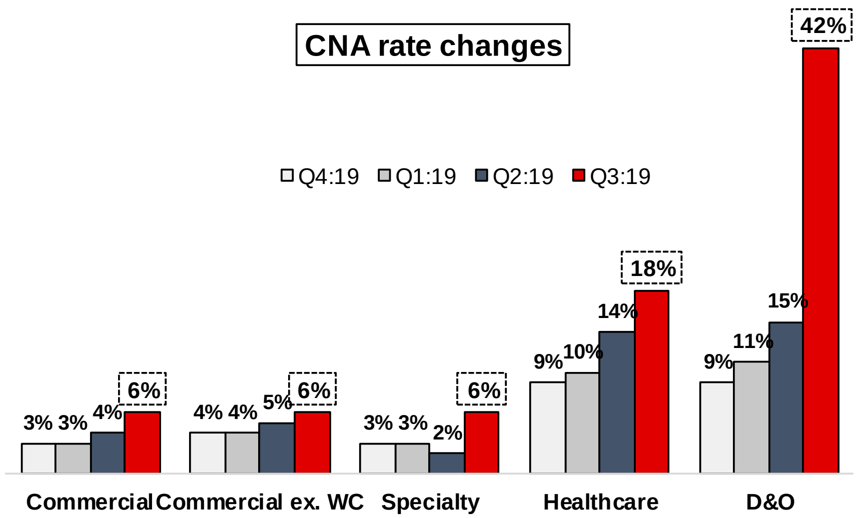
Inside P&C by The Insurance Insider

October 28, 2019

IT'S THE CHEATING PHASE, STUPID



CNA Q3 operating EPS fell 68% YoY to $0.37 per share missing consensus estimate of $1.02, as both P&C and Life & Group operating results weakened – driven by the first adverse development in P&C since Q1-15 and a charge related to life reserves. Details below.

However, looking beyond the headline beats and misses, CNA's result showed a continuation of recent trends but perhaps with a level of amplification that surprised even us.

We have been talking for some time about two key drivers of P&C conditions that were perfectly on display in CNA's results.

First, though the market may be rational and orderly in aggregate, this is an over-simplification of underlying market conditions.

In reality, the market is split between a firming but more orderly part largely in smaller and middle market accounts, and pockets of severe dislocation, largely focussed in large and complex risks, with capacity dynamics closer to 2001 than 2011.

Coming into Q3, we said there was some anecdotal evidence of these more dislocated pockets getting even harder. And CNA's report included some data points that add material new information to support this. In particular, we'd highlight two numbers. The company said:

- **Public D&O rates were up ~30%** on a median basis, and 42% on average including the impact of some large accounts that skewed the average. This is up from ~10-15% in Q1 when we first outlined our thesis on a hard market in D&O to come, and mid-teens or higher in Q2.

- **Healthcare rates were up 18%, up 13 pts over the past year.** Recall, we have previously highlighted the healthcare liability

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CNA Financial, Key Statistics

Market Cap ($mn)	**12,324**
Share price	**44.1**
MTD	**(10.4)%**
YTD	**(0.0)%**
1-YR	**4.0%**
3-YR	**26.7%**
Div Yield	**3.1%**
Price / Earnings	**14.2 x**
Price / Book	**1.0 x**
Price / Tangible Book	**1.0 x**

Source: S&P Global, Inside P&C

markets as a key segment to watch, following the big- flashing-red lights warning from market leader ProAssurance in Q1.

With numbers like this, it's hard not to be frustrated with the inane debate around whether the market in aggregate is a "hard market" akin to yesteryear. Obviously it's not. But the business has changed, with more granular management information and less correlated moves between lines of business and geographies. (Witness workers' comp as exhibit A).

Even so, it perfectly fits the new model of insurance, with more localized pricing dynamics, better understood as a series of loosely connected micro-cycles with some level of correlation due to constraints on the fungibility of capital between lines and geographies and shared macro forces drivers like inflation and tort trends.

