Sub-prime/Investment Crisis from a Rating Agency Perspective

CARe Meeting

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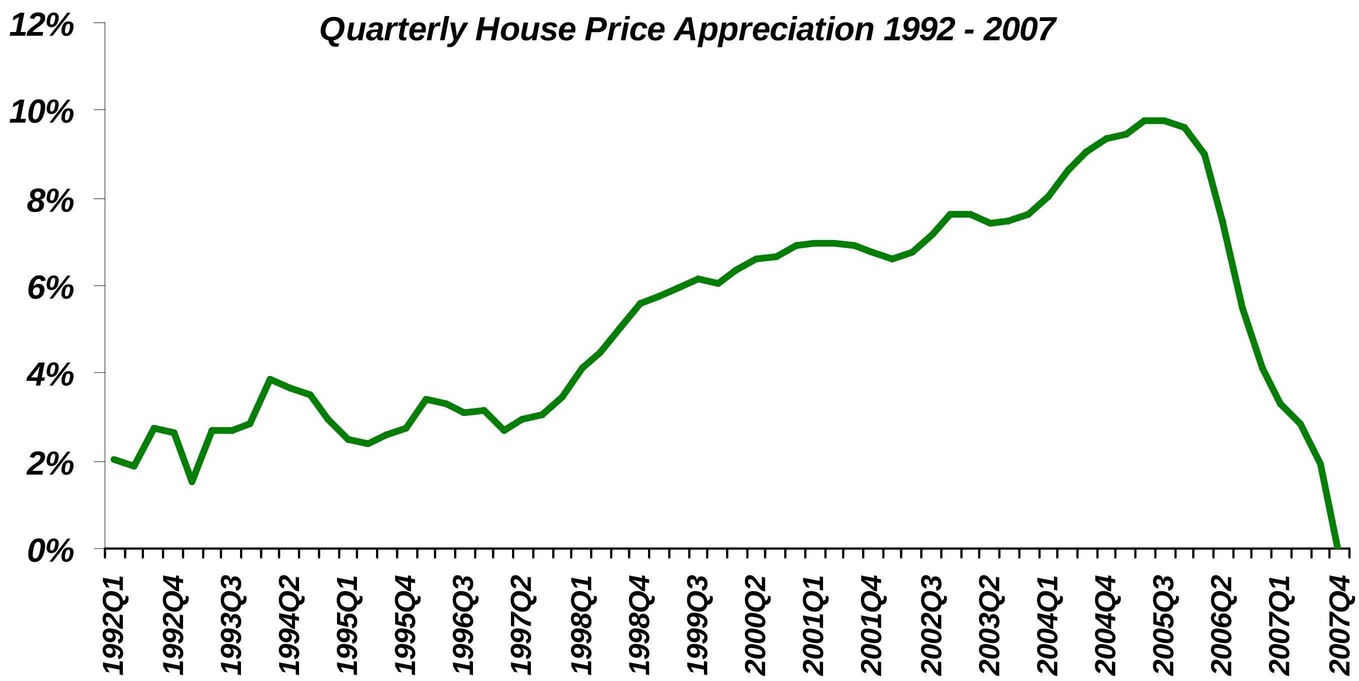
Agenda

- How Did We Get Here
- Ratings Impact
- Exposures
- 1Q08 Investment Losses
- Consideration in Evaluating Investment Losses
- Stress Testing of Exposures
- Important Tangents that we Think About
  - Non-investment Impact on Insurers
  - Market's View of Insurers

Key Elements Leading to Subprime Crisis

- **Housing bubble fueled by low interest rates, easy credit conditions & broad appetite for ARMS**
- **Bubble bursts with resets, tighter credit and falling home prices as certain mortgage borrowers can't afford their existing mortgages, can't refinance, & can't sell their homes**

