An Industry, an Economy and a Nation in Transition: 

*Impacts and Implications for P/C Insurance Markets*

National Council on Compensation Insurance 
Annual Issues Symposium 
Orlando, FL 
May 10, 2012

Robert P. Hartwig, Ph.D., CPCU, President & Economist 
Insurance Information Institute ♦ 110 William Street ♦ New York, NY 10038 
Tel: 212.346.5520 ♦ Cell: 917.453.1885 ♦ bobh@iii.org ♦ www.iii.org
Presentation Outline

- U.S. Economic Overview and Outlook
  - Summary and Consequences and Predictions for P/C Insurance
  - Labor Market “Deep Dive”
  - Economy as a Growth Engine for P/C Insurers

- Summary of P/C Financial Performance
  - Profits and Profitability

- Presidential Politics and the P/C Insurance Industry
  - The President, His Party and P/C Profitability

- Will the Market Turn? Four Necessary Criteria:
  - Underwriting Loss Trends
  - Capital/Capacity
  - Reinsurance Markets
  - Pricing Discipline

- Other Contributing Factors to the Underwriting Cycle
  - Investment Environment
  - Inflation
Economics 2012: The World Is Changing

2012 Is the First Year Since 2005 Where Economic Perceptions and Reality in the US Will Be Positive

Enormous Consequences for P/C Insurers
Economic Outlook for 2012

- Economic Growth Will Accelerate Modestly in 2012/13, Albeit Unevenly
  - No Double Dip Recession
  - Enormous regional differences persist
  - Economy remains more resilient than most pundits presume

- Consumer Confidence Will Continue to Improve

- Consumer Spending/Investment Will Continue to Expand

- Consumer and Business Lending Continue to Expand

- Housing Market Remains Weak, but Some Improvement Expected by 2013

- Inflation Remains Tame
  - Runaway inflation highly unlikely but energy spike possible; Fed has things under control

- Private Sector Hiring Remains Consistently Positive
  - Unemployment dips below 8% by year’s end

- Sovereign Debt/Euro Problems Do Not Cause Europe (or US) to Disintegrate

- Soft Landing in China

- Interest Rates Remain Low by Historical Standards; Edge Up by Year’s End

- Stock and Bond Markets More Stable, Less Volatile

- Political Environment Is More Hospitable to Business Interests
P/C Insurance Exposures Grow Robustly
- Personal and commercial exposure growth is certain in 2012; Strongest since 2004
- But restoration of destroyed exposure will take until mid-decade

P/C Industry Growth in 2012 Will Be Strongest Since 2004
- Growth likely to exceed A.M. Best projection of +3.8% for 2012
- No traditional “hard market” emerges in 2012

Underwriting Fundamentals Deteriorate Modestly
- Some pressure from claim frequency, severity in some key lines

Increasing Private Sector Hiring Will Drive Payrolls/WC Exposures
- Wage growth is also positive and could modestly accelerate
- WC will prove to be tough to fix from an underwriting perspective

Increase in Demand for Commercial Insurance Will Accelerate in 2012
- Includes workers comp, property, marine, many liability coverages
- Laggards: inland marine, aviation, commercial auto, surety
- Personal Lines: Auto leads, homeowners lags (though HO leads in NPW growth due to rates)

Industry Capacity Hits a New Record by Year-End 2012 (Barring Meg-CAT)

Investment Environment Is/Remains Much More Favorable
- Return of realized capital gains as a profit driver
- Interest rates remain low; Some upward pressure if economic strength surprises
Labor Market Trends

Is the Labor Market Finally Back on Track or Starting to Derail (Again)?

Pace of Job Gains Will Profoundly Influence WC Growth Trajectory
Unemployment and Underemployment Rates: Stubbornly High in 2012, But Falling

January 2000 through April 2012, Seasonally Adjusted (%)

Unemployment stood at 8.1% in April 2012

Unemployment peaked at 10.1% in October 2009, highest monthly rate since 1983.

