"Market and Cycle: How Long Can We Stay Profitable?" Redux

Casualty Actuarial Society Spring Meeting
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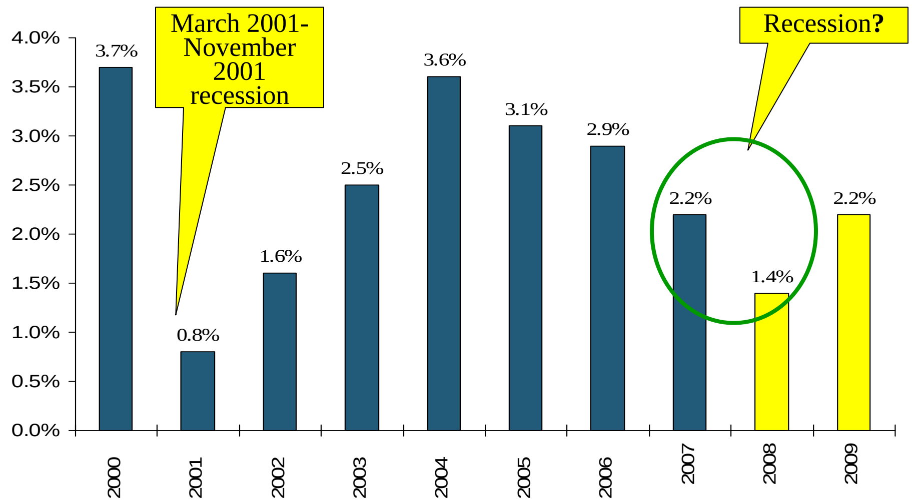
- First, let's establish my forecasting credentials.

  Here is the first slide I used in my presentation to the CAS Spring Meeting two years ago, in June 2008

Real Annual GDP Growth, 2000-2009F

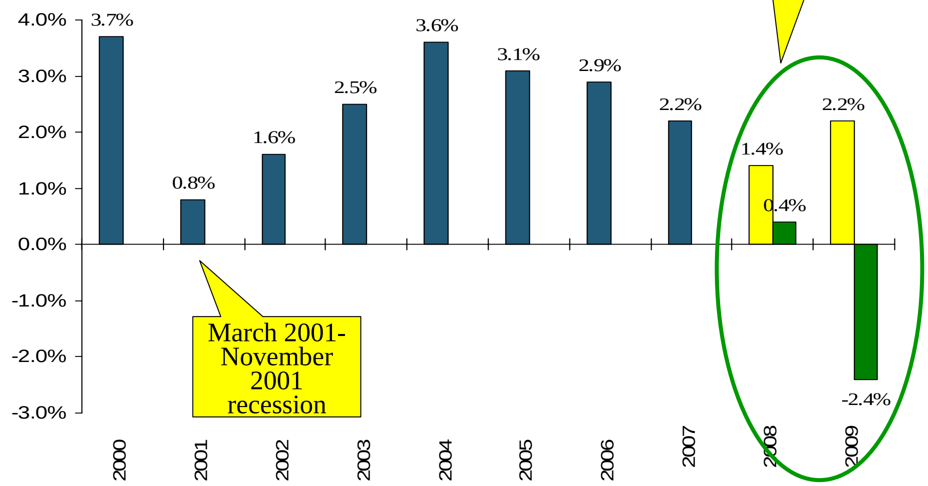
Blue bars are actual; Yellow bars are forecasts



Sources: US Department of Commerce, Blue Chip Economic Indicators 4/08; Insurance Information Institute.

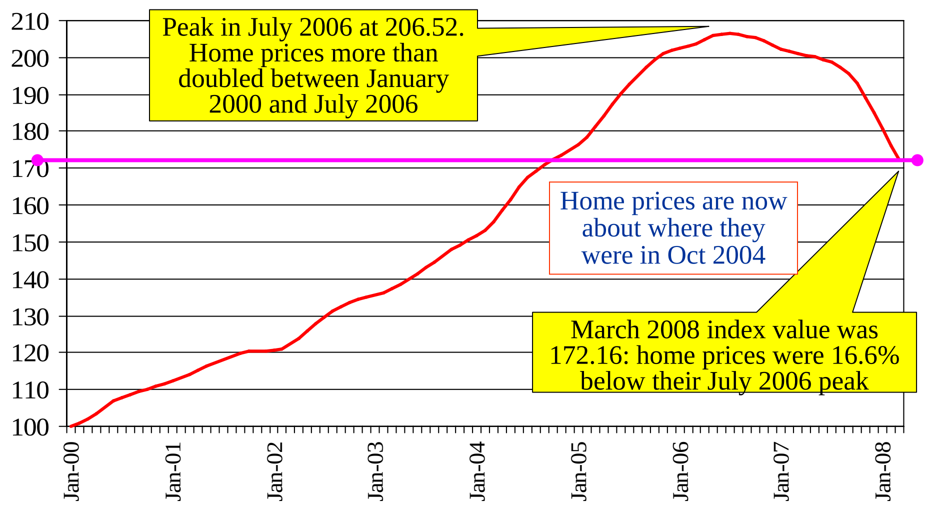
Whoops! Real Annual GDP Growth, 2000-2009

Blue bars are original actual; Yellow bars are original forecasts; Green bars are updated actual



Sources: US Department of Commerce, Blue Chip Economic Indicators 4/10; Insurance Information Institute.

Case-Schiller Home Price Index
Monthly: 20 City Composite (Jan 2000=100)



Source: http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_History_052703.xls

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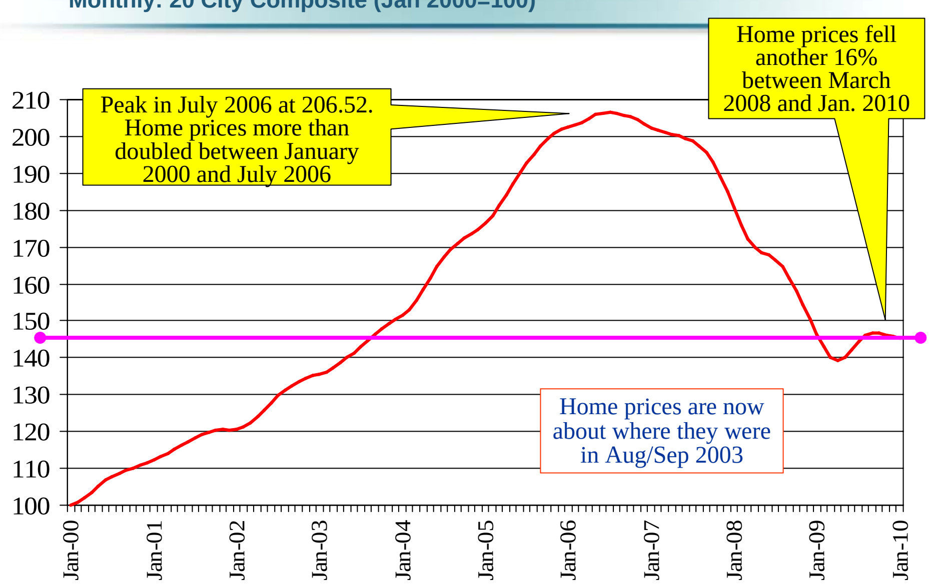

Source: http://www2.standardandpoors.com/

Housing Starts Were Forecast to Drop to 1 Million, Rebound to 1.45 Million in 2011

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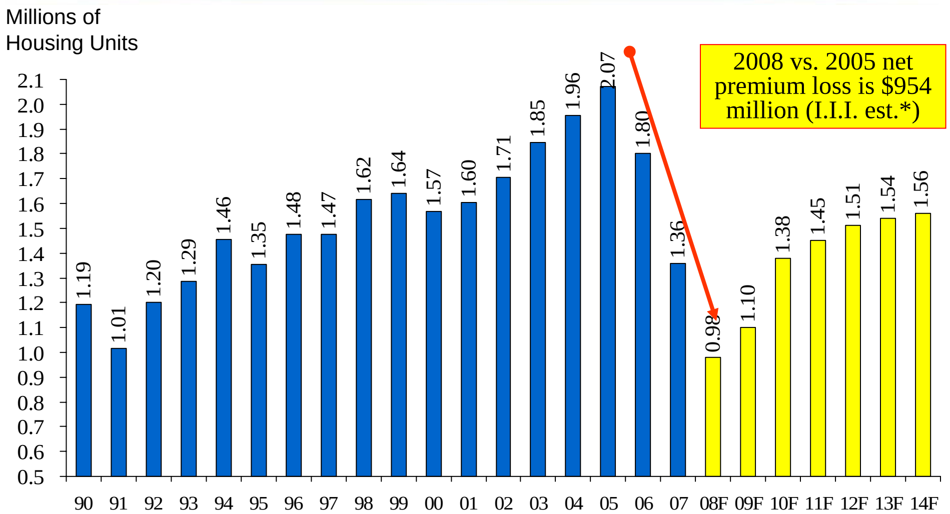

