

2008: A Make or Break Year for the P/C Insurance Industry?

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Annual Issues Symposium
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Presentation Outline

- **Weakening Economy: *Insurance Impacts & Implications***
 - Implications of Treasury “Blueprint” for insurers
- **Profitability**
- **Underwriting Trends**
- **Premium Growth**
- **Rising Expenses**
- **Capacity**
- **Investment Overview**
- **Catastrophic Loss**
- **Shifting Legal Liability & Tort Environment**
- **Presidential Politics & P/C Profitability**

A STORMY ECONOMIC FORECAST

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





What's Going On With the US and Global Economies Today?

Fundamental Factors Affecting Global Economy in 2008

- **Puncture of Not One, But Two Bubbles:** Credit and Housing in US
 - Burst Bubble → Asset Price Deflation
 - Subprime mortgage market was first part of credit bubble to burst
- **Expanding Credit Crunch:** Some credit markets have effectively seized
- **Flight to Quality/Security:** US Treasury securities are the most sought after in the world
- **Global Contagion Effect:** Securitization of asset back securities, derivatives based on those securities amplified via leverage produced contagion effect
 - Many financial institutions around the world found they are exposed
- **Global Economic Impacts:** Global Economic Slowdown
 - GDP growth in US down sharply, employment falling; Deceleration abroad too
 - Crashing dollar
 - Inflation accelerating
 - New bubbles forming in commodities and currencies



Real GDP Growth*



*Yellow bars are estimates/forecasts.

Source: US Department of Commerce, Blue Economic Indicators 4/08; Insurance Information Institute.



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 (e.g., Bear Stearns)**
 - Cash infusions necessary; Sovereign Wealth Funds important source
 - Federal Reserve forced into playing a larger role; must improvise
- 3. Most Significant Economic Event in a Generation**
 - US economy will recover, but will take 18-24 months
- 4. Shuffling of Global Economic Deck**
 - 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

- Reduces bond yields (65% - 80% of portfolio)
- Potentially contributes to inflation longer run

Fed Debt Swaps

- Fed will swap up to \$200B in bank holdings of mortgage back securities for Treasuries; Improves bank finances

Bear Stearns Bailout

- Fed on 3/14 (via J.P. Morgan) provided Bear Stearns with cash after what is effectively a “run on the bank”
- “**Too Big to Fail**” doctrine is activated
- Fed acting to prevent broader loss of confidence



What's Being Done to Fix the Economy? → Impacts on Insurers (cont'd)

Economic Fix	Impacts on Insurers
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">• Treasury March 31 “Blueprint” affects all financial firms• For insurers, major recommendation is established of Optional Federal Charter under Office of National Insurance within Treasury



Post-Crunch: Fundamental Issues To Be Examined Globally

- **Adequacy of Risk Management, Control & Supervision at Financial Institutions Worldwide**
 - Colossal failure of risk management (and regulation)
 - 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 II) 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

SUMMARY OF TREASURY “BLUEPRINT” FOR FINANCIAL SERVICES MODERNIZATION

Impacts on Insurers





Treasury Regulatory Recommendations Affecting Insurers

- **Establishment of an Optional Federal Charter (OFC)**
 - **Would provide system for federal chartering, licensing, regulation and supervision of insurers, reinsurer and producers (agents & brokers)**
 - **OFC insurers would still be subject to state taxes, provisions for compulsory coverage, residual market and guarantee funds**
 - **OFC would specify specific lines covered by charter; Separate charters needed for P/C and Life**
- **OFC Would Incorporate Several Regulatory Concepts**
 - **Ensure “safety and soundness” (solvency)**
 - **Enhance competition in national and international markets**
 - **Increase efficiency through elimination of price controls, promote more rapid technological change, encourage product innovation, reduce regulatory costs and provide consumer protection**

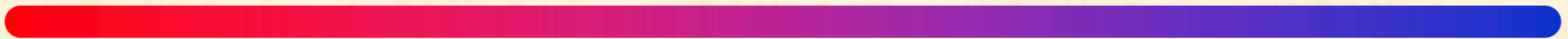


Treasury Regulatory Recommendations Affecting Insurers (cont'd)

- **Establishment of Office of National Insurance (ONI)**
 - Department within Treasury to regulate insurance pursuant to OFC
 - Headed by Commissioner of National Insurance
 - Commissioner has regulatory, supervisory, enforcement and rehabilitative powers to oversee organization, incorporation, operation, regulation of national insurers and national agencies
- **Establishment of Office of Insurance Oversight (OIO)**
 - Department within Treasury to handle issues needing immediate attention such “reinsurance collateral”; OIO could focus immediately on “key areas of federal interest in the insurance sector”
 - OIO: lead regulatory voice on international regulatory policy
 - Would have authority to ensure states achieved uniform implementation of declared US international insurance policy goals
 - OIO would also serve as advisor to Treasury Secretary on major domestic and international policy issues
- **UPDATE: HR 5840 Introduced April 17 Would Establish Office of Insurance Information (OII)**
 - Very similar to OIO

INSURANCE & THE ECONOMY

*Important But Somewhat
Muted Impacts*





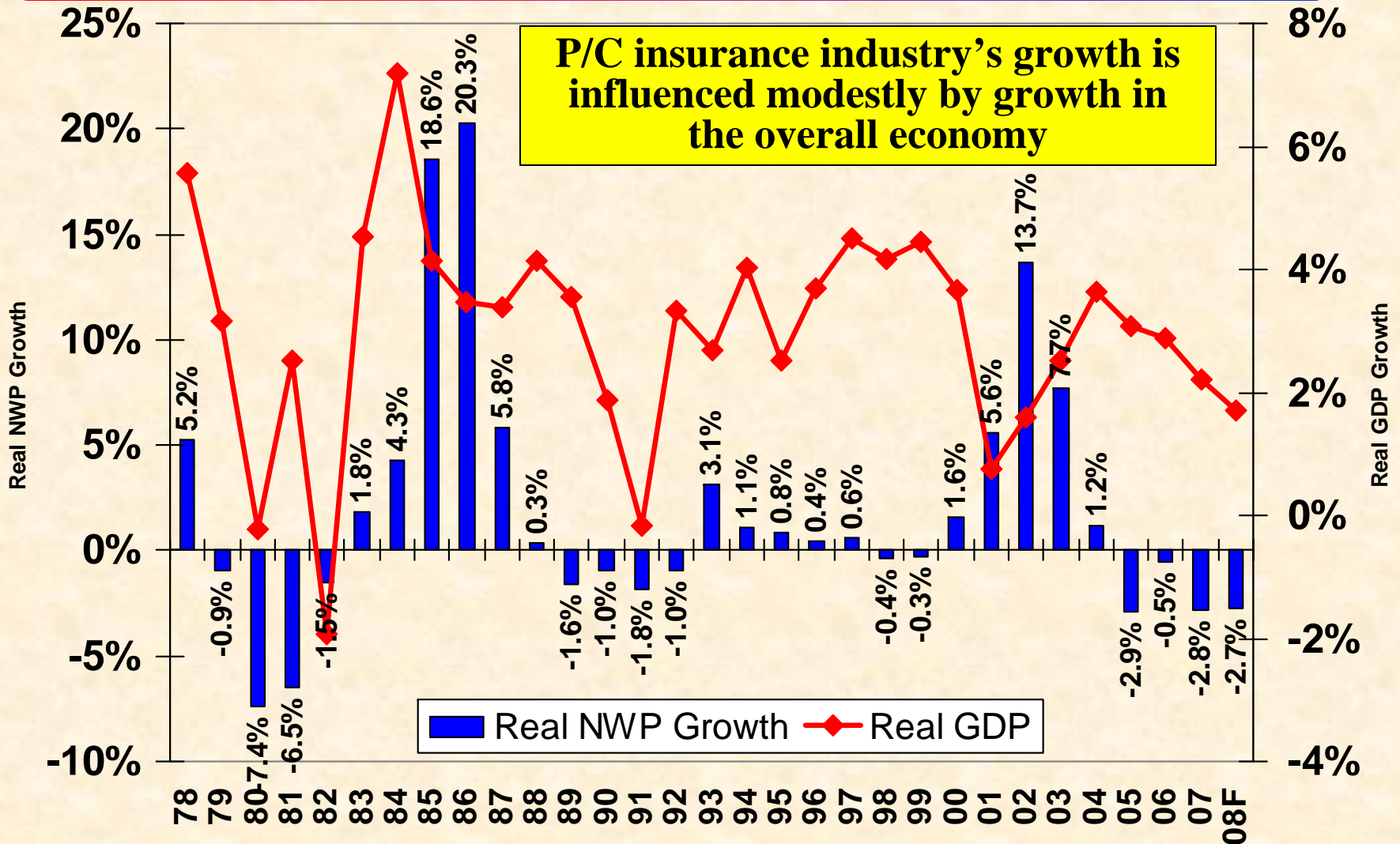
A Few Facts About the Relationship Between Insurance & Economy

- **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

Premium Growth: Modest Association



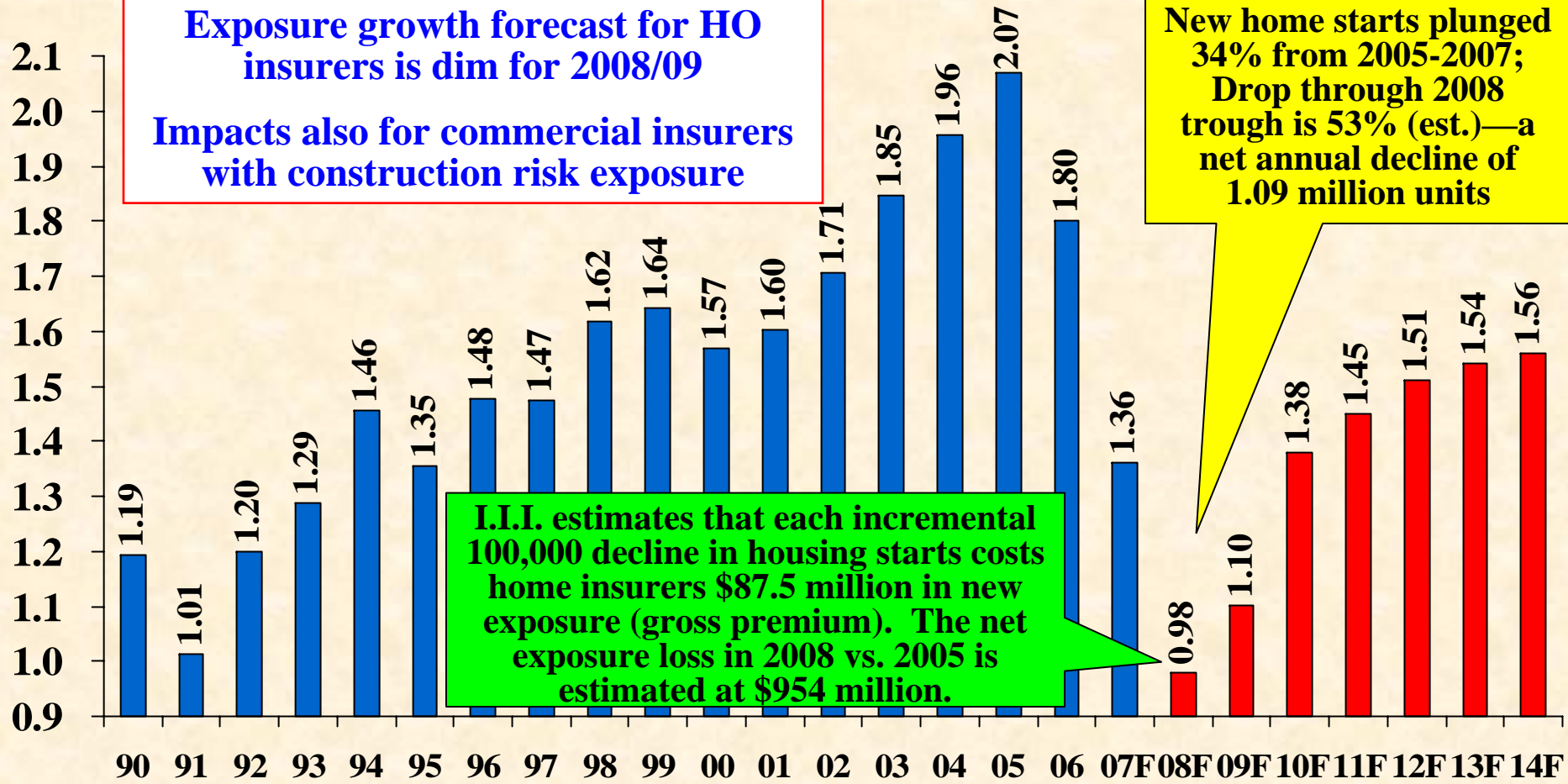


Summary of Economic Risks and Implications for (Re) Insurers

Economic Concern	Risks to Insurers
Subprime Meltdown/ Credit Crunch	<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

