



Reasons for Optimism Amidst Challenges in the P-C Insurance Industry

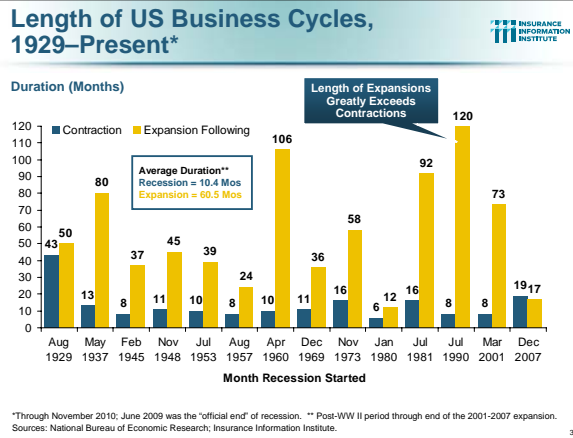
Casualty Actuaries of the Mid-Atlantic Region
December 2, 2010 Malvern, PA

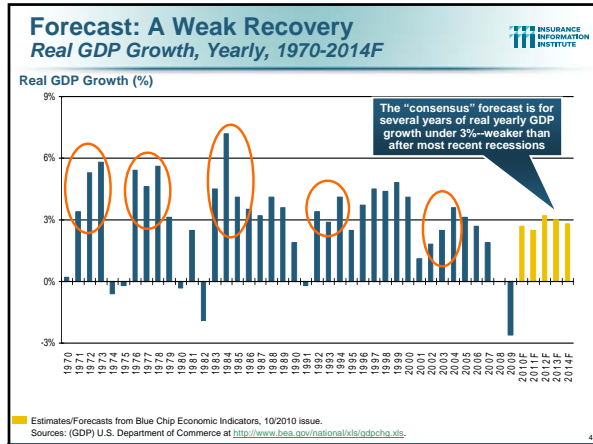
Steven N. Weisbart, Ph.D., CLU, Senior Vice President & Chief Economist
Insurance Information Institute ♦ 110 William Street ♦ New York, NY 10038
Office: 212.346.5540 ♦ Cell: (917) 494-5945 ♦ stevenw@iii.org ♦ www.iii.org

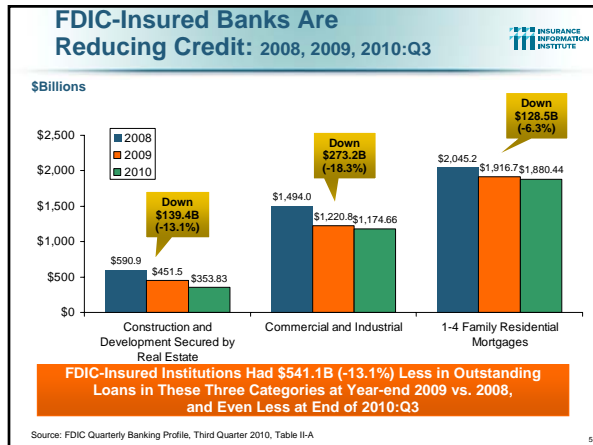


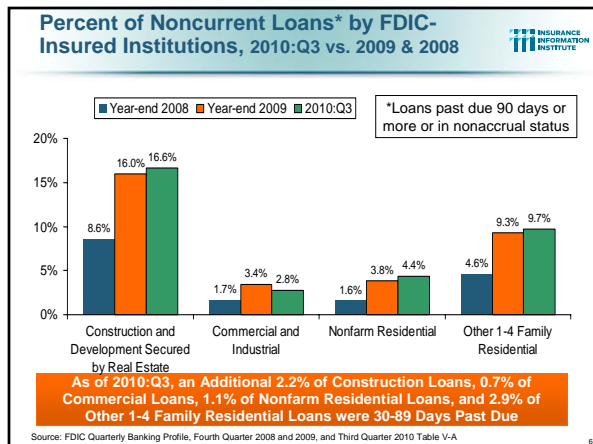
The Economic Situation

Its Effect on the Industry's Exposure Base, Growth, Investments, and Profitability

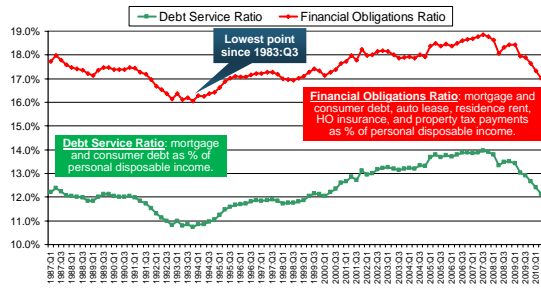








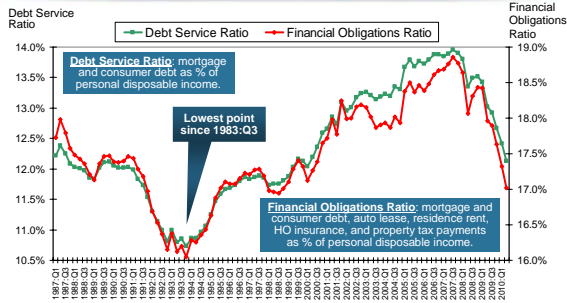
Households Are Sharply Reducing Their Financial Obligations



The Financial Obligations Ratio dropped almost 2 percentage points from 2007:Q3 to 2010:Q2, but it might be tough to shrink further if interest rates and property taxes rise.

Source: Federal Reserve Board, at <http://www.federalreserve.gov/releases/householddeb> (last frb update: Sept 27, 2010)

