The Path Ahead: Property/Casualty Insurance in the Wake of the Global Financial Crisis

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Presentation Outline

• The Economic Storm: Financial Crisis & Recession
  ➢ Exposure, Growth & Profitability
• Insurance Industry Financial Overview & Outlook
  ➢ Profitability
  ➢ Premium Growth
  ➢ Underwriting Performance: Commercial & Personal Lines
  ➢ Financial Market Impacts
  ➢ Capital & Capacity
• Shifting Legal Liability & Tort Environment
  ➢ Financial Scandals and Economic Crises
• Professional Liability Insurance Operating Environment
  ➢ Med Mal, D&O
• Key Threats and Issues Facing P/C Insurers Through 2015
  • Healthcare Debate Spillover Effects
• Financial Strength & Ratings
  ➢ Key Differences Between Insurer and Bank Performance During Crisis

Q&A
THE ECONOMIC STORM
What the Financial Crisis and Recession Mean for the Industry’s Exposure Base, Growth, Profitability and Investments
Recession began in December 2007. Economic toll of credit crunch, housing slump, labor market contraction has been severe but recovery is in sight.

The Q1:2009 decline was the steepest since the Q1:1982 drop of 6.4%.

*Blue bars are Estimates/Forecasts from Blue Chip Economic Indicators. Source: US Department of Commerce, Blue Economic Indicators 10/09; Insurance Information Institute.
Length of U.S. Business Cycles, 1929-Present*

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

Length of expansions greatly exceeds contractions

Duration (Months)

<table>
<thead>
<tr>
<th>Month</th>
<th>Contraction</th>
<th>Expansion Following</th>
</tr>
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<tbody>
<tr>
<td>Aug. 1929</td>
<td>50</td>
<td>120</td>
</tr>
<tr>
<td>May 1937</td>
<td>13</td>
<td>73</td>
</tr>
<tr>
<td>Feb. 1945</td>
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<tr>
<td>Nov. 1948</td>
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<td>July 1953</td>
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<td>Aug. 1957</td>
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<tr>
<td>Apr. 1960</td>
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<tr>
<td>Dec. 1969</td>
<td>36</td>
<td>8</td>
</tr>
<tr>
<td>Nov. 1973</td>
<td>58</td>
<td>8</td>
</tr>
<tr>
<td>Jan. 1980</td>
<td>6</td>
<td>12</td>
</tr>
<tr>
<td>Jul. 1981</td>
<td>12</td>
<td>16</td>
</tr>
<tr>
<td>Jul. 1990</td>
<td>92</td>
<td>8</td>
</tr>
<tr>
<td>Mar. 2001</td>
<td>73</td>
<td>8</td>
</tr>
<tr>
<td>Dec. 2007</td>
<td>19</td>
<td></td>
</tr>
</tbody>
</table>

* 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

P/C insurance industry’s growth is influenced modestly by growth in the overall economy.

Sources: A.M. Best, US Bureau of Economic Analysis, Blue Chip Economic Indicators, 10/09; Insurance Information Inst.
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

Eastern US growing more slowly than Plains, Mountains
Fastest Growing States in 2008: Plains, Mountain States Lead

Real State GDP Growth

Natural resource and agricultural states have done better than most others recently, helping insurance exposure in those areas

Slowest Growing States in 2008: Diversity of States Suffering

Real State GDP Growth

Percent

KY  CT  AZ  GA  IN  NV  RI  MI  DE  FL  OH  AK

-0.1%  -0.4%  -0.6% -0.6% -0.6% 0.6%  -0.9%

-1.5% -1.6% -1.6% -1.7% -2.0%

States in the North, South, East and West all represented among hardest hit but for differing reasons

P/C Premium Growth

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

Net written premiums fell 1.0% in 2007 (first decline since 1943) by 1.4% in 2008, and 4.2% in H1 2009, the first 3-year decline since 1930-33

Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute
Average Commercial Rate Change, All Lines, (1Q:2004 – 3Q:2009)

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

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Average D&O pricing is off at 44% since 2003, after rising 146% from 1999-2003.
Investment Environment

Volatility Breeds Litigation
Total Returns for Large Company Stocks: 1970-2009*

S&P 500 was down 38.5% in 2008; Up 21.0% so far in 2009*

Market rebound of 2009 still leaves investors underwater from pre-crisis highs


*Through November 9, 2008.
There were 30,333 business bankruptcies during the first half of 2009, up 64% from 2008: H1 and on track for about 60,000 for all of 2009, the most since 1993. Current recession will generate 200%+ surge.

