

# Ten Challenges for the Year Ahead

## *Overview & Outlook for the P/C Insurance Industry*

**Inland Marine Underwriting Association  
Orlando, FL**

**April 14, 2003**



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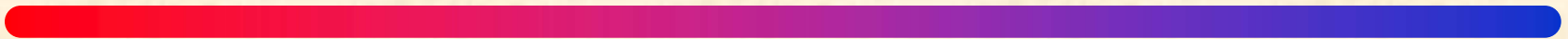


# *Presentation Outline*

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- Improve Profitability
- Improve Underwriting
  - Inland Marine Issues
- Reserving Issues
- Solvency Issues
- Improve Pricing
- Efficient Allocation of Capital
- Improve Investment Performance
- The Challenge of Terrorism
- Courts & Torts: Abuse of the Civil Justice System
- Mold
- Q & A

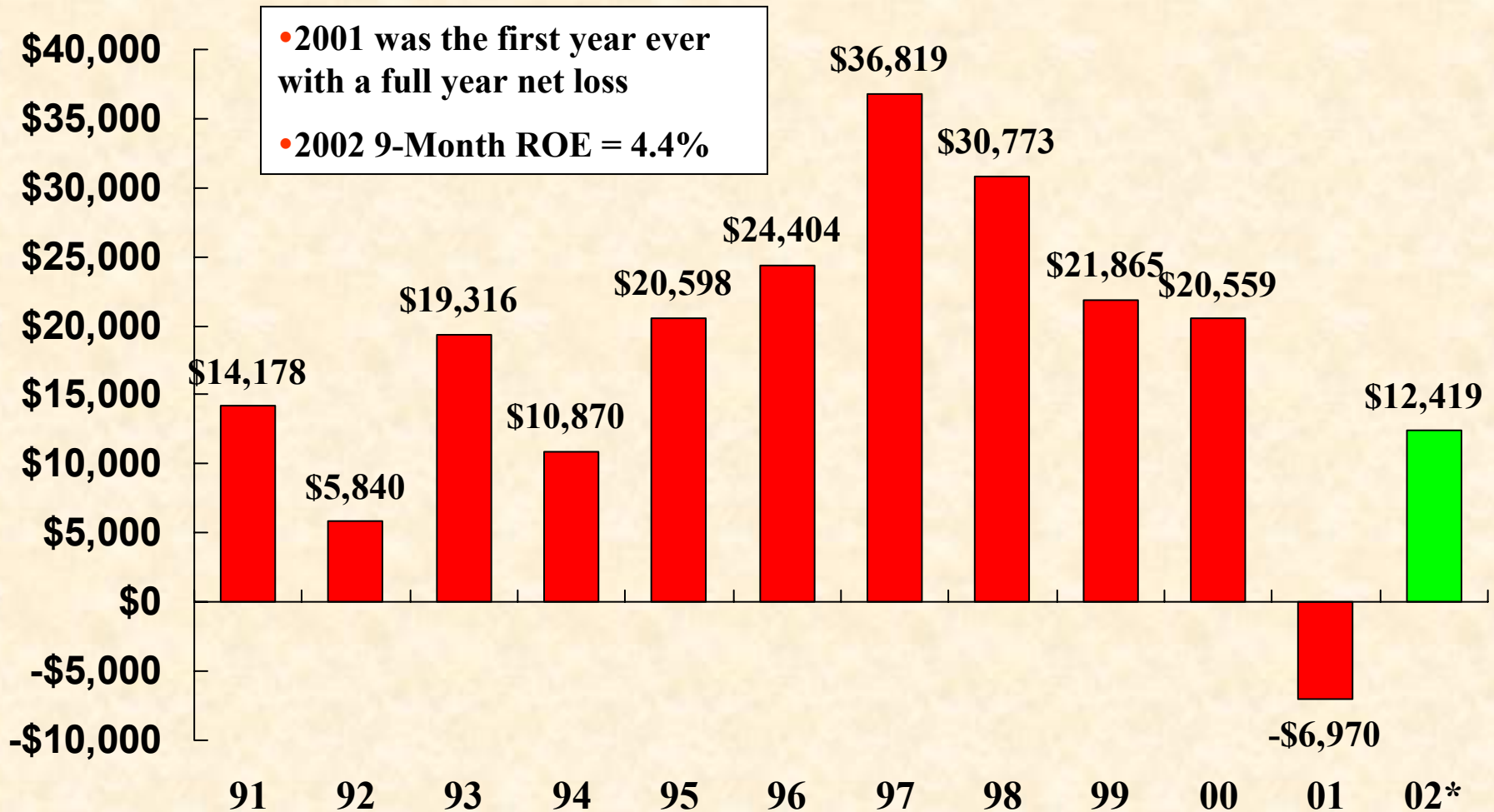
# ***IMPROVE PROFITABILITY***





# *P/C Net Income After Taxes*

## *1991-2002E (\$ Millions)*



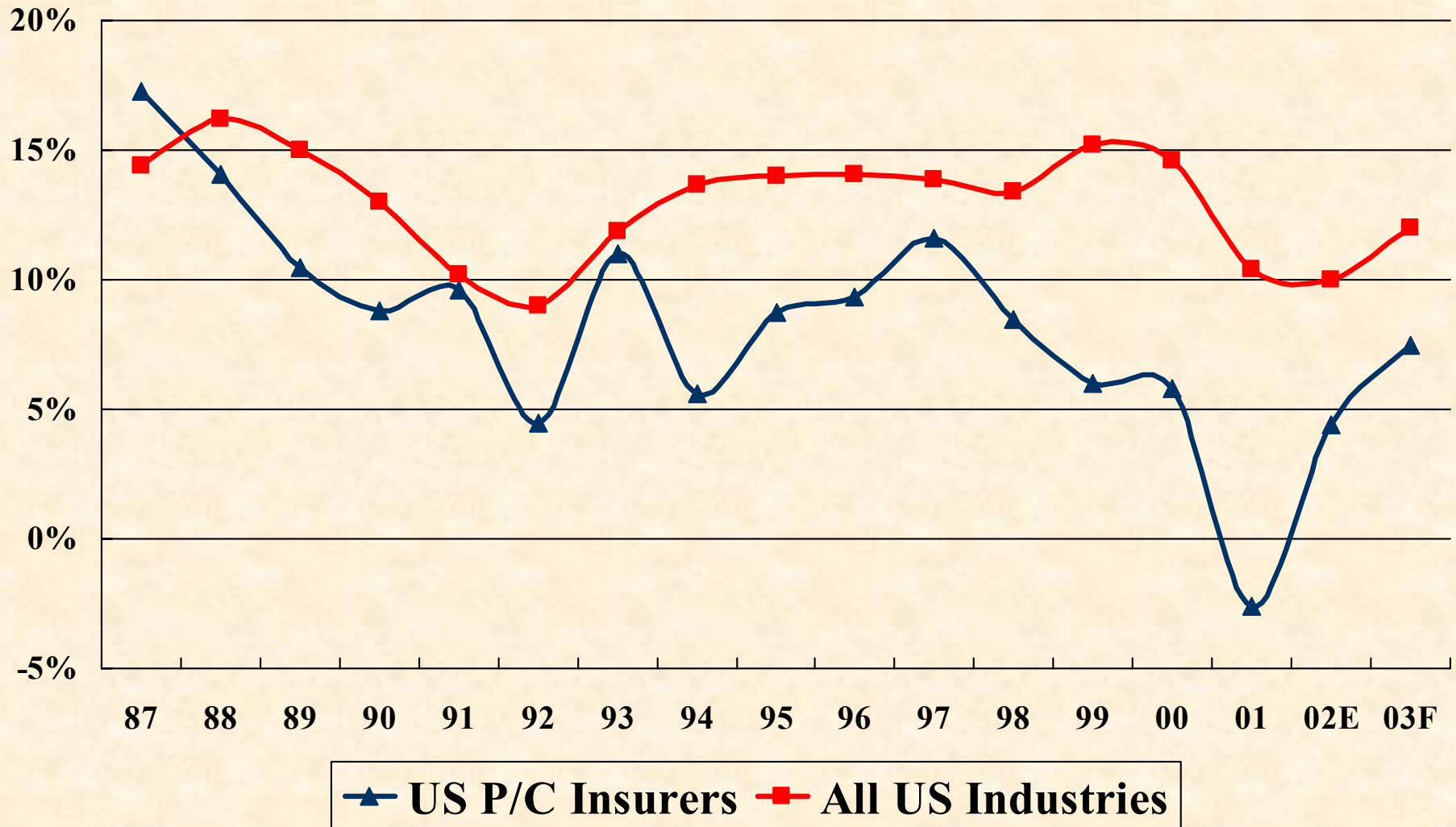
\*I.I.I. estimate based on first 9 months of 2002 data.

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



# ROE: P/C vs. All Industries

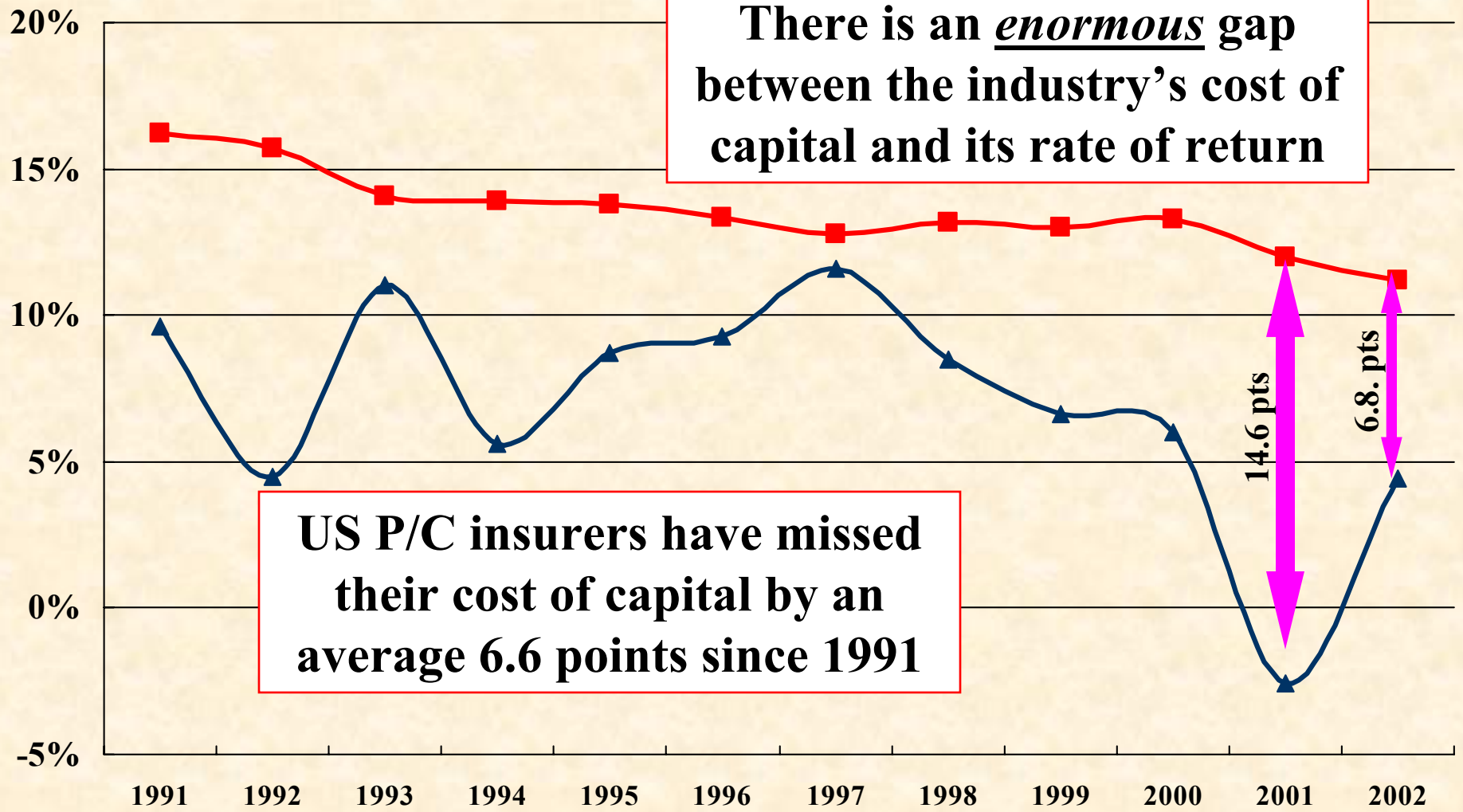
## 1987–2003F\*



▲ US P/C Insurers ■ All US Industries



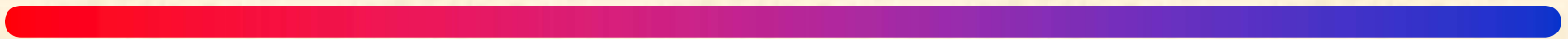
# ROE vs. Cost of Capital: US P/C Insurance: 1991 – 2002



Source: The Geneva Association, Ins. Information Inst.

—▲— ROE —■— Cost of Capital

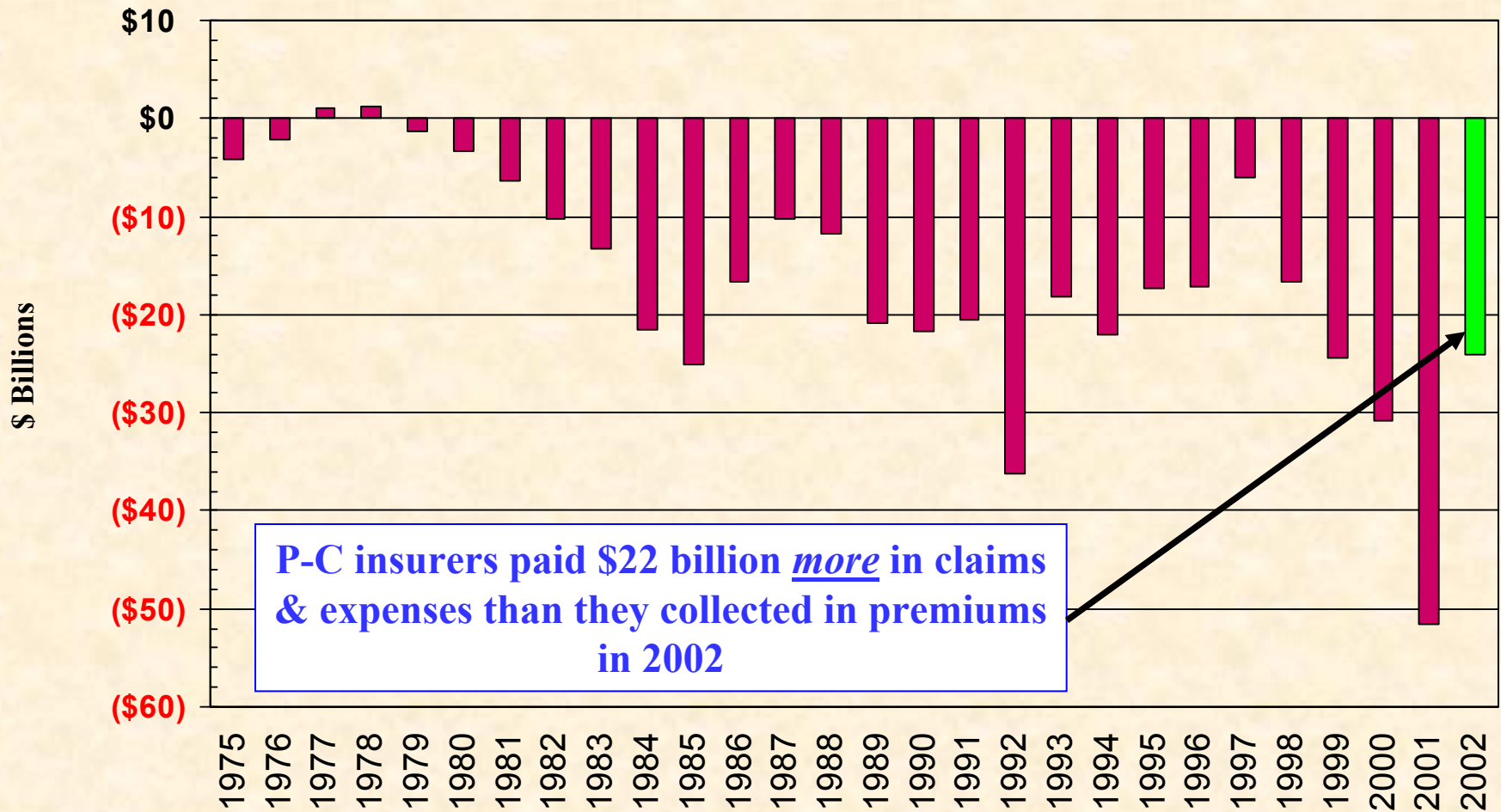
# *IMPROVE UNDERWRITING*





# Underwriting Gain (Loss)

## 1975-2002\*

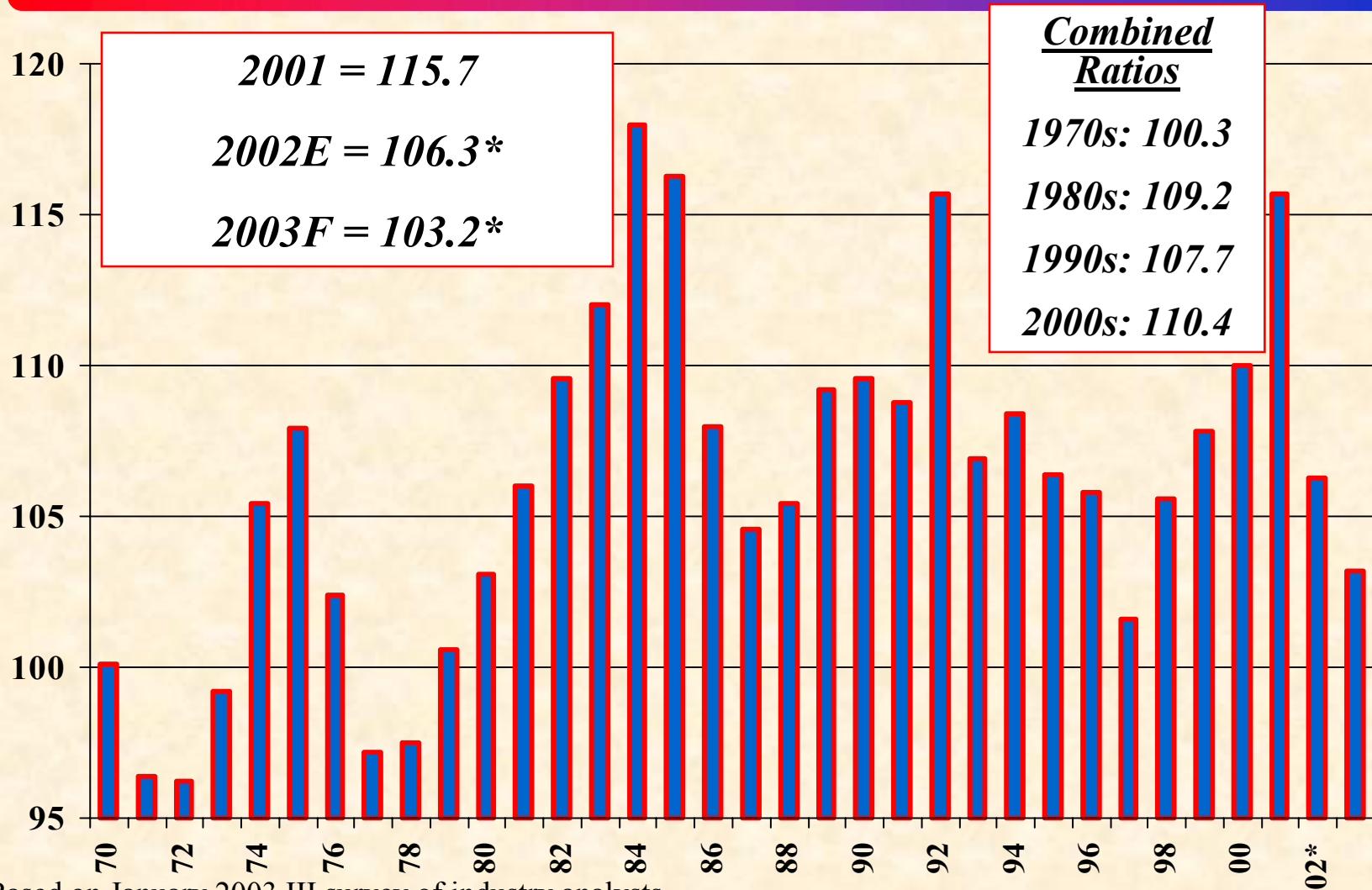


\*Annualized estimate based on first 9 months of 2002 data.

Source: A.M. Best, Insurance Information Institute



# *P/C Industry Combined Ratio*



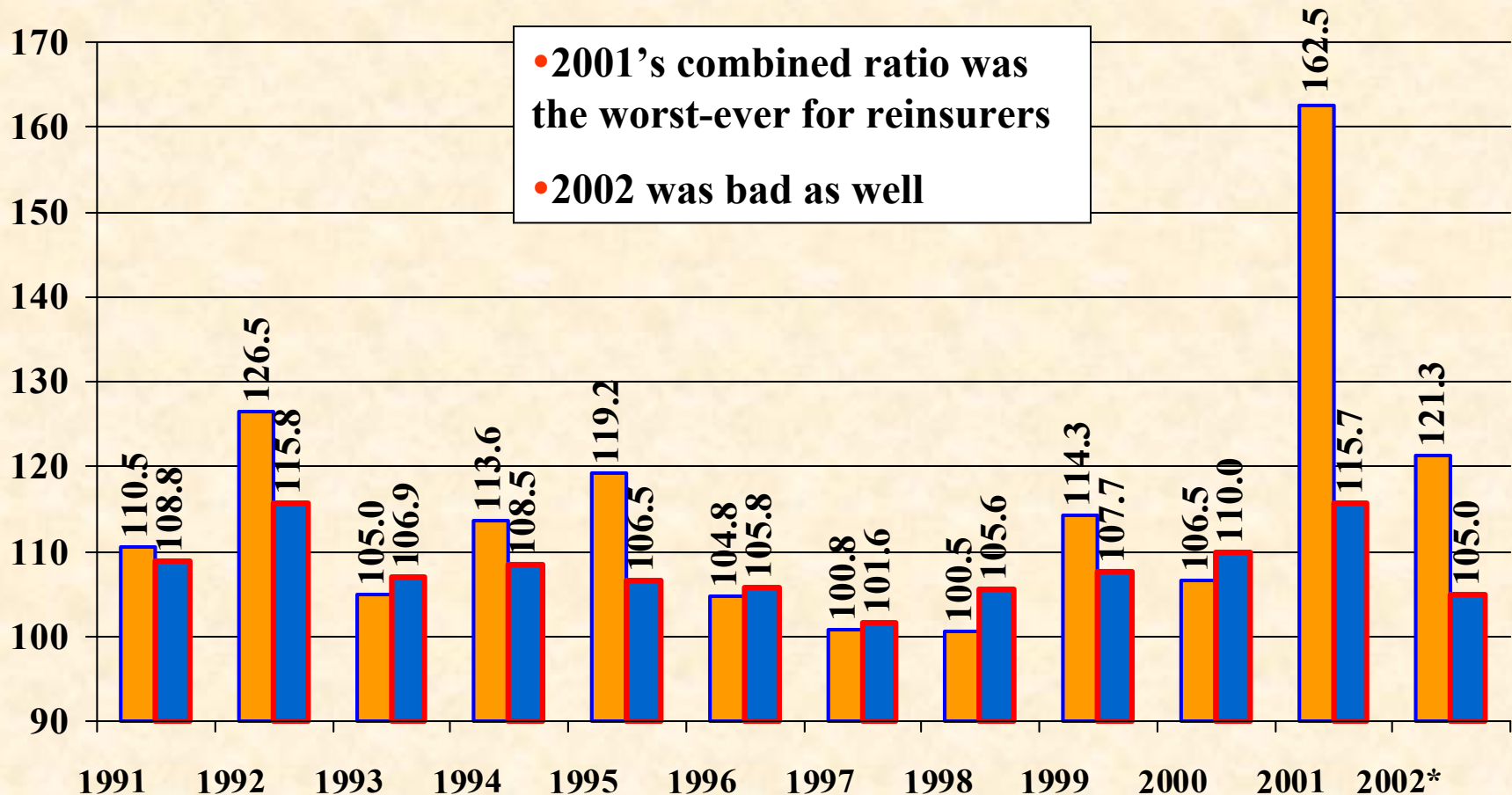
\*Based on January 2003 III survey of industry analysts.

Sources: A.M. Best; III



# Combined Ratio: Reinsurance vs. P/C Industry

■ Reinsurance ■ All Lines Combined Ratio



\*Figure for first 9 months of 2002 for all lines; Reinsurance is RAA Full-year figure

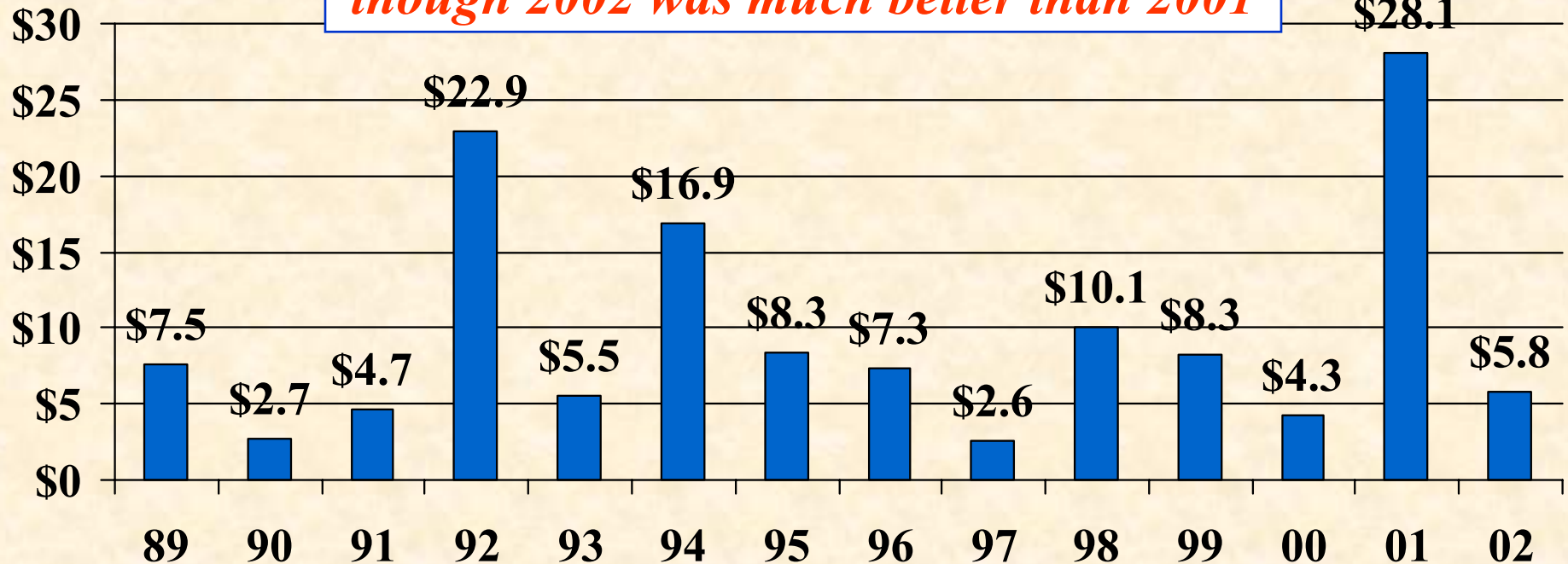
Source: A.M. Best, ISO, Reinsurance Association of America, Insurance Information Institute



# U.S. Insured Catastrophe Losses

\$ Billions

*CAT losses continue to be a problem,  
though 2002 was much better than 2001*



\*Estimate.

