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

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OVERVIEW

Surplus growth for the ALIRT P&C Composite[1] was strong in the first six 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 six 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 investment yields retreated from 2018 highs, but total return was strong as equity markets rebounded sharply in the first half of the year. The pricing environment continues to show resilience, with company managements speaking of an acceleration of rate increases in the first half, especially in commercial lines.

State of the Underwriting Cycle: Loss Cost Trends Ticking Higher?

In a number of second quarter 2019 analyst calls the conversation turned to the question of loss cost trend. As premium rates continue to firm, many analysts are eager to learn if these higher prices are in excess of, commensurate with, or lower than the current loss trend as this will help determine the direction of profit margins in the current cycle.

Setting premium rates – also known as making "loss picks" – is a notoriously difficult science given the inherent uncertainty of future trends and often significant time lag between premium inflows and the realization of losses. Analysts look to gauge "price inflection" points, that is when premium rates either rise above or fall below ultimate losses, when modelling for future profitability.

Traditionally, firmer pricing cycles occur when loss trends exceed premium rates charged, resulting in weaker than expected earnings or – in more extreme cases – operating losses. In contrast, premium rates begin to soften when loss trends are lower than anticipated, resulting in stronger earnings which attract greater competition.

When asked about loss cost trends in Travelers' 2Q analysts call, CEO Alan Schnitzer provided the following perspective:

> *Certainly everything we know about loss trend goes into our pricing models and our view of rate adequacy and our view what rate we need to achieve our return objectives … We price the product based on an estimate of losses and an interest rate curve. And so our objective is always to get the right price. And so we wade through a lot of data. We've got terrific actuaries and experts that help us think through this we've got management input on top of that. And our objective is to just get it right …*
>
> *I will say that that does come in on a lag basis. We've got to see it, we've got to put it through in our models to the extent there are regulatory filings there's a process there then you got to put it on the book it's got a earn in. So there is a lag between the recognition of these trends and the time price goes into the market and is put on the books.*

It's precisely this lag that, in our view, creates the undulations in the general pricing cycle as new information is processed, loss trend is more precisely gauged, and necessary adjustments in pricing are made.

Currently, individual lines of business where loss trends are clearly above premium rates – such as catastrophe-exposed property lines, commercial auto, certain professional liability lines, etc. – are

[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.

seeing sharper price increases, while others, such as workers compensation, are seeing prices soften as the relationship between premium and loss costs have been favorable to insurers.

Richard Reeves Whitt, Co-CEO at specialty insurer Markel, when speaking of certain more problematic lines of business said,

> *"We're seeing some uptick in severity in places like Professional and Casualty. It's manageable. But the message we're sending our underwriters and I think it's the right message is, these rates that we're looking for, they're not just nice to have, we need to have them. There is --* ***I mean we've enjoyed an incredibly benign 10 or so years quite honestly in terms of claims trend.*** *You would expect some reversion to the mean over time. And so we need to get some rate in Professional and Casualty and other areas to make sure we're keeping up with trend."*

Evan Greenberg, Chairman & CEO of Chubb Ltd., was even more pointed in his commentary during a 2Q analyst call:

> *"Well, just simply, the rate has not kept pace with loss cost trend and that puts pressure on income and it puts pressure, ultimately, on reserves. [It implies] that balance sheets over time have less redundancy in them and for some are adequate, for others -- and become negative for others …* ***And you have a loss cost environment that in many ways in the headlines is stable****, but you have areas of casualty and catastrophes and other areas within the business where there is volatility and there is trend pressure.*

Lastly, Albert A. Benchimol, President & CEO of AXIS Capital Holdings Ltd., said

> *This period of price firming is now in its eighth quarter, having started in the fourth quarter of 2017, and* ***we're starting to get the benefit of compound rate increases.*** *As you've heard from other market participants, AXIS is also seeing both an acceleration on the pace of increases and an expansion into more lines and markets.*

So the insurers seem to be hinting that the overall rate environment is "stable", especially after two years of gradually firming rates, but that certain lines of business need more rate and there is a disciplined attempt to achieve that rate. Given the nice bump in premium rate changes for 2Q2019 (see page 17), it appears that insurers are holding firm on getting that rate.

