2019 - Commentary on first nine months financial results

Insurance Industry

January 16, 2020

IN THIS ARTICLE

For the first three quarters of 2019, the property/casualty industry's financial results were quite profitable, and roughly comparable to 2018 results.

Highlights

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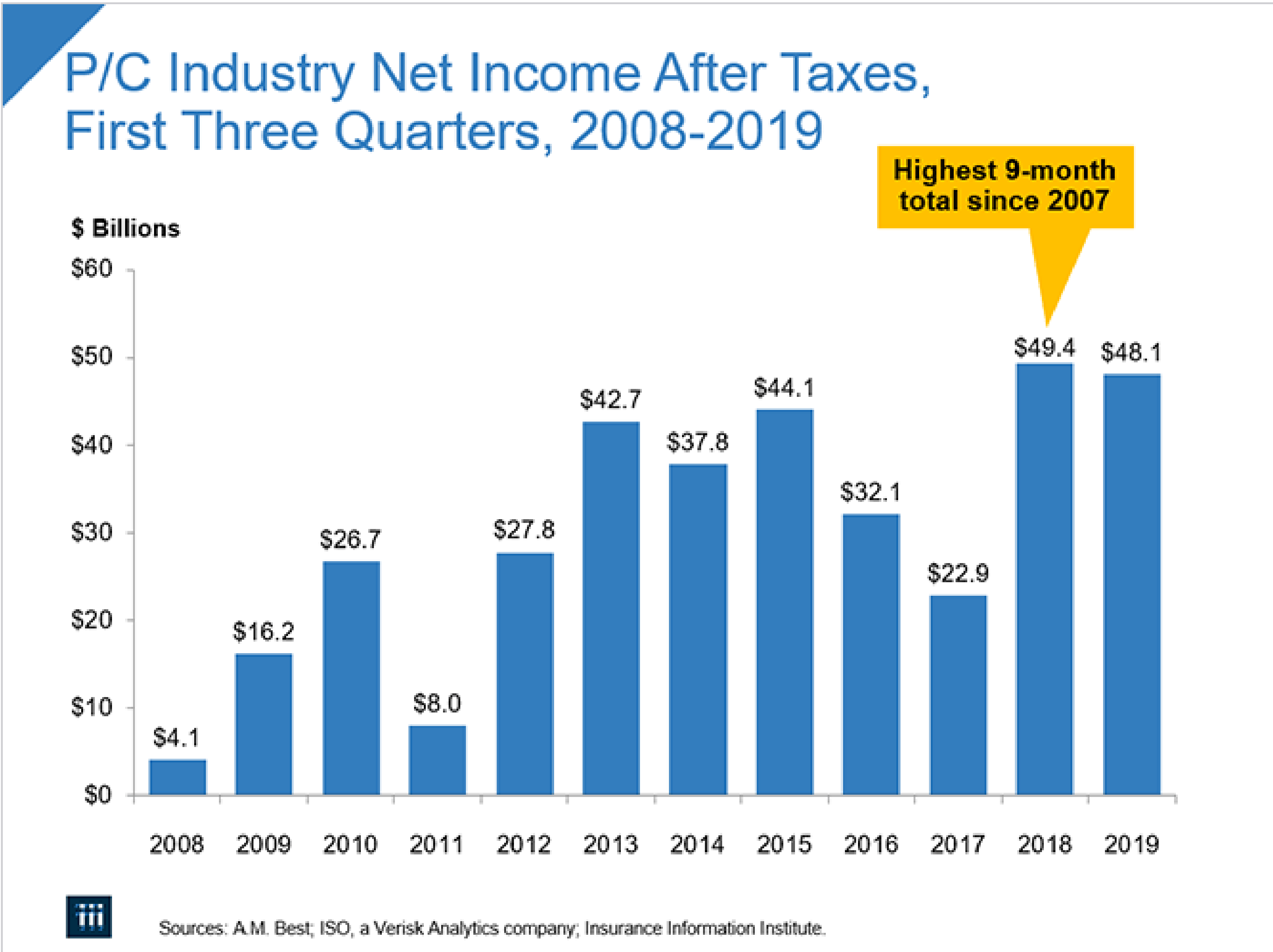
