

Insurance Markets in a Turbulent Economy

Trends & Challenges

**Association of Insurance Financial Analysts
33rd Annual Conference
Naples, FL**



March 4, 2008

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Presentation Outline

- **The Economic Storm**
 - *What it Means for the Insurance Industry*
- **Financial & Underwriting Performance**
- **Ratings & Financial Strength**
- **Premium Growth**
- **Capacity**
- **Investment Overview**
- **Shifting Legal Liability & Tort Environment**

Q&A

A STORMY ECONOMIC FORECAST

*What a Weakening Economy
& Credit Crunch Mean for
the Insurance Industry*





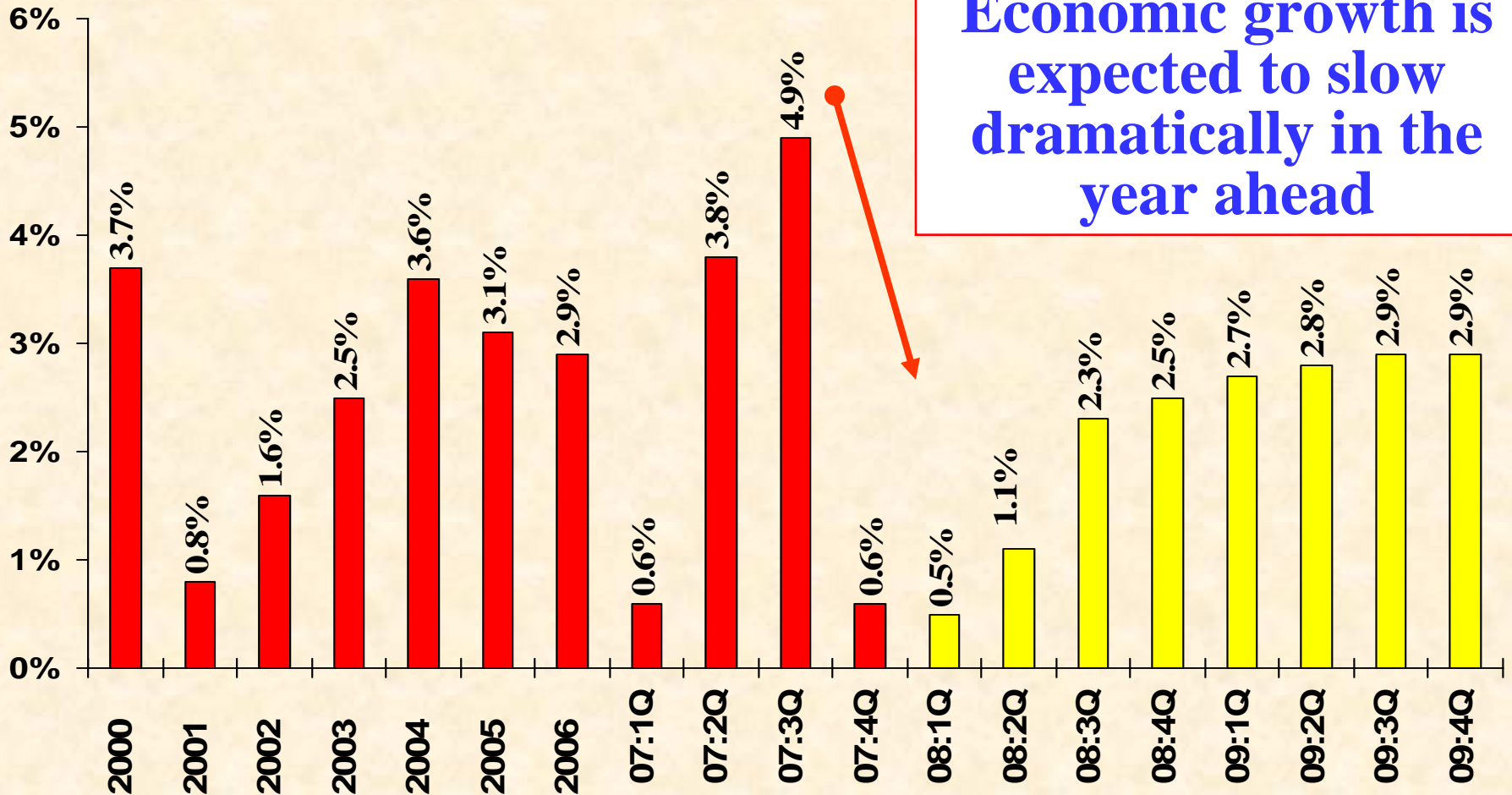
What's Going On With the US Economy Today?

Fundamental Factors Affecting US Economy in 2008

- **Puncture of Two Bubbles:** Credit and Housing
- **Credit Crunch:** Credit is the lifeblood of the US economy, but some markets have effectively seized (at least to some degree)
 - Problem originated with interest rates being left too low for too long in the early 2000s
 - Subprime mortgage market first part of credit bubble to burst; Spread via securitization and amplified via leverage and concentration of risk
 - As lenders tighten standards, credit issues have spread to prime borrowers, commercial mortgages, munis, credit cards, student loans
- **General Economic Impacts:** Burst Bubble → Asset Deflation
 - Home price bubble is bursting: Loss of value in most valuable asset impacts wealth via loss of home equity
 - Negative “wealth effect” implies consumers (2/3 of spending) become more cautious
 - Business scale back as prospects diminish in classic economic slowdown
 - Job growth stagnating (-17,000 in Jan. 2008, first decline since Aug. 2003)



Real GDP Growth*

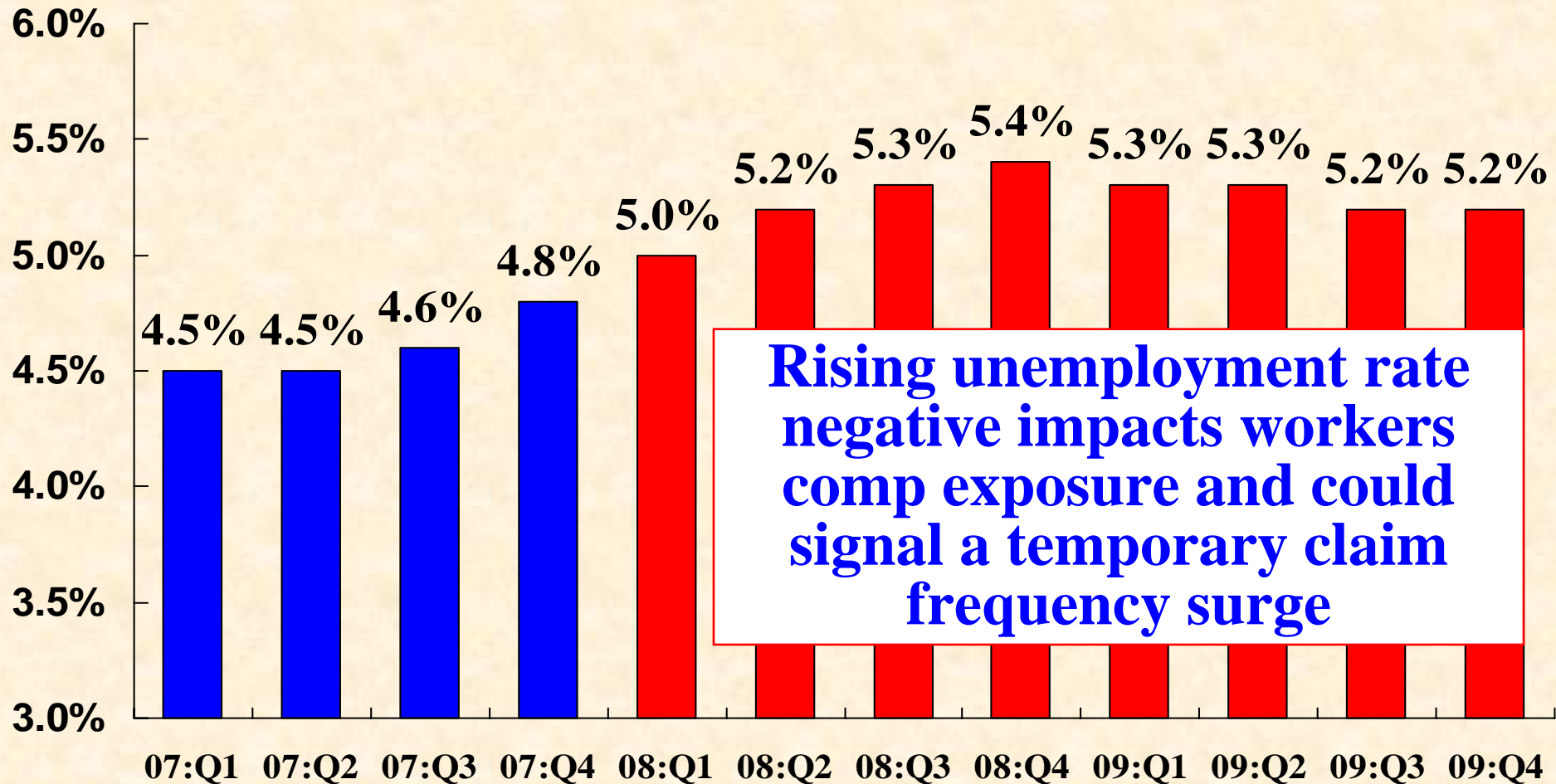


*Yellow bars are Estimates/Forecasts.

Source: US Department of Commerce, Blue Economic Indicators 2/08; Insurance Information Institute.



Unemployment Rate, (2007:Q1 to 2009:Q4F)





Toward a New World Economic Order

- 1. Credit Crunch (incl. Subprime) Issue Will Ultimately Cost Hundreds of Billions Globally**
 - Problem exacerbated by leveraged bets taken by some financial institutions therefore its reach extends beyond simple defaults
- 2. Heavy Toll on Capital Base of Some Large Financial Institutions Worldwide; US Bond Insurers**
 - Cash infusions necessary; Sovereign Wealth Funds important source
- 3. Most Significant Economic Event in a Generation**
 - US economy will recover, but will take 18-24 months
- 4. Shuffling of Global Economic Deck; Economic Pecking Order Shifting**
 - China, oil producing countries hold the upper hand
- 5. IOUs are Being Redeemed**
 - Stakes in hard assets/institutions demanded
- 6. Good News: No Shortage of Available Capital**
 - Central banks are (generally) making right decisions; Dollar sinks



What's Being Done to Fix the Economy? → Impacts on Insurers

Economic Fix	Impacts on Insurers
Fed Rate Cuts	<ul style="list-style-type: none">• Reduces bond yields (65% - 80% of portfolio)• Potentially contributes to inflation longer run
Stimulus Package	<ul style="list-style-type: none">• Hope is that \$168B plan boosts overall economic activity and employment (by 500,000 jobs) and therefore p/c personal and commercial exposures• Contributes to already exploding budget deficits— Washington may expand its search for people and industries to tax
Housing Bailout (?)	<ul style="list-style-type: none">• Keeps more people in their homes and hopefully paying HO insurance premiums• Abandoned and neglected homes have demonstrably worse loss performance
Regulatory/ Legislative Action (?)	<ul style="list-style-type: none">• Nothing solid proposed but in the wake of subprime crisis and credit crunch, actions seem inevitable• Will actions be directed primarily toward banks or broadly affecting all financial institutions



Post-Crunch: Fundamental

Issues To Be Examined Globally

- **Adequacy of Risk Management, Control & Supervision at Financial Institutions Worldwide**
 - Implications for ERM?
 - Includes review of incentives
- **Effectiveness and Nature of Regulation**
 - What sort of oversight is optimal given recent experience?
 - Credit problems arose under US and European (Basel) regulatory regimes
 - Will new regulations be globally consistent?
 - Can overreactions be avoided?
 - Capital adequacy & liquidity
- **Accounting Rules**
 - Problems arose under FAS, IAS
 - Asset Valuation, including Mark-to-Market
 - Structured Finance & Complex Derivatives
- **Ratings on Financial Instruments**
 - New approaches to reflect type of asset, nature of risk

Insurance & The Economy

Important but Somewhat
Muted Impacts





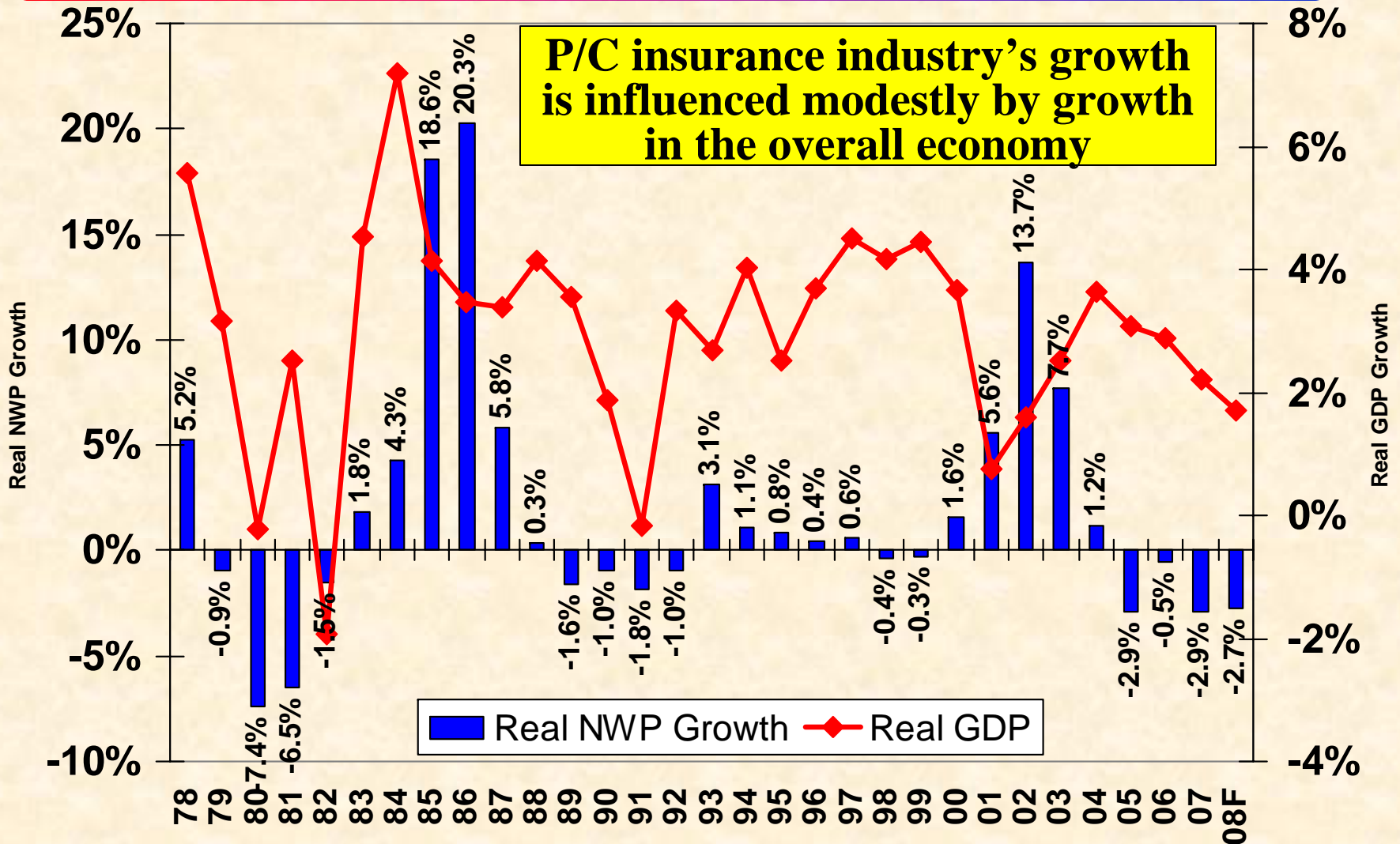
A Few Facts About the Relationship Between Insurance & Economy

- **Vast Majority of Insurance Business is Tied to Renewals**
 - Approximately 98+% of P/C business (units) is linked to renewals
 - A very large share of p/c insurance premiums are statutorily or *de facto* compulsory (e.g., WC, auto liability, surety, usually HO...)
 - P/C insurers have marginal exposure impact due to economy
 - Most life revenues and units are renewals, but some products (e.g., variable annuities are sensitive to market volatility)
 - Life insurers who manage 401(k) assets seeing more loans and hardship withdrawals;
- **Insurers are Sensitive to Interest Rates**
 - About 2/3 of P/C invested assets and 75% of Life assets are fixed income
 - Historically, yield on industry portfolios has tracked 10-year note closely
 - All else equal, lower total investment gain implies greater emphasis on underwriting
 - Historically, industry's best underwriting performances are rooted in periods when interest rates were low and/or equity market performance poor (1930s – 1950s, early 2000s gave rise to strong 2006/07)



Real GDP Growth vs. Real P/C

Premium Growth: Modest Association





Summary of Economic Risks and Implications for Insurers

Economic Concern	Risks to Insurers
Credit Crunch/ Subprime Meltdown	<ul style="list-style-type: none">• <i>Some</i> insurers have <i>some</i> asset risk• D&O/E&O exposure for <i>some</i> insurers• Client asset management liability for <i>some</i>• Bond insurer problems; Muni credit quality
Housing Slump	<ul style="list-style-type: none">• Reduced exposure growth• Deteriorating loss performance on neglected, abandoned and foreclosed properties
Lower Interest Rates	<ul style="list-style-type: none">• Lower investment income
Stock Market Slump	<ul style="list-style-type: none">• Decreased capital gains (which are usually relied upon more heavily as a source of earnings as underwriting results deteriorate)
General Economic Slowdown/Recession	<ul style="list-style-type: none">• Reduced commercial lines exposure growth• Surety slump• Increased workers comp frequency

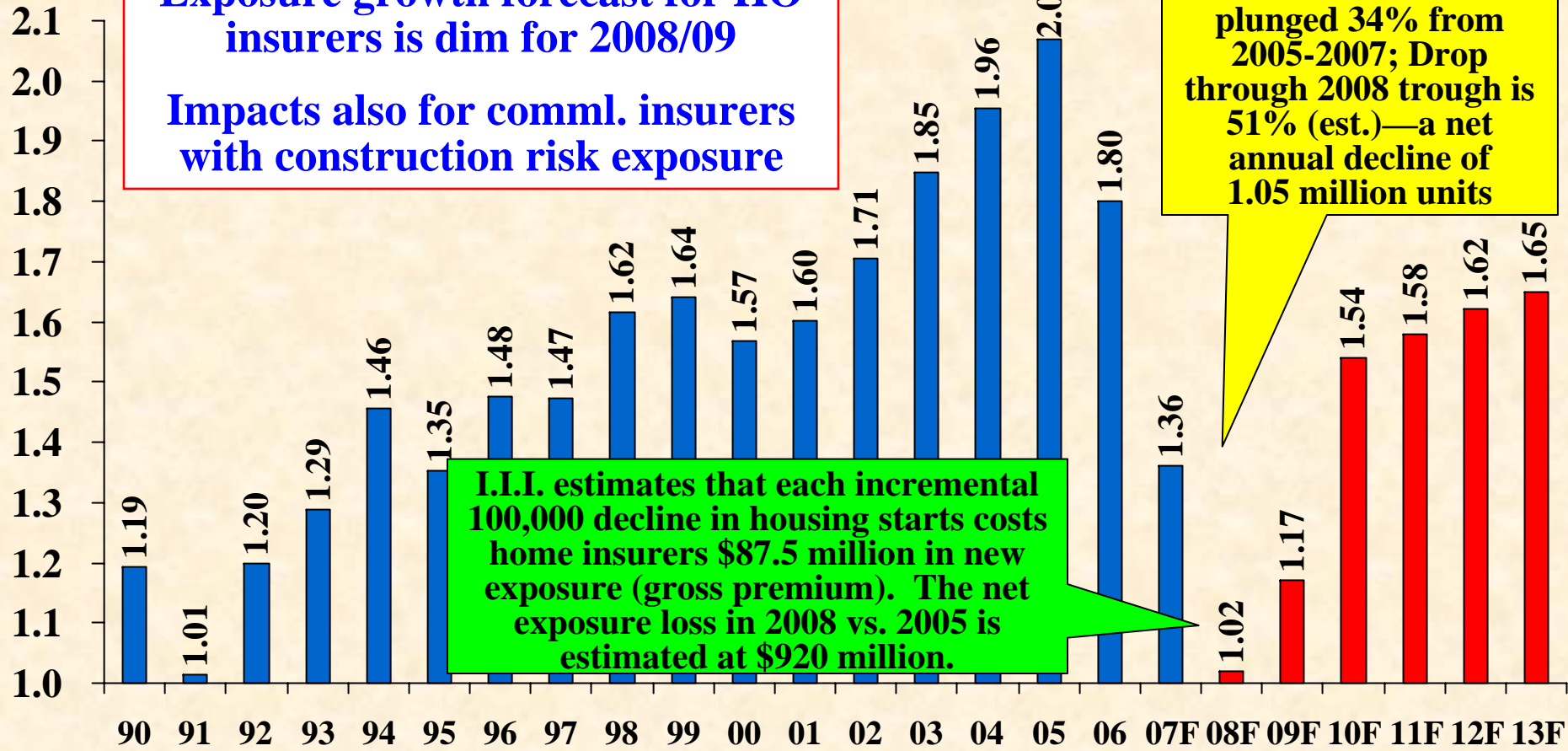


New Private Housing Starts, 1990-2013F (Millions of Units)

Exposure growth forecast for HO insurers is dim for 2008/09

Impacts also for comml. insurers with construction risk exposure

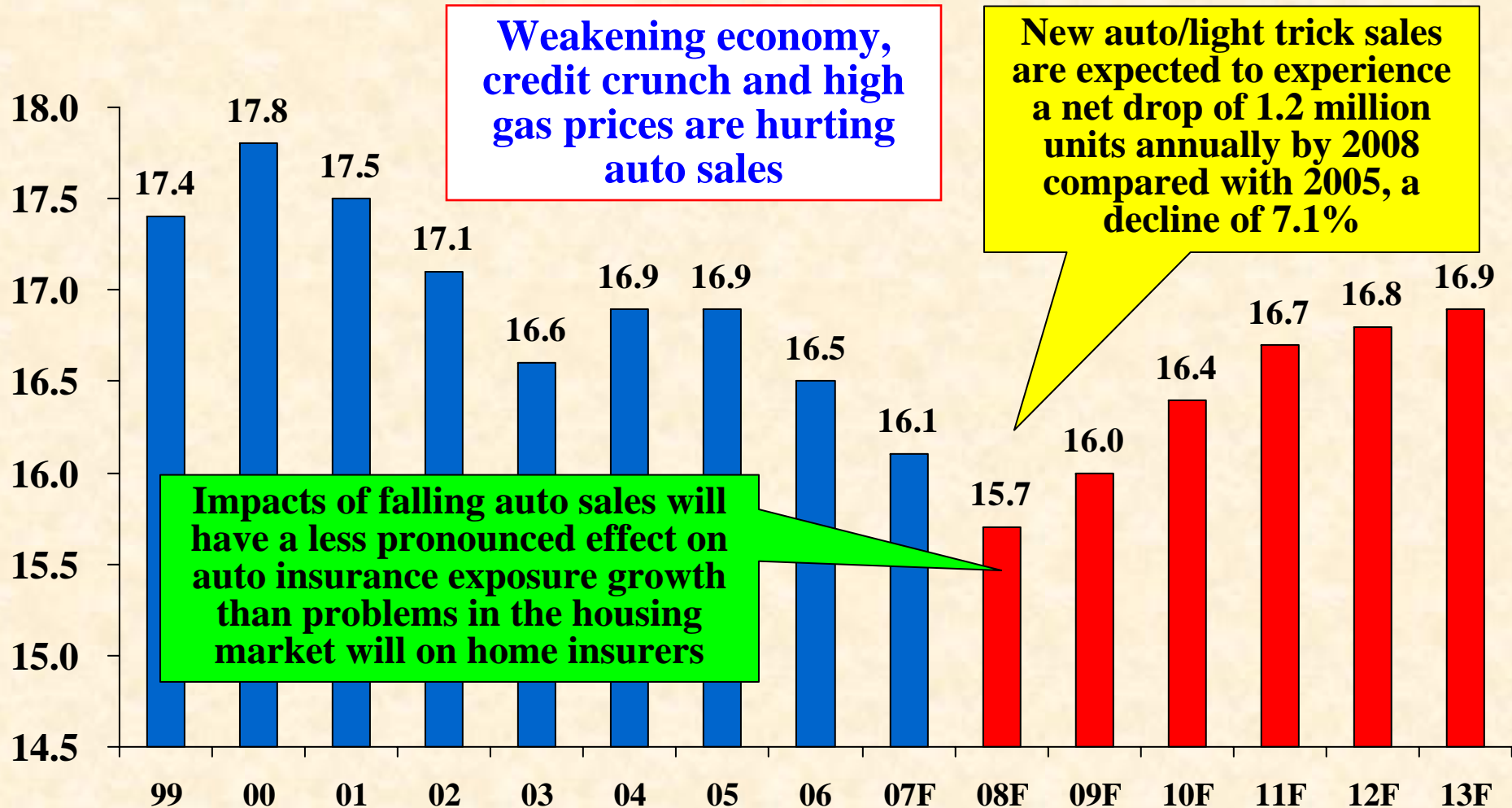
New home starts plunged 34% from 2005-2007; Drop through 2008 trough is 51% (est.)—a net annual decline of 1.05 million units



I.I.I. estimates that each incremental 100,000 decline in housing starts costs home insurers \$87.5 million in new exposure (gross premium). The net exposure loss in 2008 vs. 2005 is estimated at \$920 million.



