Financial Crisis and the Future of the P/C Insurance Industry

Challenges Amid the Global Economic Storm

Association of Professional Insurance Women
New York, NY

February 5, 2009

Robert P. Hartwig, Ph.D., CPCU, President
Insurance Information Institute ♦ 110 William Street ♦ New York, NY 10038
Tel: (212) 346-5520 ♦ bobh@iii.org ♦ www.iii.org
Presentation Outline

• Financial Crisis & The Weakening Global Economy: Insurance Impacts
  • Banks vs. Insurers
  • Economic Growth & Recession
  • Financial Strength & Ratings

• P/C Insurance Industry Overview & Outlook
  • Profitability
  • Premium Growth
  • Underwriting Performance
  • Financial Market Impacts

• Capital & Capacity

• Regulatory Response to Crisis
  • Emerging Blueprint of Regulatory Overhaul

• Important Threats Facing P/C Insurers in 2009

Q & A
THE ECONOMIC STORM

What a Weakening Economy and Financial Crisis Mean for the Insurance Industry

Exposure & Claim Cost Effects
Real GDP Growth*

Recession began in December 2007. Economic toll of credit crunch, housing slump, labor market contraction is growing.

The Q4:2008 decline was the steepest since the Q1:1982 drop of 6.4%.

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

Source: US Department of Commerce, Blue Economic Indicators 1/09; Insurance Information Institute.
Real GDP By Market 2007-2010F (% change from previous year)

All major economies except China are in recession.

Steep declines in GDP will negatively impact exposure growth on a global scale

Source: Blue Chip Economic Indicators, 1/10/09 edition.
Announced Economic Stimulus Packages Worldwide ($ Billions)*

Governments around the world are seeking to soften the economic blow through spending. Deficits as a share of GDP will mushroom leading to a potential inflationary threat and higher interest rates the future.

P/C insurers will provide insurance necessary for stimulus projects and will benefit from enhanced economic growth.

U.S. stimulus comprises: $550 billion spending and $275 billion tax relief

Sources: Wall Street Journal, January 8, 2009; Institute of International Finance.
Current recession began in Dec. 2007 and is already the longest since 1981. If it extends beyond April, it will become the longest recession since the Great Depression.

* As of February 2009
Sources: National Bureau of Economic Research; Insurance Information Institute.
Unemployment will likely peak above 8% or 9% during this cycle, impacting payroll sensitive p/c and non-life exposures.

Previous Peak: 6.3% in June 2003

Dec. 2008 unemployment jumped to 7.2%, exceeding the 6.3% peak during the previous cycle.

Trough: 4.4% in March 2007

Average unemployment rate 2000-07 was 5.0%
Rising unemployment will erode payrolls and workers comp’s exposure base.

Unemployment is expected to peak above 8% in the second half of 2009.
Job losses in 2008 totaled 2.589 million, the highest since 1945 at WW II’s end; 11.1 million people are now defined as unemployed.

The Nov./Dec. 2008 losses were the largest since May 1980 loss of 431,000, but less than the Dec. 1974 loss of 602,000.

The US has seen net job losses in only 16 of the 70 years since 1939.

2008’s job losses were exceeded only by 1945, at the conclusion of WW II.

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

Exposure growth forecast for HO insurers is dim for 2009 with some improvement in 2010.

Impacts also for comml. insurers with construction risk exposure

New home starts plunged 34% from 2005-2007; Drop through 2009 trough is 65% (est.)—a net annual decline of 1.35 million units

I.I.I. estimates that each incremental 100,000 decline in housing starts costs home insurers $87.5 million in new exposure (gross premium). The net exposure loss in 2009 vs. 2005 is estimated at about $1.2 billion.

Source: US Department of Commerce; Blue Chip Economic Indicators (1/09); Insurance Information Inst.
Auto/Light Truck Sales, 1999-2010F (Millions of Units)

Weakening economy, credit crunch are hurting auto sales; Gas prices less of a factor now.

New auto/light truck sales are expected to experience a net drop of 5.7 million units annually by 2009 compared with 2005, a decline of 20.7%.

