2018 - Commentary on year-end financial results

Insurance Industry

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For the U.S. property/casualty (P/C) insurance industry, 2018 was a year of unusual experience. Results were good in comparison with 2017—but 2017 was a horrible year. Premiums, investment income and profits rose, buoyed by a surprisingly strong (for this late in the business cycle) U.S. economy, but interest rates sagged, and fears of a looming recession grew.

Highlights

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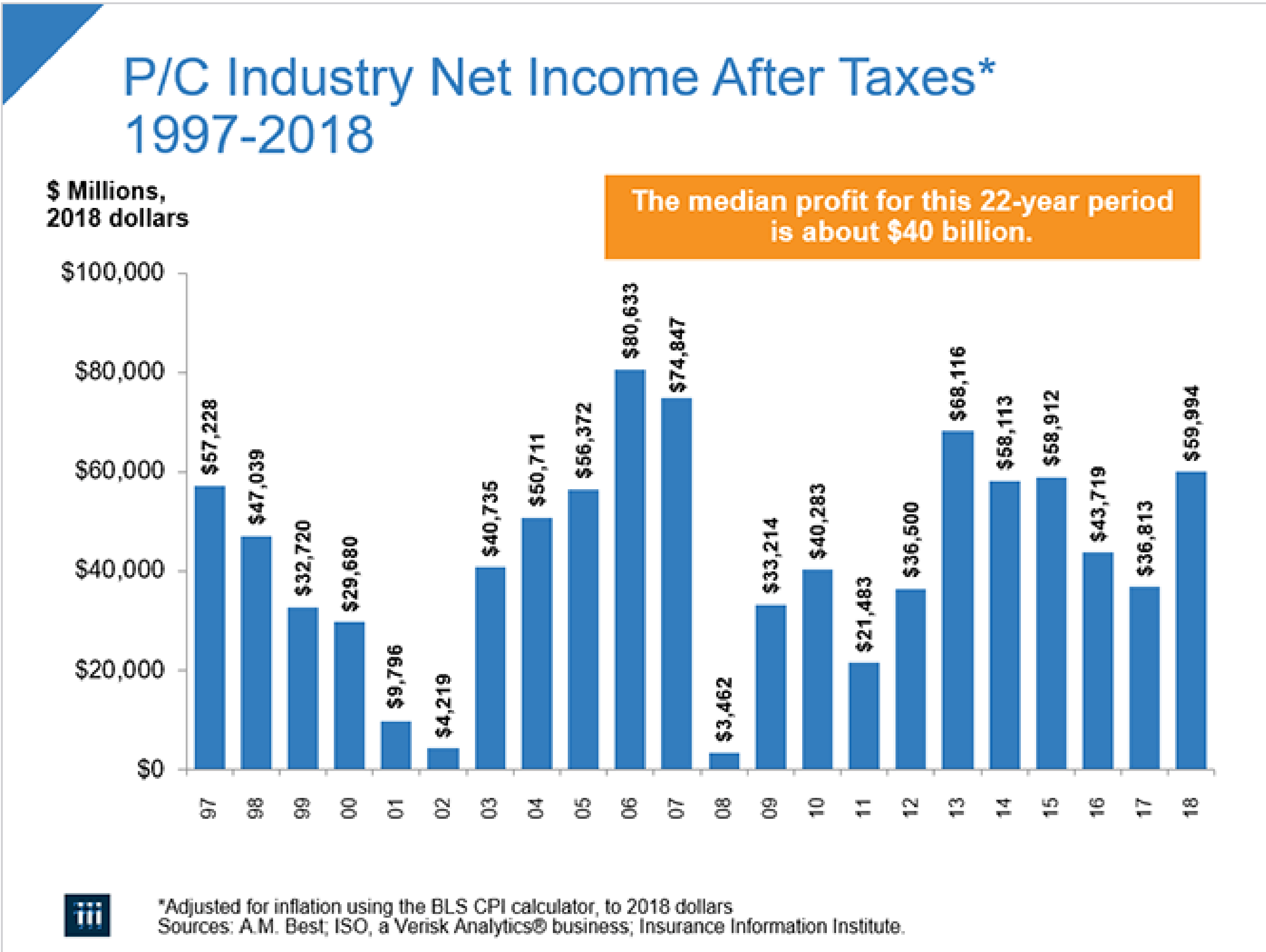
For the property/ casualty (P/C) insurance industry, 2018 was a successful year, but "normal" frames of reference were hard to come by. Net premium income appeared to grow sharply, but that was partly because of changes driven by a new tax law. Claims paid and incurred grew slowly, but that was because the base year—2017—was an especially bad year for catastrophe claims. Both investment income and realized capital gains rose but the gains were partially offset by unrealized losses largely incurred in the fourth quarter. The industry posted a $60.0 billion profit (Figure 1)—nearly double the 2017 profit—but expressed as a percentage of net worth (measured as average surplus, for P/C insurers), the industry posted an 8.0 percent mark for 2018, continuing a streak of single-digit readings.

