Inside P&C by The Insurance Insider

September 6, 2019

THIS INTEREST RATE ENVIRONMENT…..

Tick box as appropriate:

☐ *"We love this interest rate environment because it forces companies to underwrite."*

☐ *"This is one of those things that keeps me awake at night because it's really challenging."*

As we have previously outlined, we expect pressures on investment income to be a key theme in Q3 following the precipitous decline in yields. Despite a modest recovery in recent days, there appears to be a broad consensus emerging that economic reforms under President Trump have not had the impact on expected long term growth rates necessary to shift long term interest rates and inflation expectations.

As such, it was no surprise this was a hot topic among P&C companies at KBW's insurance conference Thursday. However, there was a wide range of views, with Argo CFO Jay Bullock describing it as "the thing that keeps him up at night" to Selective CFO Mark Wilcox declaring that he loves low interest rates because it forces companies to underwrite properly. We expect this to be a key controversy in Q3 earnings.

Key details from company presentations below:

Argo: With a bruising activist battle behind it, **Argo** focused its comments on Thursday on rate action (increases seen across almost all lines business), expense improvements from increase digital efficiency, and balancing overall return contributions from investment and underwriting in the face increased interest rate headwinds. Details below.

Selective: Selective downplayed rate movements in the commercial P&C sector which it believe are not as large as some market commentary might suggest. The firm also said it welcomes a low interest rate environment as it places more emphasis on underwriting discipline. Details below.

FedNat provided a progress update on diversification efforts outside of Florida, emphasized a strong belief in the positive benefits of AOB reform, and expressed frustration with the company's current valuation and inability to buy back stock while waiting for the company's acquisition of non-Florida MGA Maison to close. Details below.

Auto: Auto insurance companies pointed to a softening market with some talk of an uptick in frequency. Kemper also described Progressive as "not as formidable as they once were" in non-standard auto as a consequence of the firms shift towards a more preferred client base. Details below.

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Index	QTD	YTD
Large Cap	4.5%	26.6%
Regional	0.5%	12.9%
Specialty	6.1%	26.5%
Personal	(3.1)%	18.4%
Bermuda	6.1%	33.2%
Florida	(7.1)%	(22.9)%
IPC Select	1.1%	11.4%
S&P 500	1.2%	18.7%
S&P Fin.	(1.1)%	14.7%

Source: S&P Global, Inside P&C

SELECTIVE: "WE LOVE THIS INTEREST RATE ENVIRONMENT BECAUSE IT FORCES COMPANIES TO UNDERWRITE"

- ***Selective downplayed firming market thesis as the company "has not seen as much movement to back up the marketplace commentary"***
- ***Seeing opportunities to more than double commercial lines business in longer term***
- ***Low interest rates will put pressure on income and induce more underwriting discipline***

Selective executives shared their vision on company and the industry on broadly four avenues – market pricing momentum, the firm's growth opportunities, the implication of low interest rates and Hurricane Dorian.

Management shared a more modest view on price firming pointing that some survey results do not support the bullish tone that has been prevailing in the marketplace since at least Q1.

> "I*f you look at the CLIPS survey [Towers Watson's Commercial Lines Insurance Pricing Survey], which we think is probably the most accurate survey out there, you have not seen as much movement to back up some of the marketplace commentary".*
> ***- COO John Marchioni***

However, Marchioni noted that Selective observed a significant divergence in-between different lines on pricing. Commercial auto and property are experiencing some upward momentum and there is a potential for more firming, according to the firm.

> "***Commercial Auto*** *continues to be a line generating significant rate. For us last year, we were right around 7%. For the first half of this year, we are at about 7.3%. So pretty consistent.*
> *We are seeing a little bit more well-behaved frequency trends relative to our expectations. I think there is still a question relative to the severity and I think the accident year starting point for that line of business continues to be well over a hundred for us and for most other competitors. So there is more work to be done there in terms of price relative to loss trend.*
>
> ***Property*** *is probably the line that we have seen some movement in, market-wide and we certainly see in our own results. Our property pricing ended last year right around the 4% mark and into the first six months of this year is a little over four - at 4.3%. That is the line that needs more rate. There have been a lot more volatility for us and other companies on non-cat property losses".*
> ***- COO John Marchioni***