Impacts of falling auto sales will have a less pronounced effect on auto insurance exposure growth than problems in the housing market will on home insurers.

Source: US Department of Commerce; Blue Chip Economic Indicators (1/09); Insurance Information Inst.
Weakening wage and salary growth is expected to cause a deceleration in workers comp exposure growth.

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

Industrial production began to contract sharply during H2 2008 and is expected to shrink through the first half of 2009.

Obama stimulus program is expected benefit impact industrial production and therefore insurance exposure both directly and indirectly.

Figures for H2:09 and 2010 revised sharply upwards to reflect expected impact of Obama stimulus program.

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (1/09); Insurance Info. Inst.
Commercial insurance lines that will benefit from the Obama stimulus plan include workers comp, commercial property, commercial auto, surety, inland marine and others.
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, 8/08; Insurance Information Inst.
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 underwriting performance and could reach a record low in 2007.

2007 impairment rate was a record low 0.12%, one-seventh the 0.8% average since 1969; Previous record was 0.24% in 1972.

Source: A.M. Best; Insurance Information Institute
Summary of A.M. Best’s P/C Insurer Ratings Actions in 2008*

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.
Reasons for US P/C Insurer Impairments, 1969-2005

2003-2005

- Deficient Loss Reserves/Inadequate Pricing: 62.8%
- Alleged Fraud: 11.4%
- Catastrophe Losses: 8.6%
- Deficient Reserves/Inadequate Pricing: 8.6%
- Rapid Growth: 8.6%
- Affiliate Problems: 8.6%

Deficient reserves, CAT losses are more important factors in recent years

1969-2005

- Deficient Loss Reserves/Inadequate Pricing: 38.2%
- Alleged Fraud: 8.6%
- Catastrophe Losses: 6.5%
- Rapid Growth: 16.5%
- Reinsurance Failure: 3.5%
- Misc. Change in Business: 4.6%
- Affiliate Problems: 5.6%
- Investment Problems*: 7.3%

*Includes overstatement of assets.

Source: A.M. Best: P/C Impairments Hit Near-Term Lows Despite Surging Hurricane Activity, Special Report, Nov. 2005;
Q. DO YOU THINK THAT THESE PROBLEMS (THE MORTGAGE PROBLEMS SOME AMERICANS FACE, THE DROP IN THE STOCK MARKET AND JOB LAYOFFS) AFFECT THE ABILITY OF INSURANCE COMPANIES TO PAY THEIR CLAIMS, TO SELL MORE INSURANCE, BOTH, NONE OF THESE (DOESN’T AFFECT ABILITY TO PAY CLAIMS OR SELL INSURANCE) OR DON’T KNOW?

95% Americans think that the downturn in the economy affects the basic business of the insurance industry: the ability to pay claims and/or sell insurance

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 27 banks have gone under)
    - The Promise is Being Fulfilled
  - Renew existing policies (banks are reducing and eliminating lines of credit)
  - Write new policies (banks are turning away people who want or need to borrow)
  - Develop new products (banks are scaling back the products they offer)

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 \( \rightarrow \text{There is no credit or liquidity crisis in the insurance industry} \)

- **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
The Financial Crisis in Perspective

Bank vs. Insurer Impacts
Financial Institutions Globally Facing Huge Losses from the Credit Crunch*

The IMF estimates total “credit-turmoil-related” losses will eventually amount to $1.4 trillion.

- $205B or 20.8% of estimated total (bank+insurer) losses will be sustained by insurers worldwide.

*Global losses since the beginning of 2007.

### Top 10 Largest Bank Failures

- **Homesf Bank (1992, San Diego)**: $12.2 billion
- **First City Bancorporation (1988, Houston)**: $13.0 billion
- **Gibraltar Savings (1989, Simi Valley)**: $15.1 billion
- **Moore (1989, Dallas)**: $18.5 billion
- **Bank of New England (1991, Boston)**: $21.7 billion
- **American Savings & Loan (1988, Stockton)**: $30.2 billion
- **IndyMac (2008, Pasadena)**: $32.0 billion
- **First Republic (1988, Dallas)**: $32.5 billion
- **Continental Illinois (1984, Chicago)**: $40.0 billion
- **Washington Mutual (2008, Seattle)**: $307.0 billion

Source: FDIC; Insurance Information Institute research.

