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Midyear 2009 U.S. Personal Lines Outlook: Historical Strengths Are Put To The Test

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Midyear 2009 U.S. Personal Lines Outlook: Historical Strengths Are Put To The Test

The U.S. property/casualty (P/C) insurance industry has survived myriad natural catastrophes and significant financial turmoil. But never before has it faced the exceptional challenge of simultaneously dealing with constant deterioration from financial stress, an economic recession, and frequent and severe weather-related events. These factors led Standard & Poor's Ratings Services to revise its outlook on the U.S. personal lines insurance sector to negative from stable in December 2008 (see "2009 U.S. Personal Lines Outlook: Stormy Skies Aren't The Only Worry," published Dec. 12, 2008, on RatingsDirect).

U.S. personal lines insurers endured this storm of unprecedented and tumultuous events in 2008, and although they, along with the broader U.S. P/C industry, reported their worst financial results since 2001, P/C insurers nevertheless generally turned profits. The industry continues to operate effectively, with the economic turbulence seeming to have little effect on the fundamental business of paying claims and selling new or renewal policies. And, despite difficult conditions, U.S. P/C insurers generally have so far remained relatively unscathed compared with other industries.

However, the factors that led to subpar performance for the industry in 2008 continue to loom. Reflecting our concerns, we are maintaining our negative outlook on the U.S. personal lines P/C sector in 2009. The negative outlook indicates that in the next 12 months we expect downgrades to exceed upgrades. At this time, we expect most downgrades will be only one notch (the difference, for instance, between 'A' and 'A-'). The key issues that we will look at for potential rating actions will be how an insurer manages the volatility and mitigates the risks relating to the strains associated with capital adequacy, financial flexibility, investment-related losses, liquidity, and operating performance—all of which could result from continued difficulties in the economy and heightened weather-related activity.

Fundamental Strengths Remain Intact, But Negative Outlooks Indicate Downgrades To Come

The events in 2008 highlighted that the P/C industry is not completely insulated from the distress that the broader U.S. economy is experiencing. The impact from the financial turmoil and the economic recession contributed to substantial increases in realized and unrealized capital losses on investments, as well as difficulties in raising new capital in the debt markets. Moreover, the frequency of storm-related events underscored that the weather is unpredictable and forecasts are not always reliable. Relatively lost in the news this past year was that 2008 was one of the worst years for disaster losses. Hurricanes Gustav and Ike (both of which struck the Gulf coast in September), for instance, are counted among the most expensive natural disasters in U.S. history. These and other events reinforced our opinion that catastrophes, if not properly mitigated, have the potential to damage an insurer's enterprise.

We continue to believe that trends in the personal lines sector support a negative outlook. Through May 4, 2009, we have taken one rating action, a downgrade (Allstate Corp. and its operating subsidiaries on Jan. 29, 2009) (see chart 1). The distribution of outlooks (see chart 2), which is perhaps the best indicator of future rating activity, points to more rating actions likely in the next six to 12 months. Of the personal lines insurers we rate, 45% have negative outlooks, as opposed to 9% one year ago. Also, 50% have stable outlooks, in contrast to 82% this past

year. Currently, no company has a positive outlook, but 5% of these insurers have ratings on CreditWatch with negative implications. The ratings on personal lines insurers are concentrated in the middle of the investment-grade universe, with 59% falling into the 'A' category. The distribution of ratings has shifted slightly over the past three years out of 'AA' and into the 'A' category (see chart 3).

