

# The Insurance Cycle, Financial Crisis & Catastrophes

*Impacts and Implications for the  
Texas P/C Insurance Markets*

**Insurance Council of Texas Annual Symposium**

**Austin, TX**

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Download at [www.iii.org/presentations/ICT-TX072309/](http://www.iii.org/presentations/ICT-TX072309/)

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# *Presentation Outline*

- **The Economic Storm: Financial Crisis & Recession: US**
- **Texas: Somewhat Less of an Economic Mess**
- **Economic Trends: Personal, Commercial Exposure Implications**
- **Key Threats and Issues Facing P/C Insurers Through 2015**
- **Regulatory Reform**
- **Financial Strength & Ratings**
  - **Key Differences Between Insurer and Bank Performance During Crisis**
- **P/C Insurance Industry Overview & Outlook: US & Texas**
  - **Profitability**
  - **Premium Growth**
  - **Underwriting Performance**
  - **Financial Market Impacts**
  - **Merger & Acquisition Activity**
- **Capital & Capacity**
- **Catastrophe Loss Trends: US & Texas**

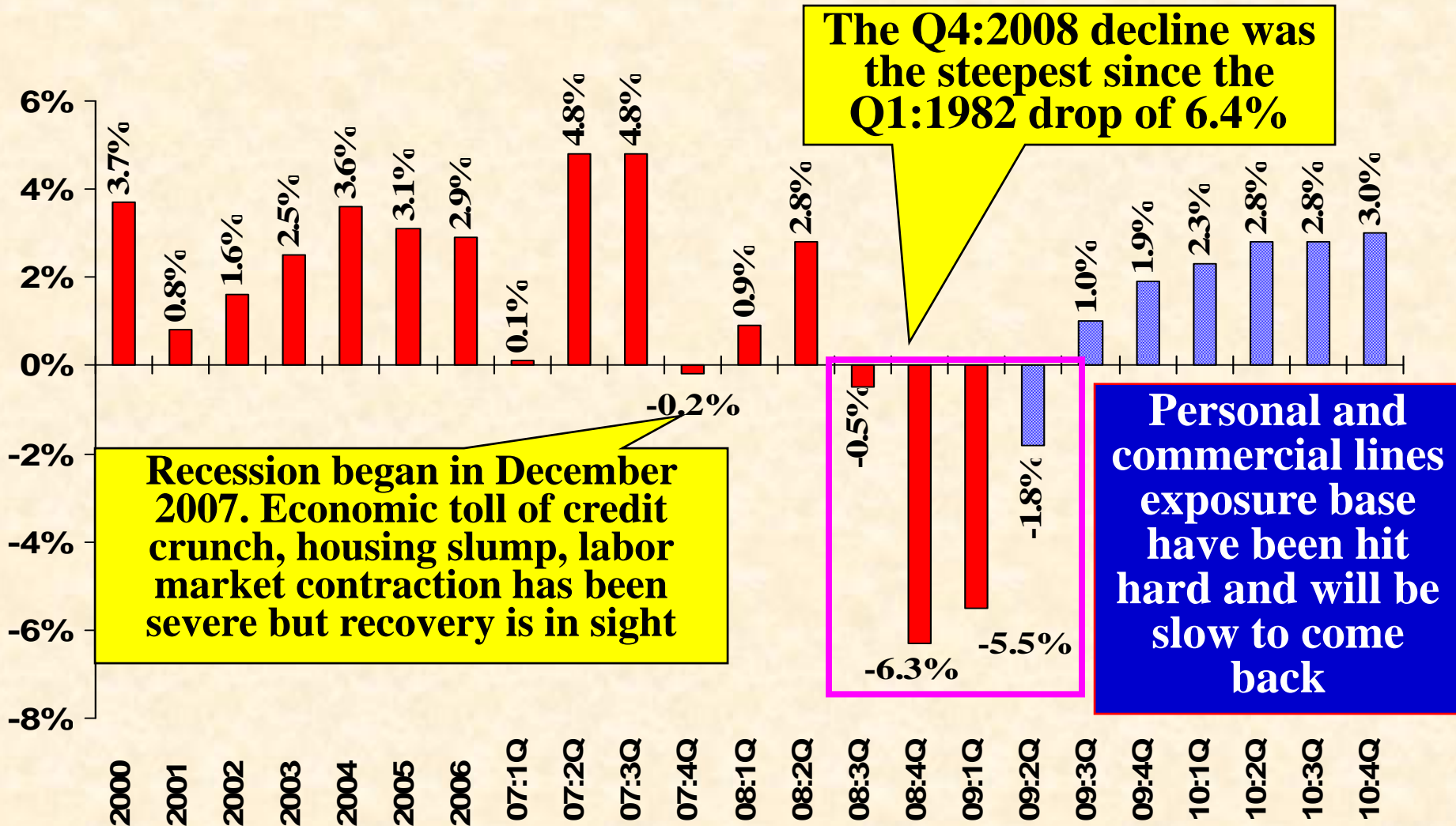
# THE ECONOMIC STORM

*What the Financial Crisis and  
Recession Mean for the  
Industry's **Exposure Base**  
and **Growth***





# Real GDP Growth\*



\*Blue bars are Estimates/Forecasts from Blue Chip Economic Indicators.

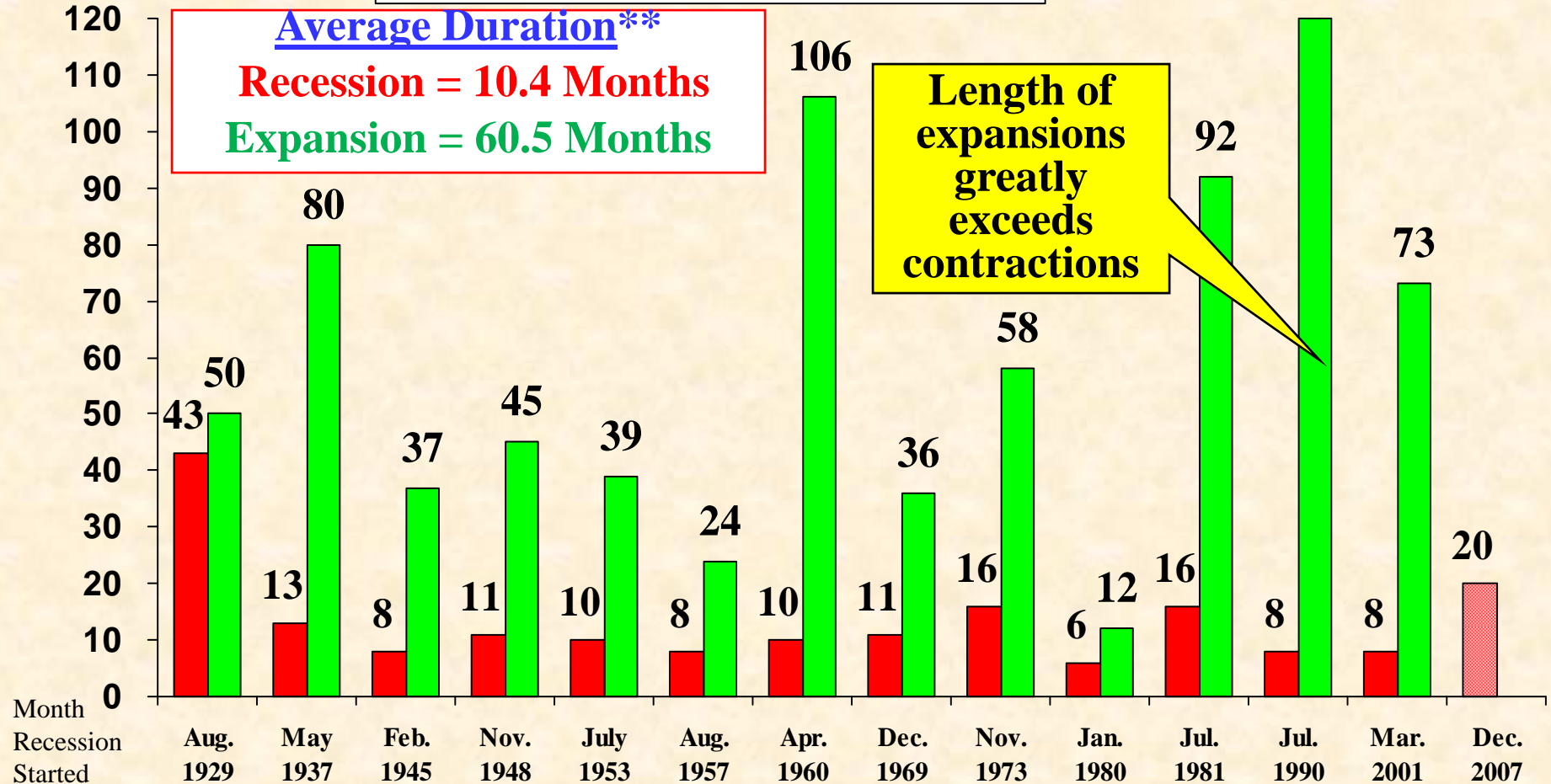
Source: US Department of Commerce, Blue Economic Indicators 7/09; Insurance Information Institute.



# Length of U.S. Business Cycles, 1929-Present\*

Duration (Months)

■ Contraction ■ Expansion Following



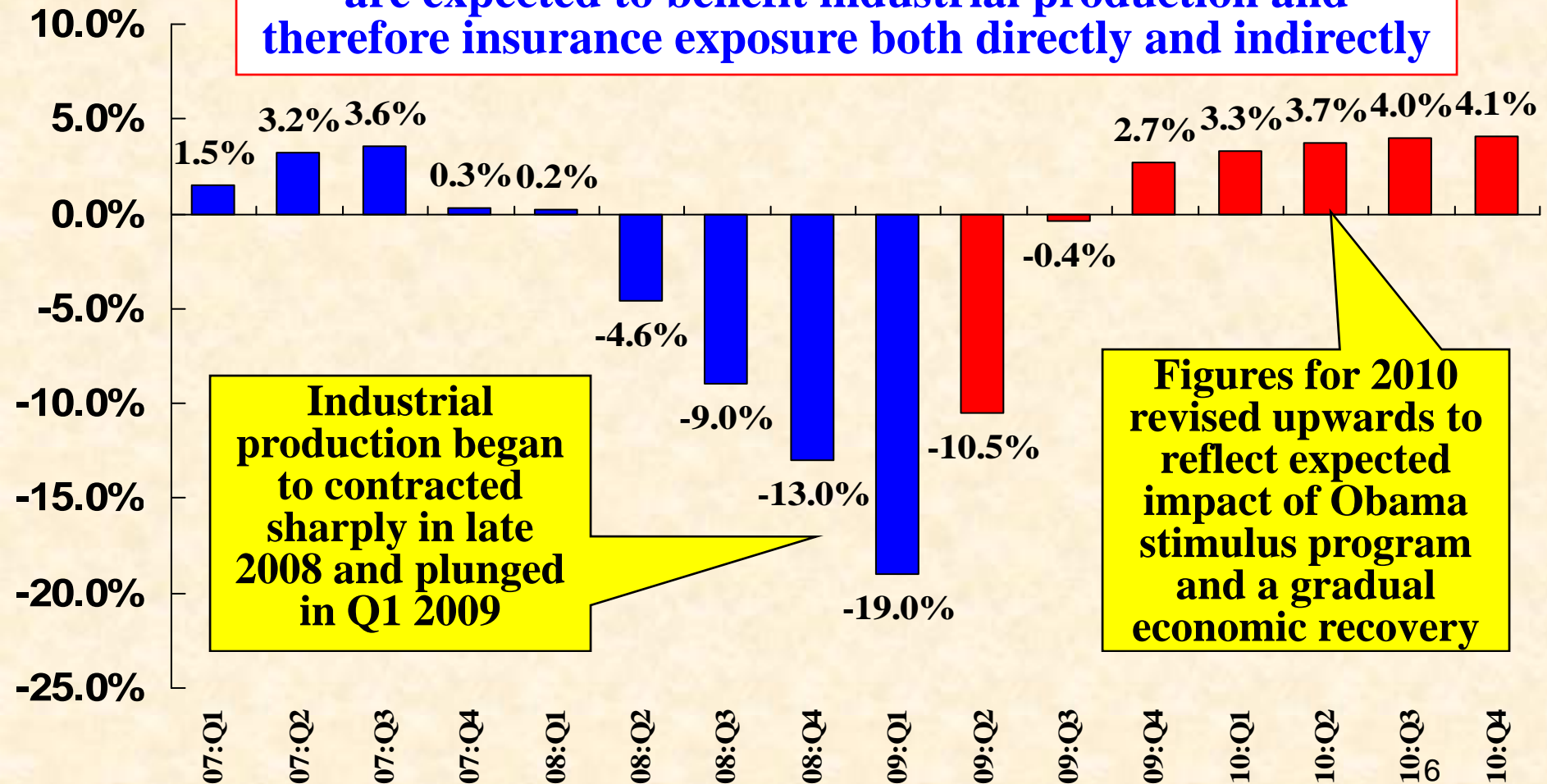
\* As of July 2009, inclusive; \*\*Post-WW II period through end of most recent expansion.

Sources: National Bureau of Economic Research; Insurance Information Institute.



# Total Industrial Production, (2007:Q1 to 2010:Q4F)

**End of recession in late 2009, Obama stimulus program are expected to benefit industrial production and therefore insurance exposure both directly and indirectly**



**Industrial production began to contract sharply in late 2008 and plunged in Q1 2009**

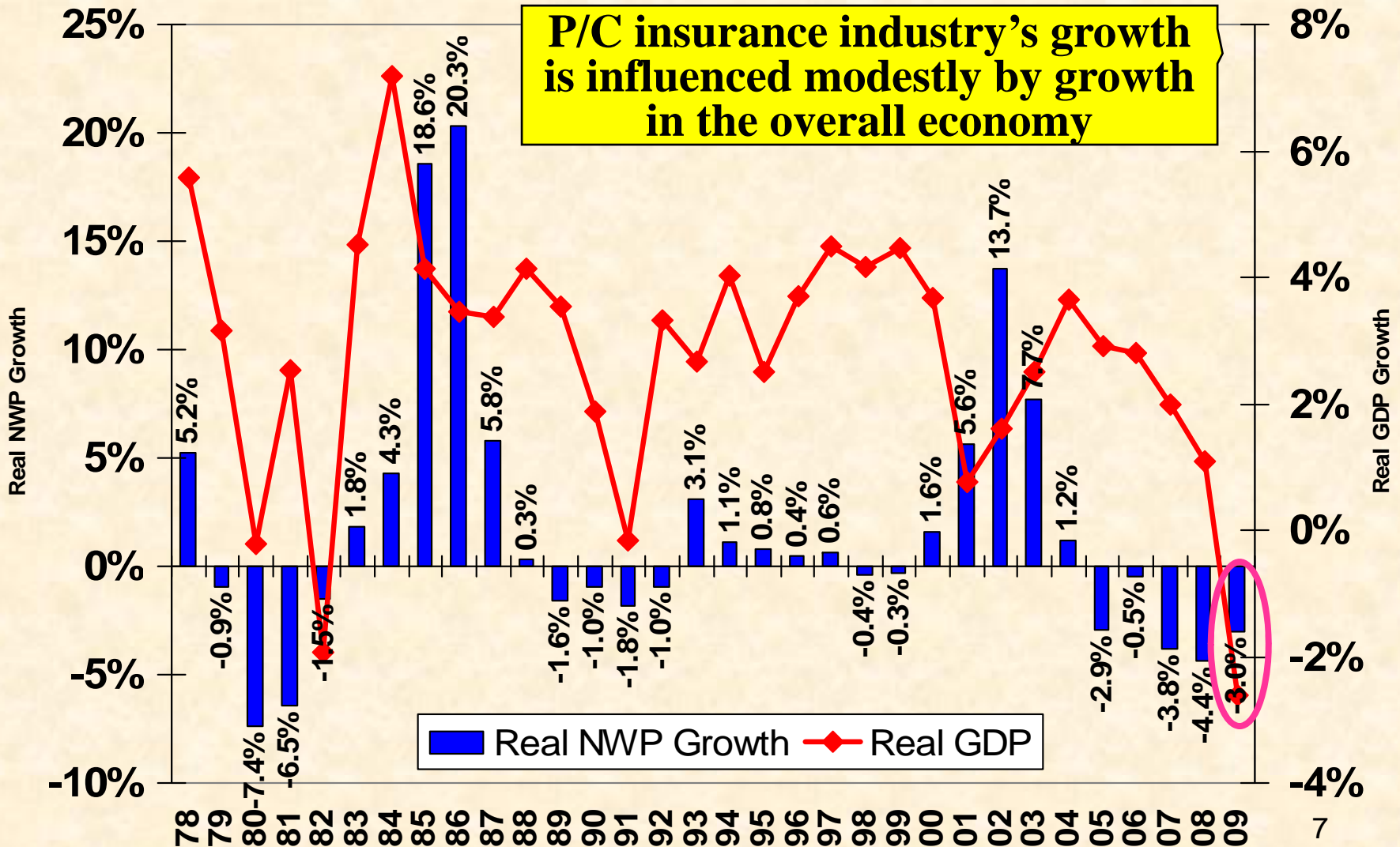
**Figures for 2010 revised upwards to reflect expected impact of Obama stimulus program and a gradual economic recovery**

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (7/09); Insurance Info. Inst.



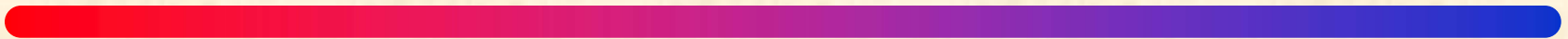
# Real GDP Growth vs. Real P/C

## Premium Growth: Modest Association



# **Inflation Trends**

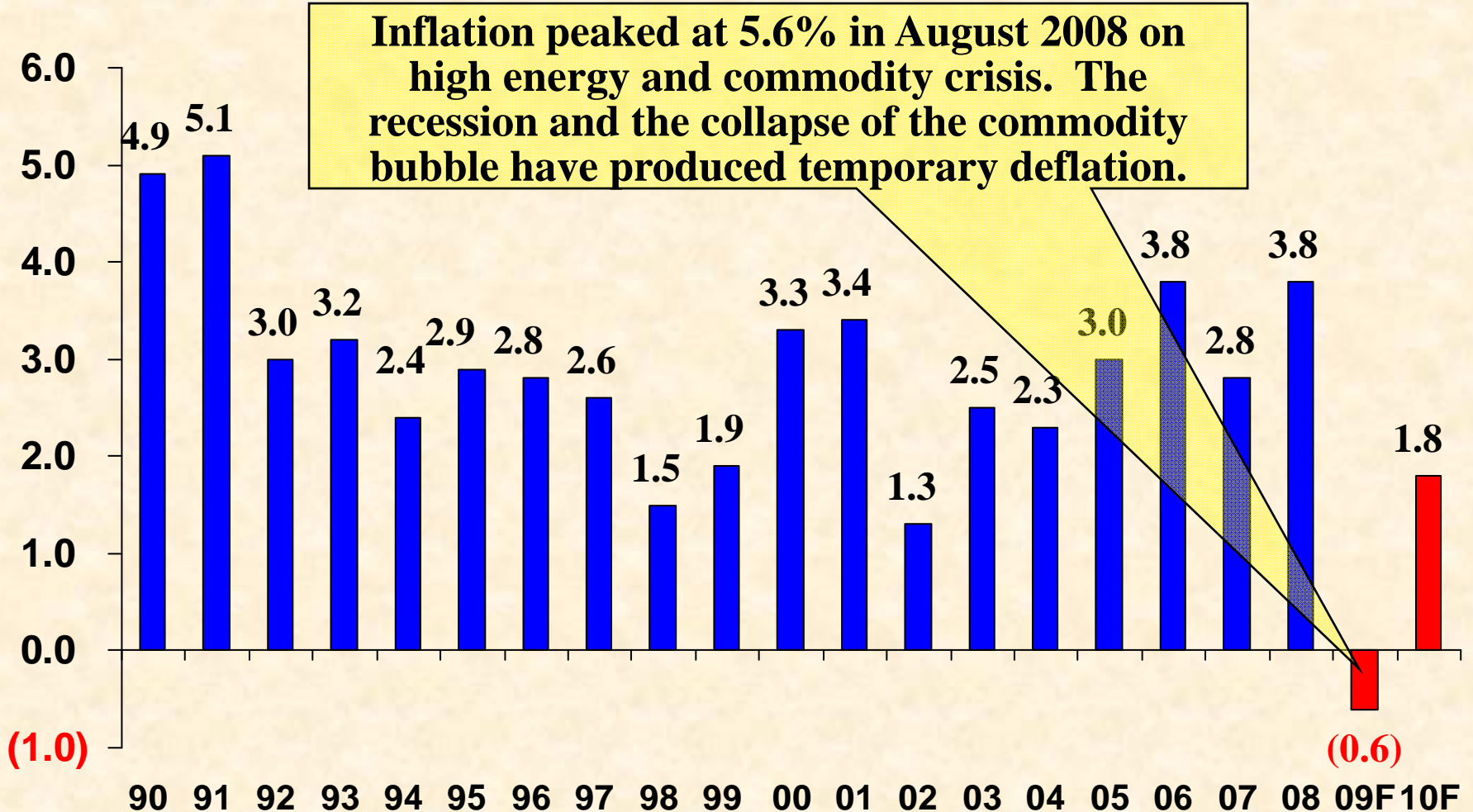
**Pressures Claim Cost  
Severities via Medical and  
Tort Channels**





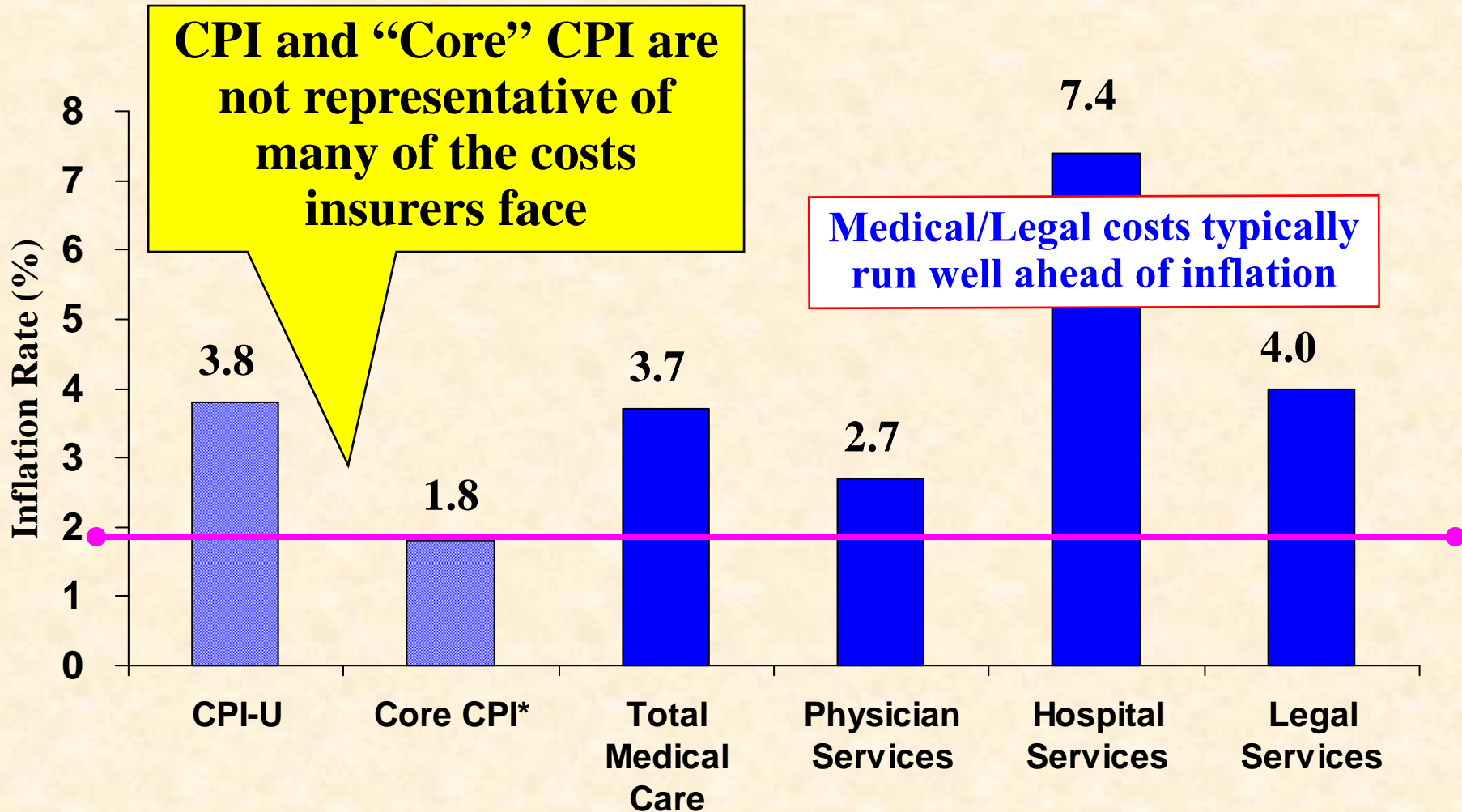


# Annual Inflation Rates (CPI-U, %), 1990-2010F





# Comparative 2008 Inflation Statistics Important to Insurers (%)



\*Core CPI is the Consumer Price Index for all Urban Consumers (CPI-U) less food and energy costs.  
Source: US Bureau of Labor Statistics; Insurance Information Institute.

# *Top Concerns/Risks for Insurers if Inflation is Reignited*



**CONCERNS:** The Federal Reserve Has Flooded Financial System with Cash (Turned on the Printing Presses), the Federal Govt. Has Approved a \$787B Stimulus and the Deficit is Expected to Mushroom to \$1.8 Trillion. All Are Potentially Inflationary.

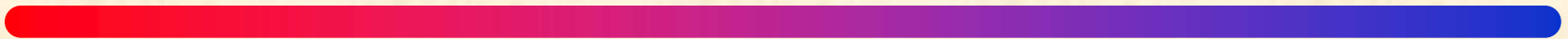
- **What are the potential impacts for insurers?**
- **What can/should insurers do to protect themselves from the risks of inflation?**

## **KEY RISKS FROM SUSTAINED/ACCELERATING INFLATION**

- **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 re-insurance more quickly and potential exhausting their reinsurance more quickly**

# Labor Market Trends

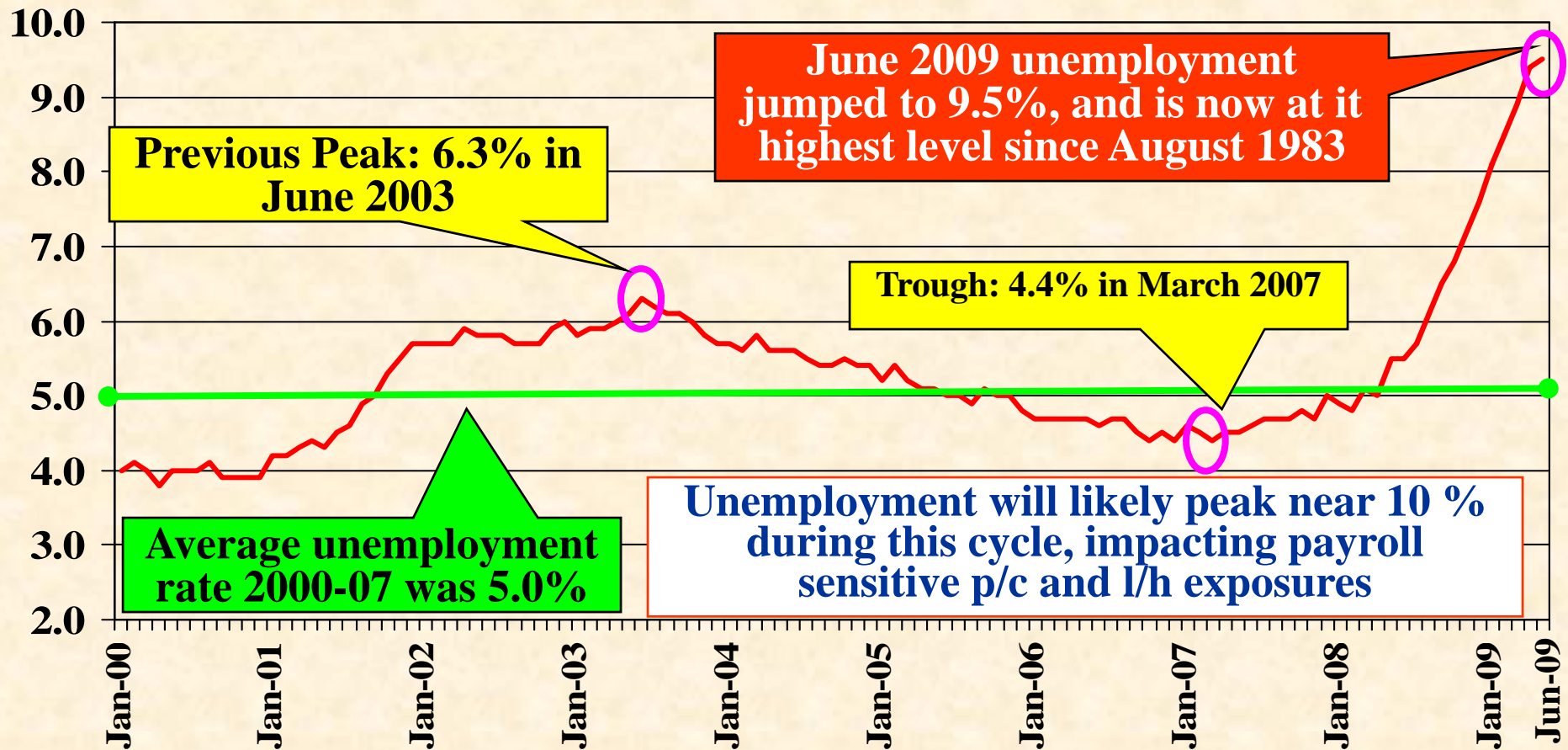
**Fast & Furious: Massive Job Losses  
Sap the Economy Workers Comp &  
Other Commercial Exposure**





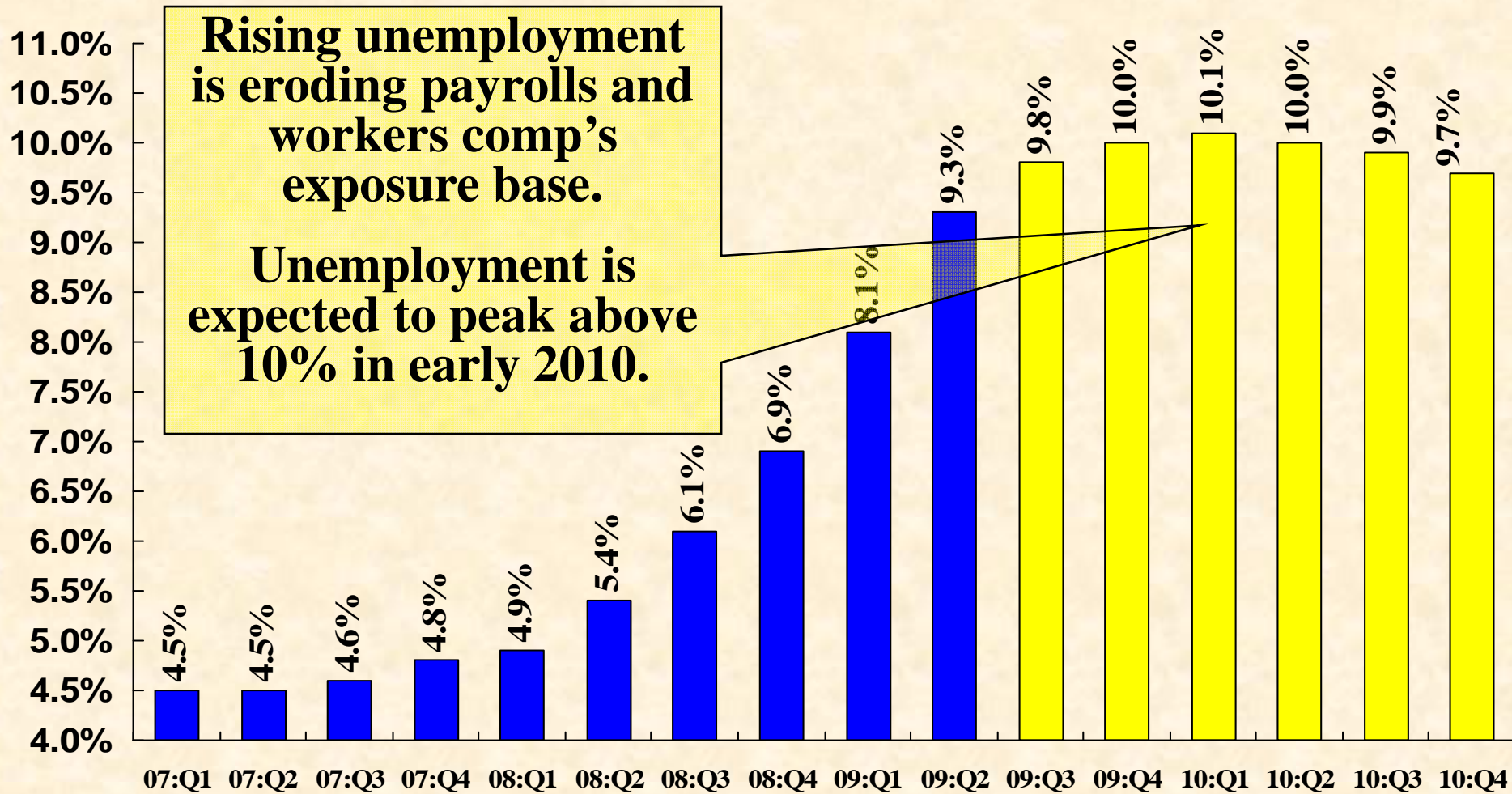
# Unemployment Rate: On the Rise

January 2000 through June 2009





# U.S. Unemployment Rate, (2007:Q1 to 2010:Q4F)\*



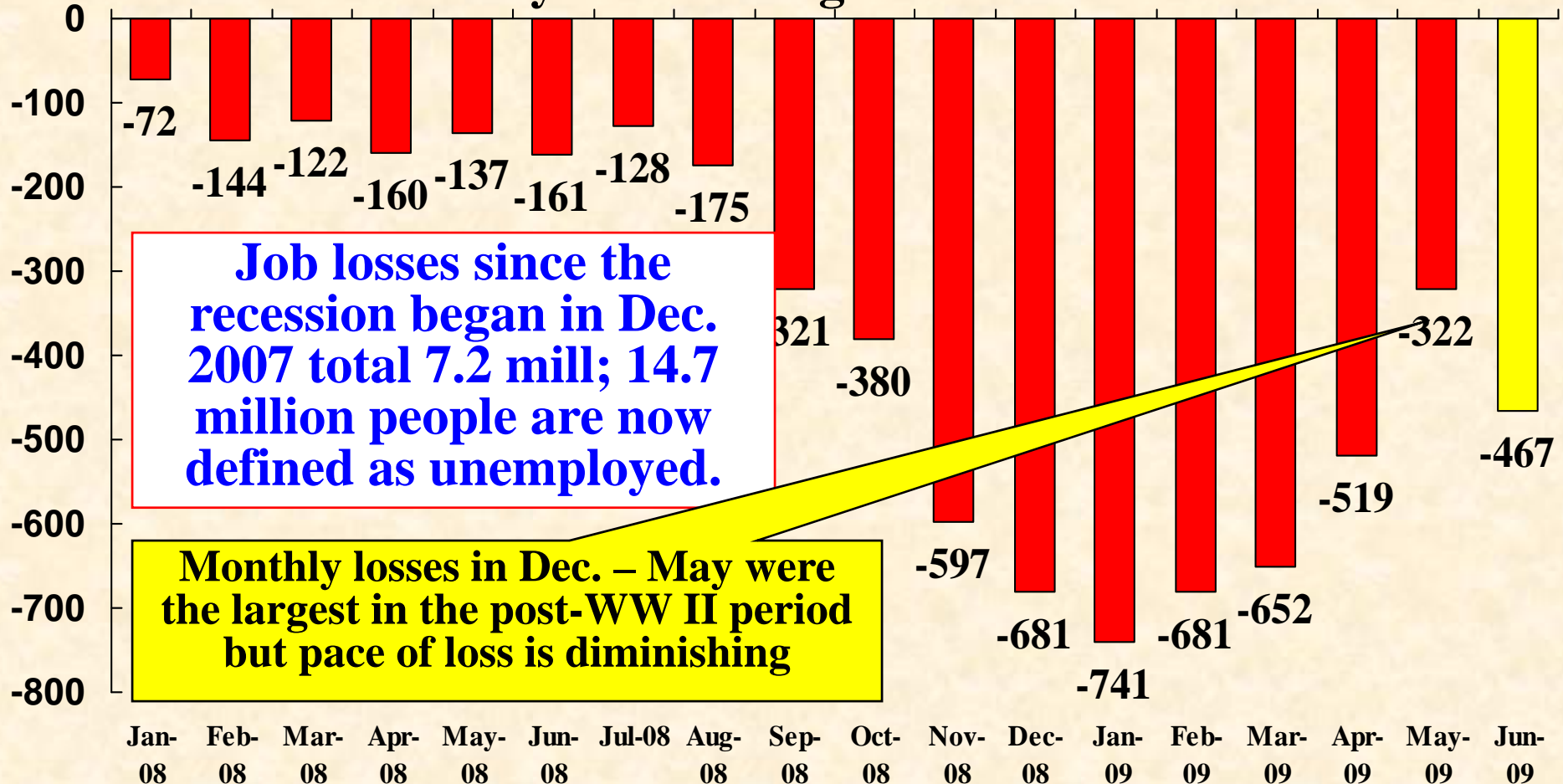
\* Blue bars are actual; Yellow bars are forecasts

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (7/09); Insurance Info. Inst.



