

---

# Forks in the Insurance Capital Road

## *An Analyst's Views on the Industry*

**By Herbert E. Goodfriend**

"Things would have been simpler to understand, had they not been explained," a renowned English nobleman once remarked. That could well have defined today's insurance marketplace and outlook. In an attempt to bridge this arcane gap, a look at worldwide and U.S. economic trends can be helpful.

### **Current Economic Trends**

The global economy is improving, but ironically the Euro has been knocking the socks off the dollar, while Europe is fragile and Japan anemic. Mexico and Canada are piggybacking on the U.S. economy.

On the plus side here at home are industrial production, consumer confidence, housing, inflation and the impact of tax refunds. On the negative side, interest rates have stabilized and there is concern that they will remain depressed next year.

Employment is another concern, especially for people seeking manufacturing posts who are at risk of becoming hard-core unemployables. There is also the war in the Middle East and high oil prices. The low dollar is a mixed bag. It is beneficial to purchasing abroad, but it can also erode confidence and exert pressure to raise interest rates if it sinks anew against the Euro.

In sum, what we're seeing is not the usual recovery from steep

economic activity declines.

Real GDP in 2003 is estimated at 3.5 percent and is projected to go to 4.2 percent in 2004. Fed funds ranged from 0.75 percent to 1.40 percent in 2003 and are projected to be 1.2 percent to 2.5 percent in 2004. The 10-year U.S. Treasury note was 4.2 percent to 4.55 percent in 2003 and will probably reach 5.0 percent in 2004.

These crosscurrents directly and indirectly affect the U.S. insurance milieu.

### **Property & Casualty (P&C) Insurance Outlook**

The P&C insurance milieu has had a sterling renaissance. However, it will take 18 months to work its way fully into insurance corporate income statements. Commercial coverage rates continue to climb – up approximately 15 percent to 20 percent in 2003 – although the pace has slowed.

Casualty lines are still the most buoyant, with combined ratios for workers' compensation averaging 116.7 percent the last five years versus 111.4 percent for all other commercial lines. Directors' and officers' liability is up about 30 percent; errors and omissions, nearly 20 percent.

Rates for personal lines have risen 10 percent to 15 percent, and there's a good spread between those rates and the consumer price index. The biggest deceleration or actual decline is occurring with commercial property risks, which have fallen by 10 percent to 20 percent from recent peaks.

As usual, reserves are a big story. While they are actuarially based, reserve settings are variable and

entail a management judgment call. For example, if an actuary gives high to low ranges, the rating agencies now recommend that management go 50 percent above the low estimate. But it's extremely difficult to be doctrinaire about reserves because of the long-tail nature for such lines as directors' and officers' liability, errors and omissions, workers' compensation, professional and general liability.

It's estimated that P&C reserves are deficient by 10 percent, excluding environmental and asbestos, or about 25 percent shortfall in total. But most companies are better positioned today than in the last cycle, although more strengthening is needed and likely. (NOTE: In mid-December, after this speech had been delivered, Hartford Insurance announced a \$1.5 billion addition to reserves.)

The outlook for P&C — premium gains, low interest rates, good cash flow — is still positive, but not as good as previously. Written premiums for 2003 are estimated to be up 13 percent and are projected to rise by 9.2 percent in 2004. Investment income, excluding capital gains or losses, is estimated to have risen 2.8 percent in 2003, but will be relatively flat in 2004. Pre-tax operating income in 2003 is estimated to be up 93.3 percent and is projected to increase another 19.4 percent in 2004 based on the combined ratios estimated at 102.8 percent in 2003 and 101.9 percent in 2004, respectively.