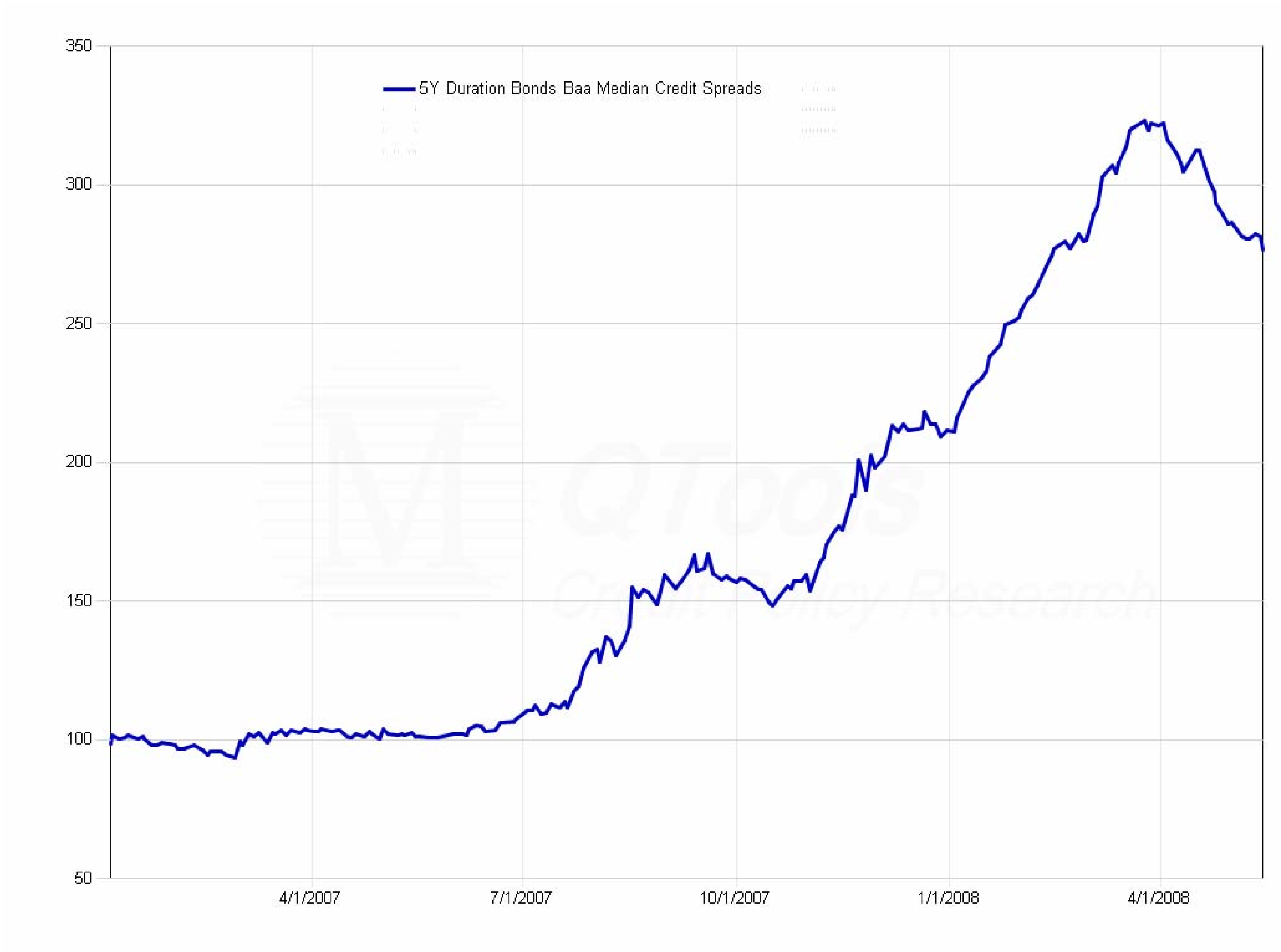


Includes homes with conforming, conventional mortgages only. Source: OFHEO

Contagion Risk--Spreading to Other Assets

- Prime residential mortgages are showing increasing losses
- Pressure in commercial real estate markets—CMBS, REO, commercial mortgage loans
- Economic impact on credit cards/car loans/student loan
- Elevated corporate defaults in a recessionary environment will raise investment losses further

