

# What Insurers Can Expect from Their Investments Today

## *An Overview of the Global Investment Environment*

**The Royal Institute of International Affairs  
London, UK**



**2 February 2004**

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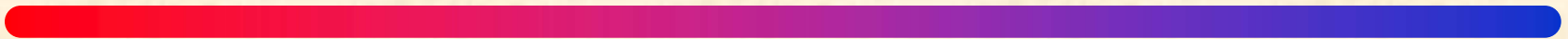
**Robert P. Hartwig, Ph.D., CPCU, Senior Vice President & Chief Economist  
Insurance Information Institute ♦ 110 William Street ♦ New York, NY 10038  
Tel: (212) 346-5520 ♦ Fax: (212) 732-1916 ♦ bobh@iii.org ♦ www.iii.org**



# *Presentation Outline*

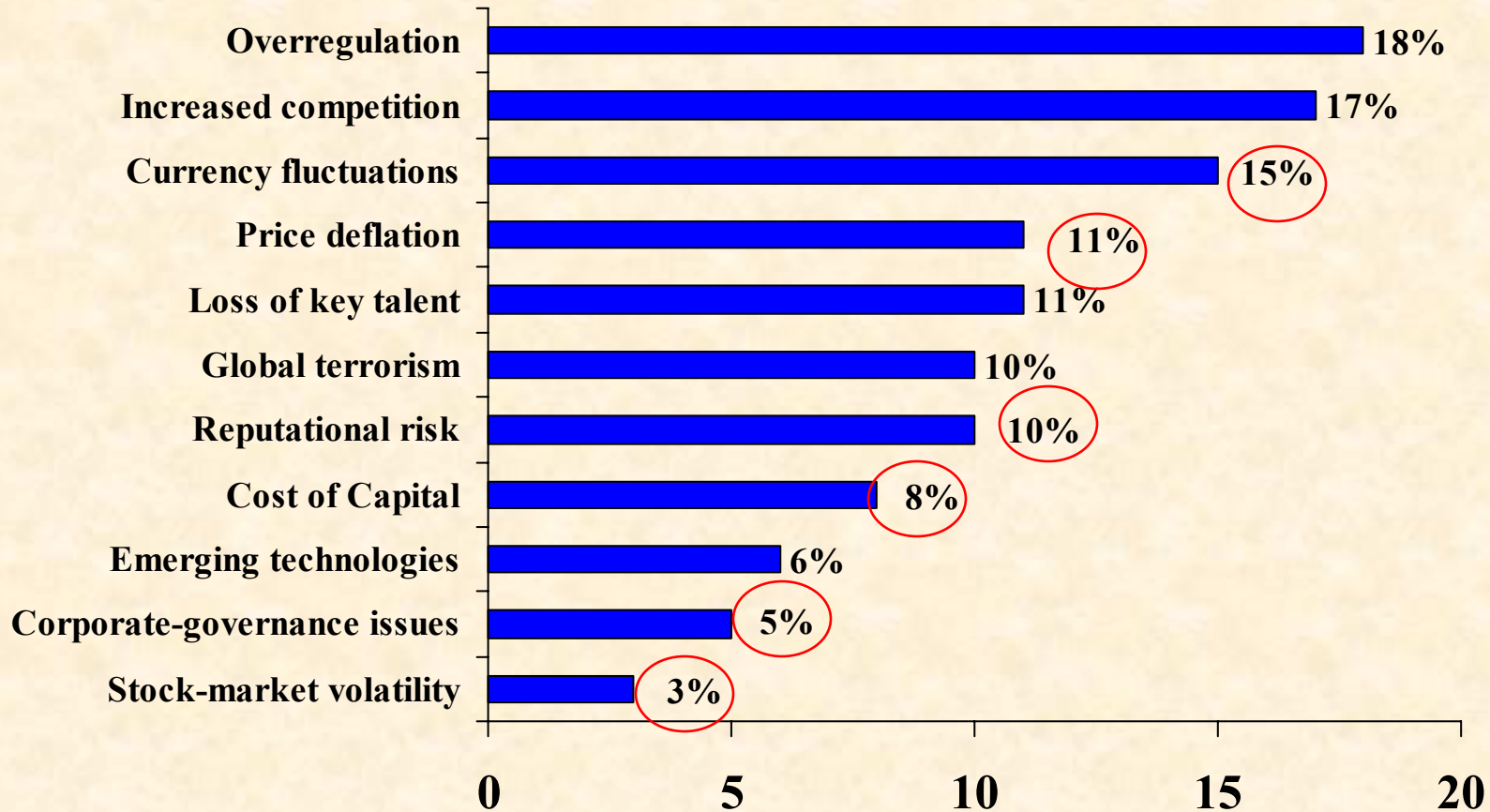
- 
- **Overview of Global Investment Environment**
  - **Global Economic Situation**
  - **Insurer Asset Allocation in the Wake of the “Perfect Storm”**
  - **Hot Spots: Are Some Markets Too Risky**
  - **Q&A**

# *GLOBAL INVESTMENT ENVIRONMENT OVERVIEW*





# CEOs: Biggest Threats to Our Business\* (%\*\*)

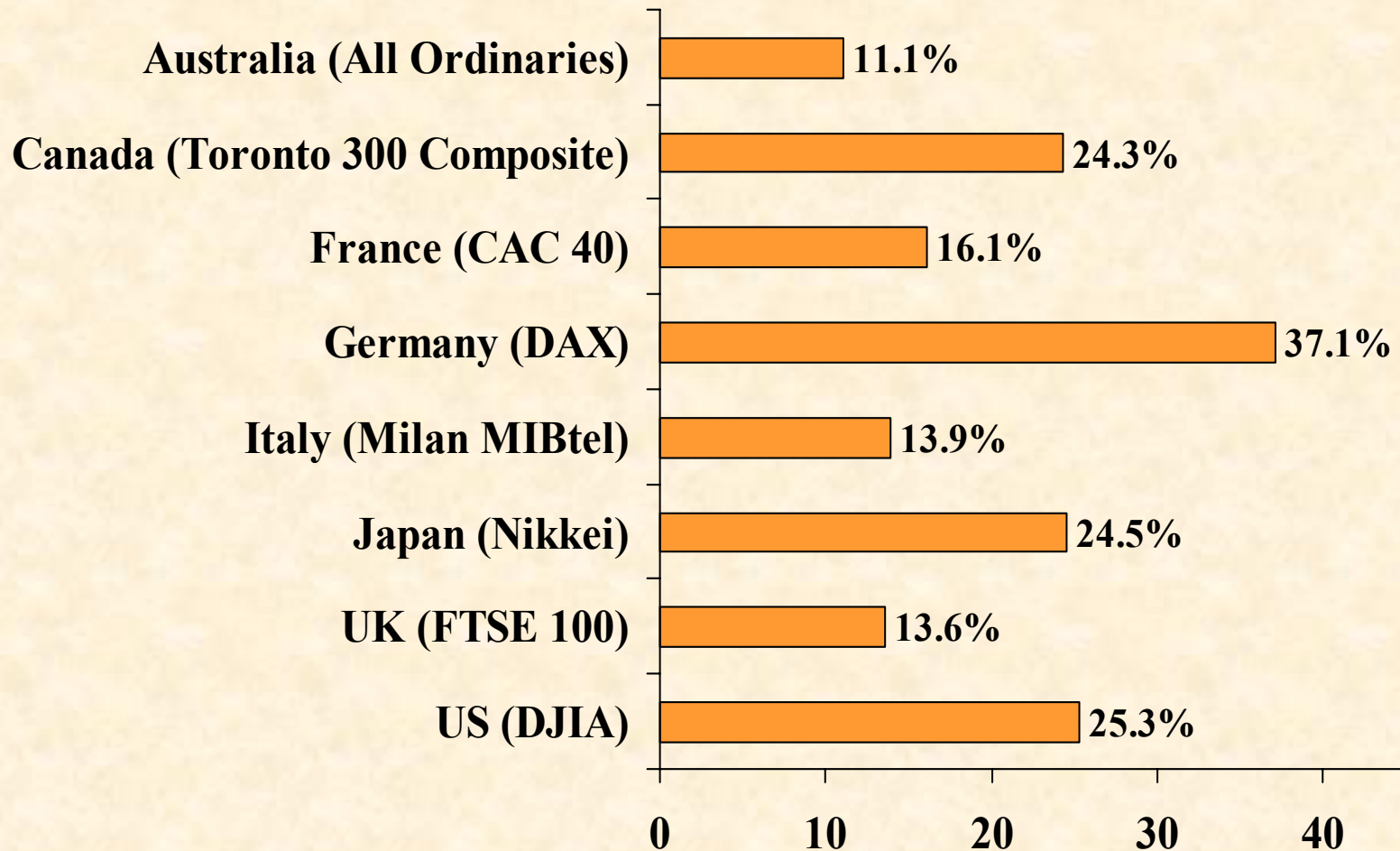


\*Survey of 1,394 CEOs globally during fourth quarter of 2003. \*\*Due to multiple answers percentage exceeds 100.

Source: PriceWaterhouseCoopers

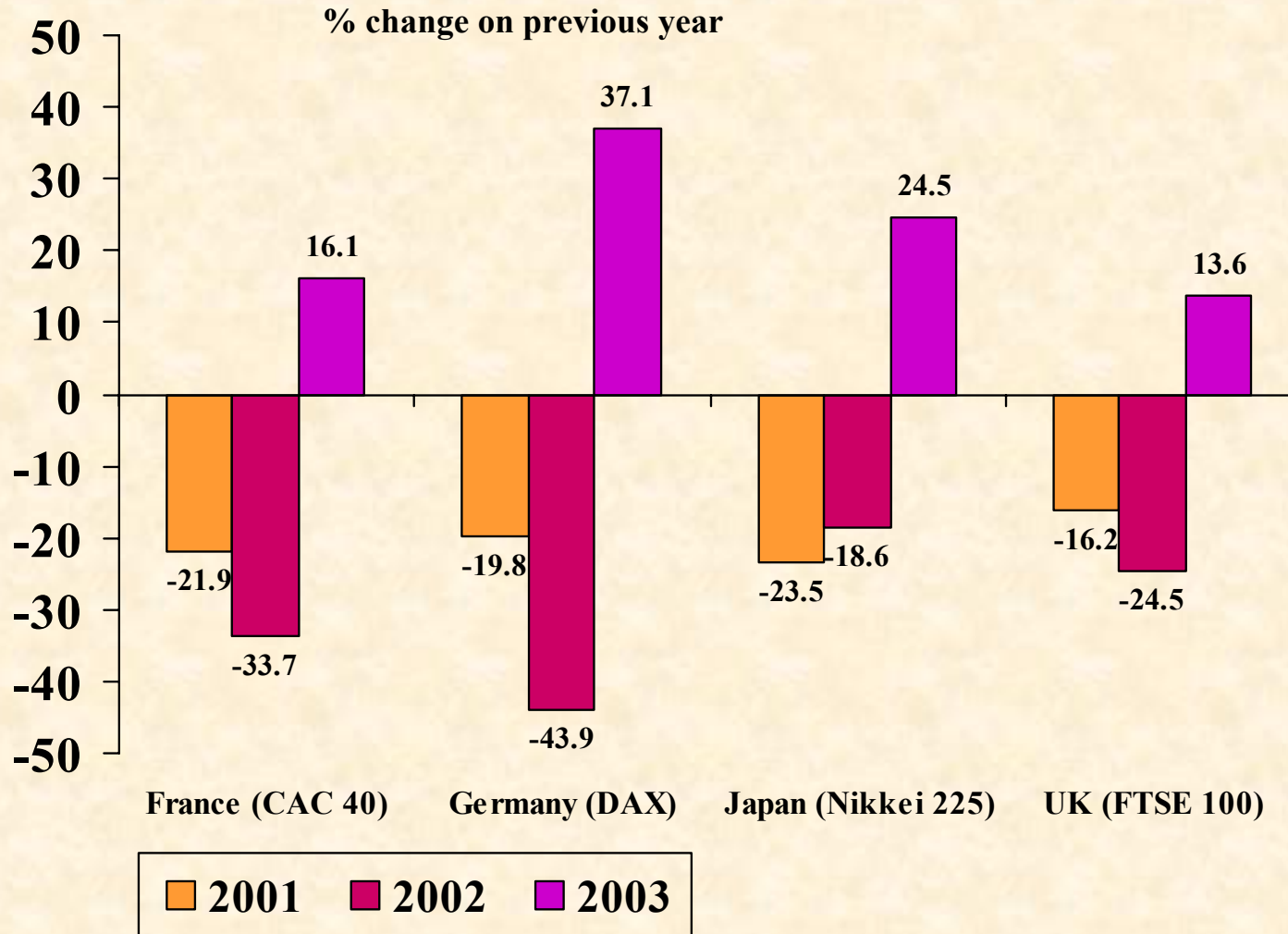


## *Stock Market Index Performance in 2003: Ranked in Local Currency Terms*



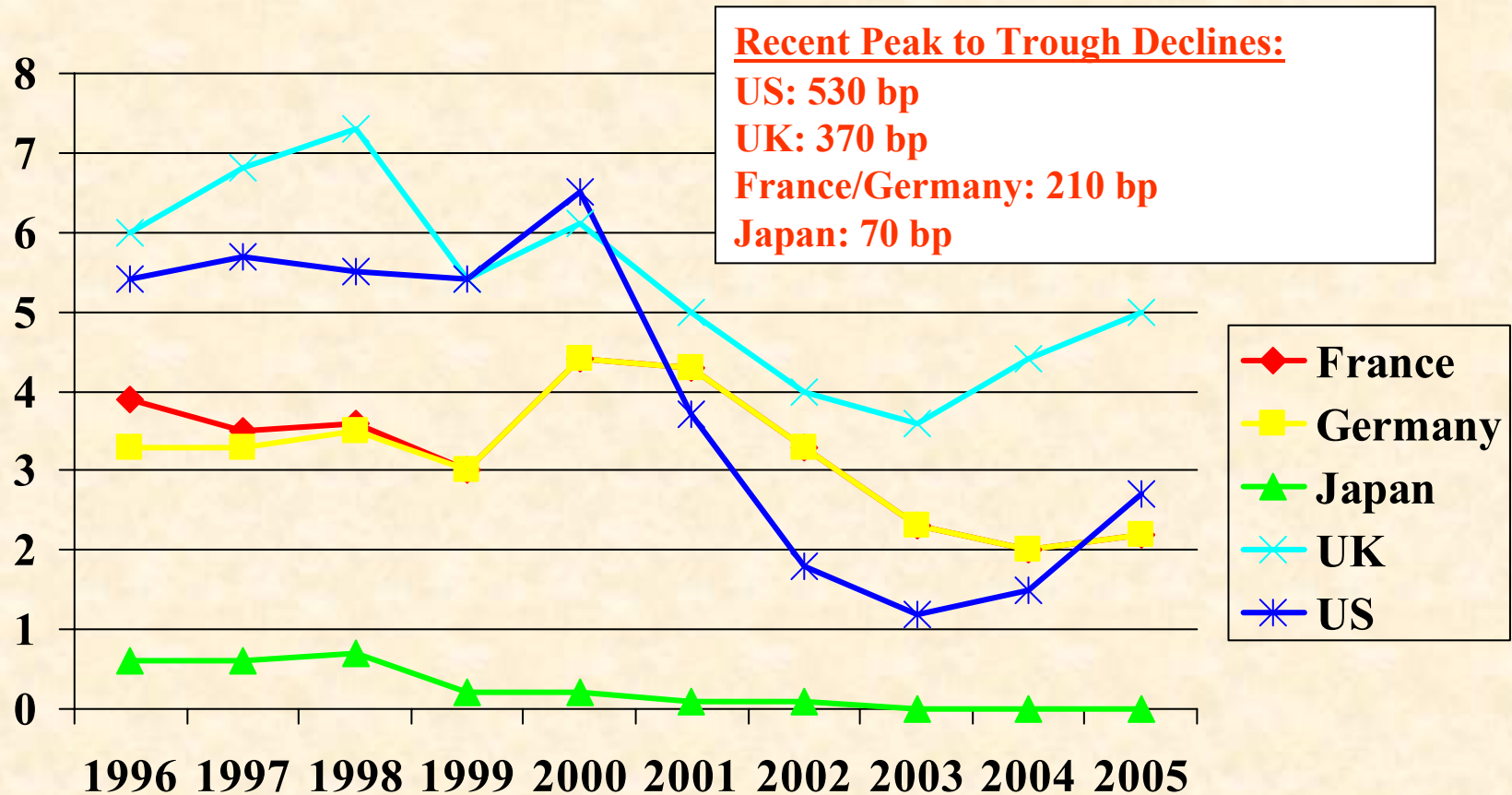


# Stock Market Index Performance in Local Currency Terms 2001-2003





# Short-term Interest Rates (% per annum)

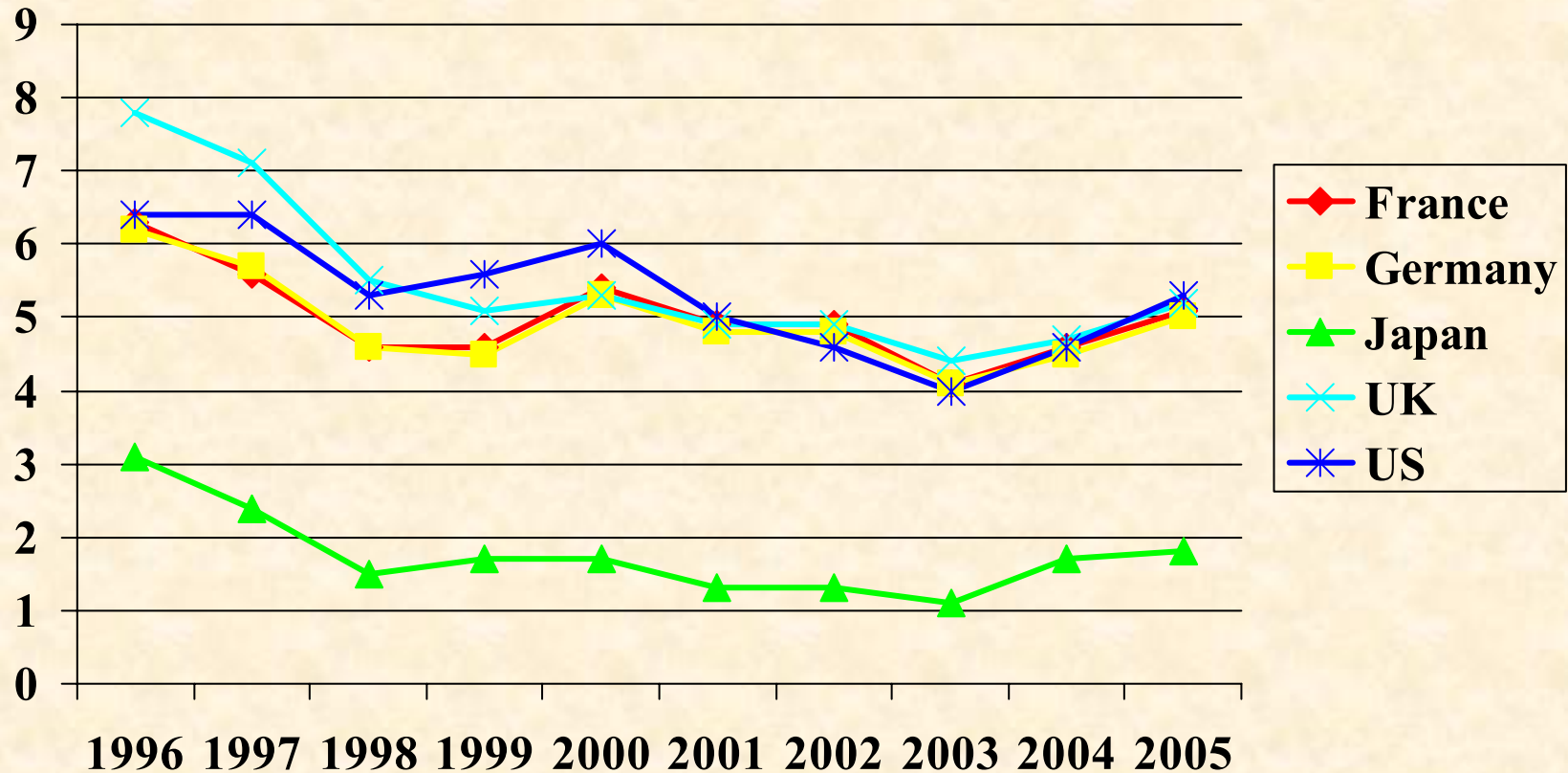


\*Three-month money market rates where available, or rates on proximately similar financial instruments.

Source: OECD, December 2003



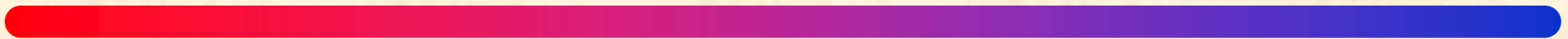
# Long-term Interest Rates (% per annum)



\*10-year benchmark government bond yields where available or yield on proximately similar financial instruments.

