2017 - Commentary on first half financial results

Insurance Industry

October 4, 2017

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First Half 2017 Financial Results*

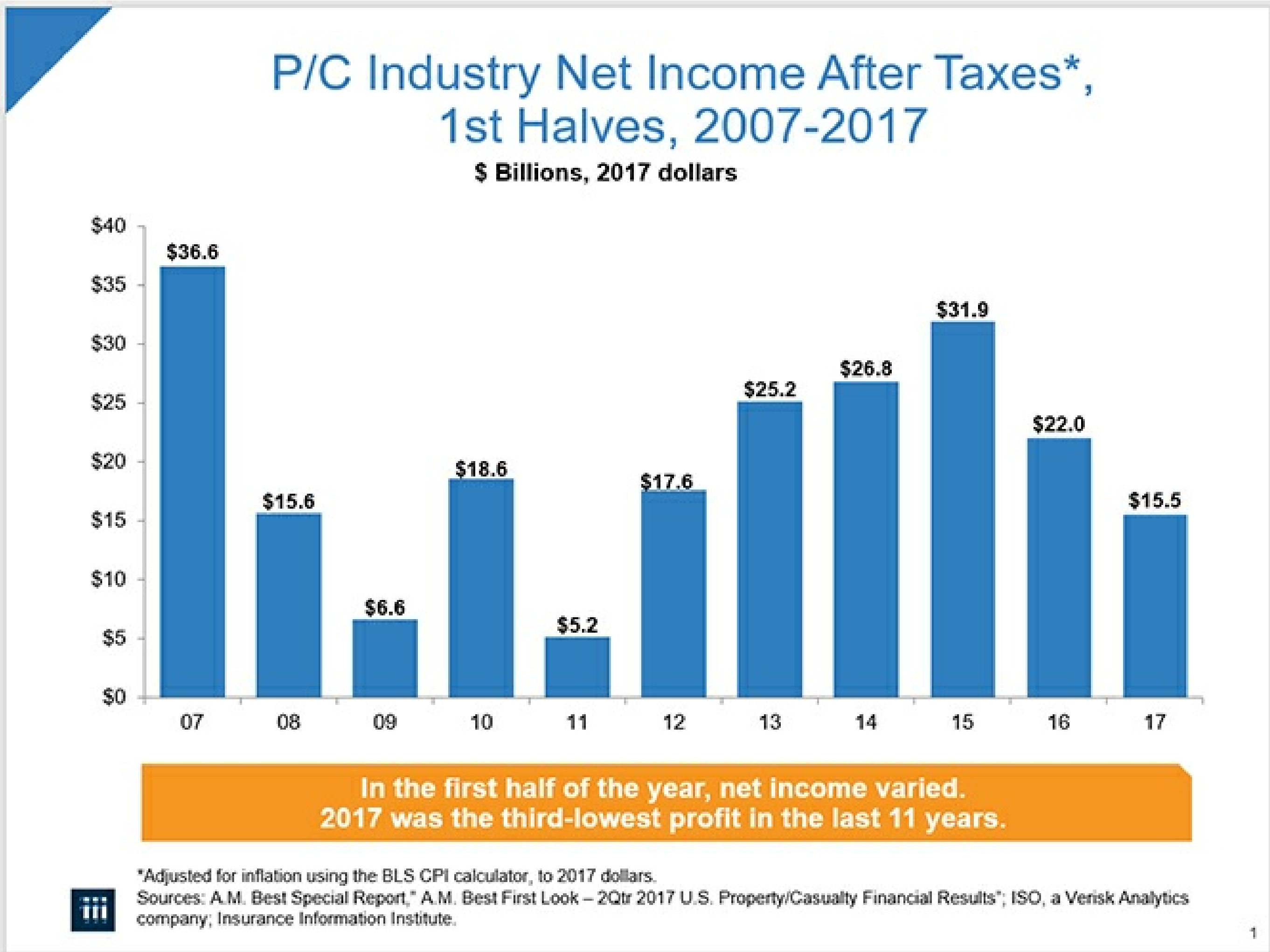
Highlights

From an underwriting profitability perspective, 2017 will likely turn out to be a tough year. The first half of 2017 produced a $4.5 billion underwriting loss. Although some of this is attributable to 2017:Q1 results, the second quarter of 2017 also produced an underwriting loss. And thanks mainly to Hurricanes Harvey and Irma, the third quarter will likely deliver a third straight quarter of underwriting losses, making it especially hard to end the year with an underwriting profit.

Results from investing the industry's assets rose slightly in the first half of 2017 versus the comparable period in 2016: Net investment gains were $26.6 billion in the first half of 2016, compared to $27.1 billion in 2017, up 1.6 percent.