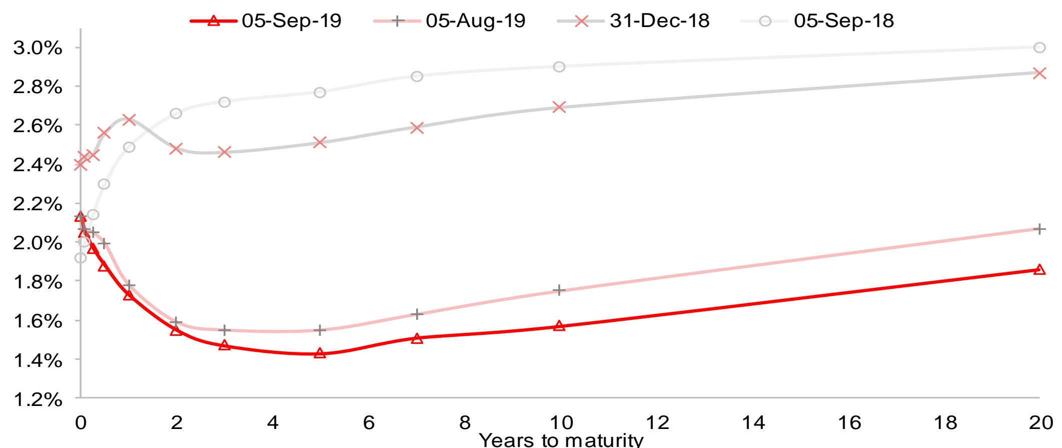
Marchioni also provided some insights on Selective's growth ambitions as the company is looking to more than double its largest business - commercial lines - over the long term.

Note, during the last three years Selective has been steadily growing quarterly at an average rate of 6.5% (on YoY basis).

> *"Our commercial lines book is 80% of our overall company, roughly $2bn. We think there is another $2.5bn market opportunity right in front of us in the geographies that we are currently in for the most part with the agencies that we currently have by just extending our share. We think that is the lowest risk way for us to grow.*
>
> *The $2.5bn of additional market opportunity is based on our view we could reasonably achieve over the longer term 3% market share in our existing footprint states, and on average if you look at across the board we are in that 1.5% range right now".*
> ***- COO John Marchioni***

One discussion that we found interesting was on interest rates. Since Q2 earnings we had 25bps Fed rate cut and 40-50bps yield contraction on the longer end of the curve. Hence, we find these data points in-between earnings seasons insightful.

EXHIBIT: US TREASURY YIELD CURVE AT VARIOUS TIMES
Source: S&P Global, Inside P&C



<u>Our takeaways from Selective's comments on interest rates are:</u>

- Few quarters of falling interest rates, even at this pace, will not make a big case for concern at P&C carriers, as it takes on average 5-7 years for low interest rates to work their way to the insurers' book yields.

- Low interest rates may have implications on insurance pricing and risk selection. However, as we discussed in "Making Interest Rates Grate Again", timing issues and the fact that interest rate movements convey

more macro information than simply future investment income complicates judgement on the isolated effect.

Below are some of the management comments on interest rates.

> *"Rates are going to go up, rates are going to go down we are going to maintain the course in terms of the investment strategy, we are not going to reach for yield in terms of trying to generate more ROE from the portfolio".*
>
> *"Rates have come down significantly in 2019 and since the end of the quarter. That is a headwind that is going to put pressure on a new money rates on a go forward basis. We think although the duration is 3.3 years we focus more on the weighted average life for the portfolio which is about five years and that kind of gives you a little bit of perspective about how much new money we need to put to work going into 2020".*
>
> *"We love this interest rate environment because it forces companies to underwrite. Big decrease in rates puts pressure on overall income performance in our sector, so you have to look at the overall portfolio between investments and underwriting to achieve your target returns and I think that is good for the industry in terms of discipline from the underwriting, risk selection and pricing perspective".*
> ***- CFO Mark Wilcox***

ARGO: MOVING ON FROM VOCE FIGHT; ACHIEVING RATE

- ***Rate momentum continues; auto remains a challenge***
- ***Inv. Income to be hit by short duration portfolio***
- ***Digitization of Argo driving efficiency, improved submission flow***

With a bruising activist battle behind it, comments from Argo management Thursday focused on more standard fare, including rate movement, hits to investment income from the recent downturn in interest rates, and the digitization of Argo. On the topic of rates, Argo sees momentum across “most lines”, specifically highlighting casualty, property, professional, and even select pockets of specialty, while even seeing opportunities get rate in competitive markets such as surety and citing “more room to run” in professional lines.

