P-C Insurance in the Post-Crisis World
Overview & Outlook for the 2010 and Beyond

Association of Profession Insurance Women
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Presentation Outline

- Reasons for Optimism, Causes for Concern
- Insurance Industry Financial Overview & Outlook
  - Profitability
  - Premium Growth
  - Underwriting Performance: Commercial & Personal Lines
  - Financial Market Impacts
- Financial Services Reform: Impacts on the Insurance Industry
- Capital & Capacity
- Tort System Review: Overview and Causes for Concern
- Performance by Segment/Line
- Financial Strength & Ratings
- The Global Economic Storm: Financial Crisis & Recession
  - Crisis-Driven Exposure Issues: Personal & Commercial Lines
  - Exposure, Growth & Profitability
- Catastrophe Losses
Reasons for Optimism, Causes for Concern in the P/C Insurance Industry

- Economic Recovery in US is Self-Sustaining: No Double Dip Recession
- Pessimism “Bubble” Persists; Negative Economic News Amplified; Positive News is Discounted
  - Financial market volatility will remain a reality
- Era of Mass P/C Insurance Exposure Destruction Has Ended
  - But restoration of destroyed exposure will take 3+ years in US
- No Secondary Spike in Unemployment or Swoon in Payrolls/WC Exposure
  - But job and wage growth remains sluggish
- Exposure Growth Will Begin in 2nd Half 2010, Accelerate in 2011
- Increase in Demand for Commercial Insurance is in its Earliest Stages and Will Accelerate in 2011
  - Includes workers comp, commercial auto, marine, many liability coverages, D&O
  - Laggards: Property, inland marine, aviation
  - Personal Lines: Auto leads, homeowners lags
- P/C Insurance Industry Will See Growth in 2011 for the First Time Since 2006
- Investment Environment Is/Remains Much More Favorable
  - Volatility, however, will persist and yields remain low
  - Both are critical issues in long-tailed commercial lines like WC, Med Mal, D&O

Source: Insurance Information Institute.
Reasons for Optimism, Causes for Concern in the P/C Insurance Industry

- P/C Insurance Industry Capacity as of 6/30/10 is at Record Levels and Has Recovered 100%+ of the Capital Lost During the Financial Crisis
  - As of 12/31/09 capacity was within 2% of pre-crisis high
- Record Capacity, Depressed Exposures Mean that Generally Soft Market Conditions Will Persist through 2010 and Potentially into 2011
- There is No Catalyst for a Robust Hard Market at the Current Time
- High Global First Half 2010 CAT Losses Insufficient to Trigger Hard Market
  - Localized insurance and reinsurance impacts are occurring, especially earthquake coverage in Latin/South America, Offshore Energy Markets, European Wind Cover
- Inflation Outlook for US and Major European Economies and Japan is Tame
  - Will temper claims inflation
  - Deflation is highly unlikely
- Financial Strength & Ratings of Global (Re)Insurance Industries Remained Strong Throughout the Financial Crisis in Sharp Contrast With Banks
- Insurers Avoided the Most Draconian Outcomes in Financial Services Reform Legislation
- Tort Environment in US is Beginning to Deteriorate; No Tort Reform in US
- Major Transformation of US Economy Underway with Major Opportunities for Insurers through 2020 in Health, Tech, Natural Resources, Energy

Source: Insurance Information Institute.
Profitability

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income</th>
<th>ROE*</th>
<th>ROE</th>
<th>ROAS ¹</th>
<th>ROAS ²</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$14,178</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>$19,316</td>
<td></td>
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<tr>
<td>1993</td>
<td>$10,870</td>
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<td>1994</td>
<td>$20,598</td>
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<td>$24,404</td>
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<td>1996</td>
<td>$36,812</td>
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<td>1997</td>
<td>$30,773</td>
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<td>1998</td>
<td>$21,865</td>
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<tr>
<td>1999</td>
<td>$20,559</td>
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<td></td>
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<tr>
<td>2000</td>
<td>$30,029</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2001</td>
<td>$3,046</td>
<td></td>
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<td>2002</td>
<td>$2,529</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2003</td>
<td>$3,043</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2004</td>
<td>$3,043</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>$65,777</td>
<td>9.6%</td>
<td>12.7%</td>
<td>5.8%</td>
<td>6.3%</td>
</tr>
<tr>
<td>2006</td>
<td>$62,496</td>
<td>9.6%</td>
<td>12.7%</td>
<td>5.8%</td>
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<td>9.6%</td>
<td>12.7%</td>
<td>5.8%</td>
<td>6.3%</td>
</tr>
<tr>
<td>2008</td>
<td>$16,531</td>
<td>9.6%</td>
<td>12.7%</td>
<td>5.8%</td>
<td>6.3%</td>
</tr>
</tbody>
</table>

* ROE figures are GAAP; ¹Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields a 7.5% ROAS for 2010:H1 and 4.6% for 2009. ²2009:H1 net income was $19.2 billion and $10.2 billion in 2008:H1 excluding M&FG.  

