

July 22, 2019

Q2: SO WHERE'S THE PAIN?

It's clear that pricing is improving. But how widespread is the pain that's driving it? (It's not just AIG & Lloyd's).

Q2: Pricing is accelerating. So where's the pain?

With pricing accelerating, we expect to get a lot of data and anecdotes over the coming weeks on various lines, segments, and geographies with the most momentum. Folks like us are going to do a lot of analysis and make a lot of charts based on what data – structured or otherwise – we get on market intelligence.

But we must always be mindful that we are analyzing an incomplete data set that may have a sample bias, due to selective disclosure, that makes it non-representative of the underlying population.

Insurance is a cyclical, competitive commodity-like business with low-to-no barriers to entry. It is a truism that improving pricing is only generated by bad results, whether from inflation and loss cost trends or from investments and interest rates (or something else).

Given industry structure, this is axiomatic. Therefore, in our view, our focus should less be on the pricing disclosures and more on understanding why the pricing has been achieved. The simple truth is, without any other context, reporting “positive trend” should be seen at least as much as a red-flag on prior accident year strength and accident year loss picks as it is a signal of a company riding the tide of higher market prices. Much blame will be attributed to the “usual suspects” of AIG and Lloyd's. However, we doubt they are the only ones cleaning house.

Next up: Travelers Q2 on Tuesday morning

Travelers' earnings are highly watched by competitors and investors alike as an early data-point and a reasonable proxy for the broader P&C market. With increased evidence of dislocation and hardening markets in some segments of P&C, the firm's disclosures are likely to face even more heightened scrutiny as a proxy for how far the impact in large and complex risk segments is spreading to businesses covering more mainstream exposures.

Non-Florida cats and 2018 creep chips away at Floridians

One notable trend last week was a series of cat pre-announcements from the Florida cohort of companies, linked to either non-Florida cat activity in Q2 or else a return of loss creep on prior year events. **Details below.**

Quick hits:

- CoreLogic sees Barry losses of \$300mn to \$600mn

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Index	QTD	YTD
Large Cap	2.0%	23.7%
Regional	0.0%	11.8%
Specialty	1.6%	21.1%
Personal	0.9%	23.8%
Bermuda	1.2%	26.8%
Florida	(8.1)%	(23.6)%
IPC Select	(1.1)%	9.1%
S&P 500	2.1%	19.8%
S&P Fin.	1.0%	17.1%

Source: S&P Global, Inside P&C

Q2: PRICING IS ACCELERATING. SO WHERE'S THE PAIN?

- ❖ *Accelerating pricing is now a consensus view, and we expect to hear a lot about it*
- ❖ *Early data points suggest positive surprises against even elevated expectations*
- ❖ *The major known unknown is how widespread the pain is that's driving the market = it's probably **NOT** just AIG and Lloyd's*

Heading into Q1 earnings, our primary research leveraging an extensive network of industry contacts made clear to us that there is real “fear” in many pockets of P&C market leading to significant dislocation and re-underwriting actions in localized segments of the market.

This was originally considered controversial by many, and somewhat dismissed as sensationalism after the first reporters out of the gate firmly signaled “nothing to see here”. However, by the end of earnings season the view had gone from controversial to consensus in the matter of weeks as more data points emerged.

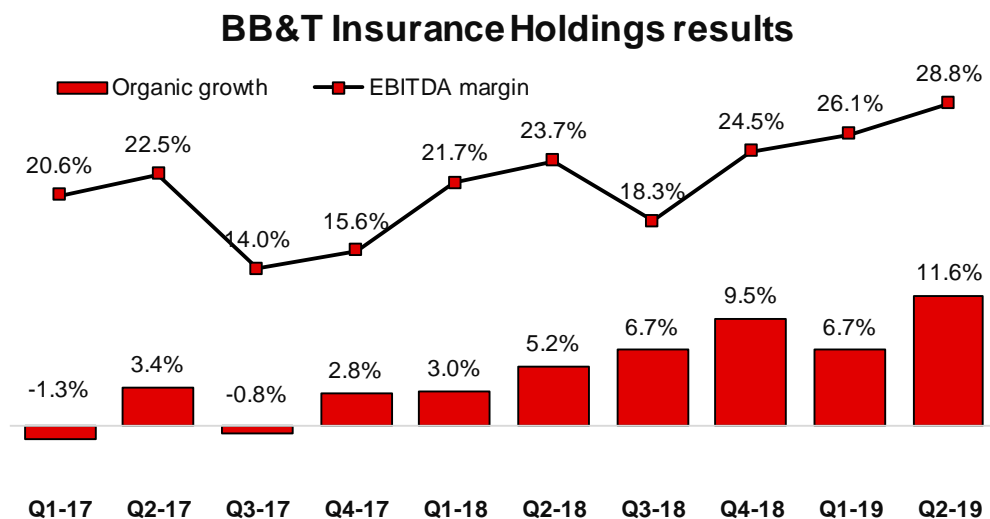
We still believe the commercial P&C market is at the beginning of a rational price correction. By rational we mean pricing is responding to losses in localized micro-cycles, and not occurring uniformly regardless of line or geography.