Households Are Sharply Reducing Their Financial Obligations



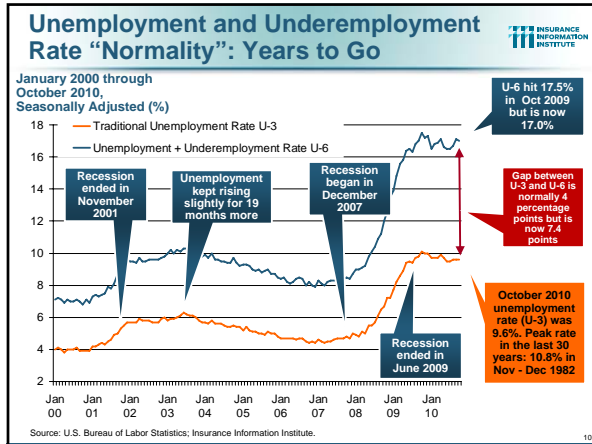
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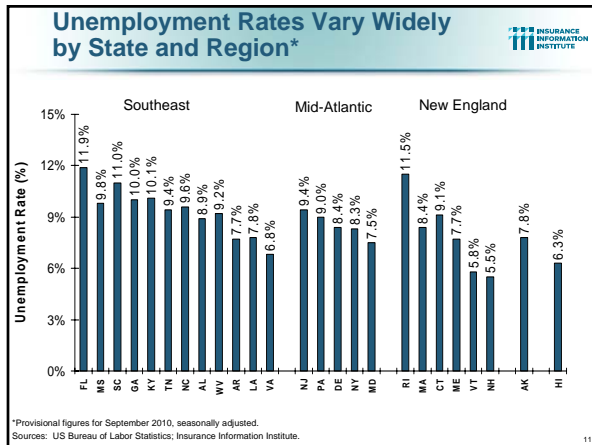
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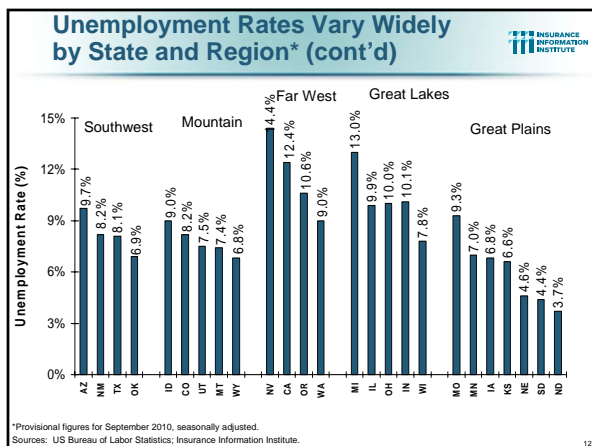


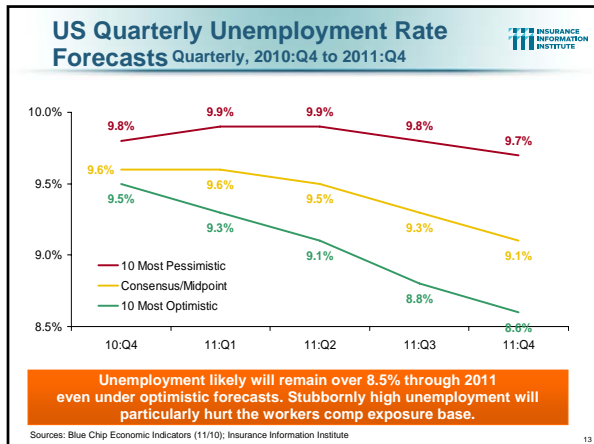
Labor Market Trends

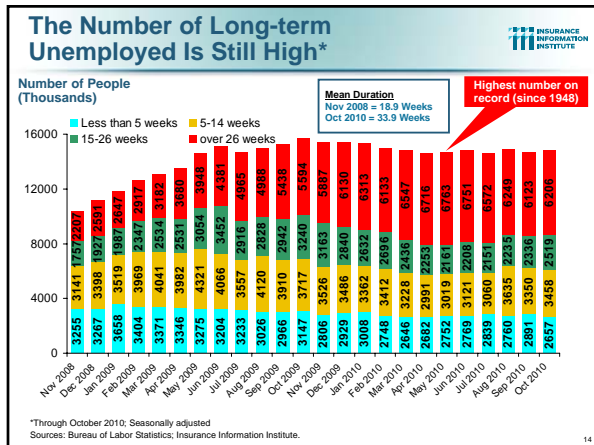
Massive Job Losses
Sap the Economy and
the Commercial & Personal Lines
Exposure Bases







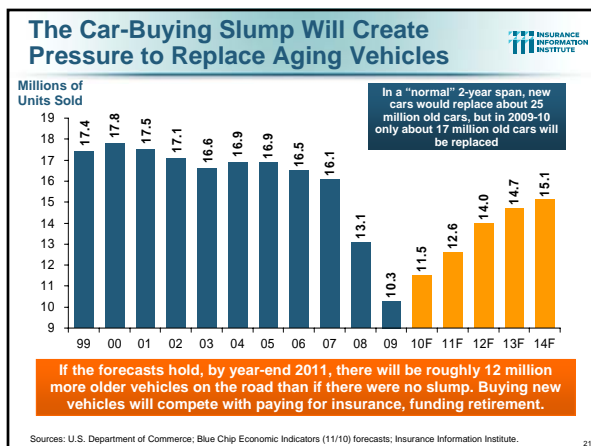
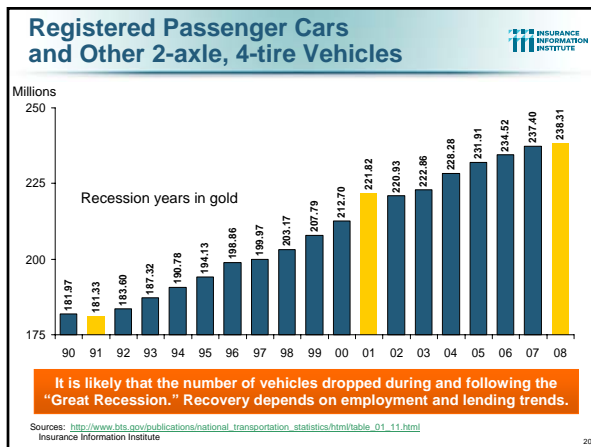
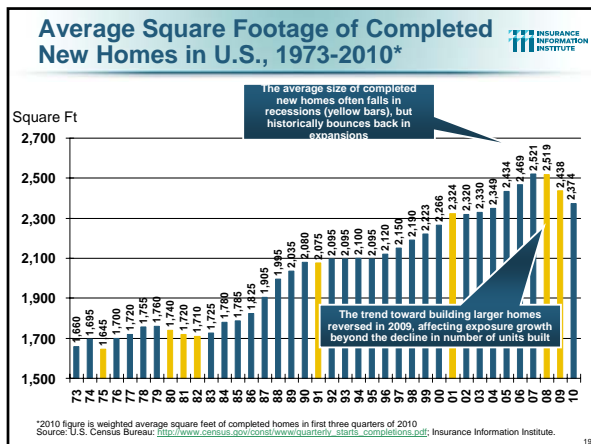


