at just 1.8 percent.

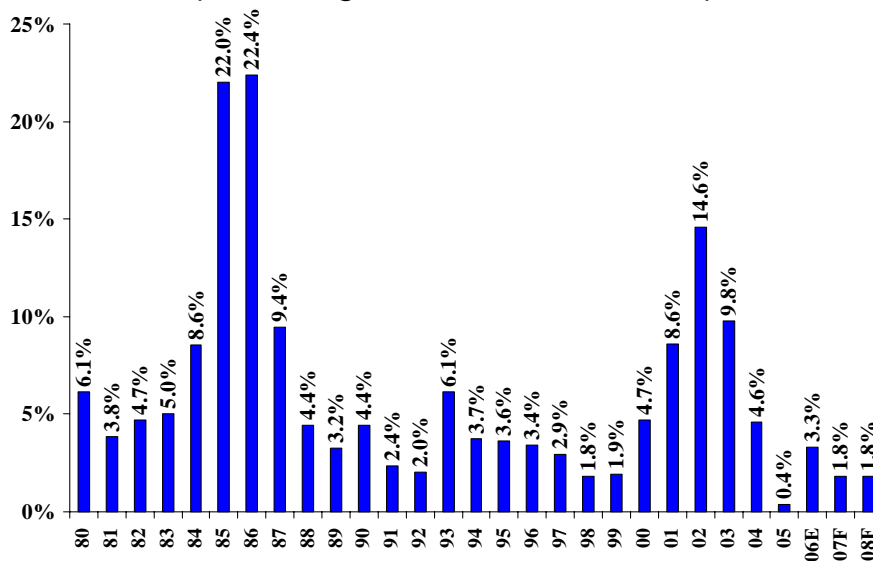
As illustrated below, premium growth peaked during the most recent cycle at 14.6 percent in 2002, before dropping to 9.8 percent in 2003. It is also worth noting that premium growth in 2006 will come in well below the average analysts' expectations from a year ago. In last year's Groundhog survey, the consensus estimate was for net written premium growth of 3.8 percent (1).

Buyers of insurance are, of course, the clear winners when it comes to reaping the benefits of slowing premium growth. Drivers, homeowners and businesses in most parts of the United States will be left with more cash in their pockets as insurance costs fall in absolute terms, or at least relative to income growth and growth in GDP. The bottom line is that falling insurance prices are lowering the cost of doing business, driving a car or owning a home for most Americans. For example, countrywide auto insurance expenditures are expected to fall 0.5 percent in 2007—the first drop since 1999 (2). Businesses will see declines of 5 percent or more in 2007, across their entire insurance program. Overall, the share of P/C insurance premiums relative to the overall economy will shrink by about 2.5 and 3.1 percent in 2006 and 2007, respectively.

For insurers, the current premium growth pattern is eerily reminiscent of the soft market of the late 1990s, when the industry recorded growth of 2.9 percent in 1997 and 1.8 percent in 1998. Those years presaged some of the worst years in the insurance industry’s history, with combined ratios rising from 102 in 1997 to nearly 116 in 2001. Fortunately, with an expected combined ratio of 96.8 in 2007 and 98.7 in 2008, the comparison—at least so far—appears to be superficial, or at least premature.

Though top line growth has slowed to a near standstill, profits (measured in dollar terms) and profitability (as measured by return on equity, or ROE) are rising due to a variety of factors, including an ebb in catastrophe losses in 2006. The respite in catastrophe losses means that 2006 was a sorely needed rebuilding year for insurers; many insurers have used the opportunity to restore their claims paying resources and to reinvest in the future of the industry. Indeed, most of the industry’s profits in 2006 will be reinvested back into the business. Profits will bolster the industry’s policyholder surplus—a measure of claims paying capacity, or capital—and will provide an additional buffer against the mega-catastrophes that lie ahead. An improved capital position also helps insurers meet the higher capital requirements imposed on them by ratings agencies in the wake of Hurricane Katrina—requirements that oblige insurers to demonstrate an ability to pay claims arising from more than one major catastrophe per year in order to maintain and improve financial strength ratings.