We see the net-balance of the new information disclosed by firms in **Q2** to date has provided further evidence of a change of risk appetite and a shifting competitive environment in broader commercial P&C markets.

Despite elevated expectations coming into Q2, **BB&T's earnings report Thursday** may have raised the bar a notch or two. The bank's insurance operations reported record organic growth at 11.6%, high-teens revenue growth, substantially better margins, and an improved pricing environment in P&C.

EXHIBIT: BB&T INSURANCE HOLDINGS RESULTS

Source: Inside P&C, company reports



Separately, **RLI**, the other company to report to date, admitted to having “underplayed” the level of market change it was seeing last quarter, and spoke bullishly of seeing multiple pockets of disruption driven by shifts in competitor risk appetites.

The company said it was seeing E&S submission flow up single digits but more pronounced in specific niches, with pricing in property +3-4%, casualty +5%, GL and commercial umbrella +mid-single digits, and commercial auto +14% (though with plenty of underpriced business still at those levels). So far so good.

EXHIBIT: RLI EARNINGS CALL – RATE COMMENTARY

Source: S&P Global, Inside P&C

<div data-bbox="237 751 306 791">RLI</div>	<ul style="list-style-type: none"> - Casualty prices up 5% in the quarter - "Growing momentum behind the rate levels, particularly in the management liability, excess liability and transportation businesses." - Transportation rate up 14% - "commercial auto market still contains a lot of underpriced business that is unattractive to us." - "The market seems to be responding rationally to where the pain has been felt most, either raising rates or redefining appetites." - "Overall, we view casualty as an improving market." - Marine rates up about 5% YTD - Property rates up 3% - 4%, "we feel good about that". - "2/3 of our overall growth is coming from organic opportunities, products we've been in for a long, long time." - "Commercial umbrella mid-single-digit increases." - GL mid-single-digit increases, mostly E&S, casualty.
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“Invert, Invert. You must always invert”: So where’s the pain?

In World War II (...bear with us for a second), mathematician Abraham Wald was given the task by the US air force of analyzing bomber survival rates to decide how to better reinforce planes to survive anti-air craft guns. At the time, the dominant view was to reinforce planes with additional armor where there was clear evidence of bullet holes on returning planes, on the assumption they must be most vulnerable in those places.

Borrowing a concept from a 19th century mathematician Carl Jacobi, Wald “inverted” the problem. Instead of analyzing the data he did have – the planes with the bullet holes – he set out to analyze the data he didn’t have – the planes that didn’t make it back.

Wald’s essential insight was that he had been given the task of studying a data sample with a natural sample bias that did not reflect the data he needed to answer the question assigned to him.

Without any data and based on logical inference and intuition, he rejected the premise of the prior analysis, analyzed instead where he found no-bullet holes on returning planes, and hypothesized those areas were where the planes that did not return were being catastrophically hit. His hunch was (much) later proved by computerized statistical modelling.

This process of “inverting the problem” has famously been adopted into the business lexicon by Warren Buffett’s long term business partner Charlie Munger, the vice chairman of Berkshire Hathaway.

And so it is with Q2 earnings season. With pricing accelerating, we expect to get a lot of data and anecdotes over the coming weeks on various lines, segments, and geographies with the most momentum. Folks like us are going to do a lot of analysis and make a lot of charts based on what data – structured or otherwise – we get on market intelligence.

But we must always be mindful that we are analyzing an incomplete data set that may or may not have a sample bias that makes it non-representative of the underlying population (e.g. the full market rate movements, or the loss context driving it).

Insurance is a cyclical, competitive commodity-like business with low-to-no barriers to entry. It is a truism that improving pricing is only generated by bad results, whether from inflation, loss cost trends and reserves, or from investments, interest rates, or something else.