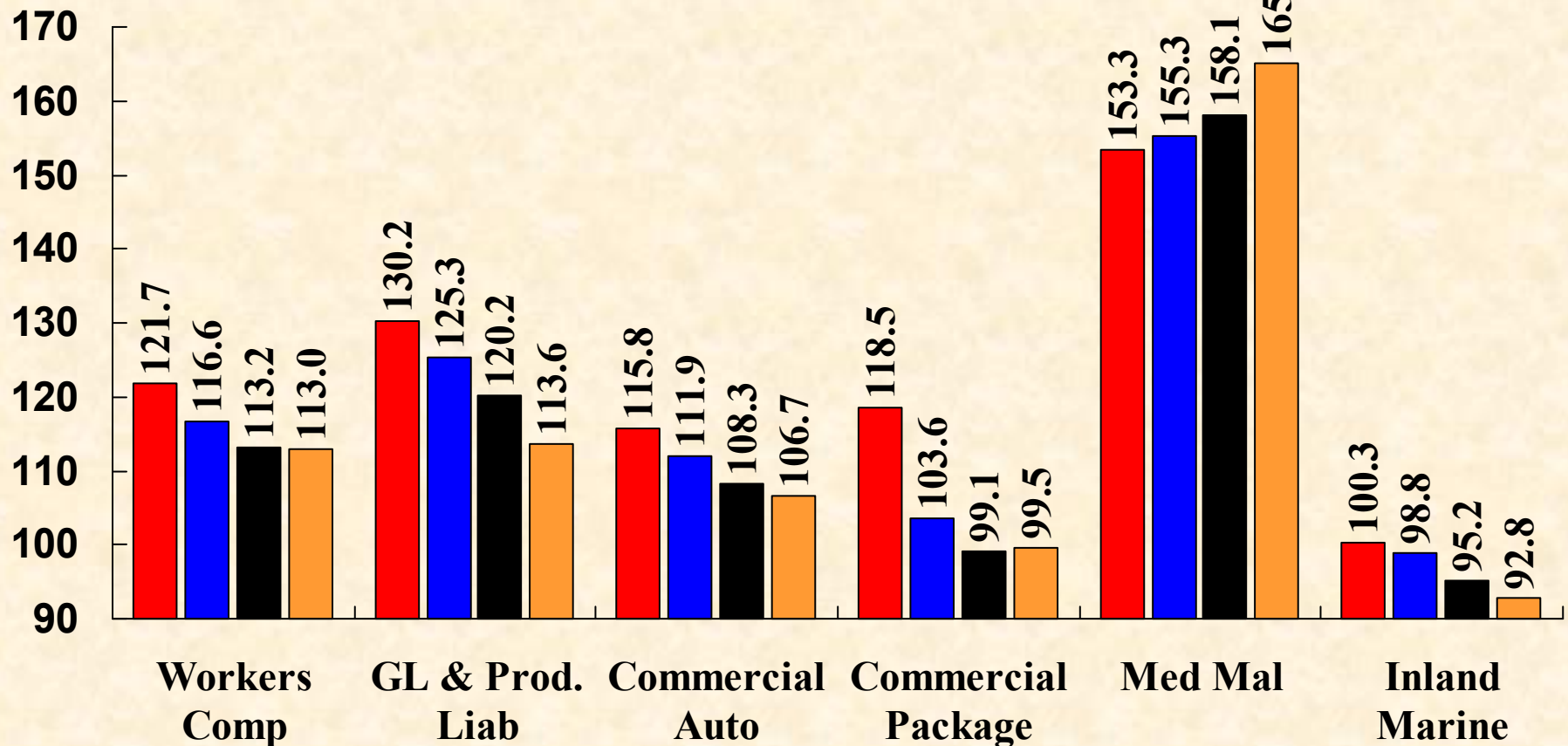
**Note:** 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims.

**Source:** Property Claims Service/ISO; Insurance Information Institute

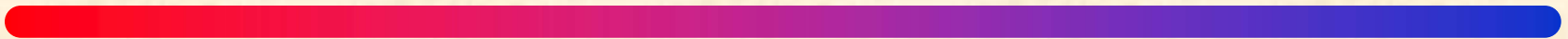


# Outlook for Commercial Lines: 2002 - 2004

2001 2002E 2003F 2004F

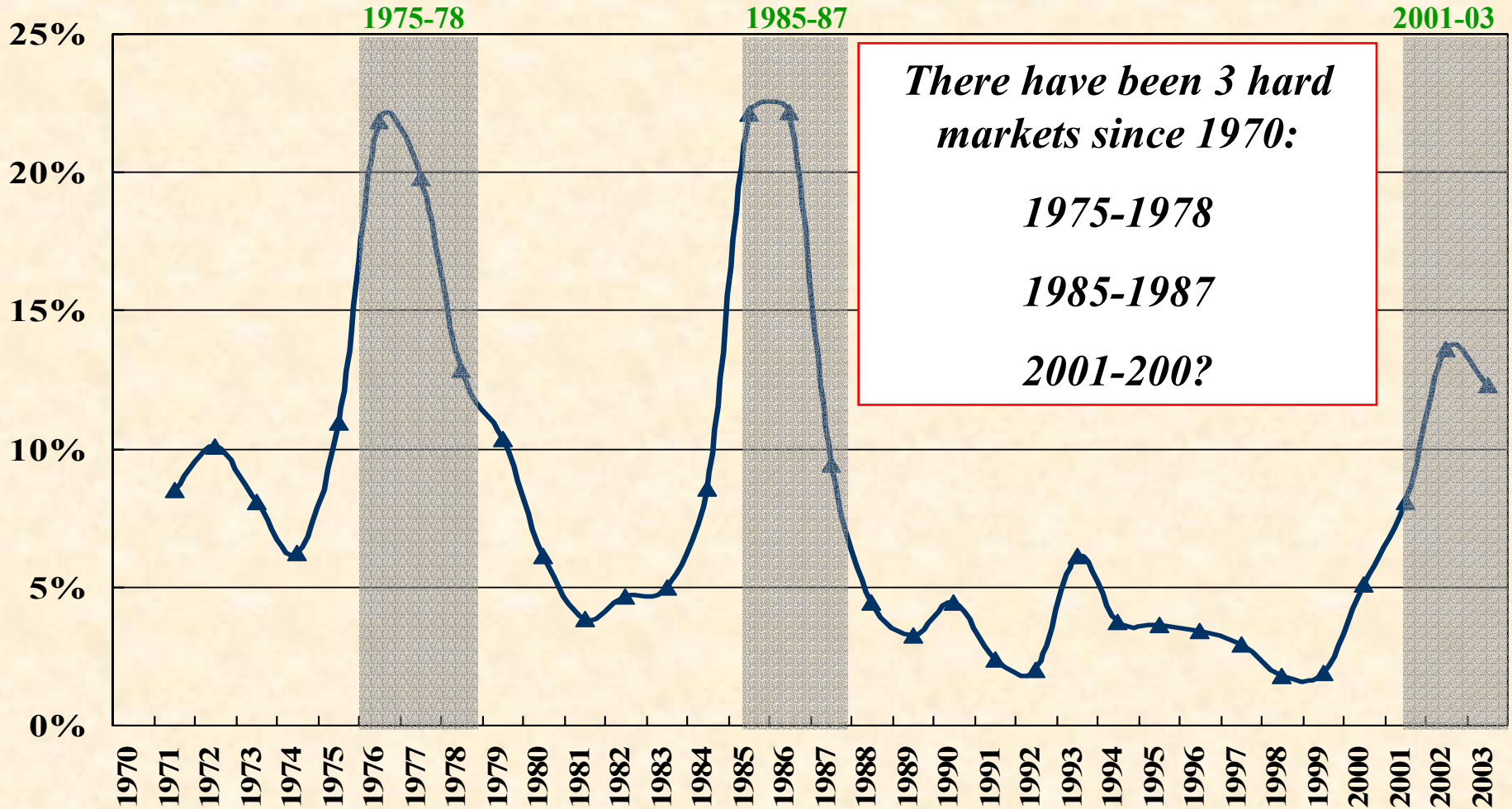


HOW DOES THIS HARD  
MARKET STACK UP TO  
PREVIOUS HARD MARKETS?



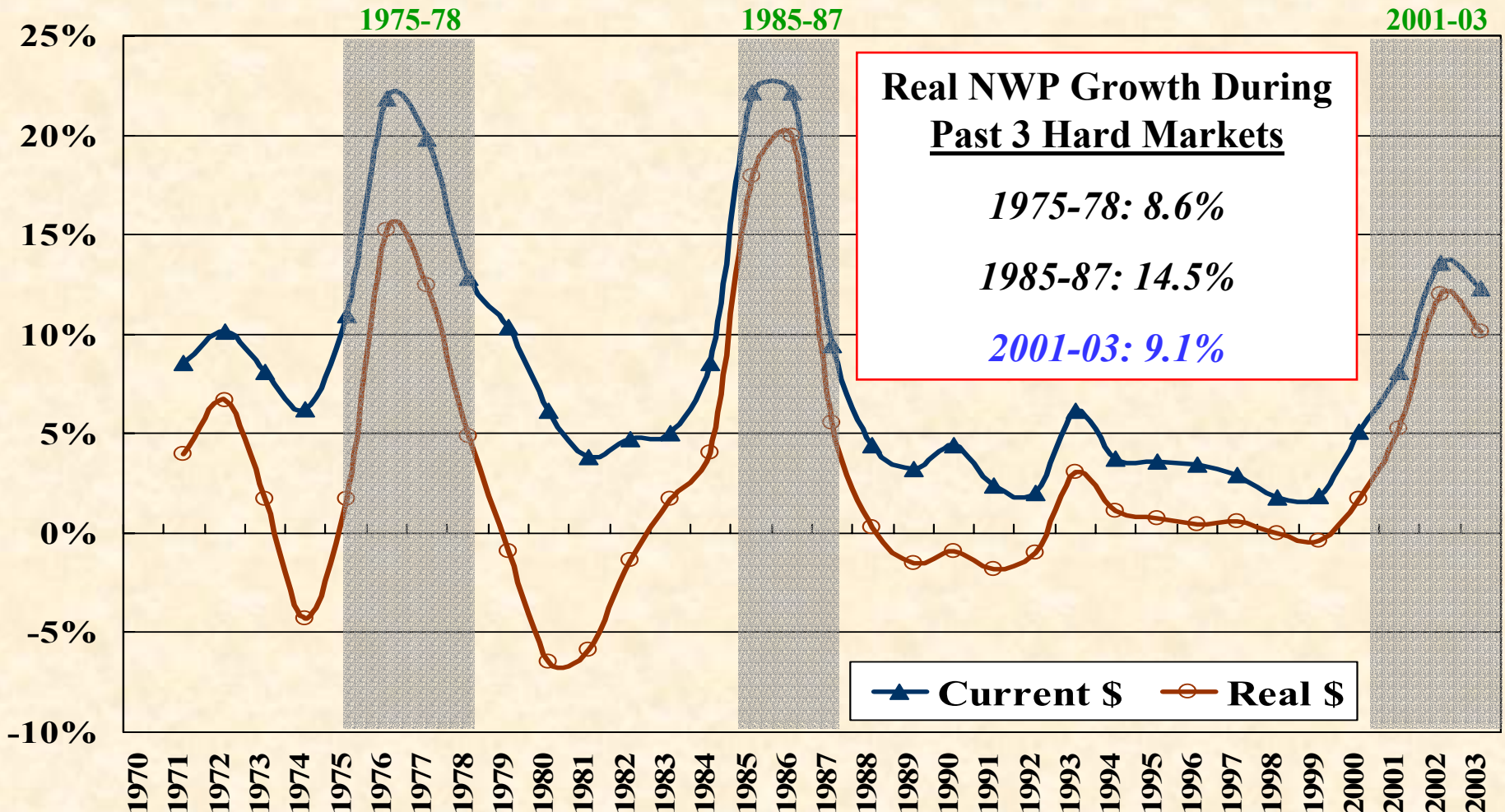


# Hard Markets Since 1970





# Strength of Recent Hard Markets by Real NWP Growth

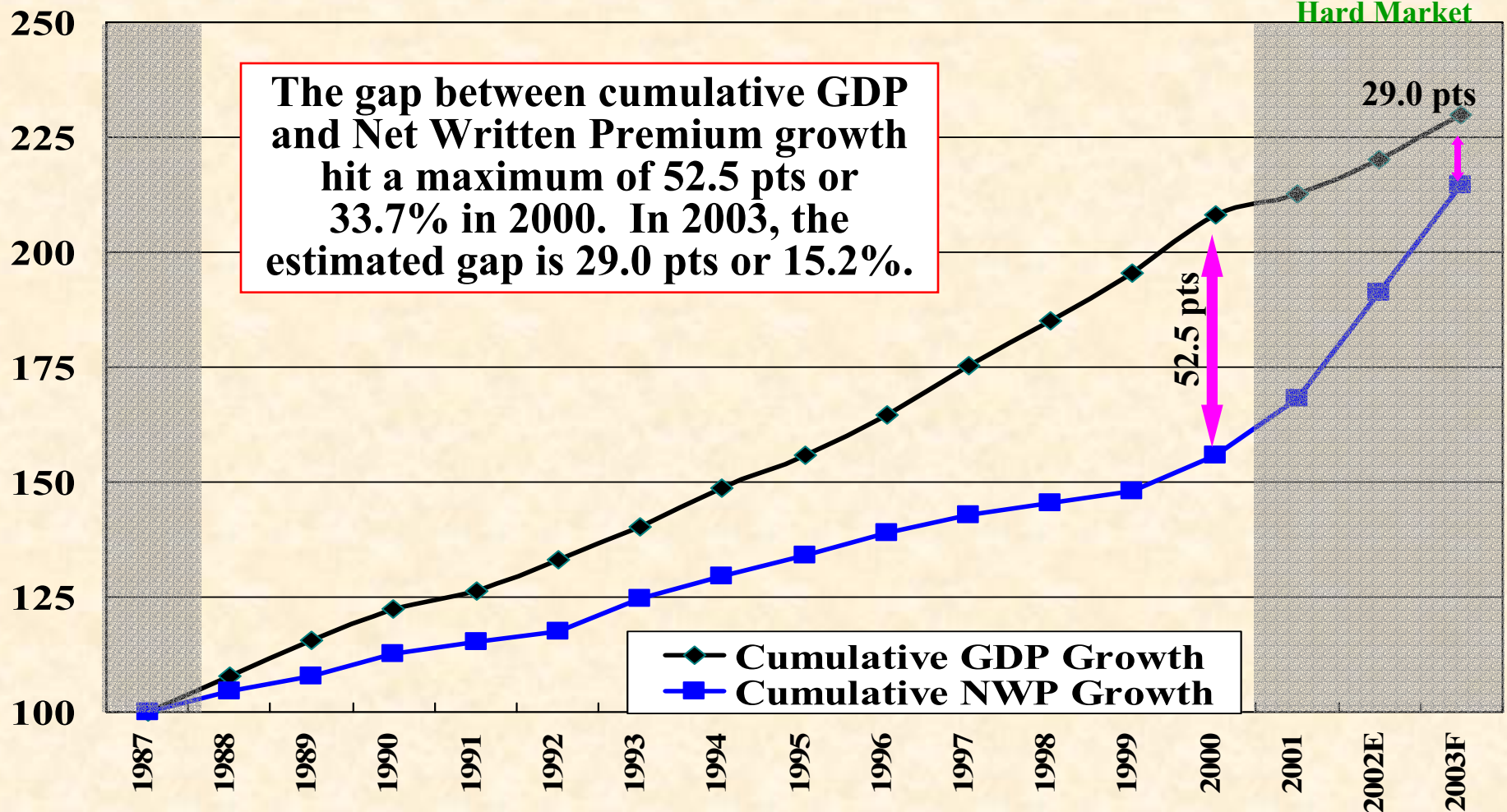


Note: Shaded areas denote hard market periods.

Source: A.M. Best, Insurance Information Institute



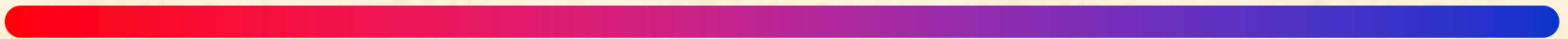
# GDP Growth vs. Net Written Premium Growth (1987=100)



Note: Shaded area denotes hard market.

Source: Insurance Information Institute

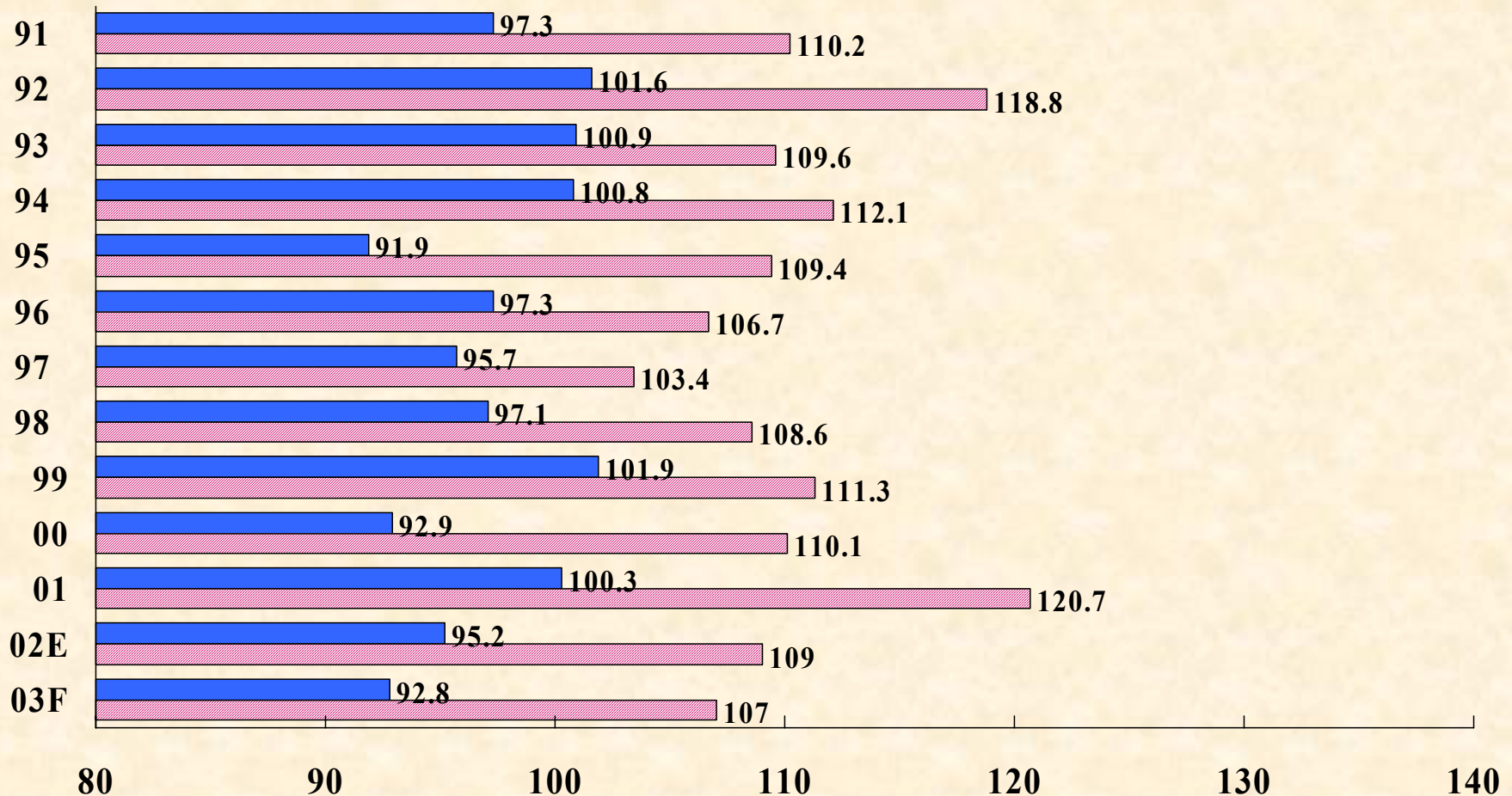
# *INLAND MARINE*





# *Combined Ratio: Inland Marine vs. Commercial Lines*

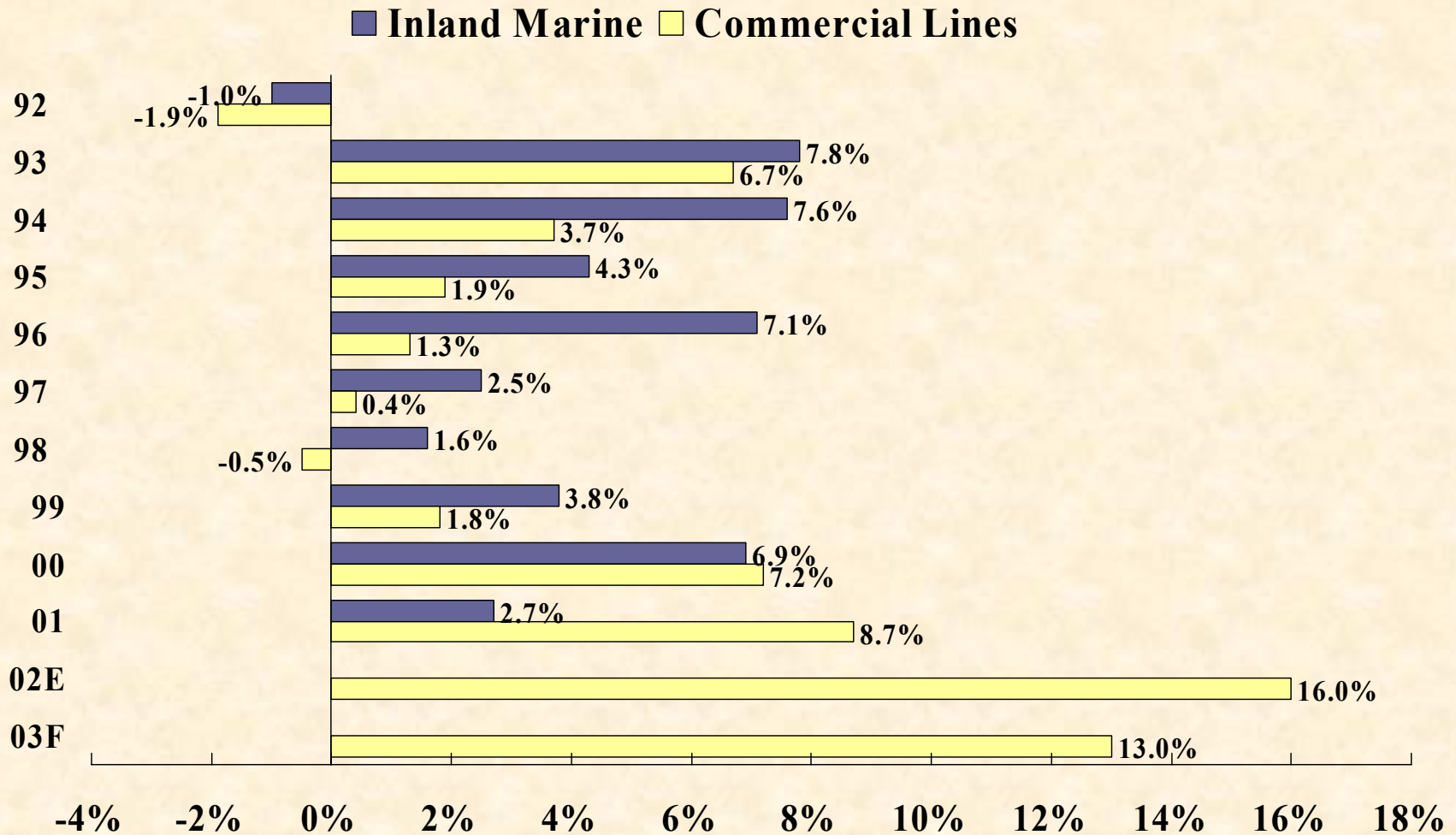
■ Inland Marine ■ Commercial Lines



Source: A.M. Best, Insurance Information Institute



# Change in Net Premiums Written: Inland Marine vs. Commercial Lines



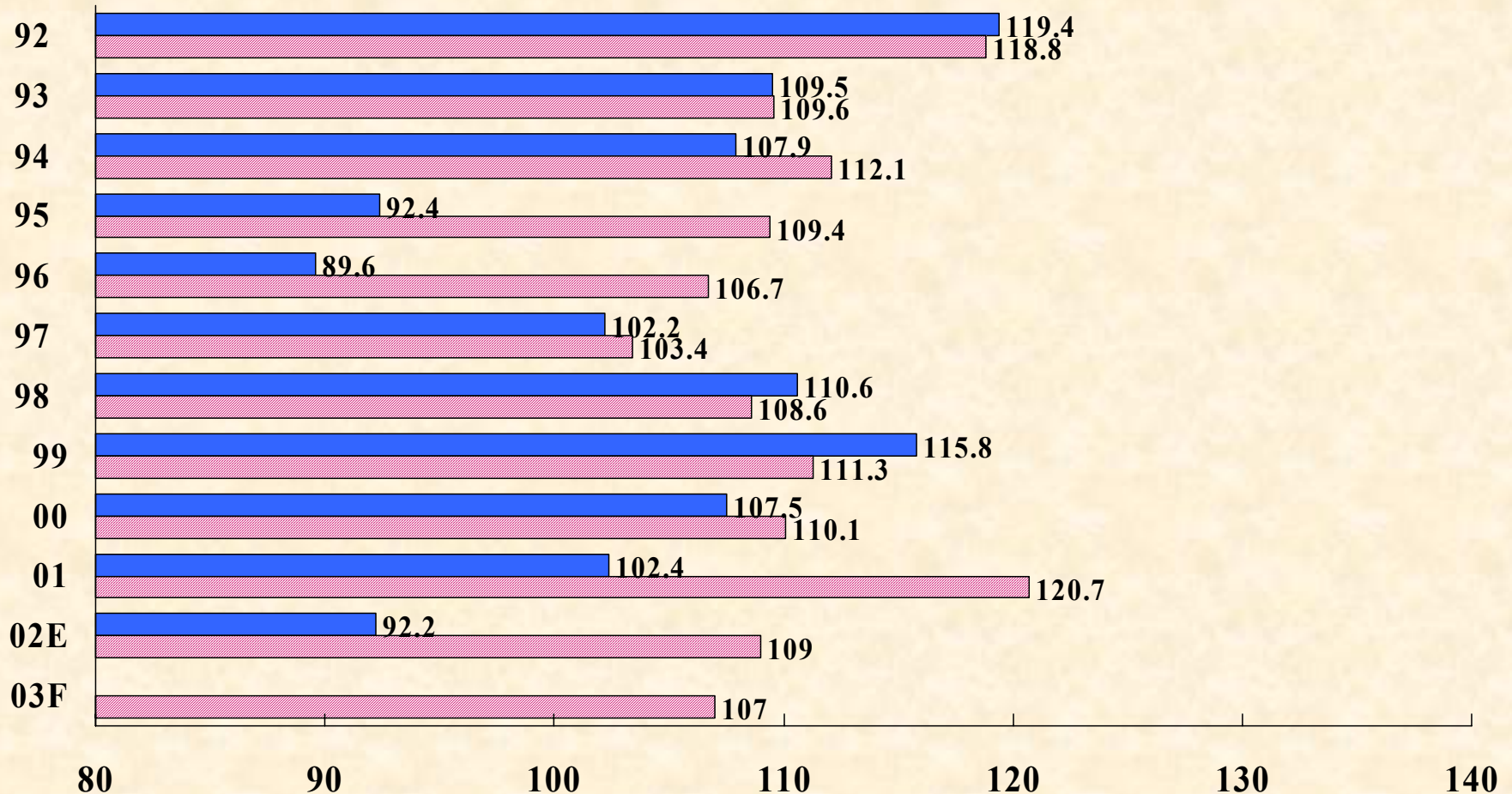
Source: A.M. Best, Insurance Information Institute



