

# The Financial Crisis and the Future of the P/C Insurance Industry *Focus on Public Sector Risk*

**Public Risk and Insurance Management Association  
Naples, FL**

**October 28, 2009**



**Download at: [www.iii.org/presentations/PRIMA-102809.html](http://www.iii.org/presentations/PRIMA-102809.html)**

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**Robert P. Hartwig, Ph.D., CPCU, President & Economist  
Insurance Information Institute ♦ 110 William Street ♦ New York, NY 10038  
Tel: (212) 346-5520 ♦ Fax: (212) 732-1916 ♦ [bobh@iii.org](mailto:bobh@iii.org) ♦ [www.iii.org](http://www.iii.org)**



# *Presentation Outline*

- **The Economic Storm: Financial Crisis & Recession**
  - Exposure, Growth & Profitability
  - Florida's Woes: Worse than Most States
- **Key Threats and Issues Facing P/C Insurers Through 2015**
- **Regulatory Reform**
- **Financial Strength & Ratings**
  - Key Differences Between Insurer and Bank Performance During Crisis
- **Insurance Industry Financial Overview & Outlook**
  - Profitability
  - Premium Growth
  - Underwriting Performance: Commercial & Personal Lines
  - Financial Market Impacts
  - Merger & Acquisition Activity
- **Capital & Capacity**
- **Catastrophe Loss Trends**

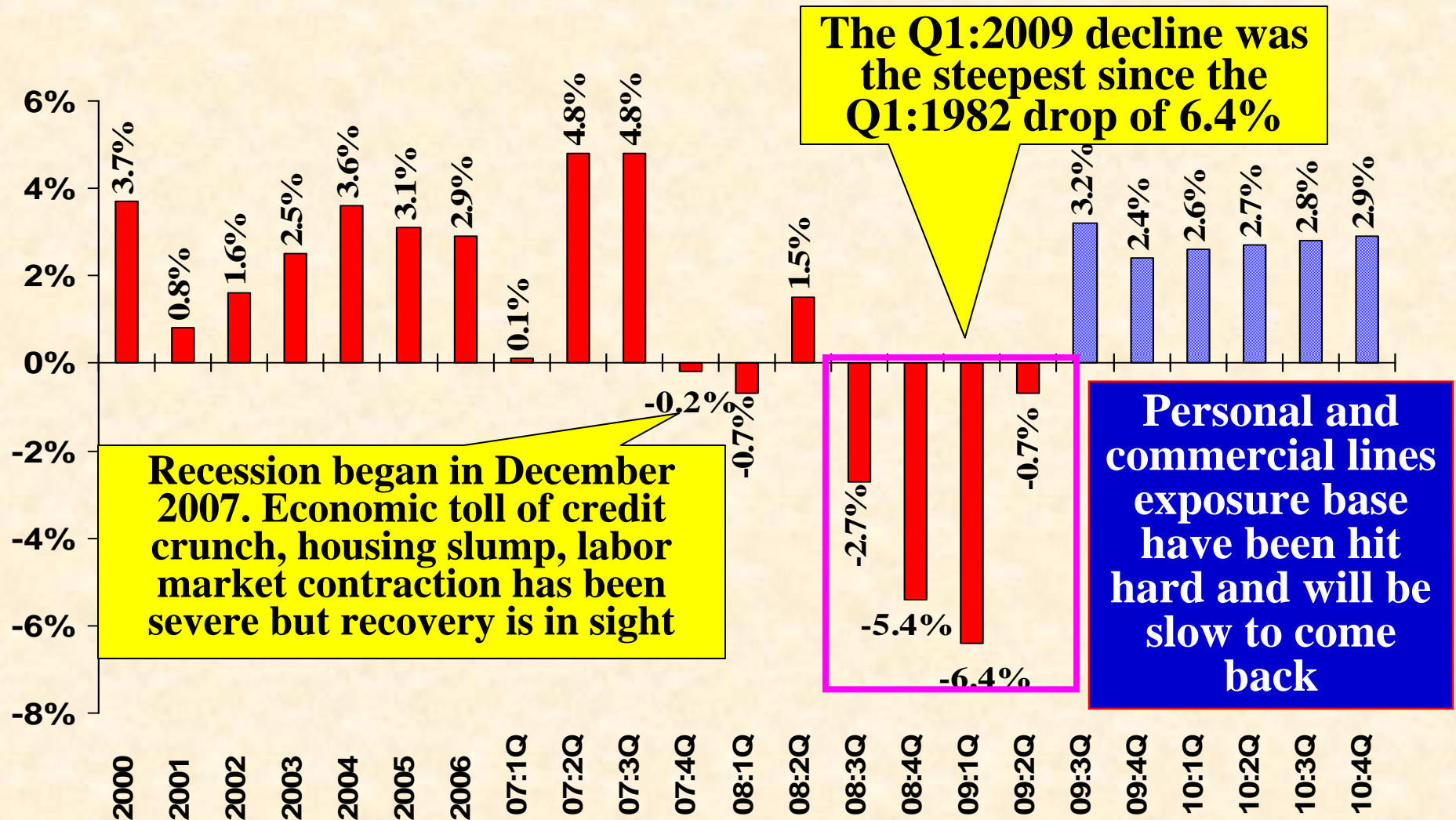
# THE ECONOMIC STORM

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





# Real GDP Growth\*



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

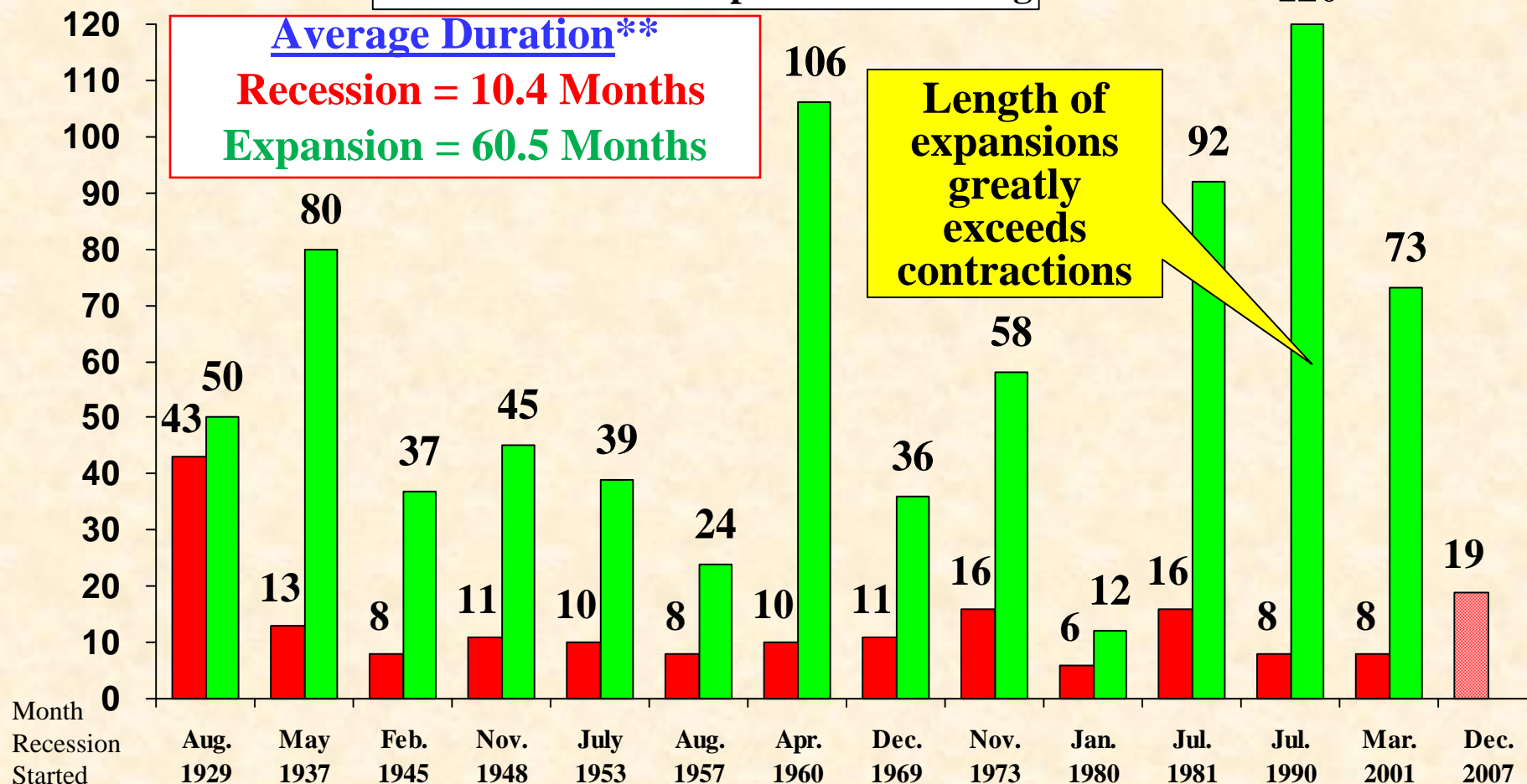
Source: US Department of Commerce, Blue Economic Indicators 10/09; Insurance Information Institute.



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

Duration (Months)

■ Contraction ■ Expansion Following



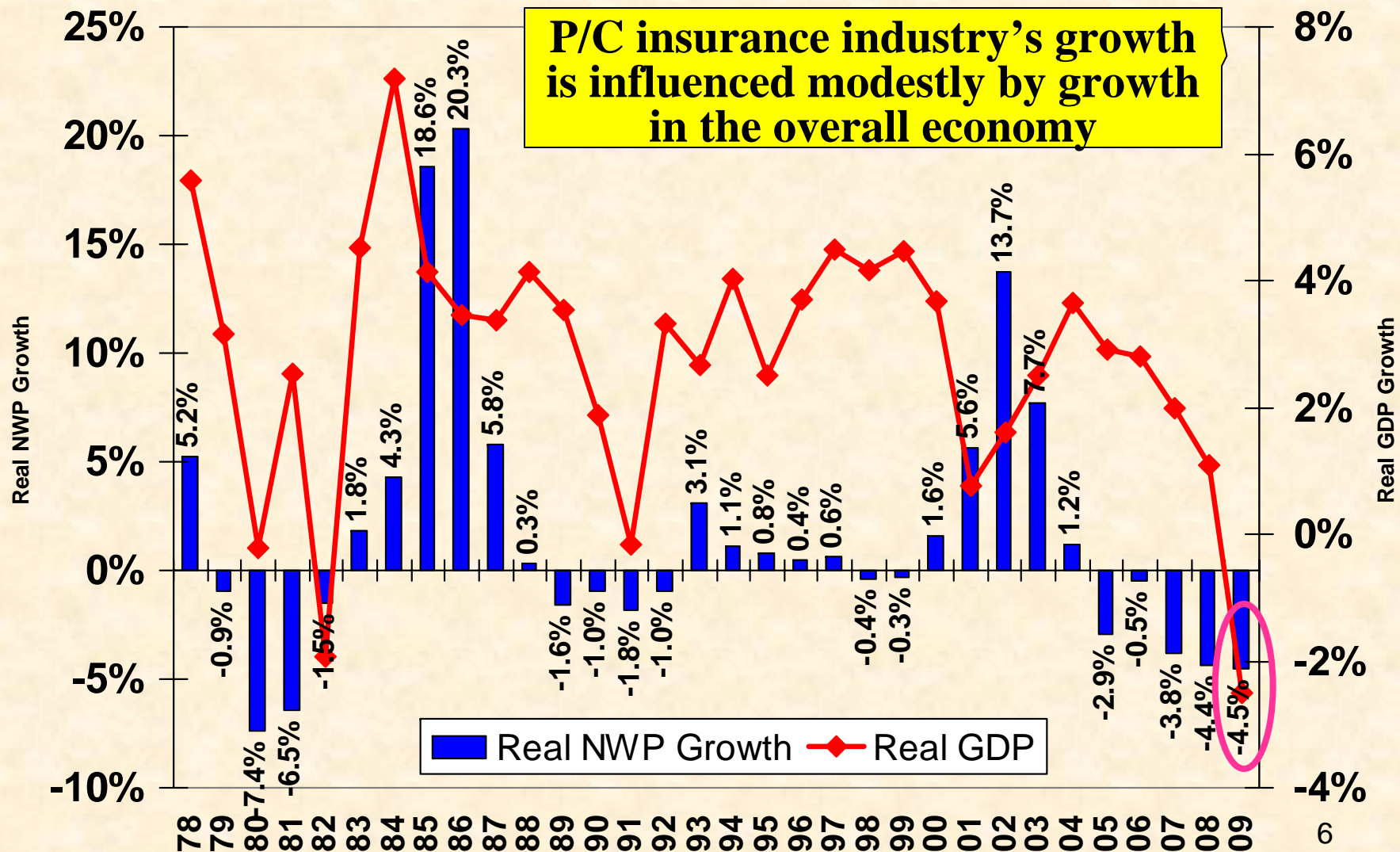
\* Through June 2009 (likely the "official end" of recession) \*\*Post-WW II period through end of most recent expansion.

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



# Real GDP Growth vs. Real P/C

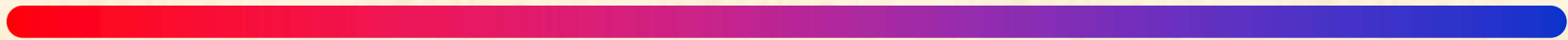
## Premium Growth: Modest Association





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

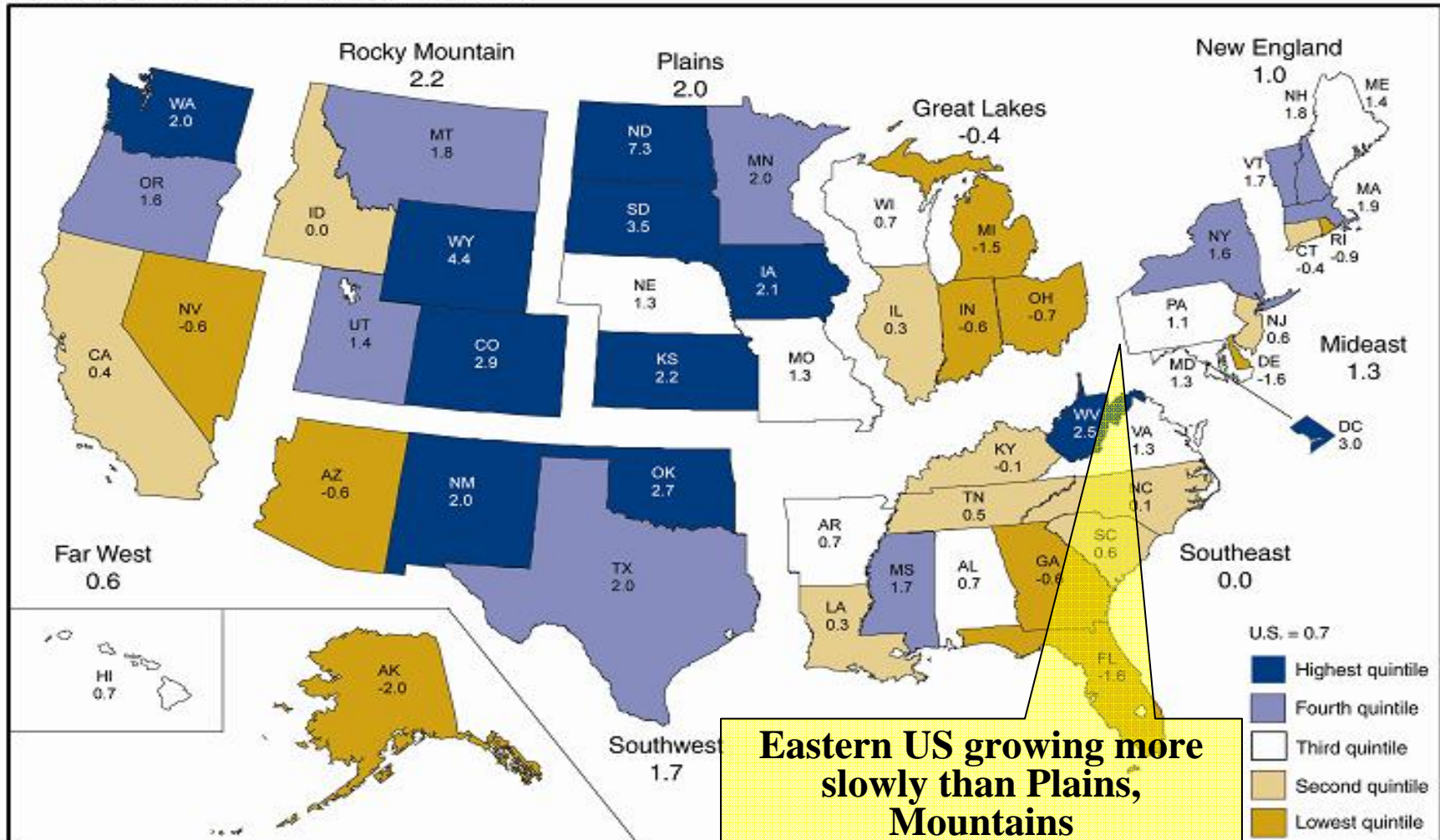
**Recovery in Some Areas Will Begin  
Years Ahead of Others & Speed of  
Recovery Will Differ By Orders of  
Magnitude**





# State Economic Growth Varied Tremendously in 2008

Percent Change in Real GDP by State, 2007-2008



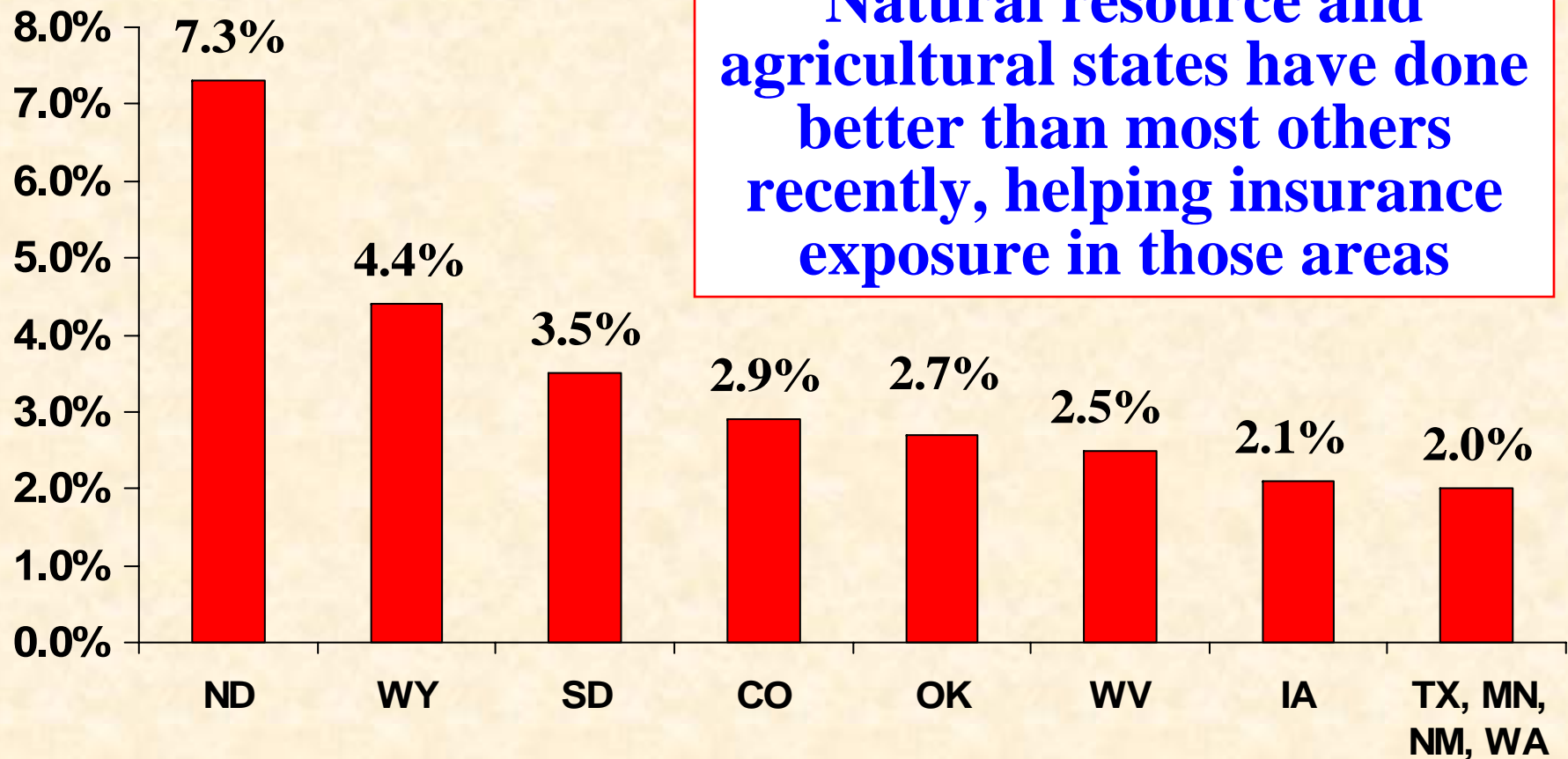




# *Fastest Growing States in 2008: Plains, Mountain States Lead*

## Real State GDP Growth

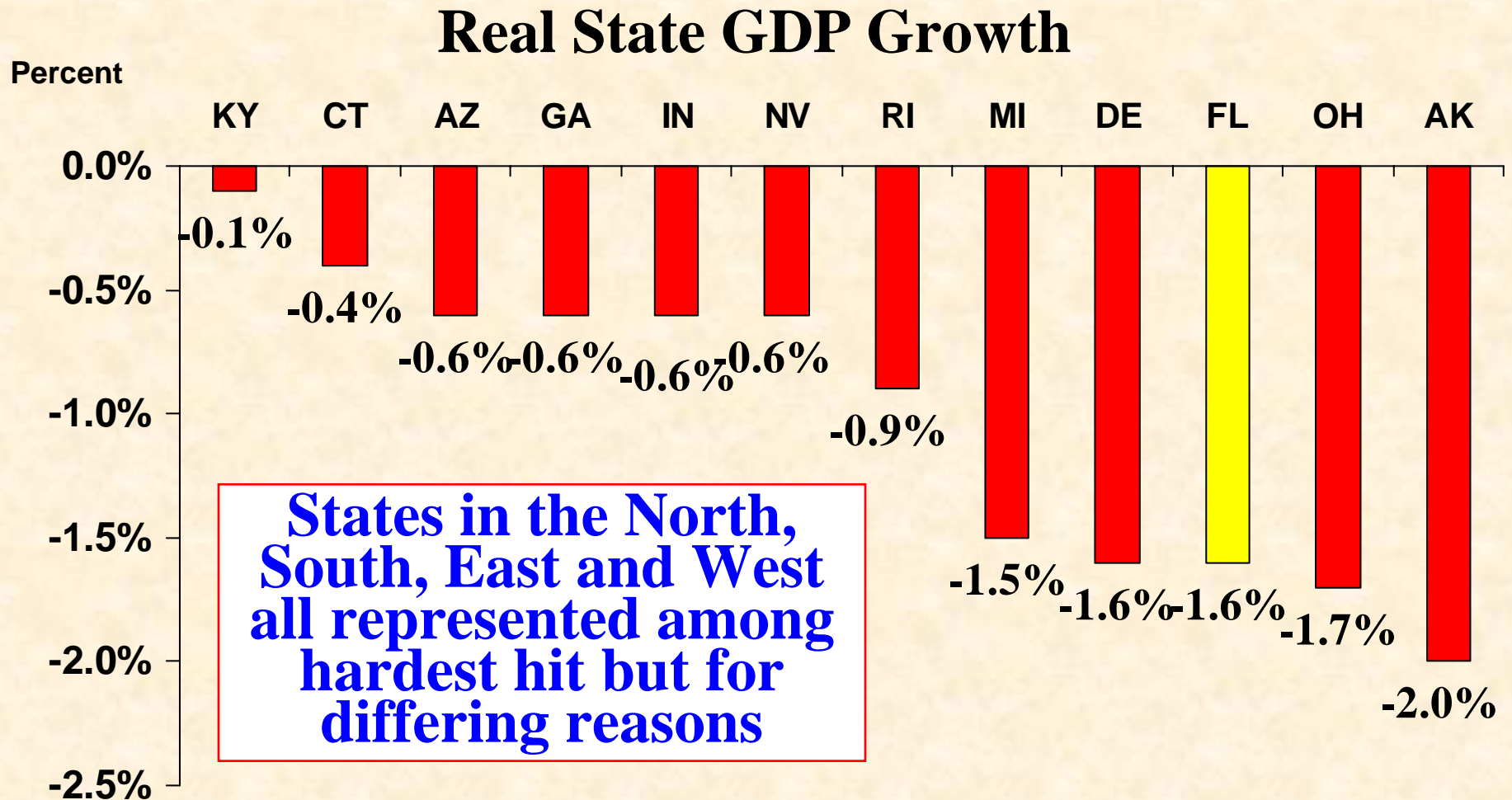
Percent



**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*



# Labor Market Trends

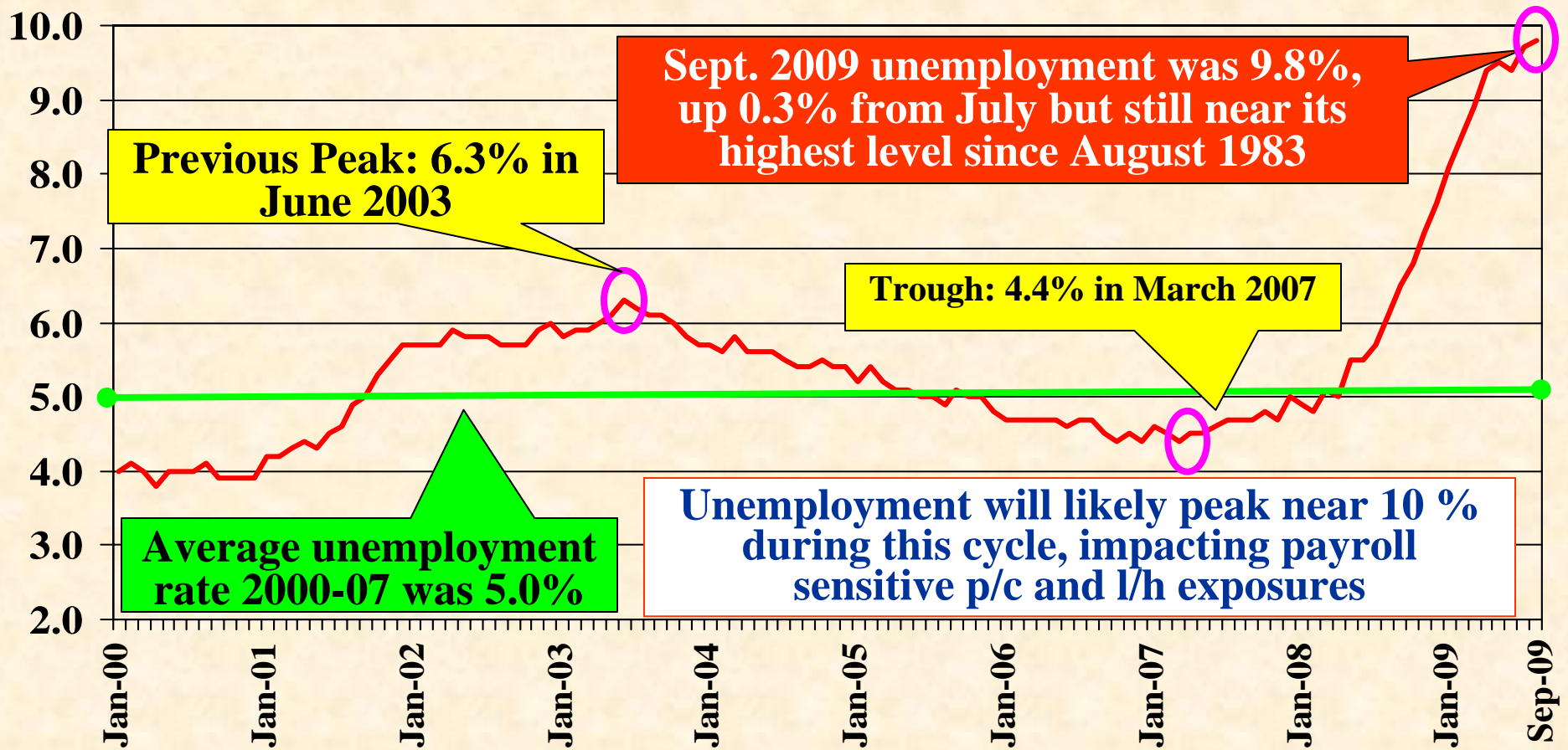
**Fast & Furious: Massive Job Losses  
Sap the Economy and Personal &  
Commercial Lines Exposure**





# *Unemployment Rate: On the Rise*

**January 2000 through September 2009\***

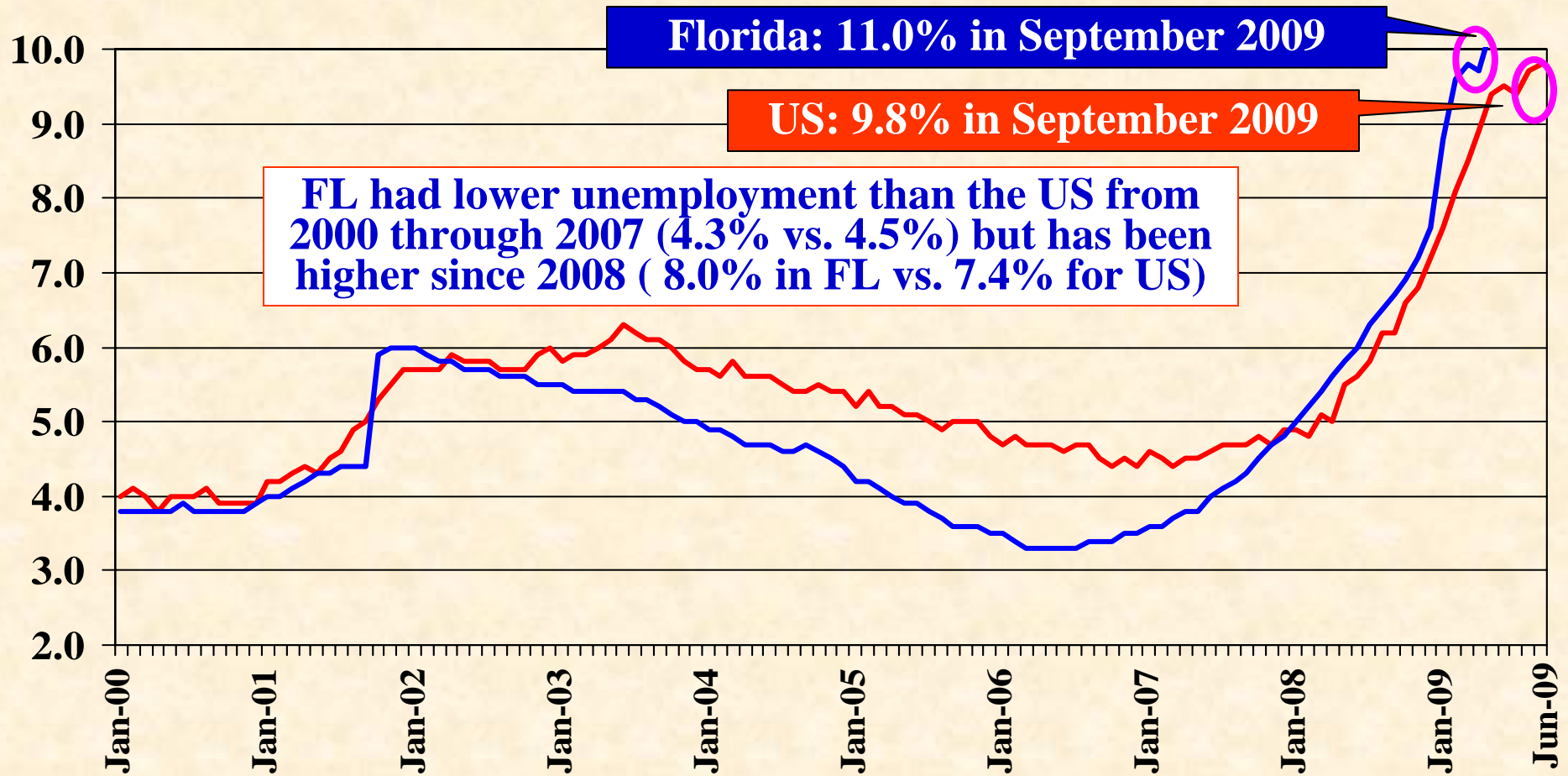


Source: US Bureau of Labor Statistics; Insurance Information Institute.



# *Unemployment Rate: Florida is Now Doing Worse Than US*

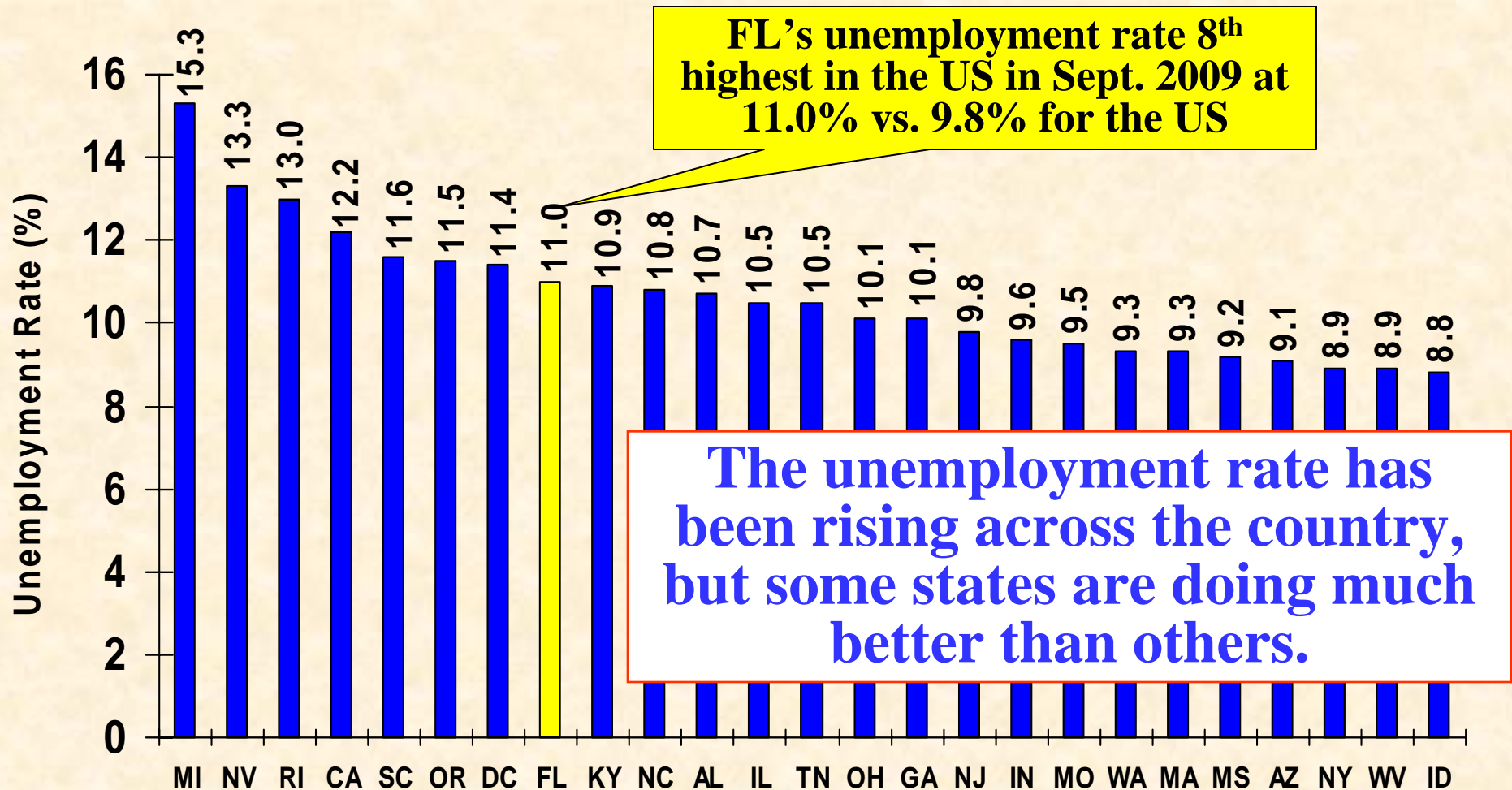
**January 2000 through September 2009**







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



\*Provisional figures for September 2009, seasonally adjusted.

