

The Financial Crisis, No-Fault Insurance and the Future of the P/C Insurance Industry

**New York Insurance Association
Albany, NY**

November 5, 2009



Download at: www.iii.org/Presentations/NYIA-110509/

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Presentation Outline

- **The Economic Storm: Financial Crisis & Recession**
 - Exposure, Growth & Profitability
- **New York No-Fault Update: The Crisis Returns**
- **Key Threats and Issues Facing P/C Insurers Through 2015**
- **Regulatory Reform**
- **Financial Strength & Ratings**
 - Key Differences Between Insurer and Bank Performance During Crisis
- **Insurance Industry Financial Overview & Outlook**
 - Profitability
 - Premium Growth
 - Underwriting Performance: Commercial & Personal Lines
 - Financial Market Impacts
 - Merger & Acquisition Activity
- **Capital & Capacity**
- **Catastrophe Loss Trends**

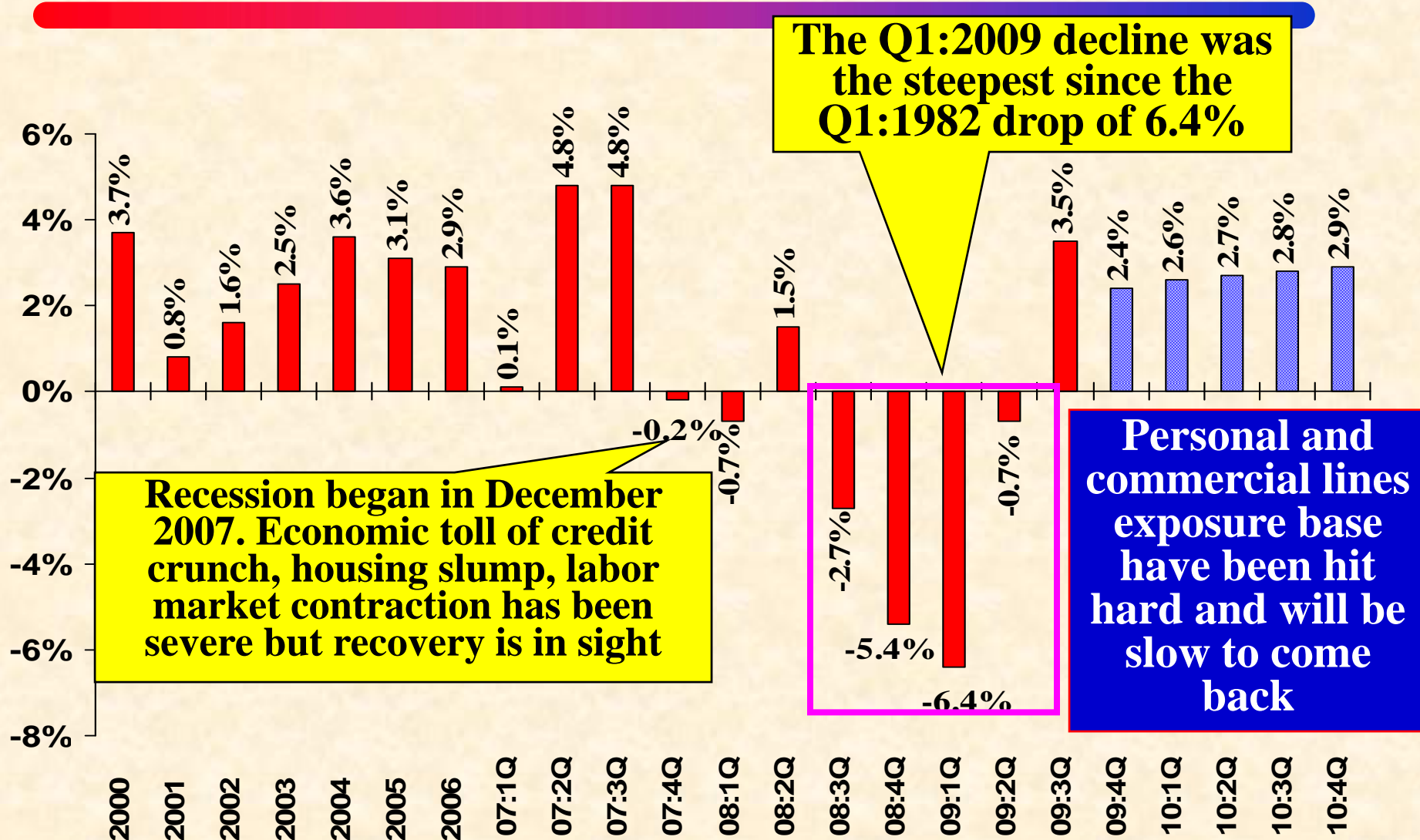
THE ECONOMIC STORM

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





Real GDP Growth*

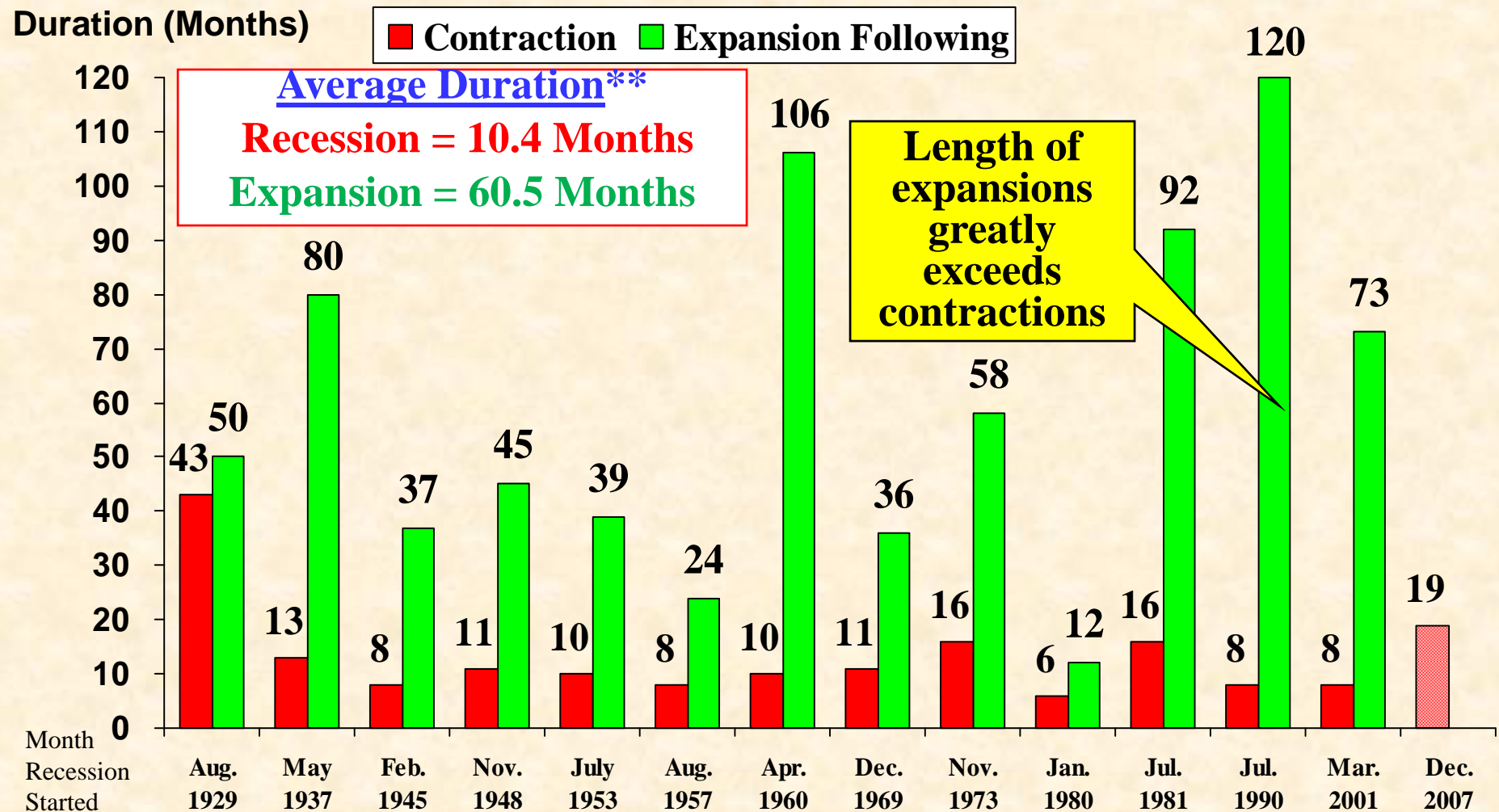


*Blue bars are Estimates/Forecasts from Blue Chip Economic Indicators.

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

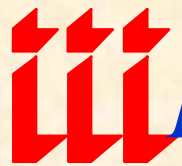


Length of U.S. Business Cycles, 1929-Present*



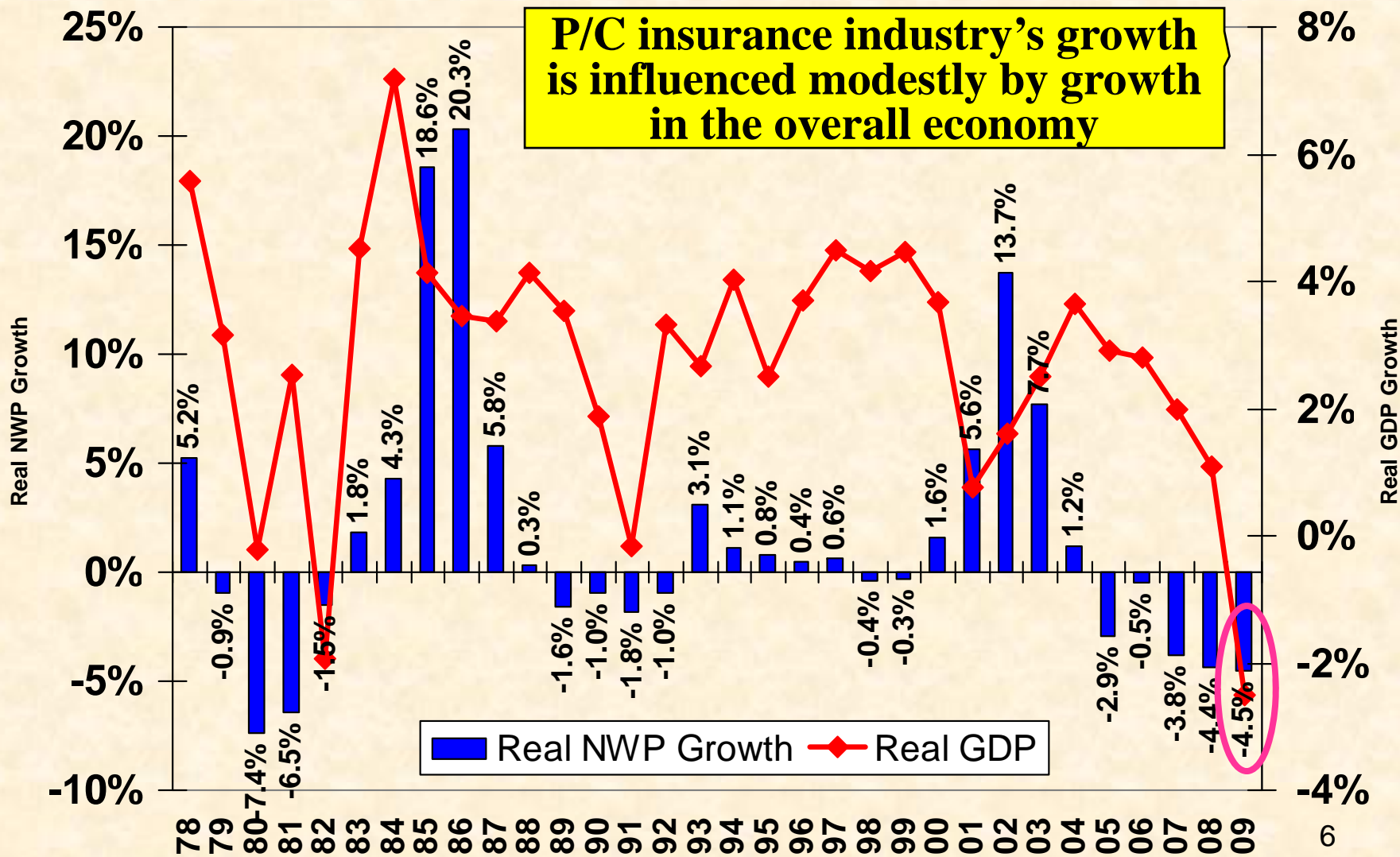
* Through June 2009 (likely the "official end" of recession) **Post-WW II period through end of most recent expansion.

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



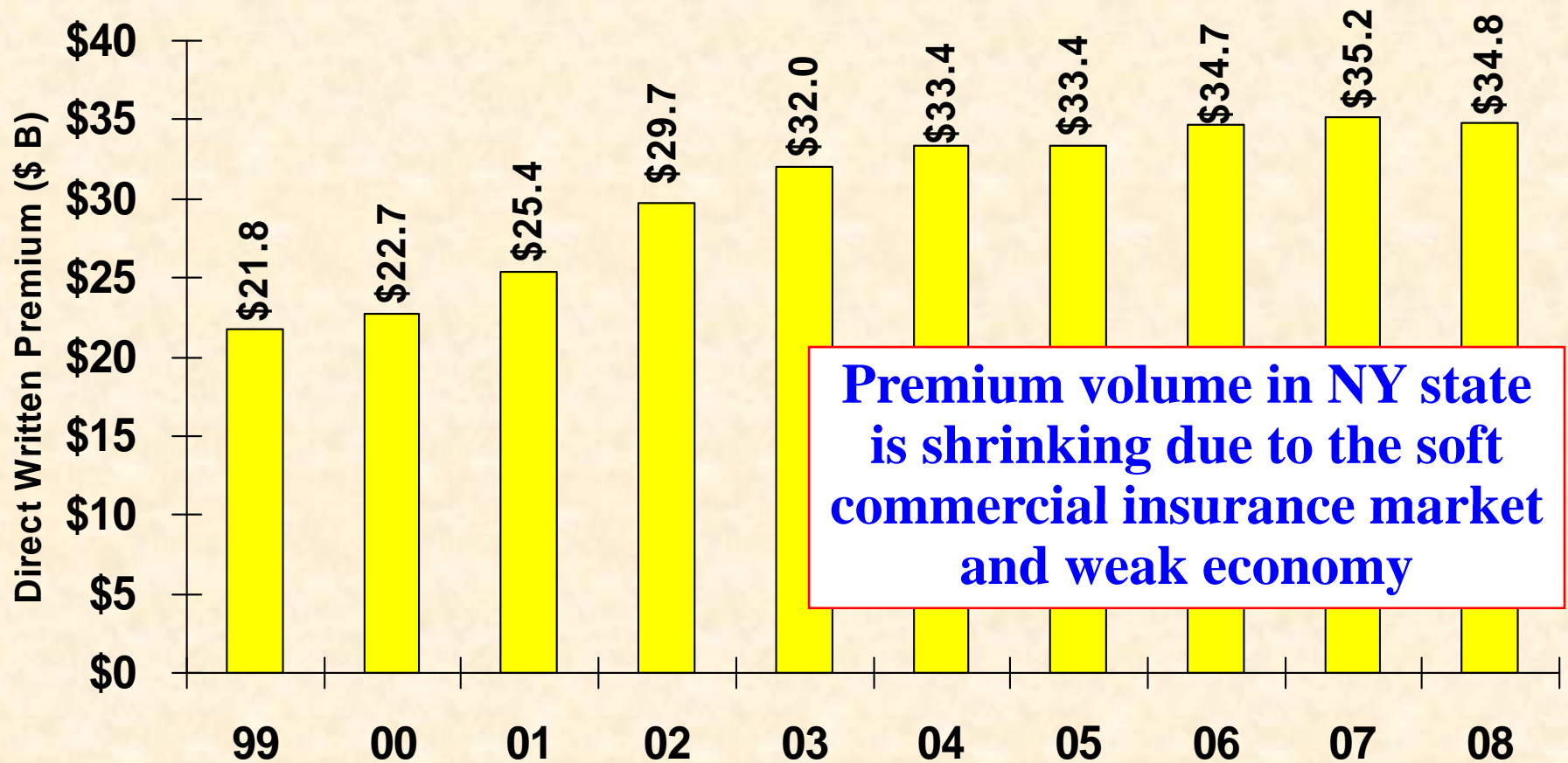
Real GDP Growth vs. Real P/C

Premium Growth: Modest Association





NY Direct Written Premiums (DWP), 1999-2008



New York PIP Insurance Update:

*Is New York's No-Fault
Crisis Returning?*



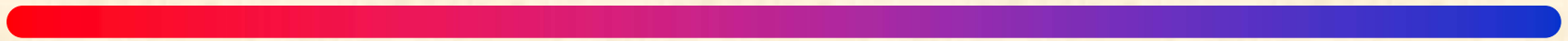


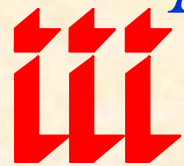
Summary of Findings: New York State's No-Fault Auto Insurance Problem

No-Fault (PIP) Costs Are Surging

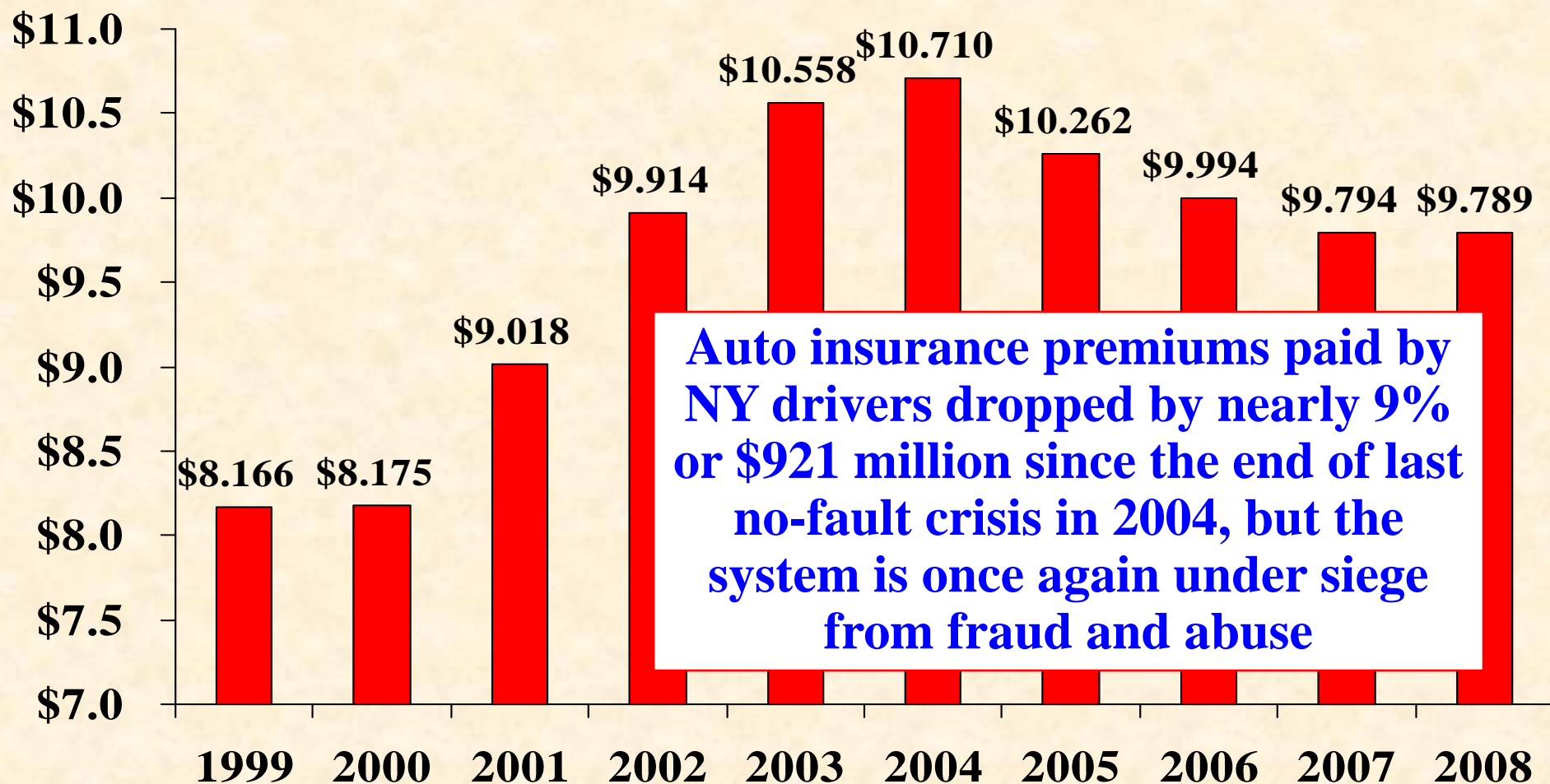
- **New York's no-fault (PIP) average claims costs—at \$8,748 per claim—are the second highest in the US (as of the 2nd quarter of 2009)**
- **The average cost per no-fault claim in New York is more than double (111%) that of the US median (\$4,152)**
- **The average cost of a no-fault claim has soared \$3,133 or 56% from \$5,615 at the end of 2004 to \$8,748 in the second quarter of 2009**
- **No-Fault claim costs as of Q2 of 2009 are the second highest in NY history, just 5% short of their all-time high of \$9,235 in the 1st quarter of 2002**

NY's Private Passenger Auto Insurance Market *Size and Marketshare*





New York State Direct Pvt. Passenger Auto Premiums Written: 1999-2008





Private Passenger Auto Insurers in New York State, 2008 (1-25)

<u>Rank</u>	<u>Company</u>	<u>Group</u>	<u>Direct Premiums Written</u>	<u>Mkt. Share (%)</u>
1.	Geico	BERKSHIRE HATHAWAY GRP	2,250,603,467	23.0
2.	Allstate Insurance Co Group	ALLSTATE INSURANCE GROUP	1,844,794,441	18.8
3.	State Farm Mutual Group	STATE FARM GRP	1,060,333,783	10.8
4.	Progressive Casualty Group	PROGRESSIVE GRP	641,957,648	6.6
5	Liberty Mutual Group	LIBERTY MUTUAL INSURANCE GROUP	559,129,362	5.7
.6.	Travelers Cos & Affil	TRAVELERS GRP	538,882,826	5.5
7.	Nationwide Group	NATIONWIDE CORP GRP	286,052,407	2.9
8.	New York Central Mut Fire Ins Co	CENTRAL SERV GRP	269,489,658	2.8
9.	Metropolitan P&C Ins Co & Affiliates	METROPOLITAN GROUP	253,168,898	2.6
10.	Hartford Fire Group	HARTFORD FIRE & CASUALTY GROUP	222,681,116	2.3
11.	American International Group	AMERICAN INTL GRP	208,727,125	2.1
12.	United Services Automobile ASN Group	UNITED SERV AUTOMOBILE ASSN GRP	191,513,078	2.0
13.	Unitrin Prop & Cas Ins Grp	UNITRIN GRP	134,559,311	1.4
14.	Motors Insurance Corp Group	GMAC INS HOLDING GRP	104,591,800	1.1
15.	Adirondack Ins Exch	N/A	98,818,395	1.0
16.	Onebeacon Ins Grp	WHITE MOUNTAIN GROUP	91,412,435	0.9
17.	Amica Mutual Group	AMICA MUTUAL GRP	86,573,149	0.9
18.	Combined Federal Ins Co & Affiliates	CHUBB & SON INC GRP	81,495,932	0.8
19.	Hanover Insurance Co Group	THE HANOVER INS GRP	81,413,362	0.8
20.	Countrywide Insurance Co	N/A	77,264,817	0.8
21.	Erie Insurance Exchange Group	ERIE INS GRP	61,404,626	0.6
22.	Esurance Ins Co and Affiliate	WHITE MOUNTAIN GROUP	60,874,361	0.6
23.	Ngm Ins Co	MAIN STREET AMER GRP	56,858,636	0.6
24.	Farmers Insurance Group	ZURICH INS GRP	55,162,750	0.6
25.	Preferred Mutual Insurance Co	N/A	50,892,503	0.5



Top Private Passenger Auto Insurers in New York State, 2008 (26-50)

<u>Rank</u>	<u>Company</u>	<u>Group</u>	<u>Direct Written Premiums</u>	<u>Mkt. Share (%)</u>
26.	Preferred Mutual Insurance Co	N/A	50,892,503	0.5
26.	Lincoln General Insurance Co	KINGSWAY GRP	48,762,542	0.5
27.	Response Ins Grp	RESPONSE INSURANCE GROUP	39,068,213	0.4
28.	Commerce Group Inc	COMMERCE INC GRP	33,329,594	0.3
29.	Utica National Insurance Group	UTICA GRP	29,739,636	0.3
30.	Mercury Casualty Group	MERCURY GENERAL GRP	28,114,418	0.3
31.	QBE The Americas	QBE INS GRP	26,518,443	0.3
32.	Amer Natl Prop & Cas Co & Affiliates	AMERICAN NATL FIN GRP	24,434,340	0.2
33.	IDS Property Casualty Group	AMERIPRISE FIN GRP	22,034,901	0.2
34.	Firemans Fund Insurance Group	ALLIANZ INSURANCE GROUP	17,792,523	0.2
35.	Tri-State Consumer Insurance Co	N/A	17,755,332	0.2
36.	Electric Insurance Company	ELECTRIC INS GRP	12,395,453	0.1
37.	American Modern Home Group INC	MUNICH RE GRP	12,310,466	0.1
38.	Balboa Casualty Grp	BANKAMERICA CORP GRP	12,275,118	0.1
39.	Eveready Insurance Co	N/A	12,002,501	0.1
40.	Merchants Mutual Group	MERCHANTS MUT GRP	11,354,814	0.1
41.	Long Island Ins Co	N/A	8,412,317	0.1
42.	Interboro Mutual Indemnity Ins Co	N/A	7,793,341	0.1
43.	California State Automobile Assoc	CALIFORNIA STATE AUTO GRP	5,796,218	0.1
44.	Harleysville Mutual Insurance Co Grp	HARLEYSVILLE GRP	5,655,744	0.1
45.	Assurant Group	ASSURANT INC GRP	5,588,944	0.1
46.	Ocean Harbor Casualty Insurance Co	OCEAN HARBOR GRP	4,943,255	0.1
47.	Infinity Prop & Cas Cos	INFINITY PROP & CAS INS GRP	4,553,098	0
48.	Central Mutual of OH Group	CENTRAL MUT INS CO GRP	4,516,397	0
49.	United Farm Family Mut Ins Co & Affi	INDIANA FARM BUREAU GRP	4,061,793	0
50.	Sentry Insurance A Mutual Co Group	SENTRY INSURANCE GROUP	3,950,514	0

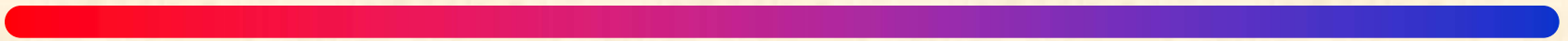
Source: Highline Data; Insurance Information Institute.

NY PIP UPDATE

*Is New York's No-Fault
System Out of Control—*

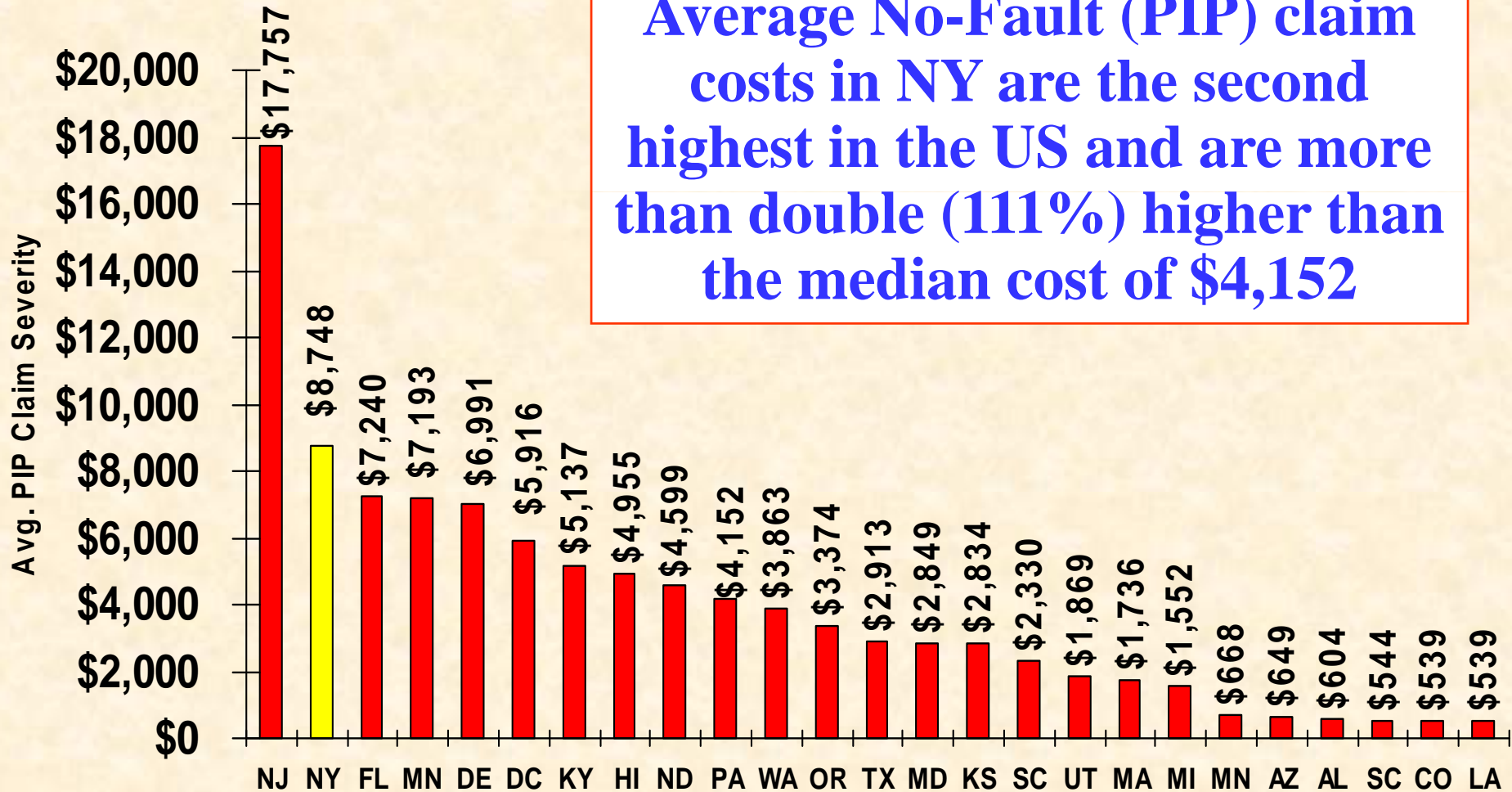


Again?



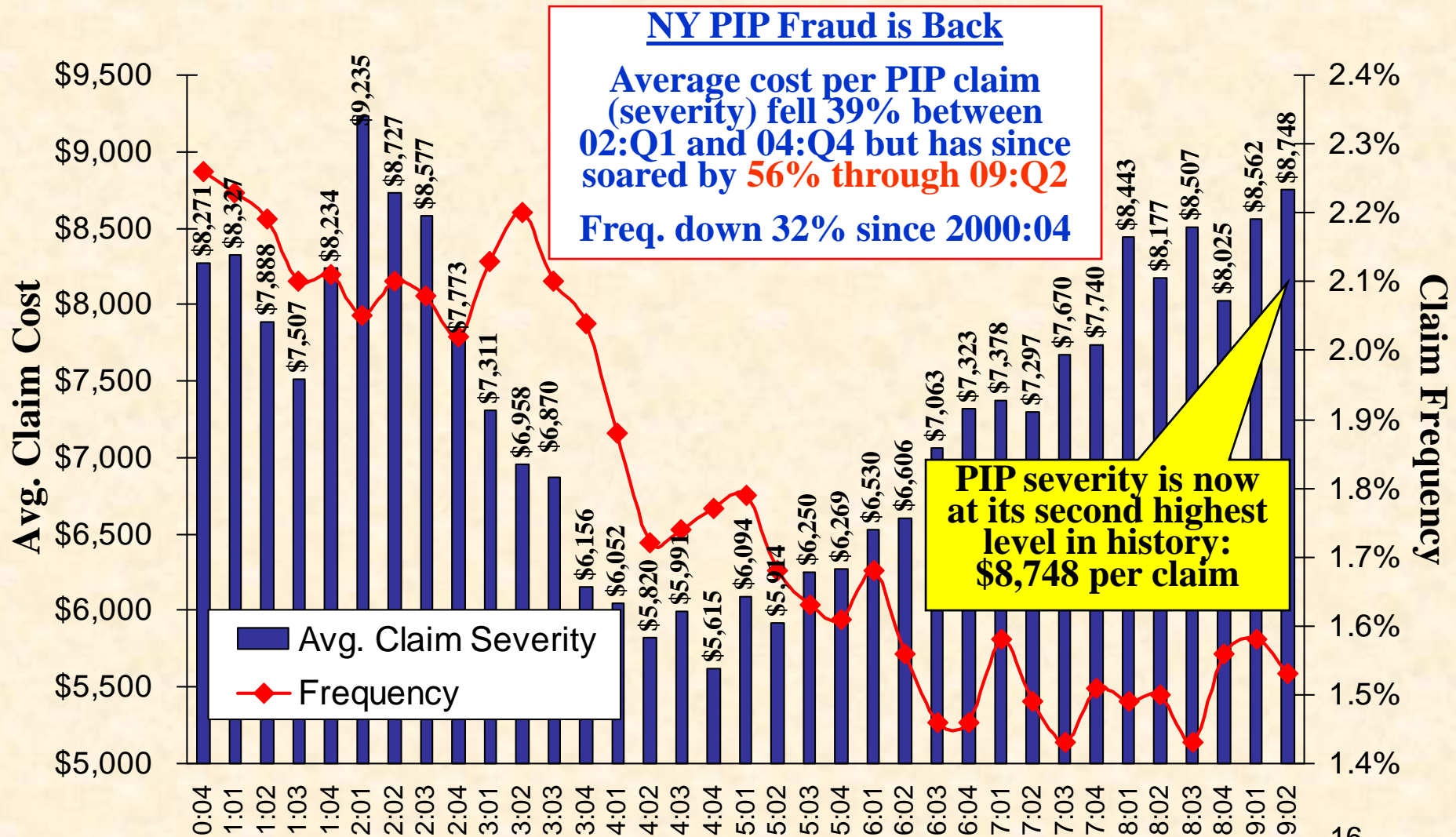


Average PIP (No-Fault) Claim Cost as of 2009:Q2





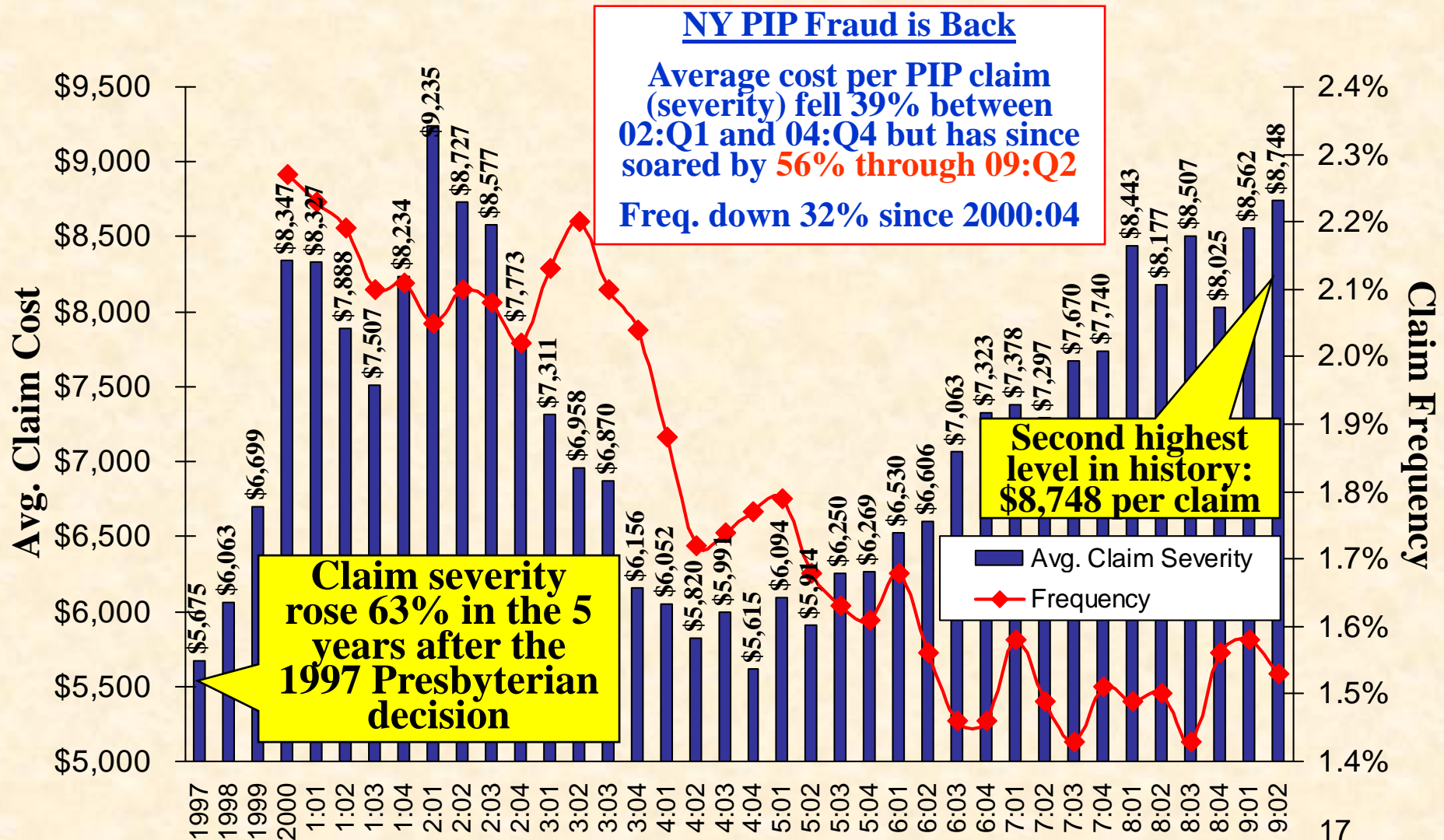
NY PIP Claim Frequency & Severity, (2000:04 – 2009:02)



Sources: Insurance Information Institute based on ISO Fast Track data.