When asked about investment income and the recent significant drop in interest rates, Argo management offered a revealing answer on the potential impact to the company’s medium-term profitability and reliance on investment income to generate overall returns.

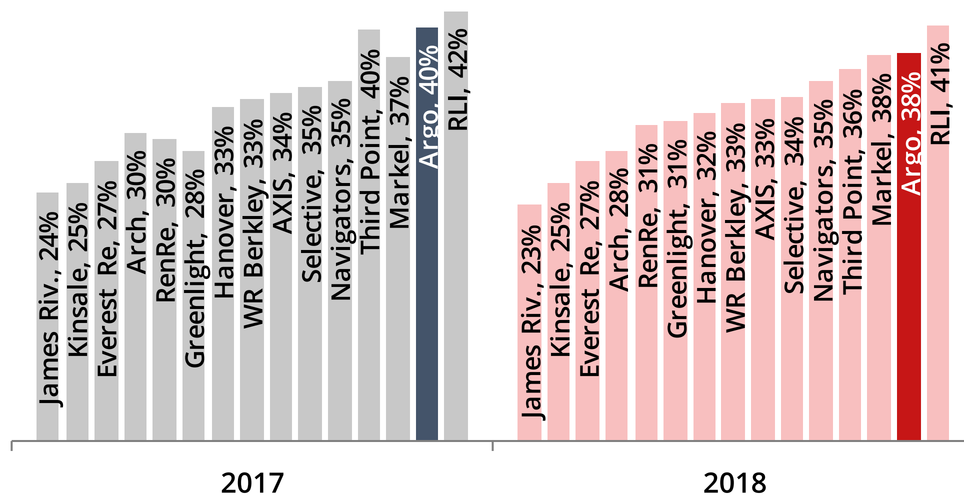
> *This is one of those things that keeps me awake at night because it's really challenging. And let me do just simple math, we run a 3-year duration. That means you've got 12 quarters worth of assets, but 3 years later you're going to have to turn the thing over. So every quarter, you've got 8.5% of your portfolio rolling off, reinvesting at fixed rate, 1.5 plus 75 plus 100. It depends on what sort of credit ratio you want to take. In our core bond portfolio, we maintain a pretty conservative risk profile. So factor that math into the net investment income, and we're just going to start to see an impact again pretty quickly, which is disappointing because we -- I felt like we've come out of that trough and we were seeing some momentum there.*
> ***– CFO Jay Bullock***

Echoing a theme from **yesterday’s edition of IPC**, Argo responded that the solution to challenges on the investment side includes making improvements to the underwriting. Argo maintained a commitment to a ~10% ROE target leading to questions whether it would an improvement in the company’s overall loss ratio or would require creative capital management to achieve the objective.

> *You redouble your efforts on the underwriting side because that's where you're going to make your money. I think you try to take a rational approach to -- I'm not -- we have a strategy and a business model in place where we are targeting, achieving at double-digit return on equity. We've defined that as the risk-free rate plus 700. That's not 10% today, right? I mean it's just not, but 10% is still the target that we set for ourselves. But we all have to think rationally about what is the impact if this interest rate environment really runs for a long period of time. I think the thing that we don't want to do is change our philosophy as it relates to the risk profile of our asset portfolio, stretching for yield, and that tends to be what happens in environments like this.*
> ***– CFO Jay Bullock***

Digitization of Argo Beyond underwriting and investment performance, Argo also provided an update on additional efficiencies the company has achieved, largely in the handling of submissions and expediting the prep time for underwriter reviews to 2 minutes down from 20, per submission. Going forward, Argo expects to achieve similar levels of efficiency through a company-wide initiative to cut down on manual processes, ultimately contributing to expense ratio improvement targeted by activist investor Voce in the first half of the year.

EXHIBIT: ARGO VERSUS PEERS EXPENSE RATIOS
Source: Company reports, S&P Global, Inside P&C



FLORIDA: FEDNAT UPBEAT ON GROWTH OPPORTUNITIES

- ***FedNat: confident AOB reform will deliver results***
- ***Diversification efforts benefitting from partnerships with nationals***
- ***Eager to initiate buyback following Maison acquisition close***

FedNat CEO Mike Braun addressed a number of topics at the KBW Insurance conference Thursday including growth opportunities in and out Florida, increased business diversification, as well as the company's current underwhelming valuation.

