U.S. P&C Insurance Industry Review 9 Months 2019

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OVERVIEW

Surplus growth for the ALIRT P&C Composite[1] was strong in the first nine months of 2019 as decent operating profitability and strong net capital gains were somewhat offset by net capital paid to parent companies. Reported underwriting results deteriorated somewhat year over year, but remained historically decent, supported by firming rates and reserve releases at a number of large personal lines carriers. Direct premiums rose moderately in the first nine months of the year while net premiums were flat, in part due to sizeable reinsurance cessions at a number of large commercial lines groups. Net yield weakened as interest rates retreated from 2018 highs, but total return was strong as equity markets rebounded sharply in the first three quarters of the year. The pricing environment continues to show resilience, with company managements speaking of an acceleration of rate increases in the first three quarters, especially in commercial lines.

State of the Underwriting Cycle: Pretty Simple Math?

After speaking somewhat obliquely to the deterioration of a number of commercial insurance lines over the past year, insurer managements – and the analyst community – could seemingly focus on little else during the recent round of analyst calls. The question of "rate adequacy" was paramount, with a purported long mispricing of a number of business lines preoccupying everyone's attention.

To give just a sampling of commentary, Robert Berkley, CEO of W.R. Berkley said:

> *"The fear factor is on the rise … It is without a doubt a challenging moment for the industry. It is going to be particularly challenging for those that have not been both paying attention and taking action. The combination of low interest rates along with Mother Nature that doesn't seem to want to leave us alone on the cat front, and then really the big nut out there being social inflation, this is a pressurized situation …*
>
> *We think this shift in the marketplace is not going to be akin to what we saw in 2011. And while no cycle is a mirror image of other cycles,* ***there certainly are some of the fundamentals that are lining up that would suggest that while it may not be like '86, it certainly could be in some ways akin to 2002, 2003****."*

Likewise, a recent advertorial in Leader's Edge had Tim Turner, Chairman and CEO of RT Specialty, claiming that many factors play into the current firming market, "but the most obvious one is the *17-year prolonged soft market*."

While we by no means deny that there is upward rate movement in a number of commercial insurance lines – we can point to commercial auto, certain habitational risks, public D&O, and catastrophe impacted property risks, among others – we do feel it prudent to put the current pricing environment in some sort of historical perspective.

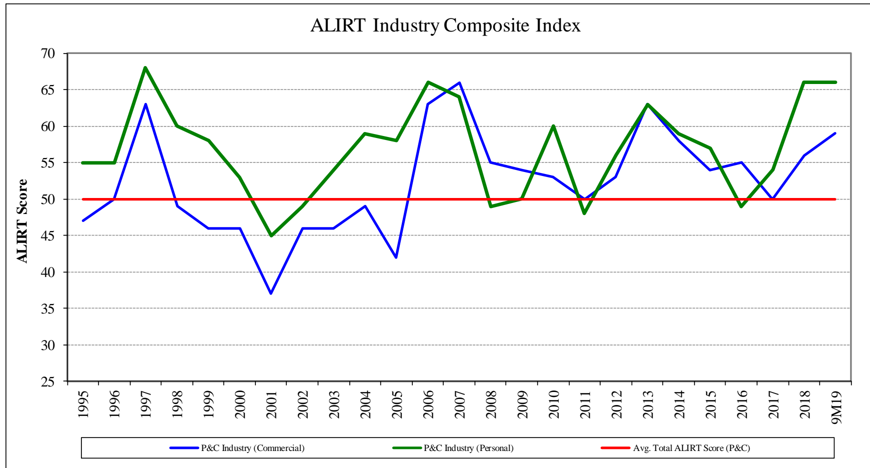
In sum, we think there is a degree of hyperbole in comparing current market conditions to the early 2000's and certainly we do not subscribe to 17 years of soft market conditions. There are any number of factors we could highlight to demonstrate that current solid financial profile of the U.S. property & casualty market is solid and that therefore the likelihood of a prolonged sharp turn in rates is not imminent. Below are just a few.

- Composite underwriting profitability in five of the past seven years when before 2004, one had to look back to the mid 1970's to witness an industry underwriting profit.

[1] The ALIRT P&C Composite is comprised of 50 large U.S. P&C insurers, representing approximately 40 % of total industry net written and 50% of total industry surplus.

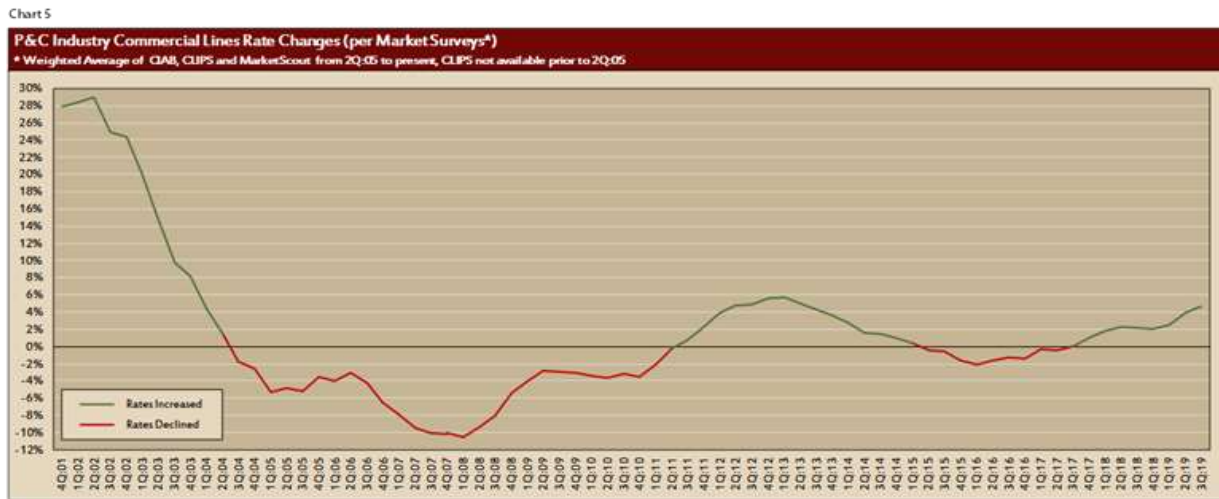
- Substantial surplus growth over the past decade, leading to composite net premium leverage of just 0.75X surplus when in the hard market period of 2001-2004, the industry was reporting leverage of over 1X surplus.