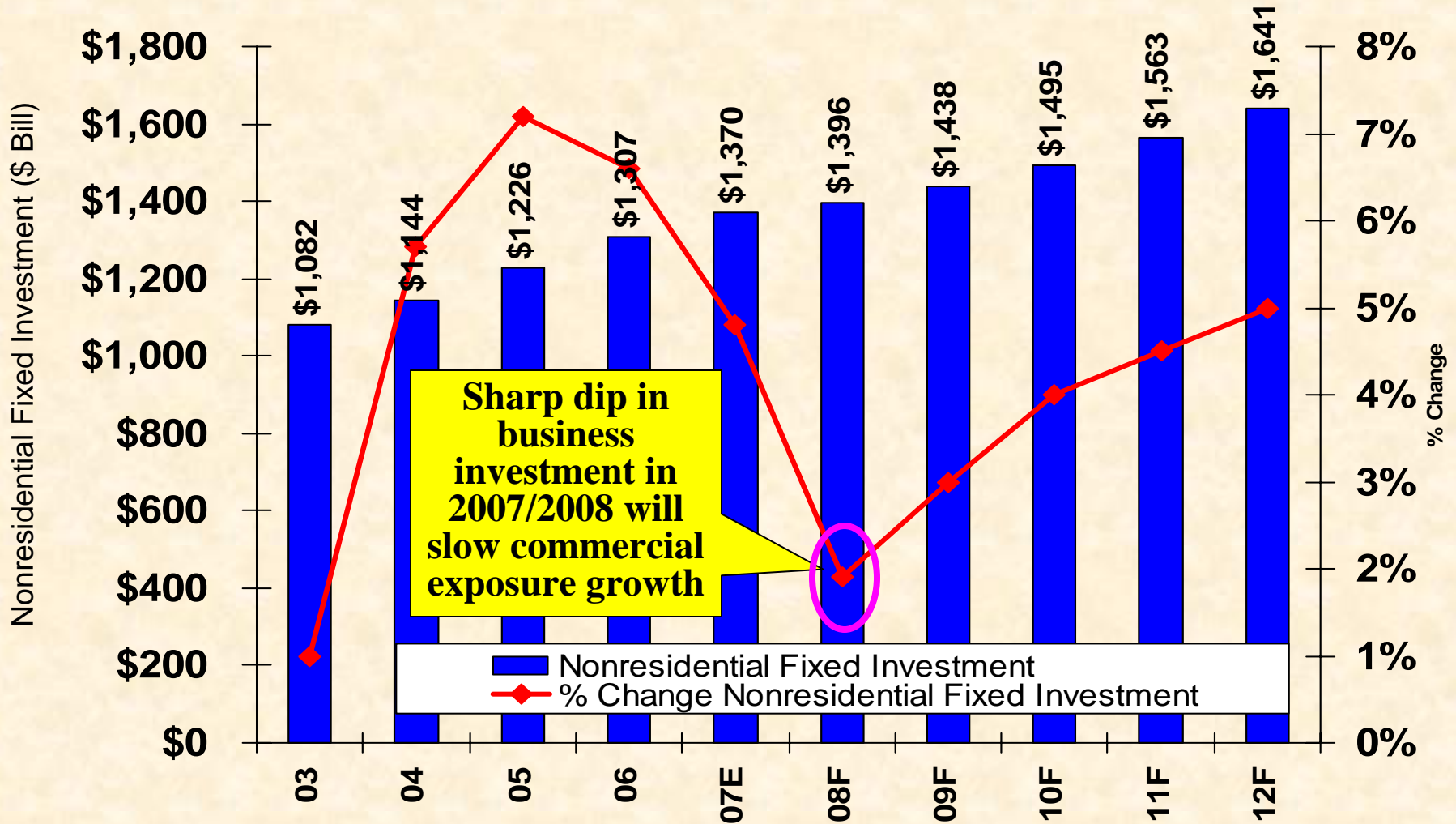
Auto/Light Truck Sales, 1999-2013F (Millions of Units)



Source: US Department of Commerce; Blue Chip Economic Indicators (10/07), except 2008/09 figures from 2/08 edition of BCEF; Insurance Info. Institute



Nonresidential Fixed Investment,* 2003 – 2012F



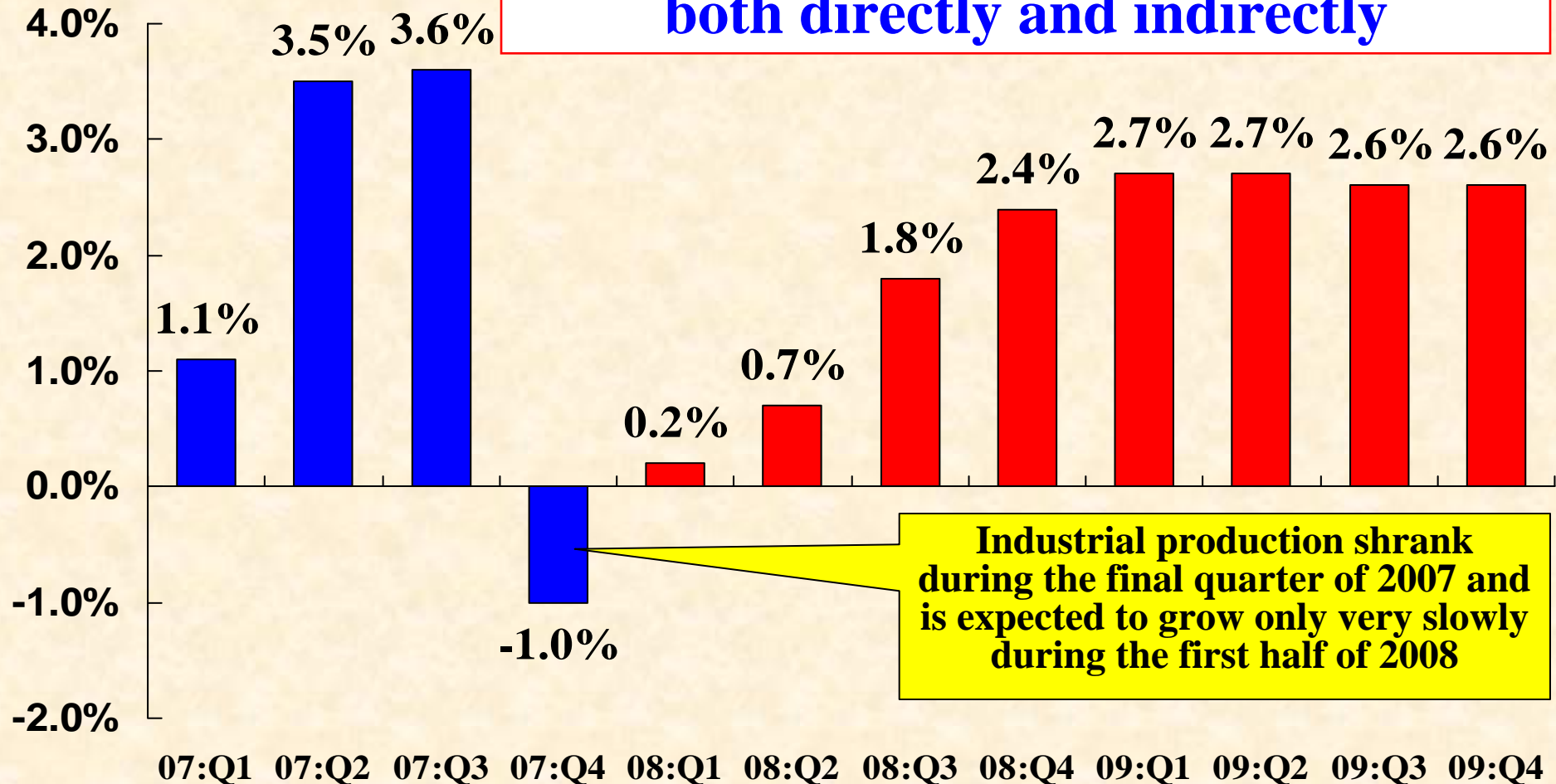
*Nonresidential fixed investment consists of structures, equipment and software.

Sources: US Bureau of Economic Analysis (Historical), *Value Line* (2/22/08) estimates/forecasts for 2008-2012.



Total Industrial Production, (2007:Q1 to 2009:Q4F)

**Industrial production affects exposure
both directly and indirectly**



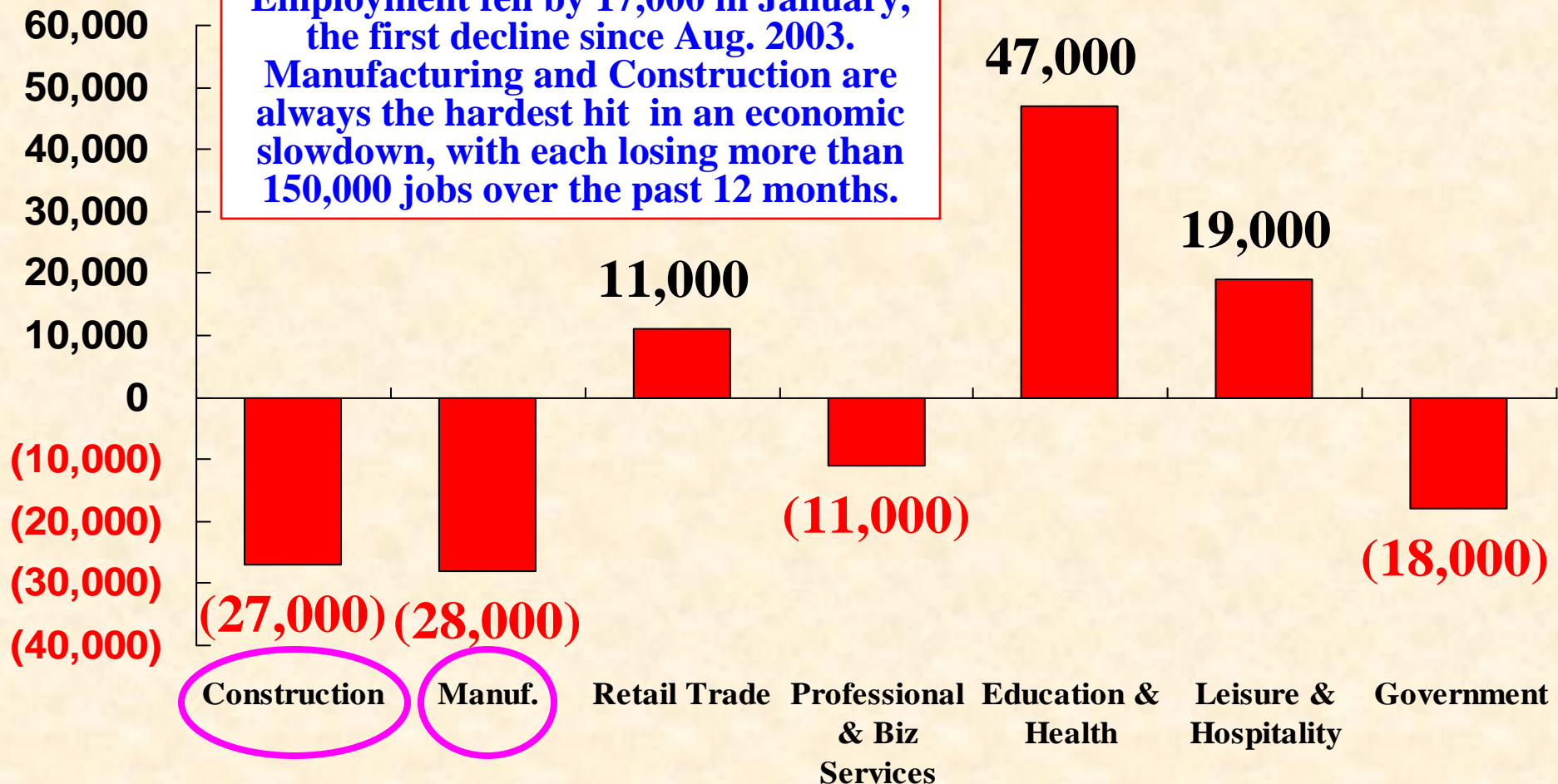
**Industrial production shrank
during the final quarter of 2007 and
is expected to grow only very slowly
during the first half of 2008**



Employment Change by Industry

Dec. 2007 to Jan. 2008p

Employment fell by 17,000 in January, the first decline since Aug. 2003. Manufacturing and Construction are always the hardest hit in an economic slowdown, with each losing more than 150,000 jobs over the past 12 months.

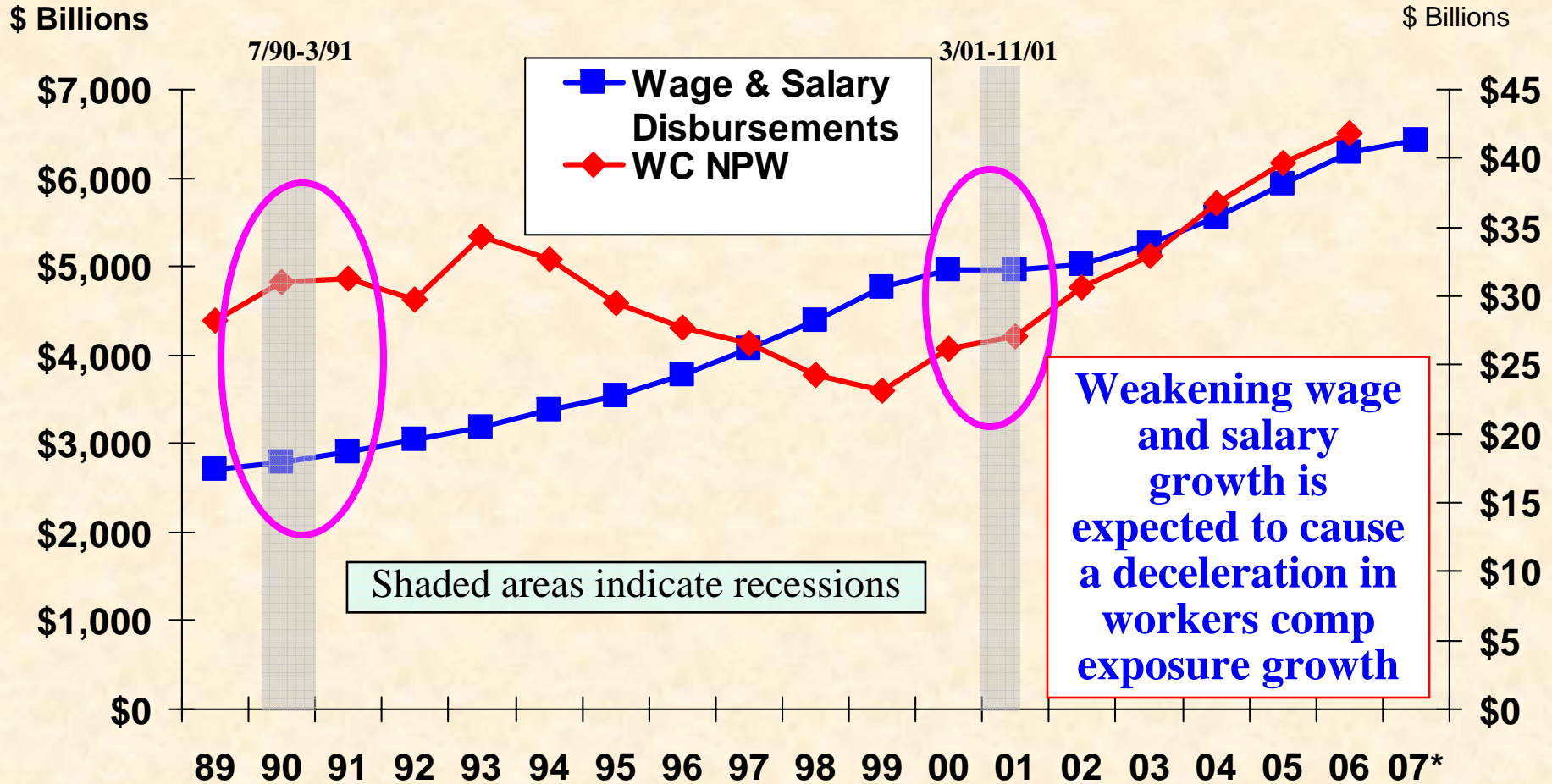


Sources: US Bureau of Labor Statistics; Insurance Information Institute.



Wage & Salary Disbursements (Payroll Base) vs. Workers Comp Net Written Premiums

Wage & Salary Disbursement (Private Employment) vs. WC NWP



*As of 7/1/07 (latest available).

Source: US Bureau of Economic Analysis; Federal Reserve Bank of St. Louis at

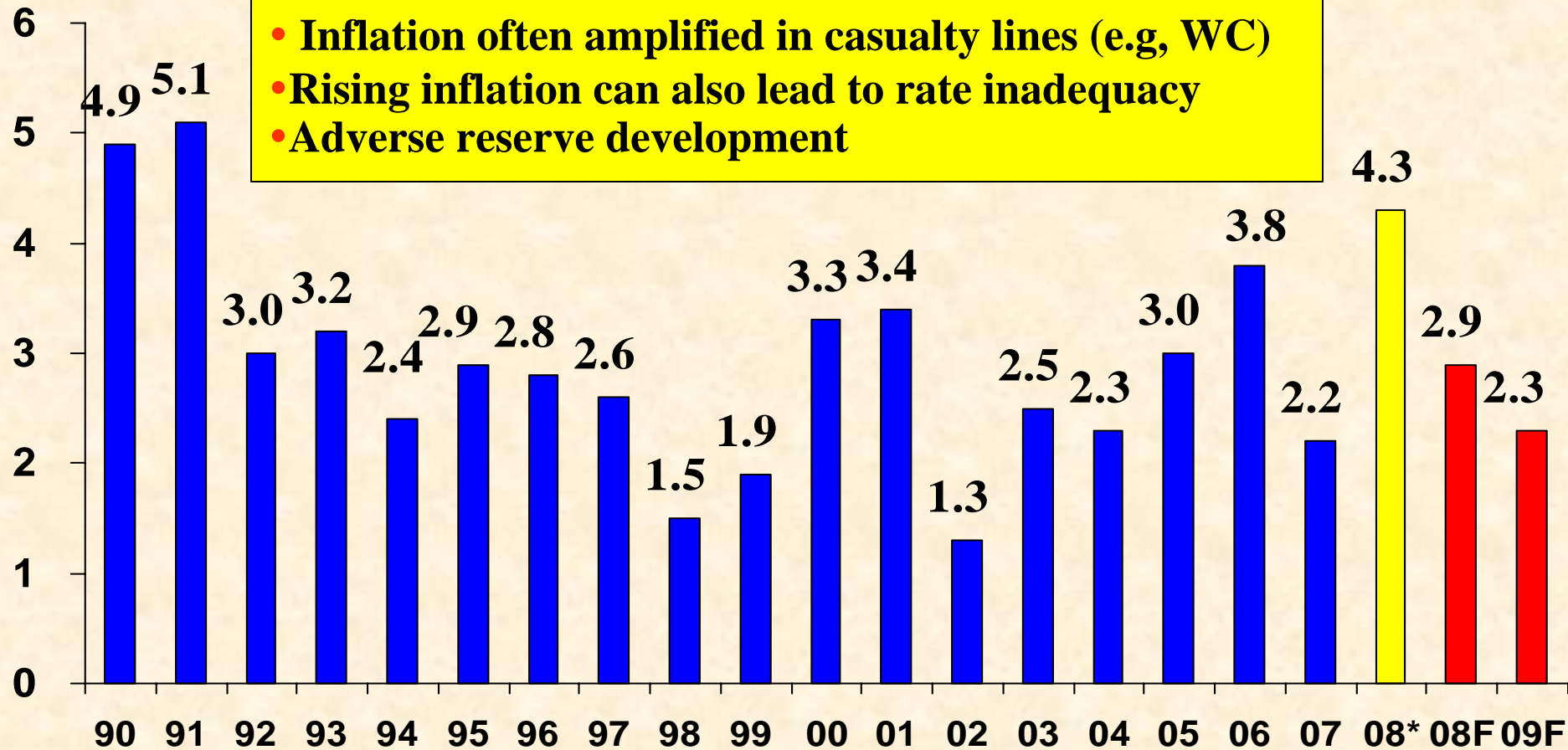
<http://research.stlouisfed.org/fred2/series/WASCUR>; I.I.I. Fact Books



Inflation Rate (CPI-U, %), 1990 – 2009F

Inflation is Accelerating

- Inflation often amplified in casualty lines (e.g, WC)
- Rising inflation can also lead to rate inadequacy
- Adverse reserve development



*12-month change Jan. 2008 vs. Jan. 2007; CPI rose at 6.8% pace N

Source: US Bureau of Labor Statistics; Blue Chip Economic Indicators, Feb. 10, 2008; Ins. Info. Institute.



Favored Industry Groups for Insurer Exposure Growth

Industry	Rationale
Health Care	<ul style="list-style-type: none">• Economic Necessity → Recession Resistant• Demographics: aging/immigration → Growth
Alternative Energy	<ul style="list-style-type: none">• Solar, Wind, Bio-Fuels, Hydro & Other
Agriculture & Food Processing & Manufacturing	<ul style="list-style-type: none">• Consumer Staple → Recession Resistant• Grain and land prices high due to global demand, weak dollar (exports)• Ethanol/Bio-Fuel Source• Acreage Growing → Farm Equipment, Transport• Benefits many other industries
Export Driven	<ul style="list-style-type: none">• Weak dollar, globalization persist; Cuba angle?
Natural Resources & Commodities	<ul style="list-style-type: none">• Strong global demand,• Supplies remain tight... <i>but beware of bubbles</i>• Significant investments in R&D, plant & equip required

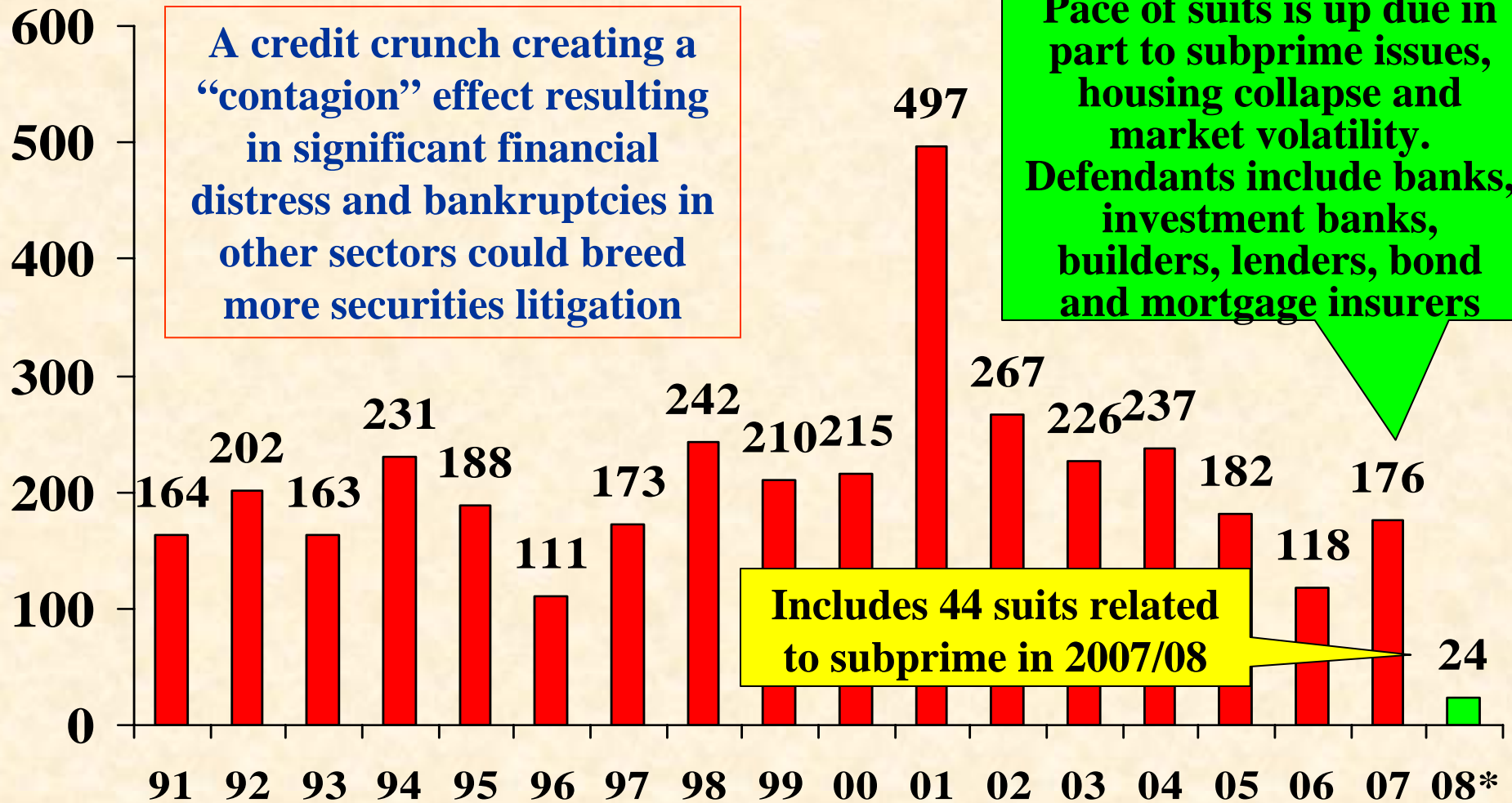
Tort Issues

**Turbulent Markets Give
Rise to Suits**





Shareholder Class Action Lawsuits*



A credit crunch creating a “contagion” effect resulting in significant financial distress and bankruptcies in other sectors could breed more securities litigation

Pace of suits is up due in part to subprime issues, housing collapse and market volatility. Defendants include banks, investment banks, builders, lenders, bond and mortgage insurers

Includes 44 suits related to subprime in 2007/08

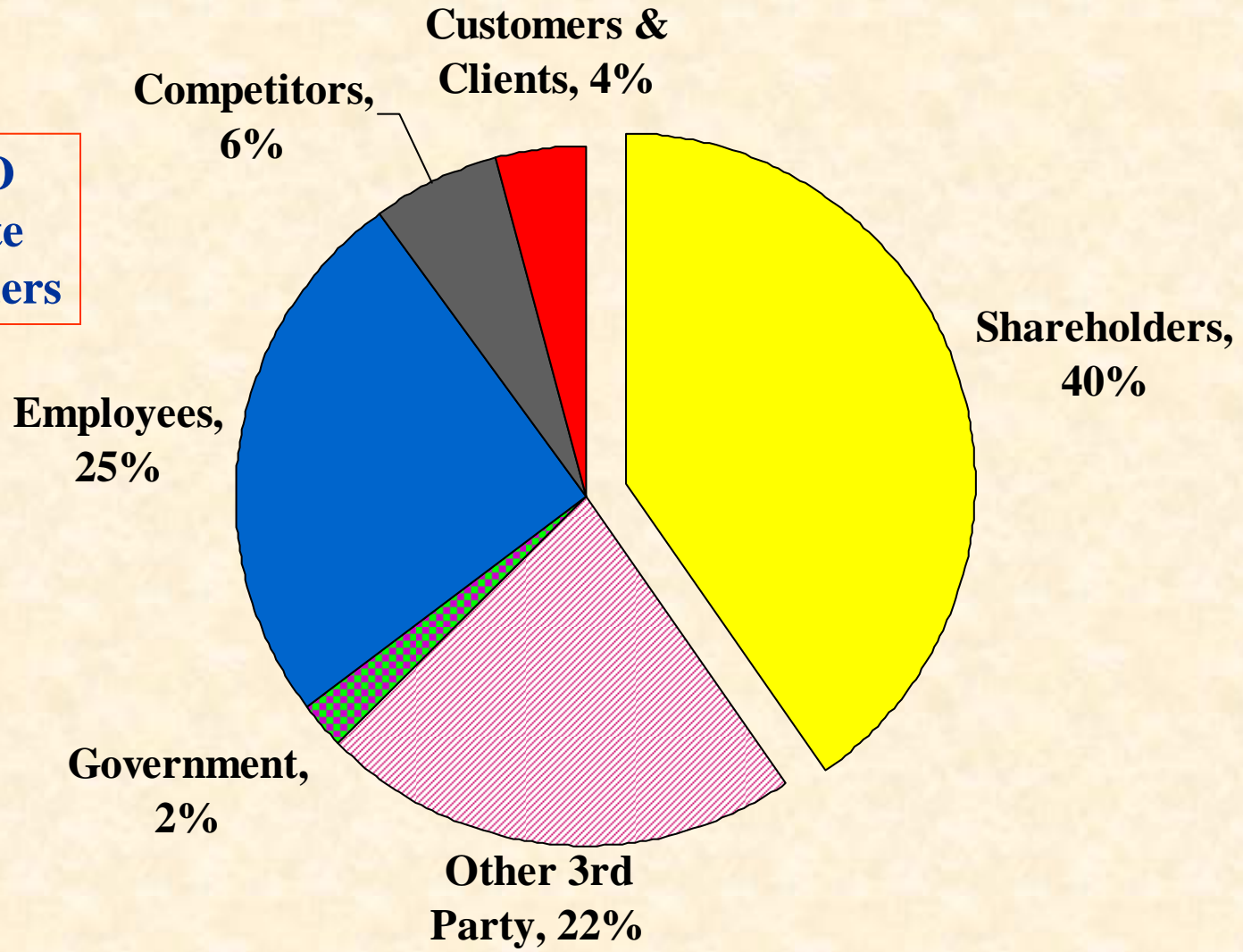
*Securities fraud suits filed in U.S. federal courts; 2008 figure is current through February 29.