**Resurgent bank failures (25 in 2008, so far in 2009) are symptomatic of weakness in the financial system. FDIC says many more may fail.**

- Sept. 25 failure of Washington Mutual was bar far the largest in US history. Sold to JP Morgan Chase by govt. for $1.9B plus WaMu’s loans and deposits.

- Failure of IndyMac was the 4th largest in history.
US Bank Failures:*
1995-2009**

Through January 23, 2009

Bank failures are up sharply. 27 banks (but no p/c or life insurers) failed in 2008/09 due to the financial crisis, including the largest in history—Washington Mutual with $307B in assets.

Remarkably, as recently as 2005 and 2006, no banks failed—the first time this had happened in FDIC history (dating back to 1934).

*Includes all commercial banking and savings institutions. **Through Jan. 23.
US Bank Failures:*
1934-2009**

Through January 23, 2009

- **Great Depression**: 355 failures between 1934 and 1940*
- **Savings & Loan Crisis**: 2808 depository institutions failed between 1982 and 1992;
- **Current Financial Crisis**: 27 banks (but no p/c or life insurers) have failed so far in 2008/09

The S&L bailout cost taxpayers as much as $160 billion. The current bailout could cost the government much more.

*Includes all commercial banking and savings institutions.
**Data begin in 1934, the year the FDIC was established.
Top 10 P/C Insolvencies, Based Upon Guaranty Fund Payments*

The 2001 bankruptcy of Reliance Insurance was the largest ever among p/c insurers

* Disclaimer: This is not a complete picture. If anything the numbers are understated as some states have not reported in certain years.

Source: National Conference of Insurance Guaranty Funds, as of September 17, 2008.
P/C INSURANCE
FINANCIAL PERFORMANCE

A Resilient Industry in Challenging Times
Profitability

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

- 2001 ROE = -1.2%
- 2002 ROE = 2.2%
- 2003 ROE = 8.9%
- 2004 ROE = 9.4%
- 2005 ROE = 9.4%
- 2006 ROE = 12.2%
- 2007 ROAS<sup>1</sup> = 12.3%
- 2008 ROAS = 1.1%*

Insurer profits peaked in 2006.

*ROE figures are GAAP; <sup>1</sup>Return on avg. surplus. 2008 numbers are annualized based on 9-mos. Actual of $4.066 billion.

Sources: A.M. Best, ISO, Insurance Information Inst.
P/C Insurance Industry ROEs, 1975 – 2010F*

1977: 19.0%
1987: 17.3%
1997: 11.6%
2006: 12.2%

1975: 2.4%
1984: 1.8%
1992: 4.5%
2008F: 1.1%
2009F: 4.5%
2010F: 6.0%
2001: -1.2%

Note: 2009 figure is actual 9-month result.
Sources: ISO; Insurance Information Institute.
The p/c insurance industry fell well short of its cost of capital in 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.

The cost of capital is the rate of return insurers need to attract and retain capital to the business.

*Excludes mortgage and financial guarantee insurers.
Presidential Politics & P/C Insurance

How is Profitability Affected by the President’s Political Party?
P/C Insurance Industry ROE by Presidential Administration, 1950-2008*

OVERALL RECORD: 1950-2008*

Democrats 8.05%
Republicans 8.02%

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

*ROE for 2008 based on H1 data. Truman administration ROE of 6.97% based on 3 years only, 1950-52.
Source: Insurance Information Institute
P/C Insurance Industry ROE by Presidential Party Affiliation, 1950–2008*

BLUE = Democratic President  RED = Republican President

Investment Performance

Investments are the Principle Source of Declining Profitability
Distribution of P/C Insurance Industry’s Investment Portfolio

As of December 31, 2007

- Bonds: 66.7%
- Common Stock: 17.9%
- Cash & Short-Term Investments: 7.2%
- Real Estate: 0.8%
- Preferred Stock: 1.5%
- Other: 5.9%

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.
Investment gains are off sharply in 2008 due to lower yields and poor equity market conditions.

1Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2006 figure consists of $52.3B net investment income and $3.4B realized investment gain. *2005 figure includes special one-time dividend of $3.2B. Sources: ISO; Insurance Information Institute.
P/C Insurer Net Realized Capital Gains, 1990-2008:Q3


Sources: A.M. Best, ISO, Insurance Information Institute.
Total Returns for Large Company Stocks: 1970-2008*

S&P 500 was down 38.5% in 2008*

The market crash of 2008 was the largest since 1931

Stock market volatility is at its highest levels since the 1930s, pushing the VIX Volatility Index (a.k.a. “Investor Fear Gauge”) to record highs in 2008.

VIX Interpretation
- VIX >30: Extreme Volatility
- VIX<20: Low Volatility
- Average: 1990-2008* = 19.49

Stock Market Daily Volatility in 2008*: Heading to “Normal”?  

Even the volatility levels are volatile.

Oct 27, 2008  
Lehman fails; AIG “rescued”  

Nov 20, 2008  
Election day  

VIX >30: Extreme Volatility  
VIX<20: Low Volatility  

*September 2 to December 31, 2008.  
At year end 2007, the notional value of CDS’s outstanding was $62.2 trillion or 4.5 times US GDP, up nearly 40 fold from 2002. The 12% decline in 08:H1 was the first since 2001.

The NY DOI has proposed regulated some CDS’s as insurance. Not all states feel they have this authority. NAIC is less interested.
Underwriting Trends

Financial Crisis Does Not Directly Impact Underwriting Performance: Cycle, Catastrophes Were 2008’s Drivers
Sources: A.M. Best; ISO, III  *A.M. Best year end estimate of 103.2; Actual 9-mos. result was 105.6.
As recently as 2001, insurers paid out nearly $1.16 for every $1 in earned premiums.

2005 ratio benefited from heavy use of reinsurance which lowered net losses.

Best combined ratio since 1949 (87.6).

Relatively low CAT losses, reserve releases.

Including Mortgage & Fin. Guarantee insurers.

Cyclical Deterioration.


Sources: A.M. Best.
Insurers earned a record underwriting profit of $31.7 billion in 2006, the largest ever but only the second since 1978. Cumulative underwriting deficit from 1975 through 2007 is $422 billion.
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.

Personal Lines

Auto (~75% of Market)
Home (~25%)
Improvement in 2009 assumes reasonable degree of underwriting discipline and average CAT activity ($10B-$12B).

2008 deterioration due to price competition and higher CAT losses. Trends reverse in 2009.

Source: A.M. Best (historical and forecast).
Auto insurance prices have clearly begun to rise in recent months.
Commercial Lines
2006/07 benefited from favorable loss cost trends, improved tort environment, low CAT losses, WC reforms and reserve releases. Most of these trends reversed in 2008 and mortgage and financial guarantee segments have big influence. 2009 is transition year.

Commercial coverages have exhibited significant variability over time.

Mortgage and financial guarantee may account for up to 4 points on the commercial combined ratio in 2008.
Average Commercial Rate Change, All Lines, (1Q:2004 – 4Q:2008)

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

Magnitude of price declines is now shrinking. Reflects shrinking capital, reduced investment gains, deteriorating underwriting performance and costlier reinsurance.
Declines in premium growth began to stabilize in later 2008 and are firming to some extent as we move into 2009, but are partly offset by flat/declining exposures due to the recession.
Advertising

Unlike in Post 9/11 Period, Insurer Advertising Likely to Remain Strong
Ad spending by P/C insurers is at a record high, signaling increased competition.

Source: Insurance Information Institute from consolidated P/C Annual Statement data.
Why Advertising Will Likely Remain Strong?

• DIRECT MARKETERS: No Agents = Advertising
  • Collectively, direct marketers have a larger market share
  • GEICO, 21st Century (formerly AIG Direct) and others are committed to the direct model
  • EA/IA companies sometimes have direct channels (some which bypass the agent, some which complement the agent)

• PERFORMANCE: U/W Results Not that Bad
  • Advertising is cut back when line is performing poorly from an underwriting perspective; Not generally the case today.