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



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

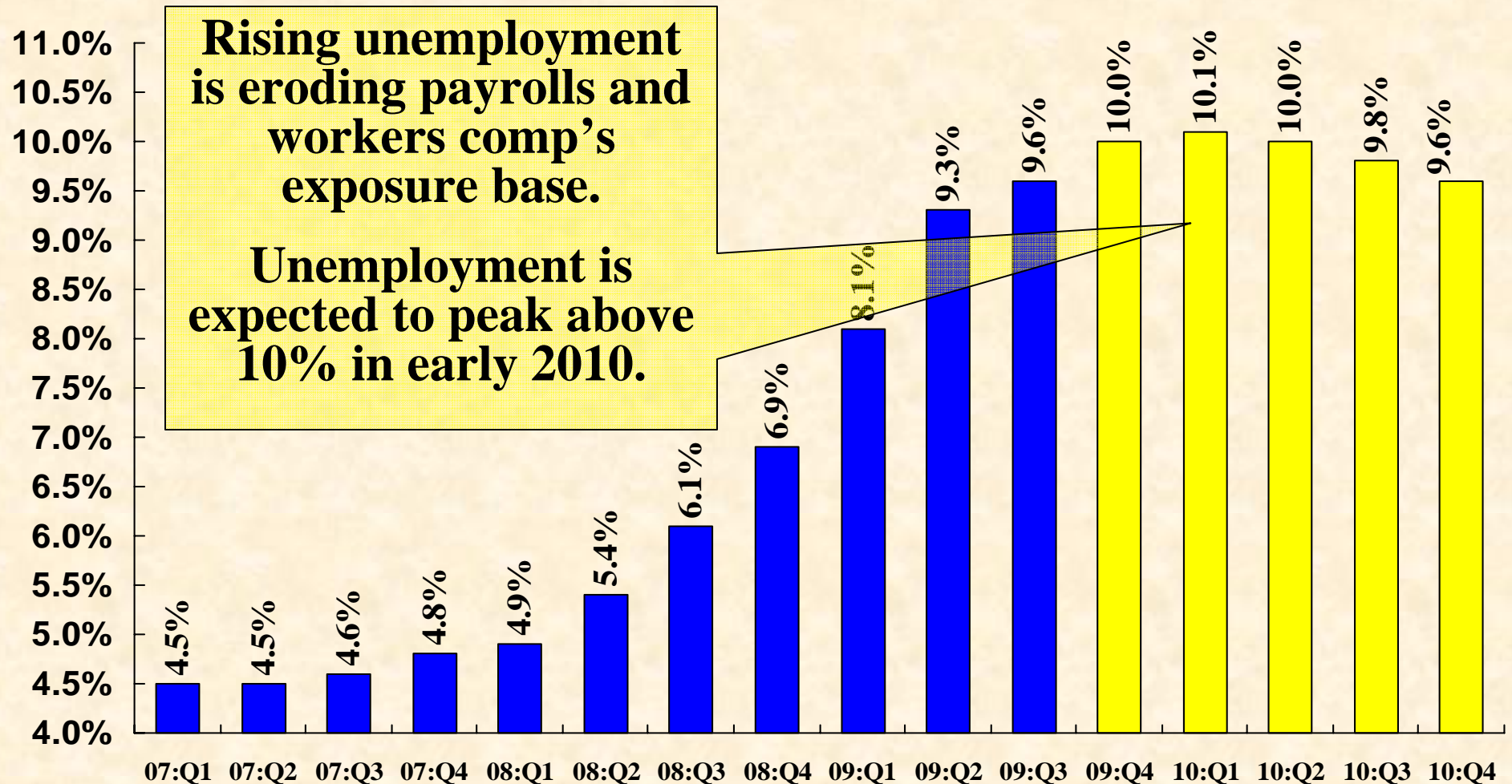


\*Provisional figures for September 2009, seasonally adjusted.

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



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

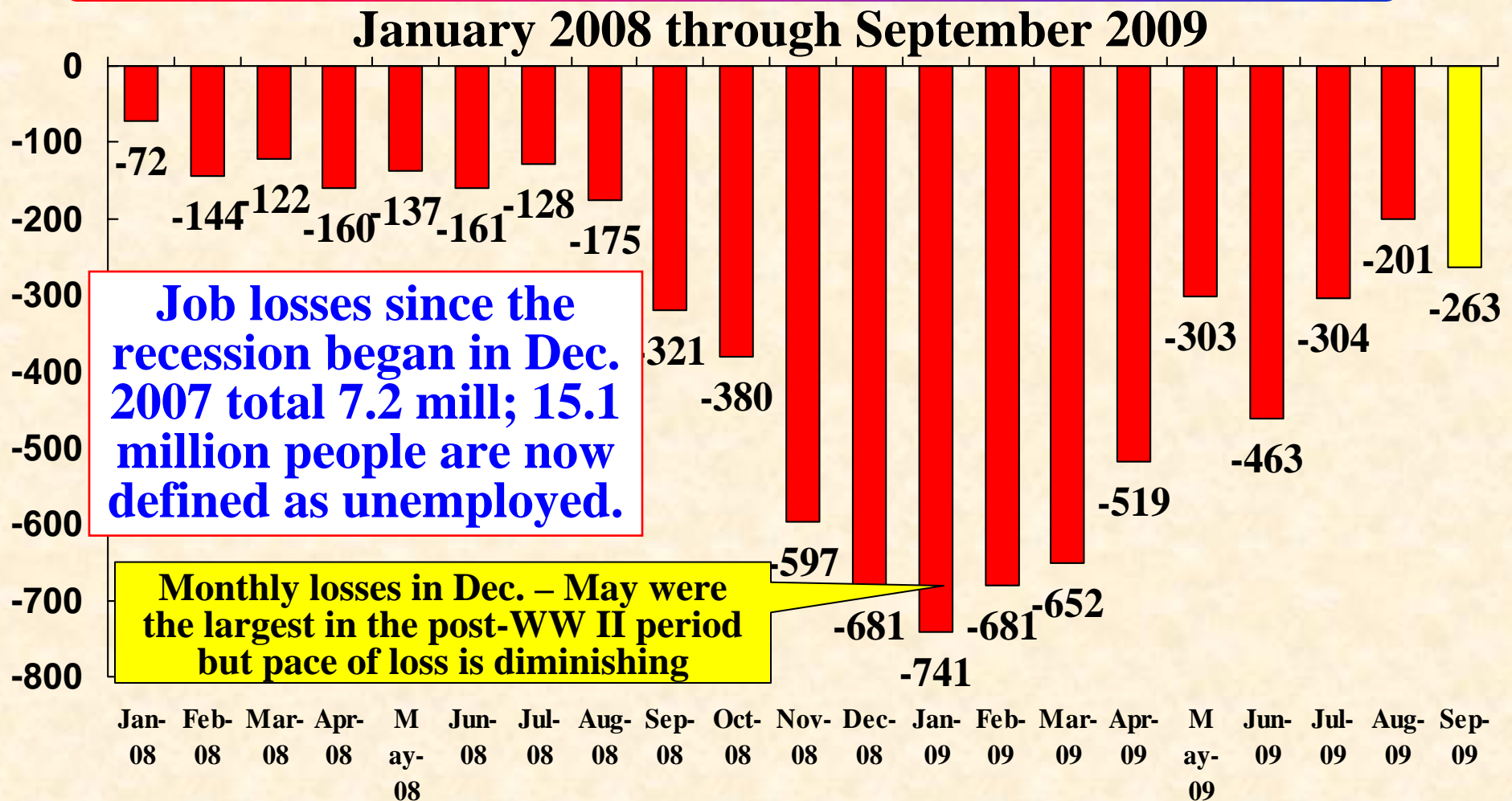


\* Blue bars are actual; Yellow bars are forecasts

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (10/09); Insurance Info. Inst.

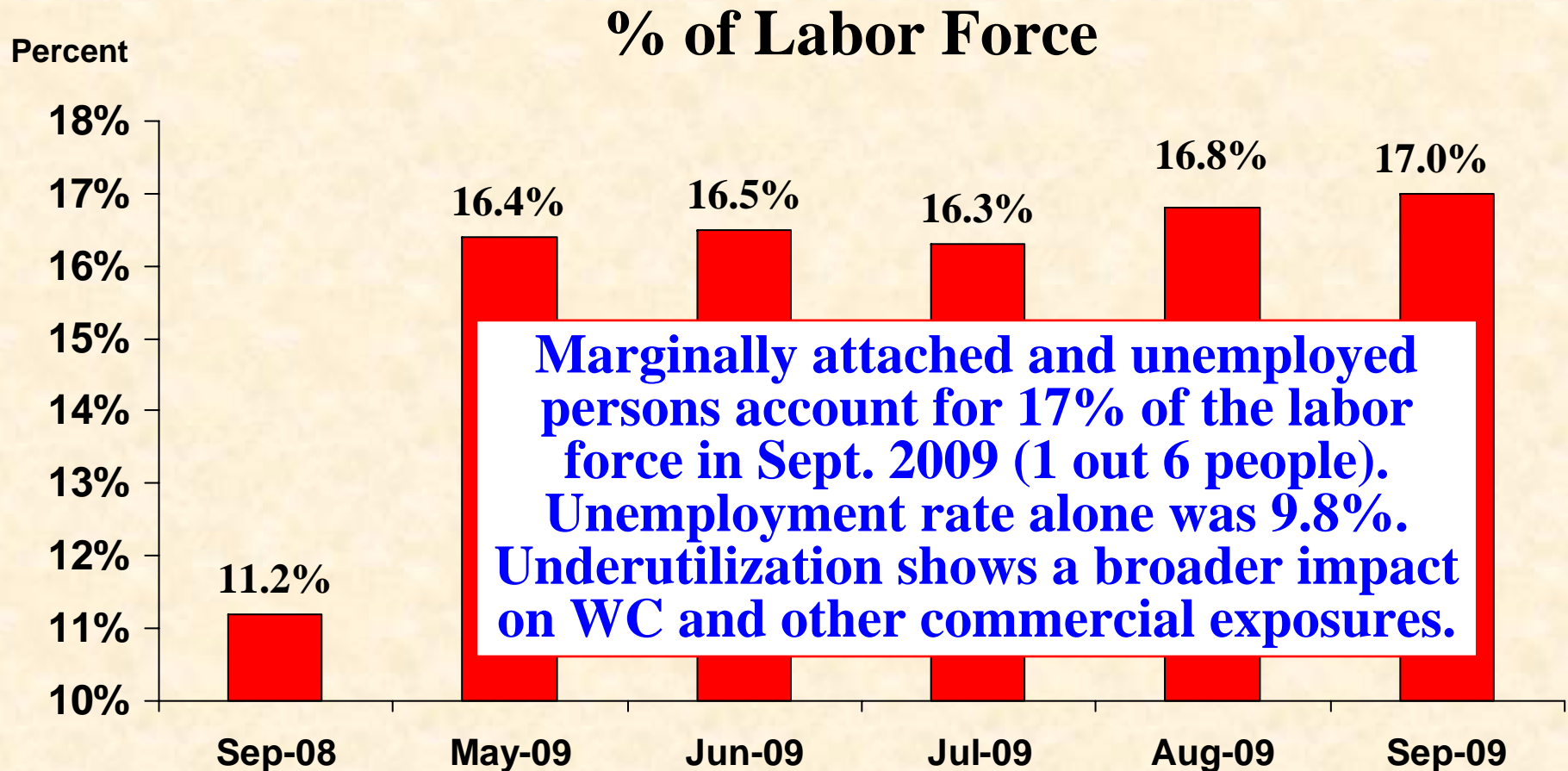


# Monthly Change Employment\* (Thousands)





# *Labor Underutilization: Broader than Just Unemployment*



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.

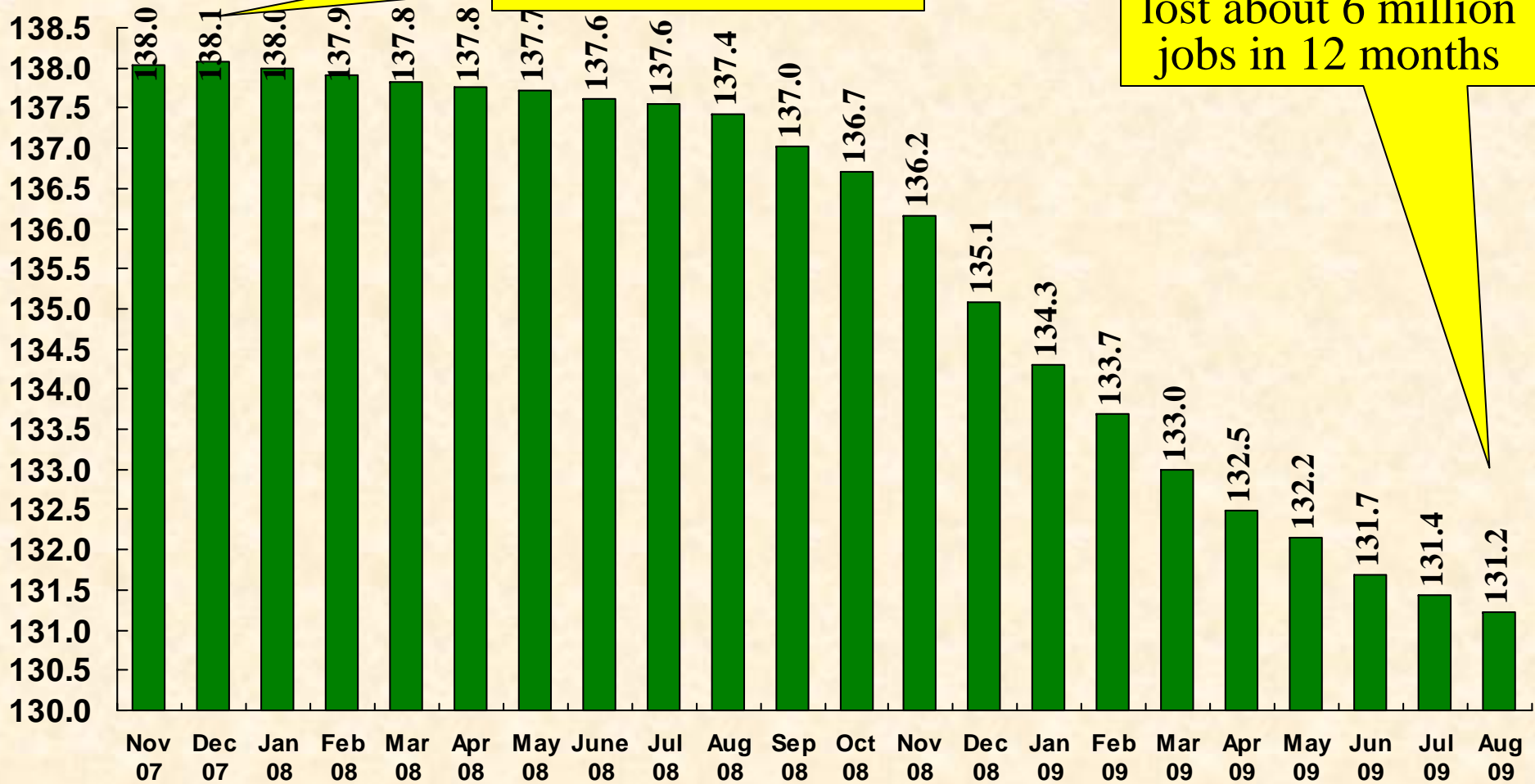
Source: US Bureau of Labor Statistics; Insurance Information Institute.





# *U.S. Nonfarm Private Employment, Monthly, Nov 2007 – August 2009*

Millions



Employment peak;  
recession starts

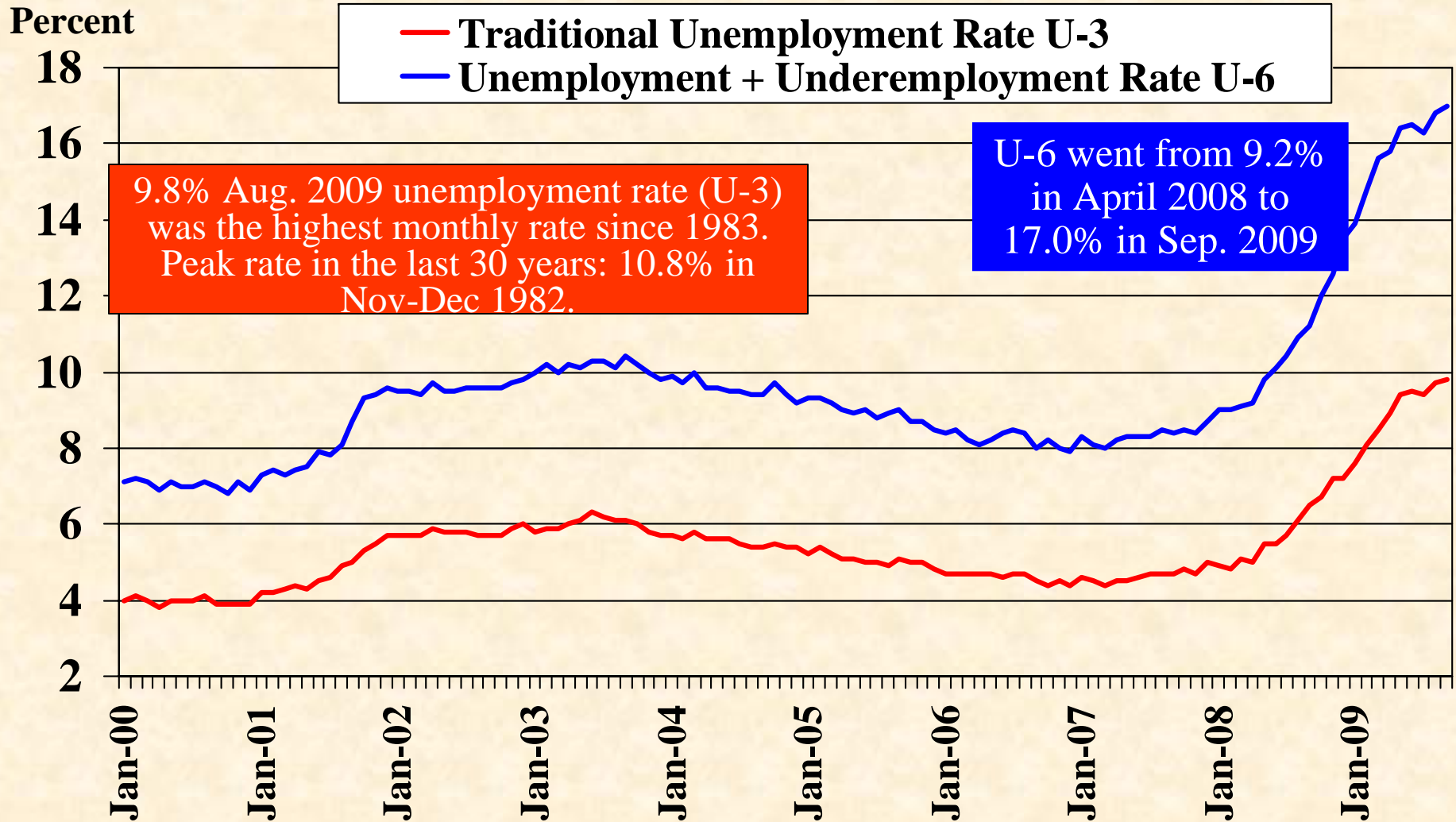
The U.S. economy  
lost about 6 million  
jobs in 12 months

Seasonally adjusted. Source: US Bureau of Labor Statistics



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

January 2000 through September 2009, seasonally adjusted

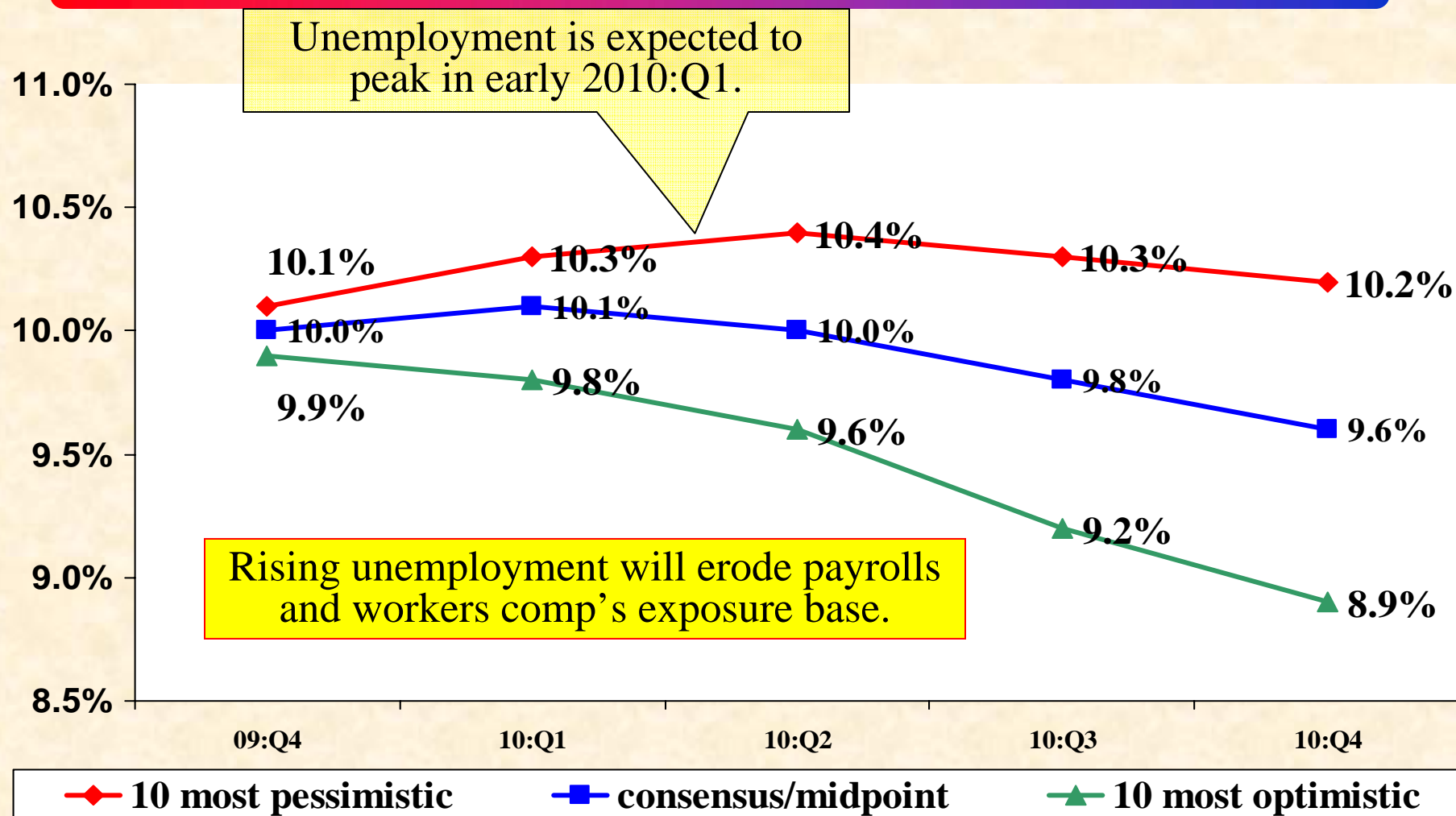


Source: US Bureau of Labor Statistics; Insurance Information Institute.



# *U.S. Unemployment Rate Forecasts*

## *Quarterly, 2009:Q4 to 2010:Q4*

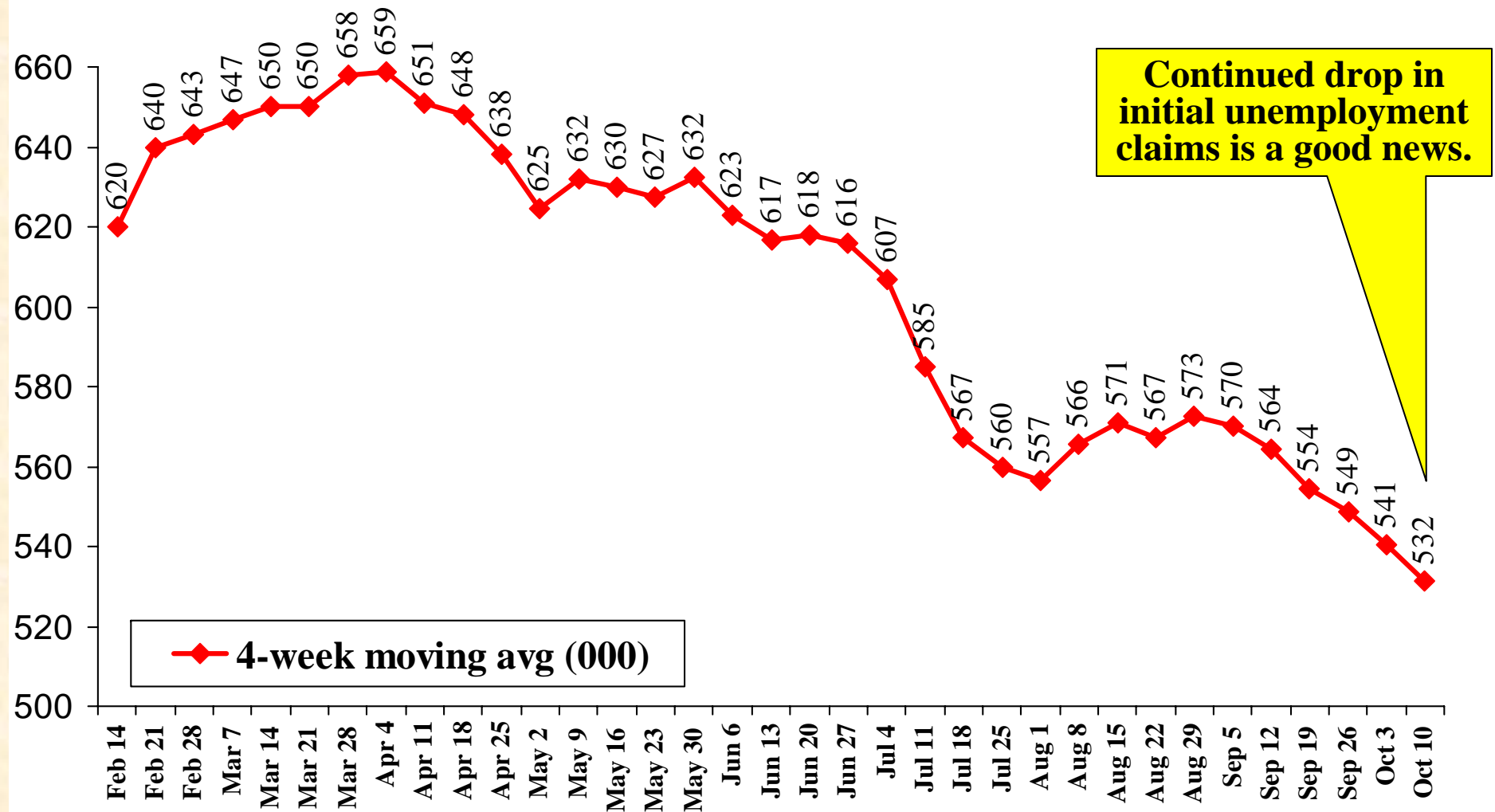


Sources: Blue Chip Economic Indicators (10/09); Insurance Info. Inst.



# *Will the Recession End Soon?*

## *Feb.-Oct. 2009 Initial Jobless Claims\**



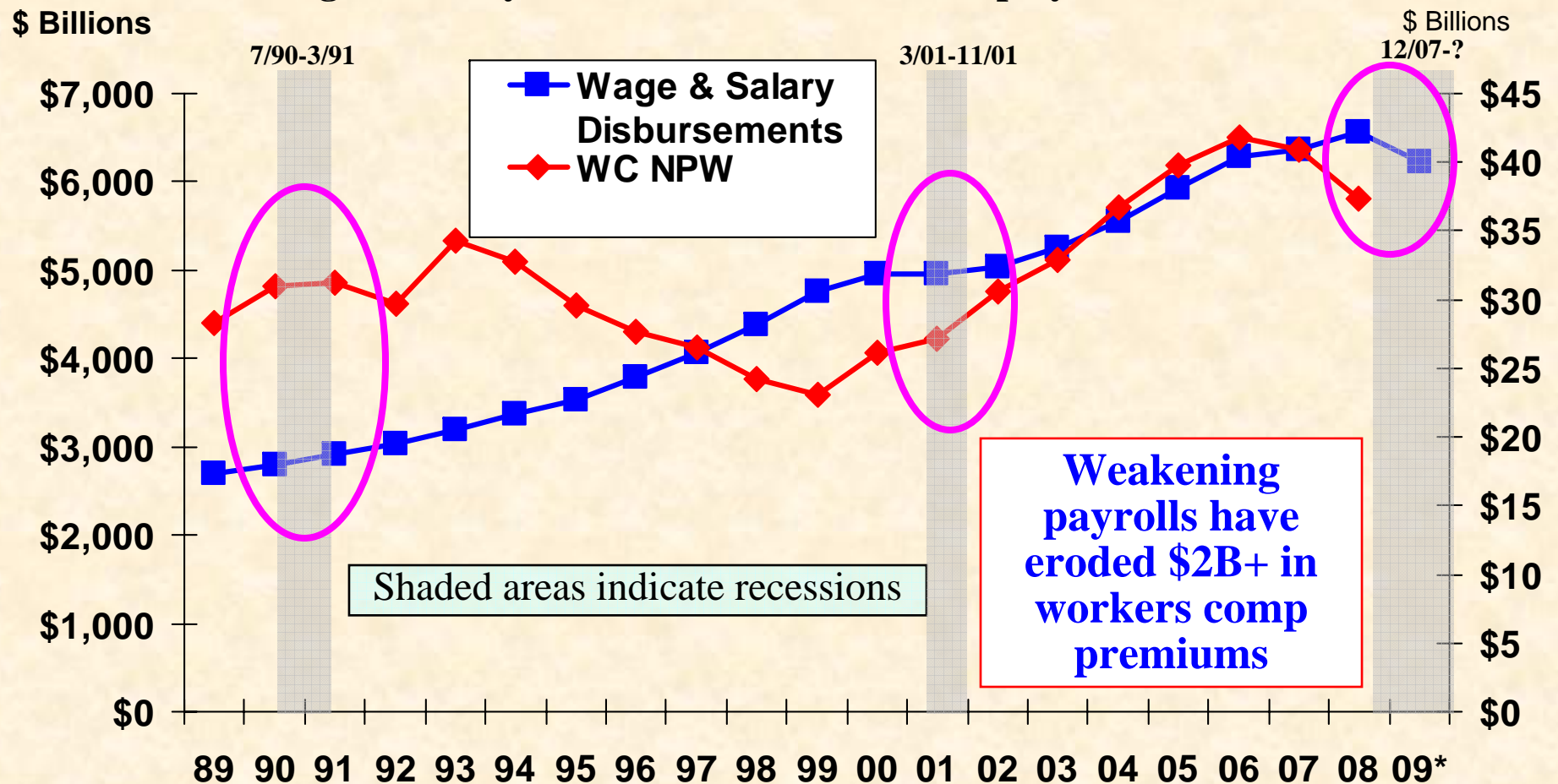
\*seasonally adjusted; state programs only

Source: <http://www.dol.gov/opa/media/press/eta/ui/current.htm>



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

**Wage & Salary Disbursement (Private Employment) vs. WC NWP**



\*Average Wage and Salary data as of 7/1/2009.