Fig. 1



The industry results were released by ISO, a Verisk Analytics® business, and the American Property Casualty Insurance Association (APCIA).

Insurance performance and profitability drivers

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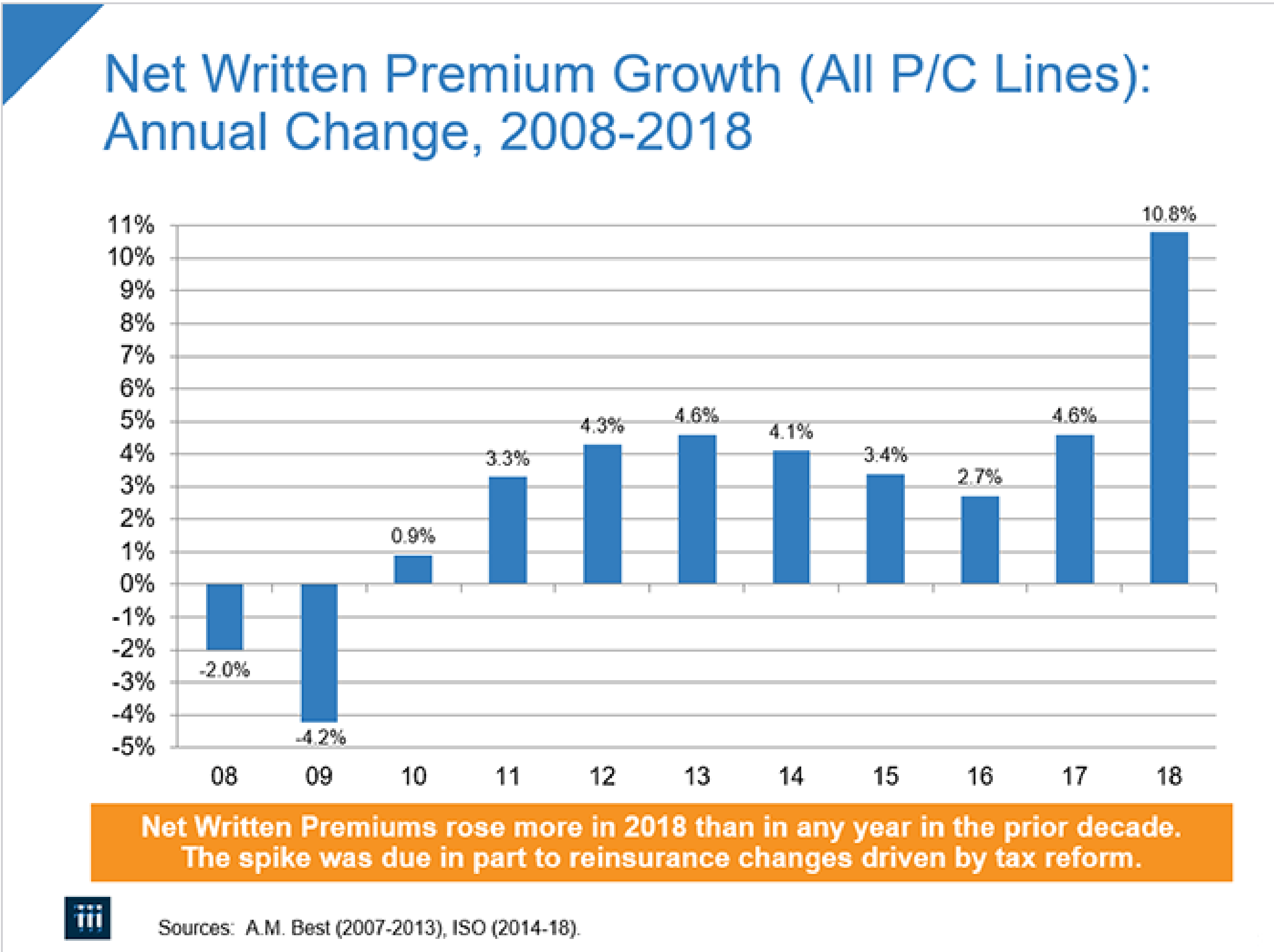
Premiums: Top line growth continues

P/C insurers measure premium income in three ways, and each of which gives a different insight into the industry's activity. Direct written premiums capture money collected for insurance; it is similar to gross retail sales. Net *written* premiums are calculated by subtracting the amounts insurers pay for reinsurance from direct premiums; they are therefore a simple gauge of the net amount of risk that insurers planned to assume. Net *earned* premiums are derived by adjusting net written premiums to reflect the insurance actually provided.