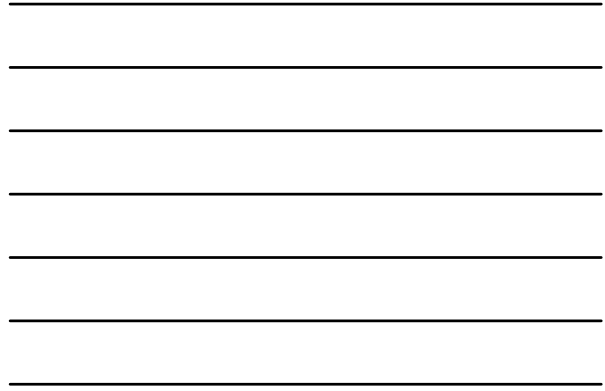
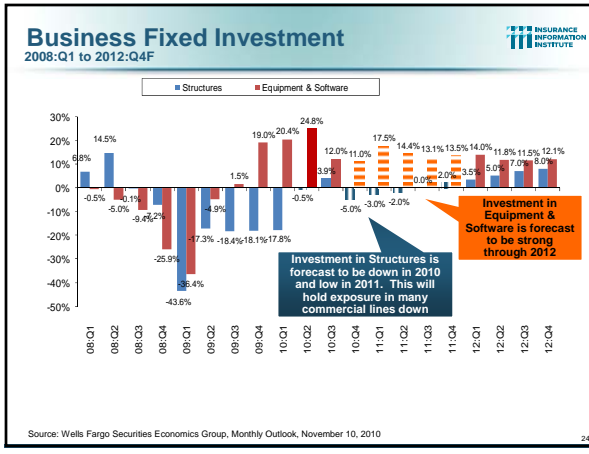
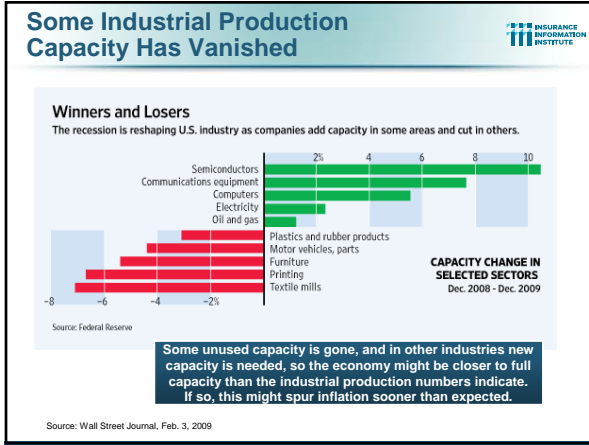
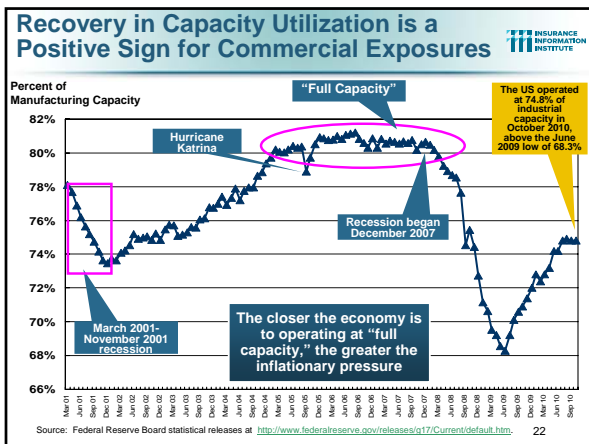


Job Growth Needed to Return to "Pre-Recession" Employment Level

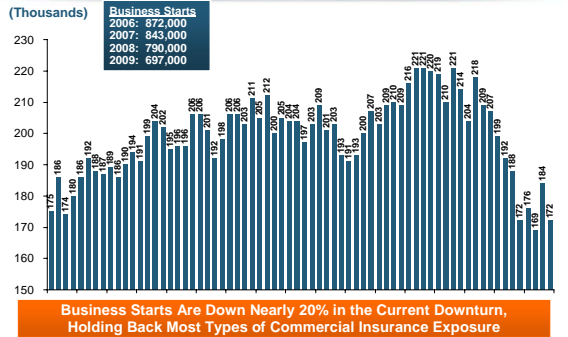
- Even if no more jobs are lost, if we are to return to the equivalent of pre-recession employment levels in 5 years' time—by the start of 2015—we would have to average adding 300,000 jobs per month every month until then.
 - ◆ This is not likely. The Obama Administration's latest forecast for average monthly job growth is
 - 95,000 in 2010
 - 190,000 in 2011
 - 251,000 in 2012
 - 274,000 in 2013
 - 267,000 in 2014

Source: Economic Report of the President, at <http://www.whitehouse.gov/sites/default/files/microsites/economic-report-president.pdf> (Table 2-3, p. 75)





Private Sector Business Starts, 1993:Q2 – 2010:Q1*



Business Starts Are Down Nearly 20% in the Current Downturn, Holding Back Most Types of Commercial Insurance Exposure

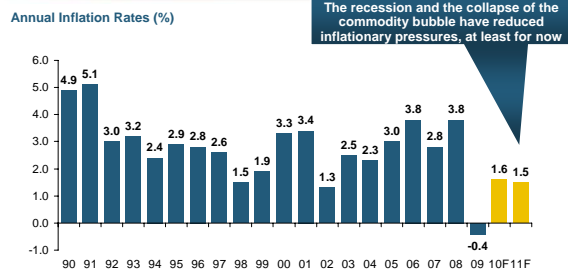
*Latest available as of November 18, 2010, seasonally adjusted
 Source: Bureau of Labor Statistics, <http://www.bls.gov/news.release/cewbd107.htm>.



Inflation Trends:
Concerns Over Stimulus Spending and Monetary Policy

Mounting Pressure on Claim Cost Severities?

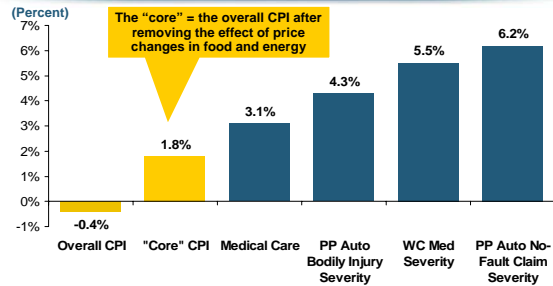
Annual Inflation Rates (CPI-U, %), 1990–2011F



The Slack in the US Economy Implies that Inflation Should Not Be a Concern Through 2010/11, but Depreciation of Dollar is Concern Longer Run

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators, 11/2010 (forecasts).