The other point we can't resist making is around CNA's long and complicated explanation of why its loss ratios have been relatively stable since 2015 despite pricing trailing loss trends, and will likely not improve going forward even as rate outpaces loss trends.

For example, on its Q3 call, the company said, in a series of delightfully complicated jargonese: "*Going forward then, even if we sustain the current rate movement, earnings to mid-2021 gaining back the lost ground in pricing, it won't necessarily equate to a dollar for dollar expansion in margin. Rather, we need to incorporate all the vectors of influence on our accident year loss ratio.*"

Hm. We have some sympathy with the company's defense against the "over-simplification of correlation". For sure, there is a tendency among external observers to over extrapolate without any sense of nuance around differentiating factors like mix change, non-rate underwriting changes etc. Fair enough.

However, our sympathy ends pretty quickly there. Because there can also be tendency to obfuscate and explain away simple gravity defying truths as some type of rocket science…or multiple "vectors of influence" to use the company's own language.

There is a simple truth why many companies' underlying loss ratios did not come down in line with the rate versus trend dynamic from 2015-2018, and the same truth explains why they won't improve now despite the inversion of the rate versus trend dynamic. And it's not that complicated, however much companies bend over backwards to make it so.

CNA: Earnings summary

CNA Financial's Q3 operating EPS fell 68% YoY to $0.37 per share missing consensus estimate of $1.02, as both P&C and Life & Group operating results weakened.

- **P&C:** Underwriting income decreased 58%, primarily due to $40mn adverse reserve development recorded in Commercial segment, which more than offset $20mn favorable development in Specialty. On the headline, the company reported its first adverse reserve development since Q1:15 (recall, last week Travelers reported its first adverse reserve development since Q4:05).
- **Life & Group**: L&G had largest impact on the consolidated bottom-line as the segment's core income dropped from $32mn to negative $122mn, largely due to the reduction of the new money yields expectation that resulted in $170mn upward revaluation of policyholder benefits.

EXHIBIT: CNA RESULTS SUMMARY

Source: Company reports, S&P Global, Inside P&C

CNA Financial						
$mn (except for EPS)	Q3:18	Q4:18	Q1:19	Q2:19	Q3:19	YOY VAR
Operating EPS.	**$ 1.17**	**$ (0.08)**	**$ 1.17**	**$ 1.08**	**$ 0.37**	**-68.4%**
P&C GWP	2,703	2,735	2,966	3,035	2,852	5.5%
P&C NWP	1,581	1,659	1,797	1,874	1,708	8.0%
NII	487	334	571	515	487	0.0%
P&C loss and LAE	1,047	1,247	1,070	1,055	1,145	9.4%
P&C amortization of DAC	337	343	342	338	345	2.4%
P&C operating expenses	237	229	225	229	229	(3.4%)
P&C U/W income	100	(92)	37	72	42	(58.0%)
L&G core income	32	7	10	7	(122)	NM
Cats	2.6%	8.5%	3.4%	2.2%	1.8%	(0.8)pts
PYD	-3.2%	-1.2%	-0.5%	-1.1%	1.2%	4.4pts
AY ex-cat LR	61.1%	64.6%	60.7%	60.8%	61.7%	0.6pts
Loss ratio	60.5%	71.8%	63.6%	61.9%	64.7%	4.2pts
Expense ratio	33.3%	33.1%	33.8%	33.4%	32.5%	(0.8)pts
Combined ratio	94.2%	105.3%	97.8%	95.7%	97.6%	3.4pts