• SLOW GROWTH: Hope to Stimulate Demand

• INTERNET: Advertising Must Include New Media
  • Will appear more ubiquitous even if ad spend flat

• REBRANDING: Some Insurers Recasting Themselves
  • Want to emphasize affordability in down economy
Catastrophe Losses

Impacting Underwriting Results and the Bottom Line
$100 Billion CAT year is coming soon

2008 CAT losses exceeded 2006/07 combined. 2005 was by far the worst year ever for insured catastrophe losses in the US, but the worst has yet to come.

*Excludes $4B-$6b offshore energy losses from Hurricanes Katrina & Rita.

**Based on PCS data through Dec. 31. PCS $2.1B loss of for Gustav. $10.655B for Ike of 12/05/08.

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

Source: Property Claims Service/ISO; Insurance Information Institute
States With Highest Insured Catastrophe Losses in 2008

Big catastrophe losses turned up in some surprising states in 2008, due to high tornado, hail and wildfire damage as well as inland hurricane damage.

- Texas: $10.2
- California: $2.2
- Minnesota: $1.6
- Ohio: $1.3
- Georgia: $1.0

Source: PCS; Insurance Information Institute.
9 of the 12 most expensive disasters in US history have occurred since 2004

In 2008, Ike became the 6th most expensive insurance event and 4th most expensive hurricane in US history

*PCS estimate as of 12/15/08.

Sources: ISO/PCS; AIR Worldwide, RMS, Eqecat; Insurance Information Institute inflation adjustments.
The number of catastrophe events reached a 10-year high in 2008.

*PCS defines a catastrophe as an event that caused at least $25 million in insured property damage and affects a significant number of policyholders and insurers.

Source: PCS; Insurance Information Institute
2008 Insured Catastrophe Loss Distribution by Category

$ Millions

Commercial, $6,804, 27%
Vehicle**, $2,268, 9%
Personal*, $16,128, 64%

2008 CAT FACTS

- The $25.2 billion in insured losses was the 4th highest ever, behind only, 2005, 2004 and 2001
- There were 37 designated catastrophes in 2008, the highest since 1998 (also 37)
- Commercial losses accounted for 27% of insured losses but just 9% of claims

*Includes homeowners, condominium and rental policies.
**Includes commercial and private passenger vehicles
Source: PCS; Insurance Information Institute research.
2008 Insured Catastrophe Loss
Distribution by Number of Claims

2008 CAT FACTS

• The $25.2 billion in insured losses was the 4th highest ever, behind only, 2005, 2004 and 2001

• There were 37 designated catastrophes in 2008, the highest since 1998 (also 37)

• Commercial losses accounted for 27% of insured losses but just 9% of claims

*Includes homeowners, condominium and rental policies.
**Includes commercial and private passenger vehicles
Source: PCS; Insurance Information Institute research.

$ Millions

Personal*, $2,700 , 69%

Commercial, $340 , 9%

Vehicle**, $876 , 22%
Capital / Policyholder Surplus

Shrinkage, but Capital is Within Historic Norms
U.S. Policyholder Surplus: 1975-2008*

Actual capacity as of 9/30/08 was $478.5, down 7.6% from 12/31/07 at $517.9B, but 68% above its 2002 trough. Recent peak was $521.8 as of 9/30/07. Estimate as of 12/31/08 is $438B is 16% below 2007 peak.

The premium-to-surplus ratio stood at $0.94:$1 at year end 2008, up from near record low of $0.85:$1 at year-end 2007

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


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

$ Billions

2006:Q4 - $487.1
2007:Q1 - $496.6
2007:Q2 - $512.8
2007:Q3 - $521.8
2007:Q4 - $517.9
2008:Q1 - $515.6
2008:Q2 - $505.0
2008:Q3 - $478.5
2008:Q4 - $438.0

Declines Since 2007:Q3 Peak
Q2: -$16.6B (-3.2%)
Q3E: -$43.3B (-8.3%)
Q4E: -$84B (-16.1%)


Premiums measure risk accepted; surplus is funds beyond reserves to pay unexpected losses. The larger surplus is in relation to premiums—the lower the ratio of premiums to surplus—the greater the industry’s capacity to handle the risk it has accepted.

