P/C Insurers Positioned for Underwriting Improvement,
But Longer-Term Challenges Await

Executive Summary: Even though the P/C insurance industry recorded underwriting profits in 2021, and the industry is positioned to generate a better statutory underwriting profit and net earnings growth in 2022, the road ahead has some obstacles, including the likelihood that pricing momentum will subside in commercial lines and rising loss potential in personal lines tied to inflationary trends and natural catastrophes, writes James Auden, managing director, Insurance at Fitch Ratings. Here, he summarizes key profit measures for the last five years and notes the growing chance that the overall industry won't see true hard market returns on capital in the current cycle.

By James B. Auden

U.S. property/casualty insurers represent a source of stability amid the recent tumult of socioeconomic disruption from the coronavirus pandemic. The industry strengthened its capital base and generated consistent statutory underwriting performance and net profits in the last four years, despite volatility in claims losses from natural catastrophes, pandemic-related claims and litigation-related loss severity.

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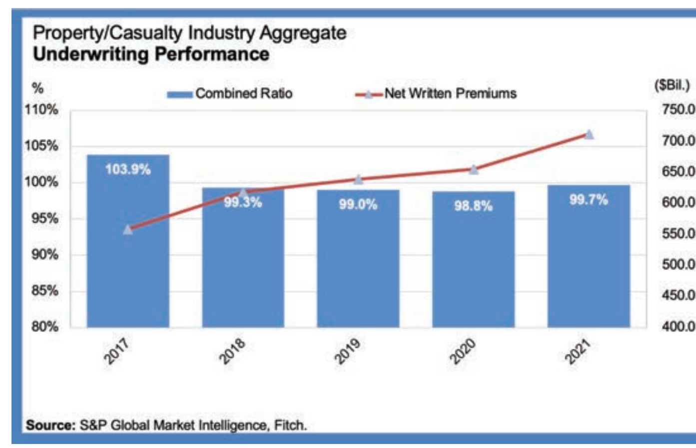
However, returns on policyholders surplus fell to 6.4 percent in 2021, relative to a long-term average of 7.7 percent, as underwriting margins deteriorated slightly and recent PHS growth from investment gains has outpaced earnings.

A number of publicly held commercial and specialty lines writers generated low-90s combined ratios or better, together with double-digit operating returns on equity in 2021. However, there is a growing chance that the vast improvement in commercial lines market conditions over the last three years will not lead to true hard-market returns on capital for the overall market in the current cycle.



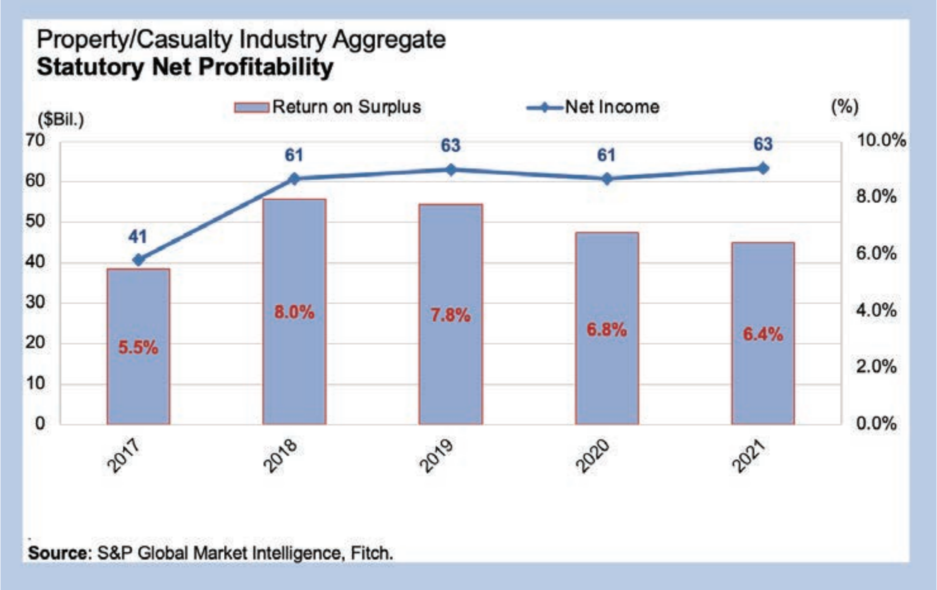
Operating performance in 2022 will benefit from recent growth flowing through earned premiums. Potential for material profit improvement may prove more difficult beyond 2022 as pricing momentum is likely to subside while numerous sources of underwriting uncertainty remain in place.

2021 Premium Growth; Steady Profits

Sharply rising prices in commercial lines insurance combined with a recovery in insured exposures following 2020 pandemic-related economic lockdowns led to strong 9 percent P/C net written premium growth in 2021, a level last reached in 2003. The industry reported a 99.7 combined ratio in 2021, representing moderate deterioration versus the prior year, and the fourth consecutive year this figure ranged between 99 and 100.