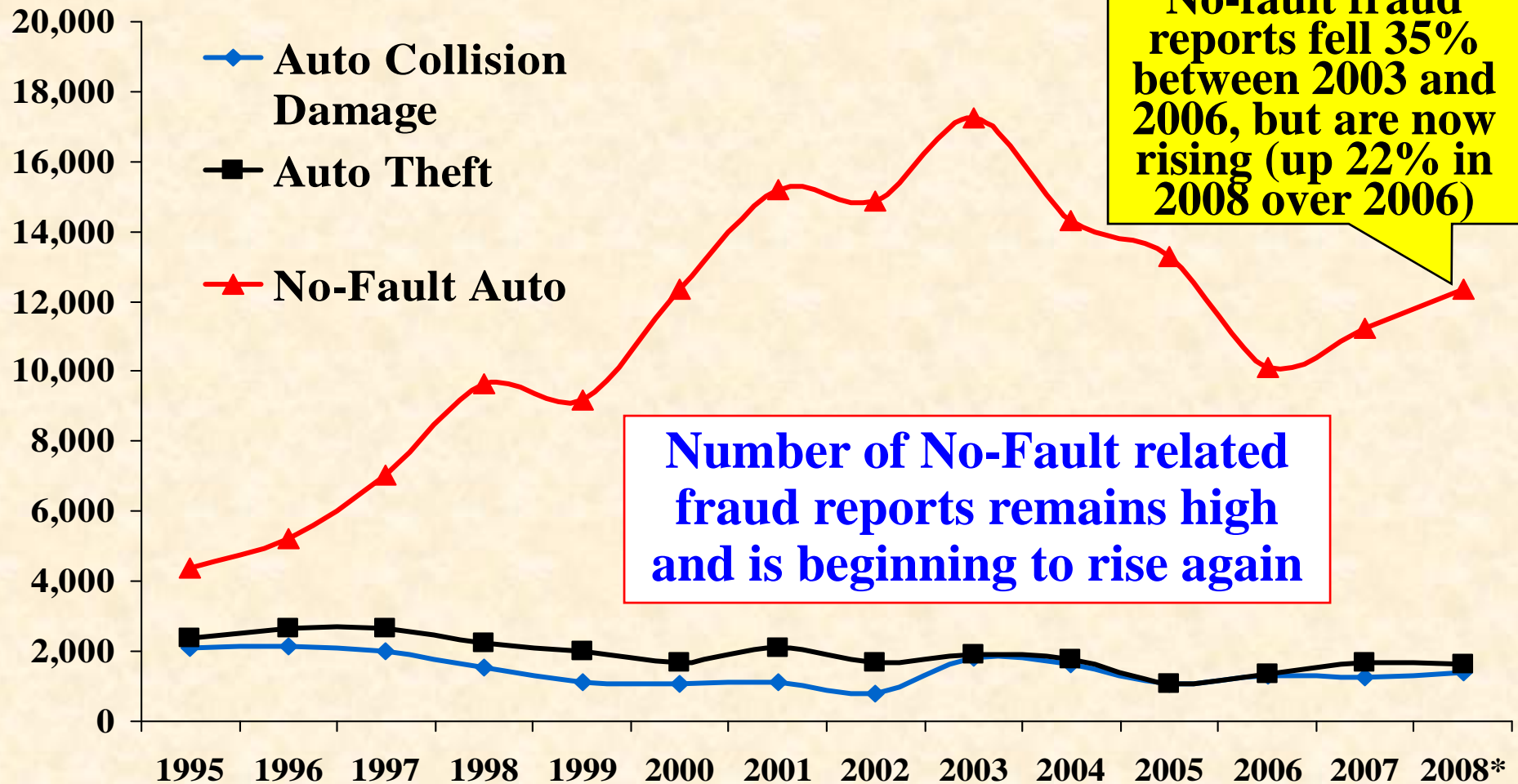


NY PIP Claim Frequency & Severity, (1997 – 2009:02)



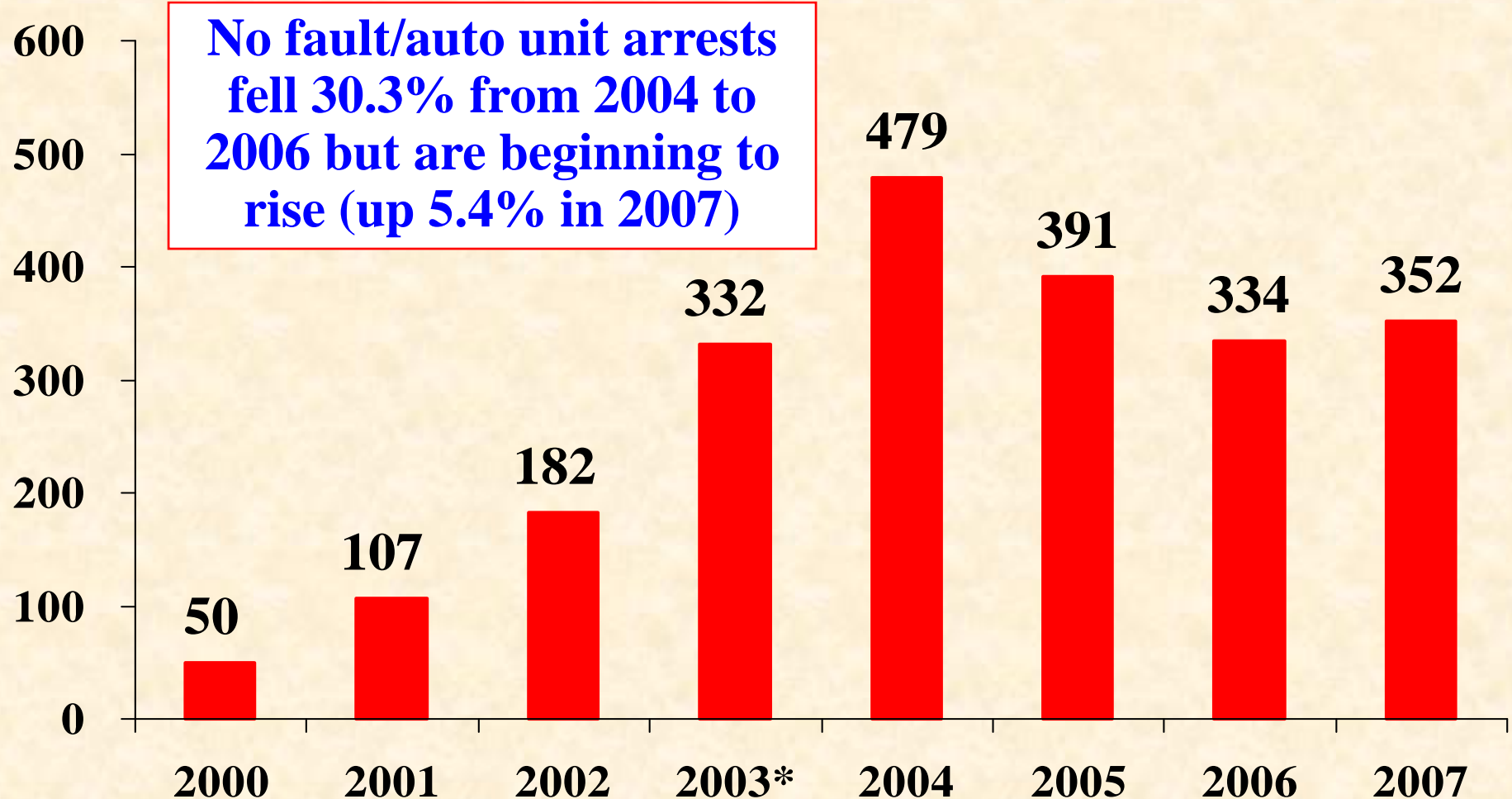


New York Insurance Fraud Reports, 1995 – 2008





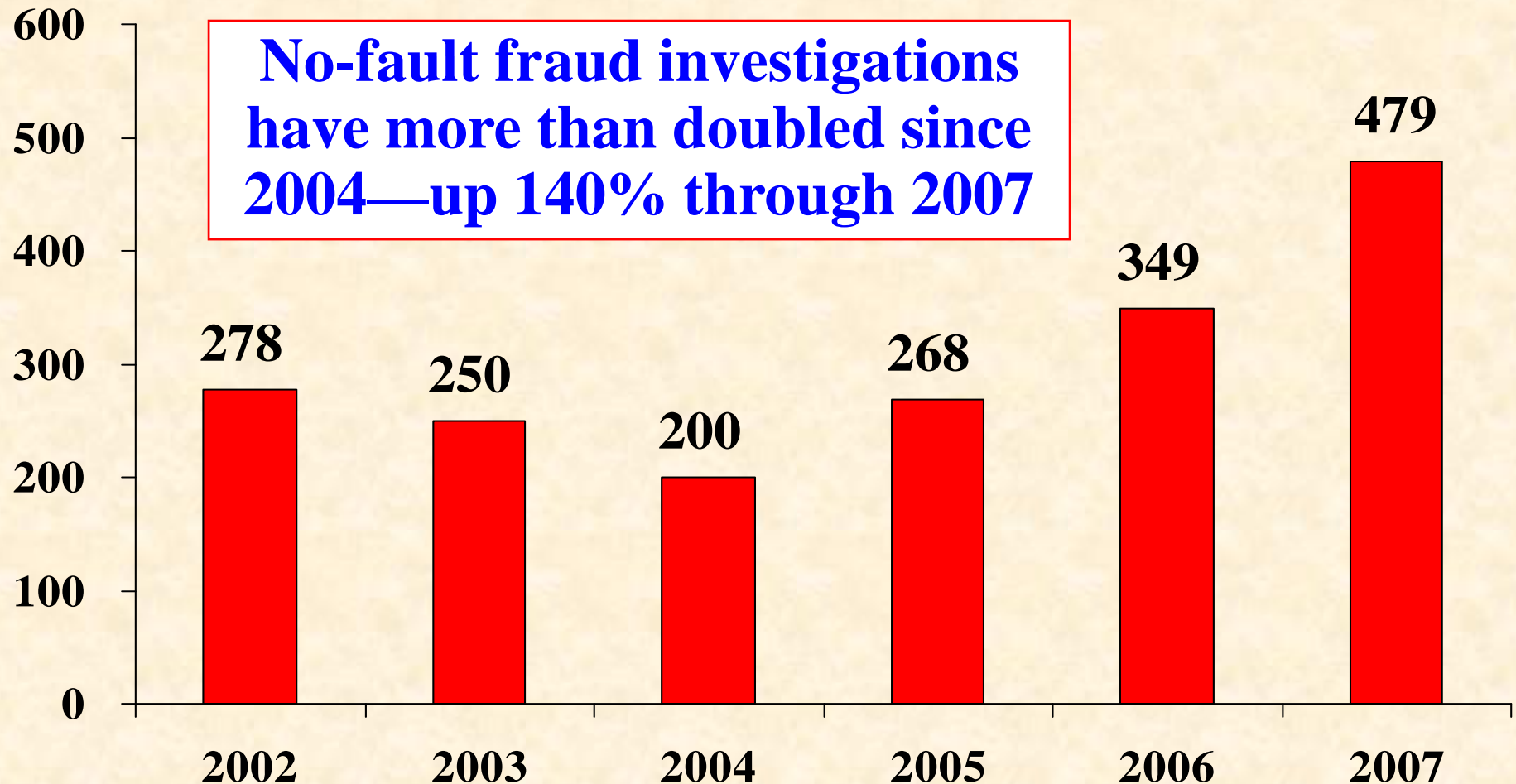
No-Fault/Auto Unit Arrests by NY Insurance Fraud Bureau



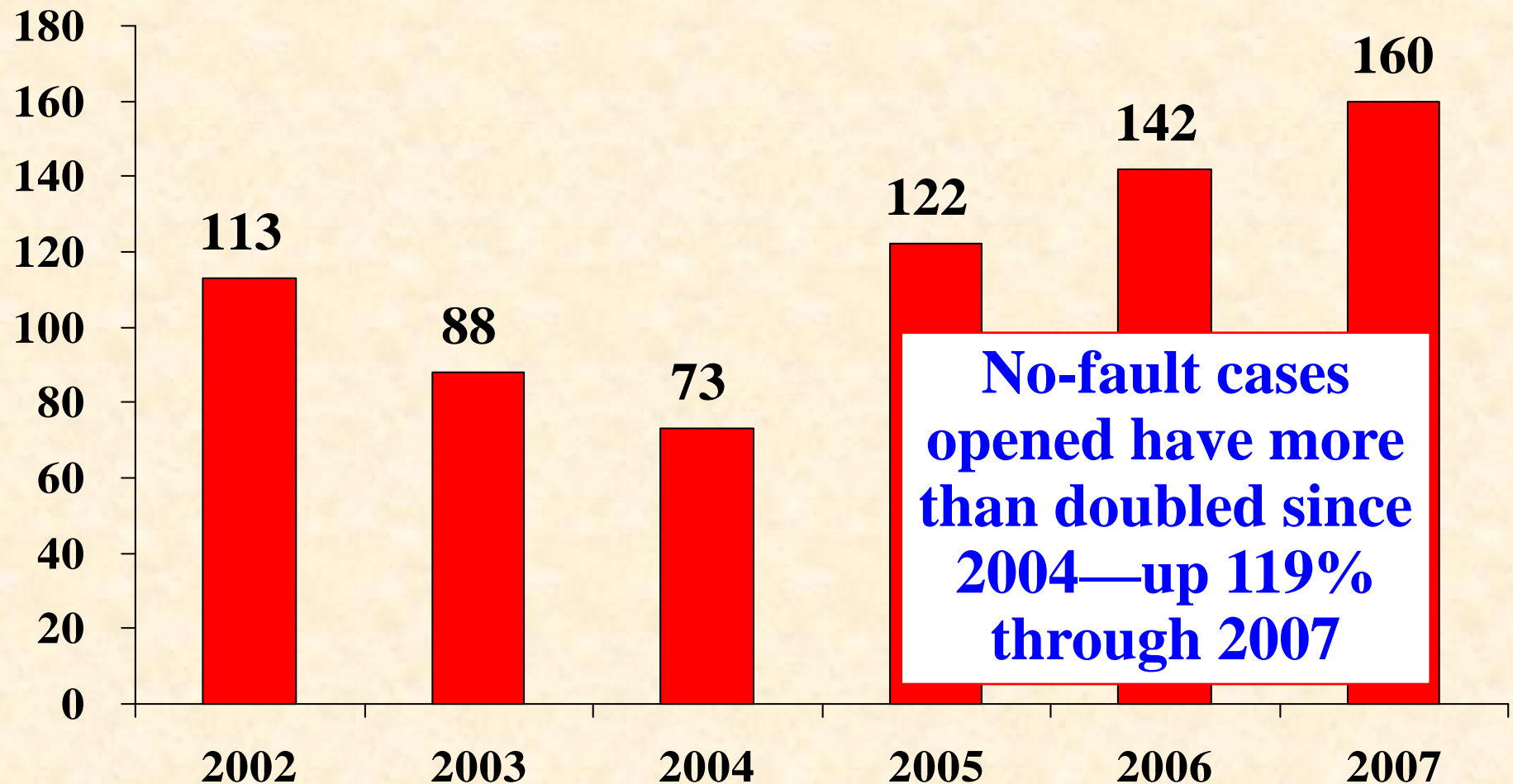
*In August 2003 the no-fault unit was merged with auto unit. Data beginning in 2003 include no-fault auto unit arrests.

Source: New York Department of Insurance, Insurance Frauds Bureau Annual Report; Insurance Info. Institute.

No-Fault Auto Unit Investigations by NY Insurance Fraud Bureau



No-Fault Auto Unit Cases Opened by NY Insurance Fraud Bureau





What Needs to be Done?

Solutions to Reduce Costs in NY's No-Fault System

- **Institute Medical Protocols/Utilization Reviews**
 - Guidelines for medical care for specific auto accident-related injuries to reduce cost of over-treatment and unnecessary treatment
 - Note: NY's no-fault system may be the last major payor for medical treatments that does not mandate protocols or utilization reviews. This virtual "blank check" drives up system costs dramatically.
- **Require Disputes Be Resolved via Arbitration**
 - Avoids costs and uncertainty of trial for all parties
 - Expedites resolution of claim
 - Unclogs overburdened court system
- **Increase Penalties for Runners**
 - Upgrading to felony from misdemeanor as deterrent



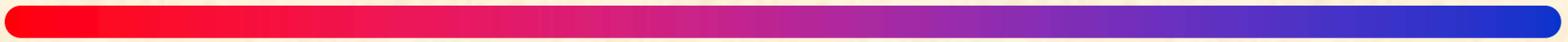
What Needs to be Done? (cont'd)

Solutions to Reduce Costs in NY's No-Fault System

- **Streamline Process for Adjudicating No-Fault Claims**
 - For small no-fault disputes (under \$5,000), permit parties to submit proof based on sworn affidavit from their doctor rather requiring that the doctor appear in person
 - Note: New York City courts are inundated with no-fault cases (approx. 1/3 of cases are no-fault and in 2009 courts were setting 2011 dates to hear cases)
- **Implement Fair Burden of Proof Requirements**
 - Presently, health service providers are required only to submit proof that a bill was received by the insurer to establish entitlement to receive amounts billed (irrespective of suspicions of fraud/abuse)
 - Insurers burden is much higher—required to produce both a witness to testify under oath that the claim was handled in accordance with regulations and a medical expert to testify on the “lack of medical necessity”
 - **Solution**: Require that in order to establish the right to no-fault benefits, the plaintiff be required to produce a witness with personal knowledge of the facts alleged in a complaint. Furthermore, there should be no presumption medical necessity based on documents submitted by non-medical plaintiffs and/or witnesses who do not have personal knowledge of such necessity

Regional Differences Will Significantly Impact P/C Markets

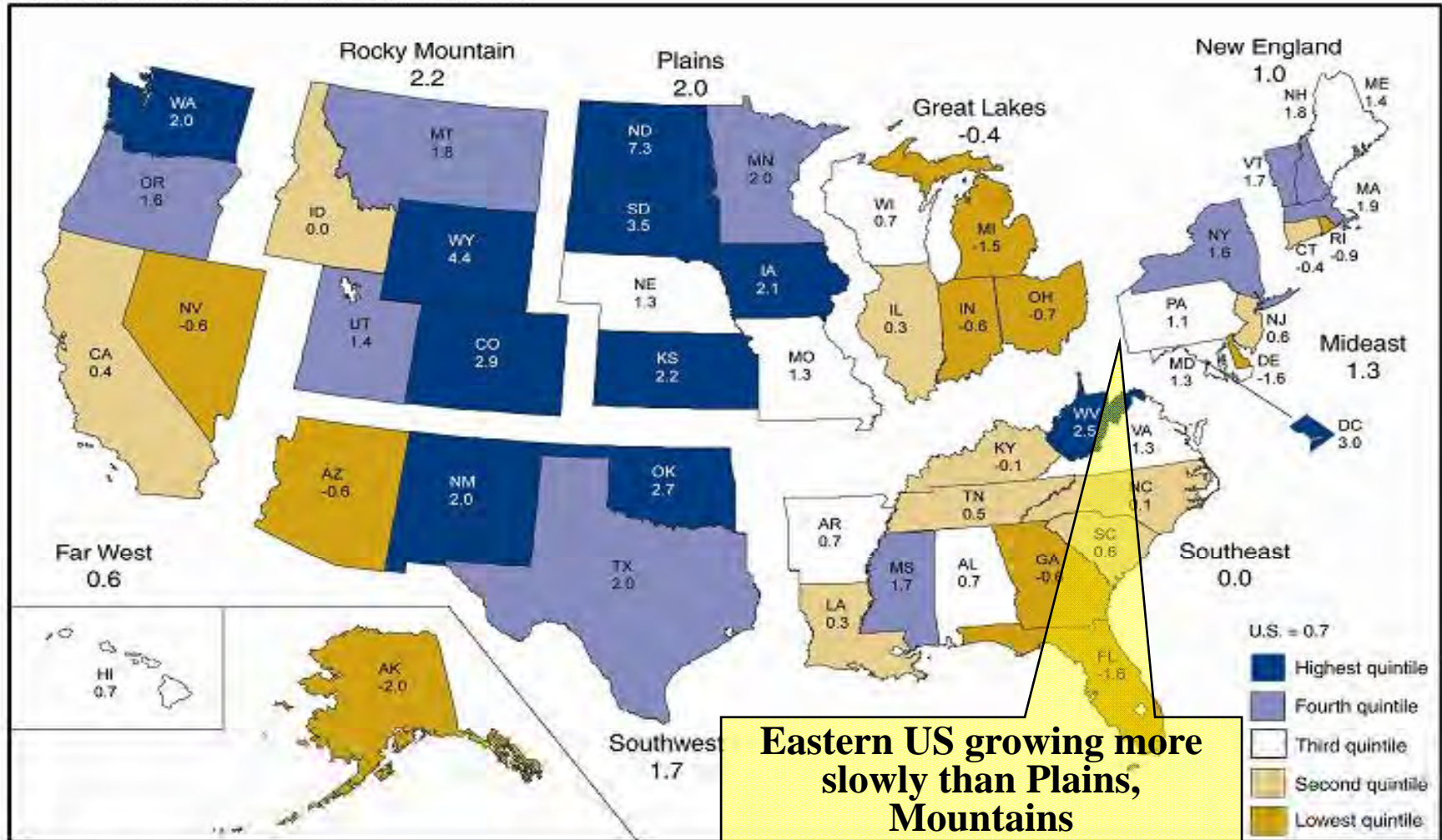
**Recovery in Some Areas Will Begin
Years Ahead of Others & Speed of
Recovery Will Differ By Orders of
Magnitude**





State Economic Growth Varied Tremendously in 2008

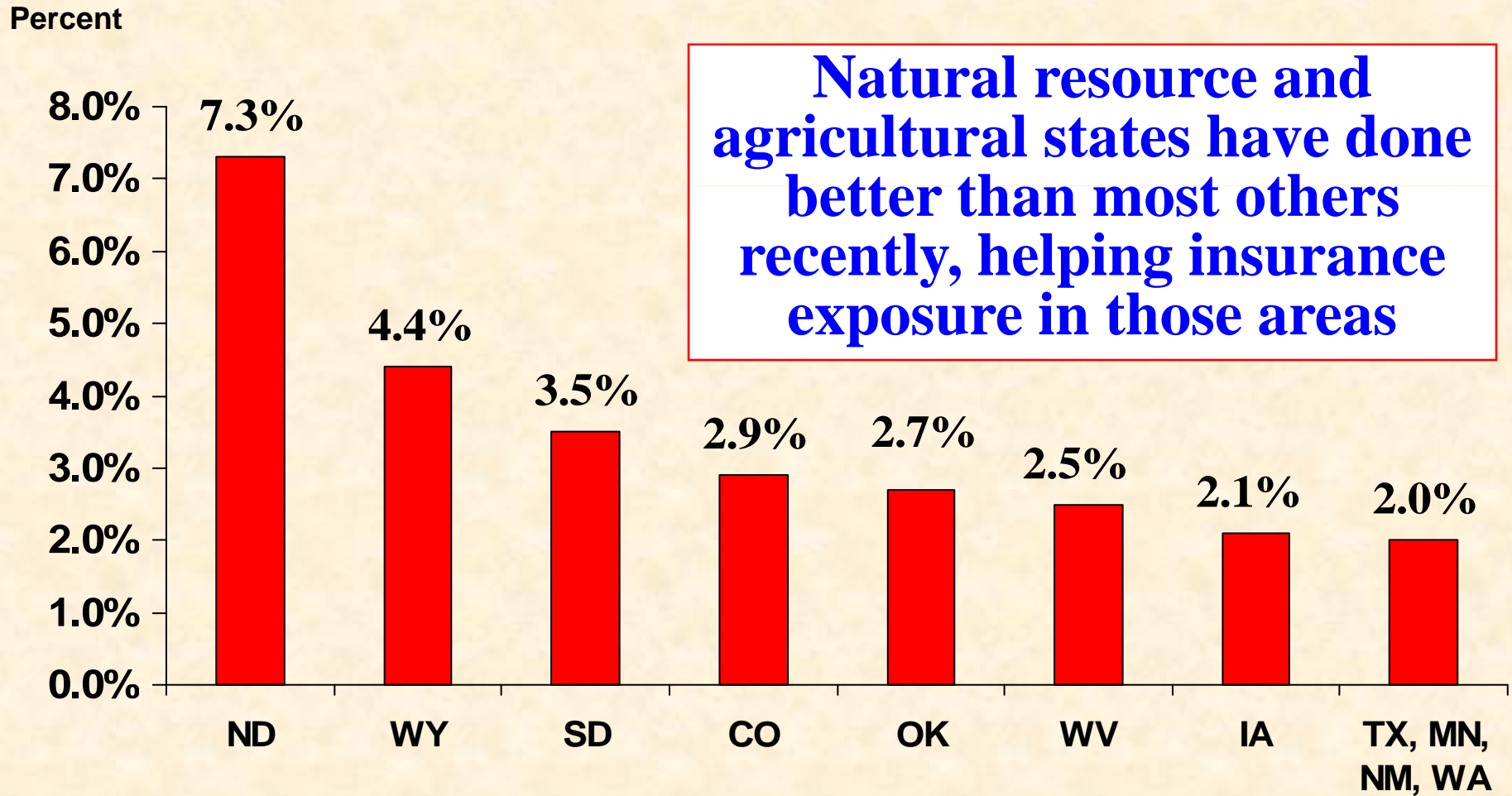
Percent Change in Real GDP by State, 2007-2008





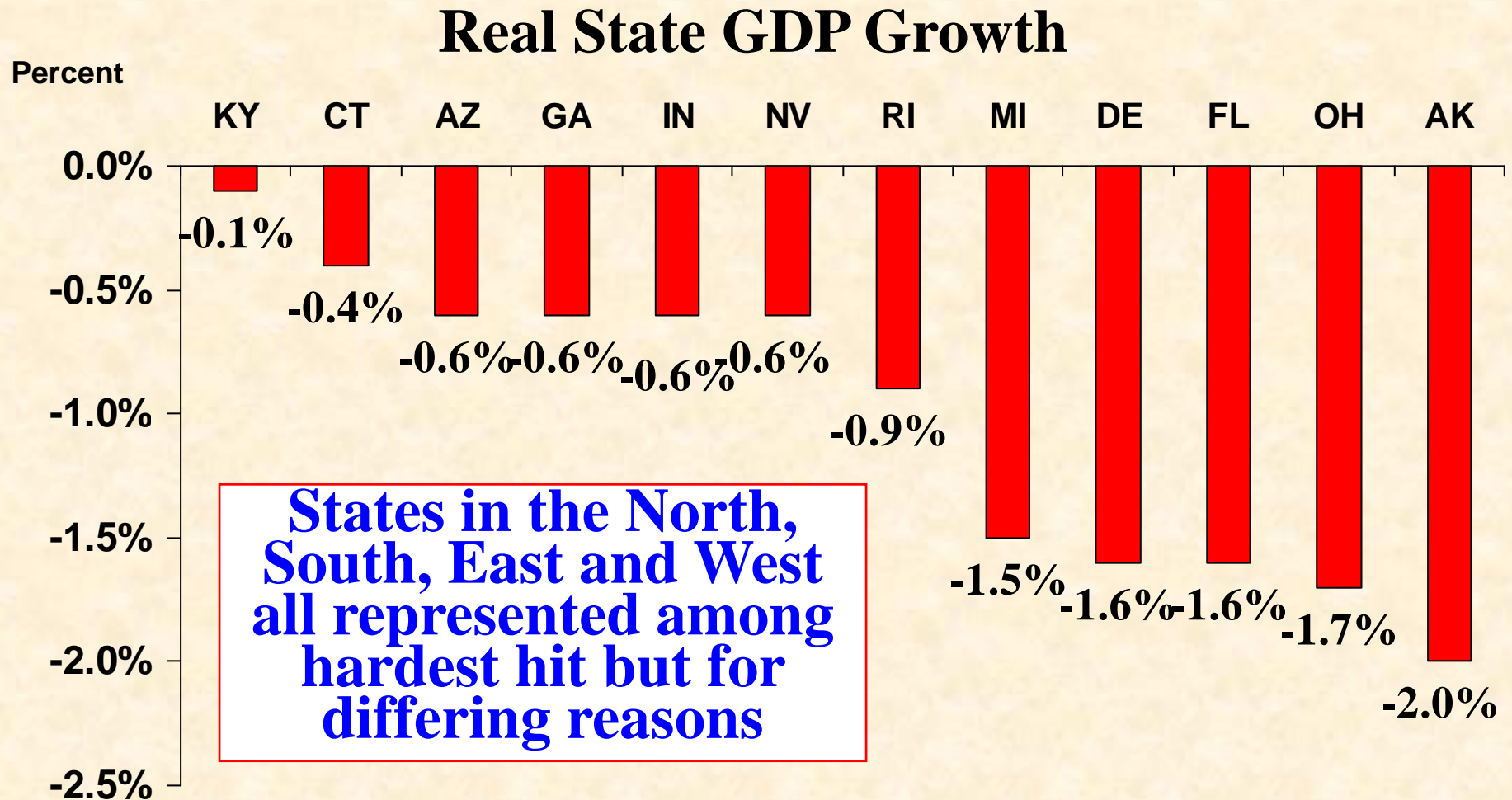
Fastest Growing States in 2008: Plains, Mountain States Lead

Real State GDP Growth



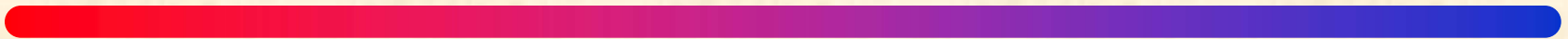


Slowest Growing States in 2008: Diversity of States Suffering



Labor Market Trends

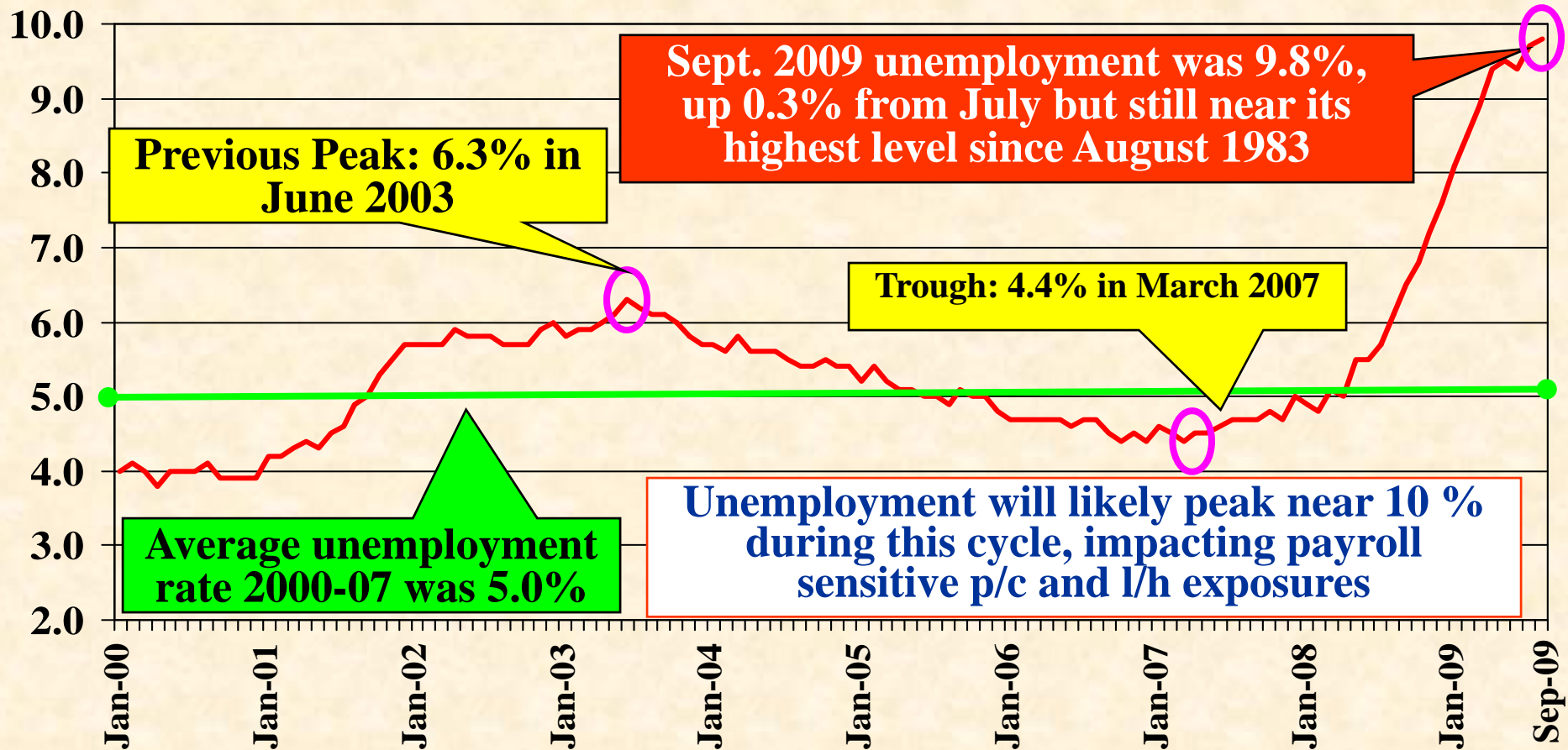
**Fast & Furious: Massive Job Losses
Sap the Economy and Personal &
Commercial Lines Exposure**





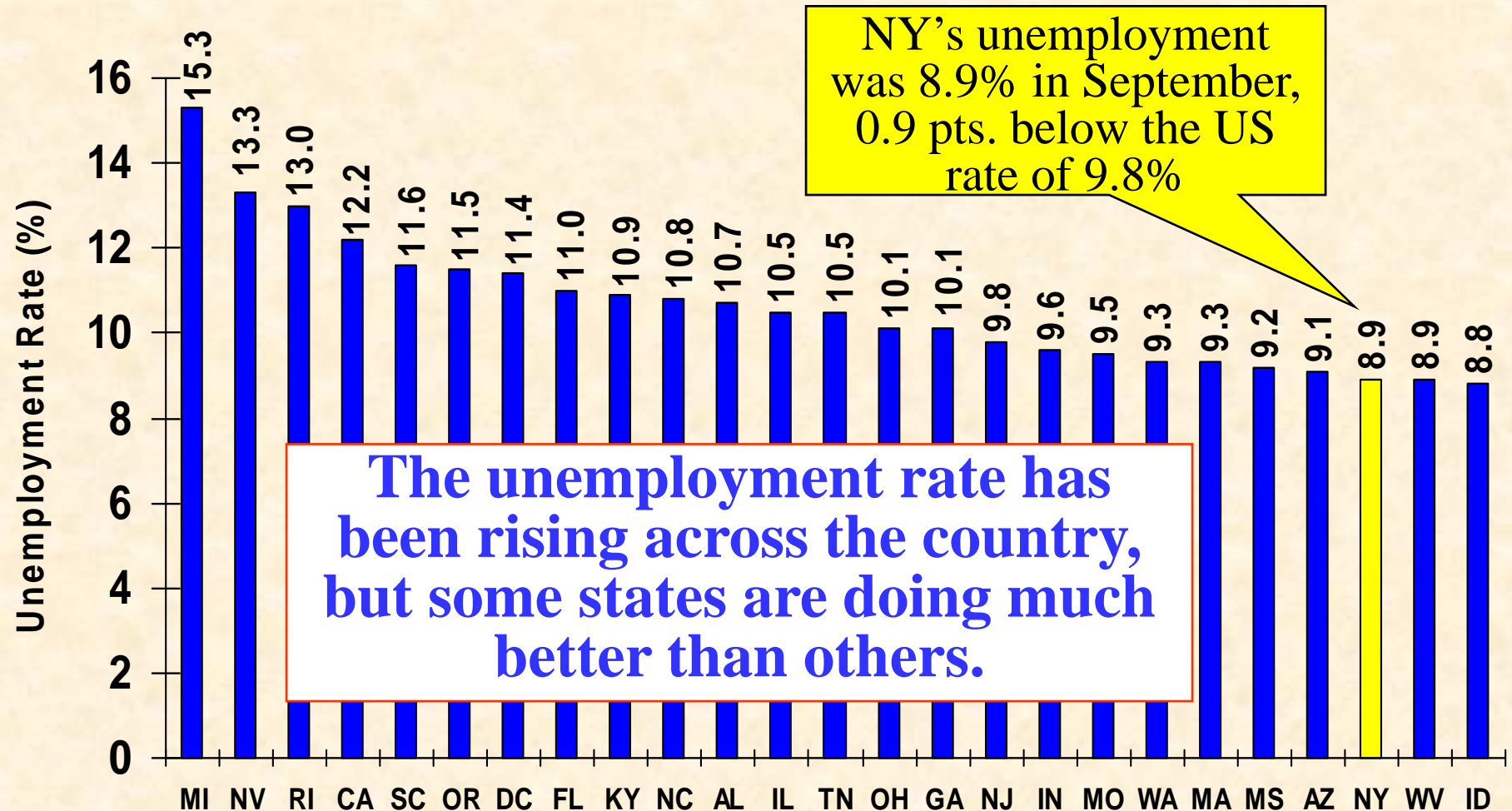
Unemployment Rate: On the Rise

January 2000 through September 2009*





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

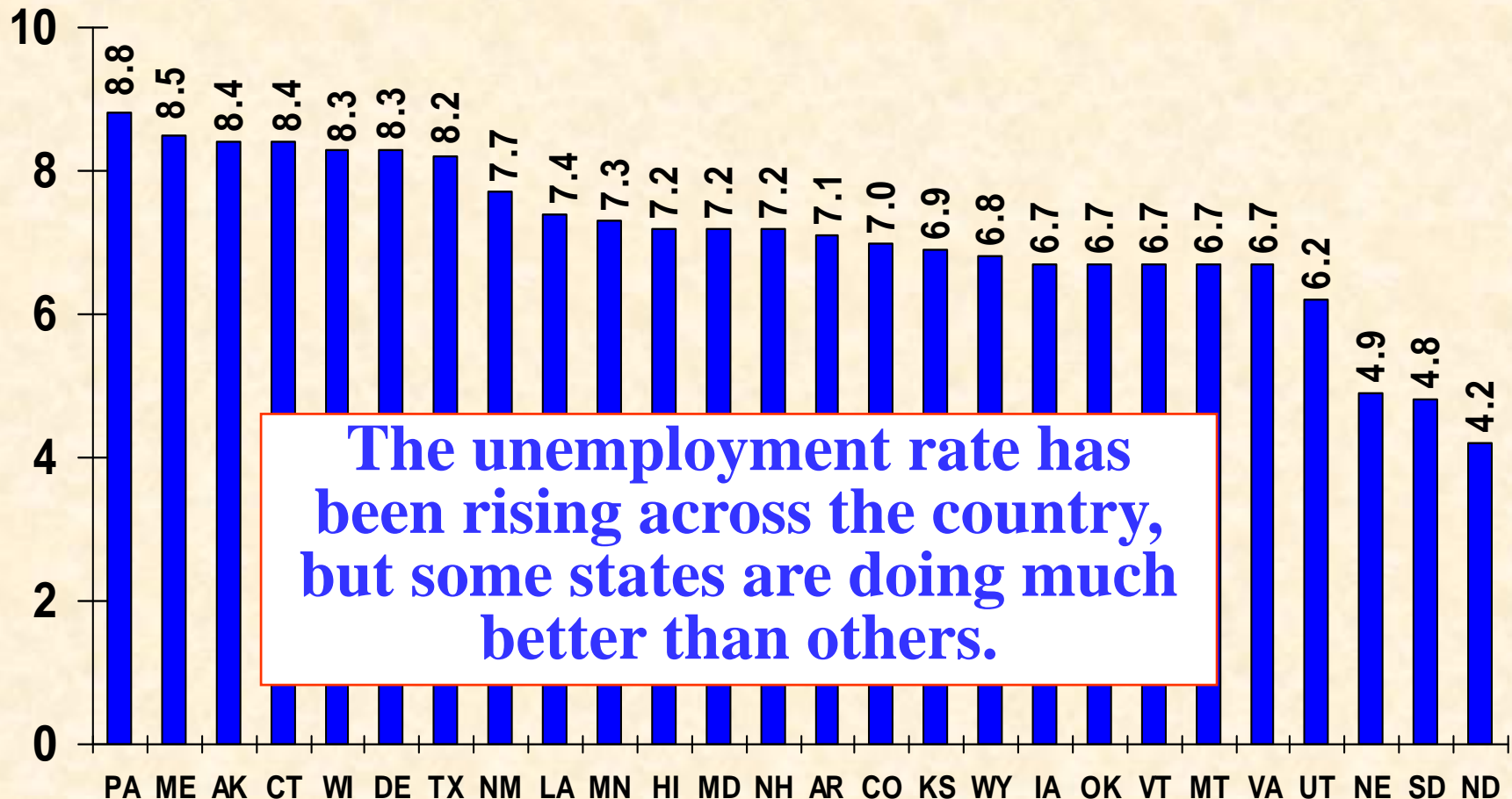


*Provisional figures for September 2009, seasonally adjusted.

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



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



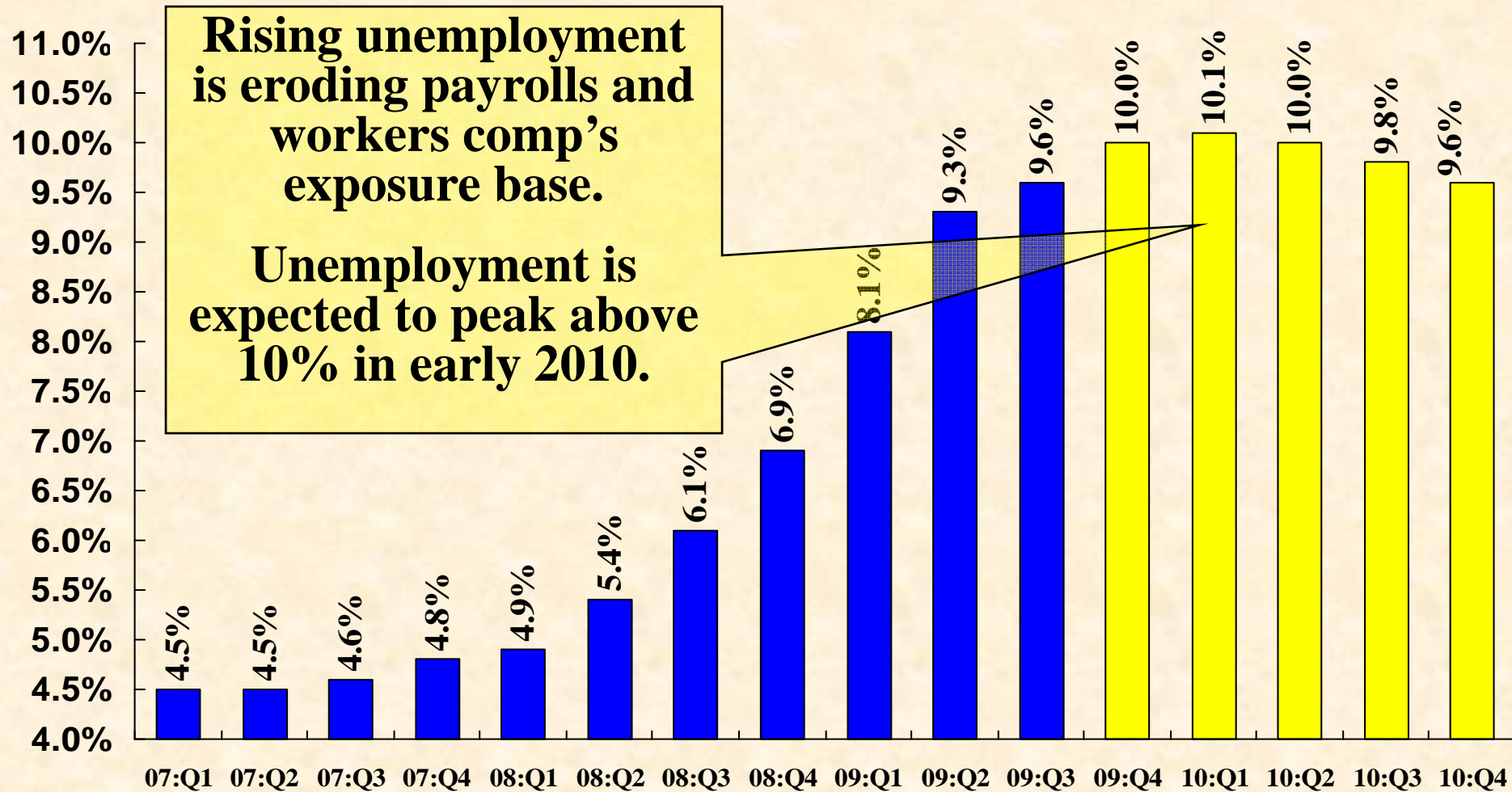
The unemployment rate has
been rising across the country,
but some states are doing much
better than others.

*Provisional figures for September 2009, seasonally adjusted.

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



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

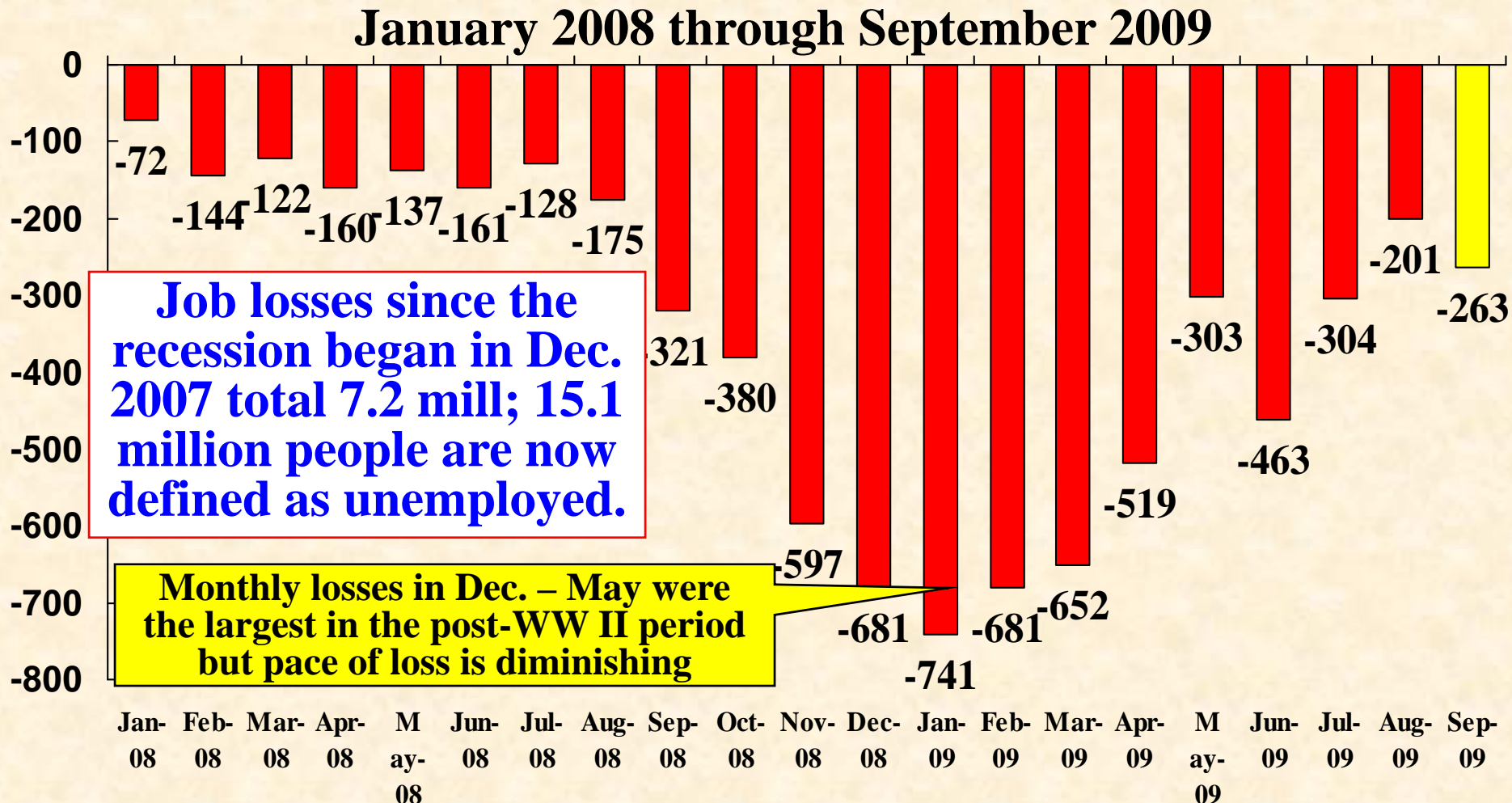


* Blue bars are actual; Yellow bars are forecasts

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

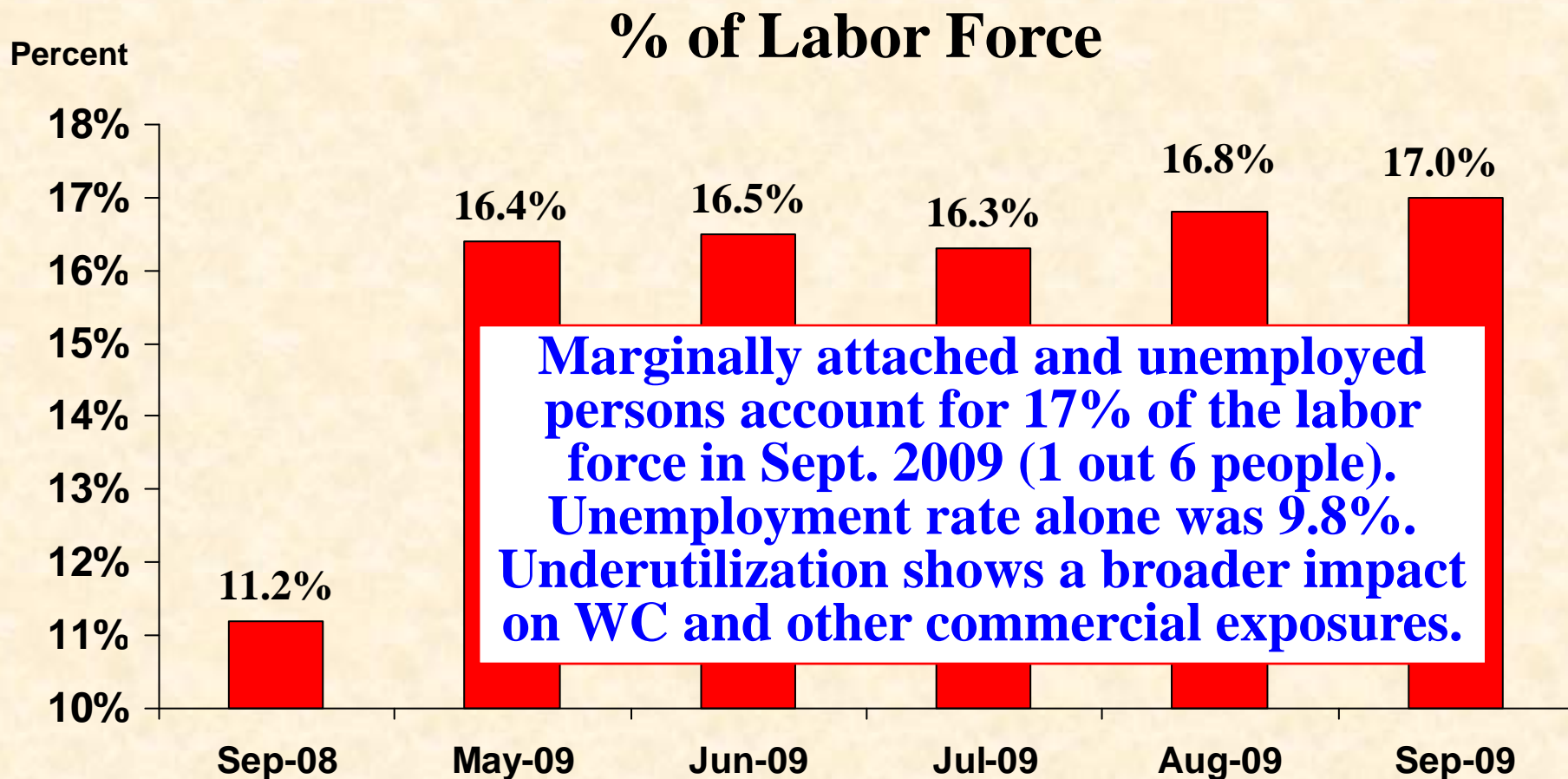


Monthly Change Employment* (Thousands)





Labor Underutilization: Broader than Just Unemployment

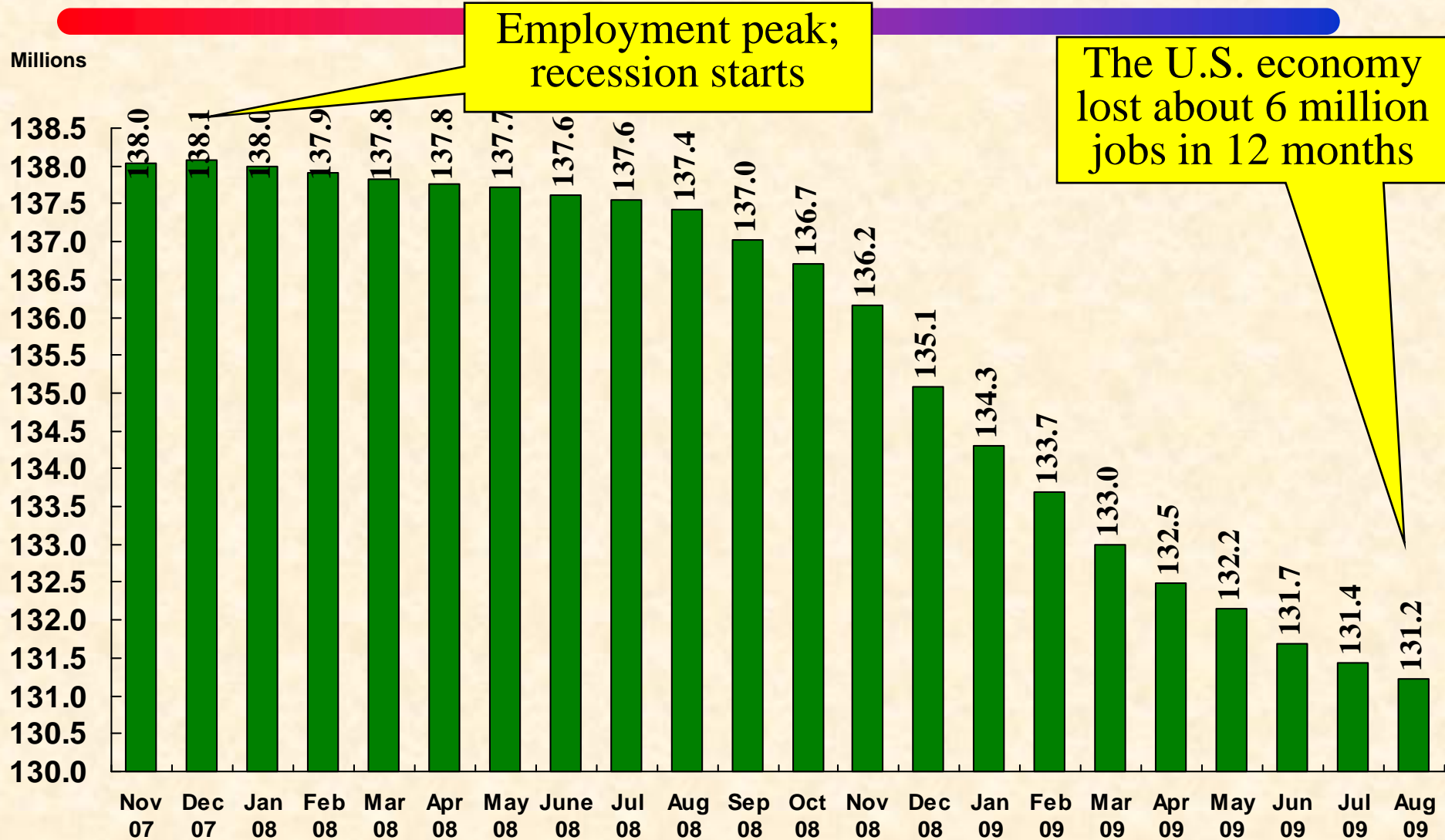


NOTE: Marginally attached workers are persons who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the recent past. Discouraged workers, a subset of the marginally attached, have given a job-market related reason for not looking currently for a job. Persons employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule.

