Economic Factors Affecting the Workers Compensation Market: An Overview and Outlook

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The Strength of the Economy Will Influence P/C Insurer Growth Opportunities

Growth Will Expand Workers Comp Payroll Exposure Base

America’s Manufacturing Renaissance? Construction Activity Still Depressed?
US Real GDP Growth*

Recession began in Dec. 2007. Economic toll of credit crunch, housing slump, labor market contraction has been severe but modest recovery is underway.

The Q4:2008 decline was the steepest since the Q1:1982 drop of 6.8%.

2012 is expected to see slow and choppy growth before accelerating modestly in 2013.

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

* Estimates/Forecasts from Blue Chip Economic Indicators.
Source: US Department of Commerce, Blue Economic Indicators 8/12; Insurance Information Institute.
Percent Change in Real GDP by State, 2011

Growth varied considerably across states but in total was weak in 2011 with US overall growth at just 1.7%

TX has been an economic growth leader

Consumer confidence has been low for years amid high unemployment, falling home prices and other factors adversely impact consumers, but improved substantially in late 2011 and early 2012.

Source: University of Michigan; Insurance Information Institute
Auto/Light Truck Sales, 1999-2022F

New auto/light truck sales fell to the lowest level since the late 1960s. Forecast for 2012-13 is still far below 1999-2007 average of 17 million units, but a recovery is underway.

Job growth and improved credit market conditions will boost auto sales in 2012 and beyond.

Car/Light Truck Sales Will Continue to Recover from the 2009 Low Point, Bolstering the Auto Insurer Growth and the Manufacturing Sector.

Source: U.S. Department of Commerce; Blue Chip Economic Indicators (10/11 and 8/12); Insurance Information Institute.
New Private Housing Starts, 1990-2022F

(Millions of Units)

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

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

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

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

Source: U.S. Department of Commerce; Blue Chip Economic Indicators (10/11 and 8/12); Insurance Information Institute.
Construction employment is still below where it was in Jan. 2010. In a normal recovery, construction employment would be growing robustly.

*Seasonally adjusted
Overall Construction Activity is Up, But Growth Is Entirely in the Private Sector as State/Local Government Budget Woes Continue

*seasonally adjusted
Source: U.S. Census Bureau, [http://www.census.gov/construction/c30/c30index.html](http://www.census.gov/construction/c30/c30index.html); Insurance Information Institute.
Value of Private Construction Put in Place, by Segment, June 2012 vs. June 2011*

Led by the Power industry, Private sector construction activity is up by double digits in many segments after plunging during the “Great Recession”

Private Construction Activity is Up in Most Segments, Including Residential Construction but Led by Power

*seasonally adjusted
Source: U.S. Census Bureau, [http://www.census.gov/construction/c30/c30index.html](http://www.census.gov/construction/c30/c30index.html); Insurance Information Institute.
Value of Public Construction Put in Place, by Segment, June 2012 vs. June 2011*

Public sector construction activity is down by substantially in many segments

Public Construction Activity is Up Down in Many Segments as State, City and County Budgets Remain Under Stress

*seasonally adjusted
Source: U.S. Census Bureau, [http://www.census.gov/construction/c30/c30index.html](http://www.census.gov/construction/c30/c30index.html) ; Insurance Information Institute.
The manufacturing sector expanded for 34 consecutive months until June 2012 and added jobs. The question is whether this will continue.

Recovery in Capacity Utilization is a Positive Sign for Commercial Exposures

March 2001 through July 2012

Percent of Industrial Capacity

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

“Full Capacity”

The US operated at 79.3% of industrial capacity in July 2012, above the June 2009 low of 68.3% and tied for the highest level since April 2008.

Manufacturing employment is up by more than 500,000 or 4.6% since Jan. 2010—a surprising source of strength in the economy.


ENERGY INTENSIVE

The value of Manufacturing Shipments in June 2012 was up 32% to $470B from its June 2009 trough. June figure is only 3.2% below its previous record high in July 2008.

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

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

**Durables:** +9.1%

**Non-Durables:** +3.0%

Manufacturing of durable goods has been especially strong in 2012.

Manufacturing is expanding across a wide range of sectors that will contribute to growth in energy demand and insurable exposures including: WC, commercial property, commercial auto and many liability coverages.

*Seasonally adjusted; Date are YTD comparing data through June 2012 to the same period in 2011.
Non-manufacturing industries have been expanding and adding jobs. The question is whether this will continue.

