How to Live to Be 100: In the Property/Casualty Insurance Industry

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Presentation Outline

- The Life Cycle of Businesses: Lessons from the Natural World
- Characteristics of the World's Oldest Businesses
- P/C Centenarians: Who Lives to Be 100+ and Why?
- Why Do Insurers Fail?
- Secrets of the Ancients: Leadership Attributes of 100+ Year Old Insurers
- Lesson from the Financial Crisis
- Q&A

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Lessons from Nature: What Would Darwin Would Say?

Longevity in the Business World Has Parallels in the Natural World

On the Life Cycle of Businesses: Lessons from Nature

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- **Most Businesses, Like Living Species, Eventually Become Extinct**
  - **99.5% of all living species to ever exist on Earth are now extinct; The proportion is higher for business and extinctions occur over a much compressed timespan.**
  - **Changes in the natural environment (not external forces like humans) were responsible for almost all extinctions**
  - **This means that despite millions of years of evolution and adaptation, virtually every species eventually confronts a change in its environment to which it cannot adapt**
  - **It is the same in business; Wall Street models likely offer less assurance than millions of years of evolution**

- **Business Cycle Gives Rise to "Creative Destruction"**
  - **Mass extinctions in business are common**
  - **Economy is constantly reinventing itself**
  - **New industries and businesses spring from the ashes of the previous generation, fill voids and occupy niches**

Mass Extinction: Surge in Business Bankruptcy Filings Amid Crisis Since 2007

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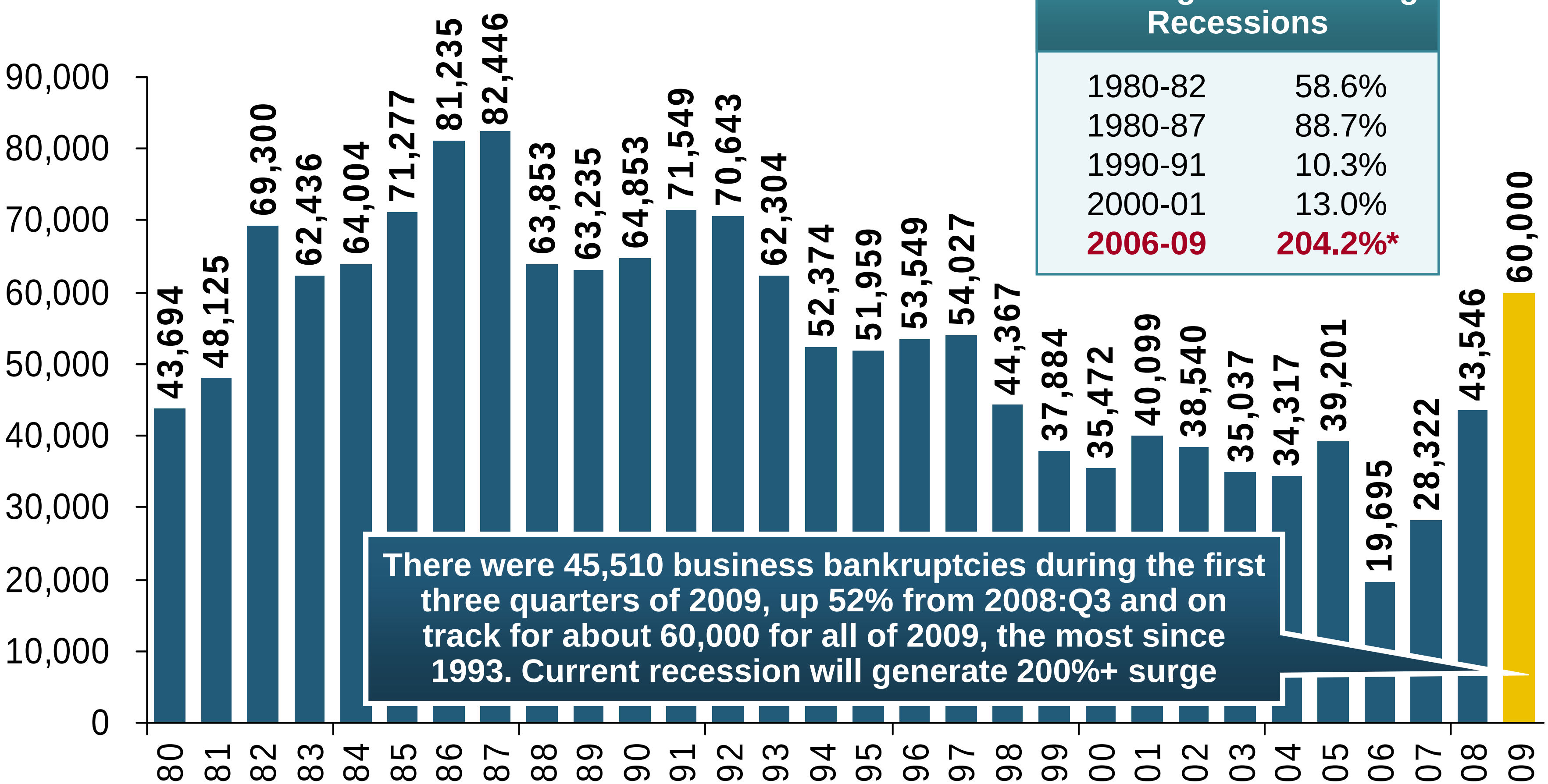
% Change Surrounding Recessions	
1980-82	58.6%
1980-87	88.7%
1990-91	10.3%
2000-01	13.0%
2006-09	**204.2%***



The Crisis Will Destroy Hundreds of Thousands of Businesses

*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.

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Lessons from History: What Types of Business Live a Very Long Time (500+ Years) and Why?

Longevity in the Business World Requires Focus, Long-Term Objectives

Number of Firms More than 500 Years Old, by Industry*

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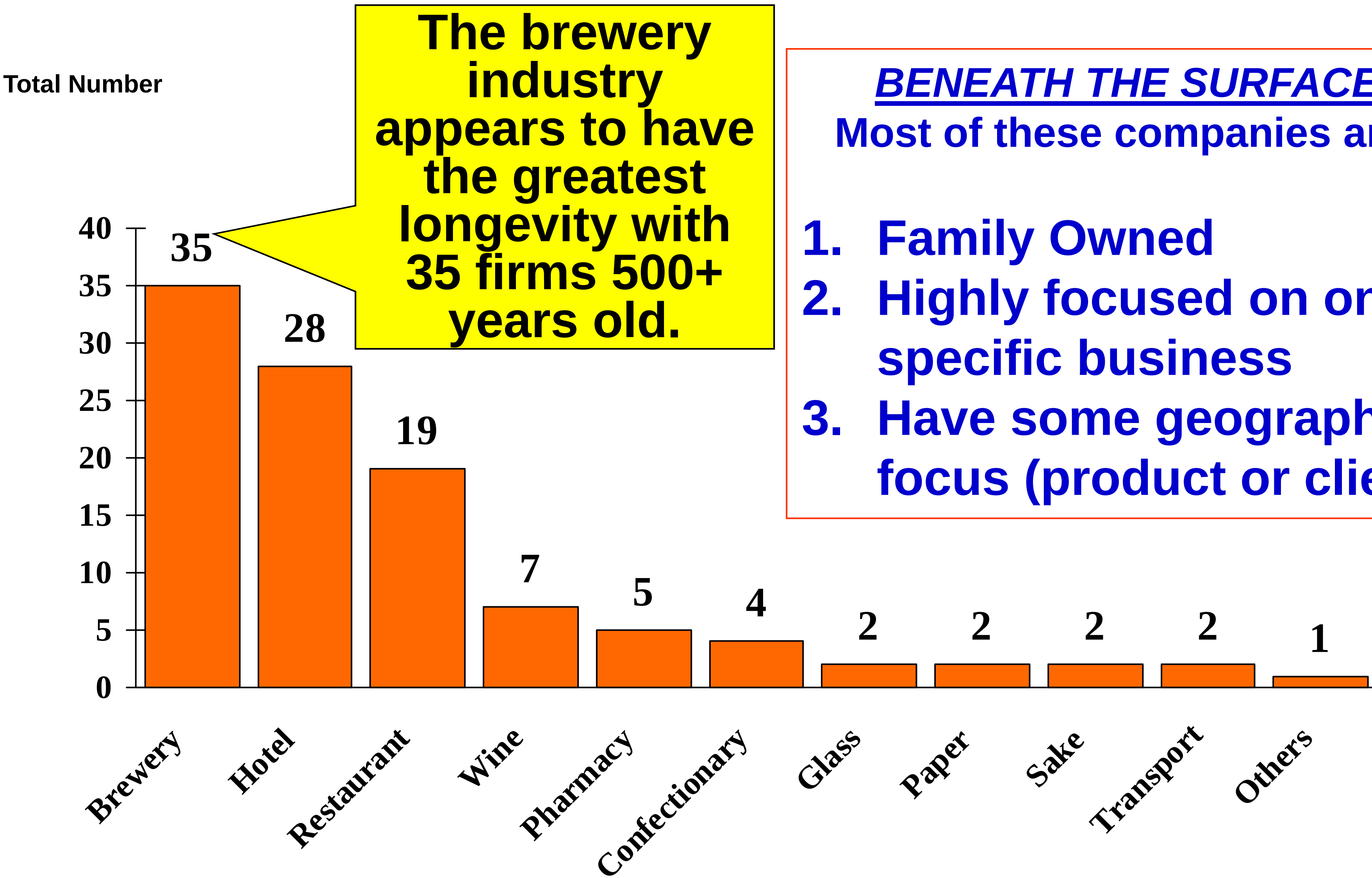

<u>BENEATH THE SURFACE</u>

Most of these companies are:

1. **Family Owned**
2. **Highly focused on one specific business**
3. **Have some geographic focus (product or client)**

Source: http://en.wikipedia.org/wiki/List_of_oldest_companies

Characteristics of Firms That Stand the Test of Time

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1. **Business Model: Highly Focused**
   - Firms tend to remain true to core business
   - Avoid businesses you don't understand
   - Some diversification is usually good, but leads to an exponential increase in complexity and unforeseen interactions across units
2. **Ownership Structure: There Exists Some Concept of Mutuality**
   - Some of the world's oldest firms are family owned (artisans, craftsman)
   - Others have some form of cooperative arrangement (agricultural)
   - Such organizations also exhibit *altruistic* behavior, a proven survival trait
3. **Communal Interest: A Concern for the Greater Common Good**
   - Perpetuation of the species (i.e., the industry) is evident in behaviors
   - Concept of mutuality extends beyond organization to communal interest
   - A strong willingness to work for the common good

Characteristics of Firms That Stand the Test of Time (cont'd)

