Property Casualty Intelligence Briefing

Inside P&C by The Insurance Insider

July 25, 2019

# THE EXCESS CAPITAL PROBLEM

***How sustainable is an income statement driven hard market?***

On Wednesday morning, Chubb held its Q2 conference call, and expressed confidence the market firming was accelerating, spreading to more territories, and would prove sustainable. Management said the transitioning market was "*income and loss reserve-driven not capital-driven".*

This is a fun statement, for lots of reasons. Not to nit-pick too aggressively, because we understand the intent of the sentence, but if loss reserves are mismarked, this should be a capital problem. Of course, management discretion over the timing of recognition of this mismarking is what historically exacerbated the cyclicality of an already inherently volatile risk-business.

If we take this statement at face value for a second, it's hard not to conclude that its calendar year results that are driving the cycle, not accident year profitability. And cynically, a lot of executive compensation across the industry is tied to calendar year results one way or another - e.g. ROE, BV growth – not ultimate accident year results. And, in our view, incentives are a better predictor of human behavior than expectations of rational competition.

Now we don't mean to clutch our pearls too aggressively and imply we are shocked, shocked that there is gambling going on in this casino. We understand the "cheating phase" is as old as sin in this industry. But it really should raise questions about the number of things that can happen that might rob the industry of its nascent discipline. The most obvious thief of rational competition in this industry is a clean-cat year, though there are plenty of other *plausible* paths (e.g. investment tailwinds).

Now, we believe industry structure is destiny. With low/no barriers to entry and excess capital on the sidelines, ultimately industry cycles are likely to prove "nasty, brutish and short" (= enjoy them while they last). The exception to this is a true exogenous shock to forward expectations, including accelerating loss trends. Though some companies including Travelers and WR Berkley have expressed concern about a challenging tort environment and social inflation, Chubb itself argued loss cost trend is stable at 4.5% in North America commercial lines, even with some notable headline losses driving severity. The ultimate test will come in H1 2020 as companies begin to lap real "rate-on-rate". A little more pain could tip the scales more aggressively. But equally, a clean cat year may just test whether there is more rate than fear in the market.

**Quick Hits:** **Workers Comp in focus as specialist EIG reports**

## INSIDE P&C RESEARCH

**Gavin Davis,** Director of Reserach
gavin.davis@insidepandc.com
(212) 224 3328

**Valerie Zhang,** Lead Analyst
valerie.zhang@insidepandc.com
(212) 224 3495

**Gianluca Casapietra,** Research Analyst
gianluca.casapietra@insidepandc.com
(212) 224 3495

**Dan Lukpanov,** Research Analyst
dan.lukpanov@insidepandc.com
(212) 224 3326

| Index | QTD | YTD |
|---|---|---|
| Large Cap | 3.2% | 25.2% |
| Regional | (0.1)% | 11.7% |
| Specialty | 2.6% | 22.3% |
| Personal | 1.8% | 24.9% |
| Bermuda | 2.1% | 27.8% |
| Florida | (8.5)% | (24.1)% |
| IPC Select | (0.5)% | 9.8% |
| S&P 500 | 2.6% | 20.5% |
| S&P Fin. | 3.3% | 19.8% |

*Source: S&P Global, Inisde P&C*

## CHUBB VERSUS THE EXCESS CAPITAL PROBLEM

- ***Greenberg: "This firming trends is sustainable and will likely to continue to accelerate and spread."***
- ***N.A. commercial renewal premiums +7%, 6.3% pricing 0.5% exposure***
- ***Company believes firming is income driven, not balance sheet***

On Wednesday, Chubb held its Q2 call and provided market commentary very much in line with most competitors and its prior messaging in Q1. Recall, last quarter, the company described the market among the best it has seen in years.

This quarter, management expressed confidence the market firming was accelerating, spreading to more territories, and would prove sustainable.

