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

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Presentation Outline

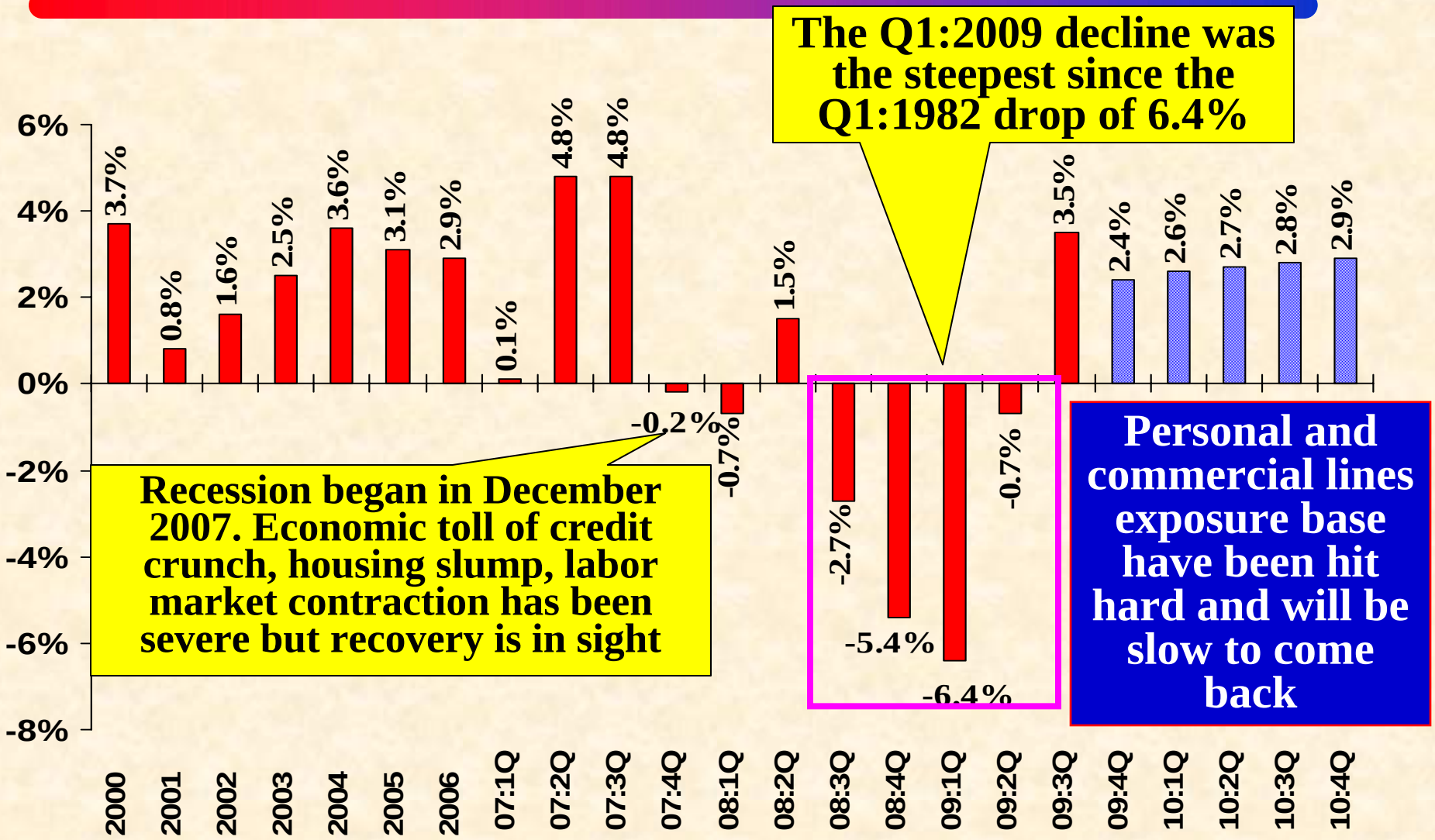
- **The Economic Storm: Financial Crisis & Recession**
  - **Exposure, Growth & Profitability**
- **Insurance Industry Financial Overview & Outlook**
  - **Profitability**
  - **Premium Growth**
  - **Underwriting Performance: Commercial & Personal Lines**
  - **Financial Market Impacts**
  - **Capital & 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

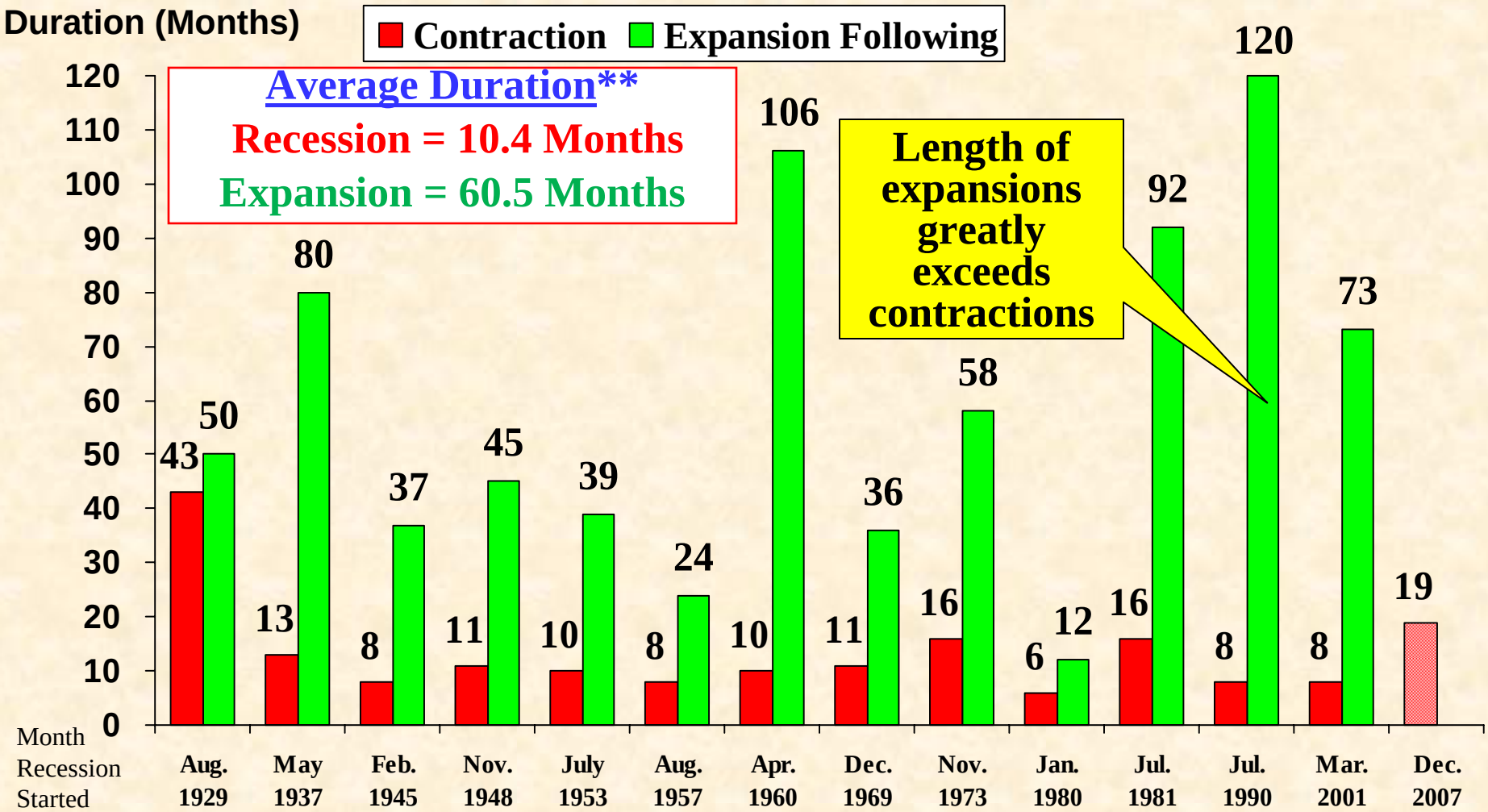
What the Financial Crisis and Recession Mean for the Industry's Exposure Base, Growth, Profitability and Investments

*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.

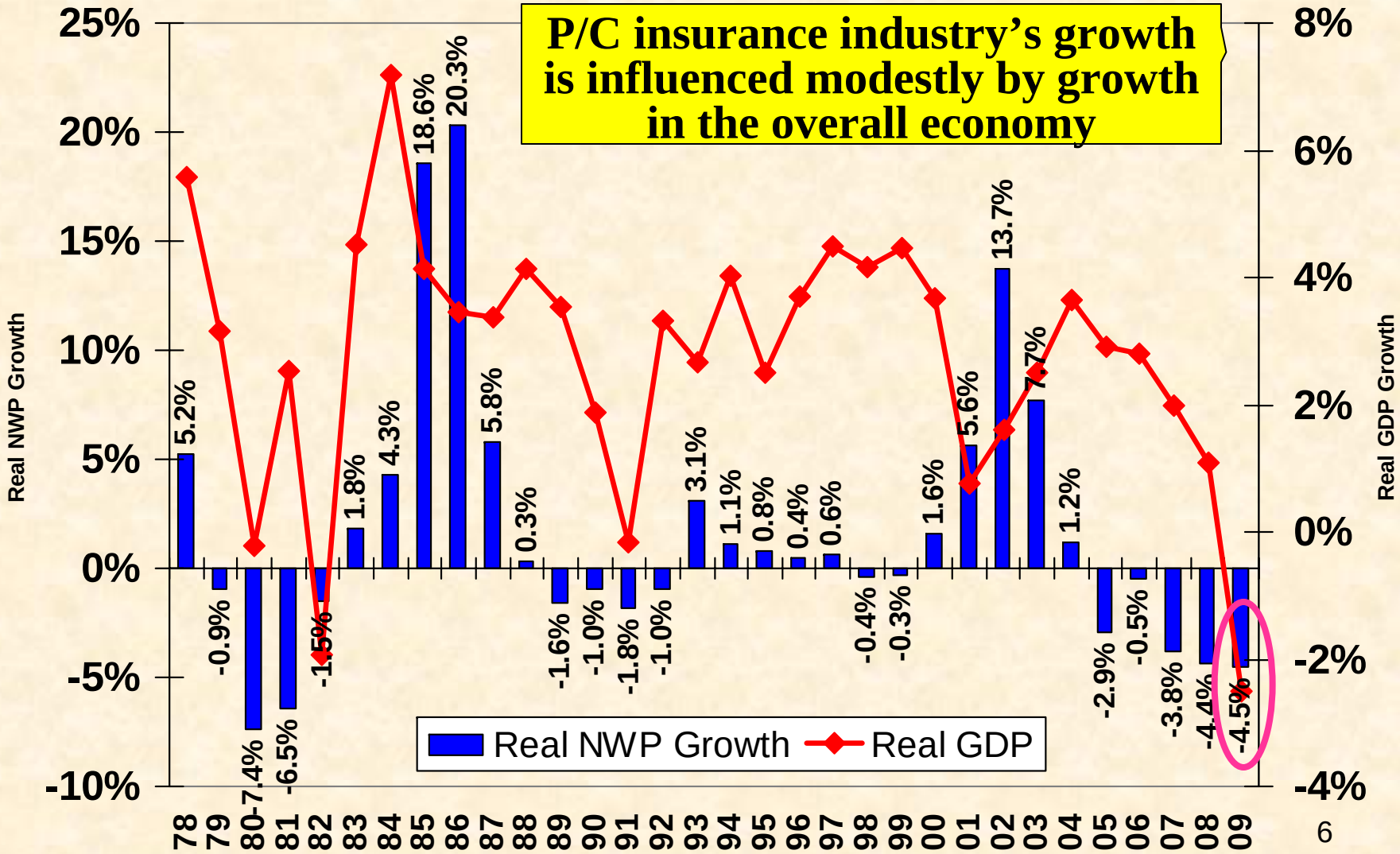
*Length of U.S. Business Cycles, 1929-Present**



* 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

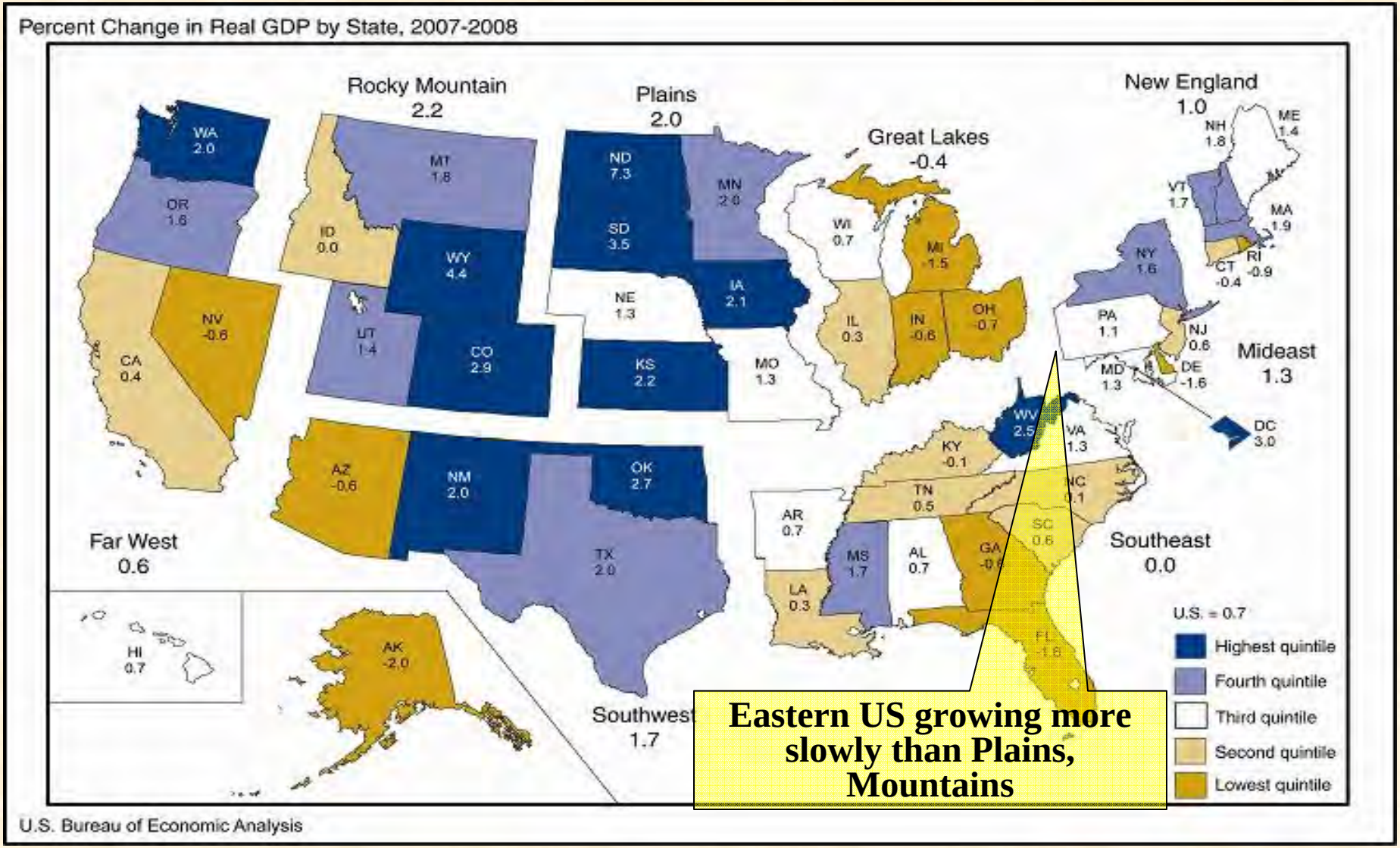


Sources: A.M. Best, US Bureau of Economic Analysis, Blue Chip Economic Indicators, 10/09; Insurance Information Inst.

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

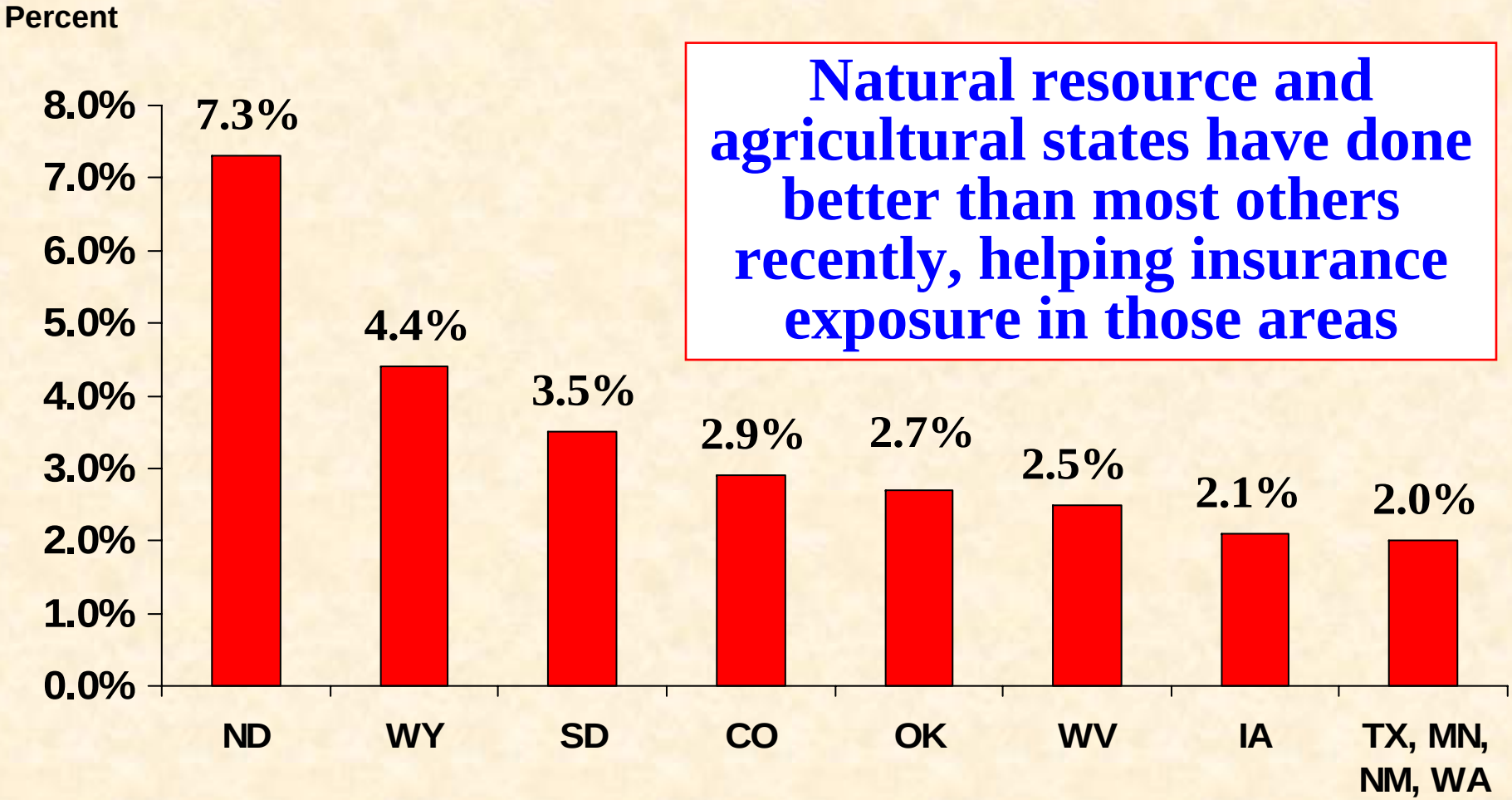
State Economic Growth Varied Tremendously in 2008



Eastern US growing more slowly than Plains, Mountains

Fastest Growing States in 2008: Plains, Mountain States Lead

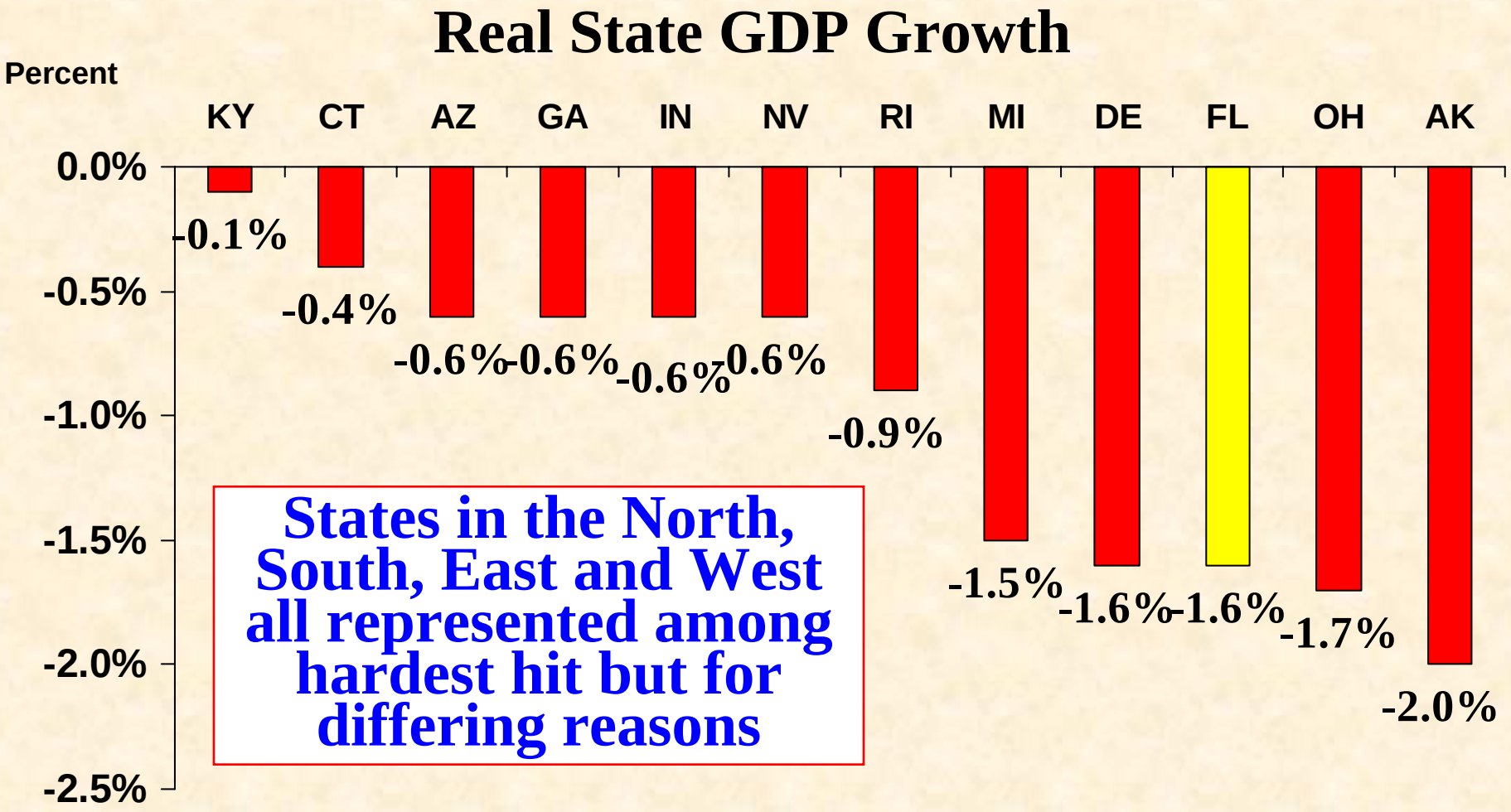
Real State GDP Growth



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

Source: US Bureau of Economic Analysis; Insurance Information Institute.

Slowest Growing States in 2008: Diversity of States Suffering



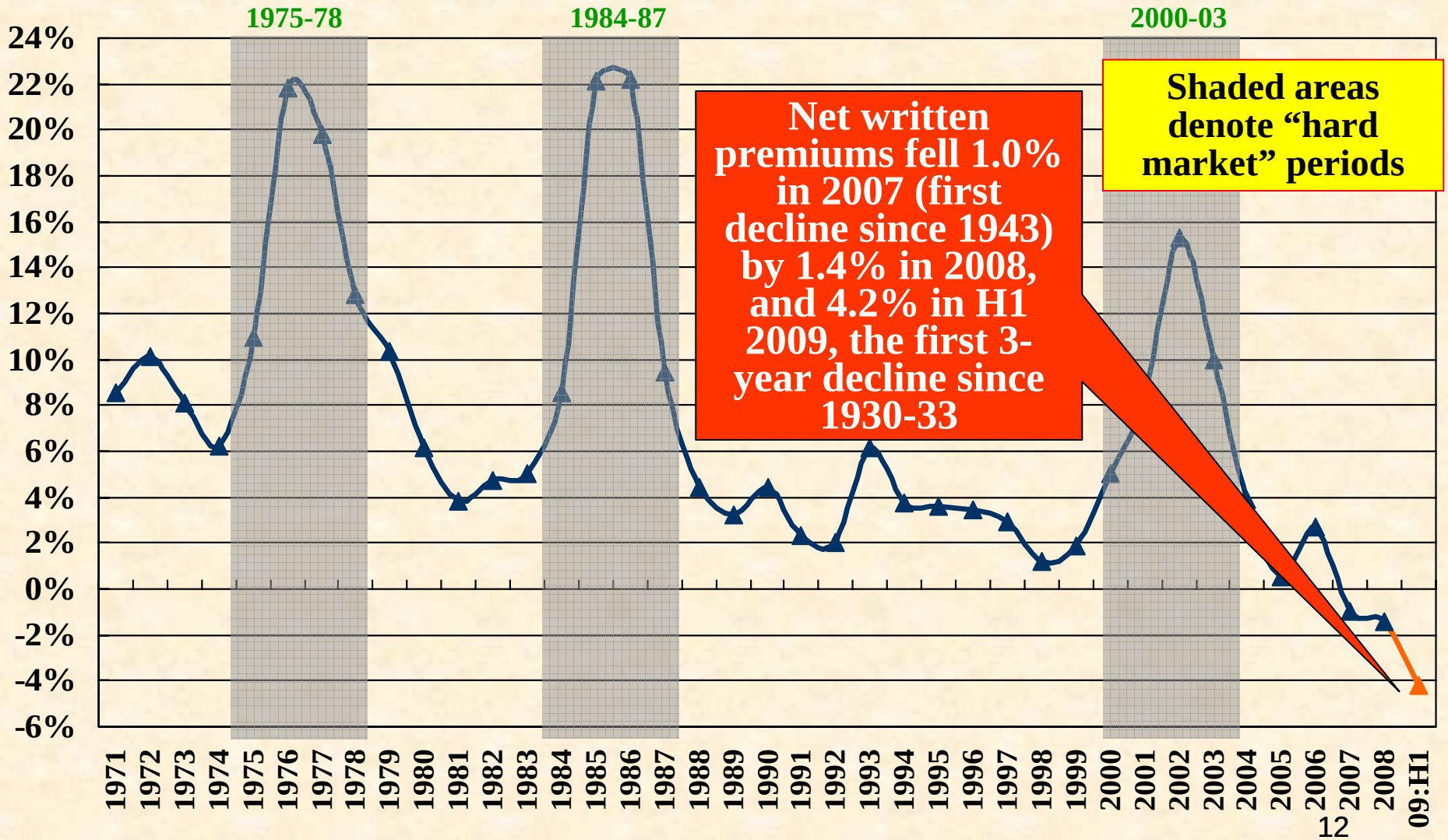
States in the North, South, East and West all represented among hardest hit but for differing reasons

Source: US Bureau of Economic Analysis; Insurance Information Institute.