Given the industry structure, this is axiomatic. Therefore, in our view, our focus should less be on the pricing disclosures and more on understanding why the pricing has been achieved. The simple truth is, without any other context, reporting “positive trend” should be seen at least as much as a red-flag on prior accident year strength and accident year loss picks as it is a signal of a company riding the tide of higher market prices.

We expect much blame will be attributed to the “usual suspects” of AIG and Lloyd’s but we doubt they are alone in needing to clean house and take remedial action. Not everyone is riding a rising tide.

Note, admittedly this sample error of pricing disclosures can work in both directions. One the one hand, selective pricing disclosure by line of business is likely to skew positive, with less information given on underperforming lines.

EXHIBIT: CHUBB Q1 EARNINGS CALL – RATE COMMENTARY

Source: S&P Global, Inside P&C

Chubb

- Major Accounts renewal pricing up 4.8%
- Risk management, pricing up 5%
- Excess casualty, pricing up 7%
- Property pricing, up nearly 9%
- Public D&O rates, up 5.5%
- Westchester, pricing up 8%
- Middle Market pricing up 3%; up 4.2%, ex-Workers’ Comp
- Primary casualty, pricing up 7%
- Excess umbrella, pricing up 4.3%
- D&O, pricing up 9%
- Homeowners, pricing up over 8%
- International Retail rates up 2%
- London Wholesale open market business, rates up over 8%
- Property, rates up over 8%
- Financial Lines, rates up 13%
- Marine, rates up 6.5%
- Aviation, rates up 18%.

However, our view is that the market-wide and highly cited rate trackers (e.g. Travelers renewal business insurance premium) can be similarly biased.

For example, indexes that focus only on *renewal* business miss the action on new business. In a high churn market this is where a lot of the pricing action is occurring, particularly for accounts moving from admitted to non-admitted markets.

Some back of the envelope math to illustrate. If renewal premium is 80% of the book, and is up 2.5%, and new business is 20% of the book, and is estimated up 10%, this would be comparable to a 4% rate increases on a weighted average basis. But the renewal premium tracker would show just 2.5%.

Similarly, our view is that the changes in risk appetite, on limits deployed, deductibles applied, and other terms and conditions changes, are likely to have a more meaningful impact on ultimate losses than pure pricing, which may not always be captured in company pricing disclosure.

This is why a “mosaic theory” approach is preferable, including granular pricing details, terms and conditions changes, new business flow, E&S submissions = trying to capture the directional shifts of the market rather than the precise temperature. Our view is that a barometer works better than a thermometer.

Loss costs: The “bullet hole” data we won’t get

As we noted above, while accelerating price increases speaks to improving conditions, it does not necessarily promise improving results.

Margin expansion depends more on the differential in the velocity of rate increases and loss cost trends. Unless rate increases outpace loss cost trends, margins are unlikely to expand and could even contract.

This is especially true if recent accident years have not been picked at accurate levels to reflect loss cost trends and require “trueing up”, as was widely seen in Q4 with commercial auto results (despite high headline rate increases).

In the mean time, there is ample evidence the velocity of loss cost trends may be accelerating in several lines, with D&O, commercial auto, medical malpractice and multiple segments within E&S, all showing signs of stress to name but a few.

Selective CEO Greg Murphy summarised this phenomena succinctly last quarter.

“Under the theme of arithmetic has no mercy, with expected loss trends up in the 3% to 4% range, the only map that improve industry-wide combined ratios is earned rate in the 5% to 6% range. Over time, generating renewal pure price increases over expected loss trend is the only way to maintain and improve profitability,” he said.

However, this data is rarely given with much specificity if at all, and tends to be spoken of only in generalized commentary. In our view, the lack of granular loss cost information is the bullet hole data we don't have that makes the pricing data we do have less helpful.

Recall, last quarter, what limited disclosure there was contained in disclosure pointed to management teams believing rate increases are either at or better than the loss cost trends.

- **AIG**, "We're seeing broad-based market support for premium rate increases across multiple line at or better than our loss cost trends."
- **Chubb**, "Overall loss cost is behaving and we have not seen deteriorating overall. On a written basis, overall rates equaled loss cost trend."
- **Selective**, "Renewal pure price increases that on average were in line with expected loss trends."
- **TRV**, "Pricing and loss cost trends are in harmony on an earned basis. On a written basis, doing little bit better."
- **WRB**, "Getting 6.4% rate increase for the portfolio overall is well outpacing in all likelihood loss cost trends."

