Financial Crisis, Recession, Stimulus & the Future of the P/C Insurance Industry

Trends, Challenges & Opportunities

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Presentation Outline

• Financial Crisis & The Weakening Economy: Insurance Impacts for the P/C Insurance Industry
  • Recession, Growth & Insurance
  • Economic Stimulus Package Impacts
• Aftershock: The P/C Insurance Landscape After the Crisis
  • Impacts & Implications for P/C Insurers
• Top 10 Threats/Issues Facing P/C Insurers
• Financial Strength & Ratings
  • Critical Differences Between P/C Insurers and Banks
• P/C Insurance Industry Overview & Outlook
  • Profitability
  • Premium Growth
  • Underwriting Performance
  • Financial Market Impacts
• Capital & Capacity
• Catastrophe Losses
THE ECONOMIC STORM

What the Financial Crisis and Deep Recession Mean for the P/C Insurance Industry
Recession began in December 2007. Economic toll of credit crunch, housing slump, labor market contraction is growing.

The Q4:2008 decline was the steepest since the Q1:1982 drop of 6.4%.

*Blue bars are Estimates/Forecasts from Blue Chip Economic Indicators.
Source: US Department of Commerce, Blue Economic Indicators 4/09; Insurance Information Institute.
GDP Growth: Advanced & Emerging Economies vs. World

1970-2010F

The world economy is forecast to grow by 0.5% in 2009, but could shrink for the first time since WW II —by 1% to 2% according to the World Bank.

Emerging economies (led by China) are expected to grow by 3.3% in 2009

Advanced economies will shrink by 1.9% in 2009

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

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, 4/09; Insurance Information Inst.
Current recession began in Dec. 2007 and is already the longest since 1981. It is now also the longest recession since the Great Depression.

“We will rebuild. We will recover.”

--President Barack Obama addressing a joint session of Congress
February 24, 2009

* As of May 2009, inclusive

Sources: National Bureau of Economic Research; Insurance Information Institute.
Length of U.S. Business Cycles, 1929-Present*

**Average Duration**
Recession = 10.4 Months
Expansion = 60.5 Months

Length of expansions greatly exceeds contractions

* As of May 2009, inclusive; **Post-WW II period through end of most recent expansion.
Sources: National Bureau of Economic Research; Insurance Information Institute.
Annual Inflation Rates (CPI-U, %), 1990-2010F

Inflation peaked at 5.6% in August 2008 on high energy and commodity crisis. The recession and the collapse of the commodity bubble have produced temporary deflation.

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators, April 10, 2009 (forecasts).
Total Industrial Production, (2007:Q1 to 2010:Q4F)

Figures for 2010 revised upwards to reflect expected impact of Obama stimulus program.

Industrial production began to contract sharply during H2 2008 and is expected to shrink through most of 2009.

Obama stimulus program is expected benefit impact industrial production and therefore insurance exposure both directly and indirectly.

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (4/09); Insurance Info. Inst.
Labor Market Trends

Fast & Furious: Massive Job Losses Sap the Economy and Workers Comp Exposure
Unemployment Rate: On the Rise

January 2000 through March 2009

March 2009 unemployment jumped to 8.5%, exceeding the 6.3% peak during the previous cycle, and is now at its highest level since Jan. 1984.

Previous Peak: 6.3% in June 2003

Trough: 4.4% in March 2007

Average unemployment rate 2000-07 was 5.0%

Unemployment will likely peak between 9% and 10% during this cycle, impacting payroll sensitive p/c and non-life exposures.

US Unemployment Rate: A Volatile History (update)

January 1948 through February 2009

Rising unemployment will erode payrolls and workers comp’s exposure base. Unemployment is expected to peak near 10% in early 2010.

* Blue bars are actual; Yellow bars are forecasts
Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (4/09); Insurance Info. Inst.
*Monthly Change Employment (Thousands)

January 2008 through March 2009

Job losses since the recession began in Dec. 2007 total 5.133 million; 13.2 million people are now defined as unemployed.

Monthly losses in Dec. – Mar. were the largest in the post-WW II period

The US has seen net job losses in only 16 of the 70 years since 1939. Losses through March 2009 already rank the year as the 6th worst in the post WW II era. 2008’s job losses even exceeded those in 1945, at the conclusion of WW II.

Weakening wage and salary growth is expected to cause a deceleration in workers comp exposure growth.

Shaded areas indicate recessions.


Construction employment declined in 47 of 50 states in 2008

Sources: Associated General Contractors of America from Bureau of Labor Statistics; Insurance Information Institute.
New Private Housing Starts, 1990-2010F (Millions of Units)

Exposure growth forecast for HO insurers is dim for 2009 with some improvement in 2010.

Impacts also for comml. insurers with construction risk exposure

New home starts plunged 34% from 2005-2007; Drop through 2009 is 73% (est.)—a net annual decline of 1.51 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 (4/09); Insurance Information Inst.
Auto/Light Truck Sales, 1999-2010F (Millions of Units)

Weakening economy, credit crunch are hurting auto sales; Gas prices less of a factor now.