Returning to Growth After Right Sizing

After shrinking materially following market challenges in 2017 and 2018 (policy count down by approx. ~50k), FedNat sees the opportunity to benefit from growth, capitalizing on rate increases taken over the last several years as well as expected benefits of the recent AOB reform. With the majority of the company's pullback coming in Florida, FedNat continues to move full steam ahead on growth outside the state, with the company's acquisition of Maison and its larger presence in Louisiana expected to close in the coming months.

Singing AOB Reform's Praises

Whereas reinsurers in the market have taken a wait-and-see approach in providing pricing credit related to AOB reform, FedNat commentary continued the theme of primary carriers sounding bullish. In noting that Citizens had dropped planned rate increases from about 8% to about 3%, FedNat believes the impact of the reform will be material:

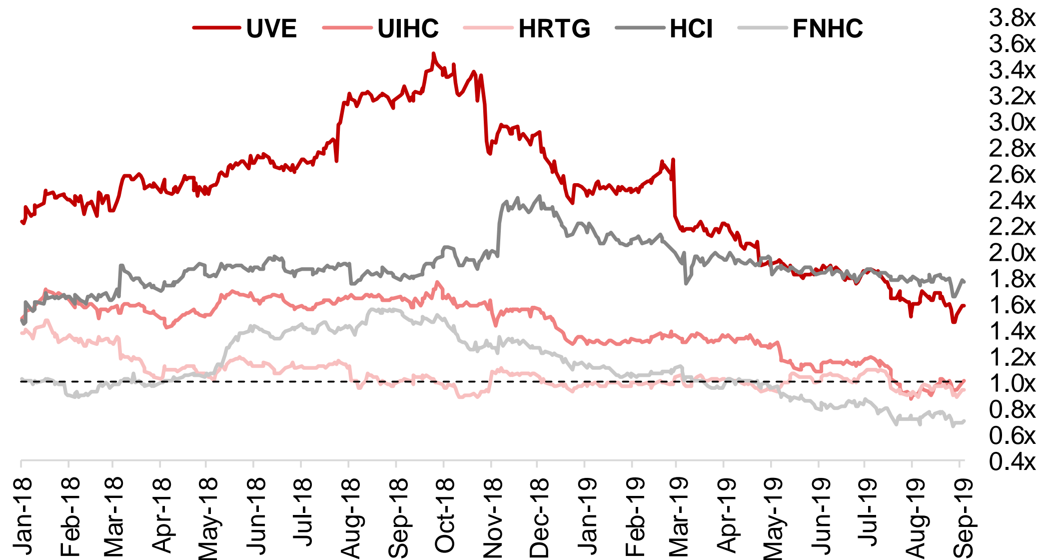
> *AOB just went into effect two months ago and I think it's going to have a significant benefit to the business. There are a lot of unscrupulous contractors and the legal environment was very punitive against insurance companies that have really punished homeowners, people that have policies in the state of Florida, not only with FedNat but with all carriers and these practices have led to inflated claims in astronomical ways. In our $450mn book we've taken three rounds of rates in excess of 21% and most recently continuing to earn in that rate has absolutely led to an enhanced book, but this AOB reform has led to a level playing field. AOB has been the big challenge for us and I believe a big part of it, not all of it, has been remediated with AOB reform.*
>
> ***– CEO Mike Braun***

FedNat provided additional color on the company's growth and distribution strategy, revealing that the company's relationship with Allstate generates in "excess of $100m" in premium while applying the same underwriting standards and little discernible difference in attritional loss ratio (mid-30s). The company

also disclosed that a significant portion of the company's non-Florida business is generated through GEICO, which will soon be joined by the approximately $100m non-Florida book added from Maison. Commenting on the acquisition, FedNat expects the acquisition to be immediately accretive on an earnings basis despite being dilutive on a book value basis.

EXHIBIT: FLORIDA PEER GROUP P/B VALUATIONS

Source: S&P Global, Inside P&C



Speaking of book value, Braun **expressed frustration** with the company's stock price—which currently trades below book value—as trading at a "deep, deep discount".