# Monthly Change Employment\* (Thousands)

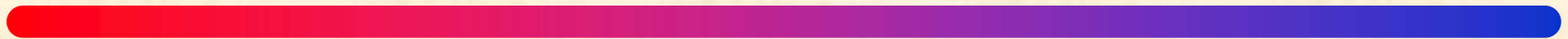
January 2008 through June 2009



# The Texas Economy

**Less of Mess in Texas & in Much  
Better Shape the US Overall, But  
Weakness is Spreading**

*Less Severe Impacts on P/C Insurer  
Exposure Growth*

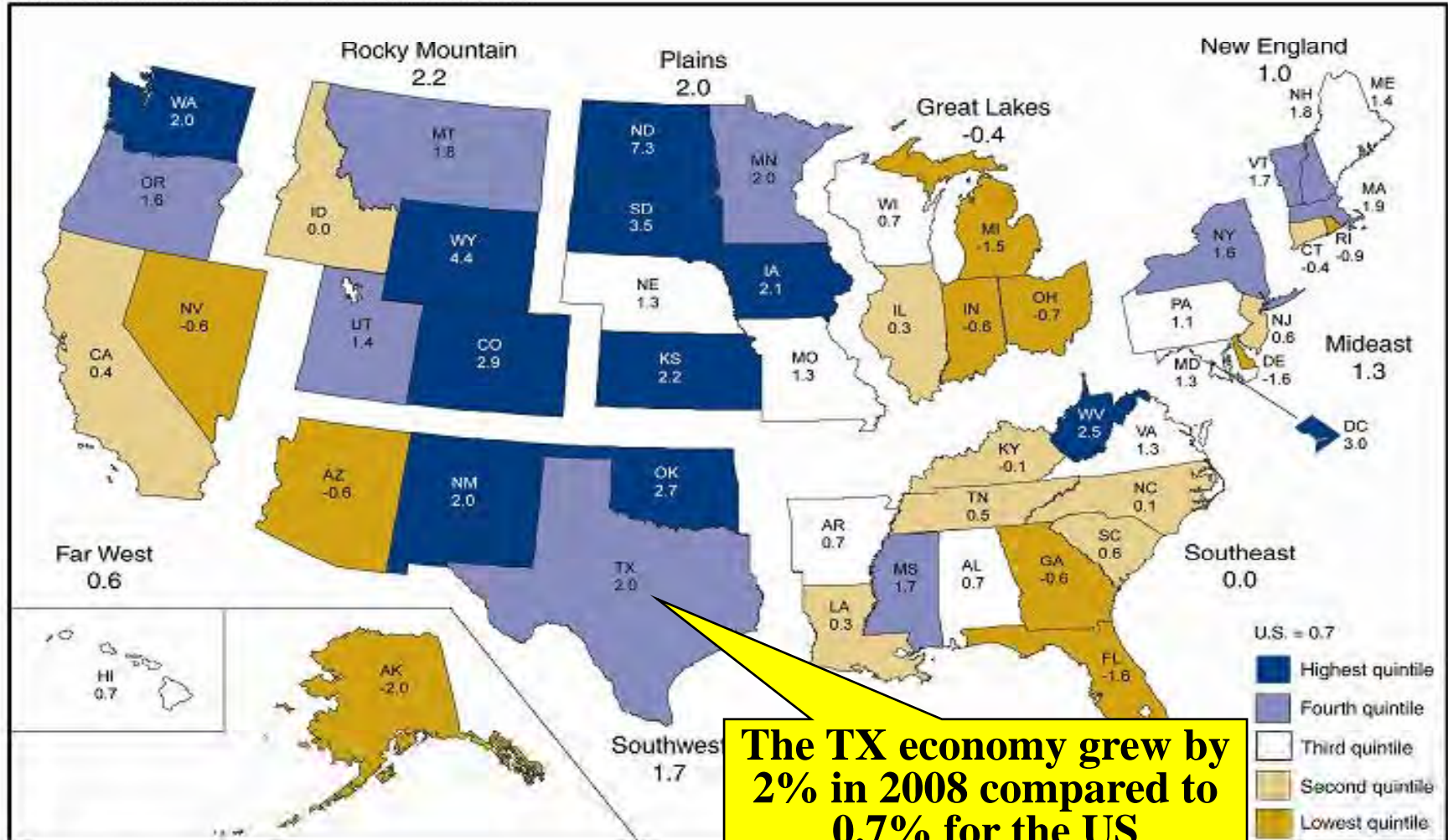






# The Texas Economy Grew Faster than Most States in 2008

Percent Change in Real GDP by State, 2007-2008

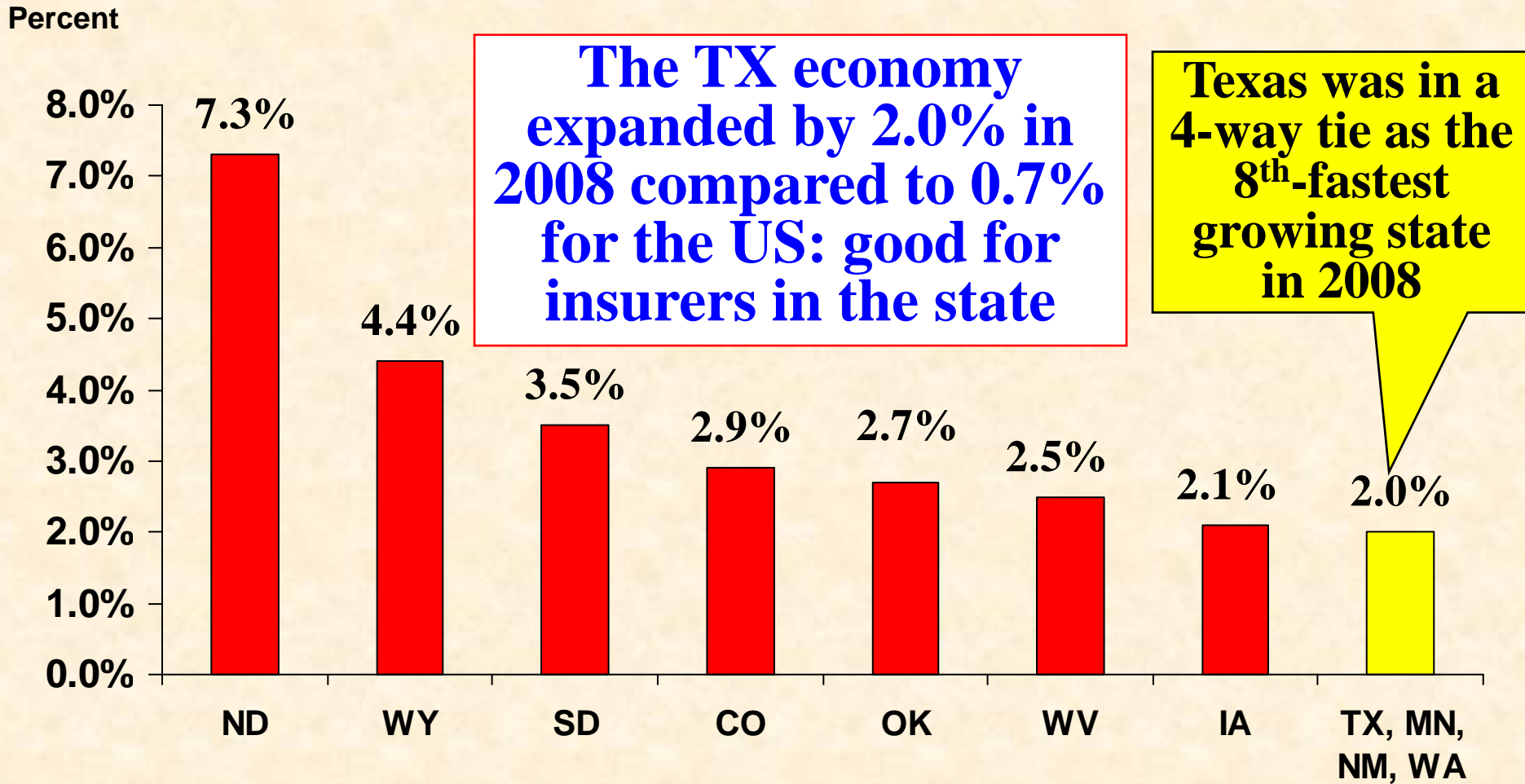


**The TX economy grew by 2% in 2008 compared to 0.7% for the US**



# *Fastest Growing States in 2008: TX is a Growth Leader*

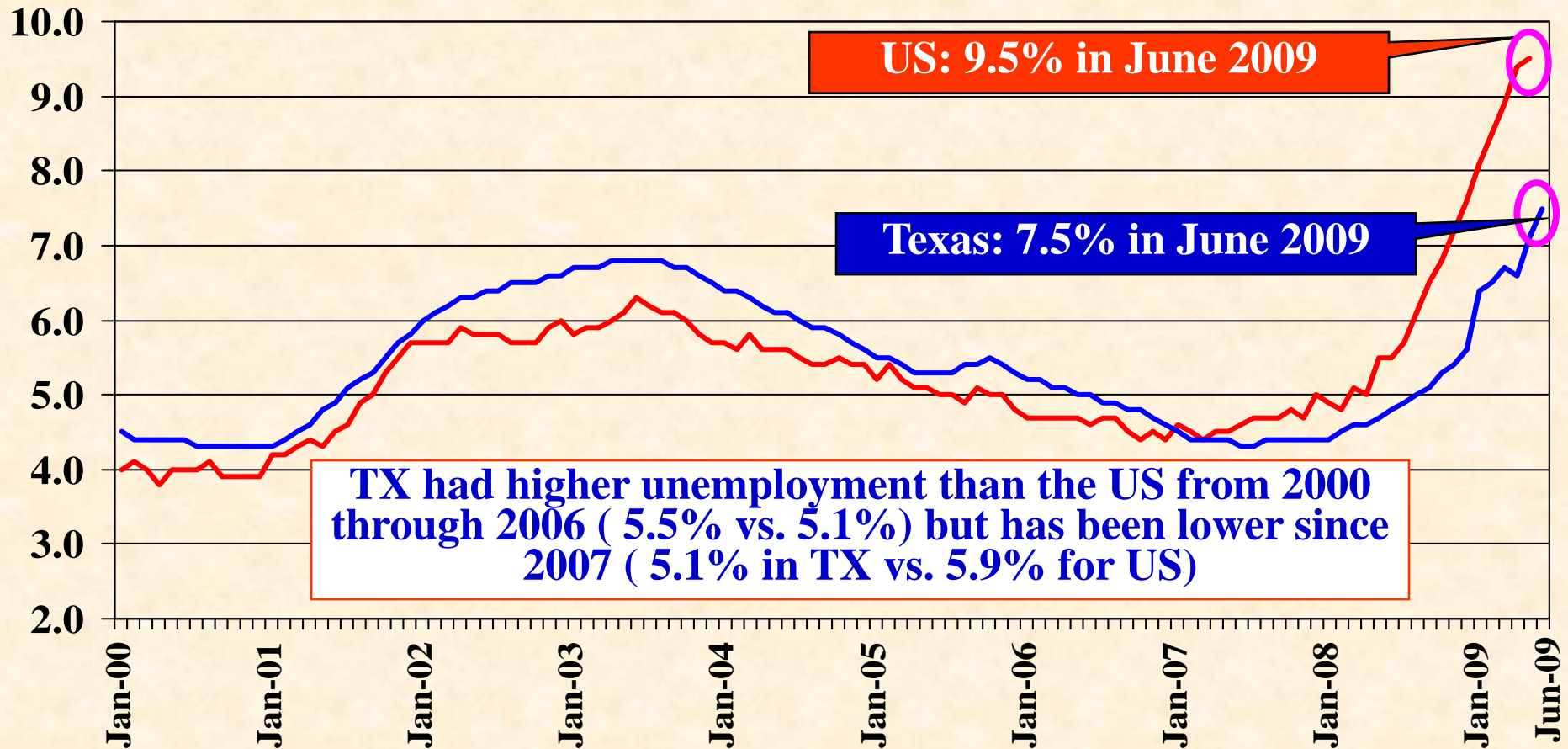
## Real State GDP Growth





# *Unemployment Rate: Texas is Doing Much Better Than US*

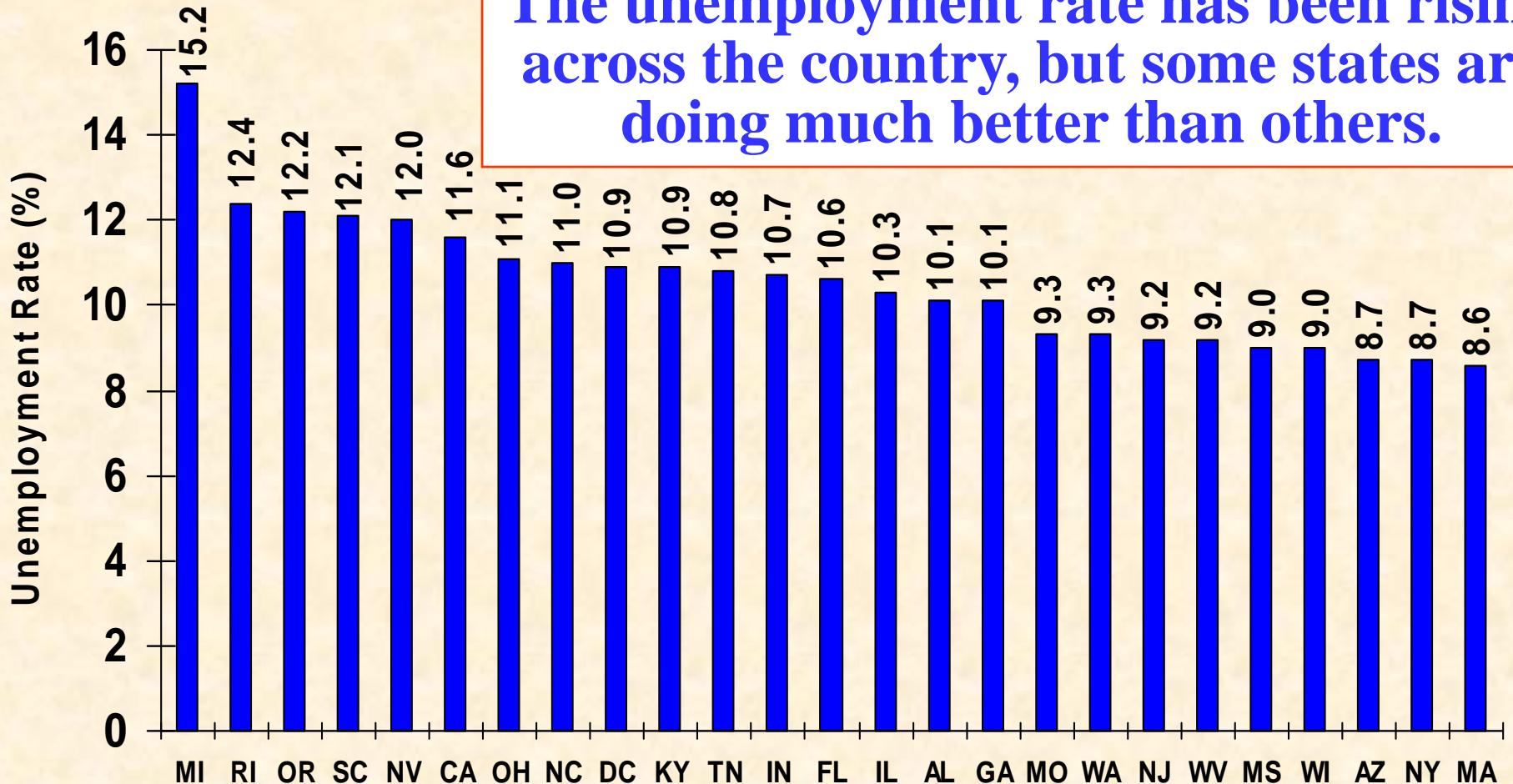
**January 2000 through June 2009**





# Unemployment Rates by State, June 2009: Highest 25 States\*

The unemployment rate has been rising across the country, but some states are doing much better than others.

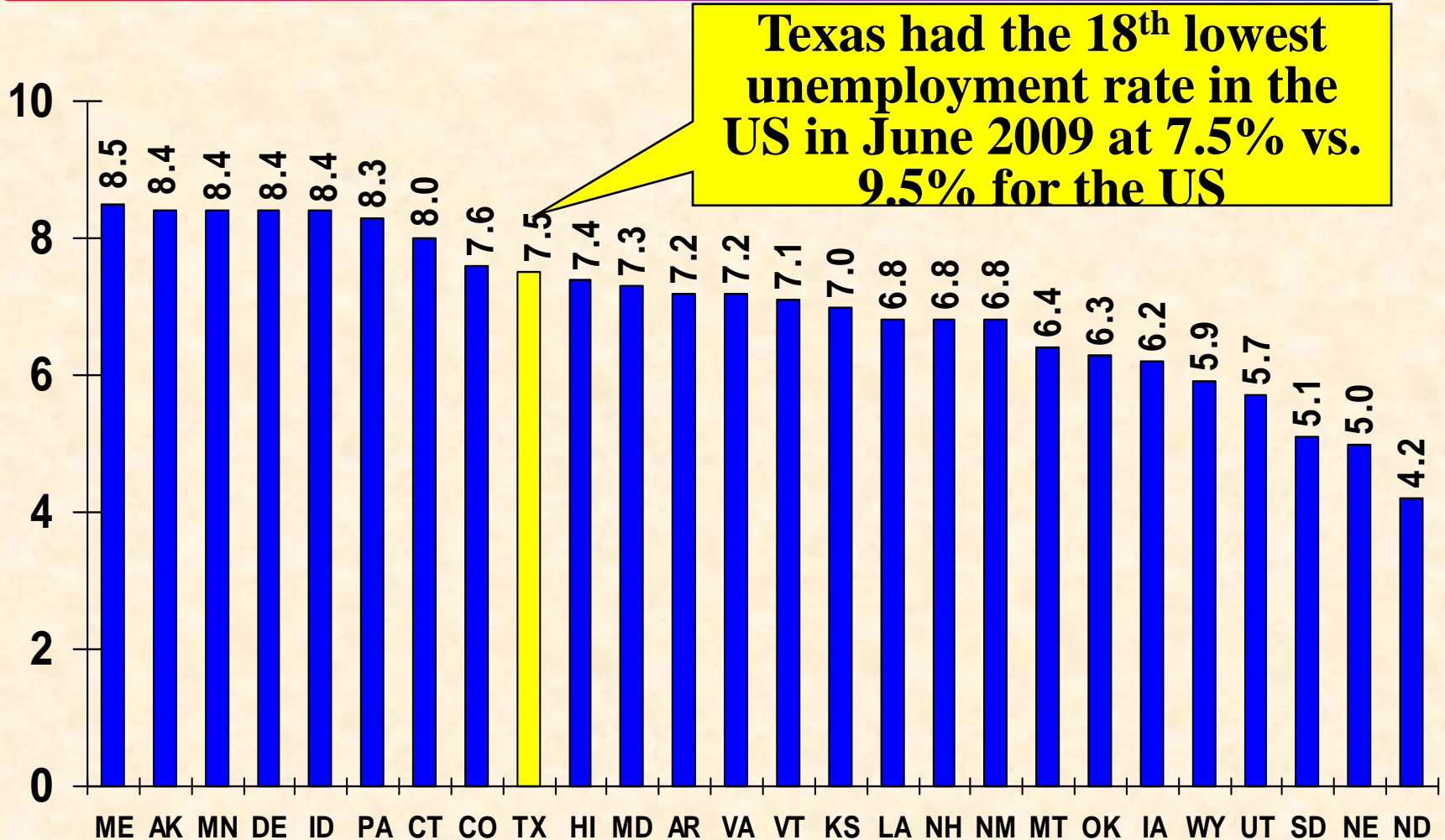


\*Provisional figures for June 2009, seasonally adjusted.

Sources: US Bureau of Labor Statistics; Insurance Information Institute.



# Unemployment Rates By State, June 2009: Lowest 25 States\*



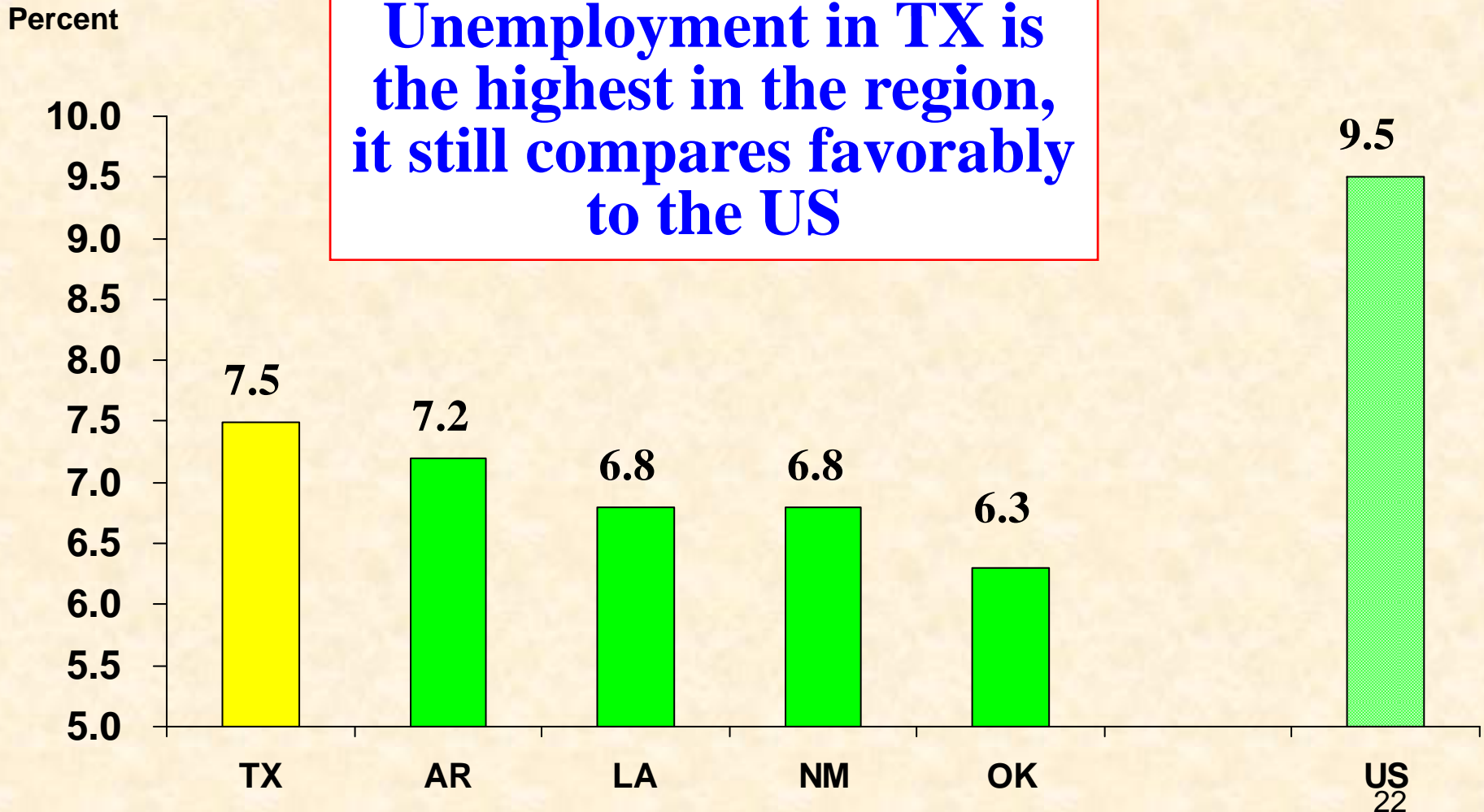
**Texas had the 18<sup>th</sup> lowest unemployment rate in the US in June 2009 at 7.5% vs. 9.5% for the US**

\*Provisional figures for June 2009, seasonally adjusted.

Sources: US Bureau of Labor Statistics; Insurance Information Institute.



# *Unemployment in Texas is High for the Region, but Low vs. US*

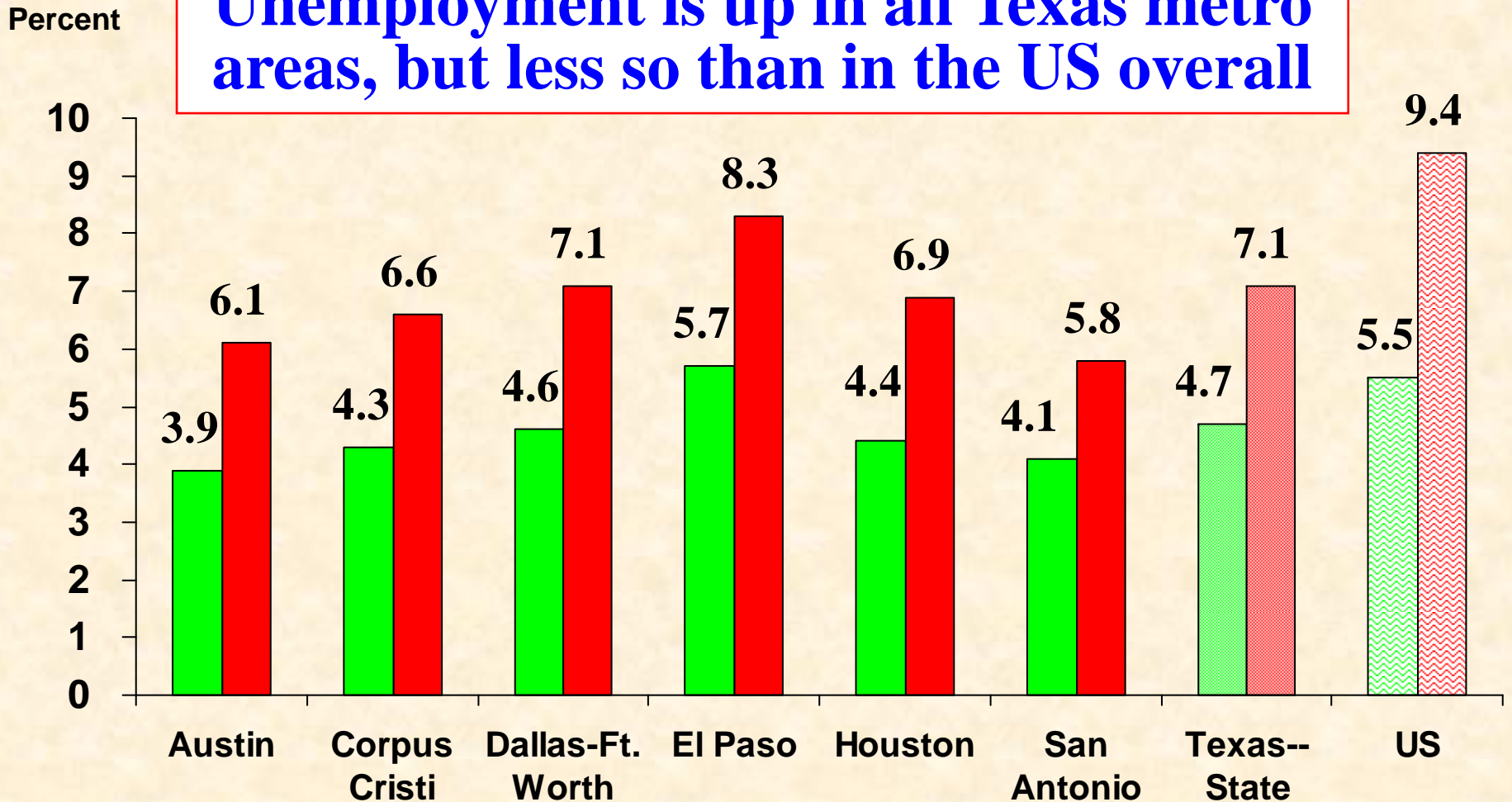


Source: US Bureau of Labor Statistics; Insurance Information Institute.



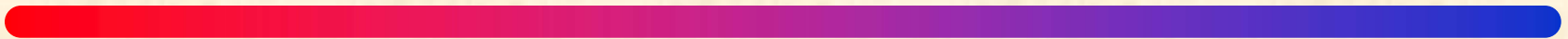
# *Unemployment in Largest Texas Cities but Below US in All*

**Unemployment is up in all Texas metro areas, but less so than in the US overall**



# GREEN SHOOTS

*Is the Recession  
Nearing an End?*







# *Hopeful Signs That the Economy Will Begin to Recover Soon*

- **Recession Appears to be Bottoming Out, Freefall Has Ended**
  - Pace of GDP shrinkage is beginning to diminish
  - Pace of job losses is slowing
  - Major stock market indices well off record lows, anticipating recovery
  - Some signs of retail sales stabilization are evident
- **Financial Sector is Stabilizing**
  - Banks are reporting quarterly profits
  - Many banks expanding lending to credit worthy people & businesses
- **Housing Sector Likely to Find Bottom Soon**
  - Home are much more affordable (attracting buyers)
  - Mortgage rates are still low relative to pre-crisis levels (attracting buyers)
  - Freefall in housing starts and existing home sales is ending in many areas
- **Inflation & Energy Prices Are Under Control**
- **Consumer & Business Debt Loads Are Shrinking**



# *11 Industries for the Next 10 Years:*

## *Insurance Solutions Needed*

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**Government**

**Education**

**Health Care**

**Energy (Traditional)**

**Alternative Energy**

**Agriculture**

**Natural Resources**

**Environmental**

**Technology**

**Light Manufacturing**

**Export Oriented Industries**

# Crisis-Driven Exposure Implications

*Home, Contractor, Auto,  
Exposure Growth Slows  
as Sales Nosedive*



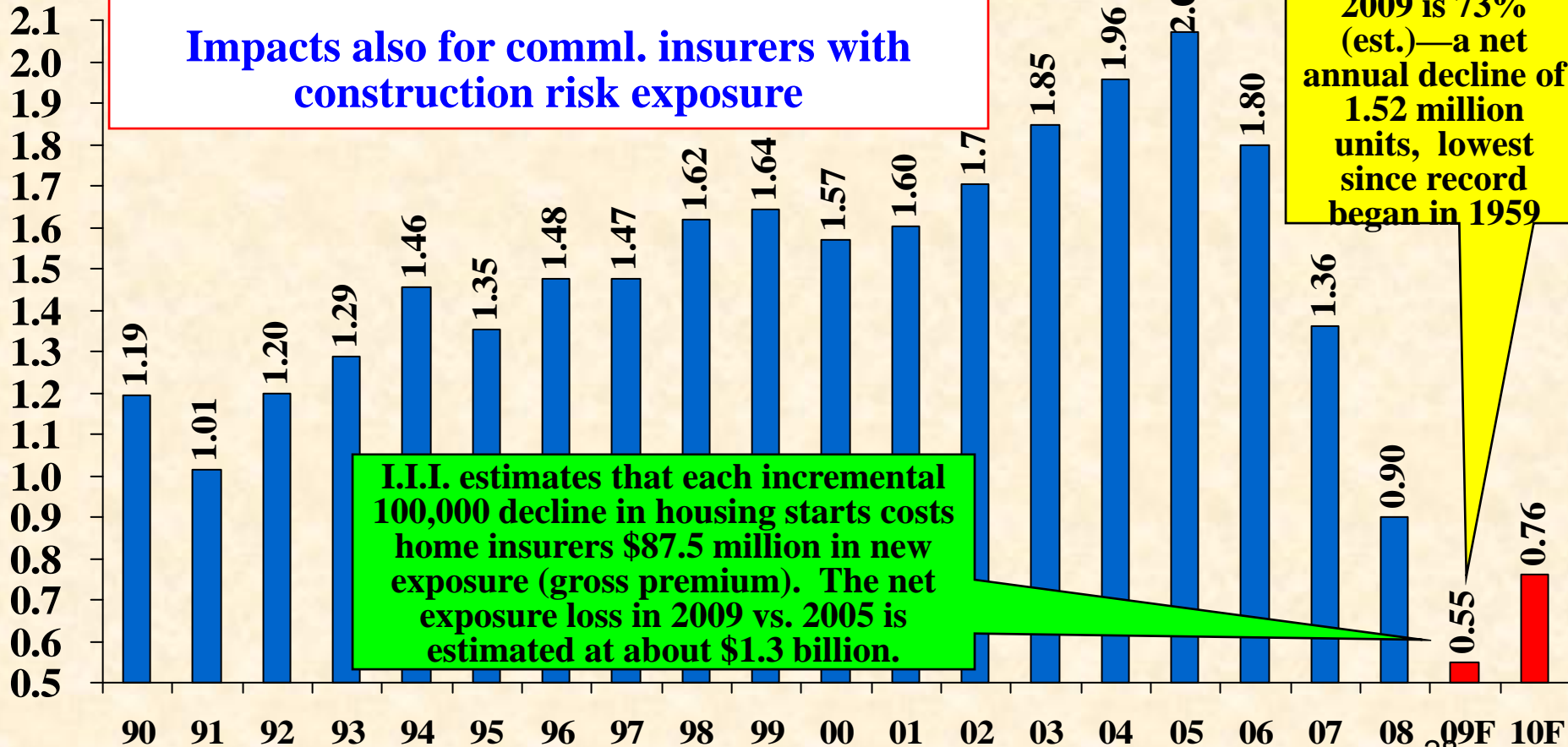


# New Private Housing Starts, 1990-2010F (Millions of Units)

Exposure growth due to home construction forecast for HO insurers is dim for 2009 with some improvement in 2010.

Impacts also for comml. insurers with construction risk exposure

New home starts plunged 34% from 2005-2007; Drop through 2009 is 73% (est.)—a net annual decline of 1.52 million units, lowest since record began in 1959



I.I.I. estimates that each incremental 100,000 decline in housing starts costs home insurers \$87.5 million in new exposure (gross premium). The net exposure loss in 2009 vs. 2005 is estimated at about \$1.3 billion.

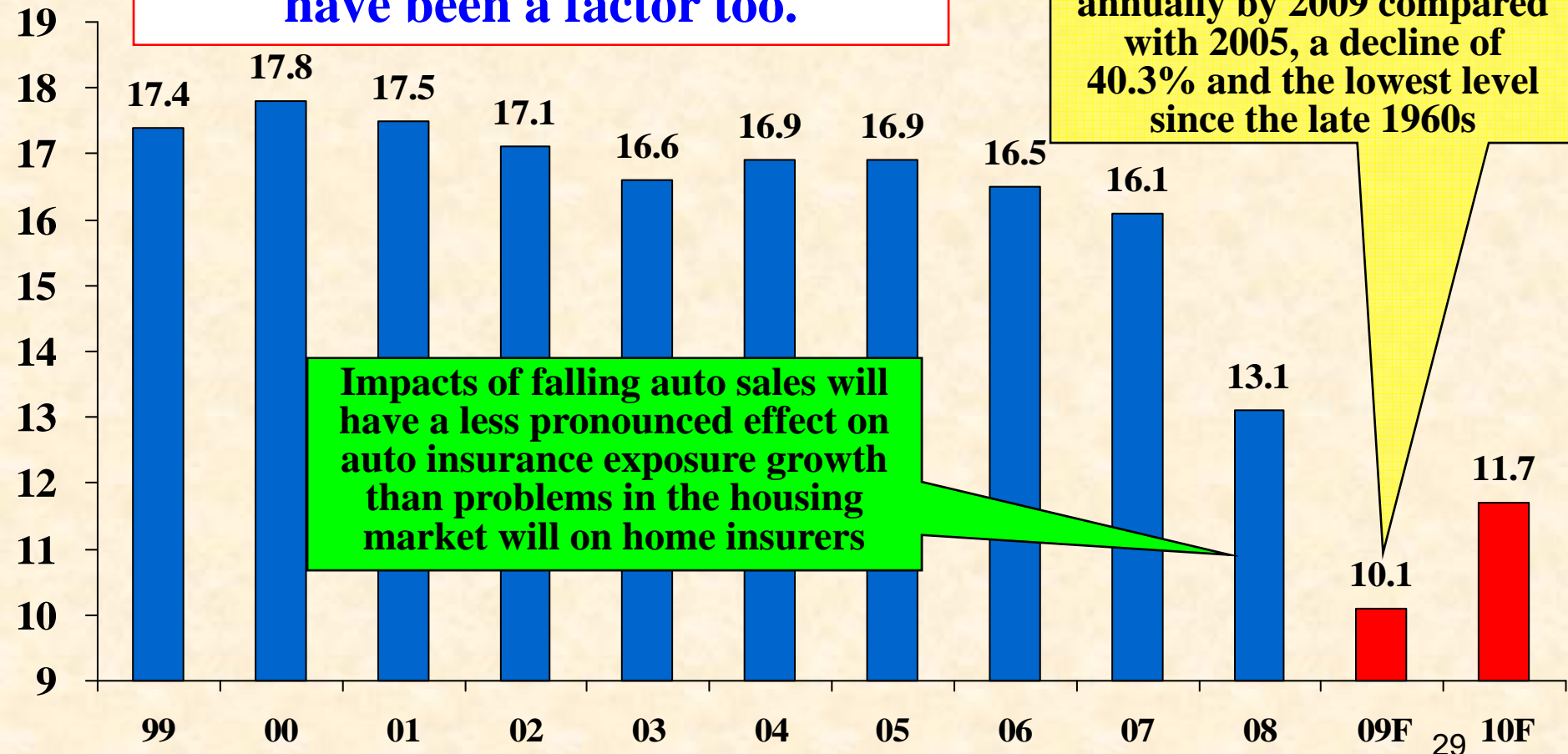


# *Auto/Light Truck Sales, 1999-2010F (Millions of Units)*

**Weak economy, credit crunch are hurting auto sales; Gas prices have been a factor too.**

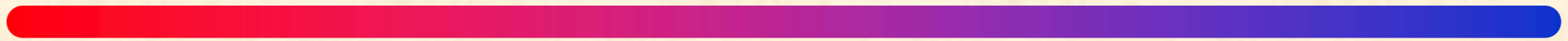
**New auto/light truck sales are expected to experience a net drop of 6.7 million units annually by 2009 compared with 2005, a decline of 40.3% and the lowest level since the late 1960s**

**Impacts of falling auto sales will have a less pronounced effect on auto insurance exposure growth than problems in the housing market will on home insurers**



# “Cash for Clunkers” or Car Allowance Rebate System (CARS)

*Program to Increase Fuel  
Efficiency and Stimulate Auto Sales  
Will Help Auto Insurers Too*



# *Car Allowance Rebate System:*

## *How it Works*



- President Obama in June 2009 signed into law the Car Allowance Rebate System (CARS) also known as “Cash for Clunkers”
- Administered by the National Highway Traffic Safety Admin. (NHTSA), the program helps people purchase a new, more fuel efficient vehicle when trading in a less fuel efficient vehicle
- Program allocates \$1 billion toward purchases between July 1 and Nov. 1, 2009 or until funds are exhausted (final rule July 24)
- Sense is that program will prove to be very popular and may be extended
- People can get between \$3,500 and \$4,500 per vehicle, depending on fuel efficiency of new vehicle vs. old vehicle
- **Auto insurers should be able to generate between \$75 - \$125 million in net new auto premiums as people trade up and buy full coverage\***

**\*Ill estimate based on 250,000 cars purchased via CARS program generating \$300-\$500 additional premium per vehicle.**

**Source: [www.CARS.gov](http://www.CARS.gov); NHSTA; Insurance Information Institute.**



# Car Allowance Rebate System: How it Works



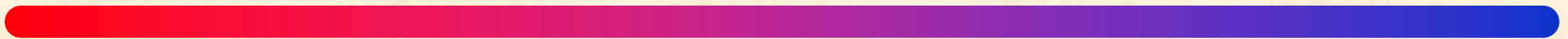
## Important Program Features

- Car must be less than 25 years old
- Only purchase or lease of new vehicles qualify
- Trade-in must get 18mpg or less
- Trade-in must have been registered and continuously insured for the past year
- No voucher needed; dealer will apply credit at purchase
- Trade-in must be scrapped; Get scrap value



# Key Threats Facing Insurers Amid Financial Crisis

*Challenges for the  
Next 5-8 Years*





# *Important Issues & Threats*

## *Facing Insurers: 2009 - 2015*

### **1. Erosion of Capital**

- **Losses are larger and occurring more rapidly than is commonly understood or presumed**
- **Surplus down 13%=\$66B since 9/30/07 peak; 12% (\$80B ) in 2008**
- **P/C policyholder surplus could be even more by year-end 2009**
- **Some insurers propped up results by reserve releases**
- **Decline in PHS of 1999-2002 was 15% over 3 years and was entirely made up and then some in 2003. Current decline is ~13% in 5 qtrs.**
- **During the opening years of 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: Capital and assets could fall much farther and faster than many believe. It will take years to return to the 2007 peaks (likely until 2011 with a sharp hard market and 2015 without one)**



# Important Issues & Threats

## Facing Insurers: 2009 - 2015

### 2. **Reloading Capital After “Capital Event”**

- Continued asset price erosion coupled with major “capital event” could lead to shortage of capital among *some* companies
- Possible Consequences: Insolvencies, forced mergers, calls for govt. aid, requests to relax capital requirements
- P/C insurers have come to assume that large amounts of capital can be raised quickly and cheaply after major events (post-9/11, Katrina).
  - *This assumption may be incorrect in the current environment*
- Cost of capital is *much* higher today, reflecting both scarcity & risk
- Implications: P/C (re)insurers need to protect capital today and develop detailed contingency plans to raise fresh capital & generate internally. Already a reality for some life insurers.



# Important Issues & Threats

## Facing Insurers: 2009 - 2015

### 3. Long-Term Reduction in 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
- Price bubble in Treasury securities keeps 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

# Important Issues & Threats



## Facing Insurers: 2009 – 2???

### 4. Regulatory Overreach

- Principle danger is that P/C insurers get swept into vast federal regulatory overhaul and subjected to inappropriate, duplicative and costly regulation (Dual Regulation)
- Danger is high as feds get their nose under the tent
- Status Quo is viewed as unacceptable by all
- Pushing for major change is not without significant risk in the current highly charged political environment
- Insurance & systemic risk
- Disunity within the insurance industry
- Impact of regulatory changes will be felt for decades
- **Bottom Line: Regulatory outcome is uncertain and risk of adverse outcome is high**



# *Important Issues & Threats*

## *Facing Insurers: 2009 - 2015*

### **5. Creeping Restrictions on Underwriting**

- Attacks on underwriting criteria such as credit, education, occupation, territory increasing
- Industry will lose some battles
- View that use of numerous criteria are discriminatory and create an adverse impact on certain populations
- Impact will be to degrade the accuracy of rating systems to increase subsidies
- Predictive modeling also at risk
- Current social and economic environment could accelerate these efforts
- Danger that bans could be codified at federal level during regulatory overhaul
- **Bottom Line: Industry must be prepared to defend existing and new criteria indefinitely**



# *Important Issues & Threats*

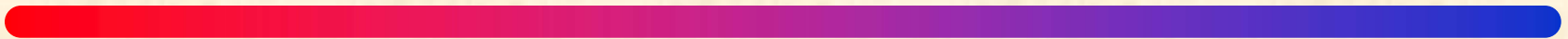
## *Facing Insurers: 2009 -2015*

### **6. 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 liab.**
- **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**

# FINANCIAL STRENGTH & RATINGS

**Industry Has Weathered  
the Storms Well**

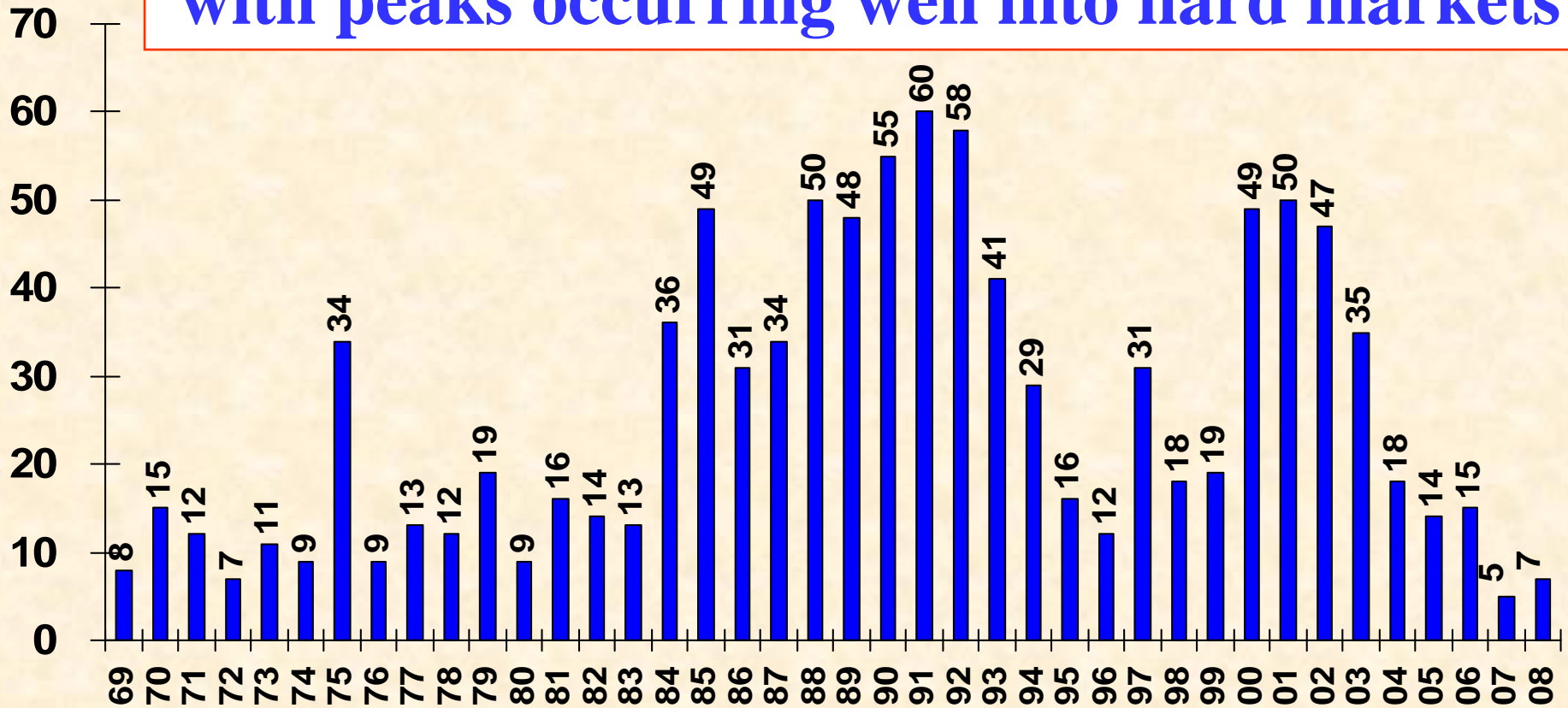






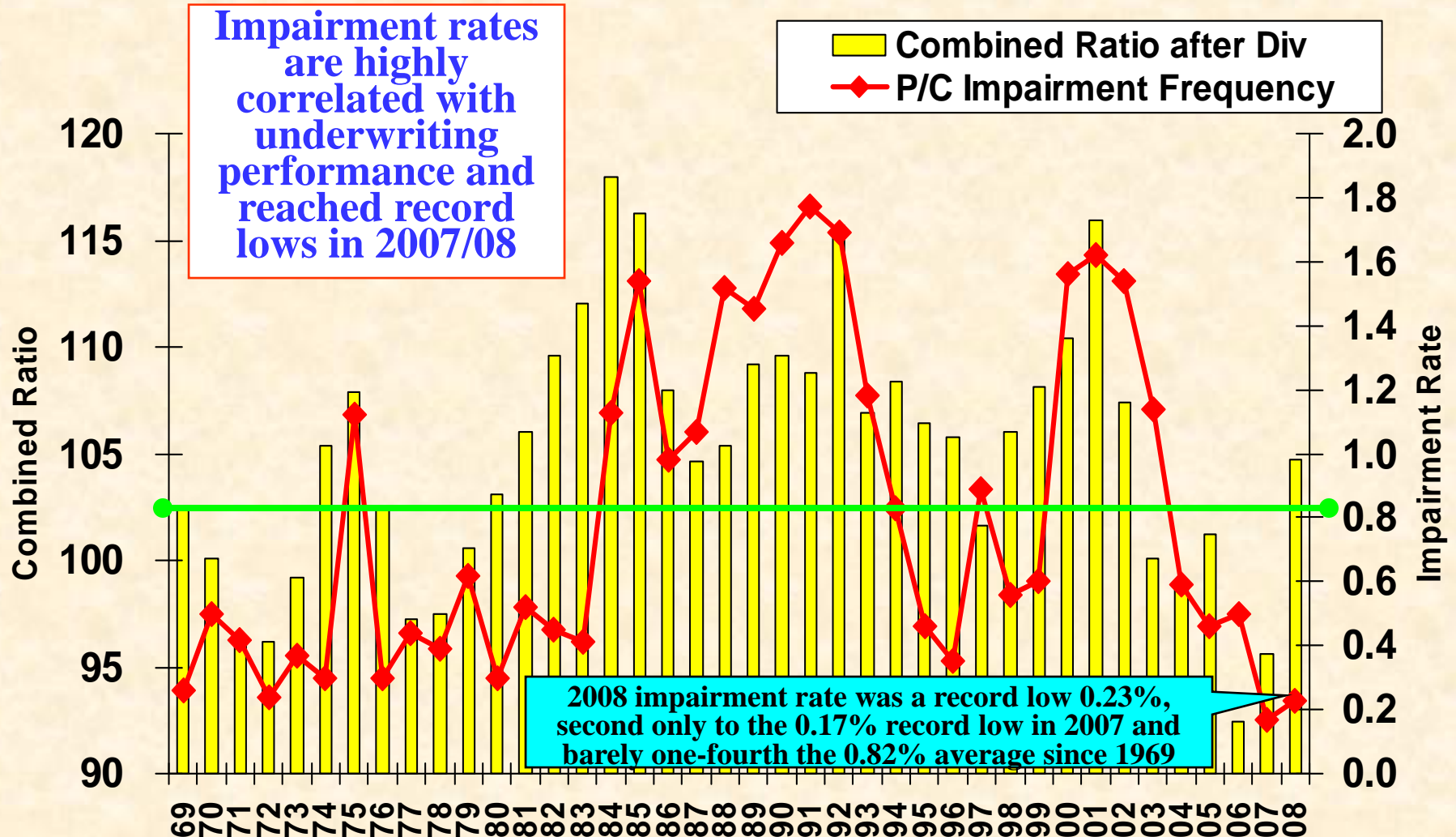
# *P/C Insurer Impairments, 1969-2008*

**The number of impairments varies significantly over the p/c insurance cycle, with peaks occurring well into hard markets**