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4. **Growth: Tend to Grow Slowly**
   - As with living species, the longest lived businesses in the world tend to grow only slowly, if at all
5. **Size: Tend to Be Small Relative to Competition**
   - Size seems to matter when it comes to species longevity: smaller = longer
   - Also true among living species (e.g., bacteria, insects)
6. **Profitability: Tend Not to Be the Most Profitable**
   - Object of continuous profit maximization is not consistent with longevity
   - A "will to survive" is still necessary

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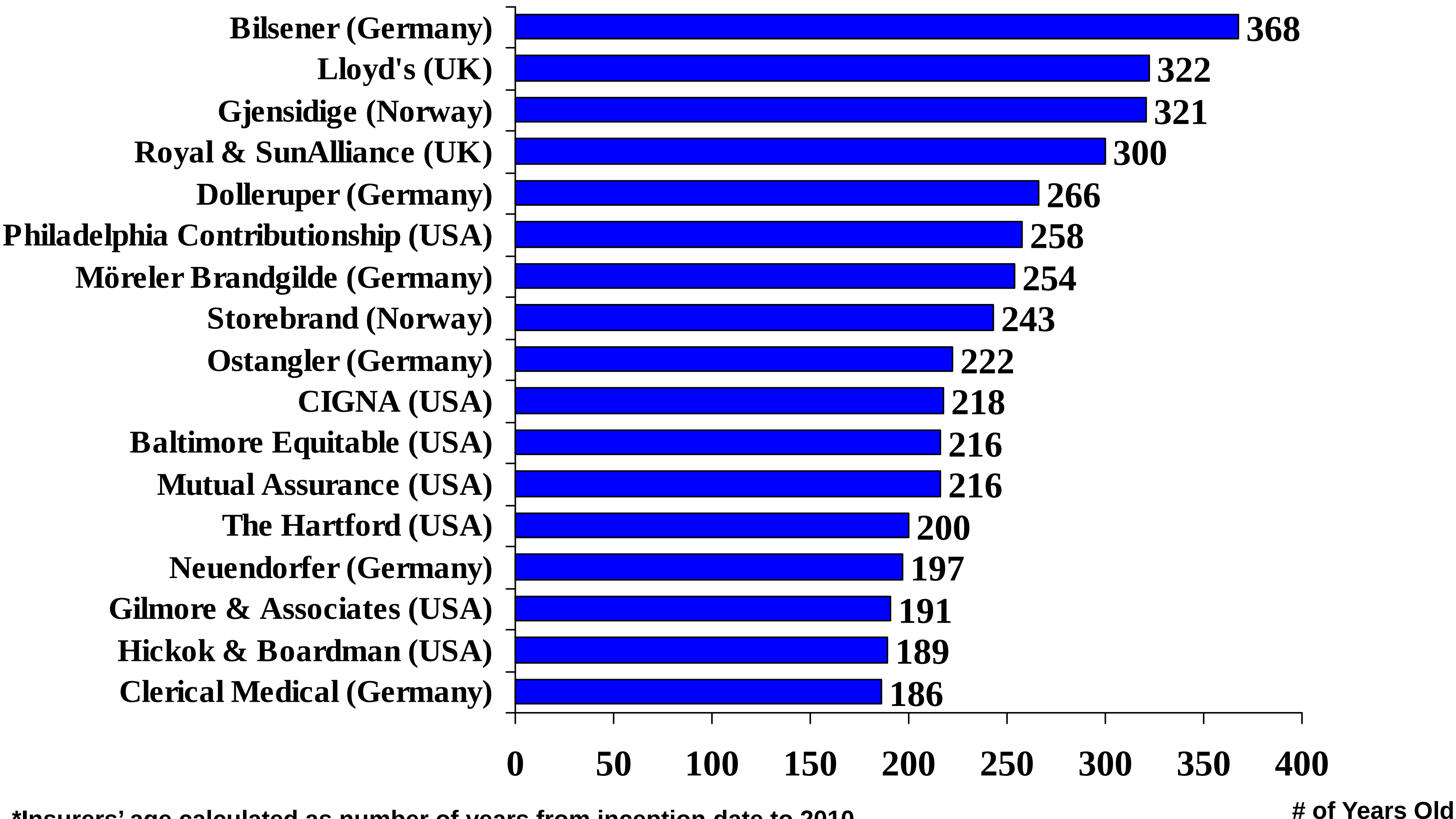
World's Oldest Insurance Companies

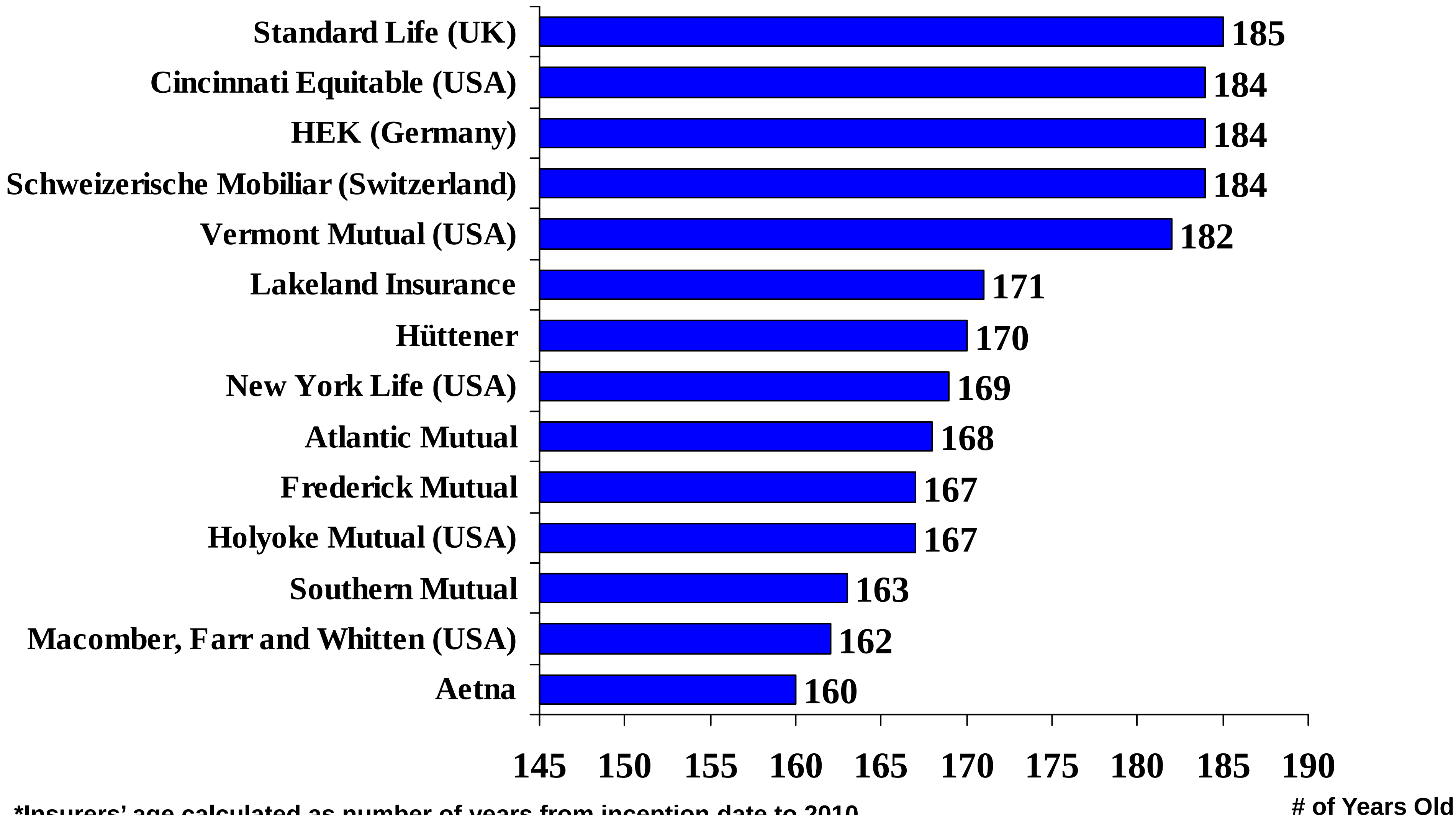
Who Has Truly Endured?

Sampling of World's Oldest Insurance Companies, by Age and Country*



*Insurers' age calculated as number of years from inception date to 2010
Source: http://en.wikipedia.org/wiki/List_of_oldest_companies

Sampling of World's Oldest Insurance Companies, by Age and Country* (cont'd)



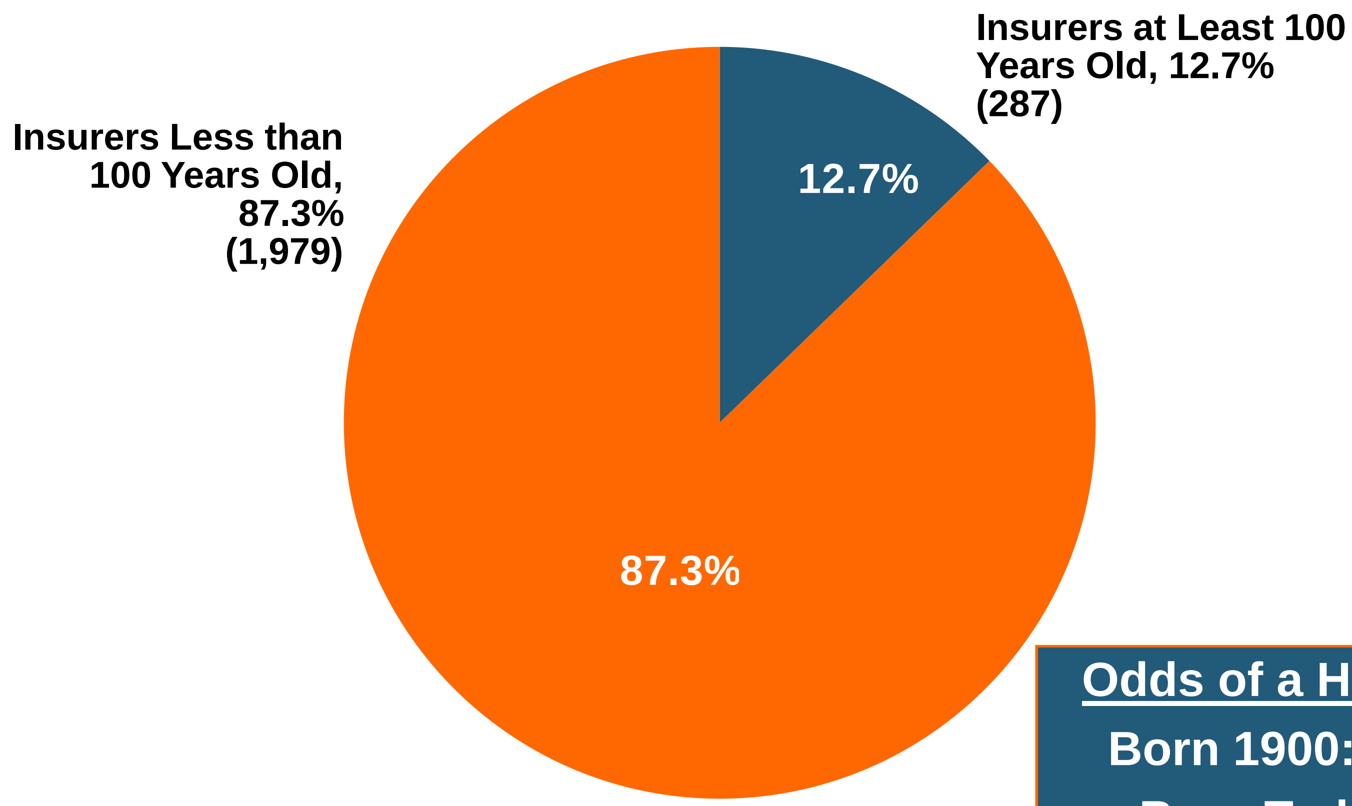
*Insurers' age calculated as number of years from inception date to 2010.
Source: http://en.wikipedia.org/wiki/List_of_oldest_companies

The Centenarians: Who Lives to Be 100+ in the P/C Insurance World?

