



# **The Workers Compensation Marketplace: *Strategic Overview and Outlook***

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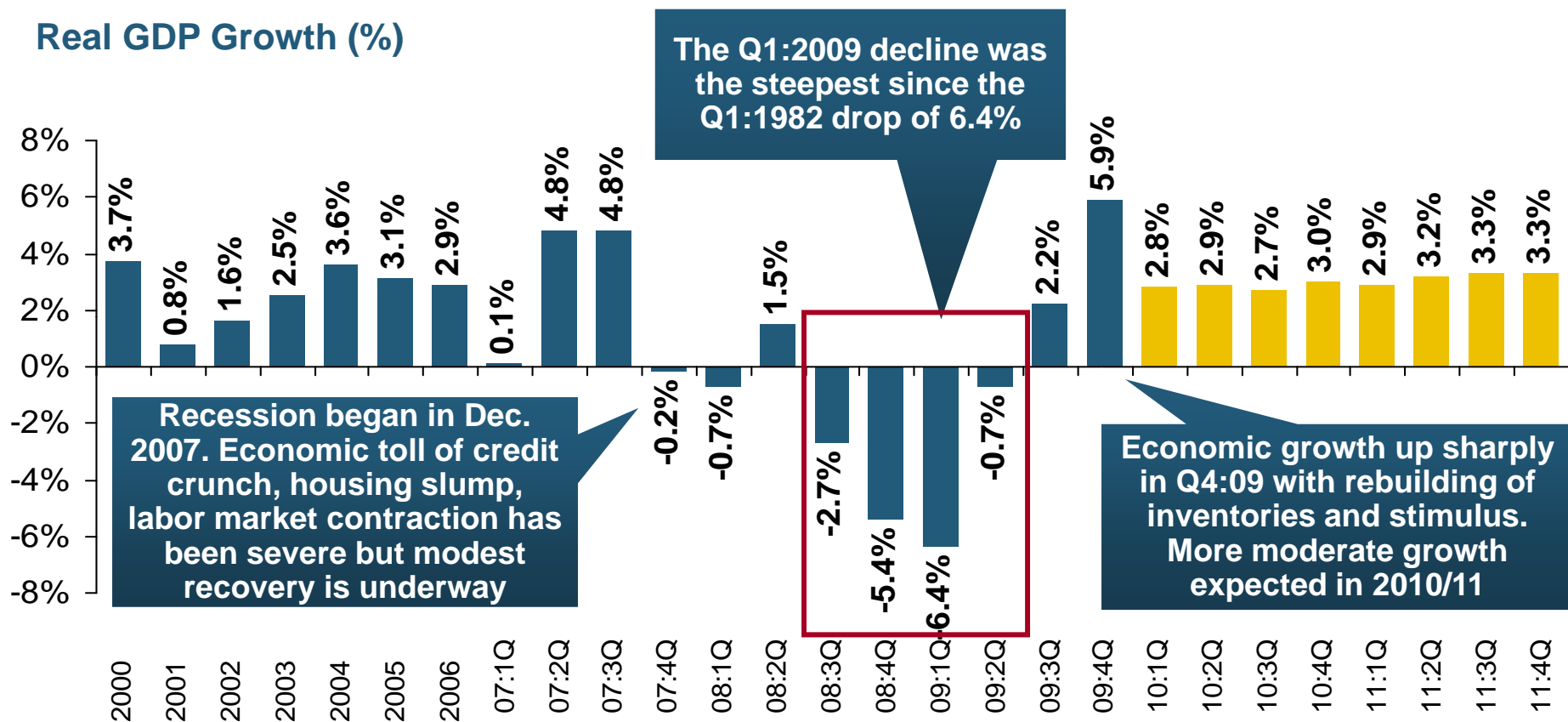
- **Workers Compensation and the Economy**
  - ◆ Regional Differences
  - ◆ Labor Market Trends
- **Crisis-Driven Exposure Drivers in Workers Comp**
  - ◆ Trends in Business Bankruptcies and New Business Formation
- **Sources of Growth in Workers Compensation**
  - ◆ Industry and Occupation Growth Analysis through 2018
- **Key Issues Facing Workers Comp Insurers in the Decade Ahead**
  - ◆ Investment Outlook, Regulation, Torts, Terrorism, Healthcare Reform
- **Workers Compensation Operating Environment**
  - ◆ Premium Growth
  - ◆ Underwriting Performance
  - ◆ Medical and Indemnity Claims Cost Trends
- **P/C Financial Overview**
- **Q&A**

# **Workers Compensation and the Economy**

**Workers Comp Exposure and  
Performance is Intimately Linked to  
the Economy and Labor Market**

# Real GDP Growth\*

## Real GDP Growth (%)



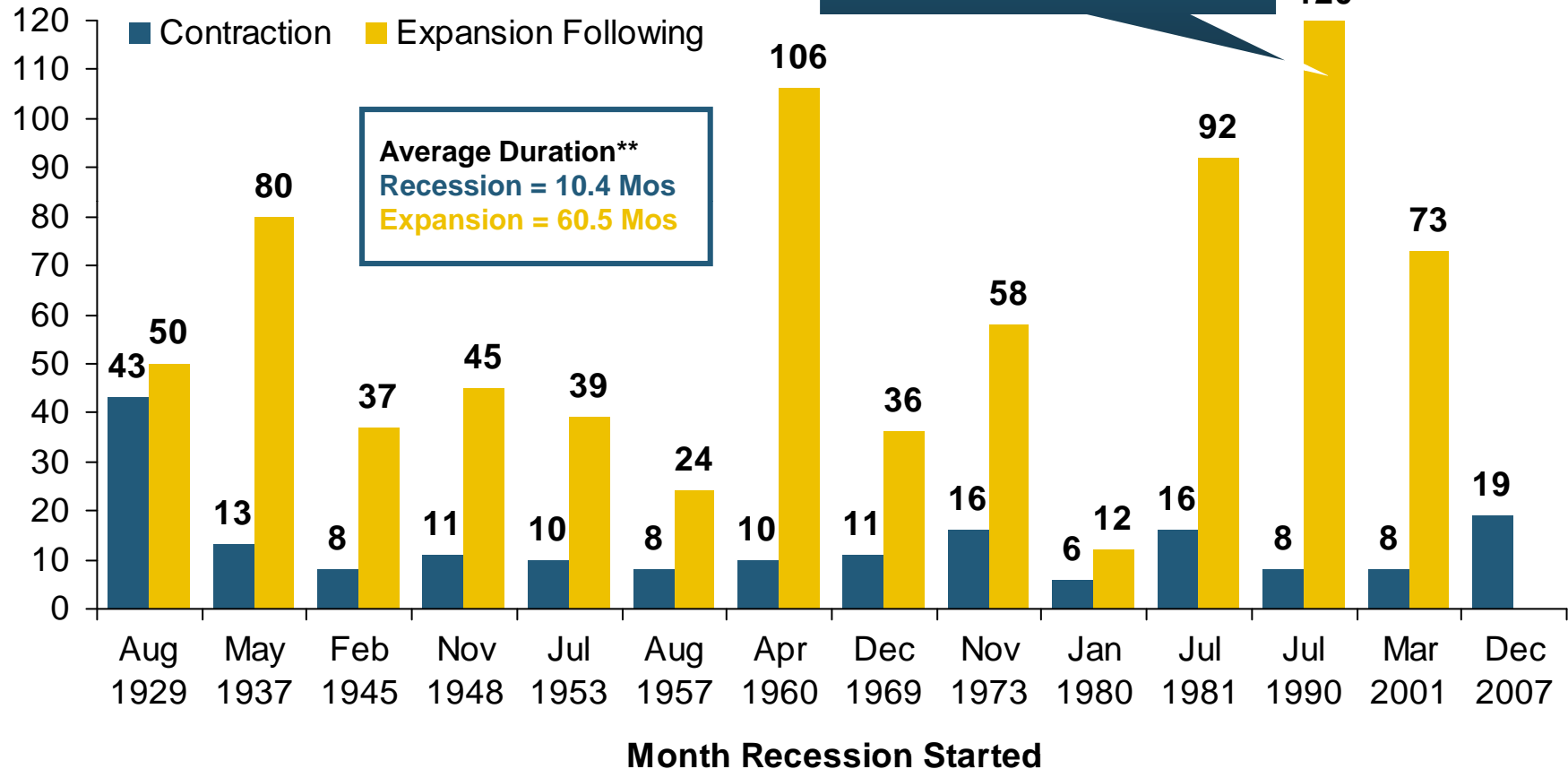
**Personal and Commercial Lines Exposure Base Have Been Hit Hard and Will Be Slow to Come Back**

\* Estimates/Forecasts from Blue Chip Economic Indicators.

Source: US Department of Commerce, Blue Economic Indicators 3/10; Insurance Information Institute.

# Length of US Business Cycles, 1929–Present\*

## Duration (Months)

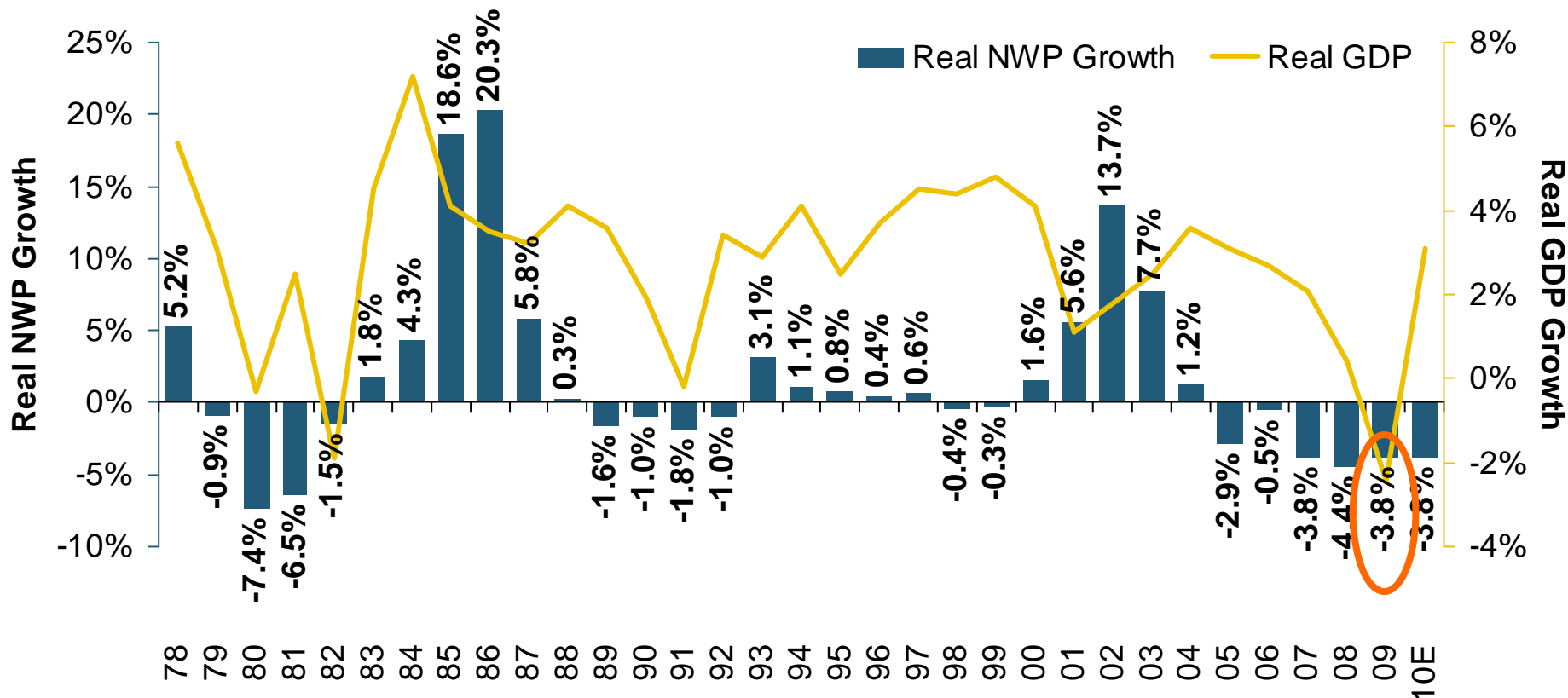


\* Through June 2009 (likely the “official end” of recession) \*\* Post-WW II period through end of most recent expansion.

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

# Real GDP Growth vs. Real P/C Premium Growth: Modest Association

Real GDP Growth vs. Real P/C (%)



**P/C Insurance Industry's Growth is Influenced Modestly  
by Growth in the Overall Economy**



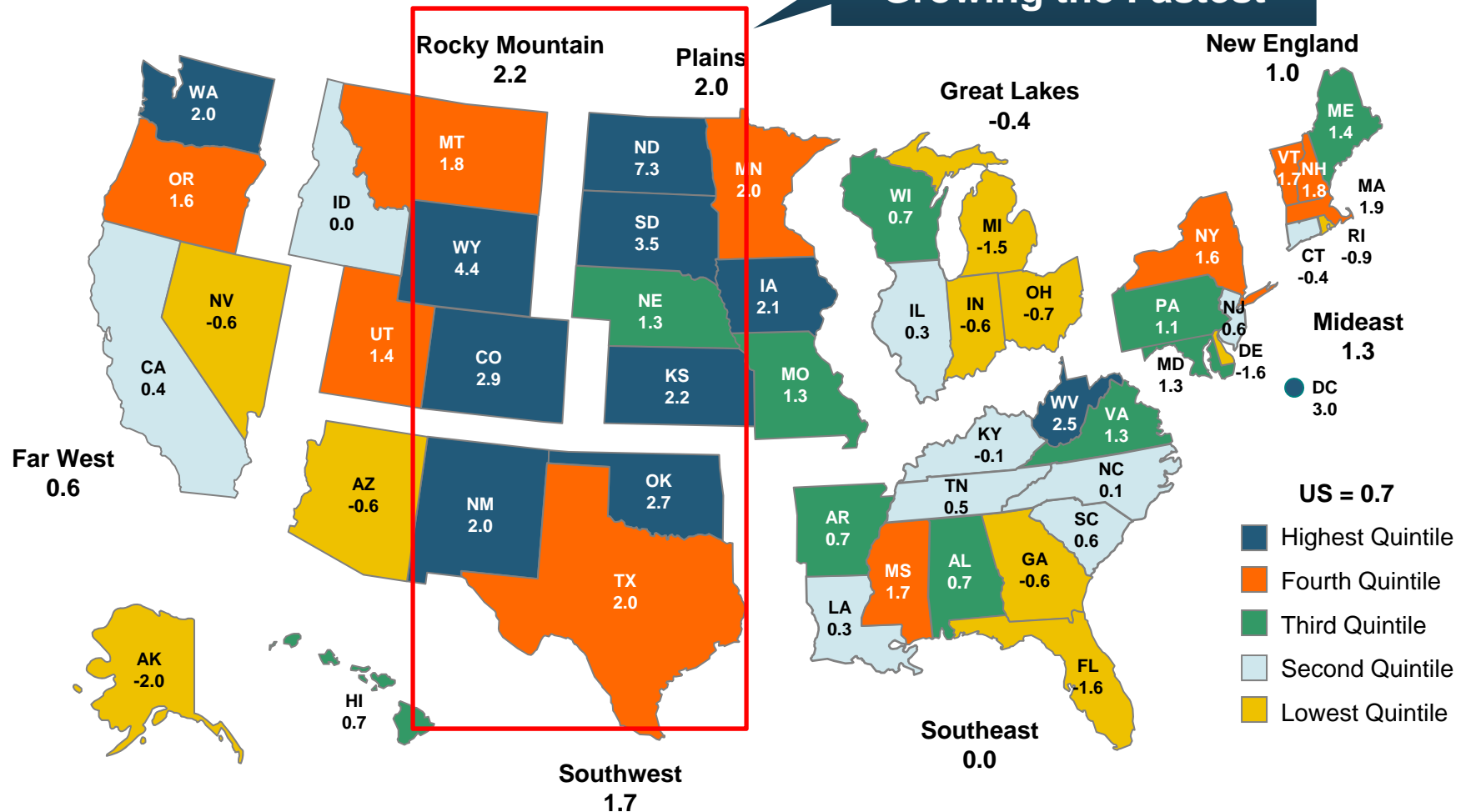
## **Regional Differences Will Significantly Impact P/C Markets**

**Recovery in Some Areas Will  
Begin Years Ahead of Others  
and Speed of Recovery Will Differ  
by Orders of Magnitude**

# State Economic Growth Varied Tremendously in 2008

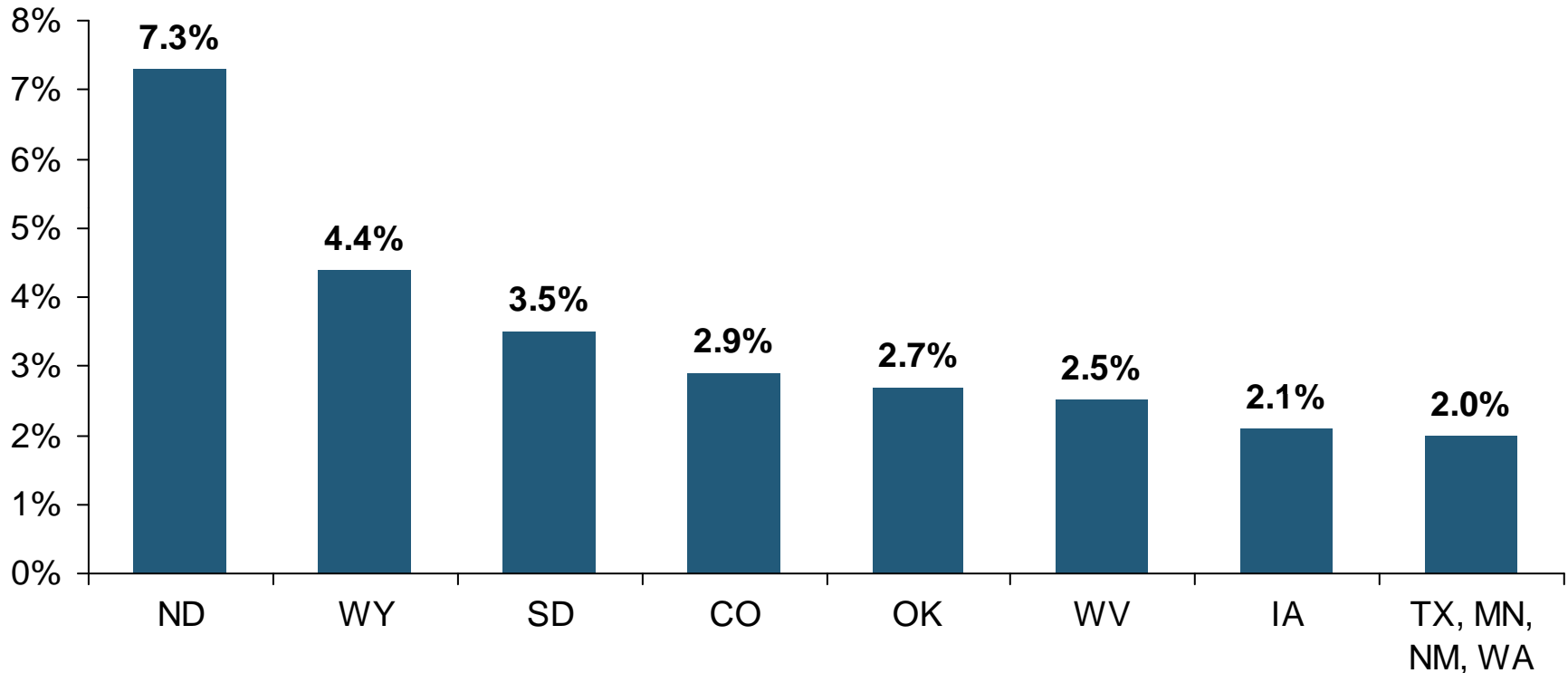
Percent Change in Real GDP by State, 2007–2008

**Mountain, Plains States  
Growing the Fastest**



# Fastest Growing States in 2008: Plains, Mountain States Lead

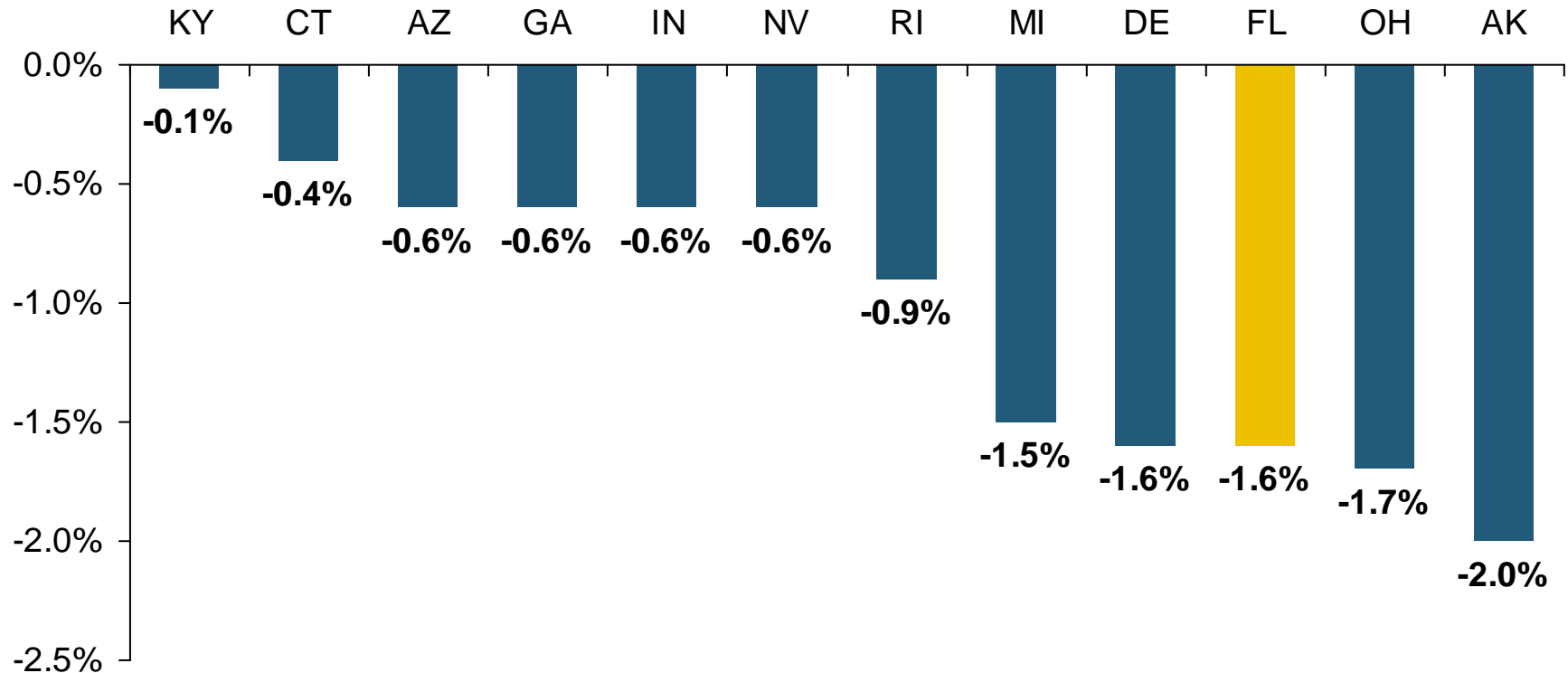
## Real State GDP Growth (%)



**Natural Resource and Agricultural States Have Done Better Than Most Others Recently, Helping Insurance Exposure in Those Areas**

# Slowest Growing States in 2008: Diversity of States Suffering

## Real State GDP Growth (%)



**States in the North, South, East and West All Represented Among  
Hardest Hit, But for Differing Reasons**

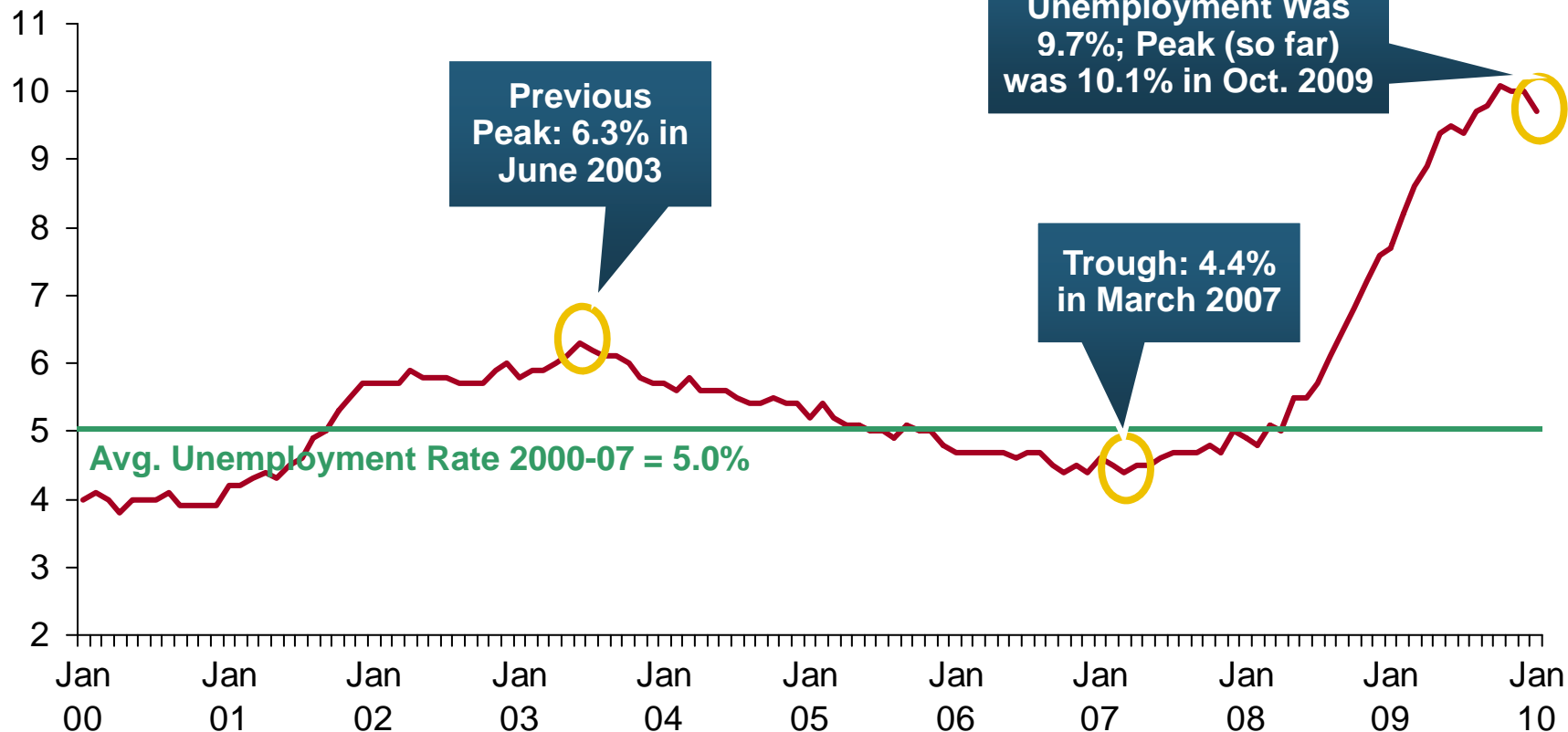
# **Labor Market Trends**

**Massive Job Losses Sapped the  
Economy and the Workers Comp  
Payroll Exposure Base**

***The Long Road to Recovery***

# Unemployment Rate: Has it Peaked?

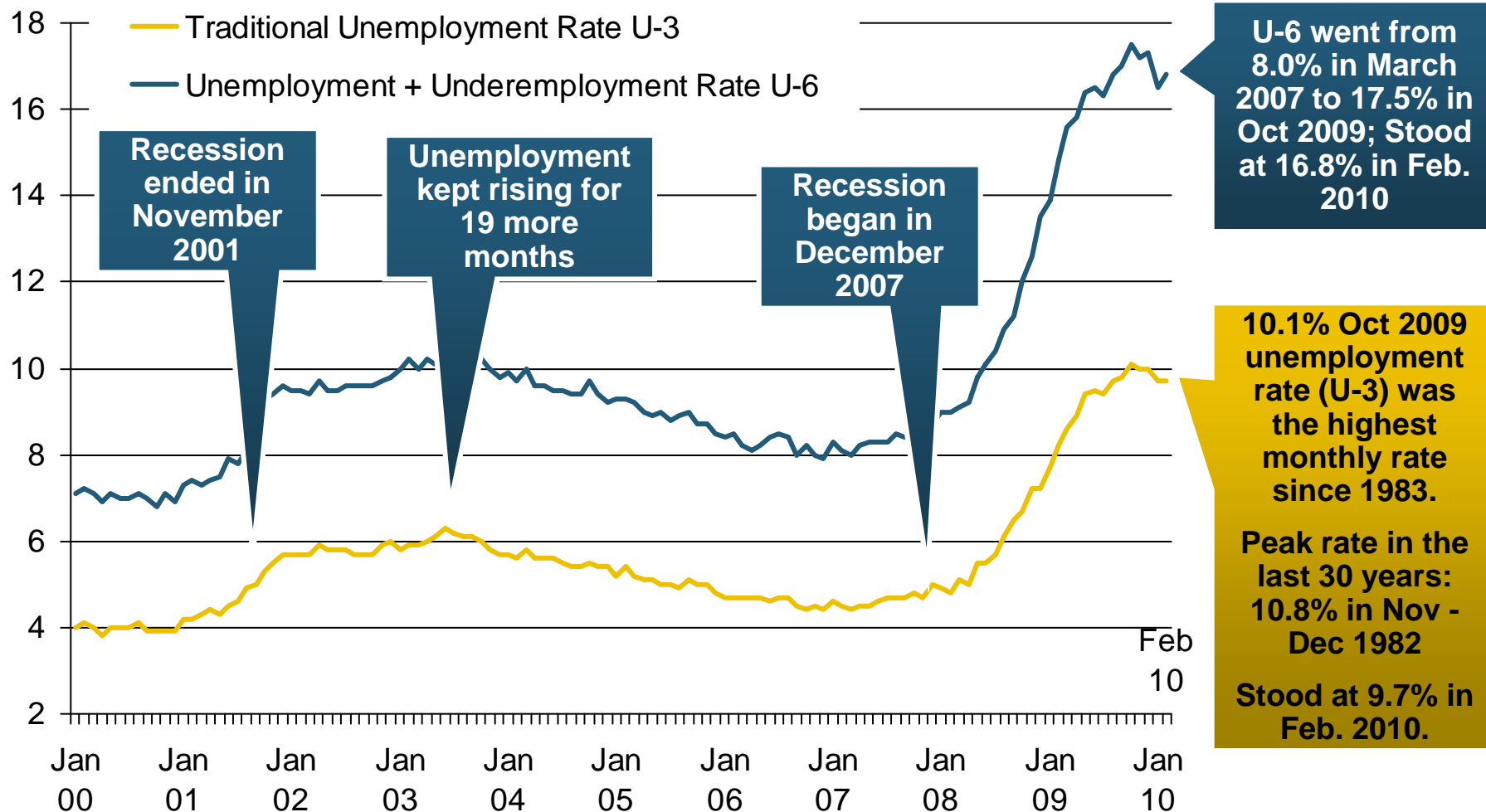
January 2000 through January 2010\* (%)



**Unemployment Will Likely Rise Again During This Cycle, Impacting Payroll Sensitive P/C and L/H Exposures**

# Unemployment and Underemployment Rates: Rocketing Up in 2008-09

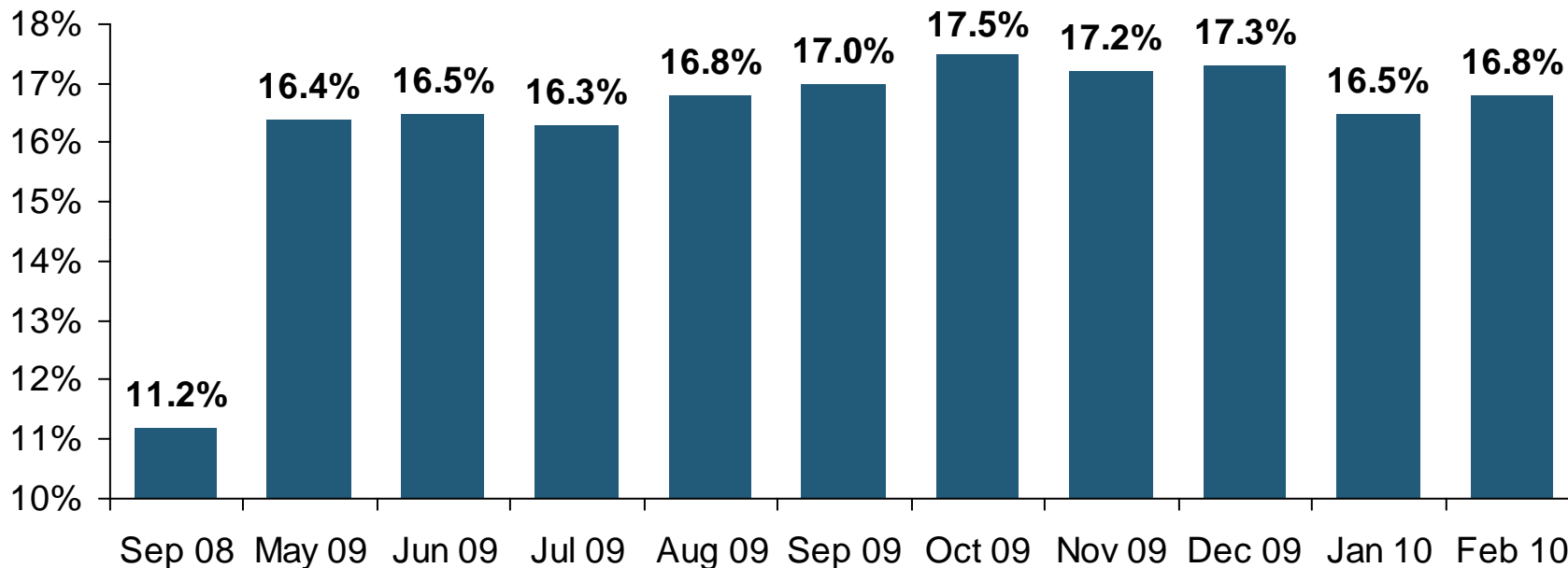
January 2000 through February 2010, Seasonally Adjusted (%)



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

# Labor Underutilization: Broader than Just Unemployment

## % of Labor Force



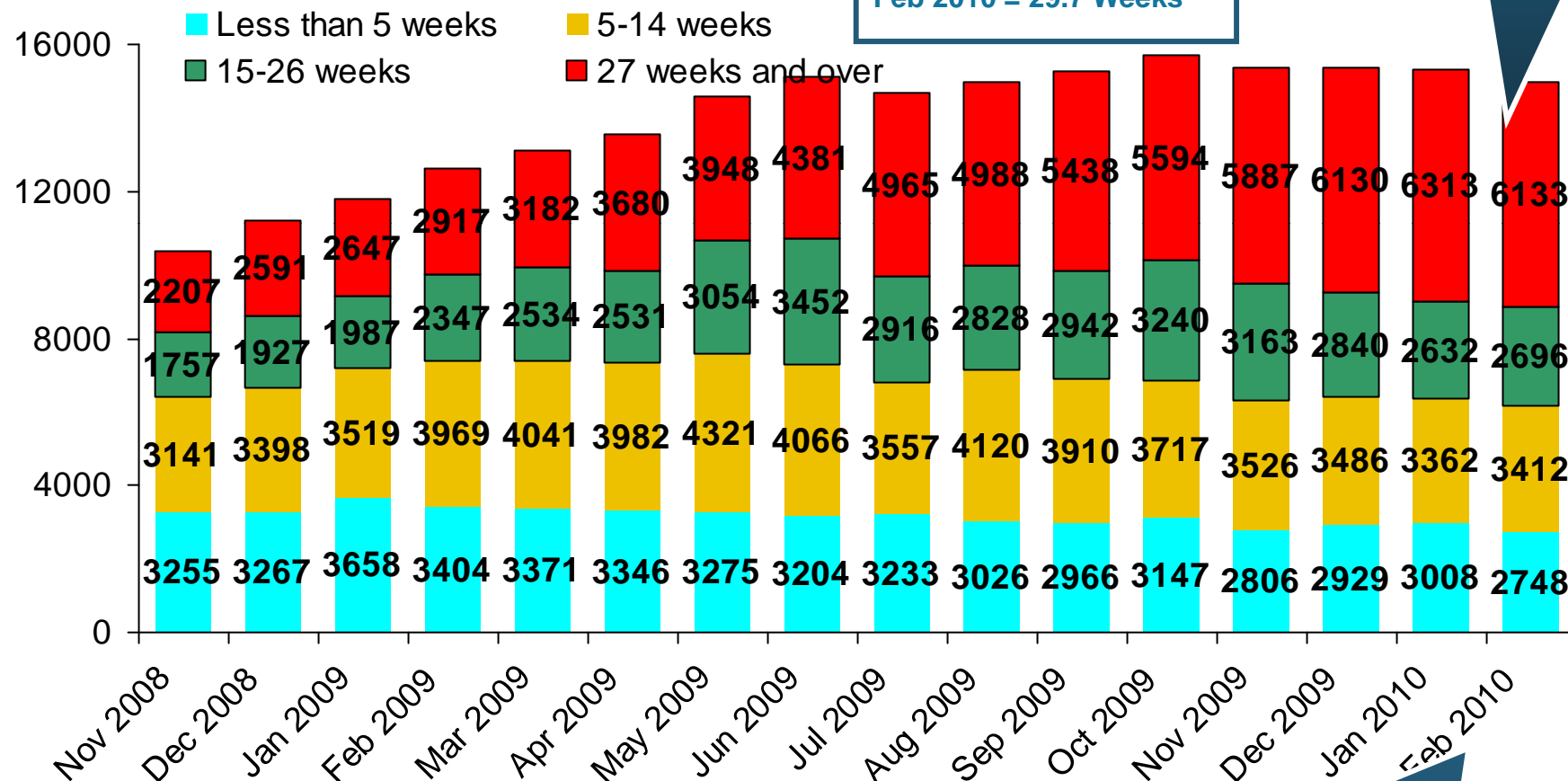
**Marginally Attached and Unemployed Persons Account for 16.8% of the Labor Force in Feb. 2010 (1 Out 6 People). Unemployment Rate Alone was 9.7%. Underutilization Shows a Broader Impact on WC and Other Commercial Exposures**

NOTE: Marginally attached workers are persons who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the recent past. Discouraged workers, a subset of the marginally attached, have given a job-market related reason for not looking currently for a job. Persons employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule.

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

# Length of Unemployment, Monthly, Nov 2008–Present\*

Number of People  
(Thousands)

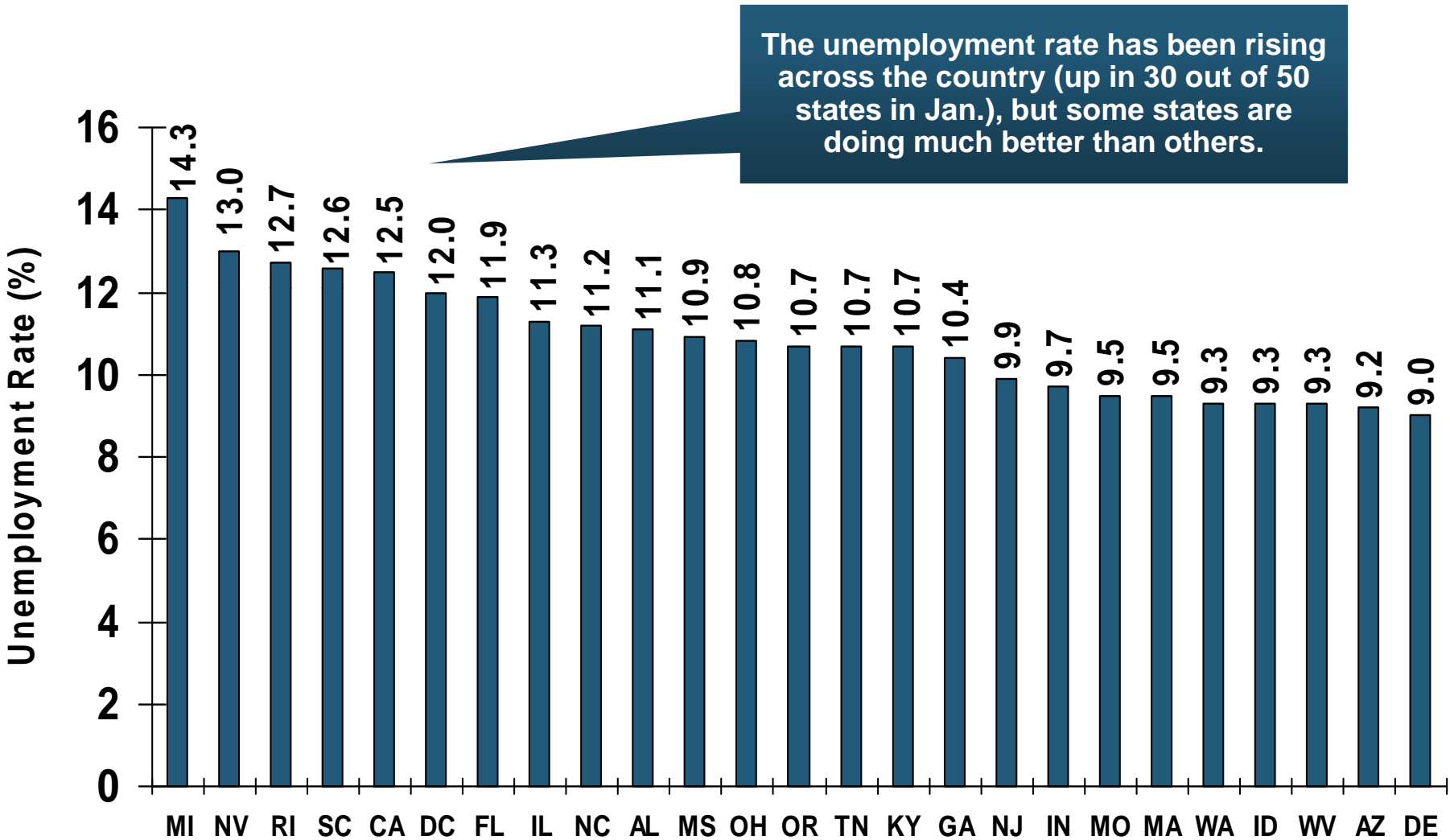


\*Through Feb. 2010; Seasonally adjusted

Sources: Bureau of Labor Statistics; Insurance Information Institute.

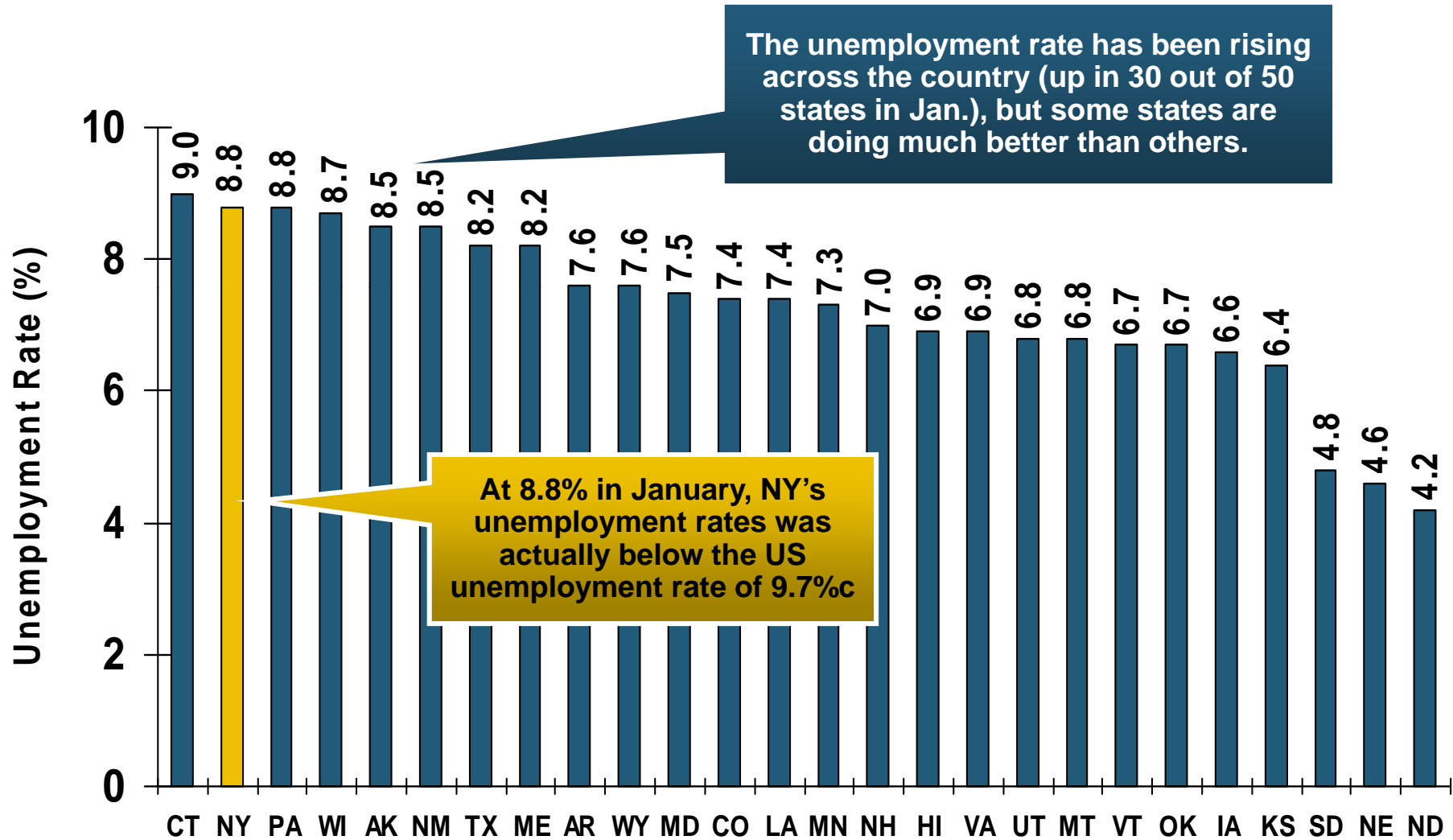
Number of long-term (27+) unemployed  
dropped by 200,000 in February 2010

# Unemployment Rates by State, January 2010: Highest 25 States\*



\*Provisional figures for January 2010, seasonally adjusted.  
Sources: US Bureau of Labor Statistics; Insurance Information Institute.