It is widely known that losses in commercial auto have surged, driven in part by higher attorney participation. So far, companies have largely only disclosed a more aggressive plaintiff bar in commercial auto and smaller end of general liability. But we think it is possible to spill over to other lines of business.

For example,

- **Medical Mal practice**: ProAssurance warned last quarter of rising severity in **health care liability**, driven by the increasing number of large verdicts, plaintiff attorneys' demand and larger underlying losses.
- **D&O**: Losses are climbing in **D&O** driven by increased frequency, higher severity and extended tail of loss development. The number of class action suites almost doubled in 2018 compared with 2015, mostly attributable to more merger objection lawsuits. This in turn drove up attorney expenses and settlement costs.

These lines will be key to monitor in Q2.

More broadly, a combination of macroeconomic forces (low unemployment, anti-immigration, trade wars) and populist political pressures all point to a potential for exogenous shocks to loss trends, with little potential for upside surprises given recent benign trends. Though this type of macro-forecasting is a fool's errand, it seems reasonable to say the risks at least appear asymmetrically skewed to the downside.

Ultimately we expect a lot of disclosure and commentary on pricing, and therefore a lot of analysis on pricing trends by industry watchers. However, we expect limited disclosure on loss cost trends, given in only the most generalized ways. More's the pity.

NEXT UP: TRAVELERS Q2 ON TUESDAY MORNING

Travelers' earnings are highly watched by competitors and investors alike as an early data-point and a reasonable proxy for the broader P&C market.

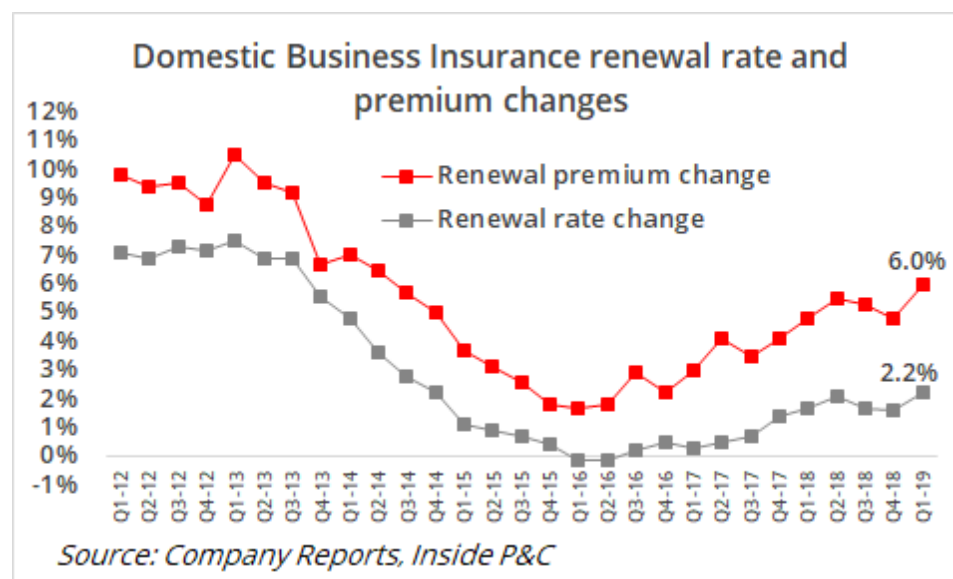
With increased evidence of dislocation and hardening markets in some segments of P&C, the firm's disclosures are likely to face even more heightened scrutiny as a proxy for how far the impact in large and complex risk segments is spreading to businesses covering more mainstream exposures.

Recall, last quarter Travelers reported renewal rate change in Business Insurance (BI) of 2.2%, the highest level since Q4:14. Similarly, renewal premium change, which includes the impact of higher exposures, reached 6.0%, the highest level since Q2:14.

Similarly, management commentary was relatively balanced, but described rate momentum as "reasonably broad-based" (ex-workers com). It will be interesting to parse the firm's commentary for a change in attitude from Q1, including its updated margin outlook for earnings guidance contained in its 10-Q each quarter.

EXHIBIT: TRAVELERS BUSINESS INSURANCE RATE CHANGE

Source: S&P Global, Inside P&C



Now, the 2.2% headline rate increase highlighted above is well below prior "hard market" levels and even below the prior market firming in 2011-2014.