Peak rate in the last 30 years: 10.8% in November - December 1982

Stubbornly high unemployment and underemployment constrain overall economic growth, but the job market is now clearly improving

**Monthly Change in Private Employment**

**January 2008 through April 2012** (Thousands)

- **Private Employers Added 4.159 million Jobs Since Jan. 2010 After Having Shed 4.66 Million Jobs in 2009 and 3.81 Million in 2008** (State and Local Governments Have Shed Hundreds of Thousands of Jobs)


December 2007 through April 2012* (Millions)

All of the jobs “lost” since President Obama took office in Jan. 2009 have been recouped


January 2010 through April 2012* (Millions)

Job gains and pay increases have added more than $600 billion to payrolls since Jan. 2010

Cumulative job gains through Apr. 2012 totaled 4.355 million


Governments at all levels are under severe fiscal strain as tax receipts plunged and pension obligations soared during the financial crisis, causing them to reduce staff.

Cumulative job losses through Apr. 2012 totaled 510,000.

**Net Change in Government Employment: Jan. 2010—Apr. 2012**

State government employment fell by 15% since the end of 2009 while Federal employment is down just 2%.

Local government employment shrank by 424,000 from Jan. 2010 through April 2012, accounting for 83% of all government job losses, negatively impacting WC exposures for those cities and counties that insure privately.

*Cumulative change from prior month; Base employment date is Dec. 2009: Fed
Unemployment Rates by State, March 2012: Highest 25 States*

In March, 30 states reported over-the-month unemployment rate decreases, 8 had increases, and 12 and the District of Columbia had no change.

*Provisional figures for March 2012, seasonally adjusted.
In March, 30 states reported over-the-month unemployment rate decreases, 8 had increases, and 12 and the District of Columbia had no change.

Unemployment Rates By State, March 2012:
Lowest 25 States*

*Provisional figures for March 2012, seasonally adjusted.
US Unemployment Rate Forecast

Rising unemployment eroded payrolls and workers comp’s exposure base.

Unemployment peaked at 10% in late 2009.

Unemployment forecasts have been revised downwards for 2012 and 2013. Optimistic scenarios put the unemployment as low as 7.7% by Q4 of this year.

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (4/12 edition); Insurance Information Institute.
Nonfarm Payroll (Wages and Salaries): Quarterly, 2005–2012:Q1

Peak was 2008:Q1 at $6.60 trillion

Recent trough (2009:Q3) was $6.25 trillion, down 5.3% from prior peak

Latest (2011:Q4) was $6.88 trillion, a new peak

Pace of payroll growth is accelerating

Growth rates in 2011/12:
- Q2 over Q1: 0.6%
- Q3 over Q2: 0.4%
- Q4 over Q3: 1.3%
- Q1 over Q4: 1.0%

Note: Recession indicated by gray shaded column. Data are seasonally adjusted annual rates.
Sources: [http://research.stlouisfed.org/fred2/series/WASCUR](http://research.stlouisfed.org/fred2/series/WASCUR); National Bureau of Economic Research (recession dates); Insurance Information Institute.
Continued Payroll Growth and Rate Increases Suggest WC NWP Will Grow Again in 2012; +7.9% Growth in 2011 Was the First Gain Since 2005

*Private employment; Shaded areas indicate recessions. Payroll and WC premiums for 2011 is I.I.I. estimate

Sources: NBER (recessions); Federal Reserve Bank of St. Louis at http://research.stlouisfed.org/fred2/series/WASCUR ; NCCI; I.I.I.
POSITIVE LABOR MARKET DEVELOPMENTS

Key Factors Driving Workers Compensation Exposure
Mass Layoff Announcements, Jan. 2002—Mar. 2012*

Mass layoff announcements peaked at more than 3,000 per month in Feb. 2009

The 1,273 mass layoffs announced in Mar. 2012 was the smallest reading since Sept. 2007

*Percentage change from same month in prior year; through March 2012; seasonally adjusted
Note: Recessions indicated by gray shaded columns.
Average Weekly Hours of All Private Workers, Mar. 2006—Apr. 2012

(Hours Worked)

Hours worked totaled 34.5 per week in April, just shy of the 24.6 hours typically worked before the “Great Recession.”

