Incorporating the New Domestic Political Paradigm into Financial Research

Insurance Focus

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Presentation Outline

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- **Financial Services Reform: Provisions Affecting Insurers**
- **Critical Distinctions Between Banks and Insurers**
- **Financial Strength/Solvency Performance Trends**
  - Impairment analysis
- **Financial Performance Under Crisis Conditions**
- **Public Opinion, Crisis and Perceptions of the Insurance Industry**
- **Insurance Industry Financial Strength During the Crisis**
  - Distinctions between insurers and banks
- **Financial Services Reform Legislation**
  - **Dodd-Frank & Insurance**
  - **Solvency II in the EU**
- **Q&A**

The New Domestic Political Paradigm: Insurance Industry Research

- Education: Getting Public Policy Makers to Understand that Insurance is Not Like Banking
- Fundamentally Different Approaches to Risk Management Between Banks and Insurers
- Moral Hazard is Well Understood and Avoided
- Insurance & Systemic Risk: Unlikely
- Regulatory Arbitrage
  - State/Federal
- Solvency Regulation in Europe
  - Solvency II
- AIG: Non-Insurance Operations
  - Risk management of large, complex organizations

Financial Services Reform

Insurers Are Impacted, But Not Significantly

Financial Services Reform:
What does it mean for insurers?

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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 with a heavy emphasis on consumer protection issues***
- **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

Systemic Risk: Oversight & Resolution Authority

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Issues Related to Systemic Risk & Resolution Authority

- **Financial Stability Oversight Council created to oversee systemic risk of large financial holding companies) [a.k.a. TOO BIG TOO FAIL]**
  - P/C insurers potentially could be determined to present systemic risk to the financial system and thus be supervised by the Federal Reserve.
  - Such supervision would subject such insurers to prudential standards, if the Council determines that financial distress at the company would pose a threat to the U.S. financial system.
- **Orderly Liquidation**
  - The legislation provides an “Orderly Liquidation Authority” mechanism whereby the FDIC would have enhance powers to resolve distress at financial institutions.
  - Insurance holding companies and any non-insurance subsidiaries of insurers may be subject to this authority.

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

Systemic Risk: Oversight & Resolution Authority

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Issues Related to Systemic Risk & Resolution Authority

- **Orderly Liquidation (cont.)**
  - Insurers are generally exempt from the liquidation authority, but the FDIC would have “backup authority” to place an insurer into orderly liquidation under state law if the state regulator has not done so within 60 days of a systemic risk determination.
- **Liquidation Fund Assessments**
  - The liquidation fund would be funded by assessments on large financial companies, potentially including insurers.
  - But the insurance industry already has a funding system (state guaranty funds) to pay for the unwinding of failed companies. Therefore, contributions to these state guaranty funds must be considered.

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

Federal Insurance Office (FIO):
What Would it Do?

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Duties of the Federal Insurance Office

- **Establishes office within US Treasury headed by a Director appointed by Treasury Secretary, and charged with:**
  - Monitor the insurance industry to gain expertise (oversight extends to all lines of insurance except health insurance, long-term care insurance and federal crop insurance).
  - Identify regulatory gaps that could contribute to a systemic crisis in the insurance industry or the U.S. financial system.
  - Gather information from the insurance industry in order to analyze such data and issue reports. May require insurers, with exception of small insurers which are exempt, to submit data and FIO director can issue subpoenas to gain such info.
  - Deal with international insurance matters.
  - Monitor the extent to which underserved communities have access to affordable insurance products.

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

Federal Insurance Office (FIO): *What Would It Do? (Cont.)*

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Duties of the Federal Insurance Office

- **Establishes office within US Treasury headed by a Director appointed by Treasury Secretary, and charged with:**
  - Make recommendations to the FSOC on whether an insurer (incl. reinsurers) poses a systemic risk and should be placed under supervision of the Federal Reserve.
  - Annual reports to Congress and the President on the insurance industry are required.
  - A study on the modernization of insurance regulation in the U.S. is required within 18 months, as is a report on the U.S. and global reinsurance market
  - Oversee the federal Terrorism Risk Insurance Program.
  - Insurance will continue to be regulated by the states, but the FIO has limited preemption authority over state law in cases where it determines that state law is inconsistent with a negotiated international agreement and treats a non-U.S. insurer less favorably than a U.S. insurer.

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

Other Matters Impacting Insurance

Derivatives and Bureau of Consumer Financial Protection

- **Derivatives:**
  - The bill would require most standardized derivatives to be routed through clearinghouses and traded on exchanges.
  - Two new classes of regulated entities would be created: swap dealers and major swap participants.
  - Both would be required to register with the SEC and/or the CFTC and would be subject to margin, capital, record-keeping and business conduct requirements.
- **Bureau of Consumer Financial Protection:**
  - The Bill creates a new federal level entity within the Federal Reserve with the authority to regulate financial products offered to consumers.
  - Insurance products are specifically exempted from this bureau's authority.

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

New Rulemakings Under The Dodd Frank Wall Street Reform and Consumer Protection Act