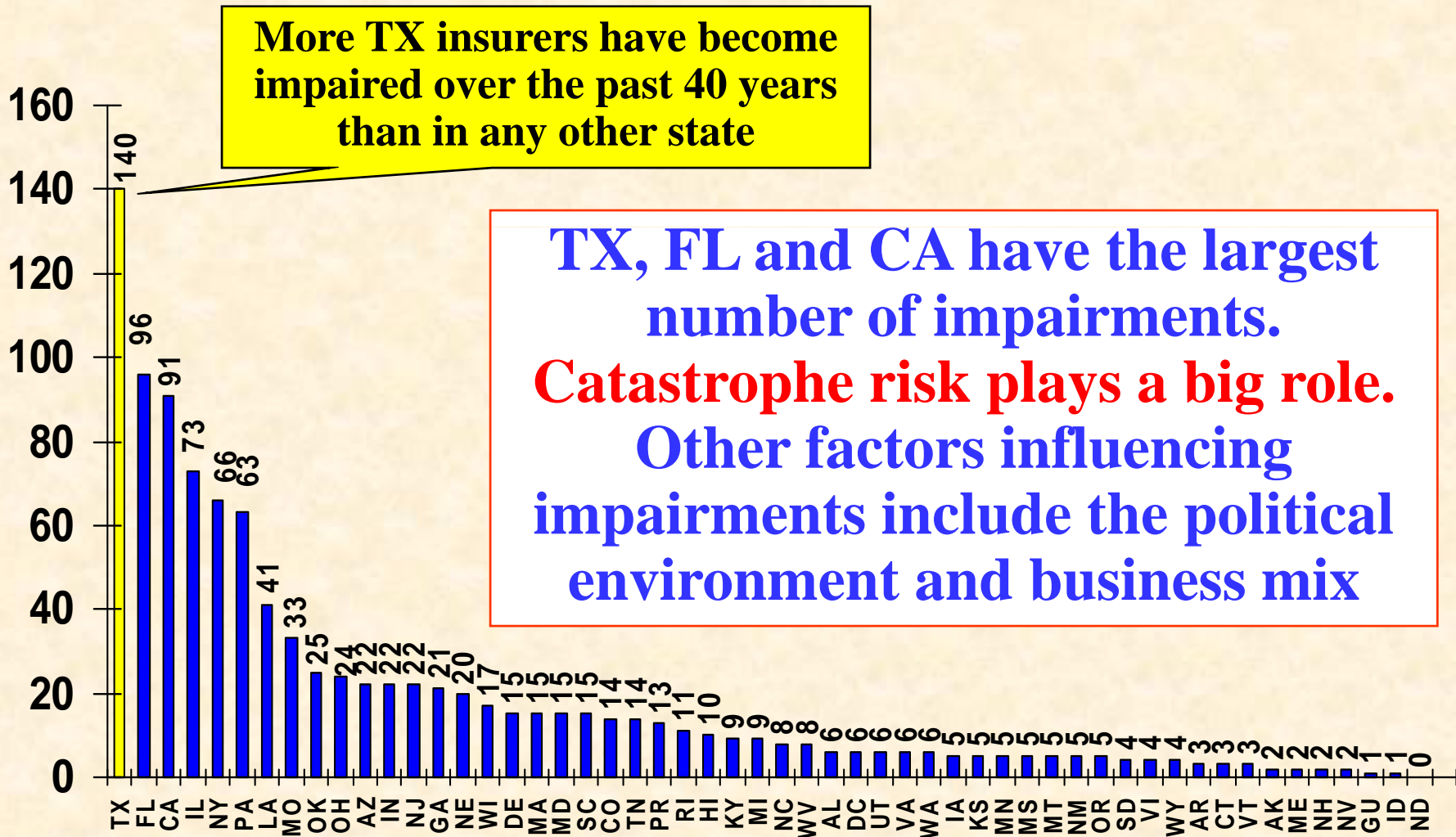


# *P/C Insurer Impairment Frequency vs. Combined Ratio, 1969-2008*





# Number of Impairments by State, 1969-2008





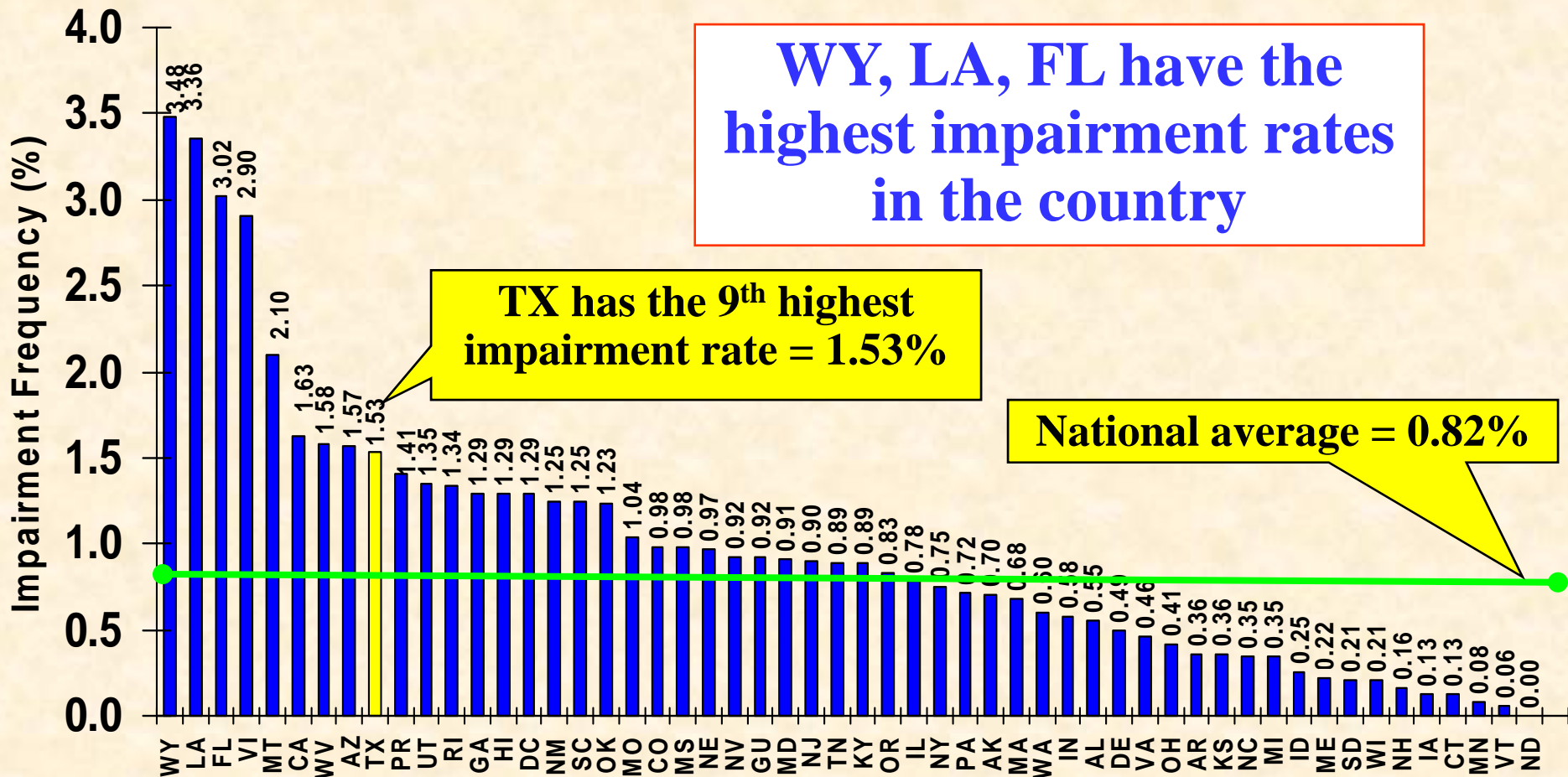
# Frequency of Impairments by State, 1969-2008

(Impairments per 100 Insurers Domiciled in State)

WY, LA, FL have the highest impairment rates in the country

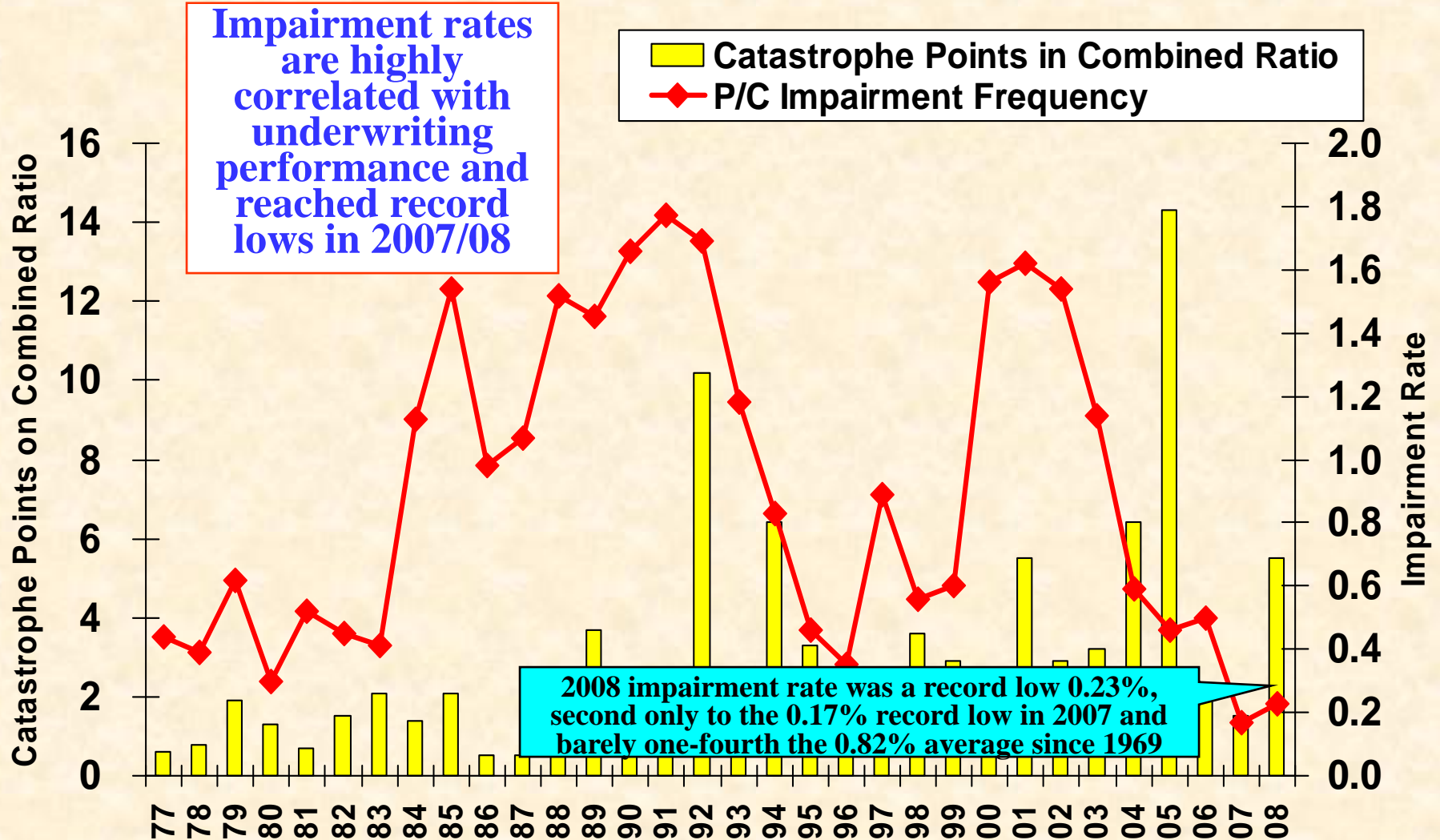
TX has the 9<sup>th</sup> highest impairment rate = 1.53%

National average = 0.82%





# *P/C Impairment Frequency vs. Catastrophe Points in Combined Ratio, 1977-2008*

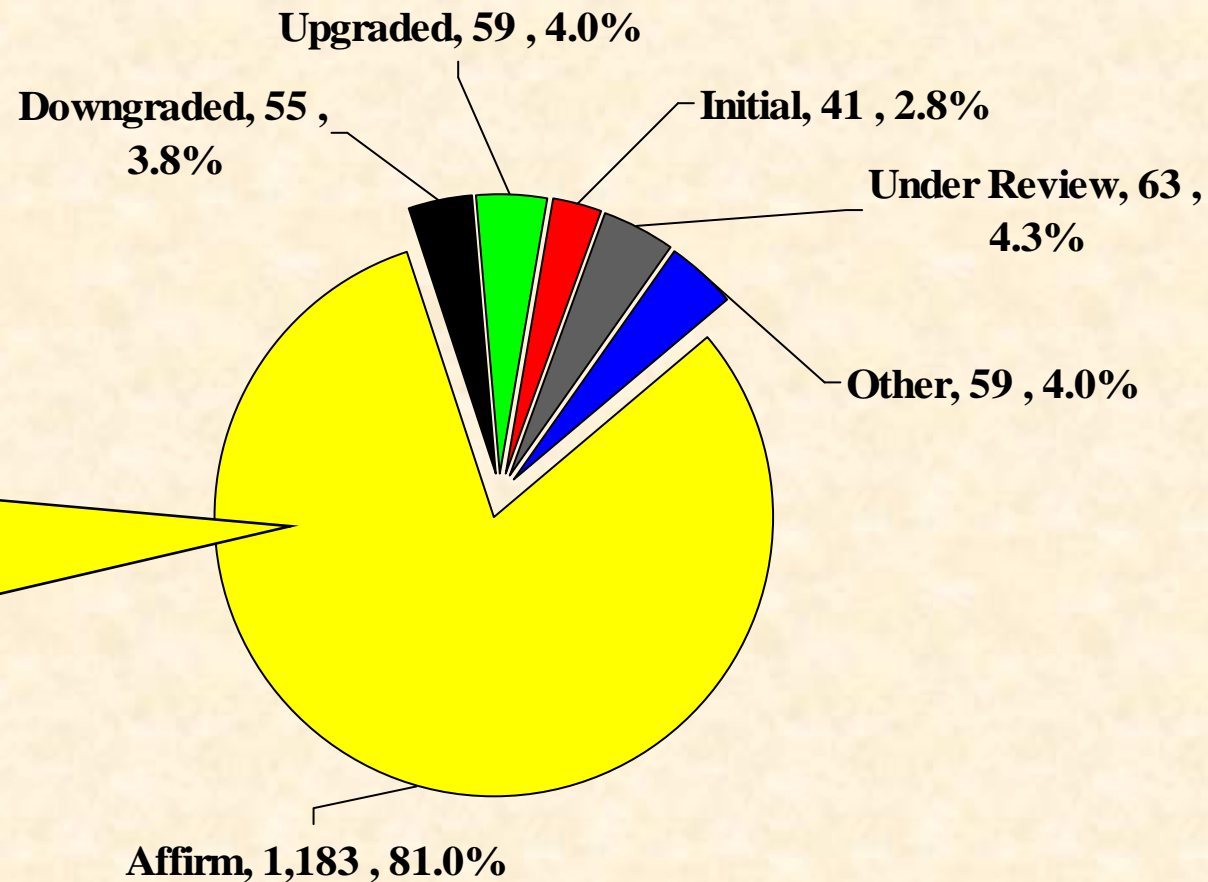




# Summary of A.M. Best's P/C Insurer Ratings Actions in 2008\*

P/C insurance is by design a resilient in business. The dual threat of financial disasters and catastrophic losses are anticipated in the industry's risk management strategy.

Despite financial market turmoil, high cat losses and a soft market in 2008, 81% of ratings actions by A.M. Best were affirmations; just 3.8% were downgrades and 4.0% upgrades



\*Through December 19.

Source: A.M. Best.



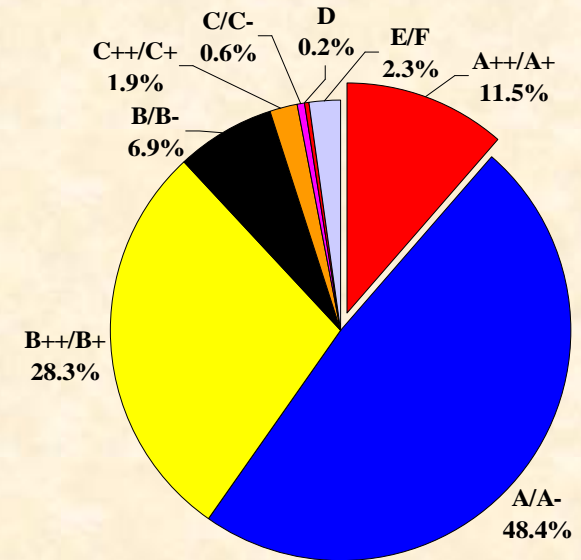
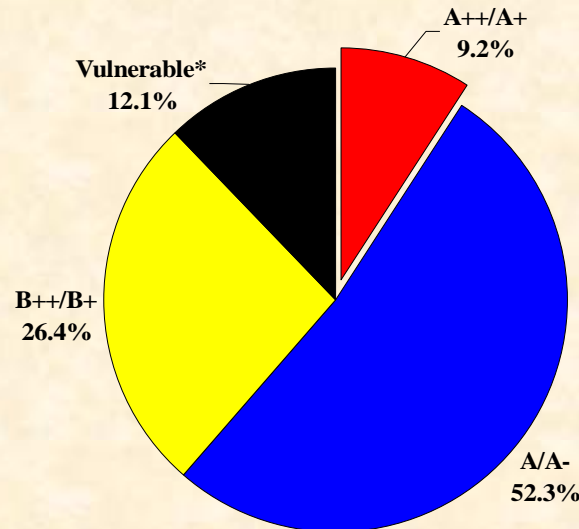
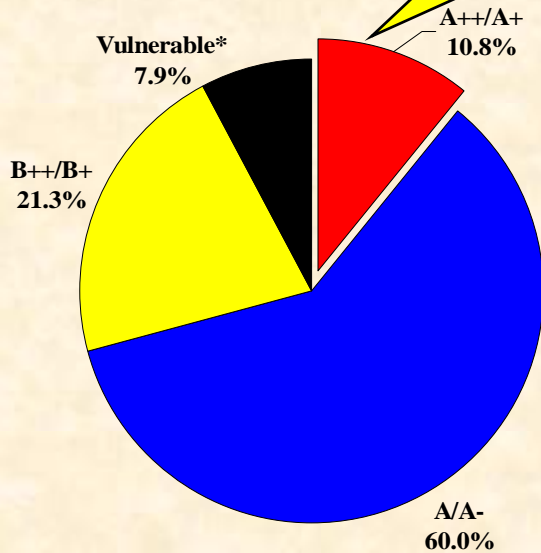
# Historical Ratings Distribution, US P/C Insurers, 2008 vs. 2005 and 2000

**2008**

**A++/A+ and  
A/A- gains**

**2005**

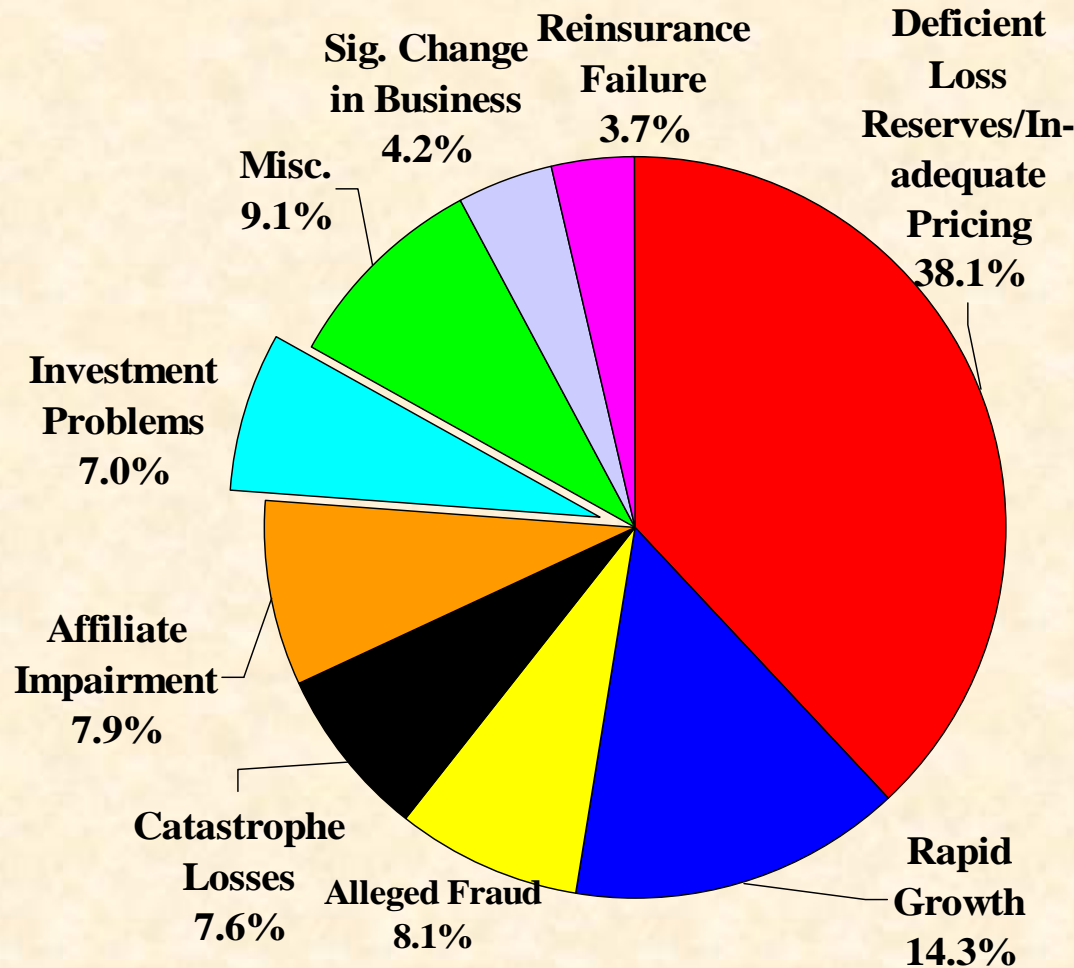
**2000**



**P/C insurer financial strength  
has improved since 2005  
despite financial crisis**



# Reasons for US P/C Insurer Impairments, 1969-2008

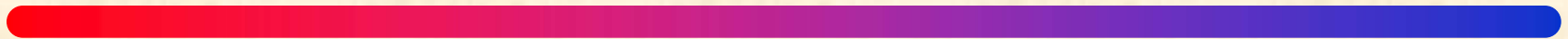


**Deficient loss reserves and inadequate pricing are the leading cause of insurer impairments, underscoring the importance of discipline. Investment catastrophe losses play a much smaller role.**



# Critical Differences Between P/C Insurers and Banks

**Superior Risk Management Model  
& Low Leverage Make  
a Big Difference**





# *How Insurance Industry Stability Has Benefitted Consumers*

## **BOTTOM LINE:**

- **Insurance Markets—Unlike Banking—Are Operating *Normally***
- **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 82 banks have gone under as of 7/17/09)**
    - ***The Promise is Being Fulfilled***
  - **Renew existing policies (banks are reducing and eliminating lines of credit)**
  - **Write new policies (banks are turning away people who want or need to borrow)**
  - **Develop new products (banks are scaling back the products they offer)**

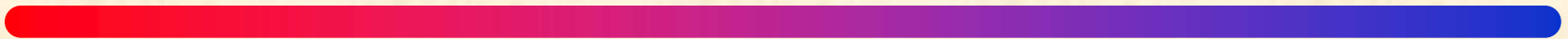


# Reasons Why P/C Insurers Have Fewer Problems Than Banks: A Superior Risk Management Model

- **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

# Regulatory Reform

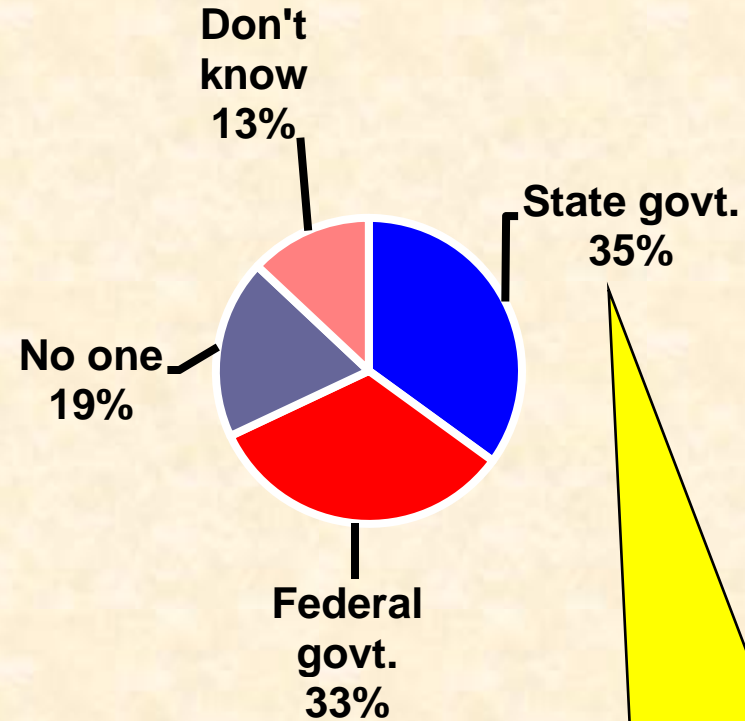
*Obama Administration's Plan  
for Reforming Financial  
Services Industry Regulation  
Will Impact Insurers*





# CONSUMER POLL: 2009 I.I.I. PULSE SURVEY

**The average American has little to no understanding of insurance regulation: 1/3 believe the industry is regulated by the federal government and nearly 20% believe it is unregulated**



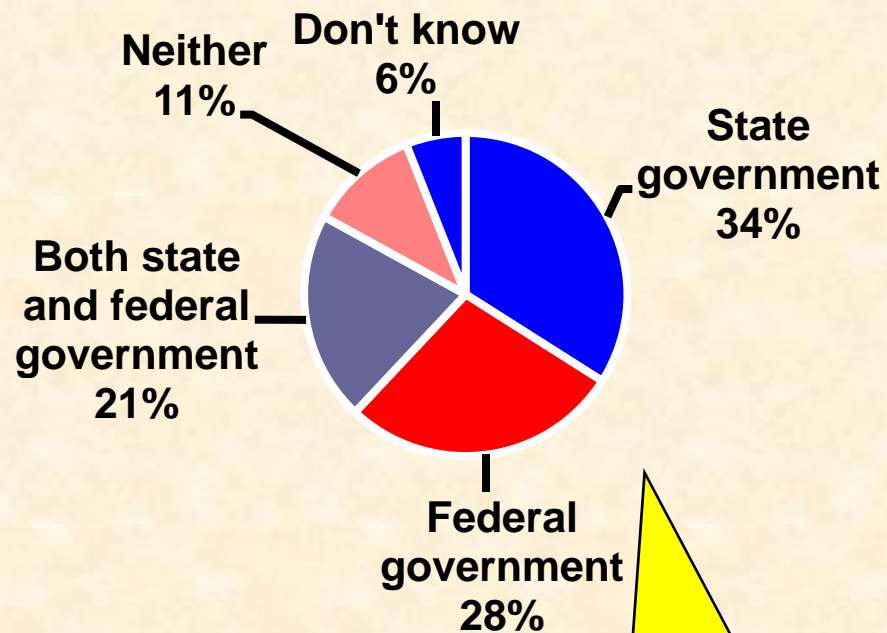
**Barely 1/3 of Americans know that insurance is regulated by the states. There is a popular notion that the industry is unregulated.**



# CONSUMER POLL: 2009 I.I.I. PULSE SURVEY

Americans are split on who they believe should regulate the insurance industry.

More than 20% believe the industry should be regulated by both the state *and* federal government.



There is no strong support for state or federal regulation among the American public



# *REGULATORY REFORM: 2009 AND BEYOND*

## FINANCIAL REGULATORY REFORM

### A NEW FOUNDATION:

Rebuilding Financial Supervision and Regulation



DEPARTMENT OF THE TREASURY



# *Obama Regulatory Reform Proposal: Plan Components*

## **I. Office of National Insurance (ONI) Duties**

1. Monitor “all aspects of the insurance industry”
2. Gather information
3. Identify the emergence of any problems or gaps in regulation that could contribute to a future crisis
4. Recommend to the Federal Reserve insurance companies it believes should be supervised as Tier 1 FHCs
5. Administer the Terrorism Risk Insurance Program
6. Authority to enter into international agreements and increase international cooperation on insurance regulation





# *Obama Regulatory Reform Proposal: Plan Components (cont'd)*

## **II. Systemic Risk Oversight & Resolution Authority**

- Federal Reserve given authority to oversee systemic risk of large federal holding companies (Tier 1 FHCs)
  - Insurers are explicitly included among the types of entities that could be found to be a Tier 1 FHC
  - ONI given authority to “recommend to the Federal Reserve any insurance companies that the ONI believes should be supervised as Tier 1 FHC.”
- Proposal also recommends “creation of a resolution regime to avoid disorderly resolution of failing bank holding companies, including Tier 1 FHCs “...in situations where the stability of the financial system is at risk.” Directly affects insurers in 2 ways:
  - Resolution authority may extend to an insurer within the BHC structure if the BHC is failing
  - If systemically important insurer is failing (as identified by ONI as Tier 1 FHC) resolution authority may apply



# Obama Regulatory Reform Proposal: Plan Components (cont'd)

## III. Consumer Financial Protection Agency (CFPA)

- Recommendation that “CFPA should have broad jurisdiction to protect consumers in consumer financial products and services such as credit, savings and payment products.”
  - Appears that Administration does not intend that the CFPA have jurisdiction over the insurance industry products or market practices
  - At the same time, there is no language that expressly excludes insurance from the scope of the CFPA’s authority
- CFPA proposal contains numerous references specific to credit and savings products but none to insurance. However, the Administration clearly anticipates that CFPA would have broad powers with the scope of the agency’s agenda defined by several “Principles for Action,” which clearly could apply to insurance regulation:
  - Transparency: Disclosures and communications with clients should be “reasonable”
  - Simplicity: Standards for simplified products, straightforward pricing
  - Fairness: Restrictions on products if benefits outweigh costs



# Obama Regulatory Reform Proposal: Plan Components (cont'd)

## IV. Other Provisions Potentially Affecting Insurers

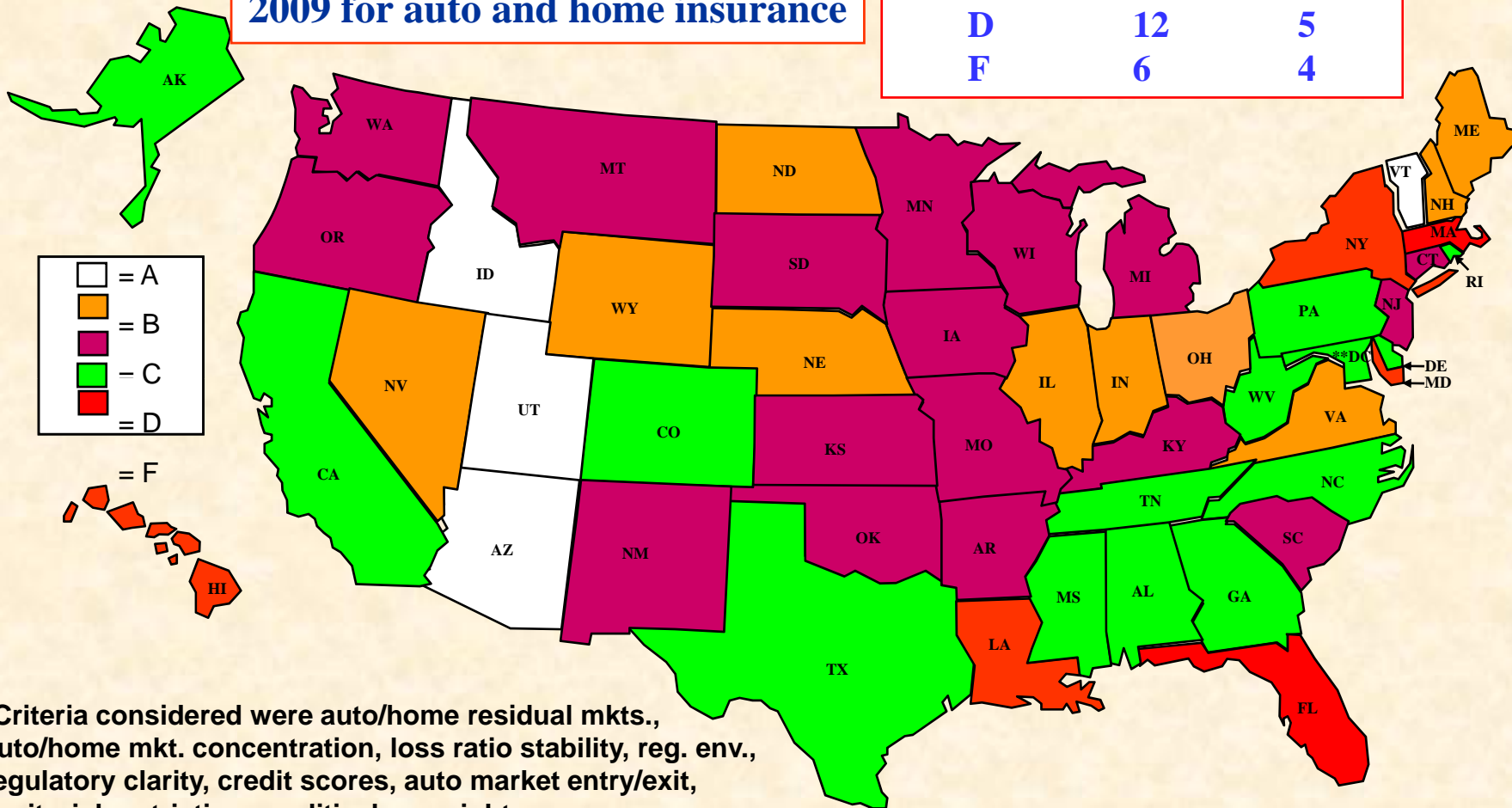
- Creation of Financial Services Oversight Council (FSOC)
  - ONI is not included among Council's membership
- Strengthen Capital and Other Prudential Standards for All Banks, Bank Holding Companies and Tier 1 Financial Holding Companies
- Require Hedge Funds and Other Private Pools of Capital to Register
  - Alternative sources of capital have played a more important role in the wake of major catastrophes such as 9/11 and Hurricane Katrina
- Institute Regulation of All OTC Derivatives, Including CDS's
- International:
  - Strengthen Intl. Capital Framework & Improve Oversight of Global Financial Markets
  - Enhance Supervision of Internationally Active Financial Services Firms
  - Determine appropriate Tier 1 FHC definition for foreign financial firms
- Improve Accounting Standards
- Tighten Oversight of Credit Rating Agencies

# Rating of Auto/Home Insurance Regulatory & Operating Environment\*



**Study suggest the insurance regulatory and operating environments deteriorated in 2009 for auto and home insurance**

<u>GRADE</u>	<u>2009</u>	<u>2008</u>
A	4	7
B	10	25
C	17	10
D	12	5
F	6	4



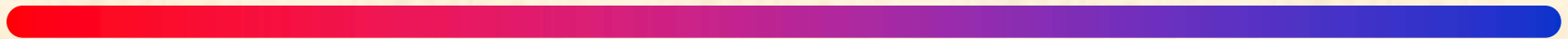
\*Criteria considered were auto/home residual mkts., auto/home mkt. concentration, loss ratio stability, reg. env., regulatory clarity, credit scores, auto market entry/exit, territorial restrictions, political oversight.

\*\*Information not available.

Source: Heartland Institute, May 2009

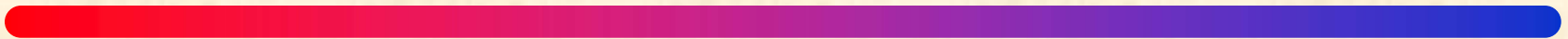
# P/C INSURANCE FINANCIAL PERFORMANCE

**A Resilient Industry in  
Challenging Times**



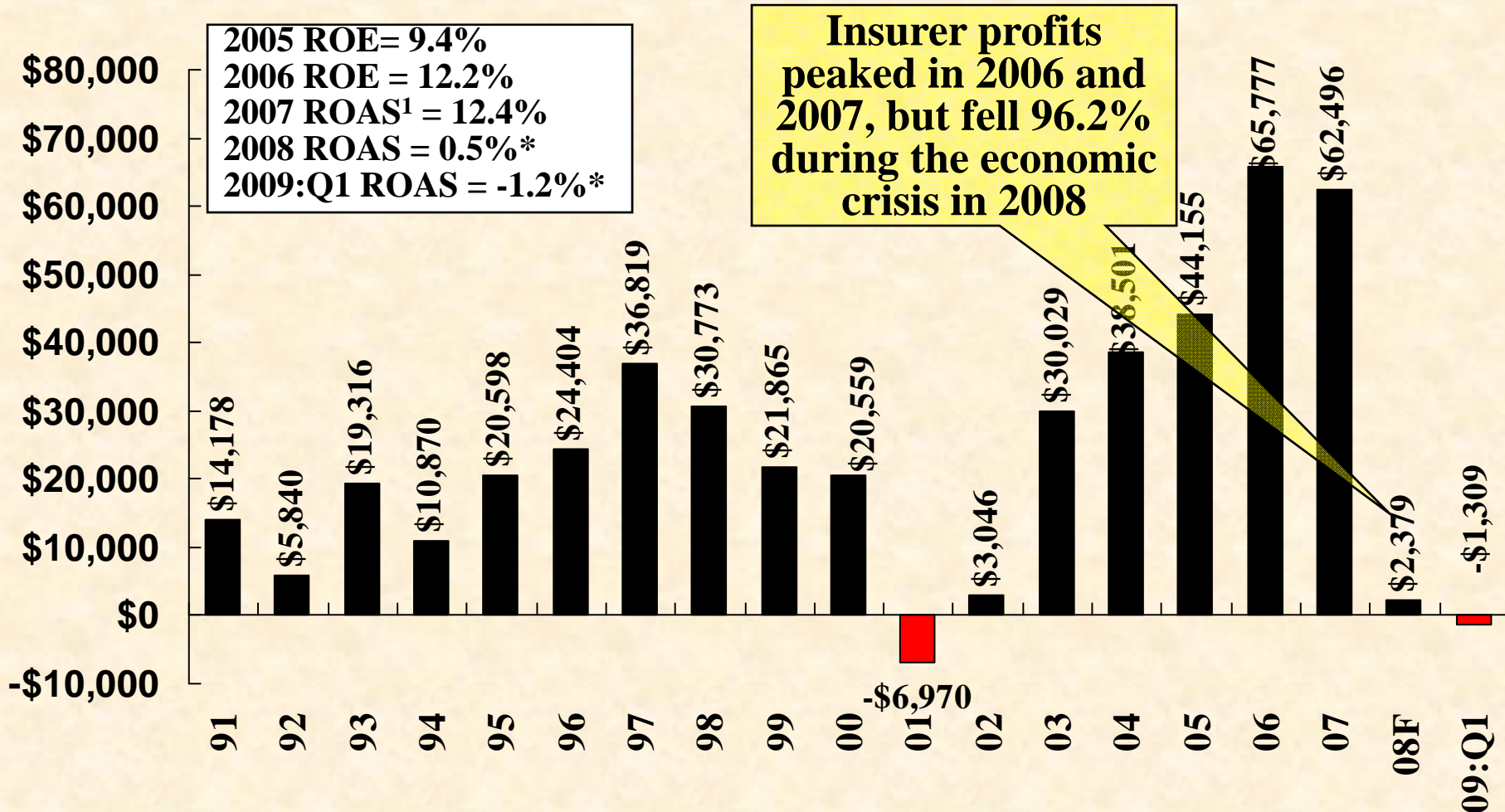
# Profitability

**Historically Volatile**





# *P/C Net Income After Taxes 1991-2009:Q1 (\$ Millions)\**

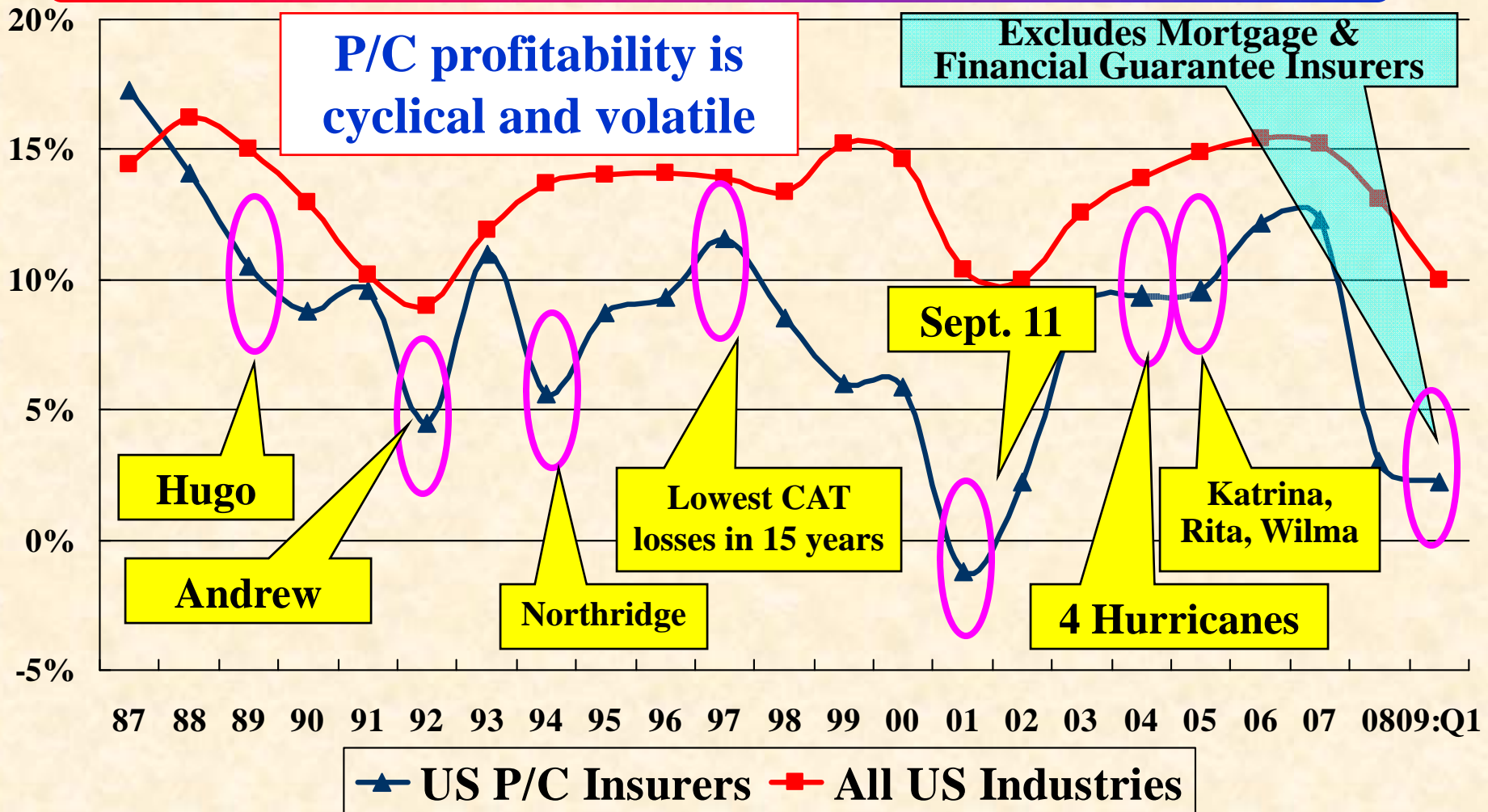


\*ROE figures are GAAP; <sup>1</sup>Return on avg. surplus. Excluding Mortgage & Financial Guarantee insurers yields an 4.2% ROAS for 2008 and 2.2%. 2009:Q1 net income was \$2.4 billion excl. M&FG.



