

## COMMENTARY ON FIRST- HALF 2007 RESULTS

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The property/casualty (P/C) insurance industry reported an annualized statutory rate of return on average surplus of 13.1 percent during the first half of 2007, down from 14.0 percent for calendar year 2006 and 13.5 percent from last year's first half. The decline in profitability is attributable to a marginal deterioration in underwriting performance, which pushed the first half 2007 combined ratio up to 92.7 compared with 92.0 during the first half of last year and 92.5 for all of 2006. Nevertheless, the industry is on track to record what could be its seventh best combined ratio since 1920. The results were released by ISO and the Property Casualty Insurers Association of America (PCI). Though profits remain reasonably strong, industry margins are virtually guaranteed to fall well short of those realized by the Fortune 500 group of companies, which is expected to turn in an average return on equity (ROE) in the 14 to 15 percent range this year.

### ***2007: A Glass Half Full or Half Empty?***

The financial performance of the property/casualty insurance industry during the first half of 2007 was generally excellent and so far has proved surprisingly resilient in the face of an increasingly price competitive environment. But at the same time the first half results provide confirmation that the industry is now past its cyclical peak in profitability of 14.0 percent achieved in 2006. In my commentary on the first quarter 2007 results I presented an analysis suggesting that if the historical trends observed during the past four market cycles hold (dating back some 35 years), the industry can expect ROEs to bottom out in 2011 at about 1 percent—not reaching another peak in profitability until 2015 or 2016.<sup>1</sup>

The most important question facing the industry today is whether this painful and destructive cycle can be broken and with it the commensurate surge in insurer impairments that invariably occur. History does not imply destiny, of course, and there are some indications that aggressive capital management, expense controls and judiciously timed realization of accumulated capital gains by insurers may be making a difference—leading to a shallower market cycle and a more modest dip in profitability. Insurance CEOs continue to vow that it will be different this time around and 2008 is quickly shaping up to be the year when the industry's fortunes will be cast.

### ***Shades of Things to Come: As Underwriting Results Slip, Realized Investment Gains Rise***

The first half results provide a telescopic glimpse into the future. It is immediately apparent that insurer profits going forward will become increasingly dependent on investment earnings as underwriting performance steadily deteriorates. It is notable that despite a \$619 million drop-off in underwriting income (the margin by which premium income exceeds claims costs, expenses and policyholder dividends) profits (net income after taxes) actually rose by \$3.2 billion, or 5.5 percent, to \$30.6 billion during the first half of 2007, up from \$25.4 billion during the first half of 2006. The increase in profits is entirely attributable to modestly higher investment income—up \$1.6 billion (6.6 percent) to \$26.1 billion—and a quantum 373.7 percent (\$3.3 billion) leap in realized capital gains to \$4.2 billion.

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<sup>1</sup> See <http://www.iii.org/financial/>

It is important to note that the decision to recognize capital gains is entirely under management discretion. Although the run-up in stock prices during the second quarter no doubt motivated some selling, companies are clearly under pressure to fill the profit void created by shrinking underwriting profits by selling a share of their investment gains accumulated over the past several years. Indeed, the practice of “banking” the majority of accumulated capital gains may well be coming to an end. In 2006, earnings were powered almost entirely by record underwriting profits and insurers realized just \$3.4 billion in capital gains throughout the entire year despite a 13.6 increase in the Standard & Poor’s 500 stock index. Realized capital gains through the first half of 2007 alone have already eclipsed gains for all of 2006 by some \$800 million.

Although insurers have accumulated significant unrealized capital gains on their books, they are ultimately a finite resource. In contrast, profits generated through disciplined underwriting are a renewable resource and in a disciplined underwriting and pricing environment provide a stable source of earnings irrespective of the investment conditions. During the late 1990s, bull markets and high interest rates allowed insurers to absorb ever larger underwriting losses. That changed when stock markets collapsed and interest rates tumbled in the early 2000s. The subprime induced market swoon in July and August of this year and the Federal Reserve’s 50 basis point rate cut are reminders of the volatility and fragility of investment returns, even in the insurance industry’s very conservatively managed investment portfolio.