P/C Premium Growth

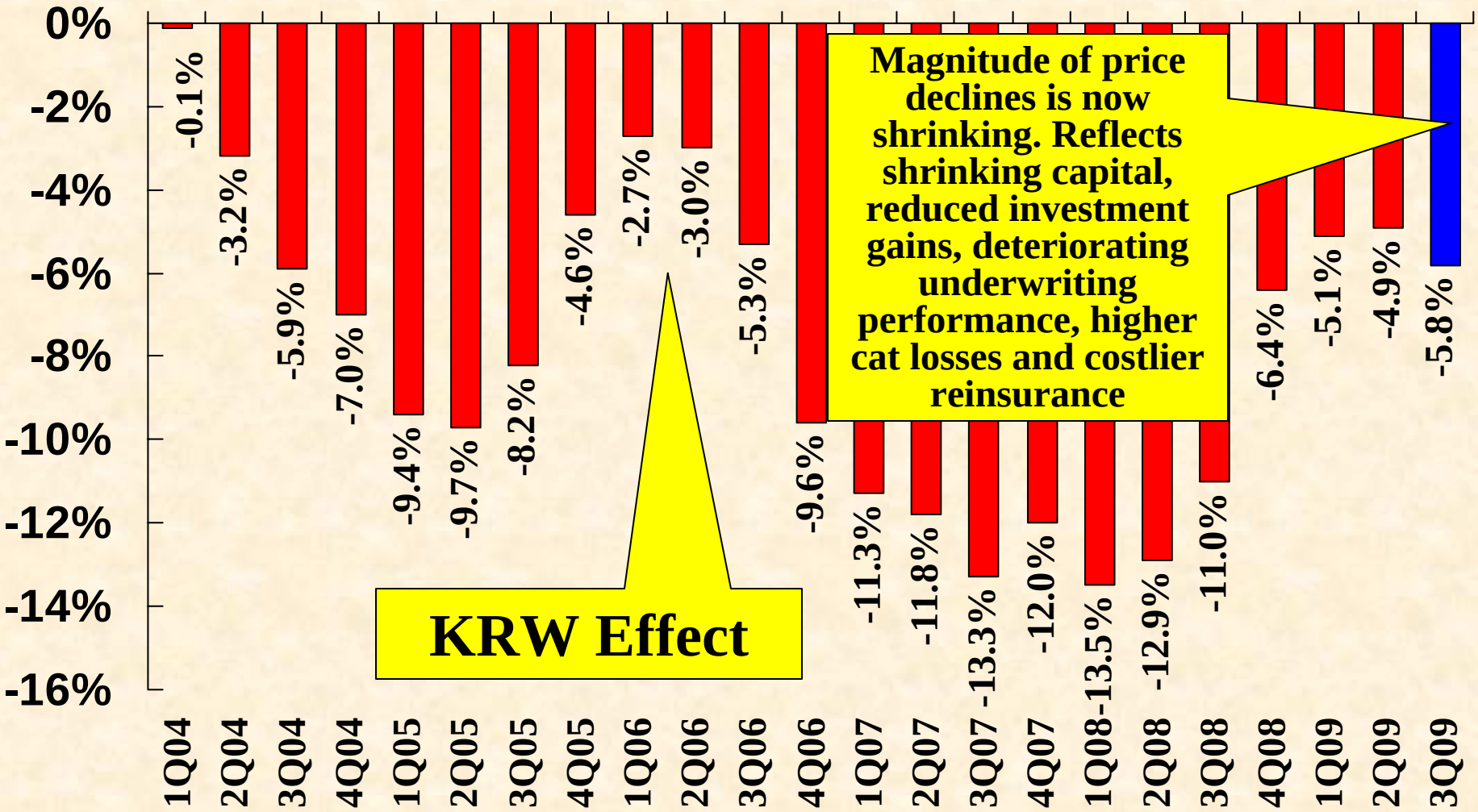
Primarily Driven by the Industry's Underwriting Cycle, Not the Economy

Strength of Recent Hard Markets by NWP Growth



Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute

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

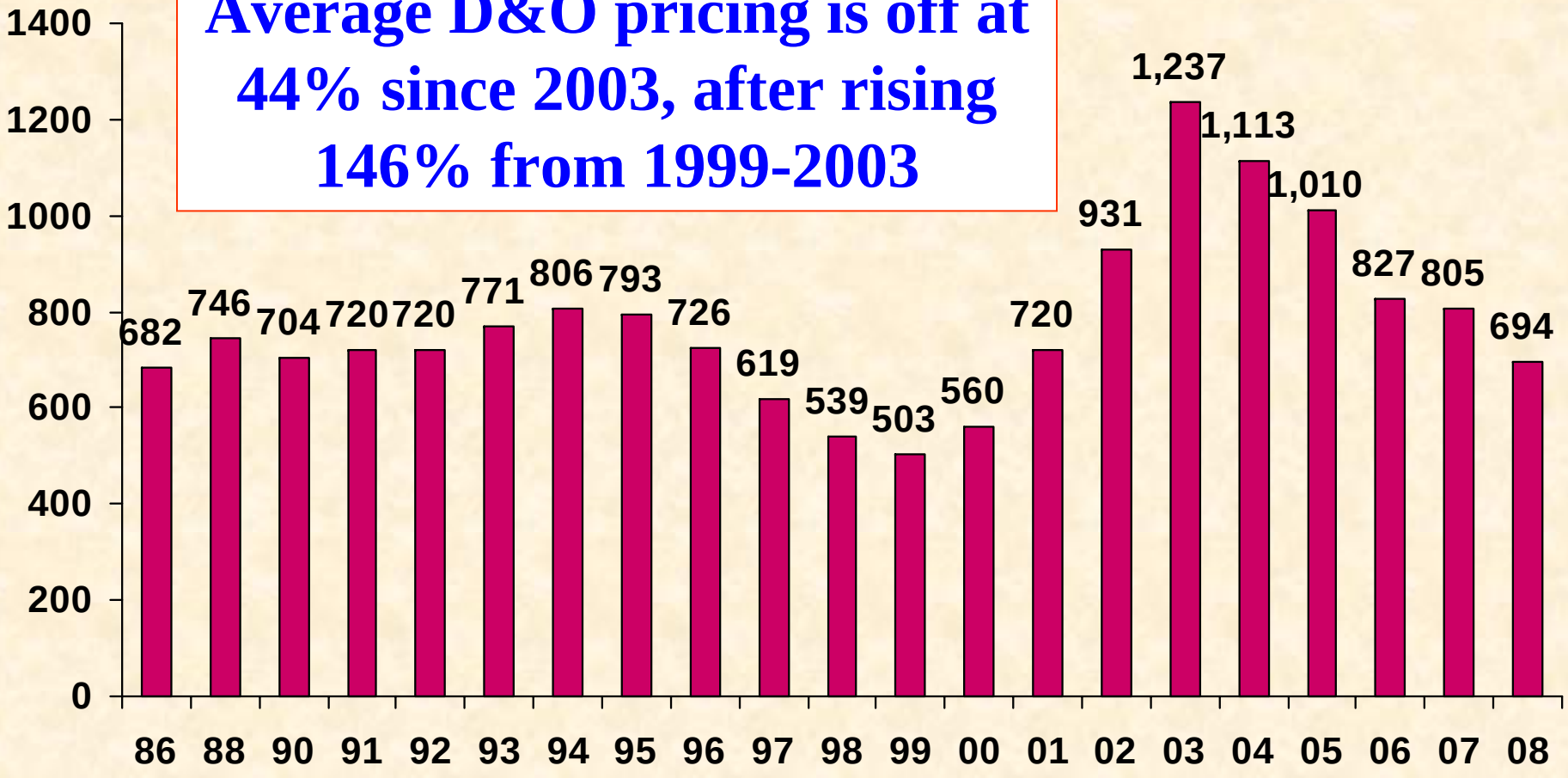


Source: Council of Insurance Agents & Brokers; Insurance Information Institute

D&O Premium Index

(1974 Average = 100)

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



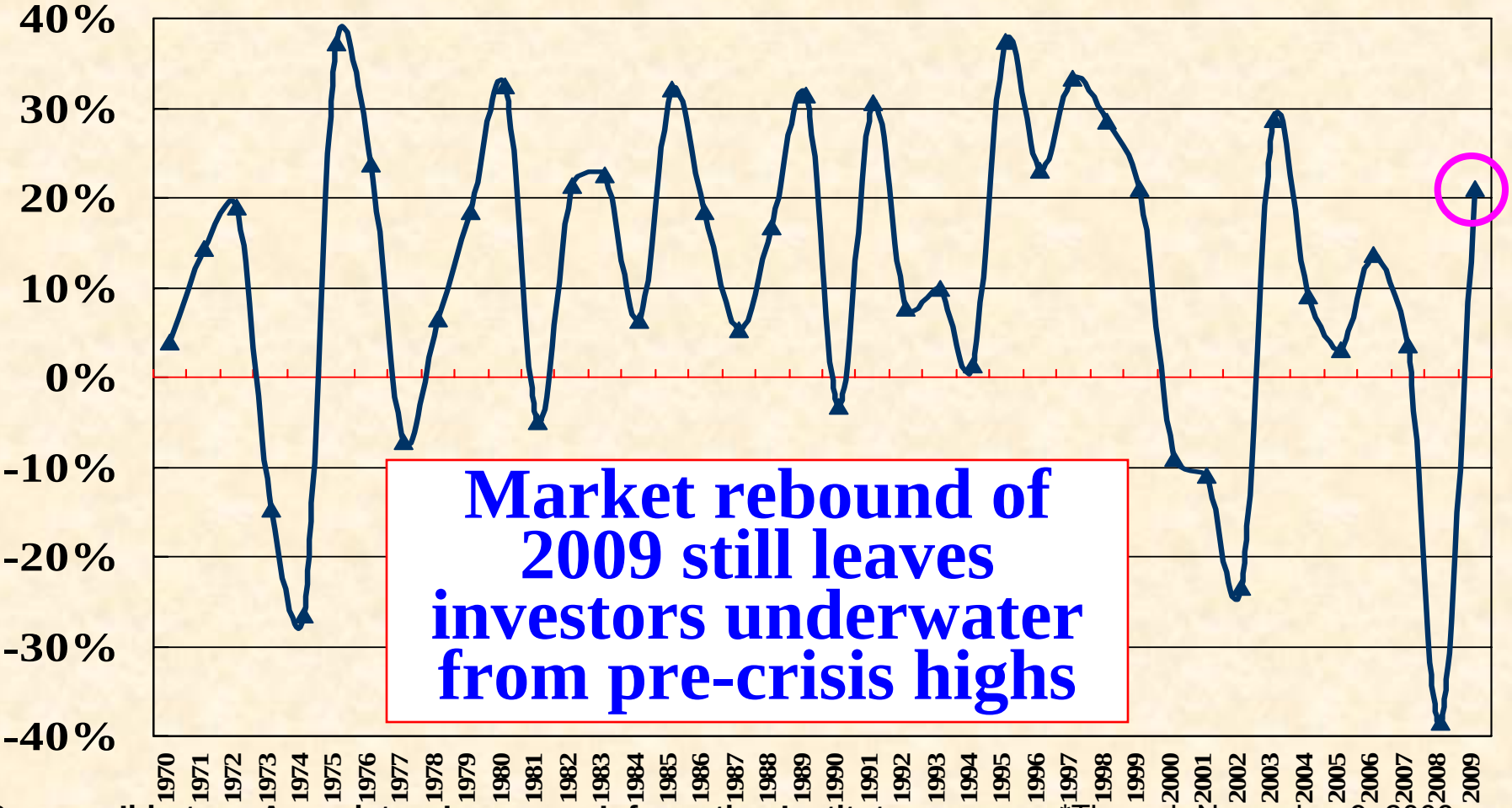
Source: Tillinghast Towers-Perrin, *2008 Directors and Officers Liability Survey.*

Investment Environment

Volatility Breeds Litigation

*Total Returns for Large Company Stocks: 1970-2009**

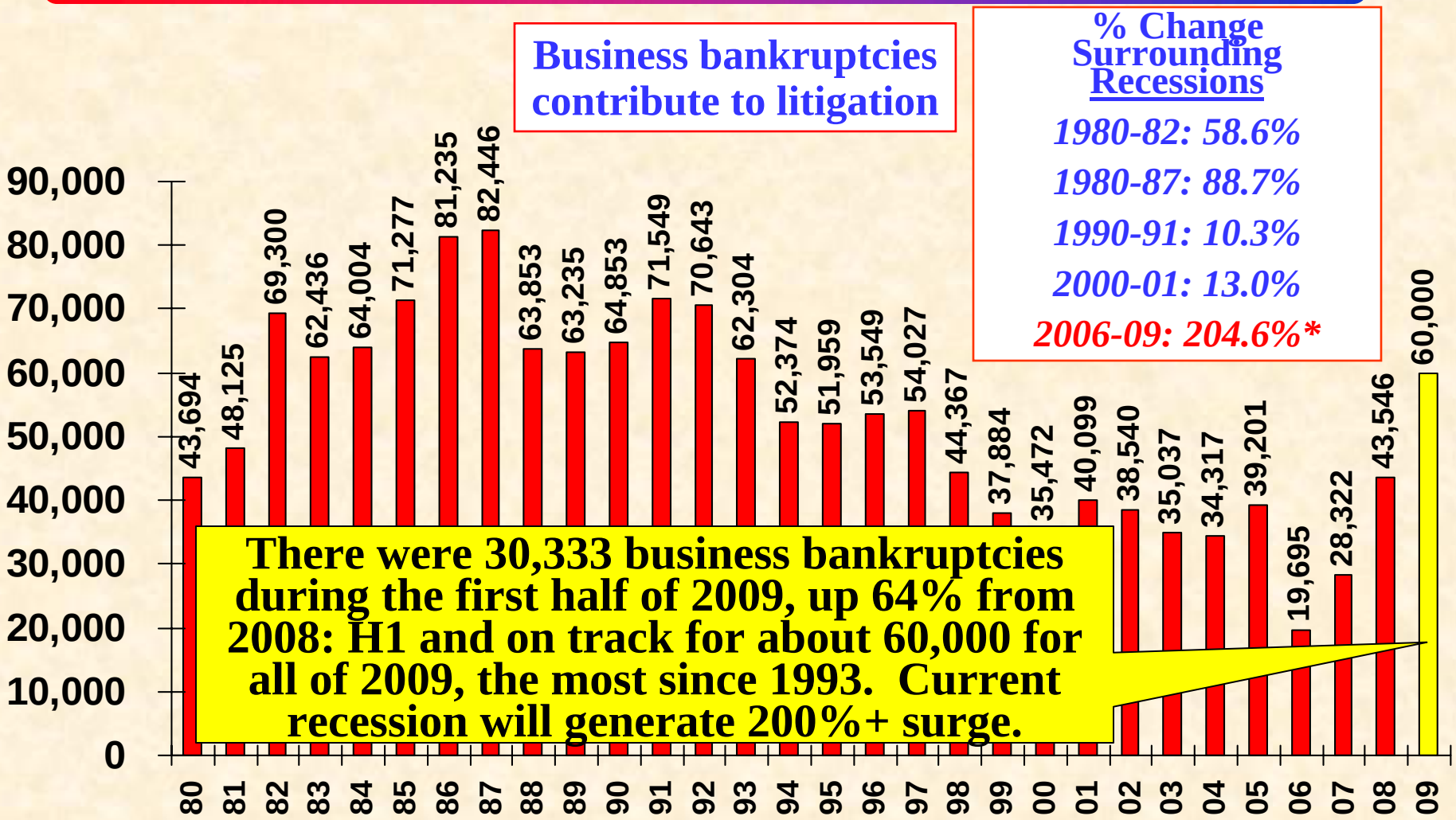
S&P 500 was down 38.5% in 2008; Up 21.0% so far in 2009*



Source: Ibbotson Associates, Insurance Information Institute.

*Through November 9, 2008.

*Business Bankruptcy Filings, 1980-2009**



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

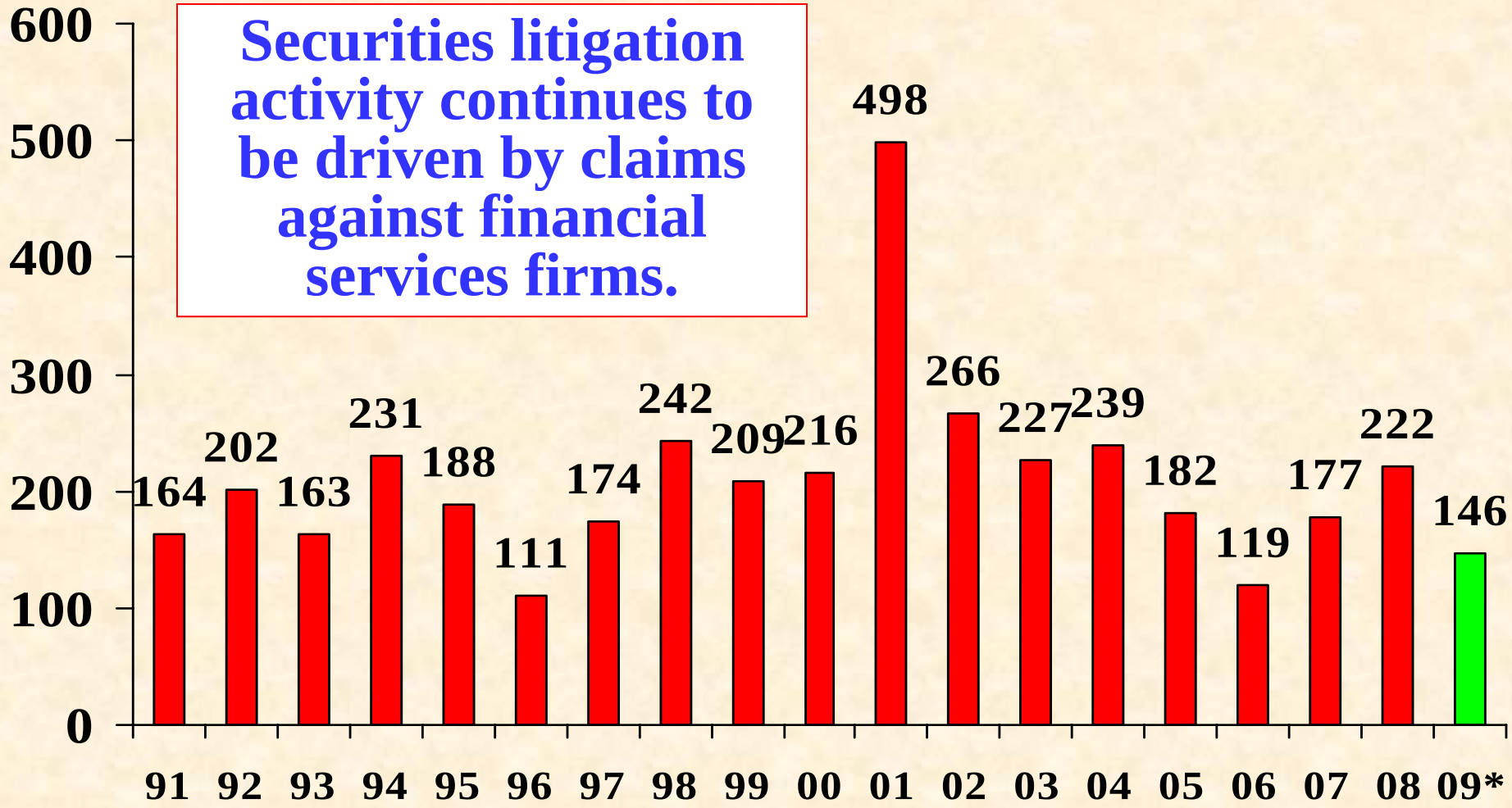
Source: American Bankruptcy Institute; Insurance Information Institute

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.

*Shareholder Class Action Lawsuits**



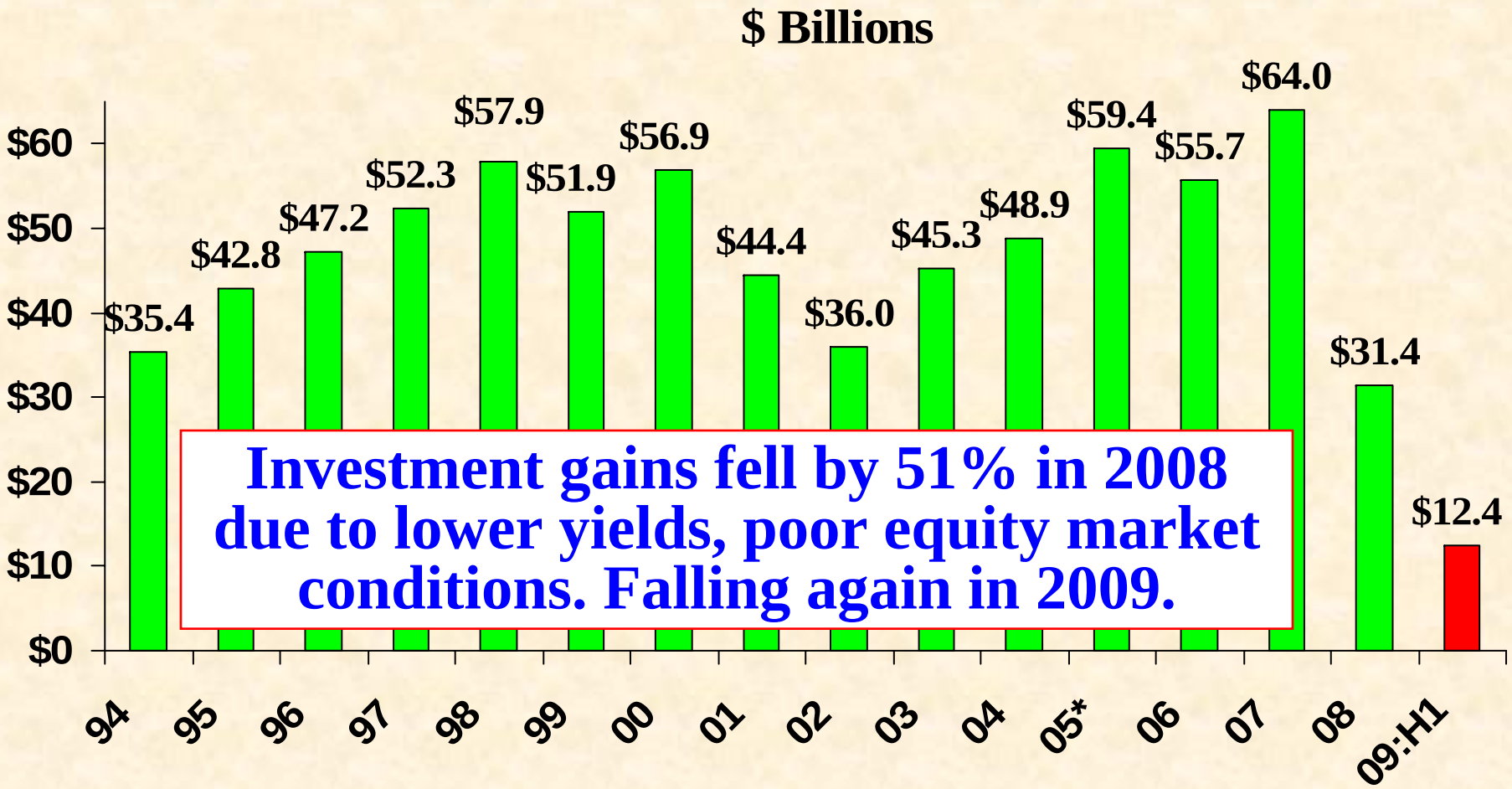
*Securities fraud suits filed in U.S. federal courts; 2009 figure is current through 11/05/09.

Source: Stanford University School of Law (securities.stanford.edu); Insurance Information Institute

P/C Investment Performance

Investments are a Principle Source of Declining Profitability

Property/Casualty Insurance Industry Investment Gain:1994- 2009:H1[1]



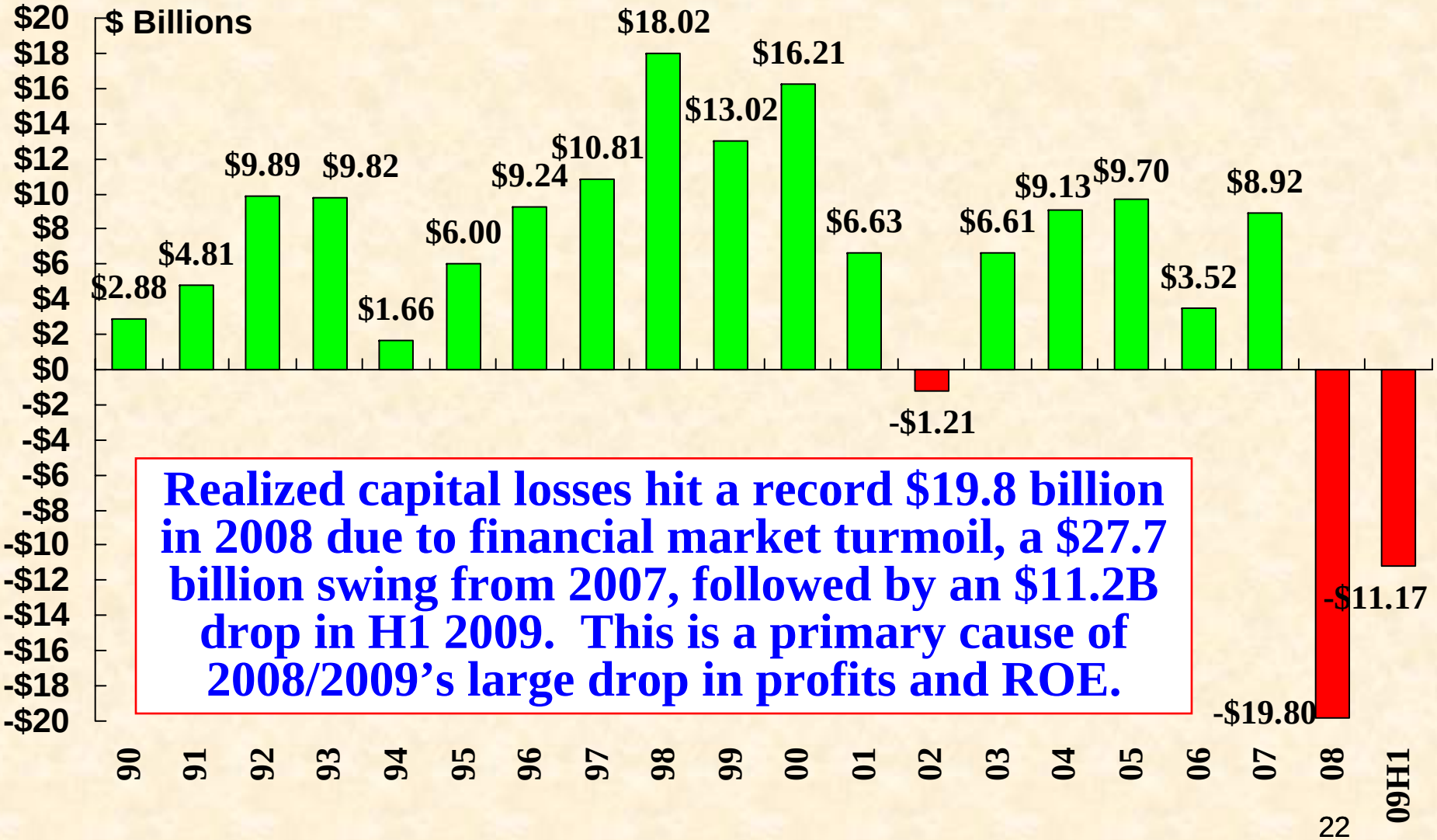
Investment gains fell by 51% in 2008 due to lower yields, poor equity market conditions. Falling again in 2009.

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

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

Sources: ISO; Insurance Information Institute.

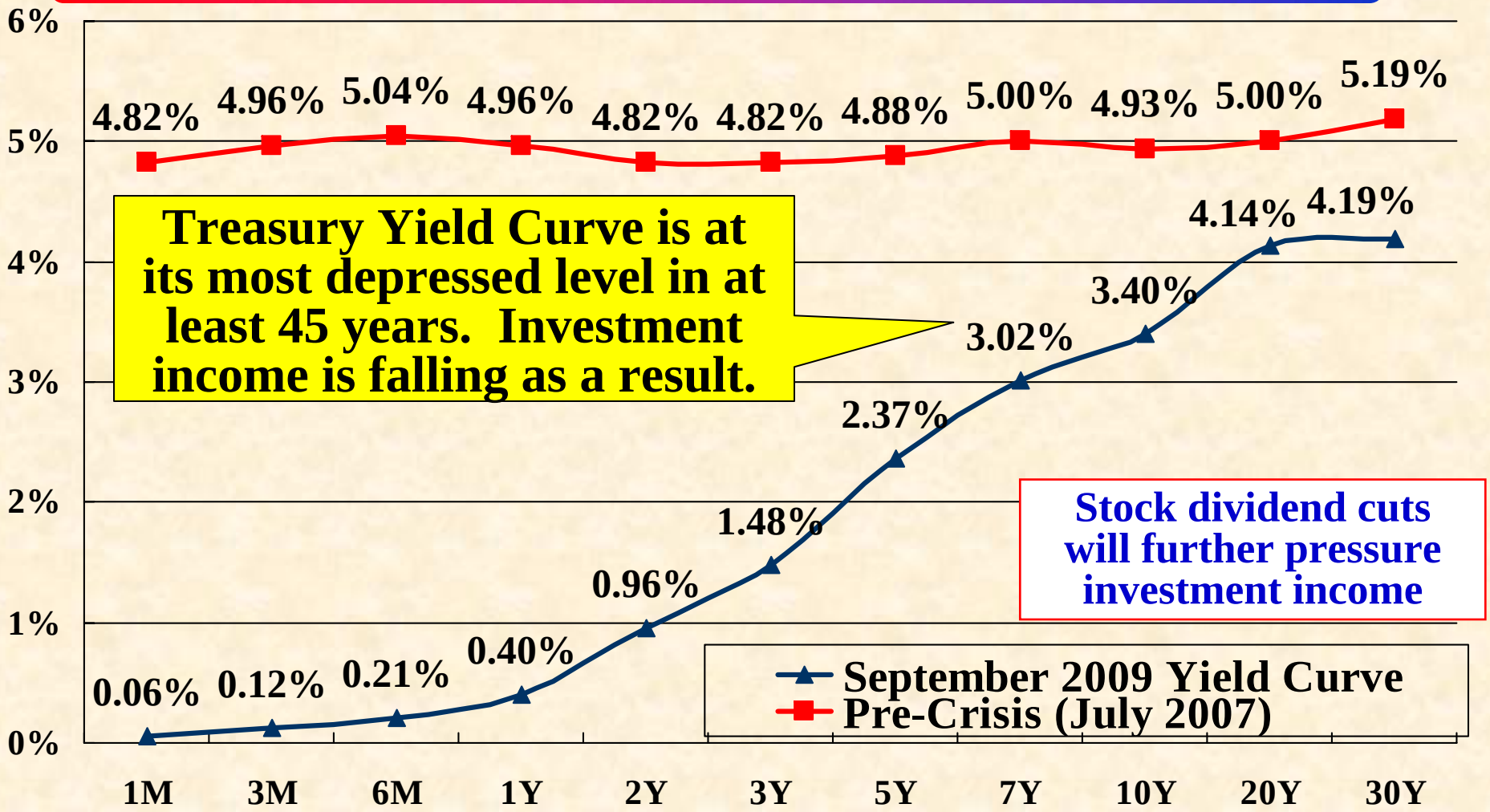
P/C Insurer Net Realized Capital Gains, 1990-2009:H1



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.

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

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



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

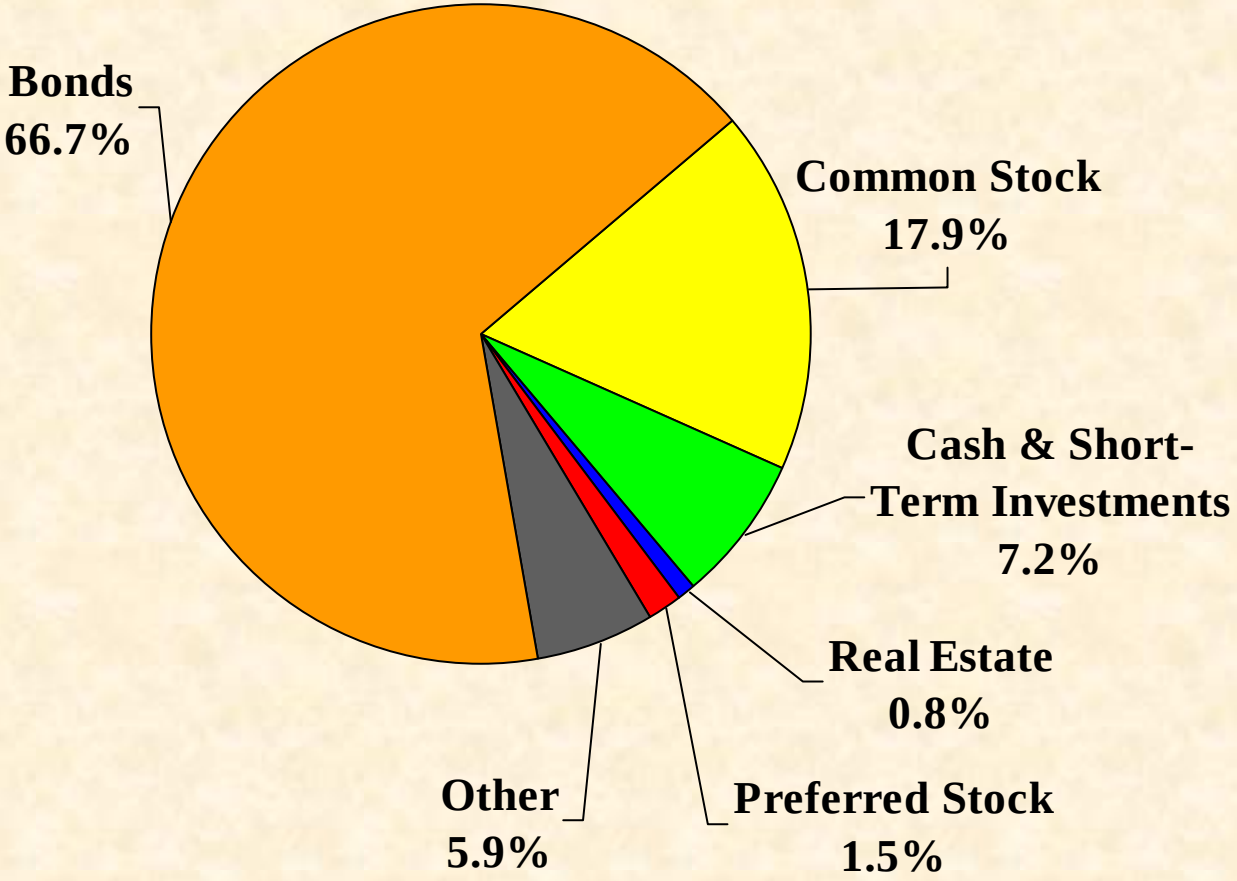
Sources: Board of Governors of the United States Federal Reserve Bank; Insurance Information Institute.