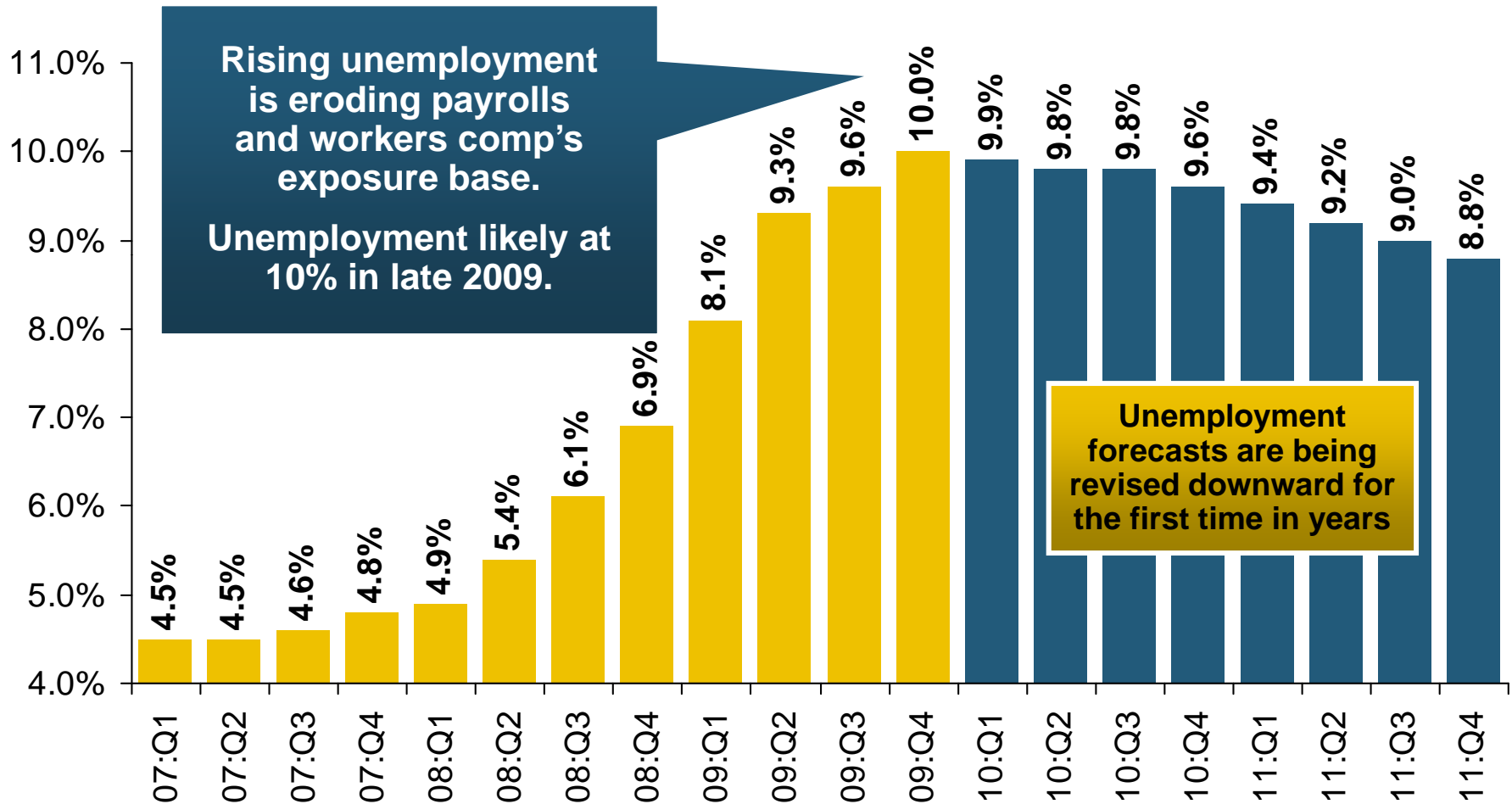
# Unemployment Rates By State, January 2010: Lowest 25 States\*



\*Provisional figures for January 2010, seasonally adjusted.  
Sources: US Bureau of Labor Statistics; Insurance Information Institute.

# US Unemployment Rate

2007:Q1 to 2011:Q4F\*

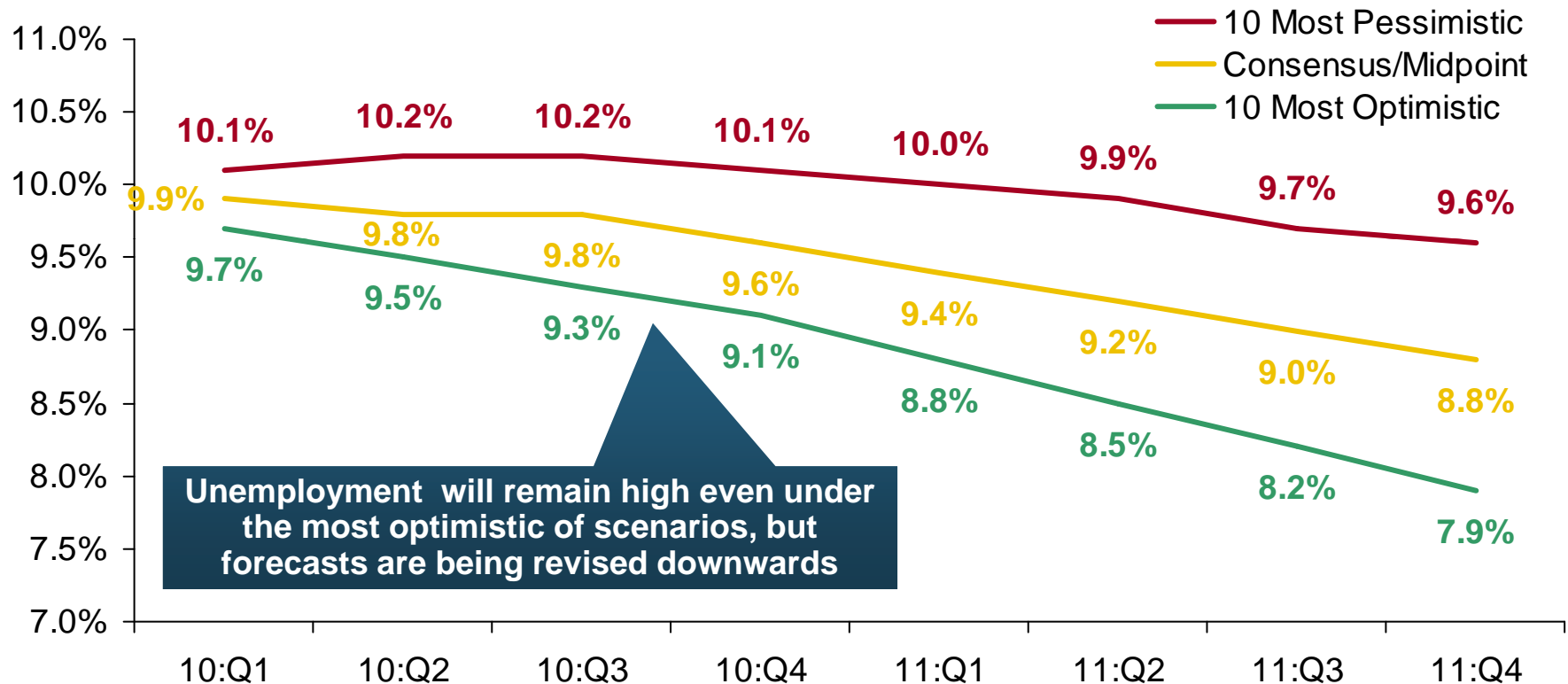


\* ■ = actual; ■ = forecasts

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (3/10); Insurance Information Institute

# US Unemployment Rate Forecasts

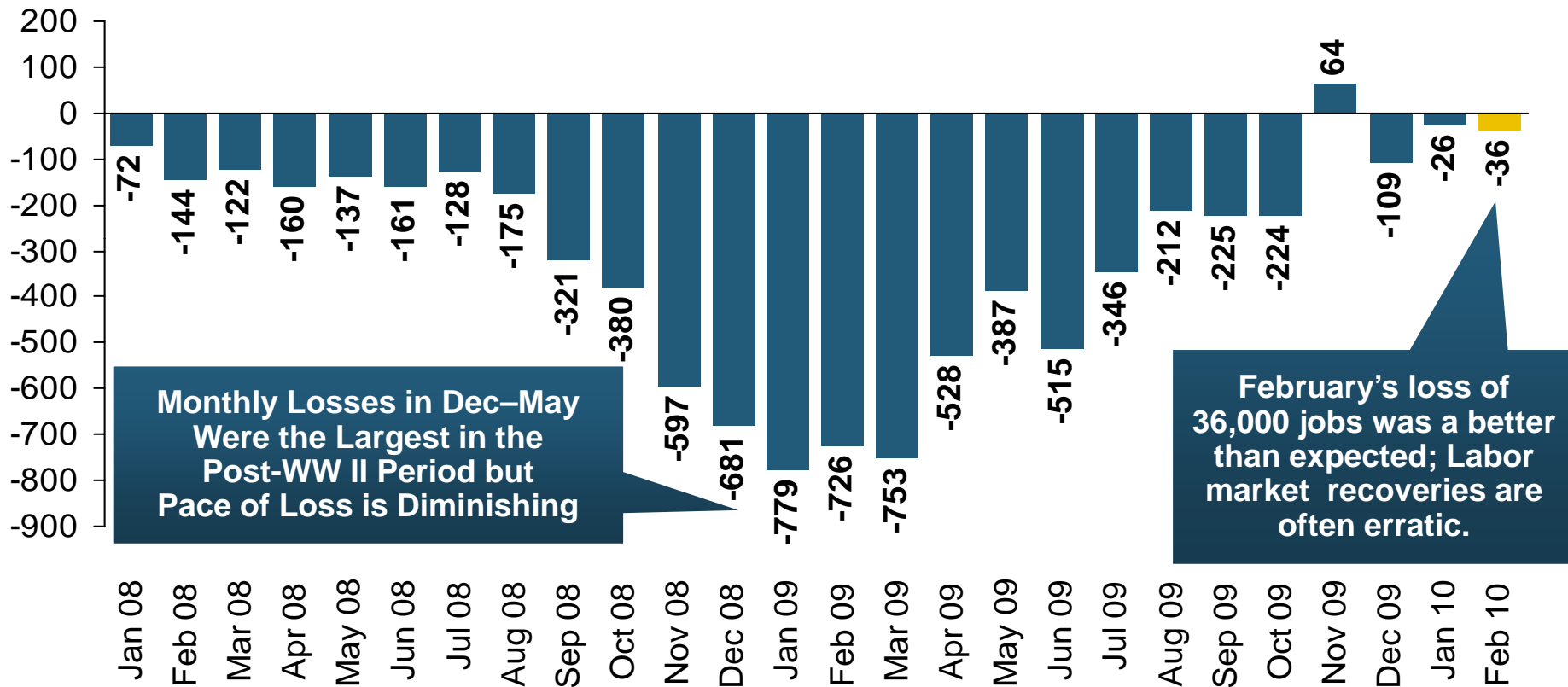
Quarterly, 2010:Q1 to 2011:Q4



**Stubbornly High Unemployment Will Hurt the  
Workers Comp's Exposure Base**

# Monthly Change Employment\*

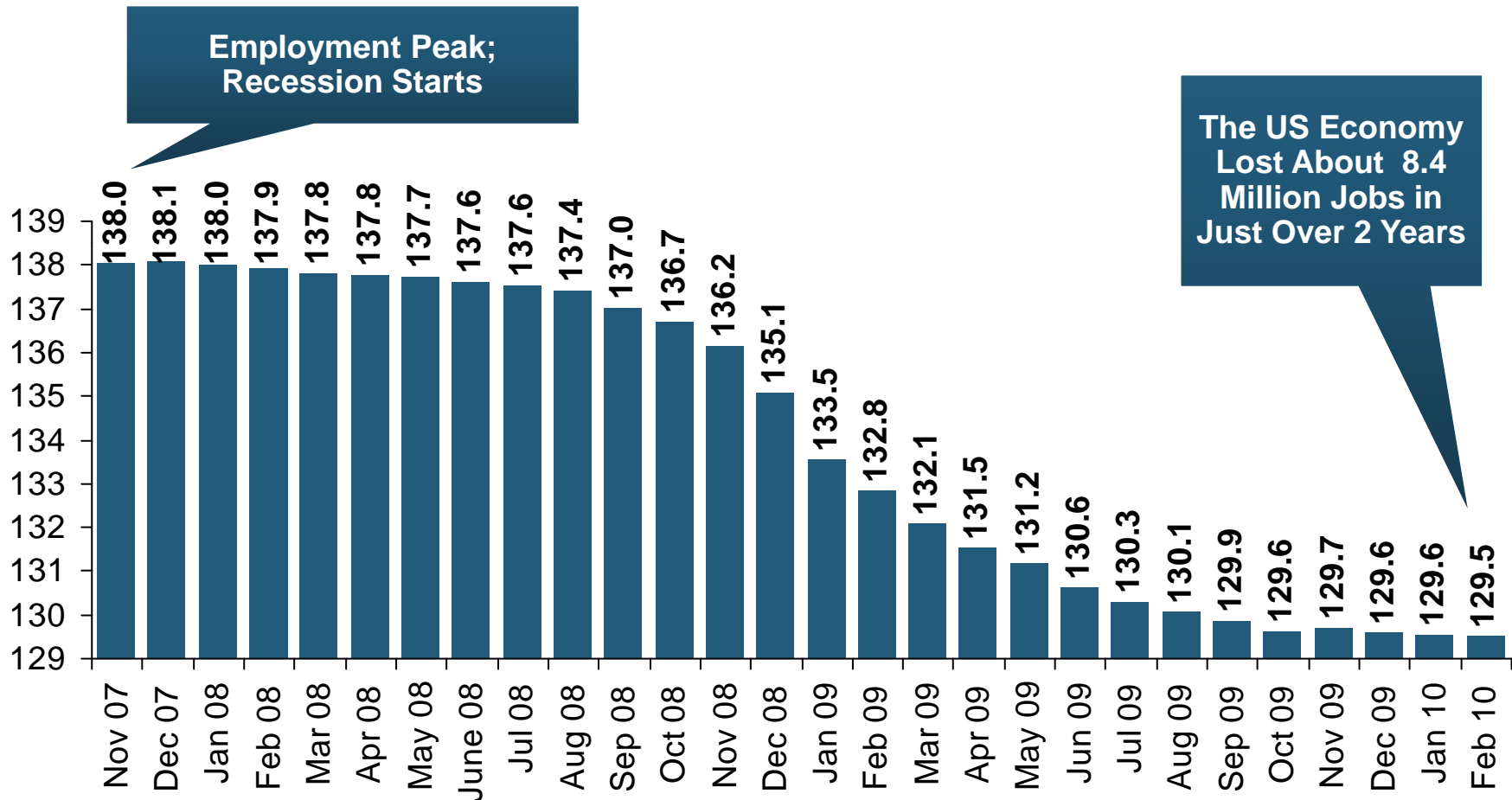
January 2008 through February 2010 (Thousands)



**Job Losses Since the Recession Began in Dec. 2007 Total 8.4 Million;  
14.9 Million People are Now Defined as Unemployed**

# US Nonfarm Private Employment

Monthly, Nov 2007 – Feb 2010 (Millions)

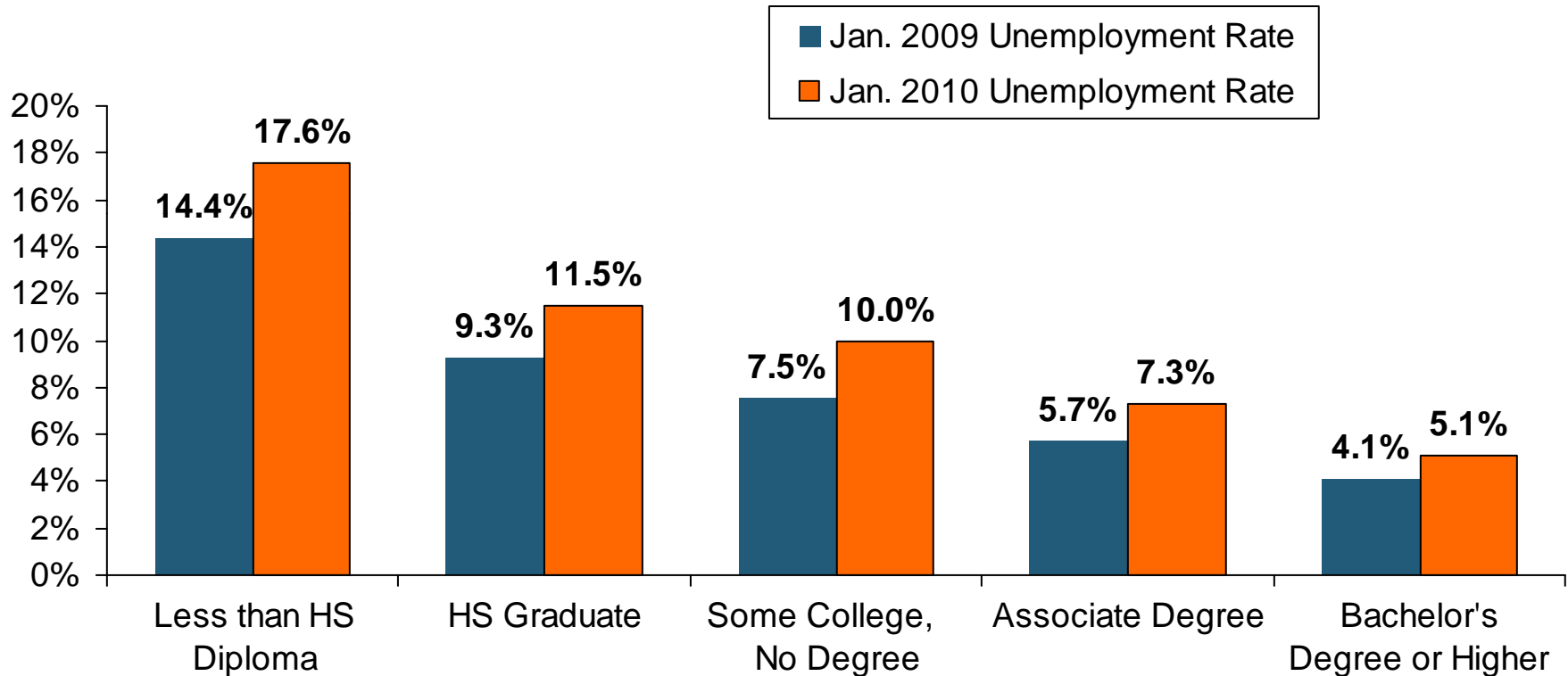


Seasonally adjusted.

Source: US Bureau of Labor Statistics

# Unemployment and Educational Attainment: More Education = Less Unemployment

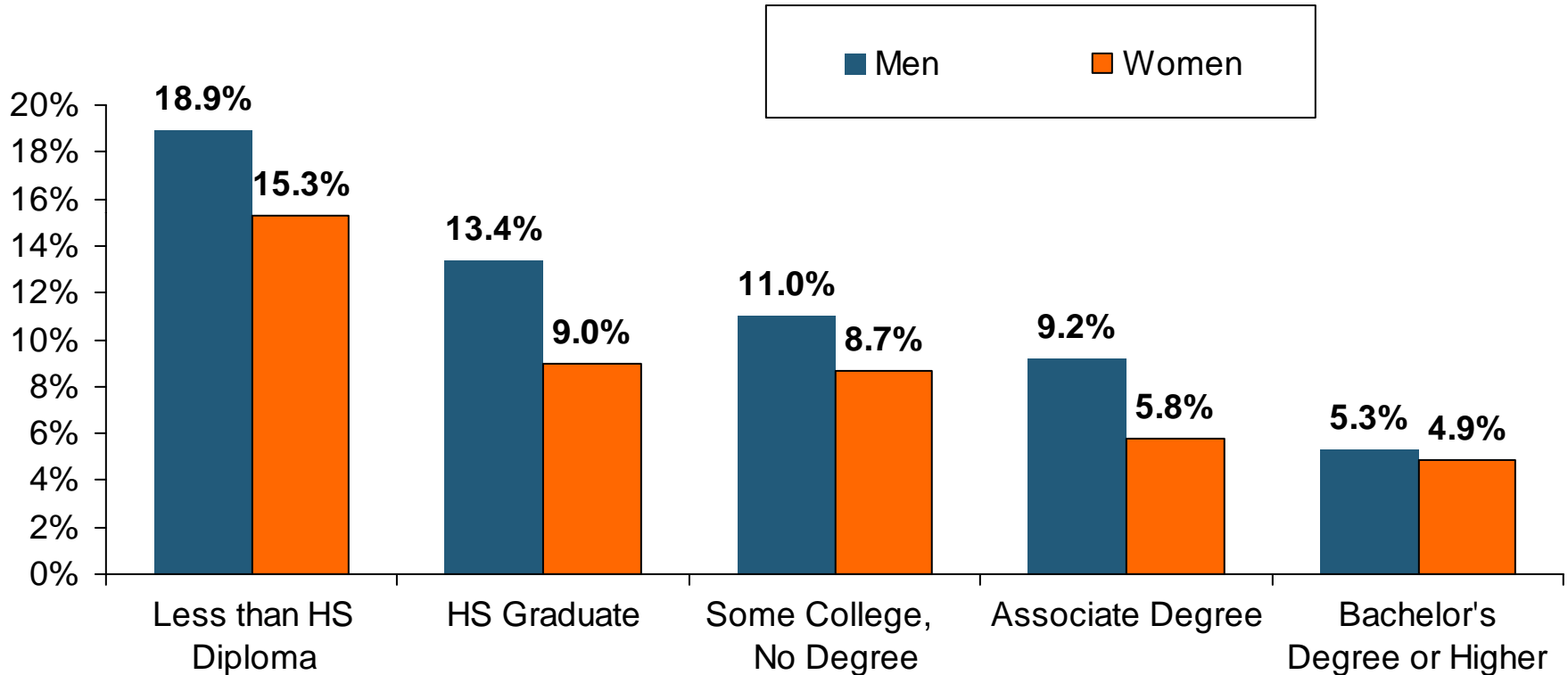
Unemployment Rate (%), January 2009 vs. January 2010



**WC Payroll Exposure Increasing Skewed in Favor of Workers with Higher Level of Educational Attainment**

# Unemployment Rate by Gender: The “Mancession” Can Impact Exposure Too

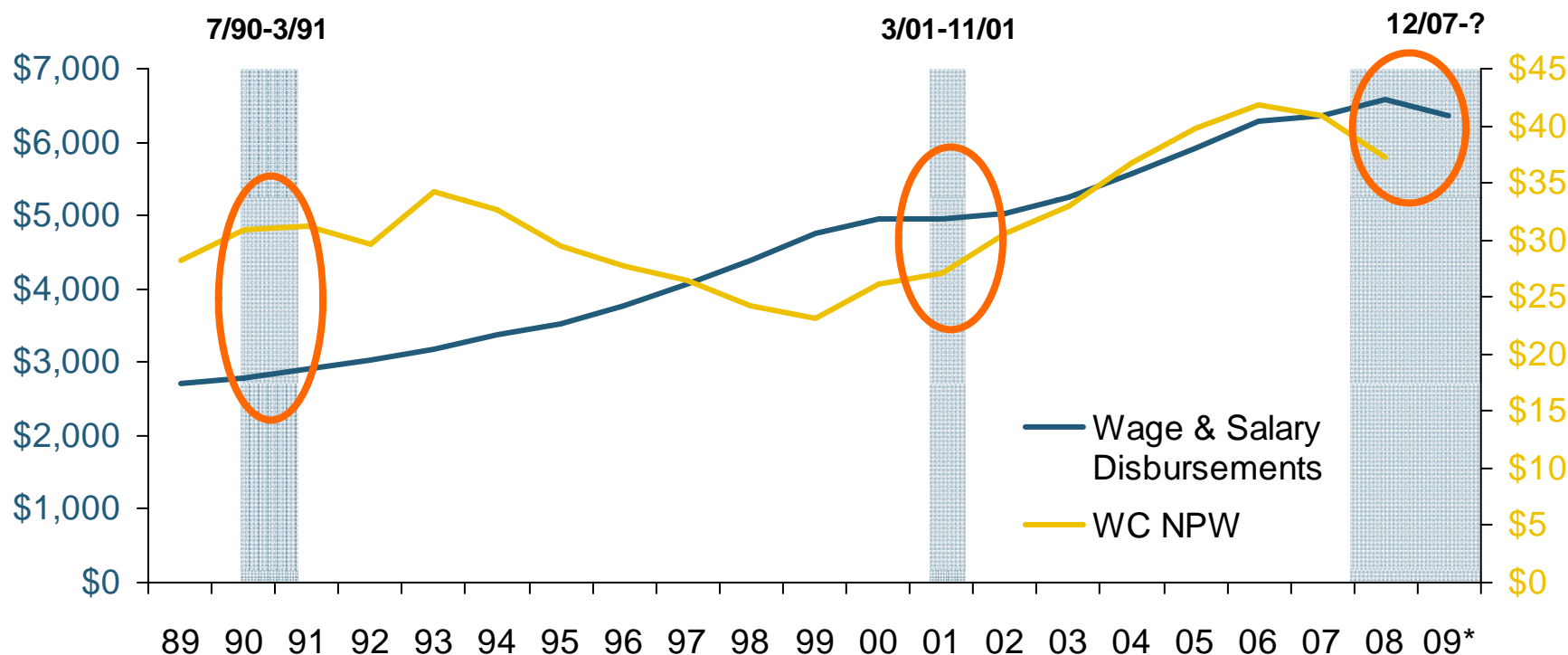
Unemployment Rate (%), January 2010



**Higher Male Unemployment Rate Is Skewing Workers Comp Exposure Toward Payroll Derived from Employment of Women**

# Wage & Salary Disbursements (Payroll Base) vs. Workers Comp Net Written Premiums

## Wage & Salary Disbursement (Private Employment) vs. WC NWP (\$ Billions)

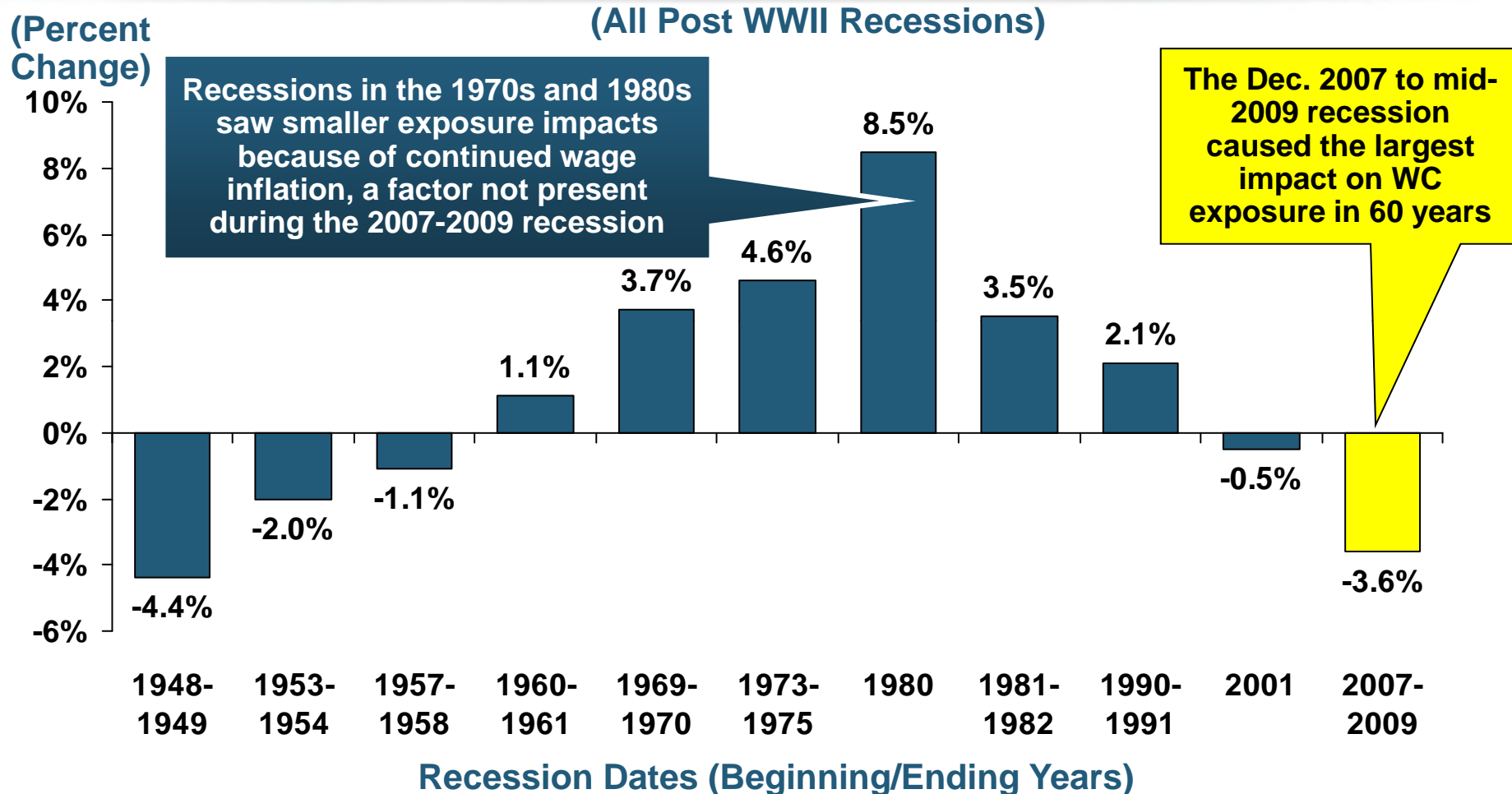


**Weakening Payrolls Have Eroded \$2B+ in Workers Comp Premiums**

\* Average Wage and Salary data as of 10/1/2009. Shaded areas indicate recessions

Source: US Bureau of Economic Analysis; Federal Reserve Bank of St. Louis at <http://research.stlouisfed.org/fred2/series/WASCUR> ; I.I.I. Fact Books

# Estimated Effect of Recessions\* on Payroll (Workers Comp Exposure)

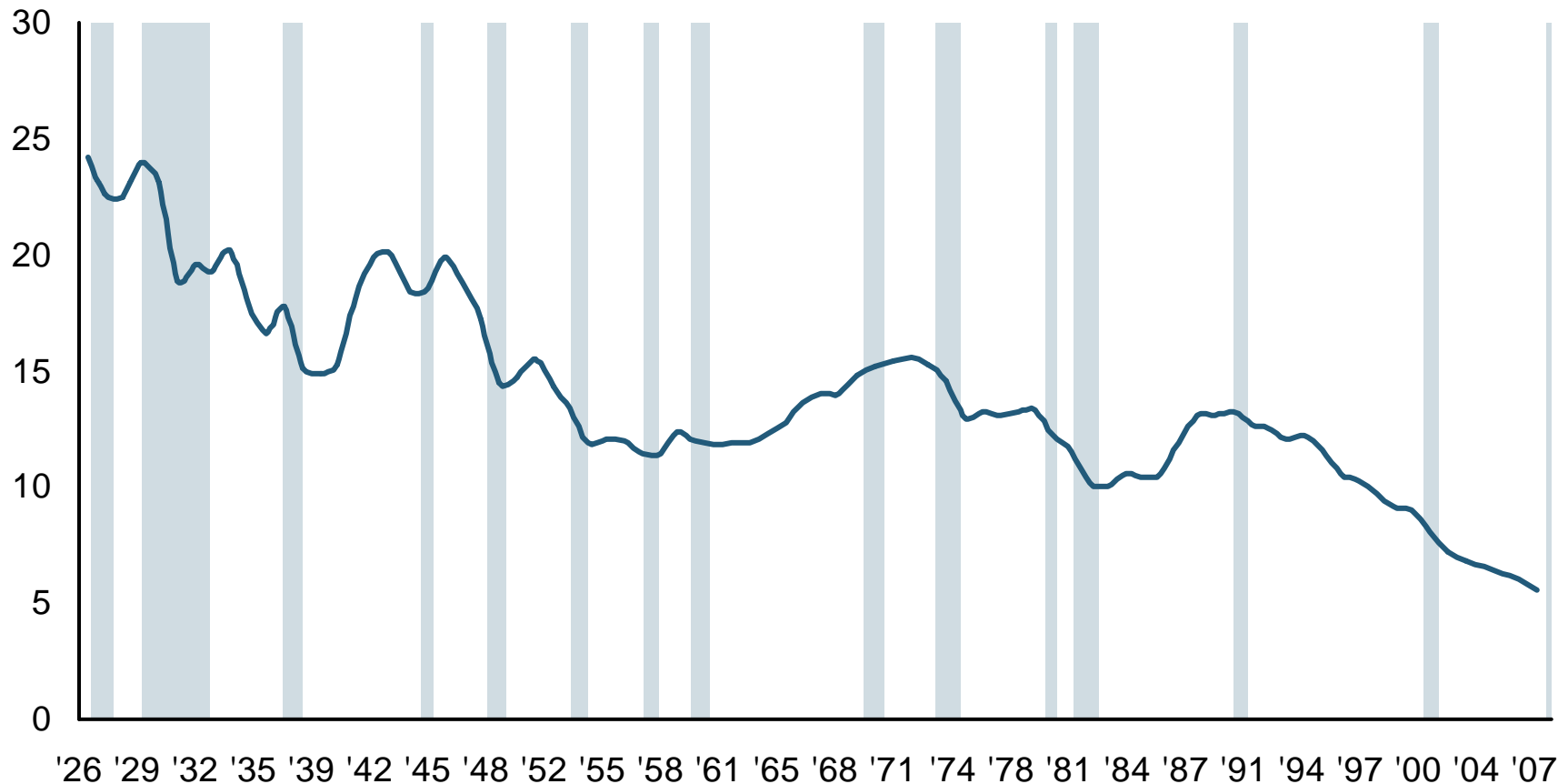


\*Data represent maximum recorded decline over 12-month period using annualized quarterly wage and salary accrual data  
Source: Insurance Information Institute research; Federal Reserve Bank of St. Louis (wage and salary data); National Bureau of Economic Research (recession dates).

# Frequency: 1926–2008

## A Long-Term Drift Downward

**Manufacturing – Total Recordable Cases**  
**Rate of Injury and Illness Cases per 100 Full-Time Workers**



Note: Recessions indicated by gray bars.

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

# 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 12 million jobs below the level needed to restore the pre-recession employment rate.

\*as of February 2010

Source: Heidi Shierholz, “Signs of Healing in the Labor Market, Though Unemployment Remains in Double Digits,” Economic Policy Institute, December 4, 2009, at

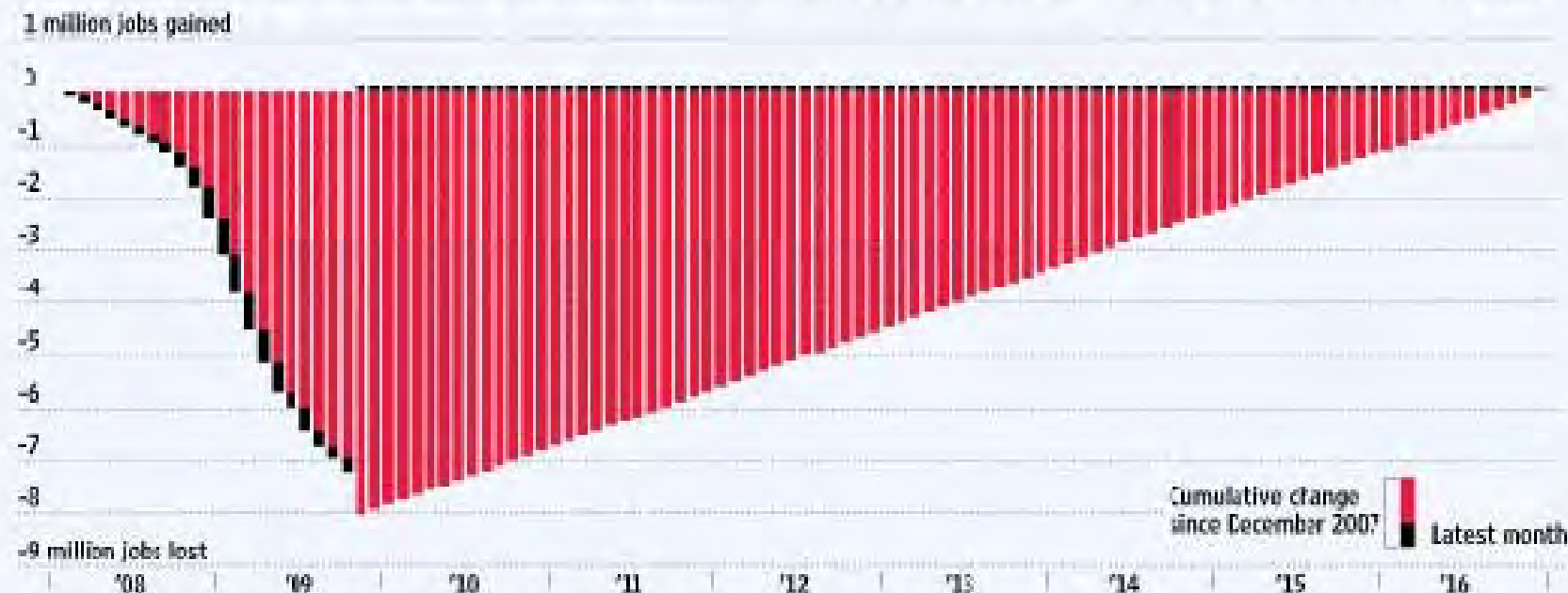
[http://www.epi.org/analysis\\_and\\_opinion/entry/signs\\_of\\_healing\\_in\\_the\\_labor\\_market\\_though\\_unemployment\\_remains\\_in\\_double/](http://www.epi.org/analysis_and_opinion/entry/signs_of_healing_in_the_labor_market_though_unemployment_remains_in_double/)

- Even if no more jobs are lost, if we are to return to the equivalent of pre-recession employment levels in 5 years' time—by the start of 2015—we would have to average adding 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

# When Might All of the Lost Jobs Be Regained? 2016?

**Long Road Back** | How long it would take to regain the job level at the start of this recession?

Assuming the average monthly pace of the most recent expansion, it would take 86 months, or not until December 2016



Note: The starting point for adding jobs back includes 824,000 jobs lost between March 2008 and March 2009 announced Friday by the Labor Department.  
Source: Labor Department (payroll figures)

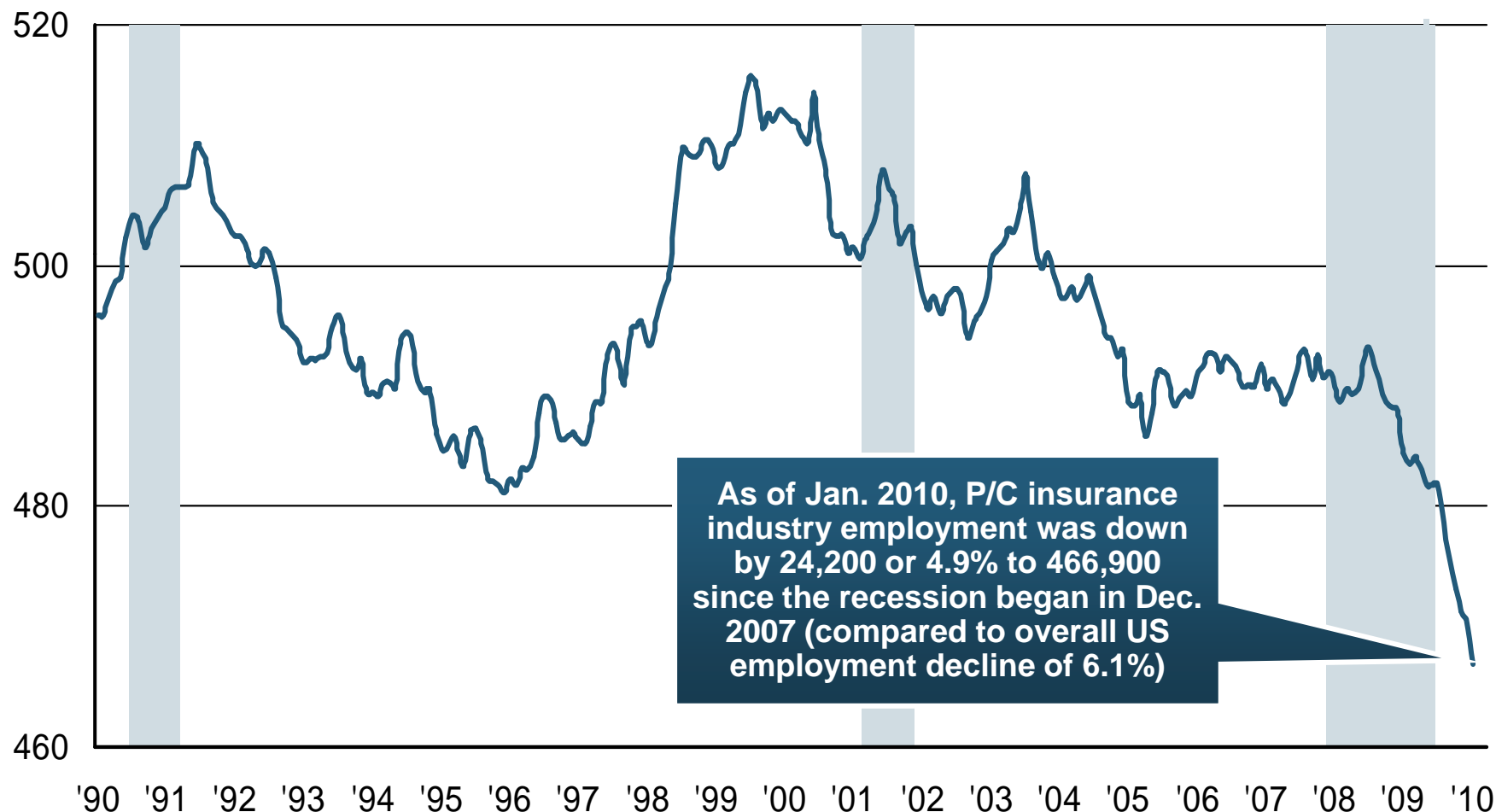
Source: *Wall Street Journal*, October 9, 2009, p. A3