- But perhaps the best measure is the ALIRT Composite Scores which reached a 25-year low of 37 in 2001 versus a well above historical average score of 59 currently (see chart below).



Hard markets occur when insurers begin to feel substantial income statement and balance sheet pain (as in 2001), and at least on a broad basis such a condition does not exist today. In fact, if anything, the current ALIRT Composite Scores indicate a potential for *softening* of rates over time.

The graph below, which charts predominantly commercial lines rate changes since 2001, may go even further in placing current pricing conditions in their proper perspective. The sharp year-over-year rate increases of the 2001 -2003 period, our last true hard market, little resemble current rate conditions which have traced a gradual and undulating pattern since the end of the great recession a decade ago. In fact, overall rate increases have not even notched the 6% mark seen in early 2013.



To conclude, rates are firming – not across the board, but certainly in lines where underwriting has been either lax or loss conditions have changed. This firming appears to be a continuation of a decade-long cycle of relatively slight underwriting corrections that naturally occur as insurers react to new information; and we see no indication that once the current pricing adjustments have been made – perhaps over the coming year or two – that rates may not smooth out yet again.

Financial Summary

Below we provide nine month 2019 financial highlights for the ALIRT P&C Composite, based on insurers' statutory financial statements.

- ***ALIRT Composite surplus rose 8.9% in the first three quarters of 2019*** as operating earnings of $18.3 billion and outsized net capital gains of $27.2 billion were somewhat offset by net capital (including shareholder dividends less net capital infusions) paid out to parent organizations of $9.3 billion.

- The ALIRT Composite reported a combined ratio of 98.7% in the first nine months of 2019, a 0.6 percentage point deterioration versus the prior year period. This largely reflects a higher reported loss ratio, in part due to larger prior year reserve releases in the first three quarters of 2018. The composite expense ratio was slightly improved in the current year period, helped by higher net written premium flows.

- The accident year combined ratio (which excludes the impact of prior year reserve development), was 100.4%, 60 basis points better than in the prior year period reflecting in part an improvement in pricing as well as lower large weather-related losses in the period.

- Pretax operating income declined by 7.2% compared to the prior year period on both lower underwriting income and weaker net investment income (in part on a large dividend paid to a composite insurer in the prior year period); reflecting this, current pre-tax return on earned premium fell by 1 percentage point to 8.7%.

- Net investment yield (annualized) of 2.99% was 69 basis points lower than in the prior year end period, while total investment return (annualized) spiked to 7.35% as equity market gains were substantial through the first nine months of the year.

- Direct premiums rose 3.0% in the first nine months of 2019 versus the prior year period, while net premium increased by 2.8% in the same period, reflecting a bounce in 3Q2019 growth. The direct premium gains reflect stronger economic conditions in the domestic market (expanding exposure units) along with measured increases in rates. We note that net written premium growth is partially constrained by sizeable reinsurance cessions and other changes within intercompany pools in the period.

- Underwriting leverage for the first three quarters of 2019, on both a gross ((direct + assumed premium)/surplus) and net (net premiums/surplus) basis, declined slightly when compared to the prior year end result at 1.21 times and 0.74 times, respectively, as surplus growth well outstripped premium flows.

Company Highlights

- In June 2019, **American Family Mutual Insurance Company, S.I**. entered into a loss portfolio transfer agreement with Main Street America Group, Inc. (MSA) to reinsure all in-force, new, and renewal direct and assumed business in respect of all past losses. This agreement had an effective date of 1/1/2019.

  American Family Insurance Mutual Holding Company merged with MSA in October 2018.

- In May 2019, **Auto-Owners Insurance Group** closed on its previously-announced acquisition of Capital Insurance Group (CIG), expanding its geographical footprint in the pacific northwest.

  CIG is comprised of four operating subsidiaries, the largest of which is California Capital Insurance Company with a 61% share of the intercompany pool in 2018. We note that several of CIG's operating subsidiaries were substantially impacted by wildfire losses in California in 2018, which likely precipitated the announced acquisition by Auto-Owners.

- In May 2019, **Hartford Financial Group** (HIG) closed on its previously announced acquisition of specialty commercial lines group Navigators Group Inc., for $2.1 billion. Management stated that this acquisition will help boost HIG's specialty and excess and surplus lines underwriting capabilities as well as its international footprint.

- On 1/1/2019, XL Reinsurance America, Inc., the lead insurer within the **AXA XL Group** entered into a whole account quota share agreement with Seaview Re Ltd, a newly formed affiliate offshore reinsurer. The XL pool companies will cede 30% of all business written (after cessions to 3rd parties and excess of loss treaties) to Seaview Re Ltd.

  The 1Q2019 premium paid to Seaview for this new arrangement resulted in negative net premium written for several of the AXA XL U.S. subsidiaries, a distortion which may reverse somewhat as the year progresses.

Financial Results for the ALIRT P&C Insurance Industry Composite

CAPITAL AND SURPLUS

Surplus for the ALIRT P&C Composite rose by 8.9% in the first nine months 2019 on operating earnings of $18.3 billion and substantial capital gains of $27.2 billion as broad equity markets rose by almost 18% through 9/30/2019. These gains were somewhat offset by net capital (surplus paid-in less shareholder dividends) paid up to parent organizations of $9.3 billion.