Sources: A.M. Best, ISO, Insurance Information Institute
ROE: P/C vs. All Industries
1987–2009*

(PERCENT)

P/C Profitability Is Cyclical and Volatile

-5% 0% 5% 10% 15% 20%

87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09

US P/C Insurers

All US Industries

Sources: ISO, Fortune; Insurance Information Institute.
The P/C Insurance Industry Well Short of Its Cost of Capital in 2008 but Narrowed the Gap in 2009 and 2010

US P/C Insurers Missed Their Cost of Capital by an Average 6.7 Points from 1991 to 2002, but on Target or Better 2003-07, Fell Short in 2008-2010

The Cost of Capital is the Rate of Return Insurers Need to Attract and Retain Capital to the Business

* Return on average surplus in 2008-2010 excluding mortgage and financial guaranty insurers.
Source: The Geneva Association, Insurance Information Institute
Median ROE for Insurers vs. Financial Firms & Other Key Industries 2009

(Profits as a % of Stockholders’ Equity)

- Food Consumer Products: 21%
- Pharmaceuticals: 21%
- Computers, Office Equip.: 19%
- Health Insurance & Mgd. Care: 14%
- Specialty Retailers: 14%
- Energy: 12%
- All Industries: 10.5%
- Diversified Financials: 9%
- Telecommunications: 9%
- Utilities: 9%
- P/C Insurance (Stock): 7%
- L/H Insurance (Stock): 7%
- Entertainment: 5%
- Commercial Banks: 4%
- P/C Insurance (Mutual)*: 3.5%
- L/H Insurance (Mutual): 0%

Stock P/C insurers earned a 7% ROE in 2009, below the 10.5% earned by the Fortune 500 as a whole and well below health insurers’ 14%. P/C Mutuals’ average ROE was 3.5%.

Commercial bank ROE was 4% in 2009.

A 100 Combined Ratio Isn’t What It Once Was: 90-95 Is Where It’s At Now

A combined ratio of about 100 generated a 7% ROE in 2009, 10% in 2005 and 16% in 1979

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

* 2009 and 2010:Q1 figures are return on average statutory surplus. 2008, 2009 and 2010:H1 figures exclude mortgage and financial guaranty insurers.
Source: Insurance Information Institute from A.M. Best and ISO data.
Financial Services Reform

Insurers Are Impacted, But Not Significantly
Financial Services Reform: What does it mean for insurers?

The Dodd Frank Wall Street Reform and Consumer Protection Act

- Systemic Risk and Resolution Authority
  - Creates the Financial Stability Oversight Council and the Office of Financial Research
  - Imposes heightened federal regulation on large bank holding companies and “systemically risky” nonbank financial companies, including insurers

- Federal Insurance Office (FIO)
  - Establishes the FIO (while maintaining state regulation of insurance) within the Department of Treasury, headed by a Director appointed by the Secretary of Treasury
  - FIO will have authority to monitor the insurance industry, identify regulatory gaps that could contribute to systemic crisis

- Surplus Lines/Reinsurance
  - Title V of the Dodd-Frank bill includes, as a separate subtitle, the Nonadmitted and Reinsurance Reform Act (NRRA), which eliminates regulatory inefficiencies associated with surplus lines insurance and reinsurance

Source: Insurance Information Institute (I.I.I.) updates and research; The Financial Services Roundtable; Adapted from summary by Dewey & LeBoeuf LLP
A total of at least 243 new rulemakings are expected under the Dodd-Frank financial reform by Federal Agency*

- Bureau of Consumer Financial Protection: 24
- CFTC: 61
- Financial Stability Oversight Council: 56
- FDIC: 31
- Federal Reserve: 54
- FTC: 2
- OCC: 17
- Office of Financial Research: 4
- SEC: 95
- Treasury: 9

* Total eliminates double counting for joint rule-makings and this estimate only includes explicit rule-makings in the bill, and thus likely represents a significant underestimate.

Not Graded: District of Columbia
Mississippi
Louisiana

Source: Heartland Institute, May 2010
Critical Differences Between P/C Insurers and Banks

Superior Risk Management Model and Low Leverage Make a Big Difference
How P/C Insurance Industry Stability Has Benefitted Consumers

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 286 banks have gone under as of 9/3/10)
  - *The promise is being fulfilled*
- Renew existing policies (*banks are reducing and eliminating lines of credit*)
- Write new policies (*banks are turning away people and businesses who want or need to borrow*)
- Develop new products (*banks are scaling back the products they offer*)
- Compete intensively (*banks are consolidating, reducing consumer choice*)

Source: Insurance Information Institute
Financial Strength & Ratings

Industry Has Weathered the Storms Well
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.
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.

