

# *Insurance & the Challenges of Economic Uncertainty*

4<sup>th</sup> Annual European Insurance Industry  
Conference  
London, U.K.

26 November 2002

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# *Presentation Outline*

## **Challenges of Economic Uncertainty**

- Economic Origins & Geopolitical Instability
- Exogenous (External Influences)
- Endogenous (Internal Influences)
- Conclusions
- Q&A

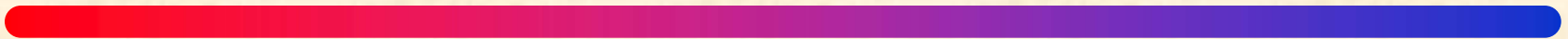


# *The Impacts & Implications*

- **IMPACTS:**
  - Volatile revenue streams
  - Volatile underwriting results
  - Volatile investment returns
  - Inconsistent financial performance
- **IMPLICATIONS:**
  - Low Return on Equity
  - Unattainable Cost of Capital
  - Mergers and Acquisitions Difficult

# *ECONOMIC OVERVIEW*

- *Weak/Weakening Growth*
- *Geopolitical Uncertainty*

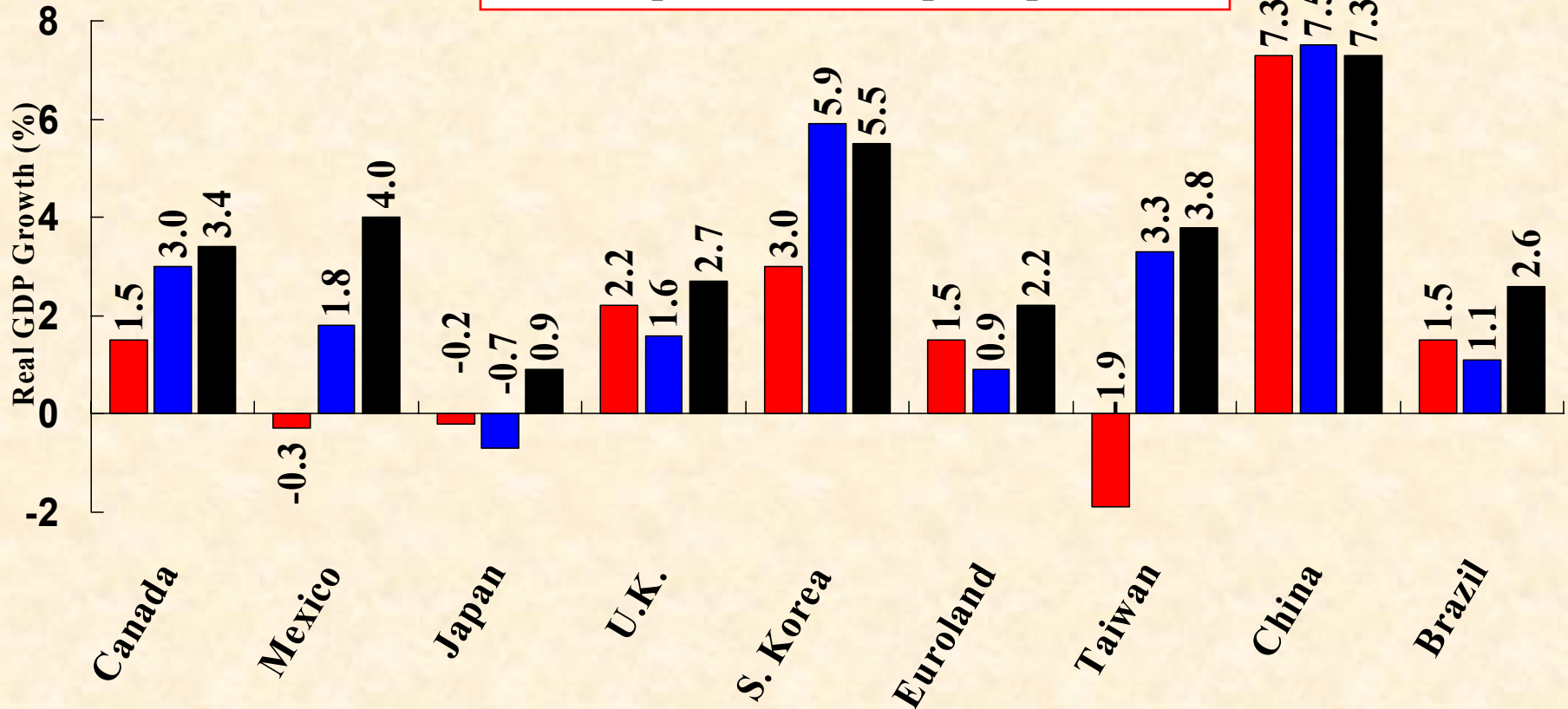




# *Economic Outlook for Major Economies (Real GDP Growth, %)*

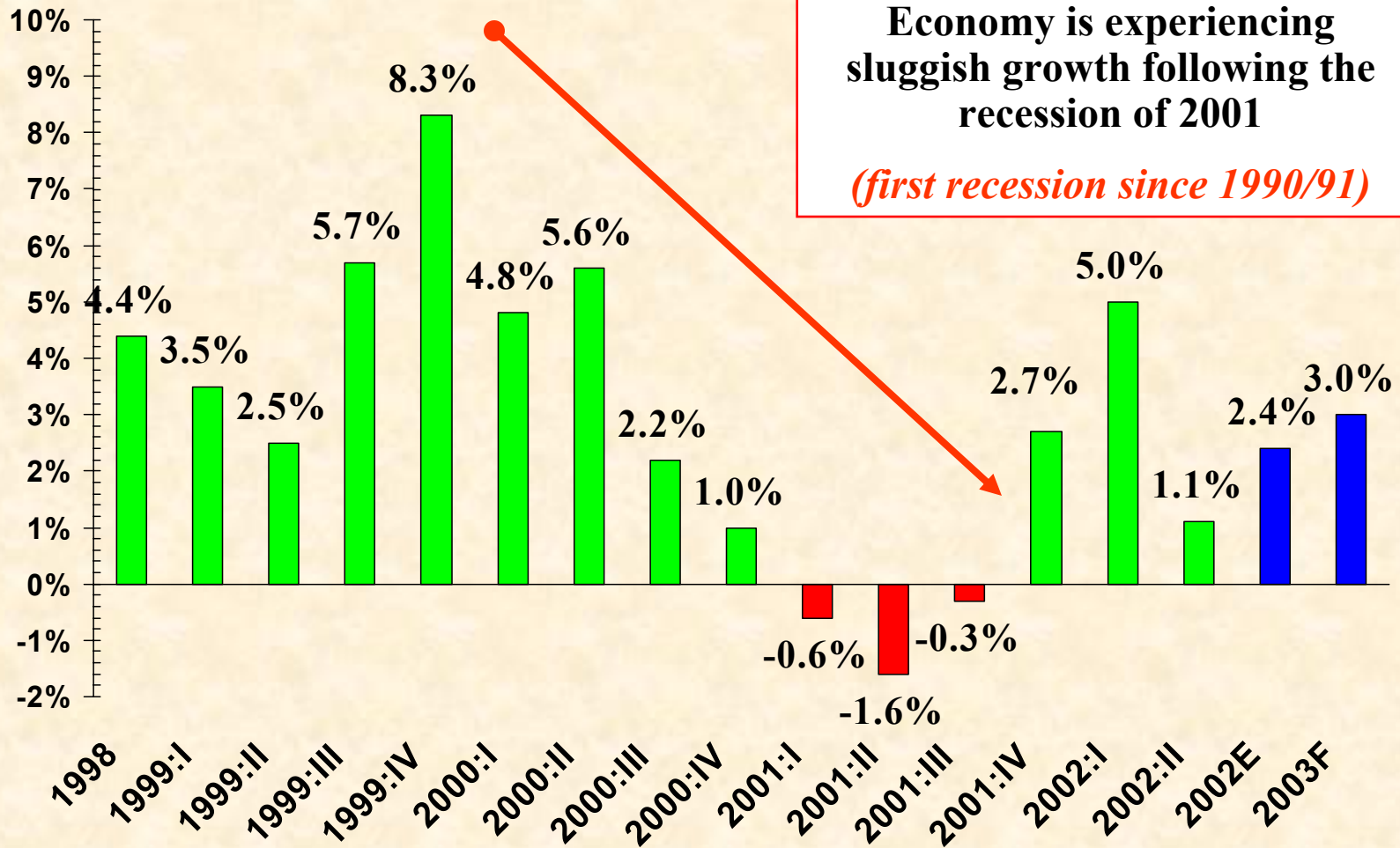
**Economic outlook for 2003 is mixed/weakening for major economies, esp. US, W. Europe, Japan**

■ 2001 ■ 2002E ■ 2003F



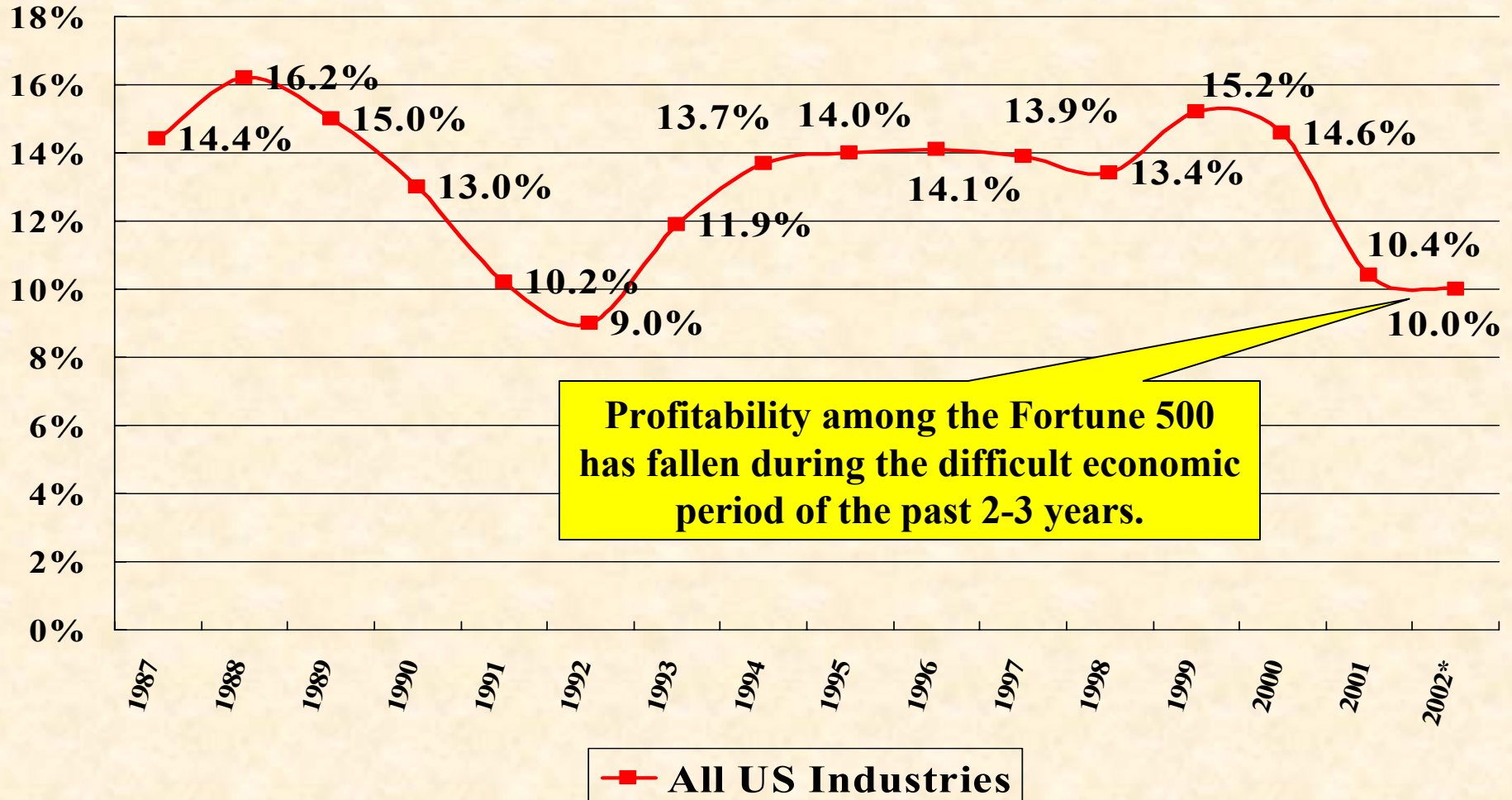


# U.S. Real GDP Growth



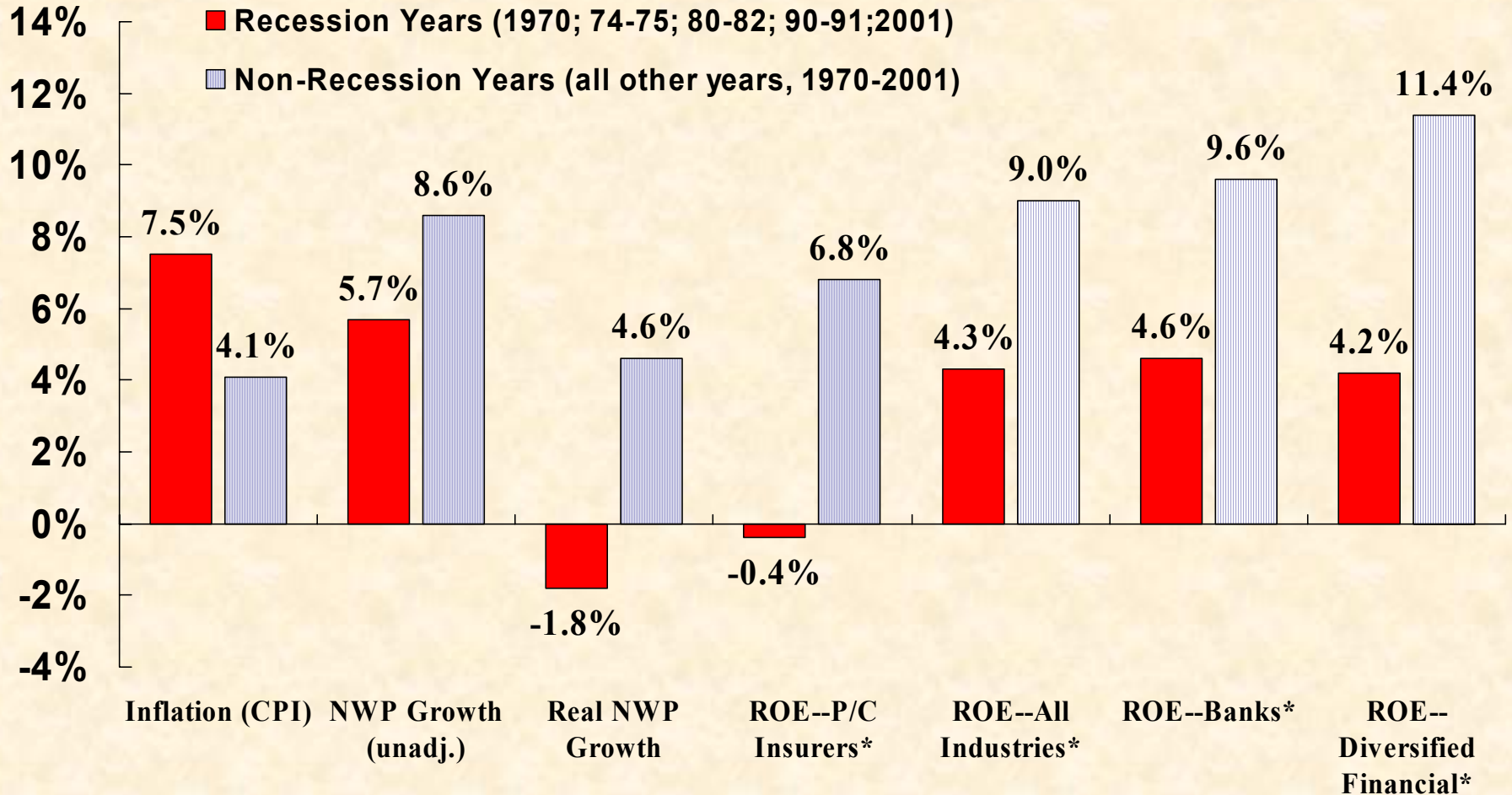


# Return in Equity: Fortune 500 1987–2002E





# *Impact of Recession on US Non-Life Premiums and Profitability (1970-2001)*



\*GAAP return on equity, adjusted for inflation; Bank data 1952-2001; Div. Fin. 1987-2001  
Source: Insurance Information Institute



# *Geopolitical Instability Remains High*



## **Terrorists & Terrorism**



## **War on Terrorism**

## **Expansion of War**



(FROM U.S. AIR FORCE)

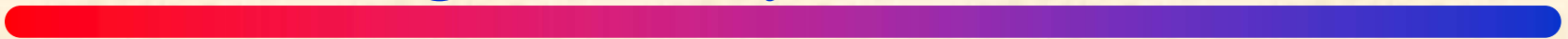
## **Is Iraq Next?**



AP PHOTO

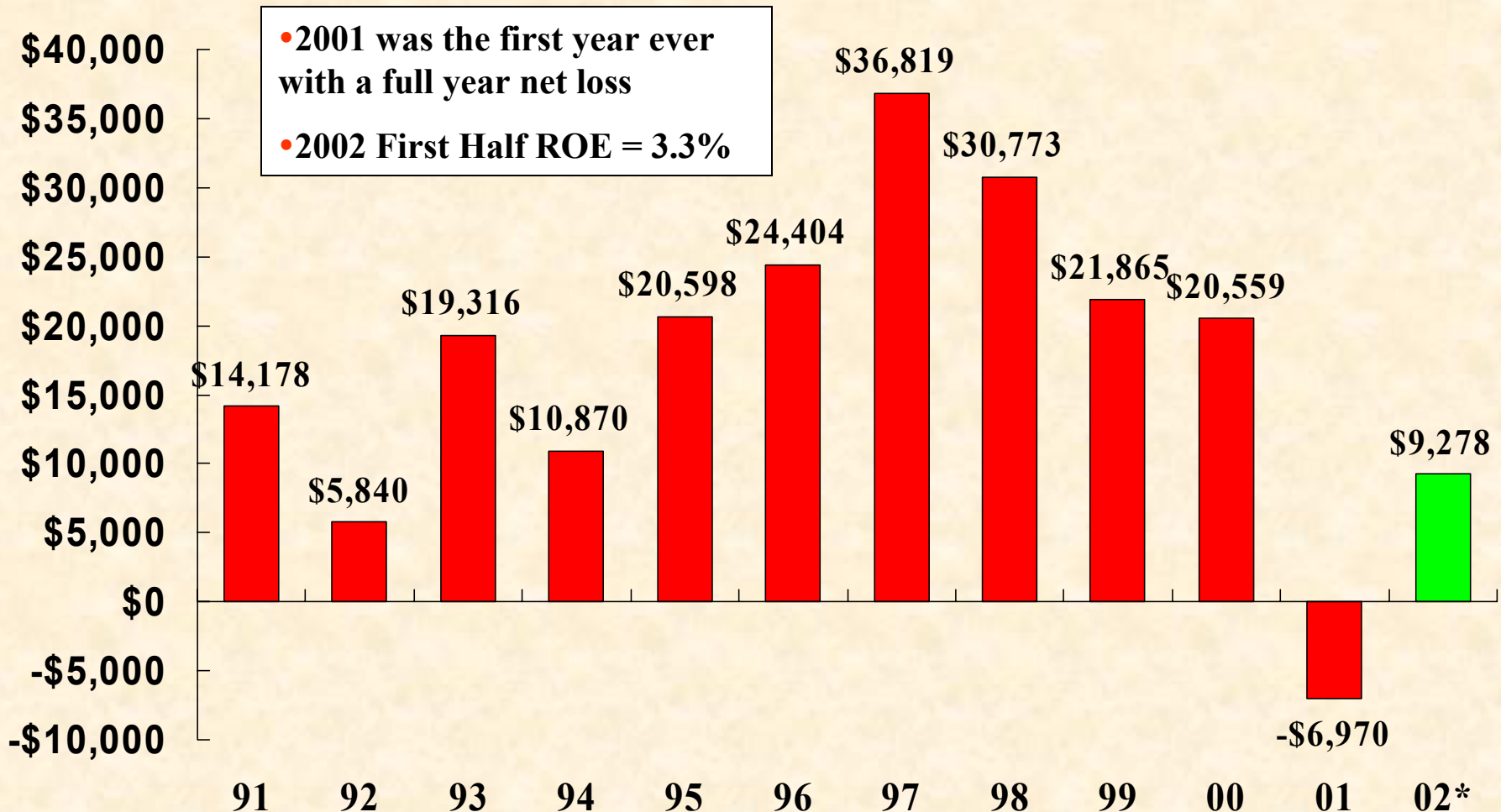
# *MANIFESTATIONS OF ECONOMIC UNCERTAINTY ON GLOBAL INSURANCE INDUSTRY:*

- *Profitability*
- *Underwriting Performance*
- *Ratings/Downgrades*
- *Management Shifts*