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**



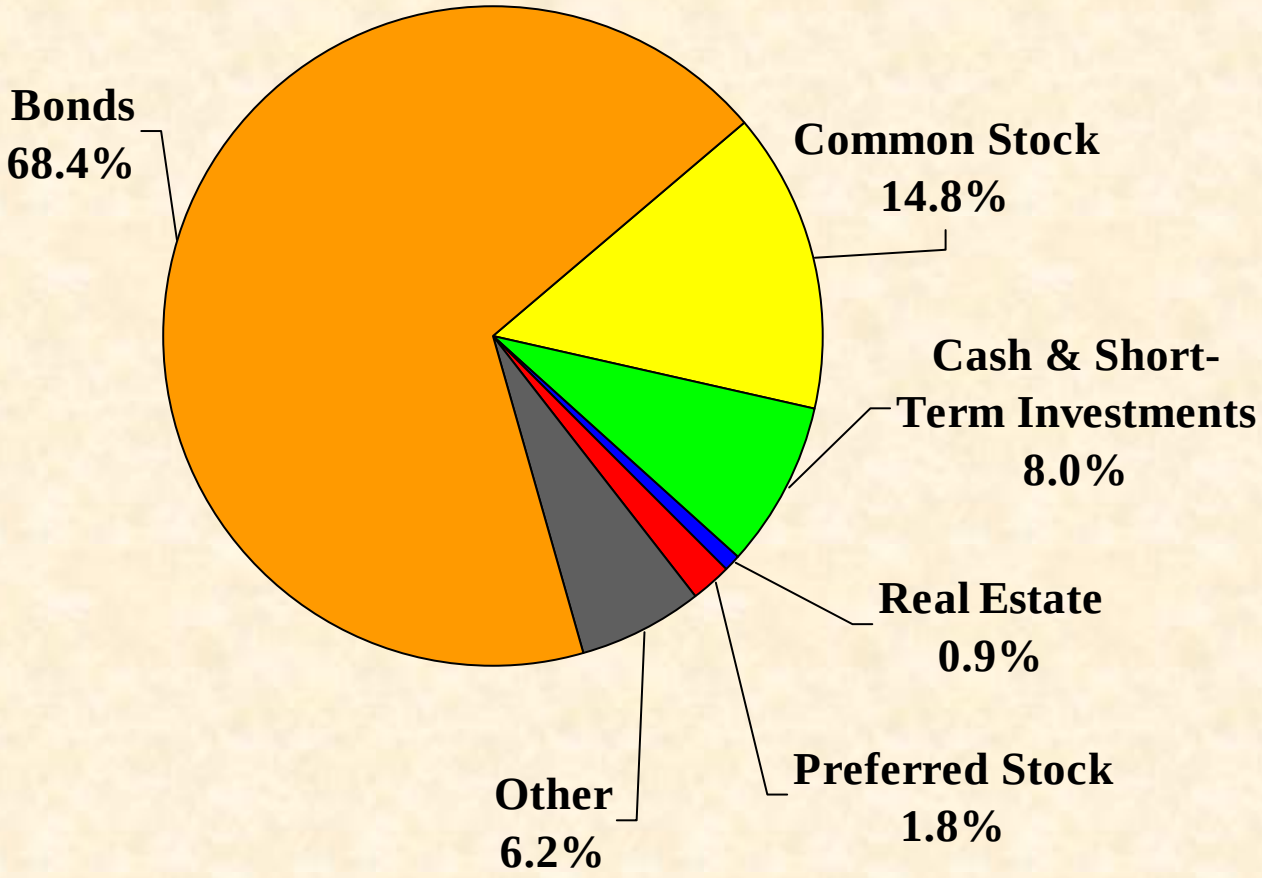
Source: NAIC; Insurance Information Institute research;.

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**

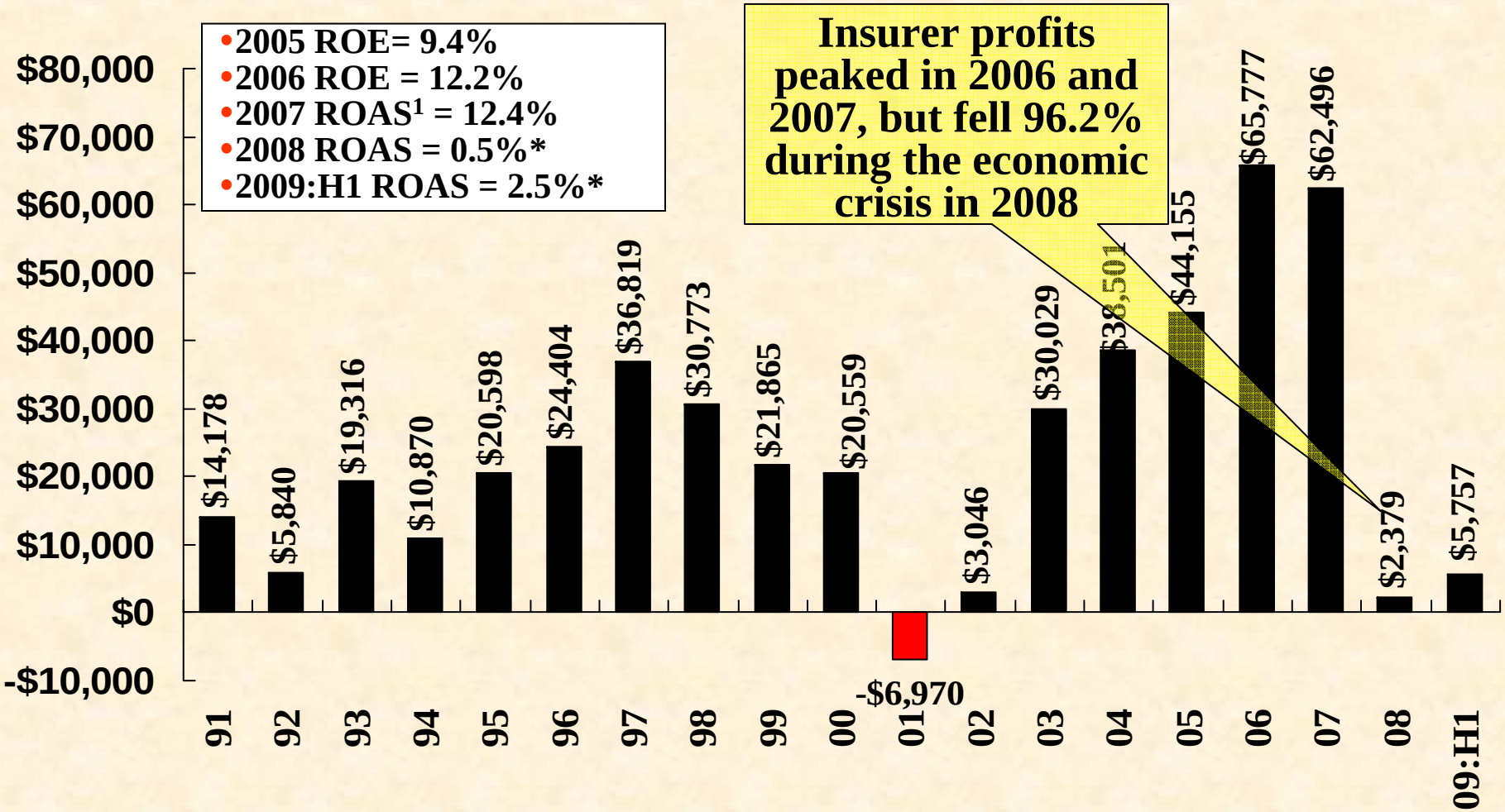


Source: NAIC; Insurance Information Institute research;.

Profitability

Historically Volatile

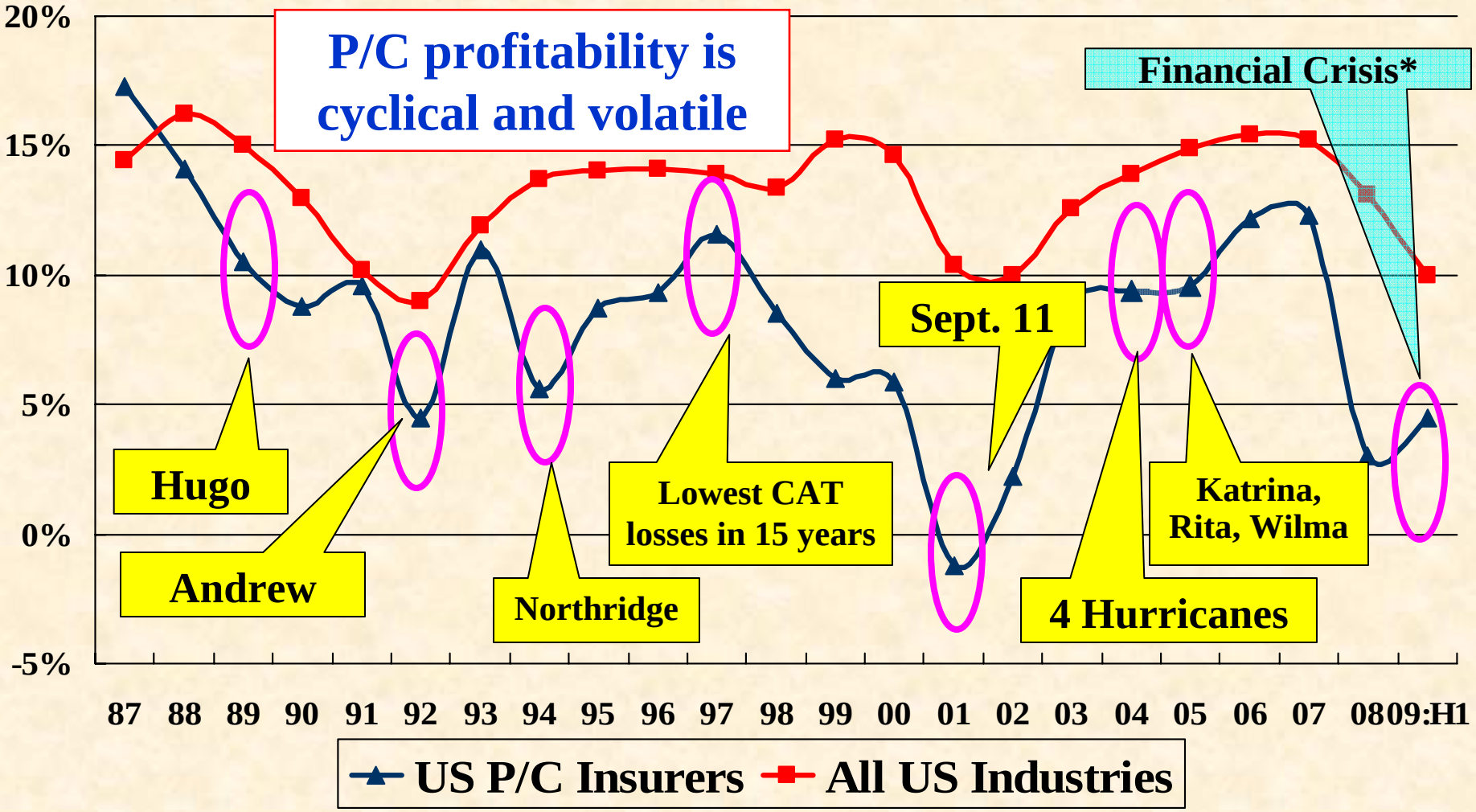
P/C Net Income After Taxes 1991-2009:H1 ($ Millions)*



*ROE figures are GAAP; [1]Return 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.

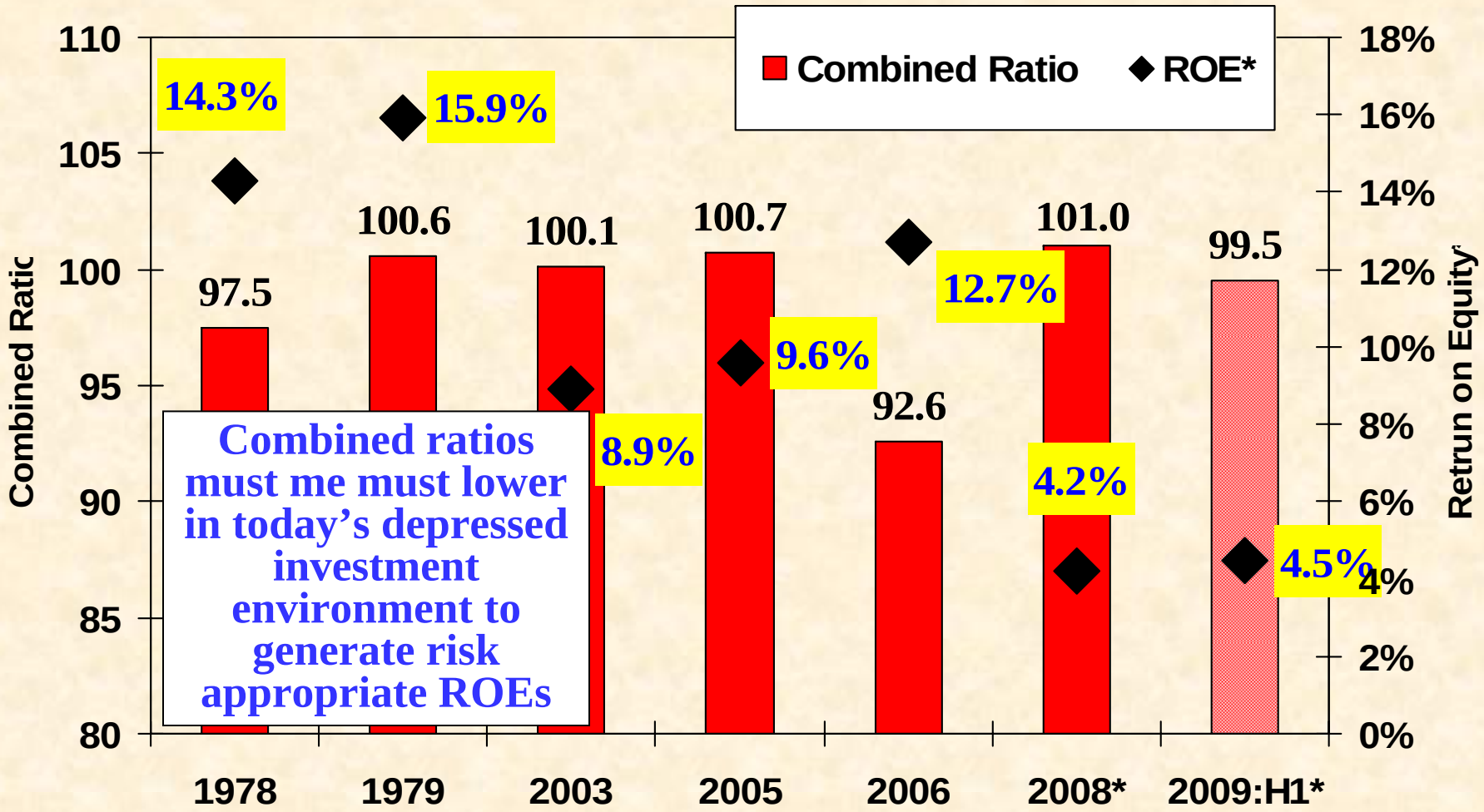
Sources: A.M. Best, ISO, Insurance Information Inst.

ROE: P/C vs. All Industries 1987–2009: H1*



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

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



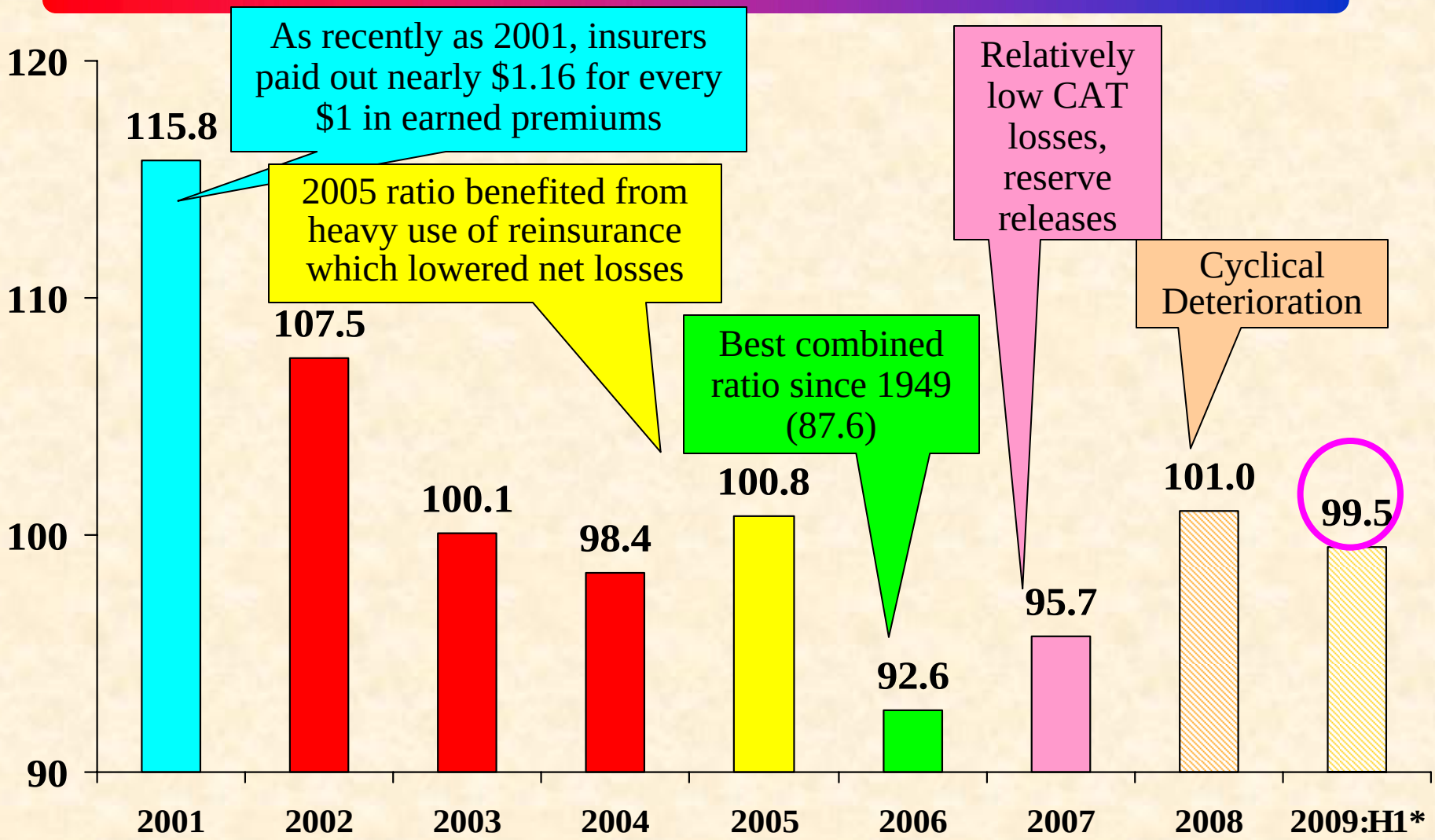
* 2008/9 figures are return on average statutory surplus. Excludes mortgage and financial guarantee insurers.

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

Underwriting Trends

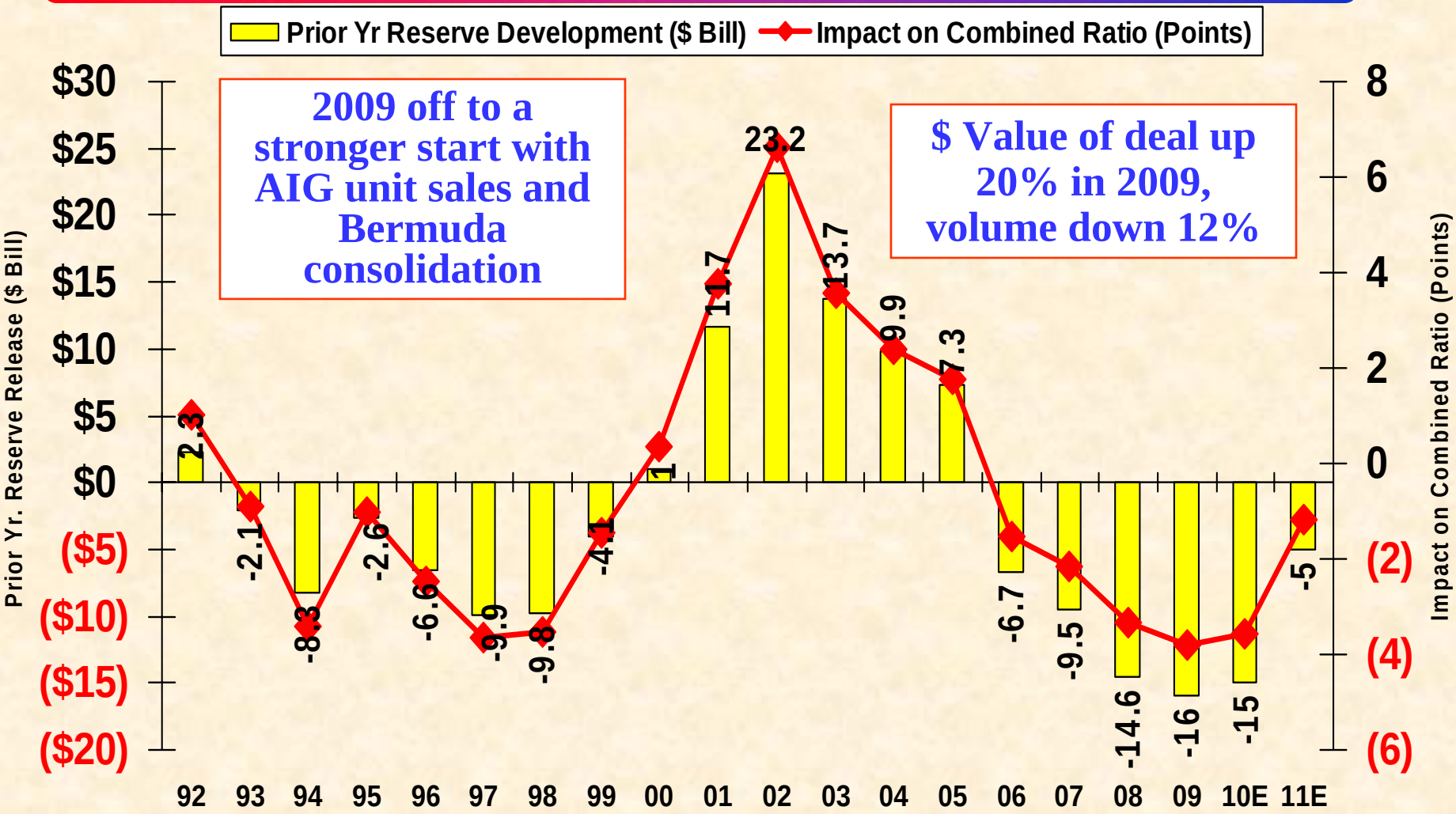
Financial Crisis Does *Not* Directly Impact Underwriting Performance: Cycle, Catastrophes Were 2008's Drivers

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.

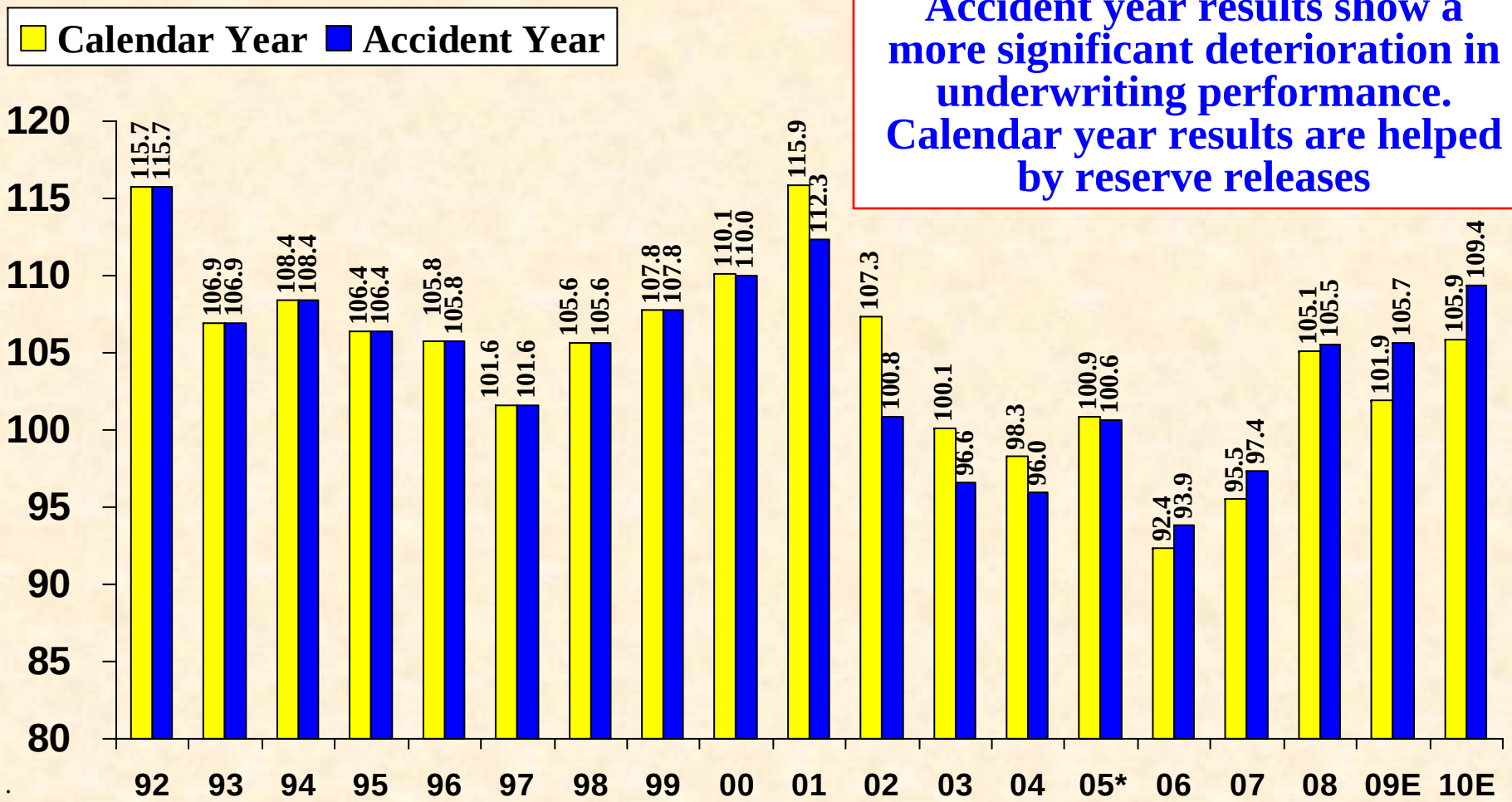
P/C Reserve Development, 1992-2011E



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.

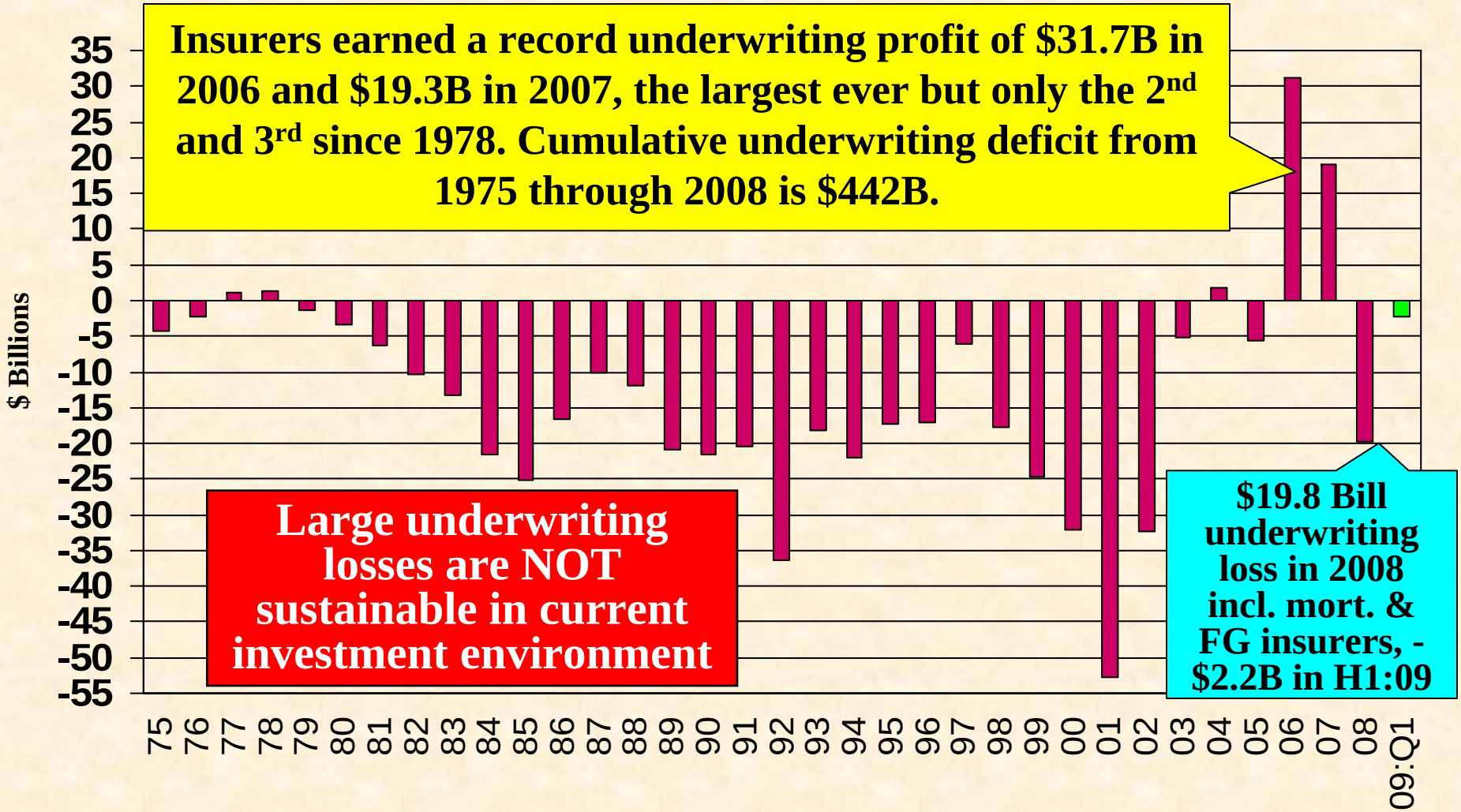
Calendar Year vs. Accident Year P/C Combined Ratio:1992- 2010E[1]

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.