*III estimate is based on $87 million in gross permium per 100,000 housing starts
Sources: US Department of Commerce; Blue Chip Economic Indicators (10/07), except 2008/09 figures from 4/08 edition of BCEI; Insurance Info. Institute

Housing Starts Dropped to ½ Million; Now Forecast to Stay Below 1 Million Through 2011

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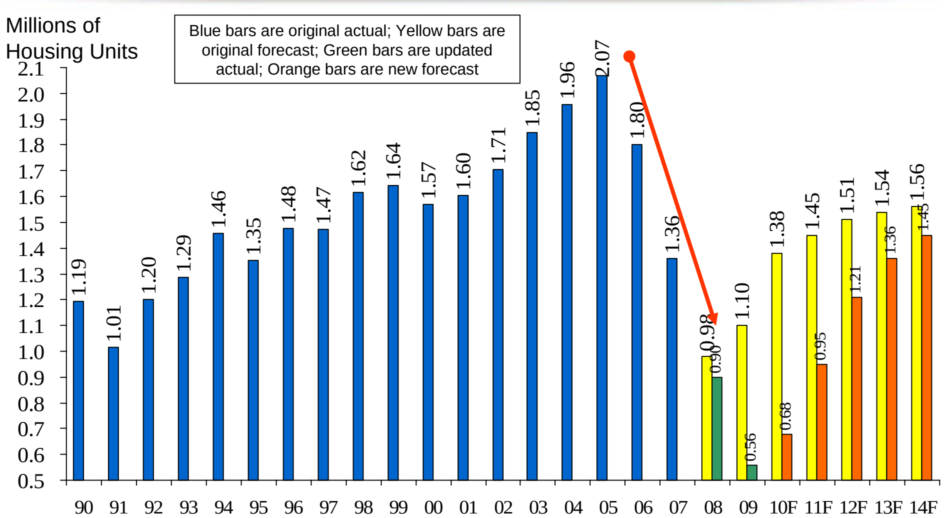

Sources: US Department of Commerce; Blue Chip Economic Indicators (3/2010 and 4/2010 issues)

Auto/Light Truck Sales, 1999-2014F

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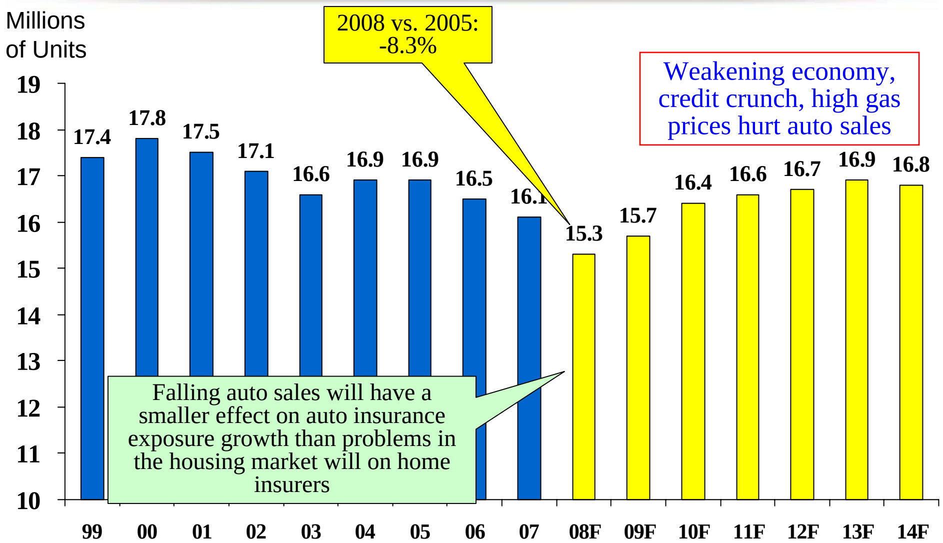

Sources: US Department of Commerce; Blue Chip Economic Indicators (10/07), except 2008/09 figures from 3/08 edition of BCEI; Insurance Info. Institute

Auto/Light Truck Sales, 1999-2014F (Millions of Units)

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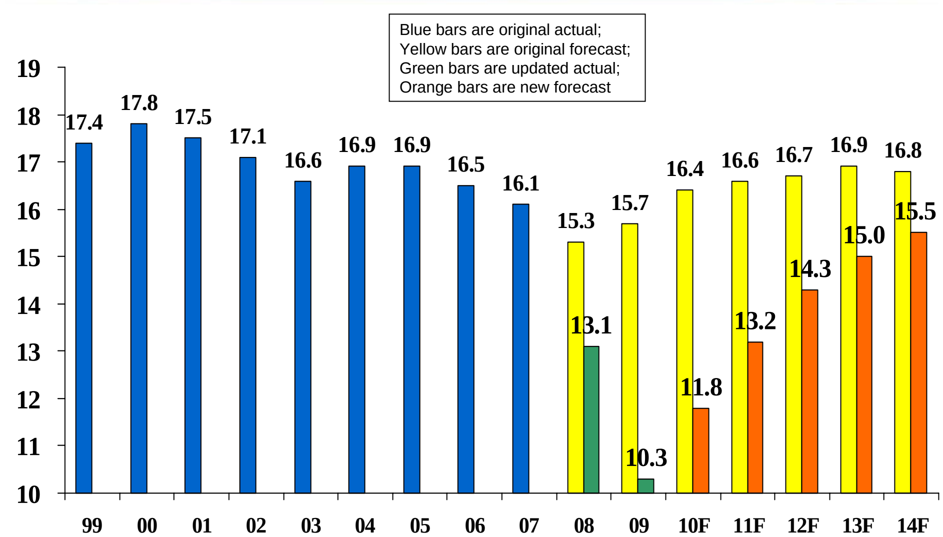

Sources: US Department of Commerce; Blue Chip Economic Indicators (3/2010 and 4/2010 issues)

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Will Premiums Ever Grow Again?

Challenge: To Grow Premium Volume and Market Penetration In a Tough Economy

P-C Premium Volume is Headed for a Fourth Consecutive Negative Year

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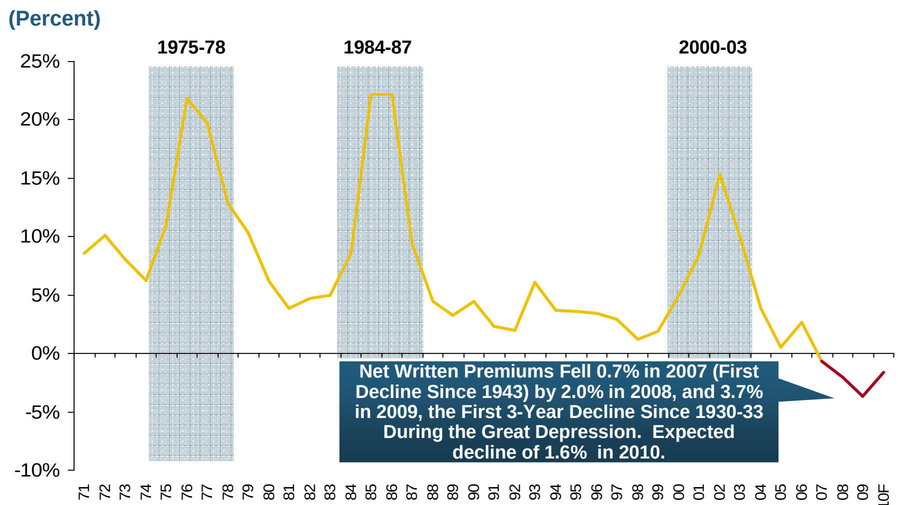
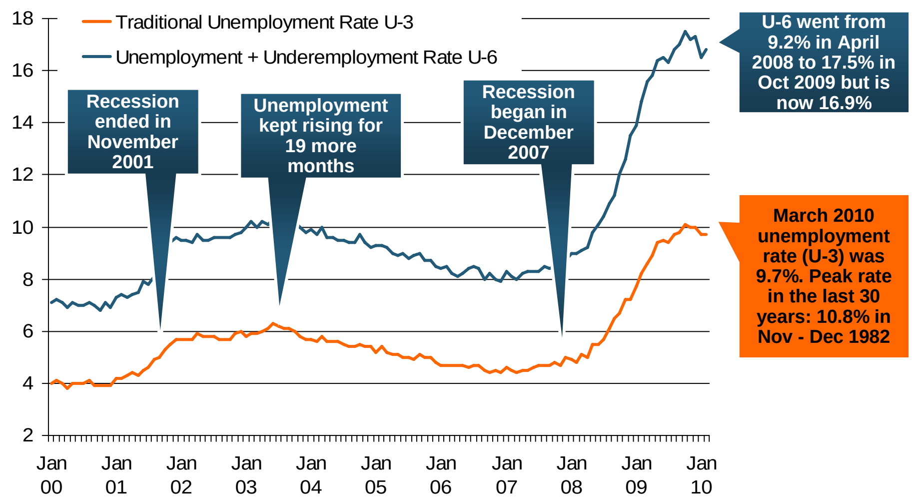