Two other measures of the industry's health were positive in 2017:1H compared to 2016:1H. Net premiums written grew by 4.1 percent for the half, compared to 3.1 percent growth in the first half of 2016. And policyholders surplus—what in other industries would be called net worth—rose by 5.4 percent over its level at the end of the first half of 2016, ending at $717.0 billion. However, the industry's overall rate of return (profitability) on capital (average surplus) fell from 6.4 percent in the first half of 2016 to 4.4 percent for the same period in 2017.

The bottom line? Net income after taxes dropped by 29.2 percent, from $21.8 billion in the first half of 2016 to $15.5 billion in the first half of 2017. This is the second straight year in which net after-tax income dropped by 29 percent from the prior first half.



Industry results were released by ISO, a Verisk Analytics company, and the Property Casualty Insurers Association of America (PCI).

Underwriting performance: Incurred claims spike

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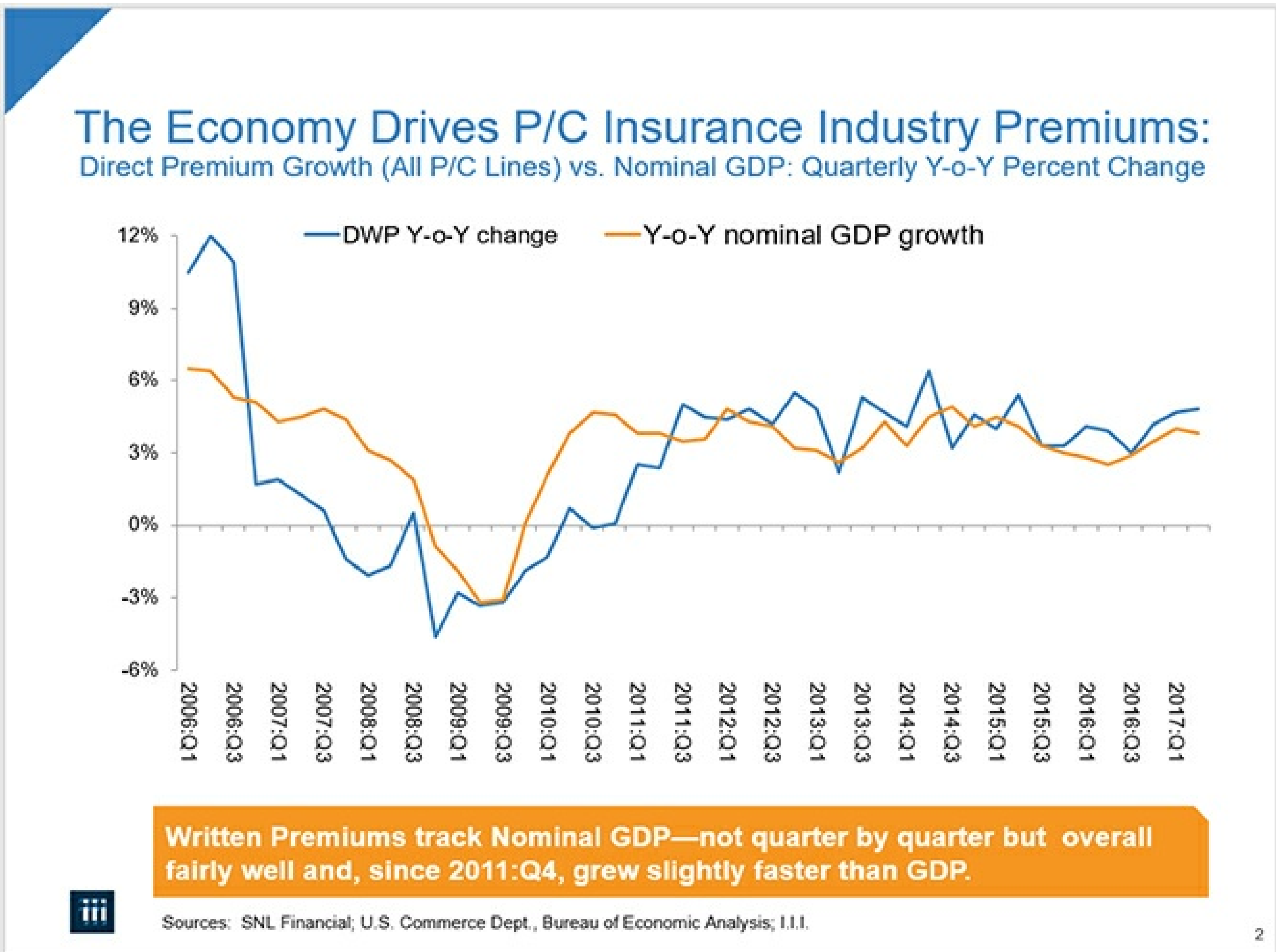
The property/casualty (P/C) industry's underwriting performance in the first half of 2017 was affected by a host of adverse conditions. A discussion of the key drivers of this first-half performance follows.

