Q3 earnings and known unknowns

"…because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say, we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know." – Donald Rumsfeld, 2002

As we head into the earnings, the above statement sums up the broader themes that will play out over the next few quarters. Much of the focus has been on catastrophe losses which fall under the "known known" category. However, the chatter on stagflation, which is a "known unknown," deserves greater scrutiny.

Stagflation – as the portmanteau indicates – is a stagnating economy with a rising inflationary environment. A combination of choked economic growth due to supply-side constraints overlapping with an uptick in inflation could end up having a broader impact, including on the insurance sector.

That impact will be felt more acutely by longer-tailed commercial lines, which face a potential negative on both the asset and liability sides as well as top-line constraints. For reinsurers, it will be a case of follow-the-fortunes depending on business mix, while personal auto insurers may react better due to the shorter-tailed nature of their business.

In the discussion below, we focus on some of earning's long-term themes and the potential short-term takeaways that we believe deserve more attention.

1. **How prepared is the industry for the prospect of stagflation?**

With slower economic growth and higher unemployment, the prospect of stagflation (albeit not the 1970s version that included double-digit inflation) looms large. The historical context provides an interesting correlation of a delayed rise in combined ratio following inflationary peaks. Unlike the 70s and 80s, interest rates will stay in the single digits, and the industry will have to eke out margin on the underwriting side.

2. **Could the reinsurer/cedent dynamic be shifting?**

With favorable reinsurance pricing over the past few years, cession rates have ticked up. Despite reinsurers exclaiming that this renewal season will be the one to finally procure desired rate increases, industry capital has not seen enough of a reduction thus far this year to support a materially different renewal season.

3. **Are rating models in personal auto sustainable?**

Recent court rulings are once again raising ethical issues in personal auto pricing. Removing credit scores from the rating models could balance the playing field for low-income drivers. The change, already the norm in much of the world, would allow a short-term advantage for some carriers, with Allstate and Root already touting their telematics capabilities. However, telematics brings its own set of biases – with low-income drivers more likely to be participating in risky activities that will raise their rates.

4. **Will commercial pricing support growth rates in broking?**

Commercial pricing commentary will be a topic of focus as investors increasingly consider the market capable of sustaining high single-digit rate hikes. Marketscout's data that came out last week showed a surprisingly high price increase of 6.8% for Q3 21 vs 5.9% for Q2 21 and 7% for Q1 21.

Truist, the first broker to report Friday, noted high but moderating organic growth in its wholesale broking business, in line with other broker projections for the quarter. Truist pointed to P&C rate increases comparable to Q2 and new business opportunities from the improving economy.

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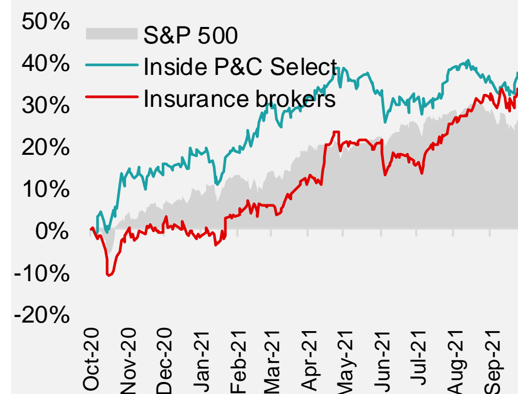
Composite	YTD px chg.	P/B
Large comm.	27.1%	1.1x
Regional	32.1%	1.6x
Specialty	25.1%	1.8x
Personal	(0.6)%	1.9x
Bermuda	10.0%	1.1x
Florida	23.0%	1.2x
Brokers	35.4%	-
IPC Select	17.6%	1.3x
S&P 500 Fin.	31.9%	-
S&P 500	18.2%	-

1YR Price Peformance



Source: S&P Global, Inside P&C

Travelers will kick off Q3 earnings tomorrow, with RLI, WR Berkley, and Marsh McLennan releasing their figures later this week. Following these will be a frenzy of releases over the next two weeks.

Results are expected to include better growth and underlying loss ratios from the robust pricing environment offset by heavy catastrophe losses in commercial lines.

Brokers are also set to benefit from the quarter's favorable pricing and economic expansion, with strong organic growth rates and some margin expansion.