## Business Bankruptcy Filings, 1980-2012: Q1

### Significant Exposure Implications for All Commercial Lines as Business Bankruptcies Begin to Decline

- **2011 bankruptcies totaled 47,806, down 15.1% from 56,282 in 2010—the second consecutive year of decline.** Business bankruptcies more than tripled during the financial crisis. Through Q1:2012, filings are down 11.1% vs. Q1:2011.

### % Change Surrounding Recessions

- 1980-82: 58.6%
- 1980-87: 88.7%
- 1990-91: 10.3%
- 2000-01: 13.0%
- **2006-09: 208.9%***

Source: American Bankruptcy Institute at [http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=61633](http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=61633); Insurance Information Institute
Business starts were up 5.0% to 758,000 in 2011. 722,000 new business starts were recorded in 2010, up 3.6% from 697,000 in 2009, which was the slowest year for new business starts since 1993.
### 12 Industries for the Next 10 Years:

**Insurance Solutions Needed**

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

Many industries are poised for growth, though insurers’ ability to capitalize on these industries varies widely.
Oil and gas extraction employment is up 25.1% since Jan. 2010 as the energy sector booms. Domestic energy production is essential to any robust economic recovery in the US.

*Seasonally adjusted

Massive Job Losses Sapped the Economy and Commercial/Personal Lines Exposure, But Trend is Improving
Unemployment and Underemployment Rates: Stubbornly High in 2012, But Falling

January 2000 through July 2012, Seasonally Adjusted (%)

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

Monthly Change in Private Employment

January 2008 through July 2012 (Thousands)

Monthly Losses in Dec. 08–Mar. 09 Were the Largest in the Post-WW II Period

172,000 private sector jobs were created in July


December 2007 through July 2012 (Millions)

Cumulative job losses peaked at 8.444 million in December 2009

Cumulative job losses as of June 2012 totaled 3.792 million

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


Cumulative Change in Private Sector Employment: Jan. 2010—July 2012

January 2010 through July 2012* (Millions)

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

Cumulative job gains through July 2012 totaled 4.652 million


Governments at All Levels are Under Severe Fiscal Strain As Tax Receipts Plunged and Pension Obligations Soared During the Financial Crisis, Causing Them to Reduce Staff.

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

State government employment fell by 1.4% since the end of 2009 while Federal employment is down by 2.1%.

Local government employment shrank by 405,000 from Jan. 2010 through June 2012, accounting for 76% of all government job losses, negatively impacting WC exposures for those cities and counties that insure privately.

Total: -536
Local: -405
State: -72
Federal: -59

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

*Provisional figures for July 2012, seasonally adjusted.

In July, 44 states reported over-the-month unemployment rate increases, 2 states and the District of Columbia had decreases, and 4 states had no change.

FL’s unemployment is above the US rate of 8.3%
In July, 44 states reported over-the-month unemployment rate increases, 2 states and the District of Columbia had decreases, and 4 states had no change.

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

Rising unemployment eroded payrolls and workers comp’s exposure base. Unemployment peaked at 10% in late 2009.

Unemployment forecasts have been revised slightly upwards for 2012 and 2013. Optimistic scenarios put the unemployment as low as 8.0% by Q4 of this year.

* = actual; ** = forecasts

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (8/12 edition); Insurance Information Institute.
US Unemployment Rate Forecasts

Quarterly, 2012:Q2 to 2013:Q4

- Unemployment will remain high even under the most optimistic of scenarios, but forecasts are being revised downwards.

Steadily Decreasing Unemployment Should Benefit the Workers Comp Exposure Base at Least Through 2013

Sources: Blue Chip Economic Indicators (8/12); Insurance Information Institute

Note: Recession indicated by gray shaded column. Data are seasonally adjusted annual rates.
Sources: [http://research.stlouisfed.org/fred2/series/WASCUR](http://research.stlouisfed.org/fred2/series/WASCUR); National Bureau of Economic Research (recession dates); Insurance Information Institute.
Payroll vs. Workers Comp Net Written Premiums, 1990-2012E

Payroll Base*
$Billions

WC NWP
$Billions

Continued Payroll Growth and Rate Increases Suggest WC NWP Will Grow Again in 2012; +7.9% Growth in 2011 Was the First Gain Since 2005

*Private employment; Shaded areas indicate recessions. Payroll and WC premiums for 2012 is I.I.I. estimate based YTD 2012 actuals. Sources: NBER (recessions); Federal Reserve Bank of St. Louis at http://research.stlouisfed.org/fred2/series/WASCUR; NCCI; I.I.I.
POSITIVE LABOR MARKET DEVELOPMENTS

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

*Seasonally adjusted.