Table 1

Surplus Development							ALIRT P&C Industry Composite	
(Data in $ Millions)	2012	2013	2014	2015	2016	2017	2018	9 Mos. '19
Surplus Beginning of Period	297,822	322,048	347,469	365,661	371,166	385,100	399,252	406,716
Operating Earnings	15,894	26,504	25,167	21,367	14,699	14,905	27,718	18,267
Net Capital Gains or (Losses)	13,401	24,761	15,304	-2,410	13,676	29,877	-8,572	27,228
Surplus Paid-In	3,123	-4,080	2,623	4,658	1,547	1,502	6,157	-36
Shareholder Dividends	-12,433	-19,612	-19,169	-18,726	-16,732	-19,280	-18,022	-9,304
All Other Changes to Surplus	-4,242	2,152	5,733	616	744	-12,852	183	-24
Surplus End of Period	322,048	347,469	365,661	371,166	385,100	399,252	406,716	442,847
Change in Surplus	***8.1%***	***7.9%***	***5.2%***	***1.5%***	***3.8%***	***3.7%***	***1.9%***	***8.9%***

Twenty-two composite companies paid dividends to parent organizations through 9/30/2019, with the largest amounts coming from personal lines giant Allstate Insurance Company ($2.1 billion). Other holding companies upstreaming substantial amounts of capital from composite companies include: Travelers ($1.8 billion), AIG ($1.7 billion), Chubb ($1.4 billion), Continental Casualty Company (lead CNA carrier = $940 million), Progressive ($500 million), and Zurich Insurance Company of America ($481 million).

Individual Company Results

All but five composite companies reported an increase in surplus in the first nine months of 2019, with fourteen reporting an increase of greater than 10%, and five reporting gains of more than 15%.

The largest surplus gains were reported by large personal lines insurers, including two Progressive subsidiaries, Progressive Casualty Insurance Company (31.7%) and Progressive Direct Insurance Company (21.2%), followed by GEICO subsidiaries, GEICO Indemnity Company (24.0%) and Government Employees Insurance Company (23.0%), and USAA Casualty Insurance Company (13.6%). Surplus at these large personal lines insurers was boosted by especially strong net capital gains in the period, reflecting in part larger than composite average holdings of unaffiliated stocks at several of the above – and especially at the GEICO companies.

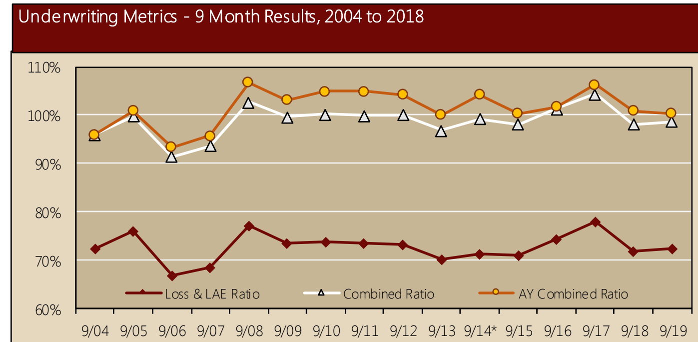
Among commercial lines predominant carriers, both Hartford Fire Insurance Company and specialty insurer Factory Mutual Insurance Company reported surplus gains of 17.3% and 14.0%, respectively, reflecting strong net capital gains but also very strong underwriting results at the latter company on a substantial prior year reserve release.

Of the five composite insurers reporting lower surplus as of 9/30/2019, three are AIG composite subsidiaries (weak underwriting results and substantial upstreaming of capital to the parent). The other two: lead Chubb insurer Federal Insurance Company (-10.6%) and lead Travelers subsidiary Travelers Indemnity Company (-0.7%) paid sizeable dividends to their respective parents.

UNDERWRITING PROFITABILITY

Chart 1 shows sixteen years of composite 9 month quarterly underwriting metrics for the ALIRT Composite.

Chart 1



*2014 accident year combined ratio adjusted for large GEICO transactions.

The ALIRT P&C Composite reported a combined ratio of 98.7% in the first nine months of 2019, weaker than in the prior year period by 0.6 percentage points but in line with 9 month underwriting results over the past decade when combined ratios were remarkably steady at around the break-even 100% mark.

This stable underwriting performance largely reflects average weather-related losses in the current period, continued prior year reserve releases, as well as the positive impact of firming rates, discussed below.

As shown on Table 2, at 100.6%, the industry *accident year* combined ratio (which excludes prior year reserve movements) was largely in-line with the full year-end 2018 figures and 60 basis points improved from the prior year period. The accident year ratios for the industry have been relatively strong over the past seven years at around break-even 100% (with the exception of large catastrophe year 2017), which speaks to both lower than average weather-related losses in the period 2013-2016 but also firming pricing/underwriting discipline broadly in recent years.

The industry expense ratio fell 0.2. percentage points to 25.8% year over year and is the best result over the past seven years, helped by improved net premium growth. This improvement is especially notable as managements for a number of large insurance groups have commented on the need for on-going technology/data science investments, which should pressure this financial metric somewhat.

Table 2

Underwriting Results					ALIRT P&C Industry Composite				
	2013	2014**	2015	2016	2017	2018	9M18	9M19	Change (points)
Loss/LAE Ratio	70.1%	70.7%	71.8%	75.5%	77.2%	72.5%	71.7%	72.5%	0.8
Expense Ratio	26.7%	27.4%	27.2%	27.0%	26.4%	26.2%	26.0%	25.8%	-0.2
Combined Ratio	97.4%	98.6%	99.6%	103.0%	104.1%	99.2%	98.1%	98.7%	0.6
AY Comb. Ratio*	99.0%	99.8%	99.5%	102.1%	104.9%	100.5%	101.0%	100.4%	-0.6
Operating Ratio	86.7%	88.6%	90.2%	93.9%	94.9%	89.4%	89.0%	90.6%	1.6

* Accident year combined ratios remove the impact of prior year reserve adjustments, thereby reflecting the profitability of business written only in the current year.
** Excludes results for two GEICO subsidiaries, GEICO Indemnity Co. and Government Employees Ins. Co.