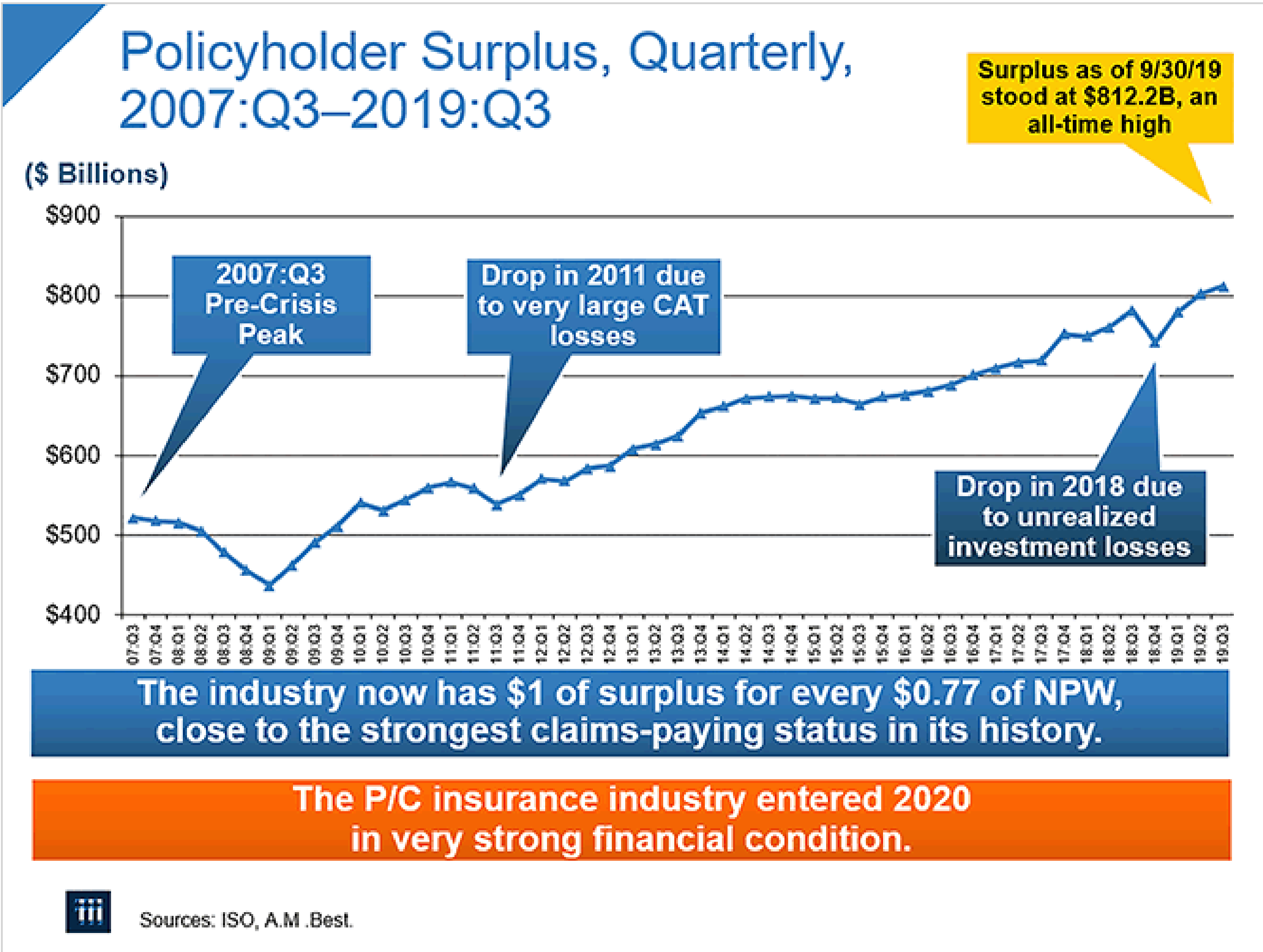
The property/casualty industry's financial results for the first three quarters of 2019 were quite profitable. This year's $48.1 billion net income after taxes was the second-highest in the last dozen years (2008 through 2019) and only slightly below the highest profit ($49.4 billion), in 2018 (**Figure 1**).