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



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



Seasonally adjusted. Source: US Bureau of Labor Statistics



Unemployment and Underemployment Rates: Rocketing Up in 2008-09

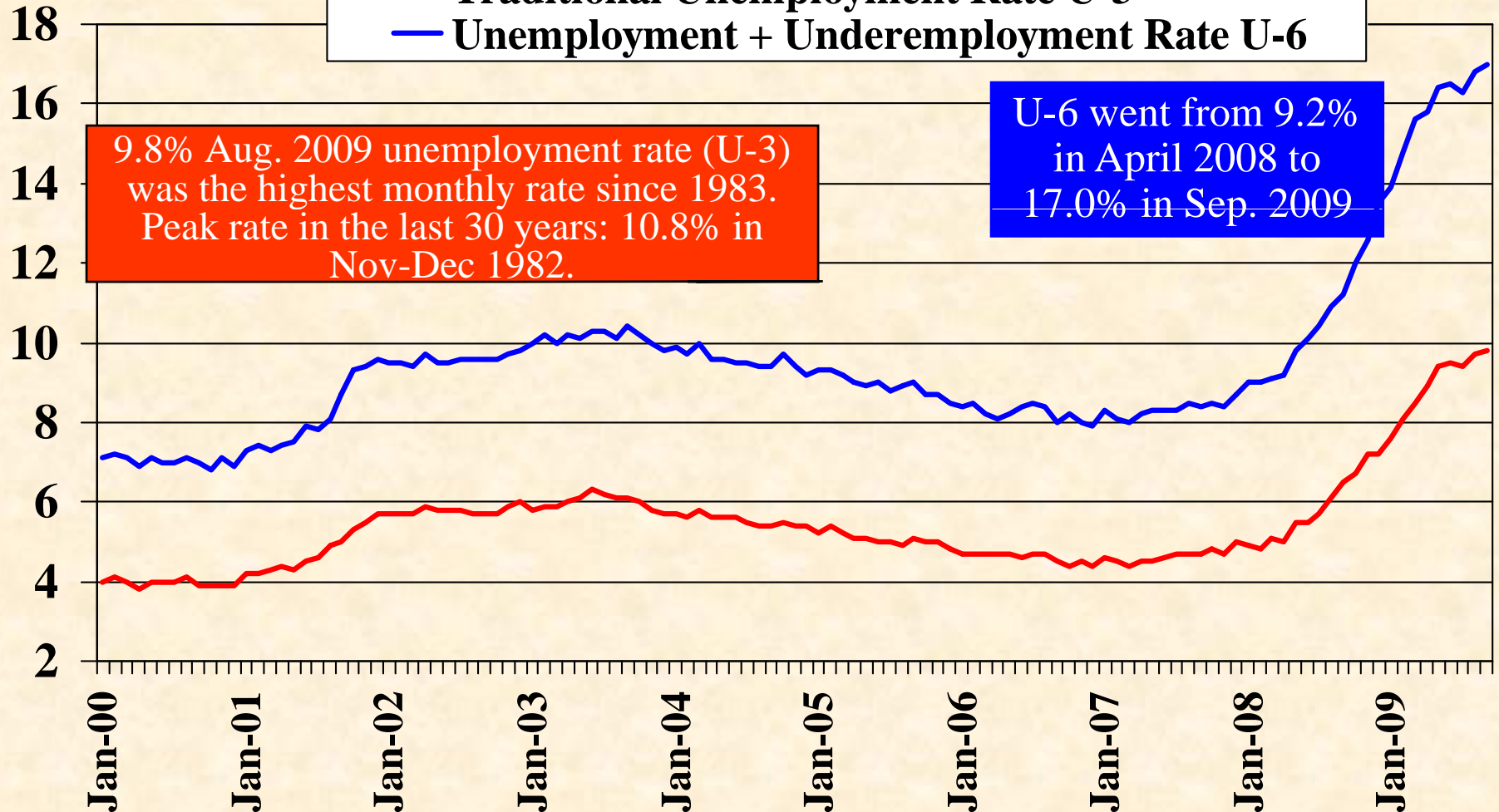
January 2000 through September 2009, seasonally adjusted

Percent

— Traditional Unemployment Rate U-3
— Unemployment + Underemployment Rate U-6

9.8% Aug. 2009 unemployment rate (U-3) was the highest monthly rate since 1983. Peak rate in the last 30 years: 10.8% in Nov-Dec 1982.

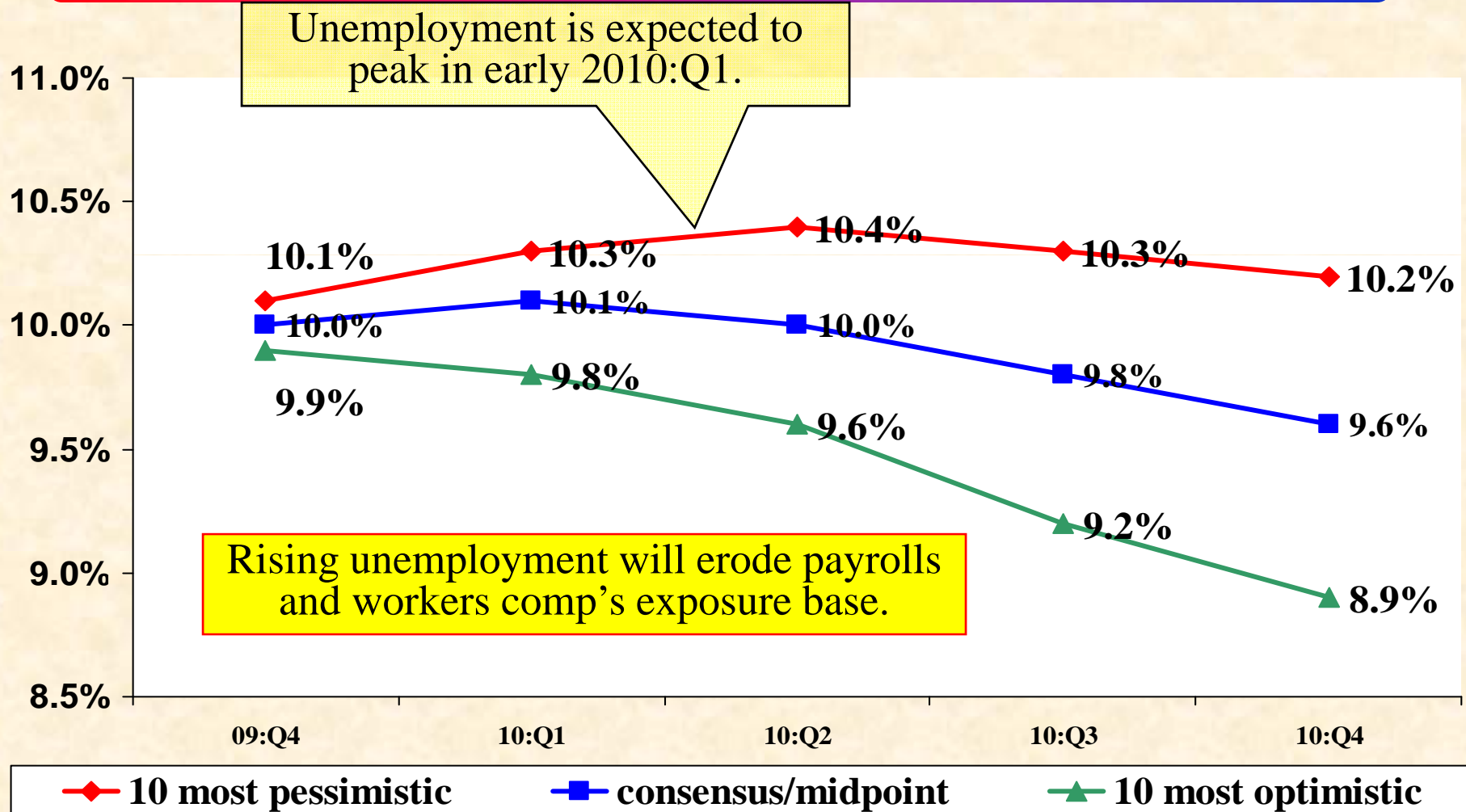
U-6 went from 9.2% in April 2008 to 17.0% in Sep. 2009





U.S. Unemployment Rate Forecasts

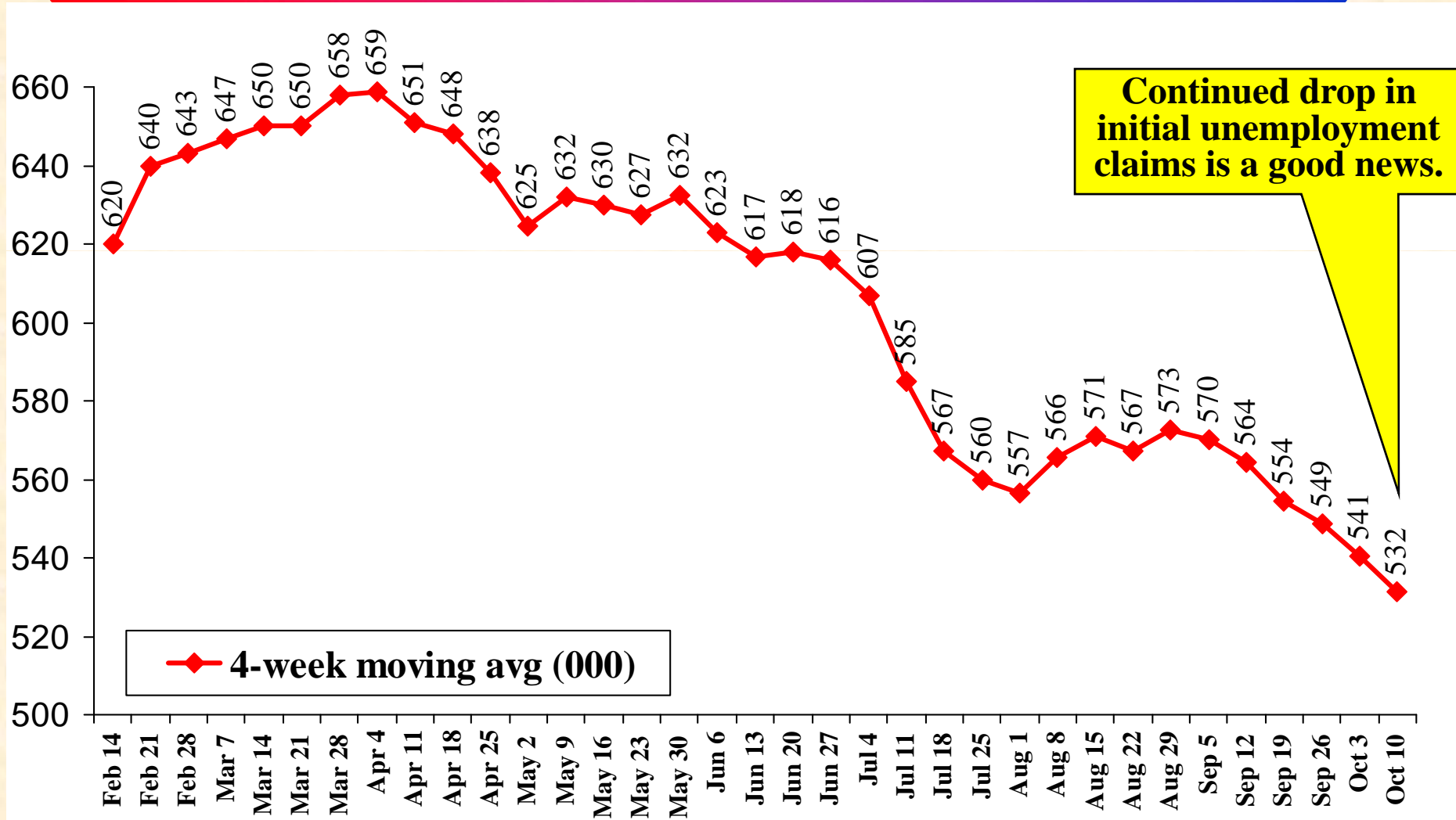
Quarterly, 2009:Q4 to 2010:Q4





Will the Recession End Soon?

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



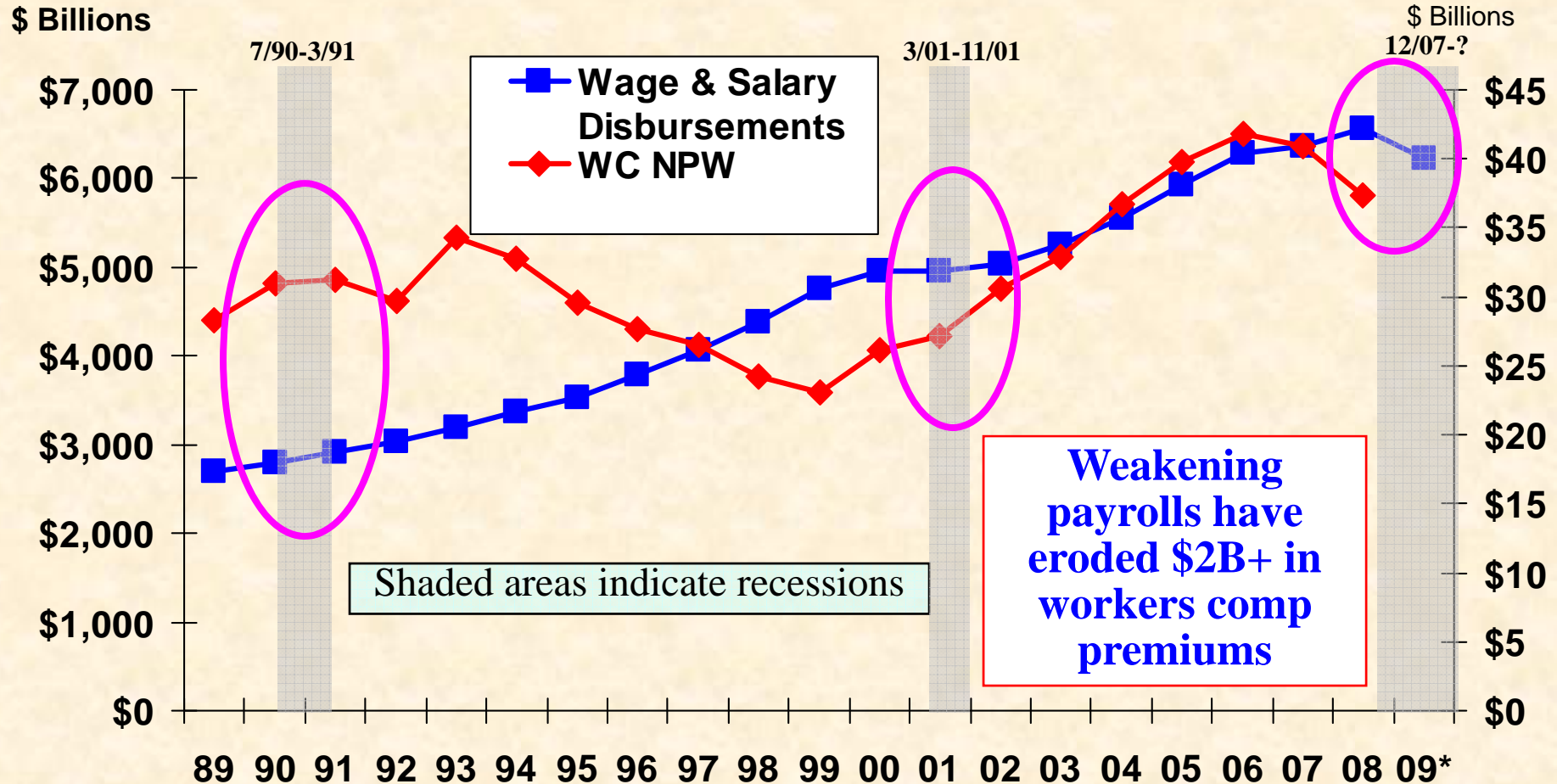
*seasonally adjusted; state programs only

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



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

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



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

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

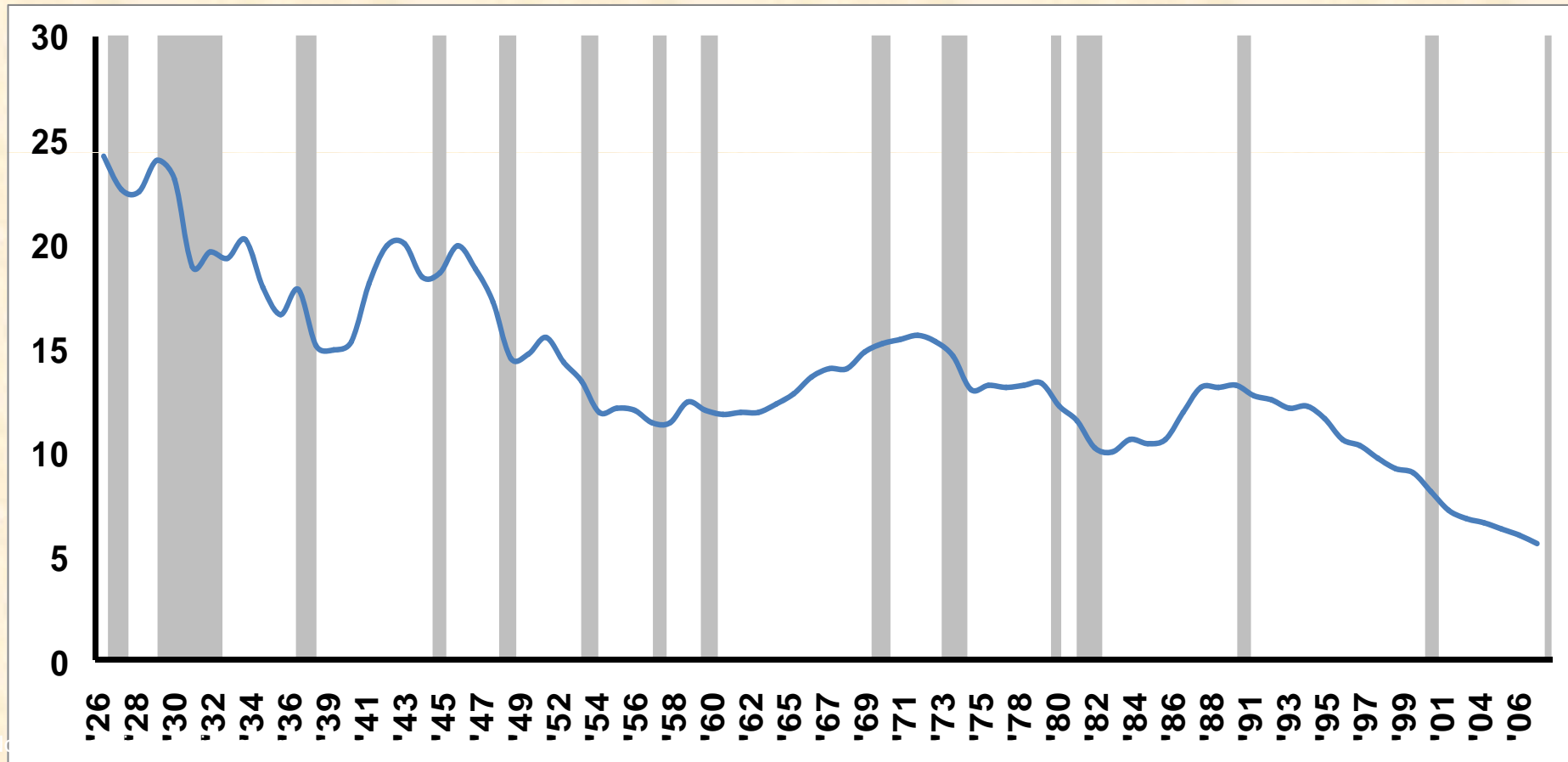
<http://research.stlouisfed.org/fred2/series/WASCUR>; I.I.I. Fact Books



Frequency: 1926-2008

A Long-Term Drift Downward

**Manufacturing—Total Recordable Cases
Rate of Injury and Illness Cases per 100 Full-Time Workers**

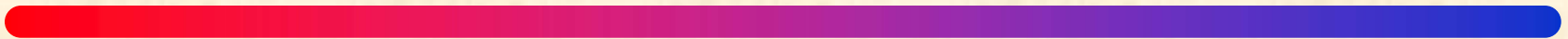


Note: Recessions indicated by gray bar.

Sources: NCCI from U.S. Bureau of Labor Statistics; National Bureau of Economic Research

Crisis-Driven Exposure Drivers

*Economic Obstacles
to Growth in P/C
Insurance*



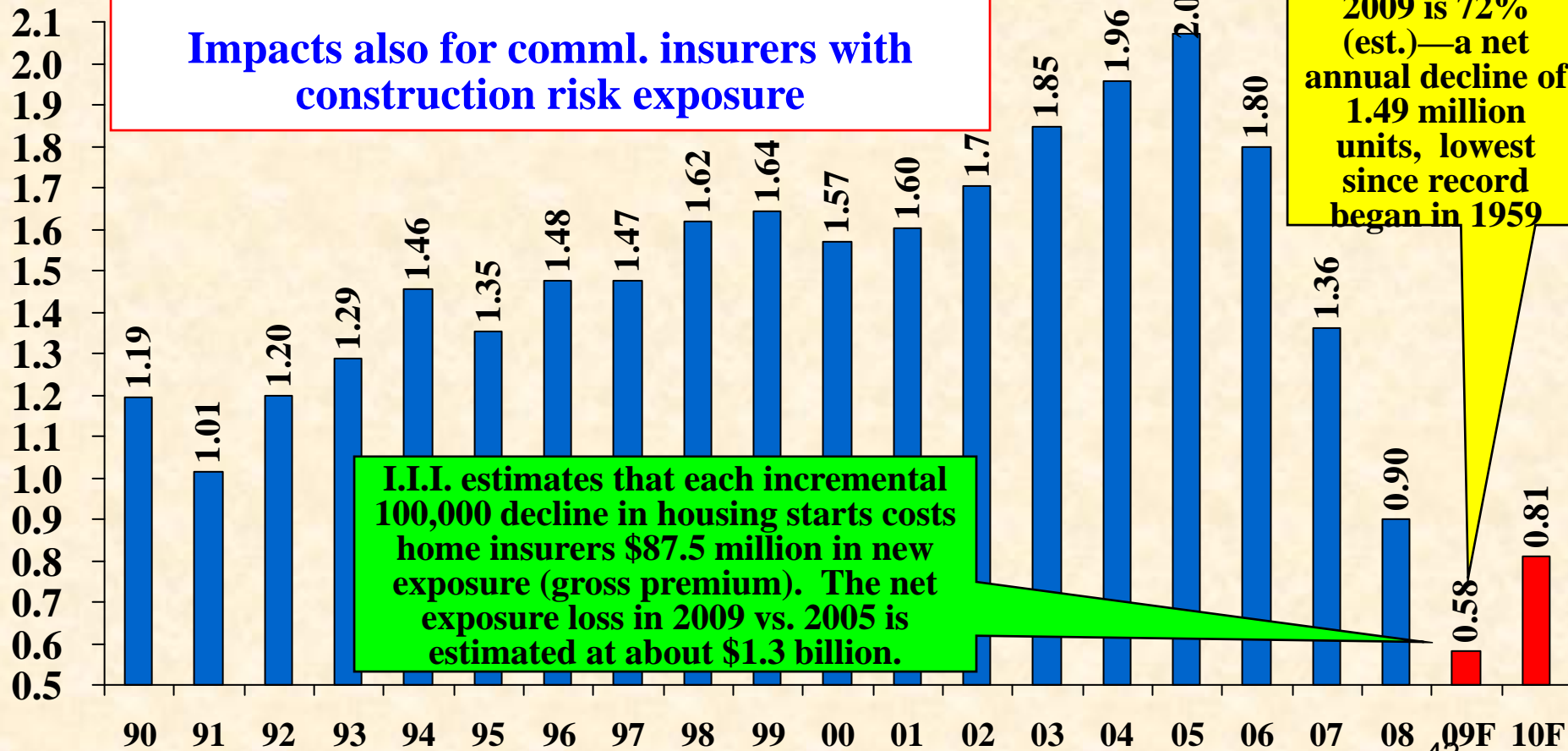


New Private Housing Starts, 1990-2010F (Millions of Units)

**Exposure growth due to home construction
forecast for HO insurers is dim for 2009
with some improvement in 2010.**

**Impacts also for comml. insurers with
construction risk exposure**

**New home starts
plunged 34%
from 2005-2007;
Drop through
2009 is 72%
(est.)—a net
annual decline of
1.49 million
units, lowest
since record
began in 1959**



**I.I.I. estimates that each incremental
100,000 decline in housing starts costs
home insurers \$87.5 million in new
exposure (gross premium). The net
exposure loss in 2009 vs. 2005 is
estimated at about \$1.3 billion.**



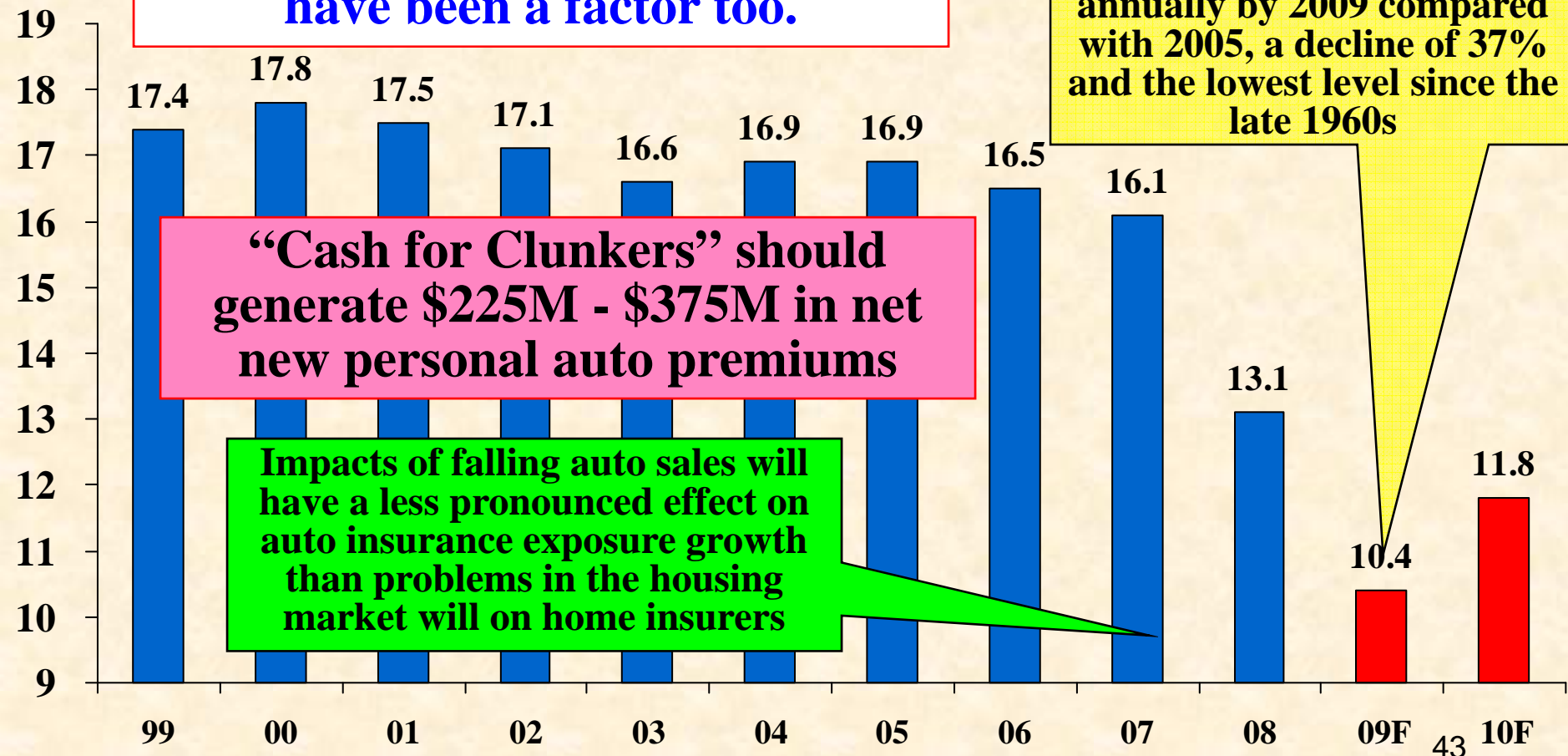
Auto/Light Truck Sales, 1999-2010F (Millions of Units)

Weak economy, credit crunch are hurting auto sales; Gas prices have been a factor too.

New auto/light truck sales are expected to experience a net drop of 6.5 million units annually by 2009 compared with 2005, a decline of 37% and the lowest level since the late 1960s

“Cash for Clunkers” should generate \$225M - \$375M in net new personal auto premiums

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



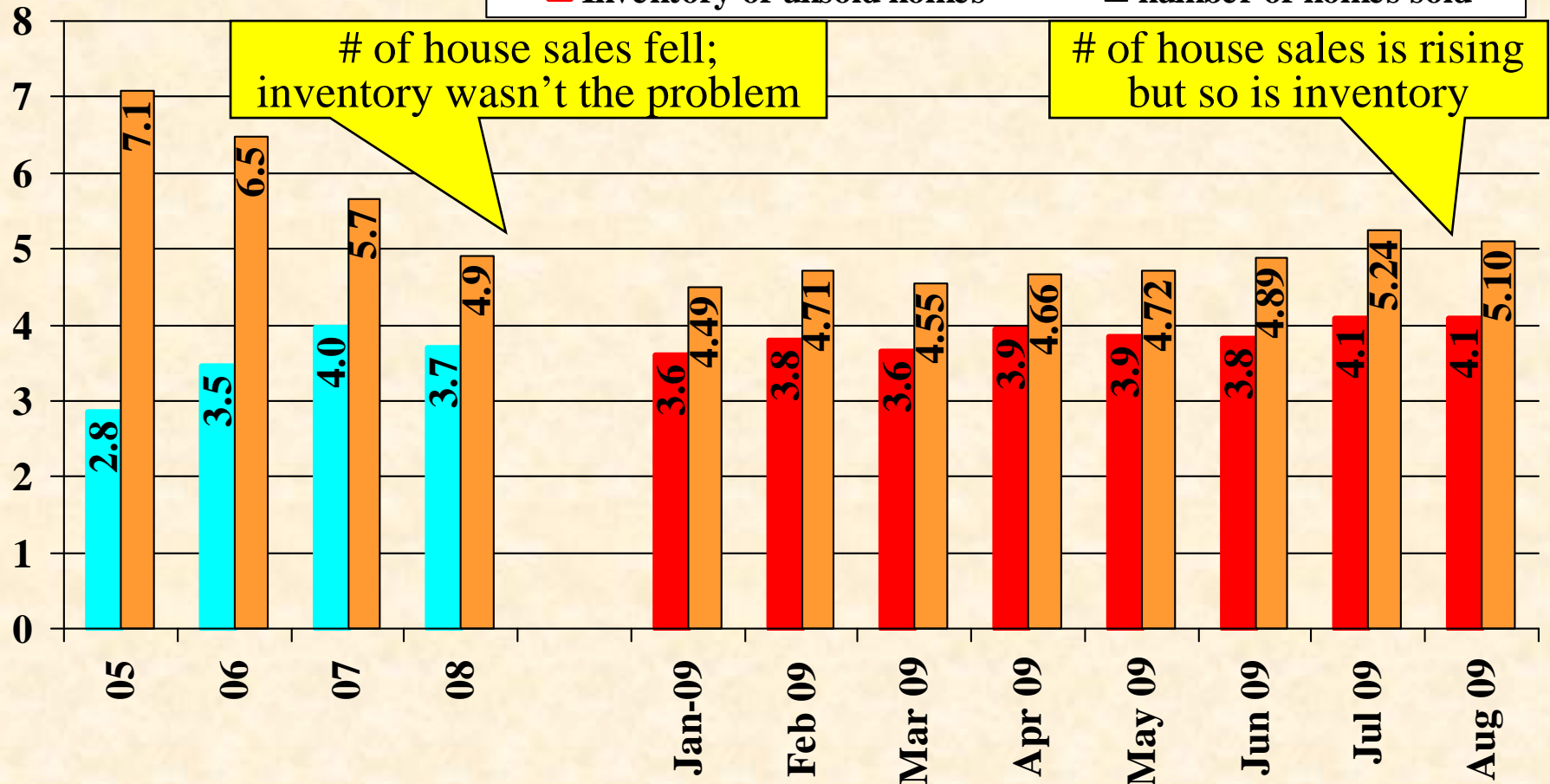


High Ratio of Unsold-Homes Inventory to Sales Will Likely Keep Prices Falling

Millions of Homes,
Annual Rate

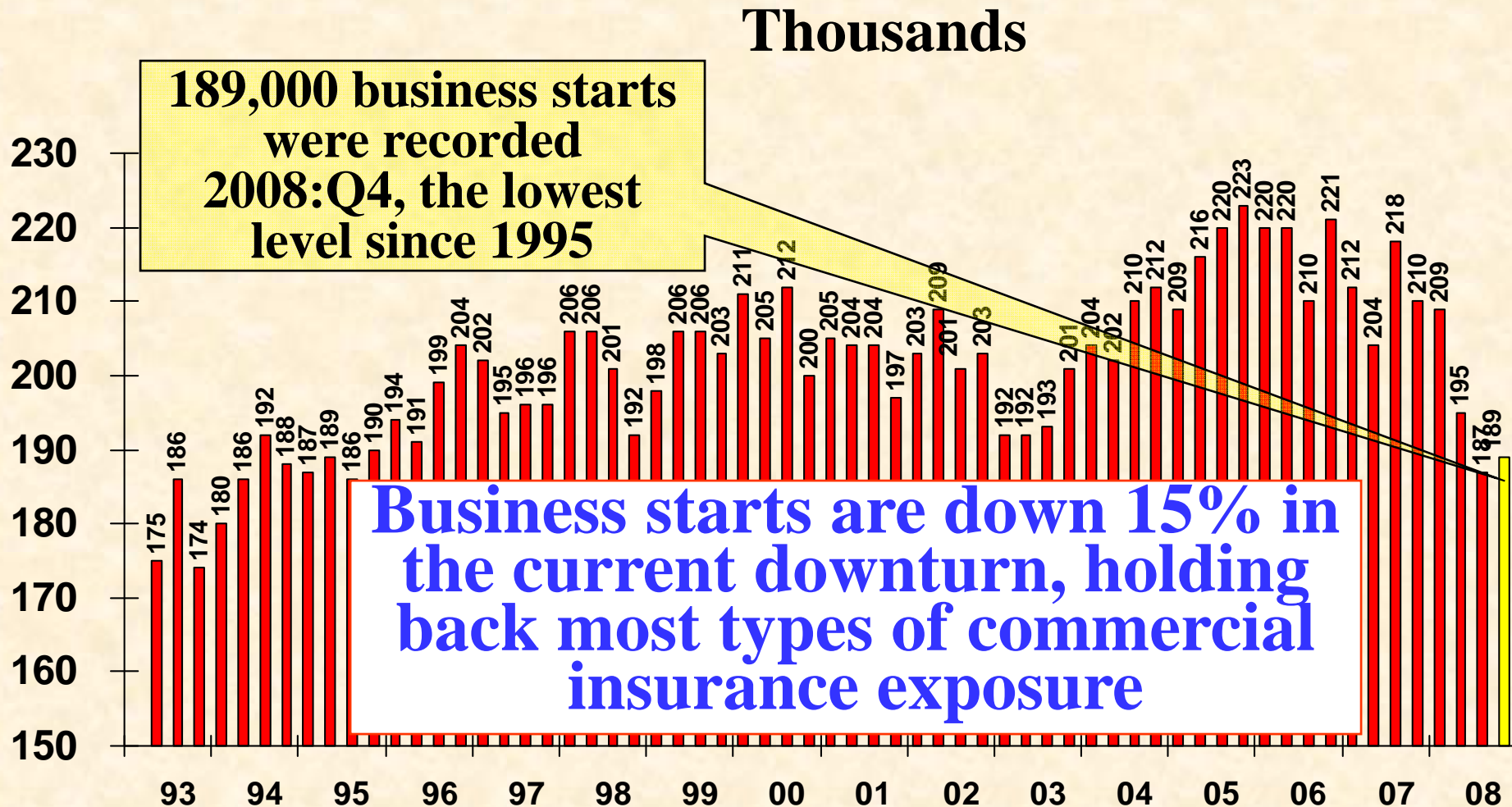
Inventory of unsold homes

number of homes sold





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

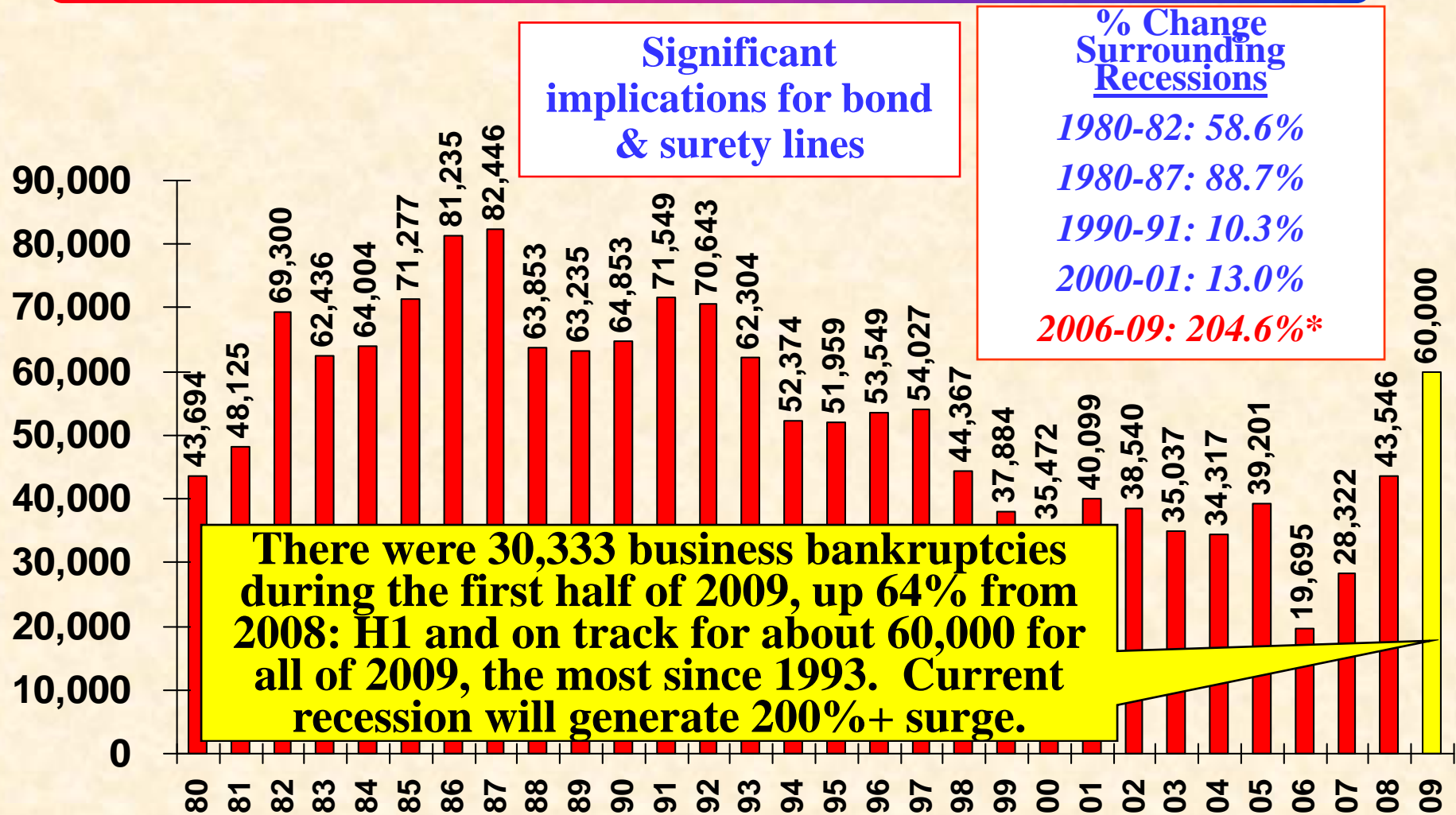


*Latest available as of Oct. 2009.