Shaded areas denote "hard market" periods
Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute

Unemployment and Underemployment Rates: Rocketing Up in 2008-09

January 2000 through March 2010, Seasonally Adjusted (%)



Source: U.S. Bureau of Labor Statistics; Insurance Information Institute.

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

- Since the start of the recession in December 2007, an estimated 8.6 million jobs have been lost.
- To keep up with population growth, the economy needs to add roughly 130,000 jobs every month.
- This means the labor market is currently about 12 million jobs below the level needed to restore the pre-recession employment rate.

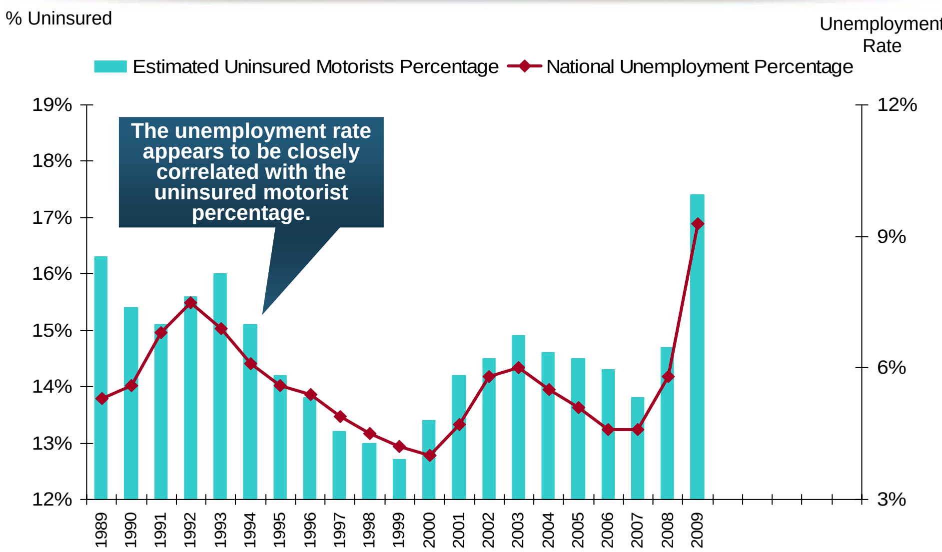
*as of March 2010
Source: Heidi Shierholz, "Signs of Healing in the Labor Market, Though Unemployment Remains in Double Digits," Economic Policy Institute, December 4, 2009, at http://www.epi.org/analysis_and_opinion/entry/signs_of_healing_in_the_labor_market_though_unemployment_remains_in_double_/

Job Growth Needed (cont'd)

- 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—including finding jobs for workforce growth, we would have to average adding 330,000 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)

Unemployment's Effect on Percent of Uninsured Motorists, 1989-2009



Source: *Uninsured Motorists, 2008* Edition, Insurance Research Council; Blue Chip Economic Indicators (Unemployment data, including forecasts); Insurance Information Institute.

Unemployment's Effect on Percent of Uninsured Motorists, 1989-2014F

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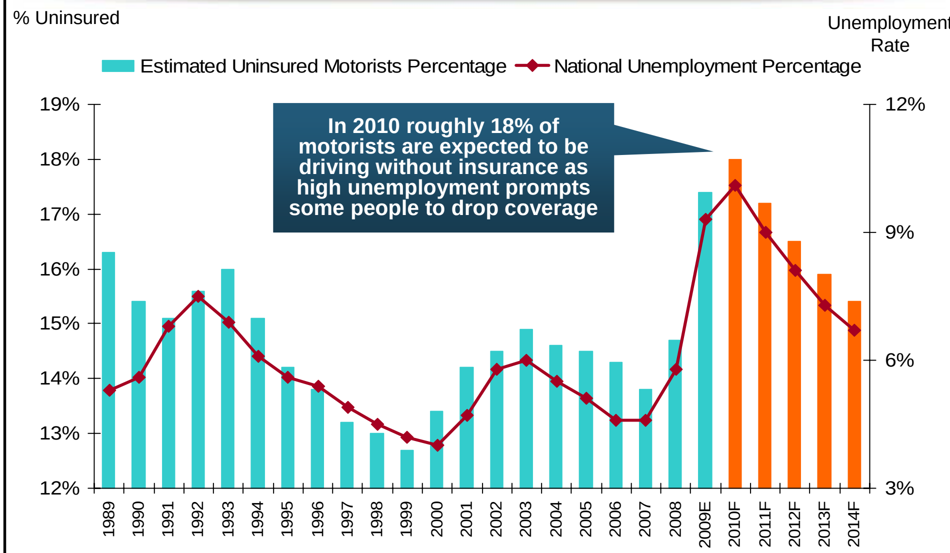

Source: *Uninsured Motorists, 2008* Edition, Insurance Research Council; Blue Chip Economic Indicators (Unemployment data, including forecasts); Insurance Information Institute.

Business Bankruptcy Filings 1980–2009

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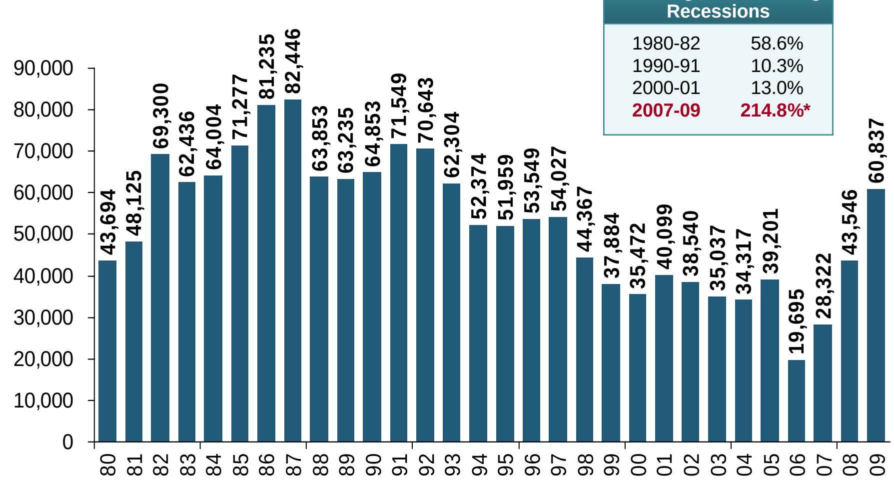
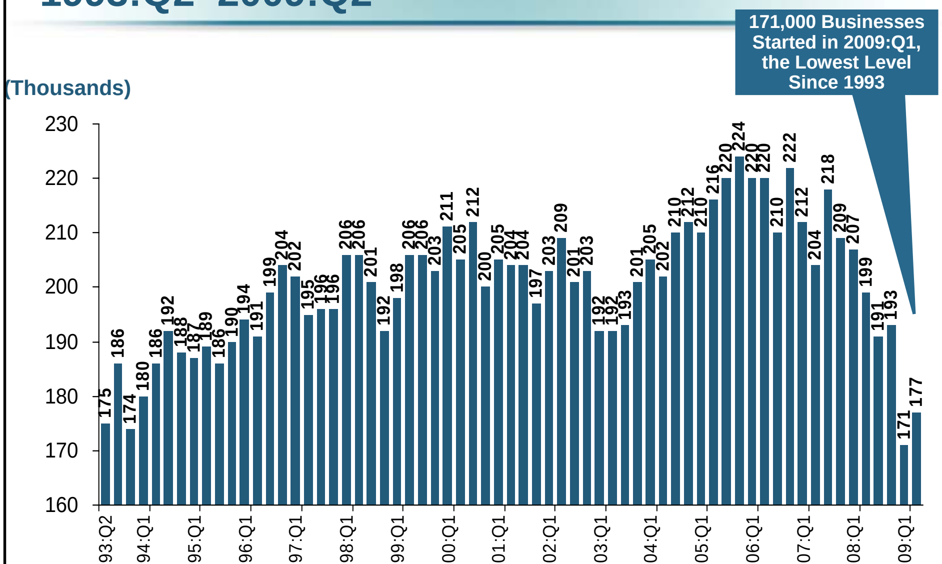
% Change Surrounding Recessions	
1980-82	58.6%
1990-91	10.3%
2000-01	13.0%
2007-09	**214.8%***



Source: American Bankruptcy Institute at http://www.abiworld.org/AM/AMTemplate.cfm?Section=Business_Bankruptcy_Filings1&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=60240

Private Sector Business Starts, 1993:Q2–2009:Q2*



*Latest available as of April 1 2010, seasonally adjusted

Source: Bureau of Labor Statistics: http://www.bls.gov/news.release/cewbd.t07.htm

Will Investments Be a Profit Source Again?