Source: Stanford University School of Law (securities.stanford.edu); Insurance Information Institute



Origin of D&O Claims for Public Companies, 2006

40% of D&O suits originate with shareholders

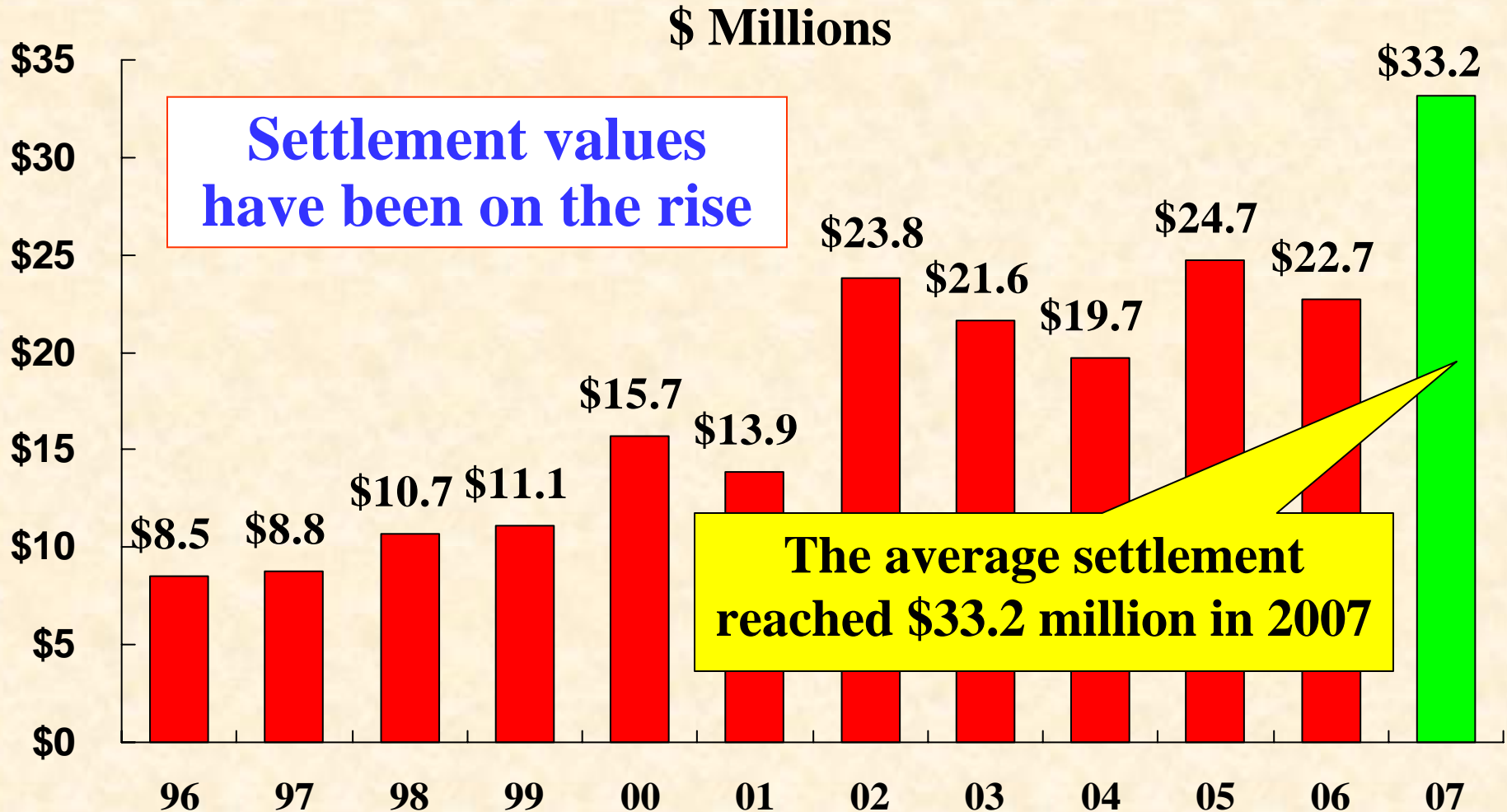


Source: Tillinghast Towers-Perrin, 2006 Directors and Officers Liability Survey.



Average Settlement Value of Shareholder Class Actions*

(Excl. Settlements Above \$1 Billion)

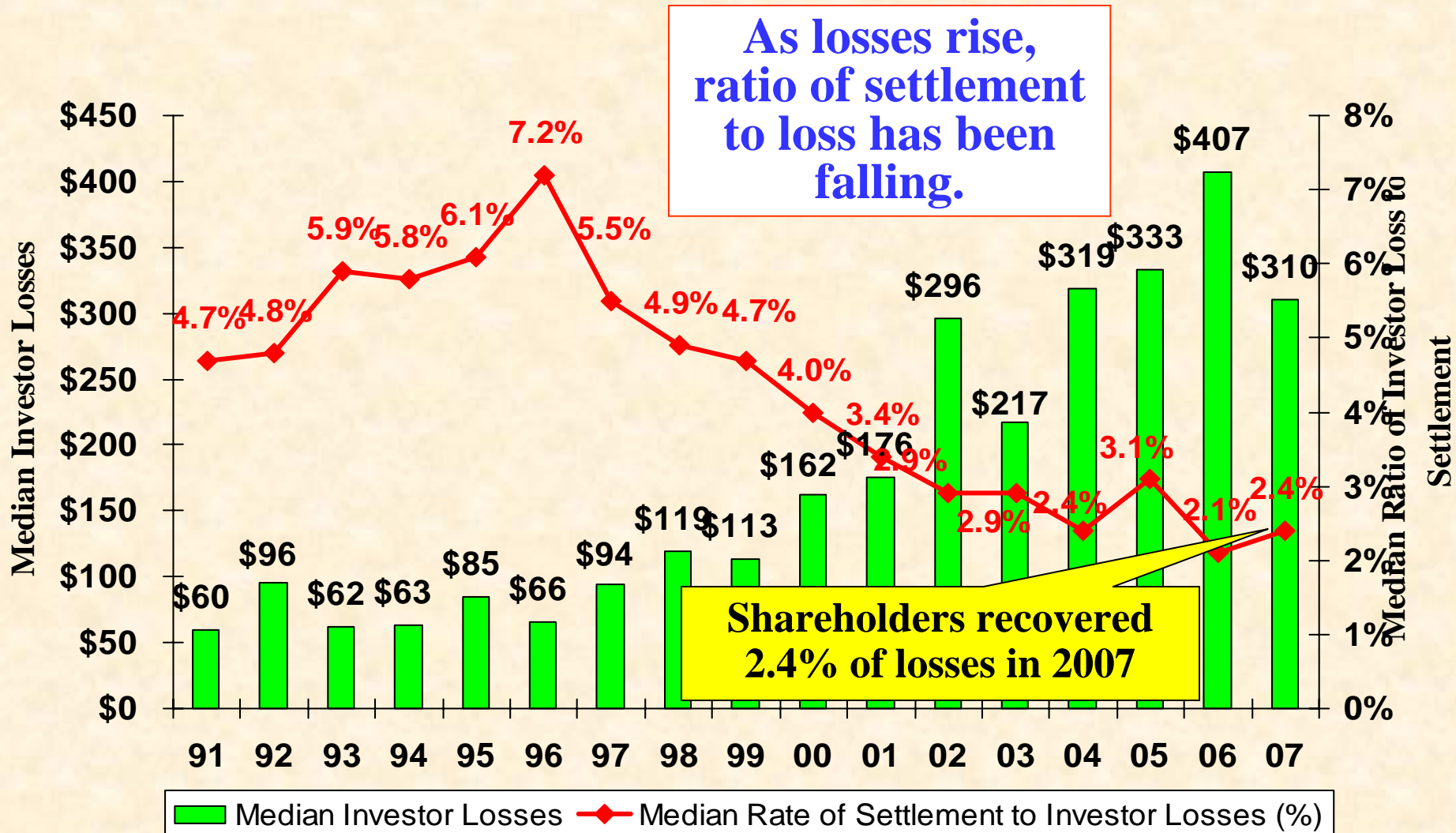


*Does not include partial or tentative settlements.

Source: NERA Economic Consulting, *Recent Trends in Shareholder Class Actions*, Dec. 2007.



Shareholder Class Actions: Median Investor Losses vs. Ratio of Settlement to Loss, 1991-2007*



PROFITABILITY & PERFORMANCE

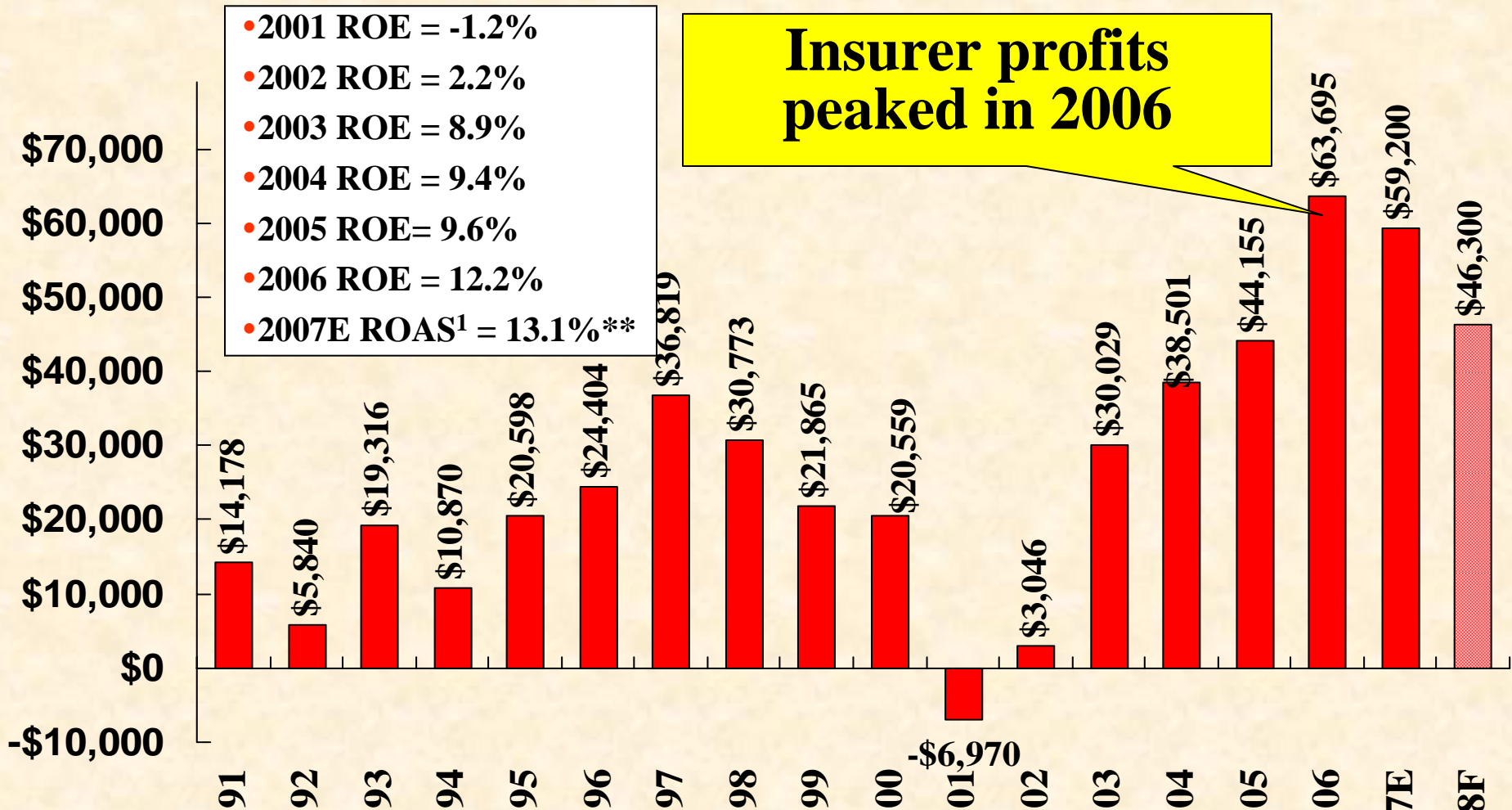
**Profits in 2006/07 Reached
Their Cyclical Peak**





P/C Net Income After Taxes

*1991-2008F (\$ Millions)**



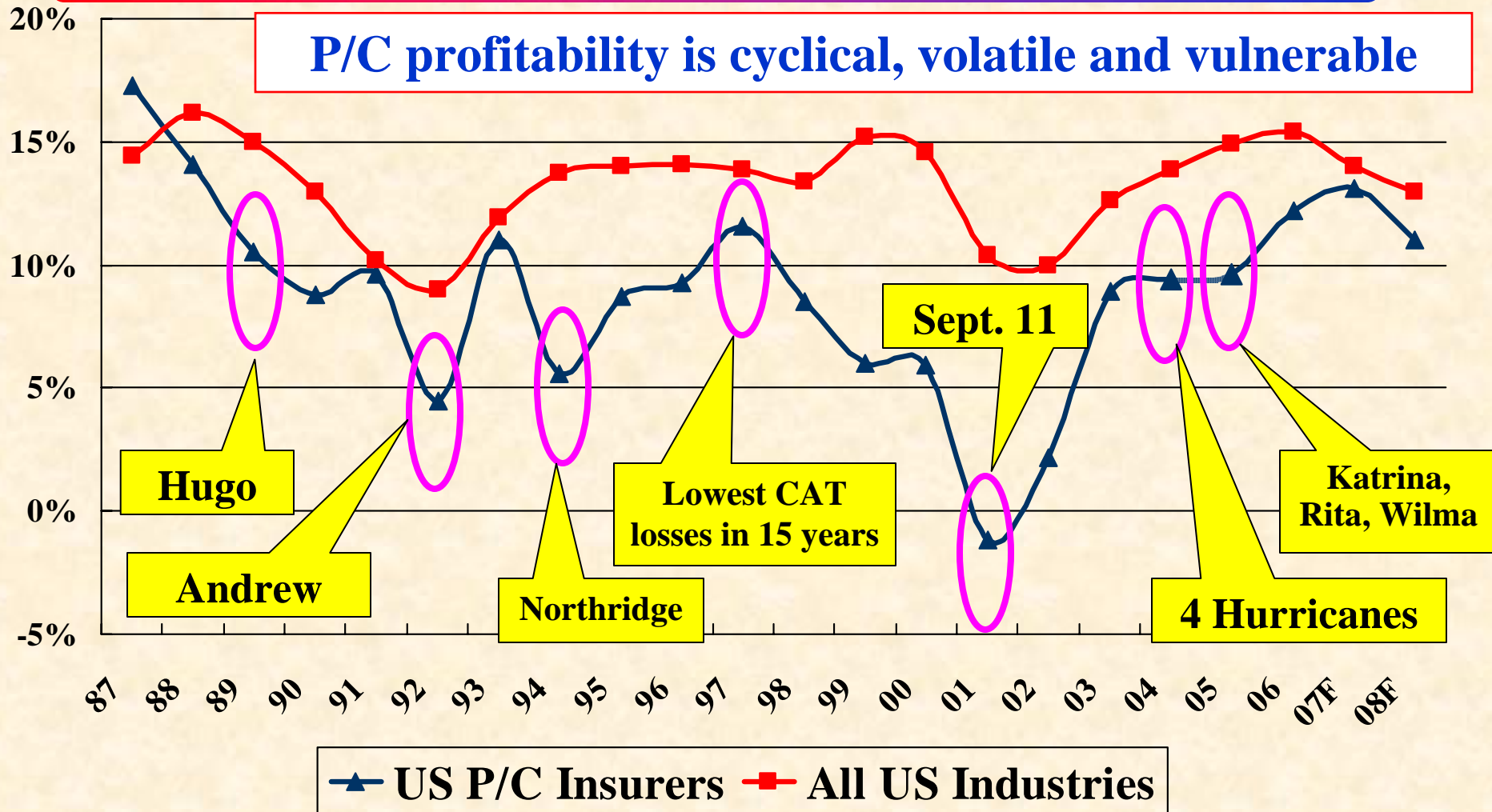
*ROE figures are GAAP; ¹Return on avg. surplus. **Return on Average Surplus; Actual 9-month 2007 result.

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



ROE: P/C vs. All Industries

1987–2008E

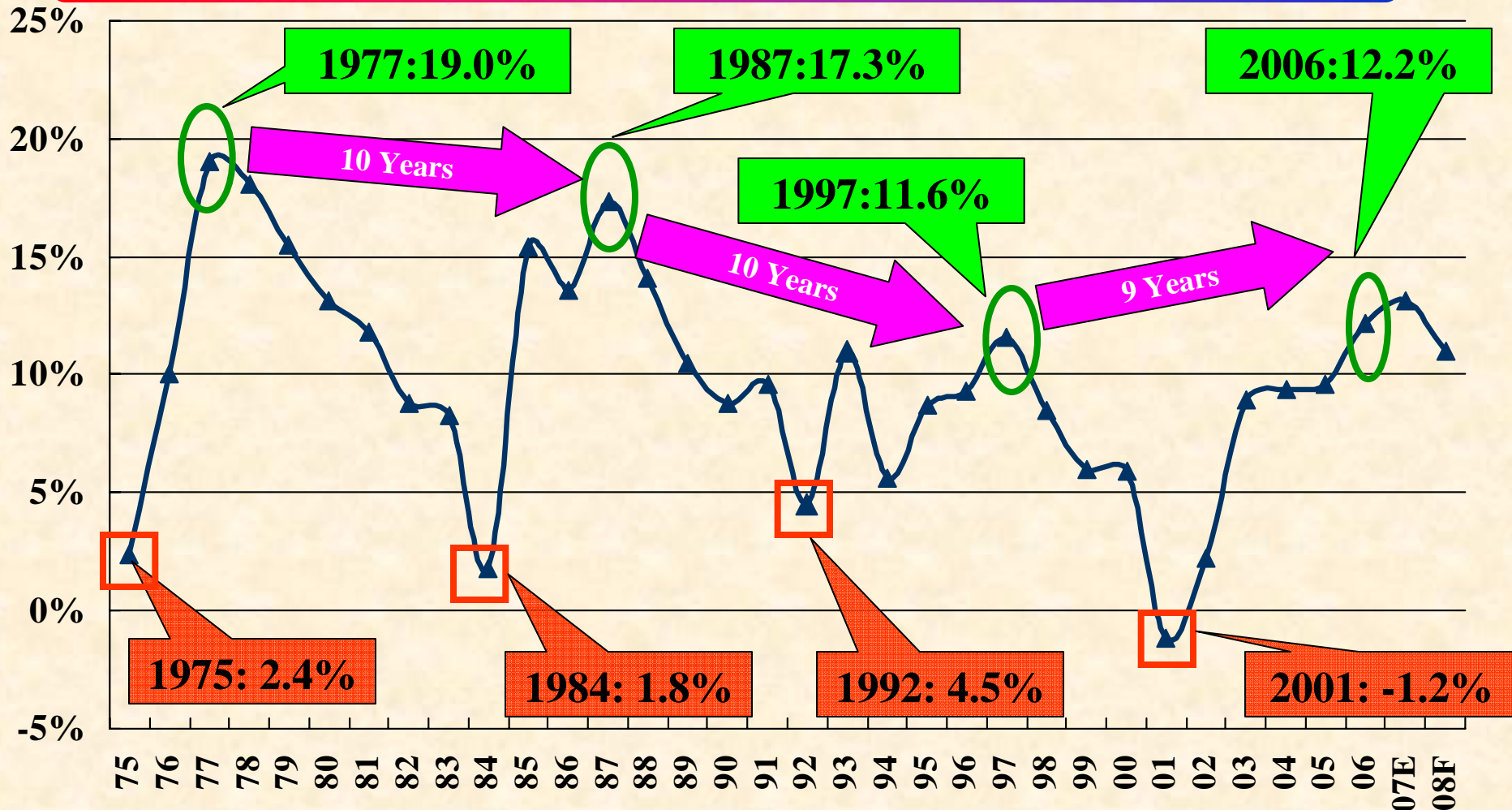


*2007 is actual 9-month ROAS of 13.1%. 2008 P/C insurer ROE is I.I.I. estimate.

Source: Insurance Information Institute; *Fortune*



Profitability Peaks & Troughs in the P/C Insurance Industry, 1975 – 2008F*

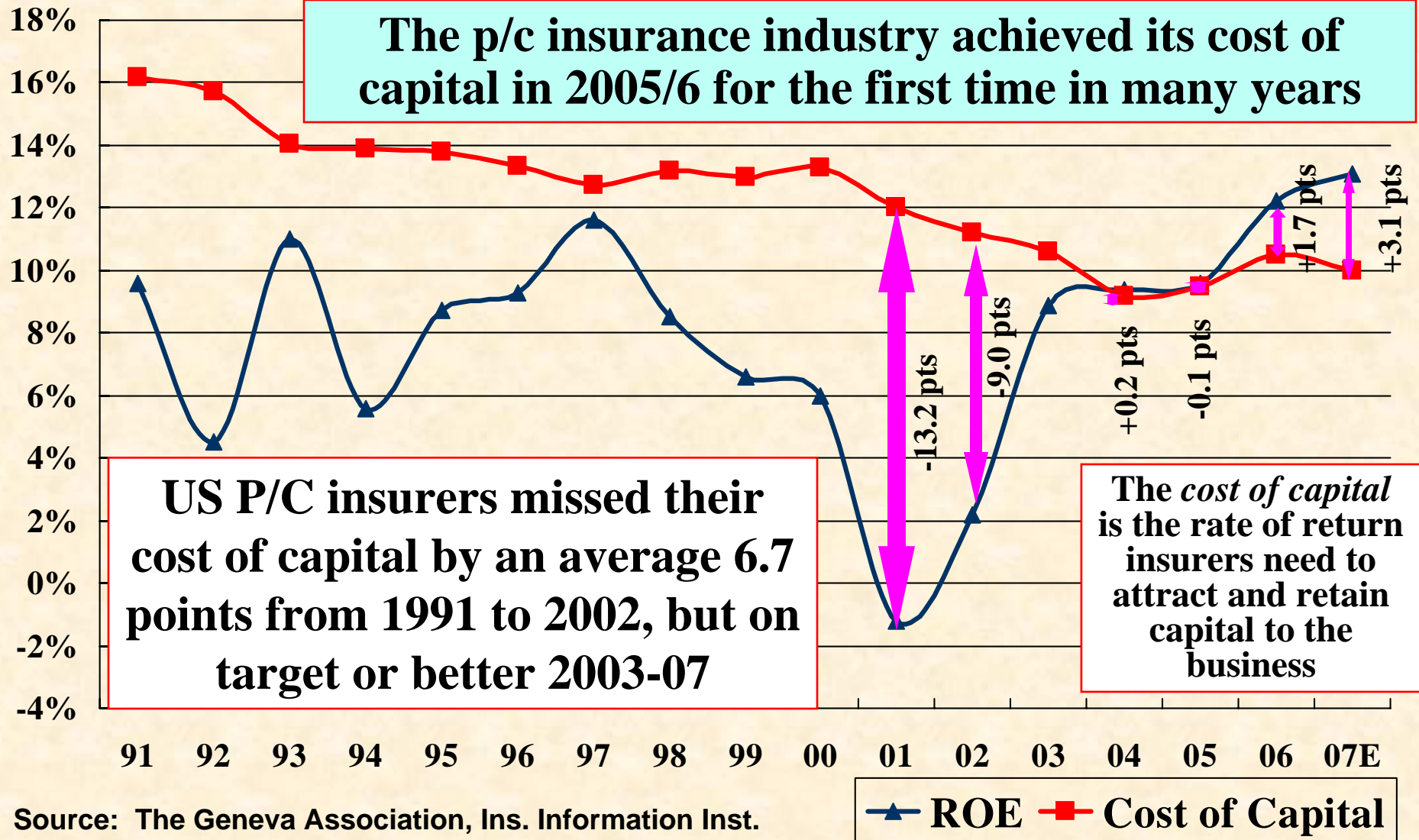


*GAAP ROE for all years except 2007 which is actual 9-month ROAS of 13.1%. 2008 P/C insurer ROE is I.I.I. estimate.