Figure 1



Although some lines of insurance were unprofitable, overall the industry's insurance operations were profitable again: $5.4 billion in net underwriting gains in 2019 vs. $4.7 billion in gains in 2018, and $21.0 billion in net underwriting losses in 2017. However, a different measure of profitability—the industry's return on average surplus (ROAS)—hit only 8.2 percent (on an annualized basis) for the first nine months. This is slightly below the profitability readings of 2014, 2015 and 2018. The context for this slight drop in ROAS is that industry surplus, the denominator of the profitability fraction—is growing. Surplus hit another peak (**Figure 2**) largely due to the surging stock market.

Figure 2

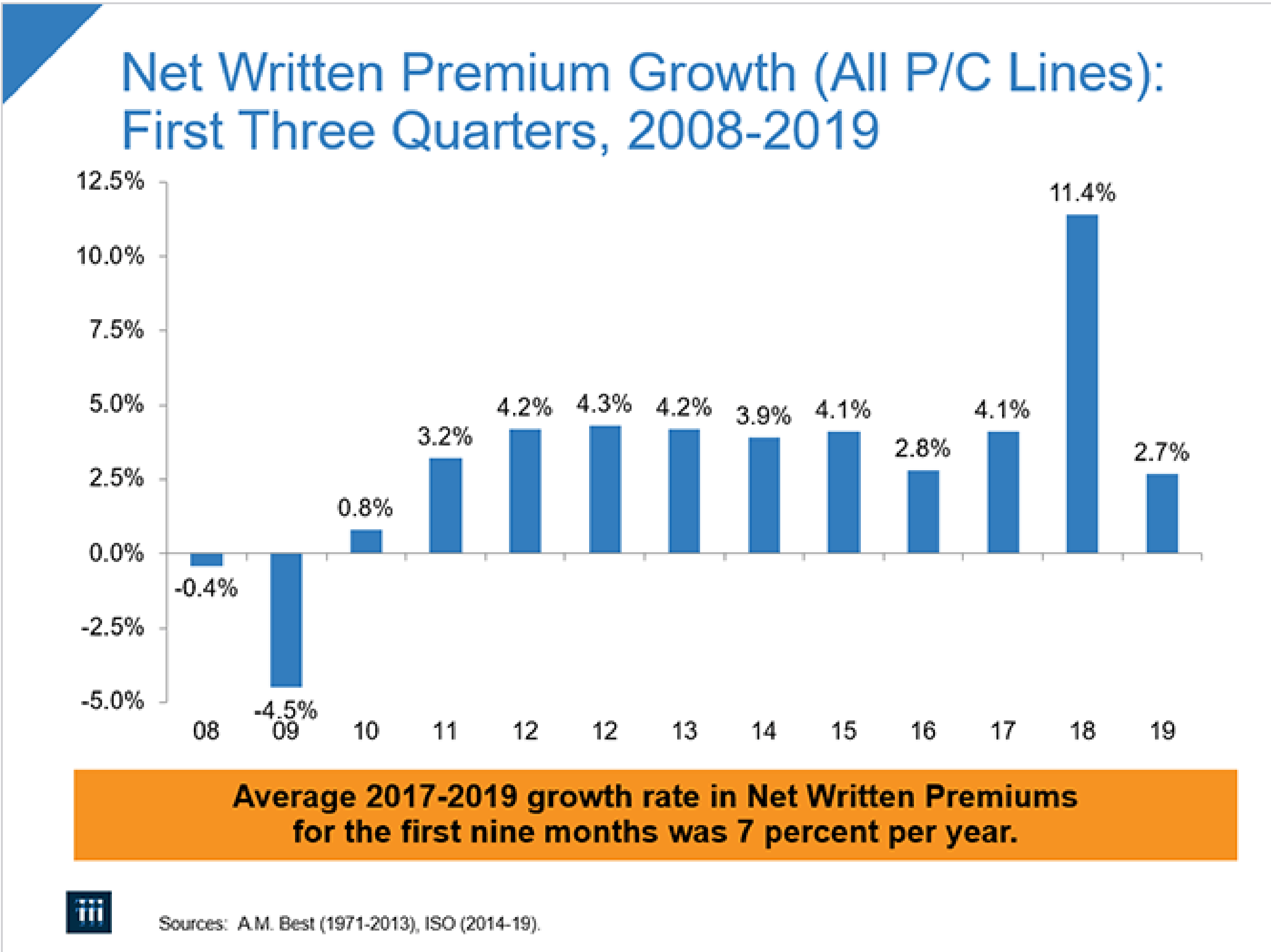


Insurance performance drivers

Premium income: Strong top-line growth

