Capital Punishment: Why Earning a Fair Rate of Return is Tougher than Ever in the P/C Insurance Business

International Union of Marine Insurers
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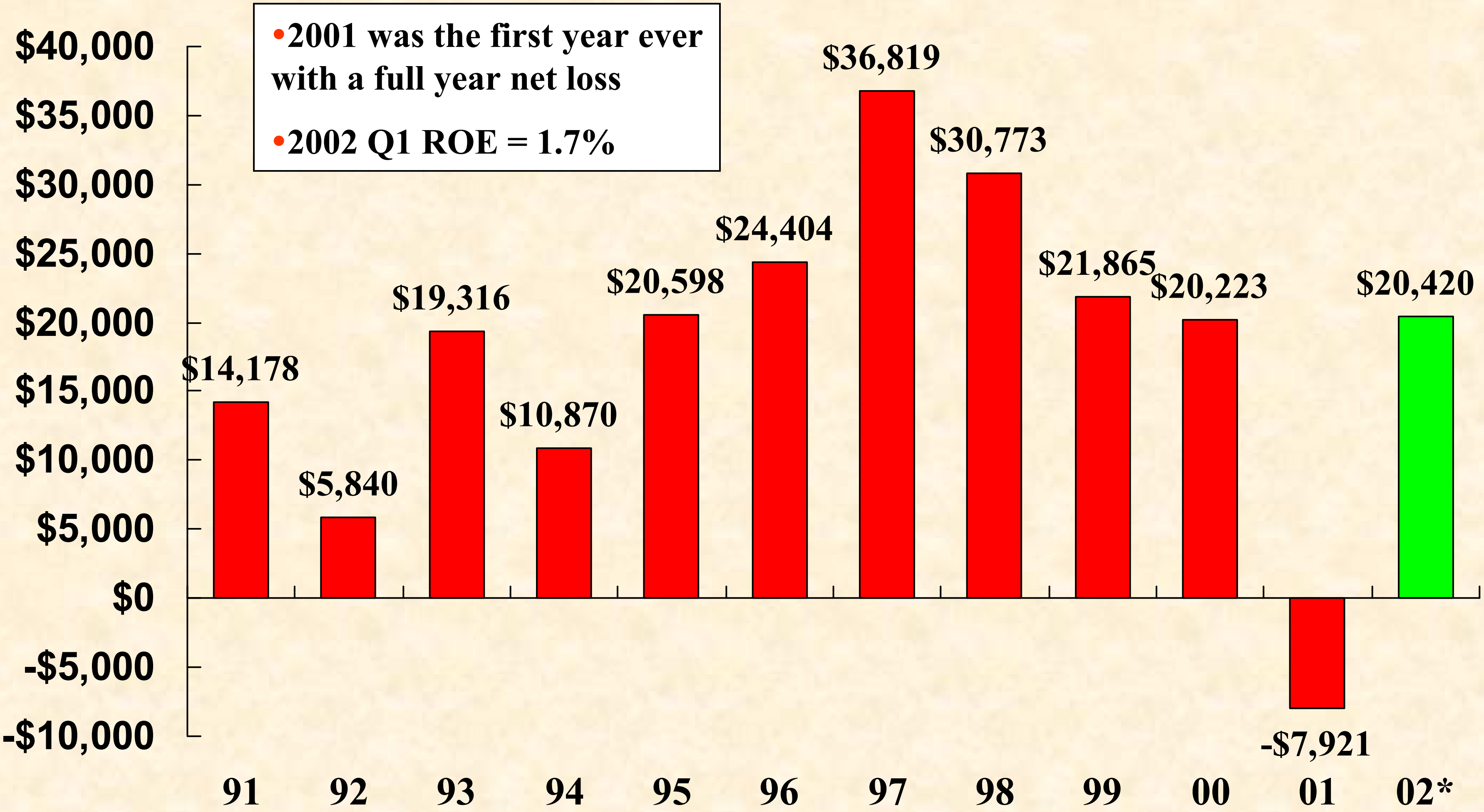
Presentation Outline

- Profitability in the P/C insurance industry
- Insurer Cost of Capital: A Global Perspective
- Supply of Capital in P/C Insurance Industry
- Cost of Capital: How is it Computed?
- Factors Influencing Cost of Capital
  - Special factors affecting p/c insurance
- Summary

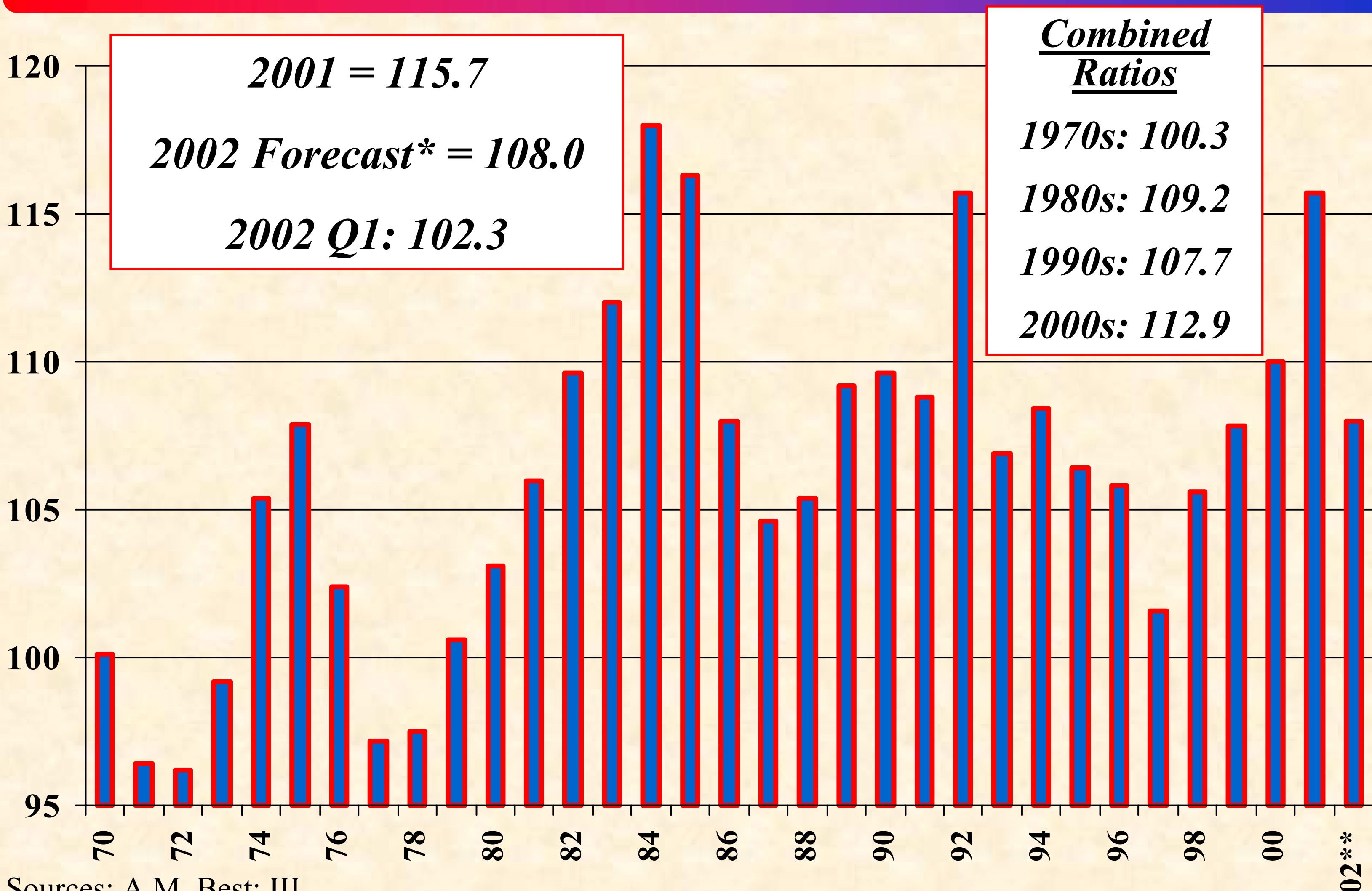
Profitability in the P/C Insurance Industry

P/C Net Income After Taxes 1991-2002 ($ Millions)



*I.I.I. estimate based on first quarter 2002 data.
Sources: A.M. Best, ISO, Insurance Information Institute.

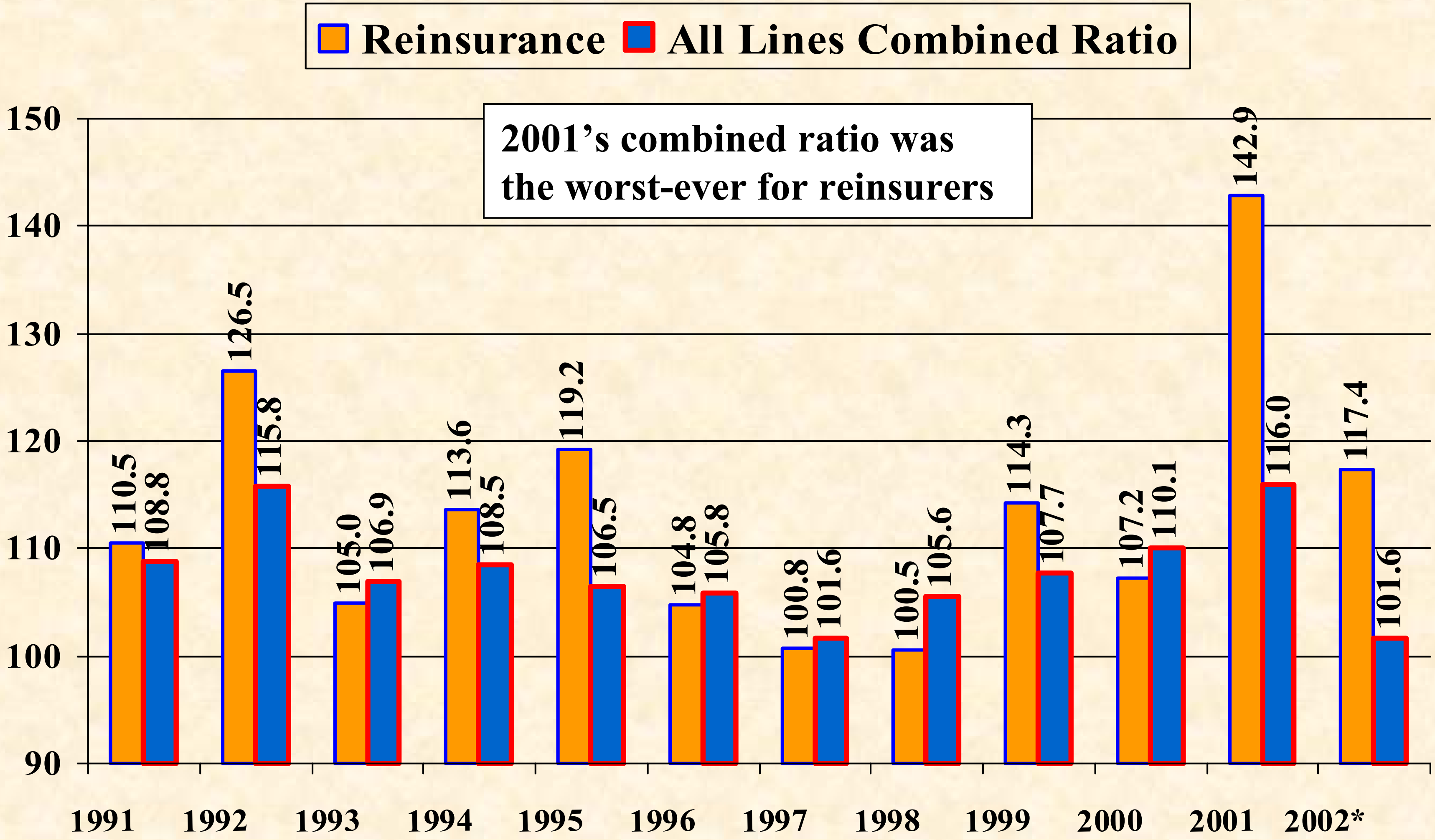
P/C Industry Combined Ratio



Sources: A.M. Best; III

* Based on III 2002 Groundhog Forecast

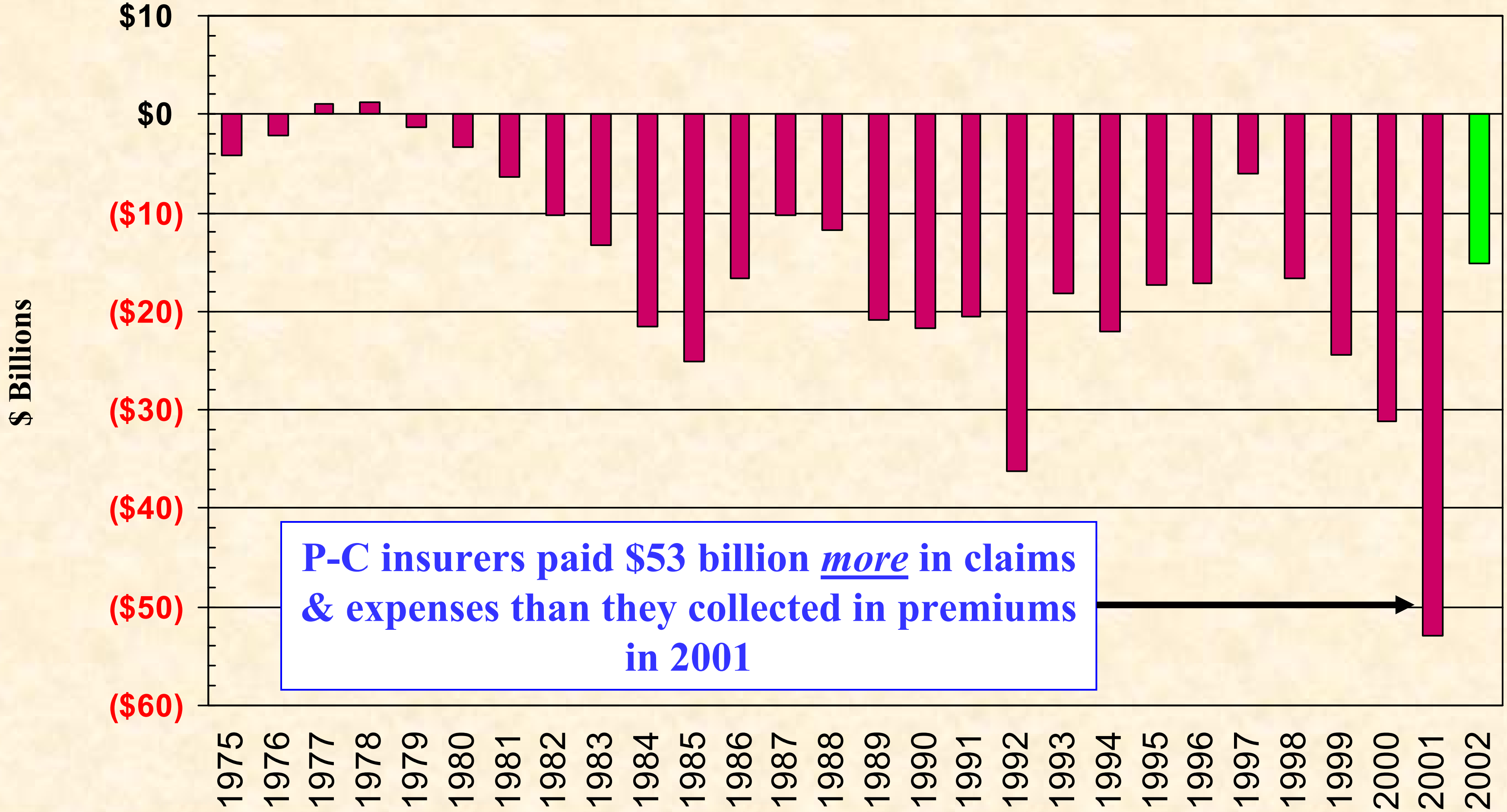
Combined Ratio: Reinsurance vs. P/C Industry



*First Quarter 2002 for all p/c; first half for reinsurance.