Source: Insurance Information Institute; *Fortune*



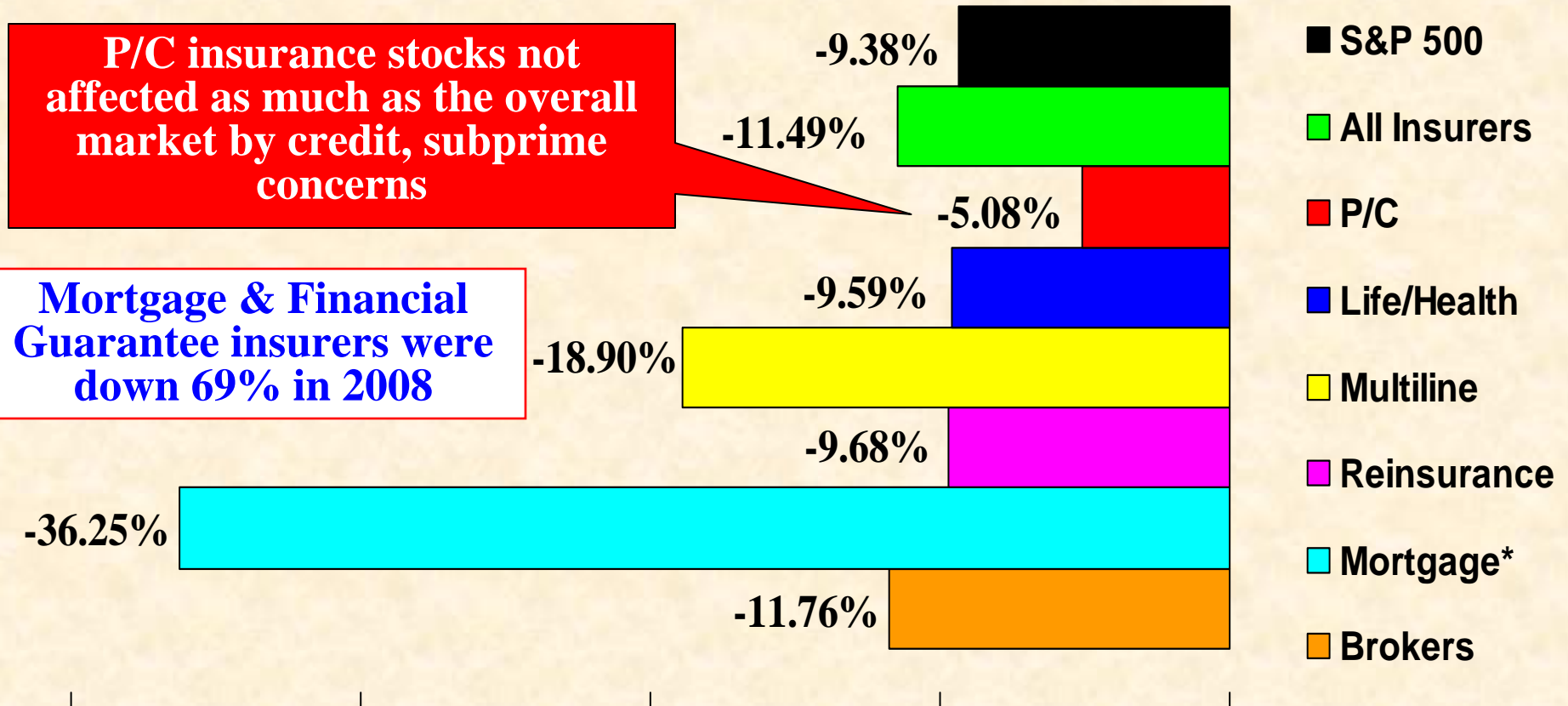
ROE vs. Equity Cost of Capital: US P/C Insurance: 1991-2007E





P/C, L/H Stocks: Ahead of the S&P 500 Index in 2008

Total YTD Returns Through February 29, 2008



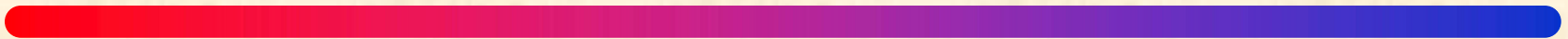
-40.0% -30.0% -20.0% -10.0% 0.0%

*Includes Financial Guarantee.

Source: SNL Securities, Standard & Poor's, Insurance Information Inst.

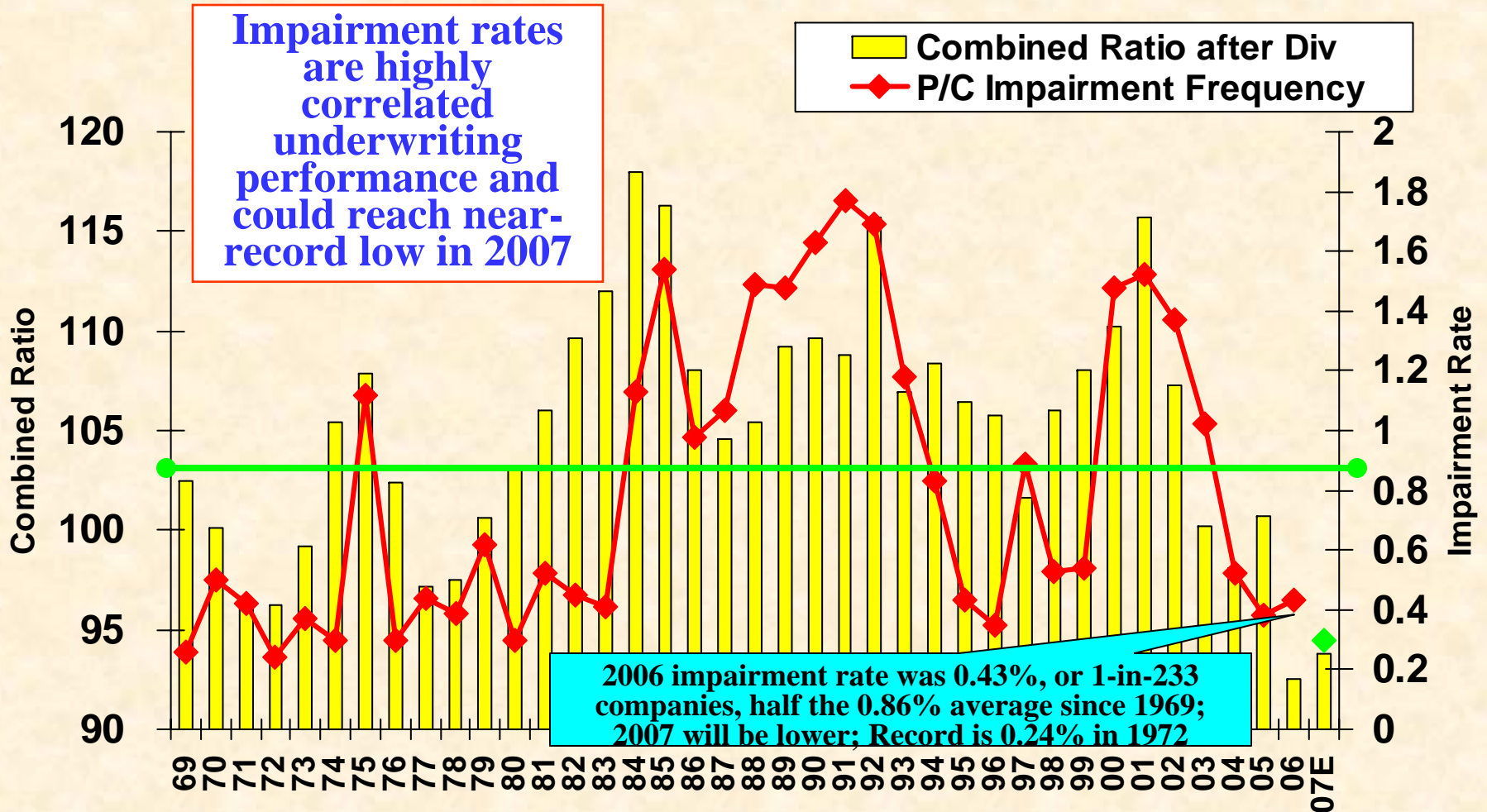
FINANCIAL STRENGTH & RATINGS

Financially Fit





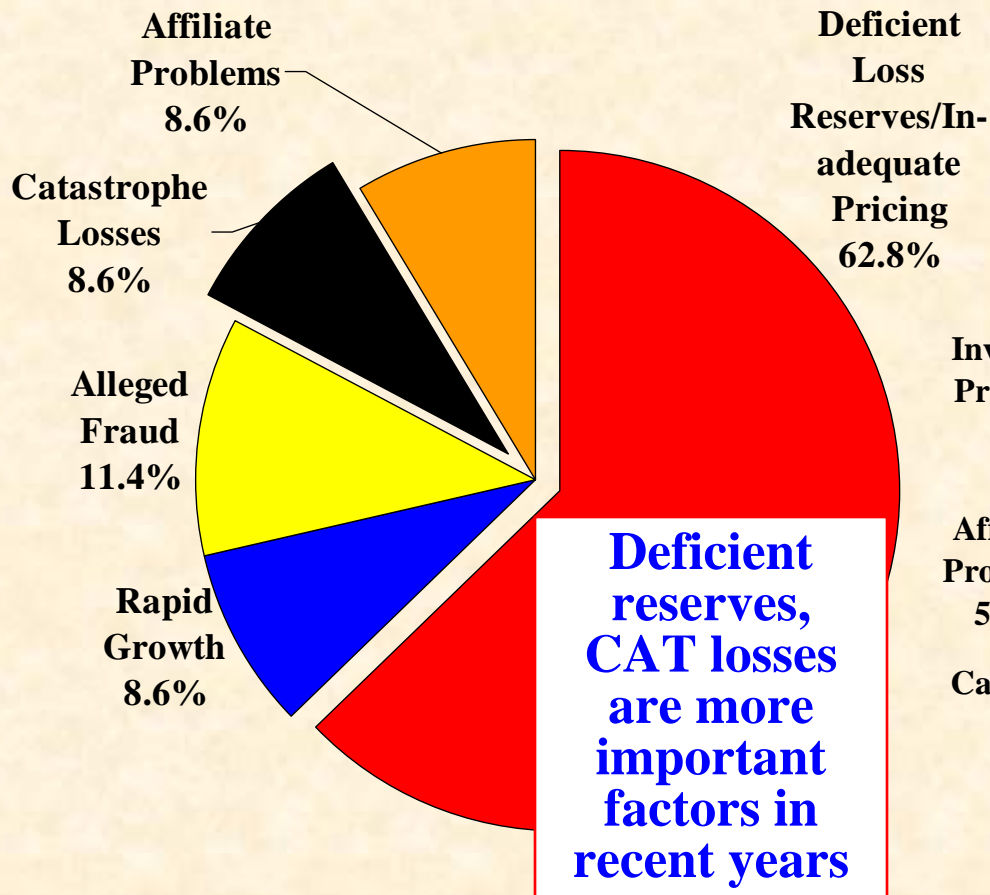
P/C Insurer Impairment Frequency vs. Combined Ratio, 1969-2007E



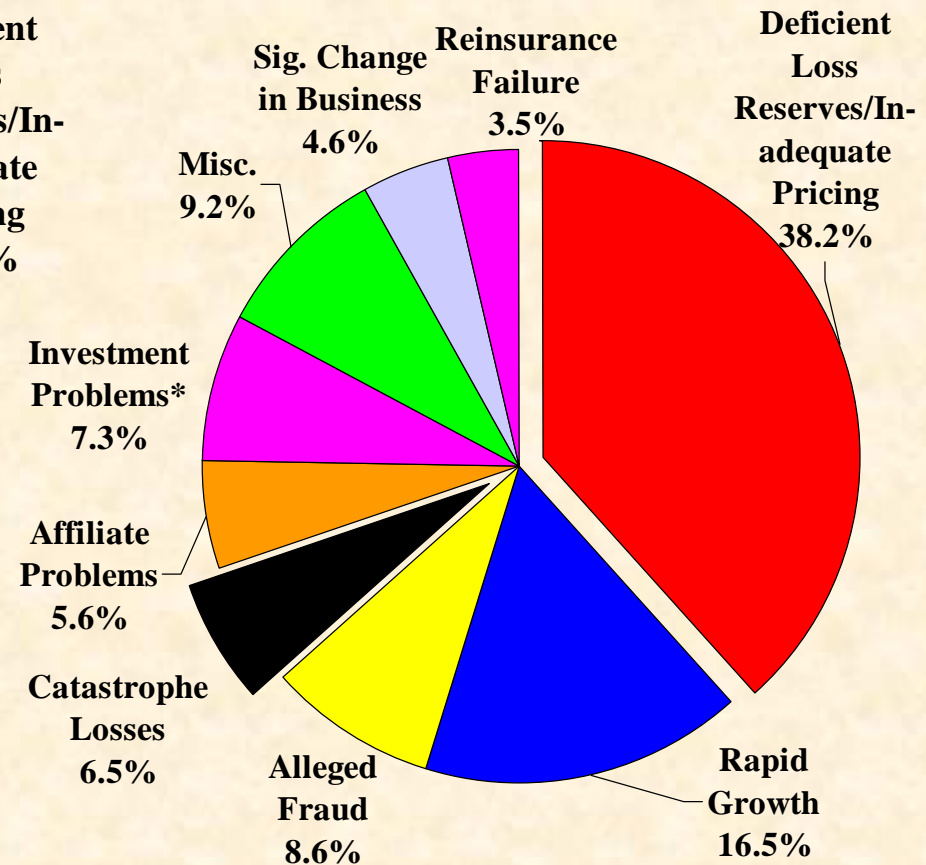


Reasons for US P/C Insurer Impairments, 1969-2005

2003-2005



1969-2005

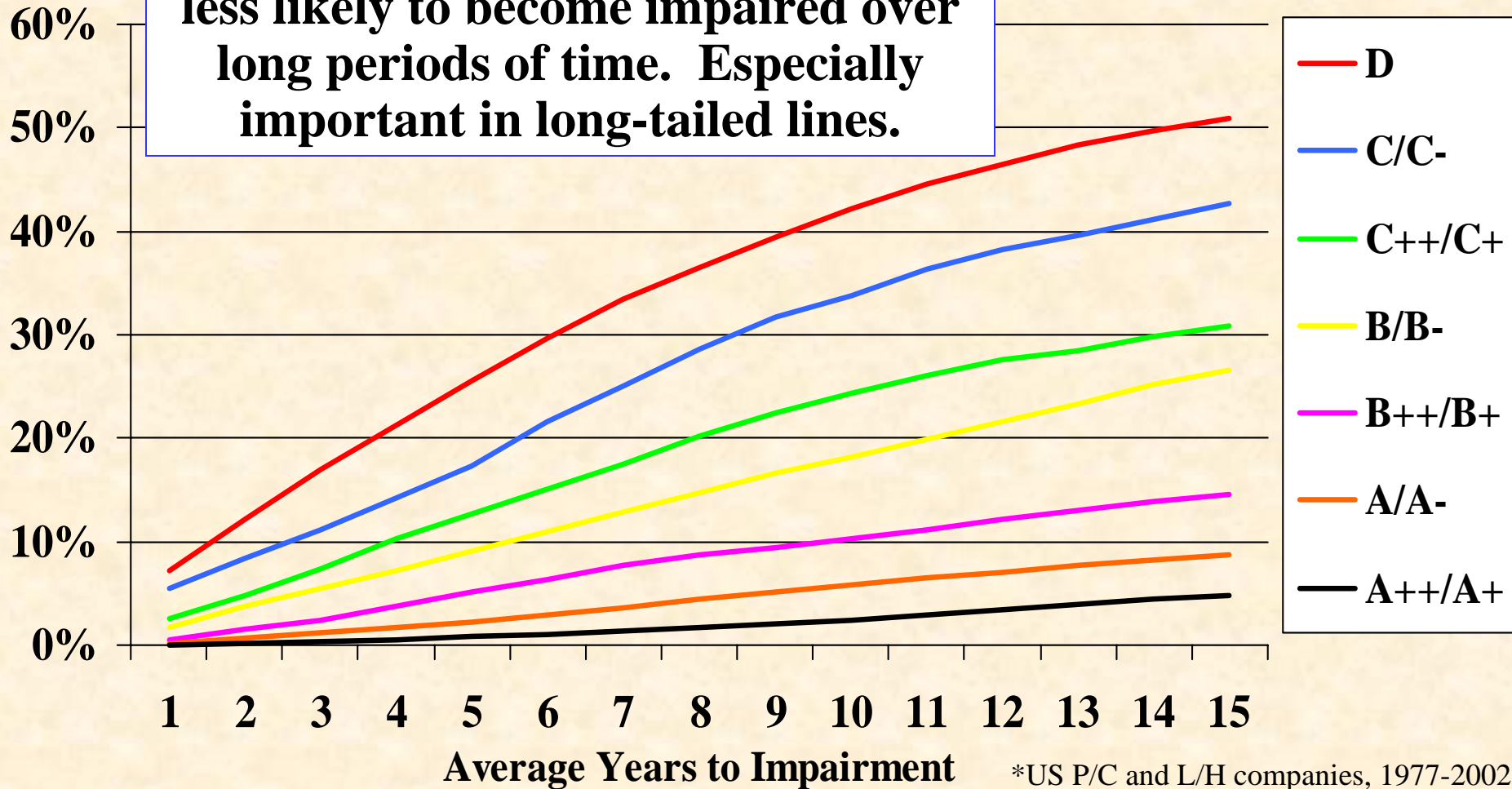


*Includes overstatement of assets.



Cumulative Average Impairment Rates by Best Financial Strength Rating*

Insurers with strong ratings are far less likely to become impaired over long periods of time. Especially important in long-tailed lines.



*US P/C and L/H companies, 1977-2002

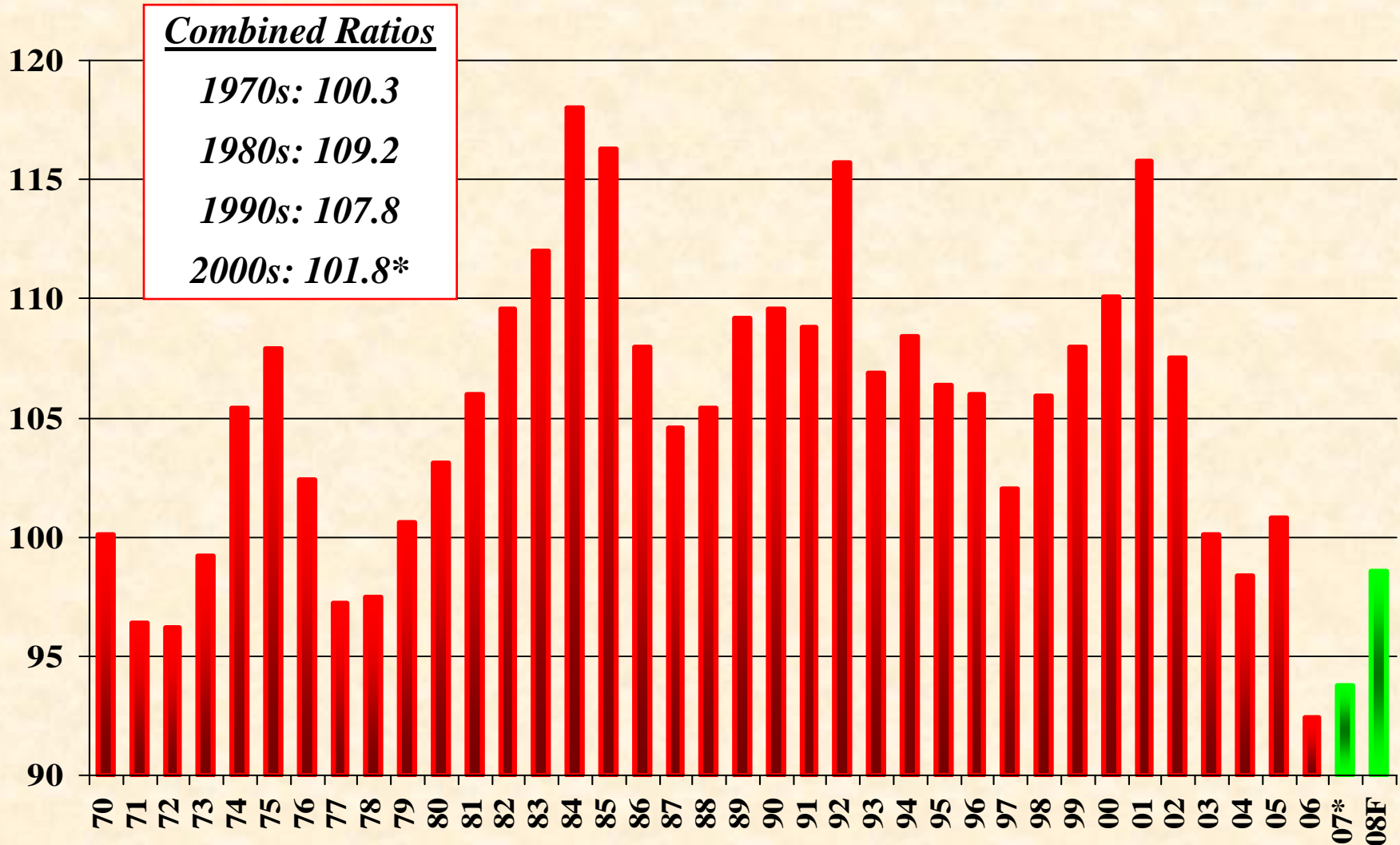
UNDERWRITING TRENDS

Extremely Strong 2006/07





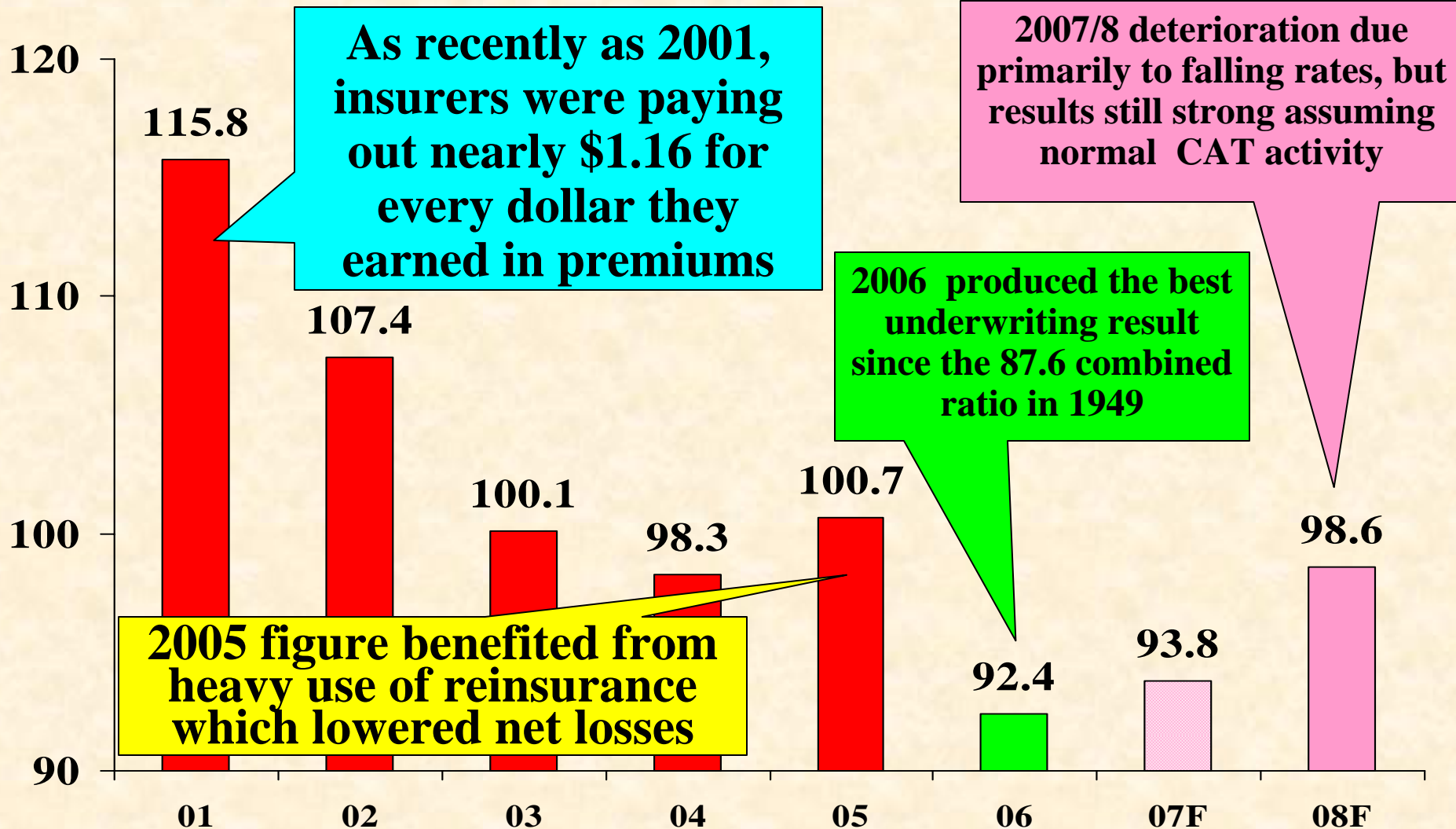
*P/C Insurance Combined Ratio, 1970-2008F**



Sources: A.M. Best; ISO, III *2007 is actual 9-month result; 2008F from A.M. Best.