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

Source: American Bankruptcy Institute; Insurance Information Institute
Recession, Investment Volatility & Reveal Scandals

• Charles Ponzi Was a Two-Bit Scamster by Today’s Standards
  ➢ Made $20 million in 1920 ($225 in today’s dollars)
• Bernard Madoff: $65 Billion Ponzi Scheme
• R. Allen Stanford: $8 Billion Fraudulent Investment Scheme Involving CDs
• Raj Rajaratnam (Galleon Group co-Founder) & 19 Others: Criminally Charged With Making Millions from Insider Trading
• Recessions ALWAYS Reveal Financial Scandals
  • 2001: Enron/Tyco
  • 1991-92: Bank of Commercial & Credit International

Sources: SEC, Bloomberg, BusinessWeek.
Securities litigation activity continues to be driven by claims against financial services firms.
P/C Investment Performance

*Investments are a Principle Source of Declining Profitability*
Property/Casualty Insurance Industry
Investment Gain: 1994-2009:H1

Investment gains fell by 51% in 2008 due to lower yields, poor equity market conditions. Falling again in 2009.

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.
Realized capital losses hit a record $19.8 billion in 2008 due to financial market turmoil, a $27.7 billion swing from 2007, followed by an $11.2B drop in H1 2009. This is a primary cause of 2008/2009’s large drop in profits and ROE.
Treasury Yield Curve is at its most depressed level in at least 45 years. Investment income is falling as a result.

Stock dividend cuts will further pressure investment income

Sources: Board of Governors of the United States Federal Reserve Bank; Insurance Information Institute.
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

Source: NAIC; Insurance Information Institute research;
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

Source: NAIC; Insurance Information Institute research;
Profitability

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

- 2005 ROE = 9.4%
- 2006 ROE = 12.2%
- 2007 ROAS¹ = 12.4%
- 2008 ROAS = 0.5%*
- 2009:H1 ROAS = 2.5%*

Insurer profits peaked in 2006 and 2007, but fell 96.2% during the economic crisis in 2008

*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.

Sources: A.M. Best, ISO, Insurance Information Inst.
ROE: P/C vs. All Industries
1987–2009: H1*

P/C profitability is cyclical and volatile

Sources: ISO, Fortune; Insurance Information Institute.
A 100 Combined Ratio Isn’t What it Used to Be: 95 is Where It’s At

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

* 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.
Underwriting Trends

Financial Crisis Does Not Directly Impact Underwriting Performance: Cycle, Catastrophes Were 2008’s Drivers
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.
Accident year results show a more significant deterioration in underwriting performance. Calendar year results are helped by reserve releases.

Note: 2005 reserve development excludes a $6 billion loss portfolio transfer between American Re and Munich Re. Including this transaction, total prior year adverse development in 2005 was $7 billion. The data from 2000 and subsequent years excludes development from financial guaranty and mortgage insurance.  
Source: Barclay’s Capital; A.M. Best.
Insurers earned a record underwriting profit of $31.7B in 2006 and $19.3B in 2007, the largest ever but only the 2nd and 3rd since 1978. Cumulative underwriting deficit from 1975 through 2008 is $442B.

Large underwriting losses are NOT sustainable in current investment environment

$19.8 Bill underwriting loss in 2008 incl. mort. & FG insurers, - $2.2B in H1:09

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

* Includes mortgage & finl. guarantee insurers
Number of Years With Underwriting Profits by Decade, 1920s –2000s

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

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

Capital/Policyholder Surplus (US)

Shrinkage, but Not Enough to Trigger Hard Market
Policyholder Surplus, 2006:Q4 – 2009:H1

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

Declines Since 2007:Q3 Peak

- 08:Q2: -$16.6B (-3.2%)
- 08:Q3: -$43.3B (-8.3%)
- 08:Q4: -$66.2B (-12.9%)
- 09:Q1: -$84.7B (-16.2%)
- 09:Q2: -$58.8B (-11.2%)

Source: ISO, AM Best.
The financial crisis now ranks as the largest “capital event” over the past 20+ years.

*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%.