New auto/light truck sales are expected to experience a net drop of 6.7 million units annually by 2009 compared with 2005, a decline of 39.6% and the lowest level since the late 1960s.

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

Source: US Department of Commerce; Blue Chip Economic Indicators (4/09); Insurance Information Inst.
AFTERSHOCK

What Will the P/C Insurance Industry Look Like After the Crisis?

6 Key Differences
6 Key Differences: P/C Insurance in the Post-Financial Catastrophe World

1. The P/C Insurance Industry Will Be Smaller: The Industry Will Have Shrunk by About 3% in Dollar Terms and by 8% on an Inflation Adjusted Basis, 2007-09
   - Falling prices, weak exposure growth, increasing government intervention in private (re)insurance markets, large retentions and alternative forms of risk transfer have siphoned away premium

2. P/C Industry Will Emerge With Its Risk Mgmt. Model More Intact than Most Other Financial Service Segments
   - Benefits of risk-based underwriting, pricing and low leverage clear

3. There Will Be Federal Regulation of Insurers: Now in Waning Months of Pure State-Based Regulation
   - Federal regulation of “systemically important” firms seems certain
   - Solvency and Rates regulation, Consumer Protection may be shared
   - Dual regulation likely; federal/state regulatory conflicts are likely
   - With the federal nose under the tent, anything is possible

Source: Insurance Info. Inst.
6 Key Differences: P/C Insurance in the Post-Financial Catastrophe World

4. Investment Earnings Will Shrink Dramatically for an Extended Period of Time: Federal Reserve Policy, Shrinking Dividends, Aversion to Stocks
   - Trajectory toward lower investment earnings is being locked in

5. Insurers Will Return to Their Underwriting Roots: Extended Period of Low Investment Exert Pressure to Generate Underwriting Profits Since 1960s
   - Chastened and “derisked” but facing the same (or higher) expected losses, insurers must work harder to match risk to price

6. P/C Insurers: Profitable Before, During & After Crisis: Resiliency Once Again Proven
   - Directly the result of industry’s risk management practices

Source: Insurance Information Inst.
Emerging Blueprint for Financial Services Regulatory Overhaul

Phase I: Systemic Risk Regulation/Regulator

- Identification of systemic risk points in the financial system
- Design of appropriate regulation to prevent future collapses
- Will require international consultation (US can’t manage systemic risk alone)

- Oversight Responsibility: Likely With Federal Reserve
  - Fed would have capacity and power to assess risk across financial markets regardless of corporate form and to intervene when appropriate*
  - Fed could oversee (according to House FS Committee Chairman Barney Frank:
    - Hedge funds (need to ensure “complete transparency”)
    - Credit ratings agencies
    - Executive compensation (to curb “perverse risk incentives”)
  - TIMELINE: Frank wants “general outline” by April 2 meeting of G20 industrialized and developing nations


Possible Regulatory Scenarios for P/C Insurers as of Year-End 2009

- **Status Quo:** P/C Insurers Remain Entirely Under Regulatory Supervision of the States
  - Unlikely, but some segments of the industry might welcome this outcome above all others
- **Federal Regulation:** Everything is Regulated by Feds
  - Unlikely that states will be left totally in the cold
- **Optional Federal Charter (OFC):** Insurers Could Choose Between Federal and State Regulation
  - Unlikely to be implemented as envisioned for past several years by OFC supporters
- **Dual Regulation:** Federal Regulation Layer Above State
  - Feds assume solvency regulation, states retain rate/form regulation
- **Hybrid Regulation:** Feds Assume Regulation of Large Insurers at the Holding Company Level
- **Systemic Risk Regulator:** Feds Focus on Regulation of Systemic Risk Points in Financial Services Sector
  - What are these points for insurers? P/C vs. Life?

Source: Insurance Information Inst.
10 Key Threats Facing Insurers Amid Financial Crisis

Challenges for the Next 5-8 Years
1. Erosion of Capital

- Losses are larger and occurring more rapidly than is commonly understood or presumed.
- Surplus down 13%=$66B since 9/30/07 peak; 12% ($80B) in 2008.
- P/C policyholder surplus could be even more by year-end 2009.
- “Price Elasticity of Capital” is too weak (low).
- Some insurers propped up results by reserve releases.
- Decline in PHS of 1999-2002 was 15% over 3 years and was entirely made up and then some in 2003. Current decline is ~13% in 5 qtrs.
- During the opening years of the Great Depression (1929-1933) PHS fell 37%, Assets fell 28% and Net Written Premiums fell by 35%. It took until 1939-40 before these key measures returned to their 1929 peaks.
- **BOTTOM LINE:** Capital and assets could fall much farther and faster than many believe. It will take years to return to the 2007 peaks (likely until 2011 with a sharp hard market and 2015 without one).