Hours worked plunged during the recession, impacting payroll exposures.

*Seasonally adjusted
Note: Recessions indicated by gray shaded columns.
The average hourly wage was $23.38, up 10.0% from $21.25 when the recession began in Dec. 2007.

Wage gains continued during the recession, despite massive job losses.

*Seasonally adjusted
Note: Recessions indicated by gray shaded columns.
Manufacturing employment is up by nearly 500,000 or 4.3% since Jan. 2010—a surprising source of strength in the economy

Manufacturing Employment, Jan. 2010—Apr. 2012*

*Seasonally adjusted
Construction Employment, Jan. 2010—Apr. 2012*

Construction employment is still below where it was in Jan. 2010. In a normal recovery, construction employment would be growing robustly.

*Seasonally adjusted
ADVERSE LONG-TERM LABOR MARKET DEVELOPMENTS

Key Factors Harming Workers Compensation Exposure and the Overall Economy
The plight of the long-term unemployed remains a serious issue for the US. Skills atrophy over time—impact on WC claim frequency/severity?

*Defined as the percentage of working age persons in the population who are employed or actively seeking work.

Note: Recessions indicated by gray shaded columns.

A “Discouraged Worker” in a month did not actively look for work in the prior month for reasons such as:

--Thinks no work available,
--Could not find work,
--Lacks schooling or training,
--Employer thinks too young or old, and other types of discrimination.

In recent good times, the number of discouraged workers ranged from
200,000-400,000 (1995-2000) or from 300,000-500,000 (2002-2007).

Notes: Recessions indicated by gray shaded columns. Data are seasonally adjusted.
The Strength of the Economy Will Influence P/C Insurer Growth Opportunities

Growth Will Expand Workers Comp Payroll Exposure Base

America’s Manufacturing Renaissance?
US Real GDP Growth*

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.

Demand for Insurance Continues To Be Impacted by Sluggish Economic Conditions, but the Benefits of Even Slow Growth Will Compound and Gradually Benefit the Economy Broadly.

* Estimates/Forecasts from Blue Chip Economic Indicators.
Source: US Department of Commerce, Blue Economic Indicators 4/12; Insurance Information Institute.
Consumer confidence has been low for years amid high unemployment, falling home prices and other factors adversely impact consumers, but improved substantially in late 2011 and early 2012.

Source: University of Michigan; Insurance Information Institute
New Private Housing Starts, 1990-2022F

New home starts plunged 72% from 2005-2009; A net annual decline of 1.49 million units, lowest since records began in 1959.

The plunge and lack of recovery in homebuilding and in construction in general is holding back payroll exposure growth.

Job growth, improved credit market conditions and demographics will eventually boost home construction.

Little Exposure Growth Likely for Homeowners Insurers Until at least 2014. Also Affects Commercial Insurers with Construction Risk Exposure, Surety.

Source: U.S. Department of Commerce; Blue Chip Economic Indicators (10/11 and 4/12); Insurance Information Institute.
Overall Construction Activity is Up, But Growth Is Entirely in the Private Sector as State/Local Government Budget Woes Continue

*seasonally adjusted
Source: U.S. Census Bureau, [http://www.census.gov/construction/c30/c30index.html](http://www.census.gov/construction/c30/c30index.html); Insurance Information Institute.
Private sector construction activity is up by double digits in many segments after plunging during the “Great Recession”.

Private Construction Activity is Up in Most Segments, Including Residential Construction

*seasonally adjusted
Source: U.S. Census Bureau, [http://www.census.gov/construction/c30/c30index.html](http://www.census.gov/construction/c30/c30index.html); Insurance Information Institute.
The manufacturing sector has been expanding and adding jobs. The question is whether this will continue.

Optimism among manufacturers was increasing in late 2011 and into early 2012.


The value of Manufacturing Shipments in Mar. 2012 was up 31% to $466B from its May 2009 trough. Dec. figure is only 3.9% below its previous record high in July 2008.

Monthly shipments are nearly back to peak (in July 2008, 8 months into the recession). Trough in May 2009. Growth from trough to March 2012 was 31%. This growth leads to gains in many commercial exposures: WC, Commercial Auto, Marine, Property and Various Liability Coverages.