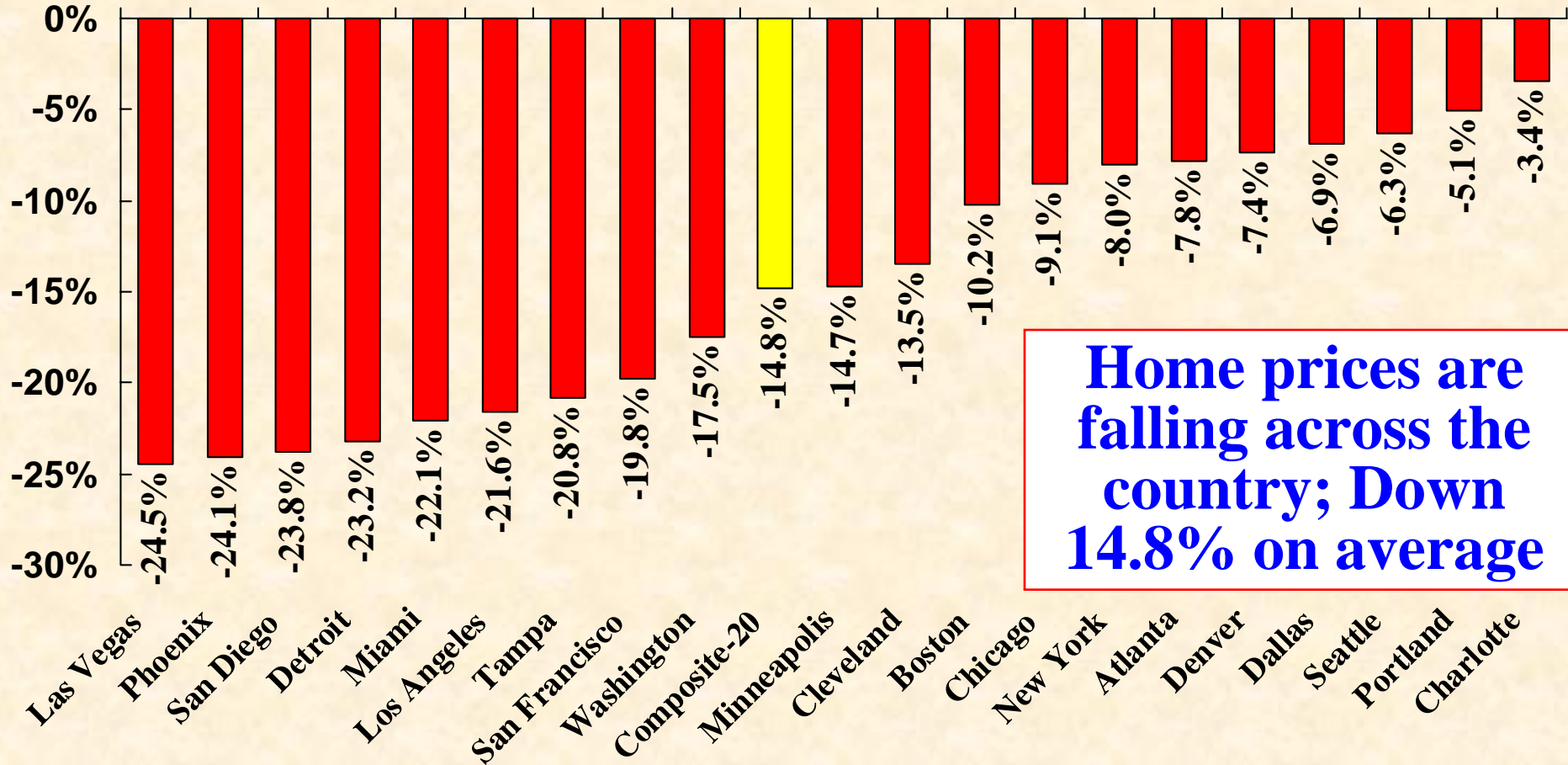


New Private Housing Starts, 1990-2014F (Millions of Units)





Change in Home Values from Maximum Price, by City*



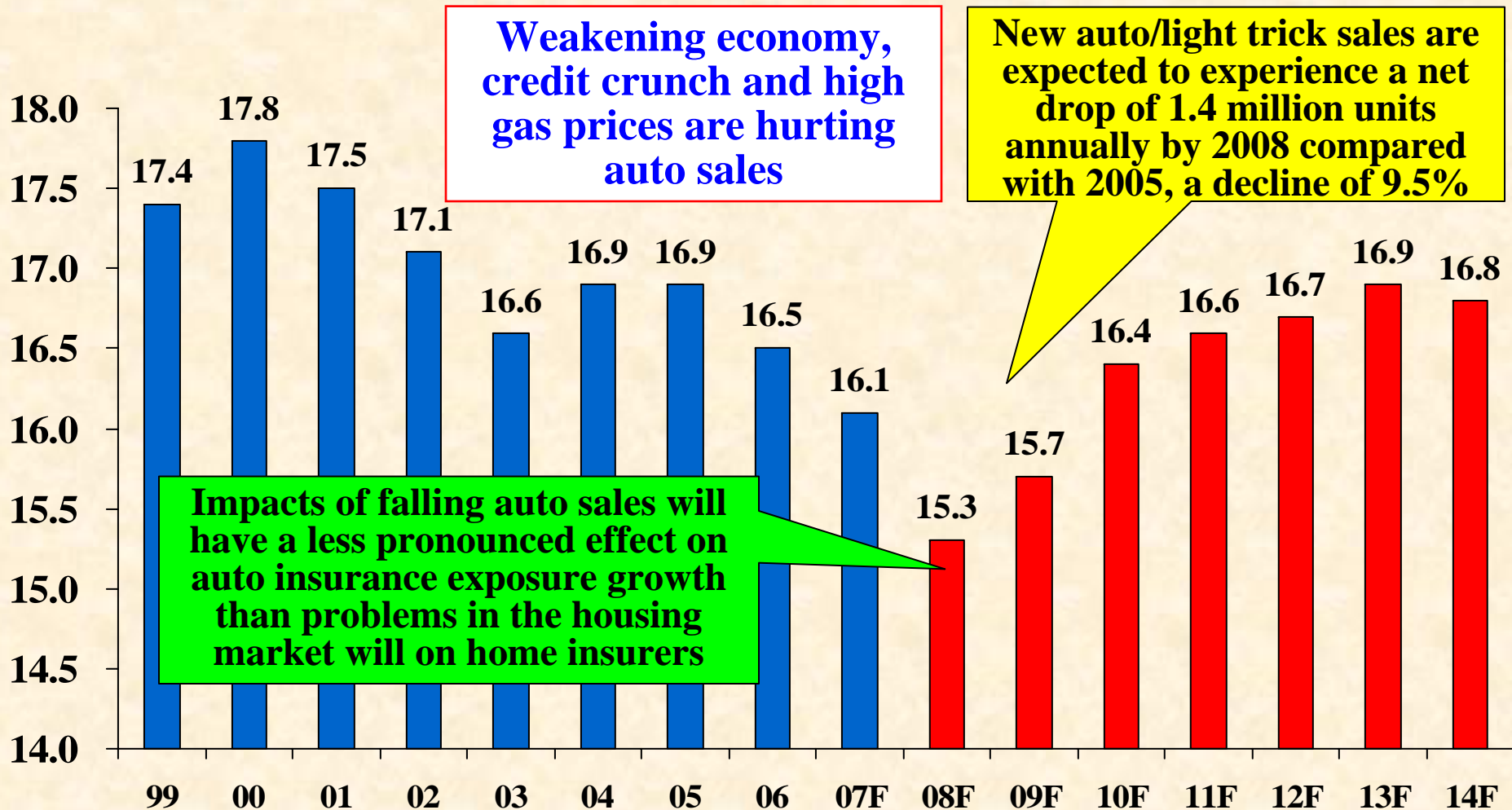
Home prices are falling across the country; Down 14.8% on average

*Calculated as of Feb. 2008 (latest available) by ILL from monthly Case-Schiller price index data. Date of maximum price varies by city (July 2006 for 20-city composite).

Source: Case-Schiller Home Price Index at Standardandpoors.com; Insurance Info. Institute

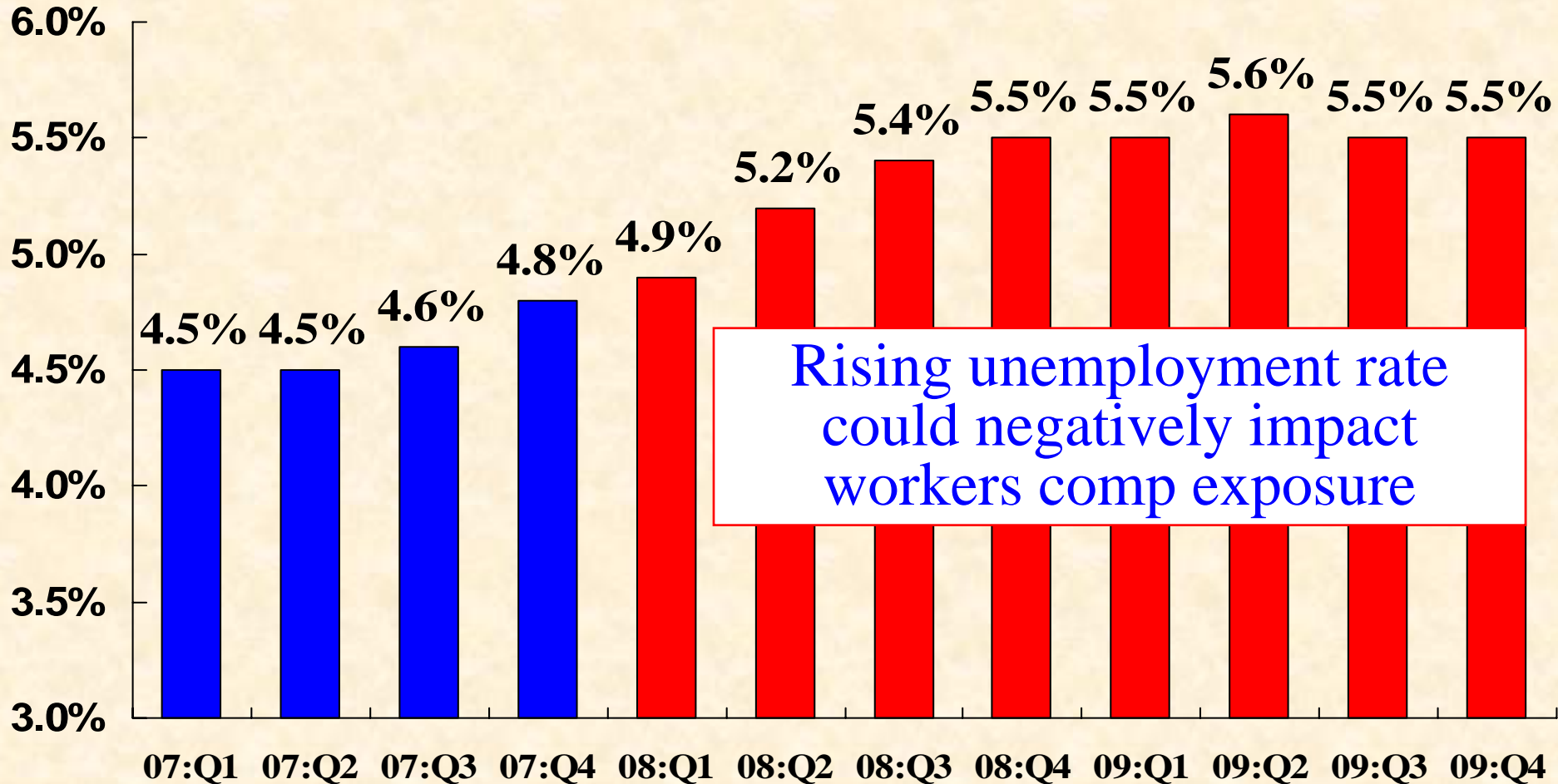


Auto/Light Truck Sales, 1999-2014F (Millions of Units)





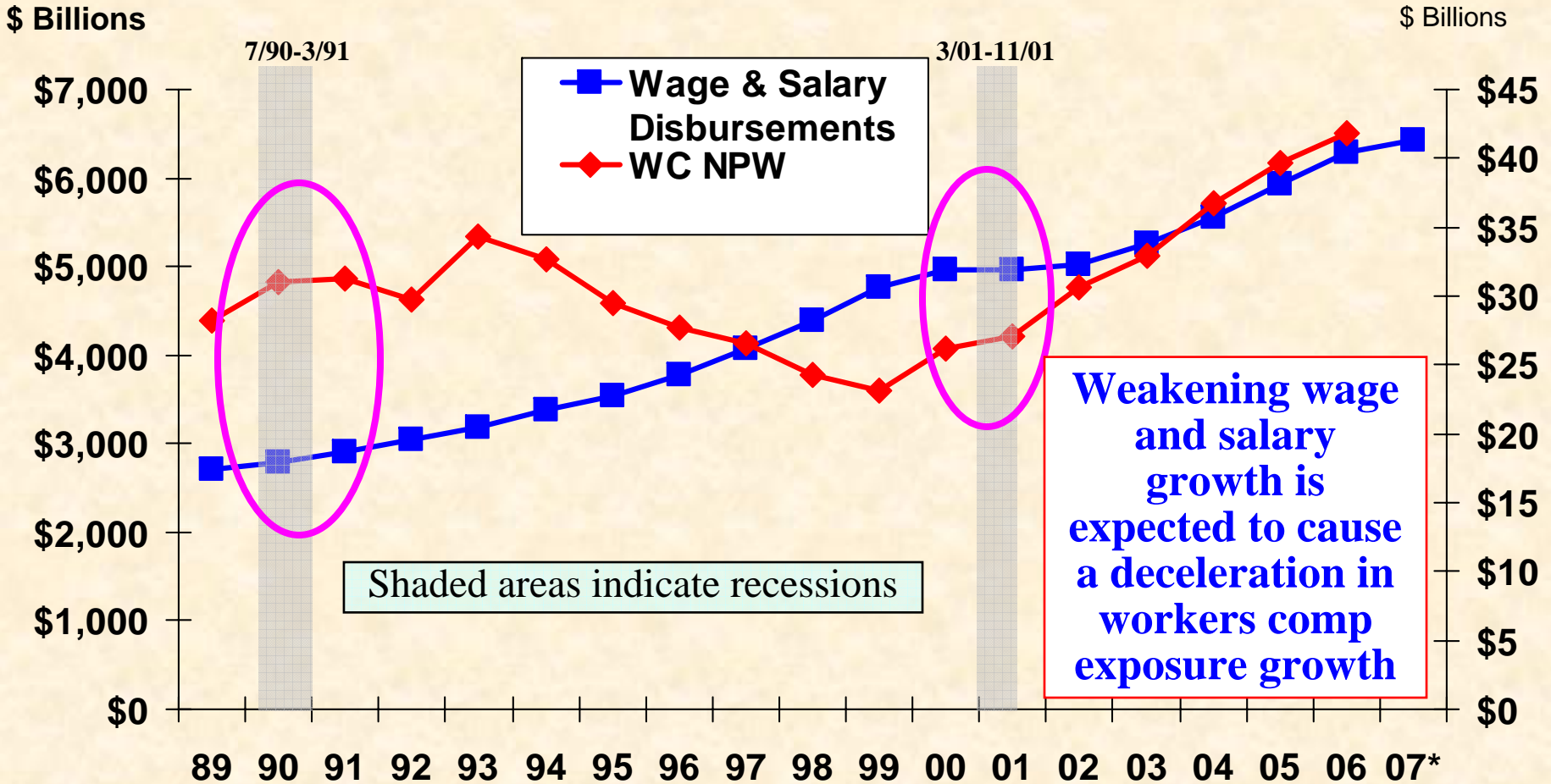
US Unemployment Rate, (2007:Q1 to 2009:Q4F)





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).

