Aon Benfield

Homeowners' ROE Outlook

October 2016

Risk. Reinsurance. Human Resources.

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Homeowners: Growth and Profitability Inviting Competition

Strong overall growth continues to be the story for Homeowners as direct written premiums increased to $89 billion in 2015 from $86 billion in 2014 for the industry in aggregate. Further, homeowners continues to post promising profitability levels that beg consideration from three perspectives:

1. While the prospective ROE on homeowners declined for the first time since 2011, the line continues to generate returns in excess of its cost of capital in thirty-four states representing 54 percent of the industry premium. Our estimate of the 2016 prospective ROE is 6.7 percent, down from last year's 8.6 percent. Florida continues to be a significant ROE drag for the industry; without Florida the prospective 2016 industry ROE is 10.9 percent versus 12.6 percent last year.

2. At expected catastrophe loss estimates and given prospective rate levels, we show the industry targeting an underwriting profit at a 94 direct combined ratio. Forty-six states totaling 73 percent of industry premium clear the hurdle to achieve underwriting results below a 100 combined ratio.

3. Finally, the question of actual profitability from an accounting perspective offers a third view. Individual state profitability varies considerably given weather driven volatility and the homeowners industry overall is benefiting from an historic dearth of hurricane activity. Over the last five years, we show the industry averaging eight points of direct underwriting profit (before tax), with thirty-eight states individually below a 100 combined ratio.

Another bright spot accretive to homeowners profitability is the continued contraction of reinsurance pricing. The heavy exposure of homeowners to catastrophic perils including hurricanes, tornadoes, hail, and winter freeze events makes the line capital intensive to write. Reinsurance capital, both traditional and non-traditional, is available at aggressive pricing and provides savvy carriers significant flexibility in managing growth options within profitable footprints while maintaining net risk positions.

Persistently low investment yields complicate the picture for carriers because of a lack of meaningful alternatives to bolster underwriting profitability. However, the short duration of the payment pattern on most personal lines business, both home and auto, makes an emphasis on underwriting paramount. The level of sophistication in pricing, claims management, marketing, and risk selection for homeowners is ramping up quickly. Further, the push of erstwhile auto specialists into homeowners to become personal lines generalists brings the analytics expertise of those carriers to bear in the homeowners space. The result is an increasing level of competition for profitable homeowners business, as reflected in our declining ROE estimate for the line, and growing investments in data and analytics initiatives.