Source: OECD, December 2003

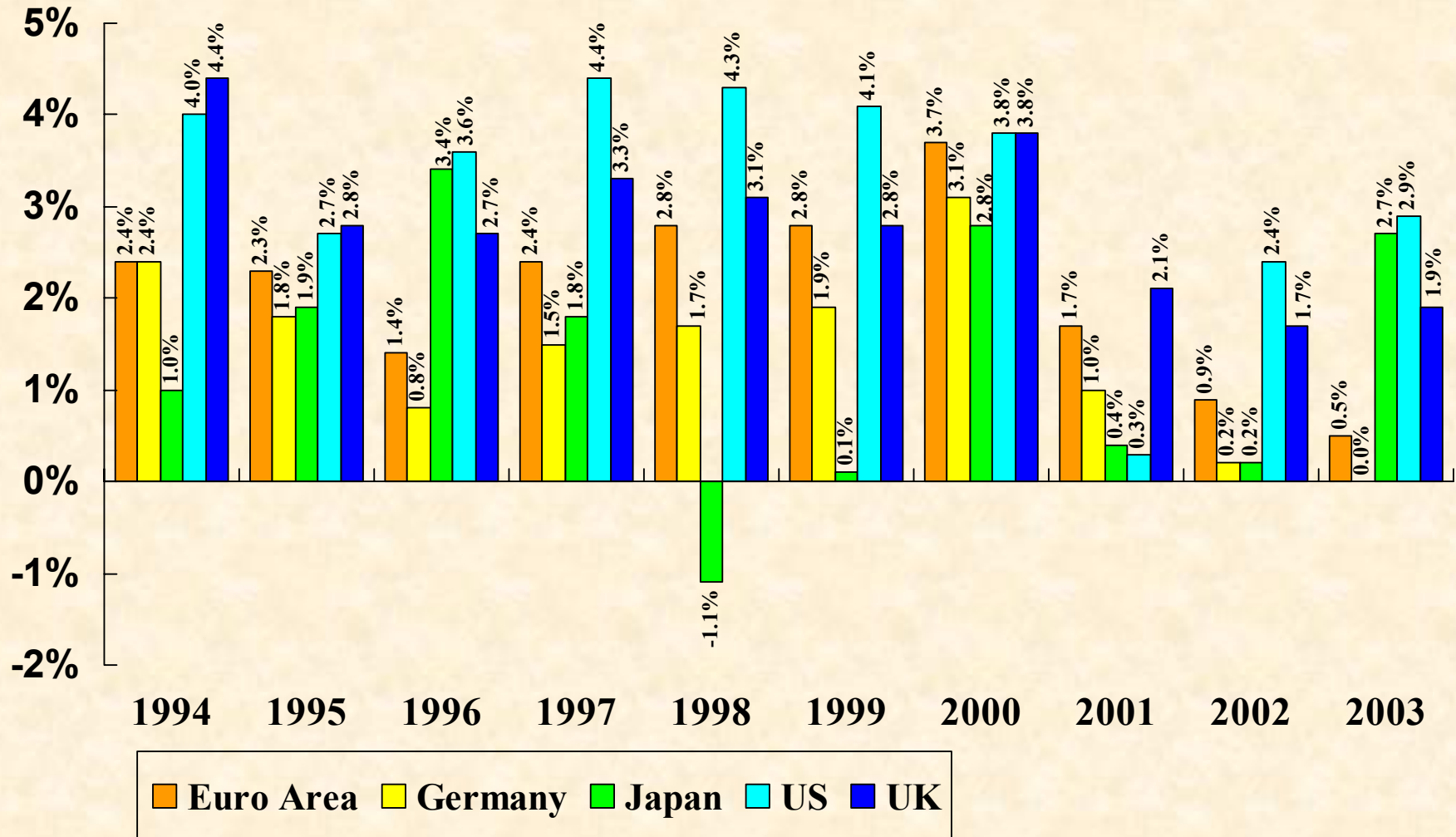
# *ECONOMIC ENVIRONMENT OVERVIEW*





# Real GDP By Country 1994-2003

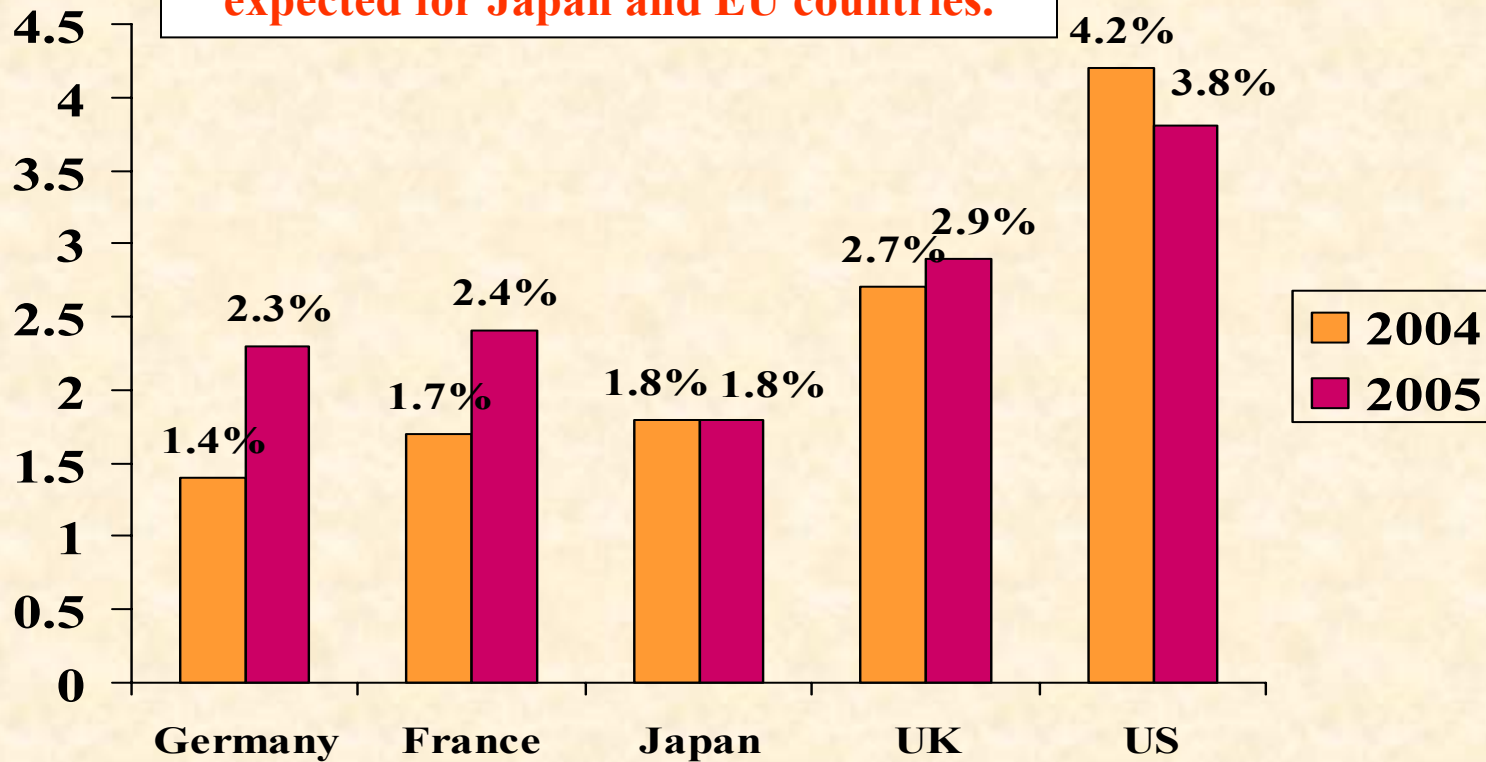
(% change on previous year)





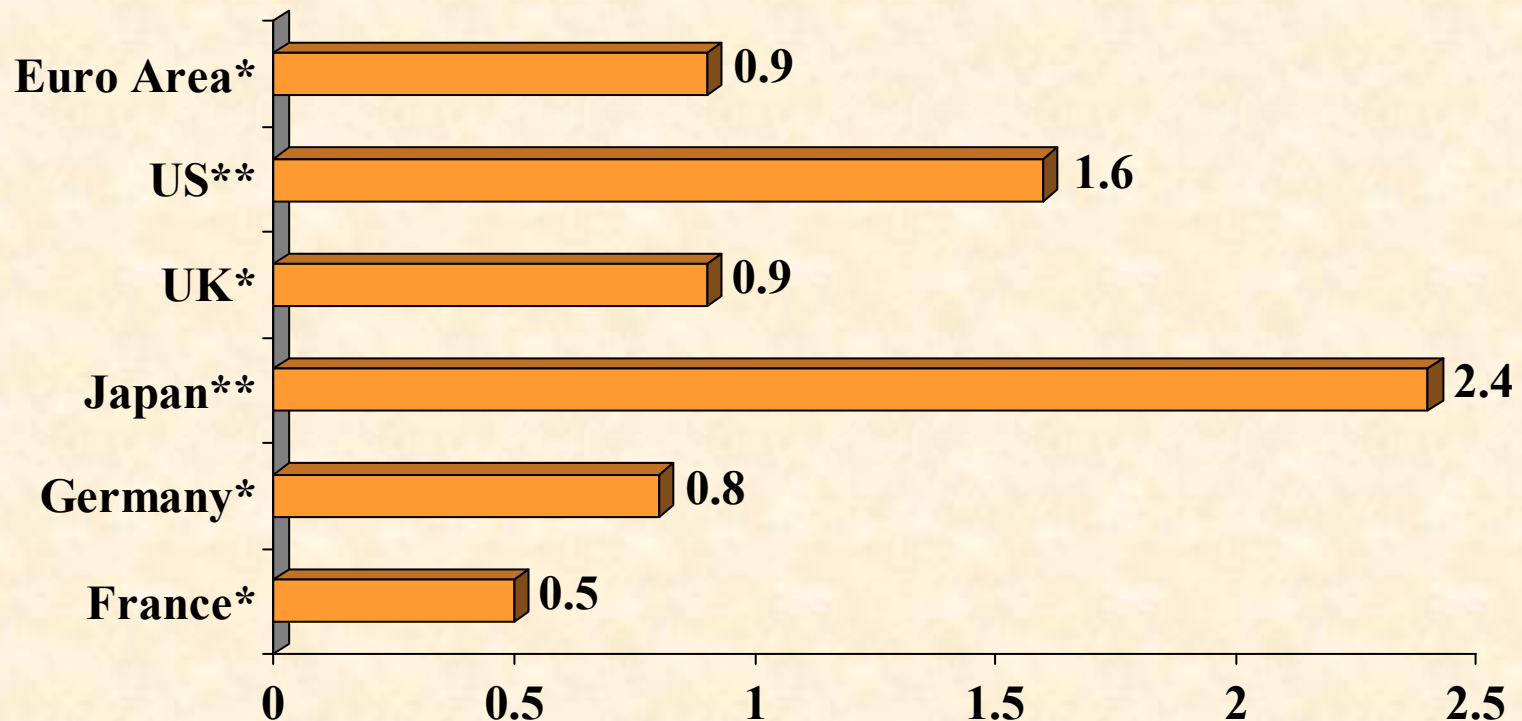
# Forecast GDP Growth by Country 2004/2005 (% change on previous year)

**US GDP is forecast to grow by just over 4% in 2004, more than double that expected for Japan and EU countries.**





# *Industrial Production* *(% change on year ago)*

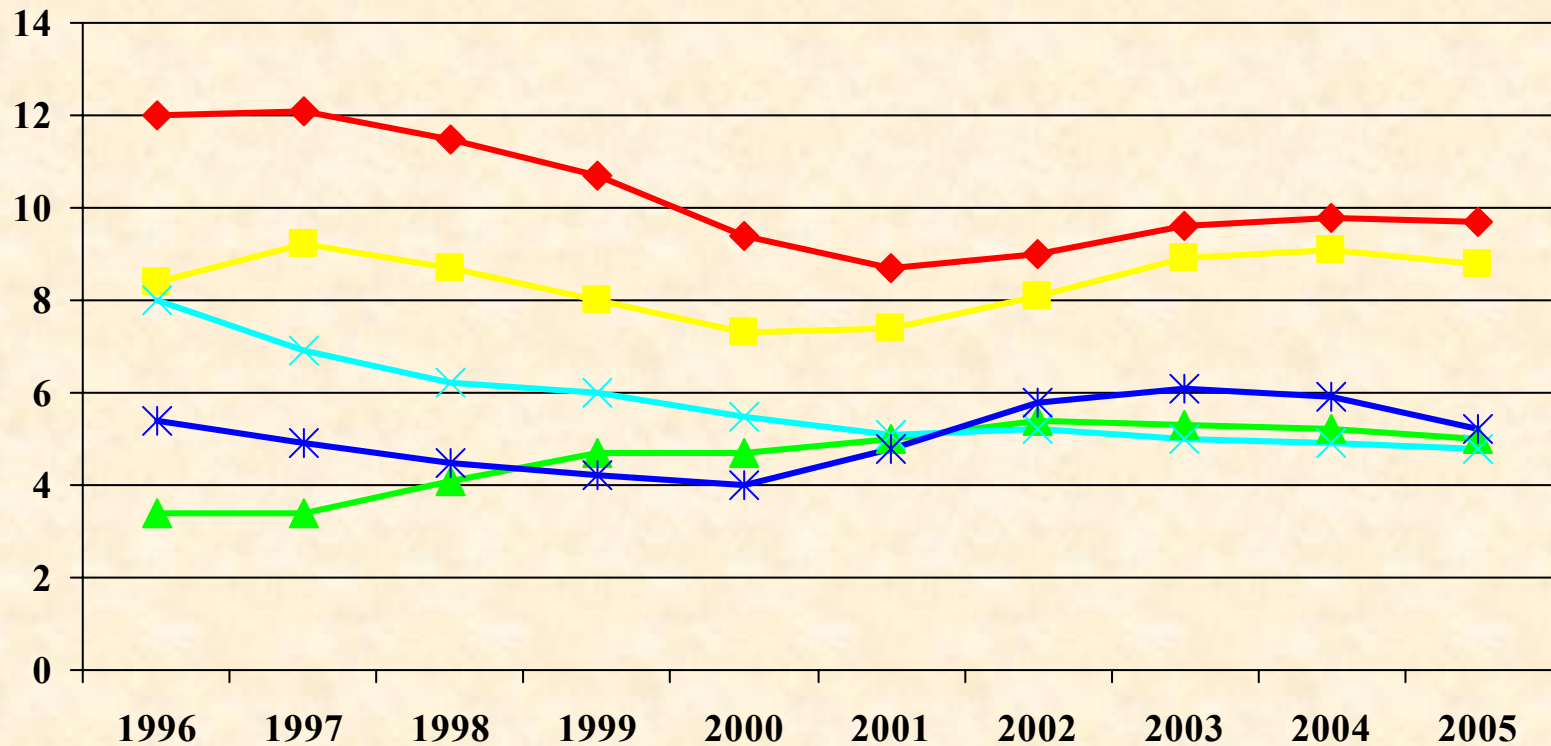


\*Year to October 2003; \*\*Year to November 2003



# Unemployment Rates 1996-2005 (% of labour force)

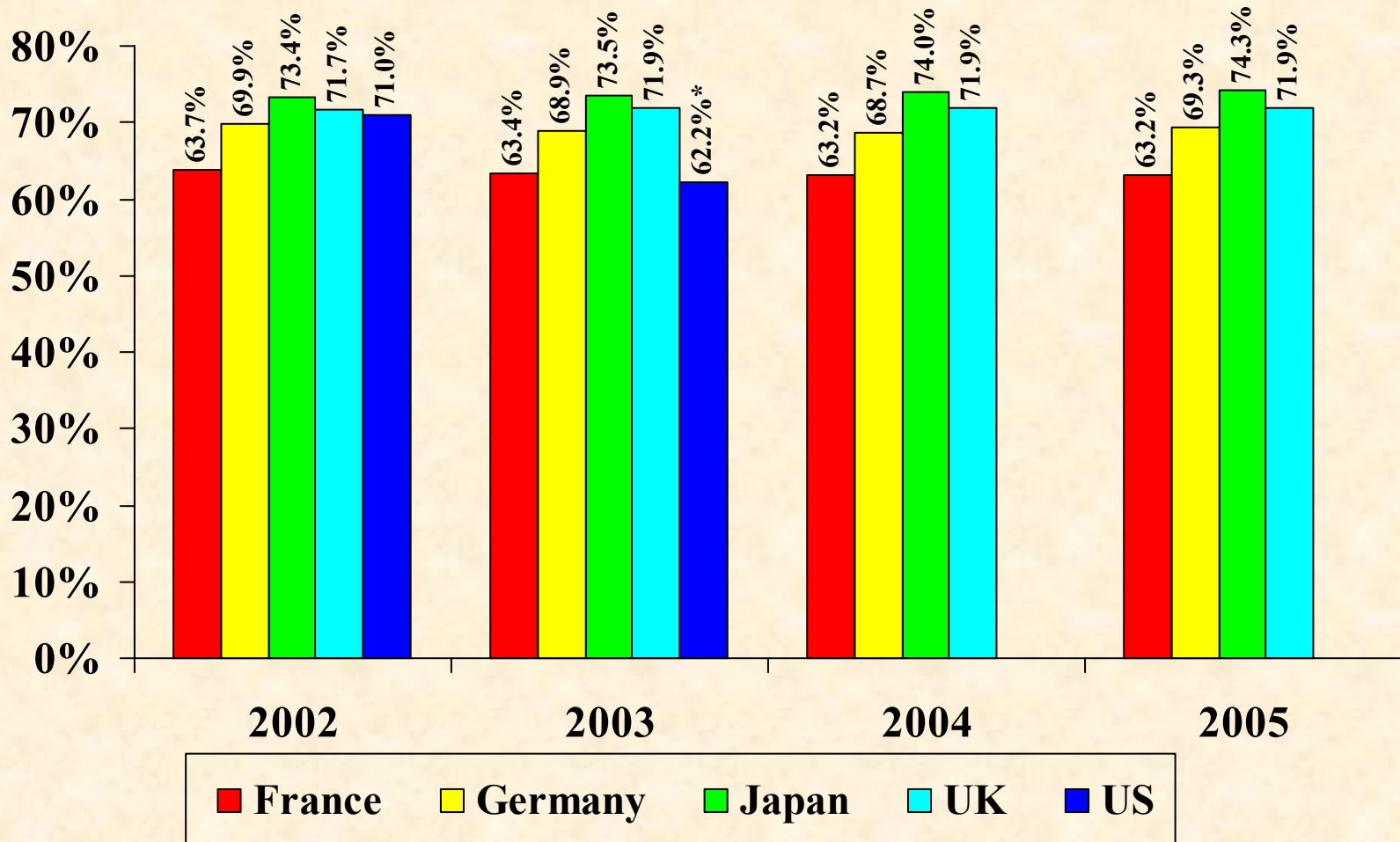
By 2005, unemployment is expected to be at least 8% in France and Germany, compared with around 5% in America, Japan and the UK.



◆ France    ■ Germany    ▲ Japan    × UK    \* US



# Employment Rates 2002-2005



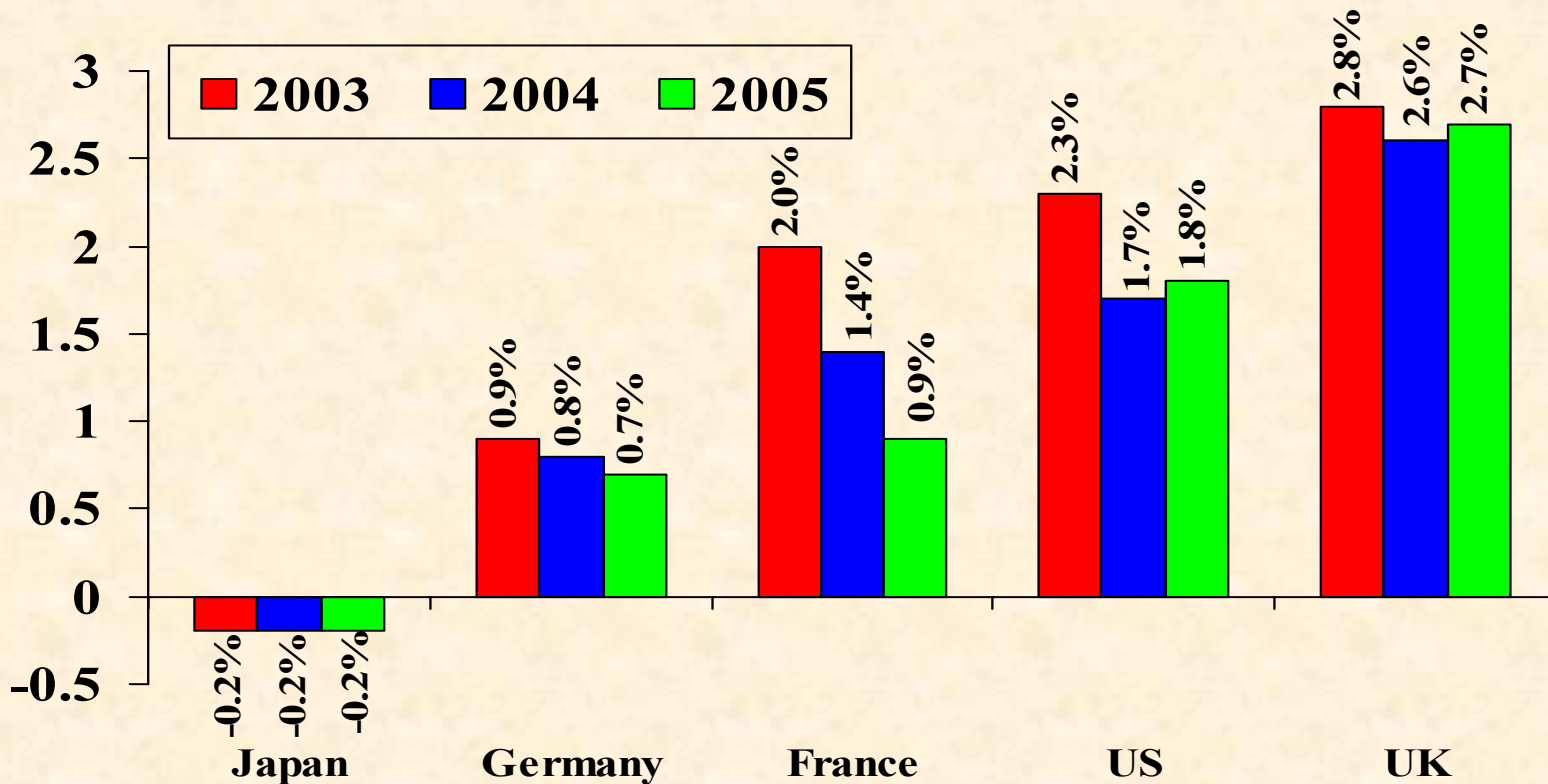
\*US figure for 2003 from Bureau of Labor Statistics data.

Source: OECD, December 2003



# Consumer Prices Forecast 2003-2005 (% change on previous year)

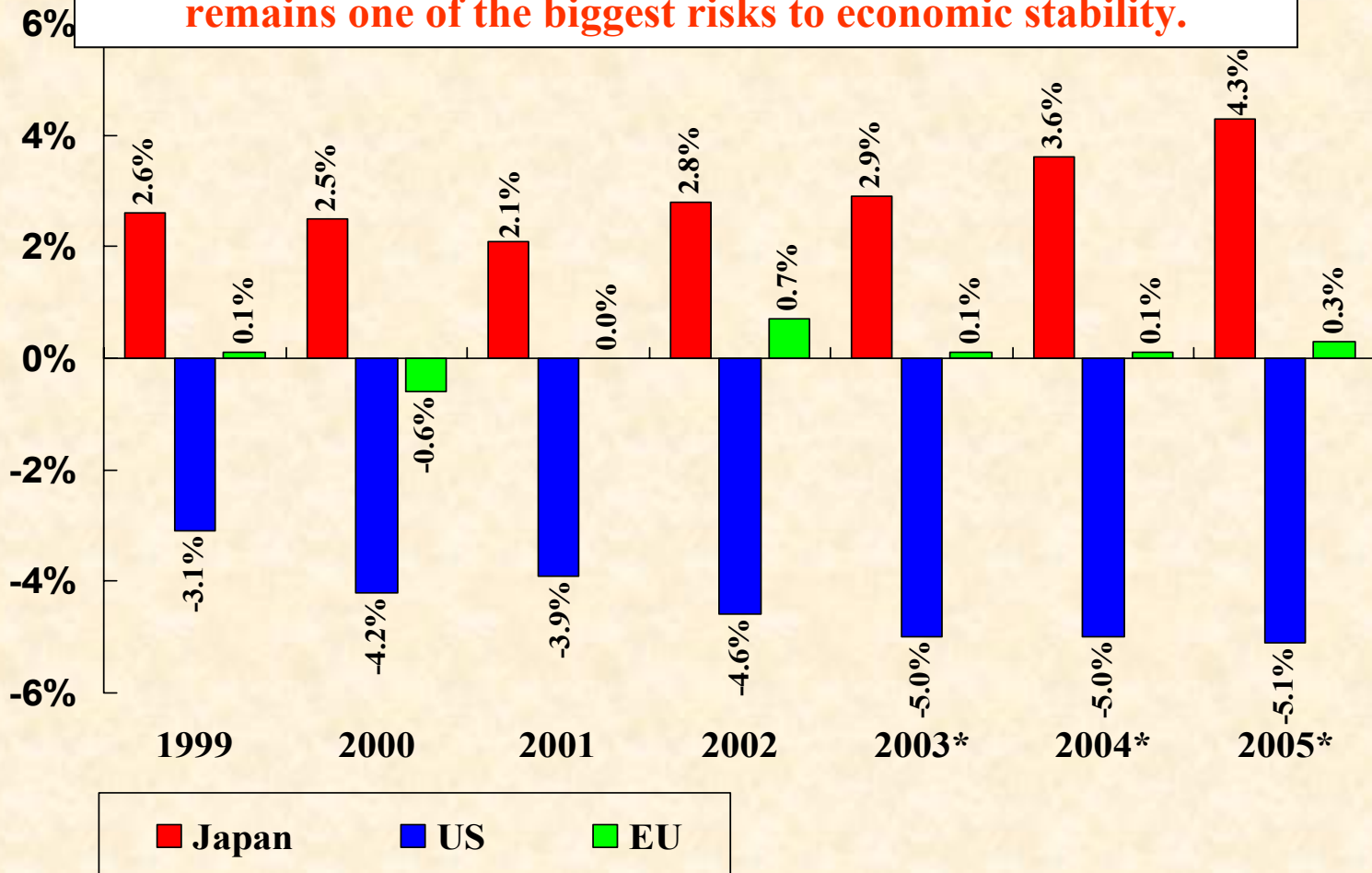
In the US and UK consumer prices are expected to rise by around 2-3% in 2004 and 2005. However, Japan continues to experience deflation.