Meanwhile, while the brokers are conceding the upward pressure on rates, they feel that it is manageable. For instance, Pat Gallagher, CEO of AJ Gallagher, has been quick to point out in almost every quarter analyst call this is by no means a "hard market."

> *"This is not a hard market. We're getting the accounts quoted, we're not having accounts canceled in a wholesale fashion, we're working through a little bit of increase here. And I've been saying for the last decade, you take me up 2%, down 3%, up 4%, down 2%, that's not a hard market. You go back to 2001, our organic growth was 19%, the market rates were up an average of over 20%, and many accounts never could get the cover they wanted. They couldn't fill out their lines. That was a hard market. So let's not get crazy here looking at this as a hard market."*

Likewise, J. Powell Brown, CEO and President of Brown & Brown, sees a very rational market:

> *Last quarter, there was a lot of discussion that the risk bearers wanted to increase rates, and it was most pronounced in London. There was some upward pricing pressure in the second quarter as risk bearers were trying to get rate increases where possible. And specifically, in the E&S space, we are seeing some carriers be more selective in either certain lines or geographies or both, which is having a potential or a pronounced impact in certain areas.* ***There's still a lot of capital that needs to get put to work, and therefore we do not believe there's going to be large swings in pricing in the near future.***

In sum, insurers continue to closely watch loss cost trend with hints that after two years of necessary rate gains, profitability in broad terms is acceptable which may incent them to defend renewals more aggressively. That said, they appear ready and willing to seek substantial rate increases in problematic

lines, despite overall capital adequacy. In short, they will not sacrifice their balance sheets to grow the top line. Brokers appear to concur, speaking of a rational market overall with pockets of more substantial price increases.

This leads ALIRT to conclude that while broad premium rates in the U.S. may continue to move higher in the immediate term, we are unlikely to see a protracted firming rate cycle.

Financial Summary

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

- ***ALIRT Composite surplus rose 7.3% in the first half of 2019*** as operating earnings of $12.7 billion and outsized net capital gains of $24.3 billion were somewhat offset by net capital (including shareholder dividends less net capital infusions) paid out to parent organizations of $7.2 billion.

- The ALIRT Composite reported a combined ratio of 98.1% in the first six months of 2019, a 1.6 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 half of 2018. The composite expense ratio was steady in the current year period, despite lower net written premium flows.

- The accident year combined ratio (which excludes the impact of prior year reserve development), was 100.6%, largely in line with the prior year period reflecting similar weather-related loss patterns.

- Pretax operating income declined sharply (by 15.8%) 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 200 basis points to 9.3%.

- Net investment yield (annualized) of 2.93% was 74 basis points lower than in the prior year end period, while total investment return (annualized) spiked to 8.86% as equity market gains were substantial through the first six months of the year.

- Direct premiums rose 2.3% in the first six months of 2019 versus the prior year period, while net premium was nearly flat (0.7%) in the same period. The direct premium gains reflect stronger economic conditions in the domestic market (expanding exposure units) along with measured increases in rates. The dip in net written premium growth is partially attributable to sizeable reinsurance cessions and other changes within intercompany pools in the period.

- Underwriting leverage for the first half of 2019, on both a gross ((direct + assumed premium)/surplus) and net (net premiums/surplus) basis, declined 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 7.3% in the first half 2019 on operating earnings of $12.7 billion and substantial capital gains of $24.3 billion as broad equity markets rebounded from large 4Q2018 losses. These gains were somewhat offset by net capital (surplus paid-in less shareholder dividends) paid up to parent organizations of $7.2 billion.

Table 1

Surplus Development						ALIRT P&C Industry Composite		
(Data in $ Millions)	2012	2013	2014	2015	2016	2017	2018	6 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	12,684
Net Capital Gains or (Losses)	13,401	24,761	15,304	-2,410	13,676	29,877	-8,572	24,290
Surplus Paid-In	3,123	-4,080	2,623	4,658	1,547	1,502	6,157	144
Shareholder Dividends	-12,433	-19,612	-19,169	-18,726	-16,732	-19,280	-18,022	-7,326
All Other Changes to Surplus	-4,242	2,152	5,733	616	744	-12,852	183	38
Surplus End of Period	322,048	347,469	365,661	371,166	385,100	399,252	406,716	436,546
Change in Surplus	***8.1%***	***7.9%***	***5.2%***	***1.5%***	***3.8%***	***3.7%***	***1.9%***	***7.3%***