# US Non-Life Net Income After Taxes 1991-2002 (\$ Millions)

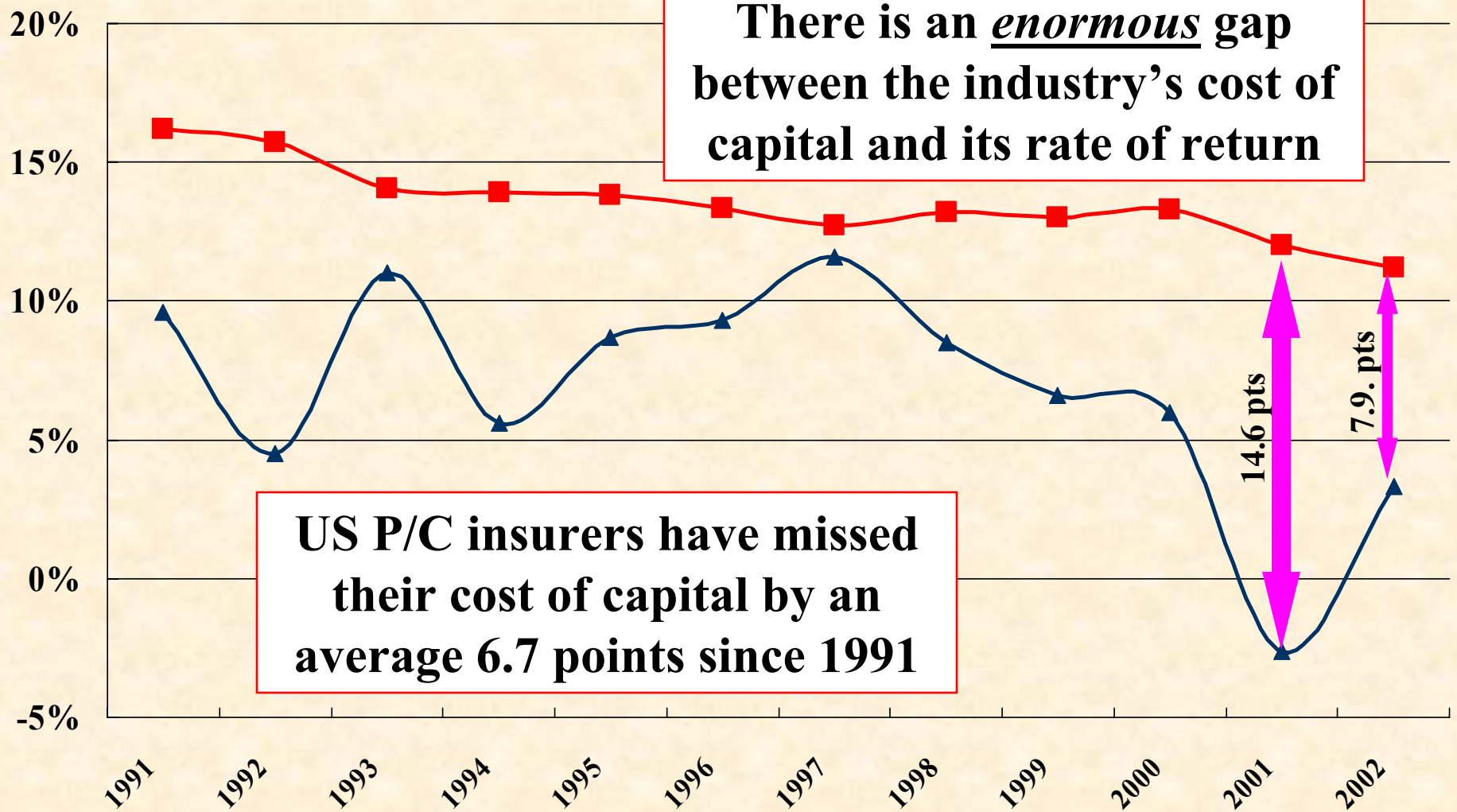


\*I.I.I. estimate based on first half 2002 data.

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



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

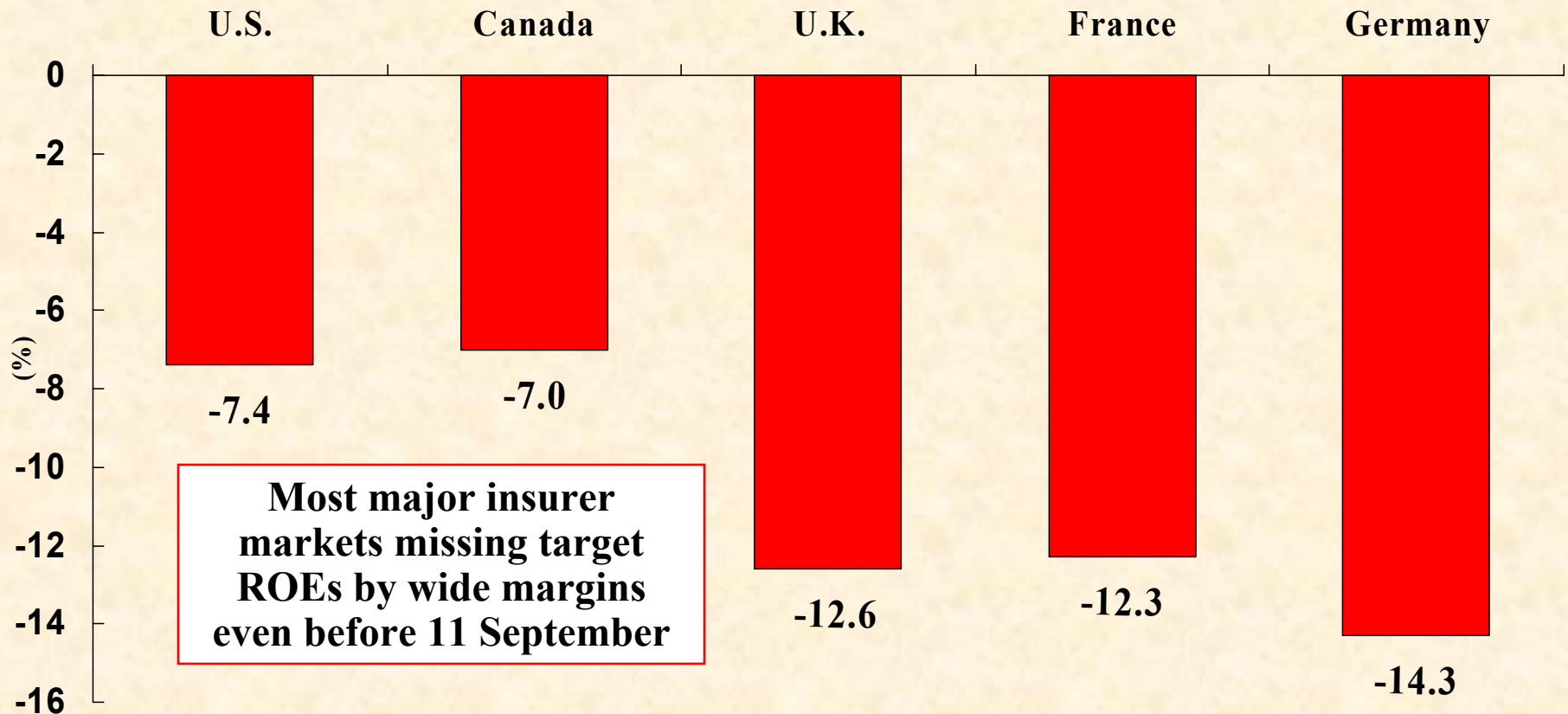


Source: The Geneva Association, Ins. Information Inst.

▲ ROE ■ Cost of Capital

# Gap Between Required and Actual UW Result Needed to Achieve Target ROE

As a % of Premium

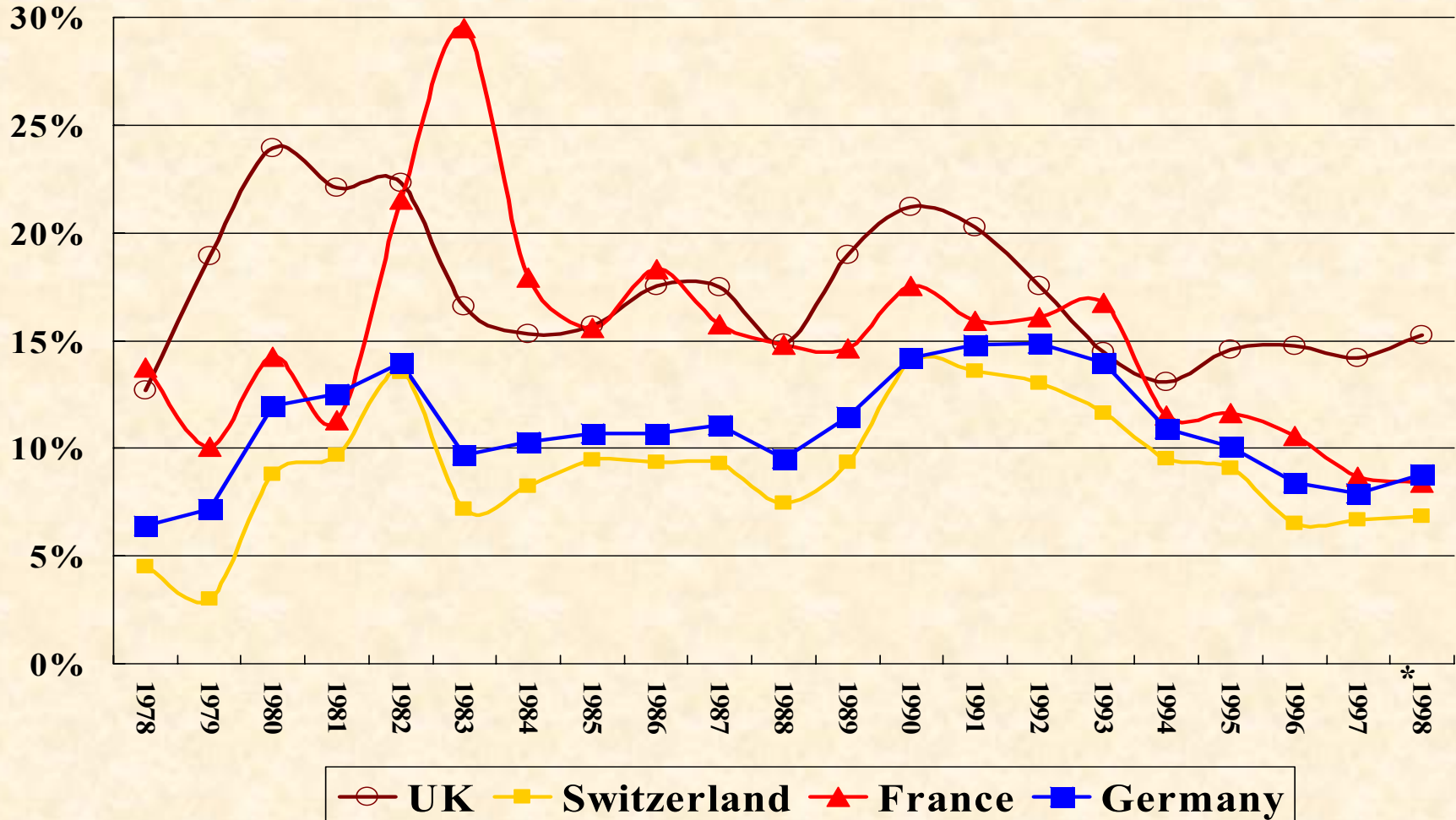


Note: US, Canada are 2000 data, 1999 for all others

Source: Swiss Re, *sigma* 5/01.



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

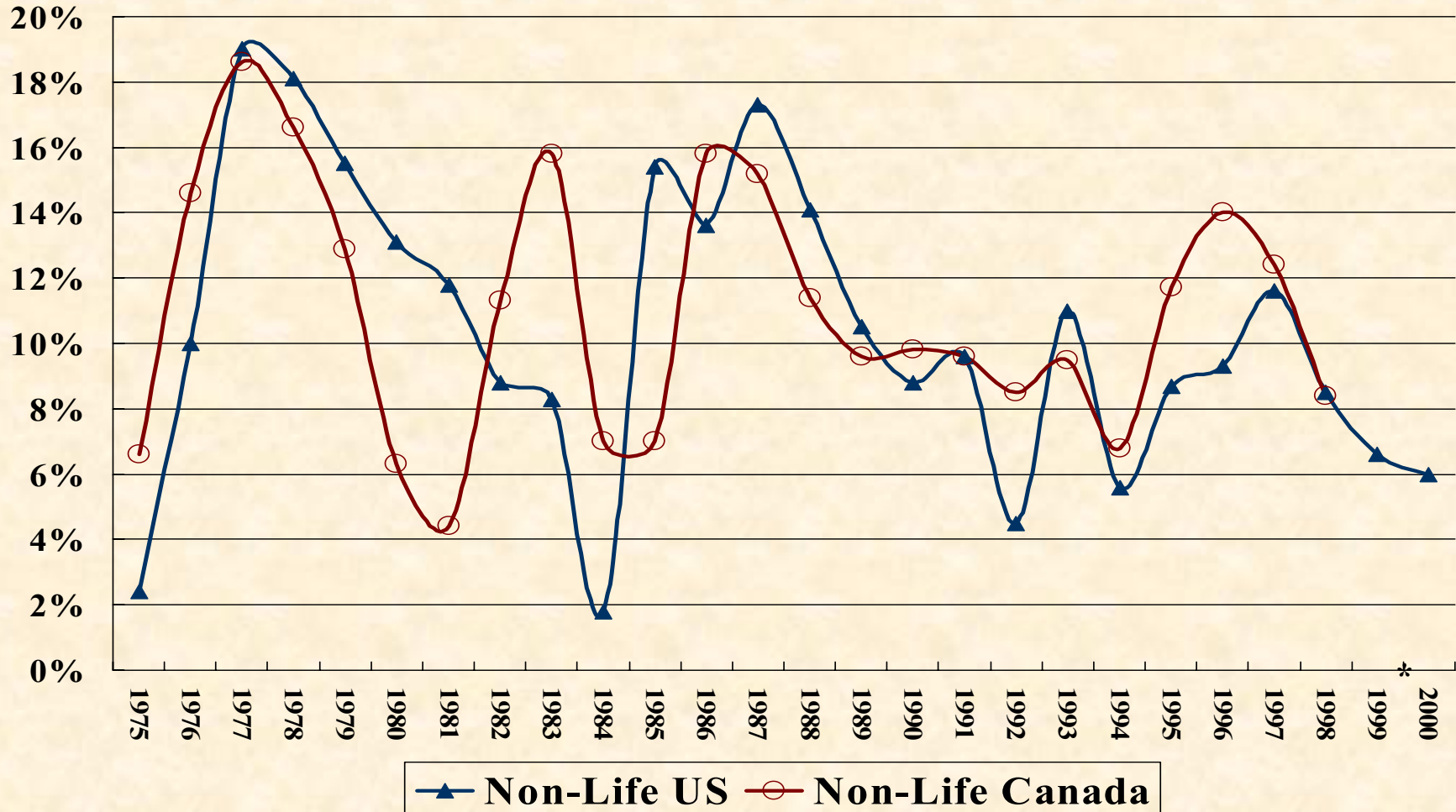


Source: Kielholz, Walter, "The Cost of Capital for Insurance Companies," *The Geneva Papers on Economic Activity*, v 25, no. 1, January 2000.



# Return on Equity

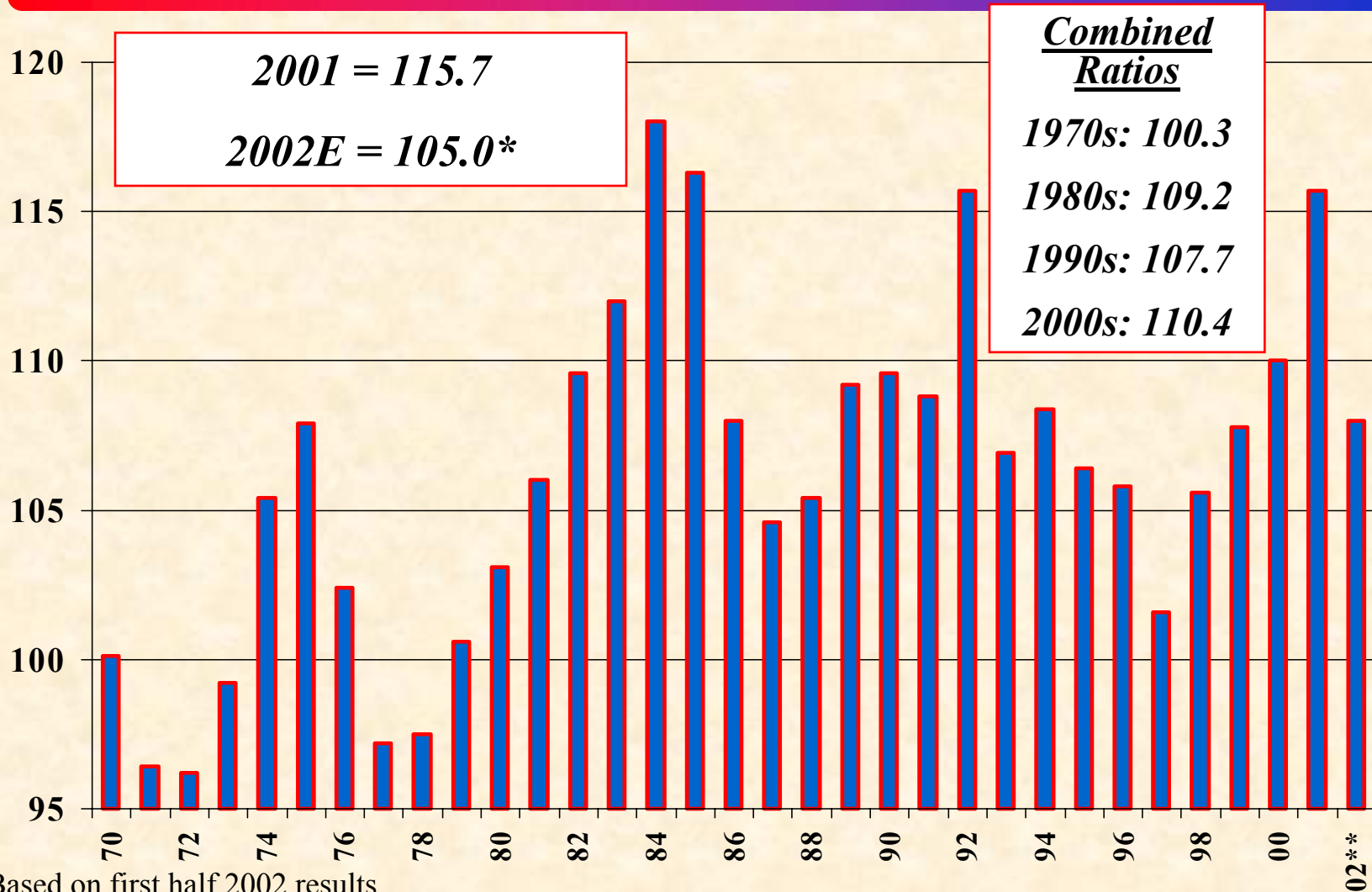
## US vs. Canada: 1975 – 2000



Source: Insurance Information Institute; Insurance Bureau of Canada.