Net written premiums in the first three quarters of 2019 grew by $12.9 billion (+2.8 percent), which seems low because it is compared to a spike in 2018 that was driven by a one-time tax-law change. This distracting anomaly can be overcome by considering the average annual growth rate over the two most recent years (2017-2019), which was 7 percent. (**Figure 3**). As Figure 3 shows, even a 7 percent growth rate is remarkably strong in recent historical perspective.

Figure 3



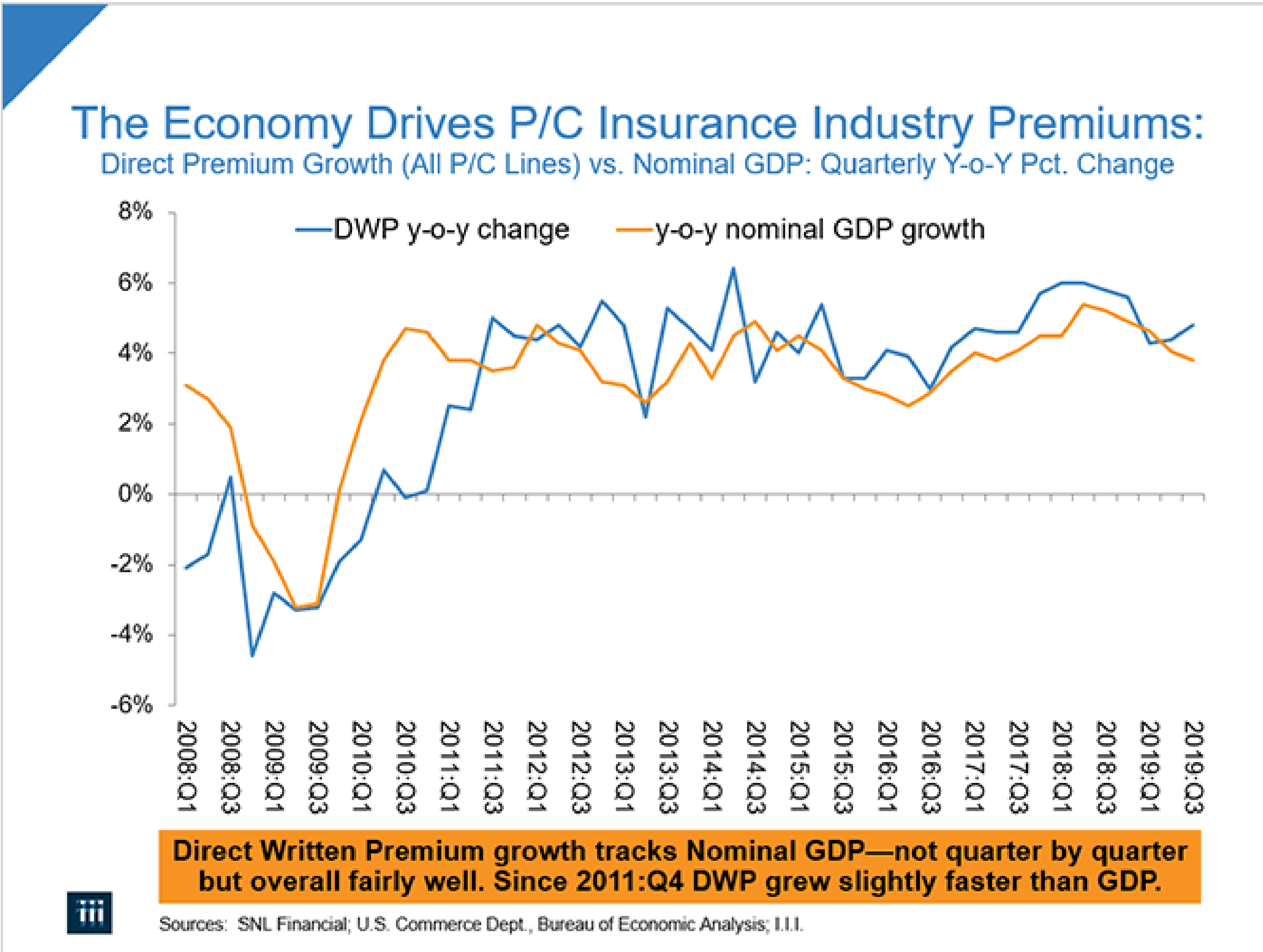
Net earned premiums also grew in 2019's first three quarters, by $20.7 billion (+4.7 percent), compared to the first three quarters of 2018 (+9.3 percent). As noted, the sharp upturn in net written and net earned premium is partly a result of changes some insurers made in response to provisions in the 2017 Tax Cuts and Jobs Act.