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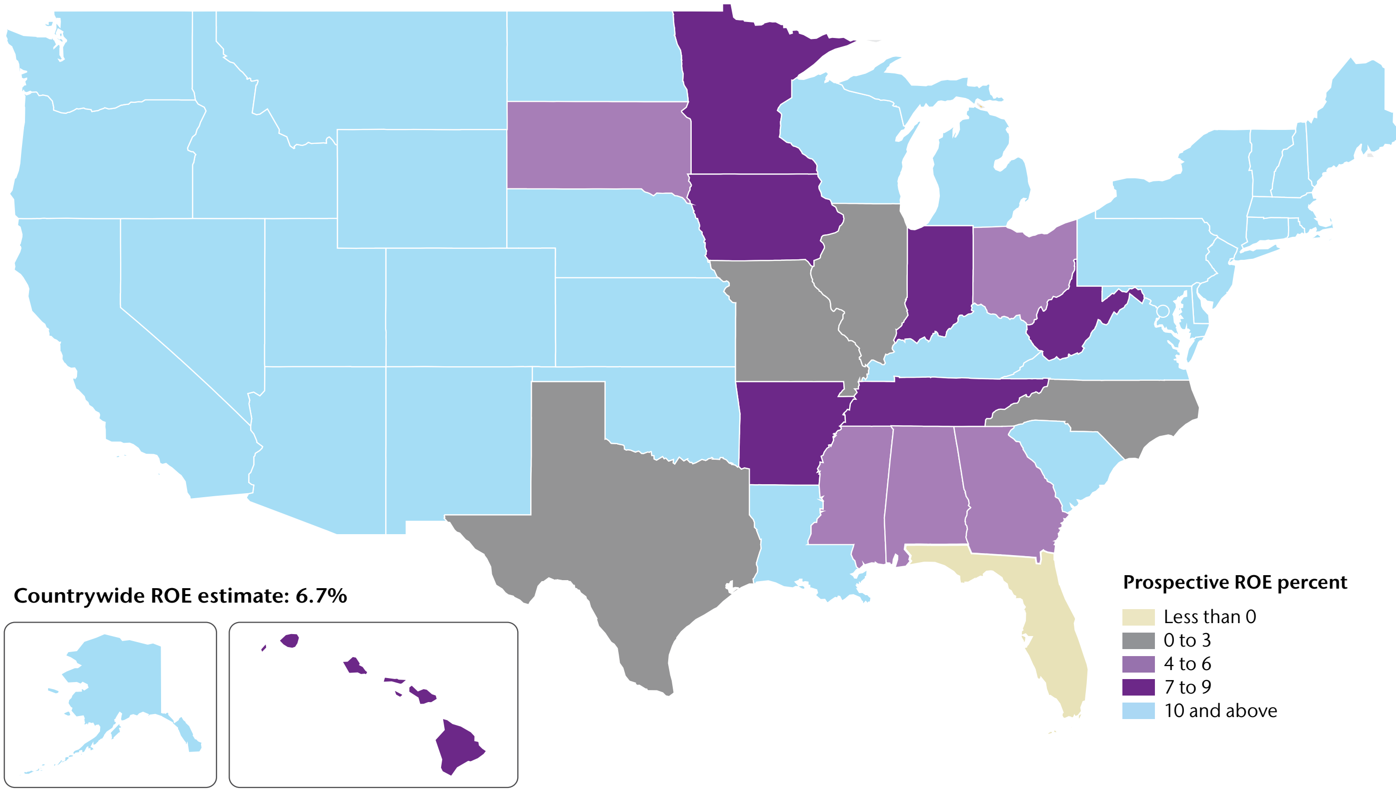
August 2016 prospective ROE at current rates

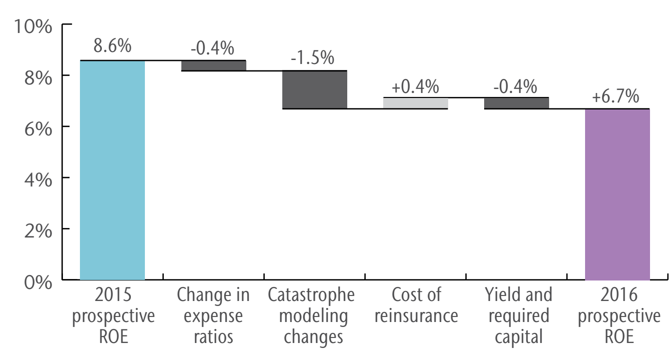


ROE study methodology

The basis of the prospective ROE estimate is industry state and aggregate statutory filing data including reported direct losses, expenses, payout pattern, and investment yields. We replace actual historical catastrophe losses as measured by Property Claim Services with a multi-model view of expected catastrophe loss. On-leveling of direct premiums to current rates uses rate filings of the top 20 insurance company groups by state. Finally, estimated capital requirements and reinsurance costs consider a nationwide personal lines company writing both home and auto business at a capitalization level consistent with an A.M. Best "A" rating. The ROE estimates exclude earthquake shake losses, as the premium and losses for that coverage are recorded on a separate statutory line of business.