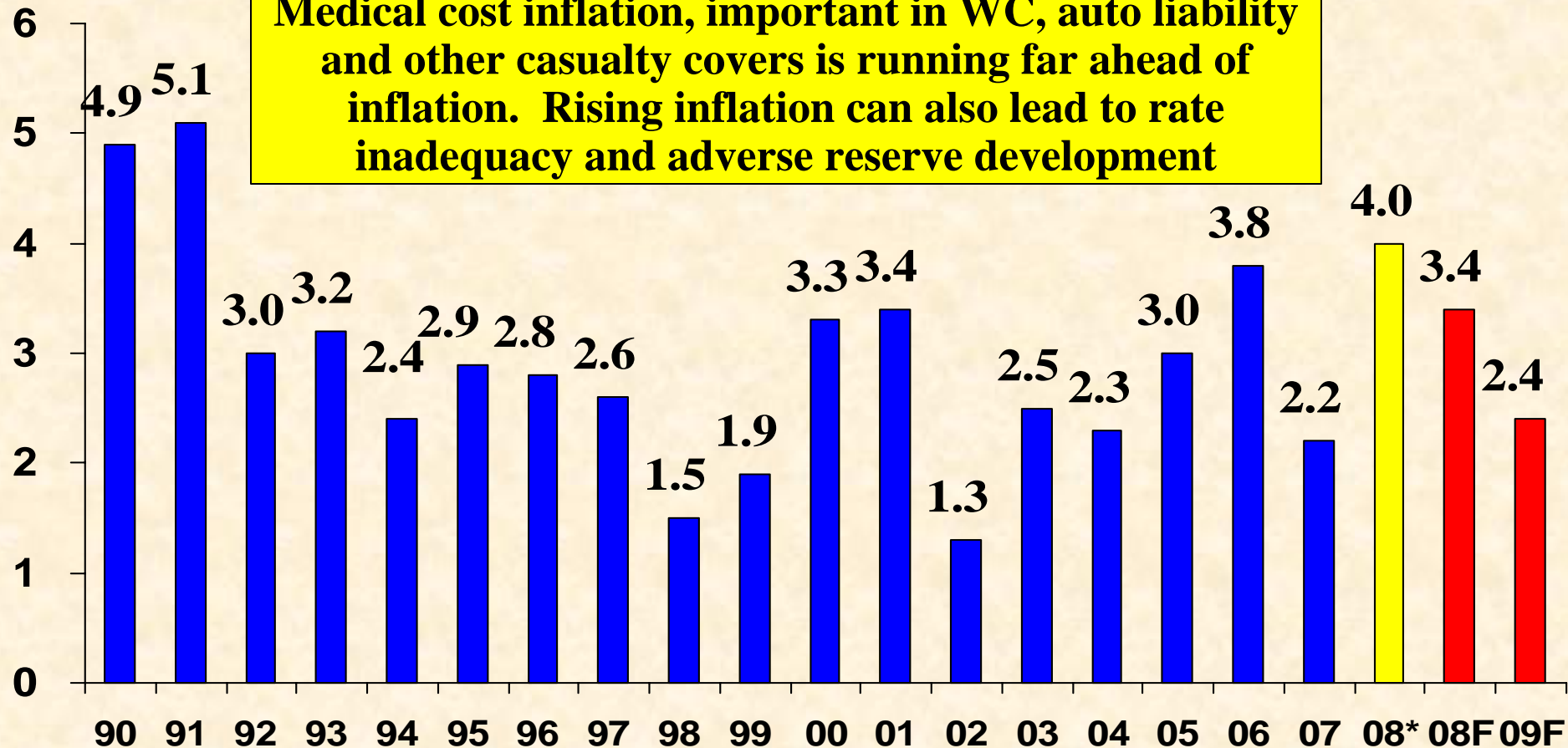
Source: US Bureau of Economic Analysis; Federal Reserve Bank of St. Louis at

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



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

Inflation was just 2.2% in 2007 but is accelerating. Medical cost inflation, important in WC, auto liability and other casualty covers is running far ahead of inflation. Rising inflation can also lead to rate inadequacy and adverse reserve development



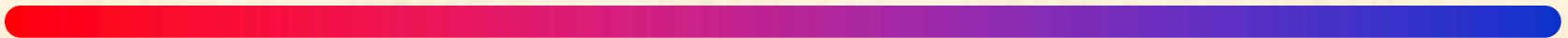
*12-month change March 2008 vs. March 2007;

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

PROFITABILITY

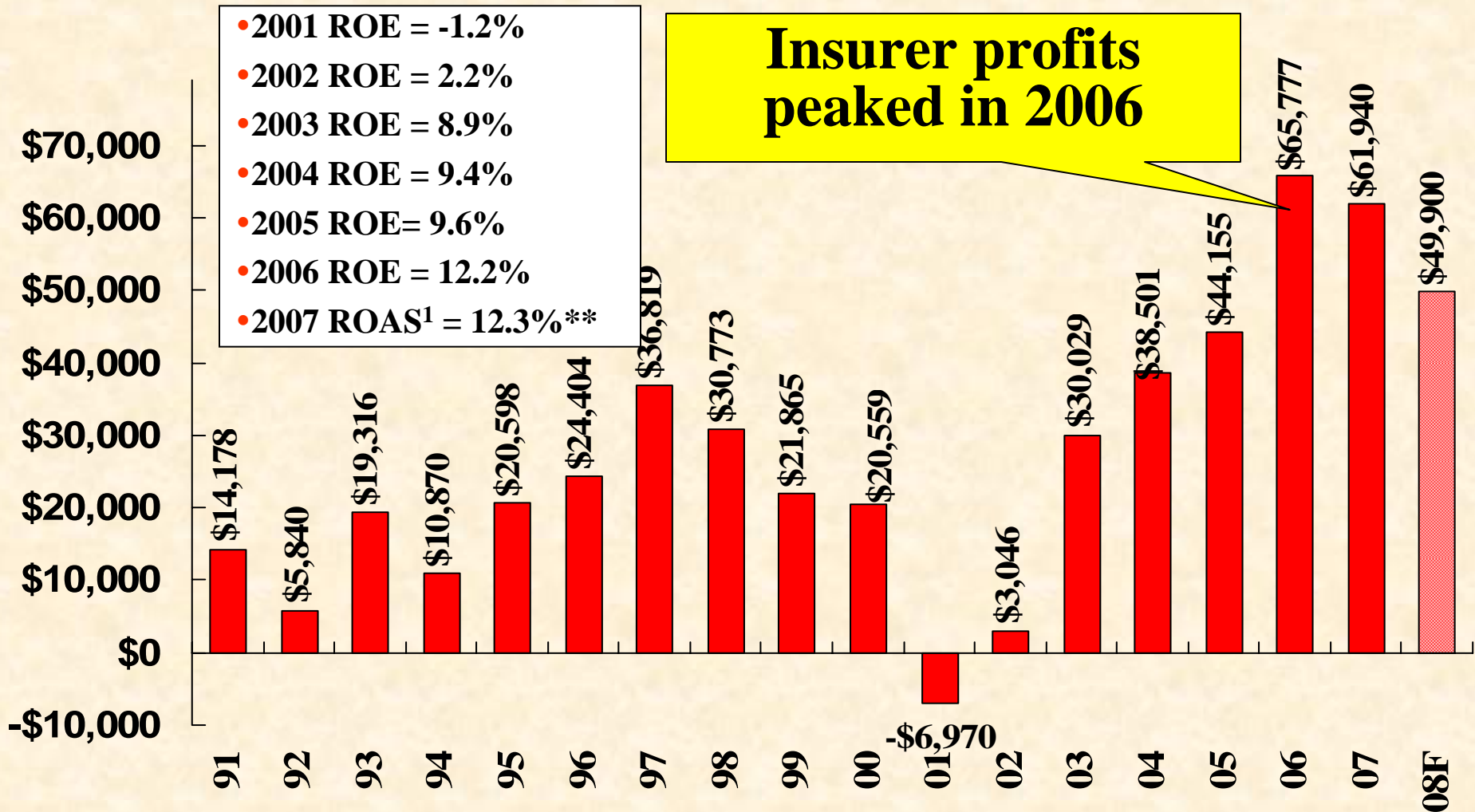
*Profits in 2006/07 Reached
Their Cyclical Peak;*

*By No Reasonable Standard Can Profits
Be Deemed Excessive*





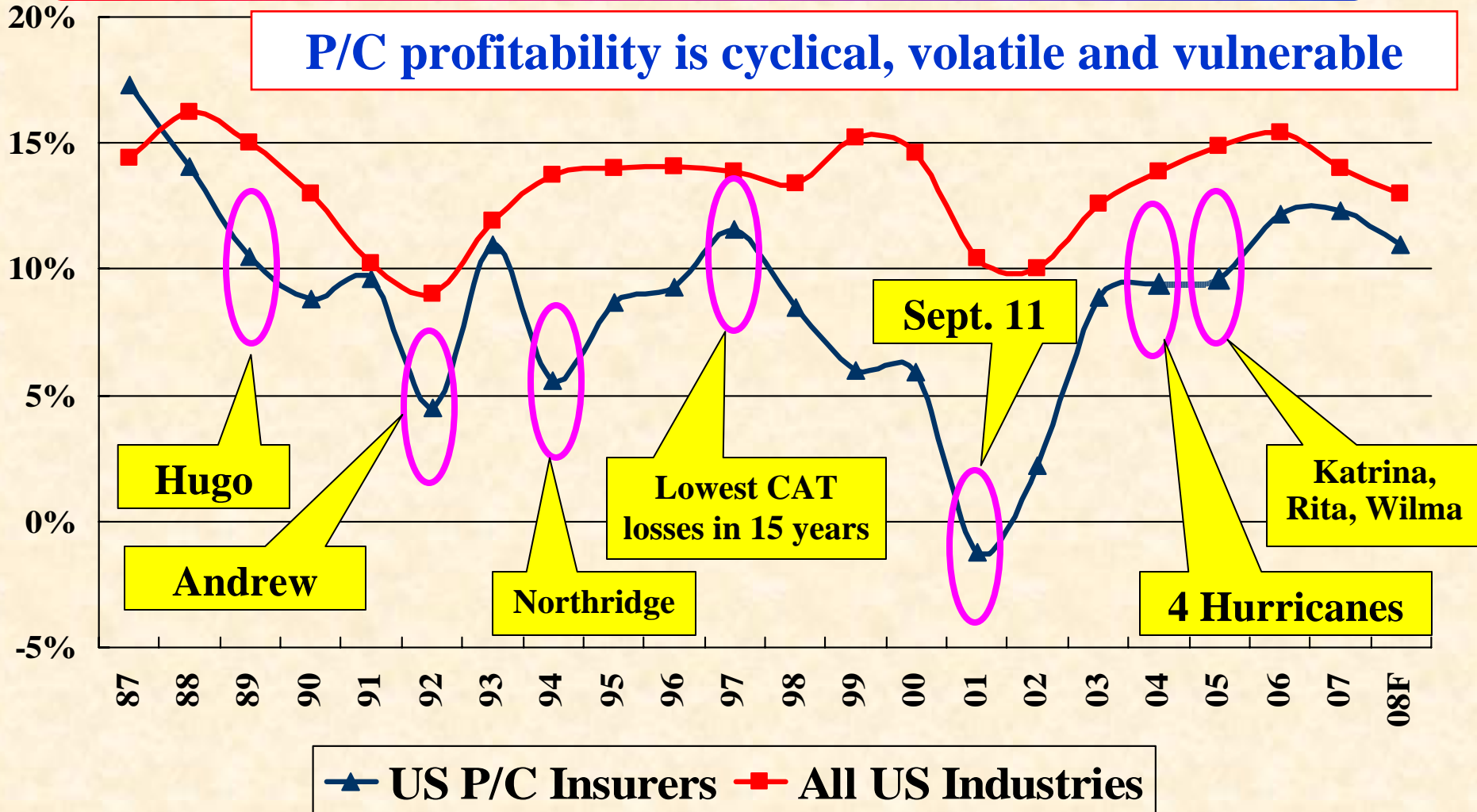
*P/C Net Income After Taxes 1991-2008F (\$ Millions)**



*ROE figures are GAAP; ¹Return on avg. surplus. **Return on Average Surplus; Sources: A.M. Best, ISO, Insurance Information Inst.