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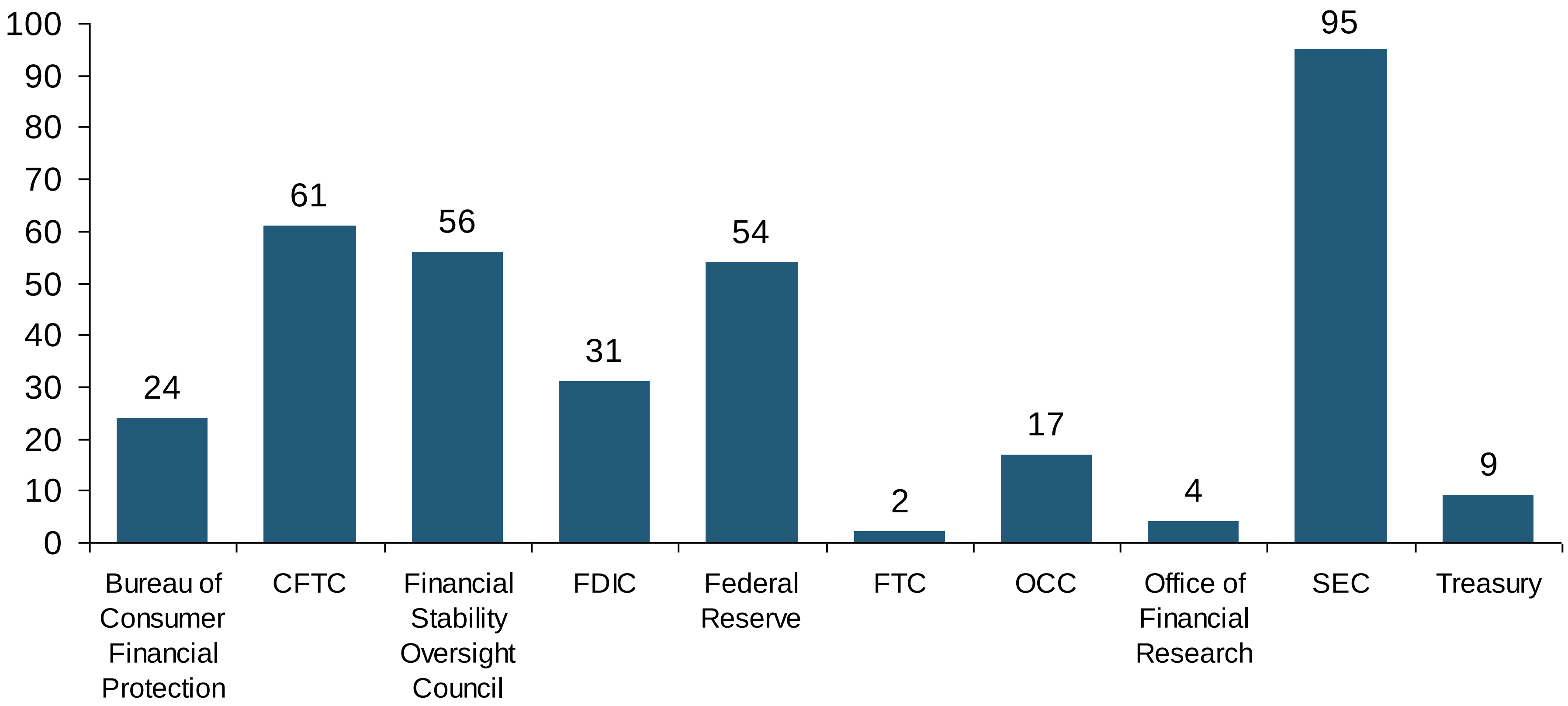
A total of at least 243 new rulemakings are expected under the Dodd-Frank financial reform by Federal Agency*



* Total eliminates double counting for joint rule-makings and this estimate only includes explicit rule-makings in the bill, and thus likely represents a significant underestimate.
Source: Wall Street Journal, July 14, 2010; Davis Polk & Wardwell.

2010 Property and Casualty Insurance State Regulatory Report Card

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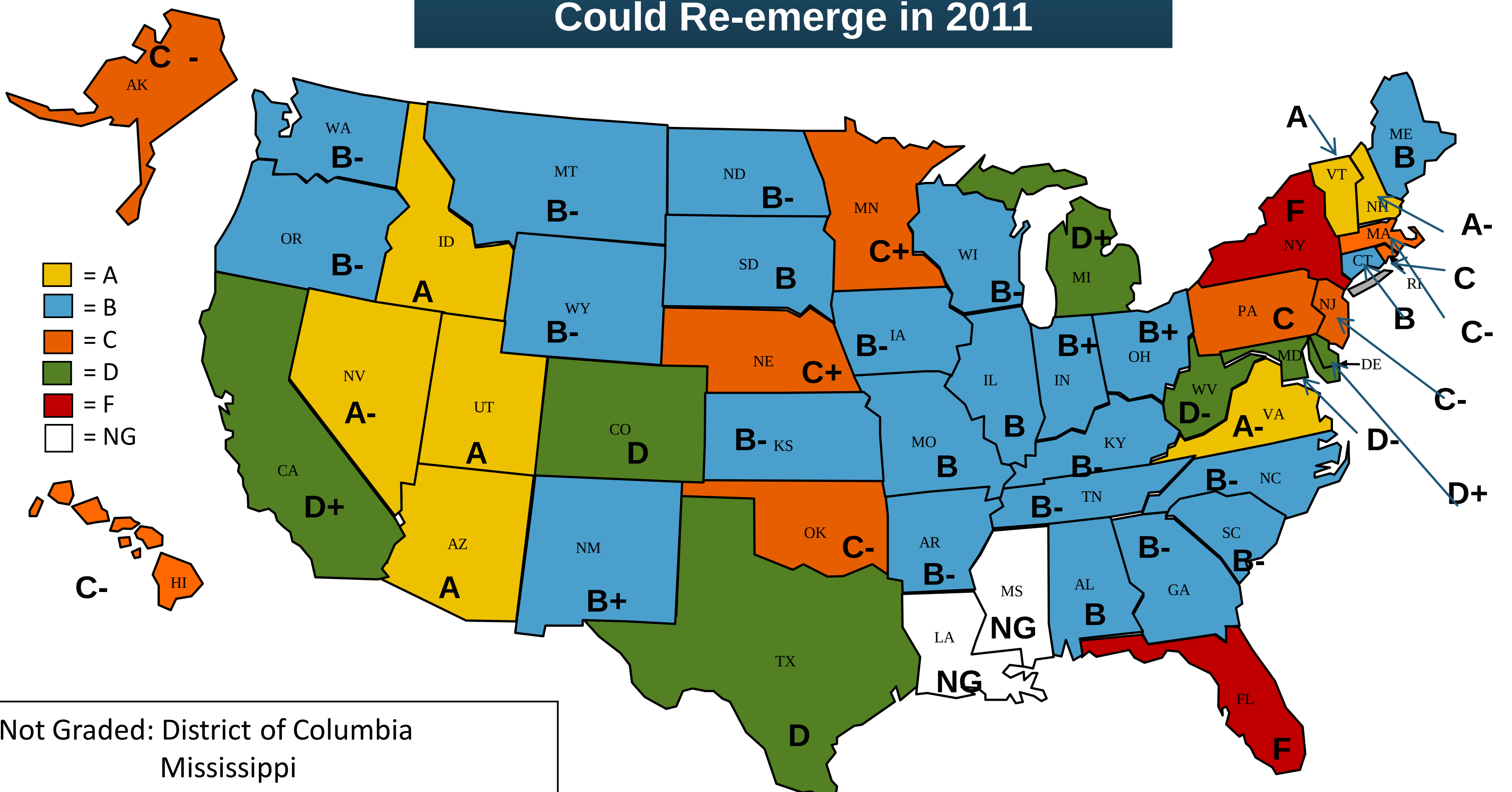
The Longstanding, Raging Debate Over Federal vs. State Regulation Could Re-emerge in 2011