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



Business Bankruptcy Filings, 1980-2009*

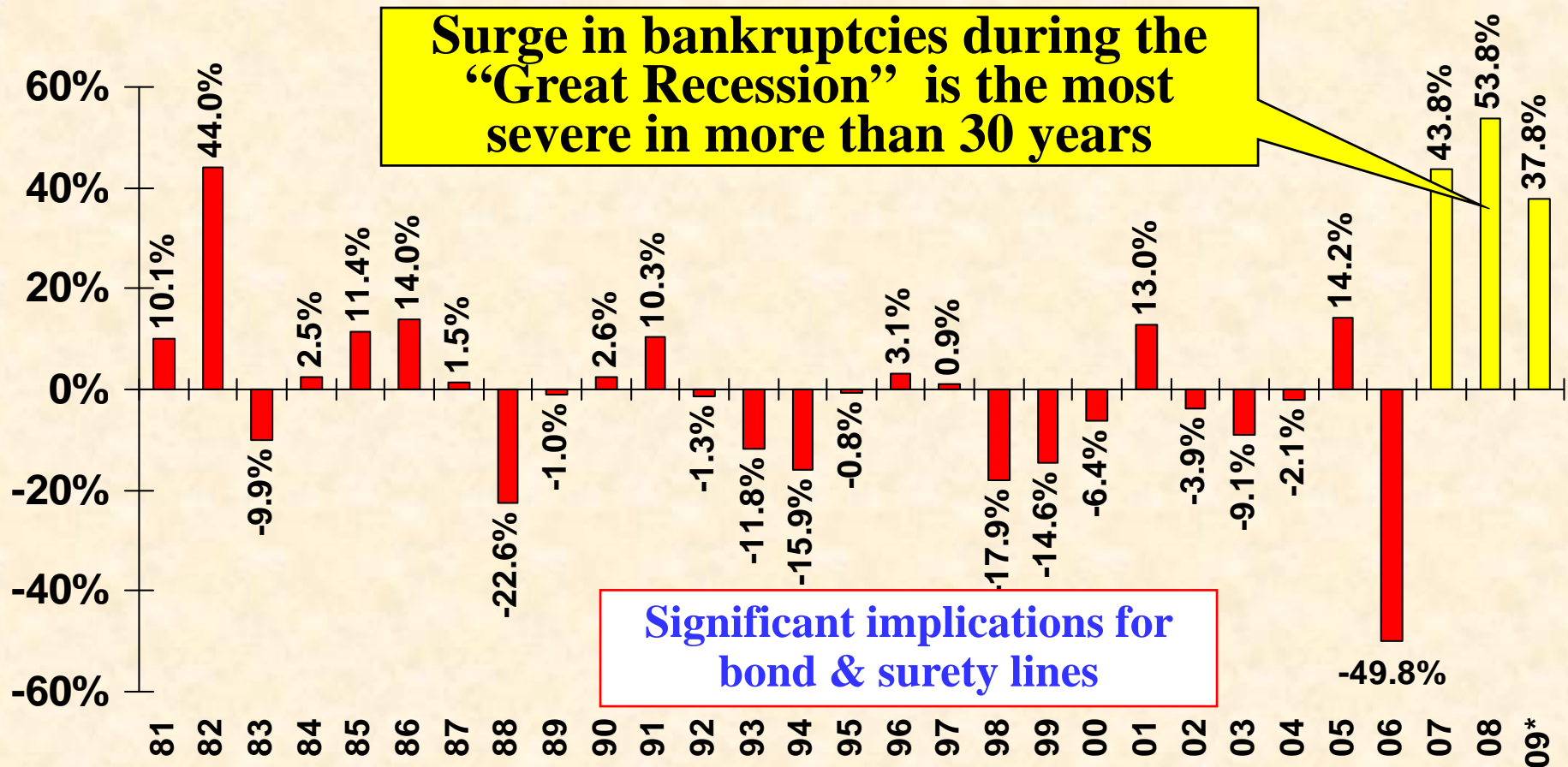


*Based estimate of 60,000 business bankruptcies in 2009; actual first half total was 30,333.

Source: American Bankruptcy Institute; Insurance Information Institute



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



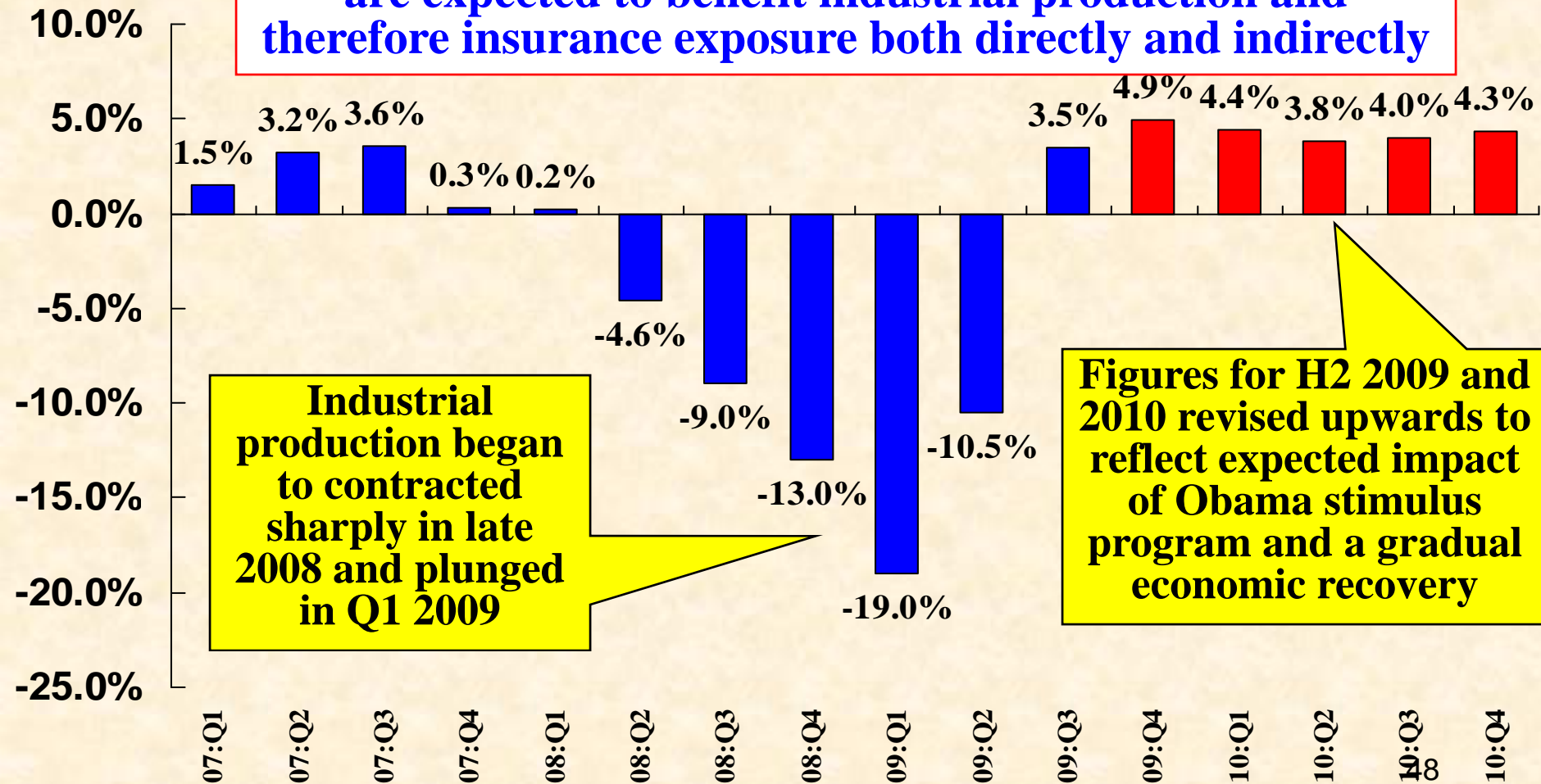
*Based estimate of 60,000 business bankruptcies in 2009. All figures are percent change from previous year.

Source: Insurance Information Institute from American Bankruptcy Institute data.



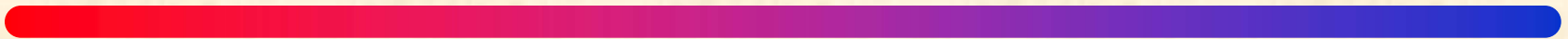
Total Industrial Production, (2007:Q1 to 2010:Q4F)

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



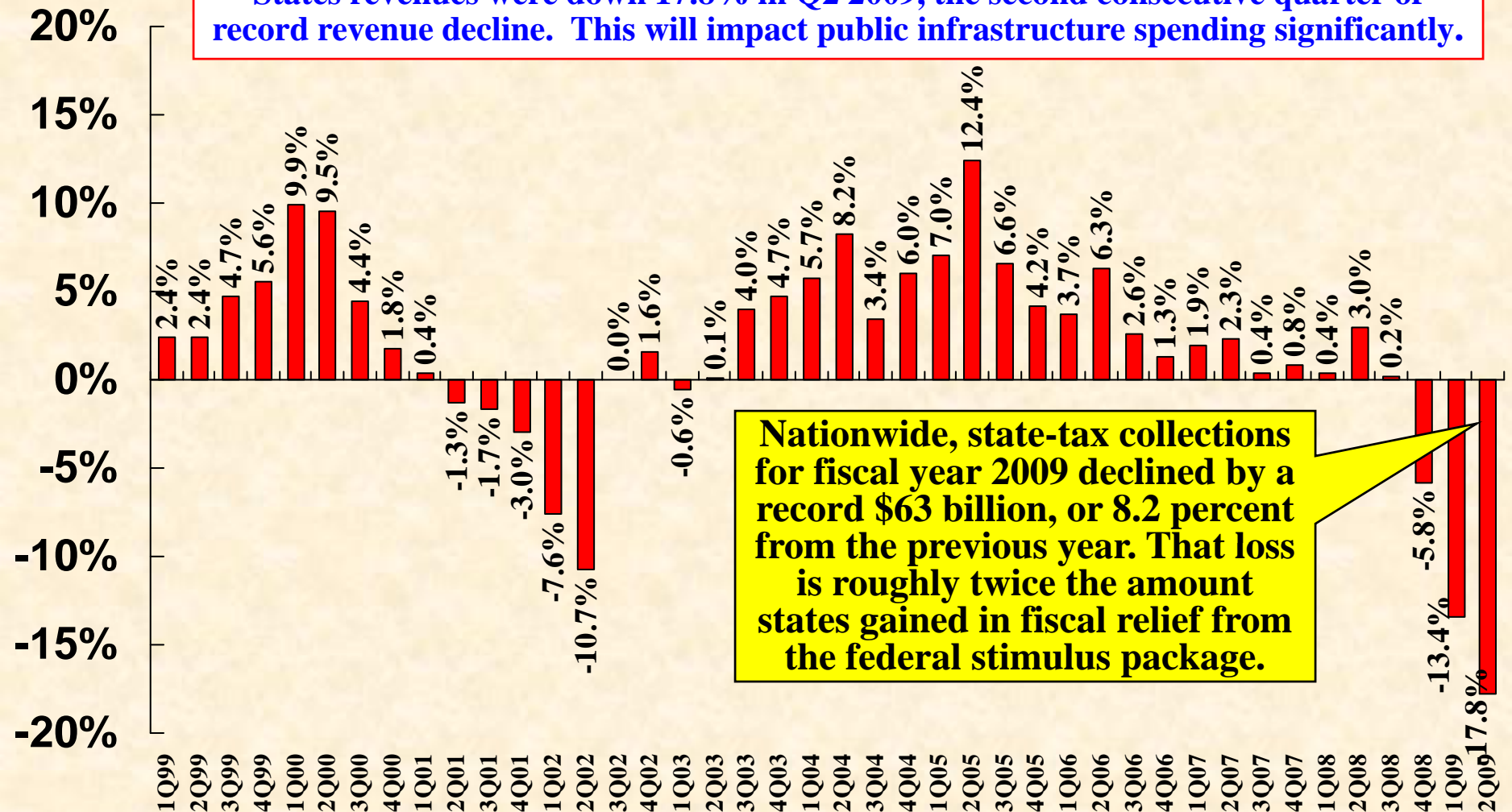
State & Local Government Finances in Dire Straights

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



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

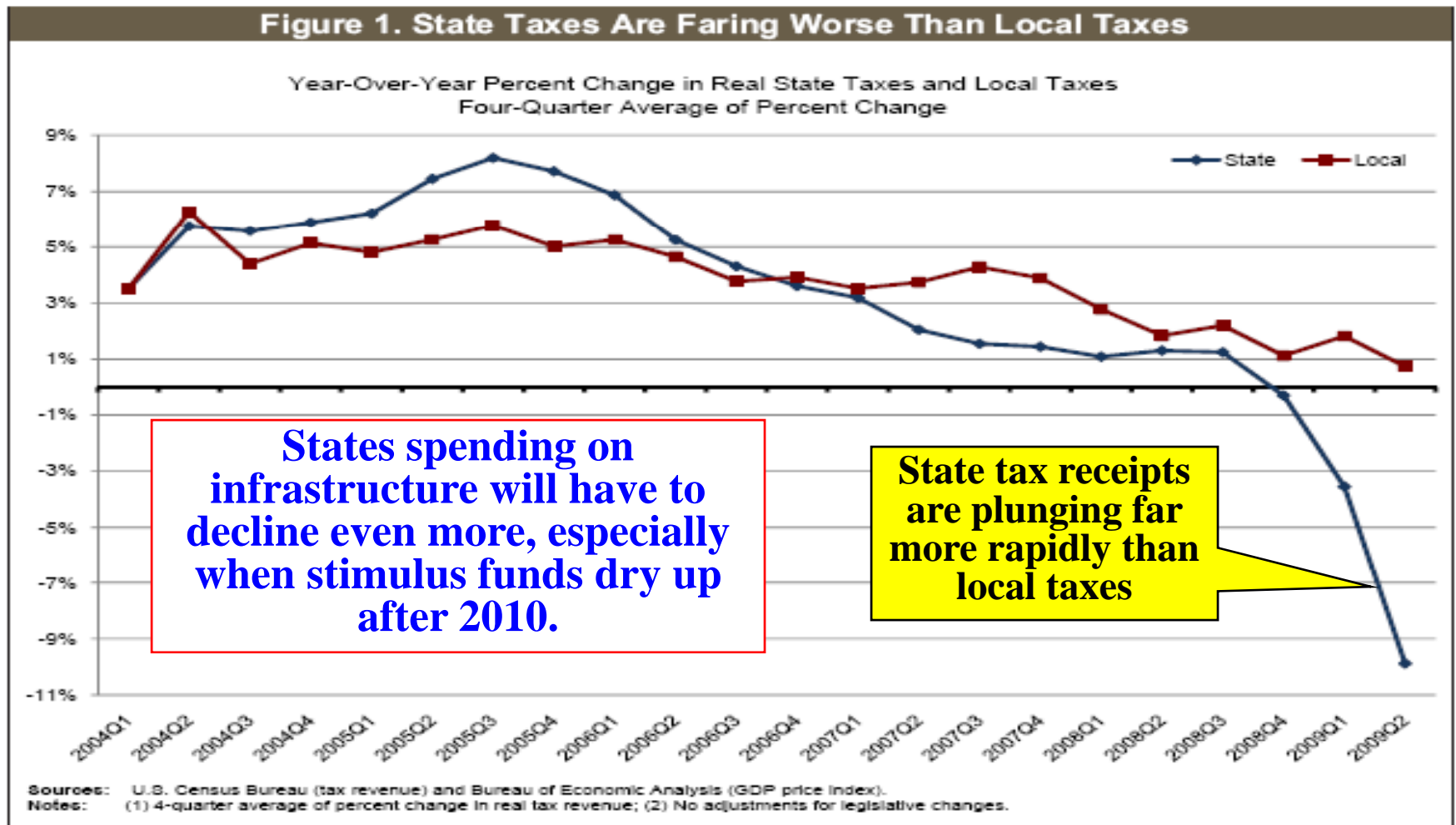
States revenues were down 17.8% in Q2 2009, the second consecutive quarter of record revenue decline. This will impact public infrastructure spending significantly.



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

http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-10-15-SRR_77.pdf

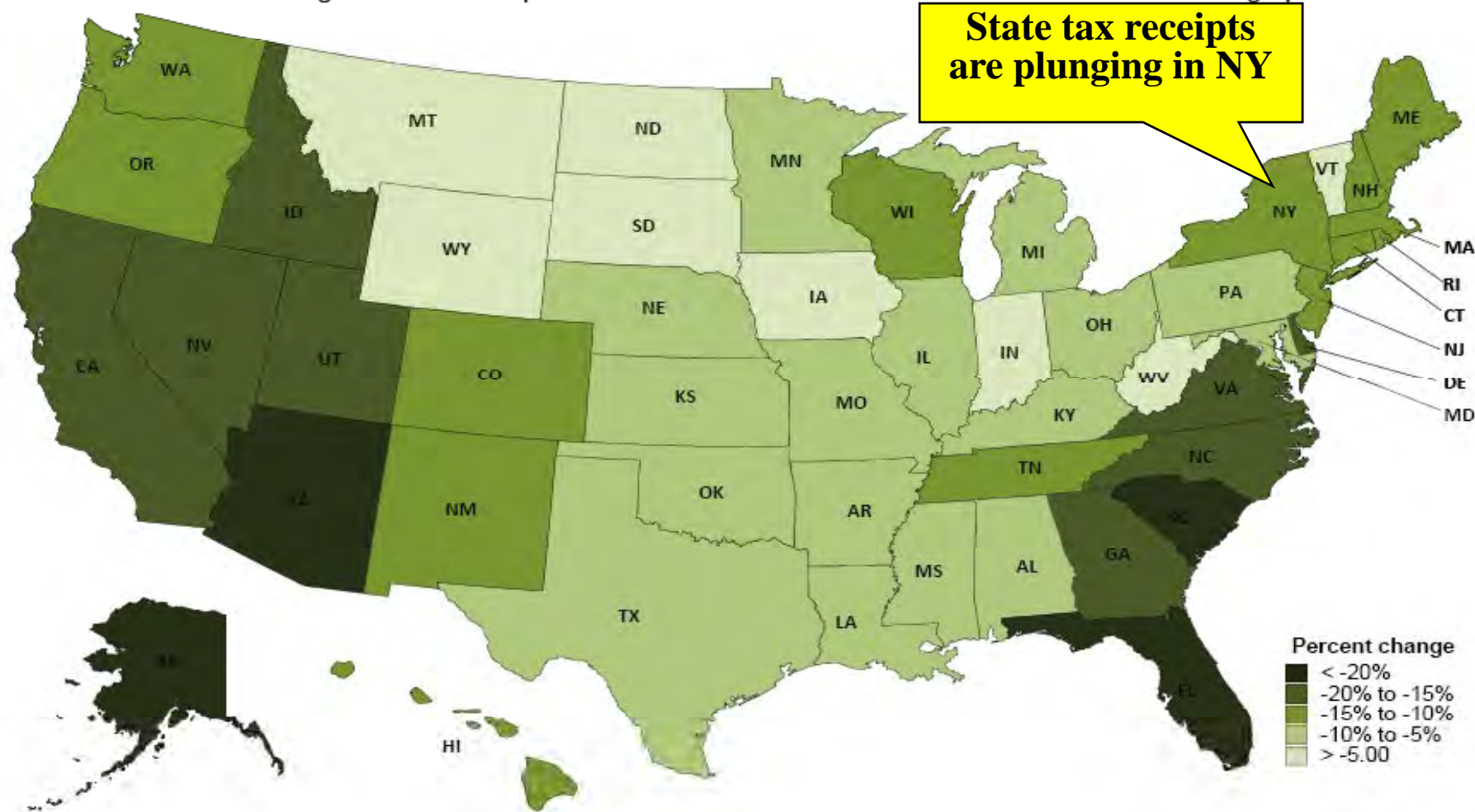
Year-Over-Year Change in Quarterly State and Local Tax Revenues (Inflation Adjusted)





State Tax Revenue Growth Adjusted for Legislative Changes

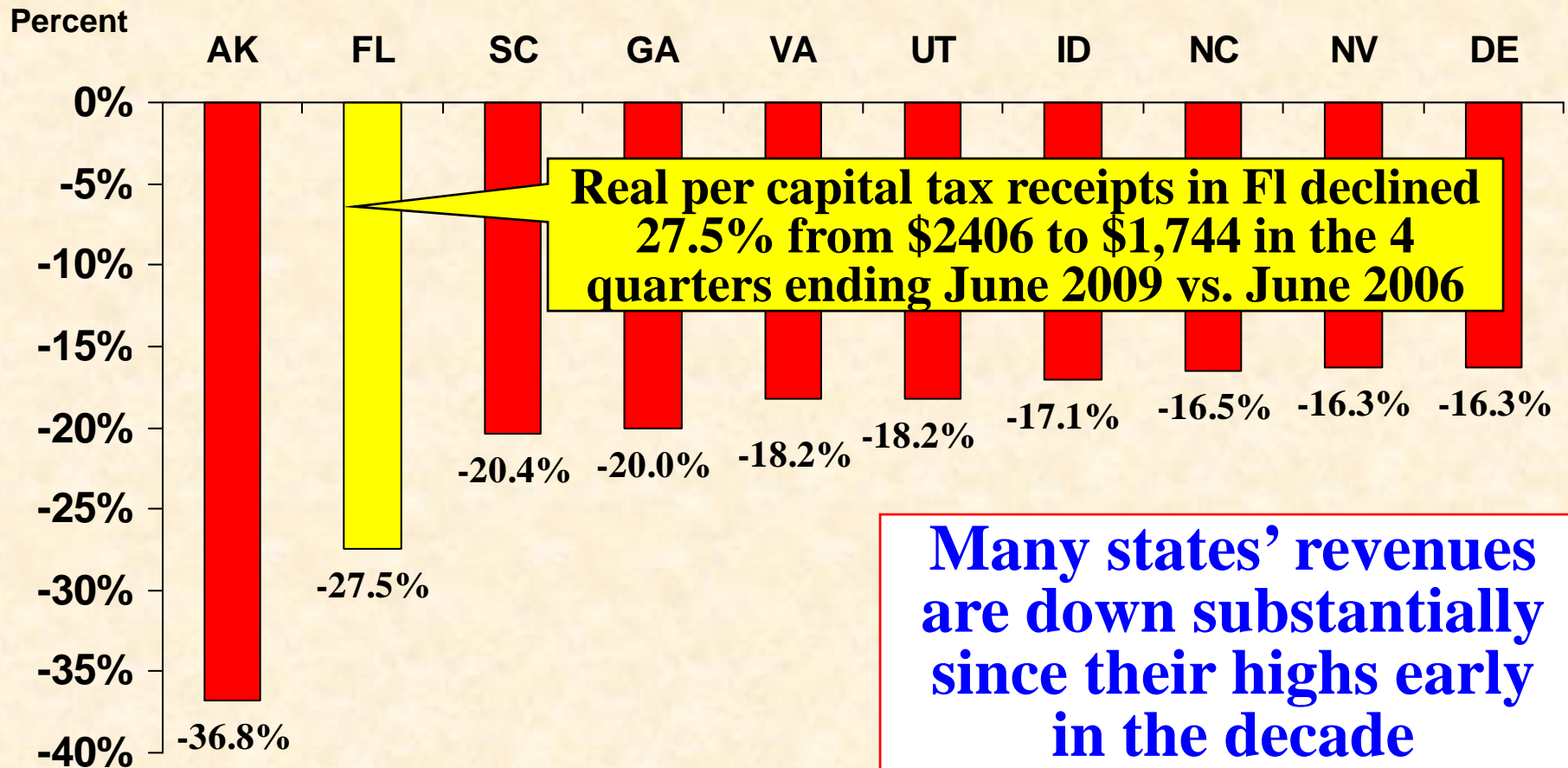
Percent Change in Real Per-Capita State Tax Revenue From Recent Peak to 4 Quarters Ending April-June 2009





States with Fastest Decline in Real Per-Capita Tax Revenues

Period Ending April-June 2009 vs. Recent Peak*



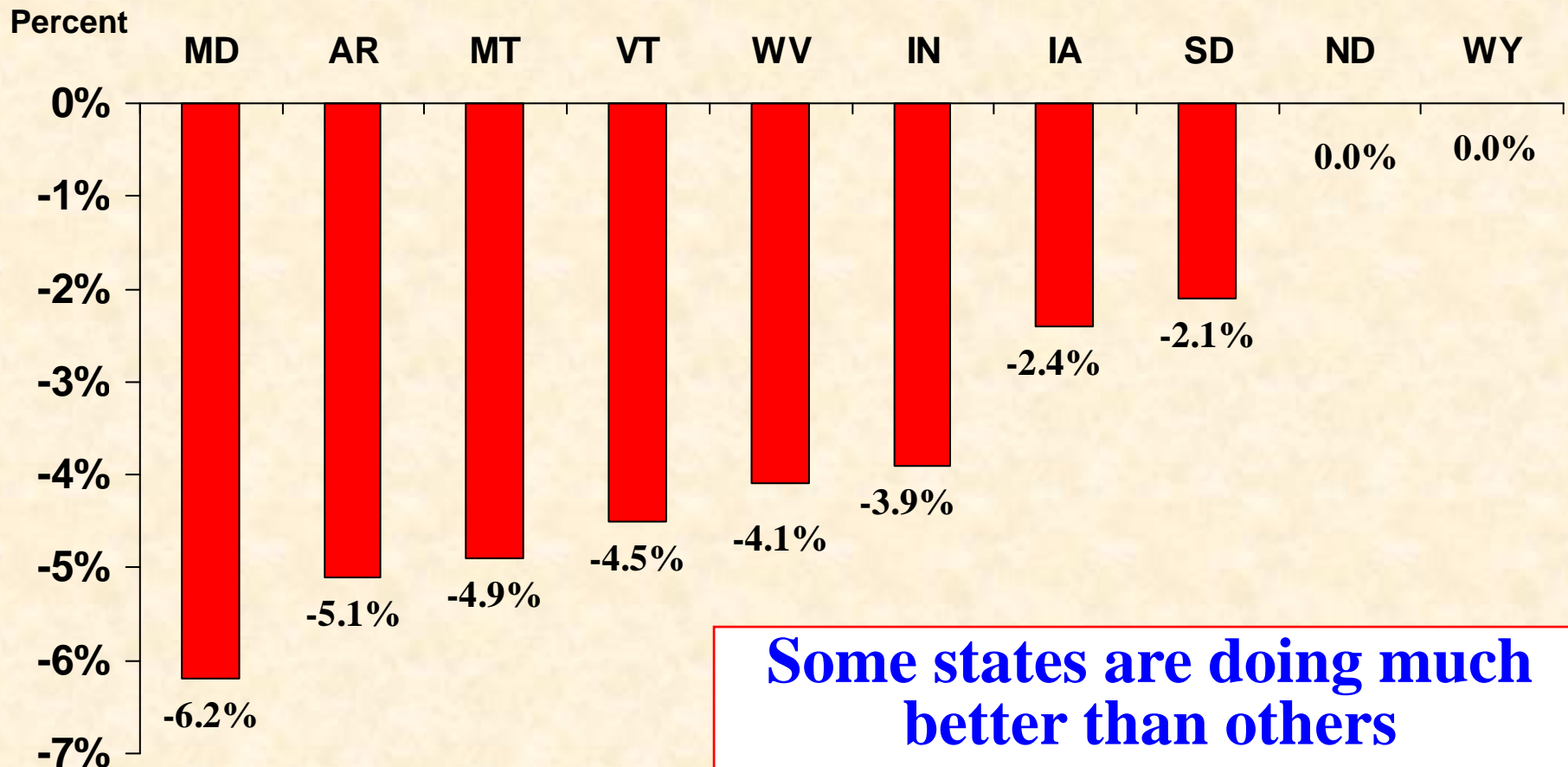
*Peak defined as July – June period between 2006-2009 with highest peak per capita revenues.

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



States with Slowest Decline in Real Per-Capita Tax Revenues

Period Ending April-June 2009 vs. Recent Peak*

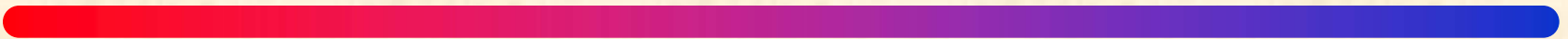


*Peak defined as July – June period between 2006-2009 with highest peak per capita revenues.

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

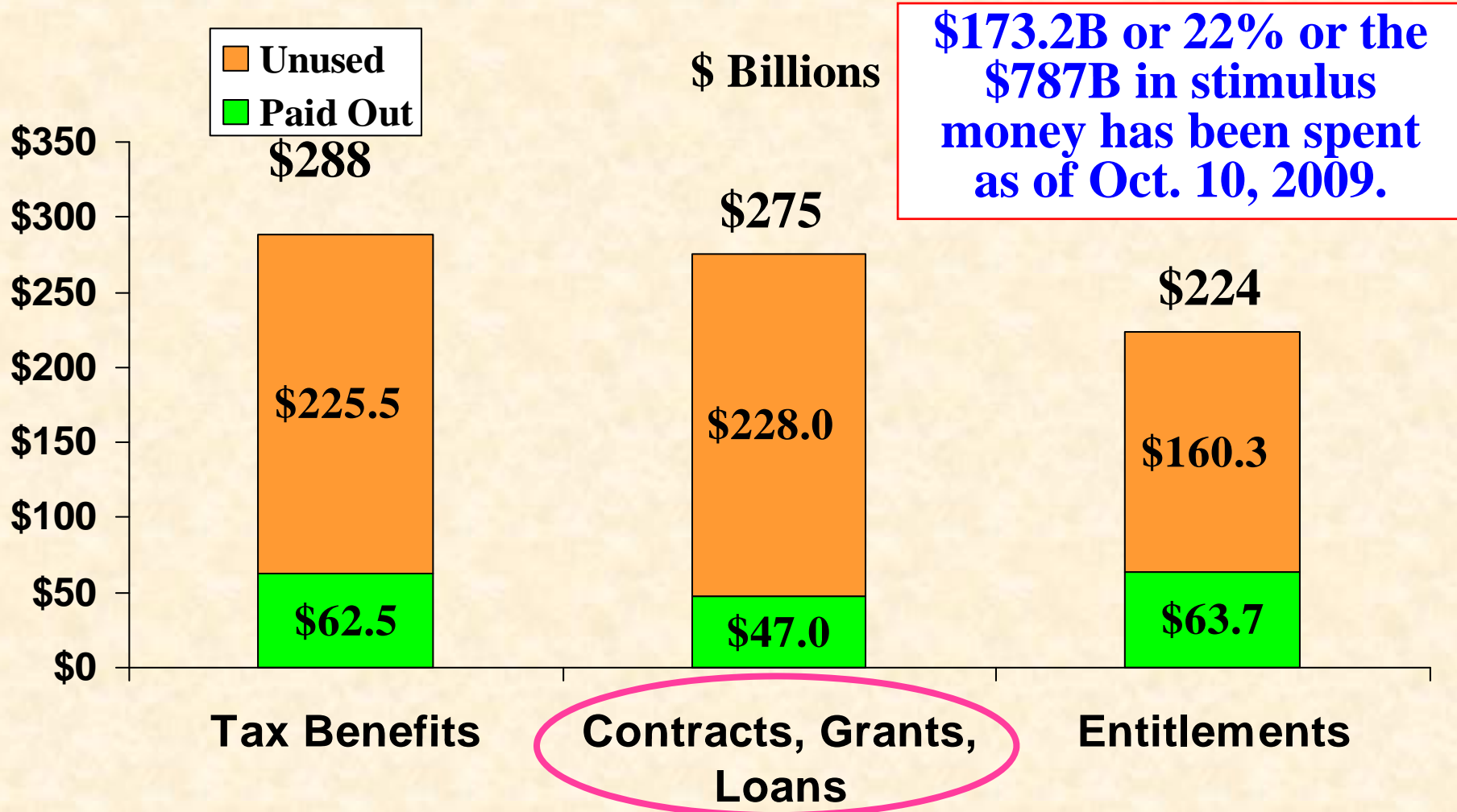
State-by-State Infrastructure Spending & Job Gains

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





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



*As of 10/10/09

Source: www.recovery.gov accessed 10/17/09; Insurance Information Institute.



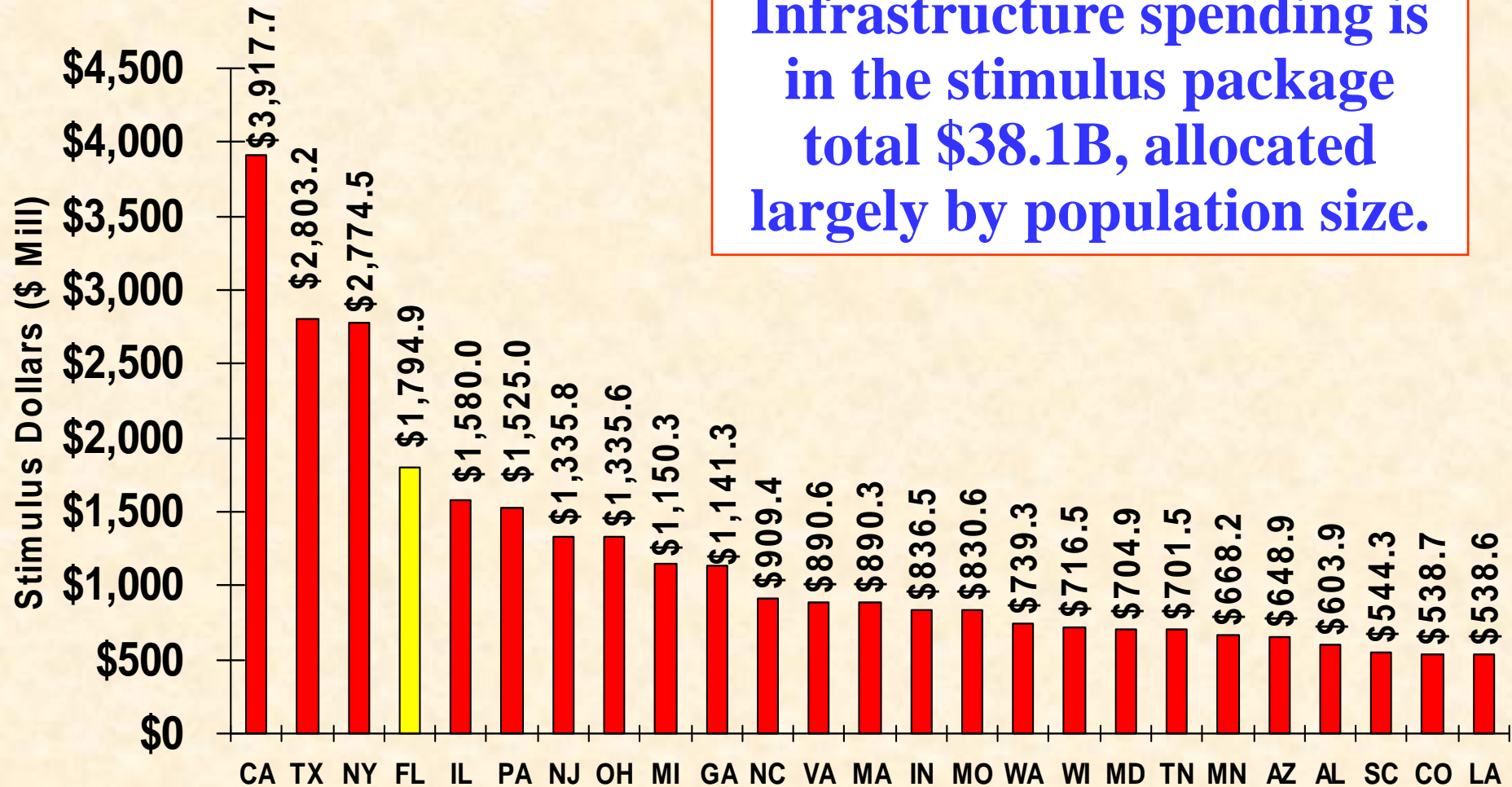
Infrastructure Stimulus Spending by State (Total = \$38.1B)

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

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



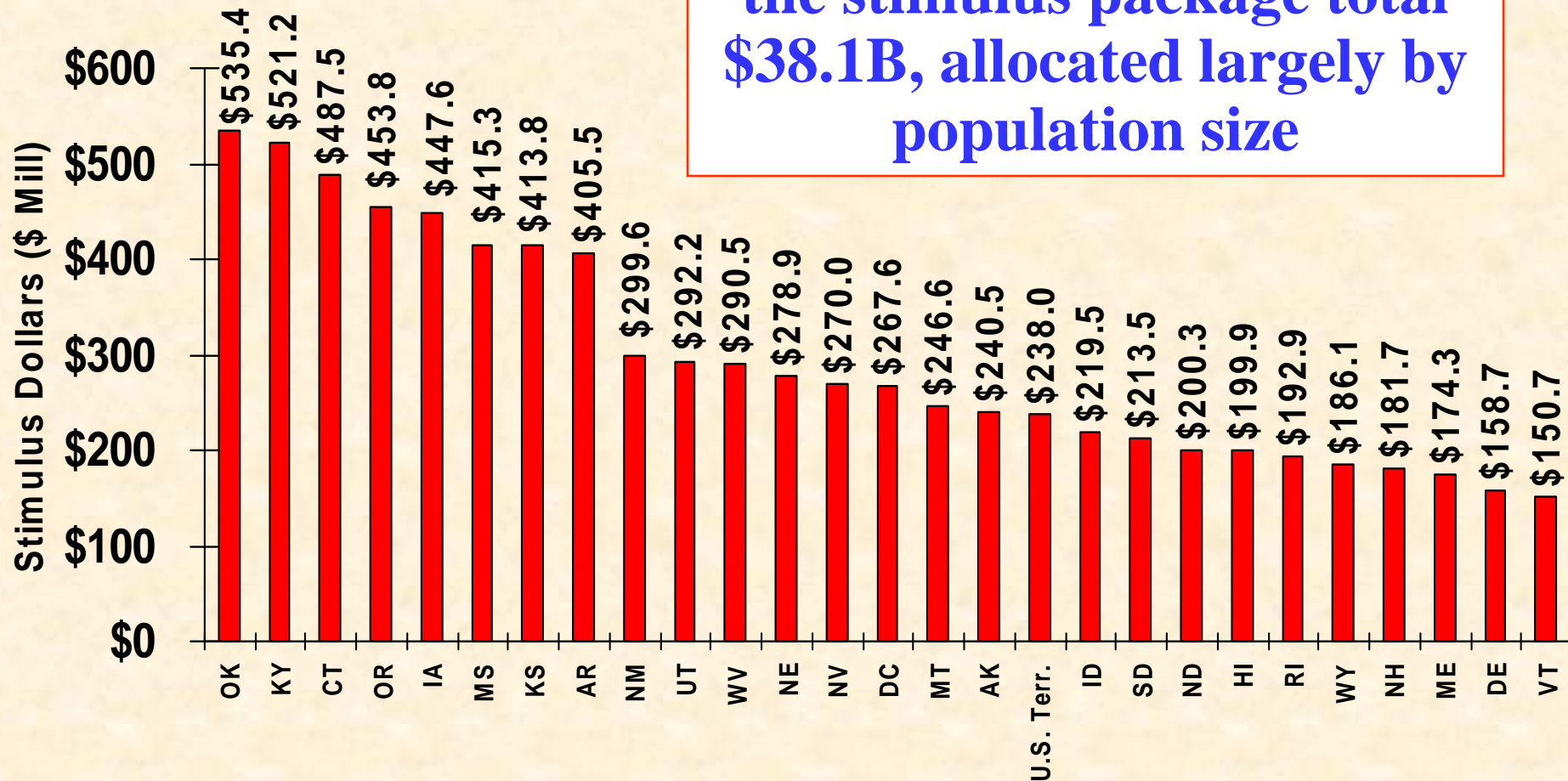
Infrastructure Stimulus Spending By State: Top 25 States (\$ Millions)





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

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



Expected Number of Jobs Gained or Preserved by Stimulus Spending

*Larger States = More Jobs
Workers Comp Benefits*





Estimated Job Effect of Stimulus: Jobs Created/Saved By State – 3.5 Mill Total

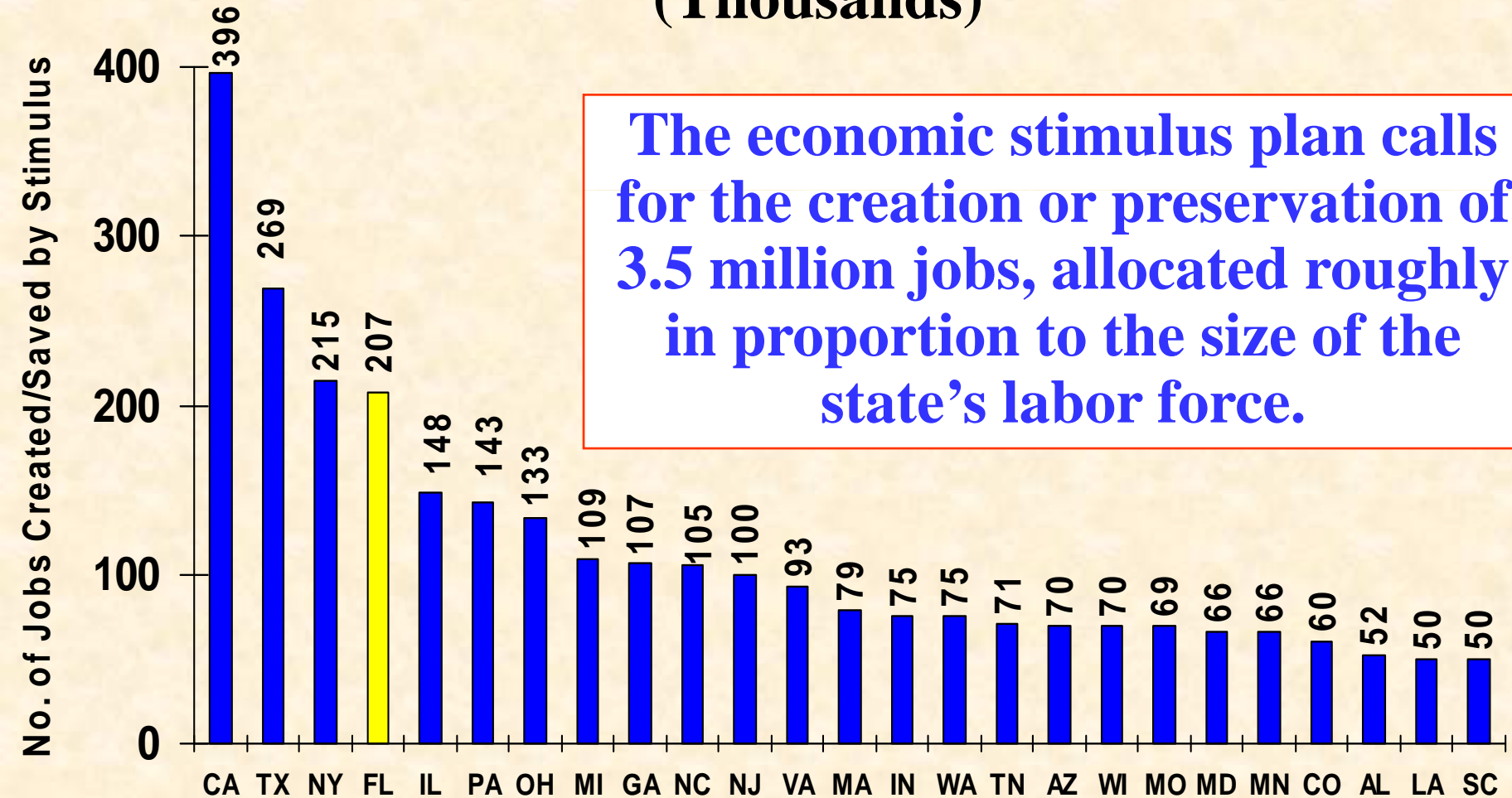
State	Jobs Created	State	Jobs Created	State	Jobs Created
AL	52,000	LA	50,000	OK	40,000
AK	8,000	ME	15,000	OR	44,000
AZ	70,000	MD	66,000	PA	143,000
AR	32,000	MA	79,000	RI	12,000
CA	396,000	MI	109,000	SC	50,000
CO	60,000	MN	66,000	SD	10,000
CT	41,000	MS	30,000	TN	71,000
DE	11,000	MO	69,000	TX	269,000
DC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