The composite operating ratio, which takes into account both underwriting and investment income, deteriorated by 1.6 percentage points versus the prior year period to 90.6%, reflecting again the higher loss ratio as well as weaker net investment income when compared to the prior year period, discussed below. We remind readers that, overall, the majority of P&C insurer profitability comes from investment income.

Individual Company Results

Twenty-seven composite companies reported combined ratios below 100% in the first nine months of 2019 (down from 32 companies as of the last reporting period), with three insurers reporting combined ratios below 90%.

Of these, the best results were reported by specialty commercial lines insurer Factory Mutual Insurance Company (80.7%), which benefited from a substantial prior year reserve release equaling 10 points on the combined ratio. Also reporting composite-leading underwriting profitability were Progressive subsidiaries Progressive Casualty Insurance Company (88.4%) and Progressive Direct Insurance Company (89.9%), both of which benefit from expense loads that are well below the industry average.

Of the 20 composite companies with the strongest reported underwriting profitability, seven were personal lines specialists (Allstate, GEICO, Metlife, Progressive, and USAA), seven were subsidiaries of national commercial lines predominant companies (Chubb Ltd., Hartford Financial, and Zurich Insurance Group), three were specialty insurers (Factory Mutual, Berkley Insurance, and Great American) and three were super regional insurers (Auto-Owners, Cincinnati, and Federated Mutual), with a mix of both personal and commercial lines business. ***This is strong evidence of widespread participation in the industry's current stable underwriting and operating profitability.***

Of the 23 composite companies reporting underwriting losses in the first nine months of 2019, four had combined ratios exceeding 110%, with the weakest underwriting results reported by AXA XL's lead U.S. pool insurer XL Reinsurance America Inc. (111.8%) as the expense ratio spiked by 6 points as net premium written fell 44% given an affiliated offshore reinsurance transaction entered into on 1/1/2019.

Other composite insurers reporting weak underwriting results include AIG composite insurers National Union Fire Insurance Company (110.7%), Lexington Insurance Company (110.5%), and American Home Assurance Company (106.9%) as expense ratios remain well above composite averages and all three reported adverse prior year reserve development. AIG management states that the group is making headway in resolving underwriting deficiencies by exiting unprofitable lines of business (= lower premium and higher expense ratios), extending lower limits, tightening terms and conditions, and making more judicious use of reinsurance.

Continental Casualty Company (CCC) reported a well above average combined ratio (110.1%). We note that this commercial lines specialist traditionally offsets underwriting losses with sizeable investment gains on its long-tail, commercial lines liabilities, resulting in decent operating returns. For example, CCC's operating ratio was a strong 79.9% in the first nine months of 2019 versus 90.6% for the composite.

A number of other companies with unprofitable underwriting results in the first nine months of 2019 were regional insurers with exposure to the middle and northern reaches of the U.S. These include American Family Mutual (107.8%), Westfield Insurance Company (107.0%), Amica Mutual Insurance Company (106.6%), and Erie Insurance Exchange (105.7%).

LOSS RESERVE ADEQUACY

Table 3 tracks prior year loss reserve development for the ALIRT P&C Composite over the past ten calendar (reporting) years.

For each calendar year period (in the columns below), we show the development for the prior 10 accident (underwriting) years as well as a catchall "prior years" category. Note that on a quarterly basis (i.e. for CY 9M19), the statutory statements only provide development for the two prior accident years and then lump all other underwriting years under a "prior years" category (in red lettering).

Table 3

Prior Year Reserve Development (calendar years 2010 - 6M2019) — Data in $ Millions
ALIRT P&C Composite

Acc. Year	CY 2010	CY 2011	CY 2012	CY 2013	CY 2014	CY 2015	CY 2016	CY 2017	CY 2018	CY 9M19	Total
Prior Yrs.	-3,553	-4,534	-1,093	-814	-443	1,471	467	-131	-458	6	-9,082
2010	--	-1,691	-1,201	-548	-285	-61	-133	-414	-153		-4,486
2011	--	--	-2,976	-263	-3	14	-450	-319	-217		-4,214
2012	--	--	--	-2,594	-753	-205	261	-302	-390		-3,983
2013	--	--	--	--	-1,458	113	237	-539	-496		-2,143
2014	--	--	--	--	--	-914	689	-568	-381		-1,174
2015	--	--	--	--	--	--	1,316	-198	-156		962
2016	--	--	--	--	--	--	--	20	8		28
2017	--	--	--	--	--	--	--	--	-1,601	-579	-2,180
2018	--	--	--	--	--	--	--	--	--	-3,399	-3,399
Total Dev.	-3,553	-6,225	-5,270	-4,219	-2,942	418	2,387	-2,451	-3,844	-3,972	-29,671

As the far-right hand column illustrates, reserve releases for the 10 year reserve triangle were the largest for ***accident years*** 2010-2012 before trailing off for accident years 2013-2014, reflecting less income statement contribution from reserve releases. The industry then actually strengthened reserves slightly for the 2015-2016 underwriting years, while development of the 2017 and 2018 underwriting years have reverted to an aggregate reserve release.

As of 9 months 2019, the 2018 accident year has proven redundant by almost $4 billion dollars. Some of this redundancy may reflect releases of some of the large reserves posted for the catastrophe losses in late 2018 as ultimate losses came in at less than expected. It is important to remember, however, that nearer underwriting years have had only a short time to develop (in the case of AY 2018, only nine months), and actuarial estimates can change – sometimes substantially – as more time elapses.