Factors contributing to weaker underwriting results include inordinately high insured catastrophe losses related to devastation from Hurricane Ida, unusual winter storms, wildfires and other inland events, along with deteriorating private passenger auto results. The industry track record of reserve adequacy continued in 2021, with favorable calendar-year development equal to 1.6 percent of earned premiums for the year.

Statutory earnings grew by 4 percent in 2021 tied to investment earnings expansion and have stayed in a tight band of $60-$63 billion each year from 2018 to 2021.



Commercial and Personal Lines Results Diverge

Underwriting performance by major customer segment differed widely in 2021 as commercial lines in aggregate moved to a material underwriting profit 96.5 combined ratio, with nearly 15 percent growth in written premium volume. A sharp decline in pandemic-related incurred losses, coupled with improving results across liability segments and continued low-90 combined ratios in workers compensation business fueled this reversal from 2020's sector underwriting loss.

Anticipated growth in earned premium tied to ongoing pricing increases across all lines outside of workers compensation create potential for further near-term underwriting improvement.

The personal lines sector moved to an underwriting loss in 2021. Private passenger auto results stumbled to a 101 combined ratio following record 2020 performance from sharp claims frequency declines as driving activity plummeted in the pandemic.

While claims frequency has not fully returned to prior norms, loss severity issues continued for bodily injury claims and emerged in physical damage coverage tied to rising inflation and supply chain shortages. Carriers are now more assertive with substantive pricing actions led by the traditionally more successful large public auto writers, which will promote stabilization in 2022 results. But loss cost trends are likely to remain unfavorable.

Difficulties in the homeowners insurance market continue. Large insured catastrophe losses have contributed to underwriting losses for the line in four of the last five years, including a 105 combined ratio in 2021. Rising costs of building materials and contract labor add to challenges in projecting losses. While pricing trends in homeowners are largely positive, companies face problems in key states: California,

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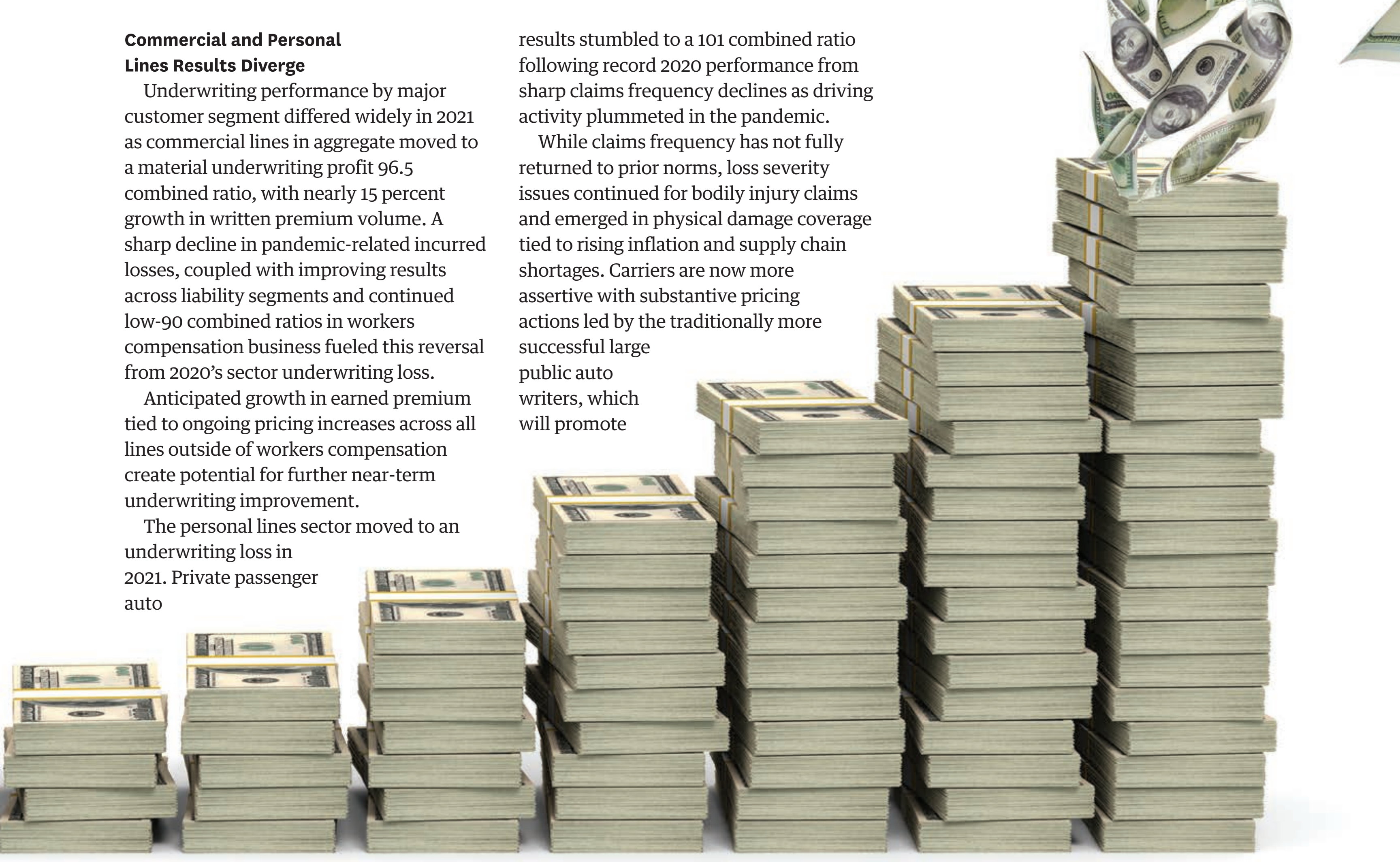