Chart 1

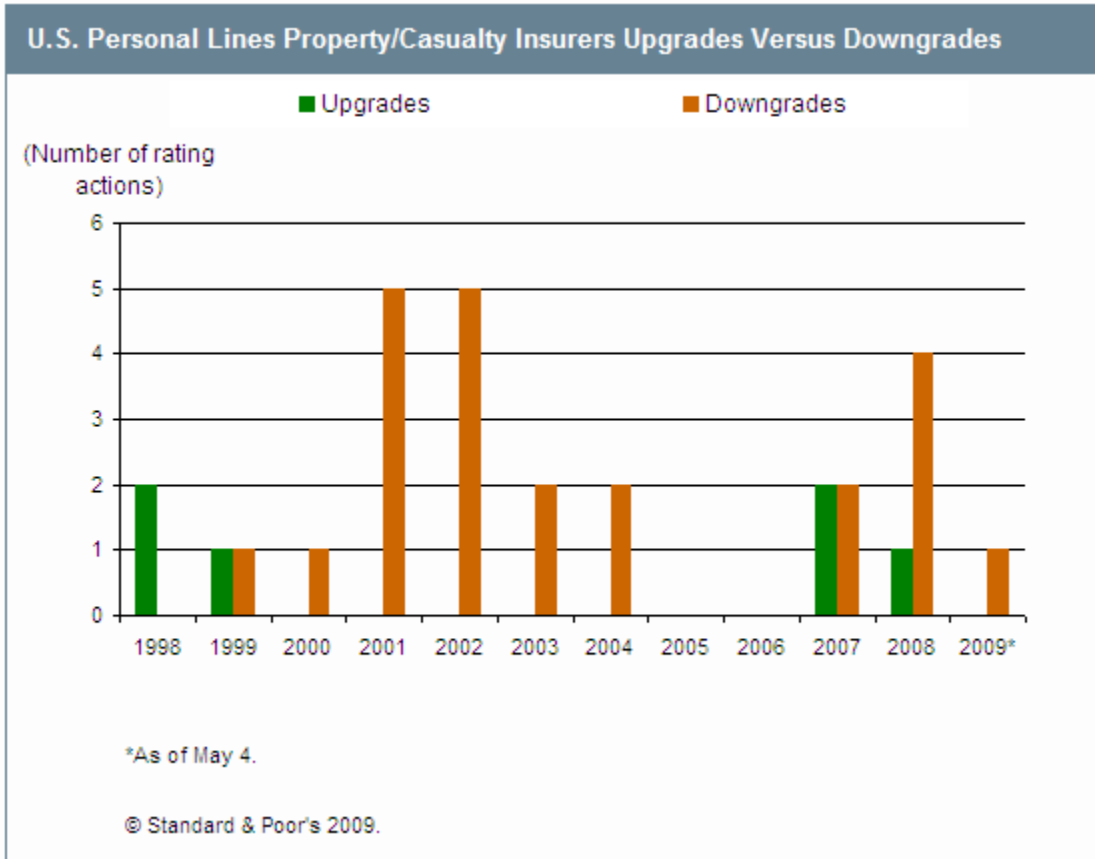


Chart 2

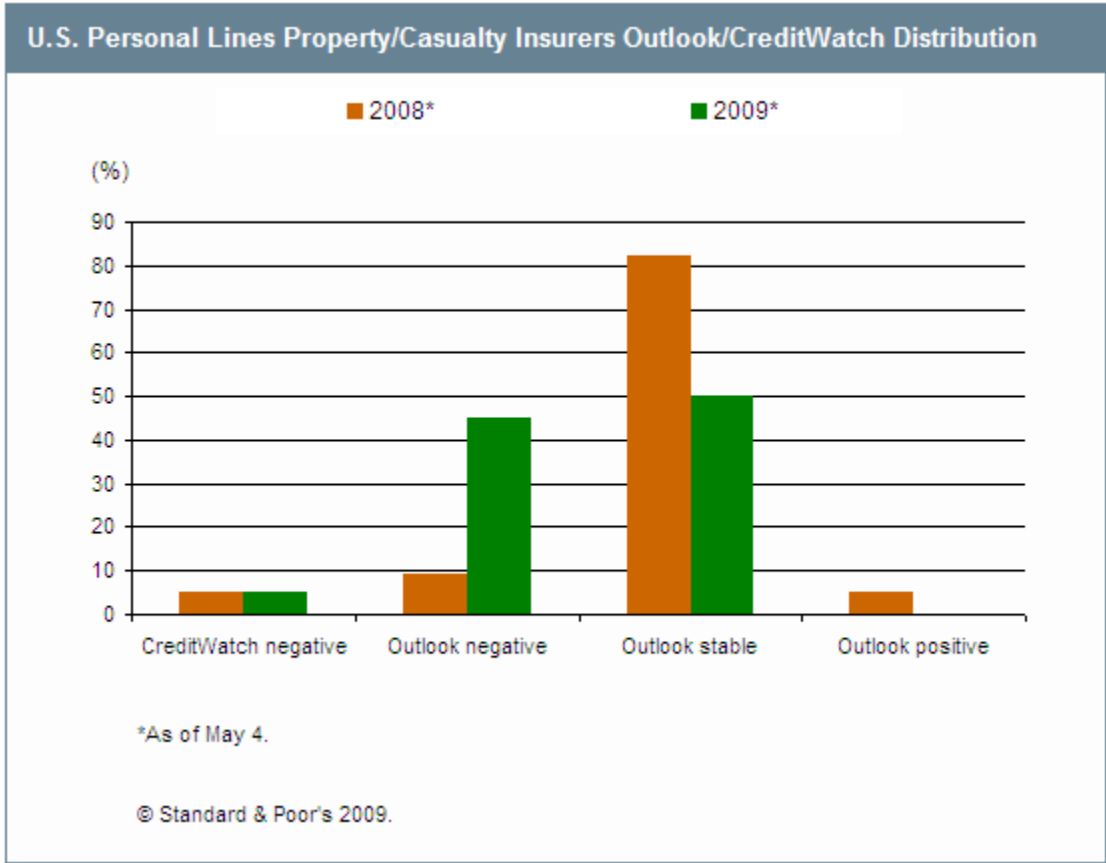
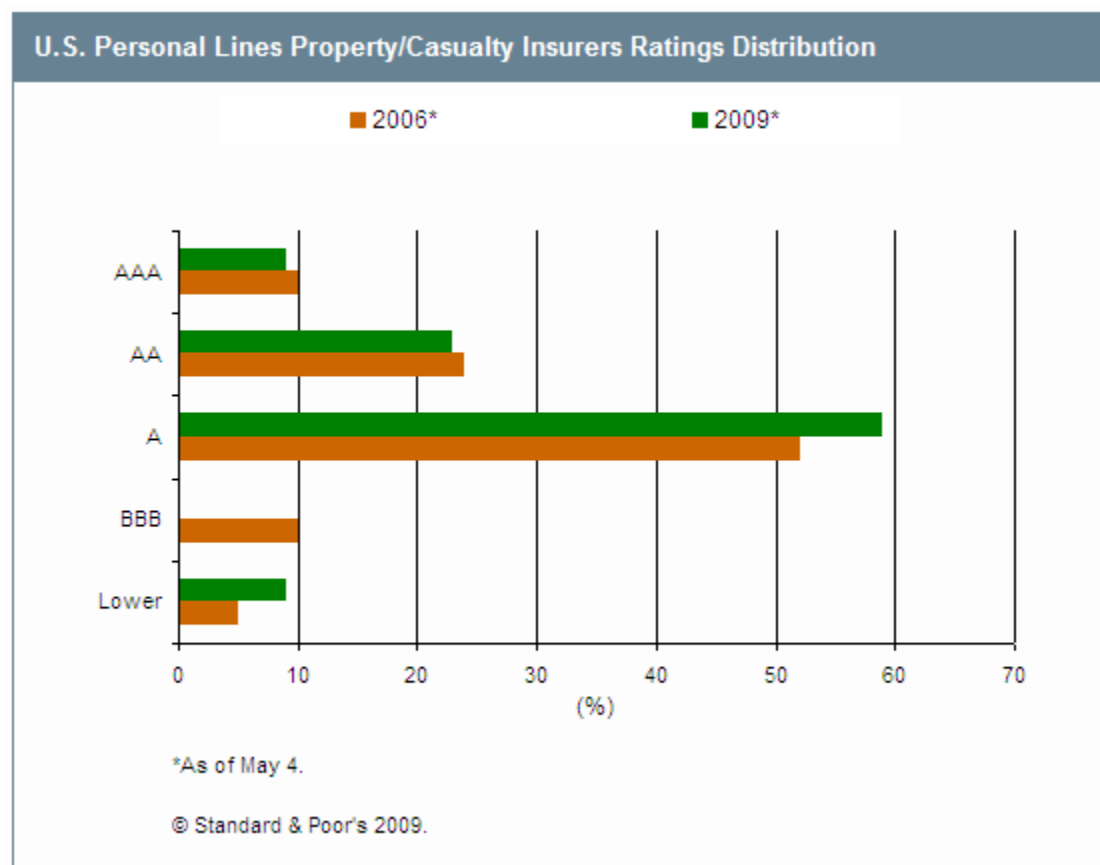


Chart 3



Despite our negative outlook, and even in the face of exceptional difficulties and current uncertainties, we remain confident in the sector's overall fundamental strength. Furthermore, we believe that most personal lines insurers are well positioned to deal with their credit, investment, and operational risks. Many companies are maintaining disciplined underwriting, improved risk management, enhanced claims-management practices, strong capitalization, and relatively healthy liquidity, in our view.