- Deficient Loss Reserves/Inadequate Pricing: 38.1%
- Rapid Growth: 14.3%
- Alleged Fraud: 8.1%
- Catastrophe Losses: 7.6%
- Affiliate Impairment: 7.9%
- Investment Problems: 7.0%
- Misc.: 9.1%
- Sig. Change in Business: 3.7%
- Reinsurance Failure: 4.2%

Shifting Legal Liability & Tort Environment

Is the Tort Pendulum Swinging Against Insurers?
Important Issues & Threats
Facing Insurers: 2010–2015

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 will be recognized as such by 2012–2014

Source: Insurance Information Institute
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
Trial Bar Priorities

- Reverse U.S. Supreme Court decisions on pleadings
- Eliminate pre-dispute arbitration
- Erode federal preemption
- Expand securities litigation
- Pass Foreign manufactures law
- Confirm pro-trial lawyer judges – “Federalize Madison County”
- Grant enforcement authorities to state
- Roll back existing legal reforms

Source: Institute for Legal Reform.
### Business Leaders Ranking of Liability Systems in 2009*

#### Best States

1. Delaware
2. North Dakota
3. Nebraska
4. Indiana
5. Iowa
6. Virginia
7. Utah
8. Colorado
9. Massachusetts
10. South Dakota

**New in 2009**
- North Dakota
- Massachusetts
- South Dakota

**Drop-offs**
- Maine
- Vermont
- Kansas

#### Worst States

41. New Mexico
42. Florida
43. Montana
44. Arkansas
45. Illinois
46. California
47. Alabama
48. Mississippi
49. Louisiana

**Newly Notorious**
- New Mexico
- Montana
- Arkansas

**Rising Above**
- Texas
- South Carolina
- Hawaii

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50. **West Virginia**

**Midwest/West has mix of good and bad states.**

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

**Source:** American Tort Reform Association; Insurance Information Institute
P/C Premium Growth Primarily Driven by the Industry’s Underwriting Cycle, Not the Economy
Soft Market Appears to Persist in 2010 but May Be Easing: Relief in 2011?

Net Written Premiums Fell 0.7% in 2007 (First Decline Since 1943) by 2.0% in 2008, and 4.2% in 2009, the First 3-Year Decline Since 1930-33.

NWP was flat with 0.0% growth in 10:H1 vs. -4.4% in 09:H1

Shaded areas denote “hard market” periods

Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute.
**Average Expenditures on Auto Insurance**

Countrywide Auto Insurance Expenditures Increased 2.6% in 2008 and 3.5% Pace in 2009 (est.) and 4% in 2010 (est.)

* Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute estimates 2008-2010 based on CPI data.
Average Premium for Home Insurance Policies**

* Insurance Information Institute Estimates/Forecasts  **Excludes state-run insurers.
Source: NAIC, Insurance Information Institute estimates 2008-2010 based on CPI data.
Average Commercial Rate Change, All Lines, (1Q:2004–2Q:2010)

(Percent)

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Change in Commercial Rate Renewals, by Line: 2010:Q2

Percentage Change (%)

Most Major Commercial Lines Renewed Down in Q2:2010 at a Faster Pace than a year Earlier

Source: Council of Insurance Agents and Brokers; Insurance Information Institute.
Change in Commercial Rate Renewals, by Account Size: 1999:Q4 to 2010:Q2

Percentage Change (%)

- Peak = 2001:Q4 +28.5%
- Trough = 2007:Q3 -13.6%
- Market has been soft for 6 years and remains soft as capital is restored and underwriting losses remain modest.
- Pricing turned negative in early 2004 and has been negative ever since.

Source: Council of Insurance Agents and Brokers; Insurance Information Institute.
Capital/Policyholder Surplus (US)

Shrinkage, but Not Enough to Trigger Hard Market

($ Billions)

2007:Q3
Previous Surplus Peak

Surplus set a new record in 2010:Q1*

Quarterly Surplus Changes Since 2009:Q1 Trough

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Change</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>09:Q1</td>
<td>-$84.7B</td>
<td>-16.2%</td>
</tr>
<tr>
<td>09:Q2</td>
<td>-$58.8B</td>
<td>-11.2%</td>
</tr>
<tr>
<td>09:Q3</td>
<td>-$31.8B</td>
<td>-5.9%</td>
</tr>
<tr>
<td>09:Q4</td>
<td>-$10.3B</td>
<td>-2.0%</td>
</tr>
<tr>
<td>10:Q1</td>
<td>+$18.9B</td>
<td>+3.6%</td>
</tr>
<tr>
<td>10:Q2</td>
<td>-$10.2B</td>
<td>-1.9%</td>
</tr>
</tbody>
</table>

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

Sources: ISO, A.M. Best.
Paid-in Capital, 2005–2010:H1

Paid-in capital for insurance operations in 2009:H1 was $2.3B. In 2010:H1 it was a record $23.8B.