Characteristics of An Exclusive Club of Insurers

100+ Year Old Insurers as a Share of All P/C Insurers

Nearly 13% of P/C insurance companies (1-in-8) today is 100+ years old. This is a surprisingly high percentage.



Odds of a Human Living to 100

Born 1900: ~0.25% (1-in-400)

Born Today: ~2% (1-in-50)

Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC; CDC

Decade of Formation for P/C Insurers at Least 100 Years Old in 2010

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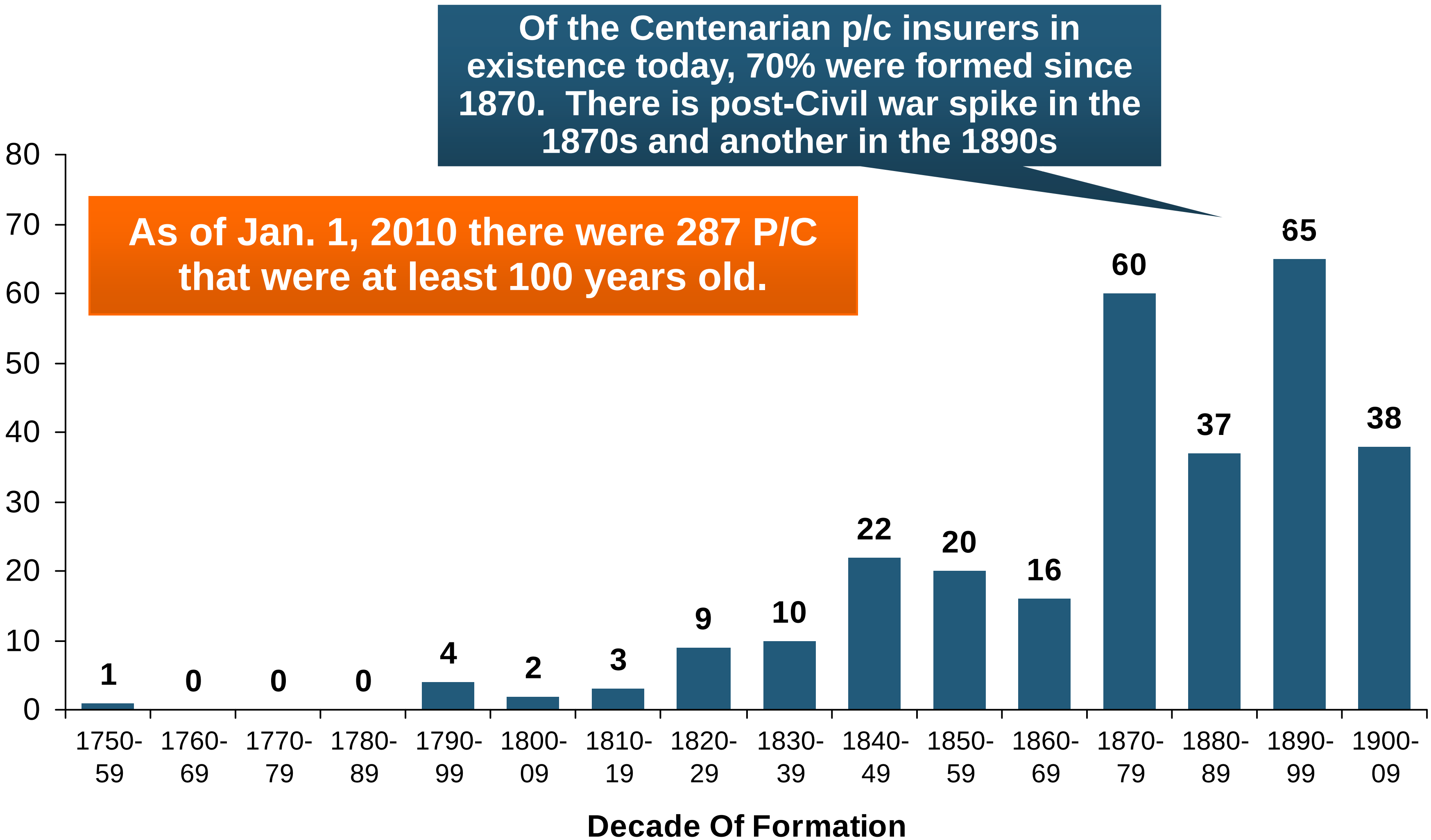

Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC.

100-year-old Insurers: Independent vs. Part of Group/Holding Company

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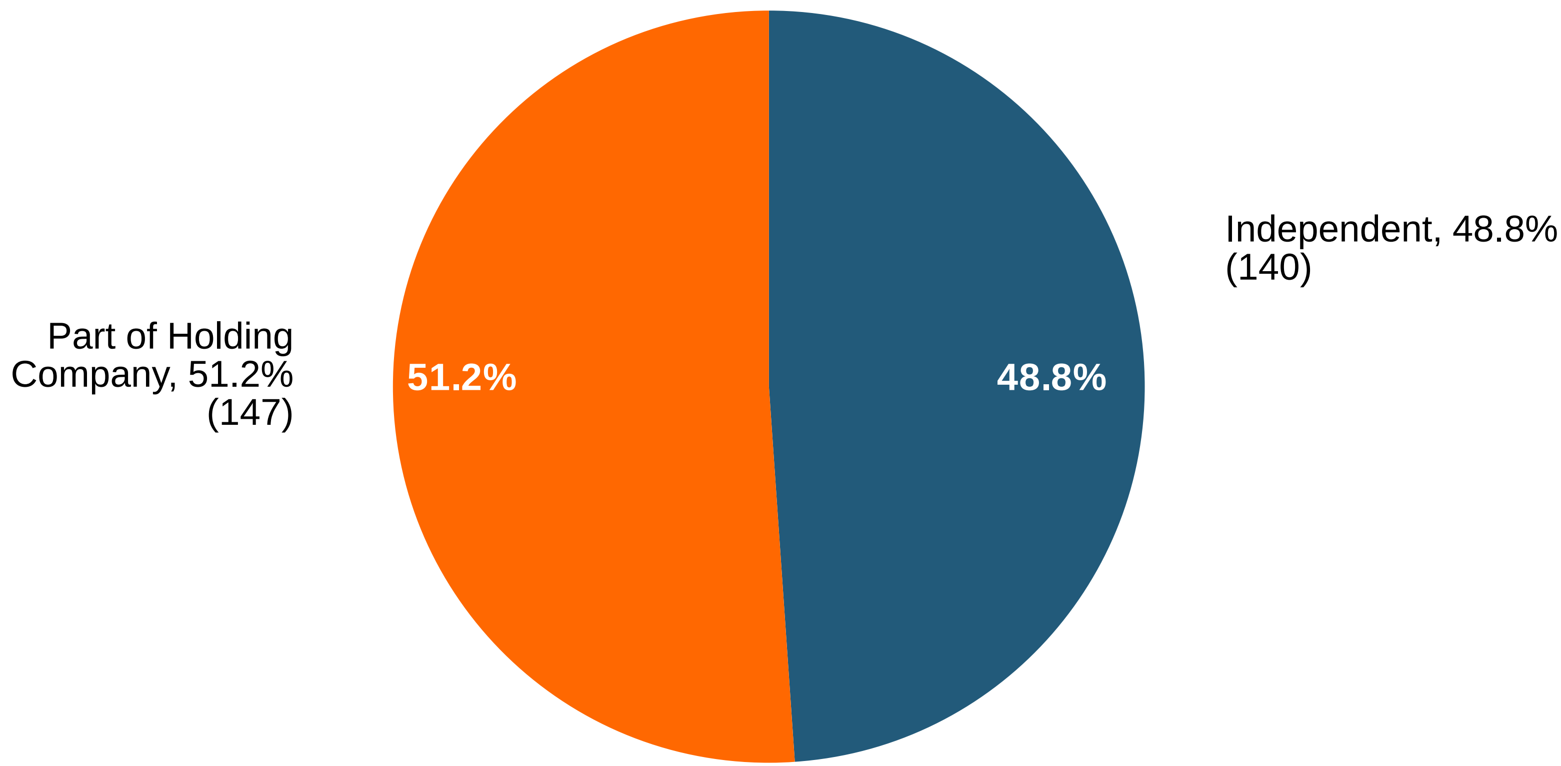
The number of 100-year-old insurers that are independent vs. part of a more diversified group structure is split almost evenly.



Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC.