# ROE: P/C vs. All Industries

## 1987–2009: Q1\*

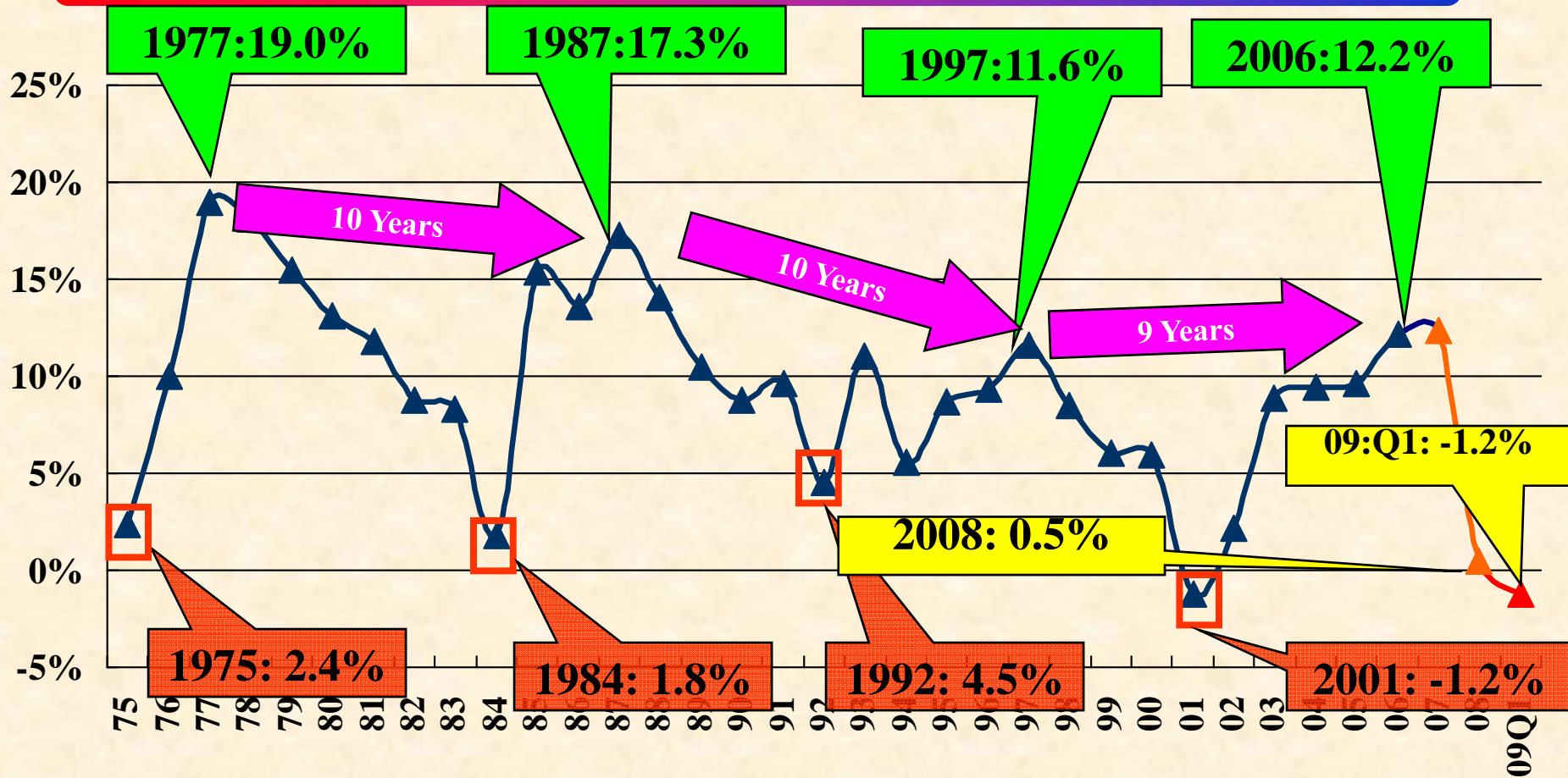


\*Excludes Mortgage & Financial Guarantee in 2008 and 2009  
Sources: ISO, *Fortune*; Insurance Information Institute.





# *P/C Insurance Industry ROEs, 1975 – 2009:Q1\**

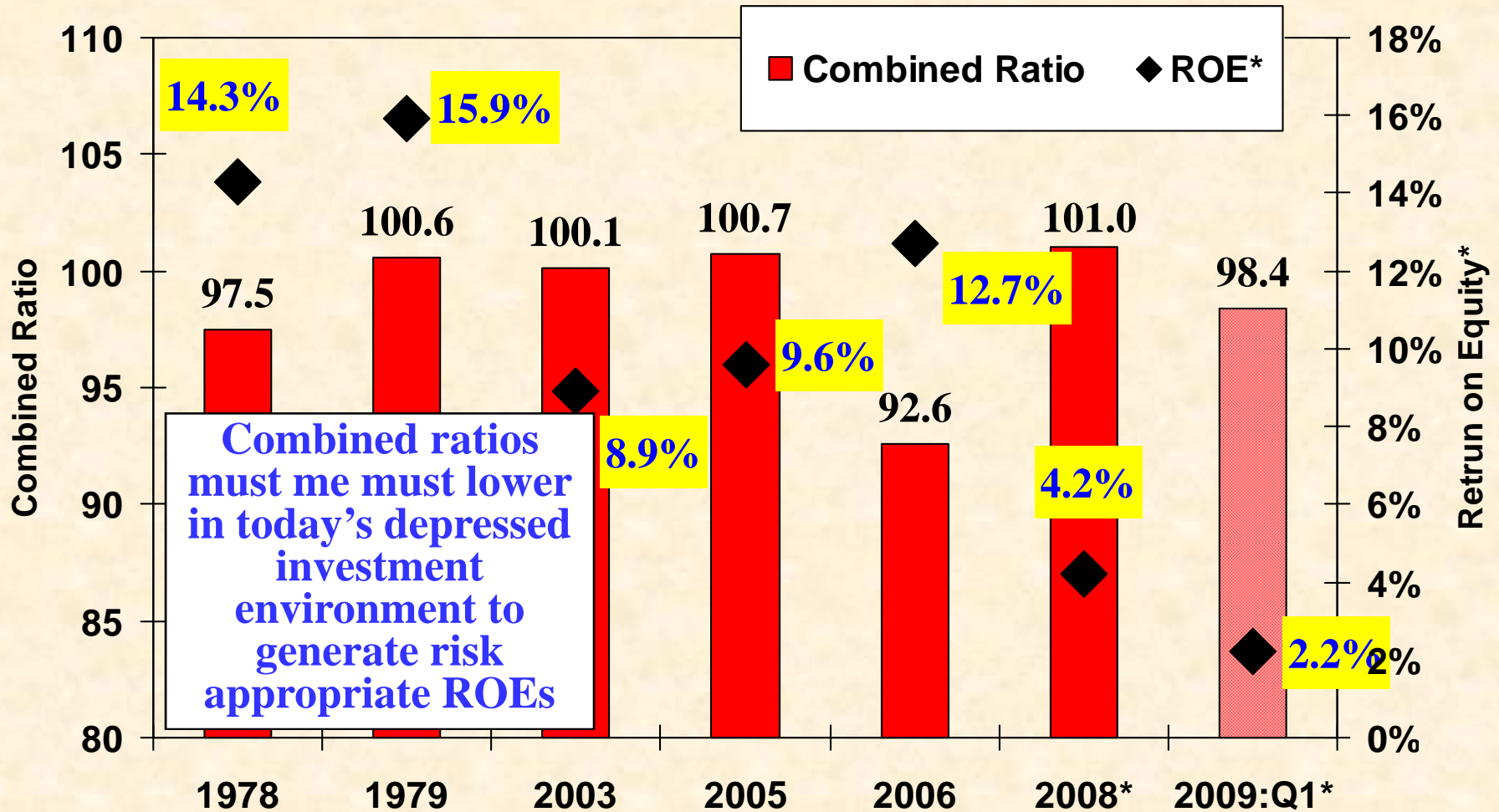


Note: 2008 result excluding Mortgage & Financial Guarantee insurers is 4.2% and 2.2 in Q1 2009.

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



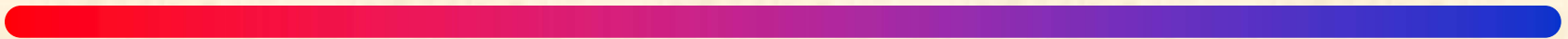
# A 100 Combined Ratio Isn't What it Used to Be: 95 is Where It's At



\* 2008/9 figures are return on average statutory surplus. Excludes mortgage and financial guarantee insurers.

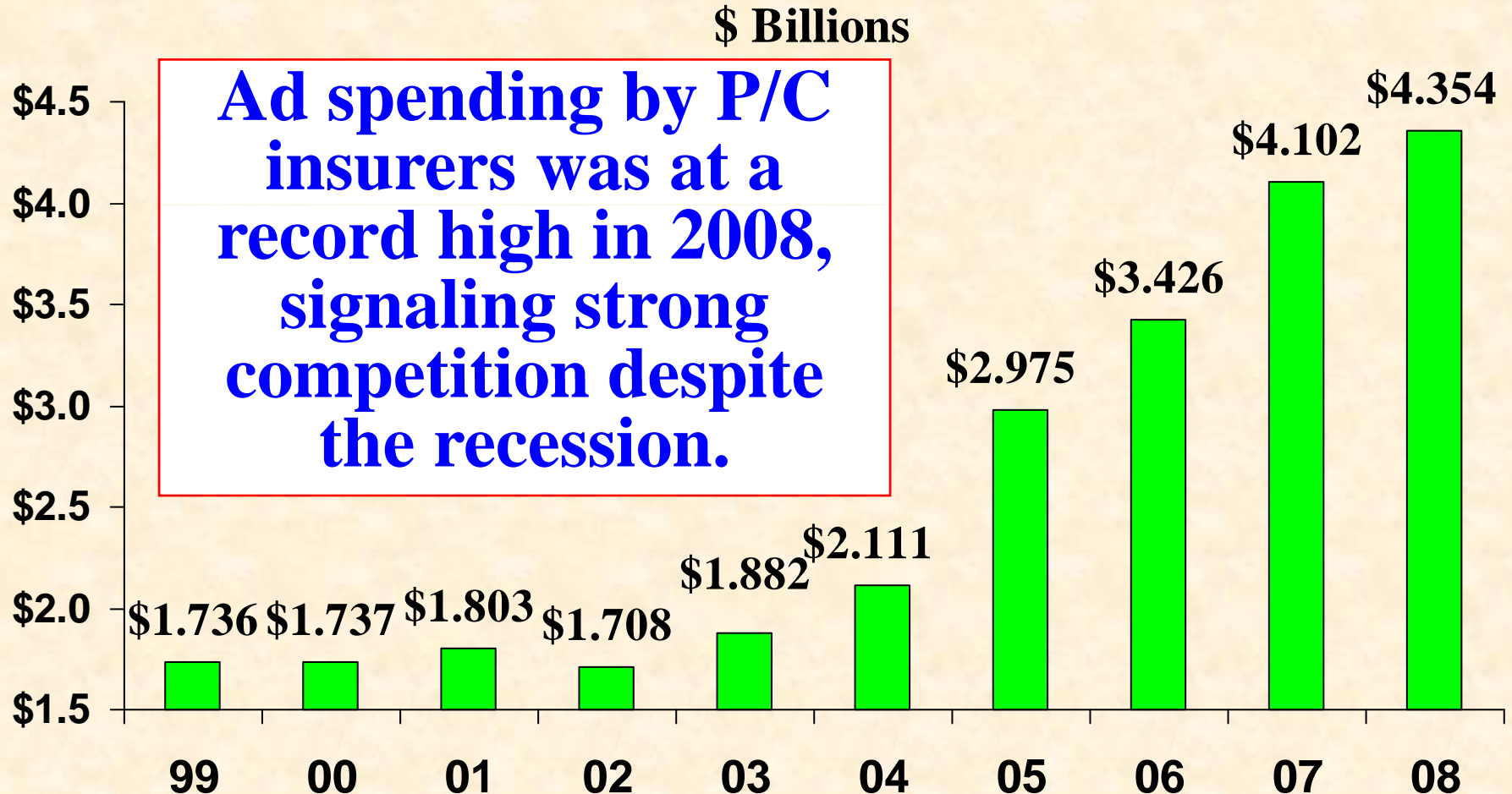
Source: Insurance Information Institute from A.M. Best and ISO data.

# Advertising Trends





# Advertising Expenditures by P/C Insurance Industry, 1999-2008



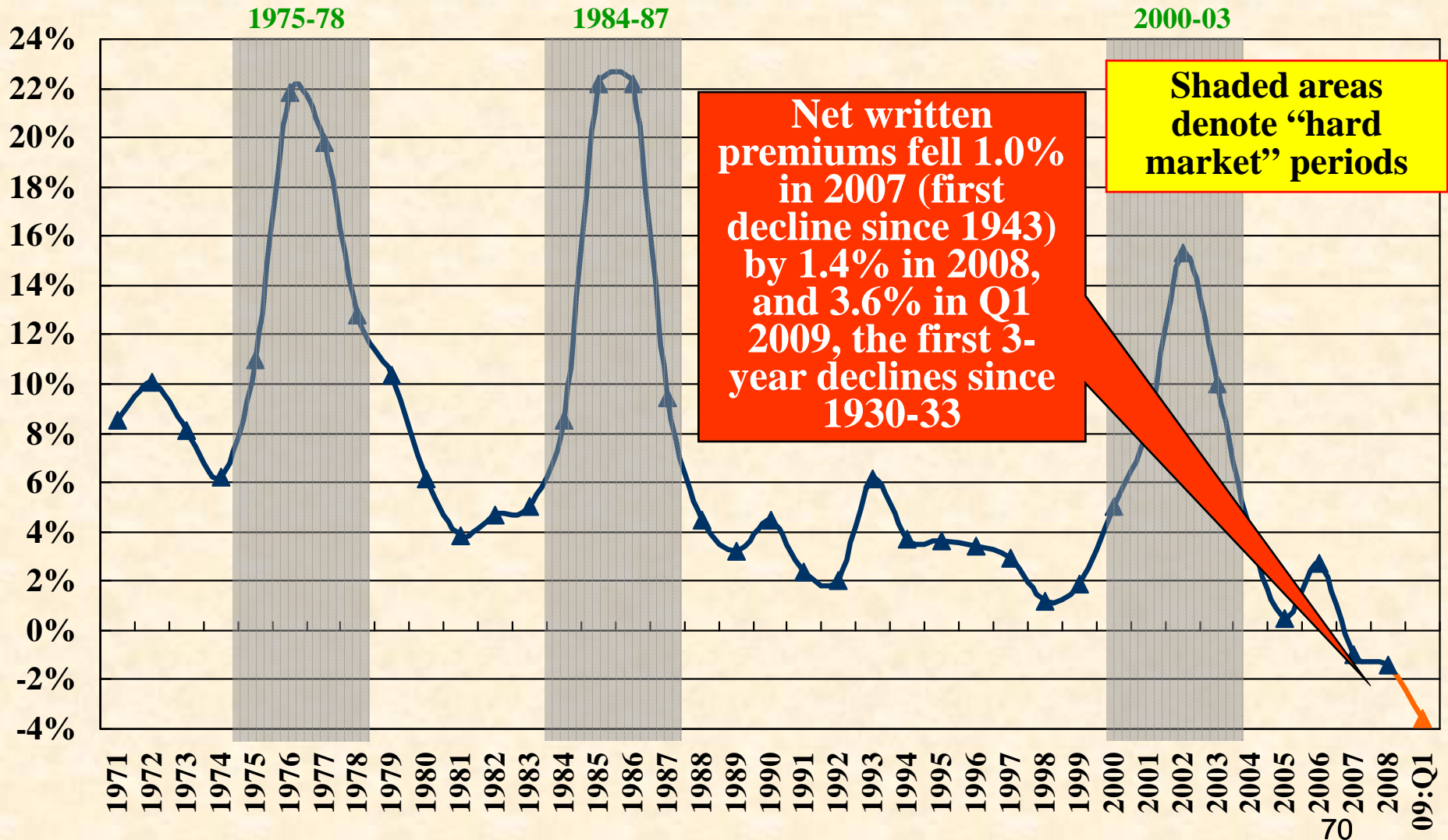
# P/C Premium Growth

**Primarily Driven by the  
Industry's Underwriting  
Cycle, Not the Economy**



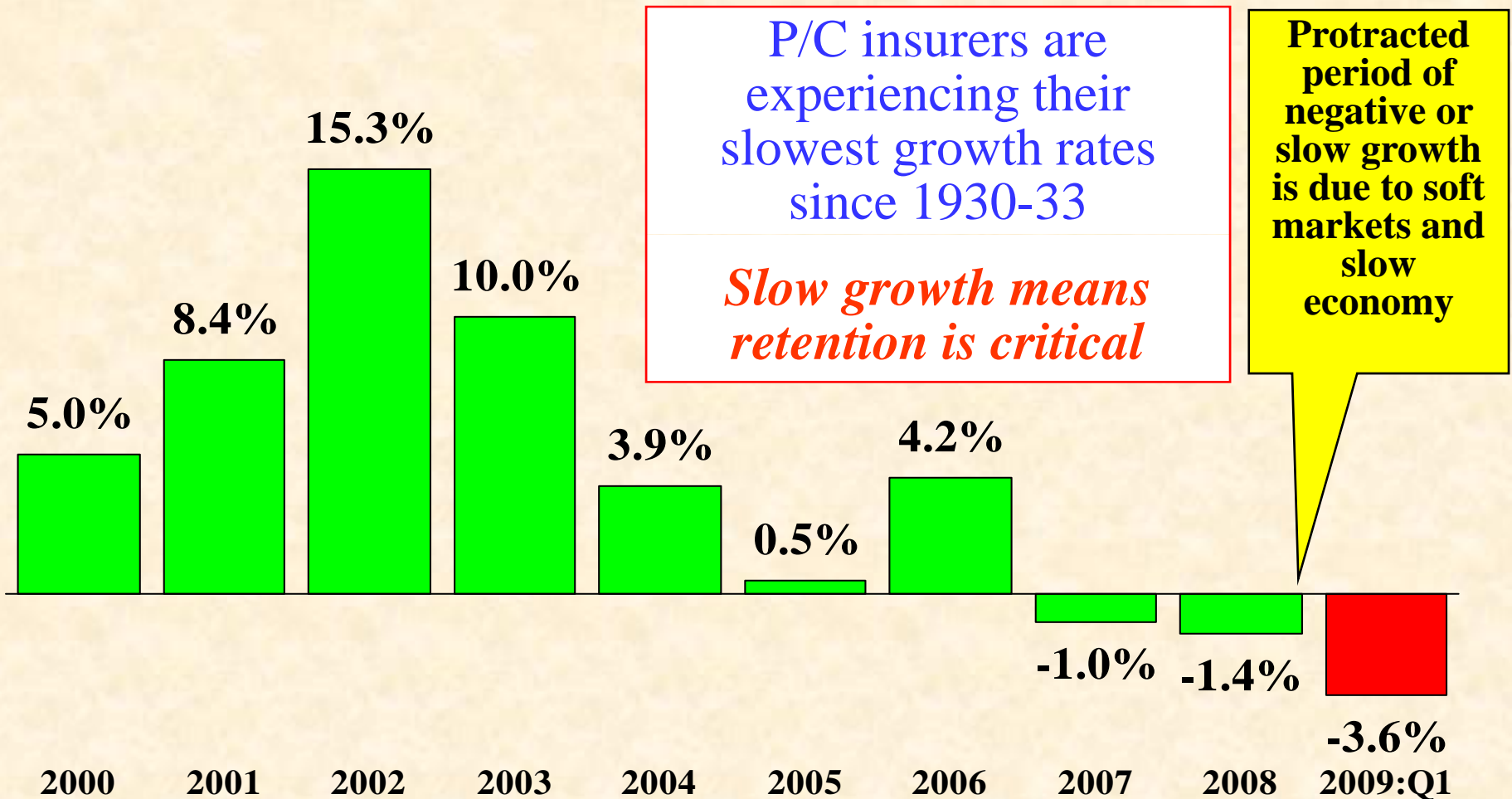


# Strength of Recent Hard Markets by NWP Growth





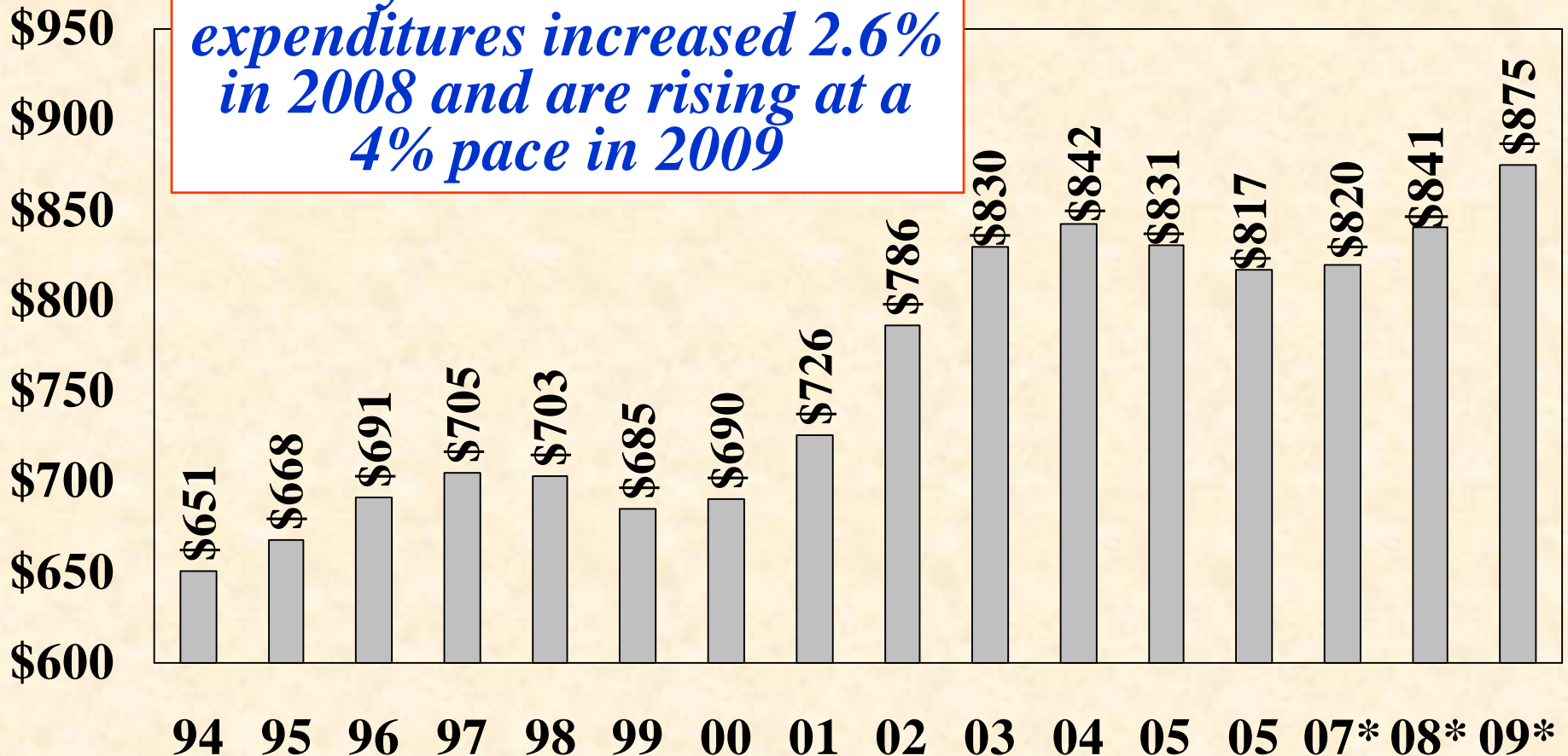
# Year-to-Year Change in Net Written Premium, 2000-2009:Q1





# Average Expenditures on Auto Insurance

*Countrywide auto insurance expenditures increased 2.6% in 2008 and are rising at a 4% pace in 2009*



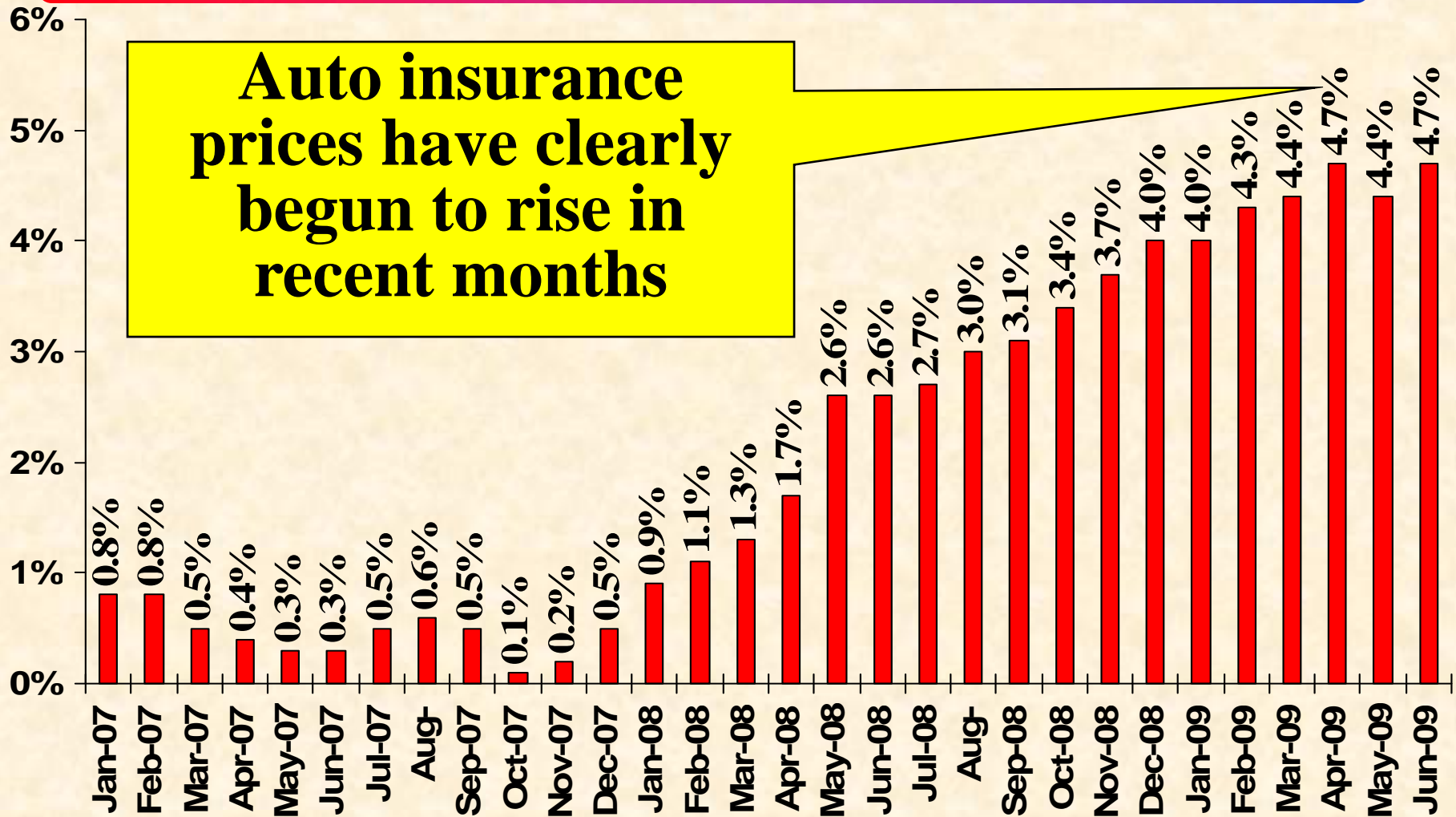
\*Insurance Information Institute Estimates/Forecasts

Source: NAIC, Insurance Information Institute estimates 2007-2009 based on CPI data.





# Monthly Change in Auto Insurance Prices\*



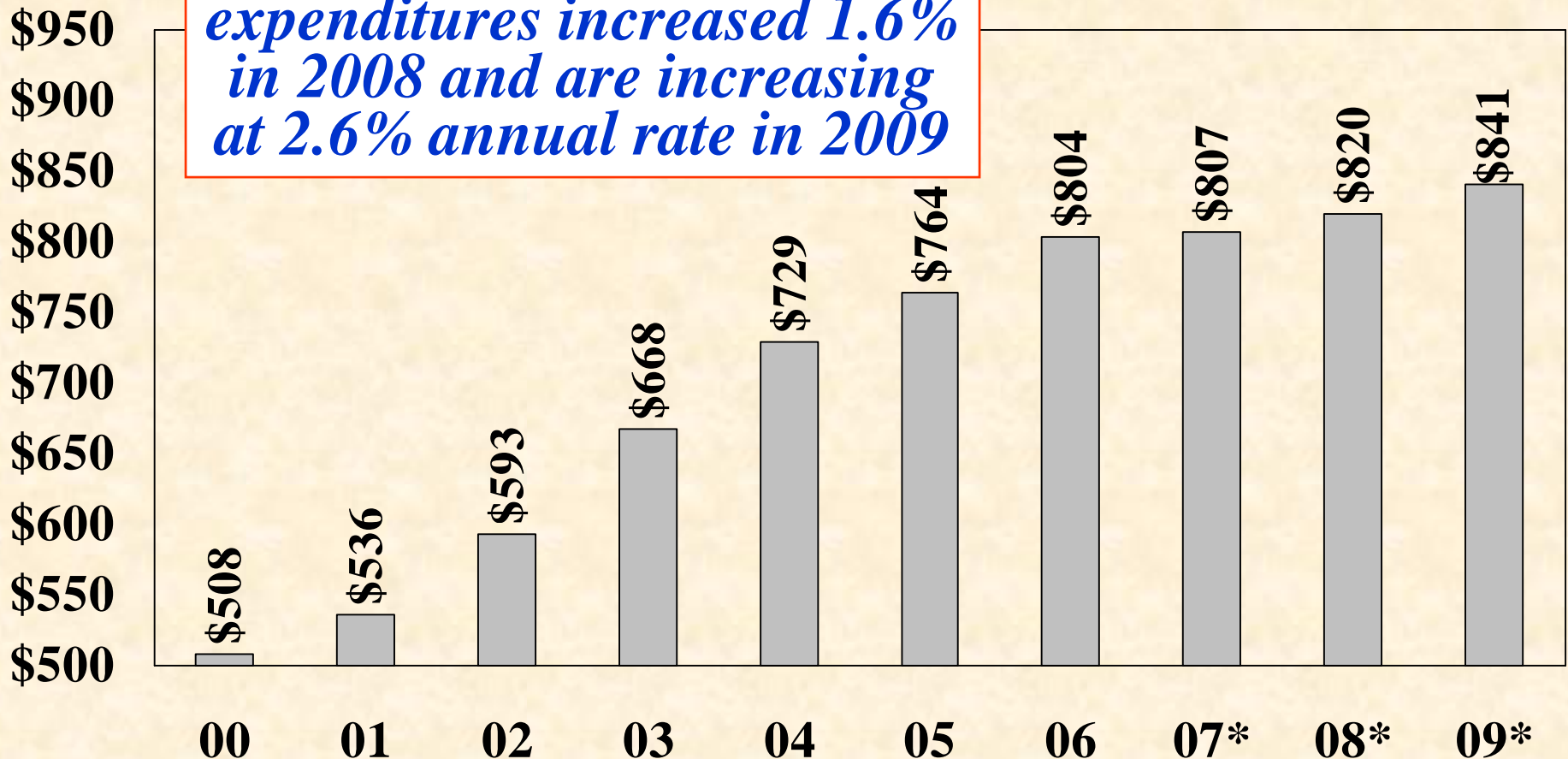
\*Percentage change from same month in prior year.

Source: US Bureau of Labor Statistics



# Average Premium for Home Insurance Policies\*\*

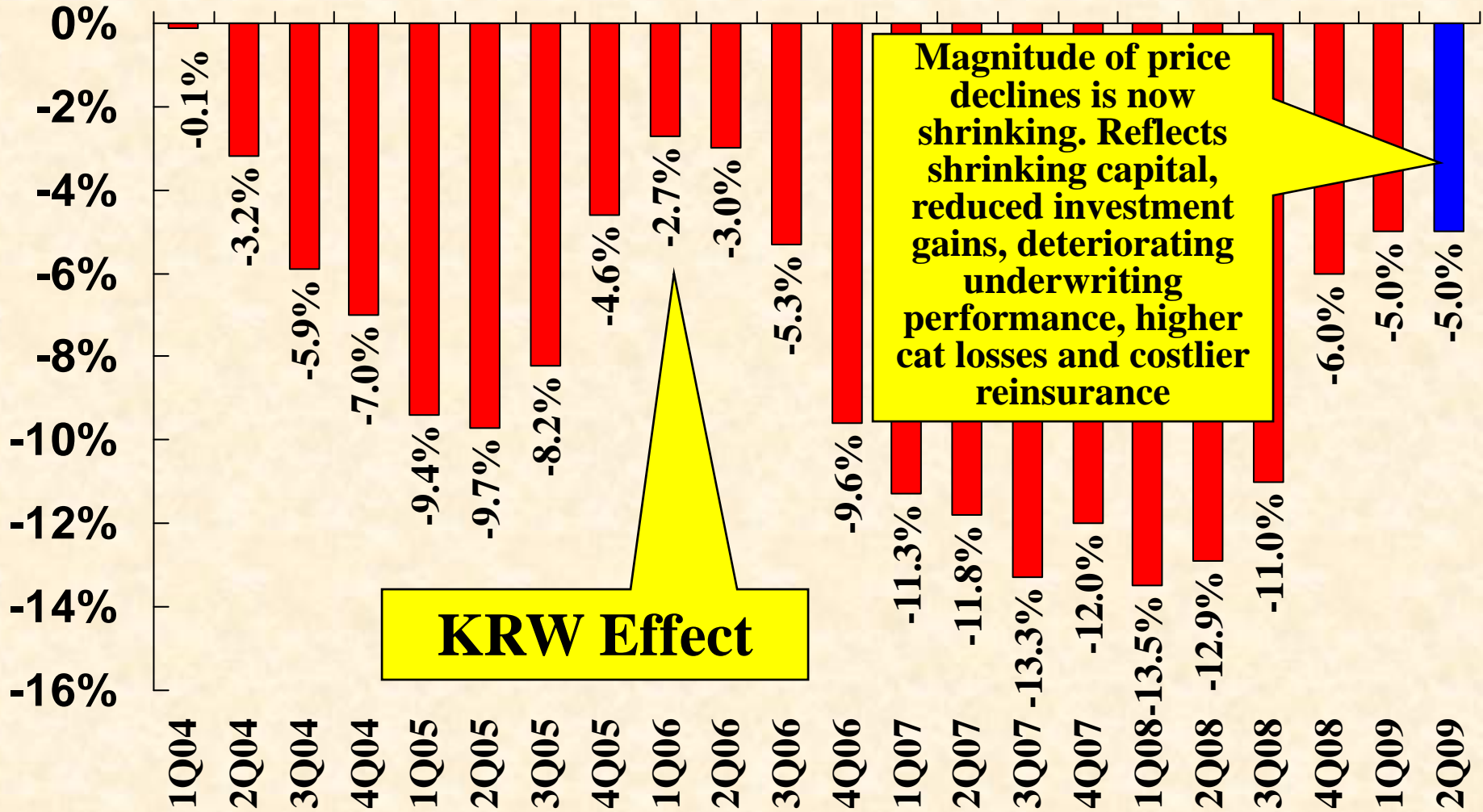
*Countrywide auto insurance expenditures increased 1.6% in 2008 and are increasing at 2.6% annual rate in 2009*



\*Insurance Information Institute Estimates/Forecasts \*\*Excludes state-run insurers.  
Source: NAIC, Insurance Information Institute estimates 2007-2009 based on CPI data.



# Average Commercial Rate Change, All Lines, (1Q:2004 – 2Q:2009)



# *PROFITS IN TEXAS:*

*Sometimes a*

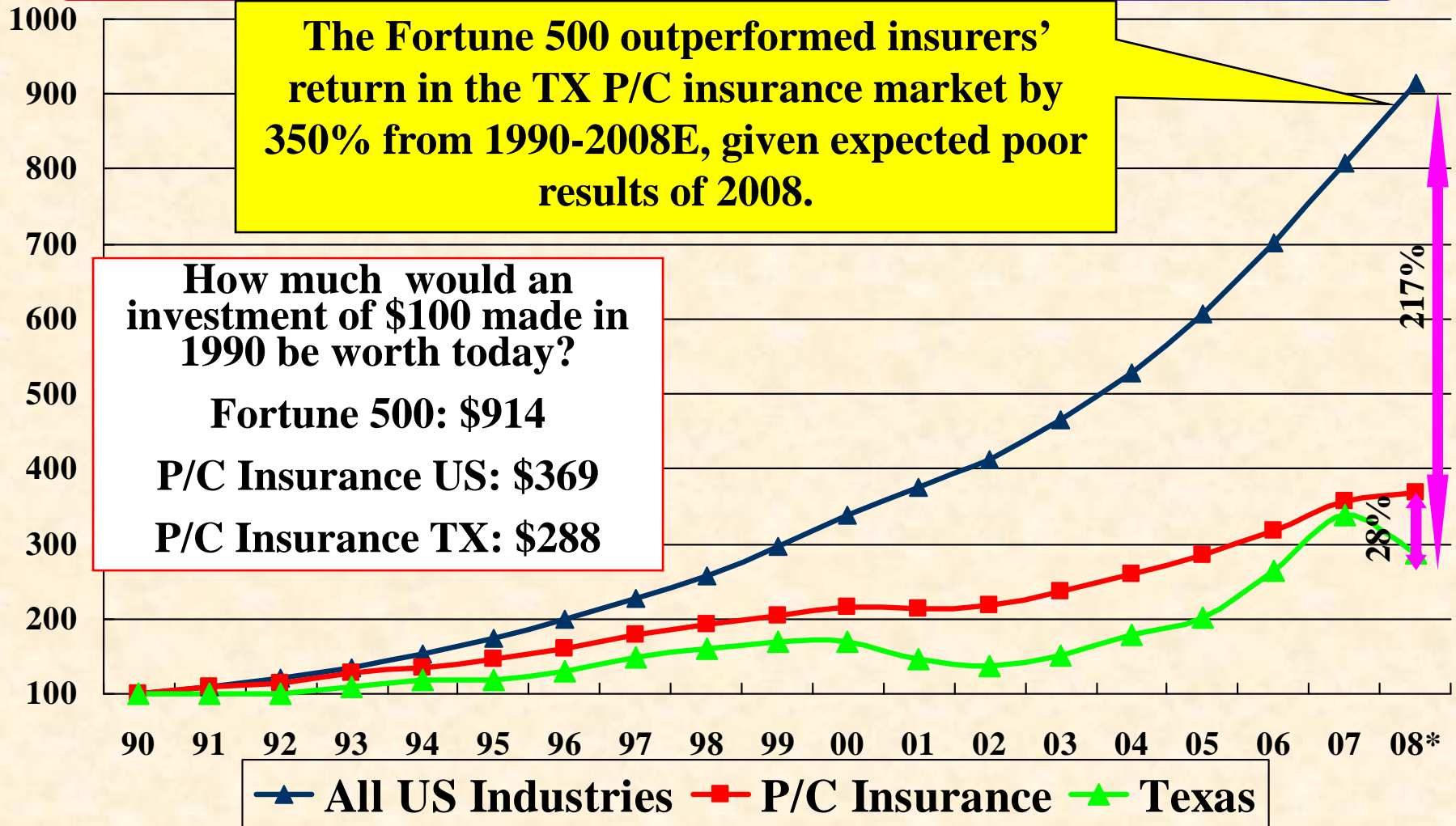
*Laggard, Ike Sets TX*

*Further Behind*





# Profitability Index: Texas vs. US P/C vs. All Industries, 1990=100



\*Assumes a TX RNW of -15% in 2008.

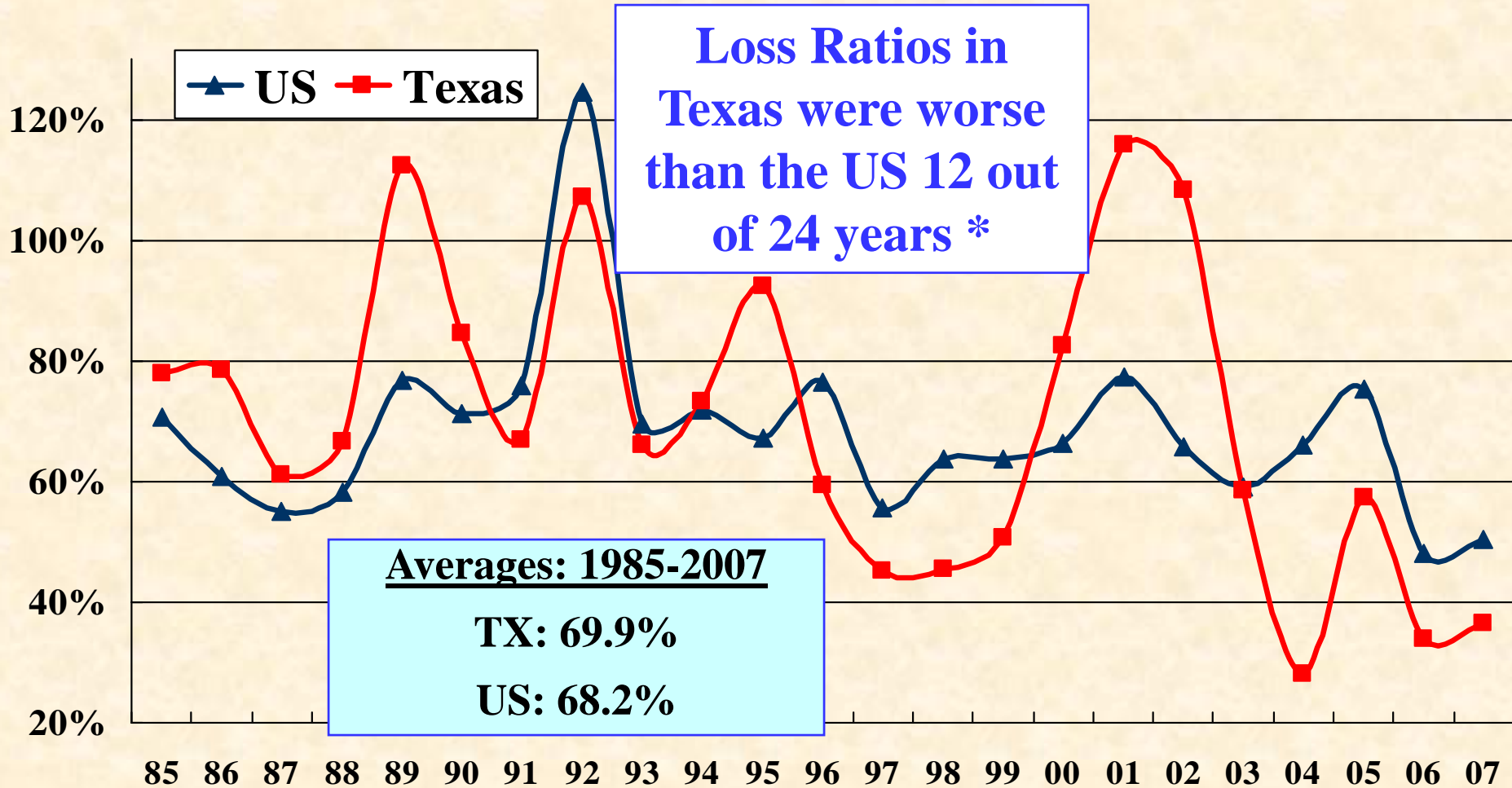
Source: Insurance Information Institute; NAIC, *Fortune*



# Homeowners Direct Loss

## Ratios: TX vs. US

1985-2007

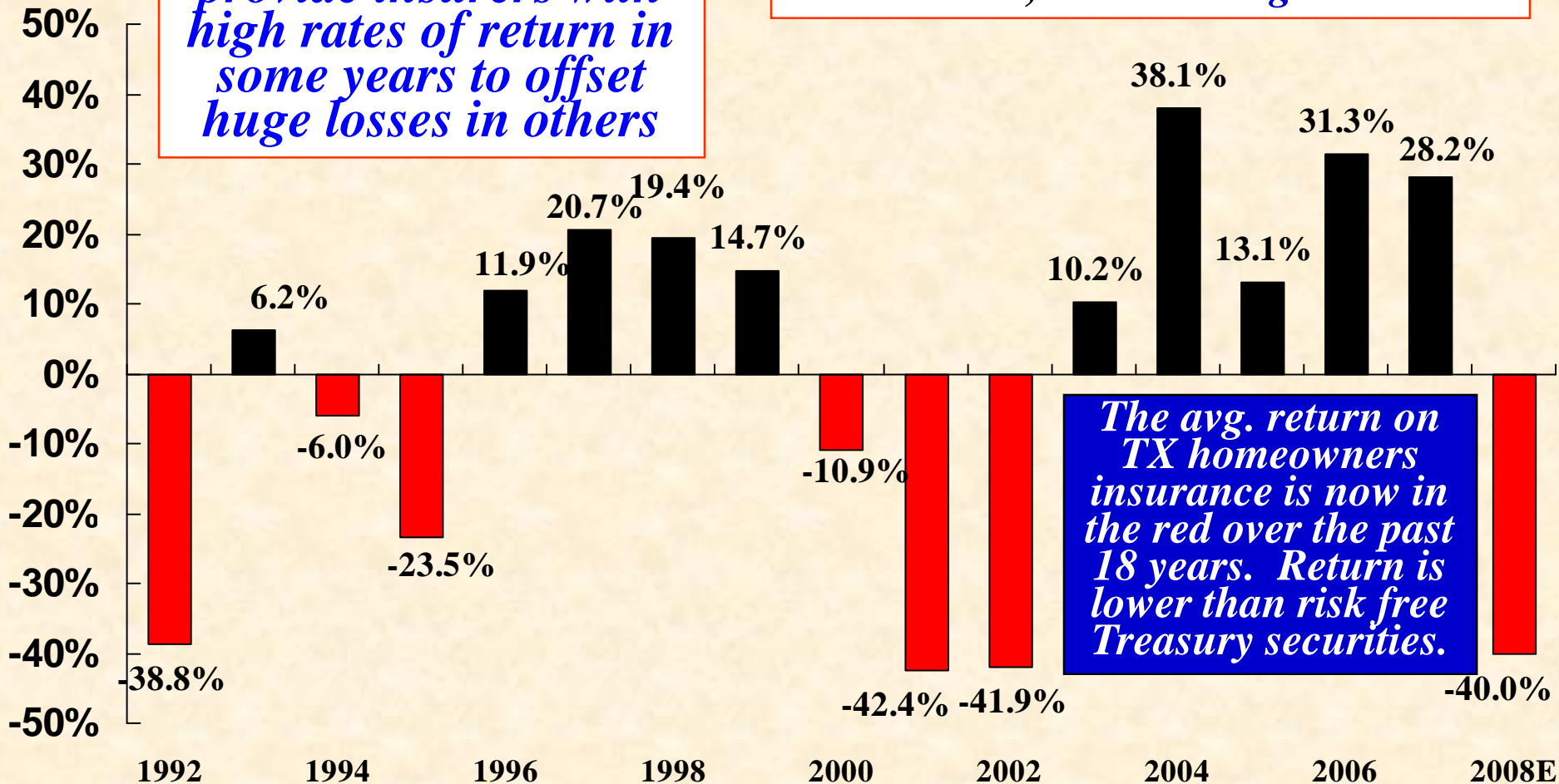


Source: NAIC; Insurance Information Institute. \*Official 2008 figures unavailable, but Hurricane Ike assures TX performed worse than the US overall.