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



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

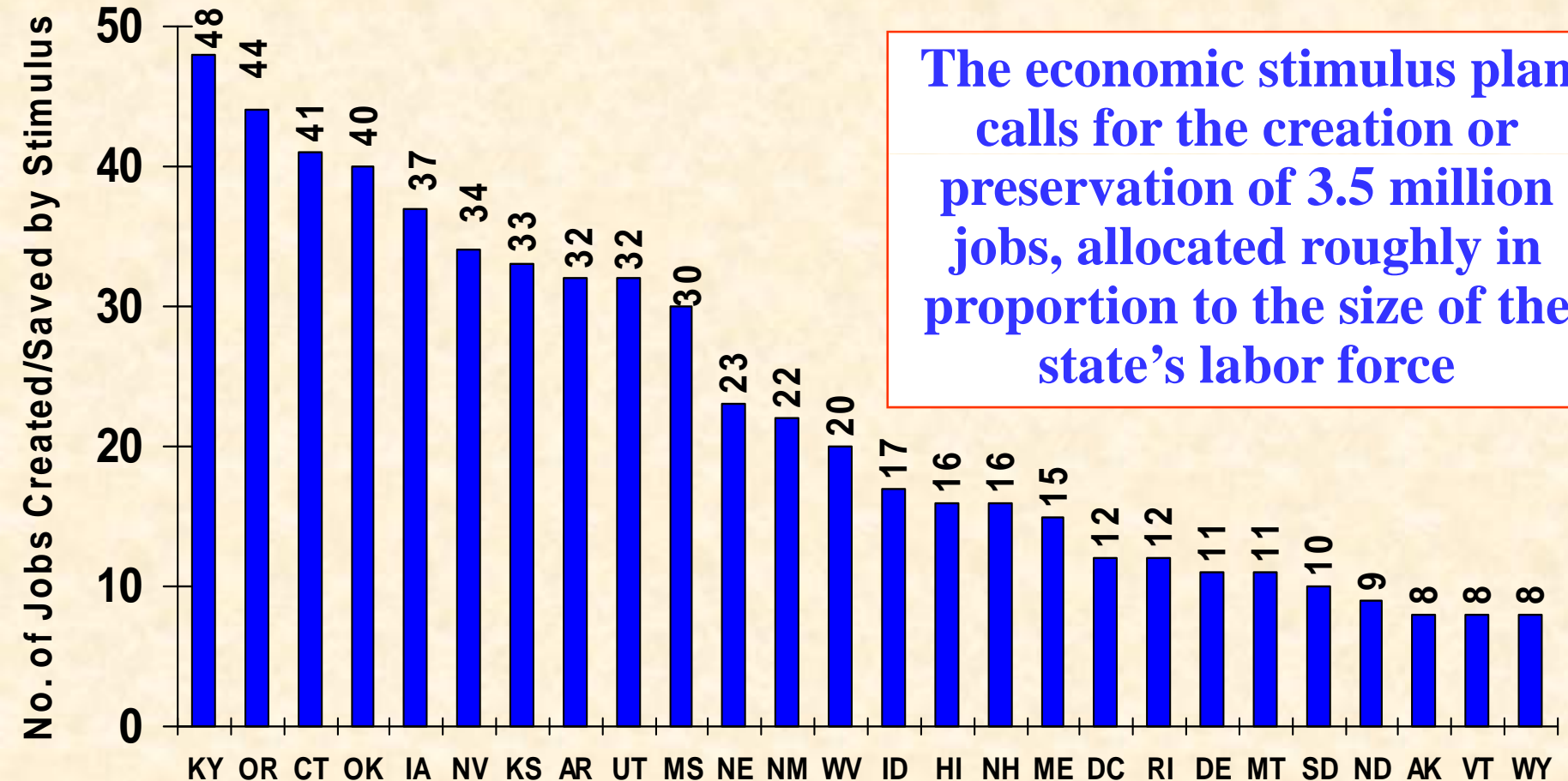
(Thousands)





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

(Thousands)



GREEN SHOOTS

*Is the Recession
Nearing an End?*





Hopeful Signs that the Economic Recovery Is Underway

- **Recession Appears to be Bottoming Out, Freefall Has Ended**
 - GDP shrinkage has ended; Economy is expanding
 - Pace of job losses is slowing
 - Major stock market indices well off record lows, anticipating recovery
 - Some signs of retail sales stabilization are evident
- **Financial Sector is Stabilizing**
 - Banks are reporting quarterly profits
 - Many banks expanding lending to very credit worthy people & businesses
- **Housing Sector Seems To Be Bottoming Out**
 - Home are much more affordable (attracting buyers)
 - Mortgage rates are still low relative to pre-crisis levels (attracting buyers)
 - Freefall in housing starts and existing home sales is ending in many areas
- **Inflation & Energy Prices Are Under Control**
- **Consumer & Business Debt Loads Are Shrinking**



11 Industries for the Next 10 Years: Insurance Solutions Needed

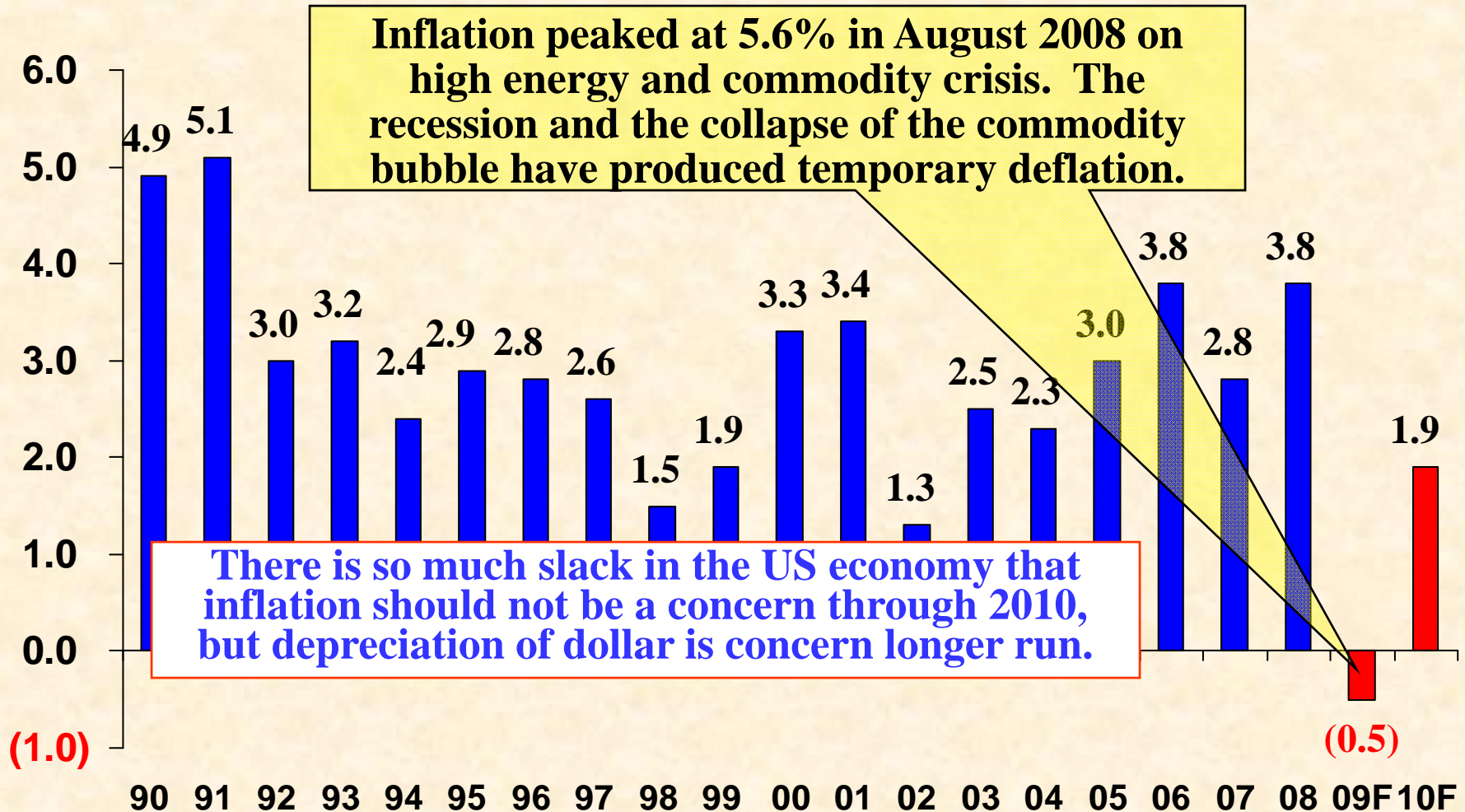
**Government
Education
Health Care
Energy (Traditional)
Alternative Energy
Agriculture
Natural Resources
Environmental
Technology
Light Manufacturing
Export Oriented Industries**

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

**Mounting Pressure on
 Claim Cost Severities?**

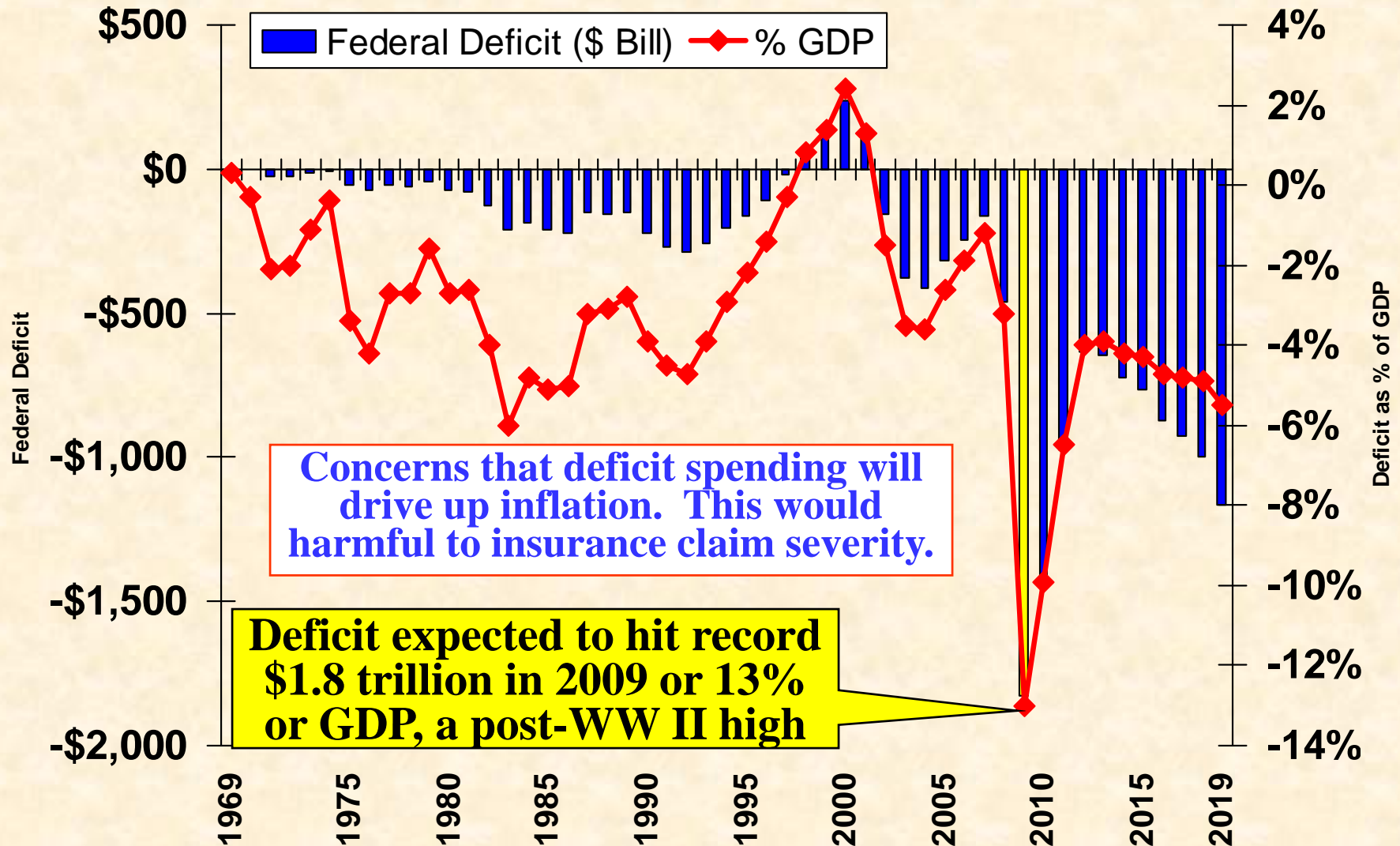


Annual Inflation Rates (CPI-U, %), 1990-2010F





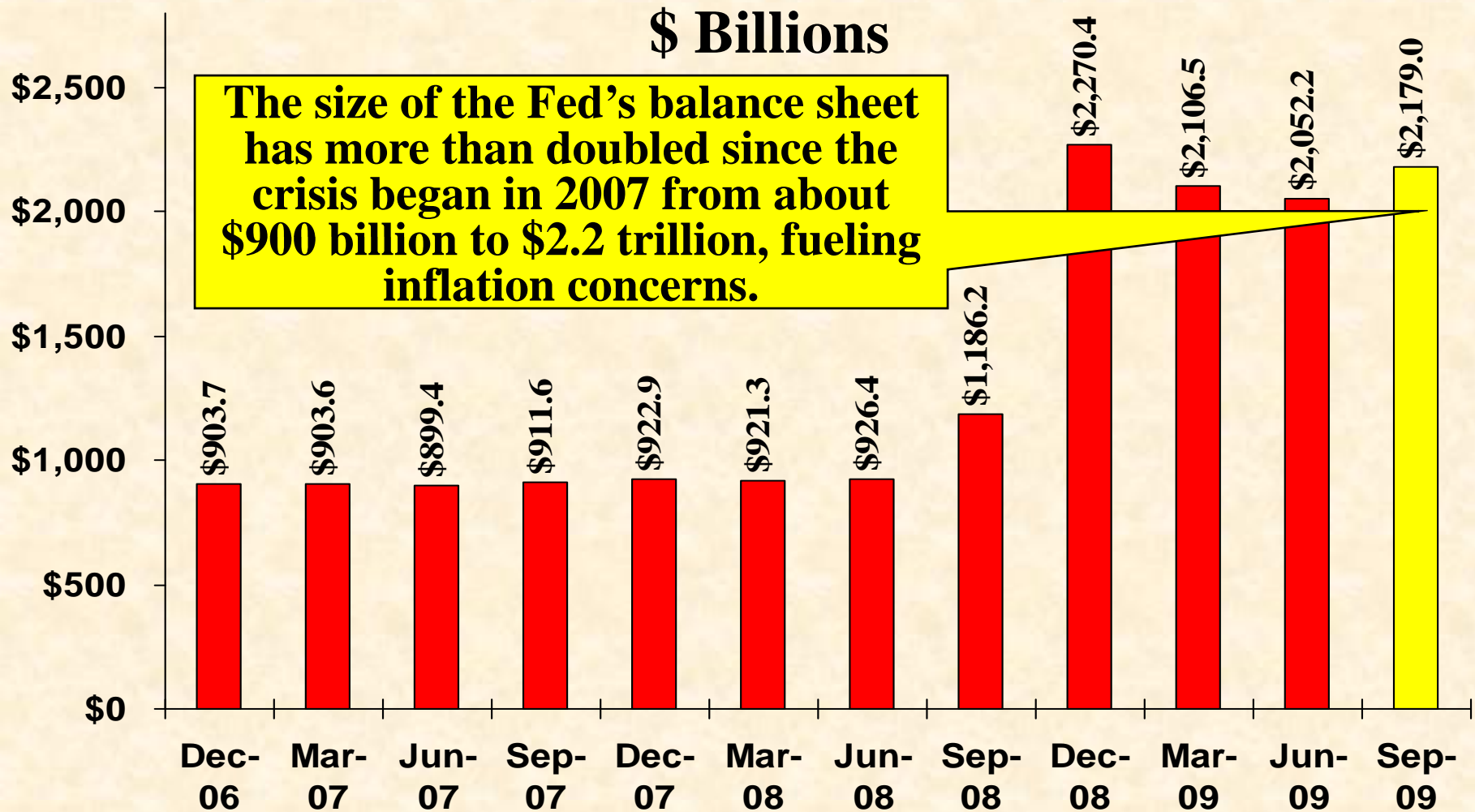
US Budget Deficit, 1969-2019F



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

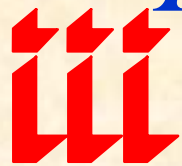


*Balance Sheet of the Federal Reserve, Dec. 2006- Sept. 2009**



*As of final Friday in each quarter.

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



Top Concerns/Risks for Insurers if Inflation is Reignited

CONCERNS: The Federal Reserve Has Flooded Financial System with Cash (Turned on the Printing Presses), the Federal Govt. Has Approved a \$787B Stimulus and the Deficit is Expected to Mushroom to \$1.8 Trillion. All Are Potentially Inflationary.

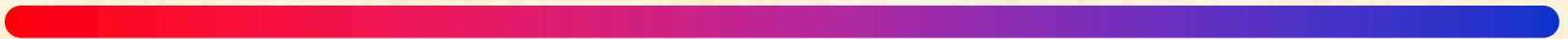
- What are the potential impacts for insurers?
- What can/should insurers do to protect themselves from the risks of inflation?

KEY RISKS FROM SUSTAINED/ACCELERATING INFLATION

- Rising Claim Severities
 - Cost of claims settlement rises across the board (property and liability)
- Rate Inadequacy
 - Rates inadequate due to low trend assumptions arising from use of historical data
- Reserve Inadequacy
 - Reserves may develop adversely and become inadequate (deficient)
- Burn Through on Retentions
 - Retentions, deductibles burned through more quickly
- Reinsurance Penetration/Exhaustion
 - Higher costs → risks burn through their retentions more quickly, tapping into re-insurance more quickly and potential exhausting their reinsurance more quickly

Key Threats Facing Insurers Amid Financial Crisis

*Challenges for the
Next 5-8 Years*





Important Issues & Threats

Facing Insurers: 2009 - 2015

1. Erosion of Capital

- Losses were larger and occurred more rapidly than is commonly understood or presumed
- Max surplus loss at 3/31/09 was 16%=\$85B from 9/30/07 peak
- P/C policyholder surplus loss could have been much larger
- Decline in PHS of 1999-2002 was 15% over 3 years and was entirely made up and then some in 2003. Current decline was ~16% in 5 qtrs.
- During the opening years of the Great Depression (1929-1933) PHS fell 37%, Assets fell 28% and Net Written Premiums fell by 35%. It took until 1939-40 before these key measures returned to their 1929 peaks.
- **BOTTOM LINE:** Capital and assets fell farther and faster than many believed possible. It will take years to return to the 2007 peaks—likely 2011 (without market relapse).



Important Issues & Threats

Facing Insurers: 2009 - 2015

2. Reloading Capital After “Capital Event”

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



Important Issues & Threats

Facing Insurers: 2009 - 2015

3. Long-Term Reduction in Investment Earnings

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



Important Issues & Threats

Facing Insurers: 2009 – 2???

4. Regulatory Overreach

- Principle danger is that P/C insurers get swept into vast federal regulatory overhaul and subjected to inappropriate, duplicative and costly regulation (Dual Regulation)
- Strong arguments for Optional Federal Charter, but...
- Pushing for major change is not without risk in the current highly charged political environment
- Dangers exist if feds get their nose under the tent
- Status Quo is viewed as unacceptable by all
- Disunity within the insurance industry
- Insurance & systemic risk—Who is important?
- Impact of regulatory changes will be felt for decades
- **Bottom Line: Regulatory outcome is uncertain and risk of adverse outcome exists**



Health Insurance Reform Debate— Potential Spillover Impacts on P/C Insurers

- **24-Hour Coverage Proposal**
 - Would roll WC and med components of auto into natl. health care plan
- **Rollback of McCarran-Ferguson Act**
 - Would repeal or restrict for health and medical malpractice insurers
 - *Slippery slope—Med Mal is a p/c line; Congress will not hesitate to breach M-F for other p/c lines in the future to show its ire over an issue (e.g., after major cat)*
- **Exclusion of Med Mal Reform from Health Care Bill**
 - Shows powerful influence of trial bar with Congress/Administration
- **FTC granted authority to conduct studies “related to insurance” –All Lines!**
- **Reporting of Claims**
- **Adjustments to Medicare Fee Schedules**
- **Patient “Bill of Rights” or Vague Standards of Care**
- **Cost Shifting into WC, Auto from Health System**
 - WC/Auto Medical: more lucrative from provider perspective
- **“Windfall” Profit Taxes? Additional Premium Taxes?**
- **Executive Compensation Restrictions?**
- **Public “Option” in P/C Lines—Nat Cat/Wind?**
- **Perception that Feds Regulate Insurance Industry Taking Root**



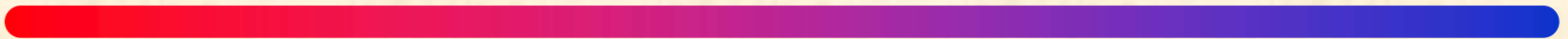
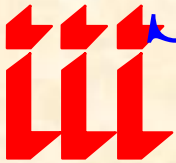
Important Issues & Threats Facing Insurers: 2009 -2015

5. Emerging Tort Threat

- No tort reform (or protection of recent reforms) is forthcoming from the current Congress or Administration
- Erosion of recent reforms is a certainty (already happening)
- Innumerable legislative initiatives will create opportunities to undermine existing reforms and develop new theories and channels of liability
- Torts twice the overall rate of inflation
- Influence personal and commercial lines, esp. auto liab.
- Historically extremely costly to p/c insurance industry
- Leads to reserve deficiency, rate pressure
- **Bottom Line: Tort “crisis” is on the horizon and will be recognized as such by 2012-2014**

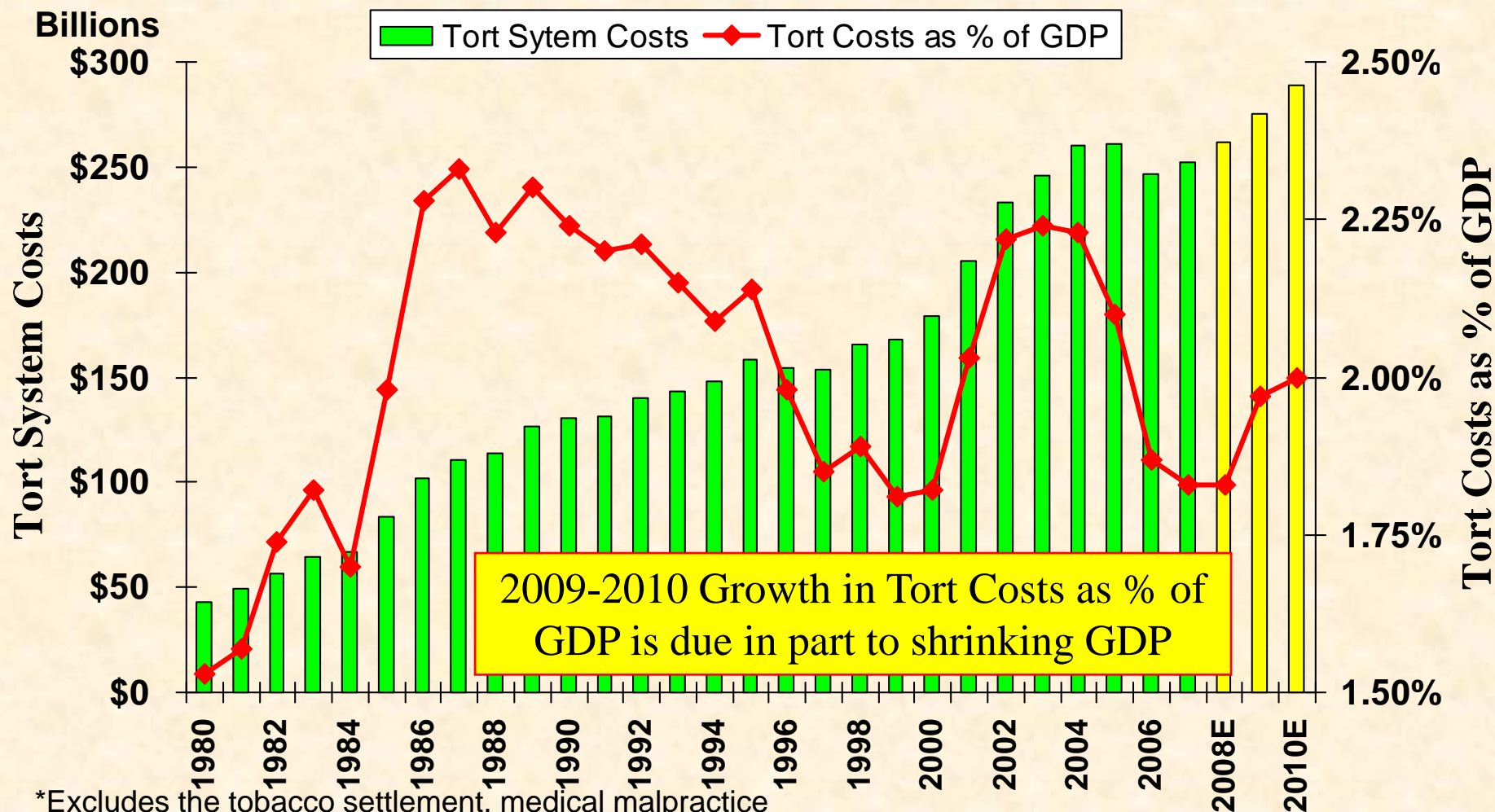
Shifting Legal Liability & Tort Environment

*Is the Tort Pendulum
Swinging Against Insurers?*





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



*Excludes the tobacco settlement, medical malpractice

Sources: Tillinghast-Towers Perrin, *2008 Update on US Tort Cost Trends*, Appendix 1A;
I.I.I. calculations/estimates for 2009 and 2010



The Nation's Judicial Hellholes (2008/2009)

Watch List

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

***Madison County,
IL***

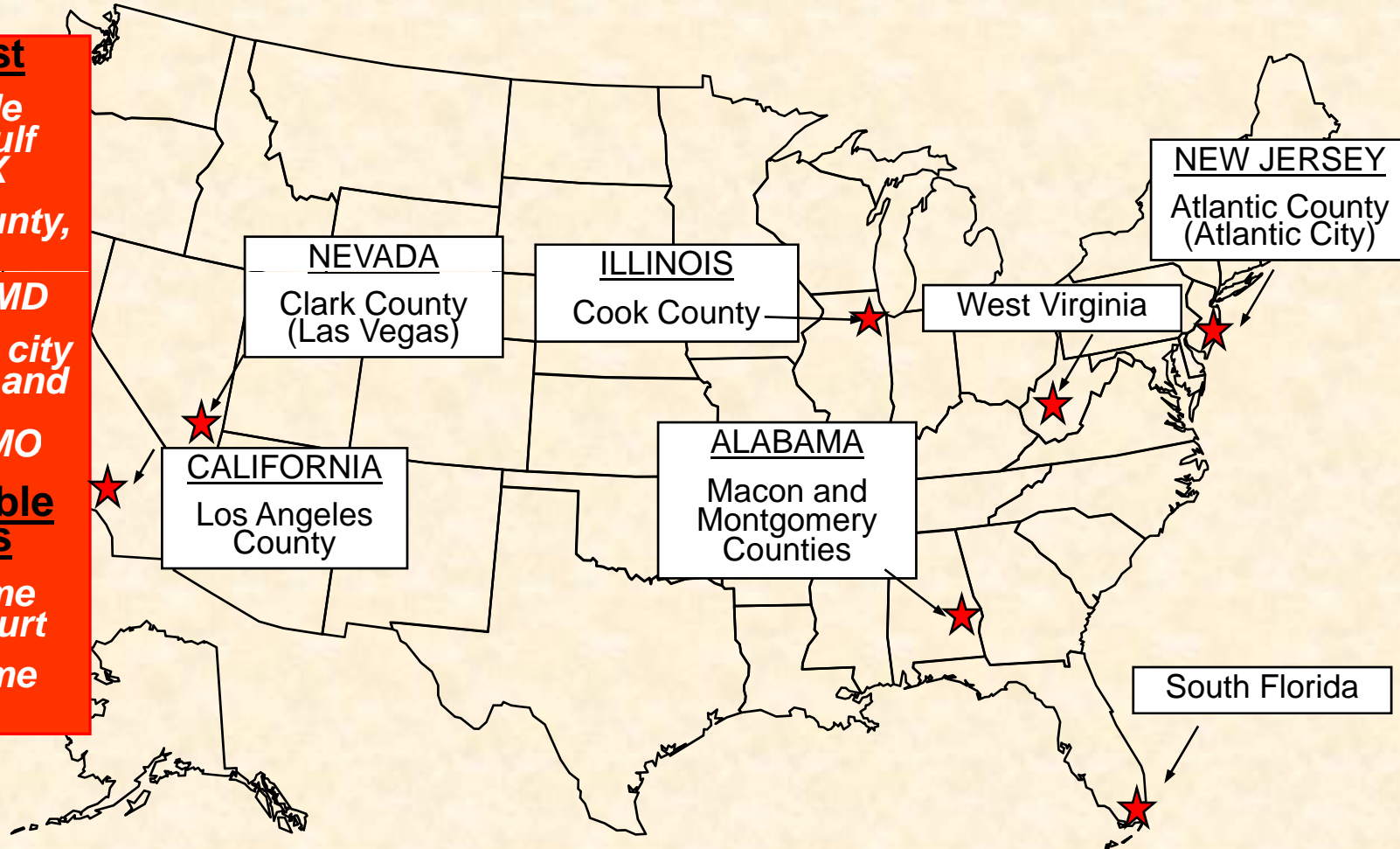
Baltimore, MD

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

Dishonorable Mentions

***MA Supreme
Judicial Court***

***MO Supreme
Court***



FINANCIAL STRENGTH & RATINGS

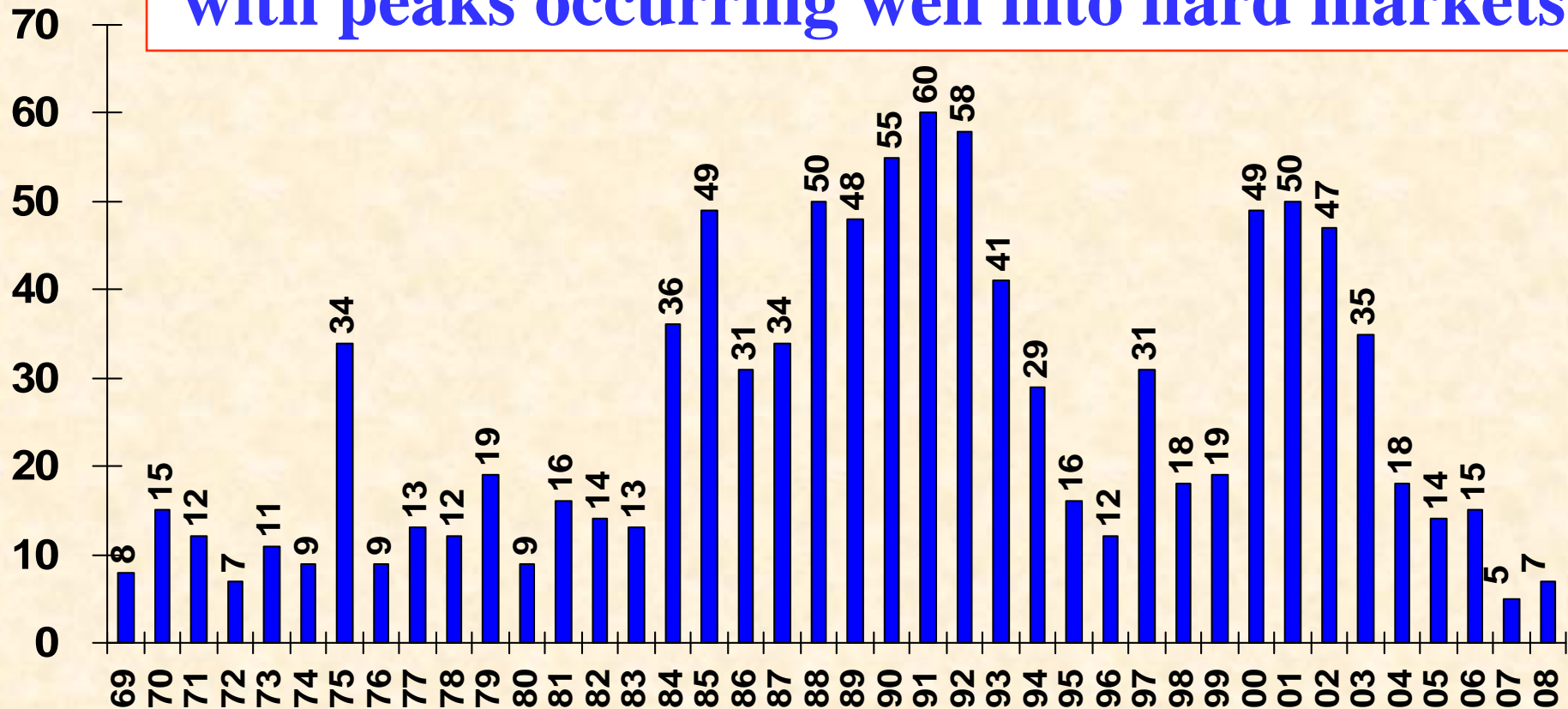
**Industry Has Weathered
the Storms Well**





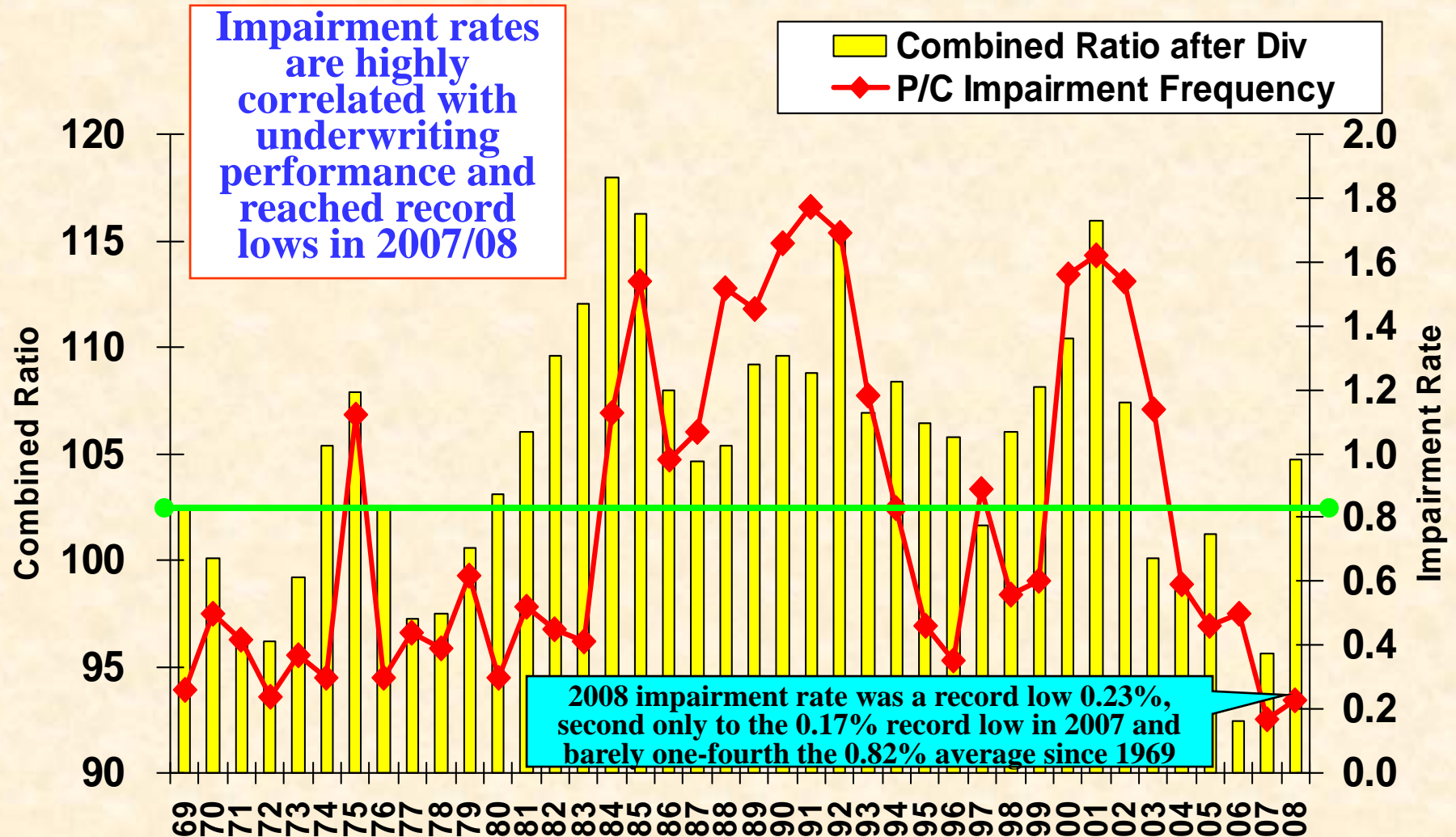
P/C Insurer Impairments, 1969-2008

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





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

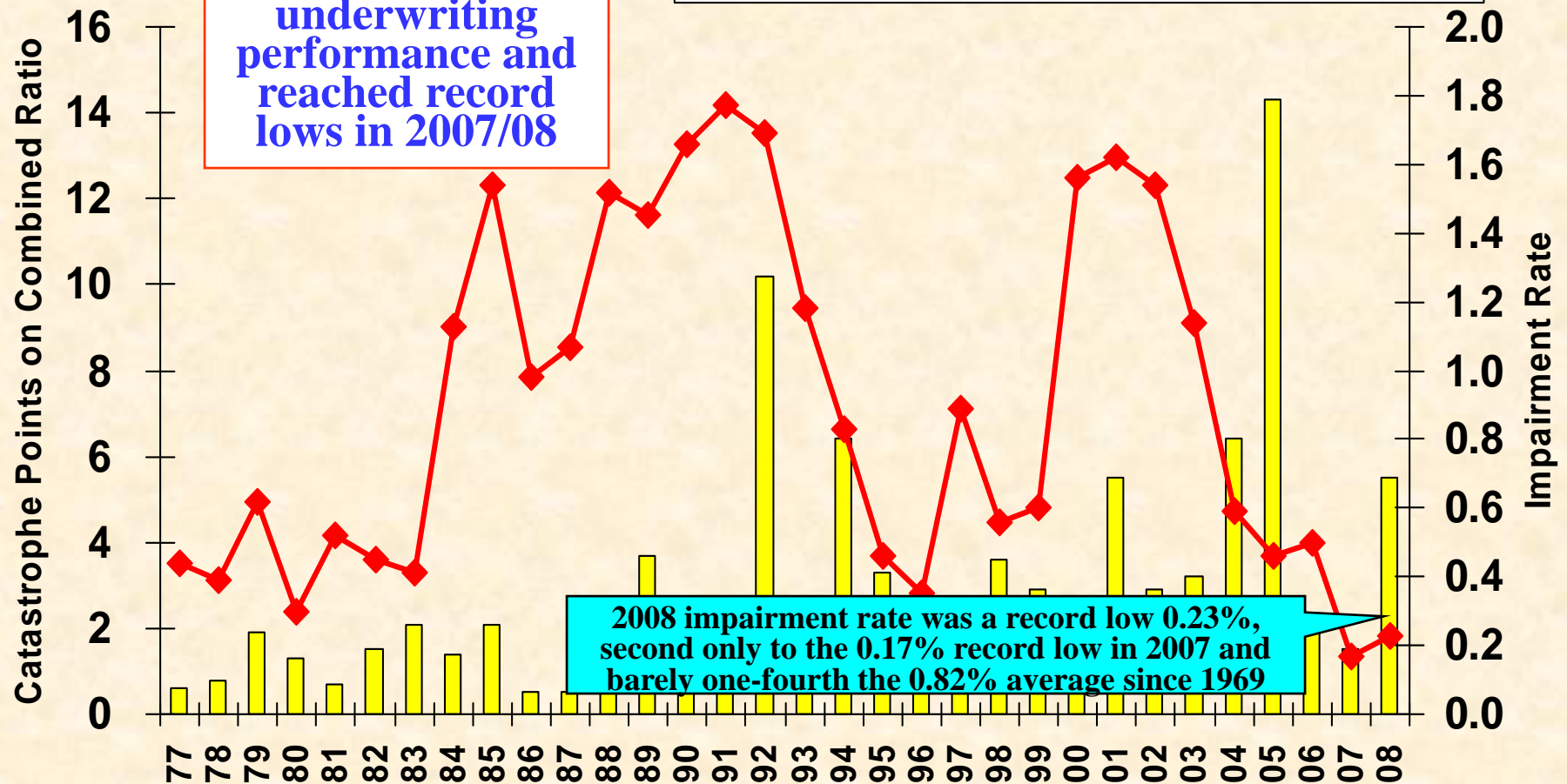




P/C Impairment Frequency vs. Catastrophe Points in Combined Ratio, 1977-2008

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

■ Catastrophe Points in Combined Ratio
◆ P/C Impairment Frequency



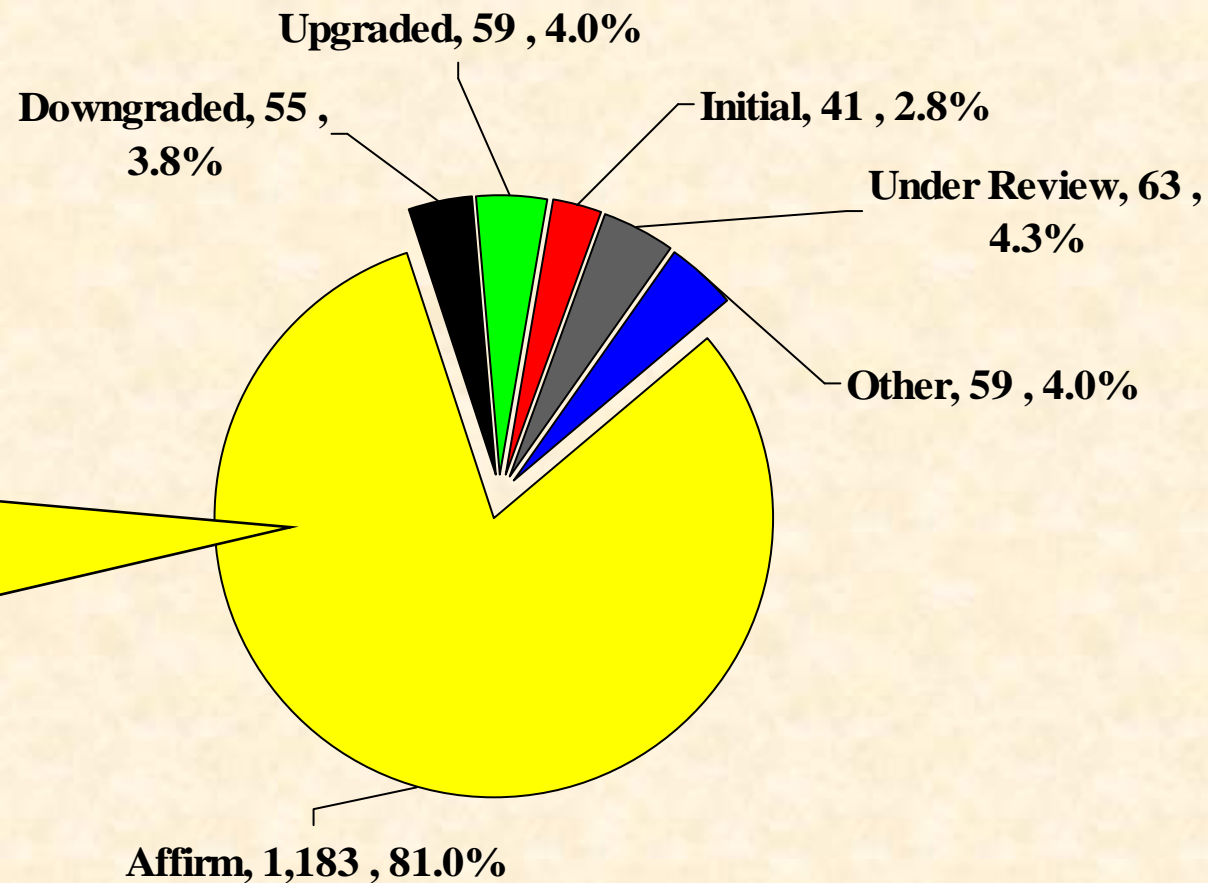
2008 impairment rate was a record low 0.23%, second only to the 0.17% record low in 2007 and barely one-fourth the 0.82% average since 1969



Summary of A.M. Best's P/C Insurer Ratings Actions in 2008*

P/C insurance is by design a resilient in business. The dual threat of financial disasters and catastrophic losses are anticipated in the industry's risk management strategy.

Despite financial market turmoil, high cat losses and a soft market in 2008, 81% of ratings actions by A.M. Best were affirmations; just 3.8% were downgrades and 4.0% upgrades



*Through December 19.

Source: A.M. Best.