Calendar year reserve releases (bottom row) also declined progressively in the years 2011-2014, ultimately resulting in the need to ***strengthen*** aggregate prior year reserves by $418 million and $2.4 billion in 2015 and 2016, respectively. This weaker performance was likely due to personal line insurers seeing higher than projected losses in their auto lines (distracted driving, more miles driven, more expensive car repairs, etc.) as well as substantial reserve strengthening in the AIG intercompany pool in the latter year.

Starting in calendar year 2017, the composite began to release aggregate reserves again with the redundancies accelerating somewhat in 2018 and for the first 9 months of 2019. Releases thus far in 2019 helped boost the industry's underwriting profitability, shaving 1.7 points off the accident year combined ratio of 100.4%.

This said, in the first nine months of 2019, ***almost all of the releases came from two composite subsidiaries of personal lines giant State Farm Insurance Group (97%).*** If we remove these companies, reserve releases were a much lower $91 million.

Making this adjustment, we also note that the commercial lines cohort needed to strengthen reserves by $135 million), though this figure is distorted by the three AIG composite subsidiaries reporting $374 million of strengthening, while Philadelphia Indemnity Insurance Company boosted prior year reserves by $181 million and Starr Indemnity & Liability Company strengthened reserved by $105 million.

Even when accounting for the above, we can see that broad reserve releases are fading for the overall industry - and especially at commercial lines predominant companies - which may well be contributing to the renewed underwriting discipline on the part of these insurers as discussed in our introductory comments.

OPERATING EARNINGS

As shown on Chart 2, pre- and after-tax operating earnings and returns[2] have stabilized somewhat after hitting a cyclical low in 2017, a year with sizeable catastrophe losses. It remains an open question whether the full year 2019 profitability metrics will return to the 20-year average mark given that the 4th quarter can often see both larger weather-related losses as well as prior year reserve true-ups (often negative).

As discussed in our introductory comments, insurance companies continue to take remedial action on certain underperforming commercial lines of business, which includes higher rates, tightening of underwriting standards and limits, and enhanced risk selection. These actions should help to shore up broad industry underwriting earnings which should continue to offset weaker net investment income, as the interest rate environment remains stuck in a decade-long slump. As for now, there is no substantial decline in earnings which argues that the current upward movement in rates may not be sustainable for the intermediate term.

Chart 2

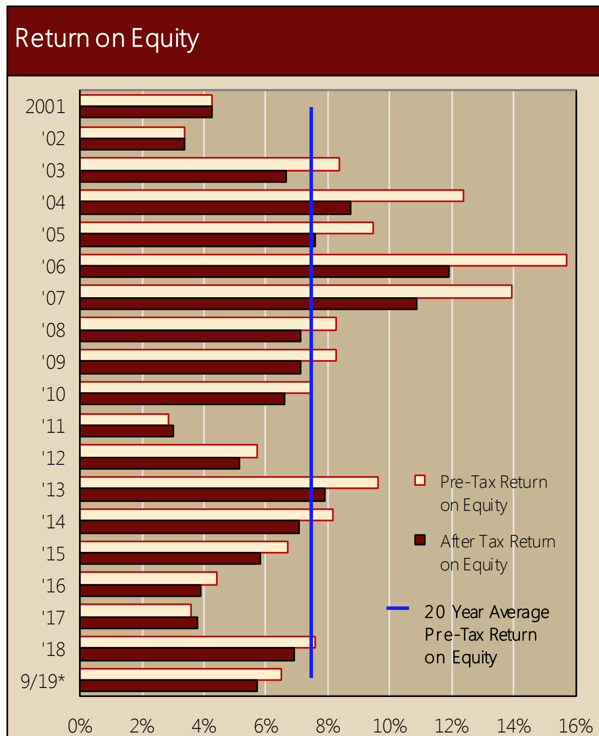
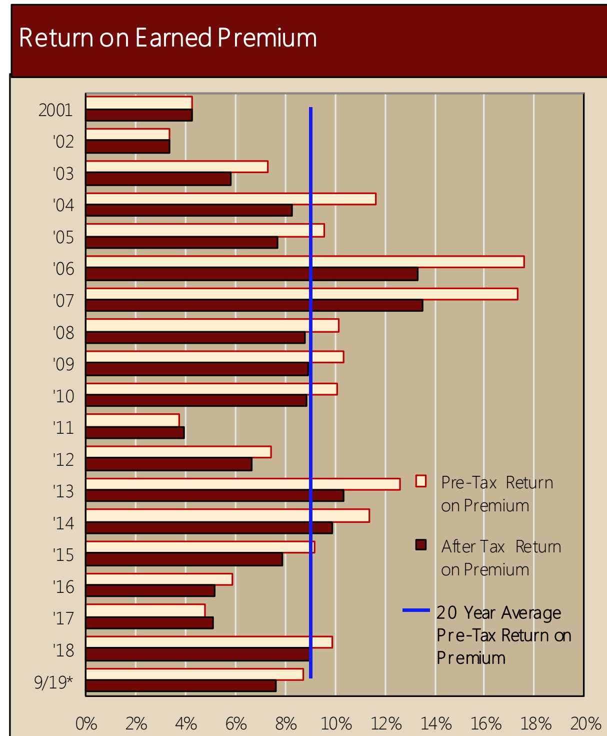


Chart 3



* Annualized

Individual Company Results

Thirteen composite companies reported annualized pretax returns on earned premium (ROP) exceeding 15% in the first 9 months of 2019, with three reporting ratios in excess of 20%. The latter include Mid-Century Insurance Company (32.9%, reflecting a surge in net investment income as the company received an extraordinary dividend from a subsidiary insurer), Factory Mutual Insurance Company (26.1% on extremely strong underwriting results driven by outsized reserve releases), and Hartford Fire Insurance Company (25.7%, large net investment gains on large affiliated holdings).

[2] Excludes the impact of net capital gains/losses.