# **Insurance Industry Employment Trends**

**Soft Market, Difficult Economy,  
Outsourcing Have Contributed to  
Industry's Job Losses**

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

Thousands



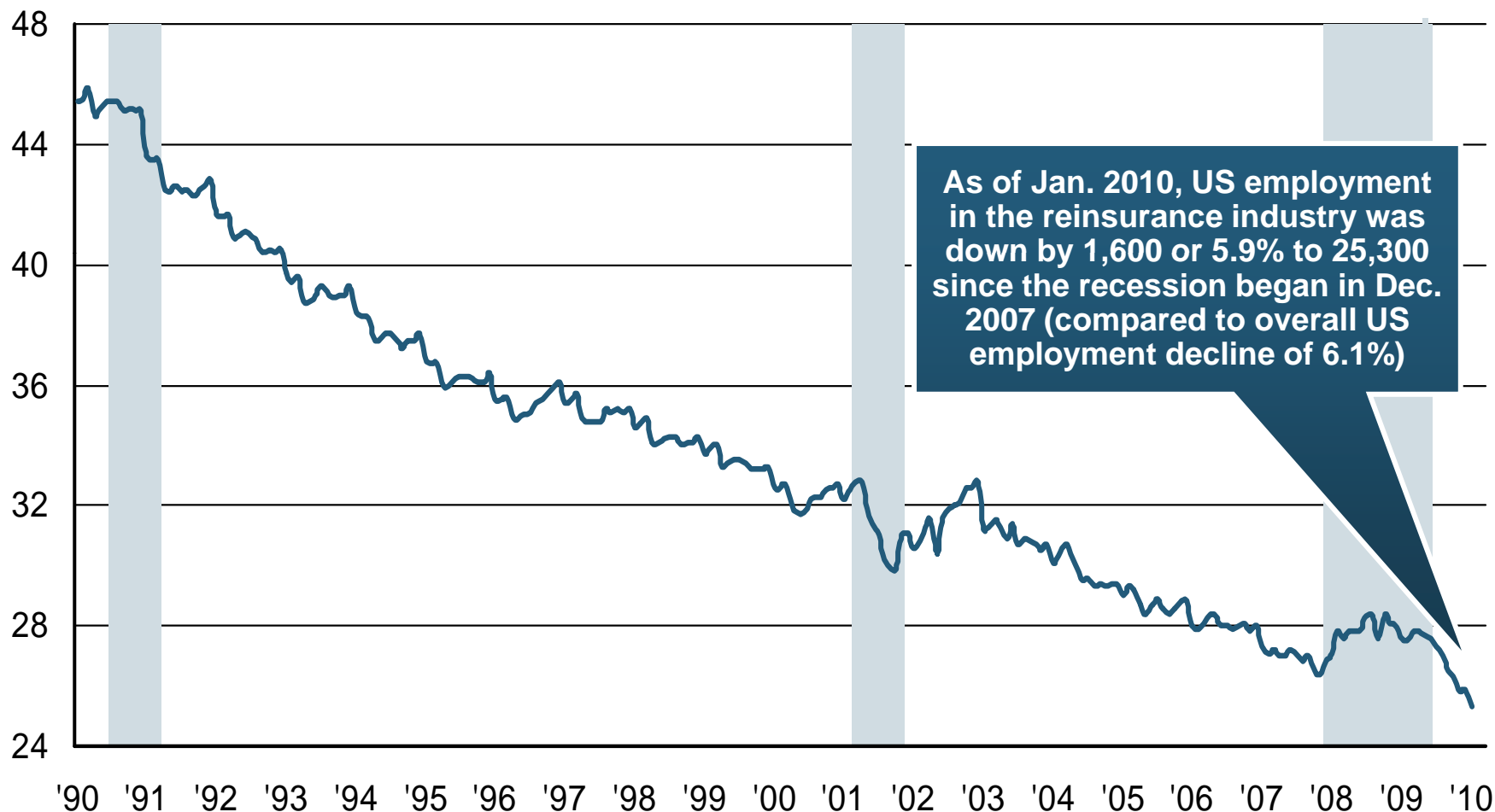
\*As of January 2010; Not seasonally adjusted; Does not including agents & brokers

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\*

Thousands



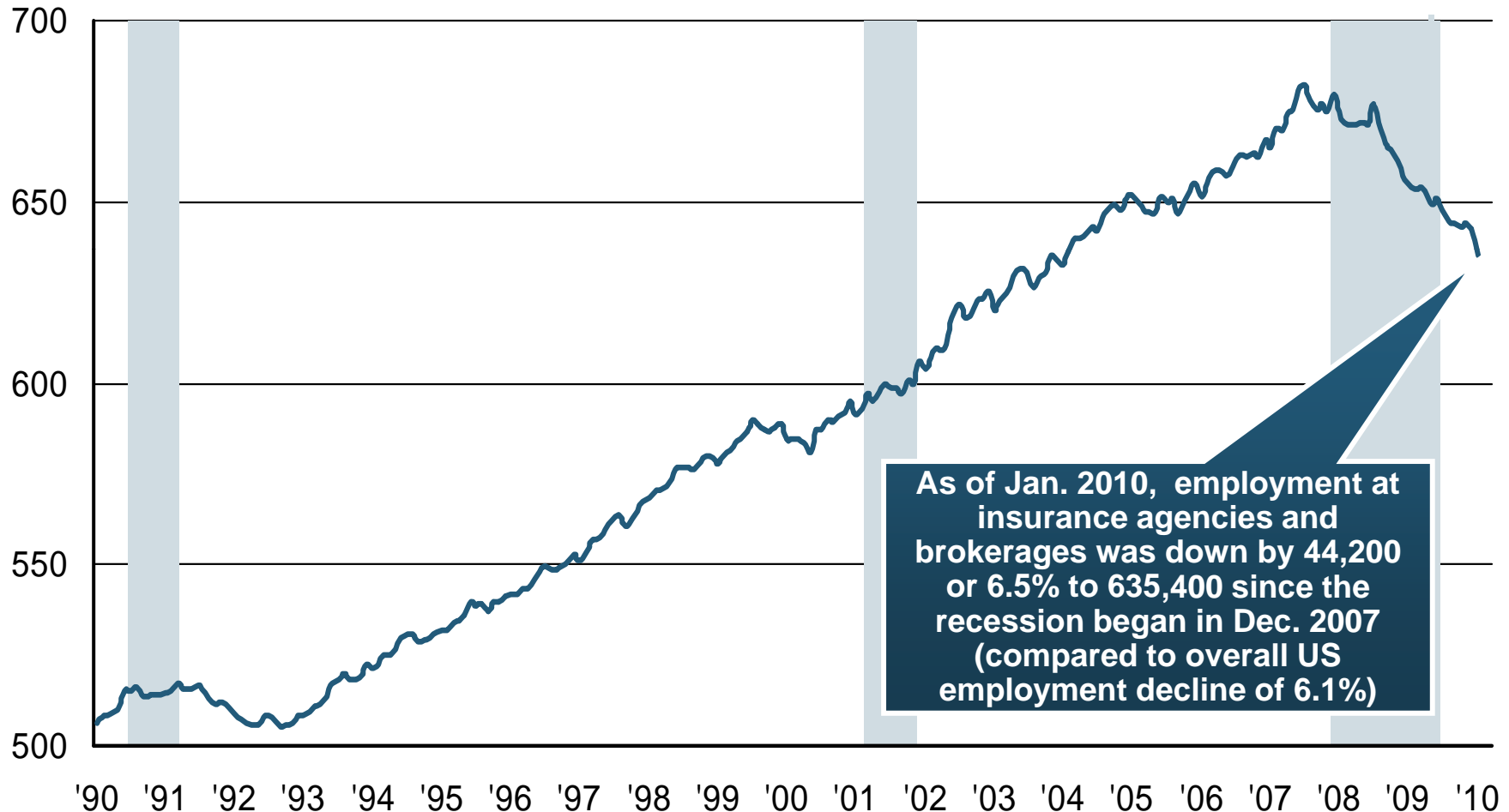
\*As of January 2010; Not seasonally adjusted; Does not including agents & brokers

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 Insurance Agencies & Brokerages: 1990–2010\*

Thousands



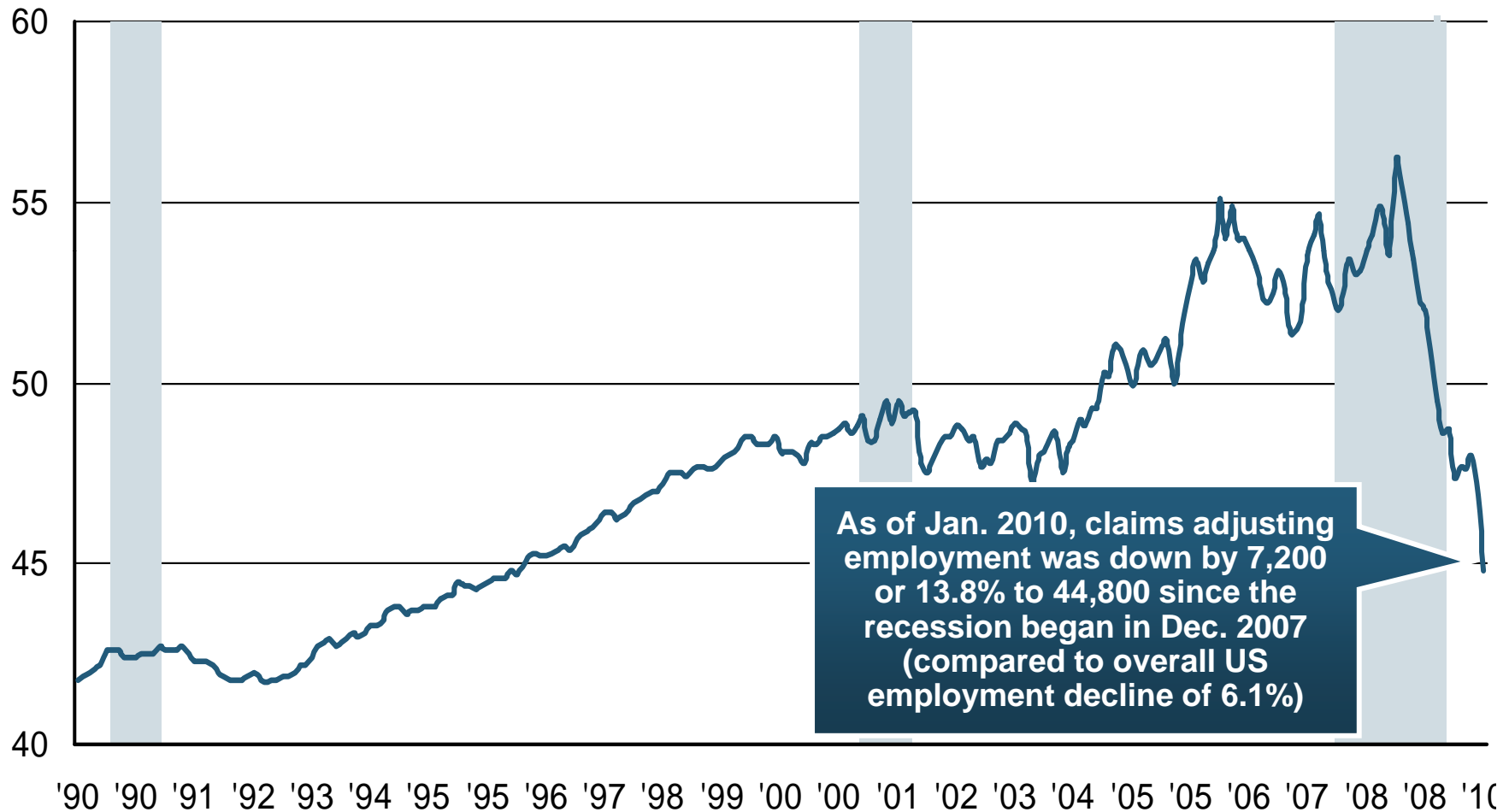
\*As of January 2010; Not seasonally adjusted. Includes all types of insurance.

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\*

Thousands



\*As of January 2010; Not seasonally adjusted.

Note: Recessions indicated by gray shaded columns.

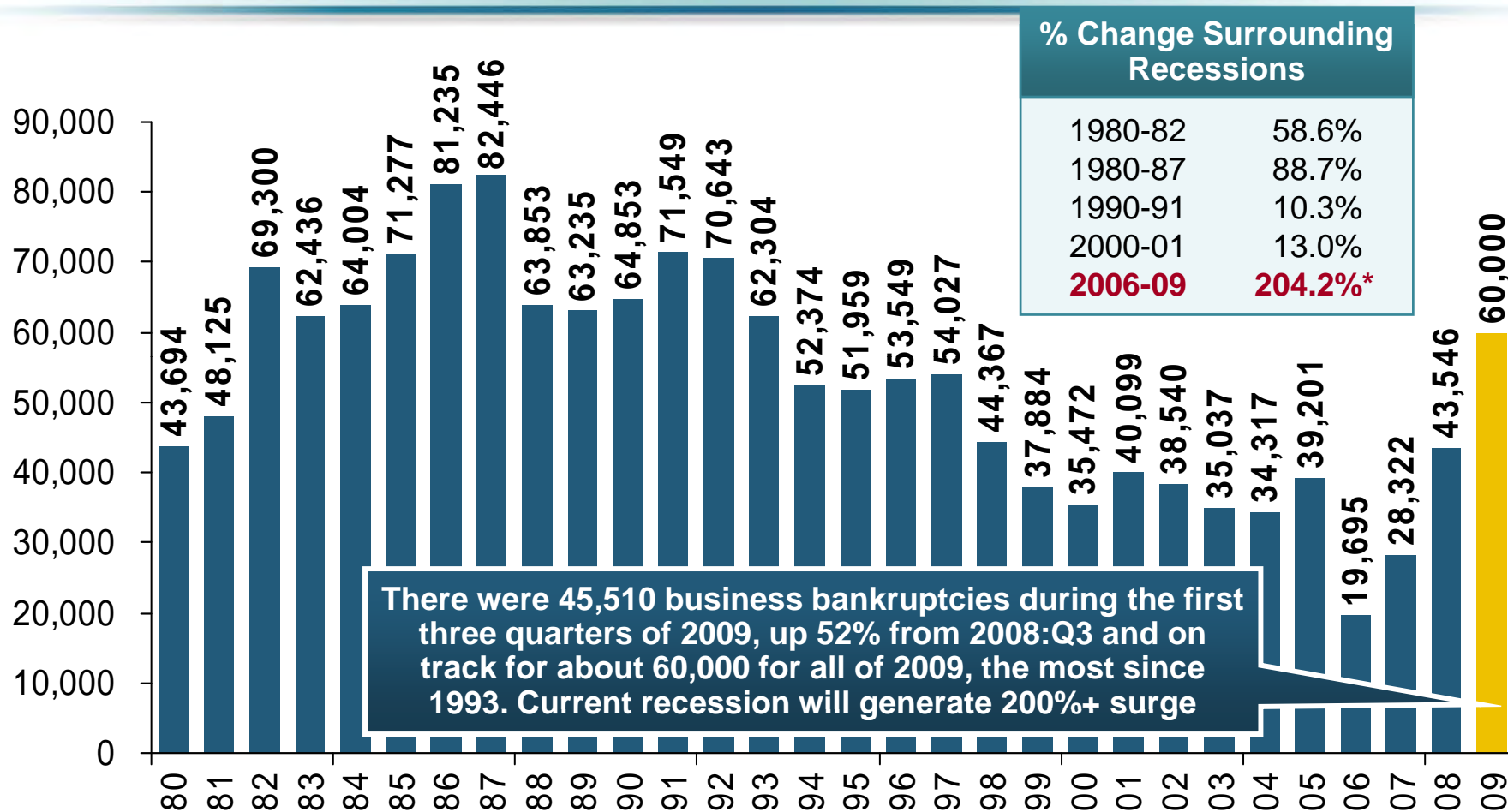
Sources: US Bureau of Labor Statistics; National Bureau of Economic Research (recession dates); Insurance Information Institutes.

# **Crisis and Recovery-Driven Exposure Drivers in WC**

**Myriad of Impacts on Workers  
Comp Exposure**

***Filling the Economic Crater***

# Business Bankruptcy Filings, 1980-2009\*



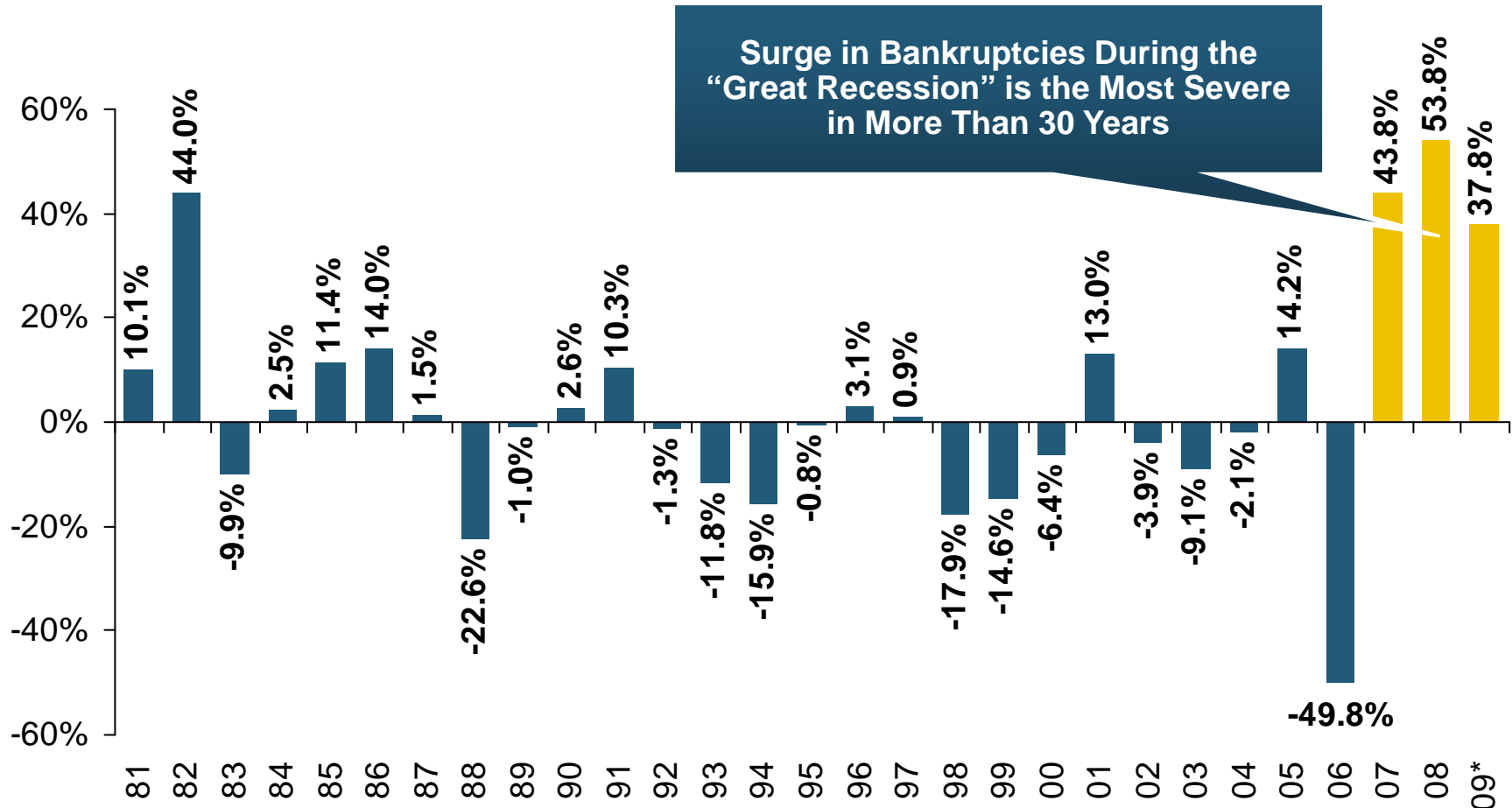
**Significant Implications for all Commercial Lines**

\*2009 is annualized estimate based on actual business bankruptcies in first three quarters of 2009

Source: American Bankruptcy Institute,

[http://www.abiworld.org/AM/Template.cfm?Section=Business\\_Bankruptcy\\_Filings1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=36301](http://www.abiworld.org/AM/Template.cfm?Section=Business_Bankruptcy_Filings1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=36301).

# Percent Change in Business Bankruptcy Filings, 1980–2009\*



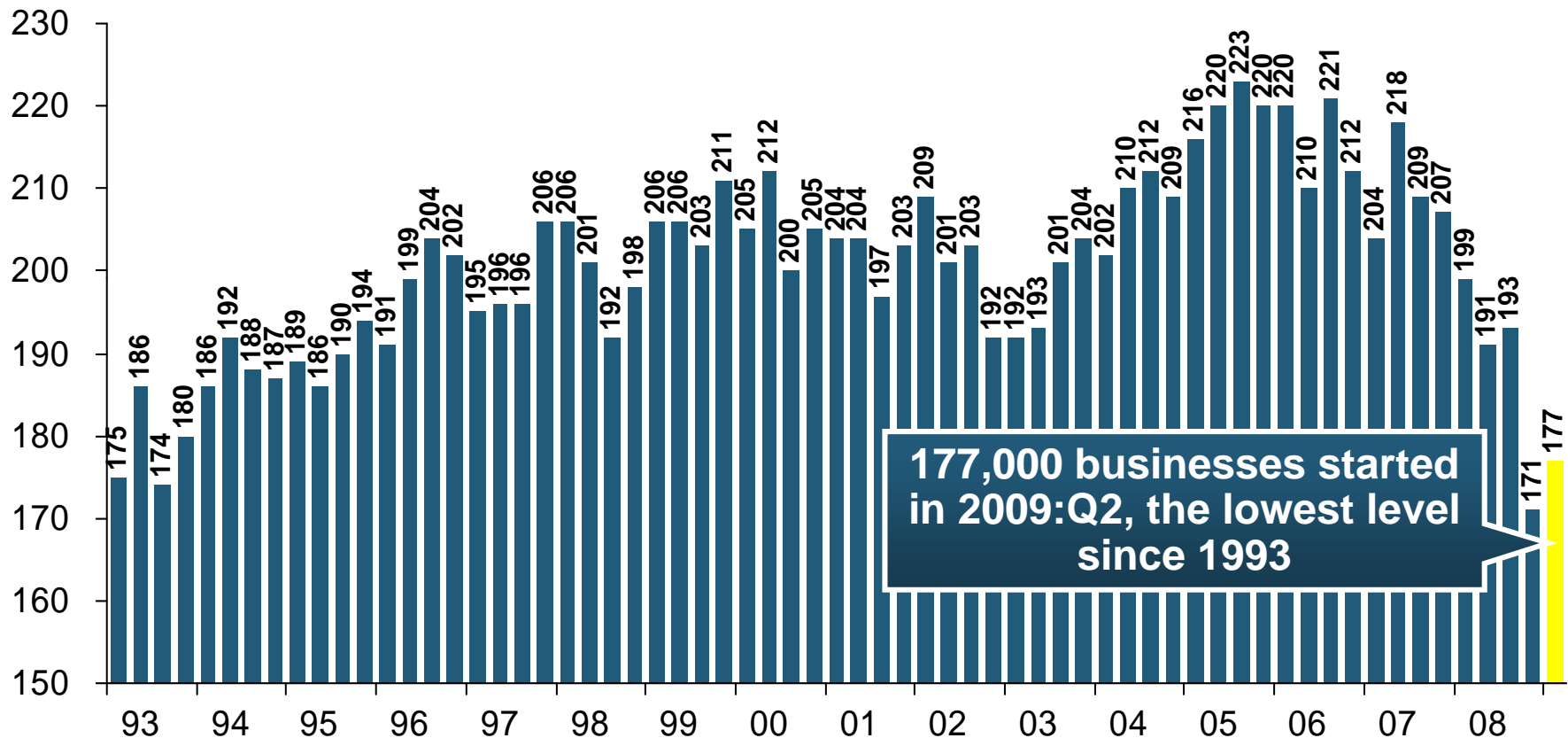
## Significant Implications for All Commercial Lines

\* Based estimate of 60,000 business bankruptcies in 2009. All figures are percent change from previous year.

Source: Insurance Information Institute from American Bankruptcy Institute data.

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

(Thousands)



177,000 businesses started in 2009:Q2, the lowest level since 1993

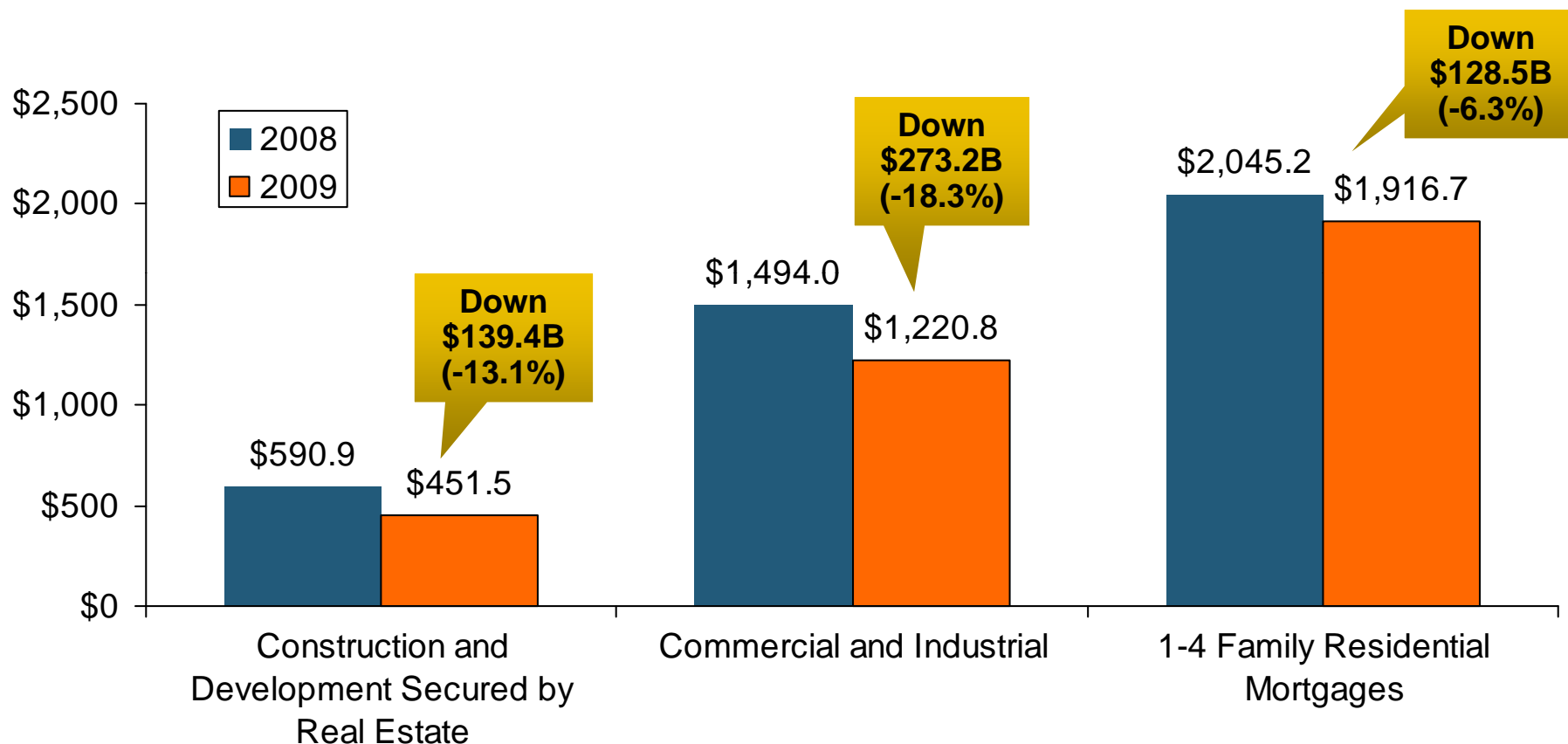
**Business Starts Are Down Nearly 20% in the Current Downturn, Holding Back Most Types of Commercial Insurance Exposure**

\*Latest available as of March 2010, seasonally adjusted

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

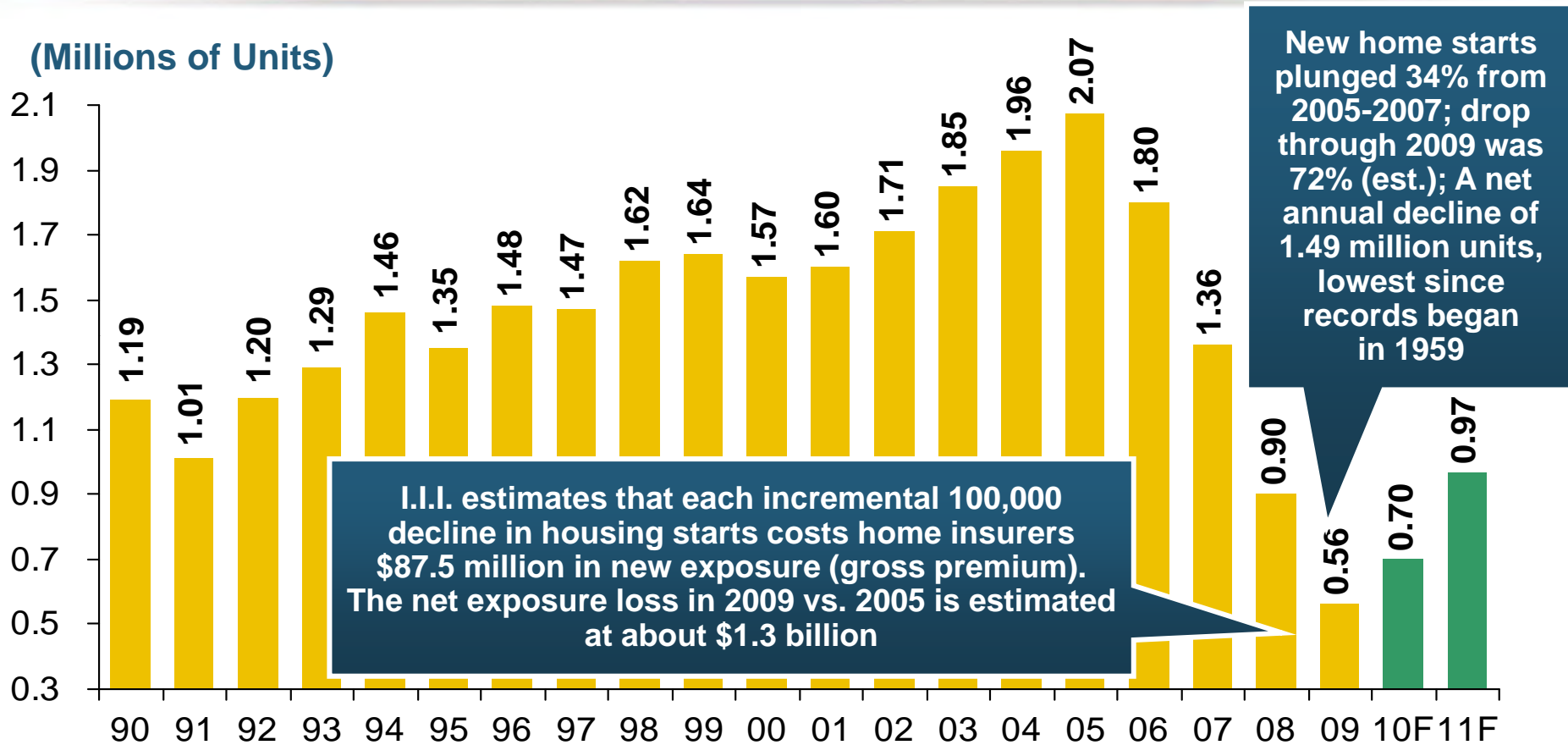
# Amount of Outstanding Loans by FDIC-Insured Institutions, 2009 vs. 2008

\$Billions



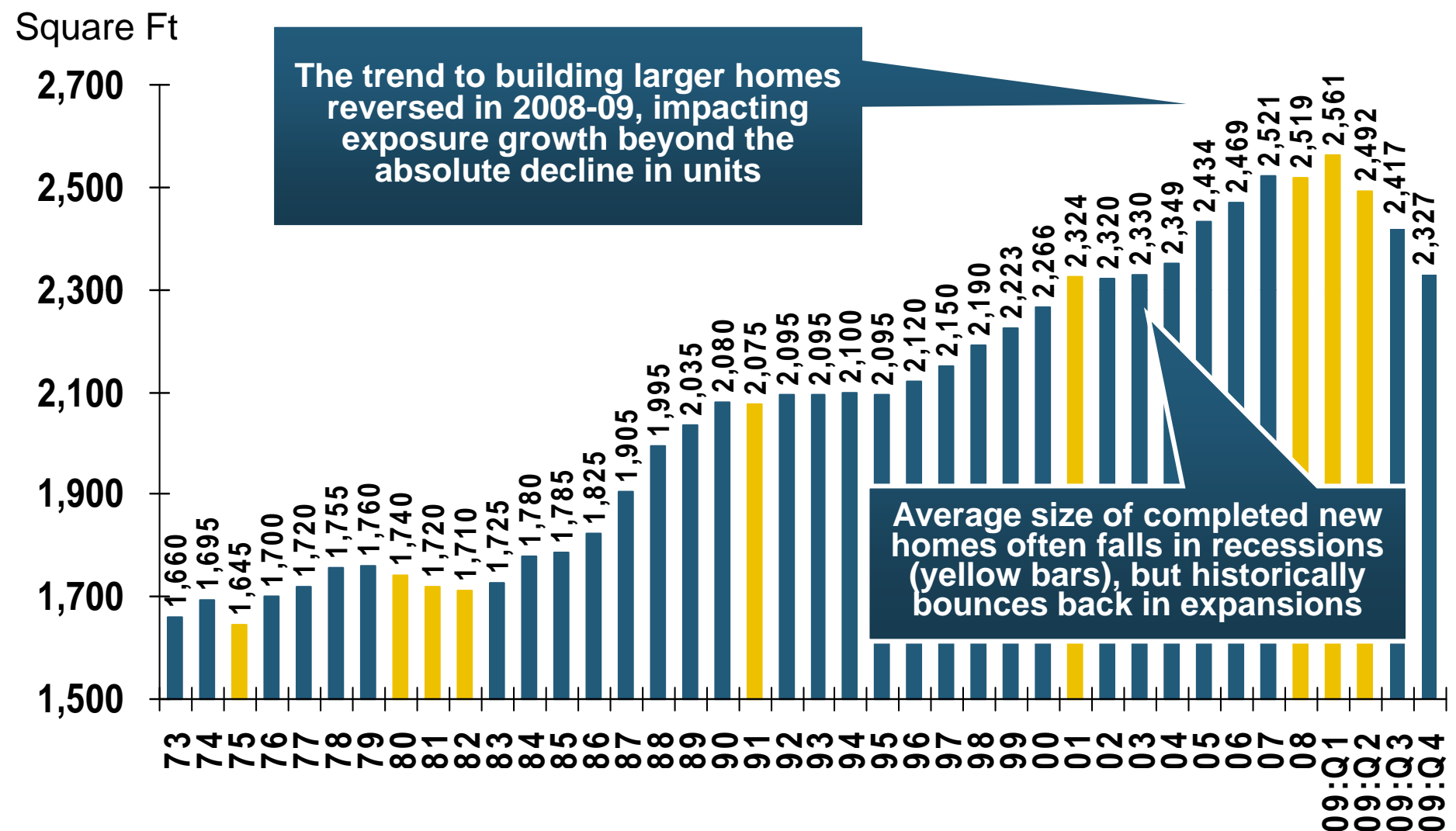
**FDIC-Insured Institutions Had \$541.1B (-13.1%) Less in Outstanding Loans in These Three Categories at Year-end 2009 vs. 2008**

# New Private Housing Starts, 1990-2011F



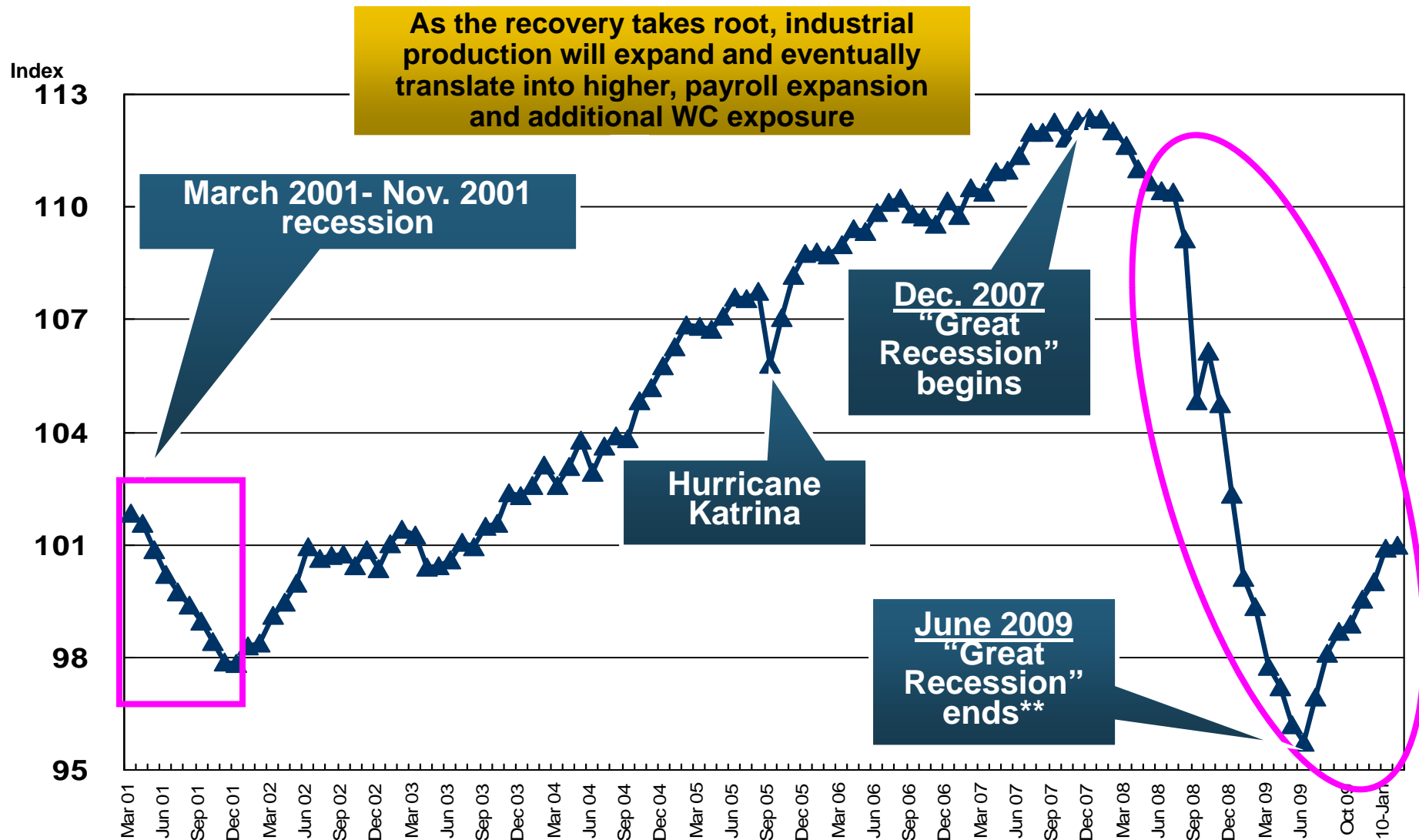
**Little Exposure Growth Likely for Homeowners Insurers  
Due to Weak Home Construction Forecast for 2010-2011.  
Also Affects Commercial Insurers with Construction Risk Exposure, Surety**

# Average Square Footage of Completed New Homes in U.S., 1973-2010:Q4



# Total Industrial Production,

monthly, Mar 2001-Feb 2010 (Index 2002=100)\*



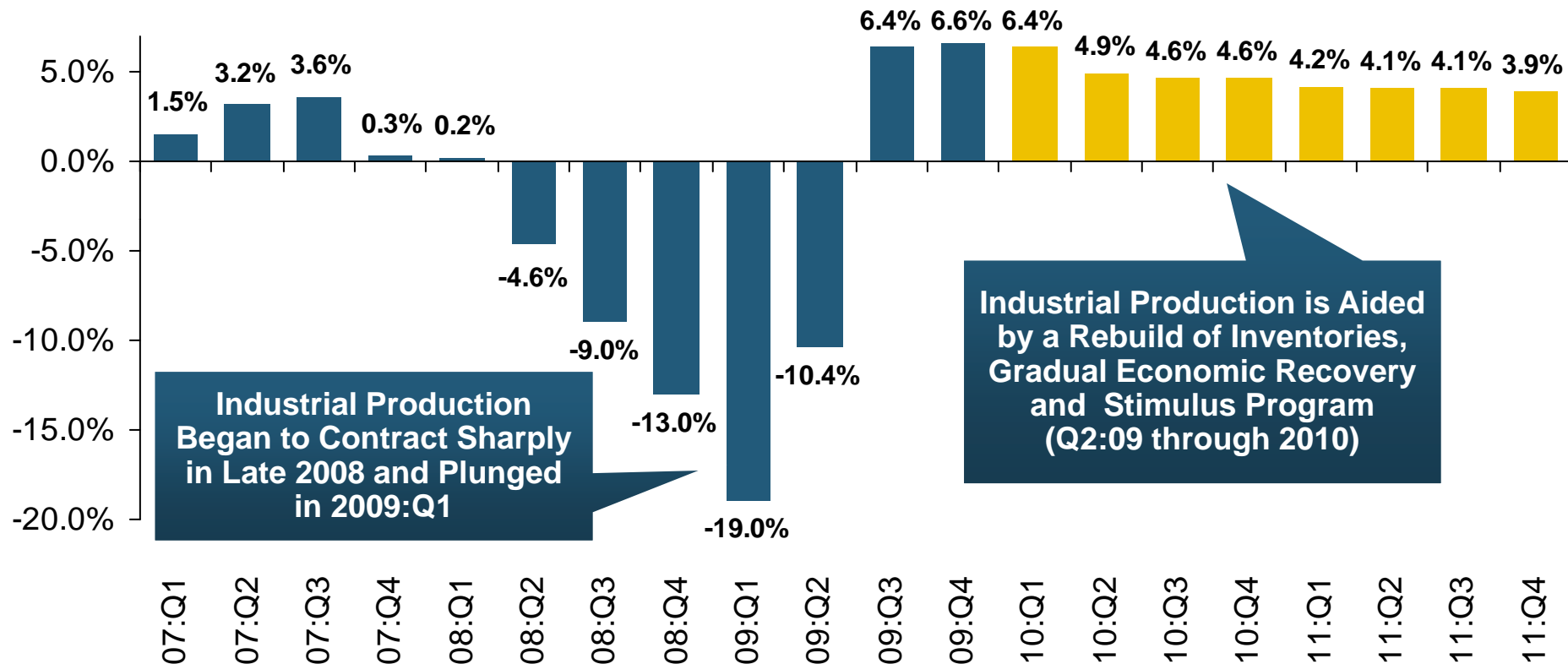
Source: [http://www.federalreserve.gov/releases/g17/ipdisk/ip\\_sa.txt](http://www.federalreserve.gov/releases/g17/ipdisk/ip_sa.txt).

\*seasonally adjusted

\*\*Official end date not yet determined.