Source: Insurance Information Inst.
2. **Reloading Capital After “Capital Event”**

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

Source: Insurance Information Inst.
3. Long-Term Loss of Investment Return

- Low interest rates, risk aversion toward equities and many categories of fixed income securities lock in a multi-year trajectory toward ever lower investment gains
- Price bubble in Treasury securities keeps yields low
- Many insurers have not adjusted to this new investment paradigm of a sustained period of low investment gains
- *Regulators will not readily accept it; Many will reject it*
- *Implication 1:* Industry must be prepared to operate in environment with investment earnings accounting for a smaller fraction of profits
- *Implication 2:* Implies underwriting discipline of a magnitude not witnessed in this industry in more than 30 years. Yet to manifest itself.
- Lessons from the period 1920-1975 need to be relearned

Source: Insurance Information Inst.
Important Issues & Threats
Facing Insurers: 2009 - 2015

4. Economic Collapse

- Long-term decline in industry growth prospects similar to the 1930s
- Collapse does not imply inability to remain profitable
- Industry in 1930s shrank but became profitable
- Some insurers will not survive due to combination of poor investment environment, operating underwriting challenges and capital depletion
- Policyholder behavior will change; Need Mitigation Strategies
  - Coverages dropped, limits lowered, higher deductibles
  - Properties not well maintained; more vacant/abandoned properties
  - More uninsured motorists (already happening)
  - Insurance fraud will increase (anecdotal evidence mounting)
- Property crime will increase (burglary, auto theft)
- Wholesale destruction of wealth (happening now)
- Loss of retirement security (deepening)
- Bottom Line: Industry can survive deep and prolonged economic downturn, but not without casualties

Source: Insurance Information Inst.
5. Regulatory Overreach

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

Source: Insurance Information Inst.
6. Creeping Restrictions on Underwriting

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

Source: Insurance Information Inst.
Important Issues & Threats Facing Insurers: 2009 - 2015

7. Exploitation of Insurance as a Wealth Redistribution Mechanism

- There is a longstanding history of attempts to use insurance to advance wealth redistribution/economic agendas
- Attacks on underwriting criteria such as credit, education, occupation and territory have been targeted in the past
- Urban subsidies; Coastal subsidies
- Insurer focus on underwriting profitability (resulting in higher rates) coupled with poor economic conditions could raise profile of affordability issue
- Calls for “excess profits tax” on insurers (during next cycle or post-cat)
- Increased government involvement in insurance (including ownership stakes) make this more likely
- Federal regulation could impose such redistribution schemes

Bottom Line: Expect efforts to address social and economic inequities through insurance

Source: Insurance Information Inst.
8. Mega-Catastrophe Losses

- $100B CAT year is not improbably over the next 5-7 year
- Severity trend remains upward
- Frequency trends highly variable but more prone to spikes
- FINANCING: Unclear if sufficient capital exists to finance mega-cats in current capital constrained environment
- Concern over reinsurance capacity and pricing
- Alternative sources of CAT financing have dried up
- CAT bonds less attractive; *Willow Re* example
- Some regulators will continue to suppress rates
- Residual markets shares remain high
- Loss of volume for private insurers in key states (e.g., FL)
- *Serves as entry point for socialization of insurance*
- **Bottom Line:** Capacity to finance mega-cats is diminished. Government may fill the void, sometimes with the industry’s support; sometimes in spite of opposition
9. Creeping Socialization and Partial Nationalization of Insurance System

- CAT risk is, on net, being socialized directly via state-run insurance and reinsurance mechanisms or via elaborate subsidy schemes involving assessments, premium tax credits, etc.
- Some (life) insurers beyond AIG asking for TARP money
- Efforts to expand flood program to include wind
- Health insurance may be substantively socialized
- Terrorism risk—already a major federal role backed by insurers
- Eventually impacts for other lines such as personal auto liability, WC?
- Feds may open to more socialization of private insurance risk
- Ownership stakes in some insurers could be a slippery slope
- Despite best efforts of companies like State Farm to charge risk appropriate premiums, withdrawal becomes business imperative and leads to greater socialization
- States like FL will lean heavily on Washington in the event of a mega-cat that threatens state finances
- **Bottom Line:** Additional socialization likely. Can insurers/will insurers draw the line?

Source: Insurance Information Inst.
10. 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.