However, it is worth noting the sequential rate change from Q4 of +0.6% was also the largest disclosed increase since at least the last cycle turn in 2010/2011 absent the fourth quarter of 2017 immediately following the impact of major hurricane losses - likely due to a one-time benefit to property pricing.

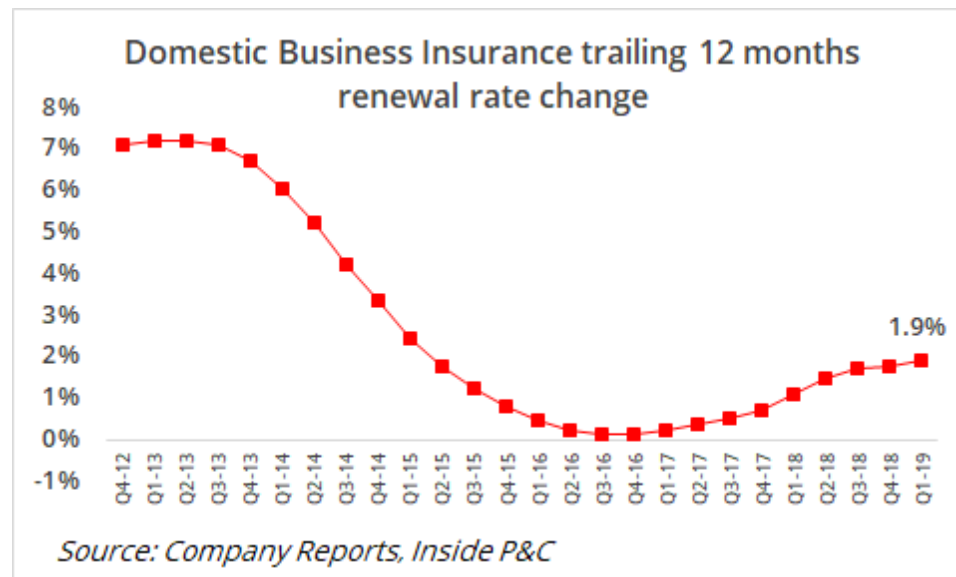
As such, measuring the pace of improvement in Q2 may be as important as the actual absolute level of rate increases reported.

We note another important factor is the context of historical pricing. It is important to remember that previous “market turns” came after periods of price *reductions*. This has meant the first price actions have largely only taken companies back to where they were a year ago, with second-year “rate-on-rate” adjustments and beyond driving the margin improvement action.

Looking at Travelers’ pricing disclosures since the end of the last hardening market, we note trailing pricing got close to zero but never actually turned negative. This gives further evidence to a secularly improving industry rationality, driven by better data and reduced cycle times for the feed-back loop between losses and pricing. The predicted and likely actual outcome of this secular change would be for firmer markets to have lower peaks of absolute rate increases.

EXHIBIT: TRAVELERS SMOOTHED BUSINESS INSURANCE RATE CHANGE

Source: S&P Global, Inside P&C



NON-FL CATS AND 2018 CREEP CHIPS AWAY AT FLORIDIANS

- ❖ **UIHC: \$16mn net cat losses, 2.3% common equity after-tax (A/T)**
- ❖ **Heritage: \$21.5mn net cat losses, 3.9% common equity A/T**
- ❖ **FedNat: \$9.3mn net cat losses, 3.4% common equity A/T**

Despite an otherwise quiet period for cat pre-announcements, one notable trend last week was a series of disclosures from the Florida cohort of companies, linked to either non-Florida cat activity in Q2 or else a return of loss creep on prior year events.

On Friday, United Insurance (UIHC) announced that it expects to incur approximately \$16mn of net retained cat losses for Q2-19. The losses stem from wind and hail events in Texas and Louisiana.

The firm also experienced \$15mn of adverse reserve development related to 2018 cat and non-cat losses primarily in Florida.

The announcement follows Heritage's July 17th press release which stated it expects \$21.5mn in weather related losses, also from wind and hail storms.

FedNat also reported last week that it estimates to absorb \$9.3mn in net catastrophe losses from 12 events related to storms generating hail or high winds. Gross losses amounted to \$17mn, \$15.5mn of which stem from the company's non-Florida property business.

FedNat's non-Florida losses are subject to a 50% profit sharing agreement with MGU that writes its non-Florida business.

From a reinsurance perspective, as the losses primarily come from an accumulation of smaller non-Florida weather events, per occurrence treaties look likely to have been spared. However, quota shares may carry some losses, and aggregate covers depending on how the rest of the year plays out.