# ROE for Homeowners Insurance in Texas, 1992 – 2008E

*Texas will need to provide insurers with high rates of return in some years to offset huge losses in others*

*Average ROE in TX 1992 through 2007 was 1.9%; -0.6% through 2008E*

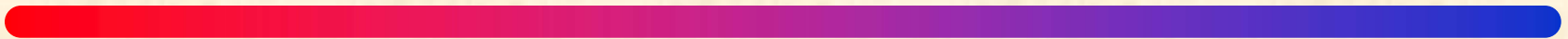


*The avg. return on TX homeowners insurance is now in the red over the past 18 years. Return is lower than risk free Treasury securities.*

Source: NAIC; Insurance Information Institute.

# *TEXAS:*

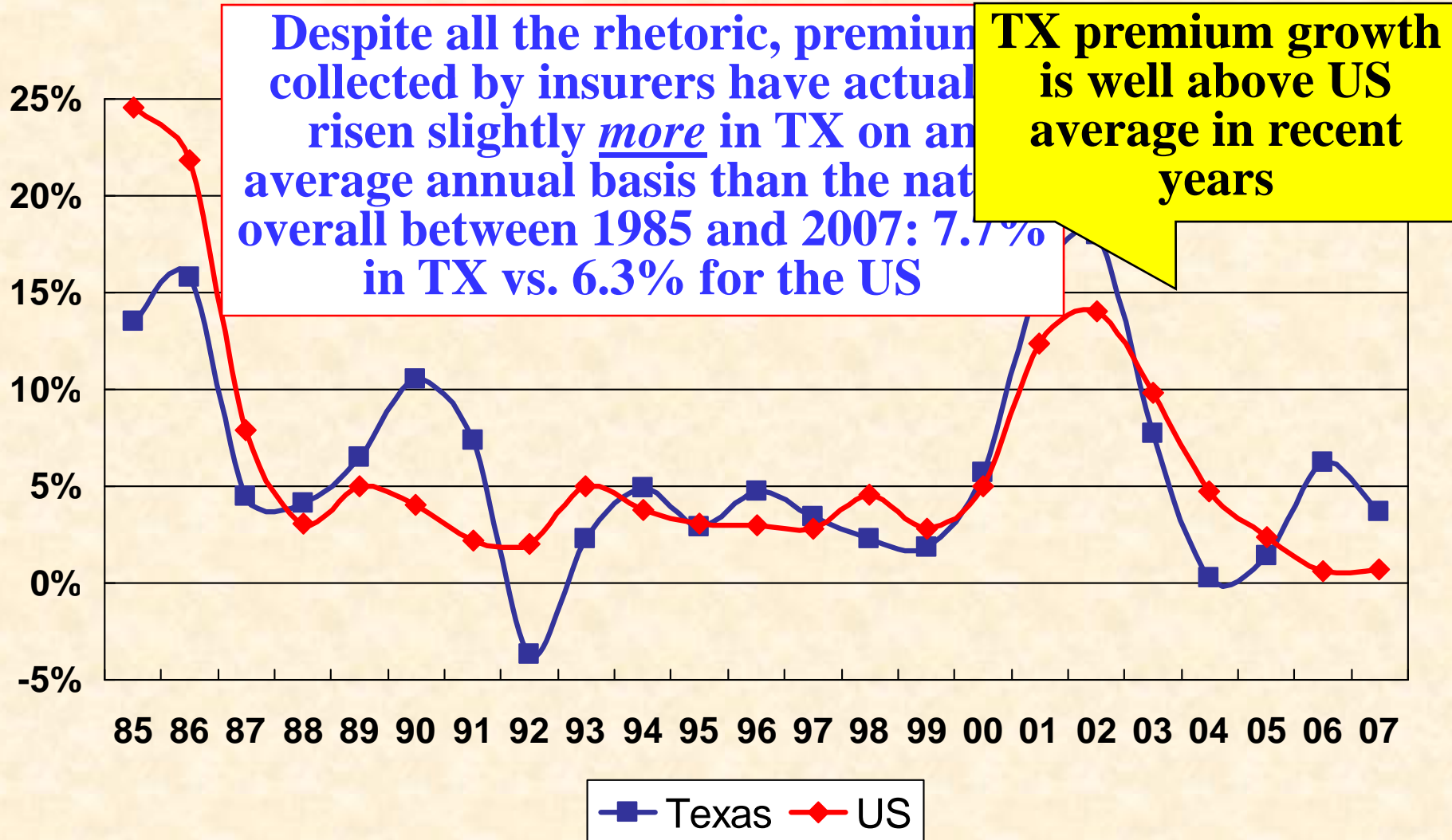
## *A GROWTH & PROFIT COMPARISON*





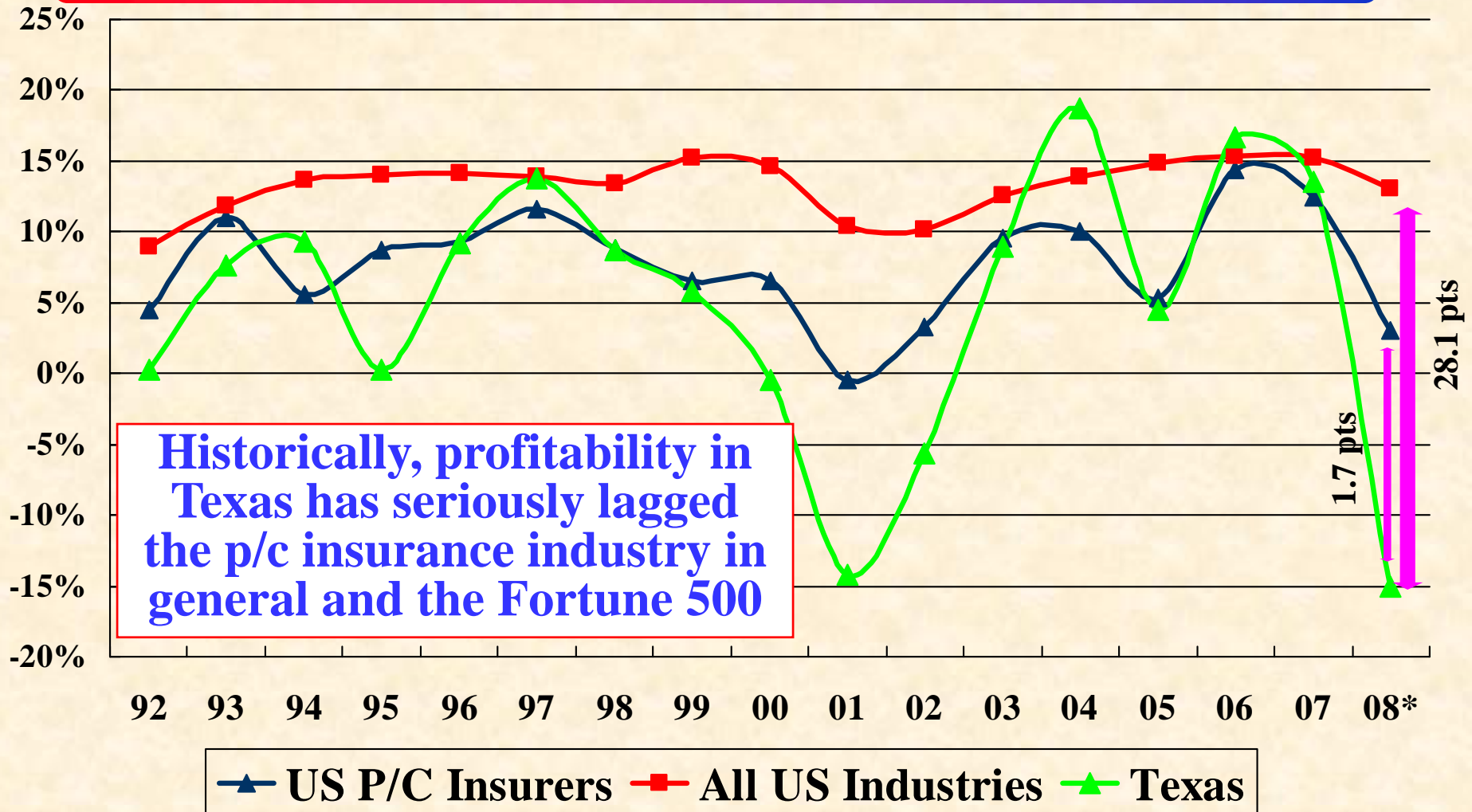


# Growth in Direct Written Premiums: TX and US





# ROE: US & TX P/C vs. All Industries, 1992–2008E



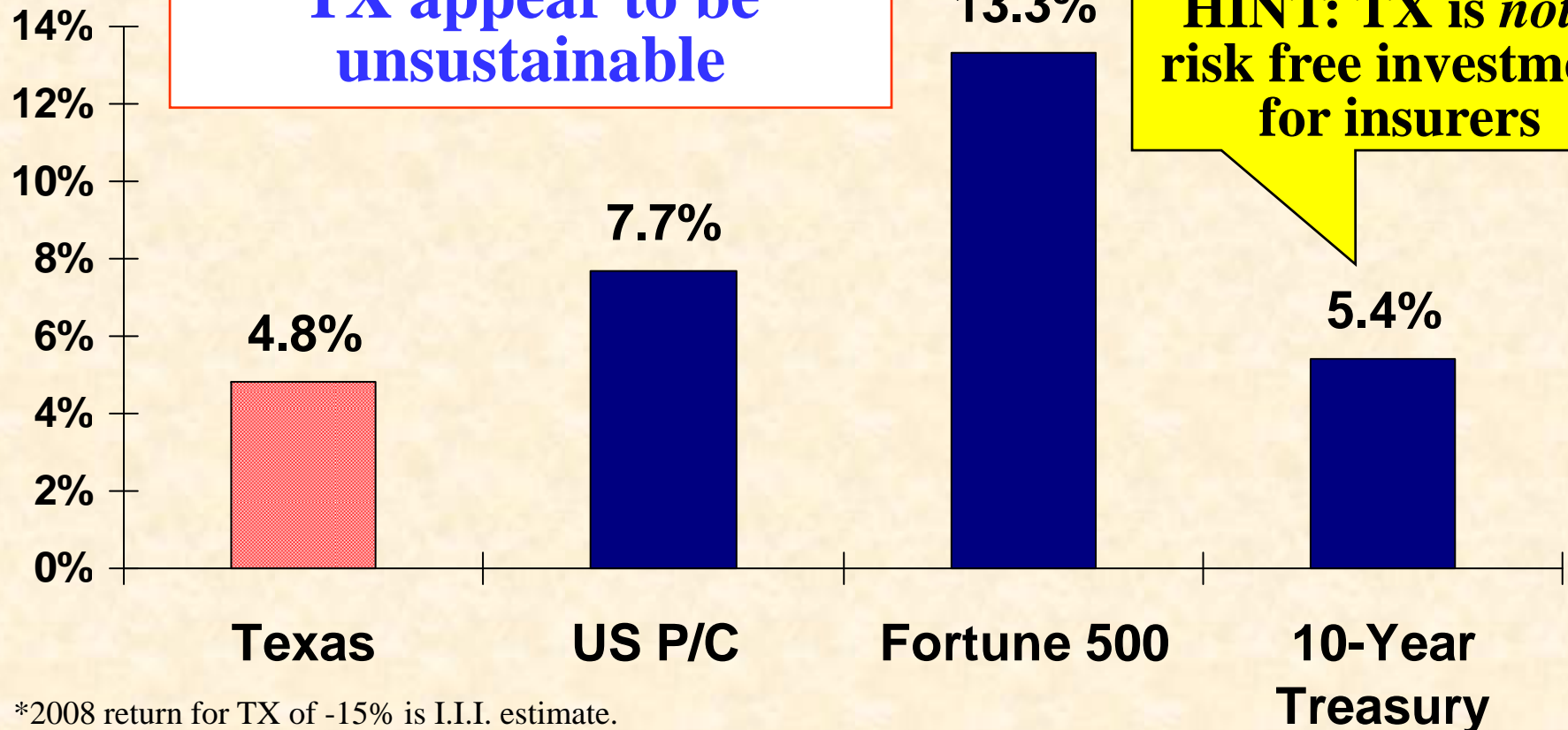
Source: Insurance Information Institute; NAIC, *Fortune*; I.I.I. estimate of -15% in 2008 influenced primarily by Hurricane Ike losses.

# Average ROE Comparison Shows Texas is Profit Laggard, 1992 – 2008\*

Despite occasional good years, improvements in TX appear to be unsustainable

TX is below even a risk-free return on Treasury securities.

HINT: TX is *not* a risk free investment for insurers

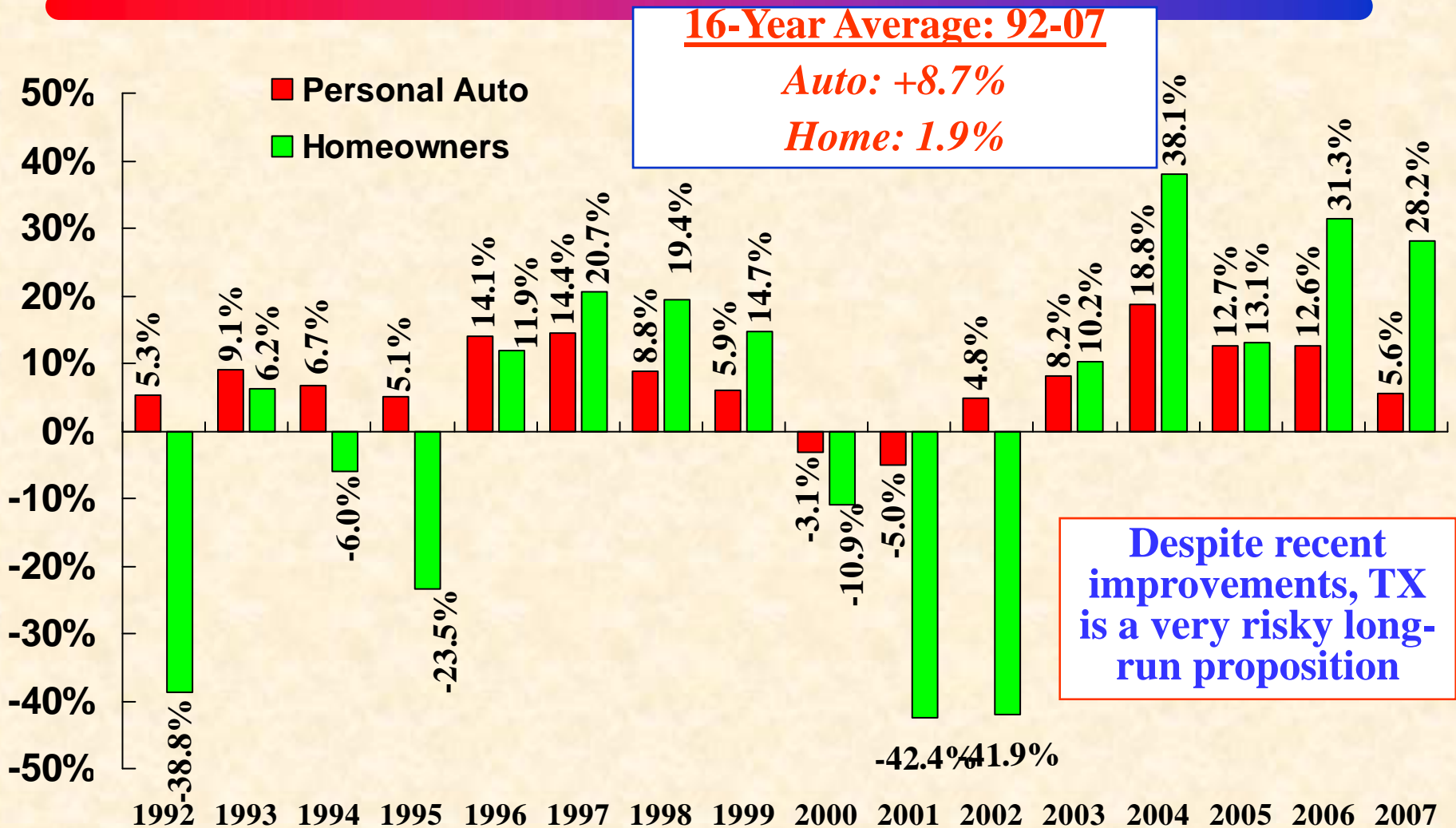


\*2008 return for TX of -15% is I.I.I. estimate.

Source: Insurance Information Institute from NAIC, Fortune and Federal Reserve data.

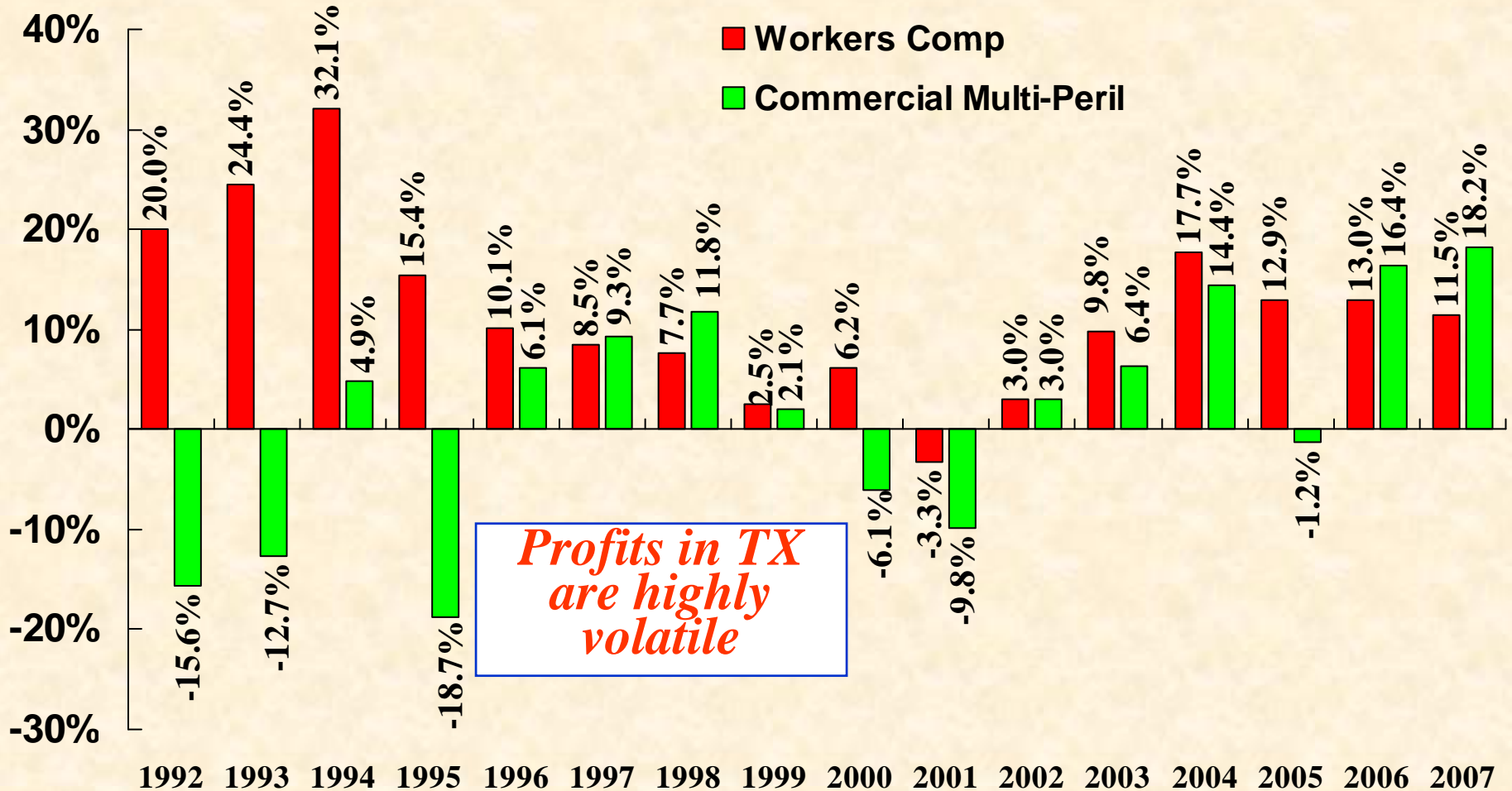


# ROE for Personal Lines in Texas 1992 - 2007



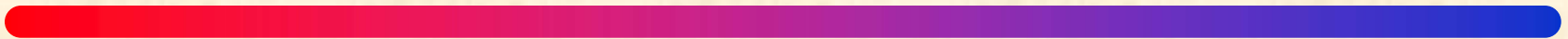


# ROE for Major Commercial Lines in TX, 1992 - 2007



# Merger & Acquisition

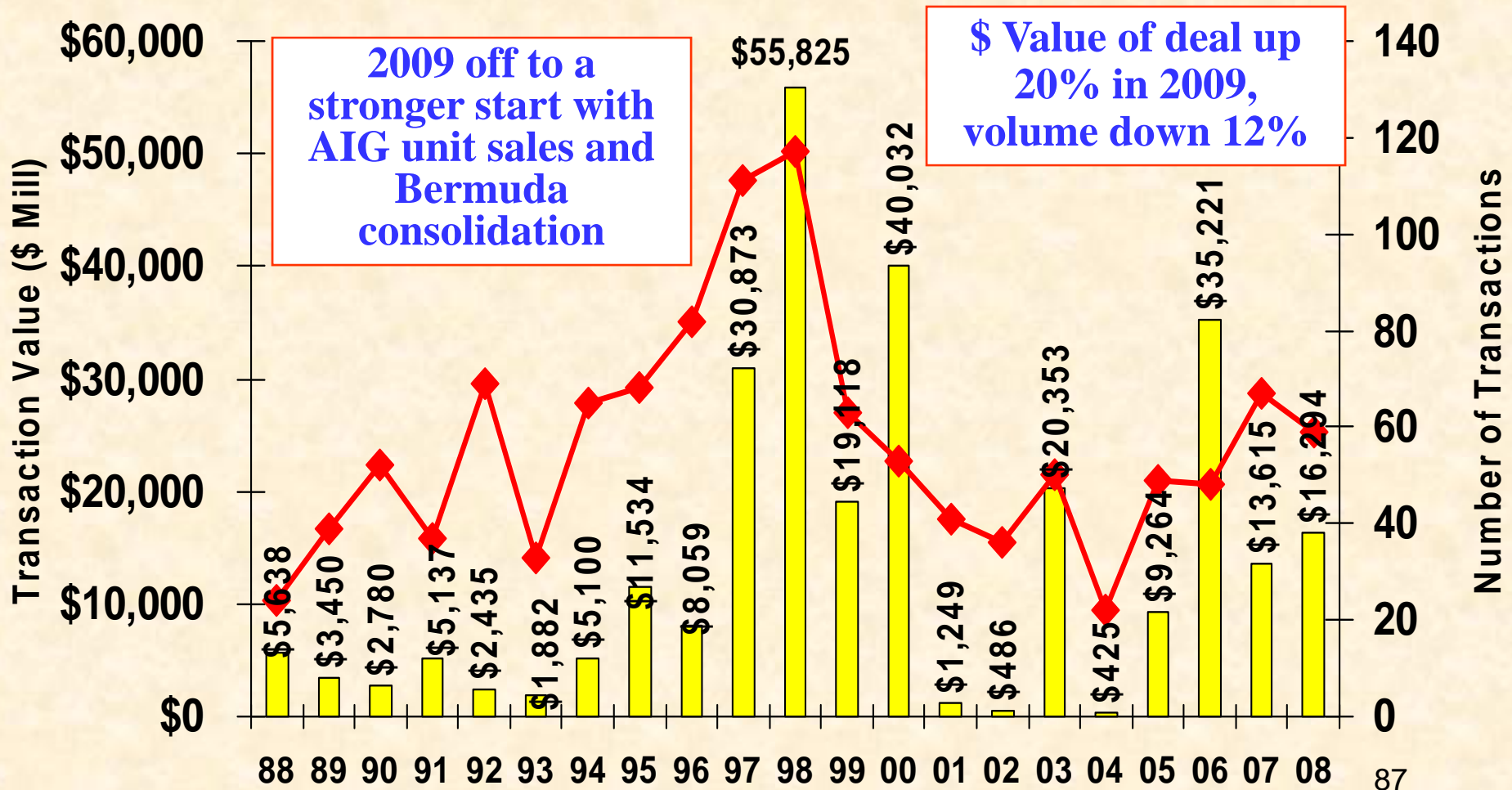
**Barriers to Consolidation  
Will Diminish in 2009/10**





# *P/C Insurance-Related M&A Activity, 1988-2008*

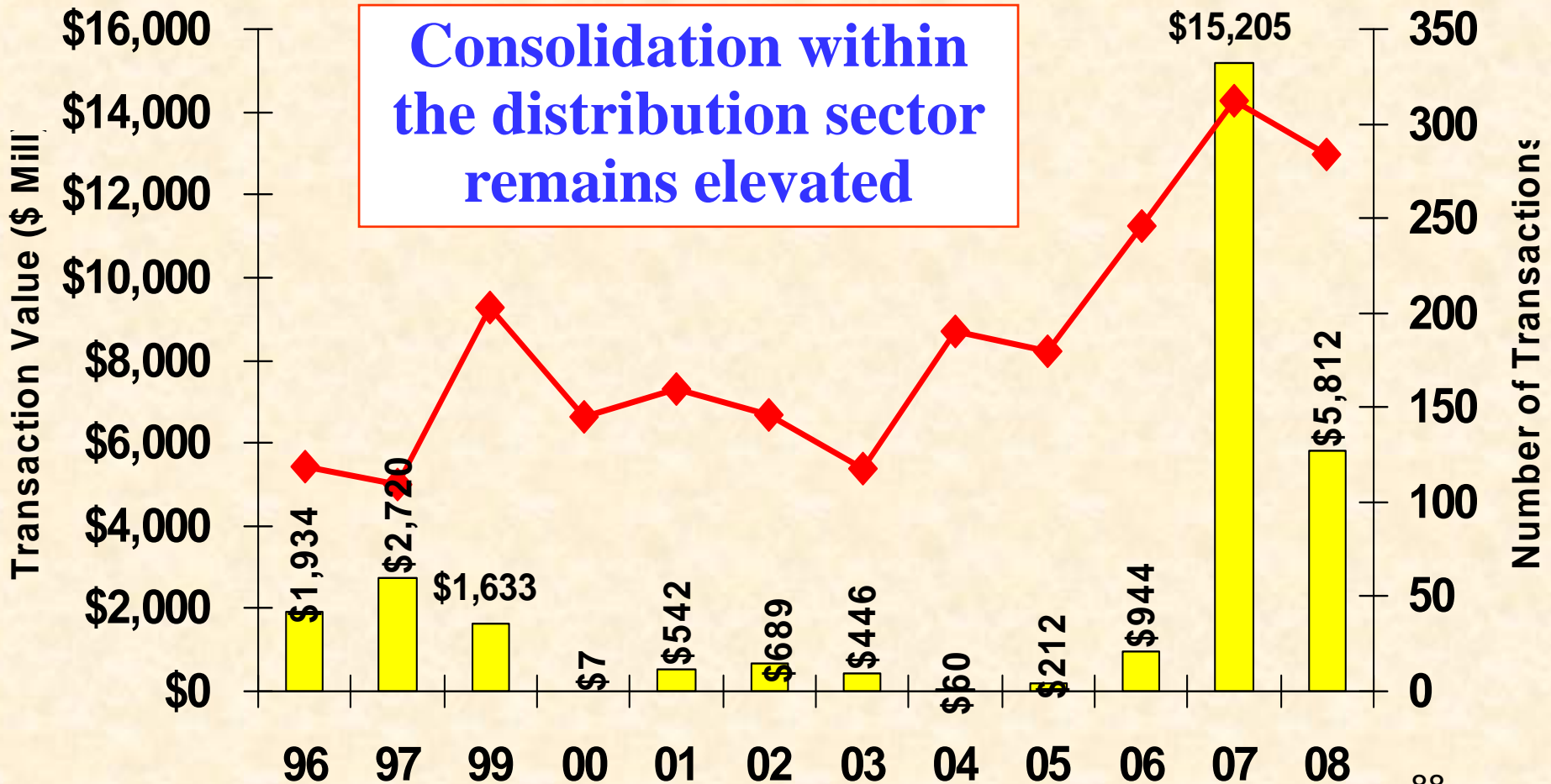
Transaction Values ◆ Number of Transactions





# *Distribution Sector: Insurance-Related M&A Activity, 1988-2008*

Transaction Values ◆ Number of Transactions



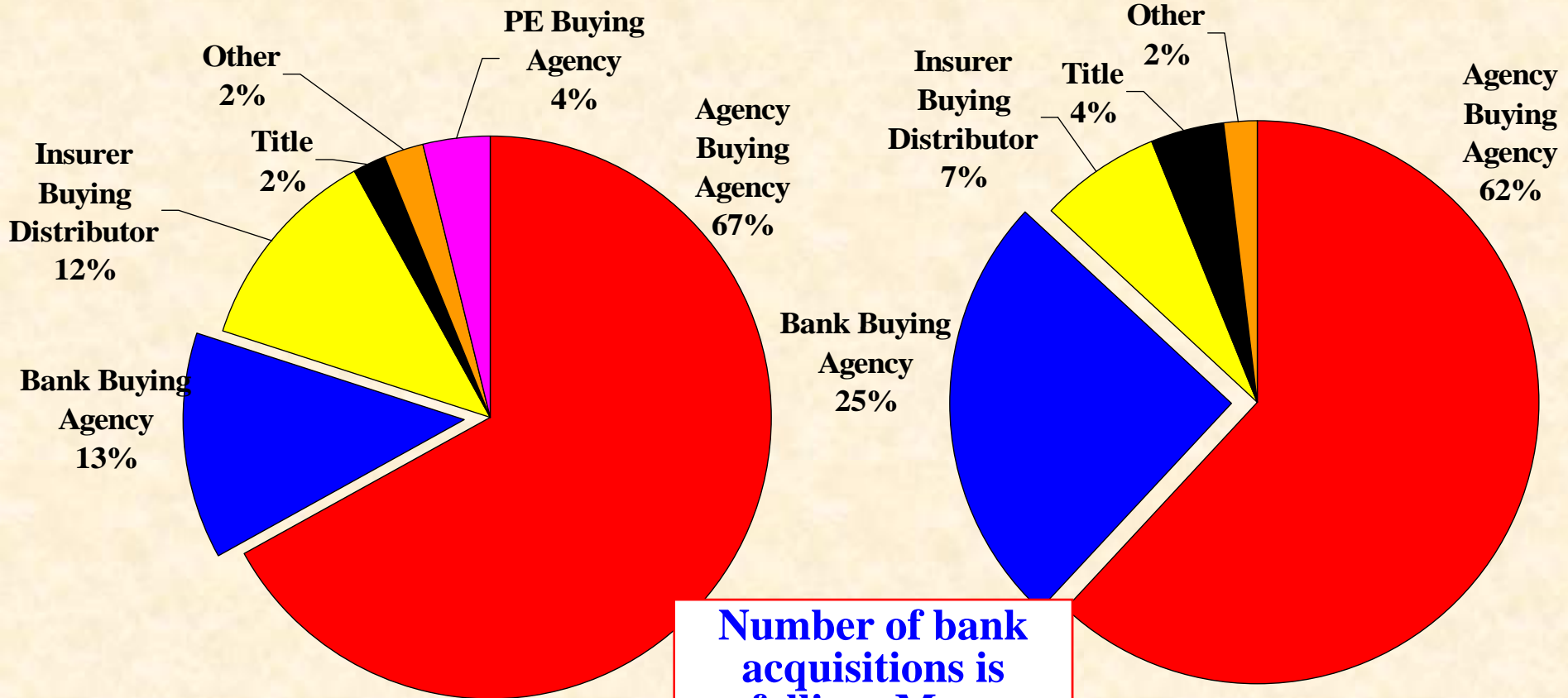




# Distribution Sector M&A Activity, 2008 vs. 2006

**2008**

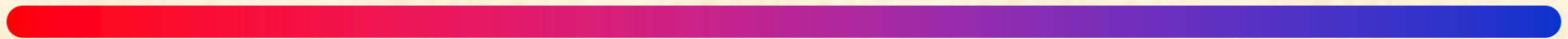
**2006**



**Number of bank acquisitions is falling; More private equity interest**

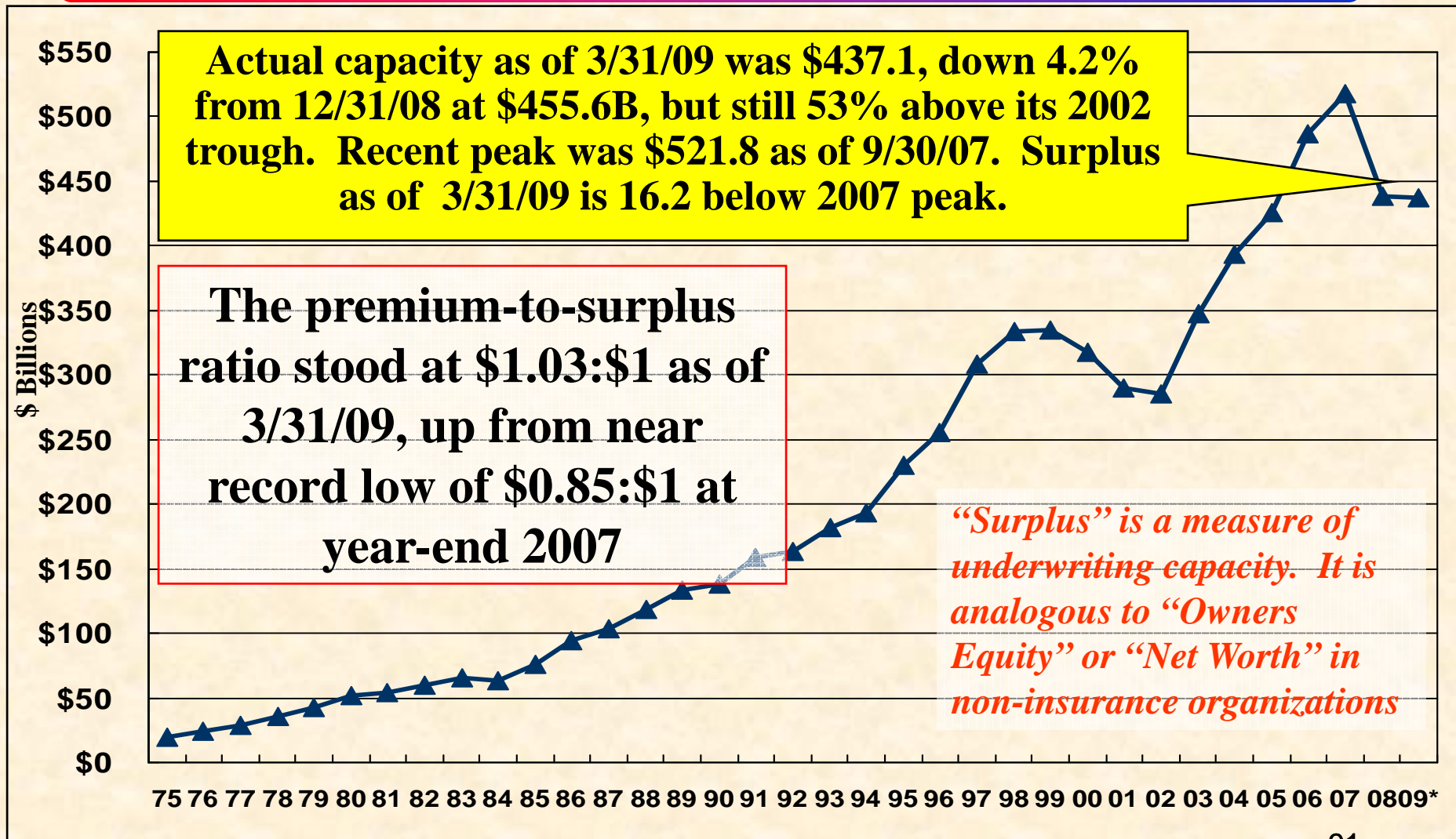
# Capital/ Policyholder Surplus

Shrinkage, but  
Capital is Within  
Historic Norms



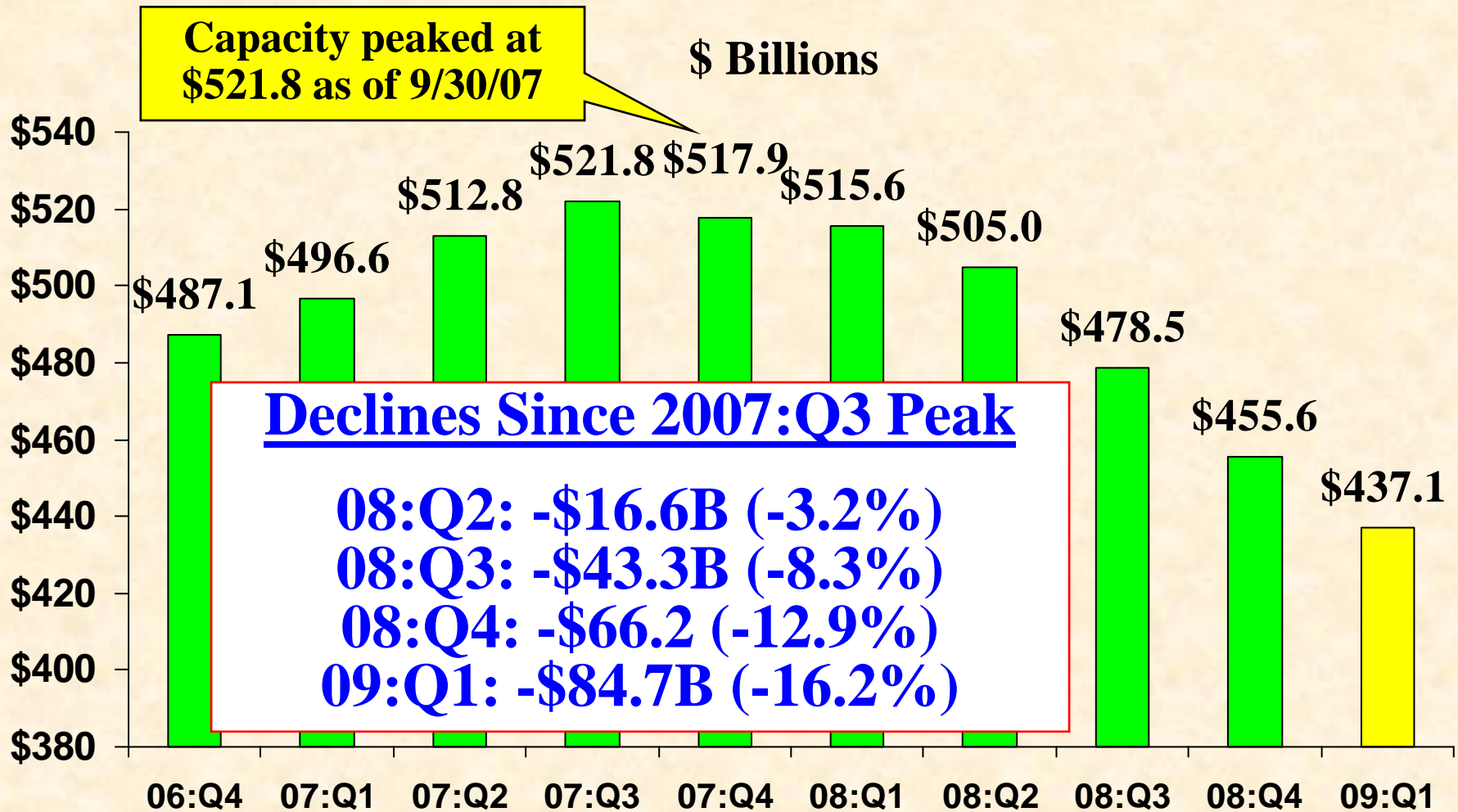


# U.S. Policyholder Surplus: 1975-2009:Q1\*



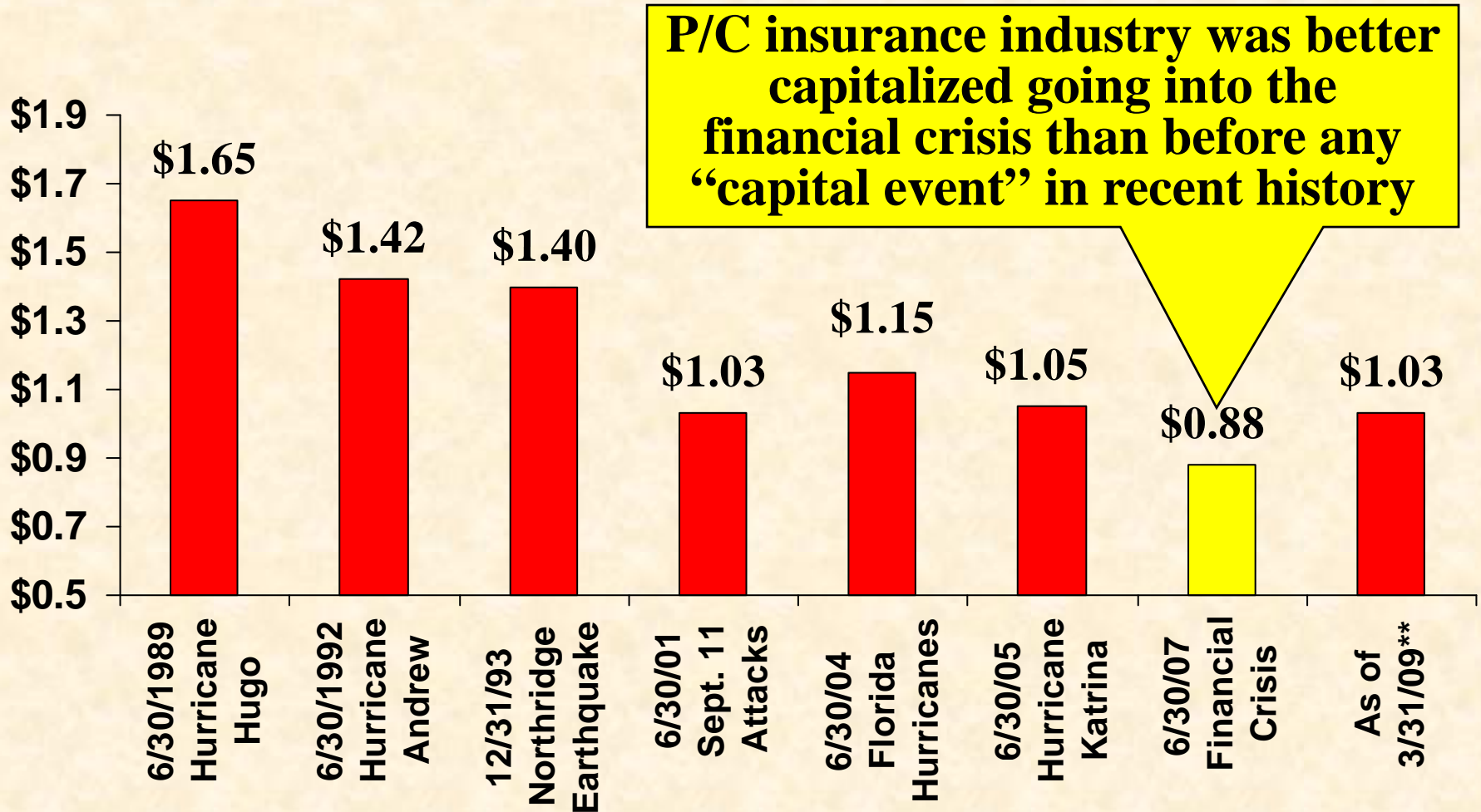


# Policyholder Surplus, 2006:Q4 – 2009:Q1





# Premium-to-Surplus Ratios Before Major Capital Events\*



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

\*\*Latest available

Source: PCS; Insurance Information Institute.