On the other hand, personal lines are likely to see margin contractions given worsening loss cost trends outpacing rates.

Reinsurers may also find themselves in a tough quarter, with catastrophe losses wiping away profits.

In this report, the Inside P&C Research Team investigates each of these issues and their potential impact on the industry's future.

Prospect of stagflation

Whispers of stagflation have begun to circulate through the economy, as the Delta variant and supply chain issues that are depressing GDP growth collide with the Federal Reserve's easy monetary policy, exacerbating inflation.

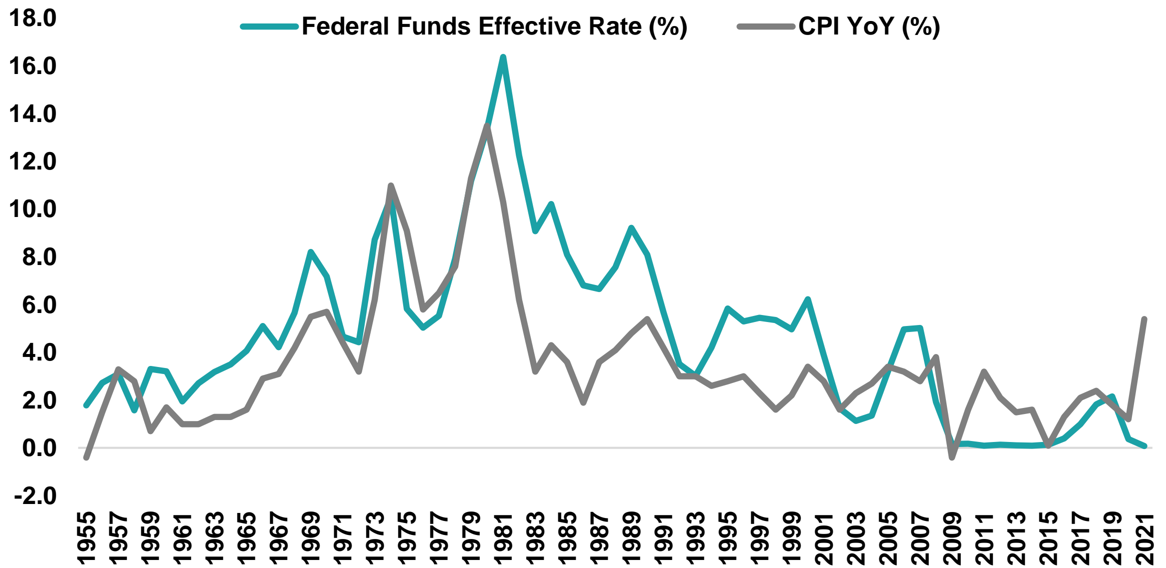
Stagflation famously last occurred in the 1970s when energy prices from the OPEC embargo combined with a sluggish economy and high unemployment hit American consumers with the one-two punch of inflation and recession. As a result, the supply shock of losing access to critical goods lasted through the decade as the period of stagflation persisted for the better part of the 1970s.

The supply chain issues and inflationary tendencies of the post-covid economy are reminiscent of the supply shocks of yesteryears, and stagflation is back on the minds of pundits, traders, and corporations alike. For insurance companies, the prospect of stagflation paints a muddy picture of the future.

The chart below shows the interrelationship between long-term interest rates and CPI. The latest CPI report indicated that it has continued to tick up, with September's CPI at 5.4%, up from August's 5.3%