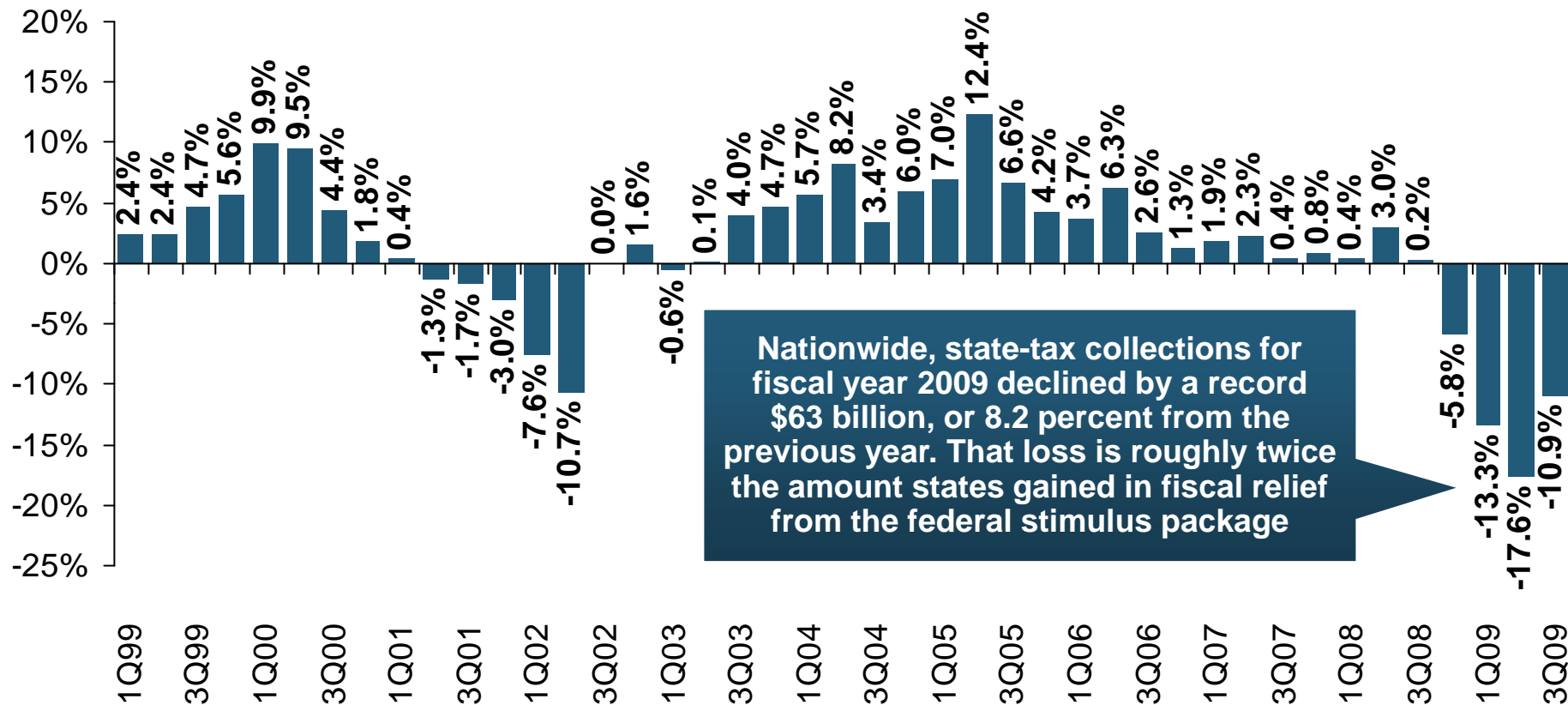
# Total Industrial Production

2007:Q1 to 2011:Q4F (%)



**End of Recession in mid-2009, Stimulus Program Are Benefiting Industrial Production and Therefore Insurance Exposure Both Directly and Indirectly, Albeit Very Modestly**

# Year-Over-Year Change in Quarterly US State Tax Revenues, Inflation Adjusted



**States Revenues Were Down 10.9% in Q3 2009, the Second Consecutive Quarter of Record Revenue Decline. This Will Impact Public Infrastructure Spending Significantly.**

# **Where Will the Growth in WC Exposure Come From?**

## **Industry and Occupation Growth Analysis**

# Fastest Growing Occupations, 2008–2018:

## Health/Science/Tech Dominate

**WC exposure growth the fastest in the health, science and tech areas**

Occupations	Percent change	Number of new jobs (in thousands)	Wages (May 2008 median)	Education/training category
Biomedical engineers	72	11.6	\$ 77,400	Bachelor's degree
Network systems and data communications analysts	53	155.8	71,100	Bachelor's degree
Home health aides	50	460.9	20,460	Short-term on-the-job training
Personal and home care aides	46	375.8	19,180	Short-term on-the-job training
Financial examiners	41	11.1	70,930	Bachelor's degree
Medical scientists, except epidemiologists	40	44.2	72,590	Doctoral degree
Physician assistants	39	29.2	81,230	Master's degree
Skin care specialists	38	14.7	28,730	Postsecondary vocational award
Biochemists and biophysicists	37	8.7	82,840	Doctoral degree
Athletic trainers	37	6.0	39,640	Bachelor's degree
Physical therapist aides	36	16.7	23,760	Short-term on-the-job training
Dental hygienists	36	62.9	66,570	Associate degree
Veterinary technologists and technicians	36	28.5	28,900	Associate degree
Dental assistants	36	105.6	32,380	Moderate-term on-the-job training
Computer software engineers, applications	34	175.1	85,430	Bachelor's degree
Medical assistants	34	163.9	28,300	Moderate-term on-the-job training
Physical therapist assistants	33	21.2	46,140	Associate degree
Veterinarians	33	19.7	79,050	First professional degree
Self-enrichment education teachers	32	81.3	35,720	Work experience in a related occupation
Compliance officers, except agriculture, construction, health and safety, and transportation	31	80.8	48,890	Long-term on-the-job training

SOURCE: BLS Occupational Employment Statistics and Division of Occupational Outlook

# Occupations with Largest Numerical Growth, 2008–2018: *Health, Services Dominate*

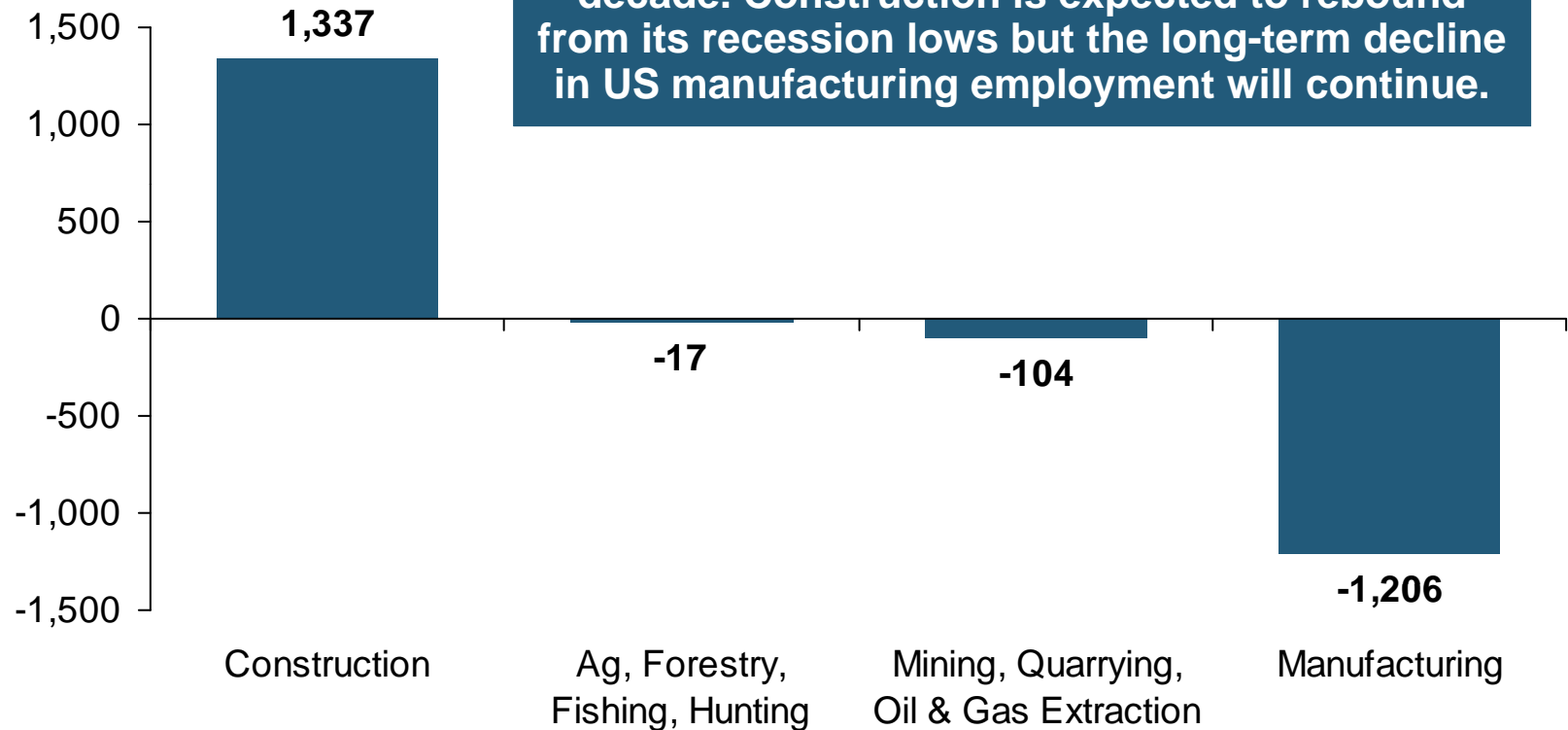
**Dollar growth in WC exposures should grow the most (at current rate levels) in the health and services industries**

Occupations	Number of new jobs (in thousands)	Percent change	Wages (May 2008 median)	Education/training category
Registered nurses	581.5	22	\$ 62,450	Associate degree
Home health aides	460.9	50	20,460	Short-term on-the-job training
Customer service representatives	399.5	18	29,860	Moderate-term on-the-job training
Combined food preparation and serving workers, including fast food	394.3	15	16,430	Short-term on-the-job training
Personal and home care aides	375.8	46	19,180	Short-term on-the-job training
Retail salespersons	374.7	8	20,510	Short-term on-the-job training
Office clerks, general	358.7	12	25,320	Short-term on-the-job training
Accountants and auditors	279.4	22	59,430	Bachelor's degree
Nursing aides, orderlies, and attendants	276.0	19	23,850	Postsecondary vocational award
Postsecondary teachers	256.9	15	58,830	Doctoral degree
Construction laborers	255.9	20	28,520	Moderate-term on-the-job training
Elementary school teachers, except special education	244.2	16	49,330	Bachelor's degree
Truck drivers, heavy and tractor-trailer	232.9	13	37,270	Short-term on-the-job training
Landscaping and groundskeeping workers	217.1	18	23,150	Short-term on-the-job training
Bookkeeping, accounting, and auditing clerks	212.4	10	32,510	Moderate-term on-the-job training
Executive secretaries and administrative assistants	204.4	13	40,030	Work experience in a related occupation
Management analysts	178.3	24	73,570	Bachelor's or higher degree, plus work experience
Computer software engineers, applications	175.1	34	85,430	Bachelor's degree
Receptionists and information clerks	172.9	15	24,550	Short-term on-the-job training
Carpenters	165.4	13	38,940	Long-term on-the-job training

SOURCE: BLS Occupational Employment Statistics and Division of Occupational Outlook

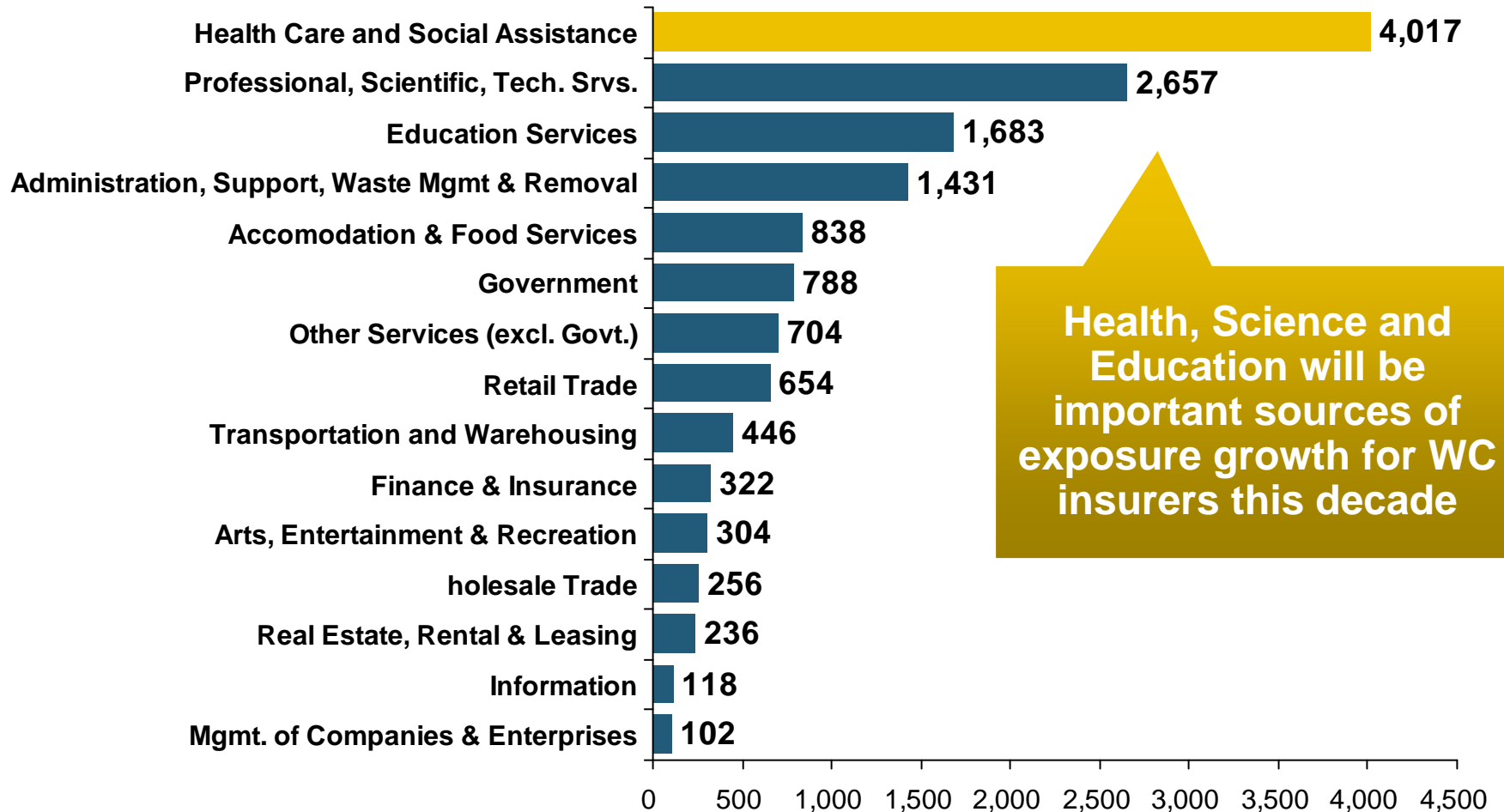
# Numeric Change in Wage and Salary Employment in Goods-Producing Industries: 2008-2018P

(Thousands)



# Numeric Change in Wage and Salary Employment in Service-Providing Industries: 2008-2018P

(Thousands)

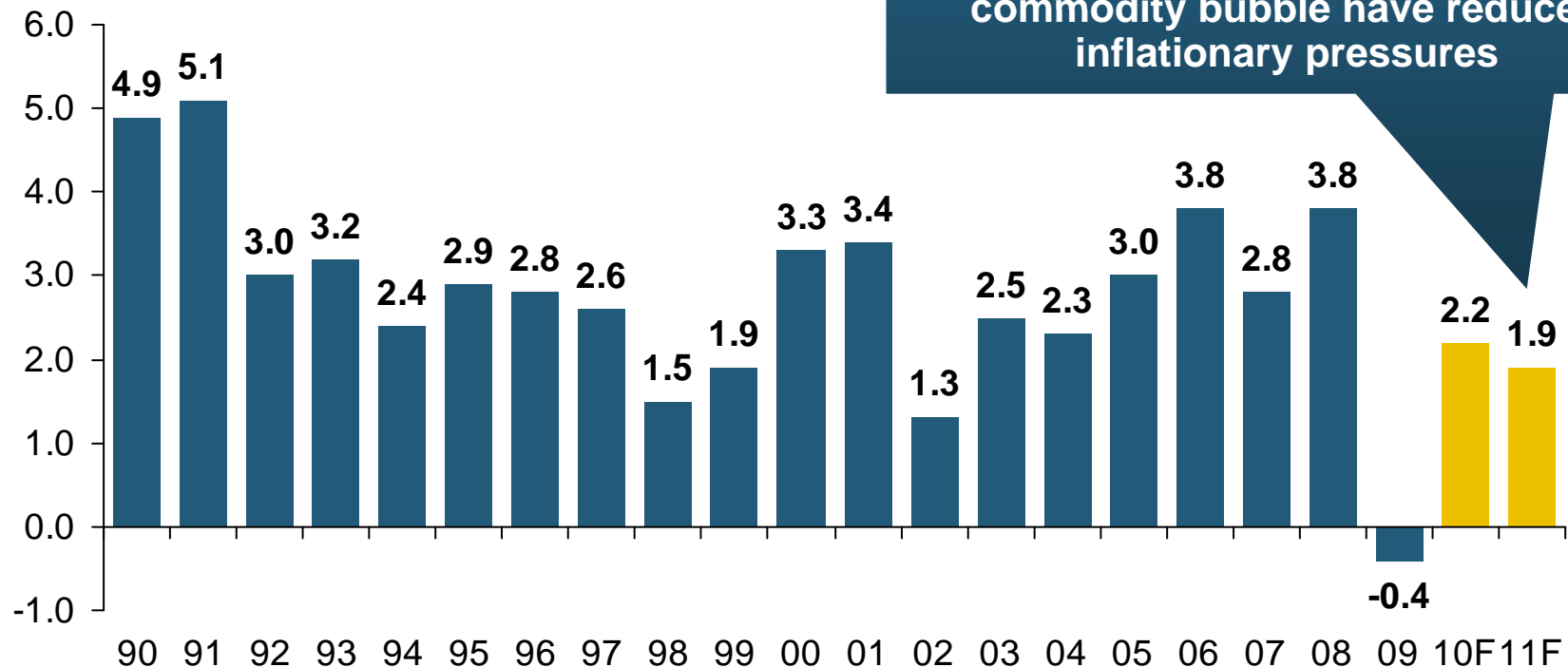


**Inflation Trends:  
*Concerns Over Stimulus Spending  
and Monetary Policy***

**Mounting Pressure on Claim  
Cost Severities?**

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

## Annual Inflation Rates (%)

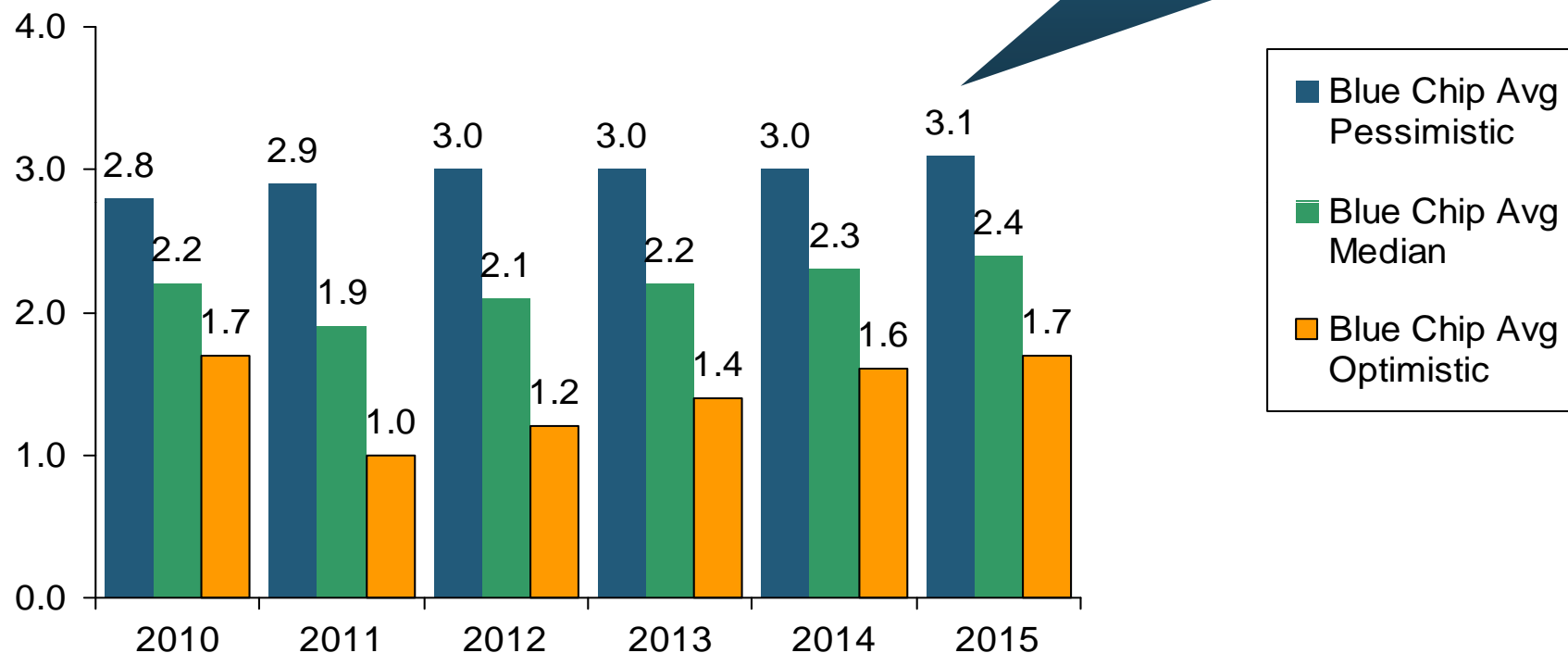


**There is So Much Slack in the US Economy That Inflation Should Not Be a Concern Through 2010/11, but Depreciation of Dollar is Concern Longer Run**

# Forecasts of Annual Inflation Rates (CPI-U, %), 2010–2015F

## Annual Inflation Rates (%)

Even the pessimistic forecasts don't see the CPI rising much above 3% in the next five years



**Inflation Will Accelerate Modestly through 2015 but Should Is Not Expected to Become a Major Concern or Threat**

# Top Risks for WC 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

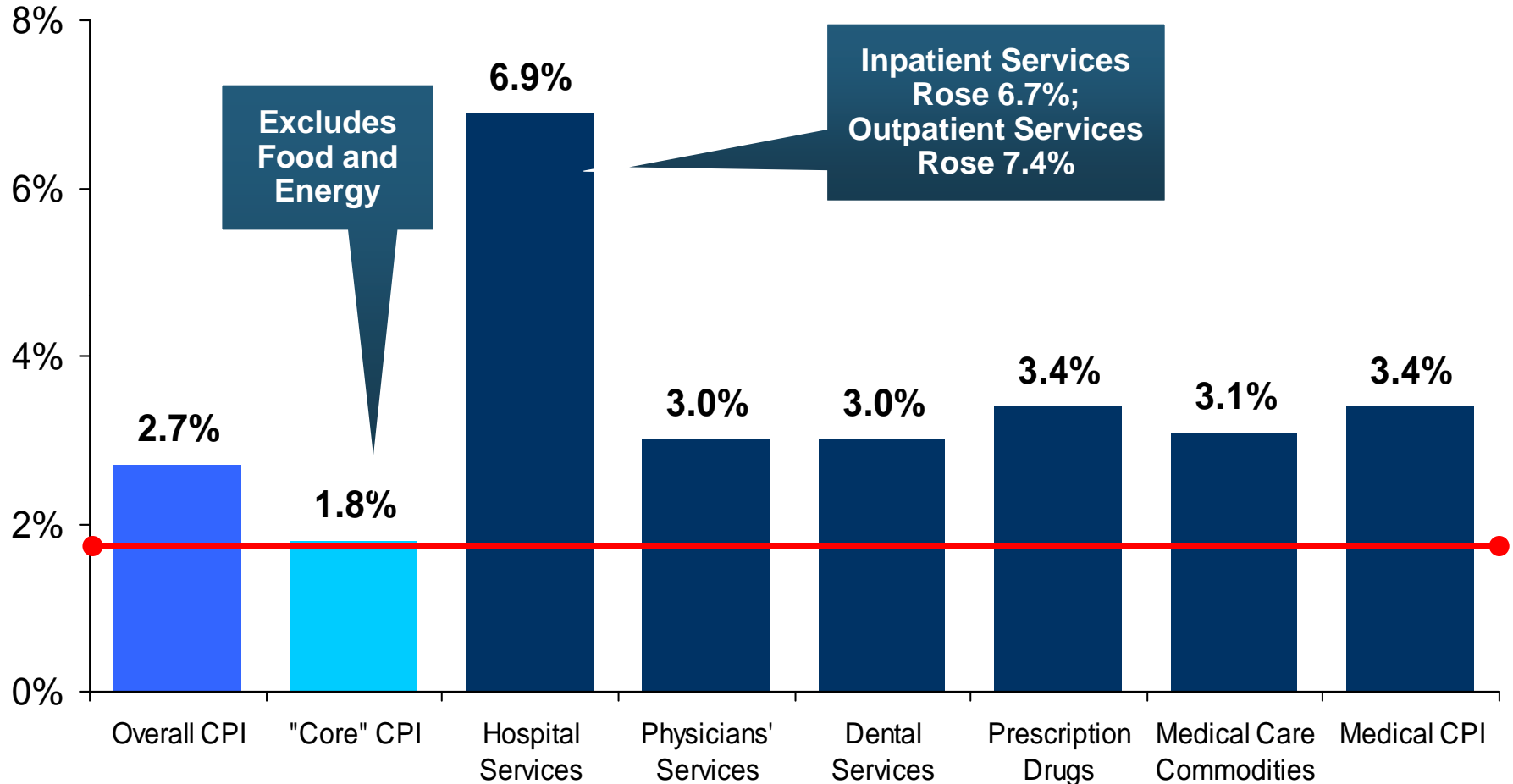
- ◆ Retentions, deductibles burned through more quickly

## ■ Reinsurance Penetration/Exhaustion

- ◆ Higher costs → risks burn through their retentions more quickly, tapping into reinsurance more quickly and potentially exhausting their reinsurance more quickly

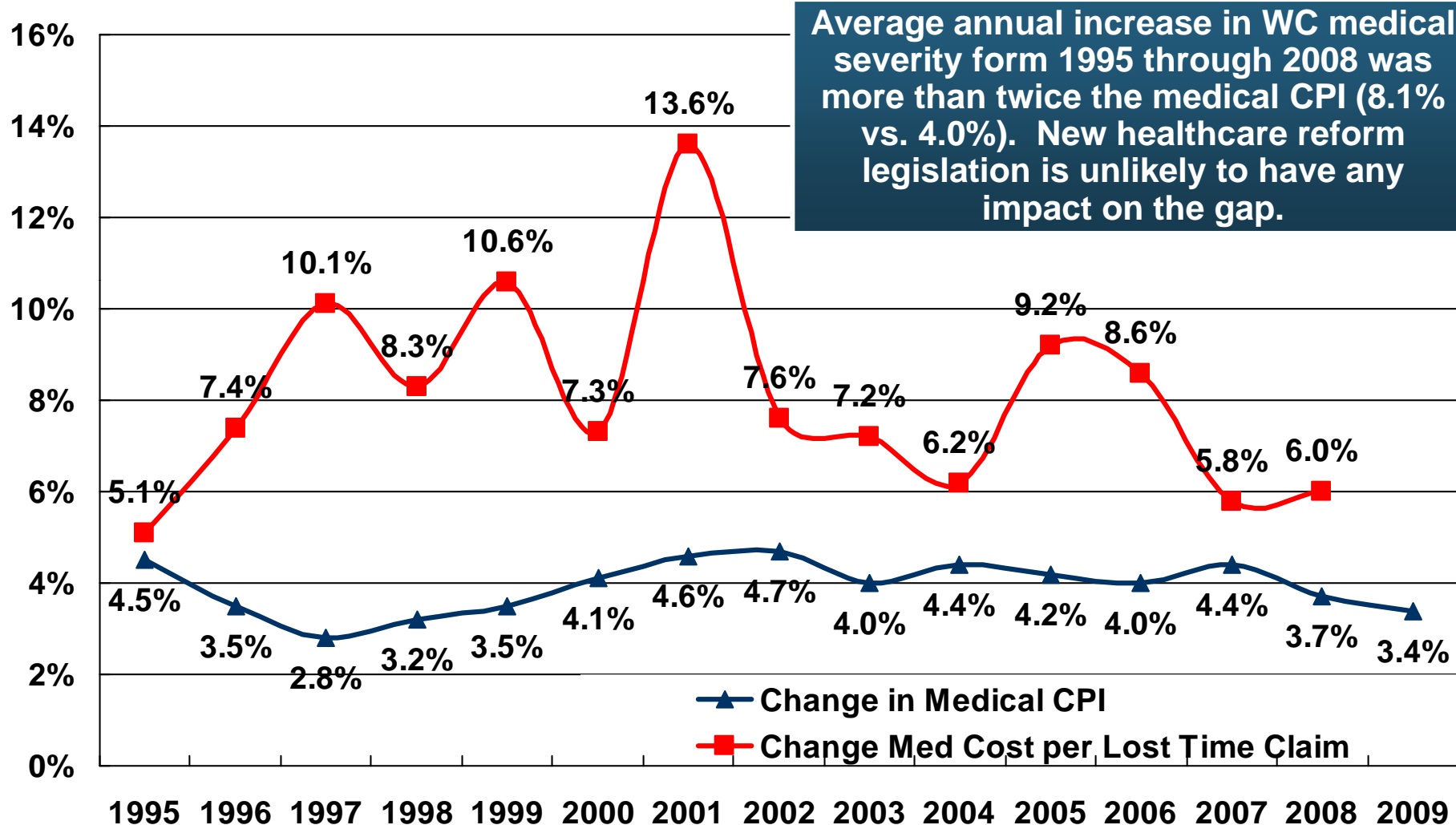
# WC Insurers Experience Inflation More Intensely than 2009 CPI Suggests

(Percent increase Dec 08 to Dec 09)



**Healthcare Costs Are a Major WC Insurance Cost Driver. They Are Likely to Increase Faster than the CPI for the Next Few Years, at Least**

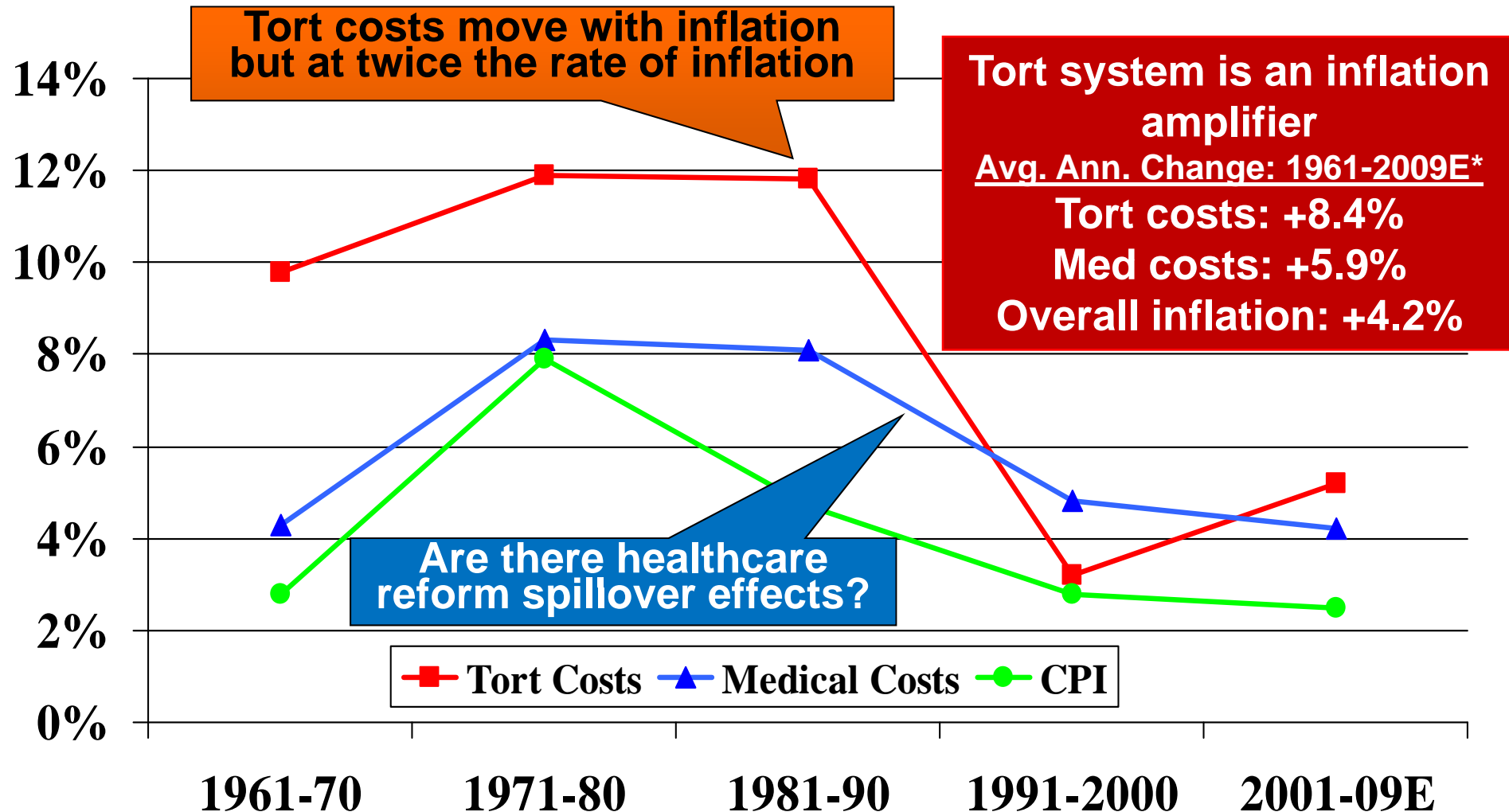
# WC Medical Severity Rising at Twice the Medical CPI Rate



# We Can Have Inflation Despite High Unemployment

- If health care financing reform becomes law, unions (and employees in general) with “Cadillac plans” may reduce these plans to avoid a new tax. To offset the reduction, they may press for higher wages. Employers will try to pass these costs to consumers as higher prices
- We can “import” inflation.
  - ◆ For example, China is raising interest rates to tame a growing inflation rate. If the prices of things we import rise, importers will try to pass these increases along to buyers.
  - ◆ And if the dollar depreciates vs. currencies of nations from which we import, the dollar price of imports will rise.
- We **had** high inflation during the 1980 and 1981-82 recessions.

# Tort Cost Growth & Medical Cost Inflation vs. Overall Inflation (CPI-U), 1961-2009E\*



\* CPI-U and medical costs as of Sept 2009; Tort figure is for full-year 2009 from Tillinghast.

Source: U.S. Bureau of Labor Statistics; Tillinghast-Towers Perrin, *2008 Update on U.S. Tort Costs*; I.I.I.

# **Key Issues Facing WC Insurers in the Post-Crisis World**

## **Challenges for the Next 5+ Years**

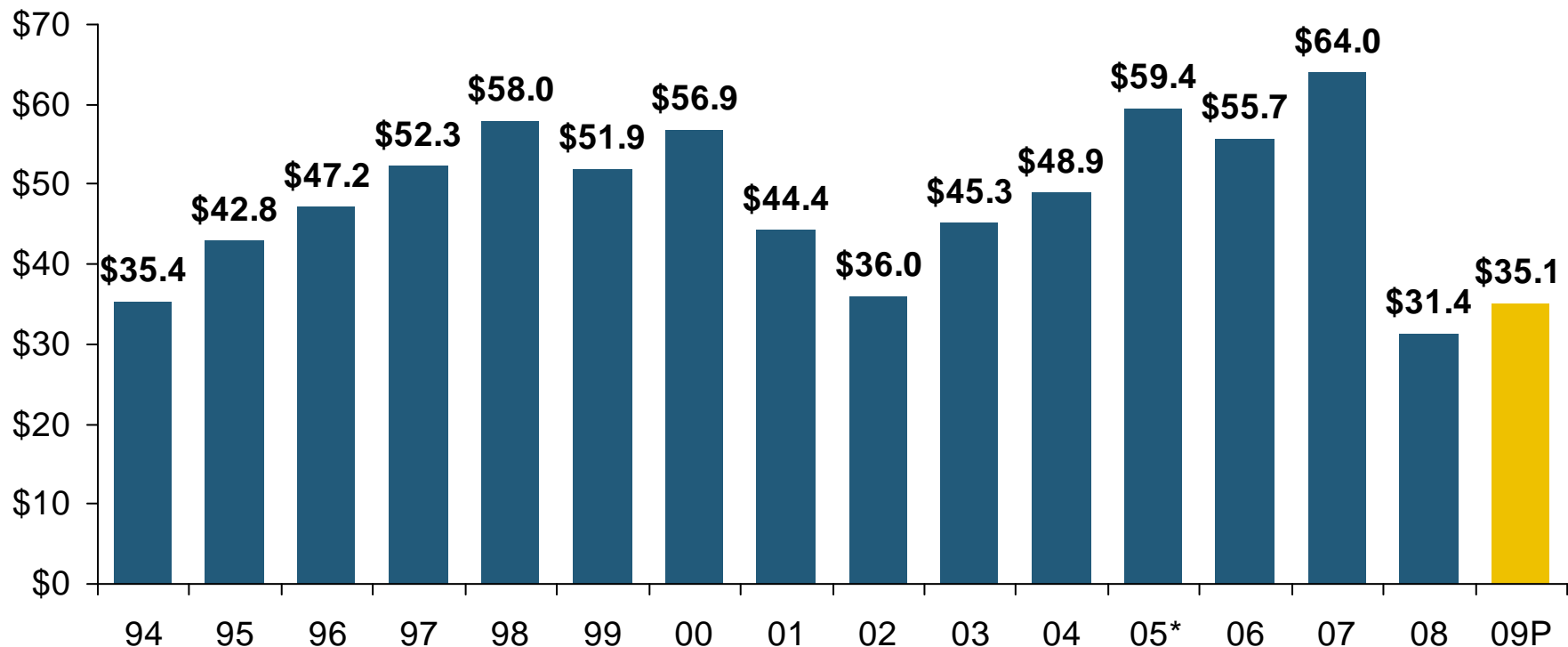
# Important Issues & Threats Facing Insurers: 2010–2015

## 1 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
- Fed actions in Treasury markets keep yields low
- Many insurers have not adjusted to this new investment paradigm of a sustained period of low investment gains
- ***Regulators will not readily accept it; many will reject it***
- ***Implication 1:*** Industry must be prepared to operate in environment with investment earnings accounting for a smaller fraction of profits
- ***Implication 2:*** Implies underwriting discipline of a magnitude not witnessed in this industry in more than 30 years. Yet to manifest itself.
- Lessons from the period 1920–1975 need to be relearned
- Long-tailed lines like WC are more impacted by reduced investment yields

# Property/Casualty Insurance Industry Investment Gain: 1994–2009P<sup>1</sup>

(\$ Billions)



**Investment Gains Fell by 51% In 2008 Due to Lower Yields, Poor Equity Market Conditions. In 2009, the Return of Realized Capital Losses Helped Offset Lower Investment Income**

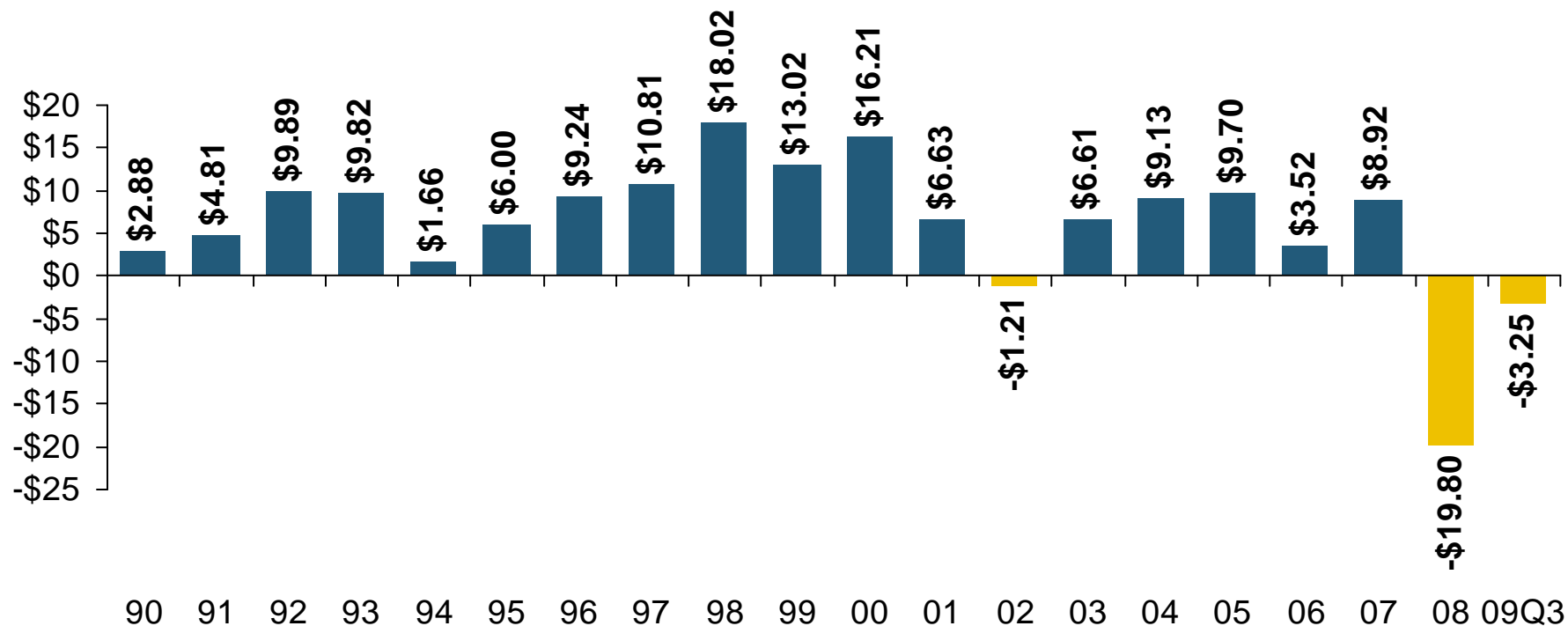
<sup>1</sup> Investment gains consist primarily of interest, stock dividends and realized capital gains and losses.

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

Sources: ISO; Insurance Information Institute.