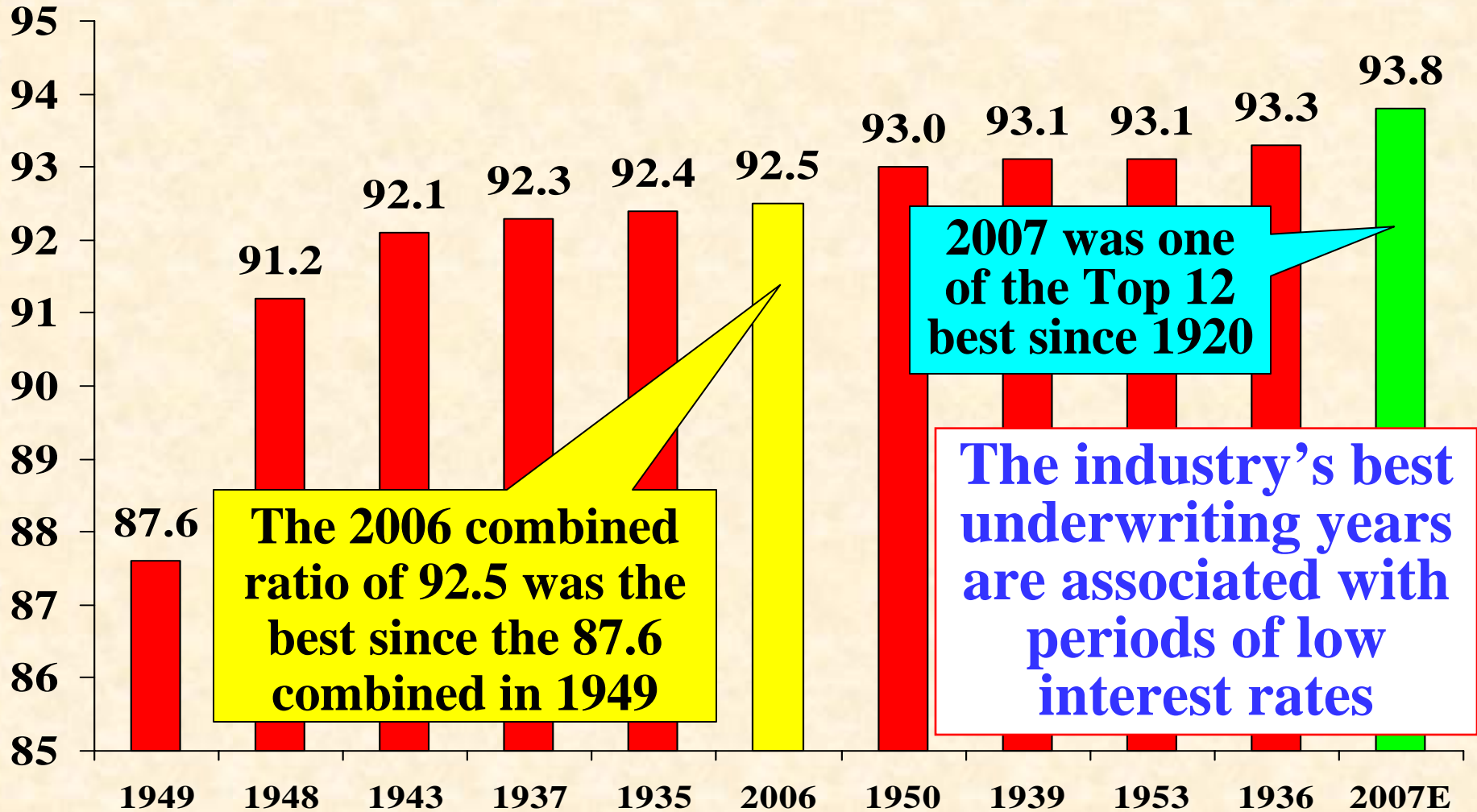
P/C Insurance Combined Ratio, 2001-2008F



Sources: A.M. Best; ISO, III. *2007 is actual 2007 9-month result; 2008 is from A.M. Best.



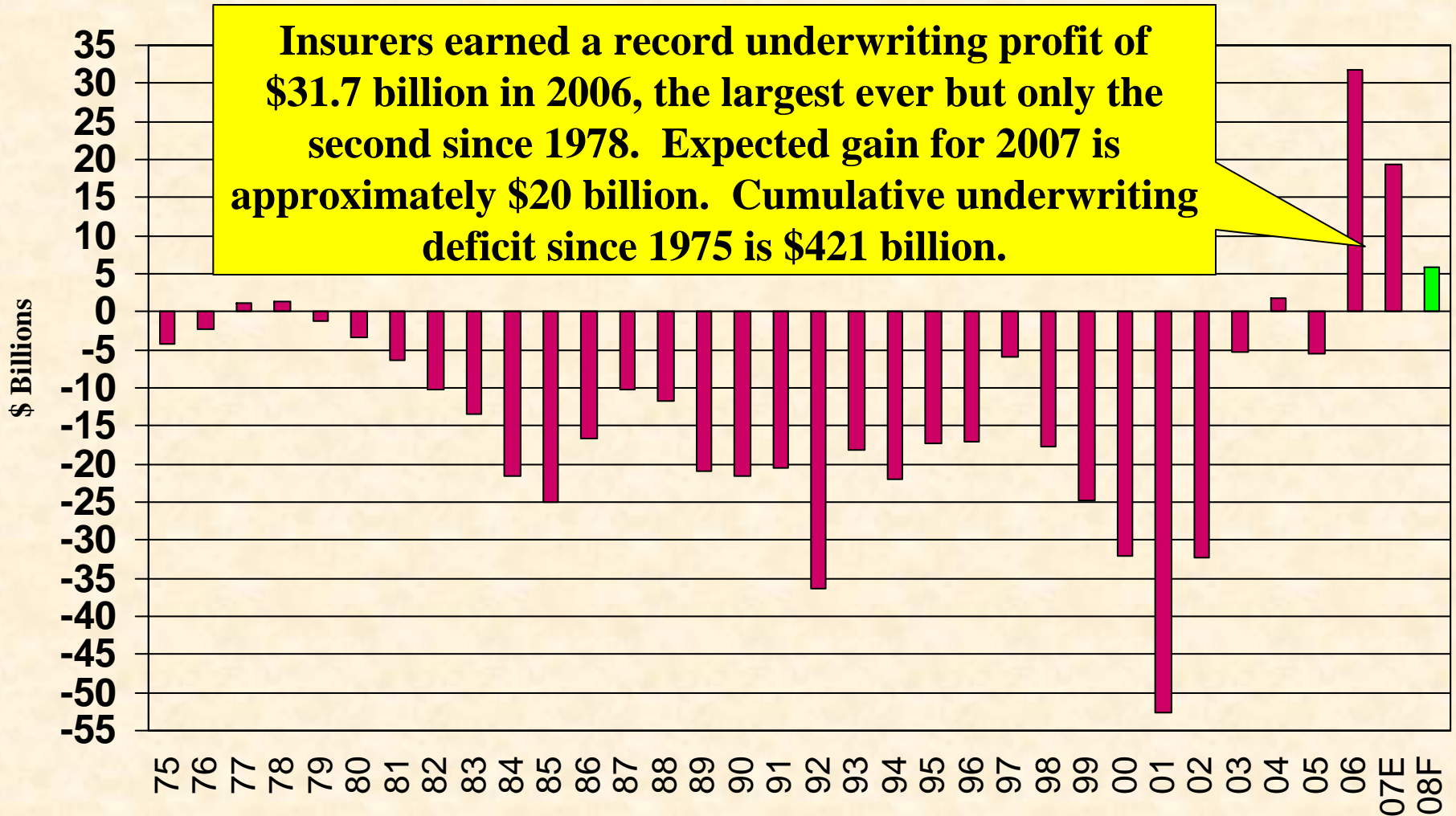
Ten Lowest P/C Insurance Combined Ratios Since 1920 vs. 2007E





Underwriting Gain (Loss)

*1975-2008F**

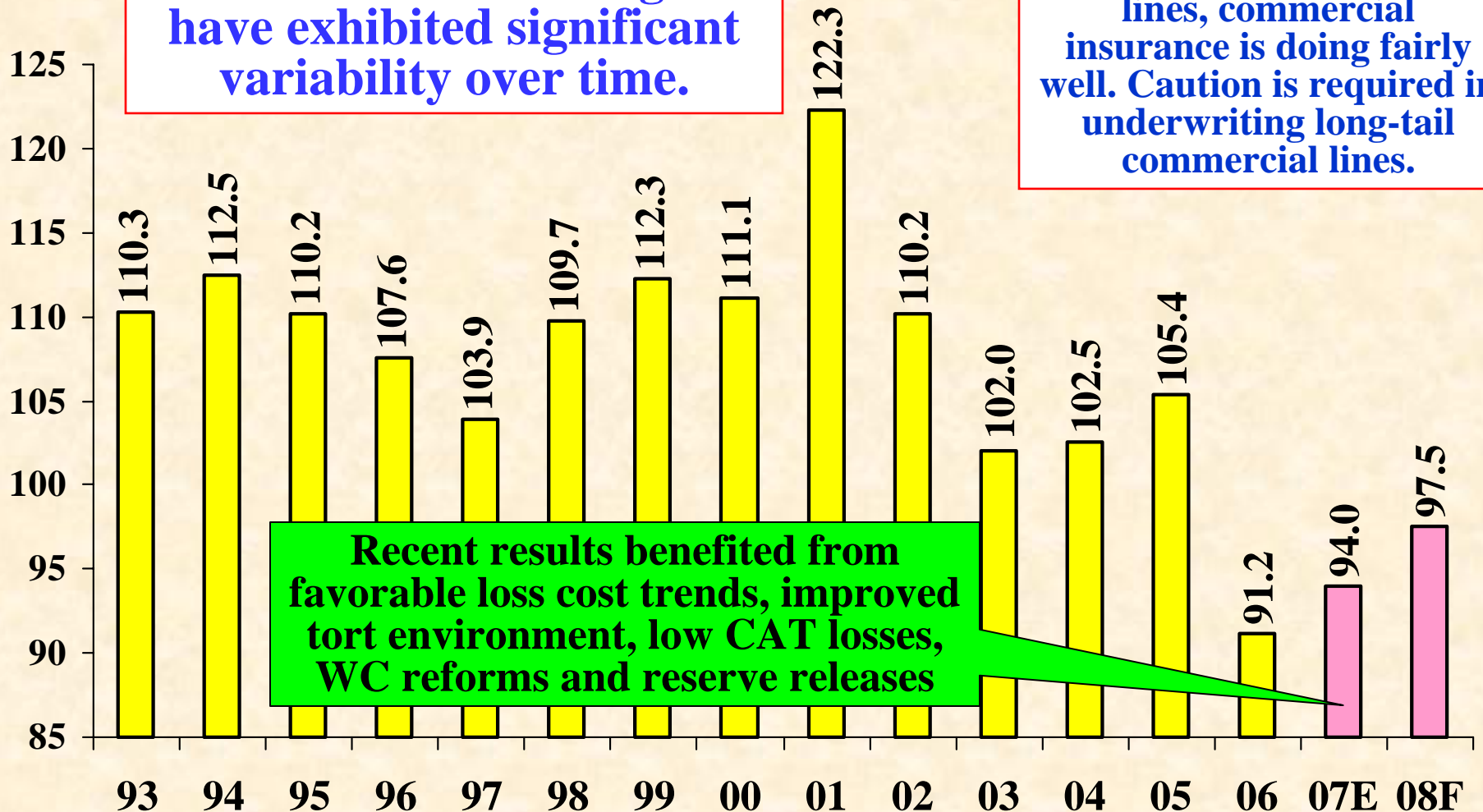




Commercial Lines Combined Ratio, 1993-2008F

Commercial coverages have exhibited significant variability over time.

Outside CAT-affected lines, commercial insurance is doing fairly well. Caution is required in underwriting long-tail commercial lines.

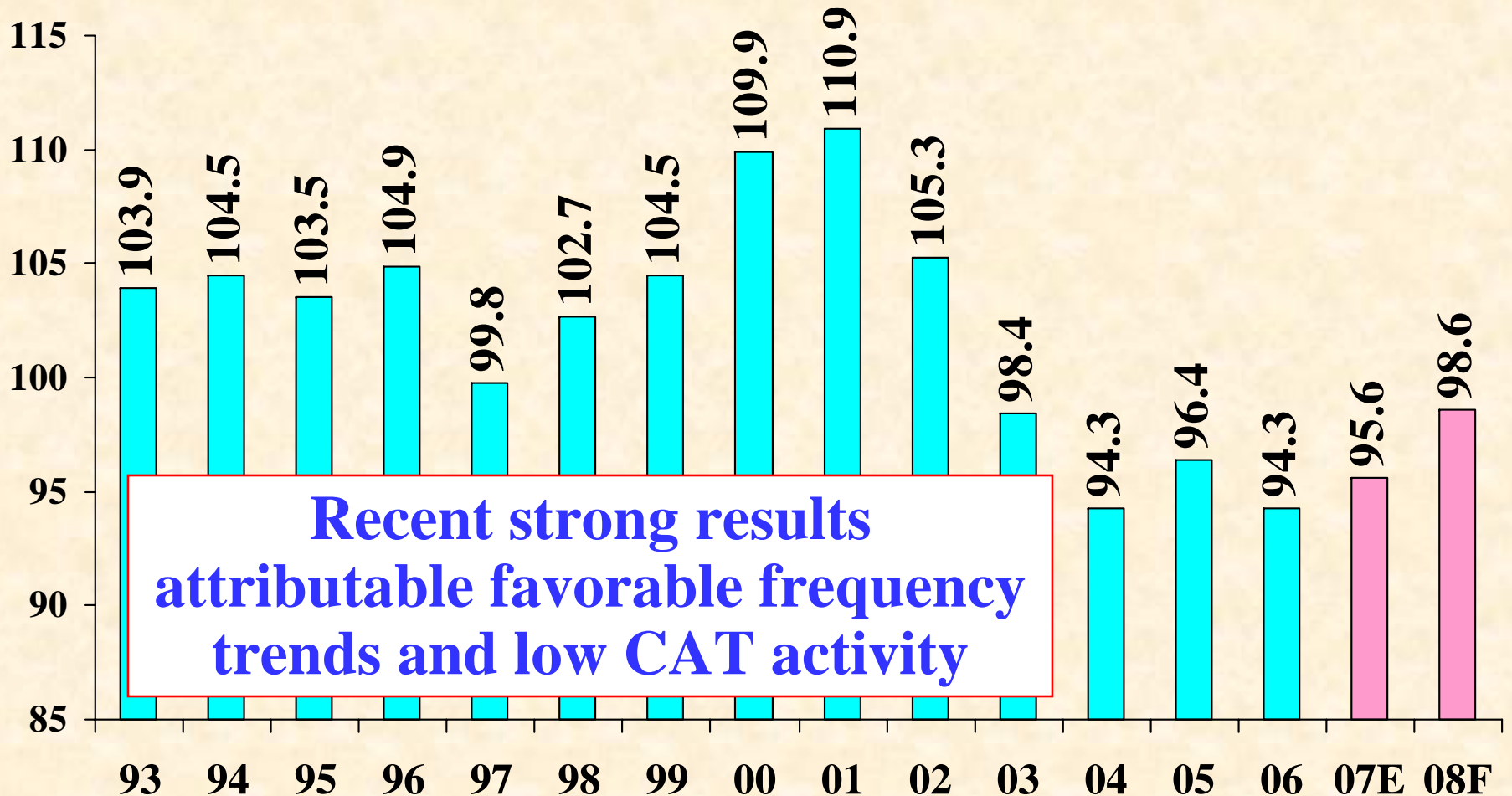


Recent results benefited from favorable loss cost trends, improved tort environment, low CAT losses, WC reforms and reserve releases



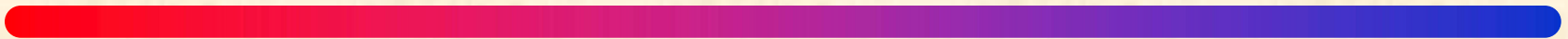
Personal Lines

Combined Ratio, 1993-2007E



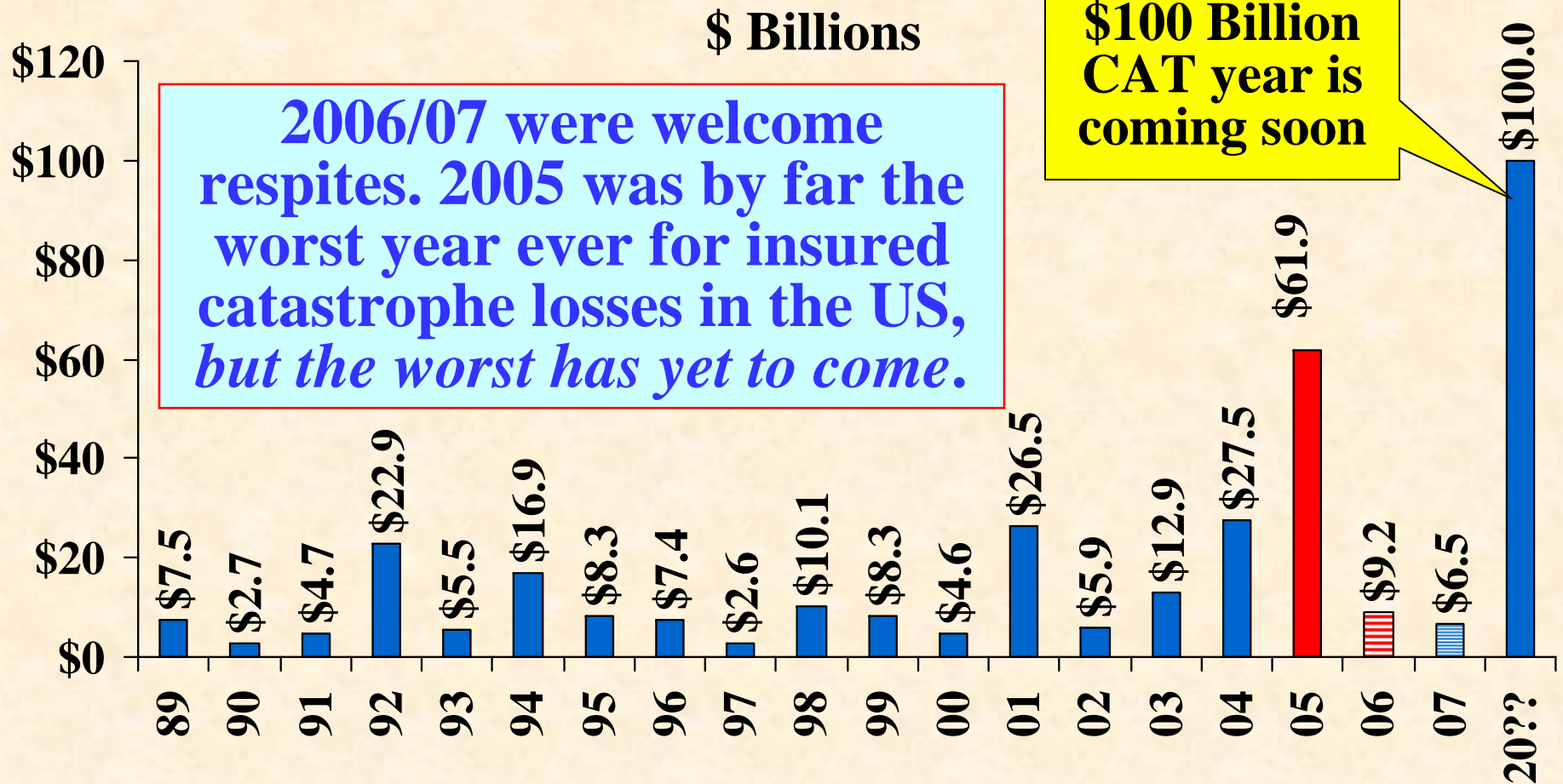
CATASTROPHIC LOSS

What Will 2008 Bring?





U.S. Insured Catastrophe Losses*



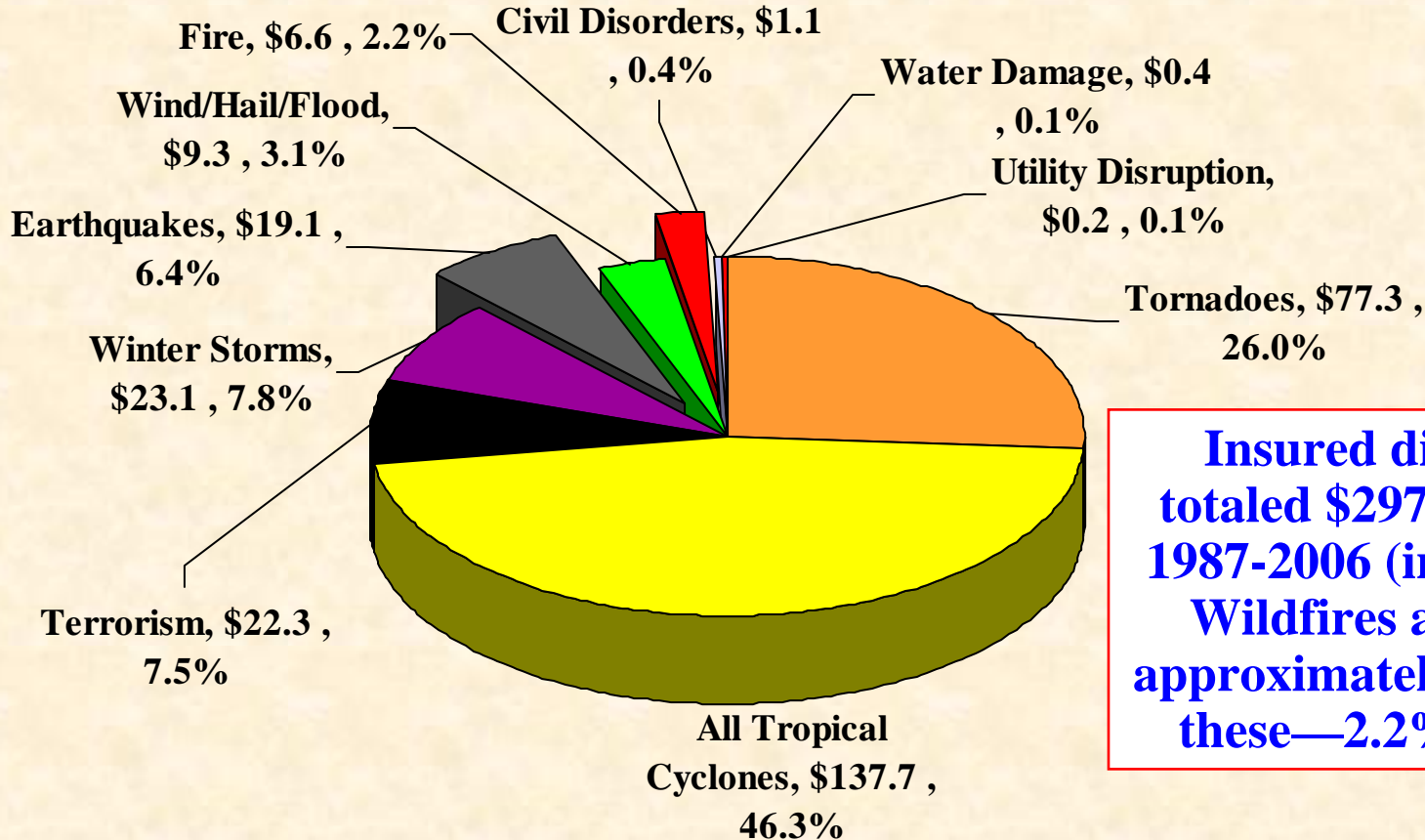
*Excludes \$4B-\$6b offshore energy losses from Hurricanes Katrina & Rita.

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. Non-prop/BI losses = \$12.2B.

Source: Property Claims Service/ISO; Insurance Information Institute



Inflation-Adjusted U.S. Insured Catastrophe Losses By Cause of Loss, 1987-2006¹



Insured disaster losses totaled \$297.3 billion from 1987-2006 (in 2006 dollars). Wildfires accounted for approximately \$6.6 billion of these—2.2% of the total.

¹ Catastrophes are all events causing direct insured losses to property of \$25 million or more in 2006 dollars.