# Combined Ratio:

## Ocean Marine vs. Commercial Lines

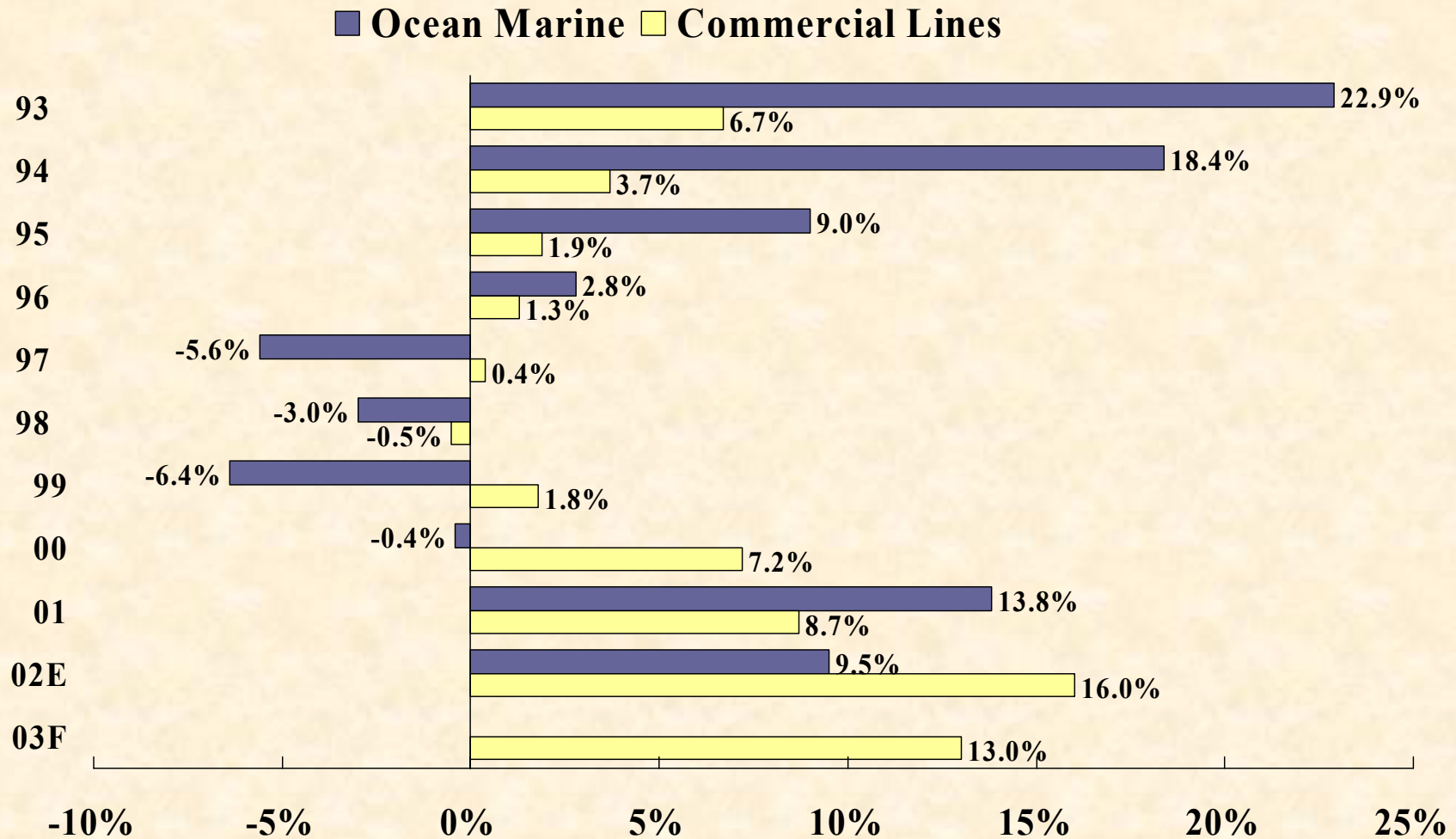
■ Ocean Marine ■ Commercial Lines



Source: A.M. Best, American Inst. Of Marine Underwriters, Insurance Information Institute



# Change in Net Premiums Written: Ocean Marine vs. Commercial Lines



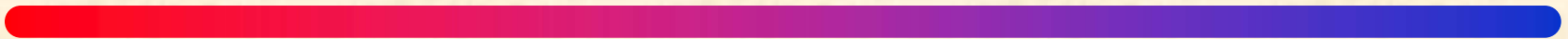
Source: A.M. Best, American Inst. Of Marine Underwriters, Insurance Information Institute



# *Inland Marine: Better Than Most, but Challenges Remain*

- Trucking Market: Bad Results → Reduced Capacity
  - Weak economy → Low or negative exposure growth
  - 2002 renewal up 15 – 30% for many trucking cos.
- Cargo Theft: Cost \$3.5B to \$12B annually (American Trucking Association/Natl. Cargo Security Council)
- Cargo: Very vulnerable to terrorism threat
  - Hundreds of thousands of points of entry to system globally
- Fine Art/Collectibles:
  - Market hardening pre-9/11
  - Post-9/11 even more difficult

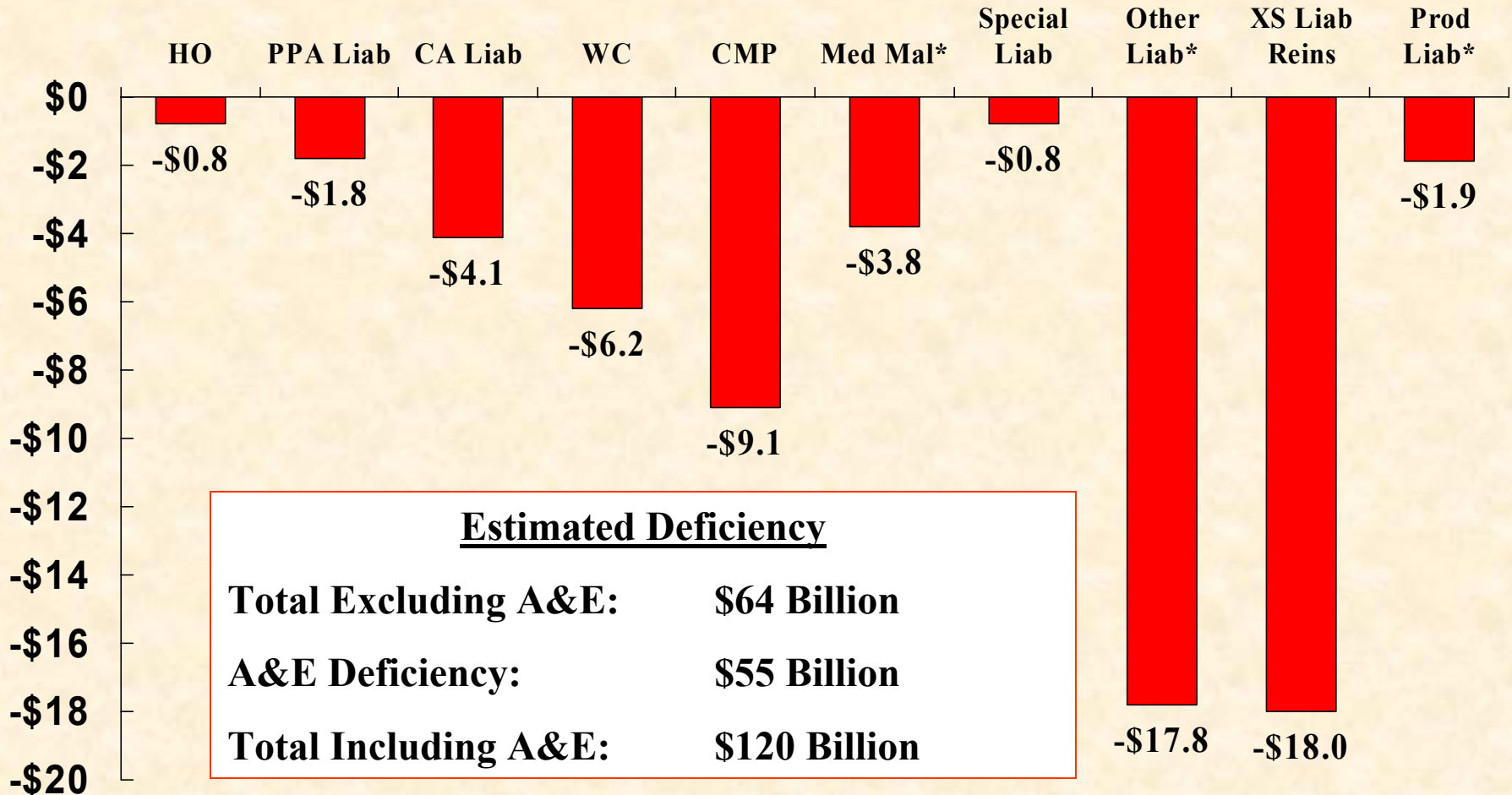
# *RESERVING ISSUES*





# Reserve Deficiency, by Line

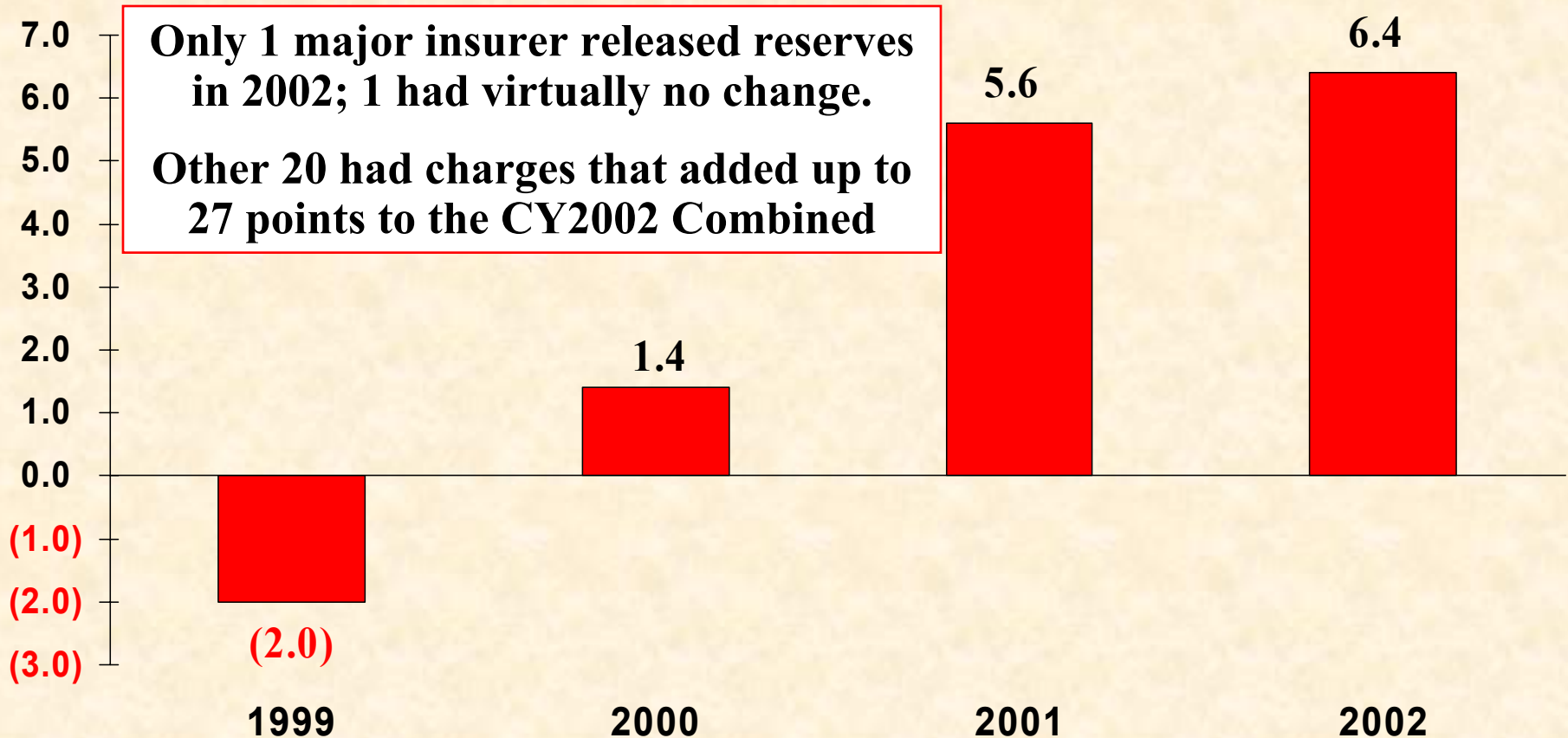
(AY 1992-2001, as of 12/01)



\*Occurrence and claims made  
Source: Morgan Stanley

# Combined Ratio: Average Impact of Prior-Year Reserve Changes (Points)

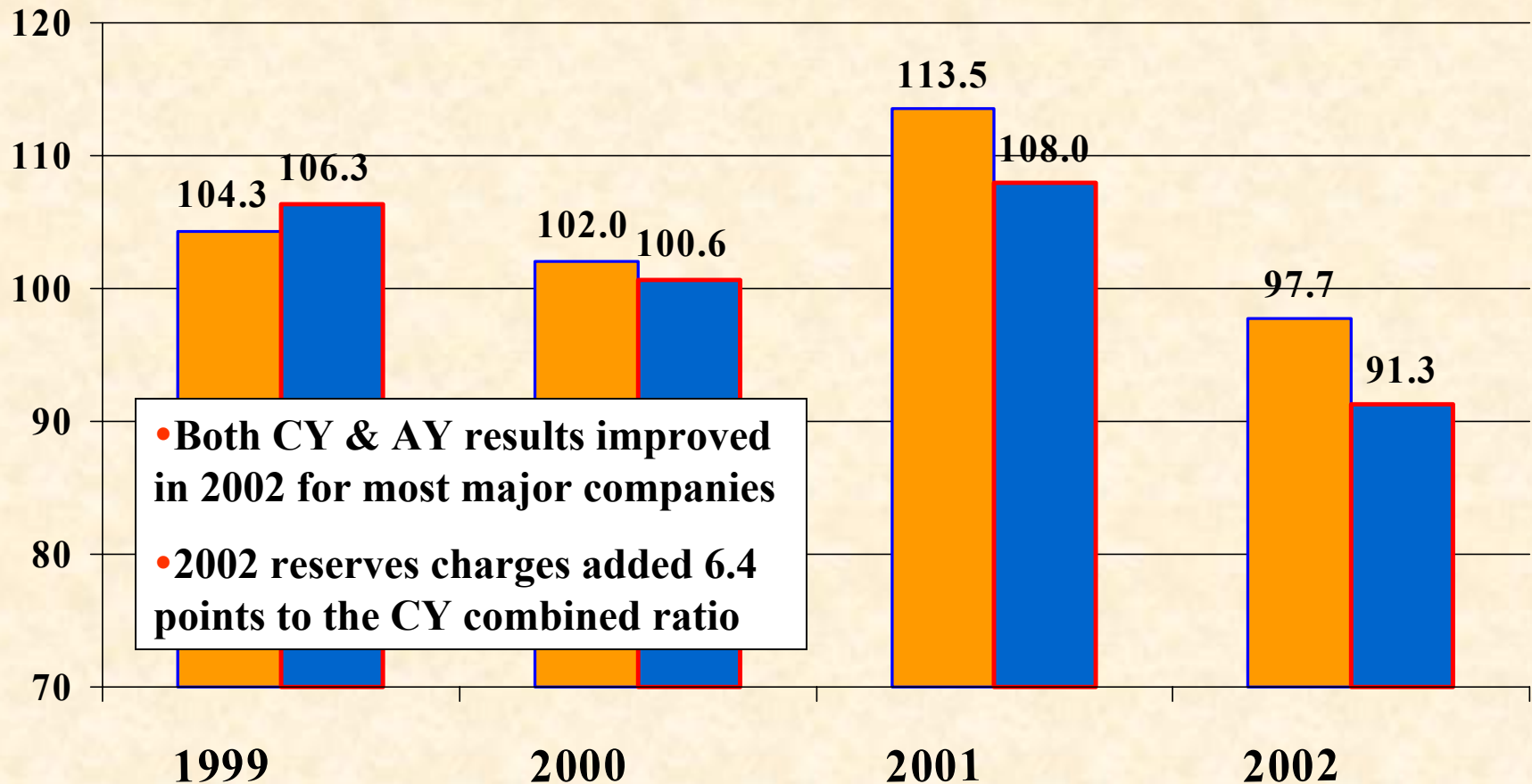
Points (Reduced)/Increased





# Average Combined Ratio: Calendar vs. Accident Year\*

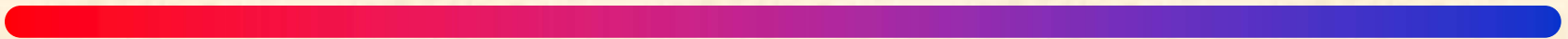
Reported Combined Ratio Accident Year Combined Ratio



\*Not market cap weighted.

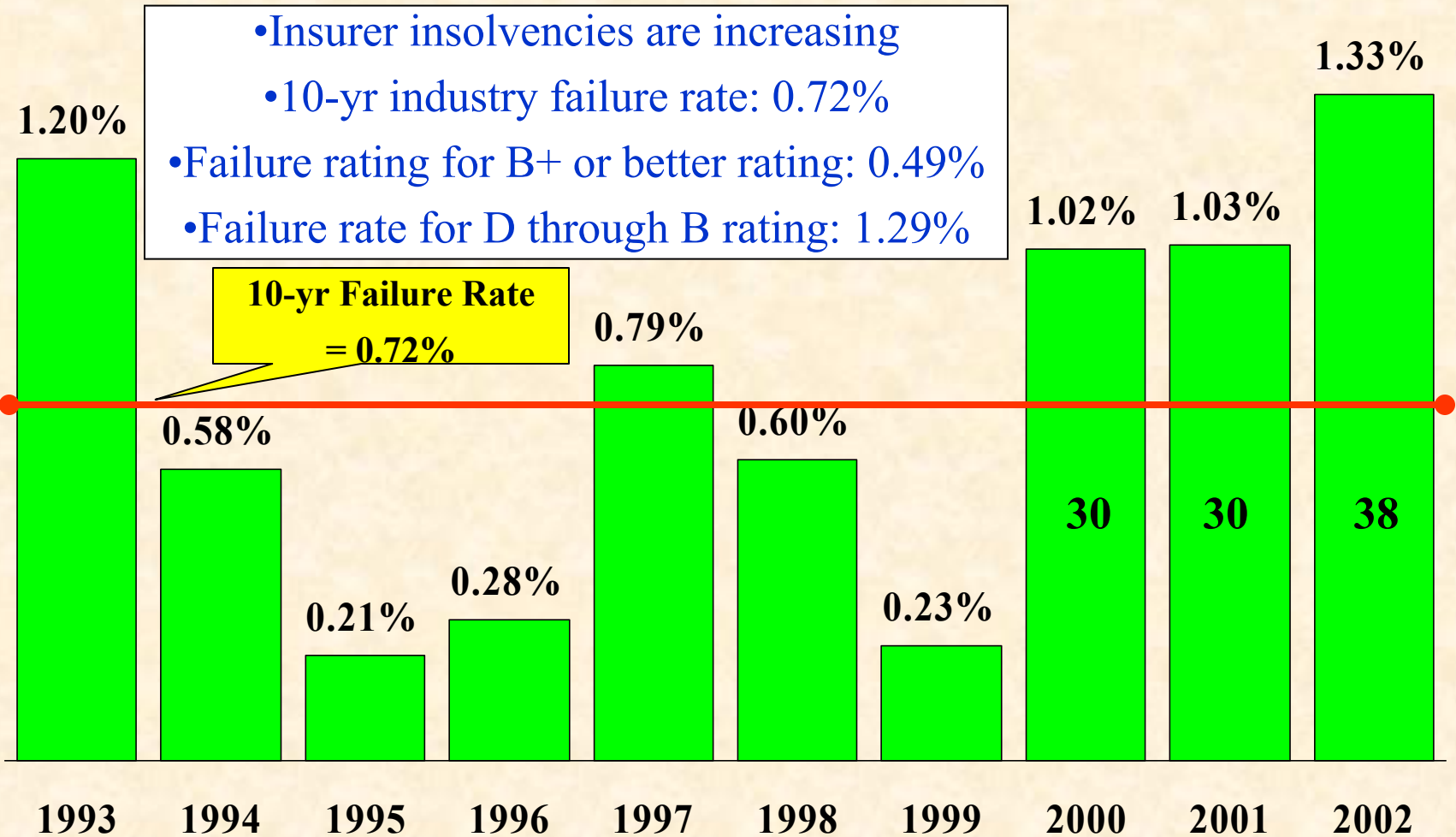
Source: Merrill Lynch universe of 22 publicly-traded companies; Insurance Information Institute.

# *(IN)SOLVENCY ISSUES*





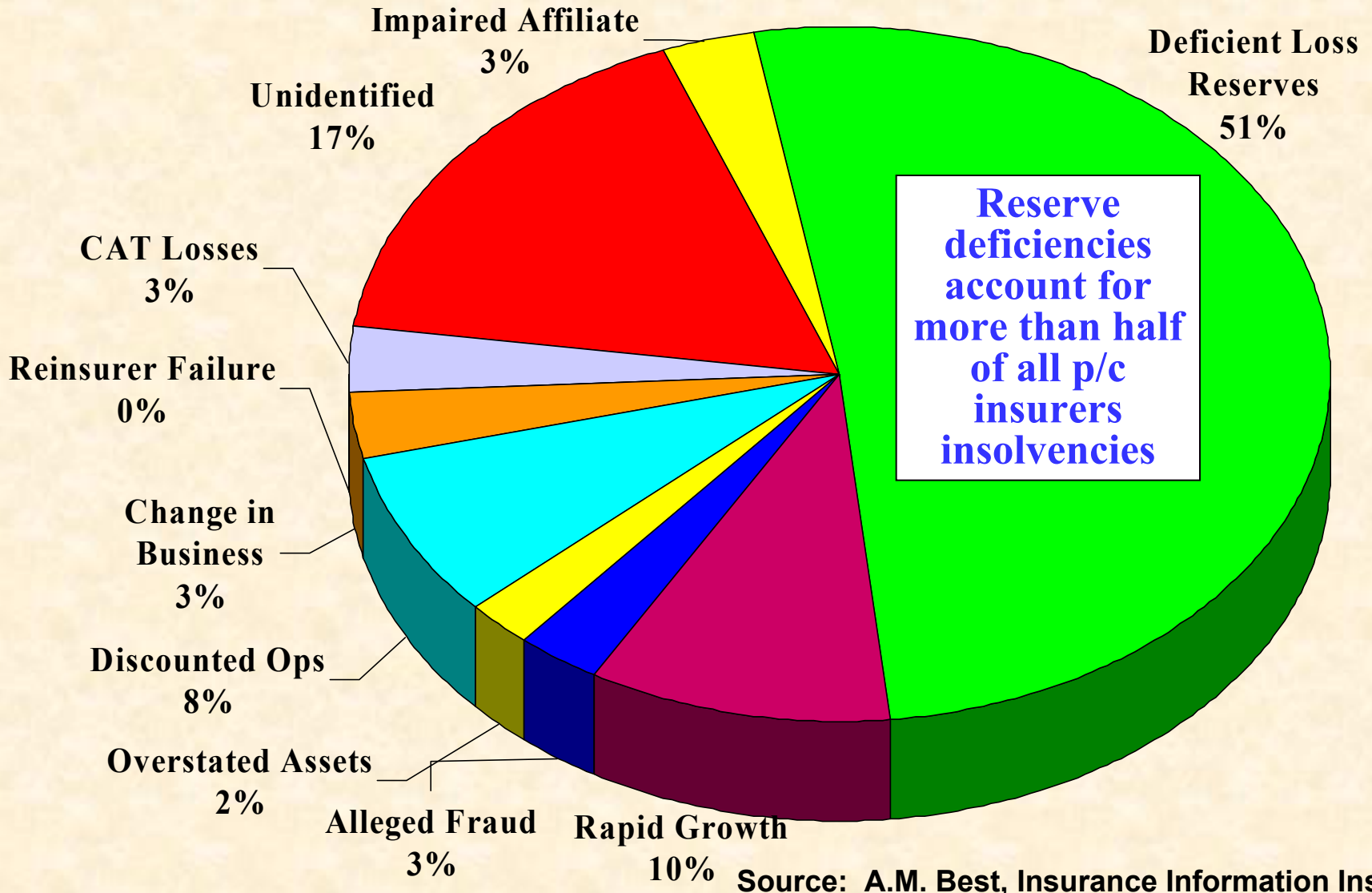
# *P/C Company Insolvency Rates, 1993 to 2002*





# *Reason for P/C Insolvencies*

*(218 Insolvencies, 1993-2002)*





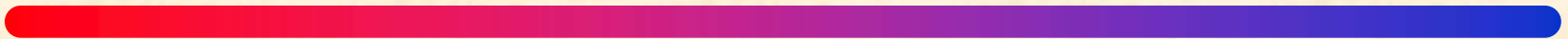
# *Ratings Downgrades: “Swarms” of Downgrades Stinging Insurers*

## **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

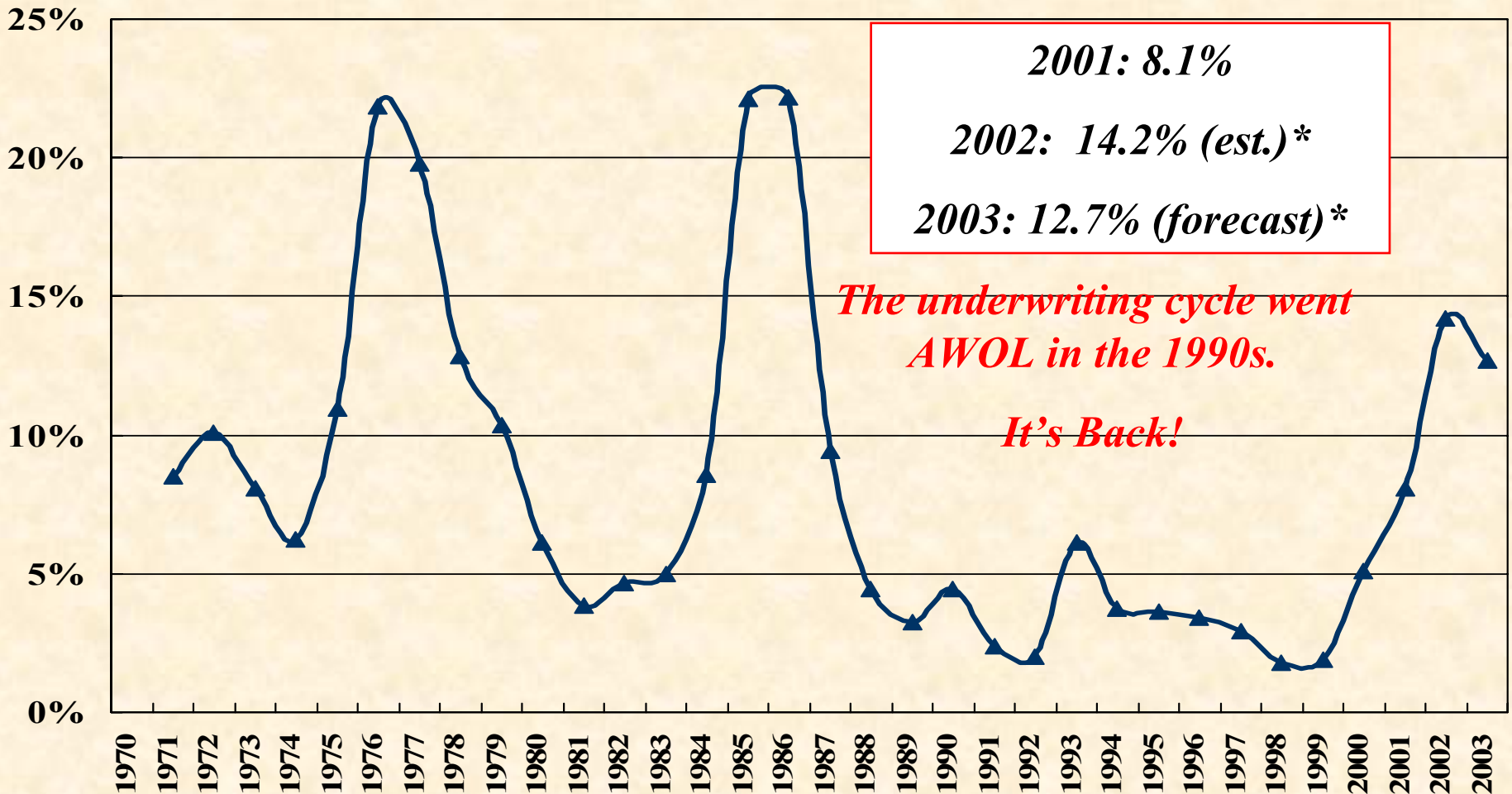
**Need to do business with quality,  
highly-rated companies**

# *IMPROVE PRICING*





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



\*Estimate/forecast based on January 2003 III survey of industry analysts.