The Rising Cost of Medical Care Affects P/C Claims More than 2009 CPI Implies

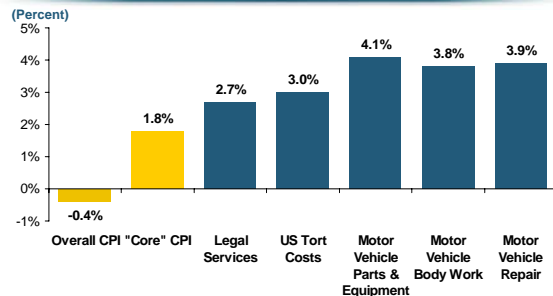


Healthcare Costs Are Major P/C Insurance Cost Drivers. They Are Expected to Increase Above the Inflation Rate (CPI) Indefinitely

Sources: BLS; medical care changes are avg. monthly year-over-year change from BLS; BI and no-fault figures from ISO Fast Track data for 4 quarters ending 09.Q3. WC figure is L.L.L. estimate based on historical NCCI data.

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Inflation in Legal and Auto Repair Costs Affects P/C Claims More than the CPI Suggests



Repair Parts/Labor and Legal/Tort Costs Are Major P/C Insurance Cost Drivers.

Sources: BLS; Legal services and motor vehicle body work are avg. monthly year-over-year change from BLS; Tort costs is 2009 Towers-Perrin estimate.

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Risks for Insurers if Inflation Is Reignited



- Rising Claim Severities**
 - ◆ Cost of claims settlement rises across the board (property and liability)
- Rate Inadequacy**
 - ◆ Rates inadequate due to low trend assumptions arising from use of historical data
- Reserve Inadequacy**
 - ◆ Reserves may develop adversely and become inadequate (deficient)
- Burn Through on Retentions**
 - ◆ Retentions, deductibles burned through more quickly
- Reinsurance Penetration/Exhaustion**
 - ◆ Higher costs → risks burn through their retentions more quickly, tapping into reinsurance more quickly and potentially exhausting their reinsurance more quickly

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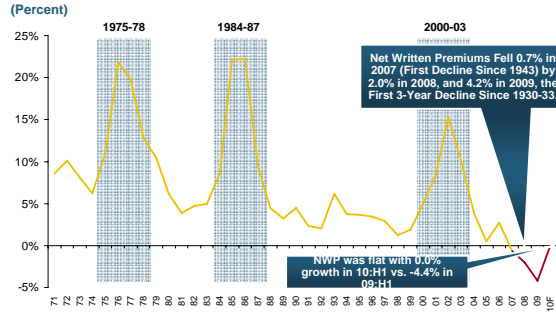


Premium and Underwriting Trends

The Financial Crisis and Recession *Didn't* Directly Affect Underwriting Performance; Cycle, Catastrophes Were Main Drivers

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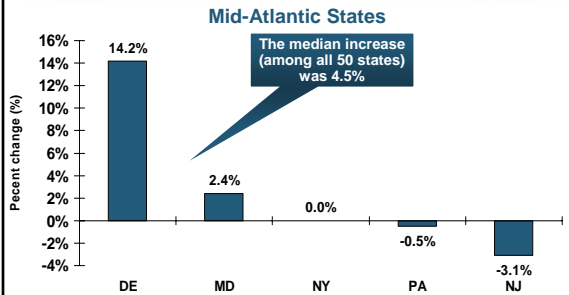
Soft Market Appears to Persist in 2010 but May Be Easing: Relief in 2011?



Shaded areas denote "hard market" periods
Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute.

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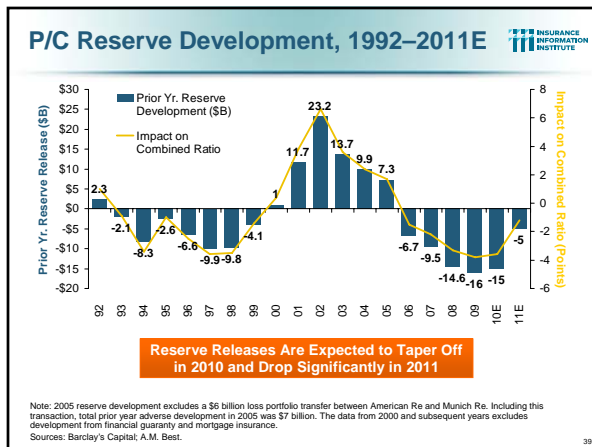
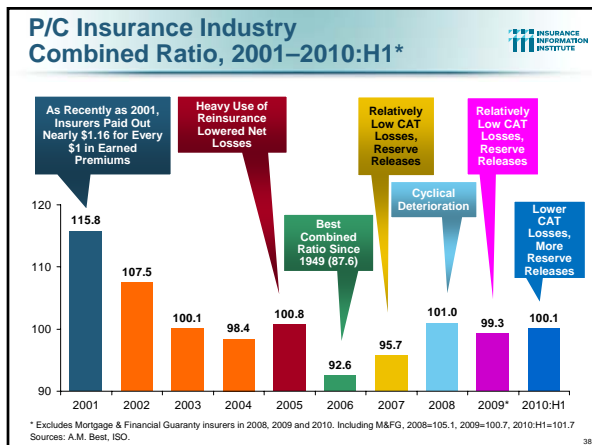
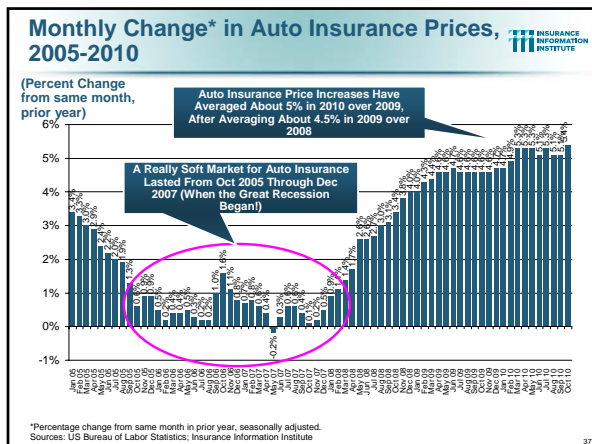
Direct Premiums Written: All Lines Percent change by State, 2004-2009



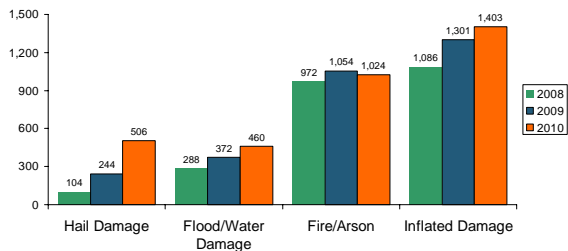
States with the poorest performing economies also produced the most negative net change in direct premiums written in the past 5 years.