ISO/Verisk estimates direct written premium growth for 2018 to have been 5.6 percent. Net written premiums in 2018 rose by $60.0 billion, or 10.8 percent, to $612.6 billion from the prior year (Figure 2). Although the rate of increase in 2018 in both net written and net earned premiums was more than double the recent history, these results are distorted by changes in reinsurance practices which were for some carriers a response to provisions in the Tax Cuts and Jobs Act that became law in the last days of 2017. And assuming no similar changes in future years to the effects of the tax law, year-over-year comparisons of net written premium growth should return to more typical levels.

Fig. 2



Normally there are two main drivers of premium growth in P/C insurance: exposure growth and rate. Exposure growth—basically an increase in the number and/or value of insurable interests (such as property and liability risks)—is determined mainly by inflation and by the health and growth of the U.S. economy (including factors such as population growth, age composition, household formation, housing preferences and more). By most measures, inflation continued to be remarkably low; the Consumer Price Index for 2018 was 2.4 percent. Real (inflation-adjusted)

GDP growth in 2018 was 2.9 percent, although the annual rate masked starts and stops during the year (the 2018:Q1 real growth rate was 2.2 percent; 2018:Q2 was 4.2 percent; 2018:Q3 was 3.4 percent; 2018:Q4 was 2.2 percent, all expressed at seasonally adjusted annual rates).

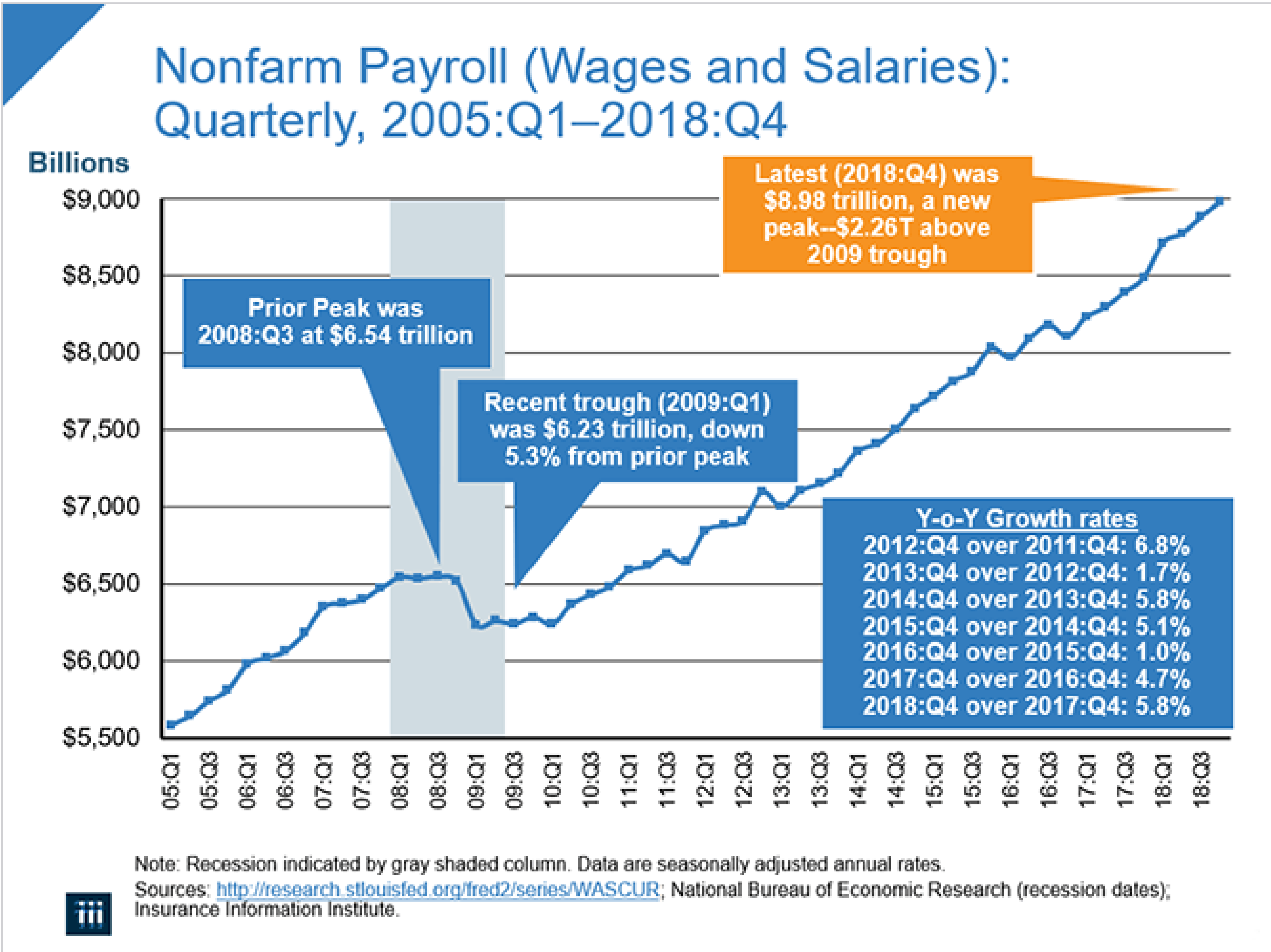
Exposure growth in key areas of the economy, such as in new vehicle sales (at near-record levels), business investment, industrial production, construction and overall employment growth, raised the value of exposures covered by the P/C insurance industry. With real GDP growth expected (at this writing) to continue at a slow-to-moderate pace in 2019 (in the range of 2.0 to 2.8 percent), and the Consumer Price Index expected to continue in the range of 1.6 to 2.2 percent, nominal values of personal and commercial lines exposures—and the premiums they generate—can be expected to rise in 2019 in the 3.5 percent to 5.0 percent range.