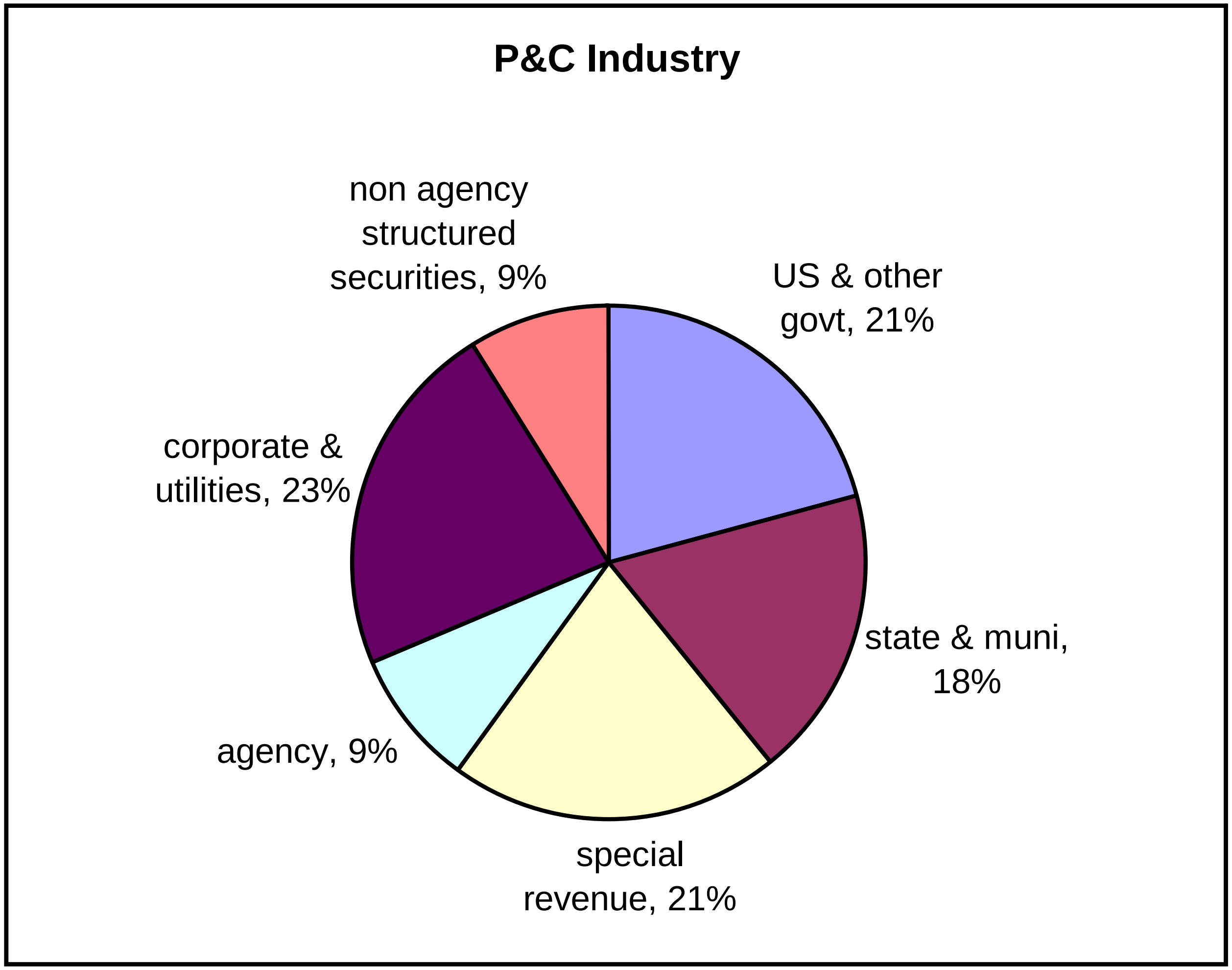
Corporate Credit Spreads Blowout…



Ratings Impact on P&C Re/Insurers

- Insurers continue to emerge through credit crisis from point of strength
- Amongst the least impacted of all financial institutions
- Very strong current financial profiles will enable most insurers to handle these investment losses
- Few rating downgrades expected driven solely by subprime/credit market concerns
- However, insurers with outsized investment losses (e.g. >10% of equity), combined with industry pressures, could prompt downgrades for weakly positioned firms