ROE: P/C vs. All Industries 1987-2008E

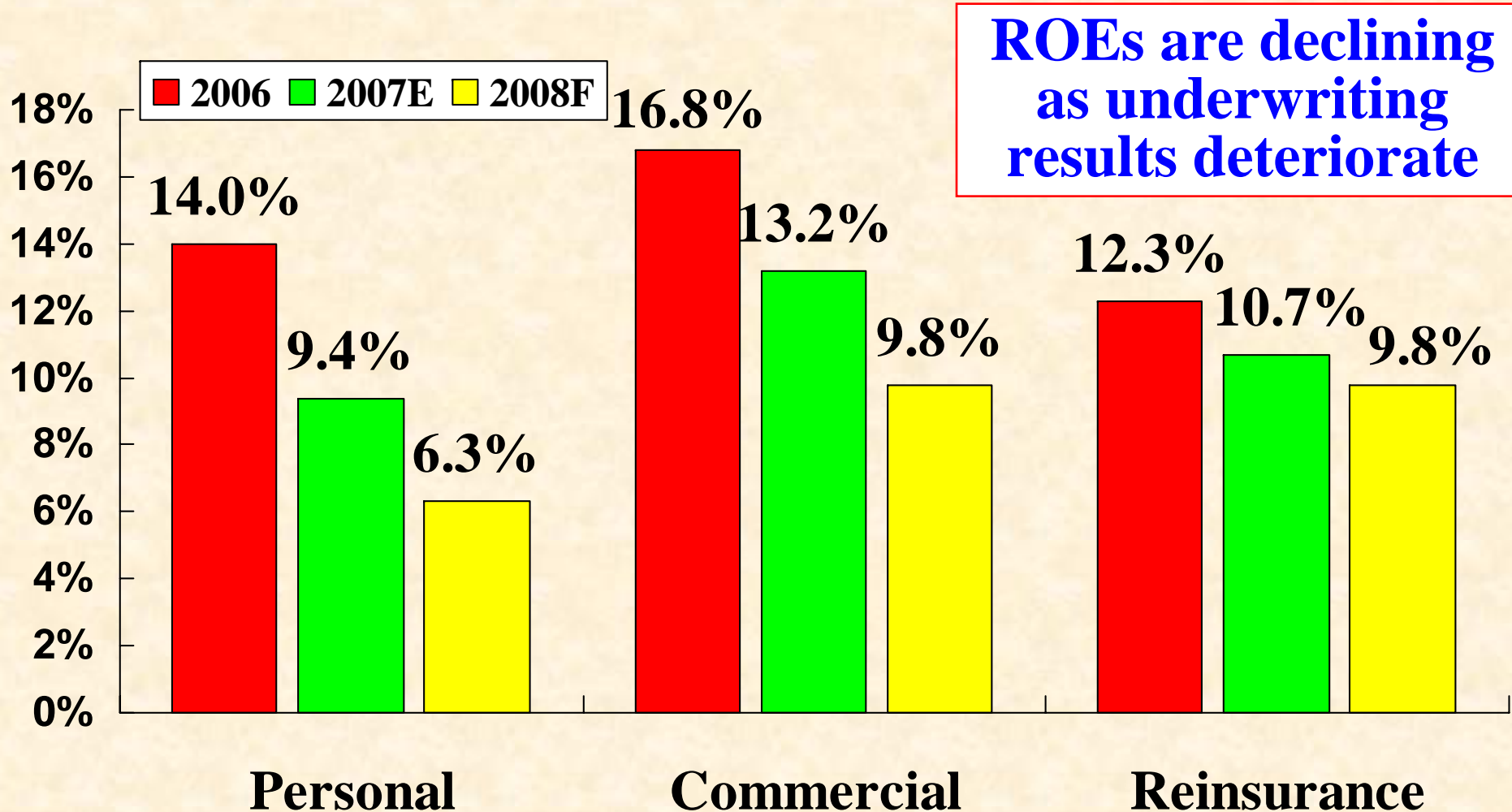


2008 P/C insurer ROE is I.I.I. estimate.

Source: Insurance Information Institute; Fortune

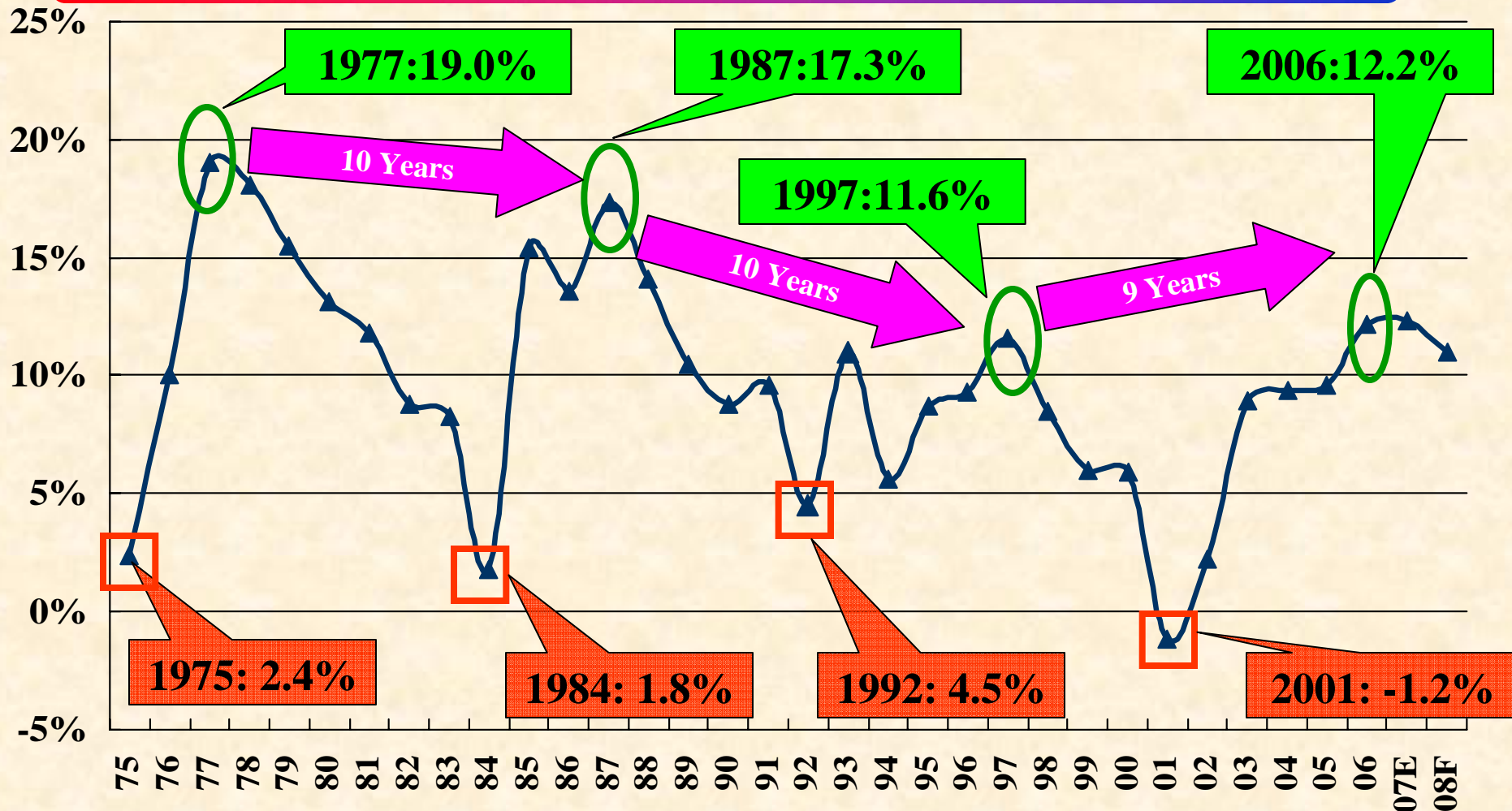


Personal/Commercial Lines & Reinsurance ROEs, 2006-2008F*





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



*GAAP ROE for all years except 2007 which is actual ROAS of 12.3%. 2008 P/C insurer ROE is I.I.I. estimate.
Source: Insurance Information Institute, ISO; *Fortune*

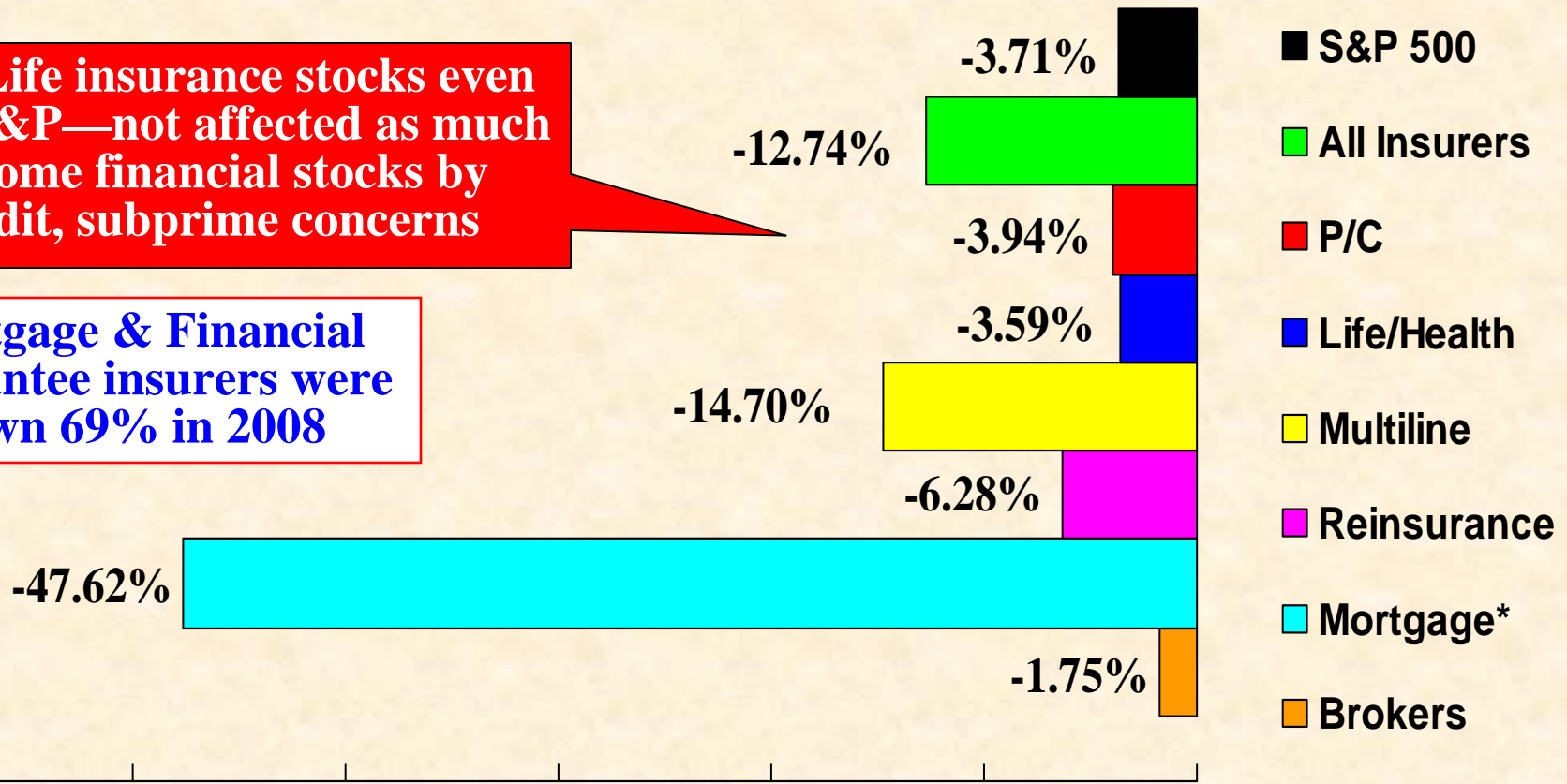


Insurance Stocks: Mixed Performance Compared to S&P 500 Index in 2008

Total YTD Returns Through May 2, 2008

P/C, Life insurance stocks even with S&P—not affected as much as some financial stocks by credit, subprime concerns

Mortgage & Financial Guarantee insurers were down 69% in 2008



-60.0% -50.0% -40.0% -30.0% -20.0% -10.0% 0.0%

*Includes Financial Guarantee.

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



Factors that Will Influence the Length and Depth of the Cycle

- **Capacity**: Rapid surplus growth in recent years has left the industry with between \$85 billion and \$100 billion in excess capital, according to analysts
 - All else equal, rising capital leads to greater price competition and a liberalization of terms and conditions
- **Reserves**: Reserves are in the best shape (in terms of adequacy) in decades, which could extend the depth and length of the cycle
 - Looming reserve deficiencies are not hanging over insurers the way they did during the last soft market in the late 1990s
 - Many companies have been releasing redundant reserves, which allows them to boost net income even as underwriting results deteriorate
 - Reserve releases will diminish in 2008; Even more so in 2009
- **Investment Gains**: 2007 was the 5th consecutive up year on Wall Street. With sharp declines in stock prices and falling interest rates, portfolio yields are certain to fall → Contributes to discipline
 - Realized capital gains are already rising as underwriting profits shrink, but like redundant reserves, realized capital gains are a finite resource
 - A sustained equity market decline (and potentially a drop in bond prices at some point) could reduce policyholder surplus

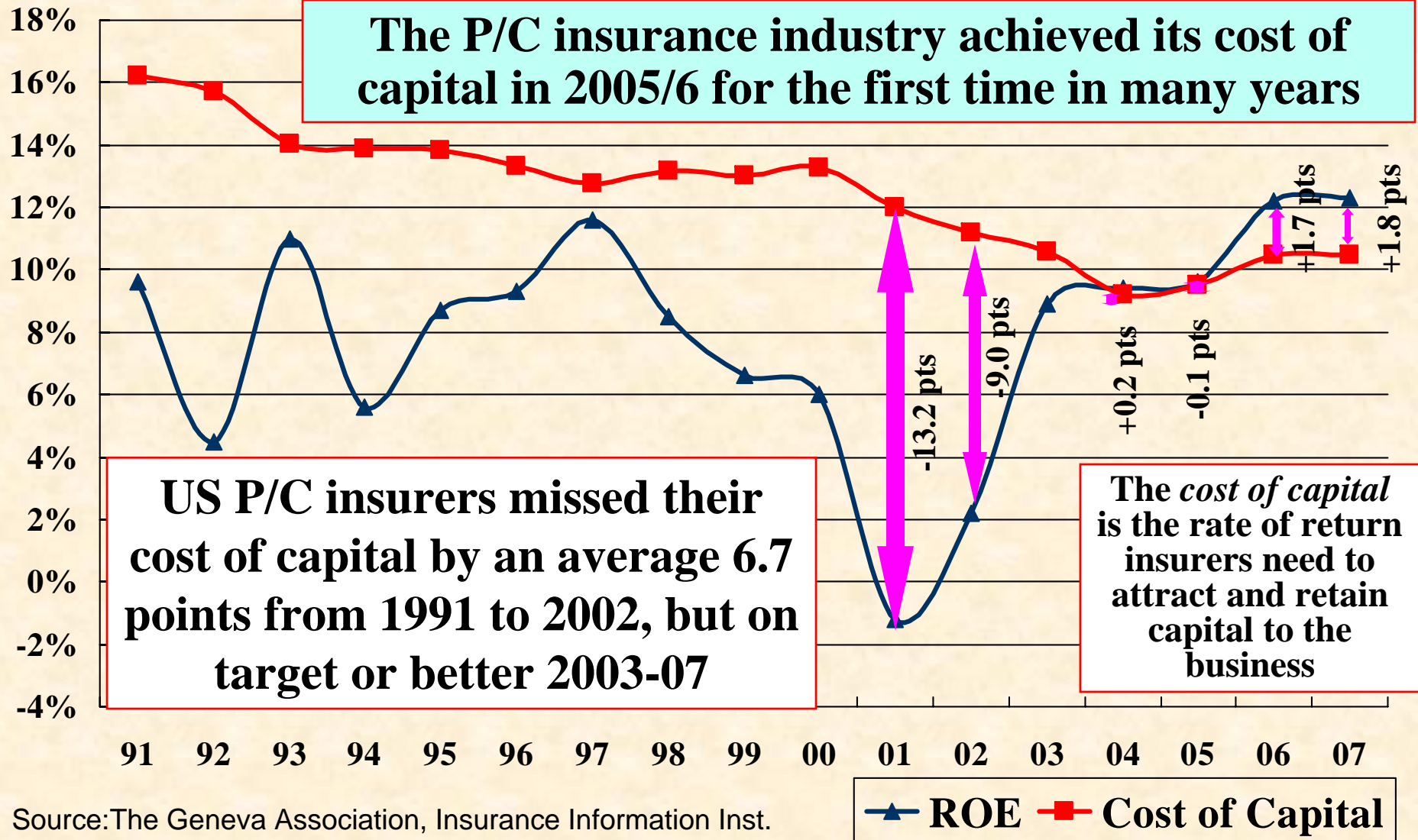


Factors that Will Influence the Length and Depth of the Cycle (cont'd)

- **Sarbanes-Oxley**: Presumably SOX will lead to better and more conservative management of company finances, including rapid recognition of deficient or redundant reserves
 - With more “eyes” on the industry, the theory is that cyclical swings should shrink
- **Ratings Agencies**: Focus on Cycle Management; Quicker to downgrade
 - Ratings agencies more concerned with successful cycle management strategy
 - Many insurers have already had ratings “haircut” over the last several years the way they did during the last soft market in the late 1990s; Less of a margin today
- **Finite Reinsurance**: Had smoothing effect on earnings; Finite market is gone
- **Information Systems**: Management has more and better tools that allow faster adjustments to price, underwriting and changing market conditions than it had during previous soft markets
- **Analysts/Investors**: Less fixated on growth, more on ROE through soft mkt.
 - Management has backing of investors of Wall Street to remain disciplined
- **M&A Activity**: More consolidation implies greater discipline
 - Liberty Mutual/Safeco deal creates 5th largest p/c insurer. More to come?