Source: Insurance Information Inst.
GREEN SHOOTS

Is the Recession Nearing an End?
Hopeful Signs That the Economy Will Begin to Recover Soon

- Recession Appears to be Bottoming Out, Freefall Has Ended
  - Pace of GDP shrinkage is beginning to diminish
  - Pace of job losses is leveling off
  - Major stock market indices well off record lows, anticipating recovery
  - Some signs of retail sales stabilization are evident

- Financial Sector is Stabilizing
  - Banks are reporting quarterly profits
  - Many banks expanding lending to credit worthy people & businesses

- Housing Sector Likely to Find Bottom Soon
  - Home are much more affordable (attracting buyers)
  - Mortgage rates are at multi-decade lows (attracting buyers)
  - Freefall in housing starts and existing home sales is ending

- Inflation & Energy Prices Are Under Control

- Consumer & Business Debt Loads Are Shrinking

10 Industries for the Next 10 Years: Insurance Solutions Needed

- Government
- Education
- Health Care
- Energy (Traditional)
- Alternative Energy
- Agriculture
- Natural Resources
- Environmental Technology
- Light Manufacturing
THE $787 BILLION ECONOMIC STIMULUS

Sectoral Impacts & Implications for P/C Insurance
Summary of Short-Run Impacts of Stimulus Package on P/C Insurance

- No Stimulus Provisions Specifically Address P/C Insurance
  - Spending, Aid and Tax Reductions benefit other industries, state and local governments, as well as individual and some corporate taxpayers
- Stimulus Package is Unlikely to Increase Net Premiums Written by More Than 1% or Approx. $4.5 Bill. by Year-End 2010
- “Direct” Impact to P/C Insurers Results Primarily from Increased Demand for Commercial Insurance
  - Primarily the result of increased infrastructure spending and the resulting need to insure workers, property and protect against liability risks
  - Because the primary objective of the stimulus is employment related, workers compensation will be the P/C line that benefits the most
  - Assuming the target of 3.5 million jobs created or preserved is achieved, private workers comp NPW (new and preserved) could amount to as much as $1.1 billion
  - Other commercial lines to benefit: surety, commercial auto, inland marine
- Other “Direct” P/C Demand Benefits Will Be Minimal
  - Tax provisions providing incentives to buy cars and homes and accelerate the depreciation of equipment will have little net impact on exposure
  - Some additional premium may be generated as older cars and equipment are replaced with new and more valuable (and therefore more expensive to insure)
Economic Stimulus Package: Where the $787B Goes

Objective is to create or preserve 3.5 million jobs

- Health Care, $59, 7%
- Education & Training, $53, 7%
- Energy, $43, 5%
- Infrastructure & Science, $111, 14%
- Protecting the Vulnerable, $81, 10%
- Other, 8, 1%
- Tax Relief, $288, 38%
- State & Local Fiscal Relief, $144, 18%

Tax relief and aid to state and local government account for 56% of stimulus. Actual spending accounts for only about 25%

Economic Stimulus Package: $143.4 in Construction Spending

There is approximately $140B in new construction spending in the stimulus package, about 1/3 of it for transportation.

State-by-State Infrastructure Employment & Spending Impacts

Bigger States Get More, Should Benefit WC Insurers the Most
Infrastructure Stimulus Spending By State: Top 25 States ($ Millions)

Infrastructure spending is in the stimulus package total $38.1B, allocated largely by population size. CA will get $3.9B—the highest amount of any state.

Sources: USA Today 2/19/09; House Transportation and Infrastructure Committee; the Associated Press.
The economic stimulus plan calls for the creation or preservation of 3.5 million jobs, allocated roughly in proportion to the size of the state’s labor force. CA is expected to see 396,000 jobs created or preserved.

Stimulus: Reading The Economic Tea Leaves for the Next 4 to 8 Years

- **Growing Role of Government:** 2009 Stimulus Package and Other Likely Spending Initiatives Guarantee that Government Will Play a Much Larger Role Than at Any Other Time in Recent History
  - Every industry, including insurance, will and must attempt to maximize direct and indirect benefits from this paradigm shift

- **Obama Administration Priorities:** Stimulus Package Acts as “Economic Tea Leaf” on the Administration’s Fiscal Priorities for the Next Several Years
  - These Include:
    - Alternative Energy
    - Health Care
    - Education
    - Aging/New Infrastructure
    - Environment

- **Stimulus is Only One Leg of the Stool**
  - (1) Stimulus; (2) Housing, and (3) Financial Services Reform

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
Impairment rates are highly correlated with underwriting performance and reached record lows in 2007/08.

2008 impairment rate was a record low 0.23%, second only to the 0.17% record low in 2007 and barely one-fourth the 0.82% average since 1969.

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

2008

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

2005

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


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 57 banks have gone under as of 5/1)
    - The Promise is Being Fulfilled
  - Renew existing policies (banks are reducing and eliminating lines of credit)
  - Write new policies (banks are turning away people who want or need to borrow)
  - Develop new products (banks are scaling back the products they offer)

Source: Insurance Information Institute
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

Source: Insurance Information Institute
Bank failures are up sharply. 57 banks (but no p/c or life insurers) failed in 2008/09 due to the financial crisis, including the largest in history—Washington Mutual with $307B in assets.

Remarkably, as recently as 2005 and 2006, no banks failed—the first time this had happened in FDIC history (dating back to 1934).

*Includes all commercial banking and savings institutions. **Through May 1.