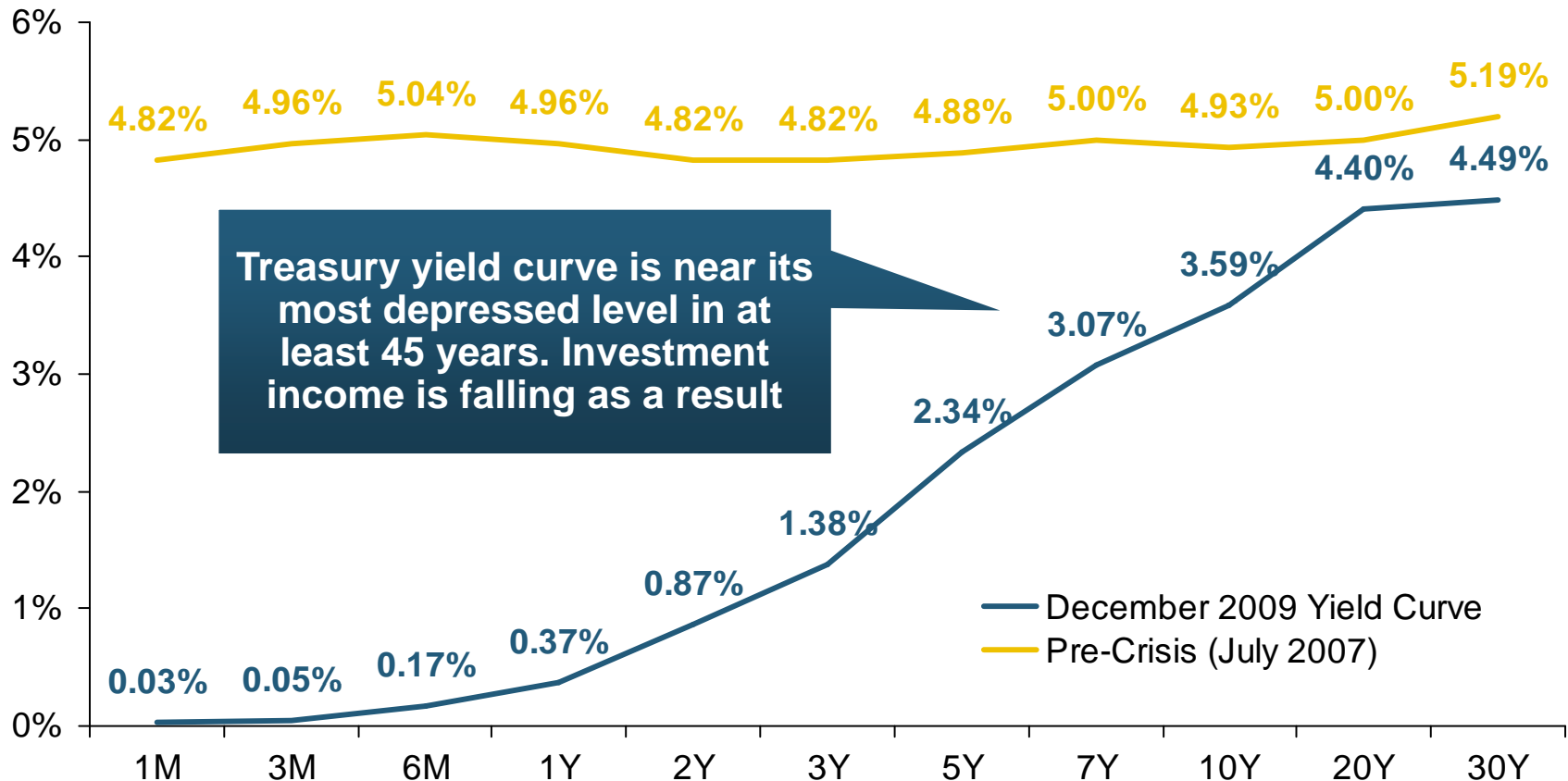
# P/C Insurer Net Realized Capital Gains, 1990-2009:Q3

(\$ Billions)



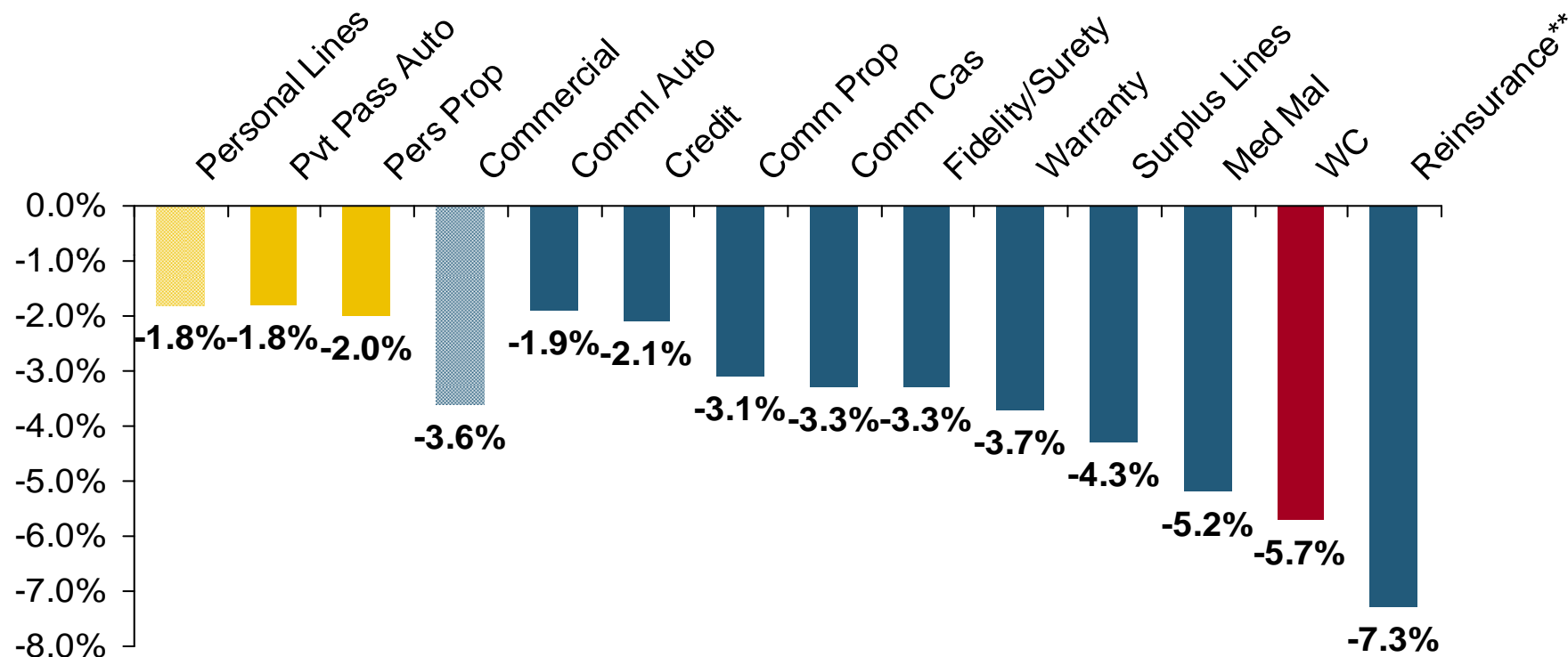
**Realized Capital Losses Hit a Record \$19.8 Billion in 2008 Due to Financial Market Turmoil, a \$27.7 Billion Swing From 2007, Followed by an \$3.25B Drop through Q3 2009. This is a Primary Cause of 2008/2009's Large Drop in Profits and ROE**

# Treasury Yield Curves: Pre-Crisis (July 2007) vs. Dec. 2009



**Stock Dividend Cuts Will Further Pressure Investment Income**

# Reduction in Combined Ratio Necessary to Offset 1% Decline in Investment Yield to Maintain Constant ROE, by Line\*



**Lower Investment Earnings Place a Greater Burden on Underwriting and Pricing Discipline**

\*Based on 2008 Invested Assets and Earned Premiums

\*\*US domestic reinsurance only.

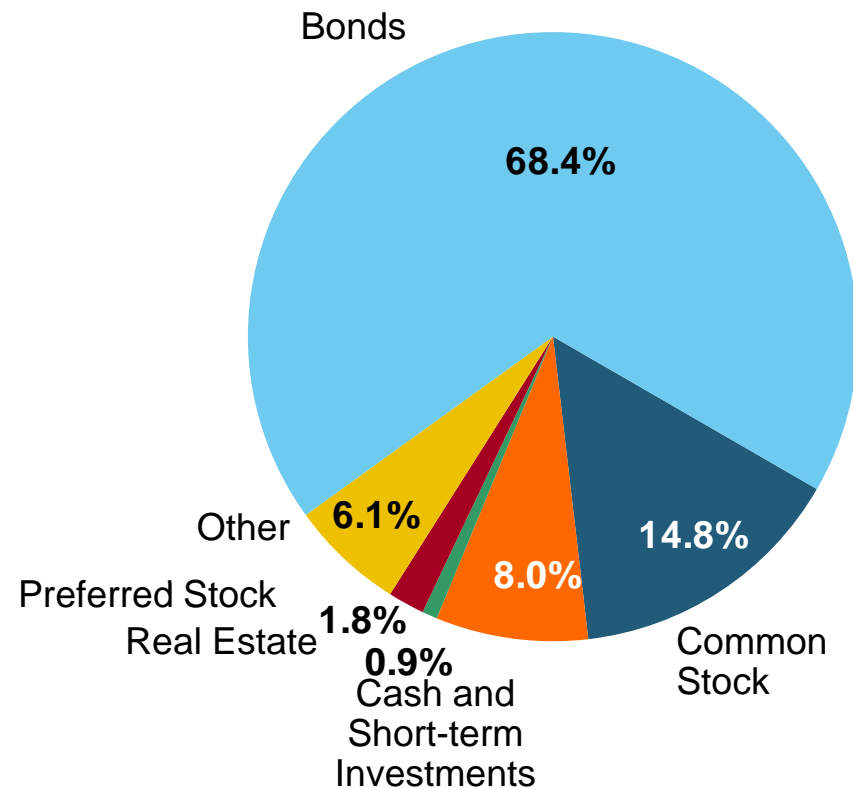
Source: A.M. Best; Insurance Information Institute.

# Distribution of P/C Insurance Industry's Investment Portfolio

## Portfolio Facts

- Invested assets totaled \$1.214 trillion as of 12/31/08
- Insurers are generally conservatively invested, with more than 2/3 of assets invested in bonds as of 12/31/08
- Only about 15% of assets were invested in common stock as of 12/31/08
- Even the most conservative of portfolios was hit hard in 2008

As of December 31, 2008



# Important Issues & Threats Facing Insurers: 2010–2???

## 2 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) more appropriate for banks
- Systemic Risk Regulator (Too Big To Fail)
  - Is any insurer systemically important? *Probably Not.*
- Federal Insurance Office Creation Within Treasury?
  - Eventual “mission creep”?; Activist director?
- Consumer Financial Protection Agency
  - Will be limited to banks/creditors (for now)
  - Does not include insurers in its current form, consequently the FTC would not gain study authority over the insurance industry
- McCarran-Ferguson Rollback
  - Health insurers lost their M-F exemption during the health reform debate
  - Med Mal insurers retained (for now) their exemption
- OFC/State Regulation Debate Lingers
- Taxation/Offshore Domiciles

**Bottom Line: Regulatory Outcome is Uncertain and Risk of Adverse Outcome Exists.  
Ultimate Regulation Structure Will Be in Place for Decades**

# Federal Insurance Office: *What Would it Do?*



## Duties of the Federal Insurance Office

- **Establishes office within US Treasury headed by a Director appointed by Treasury Secretary, and charged with:**
  1. Monitor the insurance industry to gain expertise
  2. Identify regulatory gaps that could contribute to a systemic crisis in the insurance industry or the U.S. financial system
  3. Recommend to the federal authority having systemic risk responsibility the designation of certain insurers (and their affiliates) for heightened prudential standards (although recognition of this role of the FIO is not evident in existing systemic risk regulation proposals)
  4. Assist in the administration of the Terrorism Risk Insurance Program

# Federal Insurance Office: *What Would it Do?*

## Duties of the Federal Insurance Office (continued)

5. Coordinate Federal efforts and establish Federal policy on prudential aspects of international insurance matters (including representation of the U.S. before the International Association of Insurance Supervisors and assisting the Secretary of Treasury in the negotiation of international agreements relating to prudential matters)
6. Consult with the States on national matters of importance to insurance and international insurance matters relating to prudential regulation
7. Determine whether state insurance matters are preempted by international insurance agreements relating to prudential matters
8. Advise the Secretary of Treasury on major domestic and prudential international matters of importance
9. Consult with state insurance commissioners, both individually and collectively, as appropriate

# Systemic Risk: Oversight & Resolution Authority

## Issues Related to Systemic Risk & Resolution Authority

- **Federal Authority created to oversee systemic risk of large financial holding companies (e.g., Federal Reserve or other existing/new agency) [a.k.a. TOO BIG TOO FAIL]**
  - P/C insurers are working to “carve out” and exception to systemic risk oversight (arguing they were not the source/cause of problems)
  - Without such an exception, p/c insurers could be subject to assessments (e.g., *Financial Responsibility Tax*) for failed noninsurance financial institutions or could be forced to repay funds provided for government assistance to firms due to problems outside of their p/c insurance operations
- **European Regulators Believe Large (Re)Insurers Should Be Included Under the Definition of Systemically Important Firms**
  - ECB named 8 insurers/reinsurers as systemically important

## How Current Systemic Risk Proposal Could Affect Insurers

- **Bank holding companies with more than \$50 billion in assets would be subject to an assessment (Financial Responsibility Tax) in order to build a \$50 billion fund to wind down (resolve) large, insolvent financial institutions**
  - This first group could include some insurers that own banks
- **If the \$50 billion resolution fund is exhausted, then other non-bank financial institutions (including insurers, even those without banks) with more than \$50 billion in consolidated assets would be assessed to make up any shortfall**
- **Bottom Line: P/C insurers do not object to the concept of systemic risk, but feel that the focus on size alone is inappropriate given the roots of the financial crisis and the fact that p/c insurers were not the cause**

## Rational for Excluding P/C Insurers from Systemic Regulation

- **The insurance business model (encompassing both insurers and reinsurers) has specific features that make it a source of stability within the financial system**
  - Up-front premiums provide strong operating cash flow
  - Insurance policies generally represent longer-term liabilities with little or no ability for the policy holder to demand immediate payments (no “run” on insurers)
  - The few insurers that experienced serious problems were impacted not by their insurance business but by quasi-banking activities. This includes AIG and “monoline” insurers provided financial guarantees and engaged in CDS writing and trading
- **Core Activities of Insurers Have No Systemic Relevance**
  - Only 2 non-core activities seem to have relevance assuming they are conducted on a huge scale using poor risk management control
    - Derivatives trading on non-insurance balance sheets
    - Mismanagement of short-term funding from commercial paper or securities lending

# **Critical Differences Between P/C Insurers and Banks**

**Superior Risk Management Model and  
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 198 banks have gone under as of 3/12/10)
    - **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*)

# 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

# Important Issues & Threats Facing Insurers: 2010–2015

## 3 Reemergent Terrorism Threat

- Perception (Reality) that U.S. vulnerability is rising
- Thwarted Christmas Day attack by “underwear bomber”
  - And new bin Laden tape claiming al Qaeda is responsible
- Foiled NYC Subway Bomber Plot (Zazi case)
- Trials of Guantanamo 9/11 suspects in Manhattan Court (?)
- U.K. in January Raised Terror Alert Status to 2<sup>nd</sup> Highest Level
- Increased anti-terror efforts, including full-body scans
- Effort by government to appear more vigilant, prepared
- Rise of groups such al Qaeda in the Arabian Peninsula
- U.S. military surge in Afghanistan operations
- Most buyers, producers have not thought about coverage issues recently
- **Obama Administration’s Intent to Reduce Support for TRIA**

***Terrorism Threat is Elevated and Federal Backstop is Threatened***

# Obama Administration Proposal to Scale Back Terrorism Risk Insurance Program

## Administration's Budget Proposal for FY 2011:

- Includes proposal to scale back federal support for terrorism risk insurance program
- Proposal projects savings of \$249 million from 2011-2020
- Administration's justification is that this would "encourage the private sector to better mitigate terrorism risk through other means, such as developing alternative reinsurance options and building safer buildings."

### Key Concerns

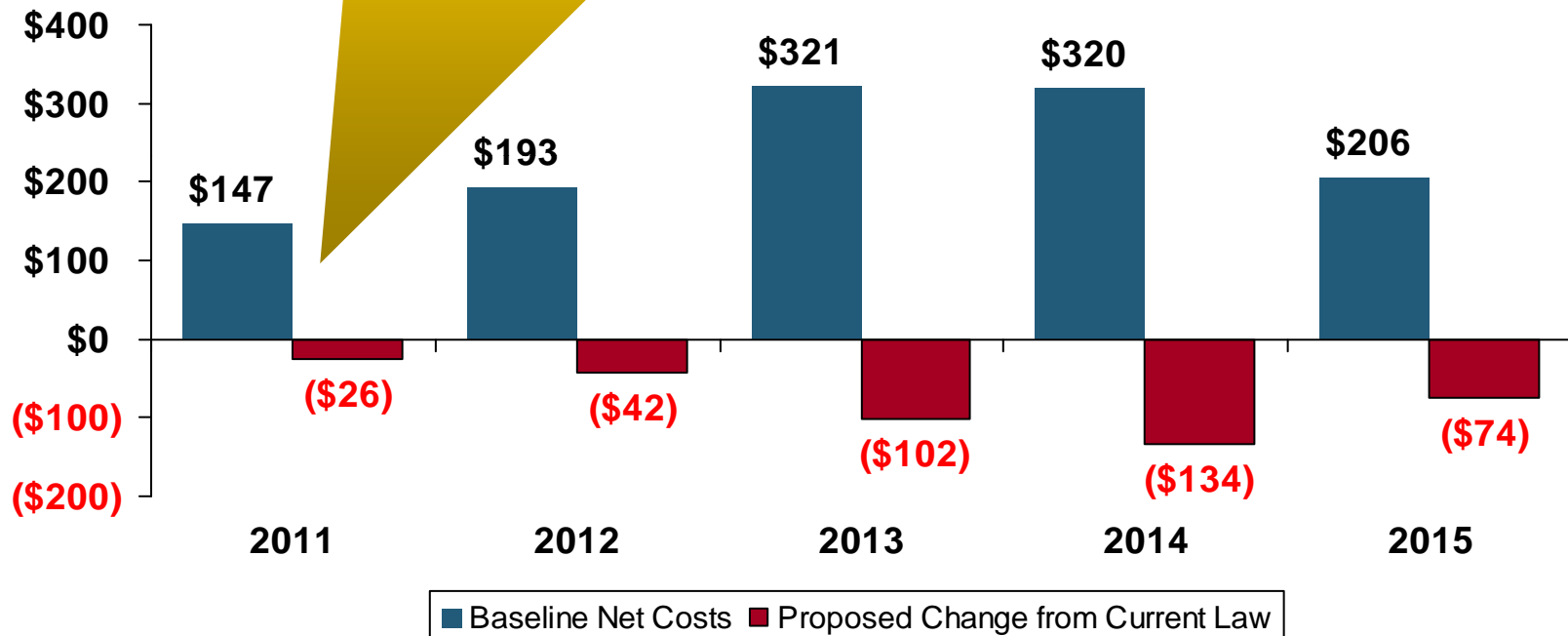
#### Among Industry Observers Over Proposed Reduction in Federal Support

- Suggestion of changes to law would have detrimental effect on availability and affordability of terrorism insurance
- A 2009 Aon study estimated some 70-80 percent of the commercial property insurance market would revert to absolute exclusions for terrorism, if TRIA is changed.

# Terrorism Risk Insurance Program Faces Reduced Support Under 2011 Proposed Federal Budget

By shifting more costs to insurers and insureds in the event of a major terrorist attack, the Administration believes that it can save \$378 million from 2011 through 2015

\$ Millions



**The availability of terrorism coverage is threatened by the proposal in the FY 2011 federal budget. Coverage will likely be less available and more expensive.**

# Important Issues & Threats Facing Insurers: 2010–2015

## 4 Healthcare Reform Legislation: Uncertain Impacts

1. Should *reduce* cost shifting into WC to make up for revenues lost from treating the uninsured
  - Effect could still linger since Medicaid reimbursements likely to be lower than for WC
2. Possibly *more* cost shifting from other med providers to make up for big cuts in Medicare reimbursement
3. Possibly higher WC claims frequency
  - Statistically, the insured tend to access the WC system more frequently than the uninsured
4. Inattention to Workers Comp by medical providers
  - Stronger and tighter focus of providers to group health, Medicare and Medicaid programs
  - Ultimately, improvements in claim management systems could benefit WC but this may take several years
5. Plan allows for discounts on health insurance for people who enroll in company wellness programs and allows employers to charge smokers more
  - To the extent the plan encourages responsible, healthy behaviors (such as weight loss, smoking cessation) worker comp will benefit
6. Plan contains little meaningful tort reform (e.g., no caps on noneconomic damages in medical cases), hence the cost of medical care, will be inflated by tort costs and the cost of defensive medicine, including care provided through the WC system
  - The CBO priced the savings from tort reform, if adopted, at \$54 billion over 10 years.

# Important Issues & Threats Facing Insurers: 2010–2015

## 5

### Emerging Tort Threat

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

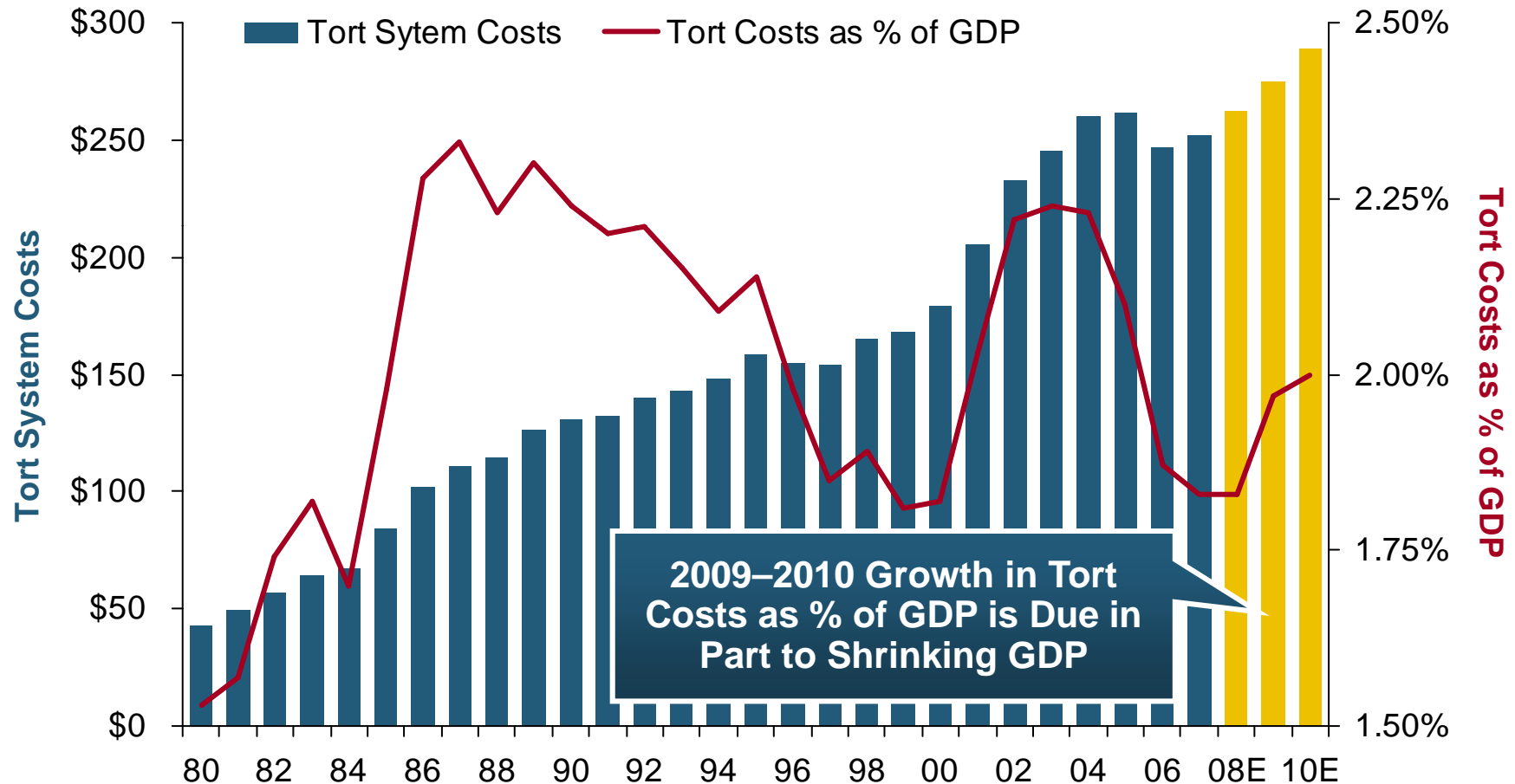
***Bottom Line:*** Tort “crisis” is on the horizon and could be recognized as such by 2012–2014

# **Shifting Legal Liability & Tort Environment**

## **Is the Tort Pendulum Swinging Against Insurers?**

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

(\$ Billions)



\* 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

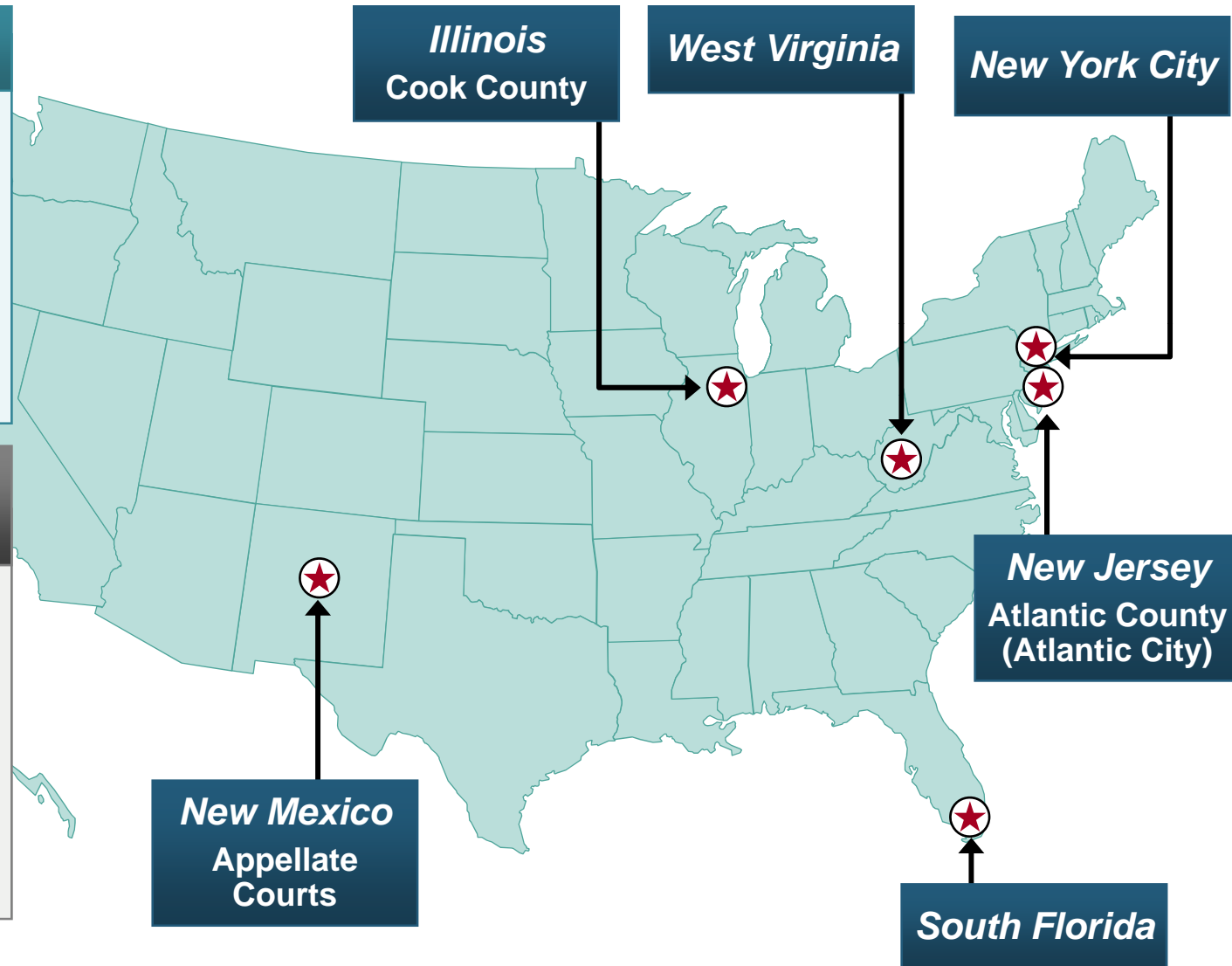
# The Nation's Judicial Hellholes: 2010

## Watch List

- California
- Alabama
- Madison County, IL
- Jefferson County, MS
- Texas Gulf Coast
- Rio Grande Valley, TX

## Dishonorable Mention

- AR Supreme Court
- MN Supreme Court
- ND Supreme Court
- PA Governor
- MA Supreme Judicial Court
- Sacramento County



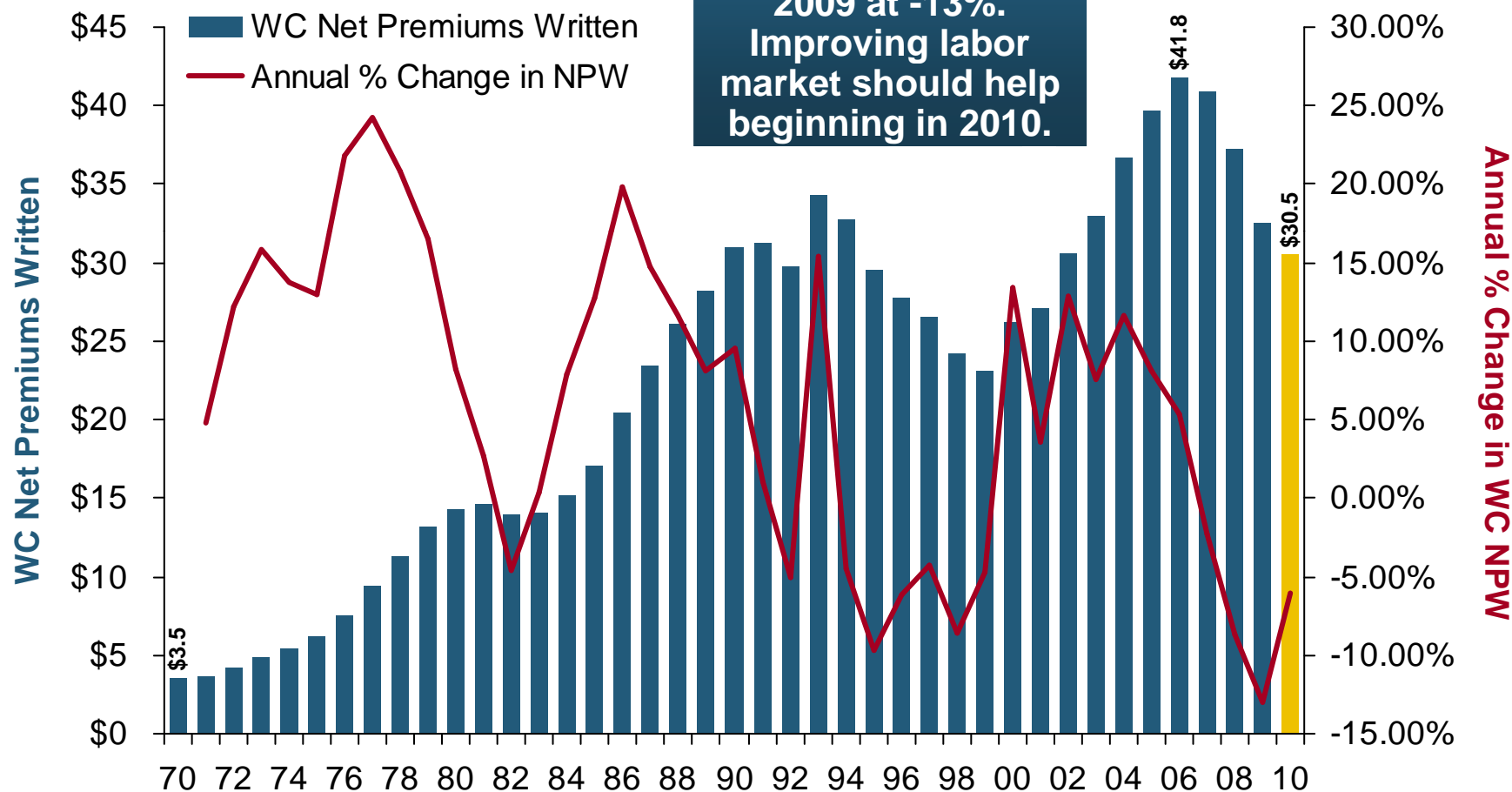


# **Workers Compensation Operating Environment**

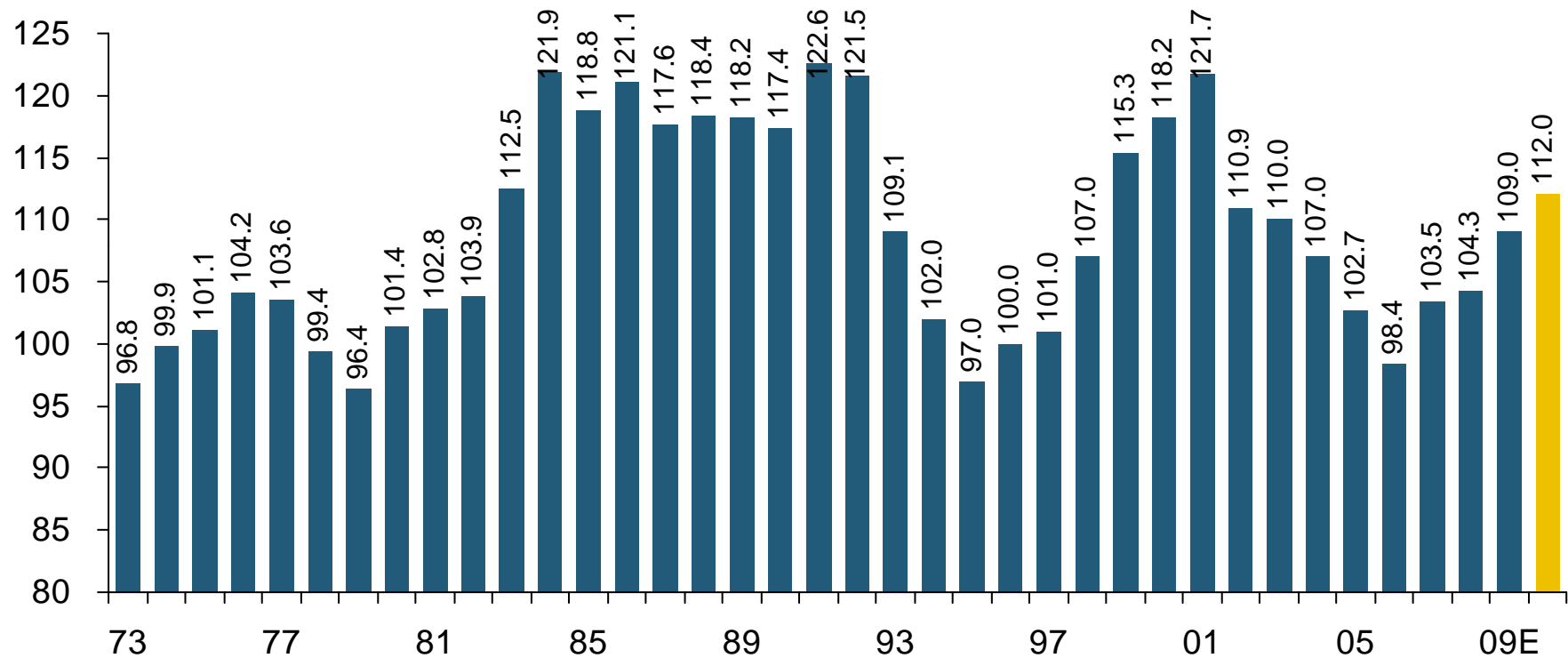
**The Weak Economy and Soft Market Have  
Made the Workers Comp Operating  
Increasingly Challenging**

# Workers Compensation Net Premiums Written and Annual Growth Rates: 1970-2010P

(\$ Billions)



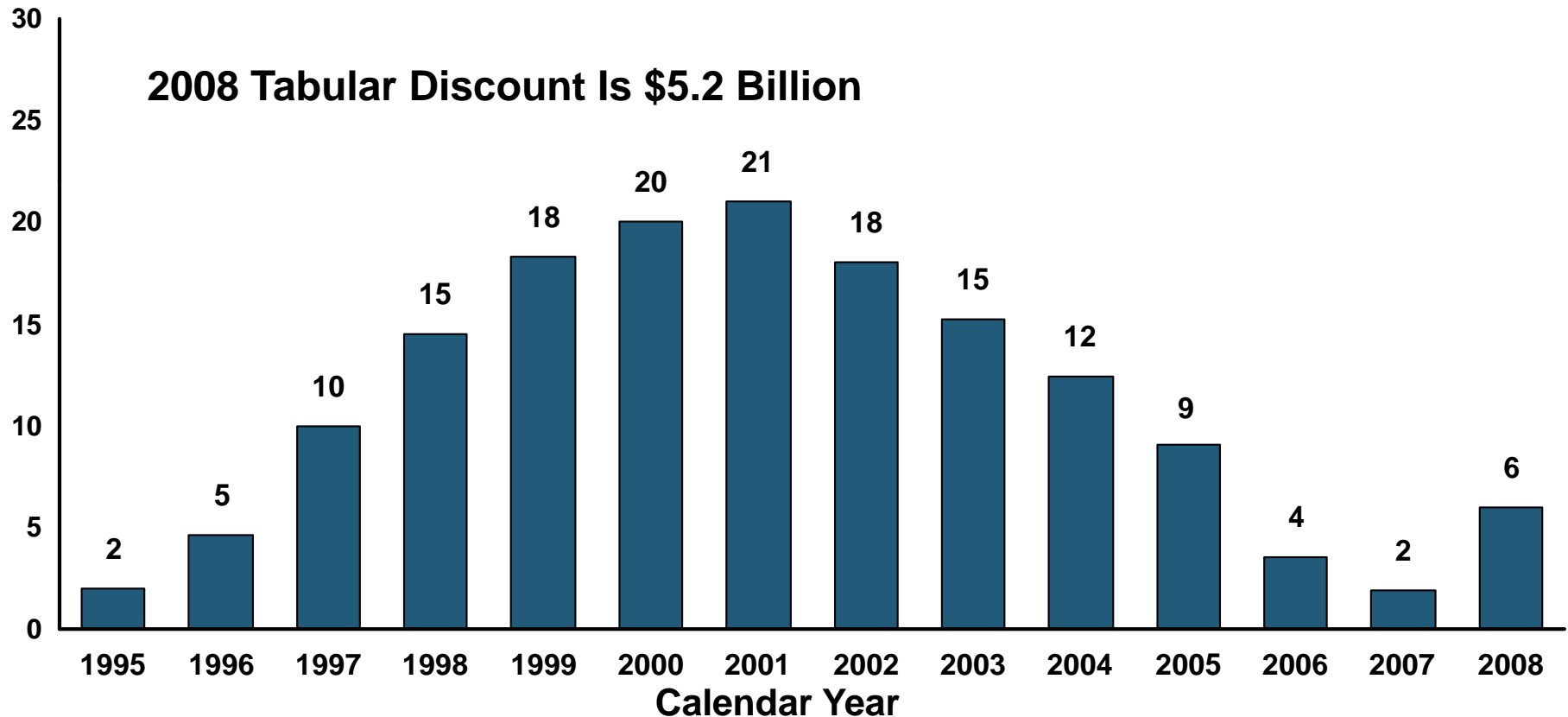
# Workers Compensation Combined Ratio: 1973–2010P



**Workers Comp Underwriting Results Are Deteriorating Markedly**

# Calendar Year Reserve Deficiency Increased in 2008

## \$ Billions WC Loss and LAE Reserve Deficiency: Private Carriers



Considers all reserve discounts as deficiencies

Loss and LAE figures are based on NAIC Annual Statement data for each valuation date and NCCI latest selections

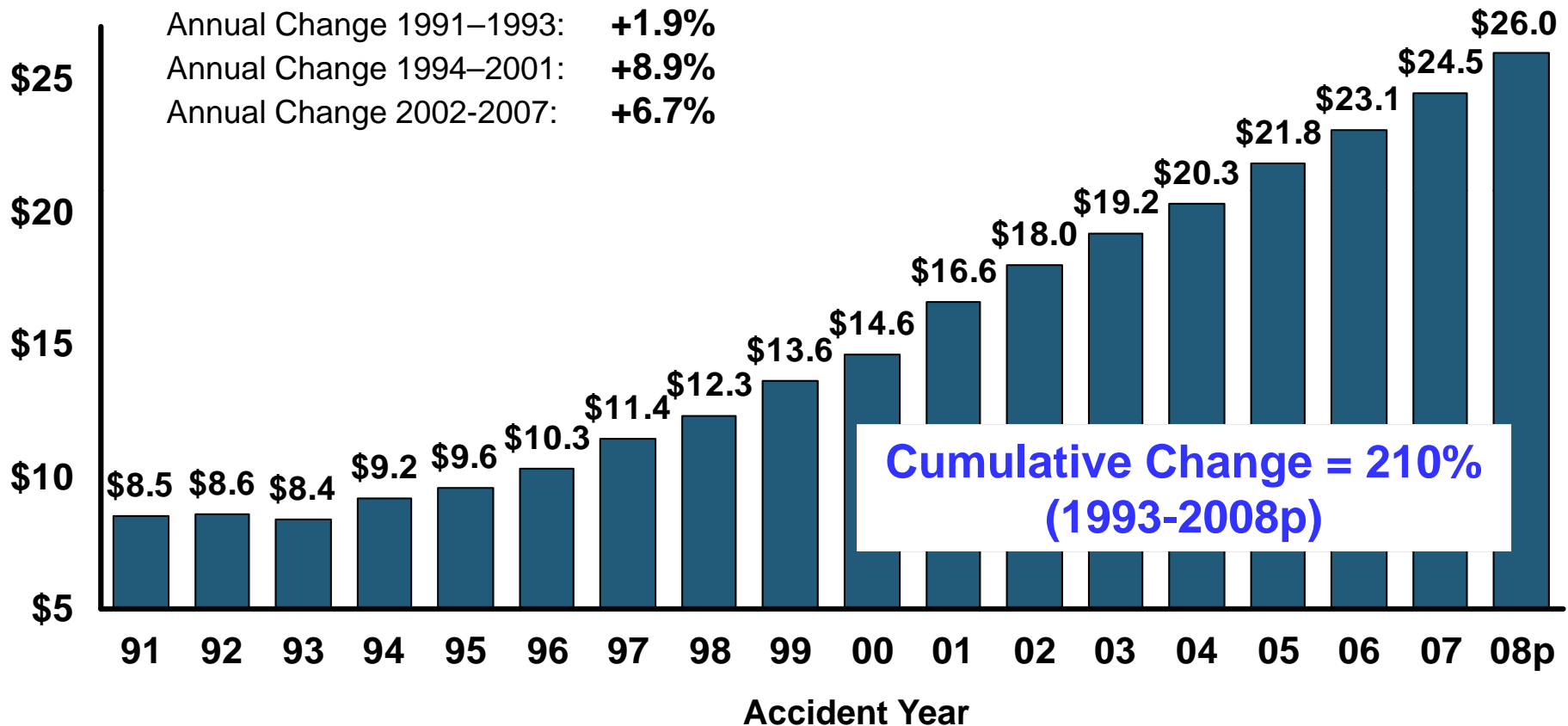
Source: NCCI analysis

# **Workers Compensation Medical Claim Cost Trends**

**Rising Medical Costs Continue to Pressure  
Workers Compensation**

# Workers Comp Medical Claim Costs Continue to Rise

## Medical Claim Cost (\$000s)

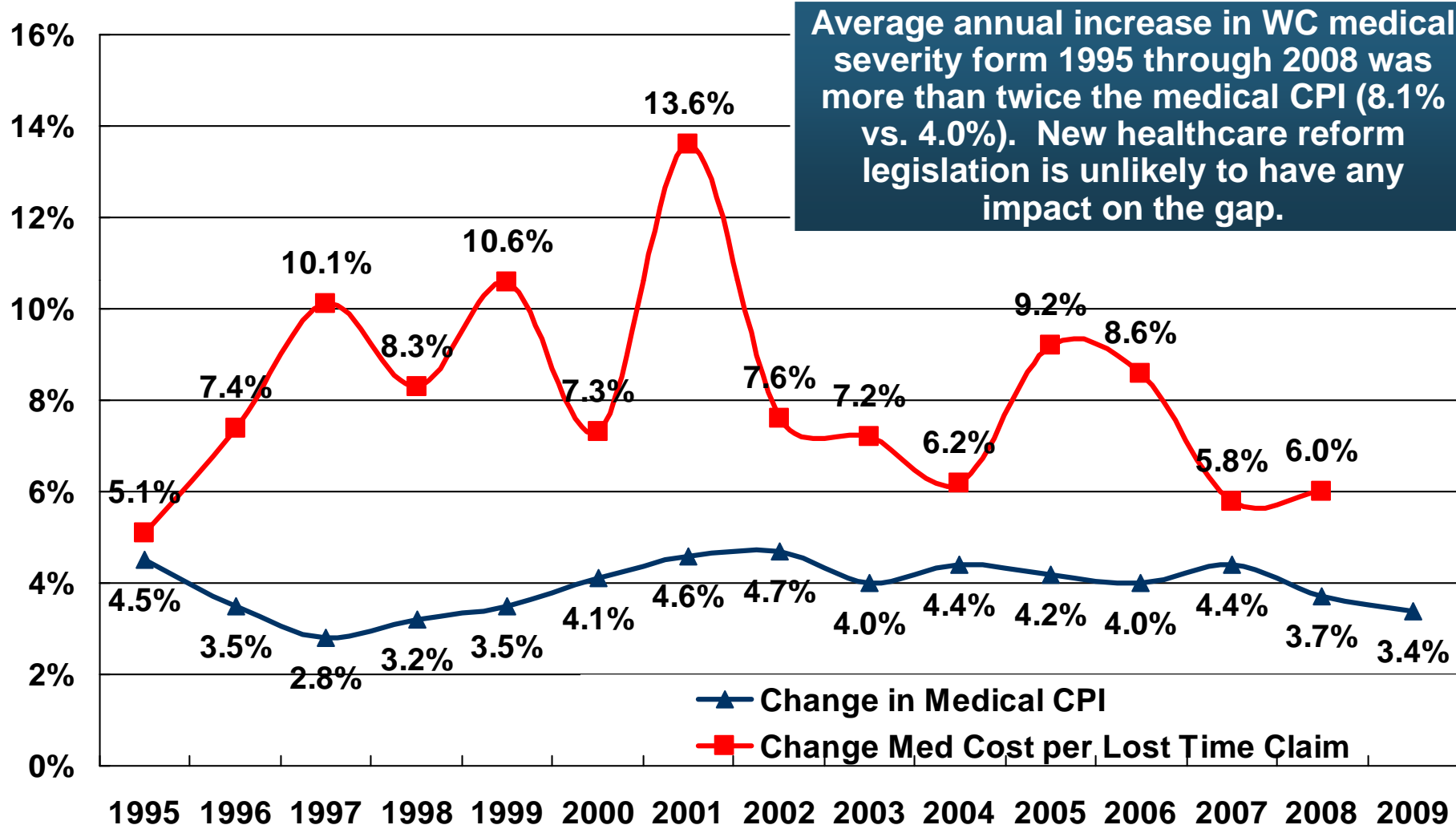


2008p: Preliminary based on data valued as of 12/31/2008

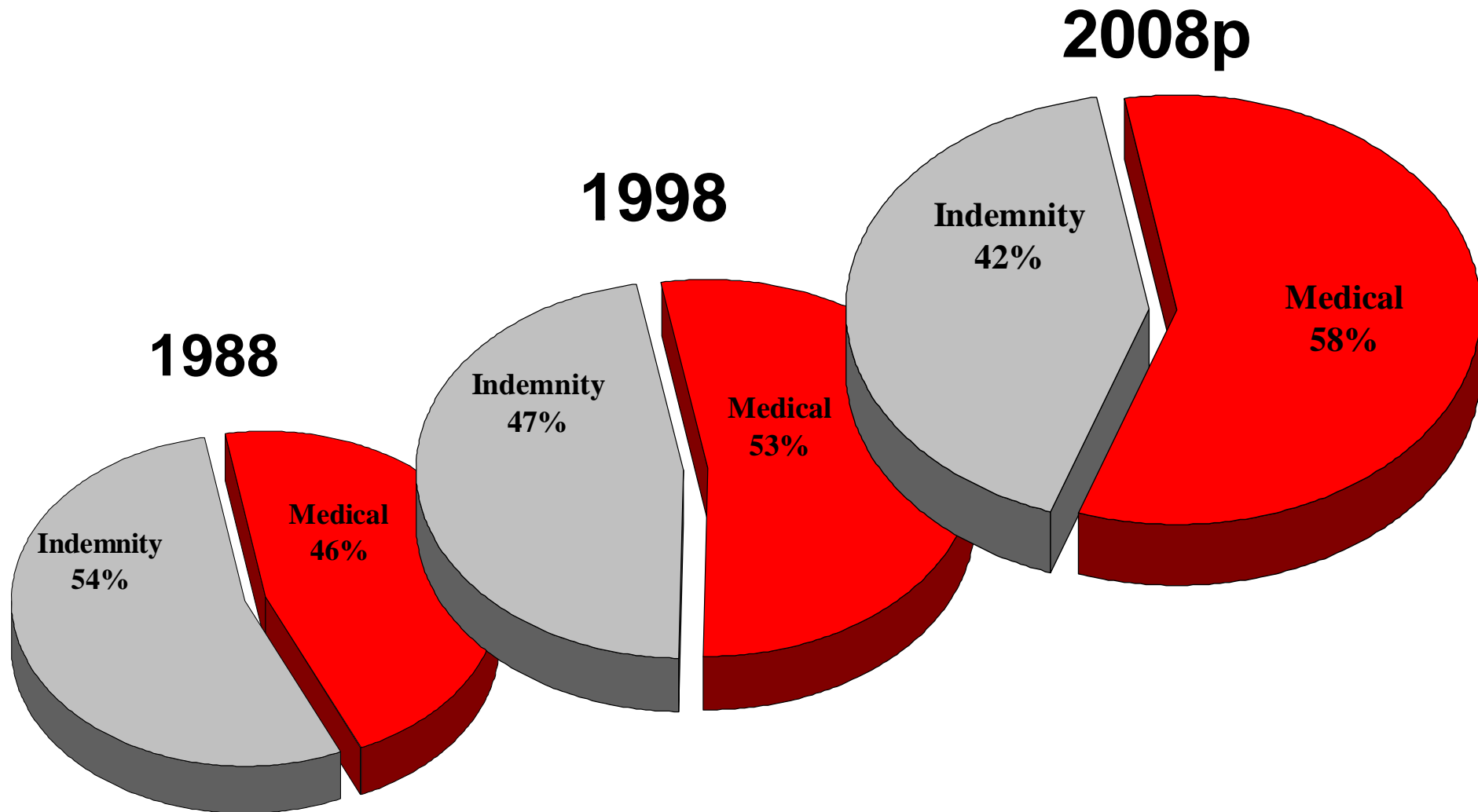
1991-2007: Based on data through 12/31/2007, developed to ultimate

Based on the states where NCCI provides ratemaking services; Excludes the effects of deductible policies

# WC Medical Severity Rising at Twice the Medical CPI Rate



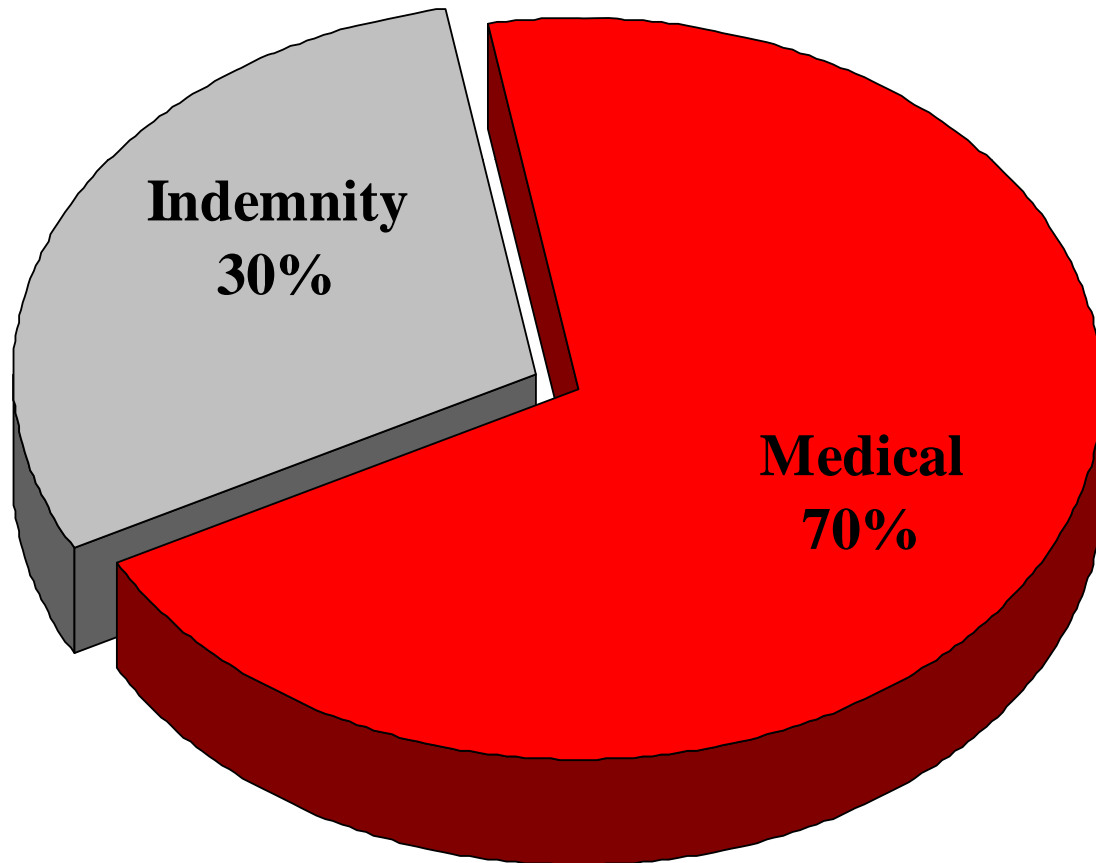
# Med Costs Share of Total Costs is Increasing Steadily



Source: NCCI (based on states where NCCI provides ratemaking services).