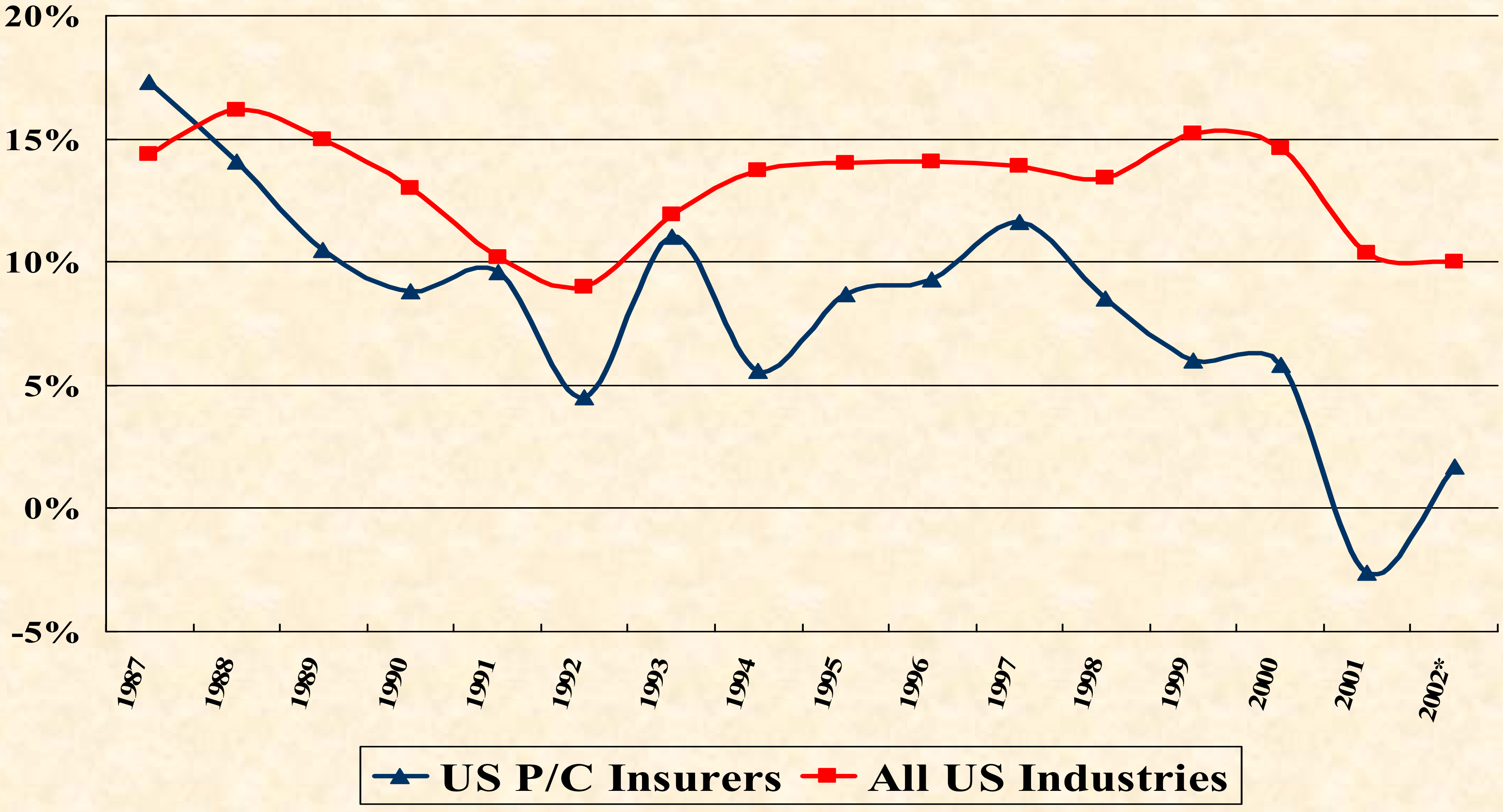
Source: A.M. Best, ISO, Reinsurance Association of America, Insurance Information Institute

*Underwriting Gain (Loss) 1975-2002**



*Annualized estimate based on first quarter 2002 data.
Source: A.M. Best, Insurance Information Institute

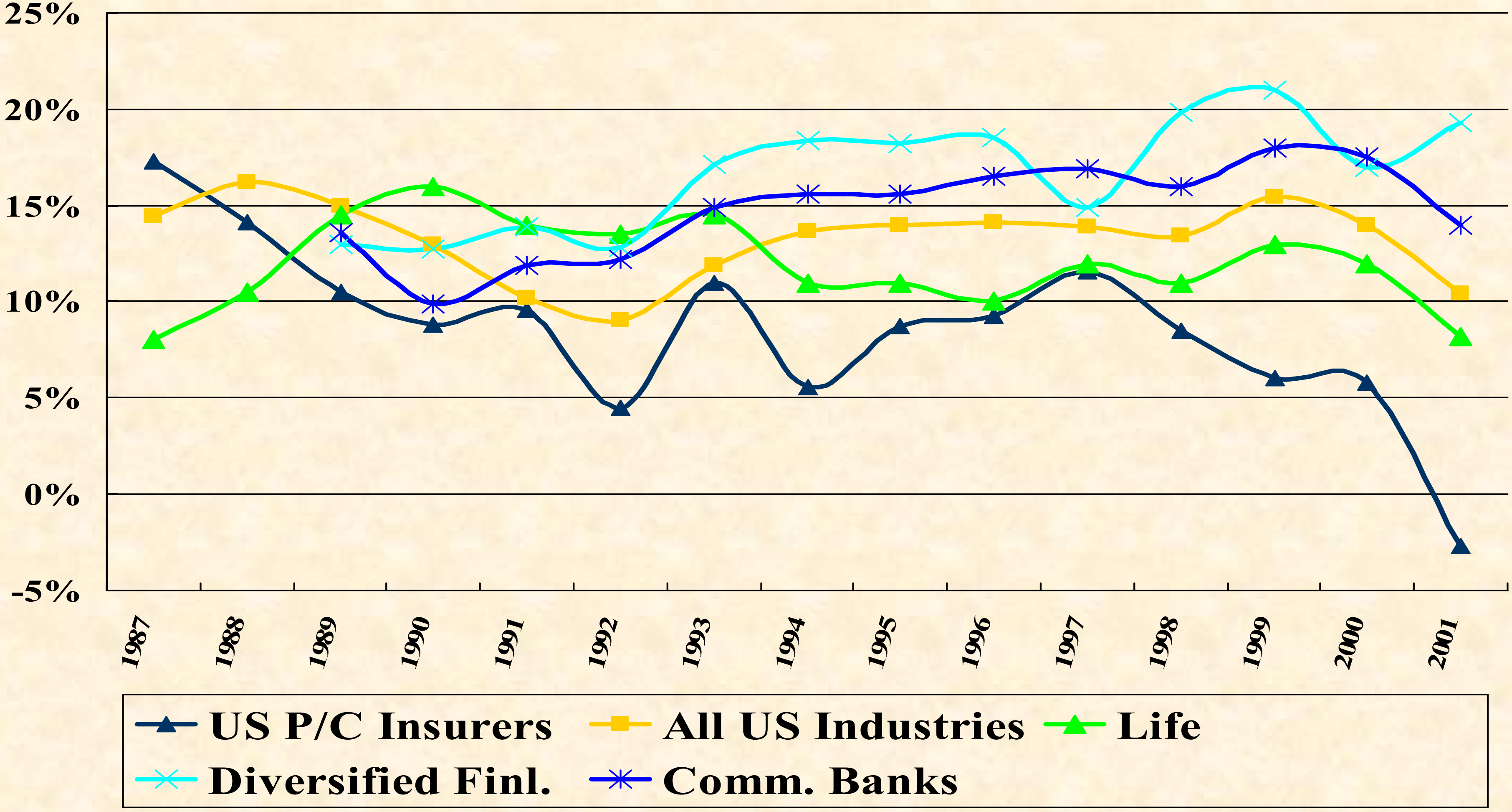
ROE: P/C vs. All Industries 1987–2002*



*First Quarter

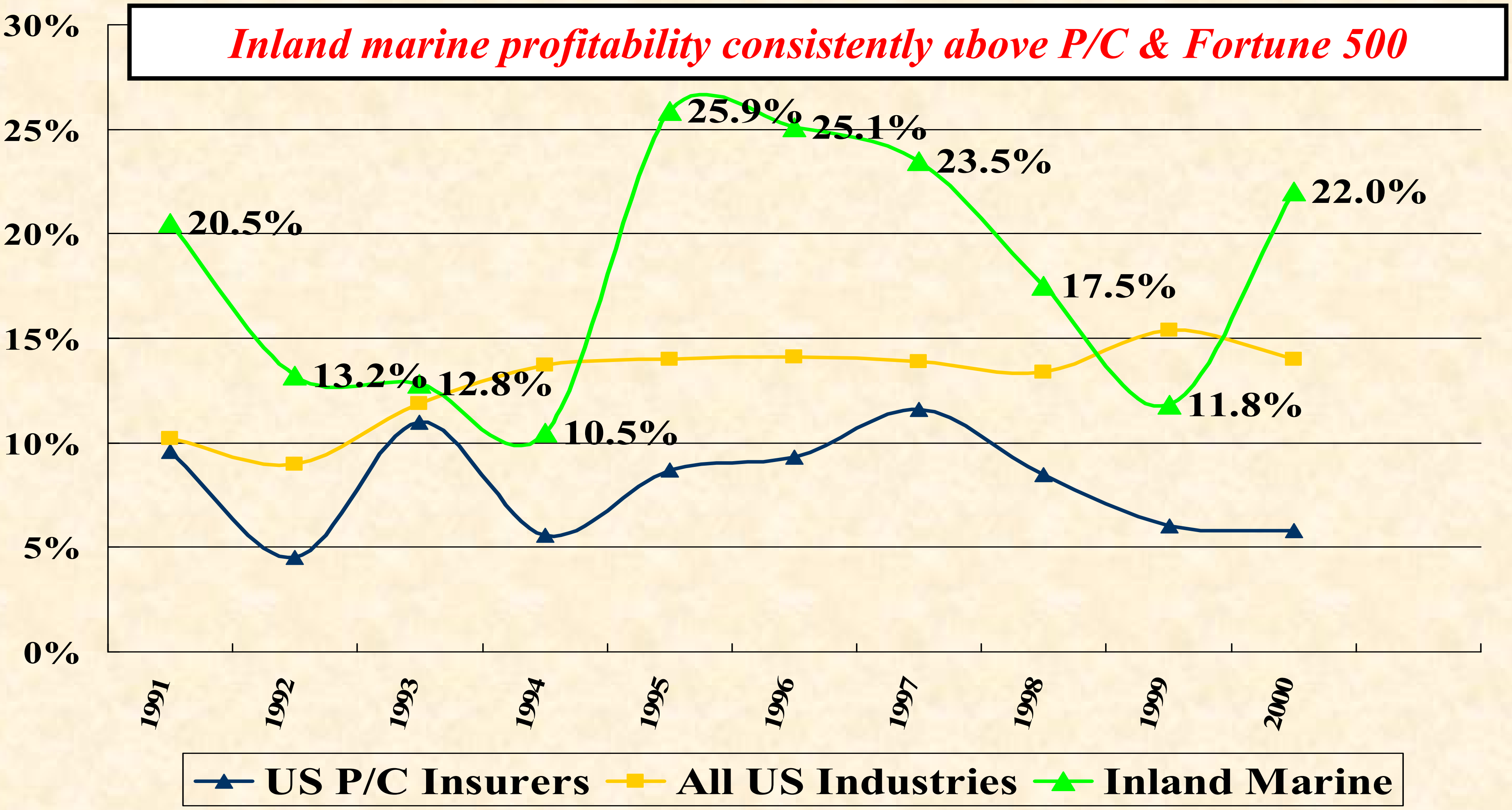
Source: Insurance Information Institute; *Fortune*

ROE: Financial Services Industry Segments, 1987–2001



Source: Insurance Information Institute; *Fortune*

ROE: Inland Marine vs. Overall P/C & Fortune 500, 1991–2000



Source: NAIC, Insurance Information Institute; *Fortune*

12% After Tax ROE Requires Underwriting Profit

P : S	*Accident Year Combined Ratio* 90.0%	92.5 %	95.0 %	97.5 %	100.0 %	102.5 %	105.0 %	107.5 %	110.0 %	112.5 %
100 %	13.0 %	11.5 %	10.1 %	8.6 %	7.1 %	5.6 %	4.1 %	2.6 %	1.1 %	-0.4 %
110 %	14.0 %	12.4 %	10.7 %	9.1 %	7.5 %	5.8 %	4.2 %	2..5 %	0.9 %	-0.7 %
120 %	15.0 %	13.2 %	11.4 %	9.6 %	7.8 %	6.1 %	4.3 %	2.5 %	0.7 %	-1.1 %
130 %	16.0%	14.0 %	**12.1 %**	**10.2 %**	8.2 %	6.3 %	4.4 %	2..4 %	0.5 %	-1.5 %
140 %	16.9 %	14.9 %	**12.8 %**	**10.7 %**	8.6 %	6.5 %	4.4 %	2.4 %	0.3 %	-1.8 %
150 %	17.9 %	15.7 %	**13.5 %**	**11.2 %**	9.0 %	6.8 %	4.5 %	2.3 %	0.1 %	-2.2 %
160 %	18.9 %	16.5 %	**14.1 %**	**11.8 %**	9.4 %	7.0 %	4.6 %	2.2 %	-0.2 %	-2.5 %
170 %	19.9 %	17.3 %	**14.8 %**	**12.3 %**	9.8 %	7.2 %	4.7 %	2.2 %	-0.4 %	-2.9 %
180 %	20.9 %	18.2 %	**15.5 %**	**12.8 %**	10.1 %	7.5 %	4.8 %	2.1 %	-0.6 %	-3.3 %
190 %	21.8 %	19.0 %	**16.2 %**	**13.3 %**	10.5 %	7.7 %	4.9 %	2.0 %	-0.8 %	-3.6 %
200 %	22.8 %	19.8 %	**16.9 %**	**13.9 %**	10.9 %	7.9 %	4.9 %	2.0 %	-1.0 %	-4.0 %
225 %	25.3 %	21.9 %	18.6 %	15.2 %	11.9 %	8.5 %	5.2 %	1.8 %	-1.5 %	-4.9 %
250 %	27.7 %	24.0 %	20.3 %	16.5 %	12.8 %	9.1 %	5.4 %	1.7 %	-2.1 %	-5.8 %