Federal funds rate and inflation

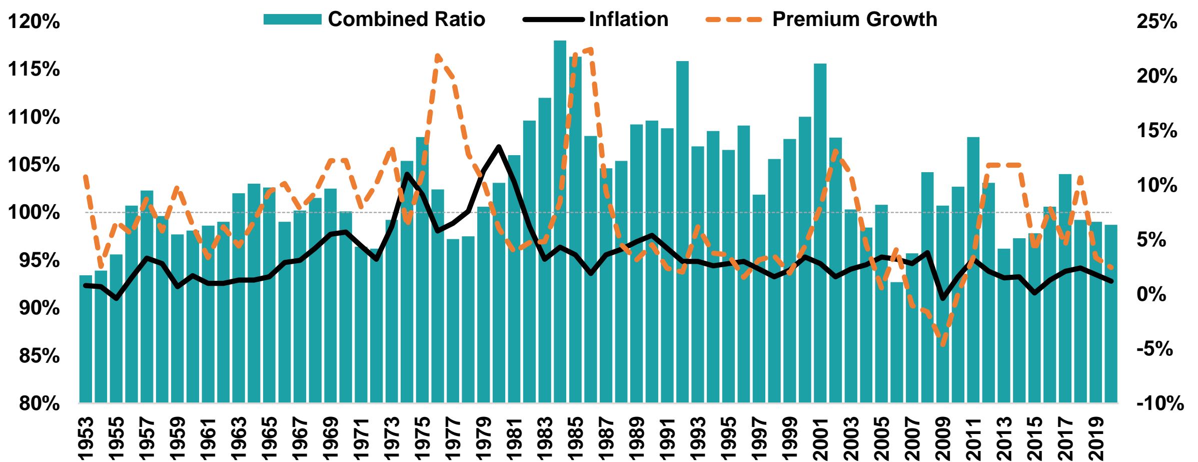
Source: AM Best, BLS



Longer-term, we see a combination of stable inflation environment does translate into a lower combined ratio over time.

Industry combined ratio and inflation

Source: AM Best, BLS



For the specific subsectors, a stagflation environment would mostly be a net-negative, although the effect will vary based on business mix, investment thesis, and prior loss cost expectations built into the book.

From a top-line perspective, most sectors are invariably tied to broader growth expectations. A slowdown in growth would pressure the top-line across most sub-sectors. Commercial insurers would also face the biggest challenge of getting the pricing right based on revised loss cost expectations. Personal auto already seems to be in the middle of corrective actions and should be able to respond faster. On the homeowners' side, demand could slow down coupled with the broader housing expectations.

On the invested assets, long-tailed classes, depending on the duration of the class, would be forced to reassess their durations and be forced to sell their holdings at a

discount. Shorter-tail personal auto and homeowners could weather the changes better, while reinsurance will depend on whose fortunes they are following.

On the liability side, commercial lines will once again be the bigger loser, depending on the class of business and a revisit of loss cost assumptions for recent accident years. Loss costs (replacement) could also negatively impact the homeowner's side. These could result in adverse developments as reserves are reexamined. Short-tail personal auto assets deploy in shorter durations so they can better withstand the shifting asset-liability mismatch.

Line of Business	Top Line	Invested Assets	Liability Side
Commercial Lines	↓	↓	↑
Personal Auto	↓	↔	↑
Homeowners	↓	↓	↑
Reinsurance	↓	↔	↑

Personal auto facing major catalysts

Progressive's September earnings report highlighted the competition heating up in the personal auto industry, with frequency fully recovered from the pandemic, severity up due to supply chain issues, and the looming threat of social inflation. Progressive's results suggest carriers will need to adapt quickly to the worsening trends by taking the foot of the growth gas pedal and increasing rates.

Alongside the rapid changes facing personal auto carriers, there has been a restored focus for removing credit scoring as a rating factor.

The personal auto insurance industry primarily predicates pricing of insurance products on a few factors common to all drivers: age, marital status, driving history, and credit score, among others.

The latter, credit score, is somewhat unique to American insurers. Many countries, such as Israel or Japan, do not even have a credit score or comparative data point to include in insurance pricing arithmetic; in most Canadian provinces, which do have a credit score, it is illegal for insurers to use it as a factor in car insurance pricing.

Some US states have followed Canada's lead and have banned the inclusion of credit scores in car insurance pricing models, including California, Hawaii, and Massachusetts. Other states, such as Maryland, Michigan, Oregon, and Utah, have legally restricted the impact of credit scores on car insurance but stopped short of eliminating it from metrics entirely. Washington state is currently undergoing a legal battle between state insurance commissioner Mike Kreidler who hopes to remove credit as a determinant for rate, and insurance firms that still use credit scores. Whether Washington will follow the lead of other states who have ended credit score-based underwriting remains to be seen.

In Illinois, so-far-unsuccessful efforts to ban credit scores from insurance pricing metrics have been based around the racial implications of credit scores. Some legislators, such as Jackie Collins, argue that credit scores are proxies for race and that minorities are negatively impacted more than other groups by the use of credit scores because poorer drivers may not be able to afford credit-weighted insurance prices. Another argument against credit is that the scores are not a direct indicator of driving performance nor a direct measure of an individual driver's risk.