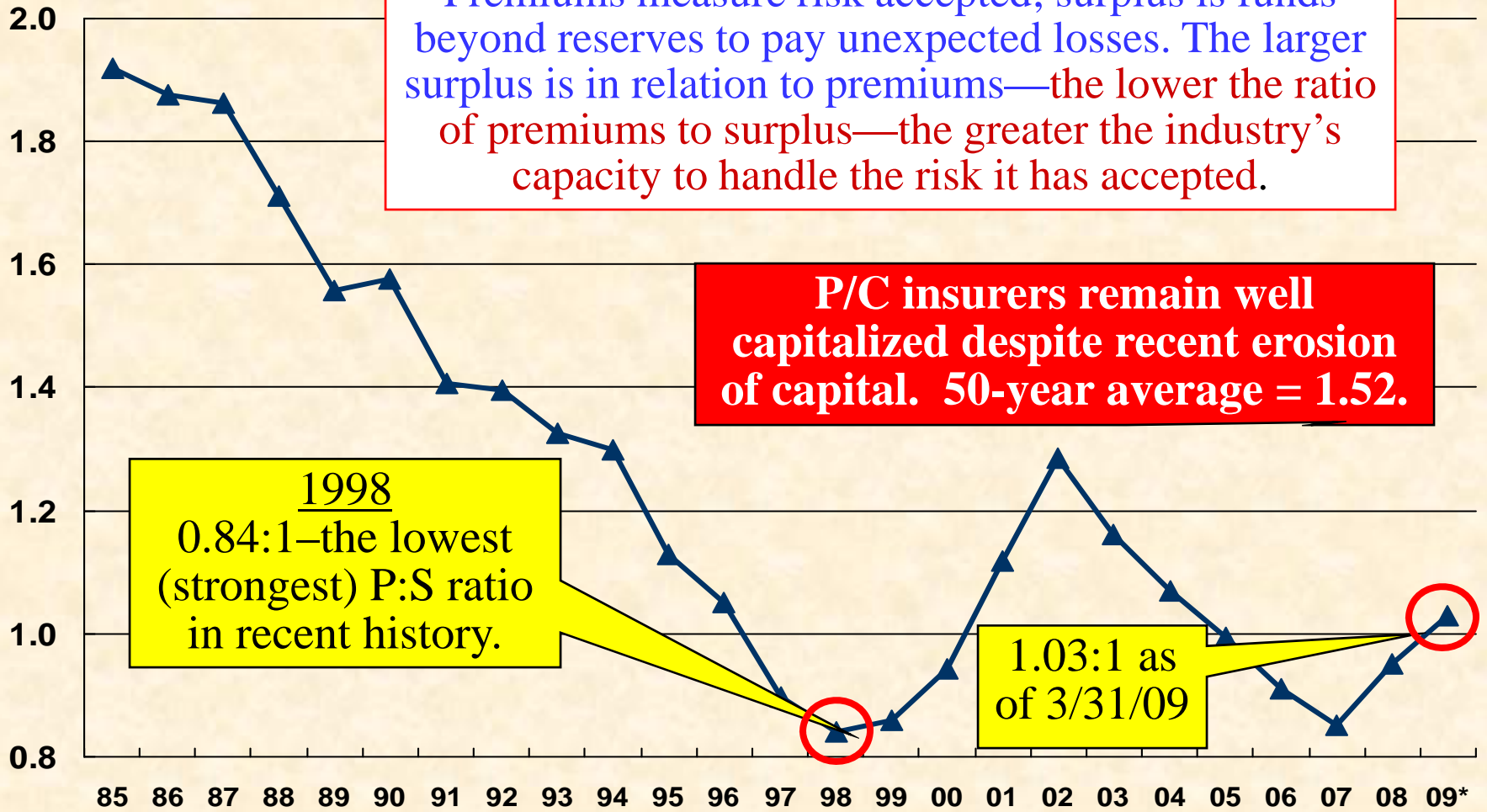
# U.S. P/C Industry Premiums-to-Surplus Ratio: 1985-2009:Q1

Premiums measure risk accepted; surplus is funds beyond reserves to pay unexpected losses. The larger surplus is in relation to premiums—the lower the ratio of premiums to surplus—the greater the industry's capacity to handle the risk it has accepted.

**P/C insurers remain well capitalized despite recent erosion of capital. 50-year average = 1.52.**

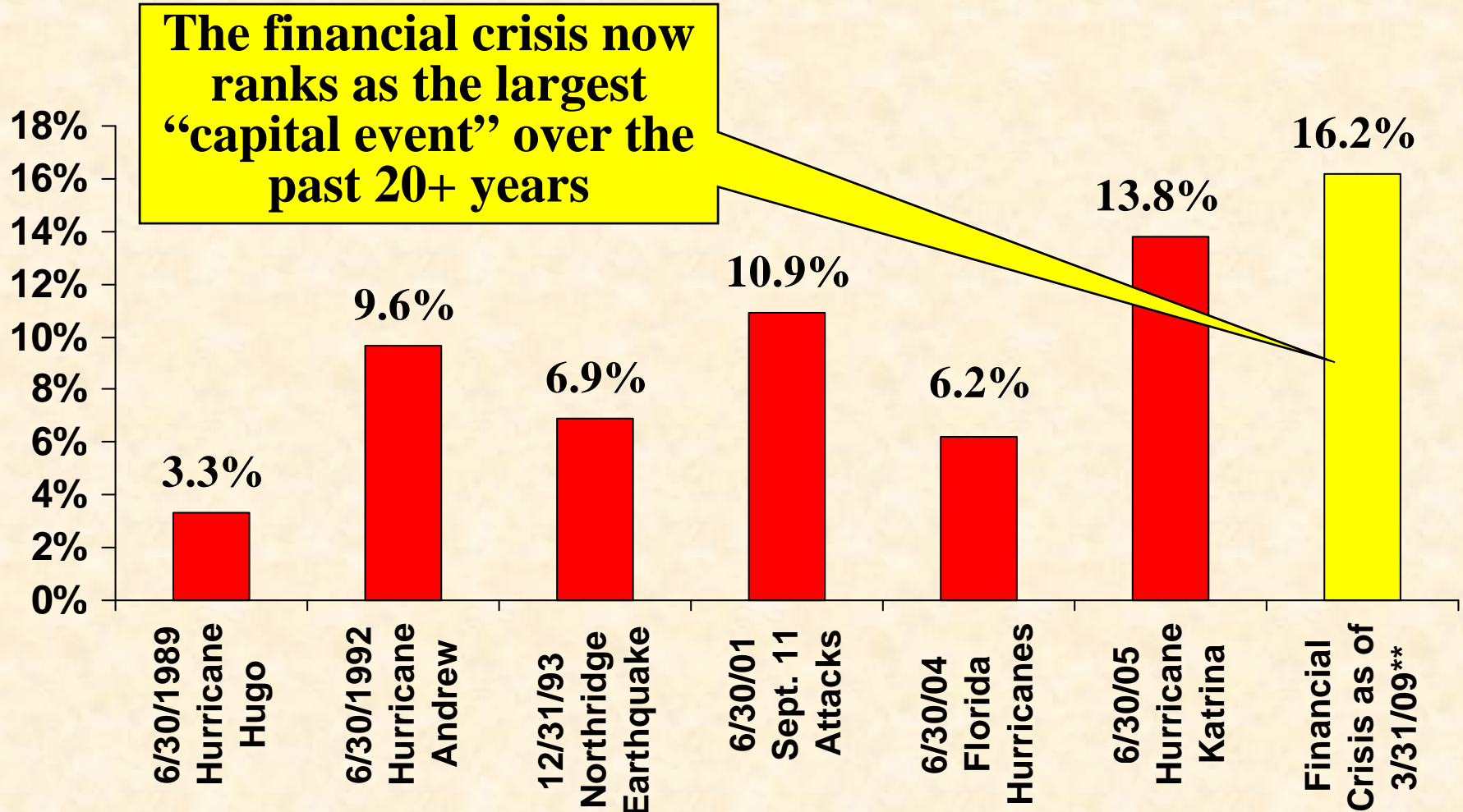
**1998**  
0.84:1—the lowest (strongest) P:S ratio in recent history.

1.03:1 as of 3/31/09





# 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.

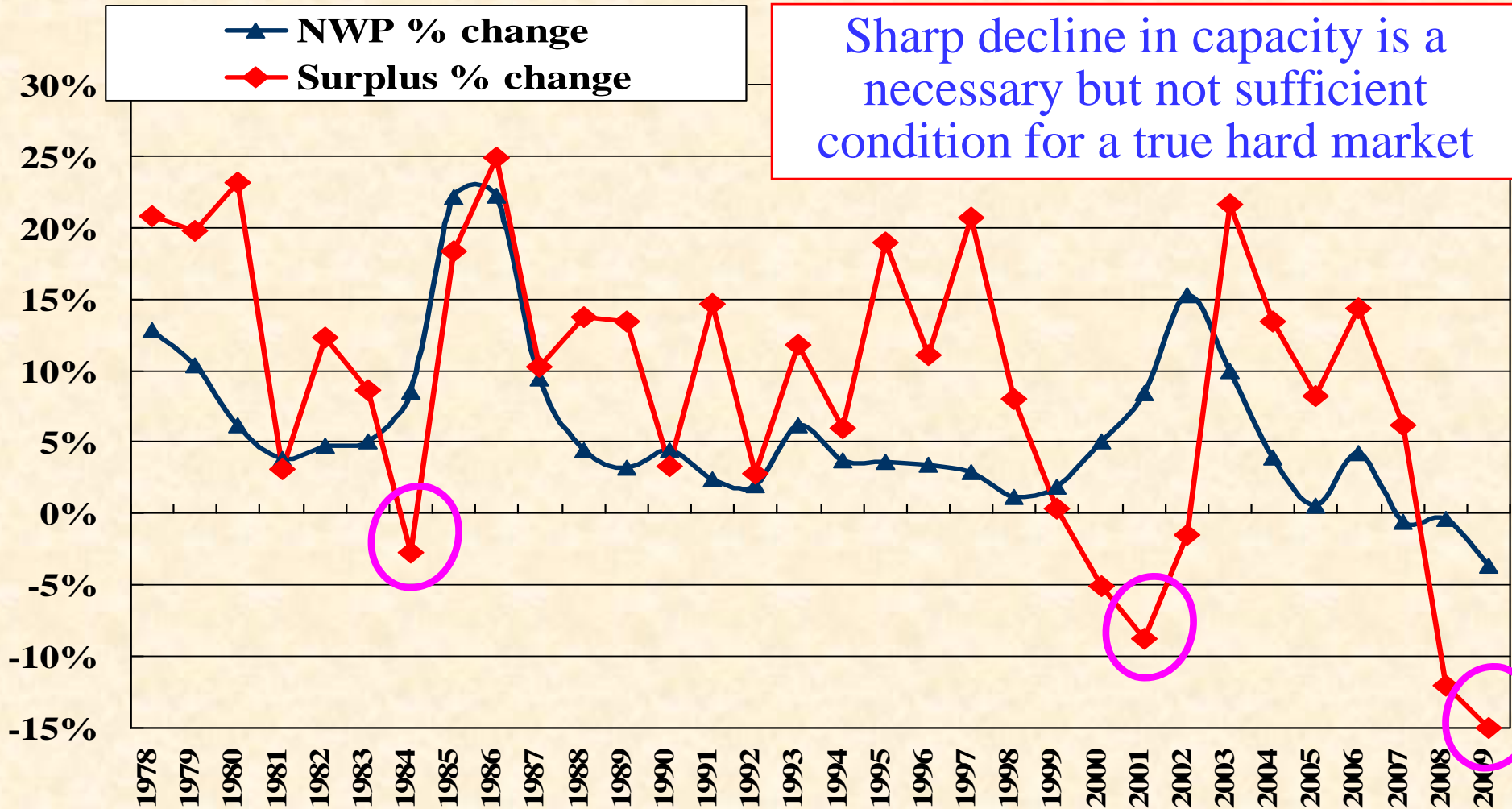
\*\*Latest available

Source: PCS; Insurance Information Institute.



# Historically, Hard Markets Follow

## When Surplus “Growth” is Negative\*



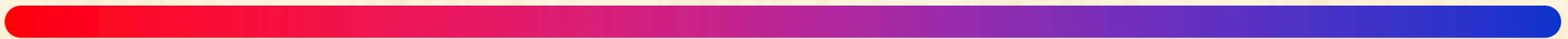
\*2009 NWP and Surplus figures are % changes for Q1:09 vs Q1:08

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



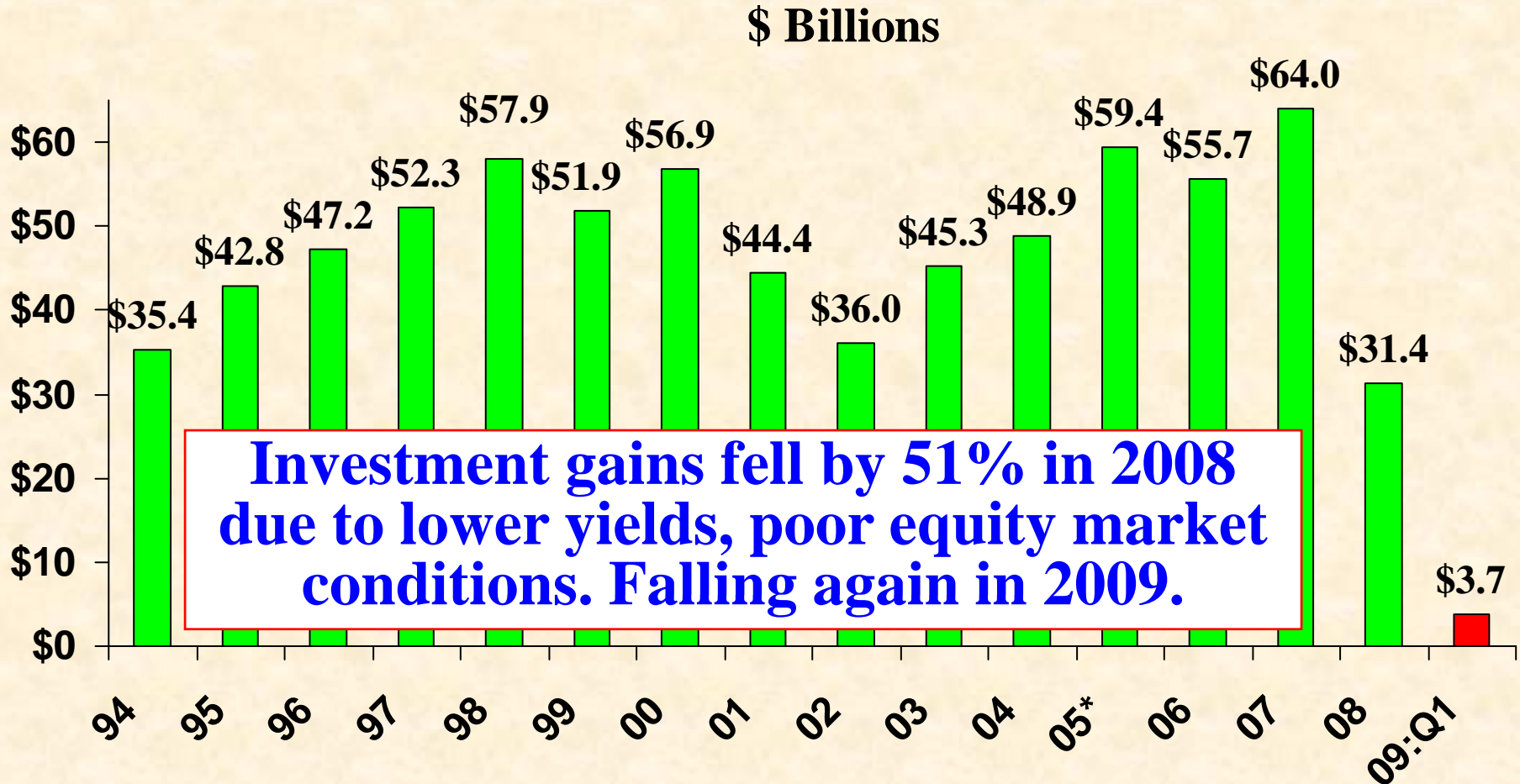
# Investment Performance

*Investments are the Principle  
Source of Declining  
Profitability*





# Property/Casualty Insurance Industry Investment Gain: 1994- 2009:Q1<sup>1</sup>



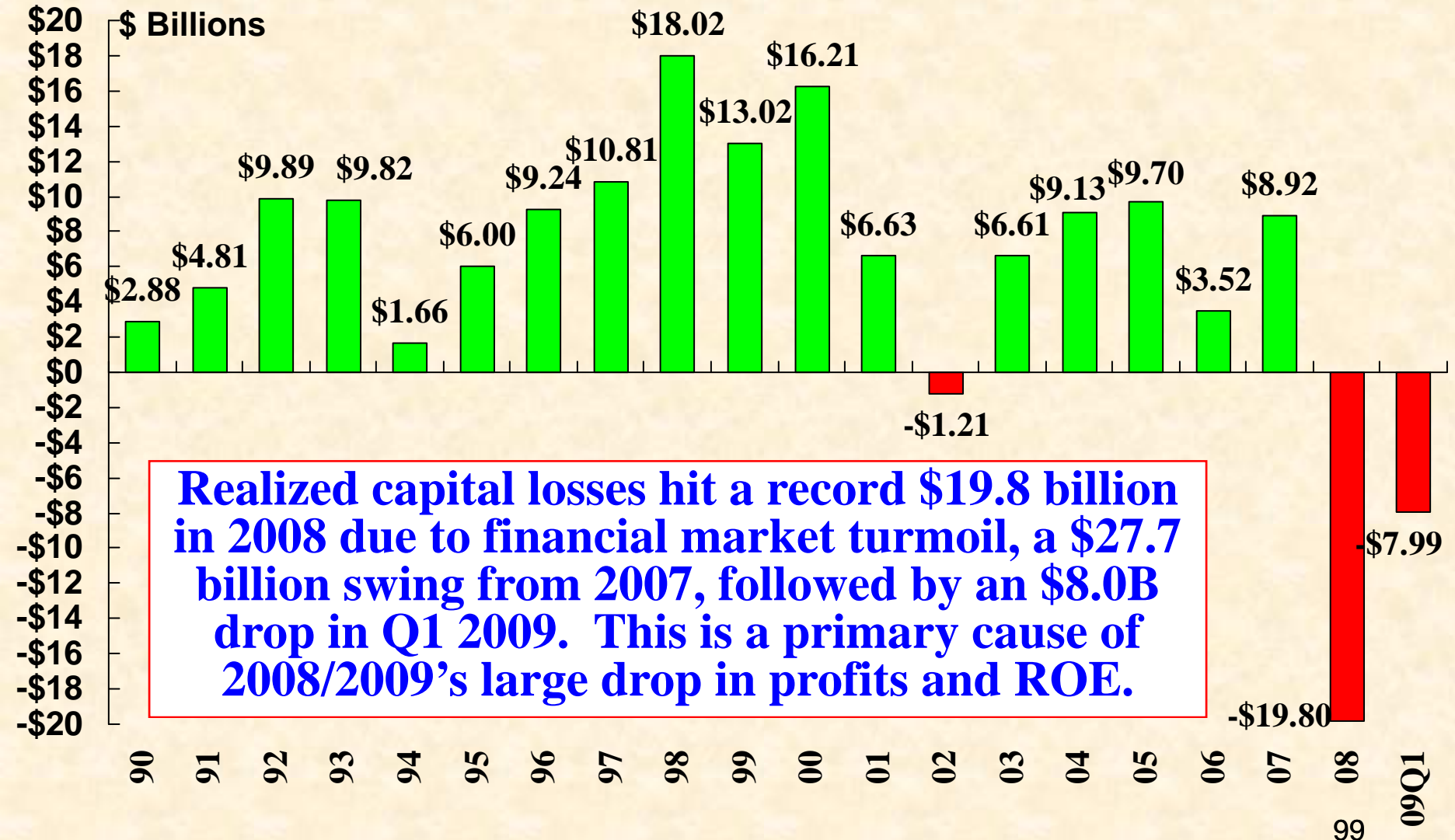
<sup>1</sup>Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2006 figure consists of \$52.3B net investment income and \$3.4B realized investment gain.

\*2005 figure includes special one-time dividend of \$3.2B.

Sources: ISO; Insurance Information Institute.

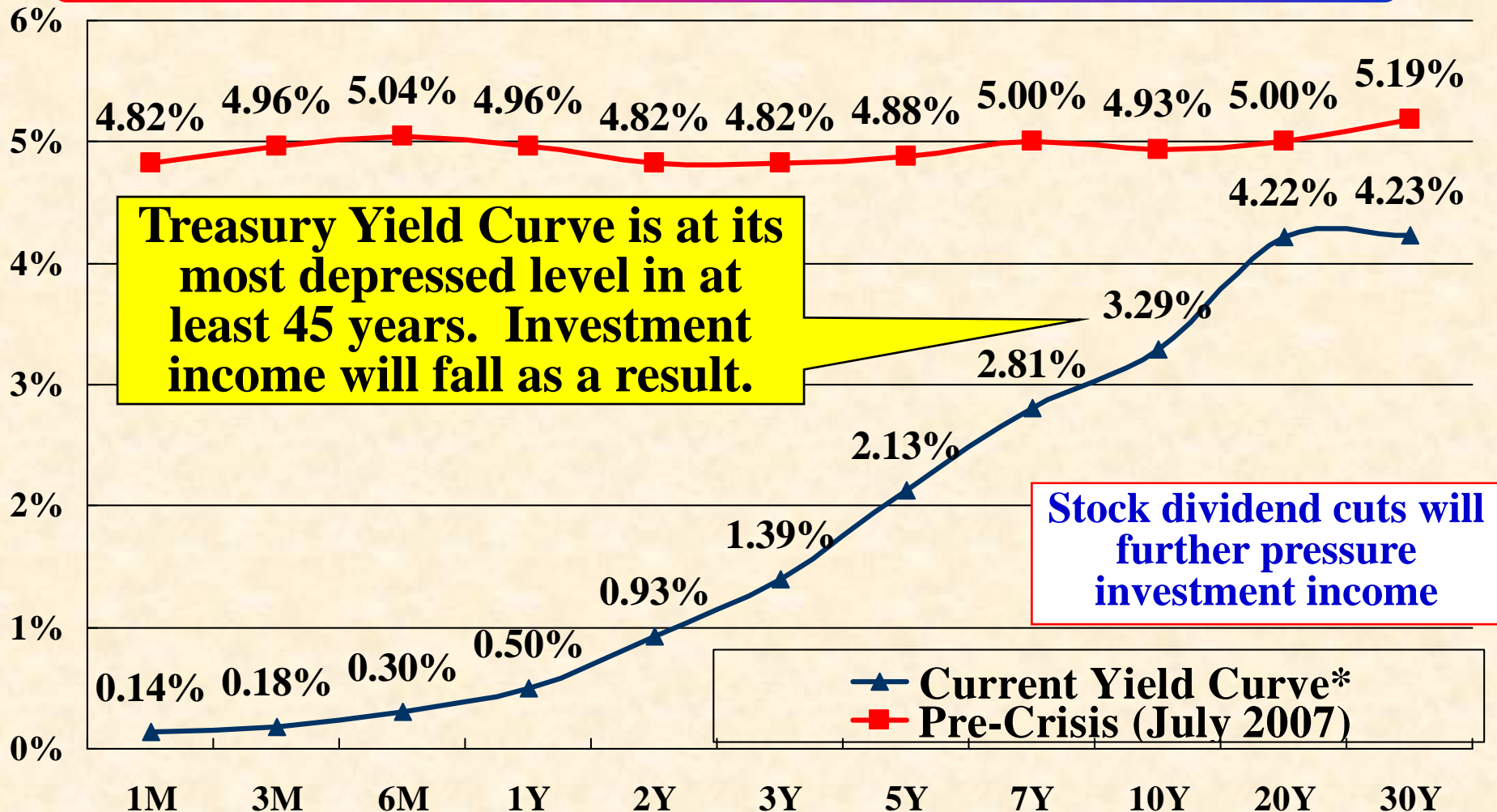


# *P/C Insurer Net Realized Capital Gains, 1990-2009:Q1*





# Treasury Yield Curves: Pre-Crisis vs. Current\*



\*May 2009.

Sources: Federal Reserve; Insurance Information Institute.

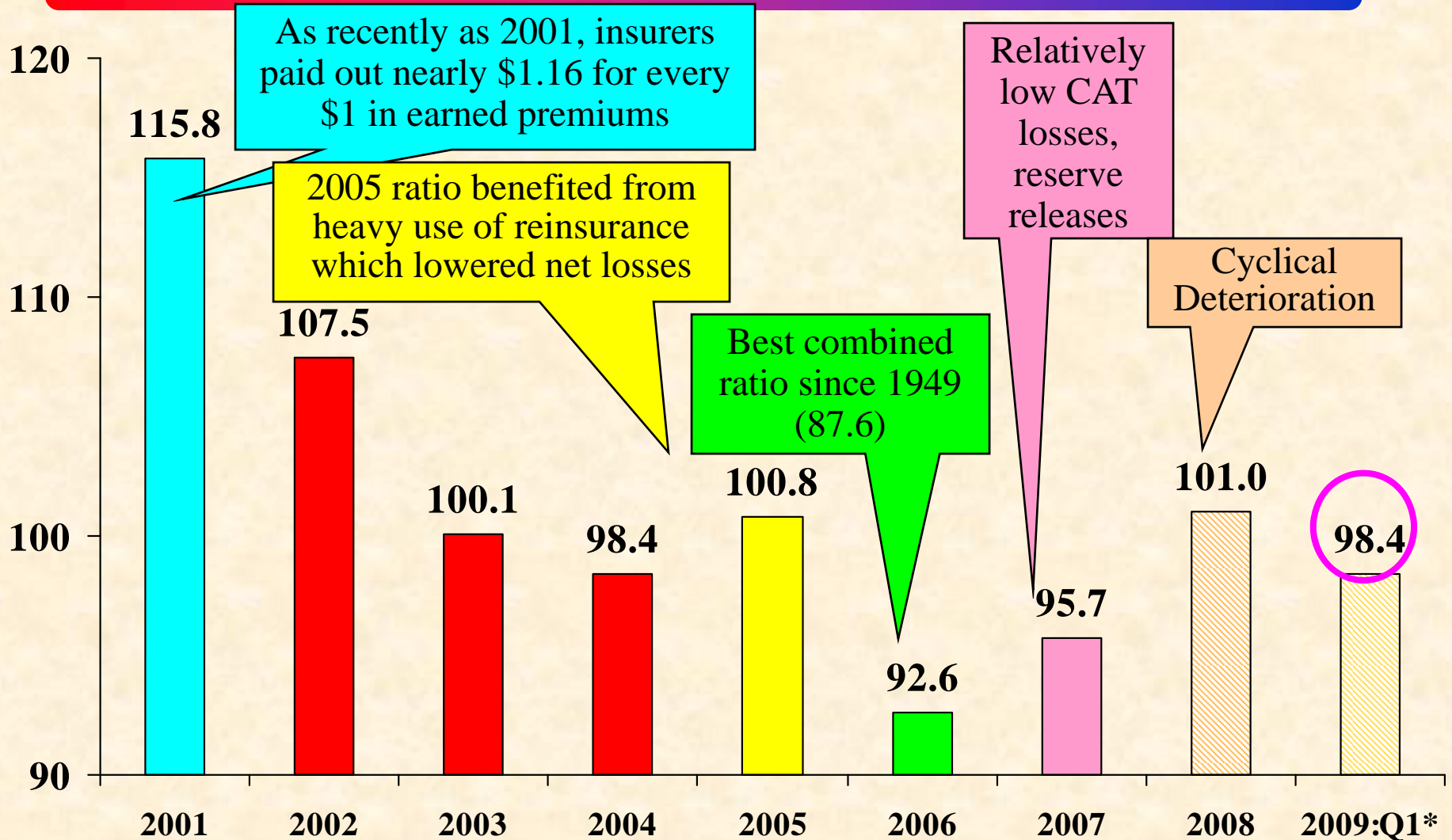
# Underwriting Trends

**Financial Crisis Does Not Directly  
Impact Underwriting  
Performance: Cycle, Catastrophes  
Were 2008's Drivers**





# *P/C Insurance Industry Combined Ratio, 2001-2009:Q1\**



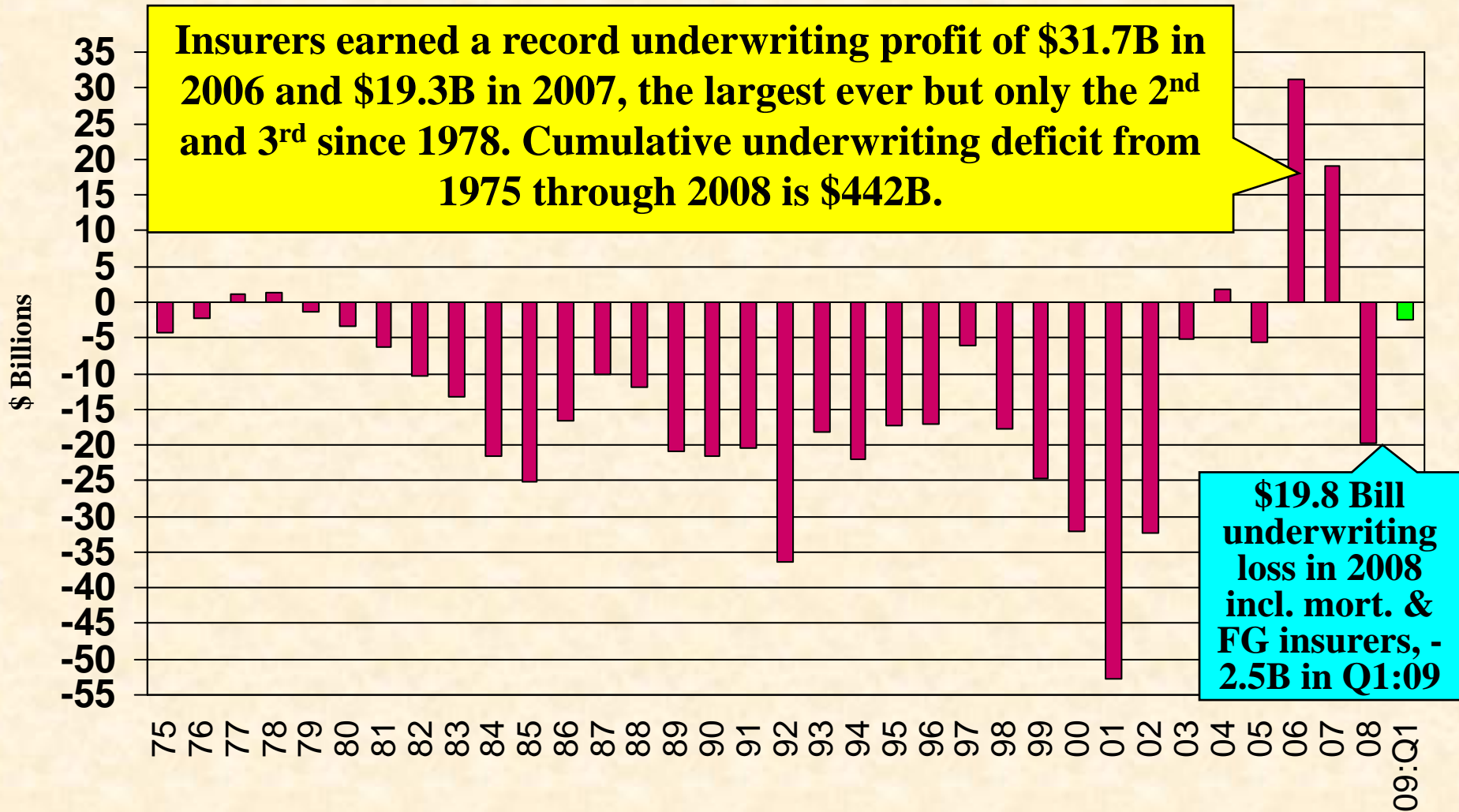
\*Excludes Mortgage & Financial Guarantee insurers in 2008/09. Including M&FG, 2008=105.1, 2009=102.2 102

Sources: A.M. Best, ISO.



# Underwriting Gain (Loss)

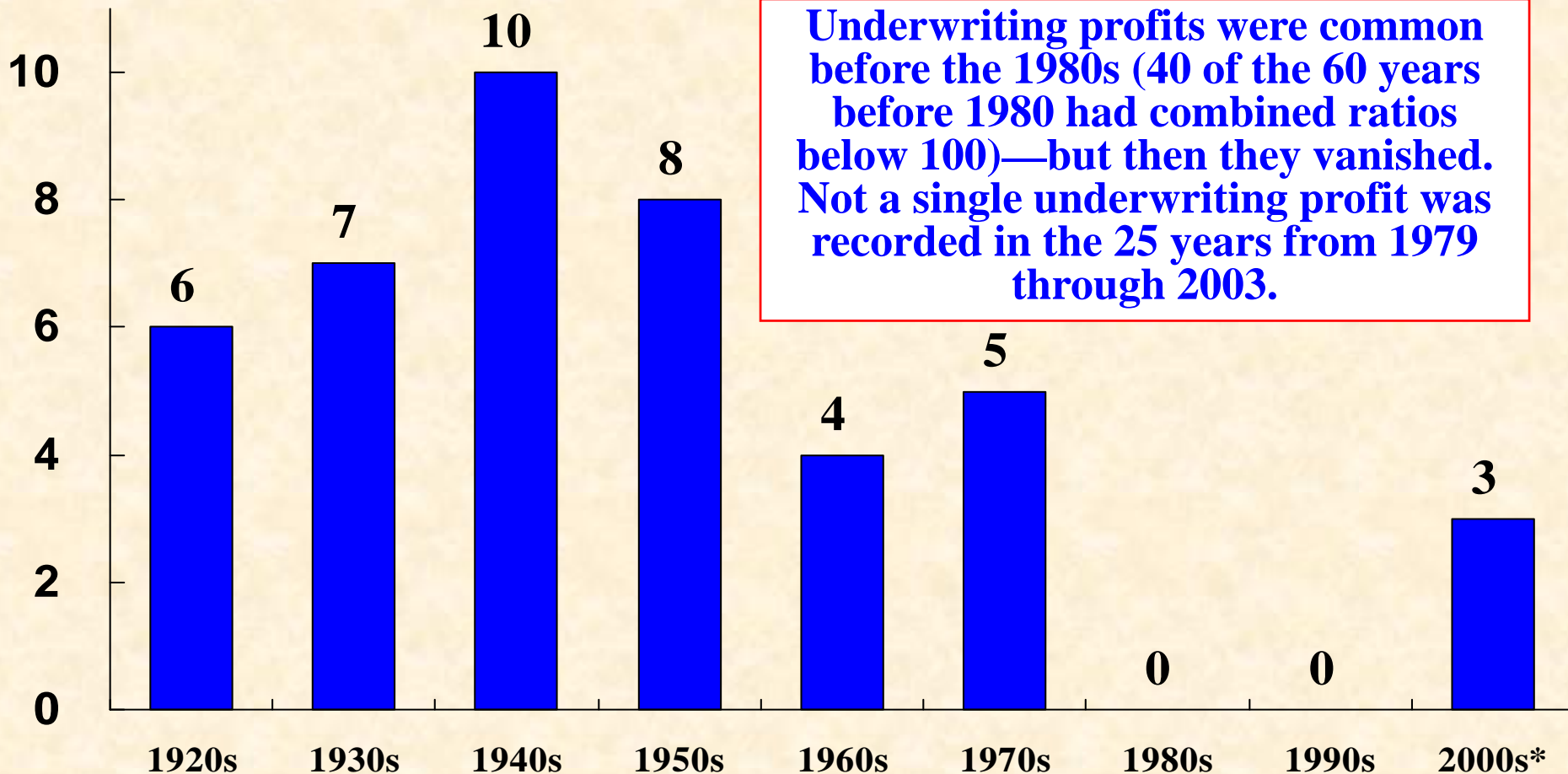
## 1975-2009:Q1\*





# Number of Years With Underwriting Profits by Decade, 1920s – 2000s

## Number of Years with Underwriting Profits



Underwriting profits were common before the 1980s (40 of the 60 years before 1980 had combined ratios below 100)—but then they vanished. Not a single underwriting profit was recorded in the 25 years from 1979 through 2003.

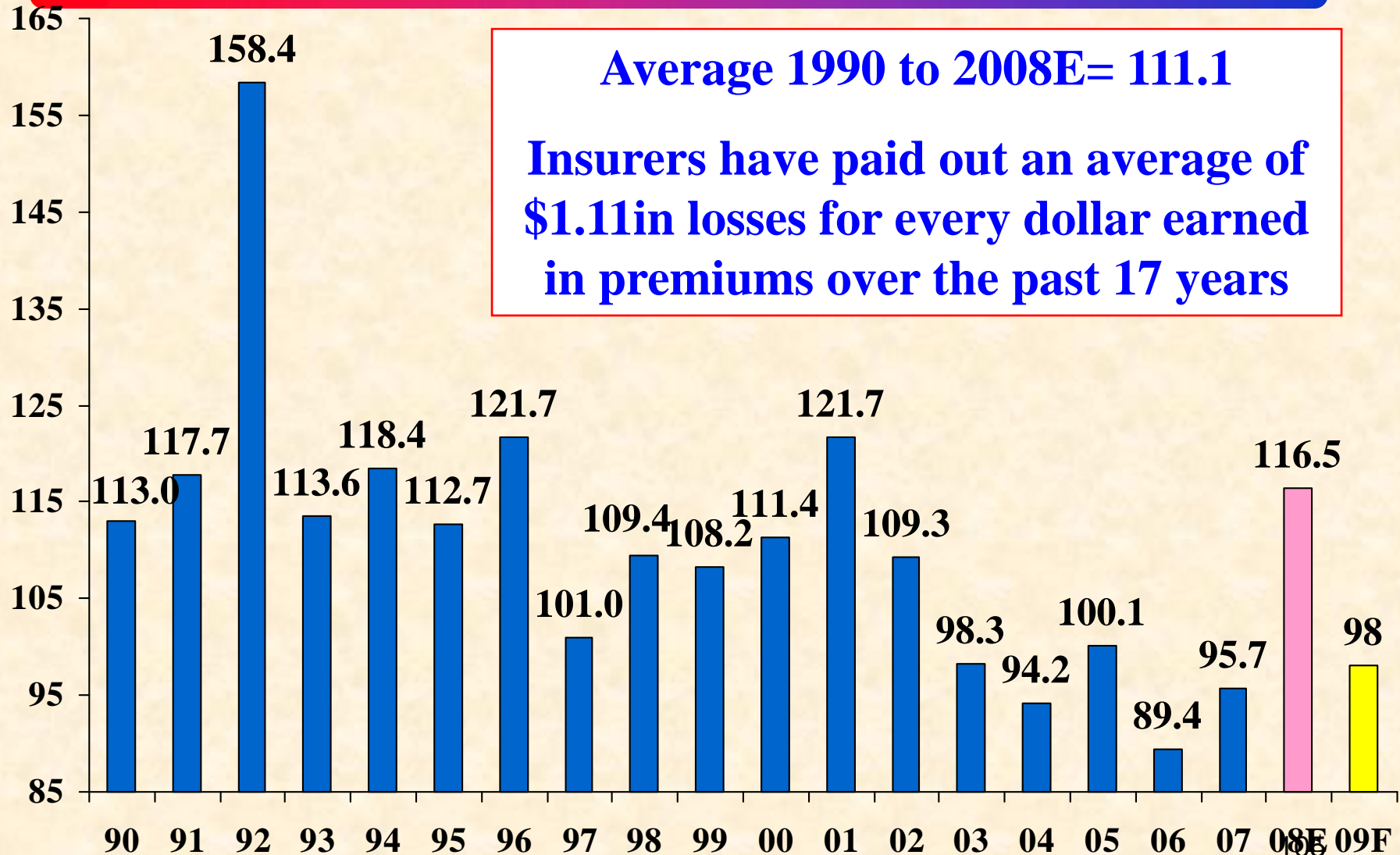
Note: Data for 1920 – 1934 based on stock companies only.

Sources: Insurance Information Institute research from A.M. Best Data.





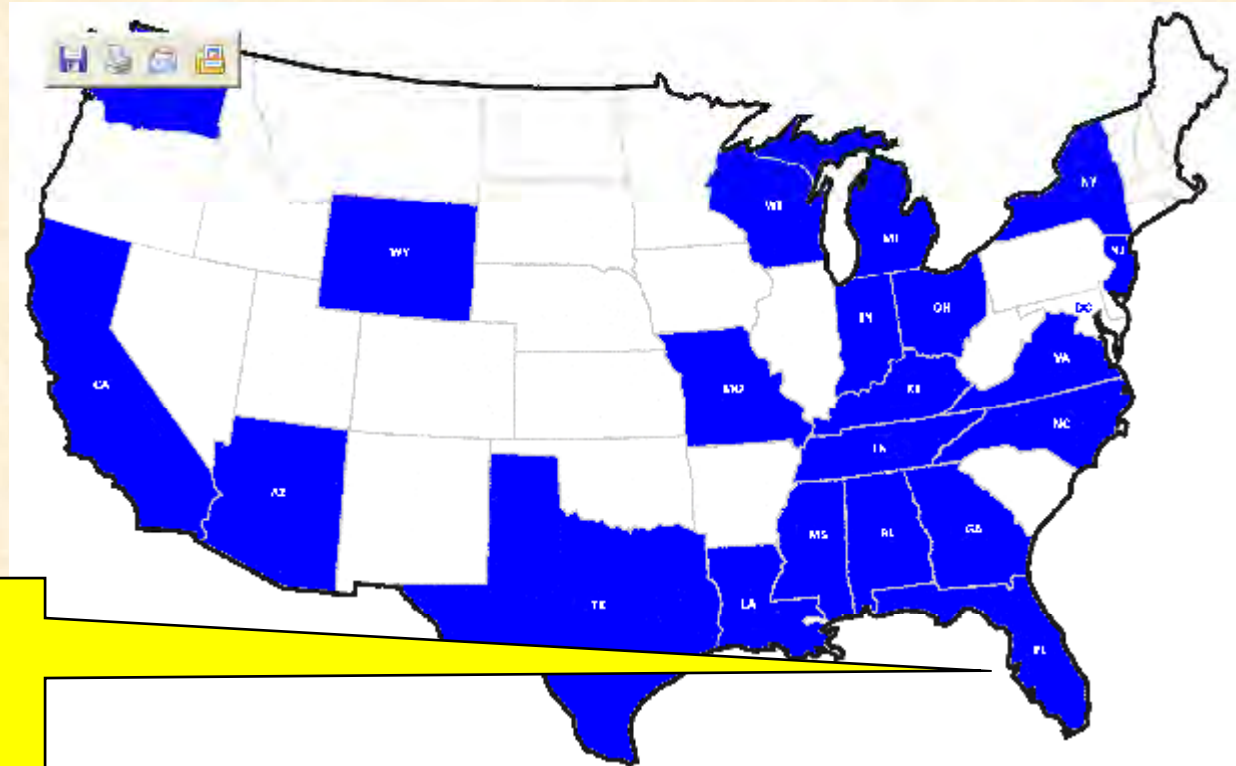
# Homeowners Insurance Combined Ratio





# States With Problem Chinese Drywall Reports\*

As of July 16, 2009, the Consumer Product Safety Commission had received 608 reports of defective Chinese drywall from 21 states plus DC, 77% of those from FL



Most problems have arisen in hotter, more humid climates such as FL and LA

\* First report was received 12/22/08.