# Current Account Balances as a % of GDP

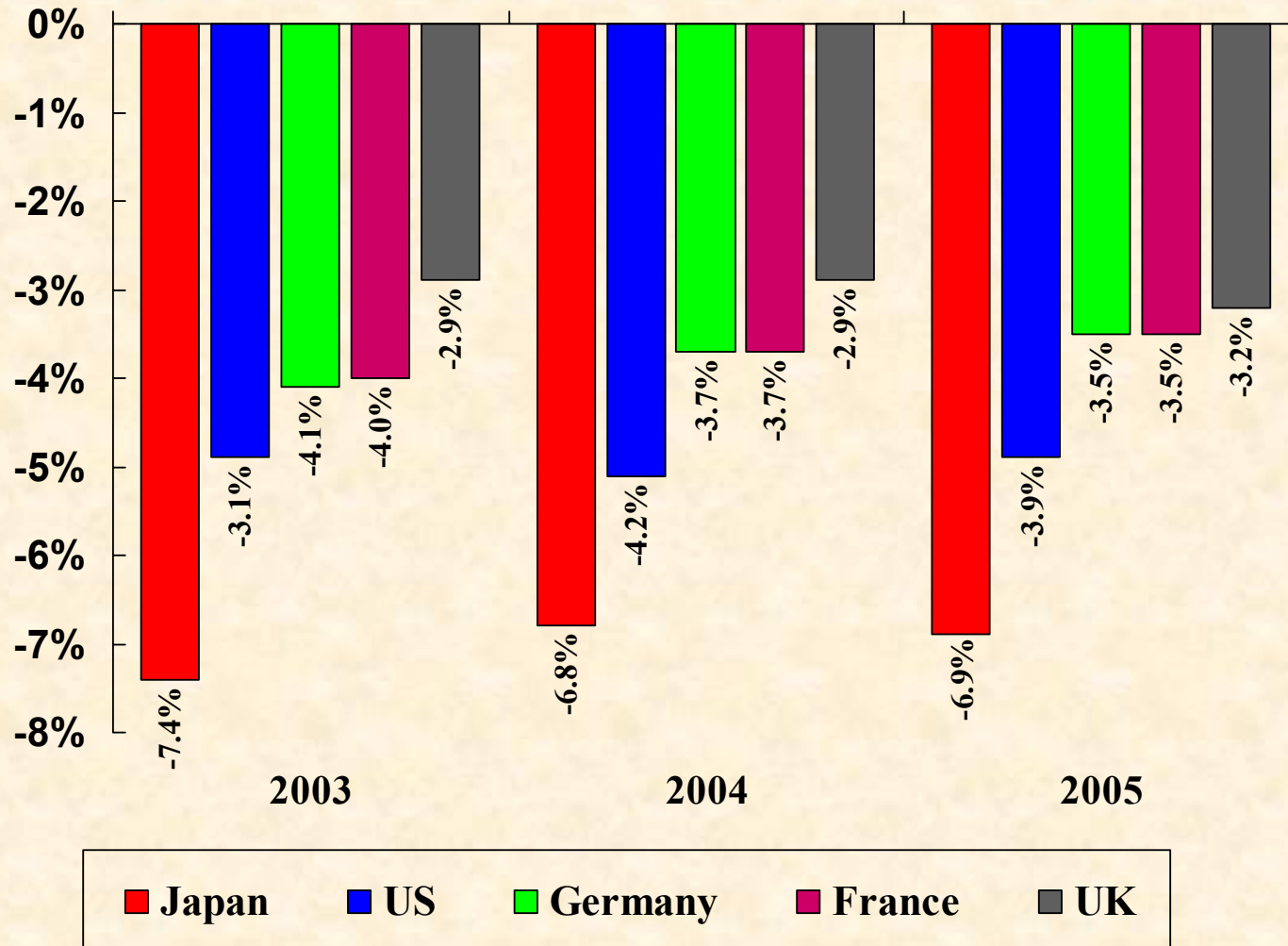


**America's current account deficit continues to grow and remains one of the biggest risks to economic stability.**

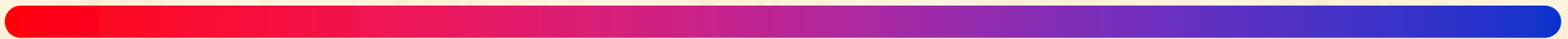




# Government Budget Balances as a % of GDP



# *EXCHANGE RATES*

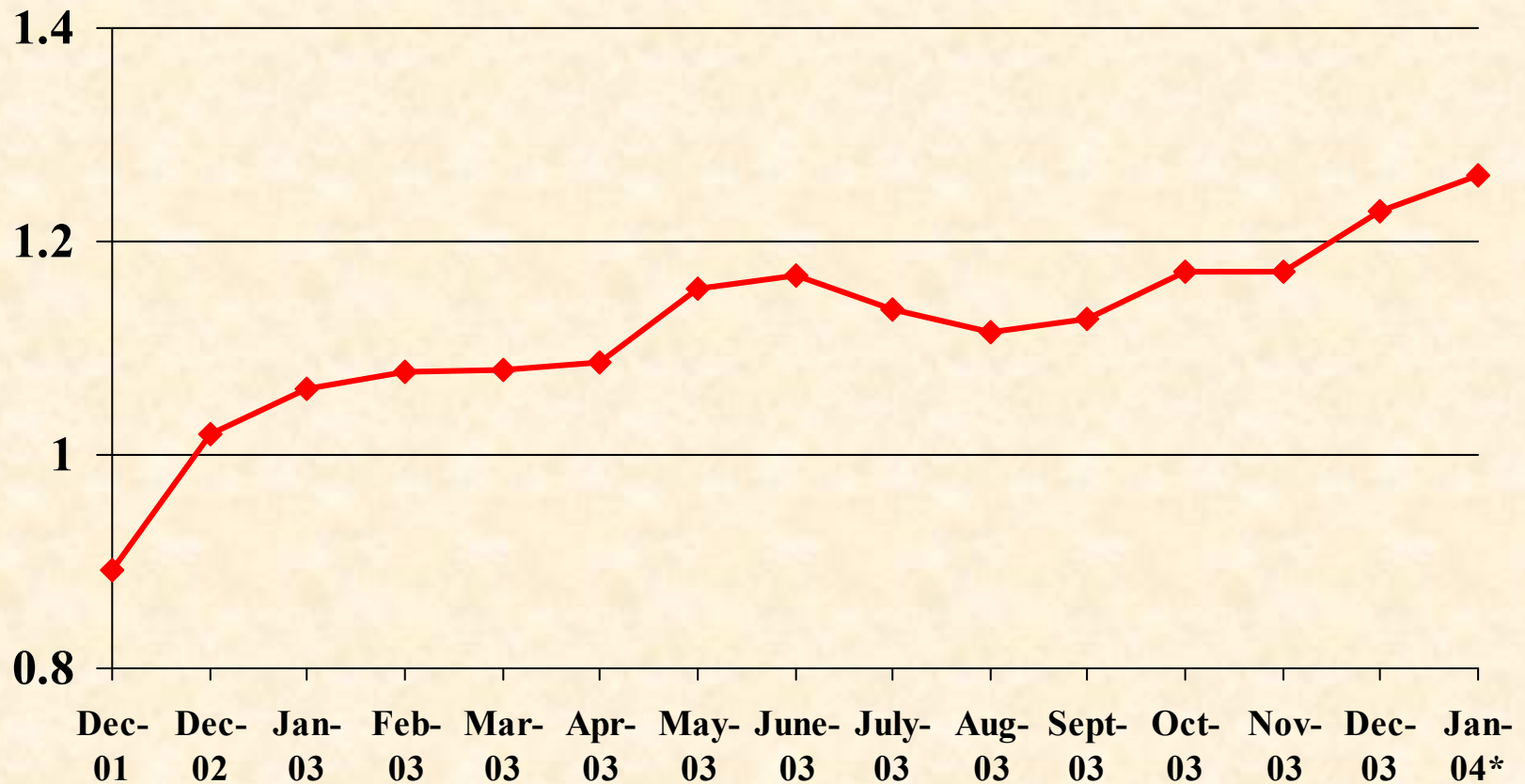




# *Euro vs US Dollar*

U.S. Dollars per Euro

**The dollar continues its slide and hit an all-time low against the Euro of \$1.2853 on January 9, 2004.**

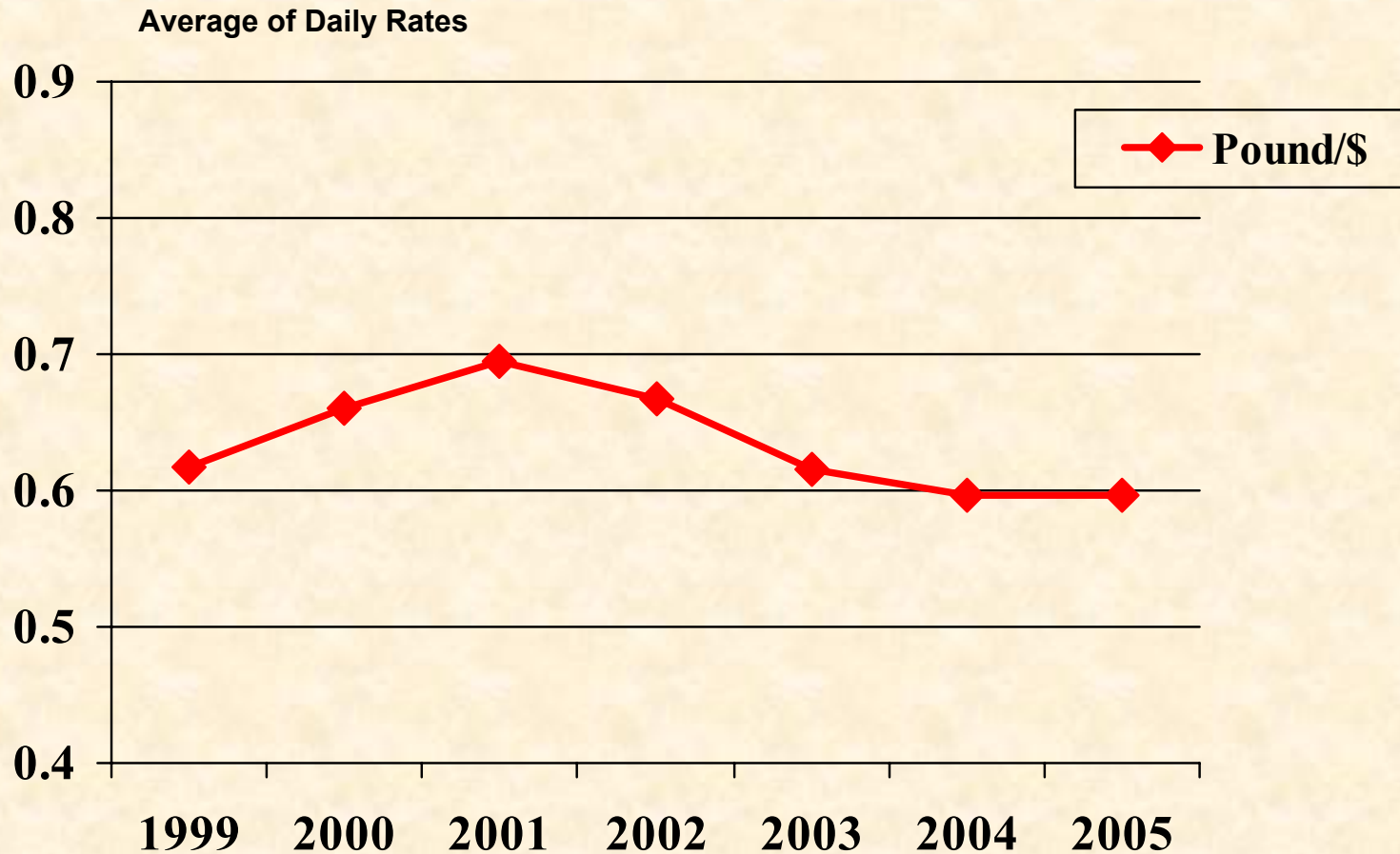


\*Rate on Jan. 21, 2004.

Source: Federal Reserve Board



# Exchange Rates: US Dollar vs British Pound\*

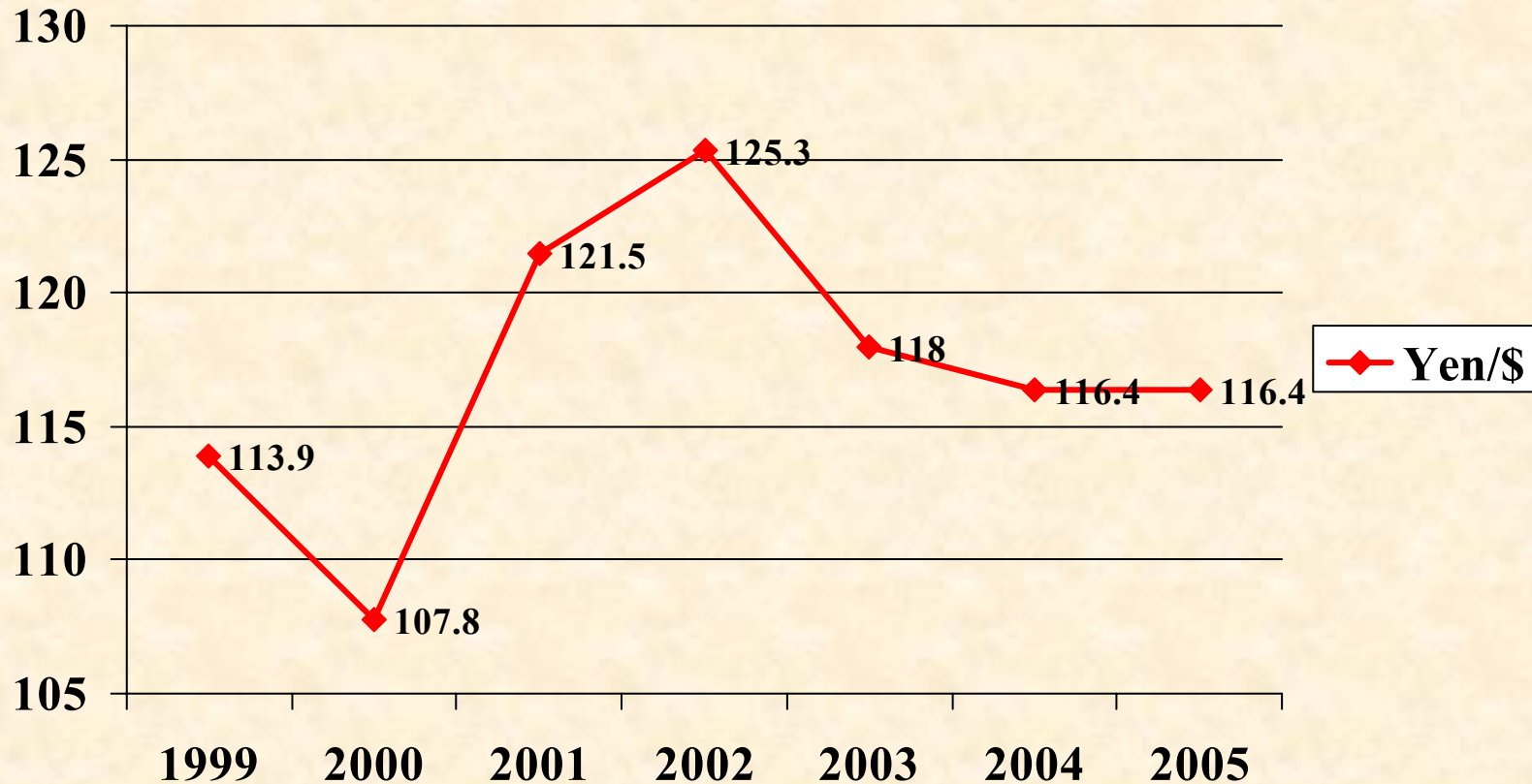


\*2003, 2004 and 2005 estimates are on the technical assumption that exchange rates remain at their levels of 3 November 2003

Source: OECD, December 2003



## *Exchange Rates: US Dollar vs Japanese Yen\* (Average of daily rates)*

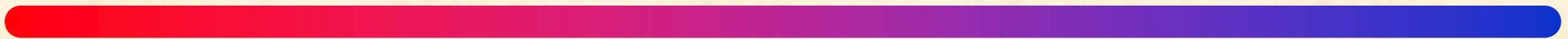


\*2003, 2004 and 2005 estimates are on the technical assumption that exchange rates remain at their levels of 3 November 2003