Not Graded: District of Columbia
Mississippi
Louisiana

Source: Heartland Institute, May 2010

Consumer Poll: I.I.I. *Pulse* Survey

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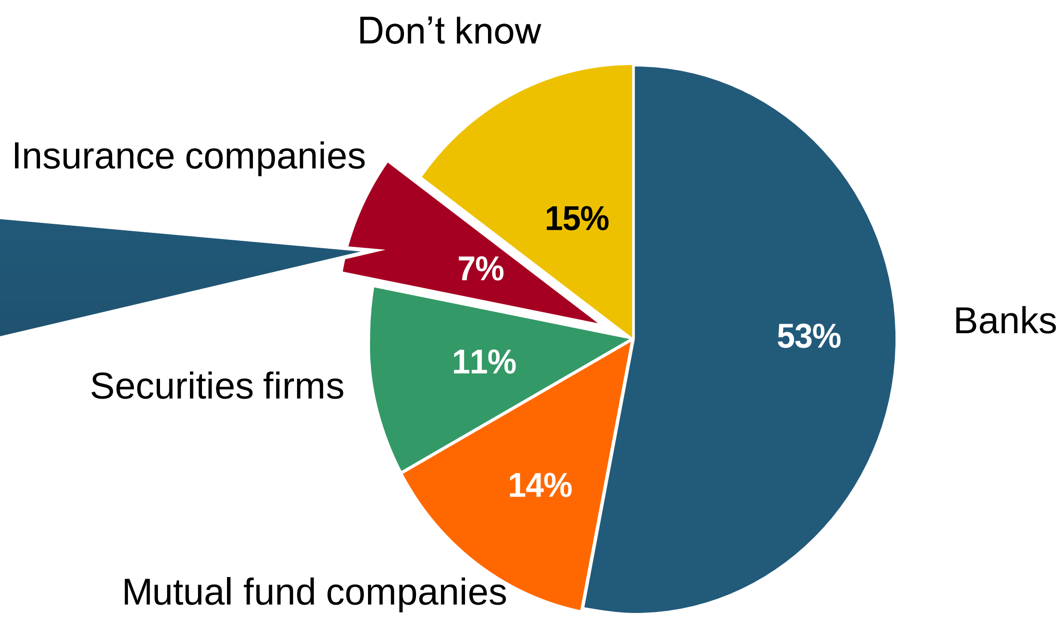
Q. Of The Following Industries, Which Do You Think Has Been Hurt Most By The Financial Crisis?

The concern people express over their insurers remains small compared to concern over banks, mutual funds and securities firms



More than Half of Americans Think that Banks Are the Industry that Has Been the Most Affected by the Financial Crisis

Source: Insurance Information Institute Annual *Pulse* Survey.

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Critical Differences Between P/C Insurers and Banks

Superior Risk Management Model and Low Leverage Make a Big Difference

How P/C Insurance Industry Stability Has Benefitted Consumers

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Bottom Line:

- Insurance markets – unlike banking – operated ***normally*** throughout the entirety of the crisis and continue to do so today
- The basic function of insurance – the orderly transfer of risk from client to insurer – ***continues uninterrupted***
- This means that insurers continue to:
  - Pay claims (whereas 300 banks have gone under as of 10/15/10)
    - ***The promise is being fulfilled***
  - Renew existing policies *(banks are reducing and eliminating lines of credit)*
  - Write new policies *(banks are turning away people and businesses who want or need to borrow)*
  - Develop new products *(banks are scaling back the products they offer)*
  - Compete intensively *(banks are consolidating, reducing consumer choice)*

Source: Insurance Information Institute

Reasons Why P/C Insurers Have Fewer Problems Than Banks

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A Superior Risk Management Model

- **Emphasis on Underwriting**
  - Matching of risk to price (via experience and modeling)
  - Limiting of potential loss exposure
  - ***Some banks sought to maximize volume and fees and disregarded risk***
- **Strong Relationship Between Underwriting and Risk Bearing**
  - **Insurers always maintain a stake in the business they underwrite, keeping "skin in the game" at all times**
  - ***Banks and investment banks package up and securitize, severing the link between risk underwriting and risk bearing, with (predictably) disastrous consequences – straightforward moral hazard problem from Econ 101***
- **Low Leverage**
  - Insurers do not rely on borrowed money to underwrite insurance or pay claims → ***There is no credit or liquidity crisis in the insurance industry***
- **Conservative Investment Philosophy**
  - High quality portfolio that is relatively less volatile and more liquid
- **Comprehensive Regulation of Insurance Operations**
  - The business of insurance remained comprehensively regulated whereas a separate banking system had evolved largely outside the auspices and understanding of regulators (e.g., hedge funds, private equity, complex securitized instruments, credit derivatives – CDS's)
- **Greater Transparency**
  - Insurance companies are an open book to regulators and the public

Source: Insurance Information Institute

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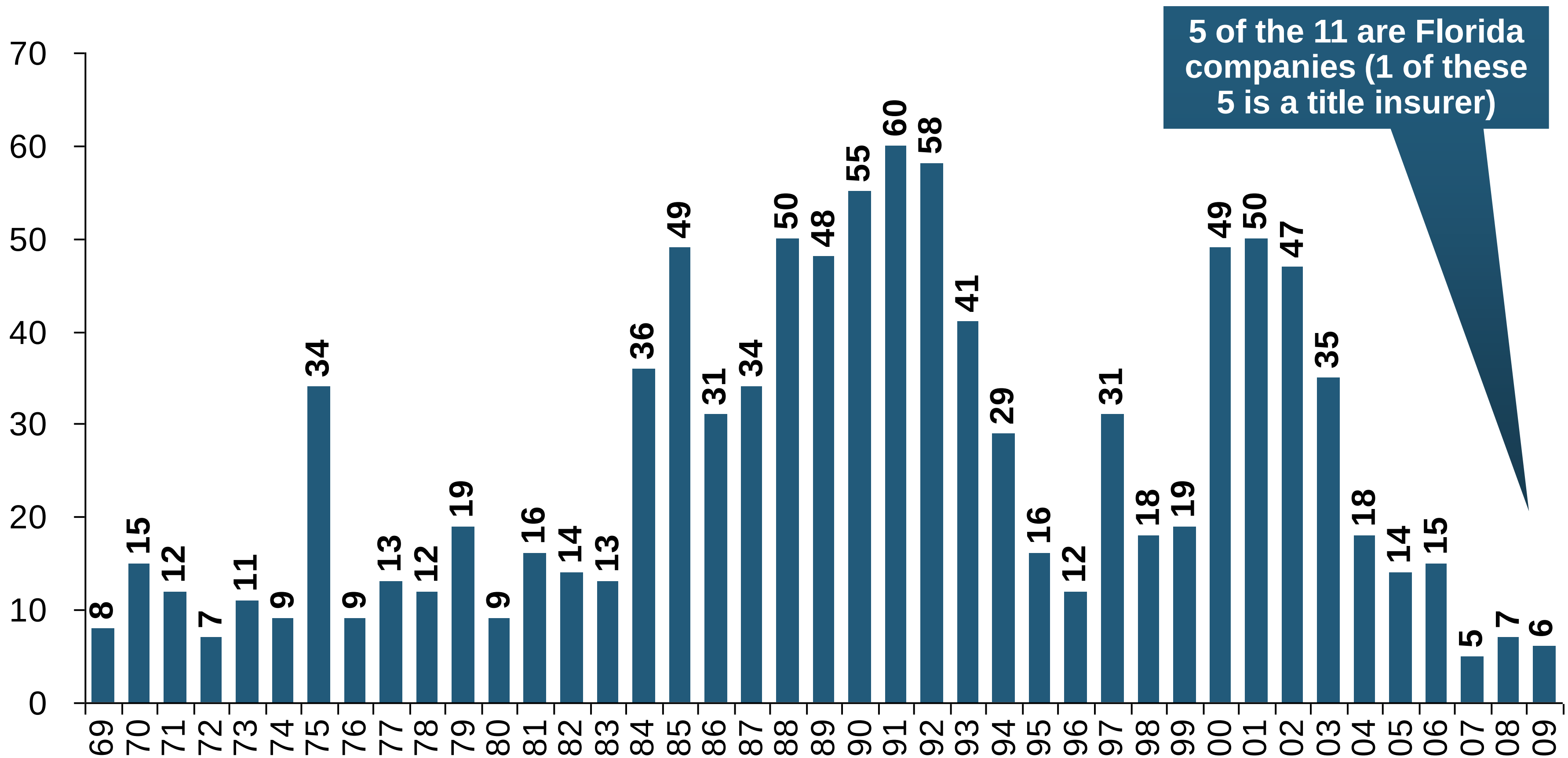
Financial Strength & Ratings