100-year-old Insurers: Some Are Shell Companies or Are in Runoff

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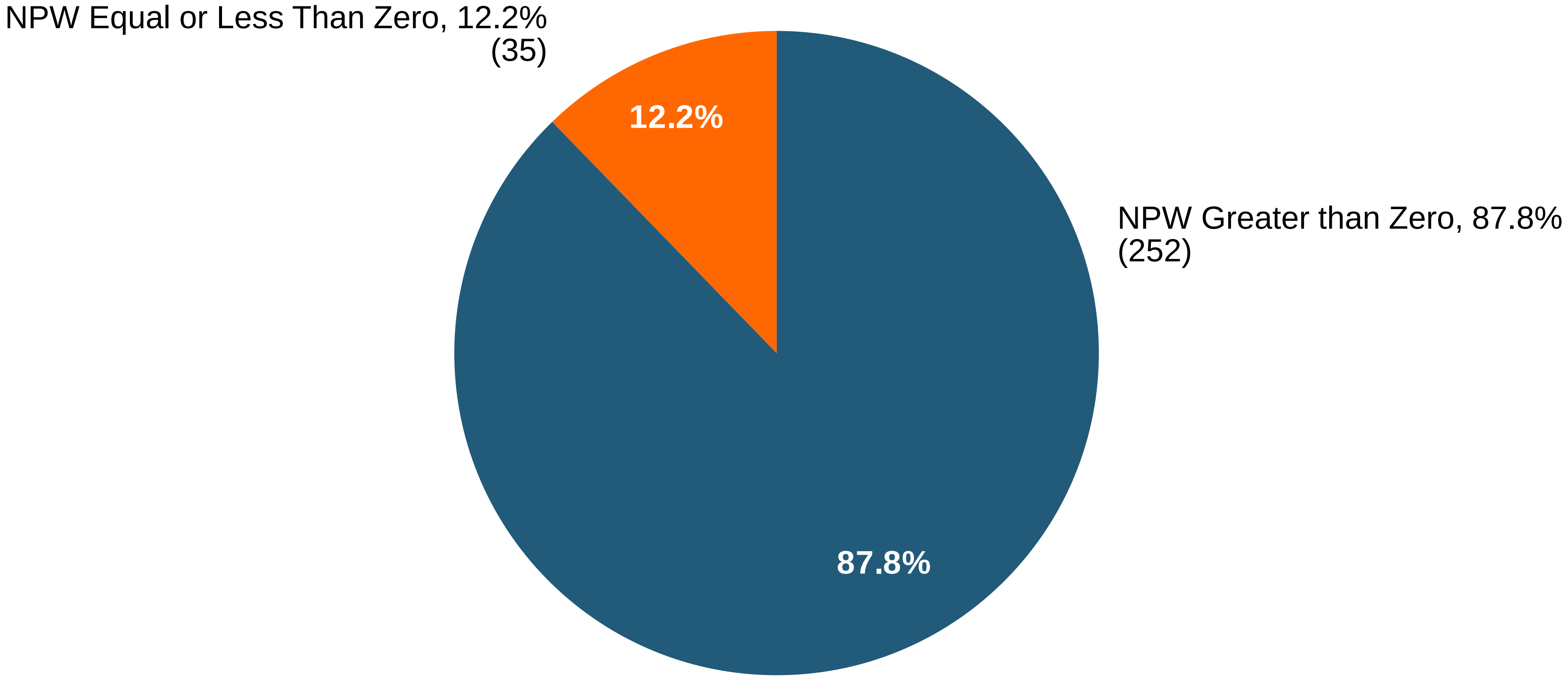
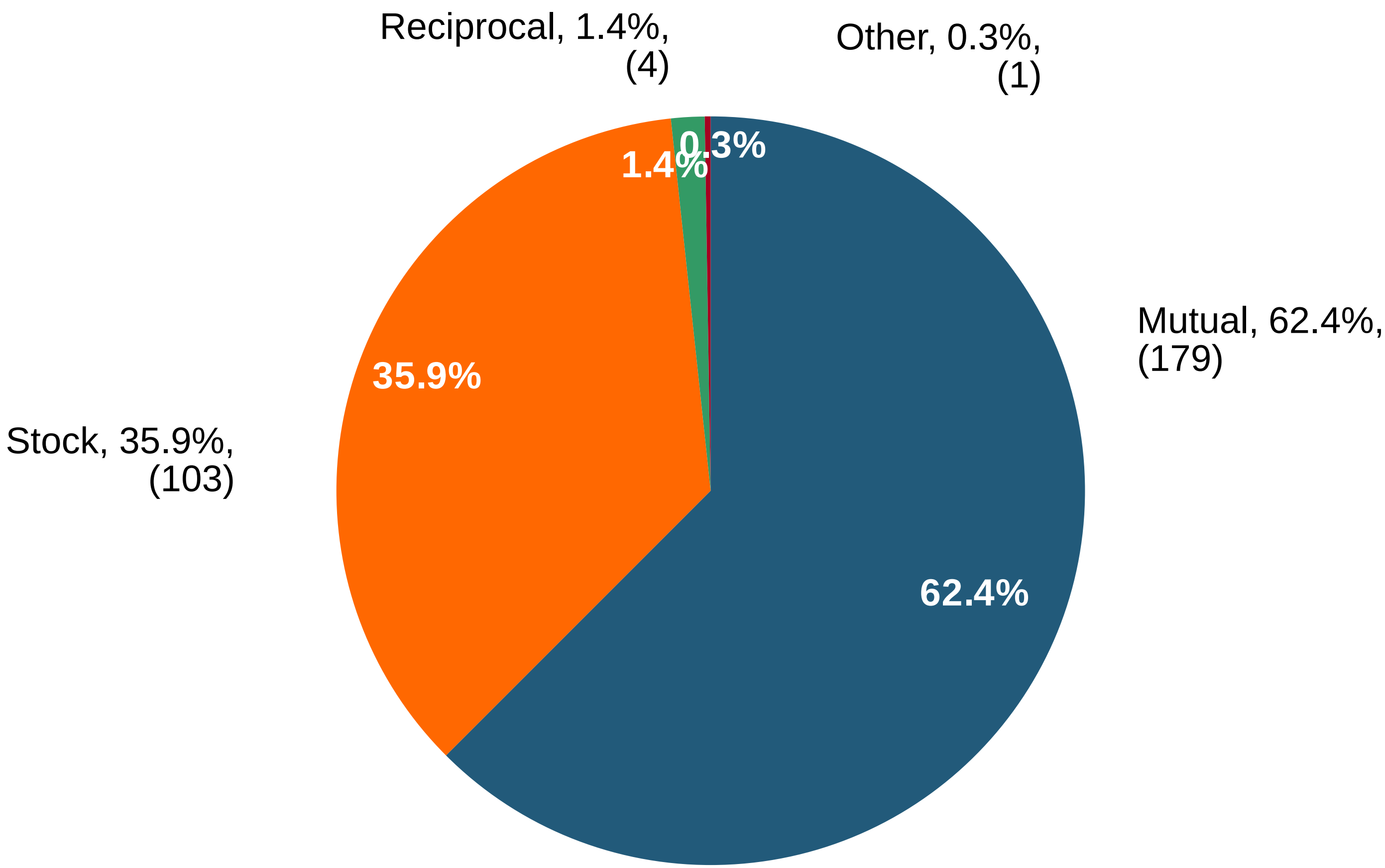
Approximately 12% of "existing" 100-year old insurers had net written premiums less than or equal to zero, suggesting they were either unused shell companies or in runoff and not actively writing new business.



Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC.

100-year-old Insurers: Mutual vs. Stock vs. Reciprocal

The vast majority (62.4%) of 100-year-old insurers are mutual insurers, while stock insurers account for 35.9% of the total.



Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC.

100-Year Old Insurers: Share of Total Industry NWP 1998 vs. 2008

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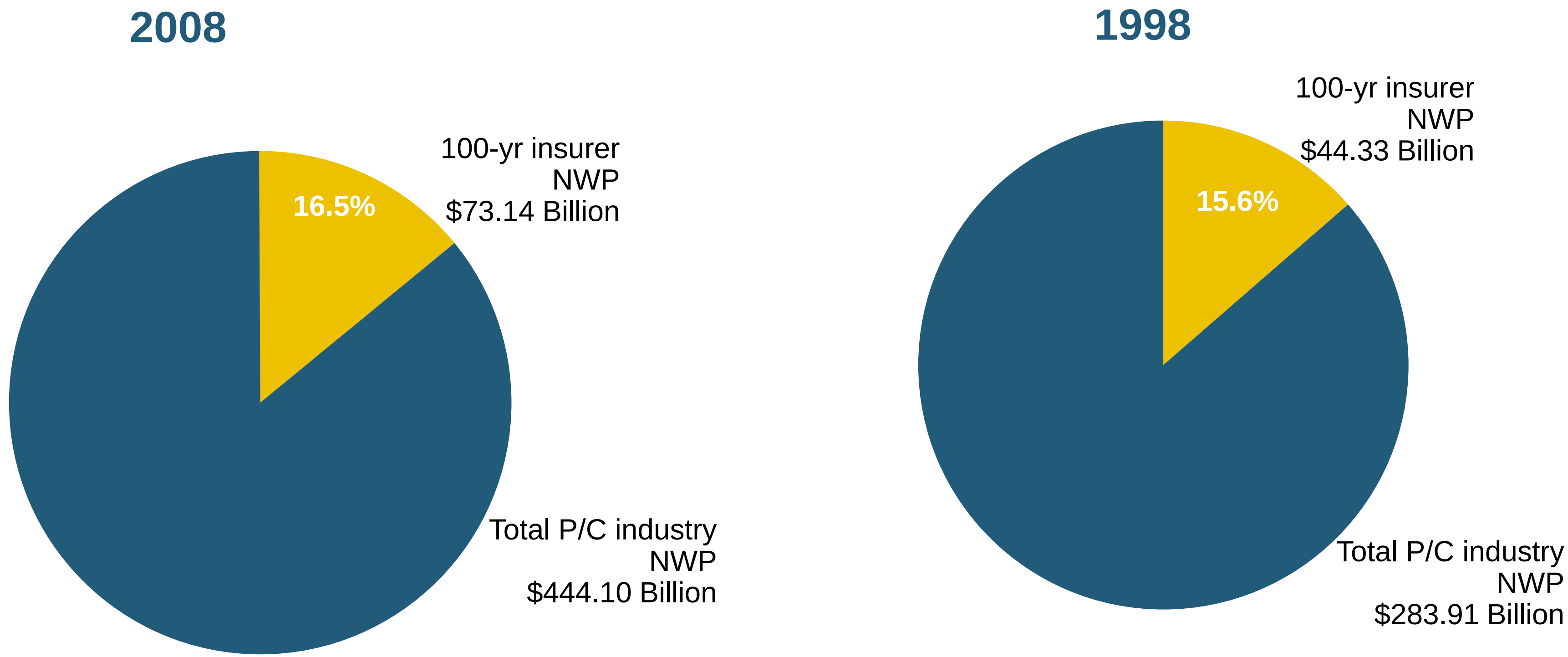
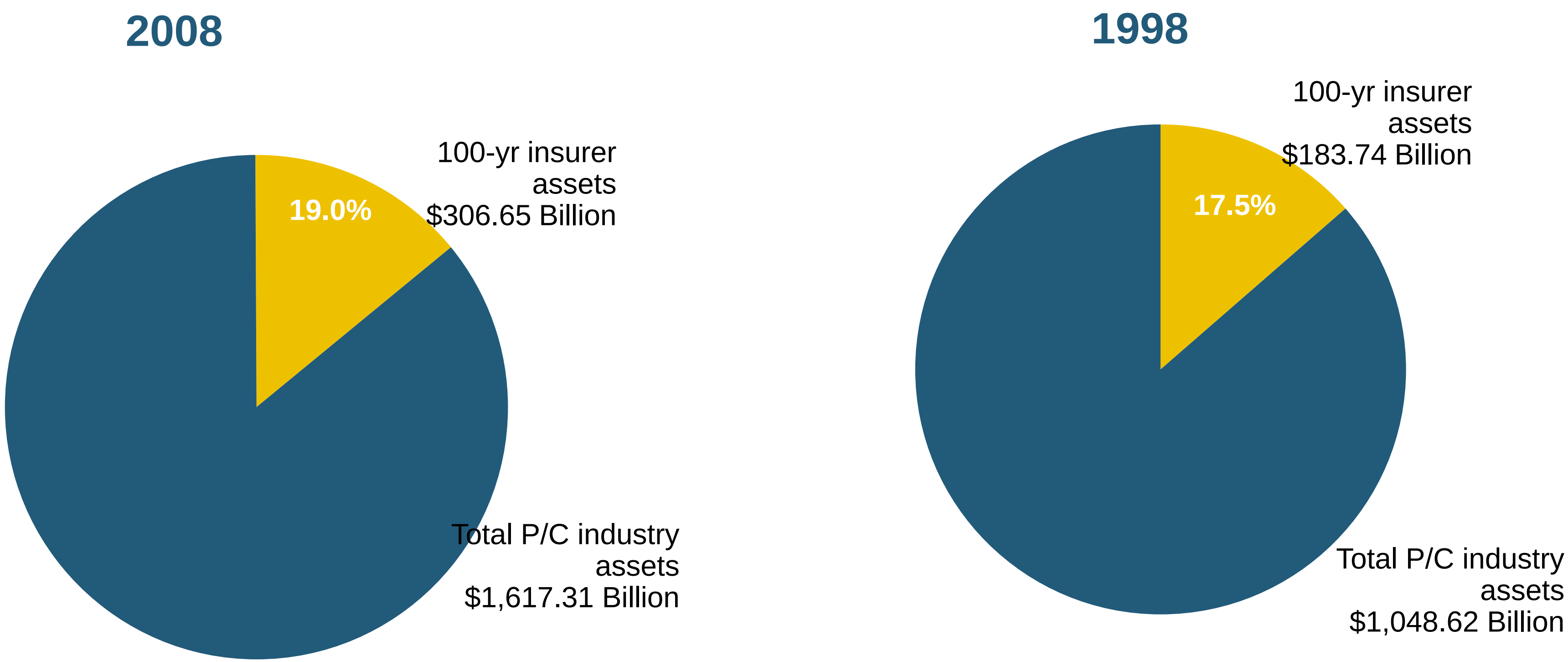