But macroeconomic forecasting has missed the mark lately. One oft-cited source—Blue Chip Financial Forecasts— reported in early April 2019 that of the 53 econometric forecasts that it surveyed, the average of the 10 highest growth rates for real GDP forecasts for the first quarter was 2.0 percent. In contrast, the announced U.S. Bureau of Economic Analysis measure of real GDP growth was 3.2 percent! Inflation in 2019:Q1 was unusually low, so nominal GDP growth was 3.8 percent (at seasonally adjusted annual rates), implying continued growth for insurable exposures.

Continuing strong labor market conditions in 2018 also aided top line growth in the P/C insurance industry. Job growth benefits the entire economy, of course, but it directly affects workers compensation insurers. The number of people employed in full-time jobs (seasonally adjusted) rose steadily through 2018 (to 129.65 million at year-end) and was up another 0.34 million by the end of the first quarter of 2018.

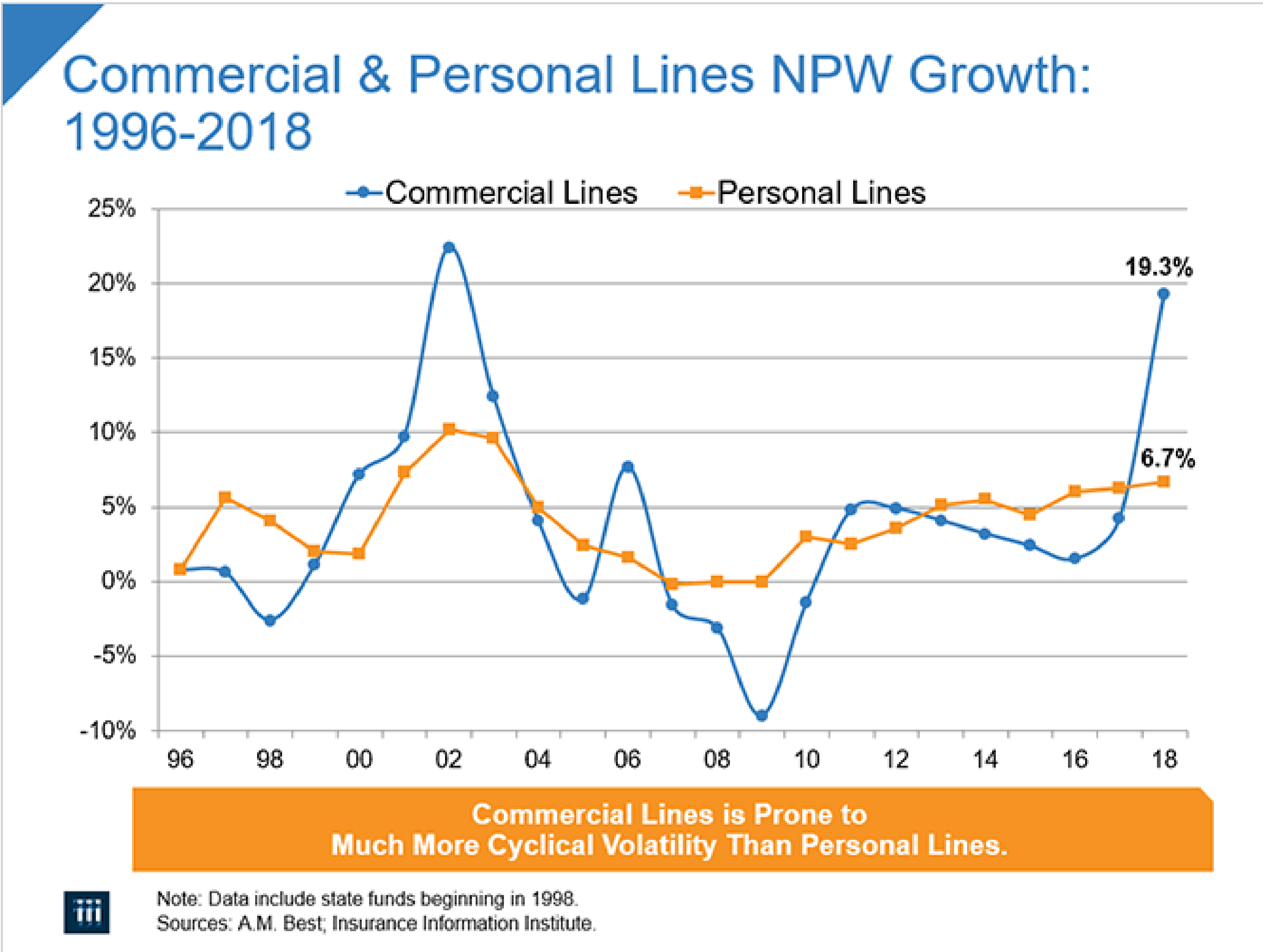
Including pay raises for continuing workers, payrolls rose 4.6 percent in 2018 over 2017 (Figure 3), driving billions of dollars in new premiums for workers compensation coverage in 2018. Job growth is likely to continue, though at a slower pace. Economists believe that the economy is close to full employment, but there still appears to be slack in the labor market (for example, the number of “involuntary part-time” workers is still about 1 million above its typical level for prosperous times).

Fig. 3