Sources: SNL Financial LC.; Insurance Information Institute.

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Number of Questionable Claims, U.S., 1st Half of 2008, 2009, 2010



Are These Increases Attributable to the Prolonged Tough Economic Environment? If so, the Upward Trend Will Likely Continue

Source: NICB ForeCAST report, July 14, 2010

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Catastrophic Loss

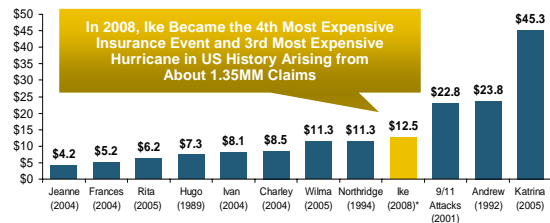
Catastrophe Losses Are Trending Adversely

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Top 12 Most Costly Disasters in US History



(Insured Losses, 2008, \$ Billions)

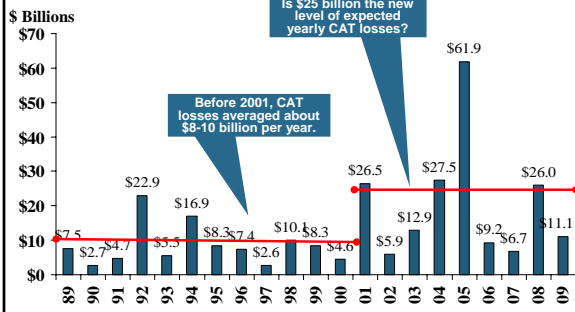


8 of the 12 Most Expensive Disasters in US History Have Occurred Since 2004

* PCS estimate as of August 1, 2009.
Sources: PCS; Insurance Information Institute inflation adjustments.

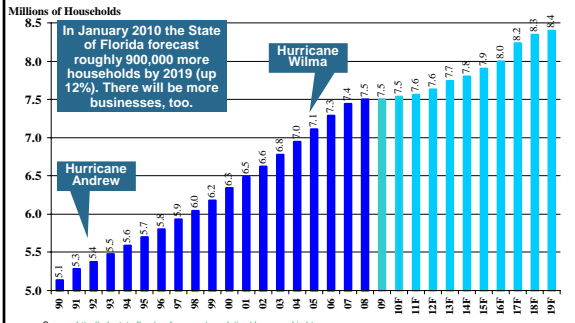
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Catastrophic Losses*: Was 2005 an Outlier or a Harbinger?



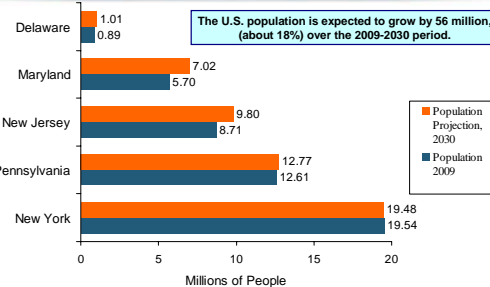
*Excludes \$4B-\$6B offshore energy losses from Hurricanes Katrina & Rita.
 Note: 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims. Non-prop/BT losses = \$12.2B.
 Source: Property Claims Service/ISO, Insurance Information Institute

A Million More Florida Resident Households in the Next Decade?



Source: <http://www.florida.gov/conferences/population/demographic.htm>
 Data are from Jan. 26, 2010 Florida Demographic Estimating conference

Population Growth Projections (to 2030) for the Mid-Atlantic States



These forecasts, released in April 2005, foresee very little population growth in the Mid-Atlantic states by 2030. Most of the growth is expected in Florida, Texas, and California.

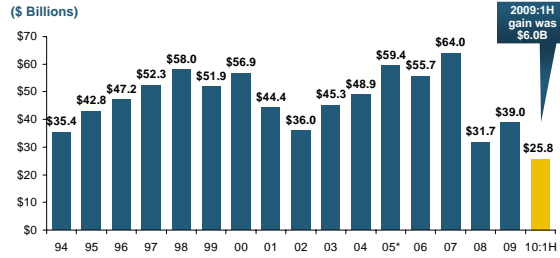
Sources: U.S. Census Bureau. Projections at <http://www.census.gov/population/projections/PressTab1.xls>; 2009 data at www.census.gov



Investment Performance

**Weak Investment Results
Are a Main Cause of Low Profits**

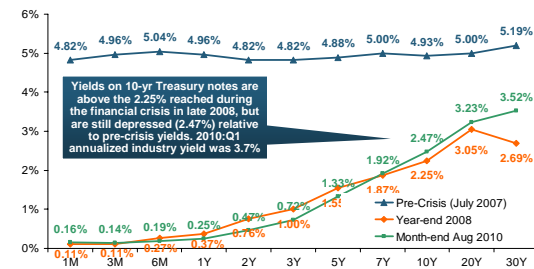
Property/Casualty Insurance Industry Investment Gain: 1994–2010:1H¹



**In 2008, Investment Gains Fell by 50% Due to Lower Yields and Nearly \$20B of Realized Capital Losses
2009 Saw Smaller Realized Capital Losses But Declining Investment Income**

¹ Investment gains consist primarily of interest, stock dividends and realized capital gains and losses.
* 2005 figure includes special one-time dividend of \$3.2B.
Sources: ISO, Insurance Information Institute.

U.S. Treasury Yields Are Low: Near 2008 Financial Crisis Levels



The Average Maturity on Bonds in P/C Insurers' Portfolios Has Remained Steady at About 7.5 Years Through the Last Decade

Sources: Board of Governors of the United States Federal Reserve Bank at http://ustreas.gov/offices/comptroller-in-chief/management/interest-rate/yield_historical_main.shtml; ISO, I.I.I.