# WC Med Cost Will Equal 70% of Total by 2018 if Trends Hold

## 2018 Estimate



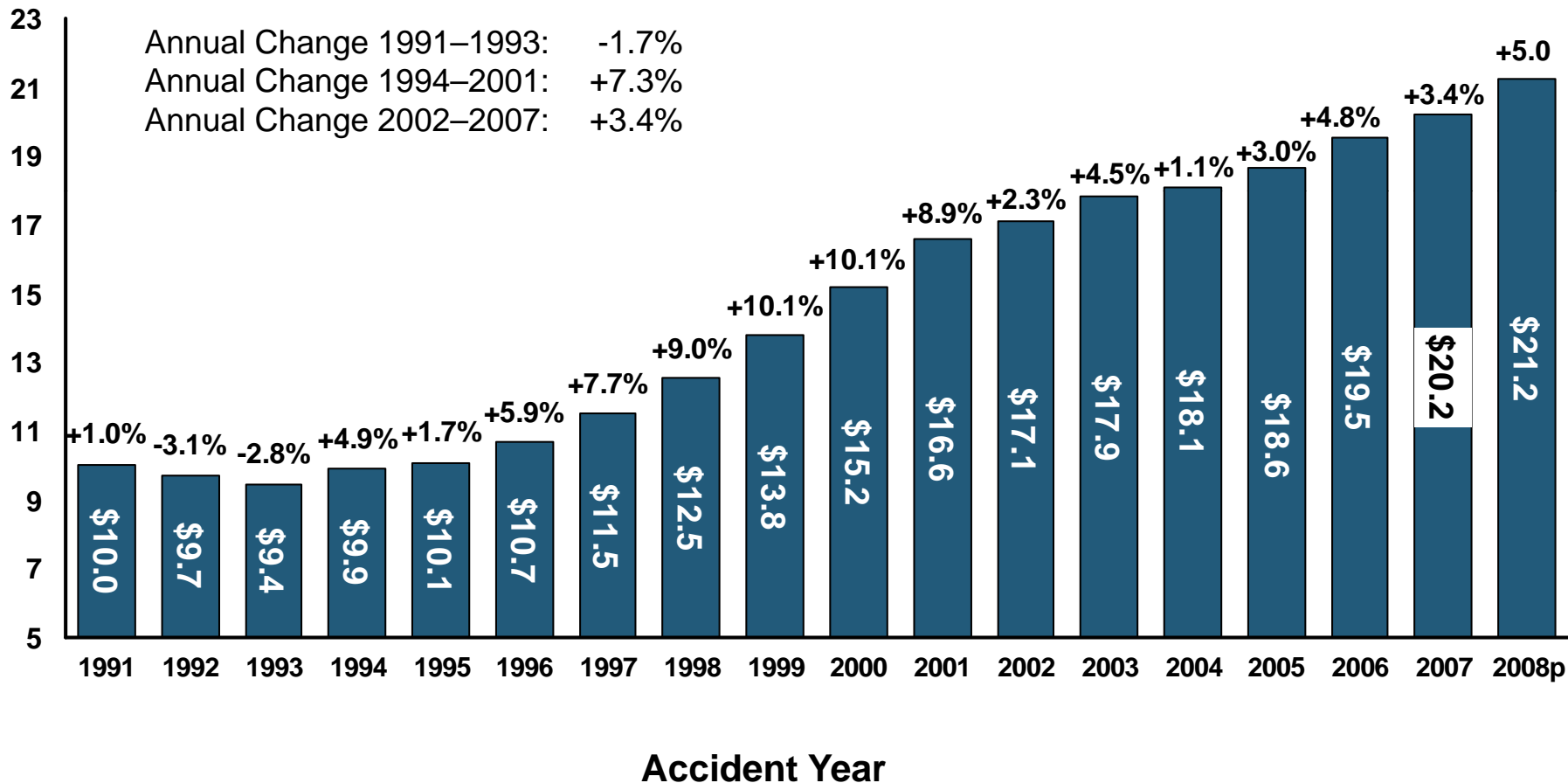
**This trend will likely be supported by the increased labor force participation of workers age 55 and older.**

# Indemnity Claim Cost Trends

**Indemnity Costs Continue to Rise at a  
Pace Above Wage Inflation**

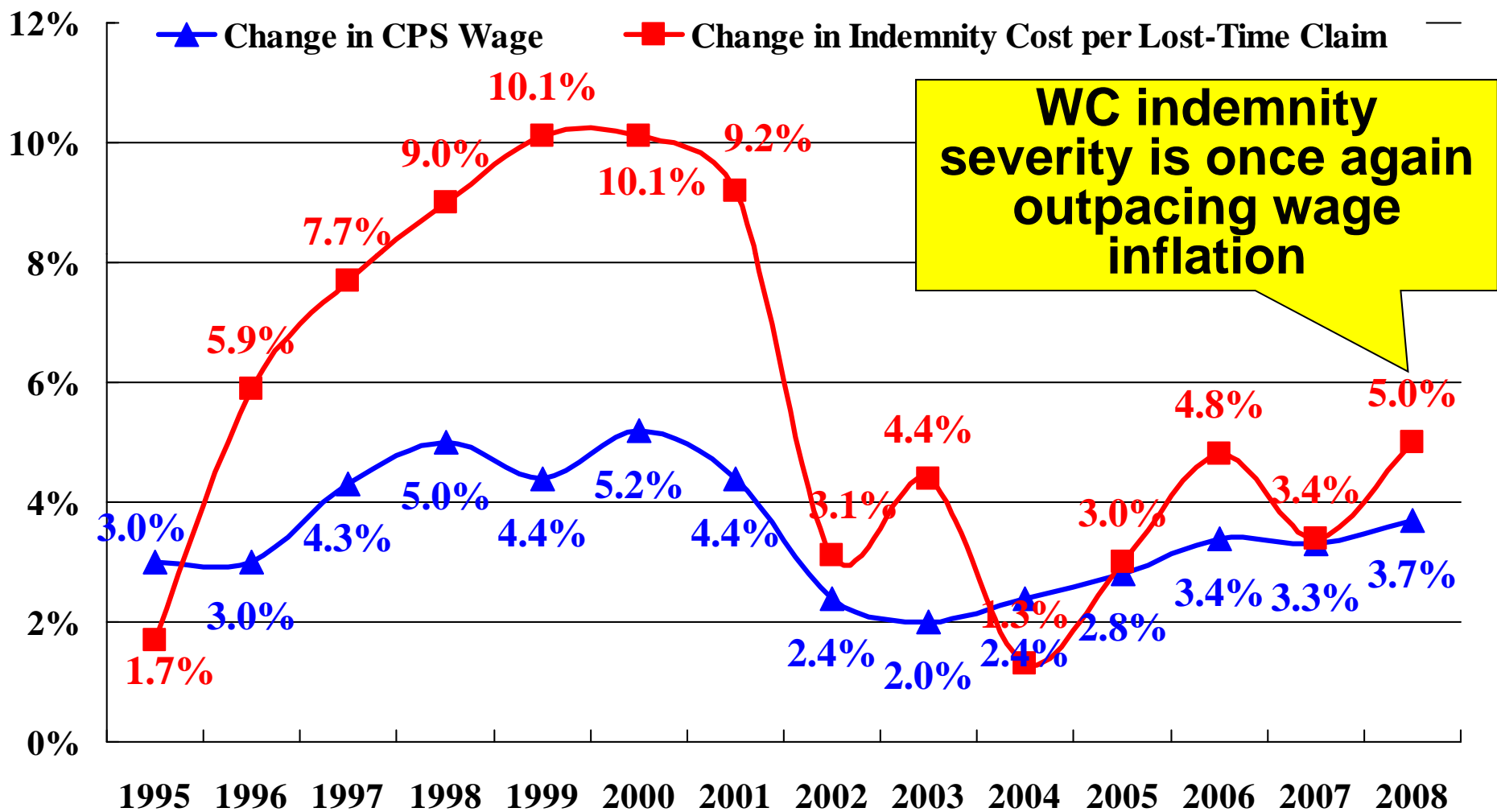
# Workers Comp Indemnity Claim Costs Continue to Grow

Indemnity  
Claim Cost (\$ 000s)



2008p: Preliminary based on data valued as of 12/31/2008  
1991–2007: Based on data through 12/31/2007, developed to ultimate  
Based on the states where NCCI provides ratemaking services  
Excludes the effects of deductible policies

# WC Indemnity Severity vs. Wage Inflation



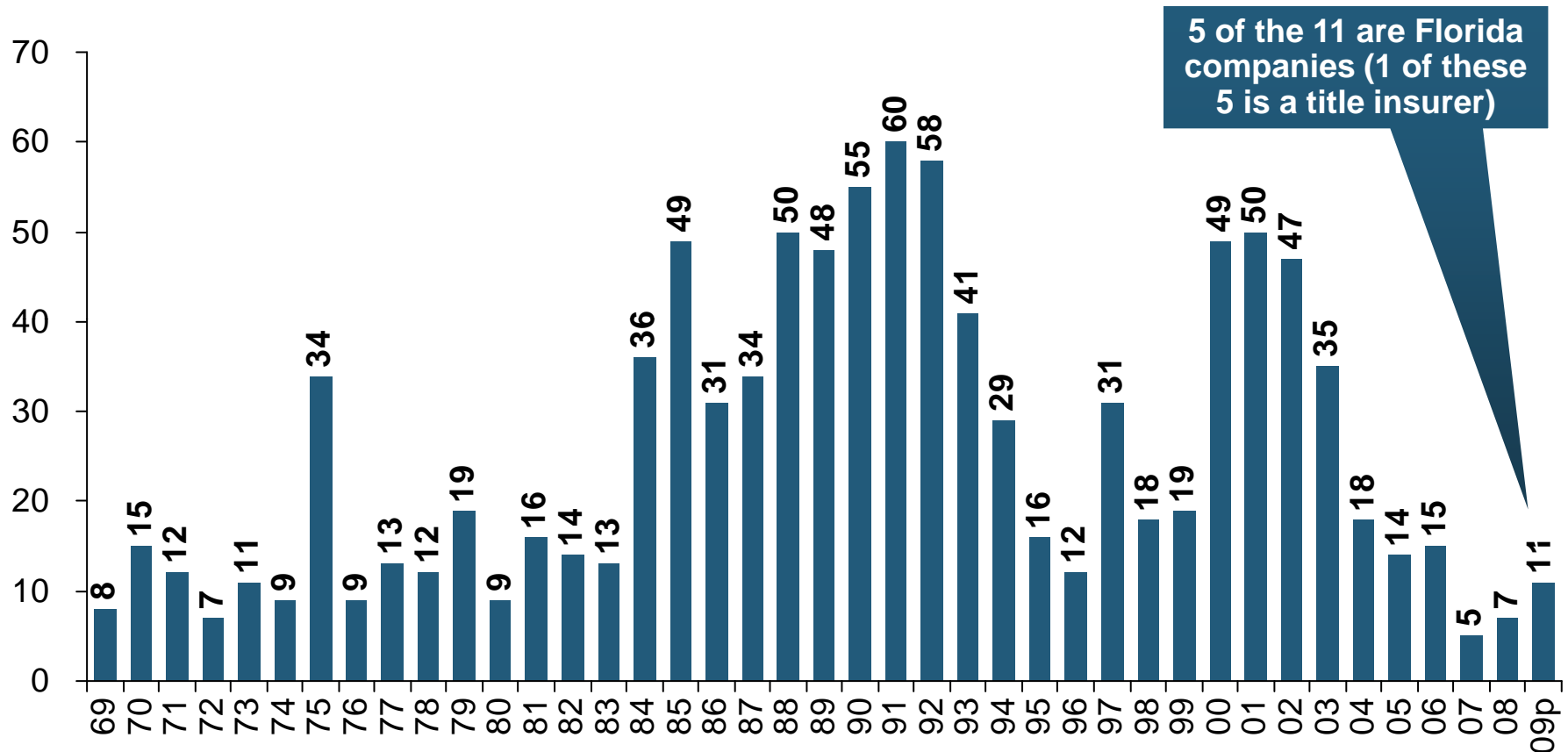
2008p: Preliminary based on data valued as of 12/31/2007; 1991-2007: Based on data through 12/31/2006, developed to ultimate. Based on the states where NCCI provides ratemaking services. Excludes the effects of deductible policies. CPS = Current Population Survey.  
Source: NCCI



# **P/C Insurance Industry Financial Strength & Ratings**

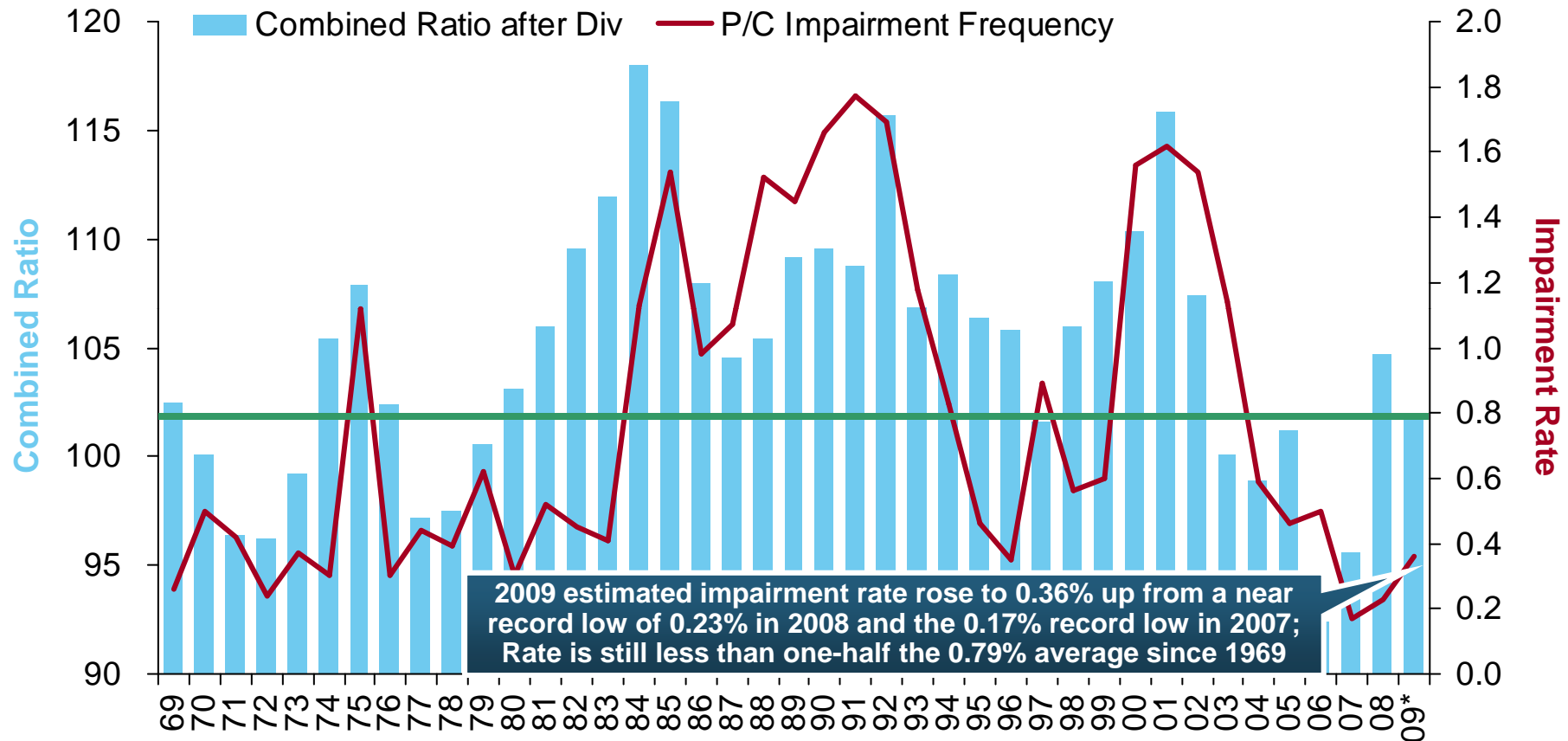
**Industry Has Weathered  
the Storms Well**

# 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**

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

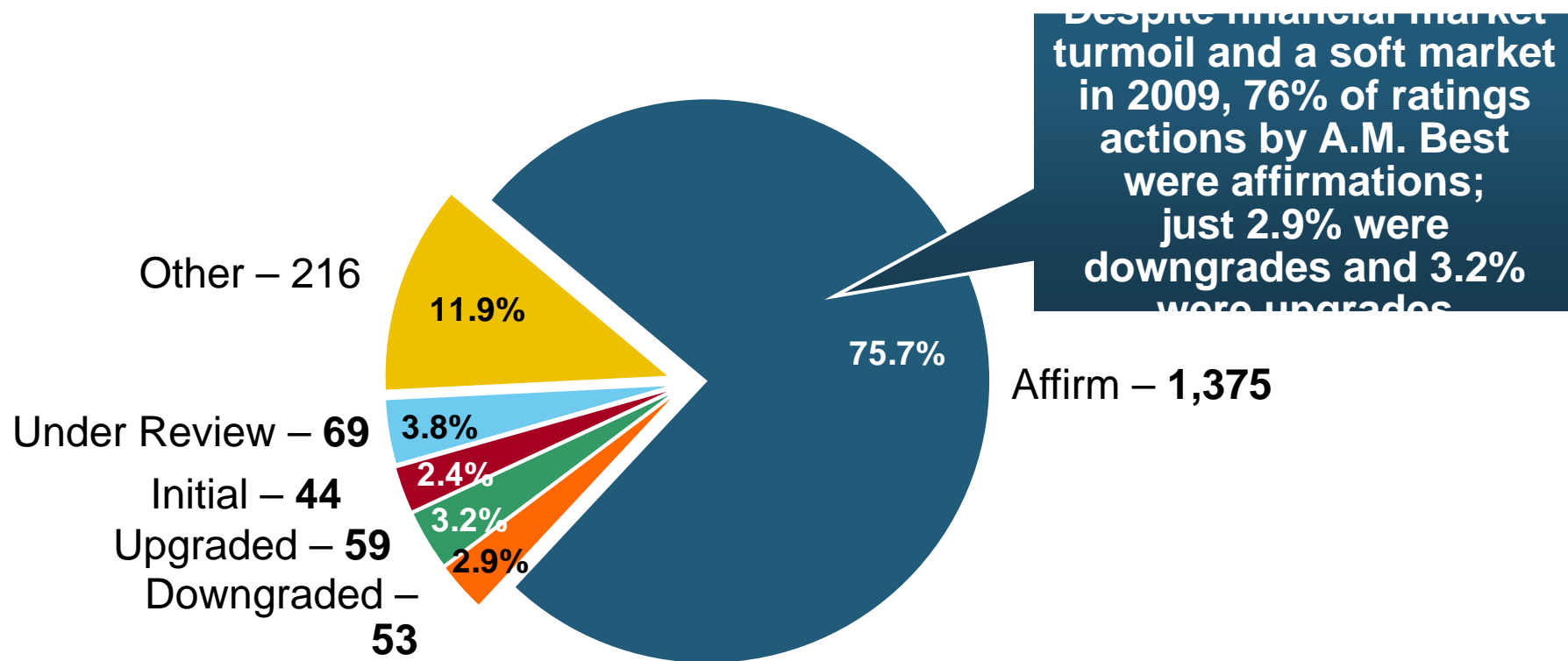


**Impairment Rates Are Highly Correlated With Underwriting Performance and Reached Record Lows in 2007/08**

\*Combined ratio of 101.7 is through Q3:09; 0.36% 2009 impairment rate is III estimate based on preliminary A.M. Best data.

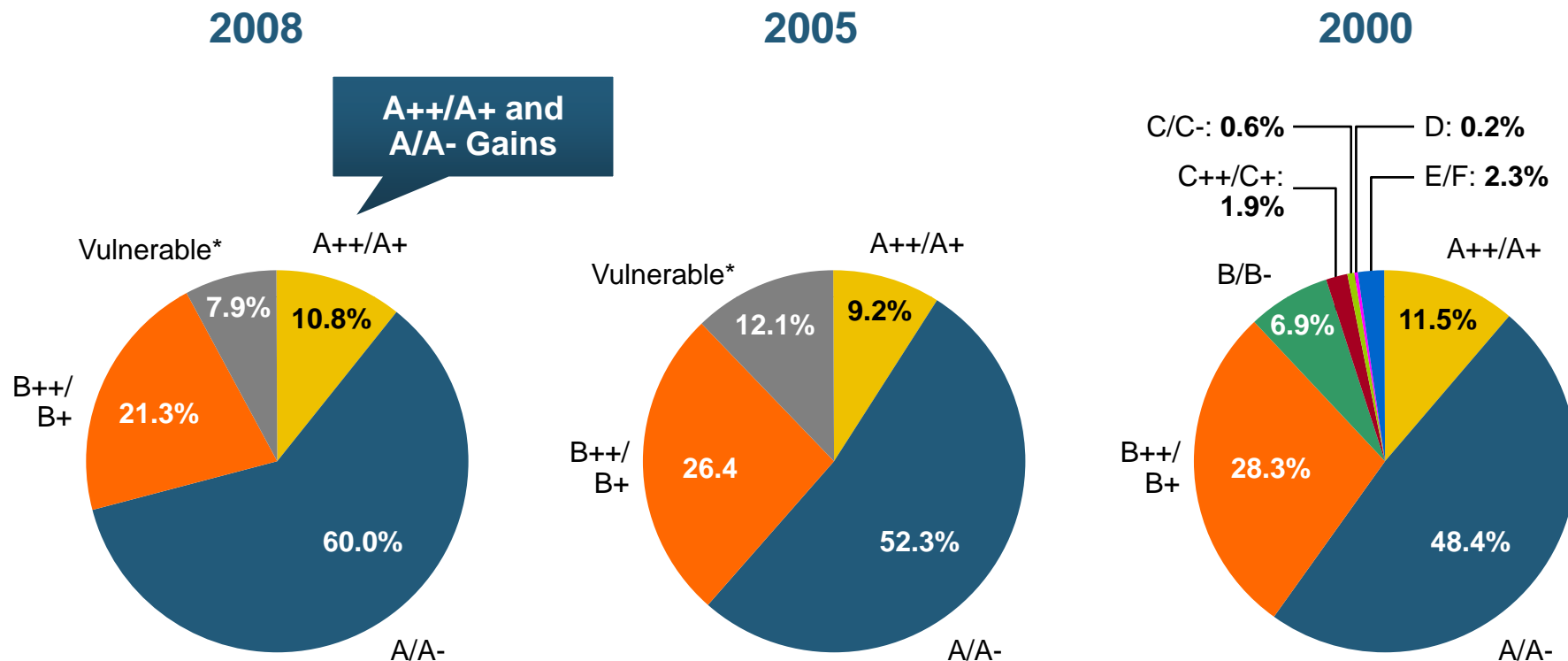
Source: A.M. Best; Insurance Information Institute

# 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**

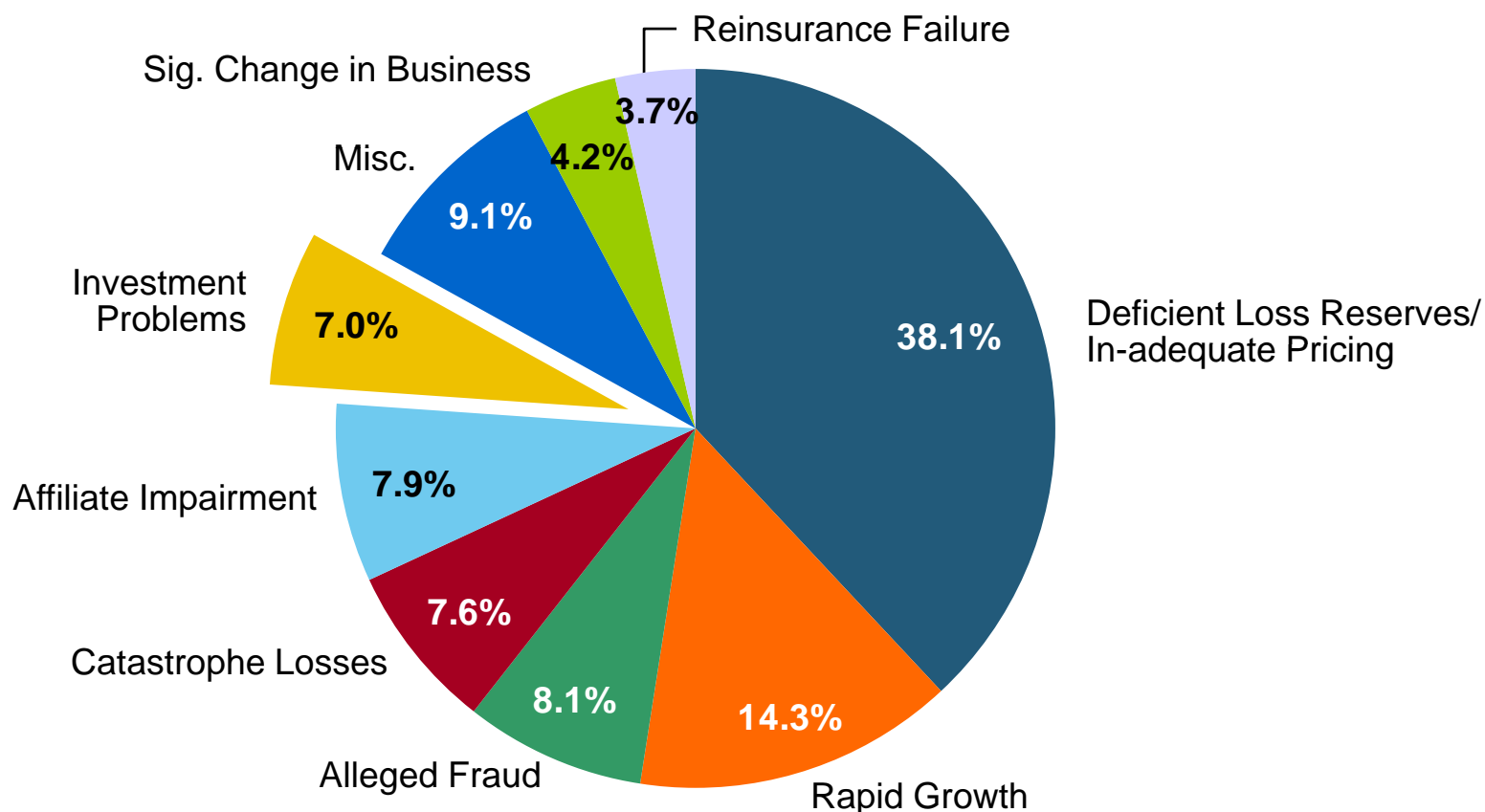
# Historical Ratings Distribution, US P/C Insurers, 2008 vs. 2005 and 2000



**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**



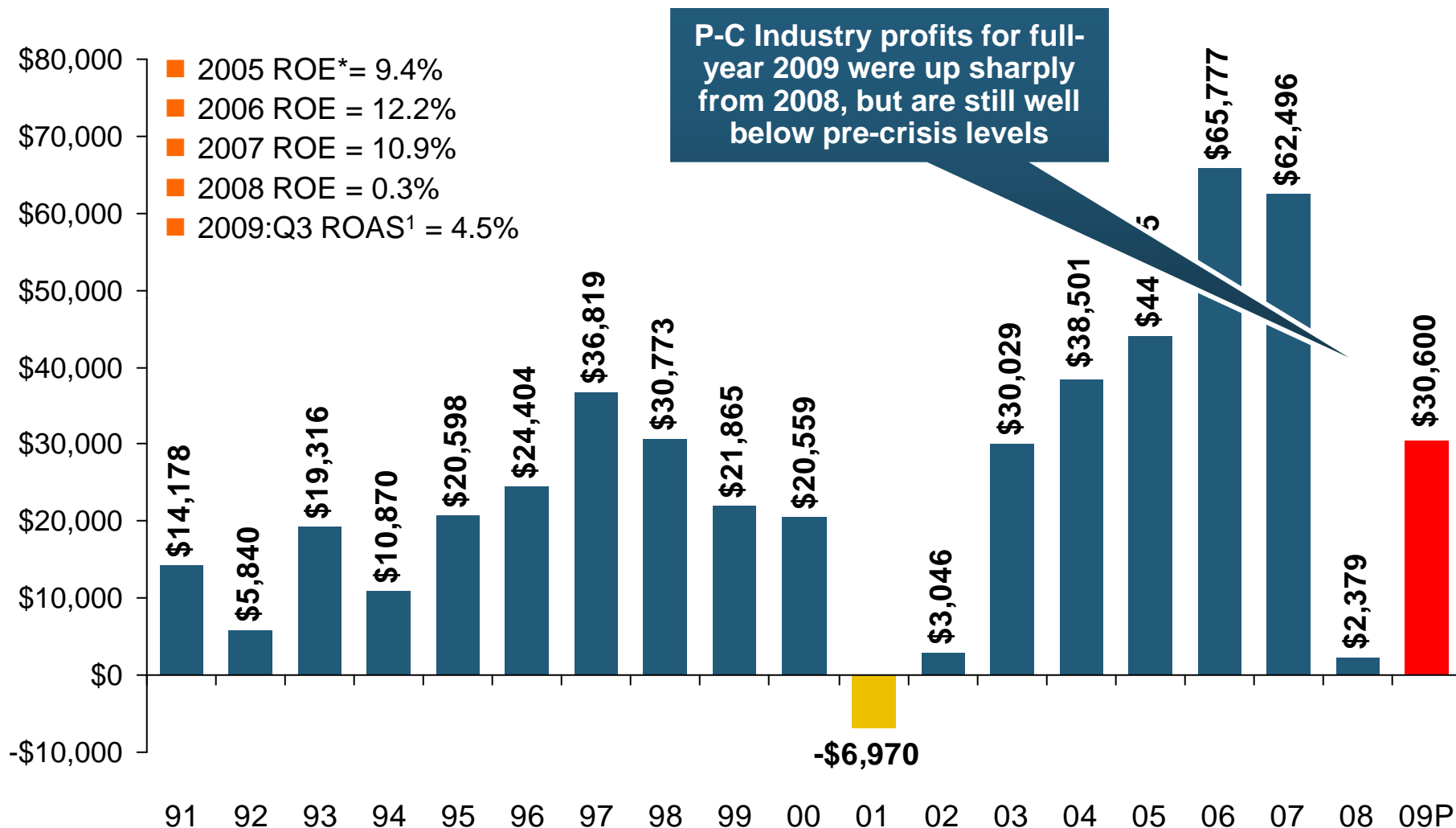
# **P/C Insurance Financial Performance**

## **A Resilient Industry in Challenging Times**

# Profitability

**Historically Volatile**

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

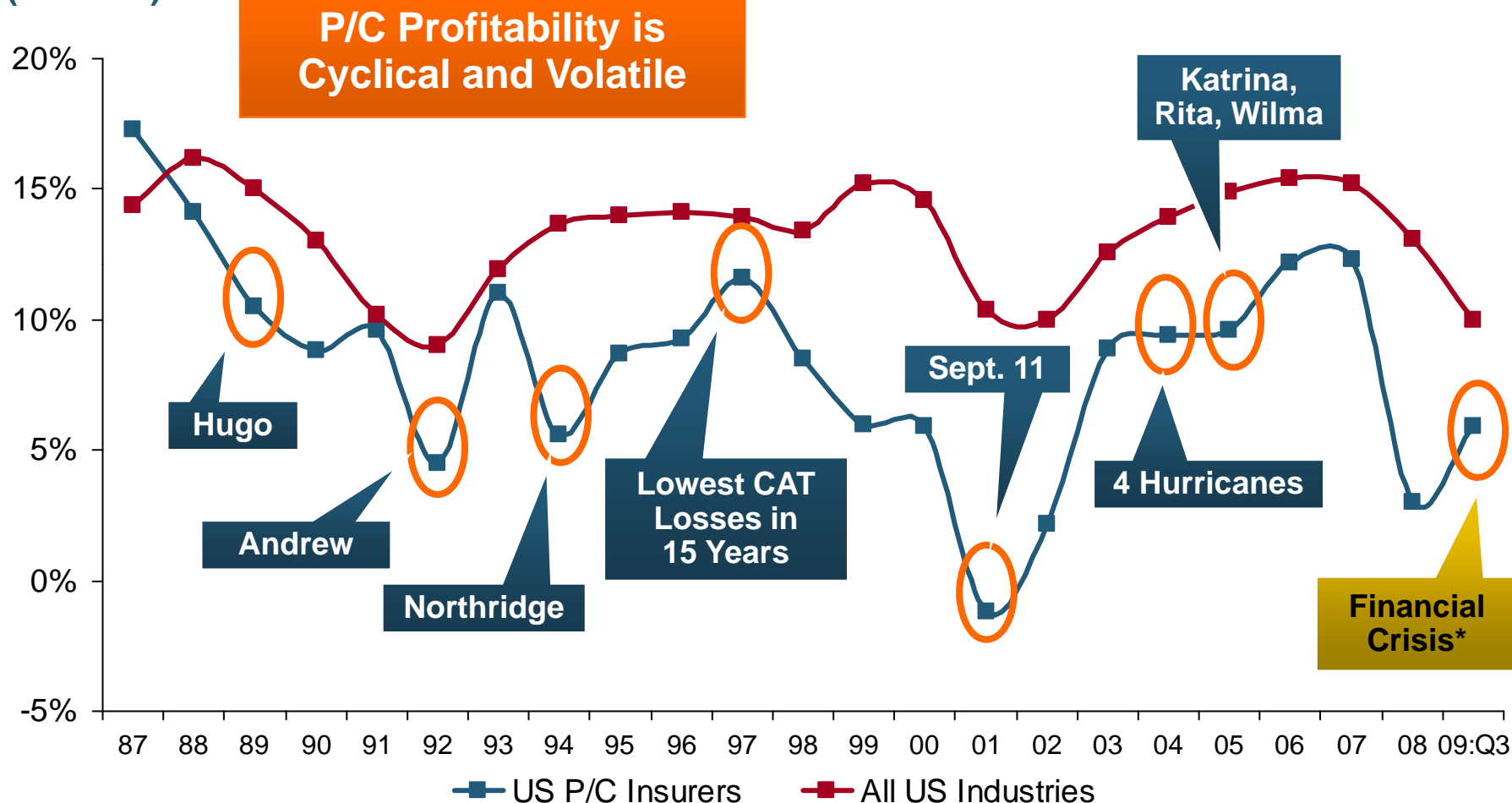


\* ROE figures are GAAP; <sup>1</sup>Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields a 4.5% ROAS for 2008 and 5.9% for the first 9 months of 2009. 2009:Q3 net income was \$20.5 billion excluding M&FG.

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

# ROE: P/C vs. All Industries 1987–2009:Q3\*

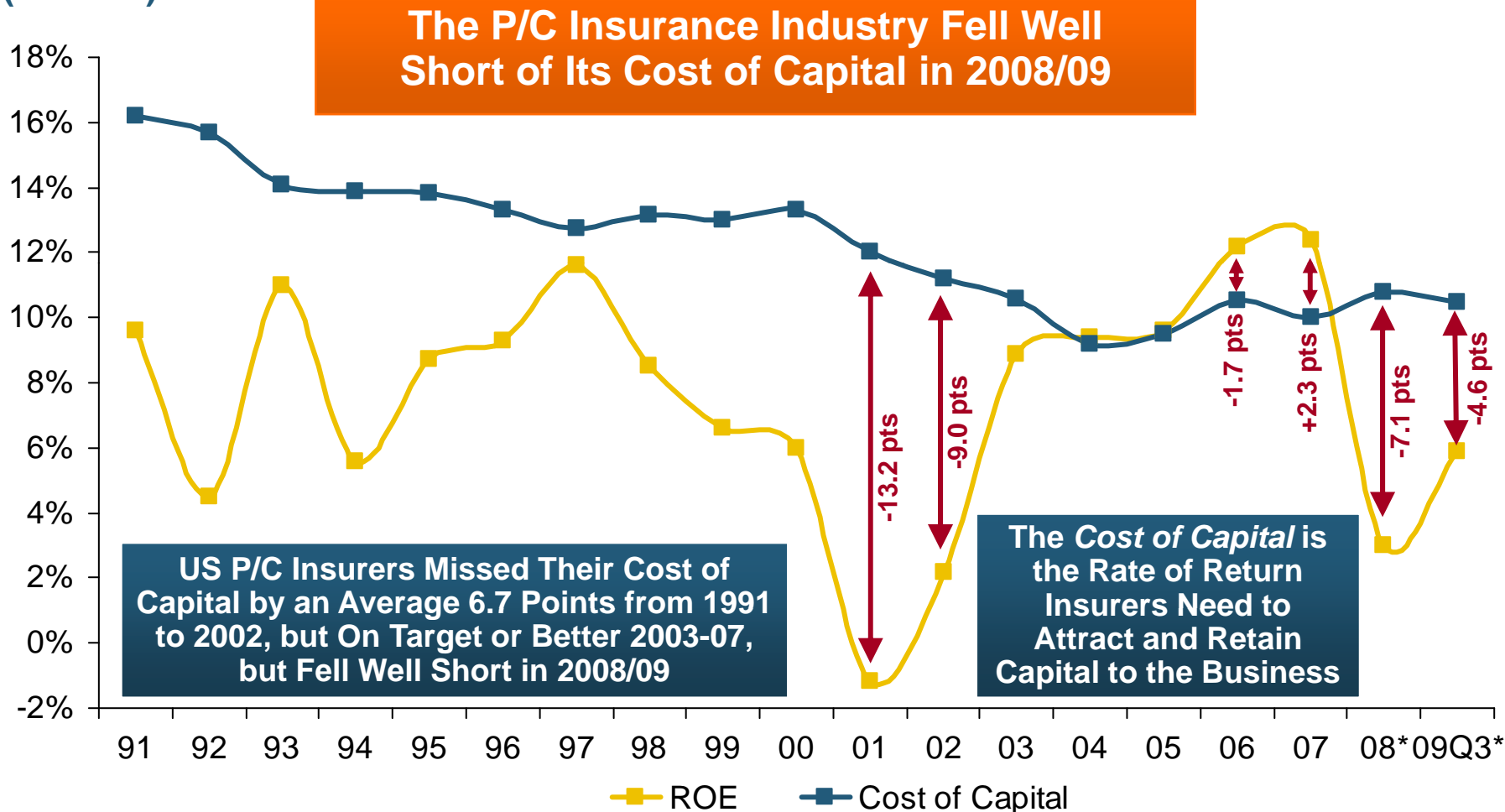
(Percent)



\* Excludes Mortgage & Financial Guarantee in 2008 and 2009 through Q3.  
Sources: ISO, *Fortune*; Insurance Information Institute.