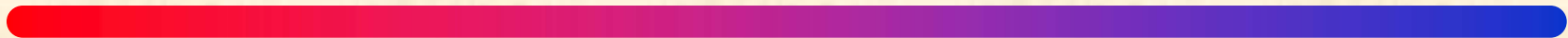
Source: US Bureau of Economic Analysis; Federal Reserve Bank of St. Louis at

<http://research.stlouisfed.org/fred2/series/WASCUR>; I.I.I. Fact Books



# Crisis-Driven Exposure Drivers

*Economic Obstacles  
to Growth in P/C  
Insurance*





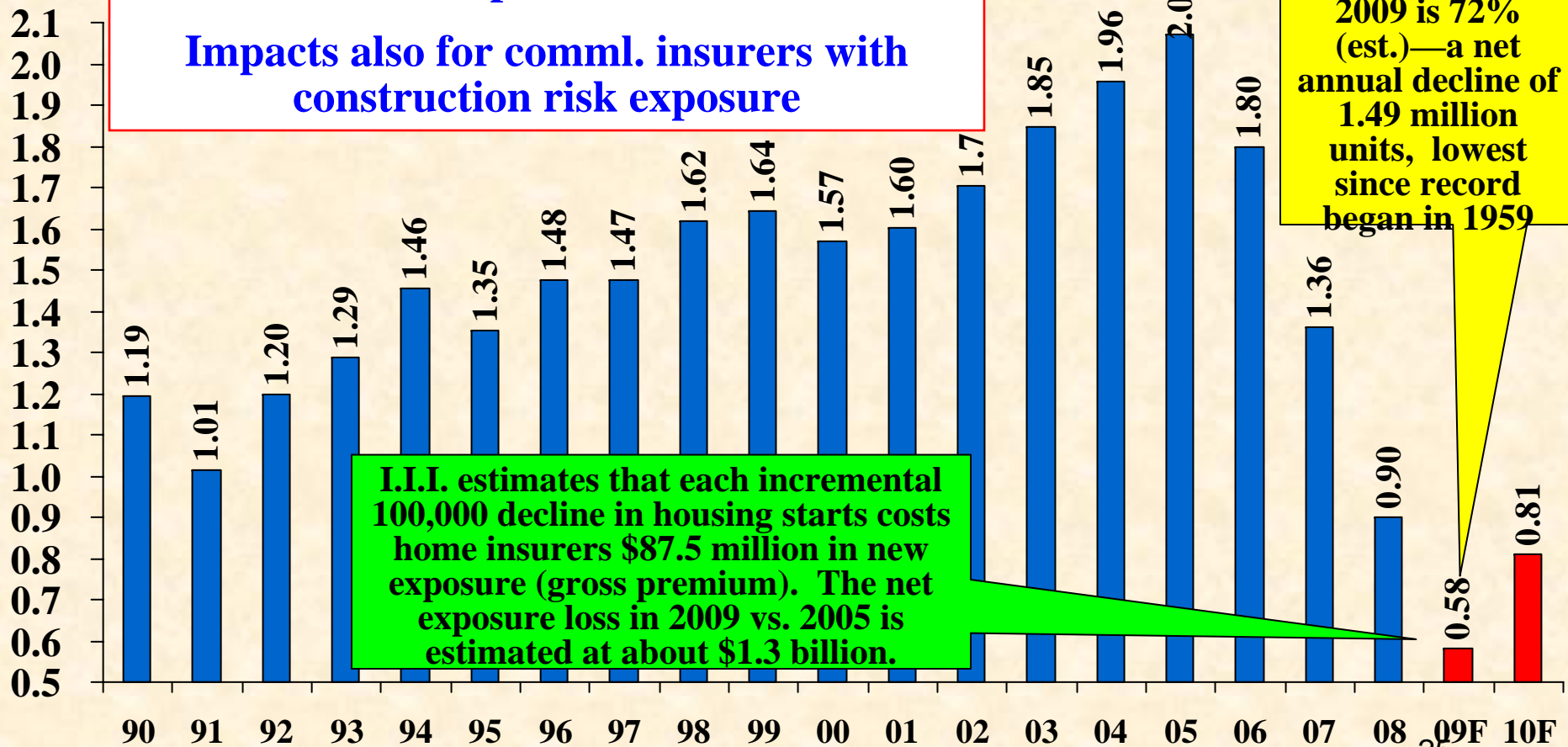
# *New Private Housing Starts, 1990-2010F (Millions of Units)*

**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 72%  
(est.)—a net  
annual decline of  
1.49 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.**

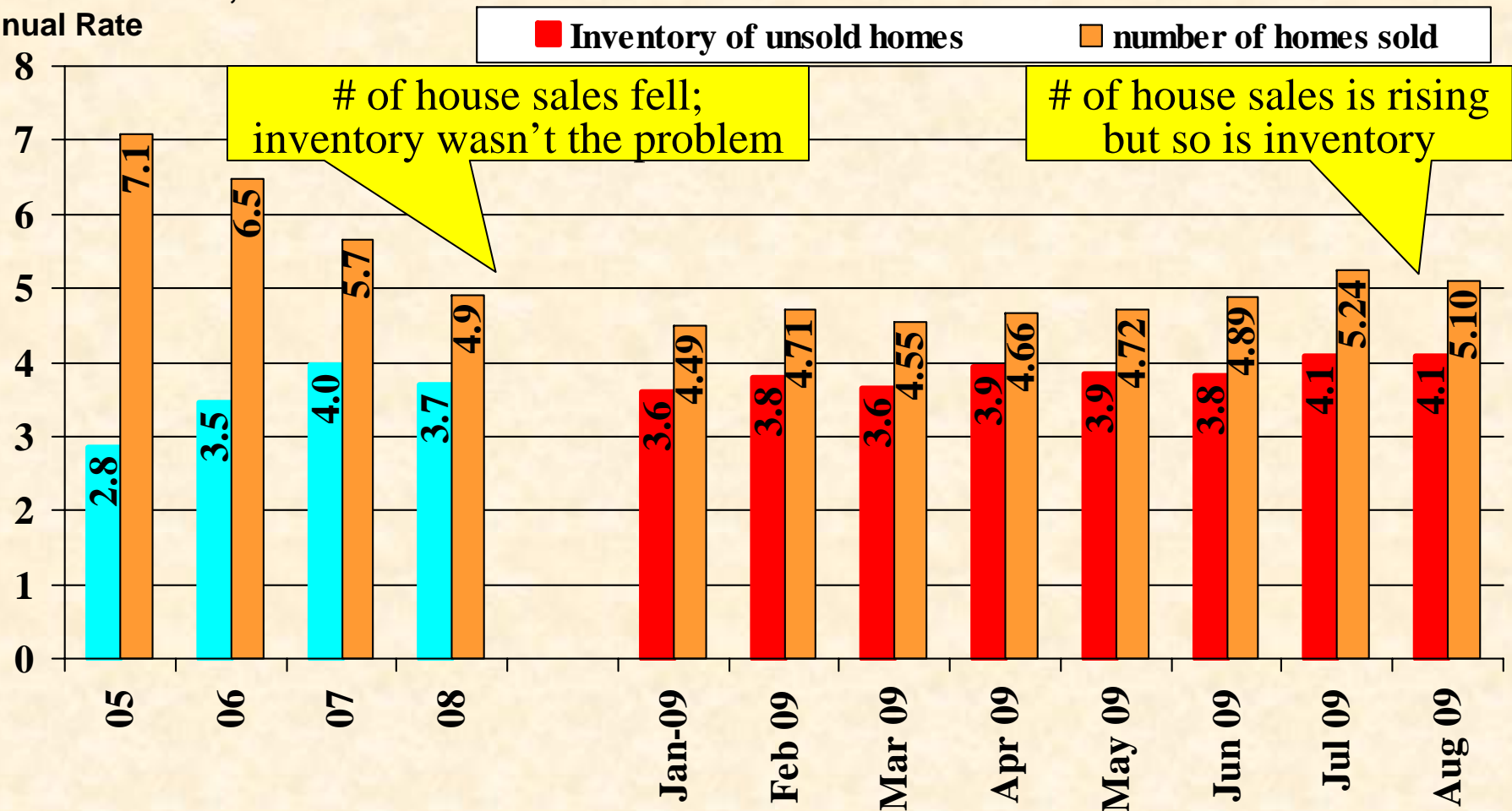


Source: US Department of Commerce; Blue Chip Economic Indicators (10/09); Insurance Information Inst.



# *High Ratio of Unsold-Homes Inventory to Sales Will Likely Keep Prices Falling*

Millions of Homes,  
Annual Rate

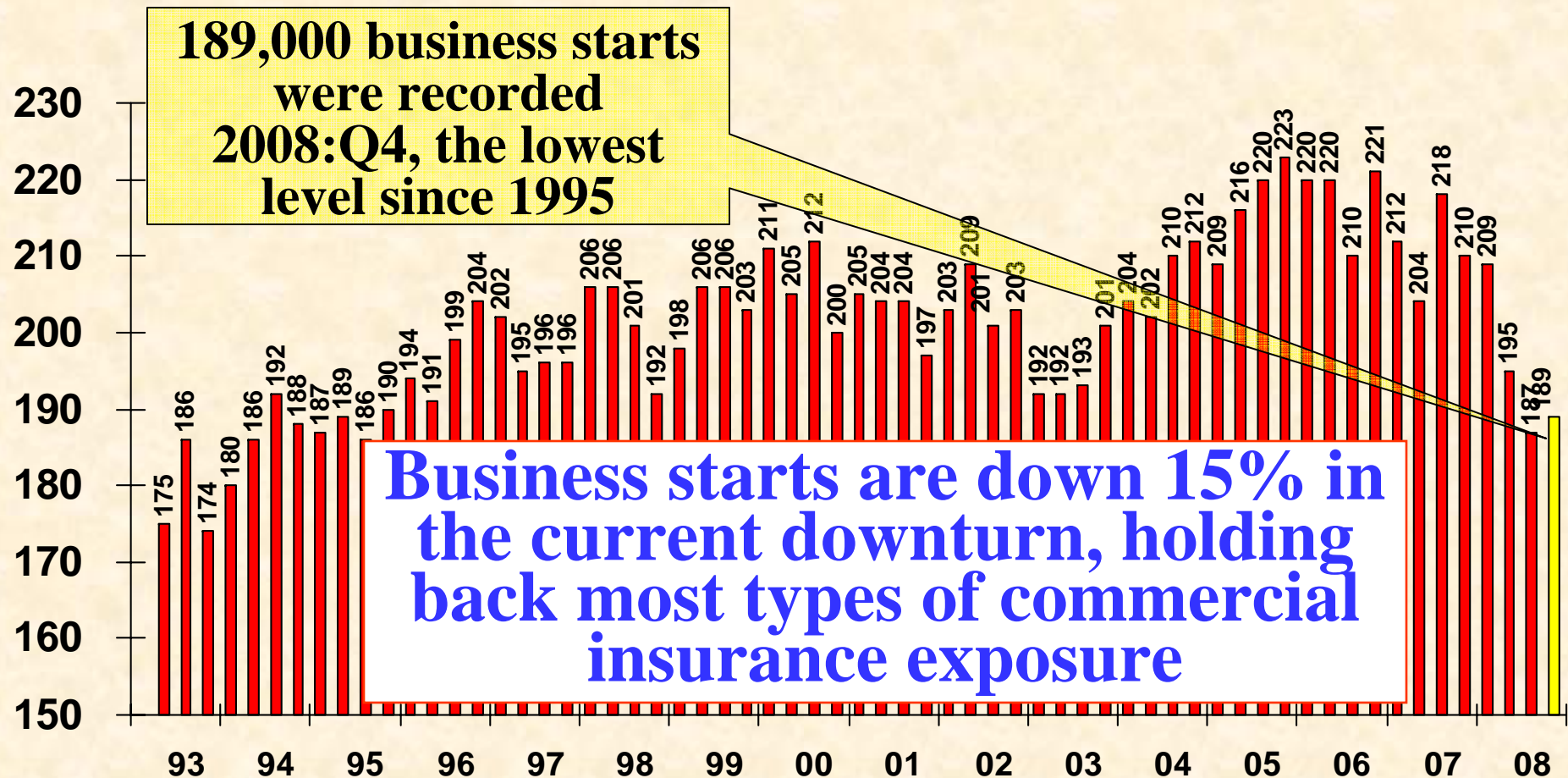


Source: <http://www.realtor.org/research/research/ehsdata>



# *Private Sector Business Starts, 1993:Q2-2008:Q4\**

Thousands

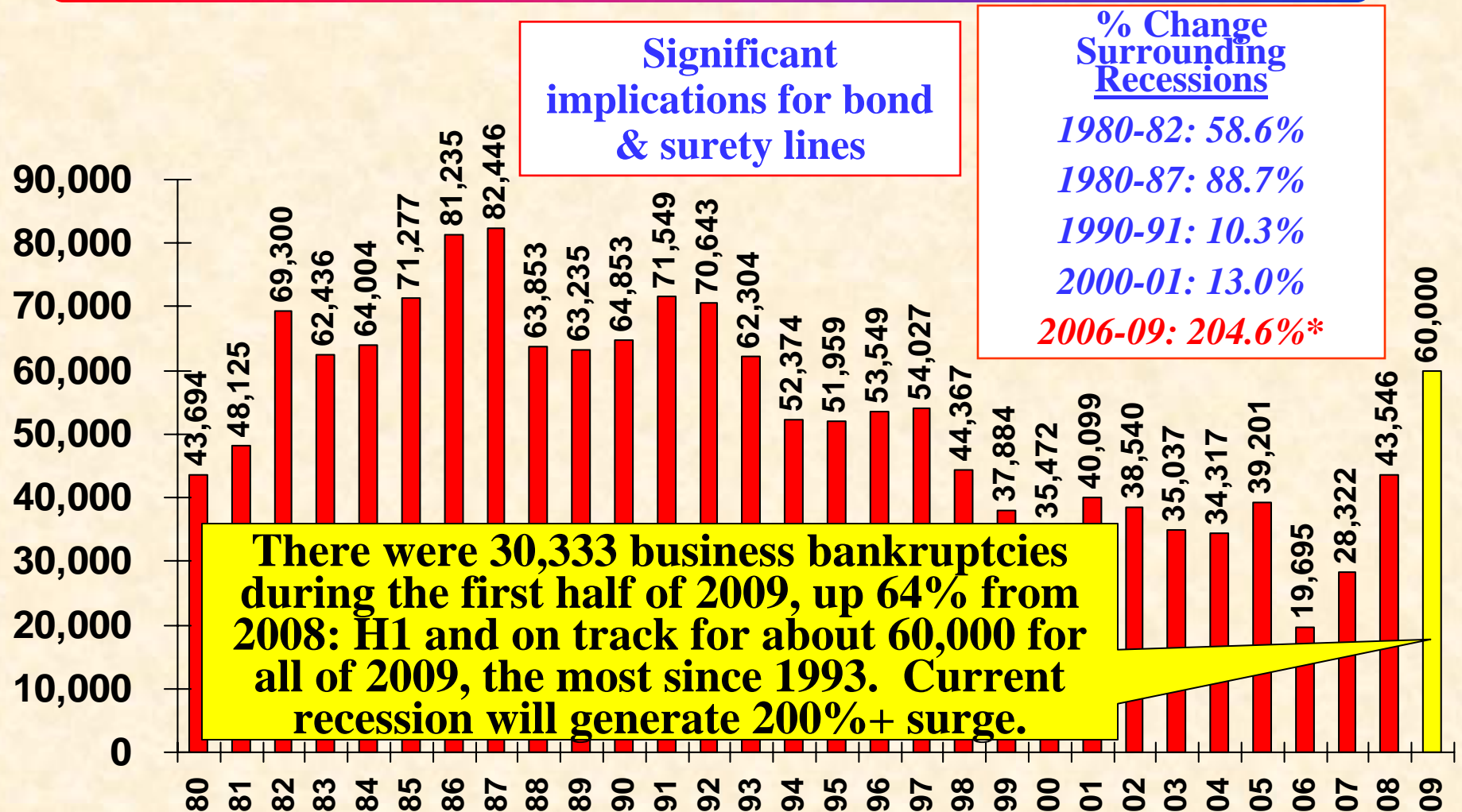


\*Latest available as of Oct. 2009.

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



# Business Bankruptcy Filings, 1980-2009\*



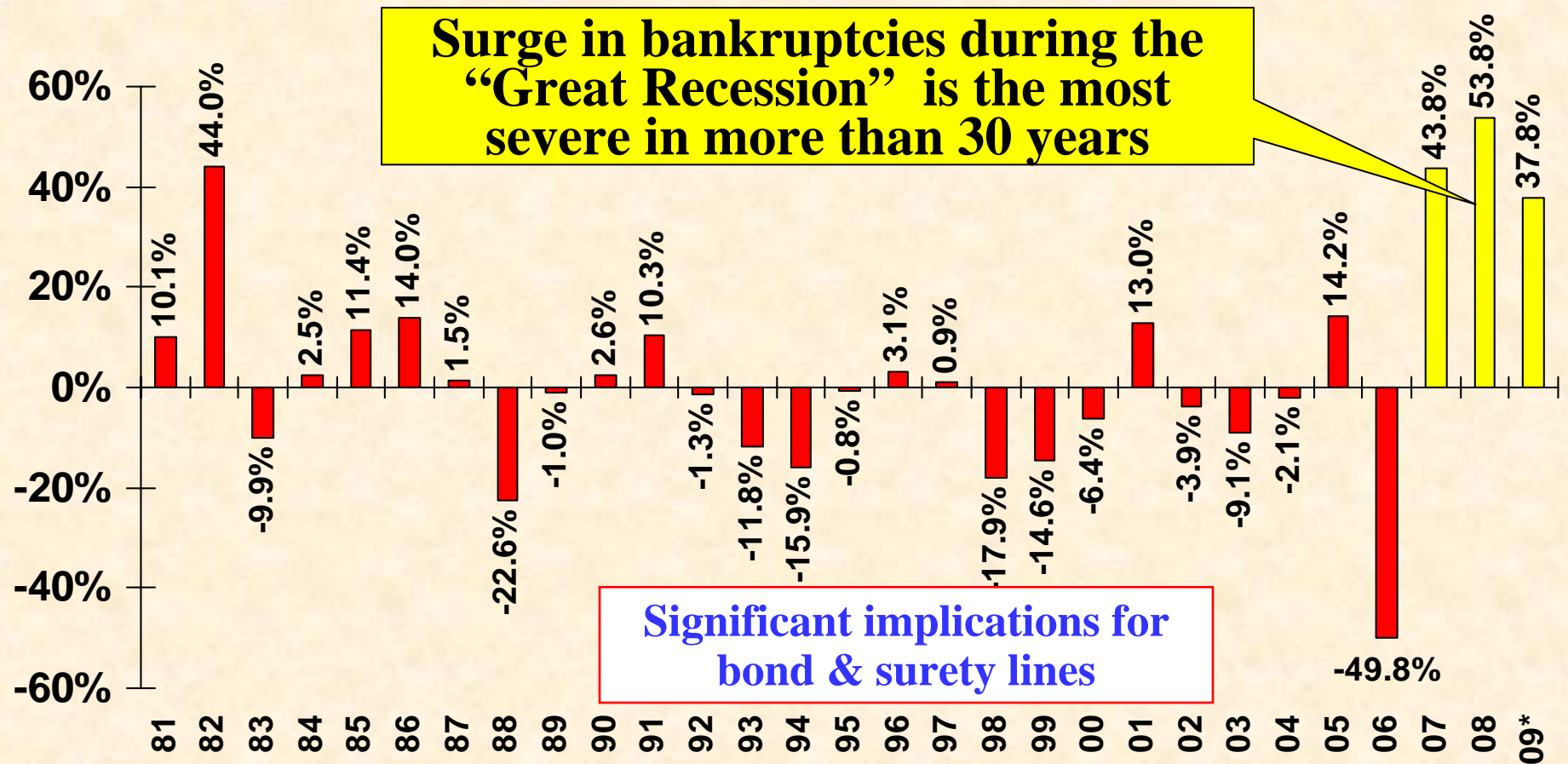
\*Based estimate of 60,000 business bankruptcies in 2009; actual first half total was 30,333.

Source: American Bankruptcy Institute; Insurance Information Institute





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

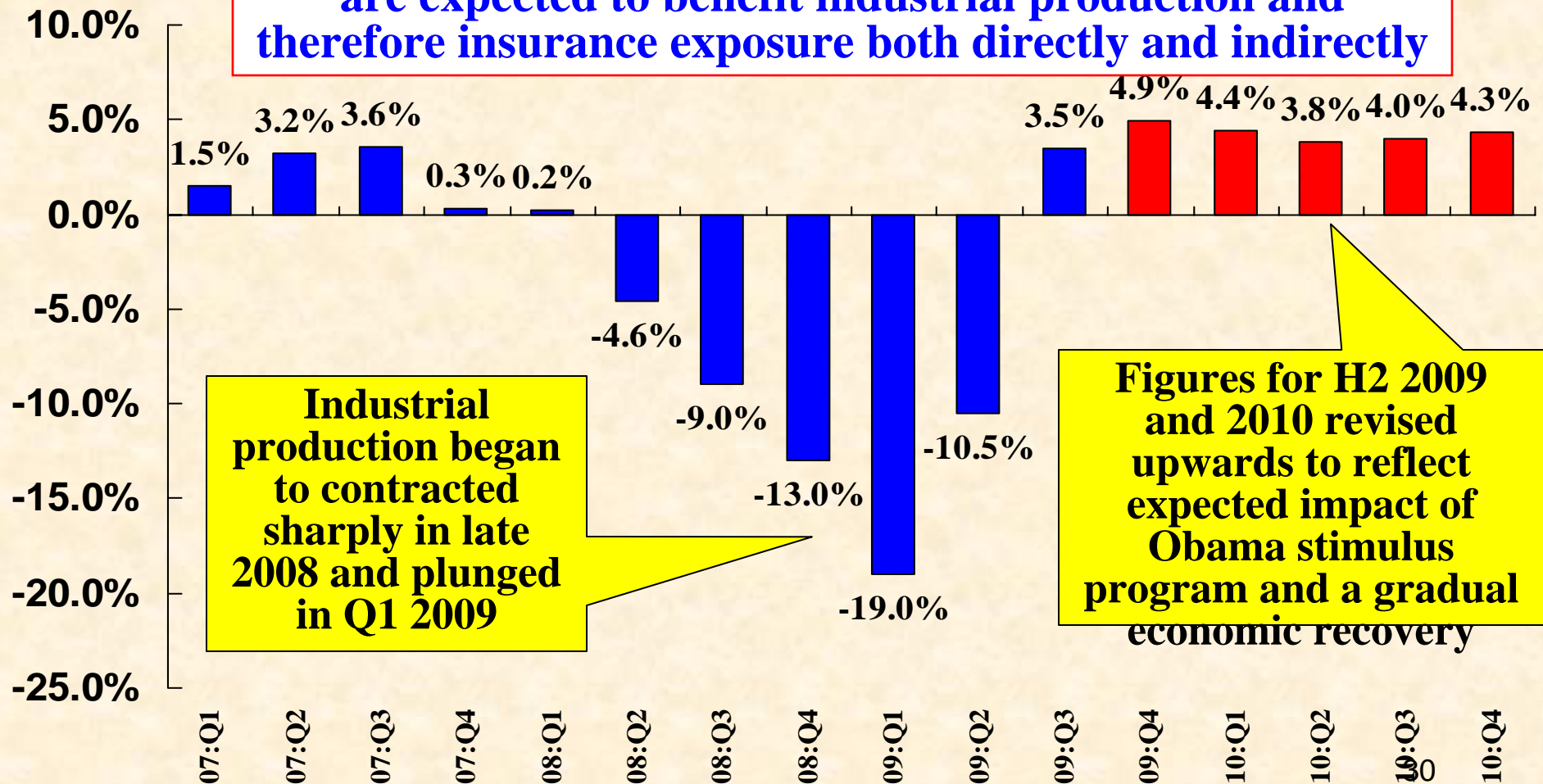


\*Based estimate of 60,000 business bankruptcies in 2009. All figures are percent change from previous year.  
Source: Insurance Information Institute from American Bankruptcy Institute data.



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

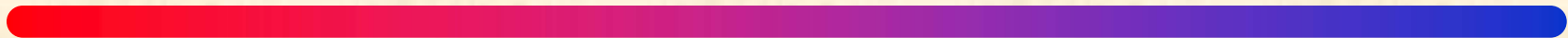
**End of recession in late 2009, Obama stimulus program are expected to benefit industrial production and therefore insurance exposure both directly and indirectly**



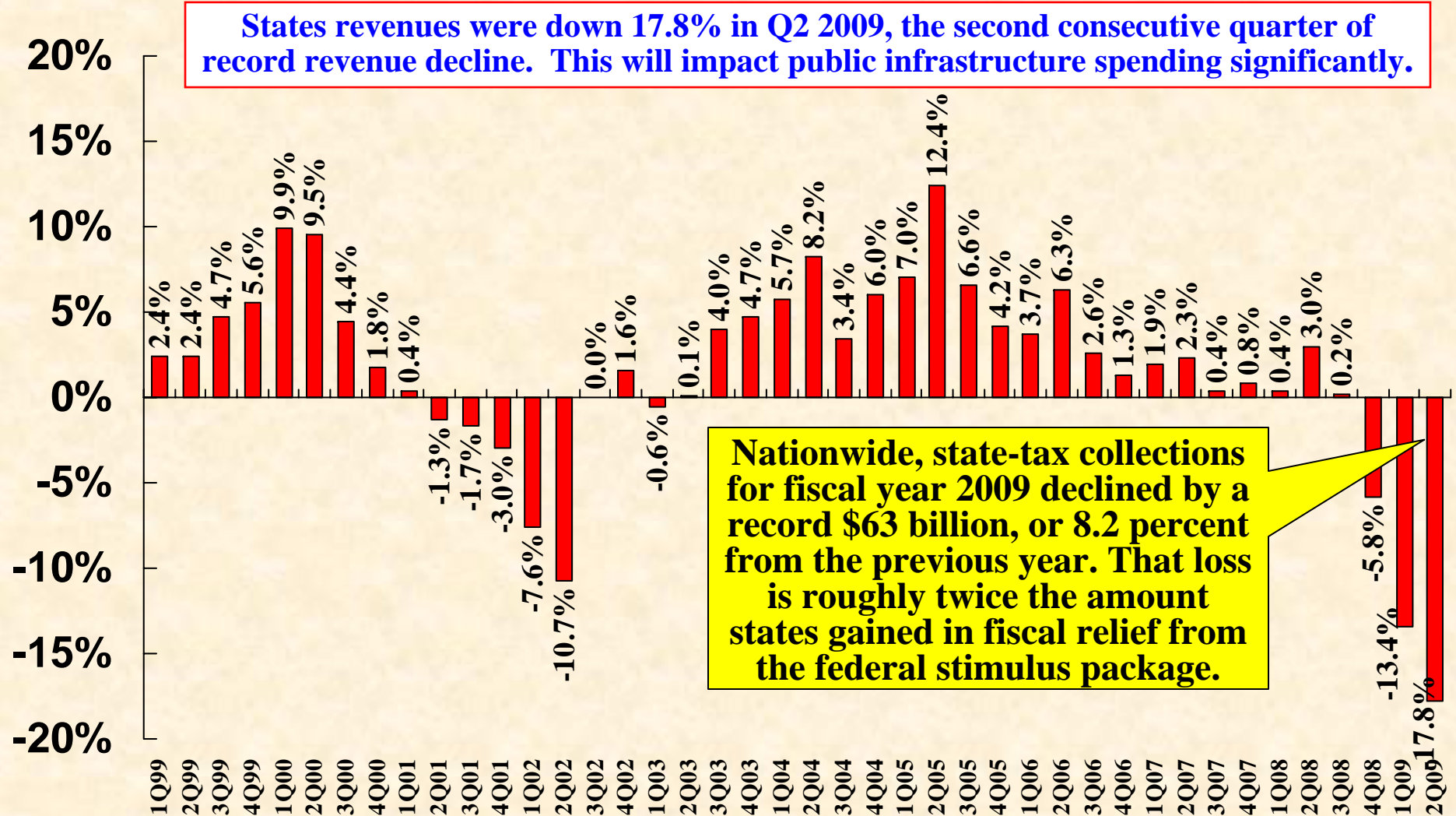
Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (10/09); Insurance Info. Inst.

# State & Local Government Finances in Dire Straights

Large, Long-Term Cuts Necessary to  
Align Spending with Shrinking  
Tax Revenues



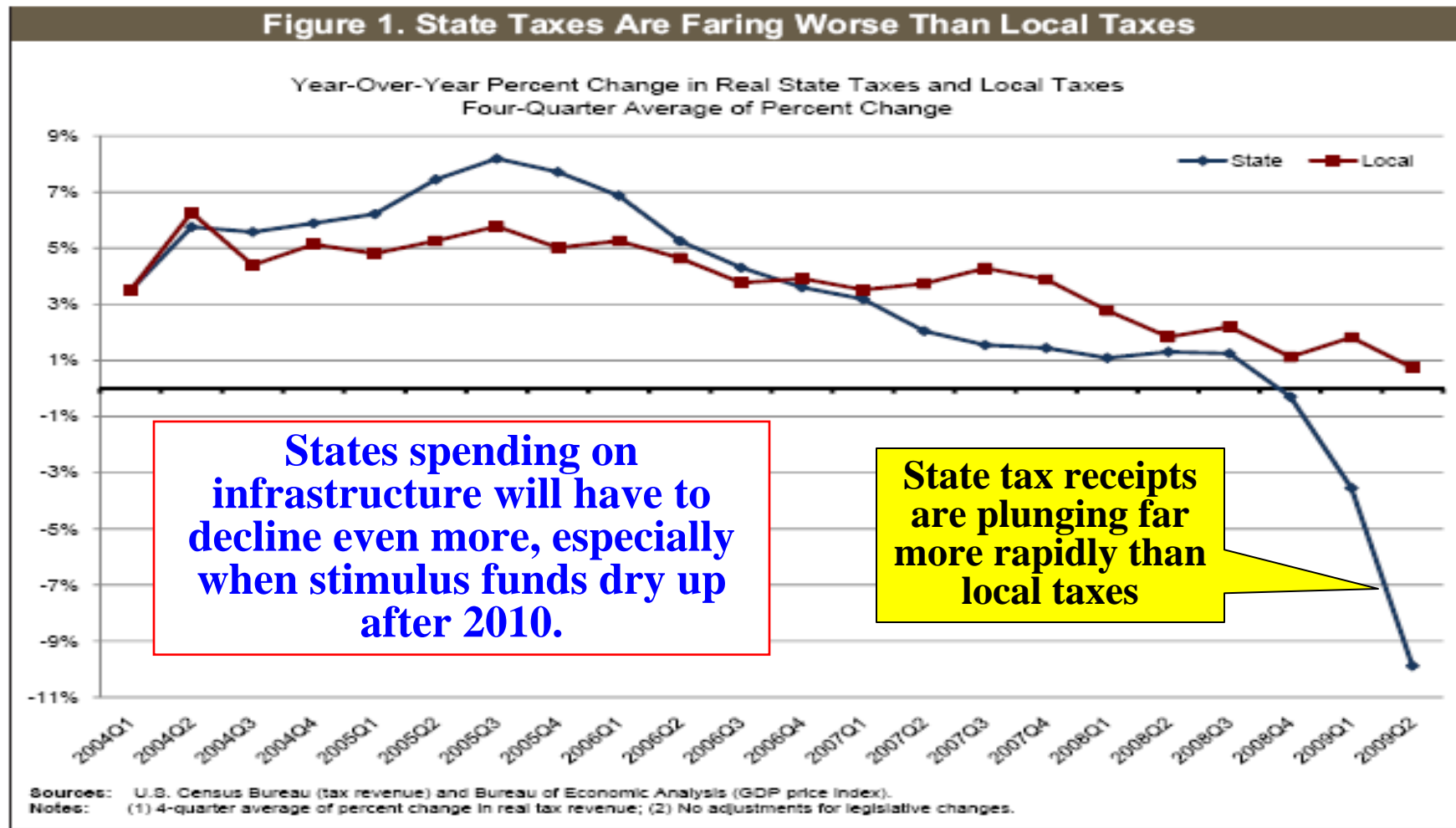
# *Year-Over-Year Change in Quarterly U.S. State Tax Revenues, Inflation Adjusted*



Source: U.S. Census Bureau; Nelson A. Rockefeller Institute of Government:

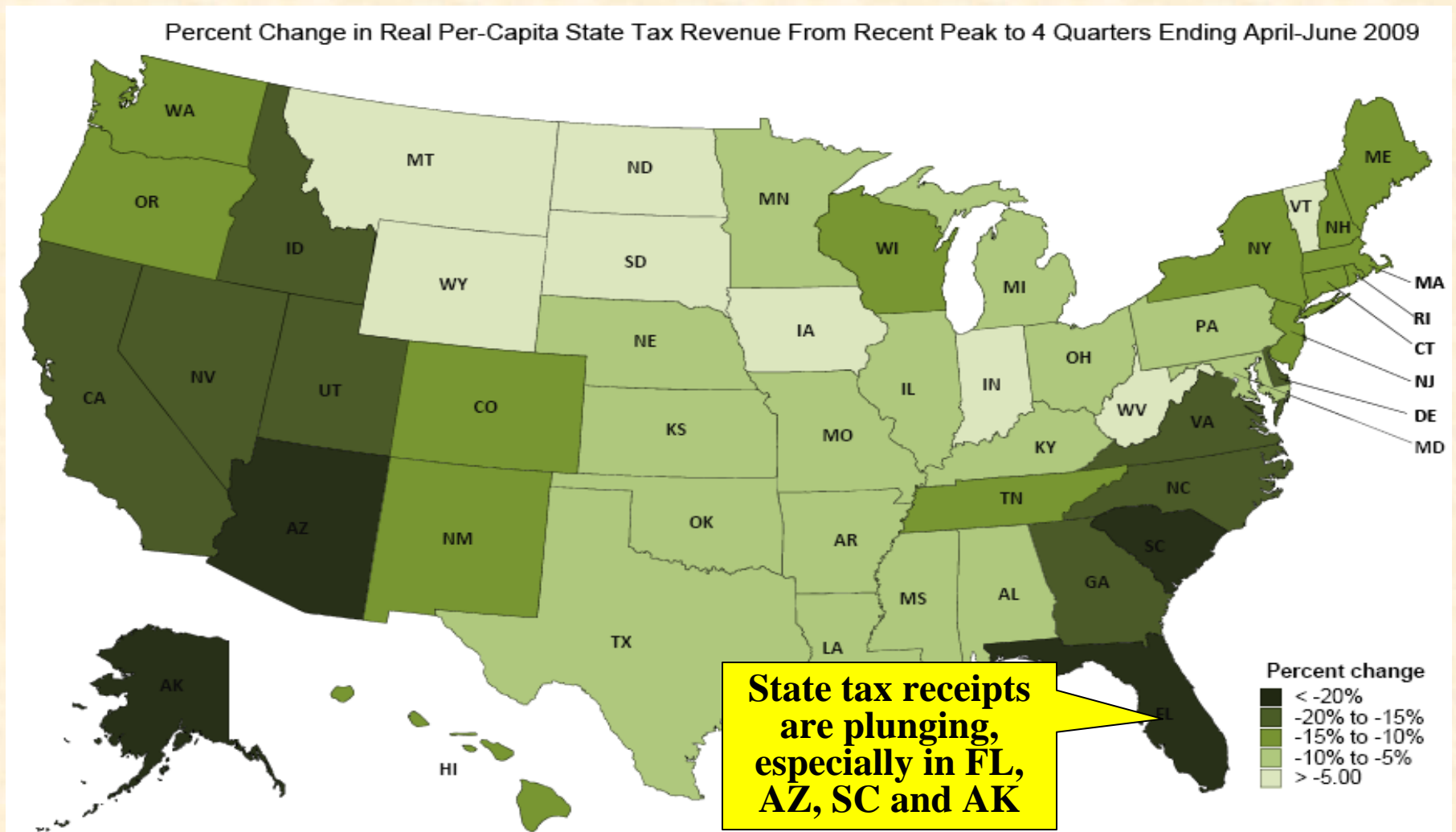
[http://www.rockinst.org/pdf/government\\_finance/state\\_revenue\\_report/2009-10-15-SRR\\_77.pdf](http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-10-15-SRR_77.pdf)

# Year-Over-Year Change in Quarterly State and Local Tax Revenues (Inflation Adjusted)





# *State Tax Revenue Growth Adjusted for Legislative Changes*

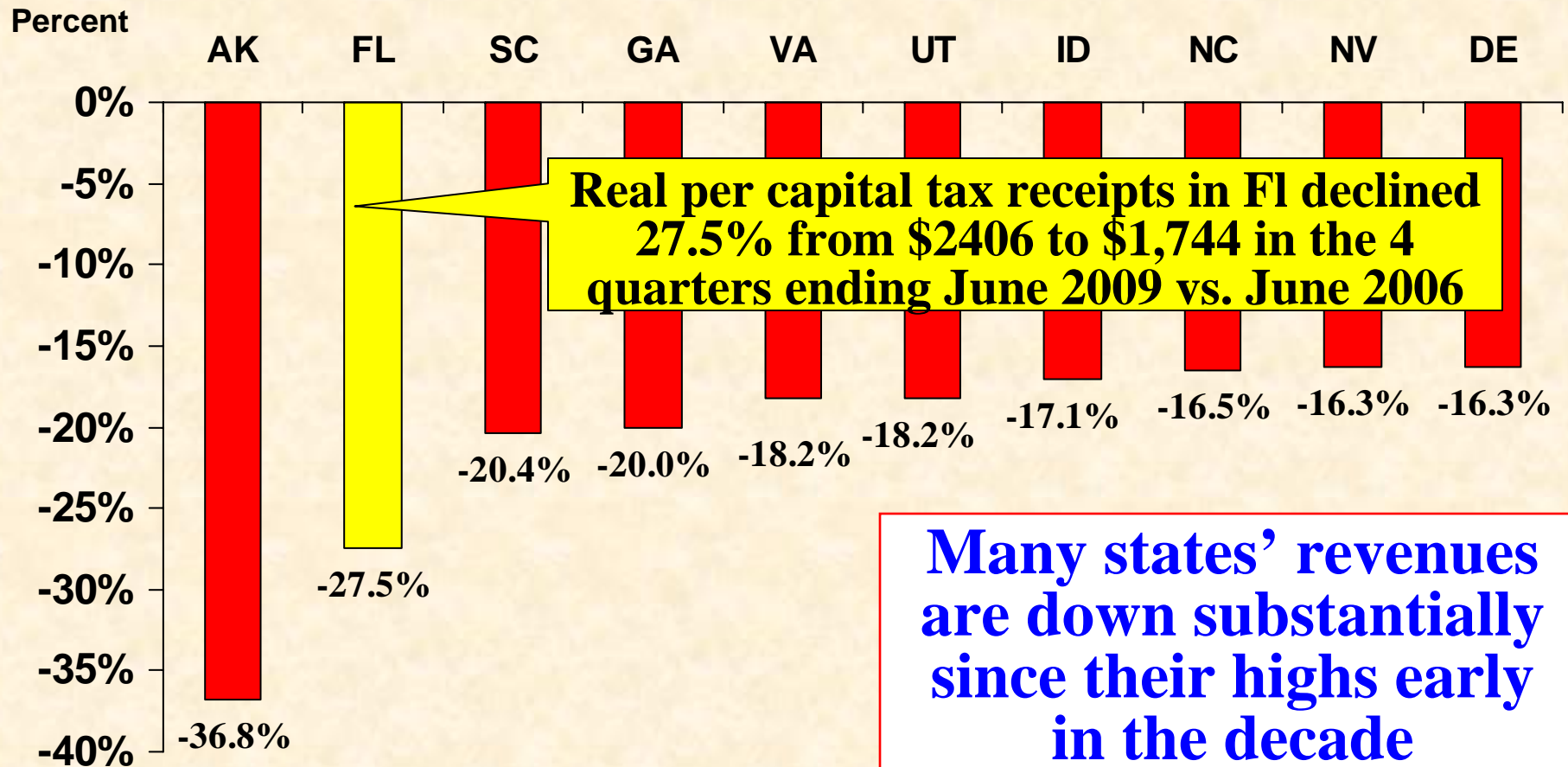


Source: U.S. Census Bureau and Bureau of Economic Analysis; Nelson A. Rockefeller Institute of Government:  
[http://www.rockinst.org/pdf/government\\_finance/state\\_revenue\\_report/2009-10-15-SRR\\_77.pdf](http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-10-15-SRR_77.pdf)



