

## Wyoming Legislative Service Office

213 State Capitol Cheyenne, Wyoming 82002

Telephone: (307) 777-7881 Fax: (307) 777-5466

E-mail: [lso@state.wy.us](mailto:lso@state.wy.us) Website: <http://legisweb.state.wy.us>

### Q u i c k R e f e r e n c e M e m o r a n d u m

**Date:** January 30, 2004

**To:** Senator Job

**From:** Brian Farmer, Associate Research Analyst

**Subject:** Insurance Industry Profit

You requested that I conduct research for you regarding the profits earned by the insurance industry generally and the profitability of medical malpractice liability insurance, in particular. Specifically, you inquired about recent trends of profitability in the insurance industry relative to the profitability of other industries. You also inquired about the profitability of the medical malpractice insurance industry and what impact, if any, it had on premiums.

I have provided a brief response and analysis to your questions. It should be noted upfront that the results reported are based on national trends and that local and regional results may vary. Further a caveat on the difference between profit and profitability is warranted. Profits, strictly speaking, are essentially equivalent to net income, although accountants and economists may disagree. Profitability includes the notion of the capacity to earn profits. Several measures exist, such as return on assets, return on equity, etc., as an indication of profitability. Please let me know if you would like a more complete discussion of any of the following points.

#### Questions:

- 1) What are the recent trends of profitability in the insurance industry?
- 2) How does the profitability of the insurance industry compare to the profitability of other industries?
- 3) What impact, if any, does the profitability of the medical malpractice liability insurance industry have on premiums?

#### Responses:

- 1) **The property and casualty insurance industry's net income grew 320 percent from \$5 billion through the first three quarters of 2002 to over \$21 billion through the first three quarters of 2003. Further indicators of profitability for the property and casualty insurance industry are summarized in Table 1. This does not account for measures of profitability in the life, health or other insurance industries.**

According to a joint statement issued by the Insurance Services Office (ISO) and the National Association of Independent Insurers (NAII), the U.S. property and casualty insurance industry's net income after taxes rose to over \$21 billion in the first nine months of 2003 from \$5 billion

through nine-months 2002. Income in the property and casualty insurance industry is primarily derived from two sources: underwriting and investments. Underwriting is the assumption of financial responsibility through the issuance of an insurance policy. Investments include the capital committed to gain a financial return. In 2003, both underwriting and investment results improved, representing a 320 percent increase in net income over the previous year. Further, industry surplus, or statutory net worth, increased just over 21 percent to \$319.9 billion as of September 30, 2003 from \$285.4 billion at year-end 2002. However, ISO and NAII report that the industry's income during the first three quarters of 2003 was 22.8 percent below its income through nine-months 1997 and surplus (\$19.4 billion as of September 30, 2003) was 5.7 percent below its peak of \$339.3 billion at June 30, 1999. Table 1 illustrates a comparison of the operating results for 2003 and 2002 and provides further indicators of profitability for the property and casualty insurance industry.

**Table 1. Operating results for nine-months 2003 and 2002 (\$ Millions)**

	<b>2003</b>	<b>2002</b>
Net Written Premium	308,554	280,297
Net Earned Premium	288,703	258,636
Incurred Loss and Loss-Adjustment Expense	217,656	206,234
Statutory Underwriting Gain (Loss)	(4,846)	(17,320)
Policyholders' Dividends	852	917
Net Underwriting Gain (Loss)	(5,698)	(18,238)
Pre-Tax Operating Income	22,111	8,521
Net Investment Income Earned	27,704	26,853
Net Realized Capital Gain (Loss)	5,875	(1,287)
Net Investment Gain	33,579	25,566
Net Income (Loss) After Taxes	21,107	5,018
Surplus (Consolidated)	319,922	273,462
Loss and Loss Adjustment-Expense Reserves	418,730	383,387
Combined Ratio, Post Dividends (%)	100.3	105.0

**Source:** ISO and NAII published data.

It may be suggested that the increase in profitability reflects the fluid nature of investment performance and financial markets. While profitability was high in the late 1990s, the property and casualty insurance industry saw decline in its rate of return in 2001. Attachment A provides a graphical depiction of the net income after taxes of the property and casualty insurance industry from 1991 through the first quarter of 2003 as reported by the Insurance Information Institute (I.I.I.). The 2003 figures reflect a decrease in net losses from underwriting as well as growth in net investment and other income. Recent trends seem to suggest a continuing recovery from the low of 2001, yet do not match the high profitability of the late 1990s. Don Griffin, NAII vice president for business and personal lines, credits recent progress for the improvements to solid underwriting, cost-based pricing, and careful claim settlement.