ISO/APCIA reported that premium growth in 2018 was significantly different for the personal lines vs. commercial lines sectors. Insurers writing primarily personal lines saw net written premium grow 6.7 percent—the same as in 2017. Insurers writing primarily commercial lines saw 2018 net written premium growth spike to 19.3 percent, vs. 4.2 percent in 2017. (Figure 4). As with the overall NPW growth rate for 2018, the spike in commercial lines is significantly due to changes in reinsurance driven by the new tax law.

Fig. 4



The other major determinant of industry premium growth is rate activity. Rates are a function of several forces, but perhaps the most important is expected future claims. Claims forecasts are, in part, affected by recent claims experience, which is discussed in the next section.

Claims performance

Claims performance in a given policy year is the result of three major forces—losses paid or incurred in the year (including loss adjustment expenses), reinsurance recoveries on those claims, and changes in claim reserves (for claims that occurred in this or prior years that are expected to be settled in current or future years).

Outlays for claims for all lines in 2018 rose to $424.2 billion, up $13.9 billion (3.4 percent) from $410.3 billion in 2017. In historical perspective, the growth in losses and loss adjustment expenses was the lowest claims growth in the last five years (since 2013). However, the low claims growth rate in 2018 is partly an artifact of the unusually high growth rate (9.7percent) in 2017 over 2016. If the 2017 claims growth rate had been lower and more typical, the 2018 growth rate would have been higher and also more typical.

Claims paid or incurred losses and loss adjustment expenses, particularly for property claims, consist of catastrophe-related claims and, for lack of a better term, non-catastrophe claims. The total amount of non-cat property claims tends to be predictable and can be expected to follow exposure growth but catastrophe-related claims are quite variable.