Exposure - Fixed Income Investment Mix



US Statutory Industry Aggregate – 2006
Source: Highline Data

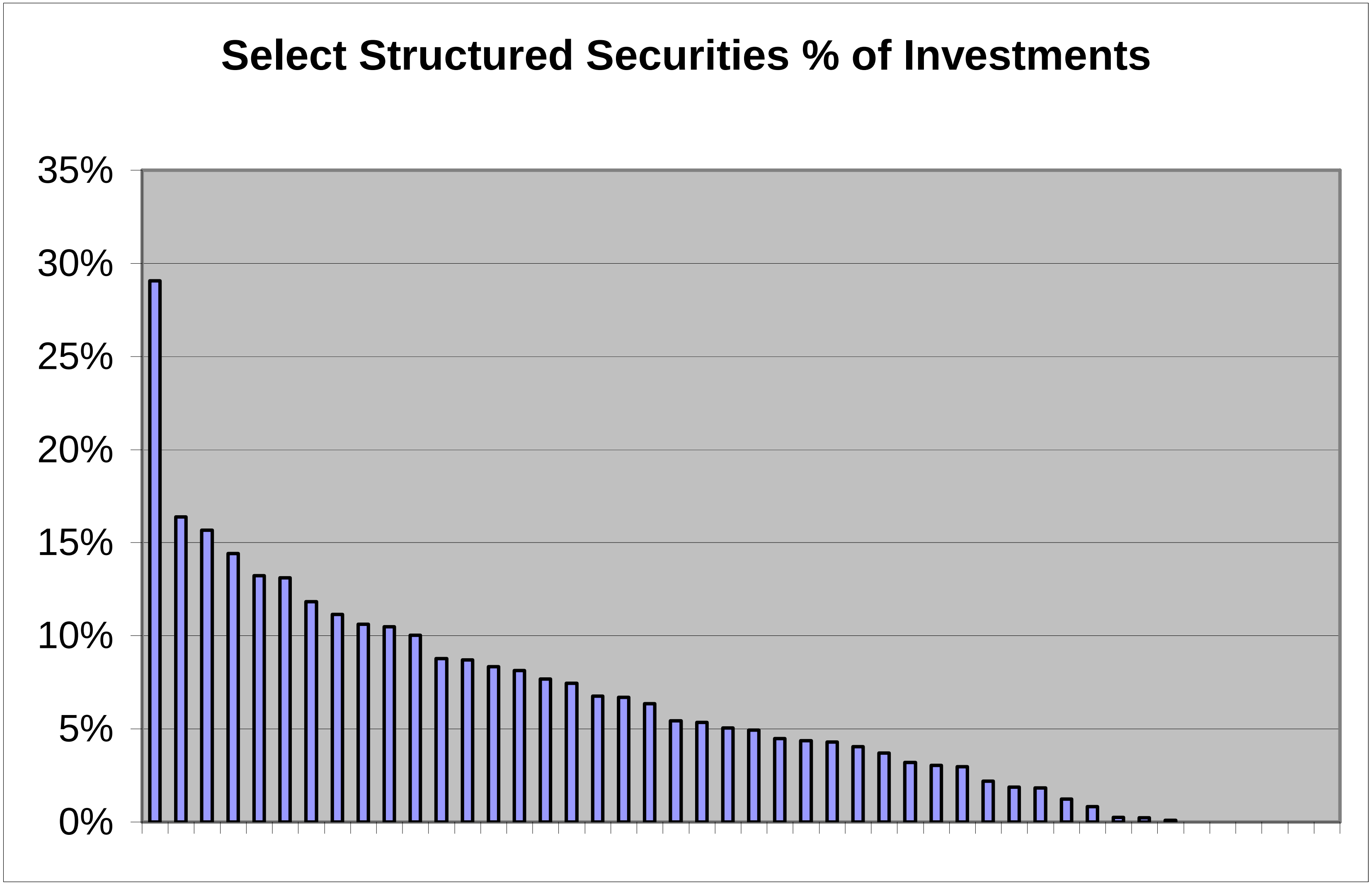
Exposures – Structured Securities

- Exposure to structured mortgage investments are moderate
  - P&C insurers: median of 12% of invested assets & 47% of equity, with range of 0% - 30% of assets
- Exposure to riskier structured mortgage investments is modest (subprime, Alt A, 2nd lien, HELOC, CDO)
  - P&C insurers: median of 4% of assets & 17% of equity

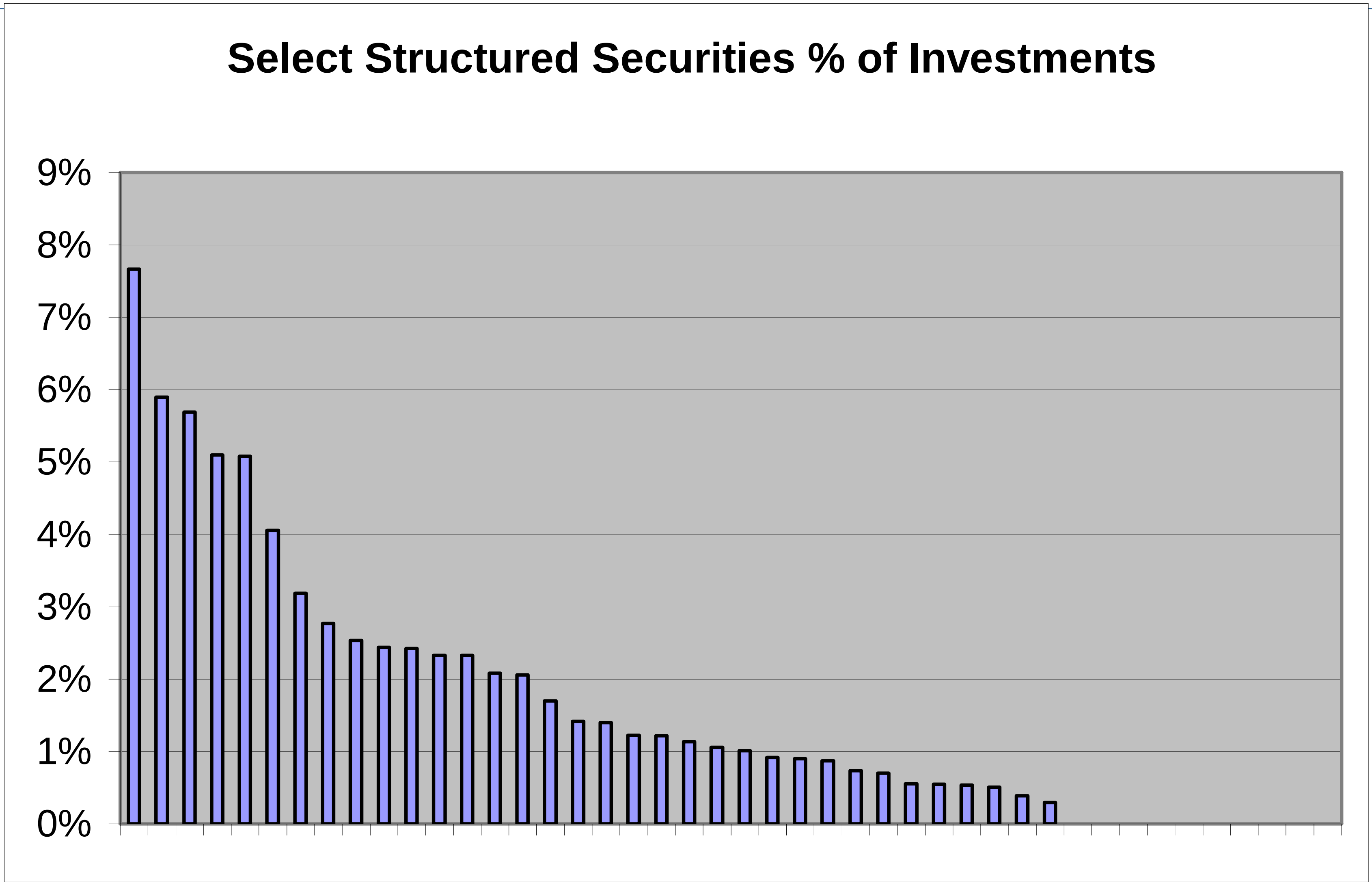
Exposures (cont)