In 2010:H1 One Insurer’s Paid-in Capital Rose by $22.5B as Part of an Investment in a Non-insurance Business

Source: ISO.
The Financial Crisis at its Peak Ranks as the Largest “Capital Event” Over the Past 20+ Years

<table>
<thead>
<tr>
<th>Event</th>
<th>Percent</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hurricane Hugo 6/30/1989</td>
<td>3.3%</td>
<td></td>
</tr>
<tr>
<td>Hurricane Andrew 6/30/1992</td>
<td>9.6%</td>
<td></td>
</tr>
<tr>
<td>Northridge Earthquake 12/31/93</td>
<td>6.9%</td>
<td></td>
</tr>
<tr>
<td>Sept. 11 Attacks 6/30/01</td>
<td>10.9%</td>
<td></td>
</tr>
<tr>
<td>Florida Hurricanes 6/30/04</td>
<td>6.2%</td>
<td></td>
</tr>
<tr>
<td>Hurricane Katrina 6/30/05</td>
<td>13.8%</td>
<td></td>
</tr>
<tr>
<td>Financial Crisis 3/31/09**</td>
<td>16.2%</td>
<td></td>
</tr>
</tbody>
</table>

* 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*

Surplus growth is now positive but premiums continue to fall, a departure from the historical pattern.

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

* 2010 NWP and Surplus figures are % changes as of H1:10 vs H1:09.
Sources: A.M. Best, ISO, Insurance Information Institute
Barriers to Consolidation Will Diminish in 2010

$ Value of Deals Down 78% in 2009, Volume Up 7%

2010: No Mega Deals So Far, Despite Record Capital, Slow Growth and Improved Financial Market Conditions

Note: U.S. Company was the acquirer and/or target.
Source: Conning Research & Consulting.
Investment Performance

Investments Are a Principle Source of Declining Profitability
Investment gains in 2010 are on track to be their best since 2007.

In 2008, Investment Gains Fell by 50% Due to Lower Yields and Nearly $20B of Realized Capital Losses

2009 Saw Smaller Realized Capital Losses But Declining Investment Income

Investment Gains Are Recovering So Far in 2010

1 Investment gains consist primarily of interest, stock dividends and realized capital gains and losses.

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

Sources: ISO; Insurance Information Institute.
P/C Insurer Net Realized Capital Gains, 1990-2010:H1

Realized Capital Losses Were the Primary Cause of 2008/2009’s Large Drop in Profits and ROE

Sources: A.M. Best, ISO, Insurance Information Institute.
Treasury Yield Curves: Pre-Crisis (July 2007) vs. August 2010

Treasury yield curve is near its most depressed level in at least 45 years. Investment income is falling as a result.

Sources: Board of Governors of the United States Federal Reserve Bank; Insurance Information Institute.
Treasury Yields Are Low and Expected to Remain Low Through 2011

Short-term yields remain very depressed, impacting insurers' ability to generate investment earnings.

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

Sources: Board of Governors of the United States Federal Reserve Bank; Blue Chip Economic Indicators, 9/10; Insurance Information Institute.
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.
Underwriting Trends – Financial Crisis Does Not Directly Impact Underwriting Performance: Cycle, Catastrophes Were 2008’s Drivers
As Recently as 2001, Insurers Paid Out Nearly $1.16 for Every $1 in Earned Premiums

Heavy Use of Reinsurance Lowered Net Losses

Relatively Low CAT Losses, Reserve Releases

Relatively Low CAT Losses, Reserve Releases

Cyclical Deterioration

Lower CAT Losses, More Reserve Releases


Sources: A.M. Best, ISO.
Underwriting Gain (Loss)
1975–2010:H1*

Cumulative underwriting deficit from 1975 through 2009 is $445B

The industry recorded a $5.1B underwriting loss in 2010:H1 compared to $2.1B in 2009:H1

Large Underwriting Losses Are NOT Sustainable in Current Investment Environment

* Includes mortgage and financial guarantee insurers.
Sources: A.M. Best, ISO; Insurance Information Institute.
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.
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.
Number of Years with Underwriting Profits by Decade, 1920s–2000s

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 excluding mortgage and financial guaranty insurers was 99.3, which would bring the 2000s total to 4 years with an underwriting profit.
Note: Data for 1920–1934 based on stock companies only.
Sources: Insurance Information Institute research from A.M. Best Data.
The Economic Storm

What the Financial Crisis and Recession Mean for the Industry’s Exposure Base, Growth and Profitability
The Q4:2008 decline was the steepest since the Q1:1982 drop of 6.8%.

Recession began in Dec. 2007. Economic toll of credit crunch, housing slump, labor market contraction has been severe but modest recovery is underway.

Economic growth up sharply in late 2009 with rebuilding of inventories and stimulus. More moderate growth expected in 2010/11 but no “double dip”

Demand Commercial Insurance Continues To Be Impacted by Sluggish Economic Conditions

* Estimates/Forecasts from Blue Chip Economic Indicators.
Source: US Department of Commerce, Blue Economic Indicators 7/10; Insurance Information Institute.
Real GDP Growth vs. Real P/C

Premium Growth: Modest Association

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

Real NWP Growth vs. Real GDP Growth

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

Sources: A.M. Best, US Bureau of Economic Analysis, Blue Chip Economic Indicators, 7/10; Insurance Information Institute
Will Future Tax Policy Impact P/C Insurance Industry Exposure and Growth?