The market share of 100-year-old insurers as a % of total P/C industry NWP remained stable over the decade ending in 2008 (latest available)

Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC; A.M. Best

100-year-old Insurers: Share of Total Industry Admitted Assets 1998 vs. 2008



The market share of 100-year-old insurers as a % of total P/C industry assets has increased slightly over the years.

Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC; A.M. Best

Distribution of 2008 NWP by Decile

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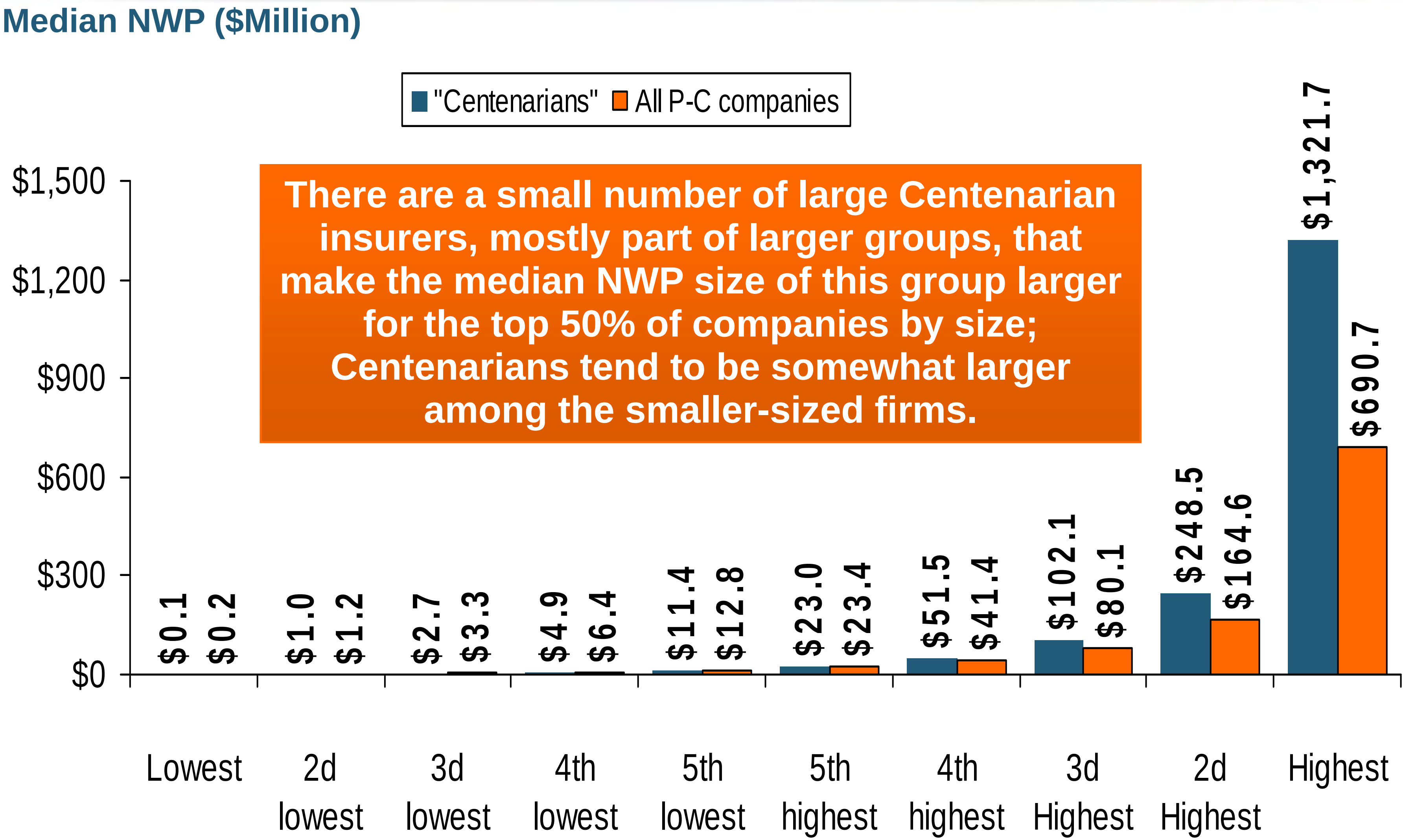
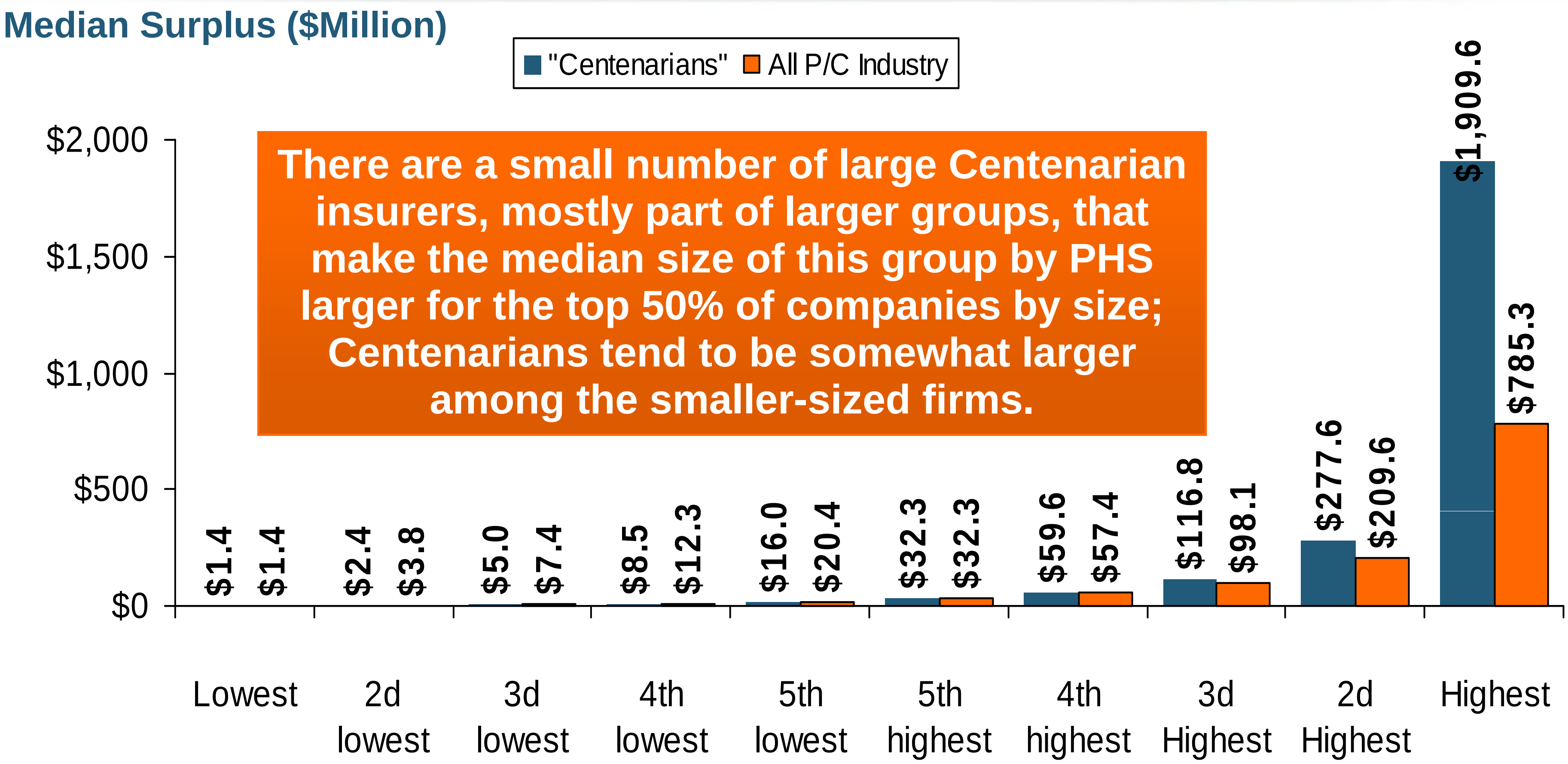