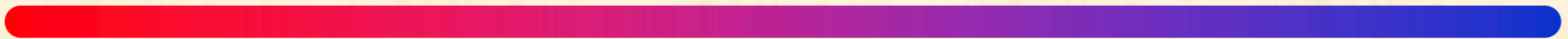
ROE vs. Equity Cost of Capital: US P/C Insurance: 1991-2007



Source: The Geneva Association, Insurance Information Inst.

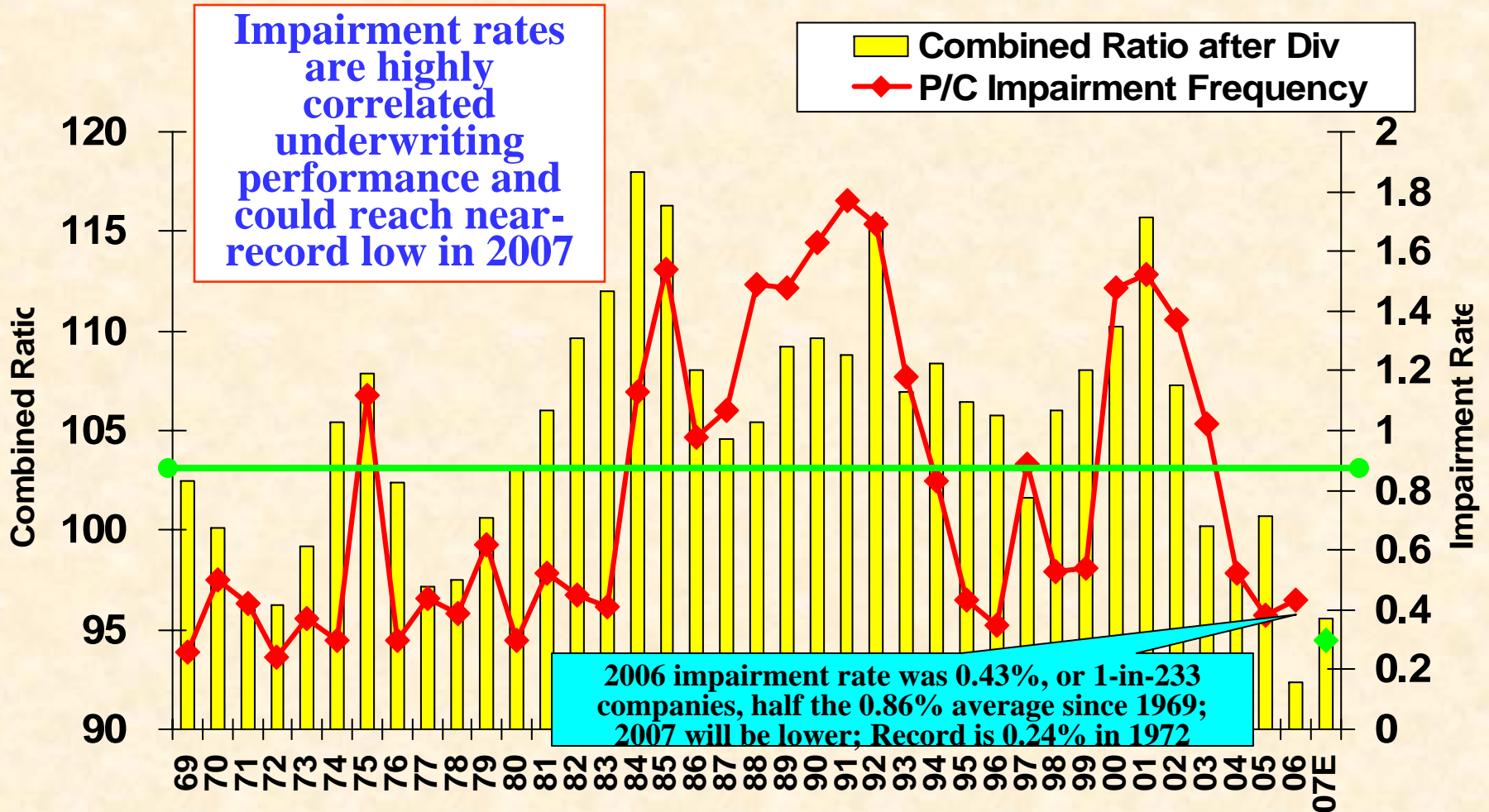
FINANCIAL STRENGTH & RATINGS

*Industry Has Weathered the Storms Well,
But Cycle May Takes Its Toll*





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

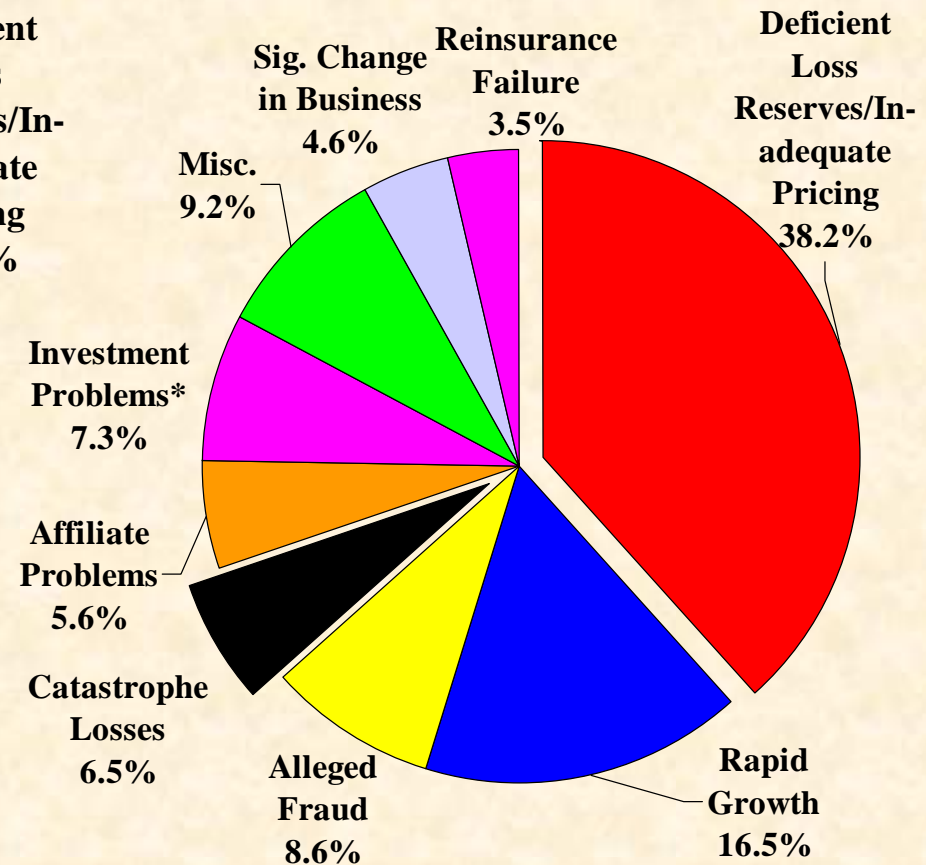
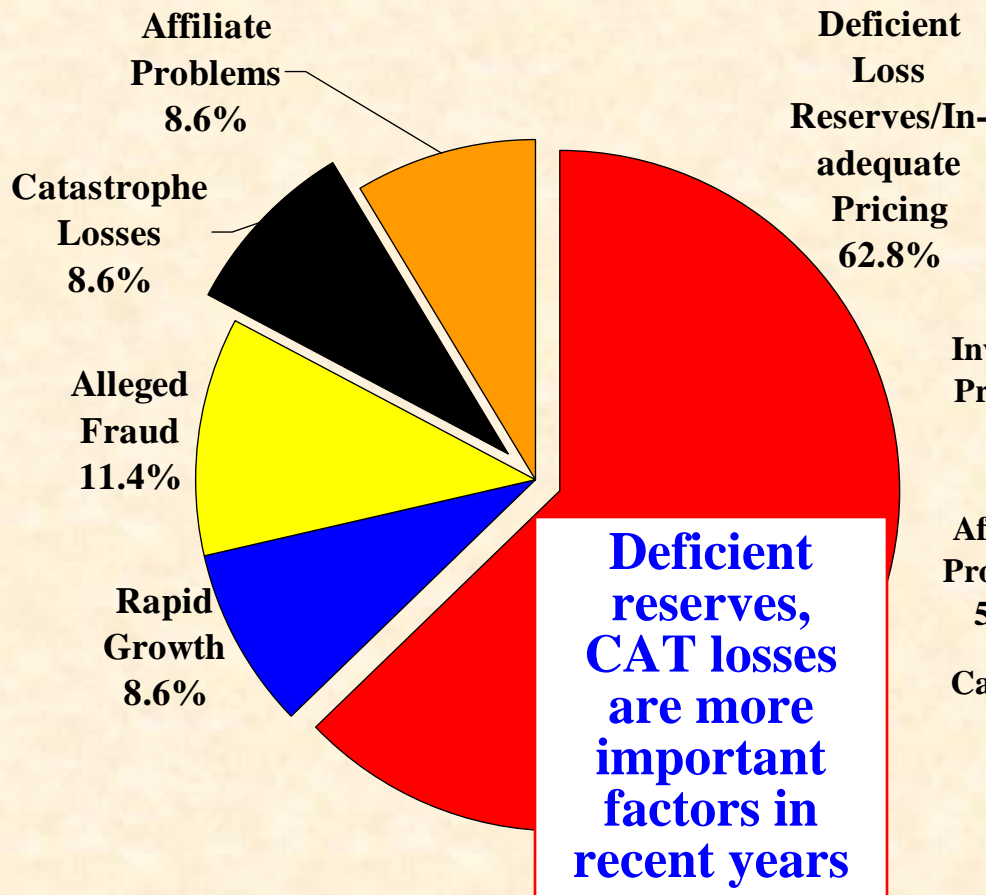




Reasons for US P/C Insurer Impairments, 1969-2005

2003-2005

1969-2005



*Includes overstatement of assets.