- Essentially no below-investment grade structured mortgage investments
- Mostly high-quality RMBS exposure (Aaa/Aa) with little CDO exposure (less than 0.1% of assets)
- Small % of RMBS holdings have been downgraded
- Additional losses anticipated manageable in context of earnings capacity, capital adequacy, & financial flexibility

CMBS, Alt-A / Subprime RMBS, and CD0—P&C Insurers



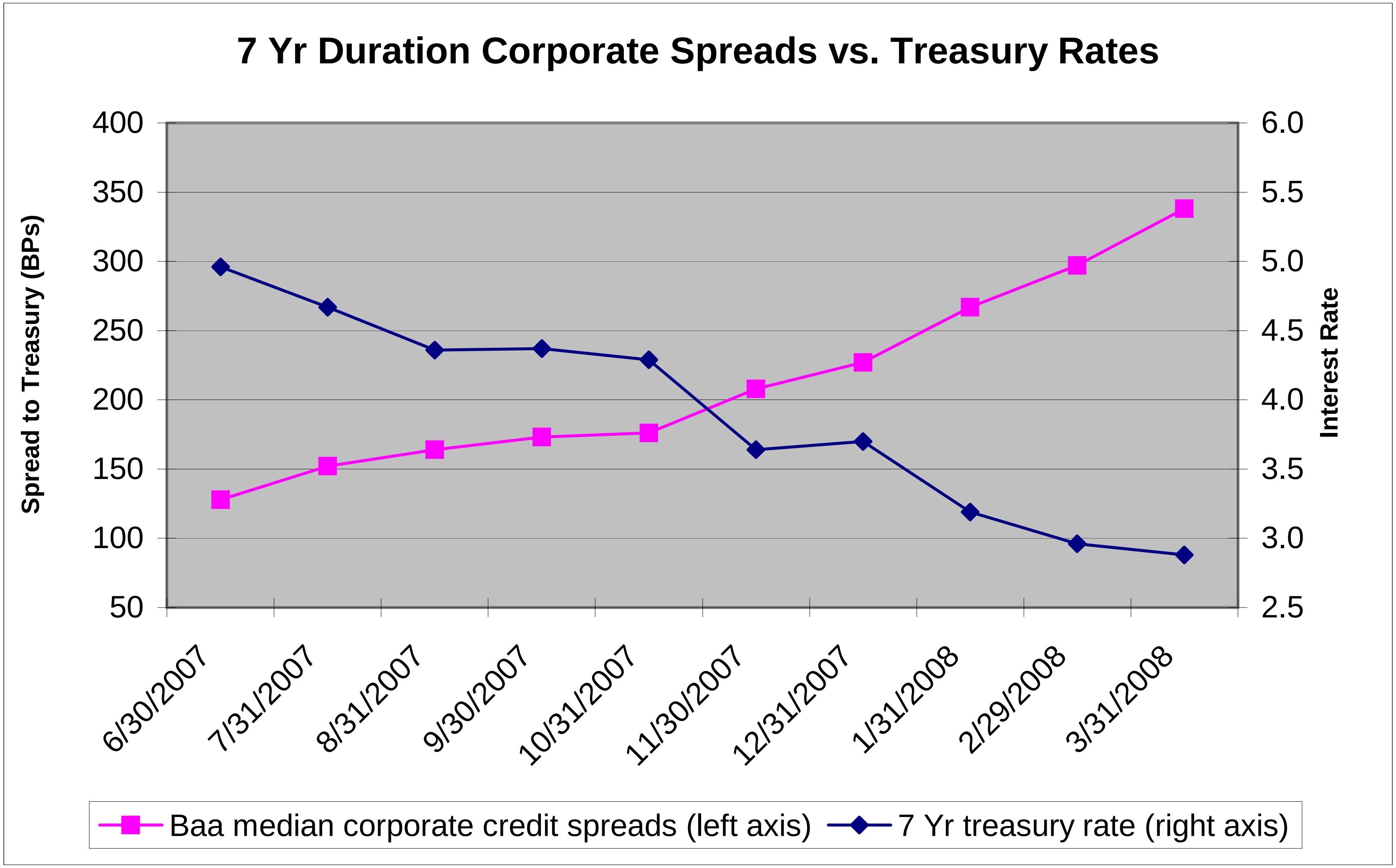
Alt-A / Subprime RMBS and CD0—P&C Insurers