In spite of these strengths, we believe that some personal lines insurers likely will be challenged to sustain their credit profiles in 2009, while others probably will manage through the series of probable perils without a rating change. We continue to believe that errors in strategic judgment and execution of business fundamentals could hurt some insurers and result in negative rating actions.

Less Available Capital And High Expected Losses Limit Financial Flexibility

Traditionally, personal lines insurers have maintained strong capital, and they generally have been able to attain additional capital relatively easily. This availability, combined with favorable underwriting results and investment returns, contributed to consistent industry (including mortgage and financial guaranty insurers) policyholder surplus (the net worth of an insurance company) growth from 2002 to a peak of \$521.8 billion on Sept. 30, 2007, according to the Insurance Services Office (ISO). However, difficulties in the economy, along with a virtual shutdown in the credit/debt markets and the payout of claims from numerous weather-related events, caused

policyholders' surplus to drop \$62.3 billion to \$455.6 billion at the end of 2008 from \$517.9 billion at year-end 2007.

Although the industry unquestionably suffered capital deterioration, as this 12% year-over-year decline shows (compared with a 6.5% increase in 2007), we believe it was not a devastating loss and that most insurers were prepared for it. Furthermore, policyholders' surplus is fairly high compared with historical levels because the majority of personal lines insurers employ disciplined underwriting profiles, and companies typically aren't taking excessive investment or leverage risk on their balance sheets. These elements contribute to our view that the capital adequacy of most rated personal lines insurers is strong, and many companies maintain capital that is redundant at the rating level. Still, we remain watchful of how these insurers will cope with potential capital strain.

Along with declining capital positions, the sector is facing more limited financial flexibility. Insurers have paid sizable losses from weather-related events almost entirely from their own retentions rather than from what they recovered through reinsurance because the more frequent (but less severe) events did not reach reinsurance coverage limits. In addition, economic turmoil, including the dislocation in the credit markets, has limited, and in most cases prevented, insurers from raising new capital. As a result, many insurers have implemented contingency plans to preserve or replace lost capital (such as suspending share buybacks or reducing dividends). Although we generally believe this is a positive factor, we also consider it to be a short-term solution.

As indicated earlier this year (see "Property And Casualty Insurance Capitalization: The Pressure Is On," published April 21, 2009, on RatingsDirect), we believe the sector faces a tough 2009 and beyond with respect to maintaining strong levels of capital adequacy. Moreover, capital appears extremely expensive and harder to come by because of the intense competition for it and the continuing recession. With less available capital, but no apparent change in expected losses, insurers have less room for deterioration (and strategic error), which could diminish their financial strength.

Further Investment Losses Are Likely, Potentially Straining Liquidity

The economic events of this past year triggered significant volatility in the equity markets and interest rates, which likely caused the value of assets across all classes to decline. According to ISO, the P/C industry's investment results were down significantly in full-year 2008, with statutory realized capital losses of \$19.8 billion and statutory unrealized capital losses of \$52.9 billion against \$455.6 billion of statutory surplus. By comparison, in 2007, the industry booked \$8.9 billion in realized capital gains and a moderate \$634 million in unrealized capital losses. We should note that although impairment losses affected P/C insurance in the aggregate, they appear to have had a greater impact on other financial services segments.

This is because most P/C companies' investment portfolios are shorter in duration and higher in quality to address the less-predictable timing and nature of their claims. And, because of the frequency of weather-related events in 2008 and thus far in 2009, many personal lines companies are regularly paying claims.

Personal lines insurers typically maintain asset portfolios that are heavily weighted in high-quality, investment-grade corporate fixed-income securities, yet many also have sought higher-yielding investments to bolster their portfolios' performance. Regardless, we are increasingly concerned about investment risk, because the general market decline in most asset classes is meaningfully affecting all insurers' portfolios, and we expect to see additional losses in 2009. Moreover, despite companies' stated intent to hold asset securities with depressed market values until prices recover

or investments mature, the instability significantly compromises investment income, which is a sizable secondary source of insurer profitability.