Some insurers, including old-guard carriers such as Allstate and new-kids-on-the-block InsurTechs such as Metromile and Root, are embracing telematics as an alternative to traditional pricing metrics like credit scores. Telematics, or better behavioral data utilization through technological tracking, might do a fairer and possibly better job at determining an individual's propensity for risk. Insurance companies usually aggregate this data through a black-box plugin that records data directly from the car.

Allstate, in particular, has been vocal in its support of telematics as a pricing alternative to credit scores and has lobbied several state regulators on reducing or eliminating the practice of credit assessment in car insurance pricing.

Companies that have telematics-centered products advertise them as being cheaper than traditional insurance – by as much as 40%, according to Allstate.

What telematics data measures	
-Miles driven	-Speeding
-Time of day	-Acceleration
-Braking	-Road Type
-Cornering	-Distractions
-Location	

But telematics data comes with its own set of problems – and opponents of the new technology have highlighted how technology meant to even the playing field in car insurance pricing may disadvantage some drivers. For example, studies by the National Equity Atlas show that Black drivers are more likely to have longer commutes to work, drive through neighborhoods with higher crime rates, and drive at night – all factors that a telematics-based car insurance pricing system would use to increase rates. There are also privacy concerns surrounding insurance companies' ability to track driver movement and behaviors so precisely.

Logistically, if the removal of credit scoring becomes more widely acceptable, personal auto carriers would need to update their rating models on a state-specific basis, a task that would likely entail rate changes being delayed for some time. Putting aside the telematics adoption, the delay in rate filings could significantly disadvantage carriers given the quickly evolving loss cost trend environment.

That said, it is still too early to see how this plays out; it could end up just being smoke and mirrors. Public support of the removal of credit scores might just be to placate a changing political landscape, and it remains to be seen how these pricing methodology replacements evolve.

Catastrophe losses drive Q3 estimates down, but 1/1 reinsurance renewals still up in the air

Situated squarely at the height of both hurricane season in the Atlantic and the wildfire season on the West Coast, the third quarter has a reputation for being particularly catastrophe-heavy. The current third quarter's catastrophe losses centered around Hurricane Ida, the most destructive hurricane to make landfall this year.

Karen Clark & Company first predicted insured losses of $18bn from the hurricane in early September. This number quickly grew as the industry took better stock of the storm's impact on Louisiana and New York. AIR predicted $20bn-$30bn of damages comprising flooding, wind, and rain impacts in Louisiana. RMS predicted $25bn-$35bn of damages from the storm in Louisiana, but as Ida made its way to New York, the risk management and modeling firm updated its estimate to $31bn-$44bn of damages in all US areas affected by the hurricane.

Several insurance carriers have so far issued catastrophe loss preannouncements in advance of their third-quarter earnings releases, as seen in the chart below. Arch Capital disclosed $330mn-$345mn in losses from Hurricane Ida and estimated that the hurricane's industry-wide impact would be close to $30bn. Renaissance Re reported $440mn in losses from Ida in a preannouncement. Everest Re reported $635mn in losses, $415mn from Ida, and $220mn from flooding in Western Europe.

Along with Ida, the industry has experienced losses from other catastrophes, including other tropical storms such as Nicholas and wildfires on the west coast, most notably the Dixie fire in July. In addition, international catastrophes, ranging from flooding in Western Europe (losses were estimated to be $40bn, with insured losses estimated at $7bn-$12bn) to the earthquake in Haiti, have also impacted firms' EPS.