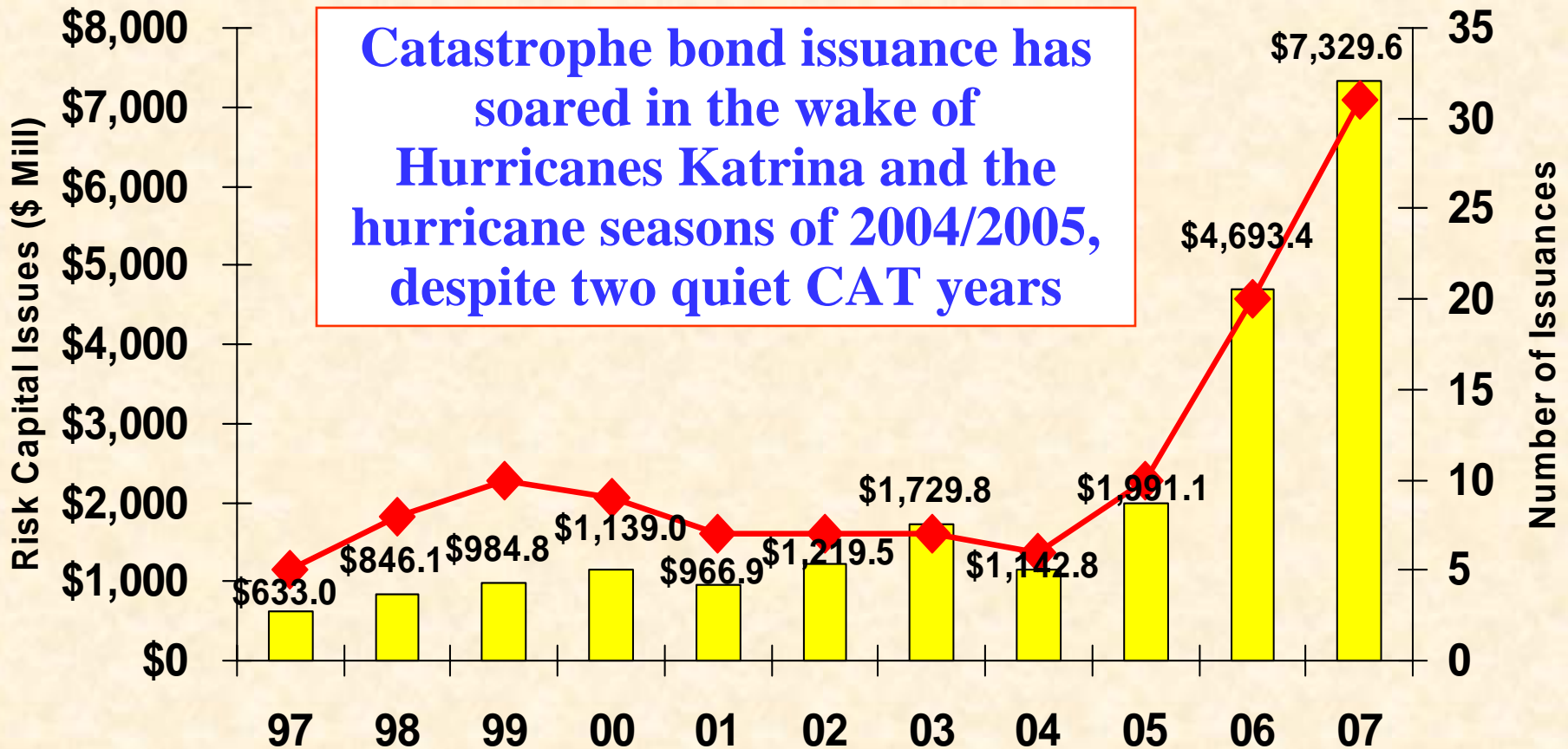
Catastrophe threshold changed from \$5 million to \$25 million beginning in 1997. Adjusted for inflation by the III.

² Excludes snow. ³ Includes hurricanes and tropical storms. ⁴ Includes other geologic events such as volcanic eruptions and other earth movement. ⁵ Does not include flood damage covered by the federally administered National Flood Insurance Program. ⁶ Includes wildland fires.



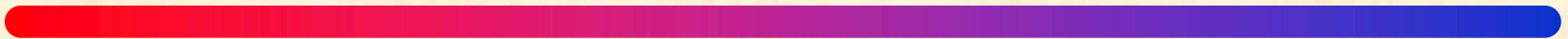
Annual Catastrophe Bond Transactions Volume, 1997-2007

■ Risk Capital Issued ◆ Number of Issuances



The 2008 Hurricane Season:

Less Activity Predicted





Outlook for 2008 Hurricane

Season: 25% Worse Than Average

	Average*	2005	2008F
Named Storms	9.6	28	13
Named Storm Days	49.1	115.5	60
Hurricanes	5.9	14	7
Hurricane Days	24.5	47.5	30
Intense Hurricanes	2.3	7	3
Intense Hurricane Days	5	7	6
Accumulated Cyclone Energy	96.2	NA	115
Net Tropical Cyclone Activity	100%	275%	125%

*Average over the period 1950-2000.

Source: Philip Klotzbach and Dr. William Gray, Colorado State University, December 7, 2007.



Landfall Probabilities for 2008 Hurricane Season: Above Average

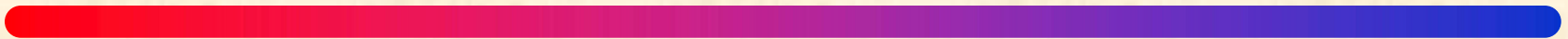
	Average*	2008F
Entire US East Coast	52%	60%
US East Coast Including Florida Peninsula	31%	37%
Gulf Coast from Florida Panhandle to Brownsville	30%	36%
Caribbean	NA	Above Average

*Average over the past century.

Source: Philip Klotzbach and Dr. William Gray, Colorado State University, December 7, 2007.

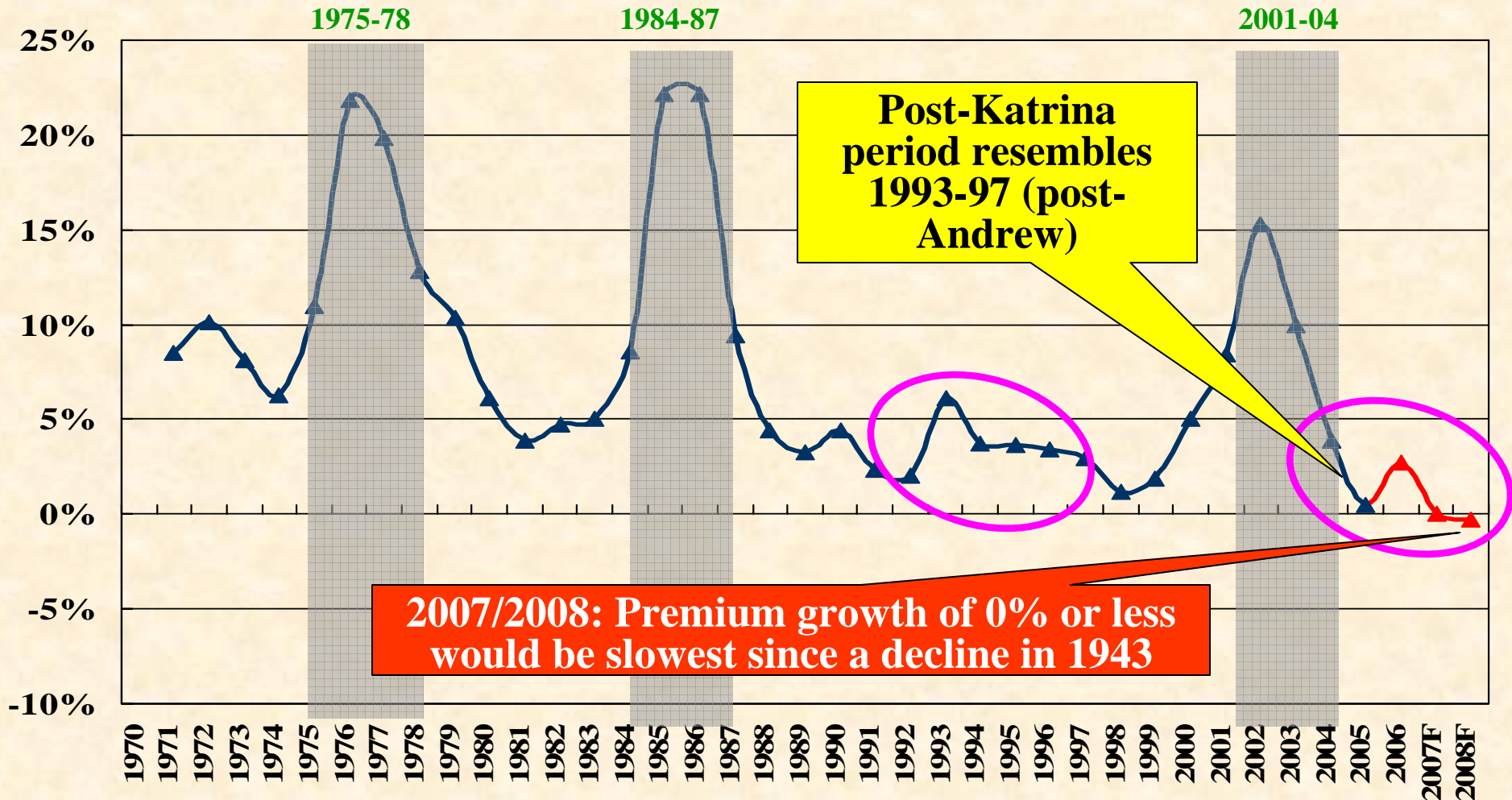
PREMIUM GROWTH

**At a Virtual Standstill
in 2007/08**





Strength of Recent Hard Markets by NWP Growth*

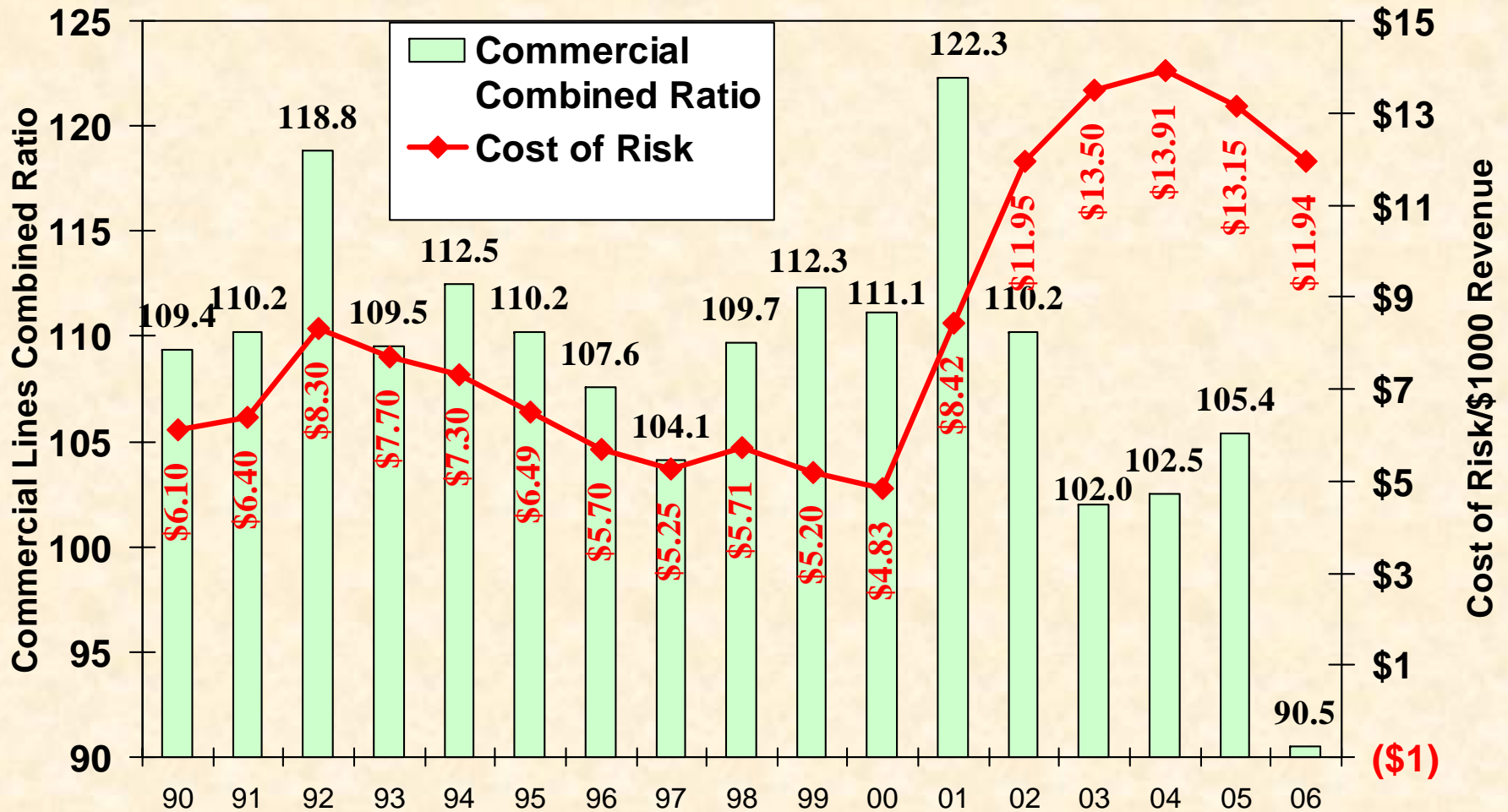


Note: Shaded areas denote hard market periods.
Source: A.M. Best, Insurance Information Institute

*2007 figure is actual 9-month figure.



Cost of Risk vs. Commercial Lines Combined Ratio



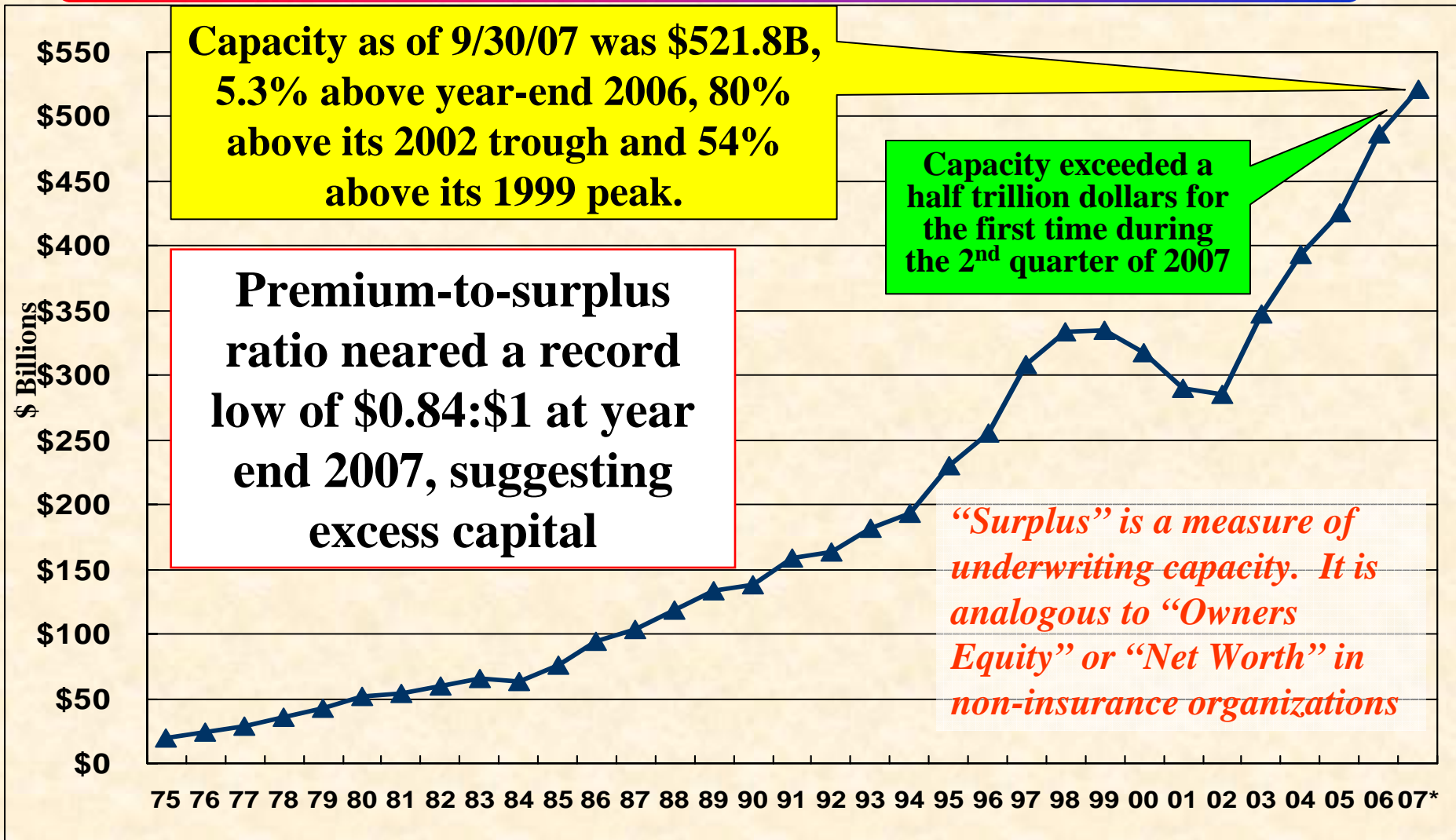
CAPACITY/ SURPLUS

Accumulation Continues





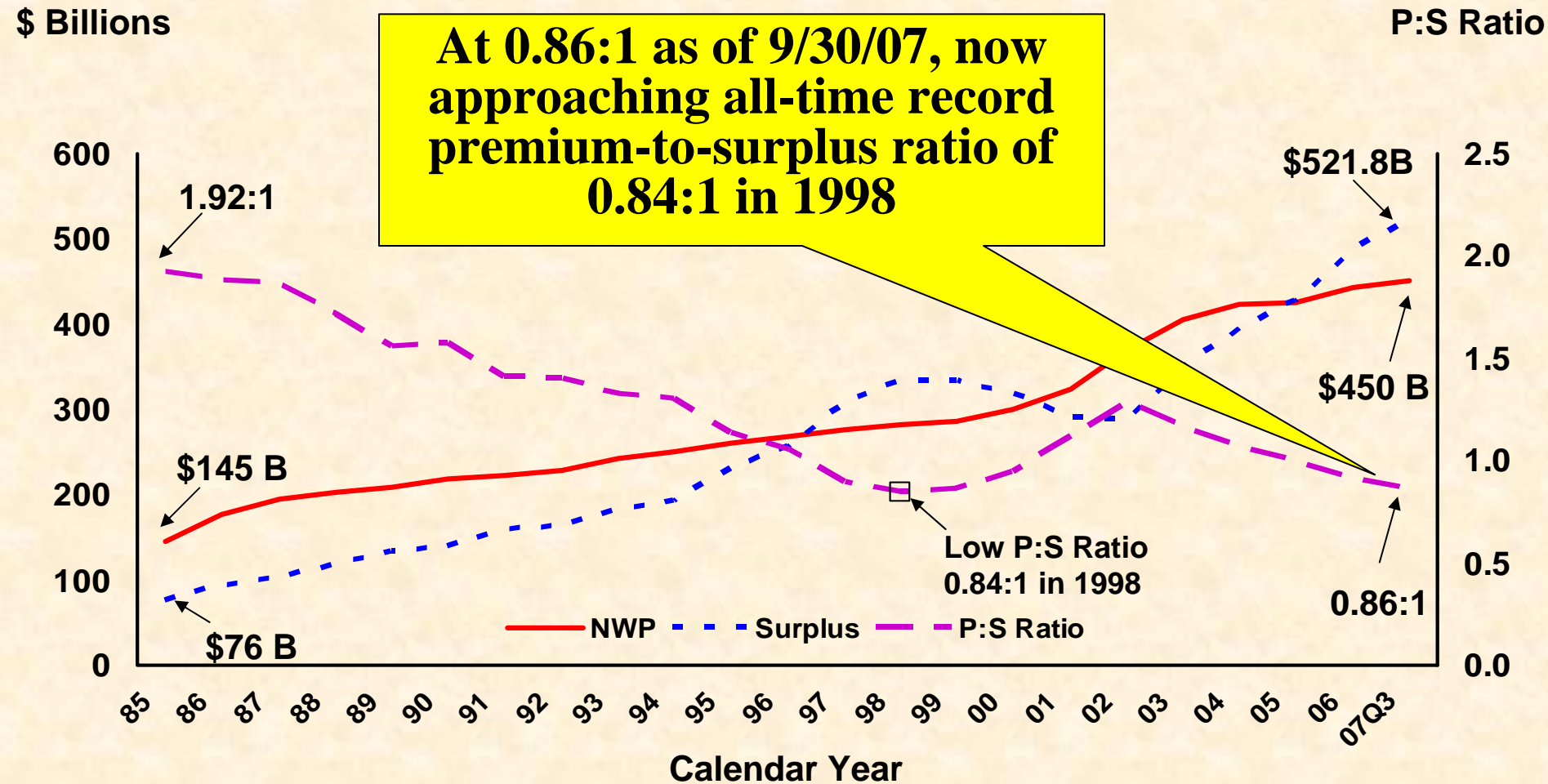
U.S. Policyholder Surplus: 1975-2007*





P/C Industry Premium-to-Surplus Ratio, 1985-2007:Q3

Private Carriers



Q3 = First 3 quarters as of 9/30/07

Source: Insurance Information Institute; 1985-2006, A.M. Best Aggregates & Averages;; 2007 ISO



P/C Insurer Share Repurchases, 1987- Through Q3:2007 (\$ Mill)

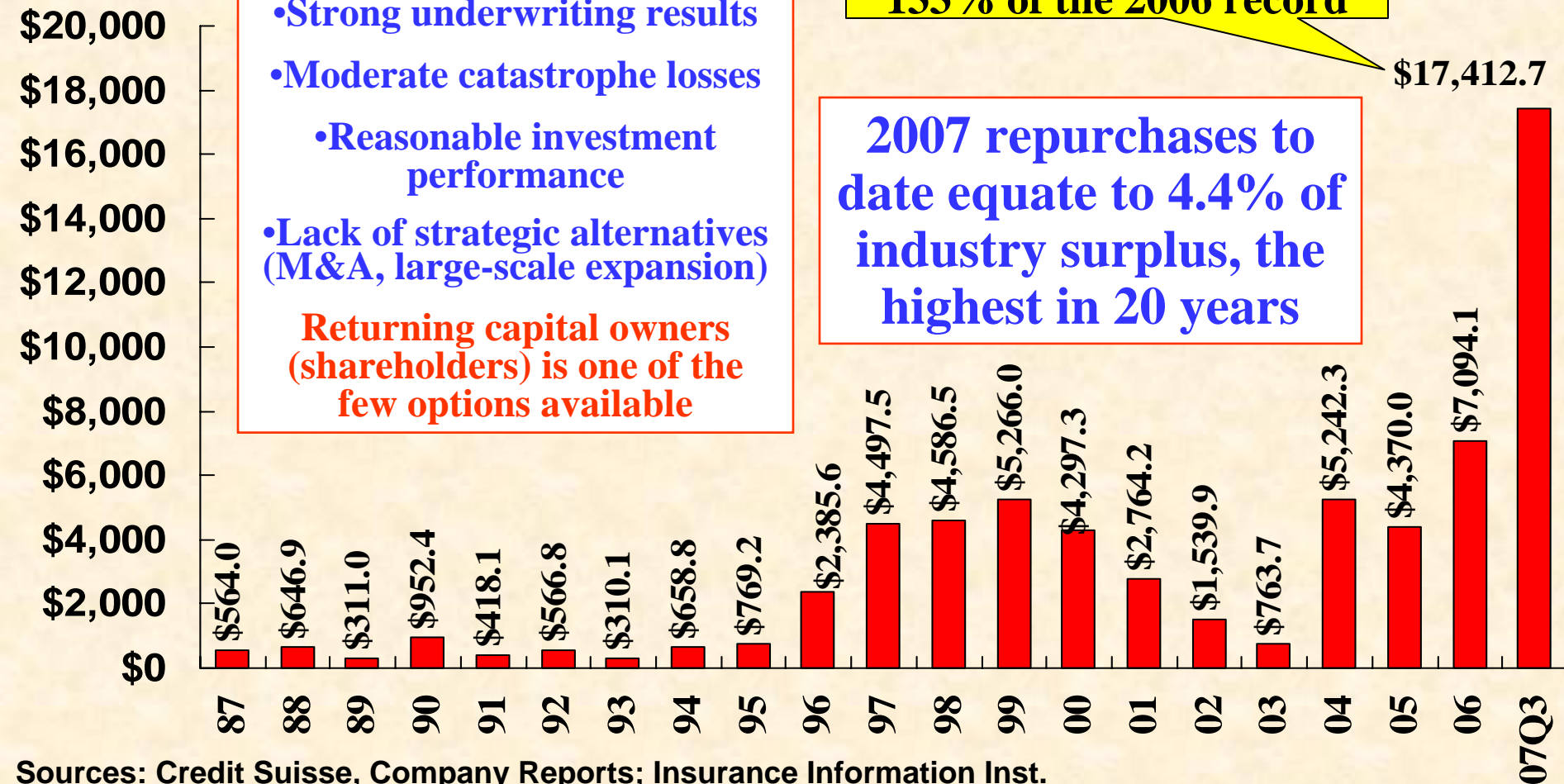
Reasons Behind Capital Build-Up & Repurchase Surge

- Strong underwriting results
- Moderate catastrophe losses
- Reasonable investment performance
- Lack of strategic alternatives (M&A, large-scale expansion)

Returning capital owners (shareholders) is one of the few options available

First 9-months 2007 share buybacks are already 133% of the 2006 record

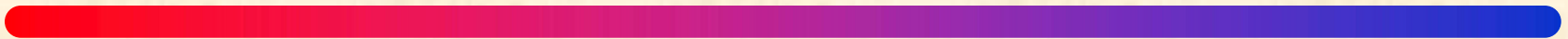
2007 repurchases to date equate to 4.4% of industry surplus, the highest in 20 years



Sources: Credit Suisse, Company Reports; Insurance Information Inst.