We believe personal lines insurers generally have sufficient liquidity to meet their short-term liabilities. We are, however, looking more closely at how insurers handle stress scenarios, balancing liquidity sources against their liability structures and potential liquidity calls. We believe that liquidity could quickly become a negative rating factor if an insurer realizes further investment portfolio losses because of an inability to hold assets until prices recover or until maturity, or because of a need to service claims activity resulting from a catastrophe.

Despite Poor 2008 Operating Performance, Basic Strengths Should Support An Underwriting Profit

Underwriting profitability, typically the largest contributor to a company's earnings, deteriorated rapidly in full-year 2008. According to ISO, the U.S. industry's statutory combined ratio (the most closely watched underwriting profitability metric) for the full year weakened 9.6 percentage points to 105.1% in 2008 from 95.5% in 2007. (The lower the combined ratio, the better the profitability. And a combined ratio of more than 100% signifies an underwriting loss.) For personal lines insurers specifically, the full-year combined ratio was 104.6% in 2008 versus 96.9% in 2007. This is the first underwriting loss for personal lines insurers since 2002.

The main reason for the higher combined ratio for personal lines insurers was the insured losses from Hurricanes Gustav and Ike. Adding to these storms were other weather-related and man-made events, which, according to a report from Munich Re, made 2008 the fourth most severe season (in terms of both the number of storms and the number of major hurricanes) since reliable data have been available.

The insured catastrophe losses from the year's events added 7.6 percentage points to the loss ratio (to 78.8% in 2008 from 71.2% a year earlier) for personal lines insurers and were greater than the insured losses from 2006 and 2007 combined. Also, about two-thirds of the claims processed involved personal lines insurers. The expense ratio, in contrast, barely moved in 2008, weakening only 0.3 percentage points to 25.4%, which likely reflects higher expenses on a relatively flat premium base (written premium growth declined 0.1% year over year).

Along with insured losses, personal lines insurers were also dealing with sizable reductions in investment income as a result of general market declines, which further contributed to weaker operating performance and lower net income.

In spite of these factors, we believe that the underlying fundamentals of the sector are strong and that it likely would produce an underwriting profit in a typical storm season. We also think that insurers will depend on their underwriting skills and risk-mitigation practices rather than on investment income, because it is doubtful that low interest rates, weak investment conditions, and fewer reserve releases will provide a significant contribution to income. Furthermore, in our view, the sector will remain susceptible to significant competition, volatility and dislocation in the credit and equity markets, the economic recession, potential fraud, and uncertainties regarding catastrophe activity. We expect these factors to hamper prospective operating profitability.

Breaking Down The Personal Lines Industry By Segment

Auto insurance: flat premium growth and slowly rising rates

The automobile insurance market, the world's largest insurance market by premium, is traditionally one of the most active and aggressive segments within P/C insurance, and perhaps the industry as a whole. And the economic recession does not appear to be hampering competition for customers.

Even in the face of an economic downturn, insurers continue to dedicate vast resources to the development and preservation of brand recognition and awareness, technology (for product, pricing, segmentation, and claims management), and distribution platforms, as they work to build market share. In mid-April, Zurich Financial Services Group announced that it, through its subsidiary Farmers Group Inc., had entered into an agreement to acquire 100% of American International Group Inc.'s U.S. personal auto group for \$1.9 billion, with the goal of accelerating its entry into the direct sales distribution channel. This is one of the fastest growing channels in the U.S. insurance marketplace, increasing to 18.0% of the total U.S. auto insurance market in 2006 from 7.7% in 1997. Owing to changing consumer buying behavior, it is also rapidly attracting entry from a rising number of the more traditional agency-focused (independent and exclusive) carriers that view this as a way to draw in new customers, while providing choice and convenience to their existing policyholders.

Premium growth in the sector was flat in 2008, mainly because of price competition and the effects of the economic downturn. We expect premium growth to remain flat in 2009. Potential changes to consumer buying behavior likely would support our viewpoint. Examples include:

- Potentially less demand for the premium-type policies that offer bells and whistles coverage pricing plans;
- Subtle increases to physical damage (collision or comprehensive) deductible changes to reduce monthly expenses;
- New pay-as-you-go driving products that base premium rates primarily on miles driven; and
- Lower motor vehicle retail sales, which have been on a steady decline along with consumer confidence.