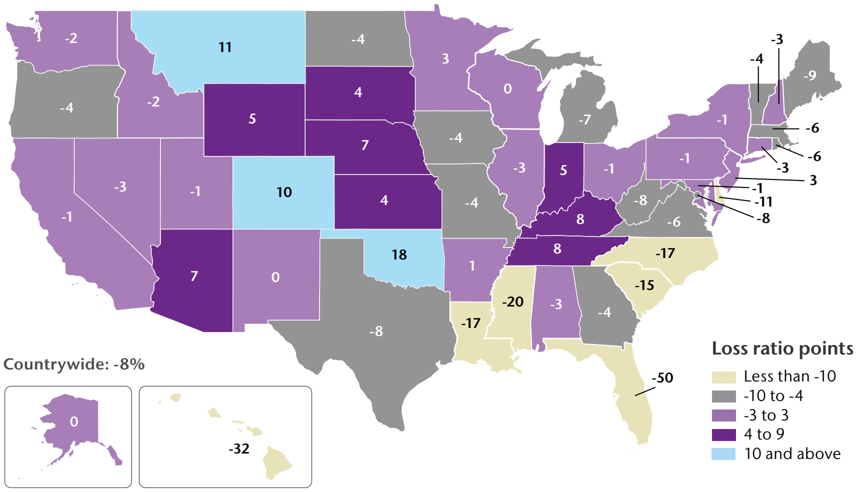
The diversification available to a nationwide personal lines insurer impacts the ROE calculation. For instance, homeowners business in California diversifies Gulf and East Coast hurricane exposure for a nationwide insurer. A California standalone would incur higher capital and reinsurance costs than the California portion of a nationwide insurer with similar premium volume in the state. Similar results are to be expected for any other regional or single state insurer.

Change in prospective ROE from previous year



The 2016 nationwide ROE estimate of 6.7 percent is an erosion from our 2015 estimate of 8.6 percent. The headwinds include (1) a slowdown of rate increases along with expense ratio noise worth 50bps on the combined ratio, (2) an increase in the estimated catastrophe loss ratio resulting from updates to the vendor catastrophe models used in the study that hurt the combined ratio by 170bps, and (3) changes in assumed yield (down 40bps) deleterious to the ROE. Declining costs of reinsurance to capitalize the volatility inherent in the homeowners line buoyed profitability somewhat against the ROE headwinds. Softening reinsurance costs have cumulatively added over 200bps of ROE in our study since 2013; it remains to be seen where reinsurance pricing will bottom out.

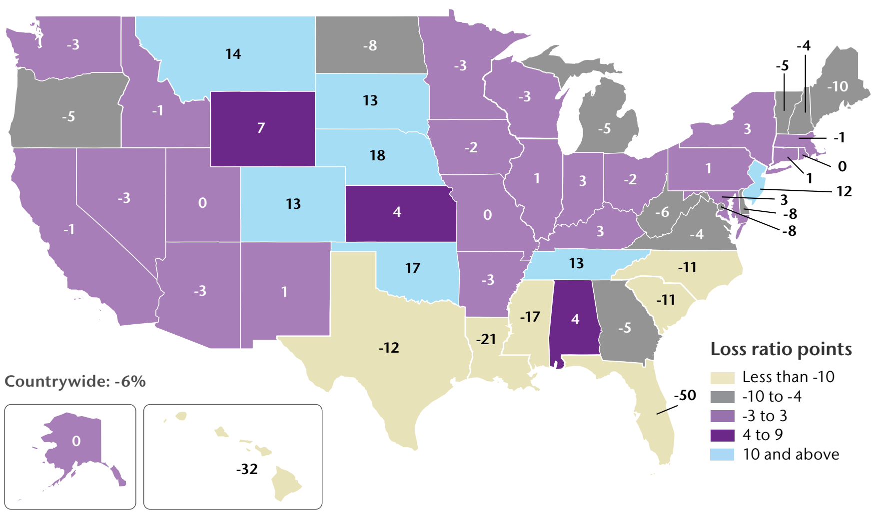
Ten year Property Claim Services loss experience vs. modeled average annual loss



The maps left and below show, in loss ratio points, the amount that catastrophe experience exceeds modeled average annual loss. Adjusting combined ratios for expected versus historical catastrophe loss is an important step to distinguish weather-related randomness from inadequately priced business. Historical catastrophes can distort measures of results at a state level, causing the noise to overwhelm the signal. While the state level adjustments can be significant, the ten year nationwide experience catastrophe loss ratio of 12 percent is meaningfully lower than the modeled expected catastrophe loss ratio of 20 percent.