Industry Has Weathered the Storms Well

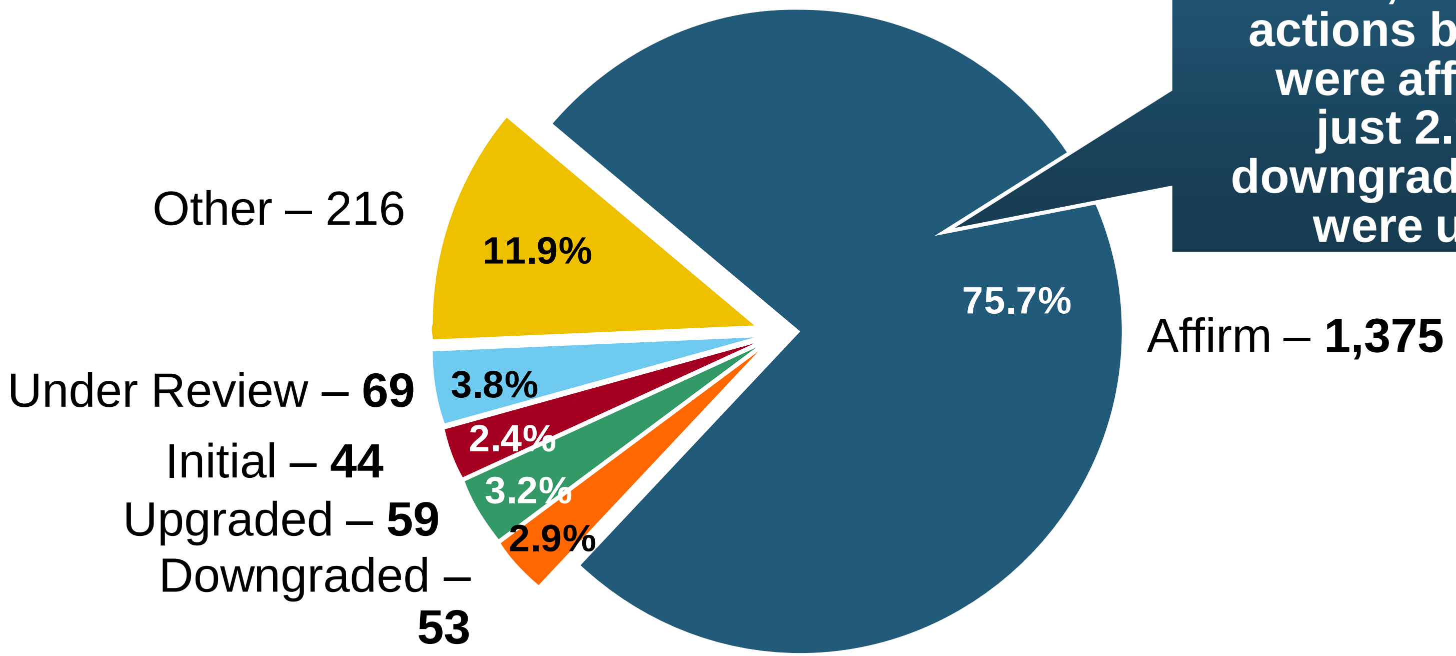
P/C Insurer Impairments, 1969–2009



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



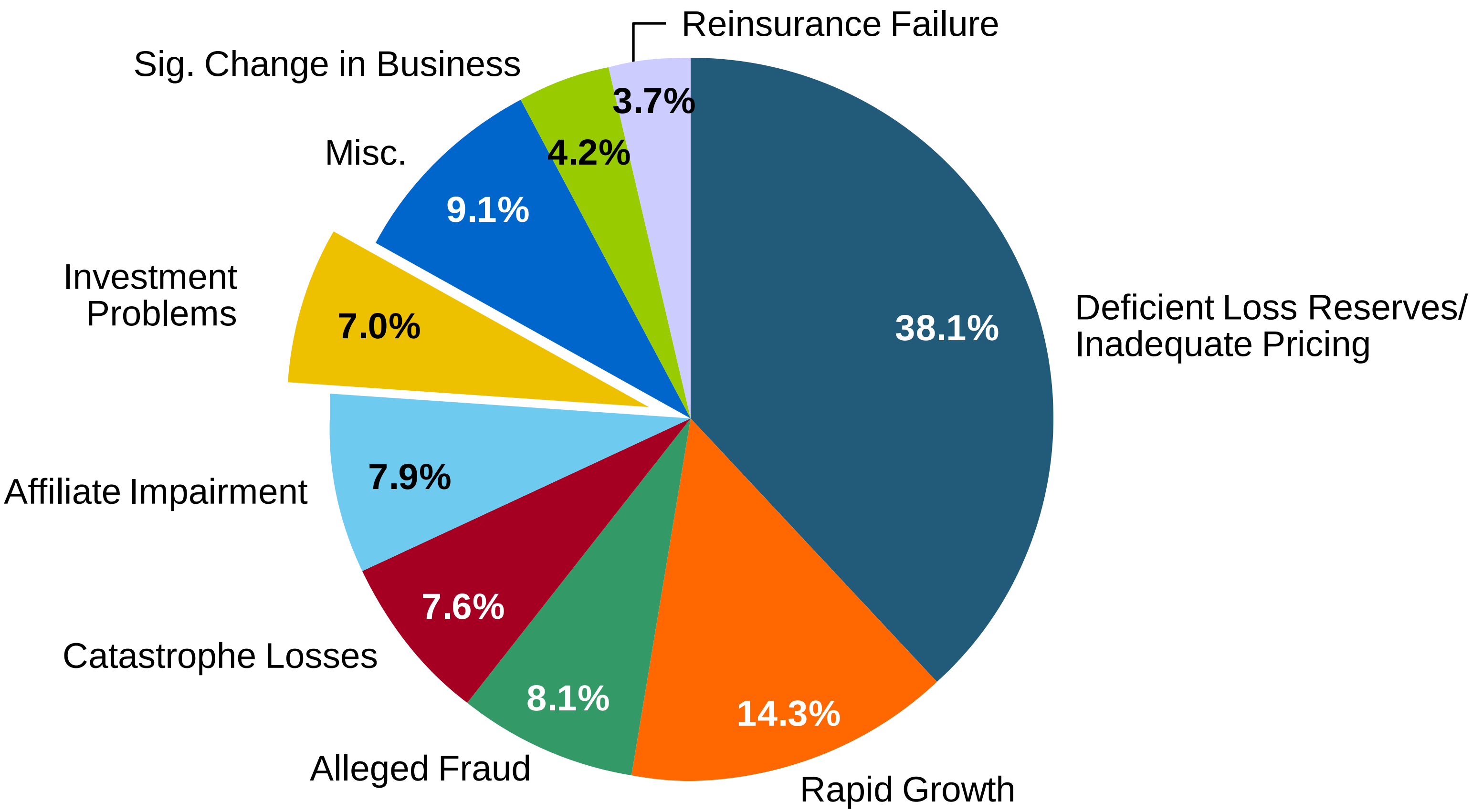
Despite financial market turmoil and a soft market in 2009, 76% of ratings actions by A.M. Best were affirmations; just 2.9% were downgrades and 3.2% were upgrades