Various Tax Proposals for 2011 Could Have Significant Impacts on the P/C Insurance Industry for Years to Come
## Potential Impacts of Current Federal Tax Proposals on P/C Insurance Industry

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Potential P/C Insurance Industry Impact</th>
<th>P/C Lines that Benefit</th>
</tr>
</thead>
</table>
| 100% Expensing of New Investment in Plant & Equipment in 2011 and Continuation of Bonus Depreciation | Could produce a 5-10% surge in investment in physical plant and equipment in 2011 which will need to be insured immediately. Although the proposal only “steals” investment from the future, this provides a permanent benefit to commercial insurers since insurance coverage must be purchased sooner and be maintained. New construction activity boosts WC and surety. | • Commercial Property  
• Construction  
• Commercial Liability  
• Commercial Auto  
• Specialty Lines  
• Excess & Surplus  
• Workers Comp  
• Surety  
• Reinsurance |
| Reinststate 36% and 39.6% Rates for High Income Taxpayers >$250K          | Potential damage to new/small business formation and growth. Weakness in these areas has hurt p/c insurance exposure and tax hikes could depress insurance exposure in this segment | • None                                                                                   |
| Continue 2001 and 2003 Tax Cuts for All Taxpayers                        | Should produce an environment that more beneficial to recovery in small business segment & associate insurance exposures | • Small Business  
• Commercial Lines  
• Personal Lines |

Sources: Proposals from Tax Policy Center; P/C discussion is Insurance Information Institute research.
<table>
<thead>
<tr>
<th>Proposal</th>
<th>Potential P/C Insurance Industry Impact</th>
<th>P/C Lines that Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Impose 20% Tax Rate for Capital Gains and Dividends for High Income Taxpayers</strong></td>
<td>The increase in dividends and capital gains taxes makes private investment less attractive. Under current law the rate is 15%. Additional taxes on investment would presumably result in a marginal but negative impact on p/c insurance exposure.</td>
<td>• None</td>
</tr>
<tr>
<td><strong>Payroll Tax Holiday</strong></td>
<td>Reducing the cost of hiring workers would theoretically reduce the cost of employment and should spark hiring, increasing overall employment and payrolls</td>
<td>• Workers comp</td>
</tr>
<tr>
<td><strong>Limit Value of Itemized Deductions to 28% for High Income Taxpayers</strong></td>
<td>Will have an unambiguously negative impact on charitable giving. Nonprofit sector will be negatively impacted.</td>
<td>• None (Commercial lines products Designed for NPOs would be negatively impacted; This is a large p/c market.)</td>
</tr>
</tbody>
</table>

Sources: Proposals (except Payroll Tax Holiday) from Tax Policy Center; P/C discussion is Insurance Information Institute research.
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

Top Quintile

- Rocky Mountain: 2.2%
- Plains: 2.0%
- New England: 1.0%

Far West: 0.6%

Top Quintile

- Mountain, Plains States Growing the Fastest

US = 0.7

- Highest Quintile
- Fourth Quintile
- Third Quintile
- Second Quintile
- Lowest Quintile

US Bureau of Economic Analysis
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

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 Commercial/Personal Lines Exposure, But Trend is Improving
Unemployment and Underemployment Rates: Rocketed Up in 2008-09; Stabilizing in 2010?

Unemployment and underemployment rates went from 8.0% in March 2007 to 17.5% in Oct 2009; stood at 16.7% in July 2010.

Unemployment rate was 9.6% in July.
Unemployment peaked at 10.1% in Oct. 2009, highest monthly rate since 1983.
Peak rate in the last 30 years: 10.8% in Nov-Dec 1982.
Rising unemployment erosion payrolls and workers comp’s exposure base.

Unemployment likely peaked at 10% in late 2009.

Unemployment forecasts remain stubbornly high through 2011.

* = actual; = forecasts

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (9/10); Insurance Information Institute
Unemployment Rates Vary Widely by State and Region*

*Provisional figures for July 2010, seasonally adjusted.
Unemployment Rates Vary Widely by State and Region* (cont’d)

*Provisional figures for July 2010, seasonally adjusted.
The job gain and loss figures in 2010 are severely distorted by the hiring and termination of temporary Census workers. So far in 2010, 763,000 private sector jobs have been created.

Monthly Losses in Dec. 08–Mar. 09 Were the Largest in the Post-WW II Period

Job Losses Since the Recession Began in Dec. 2007 Peaked at 8.4 Million in Dec. 09; Stands at 7.7 Million Through August 2010; 14.9 Million People are Now Defined as Unemployed

*Estimate based on Reuters poll of economists.
US Nonfarm Private Employment

Monthly, Nov 2007 – August 2010 (Millions)

The US Economy Lost About 8.4 Million Jobs in the Two Years from Dec. 07 – Dec. 09.

As employment expands, workers comp will be among the first lines to see exposure gains.

Seasonally adjusted.
Estimated Effect of Recessions* on Payroll (Workers Comp Exposure)

- Recessions in the 1970s and 1980s saw smaller exposure impacts because of continued wage inflation, a factor not present during the 2007-2009 recession.