Source: PCS; Insurance Information Institute.
Historically, Hard Markets Follow When Surplus “Growth” is Negative*

Sharp decline in capacity is a necessary but not sufficient condition for a true hard market

*2009 NWP and Surplus figures are % changes for H1:09 vs H1:08
Sources: A.M. Best, ISO, Insurance Information Institute
Labor Market Trends

Fast & Furious: Massive Job Losses Sap the Economy and P/C Exposure & Can Also Cause EPL Problems
Unemployment Rate: On the Rise

January 2000 through October 2009*

Average unemployment rate 2000-07 was 5.0%

Previous Peak: 6.3% in June 2003

Oct. 2009 unemployment was 10.2%, up 0.4% from Sept. and nearing its highest level since April 1983 (10.8%)

Trough: 4.4% in March 2007

Unemployment will likely peak near 10.5% during this cycle, impacting payroll sensitive p/c and l/h exposures

Job losses since the recession began in Dec. 2007 total 8.2 mill; 15.7 million people are now defined as unemployed.

Monthly losses in Dec. – May were the largest in the post-WW II period but pace of loss is diminishing

Labor Underutilization: Broader than Just Unemployment

% of Labor Force

<table>
<thead>
<tr>
<th>Month</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep-08</td>
<td>11.2%</td>
</tr>
<tr>
<td>May-09</td>
<td>16.4%</td>
</tr>
<tr>
<td>Jun-09</td>
<td>16.5%</td>
</tr>
<tr>
<td>Jul-09</td>
<td>16.3%</td>
</tr>
<tr>
<td>Aug-09</td>
<td>16.8%</td>
</tr>
<tr>
<td>Sep-09</td>
<td>17.0%</td>
</tr>
<tr>
<td>Oct-09</td>
<td>17.5%</td>
</tr>
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</table>

Marginally attached and unemployed persons account for 17.5% of the labor force in Oct. 2009 (1 out every 5.7 people). Unemployment rate alone was 10.2%. Underutilization shows a broader impact on WC and other commercial exposures.

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.

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

<table>
<thead>
<tr>
<th>State</th>
<th>Unemployment Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MI</td>
<td>15.3</td>
</tr>
<tr>
<td>NV</td>
<td>13.3</td>
</tr>
<tr>
<td>RI</td>
<td>13.0</td>
</tr>
<tr>
<td>CA</td>
<td>12.2</td>
</tr>
<tr>
<td>SC</td>
<td>11.6</td>
</tr>
<tr>
<td>OR</td>
<td>11.5</td>
</tr>
<tr>
<td>DC</td>
<td>11.4</td>
</tr>
<tr>
<td>FL</td>
<td>11.0</td>
</tr>
<tr>
<td>KY</td>
<td>10.9</td>
</tr>
<tr>
<td>NC</td>
<td>10.8</td>
</tr>
<tr>
<td>IL</td>
<td>10.7</td>
</tr>
<tr>
<td>TN</td>
<td>10.5</td>
</tr>
<tr>
<td>OH</td>
<td>10.5</td>
</tr>
<tr>
<td>GA</td>
<td>10.1</td>
</tr>
<tr>
<td>NJ</td>
<td>10.1</td>
</tr>
<tr>
<td>IN</td>
<td>9.8</td>
</tr>
<tr>
<td>MO</td>
<td>9.6</td>
</tr>
<tr>
<td>WA</td>
<td>9.5</td>
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<td>MA</td>
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<tr>
<td>MS</td>
<td>9.3</td>
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<tr>
<td>AZ</td>
<td>9.2</td>
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<tr>
<td>NY</td>
<td>9.1</td>
</tr>
<tr>
<td>WV</td>
<td>8.9</td>
</tr>
<tr>
<td>ID</td>
<td>8.8</td>
</tr>
</tbody>
</table>

*Provisional figures for September 2009, seasonally adjusted.

Insurers with heavy footprints in these states will lag behind.

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

Economic Obstacles to Growth in P/C Insurance
Private Sector Business Starts,
1993:Q2-2008:Q4*

Thousands

189,000 business starts were recorded 2008:Q4, the lowest level since 1995

Business starts are down 15% in the current downturn, holding back most types of commercial insurance exposure

GREEN SHOOTS

Business Mix & Geographic Footprint Will Impact P-C Insurer Growth Opportunities
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?
Inflation peaked at 5.6% in August 2008 on high energy and commodity crisis. The recession and the collapse of the commodity bubble have produced temporary deflation.