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.

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

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, 2009

Solvency II

Move Toward More Stringent Regulatory Requirements for Insurers Originating in Europe

Solvency II: The EU's Effort to Modernize Insurance Solvency Regulation

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- Solvency II: Provides a Comprehensive Framework for Risk Management for Defining Capital Levels and to Implement Procedures to Identify, Measure and Manage Risk Levels
  - Solvency I was primarily a Directive aimed at revising and updating existing EU solvency regimes, which had been in existence since the 1970s. The emphasis was on solvency margins.
  - Since deficiencies had been identified over the years, individual EU members adopted various fixes resulting in a patchwork of regulatory requirements inconsistent with the goal of harmonized insurance regulation across the EU. Solvency II addresses this goal of harmonization.
- Scheduled to Come into Effect in the EU on Dec. 31, 2012
- Consists of 3 Main "Pillars"
- Pillar 1: Consists of Quantitative Requirements (e.g., amount of required capital)
  - Establishes qualitative and quantitative requirements for calculation of technical provisions and Solvency Requirement Ratio (SCR) using either a standard regulator-provided formula or an internal model developed by the (re)insurer itself
- Pillar 2: Establishes Requirements for Governance
- Pillar 3: Focuses on Disclosure and Transparency Requirements

Source: European Commission; Wikipedia: http:en.wikipedia.org/wiki/Solvency_II; Insurance Information Institute