*Underwriting Gain (Loss) 1975-2009:H1**

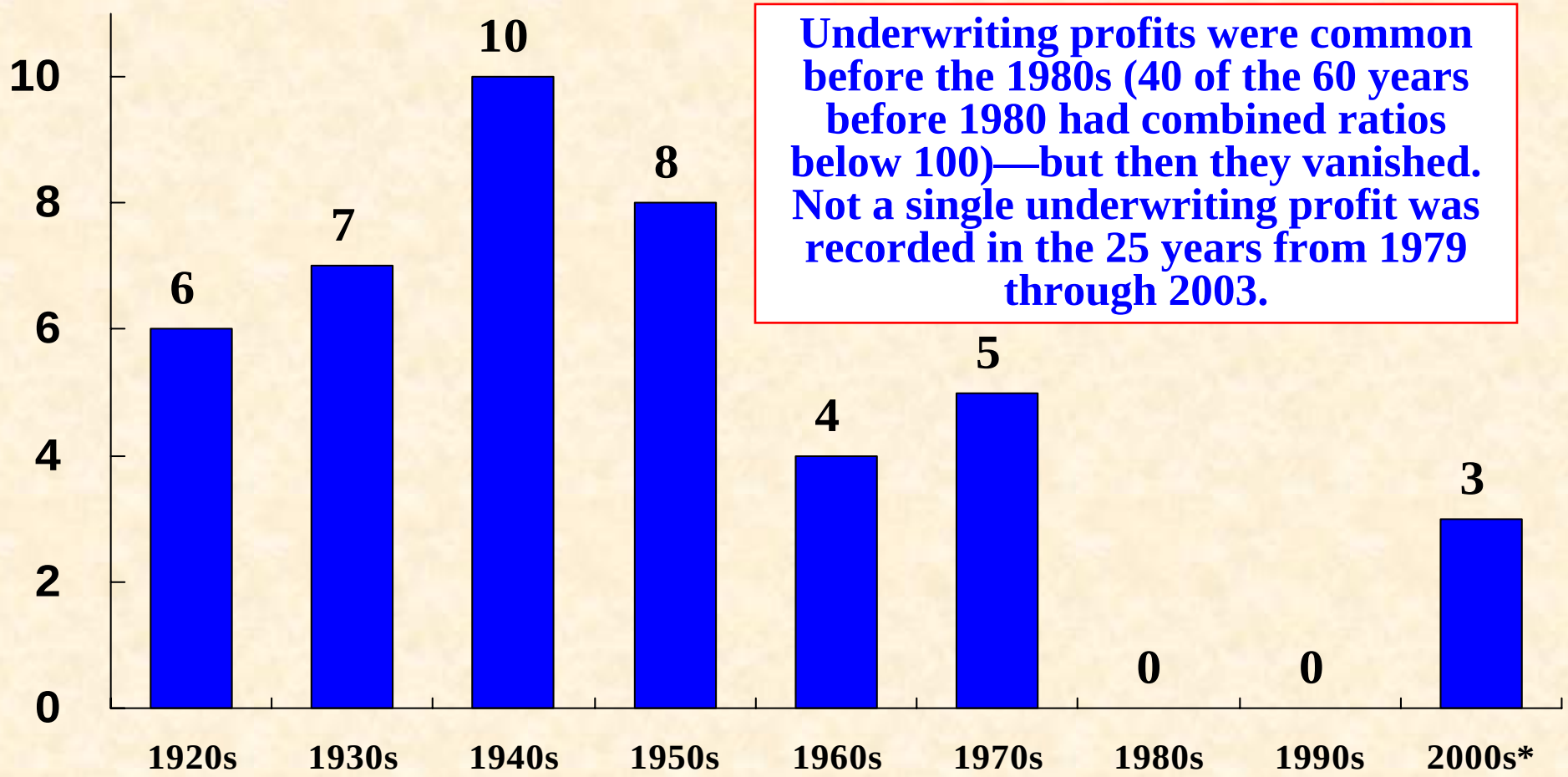


Source: A.M. Best, ISO; Insurance Information Institute

* Includes mortgage & finl. guarantee insurers

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.

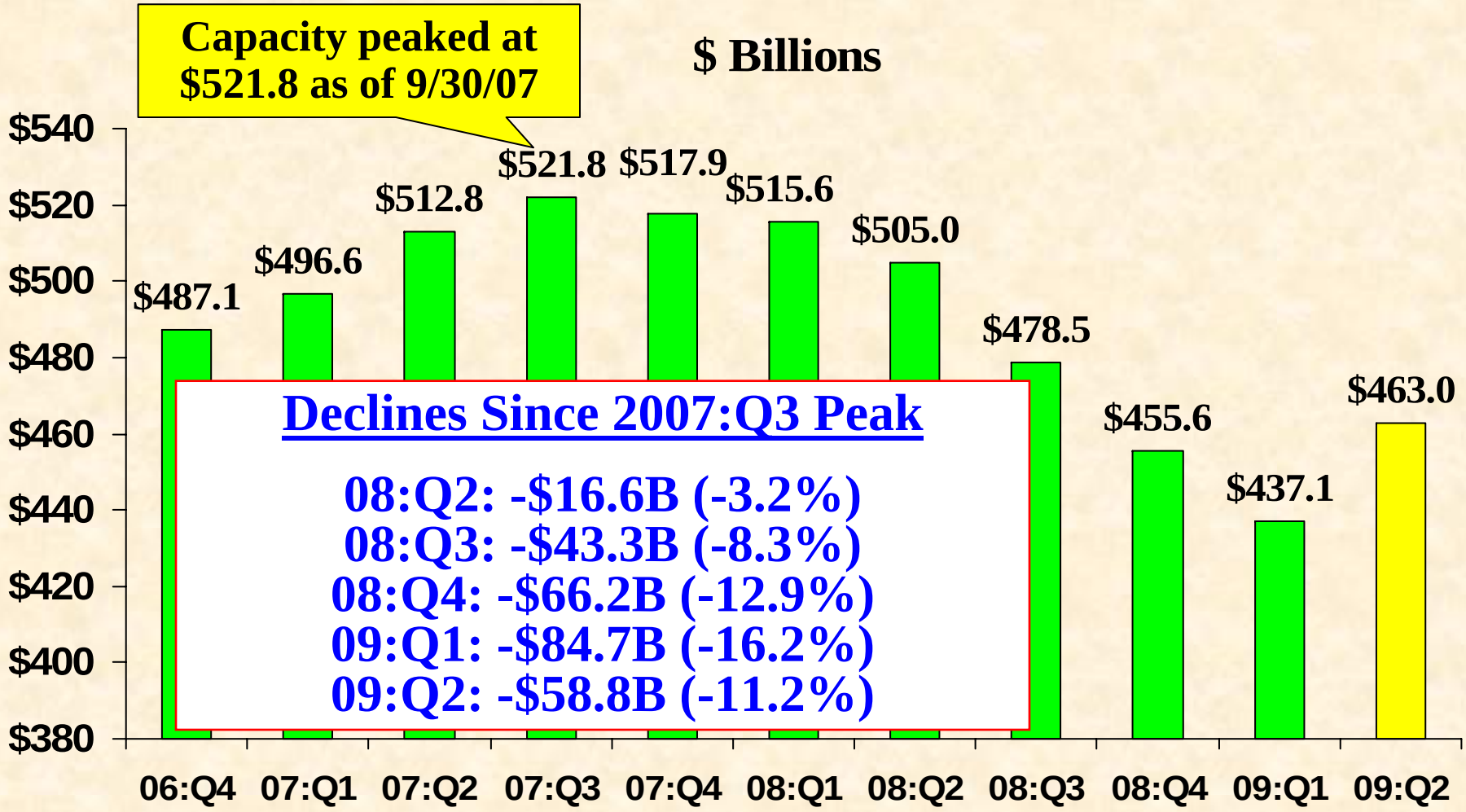
Sources: Insurance Information Institute research from A.M. Best Data.

*2000 through 2008.

Capital/ Policyholder Surplus (US)

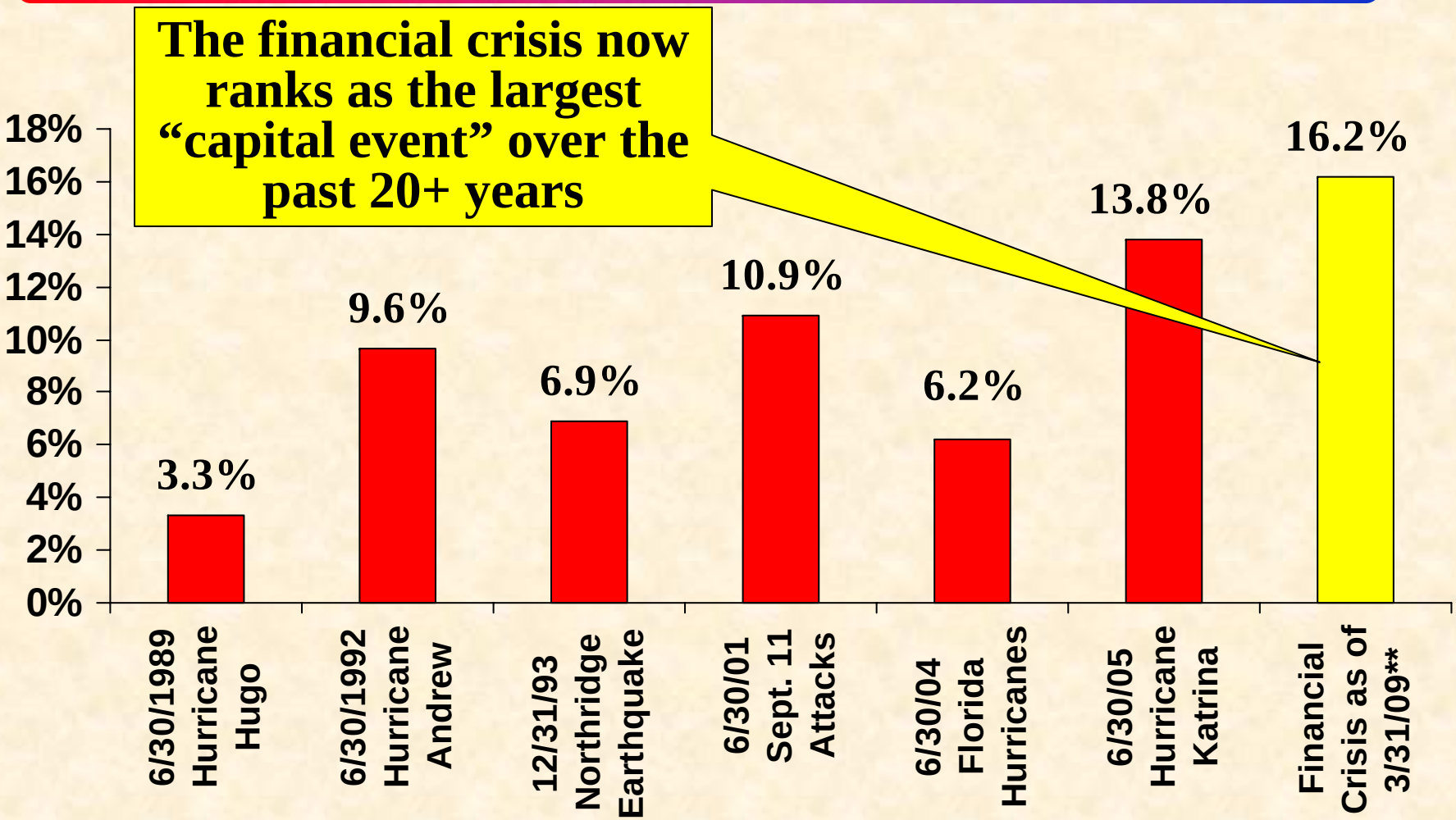
Shrinkage, but Not Enough to Trigger Hard Market

Policyholder Surplus, 2006:Q4 – 2009:H1



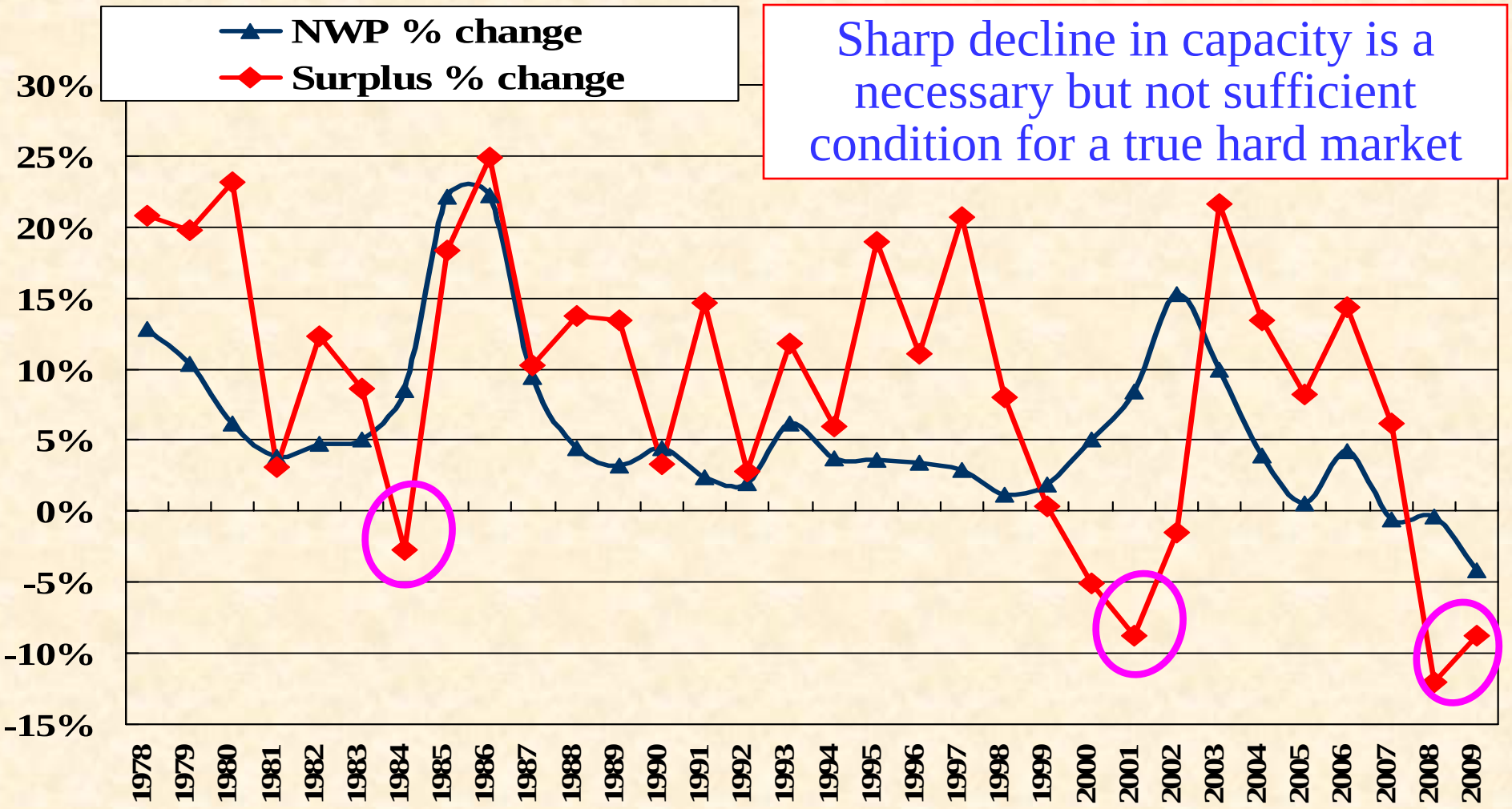
Source: ISO, AM Best.

*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%.
Source: PCS; Insurance Information Institute.

*Historically, Hard Markets Follow When Surplus "Growth" is Negative**



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

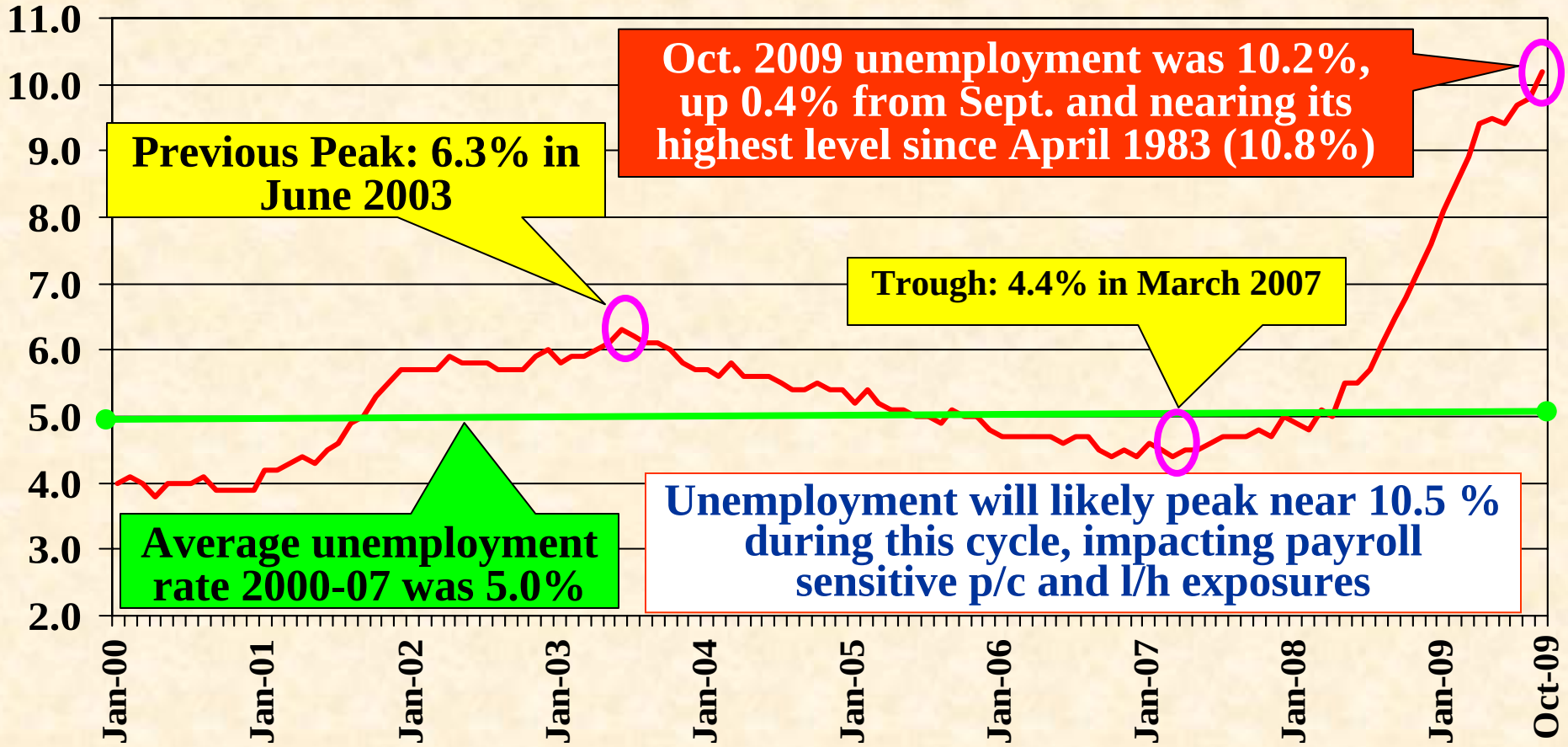
Sources: A.M. Best, ISO, Insurance Information Institute

Labor Market Trends

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

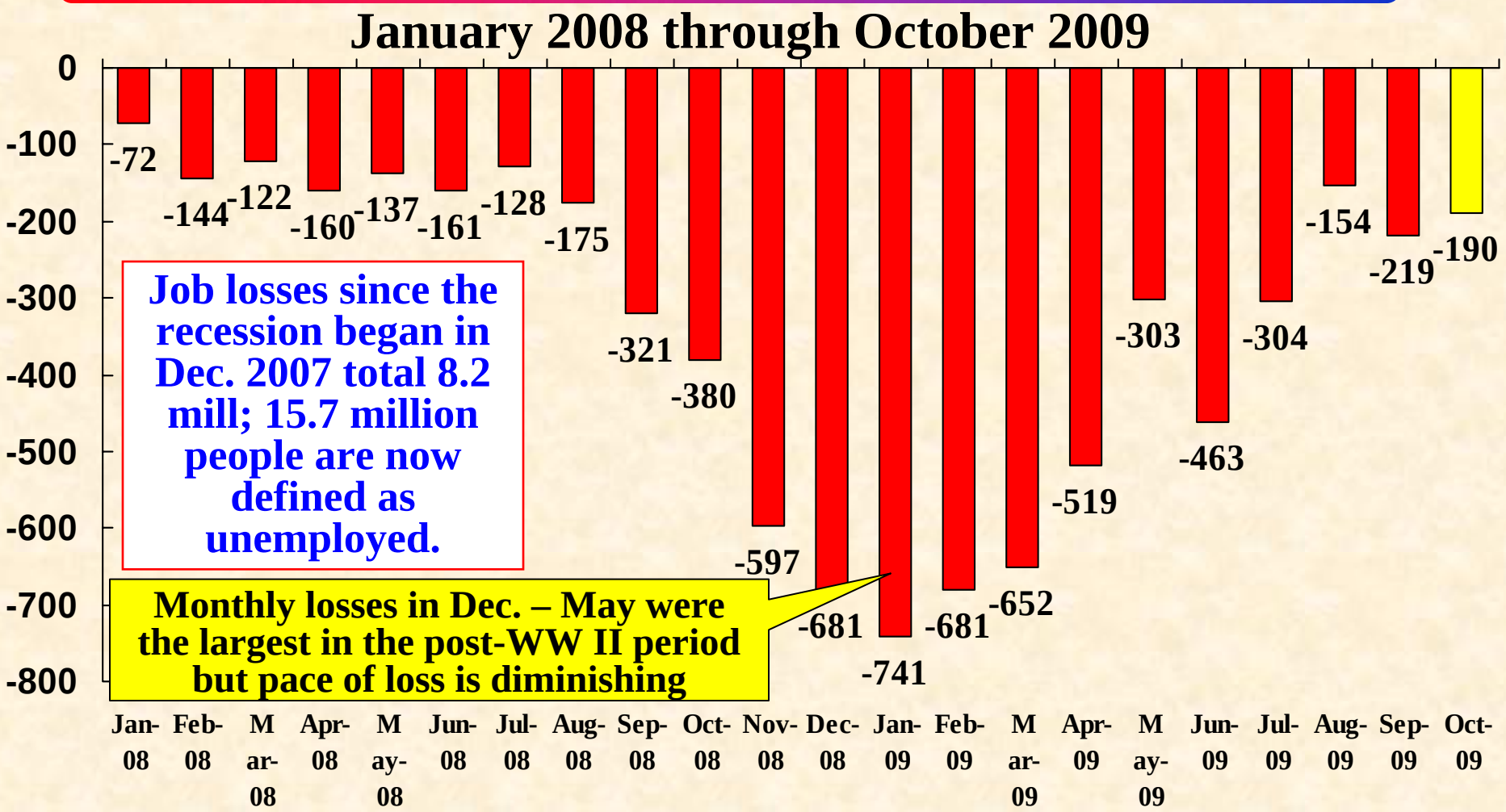
Unemployment Rate: On the Rise

January 2000 through October 2009*



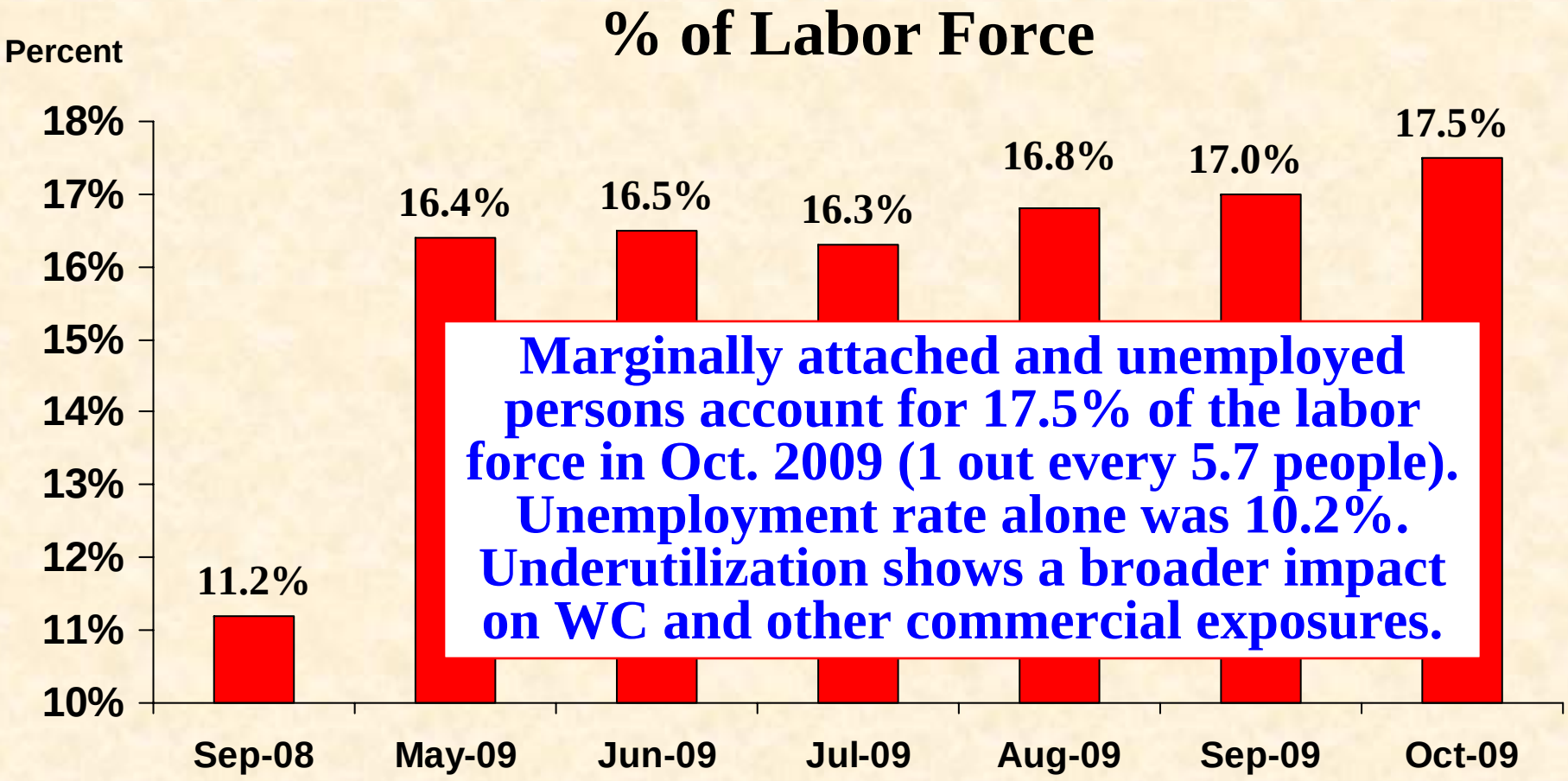
Source: US Bureau of Labor Statistics; Insurance Information Institute.

Monthly Change Employment (Thousands)*



Source: US Bureau of Labor Statistics: http://www.bls.gov/ces/home.htm; Insurance Info. Institute

Labor Underutilization: Broader than Just Unemployment

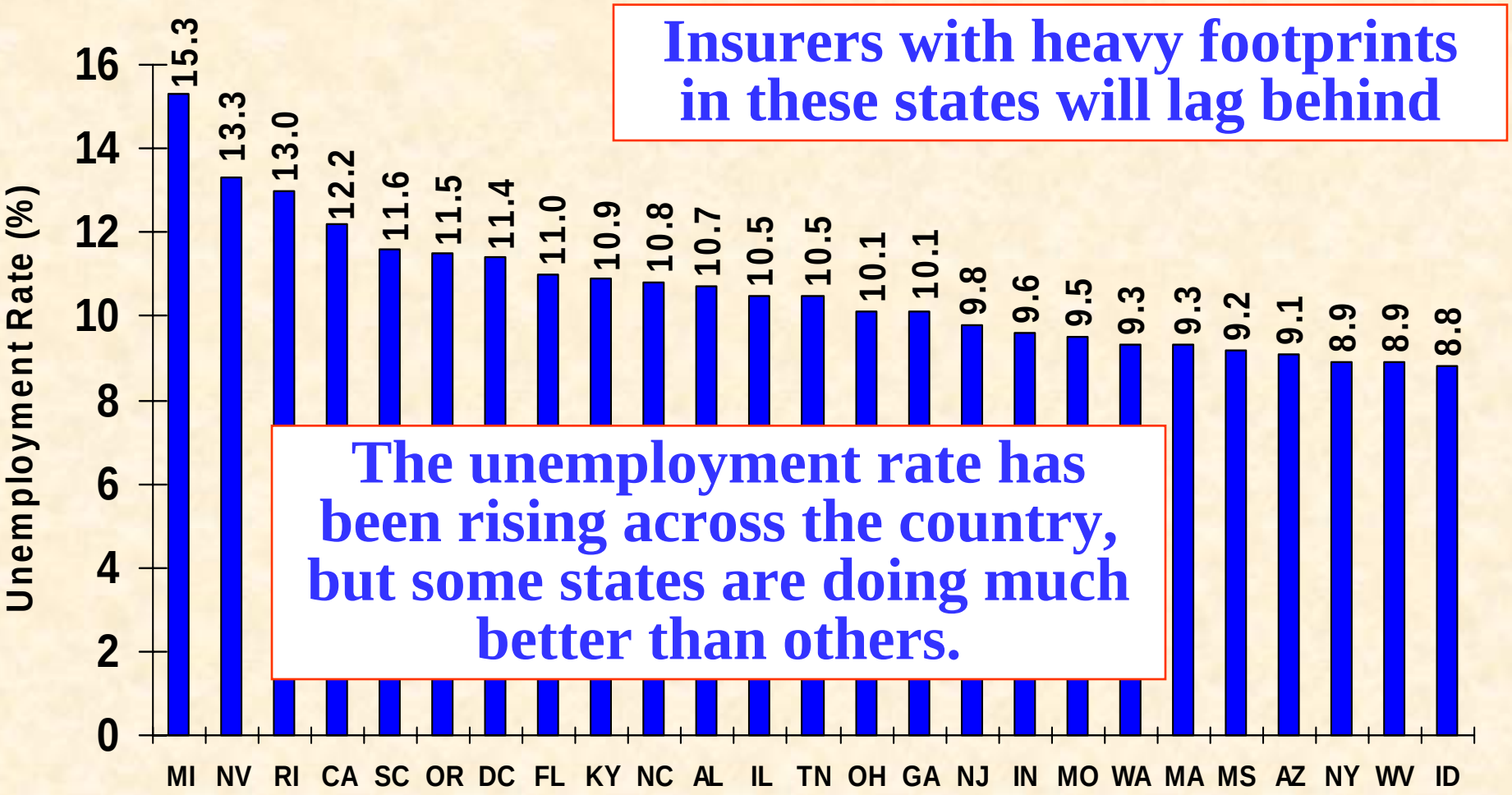


Marginally attached and unemployed persons account for 17.5% of the labor force in Oct. 2009 (1 out every 5.7 people). Unemployment rate alone was 10.2%. Underutilization shows a broader impact on WC and other commercial exposures.

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.

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

*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.

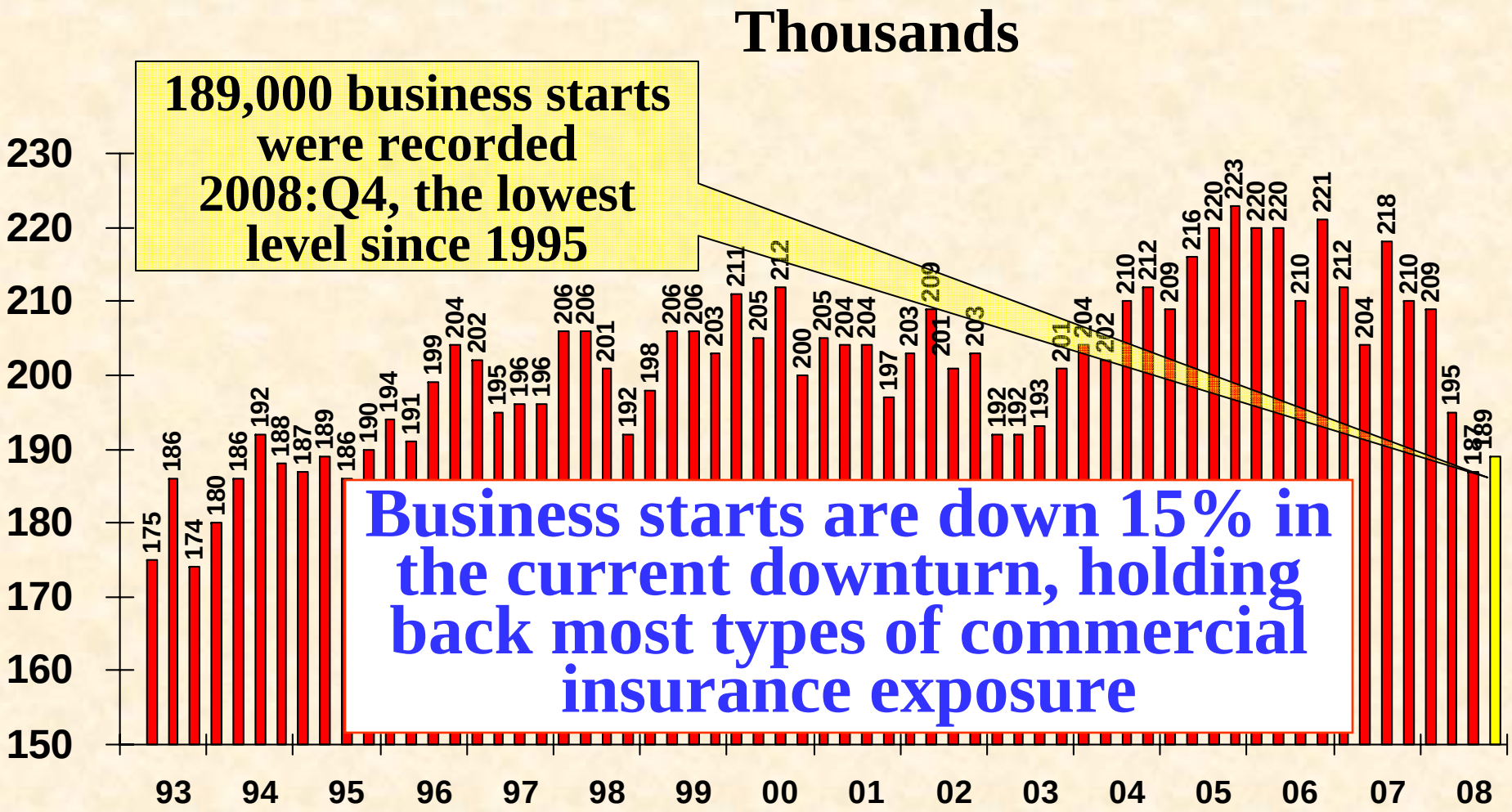
*Provisional figures for September 2009, seasonally adjusted.