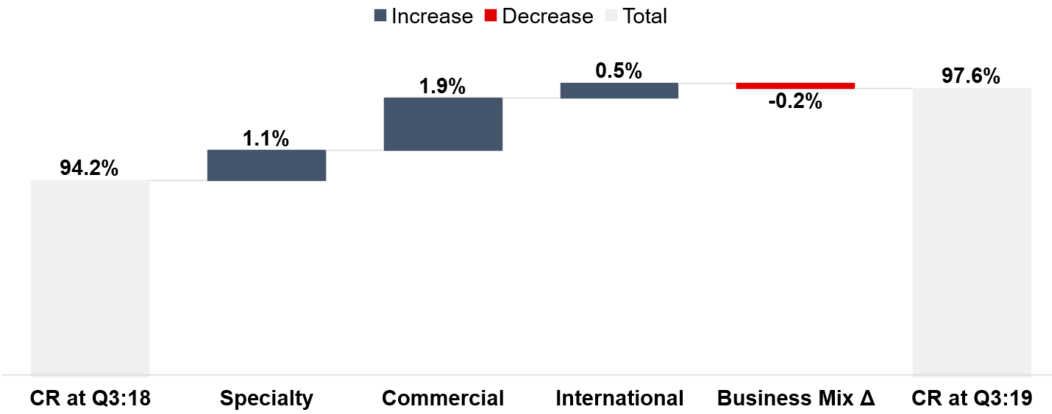
Other highlights include:

- **Underwriting results:** The combined ratio deteriorated 3.4pts YoY driven by a weaker accident year loss ratio and adverse PYS, partially offset by a better expense ratio (aided by commissions) and fewer cat losses.
  - **Segment underwriting results:** all three segments' operations (Specialty, Commercial, International) contributed to the deterioration in the consolidated combined ratio (see chart below), though the YoY is somewhat complicated by the fact the company reported a true-up charge in Q4 of last year.
  - **Underlying performance:** accident year loss ratio ex cats increased by 0.6pt driven by deterioration in all segments, again complicated somewhat by the Q4 true-up in 2018.

- **Expenses:** The expense ratio of 32.5% (lowest quarterly print in almost five years) benefitted from favourable items related to commissions.
- **Catastrophes:** cat points decreased to 1.8% from 2.6% a year ago.
- **PYD:** The company said its adverse pYD was largely due to writing down some reinsurance recoveries it had accrued for liabilities related to legacy product liability lines prior to 2009.

EXHIBIT: CNA YOY COMBINED RATIO CHANGE ATTRIBUTION

Source: Company reports, S&P Global, Inside P&C



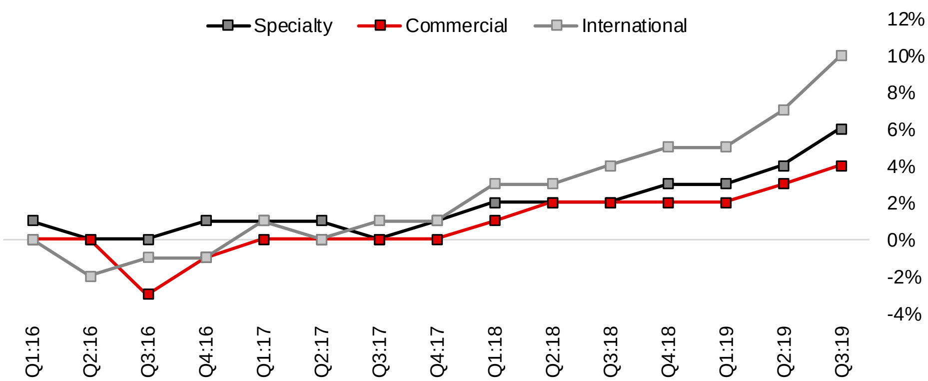
- **Top line: +9% in P&C as rates and new biz flows help**
  - By segment, Specialty was +9% GWP, Commercial: +13% and International was down 2% as increases in Canada were offset by re-underwriting actions in the firm's Lloyd's syndicate.