### ***The Subprime Lending Crisis: Implications for the Insurance Industry<sup>2</sup>***

As major purchasers of bonds and stocks, and through the nature of the products that some insurers provide, insurers are potentially exposed to the effects of the recent turmoil in the subprime and other credit markets. A September 2007 analysis by the Insurance Information Institute examining the property/casualty and life insurance industry’s exposure to the subprime issue conclude that, based on information currently available, the industry will not be materially affected by credit market developments. This conclusion is based on the recognition that both by law and by the nature of their business, insurers generally limit themselves to the low-risk end of the investing universe. Even for the very small share of their investments directly exposed to subprime and near-prime loans, insurers mainly invest in “slices” of those investments that, according to the bond-rating agencies, are as safe as the safest corporate bonds.

A small number of P/C insurers provide insurance on the credit-worthiness on mortgage-backed securities. The loss ratios for the credit insurance products of these companies are likely to rise due to increased delinquencies and defaults. Yet at least half of these companies are parts of larger financial services groups, so that the experience of this line of business is, for them, a small part of their overall operations. The others are, in general, broadly diversified.

A limited number of P/C insurers offer directors and officers (D&O) liability insurance and errors and omissions (E&O) liability insurance. It is likely that some actions will be brought that will trigger the defense benefits in these policies, and possibly some payouts under the liability benefit provisions. Typically, these claims take a long time to develop. As such, it is much too early to estimate the dimensions of the claims experience that may emerge from the recent credit market developments. Major providers of D&O coverage tend to be among the largest and most financially sound insurers.

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<sup>2</sup> Abstracted from “*Subprime Home Mortgage Loans and the Insurance Industry*,” Insurance Information Institute, September 2007. The full study can be downloaded at: <http://www.iii.org/media/research/subprime/>.

Of course some companies will be affected more than others, and the depth and length of the credit market “challenges” might be more adverse than many experts currently foresee. But for now, these developments do not appear poised to adversely affect the insurance industry’s ability to pay its claims and continue to have financially successful operations.

### ***Profits: The Key to Rebuilding Claims-Paying Capacity and Reinvestment in the Industry***

Continued strong profits in 2007 will allow insurers to make significant reinvestments in the industry. Profits bolster the industry’s policyholder surplus—a measure of claims-paying capacity or capital—and provide an additional buffer against the mega-catastrophes that lie ahead. An improved capital position will also help insurers meet the higher capital requirements imposed on them in the wake of Hurricane Katrina by ratings agencies; 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.

From year-end 2006 through June 30, 2007, policyholders’ surplus increased by \$26.6 billion, or 5.5 percent, to \$512.8 billion—surpassing the half trillion threshold for the first time. Since June 30, 2006, policyholders’ surplus is up \$68.1 billion from \$444.7, a gain of 15.3 percent. These significant increases in surplus demonstrate that insurers are reinvesting the majority of their profits (and unrealized capital gains) in the property/casualty insurance industry, bolstering industry claims-paying resources in advance of what are likely to be record-setting catastrophe losses in the relatively near future.

Consumers and regulators can expect that insurers will continue to increase their claims-paying capacity through the remainder of 2007 and into 2008. At the same time, publicly traded insurers must continue to compensate shareholders for the assets they put at risk. With few opportunities for organic growth (such as expanding into new states or branching out into new lines of business) and fewer still acquisition targets, insurers can be expected to return capital to shareholders rather than invest it unproductively. To that end, P/C insurers are in the midst of executing record share buyback plans. According to Credit Suisse, insurers through the first half of 2007 repurchased \$6.2 billion worth of shares, \$2.1 billion more than during the same period last year. If current trends hold, share repurchases will shatter the 2006 record of \$7.1 billion. Ultimately, better capital management (including share repurchases), combined with better underwriting and pricing discipline, could lead to a less severe cyclical downturn in profitability.

### ***Catastrophe Losses: The Worst Has Yet to Come (Though Maybe Not in 2007)***

When it comes to catastrophe losses, insurers necessarily prepare for the worst and hope for the best. Catastrophe losses during the first half were relatively light—at \$3.6 billion, compared to \$6.5 billion during the first half of 2006, according to ISO’s Property Claims Service. This sum is a pittance compared with the record \$62 billion in insured losses in 2005, \$40.6 billion of which was due to Hurricane Katrina. The first half is generally light on catastrophe losses and the 2007 hurricane season will not conclude until November 30. Needless to say, insurers are never out of the woods when it comes to catastrophe losses. The reality is that the 2000s has already established itself the “decade of disaster,” with record catastrophe losses set in 2001, 2004 and 2005. Insurers and reinsurers today actively plan for a \$100 billion event (or sequence of events summing to \$100 billion). There are a frighteningly large number of scenarios capable of generating a \$100 billion loss, ranging from a repeat of the 1906 San Francisco earthquake, to a strong hurricane striking Miami or New York, to a major terrorist attack.