Note: Recessions indicated by gray shaded columns.

Average Weekly Hours of All Private Workers, Mar. 2006—June 2012

(Hours Worked)

Hours worked totaled 34.5 per week in June, still shy of the 34.6 hours typically worked before the “Great Recession.”

Hours worked plunged during the recession, impacting payroll exposures.

*Seasonally adjusted
Note: Recessions indicated by gray shaded columns.
The average hourly wage was $23.50 in June, up 10.6% from $21.25 when the recession began in Dec. 2007.

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

*Seasonally adjusted
Note: Recessions indicated by gray shaded columns.
ADVERSE LONG-TERM LABOR MARKET DEVELOPMENTS

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

Labor Force Participation Rate, Jan. 2002—June 2012*

Labor Force Participation as a % of Population

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

Note: Recessions indicated by gray shaded columns.

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

Notes: Recessions indicated by gray shaded columns. Data are seasonally adjusted.
P/C Insurance Industry
Financial Overview

Profit Recovery Was Set Back in 2011 by High Catastrophe Loss & Other Factors

- **2005 ROE** = 9.6%
- **2006 ROE** = 12.7%
- **2007 ROE** = 10.9%
- **2008 ROE** = 0.1%
- **2009 ROE** = 5.0%
- **2010 ROE** = 6.6%
- **2011 ROAS** = 3.5%
- **2012:Q1 ROAS** = 7.2%

P-C Industry 2012:Q1 profits were up 29% from 2011:Q1, due primarily to lower catastrophe losses.

* ROE figures are GAAP; †Return on avg. surplus. Excluding Mortgage & Financial Guaranty insurers yields a 8.2% ROAS for 2012:Q1, 4.6% ROAS for 2011, 7.6% for 2010 and 7.4% for 2009.

Sources: A.M. Best, ISO, Insurance Information Institute
A combined ratio of about 100 generates an ROE of ~6.7% in 2012, ~7.5% ROE in 2009/10, 10% in 2005 and 16% in 1979.

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

*2008-2012 figures are return on average surplus and exclude mortgage and financial guaranty insurers. 2012:Q1 combined ratio including M&FG insurers is 99.0, ROAS = 7.2%; 2011 combined ratio including M&FG insurers is 108.2, ROAS = 3.5%.

Source: Insurance Information Institute from A.M. Best and ISO data.
Profitability Peaks & Troughs in the P/C Insurance Industry, 1975 – 2012:Q1*

*Profitability = P/C insurer ROEs. 2011 figure is an estimate based on ROAS data. Note: Data for 2008-2012 exclude mortgage and financial guaranty insurers. 2012:Q1 ROAS = 7.2% including M&FG.
Source: Insurance Information Institute; NAIC, ISO, A.M. Best.

History suggests next ROE peak will be in 2016-2017

1975: 2.4%
1984: 1.8%
1992: 4.5%
2001: -1.2%

2011: 4.6%*

2012:Q 8.2%
ROE: Property/Casualty Insurance vs. Fortune 500, 1987–2012:Q1*


P/C Profitability Is Both by Cyclicality and Ordinary Volatility

- Hugo
- Andrew
- Northridge
- Katrina, Rita, Wilma
- Sept. 11
- Lowest CAT Losses in 15 Years
- 4 Hurricanes
- Financial Crisis*
- Record Tornado Losses
The P/C Insurance Industry Fell Well Short of Its Cost of Capital Every Year Since 2008

US P/C Insurers Missed Their Cost of Capital by an Average 6.7 Points from 1991 to 2002, but on Target or Better 2003-07, Fell Short in 2008-2010

The Cost of Capital is the Rate of Return Insurers Need to Attract and Retain Capital to the Business

* Return on average surplus in 2008-2011 excluding mortgage and financial guaranty insurers.
Source: The Geneva Association, Insurance Information Institute
Financial Strength & Underwriting

Cyclical Pattern is P-C Impairment History is Directly Tied to Underwriting, Reserving & Pricing
The Number of Impairments Varies Significantly Over the P/C Insurance Cycle, With Peaks Occurring Well into Hard Markets