Q3 2021 cat disclosures

Source: Company reports

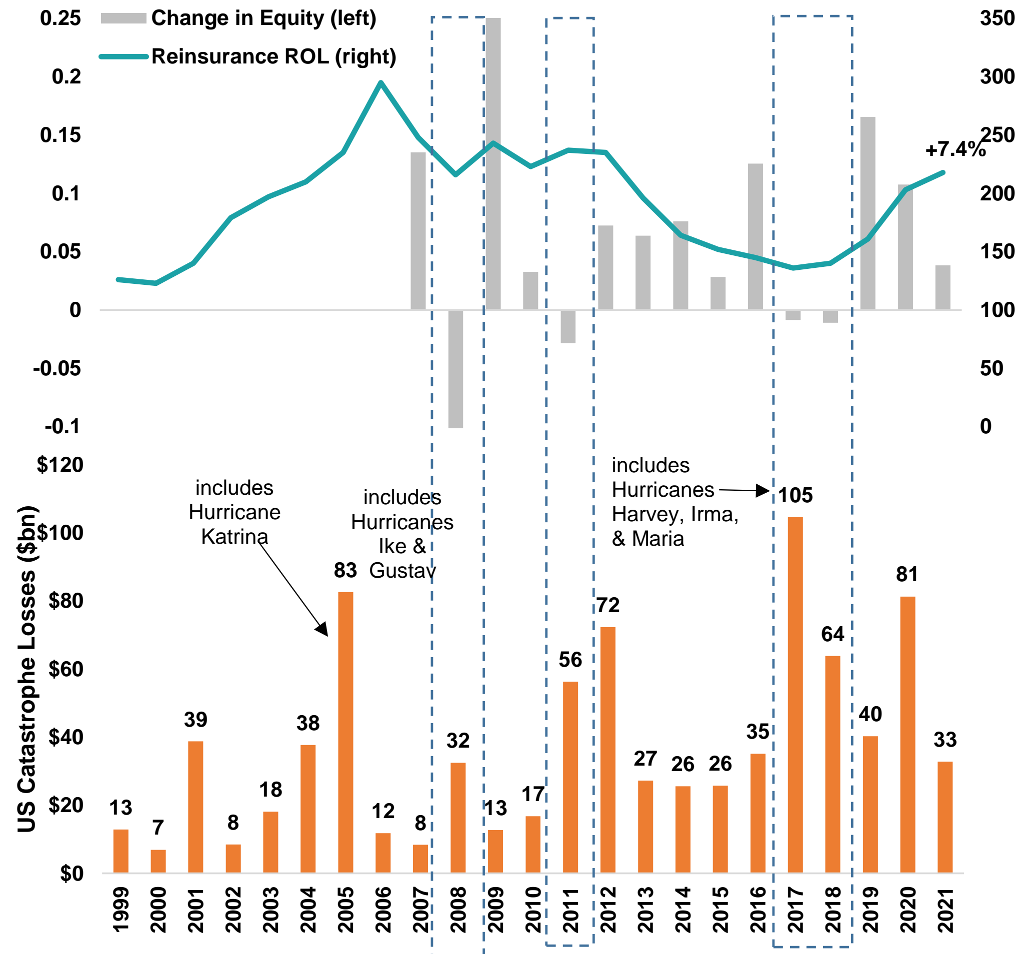
Company	Q3 2021	vs. Q3 2020	Q3 2021 disclosure notes
Allstate	$1.1B	$990M	$876M from Ida
Arch Capital	$330-345M	$190-210M	Losses primarily from Ida
Axis Capital	$250M	$240M	$175M from Ida, $55M from European floods
Everest Re	$635M	$300M	$415M from Ida, $220M from European floods
Horace Mann	$40M	$35M	Half of losses from Ida
Progressive	$510M	$115M	Losses primarily from Ida
Renaissance Re	$725M	$322M	$440M from Ida
The Hanover	$165M	$66M	Half of losses from Ida
United Insurance Holdings	$27M	$35M	Losses primarily from Ida

In comparison, Q3 2020 catastrophe losses, although still elevated, were generally lower. Last year's third quarter was awash in catastrophes, including hurricanes Isaias, Laura, Sally, Zeta, and Eta, the Derecho Windstorm, and wildfires on the West Coast.

However, year to date, Aon estimates catastrophe losses in the US have reached $33bn, compared to 2020's total of $81.3bn. As we've previously discussed, the industry's strong reinsurance capital position makes it challenging to sustain rate change.

Nonetheless, reinsurers were bullish on renewals in our recent reinsurance panel, noting that reinsurers will be pursuing higher rates and tightening terms and conditions.

US prop cat reinsurance ROL, catastrophe losses, and change in equity
Source: HX Analytics, Aon, PCS, S&P Global



Given the catastrophe losses, in aggregate, the industry estimates are expected to be 39% lower year-over-year. However, as of last week, 14 of the 26 firms within Inside P&C Select with more than three estimates available are still expected to grow earnings in Q3.