Note: 25 companies per decile for centenarians; 227 per decile for all p/c industry

Source: NAIC Annual Statement data, via Highline

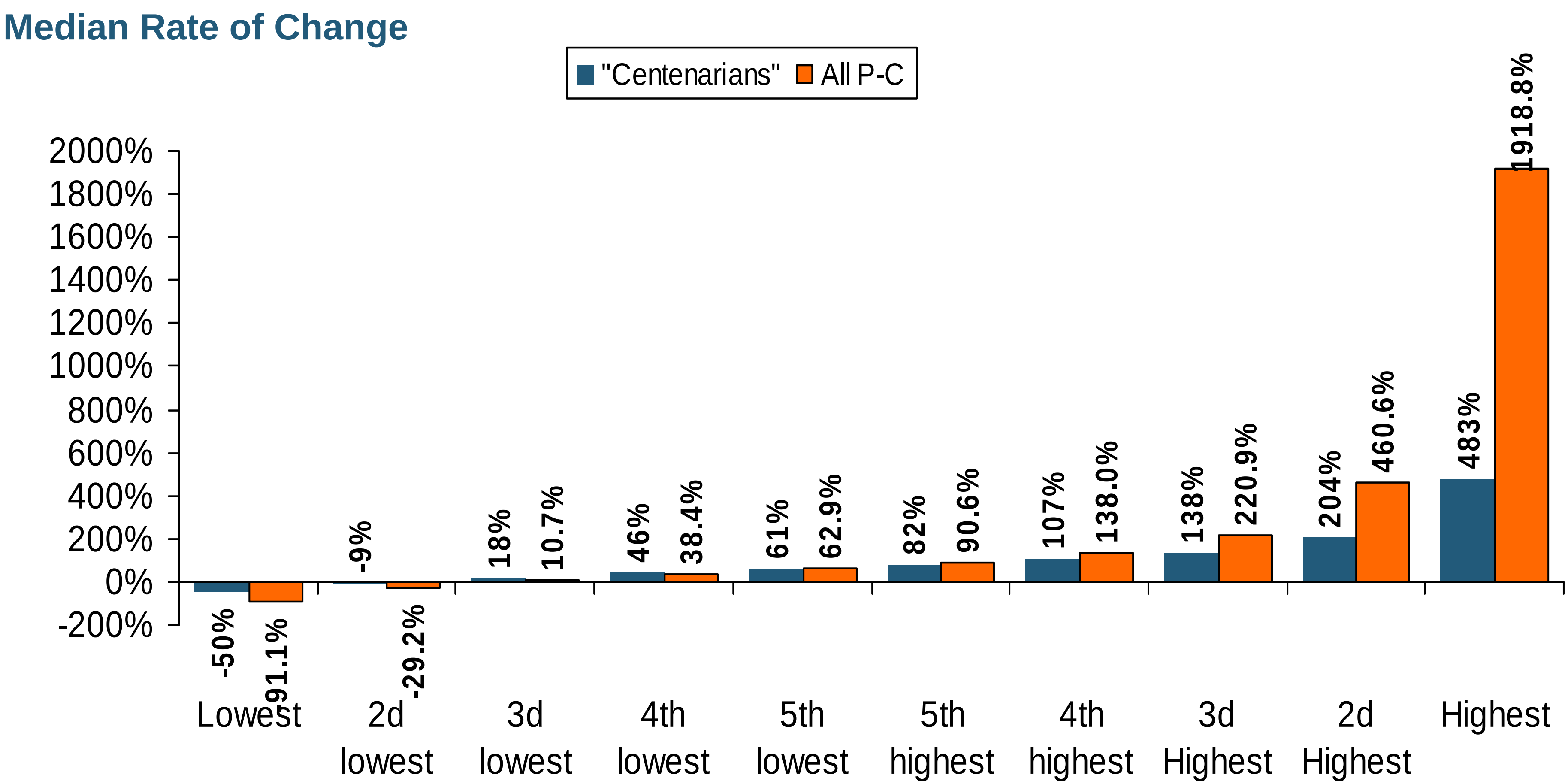
Distribution of 2008 Surplus by Decile



There are a small number of large Centenarian insurers, mostly part of larger groups, that make the median size of this group by PHS larger for the top 50% of companies by size; Centenarians tend to be somewhat larger among the smaller-sized firms.

Note: 25 companies per decile for centenarians; 225 per decile for all P-C
Source: NAIC Annual Statement data, via Highline

Distribution of 1998-2008 NWP Change, by Decile

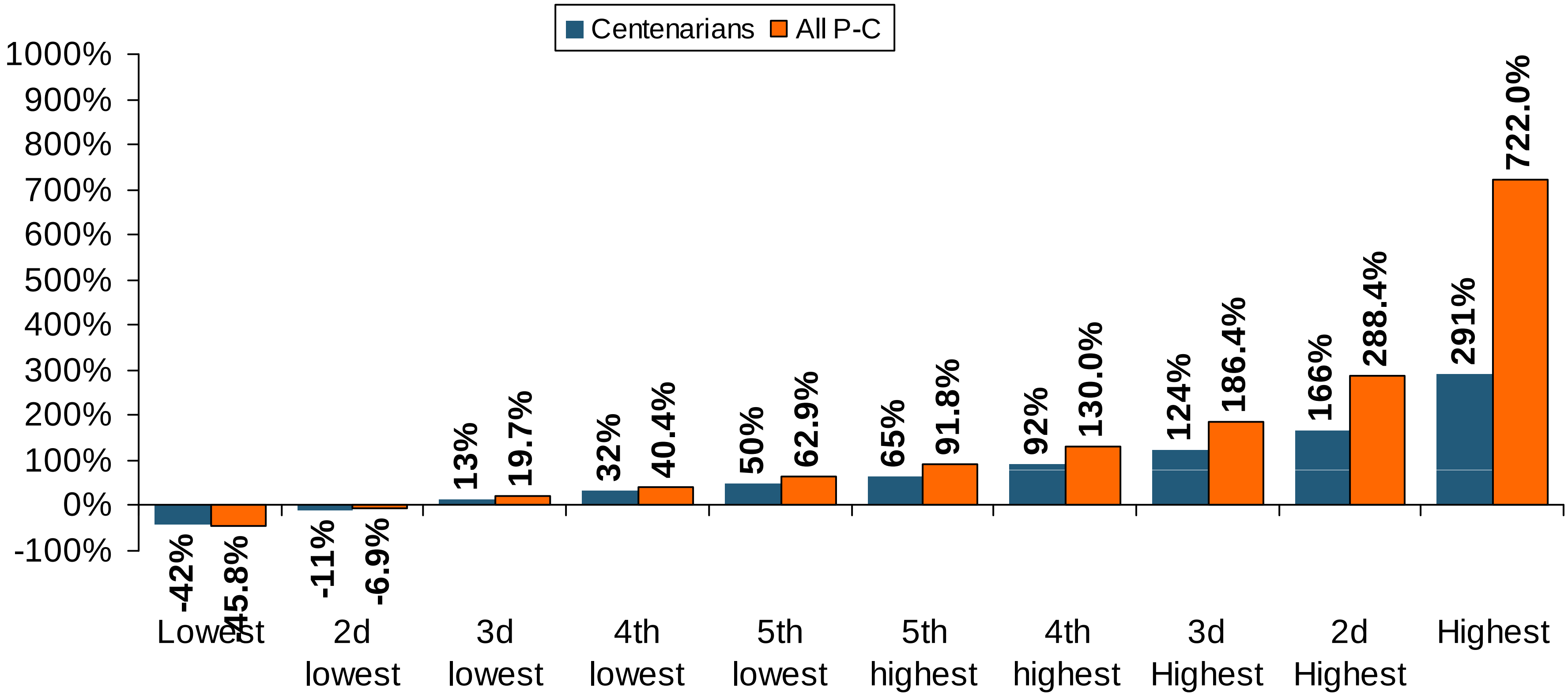


Note: 24 companies per decile for centenarians' 163 per decile for all P-C industry 1998-2008

Source: NAIC Annual Statement data, via Highline

Distribution of 1998-2008 Surplus Change, by Decile

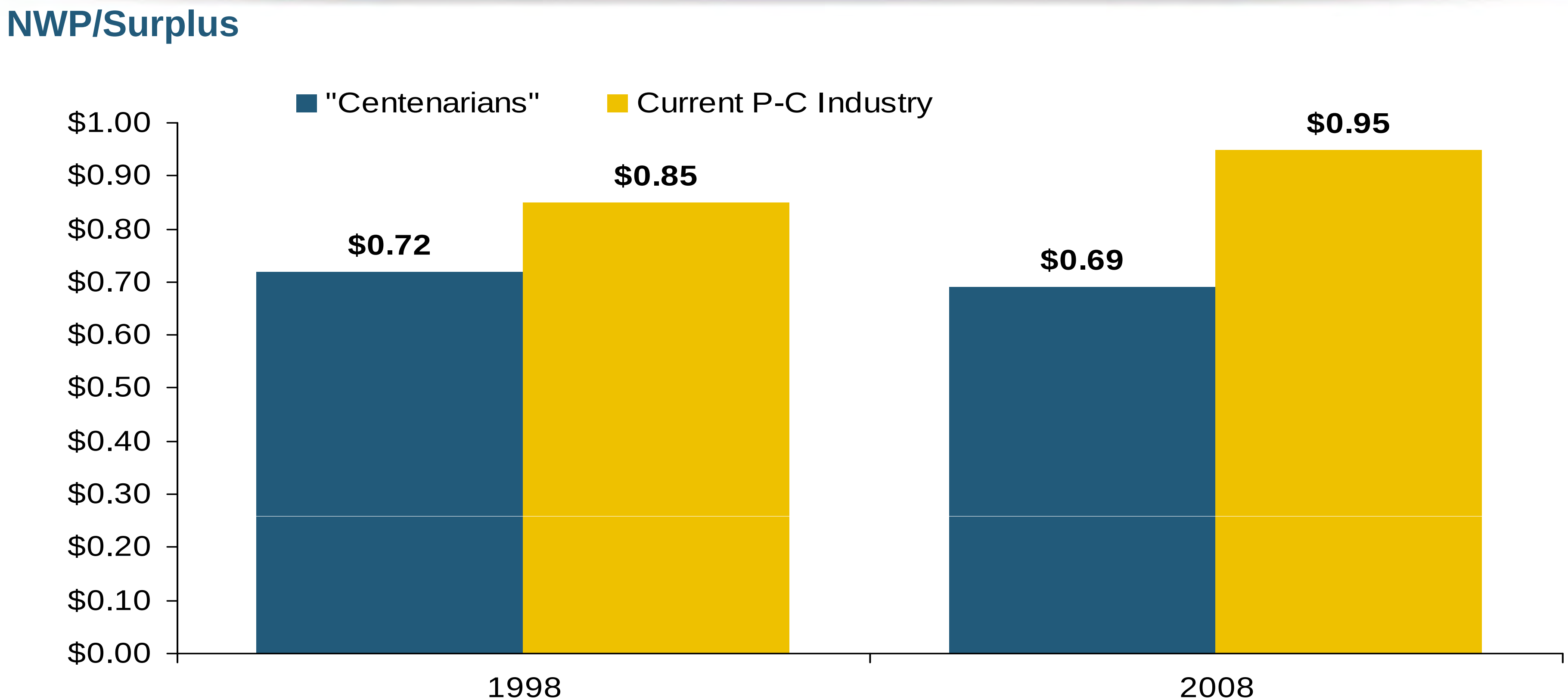
Median Rate of Change



Note: 24 companies per decile for centenarians; 163 per decile for all p-c 1998-2008