3 small insurers in Missouri did encounter problems in 2011 following the May tornado in Joplin. They were absorbed by a larger insurer and all claims were paid.
P/C Insurer Impairment Frequency vs. Combined Ratio, 1969-2011

Impairment Rates Are Highly Correlated With Underwriting Performance and Reached Record Lows in 2007; Recent Increase Was Associated Primarily With Mortgage and Financial Guaranty Insurers and Not Representative of the Industry Overall

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

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


Workers Comp and Pvt. Passenger Auto Account for Nearly Half of the Premium Volume of Impaired Insurers Over the Past Decade

- Workers Comp: 26.6%
- Pvt. Passenger Auto: 22.2%
- Homeowners: 10.9%
- Commercial MultiPeril: 8.1%
- Commercial Auto Liability: 7.7%
- Other Liability: 6.9%
- Commercial MultiPeril: 6.5%
- Med Mal: 4.8%
- Surety: 4.4%
- Financial Guaranty: 2.0%
- Title: 0.0%

The Weak Economy and Soft Market Have Made the Workers Comp Operating Environment Increasingly Challenging
Commercial Lines Combined Ratio, 1990-2012F*

*2007-2012 figures exclude mortgage and financial guaranty segments.
Source: A.M. Best; Insurance Information Institute
Workers Compensation Combined Ratio: 1994–2012F

Workers Comp Underwriting Results Are Deteriorating Markedly and the Worst They Have Been in a Decade

Sources: A.M. Best (1994-2010 all carriers); NCCI for 2011 (Private carriers only); 2012 (All Carriers) Insurance Information Institute.
Workers Comp Benefits* and Costs** per $100 of Covered Wages, 1980-2012F

(Dollars per $100 of Covered Wages)

WC costs to employers began to rise in 2011/12 for the first time since 2003

* Benefits paid during calendar year to injured workers and to providers of their medical care.

**Costs are employer expenditures for WC benefits, associated administrative costs and insurance premiums. Includes self-insured employers and payments of benefits under large insurance programs.

Workers Comp Medical and Cash Benefits per $100 of Covered Wages, 1980-2012F

(Dollars per $100 of Covered Wages)

Medical benefits as a share of total benefits has increased dramatically over the past 20 years.

Medical Cost Inflation Has Outpaced Overall Inflation For Over 50 Years

A claim that cost $1,000 in 1961 would cost nearly $17,500 based on medical cost inflation trends over the past 51 years.

Source: Department of Labor (Bureau of Labor Statistics)
Workers Compensation Medical Severity Moderate Increase in 2011

Average Medical Cost per Lost-Time Claim

Medical Claim Cost ($000s)

Annual Change 1991–1993: +1.9%
Annual Change 1994–2001: +8.9%
Annual Change 2002–2010: +6.0%

Cumulative Change = 245% (1991-2011p)

2011p: Preliminary based on data valued as of 12/31/2011
1991-2010: Based on data through 12/31/2010, developed to ultimate
Based on the states where NCCI provides ratemaking services; Excludes high deductible policies
Workers Comp Indemnity Claim Costs: Modest Increase in 2011

Average Indemnity Cost per Lost-Time Claim

Average indemnity costs per claim resumed its upward climb in 2011

Annual Change 1991–1993: -1.7%
Annual Change 1994–2001: +7.3%
Annual Change 2002–2010: +3.4%

Accident Year

2010p: Preliminary based on data valued as of 12/31/2011
1991–2010: Based on data through 12/31/2010, developed to ultimate
Based on the states where NCCI provides ratemaking services
Excludes high deductible policies
Workers Compensation Premium Continues Its Sharp Decline

Net Written Premium

$ Billions

<table>
<thead>
<tr>
<th>Year</th>
<th>State Funds ($ B)</th>
<th>Private Carriers ($ B)</th>
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</thead>
<tbody>
<tr>
<td>1990</td>
<td>31.0</td>
<td>31.3</td>
</tr>
<tr>
<td>1991</td>
<td>30.5</td>
<td>30.8</td>
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<td>1994</td>
<td>29.1</td>
<td>29.2</td>
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<td>1995</td>
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<tr>
<td>2010p</td>
<td>29.1</td>
<td>29.2</td>
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Source: 1990–2009 Private Carriers, Best's Aggregates & Averages; 2010p, NCCI
1996–2010p State Funds: AZ, CA, CO, HI, ID, KY, LA, MD, MO, MT, NM, OK, OR, RI, TX, UT Annual Statements
State Funds available for 1996 and subsequent
Nonfarm Payroll (Wages and Salaries): Quarterly, 2005–2011:Q4