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Competition in the Auto Insurance Market

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In Many States, the PP Auto Market in 2009 was Highly Competitive

Number of States with HHI* in Indicated Range

HHI Range	Number of States
under 700	2
700-799	4
800-899	7
900-999	10
1000-1099	11
1100-1199	8
1200-1299	5
1300-1399	0
1400 and over	3

An HHI Under 1000 is Generally Considered a Highly Competitive Market; HHIs Between 1000 and 1800 Indicate a Moderately Competitive Market; Over 1800 Suggests a Concentrated Market

*Herfindahl-Hirschman Index, a standard measure of market concentration
Sources: Insurance Information Institute research from SNL Financial.

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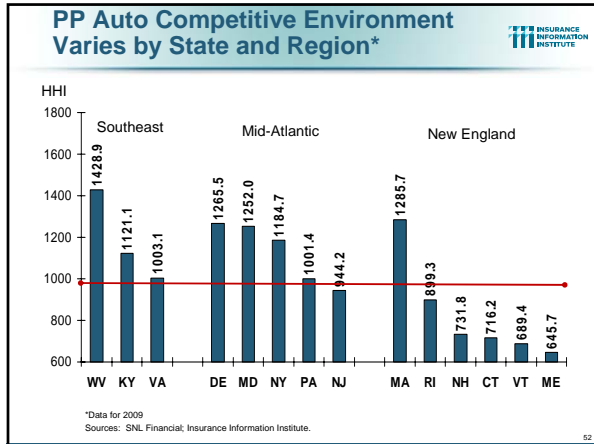
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What HHIs of 775 and 1200 Look Like

Market Type	HHI	Top 10 Carriers Market Share	Rest of Market Share
Highly Competitive	775	77.8%	22.2%
Moderately Competitive	1200	97.8%	2.2%

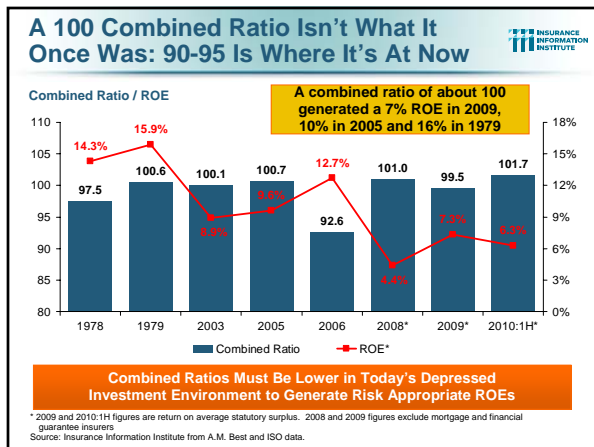
In the Highly Competitive Market, The Top 10 Carriers Have 77.8% Market Share; in the Moderately Competitive Market, the Top 10 Have 97.8%

Sources: SNL Financial; Insurance Information Institute

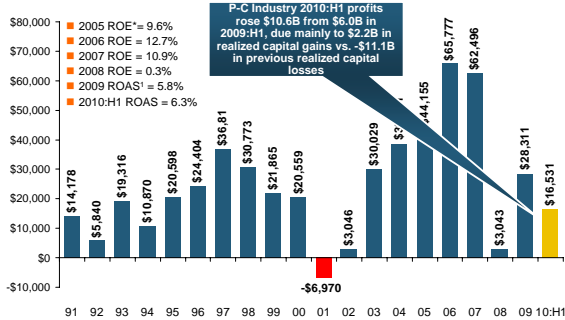


Profitability

Historically Volatile

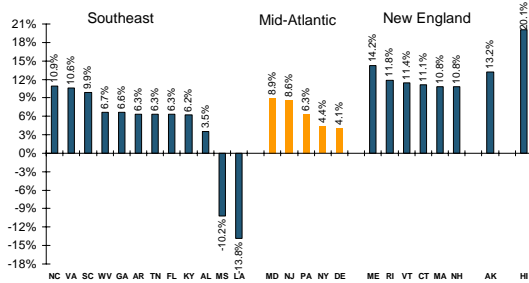


P/C Net Income After Taxes 1991–2010:H1 (\$ Millions)



* ROE figures are GAAP. † Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields a 7.5% ROAS for 2010:H1 and 4.6% for 2009. ‡ 2009:H1 net income was \$19.2 billion and \$10.2 billion in 2008:H1 excluding M&F.G.
Sources: A.M. Best, ISO, Insurance Information Institute

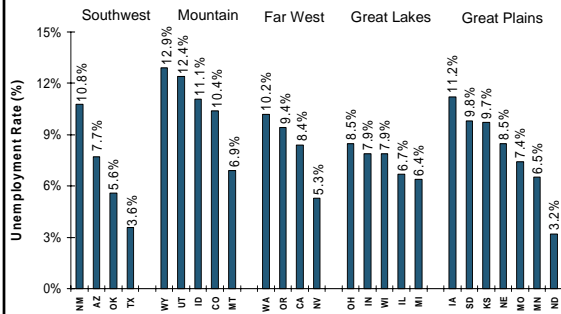
Return on Net Worth: 10-Year Avg., 1999-2008*: All Lines



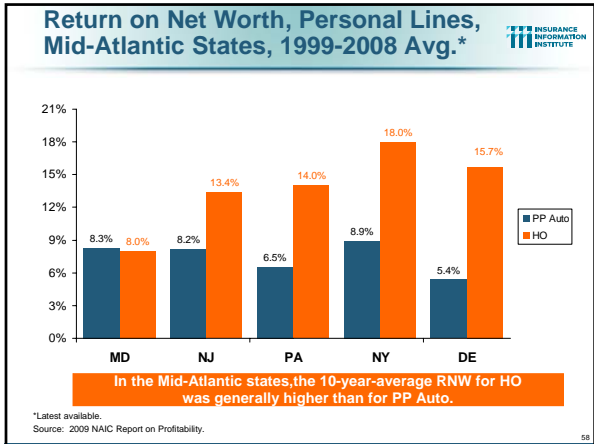
The 10-year-average U.S. all lines RNW was 7.0%.