Fifteen of the 20 composite companies with the strongest pretax ROP are commercial lines predominant companies, including subsidiaries of large national insurance groups Chubb Ltd., CNA, Hartford Financial, Travelers Corp., and Zurich. These results continue to demonstrate that industry profitability measures (as reflected by ROP) tend to be larger at carriers with longer tail liabilities given their ability to generate substantially more income on their investment "float."

Only four composite companies reported a pretax operating loss in the first nine months of 2019, though most of these were slight. All four of these insurers have a regional footprint with a personal lines orientation and include: American Family Mutual Insurance Company, S.I. (-4.0%), COUNTRY Mutual Insurance Company (-0.8%), Amica Mutual Insurance Company (-0.7%), and Farmers Insurance Exchange (-0.4%).

PREMIUM INCOME

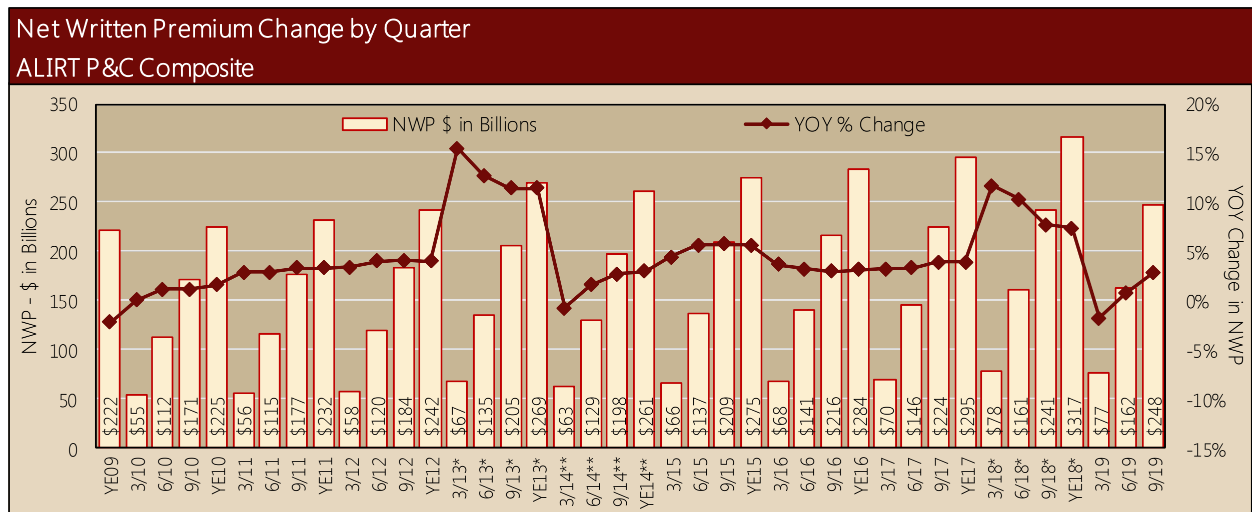
Direct and net premium written rose by 3.0% and 2.8%, respectively, in the first nine months of 2019 versus the prior year period.

As shown on Chart 4, there are periods of extreme volatility as regards year over year changes in NWP, largely tied to the restructuring of intercompany pools or the transaction of large external reinsurance deals (both affiliated and unaffiliated). For instance, 2018 saw a sharp rise in NWP as both Chubb and Zurich U.S. insurers assumed substantially more net premium as a result of changes in U.S. pool structures and/or affiliate reinsurance transactions.

The weak NWP growth in the current period reflects in part composite U.S. members of the AXA XL and Chubb ceding substantial business to offshore affiliates in early quarters of 2019; it also likely reflects in part greater use of unaffiliated reinsurance by composite carriers as reinsurance rates remain attractive and primary insurers attempt to hedge against large losses. The AIG and Chubb groups, for instance, both announced substantial reinsurance transactions covering their U.S. business in 2019.

That said, 9 month analyst calls by publicly traded P&C holding companies reiterated accelerating premium trends, pointing to both a steady economy (= positive exposure units), a strong rate environment in select lines of business, and opportunities to take-up specialty/excess & surplus lines exposure exited by both standard U.S. insurers and Lloyds of London. Whether these trends translate into a continued growth in direct and/or net premium written over the coming year remains to be seen.

Chart 4



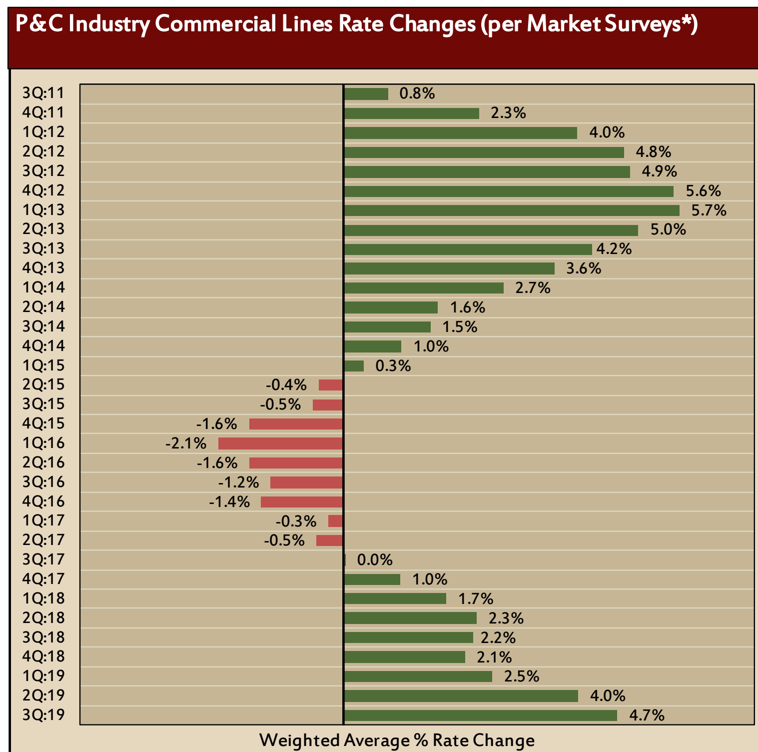
* Spike in NWP in '13 and '18 reflects the restructuring of composite intercompany pools whereby lead pool insurers assumed substantial additional premium from affiliates.
** Excludes results for two GEICO subsidiaries, GEICO Indemnity Co. and Government Employees Ins. Co. (aggregate 2014, year-over-year change in 2014).