As expected, non-cat claims rose by 5.6 percent in 2018—up by $20.0 billion, to $380.8 billion. In contrast, catastrophe claims fell by $6.2 billion, to $43.3 billion. Of course, this drop occurred because 2017 saw record catastrophe claims levels.

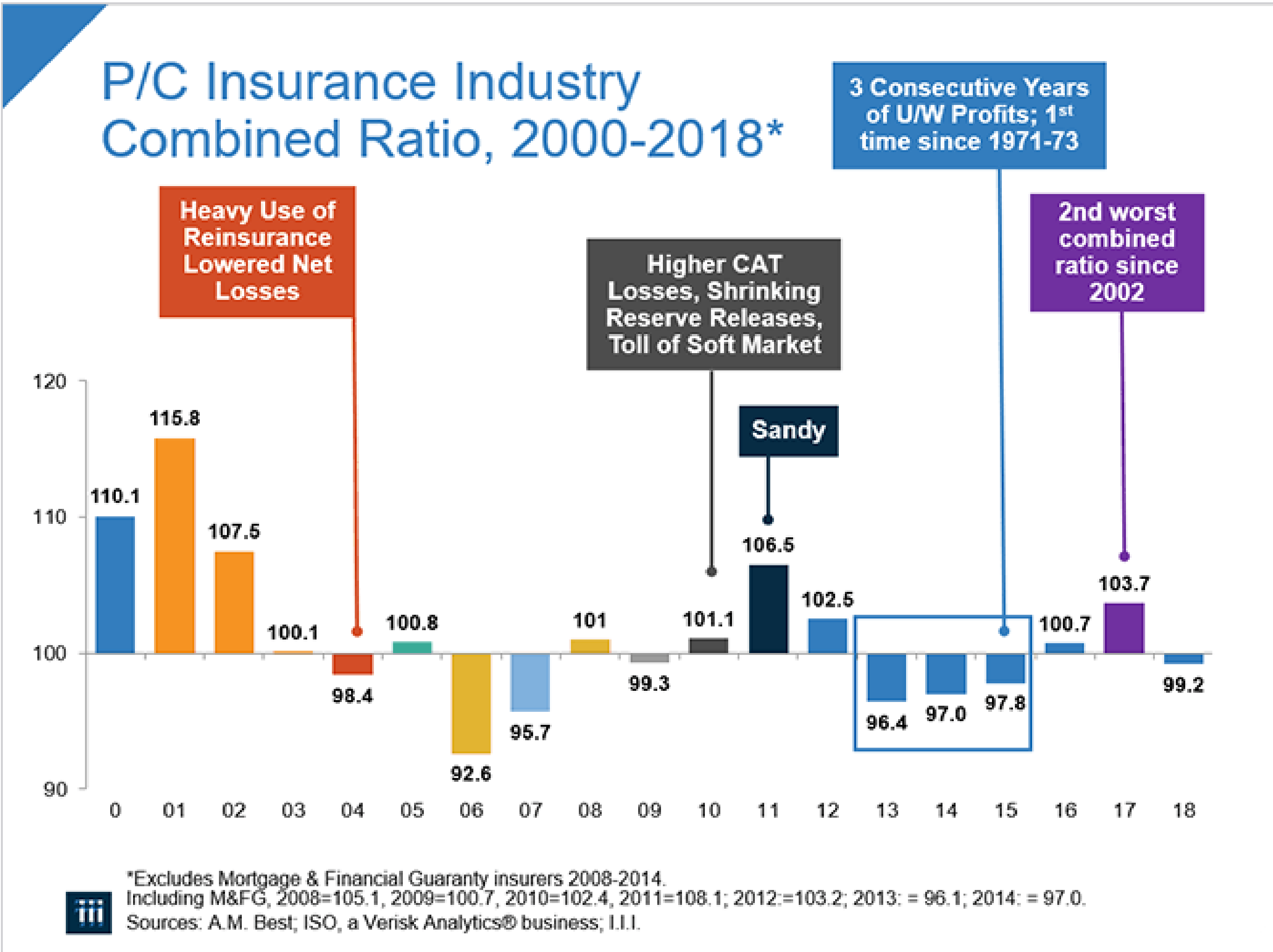
Each year insurers reassess the adequacy of their reserves for future payments of past incurred claim obligations on current and prior policies. When it is determined that these reserves are higher than needed to cover these obligations, reserves are reduced. By lowering estimates for incurred claims, reserve reductions improve underwriting results and, all other things equal, bolster profits (or offset losses) in the year that the reserves are reduced. Typically, reserve reductions are relatively small, averaging about $9.5 billion per year over the last five years. For year-end 2018, insurers reduced their prior claims reserves by $8.8 billion (compared to year-end reserves of $658.7 billion).