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

Crisis-Driven Exposure Drivers

Economic Obstacles to Growth in P/C Insurance

*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

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

Source: Ins. Info. Inst.

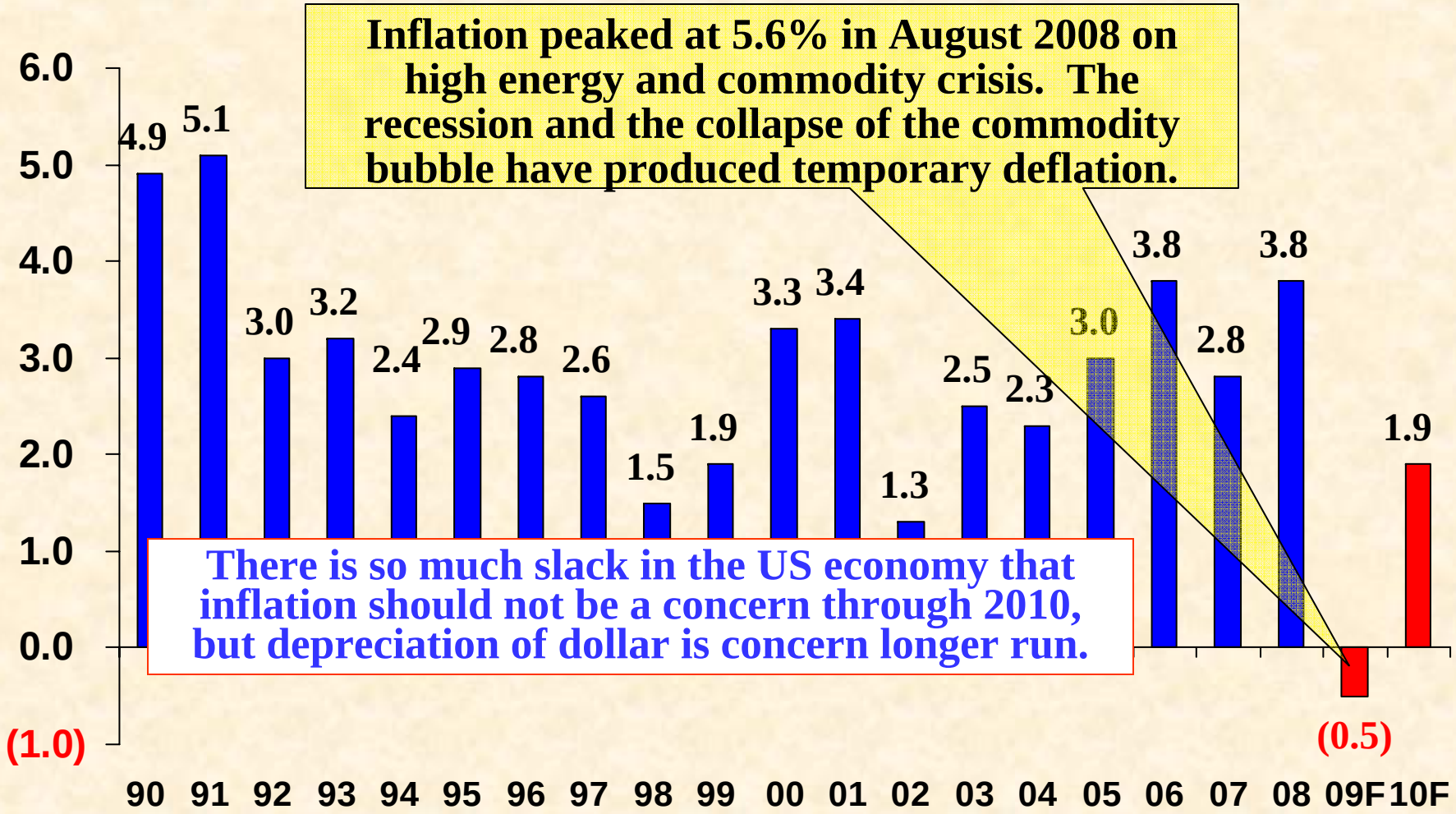
11 Industries for the Next 10 Years: Insurance Solutions Needed

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*

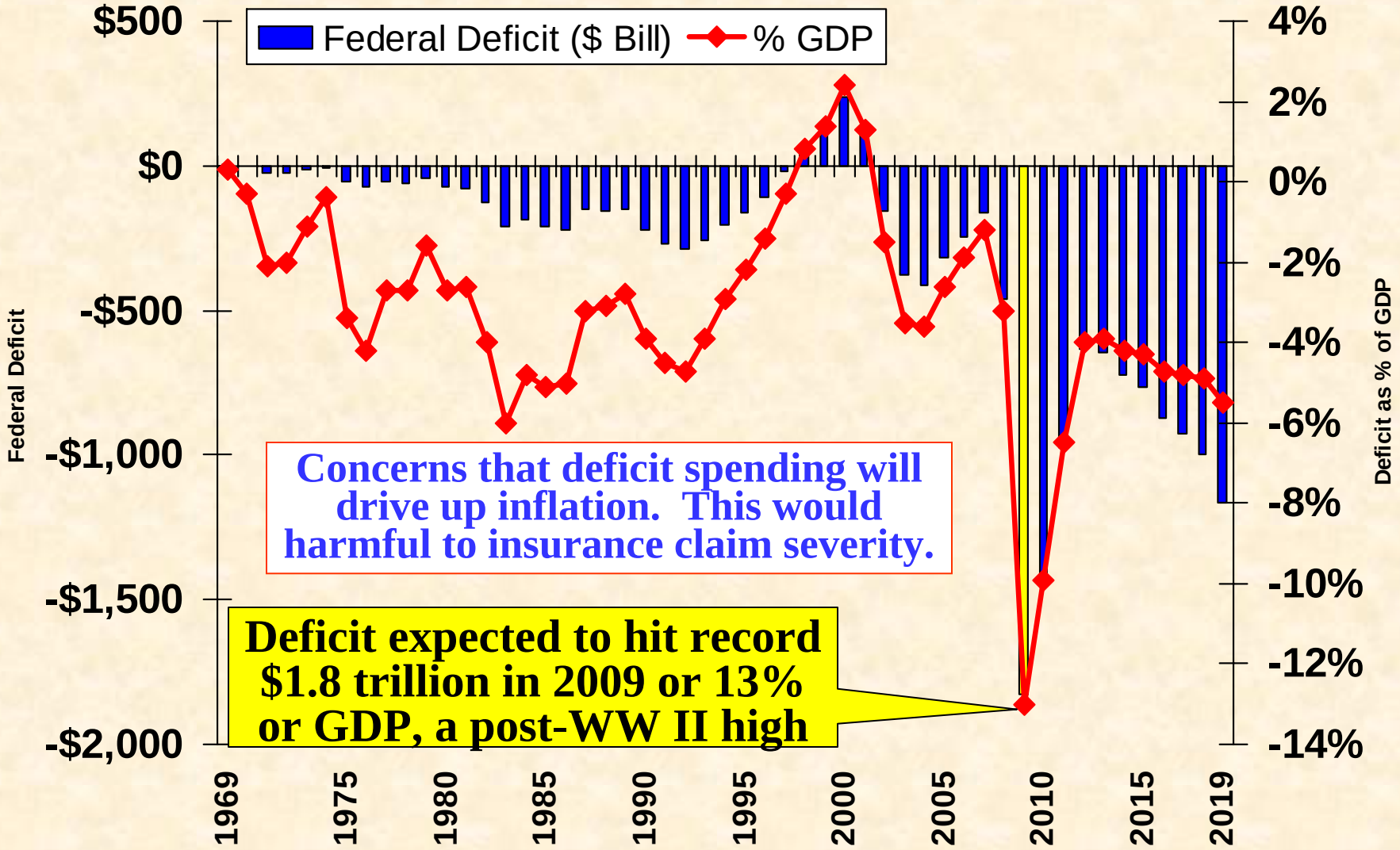
Mounting Pressure on Claim Cost Severities?

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



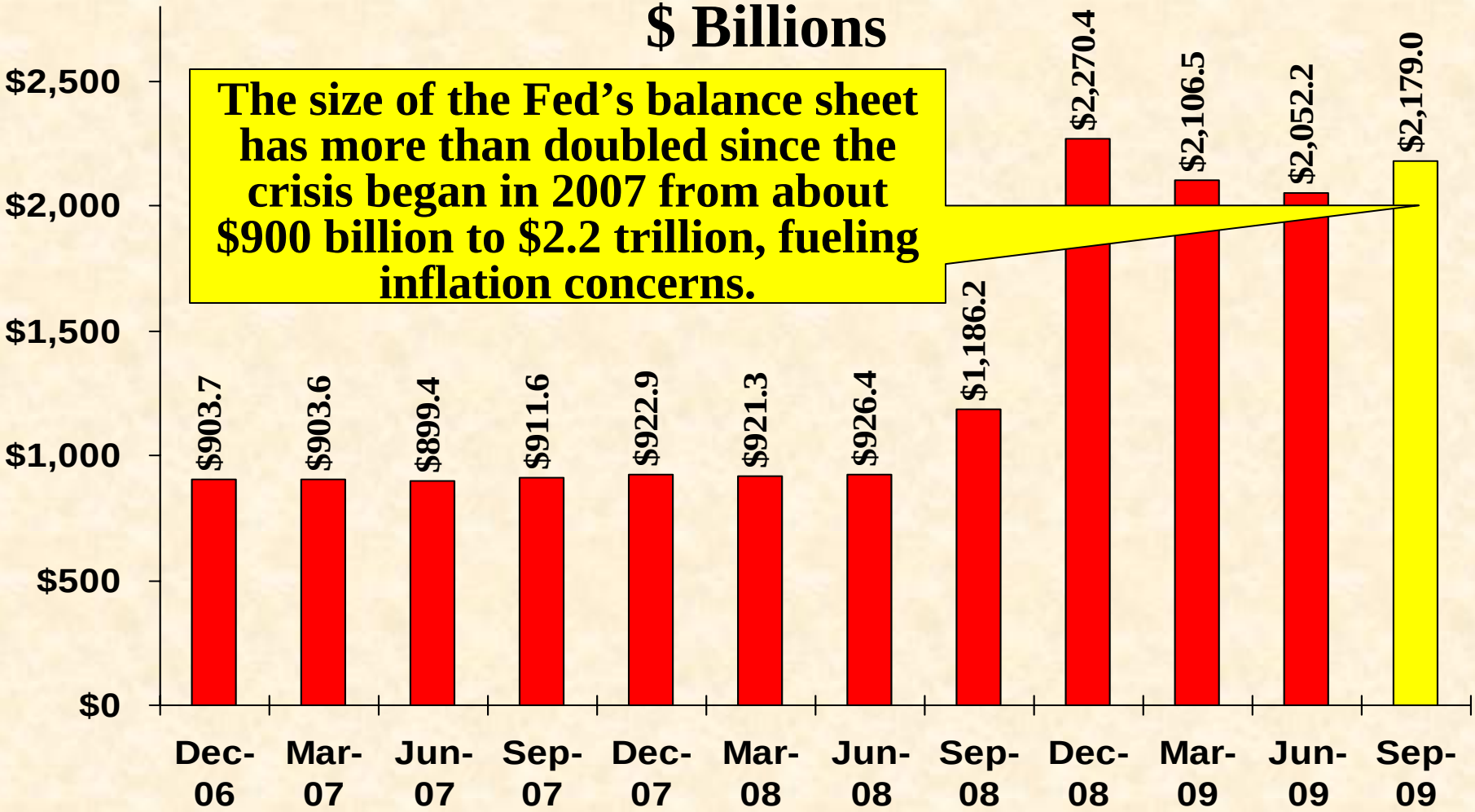
Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators, Oct. 10, 2009 (forecasts).

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.

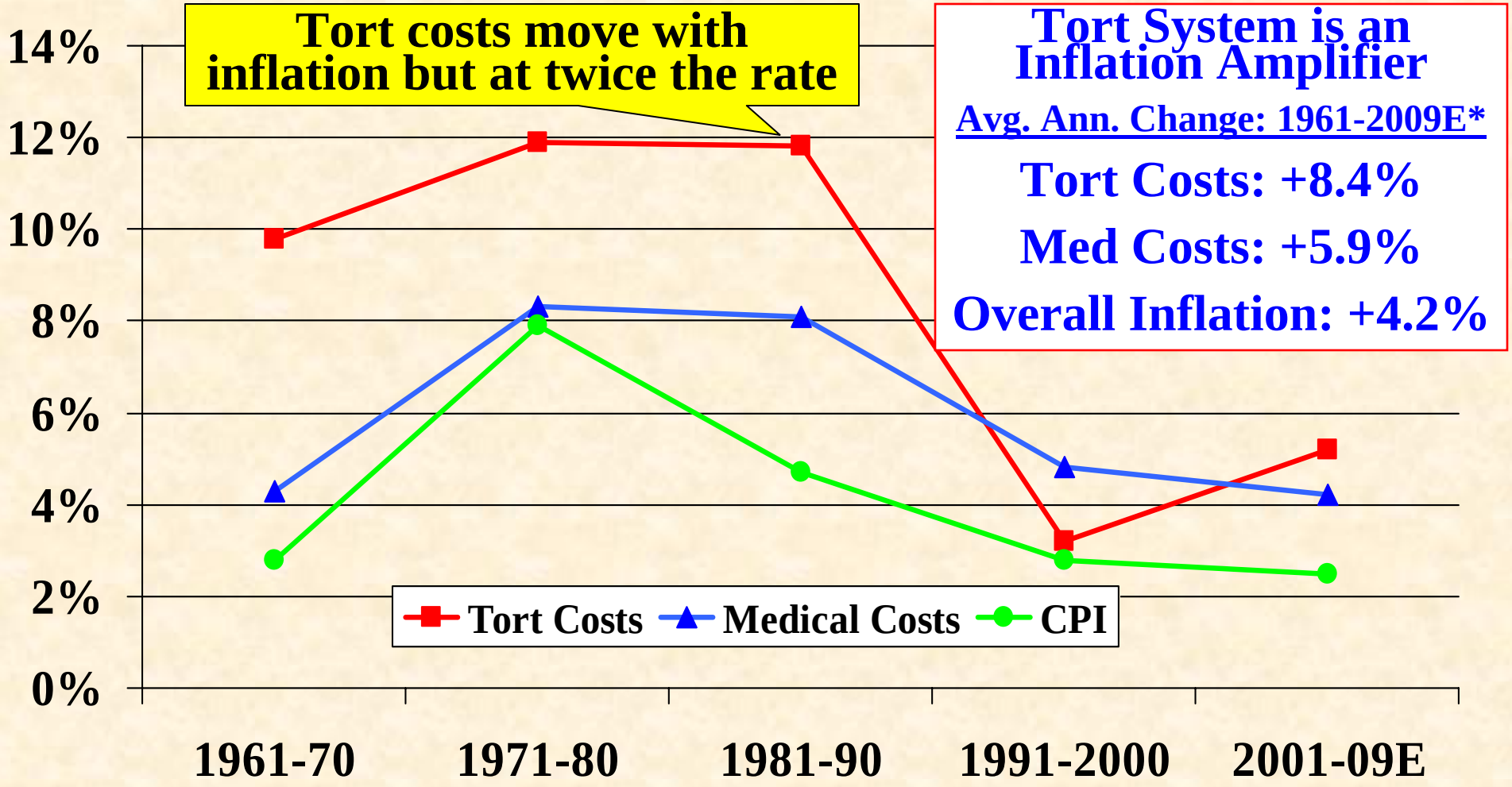
- **What are the potential impacts for insurers?**
- **What can/should insurers do to protect themselves from the risks of inflation?**

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**

Source: Ins. Info. Inst.

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



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

Sources: US Bureau of Labor Statistics, Tillinghast-Towers Perrin, *2008 Update on U.S. Tort Costs;* Insurance Info. Inst.

Shifting Legal Liability & Tort Environment

Is the Tort Pendulum Swinging Against Insurers?

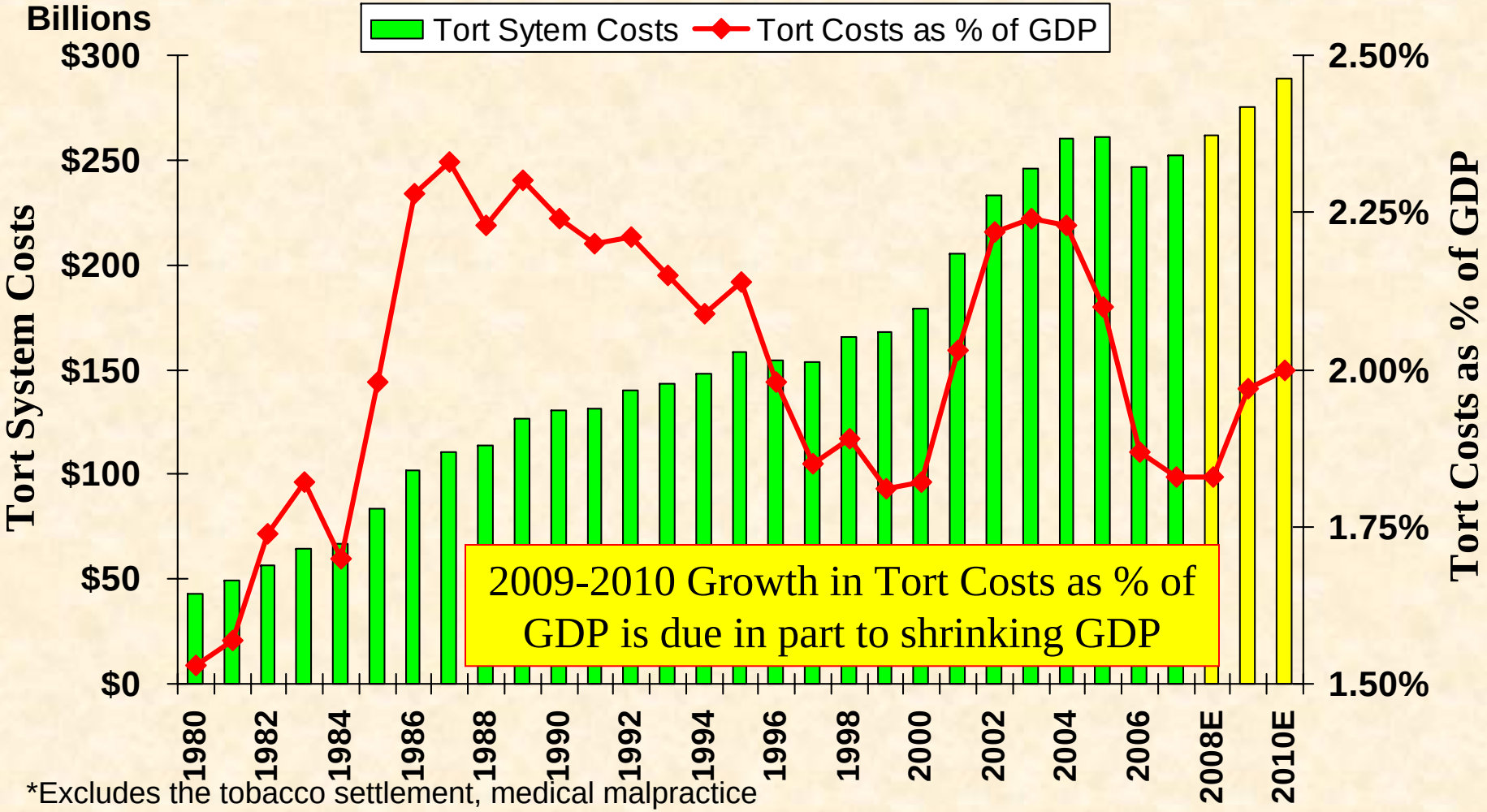
Important Issues & Threats Facing Insurers: 2009 -2015

Emerging Tort Threat

- **No tort reform (or protection of recent reforms) is forthcoming from the current Congress or Administration**
- **Erosion of recent reforms is a certainty (already happening)**
- **Innumerable legislative initiatives will create opportunities to undermine existing reforms and develop new theories and channels of liability**
- **Torts twice the overall rate of inflation**
- **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*



*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

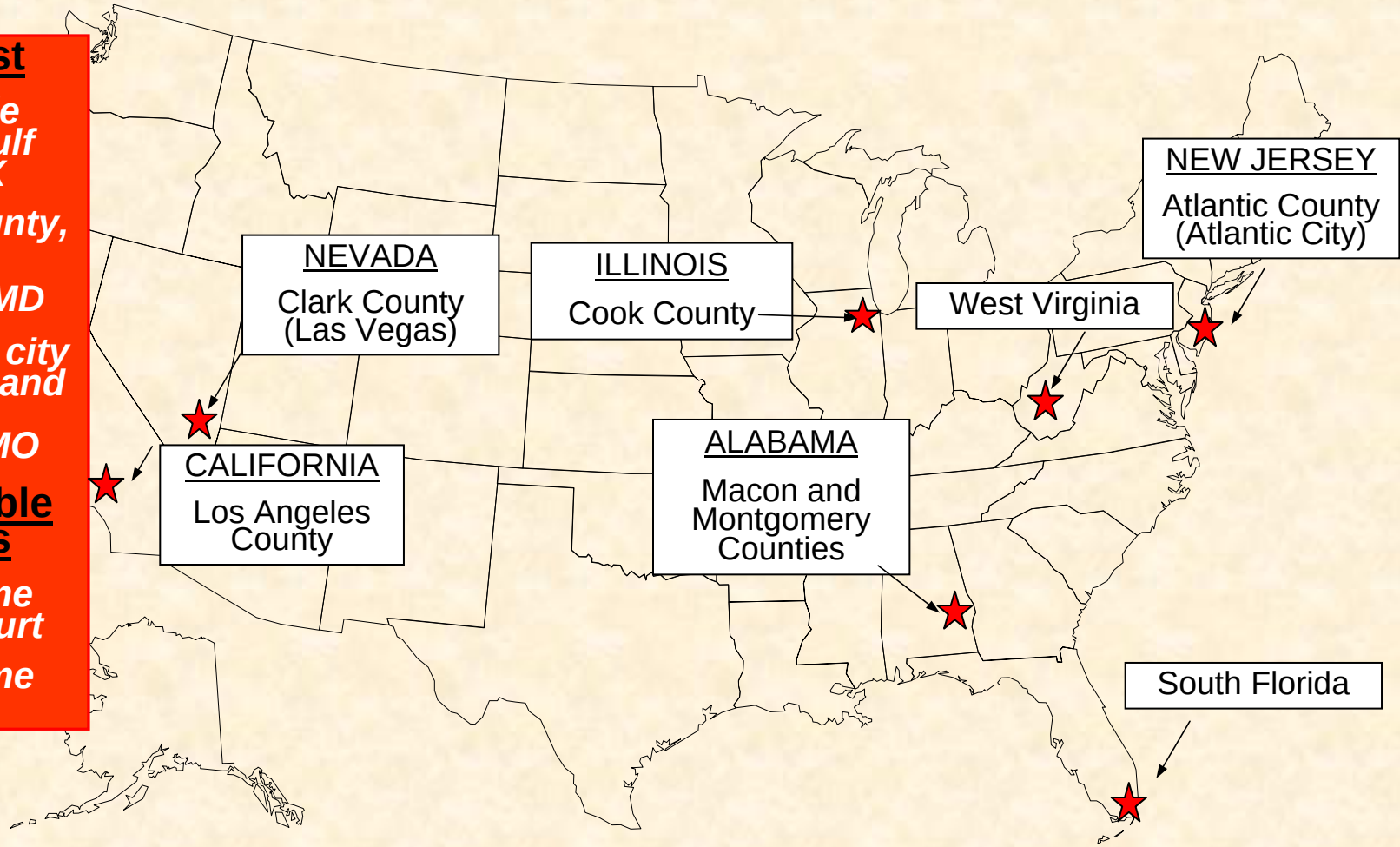
Baltimore, MD

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

Dishonorable Mentions

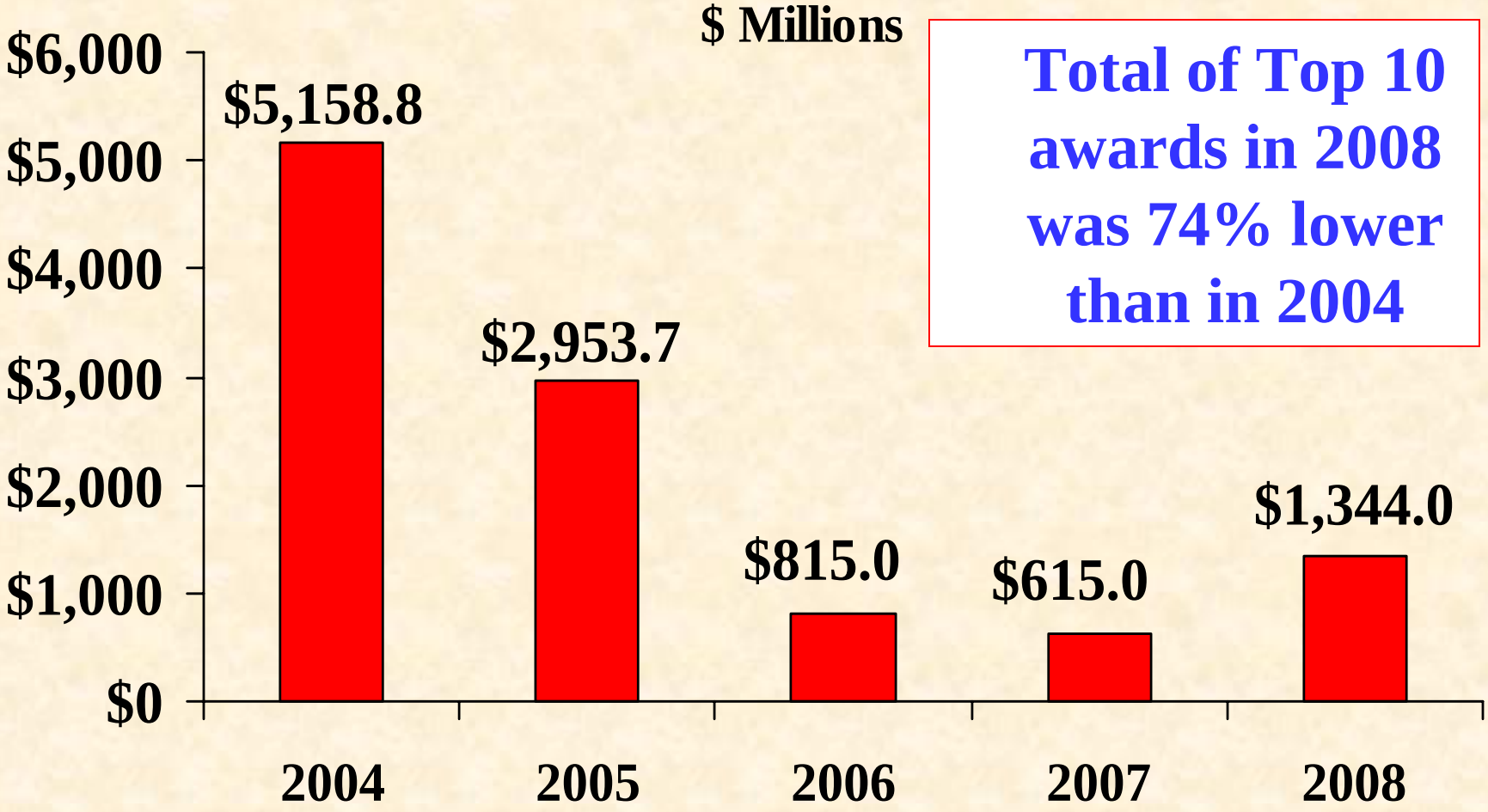
MA Supreme Judicial Court

MO Supreme Court



Source: American Tort Reform Association; Insurance Information Institute

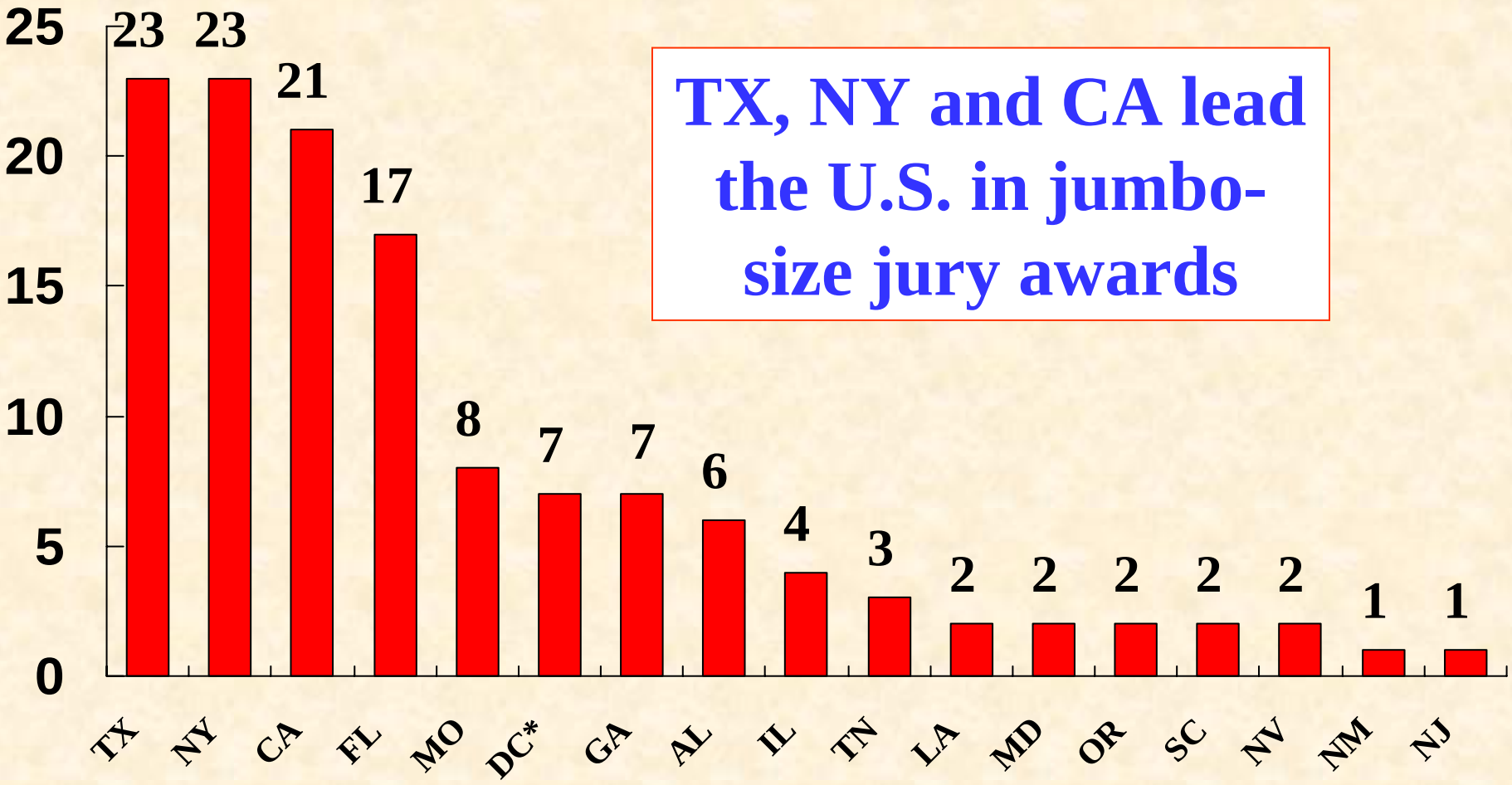
Sum of Top 10 Jury Awards, 2004-2008



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

Source: Insurance Information Institute from LawyersWeekly USA, January 2005, 2006, 2007, 2008 and 2009.