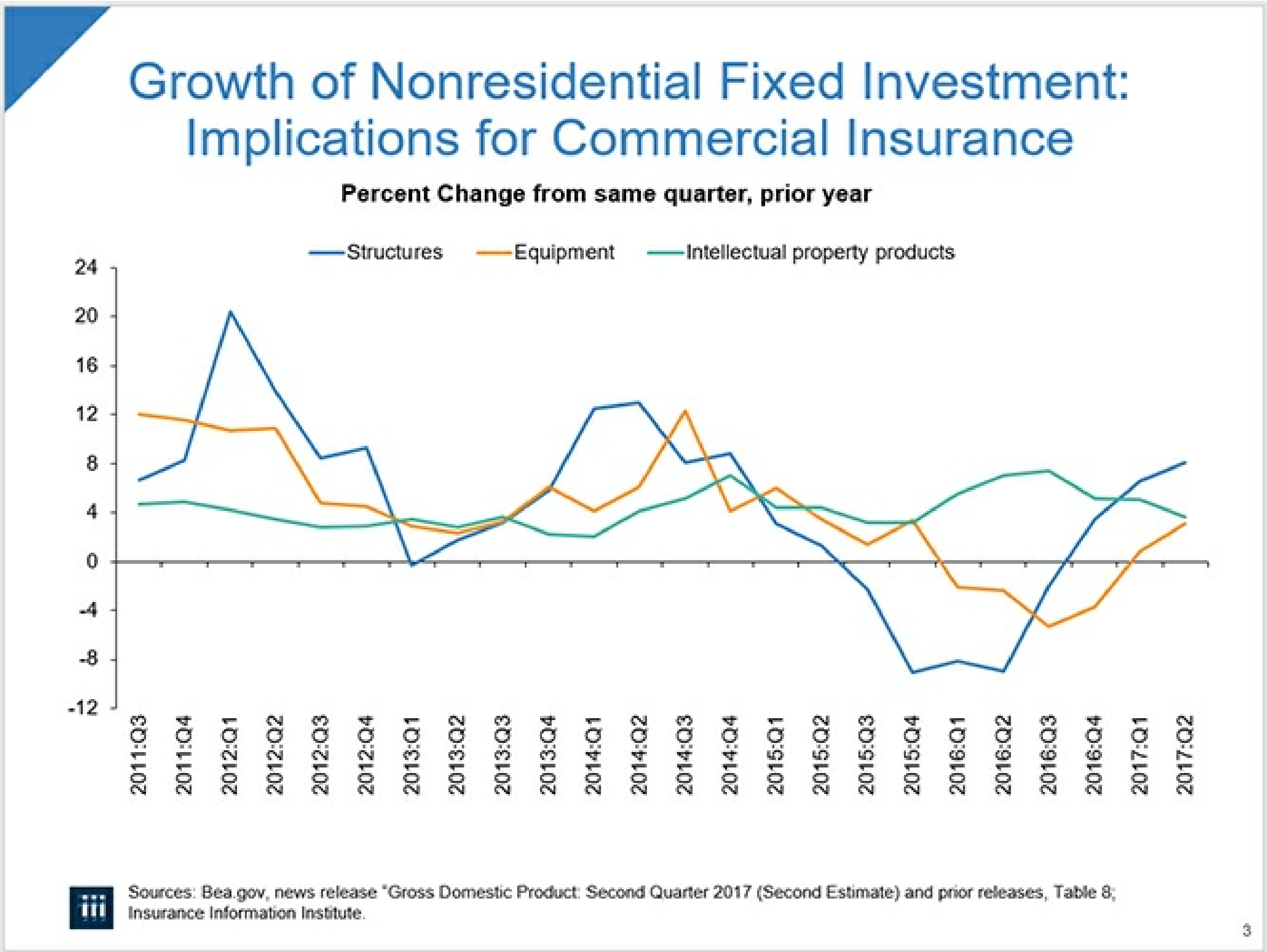
Although net premiums written (for insurance subsequently to be provided) grew by 4.1 percent in the first half of 2017, up from the 3.1 percent growth rate in the first half of 2016, but net earned premiums (for insurance actually provided) grew by only 3.4 percent, compared to growth of 3.8 percent in the comparable period in 2016.

In general, premiums may grow for any or all of several reasons. First, there is growth in the number and/or value of insurable interests (such as property and liability risks). Second, there is an increase in the willingness of buyers who had some or no insurance to purchase or add to their insurance protection, net of those who reduce or drop it. And third, there is an increase in rates (that is, the price per unit of coverage).

As a general rule, exposure growth is driven primarily by economic growth and development. The commonly used measure of economic growth is real (inflation-adjusted) GDP, but there was relatively little economic growth in the first half of 2017 (up 1.2 percent, at a seasonally-adjusted annual rate, in 2017:Q1, and up an estimated 3.0 percent, at a seasonally-adjusted annual rate, in 2017:Q2. In terms of value of economic units, the general level of prices, as measured by the Core CPI (the Consumer Price Index, excluding the effect of food and energy), rose at roughly a 2 percent annual rate.