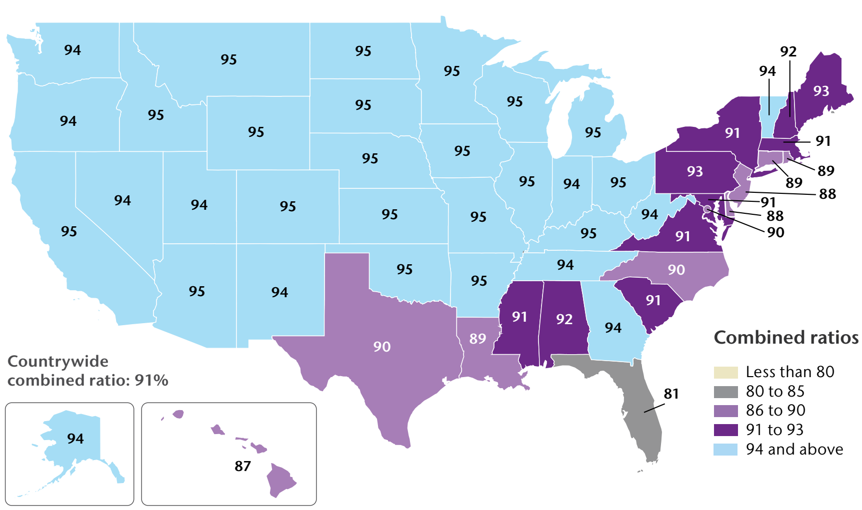
Coastal states, including Florida, benefited from the lack of a major hurricane landfall over the last ten years and, as a result, posted catastrophe loss experience of 11 loss ratio points, well below the modeled expectation of 26 points.

Five year Property Claim Services loss experience vs. modeled average annual loss



State-by-state level results in the Midwest and tornado alley show significant variability over the last five years with states like Oklahoma and Nebraska experiencing losses much higher than catastrophe model estimates. Overall, the Midwest and tornado alley five year results come in close to the model estimates, with experience causing a loss ratio drag of only 2 points versus the models. Texas presents an interesting juxtaposition as the lull in hurricane activity drives the state's favorable experience despite significant thunderstorm losses in the north and west portions of the state.

Direct combined ratio to achieve a 10 percent return on allocated capital



The percentages in the map on the left show the direct target combined ratios necessary to fund reinsurance costs and allocated capital for retained risk by state, including catastrophe and non-catastrophe risk. The targets are for a sample nationwide company only and will vary among individual companies because of state distribution of premiums, capital adequacy standards, target return on capital, allocation methodologies, reinsurance, and other considerations. For a diversified insurer with a footprint similar to the industry, the target combined ratios fall into three main categories: (1) Florida, (2) other hurricane-exposed states, and (3) states not materially exposed to hurricanes.