Number of Top 10 Jury Awards, 1995 - 2008



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

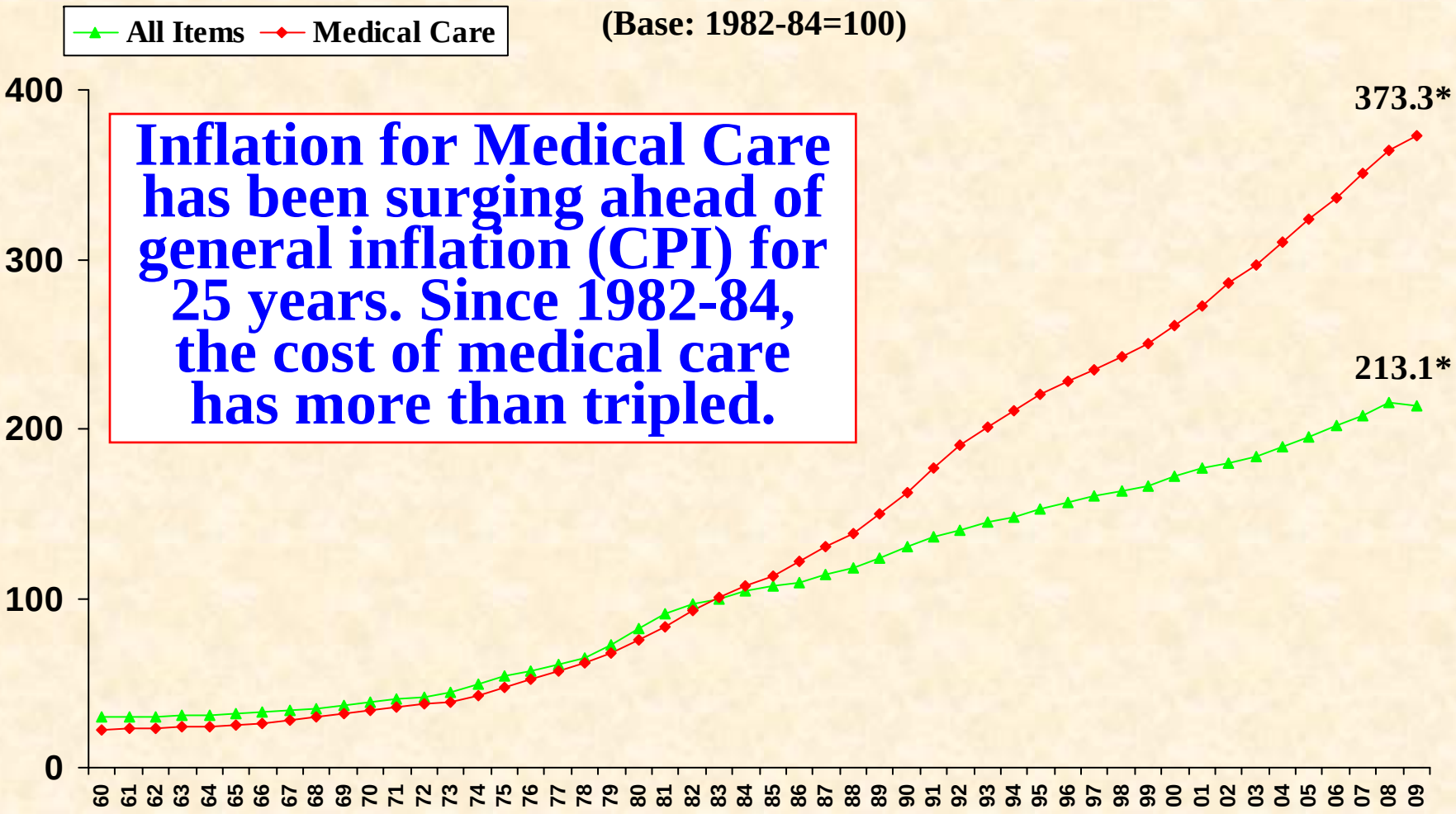
Source: LawyersWeekly USA,, January 1996-2009 issues.

*All against Iran for terrorist activity

MEDICAL & HEALTH CARE COST INFLATION

National Problem & Insurer Cost Driver

*Consumer Price Index for Medical Care vs. All Items, 1960-2009**



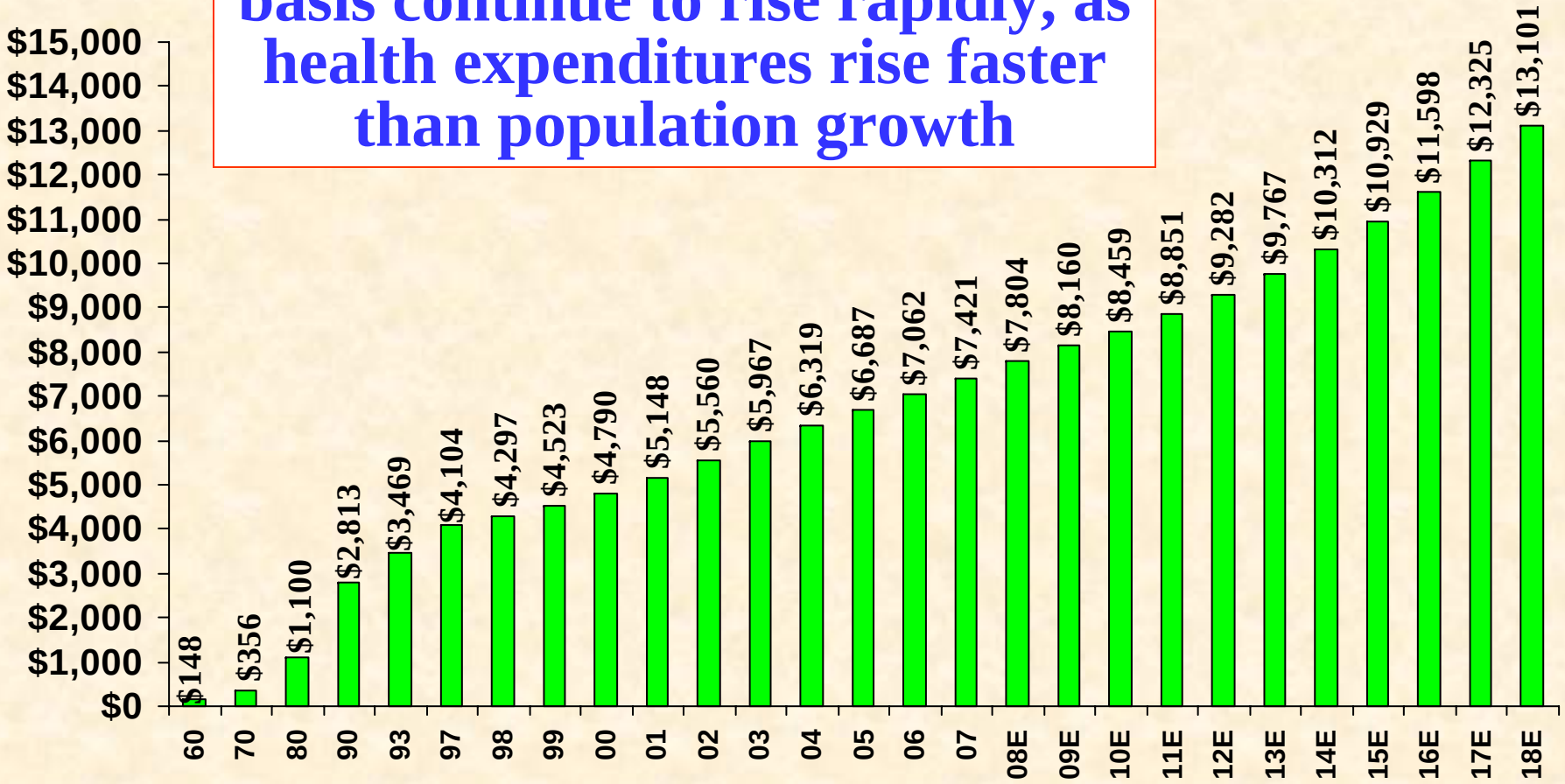
Inflation for Medical Care has been surging ahead of general inflation (CPI) for 25 years. Since 1982-84, the cost of medical care has more than tripled.

*First Half 2009 data.

Source: Department of Labor (Bureau of Labor Statistics).

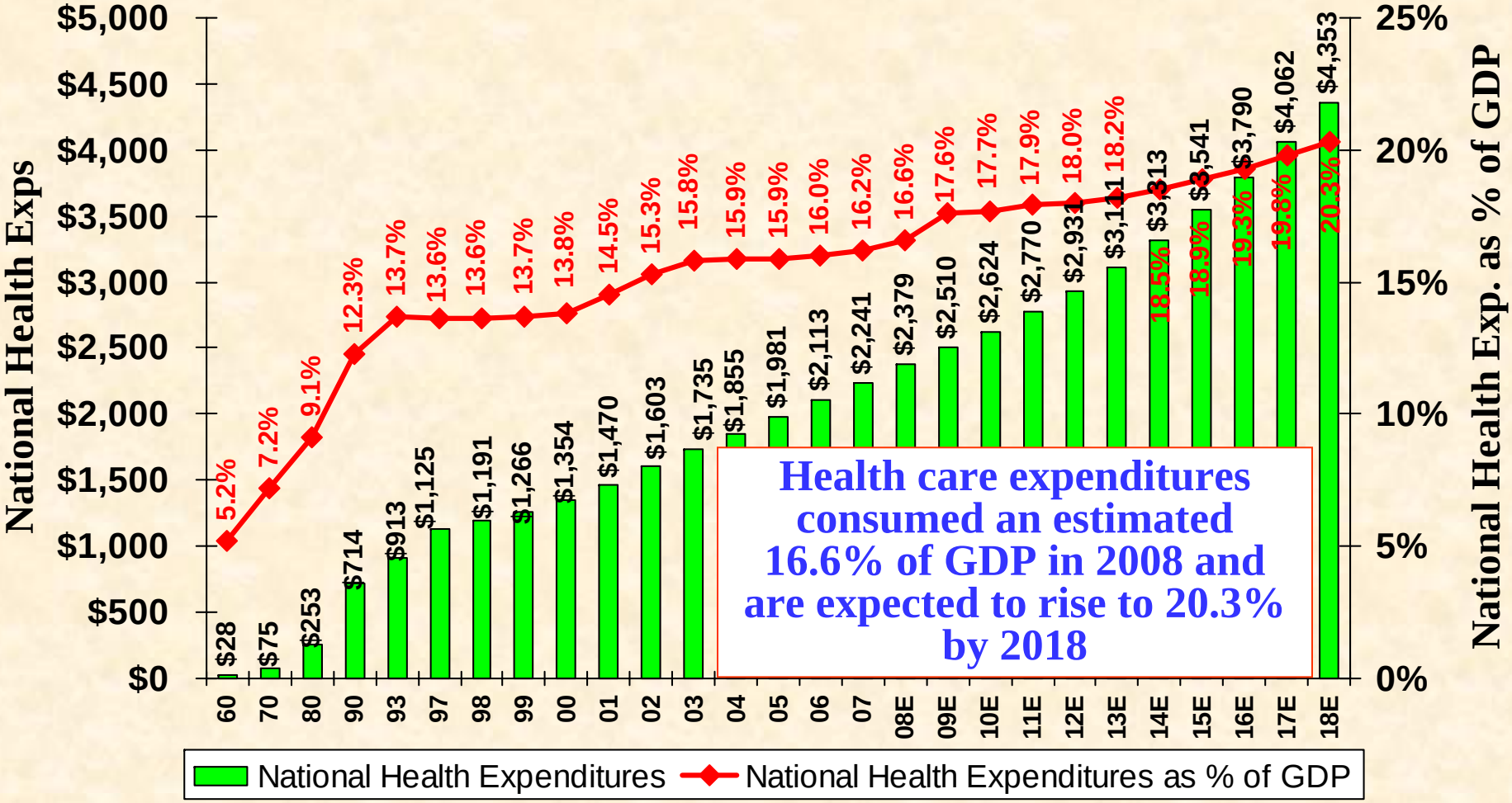
National Health Expenditures Per Capita, 1960-2018E ($Bill)

Health costs on a per capita basis continue to rise rapidly, as health expenditures rise faster than population growth



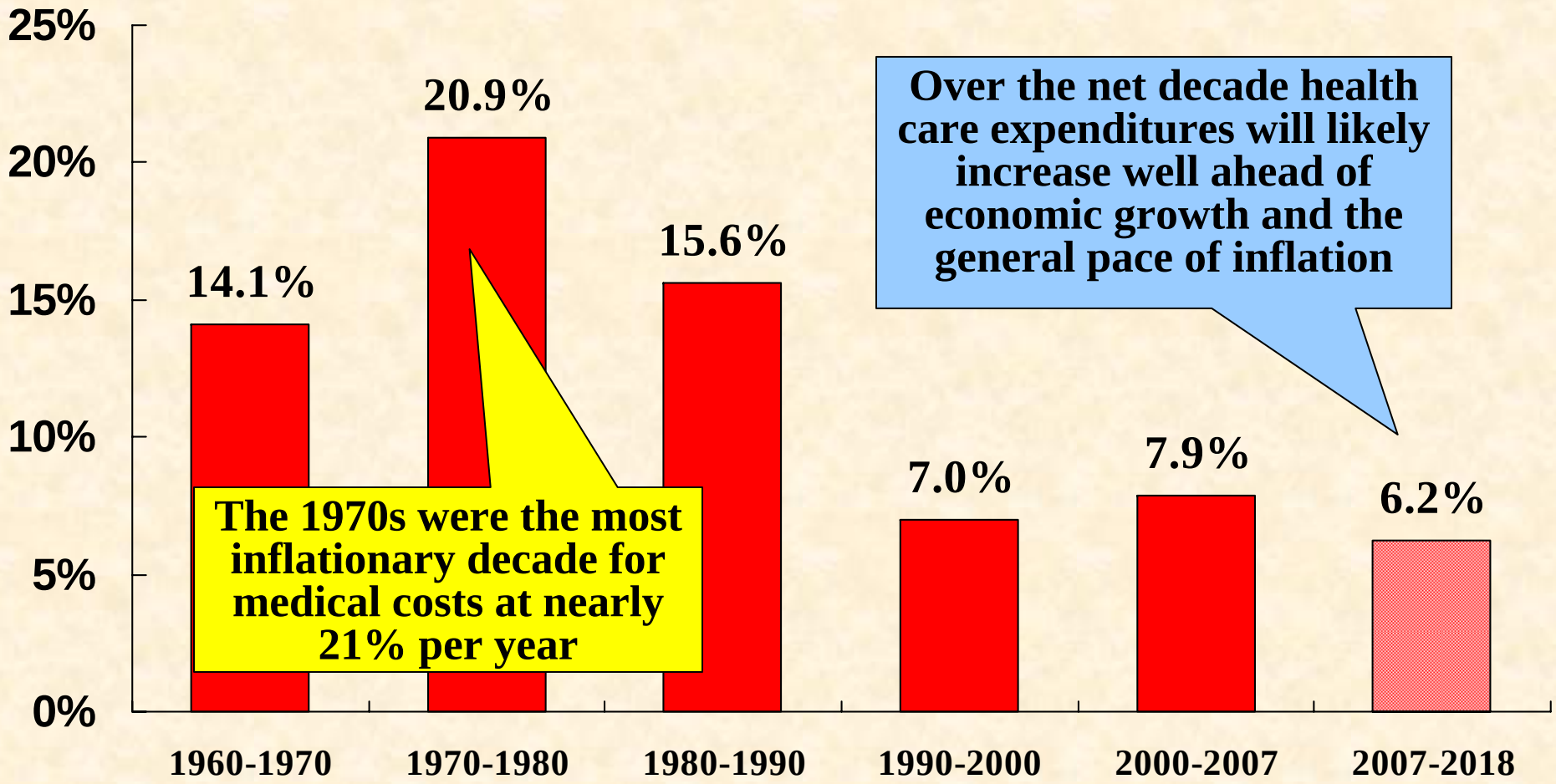
Source: Centers for Medicare & Medicaid Services, Office of the Actuary; Insurance Information Institute.

National Health Expenditures and Health Expenditures as a Share of GDP, 1960-2018F ($ Billions)



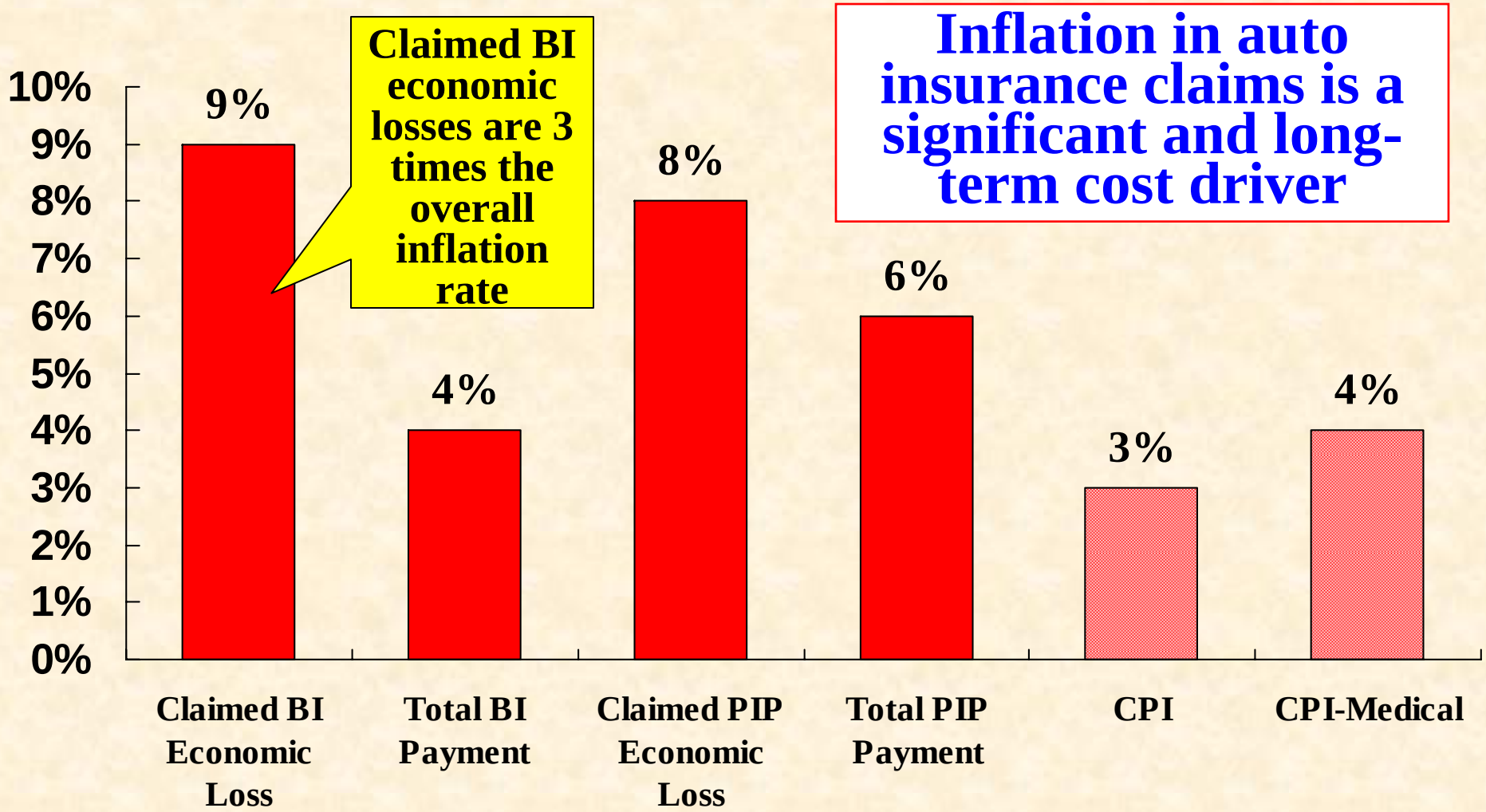
Source: Centers for Medicare & Medicaid Services, Office of the Actuary; Insurance Information Institute.

Average Annual Growth in US Per Capital Health Care Costs, 1960-2018F



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

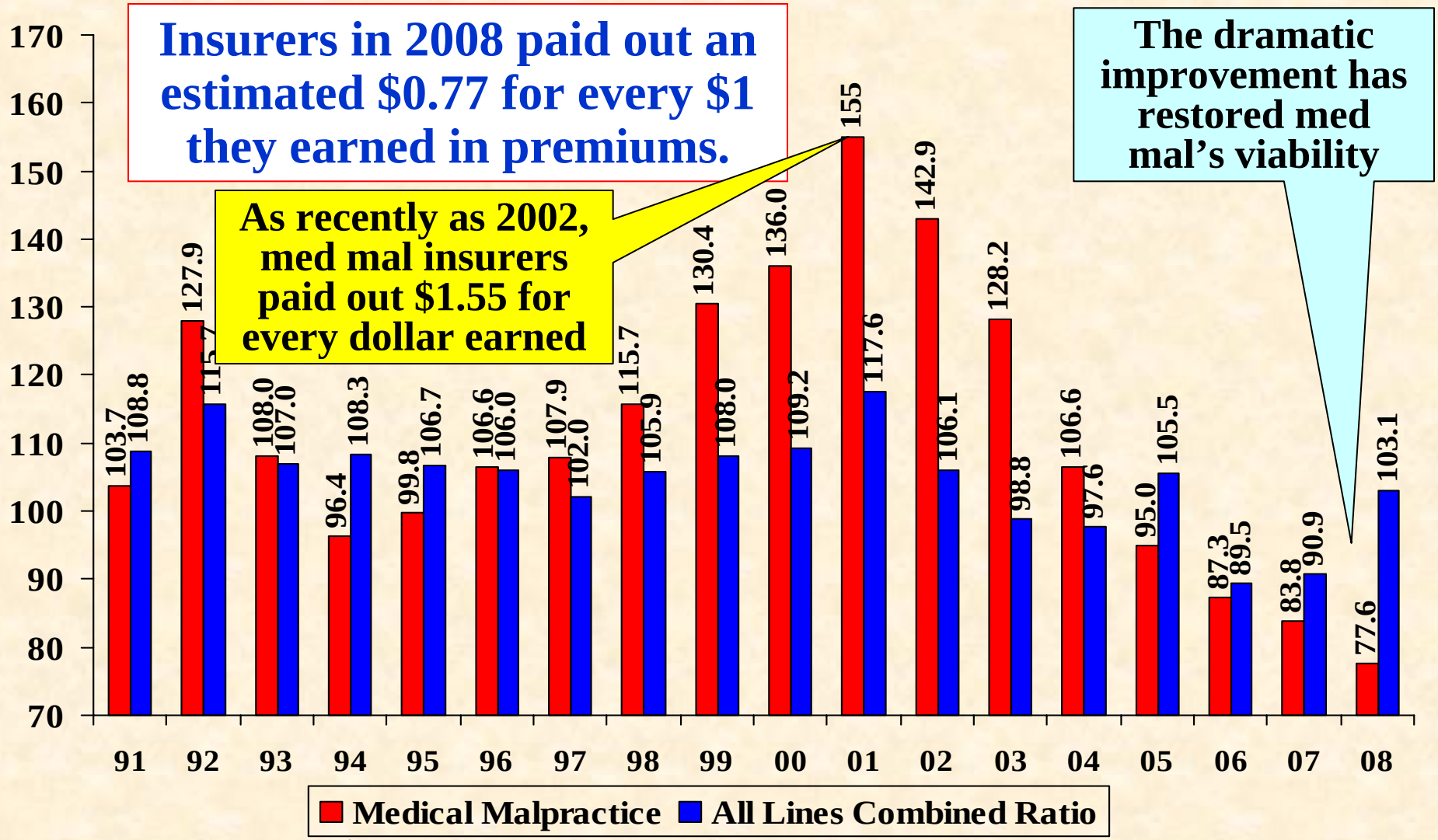


Sources: Insurance Research Council, *Auto Insurance Claims: Countrywide Patterns in Treatment, Cost and Compensation,* 2008 Edition; Insurance Information Institute.

MEDICAL MALPRACTICE OPERATING ENVIRONMENT

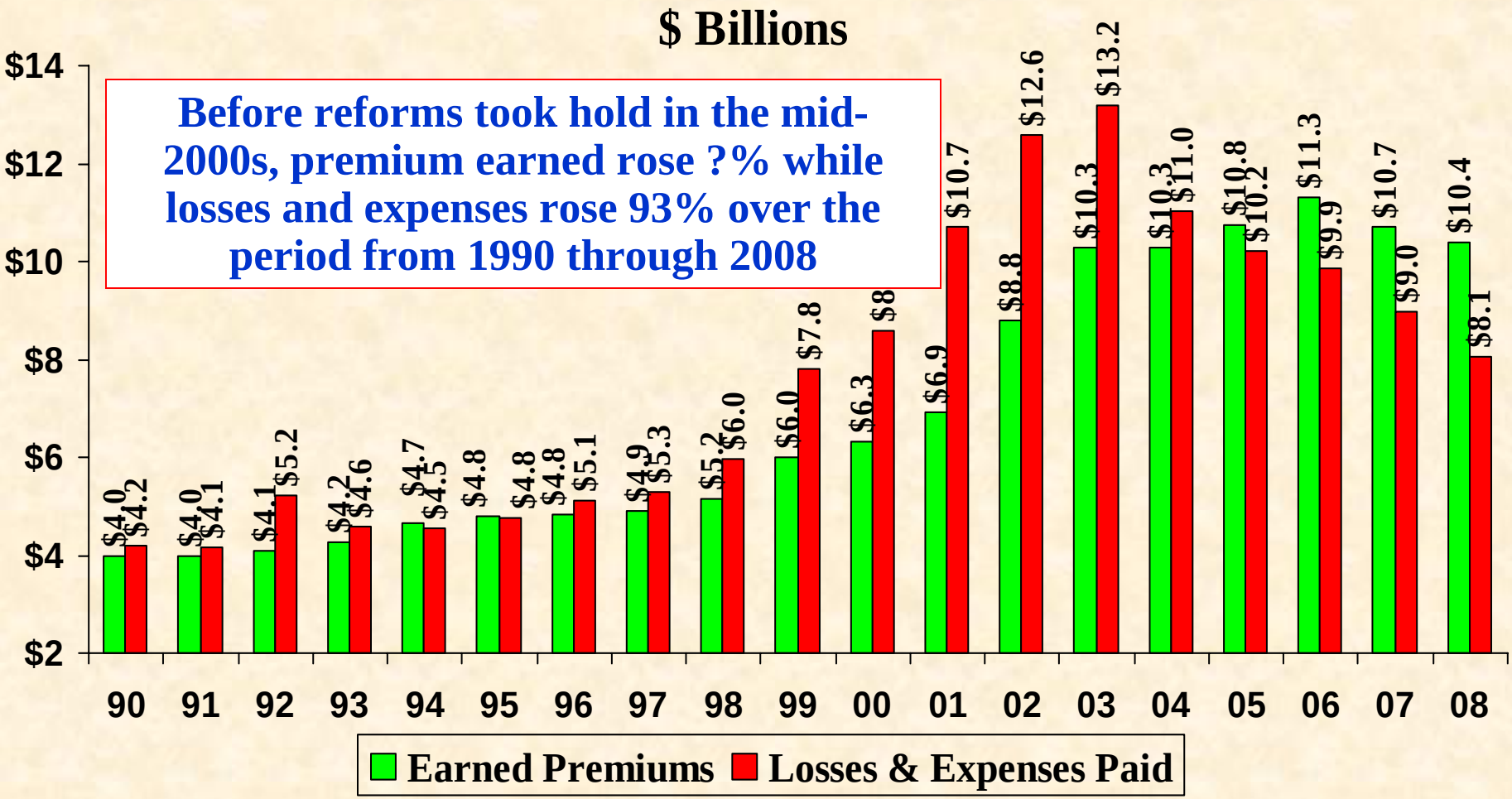
Improved, But Still Vulnerable

Medical Malpractice Combined Ratio



Source: AM Best, Insurance Information Institute

Medical Malpractice: Losses & Expenses Paid vs. Premiums Earned



Source: Computed from A.M. Best data by the Insurance Information Institute

Outlook for MPLI Operating Environment

- **<u>Short-Term</u>: Soft market persists, driven by relatively good underlying underwriting performance**
- **<u>Tort Threat</u>: 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.**
- **<u>Antitrust Repeal</u>: 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**
- **<u>Long-Run</u>: Erosion of reforms of recent years begins to take toll, further damaging results**
- **<u>Conclusion</u>: Underwriting Cycle can't be banished, but its depth and length can be moderated via disciplined underwriting and pricing**