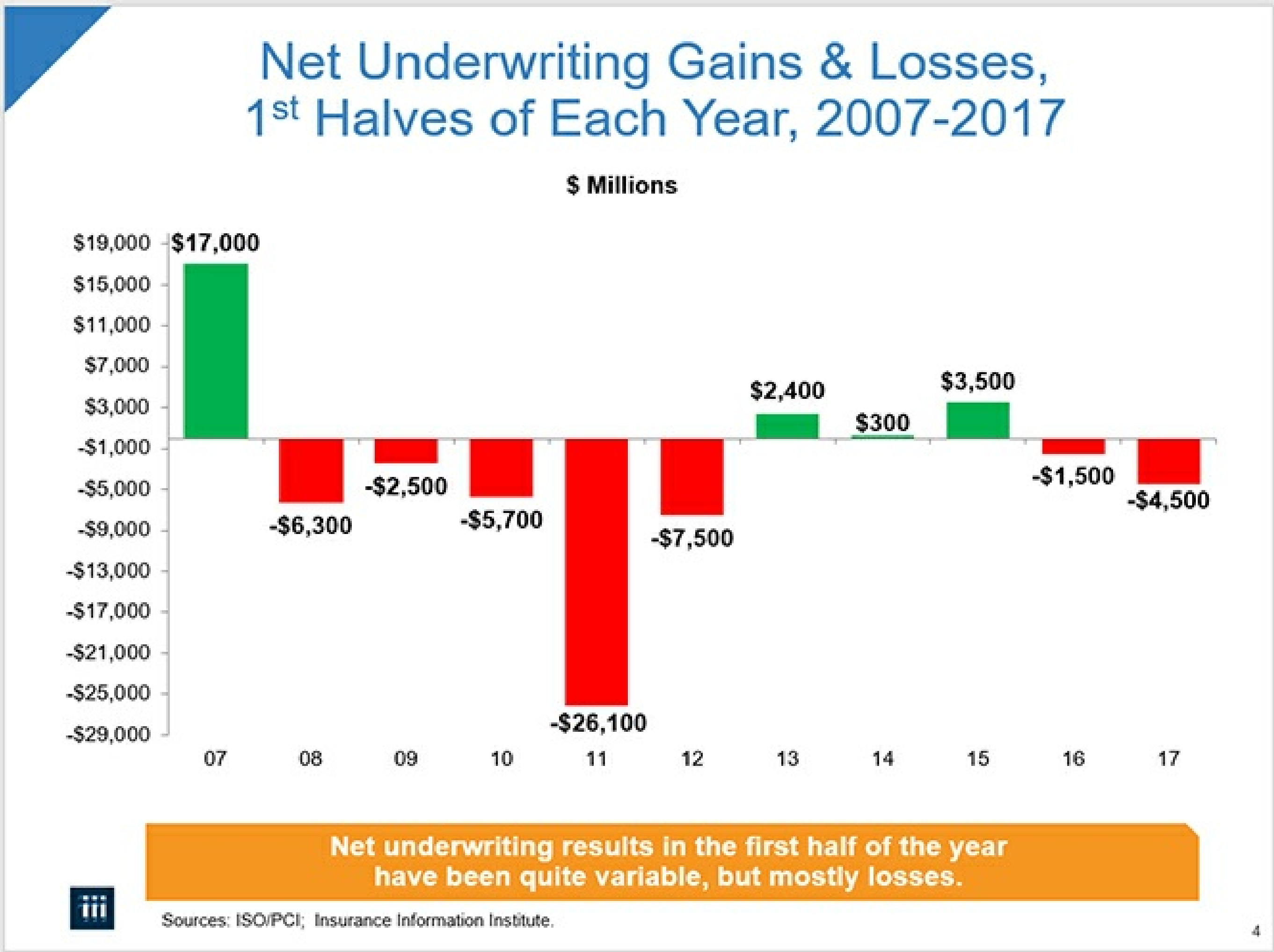
From the available data it is not easy to determine to what extent premium growth is coming from an increase in insurance buyers. Compared to the first half of 2016, the first half of 2017 saw modest population growth, continued growth in the number of people employed—especially those employed full-time—and net business formation and expansion. This all suggests that some people and businesses that had previously been un- or underinsured might have bought more coverage lately. Also, those who financed new cars or homes had to purchase insurance coverage to satisfy the conditions of their loans, even if their prior vehicles or residences were not insured. Still, in virtually every arena this growth was proceeding at a slower pace than in 2016:1H.