FedNat's share price has tumbled by more than half over the past year to $12.82. At the same time, the company has faced criticism from insurance focussed hedge fund investor Capital Returns Management. Addressing the investor's issues, FedNat agreed to schedule an annual shareholder meeting for 17 October and appoint two new members to its board.

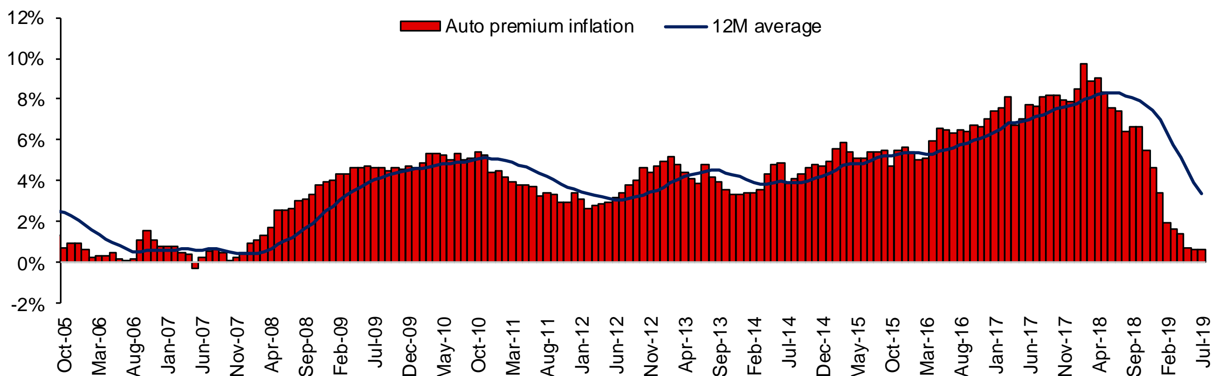
AUTO: A SEMI-SOFT MARKET & IMPROVING ACCESS TO TECH

- ***Kemper: Auto market not soft, not hard, but a happy medium***
- ***National General points to soft auto market***
- ***Horace Mann: Access to tech no longer exclusive to large carriers***
- ***Progressive "not as formidable as they once were" in non-standard auto: Kemper CEO***

At the **KBW investor conference** firms including Kemper and National General pointed to a semi-soft market in auto. This comes at a time where premium inflation in personal auto is close to zero per CPI data, a significant historical low. Management highlighted the subsector as seeing reasonable levels of profitability, and limited rate increases keeping buyers from shopping for new policies.

EXHIBIT: AUTO PREMIUM INFLATION AGAINST 12-MONTH AVERAGE

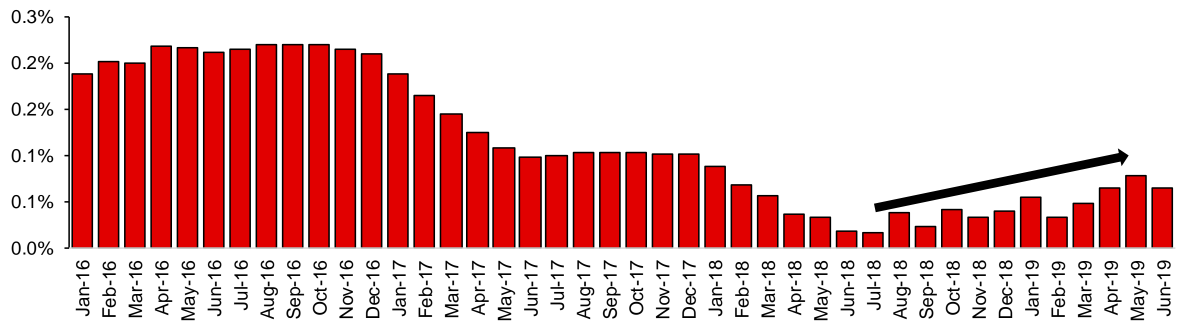
Source: BLS, Inside P&C



Beyond the rate declines, National General's management also pointed to low unemployment and gas prices driving up miles driven, a major leading indicator for frequency – something we have highlighted as starting to show in recent data in our Q2 Auto Review: The Overshoot Risk. Joseph Lacher, CEO of Kemper, also pointed to a stable frequency environment. We believe that frequency remains the most crucial thing to watch.