Q3 consensus EPS change (YoY)
Source: FactSet

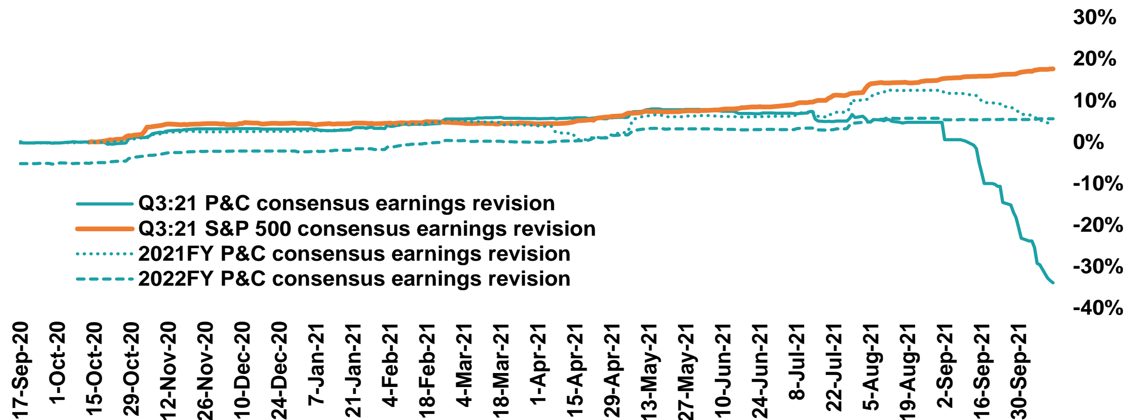
Company	Peer group	Q3-20 EPS	Q3-21E consensus	% chg (vs. Q3-20)	Est. #
Markel	Specialty	$3.99	$13.64	242%	6
Cincinnati	Regionals	$0.39	$0.99	154%	6
Arch	Bermuda	$0.29	$0.45	55%	11
WR Berkley	Specialty	$0.65	$0.95	46%	9
RLI	Specialty	$0.42	$0.59	41%	7
Chubb	Large Comm.	$2.00	$2.40	20%	18
AIG	Large Comm.	$0.81	$0.95	18%	16
Selective	Regionals	$1.06	$1.15	8%	7
FedNat	Florida	-$1.57	-$0.48	NM	4
United Ins	Florida	-$1.95	-$0.23	NM	3
Axis	Bermuda	-$0.77	-$0.05	NM	9
Heritage	Florida	-$0.75	$0.01	NM	5
United Fire	Regionals	-$1.37	$0.10	NM	3
Universal	Florida	-$1.43	$0.50	NM	2
Argo	Bermuda	-$0.34	$0.22	NM	6
CNA	Large Comm.	$0.71	$0.71	0%	4
Donegal	Regionals	$0.32	$0.26	-18%	3
AFG	Specialty	$2.45	$1.86	-24%	4
Mercury	Personal	$1.23	$0.80	-35%	2
Travelers	Large Comm.	$3.12	$1.95	-37%	19
Hartford	Large Comm.	$1.46	$0.90	-39%	16
Allstate	Personal	$2.94	$1.80	-39%	16
Horace Mann	Personal	$0.82	$0.47	-43%	5
Hanover	Regionals	$2.46	$0.60	-76%	6
Kemper	Personal	$1.36	$0.28	-79%	6
HCI	Florida	$1.60	$0.00	-NM	3
Everest Re	Bermuda	$2.42	-$1.50	-NM	8
Renaissance Re	Bermuda	-$2.64	-$6.40	-NM	10
Median				***-39%***	

Although Q3 2020 was still in the mid of the pandemic, commercial carriers began more broadly reporting a margin expansion potential as rate appeared to outrun the loss trend on both earned and written basis.

While Q3 P&C estimates have been dropping since Hurricane Ida, S&P 500 Q3 earnings estimates have been in a steady uptrend. However, 2022’s estimates have incrementally increased, suggesting confidence in market conditions.