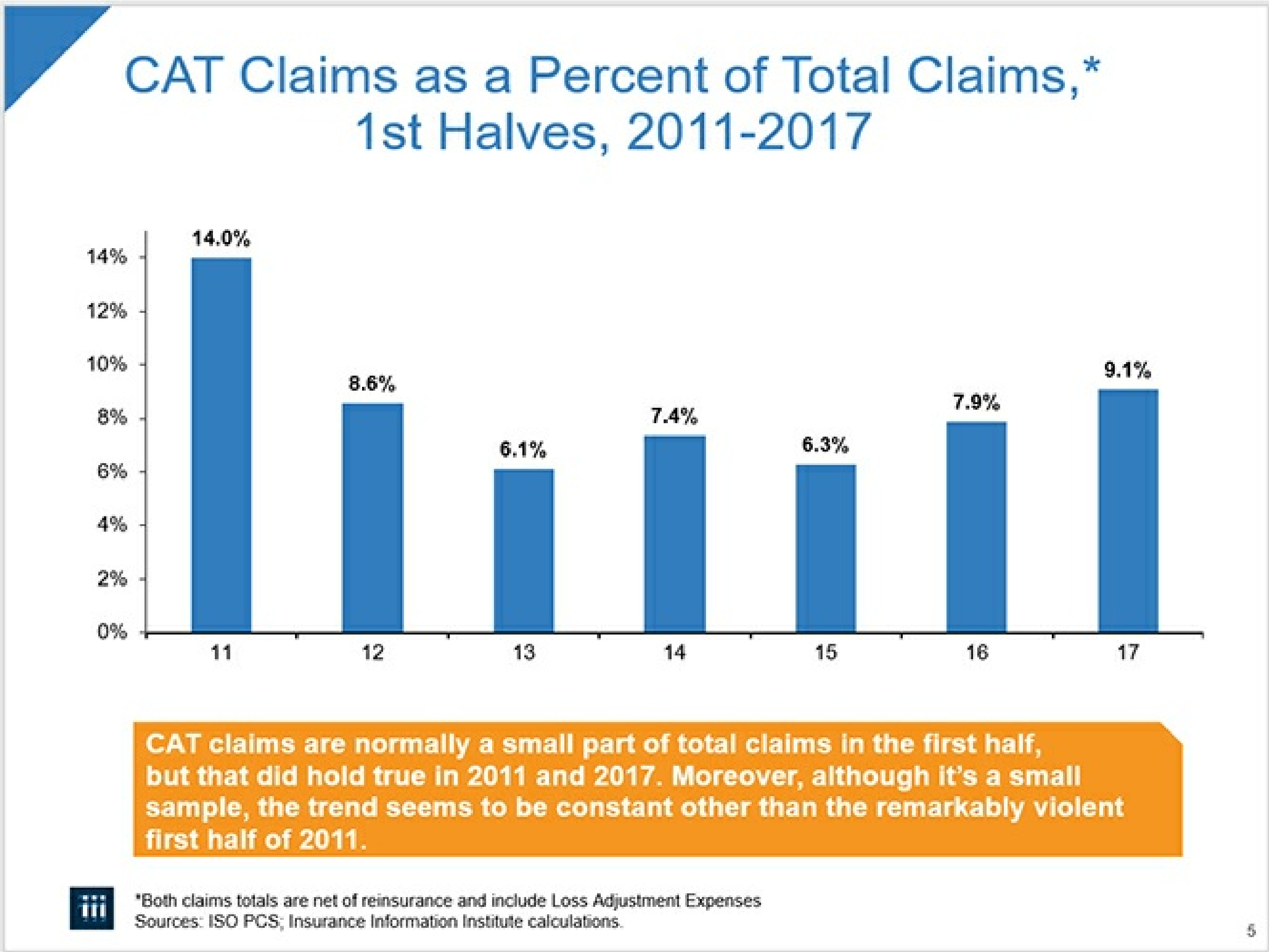
Some economists believe that the U.S. economy is approaching full employment status. Even at full employment payrolls will grow with an expanding economy and a growing population, but not as fast as in an economy rising toward full employment.

The other important determinant in industry growth is rate activity. Rates tend to be driven by trends in claim costs, conditions in the reinsurance market, marketing and distribution costs, and investments in technology, among other factors. Focusing just on claim costs, incurred losses and loss-adjustment expenses in 2017:1H rose by 5.7 percent versus the comparable prior period, outstripping the gain in earned premiums; if this relationship were expected to continue, other things equal, this would indicate that rates would rise, at least for some lines of business.

Although it is challenging to foresee the interplay of all of these and macroeconomic factors, it is certainly possible that overall industry growth in net premiums written could keep pace with overall economic growth in 2016 to 2017.