In the meantime, the blended average of several quarterly broker surveys (Chart 5) shows a rise in overall <u>commercial lines</u> premium rates in the period 3Q2011-2014. The velocity of the upward trend in pricing, however, moderated starting in 2013 and fell to break-even in mid-2015. After two years of rate decline (2Q2015-2Q2017), the current surveys show that rates have now firmed for the past two years, with a notable acceleration starting in 2Q2019 which supports commentary by a number of commercial lines insurance companies in analyst calls.

We remind our readers, however, that the current improvement in pricing should be understood within a broader context (see our historical price change chart on page 2). In fact, the trend below looks similar to one seen in 2012 which moderated in early 2013 and then slowly faded over the following two years.

While past experience is certainly not predictive of what might occur in the coming years, we do note that the industry's overall financial profile remains strong, both as concerns balance sheet strength and operating earnings and that a true "hard" market tends to occur when the industry's financial condition is substantially impaired. This is a commentary on the general outlook for the industry; as ALIRT's quarterly credit analyses show, there are always individual insurers that are facing significant financial struggles.

Chart 5



Individual Company Results

Four composite companies reported net premium growth exceeding 15% in the first nine months of 2019, with the largest reported by specialty insurers Starr Indemnity & Liability Company (42.2%, as the company retained more gross premium), American Family Mutual Insurance Company S.I. (28.2%, large loss portfolio transfer), Allianz Global Risks US Insurance Company (17.0%), and Crum & Forster's lead pool company United States Fire Insurance Company (15.1%).

Nine insurers reported a decline in NWP in the period, with 4 companies reporting declines of over 20%. These include XL Reinsurance America. Inc. (-44.4%, reflecting an intercompany reinsurance transaction) and three Chubb subsidiaries: Pacific Indemnity Company (-23.7%), ACE American Insurance Company (-23.3%), and ACE P&C Insurance Company (-21.1%), with all three appearing to assume a smaller share of the U.S. insurance pool thus far in 2019.

INVESTMENT MIX

Invested assets rose 6.2% for the ALIRT Composite in the first nine months of 2019 reflecting net premium growth and substantial gains in equities as the broad equity markets have risen sharply since year end 2018. This growth was partially offset by much lower net investment income (-7.3%) as historically low interest rates continue to constrain this source of income.

The composite investment mix at 9/30/19 (Table 4) shows a drop in the share of bond holdings wholly offset by a gain in unaffiliated and affiliated stocks as market values rose through the first three quarters of this year. The gain in the relative share of unaffiliated equities reflects in large part the aforementioned increase in values, as stocks are carried at market value under statutory accounting.

All of the other asset classes showed only small incremental changes. We do note the continued trend of smaller relative holdings of alternative investments (Schedule BA on the below chart), which may reflect the sale of hedge fund/private equity holdings which were a more popular trade for insurers over the past decade as interest rates were at historical lows.

Table 4

Distribution of Invested Assets				ALIRT P&C Industry Composite			
	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	9 Mos. 2019	Change in 2019
Bonds	55.4%	55.1%	54.5%	52.9%	55.3%	53.5%	-1.8%
Unaffiliated Stocks	14.6%	13.7%	14.4%	16.0%	13.7%	15.3%	1.6%
Affiliated Stocks	17.8%	18.4%	18.4%	18.5%	18.2%	18.6%	0.4%
Mortgage Loans & Real Estate	1.7%	2.1%	2.3%	2.5%	2.8%	2.6%	-0.2%
Cash & Short-Term	2.4%	2.4%	2.6%	2.4%	2.6%	2.7%	0.1%
Schedule BA	7.5%	7.6%	7.3%	7.1%	6.8%	6.7%	-0.1%
Other	0.5%	0.6%	0.5%	0.7%	0.6%	0.6%	0.0%
Change in Inv. Assets	3.6%	0.7%	4.5%	3.6%	1.9%	6.2%	N/M

It will be interesting to see how insurers react to the sharp downturn in broad (but especially longer term) interest rates since late 2018, which we discuss at greater depth below. With the bull market in equities now a decade old, we had anticipated perhaps a trend towards more conservative holdings, such as bonds/cash and an offsetting reduction in riskier assets such as Schedule BA/alternative investments and unaffiliated stocks. That said, less than 10% of current net capital gains were realized, meaning that insurers largely continue to hold their equity positions.

Bond holdings are not marked to market on a statutory basis, so the fear of capital losses in the case of higher interest rates is not an immediate worry (though under GAAP such unrealized losses/gains must be recognized). However, insurers now need to weigh the opportunity cost of investing today in much lower yielding securities against possible net capital losses in equities should markets reverse.

