Competitive Conditions in Global Property and Casualty (P&C) Insurance Markets

Written Statement of

Robert P. Hartwig, Ph.D., CPCU

President

Insurance Information Institute

New York, NY

United States International Trade Commission

Investigation No. 332-499

Washington, D.C.

October 2, 2008

Tel: (212) 346-5520
Email: bobh@iii.org
www.iii.org

The Insurance Information Institute (I.I.I.) is an insurance trade association based in New York City whose primary mission is to improve the public's understanding of insurance: what it does and how it works. Our members consist of insurers and reinsurers that operate on a global scale and account for more than 60 percent of the premiums written in the United States.

Thank you for the opportunity to provide a written statement to the United States International Trade Commission on competitive conditions in global property/casualty (P/C) markets.

The Property/Casualty Insurance Market: How It Operates

The property/casualty (auto, home and commercial) insurance marketplace is a dynamic, competitive and global business and an integral component of the global financial services sector. As Figure 1 shows, world insurance premiums for non-life (property/casualty) business totaled $1.7 trillion in 2007, up 7.7 percent from $1.5 trillion in 2006. The United States accounted for 39 percent, or $651.3 billion of this total.[1]

Despite slower economic growth and rising inflation, in 2007 profitability and premium growth were strong in the global insurance industry. While life insurance sector growth accelerated in 2007, non-life premium growth was slower and profitability eased slightly due to the highly competitive market conditions. Non-life premiums increased by 0.7 percent in real terms in 2007, compared with 5.4 percent growth in life premiums.[2] Emerging markets continued to experience higher non-life premium growth than industrialized markets.

Reinsurance, which is effectively insurance for insurance companies, plays a critical role by increasing capacity in the global insurance marketplace, allowing risks to be spread more widely (literally around the world) and offering protection against catastrophic losses. The top 10 global reinsurers wrote net reinsurance premiums of $118.9 billion in 2007, up from $101.1 billion in 2006. The top two global companies

[1] Swiss Re, sigma No 3/2008
[2] Ibid, 1.

(Munich Re and Swiss Re) accounted for nearly 50 percent of premiums written by the top 10 (See Figure 2).

The financial services sector is vast and the property/casualty insurance industry comprises a large part of that sector in the United States. The assets of the U.S. financial services sector grew by 9 percent to $60.4 trillion in 2007, of which the insurance sector accounted for $6.3 trillion (10 percent).[3] More than one-third (37 percent) of employment in the U.S. financial services sector in 2007 was with insurance carriers and related activities.

The highly competitive nature of the insurance business is due in part to the fact that there are such a large number of companies. Some 2,648 property/casualty insurance companies and 1,257 life/health insurance companies were operating in the United States in 2006. Many of these companies were part of larger global financial entities.

Financial assets of property/casualty insurers totaled $1.4 trillion in 2007.[4] The portfolio is conservatively invested. In 2007 alone, property-casualty insurers' investment in municipal bonds totaled $368.7 billion. Figure 3 shows that the top 10 U.S. writers of property/casualty insurance wrote some $243 billion in direct written premiums in 2007.

Economic Effects of Trade in P/C Insurance

Insurance plays an integral role in world trade and underpins the functioning and development of both global and national economies. Tens of thousands of property/casualty insurance policies in place today support a broad range of global economic activities, from major building construction projects, to financial transactions and transportation operations.

In April 2008 the World Trade Organization (WTO) reported that the world trade growth rate fell to 5.5 percent in 2007, from 8.5 percent in 2006 – and predicted even slower growth in 2008, at about 4.5 percent. The WTO noted that the financial market

[3] Insurance Information Institute (I.I.I.) Fact Book 2008
[4] Board of Governors of the Federal Reserve System, June 5, 2008

turbulence, which has considerably reduced economic growth projections for some major developed markets, has clouded the prospects for world trade in 2008.

Deteriorating conditions in world trade and the economy can have a substantial impact on property/casualty insurers. Fast forward to September 2008, and the unraveling of the financial markets has uncovered a range of economic risks with certain implications for the insurance sector.

The subprime meltdown and broader credit crisis has had a limited impact on certain individual property/casualty insurers. Some insurers have exposure to this issue on the asset side of their business resulting from subprime-related investments. Some directors' and officers' (D&O) and errors' and omissions' (E&O) exposure also exists for certain insurers.