There is so much slack in the US economy that inflation should not be a concern through 2010, but depreciation of dollar is concern longer run.

Deficit expected to hit record $1.8 trillion in 2009 or 13% or GDP, a post-WW II high.

Concerns that deficit spending will drive up inflation. This would harmful to insurance claim severity.

Sources: Congressional Budget Office analysis of President’s budget, March 2009; Insurance Information Institute.
The size of the Fed’s balance sheet has more than doubled since the crisis began in 2007 from about $900 billion to $2.2 trillion, fueling inflation concerns.

*As of final Friday in each quarter.
Source: Federal Reserve: [http://www.federalreserve.gov/releases/h41/hist/h41hist1.htm](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 reinsurance more quickly and potential exhausting their reinsurance more quickly

Tort Cost Growth & Medical Cost Inflation vs. Overall Inflation (CPI-U), 1961-2009E*

Tort System is an Inflation Amplifier
Tort Costs: +8.4%
Med Costs: +5.9%
Overall Inflation: +4.2%

*Tort costs move with inflation but at twice the rate

* CPI-U and medical costs as of Sept 2009; Tort figure is for full-year 2009 from Tillinghast.
Shifting Legal Liability & Tort Environment

Is the Tort Pendulum Swinging Against Insurers?
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
- Historically extremely costly to p/c insurance industry
- Leads to reserve deficiency, rate pressure

Bottom Line: Tort “crisis” is on the horizon and will be recognized as such by 2012-2014

Source: Insurance Information Inst.
Over the Last Three Decades, Total Tort Costs* as a % of GDP Appear Somewhat Cyclical

2009-2010 Growth in Tort Costs as % of GDP is due in part to shrinking GDP

*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

Source: American Tort Reform Association; Insurance Information Institute
Sum of Top 10 Jury Awards, 2004-2008

<table>
<thead>
<tr>
<th>Year</th>
<th>Dollars (in Millions)</th>
</tr>
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<tbody>
<tr>
<td>2004</td>
<td>$5,158.8</td>
</tr>
<tr>
<td>2005</td>
<td>$2,953.7</td>
</tr>
<tr>
<td>2006</td>
<td>$815.0</td>
</tr>
<tr>
<td>2007</td>
<td>$615.0</td>
</tr>
<tr>
<td>2008</td>
<td>$1,344.0</td>
</tr>
</tbody>
</table>

Total of Top 10 awards in 2008 was 74% lower than in 2004.

TX, NY and CA lead the U.S. in jumbo-size jury awards

Source: LawyersWeekly USA, January 1996-2009 issues. *All against Iran for terrorist activity
MEDICAL & HEALTH CARE COST INFLATION

National Problem & Insurer Cost Driver
**Inflation for Medical Care has been surging ahead of general inflation (CPI) for 25 years. Since 1982-84, the cost of medical care has more than tripled.**

*First Half 2009 data.
Source: Department of Labor (Bureau of Labor Statistics).
Health costs on a per capita basis continue to rise rapidly, as health expenditures rise faster than population growth.

Source: Centers for Medicare & Medicaid Services, Office of the Actuary; Insurance Information Institute.
Health care expenditures consumed an estimated 16.6% of GDP in 2008 and are expected to rise to 20.3% by 2018.
Average Annual Growth in US Per Capital Health Care Costs, 1960-2018

The 1970s were the most inflationary decade for medical costs at nearly 21% per year.

Over the net decade health care expenditures will likely increase well ahead of economic growth and the general pace of inflation.

Source: Insurance Information Institute calculations based on data from the Centers for Medicare & Medicaid Services, Office of the Actuary.
Auto Claim Costs Rise Faster than CPI or Health Care Costs

Inflation in auto insurance claims is a significant and long-term cost driver.

Claimed BI economic losses are 3 times the overall inflation rate.

MEDICAL MALPRACTICE OPERATING ENVIRONMENT

Improved, But Still Vulnerable
Insurers in 2008 paid out an estimated $0.77 for every $1 they earned in premiums.

As recently as 2002, med mal insurers paid out $1.55 for every dollar earned.

The dramatic improvement has restored med mal’s viability.

Source: AM Best, Insurance Information Institute
Medical Malpractice: Losses & Expenses Paid vs. Premiums Earned

Before reforms took hold in the mid-2000s, premium earned rose ?% while losses and expenses rose 93% over the period from 1990 through 2008.