Billions

Peak was 2008:Q1 at $6.60 trillion

Latest (2011:Q4) was $6.71 trillion, a new peak

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

Pace of payroll growth is accelerating

Growth rates in 2011
Q2 over Q1: 0.6%
Q3 over Q2: 0.4%
Q4 over Q3: 1.0%

Note: Recession indicated by gray shaded column. Data are seasonally adjusted annual rates.
Sources: http://research.stlouisfed.org/fred2/series/WASCUR; National Bureau of Economic Research (recession dates); Insurance Information Institute.
Resumption of payroll growth and rate increases suggests WC NWP will grow again in 2012

*Private employment; Shaded areas indicate recessions. Payroll and WC premiums for 2011 is I.I.I. estimate
Sources: NBER (recessions); Federal Reserve Bank of St. Louis at http://research.stlouisfed.org/fred2/series/WASCUR ; NCCI; I.I.I.
Average Approved Bureau Rates/Loss Costs

History of Average WC Bureau Rate/Loss Cost Level Changes

Cumulative 1990–1993
+36.3%

Cumulative 1994–1999
-27.8%

Cumulative 2000–2003
+17.1%

Cumulative 2004–2011
-26.2%

Note: Countrywide approved changes in advisory rates, loss costs and assigned risk rates as filed by applicable rating organization.
Source: NCCI.
The Q4 2011 WC rate change was the largest among all major commercial lines.
Direct Premiums Written: Worker’s Comp
Percent Change by State, 2005-2010*

Only 7 (small) states showed growth in workers comp premium volume between 2005 and 2010

Workers Comp DPW in MD dropped 14.7% from between 2005 and 2010

*Excludes monopolistic fund states: ND, OH, WA, WY as well as WV, which transitioned to a competitive structure during this period.
Sources: SNL Financial LC.; Insurance Information Institute.
Direct Premiums Written: Worker’s Comp Percent Change by State, 2005-2010*

Bottom 25 States

States with the poorest performing economies also produced the most negative net change in premiums of the past 5 years.

Workers Comp DPW plunged 28.7% from between 2005 and 2010.

*Excludes monopolistic fund states: ND, OH, WA, WY as well as WV, which transitioned to a competitive structure during this period.

Sources: SNL Financial LC.; Insurance Information Institute.
2. SURPLUS/CAPITAL/CAPACITY

Have Large Global Losses Reduced Capacity in the Industry, Setting the Stage for a Market Turn?
US Policyholder Surplus: 1975–2011*

Surplus as of 12/31/11 was $550.3 down 2.5% from the record $564.7B as of 3/31/11, but still up 25.9% ($113.2B) from the crisis trough of $437.1B at 3/31/09. Pre-crisis peak was $521.8 as of 9/30/07. Surplus as of 12/31/11 was 5.5% above 2007 peak.

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

The Premium-to-Surplus Ratio Stood at $0.80:$1 as of 12/31/11, A Near Record Low (at Least in Recent History)*

* As of 12/31/11.
Policyholder Surplus, 2006:Q4–2012:Q1

Sources: ISO, A.M. Best.

Surplus as of 3/31/12 hit an all time record high of $570.7B, 0.7% or $3.2B above the previous record set as of 3/31/11.

Drop due to near-record 2011 CAT losses

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

Quarterly Surplus Changes Since 2011:Q1 Peak

11:Q2: -$7.4B (-1.0%)
11:Q3: -$27.9B (-4.6%)
11:Q4: -$16.2B (-2.5%)
12:Q1: +$3.2B (+0.7%)

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

**Includes $22.5B of paid-in capital from a holding company parent for one insurer’s investment in a non-insurance business in early 2010.
Implied Excess (Deficit) Capital Assuming Premium/Surplus Ratio = 0.9:1

Excess/(Deficit) Capital (Policyholder Surplus)