However, a number of insurers in recent months have reported substantial losses stemming from the credit crisis in the financial sector. For example, American International Group (AIG) suffered a liquidity crisis *at the holding company level* due to large positions, mostly associated with credit default swaps (CDS), and related to mortgage debt through its London-based AIG Financial Products division. In mid-September 2008, the Federal Reserve ultimately agreed to lend AIG $85 billion to prevent its bankruptcy. As part of the agreement, the Fed gets a 79.9 percent stake in AIG. It should be noted that AIG's separately rated insurance subsidiaries were solvent at all times and met local capital requirements in all jurisdictions.[5]

In general, periods of slower economic growth or recession may have a number of implications for insurers, for example a reduction in overall exposure growth for commercial insurers. In a period of economic decline it becomes more challenging for insurers to add new insured exposures (such as vehicles, homes, office buildings, etc.). As Figure 4 shows, over time there is a modest association between the property/casualty insurance industry's premium growth and the overall growth in the economy. Through the first half of 2008, the property/casualty industry's premium growth remains negative, unchanged from the -0.6 percent recorded in 2007, while forecast real GDP growth is stalling at 1.6 percent.

---

[5] AIG press releases and regulator statements.

Rising inflation also may lead to an increase in claims (property and liability) costs for insurers, as the price of goods and services increase. It also has the potential to expand the probable and possible maximum losses for insurers, due to increased costs of supplies and labor to rebuild or repair properties in the event of loss.

Meanwhile, sharp declines in stock prices and falling interest rates translate into decreased capital gains and lower investment income for insurers. Property/casualty insurance companies make a major contribution to the economy through their investments. Property/casualty insurers doing business in the United States in 2007 had $1.1 trillion invested in the economy, via stocks and bonds. U.S. insurers hold a large percentage of their investments in the form of bonds to protect their assets against precipitous stock market declines. Typically, about two-thirds of total investments are in bonds and about one-fifth are in common stock.

Other economic factors that may affect insurers include problems in the housing market and employment. For example, the I.I.I. estimates that each incremental 100,000 decline in housing starts costs home insurers $87.5 million in new exposure (gross premium).[6] An increase in the U.S. unemployment rate and weakening wage and salary growth will have an impact on payroll sensitive property/casualty lines of insurance, such as workers compensation.

Competition in the Property/Casualty Industry

Competition is a hallmark of the property/casualty insurance industry. As previously noted, some 2,648 property/casualty insurers were operating in the United States in 2006. The overall large number of companies, which includes many relatively small-sized players, keeps the market competitive.

The top 10 U.S. writers of property/casualty insurance wrote some $243 billion in direct written premiums in 2007. As Figure 5 indicates, three of those companies – Berkshire Hathaway, American International Group (AIG), and State Farm – were also among the top 10 global insurers by revenues in 2007.

[6] "The Financial Crisis and the P/C Insurance Industry: Challenges Amid the Economic Storm", by Dr. Robert Hartwig, president, I.I.I., September 23, 2008.

This illustrates the point that while U.S. insurers hold a financially strong and competitive position in the domestic insurance market, a number are also major participants in the global insurance market. Economies of scale and the wide range of products they offer enable them to compete successfully at the international level. Price – a key concern among insurance buyers – is another factor that keeps the market competitive.

The property/casualty insurance market is cyclical. Soft market cycles are characterized by increasing competition and decreasing prices as companies compete vigorously to increase market share. As the market softens to the point that profits diminish or vanish completely, the capital needed to underwrite new business is depleted.

Hard markets are characterized by decreasing competition and rising prices. Underwriting standards become more stringent, the supply of insurance is limited due to the depletion of capital and, as a result, premiums rise. The prospect of higher profits draws more capital into the marketplace leading to more competition and the inevitable down phase of the cycle.

While the property/casualty insurance market is intensely competitive, it is important to recognize that sound underwriting plays a critical role in making insurance available and affordable, and in keeping insurers strong enough to pay claims when their insureds suffer a loss. For these reasons an insurer’s underwriting policy has to be competitive with other insurers and at the same time provide an adequate level of profitability for the company.

Factors Affecting Supply and Demand of Property/Casualty Insurance

A number of factors affect both the supply and demand of property/casualty insurance. Given the size and competitive nature of the market it might appear that the supply of insurance is virtually unlimited. In general, however, the supply of insurance is limited by two key factors: the insurer’s perception of risk in relation to profit and the insurer’s capacity to assume new business.