# *P/C Industry Combined Ratio*

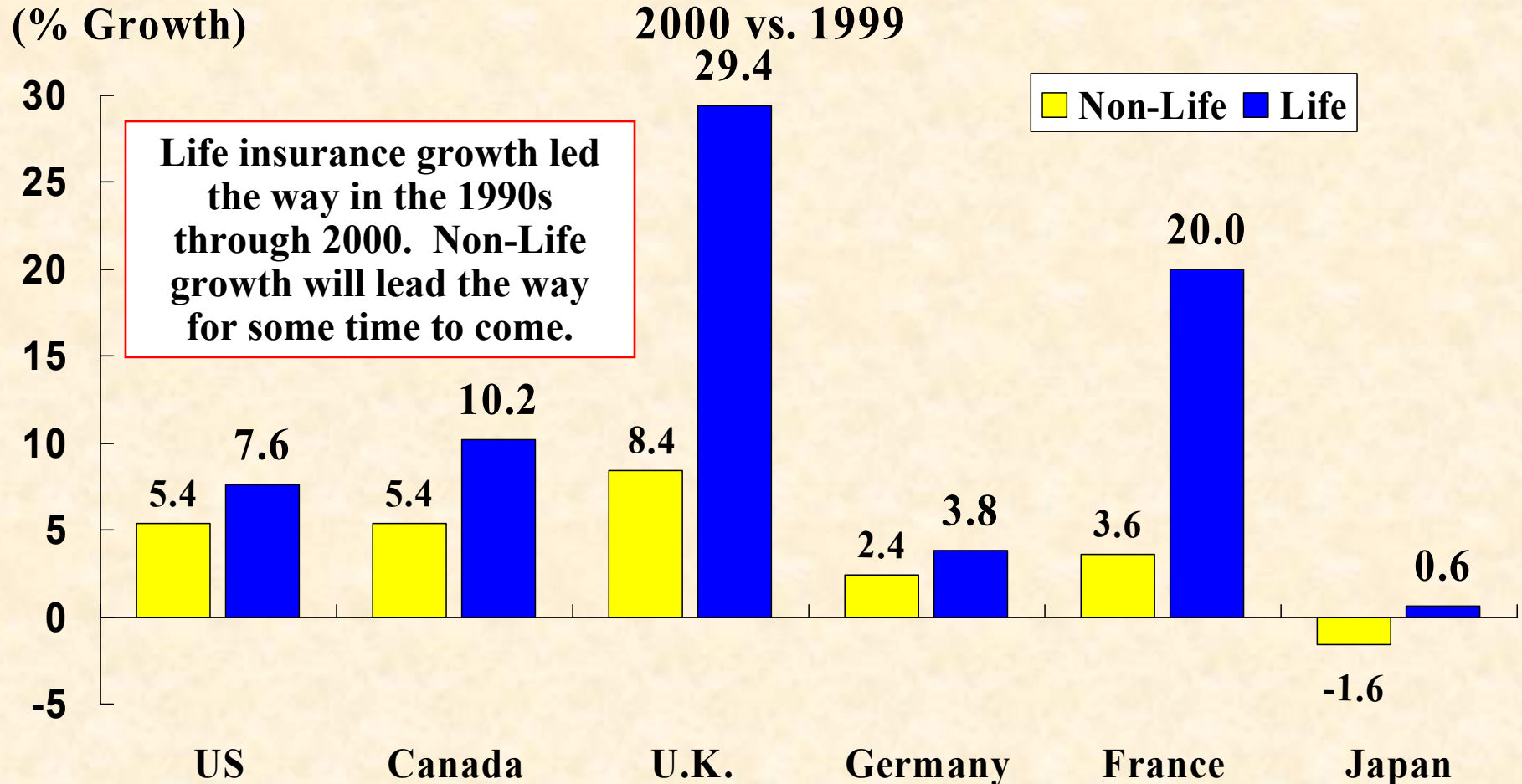


\*Based on first half 2002 results

Sources: A.M. Best; III



# Growth in Premium Volume: Life vs. Non-Life\*

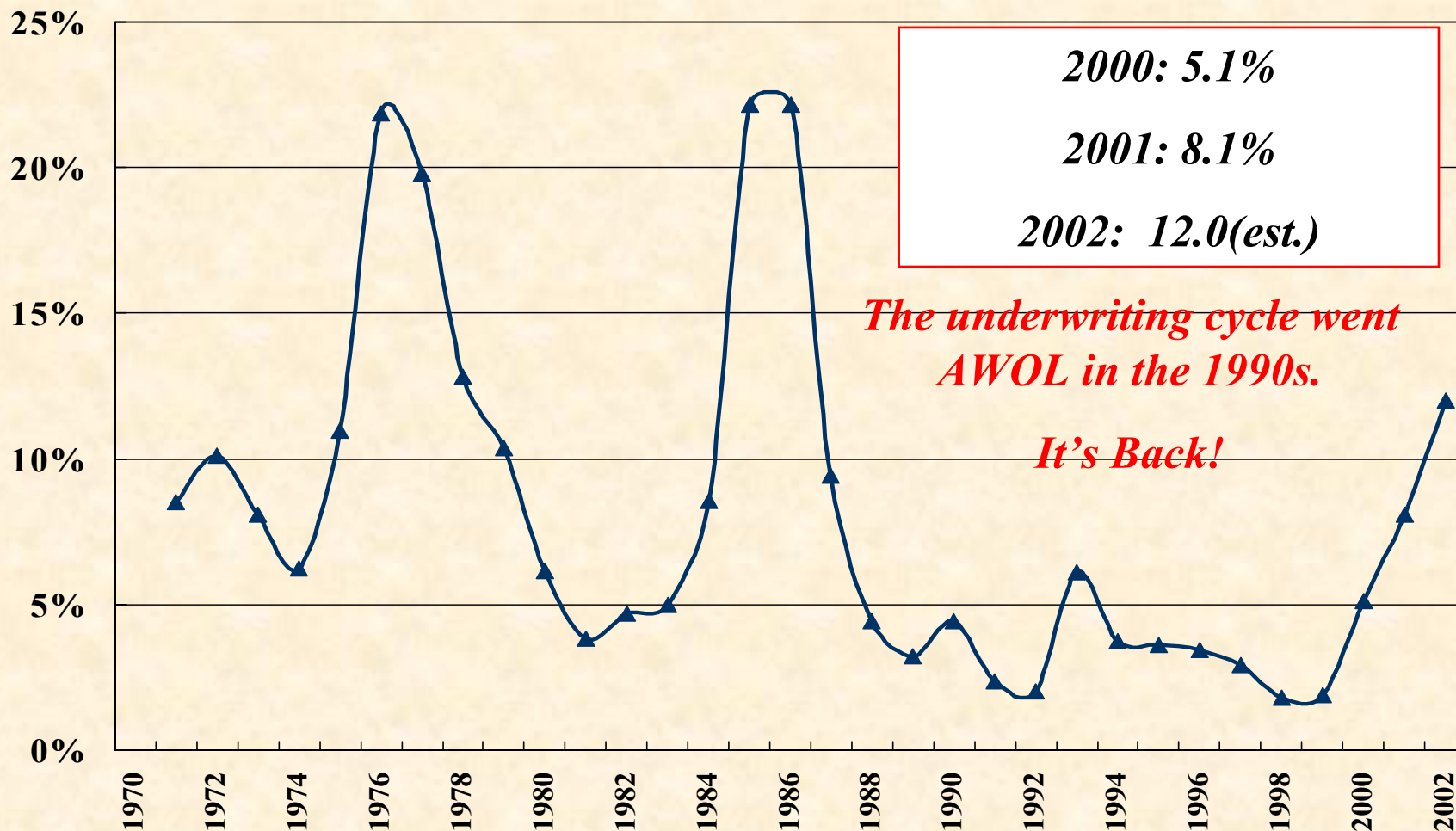


\*Growth rates based on premium volume in local currencies.

Source: Swiss Re, *sigma* 6/01.



# Growth in Net Premiums Written (All US Non-Life Lines)



\*Estimate based on first half 2002 results.

Source: A.M. Best, Insurance Information Institute



# *Ratings Downgrades: Swarms of Downgrades Stinging Insurers*

## **Reasons for Recent Downgrades of Insurers Worldwide**

- Asbestos
- Reserve Deficiencies
- Management Issues (e.g., transitions)
- Reinsurance Uncollectibles
- Investment Write-Downs
- Adverse Development
- Missed/Shifting Earnings Targets



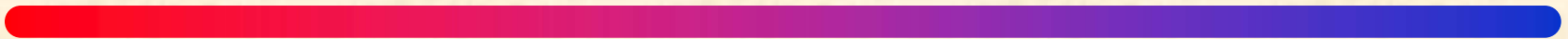
# *Large Number of Senior Management Changes: Symptomatic of Underlying Difficulties*

## **Senior Management Changes at Many Companies**

- American Re AMP Ltd. Annuity & Life Re
- Assicur. Generali AXA Corp Solutions Caliber One
- CA State Fund Chubb Cigna
- C N A Credit Suisse Employers Re
- General Star Gerling MLP
- Mutual Risk Mgmt OneBeacon Royal & SunAlliance
- Royal America Safeco St. Paul
- Scor Swiss Life Trenwick
- Zurich

# *SOURCES OF VOLATILITY & UNCERTAINTY*

*Exogenous & Endogenous Factors*



# *EXOGENOUS INFLUENCES*

*Catastrophic Loss*

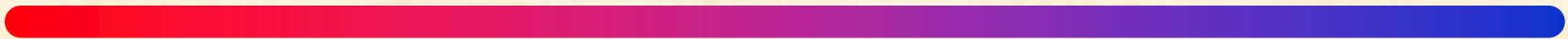
*Investment Volatility*

*Crisis in Corporate Governance*

*Excessive Litigiousness*

*Health Care Cost Inflation*

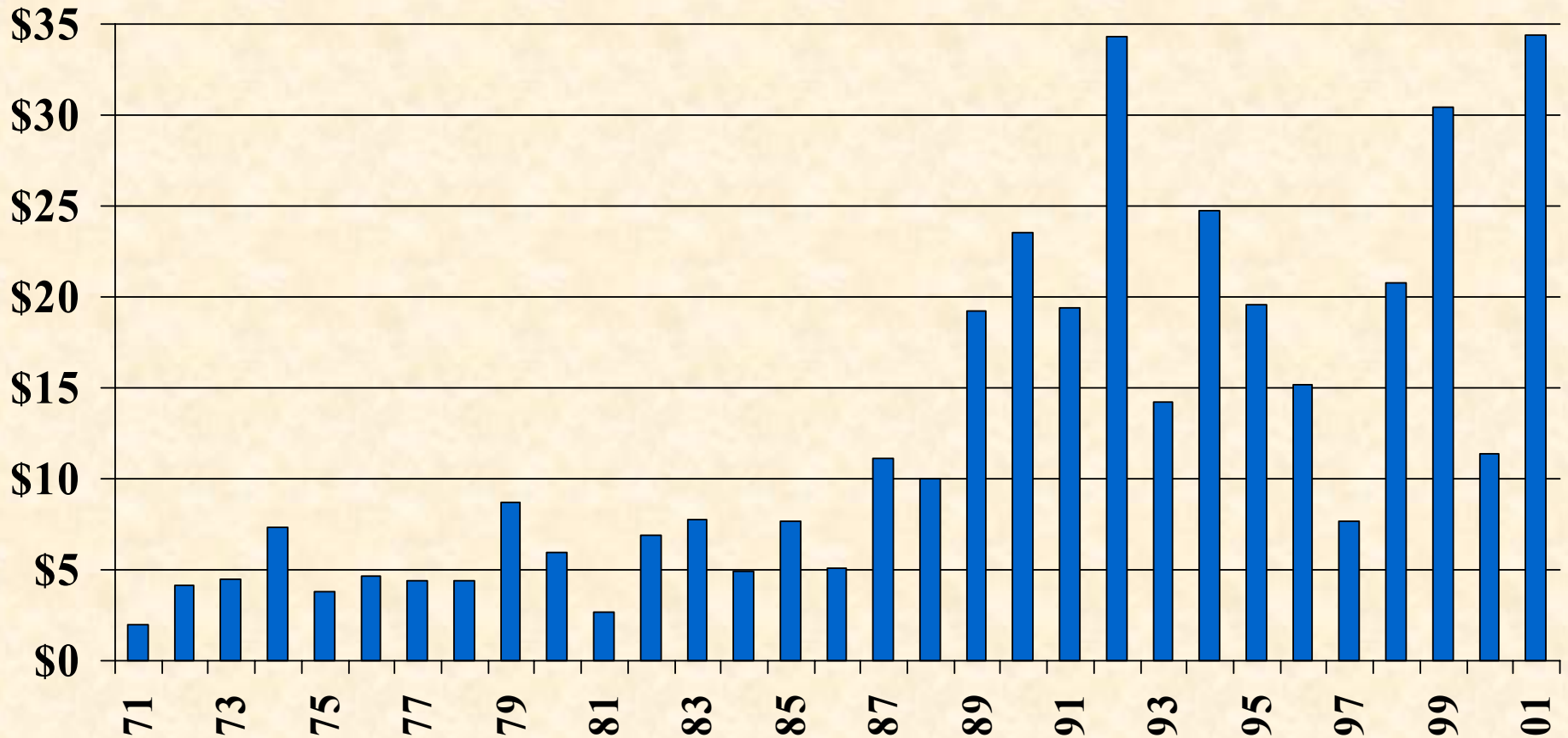
*Terrorism*





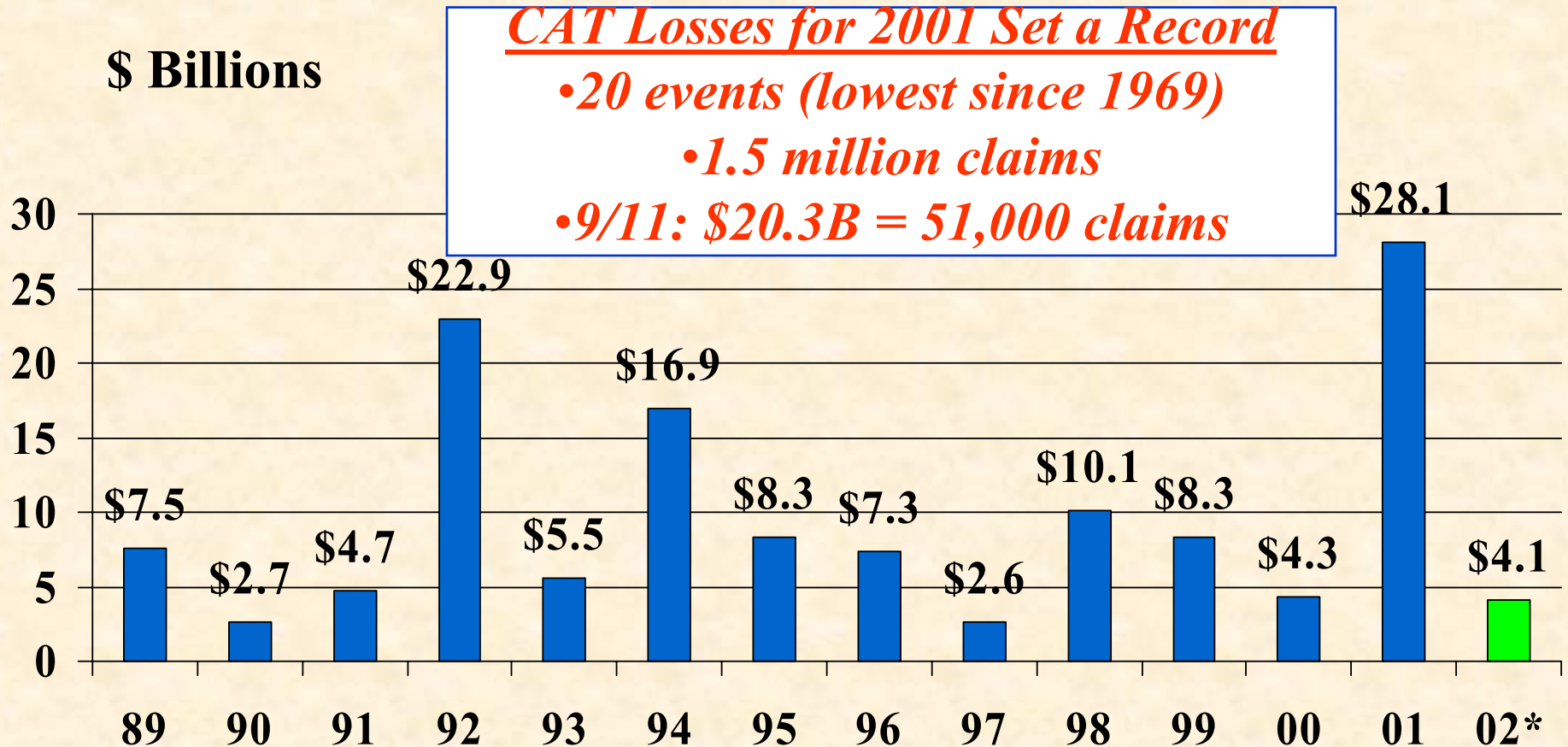
# *Worldwide Insured Catastrophe Losses*

**In Billions of 2001 US Dollars**





# U.S. Insured Catastrophe Losses



\*Estimate through October 2002.

**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.

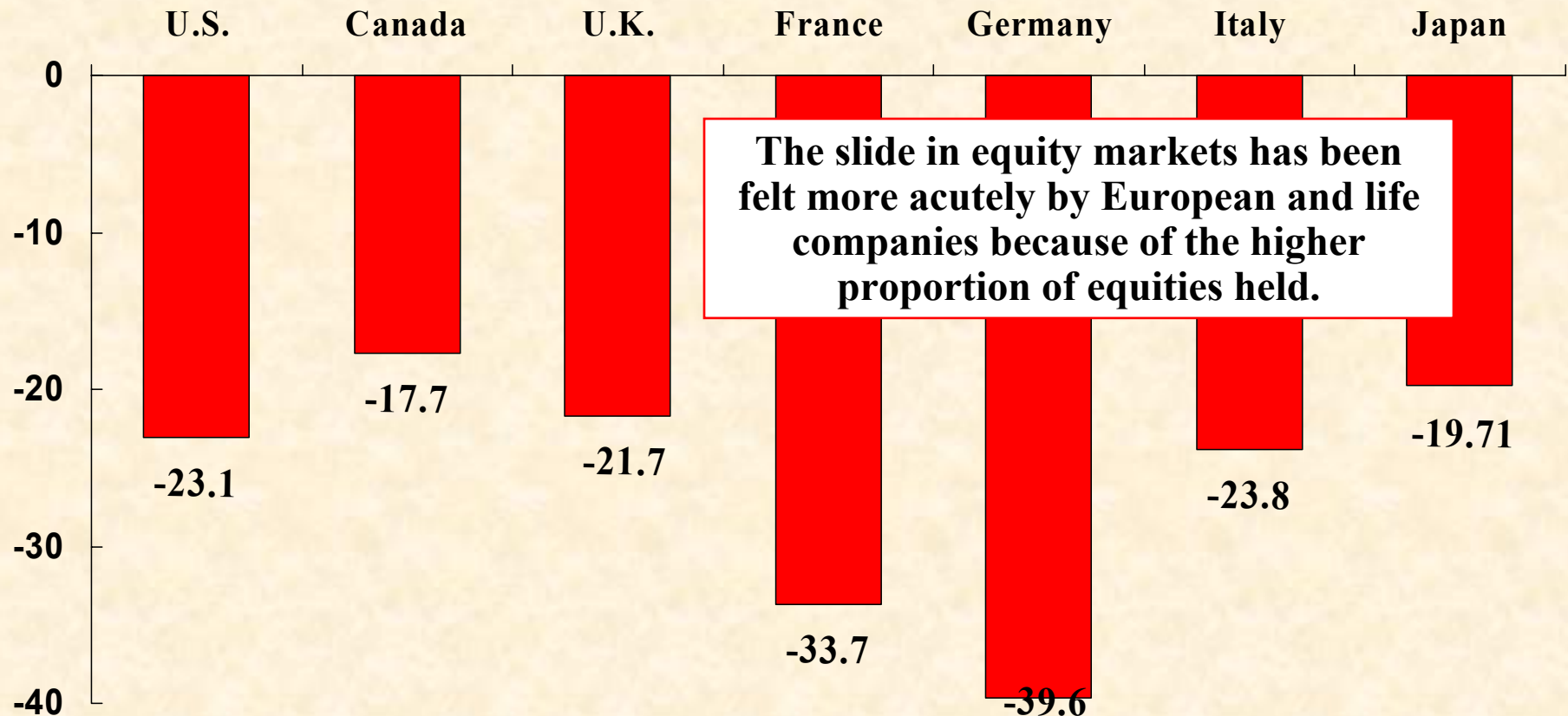
**Source:** Property Claims Service, Insurance Information Institute



# *International Stock Markets: YTD Performance (%)*

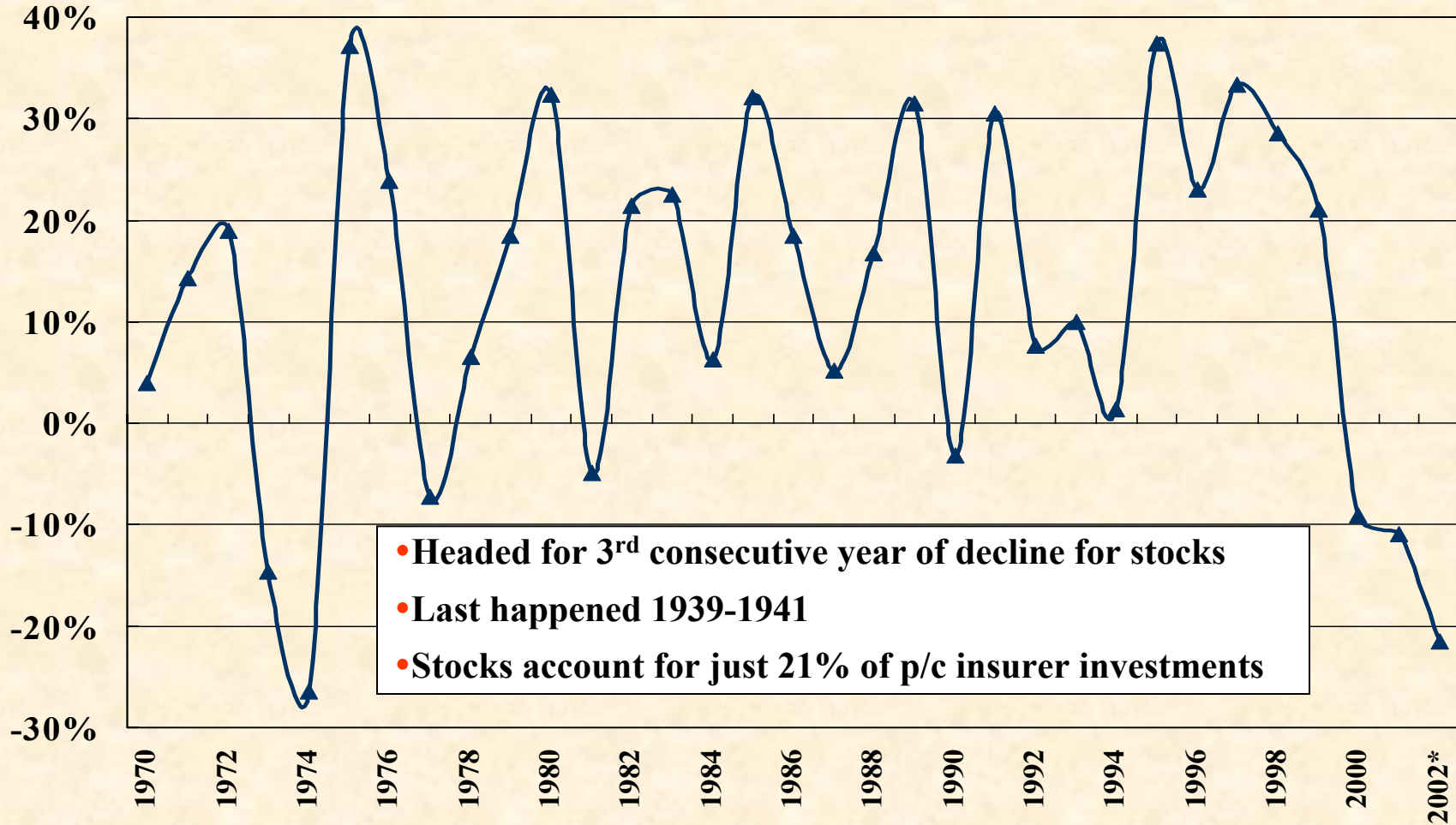
**As of 12 November 2002**

(% YTD Return)