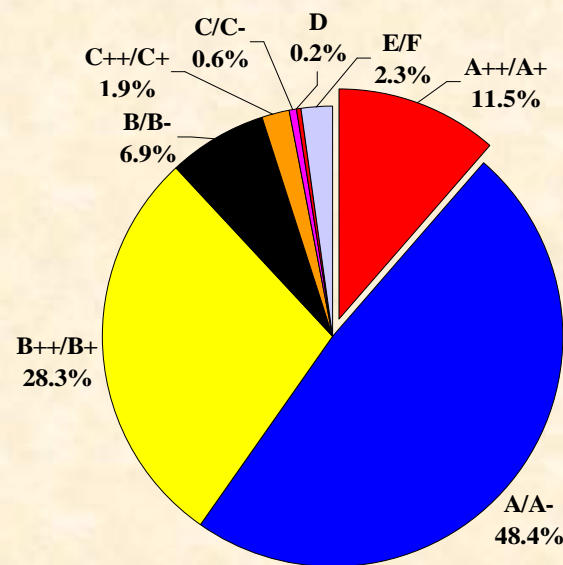
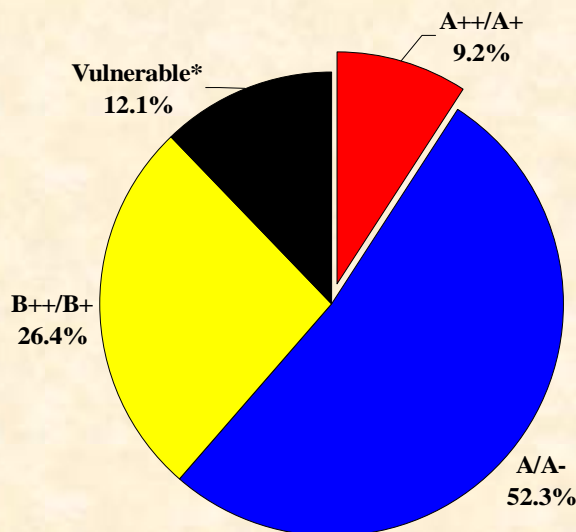
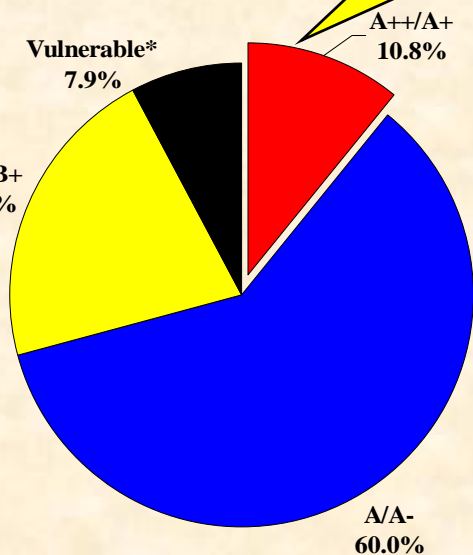
Historical Ratings Distribution, US P/C Insurers, 2008 vs. 2005 and 2000

2008

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

2005

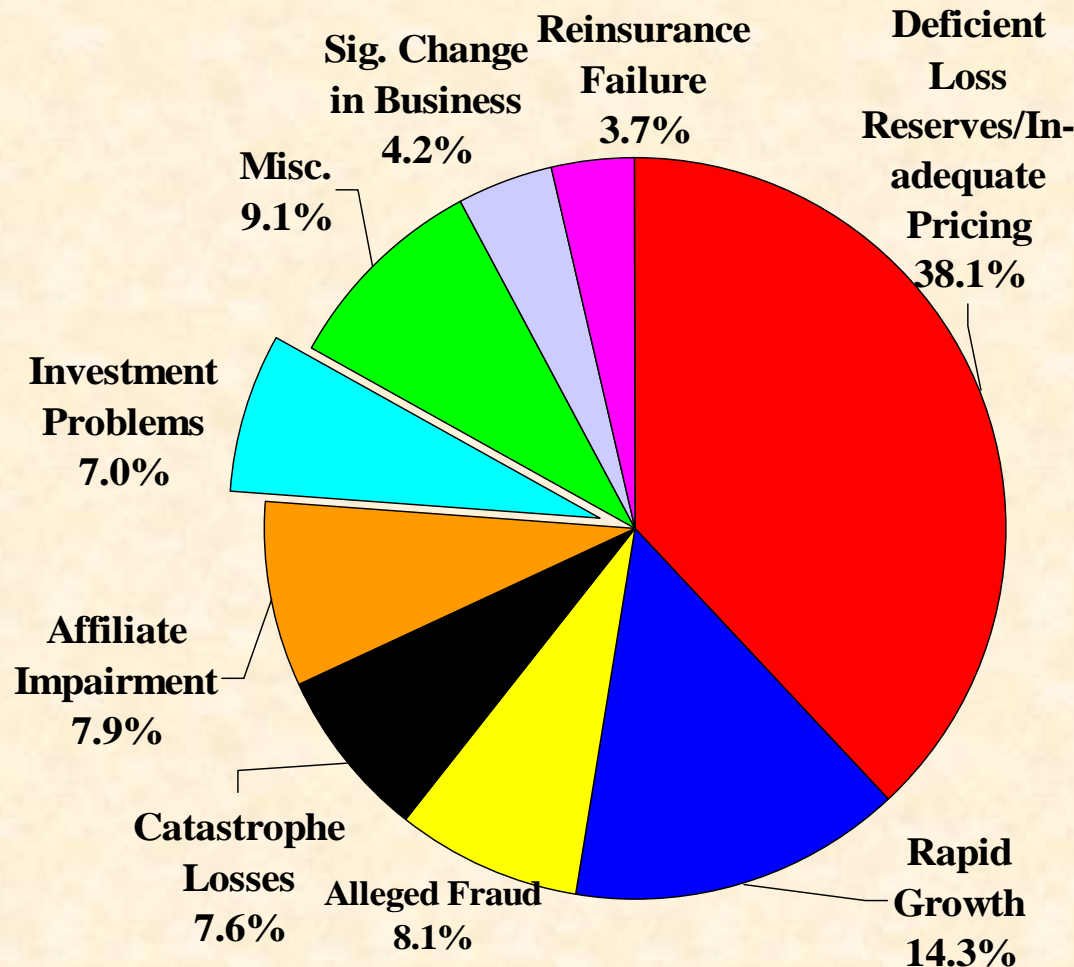
2000



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



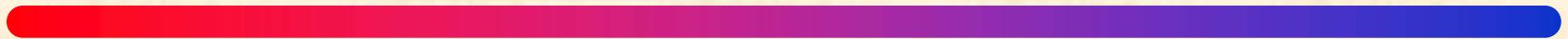
Reasons for US P/C Insurer Impairments, 1969-2008



Deficient loss reserves and inadequate pricing are the leading cause of insurer impairments, underscoring the importance of discipline. Investment catastrophe losses play a much smaller role.

Critical Differences Between P/C Insurers and Banks

**Superior Risk Management Model
& Low Leverage Make
a Big Difference**





How Insurance Industry Stability Has Benefitted Consumers

BOTTOM LINE:

- **Insurance Markets—Unlike Banking—Are Operating *Normally***
- **The Basic Function of Insurance—the Orderly Transfer of Risk from Client to Insurer—Continues *Uninterrupted***
- **This Means that Insurers Continue to:**
 - **Pay claims (whereas 123 banks have gone under as of 10/2/09)**
 - ***The Promise is Being Fulfilled***
 - **Renew existing policies (banks are reducing and eliminating lines of credit)**
 - **Write new policies (banks are turning away people and businesses who want or need to borrow)**
 - **Develop new products (banks are scaling back the products they offer)**
 - **Compete Intensively (banks are consolidating, reducing consumer choice)**



Reasons Why P/C Insurers Have Fewer Problems Than Banks:

A Superior Risk Management Model

- **Emphasis on Underwriting**
 - Matching of risk to price (via experience and modeling)
 - Limiting of potential loss exposure
 - *Some banks sought to maximize volume and fees and disregarded risk*
- **Strong Relationship Between Underwriting and Risk Bearing**
 - **Insurers always maintain a stake in the business they underwrite, keeping “skin in the game” at all times**
 - *Banks and investment banks package up and securitize, severing the link between risk underwriting and risk bearing, with (predictably) disastrous consequences—straightforward moral hazard problem from Econ 101*
- **Low Leverage**
 - Insurers do not rely on borrowed money to underwrite insurance or pay claims → *There is no credit or liquidity crisis in the insurance industry*
- **Conservative Investment Philosophy**
 - High quality portfolio that is relatively less volatile and more liquid
- **Comprehensive Regulation of Insurance Operations**
 - The business of insurance remained comprehensively regulated whereas a separate banking system had evolved largely outside the auspices and understanding of regulators (e.g., hedge funds, private equity, complex securitized instruments, credit derivatives—CDS's)
- **Greater Transparency**
 - Insurance companies are an open book to regulators and the public

Regulatory Reform

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



Status: Stalled in Congress



Obama Regulatory Reform Proposal: Plan Components

I. Office of National Insurance (ONI) Duties

1. Monitor “all aspects of the insurance industry”
2. Gather information
3. Identify the emergence of any problems or gaps in regulation that could contribute to a future crisis
4. Recommend to the Federal Reserve insurance companies it believes should be supervised as Tier 1 FHCs
5. Administer the Terrorism Risk Insurance Program
6. Authority to enter into international agreements and increase international cooperation on insurance regulation



Obama Regulatory Reform Proposal: Plan Components (cont'd)

II. Systemic Risk Oversight & Resolution Authority

- Federal Reserve given authority to oversee systemic risk of large financial holding companies (Tier 1 FHCs)
 - Insurers are explicitly included among the types of entities that could be found to be a Tier 1 FHC
 - ONI given authority to “recommend to the Federal Reserve any insurance companies that the ONI believes should be supervised as Tier 1 FHC.”
- Proposal also recommends “creation of a resolution regime to avoid disorderly resolution of failing bank holding companies, including Tier 1 FHCs “...in situations where the stability of the financial system is at risk.” Directly affects insurers in 2 ways:
 - Resolution authority may extend to an insurer within the BHC structure if the BHC is failing
 - If systemically important insurer is failing (as identified by ONI as Tier 1 FHC) resolution authority may apply

P/C INSURANCE FINANCIAL PERFORMANCE

**A Resilient Industry in
 Challenging Times**

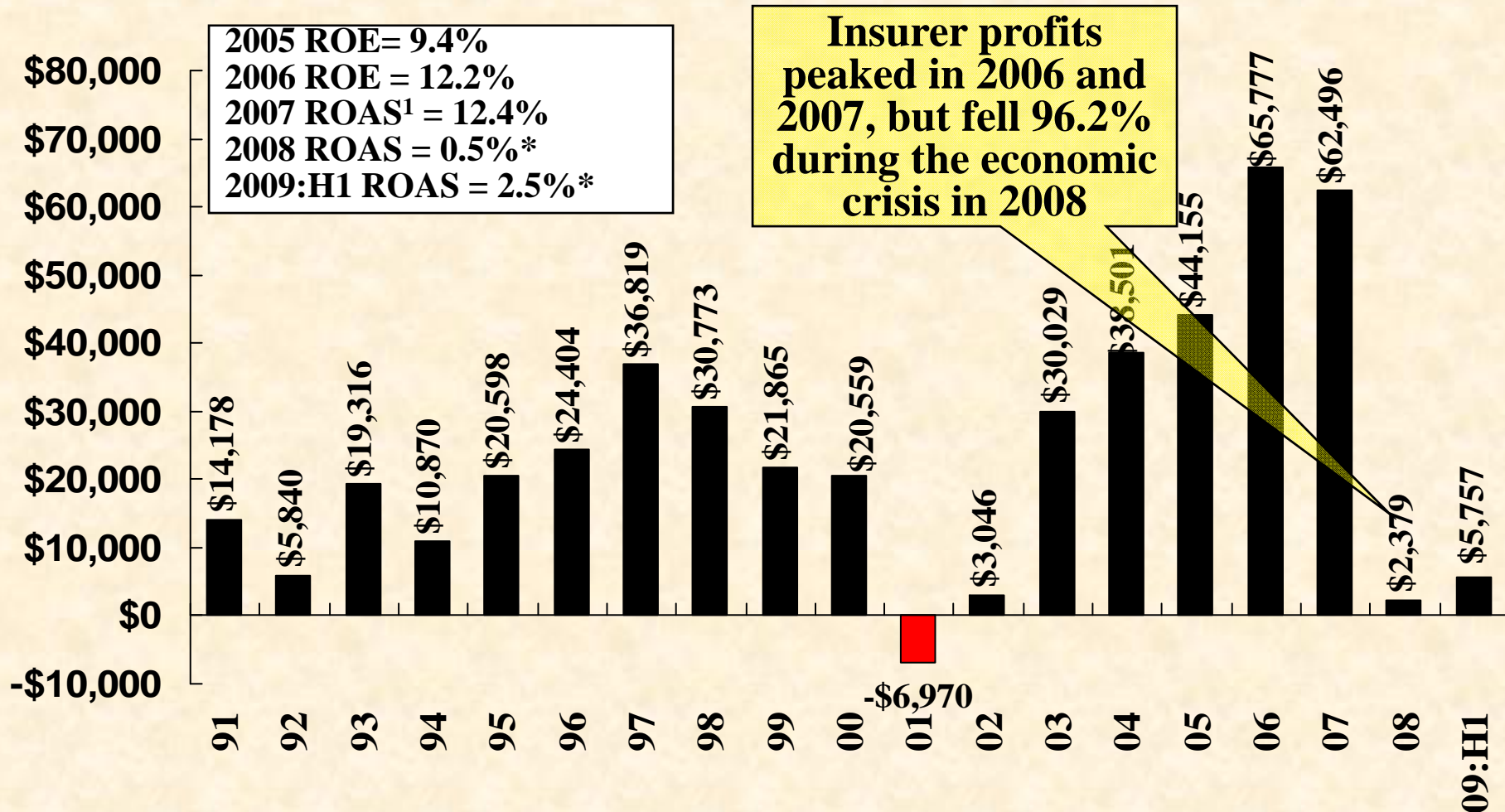
Profitability

Historically Volatile





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

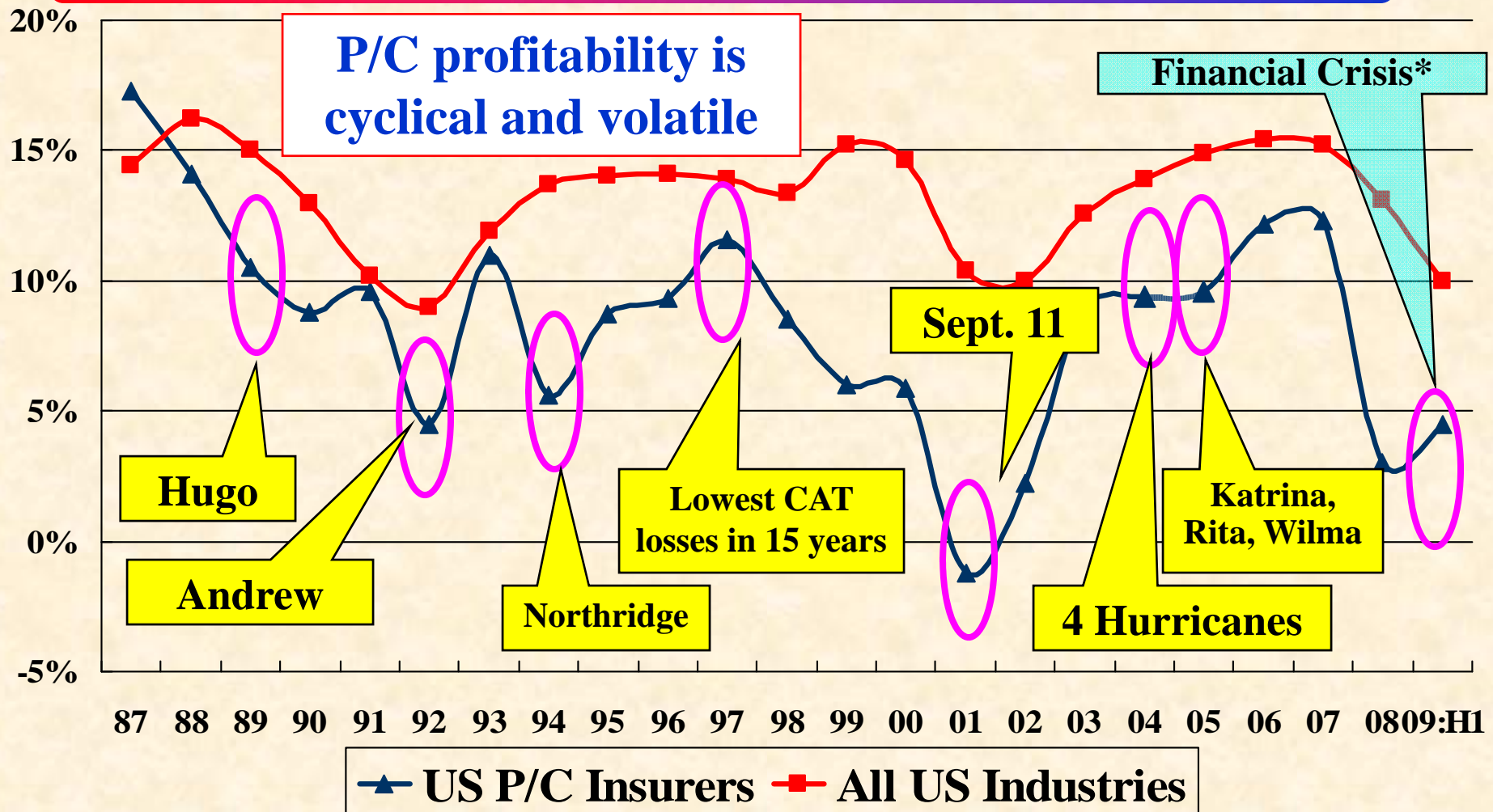


*ROE figures are GAAP; ¹Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields an 4.5% ROAS for 2008 and 2.2%. 2009:Q1 net income was \$10.0 billion excl. M&FG.



ROE: P/C vs. All Industries

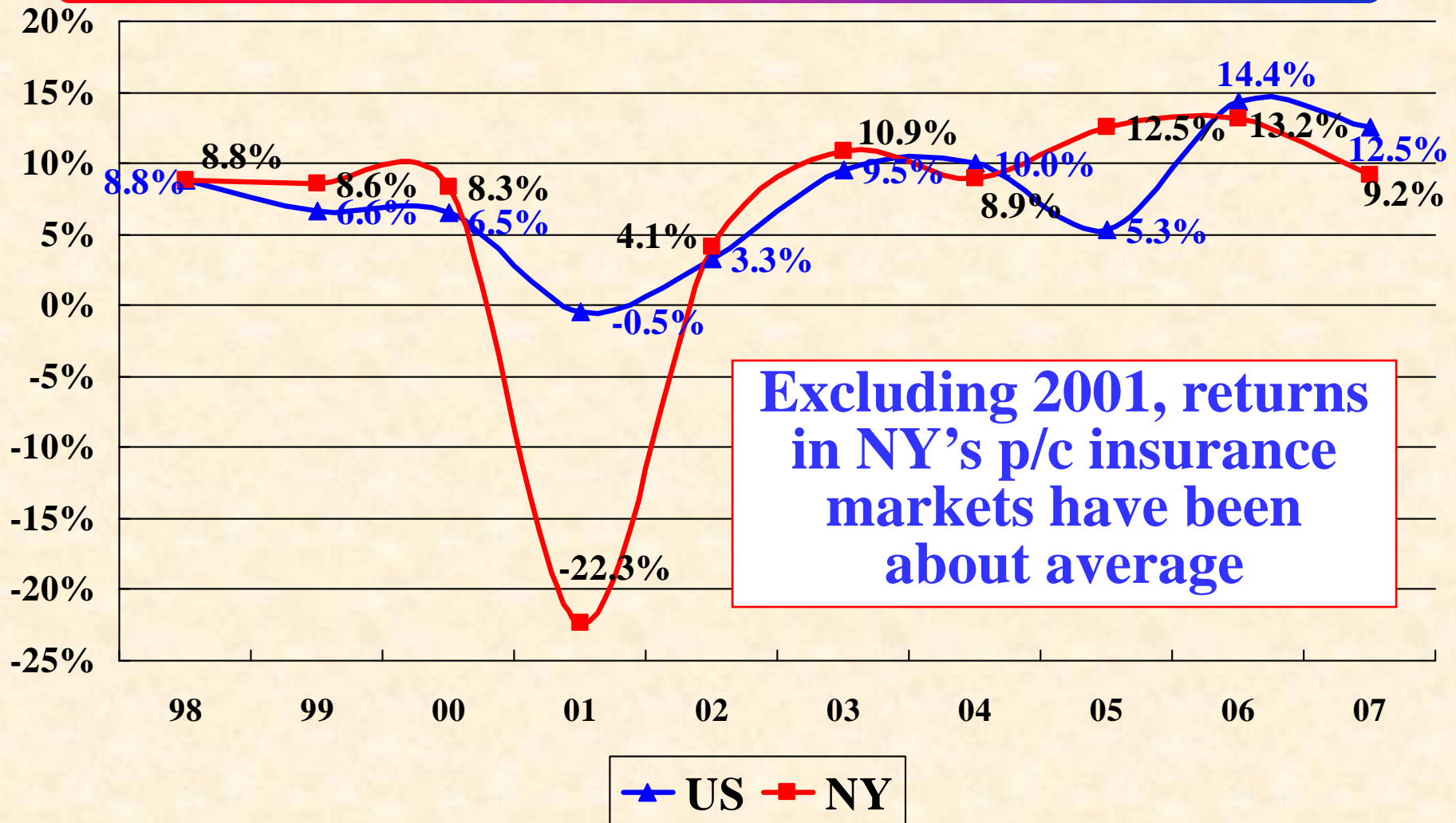
*1987–2009: H1**



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

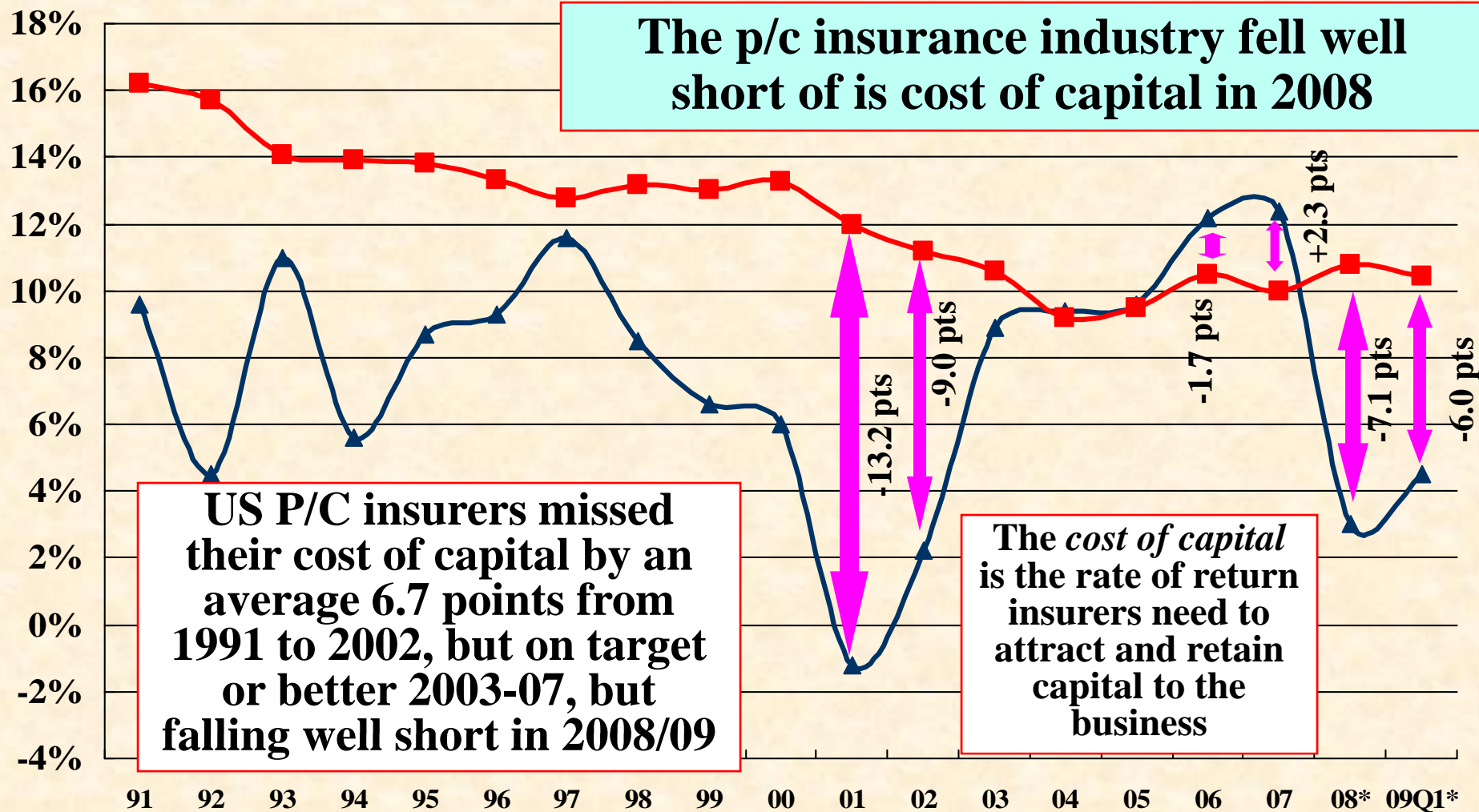


*Rates of Return on Net Worth for All Lines: US vs. NY, 1998–2007**



ROE vs. Equity Cost of Capital:

US P/C Insurance: 1991-2009:H1*

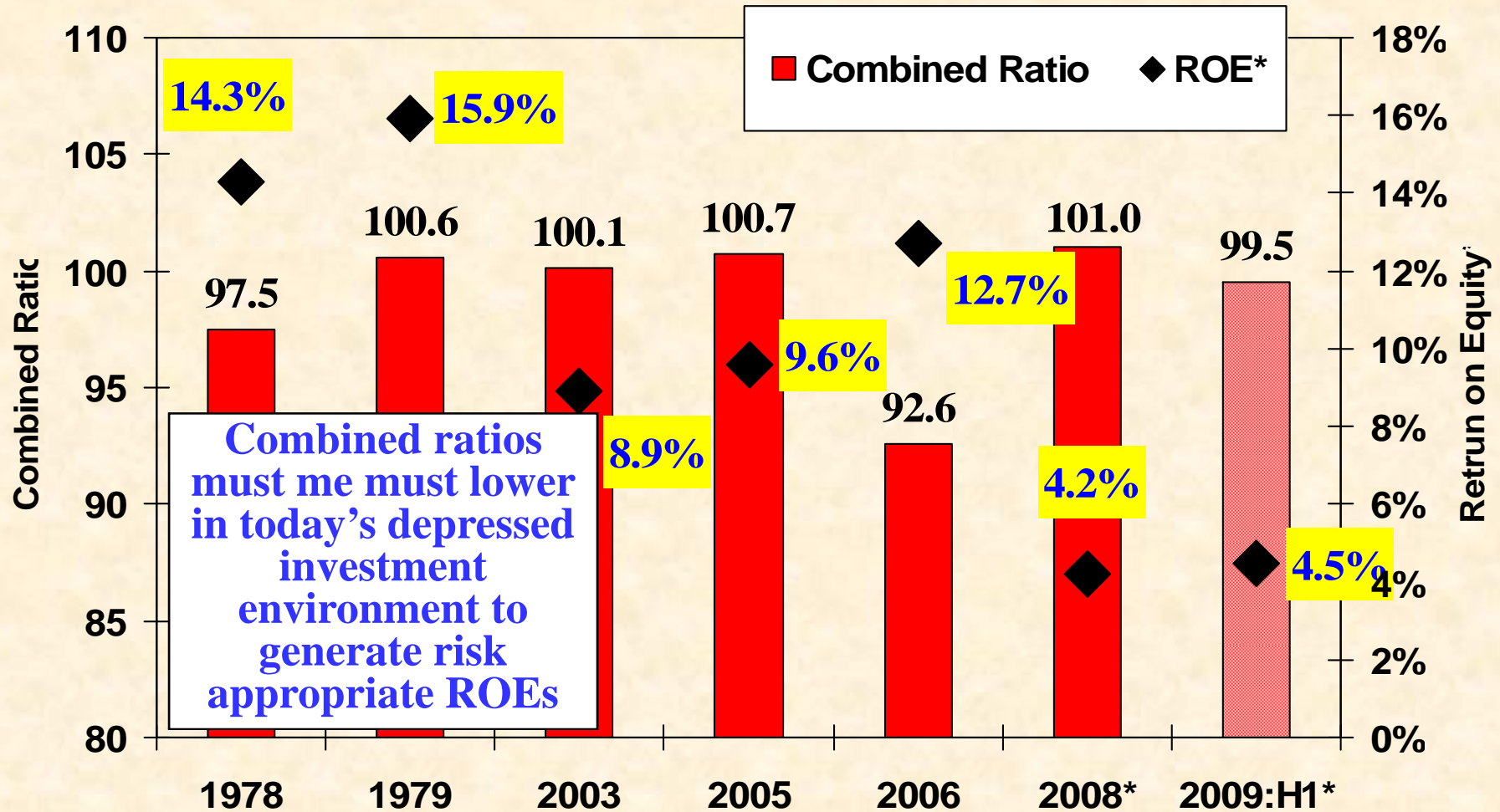


*Excludes mortgage and financial guarantee insurers.
Source: The Geneva Association, Ins. Information Inst.

—▲— ROE —■— Cost of Capital



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



* 2008/9 figures are return on average statutory surplus. Excludes mortgage and financial guarantee insurers.

Source: Insurance Information Institute from A.M. Best and ISO data.

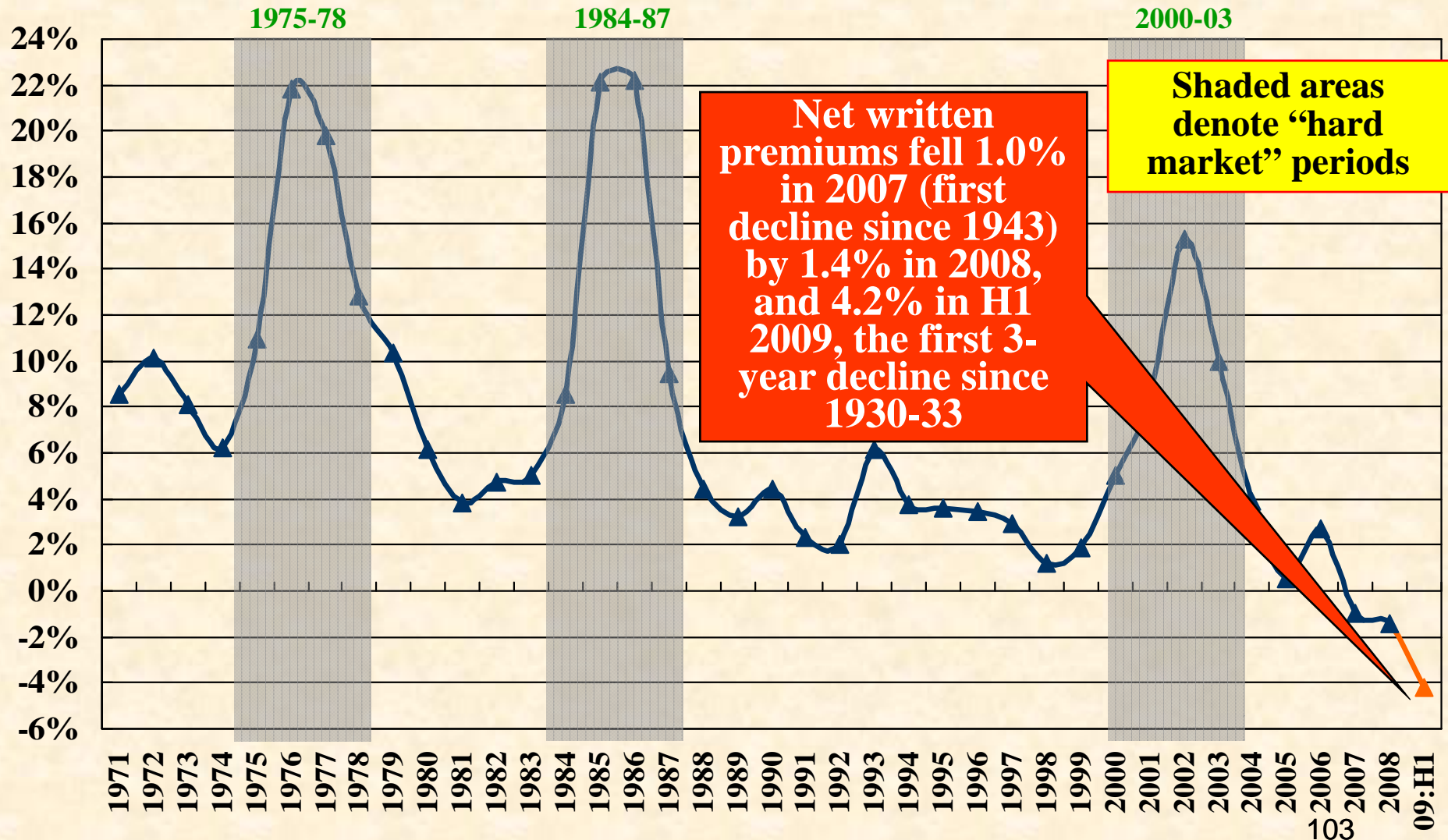
P/C Premium Growth

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





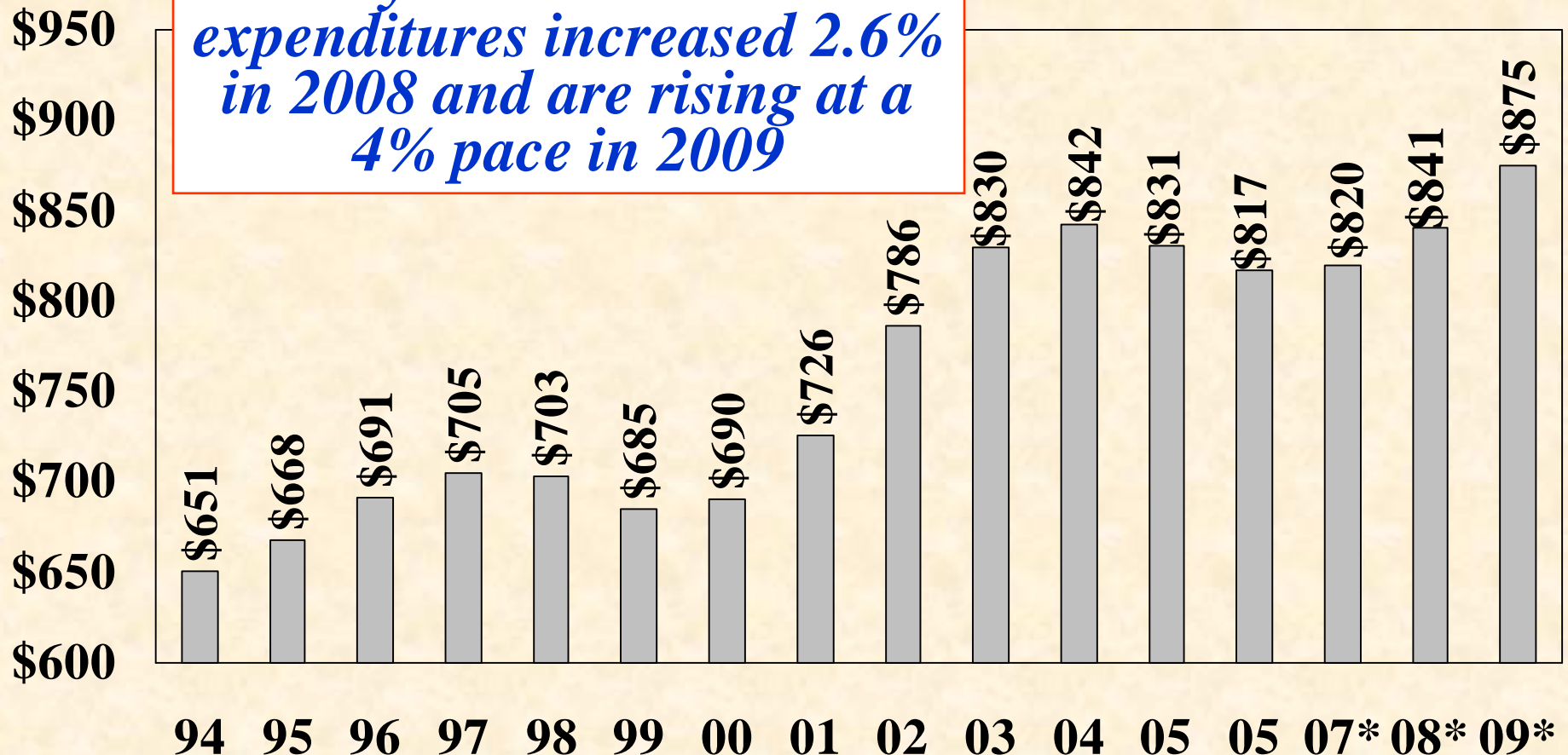
Strength of Recent Hard Markets by NWP Growth





Average Expenditures on Auto Insurance

Countrywide auto insurance expenditures increased 2.6% in 2008 and are rising at a 4% pace in 2009

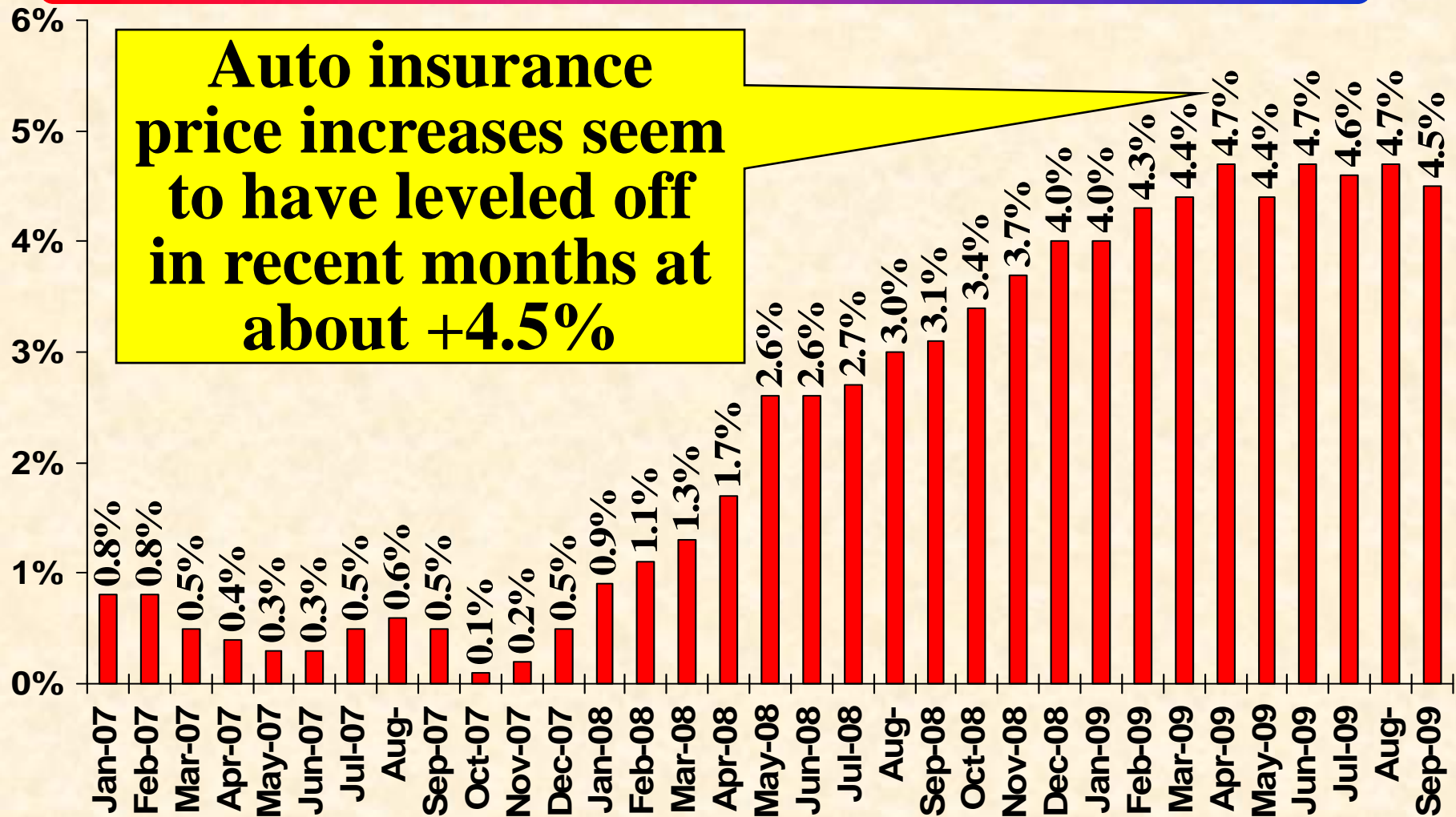


*Insurance Information Institute Estimates/Forecasts

Source: NAIC, Insurance Information Institute estimates 2007-2009 based on CPI data.



Monthly Change in Auto Insurance Prices*



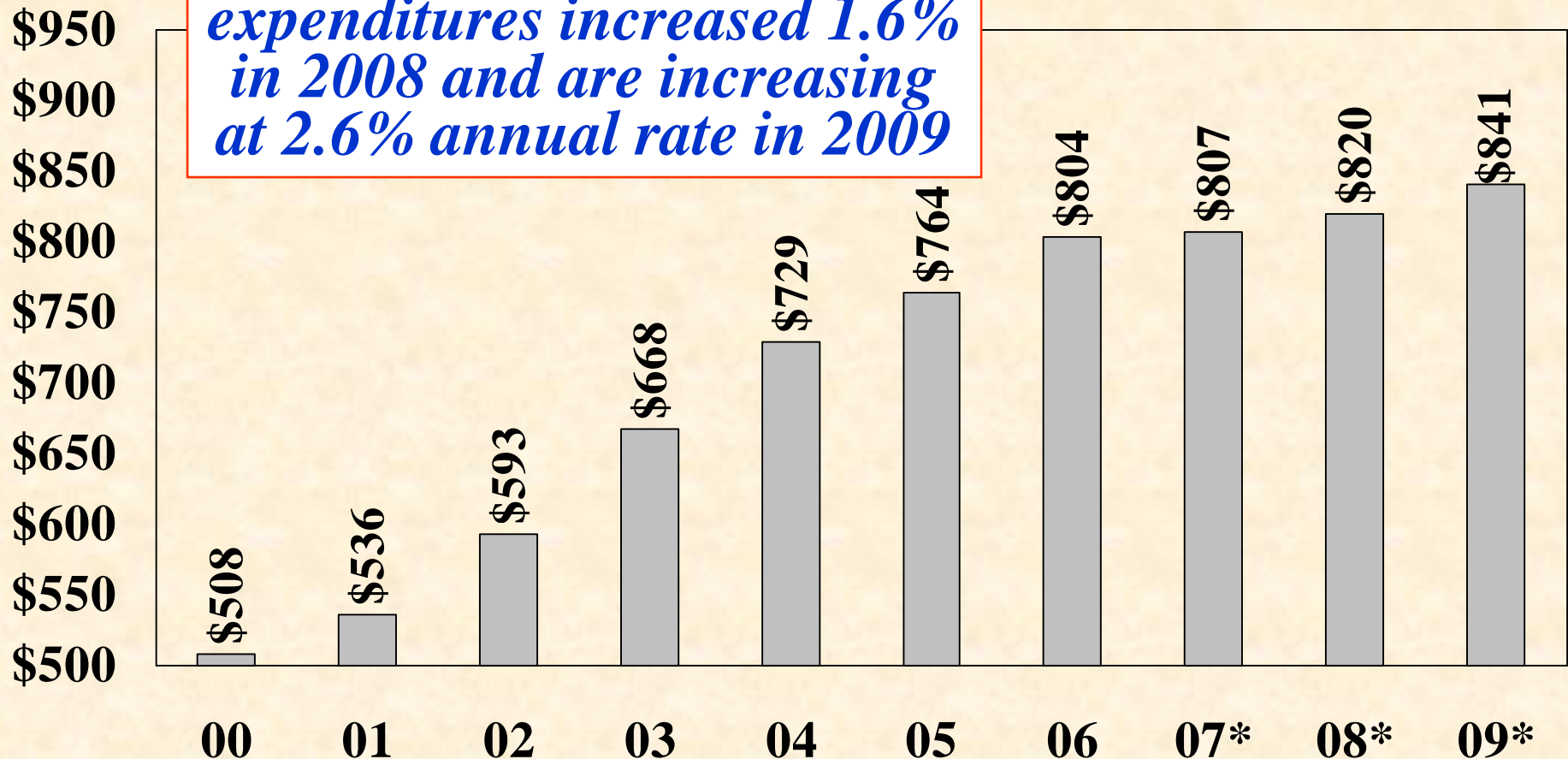
*Percentage change from same month in prior year.