US Non-Life Insurance Industry Performance

Insurer Resilience

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

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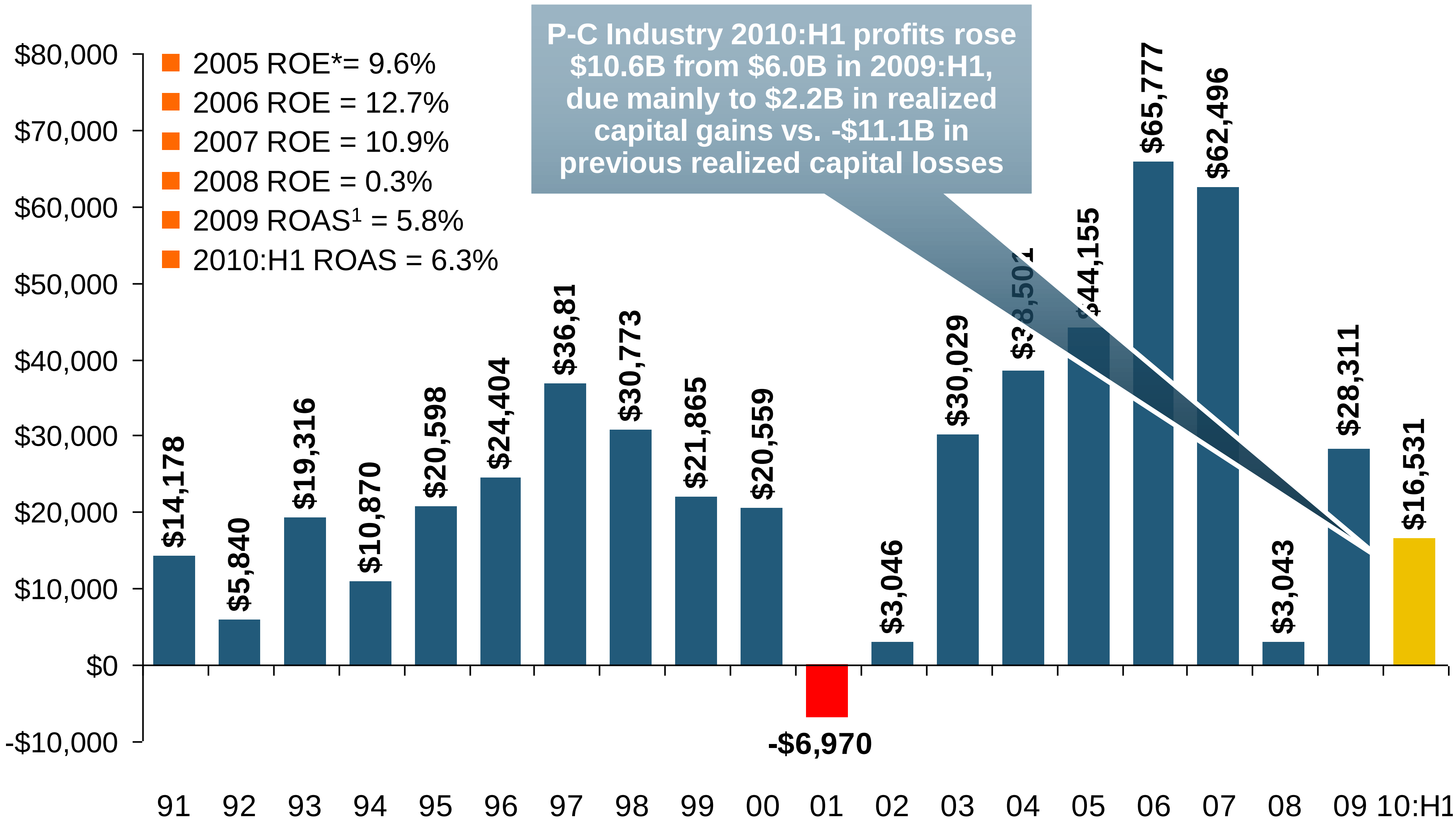
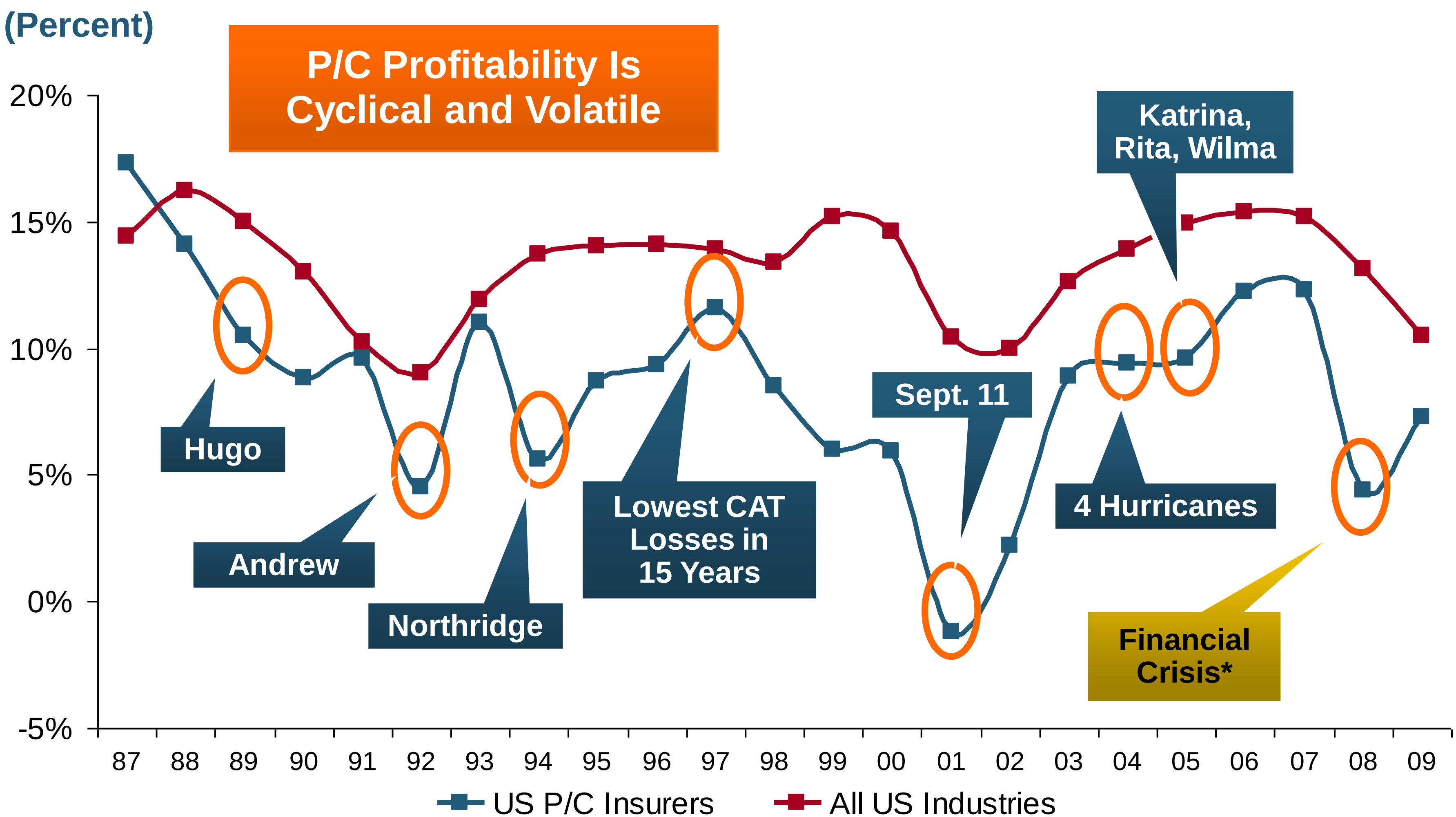


* ROE figures are GAAP; [1]Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields a 7.5% ROAS for 2010:H1 and 4.6% for 2009. 2009:H1 net income was $19.2 billion and $10.2 billion in 2008:H1 excluding M&FG.