# US: Total Returns for Large Company Stocks: 1970-2002\*

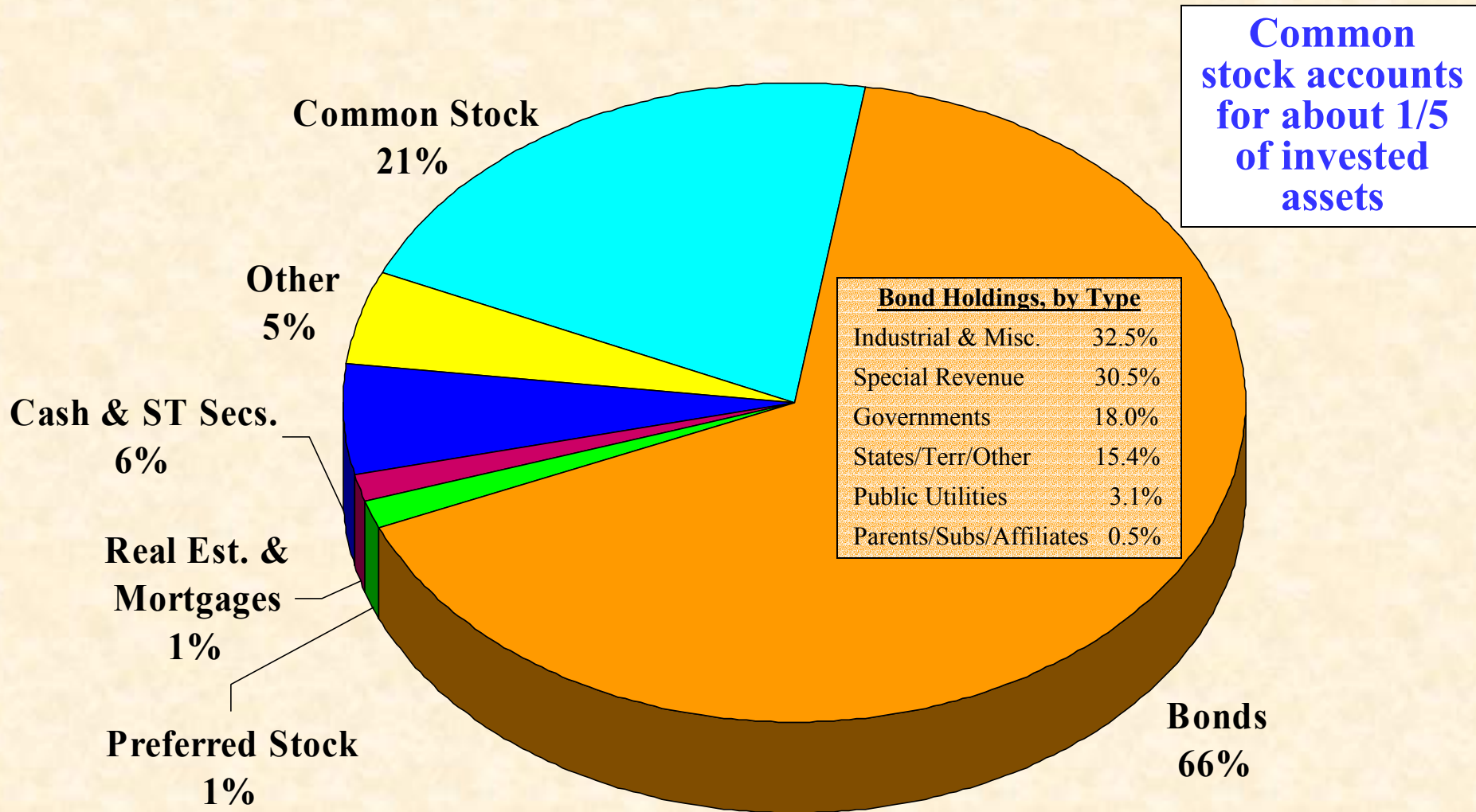


\*As of November 1, 2002.

Source: Ibbotson Associates, Insurance Information Institute



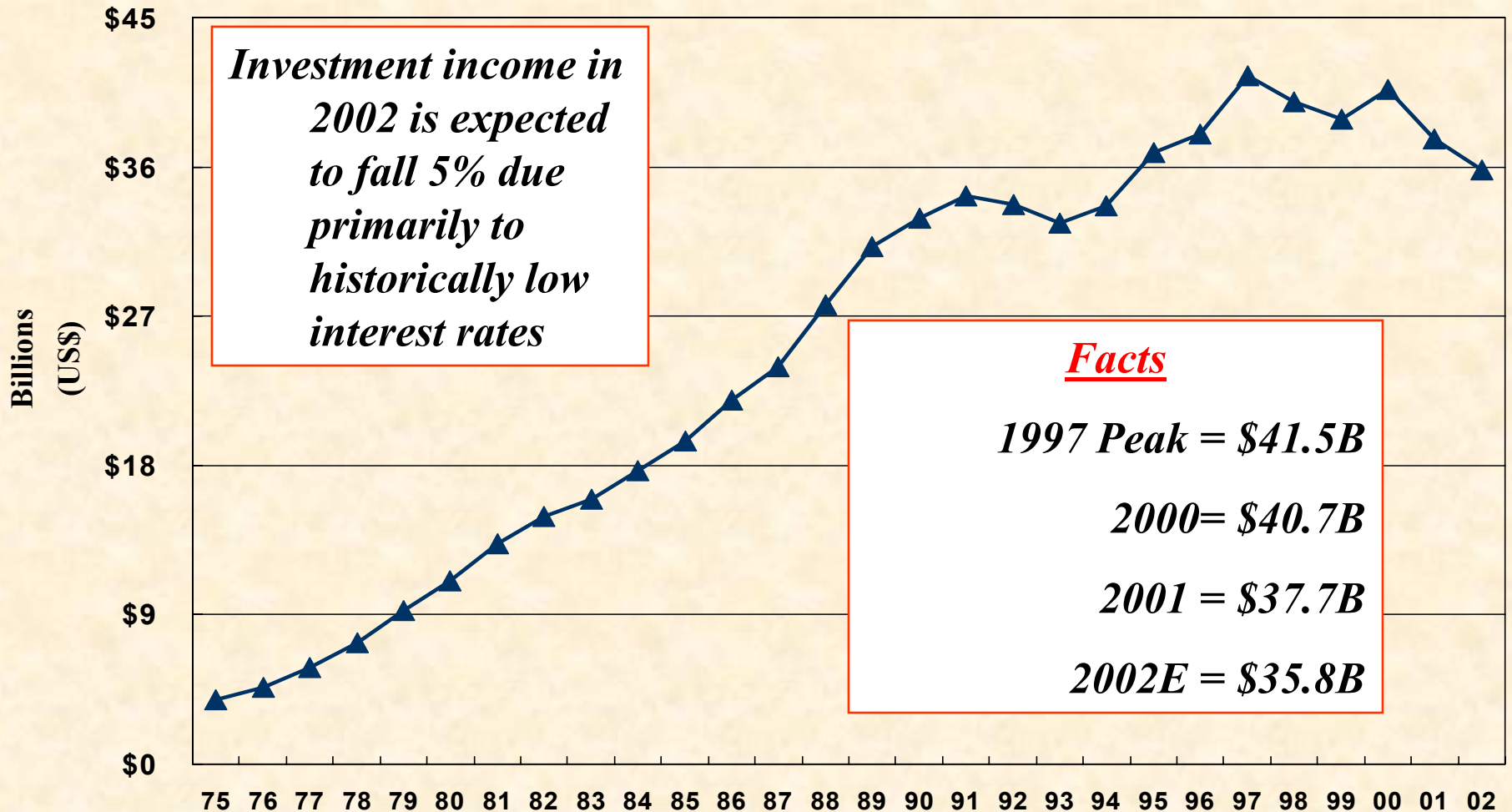
# *P/C Industry Investments, by Type (as of Dec. 31, 2001)*



Source: A.M. Best, Insurance Information Institute

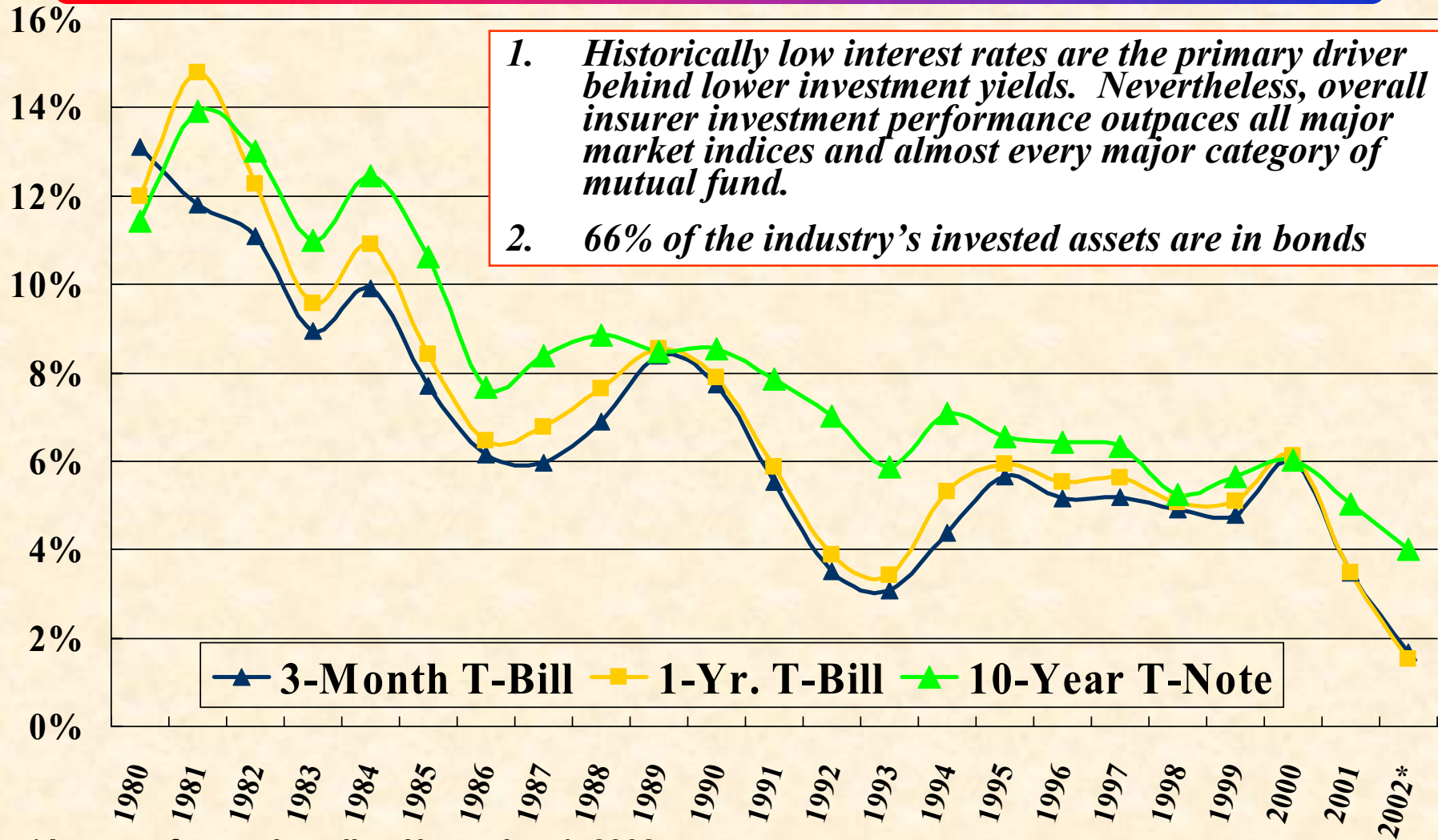


# U.S. Net Investment Income





# U.S. Interest Rates: Lower Than They've Been in Decades



- Historically low interest rates are the primary driver behind lower investment yields. Nevertheless, overall insurer investment performance outpaces all major market indices and almost every major category of mutual fund.*
- 66% of the industry's invested assets are in bonds*

▲ 3-Month T-Bill    ■ 1-Yr. T-Bill    ▲ 10-Year T-Note

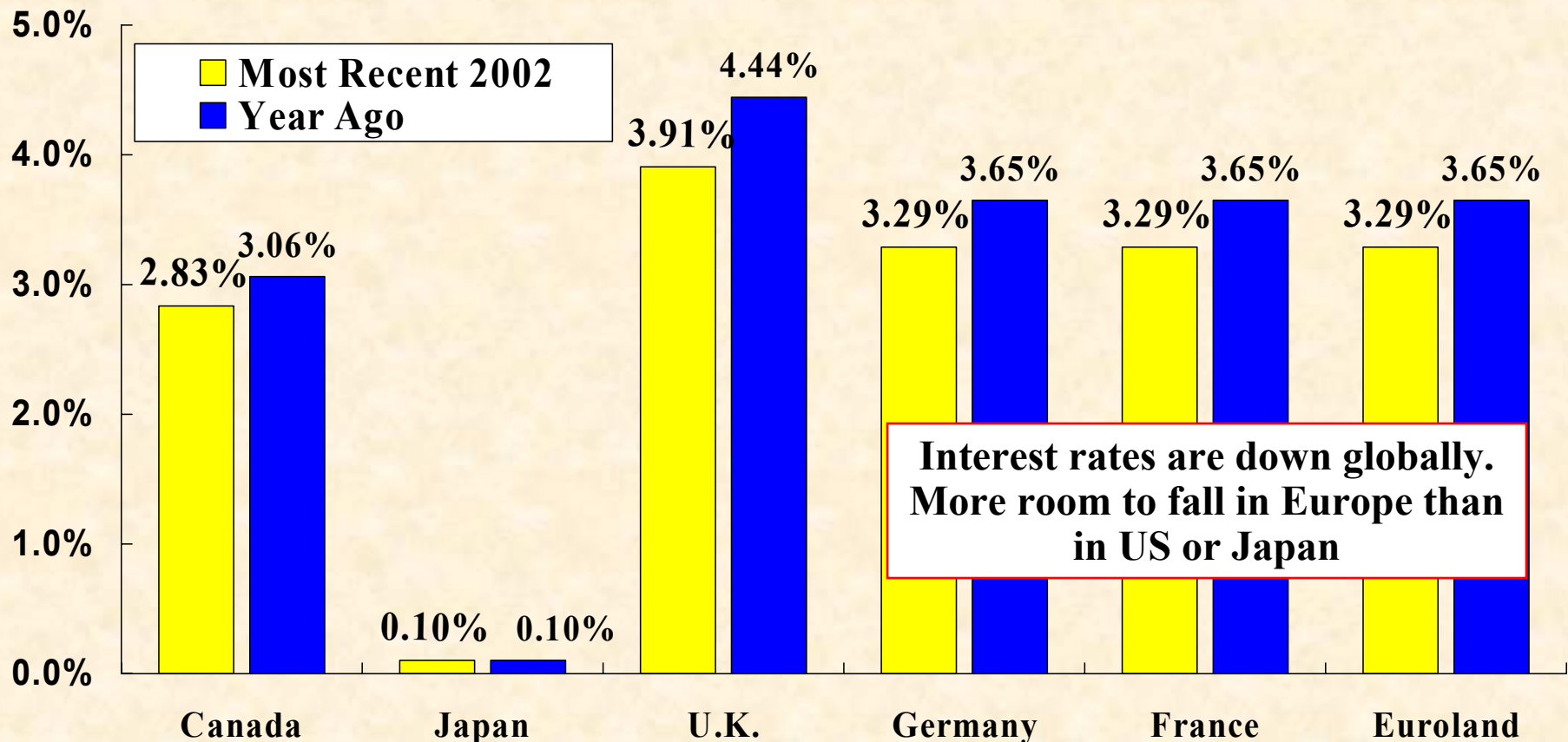
\*Average for week ending November 1, 2002.

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



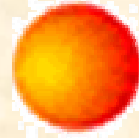
# *Falling Interest Rates Mean Lower Bond Yields for Years to Come*

## 3-Month Yields



# *Accounting Problems are Getting Many Companies into Trouble*

- Enron was tip of an iceberg
- Major implications for insurers (p/c and life)



**ANDERSEN**

THE DOCUMENT COMPANY  
**XEROX**

ride the light  
**Qwest**  
GEMSTAR-TV GUIDE  
INTERNATIONAL

**tyco**

 **ImClone Systems  
Incorporated**

**WORLD.COM.**

 **Global Crossing**

**Reliant  
Energy**

**Adelphia**

**CORNELL**



# *Corporate Governance: Expensive and Hard-Learned Lessons*

- **Crisis of Confidence—skepticism is on the rise**

- Ratings agencies      Analysts      Regulators
- Investors/Creditors      Employees      Lawmakers



- **Regulatory/Legislative Fallout Unclear**

- SEC is “rudderless”
- Enormous number of investigations under way
  - SEC, State Attorneys General, IRS, DoJ, etc.
  - Most new SEC cases are against large companies
- Many competing reforms from Congress, SEC, A.G.’s., NYSE, NASDAQ, etc.
- Collectively are likely to help, at least somewhat