Large Investment Losses Reported in 1Q08

- Continued depressed prices on structured investments
- Sudden widening of credit spreads on all fixed income securities (corporates, agencies, munis)
- Higher reported losses in income statement from other-than-temporary impairments (OTTI)
- More significant movement in unrealized losses taken through equity (AOCI)
- Accounting differences among companies with OTTI practices

Treasuries vs. Corporates



A Look at 1Q08—P&C Insurers

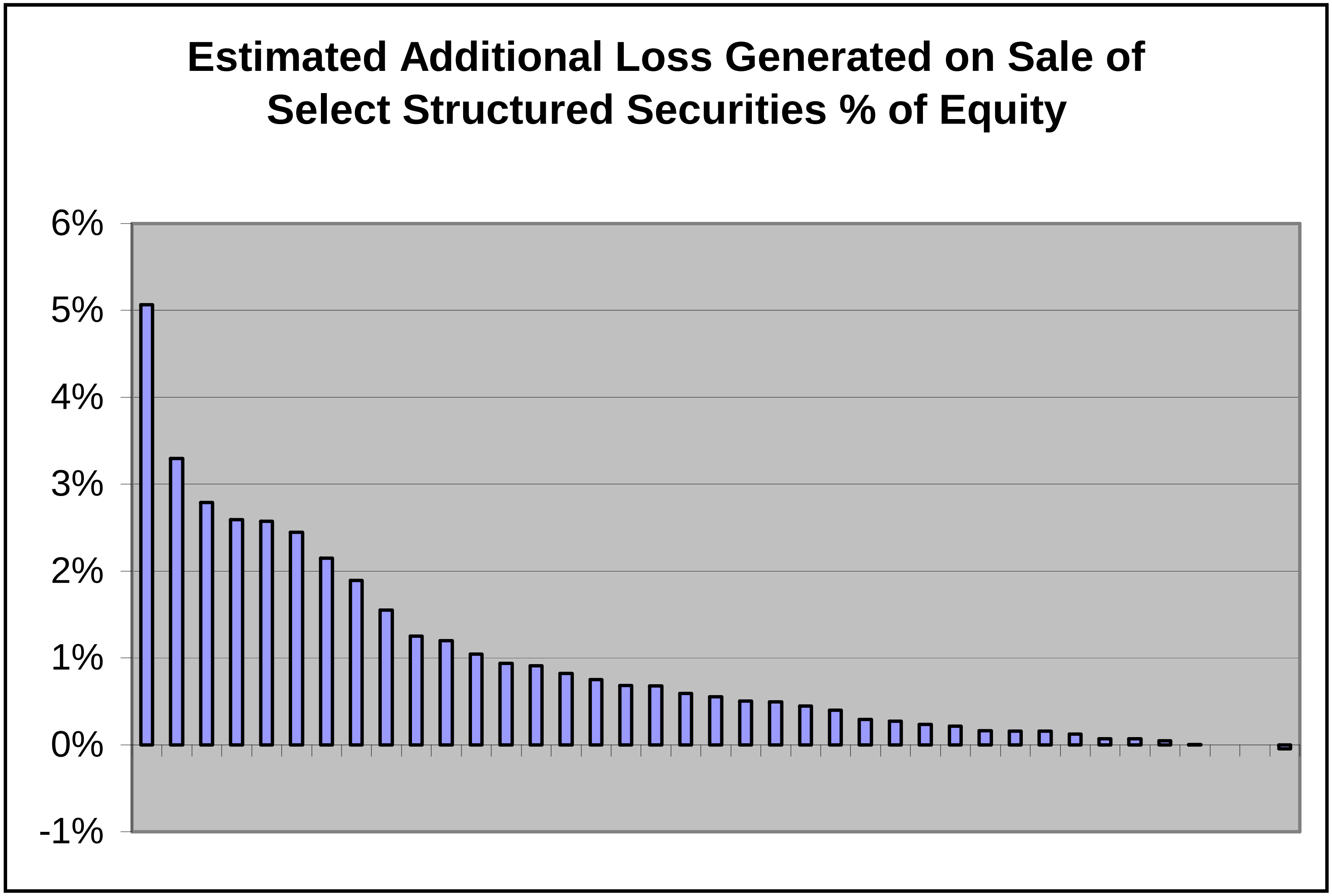
P&C Companies	Realized inv gain/(loss)				Net income/(loss)				Other than temporary impairment losses			
	1Q07		1Q08		1Q07		1Q08		1Q07		1Q08	
(Value in mil$)												
50 + Companies	$	1,784	$	(8,547)	$	16,746	$	(744)	$	650	$	7,849
	delta		$	(10,331)			$	(17,489)			$	7,199
	tax effected a		$	(6,715)								
x AIG	$	1,854	$	(2,458)	$	12,616	$	7,061	$	183	$	2,207
	delta		$	(4,312)			$	(5,554)			$	2,024
	tax effected a		$	(2,803)								