Source: NAIC Annual Statement data, via Highline

Premium to Surplus Ratios, "Centenarians" vs. Current P-C Industry, 1998 and 2008

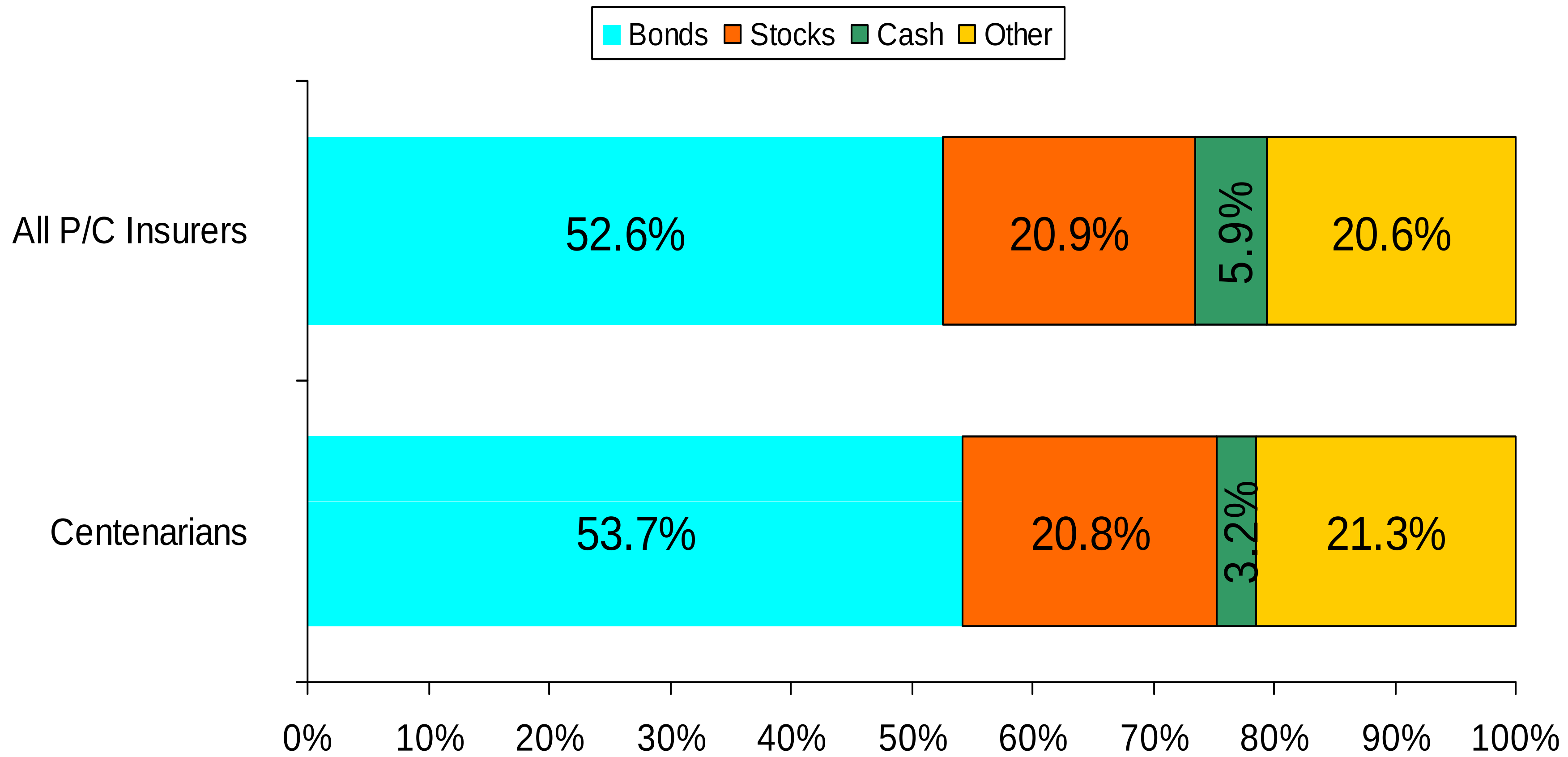


Premiums are a rough measure of risk accepted; surplus is funds beyond reserves to pay unexpected losses. The larger surplus is in relation to premiums—the lower the ratio of premiums to surplus—the greater the capacity to handle the risk it has accepted.

"Centurians" are companies at least 100 years old with positive NWP in 2008

Sources: National Association of Insurance Commissioners' Annual Statements, via Highline; I.I.I. calculations

Asset Class Distribution of Admitted Assets, "Centenarians" vs. All P/C Insurers, 2008



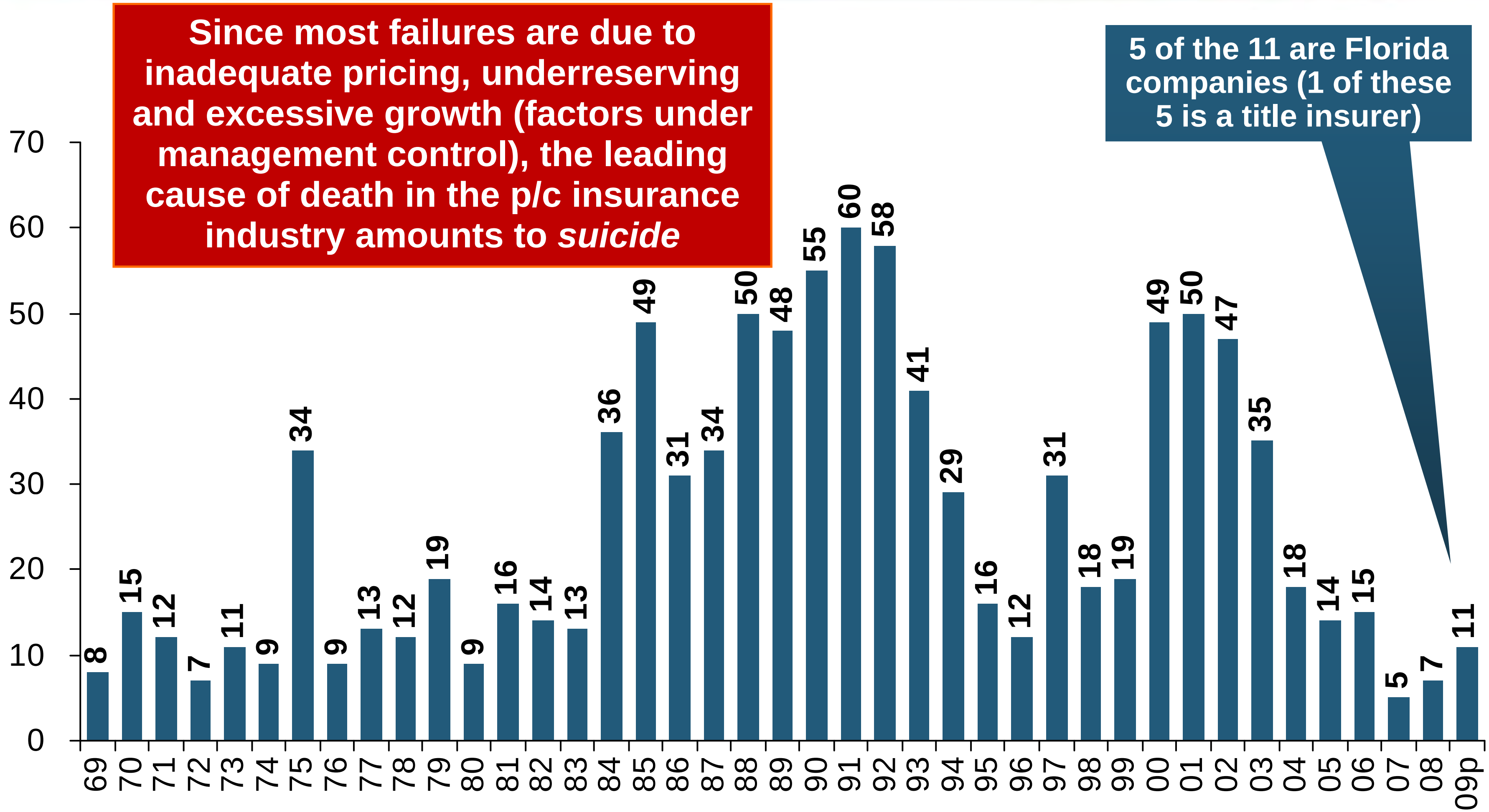
Note: 25 companies per decile

Source: NAIC Annual Statement data, via Highline

Why Do Insurers Fail?