- The Dec. 2007 to mid-2009 recession caused the largest impact on WC exposure in 60 years.

(Percent Change)

(All Post WWII Recessions)

Recession Dates (Beginning/Ending Years)


*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).
Insurance Industry Employment Trends

Soft Market, Difficult Economy, Outsourcing, Productivity Enhancements and Consolidation Have Contributed to Industry’s Job Losses
As of July 2010, P/C insurance industry employment was down by 26,900 or 5.5% to 464,200 since the recession began in Dec. 2007 (compared to overall US employment decline of 7.2%).

*As of July 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 Direct Life Insurance Industry: 1990–2010*

As of July 2010, Life insurance industry employment was down by 10,400 or 2.9% to 343,900 since the recession began in Dec. 2007 (compared to overall US employment decline of 7.2%)

*As of July 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.
As of July 2010, Health-Medical insurance industry employment was down by 11,300 or 2.6% to 430,600 since the recession began in Dec. 2007 (compared to overall US employment decline of 7.2%).

*As of July 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.
As of July 2010, US employment in the reinsurance industry was down by 1,000 or 3.7% to 25,900 since the recession began in Dec. 2007 (compared to overall US employment decline of 7.2%).

*As of July 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.
As of July 2010, employment at insurance agencies and brokerages was down by 47,900 or 7.0% to 631,700 since the recession began in Dec. 2007 (compared to overall US employment decline of 7.2%).

*As of July 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.
As of July 2010, claims adjusting employment was down by 8,100 or 15.6% to 43,900 since the recession began in Dec. 2007 (compared to overall US employment decline of 7.2%).

*As of July 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.
U.S. Employment in Third-Party Administration of Insurance Funds: 1990–2010*

Thousands

<table>
<thead>
<tr>
<th>Year</th>
<th>Employment</th>
</tr>
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<tbody>
<tr>
<td>'90</td>
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<td>'20</td>
<td>85</td>
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</tbody>
</table>

*As of July 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.
Crisis-Driven Exposure Drivers

Economic Obstacles to Growth in P/C Insurance
New auto/light truck sales fell to the lowest level since the late 1960s. Forecast for 2010-11 is still far below 1999-2007 average of 17 million units.

“Cash for Clunkers” generated about $300M in net new personal auto premiums.

Sharply lower auto sales will have a smaller effect on auto insurance exposure level than problems in the housing market will on home insurers.

Car/Light Truck Sales Will Recover from the 2009 Low Point, but High Unemployment, Tight Credit Are Still Restraining Sales.

Source: U.S. Department of Commerce; Blue Chip Economic Indicators (9/10); Insurance Information Institute.
New Private Housing Starts, 1990-2011F

New home starts plunged 34% from 2005-2007; drop through 2009 was 72% (est.); A net annual decline of 1.49 million units, lowest since records 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.

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

Source: U.S. Department of Commerce; Blue Chip Economic Indicators (9/10); Insurance Information Institute.
## Business Bankruptcy Filings, 1980-2010: H1

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<thead>
<tr>
<th>Year</th>
<th>Filings</th>
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<tbody>
<tr>
<td>80</td>
<td>43,694</td>
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<tr>
<td>81</td>
<td>48,125</td>
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<td>29,059</td>
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### % Change Surrounding Recessions

<table>
<thead>
<tr>
<th>Recessions</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-82</td>
<td>58.6%</td>
</tr>
<tr>
<td>1980-87</td>
<td>88.7%</td>
</tr>
<tr>
<td>1990-91</td>
<td>10.3%</td>
</tr>
<tr>
<td>2000-01</td>
<td>13.0%</td>
</tr>
<tr>
<td>2006-09</td>
<td>208.9%*</td>
</tr>
</tbody>
</table>

There were 60,837 business bankruptcies in 2009, up 40% from 2008 and the most since 1993. 2010: H1 bankruptcies totaled 29,059, down 4% from H1:2009, but still very high by historical standards.

**Significant Exposure Implications for All Commercial Lines.** There are some preliminary indications that business bankruptcies are beginning to decline.

Source: American Bankruptcy Institute; Insurance Information Institute
180,000 businesses started in 2009:Q4, the best quarter in 2009. 2009 was the slowest year for new business starts since 1993.

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

*Latest available as of September 12, 2010, seasonally adjusted
Recovery in Capacity Utilization is a Positive Sign for Insurance Exposure

Percent of Capacity Utilized
(Manufacturing, Mining, Utilities)

82%
80%
78%
76%
74%
72%
70%
68%
66%

“Full Capacity”

Recession began December 2007

Manufacturing capacity stood at 74.8% in July 2010, above the June 2009 low of 68.2% but well below the pre-crisis peak of 80%+

The closer the economy is to operating at “full capacity,” the greater the demand for insurance

March 2001- November 2001 recession

Hurricane Katrina

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

State tax revenues are beginning a slow recovery in 2010

Nationwide, state-tax collections for fiscal year 2009 declined by a record $63 billion, or 8.2 percent from the previous year. That loss is roughly twice the amount states gained in fiscal relief from the federal stimulus package. Receipts now beginning to recover.