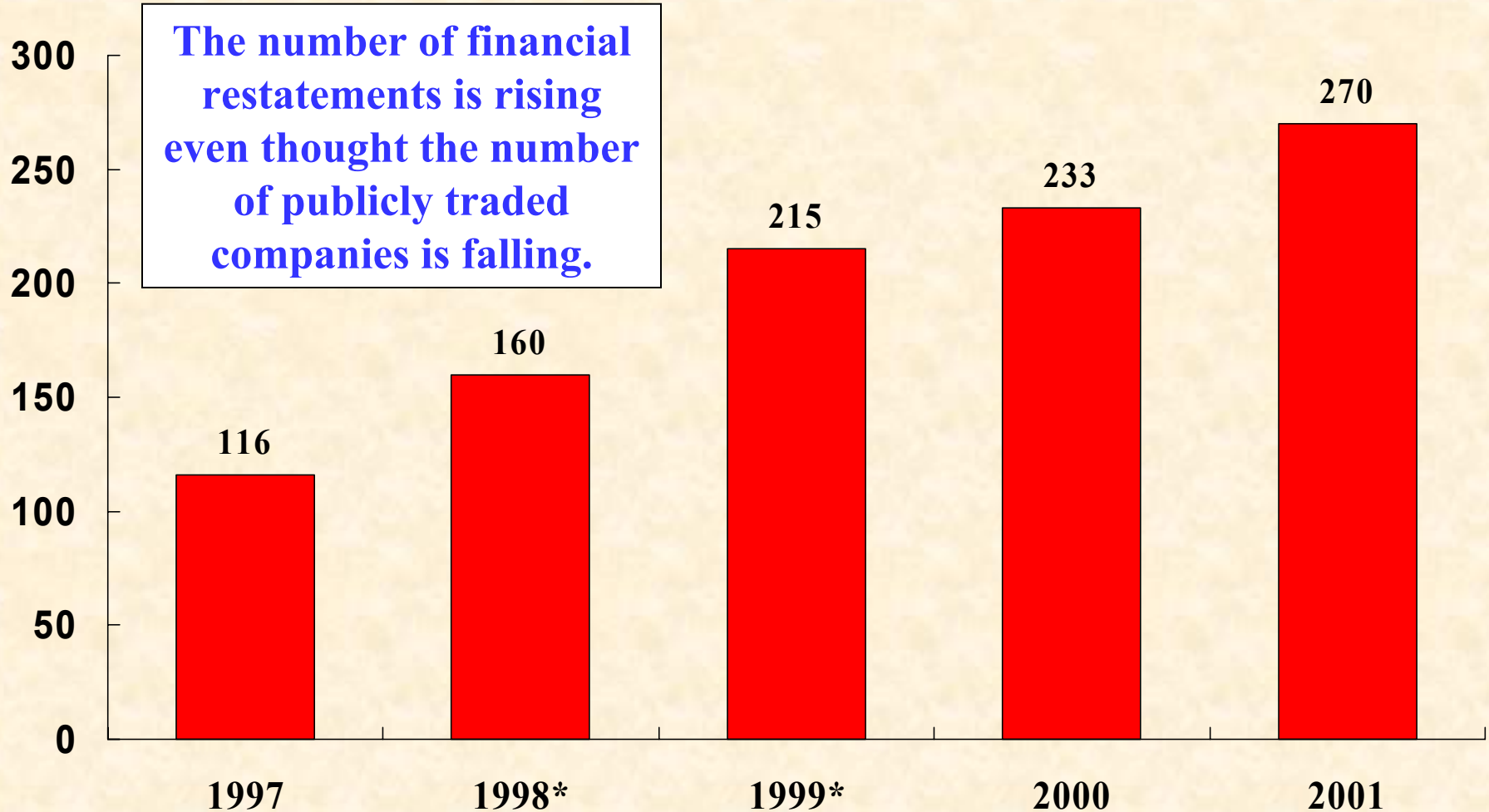


- **SEC, Administration & Congressional proposals vary**

- **Surge in shareholder suits well underway**



# *Financial Restatements Filed*



\*Approximate

Sources: Huron Consulting Group

# *Serious Implications for Insurers*

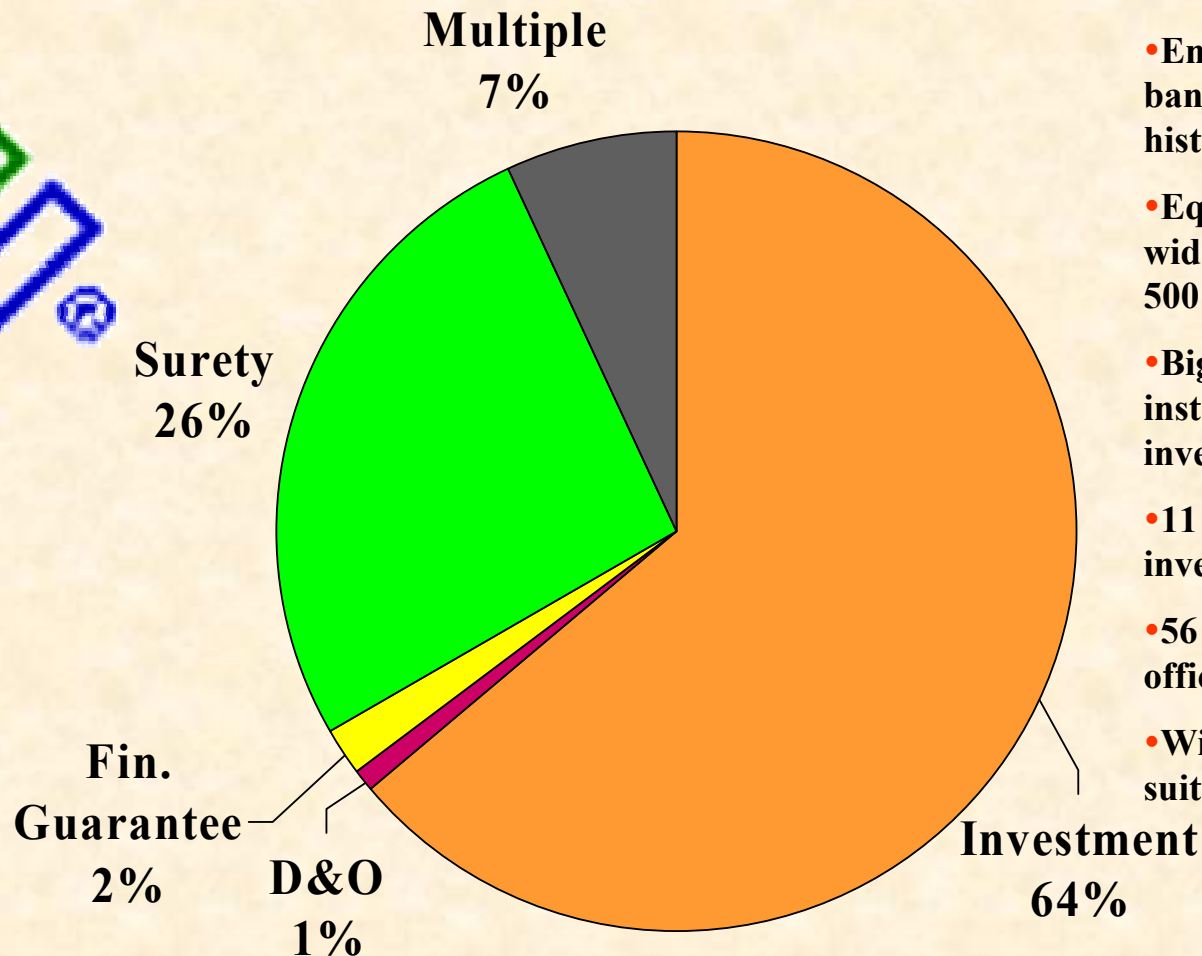
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- **Insurers exposed to a wide variety of risks:**
  - **Investment risk (as institutional investors)**
  - **Insurance risk (surety, D&O, E&O, etc.)**
  - **Litigation risk (as both plaintiff & defendant)**
  - **Accounting Risk**
  - **Regulatory risk**



# *Enron-Related Losses for Insurers*

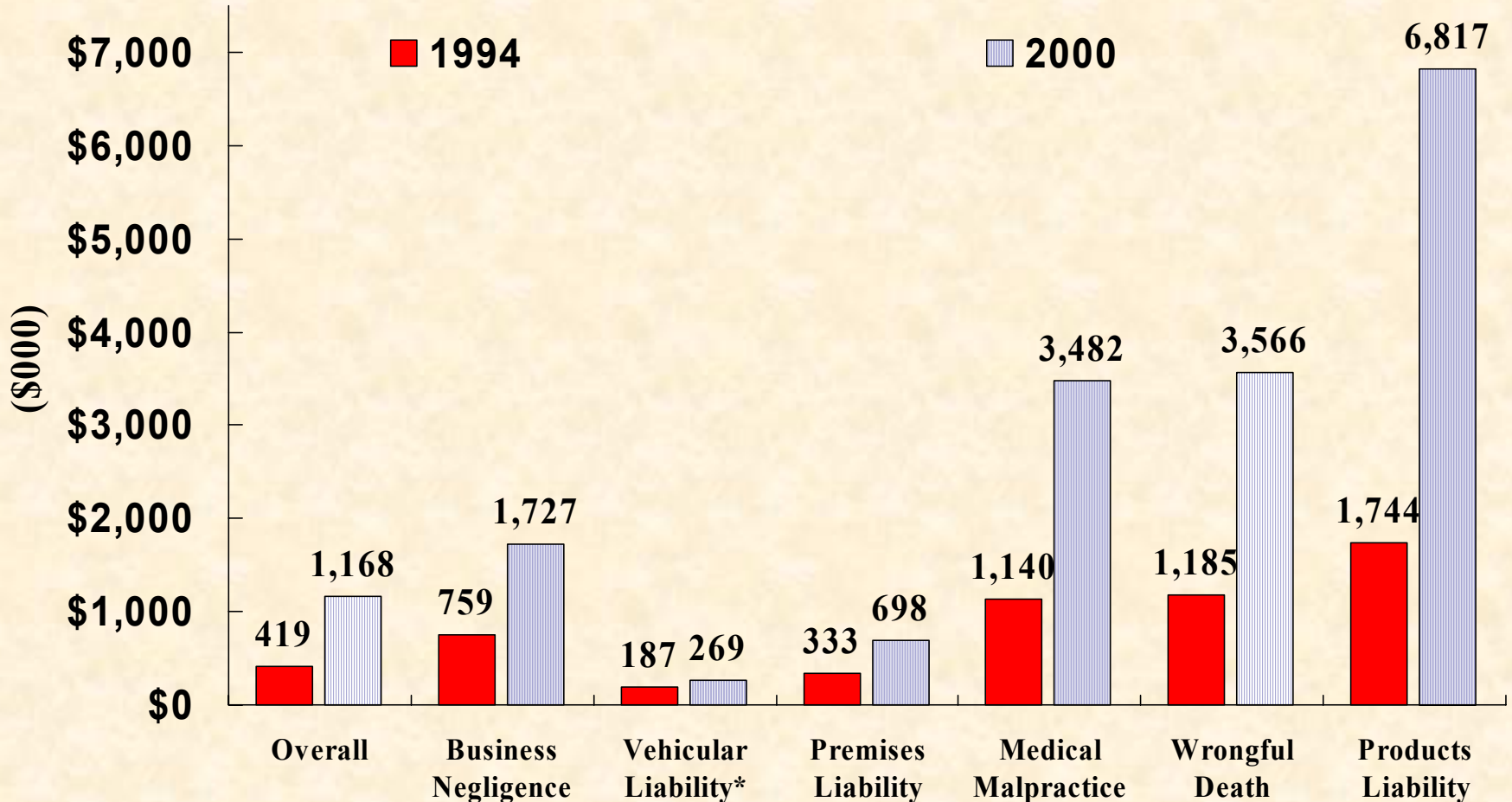
**Total Exposure (Life & Non-Life): \$3.796 Billion**



- Enron is the biggest bankruptcy in US history (\$31B+)
- Equity/debt widely-held as S&P 500 company
- Biggest impact in institutional investors/creditors
- 11 Congressional investigations
- 56 suits against officers & directors
- Will spark similar suits



# Average U.S. Jury Awards 1994 vs. 2000



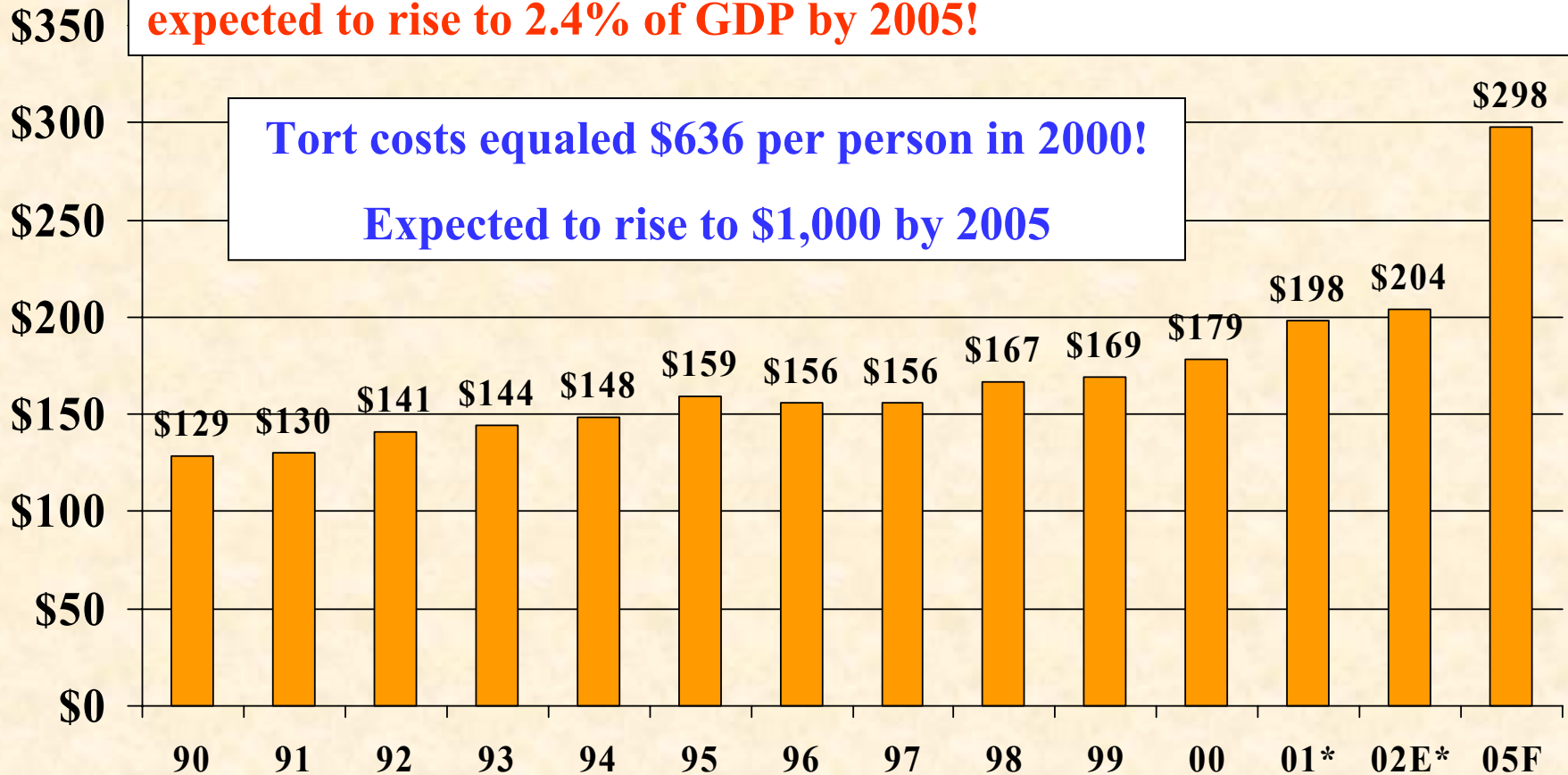
Source: Jury Verdict Research; Insurance Information Institute.



# Cost of U.S. Tort System

(\$ Billions)

**Tort costs consumed 2.0% of GDP annually on average since 1990, expected to rise to 2.4% of GDP by 2005!**

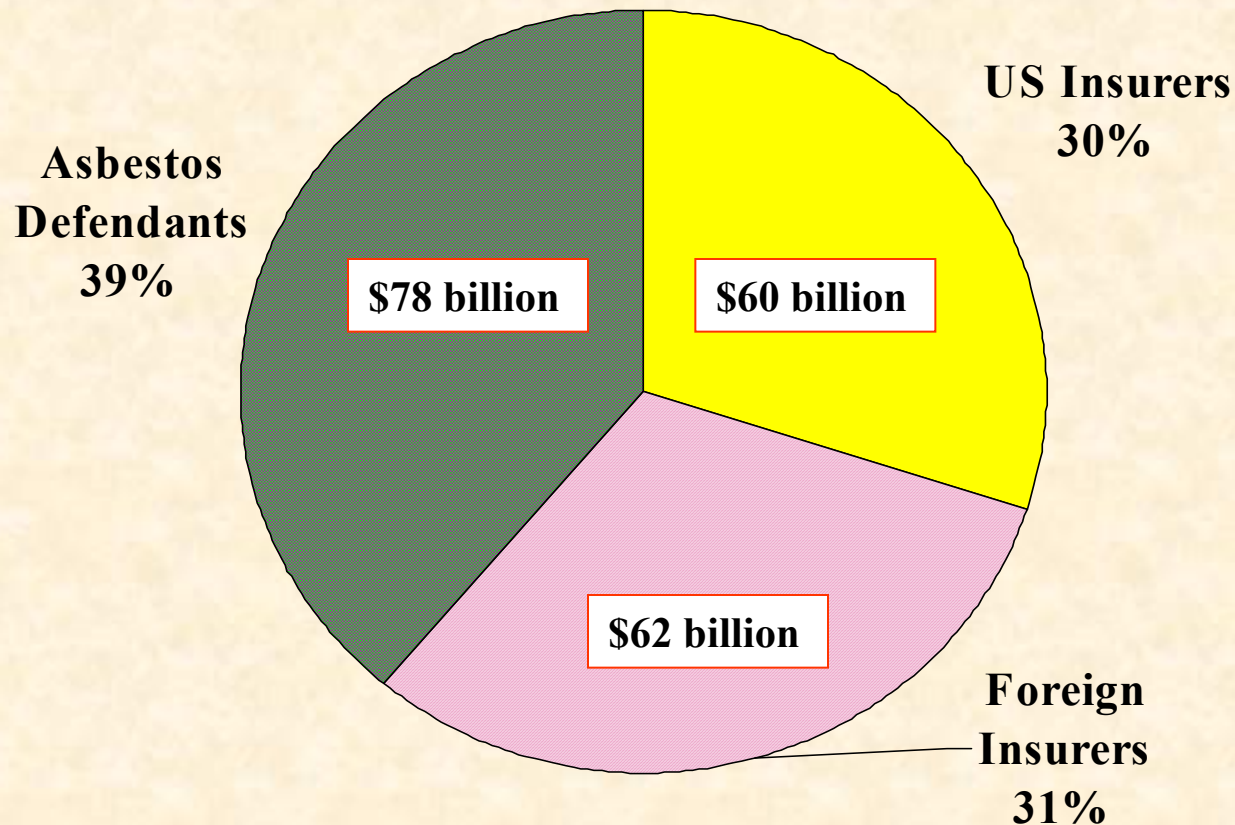


Source: Tillinghast-Towers Perrin; Insurance Information Institute estimates for 2001/2002 assume tort costs equal to 2% of GDP. 2005 forecasts from Tillinghast.



# Who Will Pay for the US Asbestos Mess?

**Estimated Total US Settlements & Expenses = \$200 billion**



Source: Tillinghast-Towers Perrin; Insurance Information Institute



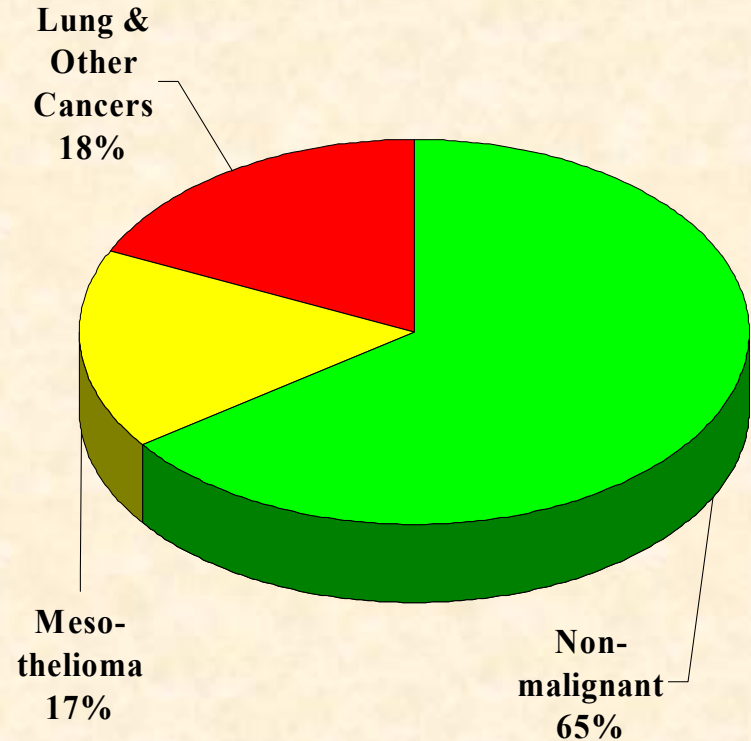
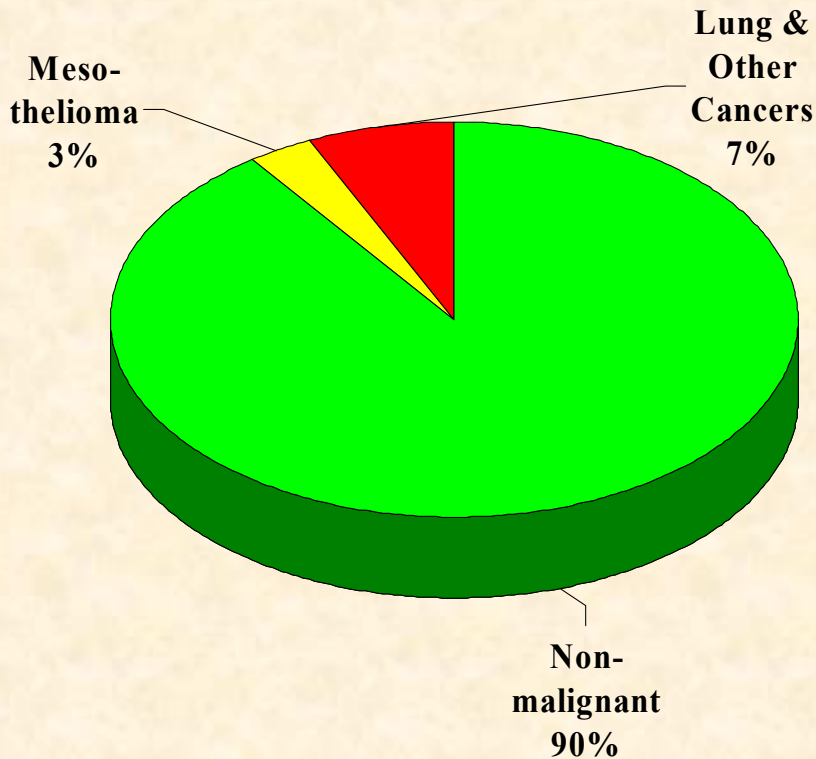
# *Non-Malignant Asbestos Claimants File Most Claims, Get Most \$\$\$*