Top 10 P/C Insolvencies, Based Upon Guaranty Fund Payments*

$ Millions

Reliance Insurance $2,265.8
Legion Insurance $1,272.7
California Compensation Ins.$1,049.7
Fremantle Indemnity Ins. $843.4
PHICO Ins. $699.4
Transit Casualty Ins. $566.5
Superior National Ins. $555.8
American Mutual Liability Ins. $543.1
Midland Insurance $531.6
Southern Family Ins. $516.8

The 2001 bankruptcy of Reliance Insurance was the largest ever among p/c insurers.

* Disclaimer: This is not a complete picture. If anything the numbers are understated as some states have not reported in certain years.

Source: National Conference of Insurance Guaranty Funds, as of September 17, 2008.
P/C INSURANCE
FINANCIAL PERFORMANCE

A Resilient Industry in Challenging Times
Profitability

Historically Volatile
P/C Net Income After Taxes 1991-2008F ($ Millions)*

2001 ROE = -1.2%
2002 ROE = 2.2%
2003 ROE = 8.9%
2004 ROE = 9.4%
2005 ROE = 9.4%
2006 ROE = 12.2%
2007 ROAS\(^1\) = 12.4%
2008 ROAS = 0.5%*

*ROE figures are GAAP; \(^1\)Return on avg. Surplus. Excluding Mortgage & Financial Guarantee insurers yields an 4.2% ROAS for 2008.

Sources: A.M. Best, ISO, Insurance Information Inst.
P/C Insurance Industry ROEs, 1975 – 2009F*

1977: 19.0%
1987: 17.3%
1997: 11.6%
2006: 12.2%

2009F: 7.4%

Note: 2008 result excluding Mortgage & Financial Guarantee insurers is 4.2%.
Sources: ISO; A.M. Best (2009F); Insurance Information Institute.
The p/c insurance industry fell well short of its cost of capital in 2008.

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.

The cost of capital is the rate of return insurers need to attract and retain capital to the business.

*Excludes mortgage and financial guarantee insurers.

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

Combined ratios must be must lower in today’s depressed investment environment to generate risk appropriate ROEs.

* 2008 figure is return on average statutory surplus. Excludes mortgage and financial guarantee insurers.

Source: Insurance Information Institute from A.M. Best and ISO data.
Presidential Politics & P/C Insurance

How is Profitability Affected by the President’s Political Party?
P/C Insurance Industry ROE by Presidential Administration, 1950-2008*

OVERALL RECORD: 1950-2008*

Democrats 8.00%
Republicans 7.89%

Party of President has marginal bearing on profitability of P/C insurance industry

*Truman administration ROE of 6.97% based on 3 years only, 1950-52.
Source: Insurance Information Institute
P/C Premium Growth

Primarily Driven by the Industry’s Underwriting Cycle, Not the Economy
Strength of Recent Hard Markets by NWP Growth

Shaded areas denote “hard market” periods.

Net written premiums fell 1.0% in 2007 (first decline since 1943) and by 1.4% in 2008, the first back-to-back decline since 1930-33.

Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute
Year-to-Year Change in Net Written Premium, 2000-2009F*

P/C insurers are experiencing their slowest growth rates since 1930-33

Slow growth means retention is critical

*2008 figure is from ISO. Excluding Mortgage & Financial Guarantee insurers = -1.5%.
Source: A.M. Best (historical and forecast)
Declines in premium growth began to stabilize in later 2008 and are firming to some extent in 2009, but are partly offset by flat/declining exposures due to the recession.
Average Commercial Rate Change, All Lines, (1Q:2004 – 1Q:2009)

Magnitude of price declines is now shrinking. Reflects shrinking capital, reduced investment gains, deteriorating underwriting performance, higher cat losses and costlier reinsurance.

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Countrywide auto insurance expenditures increased 2.6% in 2008 and are rising at a 4% pace in 2009.

*Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute estimates 2007-2009 based on CPI data.
Auto insurance prices have clearly begun to rise in recent months.

*Percentage change from same month in prior year.
Average Premium for Home Insurance Policies**

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

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

Shrinkage, but Capital is Within Historic Norms
U.S. Policyholder Surplus: 1975-2008*

Actual capacity as of 12/31/08 was $455.6 billion, down 12.0% from 12/31/07 at $517.9 billion, but still 60% above its 2002 trough. Recent peak was $521.8 billion as of 9/30/07. Surplus as of 12/31/08 is 12.7% below 2007 peak.

The premium-to-surplus ratio stood at $0.95:$1 at year end 2008, up from near record low of $0.85:$1 at year-end 2007.

“Surplus” is a measure of underwriting capacity. It is analogous to “Owners Equity” or “Net Worth” in non-insurance organizations.

Source: A.M. Best, ISO, Insurance Information Institute. *As of 12/31/08
Policyholder Surplus, 2006:Q4 – 2008:Q4

Capacity peaked at $521.8 as of 9/30/07

$ Billions

06:Q4 07:Q1 07:Q2 07:Q3 07:Q4 08:Q1 08:Q2 08:Q3 08:Q4

Source: ISO.
Premium-to-Surplus Ratios Before Major Capital Events*

P/C insurance industry was better capitalized going into the financial crisis than before any “capital event” in recent history.