1998 0.85:1—the lowest (strongest) P:S ratio in recent history.

0.92:1 as of 9/30/08

P/C insurers remain well capitalized despite recent erosion of capital.

Sources: A.M. Best, ISO, 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.

*Actual 9-month 2008 result.
Sources: A.M. Best, ISO, 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

Shaded areas denote “hard market” periods

Net written premiums fell 1.0% in 2007 (first decline since 1943) and by 0.4% in 2008, the first back-to-back decline since 1930-33

Sources: A.M. Best, ISO, Insurance Information Institute
Year-to-Year Change in Net Written Premium, 2000-2008E*

P/C insurers are experiencing their slowest growth rates since 1930-33

Slow growth means retention is critical

Protracted period of negative or slow growth is possible due to soft markets and slow economy

*2008 figure is 9-month actual result from ISO.
Source: A.M. Best (historical)
Key Issues & Threats Facing P/C Insurers Amid Financial Crisis

Manageable Challenges
Important Issues & Threats
Facing P/C Insurers in 2009

1. Reloading Capital After “Capital Event”
   - Continued asset price erosion coupled with major “capital event” could lead to shortage of capital among some companies.
   - 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, reflecting both scarcity & risk.
   - Implications: P/C insurers need to protect capital today and develop detailed contingency plans to raise fresh capital & generate internally.

2. Long-Term Loss of Investment Return
   - 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.
   - Many insurers have not adjusted to this new investment paradigm.
   - Regulators will not readily accept it; Many will reject it.
   - Implication 1: Industry must be prepared to operate in environment with investment earnings accounting for a smaller fraction of profits.
   - Implication 2: Implies underwriting discipline of a magnitude not witnessed in this industry in more than 30 years.
   - Lessons from the period 1920-1975.

Source: Insurance Information Inst.
3. **Regulatory Overreach**
   - P/C insurers get swept into vast federal regulatory overhaul and subjected to inappropriate, duplicative, and costly regulation.

4. **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.
   - Historically extremely costly to p/c insurance industry.

5. **Disintermediation**
   - Alternative forms of risk transfer are taking an ever-larger share of the (commercial) p/c insurance pie (e.g., 40%+ of workers comp).
   - Soft market did not bring it back.
   - Trend toward state-sponsored insurance and reinsurance (e.g., FL) drains premium out of private insurance markets.

*Source: Insurance Information Inst.*
AFTERSHOCK: Regulatory Response Could Be Harsh

All Financial Segments Including Insurers Will Be Impacted
**Post-Crunch: Fundamental Issues To Be Examined Globally**

- **Failure of Risk Management, Control & Supervision at Financial Institutions Worldwide: Global Impact**
  - Colossal failure of risk management (and regulation)
  - Counterparty risk and collateral management were systemic failure points
  - Implications for Enterprise Risk Management (ERM)?
  - Misalignment of management financial incentives

- **Focus Will Be on Risk Controls: Implies More Stringent Capital & Liquidity Requirements; Prevention of Systemic Risks**
  - Data reporting requirements also likely to be expanded
  - Non-Depository Financial Institutions in for major regulation
  - Changes likely under US and European regulatory regimes
  - Will new regulations be globally consistent?
  - Can overreactions be avoided?

- **Accounting Rule Changes??**
  - Problems arose under FAS, IAS
  - Asset Valuation, including Mark-to-Market
  - Structured Finance & Complex Derivatives

- **Ratings on Financial Instruments**
  - New approaches to reflect type of asset, nature of risk

CFO turnover reached a 13-year high of 19.5% in 2007. The CFO’s office often is responsible for risk management. Insurers will need to consider the risk management skills and experience of new CFOs.

CFO turnover rate:

- **2003**: 13.5%
- **2004**: 14.5%
- **2005**: 17.0%
- **2006**: 14.1%
- **2007**: 19.5%
- **2008***: 18.2%

*2008 figure based on data for first 7 months of 2008.