Property/Casualty Insurance Industry Investment Gain[1]: 1994–2009

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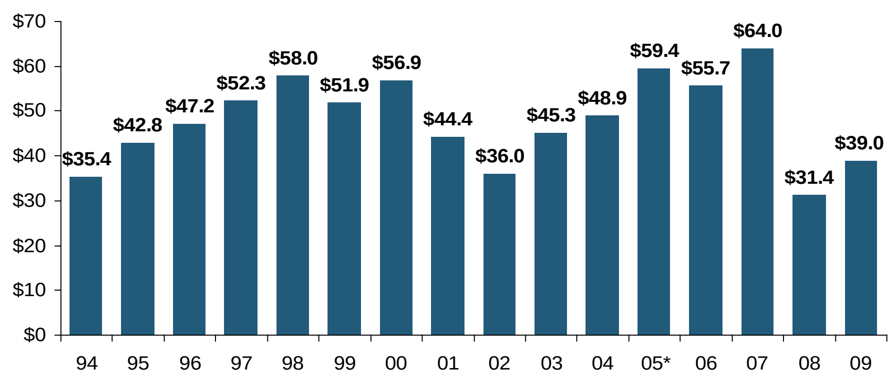
($ Billions)



Investment Gains Fell by 51% In 2008 Due to Lower Yields and Poor Equity Market Conditions. In 2009, Equity Gains Were Somewhat Offset by Asset Value Writedowns

[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 Still Quite Low Compared to Pre-Crisis Levels

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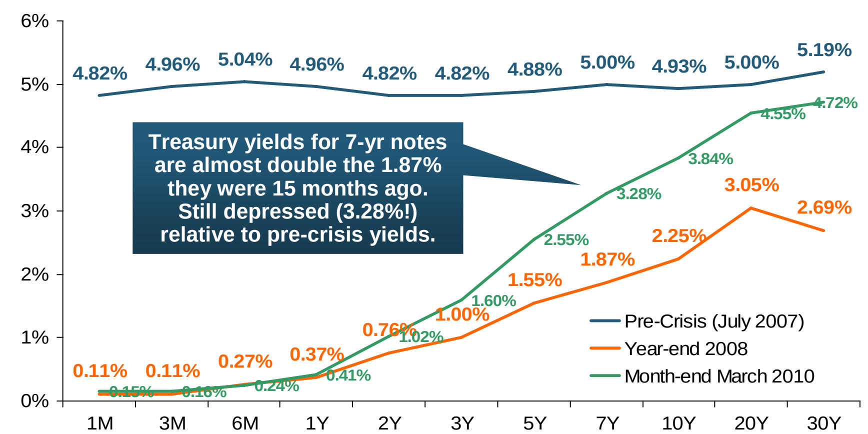

The Average Maturity on Bonds in P-C Insurers' Portfolios Has Remained Steady at About 7.5 Years Through the Last Decade

Sources: Board of Governors of the United States Federal Reserve Bank at http://ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_main.shtml ; Insurance Information Institute.

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Will Inflation Defeat Profitability Plans?

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

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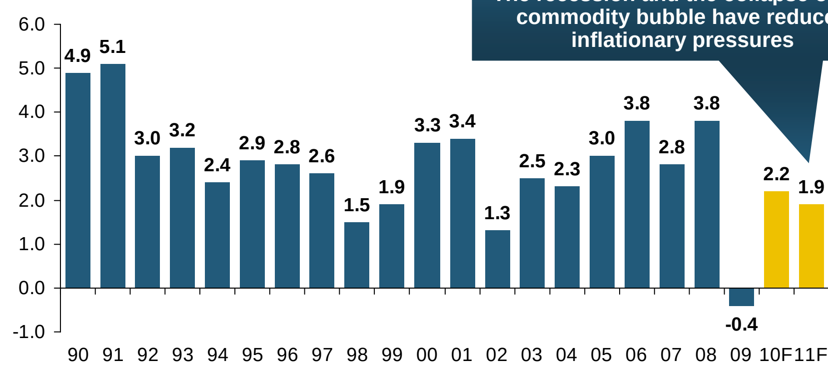
Annual Inflation Rates (%)

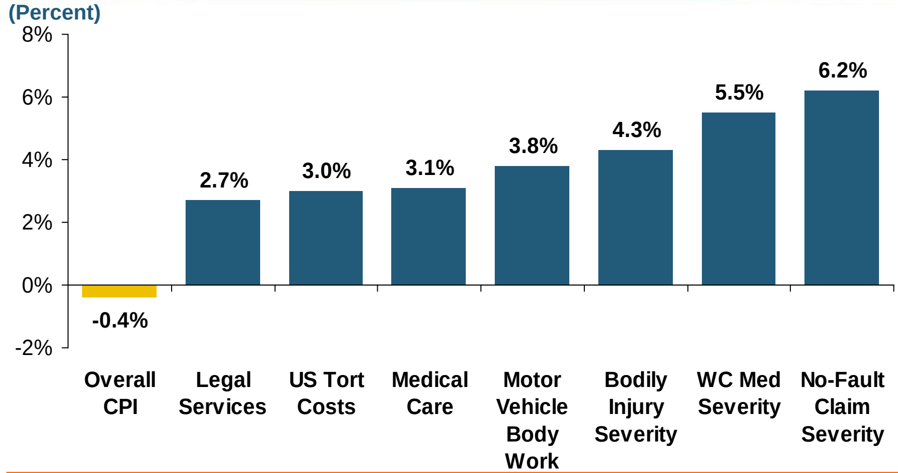
Inflation peaked at 5.6% in August 2008 on high energy and commodity crisis. The recession and the collapse of the commodity bubble have reduced inflationary pressures



There is So Much Slack in the US Economy 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, Mar. 10, 2010 (forecasts).

P/C Insurers Experience Inflation More Intensely than 2009 CPI Suggests



Healthcare and Legal/Tort Costs Are a Major P/C Insurance Cost Driver. These Are Expected to Increase Above the Overall Inflation Rate (CPI) Indefinitely

Source: CPI is Blue Chip Economic Indicator 2009 estimate, 12/09; Legal services, medical care and motor vehicle body work 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. Tort costs is 2009 Towers-Perrin estimate. WC figure is I.I.I. estimate based on historical NCCI data.

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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Will Catastrophe Losses Continue Their Adverse Trend?

US Insured Catastrophe Losses

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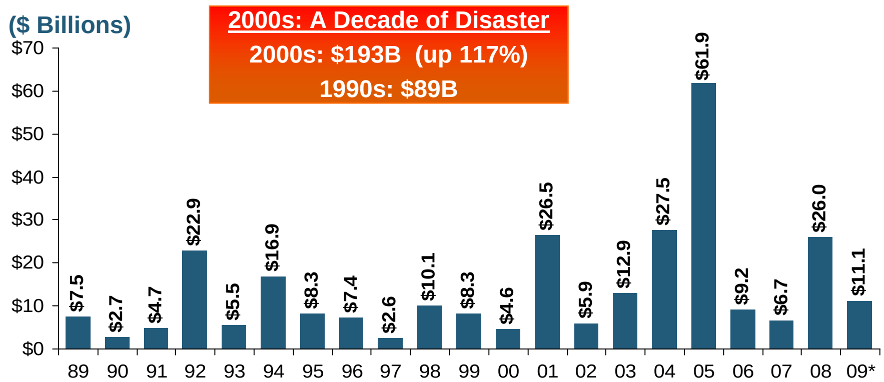


The New Normal?, In four of the nine years starting with 2001 CAT losses were $25 billion or more. Before 2001, that never happened.