The one-time tax play aside, there are two main drivers of premium growth in the property/casualty insurance industry: exposure growth and rate activity.

Exposure growth rates: High but slowing

Exposure growth—basically an increase in the number and/or value of insurable interests (such as property and liability risks)—is driven mainly by economic and demographic growth and development (**Figure 4**).

Figure 4



Overall economic growth in the first nine months of 2019 was positive and somewhat stronger than expected at this stage of recovery from the Great Recession (partly because little was expected); real (inflation-adjusted) GDP rose at a 3.1 percent rate in the first quarter, 2.0 percent in the second quarter, and 2.1 percent in the third quarter of 2019. Based on historic economic performance this deep into a recovery/expansion, one would have expected growth nearer to half of those rates. But many predictions for the fourth quarter of 2019 are in the 1.5 to 2 percent range, and some are forecasting even lower growth in 2020.

Relatively strong exposure growth in 2019 involved both personal and commercial lines of insurance. On the personal side, sales of new cars and light trucks (including SUVs and minivans) were on pace to hit 16.9 million units, just missing 17 million for the fifth year in a row, continuing a shift away from small cars toward larger, heavier personal vehicles that being more expensive to buy and to repair, also bring higher physical damage premiums. On the commercial side, business investment in software has continued more strongly than expected but investment in structures and equipment slumped in 2019.

However, it is important to look at the data as granularly as possible to note significant variations in trends. For example, on the personal insurance side, homeowners exposures have grown quite slowly; a still higher than usual share of newly-constructed housing units is in multi-unit structures (apartments and condos), representing smaller value/risk increases per insured than would be the case if these units were detached single-family homes. On the commercial side, part of the slowdown in business investment in structures and equipment was centered on the energy sector (i.e., oil and gas drilling), particularly in periods in which prices for oil and gas had been flat or falling.

Employment growth in the first nine months of 2019, seasonally adjusted at 1.25 million, was among the lowest first nine-month periods since the Great Recession (1.25 million in 2017 and 1.27 million in 2012). Please note however, that exposure growth does not automatically and directly translate into premium growth; many other factors—for example, the degree of competition, market regulation and expected claims—also can play a significant part.