Different segments of the industry saw markedly different premium flows. Net premium written growth for insurers writing mainly personal lines (mostly auto and homeowners insurance) was 6.0 percent in 2017:1H. In contrast, net premiums written for insurers writing mainly commercial lines, excluding mortgage and financial guaranty insurers, rose by 2.4 percent in 2017:1H, up 3.1 percentage points vs. 2016:1H. And insurers writing mainly balanced books of business saw net premiums written grow by 2.9 percent.



In most years, catastrophe-related claims are a small percent of total claims, but we focus on them because they can be quite volatile, as was the case in 2017 compared to 2016. In the first half of 2017, the industry's experience with catastrophe-related losses worsened compared with 2016—from $14.6 billion a year ago to $17.7 billion this year (up 21.2 percent). Non-catastrophe losses also rose, but to a lesser extent, to $176.6 billion from $169.2 billion (up 4.4 percent). As a result, total losses and loss adjustment expenses rose by 5.7 percent, to $194.3 billion. Clearly, the large rise in claims costs in relation to 3.4 percent net earned premium growth contributed to decreased profits.

Reserve releases

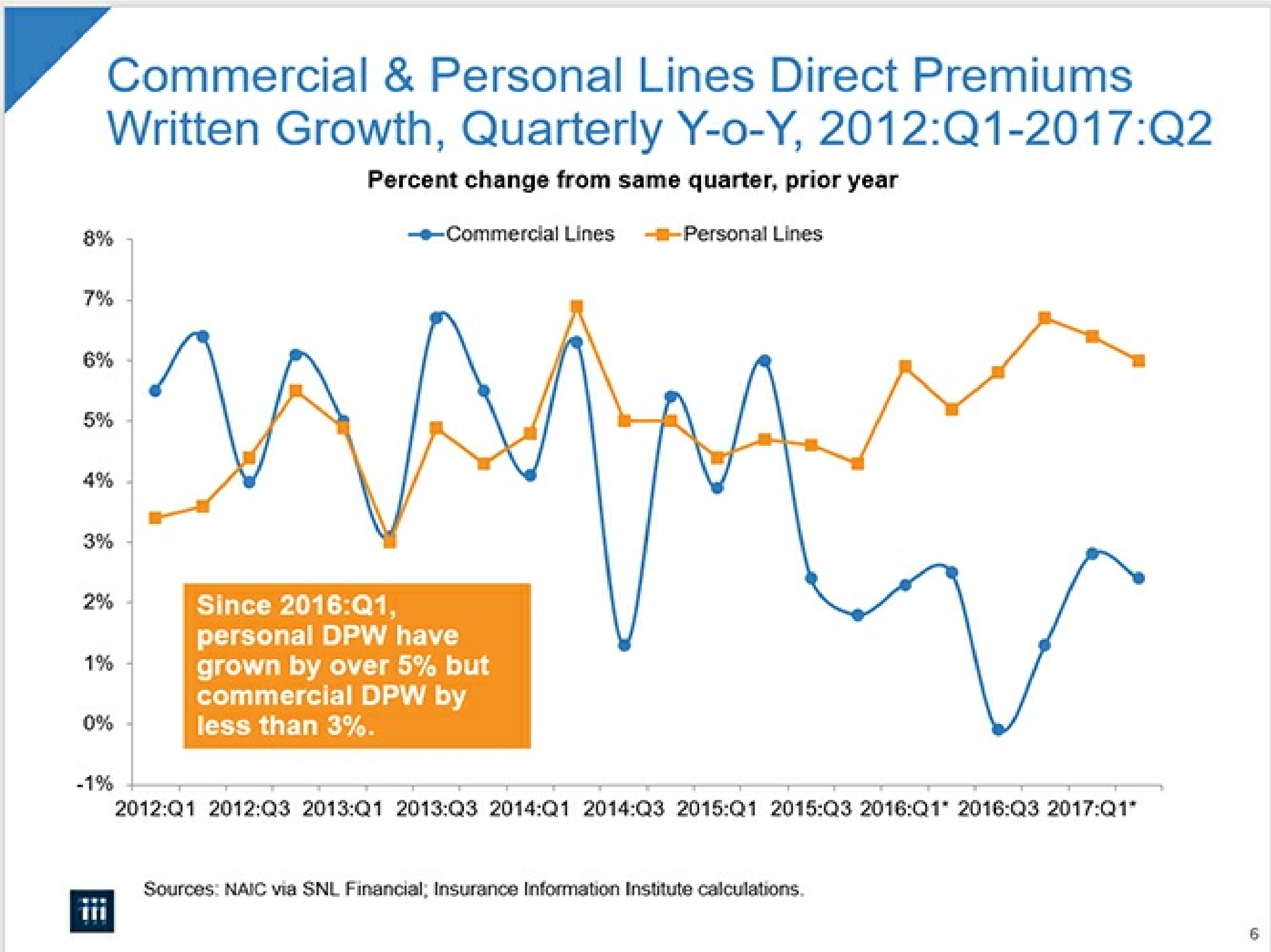
Reserve releases are generally associated with new estimates of expected costs for claims occurring in past accident years. Overall inflation continues to be remarkably low, likely contributing to these lower estimates, although prices for some items that comprise claims payouts have been increasing at higher rates. For the first half of 2017, the industry reported releases of prior-year claims reserves totaling $6.9 billion, up from $5.9 billion in the first half of 2016.