Source: A.M. Best, Insurance Information Institute



# *Council of Insurance Agents & Brokers Rate Survey*

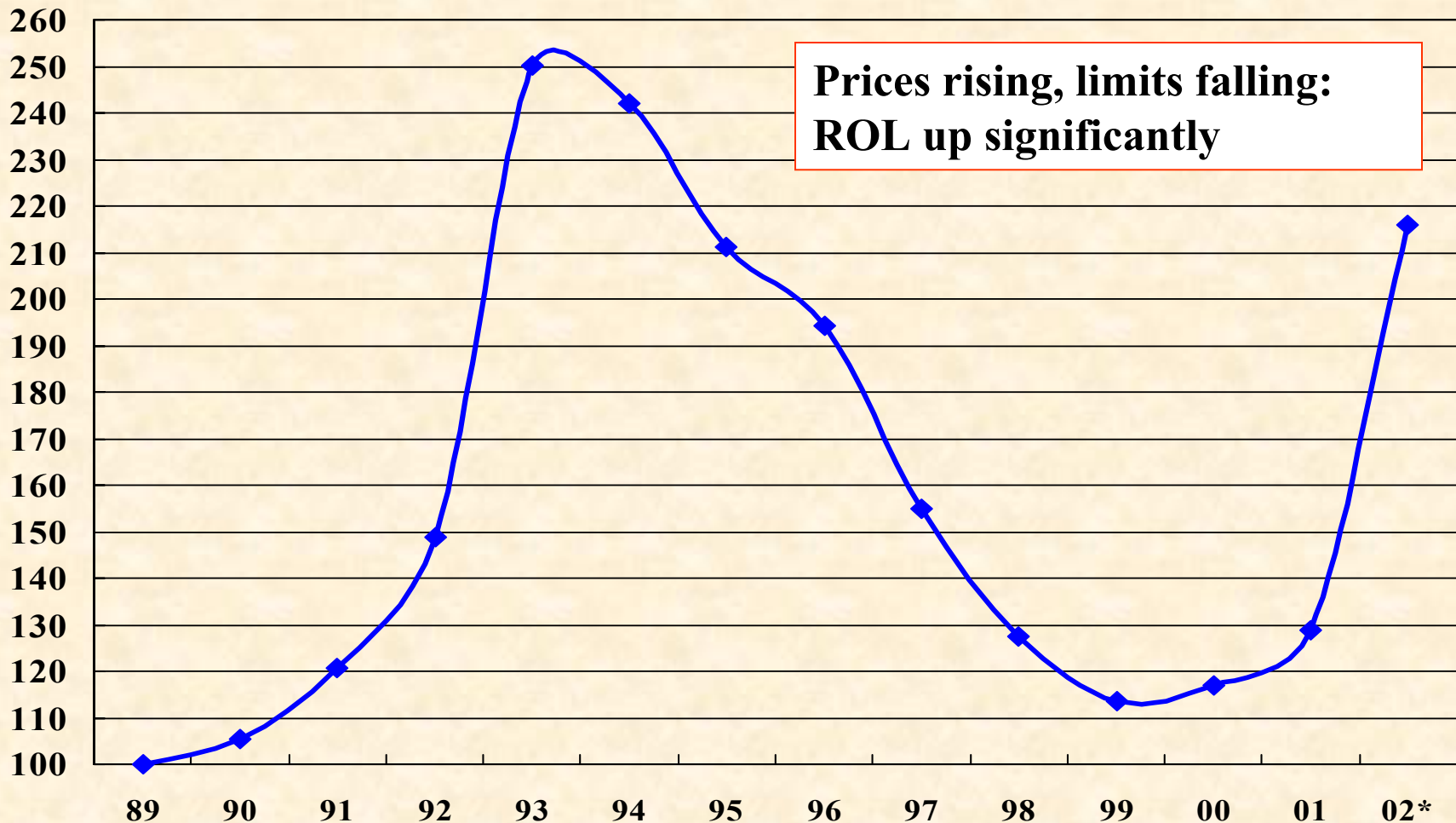
**Fourth Quarter 2002**

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

|                          | No Change | Up 1-10% | 10-20% | 20-30% | 30-50% | 50%-100% | >100% |
|--------------------------|-----------|----------|--------|--------|--------|----------|-------|
| <b>Comm. Auto</b>        | 6%        | 14%      | 42%    | 25%    | 8%     | 1%       | 0%    |
| <b>Workers Comp</b>      | 8%        | 17%      | 25%    | 24%    | 10%    | 2%       | 2%    |
| <b>General Liability</b> | 7%        | 13%      | 29%    | 37%    | 11%    | 0%       | 0%    |
| <b>Comm. Umbrella</b>    | 8%        | 3%       | 21%    | 21%    | 26%    | 10%      | 5%    |
| <b>D&amp;O</b>           | 6%        | 4%       | 22%    | 23%    | 18%    | 9%       | 3%    |
| <b>Comm. Property</b>    | 8%        | 16%      | 25%    | 25%    | 18%    | 3%       | 0%    |
| <b>Construction Risk</b> | 4%        | 8%       | 17%    | 18%    | 23%    | 9%       | 4%    |
| <b>Terrorism</b>         | 12%       | 5%       | 8%     | 12%    | 5%     | 0%       | 6%    |
| <b>Business Interr.</b>  | 13%       | 19%      | 36%    | 14%    | 4%     | 0%       | 0%    |
| <b>Surety Bonds</b>      | 8%        | 16%      | 16%    | 15%    | 6%     | 1%       | 1%    |
| <b>Med Mal</b>           | 1%        | 5%       | 6%     | 6%     | 12%    | 12%      | 16%   |



# Rate On Line Index (1989=100)

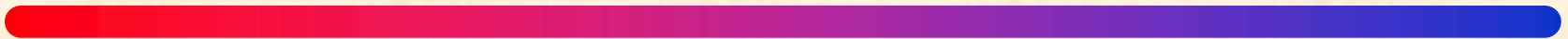


Source: Guy Carpenter

\* III Estimate

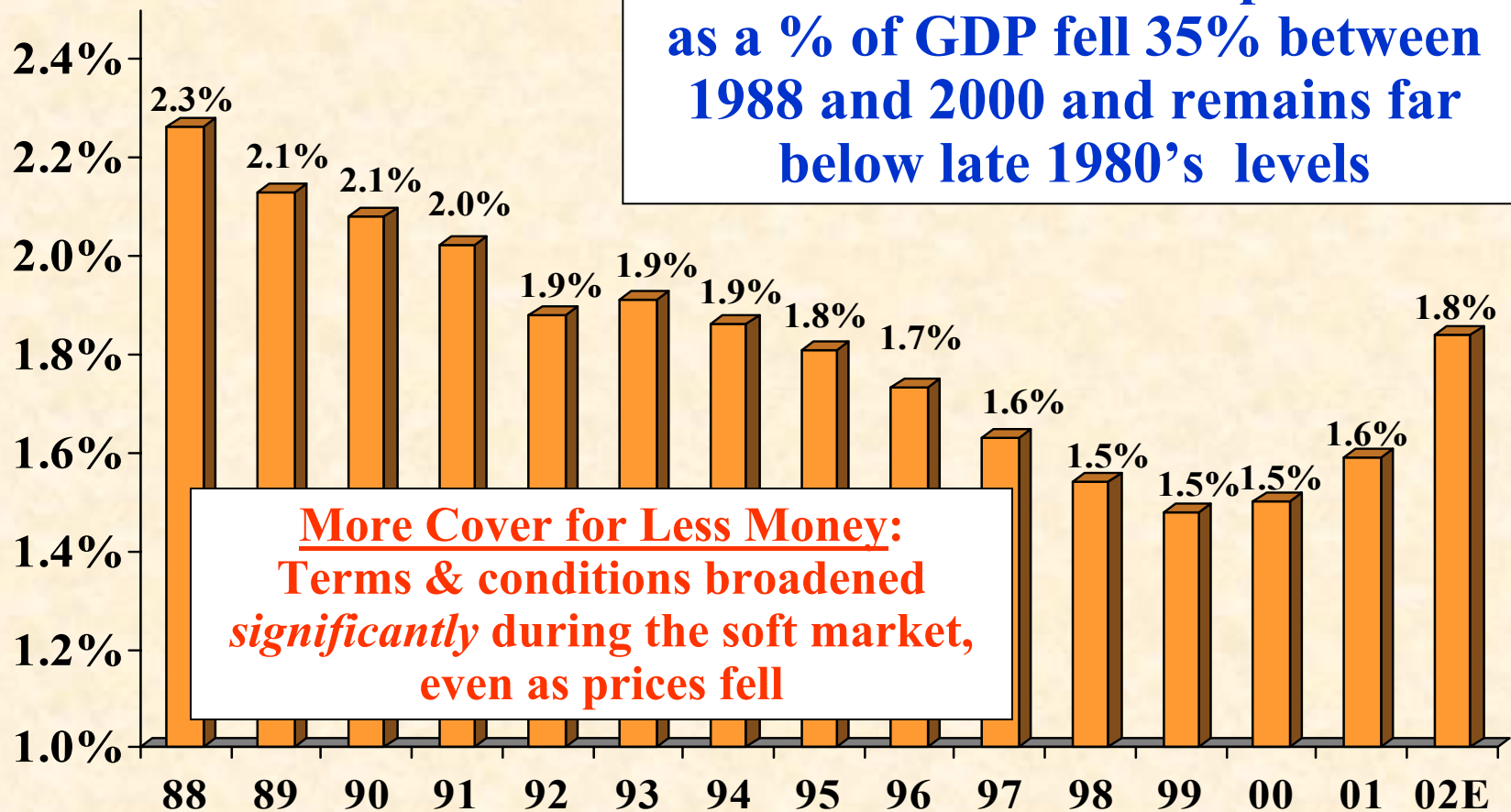
# *Urban Legend*

Insurance is More  
Expensive than Ever and is  
Putting Companies Out of  
Businesses





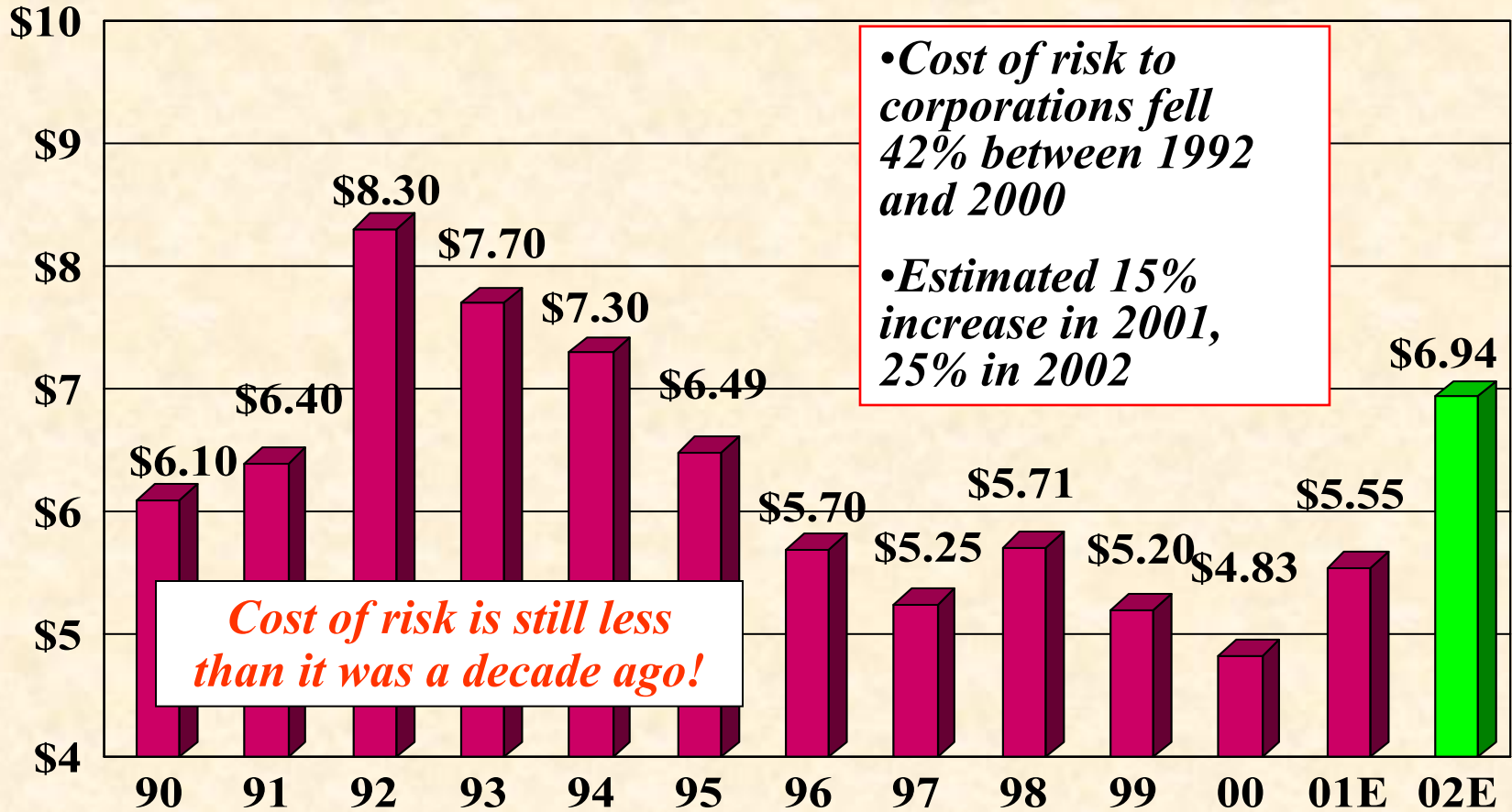
# Commercial Lines Net Written Premium as % of GDP



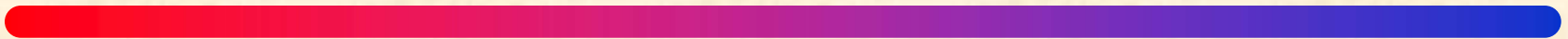
Sources: Insurance Information Institute, calculated from U.S. Bureau of Economic Analysis and A.M. Best data.



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

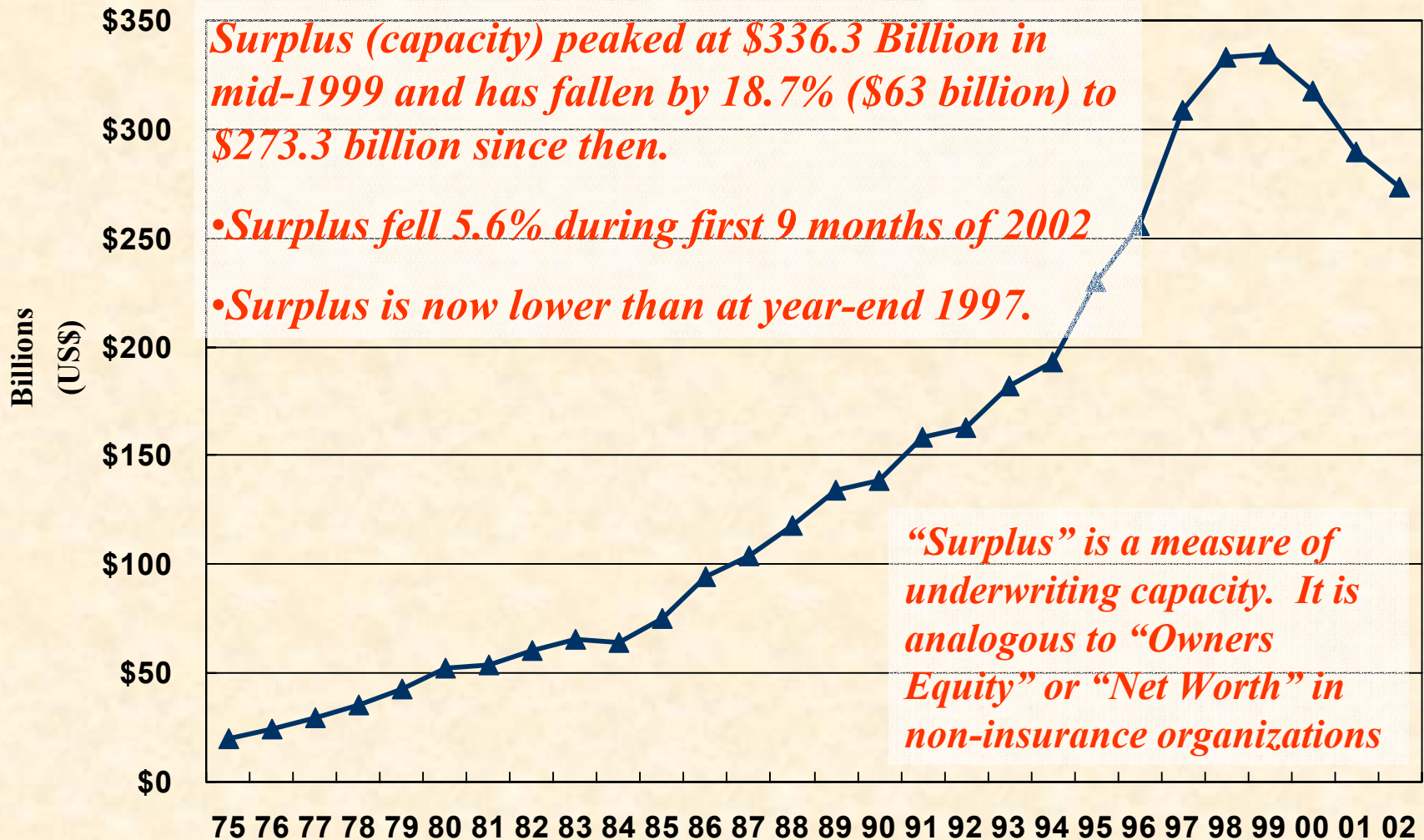


# *EFFICIENT ALLOCATION OF CAPITAL*





# Policyholder Surplus: 1975-2002\*

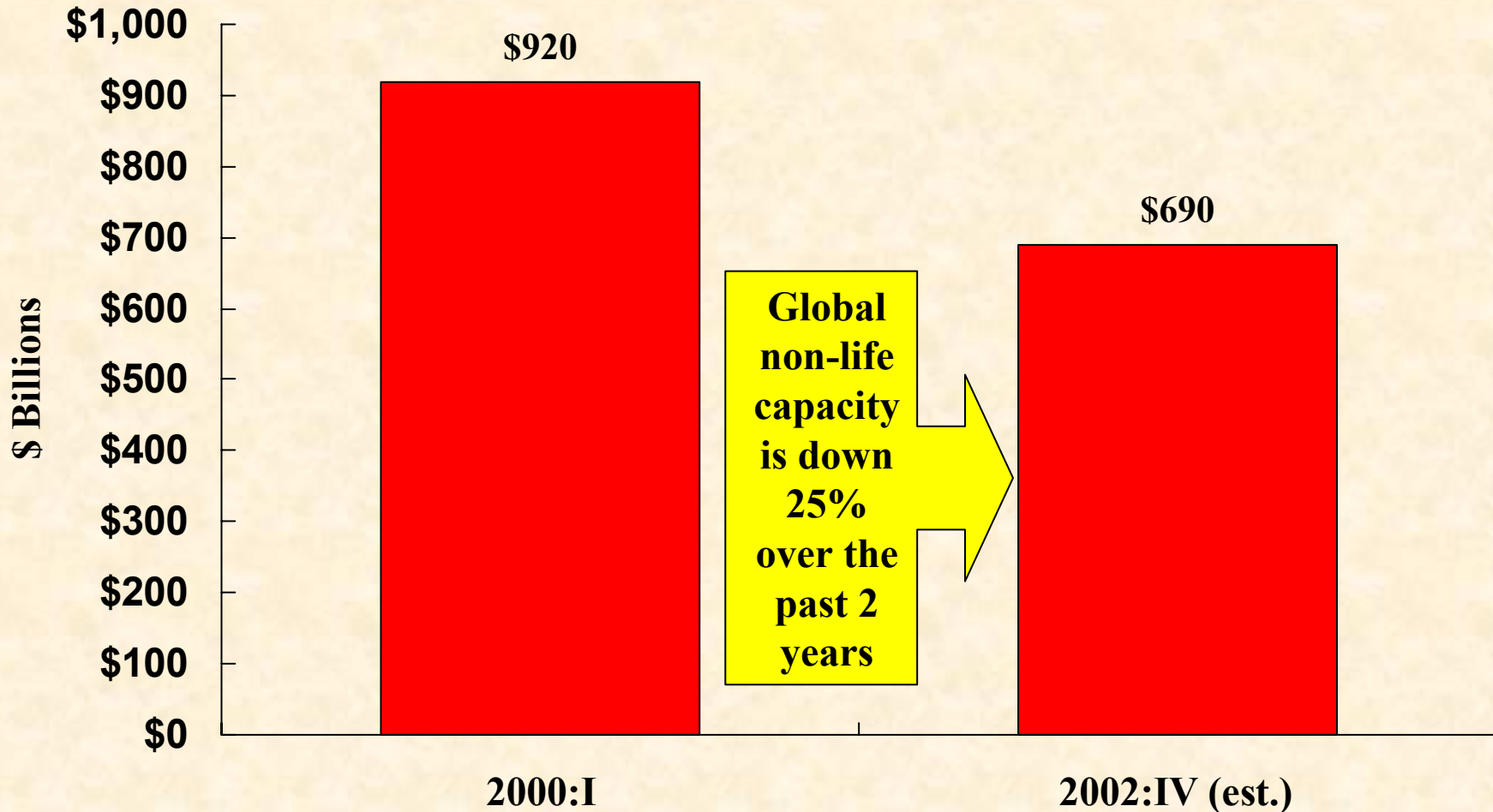


\*As of September 30, 2002

Source: A.M. Best, Insurance Information Institute



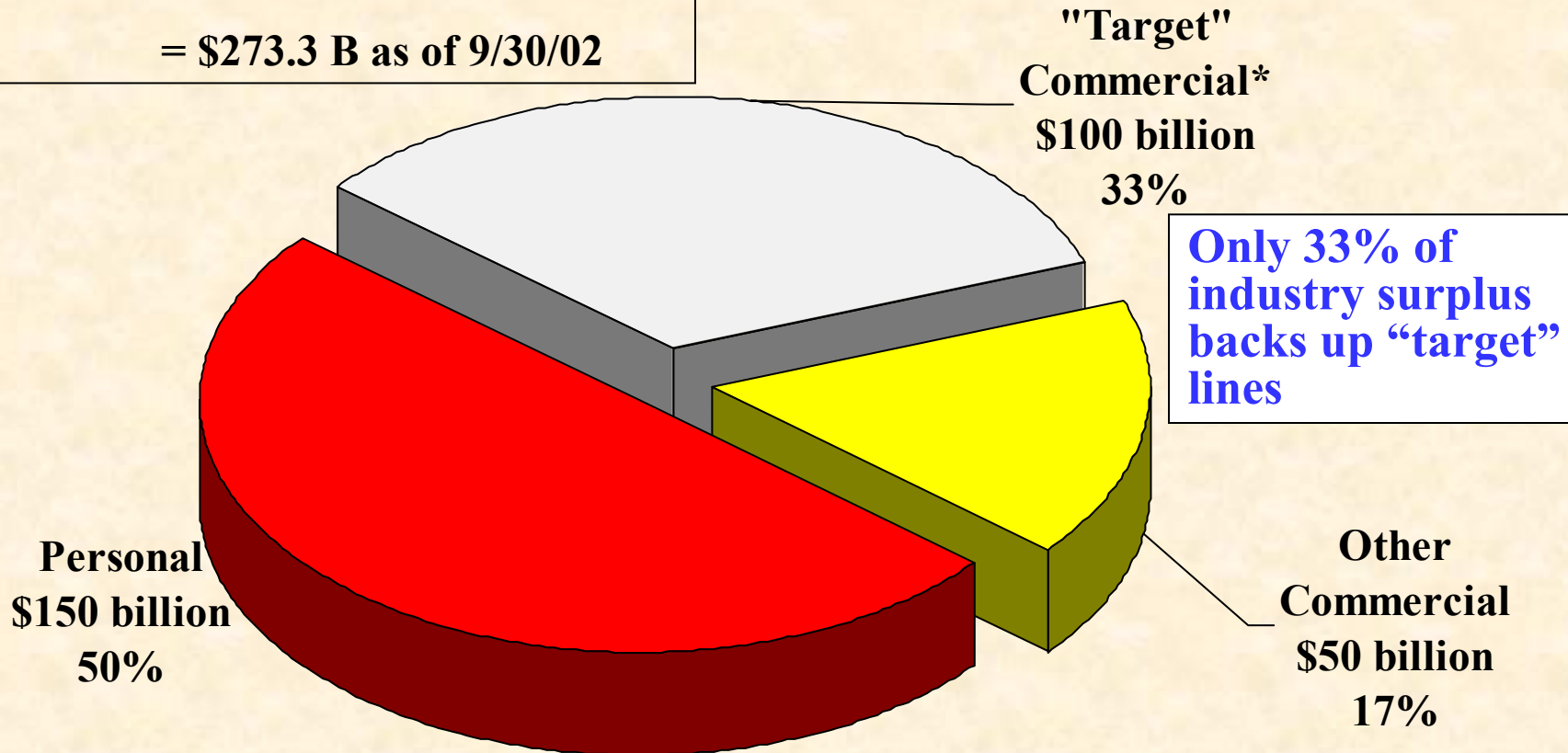
# *Global P/C Insurance Capacity is Falling Dramatically*