Source: US Bureau of Labor Statistics



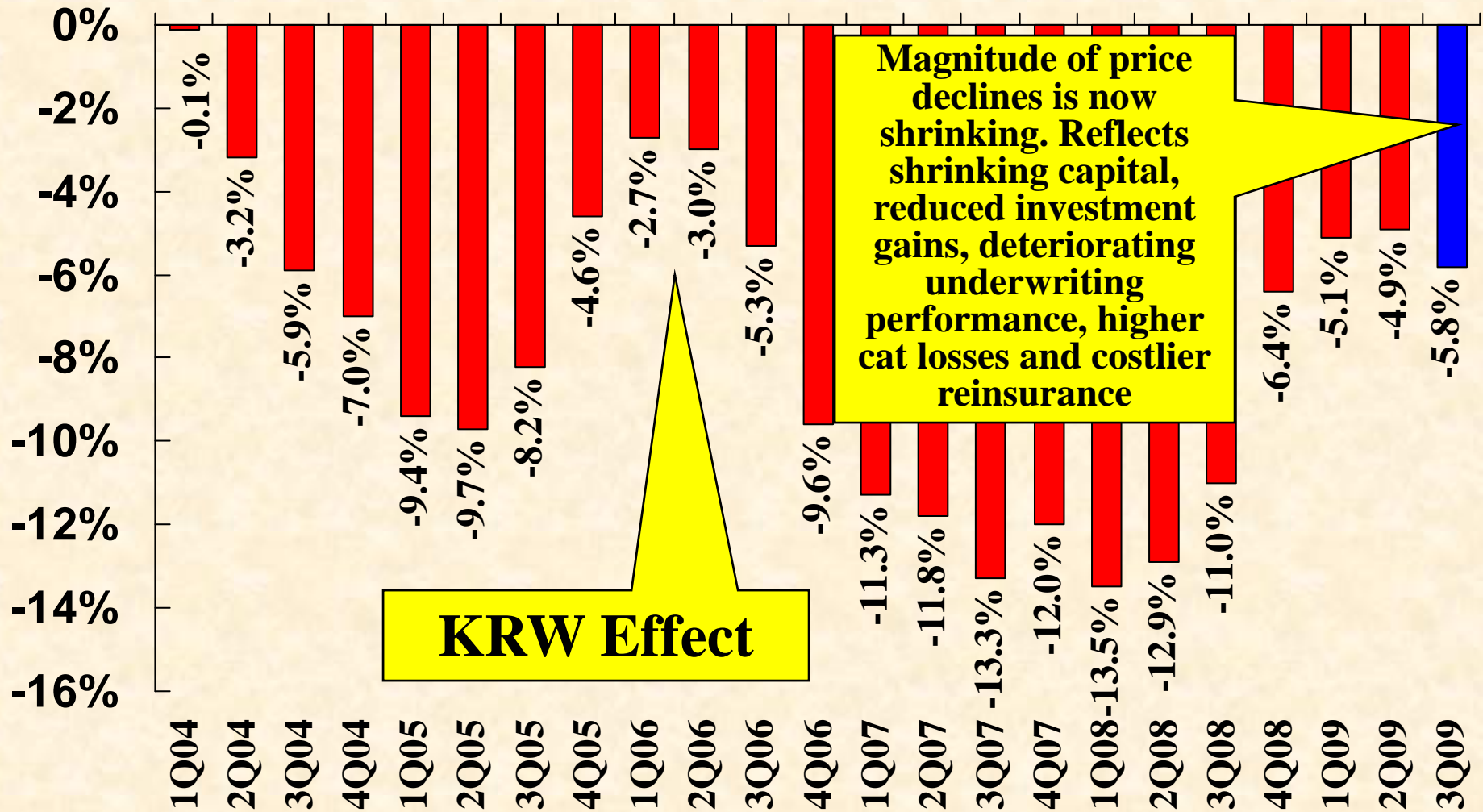
Average Premium for Home Insurance Policies**

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





Average Commercial Rate Change, All Lines, (1Q:2004 – 3Q:2009)



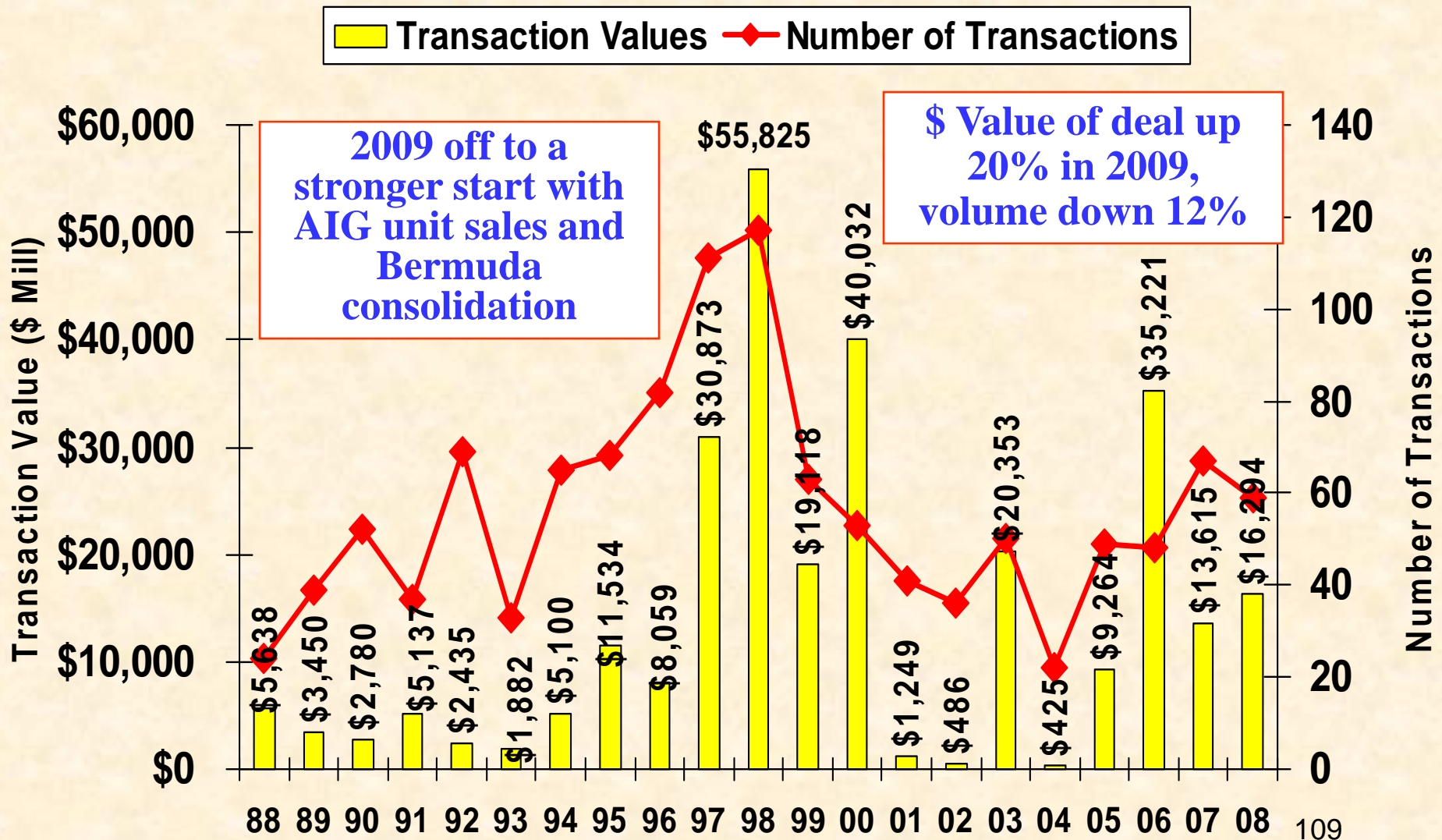
Merger & Acquisition

**Barriers to Consolidation
Will Diminish in 2010**





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



Capital/ Policyholder Surplus (US)

Shrinkage, but
Not Enough to
!!! Trigger Hard Market

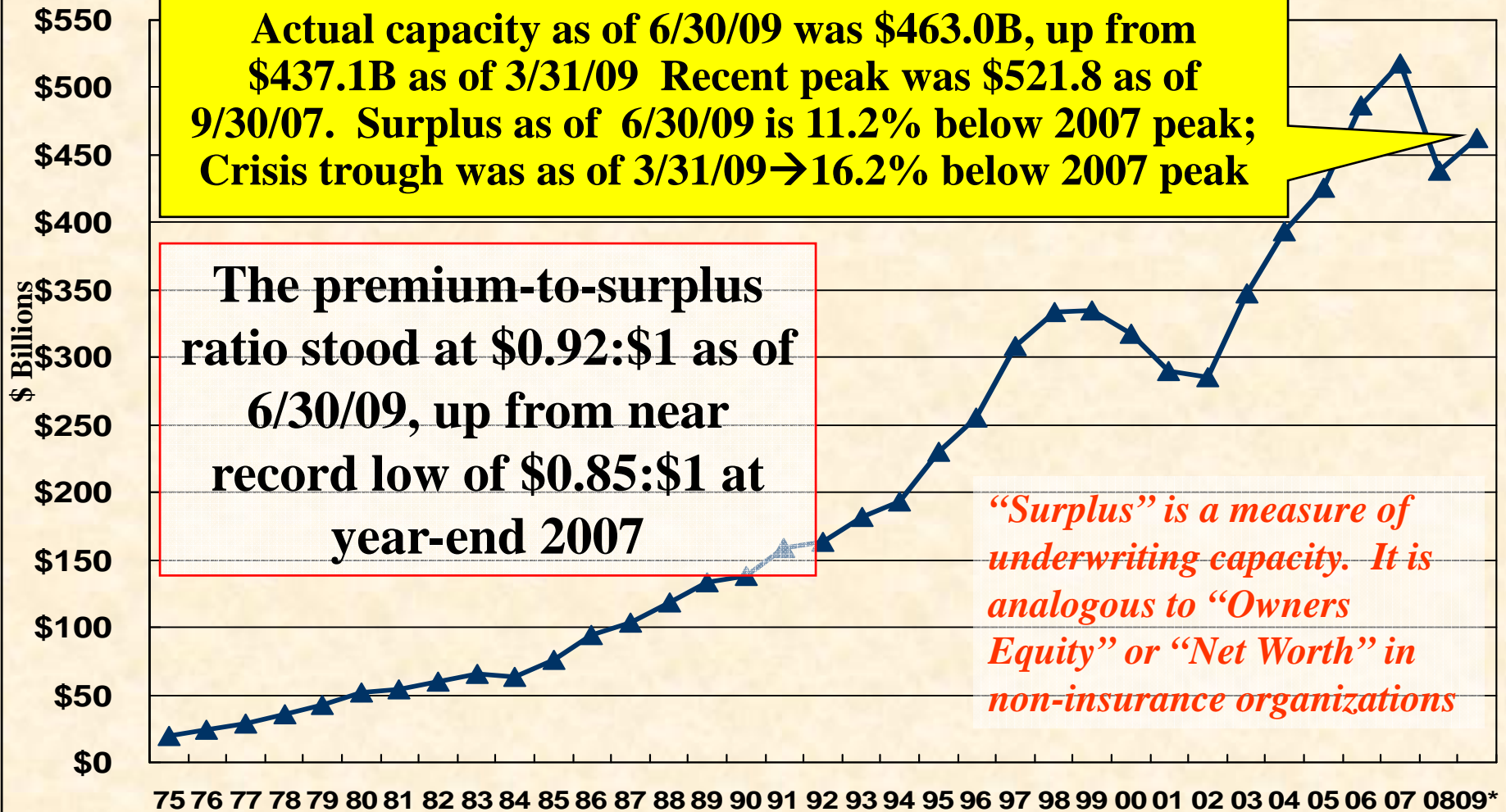


*U.S. Policyholder Surplus: 1975-2009:H1**

Actual capacity as of 6/30/09 was \$463.0B, up from \$437.1B as of 3/31/09. Recent peak was \$521.8 as of 9/30/07. Surplus as of 6/30/09 is 11.2% below 2007 peak; Crisis trough was as of 3/31/09→16.2% below 2007 peak

The premium-to-surplus ratio stood at \$0.92:\$1 as of 6/30/09, up from near record low of \$0.85:\$1 at year-end 2007

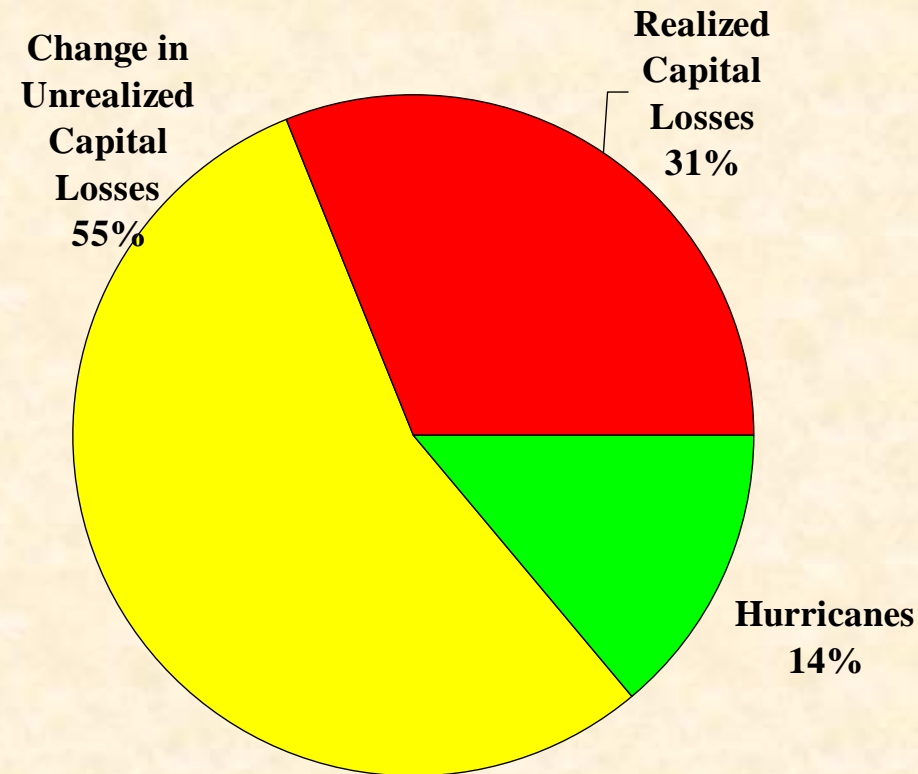
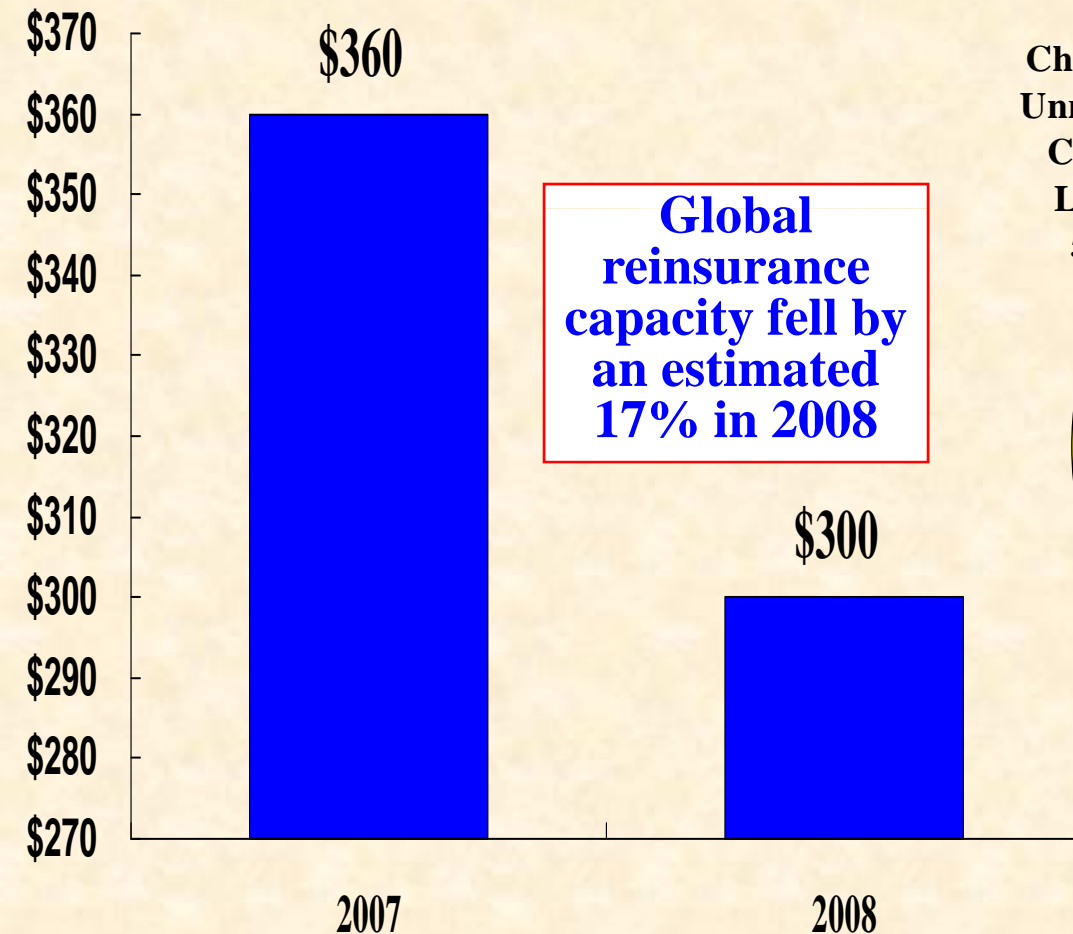
“Surplus” is a measure of underwriting capacity. It is analogous to “Owners Equity” or “Net Worth” in non-insurance organizations



Global Reinsurance Capacity Shrank in 2008, Mostly Due to Investments

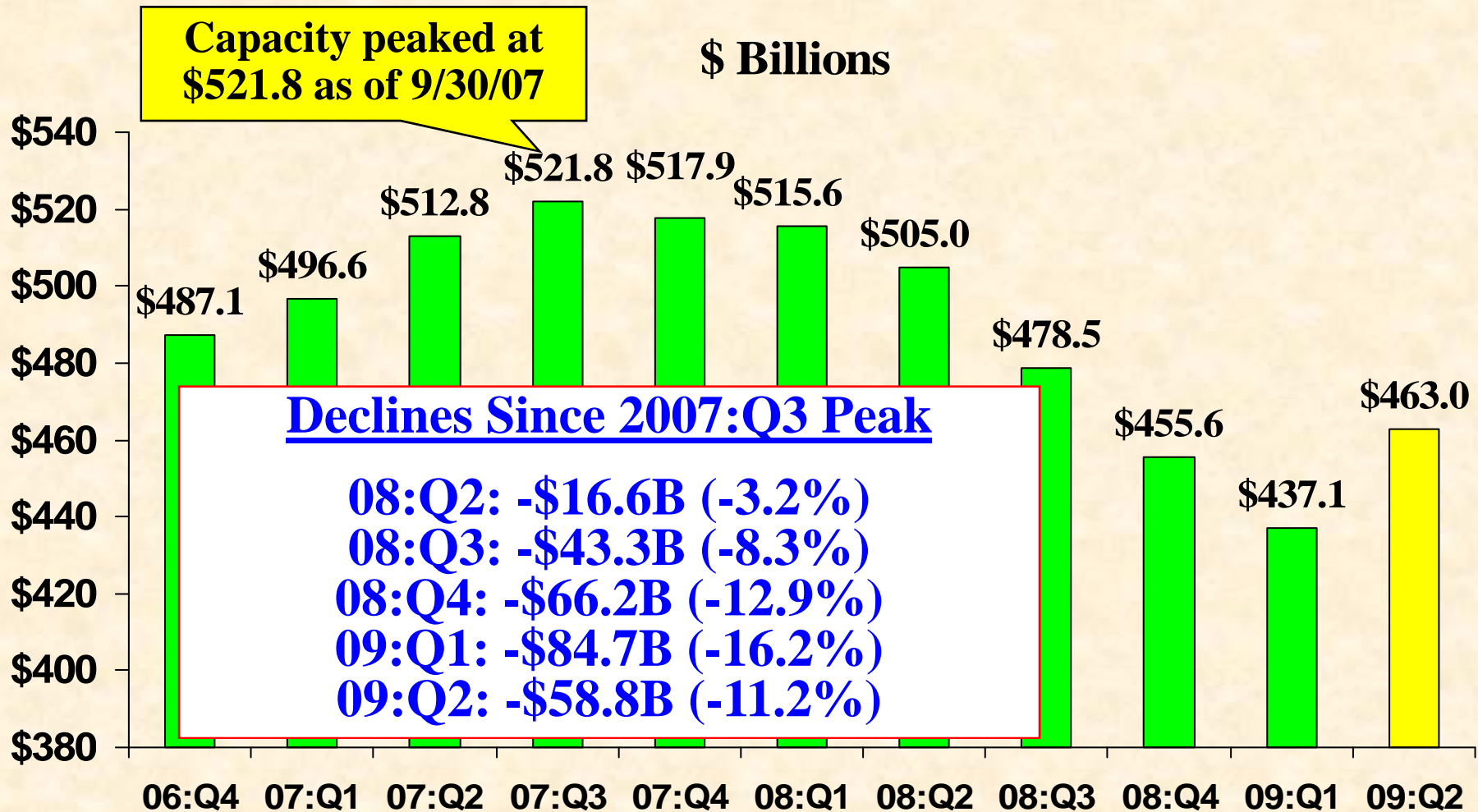
Global Reinsurance Capacity

Source of Decline



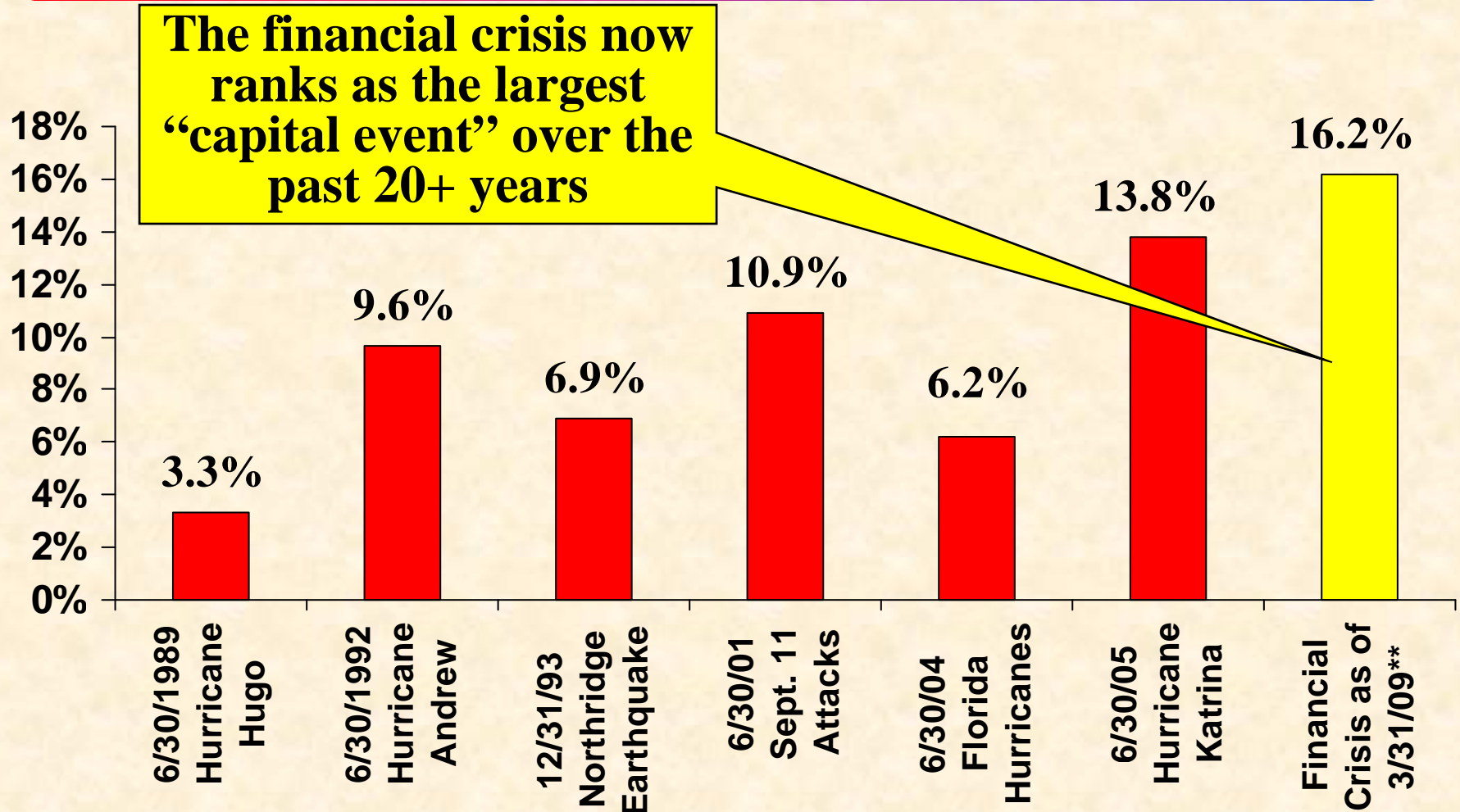


Policyholder Surplus, 2006:Q4 – 2009:H1





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

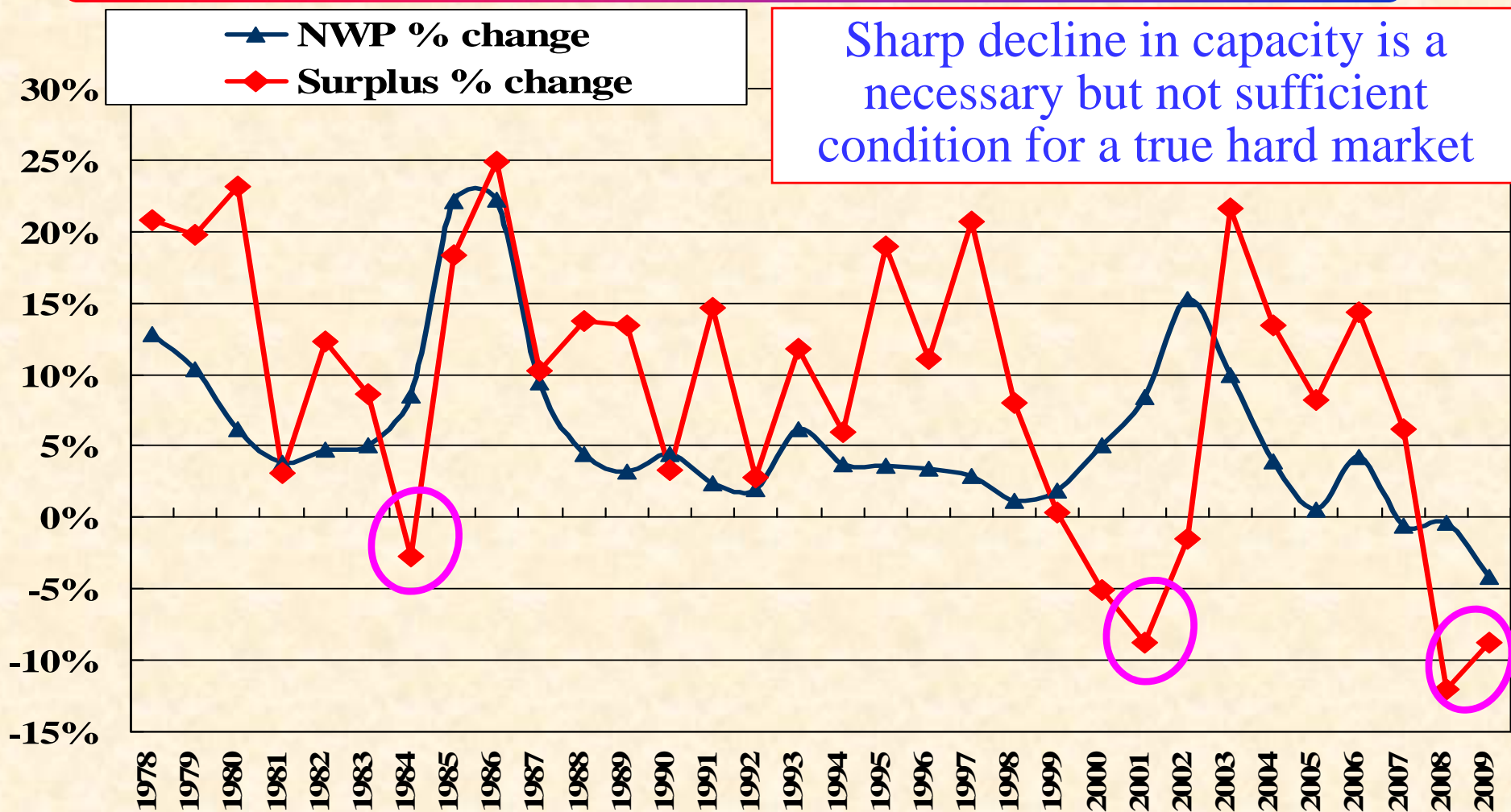


*Ratio is for end-of-quarter surplus immediately prior to event. Date shown is end of quarter prior to event.

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



*Historically, Hard Markets Follow When Surplus “Growth” is Negative**



*2009 NWP and Surplus figures are % changes for H1:09 vs H1:08

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

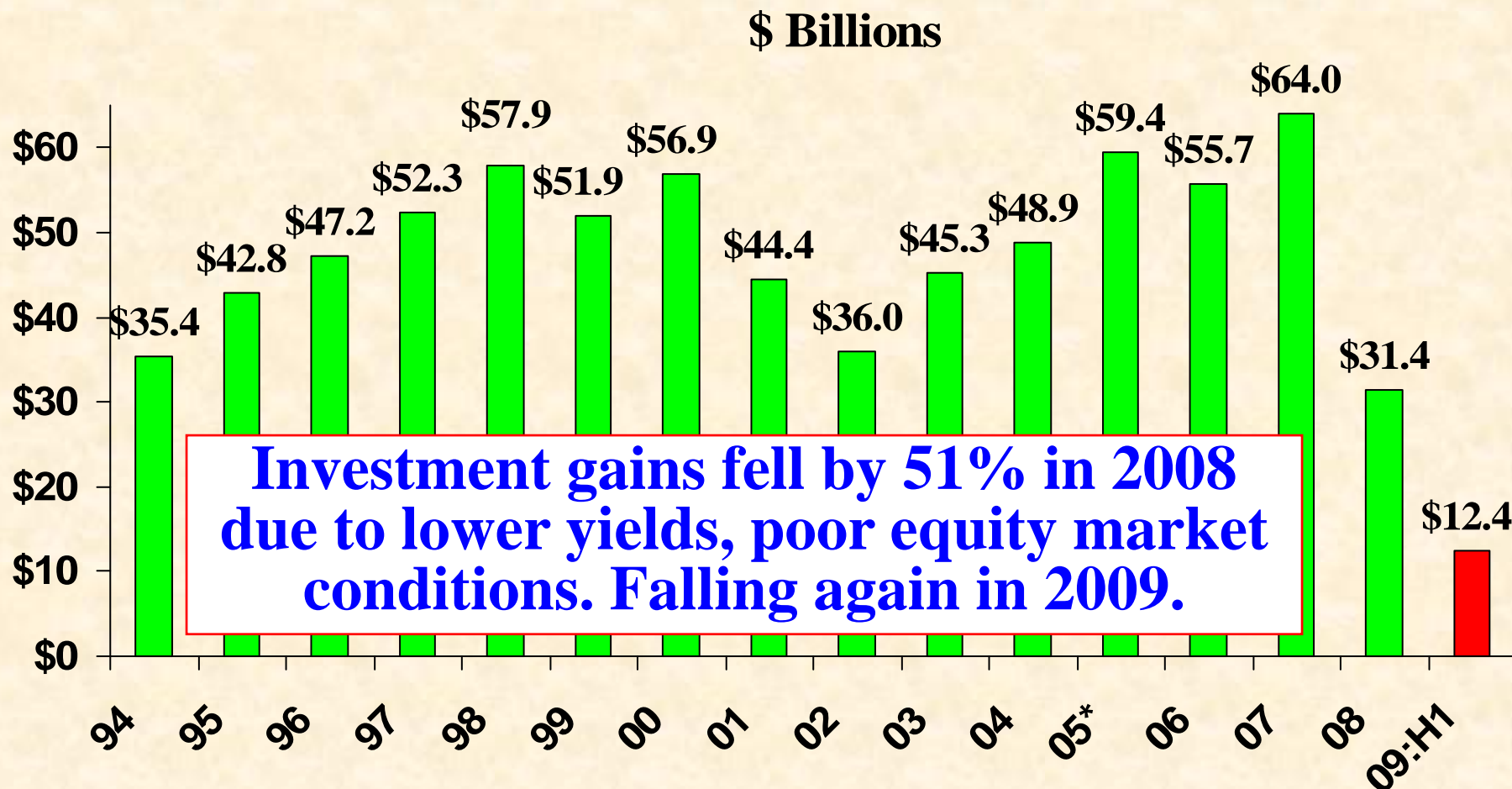
Investment Performance

*Investments are a Principle
Source of Declining
Profitability*





Property/Casualty Insurance Industry Investment Gain: 1994- 2009:H1¹



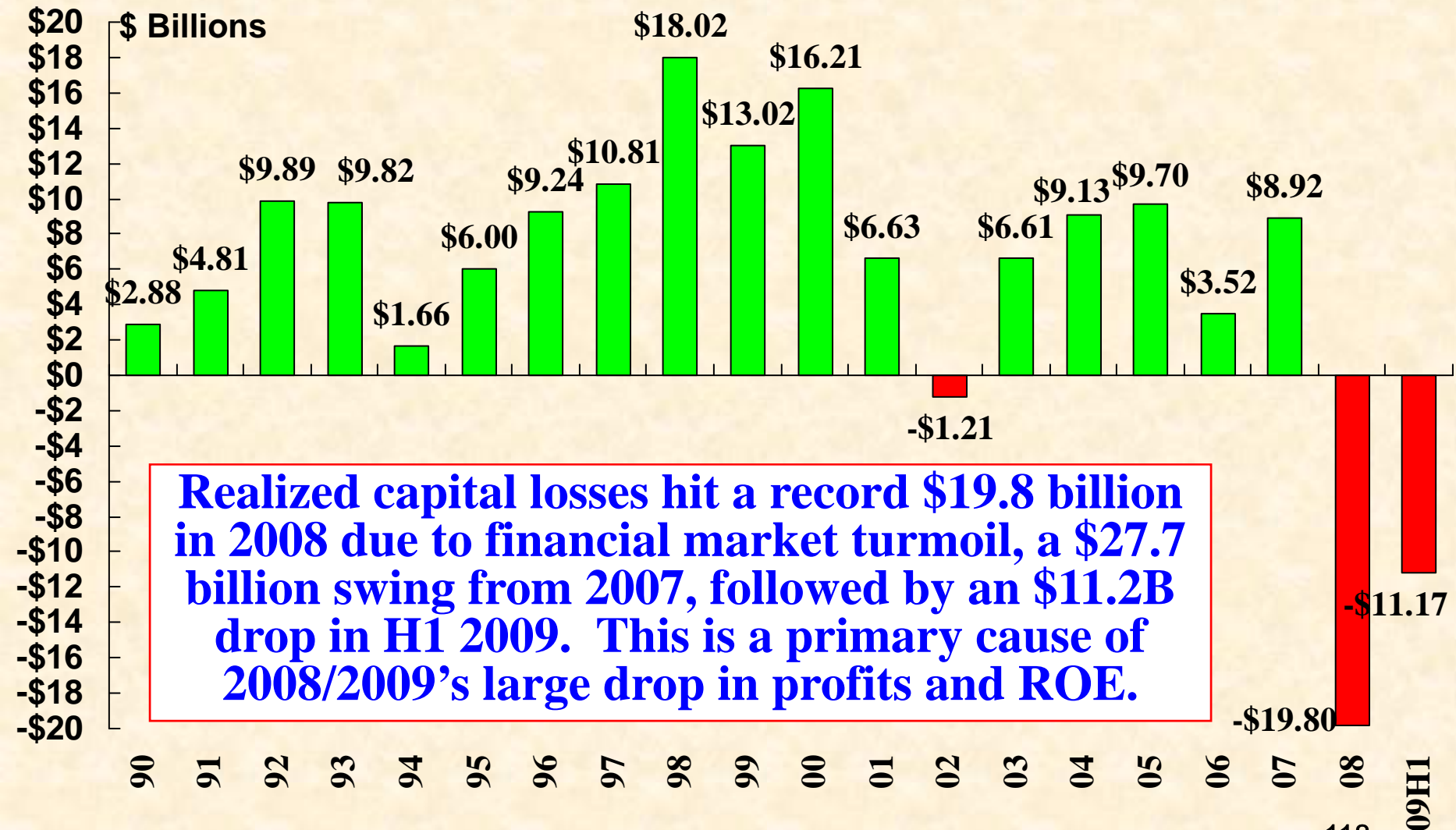
¹Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2006 figure consists of \$52.3B net investment income and \$3.4B realized investment gain.

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

Sources: ISO; Insurance Information Institute.

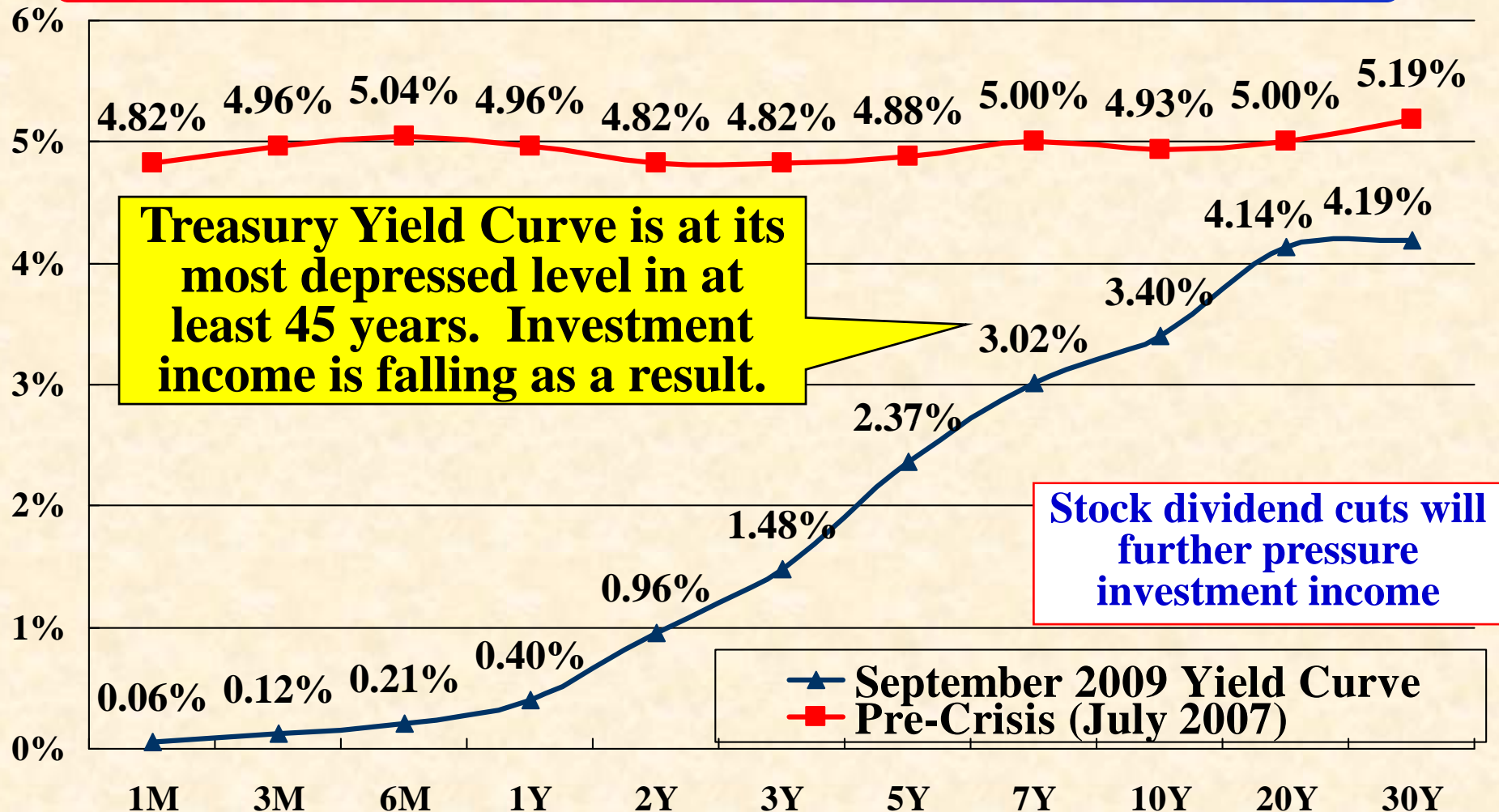


P/C Insurer Net Realized Capital Gains, 1990-2009:H1





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



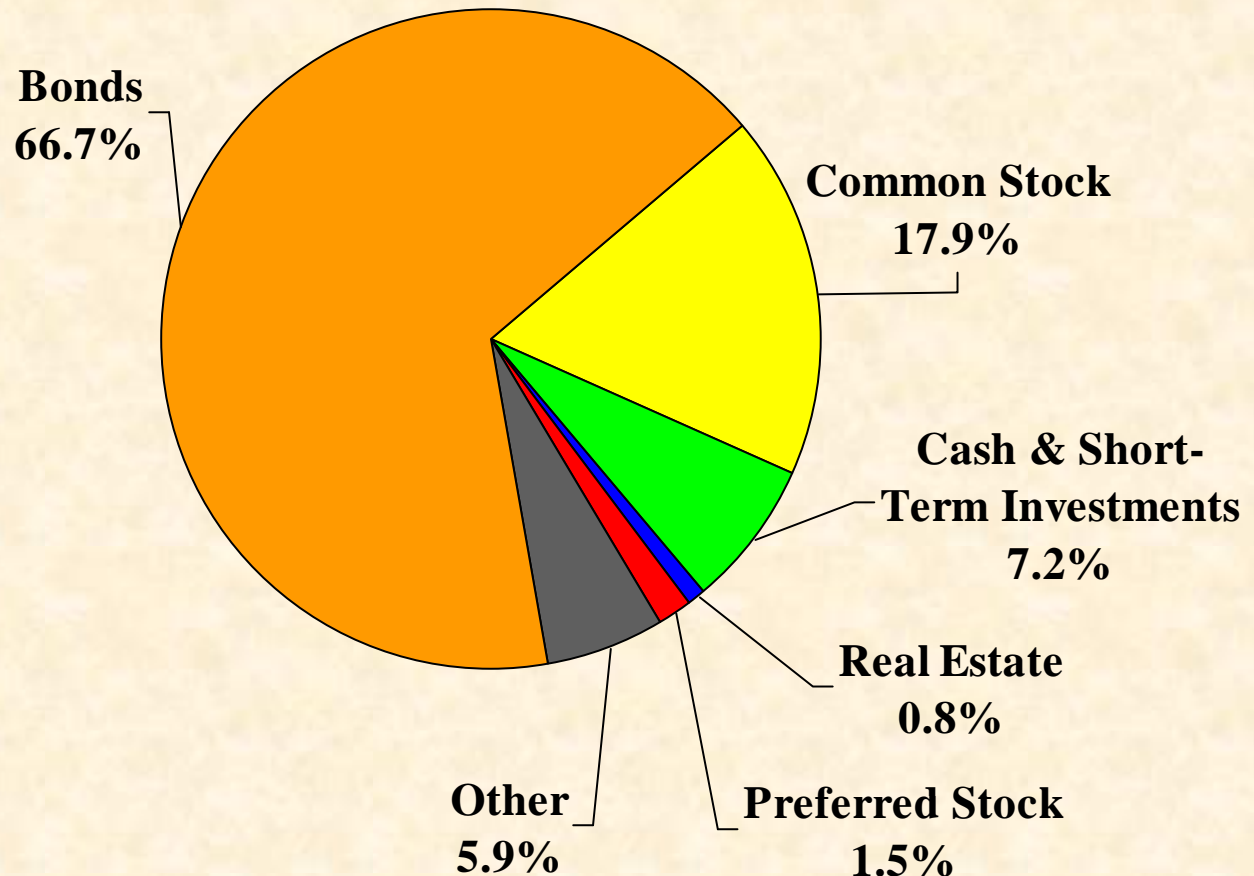


Distribution of P/C Insurance Industry's Investment Portfolio

As of December 31, 2007

Portfolio Facts

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



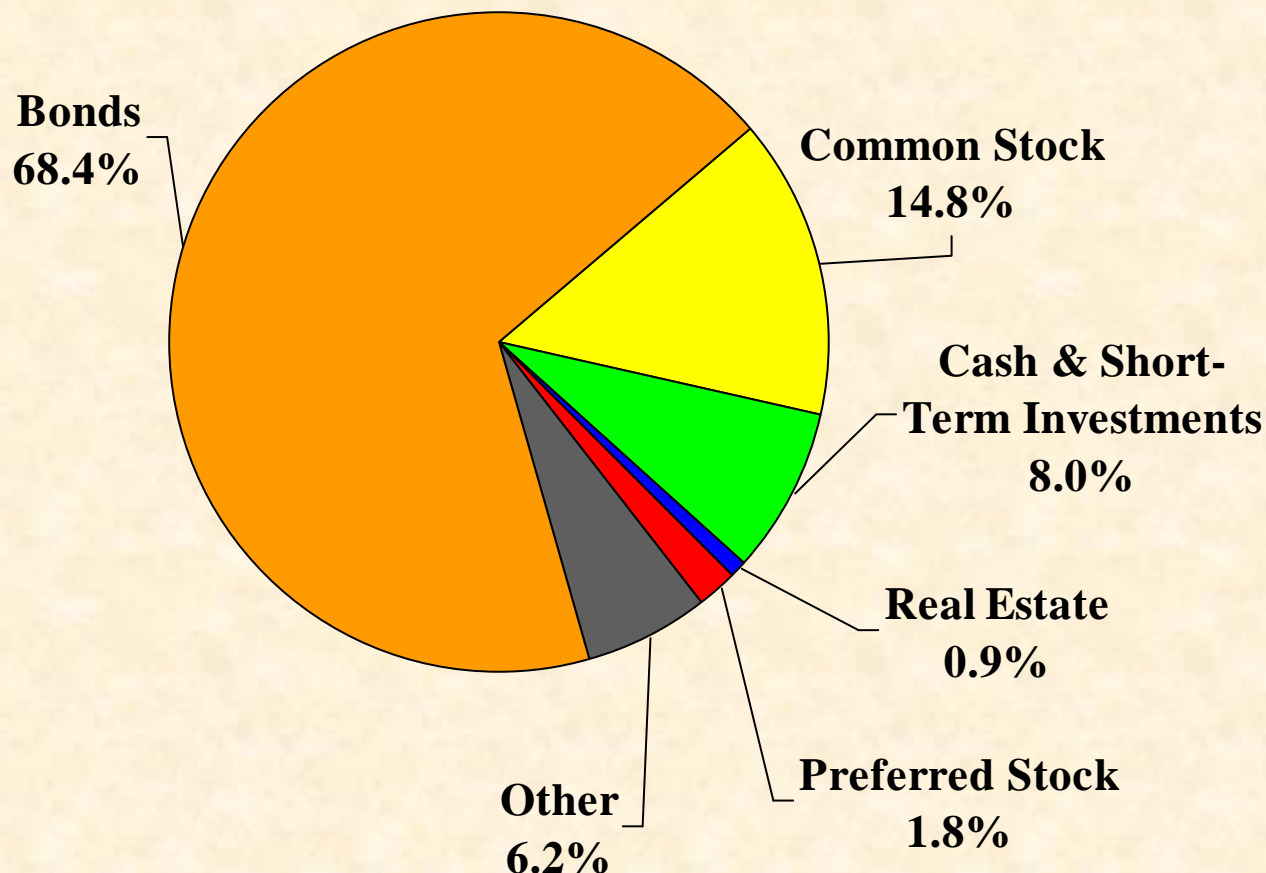


Distribution of P/C Insurance Industry's Investment Portfolio

As of December 31, 2008

Portfolio Facts

- Invested assets totaled \$1.2 trillion as of 12/31/08, down from \$1.3 trillion as of 12/31/07
- Insurers are generally conservatively invested, with 2/3+ of assets invested in bonds as of 12/31/08
- Only about 15% of assets were invested in common stock as of 12/31/08, down from 18% one year earlier
- Even the most conservative of portfolios were hit hard in 2008