Twenty composite companies paid dividends to parent organizations in the first half of 2019, with the largest amounts coming from personal lines giant Allstate Insurance Company ($1.9 billion), three Chubb subsidiaries ($1.4 billion), three Traveler subsidiaries ($1.2 billion), Continental Casualty Company (lead CNA carrier = $805 million), two AIG subsidiaries ($702 million), and Zurich Insurance Company of America ($481 million). Berkley Insurance Company ($400) and Cincinnati Insurance Company ($300 million) also reported substantial payments to parent organization in 1Q2019.

Individual Company Results

All but two composite companies reported an increase in surplus in the first half of 2019, with seven reporting an increase of greater than 10%.

The largest surplus gains were reported by large personal lines insurers, including two Progressive subsidiaries, Progressive Casualty Insurance Company (32.6%) and Progressive Direct Insurance Company (20.9%), followed by GEICO subsidiaries, GEICO Indemnity Company (21.0%) and Government Employees Insurance Company (18.2%), and USAA Casualty Insurance Company (12.0%). 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.

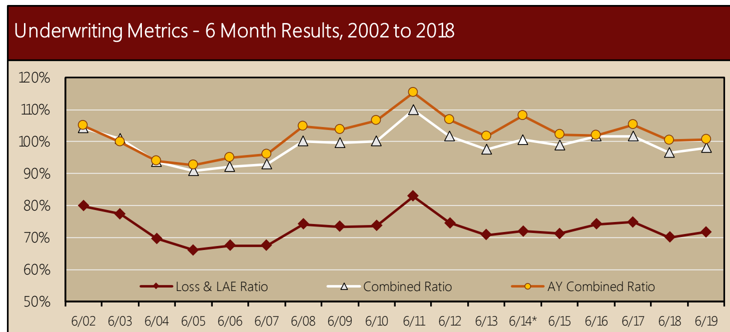
Among commercial lines predominant carriers, both Hartford Fire Insurance Company and specialty insurer Factory Mutual Insurance Company reported surplus gains of 12.9%, reflecting strong net capital gains but also very strong underwriting results at the latter company on a substantial prior year reserve release.

Only two composite insurers reported lower surplus in the first half of 2019, lead Chubb insurer Federal Insurance Company (-13.7%) and AIG subsidiary American Home Assurance Company (-3.0%), with both declines largely attributable to surplus upstreamed to parent organization.

UNDERWRITING PROFITABILITY

Chart 1 shows composite 6 month quarterly underwriting metrics for the ALIRT Composite back to 2002.

Chart 1



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

The ALIRT P&C Composite reported a combined ratio of 98.1% in the first six months of 2019, weaker than in the prior year period but in line with half year 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 period, continued prior year reserve releases, as well as the positive impact of firming rates, discussed below.

As shown on Table 2, the industry accident year combined ratio (which excludes prior year reserve movements) was largely in-line with the 6-month 2018 and full year-end 2018 figures, at 100.6%. 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 of 26.0% was in line with the prior year period but has improved (declined) sequentially over the past five years by 1.4 percentage points. 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	6M '18	6M '19	Change (points)
Loss/LAE Ratio	70.1%	70.7%	71.8%	75.5%	77.2%	72.5%	70.0%	71.7%	1.7
Expense Ratio	26.7%	27.4%	27.2%	27.0%	26.4%	26.2%	26.1%	26.0%	-0.1
Combined Ratio	97.4%	98.6%	99.6%	103.0%	104.1%	99.2%	96.5%	98.1%	1.6
AY Comb. Ratio*	99.0%	99.8%	99.5%	102.1%	104.9%	100.5%	100.4%	100.6%	0.2
Operating Ratio	86.7%	88.6%	90.2%	93.9%	94.9%	89.4%	87.6%	90.2%	2.6

* 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 2.6 percentage points versus the prior year period to 90.2%, reflecting again the higher loss ratio but substantially weaker net investment income when compared to the prior year period, discussed below.

We reiterate that while weaker year-over-year, the first half 2019 underwriting and operating results are in-line (or even slightly better) than averages over the past decade.