INVESTMENT RESULTS

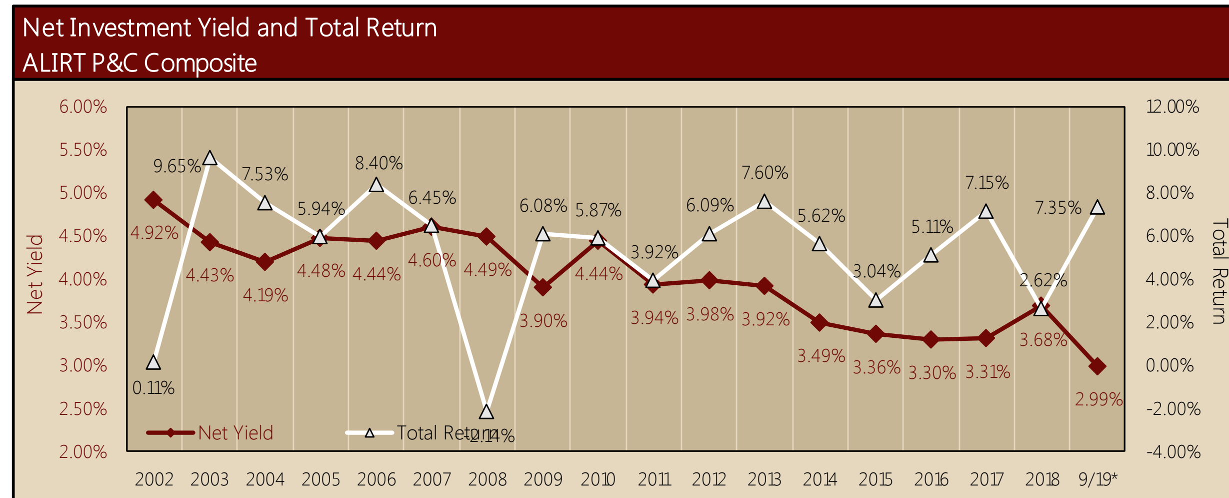
Net investment yield fell 69 basis points to 2.99% the first three quarters of 2019, one of the lowest reported by an appreciable margin over the past 20 years.

With the caveat that composite net investment yield can be distorted in any period by outsized/undersized dividends paid by affiliate investments (usually subsidiary insurers, such as in 2018), the continued downward trend in industry book yield is unmistakable.

As we have explained at length in previous reviews, this is reflective of a decades-long retreat in bond yields as the global economy retrenched after the great recession of 2008-2009. The impact of that event continues to be felt as central banks in many countries keep key lending rates at low - and in some cases negative - levels (there is an estimated $15 trillion of global government debt outstanding with negative yields). These low rates, combined with direct purchase of debt instruments by central banks, continues to contribute to downward pressure on yields of many bond issues and classes.

Because investment income is by far the largest contributor of property & casualty company earnings, the pressure on yields has resulted in insurers taking a much more aggressive stance on maintaining underwriting profitability.

Chart 6



* Quarterly results are annualized.

Total investment return was a bright spot (+7.35%) as broad equity markets have risen 24% thus far in 2019, reversing market losses sustained in 2018 after a difficult 4Q2018. The current total return ratio reflects a 20-year high, with the current market gains representing a major contributor to the industry's 9/30/2019 growth in surplus. While such gains are welcome by insurers, we do point out that the current bull market is almost 11 years old while the average U.S. bull markets lasts 4.5 years. While no one can predict market turns, certainly paper gains can just as easily become paper losses.

Table 5

Changes in Stock Market Indices

	2010	2011	2012	2013	2014	2015	2016	2017	2018	1Q19	2Q19	3Q19	4Q19*
DJIA	11.0%	5.5%	7.3%	26.5%	7.5%	-2.2%	13.4%	25.1%	-5.6%	11.2%	2.6%	1.2%	4.2%
S&P 500	12.8%	0.0%	13.4%	29.6%	11.4%	-0.7%	9.6%	19.4%	-6.2%	13.1%	3.8%	1.2%	5.5%
NASDAQ	16.9%	-1.8%	15.9%	38.3%	13.4%	5.7%	7.5%	28.2%	-3.9%	16.5%	3.6%	-0.1%	8.3%
Avg.% Change	13.6%	1.2%	12.2%	31.5%	10.8%	0.9%	10.2%	24.2%	-5.3%	13.6%	3.3%	0.8%	6.0%

* As of end of day November 30, 2019

CONCLUSION

Surplus growth for the ALIRT P&C Composite remained strong in the current period (though this is partly due to strong equity market gains which can prove fickle), underwriting results were slightly better than breakeven, and premium growth – while not exceptional – was at least steady. Net investment income remains somewhat of a weak spot given historical low investment yields, but it appears that company managements have reacted appropriately by tightening up underwriting discipline to help maintain targeted operating returns.

All of this adds up to the fact that the U.S. property & casualty industry continues in good financial health, which is one of the principal reasons that we feel the current firming rate environment will not evolve into a run-away hard market. This is not to say there are not operational and market challenges (there always are); only that the current ones are manageable and the need for pricing/underwriting adjustments will likely be addressed over the coming year without substantial market disruption.

We conclude by quoting an insurer and broker, as these constituencies have somewhat different agendas which can color their view of their industry. We believe that both are accurate.

We start with a Brian Duperreault, CEO of AIG, who in the group's nine month analyst call provides a thorough catalogue of what insurers consider their most pressing market challenges:

> *"We've been leading the market with our professional approach to judiciously deploying capacity, appropriately addressing loss cost inflation and continued underwriting discipline on our pricing models. These actions are playing out against an industry backdrop of prolonged pressures on accident year loss ratios, loss cost inflation, significant catastrophes over multiple years, pressuring the property lines, a lower interest rate environment, a complex retro market and a fatigued alternative capital market. This market dynamic is different from the past because we now see the industry as a whole is acting more rationally, and this combination of changed behavior and external forces reaffirms my belief that this market cycle is sustainable for the foreseeable future."*

Pat Gallagher, who leads A.J. Gallagher, had this to say in his recent analyst call (commentary that is, incidentally, very similar to that of another broker CEO, J Powell Brown):

> *"This is not a hard market. It's getting firmer, there's no question about it, that when you get into some higher end property stuff and catastrophe exposed or places where there've been losses, our people working very hard to place those. Some of the stuff is getting done at the last minute, it takes more effort, more submissions to more E&S markets to get it completed. We're seeing excess casualty. It takes a little more effort and cost more money as well … But this is not 2001, 2002 by any means. There is still plenty of capacity. Deals are getting done."*

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