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

**Total PHS = \$298.2 B as of 6/30/01  
= \$273.3 B as of 9/30/02**



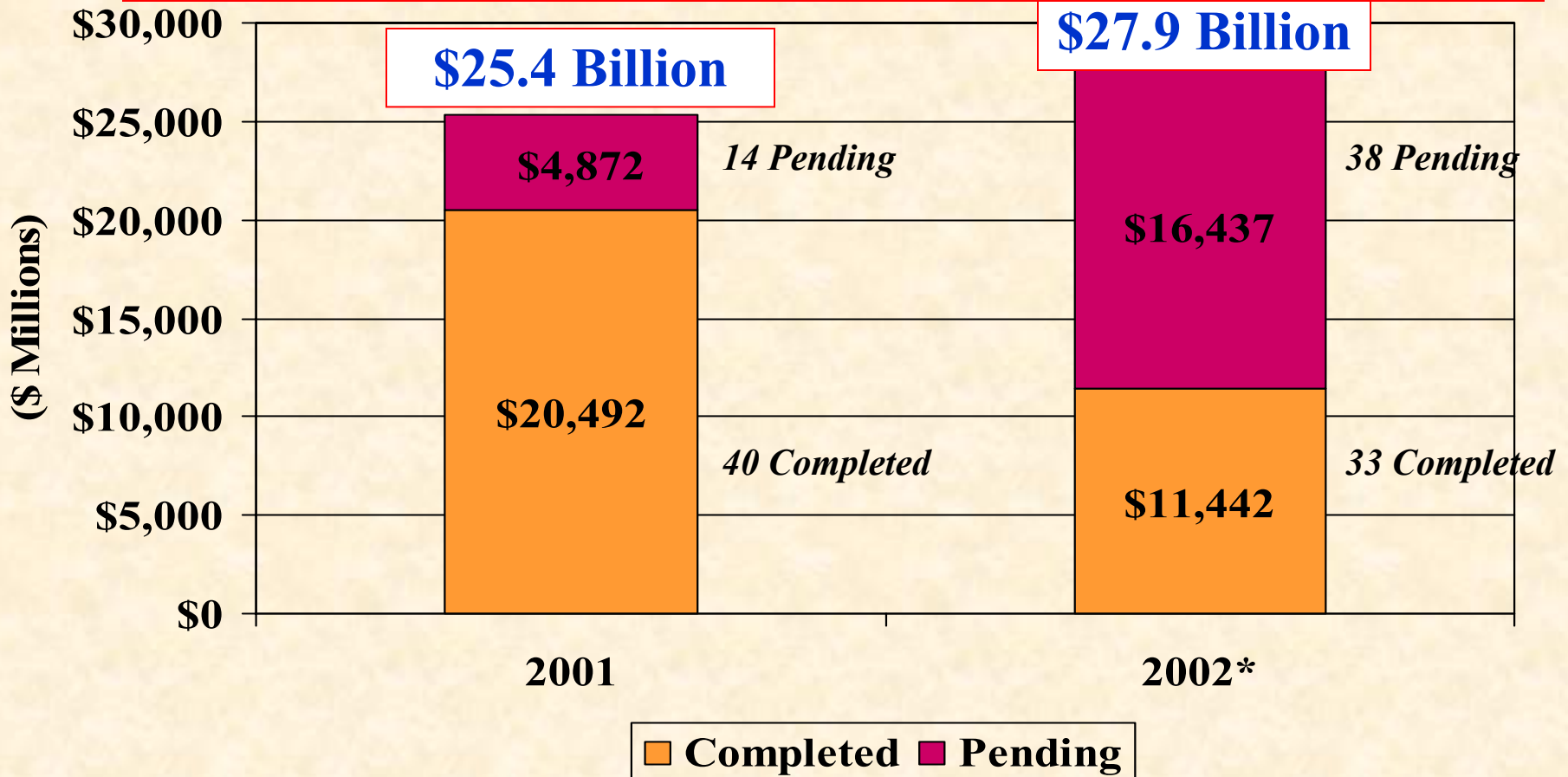
\*"Target" Commercial includes: Comm property, liability and workers comp; Surplus must also back-up on non-terrorist related property/liability and WC claims

Source: Insurance Information Institute



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

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

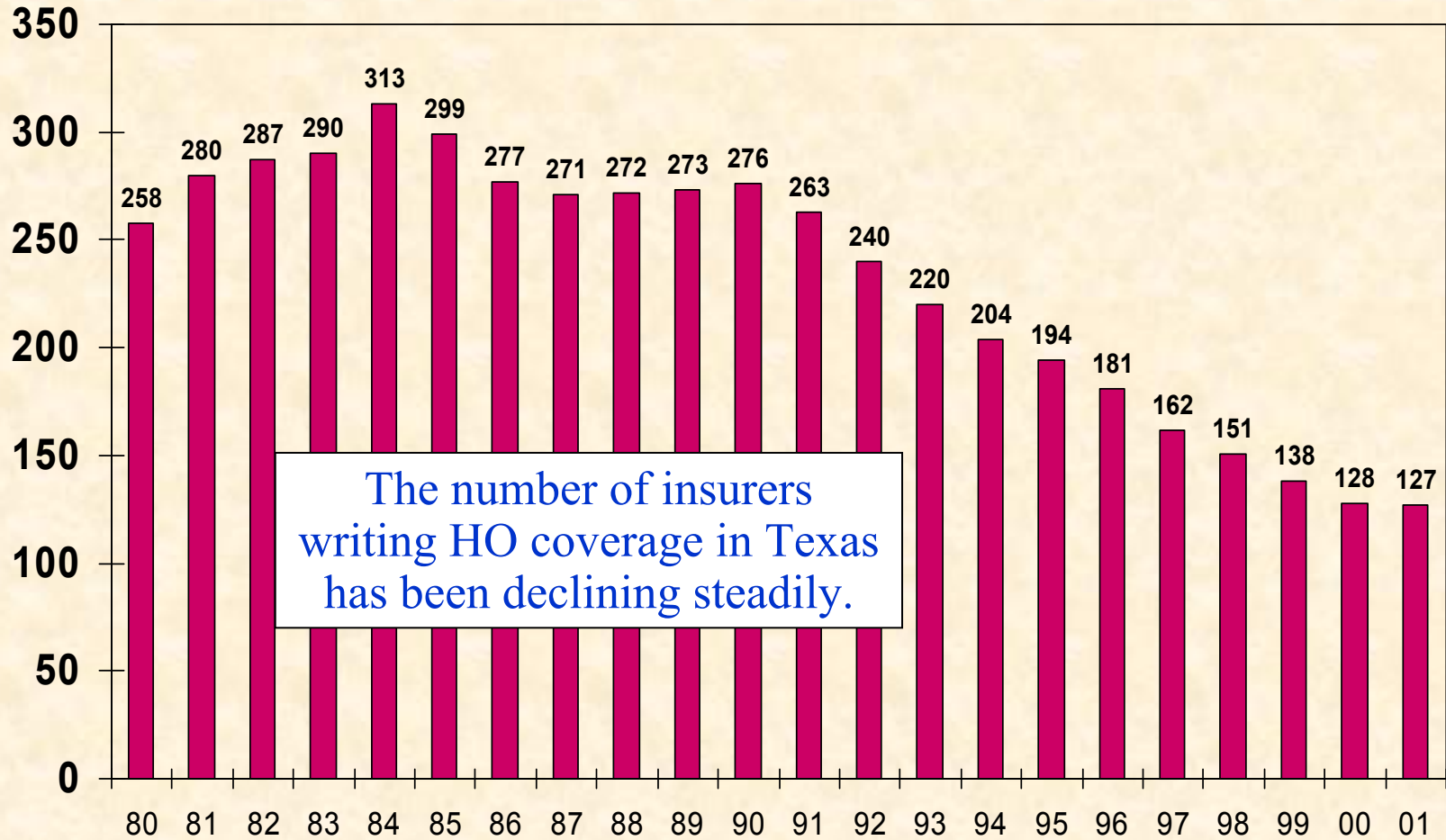


\*As of September 13, 2002.

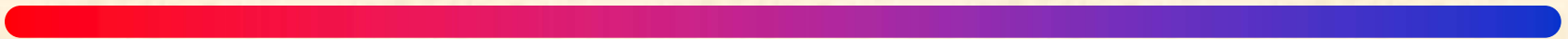
Source: Morgan Stanley, Insurance Information Institute.



# *Number of Homeowners Insurers in Texas*

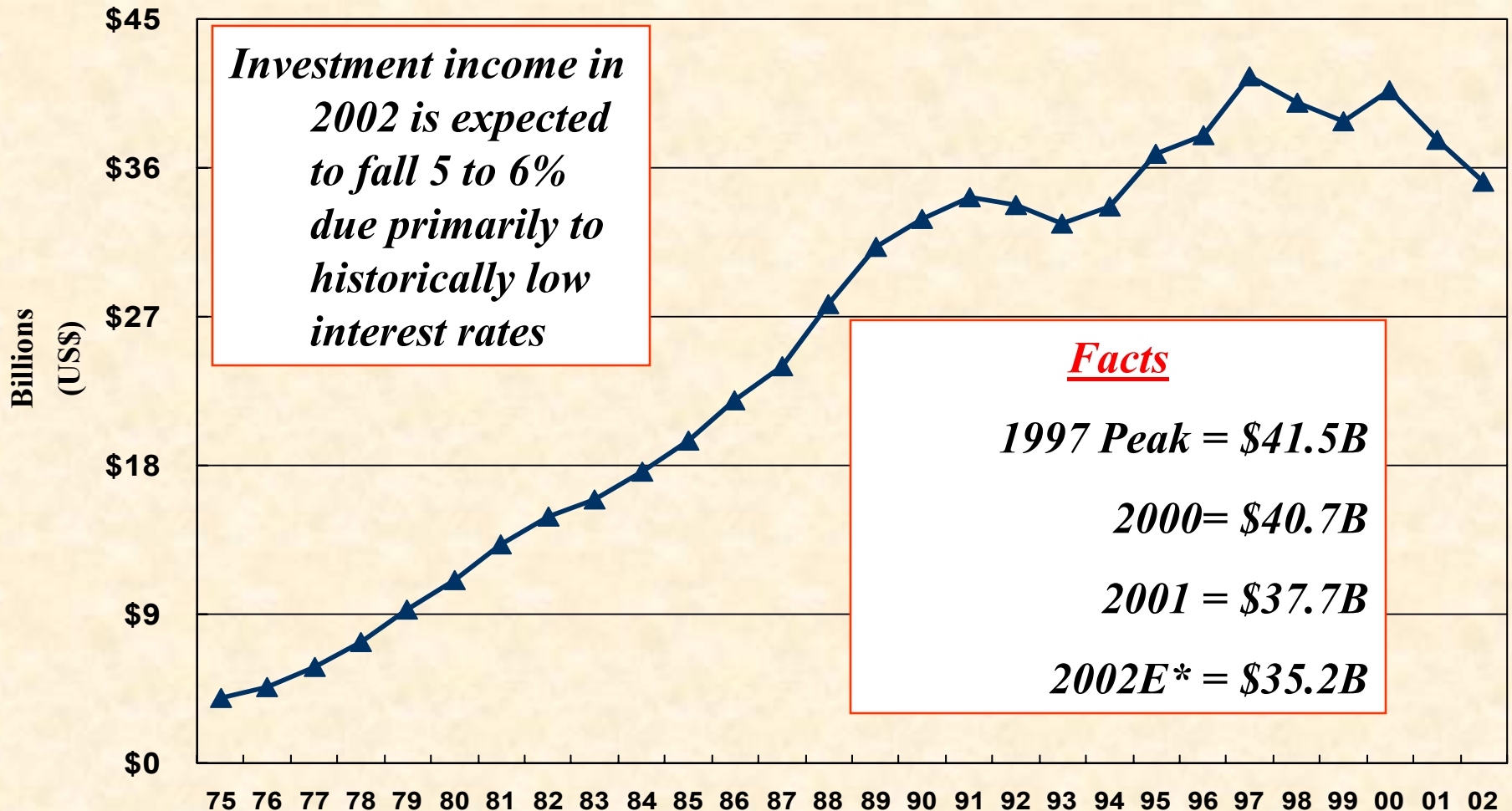


***IMPROVE  
INVESTMENT  
PERFORMANCE***





# Net Investment Income

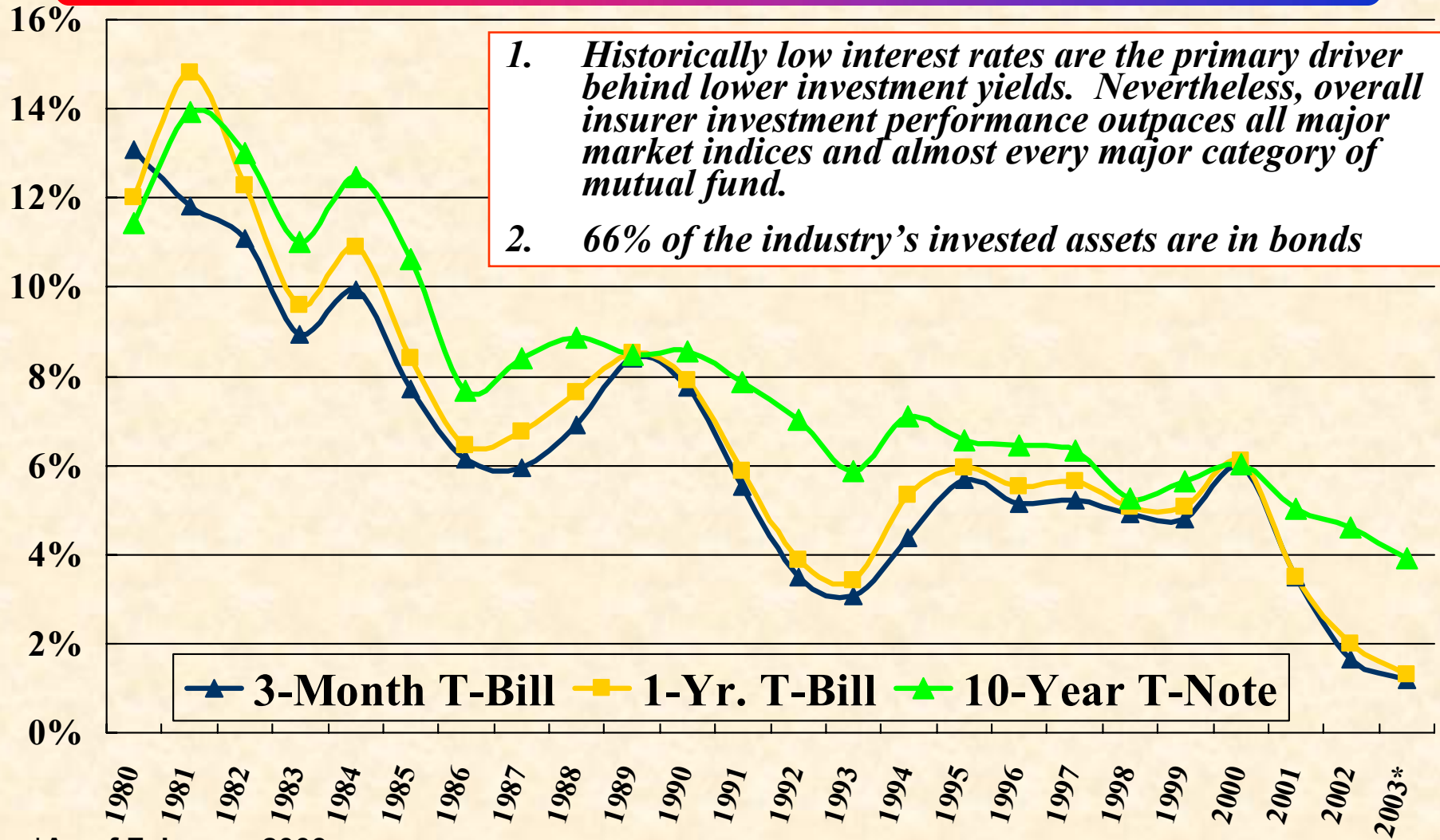


\*Annualized estimate based on first 9 months of 2002 data.

Source: A.M. Best, Insurance Information Institute



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



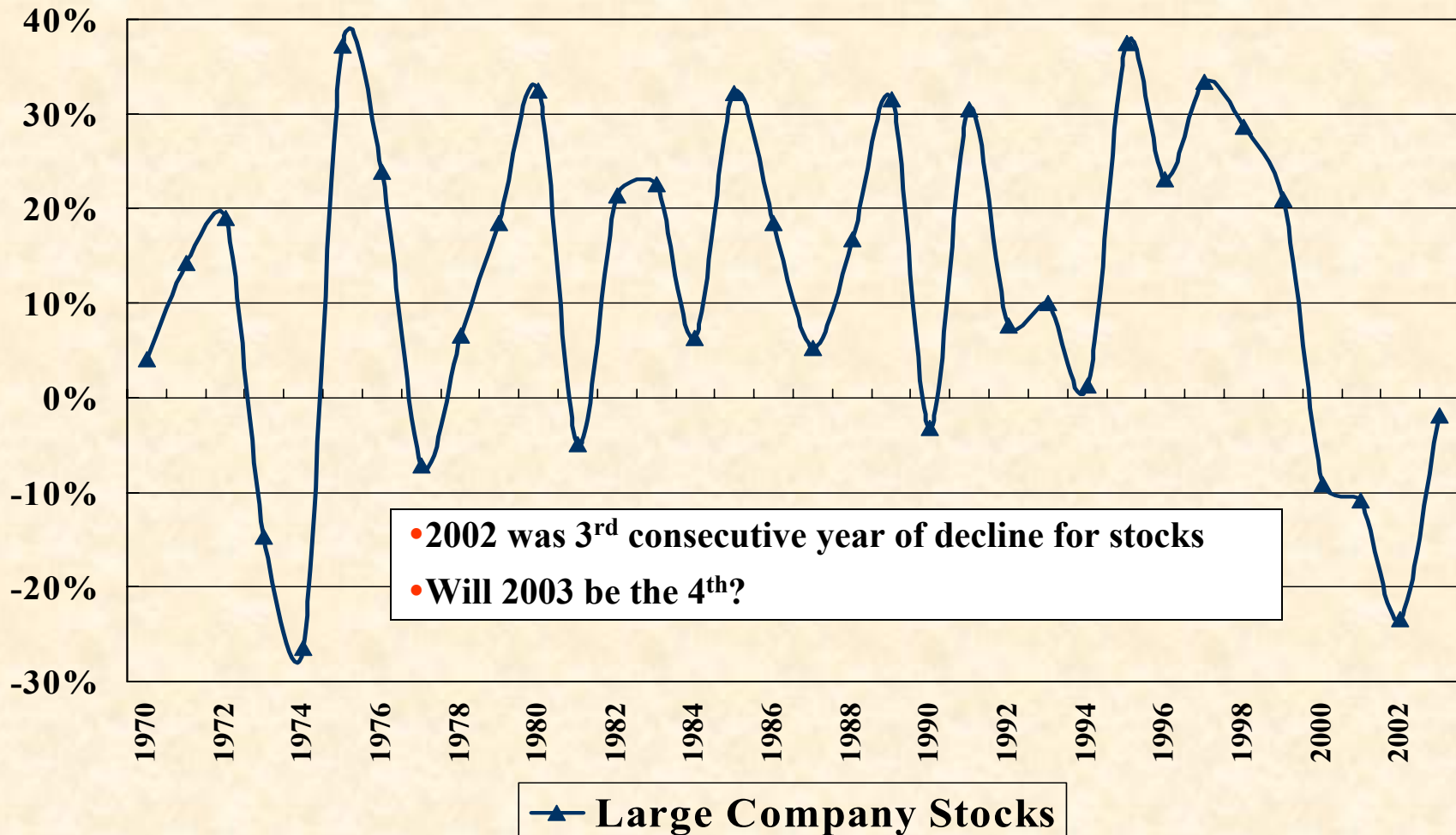
1. *Historically low interest rates are the primary driver behind lower investment yields. Nevertheless, overall insurer investment performance outpaces all major market indices and almost every major category of mutual fund.*
2. *66% of the industry's invested assets are in bonds*

\*As of February 2003.

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



# Total Returns for Large Company Stocks: 1970-2003\*

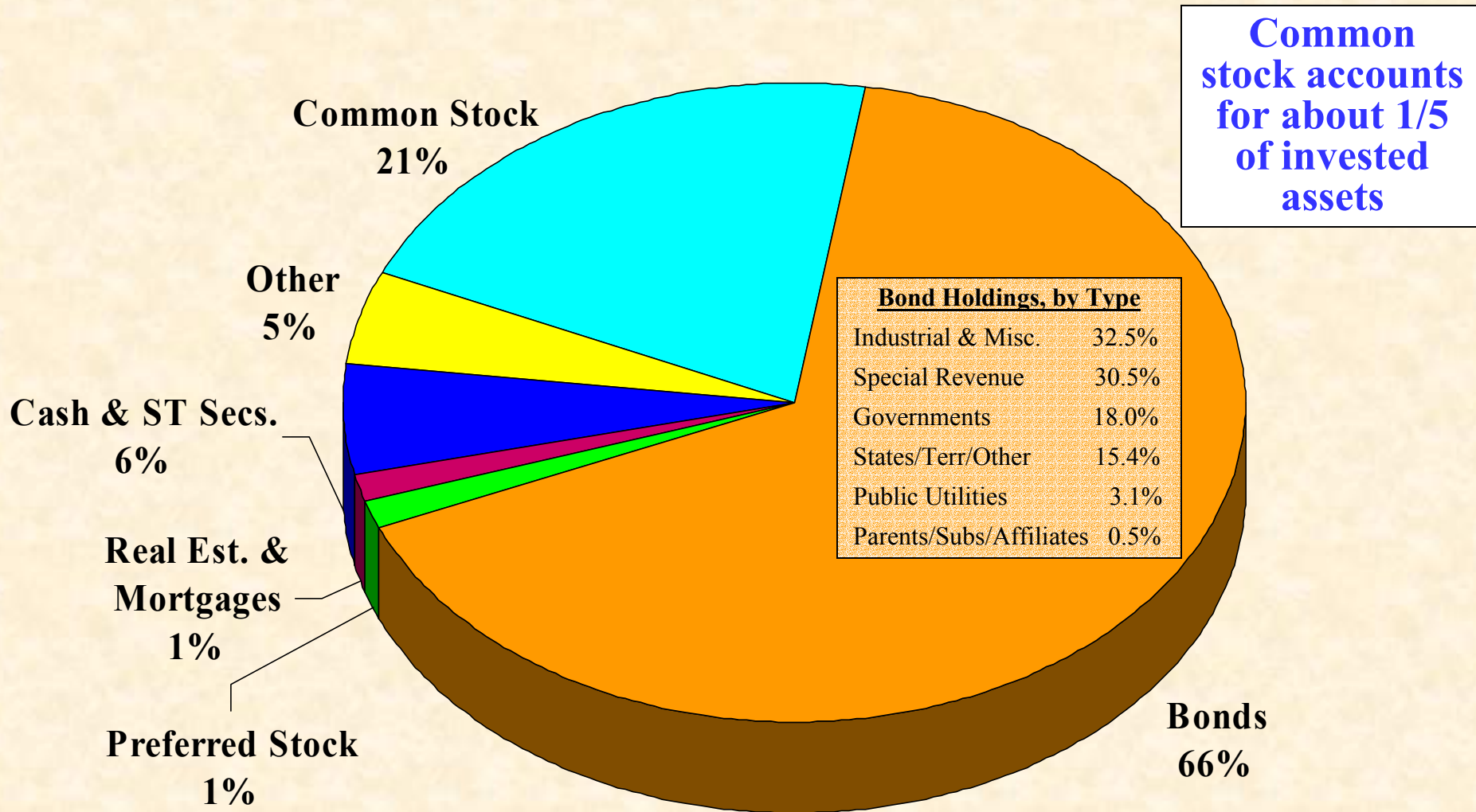


\*As of April 11, 2003.

Source: Ibbotson Associates, Insurance Information Institute



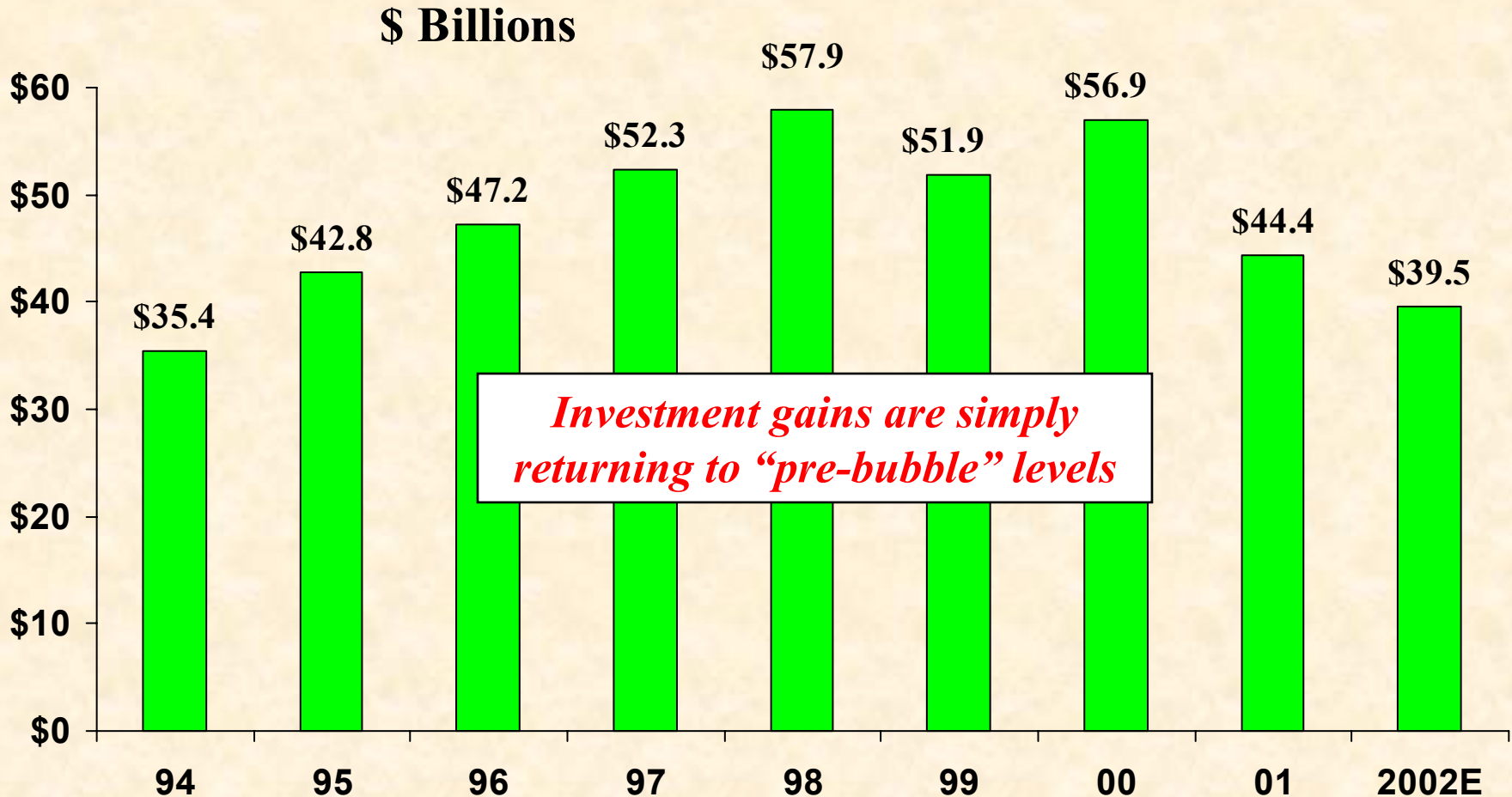
# *P/C Industry Investments, by Type (as of Dec. 31, 2001)*



Source: A.M. Best, Insurance Information Institute



# Property/Casualty Insurance Industry Investment Gain\*



\*Investment gains consists primarily of interest, stock dividends and realized capital gains and losses.  
Source: Insurance Services Office; Insurance Information Institute estimate annualized as of 9/30/02.