Individual Company Results

Thirty-two composite companies reported combined ratios below 100% in the first six months of 2019, with three insurers reporting combined ratios below 90%.

Of these, the best results were reported by specialty commercial lines insurer Factory Mutual Insurance Company (76.3%), which benefited from a substantial prior year reserve release equaling 15 points on the combined ratio. Also reporting composite-leading underwriting profitability were Progress subsidiaries Progressive Casualty Insurance Company (87.6%) and Progressive Direct Insurance Company (89.3%), 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 commercial lines specialists, including subsidiaries of Chubb Ltd., Hartford Financial, and Zurich Insurance Group, while seven were personal lines writers (Allstate, GEICO, Metlife, Progressive, and USAA), three were specialty insurers (Factory Mutual, Berkley Insurance, and Great American) and three were 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 18 composite companies reporting underwriting losses in the first half of 2019, five had combined ratios exceeding 110%.

The weakest underwriting results were reported by AXA XL's lead U.S. pool insurer XL Reinsurance America Inc. (112.4%) as the expense ratio spiked 12 points as net premium written fell 47% 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 (110.5%), Lexington Insurance Company (110.2%), and American Home Assurance Company (107.7%) as expense ratios remain well above composite averages. 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 and Erie Insurance Exchange also reported well above average combined ratios (110.3% each), with the latter reported a 6.3 percentage point spike in the loss ratio, likely tied to weather-related losses. As for Continental Casualty, this insurer 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 80.1% in the first half of 2019.

We note that a number of other companies with unprofitable underwriting results in the first six months of 2019 were personal lines carriers with exposure to the northern reaches of the U.S., which are disproportionately impacted by winter weather losses. These losses tend to be diluted by improved underwriting results in later quarters of the year.

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 6M19), 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 6M19	Total
Prior Yrs.	-3,553	-4,534	-1,093	-814	-443	1,471	467	-131	-458	-206	-9,294
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	-633	-2,234
2018	--	--	--	--	--	--	--	--	--	-3,074	-3,074
Total Dev.	-3,553	-6,225	-5,270	-4,219	-2,942	418	2,387	-2,451	-3,844	-3,913	-29,612

* Excludes results for two GEICO subsidiaries, GEICO Indemnity Company and Government Employees Insurance Company

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 6 months 2019, the 2018 accident year has proven redundant by $3.1 billion dollars. Some of this redundancy may reflect releases of some of the large reserves posted for the catastrophe losses in the second half of 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 six 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 6 months of 2019. Releases thus far in 2019 helped boost the industry's underwriting profitability, shaving 2.5 points off the accident year combined ratio of 100.6%.

This said, in the first six months of 2019, ***the majority of the releases came from two composite subsidiaries of personal lines giant State Farm Insurance Group (87%).*** If we remove these companies, reserve releases were a much lower $492 million, with the majority of this figure reported by the commercial lines cohort ($334 million), led by a $224 million release at Factory Mutual Insurance Company.

Absent the latter, 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 that we discussed in our introductory comments.

OPERATING EARNINGS

As shown on Chart 2, pre- and after-tax operating earnings and returns[2] continued to stabilize after hitting a cyclical low in 2017, which was a year with sizeable catastrophe losses. It will be interesting to see whether the slight dip in operating profitability through the first half of this year holds for the full year 2019 (likely, given the tendency of larger cat losses in the back half of the year) and/or marks a return to below historical average industry profitability over the coming years.

While insurance companies appear optimistic about the current trend in earnings, there are reasons to be skeptical. After all, one needs to go back to 2013-2014 to witness above average operating profitability in the current cycle - and this was a period with unusually low catastrophe losses. It appears more likely that profitability will begin to fade as the benefit of much-discussed firming rates is offset by the lack of substantial reserve releases across the broad industry as well as weaker net investment income, as the interest rate environment remains stuck in a decades-long slump (discussed below).