EXHIBIT: MOVING AVERAGE TTM MILES DRIVEN GROWTH

Source: FRED, Inside P&C



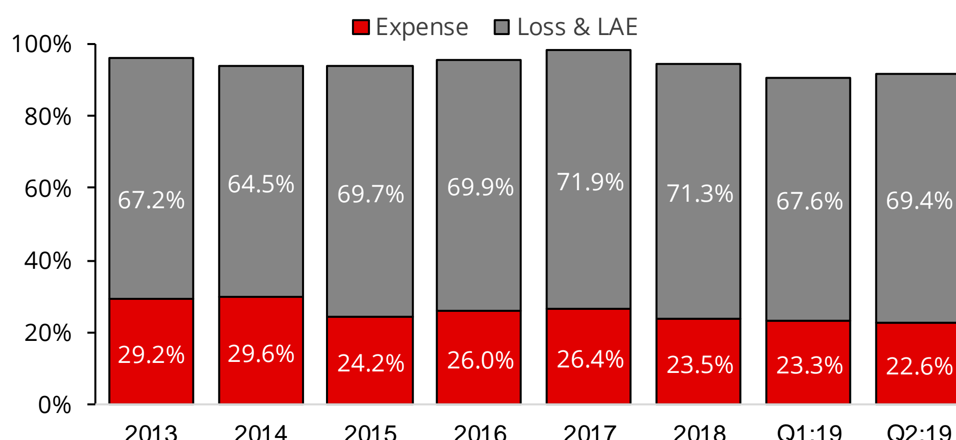
Kemper's CEO Joseph Lacher stated that while he wouldn't describe the current auto market as a soft market, he wouldn't characterize it as a hard market either. While rates have been declining, competitors are not getting aggressive when it comes to growing top line.

> *"It's not what I would describe as a significantly soft market, where people are rushing out and dropping rates and doing crazy things to grow, it's just one that's not particularly hard where people are jacking up prices. That reduces the number of consumer shopping, but it doesn't cause the supply, if you will, the company's writing business to be dramatically doing anything silly, and we're not seeing a great aggressiveness as a result."*
>
> **- CEO Joseph Lacher**

During National General's fireside talk, commentary pointed to a soft market in auto and heightened competition. While larger carriers are focused on growth, Barry Karfunkel, CEO, discussed the firm's defensive posture relative to its peers. Rather than chase business in soft markets, the firm grows during hard markets as carriers create shoppers. According to management, this allows the firm to grow while maintaining stable attractive margins.

EXHIBIT: NATIONAL GENERAL COMBINED RATIO BREAKDOWN

Source: Company Reports, Inside P&C



Telematics was also a theme during auto commentary. Starting in September, National General started to roll out a usage based app to its agency and direct businesses. 1/3 of its direct business is seeing usage of the app, while in agency it's not seeing much traction, active only in the mid-single digit range.

Management claims this will allow for the firm to further segment and boost profitability. **Horace Mann's CEO, Marita Zuraitis pushed the narrative further**, claiming that smaller companies are in a much better position to benefit from data analytics and AI, even when compared to their positioning five years ago.

She claims this to be a result of both Fintech and overall advancements in tech reducing headwinds like costs / implementation. As an example, Marita used credit in auto pricing. In the past smaller firms had to play catch-up with larger carriers which benefitted from a first mover advantage, but that time gap has shrunk, and third-party data aggregators are making it easier for firms to use analytics to their advantage.

Progressive no-longer as formidable in non-standard auto: Kemper

On growth, Joseph Lacher pointed to the risks of expanding into new sub-segments, pointing to **Progressive's** focus on increasing its addressable market at a possible loss to its core non-standard business.

Lacher discussed the risks of moving into market segments with different value propositions, and how it could impact their ability to be nimble in non-standard markets.

"So as you move into a different market segment, where the customer value proposition is different and you're providing a different level of service and you might have less fraud and you might have an ability to move differently, they are doing things that help them grow that standard and preferred environment, they make them less effective in the nonstandard space. So they're still smart, they can be effective if they wanted to.

I think what it would do is, it would start confusing their organization and they would move that direction, they would give up a lot of shareholder value creation somewhere else and they might see their retention drop or they might see something else that hurts the direct business. So they're in the space, they're not just as formidable as they once were. We are finding that we have an ability to be very price competitive with them, we've got enough scale to be effective in our claims process in the geographies we're in.

- CEO Joseph Lacher

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