> *"The pricing environment continued to firm through the quarter, and we took advantage of some of the best pricing we've seen in years. The rate of increase of prices accelerated, while at the same time, it's spread to more classes of business and more classes of risk.…Overall, where rates are moving, they are firming broadly with varying degrees to almost all short and long tail classes. In my judgment, given some of the market dislocation we've observed, including a reset of risk appetite on the part of some, this firming trends is sustainable and will likely to continue to accelerate and spread. It is income and loss reserve-driven not capital-driven.* ***- Chubb CEO Evan Greenberg***

As usual, management's prepared remarks contained a litany of various premium, renewal pricing, and rate movements by class and geography[1]. Overall, the company described North American renewal premium up 7%, with 6.3% due to rate and 0.5% due to exposure. Details by line in table below.

EXHIBIT: CHUBB NA COMMERCIAL PRICE & RATE COMMENTS

*Source: S&P Global, Inside P&C*

| Chubb NA Commercial | |
|---|---|
| | o Price, NA commercial: 7%<br>o Loss cost, NA commercial: 4.5%<br>o Rate, NA commercial: 6.3%<br>o Price, Major accounts: 8.5%<br>o Price, Risk management: 6.3%<br>o Price, Excess casualty: 10%<br>o Price, Property: 18.5%<br>o Rate, Public D&O: 11%<br>o Price, Westchester: 9.5% |

[1] As an aside, while we appreciate the color, if the disclosure is seen as useful to external stakeholders, it sure would be nice to tabulate it and present it on a consistent basis.

We'd argue this is essentially in line with WR Berkley's above 5% and Travelers 3.6% rate and 6.7% renewal premium when factoring in mix differences.

Elsewhere, the company called out other notable rate trends, including 4.5% in middle markets including significant increases in D&O, and 9% increases in London open market, driven by property. See details below.

EXHIBIT: CHUBB MISC. PRICE & RATE COMMENTS

*Source: S&P Global, Inside P&C*

| Segment | Comments |
| --- | --- |
| **Chubb Middle Market & Personal Lines** | o Price, Middle market: 4.5%<br>o Price, Middle market excl. workers' comp: 5%<br>o Price, Primary casualty: 4.5%<br>o Price, Property: 6.5%<br>o Price, Excess umbrella: 6%<br>o Price, Public D&O: 18%<br>o Price, Homeowners: 10% |
| **Chubb London** | o Rate, London open market: 9%<br>o Rate, Property: 23.5%<br>o Rate, Marine cargo: 7.5%<br>o Rate, Aviation: 12%<br>o Rate, Onshore energy: 15%<br>o Rate, D&O: 30% |

Returning to North American commercial, the ~7% written rate increases compare to estimated loss costs of 4.5%, implying a healthy margin expansion, particularly when you factor in…

- The contribution from significant improvement to **terms and conditions**.
- And the impact from **new business** not captured in the renewal metrics but likely underwritten at higher increases – especially business moving from admitted to non-admitted with freedom of rate and form.

Management wouldn't be drawn on an implied margin improvement outlook, describing the future of loss costs as unknowable (fair enough). However, it commented its 4.5% estimate off loss costs was "stable" – even with some variability by line of business, citing some volatility and headline severity from things like #metoo, chemical exposures, D&O trends etc.

In some respect the firm's commentary appears less bearish than several competitors talking about a worsening loss trend, challenging tort environment, and increasing social inflation. On the other, management has been willing to acknowledge underlying margin contraction from rate below loss trends. (See chart below)

One plausible explanation is simply Chubb's long term loss expectations have remained stable but more bearish than the industry and less responsive to short term benign trends seen over the past 5-10 years. However, admittedly, this is pure speculation – another equally plausible explanation is that companies like Travelers are just more willing to give more granular explanations of what's moving the accident year loss ratio to external stakeholders.