# ROE vs. Equity Cost of Capital: US P/C Insurance:1991-2009:Q3\*

(Percent)

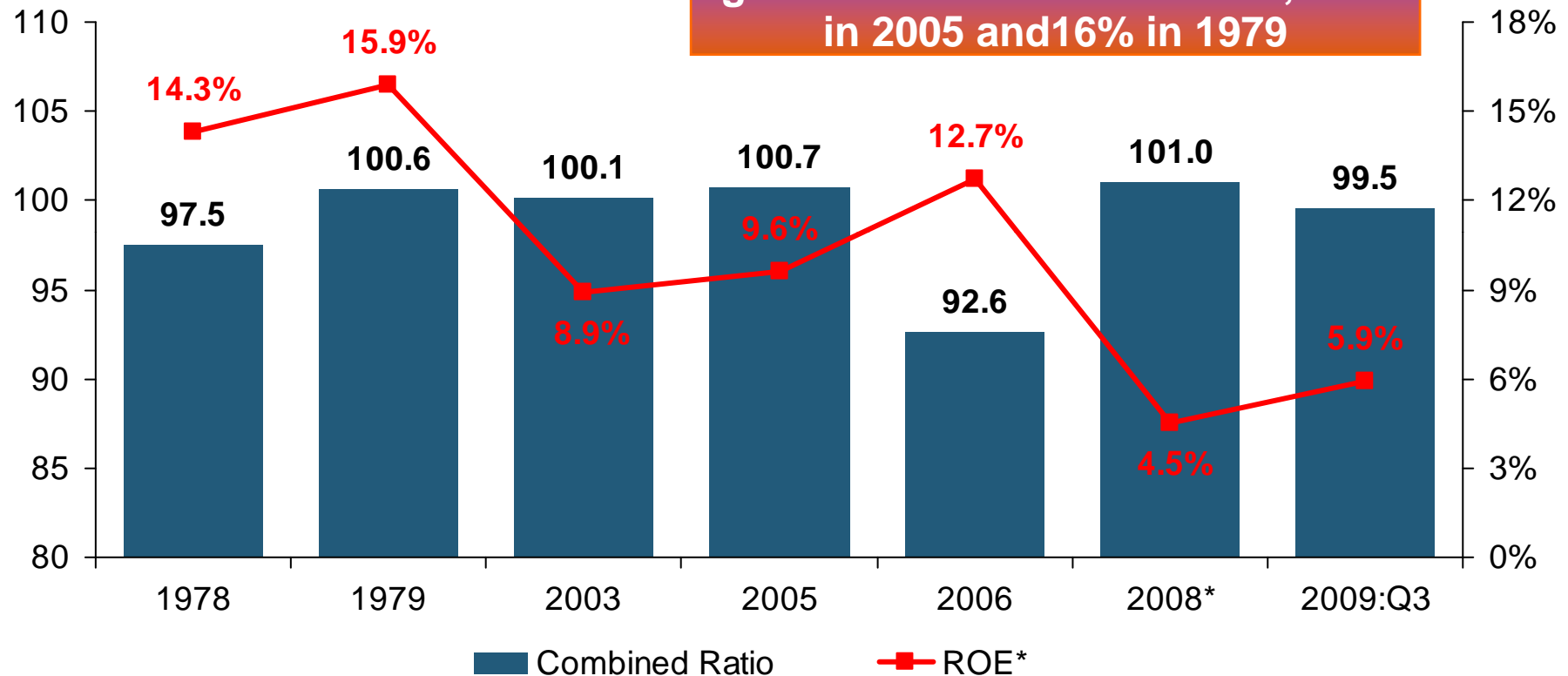


\* Excludes mortgage and financial guarantee insurers

Source: The Geneva Association, Insurance Information Institute

# A 100 Combined Ratio Isn't What It Once Was: 90-95 is Where It's At Now

## Combined Ratio / ROE



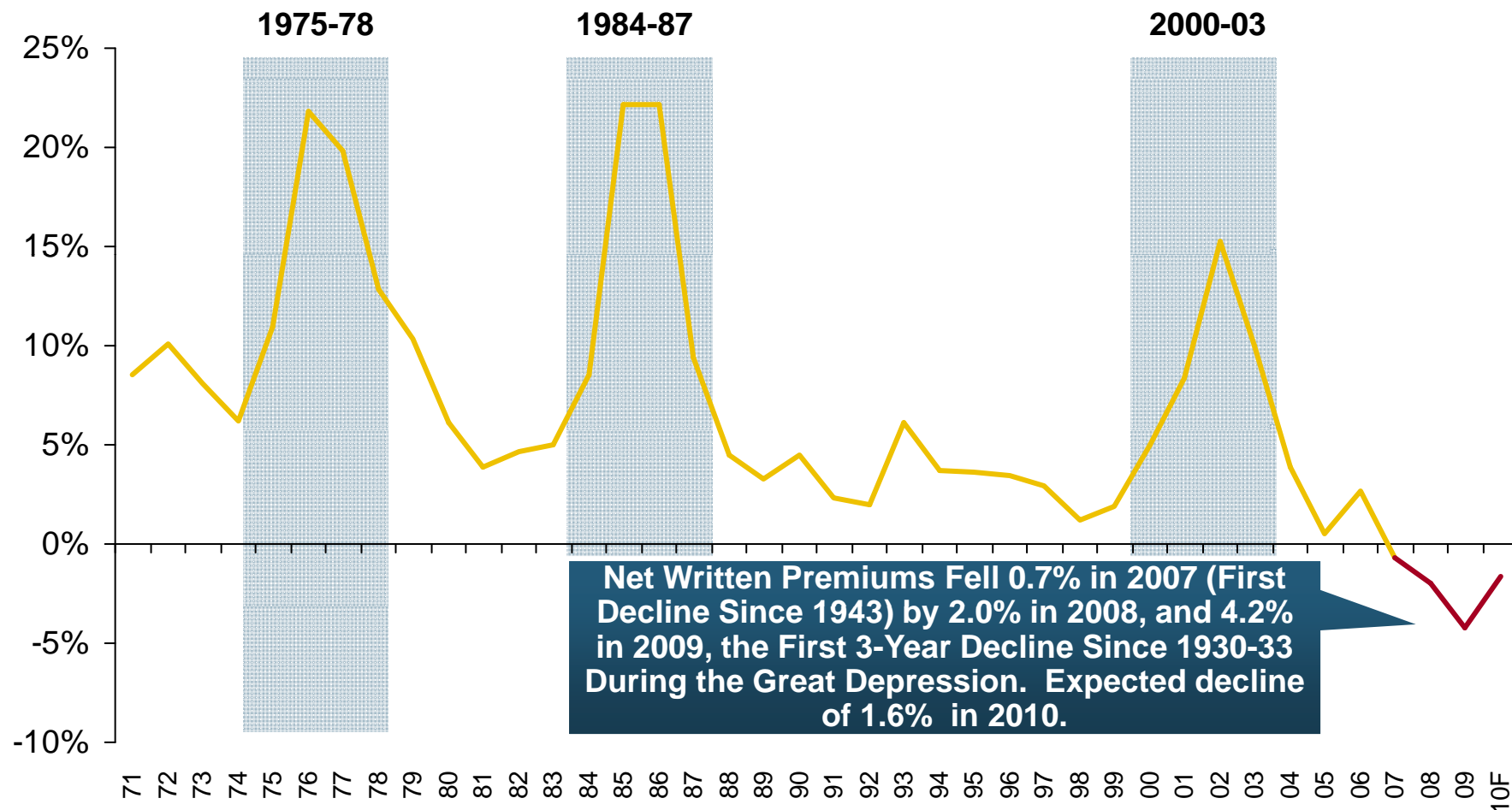
**Combined Ratios Must Be Lower in Today's Depressed Investment Environment to Generate Risk Appropriate ROEs**

\* 2009 figure is return on average statutory surplus. 2008 and 2009 figures exclude mortgage and financial guarantee insurers  
Source: Insurance Information Institute from A.M. Best and ISO data

**P/C Premium Growth  
Primarily Driven by the  
Industry's Underwriting Cycle,  
Not the Economy**

# Strength of Recent Hard Markets by NWP Growth

(Percent)

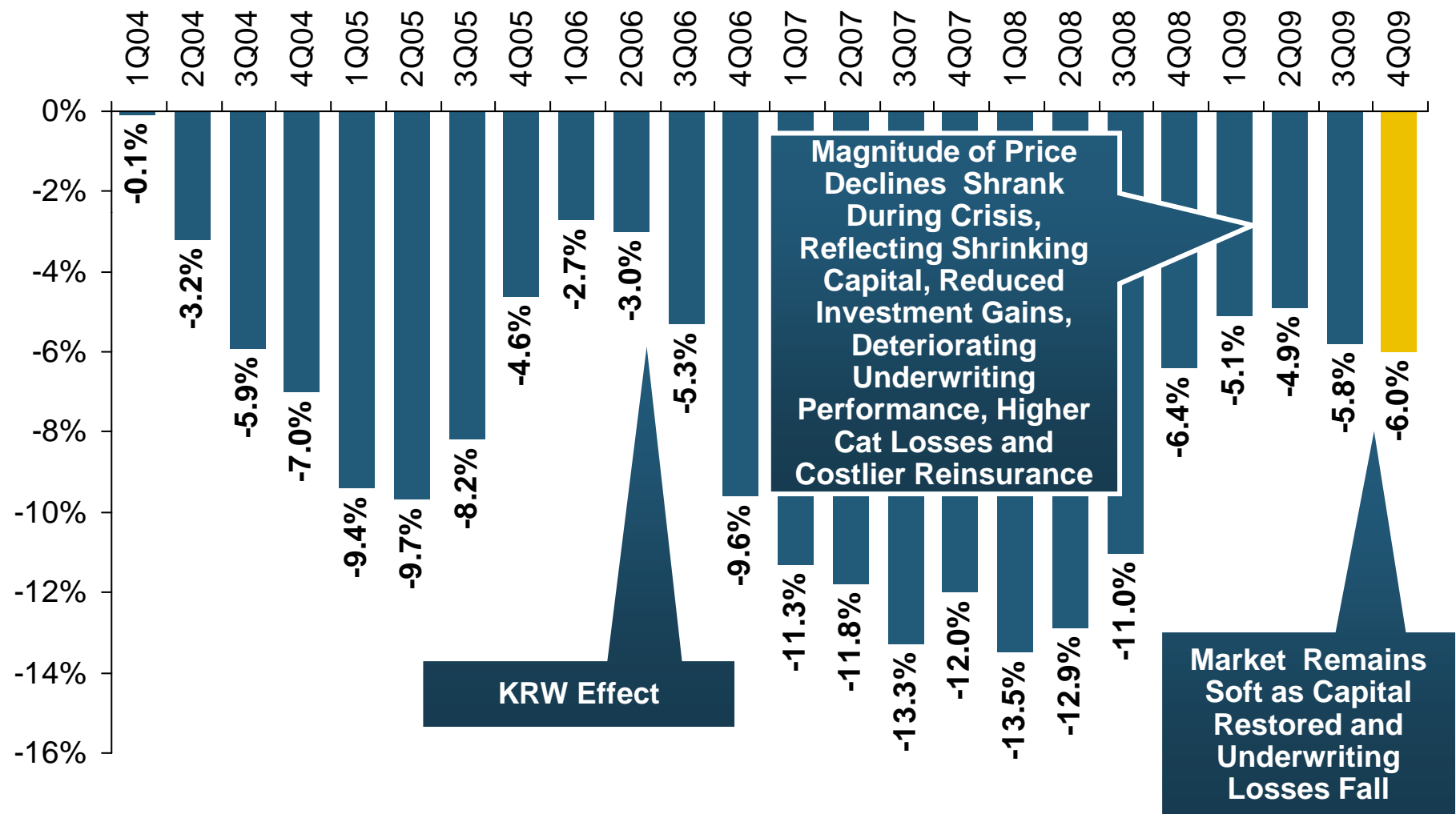


Shaded areas denote "hard market" periods

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

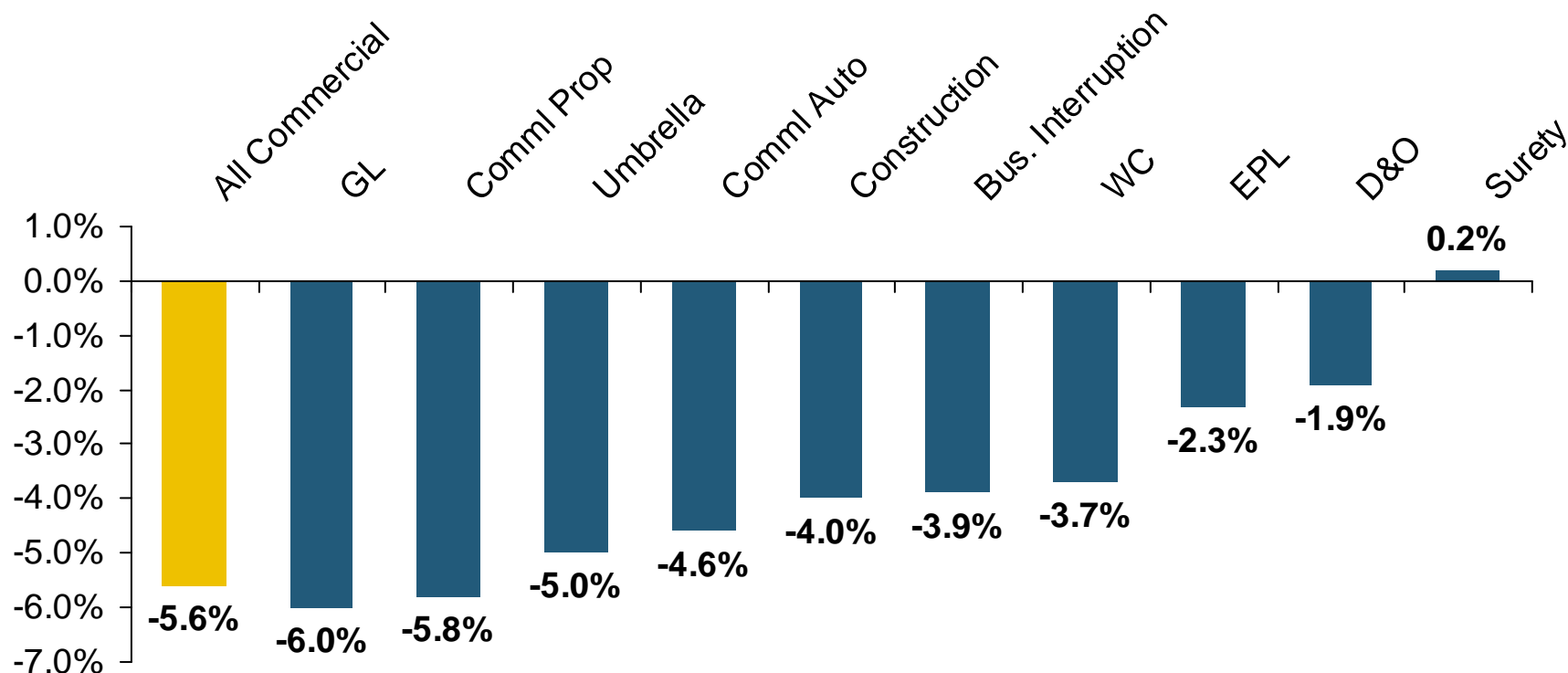
# Average Commercial Rate Change, All Lines, (1Q:2004–4Q:2009)

(Percent)



# Change in Commercial Rate Renewals, by Line: 2009:Q4

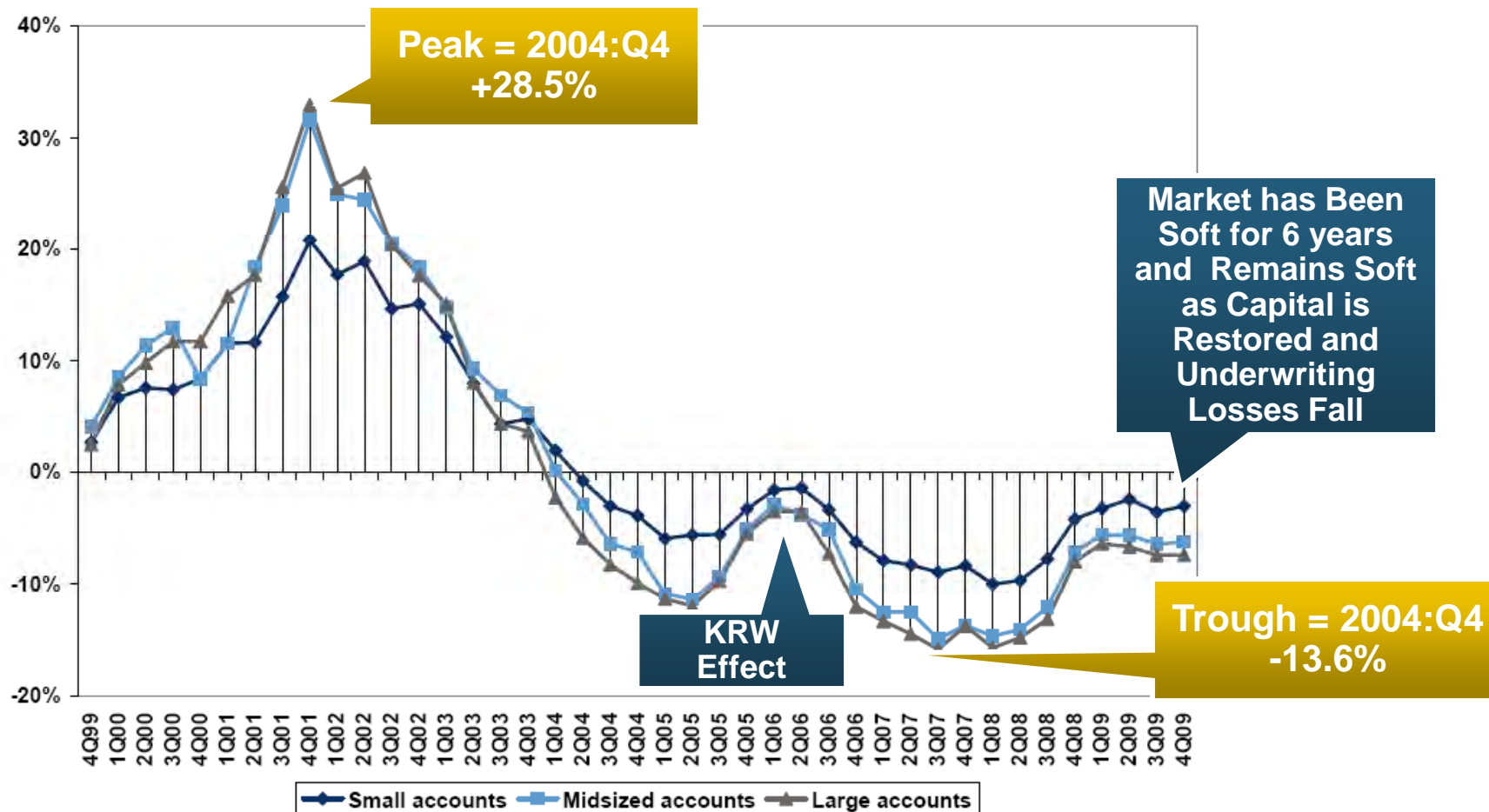
Percentage Change (%)



**Most Major Commercial Lines Renewed Down in Q4:2009 by Roughly the Same Margin as a Year Earlier**

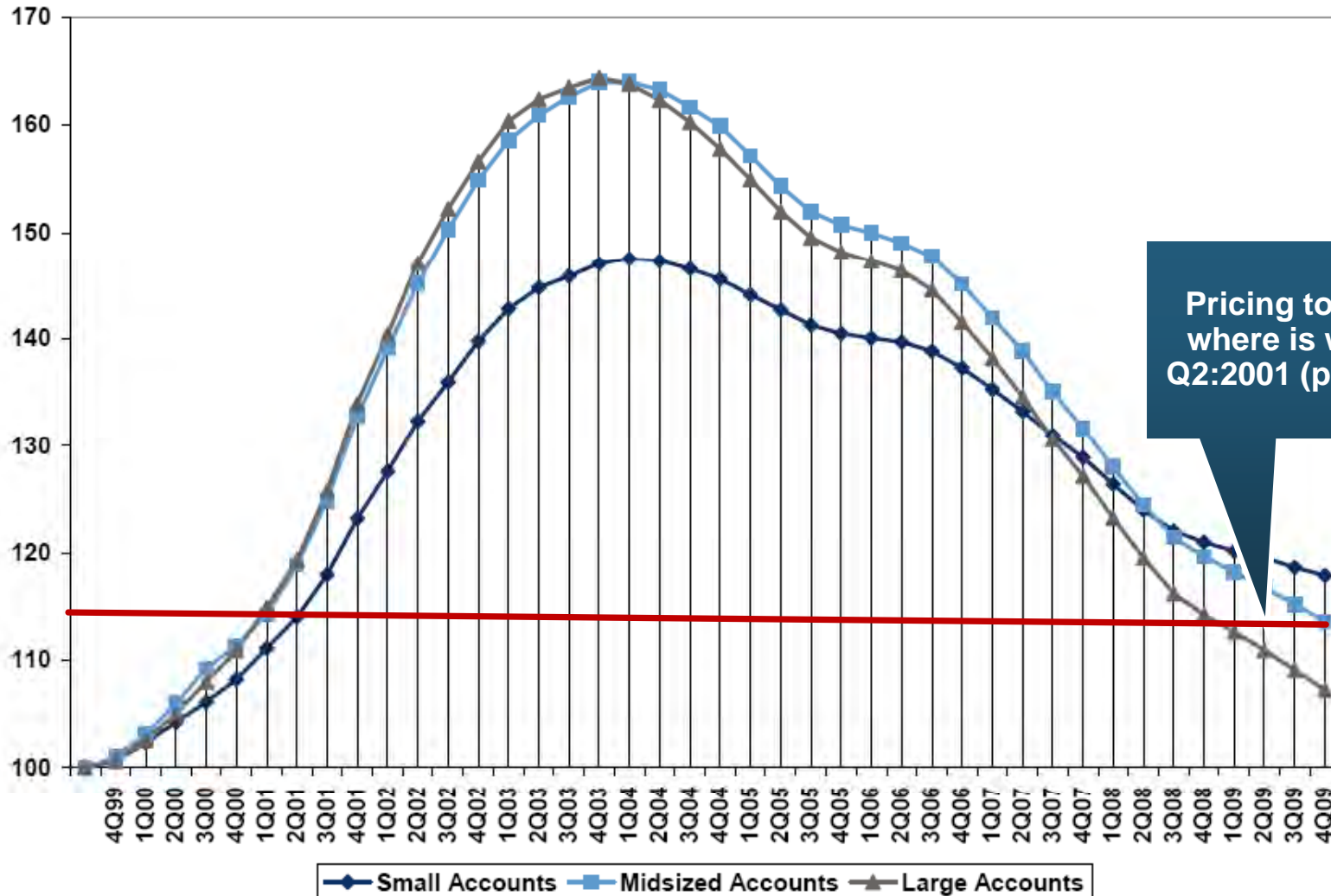
# Change in Commercial Rate Renewals, by Account Size: 1999:Q4 to 2009:Q4

Percentage Change (%)



# Cumulative Qtrly. Commercial Rate Changes, by Account Size: 1999:Q4 to 2009:Q4

1999:Q4 = 100



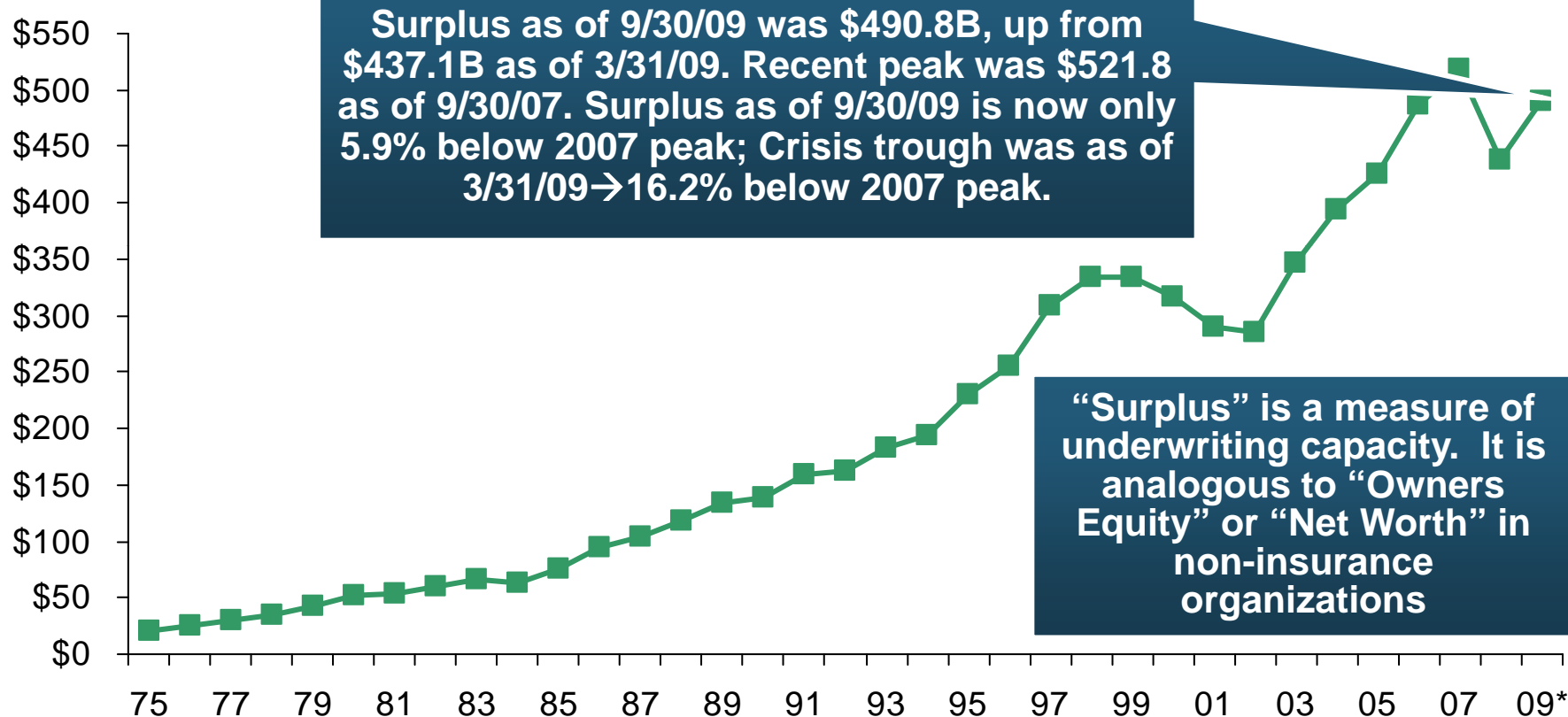
Source: Council of Insurance Agents and Brokers; Insurance Information Institute.

## **Capital/Policyholder Surplus (US)**

**Shrinkage, but Not Enough  
to Trigger Hard Market**

# US Policyholder Surplus: 1975–2009:Q3\*

(\$ Billions)



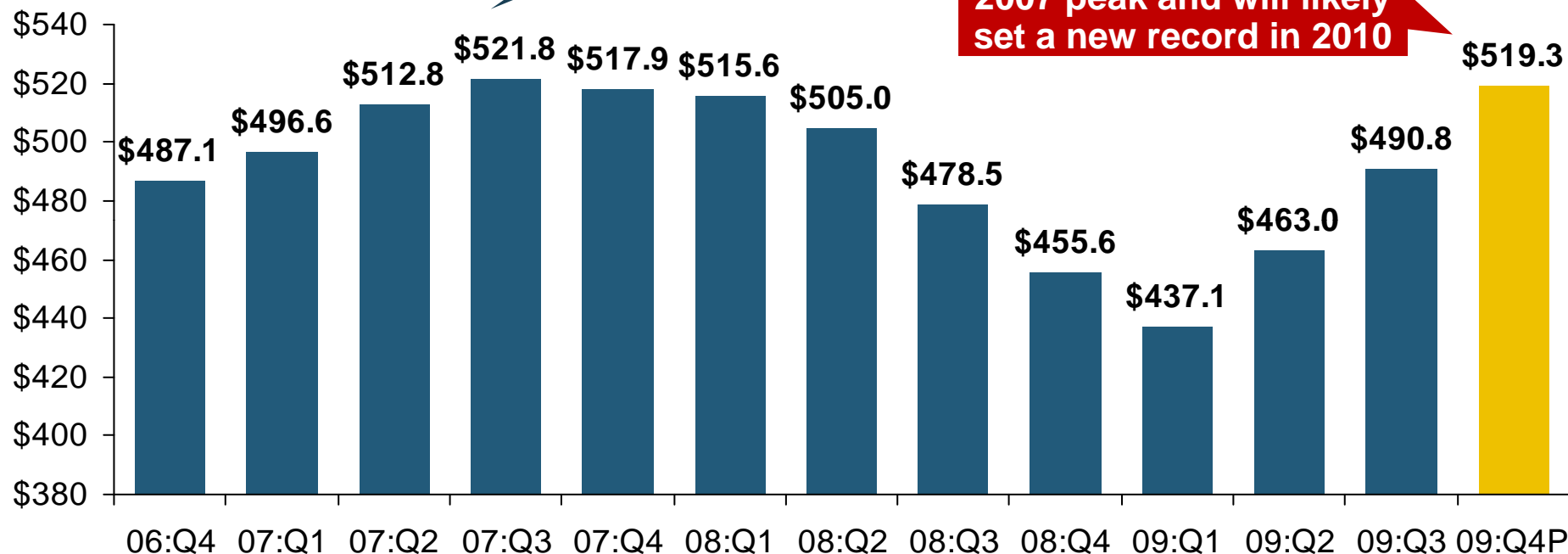
**The Premium-to-Surplus Ratio Stood at \$0.87:\$1 as of 9/30/09, Up from Near Record Low of \$0.85:\$1 at Year-End 2007**

\* As of 9/30/09

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

# Policyholder Surplus, 2006:Q4–2009:Q4P

(\$ Billions)



## 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%)**

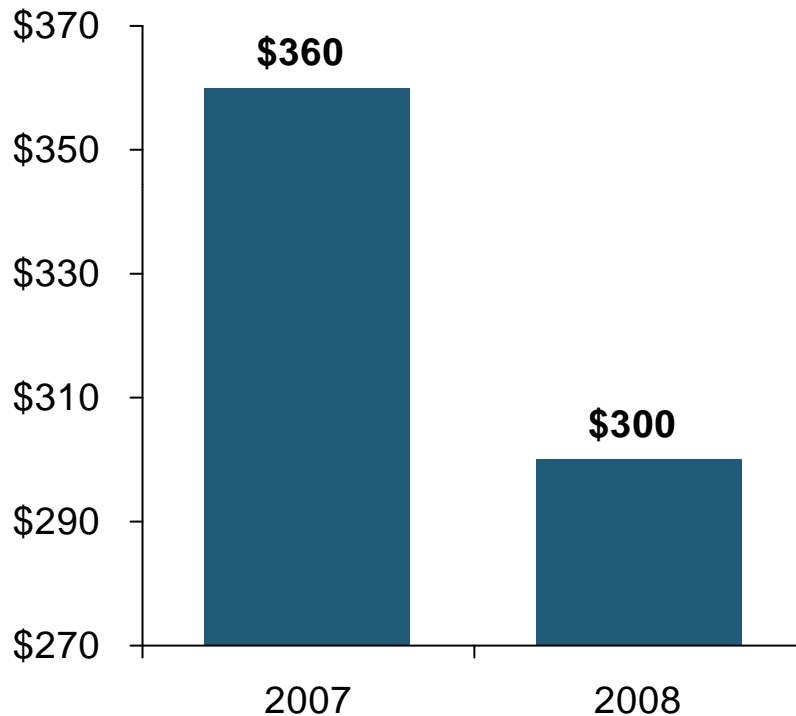
**08:Q4: -\$66.2B (-12.9%)**

**09:Q4: -\$2.5B (-0.5%)**

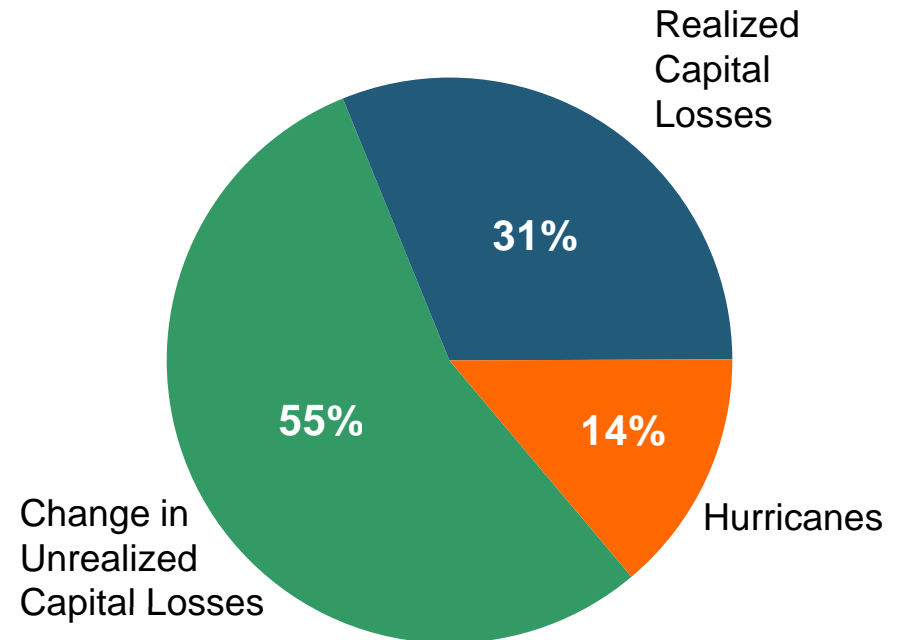
**09:Q1: -\$84.7B (-16.2%)**

# Global Reinsurance Capacity Shrank in 2008, Mostly Due to Investments

## Global Reinsurance Capacity



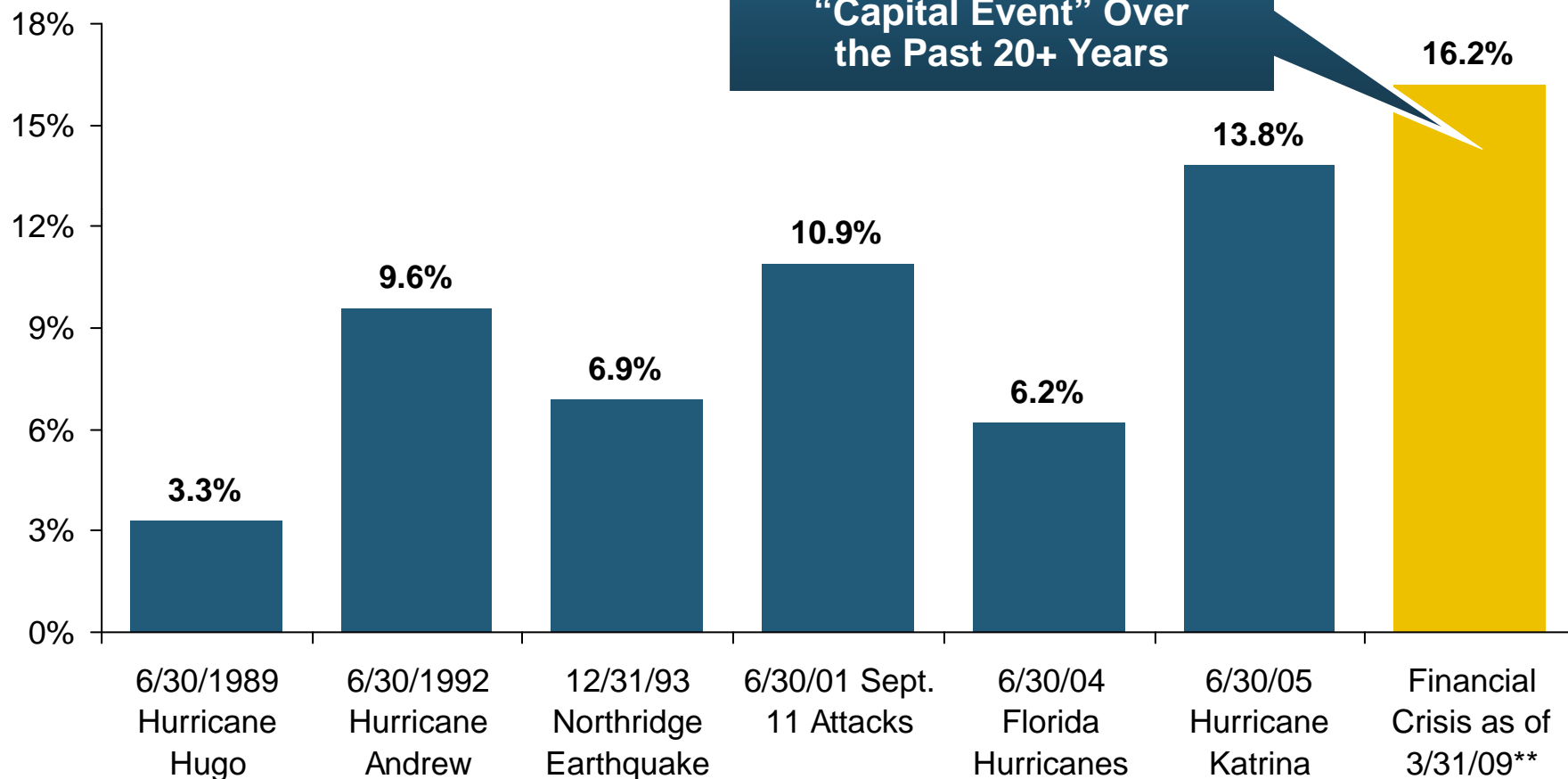
## Source of Decline



**Global Reinsurance Capacity  
Fell by an Estimated 17% in 2008**

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

(Percent)

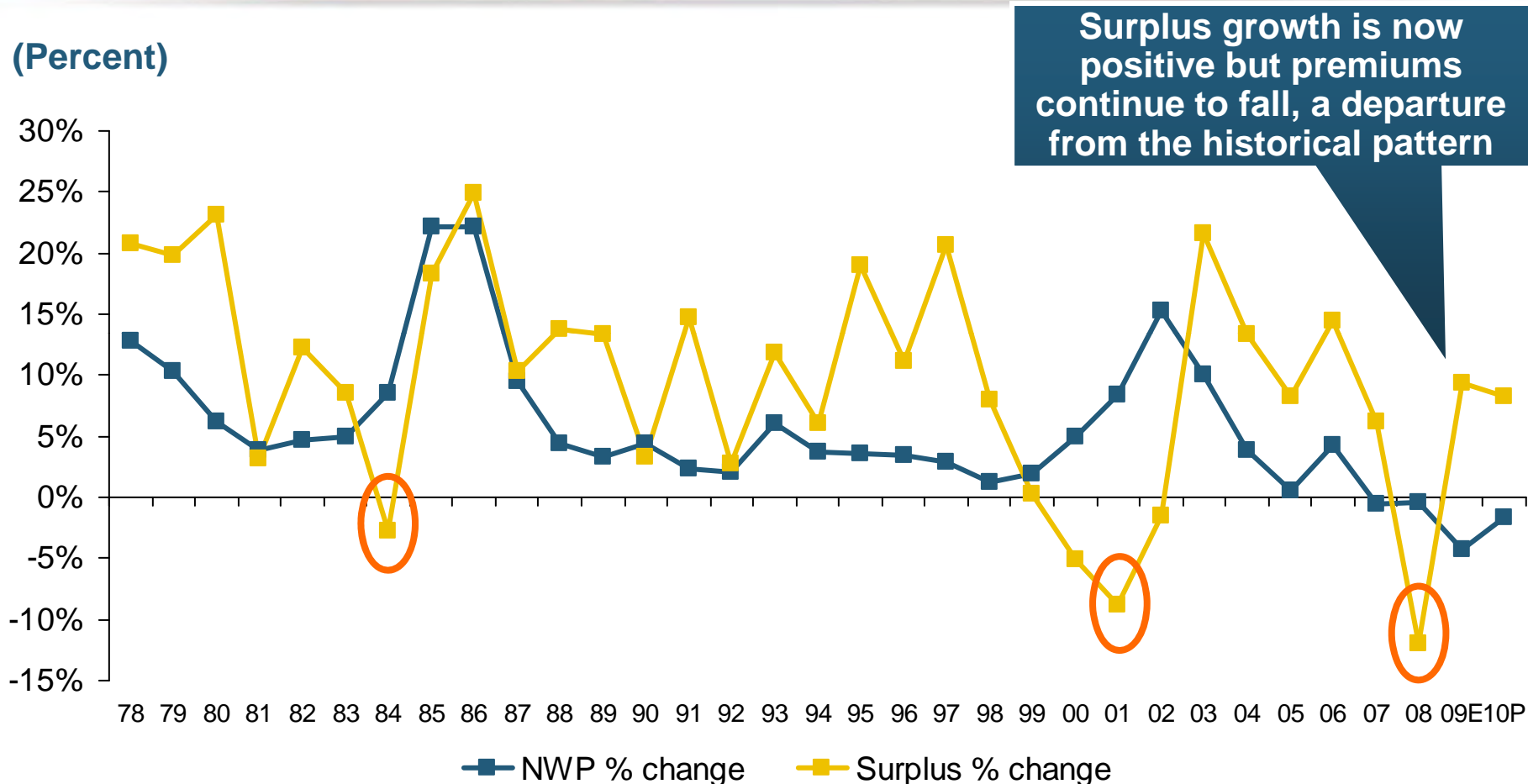


\* Ratio is for end-of-quarter surplus immediately prior to event. Date shown is end of quarter prior to event

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

Source: PCS; Insurance Information Institute

# Historically, Hard Markets Follow When Surplus “Growth” is Negative\*



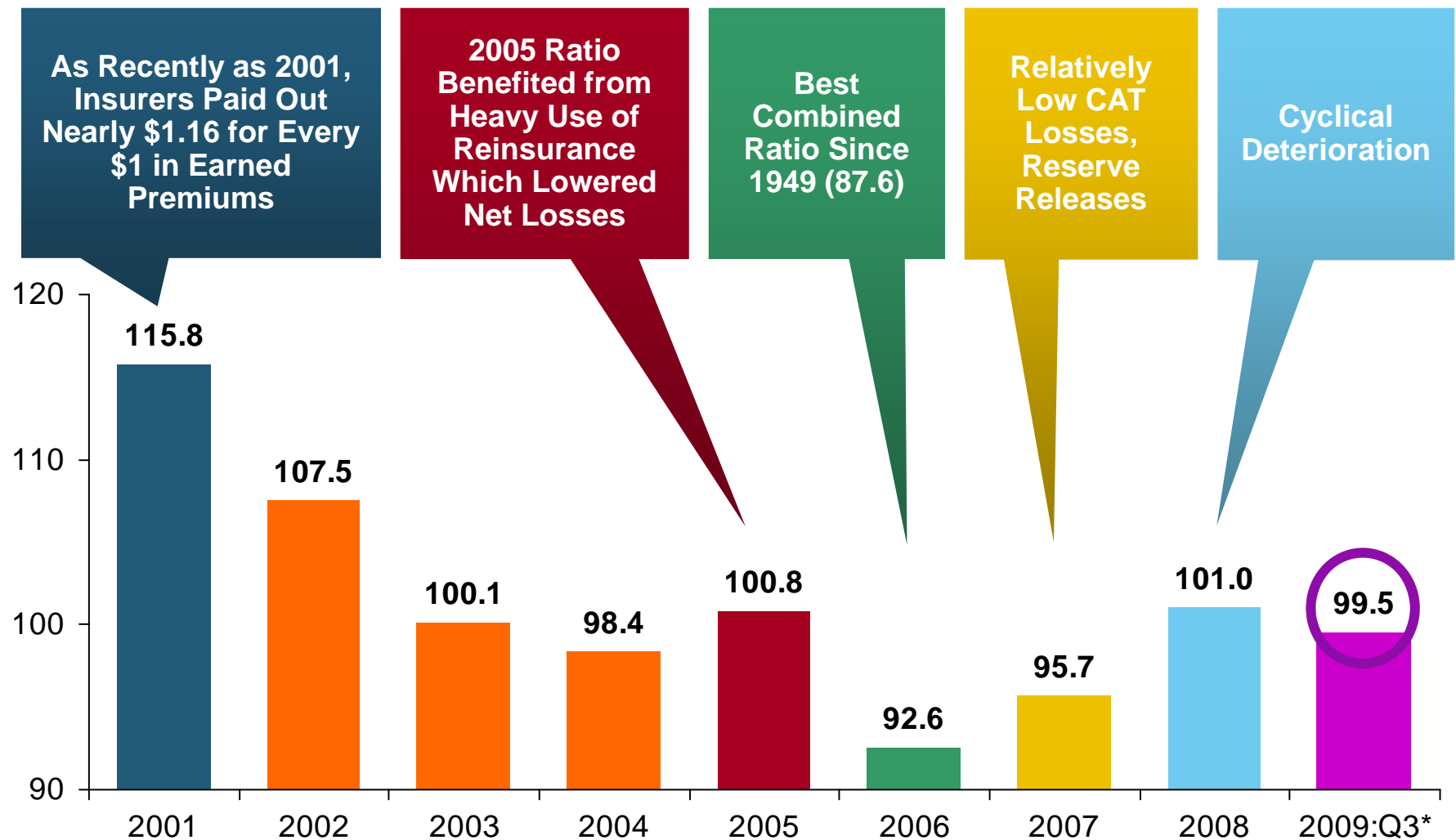
**Sharp Decline in Capacity is a Necessary but Not Sufficient Condition for a True Hard Market**

\* 2009 NWP and Surplus figures are % changes as of Q4:09P vs Q4:08

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

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

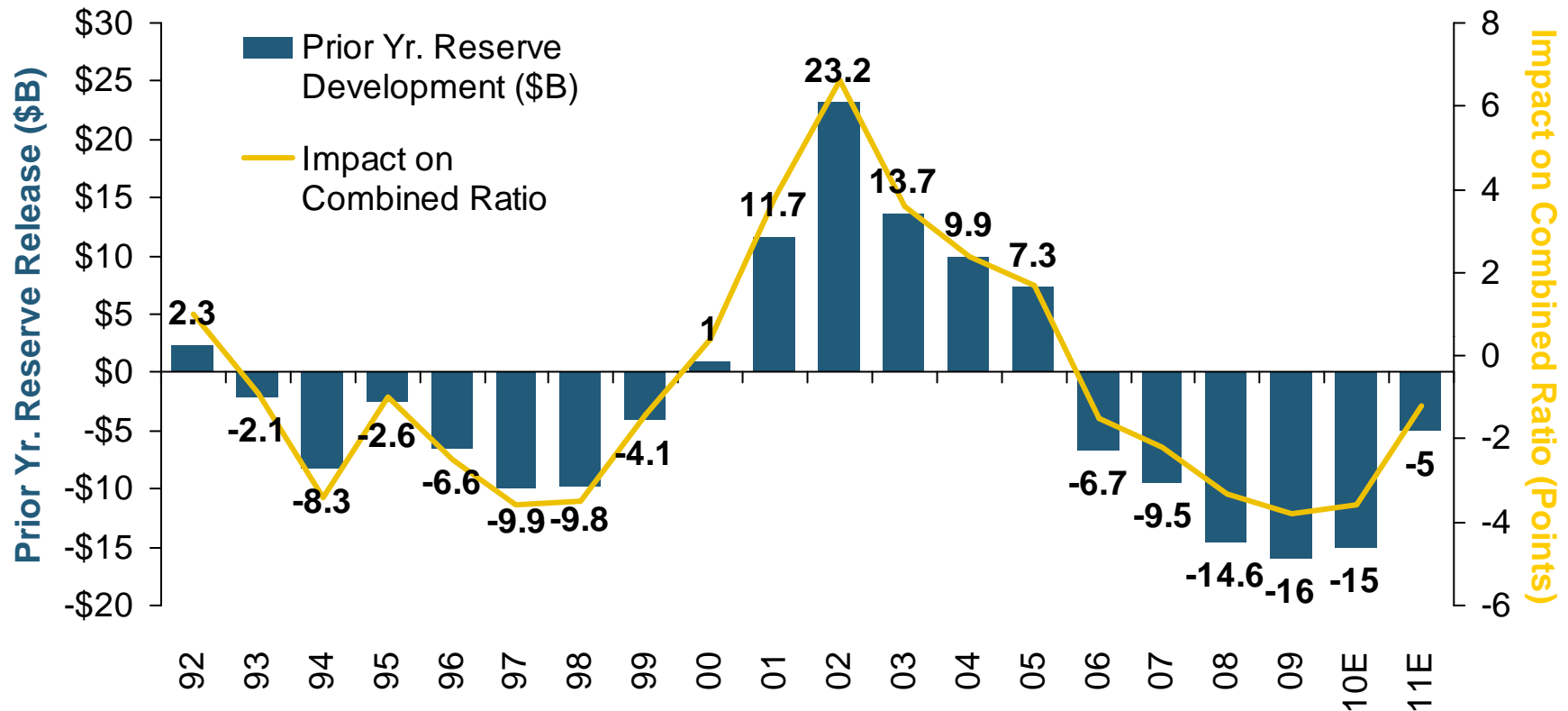
# P/C Insurance Industry Combined Ratio, 2001–2009:Q3\*



\* Excludes Mortgage & Financial Guaranty insurers in 2008. Including M&FG, 2008=105.1, 2009=100.7

Sources: A.M. Best, ISO.