As noted previously, insurers must remain competitive within the market but at the same time remain profitable. Insurers may not be willing to accept business for which they do not expect a reasonable profit or that involves unpredictable levels of risk that cannot be accurately priced. Insurers' ability to charge a premium commensurate with the risks assumed and to earn a reasonable profit may also be limited due to political/regulatory constraints. Competition in the market also plays a role.

Capacity, or the amount of insurance an insurer is able to write, is limited by financial requirements to maintain adequate levels of surplus in relation to premiums. Regulators and ratings agencies closely monitor an insurer's financial position and whether there are adequate funds available to pay claims. These requirements, which may differ significantly by country, will limit an insurer's ability to grow rapidly in a new market.

Another factor affecting supply is an individual company's resources. A company must have the physical and human capacity to handle the business it writes. Facilities need to be located appropriately to service customers, backed by an information systems infrastructure and staffed by employees with the relevant skill set and knowledge for that particular market.

A number of key factors affect the demand for insurance, including the size of the overall market, price and demographics. In developed countries, the market demand for insurable products such as auto, home and commercial building insurance may have reached saturation point. In developing countries, where the market penetration for insurance tends to be lower, individual wealth and whether or not there is a need to protect assets will affect the insurance purchasing decision.

Another factor affecting the demand for insurance is price. For insurance buyers faced with a choice of insurer price may be a determining factor, if no clear distinctions exist between the various companies offering the coverage. A range of alternatives to insurance, such as self-insurance, retention programs, captive insurers, and catastrophe bonds, also exists for individuals and businesses looking to handle their risks in different ways. As the cost of insurance increases, some of these alternatives may become more appealing.

Changing demographics such as increasing life expectancy will lead to increased demand for certain types of insurance, such as retirement products, annuities, and life insurance. Population shifts to certain parts of the world, coupled with the rising potential for catastrophic loss events like hurricanes and terrorism also have a significant impact on the shape of the global insurance market in terms of availability and affordability.

Insurance rules and regulations affect both supply and demand. For example, in the United States, there are state financial responsibility requirements on auto owners and operators. Those requirements can be met to a large extent by the purchase of auto liability insurance. Workers' compensation is also a compulsory coverage for virtually all businesses in the U.S. – most companies have no choice but to purchase the coverage.

The state-based system of insurance regulation in the U.S. that requires each insurer to obtain a license and file an annual financial statement in each state in which it operates is another factor that may affect supply and demand. At the global level, increased regulatory scrutiny of insurers and the financial services sector as a whole can be expected in the wake of the recent credit crisis. This is likely to lead to the introduction of new regulations, some of which may affect the insurance sector.

Foreign Markets for P/C Insurance

In recent years substantial progress has been made in opening foreign markets to property/casualty insurers. Today significant numbers of insurers participate in foreign markets in many different ways. Companies may engage in exporting, establish licensing agreements, or own and control assets in a foreign country via foreign direct investment (FDI).

Like any other industry, property/casualty insurers considering global expansion analyze the global environment in which they intend to do business to establish what products could be offered and what distribution channels should be used. General factors that may be considered include the level of economic stability, monetary policies, the prevailing attitude toward foreign investors and the potential for exchange-rate volatility. The culture and customs of a particular country and the regulatory and political environment are other considerations.

While the insurance market is a global business that is based upon the transfer and spread of risk by businesses and individuals around the world, limitations on foreign direct investment or ownership, may hinder this ability. As a result, insurers may decide not to invest in a specific country or region, or to cease developing their business in a particular market. Ultimately, this reduces the choice and availability of insurance for their customers. It also has an impact on regional and local economies.

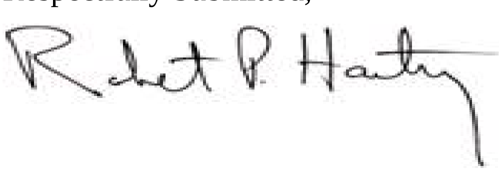
Large, sophisticated business insurance customers may require complex multi-national insurance solutions that cover multiple countries and risks under one umbrella. Typically such insurance policies are issued on a global, non-admitted basis. To the extent that a level playing field between local and foreign insurers does not exist, that can be an impediment to developing insurance solutions that are relevant to global enterprises.

In addition, if risks are required to be written on a local basis, this may hinder the development of global insurance coverage that would properly protect a company's worldwide exposures. It may also impact the insurance claims-paying process, potentially slowing the timely payment and settlement of claims.

