Insurance Carrier Profitability

Aligning Current Market Conditions With True Industry Performance

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HIGHLIGHTS

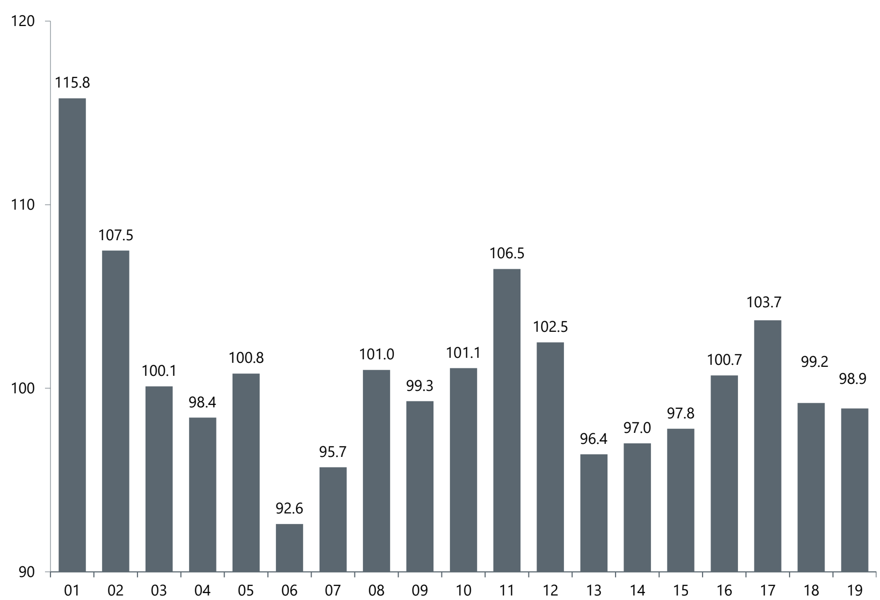
- **2001:** As recently as 2001, insurers paid out nearly $1.16 for every $1 earned in premiums
- **2005:** Heavy use of reinsurance lowered net losses
- **2006:** Best combined ratio since 1949 (87.6)
- **2007:** Relatively low CAT losses, reserve releases
- **2008:** Cyclical deterioration
- **2009:** Average CAT losses, more reserve releases
- **2011:** Higher CAT losses, shrinking reserve releases, toll of soft market
- **2012-13:** Sandy impacts and lower CAT losses
- **2017:** Sharply higher CATs are driving large underwriting losses and pricing pressure
- **Pre-COVID 2020:** Combined ratio estimate, 99.1 (AM Best)

As property and casualty premiums continue to rise, clients are struggling to reconcile these increases against insurance companies' rising top-line revenue and 99% combined ratios. The question is valid, but the short answer is that insurance accounting is complex and not always intuitive.

Insurance companies make money from two primary sources: **underwriting profits** and **investment income**. Underwriting profits can be expressed as total premium minus losses and expenses. Insurance companies focus their earnings disclosure around how their combined ratio is performing, which is simply the losses plus expenses divided by premium. The ratio is a barometer of underwriting profitability, where results less than 100% means the company made an underwriting profit, and greater than 100% signifies a loss.

FIGURE 1: P&C INSURANCE INDUSTRY COMBINED RATIO

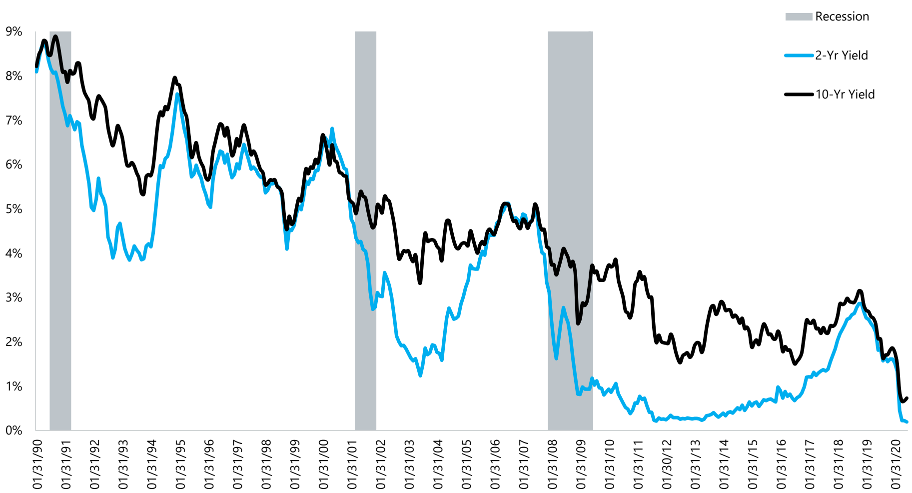
2001-2019E



* Excludes Mortgage & Financial Guaranty insurers 2008-14.
Sources: A.M. Best, ISO (2014-19).

FIGURE 2: U.S. TREASURY SECURITY YIELDS

A LONG DOWNWARD TREND, 1990 - 2020



*Monthly, constant maturity, nominal rates, through June 2020.
Sources: Federal Reserve Bank at http://www.federalreserve.gov/releases/h15/data.htm. National Bureau of Economic Research (recession dates); Insurance Information Institute.