Source: OECD, December 2003

*ASSET ALLOCATION:*

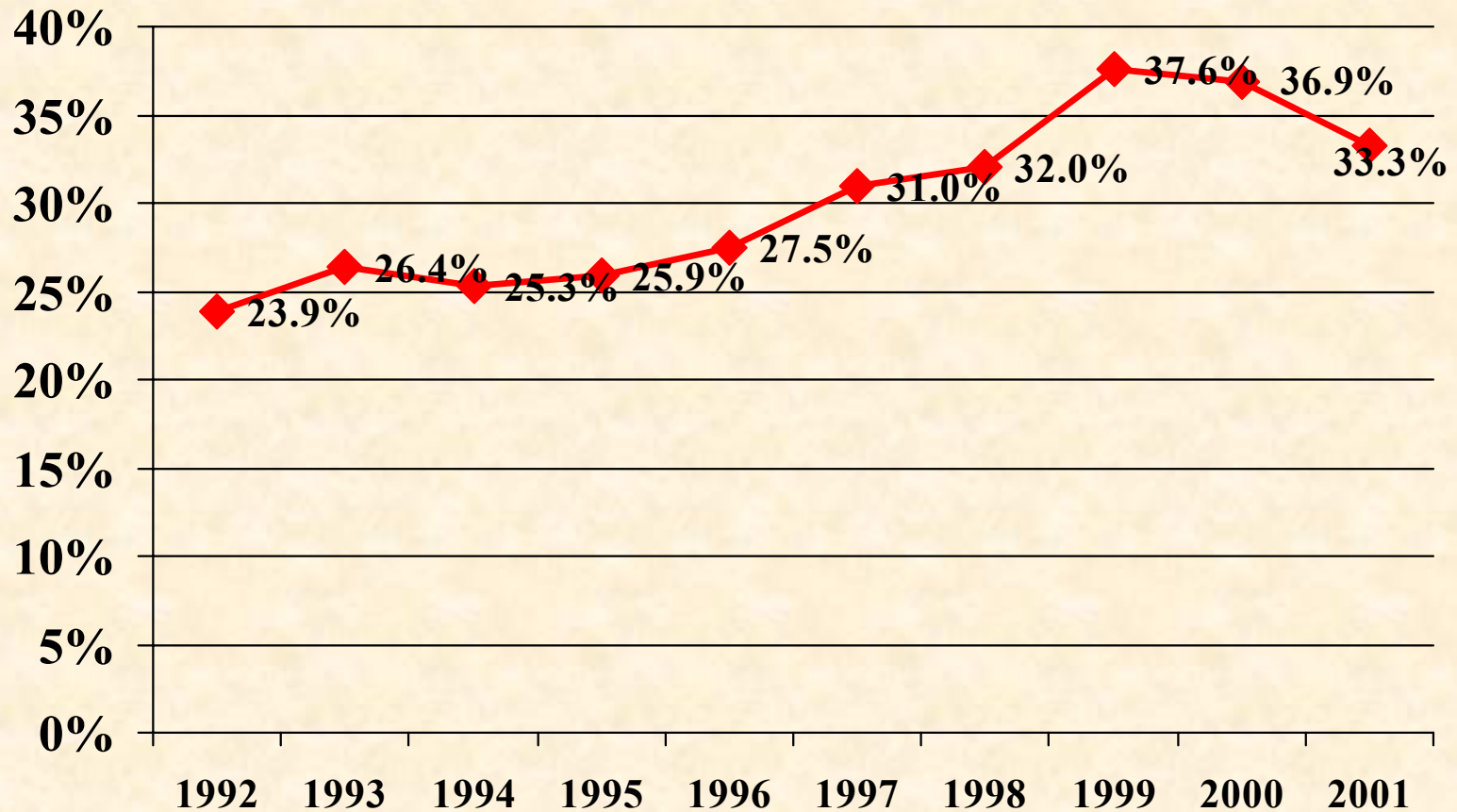
*IN THE WAKE OF THE STORM*





# *CEA Insurer Investments in Shares (Stocks) in Total 1992-2001*

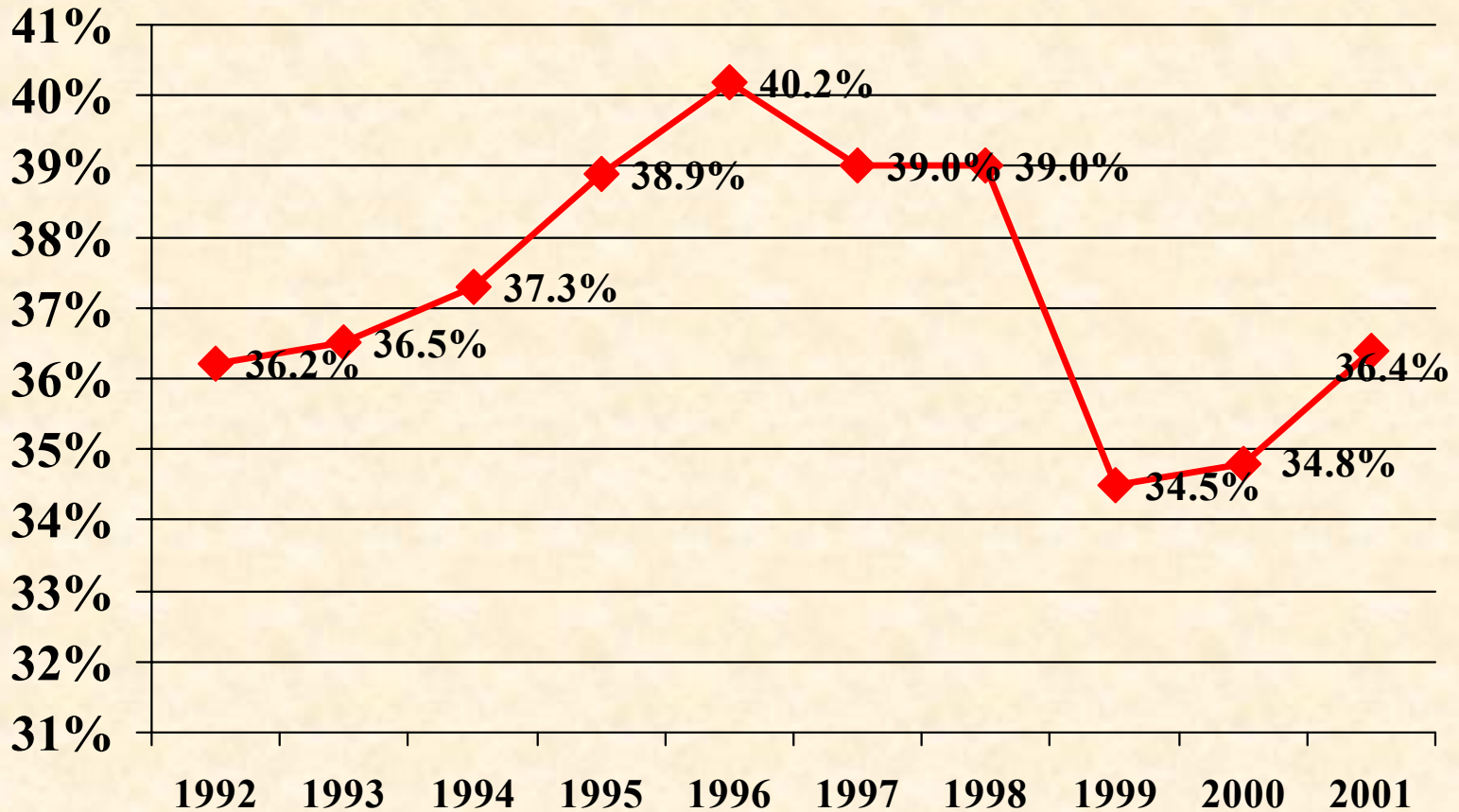
**%, 1992-2001**





# *CEA Insurer Investments in Debt & Other Fixed Income Securities in Total 1992-2001*

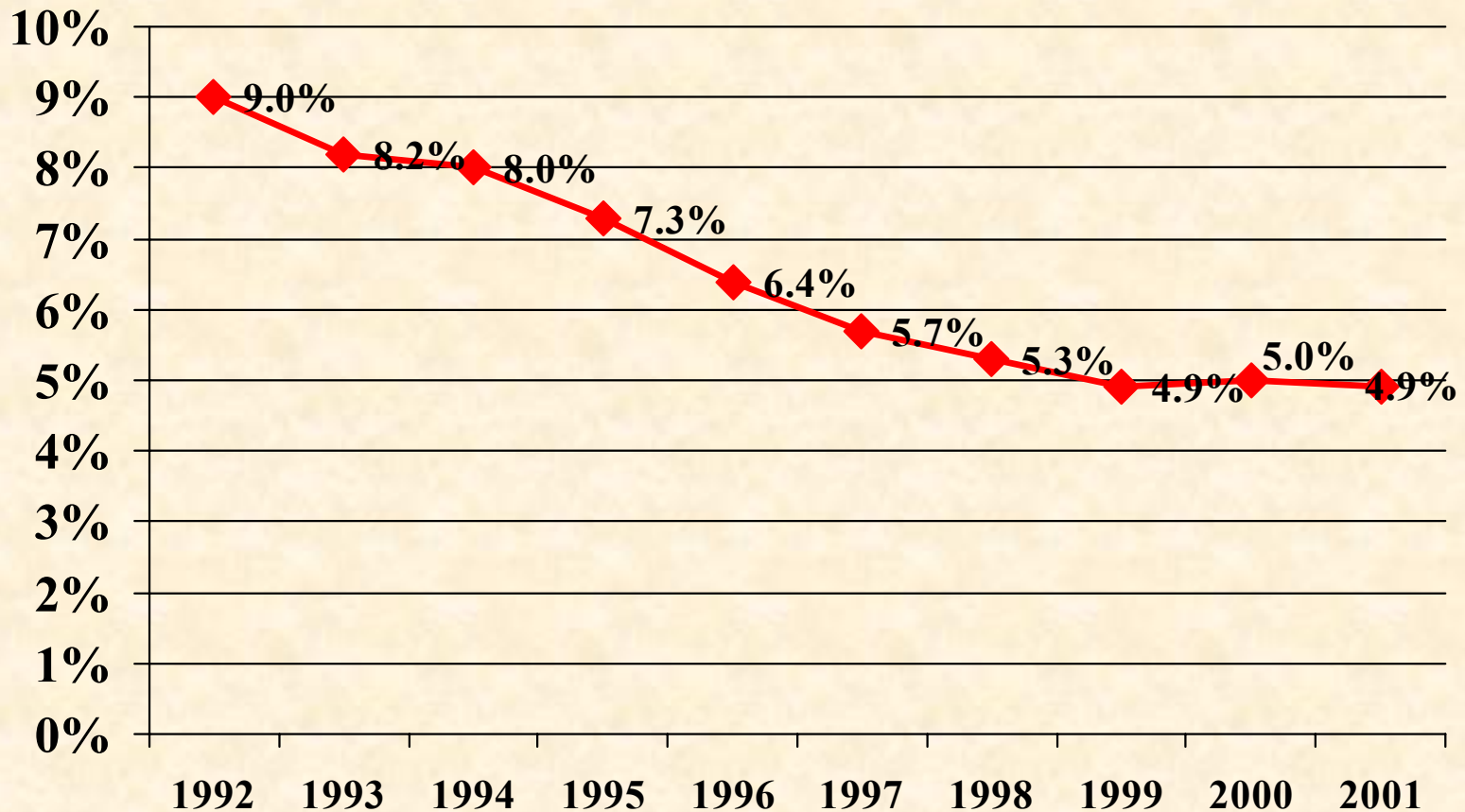
**%, 1992-2001**





# *CEA Insurer Investments in Land, Buildings and Participating Interests in Total*

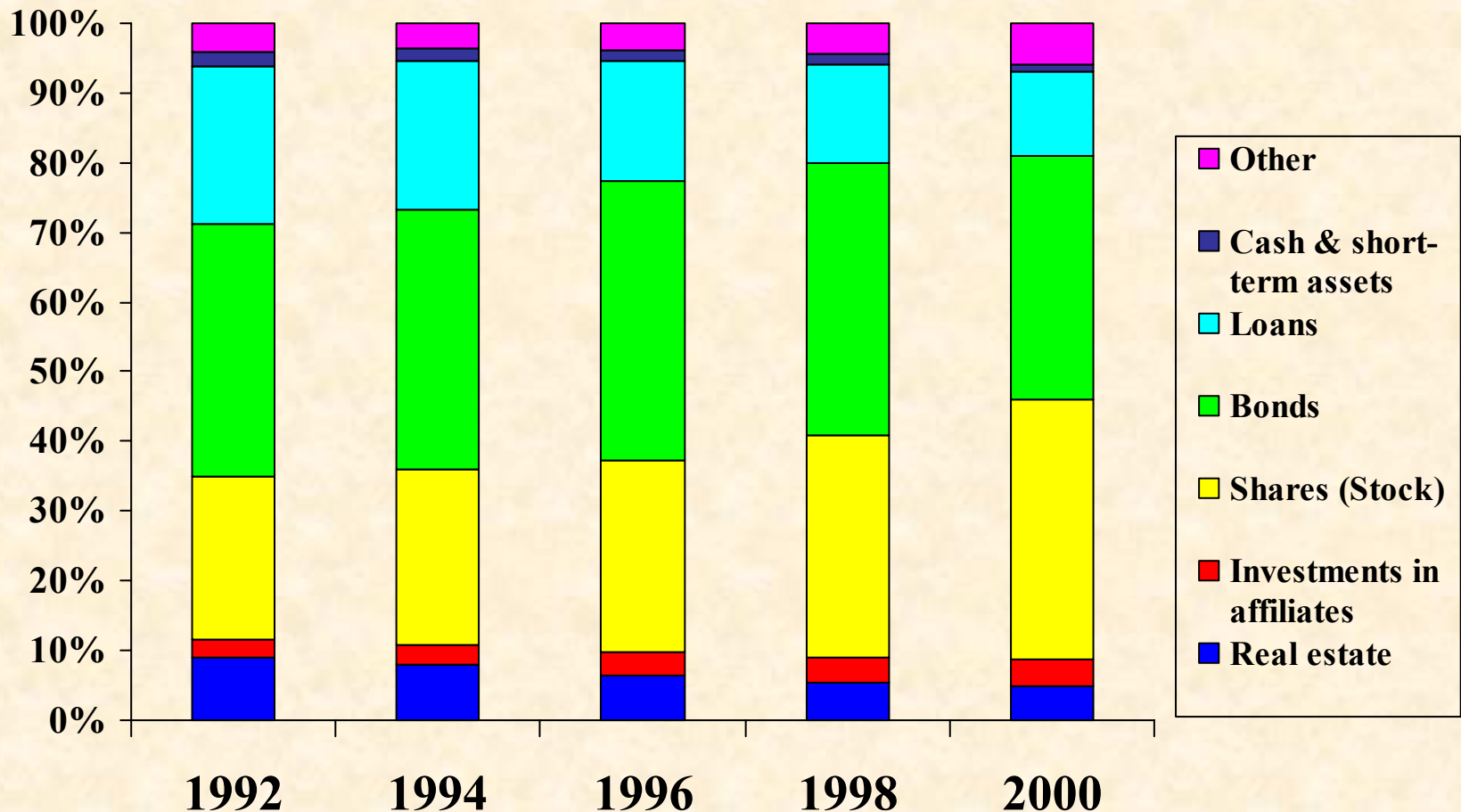
**%, 1992-2001**





# European Insurers' Asset Allocation, 1992-2000 (%)

Between 1992 and 2000, European insurers invested increasingly in equities, some 37.1% in 2000, up from 23.4% in 1992. However, there is substantial variation among European countries.



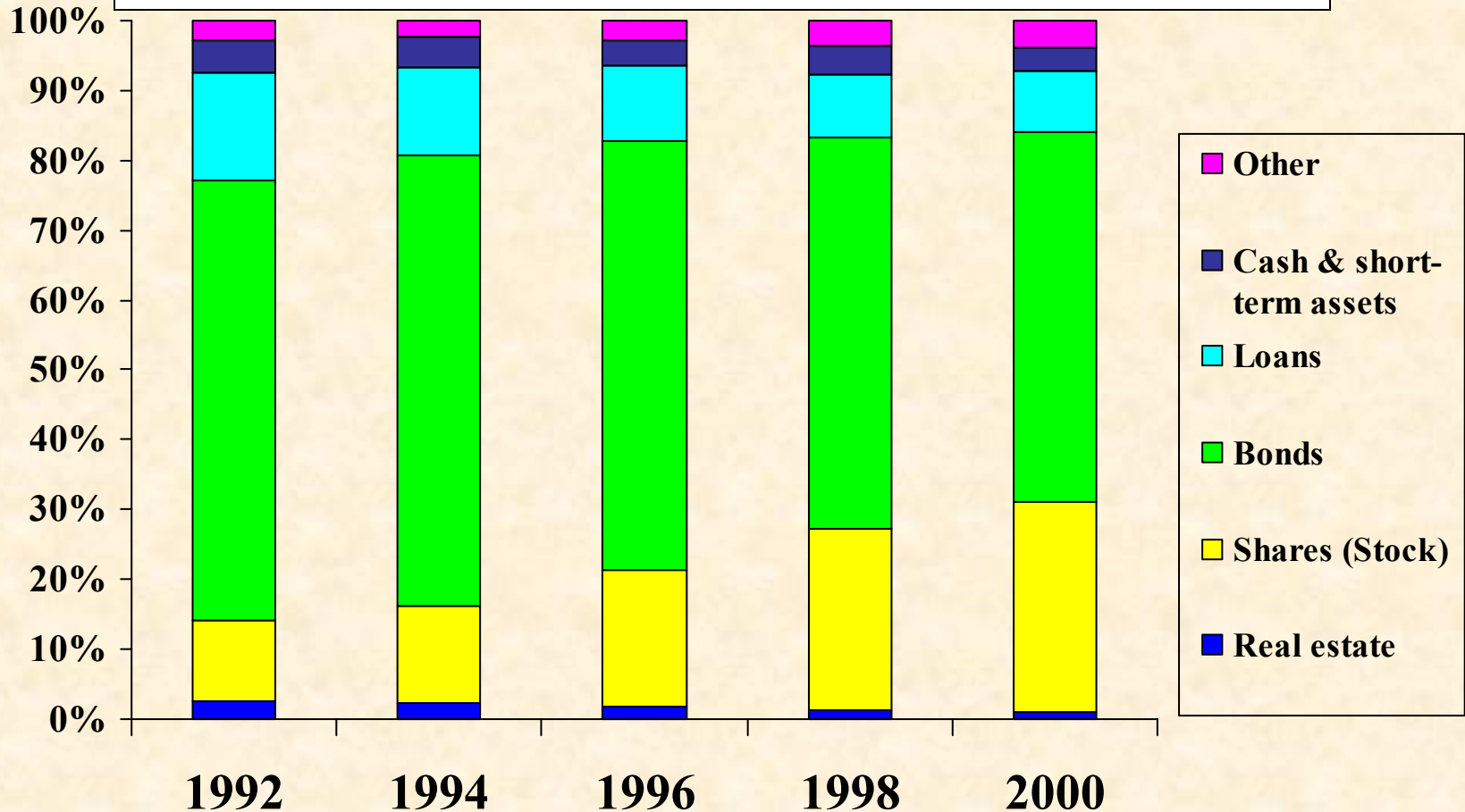
Includes separate accounts. "Loans" include mortgage loans.

Source: Swiss Re, Sigma No. 5/2002



# US Insurers' Asset Allocation, 1992-2000 (%)

By far the largest investment by US insurers is in bonds, although the industry's share in equities rose between 1992 and 2000.

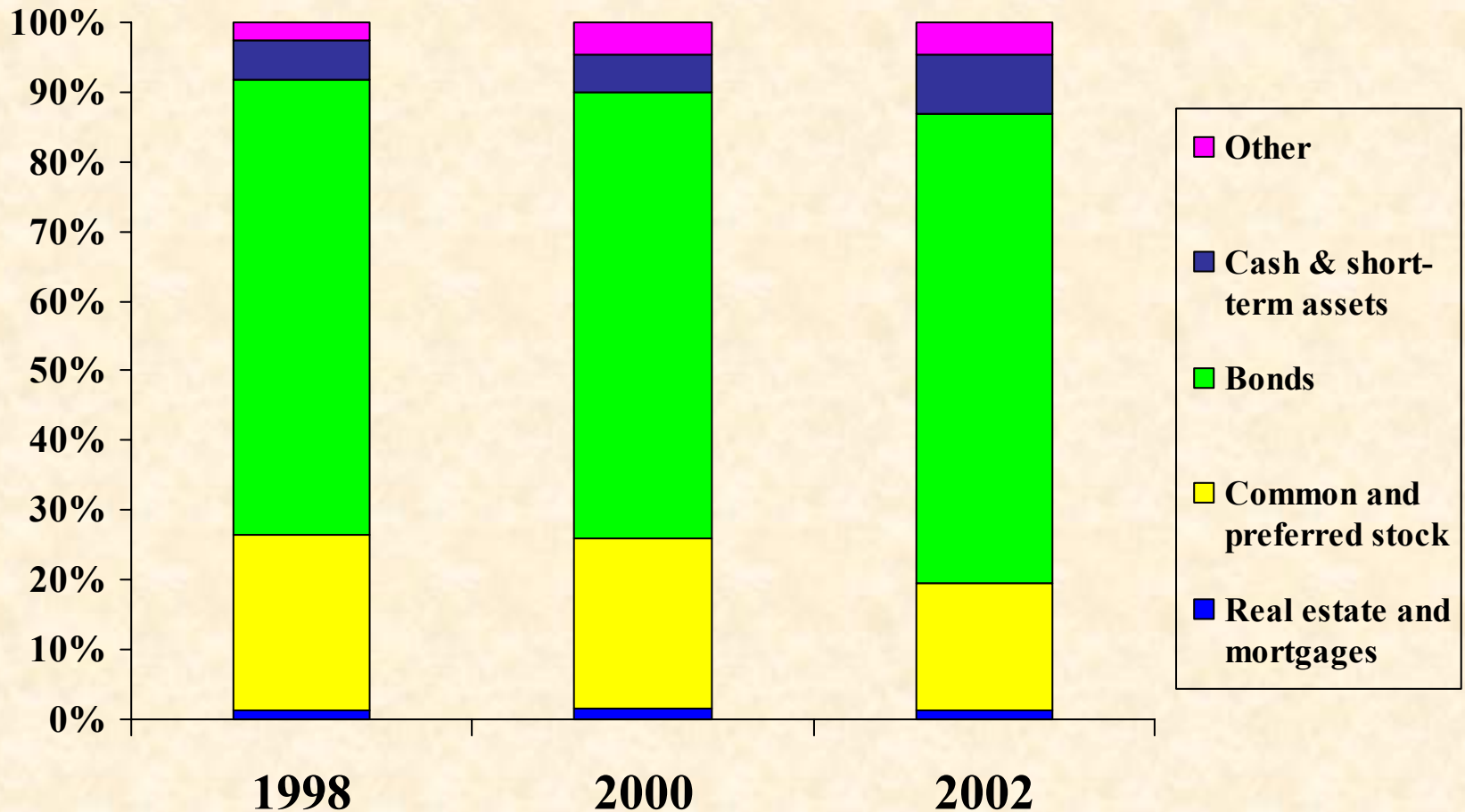


Includes separate accounts. "Loans" include mortgage loans.

Source: Swiss Re, Sigma No. 5/2002

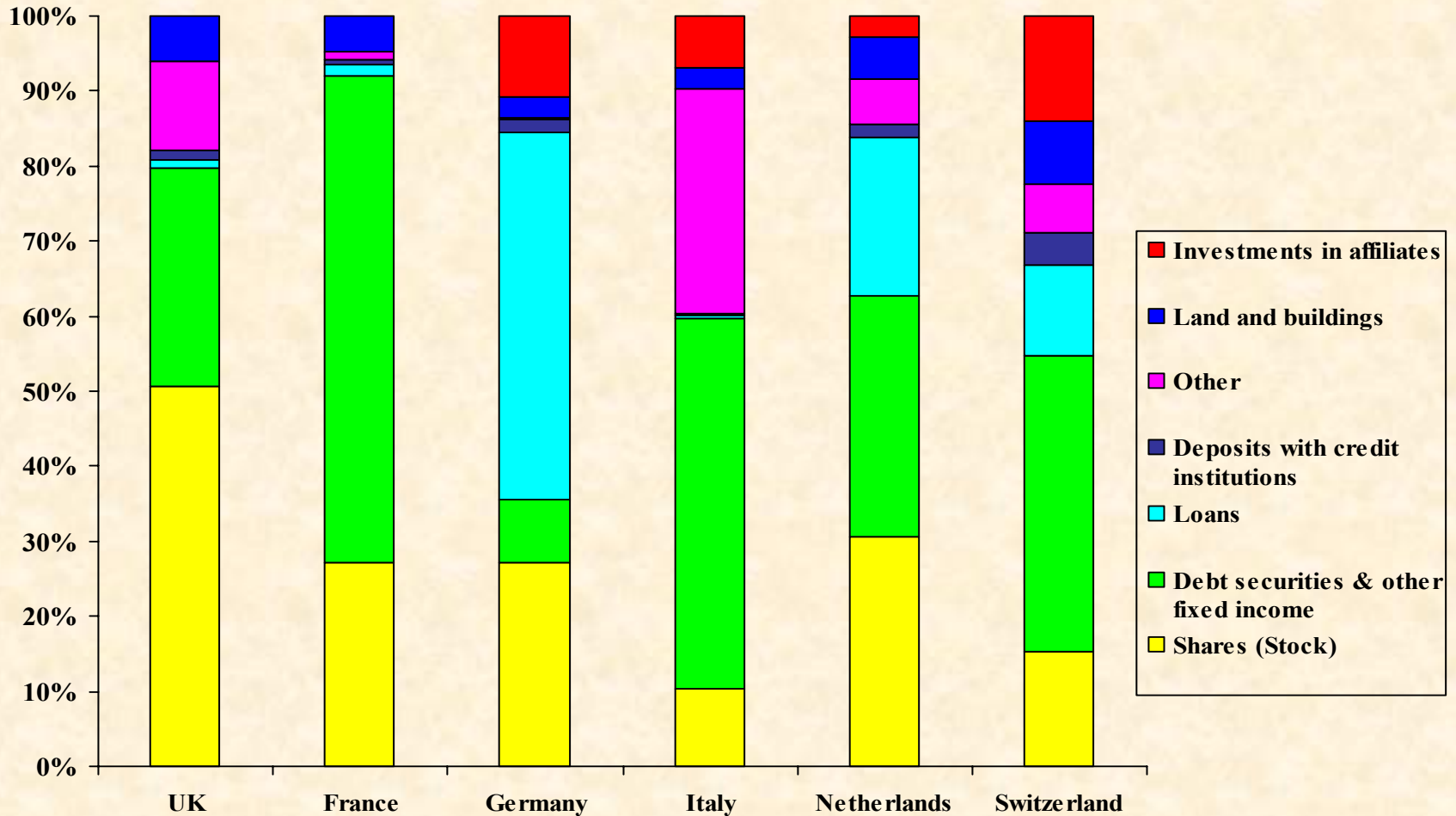


# *US Insurers' Asset Allocation, 1998-2002 (%)*





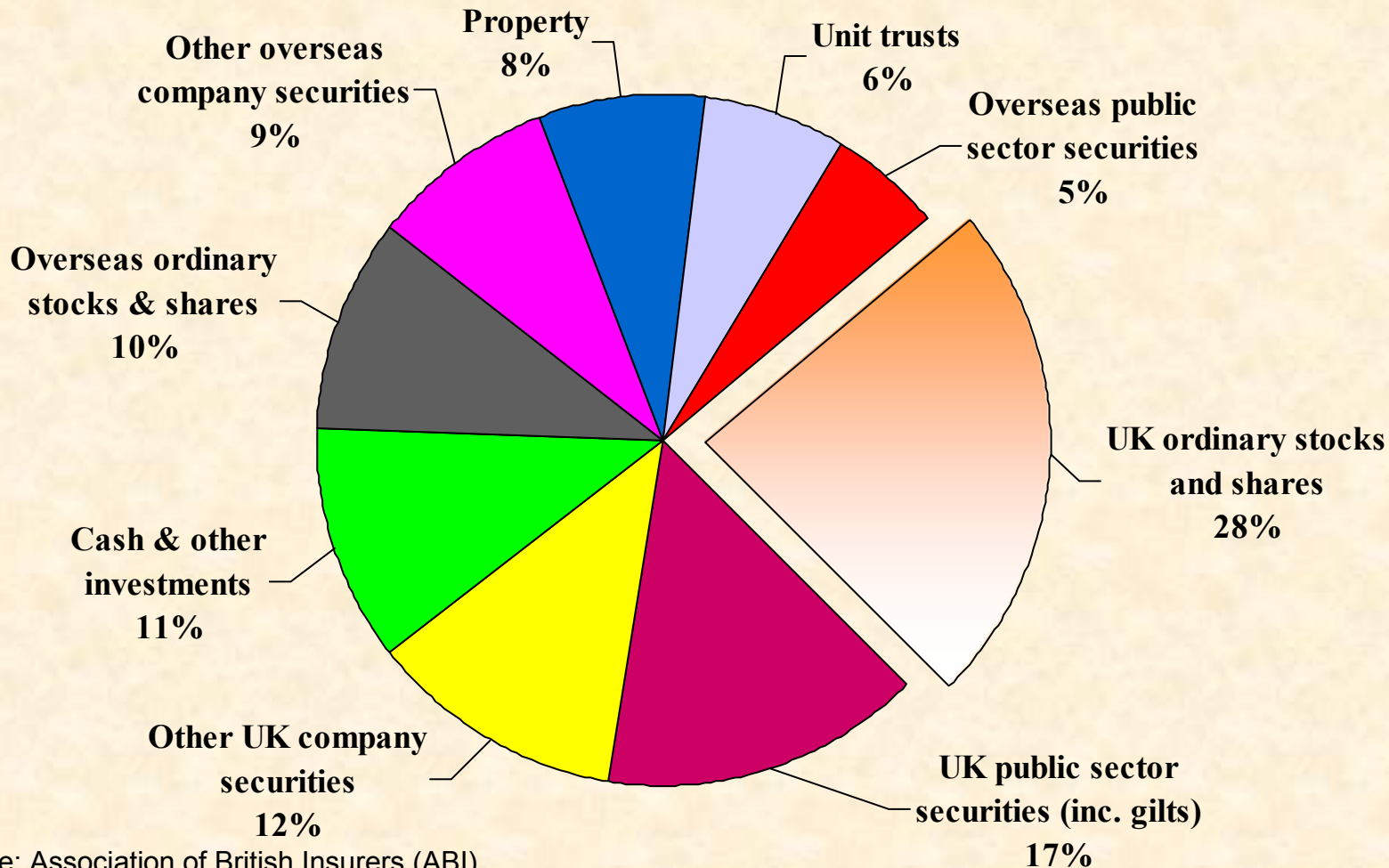
# *Insurance Asset Allocation for Key European Markets, 2001 (%)*