Underwriting results

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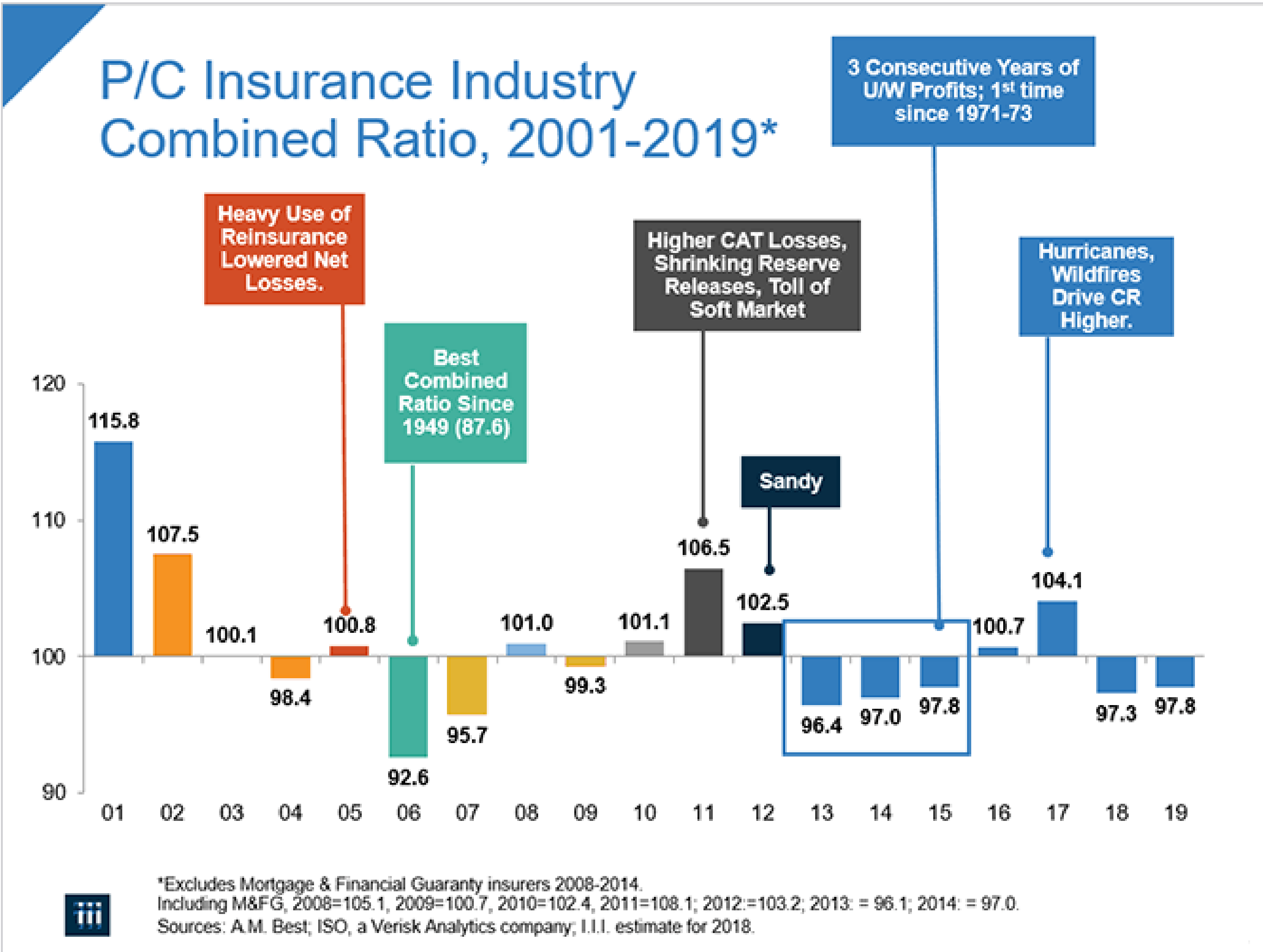
The broadest conventional measure of underwriting results is the combined ratio—the percentage of losses, loss-adjustment expenses, and all other non-investment expenses—outgo—to premiums—income. A ratio above 100 percent means insurance operations were unprofitable; and one under 100 percent indicates profit. For the first nine months of 2019, the property/casualty industry combined ratio was 97.8 percent. The comparable figure for 2018 was 97.4 percent. (**Figure 5**).

Regarding losses and loss-adjustment expenses, we can consider them as having three components: (1) catastrophe claims and adjustment expenses; (2) non-catastrophe claims and adjustment expenses; and (3) changes in reserves for claims attributable to prior years. The trends in these components differ. Catastrophe claims are quite variable; non-catastrophe claims are generally predictable; and reserve changes are in between.

Non-catastrophe claims reached $305.6 billion in the first nine months of 2019, up 7.6 percent from $284.0 billion in the comparable period in 2018. Some of this increase comes from exposure growth, some from inflation and some is random variation.

The first-nine-months' catastrophe (CAT) claims were $21.5 billion, down from $26.0 billion (-17.3 percent) in the comparable period in 2018. This result too should be viewed in historical and economic context too. Although this nine-month drop is welcome, it should not be taken as a low level of CAT claims; CAT claims in 2013, 2014 and 2015 were all below $18 billion for the entire year.