*seasonally adjusted
Manufacturing Growth for Selected Sectors, 2012 vs. 2011*

<table>
<thead>
<tr>
<th>Sector</th>
<th>Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Manufacturing</td>
<td>9.8%</td>
</tr>
<tr>
<td>Durable Mfg.</td>
<td>11.4%</td>
</tr>
<tr>
<td>Primary Metals</td>
<td>31.4%</td>
</tr>
<tr>
<td>Machinery</td>
<td>13.5%</td>
</tr>
<tr>
<td>Electrical Equip.</td>
<td>7.2%</td>
</tr>
<tr>
<td>Transportation Equip.</td>
<td>12.7%</td>
</tr>
<tr>
<td>Non-Durable Mfg.</td>
<td>8.5%</td>
</tr>
<tr>
<td>Food Products</td>
<td>6.2%</td>
</tr>
<tr>
<td>Petroleum &amp; Coal</td>
<td>15.6%</td>
</tr>
<tr>
<td>Chemical</td>
<td>6.6%</td>
</tr>
<tr>
<td>Plastics &amp; Rubber</td>
<td>10.8%</td>
</tr>
<tr>
<td>Textile Products</td>
<td>7.1%</td>
</tr>
</tbody>
</table>

Manufacturing of durable goods has been especially strong.

Manufacturing Is Expanding Across a Wide Range of Sectors that Will Contribute to Growth in Insurable Exposures Including: WC, Commercial Property, Commercial Auto and Many Liability Coverages

*Seasonally adjusted; Date are YTD comparing data through Feb. 2012 to the same period in 2011. Source: U.S. Census Bureau, Full Report on Manufacturers’ Shipments, Inventories, and Orders, [http://www.census.gov/manufacturing/m3/](http://www.census.gov/manufacturing/m3/).
Recovery in Capacity Utilization is a Positive Sign for Commercial Exposures

March 2001 through March 2012

Percent of Industrial Capacity

The US operated at 78.6% of industrial capacity in Mar. 2012, above the June 2009 low of 68.3% and close to its post-crisis peak.

The closer the economy is to operating at “full capacity,” the greater the inflationary pressure.

Source: Federal Reserve Board statistical releases at [http://www.federalreserve.gov/releases/g17/Current/default.htm](http://www.federalreserve.gov/releases/g17/Current/default.htm).
ISM Non-Manufacturing Index (Values > 50 Indicate Expansion)

January 2010 through March 2012

Non-manufacturing industries have been expanding and adding jobs. The question is whether this will continue.

2011 bankruptcies totaled 47,806, down 15.1% from 56,282 in 2010—the second consecutive year of decline. Business bankruptcies more than tripled during the financial crisis.

Sources: American Bankruptcy Institute at http://www.abiworld.org/AM/TemplateName.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=61633; Insurance Information Institute
Business starts were up 4.5% to 370,000 in the first half of 2011 vs. first half 2011. 722,000 new business starts were recorded in 2010, up 3.6% from 697,000 in 2009, which was the slowest year for new business starts since 1993.

Business Starts Were Down Nearly 20% in the Recession, Holding Back Most Types of Commercial Insurance Exposure, But Are Recovering Slowly

* Data through June 30, 2011 are the latest available as of March 7, 2012; Seasonally adjusted.
12 Industries for the Next 10 Years: Insurance Solutions Needed

<table>
<thead>
<tr>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health Care</td>
</tr>
<tr>
<td>Health Sciences</td>
</tr>
<tr>
<td>Energy (Traditional)</td>
</tr>
<tr>
<td>Alternative Energy</td>
</tr>
<tr>
<td>Petrochemical</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Natural Resources</td>
</tr>
<tr>
<td>Technology (incl. Biotechnology)</td>
</tr>
<tr>
<td>Light Manufacturing</td>
</tr>
<tr>
<td>Insourced Manufacturing</td>
</tr>
<tr>
<td>Export-Oriented Industries</td>
</tr>
<tr>
<td>Shipping (Rail, Marine, Trucking)</td>
</tr>
</tbody>
</table>