# *States with Fastest Decline in Real Per-Capita Tax Revenues*

**Period Ending April-June 2009 vs. Recent Peak\***



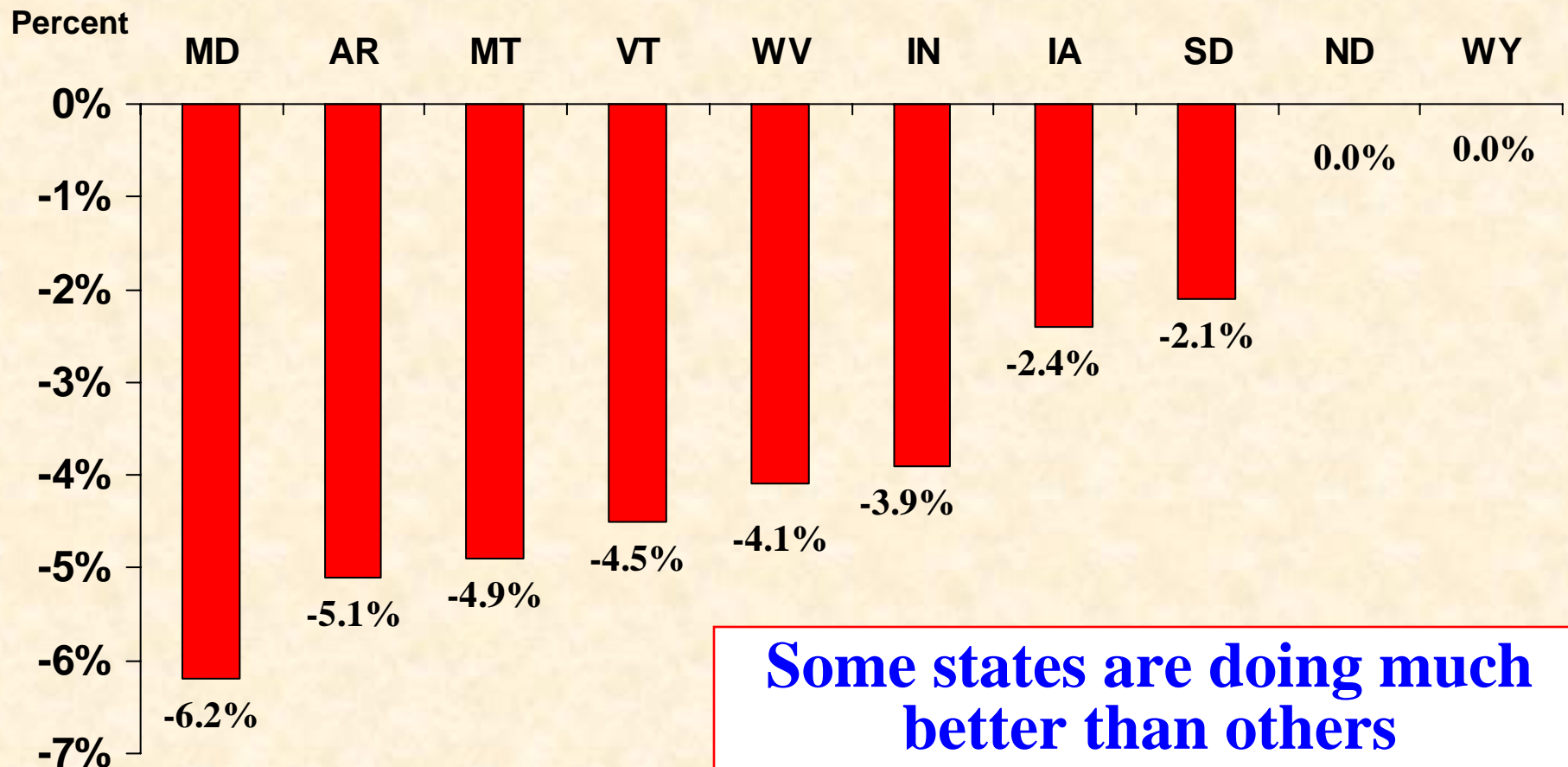
\*Peak defined as July – June period between 2006-2009 with highest peak per capita revenues.

Source: US Bureau of Economic Analysis; Nelson A. Rockefeller Institute of Govt.; Insurance Info. Inst.



# *States with Slowest Decline in Real Per-Capita Tax Revenues*

**Period Ending April-June 2009 vs. Recent Peak\***

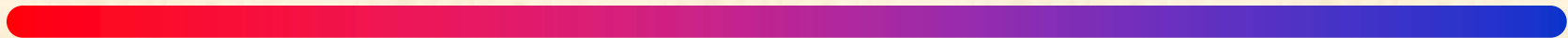


\*Peak defined as July – June period between 2006-2009 with highest peak per capita revenues.

Source: US Bureau of Economic Analysis; Nelson A. Rockefeller Institute of Govt.; Insurance Info. Inst.

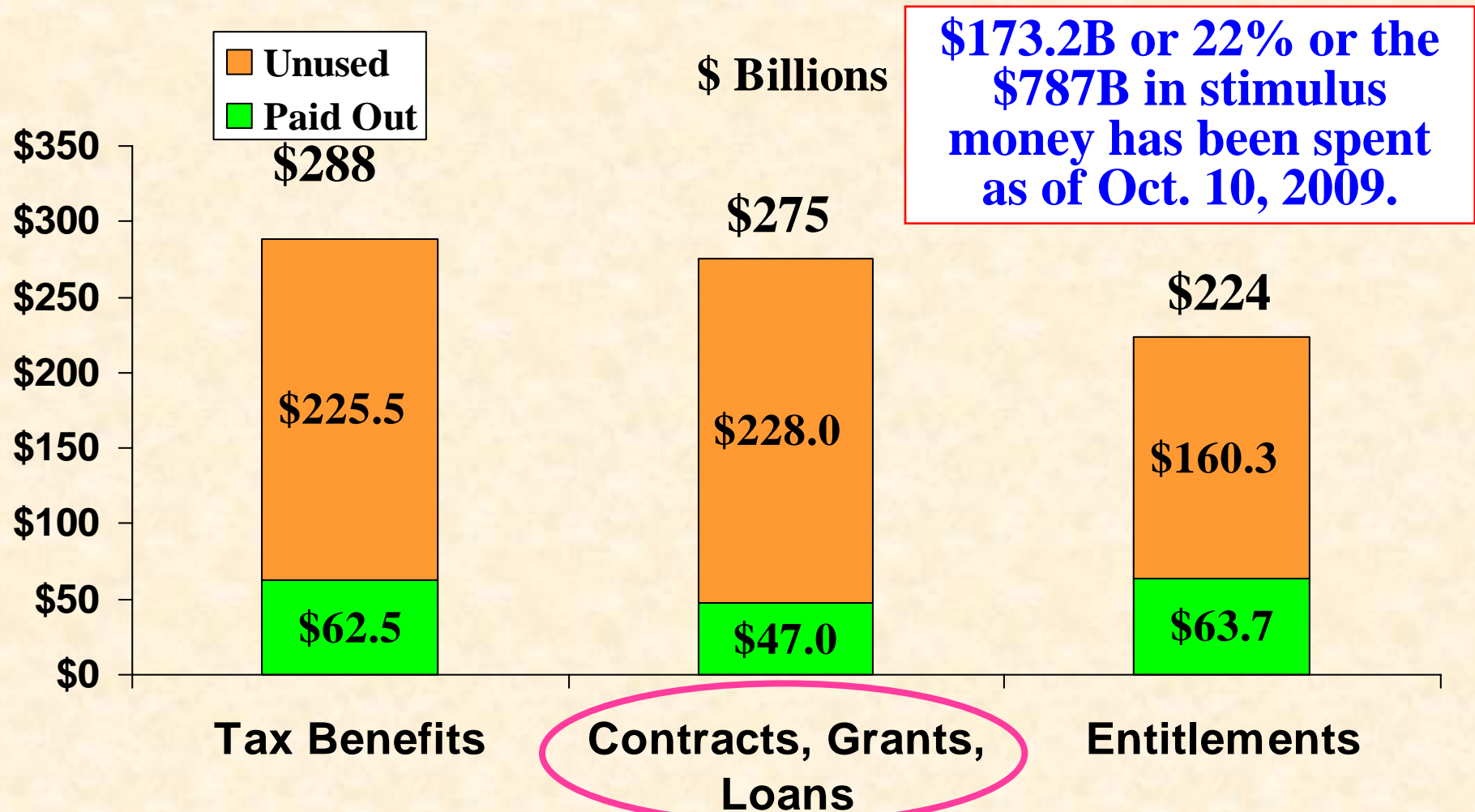
# State-by-State Infrastructure Spending & Job Gains

**Bigger States Get More, Should Benefit  
Commercial Insurers Exposure**





# *Distribution of \$787 B in Stimulus Funds\**



\*As of 10/10/09

Source: [www.recovery.gov](http://www.recovery.gov) accessed 10/17/09; Insurance Information Institute.





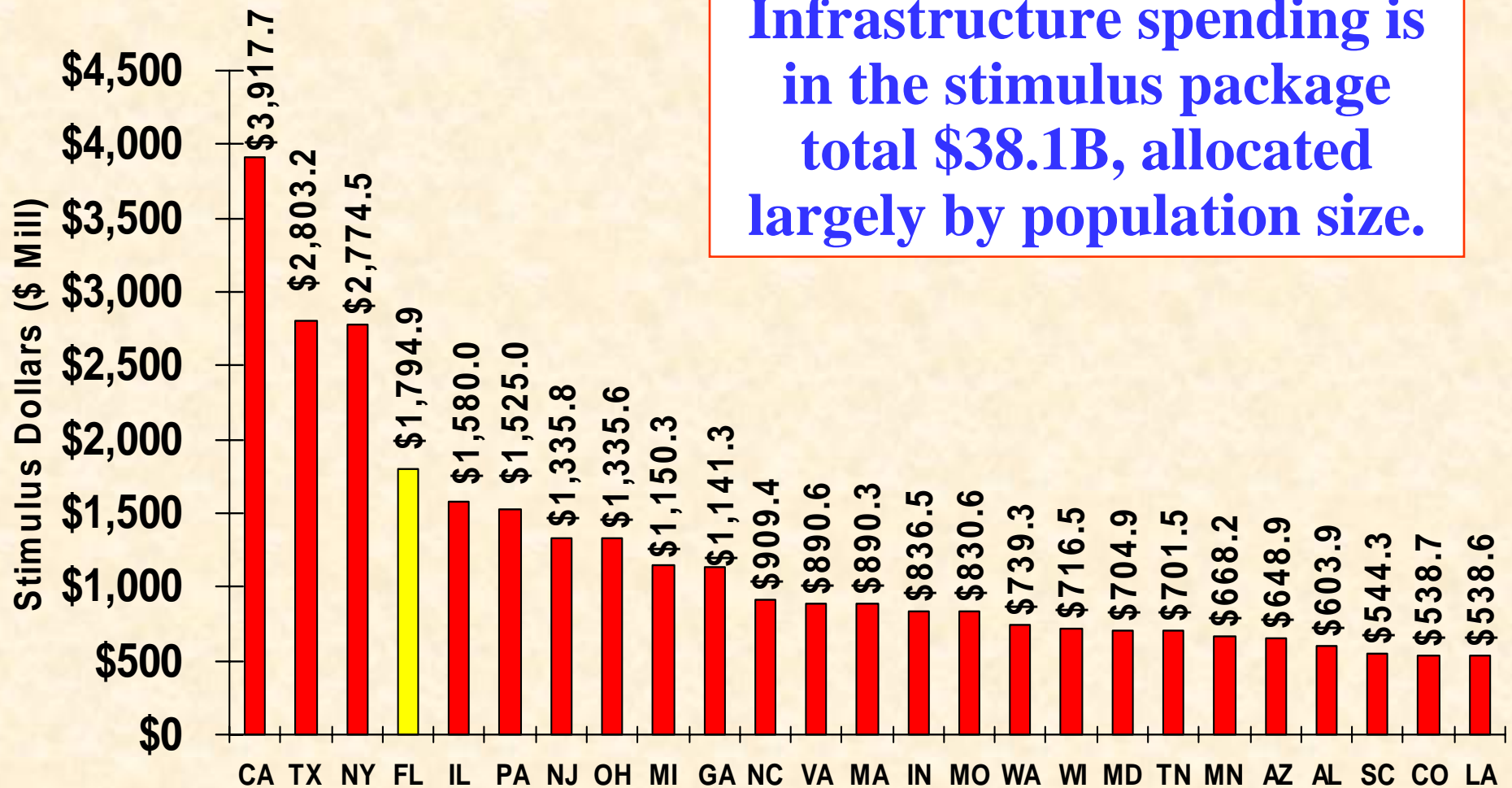
# Infrastructure Stimulus Spending by State (Total = \$38.1B)

State	Allocation	State	Allocation	State	Allocation
AL	\$603,871,807	LA	\$538,575,876	OK	\$535,407,908
AK	\$240,495,117	ME	\$174,285,111	OR	\$453,788,475
AZ	\$648,928,995	MD	\$704,863,248	PA	\$1,525,011,979
AR	\$405,531,459	MA	\$890,333,825	RI	\$192,902,023
CA	\$3,917,656,769	MI	\$1,150,282,308	SC	\$544,291,398
CO	\$538,669,174	MN	\$668,242,481	SD	\$213,511,174
CT	\$487,480,166	MS	\$415,257,720	TN	\$701,516,776
DE	\$158,666,838	MO	\$830,647,063	TX	\$2,803,249,599
DC	\$267,617,455	MT	\$246,599,815	UT	\$292,231,904
FL	\$1,794,913,566	NE	\$278,897,762	VT	\$150,666,577
GA	\$1,141,255,941	NV	\$270,010,945	VA	\$890,584,959
HI	\$199,866,172	NH	\$181,678,856	WA	\$739,283,923
ID	\$219,528,313	NJ	\$1,335,785,100	WV	\$290,479,108
IL	\$1,579,965,373	NM	\$299,589,086	WI	\$716,457,120
IN	\$836,483,568	NY	\$2,774,508,711	WY	\$186,111,170
IA	\$447,563,924	NC	\$909,397,136	U.S. Territories	\$238,045,760
KS	\$413,837,382	ND	\$200,318,301		
KY	\$521,153,404	OH	\$1,335,600,553	<b>Total</b>	<b>\$38,101,898,173</b>

Sources: USA Today, 2/17/09; House Transportation and Infrastructure Committee; the Associated Press.



# *Infrastructure Stimulus Spending By State: Top 25 States (\$ Millions)*

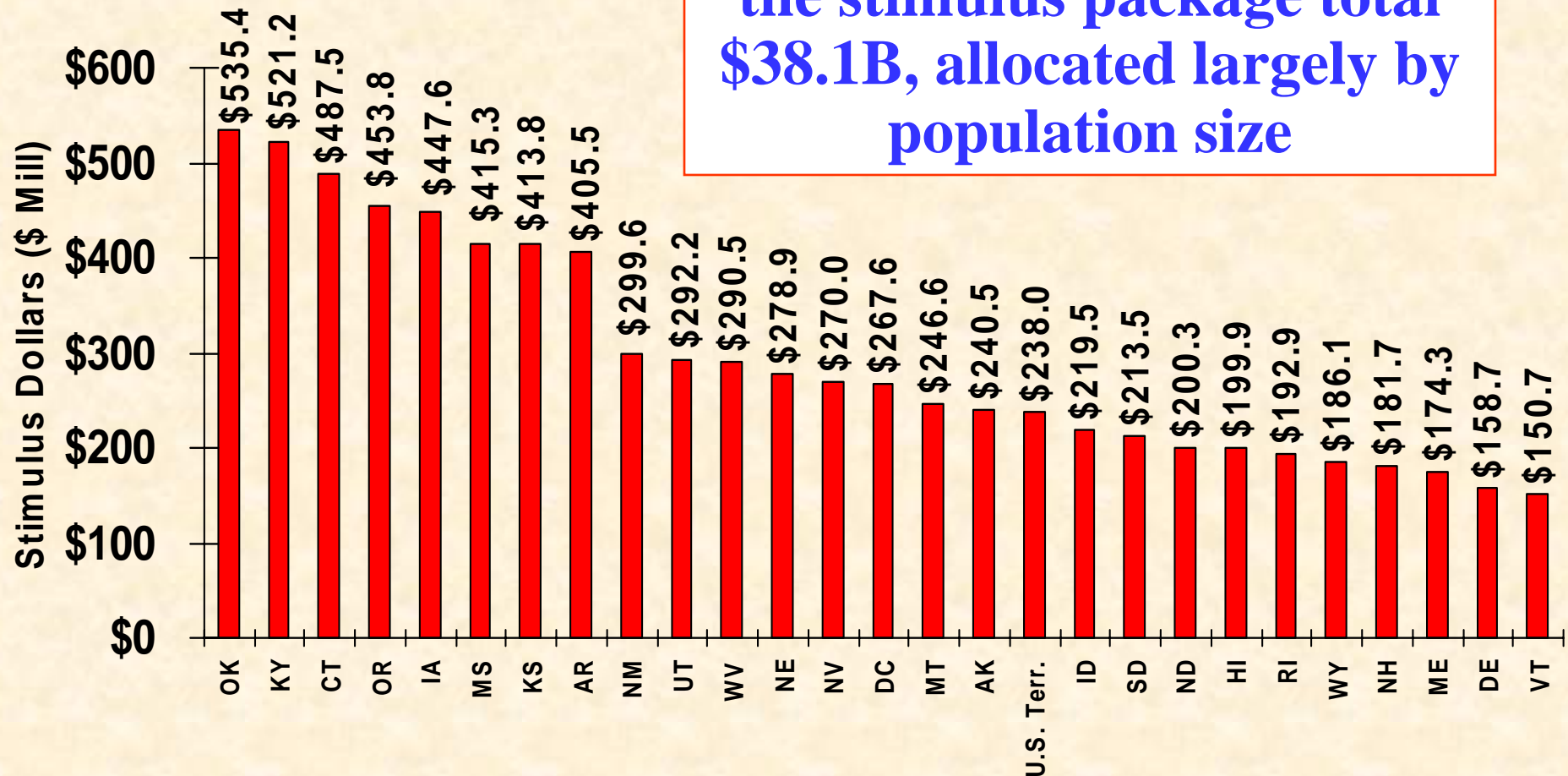


Sources: USA Today 2/19/09; House Transportation and Infrastructure Committee; the Associated Press.



# *Infrastructure Stimulus Spending By State: Bottom 25 States (\$ Millions)*

**Infrastructure spending is in the stimulus package total \$38.1B, allocated largely by population size**

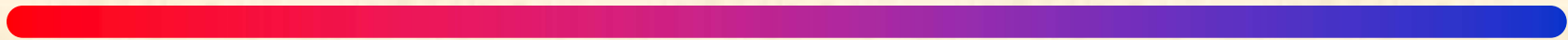


Sources: USA Today 2/19/09; House Transportation and Infrastructure Committee; the Associated Press.

# Expected Number of Jobs Gained or Preserved by Stimulus Spending

*Larger States = More Jobs*

*Workers Comp Benefits*





# *Estimated Job Effect of Stimulus: Jobs Created/Saved By State = 3.5 Mill Total*

State	Jobs Created	State	Jobs Created	State	Jobs Created
AL	52,000	LA	50,000	OK	40,000
AK	8,000	ME	15,000	OR	44,000
AZ	70,000	MD	66,000	PA	143,000
AR	32,000	MA	79,000	RI	12,000
CA	396,000	MI	109,000	SC	50,000
CO	60,000	MN	66,000	SD	10,000
CT	41,000	MS	30,000	TN	71,000
DE	11,000	MO	69,000	TX	269,000
DC	12,000	MT	11,000	UT	32,000
FL	207,000	NE	23,000	VT	8,000
GA	107,000	NV	34,000	VA	93,000
HI	16,000	NH	16,000	WA	75,000
ID	17,000	NJ	100,000	WV	20,000
IL	148,000	NM	22,000	WI	70,000
IN	75,000	NY	215,000	WY	8,000
IA	37,000	NC	105,000		
KS	33,000	ND	9,000		
KY	48,000	OH	133,000	<b>Total</b>	<b>3,467,000</b>

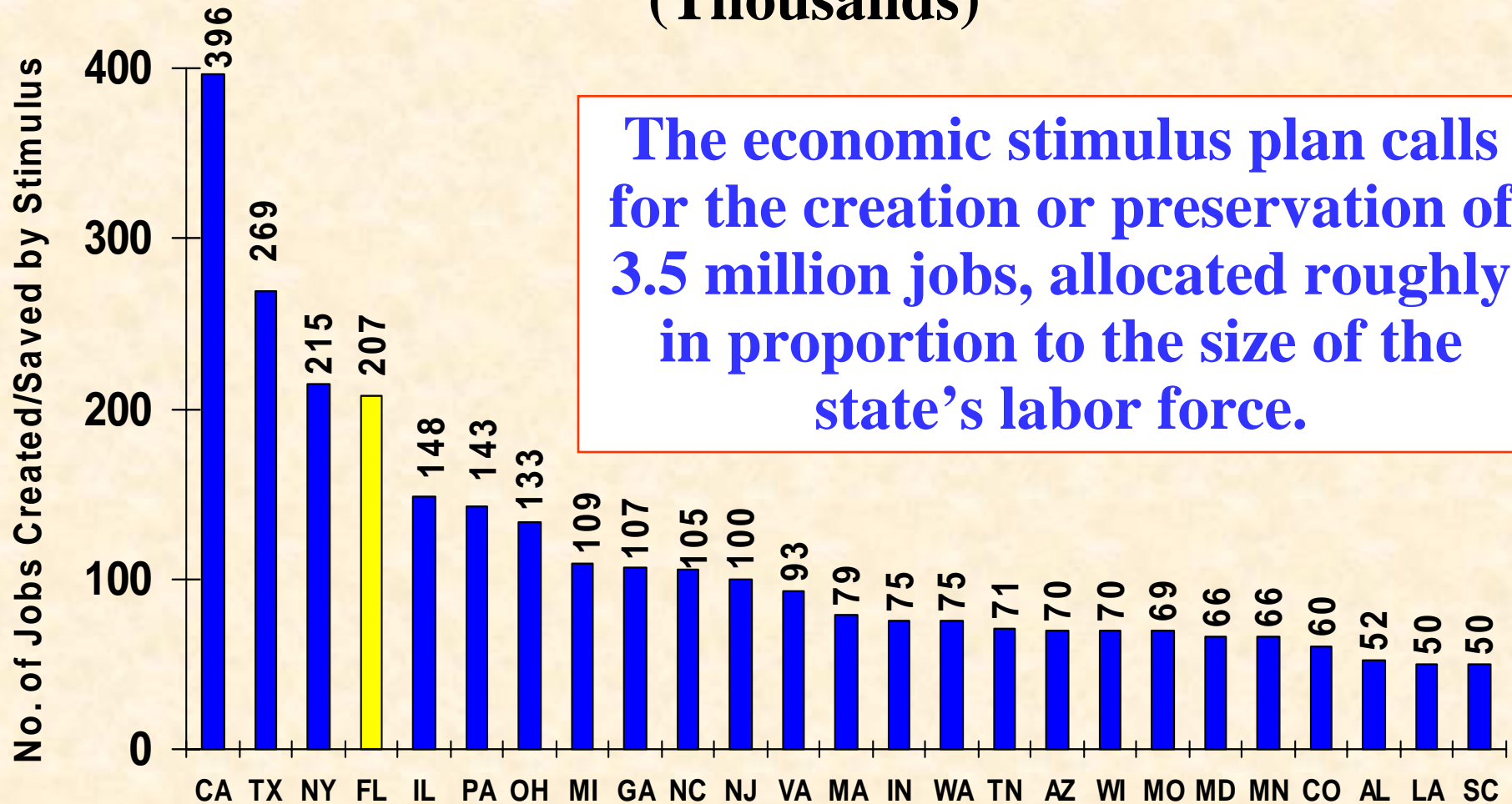
Sources: <http://www.recovery.gov/>; Council of Economic Advisers; Insurance Information Institute.





# *Estimated Job Effect of Stimulus Spending By State: Top 25 States*

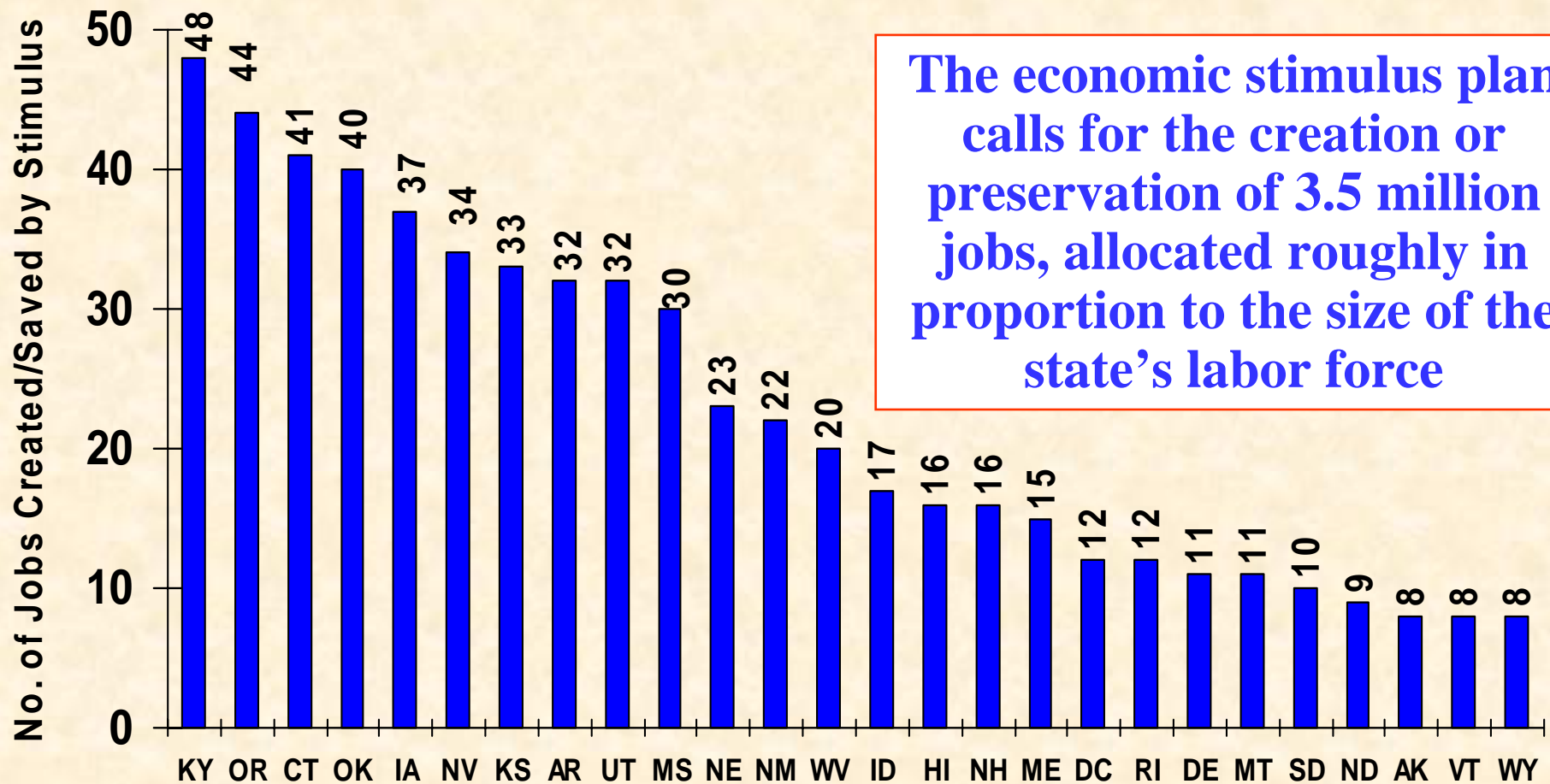
(Thousands)





# *Estimated Job Effect of Stimulus Spending By State: Bottom 25 States*

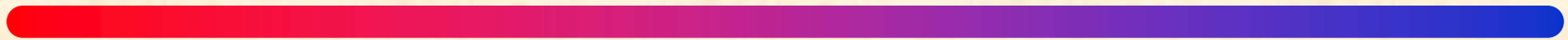
(Thousands)



Sources: <http://www.recovery.gov/>; Council of Economic Advisers Insurance Information Institute.

# GREEN SHOOTS

*Is the Recession  
Nearing an End?*





# *Hopeful Signs that the*

# *Economic Recovery Is Underway*

- **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 very credit worthy people & businesses
- **Housing Sector Seems To Be Bottoming Out**
  - 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**



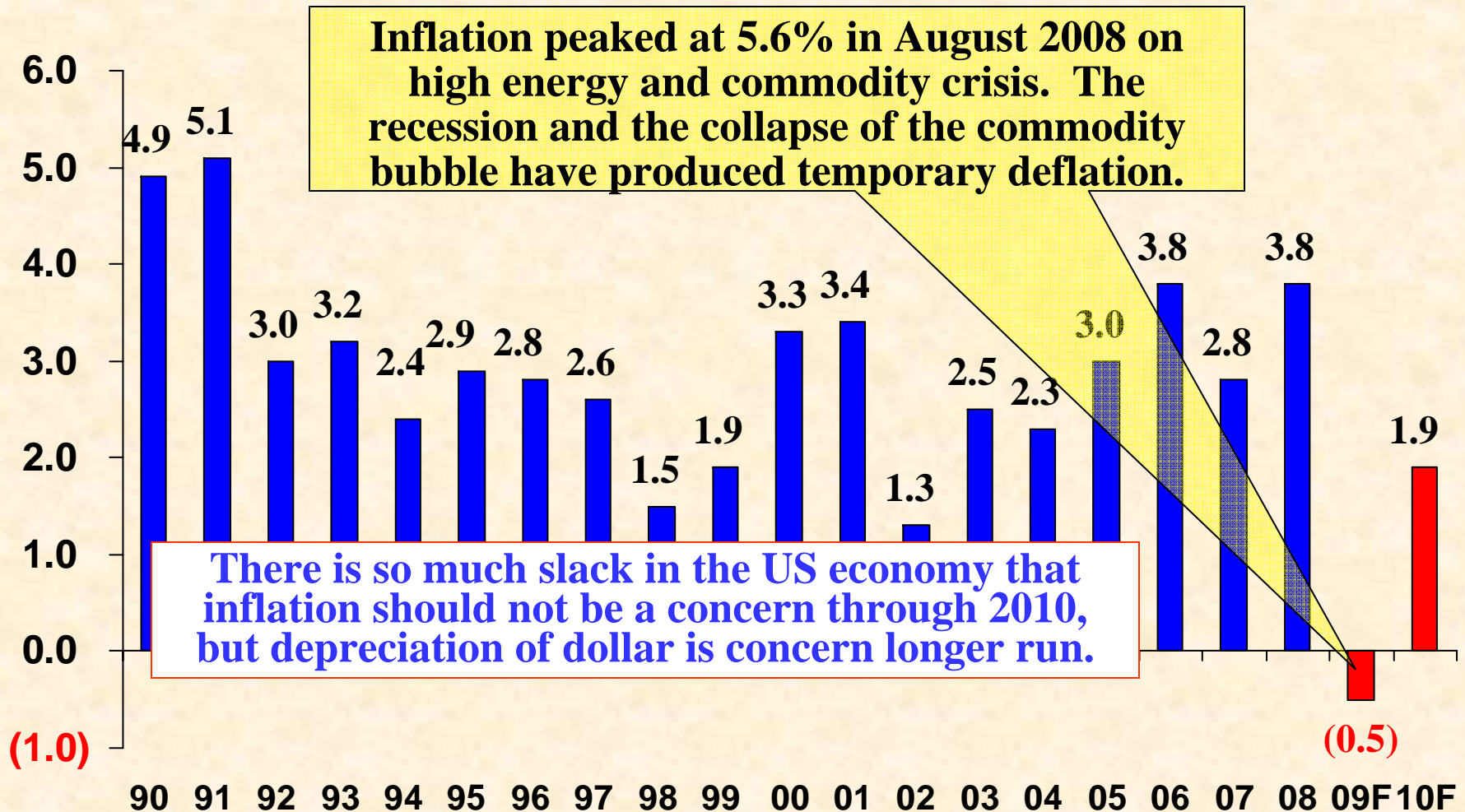
# **Inflation Trends:** *Concerns Over Stimulus Spending and Monetary Policy*