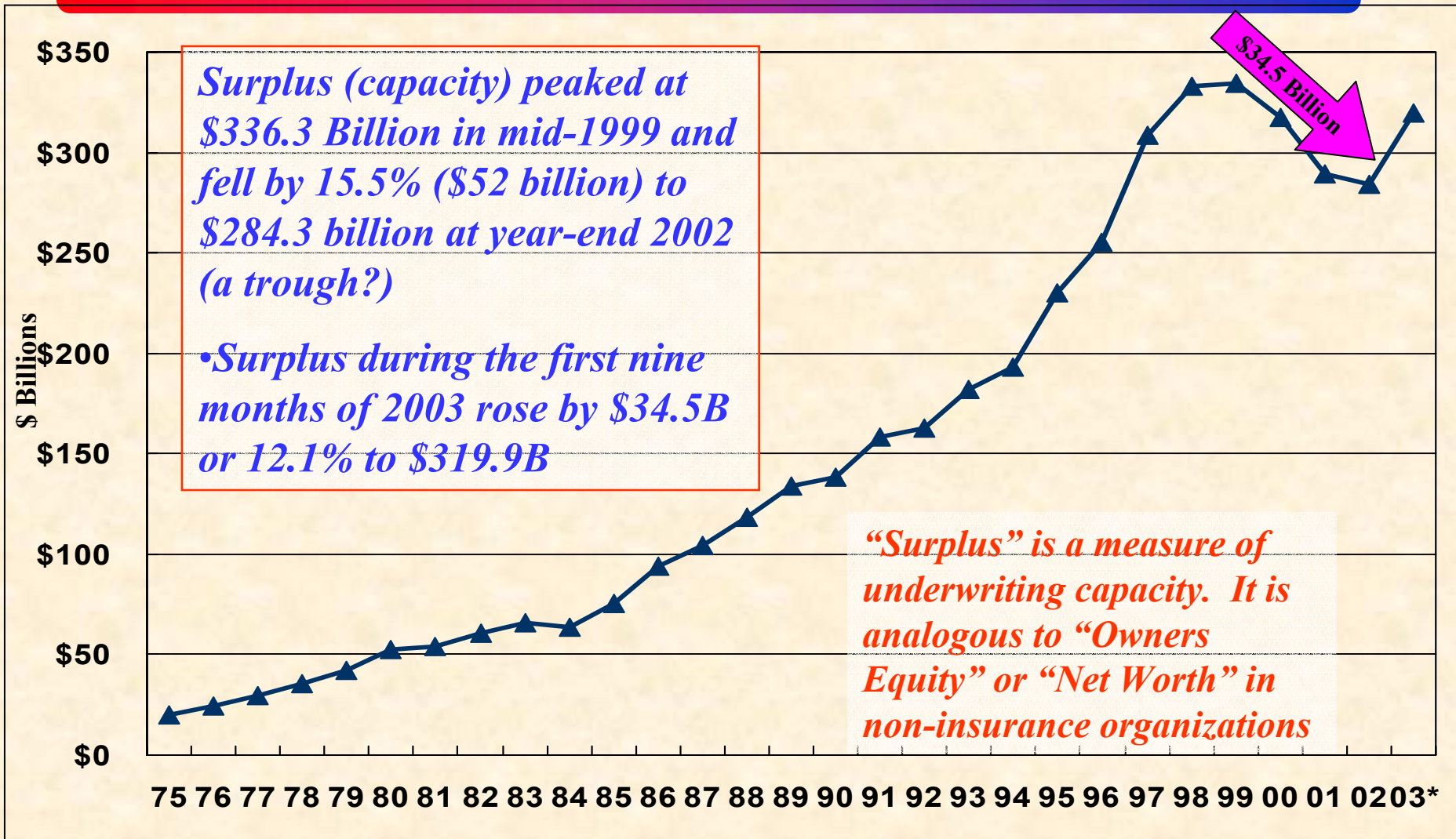
# Total Investment Holdings of UK Insurers (December 31, 2002)

The UK insurance industry had a total £1,016 billion invested at 12/31/02, the majority in stocks and shares. Altogether, UK insurers own one fifth of all UK company equity.



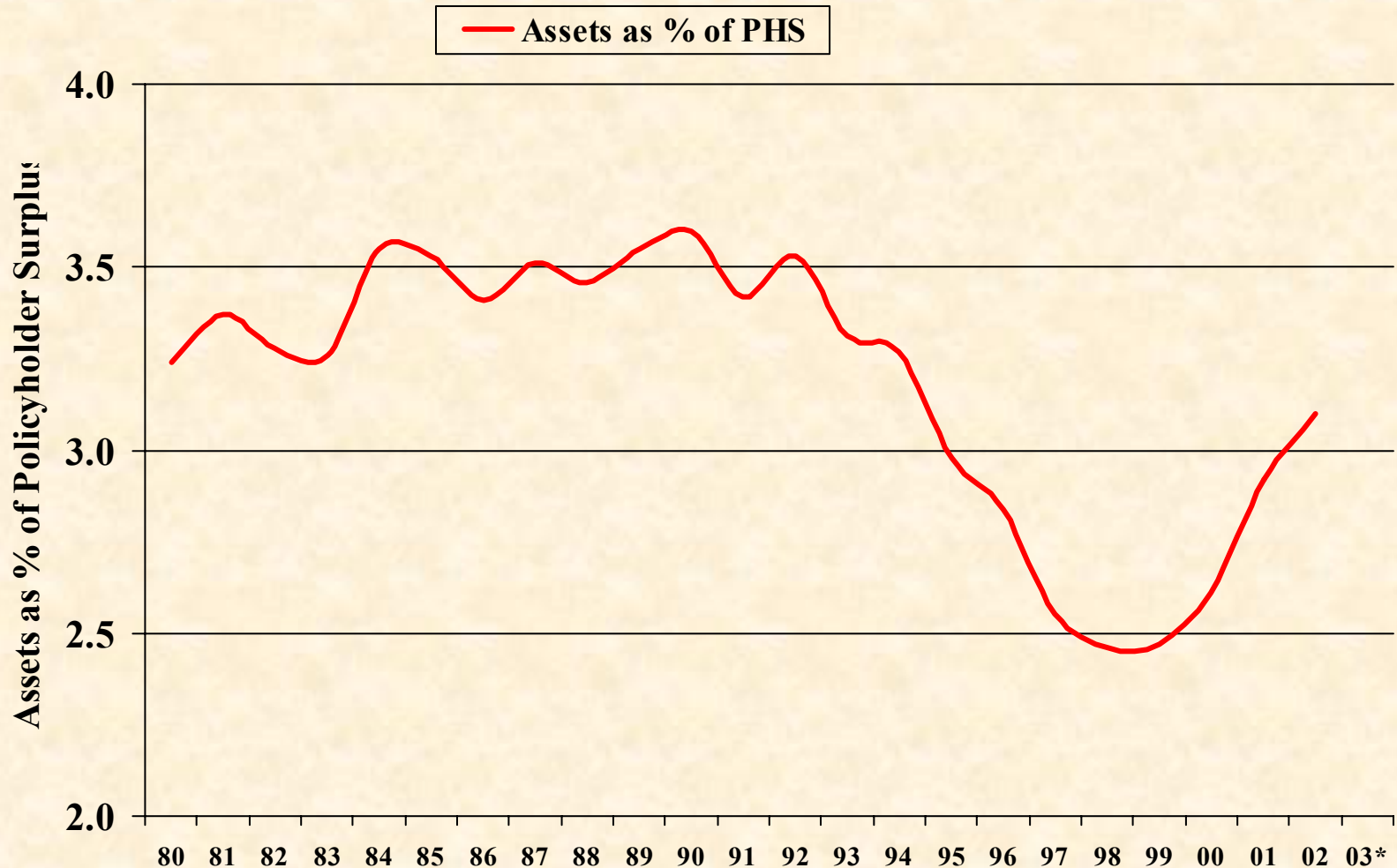


# U.S. Policyholder Surplus: 1975-2003\*





# *US Insurer Invested Assets as a Percentage of Policyholder Surplus 1980-2003\**

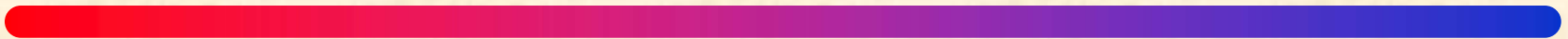


\*Insurance Information Institute Estimate based on first nine months 2003

Source: A.M. Best

# *Hot Markets:*

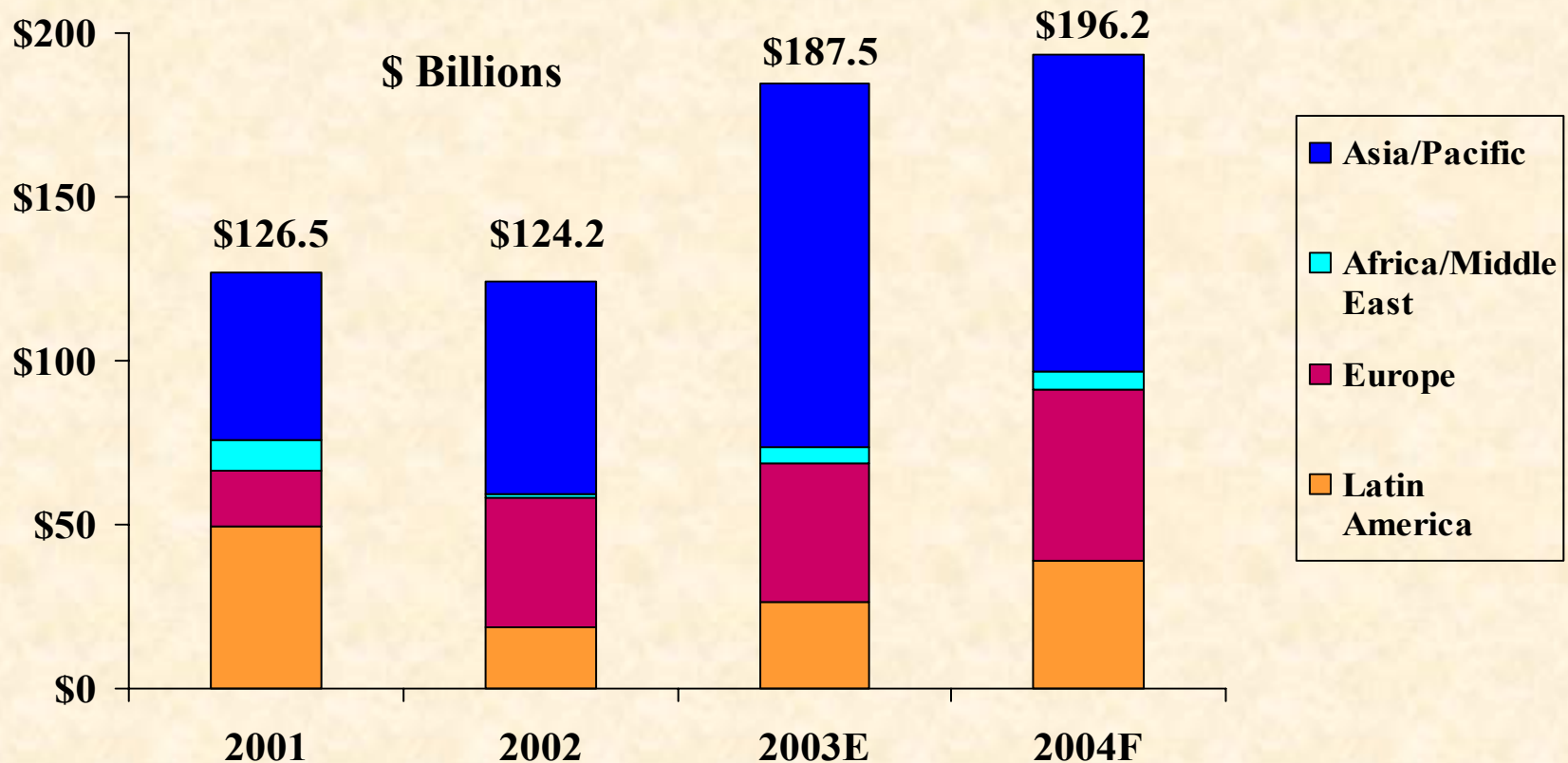
*If It's Too Good to be True...*





# Net Financial Flows to Emerging Market Economies by Region

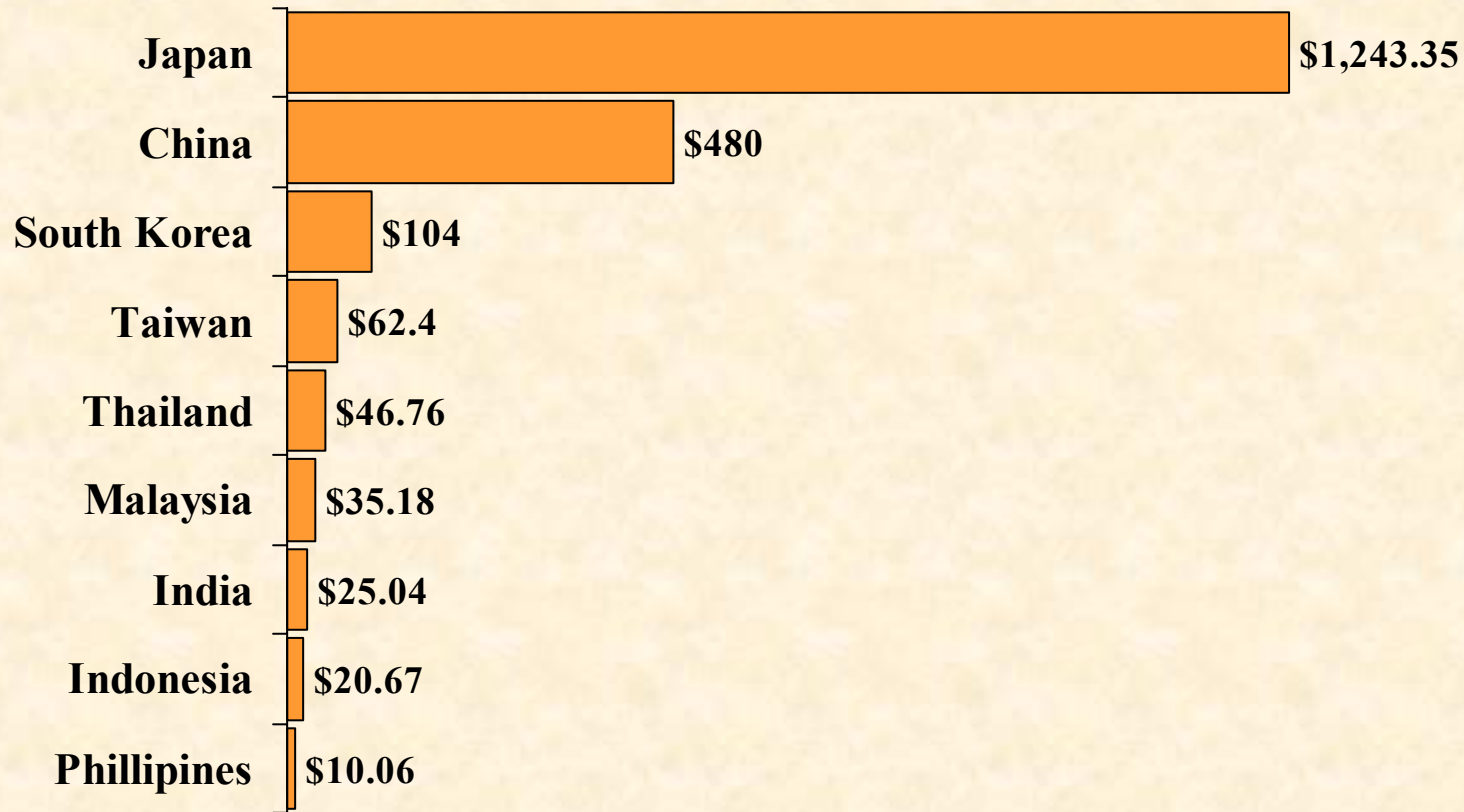
On a regional basis, Asia is projected to account for 50% of total net flows to emerging markets in 2004. Emerging Europe's share of total net private flows is expected to increase to 27% this year, up from 22% in 2003.





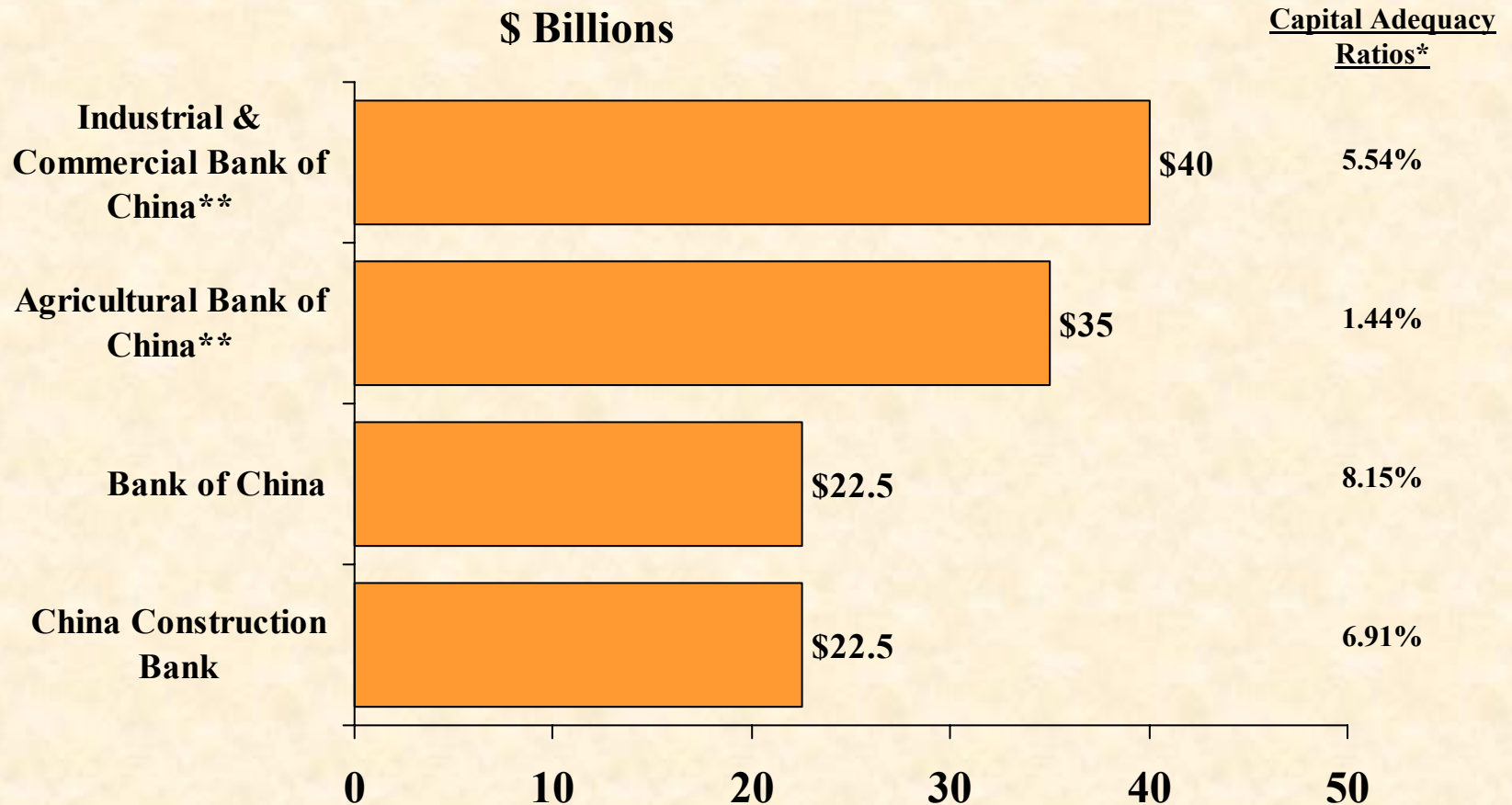
# *Estimated Total Nonperforming Loans in Asia 2002*

**\$ Billions**





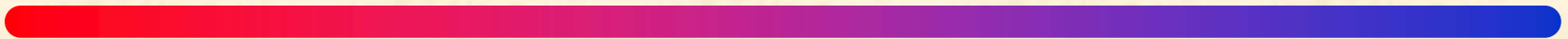
# China Bank Bailouts



\*The minimum capital-adequacy ratio of banks must be 8% to meet international standards. \*\* Tentative amounts.