Not all catastrophe risk is associated with hurricanes. The looming December 31 expiration of the Terrorism Risk Extension Act has once again made terrorism a front burner issue for insurers. Interestingly, legislation recently passed by the US House of Representatives to extend

the federal terrorism risk insurance program actually *increases* the potential for large-scale insured losses. While the proposed legislation (H.R. 2721), known as the Terrorism Risk Insurance Revision and Extension Act (TRIREA), contains several favorable provisions such as eliminating the distinction between domestic and international acts of terrorism and providing for a 15-year extension, the Act also calls on insurers to assume nuclear, biological, chemical and radiological (NBCR) risks. Insurers have not historically insured most NBCR risks and nuclear/radiological exclusions have been in place in most insurance contracts for decades. A successful NBCR attack in a major urban area could easily produce insured losses in excess of \$100 billion. Under TRIREA, insurers would be responsible for a substantial share of these losses. Nevertheless, the Administration has issued a veto threat on the legislation, suggesting that a great deal of compromising and negotiation with the Senate will occur by year's end.

### ***Profitability and Pricing***

Rising profitability is also intensifying competition throughout most of the property/casualty insurance industry and buyers of insurance are the unambiguous winners when it comes to reaping the benefits of lower insurance premiums. 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 sole major exception being insurance for property coverages in hurricane-exposed areas. 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.<sup>3</sup> At the same time the average cost of insuring a non-coastal residence is up by just 2 to 4 percent in many areas and is flat or even falling in others. Businesses, too, are seeing very significant price declines in 2007 across their entire insurance program—down 11.8 percent, according to the Council of Insurance Agents and Brokers Survey for the second quarter. The declines are a continuation of a downward trend in the cost of business insurance that began in earnest in 2004 and are likely to continue into 2008 and possibly beyond. Commercial insurance prices today stand roughly where they were in late 2001 or early 2002. Overall, the share of P/C insurance premiums relative to the overall economy shrank by 2.0 percent in 2006 and will likely shrink by another 4 to 5 percent in 2007 and 2008. Hence, while critics of the industry bemoan insurer profits, the reality is that the cost of insurance for the overwhelming majority of consumers is flat or falling and that insurance costs relative to GDP are falling.

One indicator of increased competition in the insurance industry is advertising expenditures, which rose to a record \$3.695 billion in 2006, up 24 percent from \$2.975 billion in 2005 and more than double the \$1.8 billion recorded in 2001. The increased spending in advertising expenditures is occurring across both commercial and personal lines insurers.

Improved profitability across the P/C insurance industry does not, however, mean that property insurance and reinsurance rates will fall in catastrophe-prone areas, especially those vulnerable to hurricanes. The risk in those areas remains high. Property catastrophe reinsurance prices are, however, leveling out as competition in the market heats up. One of the greatest threats to affordable property insurance coverage comes from the courts. Adverse court decisions, especially in Mississippi and Louisiana are putting upward pressure on prices and decreasing availability.

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<sup>3</sup> The Insurance Information Institute's forecast for 2007 auto insurance expenditures is available at <http://www.iii.org/media/updates/press.764681/>.

## ***Premium Growth: Price Competition Takes its Toll on Insurers, is a Boon for Buyers***

The ISO results indicate a growth rate in net written premiums of just 0.1 percent during the first half of 2007, down substantially from the 2.7 percent increase during calendar year 2006, which experienced strong growth in property-related insurance premiums in hurricane-exposed areas. The first half's slim gains are weaker than the anemic average forecast from the Insurance Information Institute's February Groundhog survey of industry analysts' calls for an increase in net written premiums of just 1.8 percent in both 2007 and 2008.<sup>4</sup> The 0.1 percent increase in premium growth, if maintained through 2007, would represent the lowest growth rates for the during the past 40 years. The deceleration in premium growth in 2007 is a direct result of a virtual across-the-board softening in the personal and commercial lines pricing environment and a leveling-off in property insurance price increases in many hurricane-exposed areas. Other factors include a general economic slowdown that is negatively impacting exposure growth through declines in home building, new vehicle sales and business investment in new plants and equipment as well as slower wage and salary growth. Actions taken by insurers to reduce their exposure to relatively catastrophe-prone (but rapidly growing) property markets like Florida are also having a negative impact on the outlook for growth as do continued interest by businesses in alternative forms of risk transfer such as captives, self insurance programs and large deductible policies. The growing market share of government operated insurers and reinsurers also represents a significant source of premium leakage.