- 2) Direct comparisons of profitability are difficult to make due to data limitations. Net income in the "finance and insurance" industry was greater than that of any other industry group in 1999. Further, insurance corporations filed 2000 returns that showed net income greater than that of several major industry groups. However, the return on equity for the property and casualty insurance industry has regularly fallen below that for all industries.**

It is extremely difficult to compare profitability between industries. As mentioned before, there are multiple measures of profitability and they are distinct from profit. An industry with high net income is not necessarily going to score high on all measures of profitability. Further, it is difficult to obtain complete and recent data from which to compare the insurance industry.

To provide some basis of comparison between the insurance industry and other industries, it is possible to compare the net income where data is available. The result, however, may be misleading as relative growth depends on the experience of the industry over time. The U.S. Census Bureau produces an annual Statistical Abstract of the United States, containing a section on "Business Enterprise." The Census Bureau reports the net income of industries based on the North American Industry Classification System (NAICS). Published NAICS data by major industry combines insurance with finance, making a direct comparison between any industry and the insurance industry alone impossible. Further, the Statistical Abstract includes investment income in business receipts for partnerships and corporations in "finance and insurance", "real estate", and "management of companies" industries. Attachment B provides a table from the 2002 Statistical Abstract that allows for some comparison between industry groups. In 1999, "finance and insurance" corporations realized the highest net income of any major industry group (\$361 billion) in 1999. The next closest was \$247 billion in net income for corporations in the "manufacturing" industry. When considering the net income for all business entities (non-farm proprietorships, partnerships, and corporations), the "finance and insurance" industry recorded a net income of \$461 billion. The total net income for all business entities in the "manufacturing" industry was \$264 billion. No other industry recorded a net income near these totals.

The IRS provides data on corporate income tax returns and also uses NAICS categories. However, the IRS breaks down major industry classifications into their minor subcomponents. In 2000, "insurance carriers and related activities" recorded the fourth largest net income (\$66.7 billion) of all minor industries in the "finance and insurance" industry group. The top three minor industries were of a finance nature: "other financial companies," "open-end investment funds," and "offices of bank holding companies." It should be further noted that the "insurance carriers and related activities" minor industry recorded net income higher than that of several major industry groups, such as "construction," "professional, scientific, and technical services," and "utilities."

Another method of comparing the profitability of industries is to examine the return on equities. Return on equities can be defined as earnings divided by equity. This measure of profitability allows for some control, or perspective, of profit. The I.I.I. provides data illustrating that the return on equities for the property and casualty insurance industry regularly falls below that of all industries (see Attachment C.) Again caution is warranted that property and casualty is only part of the larger insurance industry. Further, the nature of the insurance industry may affect the comparison. Equity can be defined as assets minus liabilities. No comparison was made on return on assets due to data limitations.

**3) According to the General Accounting Office (GAO), while multiple factors contribute to the increase in medical malpractice insurance premiums, losses on medical malpractice claims appear to be the primary driver of rate increases.**

Despite the performance of the property and casualty insurance industry as a whole, the medical malpractice liability insurance industry has experienced regular losses in underwriting. While

underwriting is only a portion of the overall profitability of the insurance industry, medical malpractice insurers are faced with expenses in excess of revenue collected from premiums. According to a June 2003 GAO report (Attachment D), multiple factors have contributed to increased premium rates. "Insurers' losses, declines in investment income, a less competitive climate, and climbing reinsurance rates have all contributed to rising premium rates." Further, GAO found that losses on medical malpractice claims appear to be the primary driver of rate increases in the long run. "Because insurers base their premium rates on their expected costs, their anticipated losses will therefore be the primary determinant of premium rates." GAO said that factors other than losses can affect premium rates in the short run. Medical malpractice insurers, the report said, also experienced decreases in their investment income as interest rates fell on the bonds that make up around 80 percent of these insurers' investment portfolios. A decrease in investment income would mean that an insurer would have to cover a greater portion of costs with income from insurance premiums.

According to the I.I.I., medical malpractice insurers paid out \$1.65 in losses and associated expenses in 2002 for every dollar they collected in premiums. Many insurers have scaled back their exposure to the medical malpractice market and, in some cases, exited the market completely. The St. Paul Companies, which until recently was the largest writer of medical malpractice in the United States, announced in December 2001 that it was exiting the market because underwriting losses threatened its solvency. In addition, at least three other insurers have restructured or collapsed.