The following table outlines the post-tax per-share, and the common equity impact of the cat events described above.

EXHIBIT: CAT EFFECTS – PER SHARE & % COMMON EQUITY

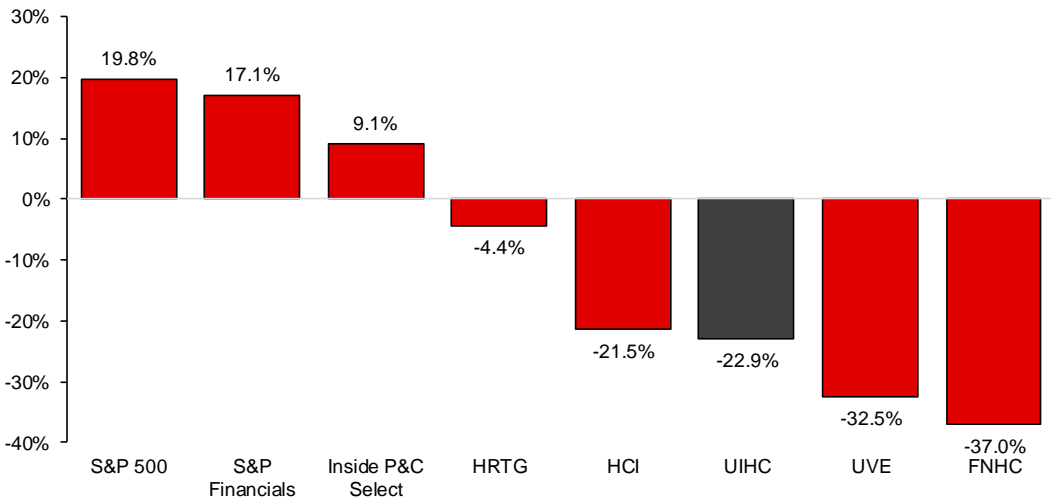
Source: Company Reports, Inside P&C

Firm:	Est. losses (\$mn)	Dil. EPS Impact	%common equity	Notes:
UIHC	16.0	0.30	2.3%	Wind & hail , Texas / Louisiana.
Heritage	21.5	0.57	3.9%	Four wind & hail storms in the southeast, compares to \$9.4mn in Q2-18
FedNat	9.3	0.57	3.4%	\$17mn gross, hail and wind related storms from 12 cat events

Floridian shares continue to underperform both the market and other P&C sub-segments this year, as persistent loss creep and the prospect of higher reinsurance costs raise questions about the true level of normalized earnings power. The group is down 24% YTD on average, with UIHC down 23%.

EXHIBIT: YTD FLORIDIAN SHARE PRICE PERFORMANCE

Source: S&P Global, Inside P&C



QUICK HITS

CoreLogic sees Barry losses of \$300mn to \$600mn

CoreLogic has estimated private market insured flood and wind losses from Hurricane Barry at between \$300mn and \$600mn.

Total flood and wind losses from Barry are likely to be between \$500mn and \$900mn.

The agency said that the larger proportion of overall losses would come from wind, with these estimated to be around \$300mn-\$500mn.

CoreLogic estimated flood losses for Louisiana residential and commercial properties at around \$200mn- \$400mn.

CoreLogic added that some \$100mn to \$200mn of residential and commercial flood loss would be covered by the National Flood Insurance Program (NFIP), with 500,000 residential and commercial property policies in Louisiana insured through it.

The company estimated insured flood losses for private insurers at less than \$100mn, and said uninsured flood loss was likely to be \$100mn.

The analysis covers residential homes, commercial property, contents and business interruption.

CoreLogic's estimates come after fellow risk modeller RMS predicted that insured losses from Barry would be less than \$500mn, with around half being covered by the NFIP.

Karen Clark & Company had earlier predicted that private market losses from Hurricane Barry would be around \$300mn.

As such, all three firm's estimate private insured losses of ~\$300mn, though the higher range in CoreLogic's estimate stands out as more pessimistic.

Barry was the second named storm and first hurricane of the North Atlantic hurricane season and made landfall near Intracoastal City in Louisiana on 13 July as a Category 1 hurricane.

It spared New Orleans a direct hit, though some levees were damaged in less populated areas of the city.

The storm brought torrential rain to areas of Alabama, Arkansas and Louisiana, but not the forecast 25 inches. Certain areas had around 3-6 inches of rain.

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

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