Source: China's central government and private-sector economists; Shenyin & Wanguo Securities, The Wall Street Journal 1/13/04

*SCANDAL, CORPORATE  
GOVERNANCE &  
IMPACTS ON INSURERS*





# *Serious Implications for Financial Institutions*

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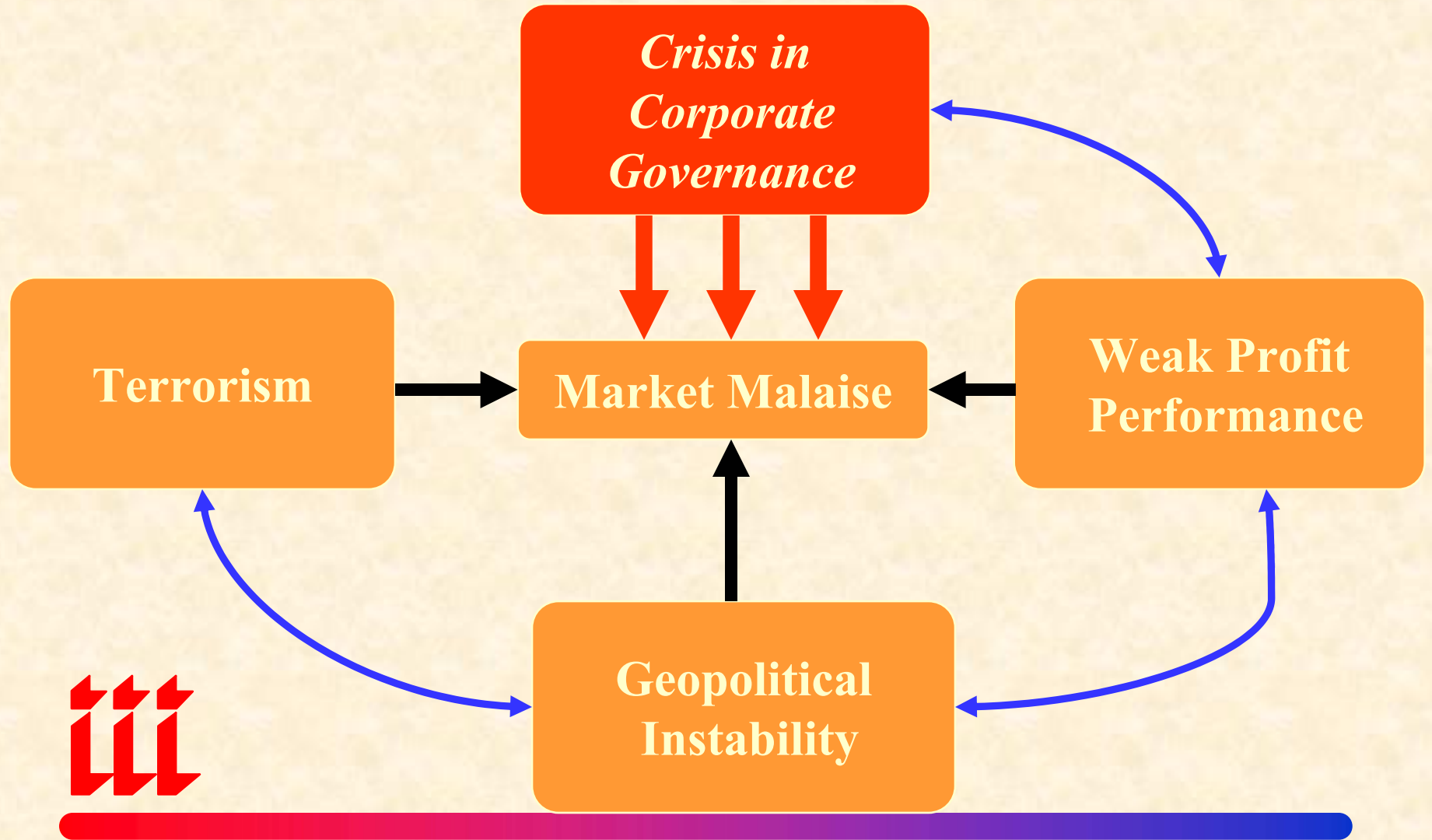
- **Insurers exposed to a wide variety of risks:**
  - **Investment risk (as institutional investors)**
  - **Insurance risk (surety, D&O, E&O, etc.)**
  - **Litigation risk (as both plaintiff & defendant)**
  - **Regulatory risk**
  - **Reputational risk**



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

- **Crisis of Confidence—skepticism/cynicism is high**
  - **Ratings agencies      Analysts      Regulators**
  - **Investors/Creditors      Employees      Lawmakers**
- **Regulatory/Legislative Fallout Unclear**
  - **SEC opening record number of investigations**
  - **SEC, Administration & Congressional proposals vary**
  - **States will take own legal action (e.g., NY)**
- **Surge in shareholder suits has already begun**

# *Market Malaise*





# Houston...

## We Have a Problem

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

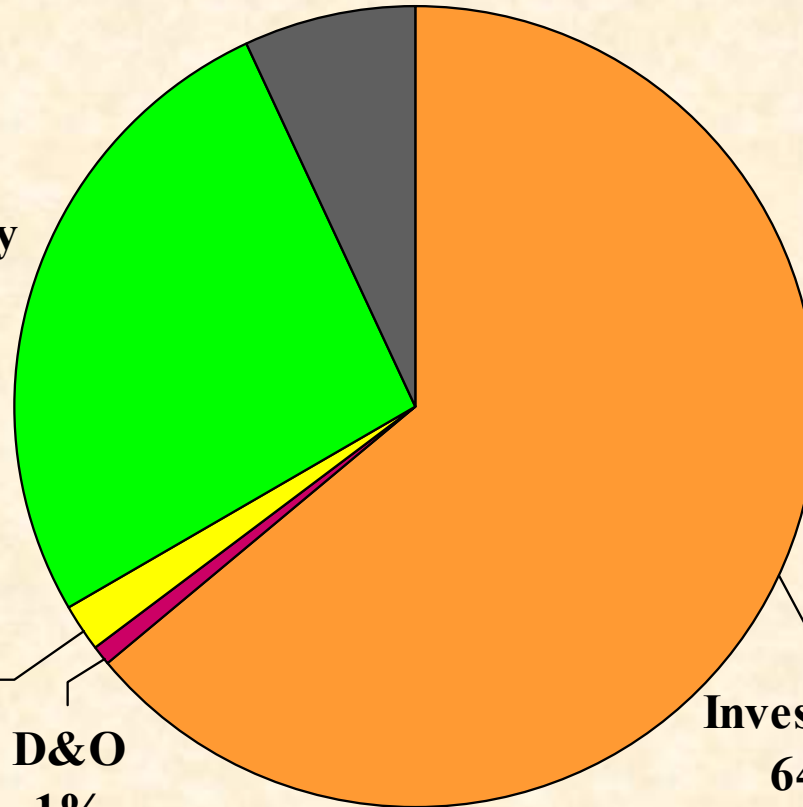
Multiple  
7%



Surety  
26%

Fin. Guarantee  
2%

D&O  
1%



Investment  
64%

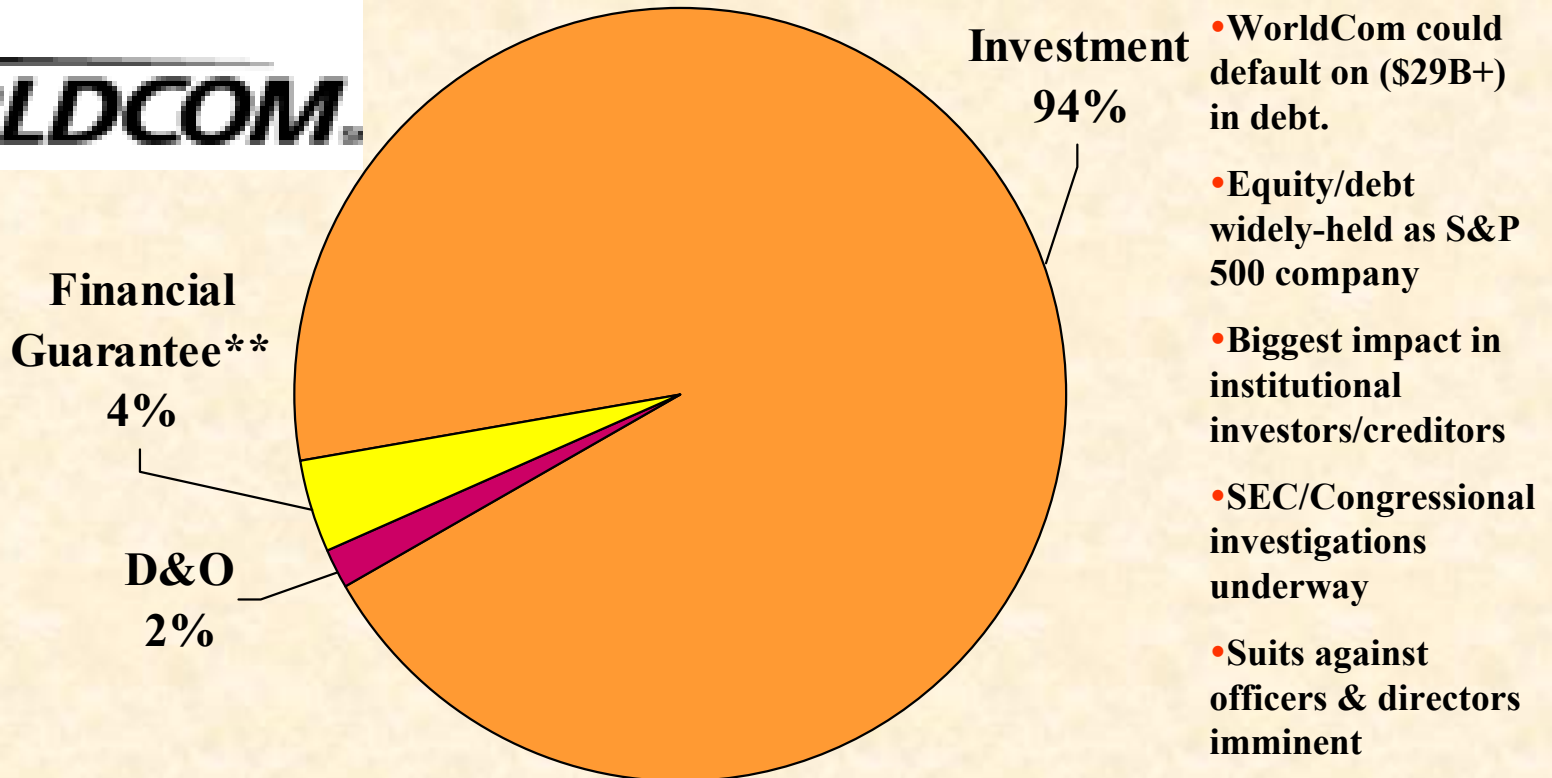
- Enron is the biggest bankruptcy in US history (\$31B+)
- Equity/debt widely-held as S&P 500 company
- Biggest impact in institutional investors/creditors
- 11 Congressional investigations
- 56 suits against officers & directors
- Will spark similar suits



# *WorldCom to WorldCon?*

## *Insurer Exposure*

**Total Exposure (Life & Non-Life): \$5.725 Billion\***



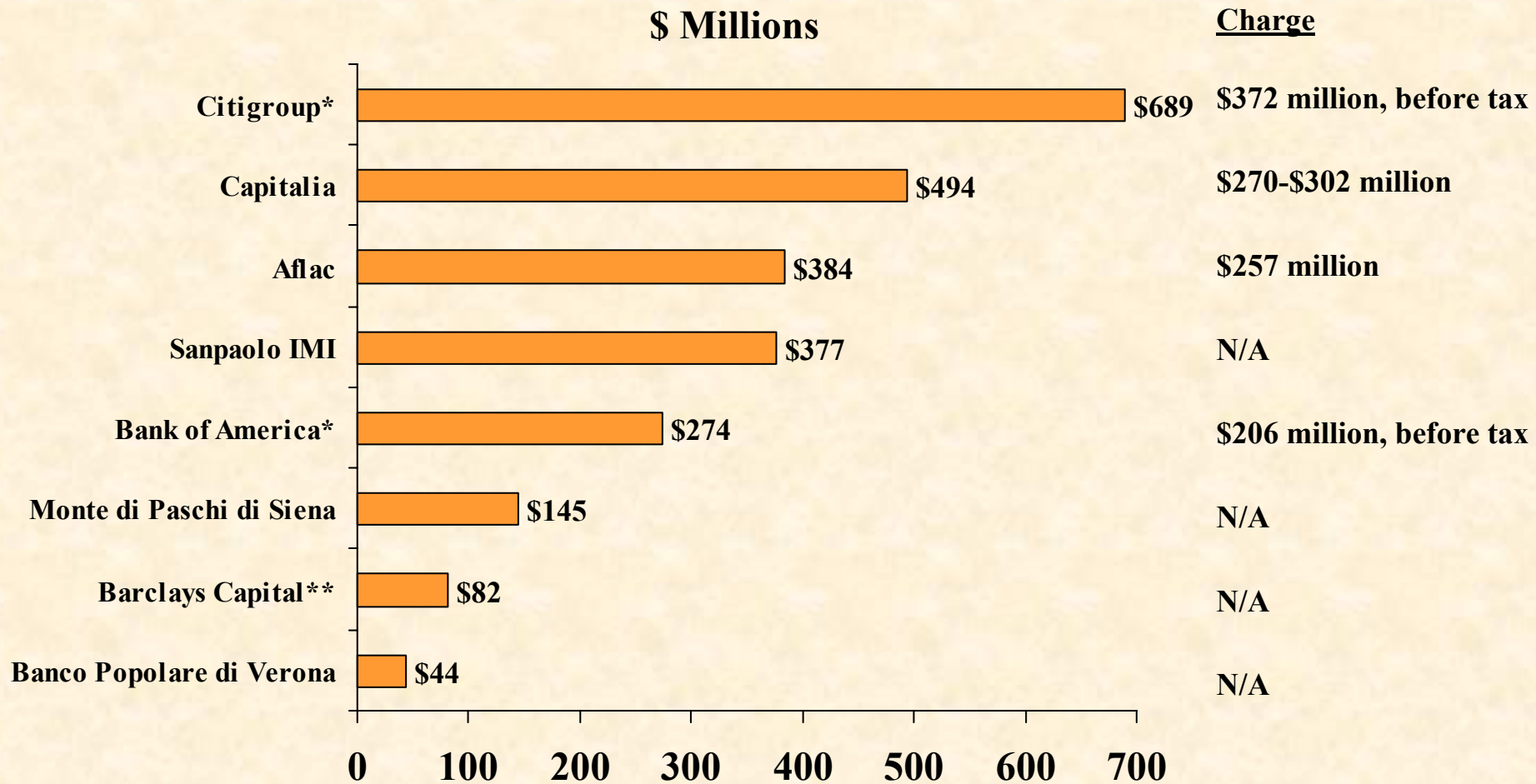
\*As of 7/1/02; Includes \$5.4B in debt assuming default, \$100 mil D&O, \$225 mil CDO (still collateralized). As of 7/1, WCOM debt trading at about \$0.15 of par, stock trading at \$0.08/share. Equity losses are indeterminant.

\*\*Does not include disclosed but unquantified exposure to credit default swaps

Source: Insurance Information Institute based in from Moody's, company announcements, III research.



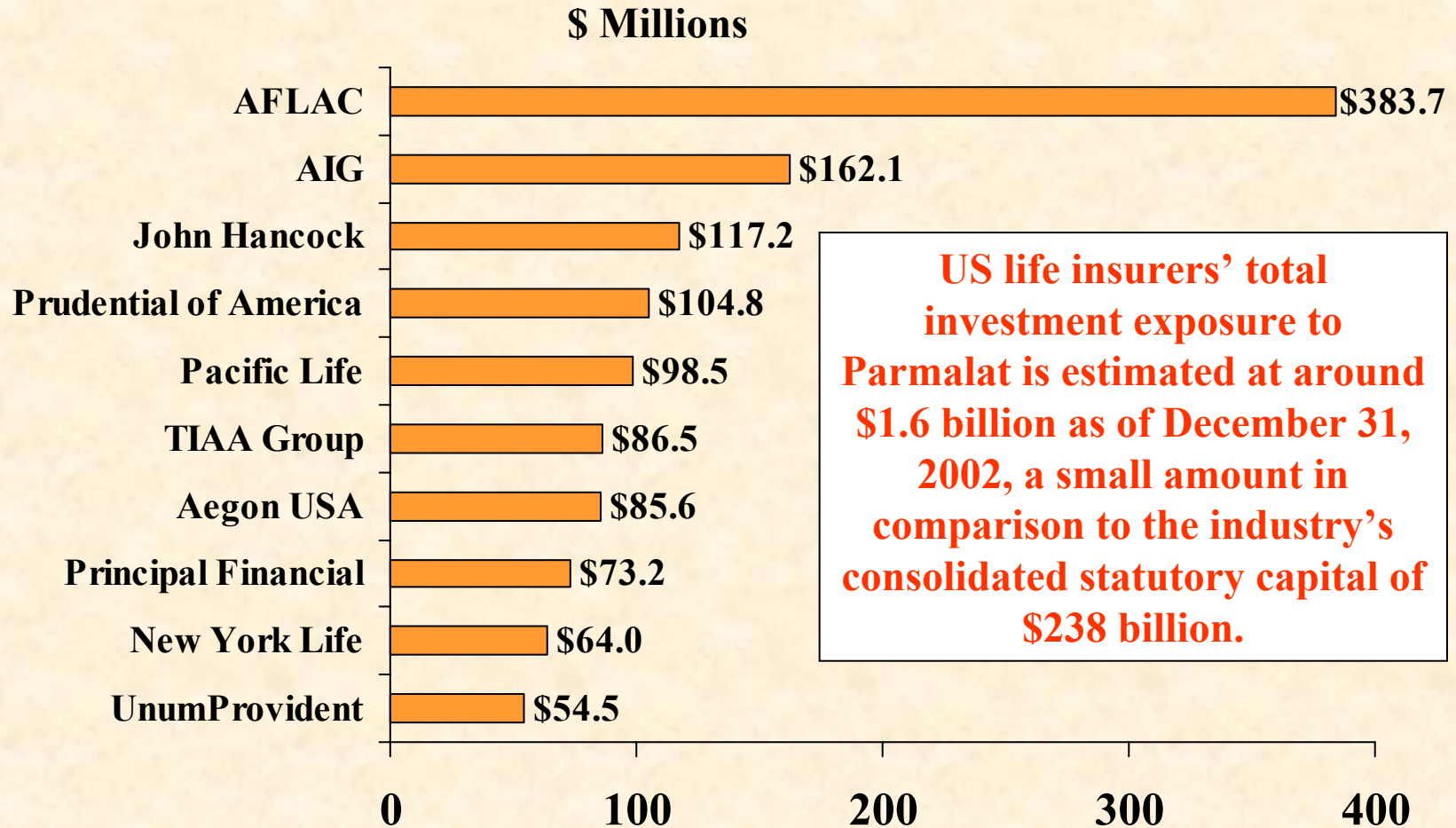
# Total Exposure to Parmalat (\$ Millions)



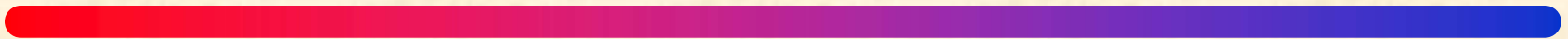
\*As of Dec. 31, 2003, before taxes; Bank of America said that total exposure to Parmalat was previously \$647 million but that a large part of that was insured or backed by cash collateral. \*\*After hedging; estimated.