Sources: A.M. Best, ISO, Insurance Information Institute

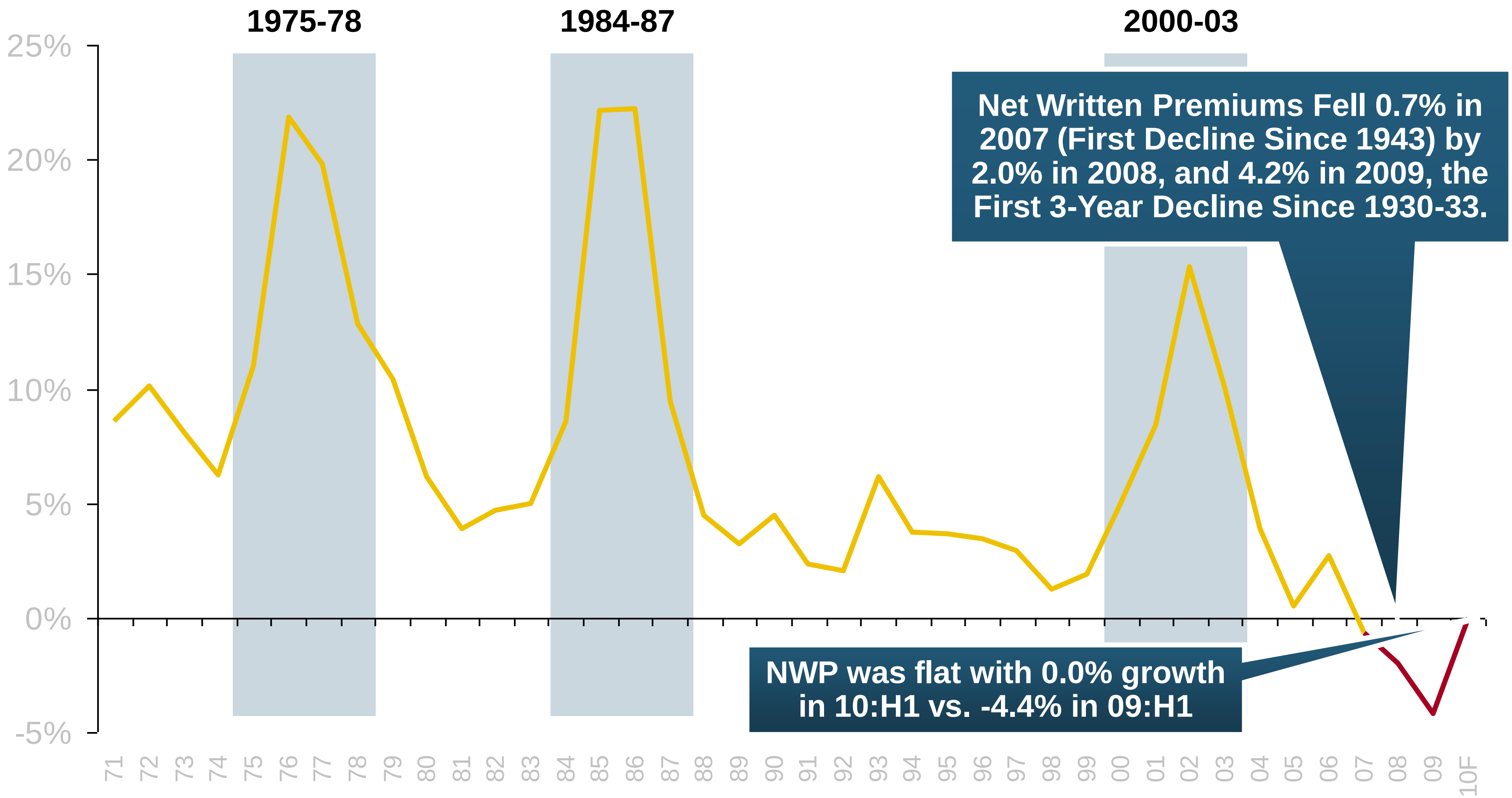
ROE: P/C vs. All Industries 1987–2009*



* Excludes Mortgage & Financial Guarantee in 2008 and 2009.
Sources: ISO, *Fortune*; Insurance Information Institute.

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

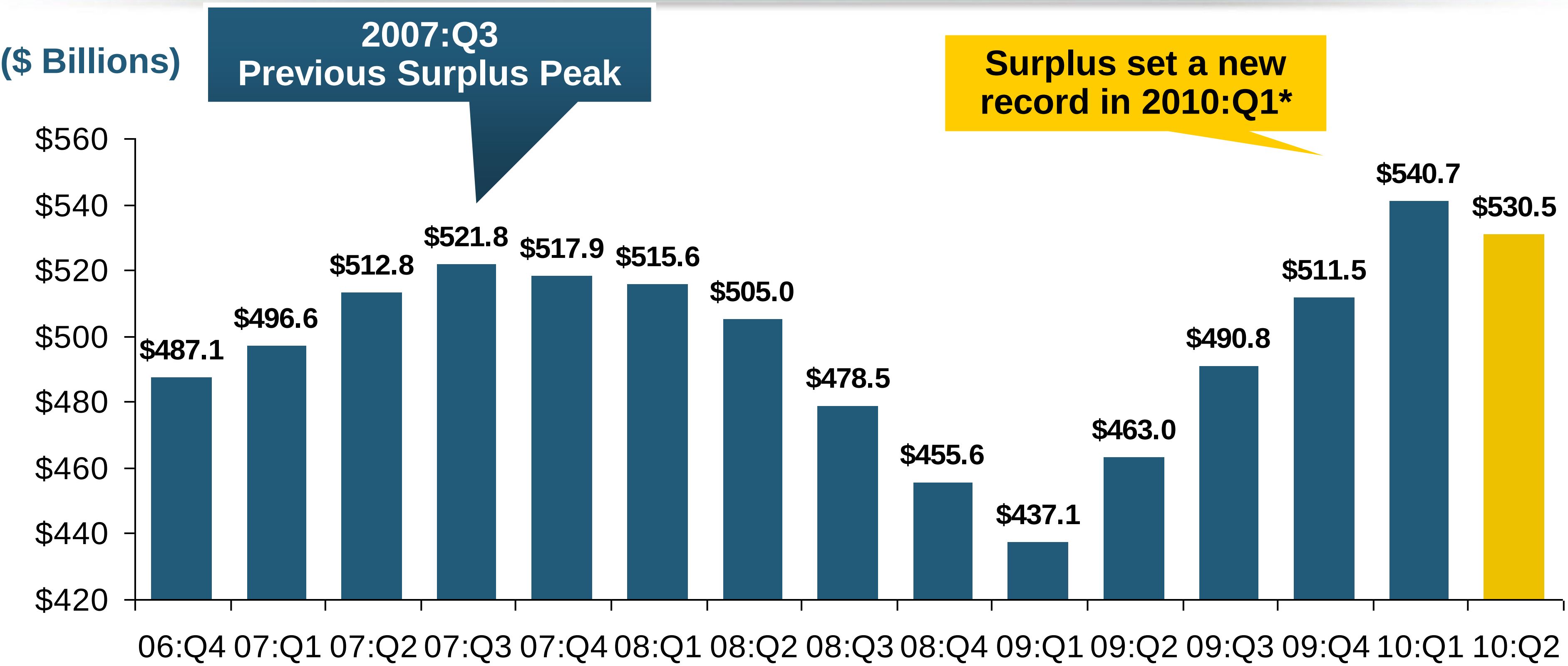
(Percent)



Shaded areas denote “hard market” periods

Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute.