Figure 5



For several years, insurers have been releasing reserves for prior-year claims even when some observers thought they would not be able to do so. For the first nine months of 2019, insurers released $6.7 billion of loss reserves, down from a $11.3 billion release in the first nine months of 2018. This release contributed to lowering the numerator in the 2018 combined-ratio fraction.

Growth in demographics/economics can increase claims as well as it raises exposures/premiums. For example, wage increases that had been inching up since the end of the Great Recession grew by 2.8 percent in the first nine months of 2019—the highest rate of increase in over a decade. More workers, particularly in riskier occupations who earn higher incomes generally bring more—and more expensive—workers compensation claims, as indemnity benefits are linked to wages.

Investment results

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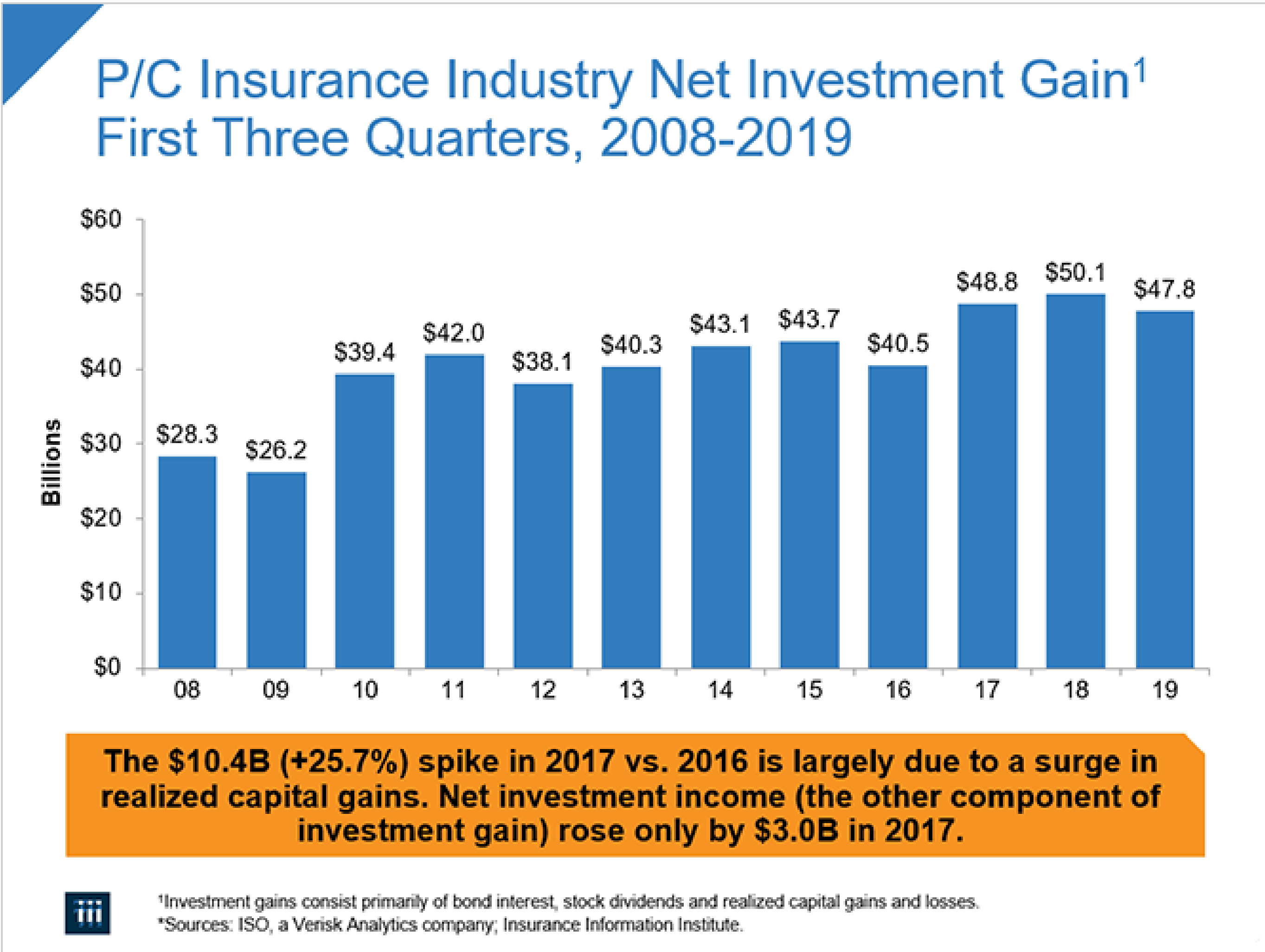
For the first three quarters of 2019, net investment gains (which include net investment income plus realized capital gains and losses) fell vs. the year-earlier period—down by $2.3 billion (-4.5 percent) to $47.8 billion, compared to $50.1 billion in 2018. Although this is not a record for net investment gains for the industry's first nine months (**Figure 6**), it is a strong performance that could become a record when the results for the fourth quarter of 2019 are in.