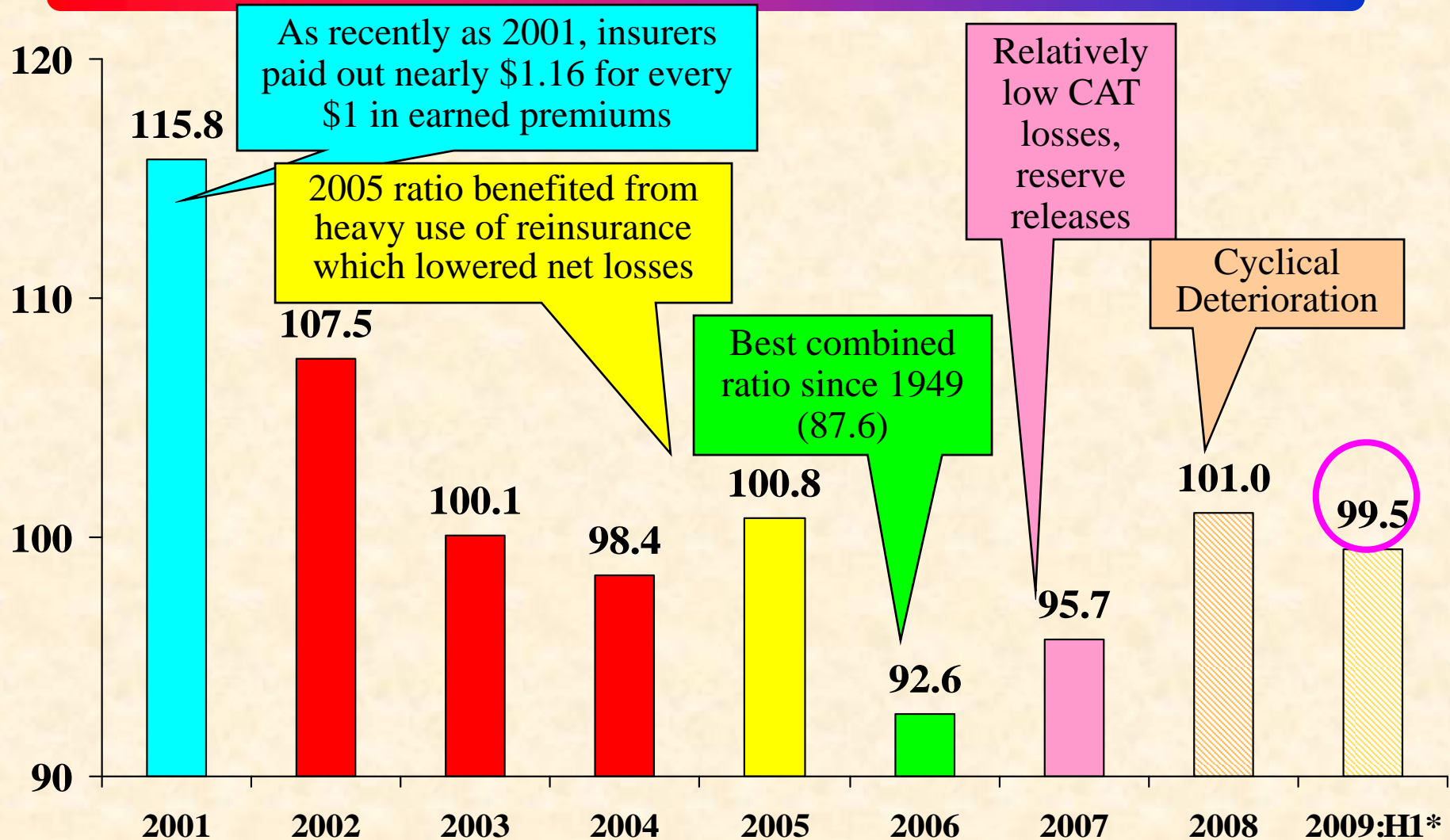
Underwriting Trends

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





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

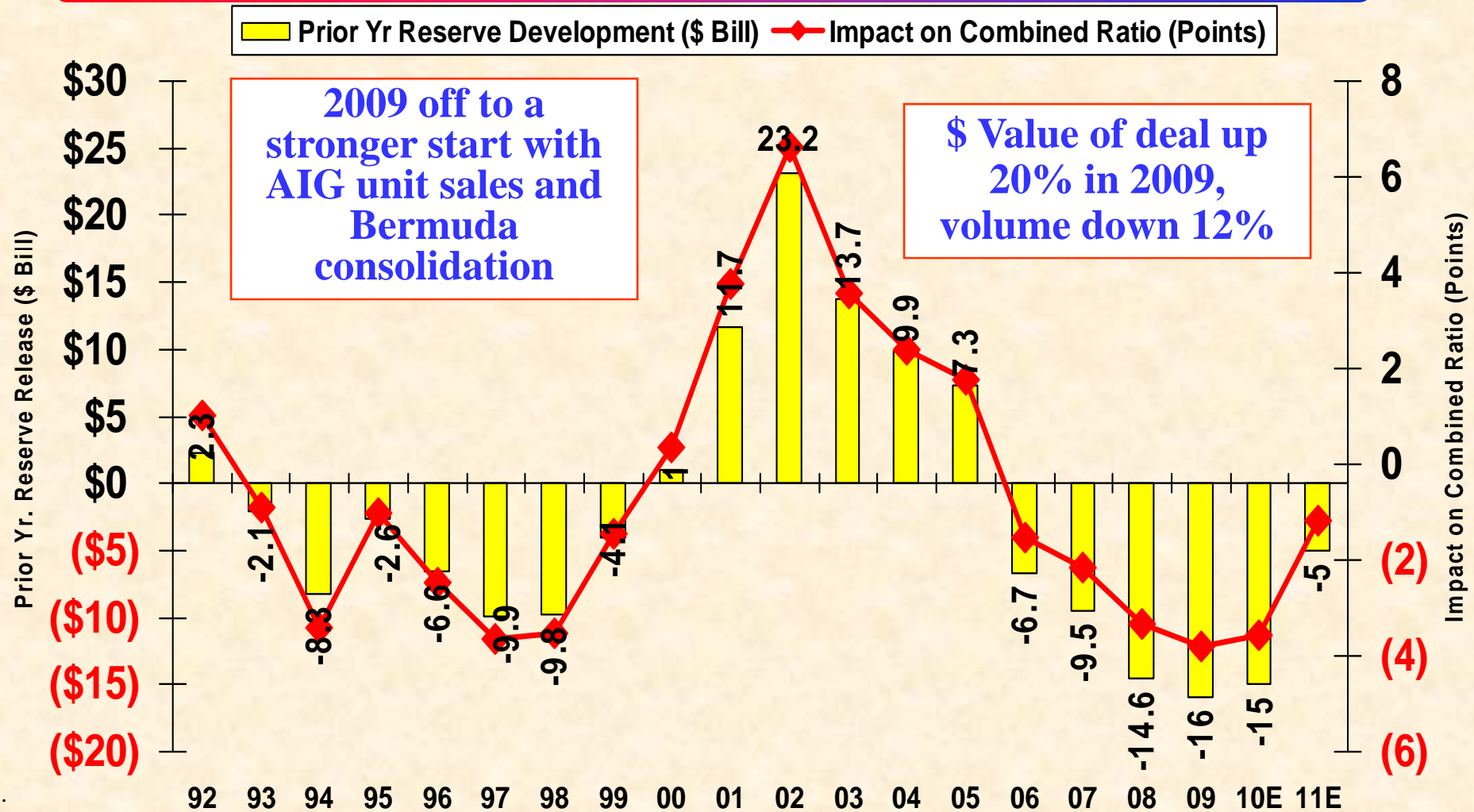


*Excludes Mortgage & Financial Guaranty insurers in 2008. Including M&FG, 2008=105.1, 2009=100.9

Sources: A.M. Best, ISO.



P/C Reserve Development, 1992-2011E

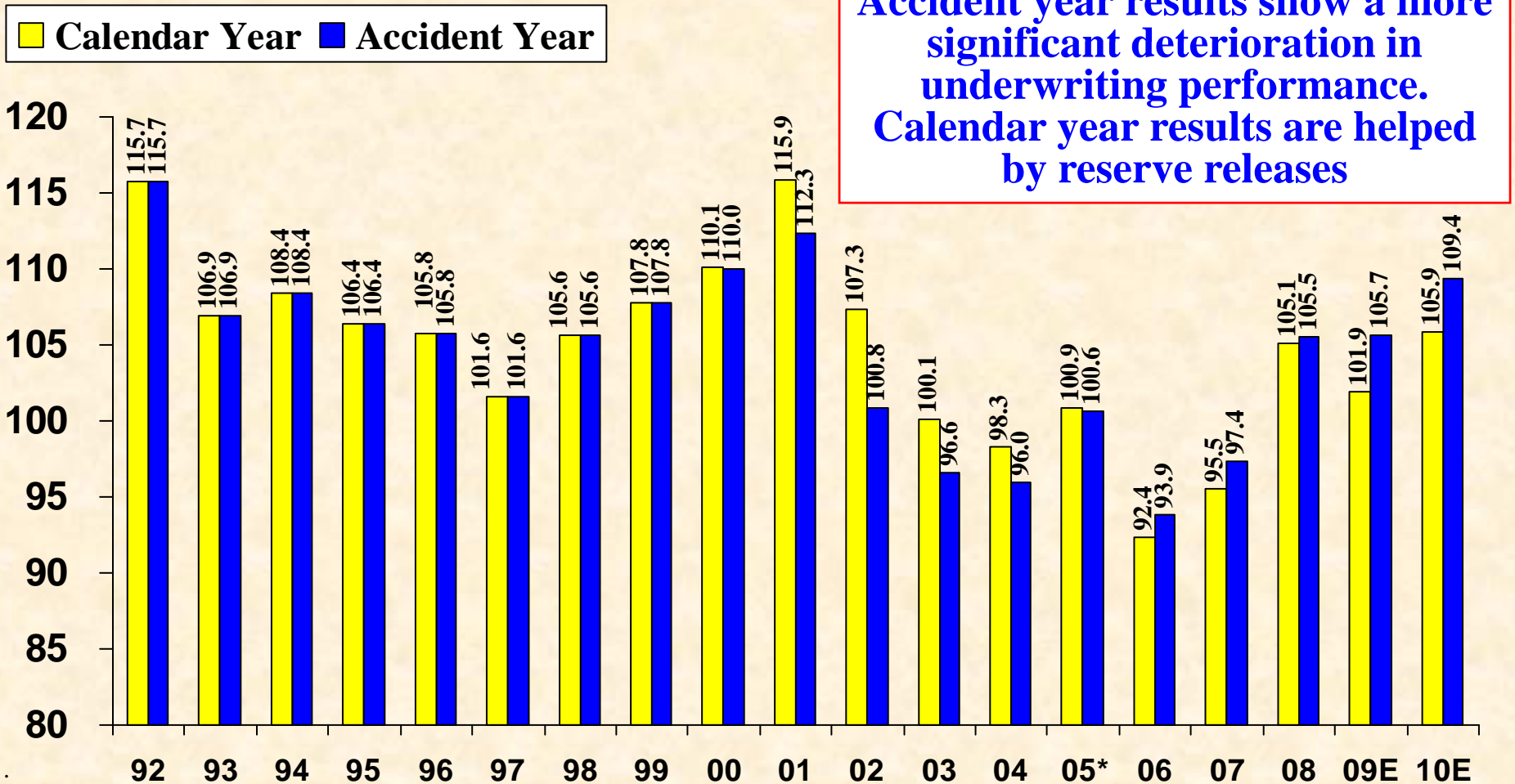


Note: 2005 reserve development excludes a \$6 billion loss portfolio transfer between American Re and Munich Re. Including this transaction, total prior year adverse development in 2005 was \$7 billion. The data from 2000 and subsequent years excludes development from financial guaranty and mortgage insurance. Source: Barclay's Capital; A.M. Best.



Calendar Year vs. Accident Year

P/C Combined Ratio: 1992- 2010E¹

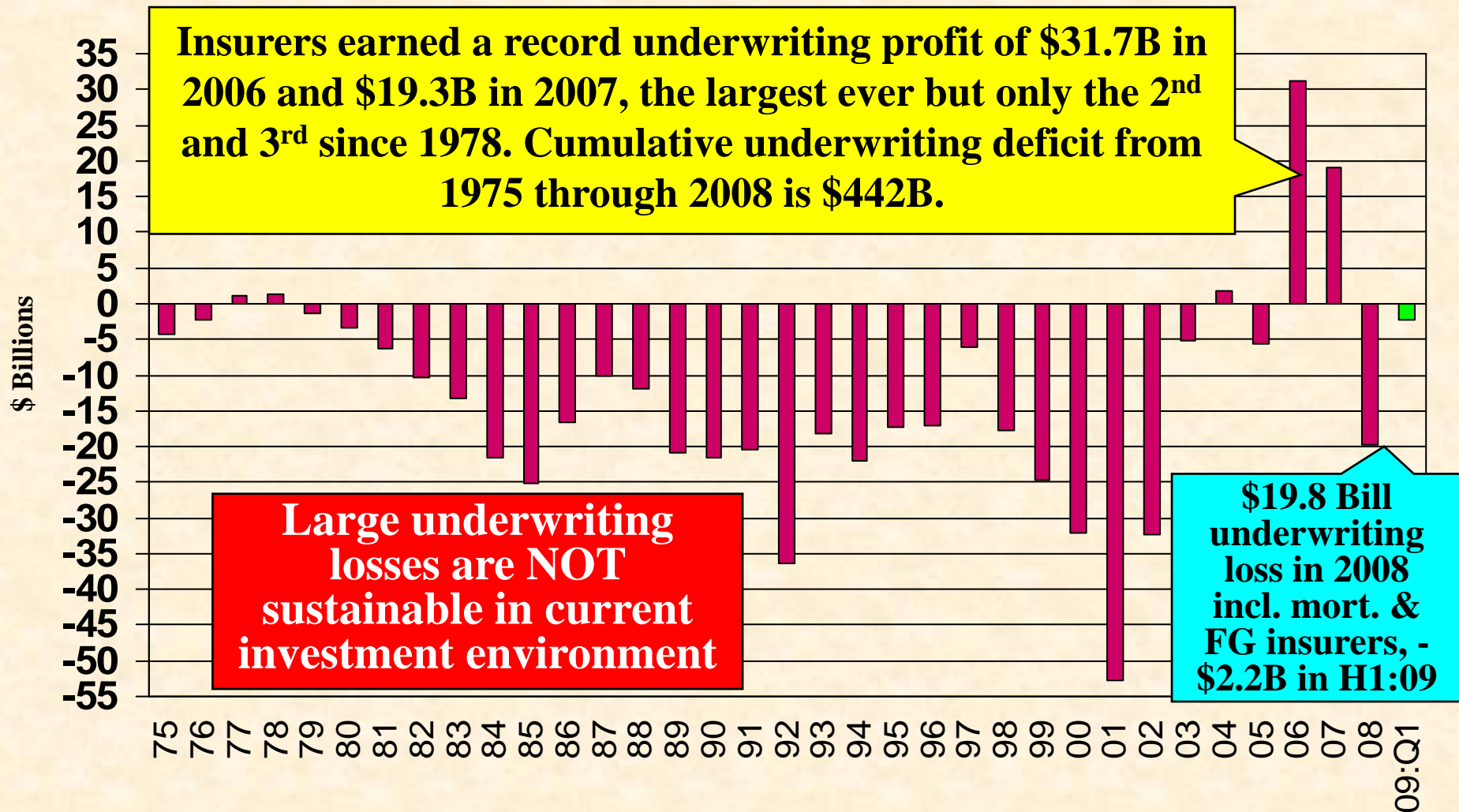


Note: 2005 reserve development excludes a \$6 billion loss portfolio transfer between American Re and Munich Re. Including this transaction, total prior year adverse development in 2005 was \$7 billion. The data from 2000 and subsequent years excludes development from financial guaranty and mortgage insurance. Source: Barclay's Capital; A.M. Best.



Underwriting Gain (Loss)

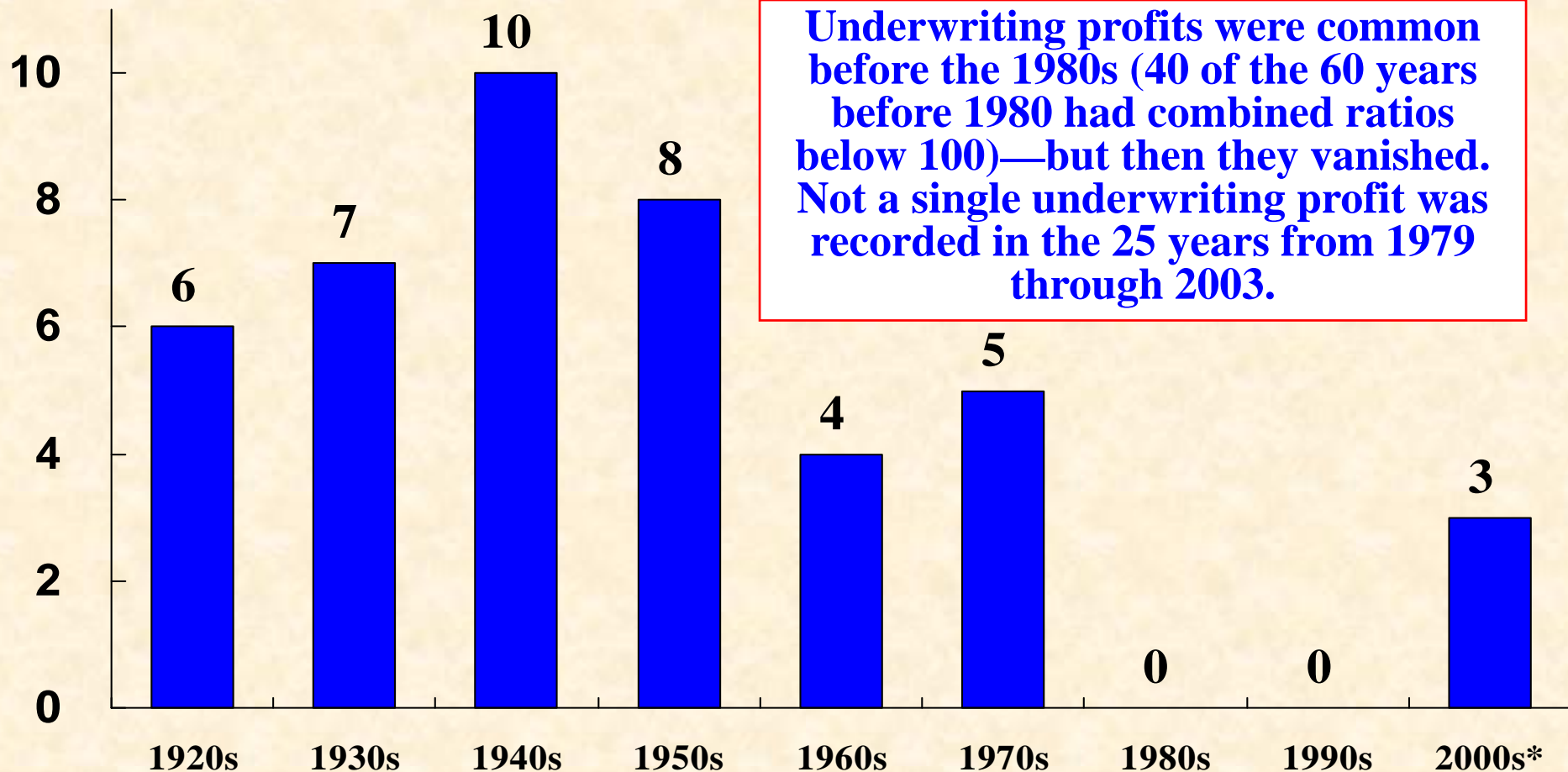
1975-2009:H1*





Number of Years With Underwriting Profits by Decade, 1920s – 2000s

Number of Years with Underwriting Profits



Underwriting profits were common before the 1980s (40 of the 60 years before 1980 had combined ratios below 100)—but then they vanished. Not a single underwriting profit was recorded in the 25 years from 1979 through 2003.

Note: Data for 1920 – 1934 based on stock companies only.

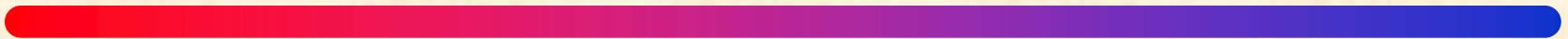
Sources: Insurance Information Institute research from A.M. Best Data.

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*2000 through 2008.

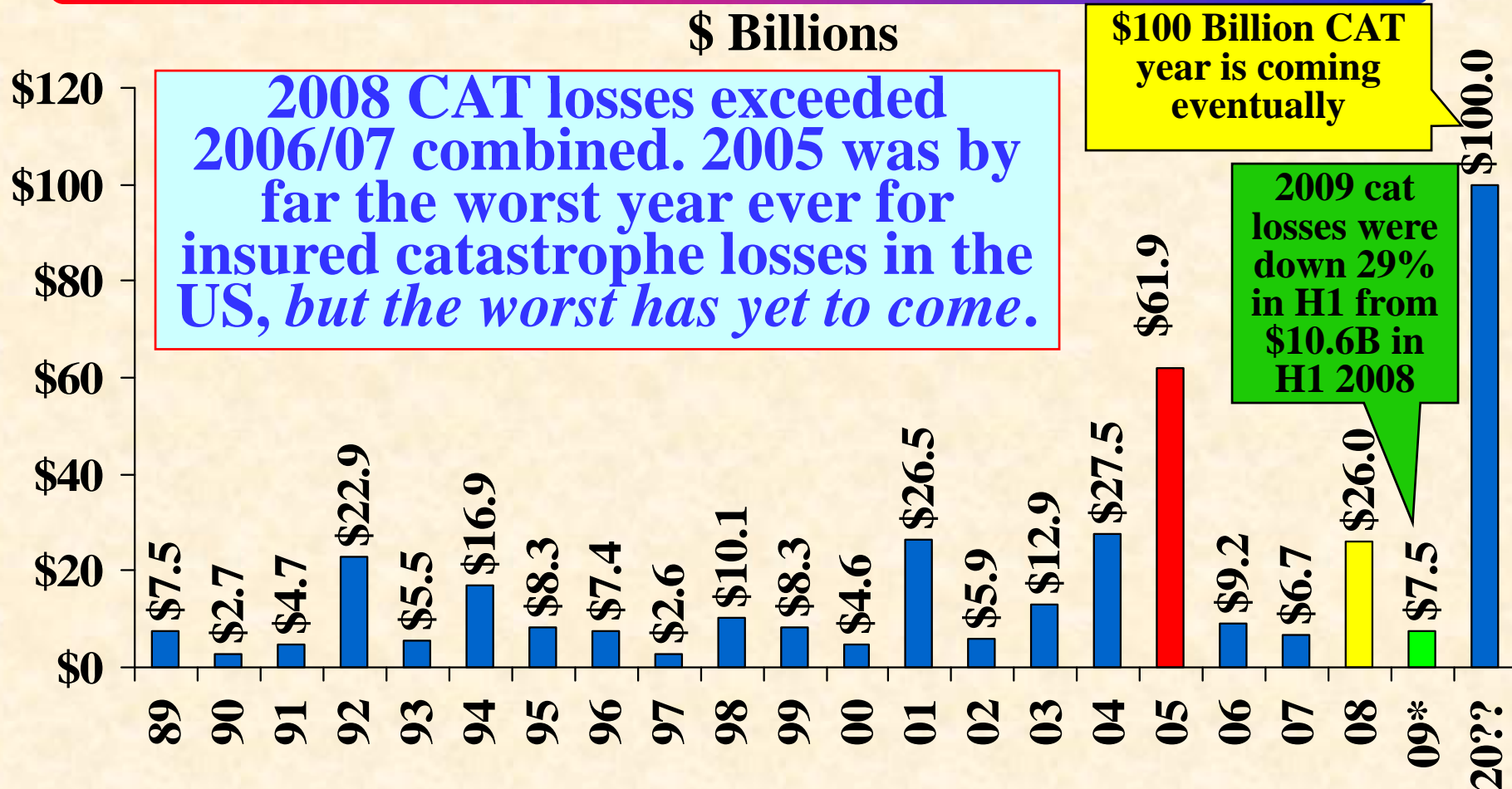
Catastrophic Loss

*Catastrophe Losses Trends
Are Trending Adversely*





U.S. Insured Catastrophe Losses



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

Note: 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = \$12.2B.¹²⁹

Source: Property Claims Service/ISO; Insurance Information Institute

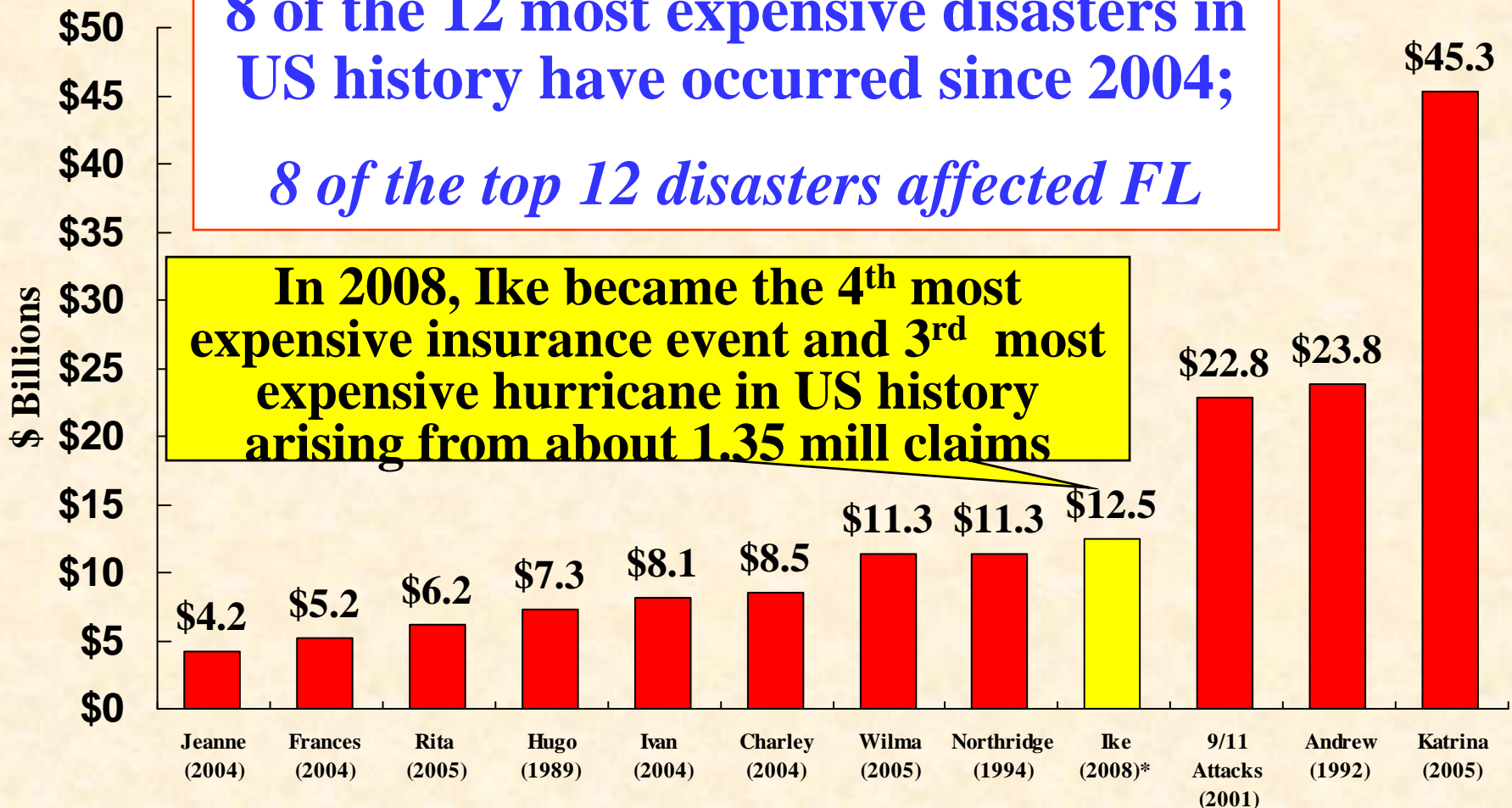


Top 12 Most Costly Disasters in US History, (Insured Losses, \$2008)

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

8 of the top 12 disasters affected FL

In 2008, Ike became the 4th most expensive insurance event and 3rd most expensive hurricane in US history arising from about 1.35 mill claims



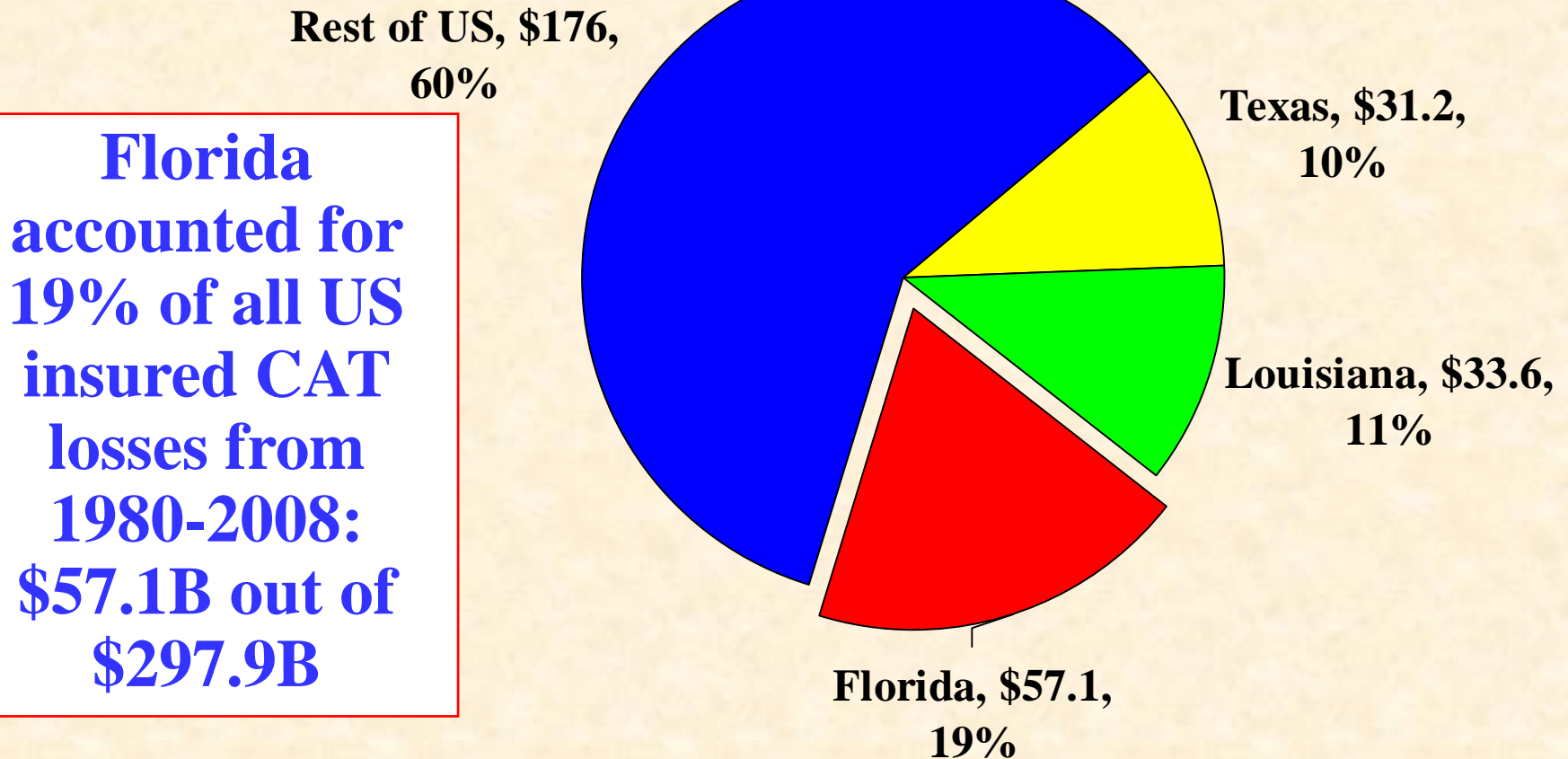
*PCS estimate as of August 1, 2009.

Sources: PCS; Insurance Information Institute inflation adjustments.



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

\$ Billions of Dollars

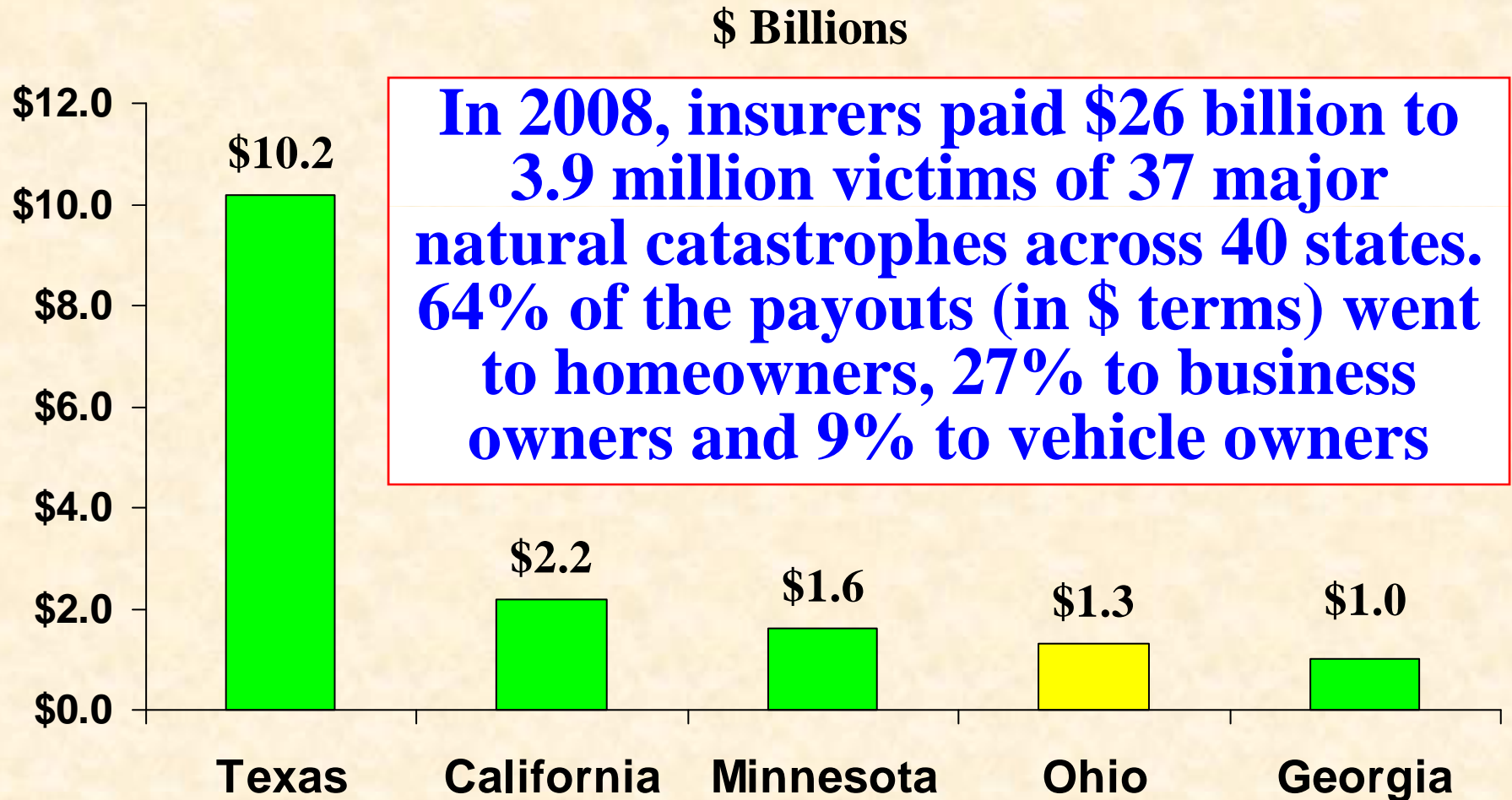


***All figures (except 2006-2008 loss) have been adjusted to 2005 dollars.**

Source: PCS division of ISO.

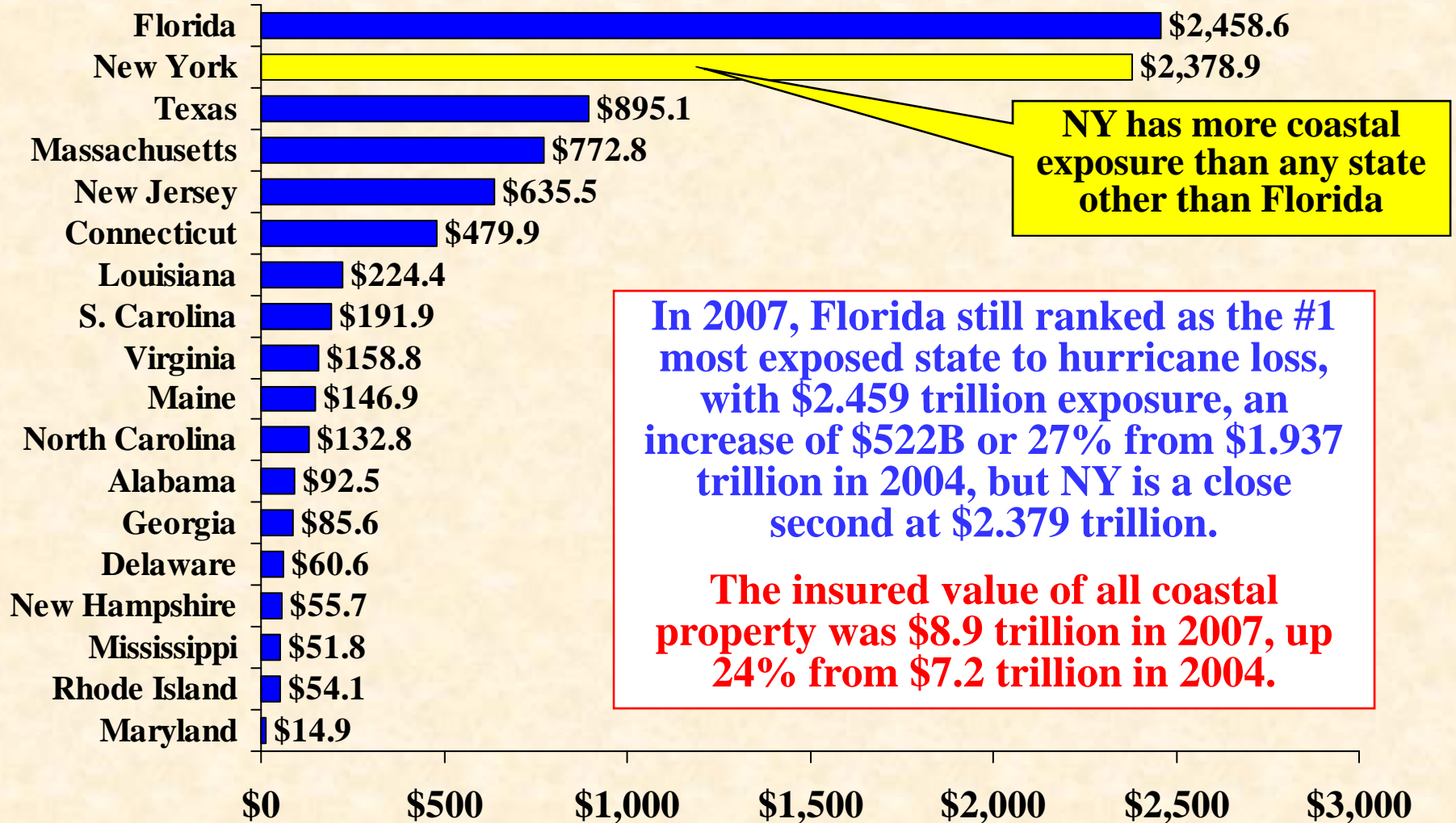


States With Highest Insured Catastrophe Losses in 2008



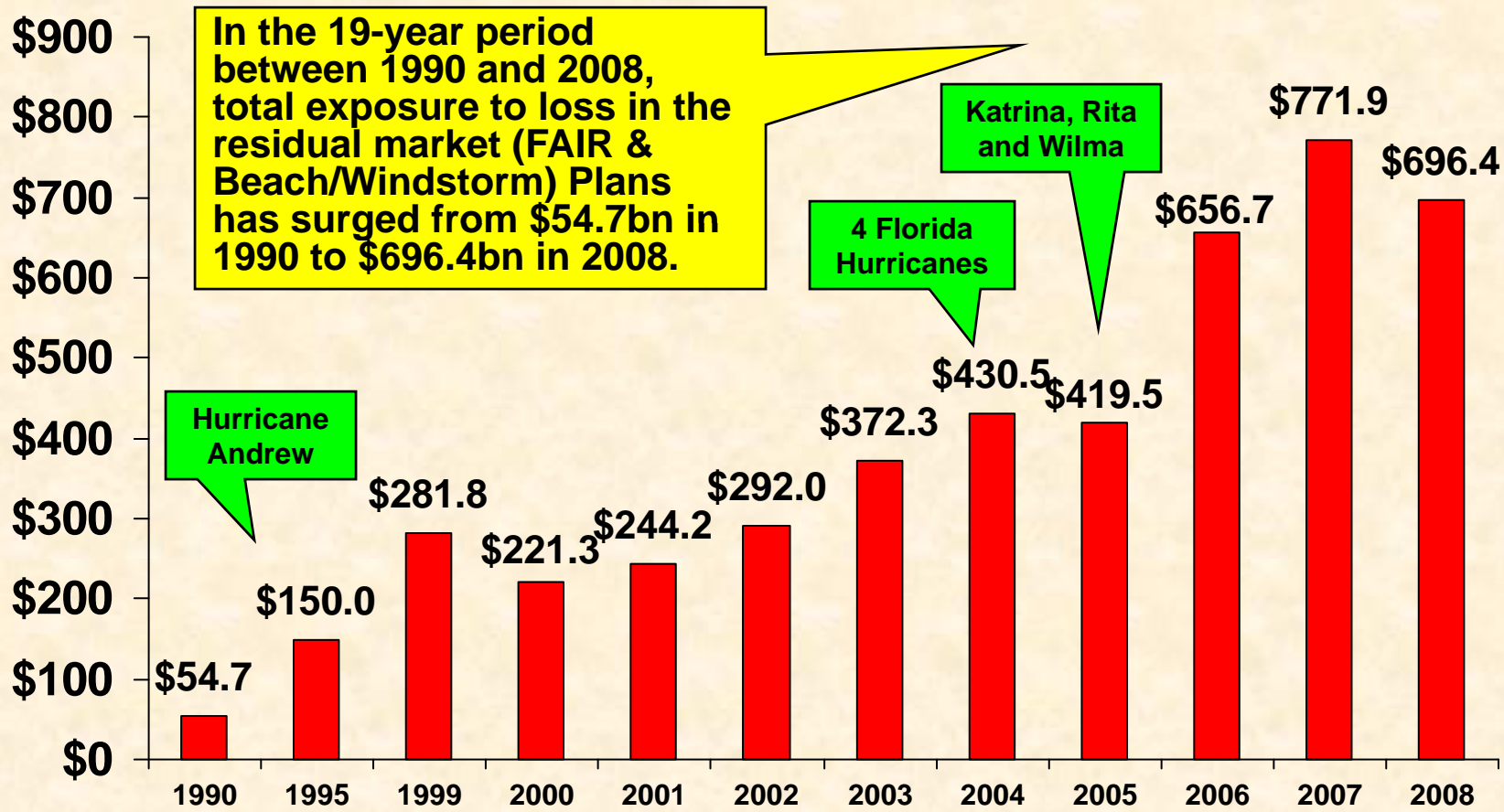


Total Value of Insured Coastal Exposure (2007, \$ Billions)





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





Insurance Information Institute On-Line

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