**Mounting Pressure on**  
** Claim Cost Severities?**

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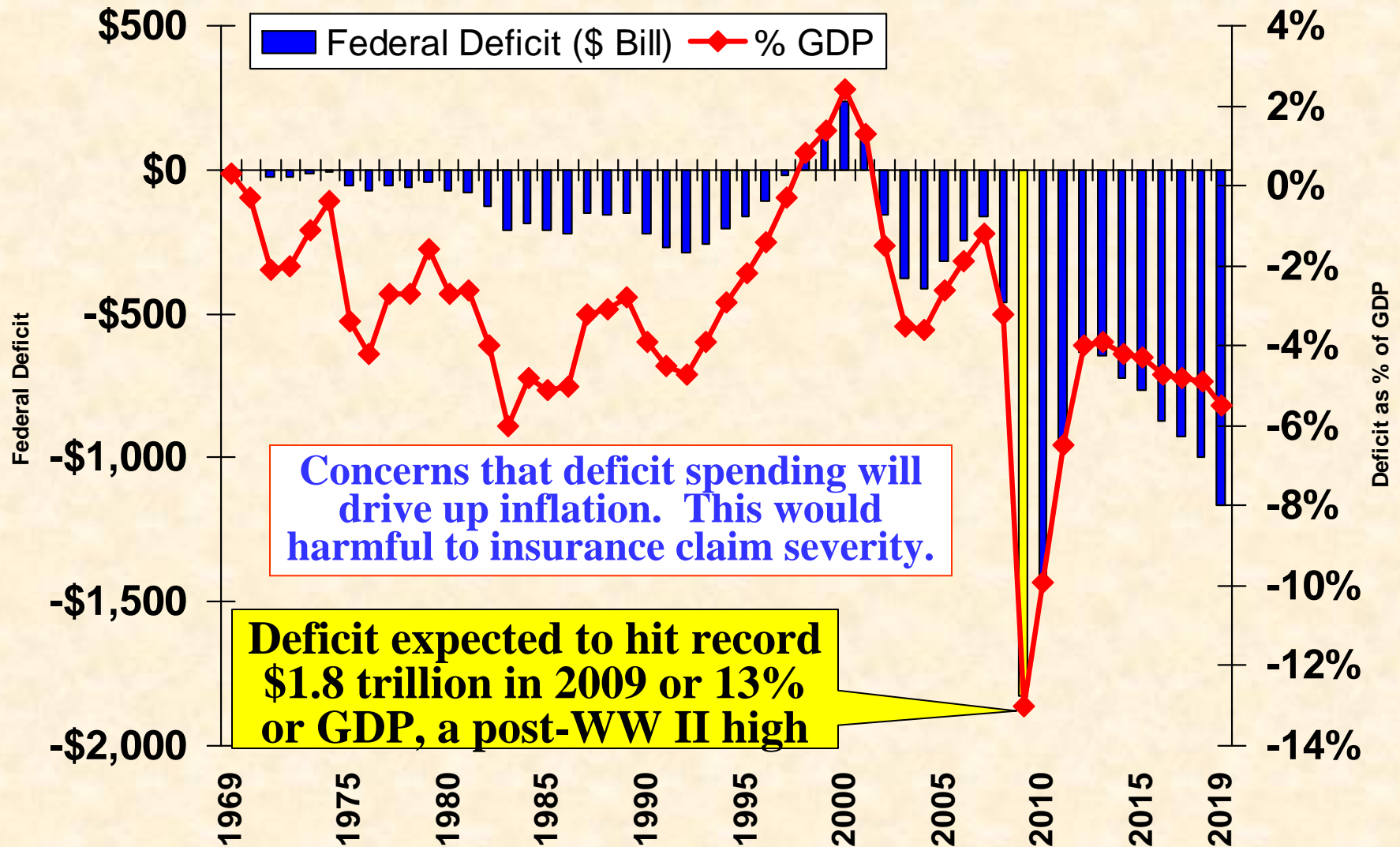
# *Annual Inflation Rates (CPI-U, %), 1990-2010F*



Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators, Oct. 10, 2009 (forecasts).<sup>50</sup>



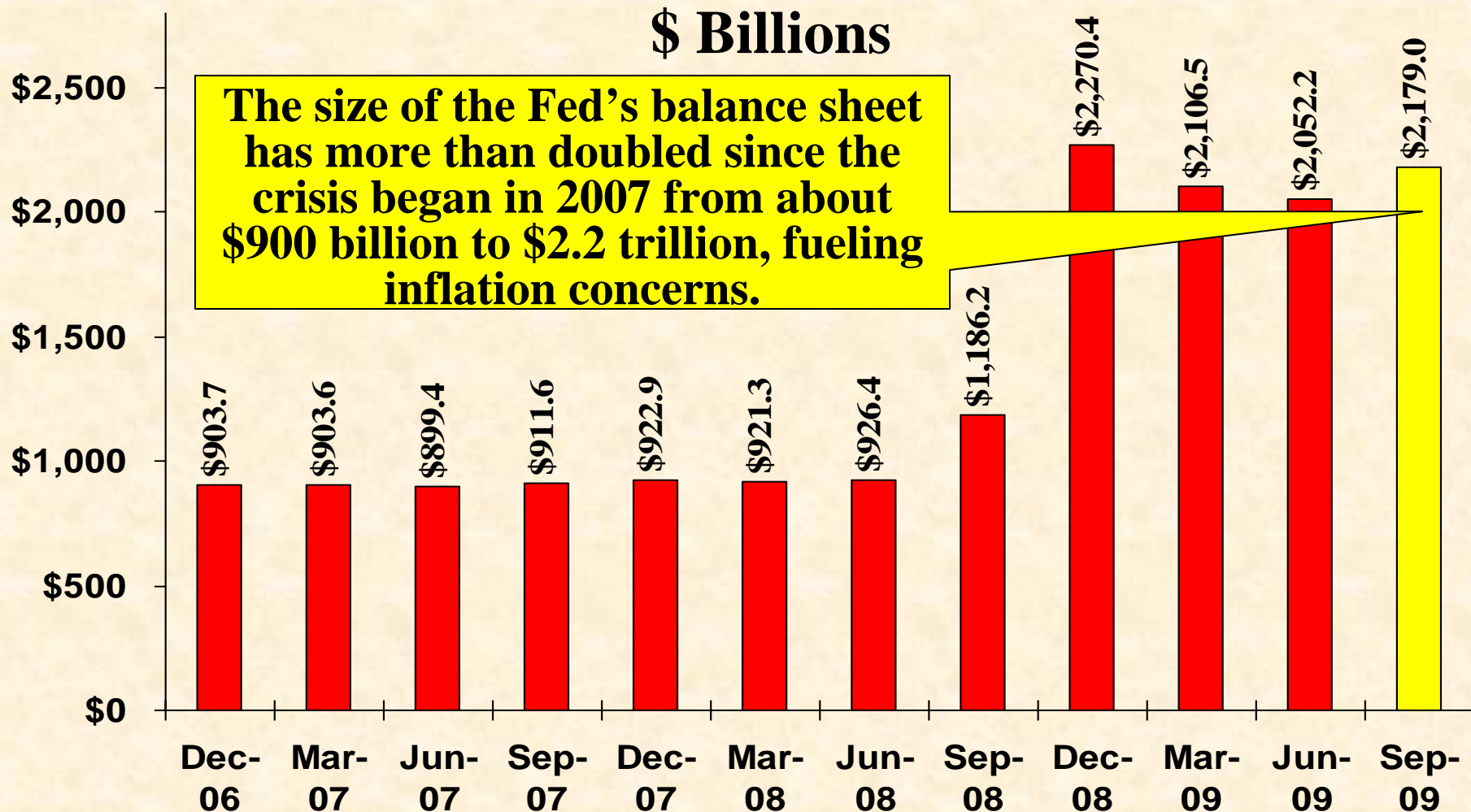
# US Budget Deficit, 1969-2019F



Sources: Congressional Budget Office analysis of President's budget, March 2009; Insurance Information Institute.



# *Balance Sheet of the Federal Reserve, Dec. 2006- Sept. 2009\**



\*As of final Friday in each quarter.

Source: Federal Reserve: <http://www.federalreserve.gov/releases/h41/hist/h41hist1.htm>



# *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



# 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 were larger and occurred more rapidly than is commonly understood or presumed
- Max surplus loss at 3/31/09 was 16%=\$85B from 9/30/07 peak
- P/C policyholder surplus loss could have been much larger
- Decline in PHS of 1999-2002 was 15% over 3 years and was entirely made up and then some in 2003. Current decline was ~16% 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 fell farther and faster than many believed possible. It will take years to return to the 2007 peaks—likely 2011 (without market relapse).



# *Important Issues & Threats Facing Insurers: 2009 - 2015*

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

- Continued asset price erosion coupled with major “capital event” would have led 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 (relative “risk-free” rates), 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
- 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



# *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)
- Strong arguments for Optional Federal Charter, but...
- Pushing for major change is not without risk in the current highly charged political environment
- Dangers exist if feds get their nose under the tent
- Status Quo is viewed as unacceptable by all
- Disunity within the insurance industry
- Insurance & systemic risk—Who is important?
- Impact of regulatory changes will be felt for decades
- **Bottom Line: Regulatory outcome is uncertain and risk of adverse outcome exists**





# *Important Issues & Threats Facing Insurers: 2009 -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 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**



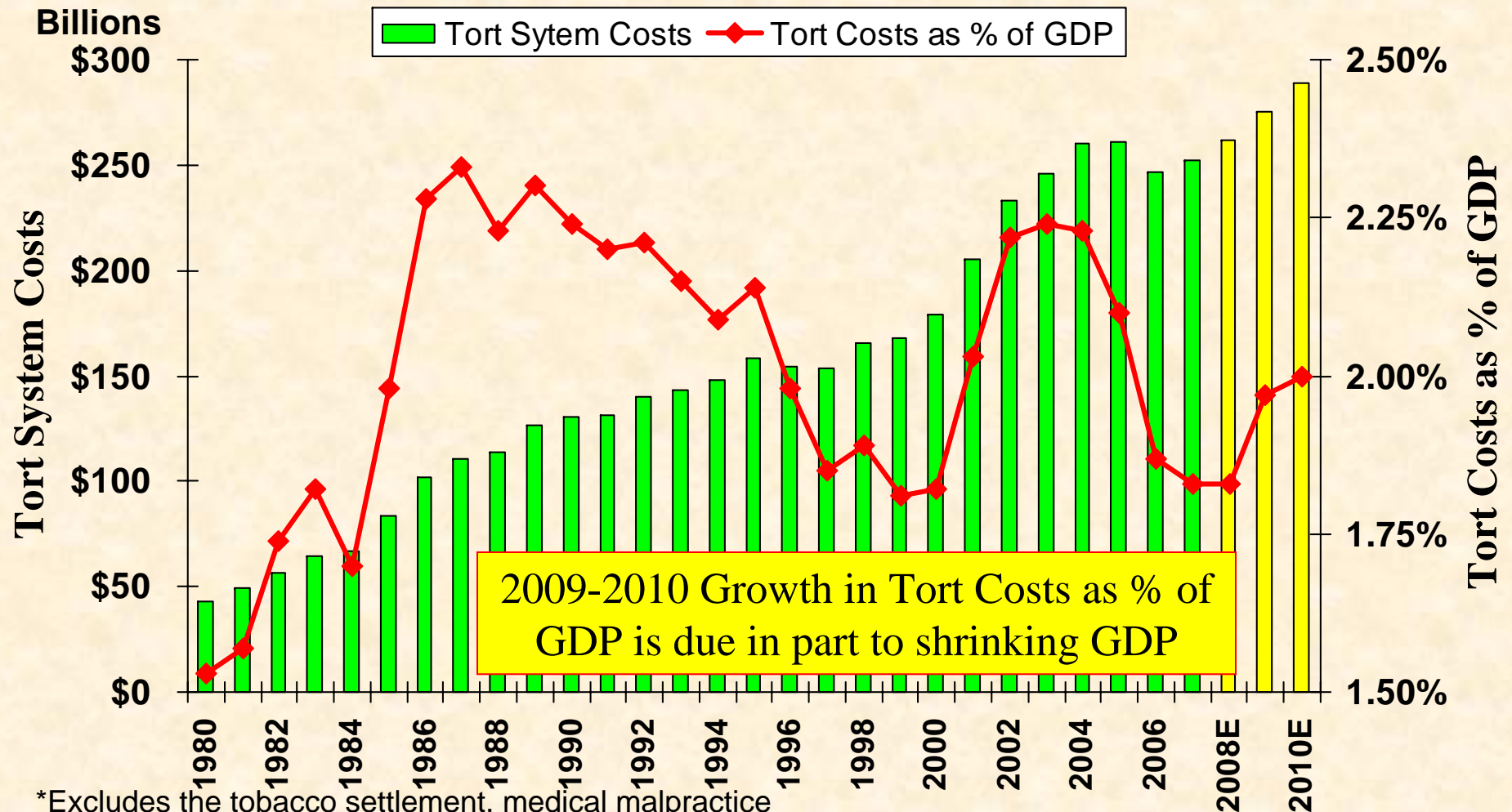
# Shifting Legal Liability & Tort Environment

*Is the Tort Pendulum  
Swinging Against Insurers?*





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



\*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 (2008/2009)*

## **Watch List**

***Rio Grande Valley & Gulf Coast, TX***

***Madison County, IL***

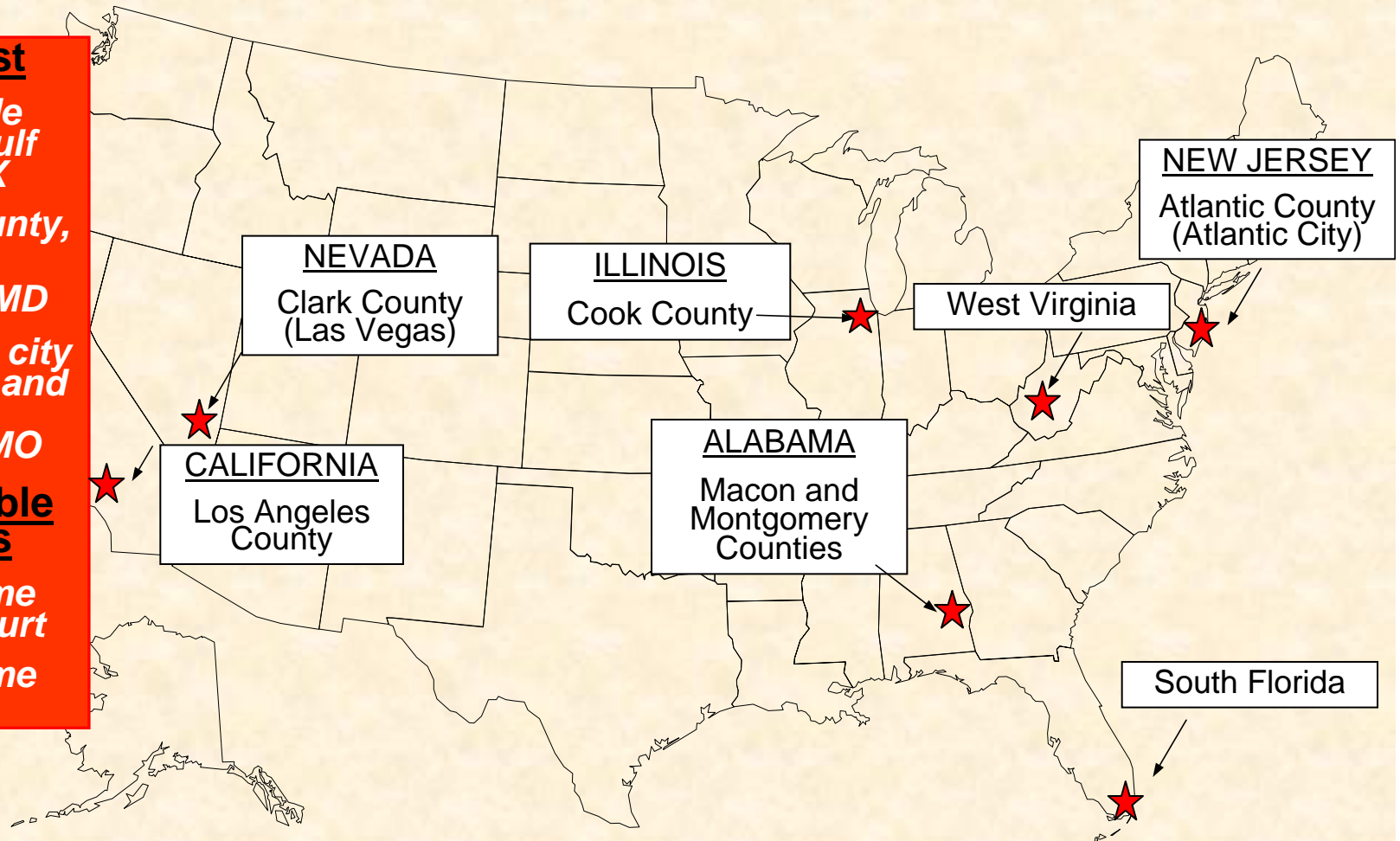
***Baltimore, MD***

***St Louis (the city of), St Louis and Jackson Counties, MO***

## **Dishonorable Mentions**

***MA Supreme Judicial Court***

***MO Supreme Court***



# **FINANCIAL STRENGTH & RATINGS**

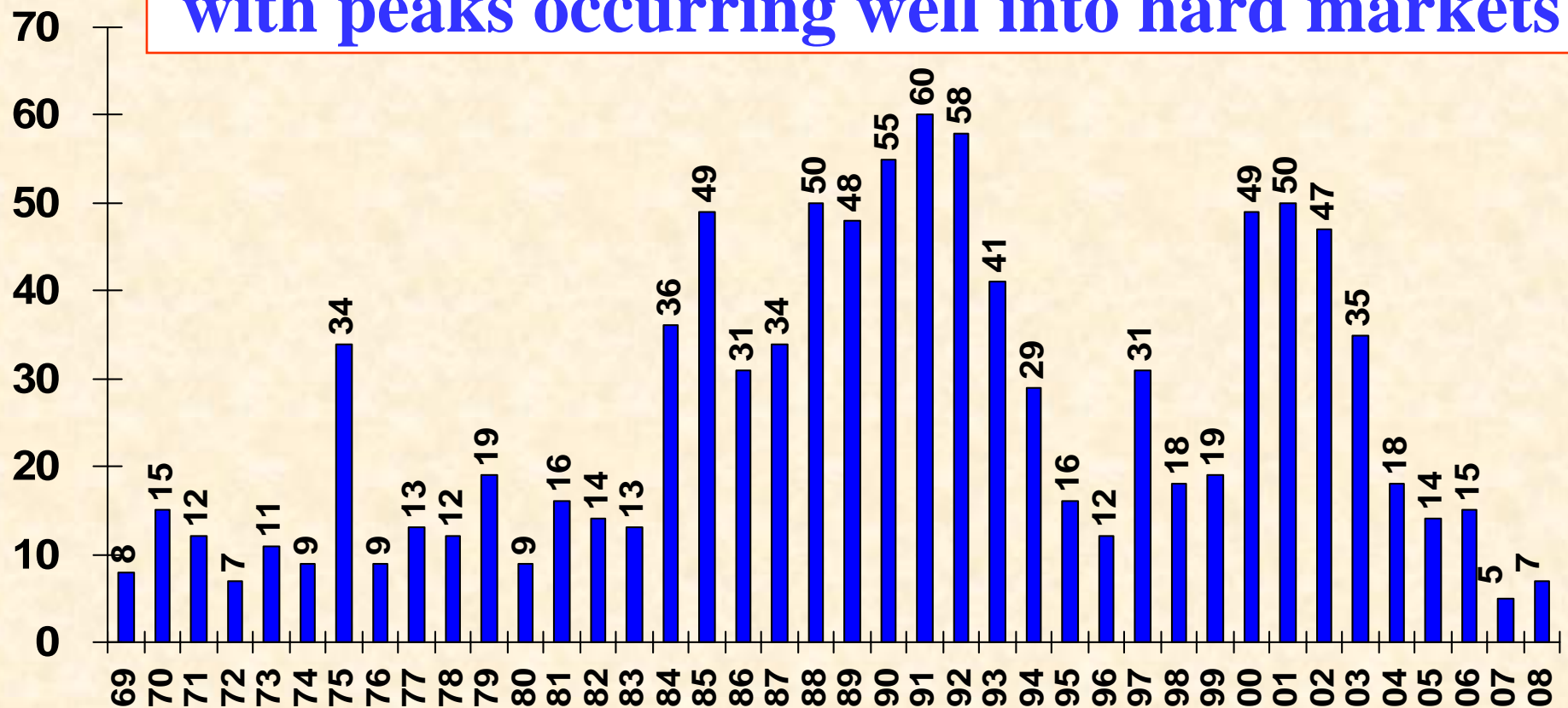
**Industry Has Weathered  
the Storms Well**





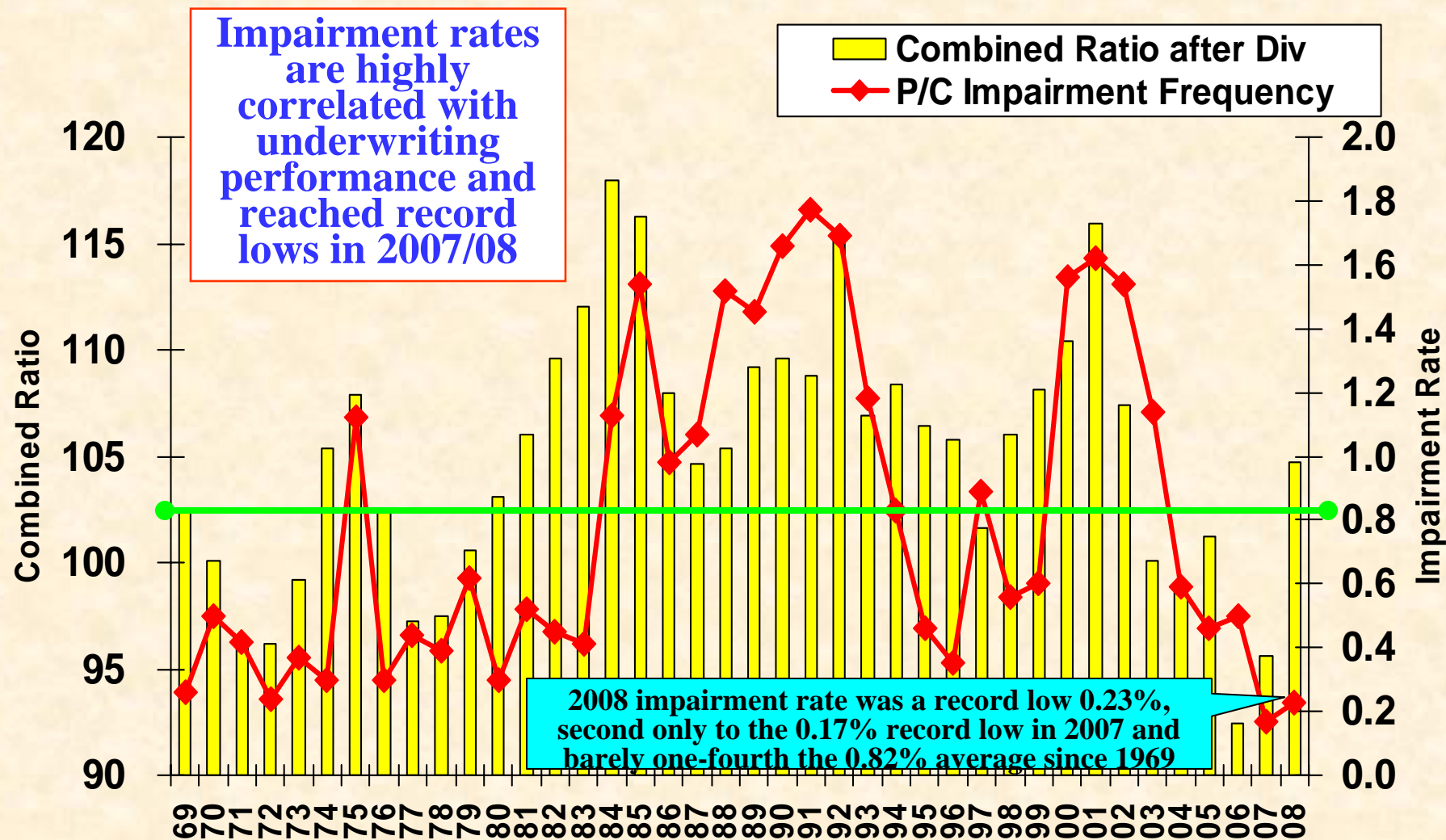
# *P/C Insurer Impairments, 1969-2008*

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





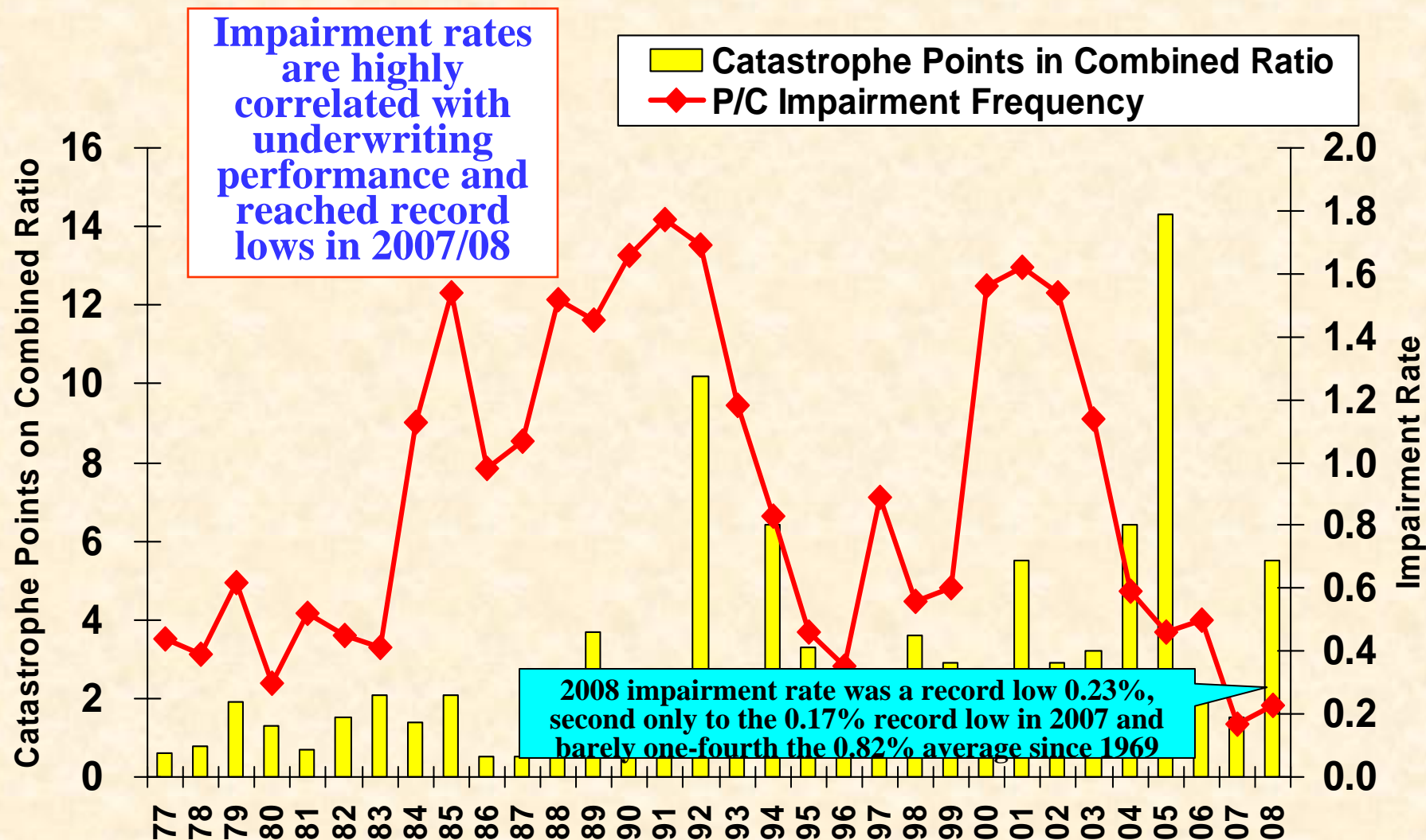
# *P/C Insurer Impairment Frequency vs. Combined Ratio, 1969-2008*







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



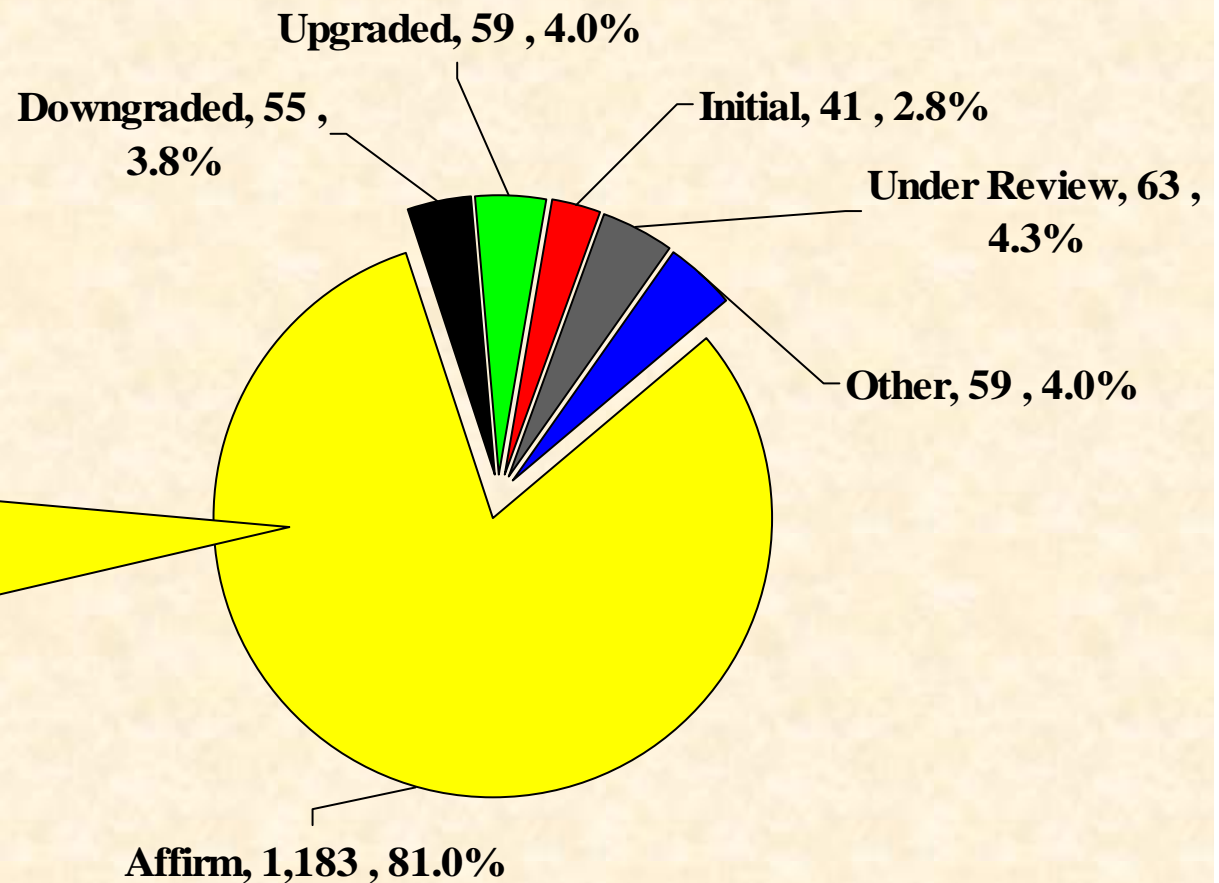
Source: A.M. Best, PCS; Insurance Information Institute



# 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

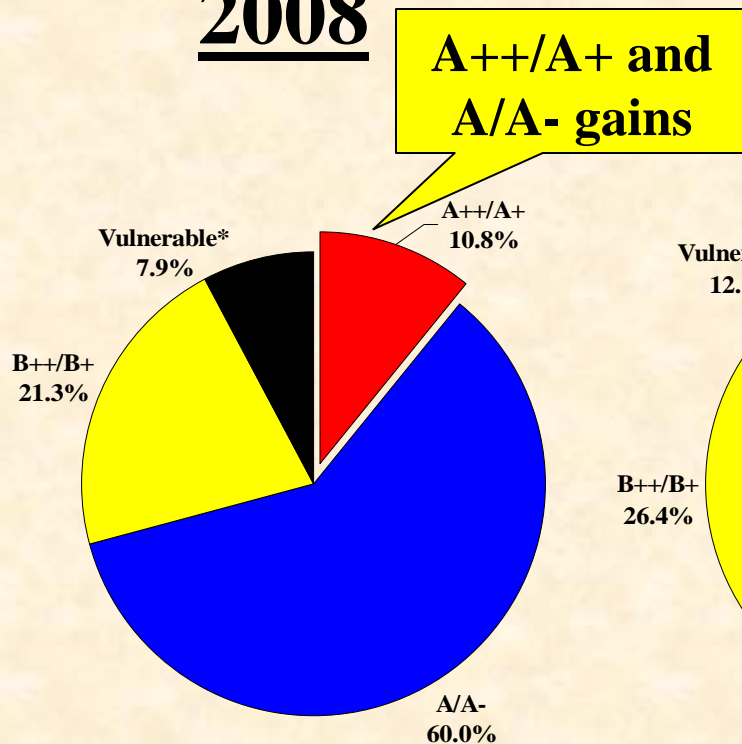


\*Through December 19.  
Source: A.M. Best.

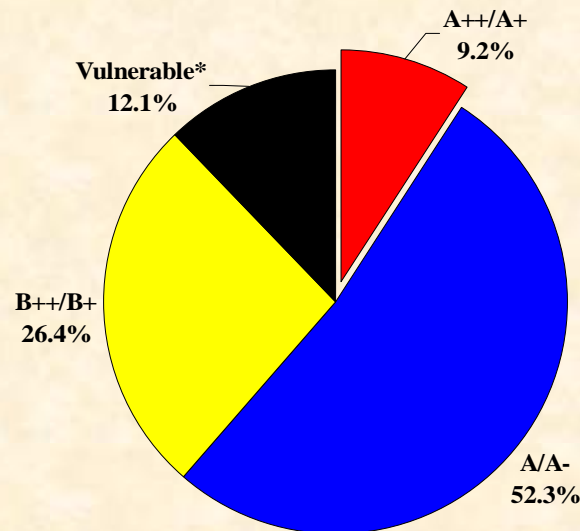


# Historical Ratings Distribution, US P/C Insurers, 2008 vs. 2005 and 2000

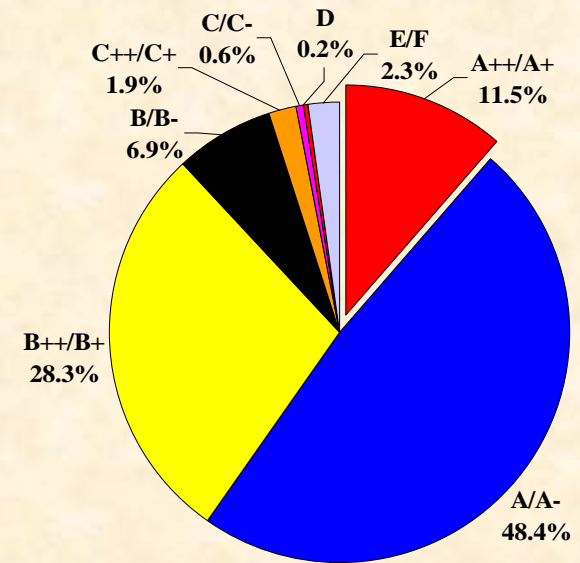
**2008**



**2005**



**2000**

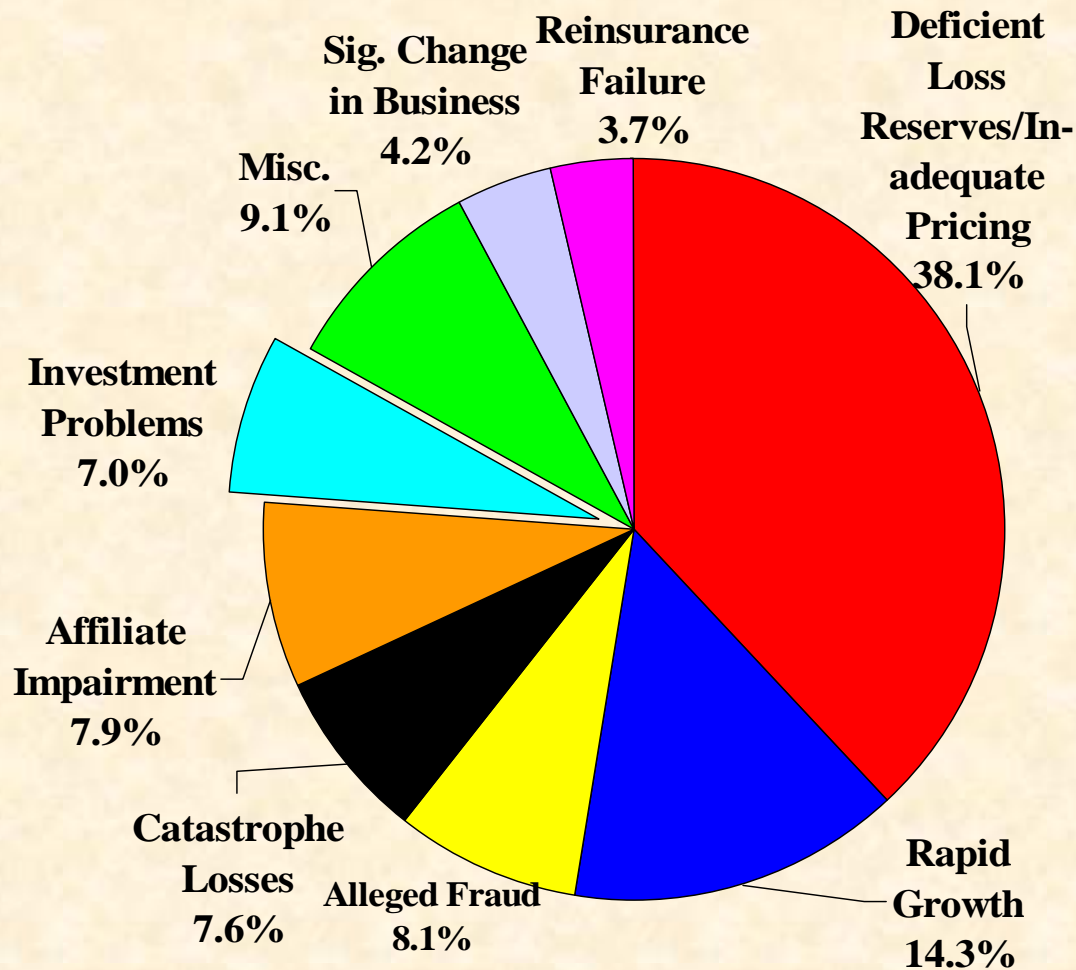


**P/C insurer financial strength  
has improved since 2005  
despite financial crisis**

Source: A.M. Best: *Rating Downgrades Slowed but Outpaced Upgrades for Fourth Consecutive Year*, Special Report, November 8, 2004 for 2000; 2006 and 2009 Review & Preview. \*Ratings 'B' and lower.