Source: Dowling & Partners

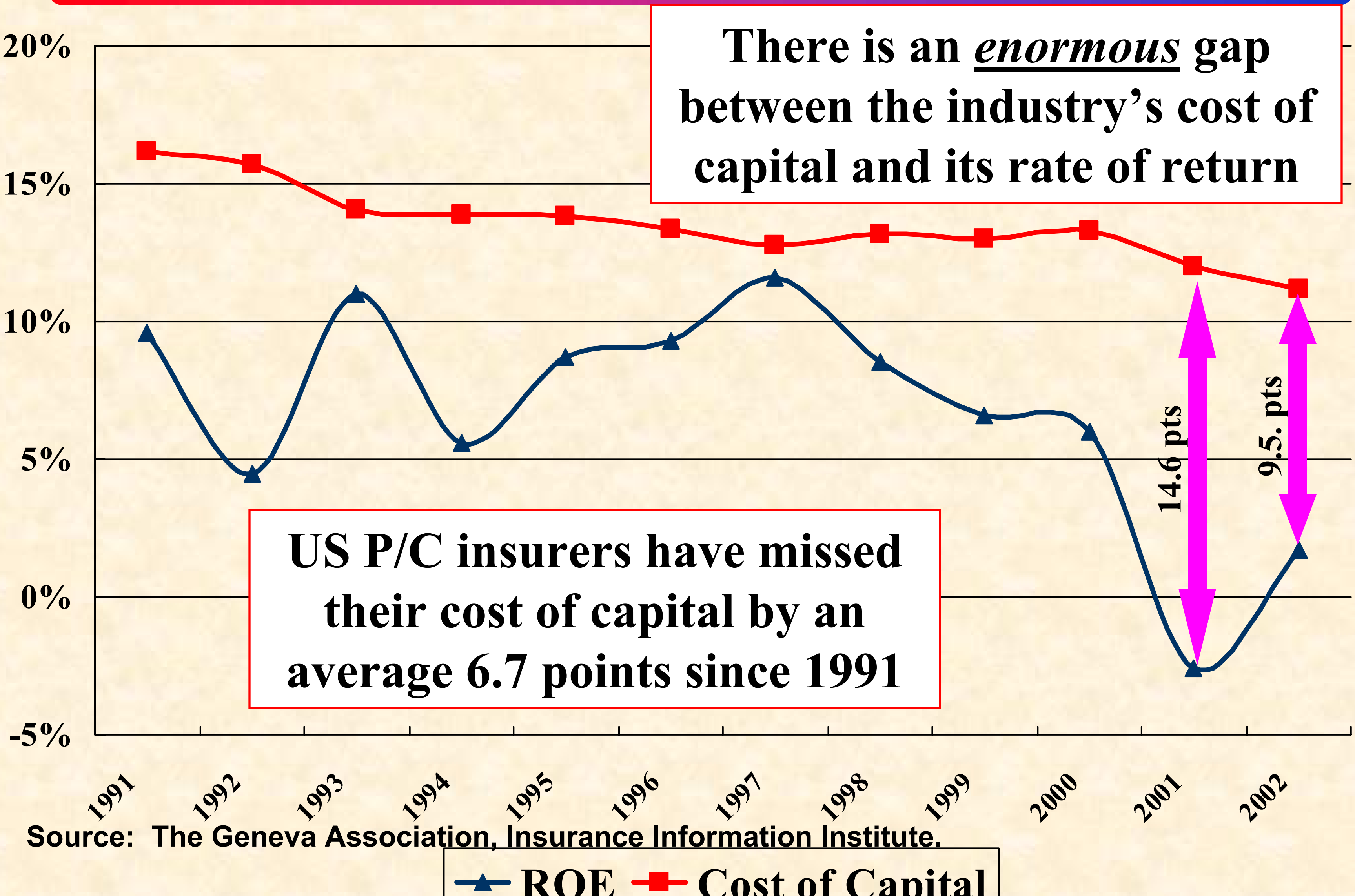
Insurer Cost of Capital

A Global Perspective

Cost of Capital: A Definition

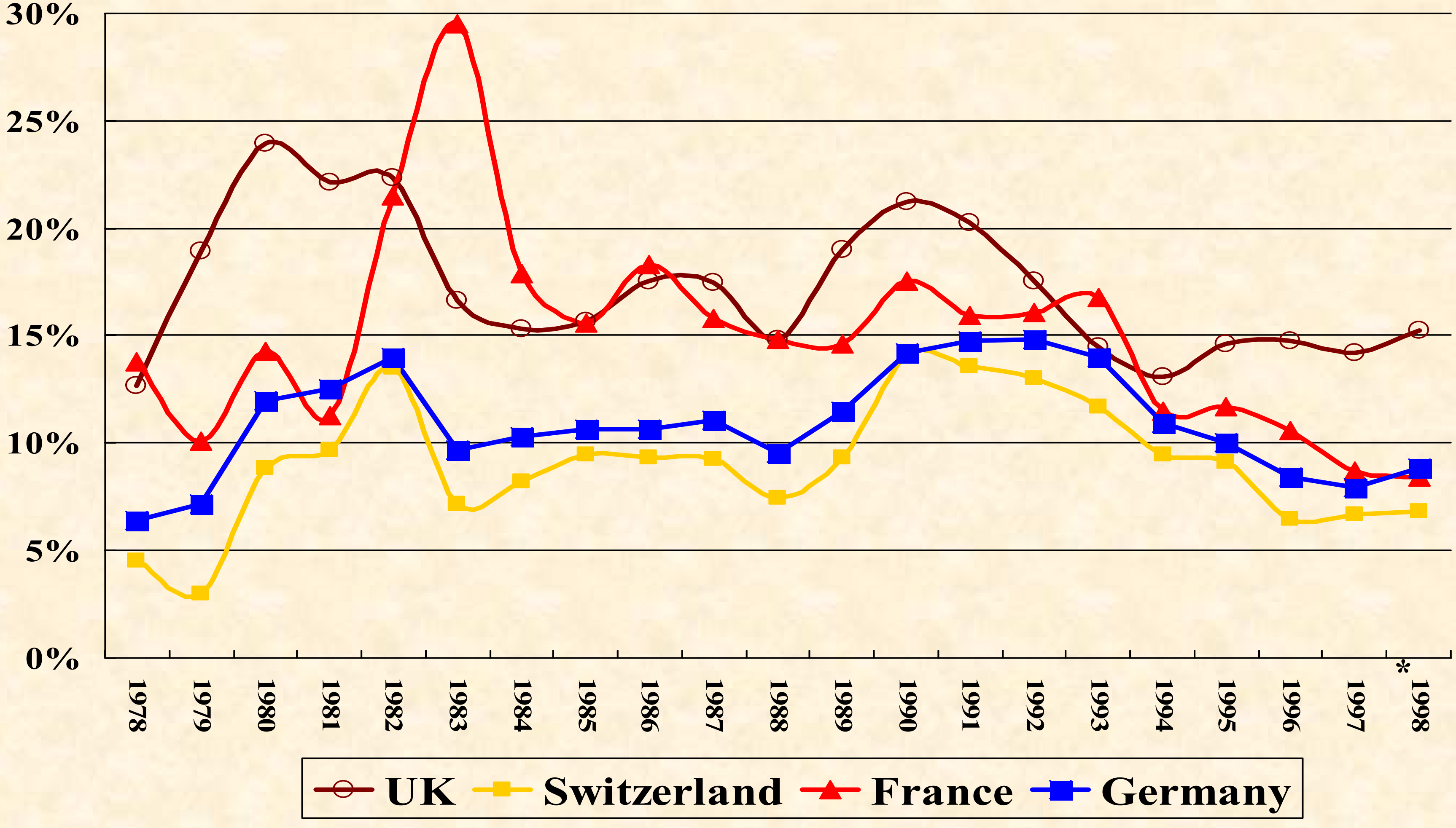
- Cost of Capital:
  - ➢Rate of return that can be earned by investors in industries offering comparable degree of risk
    - Must be sufficient to maintain & attract capital
- Insurance Cost of Capital:
  - ➢Will vary substantially by line

*ROE vs. Cost of Capital: US Non-Life 1991 – 2002**



Source: The Geneva Association, Insurance Information Institute.

Cost of Capital: Non-Life Insurers:1978 – 1998

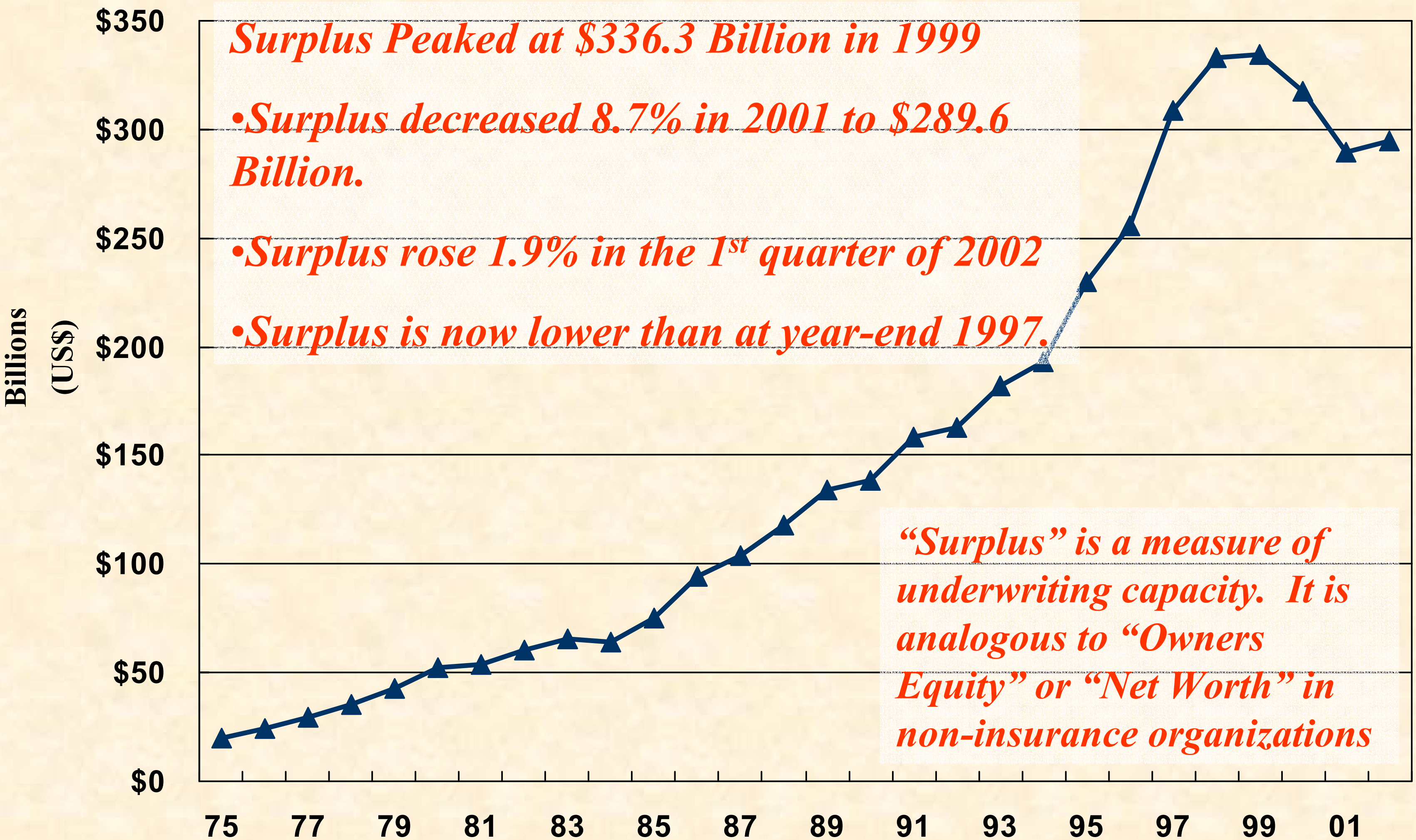


Source: Kielholz, Walter, “The Cost of Capital for Insurance Companies,” *The Geneva Papers on Economic Activity*, v 25, no. 1, January 2000.

Supply of Capital in the P/C Insurance Industry

How Much is There?

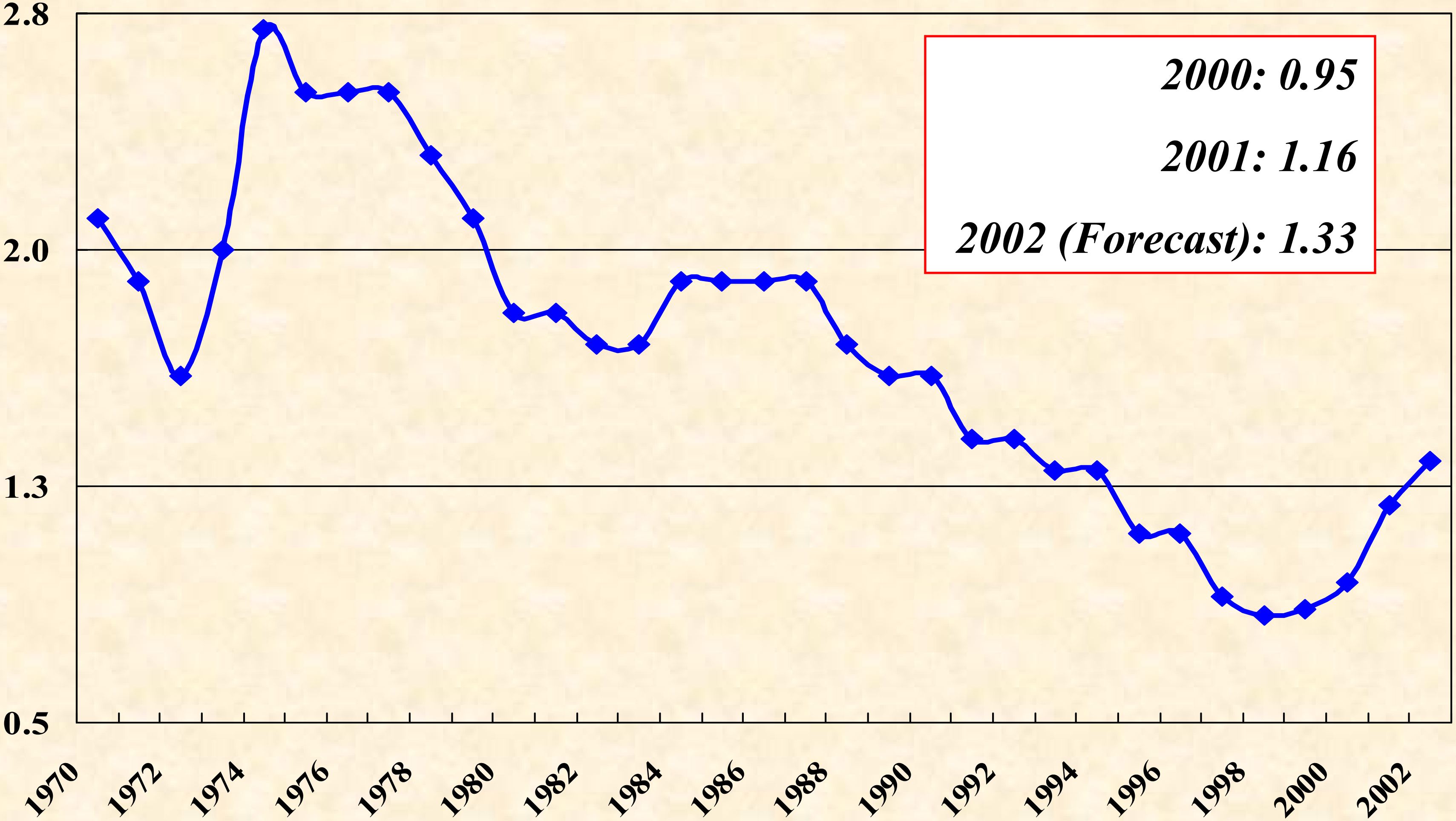
Policyholder Surplus: 1975-2002*



*As of 1st quarter 2002

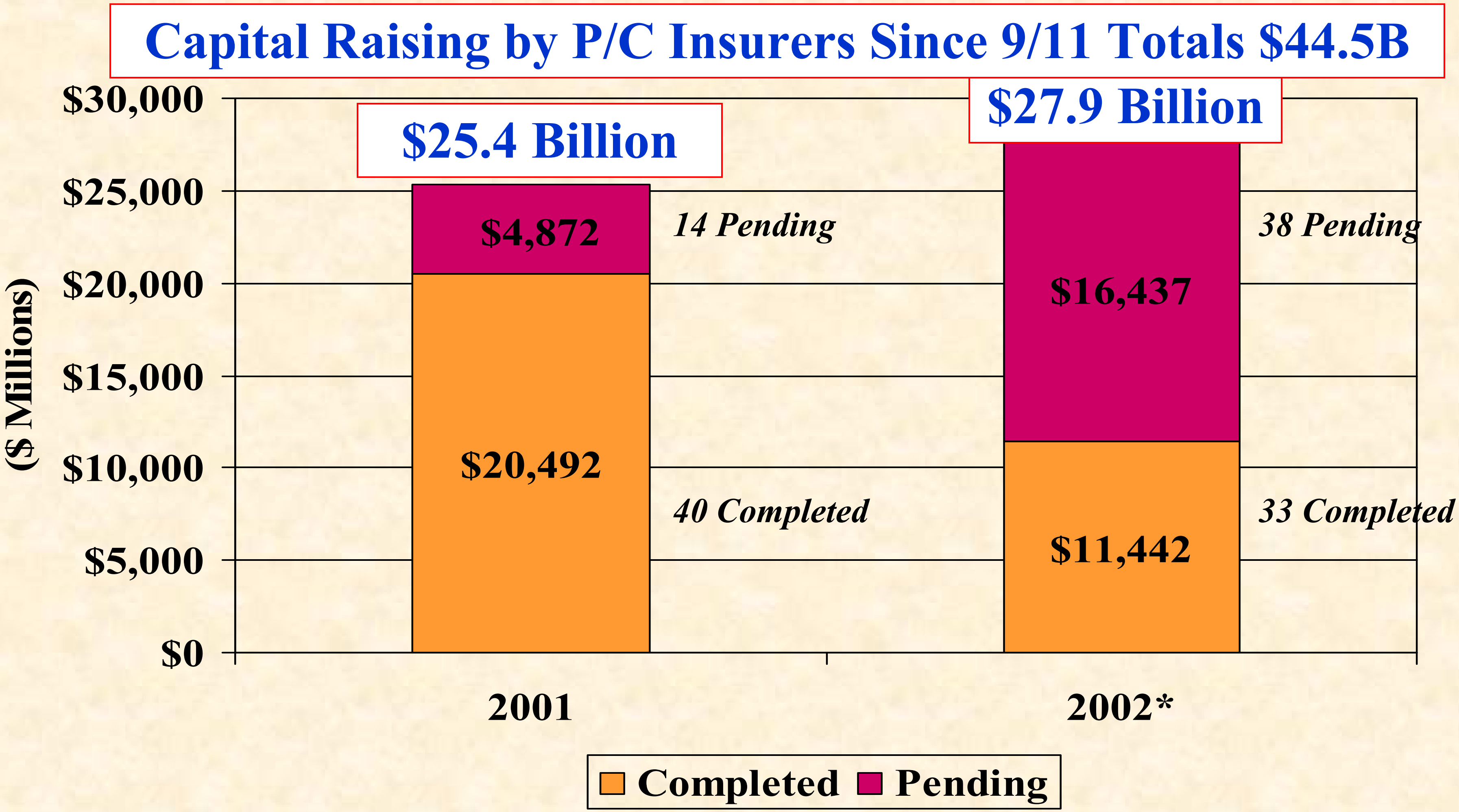
Source: A.M. Best, Insurance Information Institute

Net Premiums Written to Policyholder Surplus Ratio



Source: A.M. Best, Insurance Information Institute

Capital Raising by P/C Insurers Since September 11, 2001*

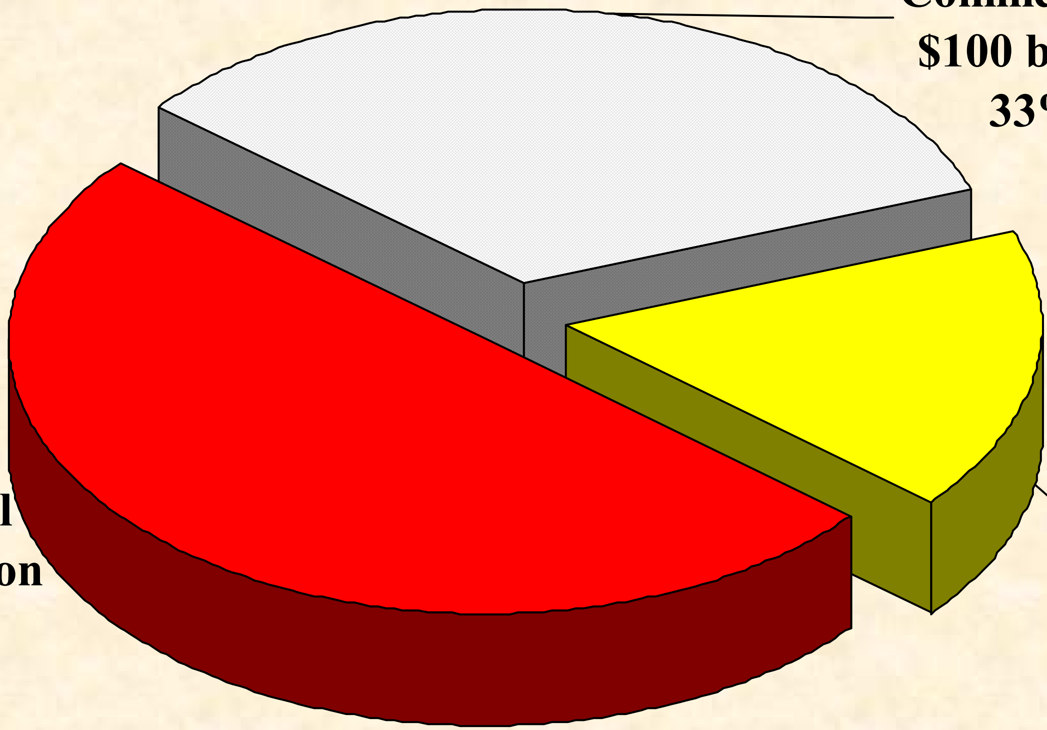


*As of September 13, 2002.