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, 1.8 percent in 1998 and 1.9 percent in 1999. Those years presaged some of the worst years in insurance industry history, with combined ratios rising from 102 in 1997 to nearly 116 in 2001. Fortunately, with a first half combined ratio of 92.7 (coming on the heels of 92.5 combined ratio for all of 2006), the comparison—at least so far—appears to be superficial, or at least premature.

## ***Underwriting Performance: Momentum is Fading as Deterioration Begins***

The P/C insurance industry's underwriting results in 2007 remained extraordinarily strong by historical standards. The first half combined ratio of 92.7, should it hold for the remainder of 2007, would become the seventh best since 1920. Last year's combined ratio of 92.5 was the best since 1949 and stands tied for the fifth best result since 1920. The first half combined ratio is up just 0.2 points from the calendar year 2006 result but up 0.7 points from first half 2006. The current period of sustained underwriting profits (2004, 2006 and possibly 2007 and 2008) is the first in a half century.

The first half's 92.7 combined ratio implies an underwriting profit after dividends of \$14.4 billion. If maintained, as seems likely, 2007 would witness only the third underwriting profit since 1978. The industry's 2006 underwriting profit totaled \$31.7 billion. Despite recent underwriting profits, there remains a cumulative underwriting loss of approximately \$414 billion since 1975 (assuming a 2007 underwriting profit of about \$28 billion).

The combined ratio is projected to rise to 96.8 in 2007 and 98.7 in 2008, according to the I.I.I.'s Groundhog survey. However, the first half results are better than anticipated, suggesting that a combined ratio of 94 or even lower is possible this year, assuming "normal" catastrophe losses.

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<sup>4</sup> Insurance Information Institute survey of industry analysts <http://www.iii.org/media/industry/financials/groundhog2007/>.

While the survey results indicate fundamentally sound underwriting performances in 2007 and 2008, the anticipated 3 to 7 point deterioration in the combined ratio over the next two years is another indicator of slimmer profit margins in the years ahead. A surge in catastrophe losses could easily push the industry combined ratio to 100 or beyond, too high to generate returns that are competitive with the Fortune 500 group. A combined ratio of 100 means that insurers are paying out exactly the same amount in claims and associated expenses that 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 10.5 percent. The underwriting profits earned in 2007 will help insurers earn their cost of capital (the rate of return necessary to retain and attract capital) for just the third time in many years. Though up substantially in 2006 and (so far) in 2007, insurer profits remain highly volatile. Just six years ago, in 2001, insurers suffered their worst year ever with negative profits 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 ROEs 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 stock market volatility. According to ISO, P/C insurers would need to generate a combined ratio of 91.5 in 2007 in order to earn a rate of return equal to that of the long-term average for the Fortune 500 group of 13.9 percent.

In the final analysis, insurers will need to find ways to generate adequate rates of return not only to compensate investors for the risk they assume and to 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 of no use to anyone, including policyholders, millions of whom depend on the industry to pay hundreds of billions of dollars in claims each year.

## **Summary**

The strong financial and underwriting performance of the P/C insurance industry during the first half of 2007 bodes well for the remainder of the year. The results are primarily attributable to a strong, across-the-board underwriting performance, resulting in one of the best combined ratios in decades. Deteriorating underwriting performance, however, will likely lead to a greater share of earnings coming from investment gains going forward—a shift that may already have begun.

One major cause for concern is the fact that premium growth in 2007—at just 0.1 percent during the first half—means that the industry growth has come to a screeching halt and is, in fact, severely negative on an inflation-adjusted basis. Another is the rapid accumulation of capital on insurer balance sheets. The current slow-growth environment means that insurers face very difficult capital allocation decisions over the next several years.

A detailed industry income statement for the first half of 2007 follows:

## First-Half 2007 Financial Results\*

--(\$ Billions)--

Net Earned Premiums	\$217.9
Incurring Losses (Including loss adjustment expenses)	142.9
Expenses	59.8
Policyholder Dividends	<u>0.6</u>
Net Underwriting Gain (Loss)	+14.4
Investment Income	26.1
Other Items	<u>-1.5</u>
Pre-Tax Operating Gain	39.1
Realized Capital Gains (Losses)	<u>4.2</u>
Pre-Tax Income	43.3
Taxes	-10.7
<b>Net After-Tax Income</b>	<b>\$32.6</b>
Surplus (End of Period)	\$512.8
Combined Ratio	92.7

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