Healthcare Reform Bill is a Trial Lawyer Dream Come True

- **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."***

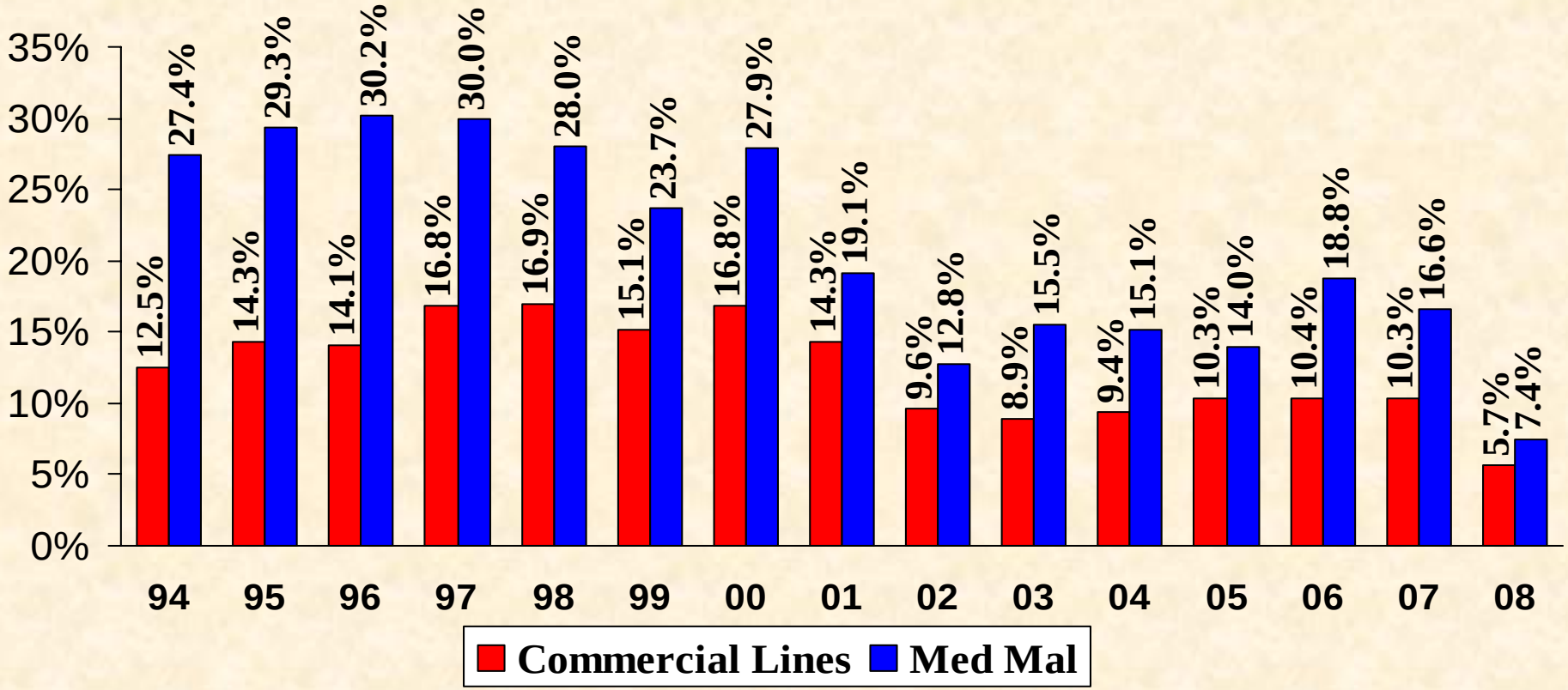
- **Jeopardizes some <u>$54 billion in savings</u> in medical care costs that Congressional Budget Office (CBO) says litigation reform would bring.**

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

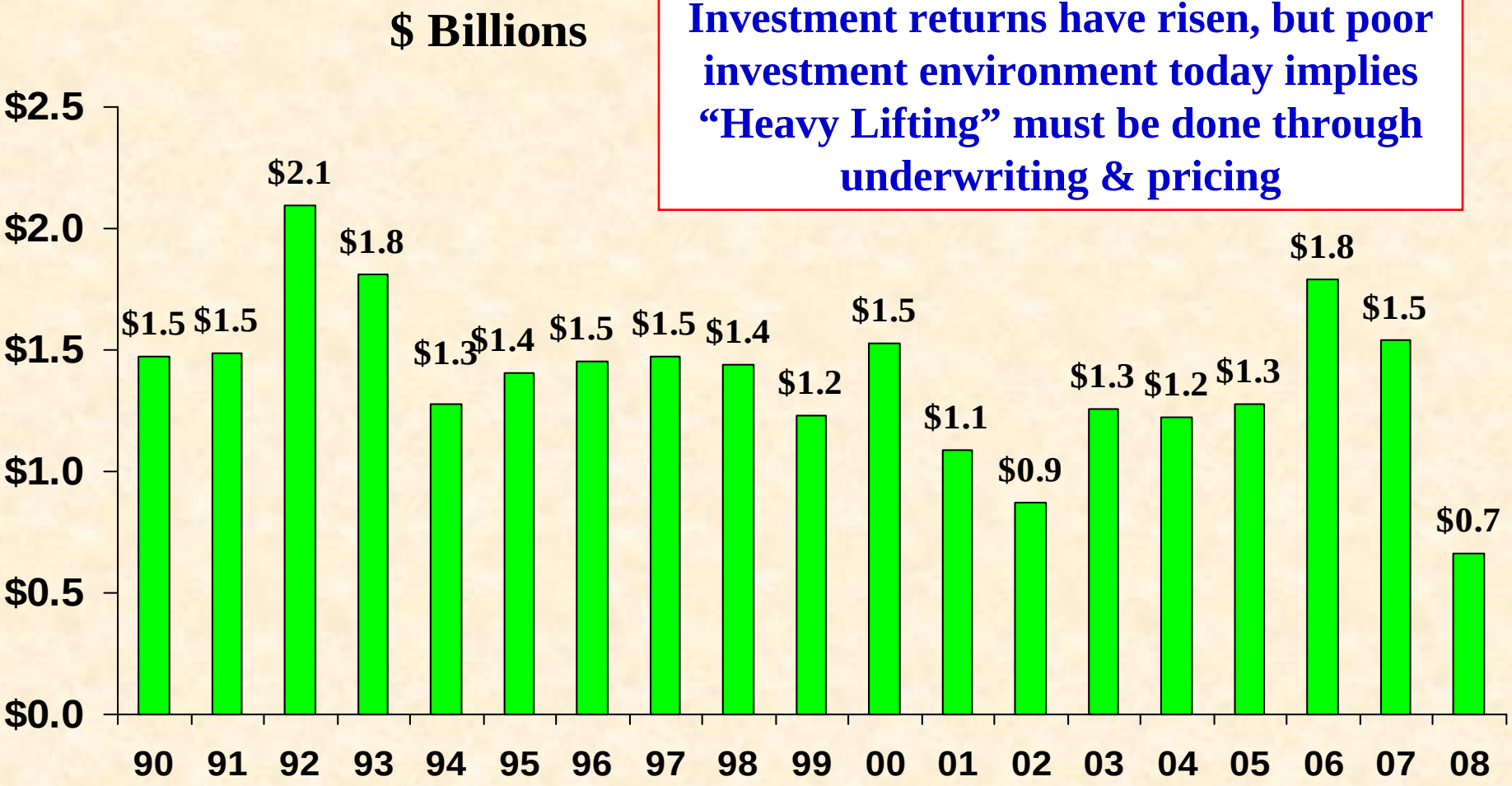


*As a % of net earned premium. Investment gains consists primarily of interest, dividends and realized capital gains and losses.

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

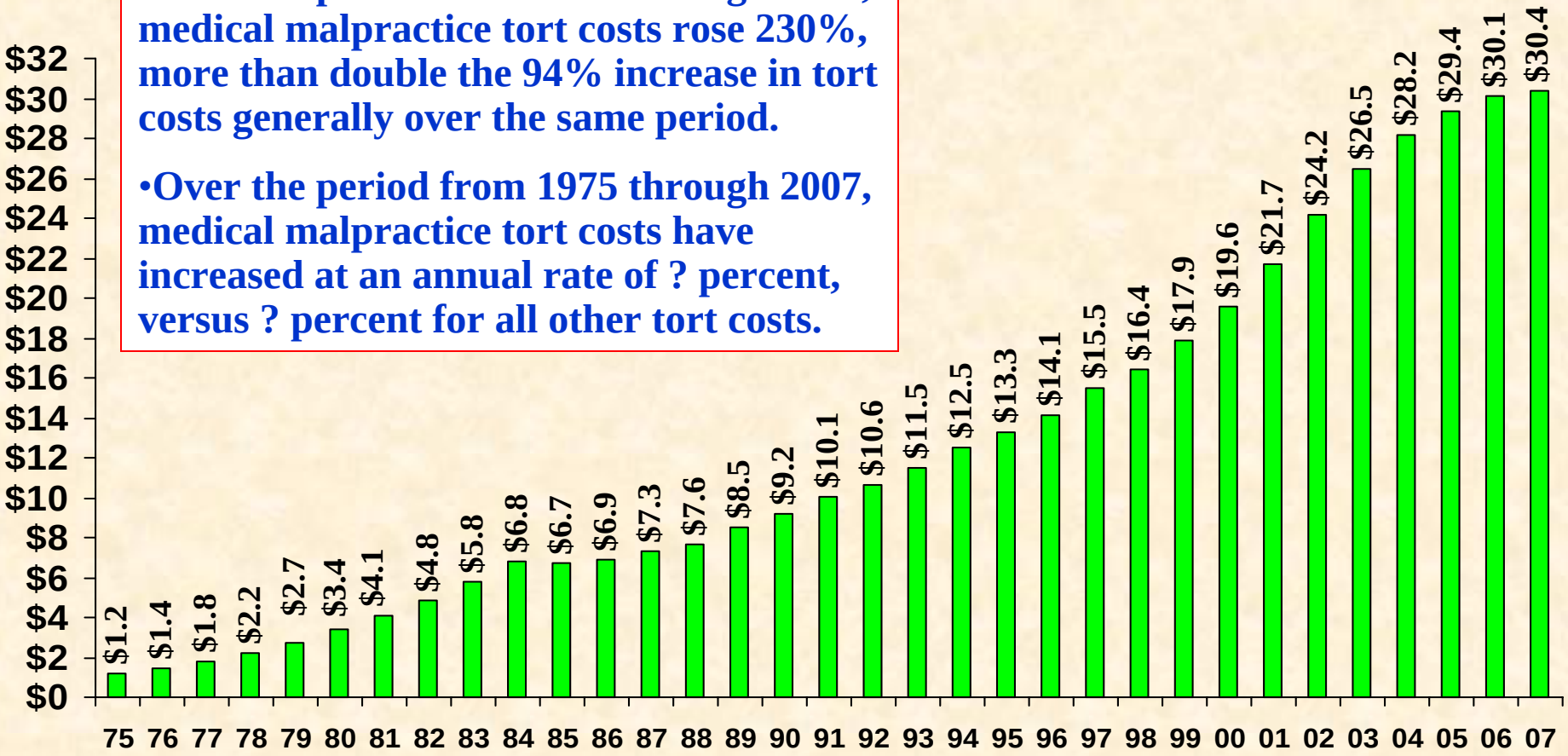
Medical Malpractice Tort Environment

Harvesting the Fruits of Reform

Medical Malpractice Tort Cost: Growth Continues, Though Modestly

$ Billions

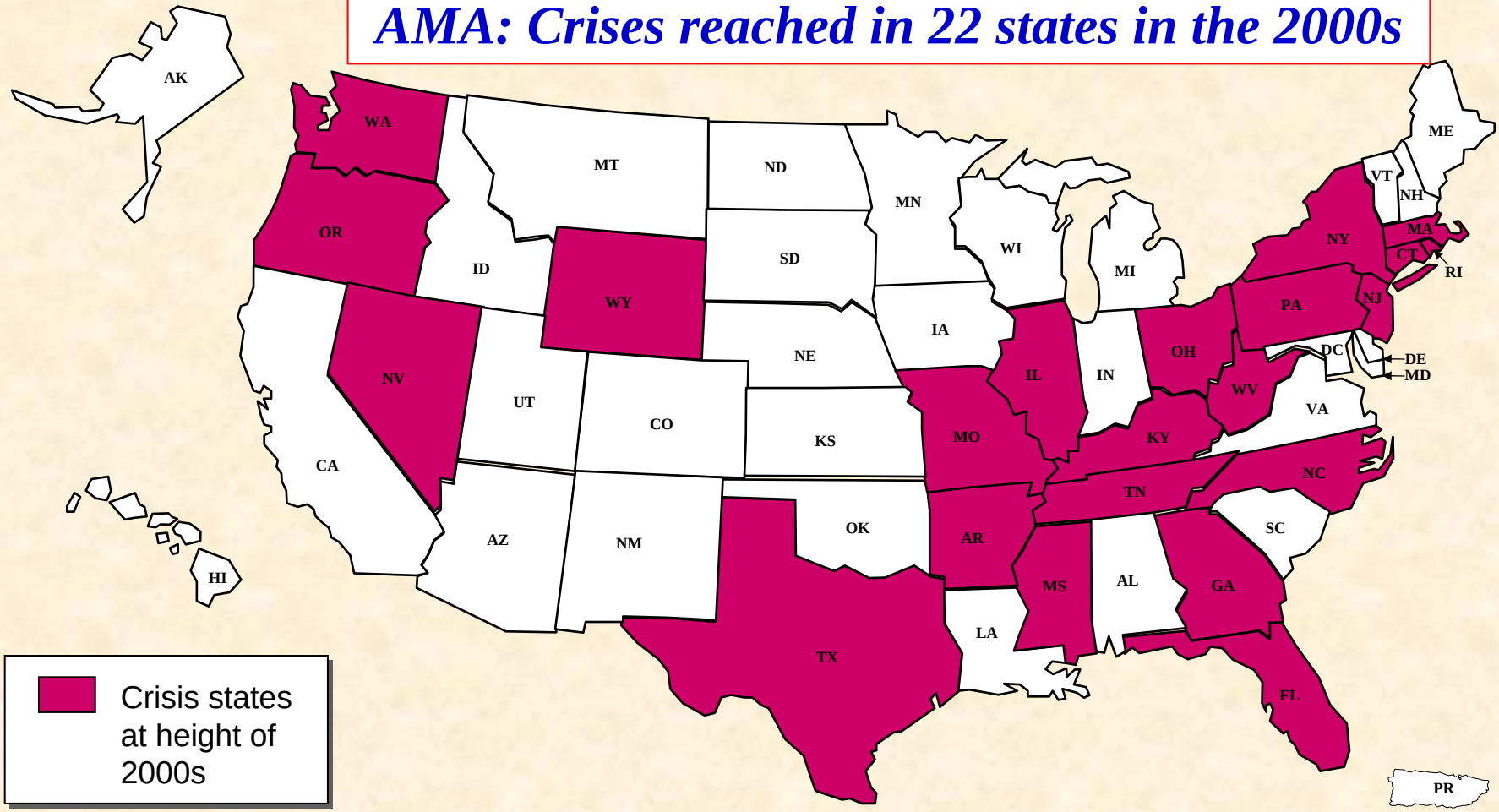
- **Over the period from 1990 through 2007, medical malpractice tort costs rose 230%, more than double the 94% increase in tort costs generally over the same period.**
- **Over the period from 1975 through 2007, medical malpractice tort costs have increased at an annual rate of ? percent, versus ? percent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



Sources: Tillinghast-Towers Perrin, US Bureau of Labor Statistics, Insurance Information Institute

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

AMA: Crises reached in 22 states in the 2000s



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

Source: American Medical Association, February 2008

2008 Top Ten Verdicts

Value	Issue	State
$388 Million	Fraud, Intentional Infliction of Emotional Distress	Nevada
$316 Million	[illegible]	Georgia
$188 Million	[illegible]	New York
$85 Million	Premises Liability	Pennsylvania
$84 Million	Negligence, Personal Injury	Texas
$66 Million	[illegible]	[illegible]klahoma
$60 Million	[illegible]	[illegible]evada
$55 Million	Negligence	California
$54 Million	Wrongful Death	Georgia
$48 Million	Negligence	Indiana

None of the top 10 awards in 2008 was related to medical liability

Source: LawyersWeekly USA, January 15, 2009.

2007 Top Ten Verdicts

Value	Issue	State
$109 Million	Medical Malpractice	New York
$102.7 Million	Premises Liability, Death	Florida
$55.2 Million	[illegible]	California
$54 Million	Private Air Crash	Florida
$54 Million	[illegible]	New Mexico
$50 Million	[illegible]	Florida
$50 Million	Product Liability, Death	Alabama
$47.6 Million	[illegible]	Nevada
$47.5 Million	Vioxx	New Jersey
$45 Million	Auto Crash, Death	Florida

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

Value	Issue	State
$28 Billion	Tobacco (Product Liability)	Florida
$2.2 Billion	**Negligence (Pharmacy Mal)**	**Missouri**
$270 Million	[illegible]	[illegible]
$225 Million	Product Liability (Rollover)	Texas
$150 Million	[illegible]	Oregon
$122 Million	Product Liab. (Auto Accident)	Virginia
$97.2 Million	[illegible]	[illegible]
$95.2 Million	**Med Mal (Birth Injury)**	**New York**
$91 Million	**[illegible] Malpractice**	**[illegible]ork**
$80 Million	**Med Mal (Birth Injury)**	**New York**
$80 Million	Prod. Liab/Personal Inj. (Auto)	Missouri

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

Total Cost = $3.0 Billion!

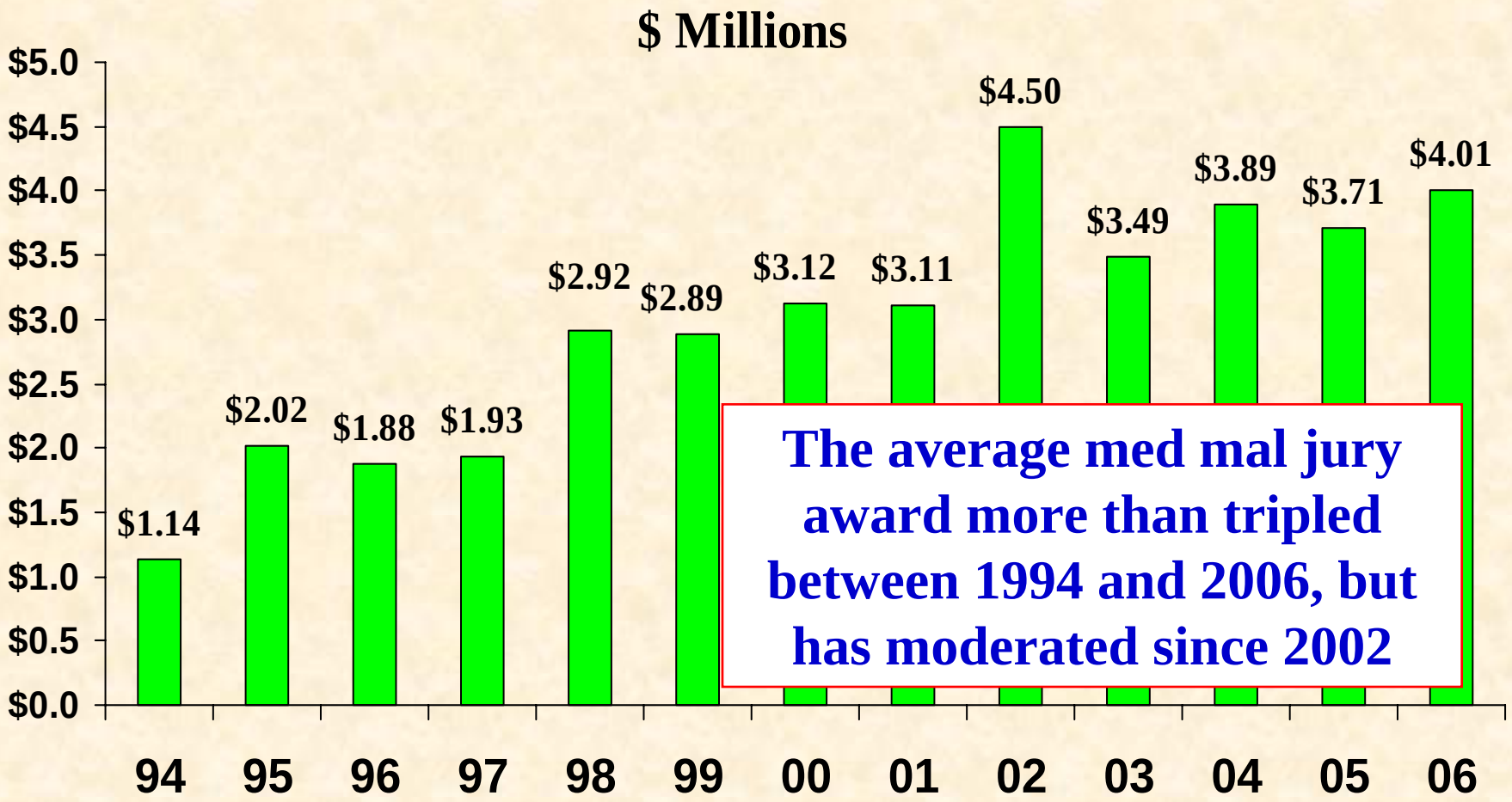
Source: LawyersWeekly USA, January 2003.

2001 Top Ten Verdicts

Value	Issue	State
$3 Billion	Tobacco	California
$1 Billion	Land Contamination	Louisiana
$480 Million	Private Airplane Crash	Florida
$312.8 Million	**Nursing Home**	**Texas**
$ 256 Million	Police Auto Crash	Colorado
$116 Million	Intellectual Property Theft	Virginia
$114.9 Million	**Medical Malpractice**	**New York**
$108.2 Million	Inheritance Dispute	Texas
$107.8 Million	**Medical Malpractice**	**New York**
$94.5 Million	Real Estate	California

Source: LawyersWeekly USA, January 2002.

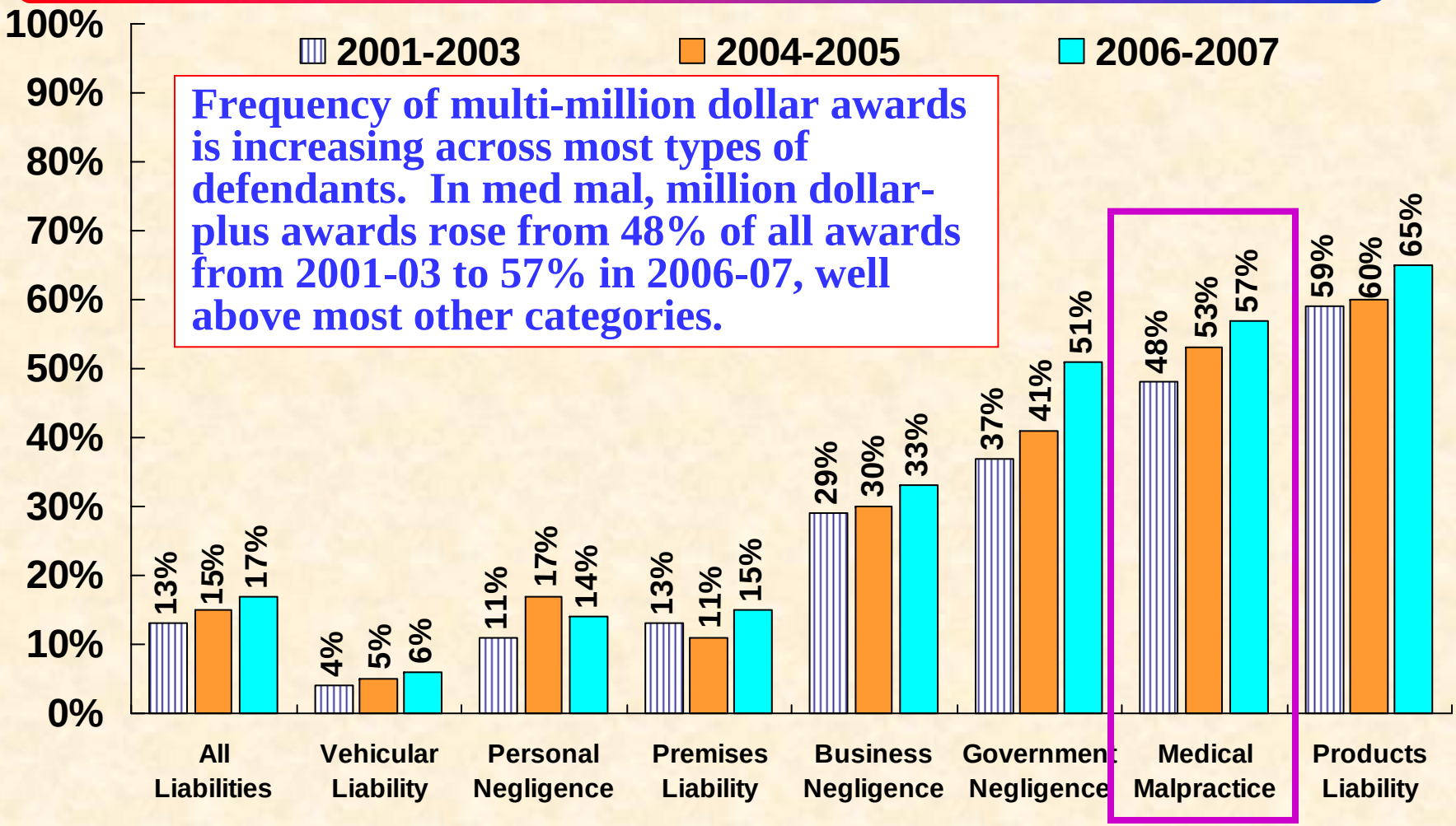
*Average Jury Award in Medical Malpractice Cases**



The average med mal 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*



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

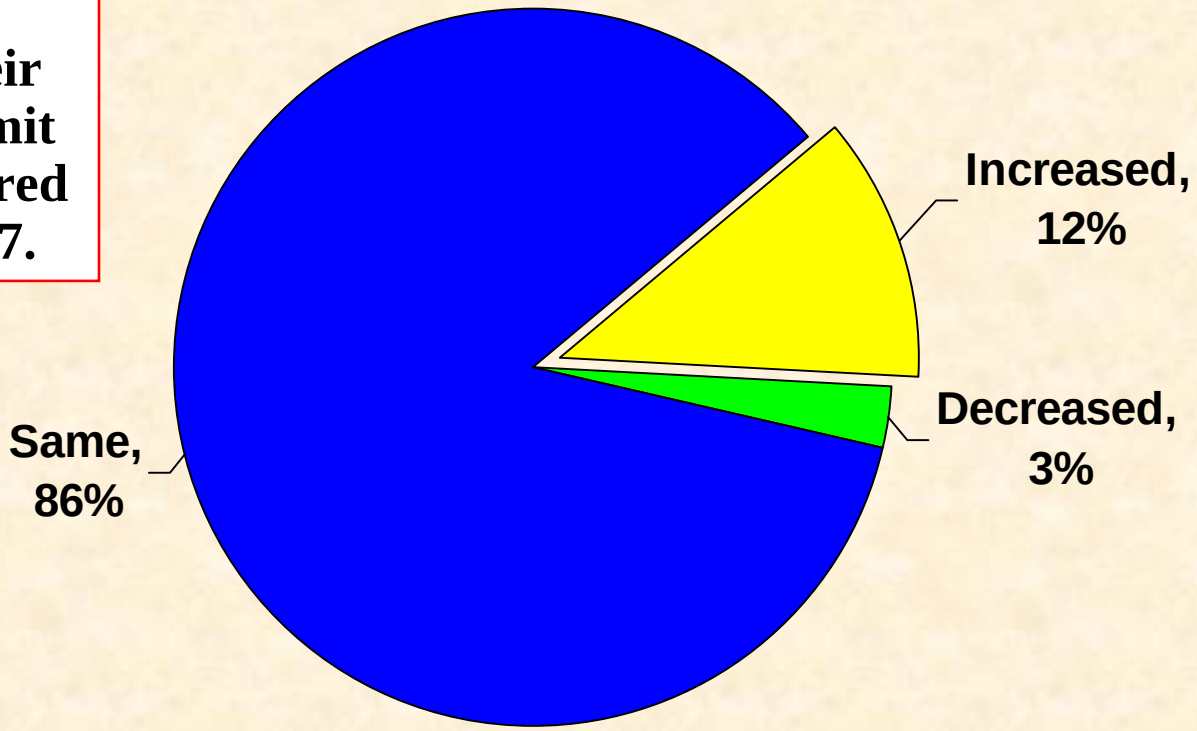
Source: Jury Verdict Research; Insurance Information Institute.

DIRECTORS & OFFICERS ENVIRONMENT

Financial Crisis Considerations

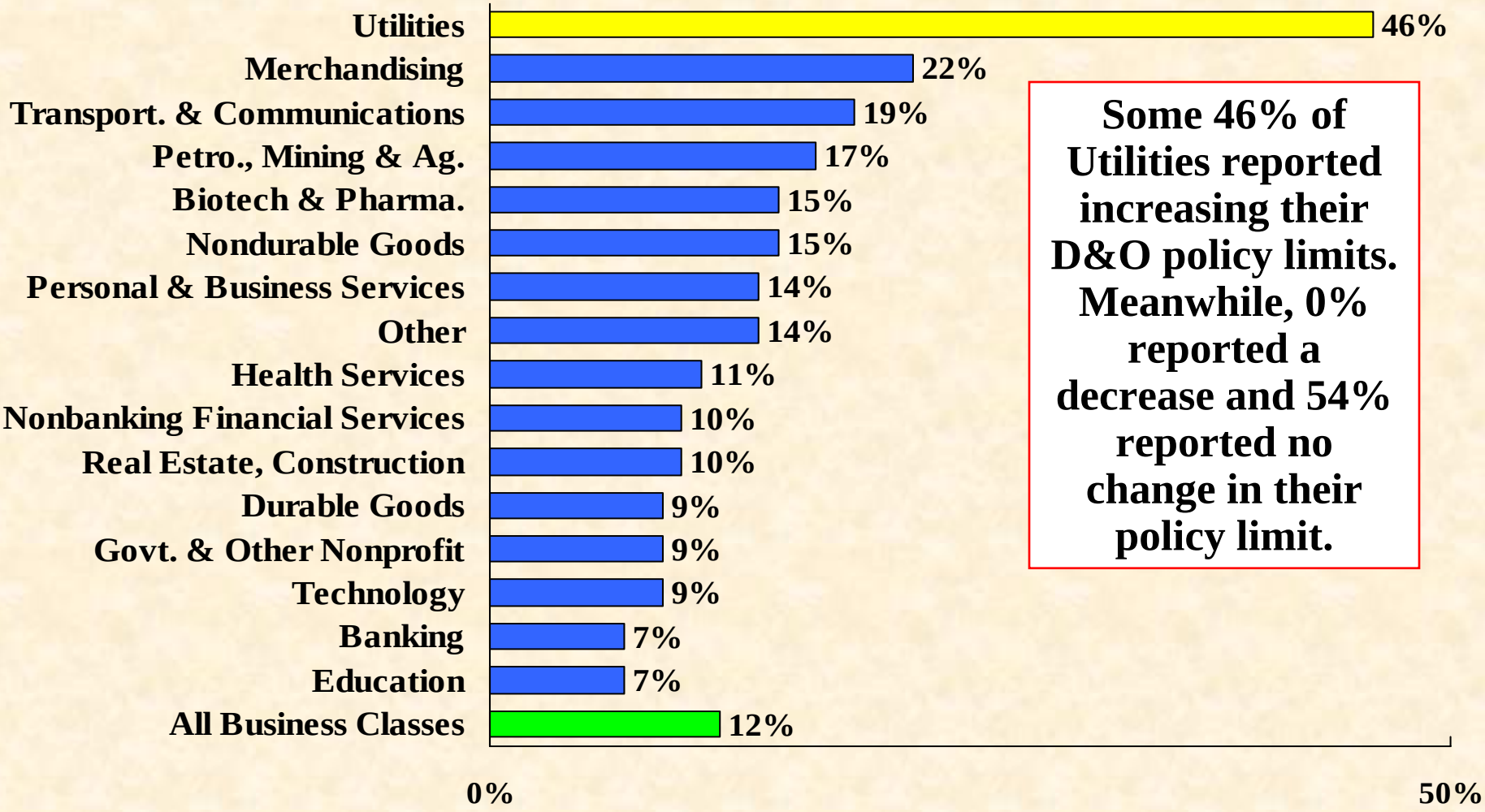
Changes in D&O Limits, All Business Classes, 2008

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*

Increases in D&O Limits by Class of Business, 2008

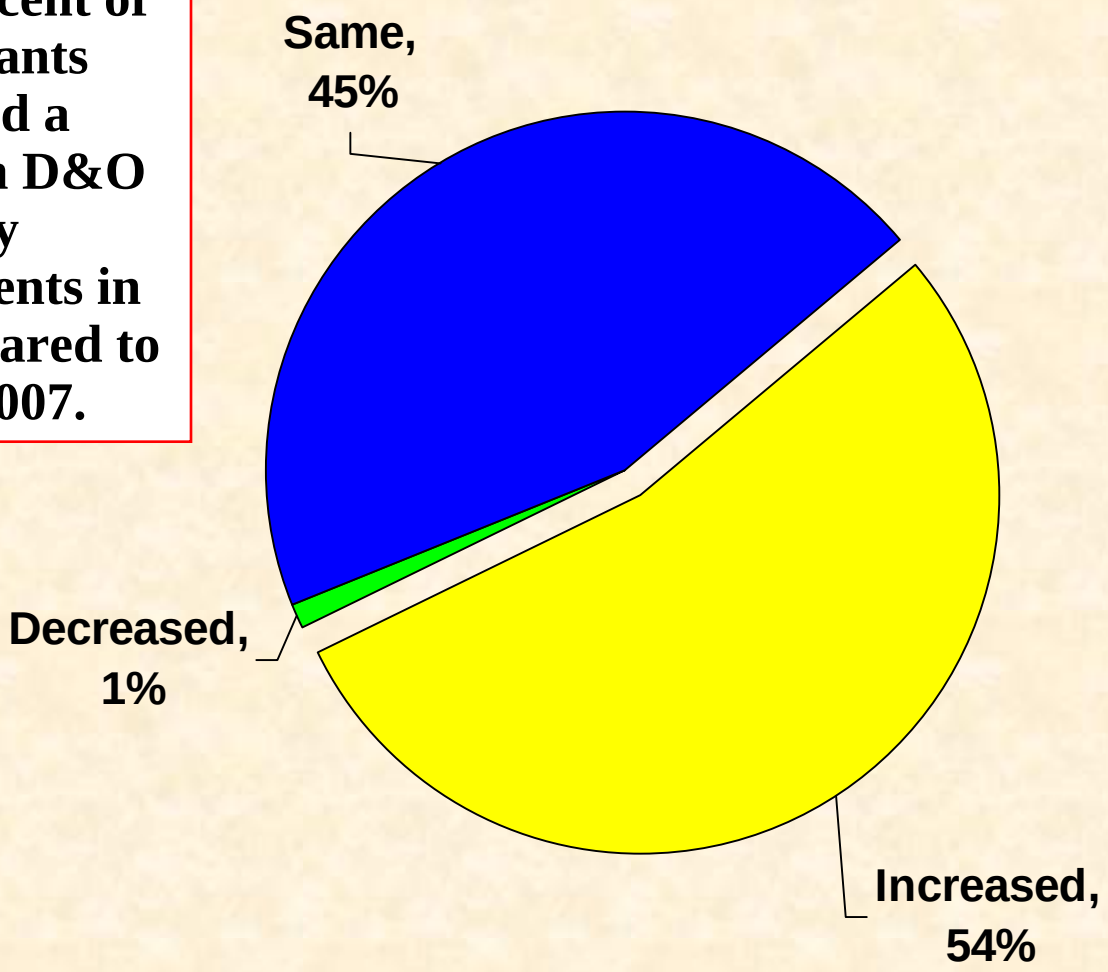


Some 46% of Utilities reported increasing their D&O policy limits. Meanwhile, 0% reported a decrease and 54% reported no change in their policy limit.