- Recall, **Travelers** explained its 1.3pt deterioration in BI was driven in part by 1pt of non-cat weather, 0.5pts of run-rate charges relating to higher loss trends in commercial auto and general liability (primary and excess), with a further 0.5pts related to trueing up Q1 for the same trend – partially offset by lower large losses.
- **RLI** pointed to higher non-cat weather and fire and marine losses in property.

EXHIBIT: TRAVELERS BI – UNDERLYING COMBINED PT. CHANGES

*Source: Company Reports, Inside P&C*

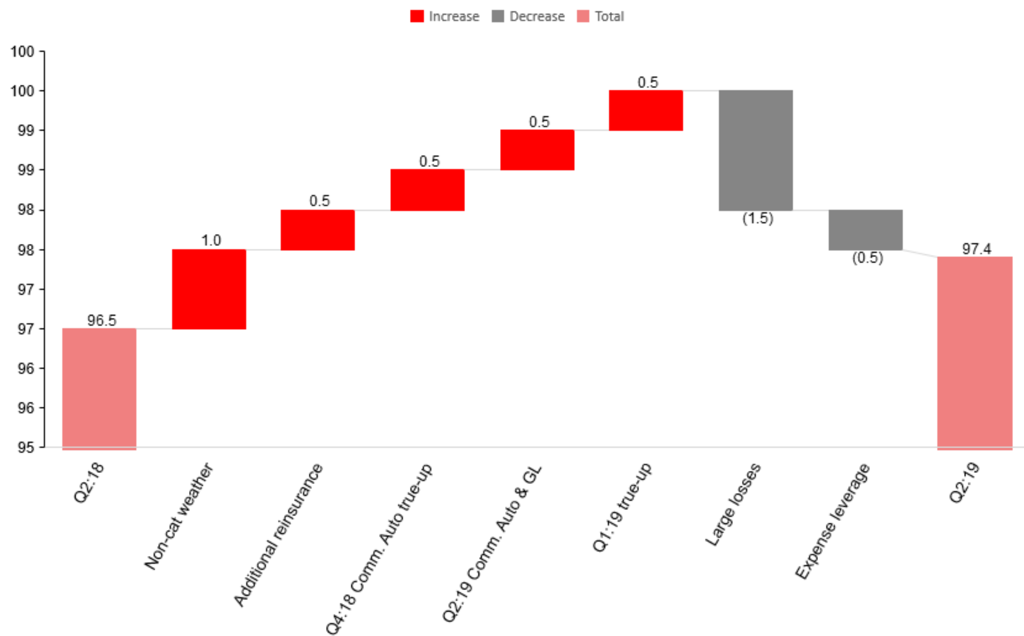
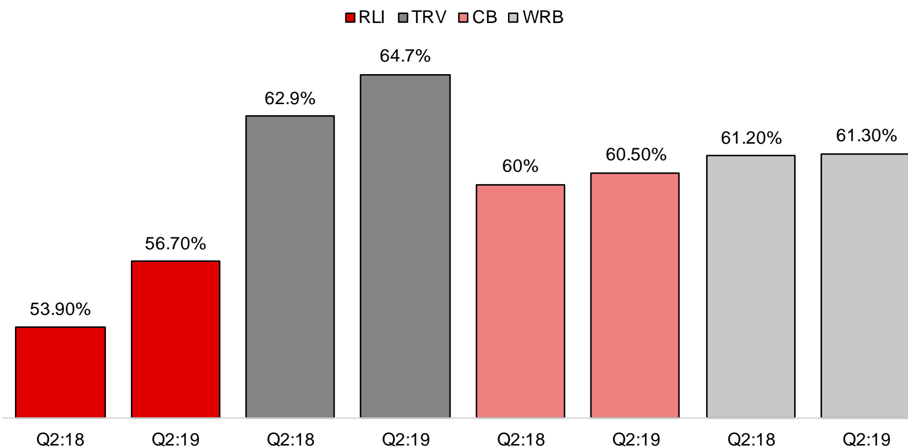



EXHIBIT: EX-CAT ACCIDENT YEAR LOSS RATIO DETERIORATING

*Source: Company Reports, Inside P&C*



## On the sustainability of an income driven firming

Now, we respect the Chubb management team as one of the best in the business. Like most other external analysts we weigh their words heavily and with great significance. When Chubb says the market is moving, accelerating and spreading, we don't think they are kidding around. The company judiciously uses its market leadership, carrying a big stick in private but often talking softly in public.