## Net Written Premium (% Change from Previous Year)

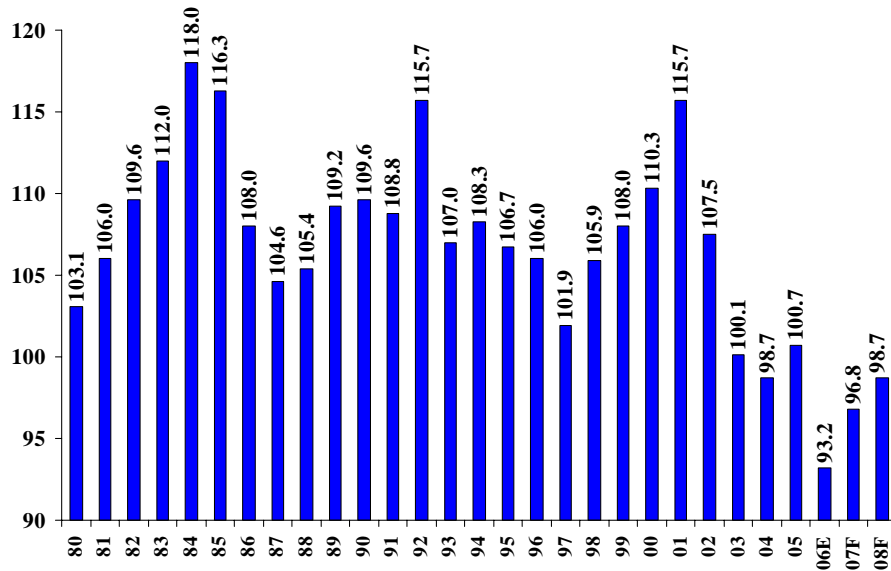


## ***Combined Ratio: Best Result in Seven Decades in '06, Remaining Strong in '07 and '08***

The combined ratio—the ratio of losses and expenses to premiums—for 2007 is projected to be 96.8, a deterioration from an estimated 93.2 in 2006. The 93.2 estimate for 2006, if accurate, would represent the industry's best underwriting performance since the 93.3 combined ratio recorded 70 years earlier in 1936. If, as predicted, the combined ratio in 2007 comes in under 100, it would produce just the third underwriting profit in the property/casualty insurance industry since 1978. It is important to note that the estimate for 2007 assumes a return to "normal" levels of expected catastrophe loss. This said, underwriting profits in 2007 will likely fall significantly from 2006 levels. The considerably slimmer margin of underwriting profitability will also be eliminated entirely if CAT losses return to 2004/05 levels.

While the survey results indicate fundamentally sound underwriting performances in 2006 and 2007, the anticipated 3.4 point deterioration in the combined ratio for 2007 begs questions about 2008 and beyond. This year's Groundhog survey includes, for the first time, combined ratio projections for 2008—the combined ratio for that year is forecasted to be 98.7, a very respectable number, but one that nonetheless represents an additional 1.9 point deterioration from 2007 and a 5.4 point deterioration relative to 2006. As the combined ratio approaches 100, returns will become progressively less competitive with the Fortune 500 group. At that point, insurers will still be paying out exactly the same amount in claims and associated expenses as they earn in premiums. As a stern reminder of the importance of generating substantial underwriting profits, the 100.7 combined ratio in 2005 produced an ROE of just 10.4 percent. The underwriting profits earned in 2006 will help insurers earn their cost of capital (the rate of return necessary to retain and attract capital) for just the second time in many years, while industry profitability as a whole—with an ROE of about 15 percent—will match that of the Fortune 500 group for the first time since 1987. Though up substantially in 2006, insurer profits remain highly volatile. In fact, just five years earlier, in 2001, insurers suffered their worst year ever with a 115.7 combined ratio for the year. Considering the tremendous risk assumed by investors who back major insurance and reinsurance companies, the returns in most years are woefully inadequate. It is clear that Fortune 500-level returns on equity in the neighborhood of 13 to 15 percent cannot be generated consistently without a substantial contribution from underwriting given the murky interest rate situation going forward and continued investment income volatility.

# Combined Ratio



## ***2007: Market Environment Looks Favorable, But Many Challenges Remain***

What are the biggest potential downside risks for 2007? Still high on the list is exposure to catastrophic loss, which superseded loss of pricing and underwriting discipline as the chief concern in 2005—by far the worst year for catastrophe losses, with \$61.2 billion in insured losses. But the worst is yet to come. With rapid coastal development, \$40 billion-plus storms are expected to become more common, and many within the industry expect a \$100 billion CAT year in the not too distant future. The \$8.8 billion in catastrophe losses for 2006, while indeed a welcome respite for the industry, is unlikely to recur in the future.

Analysts' forecasts for net written premium growth in 2007—which range from 0.1 percent on the low end to just 3.1 percent on the high side—reflect the fact that pricing and underwriting discipline, the industry's historical nemeses, remain a key issue. Regulators, especially in catastrophe-prone areas, are reluctant to allow insurers to charge risk-based rates. Most insurers are also paying more for reinsurance, which causes them to report lower "net" written premium growth figures if they cannot fully recoup those costs at the retail level. Increased interest by traditional commercial insurance buyers in alternative forms of risk transfer, especially captives, self-insurance arrangements and large deductibles, is causing significant leakage of premiums from the system. Also, insurer pullbacks from coastal areas are resulting in the ceding of significant premium to state-run residual market mechanisms, often in states that otherwise offer significant growth opportunities. The consequences of slowing/sluggish premium growth can be sobering if not appropriately handled. Management may be tempted to engage in price-based battles for market share, while CEOs may feel increased pressure to make potentially ill-fated acquisitions. The challenge is to avoid a significant sacrifice of margins on existing business lines while seeking out growth opportunities that leverage current company strengths.