Source: Computed from A.M. Best data by the Insurance Information Institute
Outlook for MPLI
Operating Environment

- **Short-Term**: Soft market persists, driven by relatively good underlying underwriting performance
- **Tort Threat**: Med mal tort costs may start to accelerate due to: current erosion of tort reforms at state and Federal level, e.g. Healthcare reform bill and potential giveaway to trial lawyers; plus increase in “never events” and strict liability for hospitals.
- **Antitrust Repeal**: Med mal insurers’ limited exemption from federal antitrust law is under attack as part of healthcare reform. Repeal would undermine competition in already fragile market
- **Long-Run**: Erosion of reforms of recent years begins to take toll, further damaging results
- **Conclusion**: Underwriting Cycle can’t be banished, but its depth and length can be moderated via disciplined underwriting and pricing
The Affordable Health Care for America Act (H.R. 3962) includes the following benefit to the trial bar:

Section 2531, entitled “Medical Liability Alternatives,” establishes an incentive program for states to adopt and implement alternatives to medical liability litigation. [BUT]…… “a state is not eligible for the incentive payments if that state puts a law on the books that limits attorneys’ fees or imposes caps on damages.”

Jeopardizes some $54 billion in savings in medical care costs that Congressional Budget Office (CBO) says litigation reform would bring.

Source: Andrew Breitbart, http://biggovernment.com; Congressional Budget Office (CBO)
Investment Component of Medical Malpractice Operating Results
Investment Gain: Med Mal vs. All Commercial Lines*

Investment returns have generally shrunk since 2000, but are still important. “Heavy Lifting” must be done through underwriting & pricing.

*As a % of net earned premium. Investment gains consists primarily of interest, dividends and realized capital gains and losses.
Source: A.M. Best; Insurance Information Institute estimate
Medical Malpractice Investment Gain*

Investment returns have risen, but poor investment environment today implies “Heavy Lifting” must be done through underwriting & pricing.

*Imputed from investment gain data as a % of net earned premium. Investment gains consists primarily of interest, dividends and realized capital gains and losses.
Source: A.M. Best; Insurance Information Institute estimate
Medical Malpractice Tort Environment

Harvesting the Fruits of Reform
Medical Malpractice Tort Cost: Growth Continues, Though Modestly

- Over the period from 1990 through 2007, medical malpractice tort costs rose 230%, more than double the 94% increase in tort costs generally over the same period.
- Over the period from 1975 through 2007, medical malpractice tort costs have increased at an annual rate of ? percent, versus ? percent for all other tort costs.

Med Mal Crises Across the U.S in the Early 2000s.*

AMA: Crises reached in 22 states in the 2000s

*Crisis states at height of 2000s

*The AMA is no longer categorizing states as crisis states.

Source: American Medical Association, February 2008
None of the top 10 awards in 2008 was related to medical liability.
# 2007 Top Ten Verdicts

<table>
<thead>
<tr>
<th>Value</th>
<th>Issue</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>$109 Million</td>
<td>Medical Malpractice</td>
<td>New York</td>
</tr>
<tr>
<td>$102.7 Million</td>
<td>Premises Liability, Death</td>
<td>Florida</td>
</tr>
<tr>
<td>$55.2 Million</td>
<td>Product Liability, Death</td>
<td>California</td>
</tr>
<tr>
<td>$54 Million</td>
<td>Private Air Crash</td>
<td>Florida</td>
</tr>
<tr>
<td>$54 Million</td>
<td>Nursing Home, Death</td>
<td>New Mexico</td>
</tr>
<tr>
<td>$50 Million</td>
<td>DUI Crash</td>
<td>Florida</td>
</tr>
<tr>
<td>$50 Million</td>
<td>Product Liability, Death</td>
<td>Alabama</td>
</tr>
<tr>
<td>$47.6 Million</td>
<td>Prempro</td>
<td>Nevada</td>
</tr>
<tr>
<td>$47.5 Million</td>
<td>Vioxx</td>
<td>New Jersey</td>
</tr>
<tr>
<td>$45 Million</td>
<td>Auto Crash, Death</td>
<td>Florida</td>
</tr>
</tbody>
</table>

1 of the top 10 awards in 2007 was related to medical liability. Total Cost = $109 Million.