- **Rate vs. Trend**. CNA provides among the clearest detail on the margin impact of rate increases, highlighting in the call that margin improvement from the +6% of rate achieved in the quarter would be about 300bps, above a recorded trend of 2.5%: "This is a good start, but obviously needs to be sustained before we recognize any meaningful margin expansion, particularly when you consider that we experienced almost four years of rate changes being lower than long run loss cost trends starting early 2015. All else equal, we would have to sustain the current rate levels through mid-2021 to make up, if you will, the lost ground in pricing".

- **Rate Disclosure**. CNA reported meaningful rate acceleration, achieving overall P&C rate increases of 6% (+200bps from Q2), Commercial up 4% (+100bps from Q2) and Specialty up 6% (+200bps from Q2). Even more impressive, rate increases in Specialty were +13% (ex-Professional E&O / Affinity). Importantly, public company D&O increased by 42% vs. 15% in Q2. Umbrella rates increased by 10%. Health care up 18% (+400bps from Q2). At this point, more confirmation is hardly necessary. Even so, this is clearly confirmation of a market split between a rationally hardening market with pockets of more severe dislocation where loss cost inflation has been rampant.

EXHIBIT: CNA RATE CHANGES BY SEGMENT

Source: Company reports, S&P Global, Inside P&C

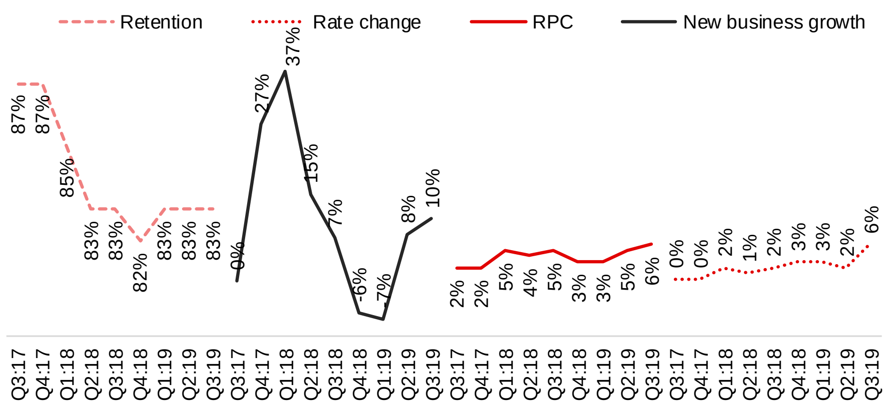


- **Social Inflation**. CNA provided additional color on *where* the social inflation is coming from, noting a particularly active plaintiff's bar in the company's healthcare portfolio, "especially in aging services" targeting medical malpractice claims. The company first took notice of the trend in 2016, updating its go-forward loss cost trends in 2017 to account for an increase in frequency and severity.

- **Submission Flow**. Based on commentary from management, the churn of accounts in the market appears to be continuing unabated. "New business pricing and that has helped fuel our new business growth, which was up 10%. It was the same period last year. This traditional market causes a heightened level of business to be marketed as agents and brokers grapple with significant changes in terms and conditions that they fear may impact even their best-performing accounts. Our focus on reenergizing relationships with our distribution partners over the last 24 months along with our talent investments that I discussed on past calls has allowed us to capitalize on this dynamic, which has contributed to our new business growth."

EXHIBIT: CNA PRODUCTION METRICS

Source: Company reports, S&P Global, Inside P&C



- **LTC charge**. The company took a meaningful \$170M reserve charge after resetting discount rate assumptions for the company's long-term care Active Life Reserves. The charge is separate from the company's annual LTC reserve review, which produced positive \$44M in development. As the company noted, this was the fourth year in a row the company's review has produced favorable development.

- **Discount Rate Change**. Given the continued structural decline in interest rates, CNA updated its discount rate assumptions, reducing near-term expectations for new money yields as well as lowering expectations for normalized new money yields for 2025 and beyond by 50bps to 3.75% from 4.25%.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, Gianluca Casapietra, Dan Lukpanov and James Thaler.