P&C Companies	Shareholders' Equity				AOCI			
	YE 07		1Q08		YE 07		1Q08	
(Value in mil$)								
50 + Companies	$	442,805	$	420,061	$	32,100	$	17,424
			$	(22,744)			$	(14,676)
x AIG	$	347,004	$	340,358	$	27,457	$	18,695
			$	(6,646)			$	(8,762)

Considerations in Evaluating Investment Losses

- Disconnect between distressed market prices on several structured investments and economic view of ultimate impairment losses
- Insurers have ability and intent to hold distressed securities until prices recover
- Expectation of prices recovering for certain securities and losses reversing (seen in April 2008)
- However, impact of reported financials need to be evaluated in context of covenants in bank credit facilities

A Measure of Further Risk… P&C Insurers



“Other” Impacts on Insurance Business

Limited impact on insurance business, unlike other financial institutions, but we are seeing:

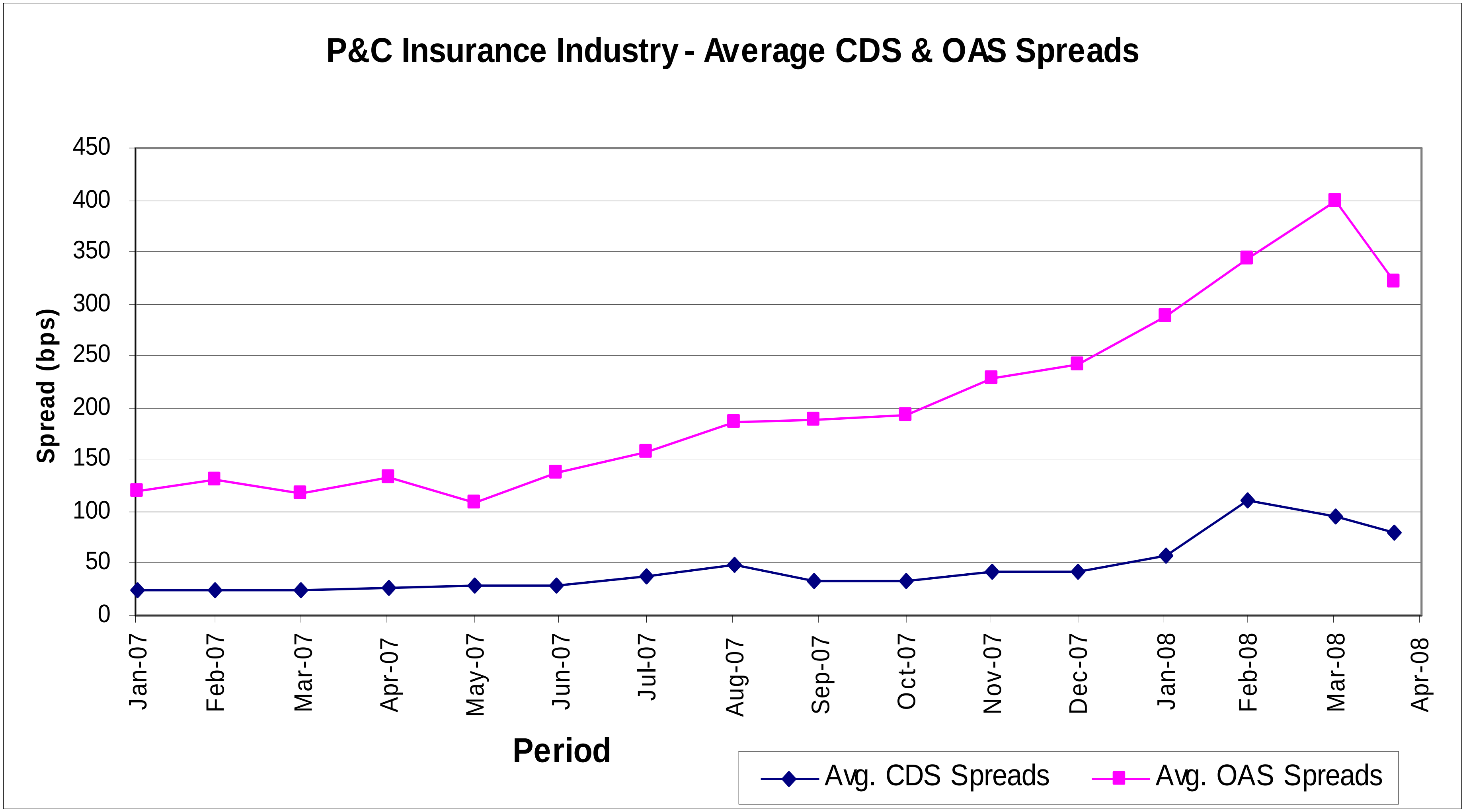
- Negative impact for professional lines—D&O and E&O losses from litigation related to mortgage lenders
- In recessionary economy, negative impact on sales of discretionary insurance products and rising claim costs for business lines like WC
- Weak US$ is benefiting companies with foreign operations, hurting international groups with US operations, and will likely make US insurers attractive to foreign buyers
- Consolidation is likely to accelerate driven by 1) access to new distribution channels, 2) expansion of product offerings, and/or 3) economies of scale