Combined ratio and underwriting profits

The industry's overall underwriting loss of $4.5 billion in the first half of 2017 compares to an underwriting loss of $1.5 billion for the first half of 2016. From an historical perspective, underwriting losses have been the norm over the past several decades. According to ISO, underwriting profits have occurred in only about one in every six calendar quarters since 1986, when ISO's quarterly data began.

Since the housing bubble burst in 2008, the Mortgage & Financial Guarantee sector of the P/C industry has disproportionately weighed down the overall industry's results, and because this line of business is written by only a few companies—some of them monoline carriers—it became common to report commercial lines insurers' results excluding M&FG data. This continues to be the case, even though the line has returned to profitability.

Different segments of the industry had different underwriting experiences. The combined ratio for insurers writing mainly personal lines (mostly auto and homeowners insurance) improved slightly to—but to a still-negative—103.0 in 2017:1H. In contrast, the combined ratio for insurers writing mainly commercial lines, excluding mortgage and financial guaranty insurers, improved (fell) to 96.5. And insurers writing mainly balanced books of business experienced a combined ratio of 102.1 in 2017:1H.



Investment performance: Interest rates remain low

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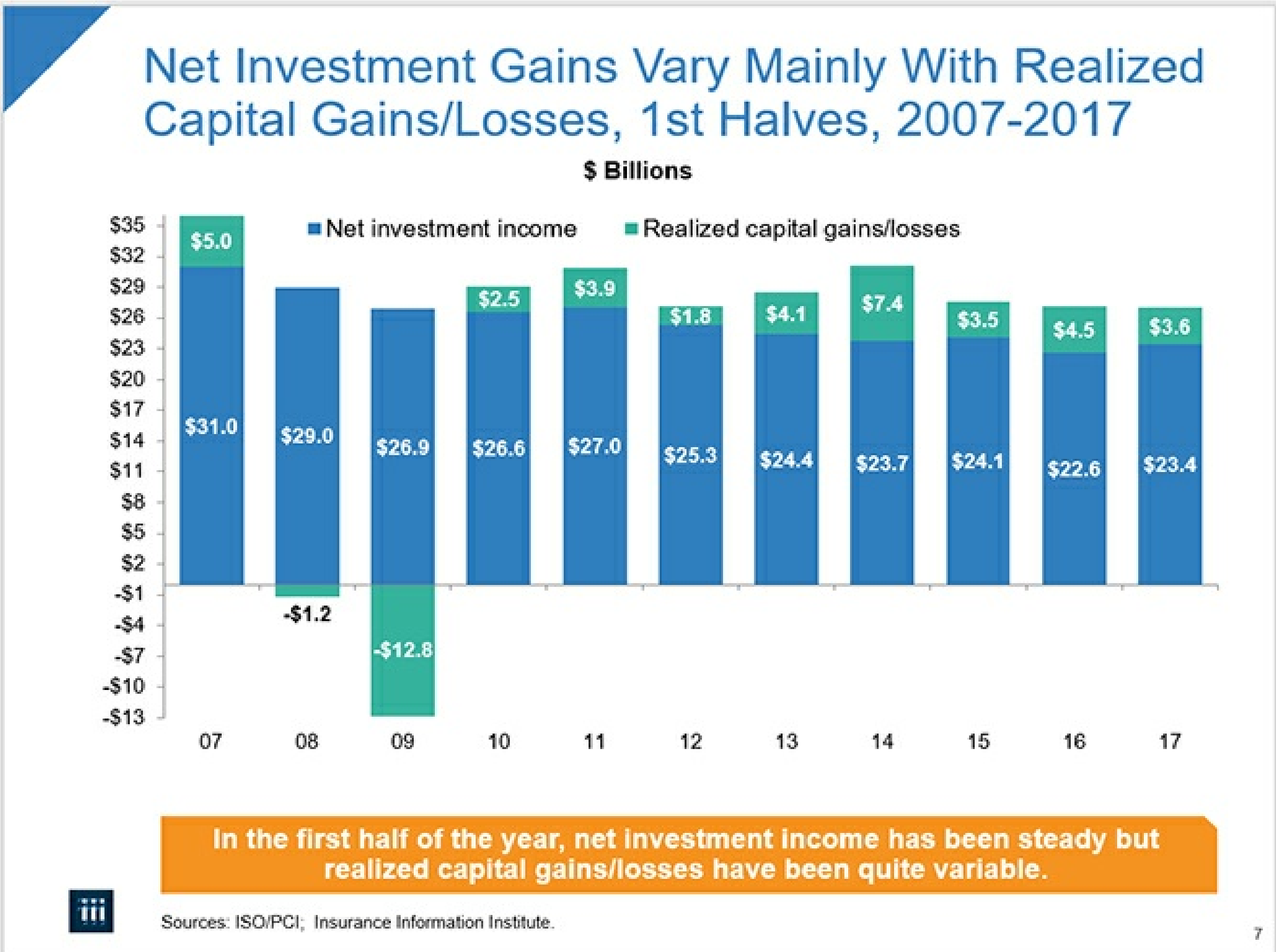
For the first half of 2017, net investment gains—which include net investment income plus realized capital gains and losses—rose by $0.43 billion (+1.6 percent) to $27.07 billion, compared to $26.63 billion in the first half of 2016.