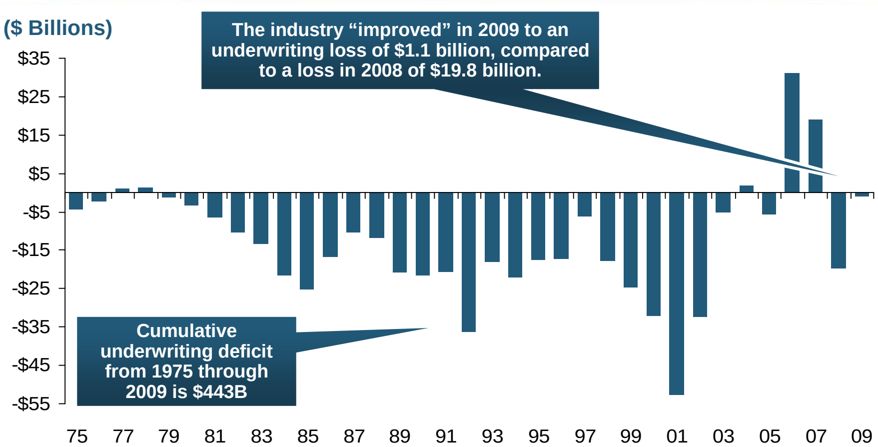
* 2009 figure is Munich Re estimate.

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/BI losses = $12.2B.

Sources: Property Claims Service/ISO; Insurance Information Institute.

Profitability:
Did Profits Reach a Cyclical Peak in 2006/07?

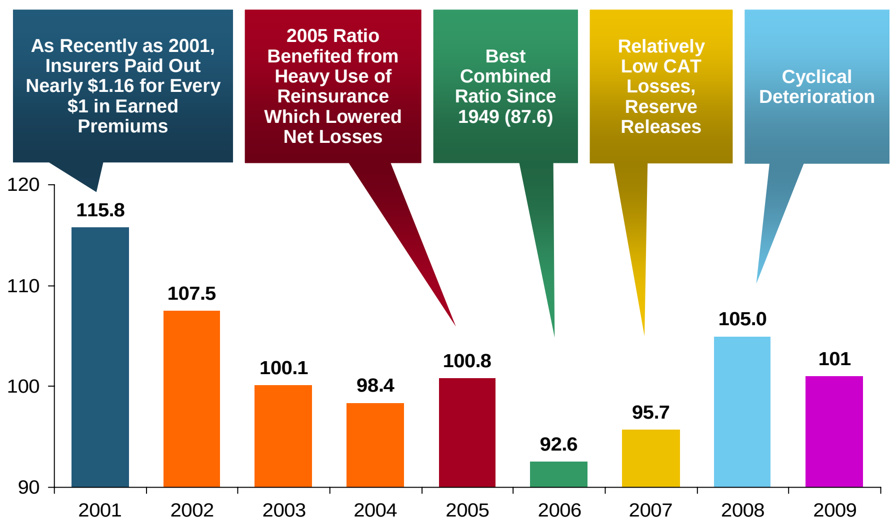
Underwriting Gain (Loss) 1975–2009



Underwriting Losses Are *NOT* Sustainable in Current Investment Environment

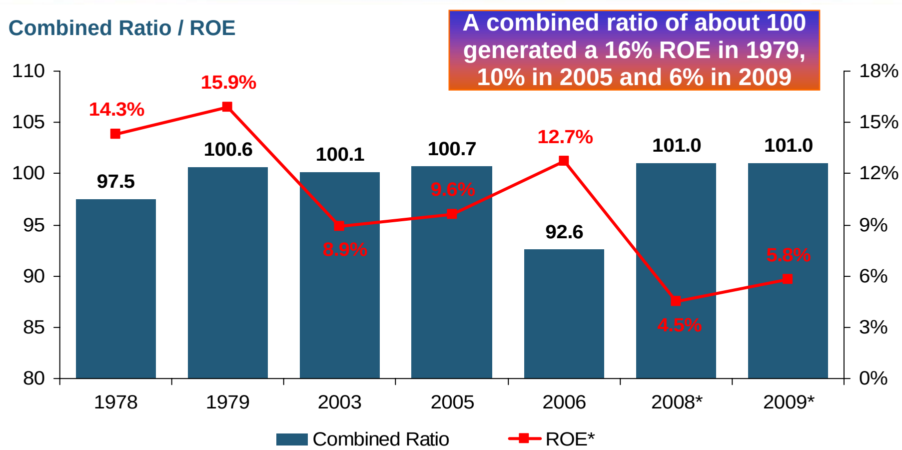
* Includes mortgage and financial guarantee insurers.
Sources: A.M. Best, ISO; Insurance Information Institute.

Lately, the P/C Insurance Industry Combined Ratio, Has Trended Up



Sources: A.M. Best, ISO.

Combined Ratios Must Be in the Low 90s Now to Produce Satisfactory ROEs



Combined Ratios Must Be Lower in Today's Depressed Investment Environment to Generate Risk Appropriate ROEs

*return on average statutory surplus.
Source: Insurance Information Institute from A.M. Best and ISO data

P/C Net Income After Taxes 1991–2009P ($ Millions)

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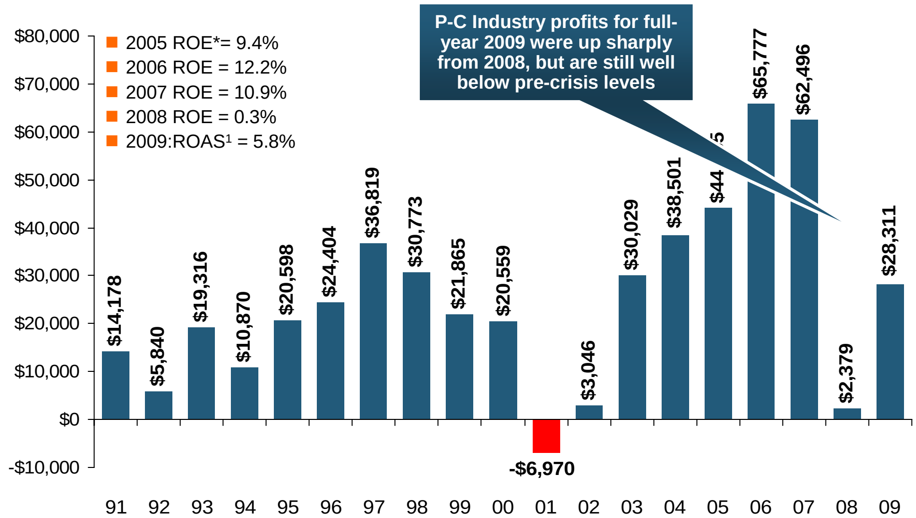

* ROE figures are GAAP; [1]Return on avg. surplus.
Sources: A.M. Best, ISO, Insurance Information Institute

ROE: P/C vs. All Industries, 1987–2009

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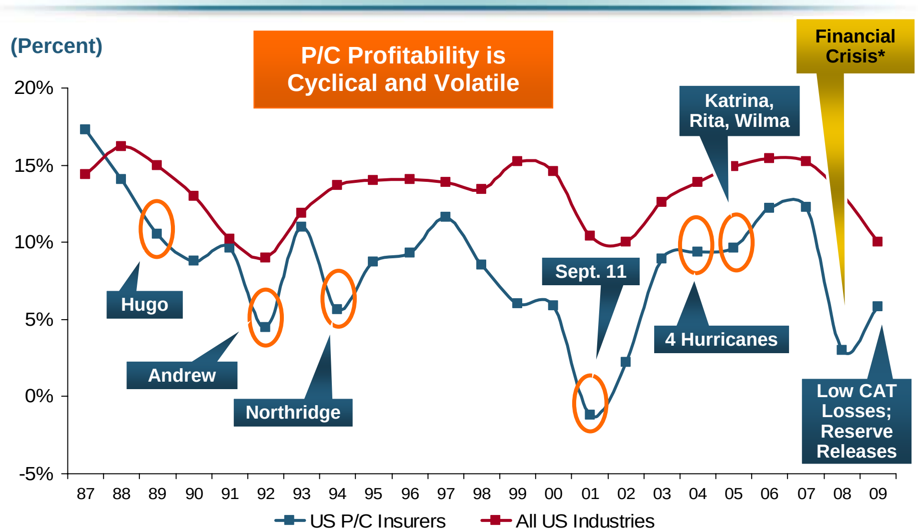

Sources: ISO, *Fortune*; Insurance Information Institute.