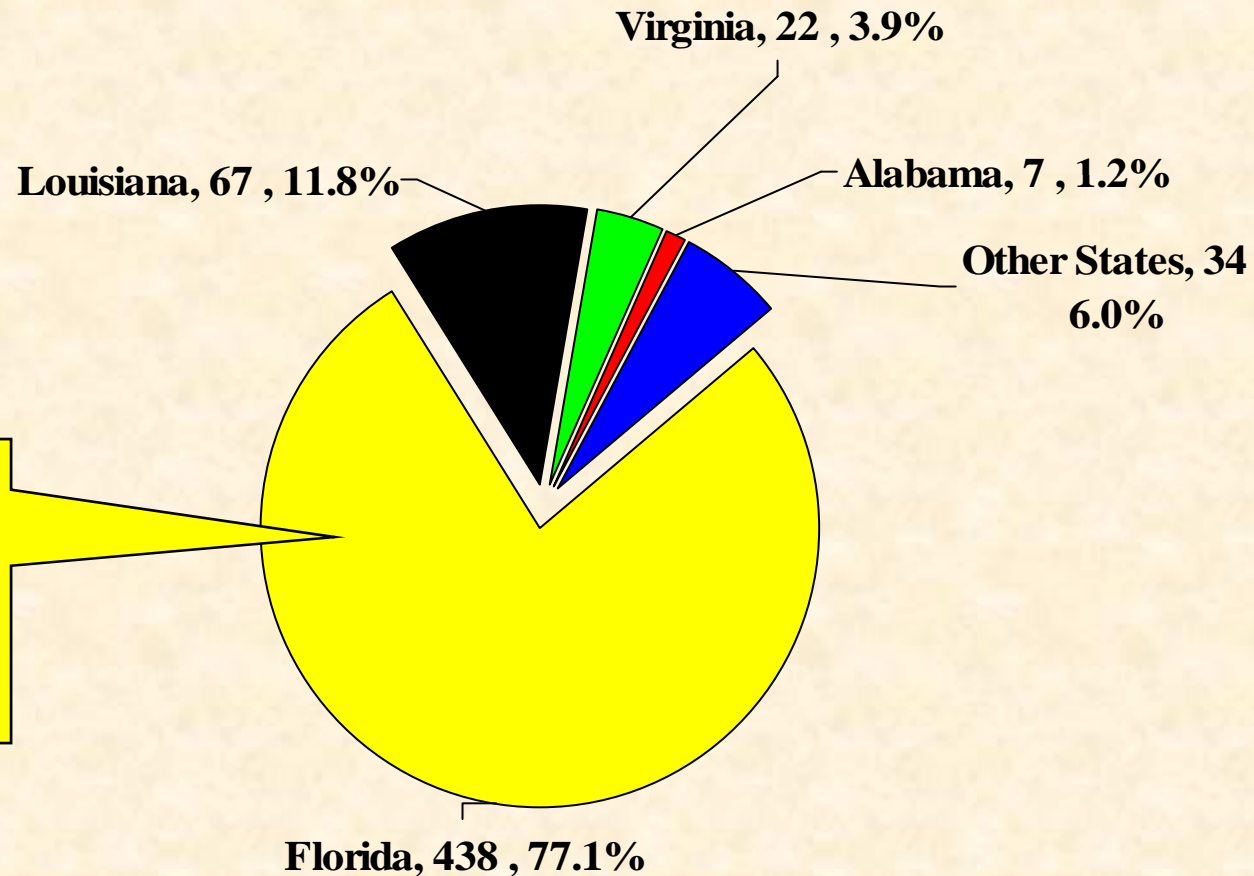
Source: US Consumer Product Safety Commission, <http://www.cpsc.gov/info/drywall/where.html> accessed 7/16/09.



# Number and Percentage of Problem Chinese Drywall Reports by State\*

Coverage for defective drywall is excluded under a standard homeowners insurance policy (construction defect and pollution exclusions apply and there is no covered cause of loss)

The vast majority of problem Chinese drywall was used in FL in the wake of the 2004/2005 hurricanes

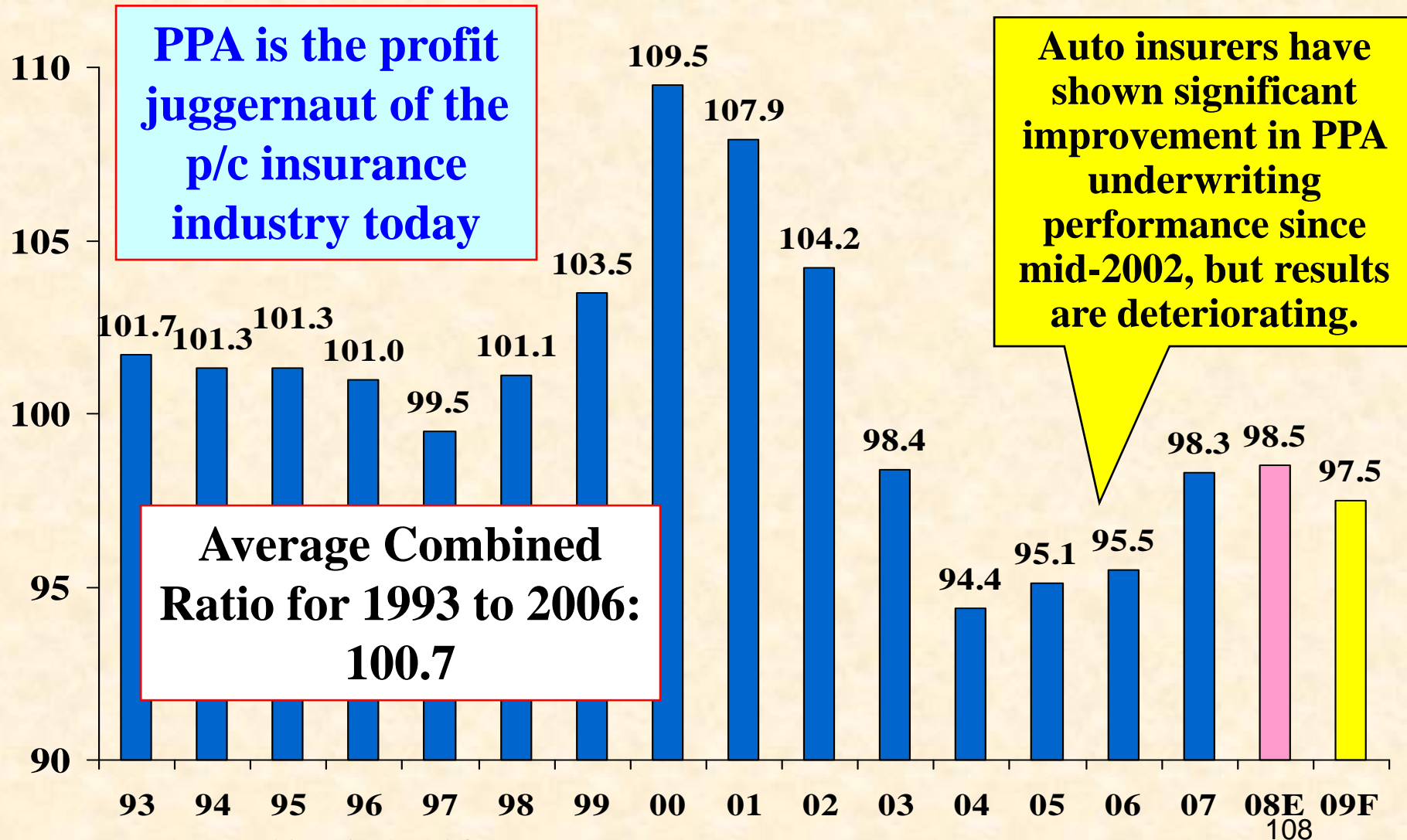


\* First report was received 12/22/08.

Source: US Consumer Product Safety Commission, <http://www.cpsc.gov/info/drywall/where.html> accessed 7/16/09.



# Private Passenger Auto (PPA) Combined Ratio

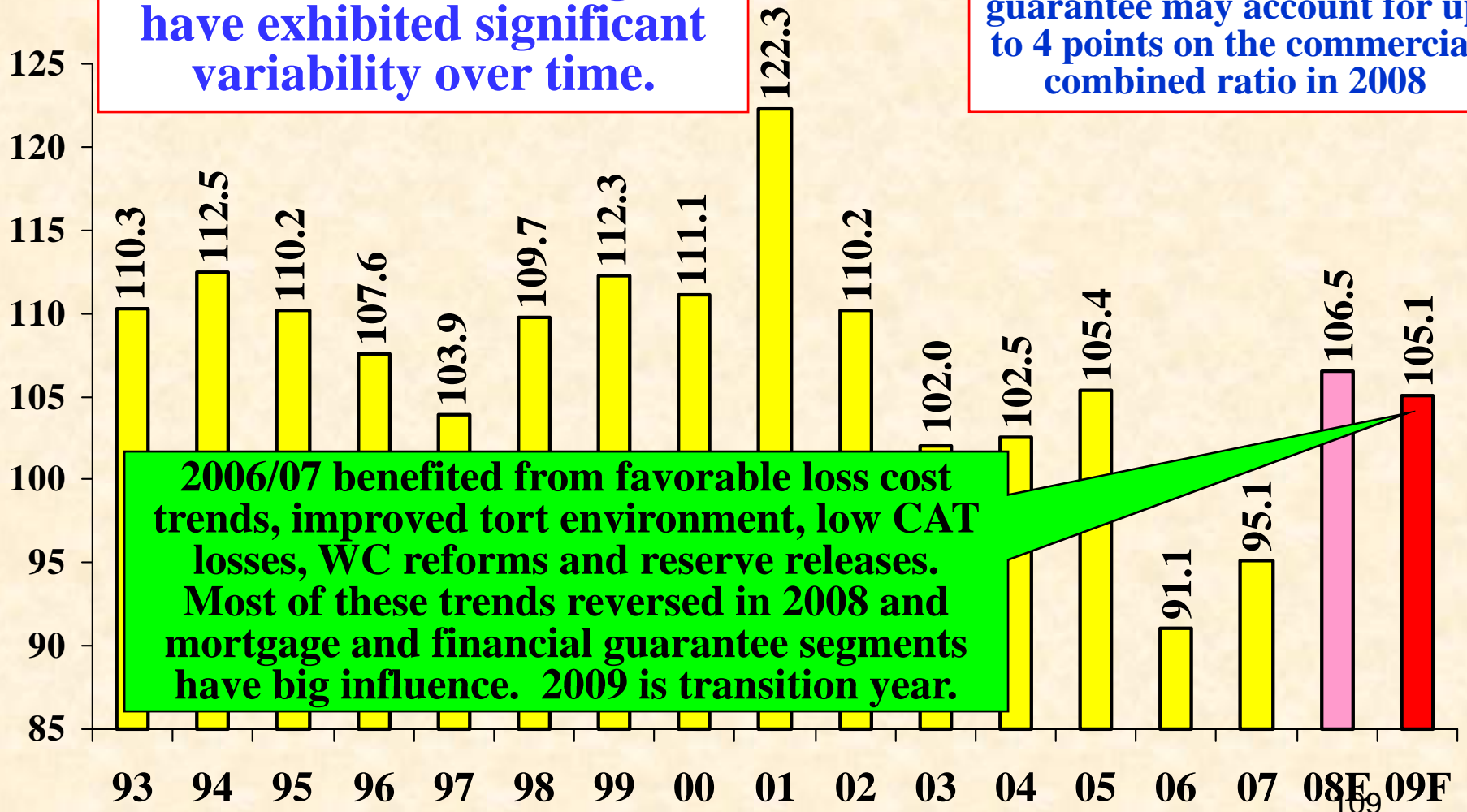




# Commercial Lines Combined Ratio, 1993-2009F

**Commercial coverages  
have exhibited significant  
variability over time.**

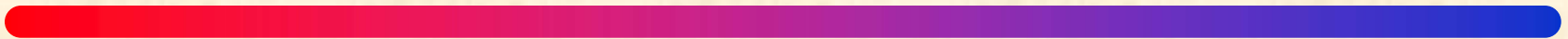
**Mortgage and financial  
guarantee may account for up  
to 4 points on the commercial  
combined ratio in 2008**



**2006/07 benefited from favorable loss cost trends, improved tort environment, low CAT losses, WC reforms and reserve releases. Most of these trends reversed in 2008 and mortgage and financial guarantee segments have big influence. 2009 is transition year.**

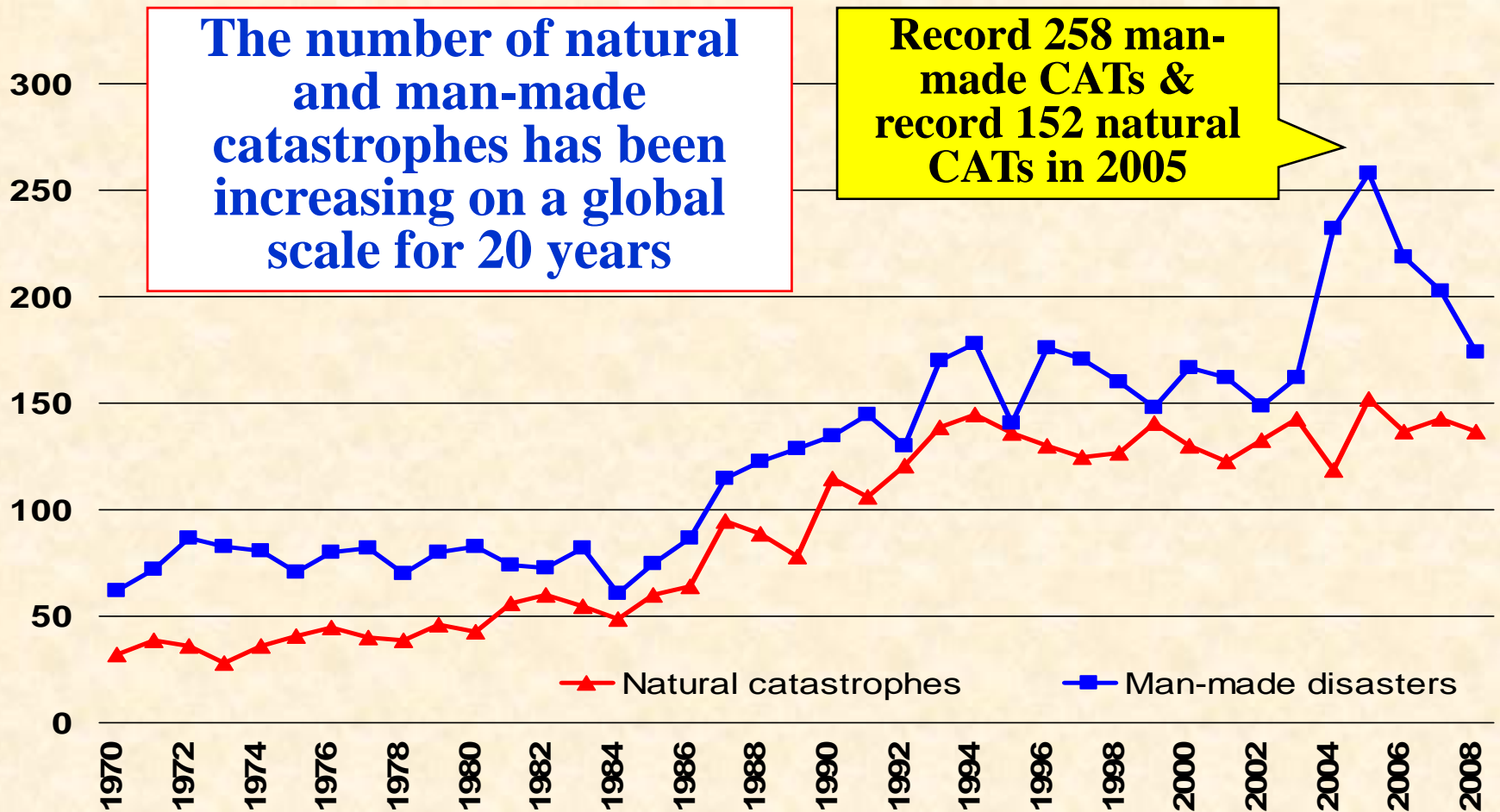
# Catastrophic Loss

*Catastrophe Losses Trends  
Are Trending Adversely*



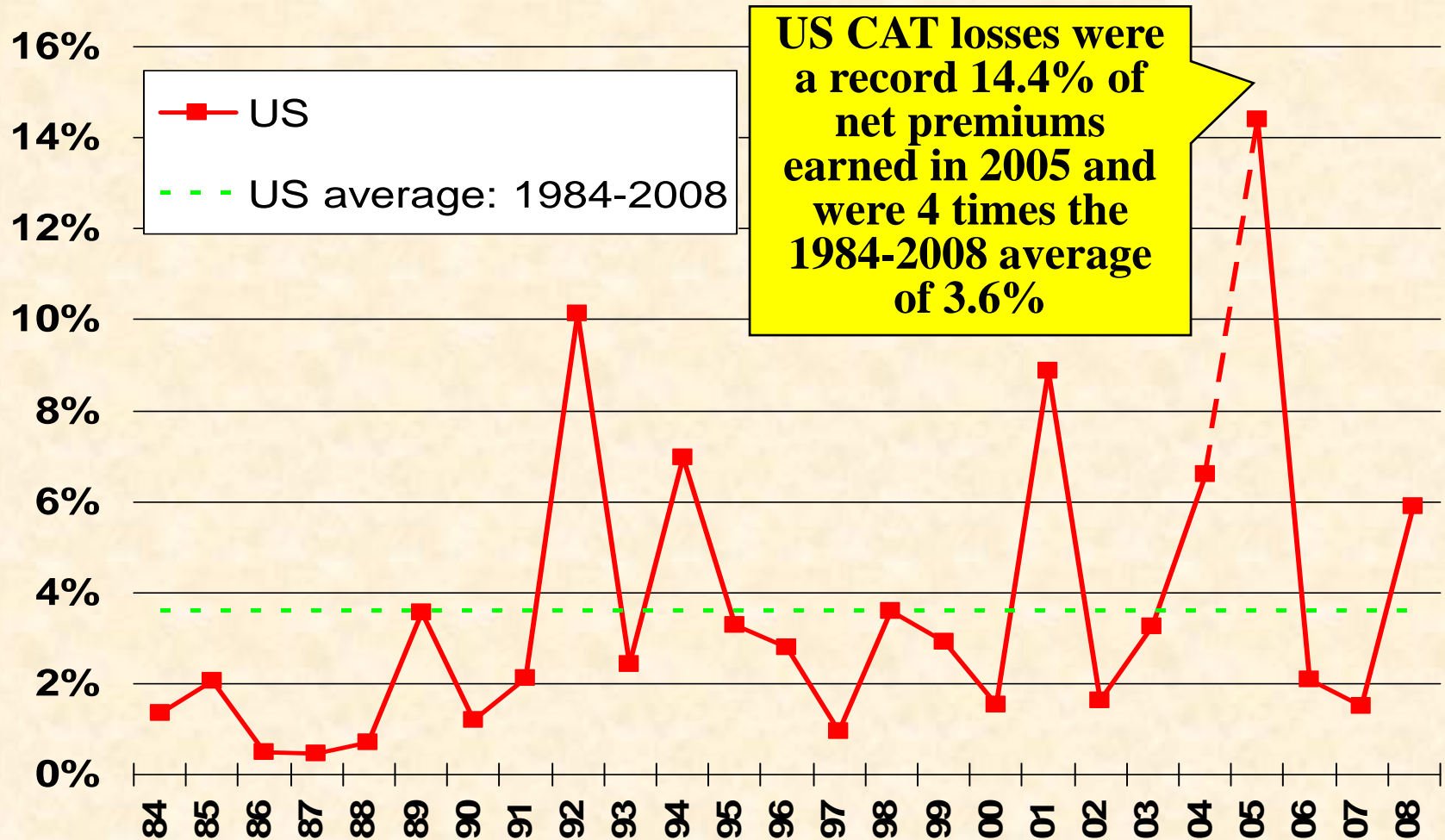


# Global Number of Catastrophic Events, 1970–2008





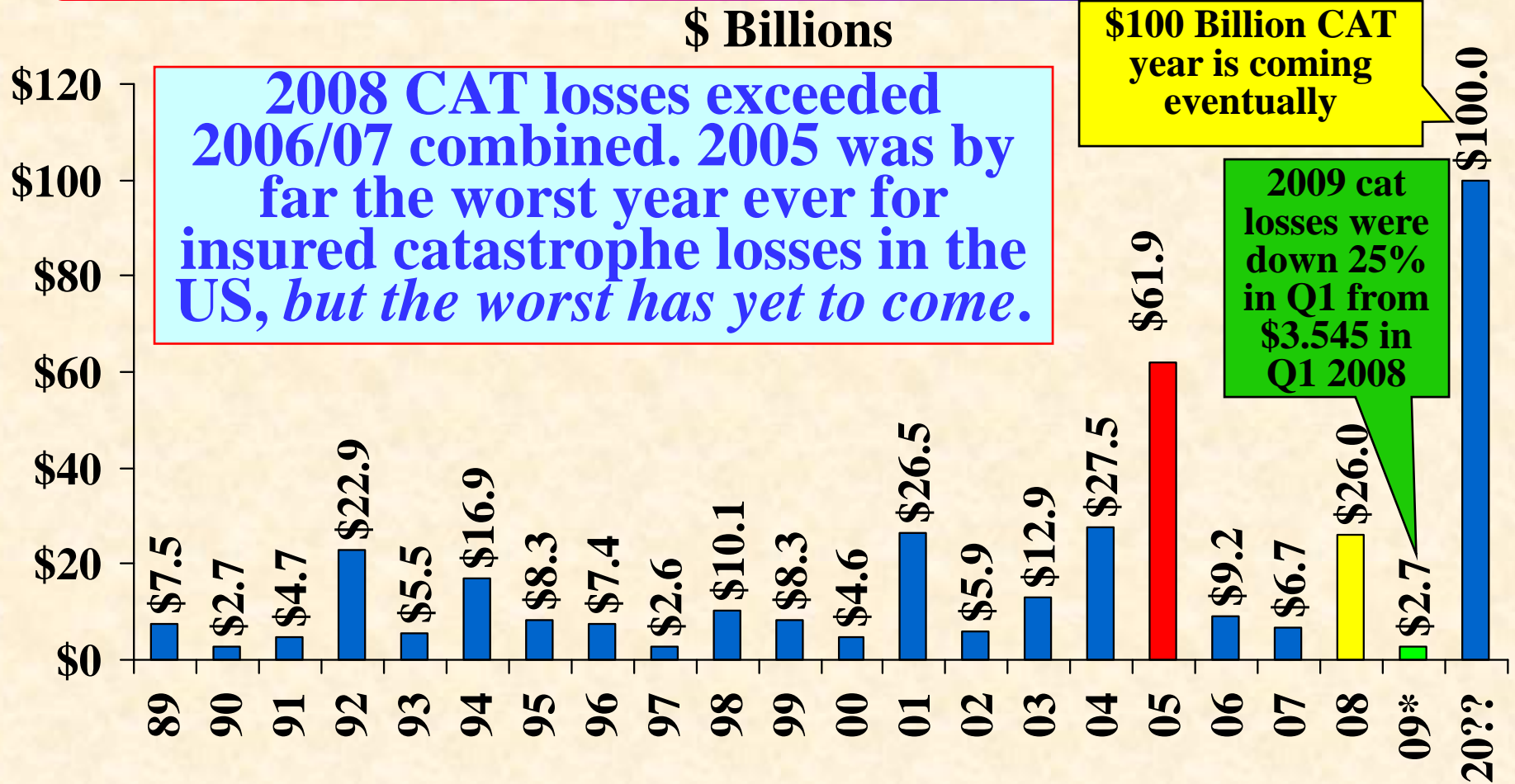
# *Insured Property Catastrophe Losses as % Net Premiums Earned, 1984–2008*







# U.S. Insured Catastrophe Losses



\*Based on PCS data through March 31 = \$2.66 billion.

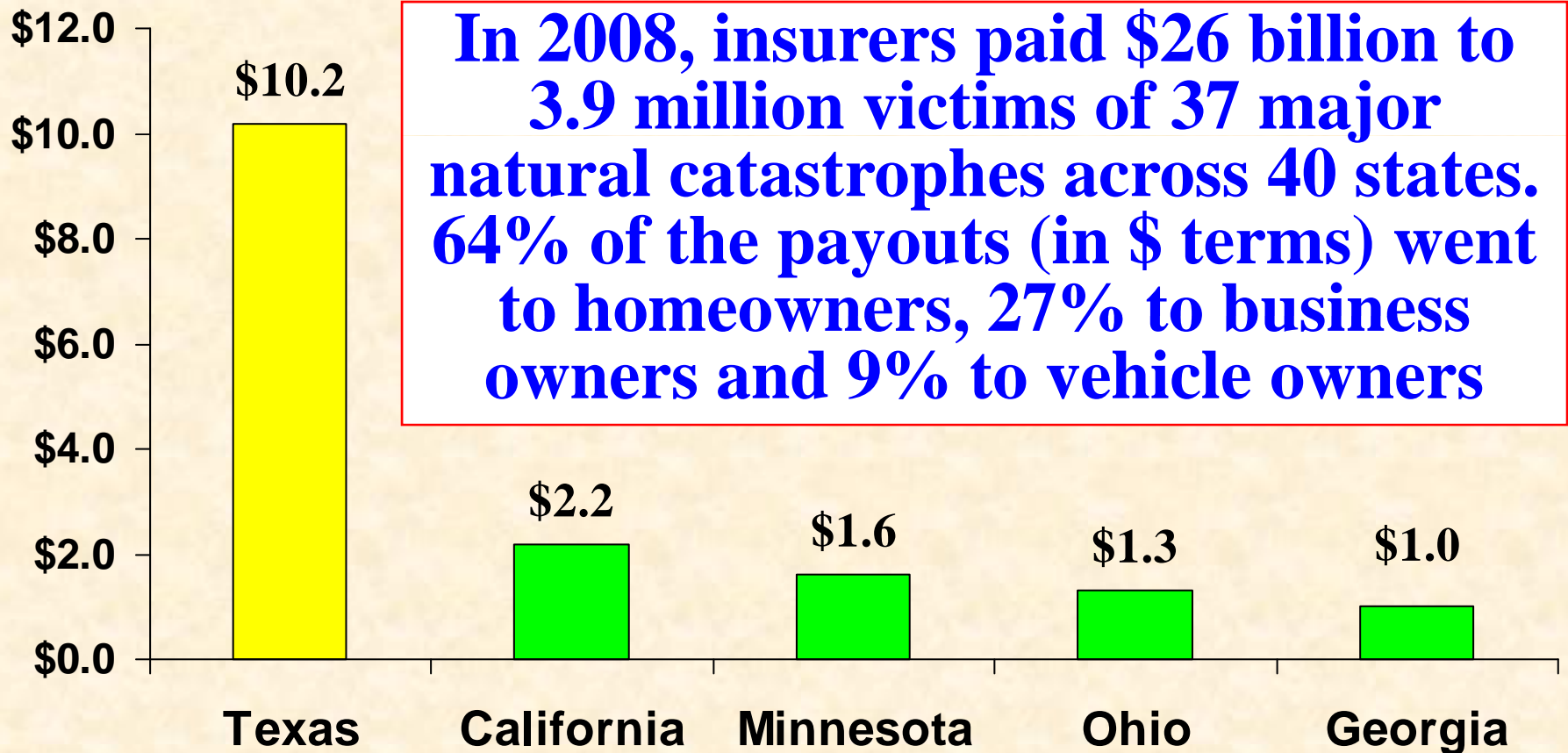
**Note:** 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = \$12.2B.<sup>113</sup>

Source: Property Claims Service/ISO; Insurance Information Institute



# States With Highest Insured Catastrophe Losses in 2008

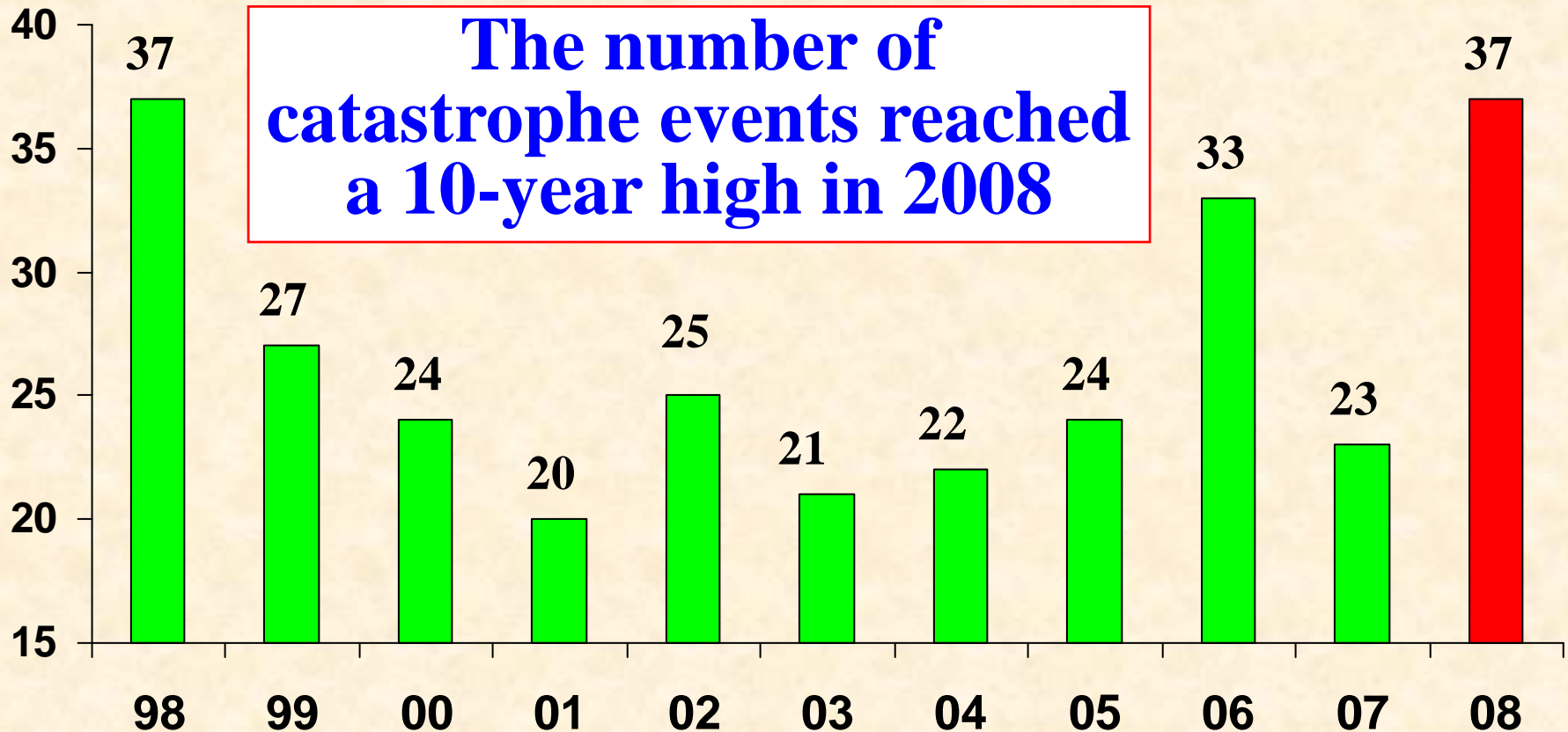
\$ Billions





# Number of PCS Catastrophe Events, 1998-2008\*

\$ Billions



\*PCS defines a catastrophe as an even that caused at least \$25 million in insured property damage and affects and significant number of policyholders and insurers.

Source: PCS; Insurance Information Institute



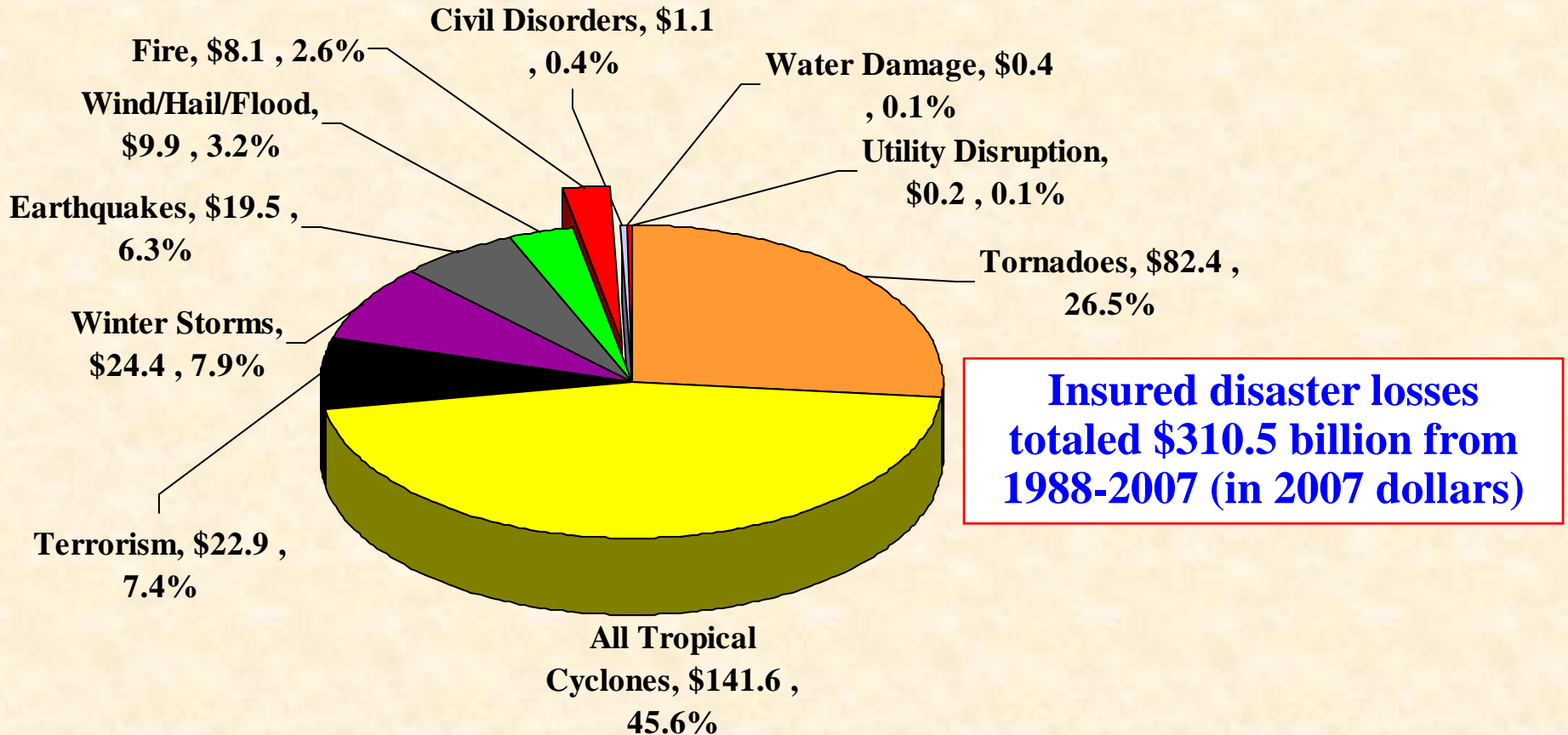
# Top 12 Most Costly Disasters in US History, (Insured Losses, \$2007)



\*PCS estimate as of 12/15/08.



# Inflation-Adjusted U.S. Insured Catastrophe Losses By Cause of Loss, 1988-2007<sup>1</sup>



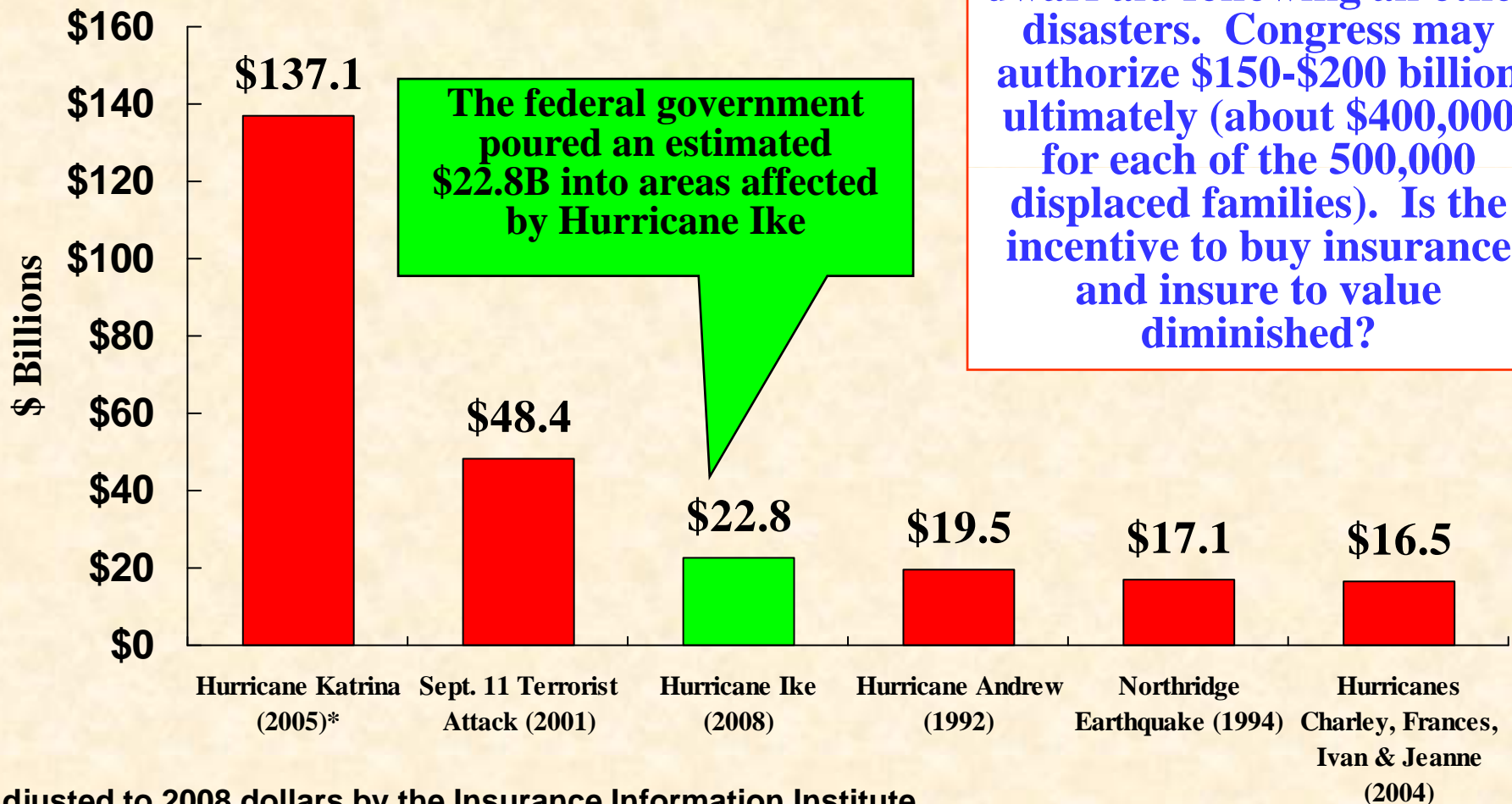
<sup>1</sup> Catastrophes are all events causing direct insured losses to property of \$25 million or more in 2007 dollars.

Catastrophe threshold changed from \$5 million to \$25 million beginning in 1997. Adjusted for inflation by the III.

<sup>2</sup> Excludes snow. <sup>3</sup> Includes hurricanes and tropical storms. <sup>4</sup> Includes other geologic events such as volcanic eruptions and other earth movement. <sup>5</sup> Does not include flood damage covered by the federally administered National Flood Insurance Program. <sup>6</sup> Includes wildland fires.



# Government Aid After Major Disasters (Billions)\*



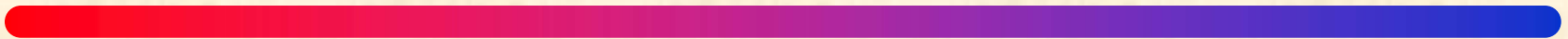
Hurricane Katrina aid will dwarf aid following all other disasters. Congress may authorize \$150-\$200 billion ultimately (about \$400,000 for each of the 500,000 displaced families). Is the incentive to buy insurance and insure to value diminished?

The federal government poured an estimated \$22.8B into areas affected by Hurricane Ike

\*Adjusted to 2008 dollars by the Insurance Information Institute.  
Source: United States Senate Budget Committee, Insurance Information Institute as of 12/31/05; Houston Chronicle, 09/24/08 for Ike.

# The 2009 Hurricane Season:

*Preview to Disaster?*





# *Outlook for 2009 Hurricane Season*

	Average*	2005	2009F
Named Storms	9.6	26	11
Named Storm Days	49.1	115.5	50
Hurricanes	5.9	14	5
Hurricane Days	24.5	47.5	20
Intense Hurricanes	2.3	7	2
Intense Hurricane Days	5	7	4
Net Tropical Cyclone Activity	100%	275%	90%

\*Average over the period 1950-2000.

Source: Dr. Phil Klotzbach and Dr. William Gray, Colorado State University, June 2, 2009.





# *Probability of Major Hurricane Landfall (CAT 3, 4, 5) in 2009*

	<b>NOAA</b>	<b>CSU</b>	<b>2005 Actual</b>
<b>Number Named Storms</b>	9-14	11	28
<b>Number of Hurricanes</b>	4-7	5	15
<b>Number of Major Hurricanes (Category 3+)</b>	1-3	2	7



# *Probability of Major Hurricane Landfall (CAT 3, 4, 5) in 2009*

	Average*	2009F
Entire US Coast	52%	48%
US East Coast Including Florida Peninsula	31%	28%
Gulf Coast from FL Panhandle to Brownsville, TX	30%	28%
<b><i>ALSO...Slightly Below-Average Major Hurricane Landfall Risk in Caribbean for 2009</i></b>		

\*Average over past century.

Source: Dr. Phil Klotzbach and Dr. William Gray, Colorado State University, June 2, 2009.