States Revenues Were Up 2.2% in Q2 2010, the 2nd Consecutive Quarter of Revenue Increase. Public Infrastructure Spending is Still Likely to Remain Depressed, Dampening Related Insurance Exposures and Demand.

Inflation Trends: Concerns Over Stimulus Spending and Monetary Policy

Mounting Pressure on Claim Cost Severities?
Inflation peaked at 5.6% in August 2008 on high energy and commodity crisis. The recession and the collapse of the commodity bubble have reduced inflationary pressures.

There is So Much Slack in the US Economy Inflation Should Not Be a Concern Through 2010/11, but Deficits and Monetary Policy Remain Longer Run Concerns

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators, 9/10 (forecasts).
P/C Insurers Experience Inflation More Intensely than 2009 CPI Suggests

Healthcare and Legal/Tort Costs Are a Major P/C Insurance Cost Driver. These Are Expected to Increase Above the Overall Inflation Rate (CPI) Indefinitely

Source: CPI is Blue Chip Economic Indicator 2009 estimate, 12/09; Legal services, medical care and motor vehicle body work are avg. monthly year-over-year change from BLS; BI and no-fault figures from ISO Fast Track data for 4 quarters ending 09:Q3. Tort costs is 2009 Towers-Perrin estimate. WC figure is I.I.I. estimate based on historical NCCI data.
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 Gov’t 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 reinsurance more quickly and potentially exhausting their reinsurance more quickly

Source: Insurance Information Institute.
Deflation is defined as a sustained decline in the general price level. It can result from the reduction in the supply of money or credit or reductions in government, personal or investment spending. When deflation takes hold, the incentive is to defer purchases until prices decline further. This depresses aggregate demand, increases unemployment and triggers recessions.

Source: Insurance Information Institute.
Deflation Basics
Primary Causes and Major Bouts of Deflation

**Deflation is**
- A falling general price level
  - Note: this is different from
    - A fall in *the rate of increase* of the general price level;
      - This is called disinflation
    - A fall in the prices of some items or category of items
- For a prolonged period
- That is expected to continue indefinitely

**Deflation results from some or all of**
- A surge in productivity, generally from technological innovation
- A steep and prolonged drop in the money supply
- A steep and prolonged recession
  - Note: this is different from a fall in *the rate of increase* of the price level

**Major US Bouts of Deflation**
- 1920-22
- 1930-33

Broad Impact of Deflation

Deflation causes...

- Consumers to delay buying things
  - They expect to buy those things later at lower prices
- A drop in the level of aggregate demand, from the delay in consumption
- A transfer of wealth
  - From borrowers and holders of illiquid assets
  - To savers/lenders and holders of liquid assets and currency
- A drop in the level of business investment
  - Following the drop in aggregate demand
  - Slack in capacity if the economy is in recession
  - Increased likelihood of lower profits or losses as selling prices drop below costs

What History Teaches Us About Deflation and the P-C Industry
From Year-end 1929 Through 1932, the Industry's Combined Ratio Rose from 96.3 to 104.9 as the CPI Dropped. But from 1933 into the 1950s, the Combined Ratio Remained Below 100 Even as Prices Slowly Rose, Then Shot Up after WWII.

*From 1920-1934, stock companies only
1920-1950: Inflation, Deflation and P-C Industry Profitability*

From 1930 to 1933 the Price Level Dropped 24%

From 1930-32 ROAS was below 1.2%, but was 5.1% in 1933 and 10% or higher in 1935-36


*stock companies only
Deflation’s Effects on the P-C Insurance Industry

- **Lower Claim Severities**
  - Particularly for property claims, severity drops for many items that insurers pay for

- **Rate contingency margins increase**
  - At least until rate construction reflects persistently declining claims severity, margins will be higher than otherwise due to high trend assumptions arising from use of historical data

- **Reserve Releases?**
  - Reserves may develop beneficially to become “redundant”

- **Lower Claim Frequency as Fewer Claims Reach Deductible, Retention Levels**

- **Less Use of Reinsurance**
  - Lower costs ➔ risks burn through their retentions less quickly, reaching policy limits less quickly
Catastrophic Loss – Catastrophe Losses Trends Are Trending Adversely
US Insured Catastrophe Losses

2000s: A Decade of Disaster
2000s: $193B (up 117%)
1990s: $89B

First Half 2010 CAT Losses Were Down 19% or $1.4B from first half 2009

2010 CAT Losses Are Running Below 2009, So Far
Figures Do Not Include an Estimate of Deepwater Horizon Loss


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.

Sources: Property Claims Service/ISO; Munich Re; Insurance Information Institute.
Combined Ratio Points Associated with Catastrophe Losses: 1960 – 2009

The Catastrophe Loss Component of Private Insurer Losses Has Increased Sharply in Recent Decades

Notes: Private carrier losses only. Excludes loss adjustment expenses and reinsurance reinstatement premiums. Figures are adjusted for losses ultimately paid by foreign insurers and reinsurers.