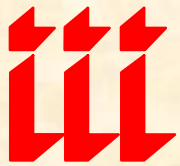
# *Reasons for US P/C Insurer Impairments, 1969-2008*



**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 123 banks have gone under as of 10/2/09)**
    - ***The Promise is Being Fulfilled***
  - **Renew existing policies (banks are reducing and eliminating lines of credit)**
  - **Write new policies (banks are turning away people 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

# Regulatory Reform

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

 Status: Stalled in Congress

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# *Obama Regulatory Reform Proposal: Plan Components*

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## **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 financial 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

# **P/C INSURANCE FINANCIAL PERFORMANCE**

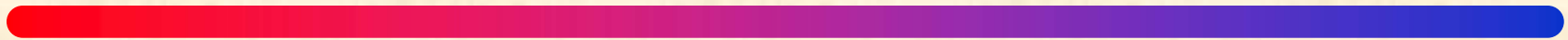
**A Resilient Industry in  
 Challenging Times**

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# Profitability

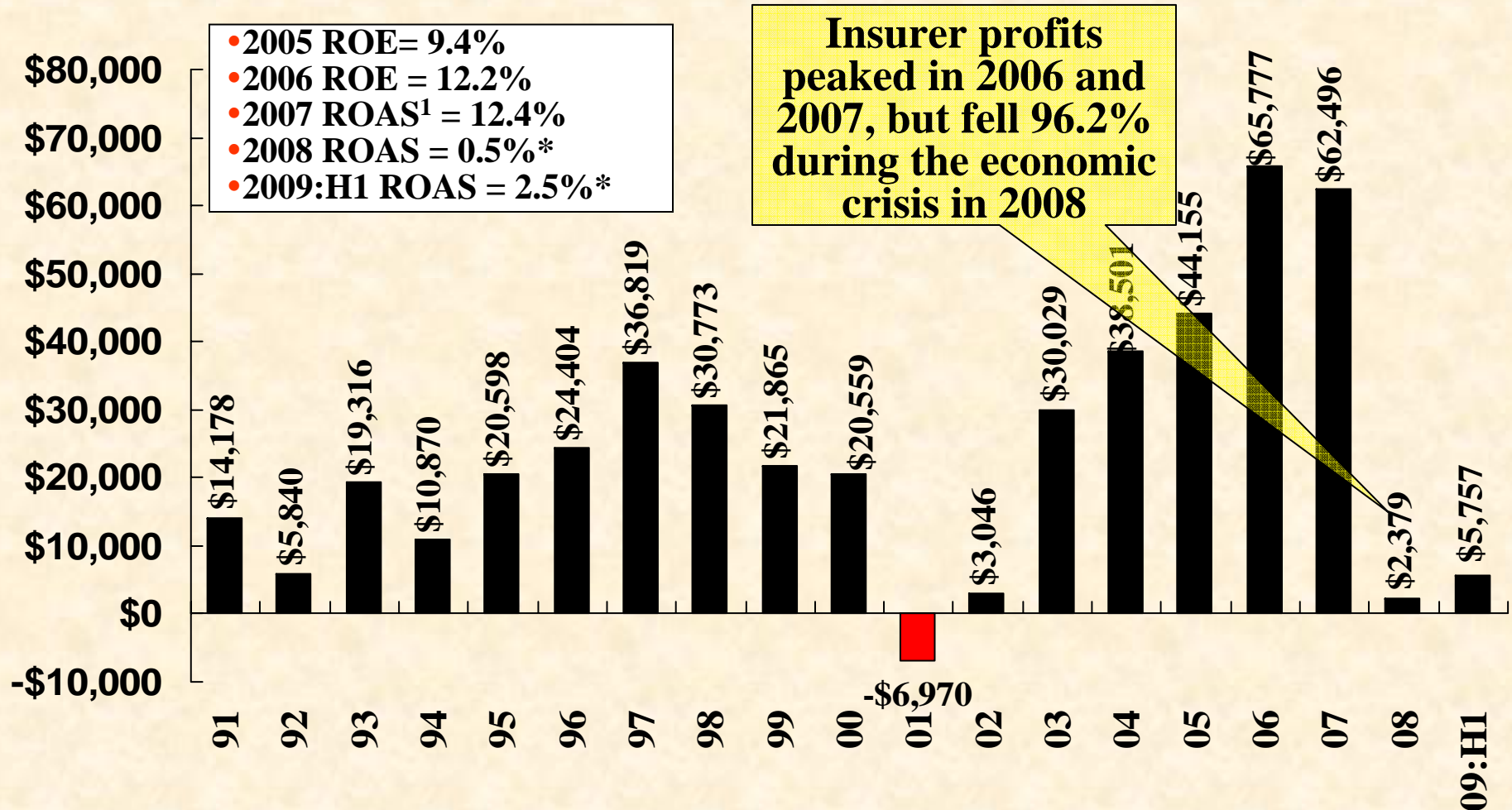
Historically Volatile







# *P/C Net Income After Taxes 1991-2009:H1 (\$ Millions)\**



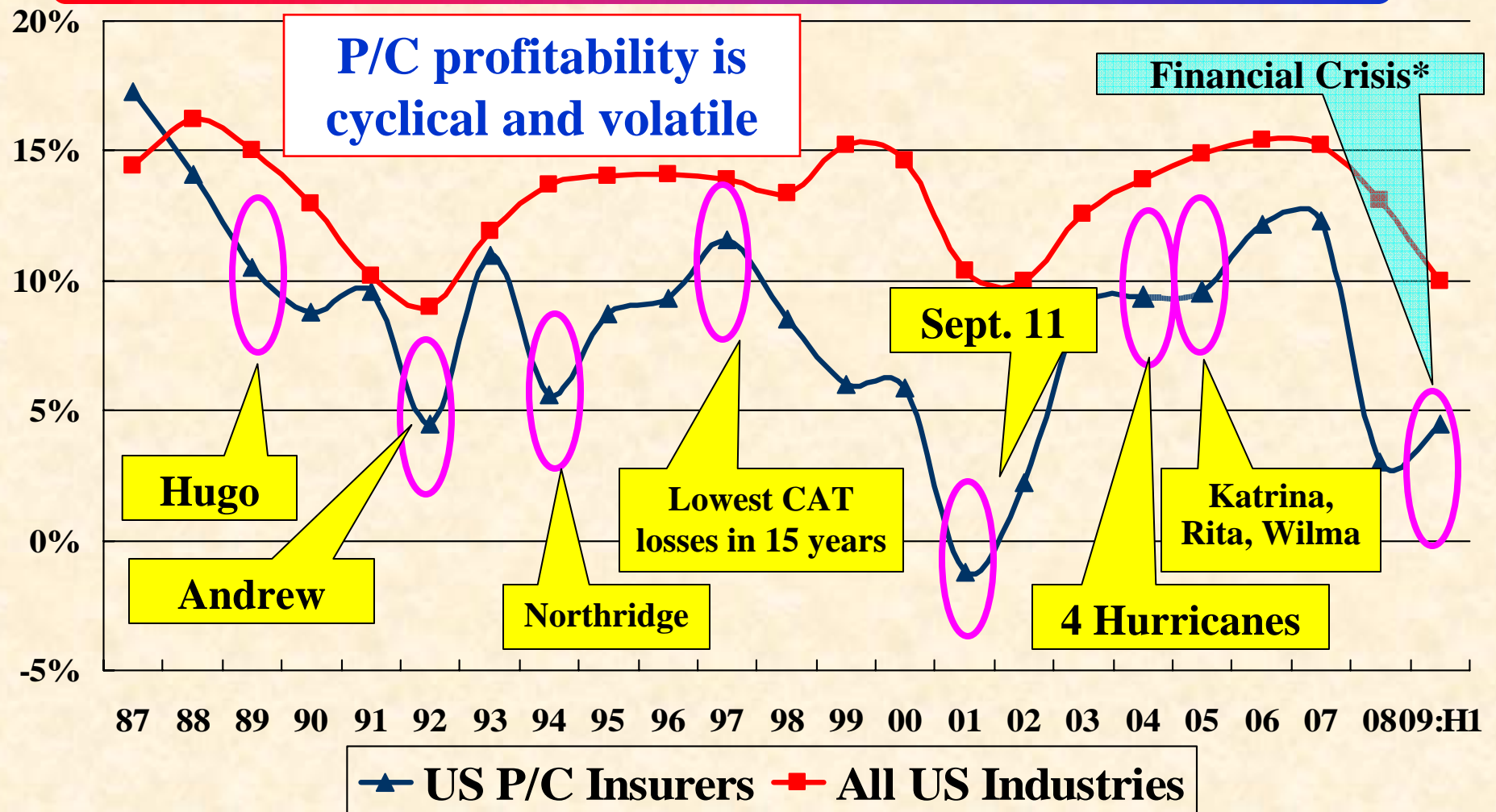
\*ROE figures are GAAP; <sup>1</sup>Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields an 4.5% ROAS for 2008 and 2.2%. 2009:Q1 net income was \$10.0 billion excl. M&FG.

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



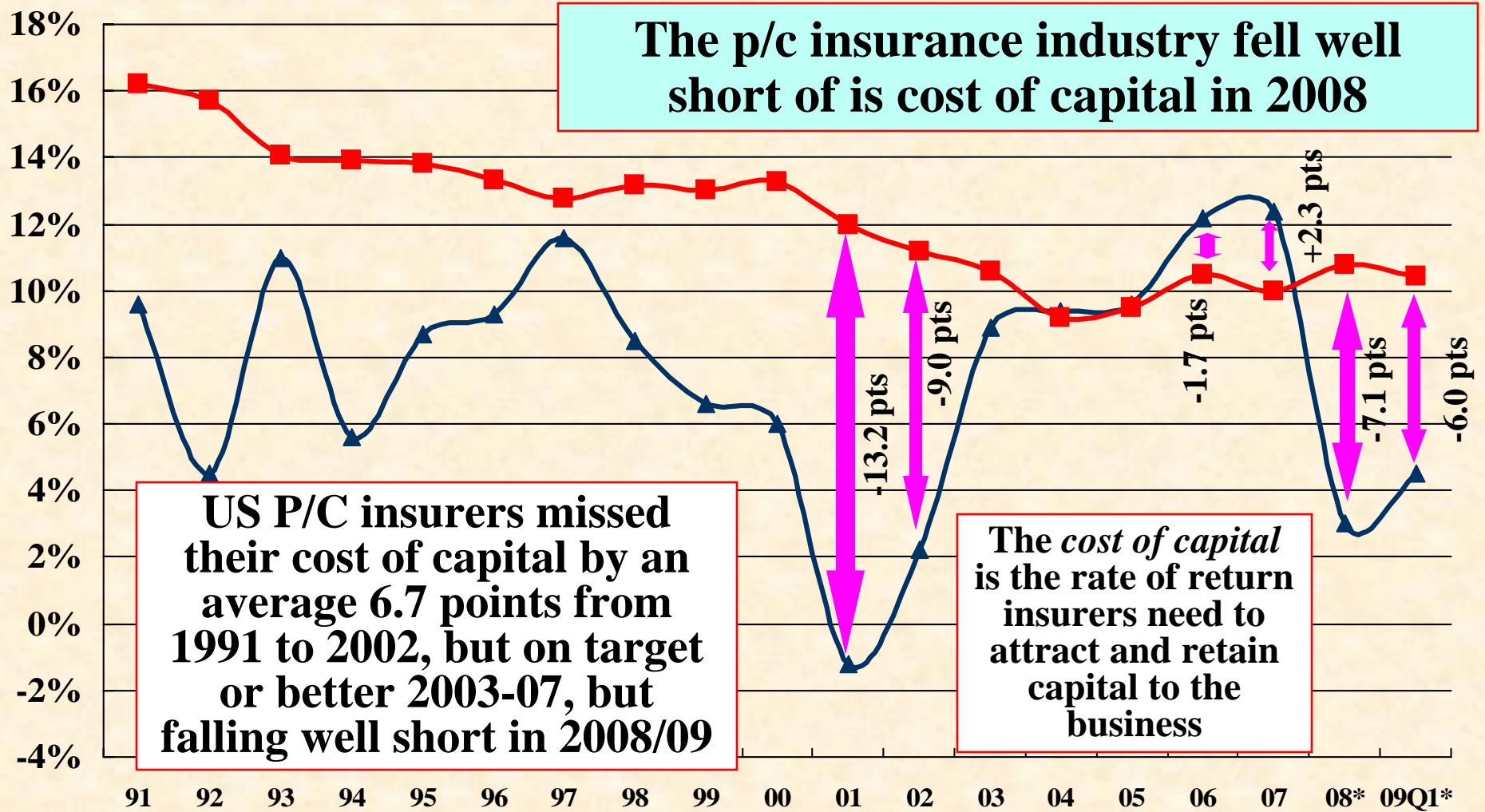
# ROE: P/C vs. All Industries

## 1987–2009: H1\*



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

# ROE vs. Equity Cost of Capital: US P/C Insurance: 1991-2009:H1\*

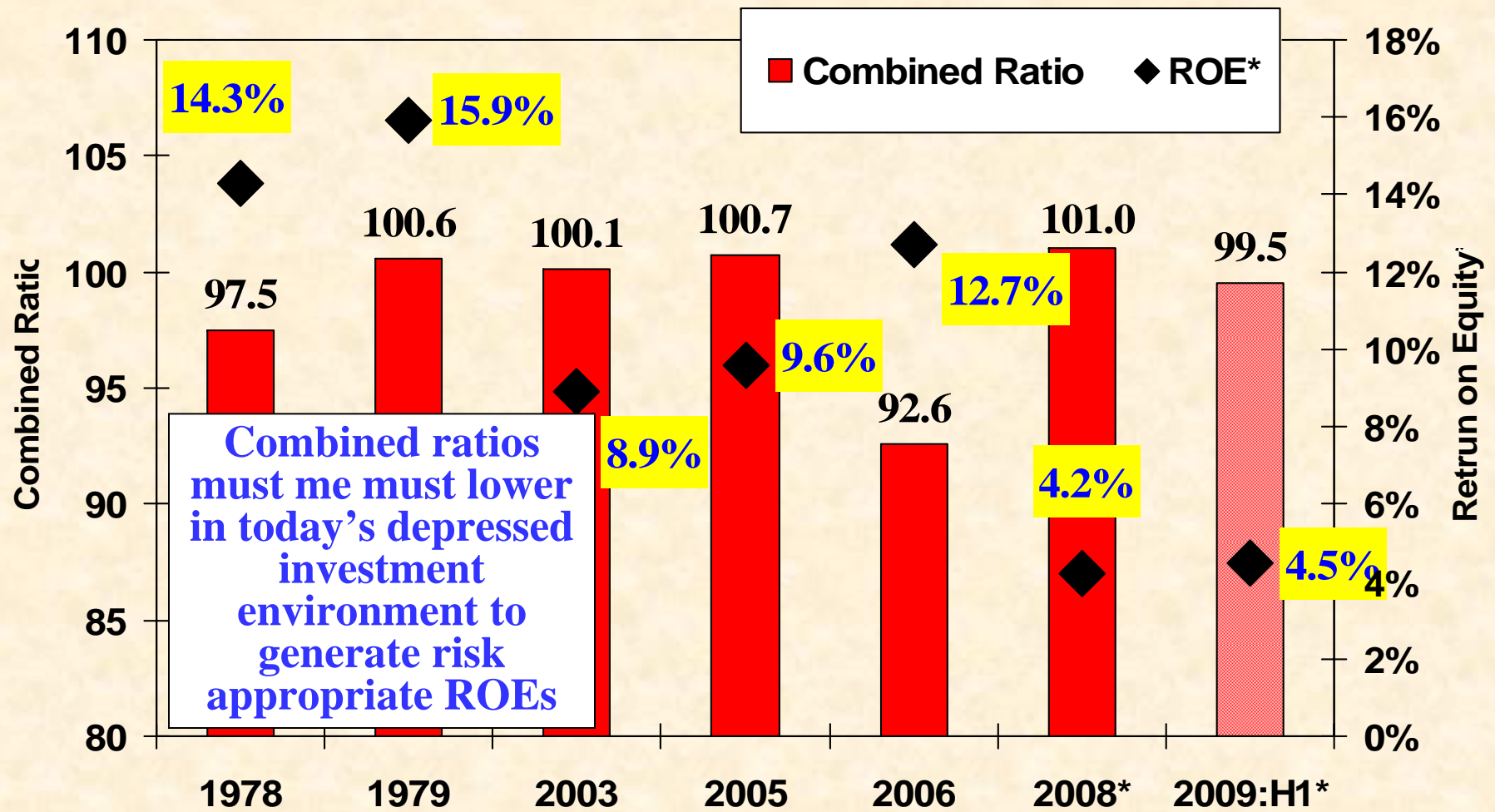


\*Excludes mortgage and financial guarantee insurers.  
Source: The Geneva Association, Ins. Information Inst.

—▲— ROE —■— Cost of Capital



## *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.

# P/C Premium Growth

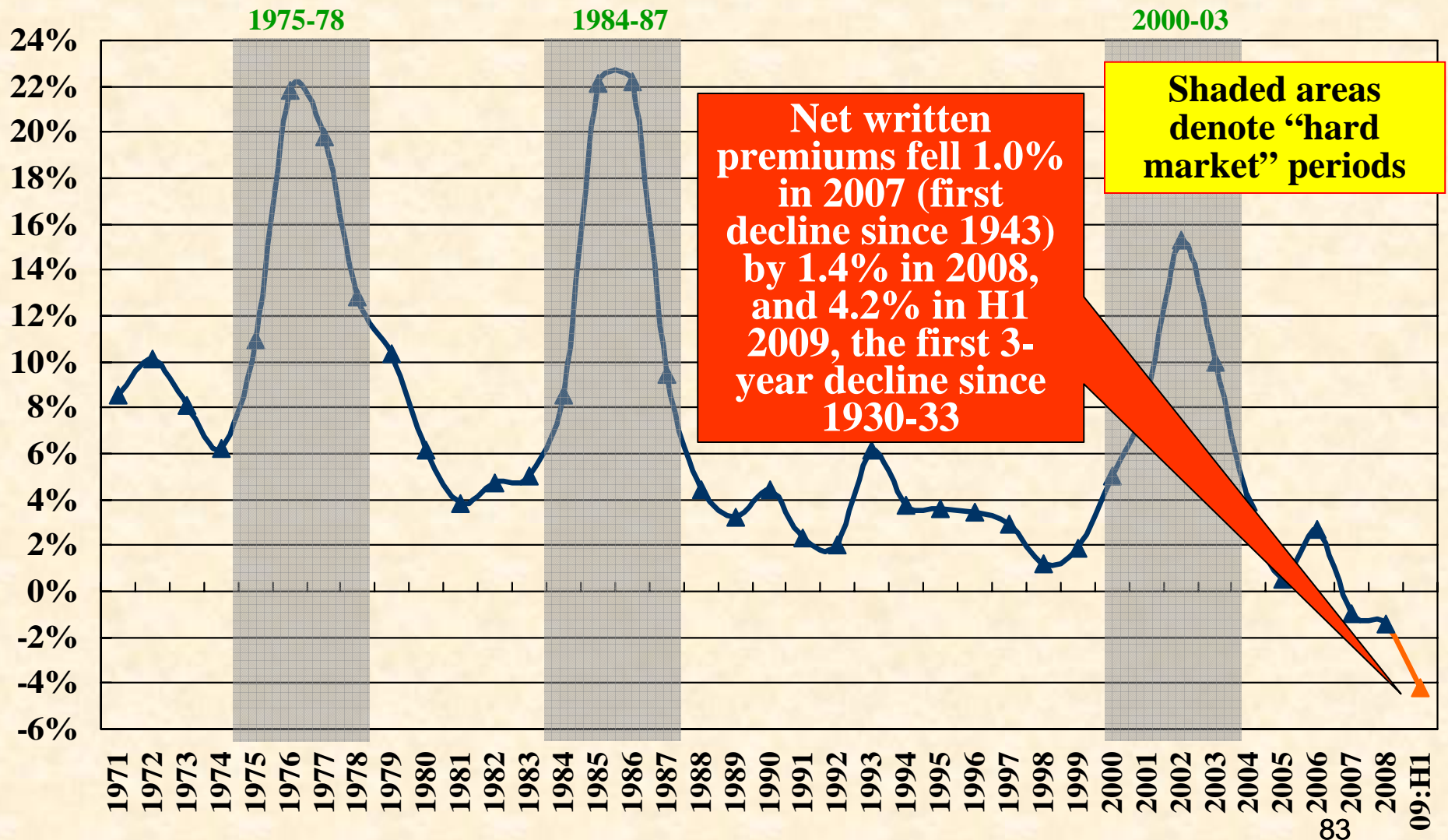
**Primarily Driven by the  
Industry's Underwriting  
Cycle, Not the Economy**







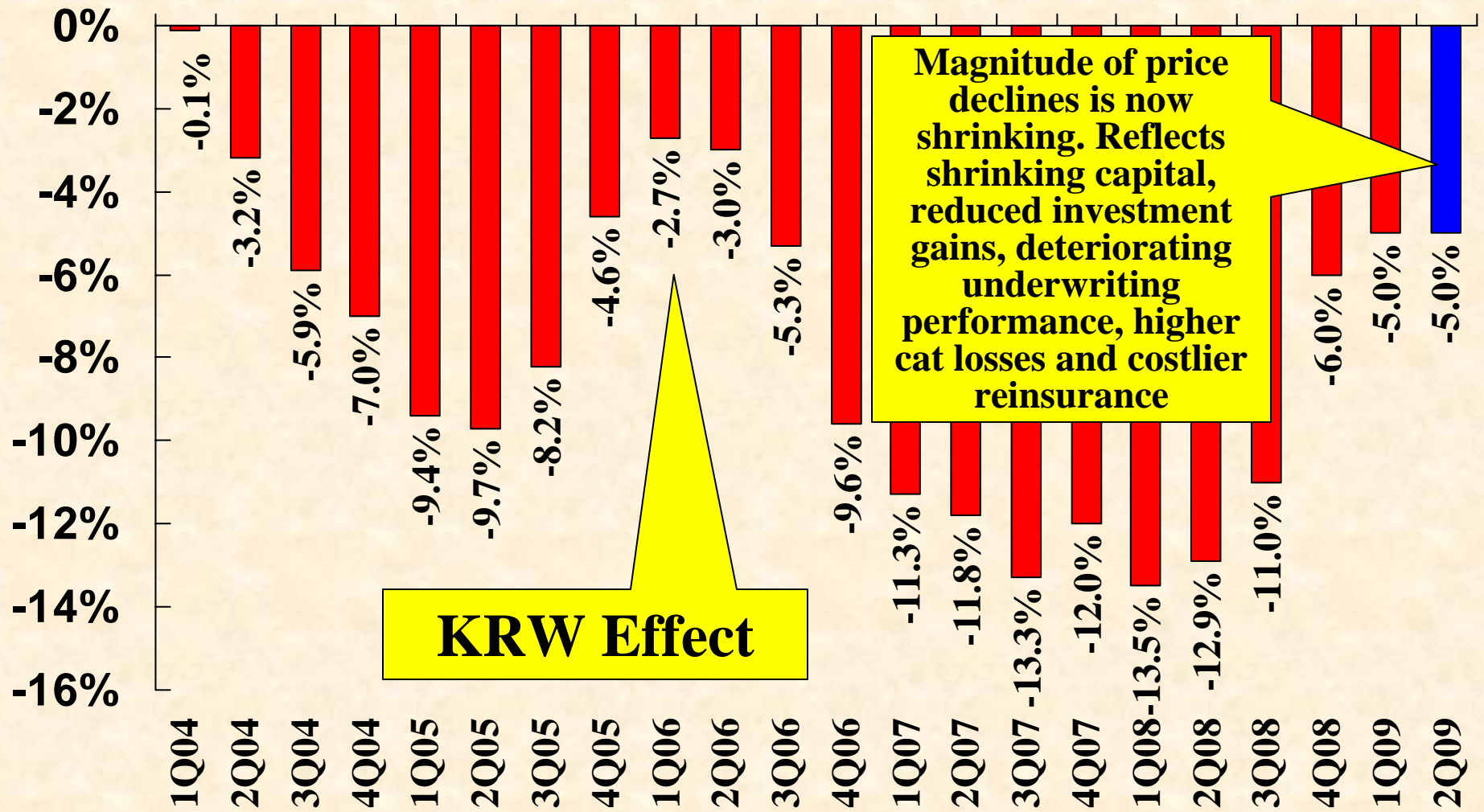
# *Strength of Recent Hard Markets by NWP Growth*



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



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



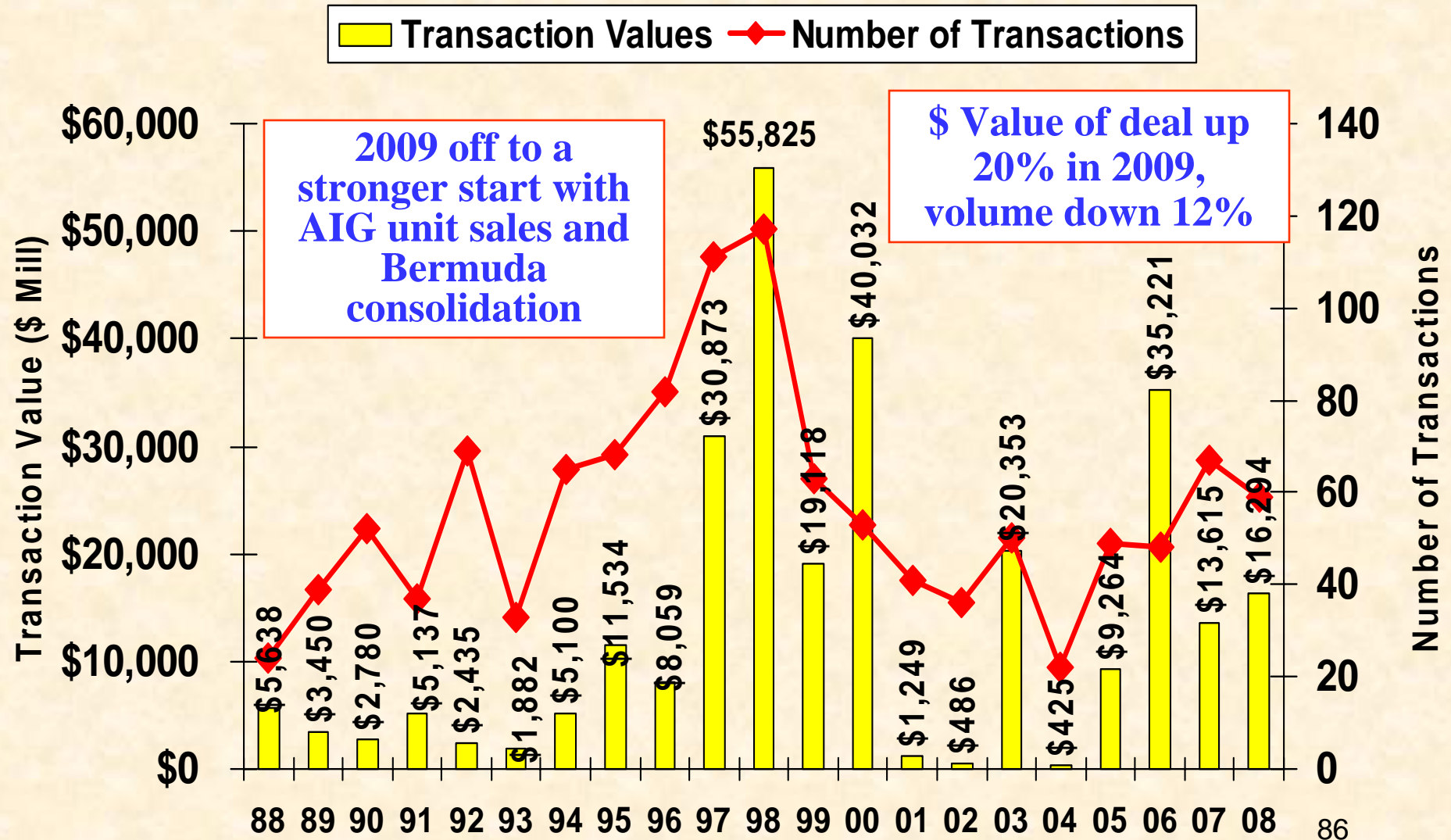
# Merger & Acquisition

**Barriers to Consolidation  
Will Diminish in 2010**





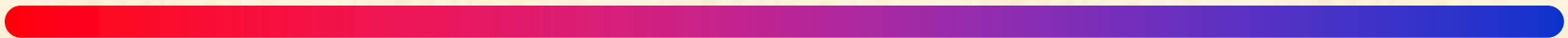
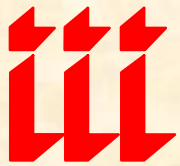
# *P/C Insurance-Related M&A Activity, 1988-2008*



Source: Conning Research & Consulting.

# Capital/ Policyholder Surplus (US)

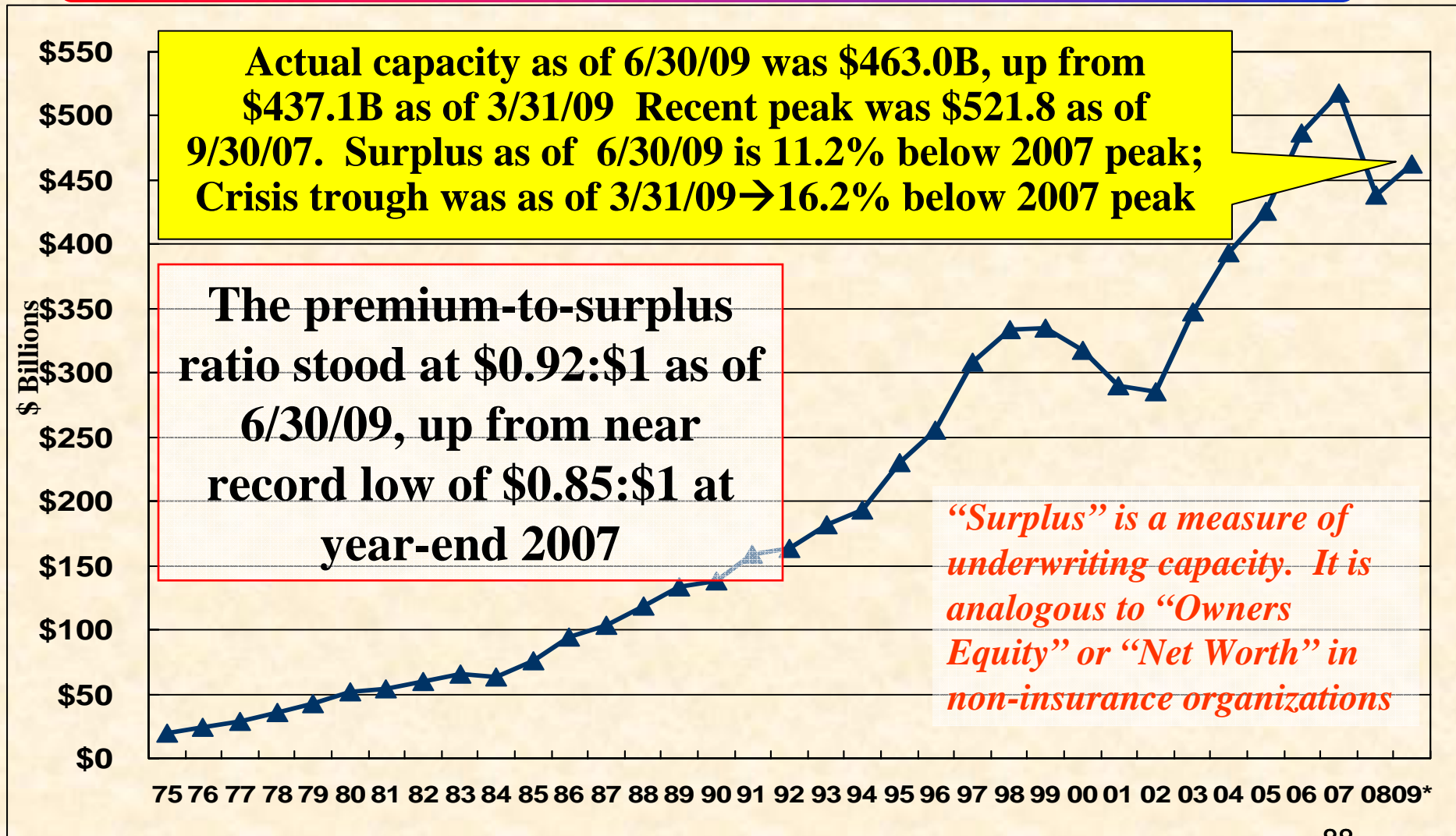
Shrinkage, but  
Capital is Within  
Historic Norms







# *U.S. Policyholder Surplus: 1975-2009:H1\**

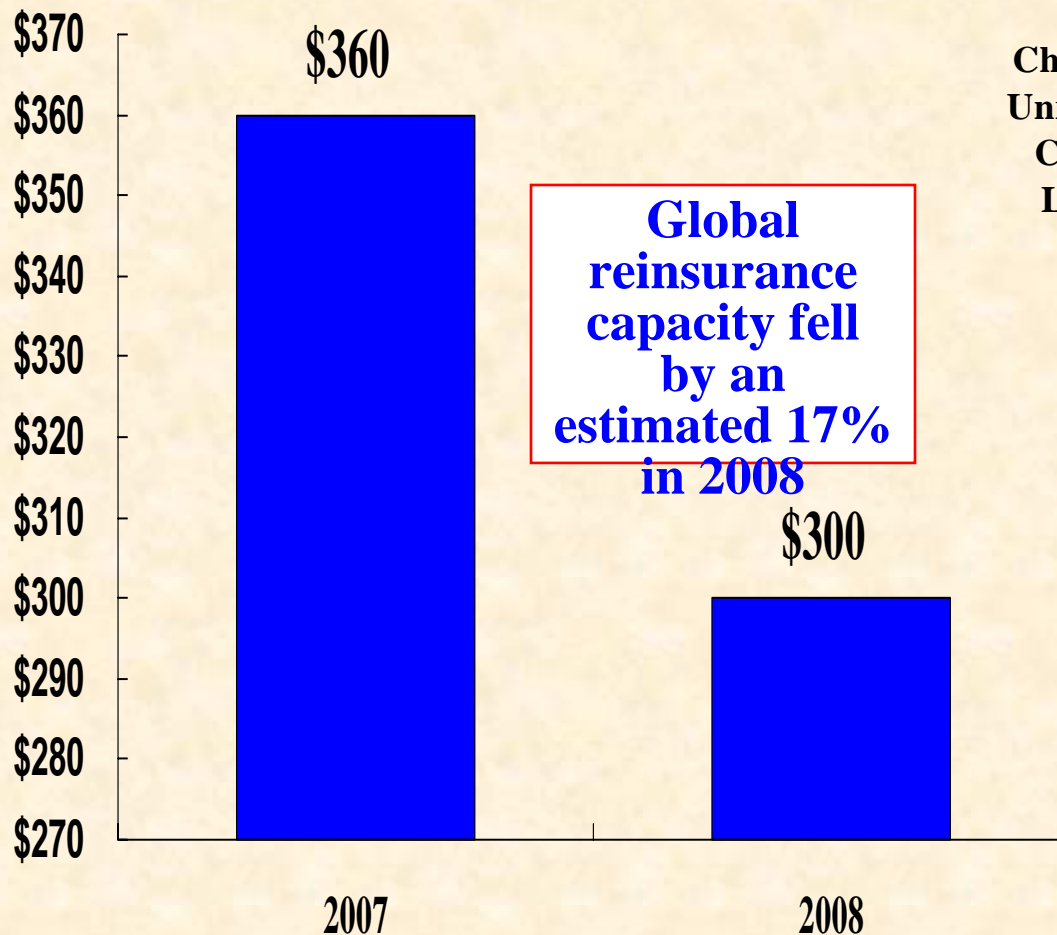


Source: A.M. Best, ISO, Insurance Information Institute.