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Excess (Deficit)</th>
<th>Annual Change in Capital</th>
</tr>
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<tbody>
<tr>
<td>2000</td>
<td>($10.6)</td>
<td>-5.1%</td>
</tr>
<tr>
<td>2001</td>
<td>($65.4)</td>
<td>-8.8%</td>
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<tr>
<td>2002</td>
<td>($103.0)</td>
<td>-15%</td>
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<td>2003</td>
<td>($124.6)</td>
<td>13.4%</td>
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<td>2004</td>
<td>($103.0)</td>
<td>8.2%</td>
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<td>2005</td>
<td>($49.2)</td>
<td>21.6%</td>
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<td>2006</td>
<td>($32.7)</td>
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<td>2007</td>
<td>($76.5)</td>
<td>12.3%</td>
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<tr>
<td>2008</td>
<td>($41.7)</td>
<td>6.2%</td>
</tr>
<tr>
<td>2009</td>
<td>$22.9</td>
<td>12.3%</td>
</tr>
<tr>
<td>2010</td>
<td>$41.7</td>
<td>8.9%</td>
</tr>
<tr>
<td>2011*</td>
<td>$42.6</td>
<td>-4.6%</td>
</tr>
</tbody>
</table>

2006/07: Low CAT losses, strong underwriting results since 1940s increase capital
2009-10: End of financial crisis, rising asset prices, modest u/w losses push capital to record levels
2005: Katrina, Rita, Wilma produce record CAT losses
2008: Financial crisis causes sharp drop in capital


Note: The assumption of a 0.9:1 P/S ratio is derived from a Feb. 2011 announcement by Advisen, Ltd., that the US P/C insurance industry has $74 billion in excess capital. The implied P/S ratio (calculated by III) is 0.88:1, which was rounded to 0.9:1.

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

* Net Premiums Written
M&A Activity in the US P/C Insurance Industry, 1997-2011*

P/C M&A activity in 2011 is up 60% since 2008, its highest level (in $ terms) since 2008

M&A Activity in the P/C Insurance Industry Remains Well Below its 1990s Peak

*2011 data are through December 1.
Source: SNL Securities; Insurance Information Institute.
Paid-in capital for insurance operations rose by $27.4B in 2010, the largest on record dating back to 1959.

In 2010 One Insurer’s Paid-in Capital Rose by $22.5B as Part of an Investment in a Non-insurance Business.
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Ratio (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/1989</td>
<td>Hurricane Hugo</td>
<td>3.3%</td>
</tr>
<tr>
<td>6/30/1992</td>
<td>Hurricane Andrew</td>
<td>9.6%</td>
</tr>
<tr>
<td>12/31/93</td>
<td>Northridge Earthquake</td>
<td>6.9%</td>
</tr>
<tr>
<td>6/30/01</td>
<td>Sept. 11 Attacks</td>
<td>10.9%</td>
</tr>
<tr>
<td>6/30/04</td>
<td>Florida Hurricanes</td>
<td>6.2%</td>
</tr>
<tr>
<td>6/30/05</td>
<td>Hurricane Katrina</td>
<td>13.8%</td>
</tr>
<tr>
<td>Financial Crisis as of 3/31/09**</td>
<td>16.2%</td>
<td></td>
</tr>
<tr>
<td>3/31/11</td>
<td>Tornados &amp; Severe Storms</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

* Ratio is for end-of-quarter surplus immediately after the event. Date shown is end of quarter prior to event.
** Date of maximum capital erosion; As of 9/30/09 (latest available) ratio = 5.9%

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

- Surplus growth was positive until Q1:2011 but is now down slightly.
- Sharp Decline in Capacity is a Necessary but Not Sufficient Condition for a True Hard Market.

* 2011 NWP and Surplus figures are % changes as of Q4:11 vs. Q4:10.
Sources: A.M. Best, ISO, Insurance Information Institute
The premium-to-surplus ratio (a measure of leverage) hit a record low at just 0.76:1 in 2010. It has decreased as PHS grows more quickly than NPW, with the effect of holding down profitability.

Record High P-S Ratio was 2.7:1 in 1974

Record Low P-S Ratio was 0.76:1 as of 12/31/10, rising slightly to 0.80:1 as of 12/31/11

The Premium-to-Surplus Ratio in 2011:Q4 Implies that P/C Insurers Held $1 in Surplus Against Each $0.80 Written in Premiums. In 1974, Each $1 of Surplus Backed $2.70 in Premium.