Source: LawyersWeekly USA, January 22, 2008.
## 2002 Top Ten Verdicts

<table>
<thead>
<tr>
<th>Value</th>
<th>Issue</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>$28 Billion</td>
<td>Tobacco (Product Liability)</td>
<td>Florida</td>
</tr>
<tr>
<td>$2.2 Billion</td>
<td>Negligence (Pharmacy Mal)</td>
<td>Missouri</td>
</tr>
<tr>
<td>$270 Million</td>
<td>Personal Injury (Burn)</td>
<td>Kentucky</td>
</tr>
<tr>
<td>$225 Million</td>
<td>Product Liability (Rollover)</td>
<td>Texas</td>
</tr>
<tr>
<td>$150 Million</td>
<td></td>
<td>Oregon</td>
</tr>
<tr>
<td>$122 Million</td>
<td>Product Liability (Auto Accident)</td>
<td>Virginia</td>
</tr>
<tr>
<td>$97.2 Million</td>
<td>Business Fraud</td>
<td>California</td>
</tr>
<tr>
<td>$95.2 Million</td>
<td>Medical Mal (Birth Injury)</td>
<td>New York</td>
</tr>
<tr>
<td>$91 Million</td>
<td>Medical Mal (Birth Injury)</td>
<td>New York</td>
</tr>
<tr>
<td>$80 Million</td>
<td>Medical Mal (Birth Injury)</td>
<td>New York</td>
</tr>
<tr>
<td>$80 Million</td>
<td>Prod. Liab./Personal Inj. (Auto)</td>
<td>Missouri</td>
</tr>
</tbody>
</table>

7 of the top 20 awards in 2001/2002 were related to medical liability.

Total Cost = $3.0 Billion!
## 2001 Top Ten Verdicts

<table>
<thead>
<tr>
<th>Value</th>
<th>Issue</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3 Billion</td>
<td>Tobacco</td>
<td>California</td>
</tr>
<tr>
<td>$1 Billion</td>
<td>Land Contamination</td>
<td>Louisiana</td>
</tr>
<tr>
<td>$480 Million</td>
<td>Private Airplane Crash</td>
<td>Florida</td>
</tr>
<tr>
<td><strong>$312.8 Million</strong></td>
<td>Nursing Home</td>
<td>Texas</td>
</tr>
<tr>
<td>$256 Million</td>
<td>Police Auto Crash</td>
<td>Colorado</td>
</tr>
<tr>
<td>$116 Million</td>
<td>Intellectual Property Theft</td>
<td>Virginia</td>
</tr>
<tr>
<td><strong>$114.9 Million</strong></td>
<td>Medical Malpractice</td>
<td>New York</td>
</tr>
<tr>
<td>$108.2 Million</td>
<td>Inheritance Dispute</td>
<td>Texas</td>
</tr>
<tr>
<td><strong>$107.8 Million</strong></td>
<td>Medical Malpractice</td>
<td>New York</td>
</tr>
<tr>
<td>$94.5 Million</td>
<td>Real Estate</td>
<td>California</td>
</tr>
</tbody>
</table>

The average medical malpractice jury award more than tripled between 1994 and 2006, but has moderated since 2002.

*Ultimate award may be reduced by judge or upon appeal.
Source: Jury Verdict Research; Insurance Information Institute.
### Trends in Million Dollar Verdicts

The frequency of multi-million dollar awards is increasing across most types of defendants. In medical malpractice (med mal), million dollar-plus awards rose from 48% of all awards from 2001-03 to 57% in 2006-07, well above most other categories.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Malpractice</td>
<td>48%</td>
<td>53%</td>
<td>57%</td>
</tr>
<tr>
<td>Products Liability</td>
<td>64%</td>
<td>65%</td>
<td>65%</td>
</tr>
<tr>
<td>All Liabilities</td>
<td>13%</td>
<td>15%</td>
<td>17%</td>
</tr>
<tr>
<td>Vehicular Liability</td>
<td>4%</td>
<td>5%</td>
<td>6%</td>
</tr>
<tr>
<td>Personal Negligence</td>
<td>11%</td>
<td>17%</td>
<td>14%</td>
</tr>
<tr>
<td>Premises Liability</td>
<td>13%</td>
<td>11%</td>
<td>15%</td>
</tr>
<tr>
<td>Business Negligence</td>
<td>29%</td>
<td>30%</td>
<td>33%</td>
</tr>
<tr>
<td>Government Negligence</td>
<td>37%</td>
<td>41%</td>
<td>51%</td>
</tr>
</tbody>
</table>

Verdicts of $1 million or more. **2006-2007 is latest available data.**

Source: Jury Verdict Research; Insurance Information Institute.
DIRECTORS & OFFICERS
ENVIRONMENT

Financial Crisis Considerations
Changes in D&O Limits, All Business Classes, 2008

Only 3 percent of participants reported decreasing their D&O policy limit in 2008, compared to 18% in 2007.