Source: Morgan Stanley, Insurance Information Institute.

Capital Myth 3: P/C Insurers Have $300 Billion to Pay Terrorism Claims

Total PHS = $298.2 B as of 6/30/01



Only 33% of industry surplus backs up "target" lines

*"Target" Commercial includes: Comm property, liability and workers comp; Surplus must also back-up on non-terrorist related property/liability and WC claims

Source: Insurance Information Institute

Price Increases Needed to Achieve Cost of Capital

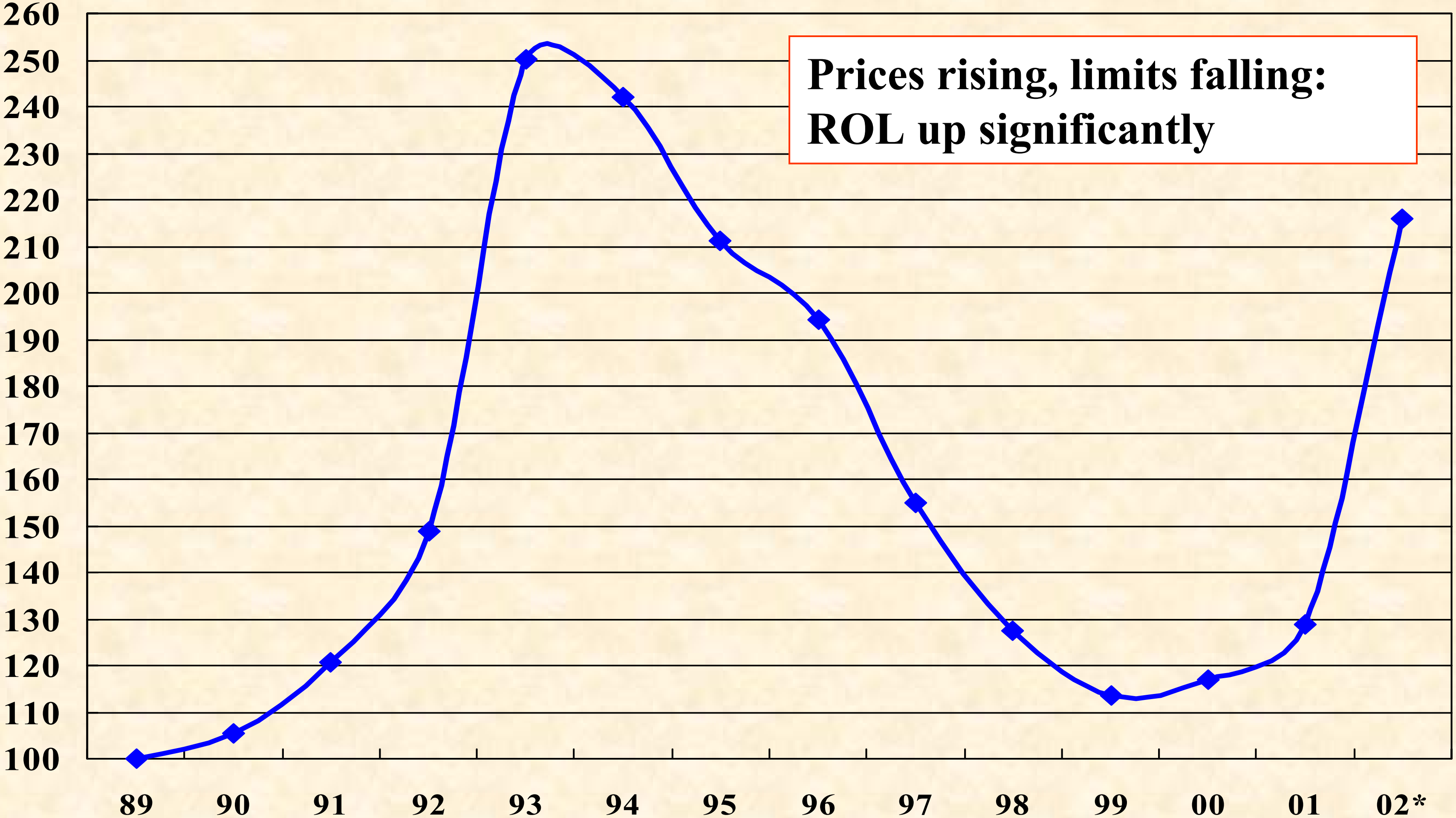
Second Quarter 2002

Rate Increases By Line of Business

	No Change	Up 1-10%	10-20%	20-30%	30-50%	50%-100%	>100%
Comm. Auto	2%	6%	28%	39%	21%	1%	1%
Workers Comp	5%	13%	19%	32%	15%	5%	2%
General Liability	2%	9%	24%	45%	15%	2%	1%
Comm. Umbrella	2%	4%	10%	20%	27%	17%	16%
Comm. Property	3%	4%	16%	30%	31%	13%	1%
Business Interr.	3%	8%	32%	33%	10%	1%	0%
Surety Bonds	10%	13%	16%	14%	6%	0%	1%

Source: Council of Insurance Agents and Brokers

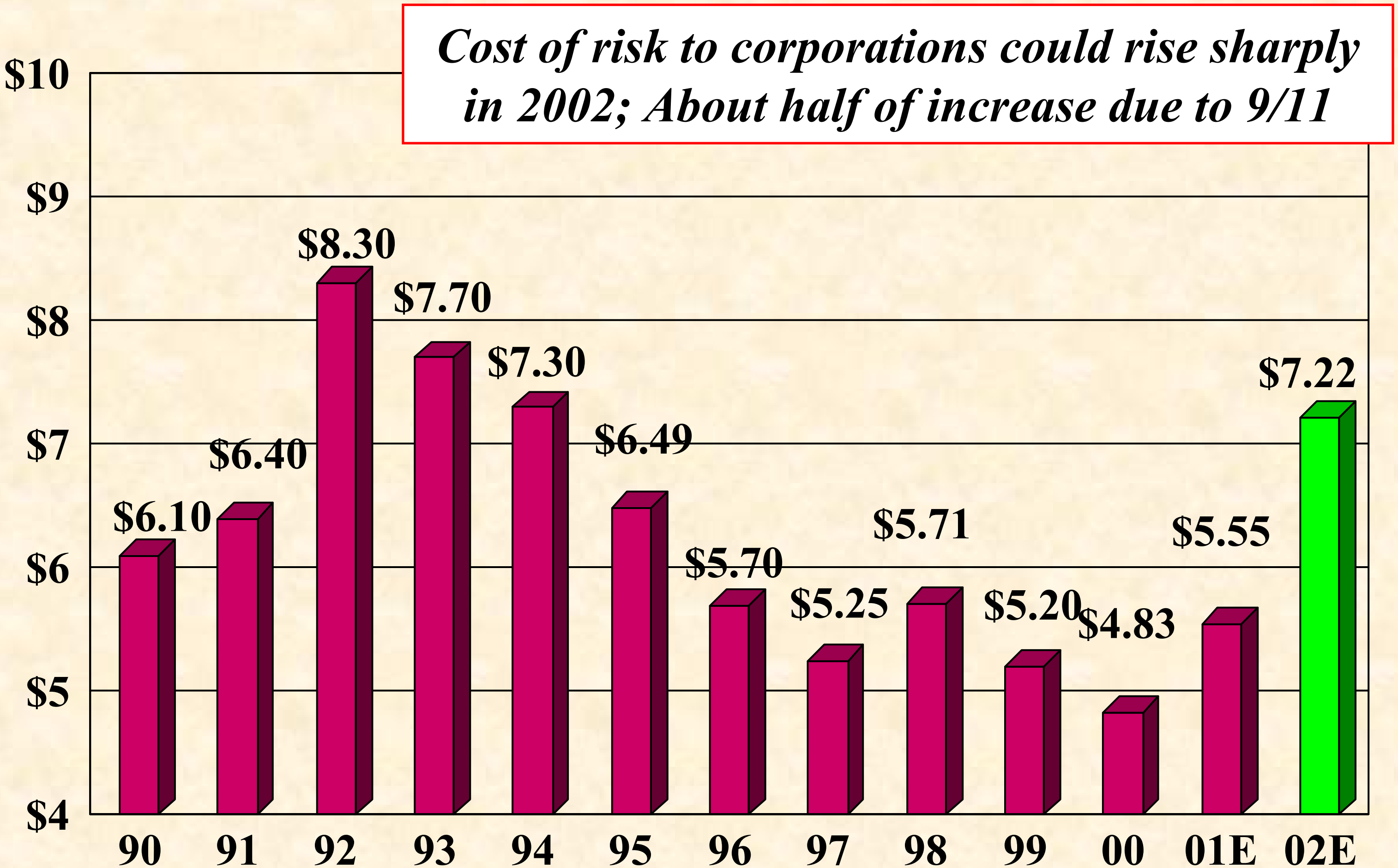
Rate On Line Index
(1989=100)



Source: Guy Carpenter

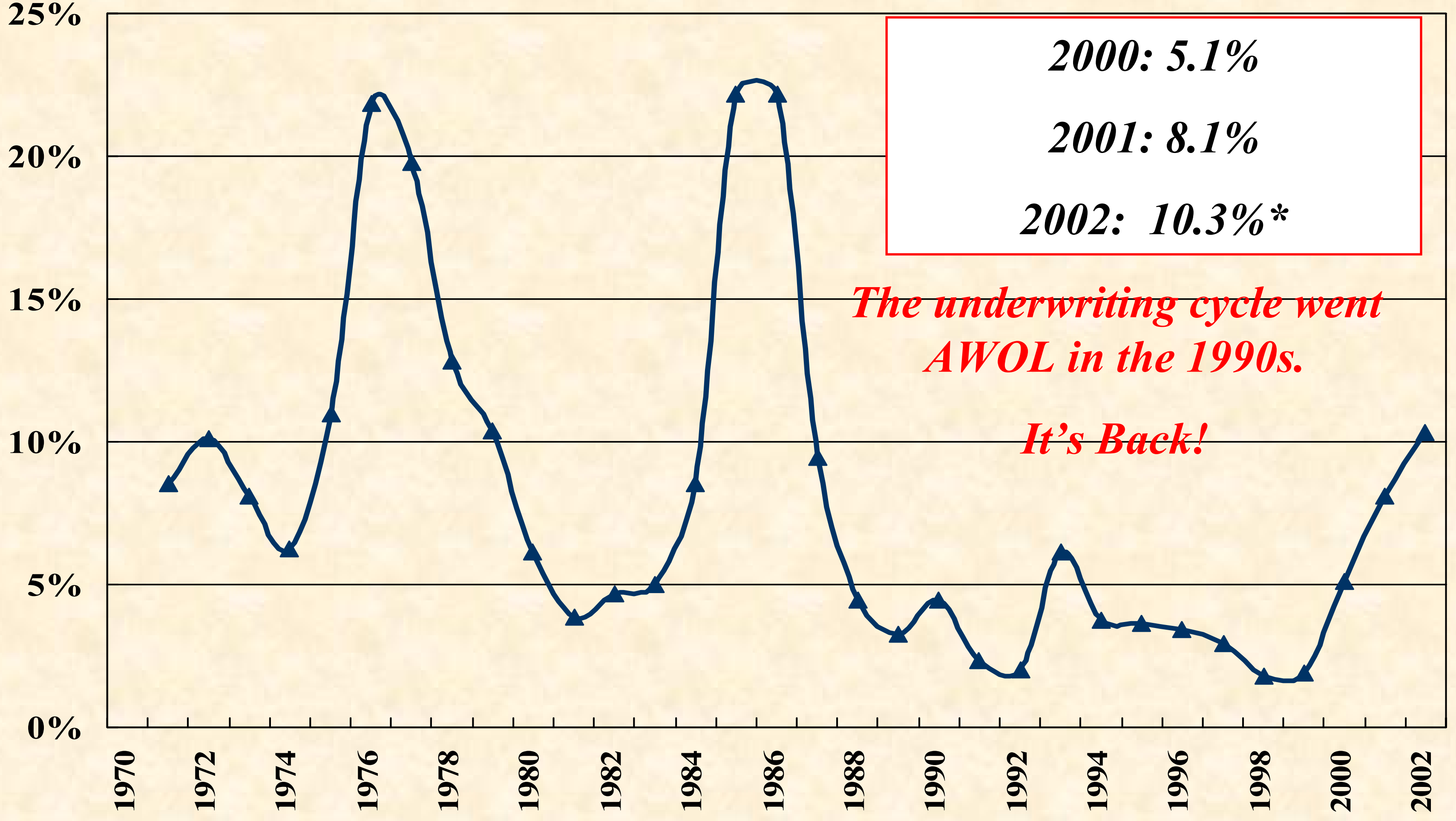
* III Estimate

Cost of Risk per $1,000 of Revenues: 1990-2002E



Source: 2001 RIMS Benchmark Survey; Insurance Information Institute estimates.

Growth in Net Premiums Written (All P/C Lines)



*Estimate based on first quarter 2002

Source: A.M. Best, Insurance Information Institute

Cost of Capital:

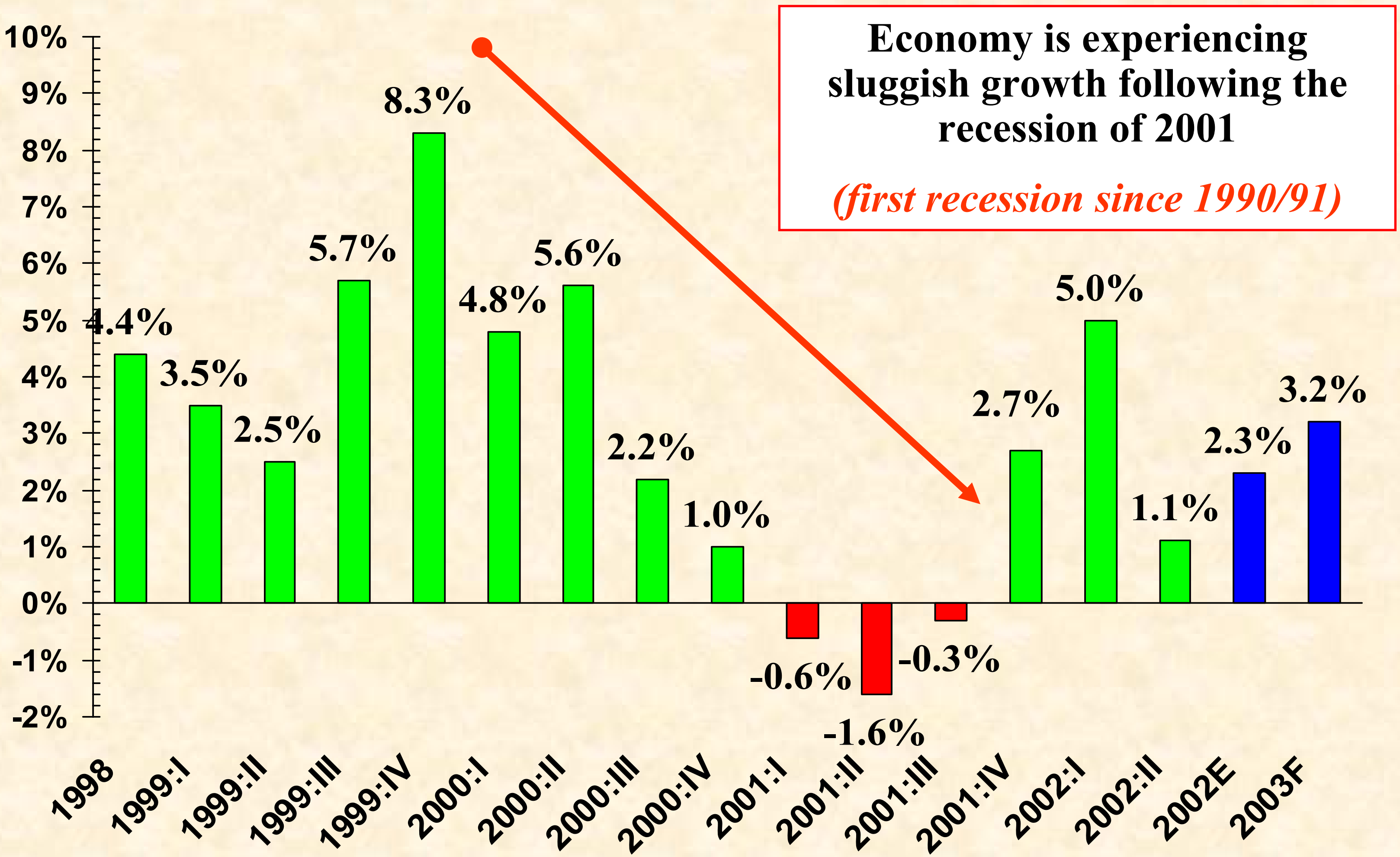
How is it Computed?