Chart 2

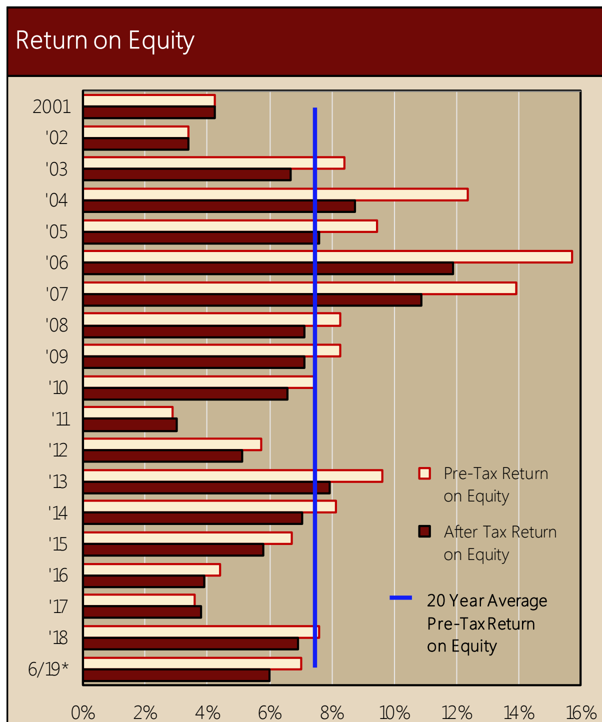
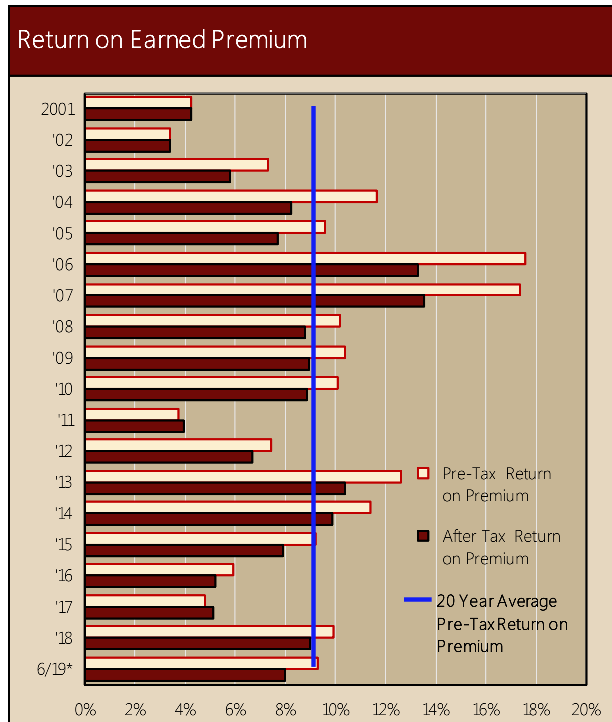


Chart 3



* Annualized

Individual Company Results

Twelve composite companies reported annualized pretax returns on earned premium (ROP) exceeding 15% in the first half of 2019, with three reporting ratios in excess of 20%. The latter include Factory Mutual Insurance Company (28.7% on extremely strong underwriting results driven by outsized reserve releases), Hartford Fire Insurance Company (26.3%, large investment gains), and Zurich American Insurance Company (21.7%, distorted upwards by a sharp decline in net earned premium).

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

Of the 20 composite companies with the strongest pretax ROP, all but three are commercial lines predominant companies, including subsidiaries of large national insurance groups Chubb Ltd., CNA, Hartford Financial, and Travelers Corp. 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."

Six composite companies reported a pretax operating loss in the first six months of 2019. These include regional personal lines writer Erie Insurance Exchange (-4.0%), American Family Mutual Insurance Company, S.I. (-3.7%), Allianz Global Risks U.S. Insurance Company (-2.4%), Amica Mutual Insurance Company (-1.1%), COUNTRY Mutual Insurance Company (-1.1%), and Farmers Insurance Exchange (-0.2%).

We note that most of these companies are regional insurers with sizeable personal lines exposure and so the current poor operating performance likely represents outsized weather-related losses in the first half of the year relative to the composite.