From a pricing perspective, we have observed moderate single-digit rate increases since mid-2008, and we believe they are likely to continue through 2009 as insurers attempt to protect profit margins and get ahead of looming inflationary loss costs. Standard & Poor's perceives that insurers are using sophisticated technological enhancements to more finitely (re)underwrite business to compensate for volatility, increased risk (including questionable claims and fraud), and weak investment conditions. The unemployment rate could also affect costs and pricing. The Insurance Research Council warns that an increase in the unemployment rate of one percentage point is directly associated with an increase in the uninsured motorist rate of more than three-quarters of one percentage point. This could increase the risk to all drivers, influence loss cost trends, and affect the extent of future price changes.

Homeowners' insurance: reevaluating underwriting under stressful conditions

The homeowners' segment is currently feeling the heat from a significant amount of claims payments because of the frequency and severity of weather-related events, sliding house prices and values, foreclosures hitting record highs, and unpredictable regulation. These forces are compelling insurers to reevaluate where and how they underwrite business.

Average price increases are in the low- to mid-single digits nationwide but are rising rapidly in many states, especially along the coasts, because of the possibility of unusually frequent and severe natural catastrophes. Insurers nationwide could also raise prices further to recoup the cost of buying reinsurance, and authorities could seek to

strengthen their state-backed catastrophe funds via policy assessments. As a result, insurers are likely to price differently because of the potential volatility to their risk and claims profile. Standard & Poor's believes that homeowners' insurers might attempt to compensate for unstable investment conditions and economic changes related to lower home sales, accompanying values and deductibles, increased foreclosure rates, and potential fraud, because consumers tend to file more claims during economic downturns.

Although it appears many insurers are increasing rates, some personal lines companies are discovering that additional state regulatory pressure is making it more difficult to do this. One such example is in Florida, where the largest domestic personal lines insurer, State Farm Mutual Automobile Insurance Co., announced that its subsidiary, State Farm Florida Insurance Co., would discontinue its Florida property insurance product lines because of its belief that it is unable to obtain regulatory approval for what it views as adequate property insurance rates. Although this type of behavior is not widespread, the politically charged debate is prevalent in many states and has contributed to the persistent reluctance of insurers to add market volume there.

Overall, we believe companies in this line are being more selective in their underwriting practices, as demonstrated by risk-mitigation efforts. In addition, we believe that a combination of potential increases in catastrophe frequency, increased reinsurance costs, and regulatory resistance to raise rates is squeezing profitability in this line.

With Great Challenges Come Great Opportunities

Changes in the markets, the economy, and the weather are creating difficult operating conditions for U.S. personal lines companies. But, regardless of the imminent risk, we expect them to stay true to their basic fundamentals, including maintaining a disciplined underwriting approach, improving risk management and risk segmentation, and enhancing claims-management processes by using sophisticated risk controls and cutting-edge technology. At the same time—and as a result of continued volatility—credit, investment, liquidity, and operational issues will also essentially rise to the forefront of insurers' strategic considerations.

It's likely that competition will remain high, risks will persist, and volatility will prove costly. In spite of this, we believe that most U.S. personal lines insurers will generally manage through these tough times and remain prudent in their pricing and risk-management decisions. Another important factor is expense management, which will be a key element in performance as expense growth continues to outpace revenue growth. We believe this gap will remain, because net premiums written likely will remain flat in 2009.

Economic conditions probably will continue to impede earnings. Therefore, insurers have no quick solution for replenishing losses in policyholder surplus. This might compel some companies to alter their strategic initiatives, whether by reducing the supply of or capacity to assume risk or by expanding cost-cutting tactics to protect near-term viability. Mergers could be in the cards in the personal lines sector, but we believe these will be limited to insurers that seek a rapid expansion into new markets, territories, or product lines, primarily because of the sluggish conditions.

In our view, it will be vital for companies to focus on lessons learned and remain up to date on regulatory and accounting changes to make smooth transitions and come out ahead of their competitors. Insurers with strong leadership and the ability to adapt to changing conditions likely will be better positioned to move forward in this unstable market. Amid the many uncertainties in today's economy, the challenges that personal lines insurers face can become great opportunities for flexible companies.

Related Research

- "Analysis Of Nonlife Insurance Operating Performance," published April 22, 2009.
- "Criteria | Insurance | General: Investments," published April 22, 2009.
- "Analysis Of Insurer Capital Adequacy," published April 22, 2009.

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