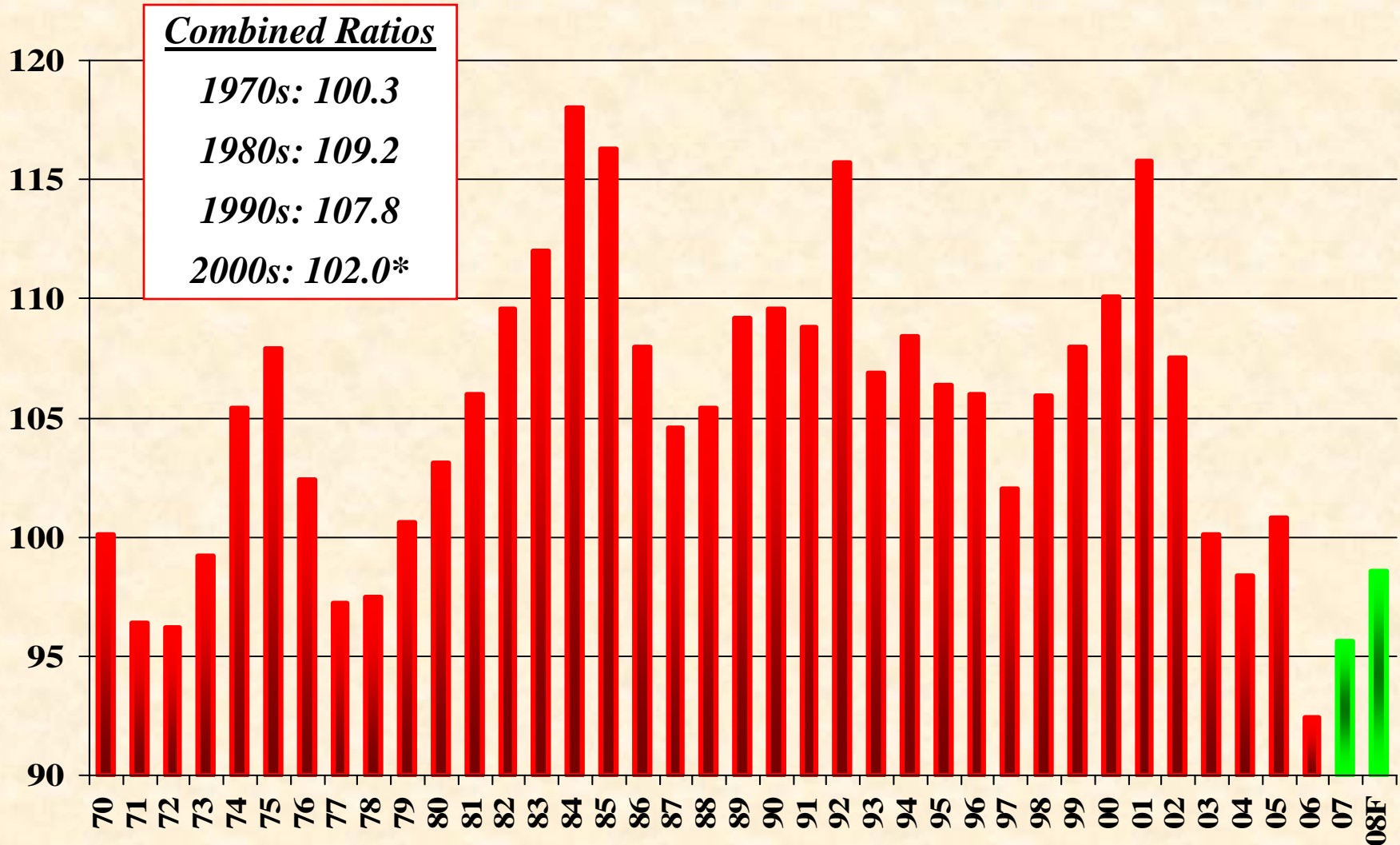
UNDERWRITING TRENDS

*Extremely Strong 2006/07;
Relying on Momentum &
Discipline for 2008*





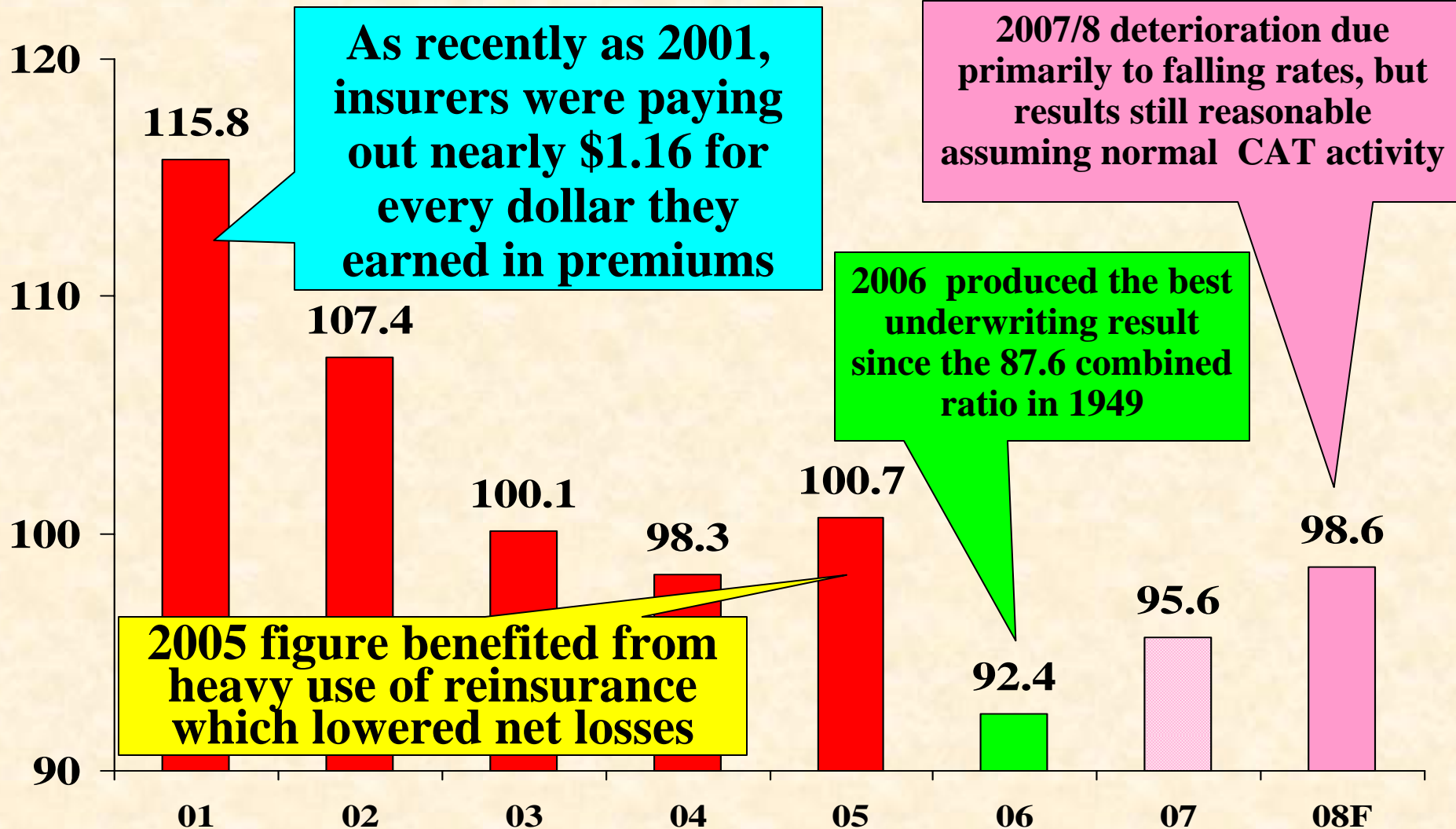
*P/C Insurance Combined Ratio, 1970-2008F**



Sources: A.M. Best; ISO, III *Full year 2008 estimates from III.