PREMIUM INCOME

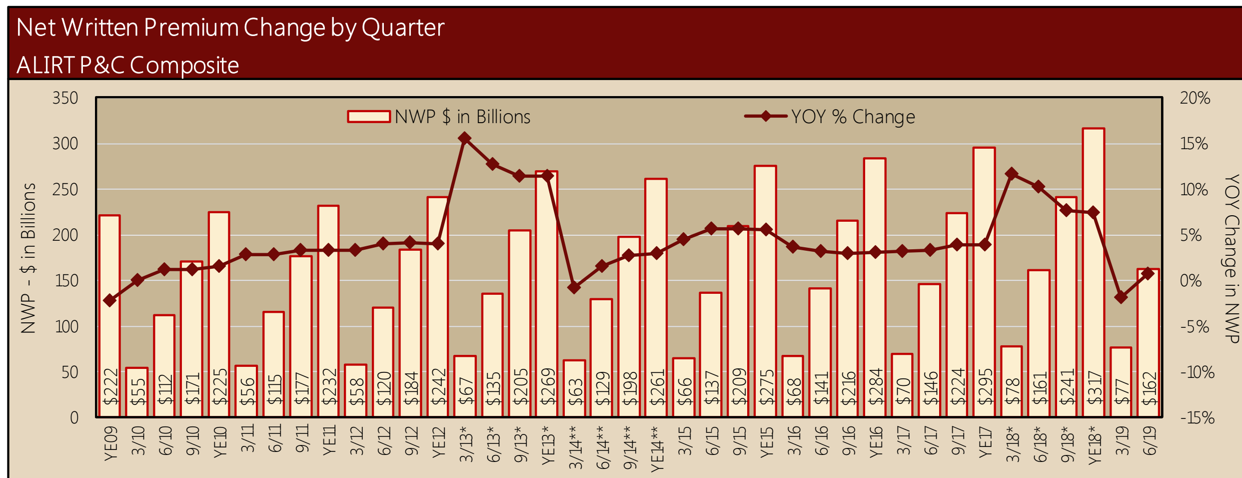
Direct premium rose just 2.3% while net written premium (NWP) was largely flat, increasing by 0.7% in the first half of 2019 versus the prior year period.

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, Chubb and Zurich insurance groups ceding business to offshore affiliates in 1Q2019; it also likely reflects 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, the easing of direct premium flow indicates that, while the economy and firming rates remain tailwinds, the ability to generate strong top line growth remains difficult for the industry. It will be interesting to see if competition for limited direct premium dollars results in a slowing or reversal of the current favorable rate environment in the coming periods.

Chart 4

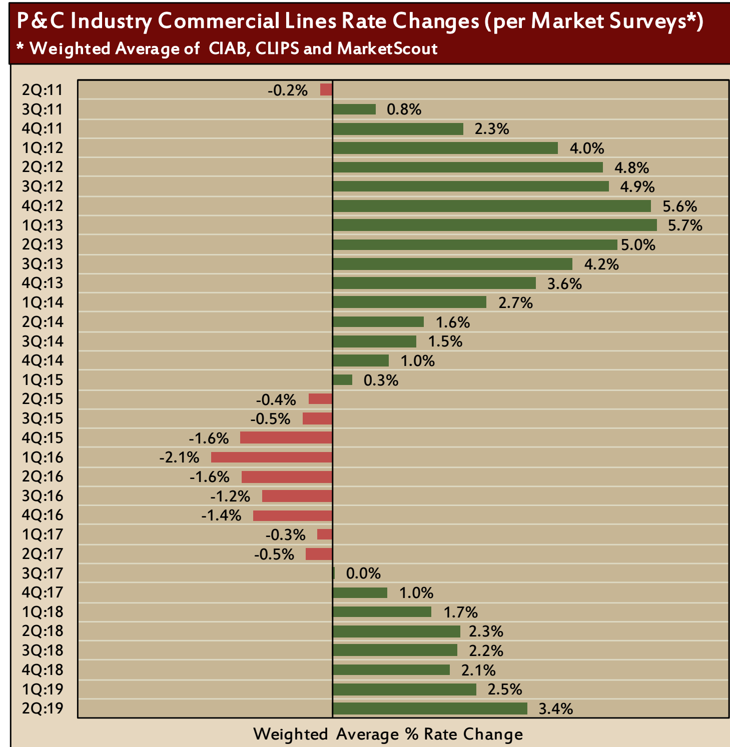


* Spike in NWP in '13 and '18 reflects the restructuring of composite intercompany pools whereby lead pool insurers assumed substantial additional premium from affiliates.
** Excludes results for two GEICO subsidiaries, GEICO Indemnity Co. and Government Employees Ins. Co. (aggregate 2014, year-over-year 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 shows that rates have now firmed for the past almost two years, including by 3.4% in 2Q2019.