*2011 data are as of 12/31/11.
Sources: Insurance Information Institute calculations from A.M. Best data.
3. REINSURANCE MARKET CONDITIONS

Record Global Catastrophes Activity is Pressuring Pricing
Reinsurers Paid a High Proportion of Insured Losses Arising from Major Catastrophic Events Around the World in Recent Years

Source: Insurance Information Institute from reinsurance share percentages provided in RAA, ABIR and CEA press release, Jan. 13, 2011.
Global Property Catastrophe Rate on Line Index, 1990—2012 (as of Jan. 1)

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

Sources: Guy Carpenter; Insurance Information Institute.
Most excess reinsurance capacity was removed from the market in 2011, but there does not appear to be a shortage, leading to modest increases in 2012 reinsurance renewals except in areas hit hard by CATs.
Is There Evidence of a Broad and Sustained Shift in Pricing?
Distribution of Direct Premiums Written by Segment/Line, 2010

- Personal/Commercial lines split has been about 50/50 for many years; Personal Lines overtook Commercial Lines in 2010
- Pvt. Passenger Auto is by far the largest line of insurance and is currently the most important source of industry profits
- Billions of additional dollars in homeowners insurance premiums are written by state-run residual market plans

Sources: A.M. Best; Insurance Information Institute research.
Premium Growth Is Up Modestly: More in 2012?

(Percent)

1975-78
1984-87
2000-03

Net Written Premiums Fell 0.7% in 2007 (First Decline Since 1943) by 2.0% in 2008, and 4.2% in 2009, the First 3-Year Decline Since 1930-33.

2012:Q1 growth was +3.1%

Shaded areas denote “hard market” periods
Sources: A.M. Best (historical and forecast), ISO, Insurance Information Institute.
Direct Premiums Written: All P/C Lines
Percent Change by State, 2005-2010

Top 25 States

North Dakota is the growth juggernaut of the P/C insurance industry—too bad nobody lives there...

Sources: SNL Financial LC.; Insurance Information Institute.
US Direct Premiums Written declined by 1.6% between 2005 and 2010

States with the poorest performing economies also produced the most negative net change in premiums of the past 5 years

Sources: SNL Financial LC; Insurance Information Institute.
Finally! A sustained period of growth in written premium growth (vs. the same quarter, prior year)

Sources: ISO, Insurance Information Institute.
Growth in Net Written Premium by Segment, 2011 vs. 2010

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

Commercial lines growth improved dramatically as a 7-year long soft market came to an end and an improving economy bolstered demand.

Source: ISO/PCI; Insurance Information Institute
Average Commercial Rate Change, All Lines, (1Q:2004–2Q:2012)

Pricing as of Q2:2012 was positive marking the first full year of gains since 2003. Increases are holding steady in 2012.

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

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Change in Commercial Rate Renewals, by Account Size: 1999:Q4 to 2012:Q2

Percentage Change (%)

Peak = 2001:Q4 +28.5%

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

Trough = 2007:Q3 -13.6%

KRW : No Lasting Impact

Pricing turned positive in Q3:2011, the first increase in nearly 8 years; Q2:2012 renewals were up 4.3%

Source: Council of Insurance Agents and Brokers; Barclay’s Capital; Insurance Information Institute.

1999:Q4 = 100

Despite 4 consecutive quarters of gains (Q2:2012 = 4.3%), pricing today is where it was in early 2001 (pre-9/11), suggesting additional rate need going forward, esp. in light of record low interest rates.

Upward pricing pressure is smaller for large accounts, 3.7% in Q2:2012, vs. 4.3% for small accounts and 4.9% for medium accounts.

Source: Council of Insurance Agents and Brokers; Barclay's Capital; Insurance Information Institute.
Change in Commercial Rate Renewals, by Line: 2012:Q2

Major Commercial Lines Renewed Uniformly Upward in Q2:2012 for Only the Fourth Time Since 2003; Property Lines & Workers Comp Leading the Way; Cat Losses and Low Interest Rates Provide Momentum Going Forward

Source: Council of Insurance Agents and Brokers; Insurance Information Institute.
WC rate changes have been positive for 5 consecutive quarters, longer than any other commercial line.

Source: Council of Insurance Agents and Brokers; Information Institute.
How the Risk Dollar is Spent (2011)

Management & Professional Liability Costs Account for 9% - 13% of the Risk Dollar

Firms w/Revenues < $1 Billion

- Total Prof. Liability Costs, 8%
- WC Retained Losses, 9%
- WC Premiums, 8%
- Total Mgmt. Liab., 13%
- Property Premiums, 21%
- Retained Property Losses, 3%
- Liability Premiums, 21%
- Liability Retained Losses, 13%

Firms w/Revenues > $1 Billion

- Total Prof. Liability Costs, 3%
- WC Retained Losses, 21%
- WC Premiums, 6%
- Total Mgmt. Liab., 6%
- Property Premiums, 13%
- Retained Property Losses, 8%
- Liability Premiums, 10%
- Liability Retained Losses, 12%