Since roughly 80% of P&C bond/cash investments are in 10-year or shorter durations, most P&C insurer portfolios will have low-yielding bonds for years to come.

10-YEAR TREASURY

- **09/19:** 1.90%
- **08/20:** 0.68%

HIGHLIGHTS

- Fed emergency rate actions and stimulus in response to COVID-19 have pushed rates to new low.

HOWEVER, THE COMBINED RATIO DOES NOT INCLUDE A CRITICAL PART OF INSURANCE PROFITABILITY, which is investment income. In fact, such income historically represents the vast majority of insurance company profits.

When interest rates were significantly higher, investment income often allowed carriers to write to a combined ratio well in excess of 100%. Figure 2 shows over the past decade, however, interest rates have fallen to near zero and yields on carrier portfolios — heavily weighted toward long-term bonds — have plummeted. As a result, insurance companies are now more focused on underwriting profitability and pursuing combined ratios in the low to mid-90s to make their target risk-adjusted returns.

As noted in Figure 1, the industry has not historically produced combined ratios at that level. Carriers have two options and are pursuing both simultaneously:

1. Reduce their exposure to losses through selective underwriting and deployment of capital.
2. Increase prices.

Combined ratio

LET'S ASSESS CARRIER PROFITABILITY BY BETTER UNDERSTANDING THE COMBINED RATIO. Key to the combined ratio is determining what reserves, or future policyholder obligations, should be accrued on the balance sheet of an insurance company. Setting reserves is a mixture of science and art; numerous factors inform how insurance companies establish reserves, which are governed by a combination of actuarial principles and company management. Carriers have huge pools of loss data and use this to determine patterns and develop the statistical credence necessary to estimate outstanding liabilities. However, because claims can take years or even decades to close, claims reported in the past are subject to events impacting current loss severity trends, including nuclear verdicts, social inflation, corporate accountability, jury composition and/or litigation financing, to name a few. Were these trends contemplated 5 to 10 years ago when insurance companies set reserves?

Before we answer that question, let's discuss a critical aspect of insurance accounting, the difference between calendar and accident year results.

For accounting purposes, insurance company financial statements are presented on a calendar-year basis.

Calendar-year results represent all transactions between January and December, including premiums received, an estimate of ultimate losses for claims in that year, and changes in estimates made from prior years. Put more simply, calendar-year results can sometimes blur the true picture by including the impact of reserve releases or increases from earlier years.

Accident-year results, however, represent only ultimate losses for claims that occurred in that specific year. Losses more closely match the premiums collected, and results are considered more reflective of a carrier's true financial performance. At the end of each year, management sets the ultimate loss reserves for the current accident year, and any changes in older years are reconciled in the calendar year results. In the insurance industry, this is called "prior year development."

In a perfect world, accident year and calendar year results would be the same (outside of statutory allowed discounting on certain workers' compensation reserves). Since there can often be a significant spread, you will frequently see a callout for "prior accident years" in insurance company financial disclosures. This is the reconciliation point to represent how the calendar-year financials are being impacted by reserve estimate changes from older accident years.

Analyzing carrier financial reporting

Insurers manage their book of business at a more granular level than what the outside observer can access through the carriers' financial reporting. As an example, we are going to review **other liability**, which includes non-products general liability, environmental, umbrella/excess casualty and financial lines (occurrence based policies only, excludes claims made). From our perspective, it is grouped together under one financial disclosure. However, carriers will actively manage the profitability, growth and capital deployment at the product level.

Jumping into the details, we analyzed the year-end financial statements for three of the largest lines of business (workers' compensation, other liability, and commercial auto). The results are instructive and help address why carriers are shifting how they deploy capital.

FIGURE 3: COMMERCIAL AUTO

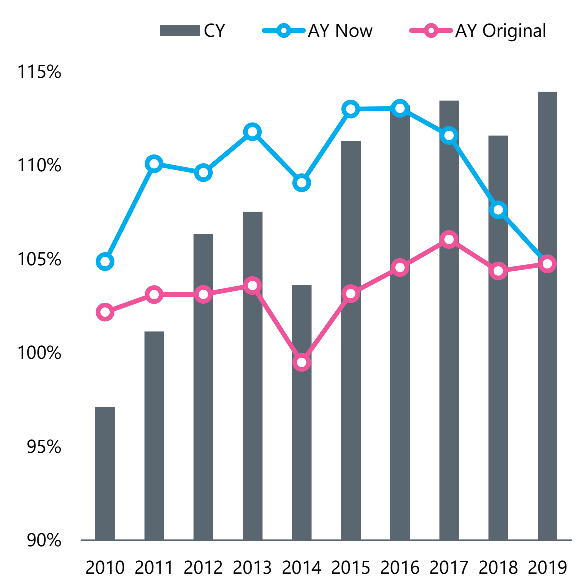
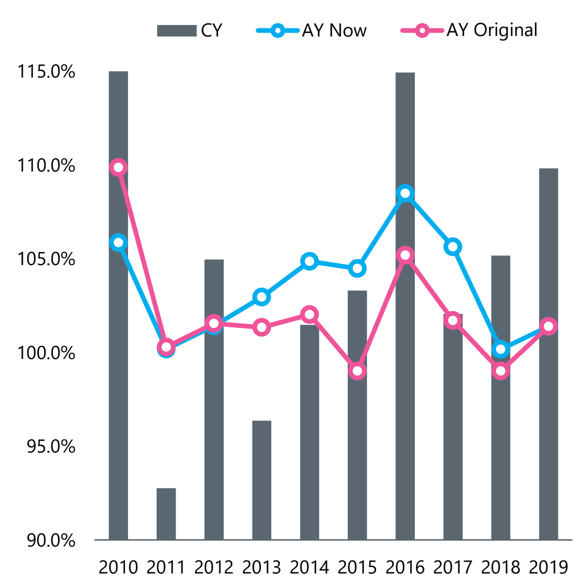