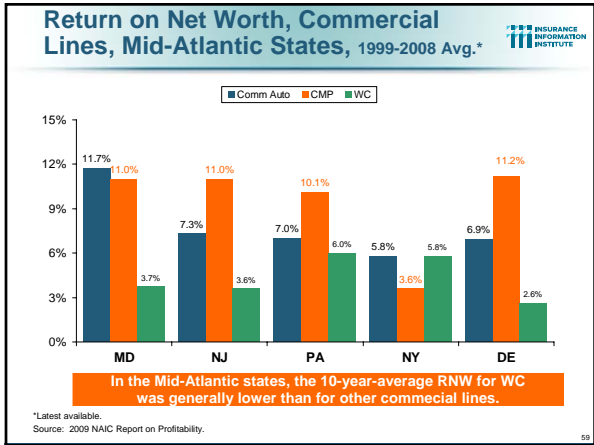
*Latest available.
Source: 2009 NAIC Report on Profitability.

Return on Net Worth: 10-Year Average, 1999-2008*: All Lines* (cont'd)



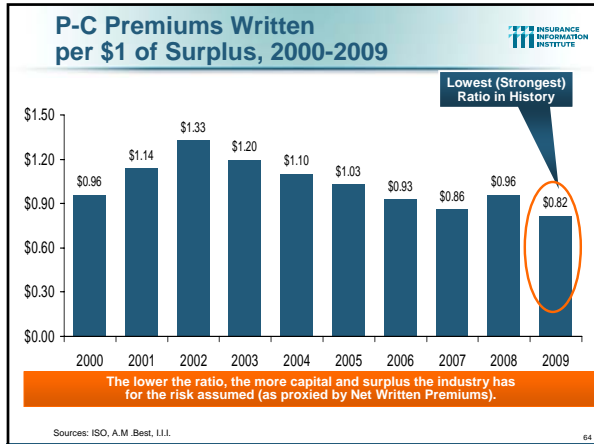
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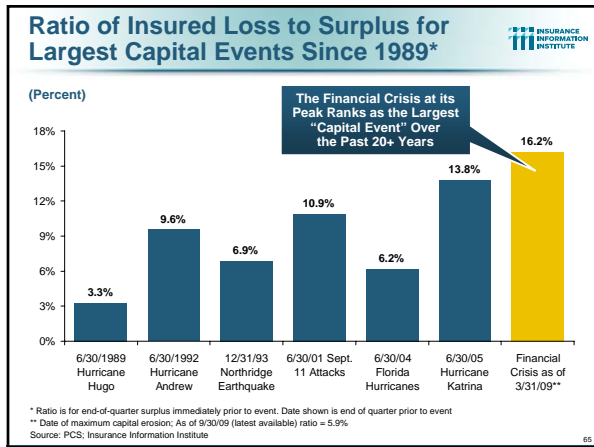


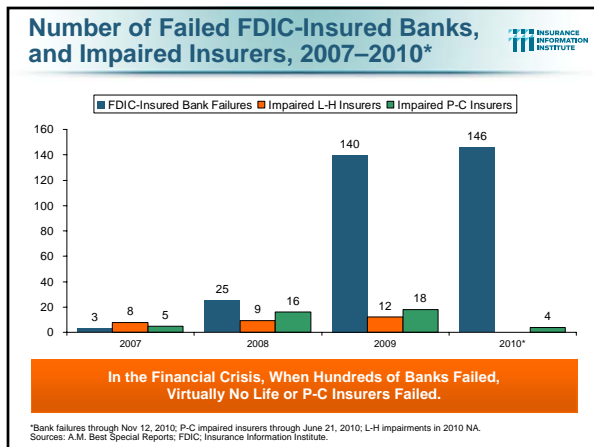


Financial Strength & Capacity

The P-C Industry Has Weathered the Storm Well










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Will the 2010 Midterm Election Results Affect P/C Insurer Profitability & Performance?

Yes, But Most Impact is on Structure, Legislation and Regulation

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The 2010 Midterm Elections: What do the results mean for insurers?



Catastrophe Financing

- Supporters of Homeowners Defense Act (e.g., Rep. Neil, D-FL) defeated; Act proposed a larger role for the federal govt. in financing natural catastrophe losses
- Rep. Gene Taylor (D-MS) defeated: He supported adding wind to NFIP
- Unclear if flood program once again winds up in limbo

Health Care Reform (Obamacare)

- Promises to "repeal and replace" aren't credible (Senate and White House still Democratically controlled); Object is to starve implementation via low/no funding
- Obamacare and Boehnercare will do little to control the trajectory of costs
- Impacts on benefits business
- Republicans need plan to deal with entitlement (Medicare) to cut budget


Dodd-Frank

- Likely few major provisions impact insurers the most (e.g., creation of FIO) unlikely to be affected

Source: Insurance Information Institute research.

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The 2010 Midterm Elections: What do the results mean for insurers?



Tort Reform

- Tort was not a major issue in the 2010 campaign, but the new House can be expected to receptive to the idea of federal tort reform, unlike prior Congresses since 2006
- Fewer new pieces of legislation likely to spawn tort actions (e.g., climate change)
- State legislatures and governorships more receptive to tort reforms

Taxes/Fiscal Policy

- Odds of an across-the-board continuation of Bush tax cuts more likely; Benefits small business and high net worth individuals and their insurers.
- Immediate expensing of new investment in 2011?? Good for p/c exposures.

Regulatory/Business Policy

- More pro-business stance
- Should help stimulate commercial exposures (WC payrolls, property & liability)
- Ohio monopolistic state fund→Move to competitive structure?

Source: Insurance Information Institute research.

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Financial Services Reform

Insurers Are Impacted, But Not Significantly

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Financial Services Reform: What does it mean for insurers?



The Dodd Frank Wall Street Reform and Consumer Protection Act

- **Systemic Risk and Resolution Authority**
 - Creates the Financial Stability Oversight Council and the Office of Financial Research
 - Imposes heightened federal regulation on large bank holding companies and "systemically risky" nonbank financial companies, including insurers
- **Federal Insurance Office (FIO)**
 - Establishes the FIO (while maintaining state regulation of insurance) within the Department of Treasury, headed by a Director appointed by the Secretary of Treasury
 - FIO will have authority to monitor the insurance industry, identify regulatory gaps that could contribute to systemic crisis
 - **CONCERN: FIO morphs into quasi/shadow or actual regulator**
- **Surplus Lines/Reinsurance**
 - Title V of the Dodd-Frank bill includes, as a separate subtitle, the Nonadmitted and Reinsurance Reform Act (NRRA), which eliminates regulatory inefficiencies associated with surplus lines insurance and reinsurance

Source: Insurance Information Institute (I.I.I.) updates and research; The Financial Services Roundtable; Adapted from summary by Dewey & LeBoeuf LLP