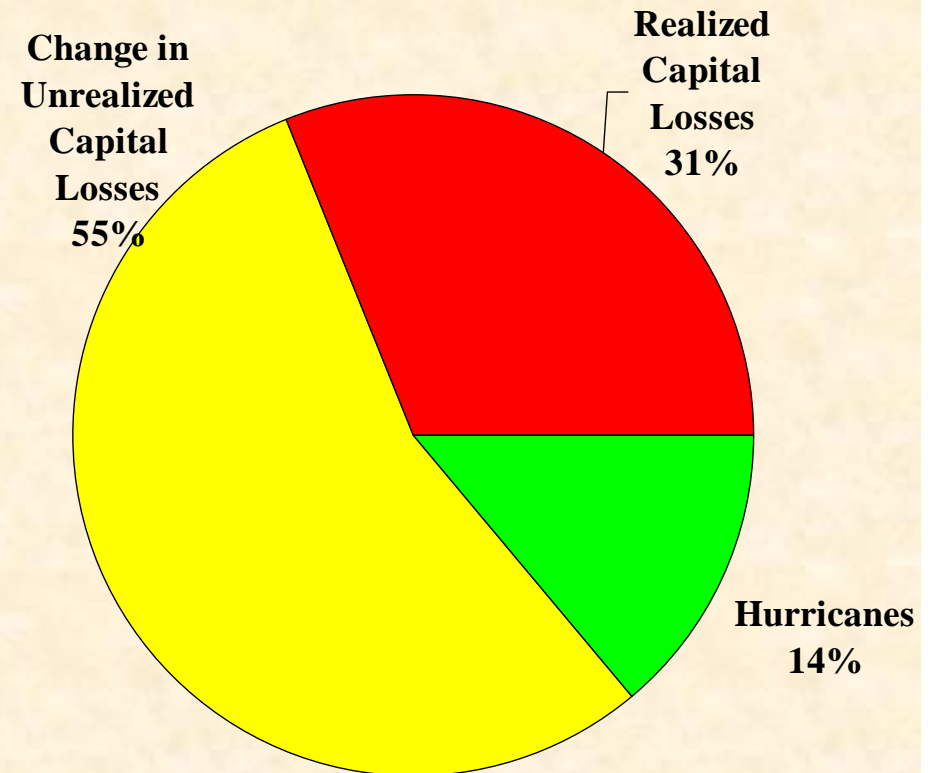
\*As of 6/30/09

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

## Global Reinsurance Capacity

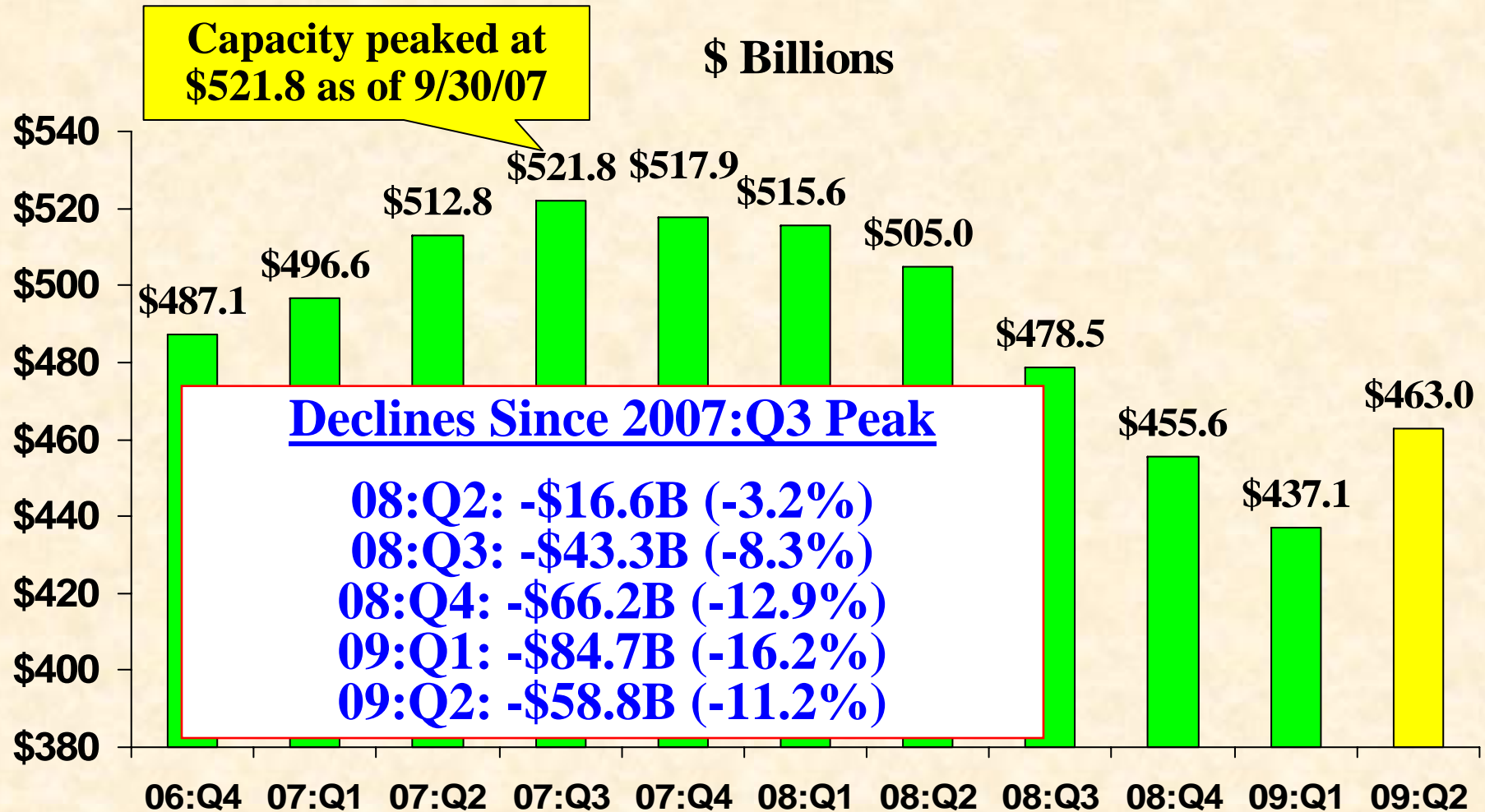


## Source of Decline



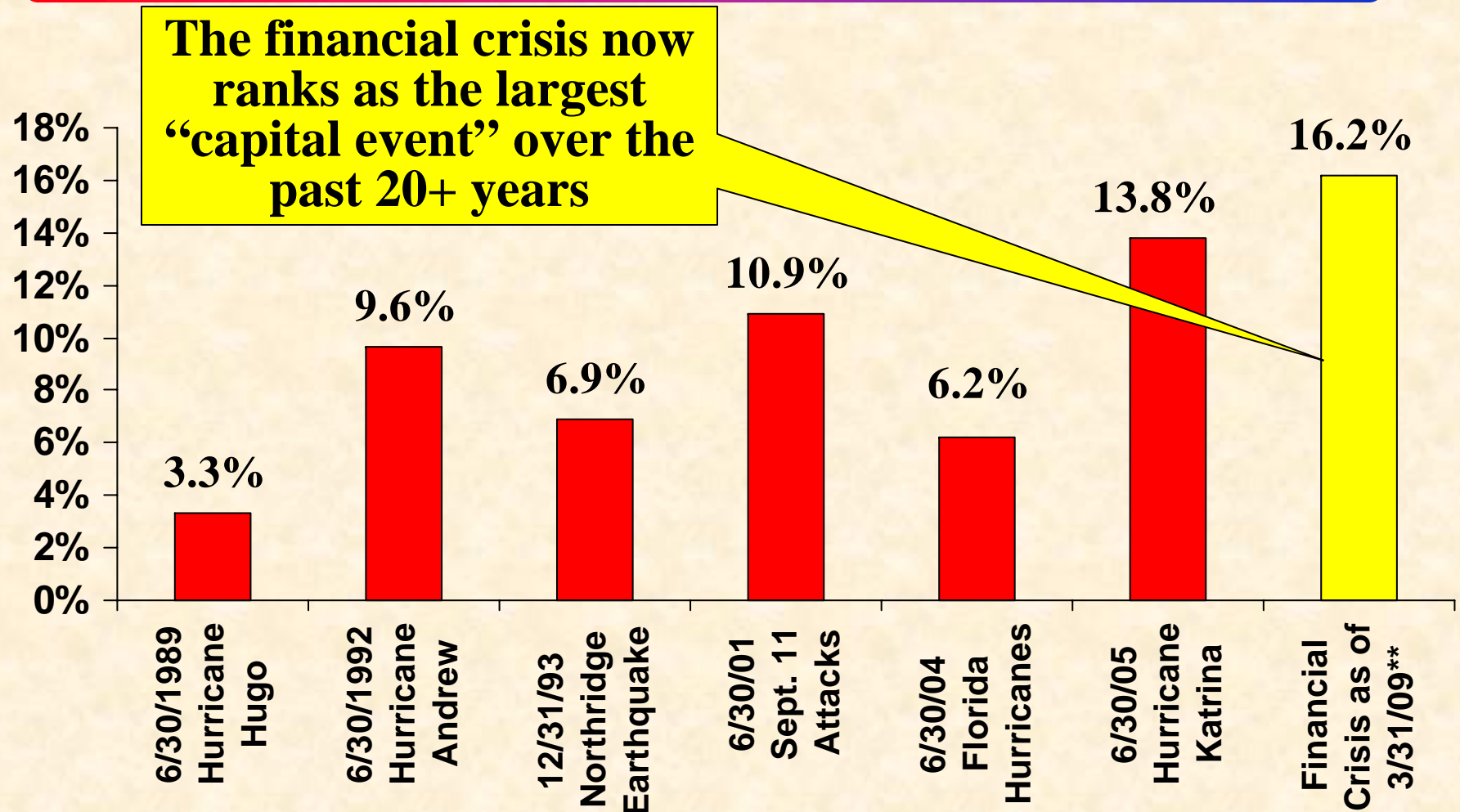


# *Policyholder Surplus, 2006:Q4 – 2009:H1*





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



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

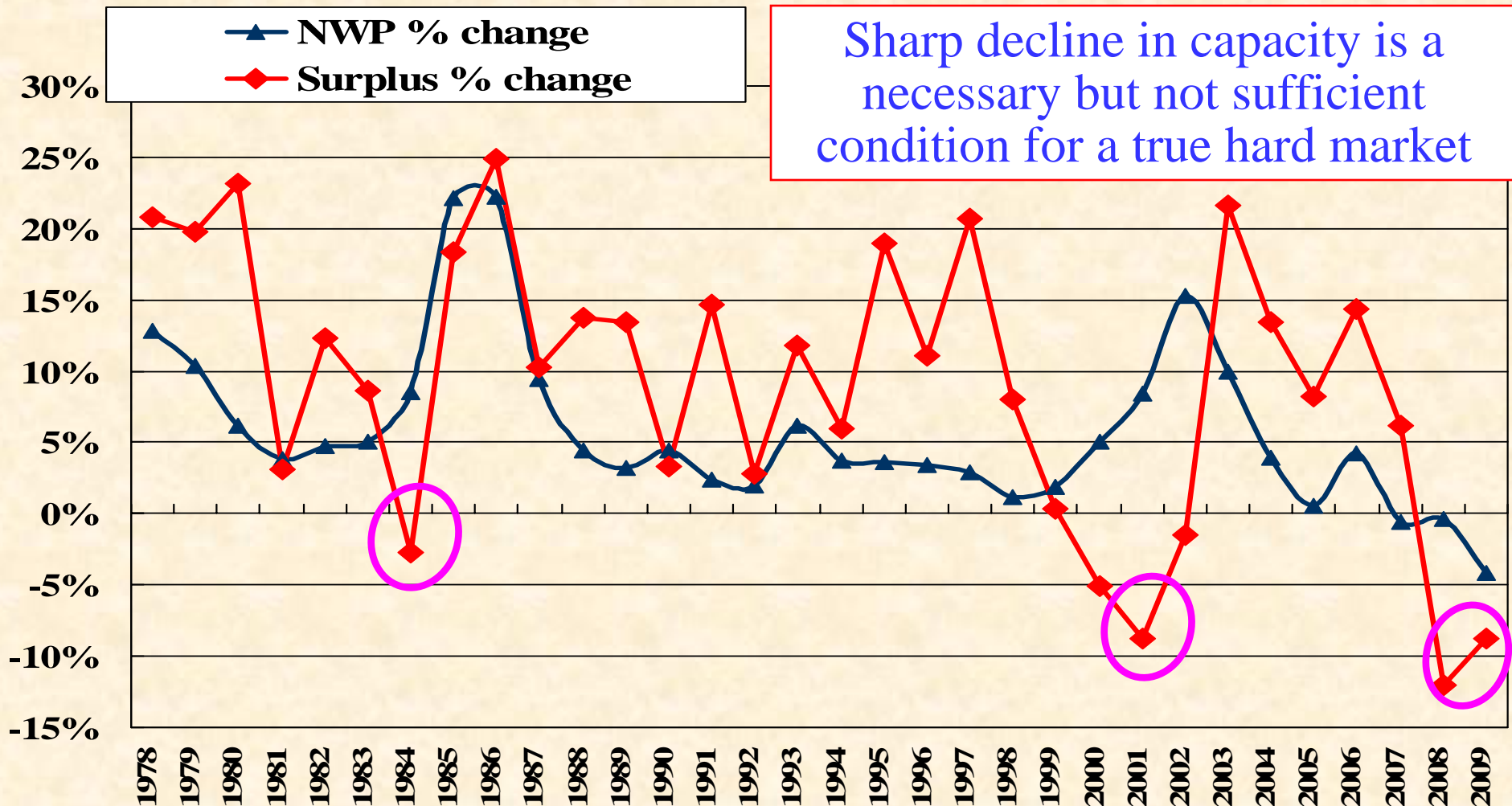
\*\*Date of maximum capital erosion; As of 6/30/09 (latest available) ratio = 11.2%.

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 for H1:09 vs H1:08

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



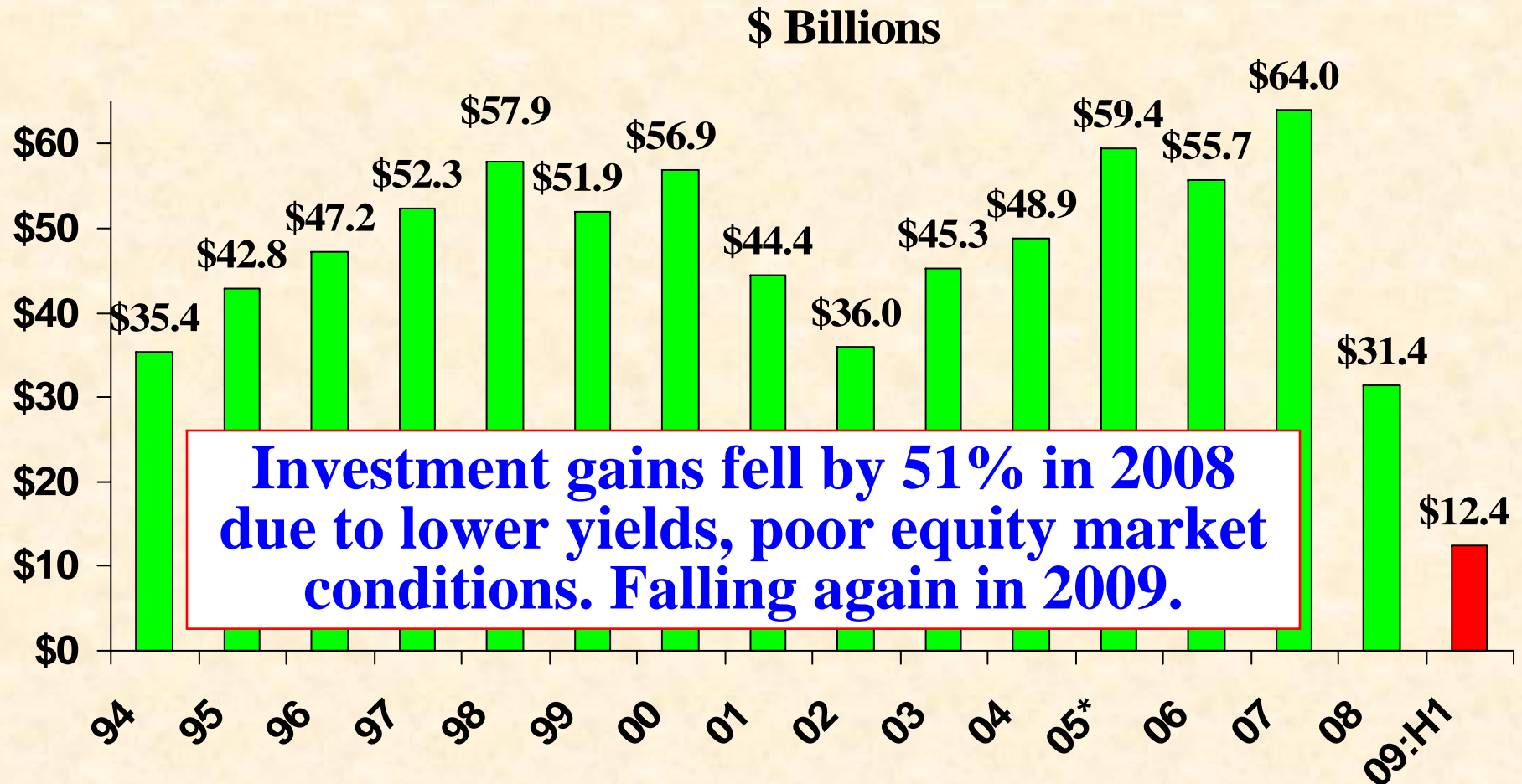
# Investment Performance

*Investments are a Principle  
Source of Declining  
Profitability*





# Property/Casualty Insurance Industry Investment Gain: 1994- 2009:H1<sup>1</sup>



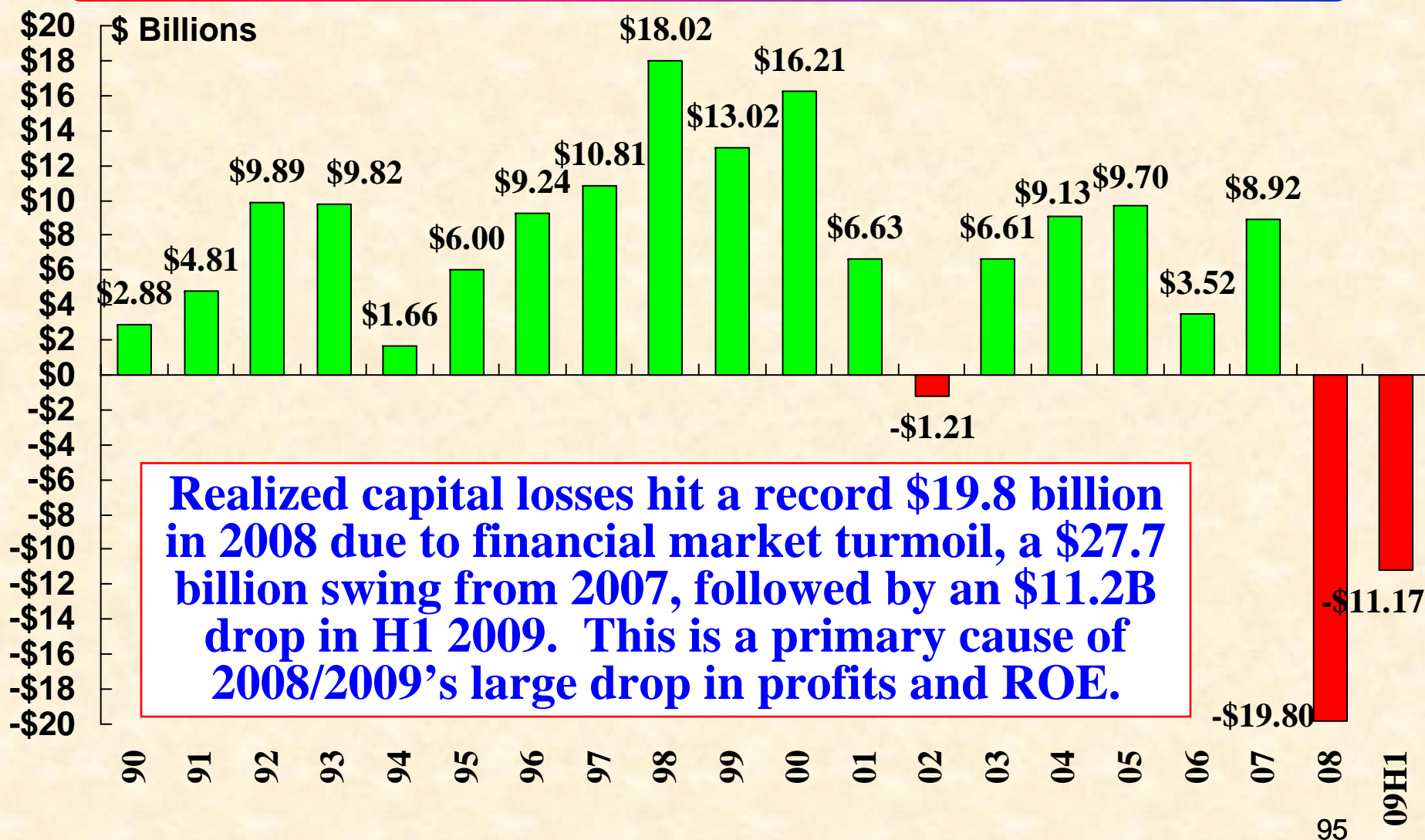
<sup>1</sup>Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2006 figure consists of \$52.3B net investment income and \$3.4B realized investment gain.

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

Sources: ISO; Insurance Information Institute.



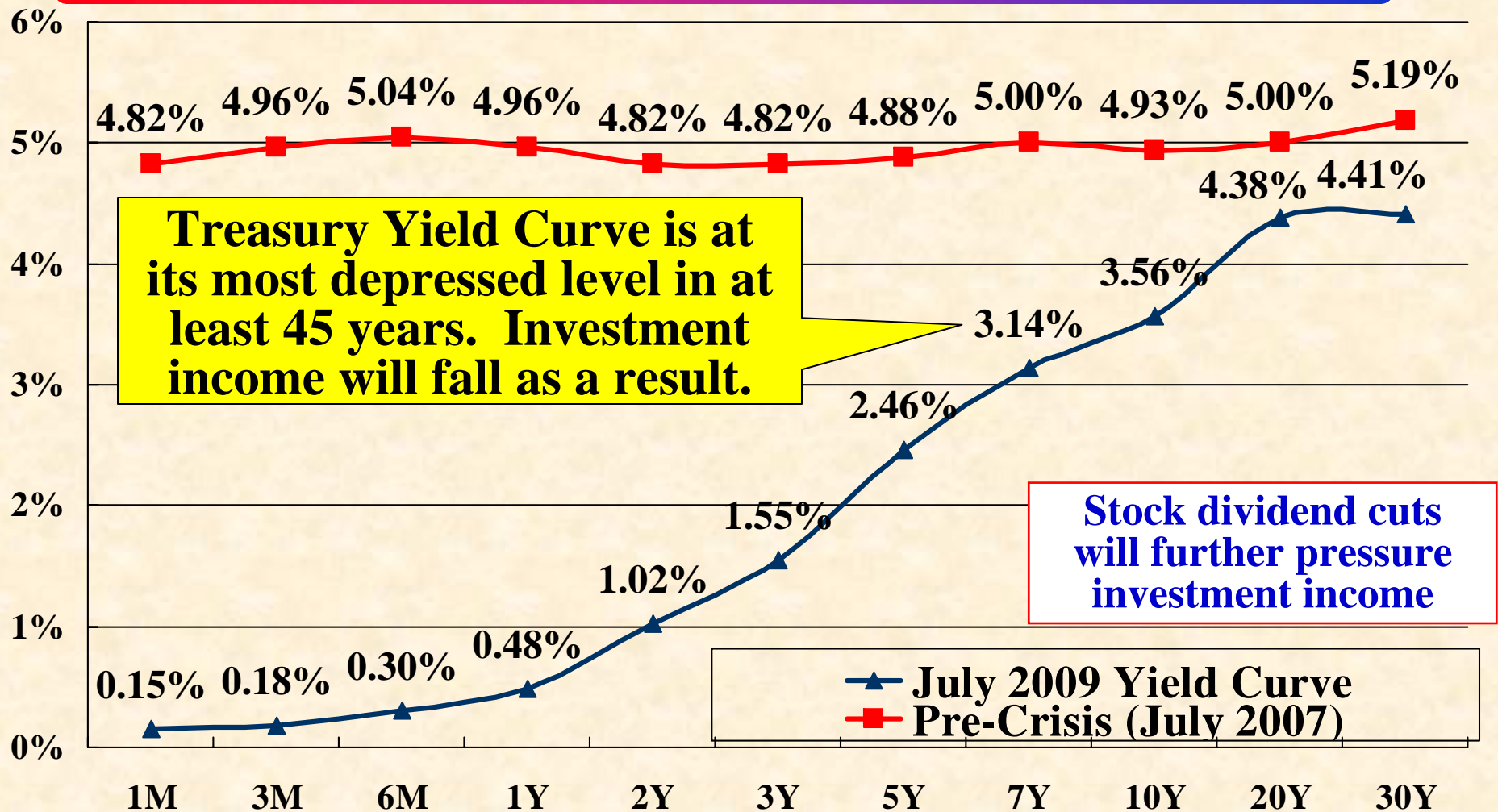
# *P/C Insurer Net Realized Capital Gains, 1990-2009:H1*



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



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



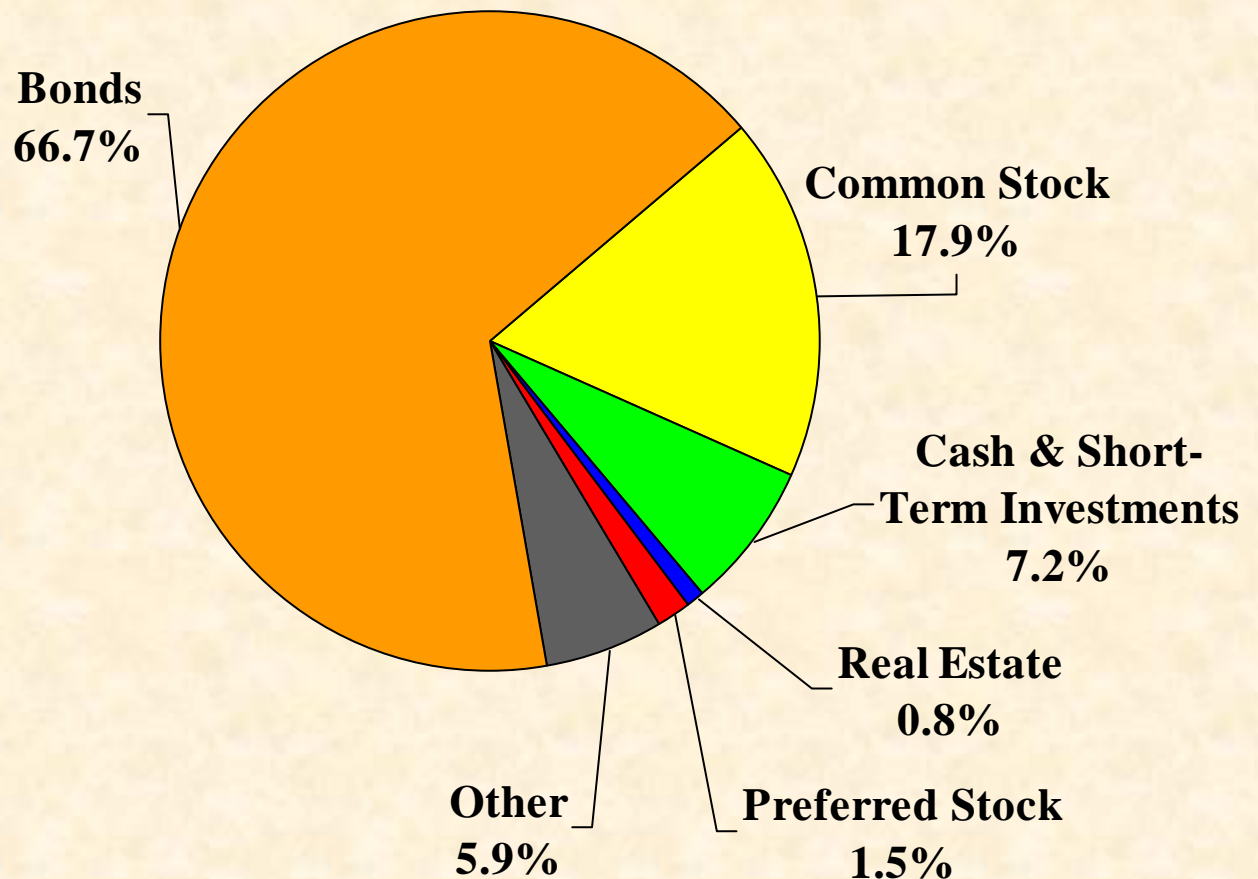


# *Distribution of P/C Insurance Industry's Investment Portfolio*

**As of December 31, 2007**

## Portfolio Facts

- Invested assets totaled \$1.3 trillion as of 12/31/07
- Insurers are generally conservatively invested, with 2/3 of assets invested in bonds as of 12/31/07
- Only about 18% of assets were invested in common stock as of 12/31/07
- Even the most conservative of portfolios was hit hard in 2008





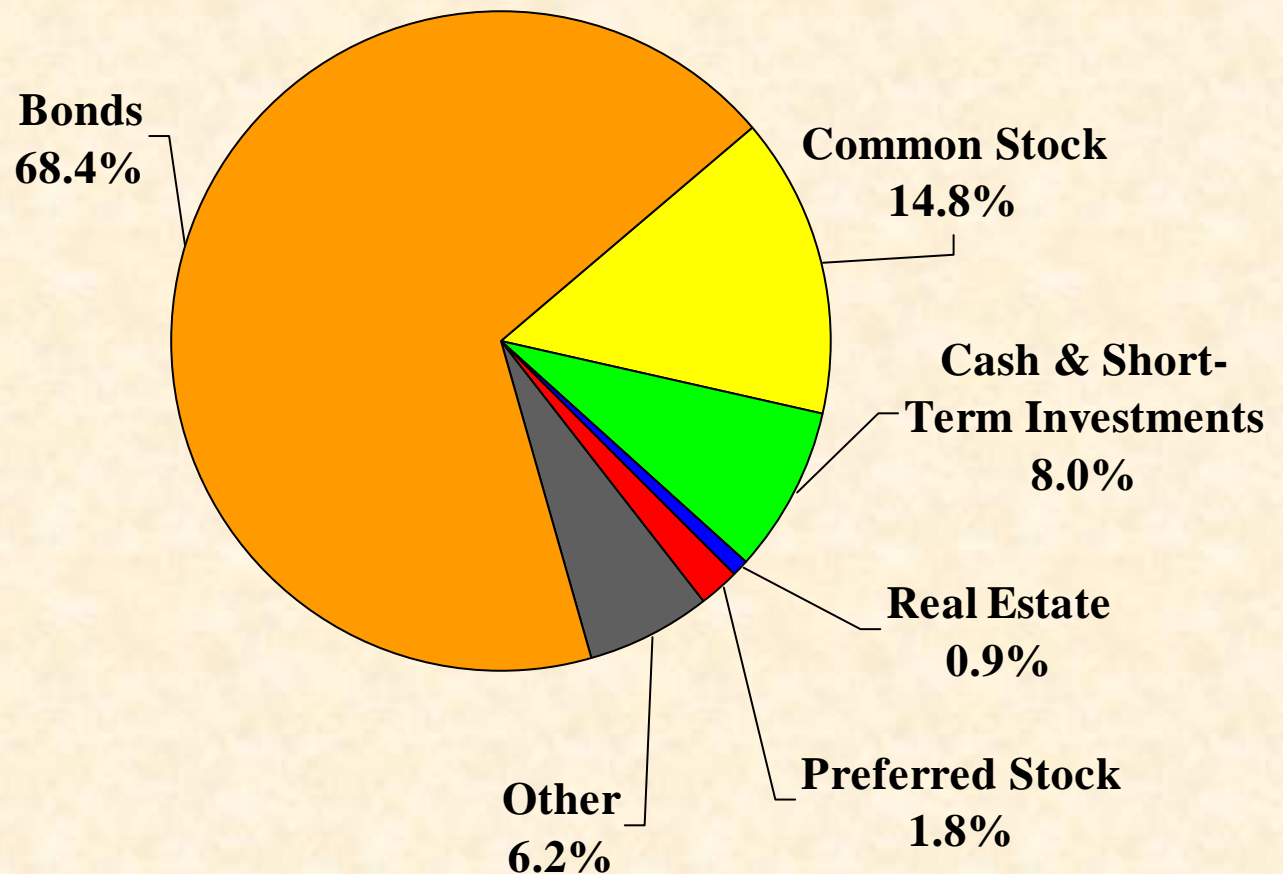


# *Distribution of P/C Insurance Industry's Investment Portfolio*

**As of December 31, 2008**

## Portfolio Facts

- Invested assets totaled \$1.2 trillion as of 12/31/08, down from \$1.3 trillion as of 12/31/07
- Insurers are generally conservatively invested, with 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, down from 18% one year earlier
- Even the most conservative of portfolios were hit hard in 2008