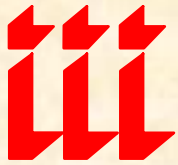


# *Parmalat Exposure: Top 10 US Life Insurers*






*Who's Who in the  
Corporate House of Ill-Repute*










# Corporate Hall of Shame

Company	Problem	Potential Charges
	D&Os created complex outside partnerships that kept billions in losses of Enron's balance sheet; Accused by CA of manipulating energy market	<ul style="list-style-type: none"><li>• Securities Fraud</li><li>• Insider trading</li><li>• Perjury</li></ul>
	Lax oversight of some client books, conflicts of interest, shredded documents	<ul style="list-style-type: none"><li>• Guilty of obstruction of justice</li><li>• Individual partners may be liable</li></ul>
	Inappropriately accounted for \$3.8B in expenses, inflated profits	<ul style="list-style-type: none"><li>• Fraud</li></ul>






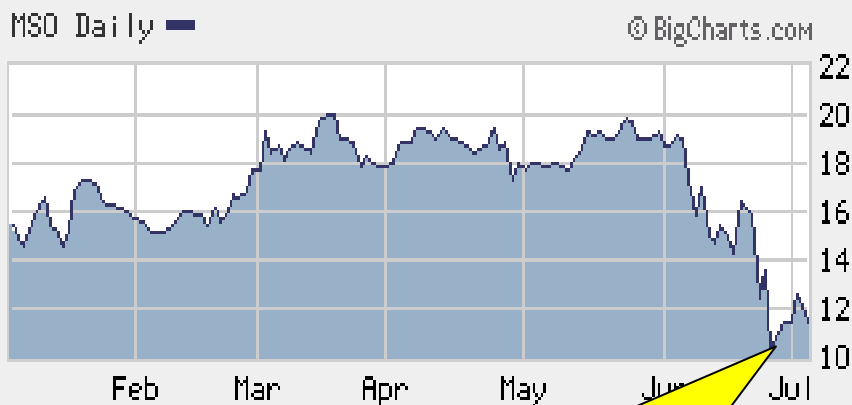
# Corporate Hall of Shame

Company	Problem	Potential Charges
	Ex-CEO Dennis Kozlowski indicted for tax evasion on art purchases	<ul style="list-style-type: none"><li>• Tax evasion</li><li>• Misuse of corporate funds</li><li>• SEC accounting query</li></ul>
	Bogus capacity swaps inflated revenues (Qwest did too); Dynegy = “round-tripping” to inflate revenue	<ul style="list-style-type: none"><li>• Securities fraud</li><li>• Insider trading</li></ul>
 <b>ImClone Systems Incorporated</b>	Ex-CEO Sam Waksal indicted June 12 for tipping off family & <u>friends</u> that FDA did not approval of cancer drug Erbitux	<ul style="list-style-type: none"><li>• Insider Trading</li></ul>  



# Corporate Hall of Shame

Company	Problem	Potential Charges
	\$4.6B in undisclosed loans to founding Rigas family; Misc. unconventional transactions, questionable accounting	<ul style="list-style-type: none"><li>• Securities fraud</li><li>• Misuse of corporate funds</li><li>• SEC accounting query</li></ul>
	Questionable acctg. in sales of fiber optic capacity; Ex-CEO Nacchio under fire for excessive compensation & questionable stock sales	<ul style="list-style-type: none"><li>• Fraud</li><li>• Possible insider trading</li></ul>
	Complex projects exaggerated cash flow; “Round-tripping” to inflate revenue	<ul style="list-style-type: none"><li>• Possible fraud</li></ul>



**Martha Stewart Omnimedia fell by more than 50% after Imclone insider trading scandal broke out**



**This sumptuous New England lobsterbake is available at MarthaStewart.com for just \$250!**

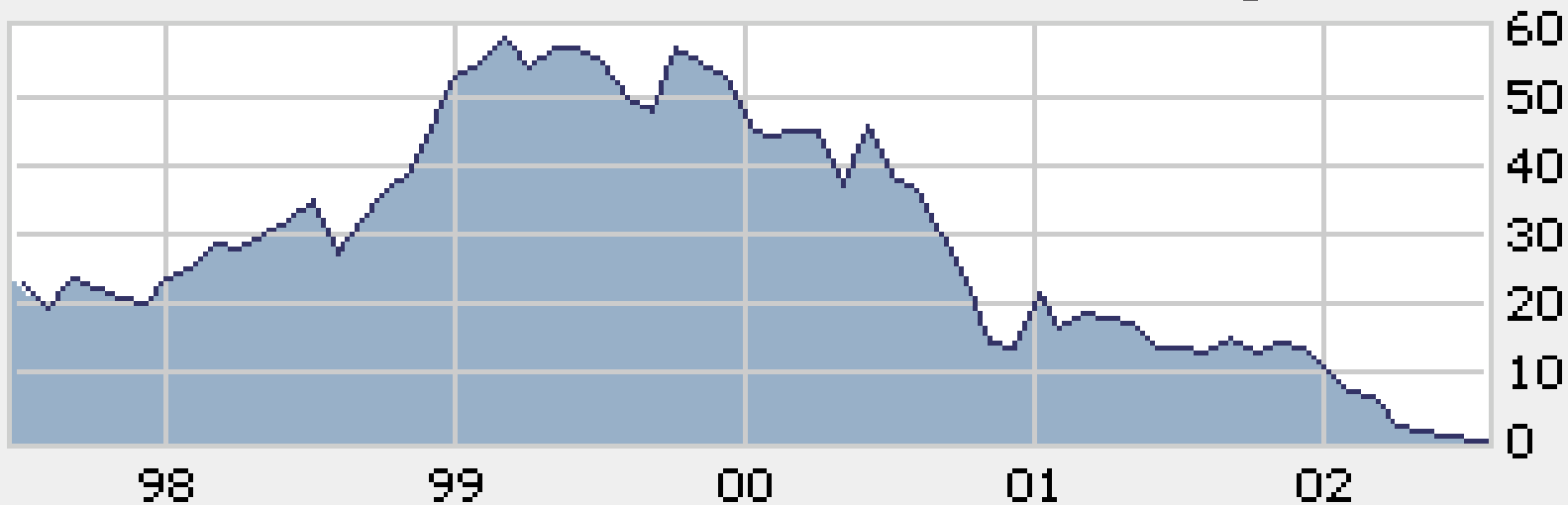


# *WorldCom: From \$60/share in to 6 Cents in Three Years*

**As of July 1, 2002**

WCOM Monthly

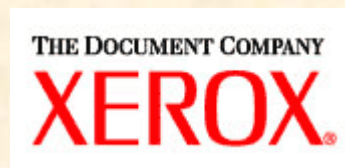
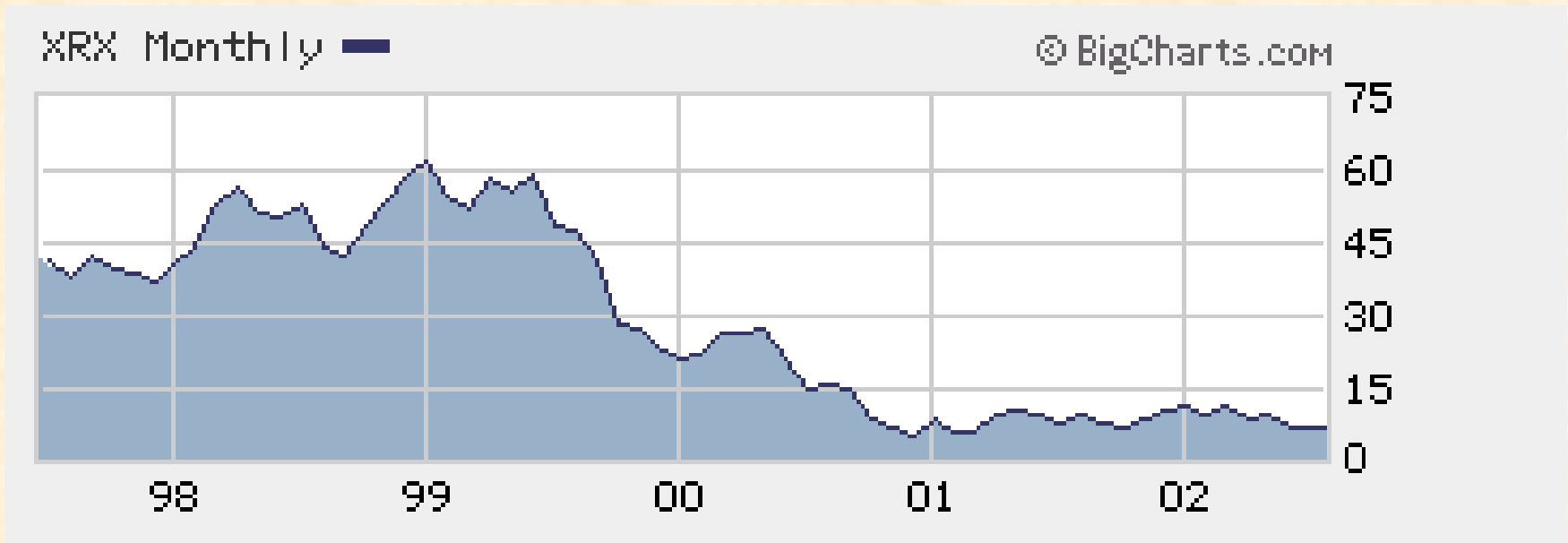
© BigCharts.com





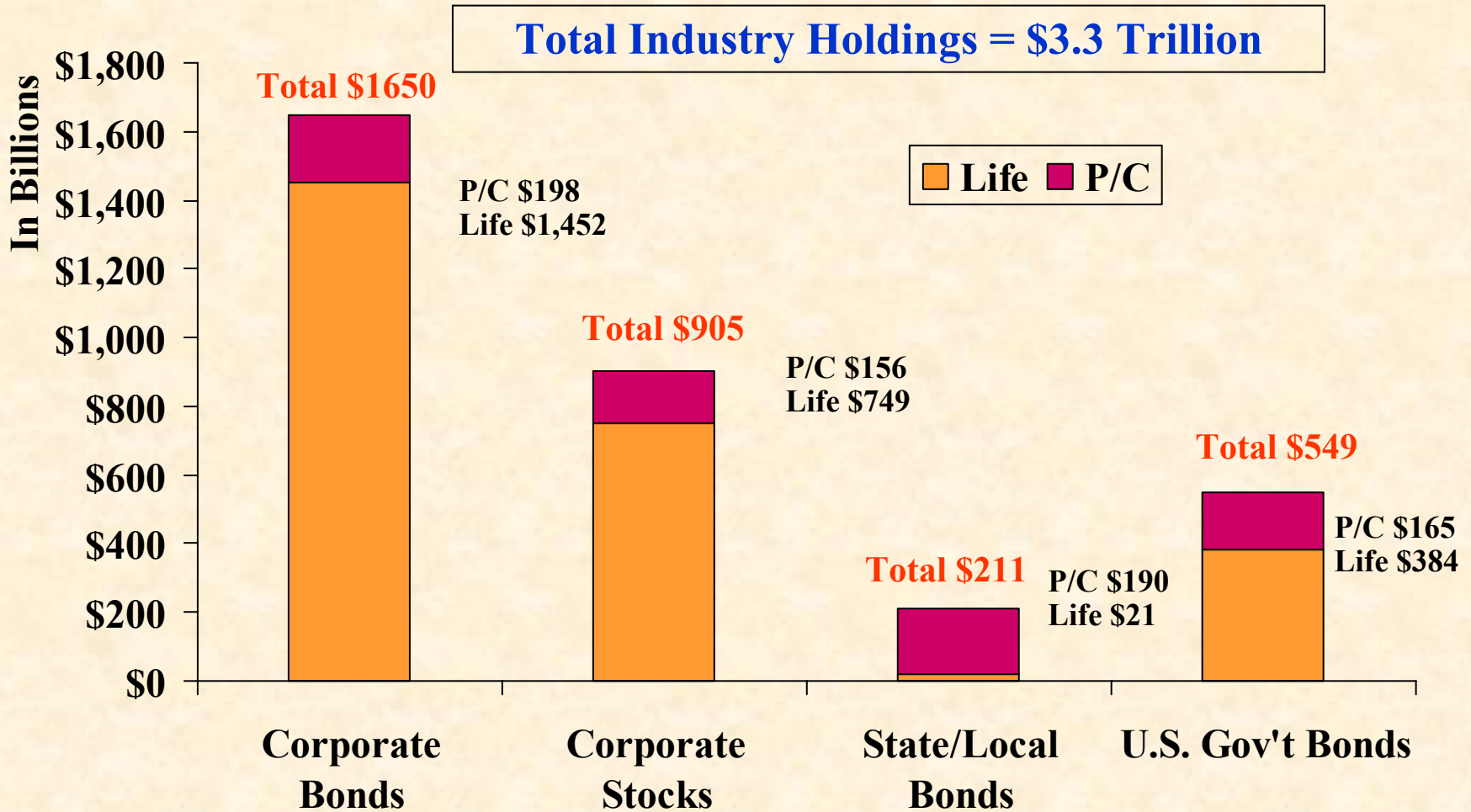
# *Xerox: From \$60/share in to \$6.60 Cents in Three Years\**

**As of July 1, 2002**





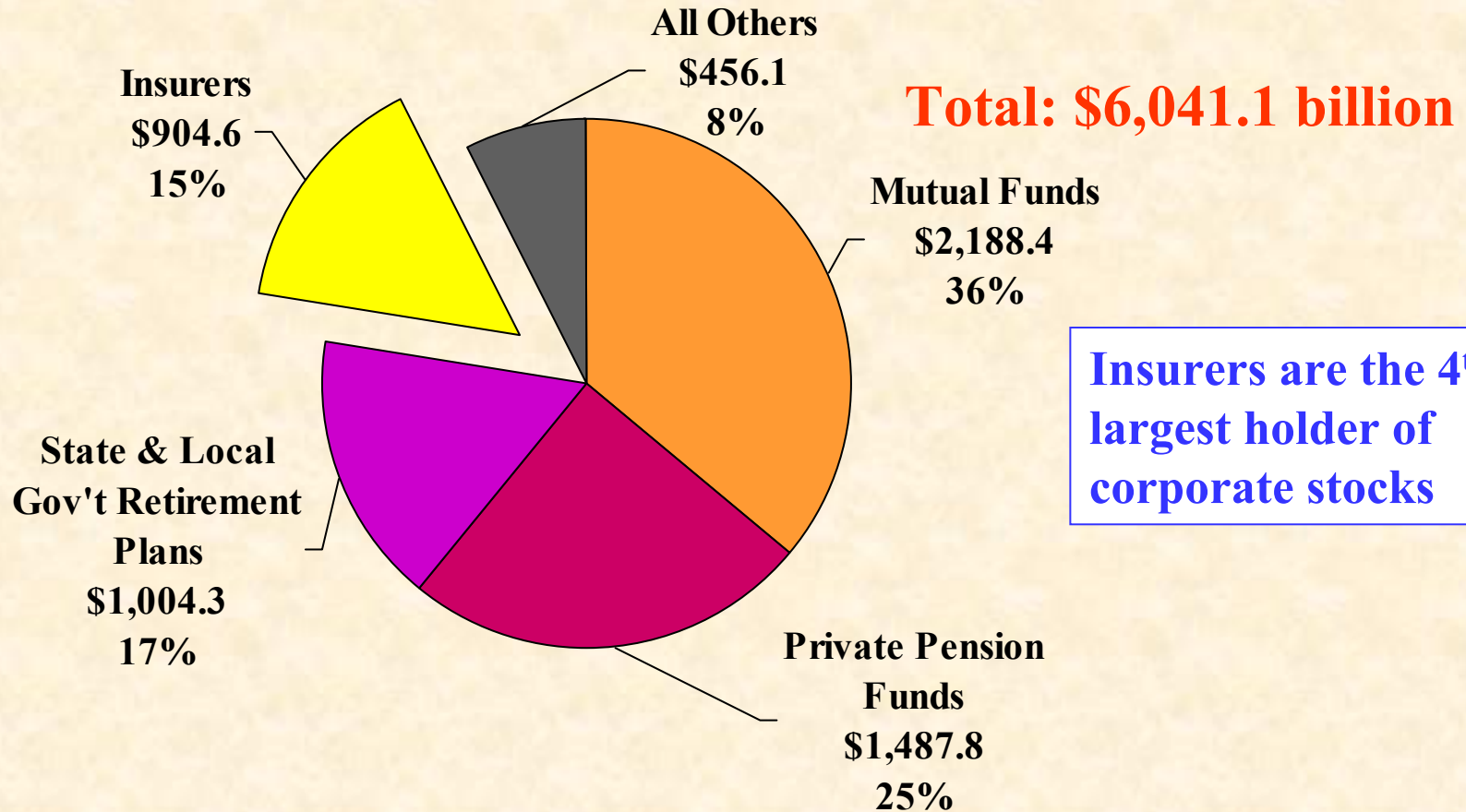
# *U.S. Insurance Industry Stock and Bond Holdings, 2002*