High on the list of external threats are adverse court decisions in Mississippi and Louisiana that have injected significant additional uncertainty into what are already very difficult operating environments. The suits threaten insurers' ability to operate in coastal sections of these states.

Virtually all the litigation in these states involves insurance coverage disputes in which structures were damaged or destroyed by water.

Regulatory and legislative risks also loom large in 2007. A special session of the Florida legislature in January produced damaging legislation that effectively socializes much of the Florida homeowners and reinsurance markets. The state's governor also imposed a freeze on all rate changes and non-renewals, potentially leaving insurers exposed to excessive catastrophe losses and ratings downgrades. Separately, some states are attacking the right of insurers to use certain underwriting criteria, despite the fact that such criteria are accurate predictors of future loss and result in a rating system that is more equitable for all policyholders.

Among other major external risks, terrorism remains a key concern, despite the two-year extension of the Terrorism Risk Insurance Act signed by President Bush in late 2005. The extension, which has a new expiration date of December 31, 2007, pushed considerably more risk onto private insurers, who have consistently maintained that large-scale terrorism events are not privately insurable. For example, individual company deductibles rose from 15 percent of direct earned premiums in 2005 to 17.5 percent in 2006 and 20 percent in 2007. Likewise, industry aggregate deductibles are raised from \$15 billion in 2005 to \$25 billion in 2006 and \$27.5 billion in 2007. Many insurers now have retentions greater than or equal to their actual 9/11 losses. While the shift to Democratic control in Congress leads many industry pundits to believe that passage of some form of backstop is likely, there is concern as to exactly what the program will look like and how it will operate.

Fortunately for insurers, at least some of the momentum built in 2006 will be carried into 2007 and 2008. That being said, insurers will need to come to grips with a variety of challenges unrelated to catastrophe losses, including increasing price pressure and the slow growth environment that could erode underwriting performance and profitability in the year ahead.

A table containing the estimates and forecasts of the survey participants follows.

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- (1) The Insurance Information Institute's 2006 Groundhog forecast can be accessed at: <http://www.iii.org/media/industry/financials/groundhog2006/>
  - (2) The Insurance Information Institute's 2007 auto insurance expenditure forecast can be accessed at: <http://www.iii.org/media/industry/additional/2007autooutlook/>.

## THE INSURANCE INFORMATION INSTITUTE'S 2007 GROUNDHOG FORECAST

### Net Written Premiums\* (% Change from Prior Year)

Company	Est. 2006	Forecast 2007	Forecast 2008
Gill & Roeser	3.0	3.1	3.0
Firemark Investments	4.0	3.1	2.0
A.G. Edwards	2.8	3.0	3.0
Goldman Sachs	2.9	2.5	2.5
Standard & Poor's	3.6	2.3	2.0
Bear Stearns	3.0	2.0	1.0
Langen McAlleney	2.0	2.0	2.0
Merrill Lynch	3.4	2.0	1.5
Tillinghast	3.5	1.8	3.0
Lehman Brothers	4.3	1.4	1.6
Fitch Ratings	3.3	1.3	1.9
Conning & Co.	3.1	0.6	1.7
Raymond James	4.6	0.1	-2.0
A.M. Best	2.6	0.1	NA
<b>Average</b>	<b>3.3</b>	<b>1.8</b>	<b>1.8</b>
*Ranked highest to lowest for 2007			

### Combined Ratio\* (After Dividends)

Company	Est. 2006	Forecast 2007	Forecast 2008
Gill & Roeser	95.5	100.0	102.0
Conning & Co.	96.1	99.4	101.6
Bear Stearns	94.0	99.0	99.0
A.G. Edwards	93.9	97.5	98.0
Standard & Poor's	93.5	97.0	99.5
Firemark Investments	92.5	97.0	100.0
Merrill Lynch	92.0	97.0	98.5
A.M. Best	93.3	96.8	NA
Raymond James	91.8	96.4	98.4
Tillinghast	93.6	96.0	99.0
Fitch Ratings	92.0	95.3	98.6
Goldman Sachs	92.6	95.1	96.2
Langen McAlleney	93.2	94.7	96.2
Lehman Brothers	91.1	93.9	95.6
<b>Average</b>	<b>93.2</b>	<b>96.8</b>	<b>98.7</b>
*Ranked highest to lowest for 2007			