Overall underwriting performance

The financial results from underwriting are the result of earned premiums minus claims, operating expenses, and policyholder dividends. As noted, claims in 2018 were $424.2 billion. Expenses were $167.0 billion. Policyholder dividends were $3.0 billion. The industry's overall underwriting loss in 2018 was $0.1 billion. For perspective, the industry recorded an underwriting loss in 2017 as well, but much larger at $23.3 billion.

Another widely used industry metric for gauging overall insurance operations (excluding investment performance) is combined ratio. The combined ratio is the sum of three percentages: losses and loss adjustment expenses as a percent of earned premiums; policyholder dividends as a percent of earned premiums; and other expenses as a percent of written premiums. In 2018 this ratio was 99.2; in 2017 it was 103.7, and in 2016 it was 100.6. Any number over 100 means that considering all lines of business together, insurers paid out more than they took in as premiums for insurance they provided. As Figure 5 shows, a combined ratio of 103.7 is unusually high, and 99.2 is more typical of combined ratios achieved in the last six years.

Fig. 5



Investment performance: Interest rates remain low

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For the full year 2018, net investment gains at $65.8 billion were slightly higher (by $1.7 billion, or 2.7 percent) than the $64.0 billion of gains in 2017. 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.

Net investment income in 2018

Net investment income itself has basically two elements: interest payments from bonds, and dividends from stock. The industry's net investment income for the full year 2018 was $55.3 billion, compared to $48.9 billion in 2017 (+13.2 percent). Most of this income comes from the industry's bond investments, which are mainly high-quality corporate and municipal bonds.

The environment for bond investing in 2018 was challenging and essentially directionless. Average monthly corporate bond market yields in 2018, as captured by Moody's AAA-rated seasoned bond index, rose in the first five months of the year (from 3.55 percent in January 2018 to 4.00 percent in May, then fell slightly for the next four months (to about 3.90 percent), and rose again in the last quarter (to 4.14 percent in October, 4.22 percent in November, and 4.02 percent in December).

The other significant source of net investment income (apart from bond yields) is stock dividends. In 2018 market wide net dividends from all common and preferred stock rose steadily ($1,213 billion at a seasonally-adjusted annual rate in the first quarter, $1,223 billion and $1,251 billion in the second and third quarters, and $1,280 billion in the fourth quarter), up by 2.2 percent in 2018 over 2017. For the industry on average stock holdings constitute roughly only about 20 percent of the industry's invested assets.

Realized capital gains

The broad stock market's total return was -4.4 percent in 2018. Because the annual drop was largely caused by a sharp drop in the fourth quarter, there were ample opportunities earlier for realizing capital gains. And insurers tallied $10.4 billion in realized capital gains. Although this did not match the $15.1 billion in realized capital gains in 2017, it bested the $7.3 billion in 2016.