Many industries are poised for growth, though insurers’ ability to capitalize on these industries varies widely.
Presidential Politics & the P/C Insurance Industry

How Is Profitability Affected by the President’s Political Party?
OVERALL RECORD: 1950-2012*
Democrats 7.67%
Republicans 7.97%

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

Source: Insurance Information Institute

*Truman administration ROE of 6.97% based on 3 years only, 1950-52; ROEs for the years 2008 forward exclude mortgage and financial guaranty segments. Estimated ROE for 2012 = 7.0%.
P/C insurance Industry ROE by Presidential Party Affiliation, 1950-2012*

BLUE = Democratic President
RED = Republican President

*ROEs for the years 2008 forward exclude mortgage and financial guaranty segments; Estimated 2012 ROE = 7.0%
Source: Insurance Information Institute
Election 2012: Political Issues Impacting Insurers

- **Presidential Race Is Tight**
- **Potential for Senate to Flip Republican**
- **Affordable Care Act/Health Care Reform (ObamaCare)**
  - Romney, Republicans generally vow to repeal the Act
  - Complete repeal is unlikely as several popular ACA provisions are already implemented
  - Supreme Court will rule on the constitutionality of the Act in June; Outcome uncertain
- **Dodd-Frank Act/Financial Services Reform & Implementation**
  - Republicans refer to DFA as a “confidence killer” and want it scaled back
  - Outright repeal is highly unlike irrespective of election outcome
  - Systemic criteria have been developed; Designations in late 2012
  - Financial Stability Oversight Council: Current/future composition impacted by election
  - Changes to DFA and/or implementation will have little impact on P/C insurers
- **Key Committee Shifts Possible**
  - **Senate Banking Chair**: Tim Johnson (D-SD) → Richard Shelby (R-AL)
  - **House Finl. Svcs. Chair**: Spencer Bachus (R-AL) → Jeb Hensarling (R-TX) (term limits)
    - If House flipped Chair would go to Maxine Waters (D-CA)
- **Federal Insurance Office**
  - If Romney wins, he will appoint a new Treasury Secretary
  - FIO leadership, staffing, agenda and budget could be impacted
  - Secretary Geithner likely to step down after election even if Obama is re-elected
- **Agent Licensing, NFIP**
P/C Insurance Industry
Financial Overview

Profit Recovery Was Set Back in 2011 by High Catastrophe Loss & Other Factors
P/C Net Income After Taxes
1991–2011 ($ Millions)

P-C Industry 2011 profits were down 46% to $19.2B vs. 2010, due primarily to high catastrophe losses and as non-cat underwriting results deteriorated.

- ROE figures are GAAP; \(^1\)Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields a 4.6% ROAS for 2011, 7.6% for 2010 and 7.4% for 2009.

Sources: A.M. Best, ISO, Insurance Information Institute
A 100 Combined Ratio Isn’t What It Once Was: Investment Impact on ROEs

Combined Ratio / ROE

A combined ratio of about 100 generated ~5.5% ROE in 2009/10, 10% in 2005 and 16% in 1979

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

* 2008 -2011 figures are return on average surplus and exclude mortgage and financial guaranty insurers. 2011 combined ratio including M&FG insurers is 108.2, ROAS = 3.5%.
Source: Insurance Information Institute from A.M. Best and ISO data.
Profitability Peaks & Troughs in the P/C Insurance Industry, 1975 – 2011*

*Profitability = P/C insurer ROEs are I.I.I. estimates. 2011 figure is an estimate based on ROAS data. Note: Data for 2008-2011 exclude mortgage and financial guaranty insurers. For 2011:Q3 ROAS = 3.5% including M&FG.

Source: Insurance Information Institute; NAIC, ISO, A.M. Best.
Top 14 Most Costly Disasters in U.S. History

(Insured Losses, 2011 Dollars, $ Billions)

Taken as a single event, the Spring 2011 tornado and storm season are is the 4th costliest event in US insurance history.

Hurricane Irene became the 11th most expense hurricane in US history.