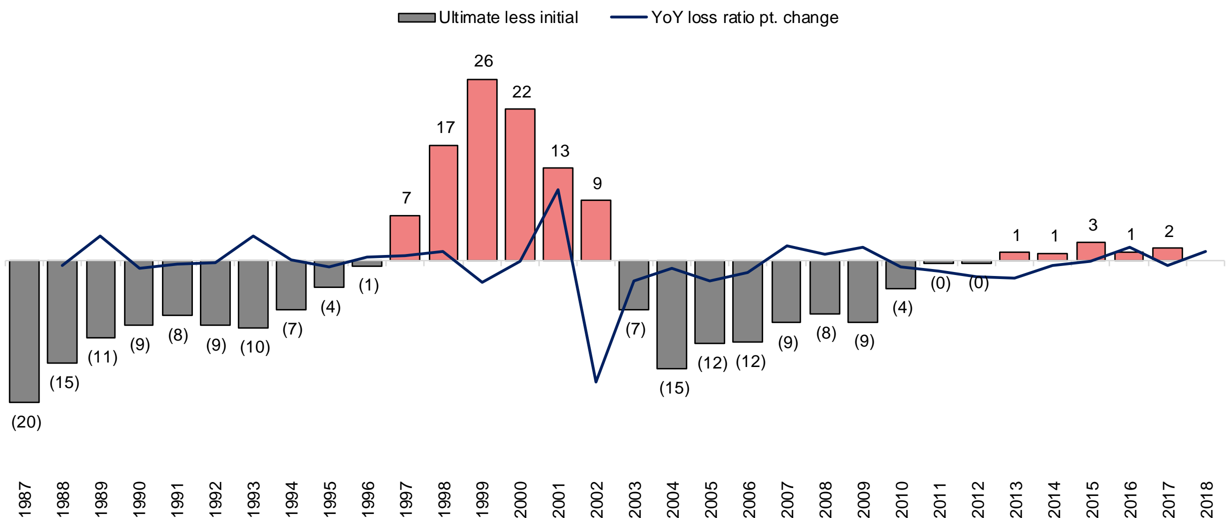
But by far the most interesting comment on the call came when CEO Evan Greenberg described the transitioning market as "income and loss reserve-driven not capital-driven".

This is a fun statement, for lots of reasons. Not to nit-pick too aggressively, because we understand the intent of the sentence, but if loss reserves are mismarked, this should be a capital problem. Of course, management discretion over the timing of recognition of this mismarking is what historically exacerbated the cyclicality of an already inherently volatile risk-business.

For example, just for illustration, we show other liability occurrence P&C industry results in the chart below, highlighting the inherent stability of calendar year loss picks relative to wild swings in true ultimate profitability.

EXHIBIT: OTHER LIABILITY YOY INCURRED LR CHANGE VS. ULTIMATE TO INITIAL CHANGE

*Source: S&P Global, Inside P&C. Note: "Ultimate" = most recently stated period.*