Source: ISO; Insurance Information Institute.
Global Natural Catastrophes: January – June 2010

The 12 Jan. Haiti quake killed 225,500 people, caused $8B+ in economic damage, but little in the way of insured losses.

Chilean earthquake (mag. 8.8) on 27 Feb. produced at least $4 billion in insured losses, $20 billion in economic losses. Most costly insurance event in 2010.

Severe winter weather in the Eastern US produced insured losses of at least $1B in insured losses and $2B in economic losses.

Winter Storm Xynthia produced at least $2B in insured losses and $4B in economic losses.

Global natural catastrophes

Geophysical events (earthquake, tsunami, volcanic activity)

Meteorological events (storm)

Hydrological events (flood, mass movement)

Climatological events (extreme temperature, drought, wildfire)

Selection of significant natural catastrophes (see table)

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Natural Disasters in the United States, 1980 – 2010
Number of Events (Annual Totals 1980 – 2009 vs. First Half 2010)

Number of events in first half of 2010 is close to the annual totals from five of past ten years.

First Half 2010
95 Events

Source: MR NatCatSERVICE

© 2010 Munich Re
## Top 12 Most Costly Disasters in US History

(Insured Losses, 2009, $ Billions)

<table>
<thead>
<tr>
<th>Event</th>
<th>Year</th>
<th>Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hurricane Katrina Remains</td>
<td>2005</td>
<td>$45.3</td>
</tr>
<tr>
<td>Andrew</td>
<td>1992</td>
<td>$23.8</td>
</tr>
<tr>
<td>9/11 Attacks</td>
<td>2001</td>
<td>$22.8</td>
</tr>
<tr>
<td>Northridge</td>
<td>1994</td>
<td>$18.2</td>
</tr>
<tr>
<td>Ike</td>
<td>2008</td>
<td>$12.5</td>
</tr>
<tr>
<td>Wilma</td>
<td>2005</td>
<td>$11.3</td>
</tr>
<tr>
<td>Charley</td>
<td>2004</td>
<td>$8.5</td>
</tr>
<tr>
<td>Ivan</td>
<td>2004</td>
<td>$8.1</td>
</tr>
<tr>
<td>Hugo</td>
<td>1989</td>
<td>$7.3</td>
</tr>
<tr>
<td>Rita</td>
<td>2005</td>
<td>$6.2</td>
</tr>
<tr>
<td>Frances</td>
<td>2004</td>
<td>$5.2</td>
</tr>
<tr>
<td>Jeanne</td>
<td>2004</td>
<td>$4.2</td>
</tr>
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</table>

**Hurricane Katrina Remains, By Far, the Most Expensive Insurance Event in US and World History**

8 of the 12 Most Expensive Disasters in US History Have Occurred Since 2004; 8 of the Top 12 Disasters Affected FL

Sources: PCS; Insurance Information Institute inflation adjustments.
Share of Losses Paid by Reinsurers for Major Catastrophic Events

Reinsurance plays a very large role in claims payouts associated with major catastrophes.

<table>
<thead>
<tr>
<th>Event</th>
<th>Coverage</th>
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<tbody>
<tr>
<td>Hurricane Hugo (1989)</td>
<td>30%</td>
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<tr>
<td>Hurricane Andrew (1992)</td>
<td>25%</td>
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<tr>
<td>Sept. 11 Terrorist Attack (2001)</td>
<td>60%</td>
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<tr>
<td>2004 Hurricane Season</td>
<td>20%</td>
</tr>
<tr>
<td>2005 Hurricane Season</td>
<td>45%</td>
</tr>
<tr>
<td>2008 Texas Hurricane</td>
<td>33%</td>
</tr>
</tbody>
</table>

Source: Wharton Risk Center, Disaster Insurance Project, Renaissance Re, Insurance Information Institute.
Total Value of Insured Coastal Exposure

(2007, $ Billions)

Florida: $2,458.6
New York: $2,378.9
Texas: $895.1
Massachusetts: $772.8
New Jersey: $635.5
Connecticut: $479.9
Louisiana: $224.4
S. Carolina: $191.9
Virginia: $158.8
Maine: $146.9
North Carolina: $132.8
Alabama: $92.5
Georgia: $85.6
Delaware: $60.6
New Hampshire: $55.7
Mississippi: $51.8
Rhode Island: $54.1
Maryland: $14.9

In 2007, Florida Still Ranked as the #1 Most Exposed State to Hurricane Loss, with $2.459 Trillion Exposure, but Texas is very exposed too, and ranked #3 with $895B in insured coastal exposure.

The Insured Value of All Coastal Property Was $8.9 Trillion in 2007, Up 24% from $7.2 Trillion in 2004.

Source: AIR Worldwide
Thank you for your time and your attention!

Twitter: twitter.com/bob_hartwig

Download: www.iii.org/presentations