*Losses will actually be broken down into several “events” as determined by PCS. Includes losses for the period April 1 – June 30. Sources: PCS; Insurance Information Institute inflation adjustments.
US CAT Losses in 2011 Were the 5th Highest in US History on An Inflation Adjusted Basis

*PCS figure as of April 6, 2012.

Note: 2001 figure includes $20.3B for 9/11 losses reported through 12/31/01 ($25.9B 2011 dollars). Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = $12.2B ($15.6B in 2011 dollars.)

Sources: Property Claims Service/ISO; Insurance Information Institute.
The BIG Question: When Will the Market Turn?

Are Catastrophes and Other Factors Pressuring Insurance Markets?
**Criteria Necessary for a “Market Turn”: All Four Criteria Must Be Met**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Status</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustained Period of Large Underwriting Losses</td>
<td>Early Stage, Inevitable</td>
<td>• Apart from 2011 CAT losses, overall p/c underwriting losses remain modest</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Combined ratios (ex-CATs) still in low 100s (vs. 110+ at onset of last hard market)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Prior-year reserve releases continue to reduce u/w losses, boost ROEs, though more modestly</td>
</tr>
<tr>
<td>Material Decline in Surplus/Capacity</td>
<td>Entered 2011 At Record High; Only Small Decline</td>
<td>• Surplus hit a record $565B as of 3/31/11</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Fell just 1.6% through 12/31/11 from 12/31/10</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Will likely see new record in 2012</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Little excess capacity remains in reinsurance markets</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Modest growth in demand for insurance is insufficient to absorb much excess capacity</td>
</tr>
<tr>
<td>Tight Reinsurance Market</td>
<td>Somewhat in Place</td>
<td>• Much of the global “excess capacity” was eroded by cats</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Higher prices in Asia/Pacific</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Modestly higher pricing for US risks</td>
</tr>
<tr>
<td>Renewed Underwriting &amp; Pricing Discipline</td>
<td>Some Firming esp. in Property, WC</td>
<td>• Commercial lines pricing trends have turned from negative to flat and now positive, esp. Property &amp; WC;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Competition remains intense as many seek to maintain market share</td>
</tr>
</tbody>
</table>

Sources: Barclays Capital; Insurance Information Institute.
1. UNDERWRITING

Have Underwriting Losses Been Large Enough for Long Enough to Turn the Market?
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

Higher CAT Losses, Shrinking Reserve Releases, Toll of Soft Market

Best Combined Ratio Since 1949 (87.6)

Cyclical Deterioration

Avg. CAT Losses, More Reserve Releases

Sources: A.M. Best, ISO.
Commercial Lines Combined Ratio, 1990-2012F*

- Commercial lines underwriting performance in 2011 was the worst since 2002

*2007-2012 figures exclude mortgage and financial guaranty segments.
Source: A.M. Best; Insurance Information Institute
Underwriting Gain (Loss) 1975–2011*

Cumulative underwriting deficit from 1975 through 2011 is $479B

Underwriting losses in 2011 totaled $36.5B, the largest since 2001

Large Underwriting Losses Are NOT Sustainable in Current Investment Environment

* Includes mortgage and financial guaranty insurers in all years
Sources: A.M. Best, ISO; Insurance Information Institute.
P/C Reserve Development, 1992–2013F


Prior year reserve releases totaled $8.8 billion in the first half of 2010, up from $7.1 billion in the first half of 2009.

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: Barclays Capital; A.M. Best.
Financial Strength & Underwriting

Cyclical Pattern is P-C Impairment History is Directly Tied to Underwriting, Reserving & Pricing
Impairment Rates Are Highly Correlated With Underwriting Performance and Reached Record Lows in 2007; Recent Increase Was Associated Primarily With Mortgage and Financial Guaranty Insurers and Not Representative of the Industry Overall

2011 impairment rate was 0.91%, up from 0.67% in 2010; the rate is slightly higher than the 0.82% average since 1969

Source: A.M. Best; Insurance Information Institute
Historically, Deficient Loss Reserves and Inadequate Pricing Are By Far the Leading Cause of P-C Insurer Impairments. Investment and Catastrophe Losses Play a Much Smaller Role.