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

**Latest available

Source: PCS; Insurance Information Institute.
The financial crisis now ranks as the 2nd largest “capital event” over the past 20+ years.

<table>
<thead>
<tr>
<th>Event</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hurricane Hugo</td>
<td>3.3%</td>
</tr>
<tr>
<td>Hurricane Andrew</td>
<td>9.6%</td>
</tr>
<tr>
<td>Northridge Earthquake</td>
<td>6.9%</td>
</tr>
<tr>
<td>Sept. 11 Attacks</td>
<td>10.9%</td>
</tr>
<tr>
<td>Florida Hurricanes</td>
<td>6.2%</td>
</tr>
<tr>
<td>Hurricane Katrina</td>
<td>13.8%</td>
</tr>
<tr>
<td>Financial Crisis as of 12/31/08*</td>
<td>12.9%</td>
</tr>
</tbody>
</table>

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

**Latest available

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

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

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

0.95:1 as of 12/31/08

Sources: A.M. Best, ISO, 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.

Sources: A.M. Best, ISO, Insurance Information Institute
New Funds Contributing to US Policyholder Surplus, 2005-2008

$ Billions

New funds entering the p/c insurance industry is up in 2008, but swamped by amount eroded away

*Through Q4 2009 (latest available).
Source: ISO; Insurance Information Institute
Investment Performance

*Investments are the Principle Source of Declining Profitability*
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

Source: NAIC; Insurance Information Institute research
Investment gains fell by 51% in 2008 due to lower yields, poor equity market conditions.

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.
Investment income fell 7.0% in 2008, the first drop since 2002 and the largest since the 8.0% drop in 2001.

**Growth History**

- 2003: +3.9%
- 2004: +3.4%
- 2005: +24.4%*
- 2006: +5.2%
- 2007: 5.3%
- 2008: -7.0%

Source: A.M. Best, ISO, Insurance Information Institute;
*Includes special dividend of $3.2B. Increase is 15.7% excluding dividend.
Realized capital losses hit a record $19.8 billion in 2008 due to financial market turmoil, a $27.7 billion swing from 2007. This is the primary cause of 2008’s large drop in profits and ROE.

Sources: A.M. Best, ISO, Insurance Information Institute.
Total Returns for Large Company Stocks: 1970-2009*

S&P 500 is down 2.9% in 2009*

The market crash of 2008 was the biggest since 1931


*Through May 1, 2009.
Treasury Bond Yields Have Generally Been Falling

- U.S. Treasury 10-Year Note Yield

Sources: US Bureau of Labor Statistics (history); Blue Chip Economic Indicators, April 2009 issue (forecasts)
Treasury Yield Curves: Pre-Crisis vs. Current*

Treasury Yield Curve is at its most depressed level in at least 45 years. Investment income will fall significantly as a result.

Stock dividend cuts will further pressure investment income.

*March 2009.
Sources: Federal Reserve; Insurance Information Institute.
Underwriting Trends

Financial Crisis Does Not Directly Impact Underwriting Performance: Cycle, Catastrophes Were 2008’s Drivers
**P/C Insurance Combined Ratio, 1970-2008F**

- **Combined Ratios**
  - 1970s: 100.3
  - 1980s: 109.2
  - 1990s: 107.8
  - 2000s: 102.9

**Including Mort. & Fin. Guarantee insurers = 105.1; Excl. = 101.0.**

Sources: A.M. Best; ISO, III  
*Excluding mortgage & financial guarantee insurers in 2008 = 101.0.*
As recently as 2001, insurers paid out nearly $1.16 for every $1 in earned premiums.

2005 ratio benefited from heavy use of reinsurance which lowered net losses.

Relatively low CAT losses, reserve releases.

Including Mortgage & Fin. Guarantee insurers.

Best combined ratio since 1949 (87.6).

Cyclical Deterioration.


Sources: A.M. Best.
Insurers earned a record underwriting profit of $31.7B in 2006 and $19.3B in 2007, the largest ever but only the 2nd and 3rd since 1978. Cumulative underwriting deficit from 1975 through 2008 is $442B.

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

* Includes mortgage & finl. guarantee insurers
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.

Note: Data for 1920 – 1934 based on stock companies only.
Sources: Insurance Information Institute research from A.M. Best Data.

Personal Lines

Auto (~75% of Market)
Home (~25%)
Personal Lines

Combined Ratio, 1993-2009F

2008 deterioration due to price competition and higher CAT losses. Trends reverse in 2009.

Improvement in 2009 assumes reasonable degree of underwriting discipline and average CAT activity ($10B-$12B)

Source: A.M. Best (historical and forecast).
Homeowners Insurance
Combined Ratio

Average 1990 to 2008E = 111.1

Insurers have paid out an average of $1.11 in losses for every dollar earned in premiums over the past 17 years.

Sources: A.M. Best (historical and forecasts)
PPA is the profit juggernaut of the p/c insurance industry today.