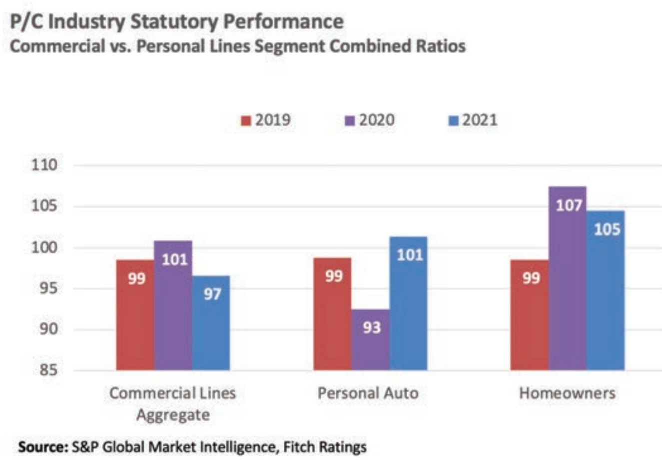

addressing wildfire exposures, and Florida, where an unfavorable regulatory and litigation environment will hinder overall improvement in segment performance.

Slowing Surplus Growth

Based on current market fundamentals, the P/C industry is positioned to generate a better statutory underwriting profit and net earnings growth in 2022. A reversion toward historical averages for insured catastrophe losses would promote more substantial improvement. However, surplus growth and capital formation is anticipated to moderate relative to the last three years.

Earnings stability and sharp increases in investment gains led to a 38 percent increase in industry policyholders surplus from 2018-2021 to a record level exceeding $1 trillion. Unrealized investment gains, primarily on equity and alternative assets, contributed approximately 50 percent of this increase prior to dividend distributions.

Year-to-date 2022 equity market declines and rising interest rates point to diminishing reported realized and unrealized investment gains going forward.

Longer-Term Challenges

The recent run of surplus growth has strengthened capital adequacy based on operating leverage ratios and risk adjusted capital measures, which boosts the capability to manage through adverse events. Outside of the always present risk for large natural catastrophe losses, several other factors bear watching that could derail future P/C market performance, including:

- **Heightened inflation uncertainty.** A revival of inflation to levels unseen in 40 years from looser monetary policy and pandemic-influenced supply chain disruption poses unique challenges to insurers. In 2021, effects of inflation were most visible in property and automobile lines. An extended period of high inflation would increase the threat of more pronounced pricing errors and reserve deficiencies in longer-tail liability lines and workers compensation.
- **Litigation exposure.** Past under-performance across multiple product segments, including auto, professional liability, product liability, employment practices liability and general liability relates to rising loss severity tied to changes in litigation trends and settlement costs, or "social inflation." A pandemic-related pause tied to court closures and a slowdown in judicial activity is likely to subside, and risk of jumbo settlements and verdicts remains escalated. Passage of any meaningful tort reform measures currently does not seem a high priority on the public policy agenda.
- **Waning pricing momentum.** Hardening commercial pricing actions initially represented a response to poor performance in property and liability product segments. Uncertainty and fear tied to socioeconomic disruption from the pandemic supported further positive rate movement and demand for coverage. Maintaining rate increases at a level to keep pace with loss costs is a longer-term challenge. Inevitably competitive forces and policyholder adaptation will influence a shift in the pricing cycle and deterioration in rate adequacy.
- **Geopolitical risks.** Domestic insurers do not likely have meaningful underwriting or investment exposures tied to the Russia-Ukraine conflict. However, events that affect global trade and economic growth can have unanticipated impact on insurers regarding underwriting exposures, claims costs and investment performance. CM