# TEXAS Catastrophe Loss Overview

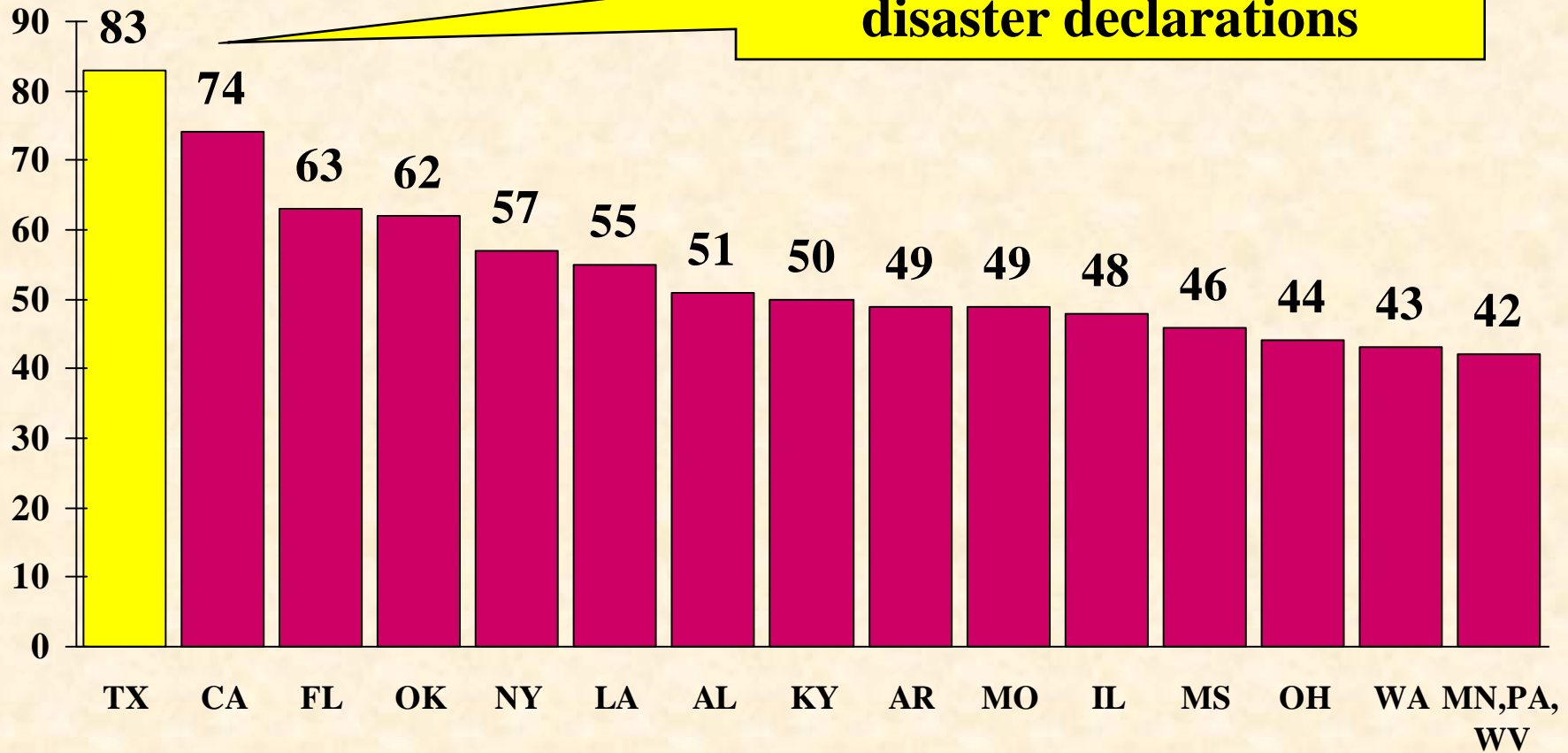
*Everything's Bigger in TX—  
Including the CAT Losses*





# Top 10 Major Disaster Declaration Totals By State: 1953-2009\*

Total Number



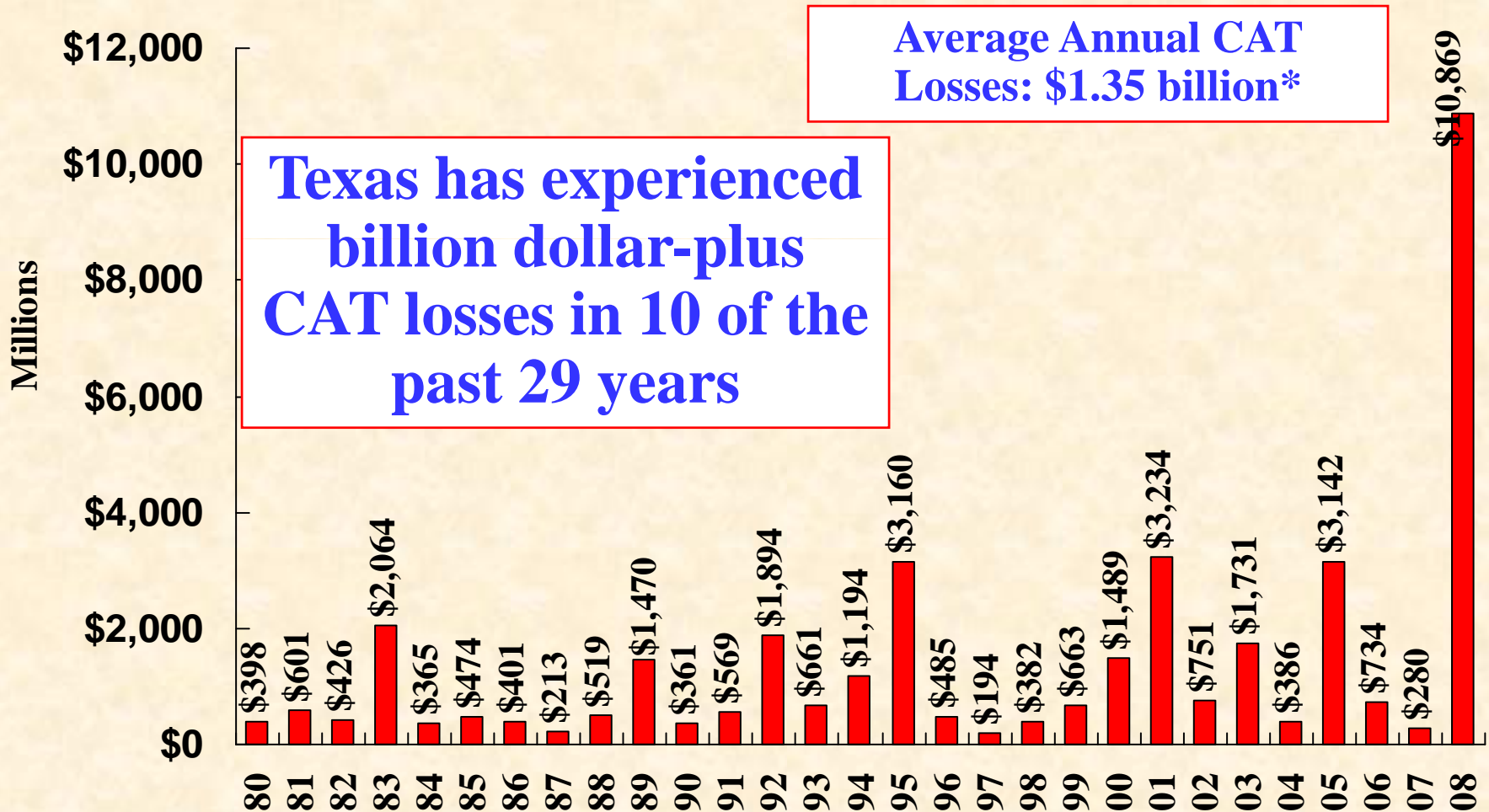
**From 1953-2009\*, Texas leads the country in major disaster declarations**

\*Through July 2, 2009.

Source: Federal Emergency Management Agency (FEMA)



# TEXAS: Insured Catastrophe Losses, 1980-2008\* (\$2008, in Millions)

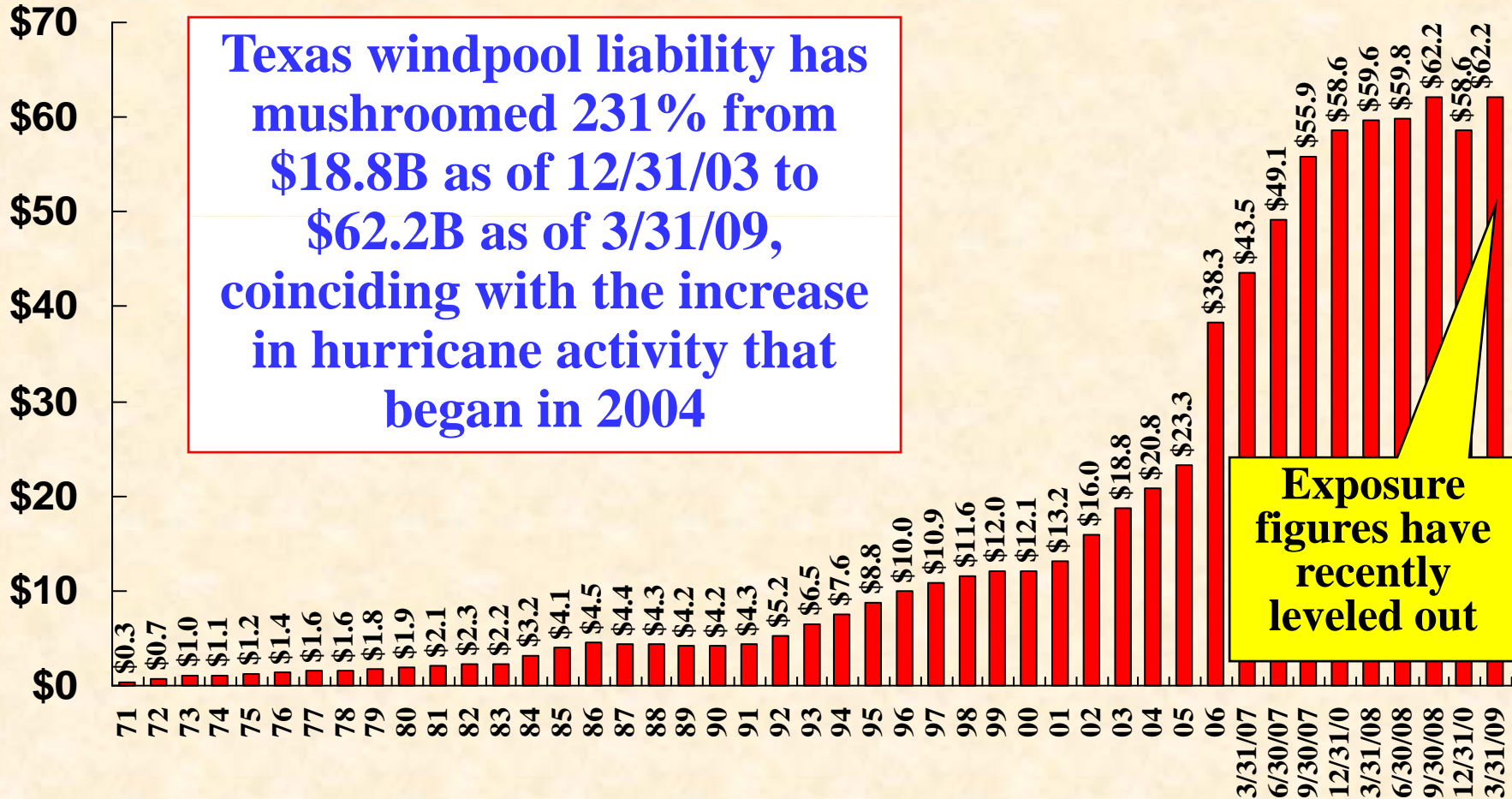


\*Losses stated in 2008.

Sources: ISO/PCS; Insurance Information Institute



# TEXAS: Windpool Direct Liability In-Force, 1971-2009: Q1\*



\*As of Dec. 31 for annual figures.

Sources: Texas Windstorm Insurance Association; Insurance Information Institute



# *Distribution of US Insured CAT Losses: TX, FL, LA vs US, 1980-2008\**

**\$ Billions of Dollars**

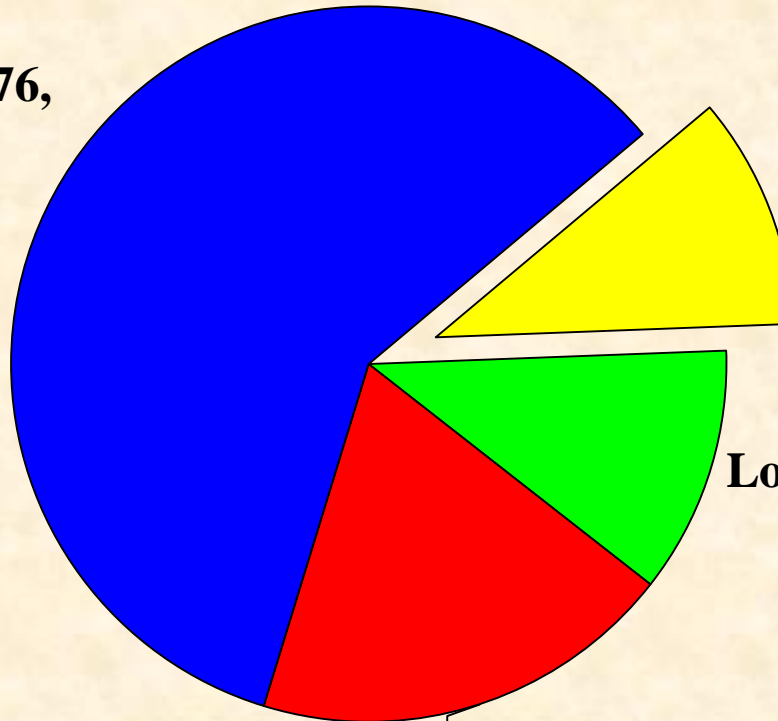
**Rest of US, \$176,  
60%**

**Texas, \$31.2,  
10%**

**Louisiana, \$33.6,  
11%**

**Florida, \$57.1,  
19%**

**Texas  
accounted for  
10% of all US  
insured CAT  
losses from  
1980-2008:  
\$31.2B out of  
\$297.9B**

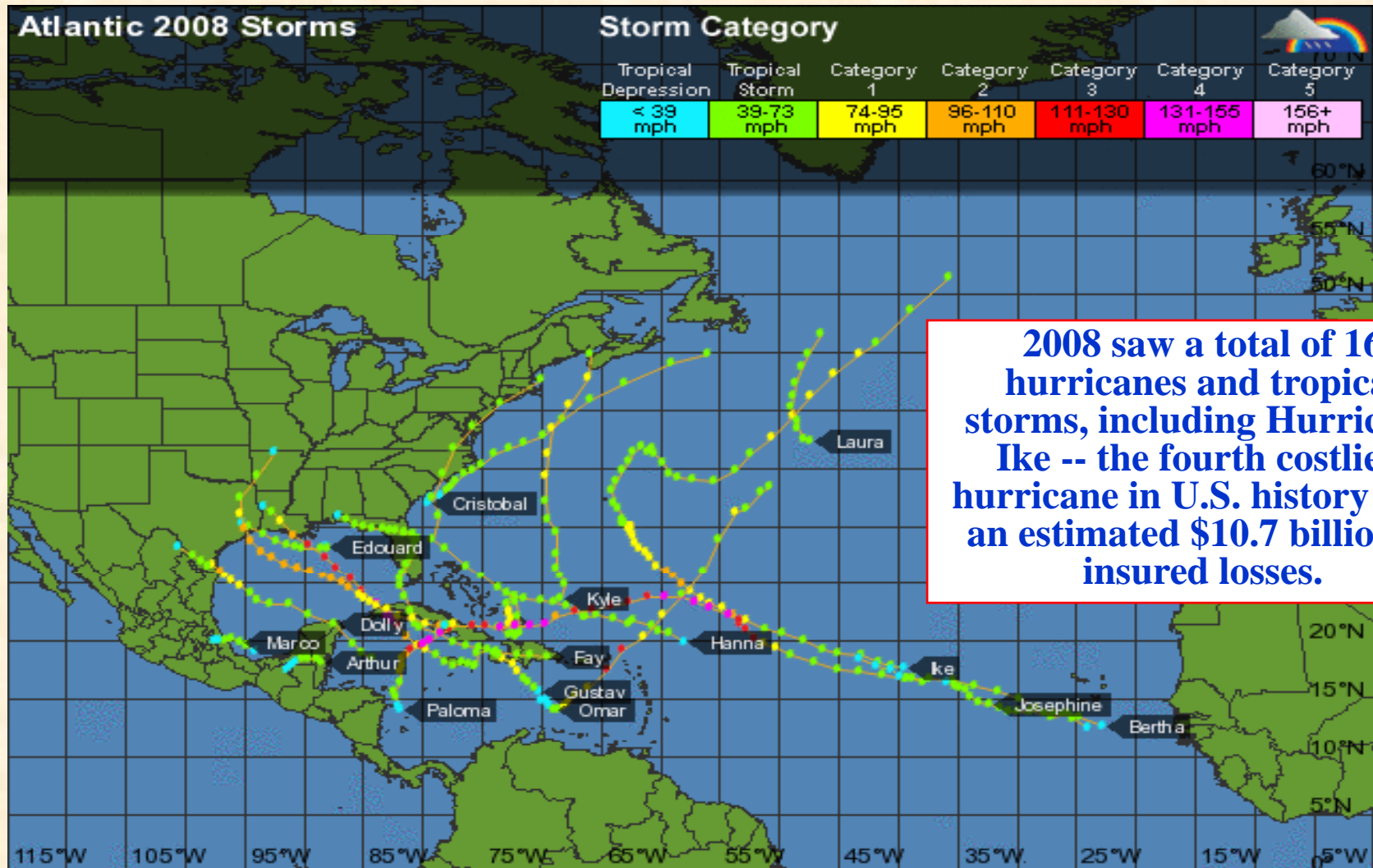


**\*All figures (except 2006-2008 loss) have been adjusted to 2005 dollars.**

**Source: PCS division of ISO.**



# 2008 Was A Relatively Active Hurricane Season

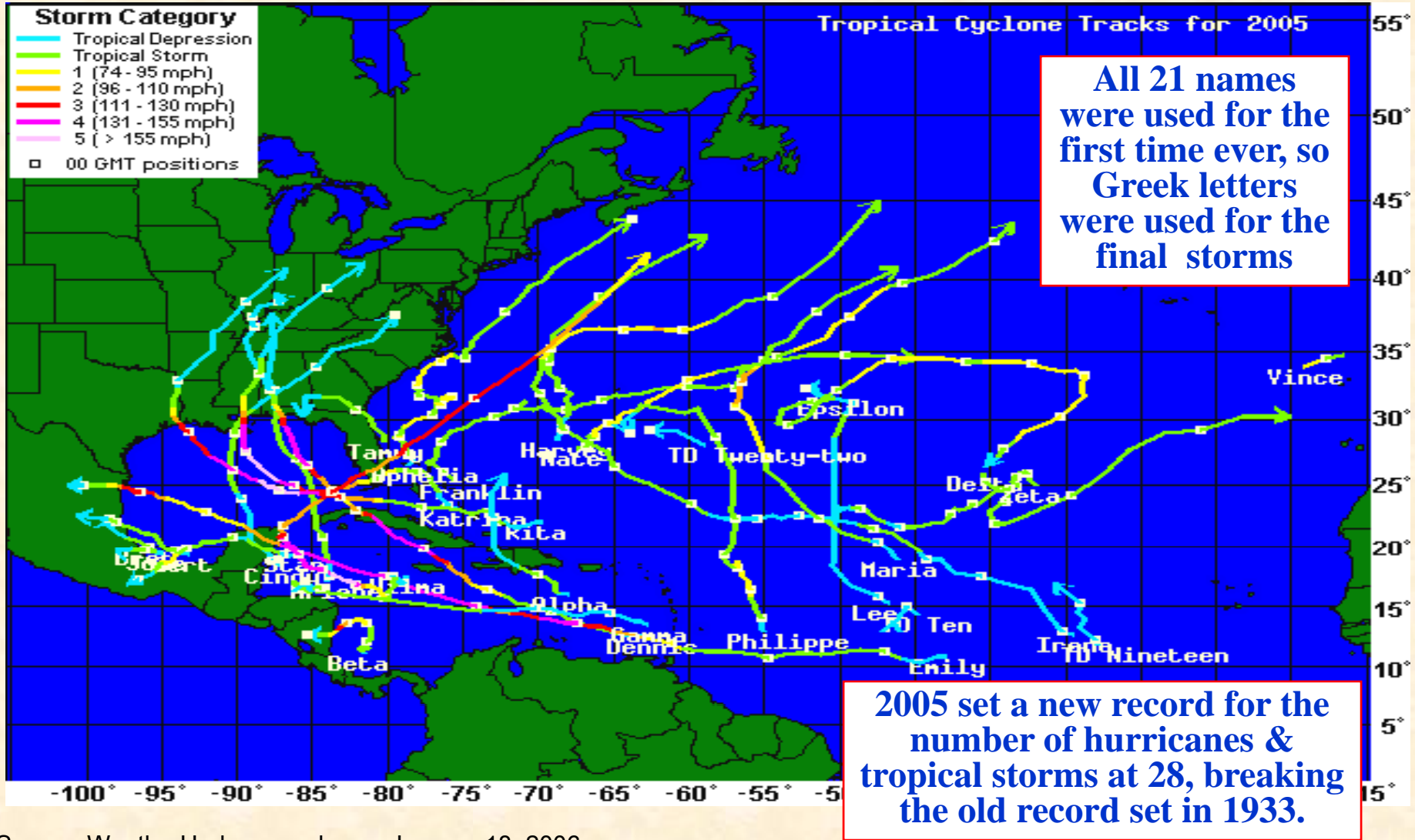


**2008 saw a total of 16 hurricanes and tropical storms, including Hurricane Ike -- the fourth costliest hurricane in U.S. history with an estimated \$10.7 billion in insured losses.**





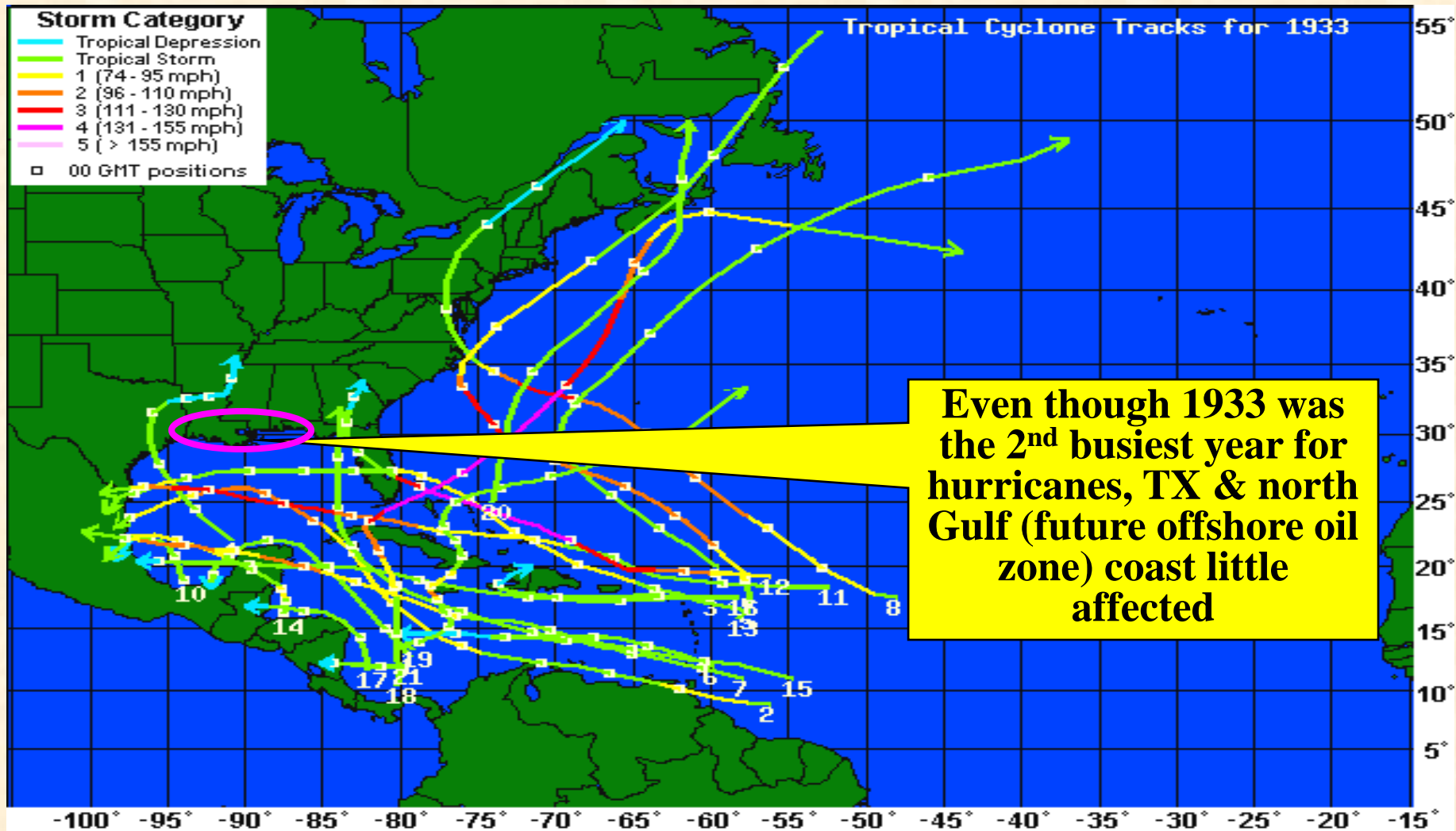
# 2005 Was a Busy, Destructive, Deadly & Expensive Hurricane Season





# Tropical Cyclone Activity in 1933

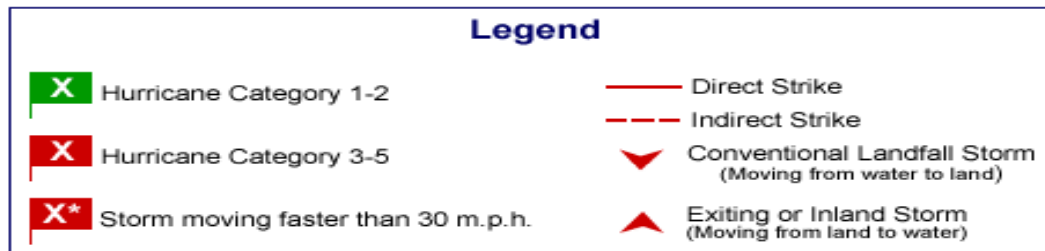
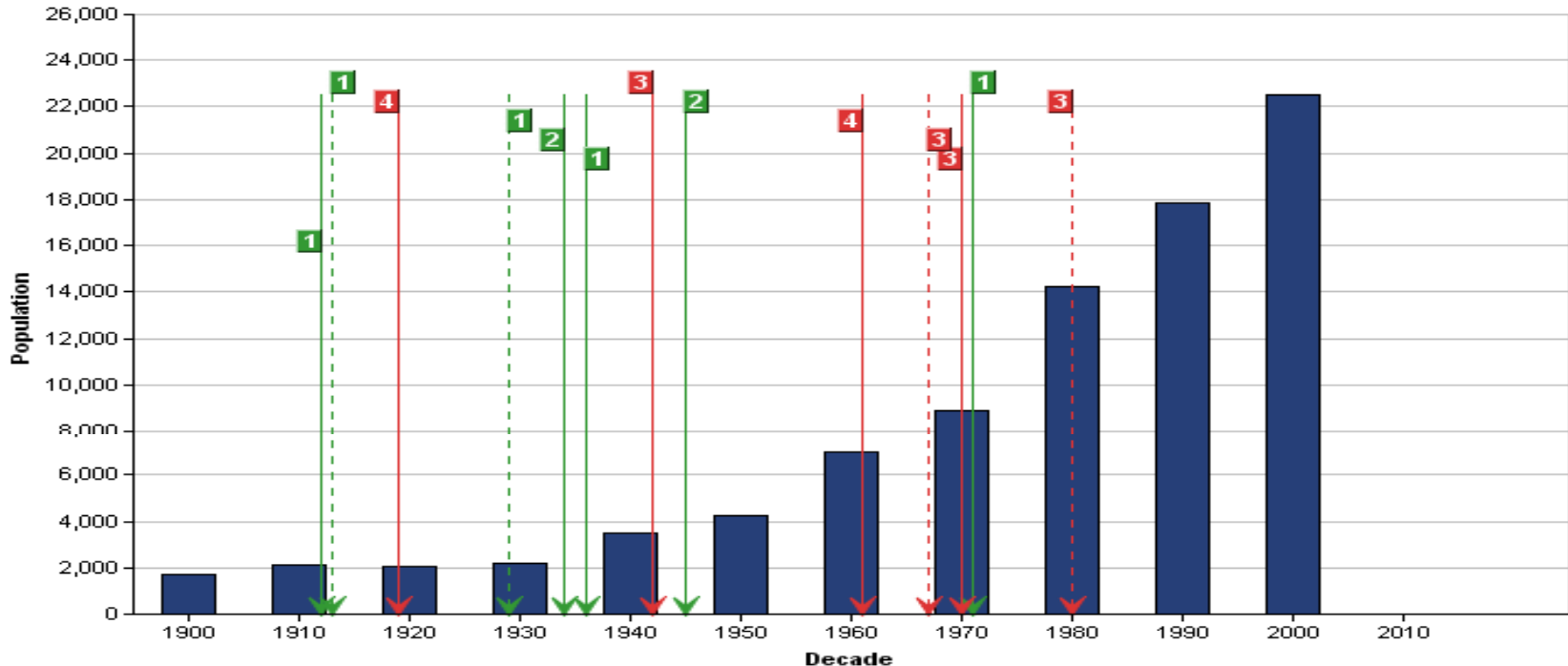
## Held the Record Before 2005





# Historical Hurricane Strikes in Aransas County, TX, 1900-2007

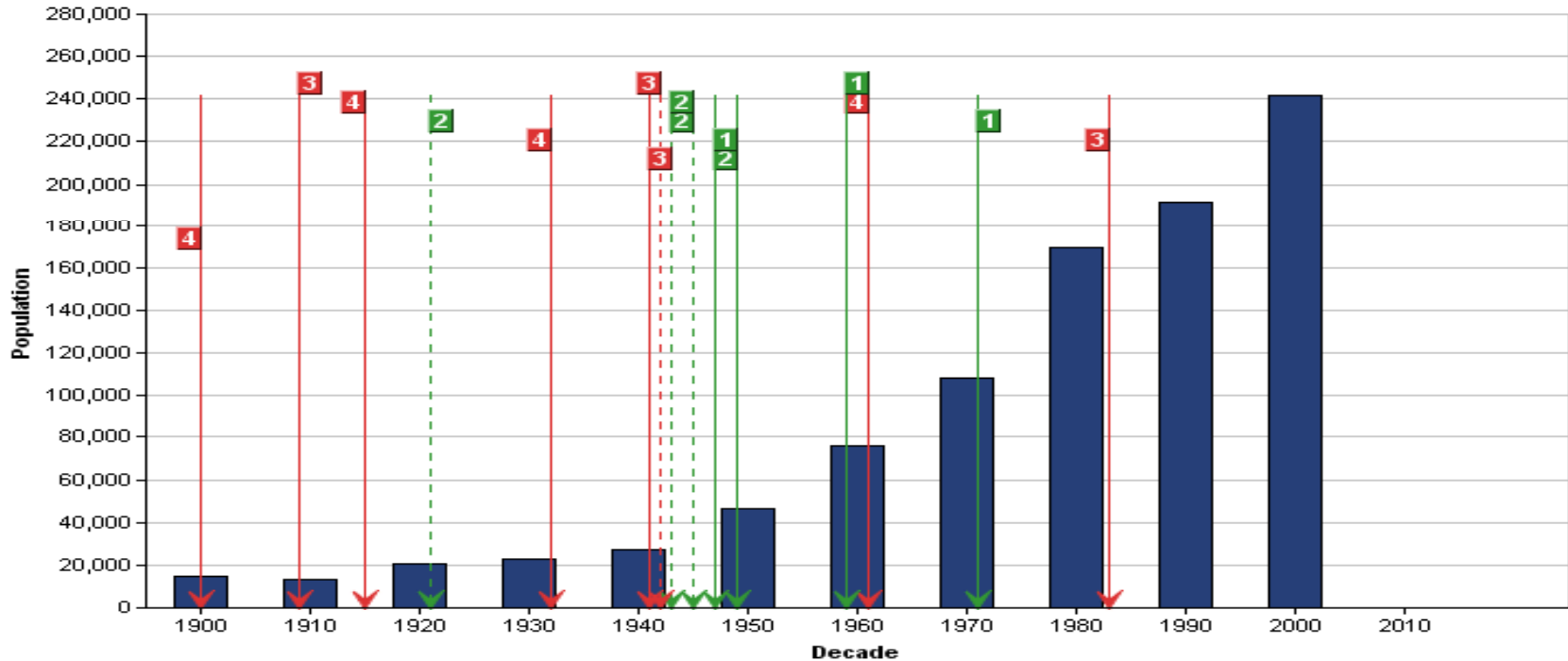
## Hurricane Strikes vs Population for Aransas, Texas





# Historical Hurricane Strikes in Brazoria County, TX, 1900-2007

## Hurricane Strikes vs Population for Brazoria, Texas



### Legend

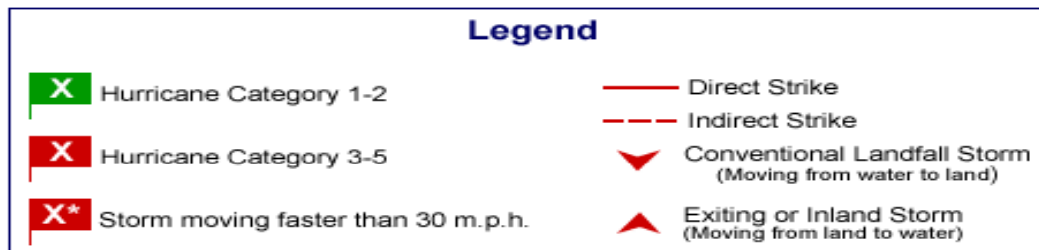
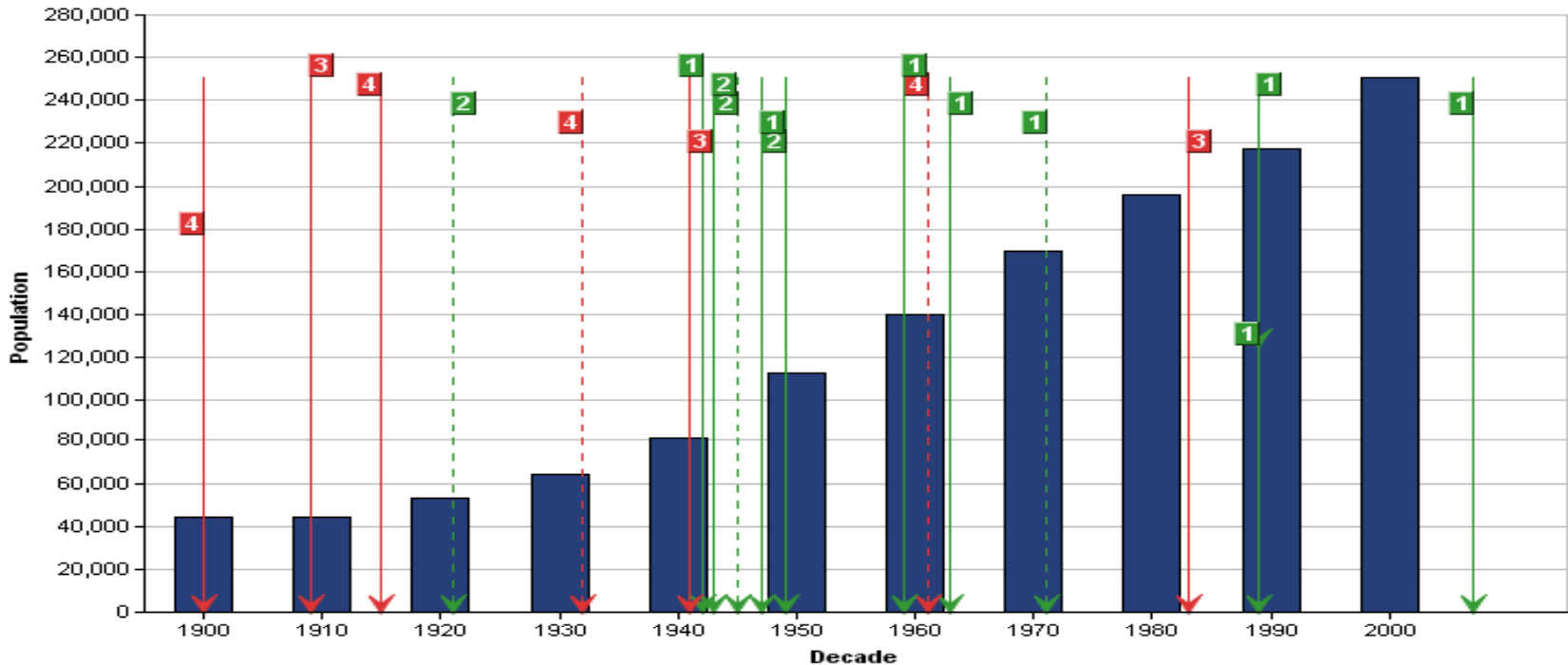
- Hurricane Category 1-2
- Hurricane Category 3-5
- Storm moving faster than 30 m.p.h.
- Direct Strike
- Indirect Strike
- Conventional Landfall Storm (Moving from water to land)
- Exiting or Inland Storm (Moving from land to water)





# Historical Hurricane Strikes in Galveston County, TX, 1900-2007

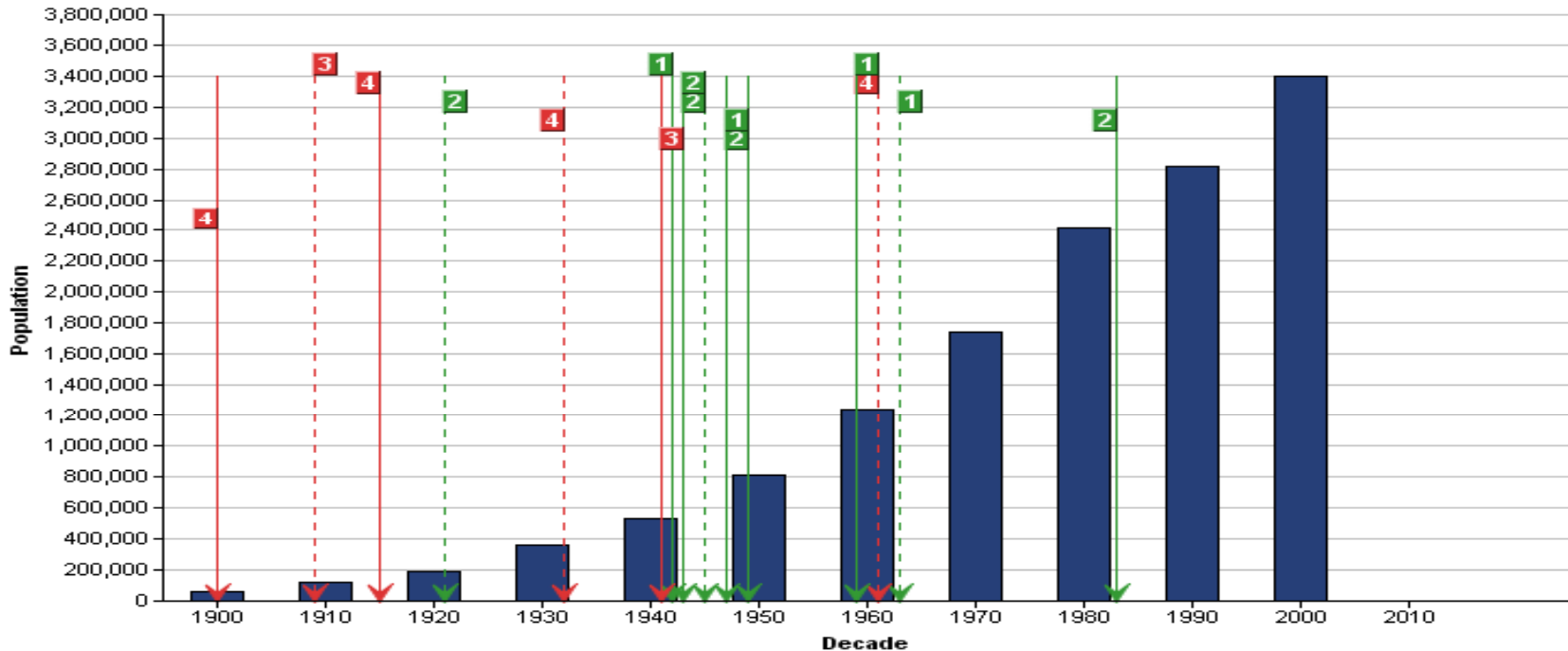
## Hurricane Strikes vs Population for Galveston, Texas





# Historical Hurricane Strikes in Harris County, TX, 1900-2007

## Hurricane Strikes vs Population for Harris, Texas



### Legend

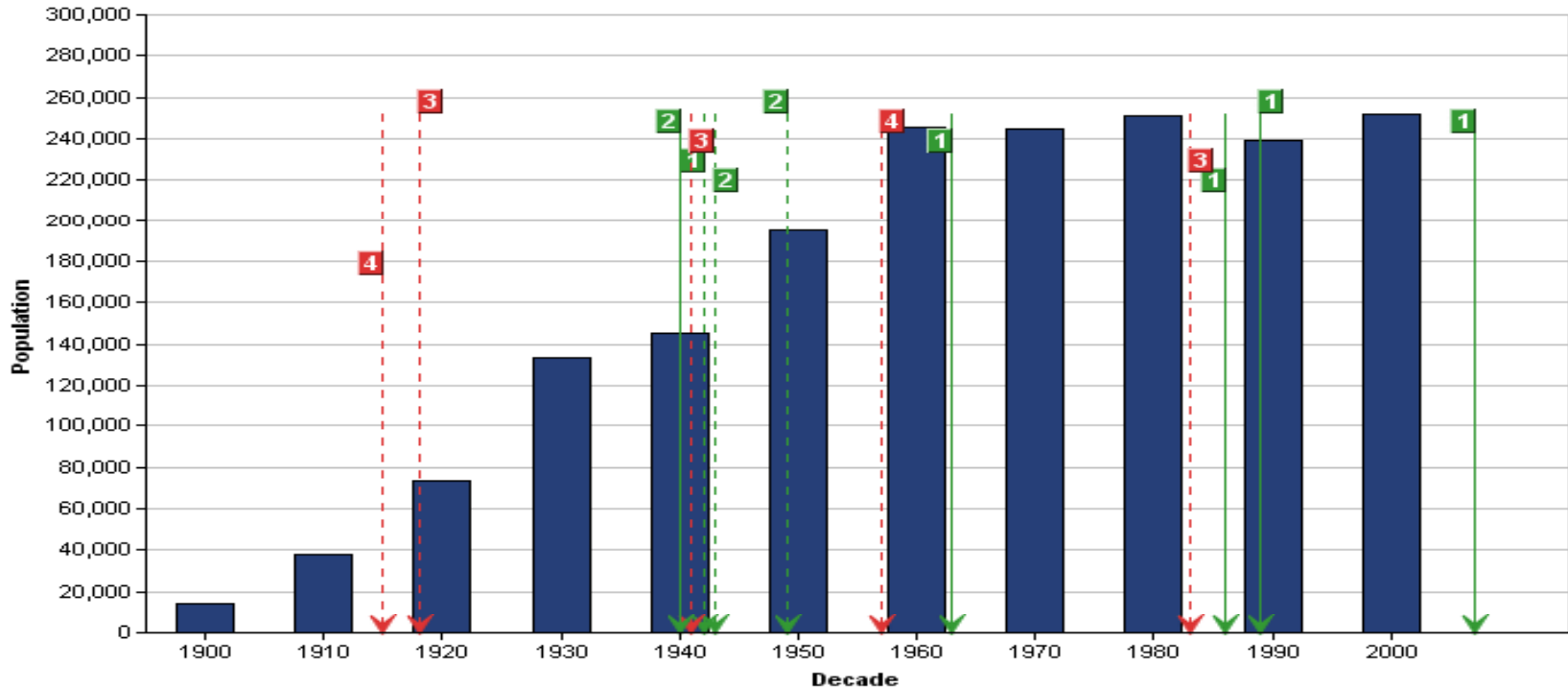
- Hurricane Category 1-2
- Hurricane Category 3-5
- Storm moving faster than 30 m.p.h.
- Direct Strike
- Indirect Strike
- Conventional Landfall Storm (Moving from water to land)
- Exiting or Inland Storm (Moving from land to water)





# Historical Hurricane Strikes in Jefferson County, TX, 1900-2007

## Hurricane Strikes vs Population for Jefferson, Texas



### Legend

- Hurricane Category 1-2
- Hurricane Category 3-5
- Storm moving faster than 30 m.p.h.
- Direct Strike
- Indirect Strike
- Conventional Landfall Storm (Moving from water to land)
- Exiting or Inland Storm (Moving from land to water)





# *Insurance Information Institute On-Line*

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