Source: Tillinghast Towers-Perrin, 2008 Directors and Officers Liability Survey
Some 46% of Utilities reported increasing their D&O policy limits. Meanwhile, 0% reported a decrease and 54% reported no change in their policy limit.

Source: Tillinghast Towers-Perrin, 2008 Directors and Officers Liability Survey
Changes in D&O Policy Enhancements, All Business Classes, 2008

Only 1 percent of participants reported a decrease in D&O policy enhancements in 2008, compared to 3% in 2007.

Increased, 54%
Same, 45%
Decreased, 1%

Source: Tillinghast Towers-Perrin, 2008 Directors and Officers Liability Survey
Some 79% of Biotech & Pharmaceutical companies reported an increase in coverage enhancements to their D&O policies. Meanwhile, 0% reported a decrease and 45% no change in policy enhancements.

Source: Tillinghast Towers-Perrin, 2008 Directors and Officers Liability Survey
The percentage of participants purchasing EPL coverage as part of their D&O policy decreased slightly, from 60% in 2007 to 57% in 2008.

Only 10% of respondents reporting buying no EPL coverage.

Source: Tillinghast Towers-Perrin, 2008 Directors and Officers Liability Survey
D&O Premium Index
(1974 Average = 100)

Average D&O pricing is off at 44% since 2003, after rising 146% from 1999-2003

Key Threats Facing P/C Insurers Amid Financial Crisis

Challenges for the Next 5-8 Years
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.
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 account 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
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

Source: Insurance Information Inst.
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
FINANCIAL STRENGTH & RATINGS

Industry Has Weathered the Storms Well
The number of impairments varies significantly over the p/c insurance cycle, with peaks occurring well into hard markets.

Source: A.M. Best; Insurance Information Institute
Impairment rates are highly correlated with underwriting performance and reached record lows in 2007/08.

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

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

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

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

Critical Differences Between P/C Insurers and Banks

Superior Risk Management Model & Low Leverage Make a Big Difference
How Insurance Industry Stability Has Benefitted Consumers

BOTTOM LINE:

• Insurance Markets—Unlike Banking—Are Operating Normally

• The Basic Function of Insurance—the Orderly Transfer of Risk from Client to Insurer—Continues Uninterrupted

• This Means that Insurers Continue to:
  - Pay claims (whereas 145 banks have gone under as of 11/6/09)  
    • 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)

Source: Insurance Information Institute
Reasons Why P/C Insurers Have Fewer Problems Than Banks: A Superior Risk Management Model

- **Emphasis on Underwriting**
  - Matching of risk to price (via experience and modeling)
  - Limiting of potential loss exposure
  - Some banks sought to maximize volume and fees and disregarded risk

- **Strong Relationship Between Underwriting and Risk Bearing**
  - Insurers always maintain a stake in the business they underwrite, keeping “skin in the game” at all times
  - Banks and investment banks package up and securitize, severing the link between risk underwriting and risk bearing, with (predictably) disastrous consequences—straightforward moral hazard problem from Econ 101

- **Low Leverage**
  - Insurers do not rely on borrowed money to underwrite insurance or pay claims ➔ There is no credit or liquidity crisis in the insurance industry

- **Conservative Investment Philosophy**
  - High quality portfolio that is relatively less volatile and more liquid

- **Comprehensive Regulation of Insurance Operations**
  - The business of insurance remained comprehensively regulated whereas a separate banking system had evolved largely outside the auspices and understanding of regulators (e.g., hedge funds, private equity, complex securitized instruments, credit derivatives—CDS’s)

- **Greater Transparency**
  - Insurance companies are an open book to regulators and the public

Source: Insurance Information Institute
THANK YOU FOR YOUR TIME AND YOUR ATTENTION!