Figure 6



Net investment income

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Net investment income has basically two elements: interest payments from bonds and dividends from stock. The industry's net investment income for the first three quarters of 2019 was $40.4 billion, roughly the same as the $40.9 billion in the first three quarters of 2018. Most of this income comes from the industry's bond investments, which are mainly high-quality corporates and municipals.

Corporate bond market yields, as captured by Moody's AAA-rated seasoned bond index, generally were lower in 2019 than in 2018. In the first quarter of 2019 they averaged 3.83 percent; in the second quarter averaged 3.59 percent; and in the third quarter, 3.10 percent. This compares to generally higher yields (3.75, 3.94, and 3.92 percent) for the first three quarters of 2018. The other significant source of net investment income (besides bond yields) is stock dividends, which were essentially flat in 2019 vs. 2018's first three quarters. The level of dividends in third quarter 2019 was—0.3 percent lower than in the third quarter a year earlier. Stock holdings in general represent between one-fifth and one-fourth of the industry's invested assets.

Realized capital gains/losses

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Only realized capital gains and losses affect insurer net income; *unrealized* capital gains and losses affect policyholders' surplus. Realized capital gains from the first three quarters of 2019 were $7.5 billion, down from $9.3 billion through the first three quarters of 2018.

Policyholders' surplus (capital/capacity)

Driven in part by *unrealized* capital gains, policyholders' surplus as of September 30, 2019, stood at $812.2 billion—its highest level ever. Policyholders' surplus has generally increased in recent years as industry profits rose and as assets in the industry's investment portfolio increased in value in the wake of recovery from the financial crisis and the Great Recession.

One commonly used measure of capital adequacy, the ratio of 12-month trailing net premiums written to surplus, currently stands at 0.77, close to its strongest level in modern history. (A ratio of 1.0 is considered strong, and a lower ratio is even stronger.) The bottom line is that the industry is and for the foreseeable future will remain extremely well capitalized and financially prepared to pay very large-scale losses in 2020 and beyond.

Summary

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The combined effect of underwriting profits and investment gains produced an overall 8.2 percent rate of return on average surplus (profitability) in the first three quarters of 2019—down slightly from the 8.6 percent in the first three quarters of 2018. Policyholders' surplus hit a record. This was thanks in large part to continued growth in unrealized capital gains. Also, premium growth, while still modest, is now experiencing its longest sustained period of increases in a decade. Fundamentally, the property/casualty industry remains quite strong financially, with capital adequacy ratios remaining high, relative to long-term historical averages.

An industry income statement for the first three quarters of 2019 follows.

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

First Nine Months 2019 Financial Results*

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(Billions)

Net Earned Premiums	$463.190
Incurred Losses (including LAE and reserve changes)	327.059
Other underwriting and operations expenses	129.220
Policyholder Dividends	1.555
Net Underwriting Gain/Loss	5.356
Net Investment Income Earned	40.378
Net Other Items	1.370
Pre-tax Operating Gain/Loss	47.104
Net Realized Capital Gains/Losses	7.457

Net Pre-tax Income	54.560
Taxes	6.480
Net After-Tax Income	**$48.075**
Surplus (End of Period)	$812.2
Combined Ratio	97.8

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

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