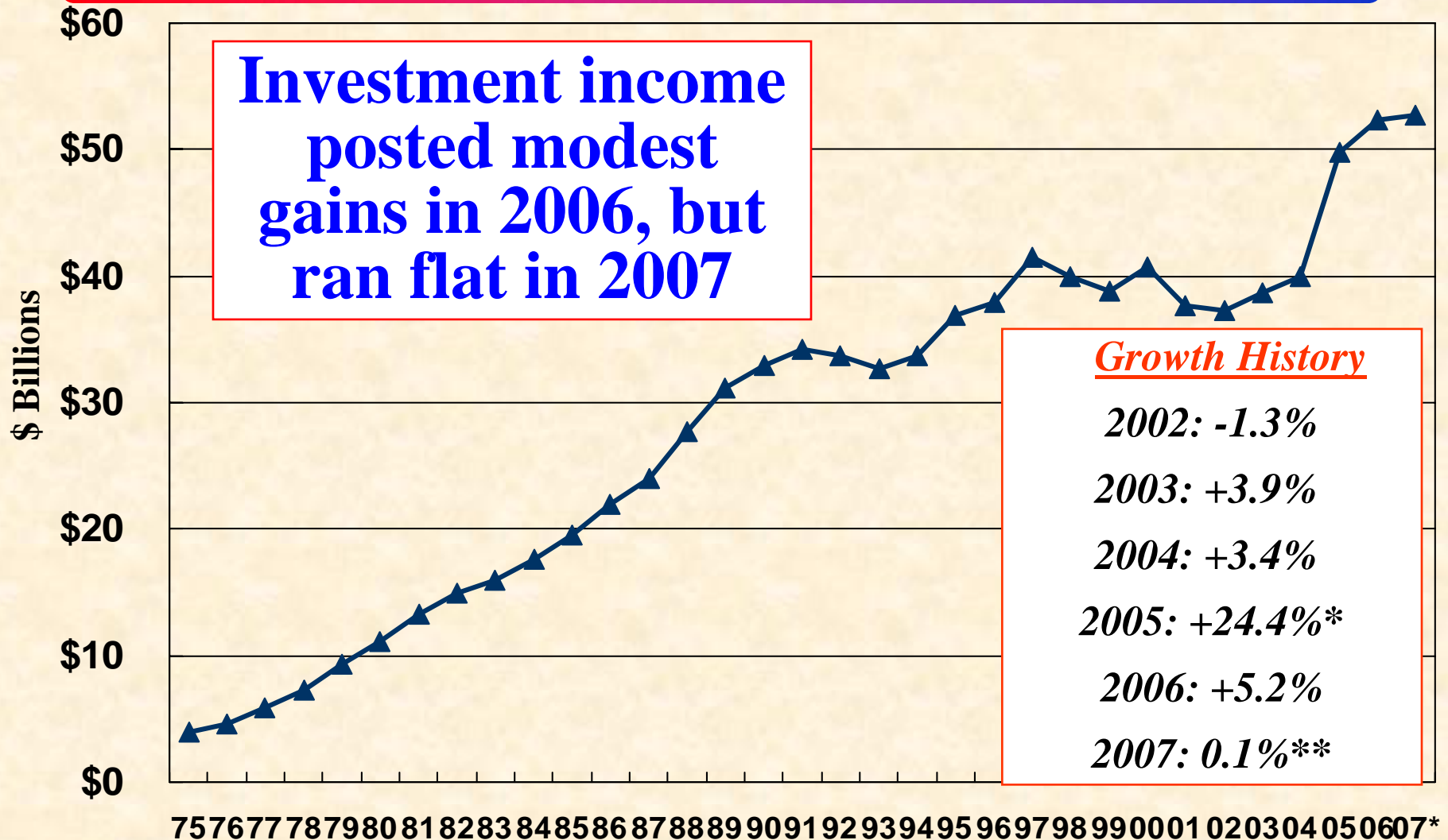
INVESTMENT OVERVIEW

*More Pain,
Little Gain*





Net Investment Income



Source: A.M. Best, ISO, Insurance Information Institute;

*Includes special dividend of \$3.2B. Increase is 15.7% excluding dividend. **Based on annualized 9M result of \$39.515B.



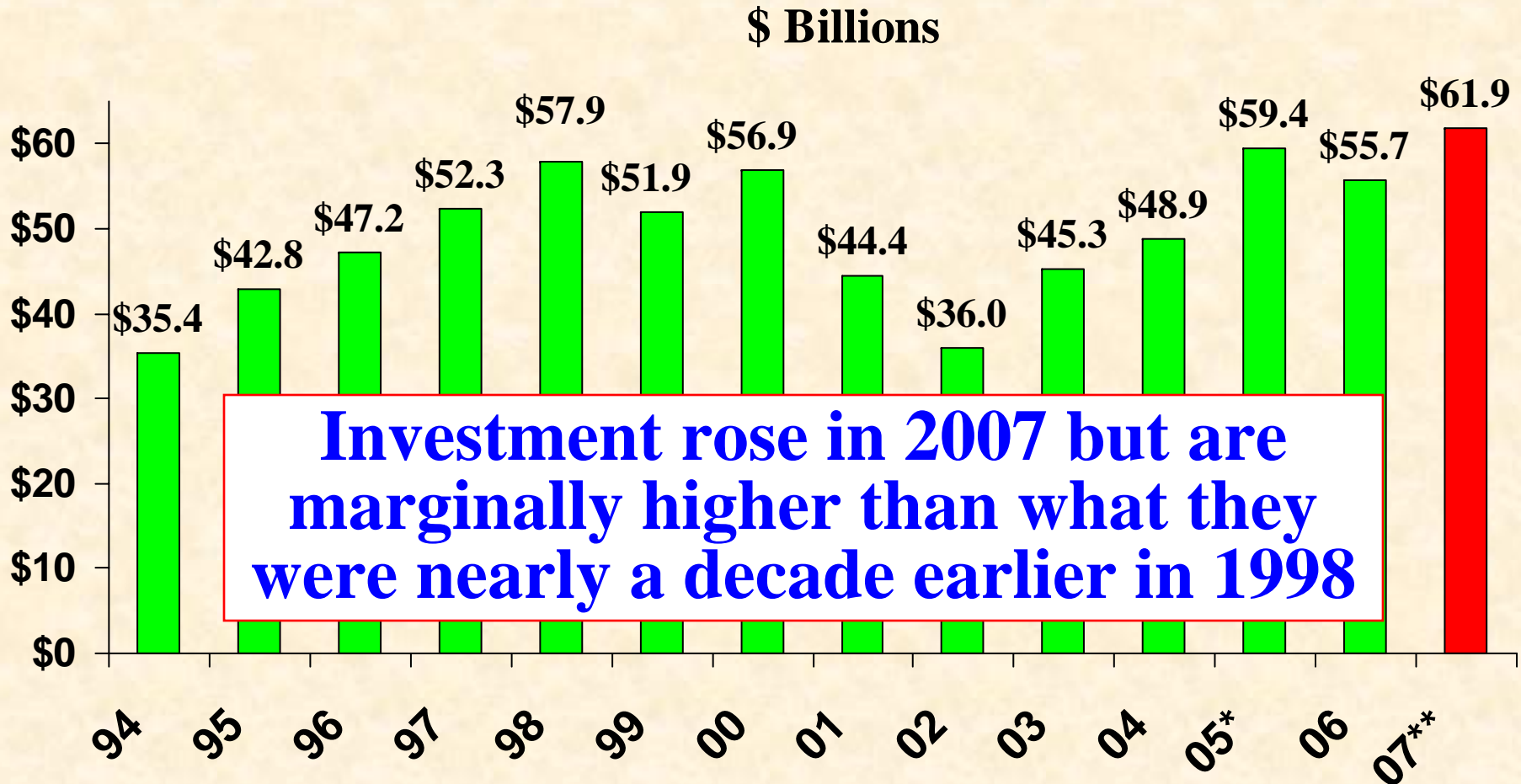
Total Returns for Large Company Stocks: 1970-2008*

S&P 500 was up 3.53% in 2007, but down -9.38% so far in 2008*





Property/Casualty Insurance Industry Investment Gain¹



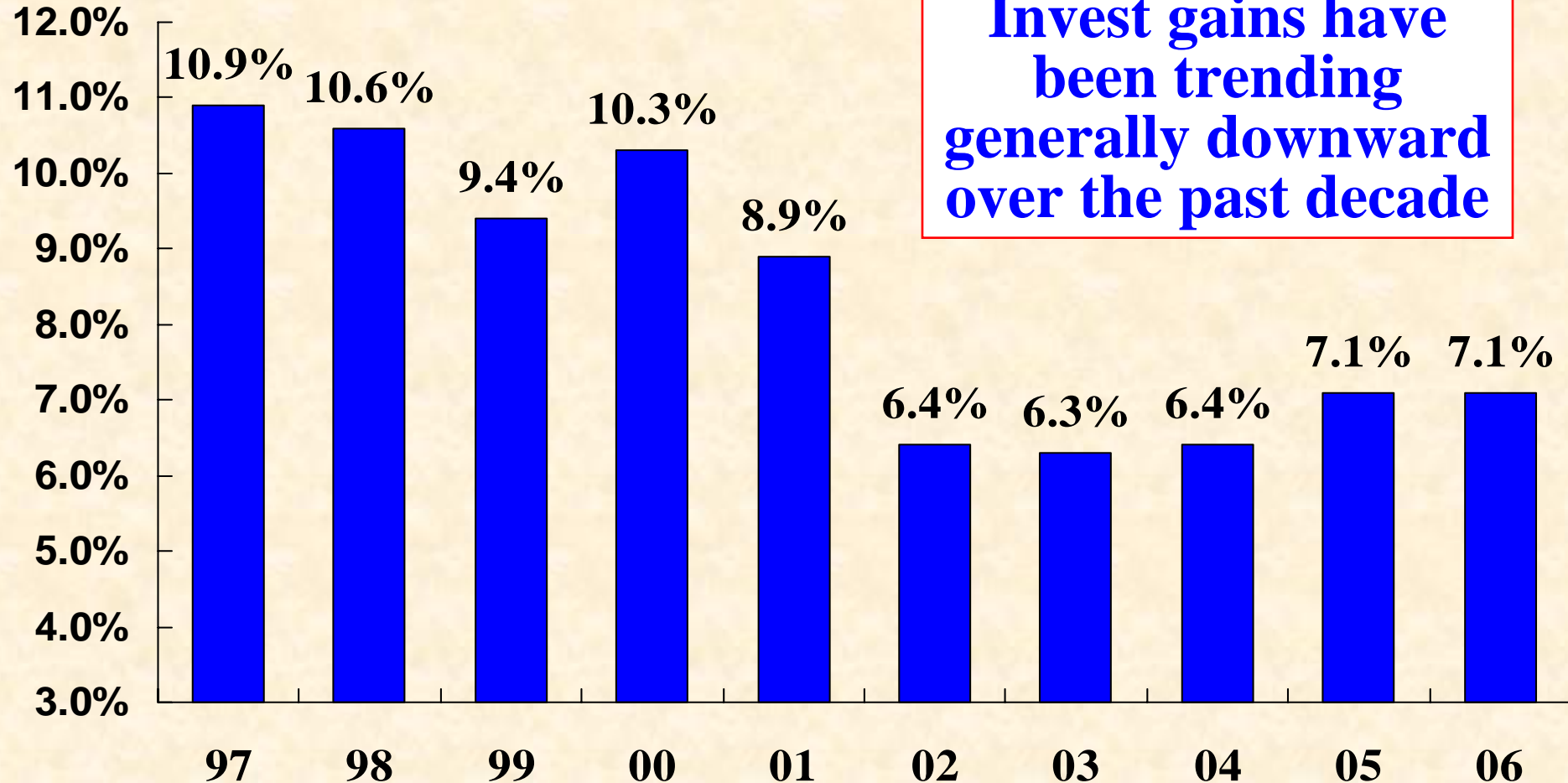
¹Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2006 figure consists of \$52.3B net investment income and \$3.4B realized investment gain.

*2005 figure includes special one-time dividend of \$3.2B. **A.M. Best estimate

Sources: ISO; Insurance Information Institute.



Investment Gain on Funds & Other Income, 1997-2006

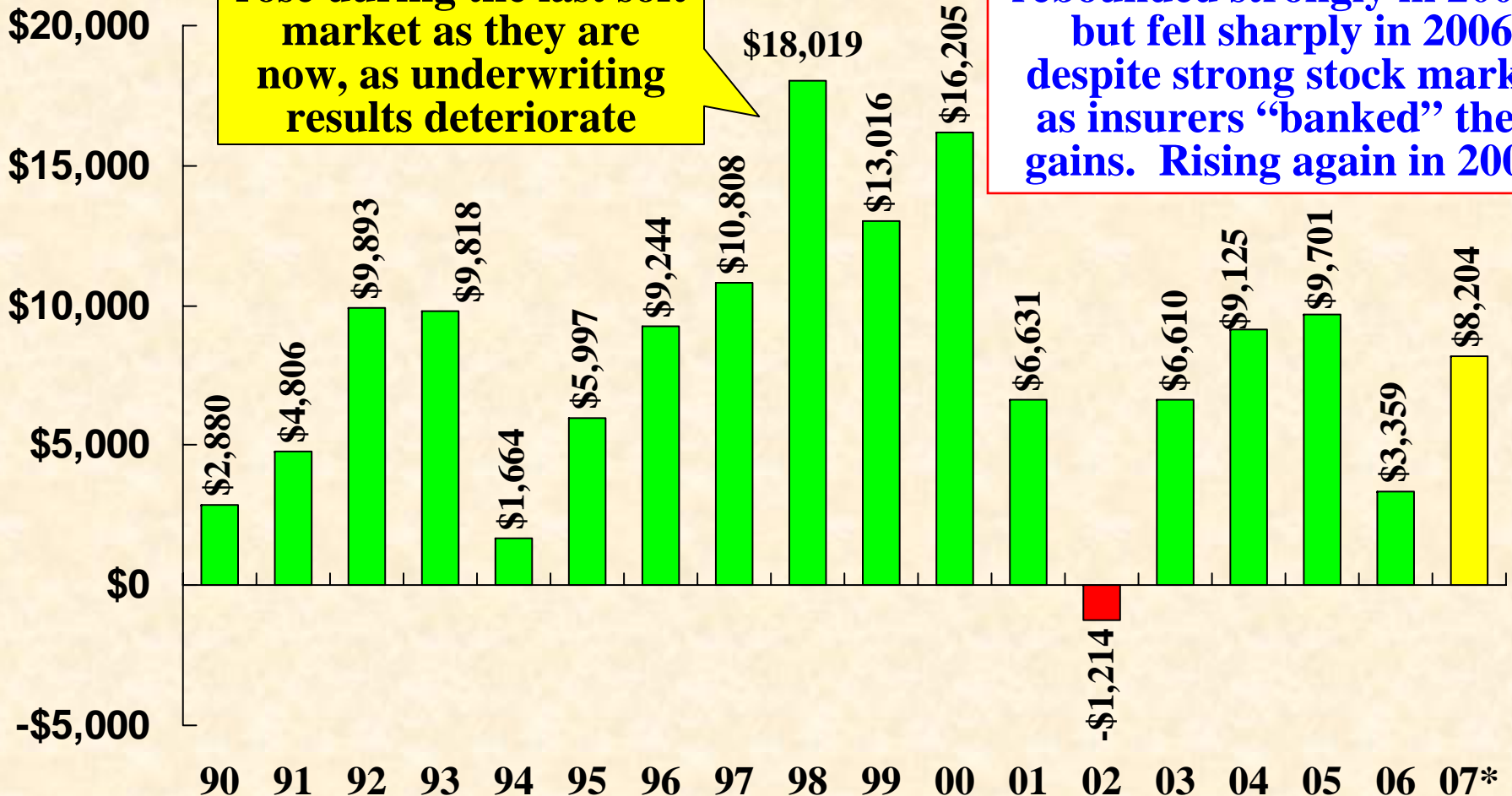




US P/C Net Realized Capital Gains, 1990-2007:9 Months (\$ Millions)

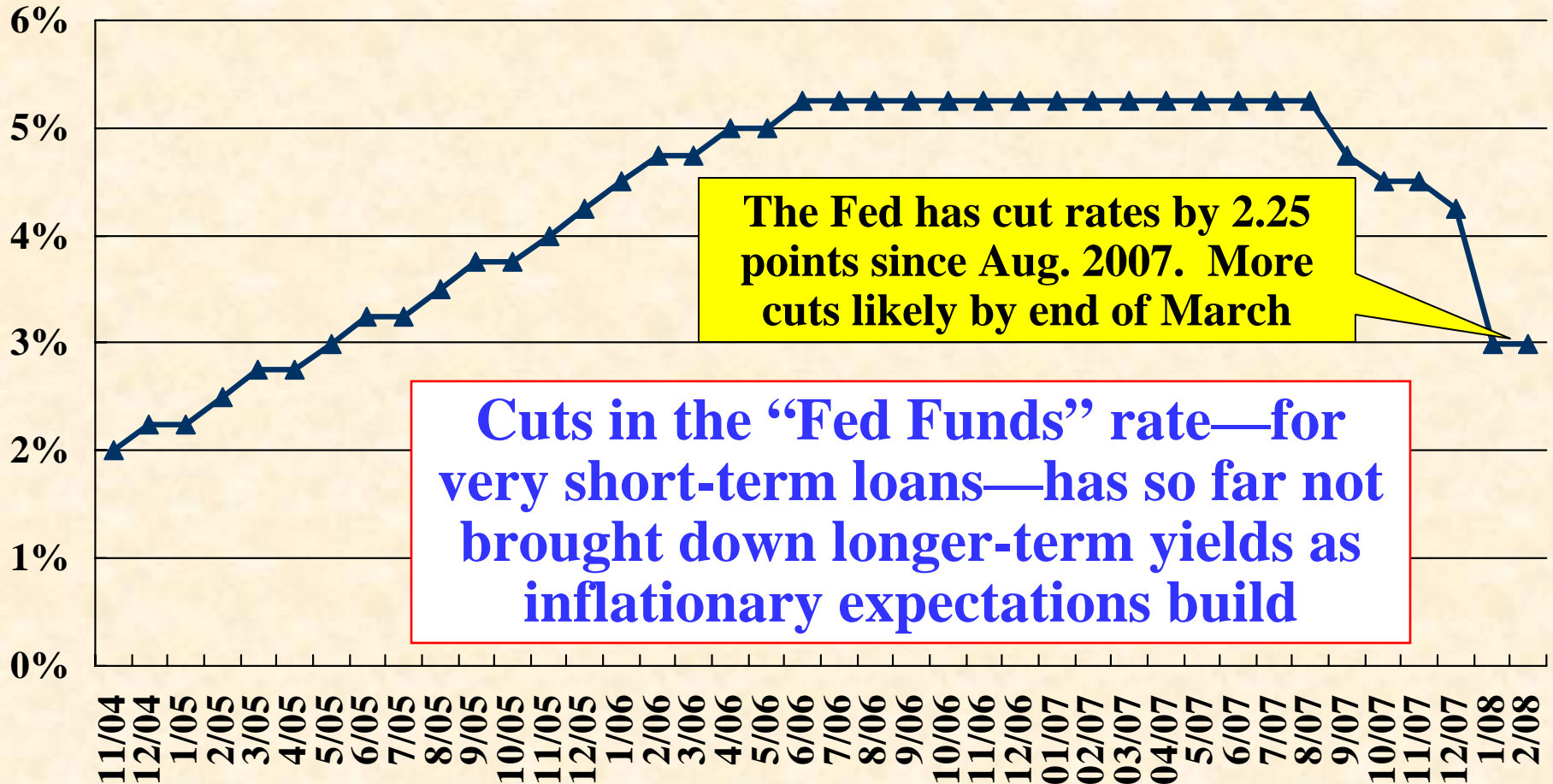
Realized capital gains rose during the last soft market as they are now, as underwriting results deteriorate

Realized capital gains rebounded strongly in 2004/5 but fell sharply in 2006 despite strong stock market as insurers "banked" their gains. Rising again in 2007.



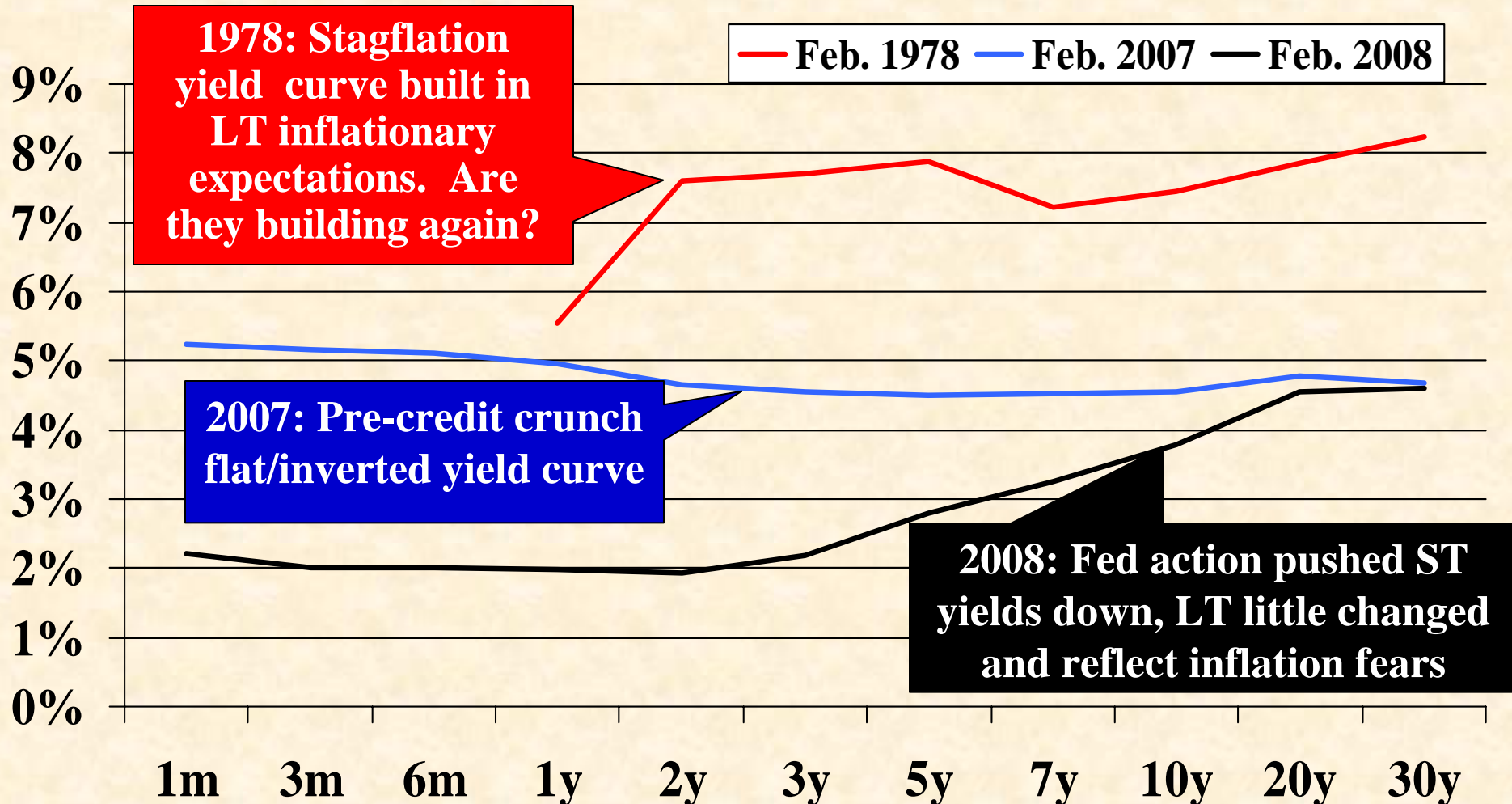


The “Fed” is Now Aggressively Pushing the “Fed Funds” Rate Down





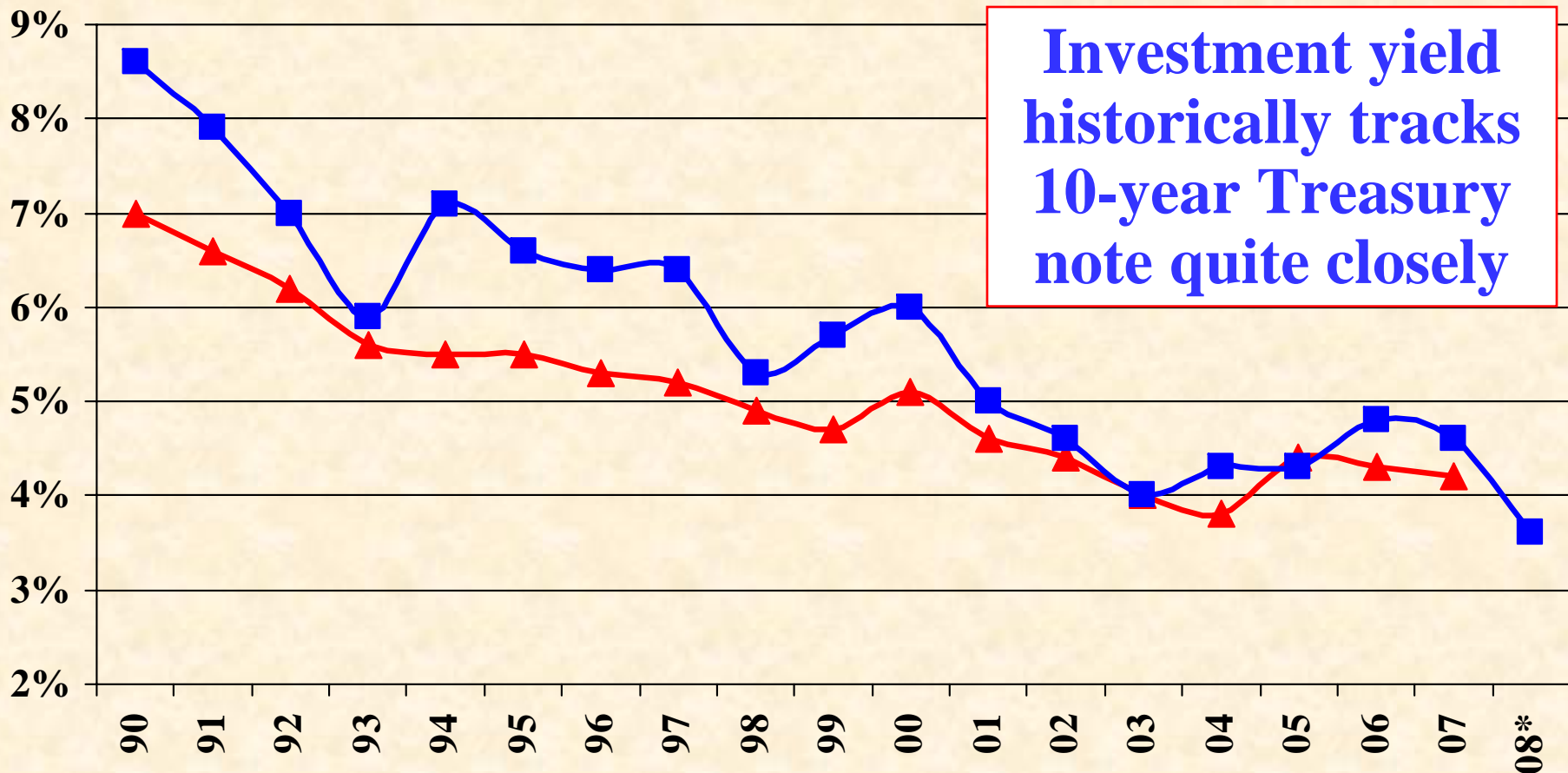
Yield Curves for Last Week of February 2008, 2007, 1978*



*Constant maturities for last week of February each year. No data for 1m, 3m or 6m available for 1978. 20-yr 1978 figures is III interpolated value.