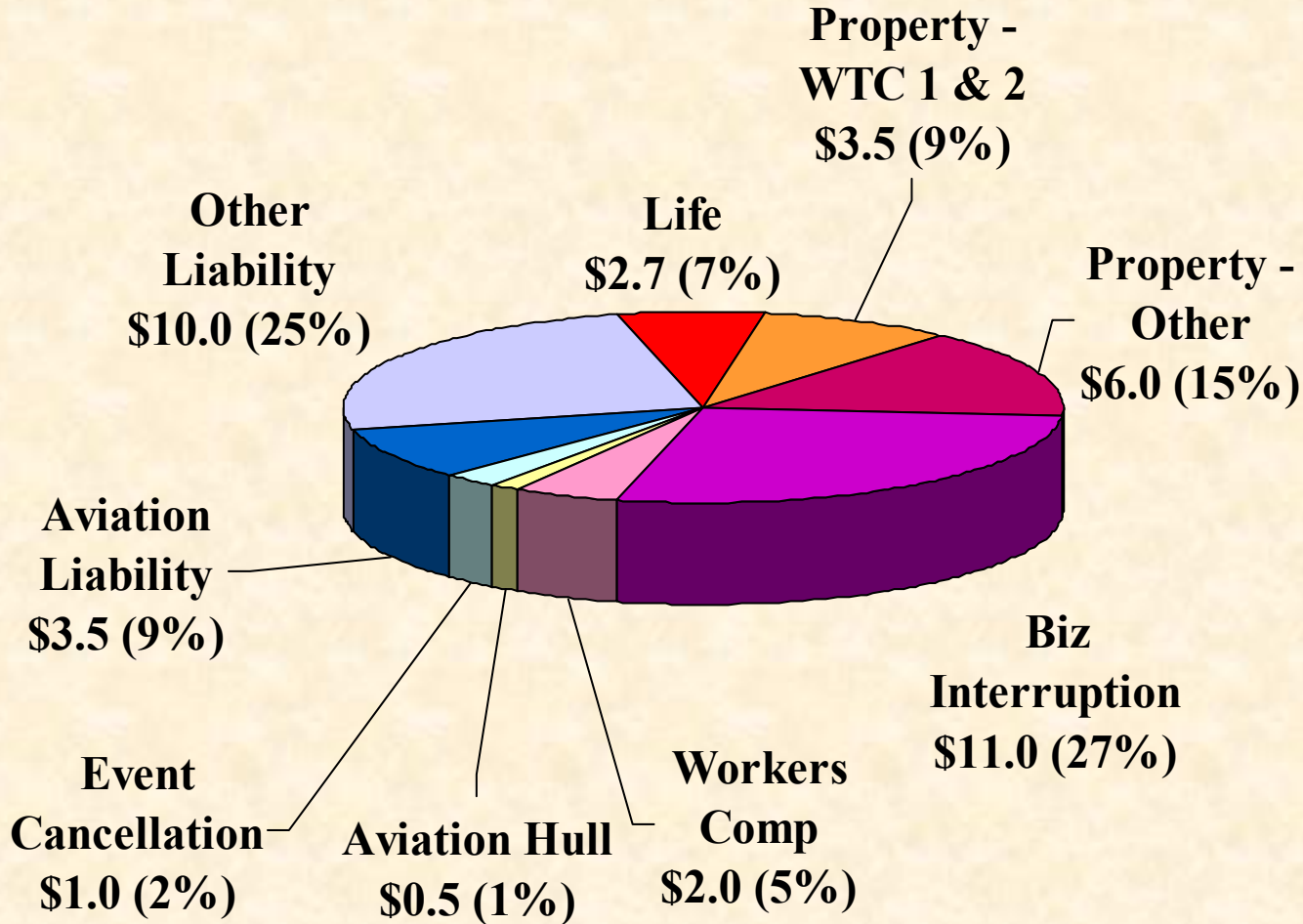
# ***THE CHALLENGE OF TERRORISM***





# Sept. 11 Industry Loss Estimates

(\$ Billions)



## Consensus Insured Losses Estimate: \$40.2B



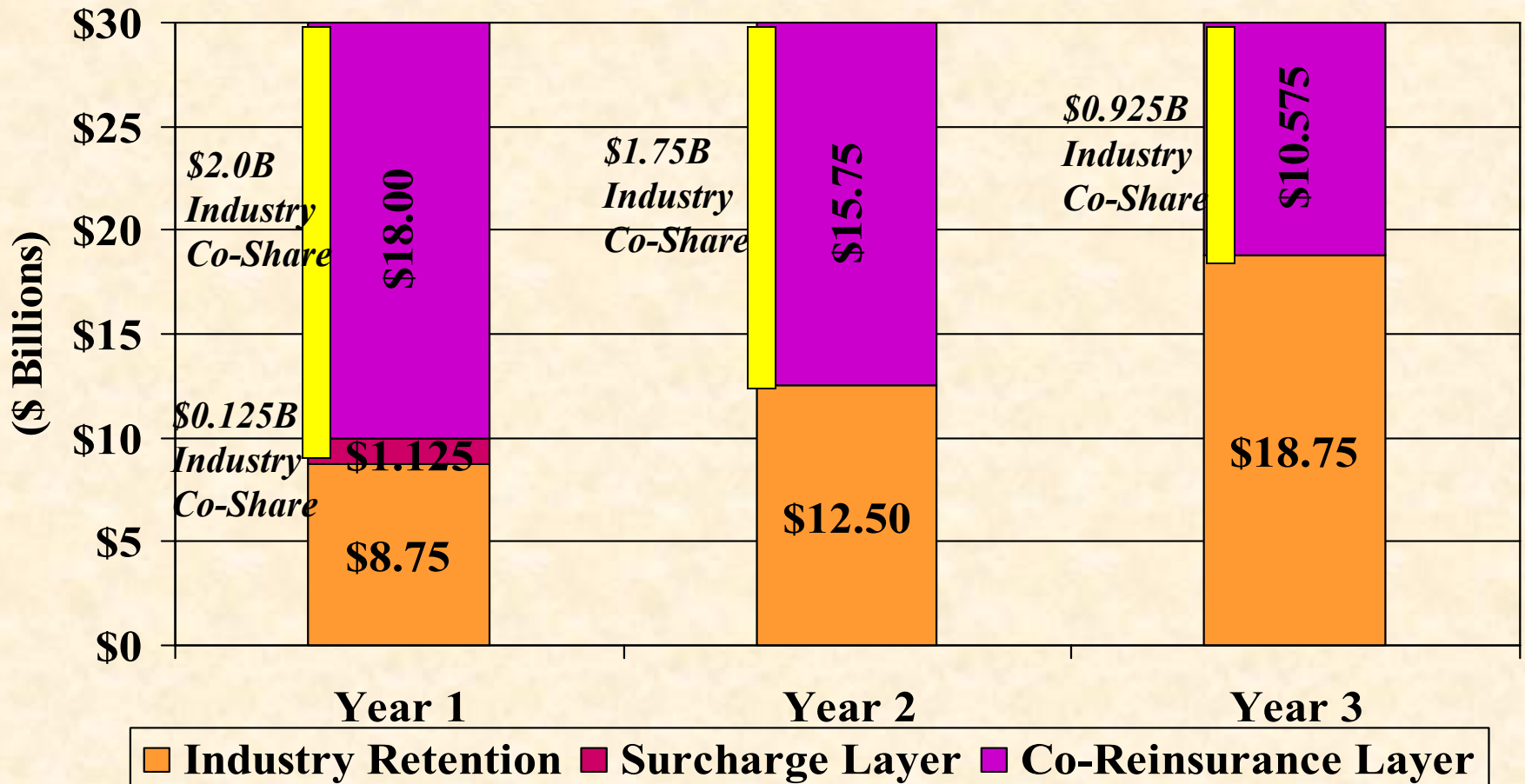
# Industry Losses Under Proposed Federal Backstop Using 9/11 Scenario

(as interpreted on date of enactment, Nov. 26, 2002)

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

**\$14.25B**

**\$19.675B**



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



# Property Market Response

## Terrorism Market is Inconsistent

- Moderate take-up rate among small risks
- Very low take-up rate for larger risks
  - Carriers/brokers report take-up rate of just 15% - 25 % for larger risks
- Prices cited varied from 0% to 1,000% of property premiums but quotes in the 2% - 8% range typical as insurers sought to distribute max loss under TRIA loss across policyholder base
- Could change substantially for 2003 renewal: more indiv. rating
- **Reasons Businesses Decline Coverage**
  - *Expense*
  - *Want to bargain with insurer; attempt to change terms/conditions*
  - *Feel likelihood of an attack impacting them is remote*
  - *Believe government will bail them out*
  - *Feel "Fire Following" provision will compel coverage*
  - *Will try self insurance; investigate alternative risk transfer options*



# *Property Market Response*

## • **Problems**

- Low take-up rate => possible adverse selection problem
- Insurability of terrorism still question despite TRIA
- 12/31/05 sunset date will cause market to unravel in 2004

## • **Stand-alone terrorism market**

- Some quotes being sought for certified and non-certified losses
- Those treaties that existed are expiring and capacity for 2003 is uncertain
- Some insurers have reallocated resources

## • **Reinsurance Market**

- Some property catastrophe treaty renewals at Jan 1 were renewed including “non-certified” terrorism but still excluding nuclear, biological and chemical
- Reinsurers cautious about risk accumulation (e.g., zip code buckets)
- Insurers are seeking reinsurance to buy down their retentions

*ABUSE OF THE  
U.S. CIVIL JUSTICE  
SYSTEM*





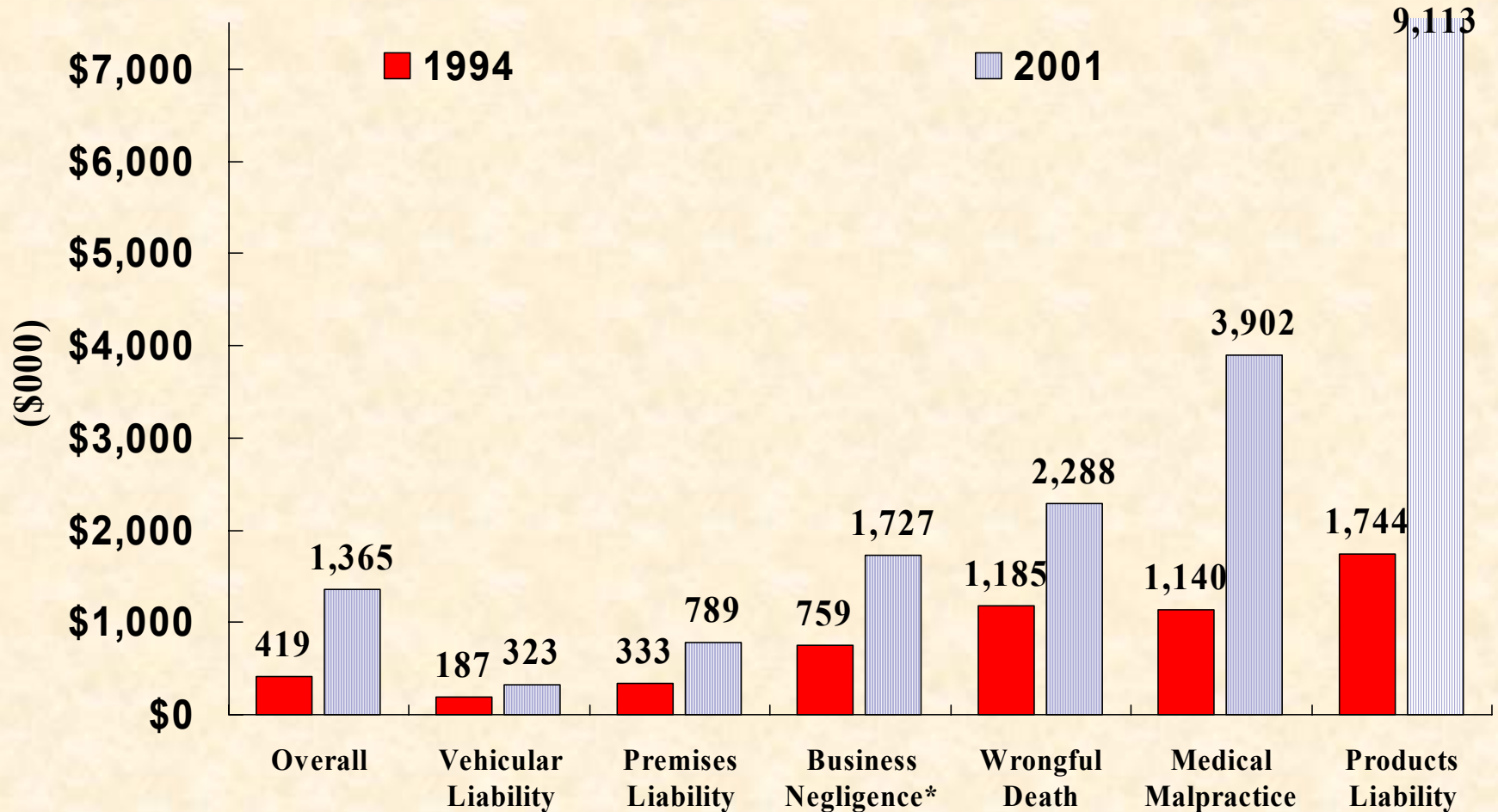
# TORT-ure

- Asbestos
- “Toxic” Mold
- Medical Malpractice
- Construction Defects
- Lead
- Fast Food
- Arsenic Treated Lumber
- Guns
- Genetically Modified Foods (Corn)
- Pharmaceuticals & Medical Devices
- Security exposures (workplace violence, post-9/11 issues)
- What’s Next?
- Slavery
- *Sept. 11??*





# Average Jury Awards 1994 vs. 2001

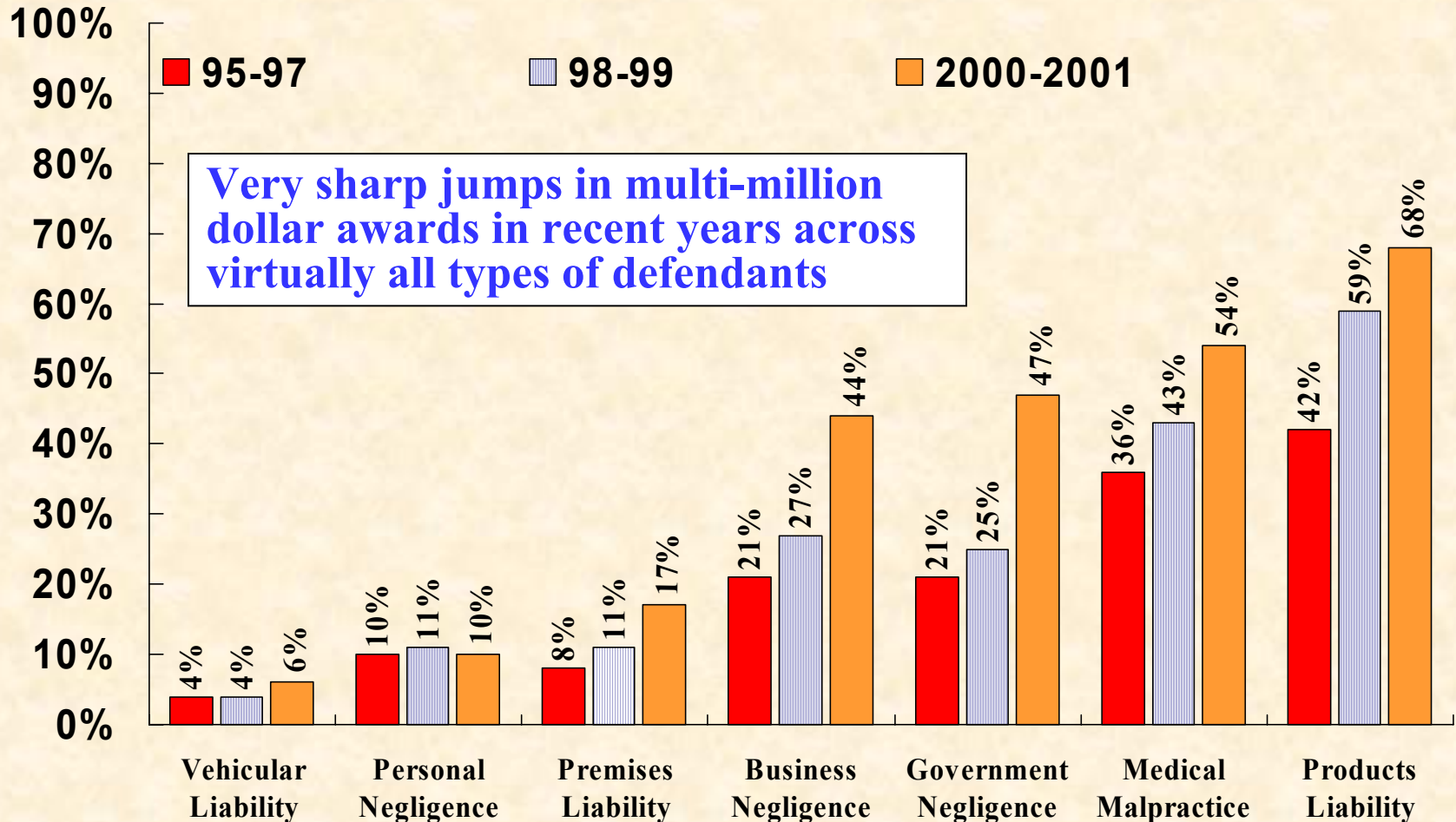


\*Figure is for 2000 (latest available)

Source: Jury Verdict Research; Insurance Information Institute.



# Trends in Million Dollar Verdicts\*



\*Verdicts of \$1 million or more.

Source: Jury Verdict Research; Insurance Information Institute.



# *Probability of Plaintiff*

## *Verdict is Rising*

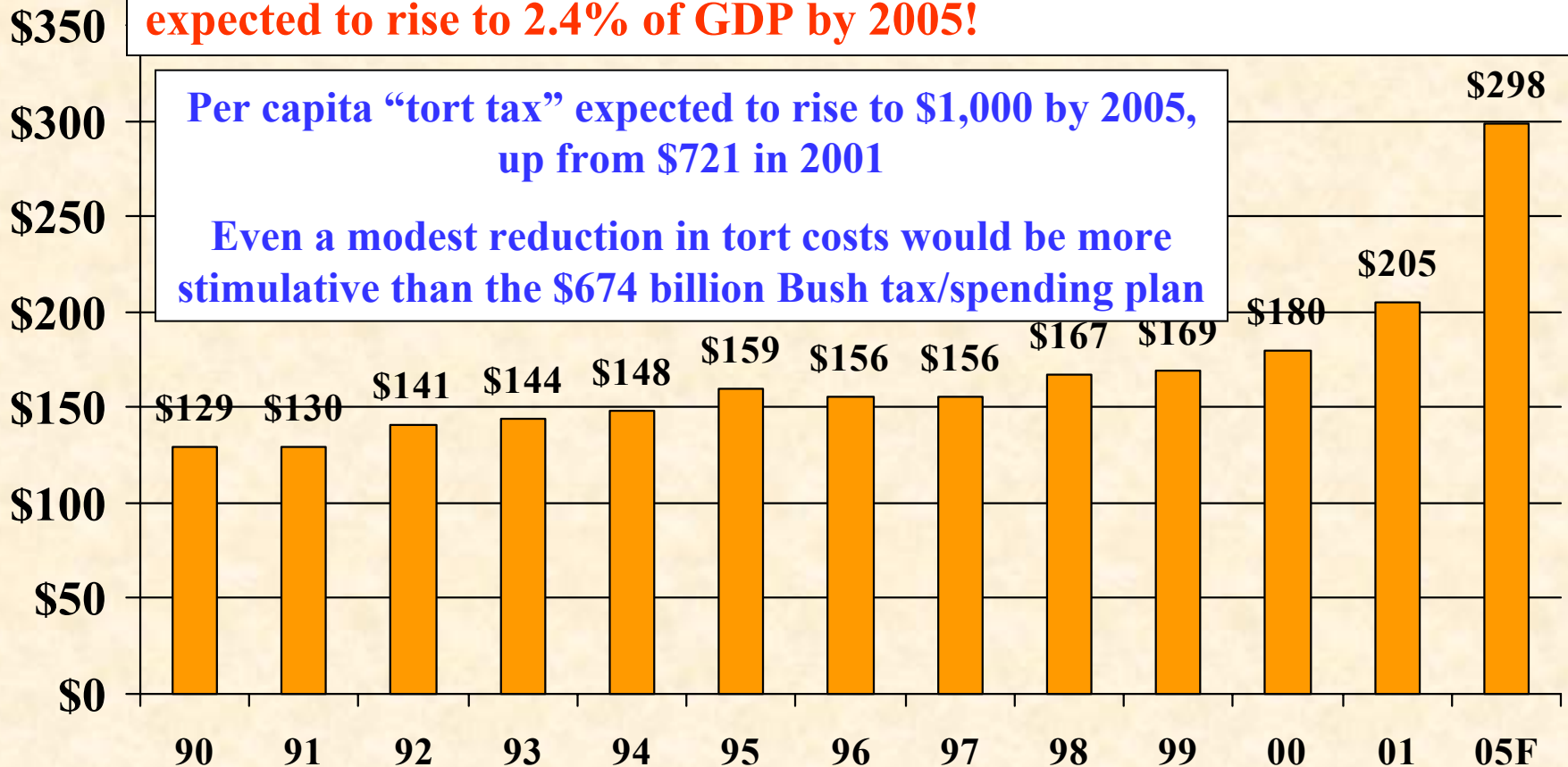
|                            | <u>1994</u> | <u>1997</u> | <u>2001</u> |
|----------------------------|-------------|-------------|-------------|
| <b>Premises Liability</b>  | 43%         | 45%         | 57%         |
| <b>Business Negligence</b> | NA          | 57%         | 66%         |
| <b>Vehicular Liability</b> | 58%         | 59%         | 68%         |
| <b>Products Liability</b>  | 39%         | 39%         | 56%         |

Source: Jury Verdict Research, *2002 Current Award Trends*



# 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!**



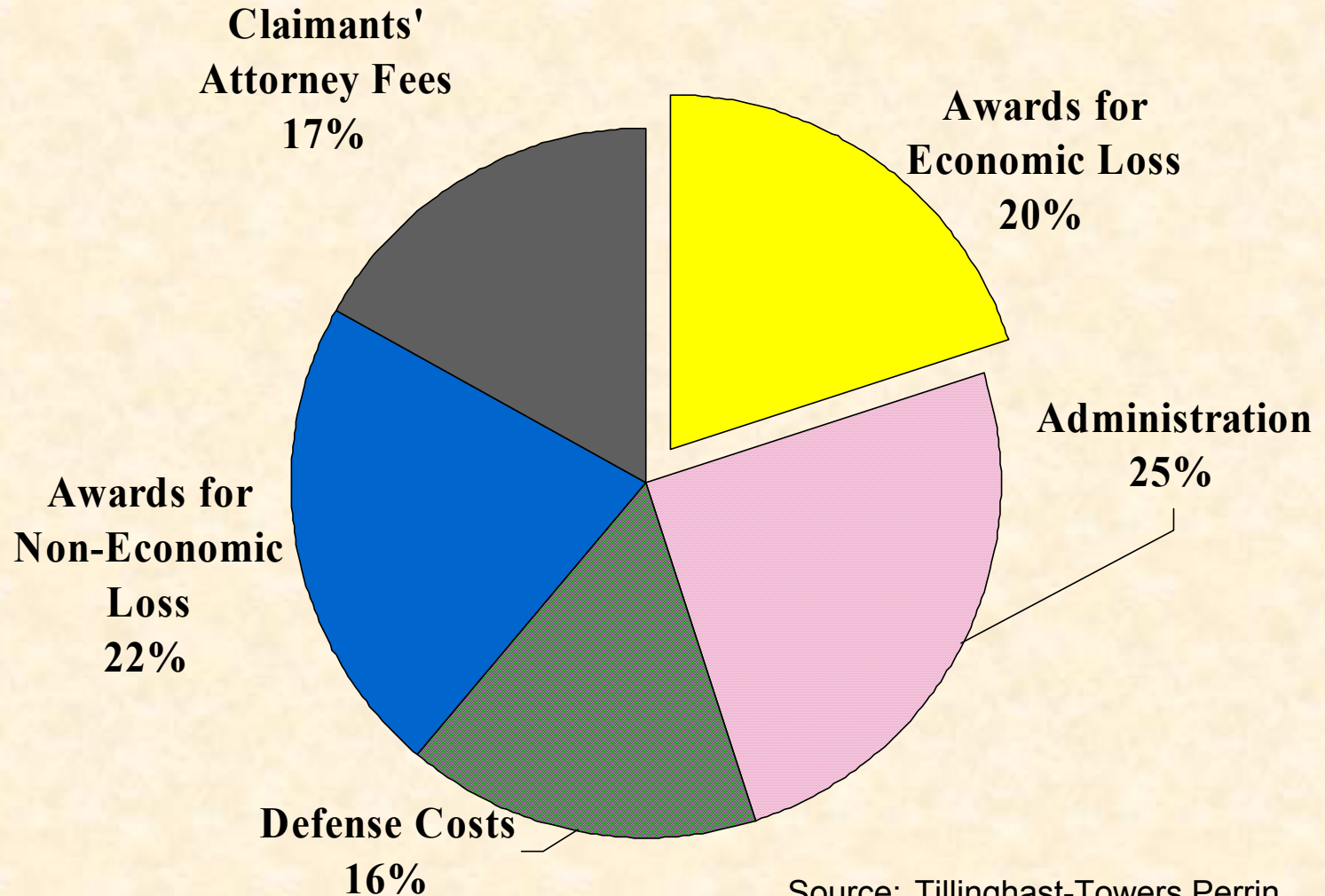
Source: Tillinghast-Towers Perrin. 2005 forecasts from Tillinghast.