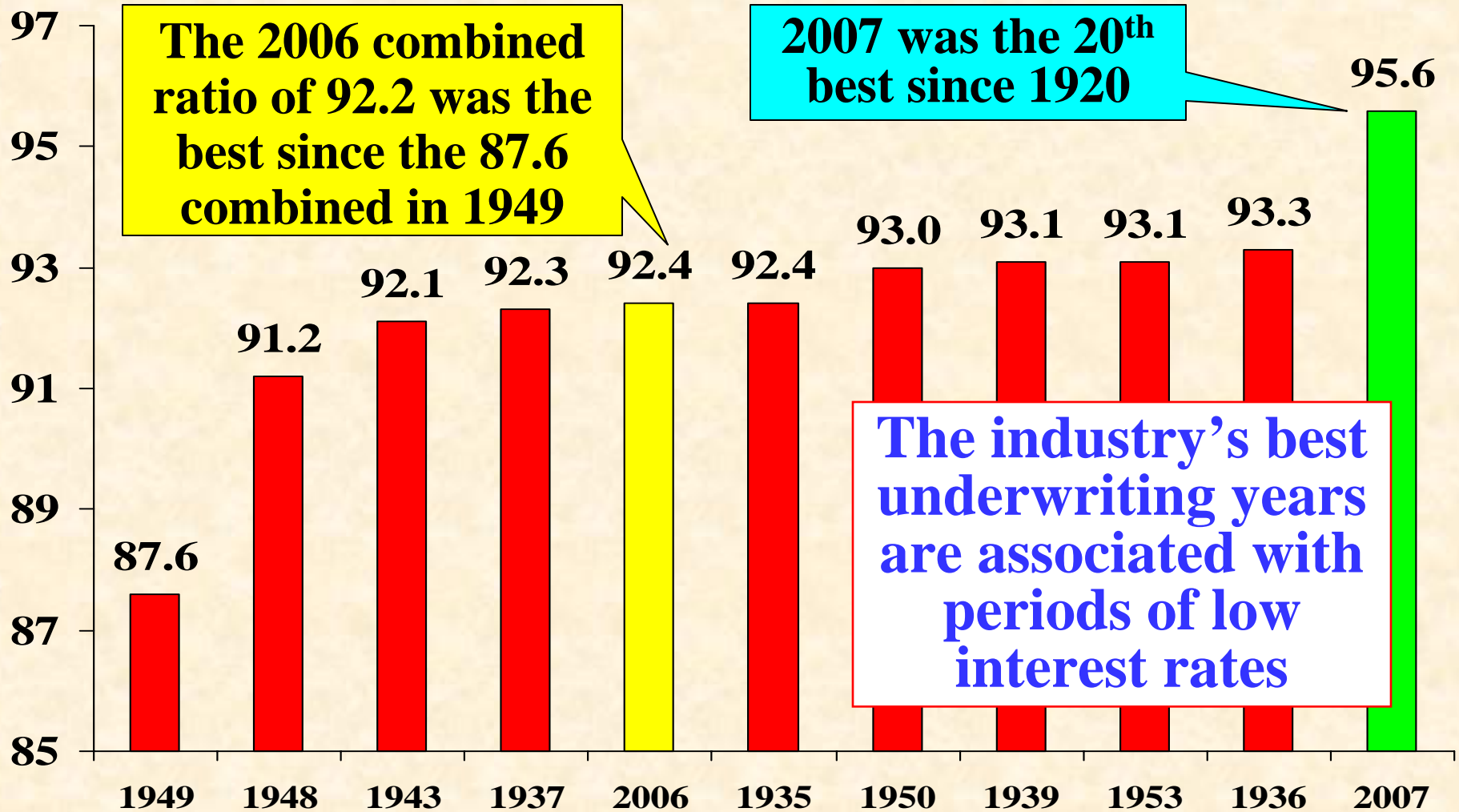


P/C Insurance Combined Ratio, 2001-2008F



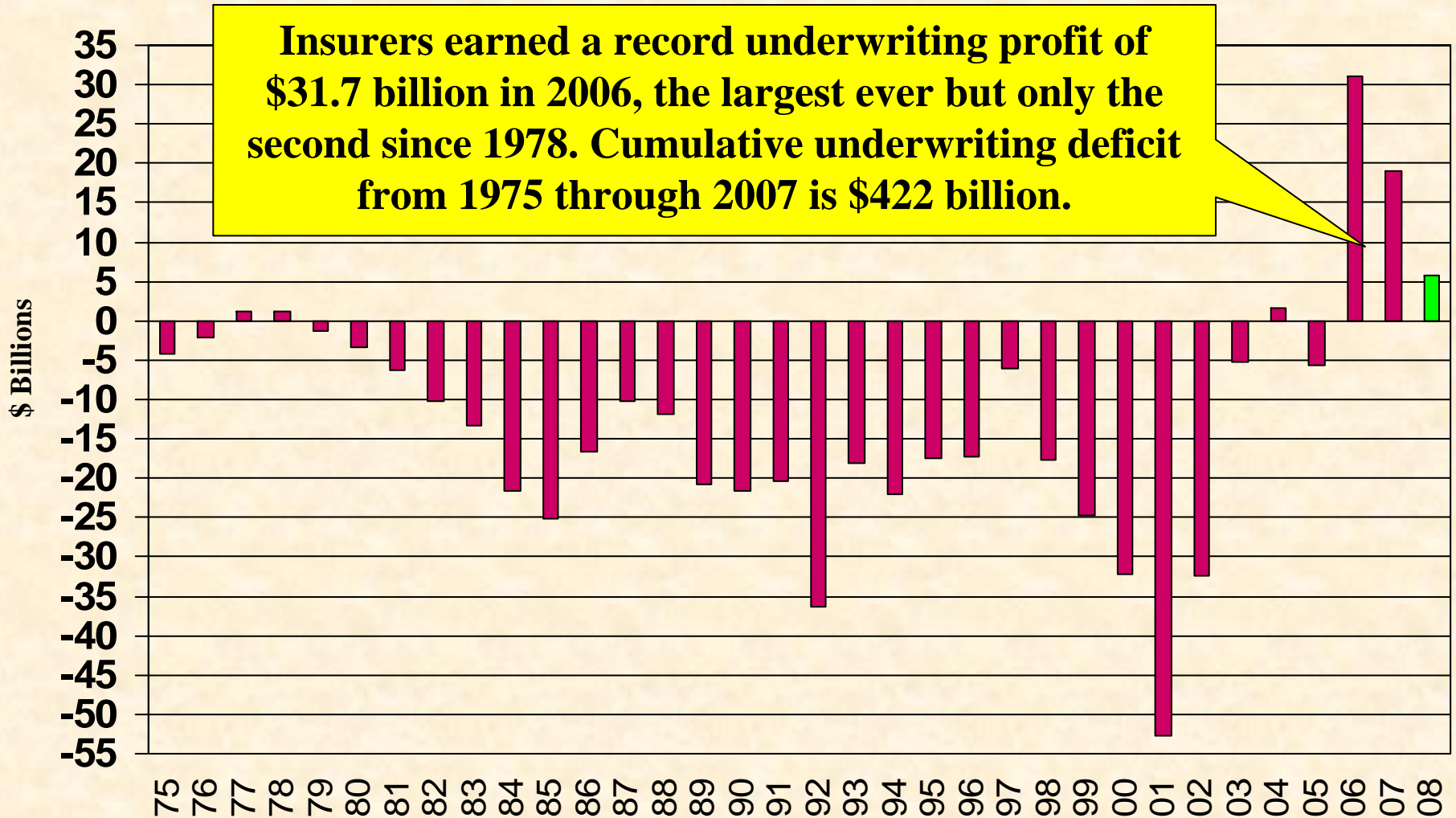


Ten Lowest P/C Insurance Combined Ratios Since 1920 vs. 2007



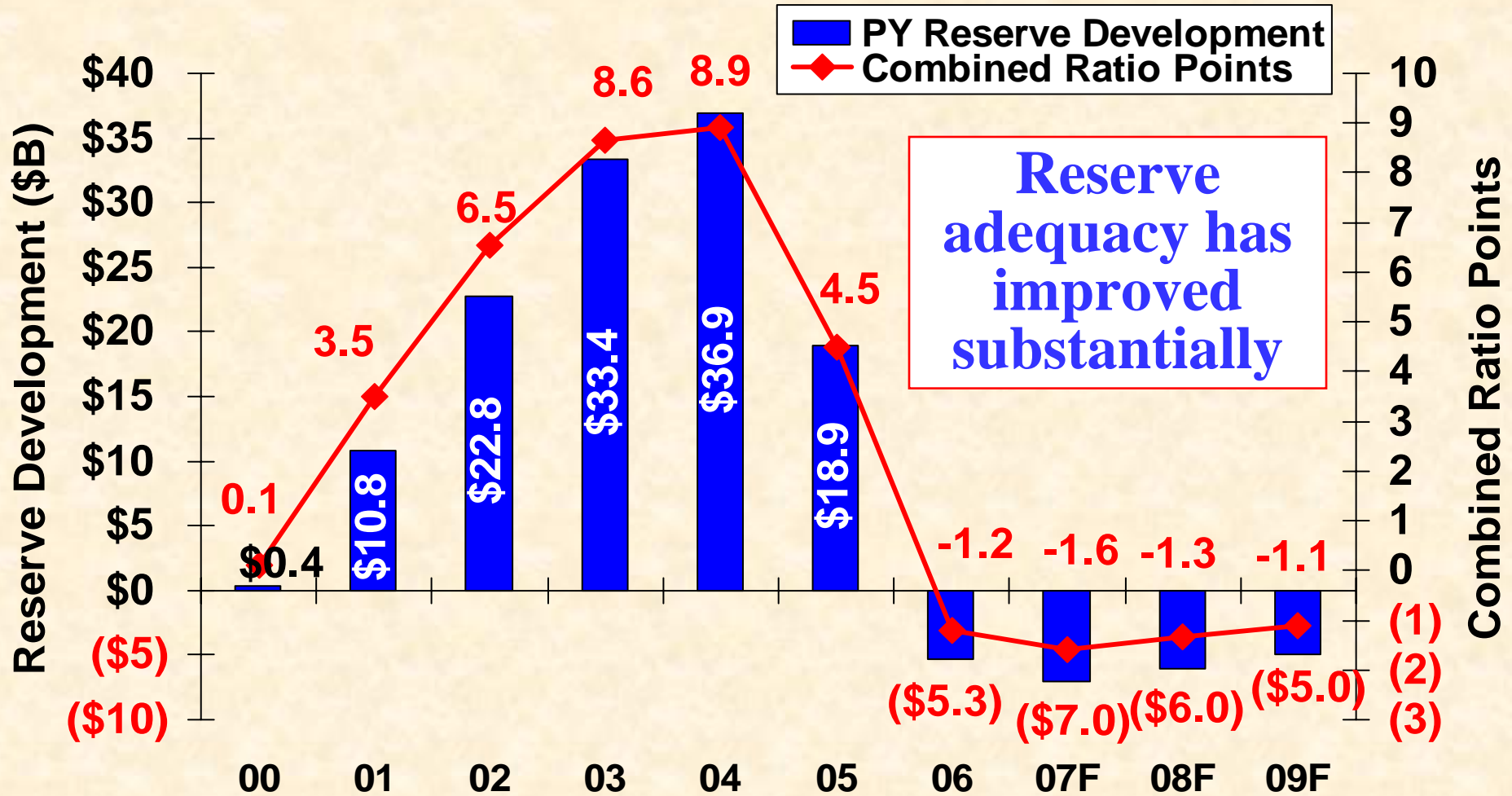


Underwriting Gain (Loss) 1975-2008F*





Impact of Reserve Changes on Combined Ratio

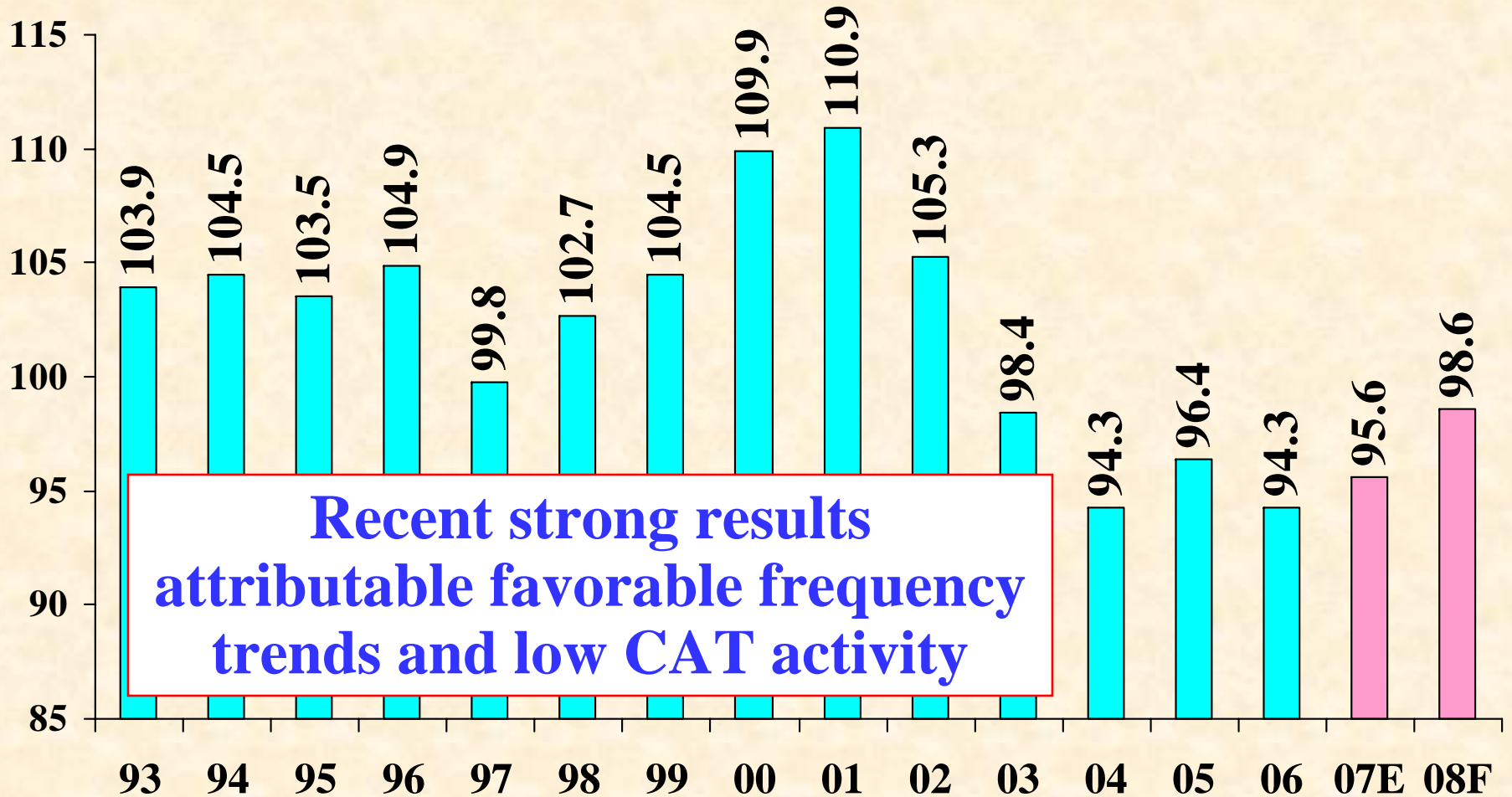


PERSONAL LINES

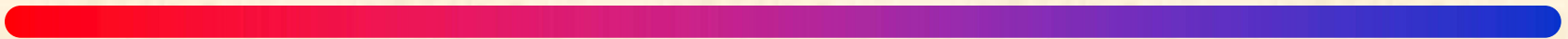




Personal Lines Combined Ratio 1993-2007E



COMMERCIAL LINES

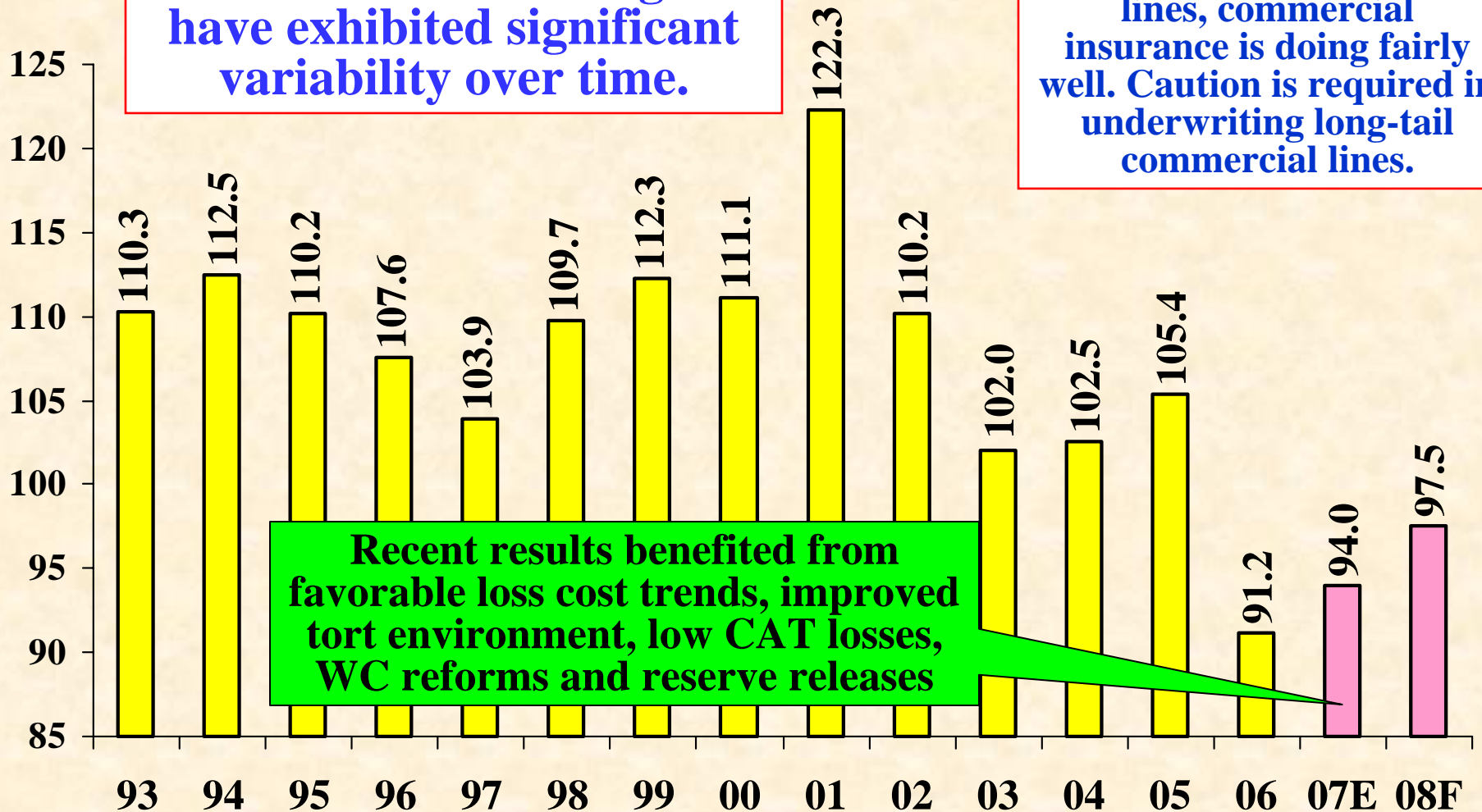




Commercial Lines Combined Ratio 1993-2008F

Commercial coverages have exhibited significant variability over time.

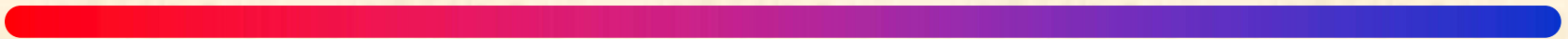
Outside CAT-affected lines, commercial insurance is doing fairly well. Caution is required in underwriting long-tail commercial lines.