## **DISTRIBUTION OF CLAIMS**

## **ALLOCATION OF COMPENSATION**

1991-2000

1991-2000



# *THE CHALLENGE OF TERRORISM*



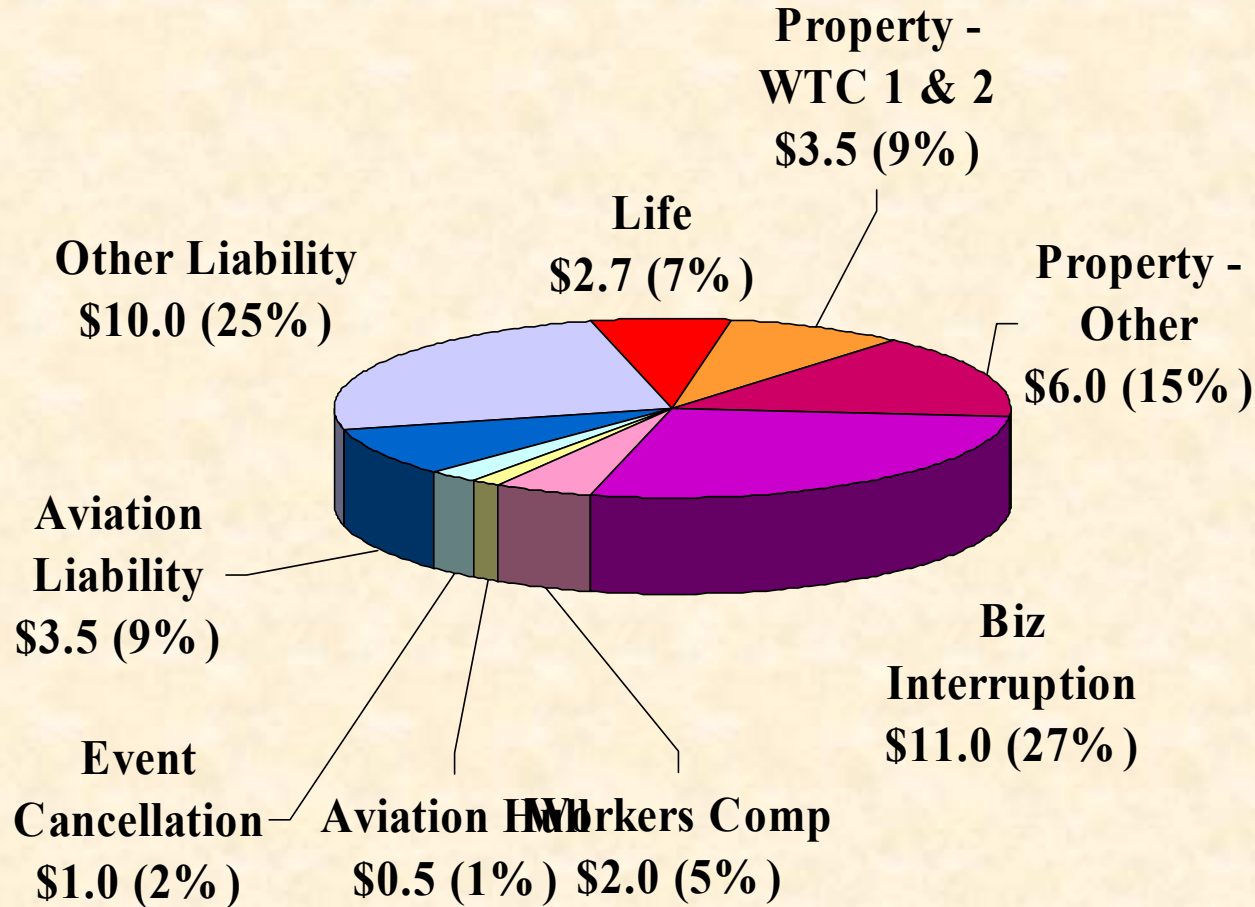
Spencer Platt / Getty Images





# Sept. 11 Industry Loss Estimates

(\$ Billions)



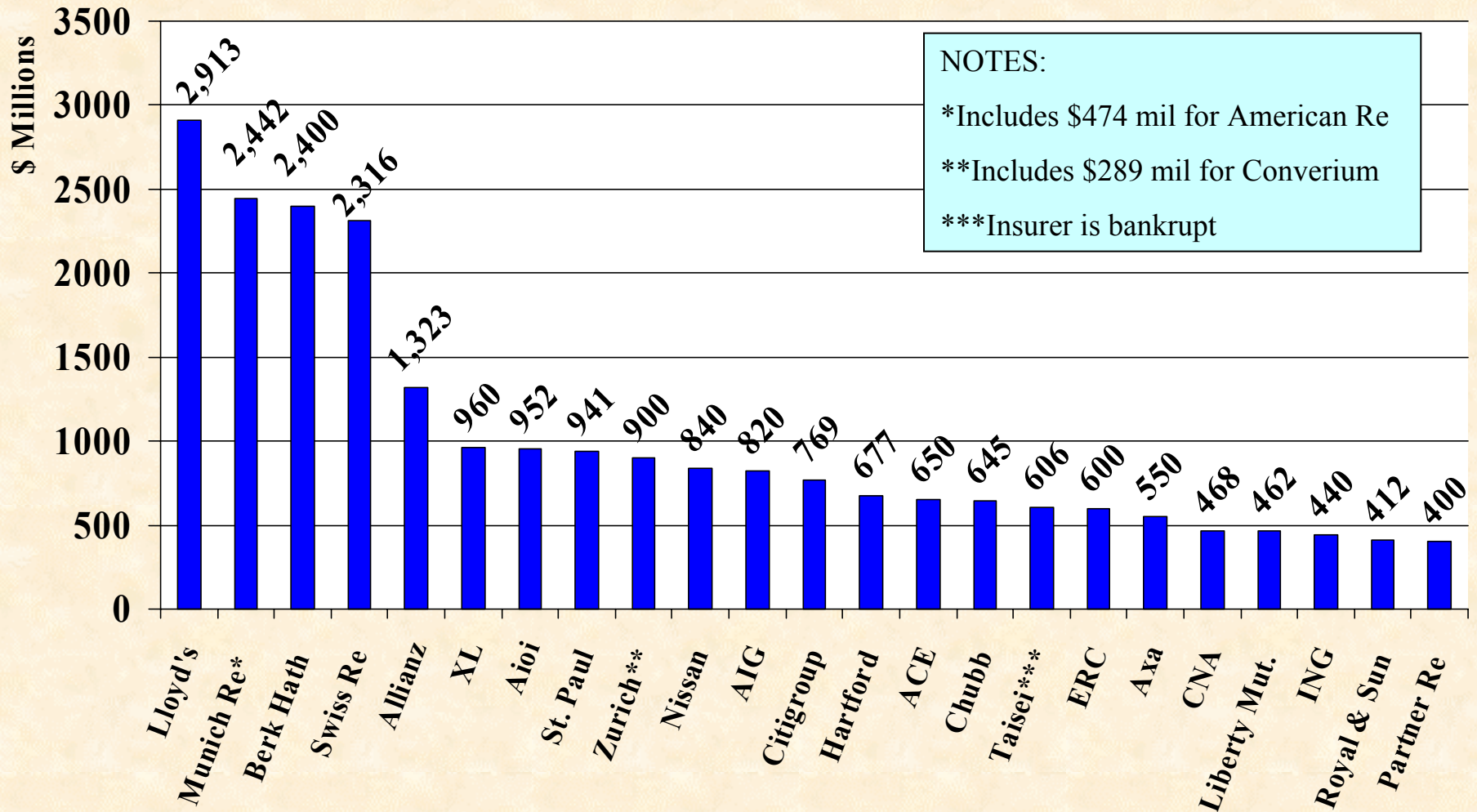
## Consensus Insured Losses Estimate: \$40.2B



# Insured Loss Estimates

(updated through September 13, 2002)

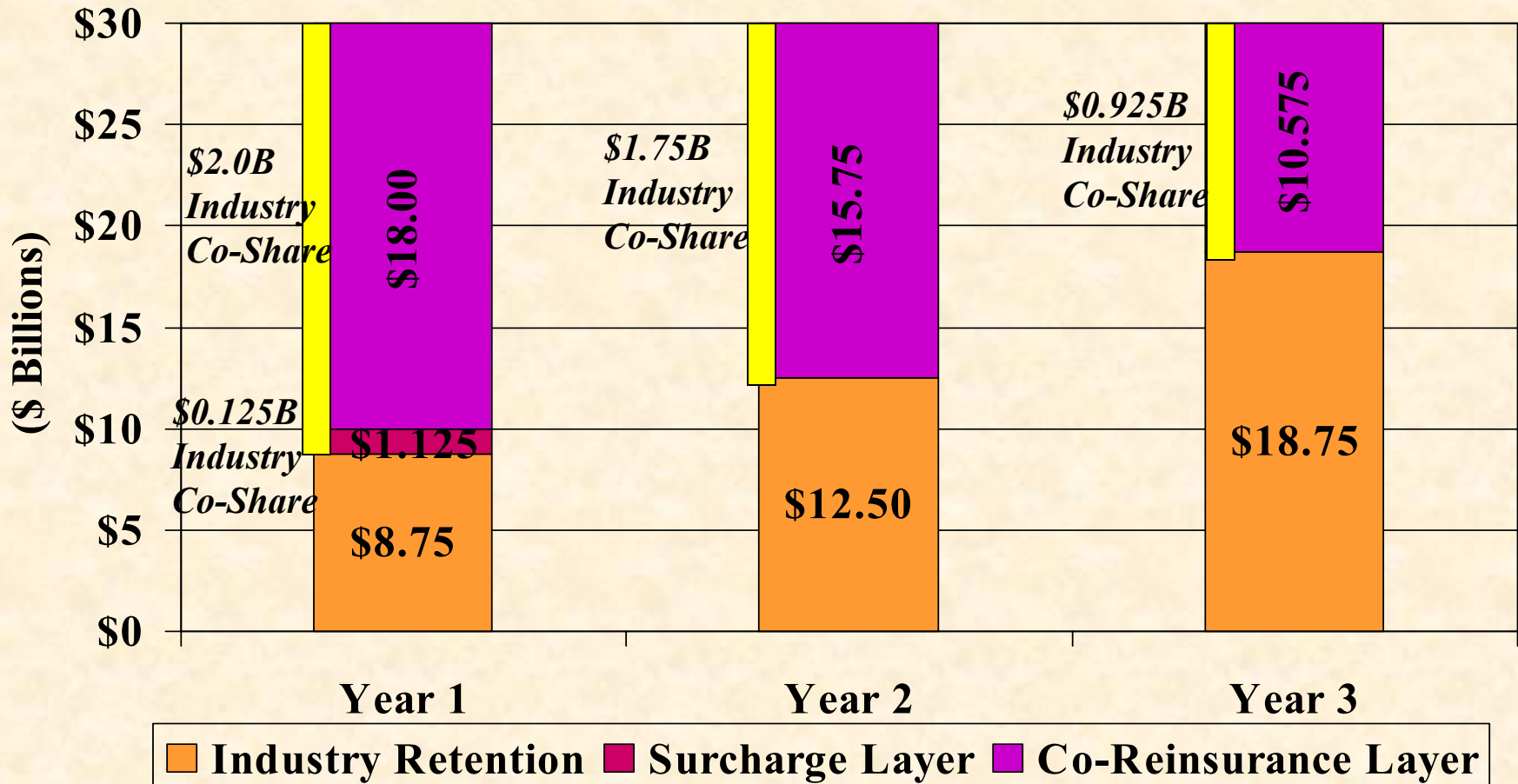
Top 20 Groups (pre-tax, net of reinsurance, \$ millions)





# Industry Losses Under Proposed Federal Backstop Using 9/11 Scenario (as proposed/interpreted as of 10/18/02)

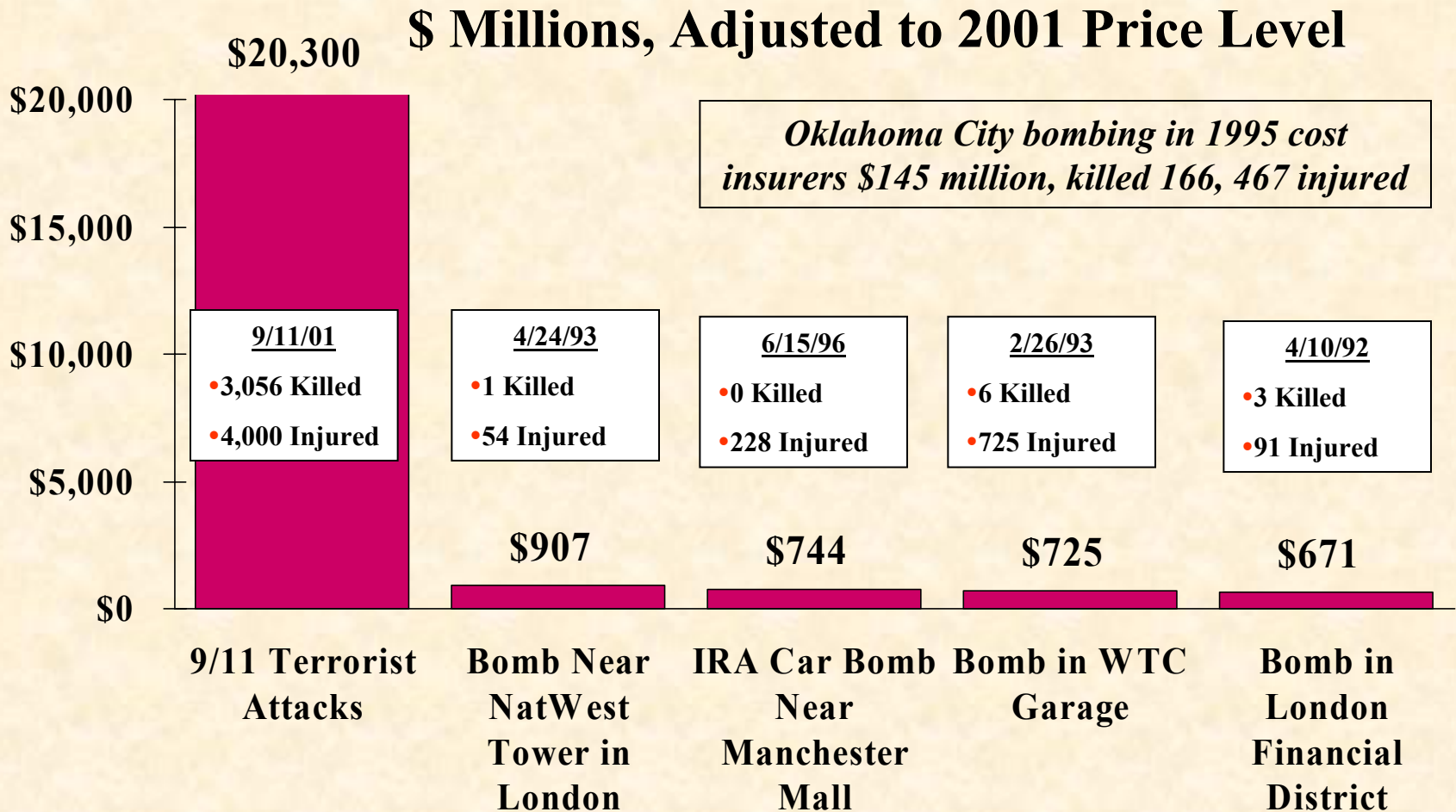
**Total Ind. Loss:** \$10.875B \$14.25B \$19.675B



**Assumes \$30B Commercial Prop & WC Loss, \$125B "At Risk" Commercial DPW**



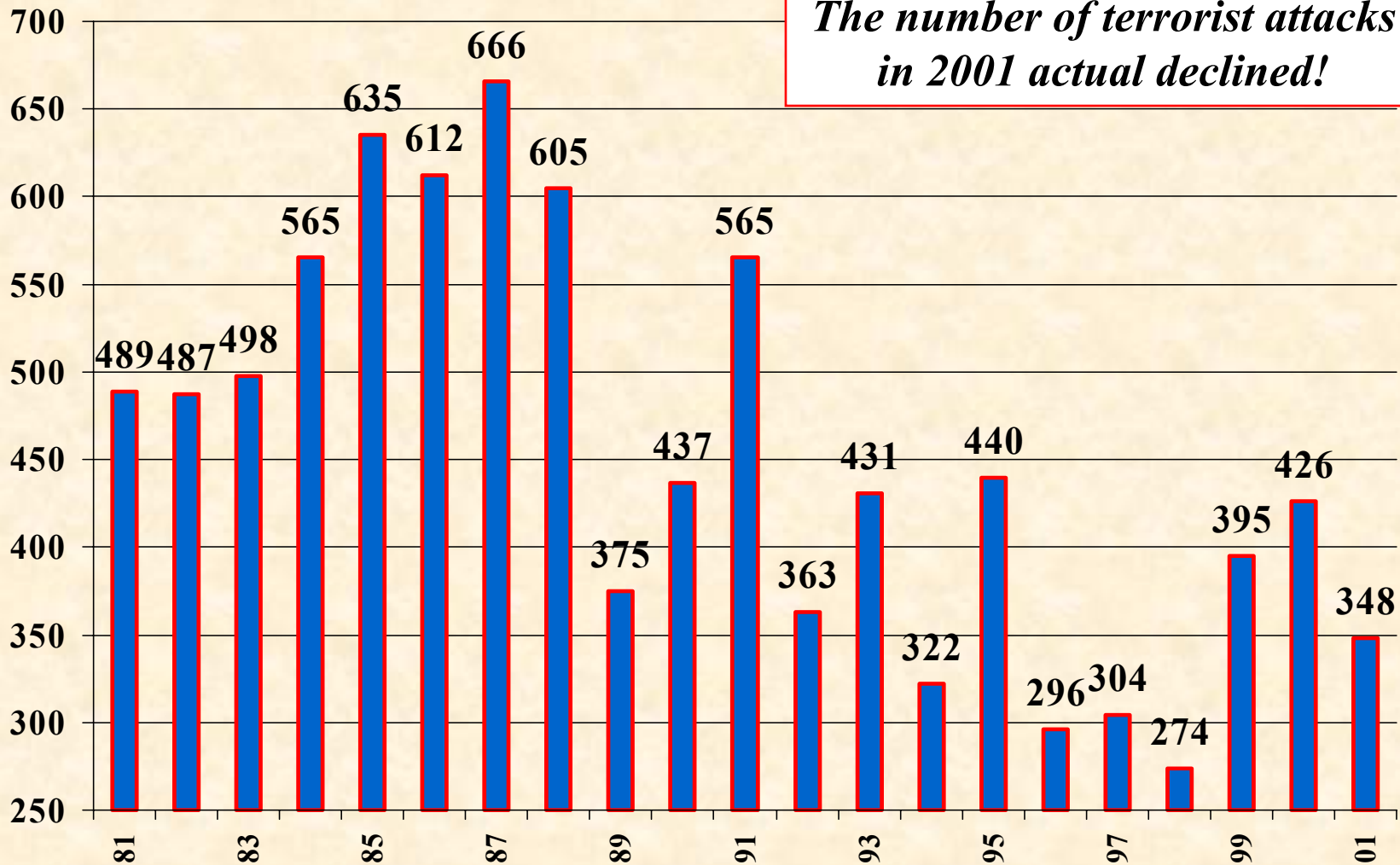
# Top 5 Costliest Terrorist Attacks (by insured property loss\*)



\*Includes business interruption and aviation hull losses.  
Source: Swiss Re; Insurance Information Institute.