Policyholders' surplus

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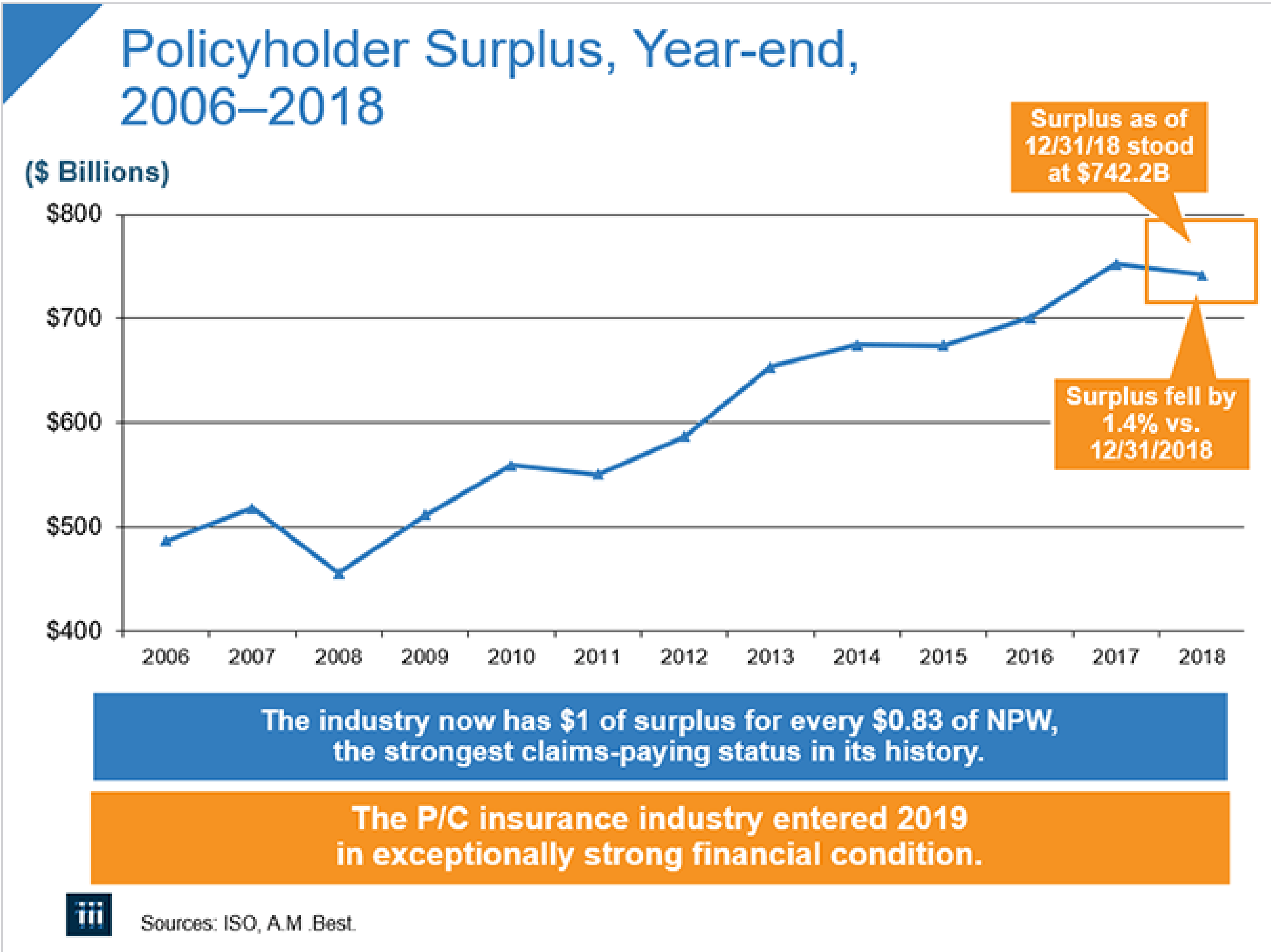
An insurer's excess of assets over liabilities is its capital "cushion," which provides the wherewithal to pay claims and expenses beyond what was contemplated in premiums. As a rough rule of thumb, one commonly-used indicator of capital adequacy is the ratio of net premiums written to surplus. For many years, a ratio of 1:1 was taken as quite strong. But recently surplus growth has far outpaced premium growth, resulting in ratios that are even stronger than 1:1. At year-end 2018 the ratio of new premiums written to surplus stood at 0.83-to-1.0 (lower numbers are stronger).

As noted above, under insurance company statutory accounting, unrealized capital gains and losses are not considered income but affect the capital position of insurers as reflected in the Policyholders' Surplus account. As of December 31, 2018, surplus stood at $742.2 billion, down $8.5 billion (-1.1 percent) vs. year-end 2017 (Figure 6). Despite this modest decline—mainly attributable to the stock market plunge in the fourth quarter of 2018—this is very near the historically highest dollar measure of policyholders' surplus. Moreover, the stock market's robust rebound in the first quarter of 2019 likely further boosted surplus. The industry is, and will remain, extremely well capitalized and financially prepared to pay very large-scale losses in 2019 and beyond.

Fig. 6



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

Full-Year 2018 Financial Results

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	$ Billions	Percent change from 2017
Net Earned Premiums	$594.07	9.9%
Incurred Losses (Including loss adjustment expenses and reserve releases)	424.2	3.4
Expenses	167.0	10.5
Policyholder Dividends	3.0	15.5
Net Underwriting Gain (Loss)	-0.1	100.5
Investment Income	55.3	13.2
Other Items	-1.4	-74.0
Pre-Tax Operating Income	56.6	178.3
Realized Capital Gains	10.4	-31.2
Pre-Tax Income	67.0	89.3

	$ Billions	Percent change from 2017
Taxes	7.0	-1100.0
Net After-Tax Income	60.0	66.3
Surplus (End of Period)	742.16	-1.1
Combined Ratio	99.2	4.4

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

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