Auto insurers have shown significant improvement in PPA underwriting performance since mid-2002, but results are deteriorating.

Average Combined Ratio for 1993 to 2006: 100.7
Auto insurance prices have clearly begun to rise in recent months.

*Percentage change from same month in prior year.
Commercial Lines
Commercial coverages have exhibited significant variability over time.

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

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

Sources: A.M. Best (historical and forecasts)
Average Commercial Rate Change, All Lines, (1Q:2004 – 1Q:2009)

Magnitude of price declines is now shrinking. Reflects shrinking capital, reduced investment gains, deteriorating underwriting performance, higher cat losses and costlier reinsurance.

KRW Effect

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Catastrophe Losses

Impacting Underwriting Results and the Bottom Line
Top 10 Changes in the Financing of Catastrophic Loss

1. Capital Has Become Much More Scarce
   - Though still adequate, existing US p/c capital base shrank by an estimated 16% as of year-end 2008 from Q3:07 peak; Global (re)insurance impacted as well as recent deal with Buffett deal with Swiss Re indicates.
   - Speed with which any given amount of capital can be raised has slowed

2. Capital Has Become More Expensive
   - Scarcity and volatility have driven cost of capital higher
   - More competition on the open market for the limited amount of capital available

3. Investment Earnings Can Offset Only a Smaller Share of Catastrophe Losses
   - Low interest rates, poor equity market performance, write downs eat into returns

4. Alternative Sources of Capital Have Dried-Up
   - E.g., hedge fund, private equity money is far less available

5. Catastrophe Bonds Cannot Be Assumed to Be Uncorrelated With Tradition Financial Market Risk
   - Example of Willow Re (failed to fully meet Feb. 2 interest payment due to Lehman’s failure which caused a total return swap to become worthless, exposing investor principal and interest to market risk); A.M. Best concerned about 3 other Lehman-backed bonds from Ajax Re, Newton Re & Carillon Re
   - Will result in changes in how such instruments are funded and investments held
Top 10 Changes in the Financing of Catastrophic Loss

6. State Run Residual Markets Are More Vulnerable Due to Shaky Financing Arrangements
   • FL’s situation is more precarious than ever & growing; Threatens state’s finances
   • States using assessment mechanism as zero cost lines of credit (e.g., Texas) creating a high opportunity cost for insurers without fixing state’s fiscal exposure

7. Economics of Start-Ups and Take-Out Companies in CAT Zones Becomes Less Compelling Due to Higher Cost of Capital
   • Harder to raise cash
   • Tougher to meet target ROI as cost of capital rises

8. Financial Services Regulatory Overhaul Will Change How the Business of Insurance Is Regulated
   • Unclear how this will affect how cat loss is financed
   • Nat Cat legislation is not (currently) part of the overhaul discussion
   • Systemic Risk Regulator: What are p/c systemic risk points? (CAT exposure?; Guaranty Funds?)
   • Will be impacts on sources of capital as well (e.g., hedge funds)

9. Federal Government is Fiscally Constrained
   ➢ Can/would federal play a bigger role in financing CAT risk? Fed backstops to be sought?

10. Return on Investment for Mitigation is Greatly Increased
    ➢ Investments in mitigation provide a guaranteed high rate of return: up to 500%
    ➢ Mitigation preserves and conserves scarce private capital and government resources
U.S. Insured Catastrophe Losses*

2008 CAT losses exceeded 2006/07 combined. 2005 was by far the worst year ever for insured catastrophe losses in the US, but the worst has yet to come.

*Excludes $4B-$6b offshore energy losses from Hurricanes Katrina & Rita.

**Based on PCS data through Dec. 31. PCS $2.1B loss of for Gustav. $10.655B for Ike of 12/05/08.

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.

Source: Property Claims Service/ISO; Insurance Information Institute
The number of catastrophe events reached a 10-year high in 2008.

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

Source: PCS; Insurance Information Institute
Big catastrophe losses turned up in some surprising states in 2008, due to high tornado, hail and wildfire damage as well as inland hurricane damage.
Share of Losses Paid by Reinsurers, by Disaster*

Reinsurance is playing an increasingly important role in the financing of mega-CATs.

*Excludes losses paid by the Florida Hurricane Catastrophe Fund, a FL-only windstorm reinsurer, which was established in 1994 after Hurricane Andrew. FHCF payments to insurers are estimated at $3.85 billion for 2004 and $4.5 billion for 2005. Ike share is an estimate as of 2/9/09.

Sources: Wharton Risk Center, Disaster Insurance Project; Insurance Information Institute.
Number of U.S. Significant Natural Catastrophes*, 1950 – 2008

There is a clear upward trend in the number of significant natural catastrophes in the US

Sources: Munich Re NatCatSERVICE *$1 billion economic loss and/or 50 fatalities.
Top 12 Most Costly Disasters in US History, (Insured Losses, $2007)

9 of the 12 most expensive disasters in US history have occurred since 2004

In 2008, Ike became the 6th most expensive insurance event and 4th most expensive hurricane in US history

*PCS estimate as of 12/15/08.