P/C Investment Income as a % of Invested Assets Follows 10-Year US T-Note

▲ P-C Inv Income/Inv Assets ■ 10-Year Treasury Note



*As of January 2008 month-end.

Sources: Board of Governors, Federal Reserve System; A.M.Best; Insurance Information Institute.

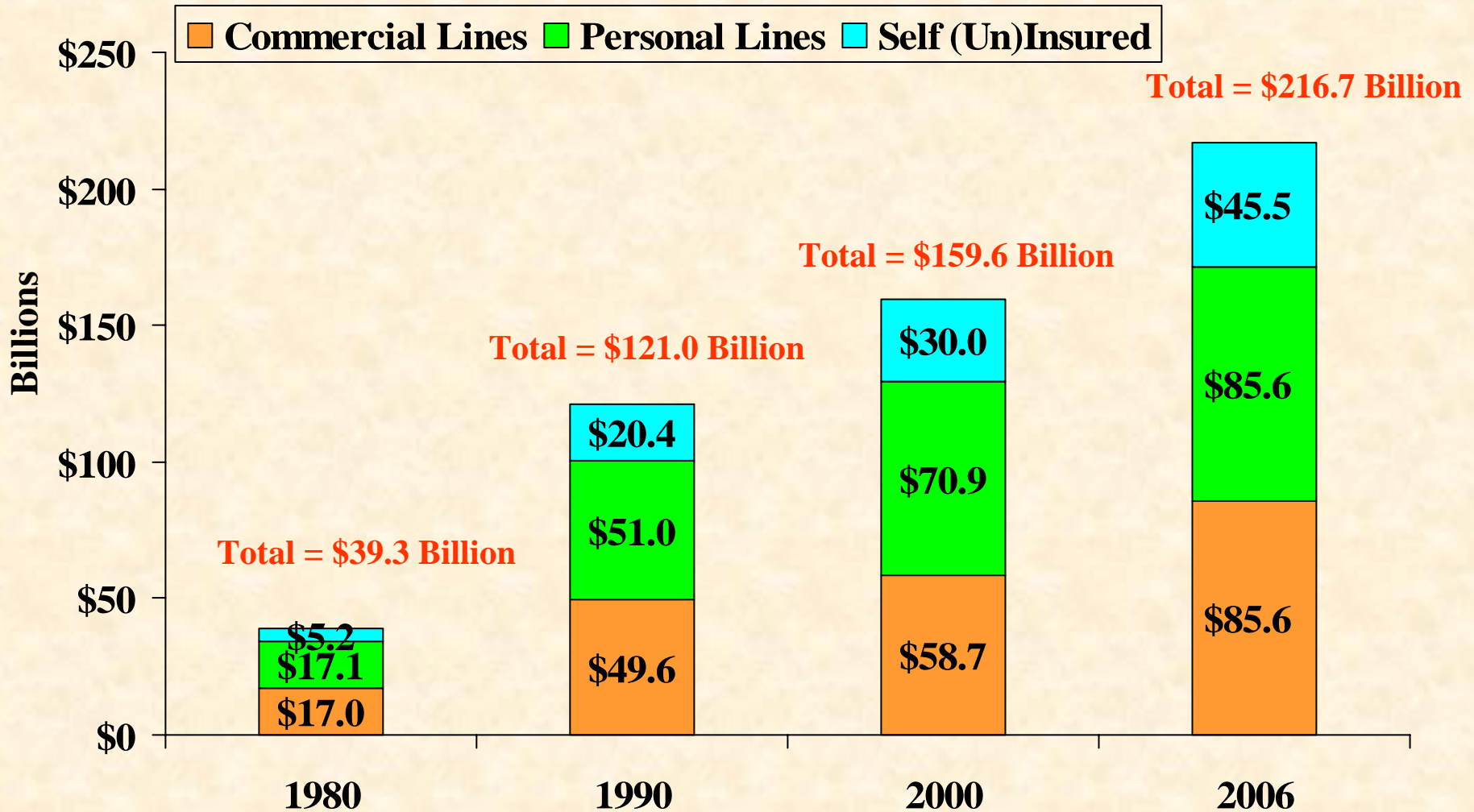
Shifting Legal Liability & Tort Environment

*Will the Pendulum Swing
Against Insurers?*





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



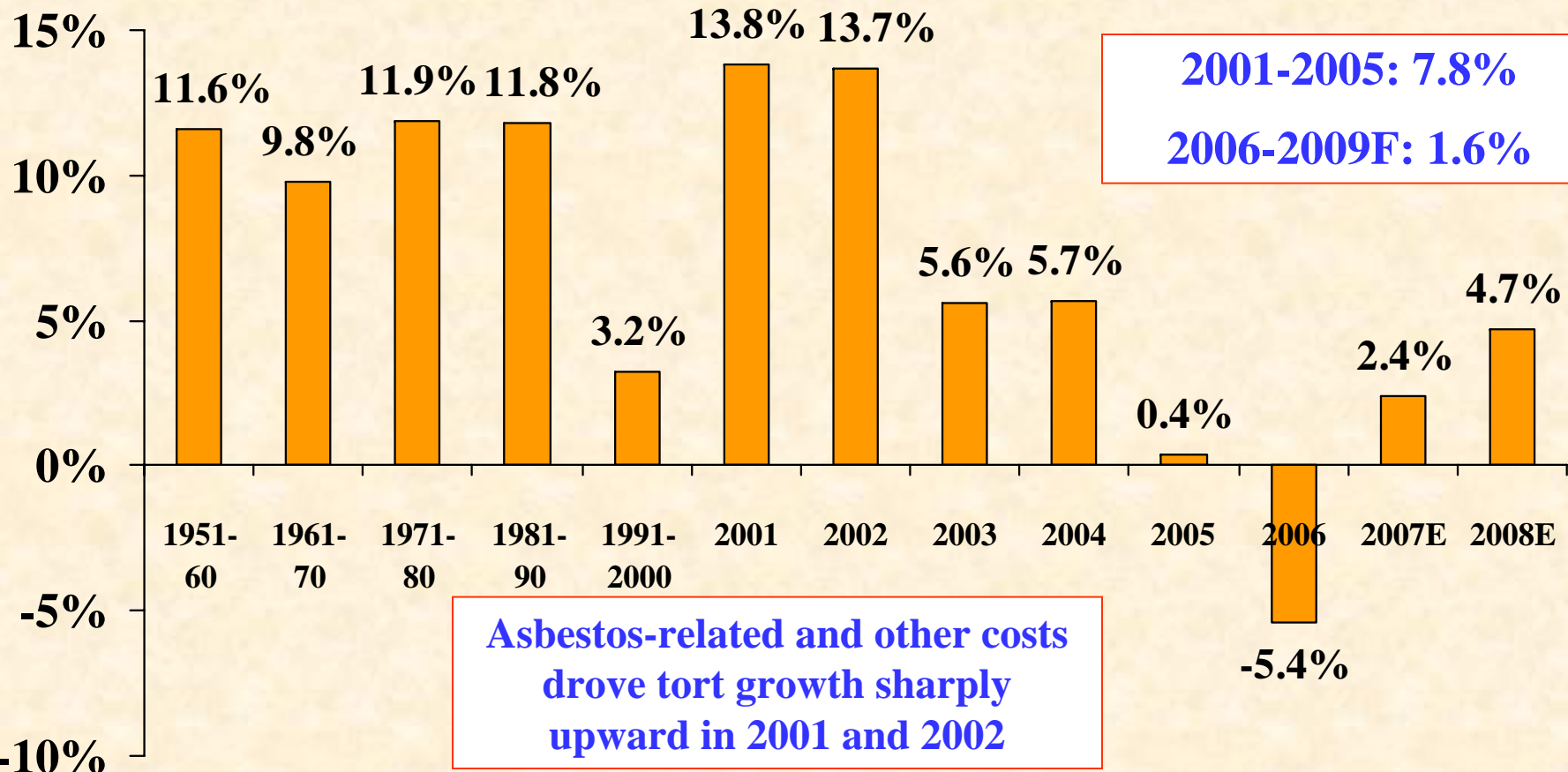
*Excludes medical malpractice

Source: Tillinghast-Towers Perrin, 2007 Update on US Tort Cost Trends.



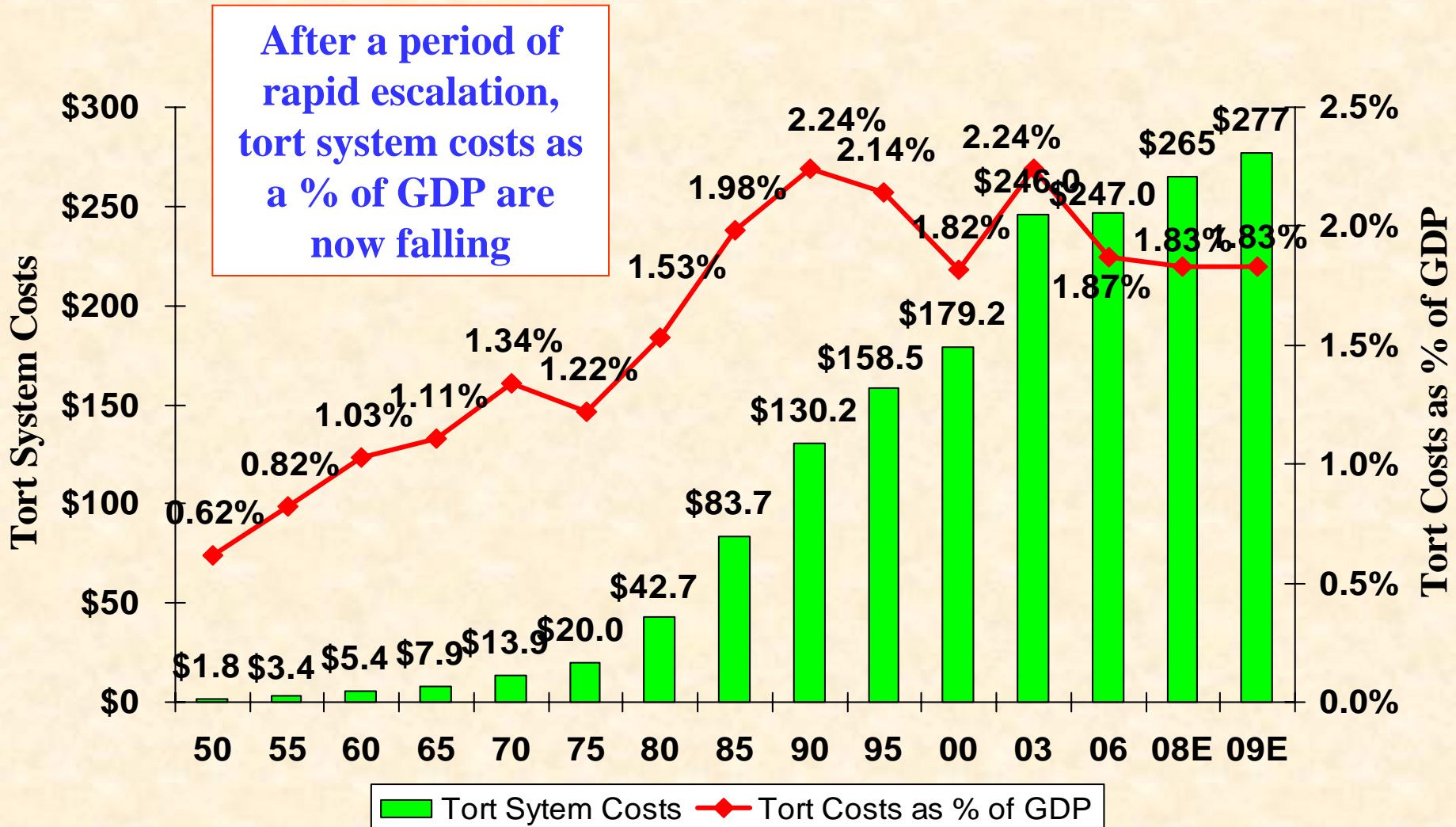
Growth in Cost of U.S. Tort System, 1951-2009F

Tort costs moderated beginning in 2003 as many improvements in the tort system began to bear fruit





Tort System Costs, 1950-2009E





The Nation's Judicial Hellholes (2007)

Watch List

Madison County, IL

St. Clair County, IL

Northern New Mexico

Hillsborough County, FL

Delaware

California

Dishonorable Mentions

District of Columbia

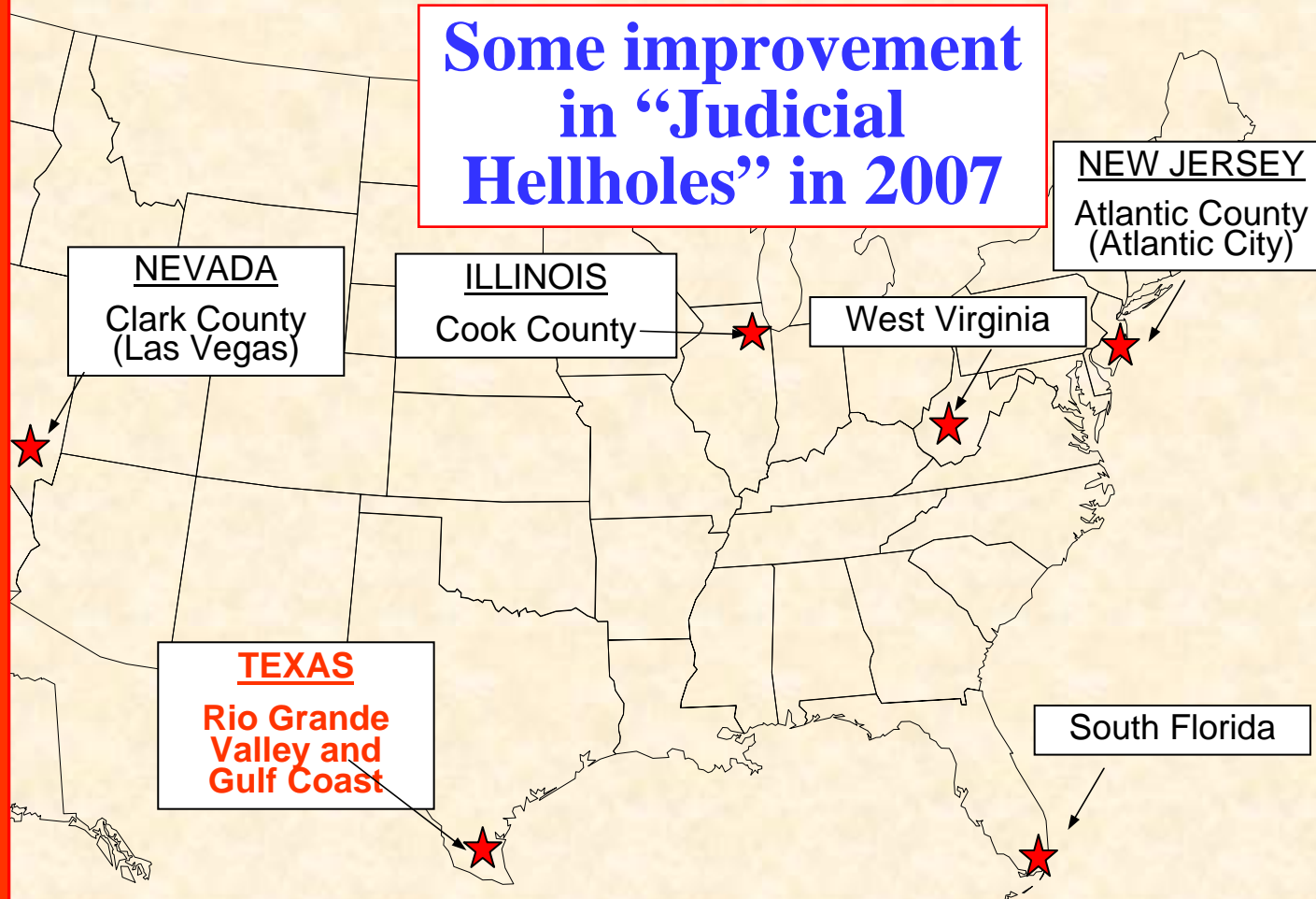
MO Supreme Court

MI Legislature

GA Supreme Court

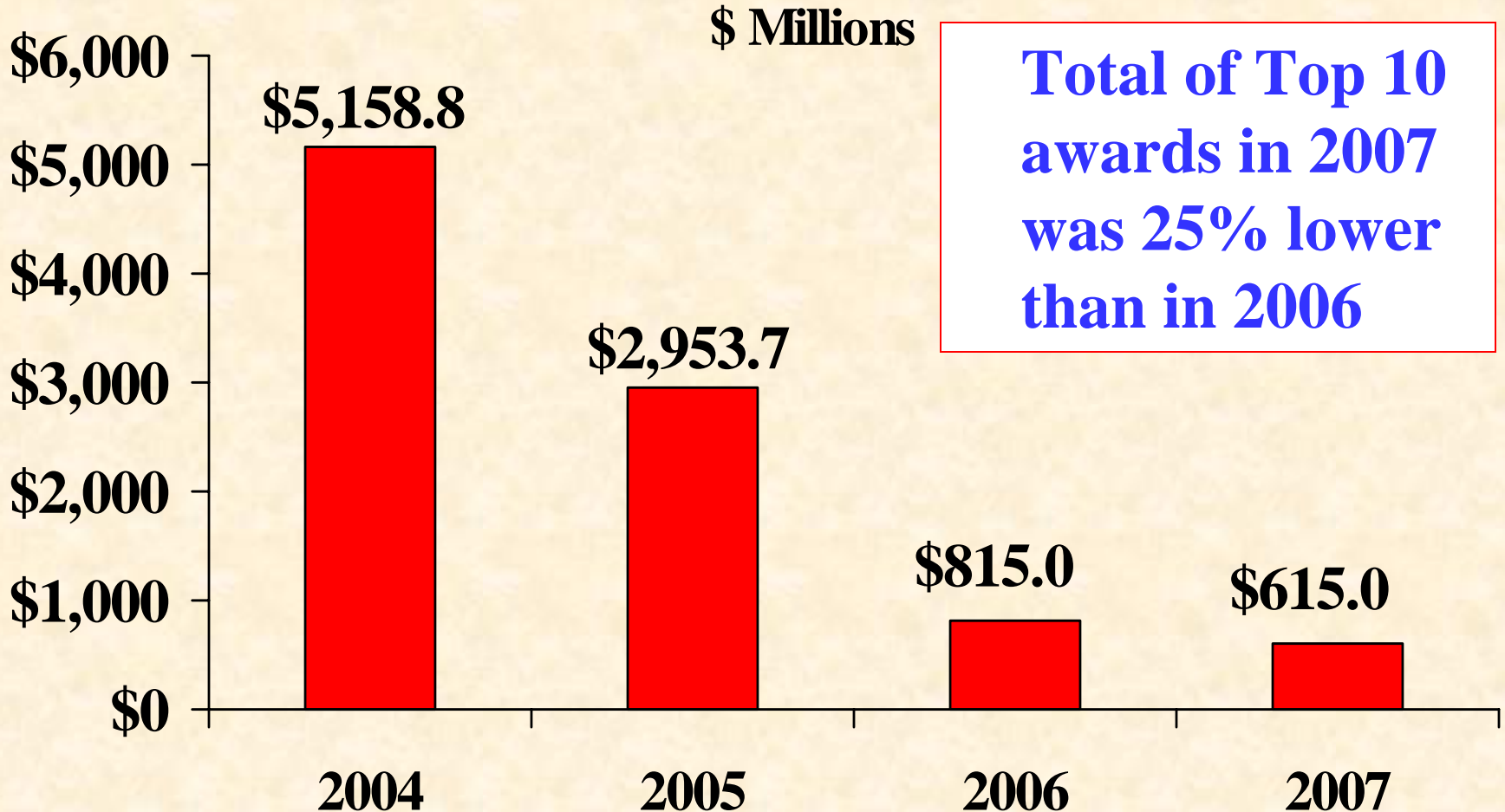
Oklahoma

Some improvement
in "Judicial
Hellholes" in 2007





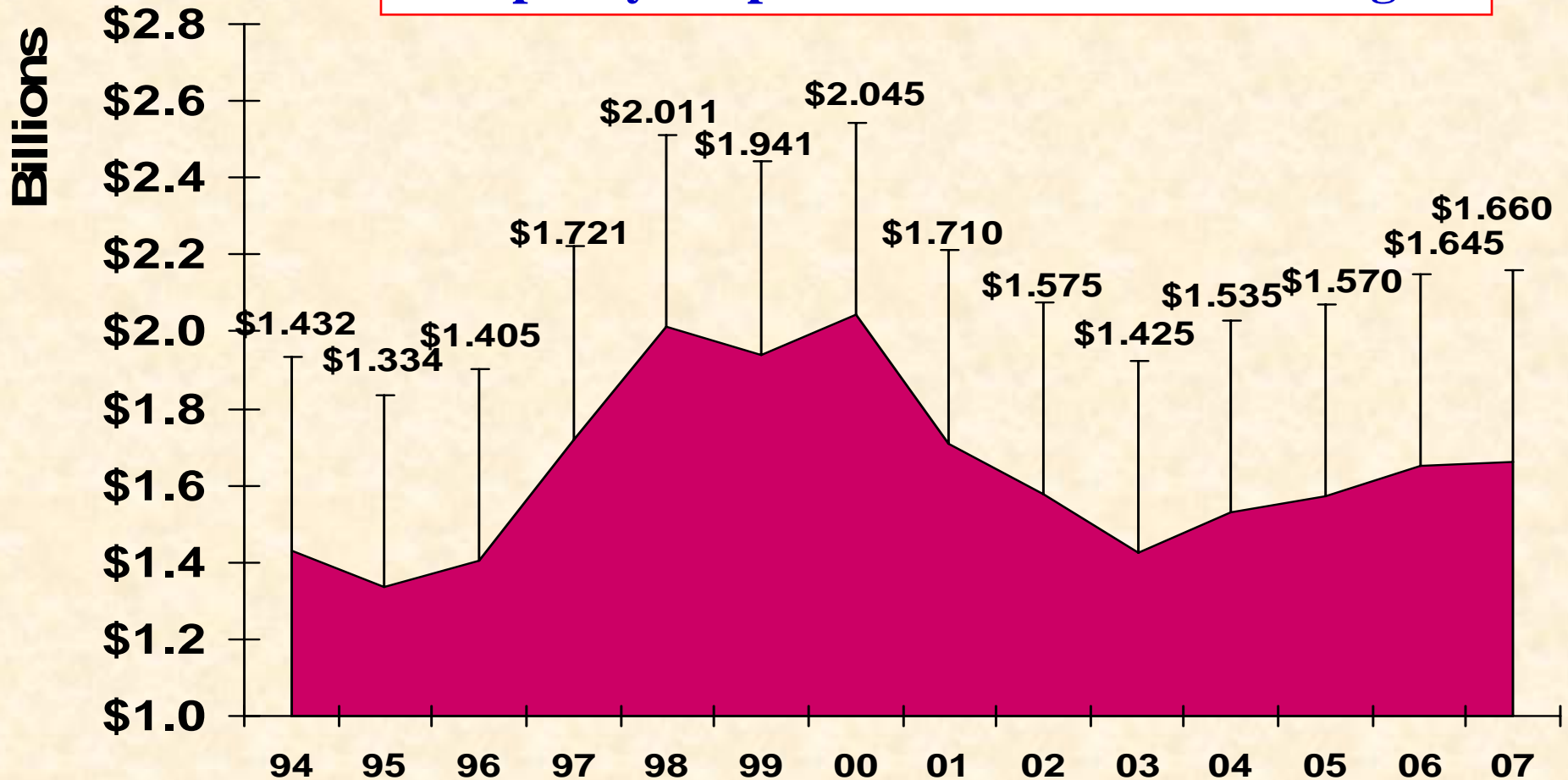
Sum of Top 10 Jury Awards





Excess Liability Market Capacity – North America

Capacity is up 16.5% since its 2003 trough





Summary

- **Economy will provide muted bumps for insurers**
- **Results were very good in 2006/07; Overall profitability reached its highest level (est. 12-13%) since 1988**
- **Underwriting results were aided by lack of CATs & favorable underlying loss trends, including tort system improvements**
- **Property cat reinsurance markets past peak & more competitive**
- **Premium growth rates are slowing to their levels since WW II; Commercial leads decreases.**
- **Rising investment returns insufficient to support deep soft market in terms of price, terms & conditions as in 1990s**
- **How/where to deploy/redeploy capital??**
- **Major Challenges:**
 - **Slow Growth Environment Ahead; Cyclical & Economic**
 - **Maintaining price/underwriting discipline**
 - **Managing variability/volatility of results**
 - **Managing regulatory/legislative environment**



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