### **Potpourri**

Interlaced within these expectations are eddies of conflict and opportunity on several fronts. There are a number of issues that are

---

*Herbert E. Goodfriend is senior vice president of Gill and Roeser, Inc., a leading financial advisor and reinsurance intermediary. This article is adapted from his presentation at the Society of Insurance Financial Management's Dec. 11, 2003, Annual Meeting in New York City.*

(Continued)

# Forks in Insurance Capital Road

(Continued from Page 1)

impacting future expectations, including:

- Tort reform: Unlikely in the near team.
- Reinsurance recoverables: Mixed signals.
- Mold: Not spreading, but negatively affecting specific markets, such as Texas.
- Insurance brokers: Growth is slowing, acquisitions are more suspect and banks more formidable.
- Personal auto: Loss costs are beginning to stabilize.
- Hurricanes and other catastrophes: We've dodged some bullets, with the exception of Bermuda, the West Coast fires and California mudslides.
- Reinsurance rating agency downgrades and reserve issues.
- Returns on earnings: 3.3 percent in 2002; 2003 estimated at 8.5 percent; 2004 projected at 12.8 percent.
- Costs of capital: 11.2 percent in 2002; 2003 estimated at 15 percent plus; 2004 projected at 17 percent plus.
- Asbestos reform: Prospects have brightened, but there's no quantum gain.
- Medical malpractice: Hot potato, politically, both regionally and nationally.
- Low bond yields: Affected life companies most. Investment income makes for unpleasant reading.
- Use of derivatives: Not for the faint of heart.

## Life Insurance

If the P&C business has been "buoyant" in 2003, the word that best describes the life insurance business could well be "moribund." The following items are noteworthy:

- The variable market has stabilized after taking a beating, but it's more capital-intensive and we're seeing modest ROEs.
- Investment spreads are not cushy.

- Asset liability matching has been made all the more difficult by adverse yields and opportunity phenomena.
- New U.S. Treasury tax and capital initiatives.
- The "Urge to Merge" has not become passé, but sales of blocks of business and shells are more in vogue.
- There are fewer conversions from mutual status.
- Intrinsic growth rates are estimated at 4 percent in premiums, but policy counts are down 1 percent to 3 percent, while the average premium per policy is up 7.9 percent
- Ratings are under siege
- Bank roles in distribution add to fluidity of product and consumer divided loyalties.

## Health Insurance

As for the third member of the insurance troika — health insurance — at long last we're seeing excellent earnings, but for how long? There are numerous new governmental edicts on Medicare and standards of care. The Blues' rush to convert is probably over. Medical — drug inflation, worst of all leading indicators, is up 14 percent. Divestitures and departures from the health fray are probably not complete.

## Capital

Intertwined with all this are related overall insurance capital market trends:

- Use of new preferred trust financials for smaller enterprises, very often mutual or privately owned.
- Sales of shells, especially located in desirable market states.
- Sales of books of business and/or renewal rights.
- Reinsurance tie-ins, contingent capital hybrids.
- Walling off of prior exposures in order to consummate a merger or a sale.

- Reserve strengthenings.
- Company share buybacks.
- Dividend increases spurred by new federal tax enactment.
- Carrier withdrawals from the fields of reinsurance, workers' compensation and personal lines.
- Lloyd's Syndicate fluidity — rating agencies changing outlook, downgraded to "A" despite rebound.
- Increased use of dynamic financial analysis (DFA) and enterprise value concepts.
- Increased static from reinsurers versus rating agencies.
- Asset accumulation, money management acquisitions.

## Attractiveness Despite Downsides

For all of its ills, the insurance business still attracts market capital from both public and private sources, and the IPO market has reawakened from its coma.

After this brief summary of the insurance capital markets, many readers might agree that it would take a person wiser than Solomon to synthesize these observations. I am not that person. No, I defer to another insurance pundit, Yogi Berra, who commented, "When you reach a fork in the road, take it!"

*The full text, as well as charts on mergers and acquisitions, financings and equities valuations, is available through Mr. Goodfriend at [hgoodfriend@gillroeser.com](mailto:hgoodfriend@gillroeser.com) or (212) 972-4880.*