Cost of Capital: Methods

- 2 Commonly Used Methods
  - Discounted Cash Flow (DCF)
    - Uses current dividend yield & dividend (or earnings) growth rate
  - Capital Asset Pricing Model (CAPM)
    - Uses risk-free interest rate, risk premium & measure of relative risk, Beta (β)
- Factors currently affecting costs of capital
  - Dividend yields very low (1.39% mid-2002), little growth expected; Recent earnings performance poor
  - Interest rates very low (short-term rates < 1.8% mid-2002)
  - Risk premium shrinking (return on alternatives to risk-free return are shrinking)
  - Beta (β) low relative to overall stock market (stock price volatility slightly less than overall market: $\beta = 0.96$)
- CURRENT P/C COST OF CAPITAL IS: 11% - 12%

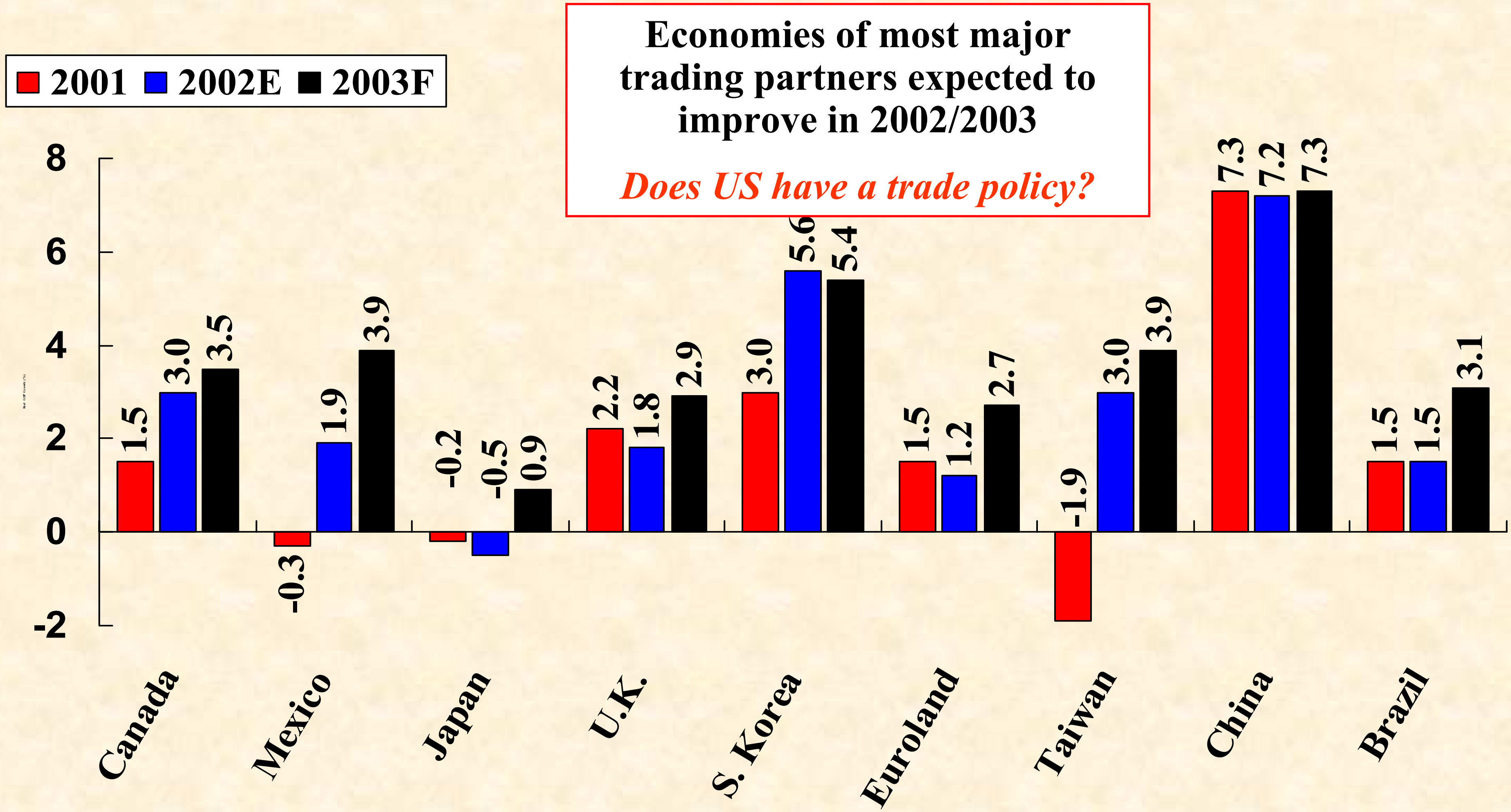
Factors Influencing the Cost of Capital

Real GDP Growth



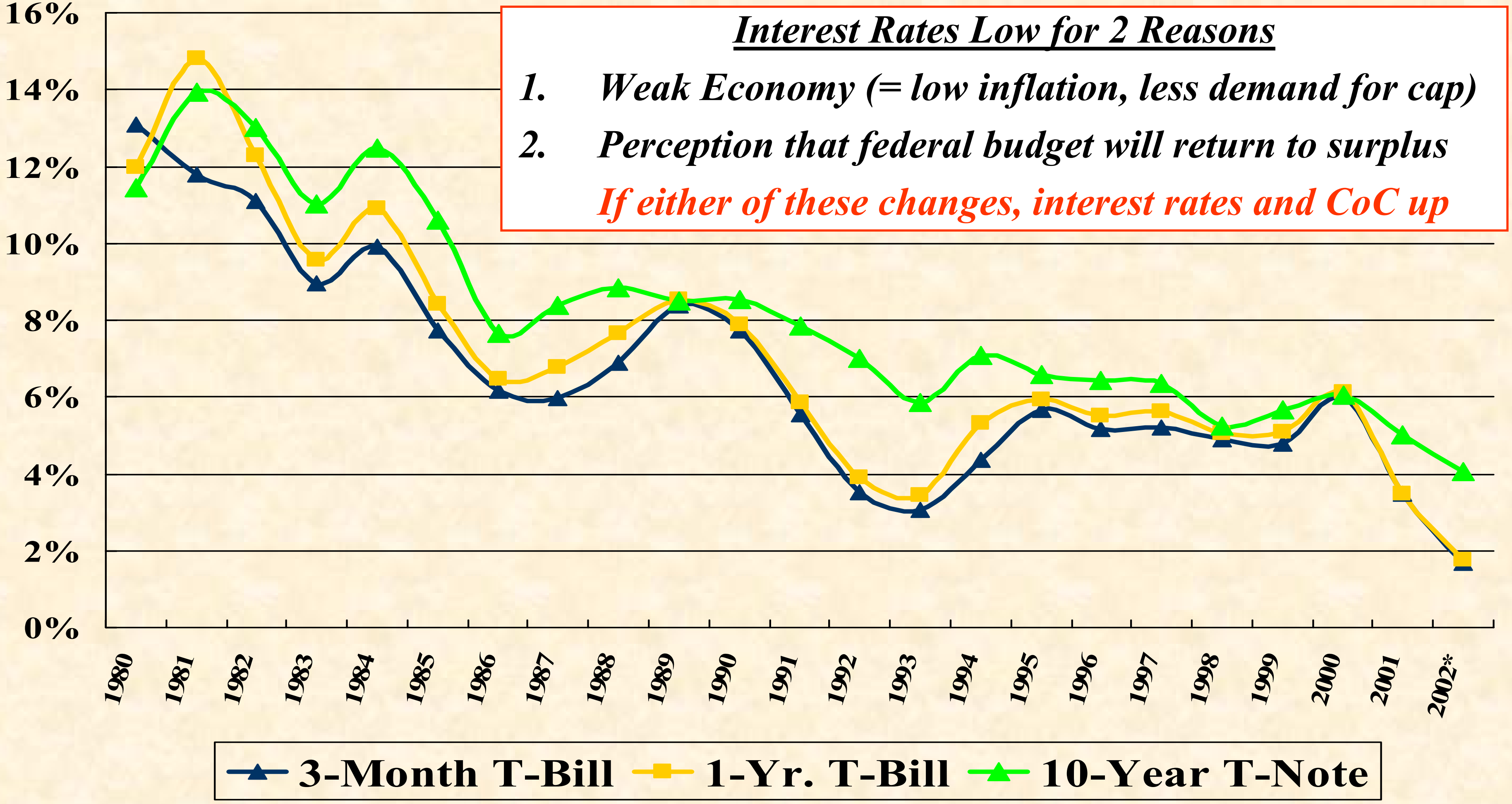
Source: US Department of Commerce, Blue Economic Indicators 9/02, Insurance Information Institute.

Economic Outlook for Major US Trading Partners *(Real GDP Growth, %)*



Source: Blue Chip Economic Indicators, September 2002.

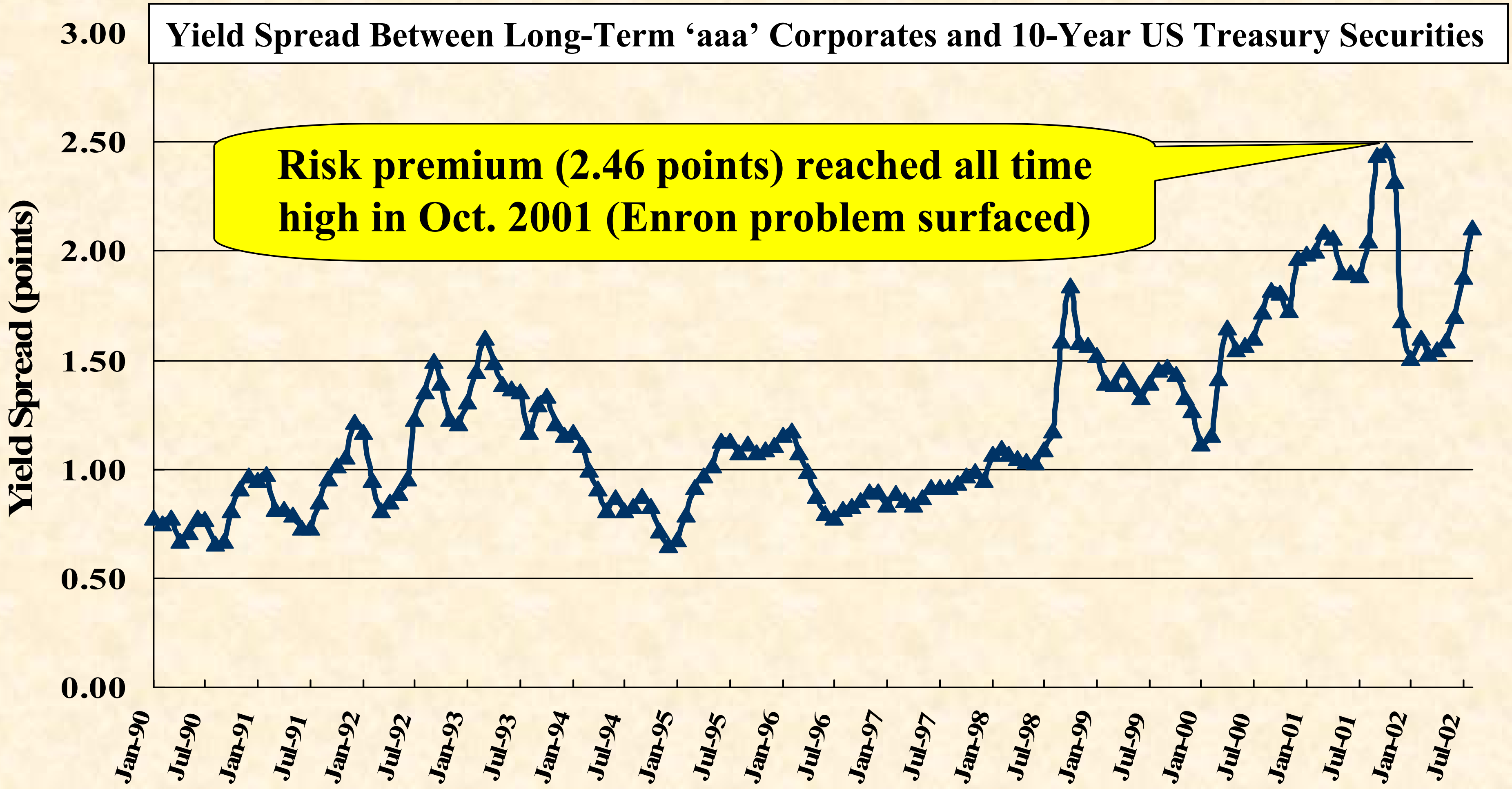
Interest Rates: Lower Than They've Been in Decades



*Average for week ending September 6, 2002.

Source: Board of Governors, Federal Reserve System; Insurance Information Institute

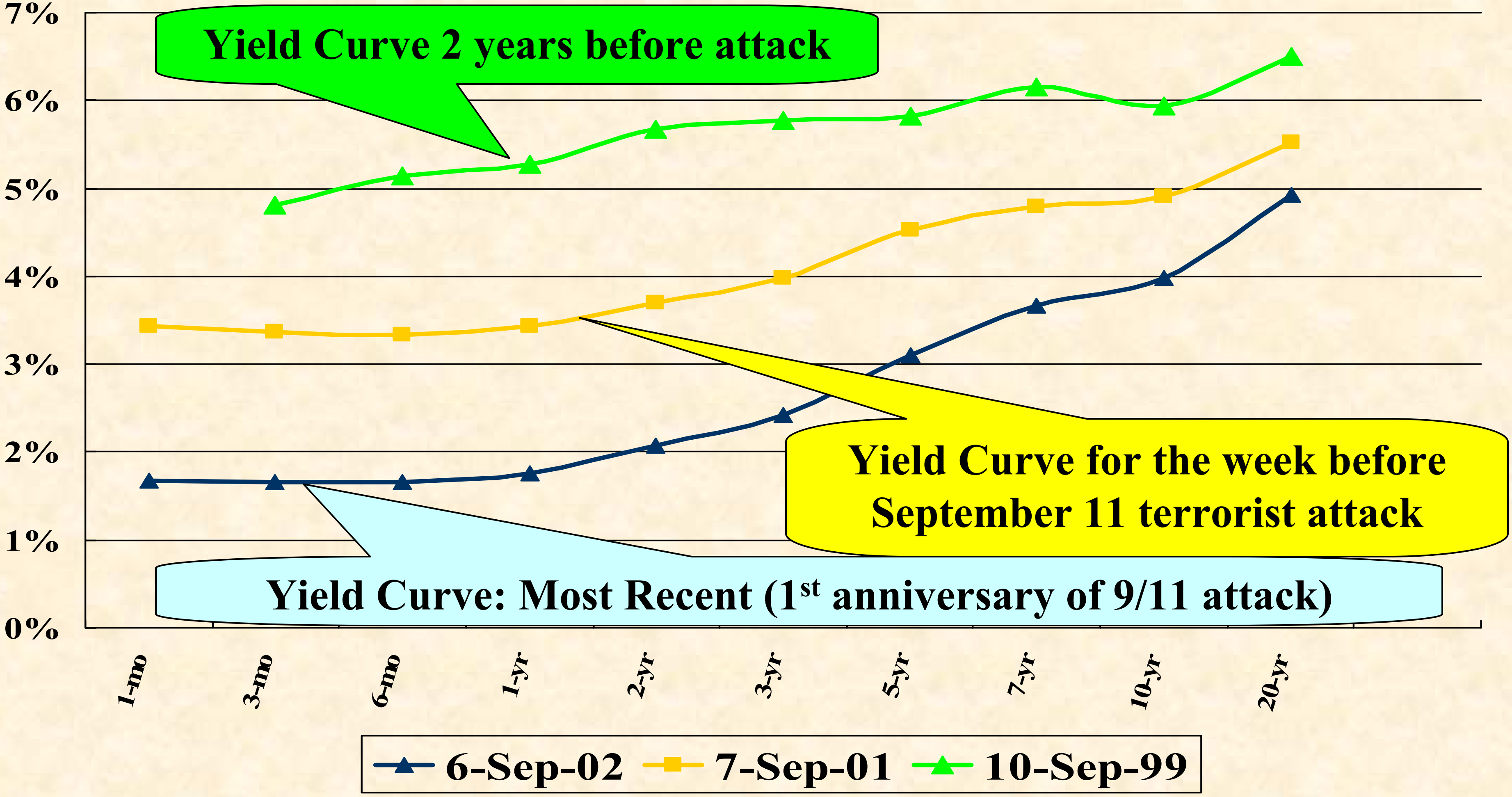
Risky Business: Yield Spread Rising with Corporate Scandals*



*January 1990 through August 2002

Source: Board of Governors, Federal Reserve System; Insurance Information Institute

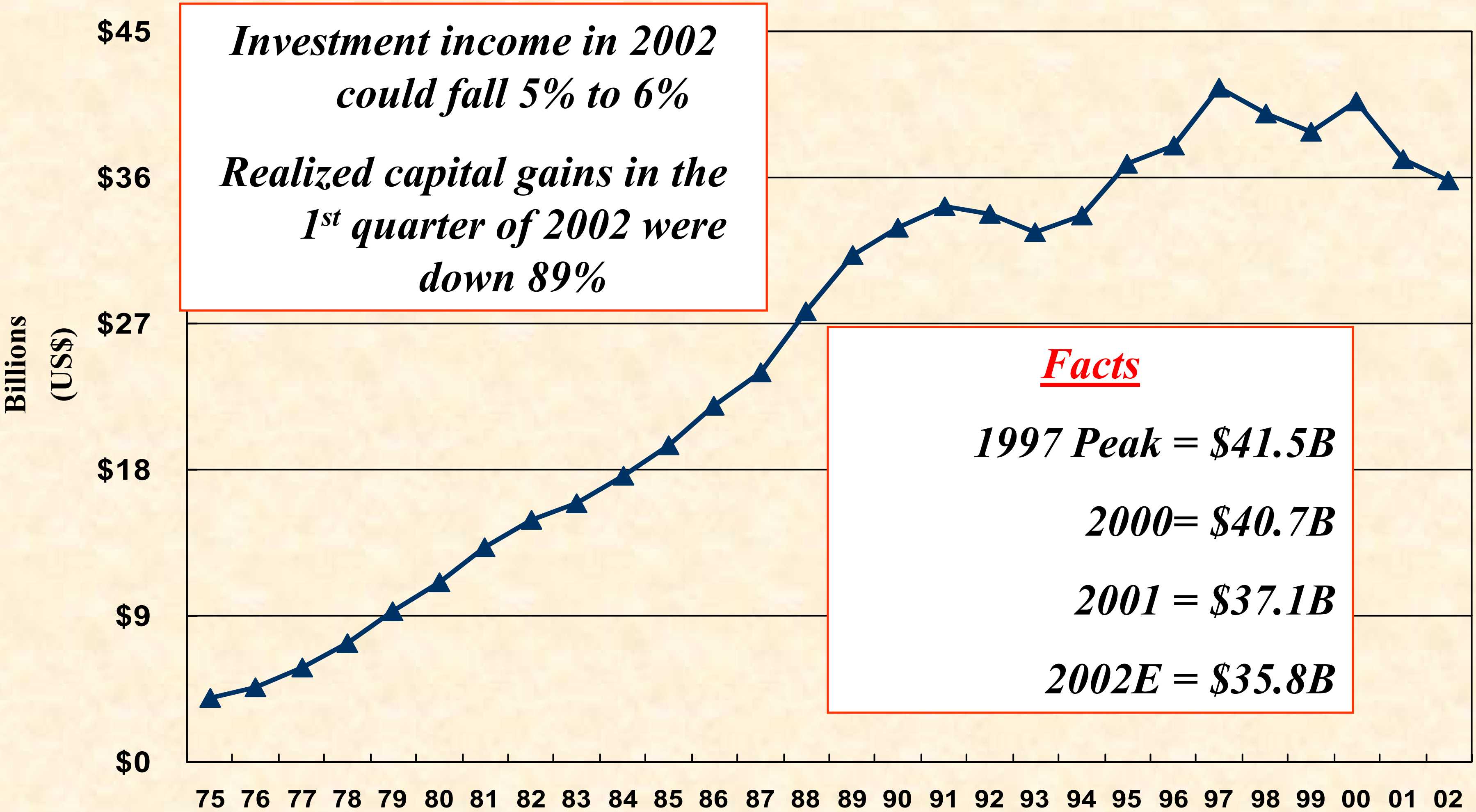
Treasury Yield Curve: Rates Down Across Every Maturity, esp. Short-Term



*Data are averages for all trading days for the week on the indicated date.