# Where the Tort Dollar Goes (2000)

Tort System is extremely inefficient:

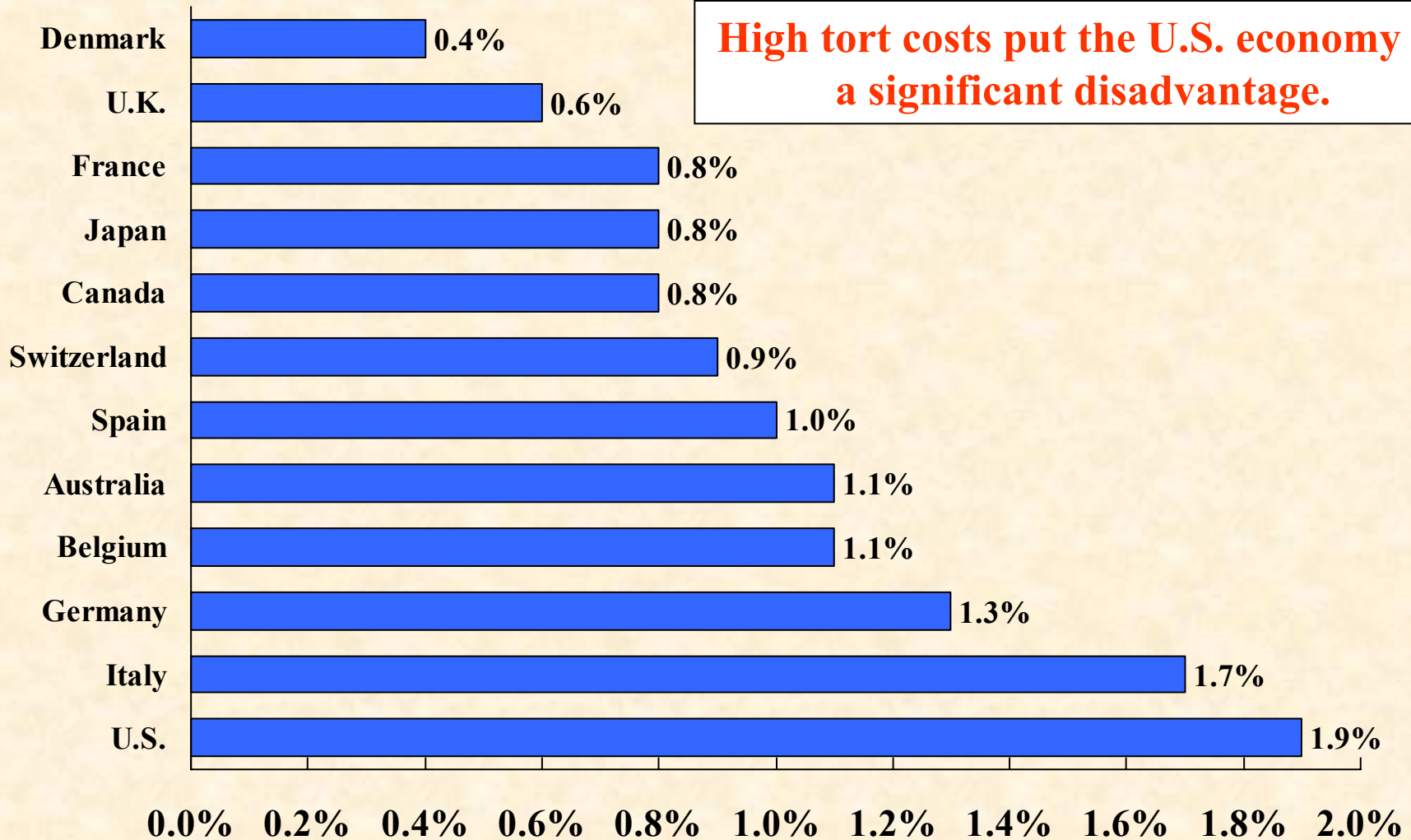
- Only 20% of the tort dollar compensates victims for economic losses
- At least 58% of every tort dollar never reaches the victim



Source: Tillinghast-Towers Perrin



# *Tort Costs as a % of GDP\**



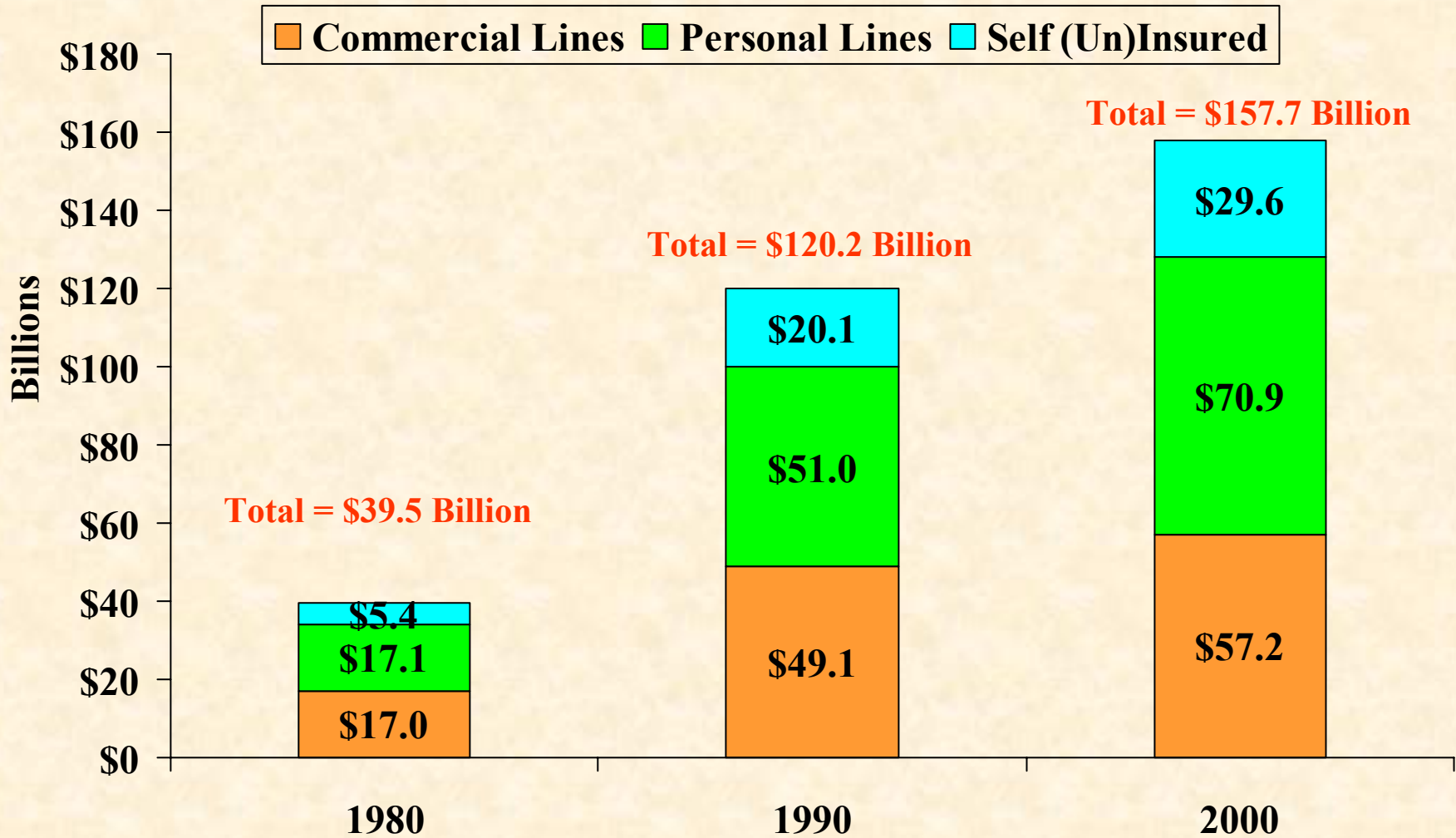
**High tort costs put the U.S. economy at a significant disadvantage.**

\*1998 (latest available)

Source: Tillinghast-Towers Perrin



# *Personal, Commercial & Self (Un) Insured Tort Costs\**



\*Excludes medical malpractice  
Source: Tillinghast-Towers Perrin



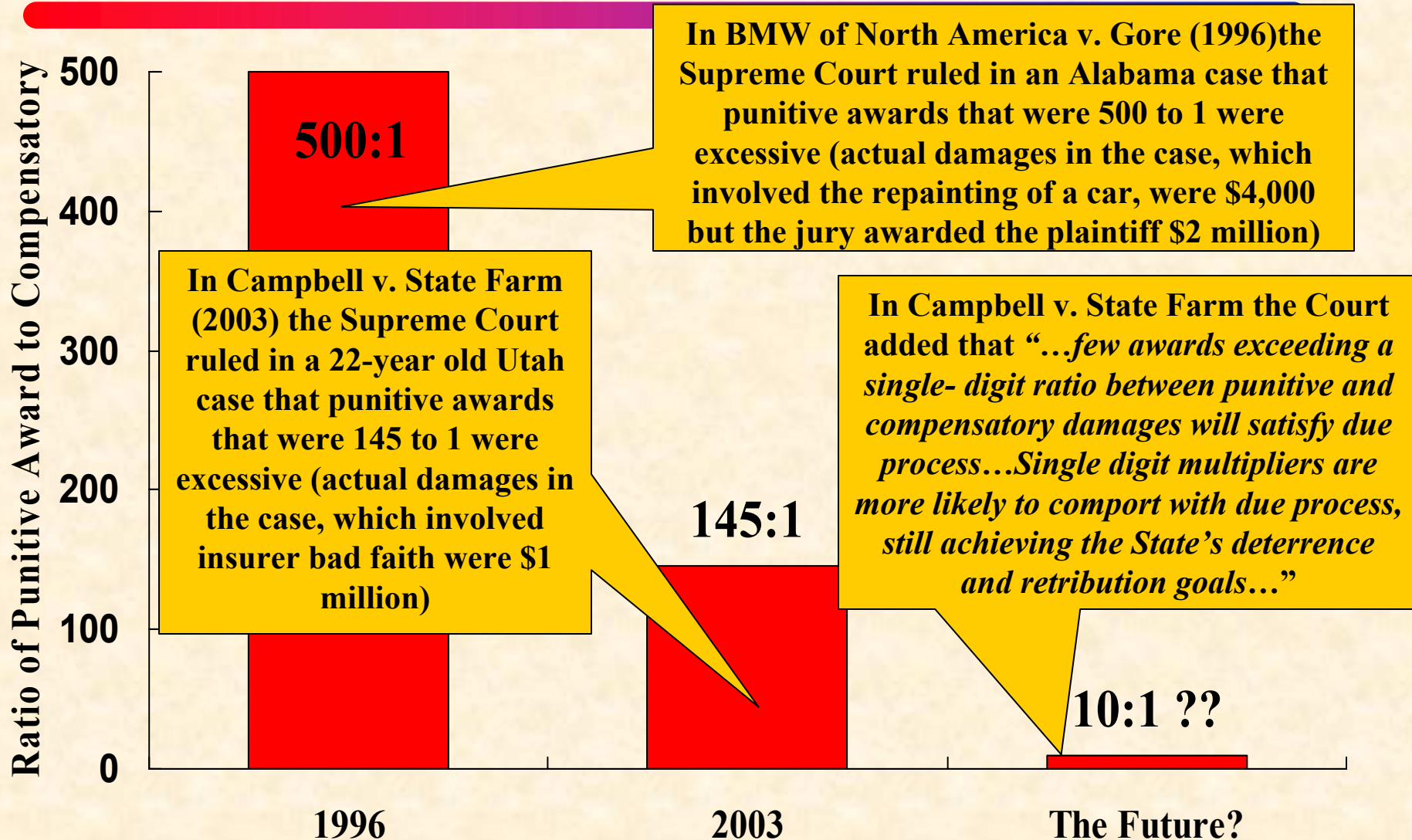
# *There is a Glimmer of Hope for Tort Reform*

## **Best Chance for Tort Reform in Years**

- Medical Malpractice
  - States—already happening
  - Federal reform is possible (but increasingly unlikely)
- General Federal Tort Reform
  - Broad support across all industries
  - But only 3 previous examples of federal tort limits
    - Light aircraft (GARA), vaccines, implantable med devices
- Asbestos Reform (Supreme Court no help)
- Punitive Damages—What's Reasonable
  - Supreme Court ruled favorably in *Campbell v. State Farm*

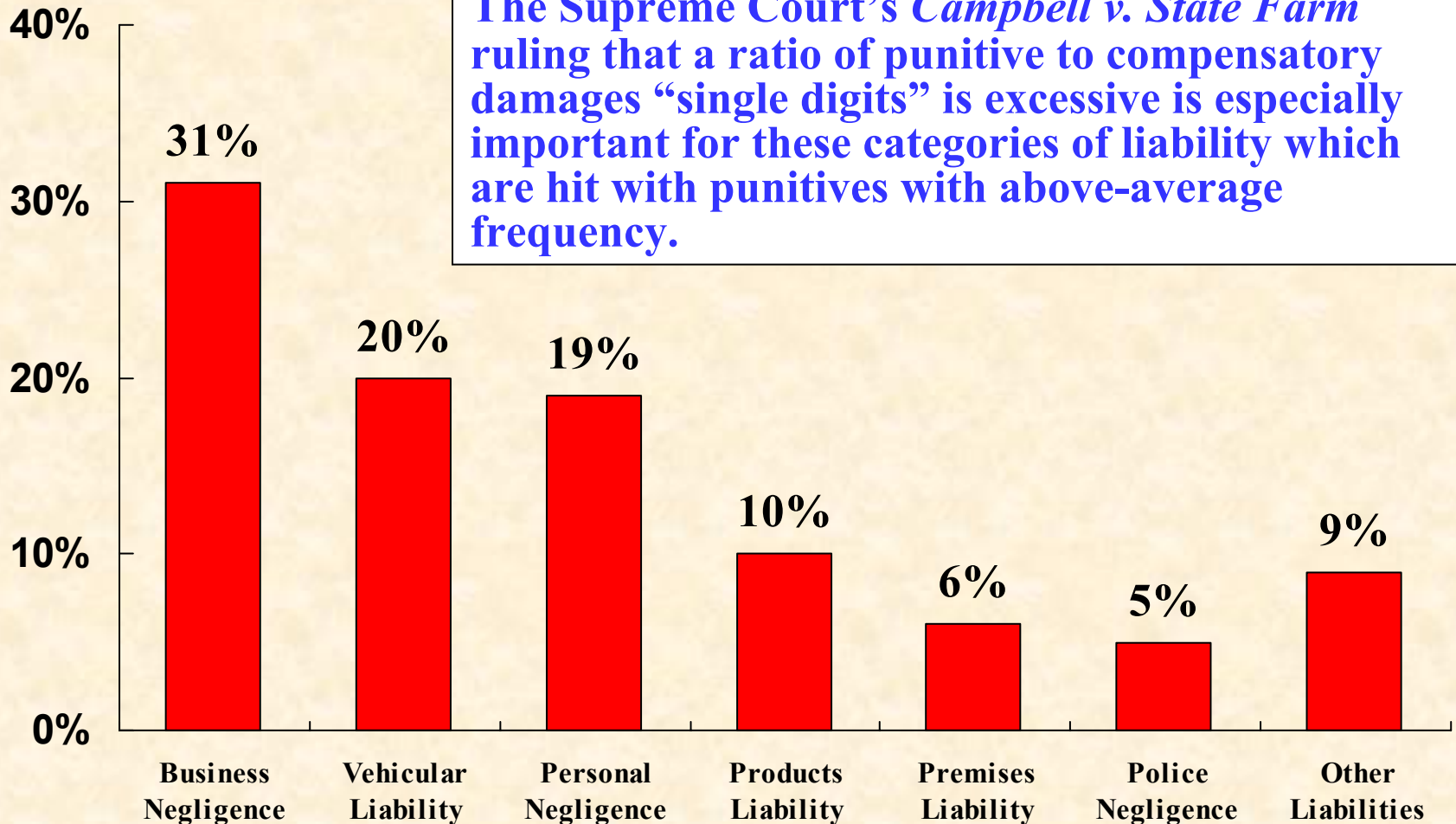


# Are We Finally Seeing Punitives Reigned In by the Supreme Court?



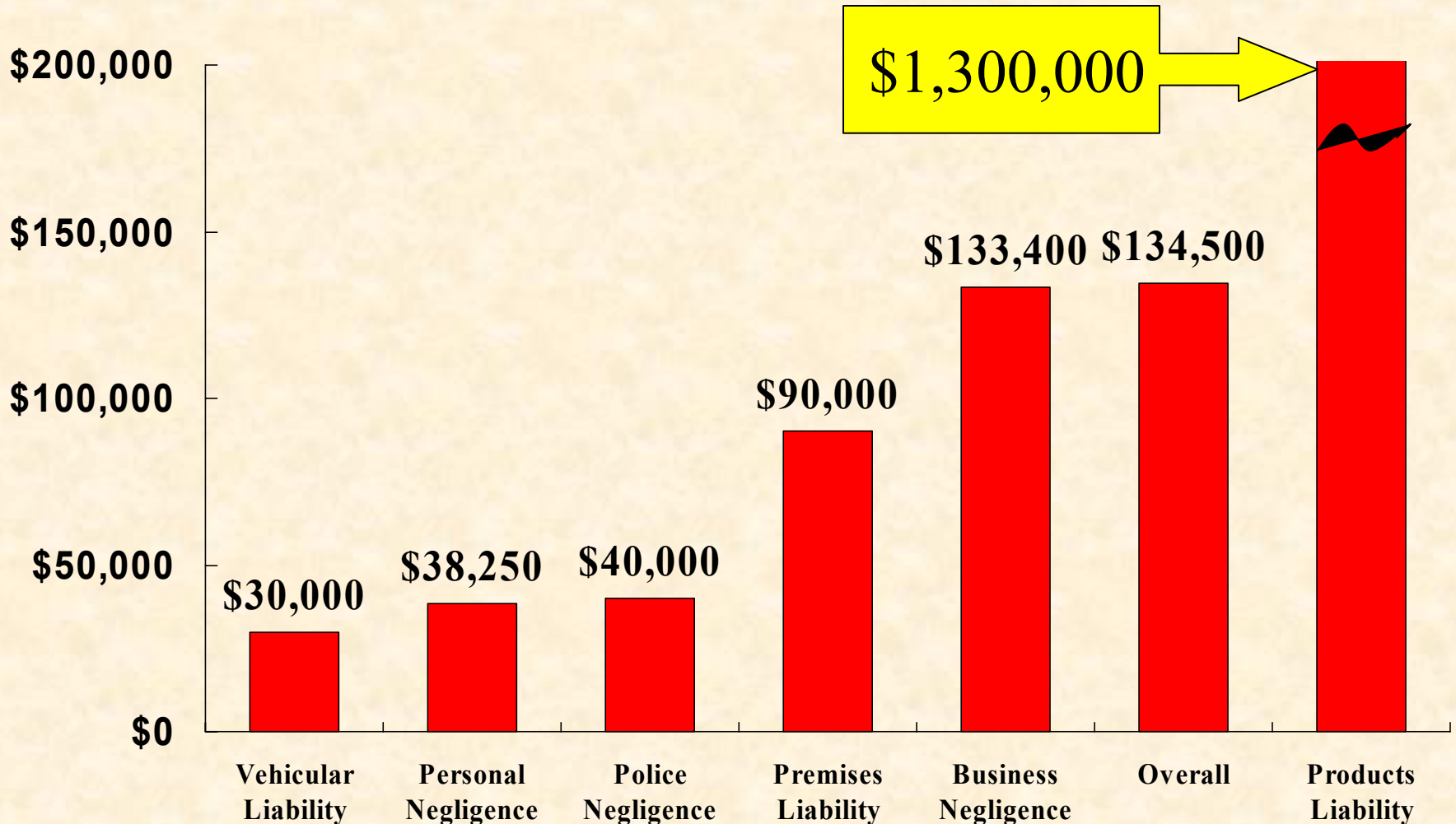


# Categories of Liability With Highest % of Punitive Awards



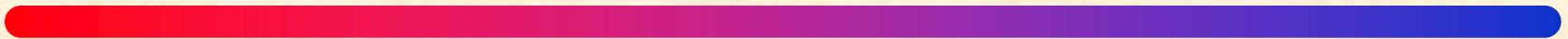


# *Median Punitive Award for Most Frequent Categories of Liability, 2001*



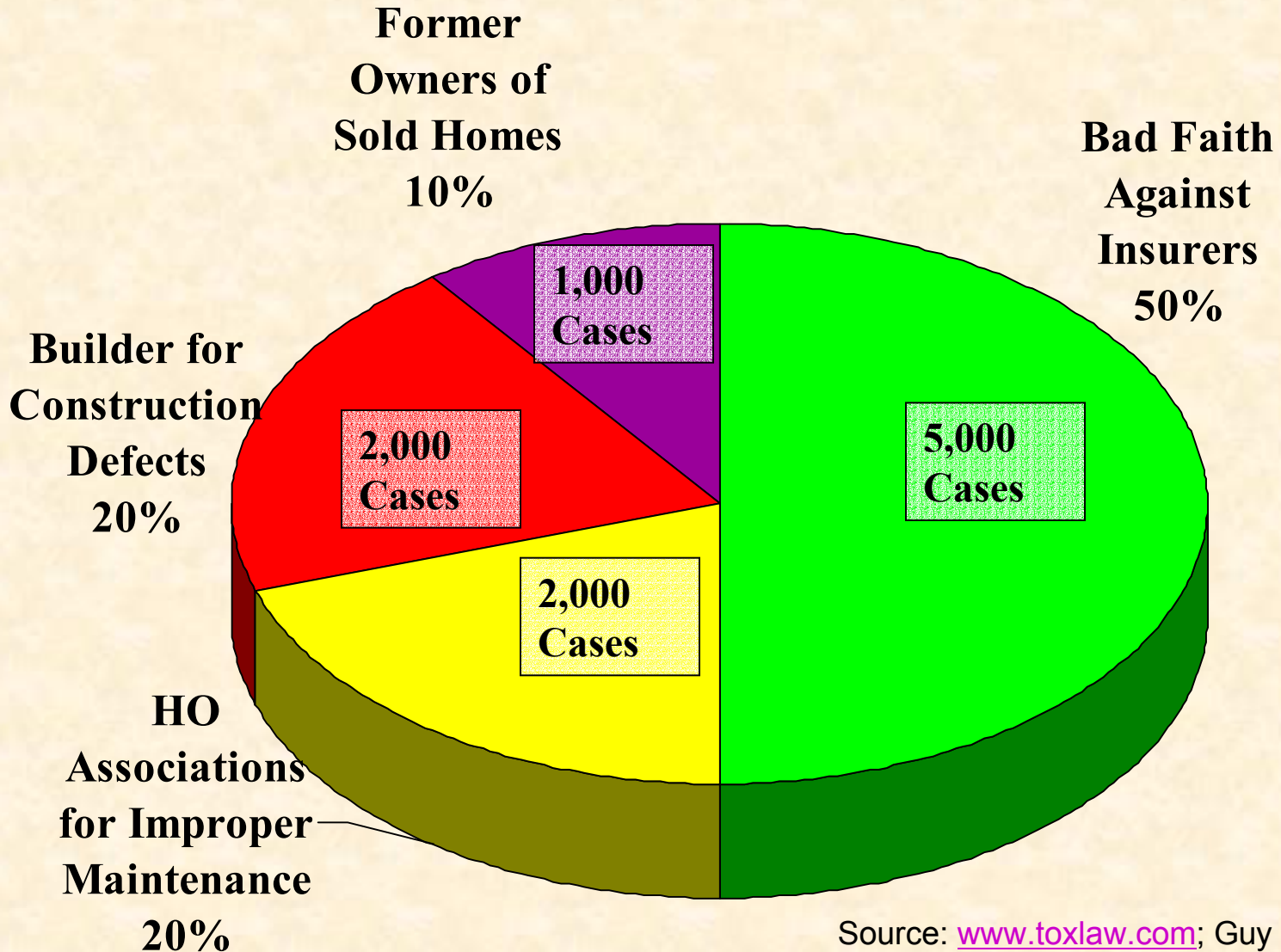
Source: Jury Verdict Research; Insurance Information Institute.

# ***‘TOXIC’ MOLD***



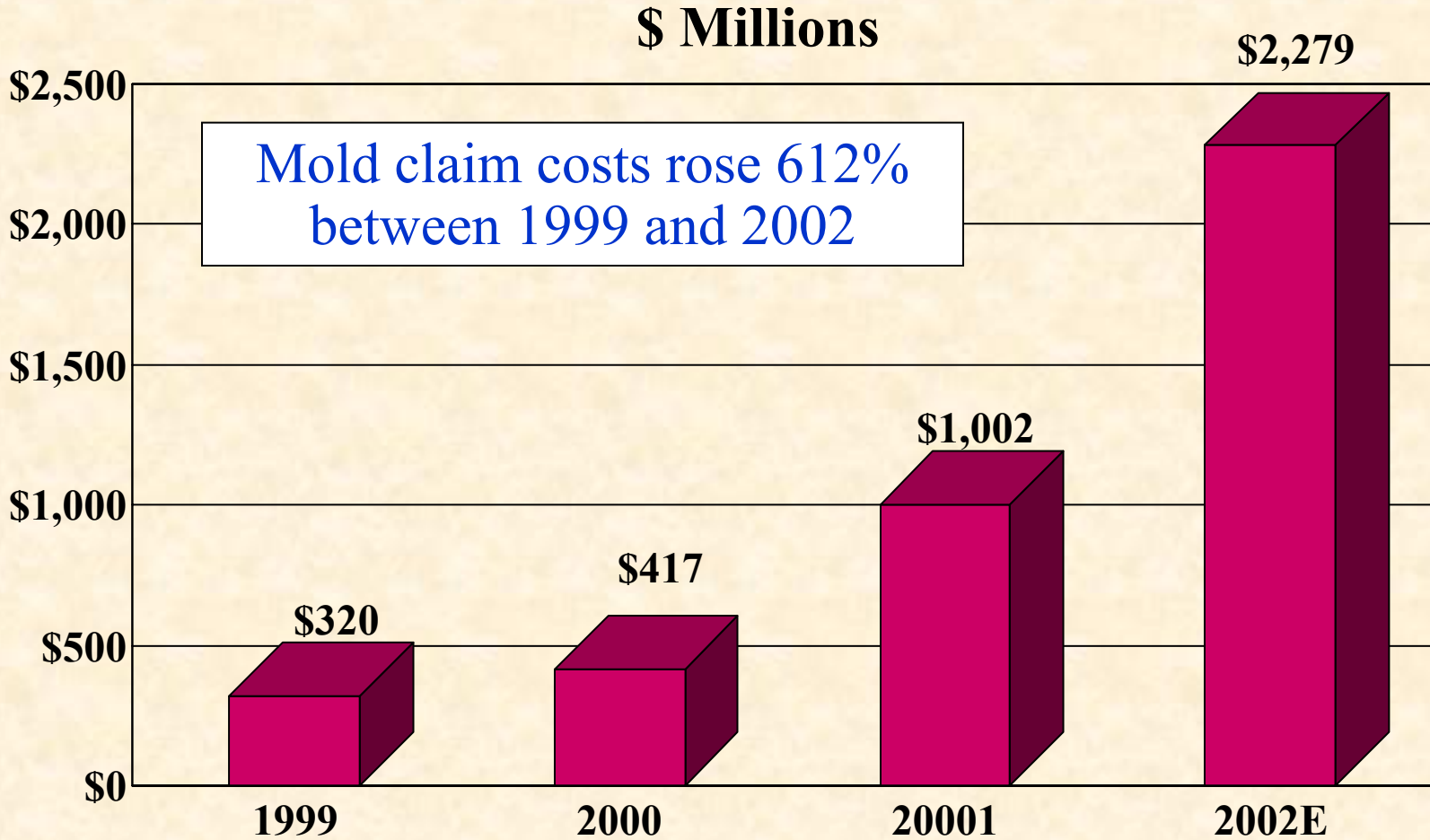


# *U.S.: Documented Toxic Mold Suits*





# *TX: Annual Losses from Mold Claims\**

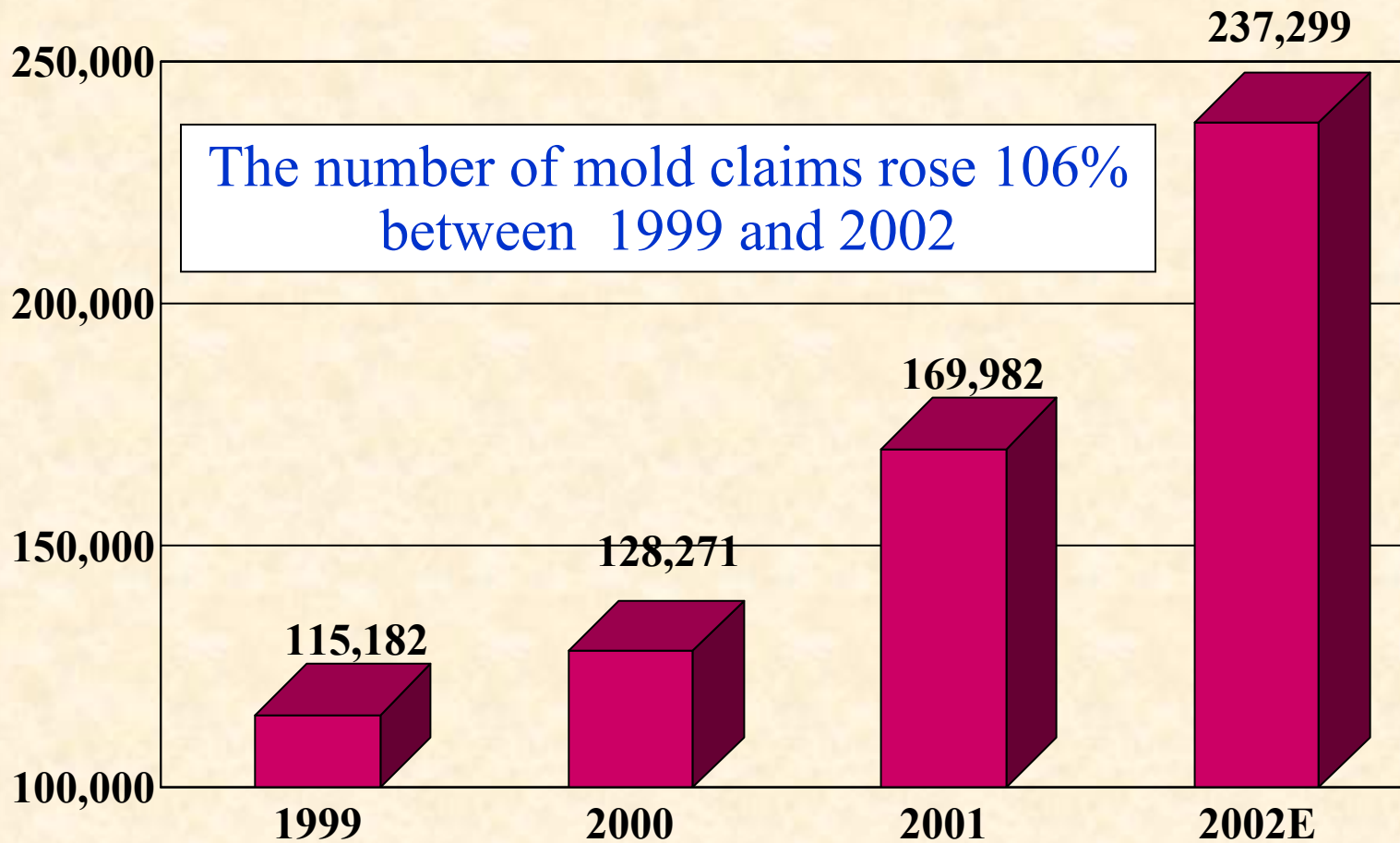


Source: Texas Department of Insurance;

\*2002 III estimate is annualized figure based on data through September 2002.