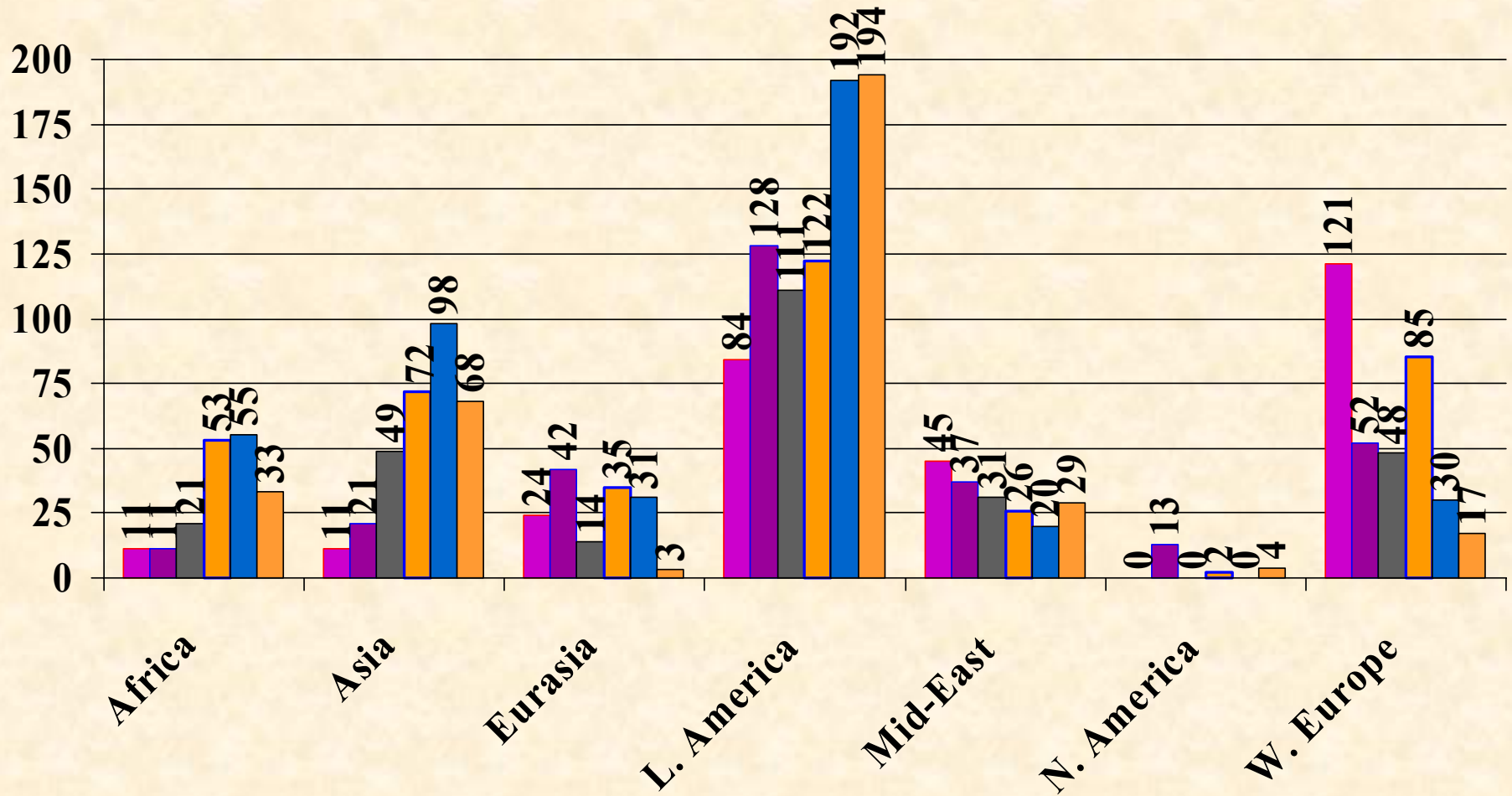


# Total International Terrorist Attacks (1981-2001)





# *International Terrorist Attacks by Region, 1996-2001*



# *ENDOGENOUS INFLUENCES*

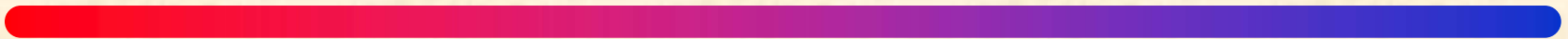
*Cyclical*

*Capacity/Capital*

*Reserve Deficiencies*

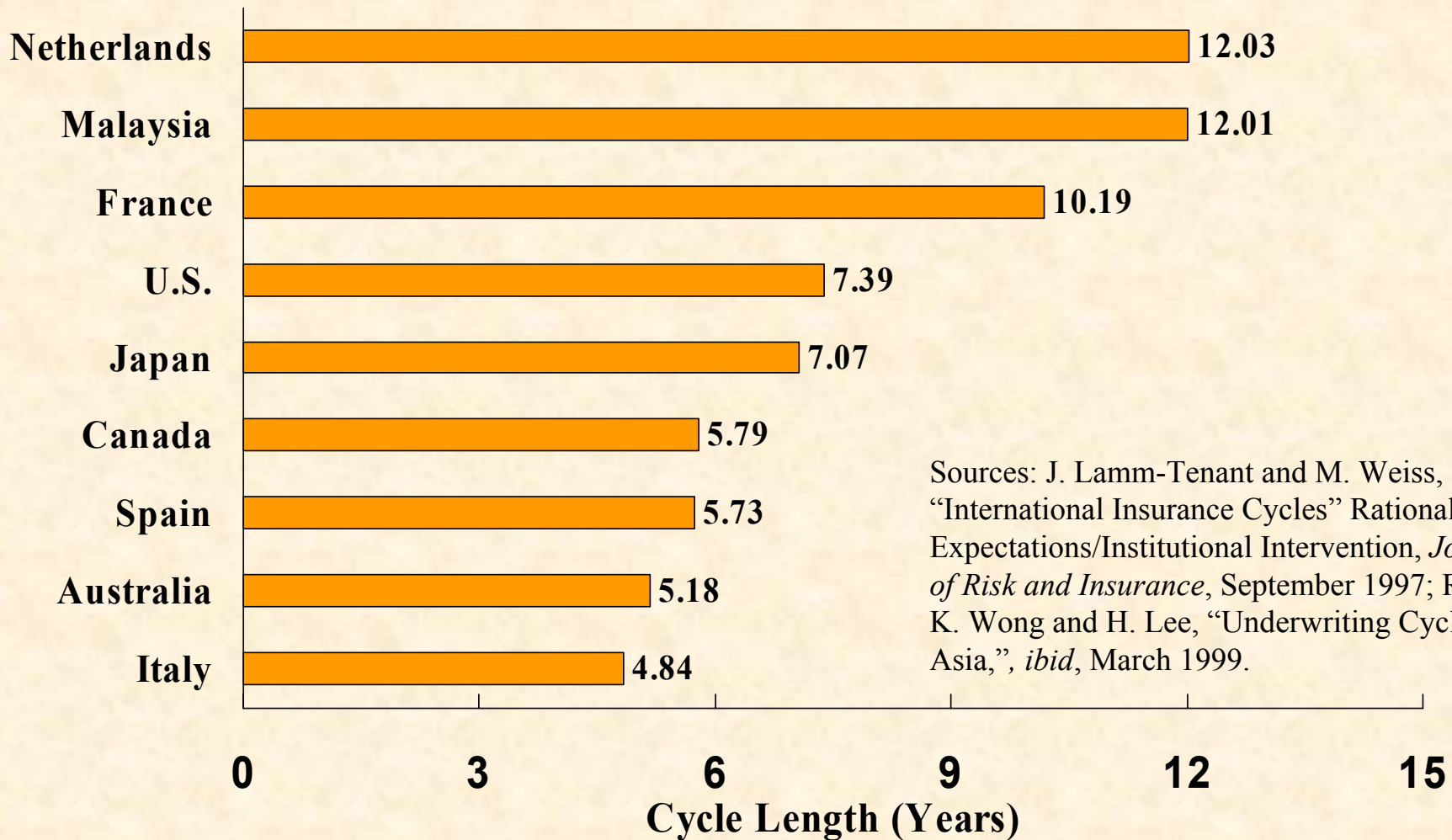
*Pricing*

*Mergers & Acquisitions*





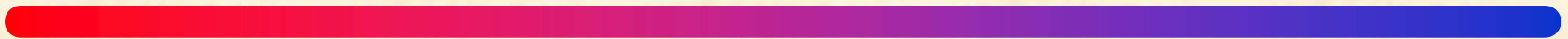
# Length of Underwriting Cycle, Selected Countries\*



Sources: J. Lamm-Tenant and M. Weiss, "International Insurance Cycles" Rational Expectations/Institutional Intervention, *Journal of Risk and Insurance*, September 1997; R. Chen, K. Wong and H. Lee, "Underwriting Cycles in Asia," *ibid*, March 1999.

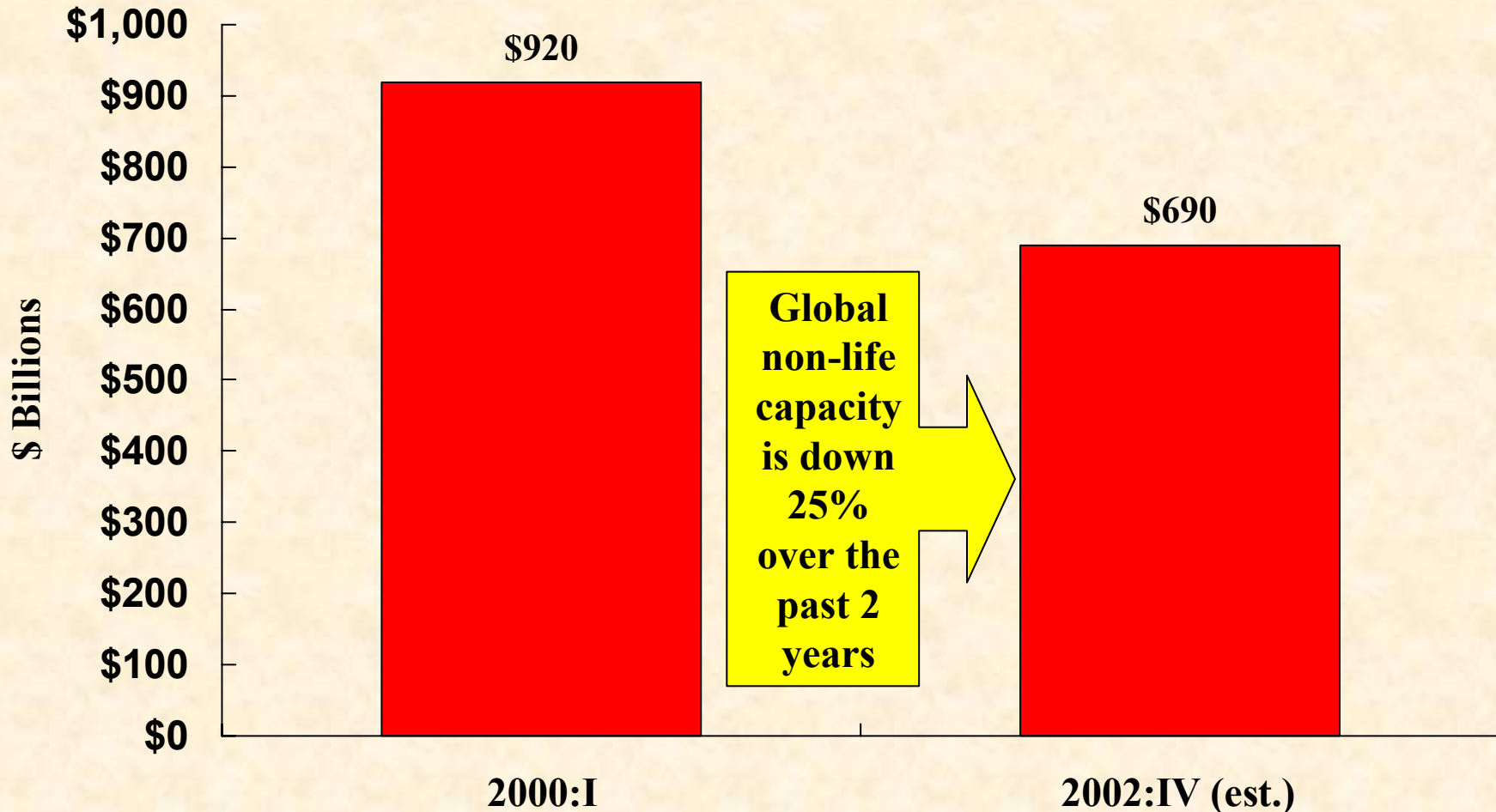
\*Study found no cycles evident in Austria, Denmark, S. Korea or Taiwan.