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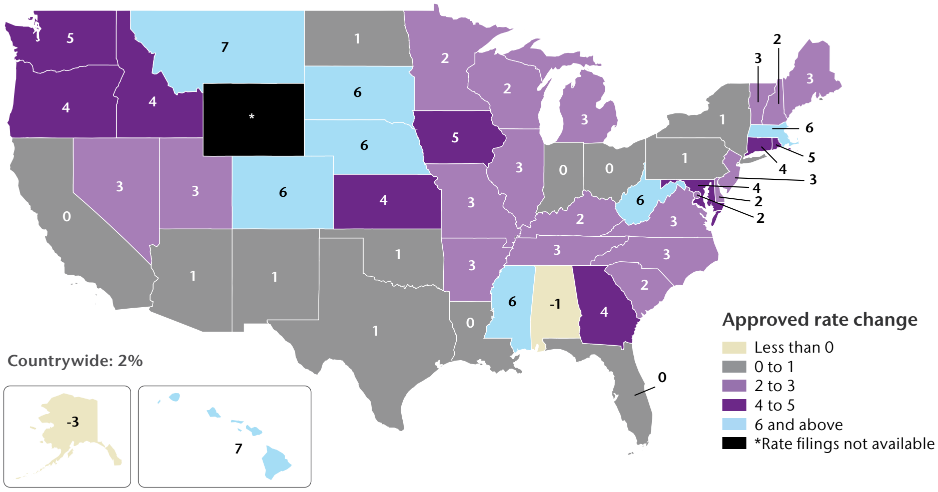
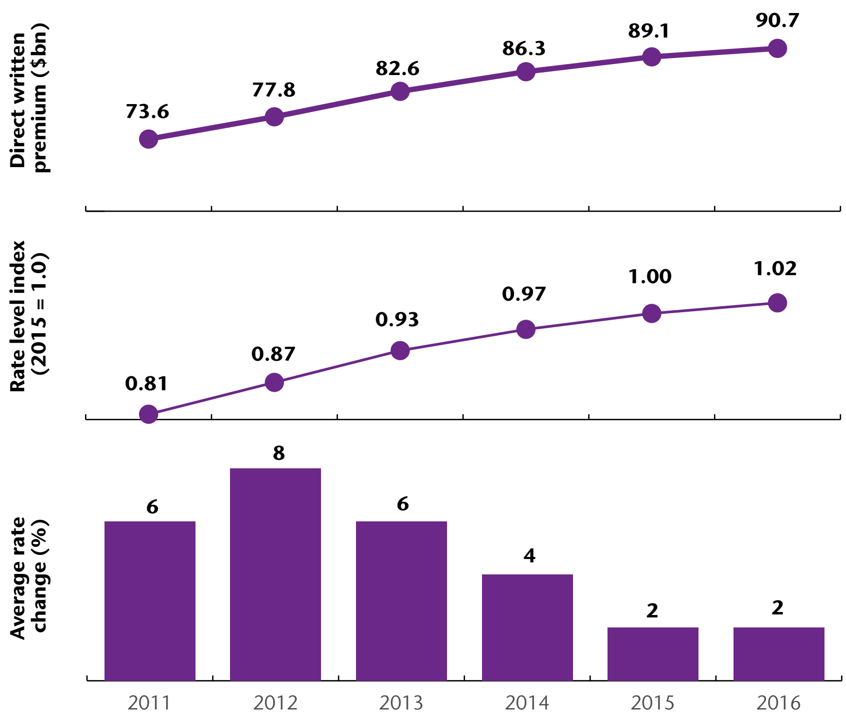
Homeowners average approved rate change



The map on the left shows average approved rate changes filed between January 2015 and August 2016 for the top 20 homeowners groups by state that made a filing in the period. Rate activity, while still positive, showed material slowdown nationwide. The largest rate increases primarily came in states with significantly adverse tornado and hail experience in the last three to five years, including Montana, South Dakota, Nebraska, and Colorado. Filed rate changes in Florida came in flat overall in a competitive and highly regulated environment.

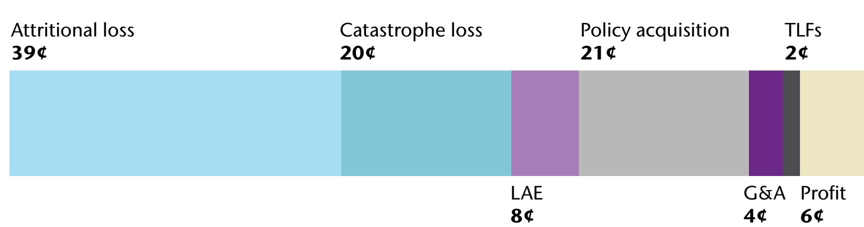
Premium growth and rate change, 2011 to 2016



Homeowners was a growth engine for the insurance industry from 2011 to 2015 as one of the few lines to outpace GDP. Direct premiums increased from $74 billion in 2011 to $89 billion in 2015 with a projected $91 billion for 2016 given prospective rate activity. A strong component of growth over the five year period from 2011 to 2015 was an emphasis on rate adequacy with indicated rate levels increasing over 25 percent. Policyholders changing carriers will prevent the industry from realizing the full aggregate benefit of individual carriers' rate actions.

Rate activity for the industry nationwide remains in positive territory while showing signs of slowing in 2015 and 2016. Six states, including Alaska, Alabama, Arizona, Florida, Indiana, and Ohio have negative rate on-level factors for 2015, suggesting prospective 2016 premiums will be lower than 2015 nominal premiums before accounting for any exposure growth.

One dollar of homeowners premium



Our study suggests that, at prospective 2016 rates and before income taxes, insurers keep slightly less than six cents of profit for every premium dollar they earn. That six cents of direct profit must then be shared between the primary carrier, reinsurance partners, and the US Treasury.

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