As discussed in our introductory comments, management for a number of insurance organizations appeared pleasantly surprised by the pop in broad rates in 2Q2019, which seemed to come in beyond expectations. This trend is corroborated by the broker surveys which also showed a small surge in the current period after that rate firming trend of 3Q17 to 2Q18 appeared to be easing somewhat.

Chart 5



<u>Individual Company Results</u>

Four composite companies reported net premium growth exceeding 15% in the first half of 2019, with the largest reported by specialty insurers Starr Indemnity & Liability Company (46.9%, including a surge in direct premium written), American Family Mutual Insurance Company S.I. (34.2%, large loss portfolio transfer), Federal Insurance Company (17.5%, as it appears that the company assumed a greater net share of Chubb's U.S. intercompany pool beginning in 1Q2019), and Allianz Global Risks US Insurance Company (17.2%).

Ten insurers reported a decline in NWP in the period, with 5 companies reporting declines of over 30%. These include XL Reinsurance America. Inc. (-47.1%, reflecting an intercompany reinsurance transaction), Zurich American Insurance Company (-44.5%, which may relate to a new whole account quota share agreement with an offshore affiliate), and three Chubb subsidiaries: Pacific Indemnity Company (-34.7%), ACE American Insurance Company (-34.2%), and ACE P&C Insurance Company (-31.7%), where it appears the latter assumed a smaller share of the U.S. insurance pool in the first half of 2019.

INVESTMENT MIX

Invested assets rose 4.5% for the ALIRT Composite in the first half of 2019 reflecting anemic net premium growth and lower net investment income (-9.5%) but substantial gains in equities as the market losses in 4Q2018 reversed through six months of 2019.

The composite investment mix at 6/30/19 (Table 4) shows a drop in the share of bond holdings wholly offset by a gain in unaffiliated and affiliated stocks. This likely reflects the positive change in the market value for stocks and not a decision by insurers to boost investments in these securities; i.e. the relative value of stock holdings rose in the period. 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	6 Mos. 2019	Change in 2019
Bonds	55.4%	55.1%	54.5%	52.9%	55.3%	53.6%	-1.7%
Unaffiliated Stocks	14.6%	13.7%	14.4%	16.0%	13.7%	15.0%	1.3%
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%	2.7%	-0.1%
Cash & Short-Term	2.4%	2.4%	2.6%	2.4%	2.6%	2.8%	0.2%
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%	4.5%	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.

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, which are marked to market under statutory accounting.

INVESTMENT RESULTS

Net investment yield fell 74 basis points to 2.93% the first half of 2019, one of the lowest reported by an appreciable margin over the past 20 years.

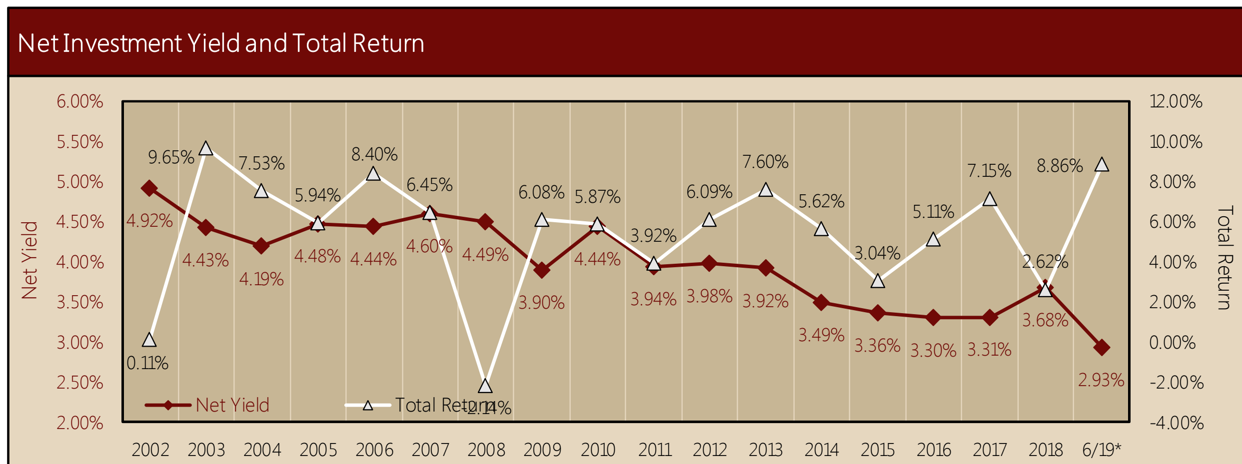
We note that investment income (and hence investment yield) was somewhat distorted by much lower investment income in the first six months of 2019 at large composite insurer Liberty Mutual Insurance Company, which received a substantial dividend in the prior year period tied to the sale of an affiliate. In addition, the composite's investment yield can be whipsawed somewhat by the payment/non-payment of affiliated dividends. All of that said, the ongoing poor trend in investment yield is undeniable.