Source: Tillinghast Towers-Perrin, *2008 Directors and Officers Liability Survey*

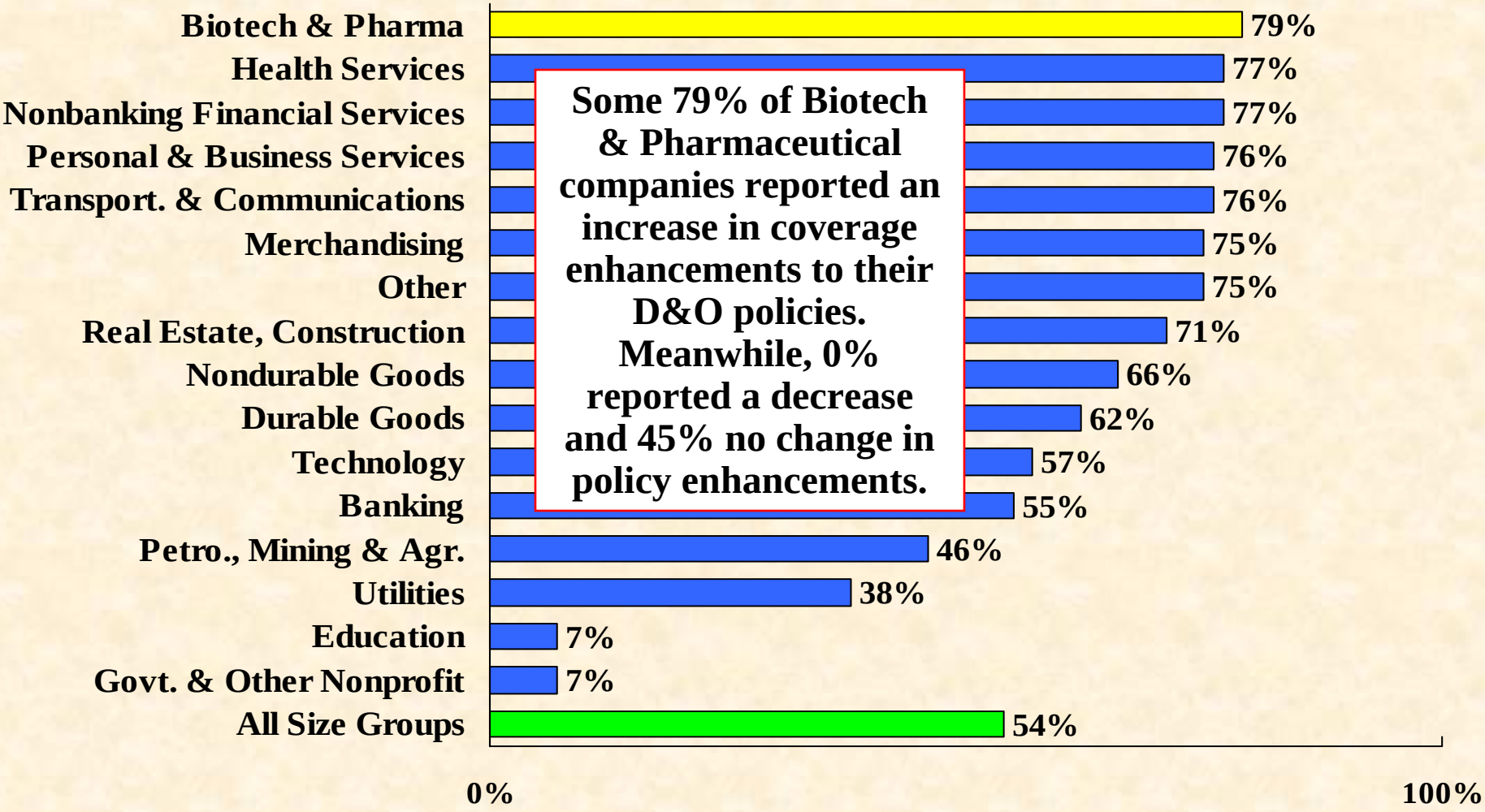
Changes in D&O Policy Enhancements, All Business Classes, 2008

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



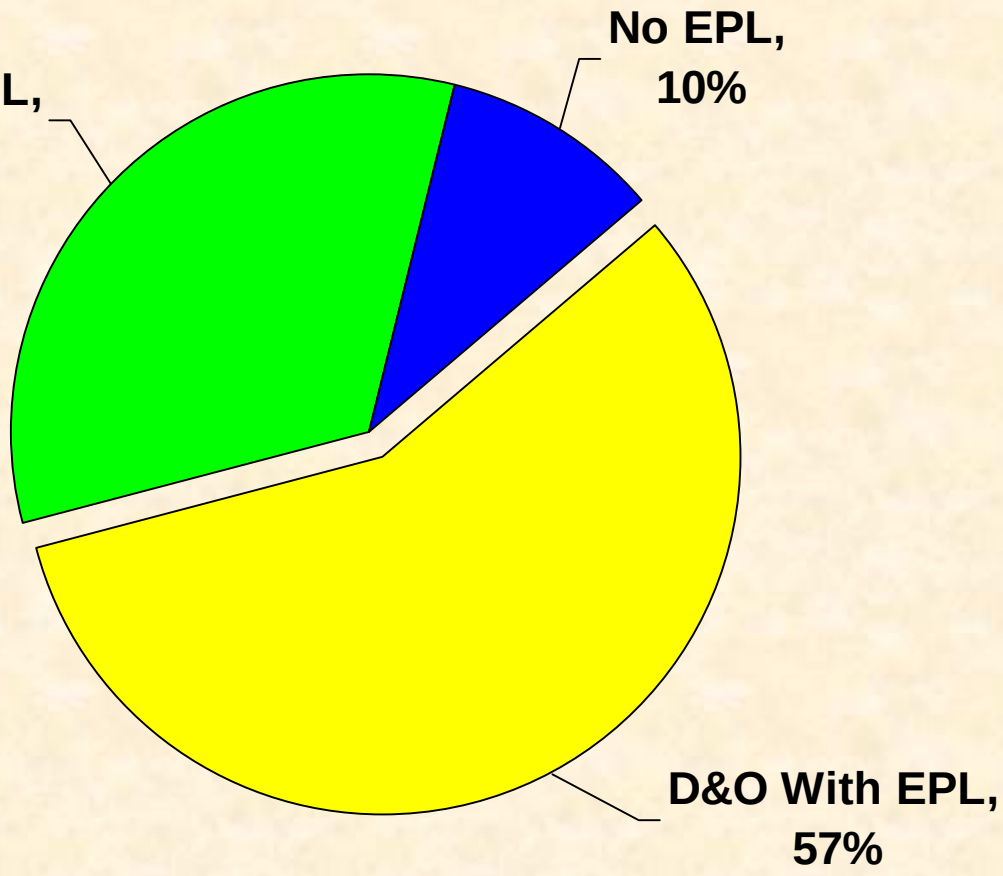
Source: Tillinghast Towers-Perrin, *2008 Directors and Officers Liability Survey*

Increases in Enhancements by Class of Business, 2008



Source: Tillinghast Towers-Perrin, *2008 Directors and Officers Liability Survey*

Prevalence of EPL Coverage by Full-Time Employees, 2008



The percentage of participants purchasing EPL coverage as part of their D&O policy decreased slightly, from 60% in 2007 to 57% in 2008.

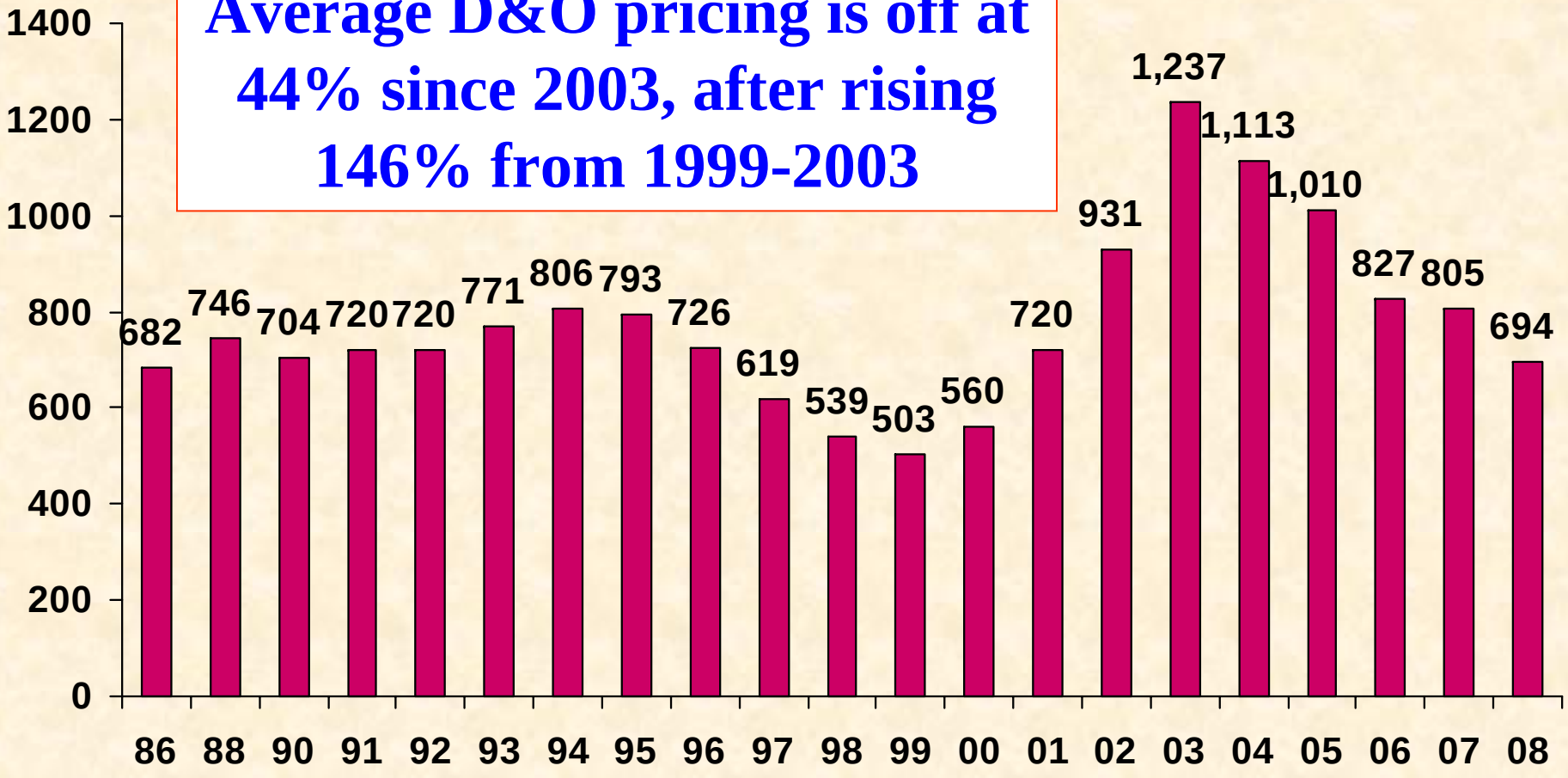
Only 10% of respondents reporting buying no EPL coverage.

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



Source: Tillinghast Towers-Perrin, *2008 Directors and Officers Liability Survey.*

Key Threats Facing P/C Insurers Amid Financial Crisis

Challenges for the Next 5-8 Years

Important Issues & Threats Facing Insurers: 2010 - 2015

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.**

Source: Insurance Information Inst.

Important Issues & Threats Facing Insurers: 2010 - 2015

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 <u>not</u> 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**

Source: Insurance Information Inst.

Important Issues & Threats Facing Insurers: 2010 – 20??

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 <u>decades</u>**
- **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

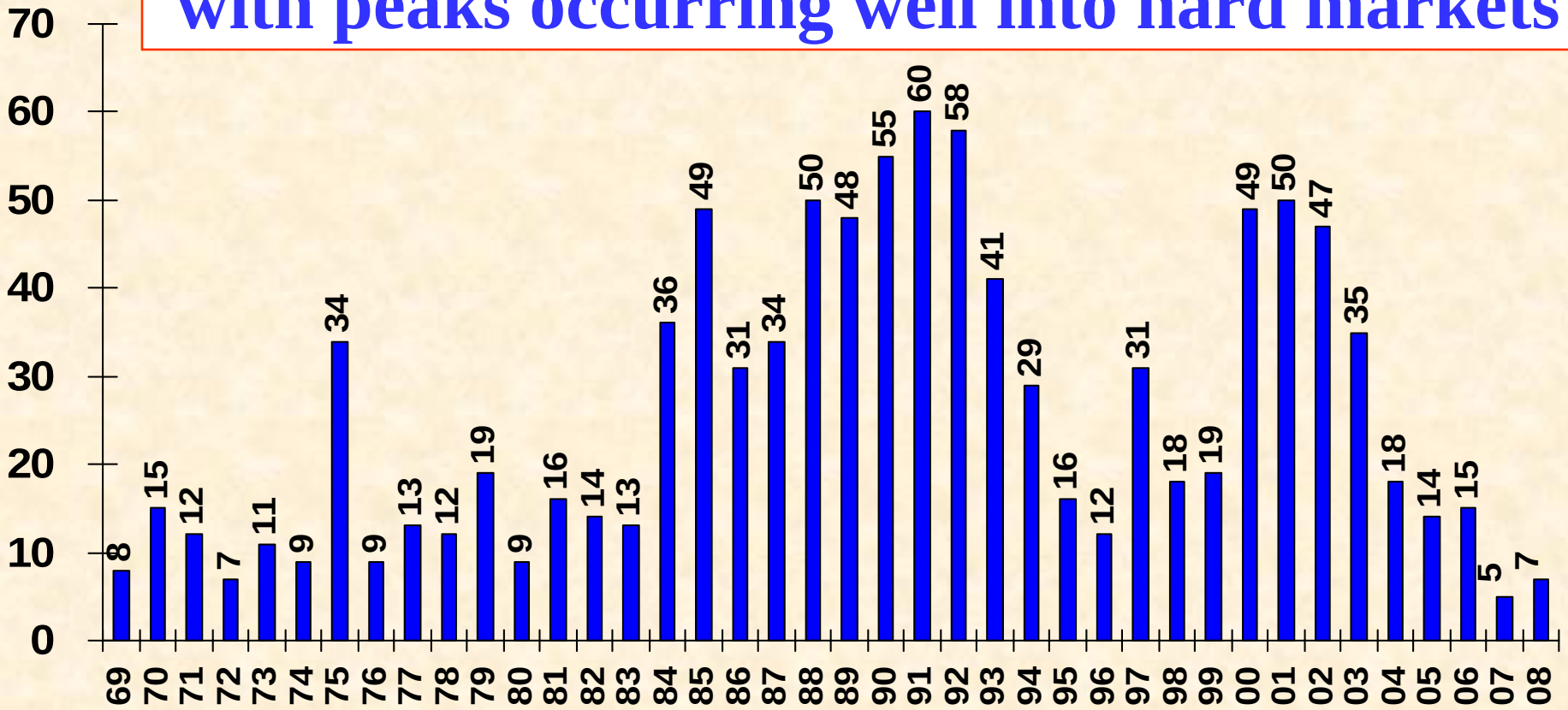
- **24-Hour Coverage Proposal**
  - **Would roll WC and med components of auto into natl. health care plan**
- **Rollback of McCarran-Ferguson Act**
  - **Would repeal or restrict for health and medical malpractice insurers**
  - ***Slippery slope—Med Mal is a p/c line; Congress will not hesitate to 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

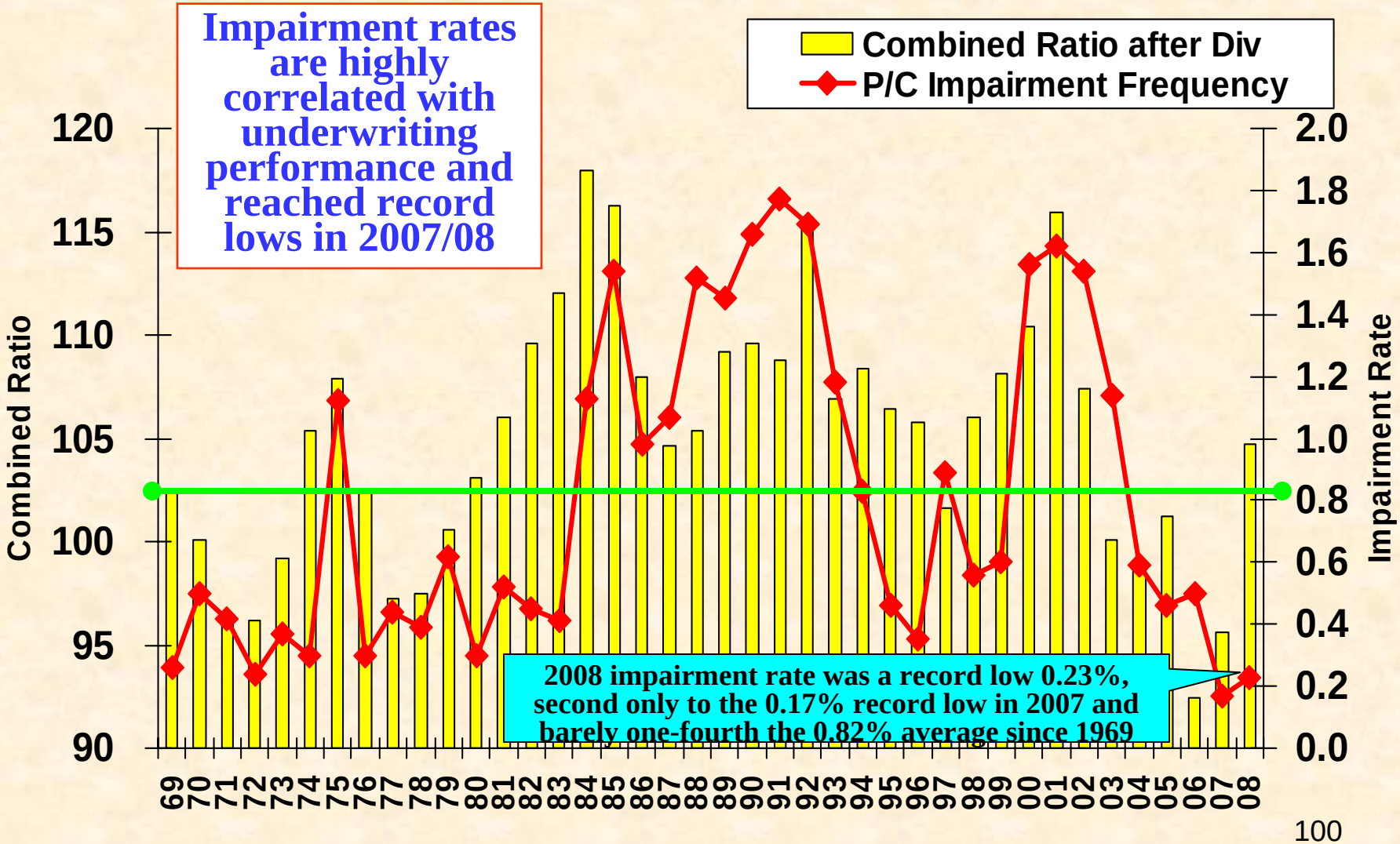
P/C Insurer Impairments, 1969-2008

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



Source: A.M. Best; Insurance Information Institute

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

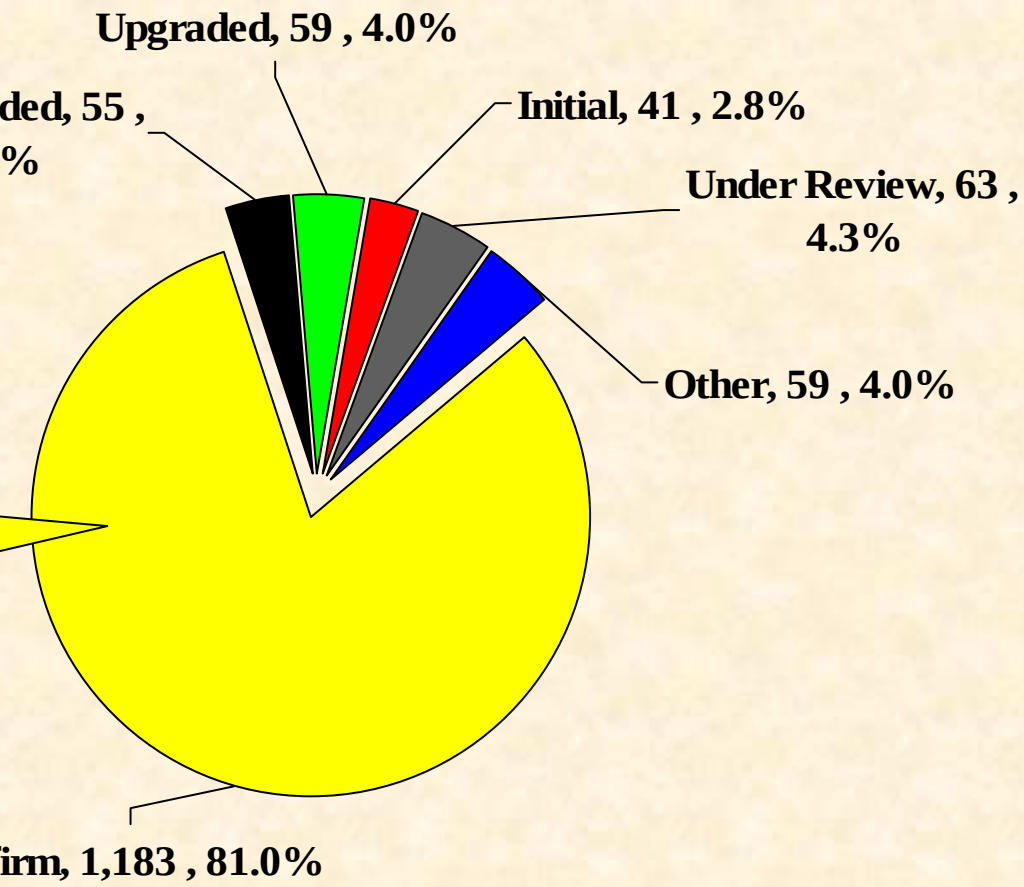


Source: A.M. Best; Insurance Information Institute

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

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

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

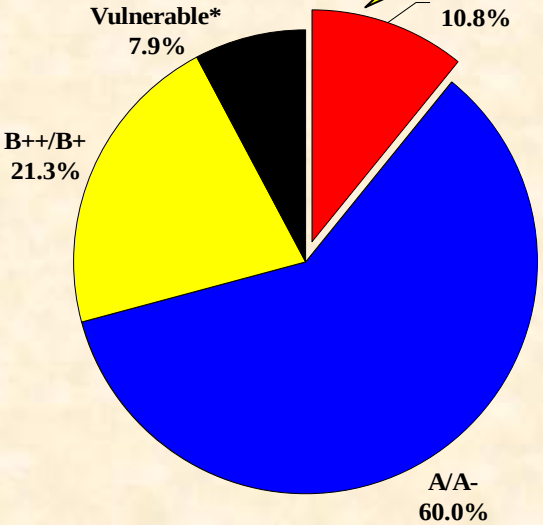


*Through December 19.
Source: A.M. Best.

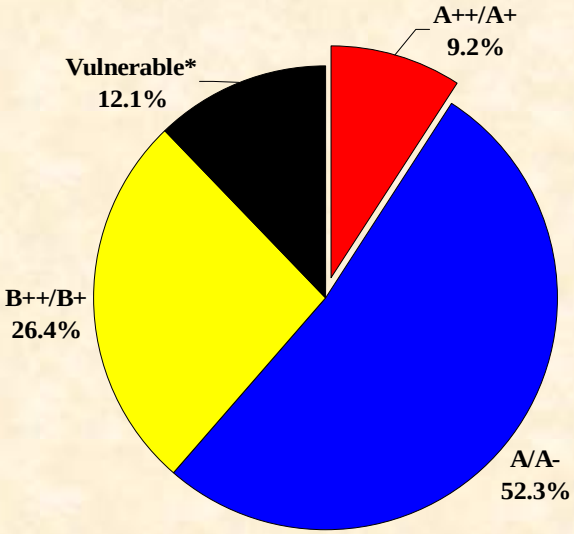
Historical Ratings Distribution,
US P/C Insurers, 2008 vs. 2005 and 2000

2008

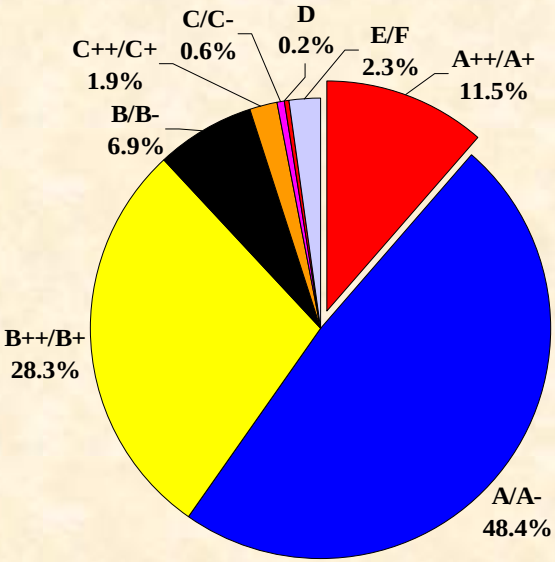
A++/A+ and A/A- gains



2005



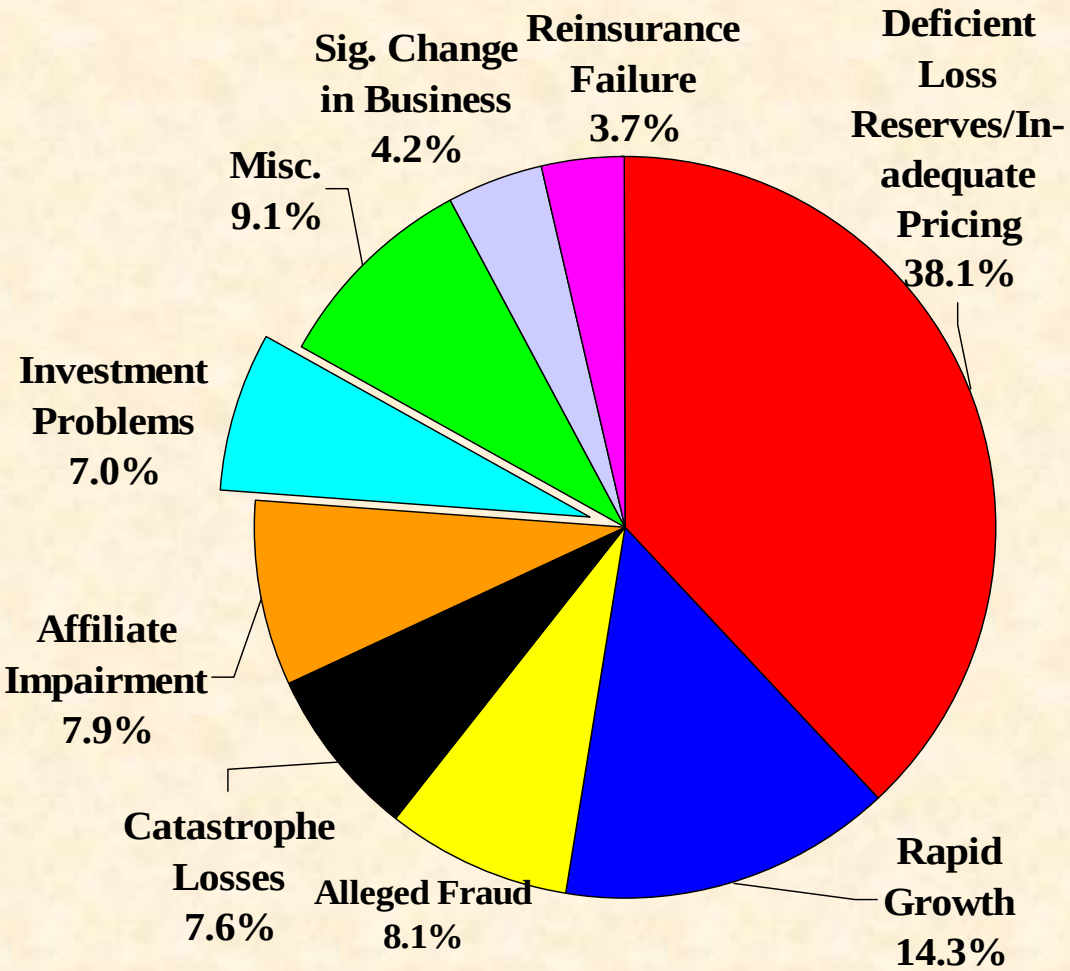
2000



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

Source: A.M. Best: *Rating Downgrades Slowed but Outpaced Upgrades for Fourth Consecutive Year*, Special Report, November 8, 2004 for 2000; 2006 and 2009 *Review & Preview*. *Ratings 'B' and lower.

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.

Source: A.M. Best: *1969-2008 Impairment Review*, Special Report, Apr. 6, 2008

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

Insurance Information Institute On-Line

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THANK YOU FOR YOUR TIME AND YOUR ATTENTION!