FIGURE 4: OTHER LIABILITY



TO ORIENT THE DATA, LET'S TAKE A LOOK AT COMMERCIAL AUTO FOR 2018. When the industry collectively set its reserves at year-end 2018, it reported the following:

1. For all policies in force for accident year 2018, the industry originally set reserves to produce a 104.4% combined ratio *(pink line)*. The industry also increased prior year reserves by $1.8 billion, generating a 111.6% calendar year result *(gray bar)*.
2. By year-end 2019, just 12 months later, the 2018 accident year results have further deteriorated to 107.6% *(blue line)*. That change in the 2018-year estimate is embedded the calendar year 2019 results as part of the prior year development. Calendar year 2019 results include $2.6 billion of adverse development.

General takeaways

AUTO AND LIABILITY

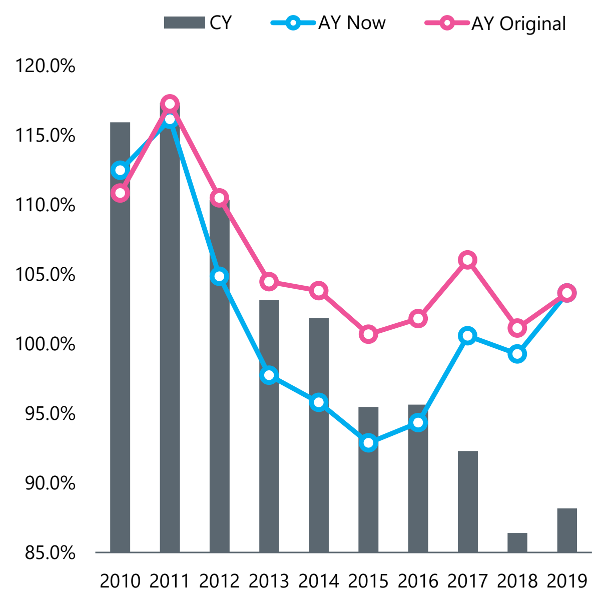
- Calendar-year results have been worse than accident year, meaning continued adverse prior-year reserve development.
- Commercial auto rates have been firming for over five years, and results are still unprofitable. Price increases of +5% to +10% over the past few years have slowed the deterioration but are not making the line profitable. Ultimately, price increases have been eroded by the ever-increasing severity of claims and the frequency of claims during the booming economy.
- For other liability, similar trends are unfortunately starting to emerge. Accident year combined ratios are worse now than originally estimated across all years beginning in 2014. This highlights why carriers are pulling back on capacity and setting higher terms.
- Actuarial methodologies clearly have not kept up with dynamically changing claims trends environment. If they had, there would not be these large amounts of adverse development. **The question remains how much more will recent years ('17-'19) develop upward for other liability?**

WORKERS' COMPENSATION

Calendar-year results have been very positive for the industry, as demonstrated by two years of industry combined ratios in the 80s.

- Unlike liability lines, WC has experienced billions in prior-year reserve releases. That is why we see such a difference in the accident year versus the calendar-year results.
- The most recent accident years are now hovering around 100%, further predicting the soft rate environment is starting to flatten.
- WC is a product that is very reliant on investment income given the duration of claim payouts. There is potential for pricing pressure with this depressed interest rate environment, in addition to the worsening combined ratio.
- There remains uncertainly in terms of ultimate loss and exposure to COVID-19 and the economic impact it created, putting further pressure on the product.

FIGURE 5: WORKERS' COMPENSATION



Conclusion

Reviewing insurance company-reported financial results requires a strong understanding of the underlying trends in the business and the challenges of reserving for long-tail business. As we have seen from this analysis, while reported insurance company results look acceptable, there is a large variation of profitability by product, as well as the true underlying economics, as large WC reserve releases have masked some of the weaknesses with other products. In today's market environment, there is more uncertainty in predicting claims severity, and uncertainty yields conservatism in both capital deployment and terms.

At Lockton, our philosophy is to help our clients navigate the market and secure the best possible outcome. Using advanced analytics to assess your insurance versus self-insurance needs, rethinking your appetite toward corporate volatility, and telling the best possible story about your controls, products and risk culture are keys to managing through this marketplace.

UNCOMMONLY INDEPENDENT