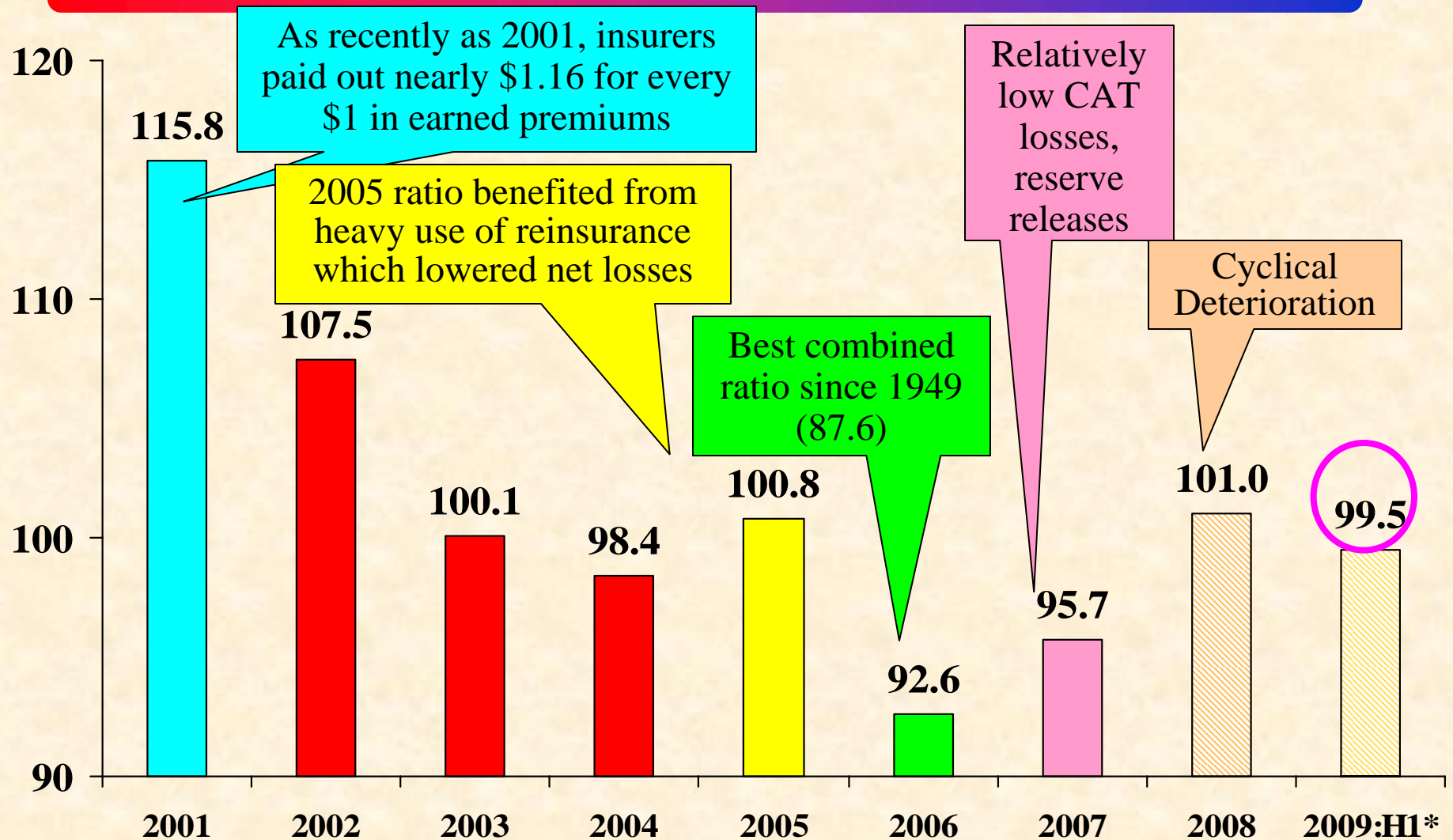
# Underwriting Trends

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





# *P/C Insurance Industry Combined Ratio, 2001-2009:H1\**

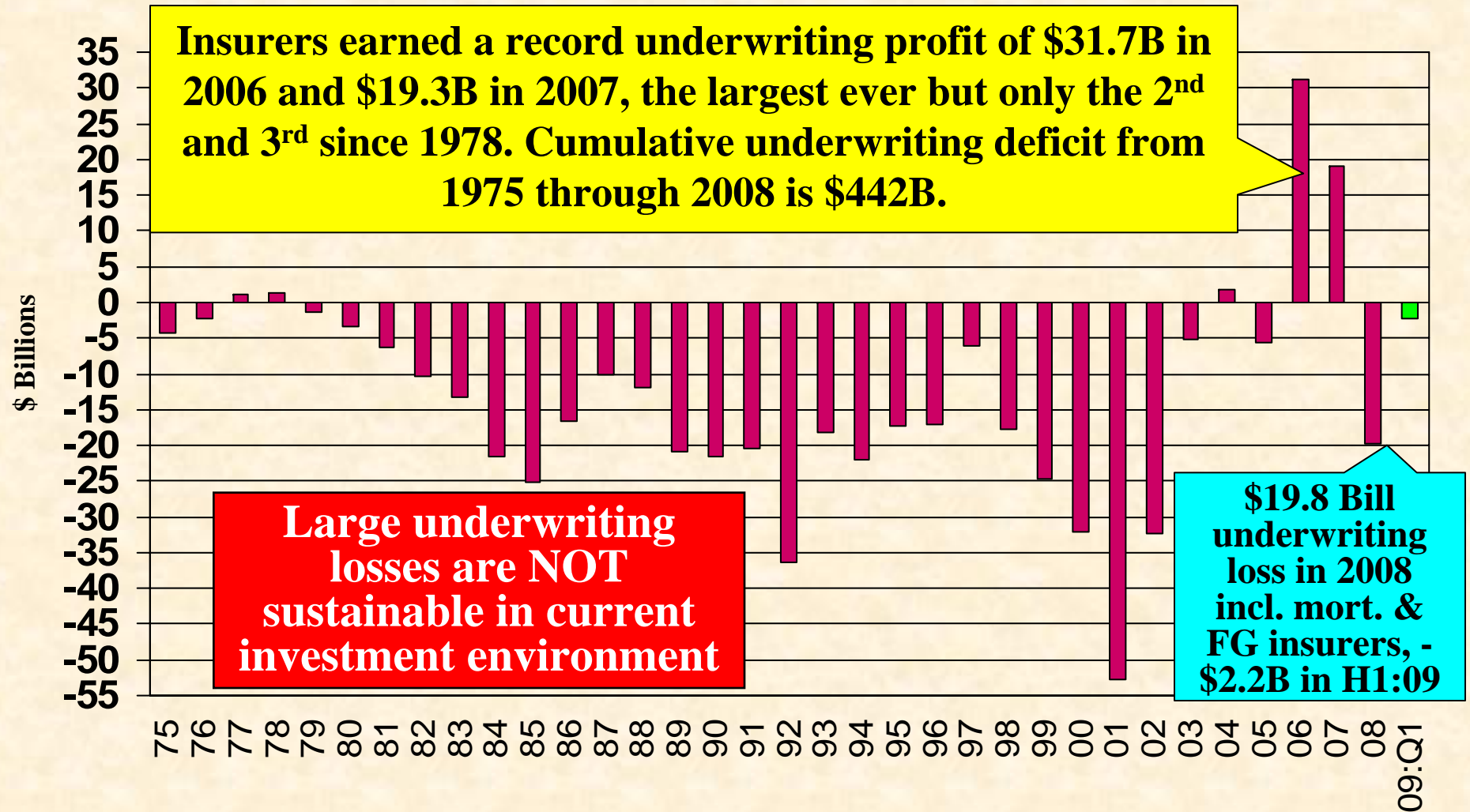


\*Excludes Mortgage & Financial Guaranty insurers in 2008. Including M&FG, 2008=105.1, 2009=100.9  
Sources: A.M. Best, ISO.



# *Underwriting Gain (Loss)*

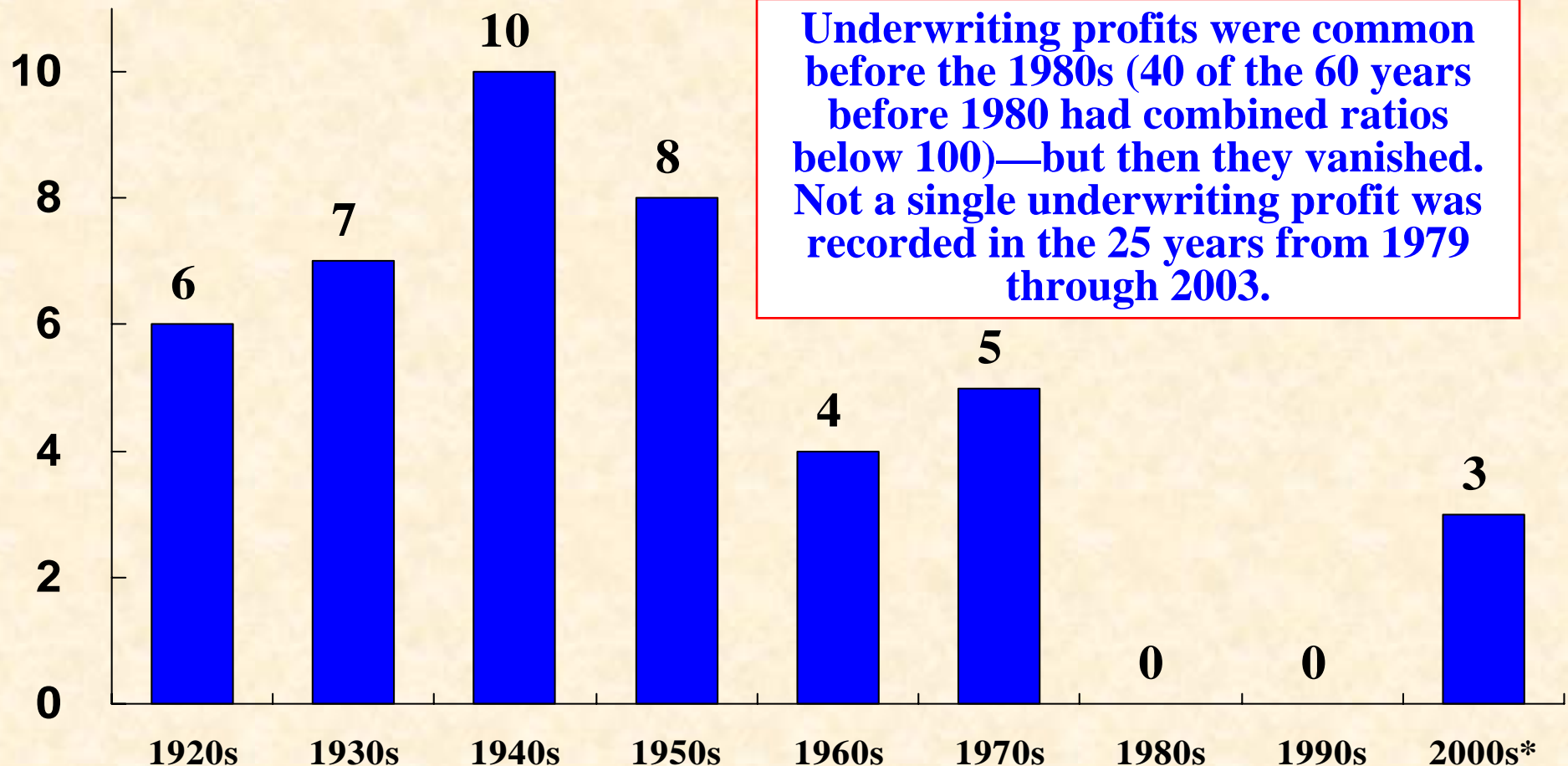
## *1975-2009:H1\**





# *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.

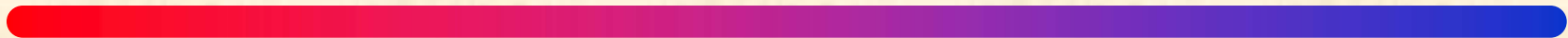
102

\*2000 through 2008.



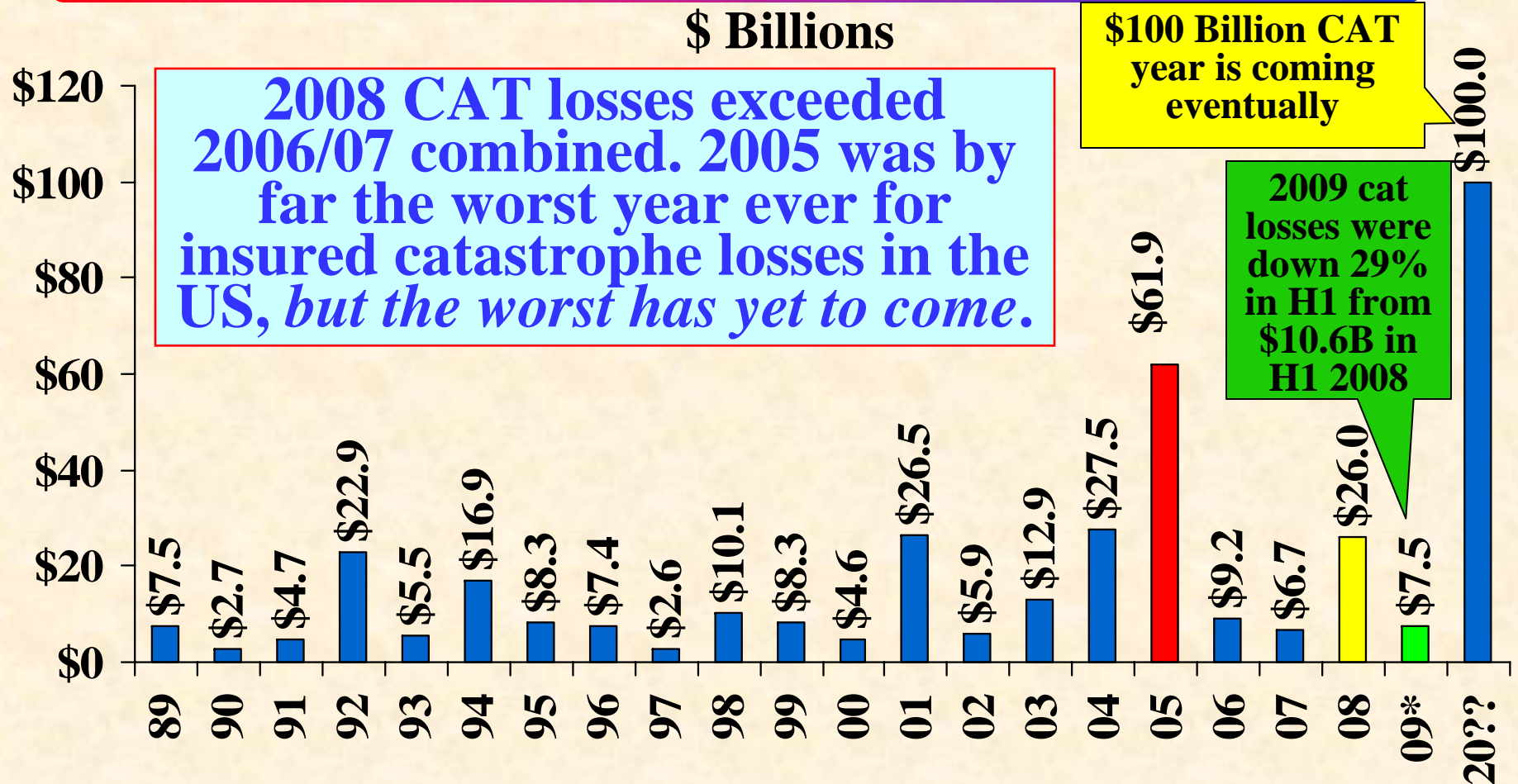
# Catastrophic Loss

*Catastrophe Losses Trends  
Are Trending Adversely*





# U.S. Insured Catastrophe Losses



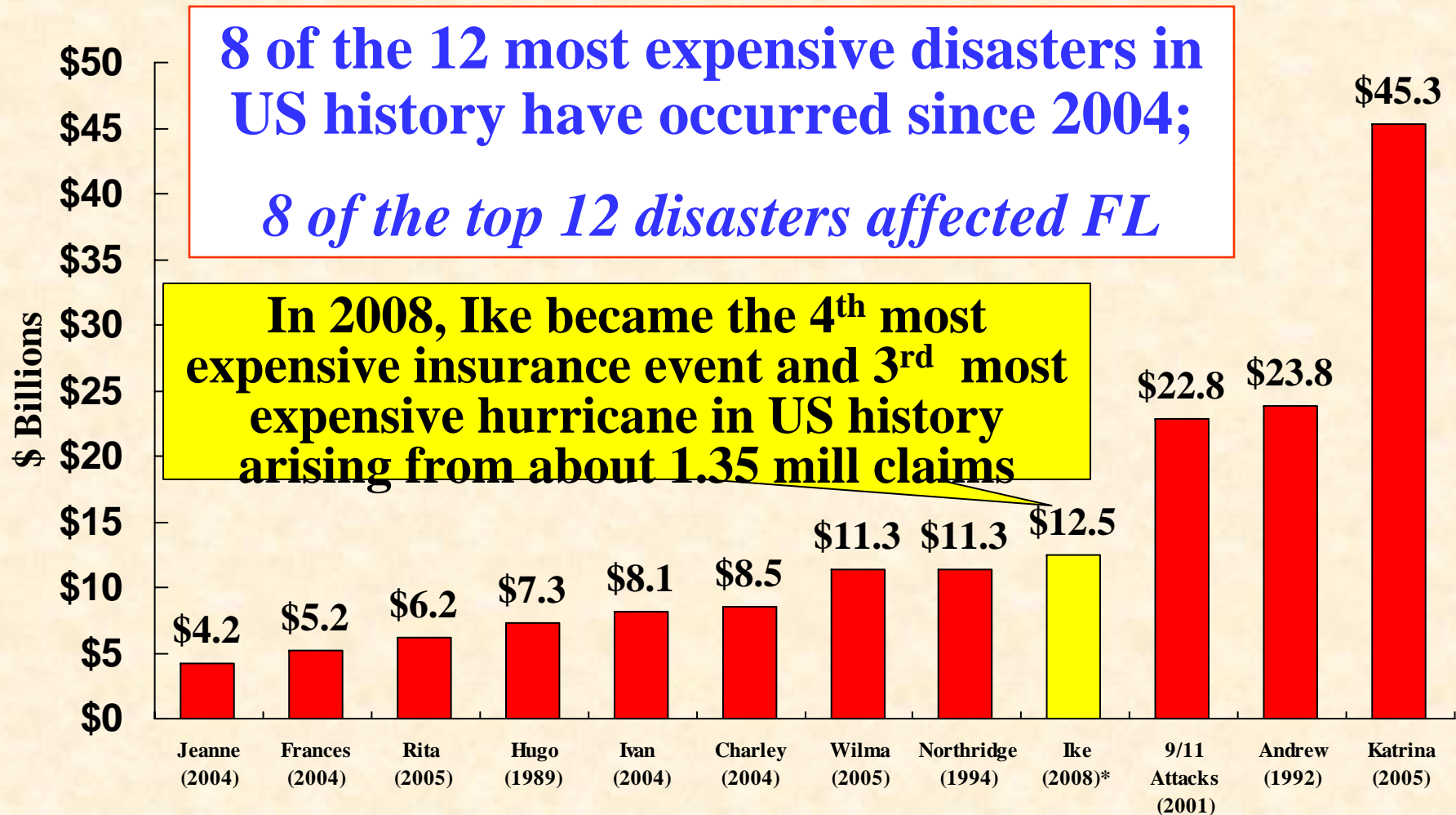
\*Based on PCS data through June 30 = \$7.5 billion.

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>104</sup>

Source: Property Claims Service/ISO; Insurance Information Institute



# Top 12 Most Costly Disasters in US History, (Insured Losses, \$2008)



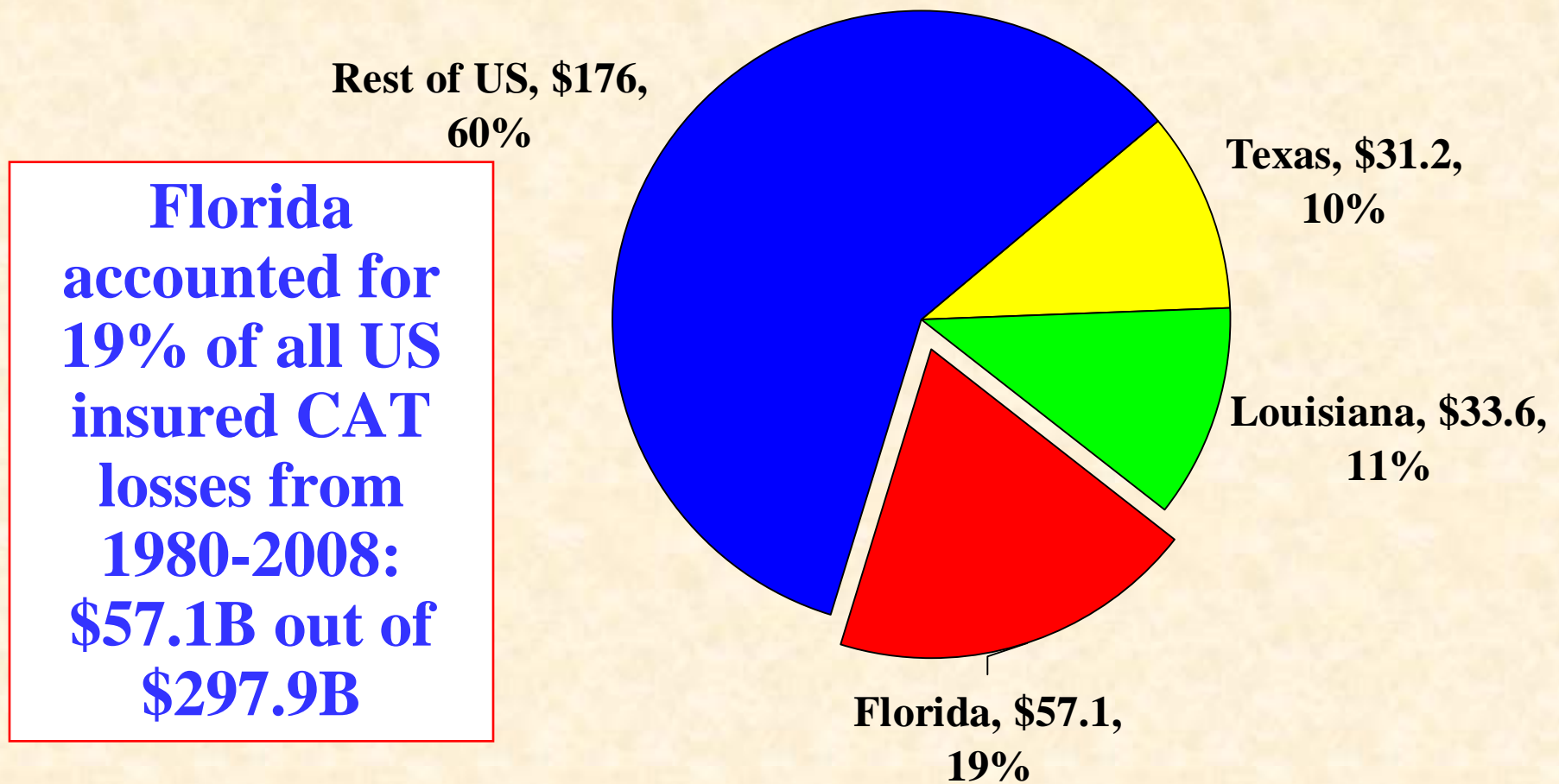
\*PCS estimate as of August 1, 2009.

Sources: PCS; Insurance Information Institute inflation adjustments.



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

**\$ Billions of Dollars**



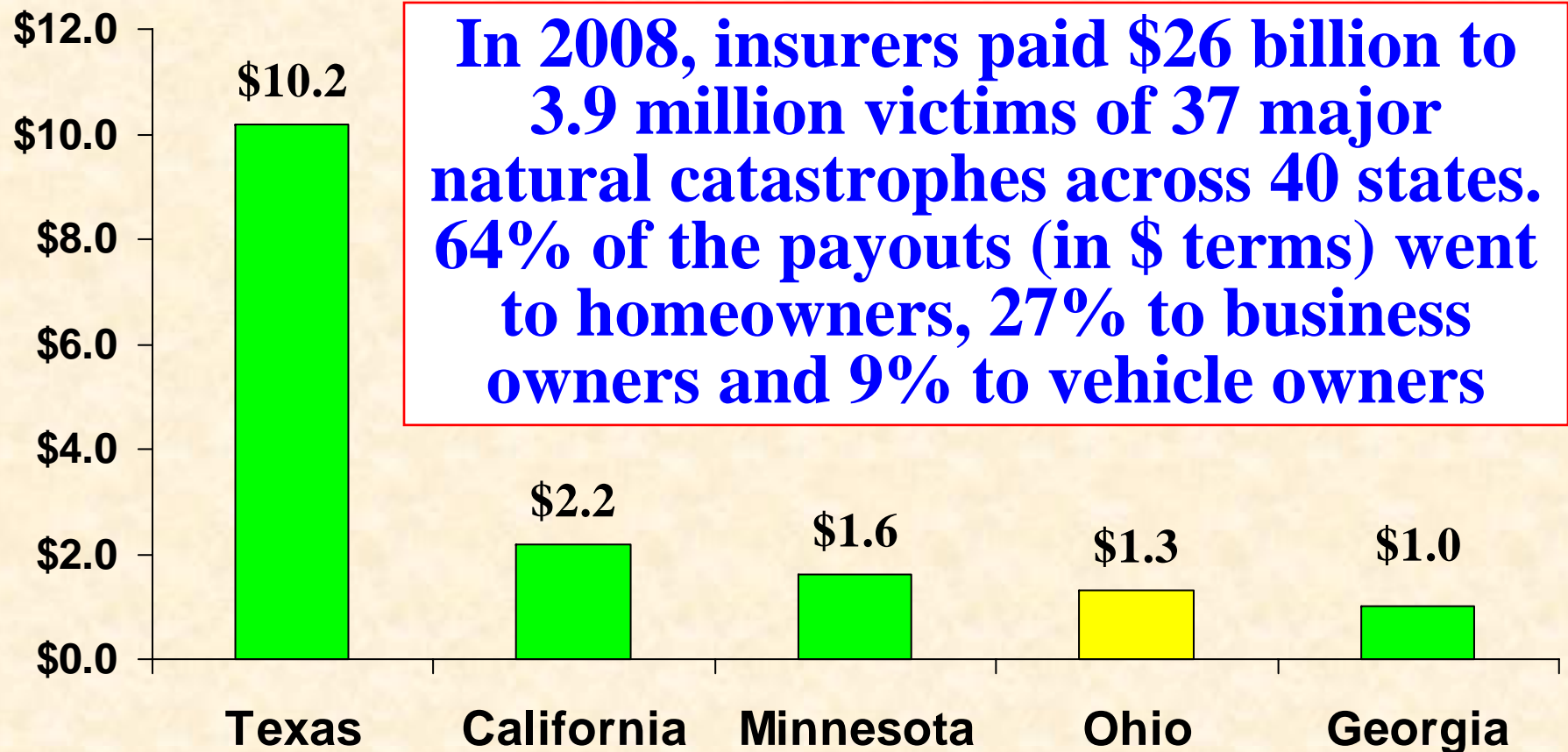
\*All figures (except 2006-2008 loss) have been adjusted to 2005 dollars.

Source: PCS division of ISO.



# *States With Highest Insured Catastrophe Losses in 2008*

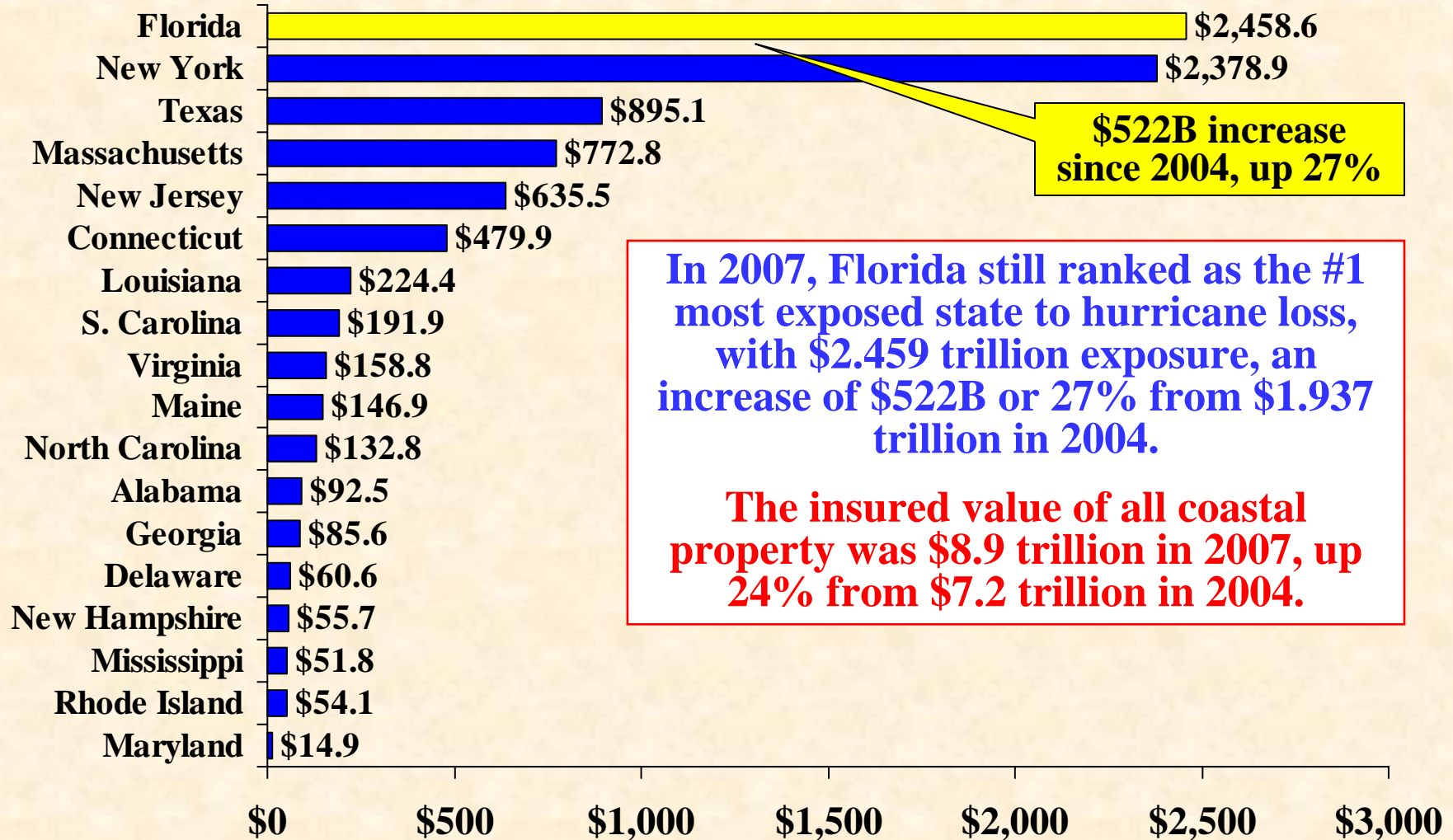
**\$ Billions**







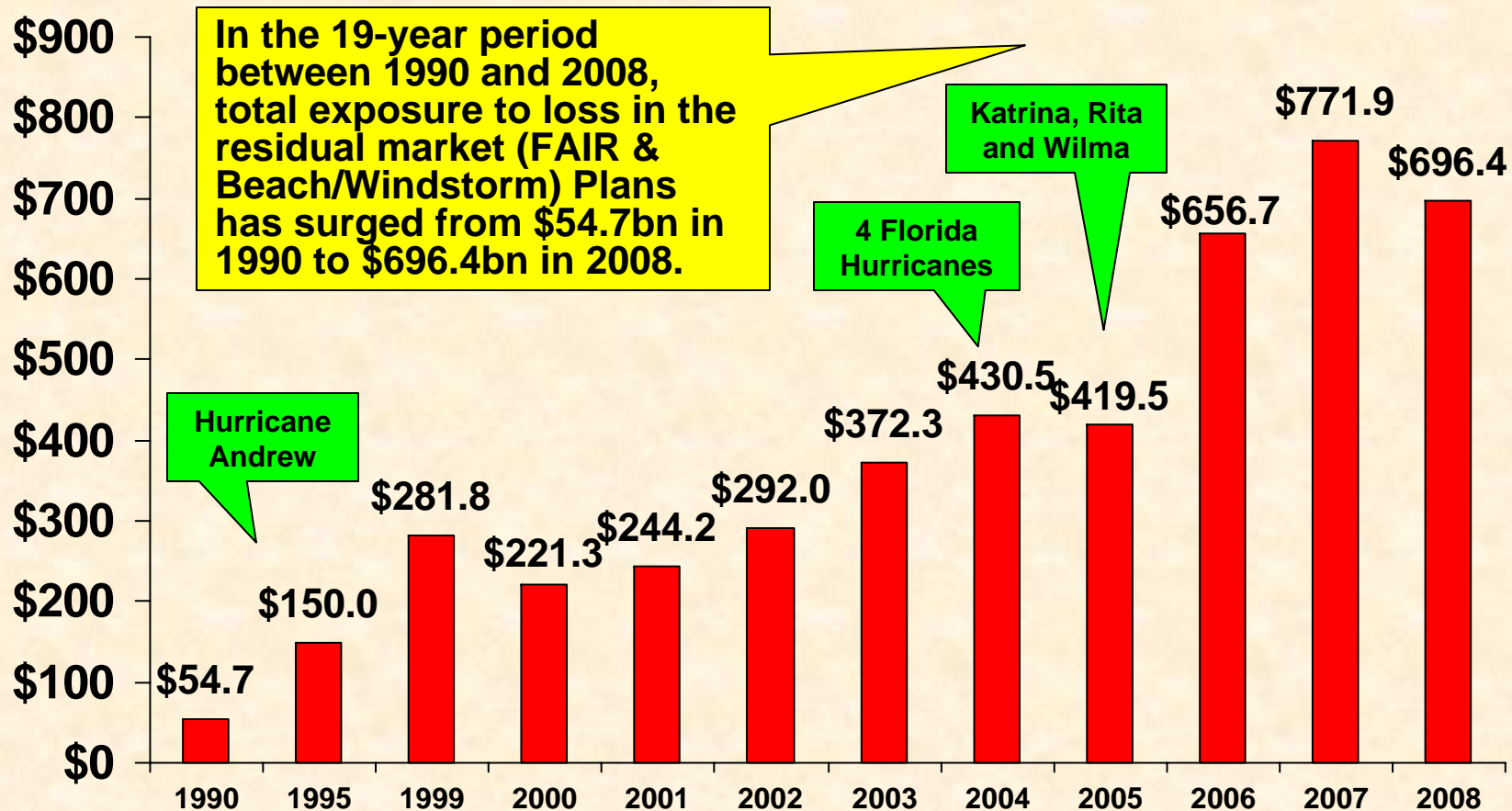
# *Total Value of Insured Coastal Exposure (2007, \$ Billions)*



Source: AIR Worldwide



# *U.S. Residual Market Exposure to Loss (Billions of Dollars)*



Source: PIPSO; Insurance Information Institute



# *Insurance Information Institute On-Line*

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YOUR ATTENTION!***

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