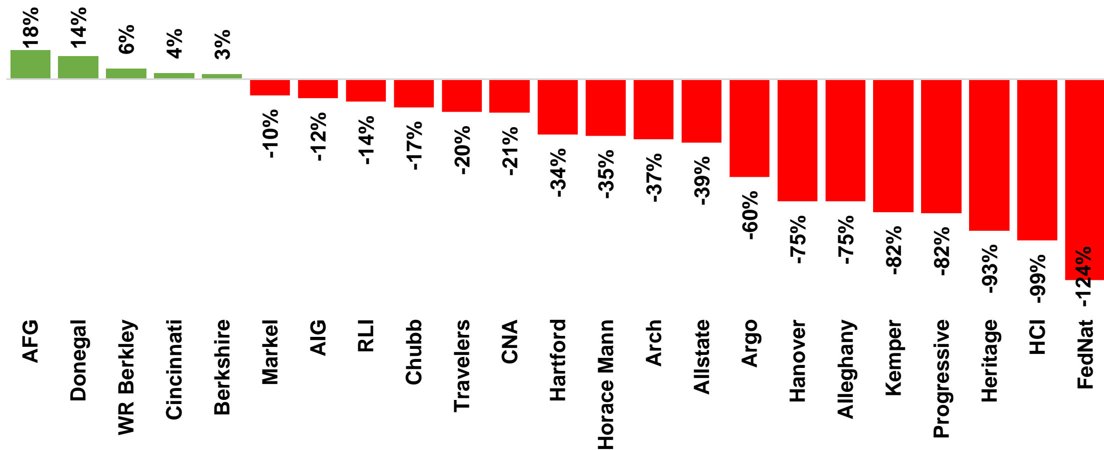
This could potentially end up as a problem if loss cost inflation uptick intersects with a rebound in social inflation shift from a reopened court system.

Inside P&C Select earnings revisions (aggregate earnings)
Source: FactSet



Below we see that several companies, including American Financial Group, Donegal, and WR Berkley, have had their estimates increased during the quarter and are expecting minimal impacts from Hurricane Ida.

EPS consensus change on Q3:21 earnings since July 1, 2021, by company
Source: FactSet



Brokers continue to benefit from economic growth

For brokers, the focus for the quarter and into 2022 is maintaining growth. Economy-sensitive brokers have benefitted from the improving macro environment and strong pricing in commercial lines, but signs of a slowdown threaten the brokerage super-cycle.

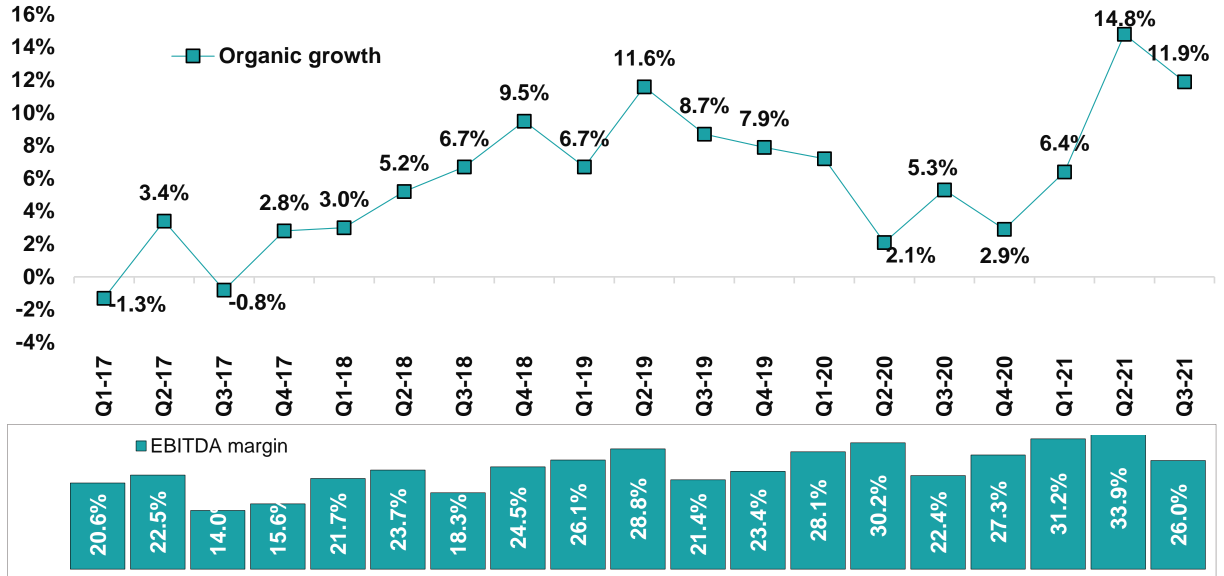
Truist's report last week served as the first broker data point. Although Truist's sizable exposure to the middle market wholesale space (approximately 50% with the remainder primarily retail) makes it less comparable to other public brokers, it can serve as a fractional and directional proxy for the industry revenues.