Sources: ISO/PCS; AIR Worldwide, RMS, Eqecat; Insurance Information Institute inflation adjustments.
2008 CAT FACTS

• The $25.2 billion in insured losses was the 4th highest ever, behind only, 2005, 2004 and 2001
• There were 37 designated catastrophes in 2008, the highest since 1998 (also 37)
• Commercial losses accounted for 27% of insured losses but just 9% of claims

*Includes homeowners, condominium and rental policies.
**Includes commercial and private passenger vehicles

Source: PCS; Insurance Information Institute research.
2008 Insured Catastrophe Loss Distribution by Number of Claims

2008 CAT FACTS

- The $25.2 billion in insured losses was the 4th highest ever, behind only 2005, 2004 and 2001.
- There were 37 designated catastrophes in 2008, the highest since 1998 (also 37).
- Commercial losses accounted for 27% of insured losses but just 9% of claims.

$ Millions

- Personal*, $2,700, 69%
- Commercial, $340, 9%
- Vehicle**, $876, 22%

*Includes homeowners, condominium and rental policies.
**Includes commercial and private passenger vehicles.

Source: PCS; Insurance Information Institute research.
Natural Catastrophes in 2008 by Type and Location

- 750 natural hazard losses events
- Significant loss events

Great natural catastrophes
- Hurricane Ike (Sept. 6-14, 2008) Caribbean, USA
- Cyclone Nargis (May 2-5, 2008) Myanmar
- Earthquake (May 12, 2008) China
- Winter damage (Jan 10–Feb 13, 2008) China

- Geophysical (earthquake, tsunami, volcanic)
- Meteorological (storm)
- Hydrological (flood, mass movement)
- Climatological (extreme temperature, drought, wildfire)

Energy sector was impacted significantly by catastrophes in 2008: Ike, European Wind/Winter Storms, China Earthquake

Source: 2009 Münchener Rückversicherungs-Gesellschaft, Geo Risk Research, NatCatSERVICE

As of January 2009
Some of the Costliest Natural Catastrophes in 2008 Impacted the Energy Business and Its Insurers Significantly

### Deadliest catastrophes

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Area</th>
<th>Deaths</th>
</tr>
</thead>
<tbody>
<tr>
<td>May</td>
<td>Cyclone Nargis</td>
<td>Myanmar</td>
<td>84,500</td>
</tr>
<tr>
<td>May</td>
<td>Earthquake</td>
<td>China</td>
<td>70,000</td>
</tr>
<tr>
<td>January</td>
<td>Cold wave</td>
<td>Afghanistan, Kyrgyzstan, Tajikistan</td>
<td>1,000</td>
</tr>
<tr>
<td>August/September</td>
<td>Floods</td>
<td>India, Nepal, Bangladesh</td>
<td>635</td>
</tr>
</tbody>
</table>

### Costliest catastrophes (overall losses)

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Area</th>
<th>US$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>May</td>
<td>Earthquake</td>
<td>China</td>
<td>85,000</td>
</tr>
<tr>
<td>September</td>
<td>Hurricane Ike</td>
<td>Caribbean, USA</td>
<td>30,000</td>
</tr>
<tr>
<td>January/February</td>
<td>Winter damage</td>
<td>China</td>
<td>21,100</td>
</tr>
<tr>
<td>August/September</td>
<td>Hurricane Gustav</td>
<td>Caribbean, USA</td>
<td>10,000</td>
</tr>
</tbody>
</table>

### Costliest catastrophes (insured losses)

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Area</th>
<th>US$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>September</td>
<td>Hurricane Ike</td>
<td>Caribbean, USA</td>
<td>15,000</td>
</tr>
<tr>
<td>August/September</td>
<td>Hurricane Gustav</td>
<td>Caribbean, USA</td>
<td>5,000</td>
</tr>
<tr>
<td>January/February</td>
<td>Winter damage</td>
<td>China</td>
<td>1,600</td>
</tr>
<tr>
<td>March</td>
<td>Winter storm Emma</td>
<td>Europe</td>
<td>1,500</td>
</tr>
</tbody>
</table>

Source: 2009 Münchener Rückversicherungs-Gesellschaft, Geo Risk Research, NatCatSERVICE

As of January 2009
The number of natural catastrophes is rising globally. This has significant ramifications for the energy sector and its insurers.

Source: 2009 Münchener Rückversicherungs-Gesellschaft, Geo Risk Research, NatCatSERVICE

As of January 2009
The overall and insured costs from natural catastrophes has been on the rise in recent years. This has significant implications for insurers and reinsurers.
Rising Number of U.S. Landfalling Tropical Cyclones Has Been Very Costly for Insurers

Six tropical cyclones made landfall in the US in 2008

Source: Munich Re from NOAA
Insurance Information
Institute On-Line

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