Capital and Capacity

How Much is Enough?
How Much is Too Much?

One Analyst's Opinion

- "Commercial lines P&C insurers and Bermuda (re)insurers appear to have significant excess capital as of year-end 2009."
- "The US P&C insurance industry could have around $100 billion of excess capital as of year-end 2009."

Source: Jay Gelb, "How Much Excess Capital?", Barclays Capital, March 23, 2010

Policyholder Surplus, 2006:Q4–2010:Q1E

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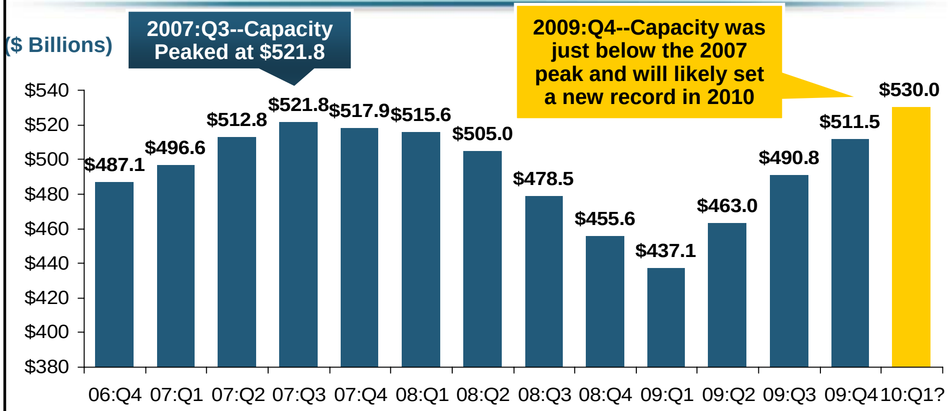

Declines Since 2007:Q3 Peak

08:Q2: -$16.6B (-3.2%)	**09:Q2: -$58.8B (-11.2%)**
08:Q3: -$43.3B (-8.3%)	**09:Q3: -$31.8B (-5.9%)**
08:Q4: -$66.2B (-12.9%)	**09:Q4: -$10.3B (-2.0%)**
09:Q1: -$84.7B (-16.2%)	

Source: ISO, AM Best.

Ratio of Insured Loss to Surplus for Largest Capital Events Since 1989*

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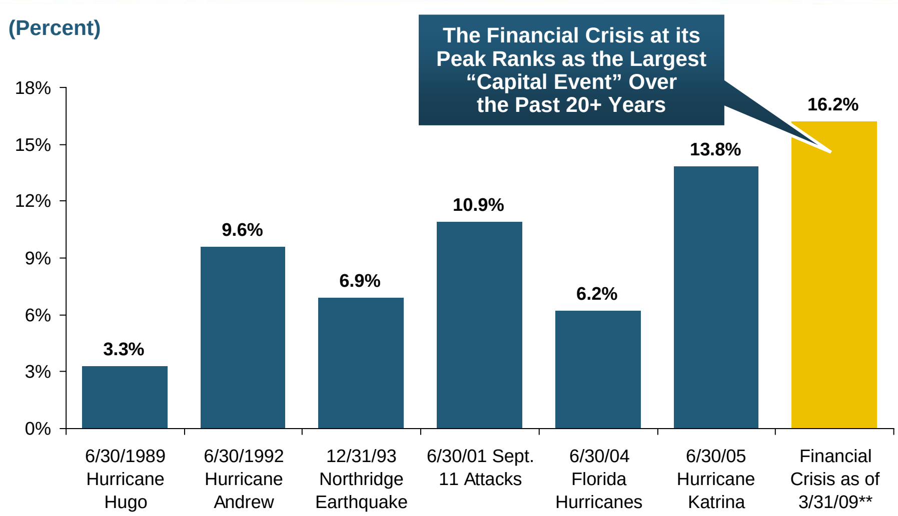

* Ratio is for end-of-quarter surplus immediately prior to event. Date shown is end of quarter prior to event
** Date of maximum capital erosion; As of 9/30/09 (latest available) ratio = 5.9%
Source: PCS; Insurance Information Institute

P/C Insurer Impairment Frequency vs. Combined Ratio, 1969-2009

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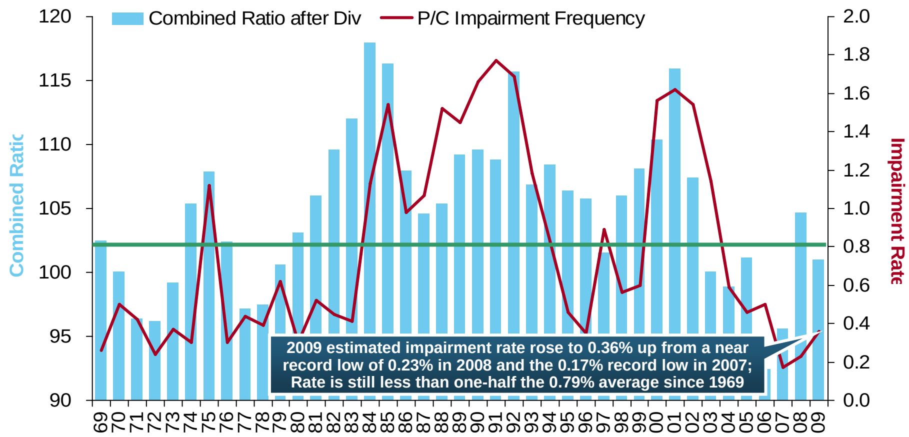

Impairment Rates Are Highly Correlated With Underwriting Performance and Reached Record Lows in 2007/08

0.36% 2009 impairment rate is III estimate based on preliminary A.M. Best data.
Source: A.M. Best; Insurance Information Institute

Reasons for US P/C Insurer Impairments, 1969–2008

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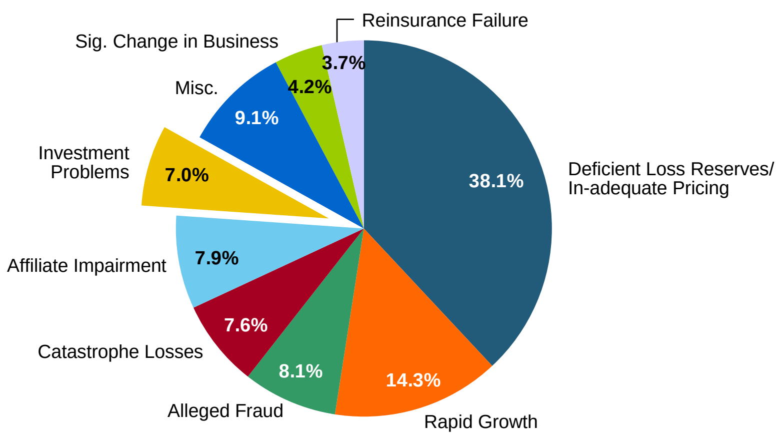
Deficient Loss Reserves and Inadequate Pricing Are the Leading Cause of Insurer Impairments, Underscoring the Importance of Discipline. Investment Catastrophe Losses Play a Much Smaller Role



Source: A.M. Best: *1969-2008 Impairment Review*, Special Report, Apr. 6, 2008

Can Anything Change the Profit Cycle?

Four Factors That Could Affect the Length and Depth of the Cycle

Two Factors that Could Make the Cycle Longer and Deeper

What I Said Then	Capacity: Analysts say surplus growth in recent years has left the industry with between $85-$100 billion in excess capital. All else equal, rising capital leads to greater price competition and a liberalization of terms and conditions
	Reserves: Reserves are in the best shape (in terms of adequacy) in decades, which could extend the depth and length of the cycle. But reserve releases will diminish in 2008; Even more so in 2009
What I Say Now	Capacity: My prior analysis is still valid. All else equal, rising capital leads to greater price competition and a liberalization of terms and conditions
	Exposure Growth: A long, slow recovery from the "Great Recession" could keep the demand for insurance growing at low single digits—or less. Reserve releases didn't diminish as expected, but will likely diminish in 2010 and 2011.