This is doubly disappointing as we had begun to see a slight resurgence in this ratio since it bottomed out in 2016, reflecting an improvement in U.S. government bond yields in 2017 and 2018. In fact, late last year, insurer management began to speak of new money yields finally surpassing portfolio yields.

However, since hitting cyclical highs of around 3.2% in early November 2018, the yield on the closely-watched 10-year Treasury bond has fallen in half to around 1.6% currently (see chart to the left). This is in part due to fears of a global economic slump which has led the Federal Reserve to reverse course in 2019 (after raising the key federal funds lending rate seven times over the past two years), including a rate cut in July and a pause in its plan to reduce its balance sheet via a quantitative easing program.

In sum, the traditional earnings support of investment income remains challenged which may continue to put a floor under pricing.

Chart 6



* Quarterly results are annualized.

However, total investment return was a bright spot (+8.86%) as broad equity markets rose by almost 14% in 1Q2019 (Table 5), reversing large losses in 4Q. The current total return ratio reflects a 20-year high. These market gains were a major contributor to the industry's 6/30/2019 growth in surplus.

Whether such market gains are sustainable throughout the year remains an open question. While equity market performance in 2Q2019 was decent (at +3.3%), we have seen a substantial retrenchment in markets (-2.6%) in the current quarter as trade war and global growth worries, together with the long tenure of the current bull market, give investors pause.

Table 5

Changes in Stock Market Indices

	2010	2011	2012	2013	2014	2015	2016	2017	2018	1Q19	2Q19	3Q19*
DJIA	11.0%	5.5%	7.3%	26.5%	7.5%	-2.2%	13.4%	25.1%	-5.6%	11.2%	2.6%	-3.1%
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%	-2.5%
NASDAQ	16.9%	-1.8%	15.9%	38.3%	13.4%	5.7%	7.5%	28.2%	-3.9%	16.5%	3.6%	-2.2%
Avg.% Change	13.6%	1.2%	12.2%	31.5%	10.8%	0.9%	10.2%	24.2%	-5.3%	13.6%	3.3%	-2.6%

* As of end of day August 27, 2019

CONCLUSION

The U.S. property & casualty industry is in a "steady as she goes" mode, with near historical average operating earnings on slightly better than break-even underwriting results and (somewhat pressured) investment income. These earnings contributed to additional surplus growth, supplemented in the first half of 2019 by substantial unrealized gains on non-affiliated equities as stock markets surged.

Direct and net premium growth remains anemic, however, despite a strong U.S. economy (= higher exposure units) and gradual rate firming broadly. The struggle to boost revenues could promote an increase in competitive behavior which would likely substantially slow or even reverse the aforementioned current positive direction in rates in the medium term

All that said, businesses in general now function in a world revolutionized by data science – and the insurance sector is no exception. Almost every publicly traded insurer is eager to discuss current investments in digital/data technologies that promise to improve worksite productivity as well as pricing, underwriting, claims handling, and sales/marketing regimens. But these technologies require substantial investment and the ability to afford them may further separate the better performing insurers from their smaller/less nimble peers, resulting in certain of the latter being adversely selected against.

Lastly, economic and capital market conditions remain wildcards, especially after a decade of a bull market in equities and global economic expansion. The expansion of U.S. trade spats with various countries (and especially China), together with saber rattling in the middle east and substantial central bank intervention in a number of large economies, could potentially lead to a loss of confidence generally among consumers, investors and businesses and precipitate the onset of recession.

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