Conclusion

The global nature of the property/casualty insurance business enables the transfer and spread of risk ensuring that sufficient funds will be available to pay claims to businesses and individuals in the event of loss. In recent years the pace of growth in global operations by insurers has accelerated as markets have opened and barriers to trade have reduced. Going forward, a continuing focus on transparent, open markets and a lowering of trade barriers will be required to ensure that the property/casualty insurance market remains competitive and that its products are available and affordable.

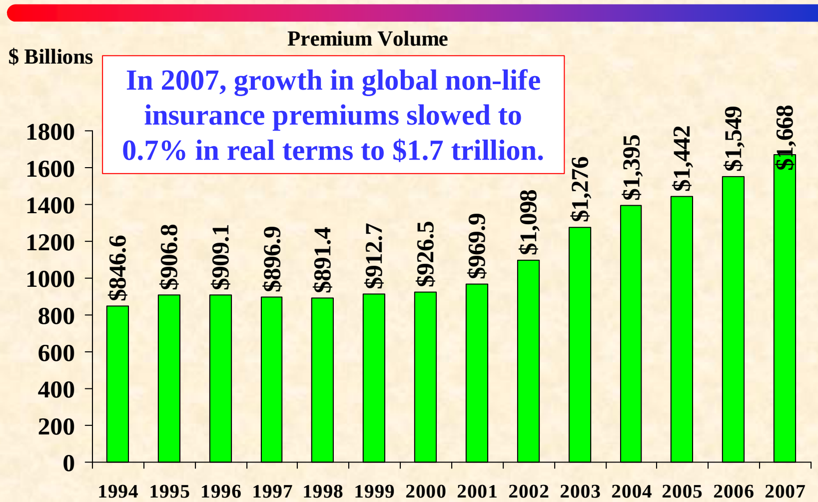
Respectfully Submitted,



Dr. Robert Hartwig, PhD, CPCU
President, Insurance Information Institute

Figure 1.

World Non-Life[1] Insurance Premium Volume 1994-2007

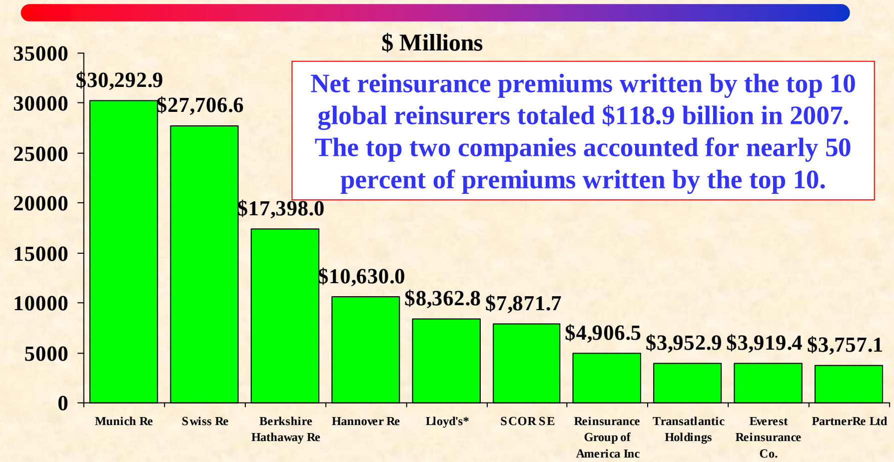


[1]Includes accident and health insurance.

Source: Swiss Re, *sigma*, various issues.