Policyholder Surplus, 2006:Q4–2010:Q2



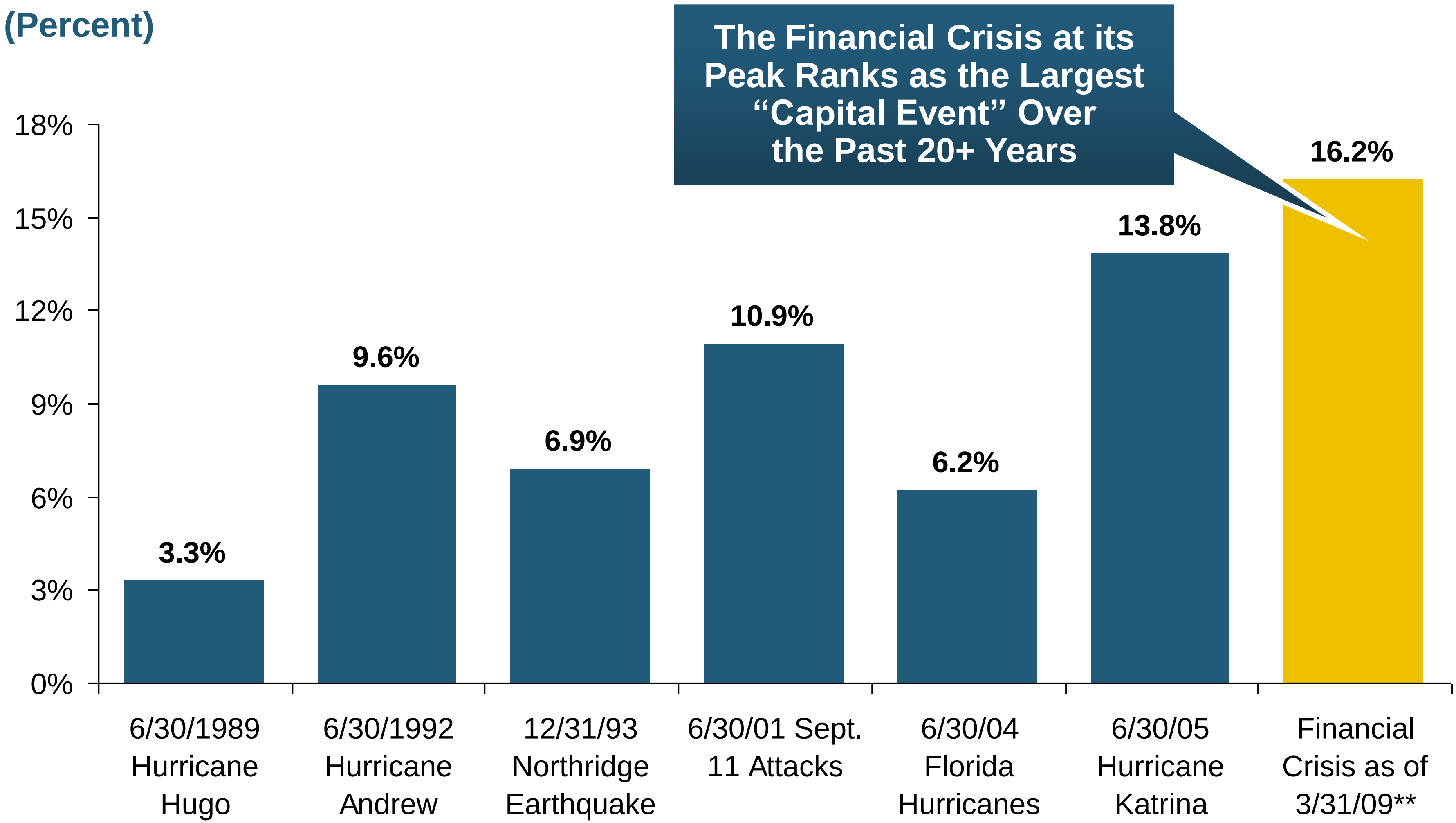
*Includes $22.5B of paid-in capital from a holding company parent for one insurer's investment in a non-insurance business

Quarterly Surplus Changes Since 2009:Q1 Trough

09:Q1: -$84.7B (-16.2%)	*10:Q1: +$18.9B (+3.6%)*
09:Q2: -$58.8B (-11.2%)	10:Q2: -$10.2B (-1.9%)
09:Q3: -$31.8B (-5.9%)	
09:Q4: -$10.3B (-2.0%)	

Sources: ISO, A.M .Best.

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

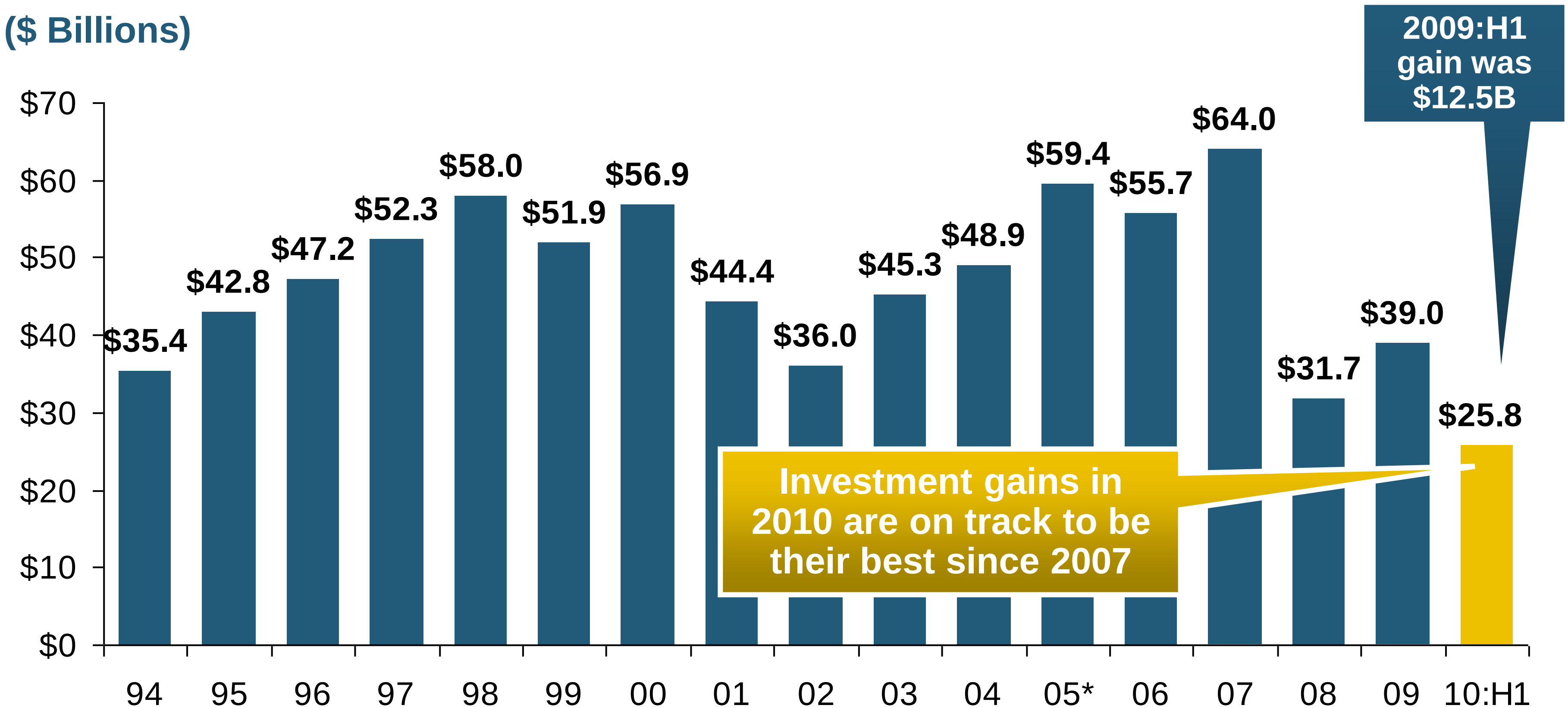


* Ratio is for end-of-quarter surplus immediately prior to event. Date shown is end of quarter prior to event

** Date of maximum capital erosion; As of 9/30/09 (latest available) ratio = 5.9%

Source: PCS; Insurance Information Institute

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



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
Investment Gains Are Recovering So Far in 2010

[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.

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