Leading Reasons Why Most Insurers Don’t Make it to 100

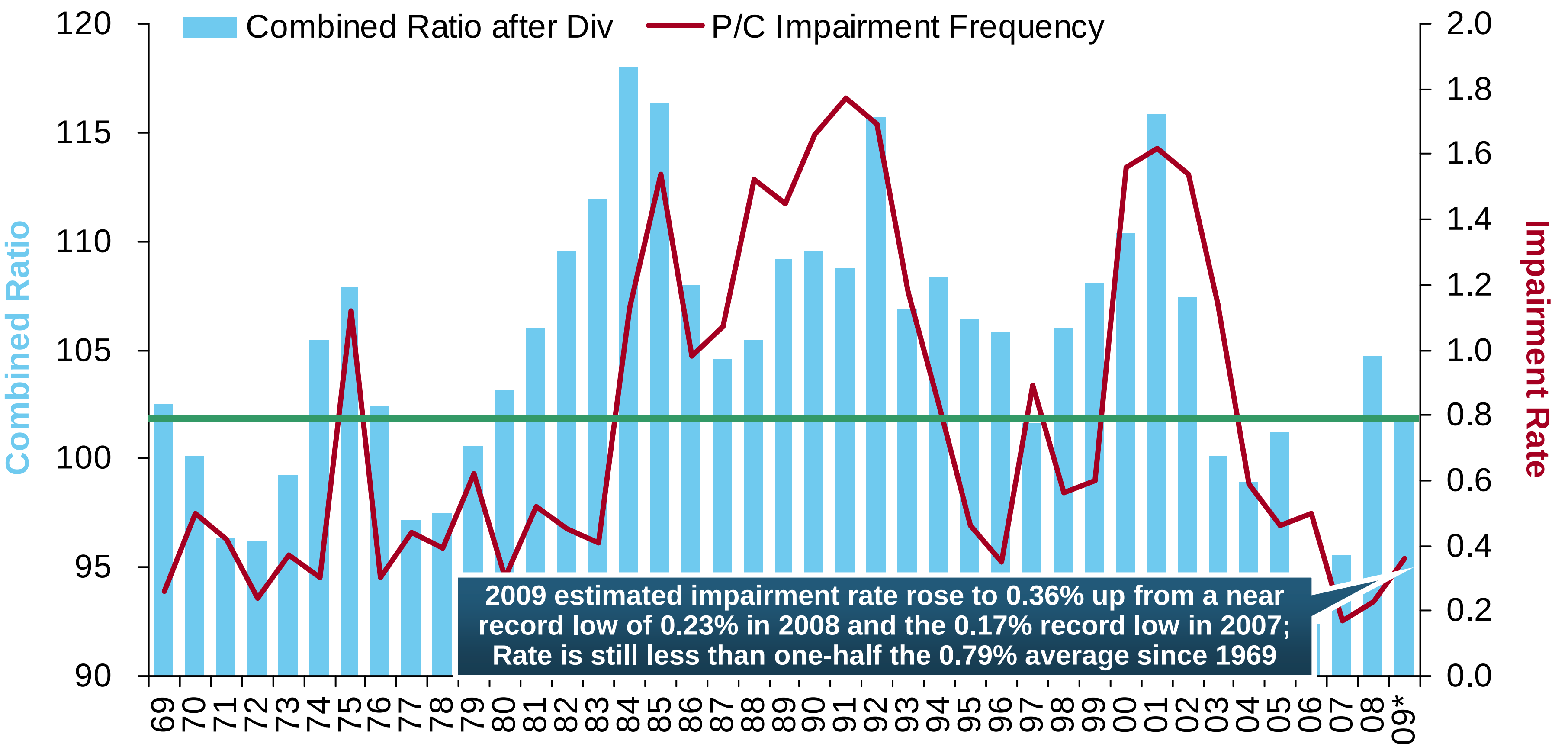
P/C Insurer Impairments, 1969–2009p



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

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

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

Five Deadliest Sins for P/C Insurance Companies

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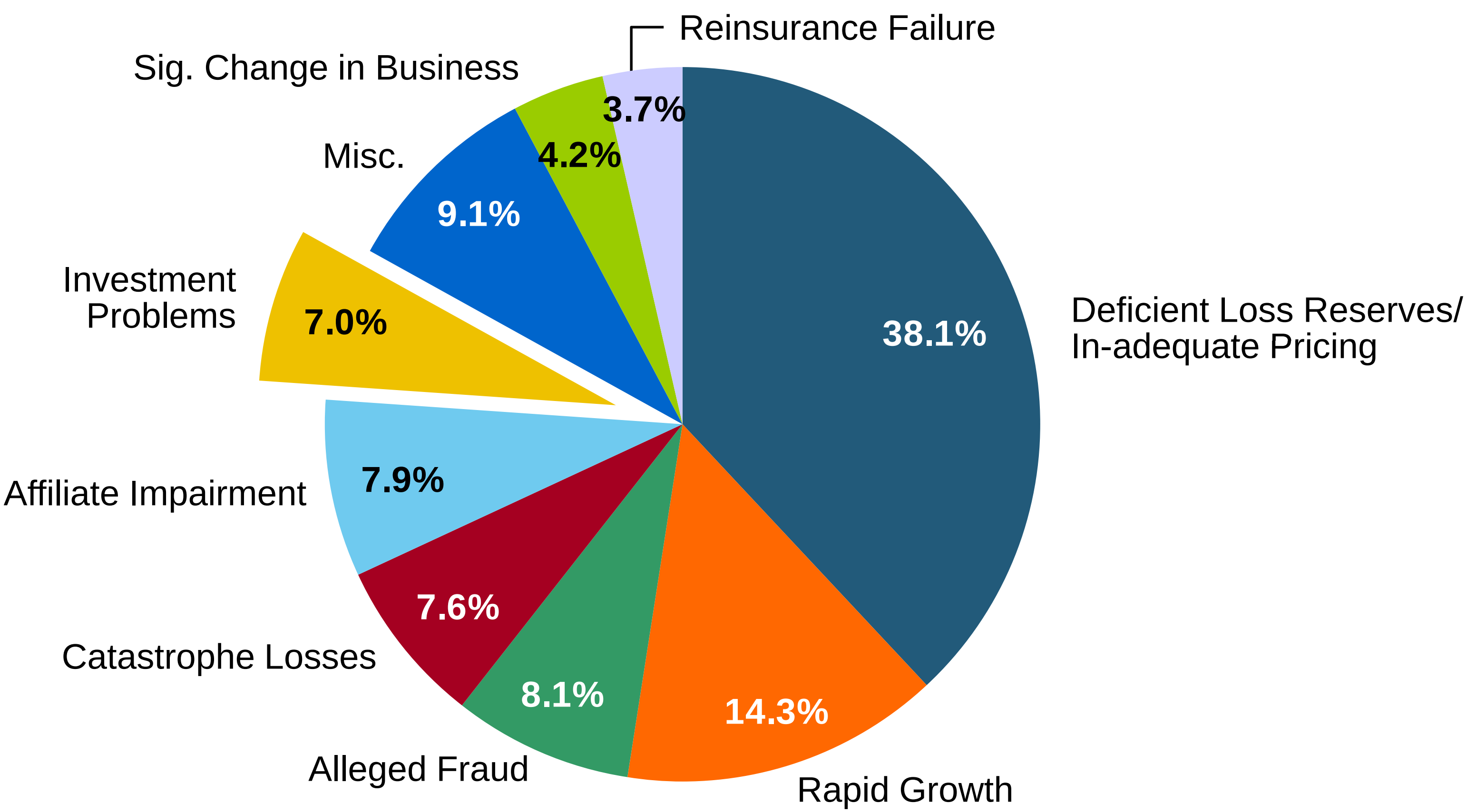
OPERATIONAL ISSUES

1. **Underpricing/Underreserving (~38% of failures)**
   - Leading cause of p/c insurer death according to A.M. Best
2. **Excessive Growth (~14%)**
   - Too much growth too fast (organically or via M&A) can be fatal
3. **Excessive Catastrophe Exposure (~8%)**
   - Too much underpriced exposure, too little reinsurance, insufficient diversification
4. **Investment Problems (~7%)**
   - Investments are too risky, too illiquid or insufficiently understood
5. **Affiliate Problems (~8%)**
   - Non-core operations can cause problems for parent (e.g., AIG)

Source: I.I.I. research.

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

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



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

Leadership Attributes Found in Insurers that Reach 100+ Years

Secrets of the Ancients

Leadership Attributes Inherent in Long-Lived Insurance Companies

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1. **Management Acts as a Steward of the Enterprise**
   - Objective is to pass a healthy firm safely and securely to the next generation of management and policyholders
2. **Management Financial Incentives**
   - In line with the goal of providing the protection purchased
   - There is typically no 3rd party (shareholders) to compensate (60%+ mutuals)
     - Objective if public company is to maximize profits
   - CEO (total) comp is a smaller multiple relative to average employee
3. **Nimble: Environment for Small Insurers Can & Does Change**
   - Not always first to change, but adaptation occurs within reasonable timefram
4. **Customer Focus & Relationship Driven**
   - Customer is the #1 priority
   - Committed to agency form of distribution, with 21st century enhancement
5. **Regulation**
   - In favor of comprehensive but local regulation (contrast with banks)

Traits to Admire in an Insurer and Its Management?

1. **A Firm Whose Management's Incentives are Strictly Aligned With the Insurer's Principal Stakeholders**
   - Customers, agents, employees, shareholders, community
   - These include financial and operational objectives

2. **Management Is Knowledgeable**
   - Management of small, long-lived insurer is no less knowledgeable about industry trends, opportunities and threats than larger competitors

3. **Intuitive and Comprehensive Understanding of Enterprise Risk Management**
   - Much is made of ERM today, but long-lived insurers practiced it well before it had a name

What Do I Admire in an Insurer and Its Management?

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4. **CEO is Willing to Seek Advice and Counsel**
   - No imperial CEOs; Self-aggrandizement is rare
   - CEO is a listener and consensus builder

5. **Commitment to Core Constituencies**
   - Customer is the #1 priority
   - Committed to agency form of distribution, with 21st century enhancement

6. **Lack of a "Wandering Eye"**
   - Disciplined enough to stick with the business you know, but also adapting to changing business conditions and seizing opportunities as necessary

Lessons from the Financial Crisis

What Have the Past Two Years Taught the P/C Insurance Industry?

Lessons All Financial Industries Must Learn from the Recent Financial Crisis

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1. **Risk Management Matters**
2. **Getting Involved in Businesses You Don't Understand Can Be Fatal**
3. **Too Rapid Growth Can Kill Quickly**
4. **Management Financial Incentives Can Pervert Risk Management Controls**
5. **Support of Comprehensive and Appropriate Regulation is Vital to Longevity of Financial Services Enterprises**
6. **Keeping "Skin in the Game" is Critical**
7. **Never Lose Sight of What is in the Best Interest of the Customer**

What Some Insurers Learned From the Financial Crisis

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Bottom Line:

- Adherence to Sound Risk Management Makes a Big Difference
- Keeping Skin in the Game Matters
- Taking Inordinate Risk on the Investment Portfolio Can Be Dangerous
- Involvement in Non-Core Business Can Cause Serious Problems
- Tail Probabilities Matter and May Often Be Underestimated
- Can’t Substitute Liquidity for Capital
- Regulatory Vacuums and Regulatory Arbitrage are Dangerous
- Government Money Comes With Many Strings Attached

Source: Insurance Information Institute

Insurance Information Institute Online:

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Thank you for your time
and your attention!