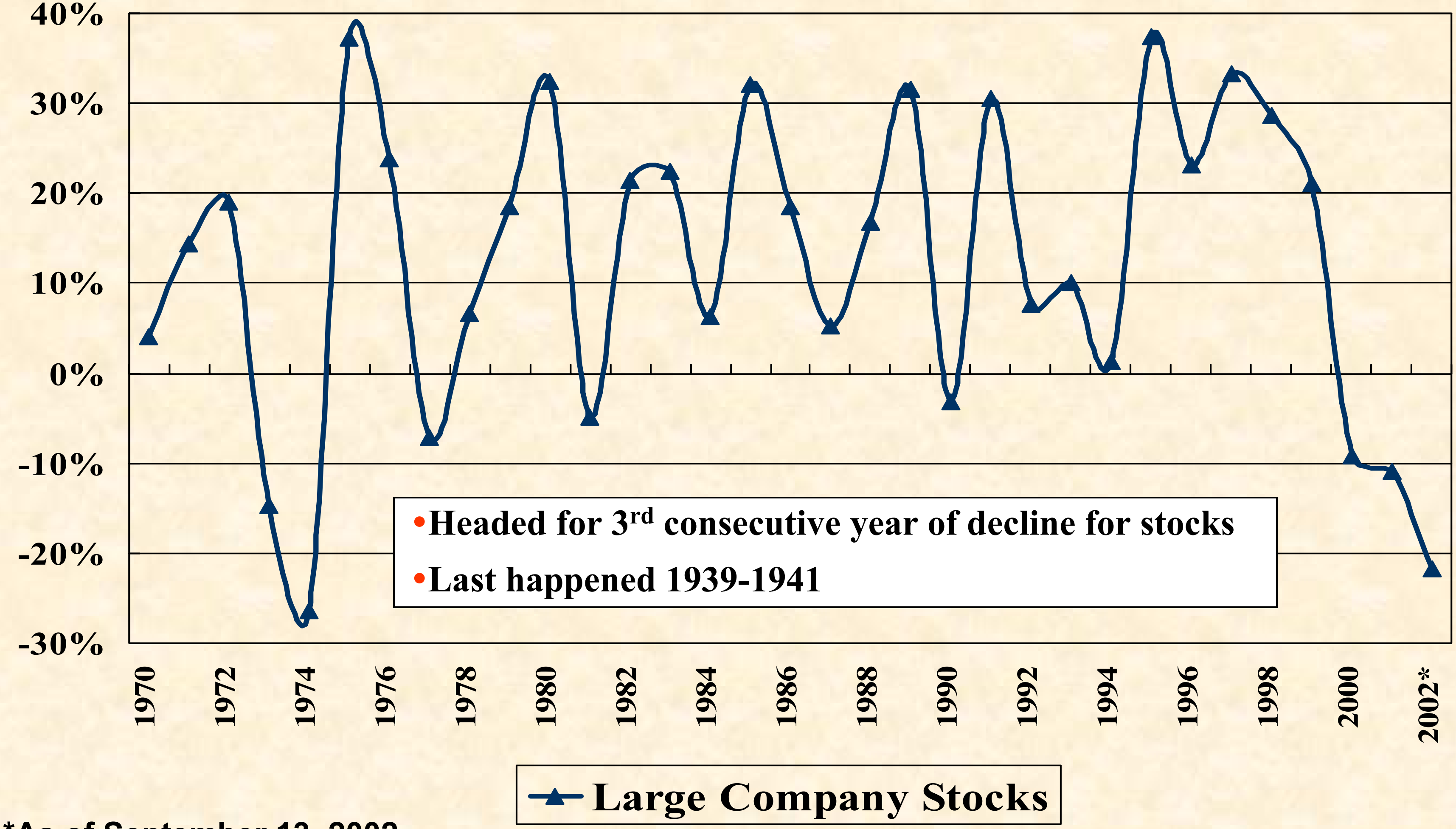
Source: Board of Governors, Federal Reserve System; Insurance Information Institute

Net Investment Income



Source: A.M. Best, Insurance Information Institute

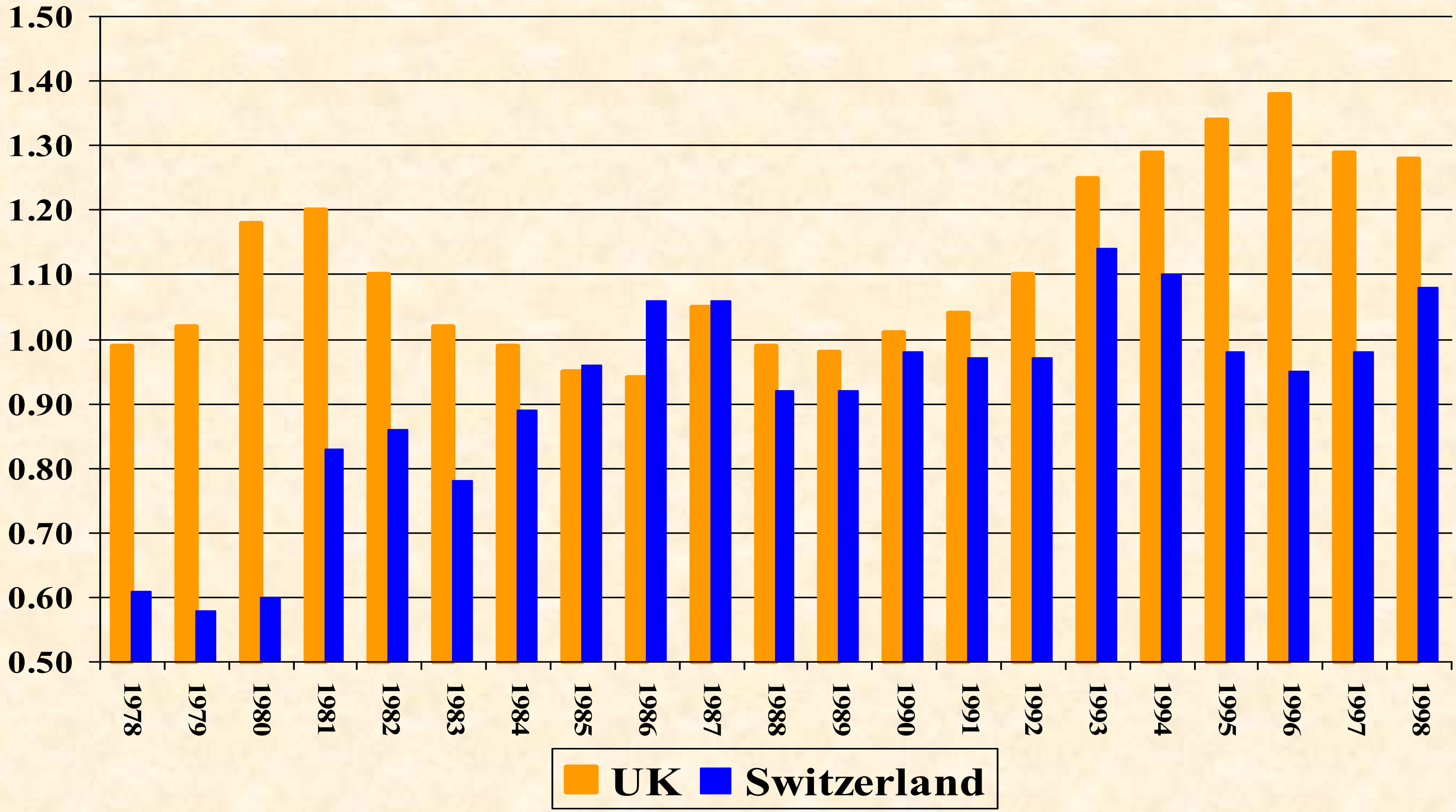
Total Returns for Large Company Stocks: 1970-2002*



*As of September 13, 2002.

Source: Ibbotson Associates, Insurance Information Institute

Average Betas: Non-Life Insurers:1978 – 1998



Source*:* **Kielholz, Walter, "The Cost of Capital for Insurance Companies,"** ***The Geneva Papers on Economic Activity*****, v 25, no. 1, January 2000*****.***

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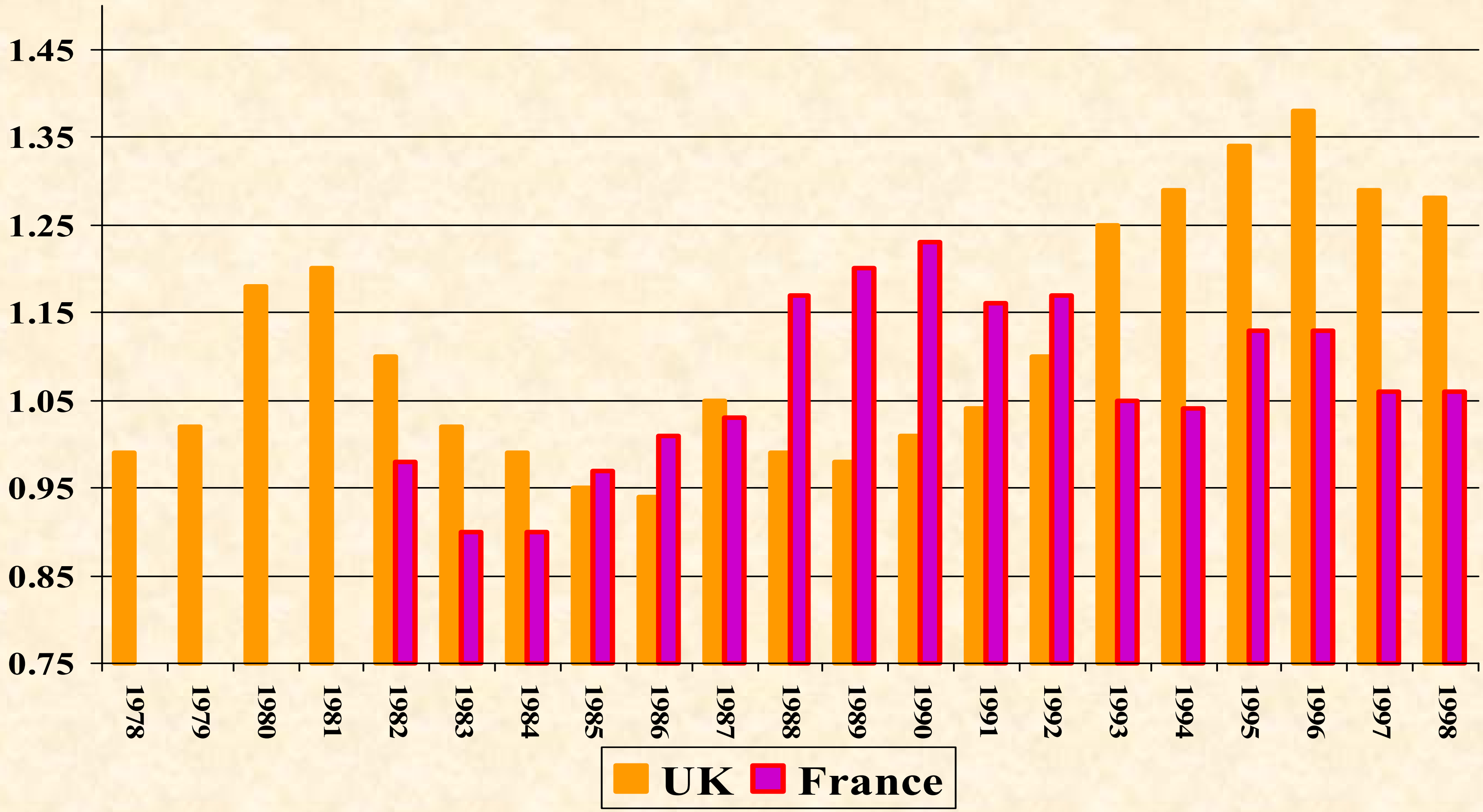

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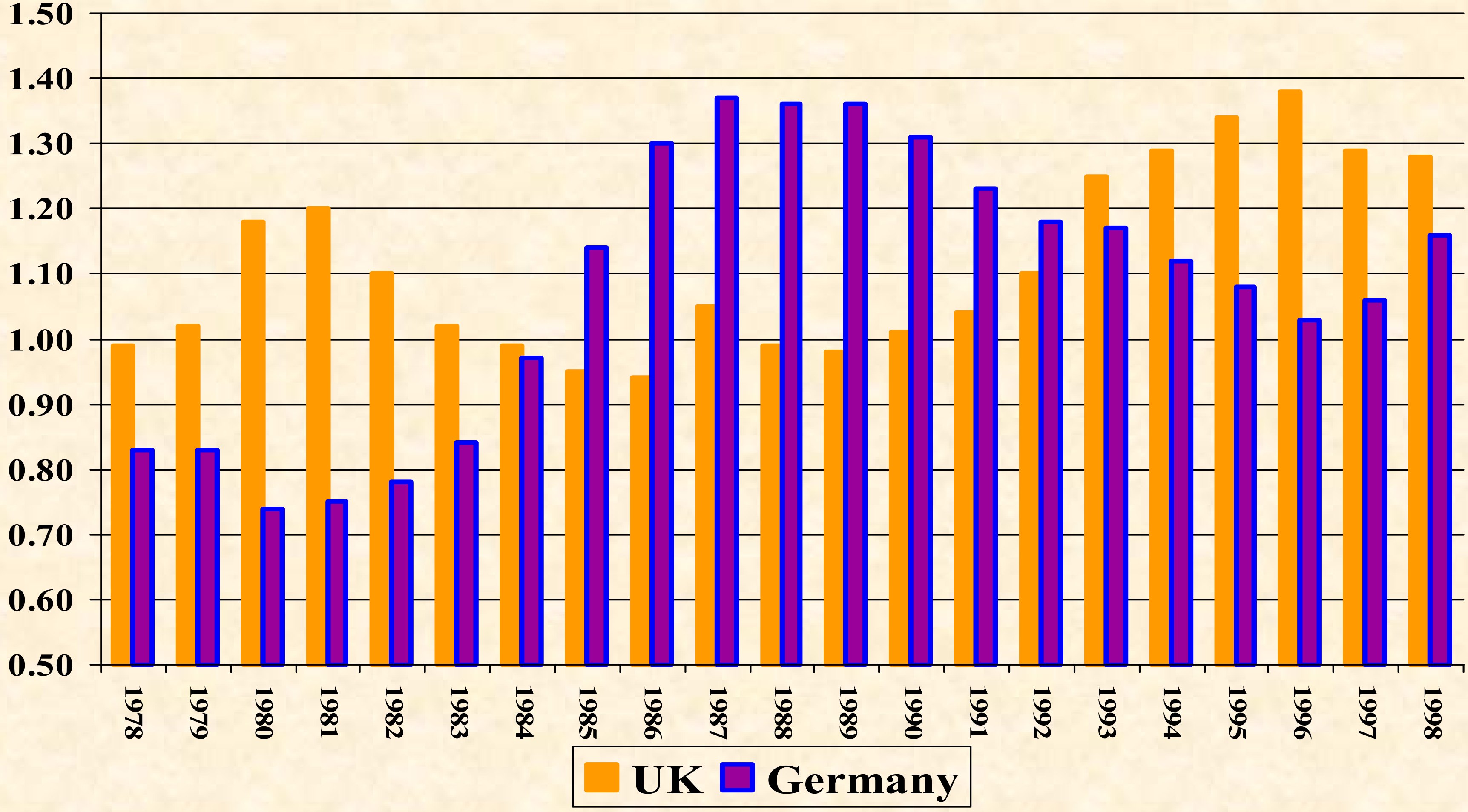