Workers Comp accounted for more than 25% of the premium volume of impaired insurers over the past decade.

2. SURPLUS/CAPITAL/CAPACITY

Have Large Global Losses Reduced Capacity in the Industry, Setting the Stage for a Market Turn?
Policyholder Surplus, 2006:Q4–2011:Q4

The Industry now has $1 of surplus for every $0.80 of NPW, close to the strongest claims-paying status in its history.

Surplus as of 12/31/11 was down 2.5% below its all time record high of $564.7B set as of 3/31/11. A new record high in 2012 is possible.

Quarterly Surplus Changes Since 2011:Q1 Peak

11:Q2: -$5.6B (-1.0%)
11:Q3: -$26.1B (-4.6%)
11:Q4: -$14.3B (-2.5%)

*Includes $22.5B of paid-in capital from a holding company parent for one insurer’s investment in a non-insurance business in early 2010.

Sources: ISO, A.M. Best.
The Financial Crisis at its Peak Ranks as the Largest “Capital Event” Over the Past 20+ Years

2011 severe storms reduced capacity by just 3.8%

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

* Ratio is for end-of-quarter surplus immediately after the 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
3. REINSURANCE MARKET CONDITIONS

Record Global Catastrophes Activity is Pressuring Pricing
Global Property Catastrophe Rate on Line Index, 1990—2012 (as of Jan. 1)

Property-Cat reinsurance pricing is up about 8% as of 1/1/12—modest relative to the level CAT losses.

Year Over Year % Change

Cumulative Rate on Line Index

Sources: Guy Carpenter; Insurance Information Institute.
4. RENEWED PRICING DISCIPLINE

Is There Evidence of a Broad and Sustained Shift in Pricing?
Premium Growth Is Up Modestly: More in 2012?

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.

2011 growth was +3.3%

NWP was up 0.9% in 2010

Shaded areas denote “hard market” periods
Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute.
Finally! Back-to-back quarters of net written premium growth (vs. the same quarter, prior year)

In 2011, growth in personal lines predominating cos. (+2.9%) and commercial lines predominating cos. (+4.3%), diversified (+2.4%)
Growth in Net Written Premium by Segment, 2011 vs. 2010

Source: ISO/PCI; Insurance Information Institute

Personal lines insurer growth decelerated as auto pricing moderated even has homeowners insurance rates rose.

Commercial lines growth improved dramatically as a 7-year long soft market came to an end and an improving economy bolstered demand.
Average Commercial Rate Change, All Lines, (1Q:2004–1Q:2012)

Pricing as of Q1:2012 was positive for only the third time since 2003. Slightly stronger gains in Q4.

Q2 2011 marked the 30th consecutive quarter of price declines.

Source: Council of Insurance Agents & Brokers (1Q04-4Q11); Insurance Information Institute
Change in Commercial Rate Renewals, by Account Size: 1999:Q4 to 2012:Q1

Percentage Change (%)

Peak = 2001:Q4 +28.5%

Pricing Turned Negative in Early 2004 and Remained that way for 7 ½ years

Trough = 2007:Q3 -13.6%

KRW: No Lasting Impact

Pricing turned positive in Q3:2011, the first increase in nearly 8 years; Q1:2012 renewals were up 4.4%

Source: Council of Insurance Agents and Brokers; Barclay’s Capital; Insurance Information Institute.
Despite 3 consecutive quarters of gains (Q1:2012 = 4.4%), pricing today is where it was in early 2001 (pre-9/11)

Upward pricing pressure is small for large accounts, 4.1% in Q1:2012, vs. 4.2% for small accounts and 4.9% for medium accounts.