*RESTORE &  
REBUILD  
DESTROYED  
CAPACITY*



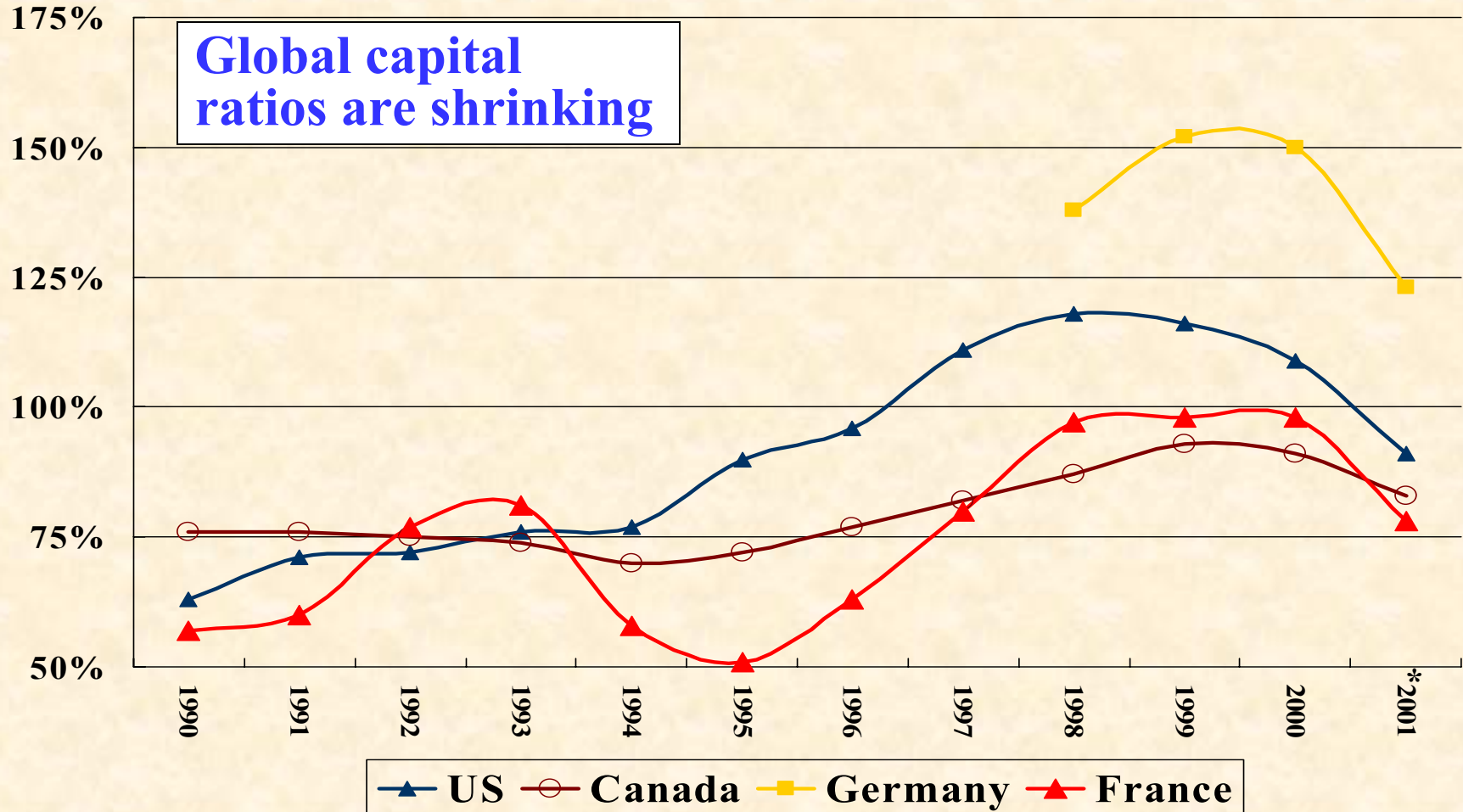


# *Global Non-Life Insurance Capacity is Falling Dramatically*



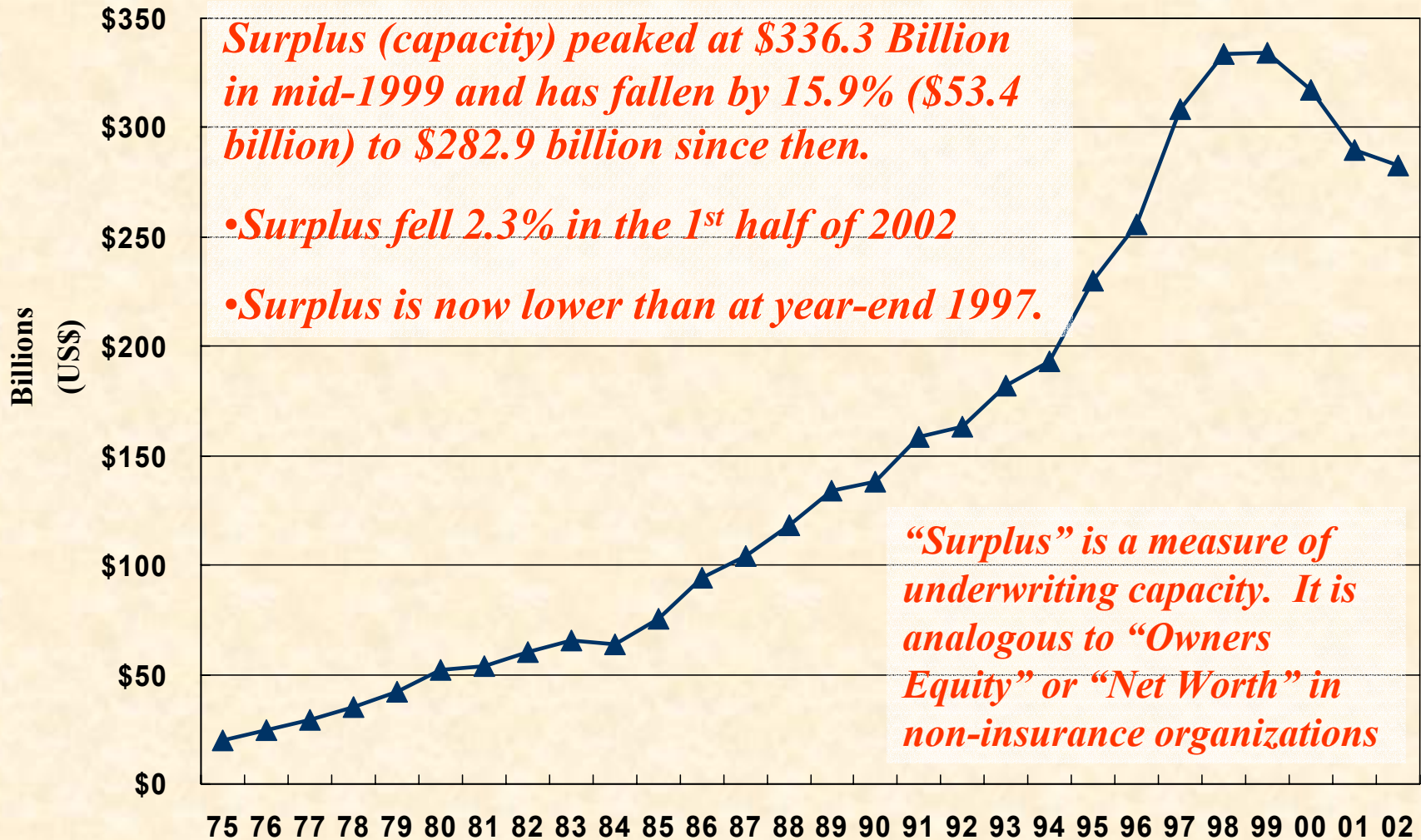


# Capital Funds as a Percentage of Net Premium





# Policyholder Surplus: 1975-2002\*



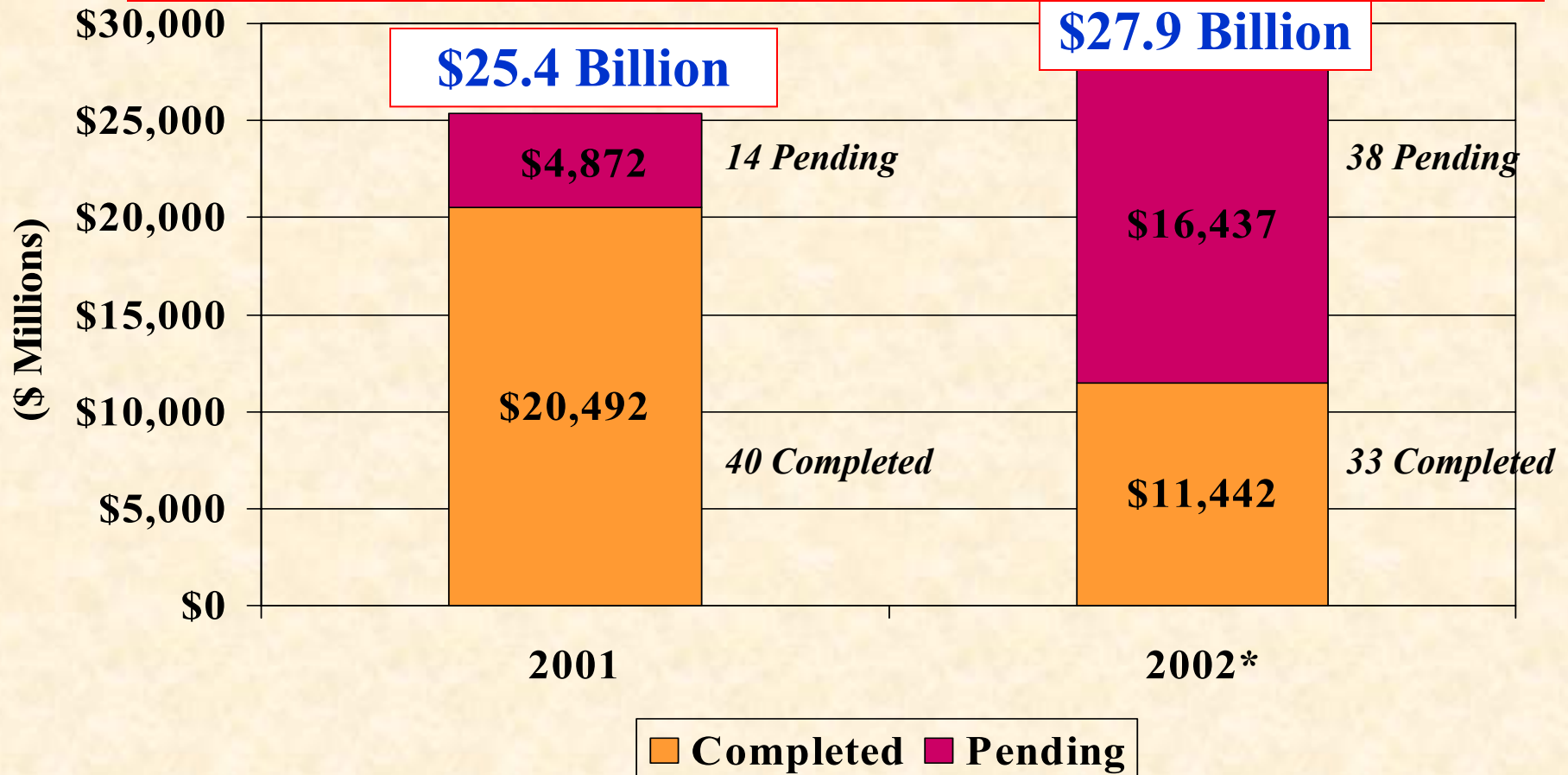
\*As of June 30, 2002

Source: A.M. Best, Insurance Information Institute



# Capital Raising by Non-Life Insurers Worldwide Since Sept. 11, 2001\*

**Capital Raising by P/C Insurers Since 9/11 Totals \$53.2B**



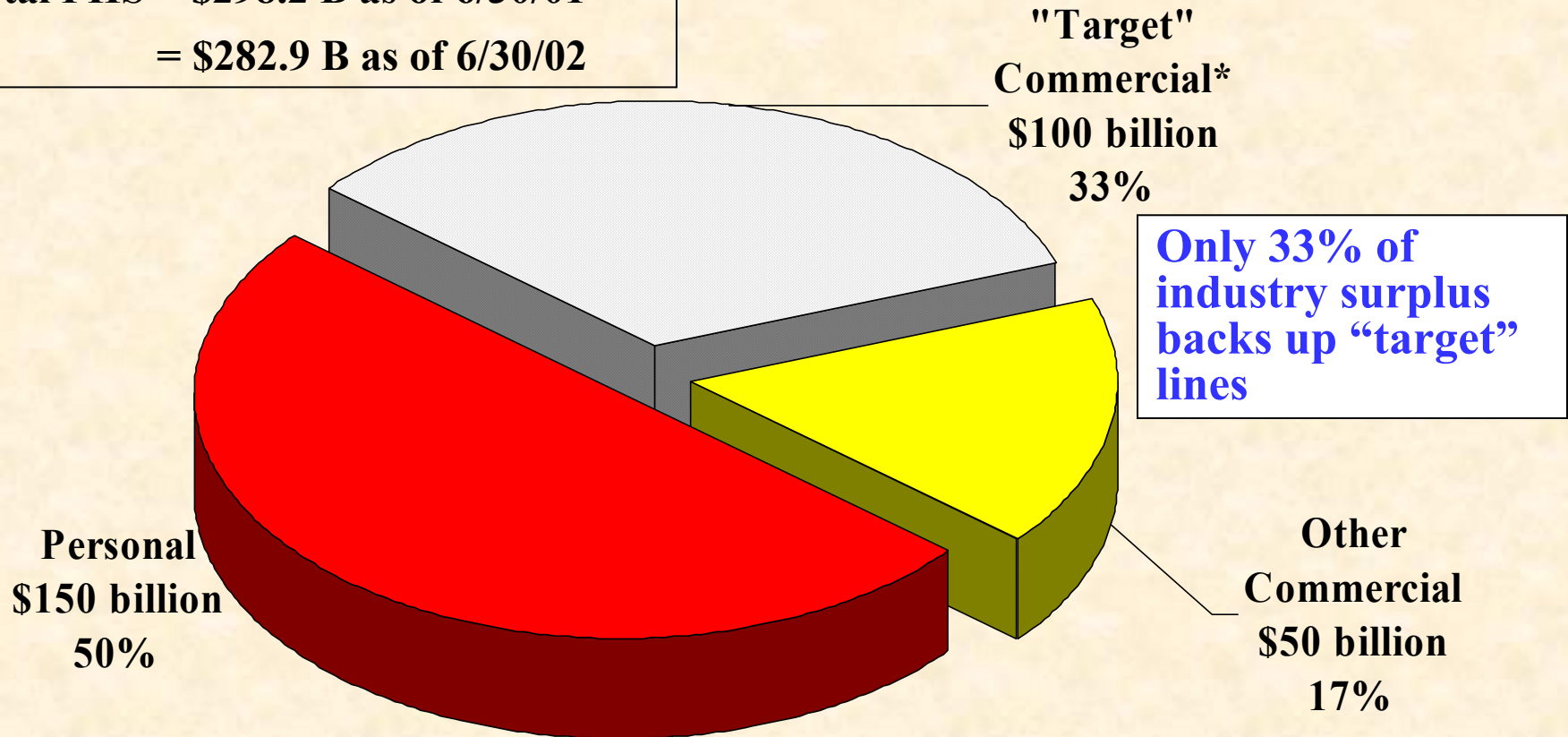
\*As of September 13, 2002.

Source: Morgan Stanley, Insurance Information Institute.



# Capital Myth: US P/C Insurers Have \$300 Billion to Pay Terrorism Claims

Total PHS = \$298.2 B as of 6/30/01  
= \$282.9 B as of 6/30/02



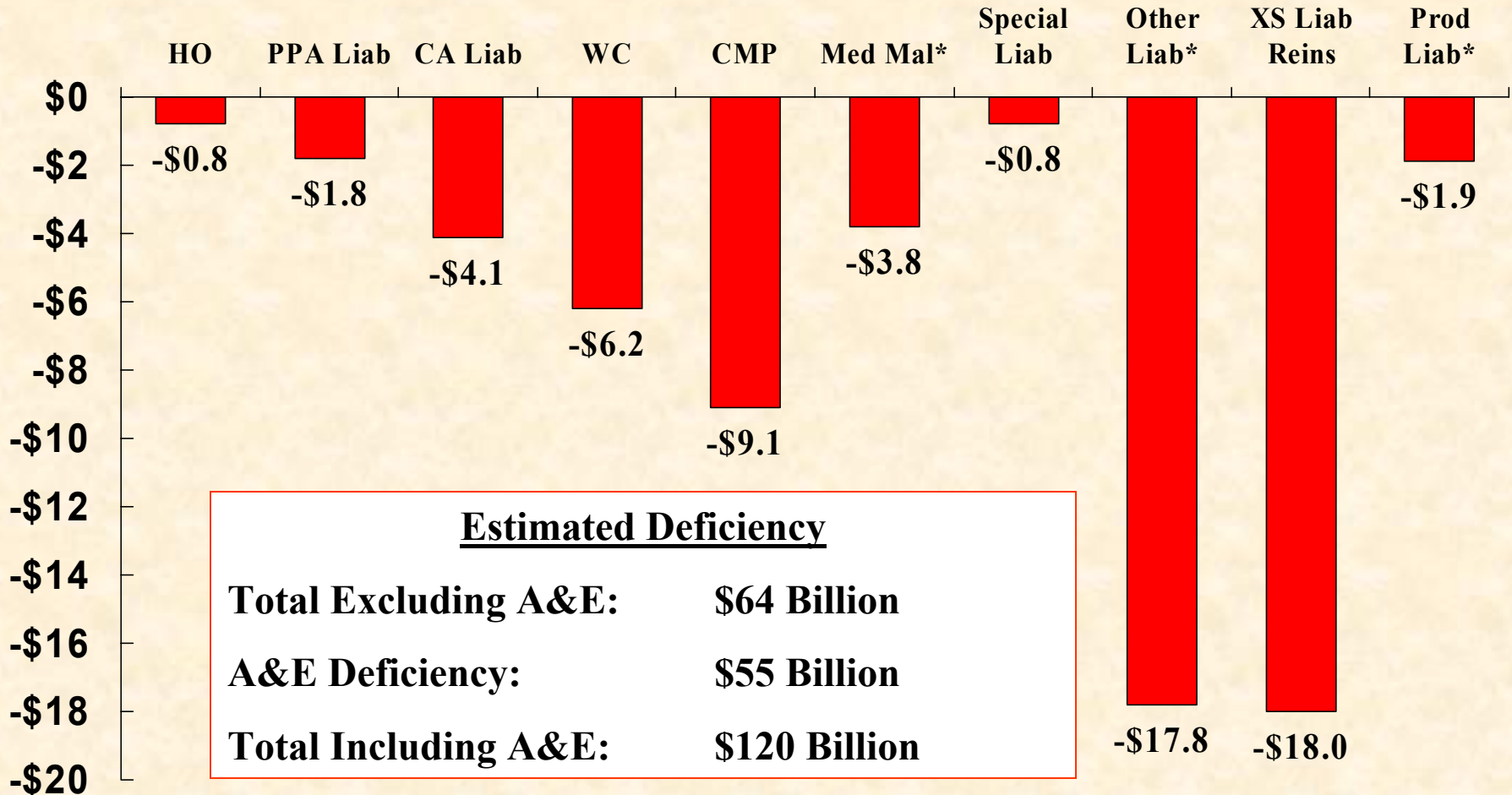
\*"Target" Commercial includes: Comm property, liability and workers comp; Surplus must also back-up on non-terrorist related property/liability and WC claims

Source: Insurance Information Institute



# U.S. Reserve Deficiency, by Line

(AY 1992-2001, as of 12/01)



\*Occurrence and claims made  
Source: Morgan Stanley



# *US: Commercial Rate Survey*

**Third Quarter 2002**

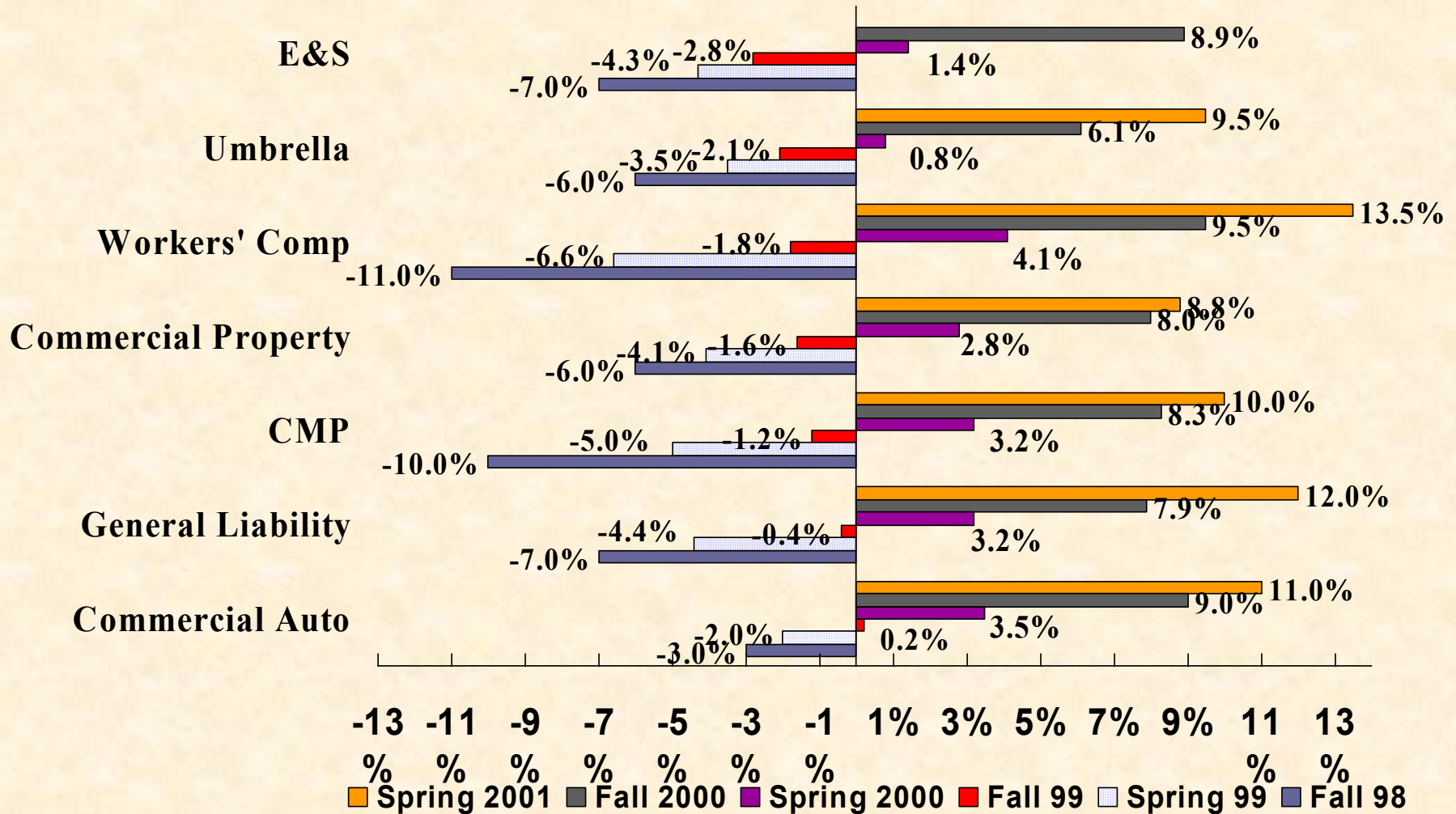
## **Rate Increases By Line of Business**

No

	<b>Change</b>	<b>Up 1-10%</b>	<b>10-20%</b>	<b>20-30%</b>	<b>30-50%</b>	<b>50%-100%</b>	<b>&gt;100%</b>
<b>Comm. Auto</b>	<b>6%</b>	<b>18%</b>	<b>37%</b>	<b>24%</b>	<b>12%</b>	<b>0%</b>	<b>0%</b>
<b>Workers Comp</b>	<b>9%</b>	<b>16%</b>	<b>27%</b>	<b>23%</b>	<b>13%</b>	<b>2%</b>	<b>0%</b>
<b>General Liability</b>	<b>8%</b>	<b>13%</b>	<b>38%</b>	<b>28%</b>	<b>9%</b>	<b>1%</b>	<b>0%</b>
<b>Comm. Umbrella</b>	<b>4%</b>	<b>9%</b>	<b>12%</b>	<b>27%</b>	<b>27%</b>	<b>11%</b>	<b>5%</b>
<b>D&amp;O</b>	<b>4%</b>	<b>9%</b>	<b>21%</b>	<b>16%</b>	<b>18%</b>	<b>16%</b>	<b>3%</b>
<b>Comm. Property</b>	<b>8%</b>	<b>9%</b>	<b>30%</b>	<b>23%</b>	<b>21%</b>	<b>5%</b>	<b>0%</b>
<b>Business Interr.</b>	<b>13%</b>	<b>17%</b>	<b>31%</b>	<b>20%</b>	<b>6%</b>	<b>2%</b>	<b>0%</b>
<b>Surety Bonds</b>	<b>16%</b>	<b>13%</b>	<b>17%</b>	<b>20%</b>	<b>2%</b>	<b>0%</b>	<b>1%</b>
<b>Med Mal</b>	<b>5%</b>	<b>3%</b>	<b>5%</b>	<b>6%</b>	<b>17%</b>	<b>11%</b>	<b>19%</b>



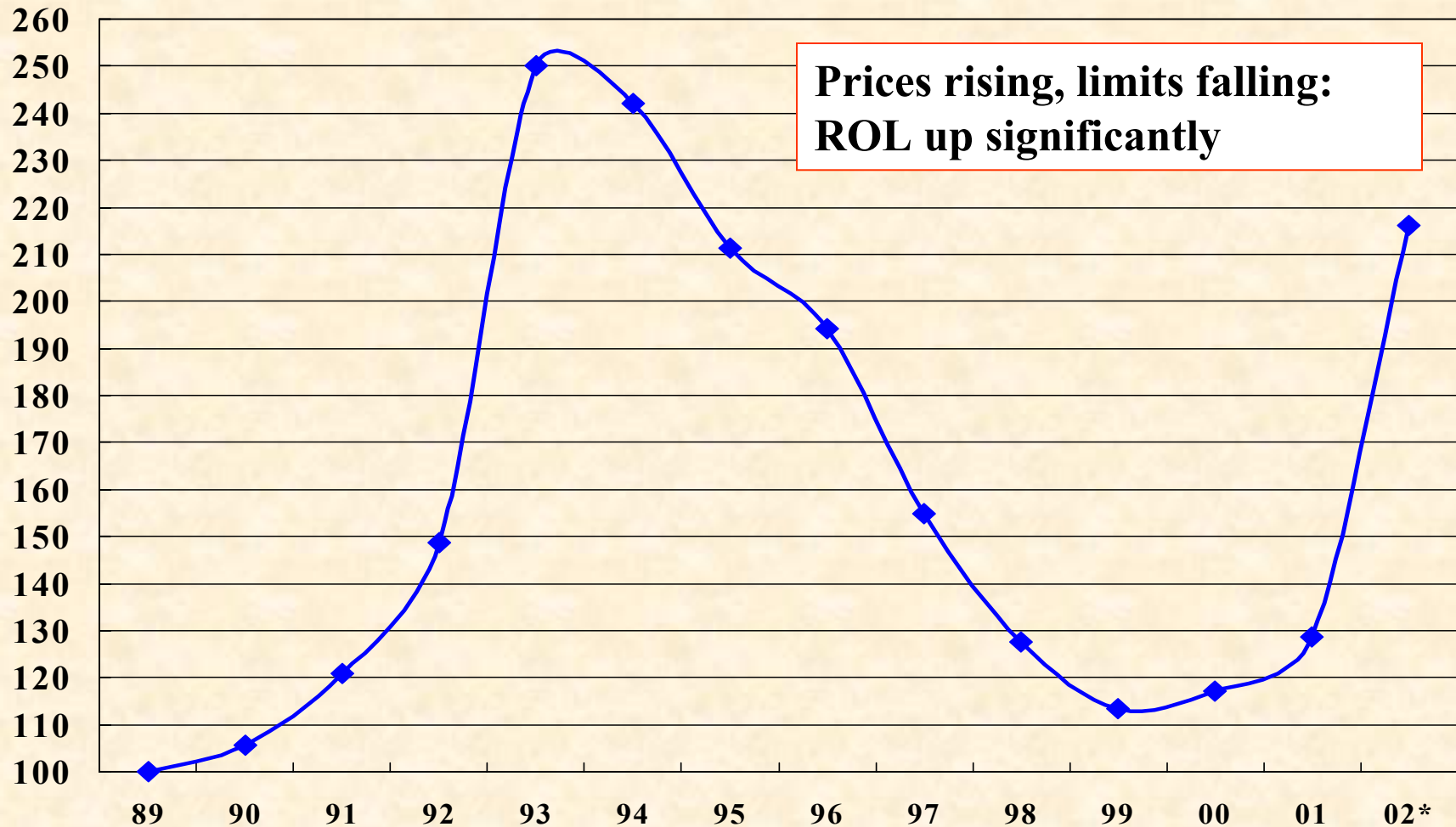
# US: Average Price Change of Commercial Insurance Renewals (Pre-9/11)



Source: Conning



# Rate On Line Index (1989=100)

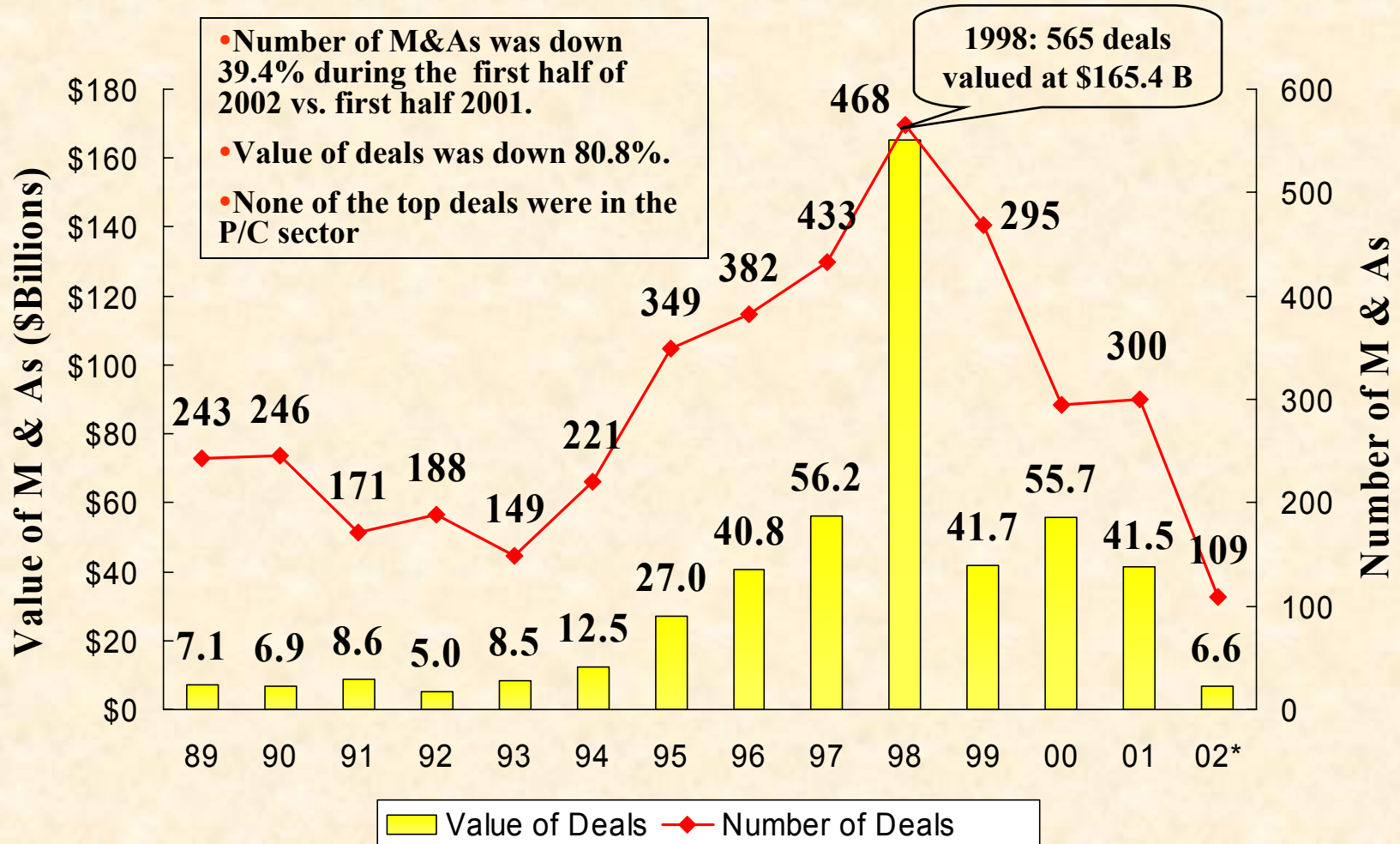


Source: Guy Carpenter

\* III Estimate



# Insurance Mergers and Acquisitions



Source: Compiled from Conning & Company reports.



*Insurance Information  
Institute On-Line*

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