Market’s View on Insurers

Market’s view of insurers has deteriorated, somewhat constricting their financial flexibility, but much less than other financial institutions:

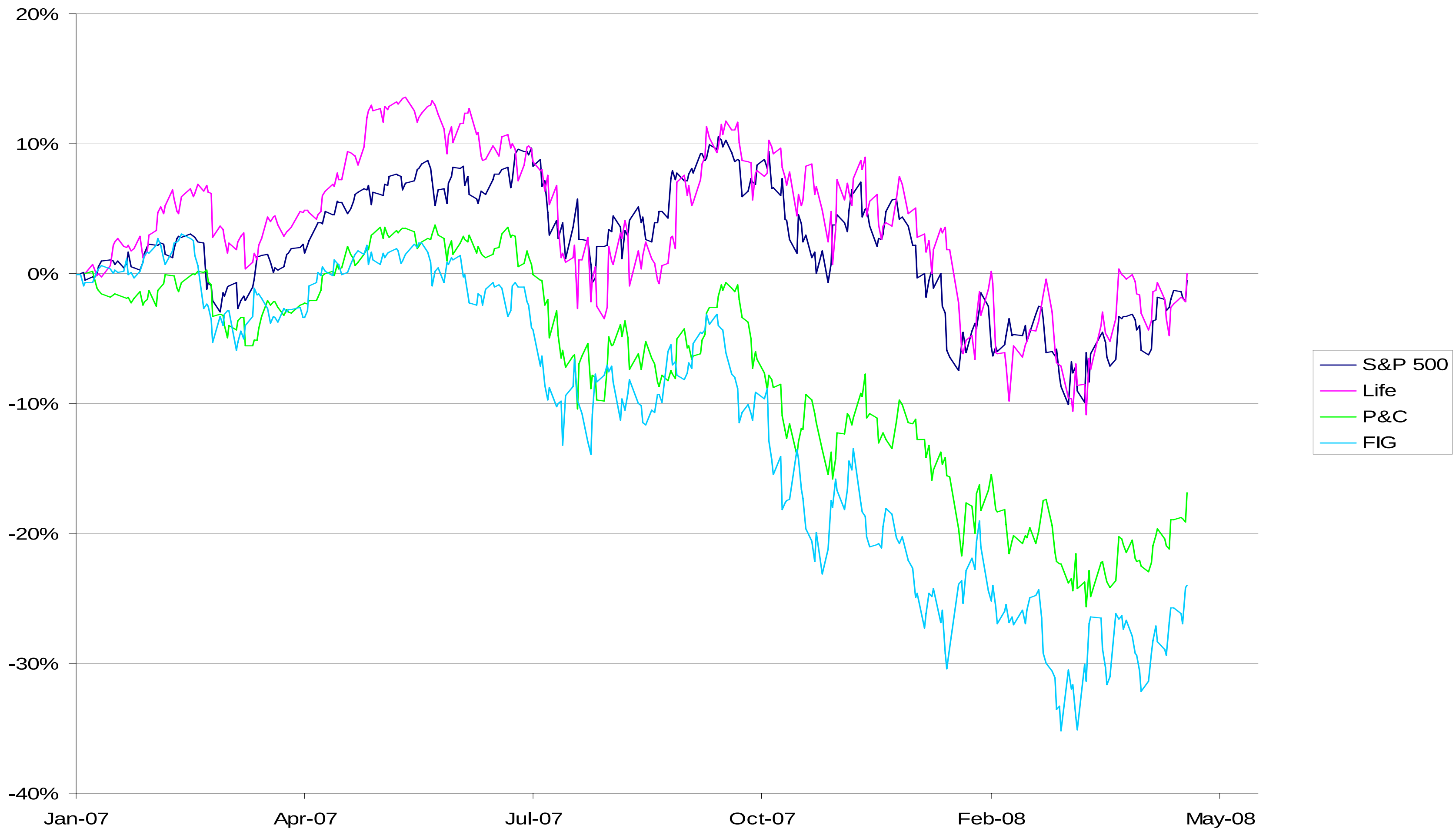
- Credit spreads for CDS and bonds have widened considerably, increasing insurers’ funding costs
- Dramatic decline in issuance of debt and hybrids in past 9 months
- Stock prices have dropped about 10%-20% in past 6 months--more dramatic decline for p&c insurers—diminishing insurers’ intent to issue shares
- Hasn’t stopped active share buyback programs in 1Q08

Market's View of Insurers (cont.)



CDS spread to Libor / OAS spread to Treasury

Market's View of Insurers (cont.)



Performance of Life (DJUSIL), P&C (DJUSIP), and Financial Institutions (DJUSFN) Stock Indices Relative to the S&P 500

Conclusion

Although insurers are facing these higher investment losses from a position of current strength, we note that the fundamental credit trends are negative as the economic recessionary conditions, higher corporate default rates anticipated, and softening p&c pricing environment will all put incremental pressure on the industry.

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