Two Factors that Could Make the Cycle Shorter and Shallower

What I Said Then	Information Systems: Management has more and better tools that allow faster adjustments to price, underwriting and changing market conditions than it had during previous soft markets
	Investment Results: 2007 was the 5th consecutive up year on Wall Street. With declines in stock prices and falling interest rates, portfolio yields are likely to fall. A sustained equity market decline (and potentially a drop in bond values) could reduce policyholder surplus
What I Say Now	Reserves: After several consecutive years of reserve releases, insurers might have to begin strengthening again. This will cut into profits and put pressure on for rate hikes
	Investment Results: With declines in stock dividends and persistently low interest rates, portfolio yields are likely to remain weak. Regulators and rating agencies might also require companies to hold more capital for a given portfolio of risks

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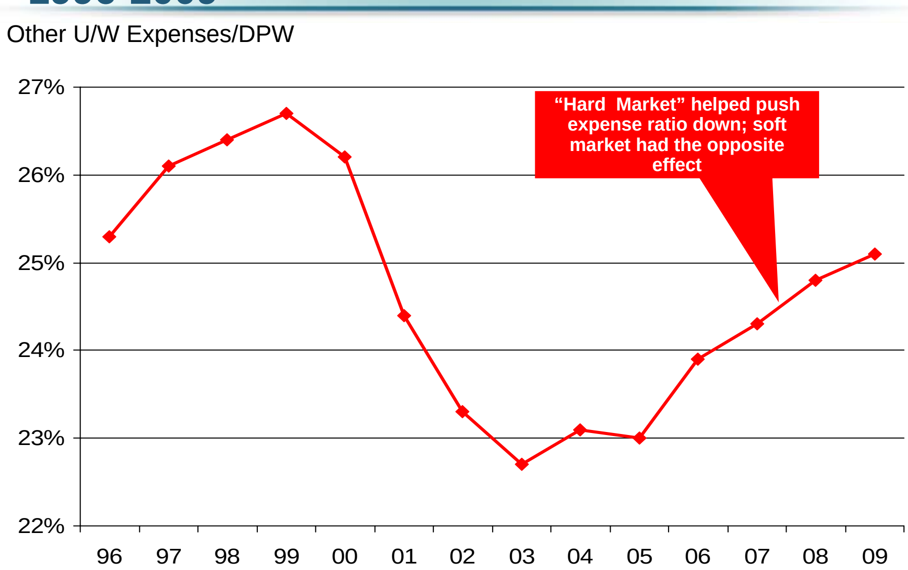
Thank you for your time and your attention!

Employment and Underwriting Expenses

U.S. P/C Industry Expense Ratios, 1996-2009



Sources: SNL Financial; Insurance Information Institute.

U.S. Employment in the Direct P/C Insurance Industry: 1990–2010*

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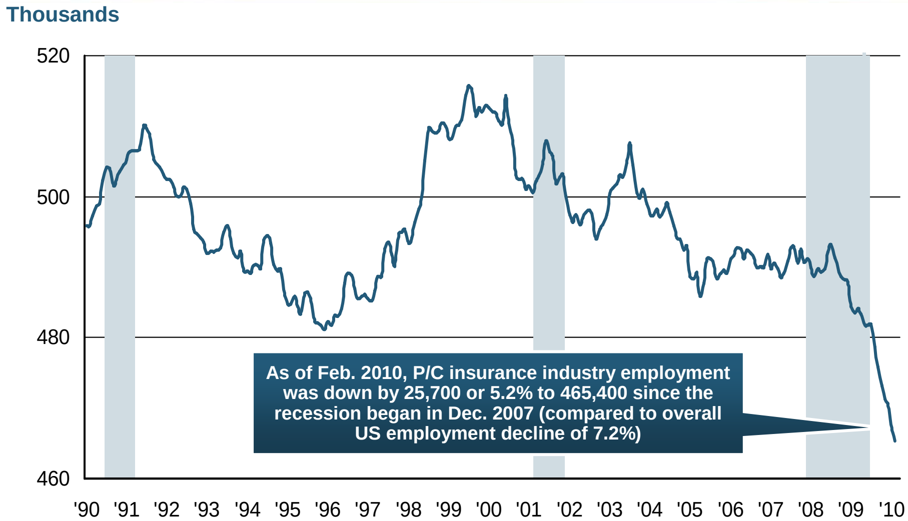

*As of February 2010; Not seasonally adjusted; Does not including agents & brokers

Note: Recessions indicated by gray shaded columns.

Sources: US Bureau of Labor Statistics; National Bureau of Economic Research (recession dates); Insurance Information Institutes.

U.S. Employment* in the Reinsurance Industry: 1990–2010

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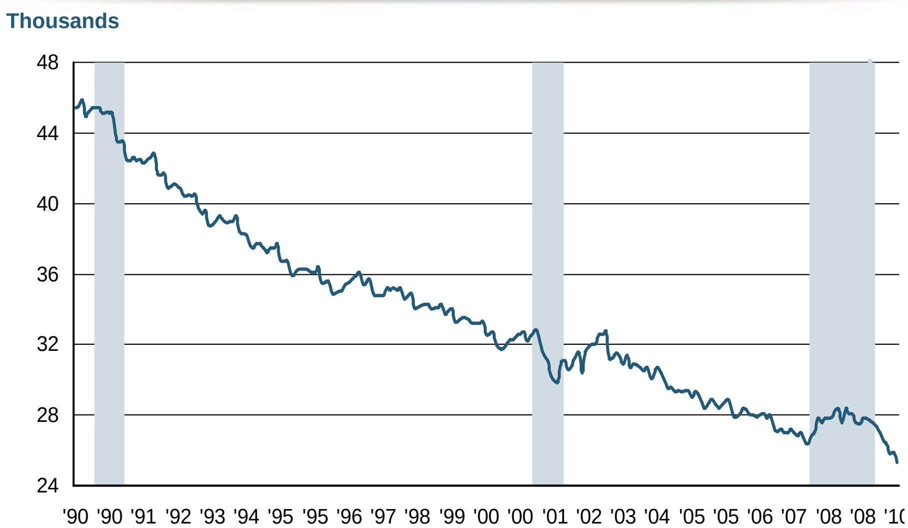
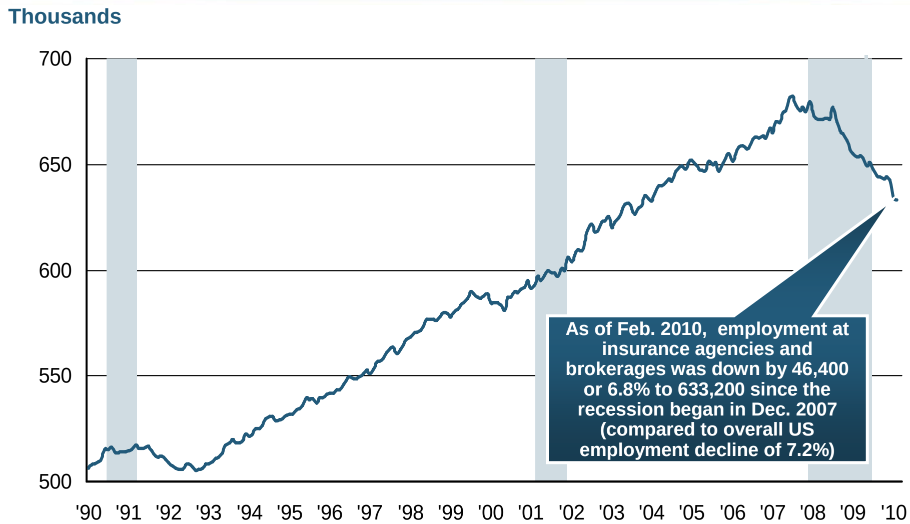


*not seasonally adjusted; not including agents & brokers

Note: Recessions indicated by gray shaded columns.