# *U.S. Institutional Investor Market in Corporate Equities*

**Market Value of Holdings, as of December 31, 2002**

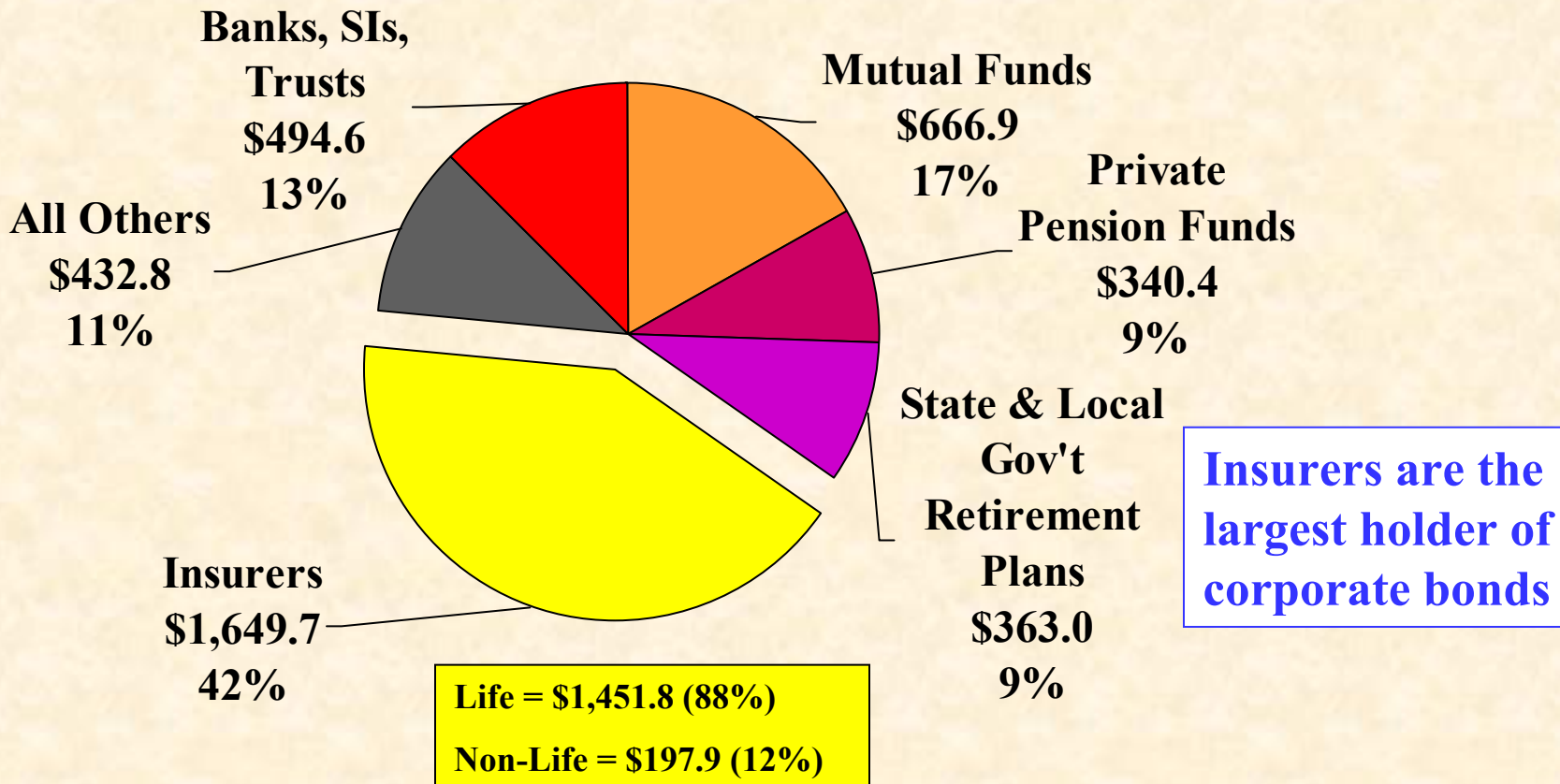




# *U.S. Institutional Investor Market in Corporate and Foreign Bonds*

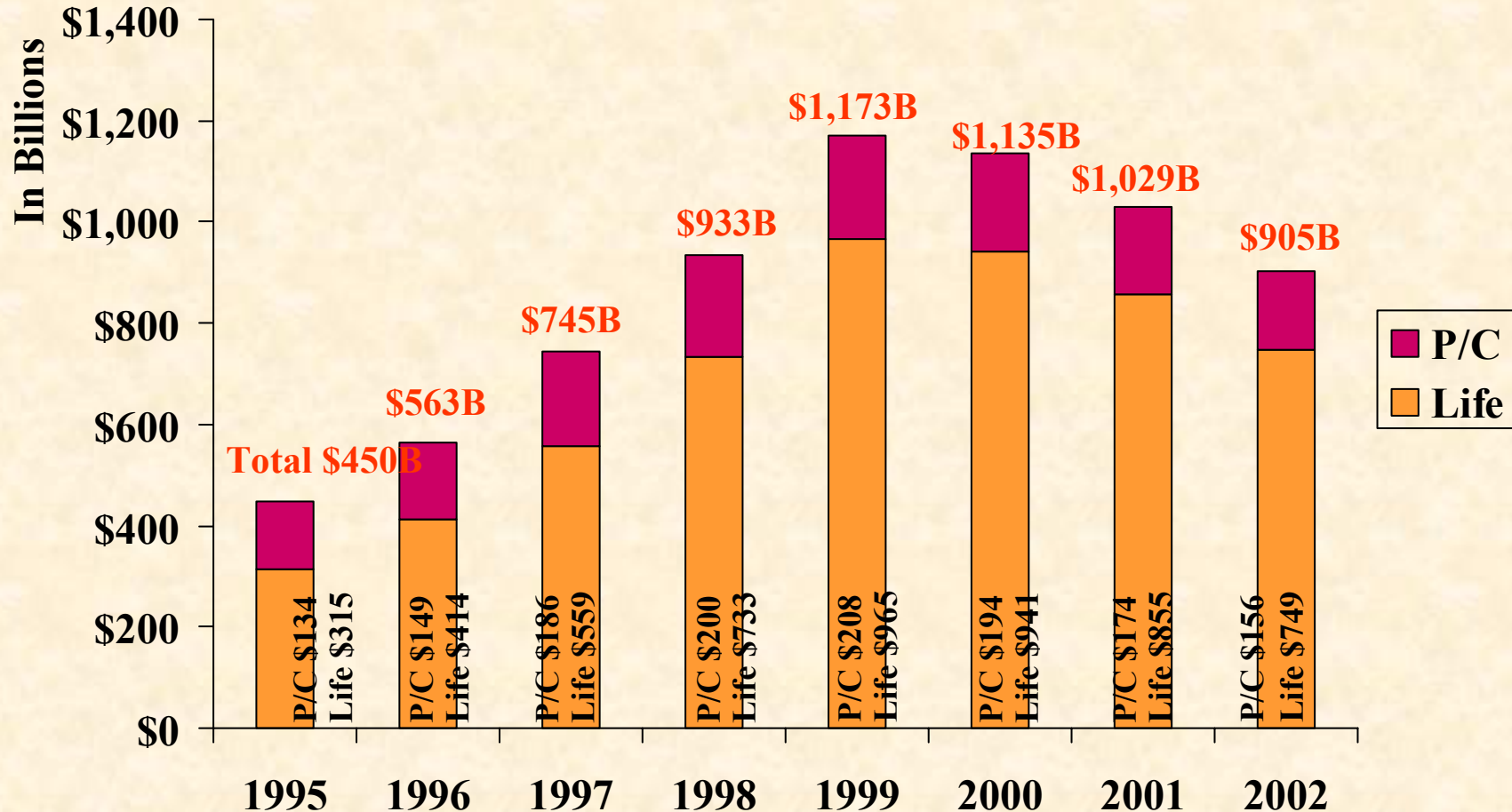
**\$ Billions Year-End 2002**

**Total: \$3,947.4 billion**



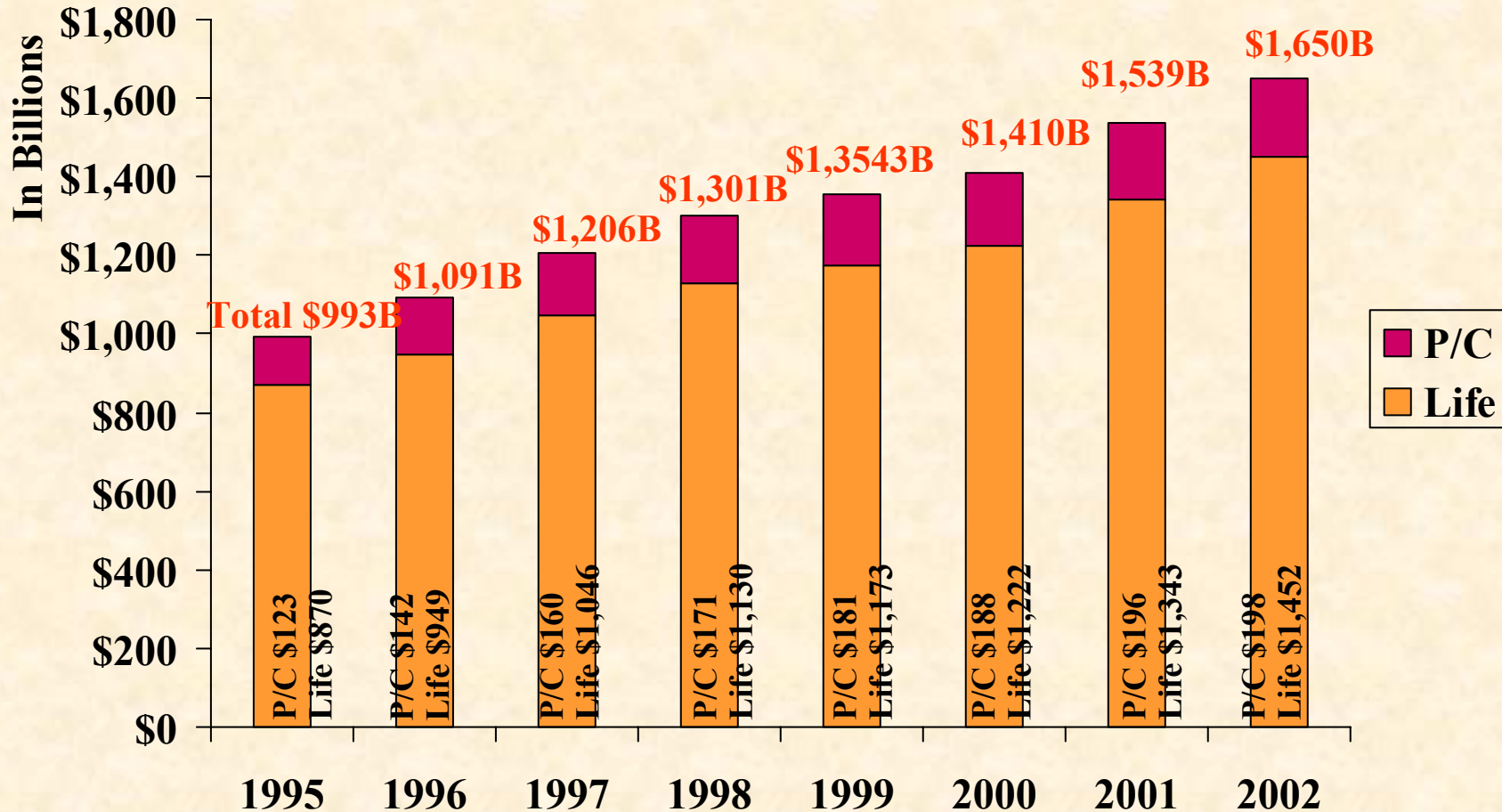


# *U.S. Insurance Industry: Corporate Equity Holdings, 1995-2002*





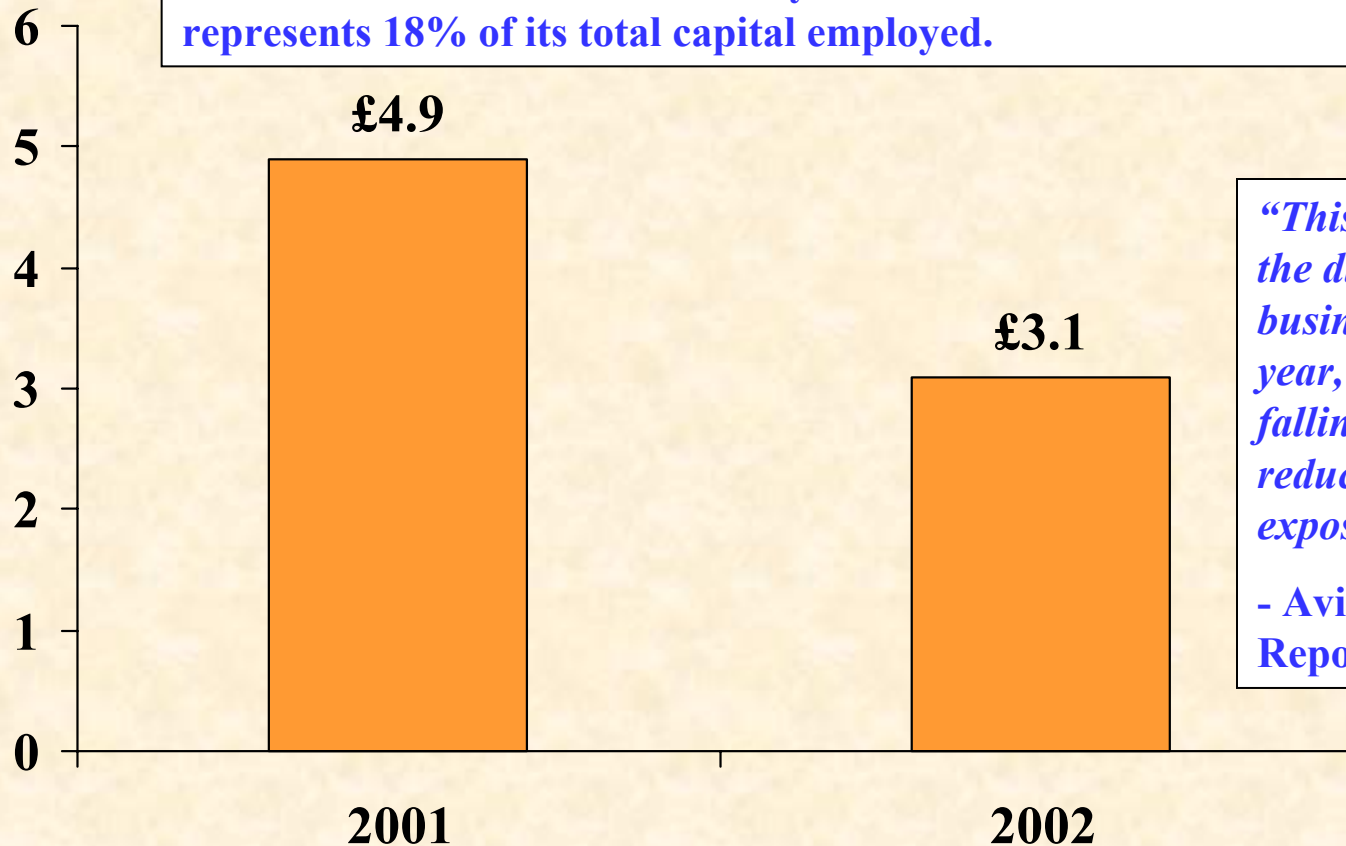
# *U.S. Insurance Industry: Corporate Bonds Holdings, 1995-2002*





# Aviva Equity Exposure 2001 vs. 2002

Aviva's exposure to equities reduced from £ 4.9 billion at 31 December 2001 to £ 3.1 billion at year-end 2002. This represents 18% of its total capital employed.



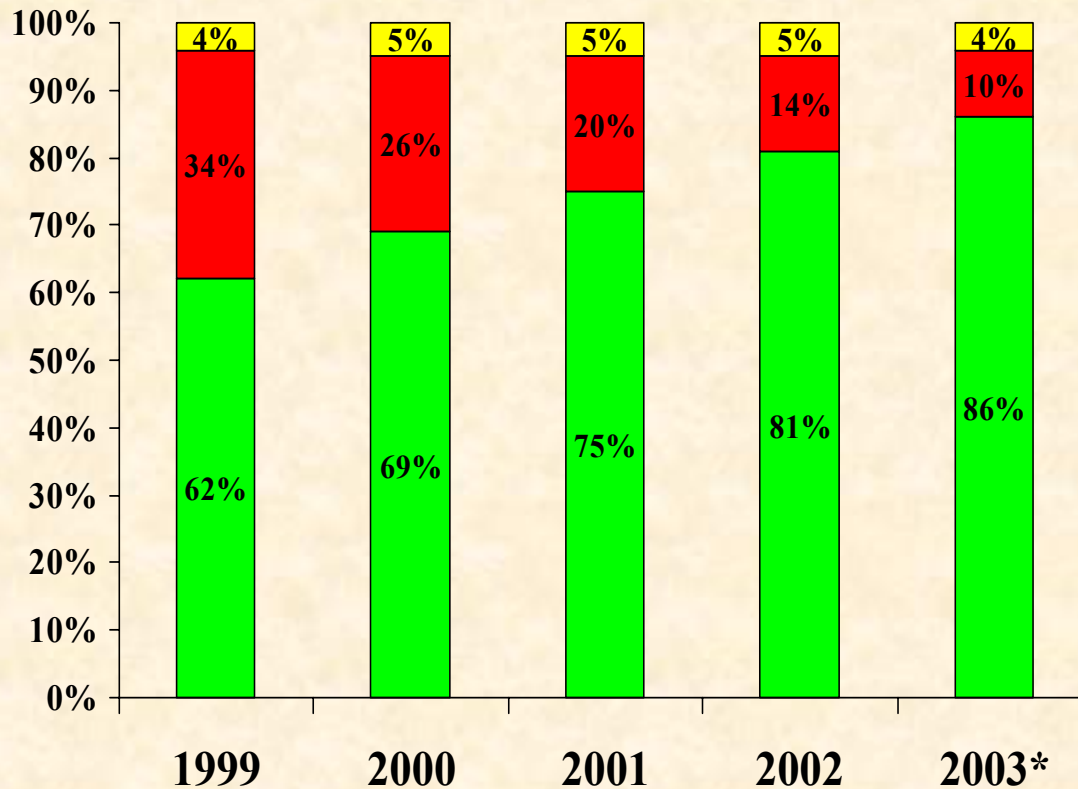
*“This reduction reflects the divestment of businesses during the year, the impact of falling markets and the reduction of equity exposures.”*

*- Aviva 2002 Annual Report*



# Swiss Re Equity Exposure 1999-2003

Swiss Re's fixed income portfolio increased to CHF 81 billion at the end of the first half of 2003, up from CHF 74 billion at year-end 2002.



*“Strong growth in fixed income portfolio reflects reallocation of funds from equity portfolios, cash inflows, market appreciation and two Admin Re transactions.”*

*- Swiss Re Analysts' Meeting, 08/29/03*

- Other Investments
- Shares
- Fixed Income Investments

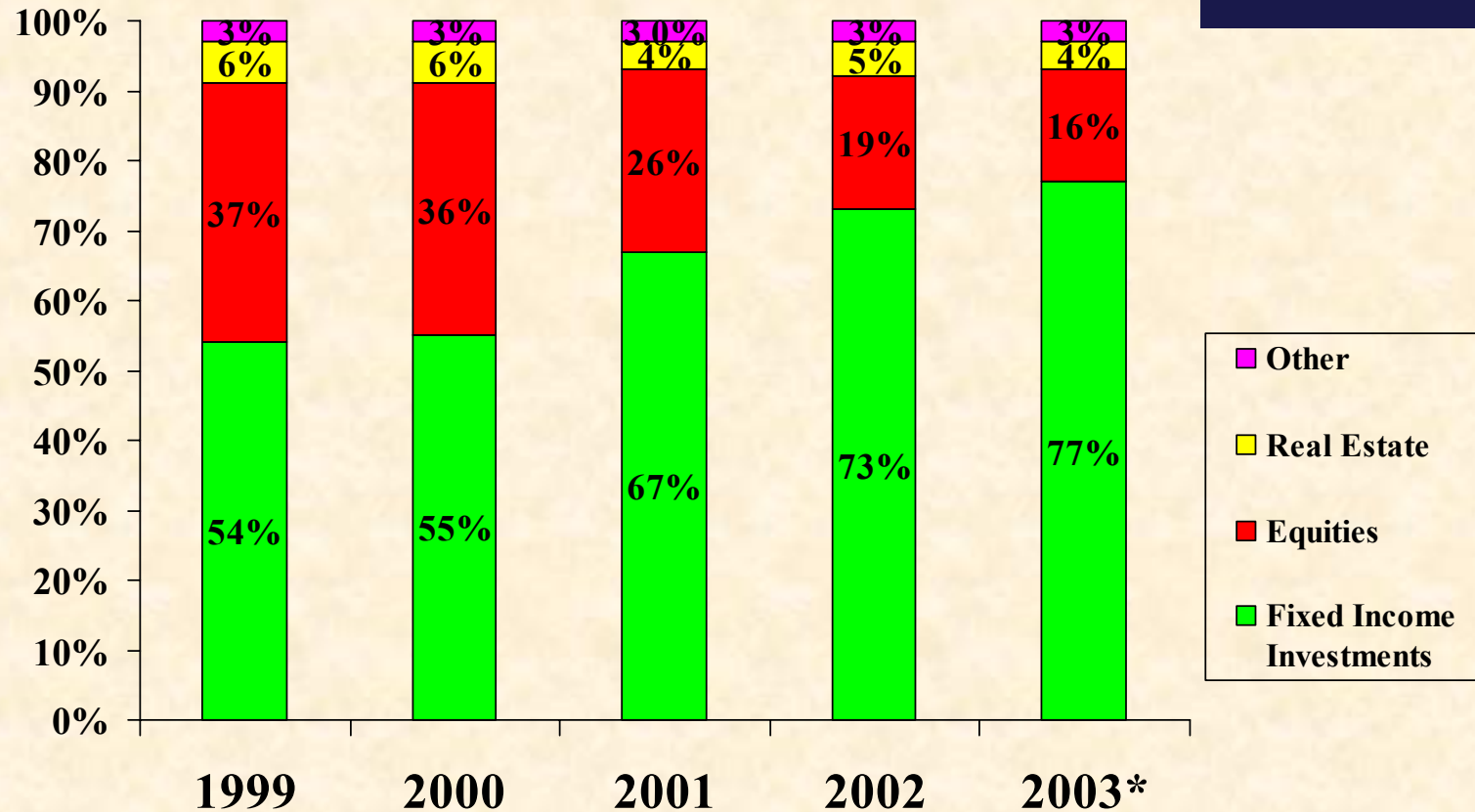
\*As of June 30, 2003

Source: Swiss Re



# Allianz Group Equity Exposure 1999-2003\*

Allianz's equity exposure has reduced significantly since 1999.



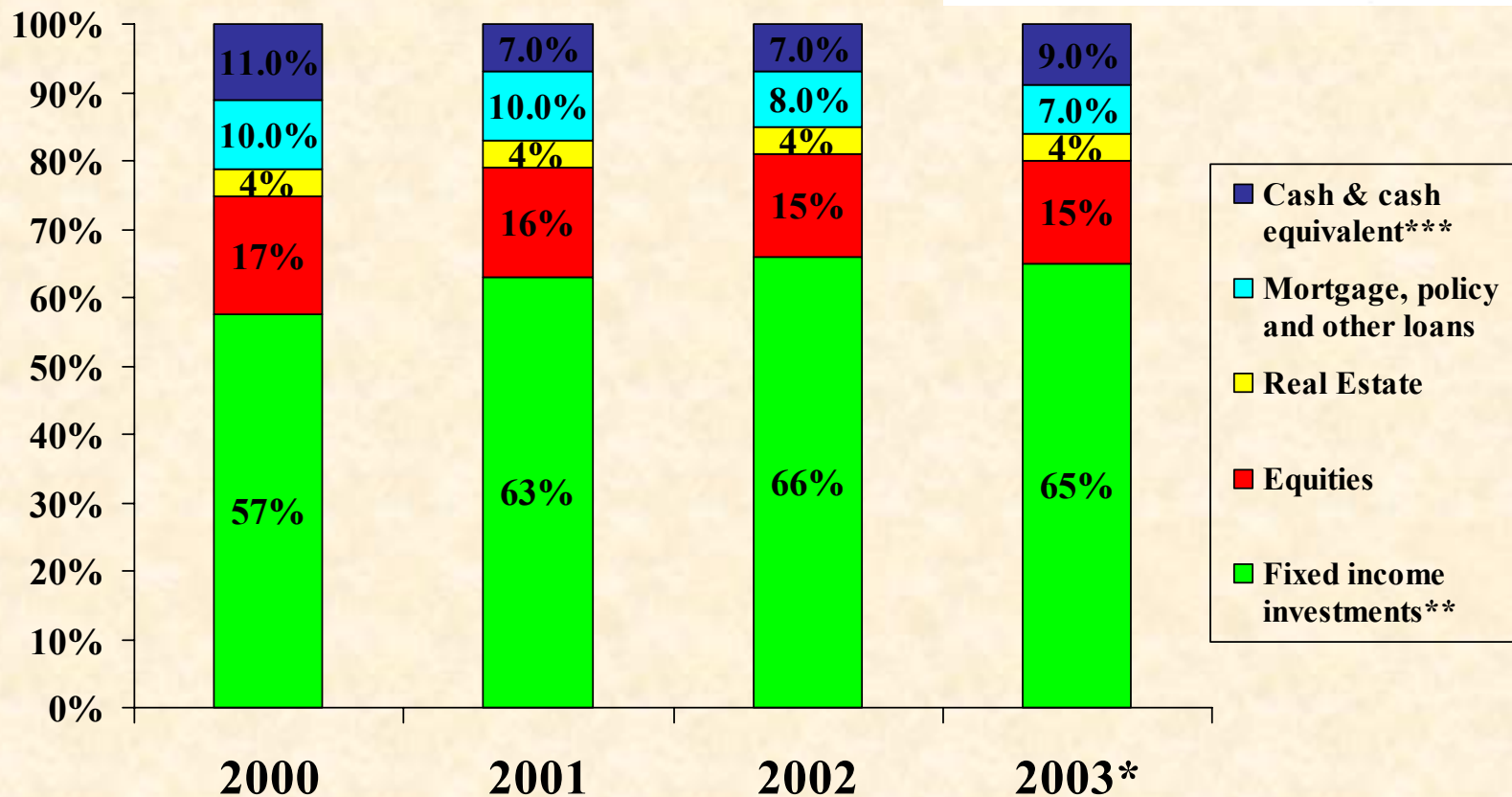
\*As of September 30, 2003.

Source: Allianz Group Financial Results 9M 2003.



# AXA Equity Exposure 2000-2003\*

Axa's equity exposure has stayed pretty steady, while its fixed income investment has increased.



\*As of June 30, 2003. \*\*Including mutual funds in bonds. \*\*\*Not netted of bank overdrafts.

Source: AXA Group Financial Results 6M 2003/Full year 2002/2001/2000.

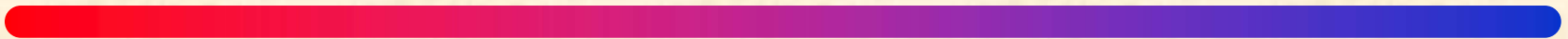


# *Beginning of the End: Bursting of the Tech Bubble*

## Composite of Nasdaq 100 Stocks

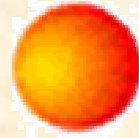


# *Corporate Governance*



# *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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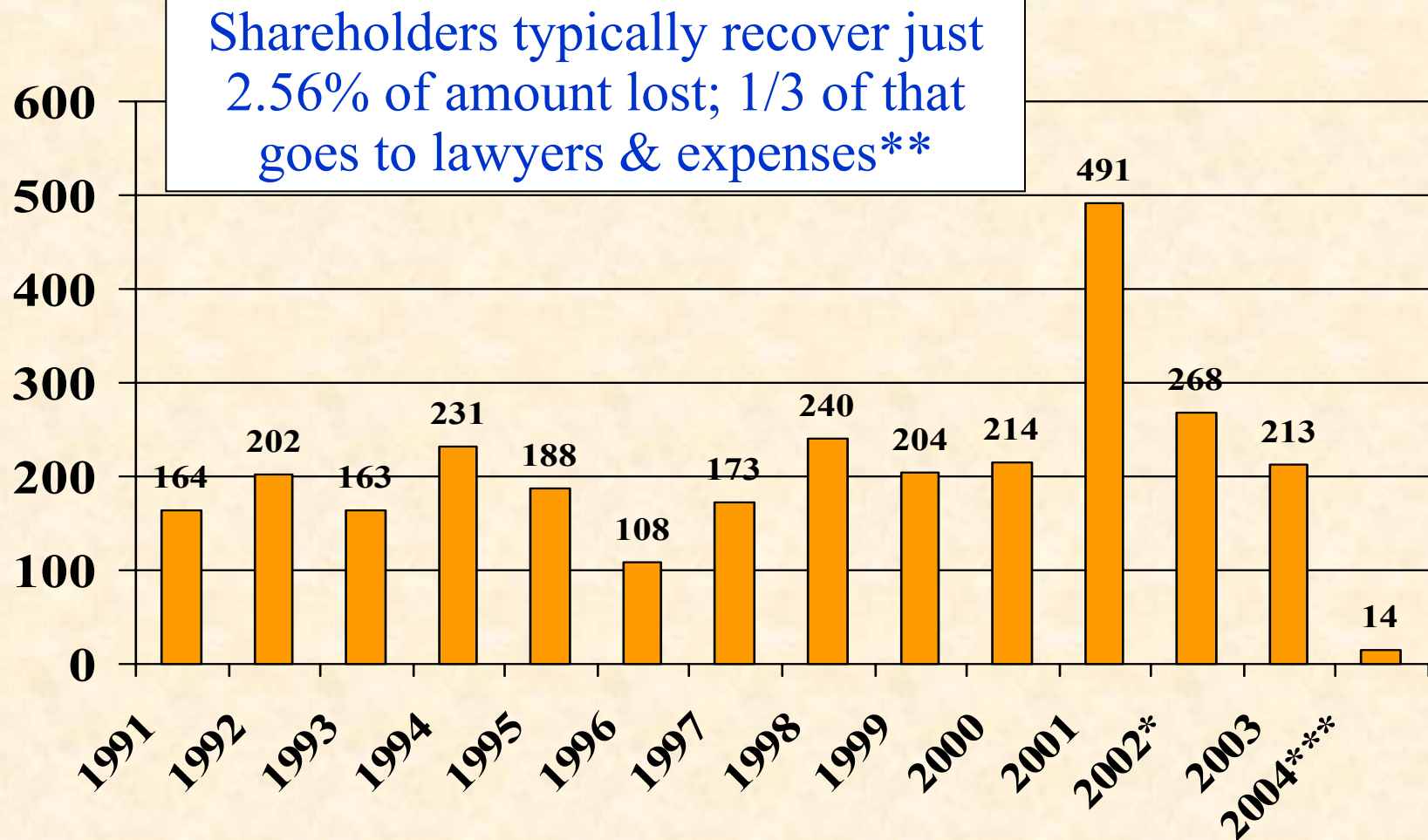
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# Shareholder Class Action Lawsuits\*



\*Securities fraud suits filed in U.S. federal courts. Figures include IPO allocation Filings.

\*\*Suits of \$100 million or more. \*\*\*2004 figures as of 1/29/04

Source: Stanford University School of Law; Woodruff-Sawyer & Co.; Insurance Information Institute



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