Emerging Blueprint for Financial Services Regulatory Overhaul

Phase I: Systemic Risk Regulation/Regulator

- Identification of systemic risk points in the financial system
- Design of appropriate regulation to prevent future collapses
- Will require international consultation (US can’t manage systemic risk alone)

• Oversight Responsibility: Likely With Federal Reserve

  - Fed would have capacity and power to assess risk across financial markets regardless of corporate form and to intervene when appropriate*
  - Fed could oversee (according to House FS Committee Chairman Barney Frank):
    - Hedge funds (need to ensure “complete transparency”)
    - Credit ratings agencies
    - Executive compensation (to curb “perverse risk incentives”)
  - TIMELINE: Frank wants “general outline” by April 2 meeting of G20 industrialized and developing nations


Emerging Blueprint for Financial Services Regulatory Overhaul (cont’d)

Phase I: Systemic Risk Regulation/Regulator: OTHER (cont’d)

• Unification of federal bank regulatory agencies
• Creation of a Financial Products Safety Commission to vet products before sold to investors
• Creation of federal insurance program for muni bonds paid via premiums
• Support for status quo on mark-to-market

Phase II: Sectoral Reform/Overhaul

• Each segment of the financial services industry will be examined and subject to regulation specific to its function, risks and other factors
• TIMELINE: August 2009 or later

Federal Encroachment on Regulation of Insurance in Certain Amid a Regulatory Tsunami
- $150 billion in aid to AIG makes increased federal involvement in insurance regulation a certainty
- States will lose some of their regulatory authority
- What Feds get/what states lose is unclear

Removing the “O” from “OFC”?
- Treasury in March proposed moving solvency and consumer protection authority to a federal “Office of National Insurance”
- Moving toward more universal approach for regulation of financial services, perhaps under Fed/Treasury?
- Is European (e.g., FSA) approach in store?
- Treasury proposed assuming solvency and consumer protection roles while also eliminating rate regulation
- Expect battle over federal regulatory role to continue to be a divisive issue within the industry
- States will fight to maximize influence, arguing that segments of the financial services industry under their control had the least problems
Possible Regulatory Scenarios for P/C Insurers as of Year-End 2009

- **Status Quo:** P/C Insurers Remain Entirely Under Regulatory Supervision of the States
  - Unlikely, but some segments of the industry might welcome this outcome above all others

- **Federal Regulation:** Everything is Regulated by Feds
  - Unlikely that states will be left totally in the cold

- **Optional Federal Charter (OFC):** Insurers Could Choose Between Federal and State Regulation
  - Unlikely to be implemented as envisioned for past several years by OFC supporters

- **Dual Regulation:** Federal Regulation Layer Above State
  - Feds assume solvency regulation, states retain rate/form regulation

- **Hybrid Regulation:** Feds Assume Regulation of Large Insurers at the Holding Company Level

- **Systemic Risk Regulator:** Feds Focus on Regulation of Systemic Risk Points in Financial Services Sector
  - What are these points for insurers? P/C vs. Life?

Source: Insurance Information Inst.
Major Regulatory Considerations for Insurance Regulation in 2009

- **Power Sharing:** Will Feds and States Divide Regulatory Authority & How?
  - Holding company (federal) and operating company/insurer (state)?
- **Pre-Emption:** Will Congress Pass Legislation Pre-Empting State Authority?
- **Regulatory Consolidation:** Will Regulatory Authority (now spread over 4+ agencies) be Consolidated Into One Entity? Will it Involve States?
- **Life vs. P/C:** Will Separate Regulatory Structures Emerge?
- **Guaranty Fund System:** FDIC has suggested federalization of system
- **State Run Insurers:** Who Would Regulate State-Run Insurers (Property, WC)?
  - Many coastal states have large state-run entities
  - About 25 states operate workers comp state funds or monopolistic insurers
- **Regulation of Credit Default Swaps as Insurance:** Will Feds take this up?
- **Insurer Divisiveness:** Industry is Not United on Many Key Issues

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