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Five Challenges Facing P-C Insurers in the Next 5-6 Years

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1

Protecting Capital



- **Black Swan:** Surplus losses (mainly asset value losses) were larger and occurred more quickly than was believed possible
- In 6 calendar quarters surplus dropped over 16% (\$85B) from 9/30/07 peak (a bigger capital hit than KRW in 2005)
 - ◆ Luckily for the industry, at the same time as the financial crisis/recession, it suffered only one major CAT event (Ike), unlike 2004-05 *but this could have happened*
- The surplus loss has now been rebuilt, but now some equity analysts are again saying the P/C industry has "excess surplus"
 - ◆ They're calling for stock buy-backs, strategic acquisitions, etc.
- **It Could Have Been Worse:** During the Great Depression (1929–1933) PHS fell 37%, Assets fell 28% and Net Written Premiums fell by 35%. It took until 1939–40 before these key measures returned to their 1929 peaks

Bottom Line: We Should not Dismiss our Fresh Appreciation for the Vulnerability of the Capital We Have.

2

Reloading Capital After "Capital Event"



- P/C insurers had come to believe that large amounts of capital can be raised quickly and cheaply after major events (9/11, Katrina)
 - ◆ *This assumption was incorrect during and immediately after the financial crisis*
- The cost of capital can rise sharply (relative to "risk-free" rates), reflecting both scarcity, increasing volatility, and heightened investor risk aversion
- Possible consequences of a failure to "reload": Insolvencies, forced mergers, calls for government aid, requests to relax capital requirements

Implications: P/C (re)insurers need to develop detailed contingency plans to raise fresh capital and/or generate it internally. Problems raising capital in a difficult environment were a reality for some life insurers.

3

Years of Low Investment Earnings



- Low interest rates, risk aversion toward equities and many categories of fixed income securities lock in a multi-year trajectory toward ever lower investment gains
- Fed actions in Treasury markets keep yields low
- Many insurers have not adjusted to this new investment paradigm of a sustained period of low investment gains
- **Regulators will not readily accept it; many will reject it**
- **Implication 1:** Industry must be prepared to operate in environment with investment earnings accounting for a smaller fraction of profits
- **Implication 2:** Implies underwriting discipline of a magnitude not witnessed in this industry in more than 30 years. Yet to manifest itself.
- Lessons from the period 1920–1975 need to be relearned

4

The Return of Terrorism Risk



- Rising perception that the U.S. is vulnerable to terrorism
- The thwarted Christmas Day attack by the “underwear bomber” reminded us that al Qaeda is still intent on bringing terror to the U.S.
 - Al Qaeda might step up its terrorist efforts in response to the surge in Afghanistan
 - Media reports on newly-discovered terrorist groups, such as “al Qaeda in the Arabian Peninsula”
- We will see increased anti-terror efforts
 - full-body scans at airports
 - Efforts by the government to appear more vigilant, prepared
 - Reports on new anti-terror coordination efforts
 - The trial of 9/11 suspects will focus media attention on terrorism and terrorists, possibly for several years

Bottom Line: Buyers and producers will likely have new discussions about terrorism coverage

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The Re-Emerging Tort Threat




- No tort reform (or protection of recent reforms) is forthcoming from the current Congress or Administration
- Erosion of recent reforms is a certainty (already happening)
- Innumerable legislative initiatives will create opportunities to undermine existing reforms and develop new theories and channels of liability
- Torts twice the overall rate of inflation
- Influence personal and commercial lines, esp. auto liability
- Historically *extremely* costly to p/c insurance industry
- Leads to reserve deficiency, rate pressure

Bottom Line: Tort “crisis” is on the horizon and will be recognized as such by 2012–2014




Summary and Conclusion

**Causes for Concern
& Reasons for Optimism
in the P/C Insurance Industry**

Causes for Concern in the P/C Insurance Industry 


- Record Insuring Capacity, Depressed Exposures
 - ◆ For many lines, **soft market conditions** will persist through 2011
 - ◆ There is no obvious catalyst for a robust hard market any time soon
- Pessimism “Bubble” Persists; Negative Economic News Amplified; Positive News is Discounted
 - ◆ **Financial market volatility** will remain a reality
- Investment Environment Is Challenging
 - ◆ **Yields remain low**
 - ◆ Both yield and volatility are critical issues in long-tailed commercial lines like WC, Med Mal, D&O

Source: Insurance Information Institute. 79

Causes for Concern in the P/C Insurance Industry 

- The U.S. tort environment is deteriorating
 - ◆ No Tort Reform in U.S.
- High Global First-Half-2010 CAT Losses
 - ◆ Localized insurance and reinsurance effects, especially
 - Earthquake coverage in Latin/South America,
 - Offshore energy markets,
 - European wind cover
 - ◆ Insufficient to trigger hard market

Source: Insurance Information Institute. 80

Reasons for Optimism in the P/C Insurance Industry 

- Era of mass P/C-insurance exposure destruction is over
 - ◆ But restoring destroyed exposure will take 3+ years in U.S.
 - ◆ Job and wage growth remains sluggish
- Demand for commercial insurance will continue growing in 2011
 - ◆ 6-year slump in demand ended in 2010
 - ◆ Growth includes workers comp, commercial auto, marine, many liability coverages, D&O
 - ◆ Laggards: Property, inland marine, aviation
- Personal Lines: Auto leads, homeowners lags

Source: Insurance Information Institute. 81

**Reasons for Optimism
in the P/C Insurance Industry**



- P/C insurance industry capacity is at record levels as of 6/30/10
 - ◆ Recovered 100%+ of the capital lost during the financial crisis
- Financial Strength & Ratings of Global (Re)Insurance Firms Remained Strong Throughout the Financial Crisis
 - ◆ Sharp Contrast With Banks
- Insurers Avoided the Most Draconian Outcomes in Financial Services Reform Legislation

Source: Insurance Information Institute. 82

**Reasons for Optimism
in the P/C Insurance Industry**



- Inflation outlook for most major world economies is tame
 - ◆ Will temper claims inflation
 - ◆ But inflation in China may be an exception
- Major transformation of U.S. economy is underway
 - ◆ Major opportunities for insurers in
 - Health
 - Tech
 - Natural Resources
 - Energy

Source: Insurance Information Institute. 83

Insurance Information Institute Online:

www.iii.org

*Thank you for your time
and your attention!*