# Texas: Estimated Total Number of Mold Claims, 1999-2002E\*

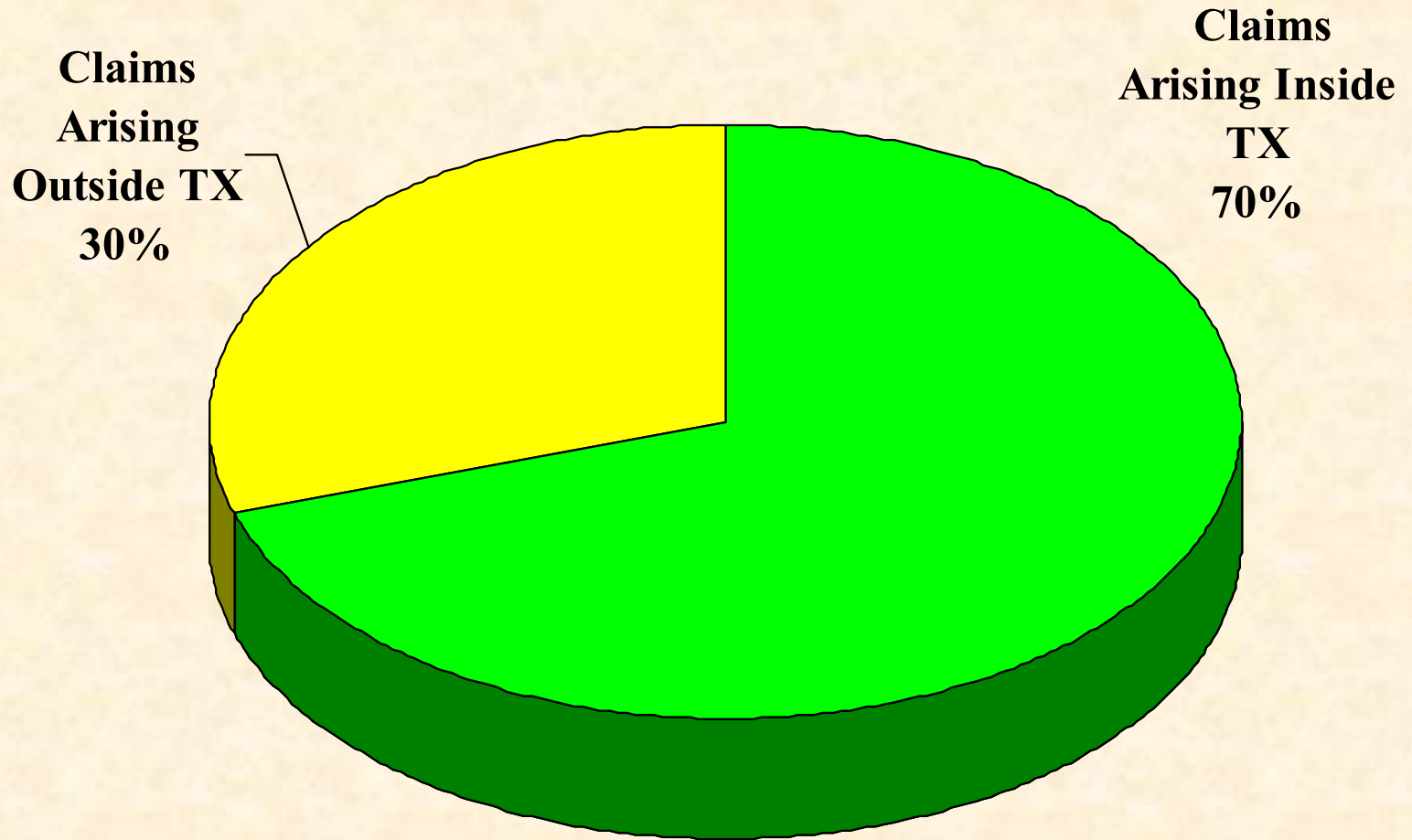


Source: Texas Department of Insurance;

\*2002 III estimate is annualized figure based on data through September 2002.

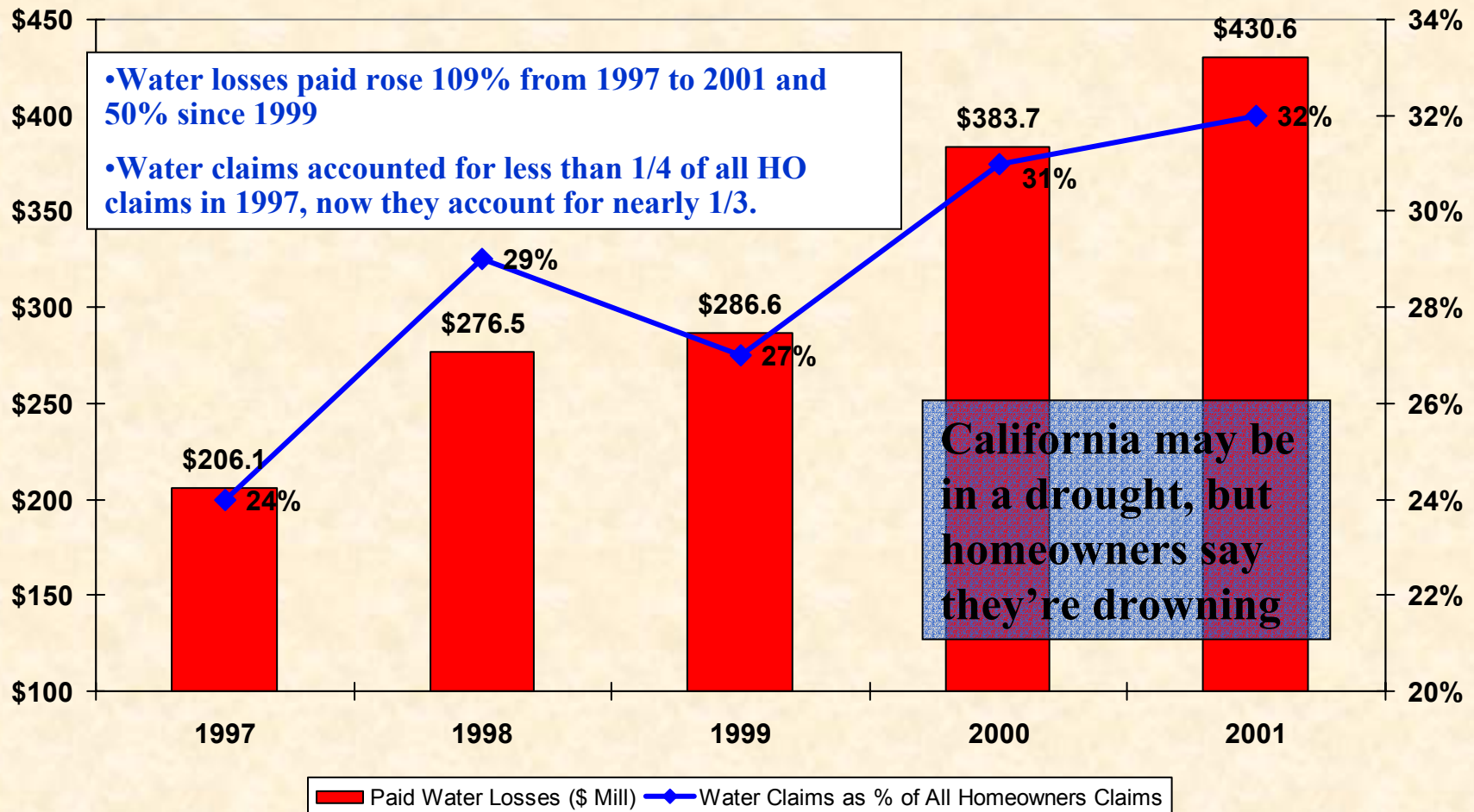


# *Texas Accounted for the Vast Majority of New Mold Cases in 2001*





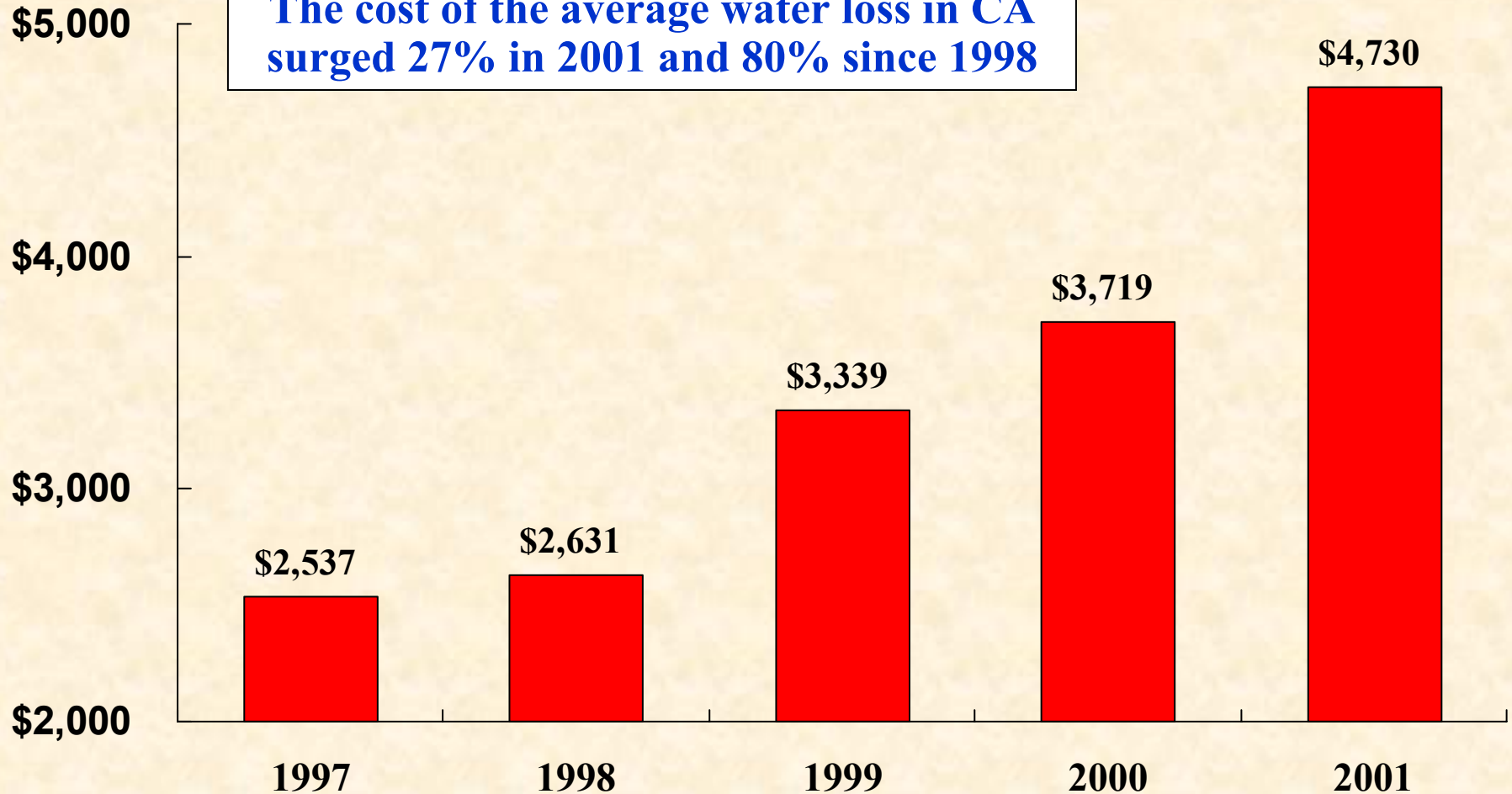
# California: Surging Water Claim Frequency and Costs: Symptom of Growing Mold Problem





# *Sharply Rising Average Water Claim Cost: Mold Symptom*

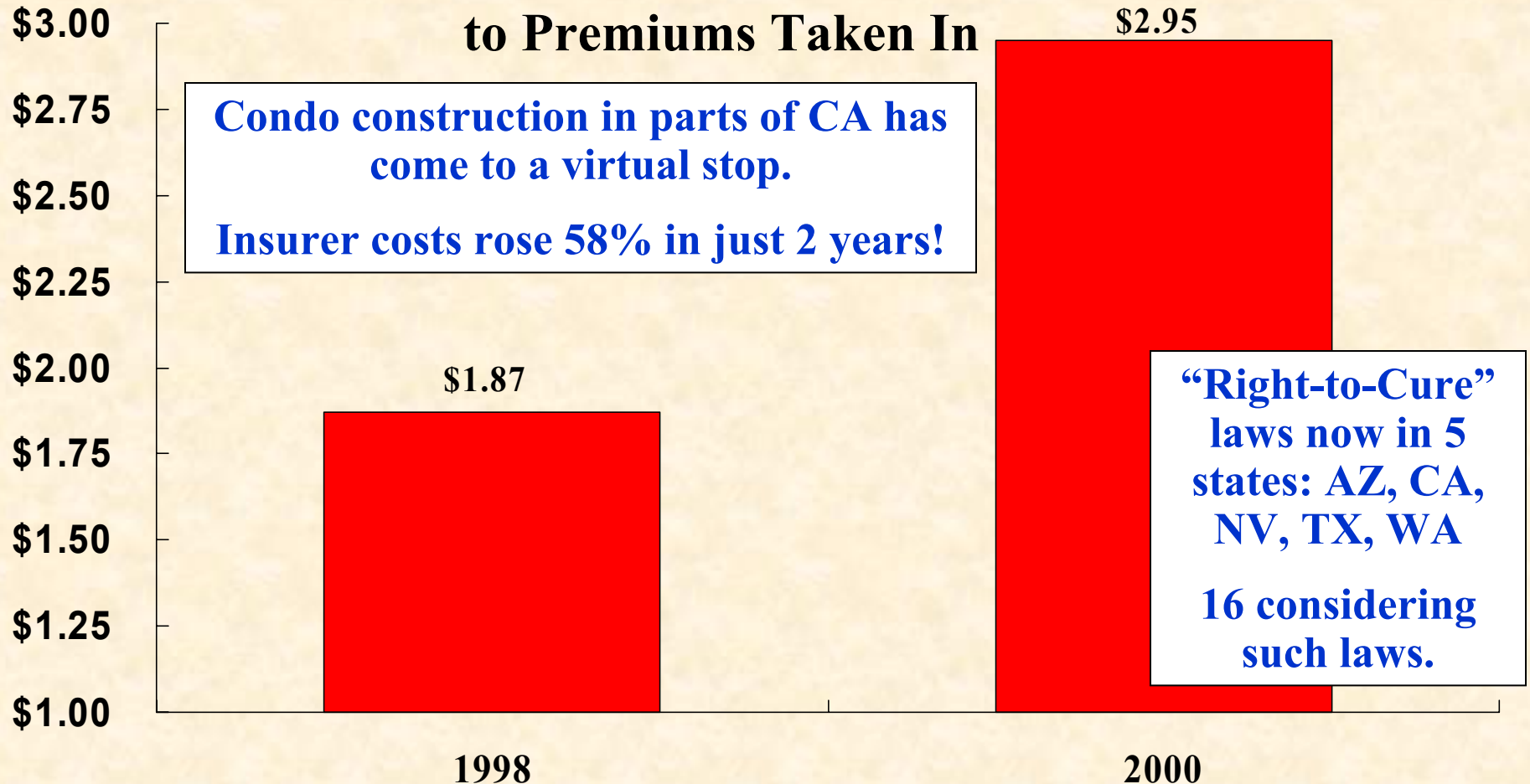
**The cost of the average water loss in CA  
surged 27% in 2001 and 80% since 1998**





# *Construction Defect Litigation Destroying CA Condo Market*

## **Ratio of Losses Paid Out to Premiums Taken In**

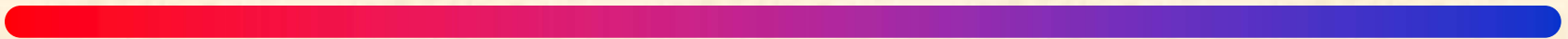




# *Where are the Next Battlefields for Mold?*

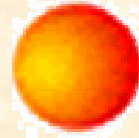
- Homeowners issue probably crested in 2003
- Migration to commercial area affects many lines:
  - Commercial Property      Commercial Liability
  - Products Liability      Builders Risk/Construction Defects
  - Workers Comp...
- Hot Spots:
  - Apartments/Condos/Co-ops      Office Structures
  - Schools      Municipal Buildings
  - Cars? (GM case in NC)
- Trend toward class actions since science doesn't support massive individual non-economic damages
  - Much more lucrative for trial lawyers to form class

# *CRISIS IN CORPORATE GOVERNANCE*



# *Accounting Problems are Getting Many Companies into Trouble*

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



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THE DOCUMENT COMPANY  
**XEROX**

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

**tyco**

 **ImClone Systems  
Incorporated**

**WORLD.COM.**

 **Global Crossing**

**Reliant  
Energy**

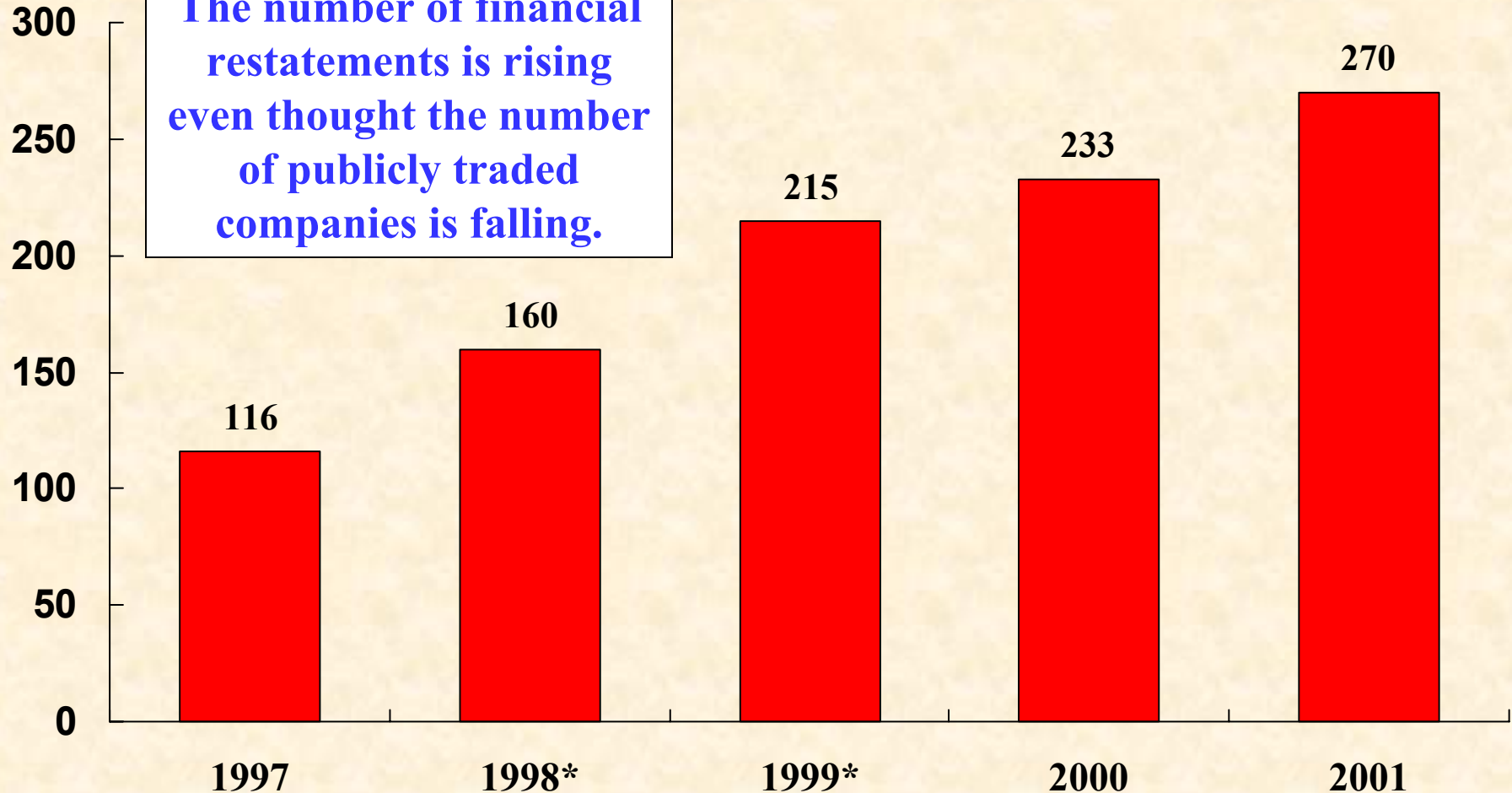
**Adelphia**

**CORNELL**



# *Financial Restatements Filed*

The number of financial restatements is rising even though the number of publicly traded companies is falling.

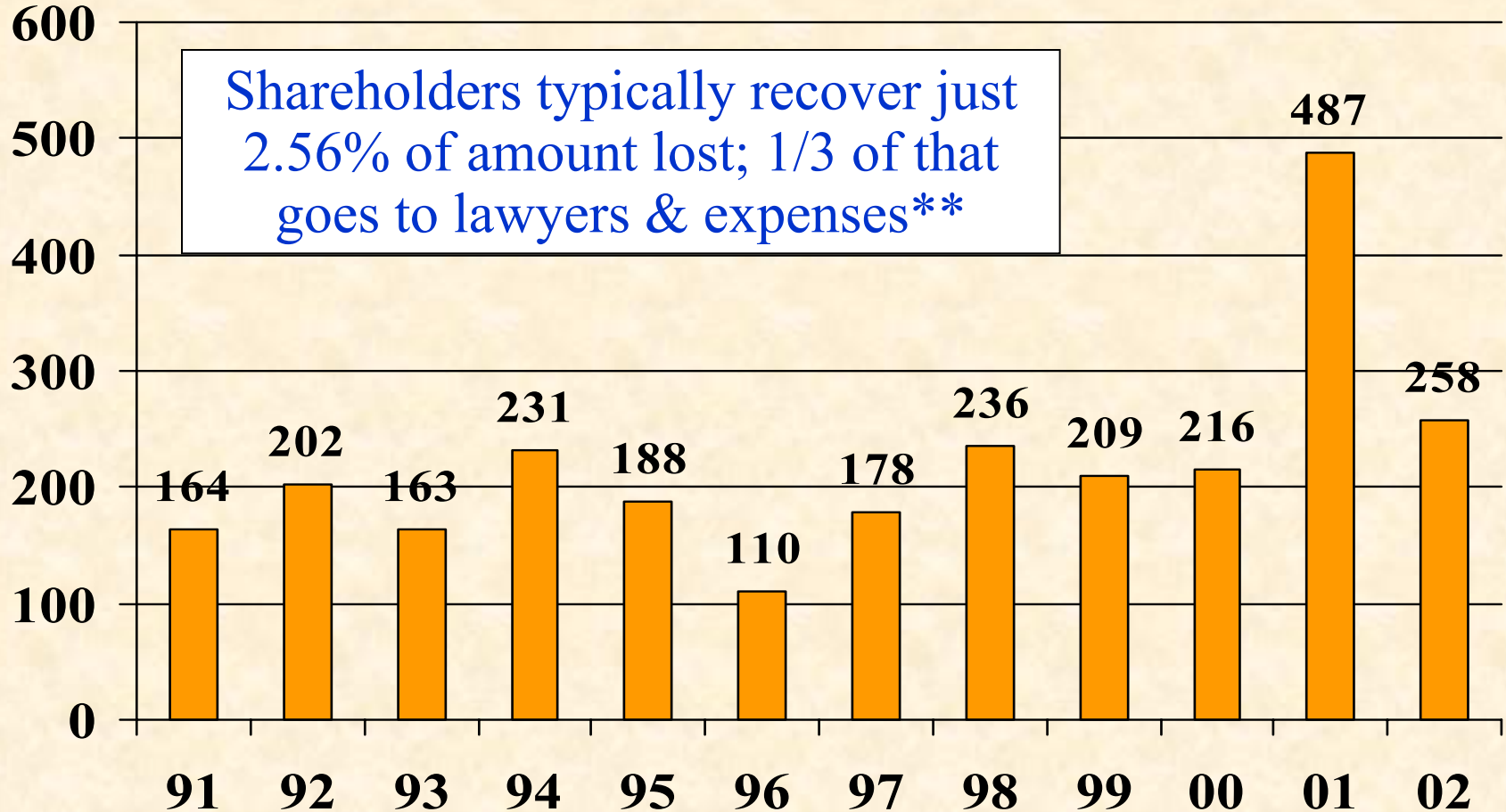


\*Approximate

Sources: Huron Consulting Group



# Shareholder Class Action Lawsuits\*



\*Securities fraud suits filed in U.S. federal courts.

\*\*Suits of \$100 million or more.

Source: Stanford University School of Law; Insurance Information Institute



# Summary

- **Economics of the industry suggest hard market should continue into 2004**
  - **If it doesn't, it will end badly for some insurers**
  - **Combined ratio remains unacceptably high given current investment environment**
  - **Top line improvement outpacing bottom line improvement**
  - **Reserve hangover still enormous**
- **US courts still out of control**
  - **Hopes for significant tort reform probably too high**
- **Mold situation probably crested in 2002**



# *Insurance Information Institute On-Line*

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