Source: Council of Insurance Agents and Brokers; Barclay's Capital; Insurance Information Institute.
Change in Commercial Rate Renewals, by Line: 2012:Q1

Percentage Change (%)

<table>
<thead>
<tr>
<th>Line</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surety</td>
<td>0.8%</td>
</tr>
<tr>
<td>EPL</td>
<td>2.0%</td>
</tr>
<tr>
<td>Comm Auto</td>
<td>3.1%</td>
</tr>
<tr>
<td>General Liability</td>
<td>3.1%</td>
</tr>
<tr>
<td>Umbrella</td>
<td>3.3%</td>
</tr>
<tr>
<td>D&amp;O</td>
<td>3.6%</td>
</tr>
<tr>
<td>Construction</td>
<td>3.8%</td>
</tr>
<tr>
<td>EPL</td>
<td>4.0%</td>
</tr>
<tr>
<td>Bus. Interruption</td>
<td>4.0%</td>
</tr>
<tr>
<td>Commercial Property</td>
<td>6.5%</td>
</tr>
<tr>
<td>Workers Comp</td>
<td>7.4%</td>
</tr>
</tbody>
</table>

Workers Comp rate increases are larger than any other line, followed by Property lines.

Major Commercial Lines Renewed Uniformly Upward in Q1:2012 for Only the Third Time Since 2003; Property Lines & Workers Comp Leading the Way

Source: Council of Insurance Agents and Brokers; Insurance Information Institute.
Workers Comp Rate Changes, 2008:Q4 – 2012:Q1

WC rate changes have been positive for 4 consecutive quarters, longer than any other commercial line.

Source: Council of Insurance Agents and Brokers; Information Institute.
Investment Performance is a Key Driver of Profitability

Does It Influence Underwriting or Cyclicality?
Insurers Have Not Yet Fully Adapted to a Persistently Low Interest Rate Environment

No Expectation that Rates Would Be:

- Pushed to Such Low Levels
- Pushed Down So Rapidly
- Held to Such Low Levels for So Long
- Suppressed via Unprecedented Aggressiveness of the Federal Reserve
  - Use of traditional and unconventional tools (QE)
  - Unconventional ‘s policies couldn’t be anticipated, esp. QE1, 2 (3?)

Competitive Pressure → Protracted Soft Market

Ability to Release Prior Reserves Eases Urgency

Realization of Capital Gains
Investment Income in 2011 Was Surprisingly Strong, Though Investment Income Is Likely to Weaken in 2012 Due to Persistently Low Interest Rates

1 Investment gains consist primarily of interest and stock dividends.

*2012F-201F based on Conning projections.

Sources: ISO; Conning Research & Consulting; Insurance Information Institute.
Insurers Posted Net Realized Capital Gains in 2010 and 2011 After Following Two Years of Realized Losses During the Financial Crisis. 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.
Investment Gains in 2011 Were Surprisingly Robust. Investment Gains Recovered Significantly in 2011 Due to Realized Investment Gains; The Financial Crisis Caused Investment Gains to Fall by 50% in 2008

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.
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.
Yields on 10-Year U.S. Treasury Notes have been essentially below 5% for nearly a decade.

Since roughly 80% of P/C bond/cash investments are in 10-year or shorter durations, most P/C insurer portfolios will have low-yielding bonds for years to come.

*Monthly, through March 2012. Note: Recessions indicated by gray shaded columns.
Inflation

Is it a Threat to Claim Cost Severities
The slack in the U.S. economy suggests that inflationary pressures should remain subdued for an extended period of times. Energy, health care and commodity prices, plus U.S. debt burden, remain longer-run concerns.
P/C Personal Insurance Claim Cost Drivers Grow Faster Than the Core CPI Suggests

Price Level Change: 2011 vs. 2010

Certain cost drivers critical to WC are rising faster than the overall CPI

- Excludes Food and Energy
- "Core" CPI: 1.7%
- Inpatient Hospital Services: 6.8%
- Outpatient Hospital Services: 5.1%
- Prescription Drugs: 4.2%
- Medical Care Commodities: 3.0%
- Legal Services: 3.2%
- Motor Vehicle Parts & Equipment: 5.0%
- Residential Maint. & Repair: 7.1%

Healthcare costs are a major WC, liability, med pay, and PIP claim cost driver. They are likely to grow faster than the CPI for the next few years, at least.

Thank you for your time and your attention!

Twitter: twitter.com/bob_hartwig

Download at www.iii.org/presentations