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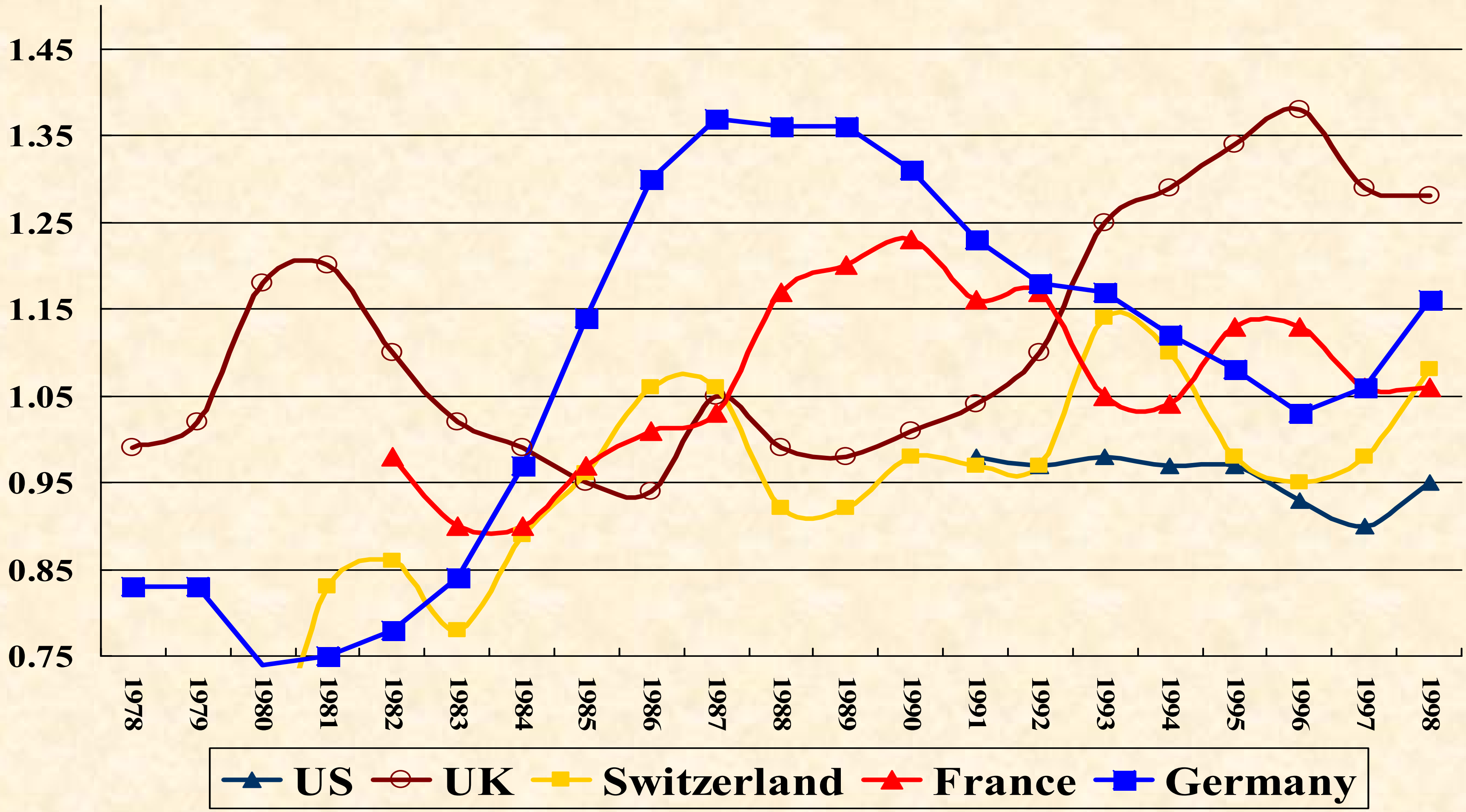
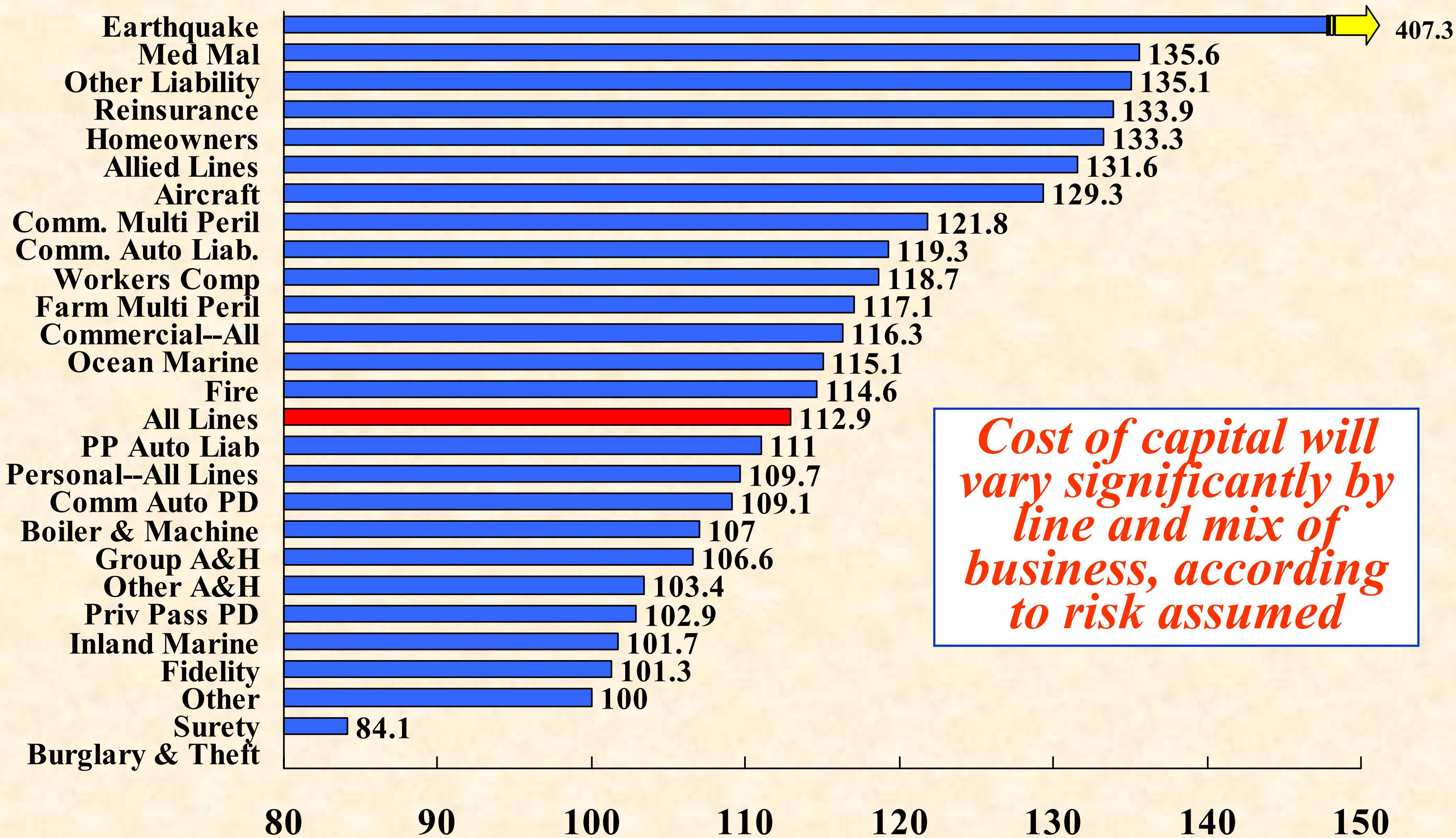


Source*: Kielholz, Walter, "The Cost of Capital for Insurance Companies," *The Geneva Papers on Economic Activity*, v 25, no. 1, January 2000*.

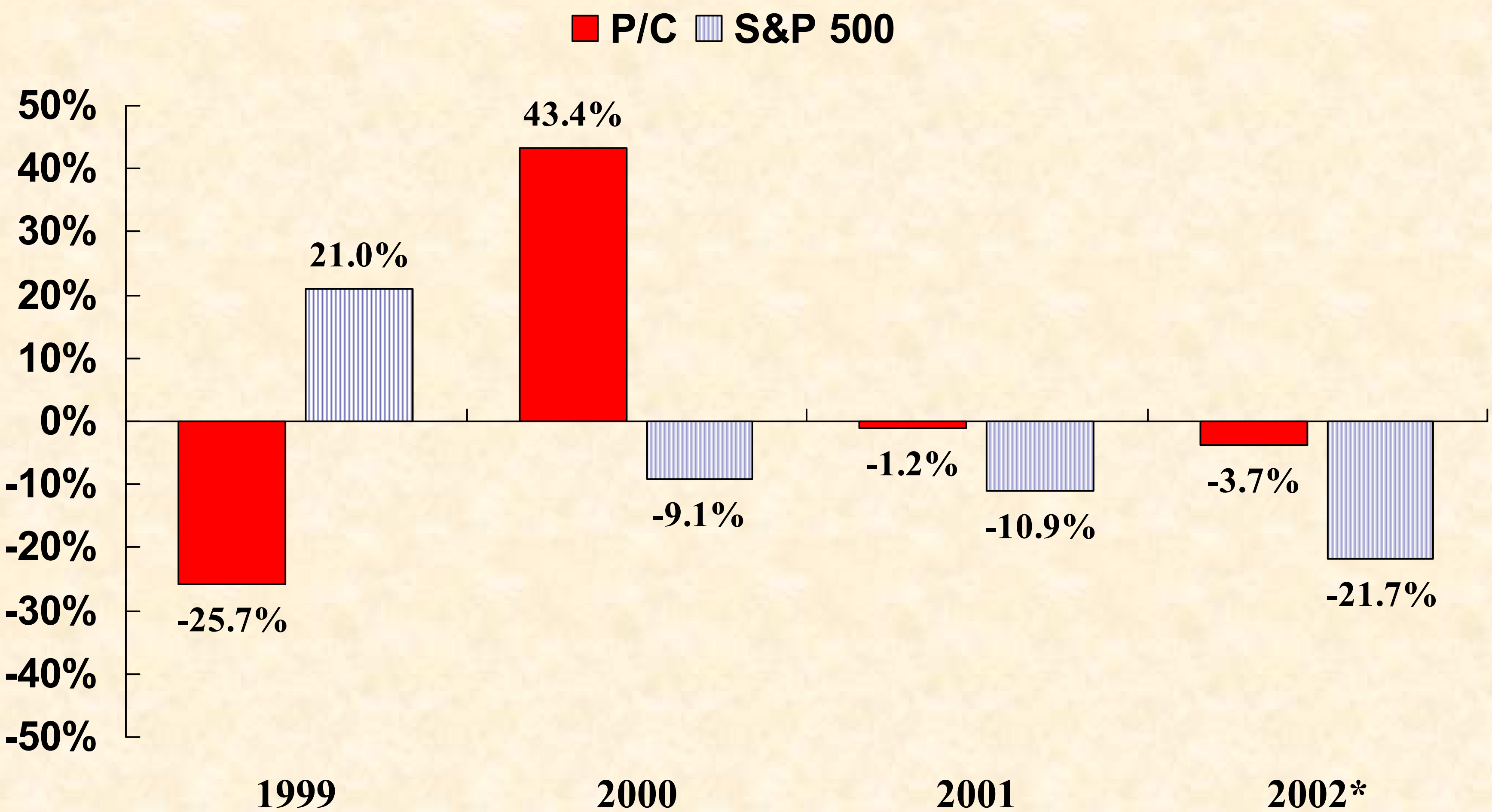
World's Most Dangerous Lines of Insurance (Combined Ratio + 1 Std. Deviation)



Cost of capital will vary significantly by line and mix of business, according to risk assumed

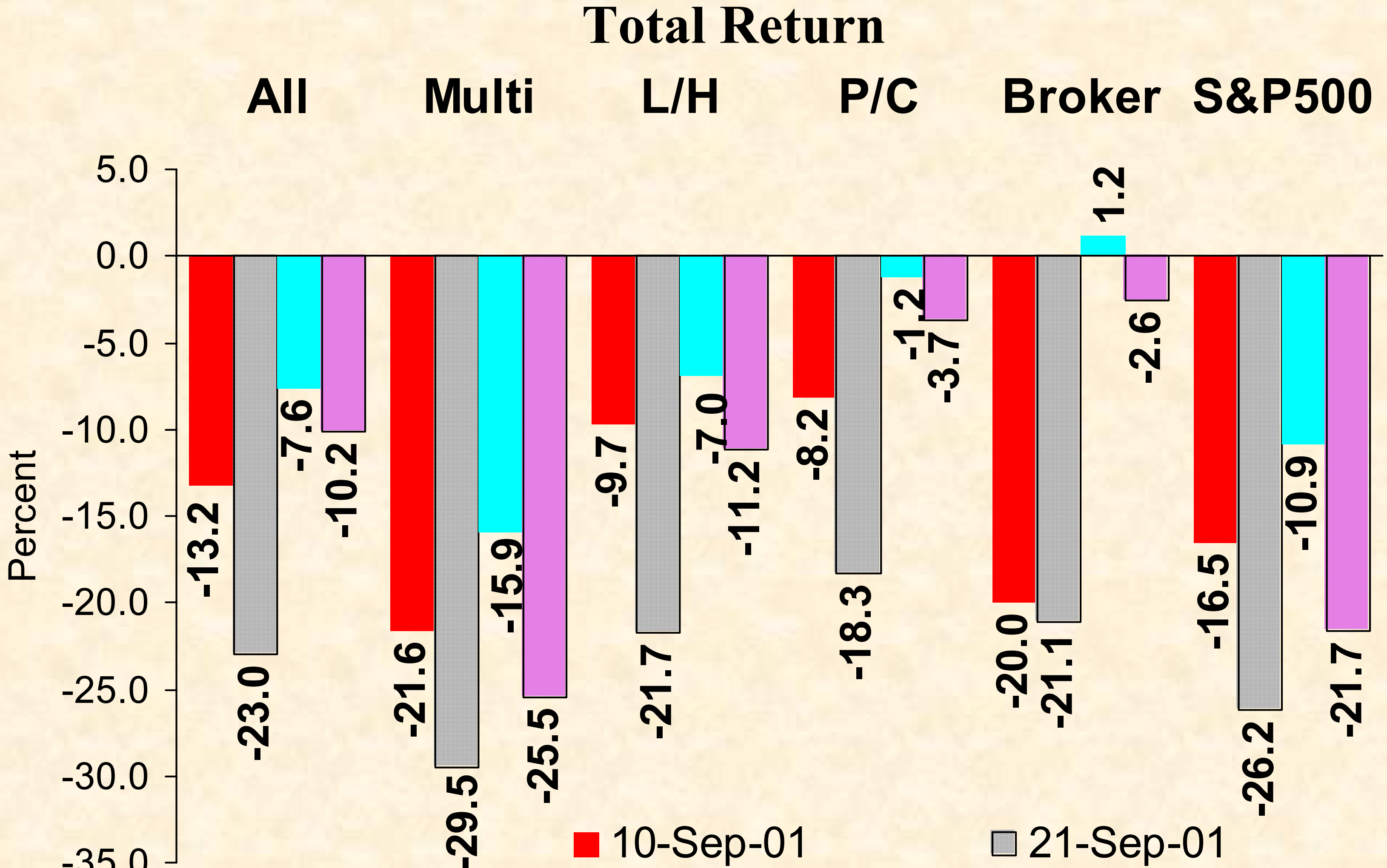
Source: Insurance Information Institute, calculated from A.M. Best combined ratio data.