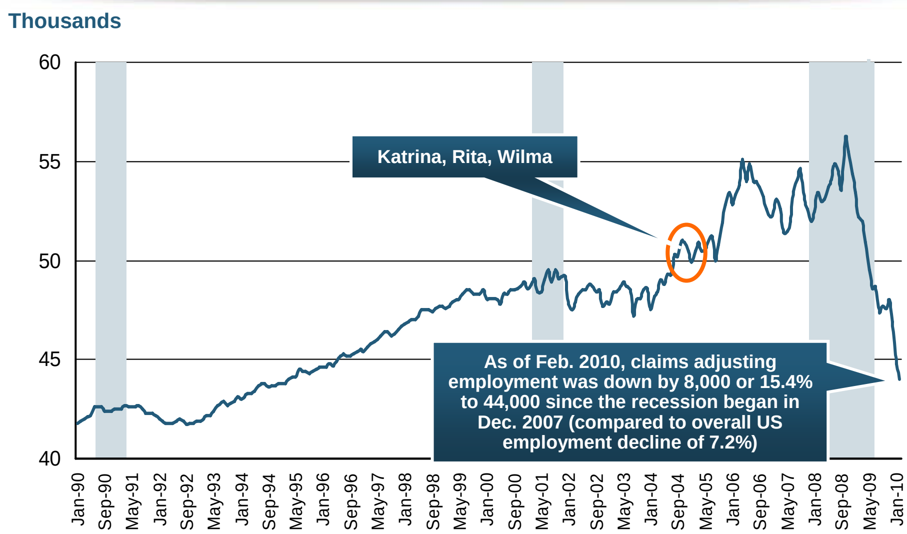
Sources: US Bureau of Labor Statistics; National Bureau of Economic Research

U.S. Employment in Insurance Agencies & Brokerages: 1990–2010*



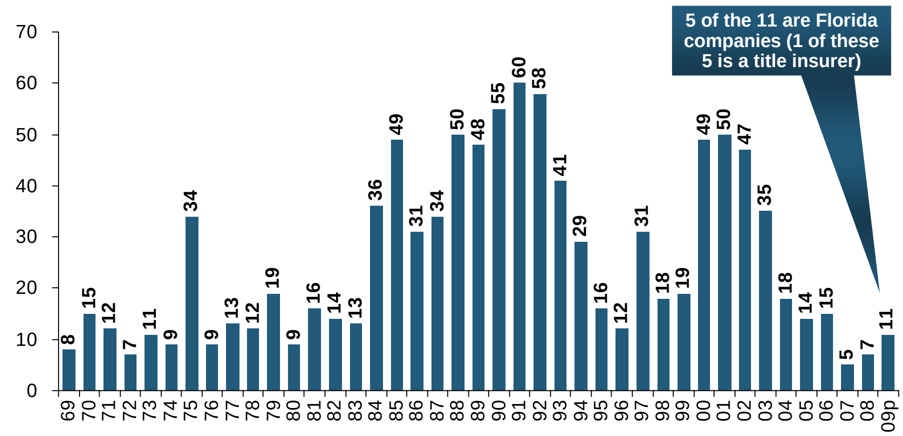
*As of February 2010; Not seasonally adjusted. Includes all types of insurance.
Note: Recessions indicated by gray shaded columns.
Sources: US Bureau of Labor Statistics; National Bureau of Economic Research (recession dates); Insurance Information Institutes.

U.S. Employment in Insurance Claims Adjusting: 1990–2010*



*As of February 2010; Not seasonally adjusted.
Note: Recessions indicated by gray shaded columns.
Sources: US Bureau of Labor Statistics; National Bureau of Economic Research (recession dates); Insurance Information Institutes.

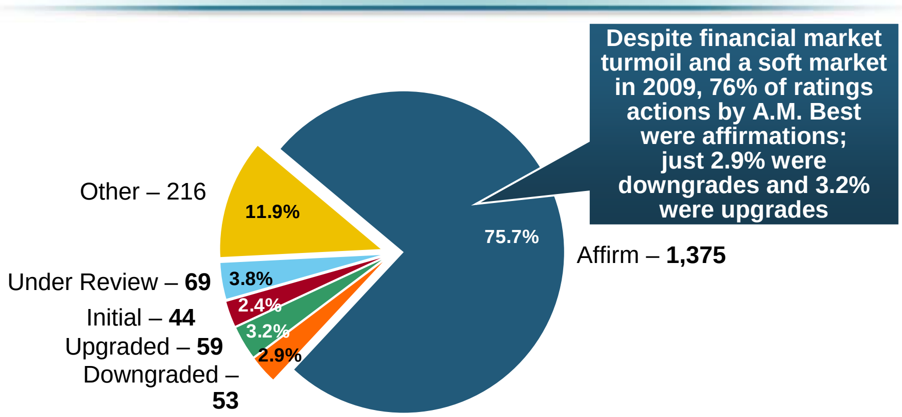
P/C Insurer Impairments, 1969–2009p



The Number of Impairments Varies Significantly Over the P/C Insurance Cycle, With Peaks Occurring Well into Hard Markets

Source: A.M. Best; Insurance Information Institute.

Summary of A.M. Best's P/C Insurer Ratings Actions in 2009



P/C Insurance is by Design a Resilient Business.
The Dual Threat of Financial Disasters and Catastrophic Losses Are Anticipated in the Industry's Risk Management Strategy

Source: A.M. Best.

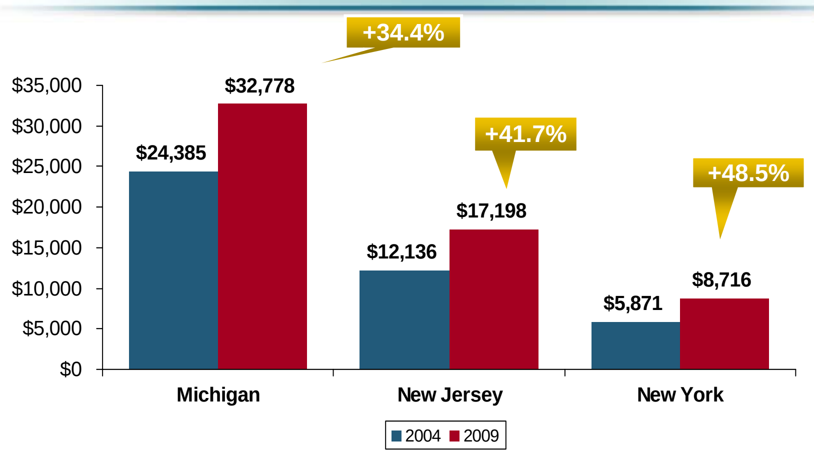
Other Challenges to Profitability

Skyrocketing No-Fault (PIP) Claim Costs

Terrorism

A New Tort Explosion

Increase in No-Fault Claim Severity: 2004 – 2009



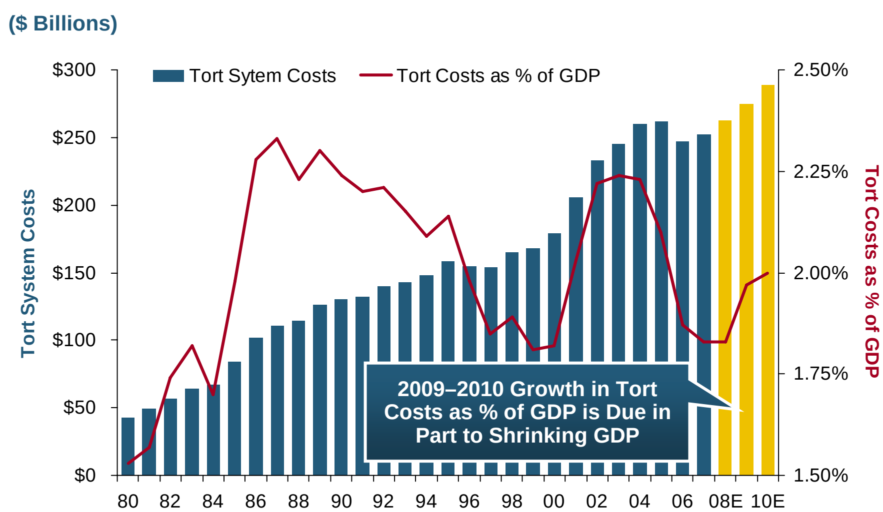
The no-fault systems in MI, NJ, and NY are under stress due to rising fraud and abuse which will ultimately lead to higher premiums for drivers

Sources: Insurance Information Institute research from ISO/PCI *Fast Track* data.

Terrorism: Insurance Concerns Resurface

- Perception is rising that U.S. is vulnerable
  - Thwarted Christmas Day attack by "underwear bomber"
- Foiled NYC Subway Bomber Plot (Zazi case)
- Trials of Guantanamo 9/11 suspects
  - in Manhattan? (Higher Media Attention)
- Government effort to appear more vigilant, prepared
  - Increased anti-terror efforts at airports, including full-body scans
- Rise of groups such as al Qaeda in the Arabian Peninsula

Over the Last Three Decades, Total Tort Costs* as a % of GDP Appear Somewhat Cyclical



* Excludes the tobacco settlement, medical malpractice

Sources: Tillinghast-Towers Perrin, *2008 Update on US Tort Cost Trends*, Appendix 1A; I.I.I. calculations/estimates for 2009 and 2010