# P/C Reserve Development, 1992–2011E

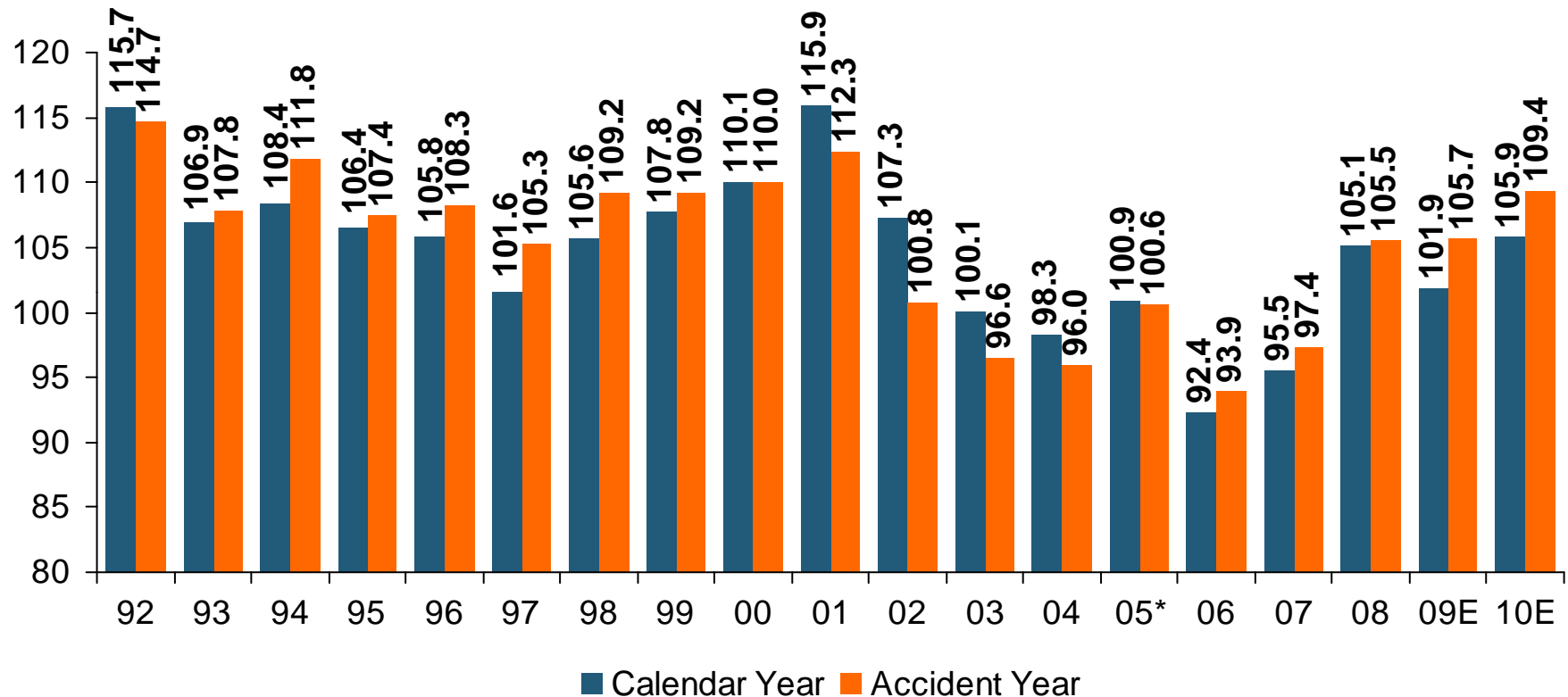


**Reserve Releases Will Expected to Taper Off  
in 2010 and Drop Significantly in 2011**

Note: 2005 reserve development excludes a \$6 billion loss portfolio transfer between American Re and Munich Re. Including this transaction, total prior year adverse development in 2005 was \$7 billion. The data from 2000 and subsequent years excludes development from financial guaranty and mortgage insurance.

Sources: Barclay's Capital; A.M. Best.

# Calendar Year vs. Accident Year P/C Combined Ratio: 1992–2010E<sup>1</sup>



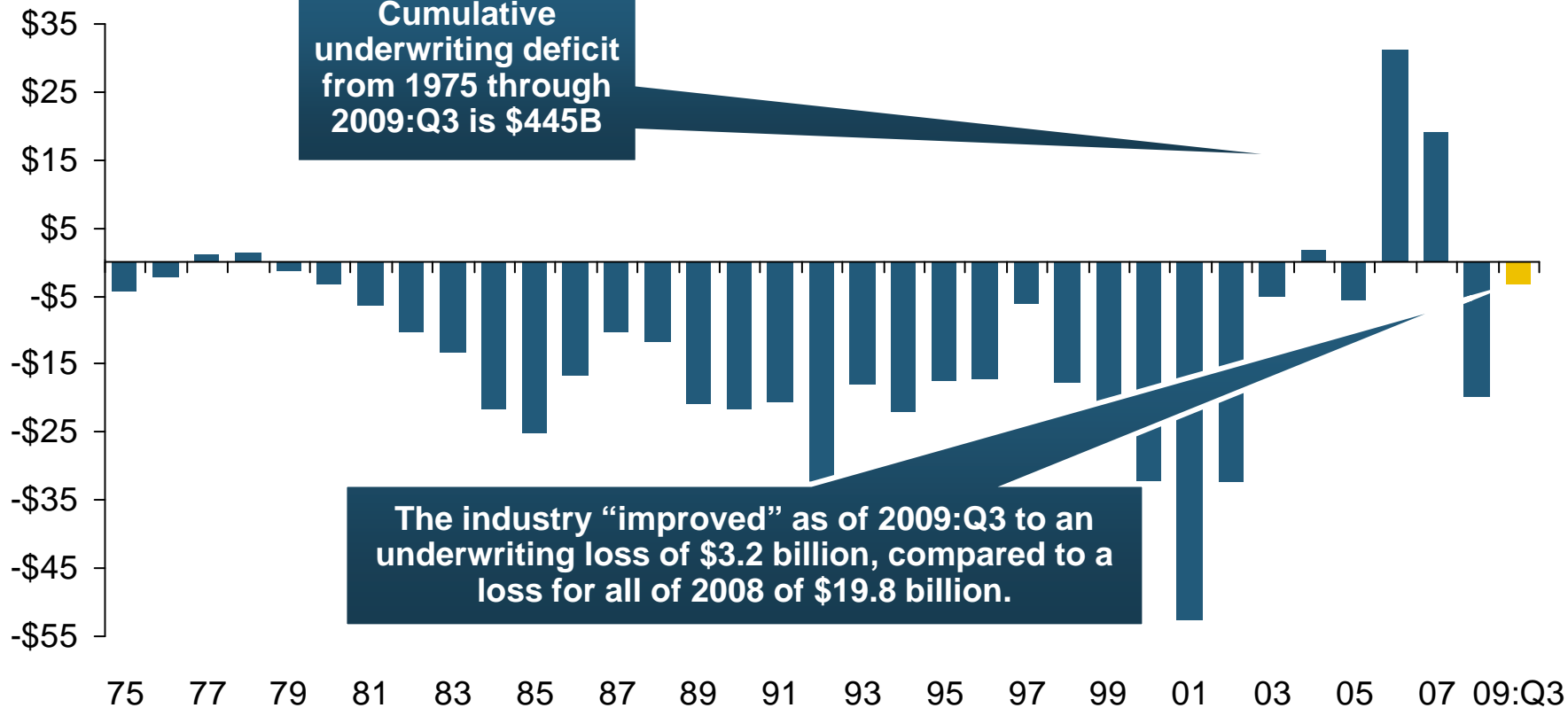
**Accident Year Results Show a More Significant Deterioration in Underwriting Performance. Calendar Year Results Are Helped by Reserve Releases**

Note: 2005 reserve development excludes a \$6 billion loss portfolio transfer between American Re and Munich Re. Including this transaction, total prior year adverse development in 2005 was \$7 billion. The data from 2000 and subsequent years excludes development from financial guaranty and mortgage insurance.

Sources: Barclay's Capital; A.M. Best.

# Underwriting Gain (Loss) 1975–2009:Q3\*

(\$ Billions)



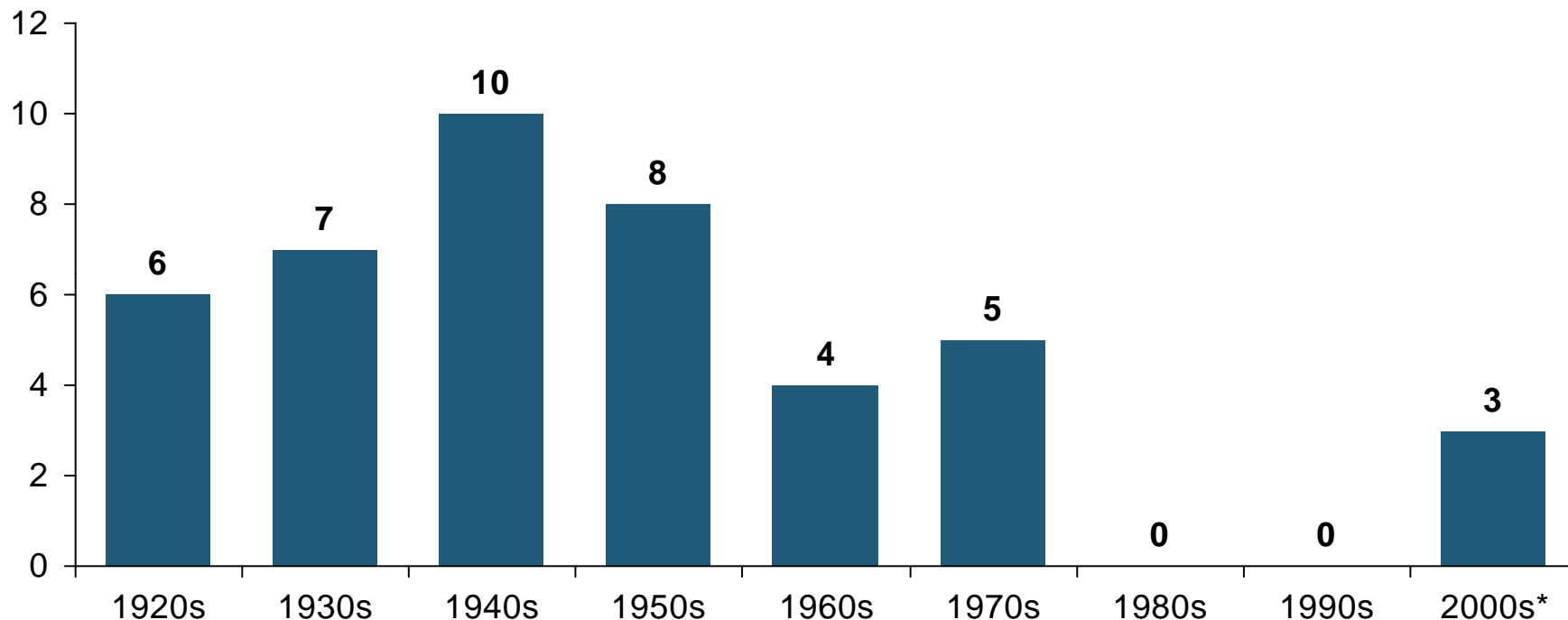
**Large Underwriting Losses Are *NOT* Sustainable  
in Current Investment Environment**

\* Includes mortgage and financial guarantee insurers.

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

# 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**

\* 2000 through 2009. 2009 combined ratio was 100.7 through Q3.

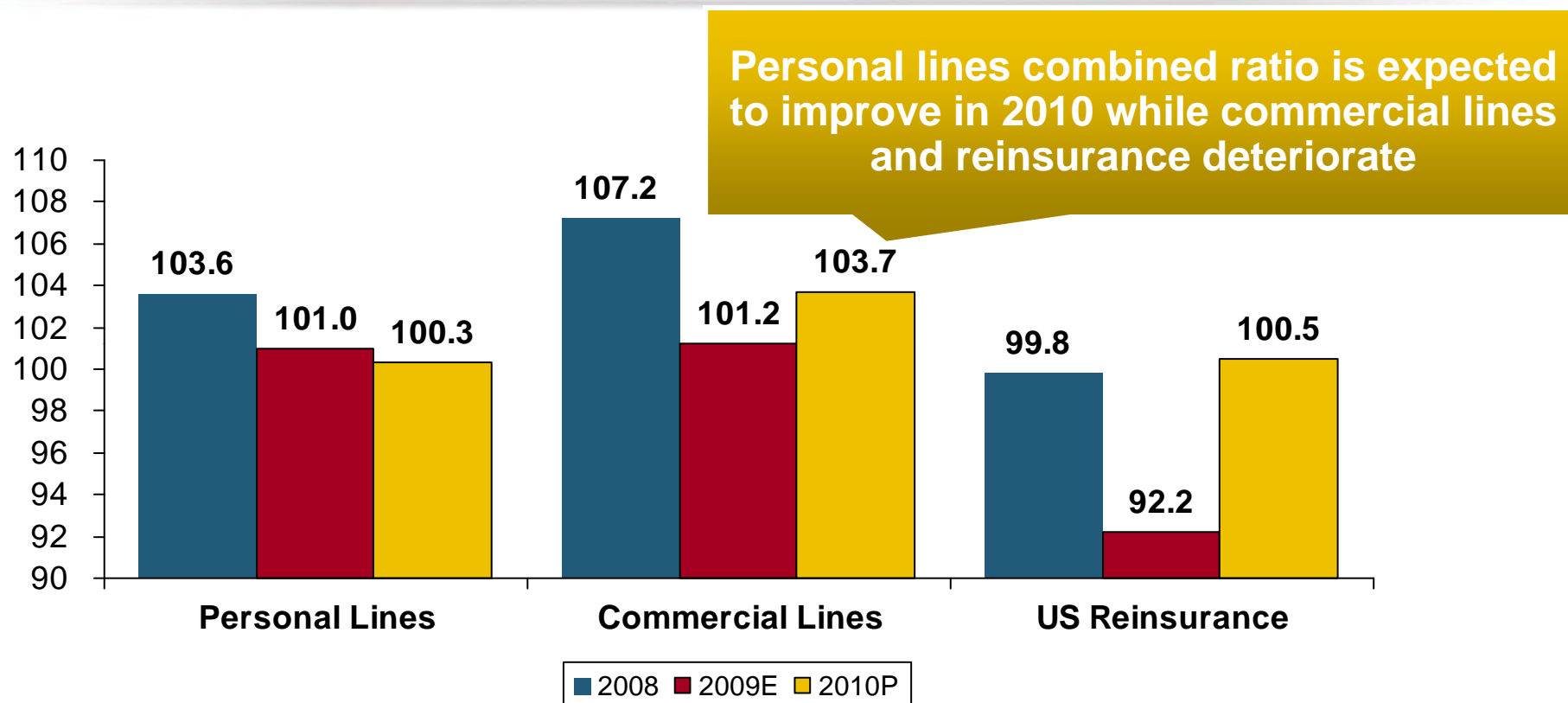
Note: Data for 1920–1934 based on stock companies only.

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



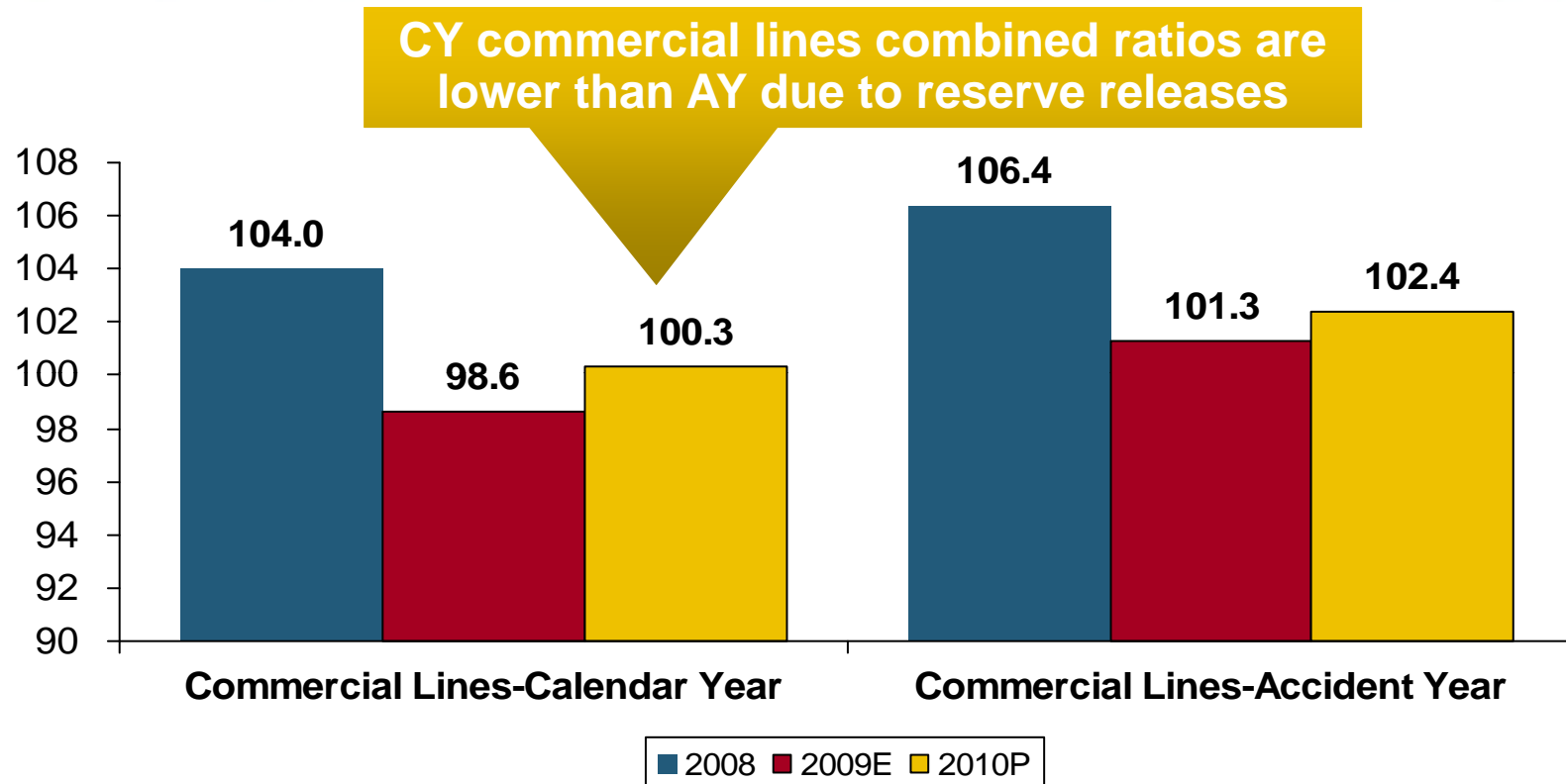
# **Performance by Segment: Commercial/Personal Lines & Reinsurance**

# Calendar Year Combined Ratios by Segment: 2008-2010P



Overall deterioration in 2010 underwriting performance is due to expected return to normal catastrophe activity along with deteriorating underwriting performance related to the prolonged commercial soft market

# Calendar vs. Accident Year Combined Ratios by Segment: 2008-2010P\*

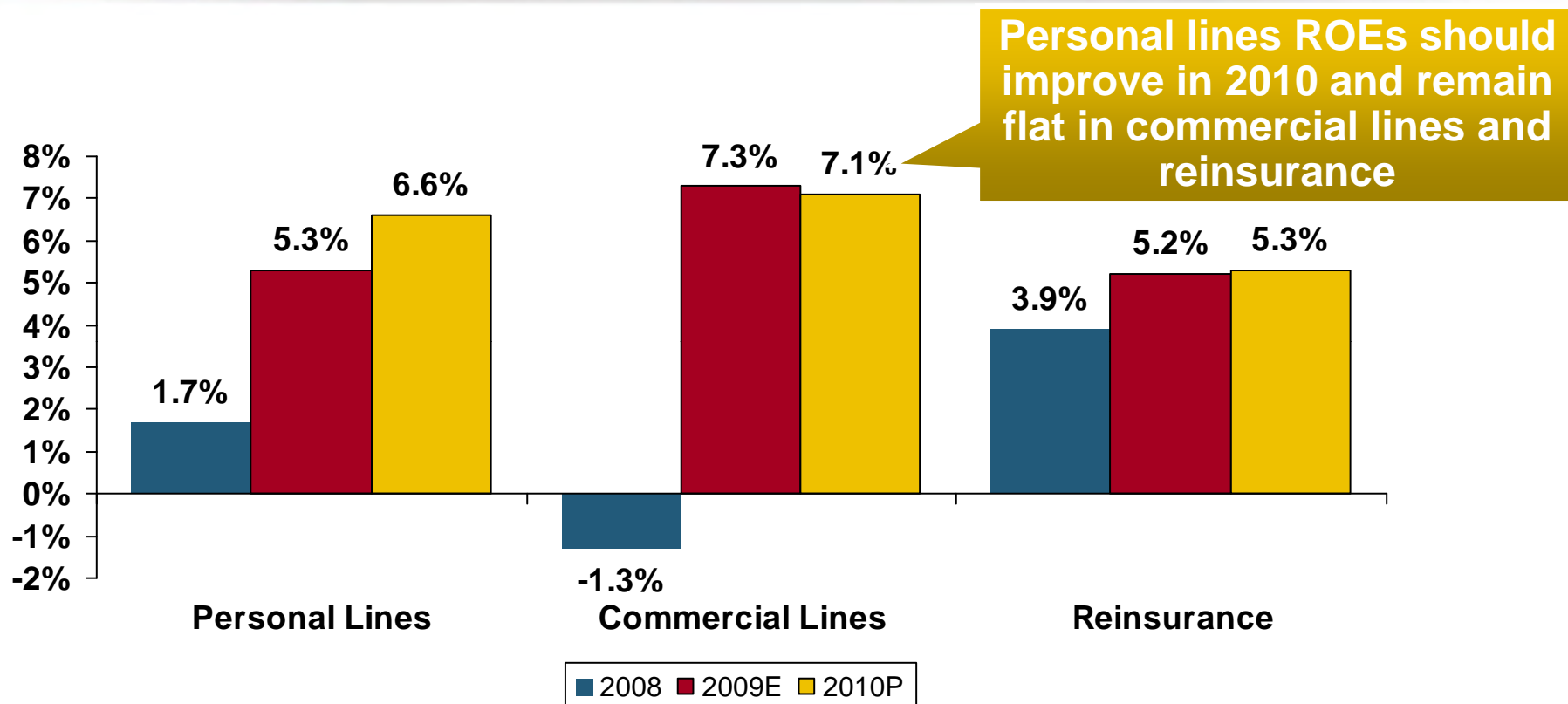


**The ability of reserves releases to favorably impact calendar year results will diminish over time reserved redundancies fall**

\*Normalized to reflect average/typical level of catastrophe losses.

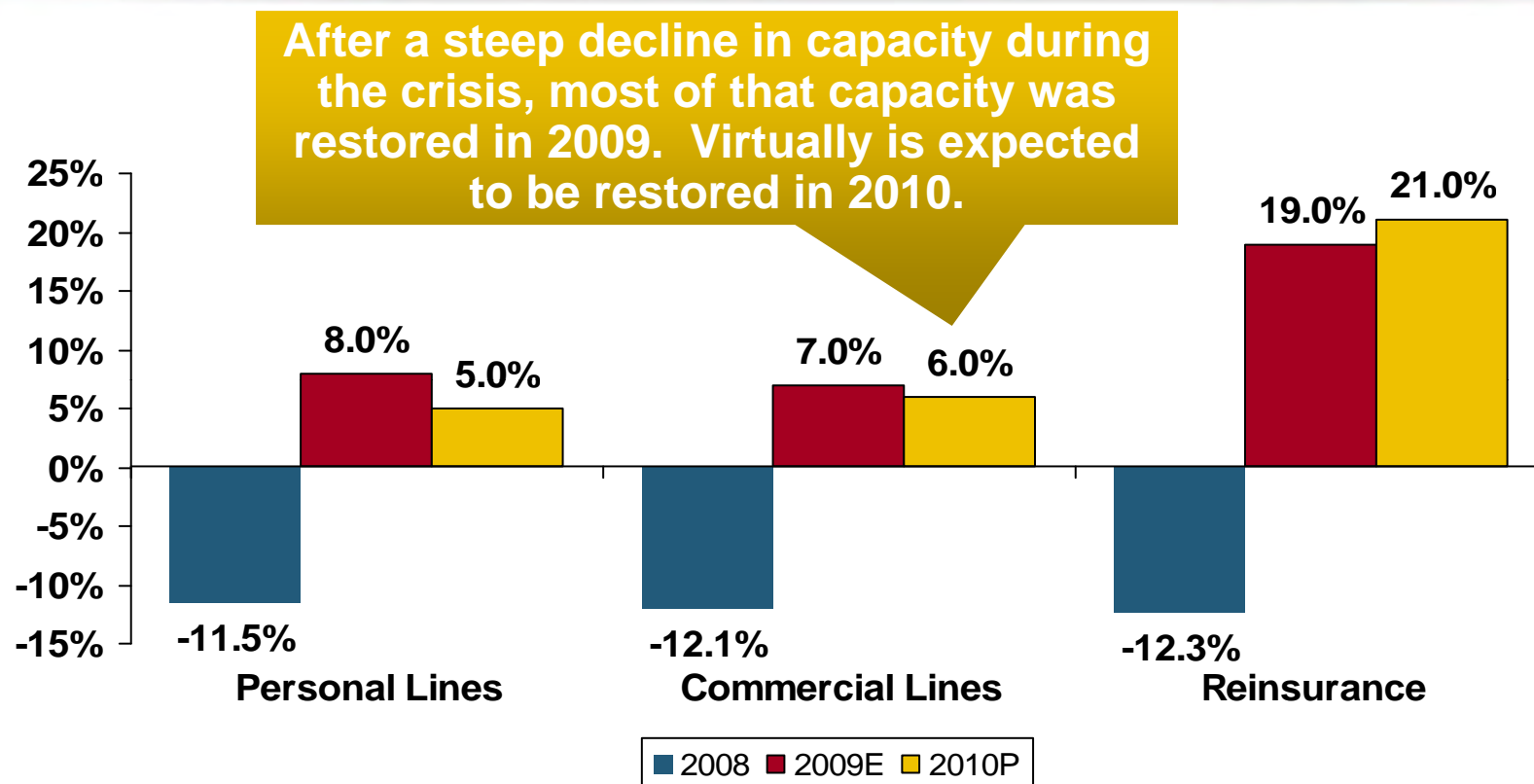
Sources: A.M. Best (historical and estimates/projected for 2009 and 2010); Insurance Information Institute.

# After-Tax Return on Surplus (ROE) by Segment: 2008-2010P



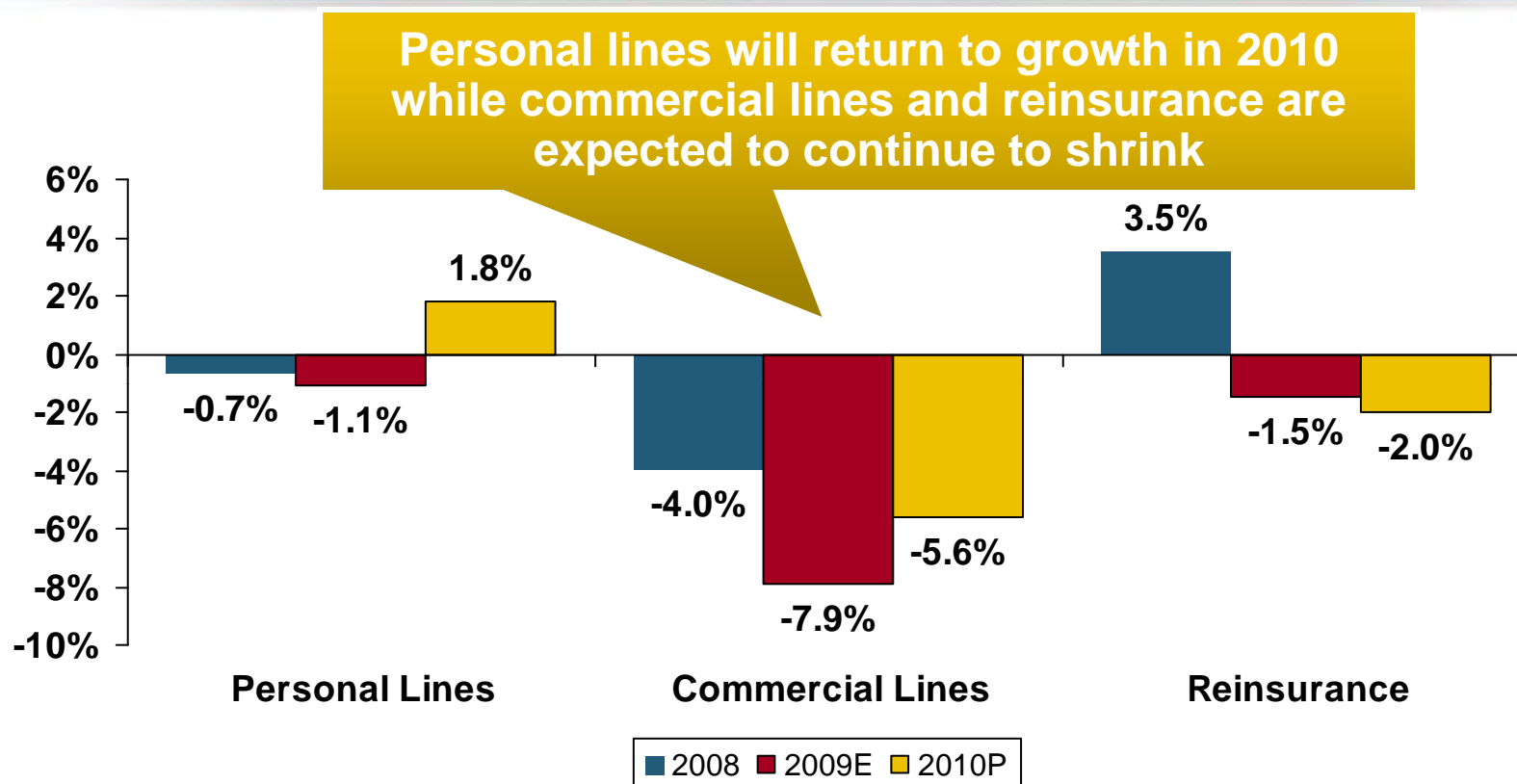
**Profitability will rise or stabilize across most p/c lines, barring a financial crisis relapse or major catastrophic losses**

# Change in Policyholder Surplus by Segment: 2008-2010P



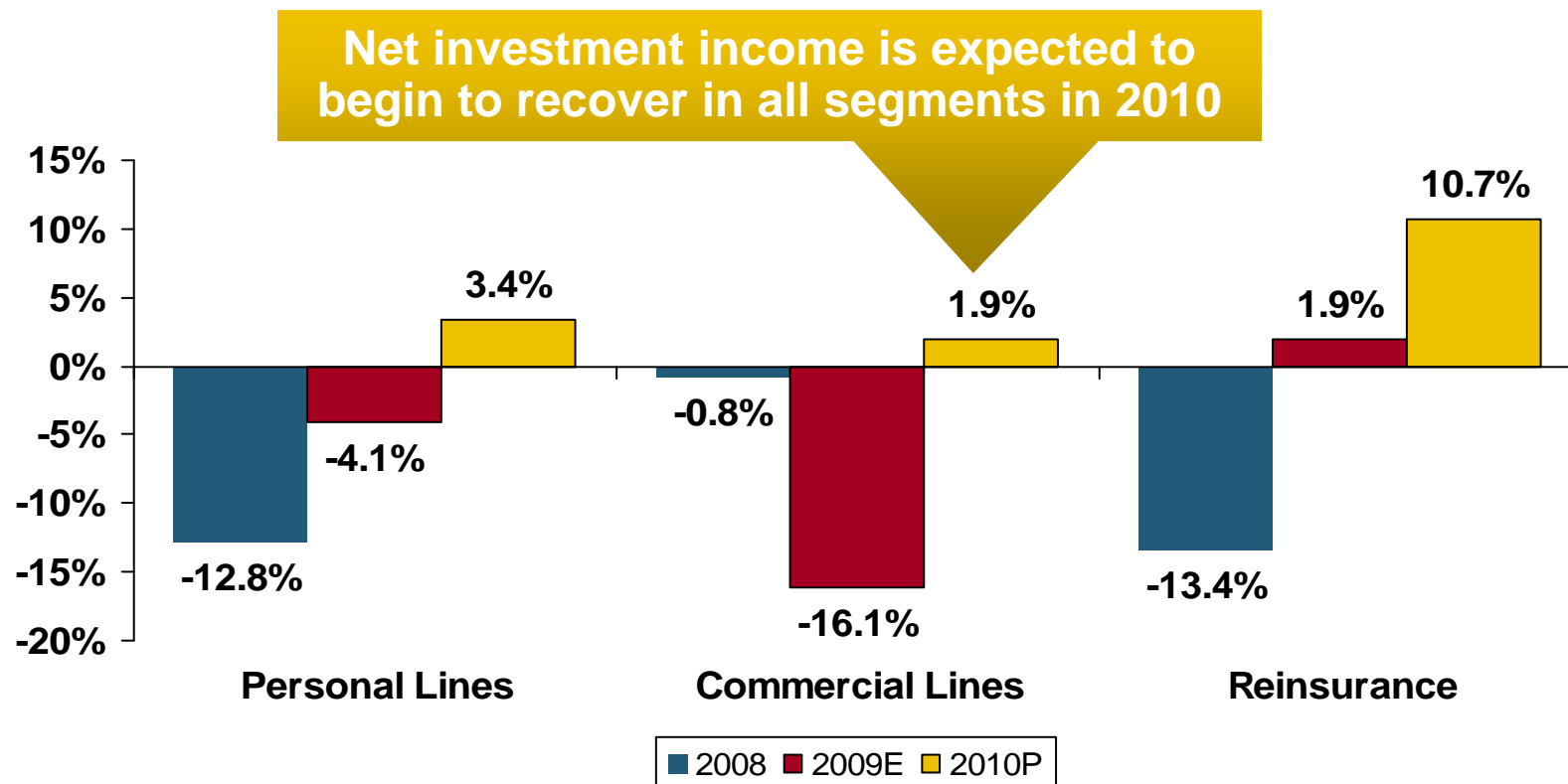
Rapid growth in policyholder surplus to pre-crisis levels combined with ongoing slow growth or declines in premiums (esp. in commercial lines) implies a build-up of excess capacity—a major factor in weak commercial lines and reinsurance pricing

# Net Written Premium Growth by Segment: 2008-2010P



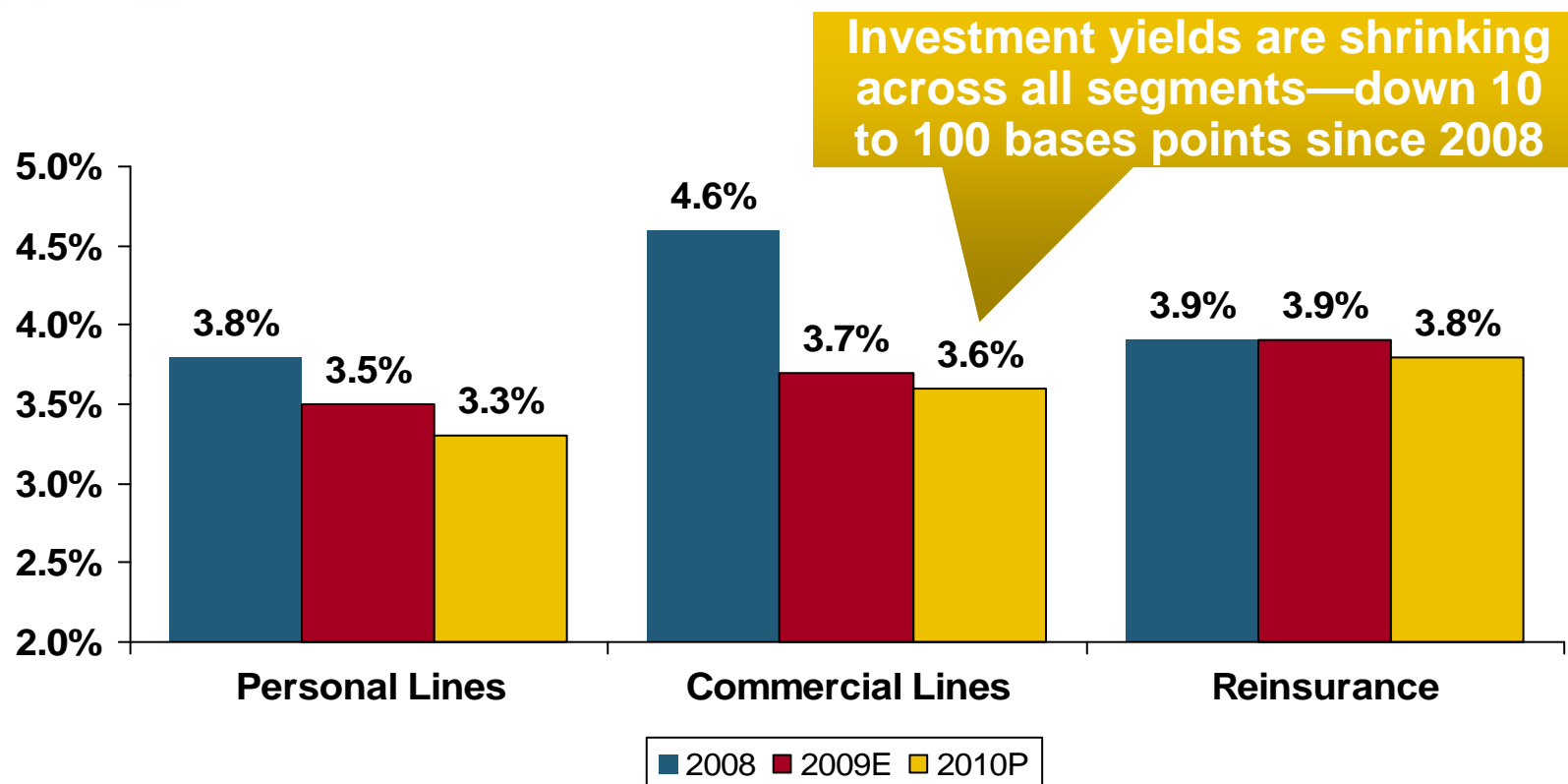
Rate and exposure are more favorable in personal lines, whereas a prolonged soft market and sluggish recovery from the recession weigh on commercial lines. Low catastrophe losses and ample capacity are holding down reinsurance prices while higher insurer retentions impact premiums

# Change in Net Investment Income by Segment: 2008-2010P\*



Investment income consists primarily of interest on bonds and stock dividends. Both were hit hard during the financial crisis as the Fed slashed interest rates to near zero and corporations cut dividends. A recovery in investment asset values beginning in Q2 2009—which reduced realized capital losses—has helped offset some of the decrease in investment income.

# Investment Yield by Segment: 2008-2010P\*



**The Fed slashed interest rates in 2008 and has kept them low since, eroding the yield on all types of bonds, especially US Treasury securities. Yields will not recover until the Fed begins monetary policy tightening.**

- **The Workers Compensation Line Has Been Significantly Impacted by The Weak Economy**
  - ◆ Recouping exposure losses will take years
- **Large Differences in Growth Prospects for Different Parts of the US, as well as Various Industries and Occupations Important to WC**
- **The New Decade Brings Numerous Operating Challenges**
- **Impacts of Regulatory/Legislative Changes Still Not Completely Known**
- **Overall P/C Operating Environment to Become More Challenging**
- **Growth Likely in Overall P/C Insurance Industry in 2011 for the First Time Since 2006**

Insurance Information Institute Online:

**[www.iii.org](http://www.iii.org)**

*Thank you for your time  
and your attention!*

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