Figure 2

Top Ten Global Reinsurers, By Net Reinsurance Premiums Written, 2007

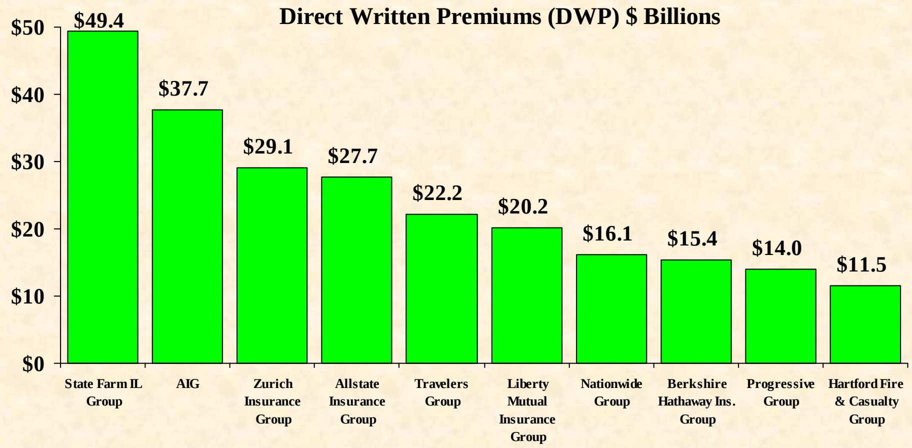


*Based on published pro-forma accounts for the market, which represent an aggregation of all syndicates participating at Lloyd's. As a result, some premium included for Lloyd's may also be included by other groups in this list that consolidate their Lloyd's operations.

Source: Standard & Poor's

Figure 3

Leading U.S. Writers of P/C Insurance By DWP, 2007 ($ Billions)[1]

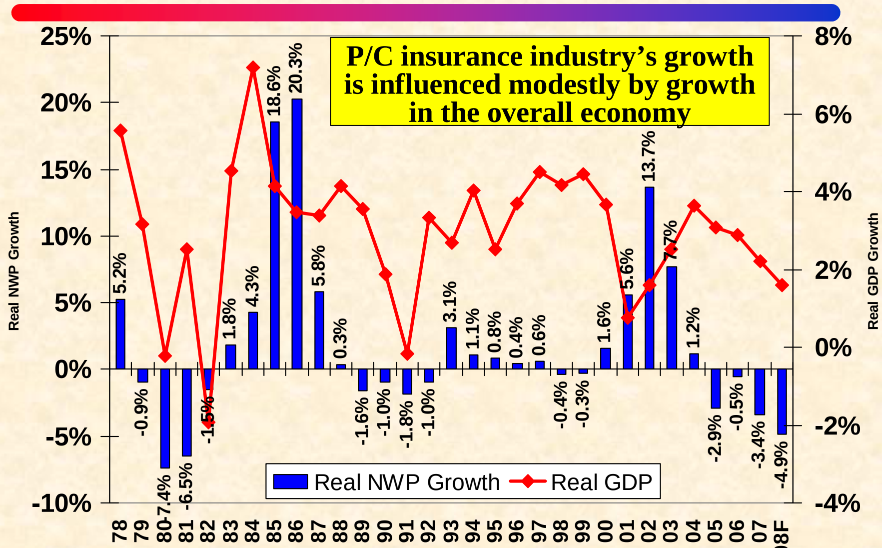


[1]Before reinsurance transactions, excluding state funds.

Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data LLC.

Figure 4

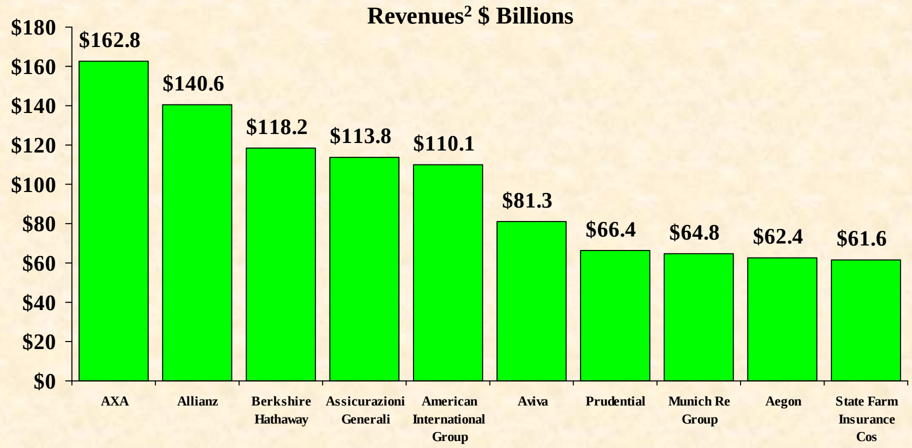
Real GDP Growth vs. Real P/C Premium Growth: Modest Association



Sources: A.M. Best, US Bureau of Economic Analysis, Blue Chip Economic Indicators, 8/08; Insurance Information Inst.

Figure 5

Top Ten Global Insurers, By Revenues, 2007[1]



[1]Based on an analysis of companies in the Global Fortune 500. Includes stock and mutual companies.
[2]Revenues include premium and annuity income, investment income and capital gains or losses but exclude deposits; includes consolidated subsidiaries, excludes excise taxes.

Source: Fortune.