Truist Insurance reported organic growth of 11.9% and a 370bp EBITDAC margin expansion YoY. The broker saw substantial growth in new business volume at 26% for Q3:21, following 25% growth in new business in Q2:21, 12.8% in Q1:21, and 19.5% in Q4:20.

The broker noted no moderation in Q3 rates, with rate increases comparable to Q2 or slightly up.

Truist Insurance organic growth and EBITDA margin over time

Source: Company reports



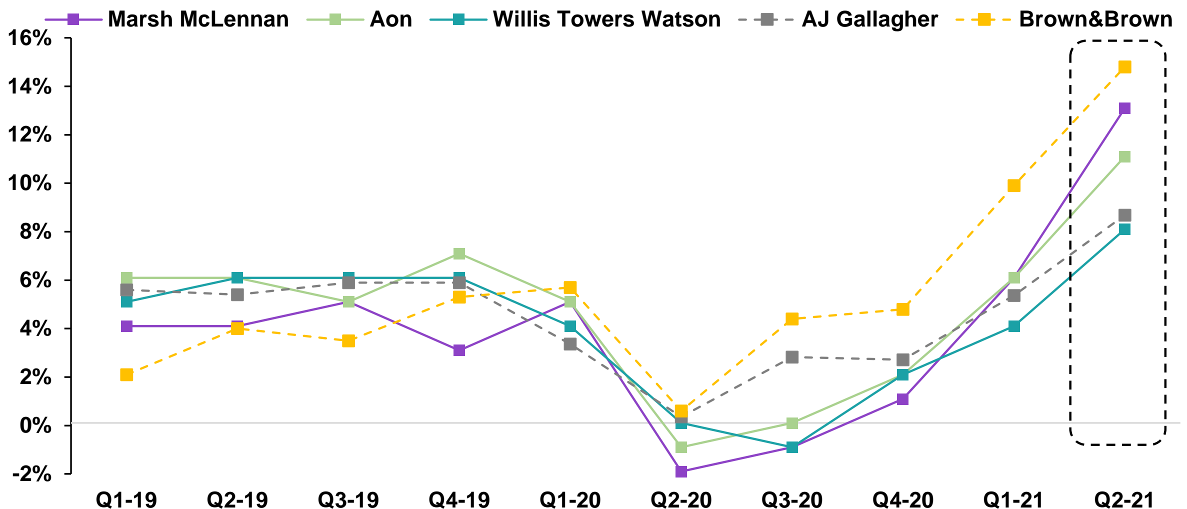
This appears as a positive, although largely anticipated, sign for where peers are likely headed. The earnings in the peer group will be watched for updates on the macro environment and upgrades on growth guidance (or otherwise hints).

Note, on its investor day last month, AJ Gallagher pointed to faster organic growth in its brokerage business, with moderating growth in risk management services.

Willis's results are likely to face the most scrutiny, given its lower margins and slower growth, having potentially missed opportunities from broker super-cycle due to the distraction caused by the failed merger with Aon. The investor day, led by new CEO Carl Hess, left some skepticism in the company's ability to reach aggressive margin targets while balancing the needs of its employees and now activist supergroup.

Broker organic growth (quarterly data)

Source: Company reports, Inside P&C



Marsh McLennan is expected to report Thursday, with Brown & Brown, AJ Gallagher, and Aon the following week.

Q3 P&C earnings calendar (announced firms only)

Source: Company reports, S&P Global

MO/YR	MON	TUES	WED	THURS
Oct 2021	18	19 Travelers	20 RLI	21 WR Berkley Marsh McLennan
	25 RenRe Brown	26 Chubb	27 Selective Hanover Donegal Cincinnati Arch Everest Re Axis	28 Hartford Willis AJ Gallagher
Nov 2021	1	2 Mercury Argo James River	3 Allstate Horace Mann Progressive	4 United Fire AIG
	8 Global Indemnity	9	10	11

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