In measuring insurance company net investment gains, accounting rules recognize two components: (i) Net investment income, and (ii) realized capital gains or losses. Unrealized capital gains or losses are not considered income and affect only surplus on the balance sheet. The industry's net investment income for the first half of 2017 was $23.45 billion, up from $22.19 billion in the comparable year-earlier period, up $1.26 billion, or 5.7 percent.

Net investment income

Net investment income itself has basically two elements—interest payments from bonds and dividends from stock.

Corporate bond market yields in the first half of 2017 moved in unexpected ways. As an indicator of prevailing corporate bond yield levels, yields in Moody's AAA-rated seasoned bond index averaged 3.9 percent in the first quarter of 2017, continuing an upward trend that began in July 2016. But then, even as the economy continued to strengthen, yields began another downward trek, averaging 3.8 percent in 2017:Q2 and continued down in 2017:Q3. Since the U.S. labor market seems to be improving without unleashing above-target inflation, the Fed, in pursuit of its goal of maximum employment, has reiterated that it expects interest rates to stay low for a substantial amount of time.



The other significant source of net investment income (besides bond yields) is stock dividends. Seasonally adjusted, net dividends in 2017:1H rose by 1.5 percent but in 2016:1H they fell by 4.1 percent. Stock holdings in general represent roughly only about one-sixth of the industry's invested assets.

Realized capital gains

Realized capital gains in 2017:1H were $3.62 billion. This is down from the 2016:1H result ($4.44 billion), but $3.6 billion is actually a more or less typical result, at least by recent historical standards. Realized capital gains in the first half of 2012, and 2013 were $1.7 billion, and $3.9 billion, respectively. Outliers were 2015, at $8.2 billion, and 2014, at $7.2 billion.

Policyholders' surplus (capital/capacity): High surplus demonstrates industry strength and resilience

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Policyholders' surplus as of June 30, 2017 stood at $717.0 billion—up $36.4 billion (+5.7 percent) from the year-earlier period. Policyholders' surplus has generally continued to increase in recent years as industry profits rose, and as assets held in the industry's investment portfolio increased in value in the wake of the financial crisis and the Great Recession. It is worth noting that surplus increased despite very high catastrophe losses in 2011 and 2012. The fact that the industry was able to rapidly and fully recoup its losses to surplus even in the wake of disasters like superstorm Sandy (which produced $18.8 billion in insured losses in 2012) is continued evidence of the P/C insurance industry's remarkable resilience in the face of extreme adversity.

The bottom line is that the industry is, and will remain, extremely well capitalized and financially prepared to pay out very large scale losses in 2017 and beyond. One commonly used measure of capital adequacy, the ratio of net premiums written to surplus, currently stands at 0.75, close to its strongest level in modern history.

Summary

The property/casualty insurance industry turned in a profitable overall performance in the first half of 2017 but did not generate an underwriting profit. Policyholders' surplus reached a new all-time record high. Premium growth, while still modest, is now experiencing its longest sustained period of gains in a decade.

Fundamentally, the P/C insurance industry remains quite strong financially, with capital adequacy ratios remaining high relative to long-term historical averages.

A detailed industry income statement for the first half of 2017 follows.

To view the full report from ISO and PCI, click here.

To view the press release from ISO and PCI, click here.

First Half 2017 Financial Results*

($ billions)

Net Earned Premiums	$265.80
Incurred Losses (Including loss adjustment expenses)	194.3
Expenses	75
Policyholder Dividends	1
Net Underwriting Gain (Loss)	-4.5
Investment Income	23.4
Other Items	4.9
Pre-Tax Operating Gain	14
Realized Capital Gains (Losses)	3.6
Pre-Tax Income	25.8
Taxes	2.1

Net After-Tax Income	$15.50
Surplus (End of Period)	$717.00
Combined Ratio	100.7**

*Figures may not add to totals due to rounding. Calculations in text based on unrounded figures.
**Includes mortgage and financial guaranty insurers.

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