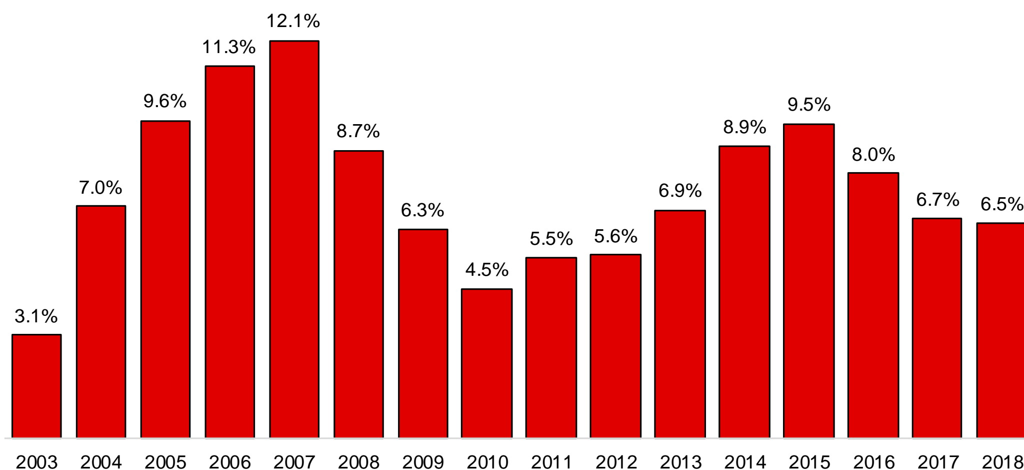



If we take this "income driven" statement at face value for a second, it's hard not to conclude that its calendar year results that are driving the cycle due to lower releases, not accident year profitability. And reported trailing returns in this industry have not reached levels of prior cycle nadirs (see chart below).

Indeed, Travelers CEO Alan Schnitzer this week pointed to a different starting point on return adequacy relative to 2011 on Travellers call Tuesday.

EXHIBIT: P&C INDUSTRY 3YR ROLLING RETURN ON SURPLUS

*Source: S&P Global, Inside P&C*




Cynically, a lot of executive compensation across the industry is tied to calendar year results one way or another - e.g. ROE, BV growth – not ultimate accident year results. And, in our view, *incentives are a better predictor of human behavior than expectations of rational competition.*

Now we don't mean to clutch our pearls too aggressively and imply we are shocked, shocked that there is gambling going on in this casino. We understand the "cheating phase" is as old as sin in this industry.

But it really should raise questions about the number of things that can happen that might rob the industry of its inchoate discipline. The most obvious thief of rational competition in this industry is a clean-cat year, though there are plenty of other plausible paths (e.g. investment tailwinds).

**Now, we believe industry structure is destiny**. With low/no barriers to entry and excess capital on the sidelines, ultimately industry cycles are likely to prove "nasty, brutish and short" (= enjoy them while they last). The exception to this is a true exogenous shock to forward expectations, including accelerating loss trends.

Though some companies including Travelers and WR Berkley have expressed concern about a challenging tort environment and social inflation, Chubb itself argued loss cost trend is stable at 4.5% in North America commercial, even with some notable headline losses driving severity.

The ultimate test will come H1 2020 as companies begin to lap real "rate-on-rate". A little more pain could tip the scales more aggressively. But equally, a clean cat year may just test whether there is more rate than fear in the market.

Recall, Broker Brown & Brown CEO J Powell Brown that there "is 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". Ultimately, that excess capital is likely going to be tested as to just how disciplined it is.

## WORKERS COMP IN FOCUS AS SPECIALIST EIG REPORTS

- ***Commentary from Travelers and WR Berkley points to continued lower rates but also continued favourable loss trends***
- ***Employers Holdings AY loss ratio up 3.7 points in Q2, with the all-in loss ratio aided by the PYD ratio (down 4.2 points)***

Employers Holdings earnings provides the first pure-play view on the workers' compensation business, and though its relatively small relative to the view of the national players, it provides an interesting lens on a market that is facing significantly different trends to the segments of P&C getting the most attention.

Employers Holdings' earnings press release is usually muted on industry trend commentary, with most of the pricing information typically delivered on the conference call. But notably, following pricing that has been down at or above double digits for five consecutive quarters, the firm is showing signs of strain on its expense ratio and accident year loss ratio. Details below.