Source: 2011 RIMS Benchmark Survey, Advisen; Insurance Information Institute
INVESTMENTS: THE NEW REALITY

Investment Performance is a Key Driver of Profitability

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

- No Expectation that Rates Would Be:
  - Pushed to Such Low Levels
  - Pushed Down so Rapidly
  - Held to Such Low Levels for So Long
  - Suppressed via Unprecedented Aggressiveness of the Federal Reserve
    - Use of traditional and unconventional tools (QE)
    - Unconventional ‘s policies couldn’t be anticipated, esp. QE1, 2 (3?)

- Competitive Pressure → Protracted Soft Market
- Ability to Release Prior Reserves Eases Urgency
- Realization of Capital Gains
Investment Income in 2011 Was Surprisingly Strong, Though Investment Income Is Likely to Weaken in 2012 Due to Persistently Low Interest Rates

Investment gains consist primarily of interest and stock dividends.

*2012F is based on annualized Q1:2012 actual figure of $11.656B.
Sources: ISO; Conning Research & Consulting; Insurance Information Institute.
Investment Gains in 2011 Were Surprisingly Robust. Investment Gains Recovered Significantly in 2011 Due to Realized Investment Gains; The Financial Crisis Caused Investment Gains to Fall by 50% in 2008

1 Investment gains consist primarily of interest, stock dividends and realized capital gains and losses.
* 2005 figure includes special one-time dividend of $3.2B; 2012F figure is III estimate based on annualized actual Q1:2012 result of $12.341B.
Sources: ISO; Insurance Information Institute.
Insurers Posted Net Realized Capital Gains in 2010 and 2011 After Following Two Years of Realized Losses During the Financial Crisis. Realized Capital Losses Were the Primary Cause of 2008/2009’s Large Drop in Profits and ROE.

Sources: A.M. Best, ISO, Insurance Information Institute.
Yields on 10-Year U.S. Treasury Notes have been essentially below 5% for a full decade.

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

*Monthly, through June 2012. Note: Recessions indicated by gray shaded columns.
Treasury Yield Curves: Pre-Crisis (July 2007) vs. July 2012*

Treasury yield curve remains near its most depressed level in at least 45 years. Investment income is falling as a result. Fed is unlikely to hike rates until well into 2014 at the earliest.

The Fed Is Actively Signaling that it Is Determined to Keep Rates Low Through Late 2014; This Adds to Pricing Pressure for Insurers.

*Week ending July 27.
Source: Federal Reserve Board of Governors; Insurance Information Institute.
Reduction in Combined Ratio Necessary to Offset 1% Decline in Investment Yield to Maintain Constant ROE, by Line*

Lower Investment Earnings Place a Greater Burden on Underwriting and Pricing Discipline

*Based on 2008 Invested Assets and Earned Premiums
**US domestic reinsurance only
Source: A.M. Best; Insurance Information Institute.
Inflation

Is it a Threat to Claim Cost Severities
Annual Inflation Rates, (CPI-U, %), 1990–2017F

Inflation peaked at 5.6% in August 2008 on high energy and commodity crisis. The recession and the collapse of the commodity bubble reduced inflationary pressures in 2009/10.

Higher energy, commodity and food prices pushed up inflation in 2011, but not longer turn inflationary expectations.

The slack in the U.S. economy suggests that inflationary pressures should remain subdued for an extended period of times. Energy, health care and commodity prices, plus U.S. debt burden, remain longer-run concerns.

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators, 10/11 and 5/12 (forecasts).
P/C Personal Insurance Claim Cost Drivers Grow Faster Than the Core CPI Suggests

Price Level Change: 2011 vs. 2010

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

Copper prices spiked and retreated in 2011. In July its price was 33% higher than a year earlier; by November it cost 8% less than in November 2010.

Presidential Politics & the P/C Insurance Industry

How Is Profitability Affected by the President’s Political Party?
P/C Insurance Industry ROE by Presidential Administration, 1950-2012*

OVERALL RECORD: 1950-2012*
Democrats 7.67%
Republicans 7.97%

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

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

BLUE = Democratic President  RED = Republican President

*ROEs for the years 2008 forward exclude mortgage and financial guaranty segments; Estimated 2012 ROE = 7.0%
Source: Insurance Information Institute
Thank you for your time and your attention!

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