P/C Performance Volatile, but Better than S&P 500 Lately



*Through September 13, 2002.
Source: SNL Securities, Insurance Information Institute

Insurer Stock Price Performance: Before & After 9/11



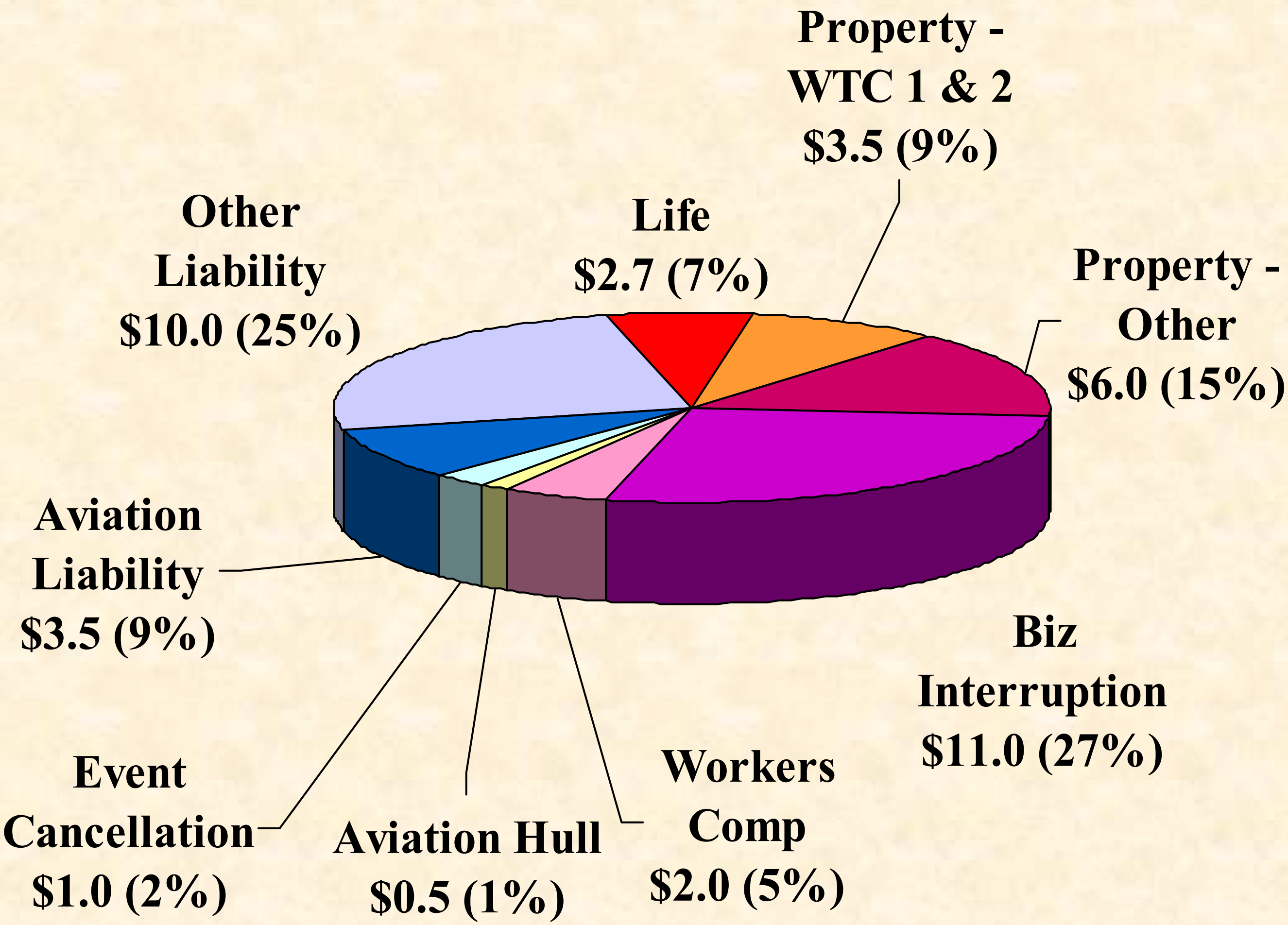
Source: SNL Securities, Insurance Information Institute

Special Factors Influencing Insurers' Cost of Capital

Terrorists
Trial Lawyers
Tycoons
Tempests

Sept. 11 Industry Loss Estimates

($ Billions)



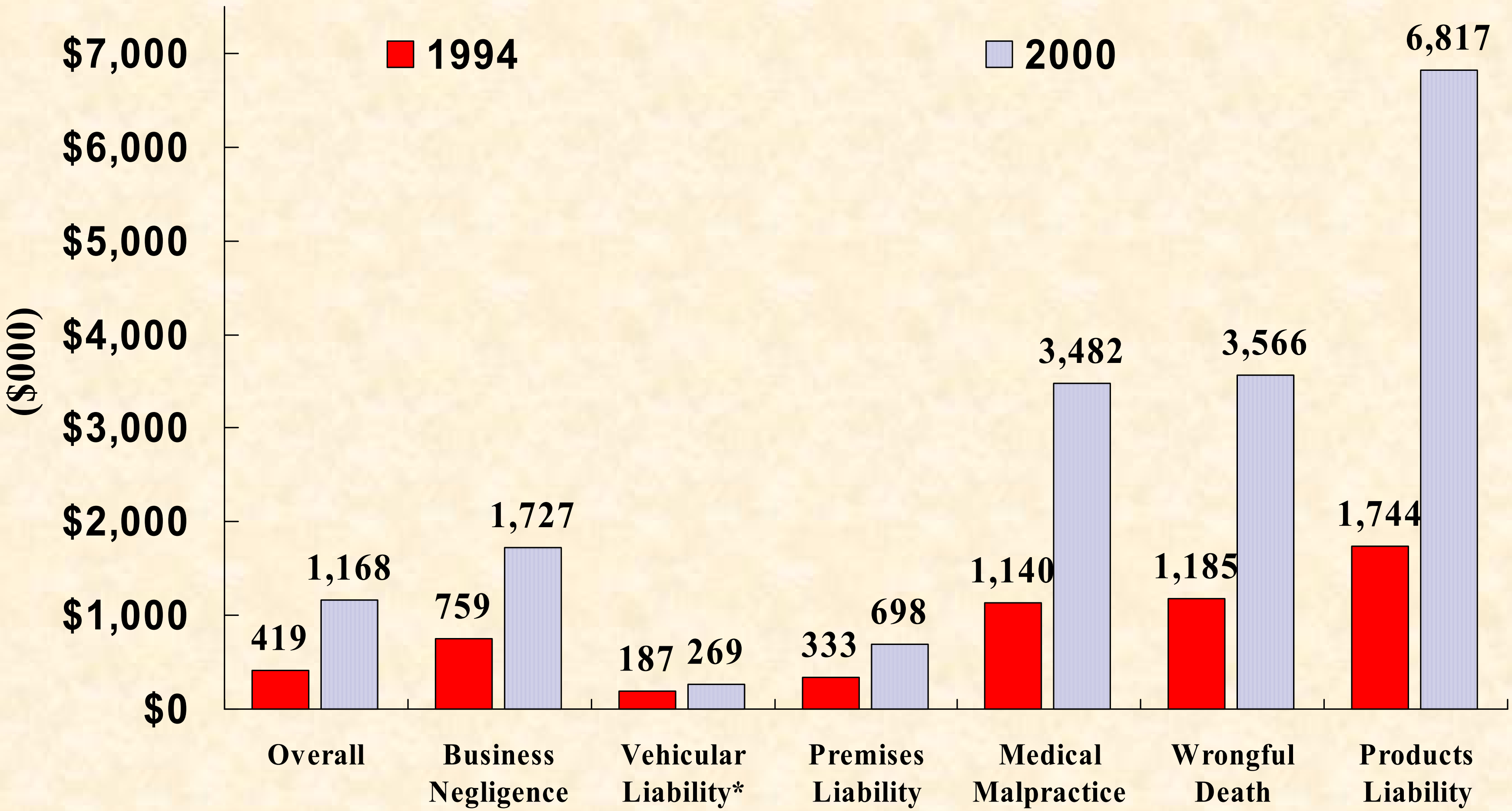
Insured Losses Estimate: $40.2B

Source: Insurance Information Institute, July 2002

Accounting Problems are Getting Many Companies into Trouble

- Enron fallout much worse than anticipated
- Many companies restating earnings

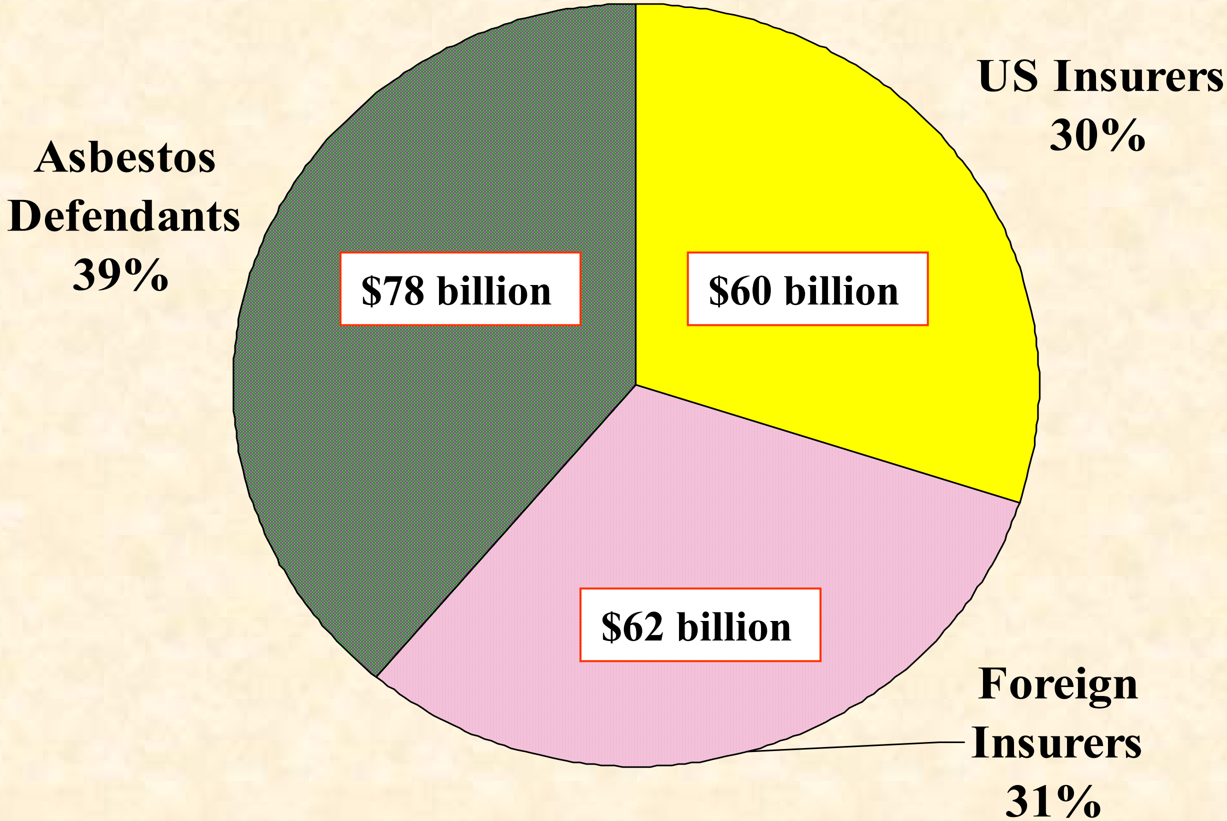
Average Jury Awards 1994 vs. 2000



Source: Jury Verdict Research; Insurance Information Institute.

Who Will Pay for the US Asbestos Mess?

Estimated Total US Settlements & Expenses = $200 billion



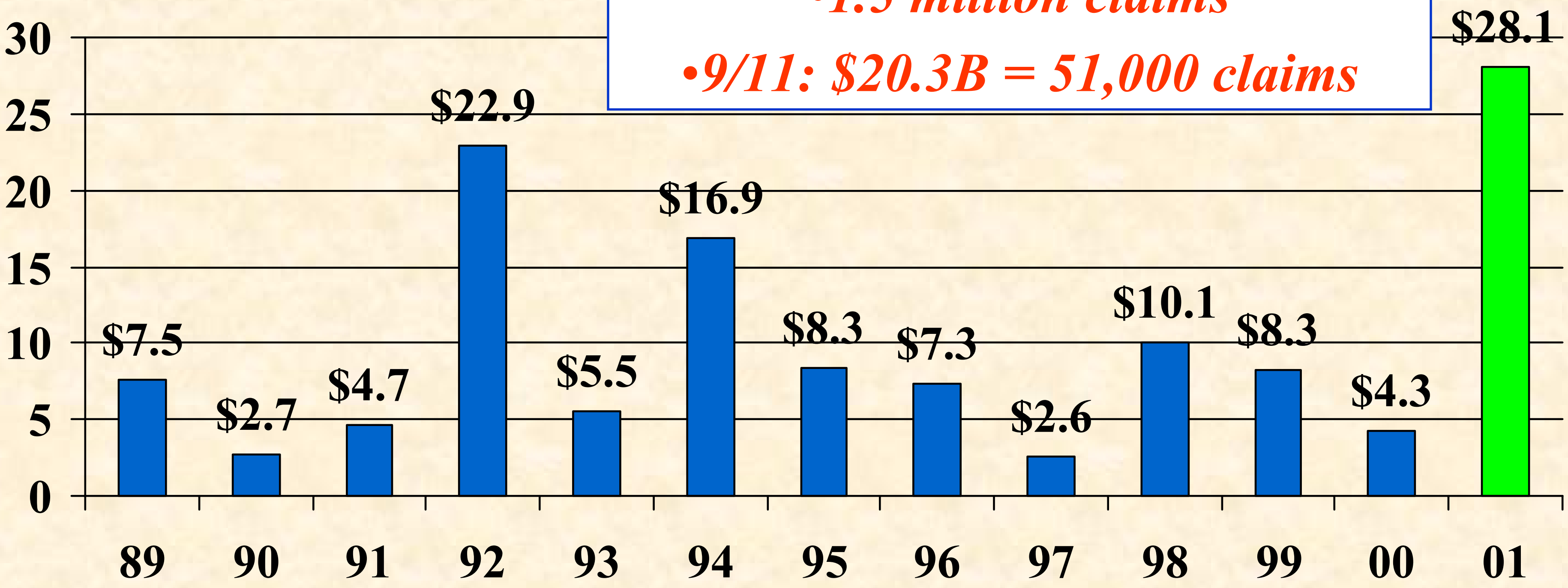
Source: Tillinghast-Towers Perrin; Insurance Information Institute

U.S. Insured Catastrophe Losses

$ Billions

CAT Losses for 2001 Set a Record

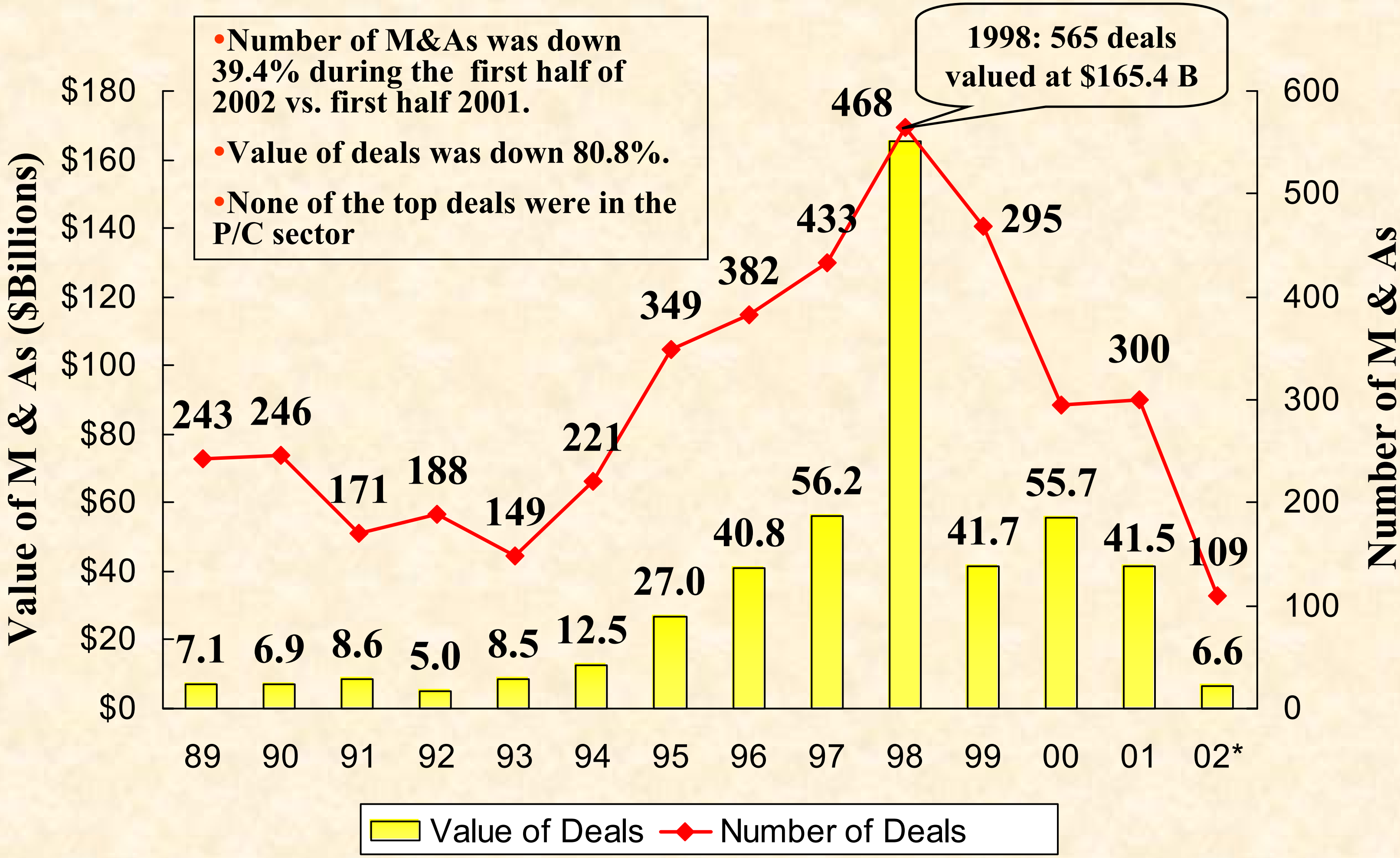
- ***20 events (lowest since 1969)***
- ***1.5 million claims***
- ***9/11: $20.3B = 51,000 claims***



*** Includes $20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims.**

Source: Property Claims Service, Insurance Information Institute

Insurance Mergers and Acquisitions



Source: Compiled from Conning & Company reports.

Summary

- Industry not even close to earnings its cost of capital
- Hard market must continue for it to be earned
- Lots of new capital seeking high rate of return
- Not all companies will be able to meet investor expectations
- Shareholders like to be more impatient (have give p/c stocks benefit of the doubt)
- Increase in M&A activity possible to squeeze excess capacity from industry, but not anytime soon.

Insurance Information Institute On-Line

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