Recall, this quarter's earlier reporters - **Travelers** and **WR Berkley** – already provided some indicators on how the business developed in Q2. In short, it looks no different from recent trends.

**WR Berkley** reported 4.1% percent rate declines in workers' comp and highlighted that the state rating bureaus' actions are adding to the impact of a competitive marketplace.

"You have seen action, and you continue to see action by state rating bureaus that is pretty aggressive in our opinion", said CEO Rob Berkley.

However, the company noted there is a potential for reversal.

"There is a lot of data that would suggest that you're going to see a tick up particularly in the frequency line. I think as we touched on last quarter, I will reference again in a tight labor market, when you have more people working overtime and you have a lot of people and jobs that they are not as well trained for, that's often time where you have accidents and, unfortunately, people can get hurt and that can lead to frequency".

Travelers did not report a rate change in Q2 for workers' comp, alluding to competitive sensitivity, but made it clear that the recent trends persist for the business, describing them as a negative tailwind to overall pricing disclosed.

Similarly the company saw continued stability on loss trends, describing it as "behaving well".

"What you see this quarter is simply another quarter's worth of data where things had come in more favorably than what we would have embedded in the prior pick," company executives explained.

# Employers Holdings reports lower EPS YoY on higher underwriting expenses, higher AY loss ratio.

The workers' compensation specialist Employers Holdings reported 4.3% YoY decline in adjusted EPS in Q2.

The result was largely driven by a higher underwriting expense ratio (up 2.5 points on the combined) and a higher accident year loss ratio (up 3.7 points), partially offset by more favorable prior year development (down 4.2 points) and higher NII.

EXHIBIT: EMPLOYERS HOLDINGS' Q2 RESULTS

*Source: S&P Global, Inside P&C*

**Employers Holdings**

| Line Item ($mn) | Q2-18 | Q2-19 | y/y chg |
|---|---|---|---|
| **Diluted EPS** | **0.94** | **0.90** | **-4.3%** |
| Gross written premiums | $186 | $177 | -5.3% |
| *Prior year* | *-9.3%* | *-13.5%* | *-4.2pts* |
| *AY loss ratio* | *62.5%* | *66.2%* | *+3.7pts* |
| Loss ratio | 53.2% | 52.7% | -0.5pts |
| Comission expense ratio | 13.8% | 13.5% | -0.3pts |
| Underwriting and other expense ratio | 22.5% | 25.0% | +2.5pts |
| **Combined ratio before LPT** | **89.5%** | **91.2%** | **+1.7pts** |
| Impact of the LPT on the combined | -3.9% | -3.2% | +0.7pts |
| **Combined ratio** | **85.6%** | **88.0%** | **+2.4pts** |
| Underwriting gain (loss) | $25.6 | $21.1 | -17.6% |
| NII (loss) | $20.3 | $21.4 | 5.4% |
| BVPS | $29.20 | $35.15 | 5.8% q/q |
| Adjusted ROE (annualized) | 18.0% | 14.8% | -3.2pts |

*Source: Company reports, Inside P&C*

Other notable items included:

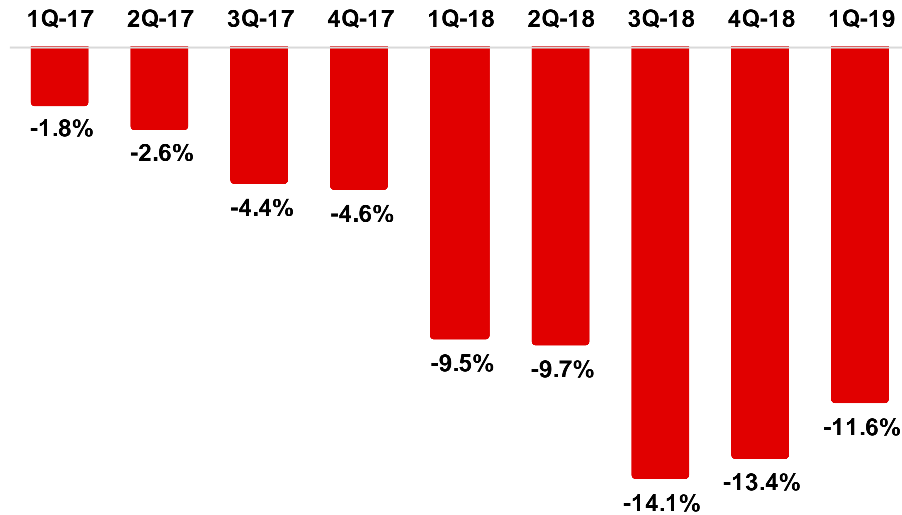
- Gross written premium down 5.3% YoY, most likely due to continued headwinds from workers' comp pricing pressure.
- Net investment income up 5.4%.

On the renewal premium and rate changes, Employers Holdings normally discloses the numbers on the conference calls that is scheduled to hold on Thursday at 11:30 ET.

Of note, the company reported renewal rate decreases at or near double-digits for five consecutive quarters (see chart below).

EXHIBIT: EMPLOYERS HOLDINGS' RENEWAL RATE CHANGE

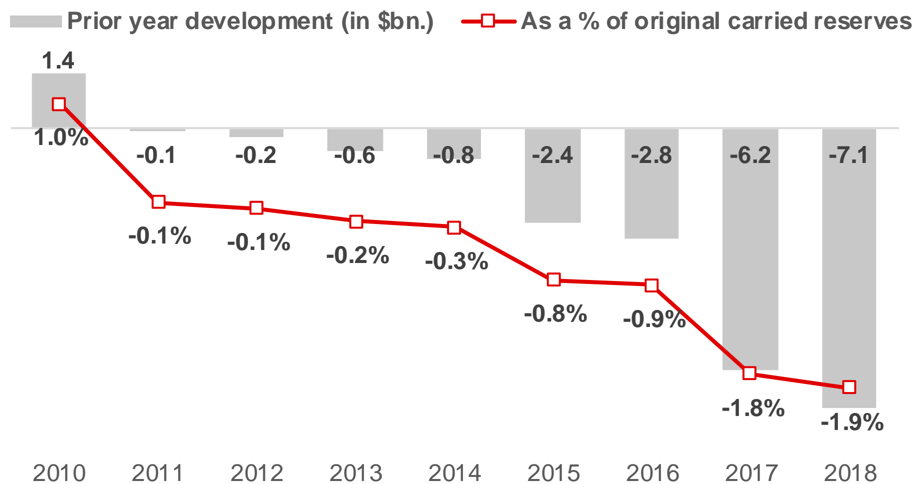
*Source: S&P Global, Inside P&C*




Recall, the price competition in Workers comp comes amid a period of extremely benign loss trends. Overall industry workers' comp reserves has not developed unfavorably since 2010 (see chart below).

EXHIBIT: P&C INDUSTRY WORKERS' COMP PRIOR YEAR DEVELOPMENT (STATUTORY DATA)

*Source: S&P Global, Inside P&C*



This research report was written by Insider Publishing's Research team which includes Gavin Davis, Valerie Zhang, Gianluca Casapietra, and Dan Lukpanov.

The content of this report is the copyright of Insider Publishing Ltd. All rights reserved. Registered in England 3923422. Insider Publishing actively monitors the usage of our reports, emails and websites and reserves the right to terminate accounts if abuse occurs. No part of this report may be used, reproduced or stored in an information retrieval system or transmitted in any manner whatsoever without prior consent from Insider Publishing

For further information on what you can, and cannot do with the information contained within this report, please refer to our Terms & Conditions page on our website. Insider Publishing Limited - 3rd Floor, 41 Eastcheap, London, EC3M 1DT, United Kingdom.