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

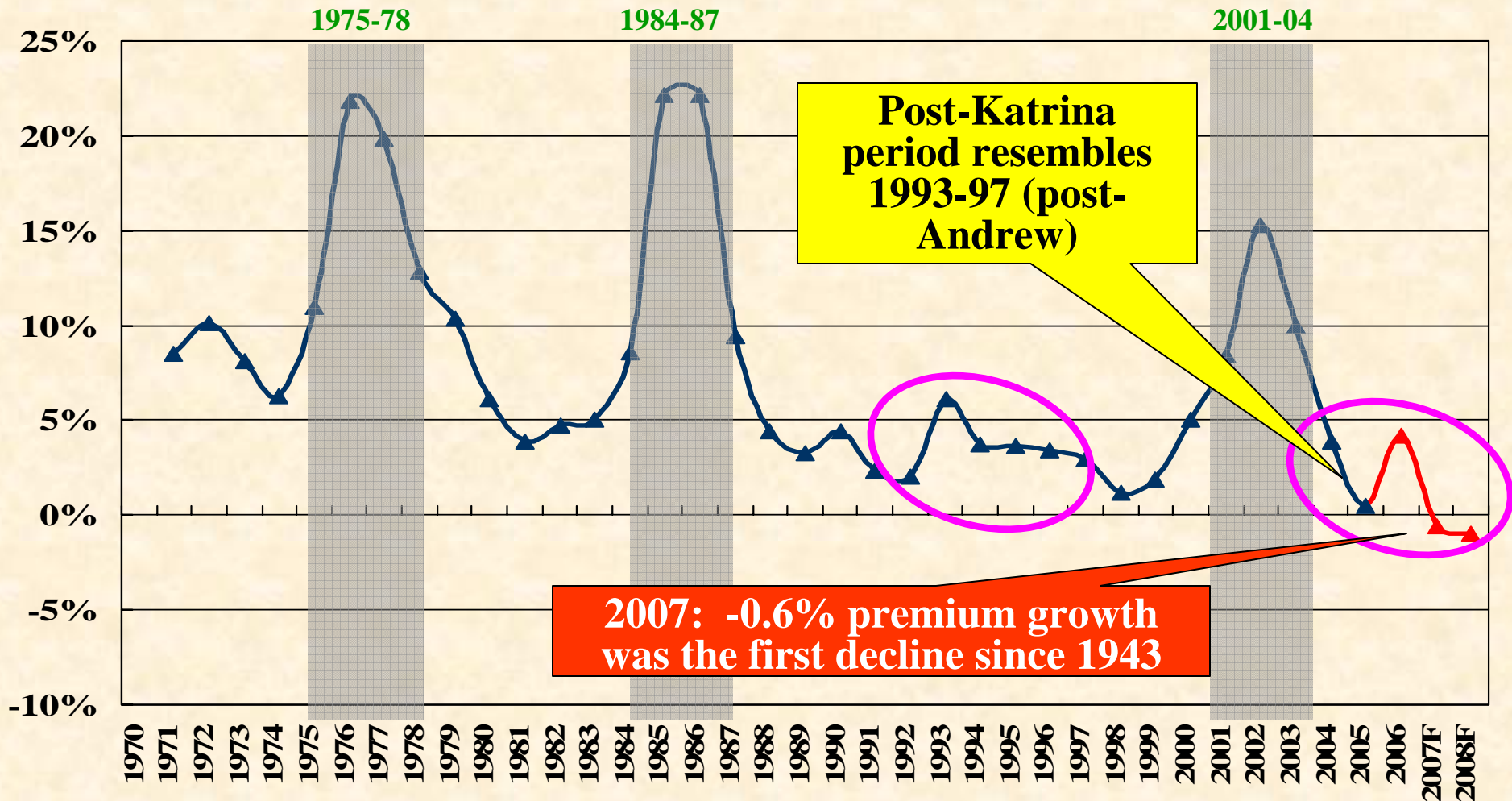
PREMIUM GROWTH

*At a Virtual Standstill
in 2007/08*





Strength of Recent Hard Markets by NWP Growth*

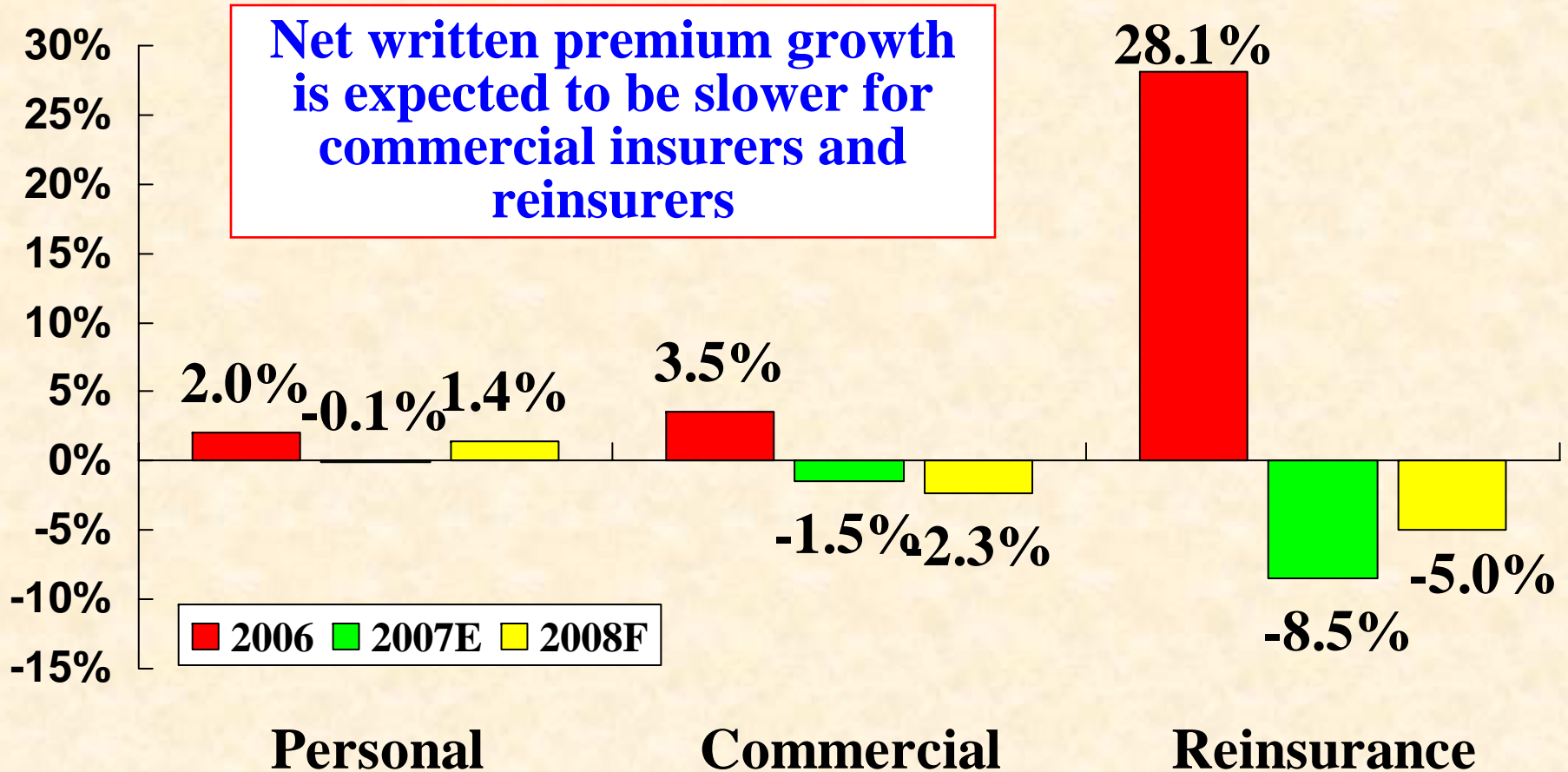


Note: Shaded areas denote hard market periods.

Source: A.M. Best, Insurance Information Institute

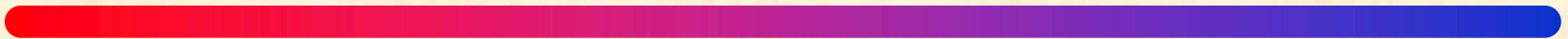


Personal/Commercial Lines & Reinsurance NPW Growth 2006-2008F



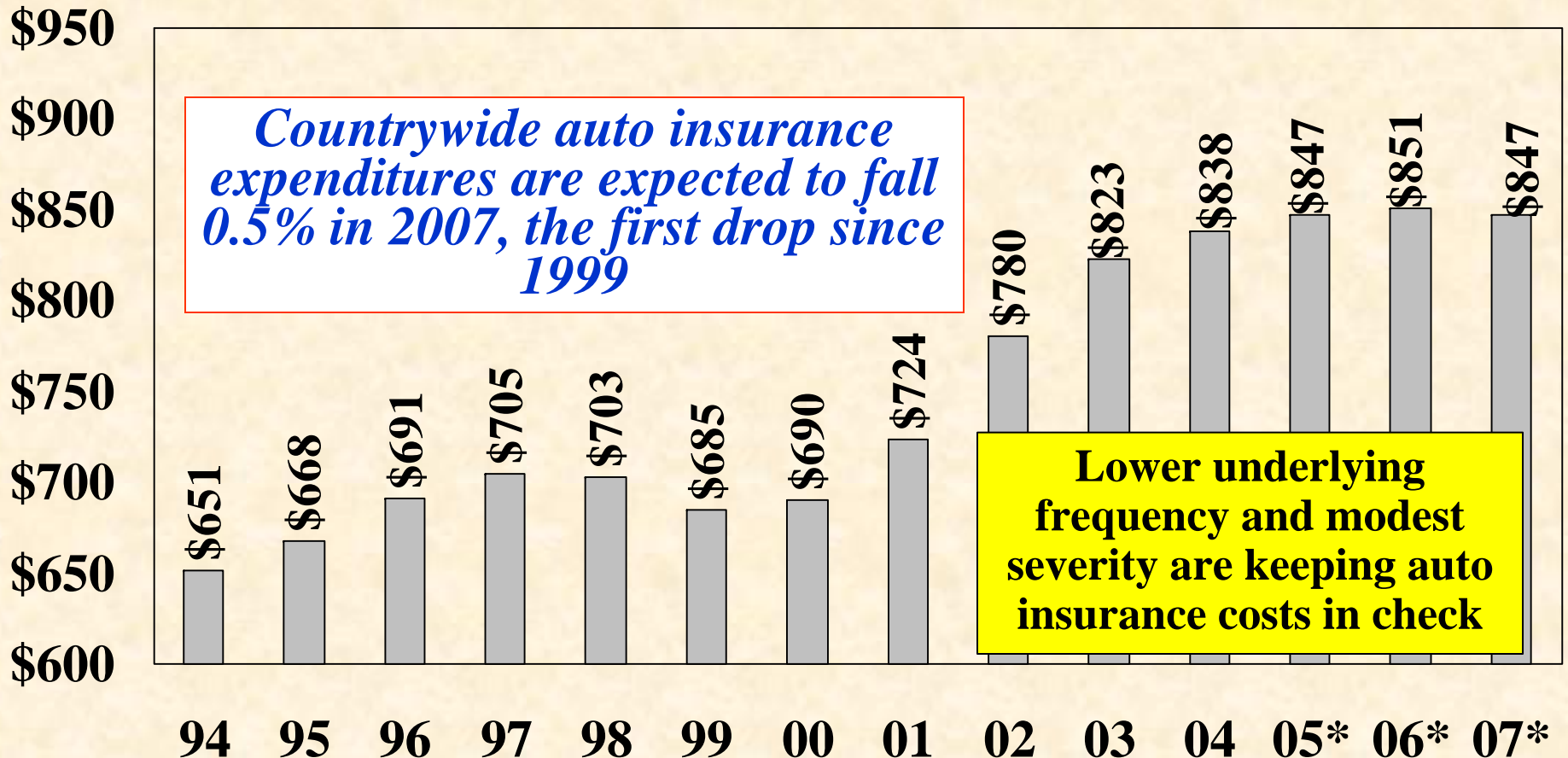
WEAK PRICING

*Under Pressure in 2007/08 Especially
Commercial Lines*





Average Expenditures on Auto Insurance

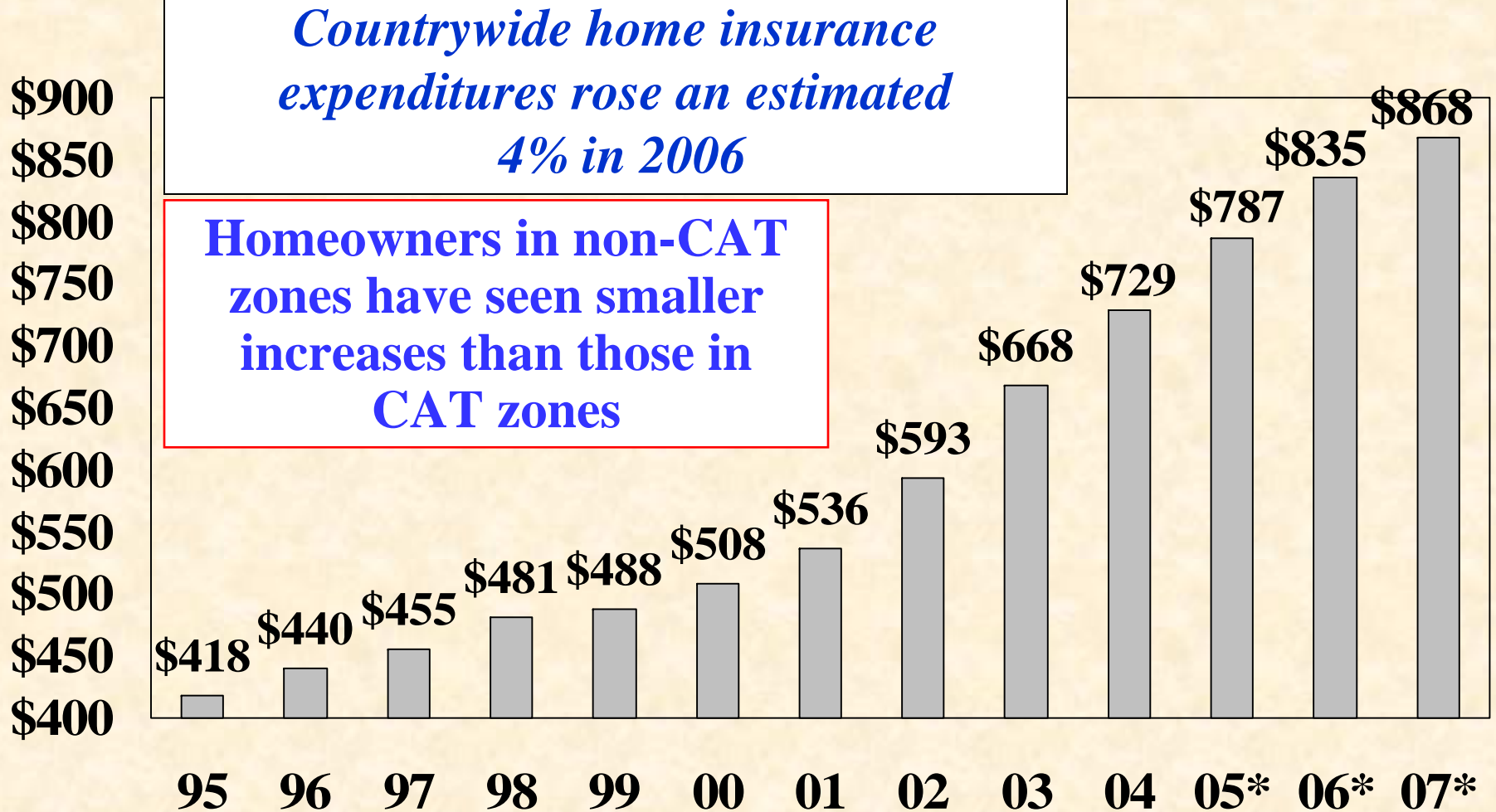


*Insurance Information Institute Estimates/Forecasts

Source: NAIC, Insurance Information Institute



Average Expenditures on Homeowners Insurance**



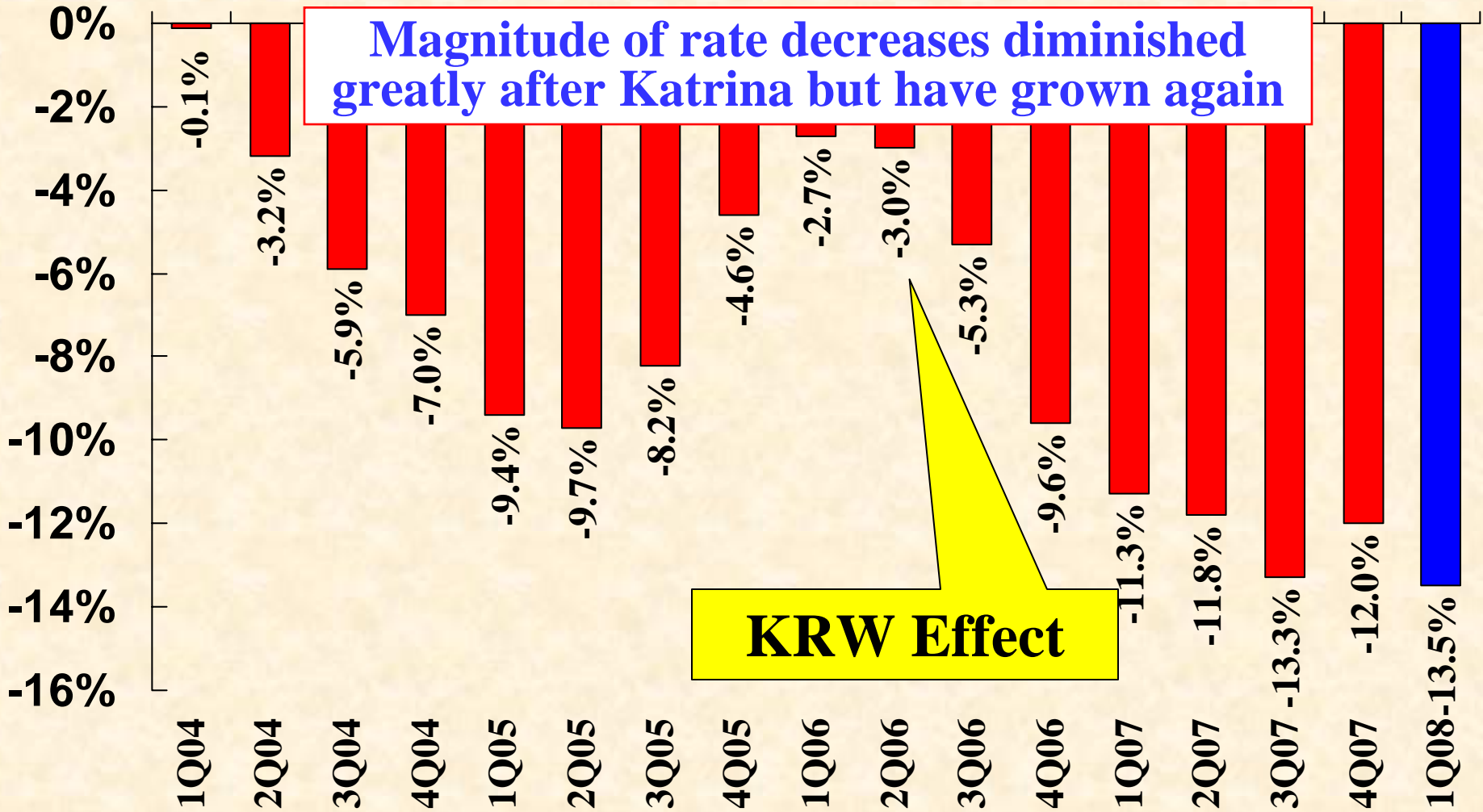
*Insurance Information Institute Estimates/Forecasts

**Excludes cost of flood and earthquake coverage.

Source: NAIC, Insurance Information Institute

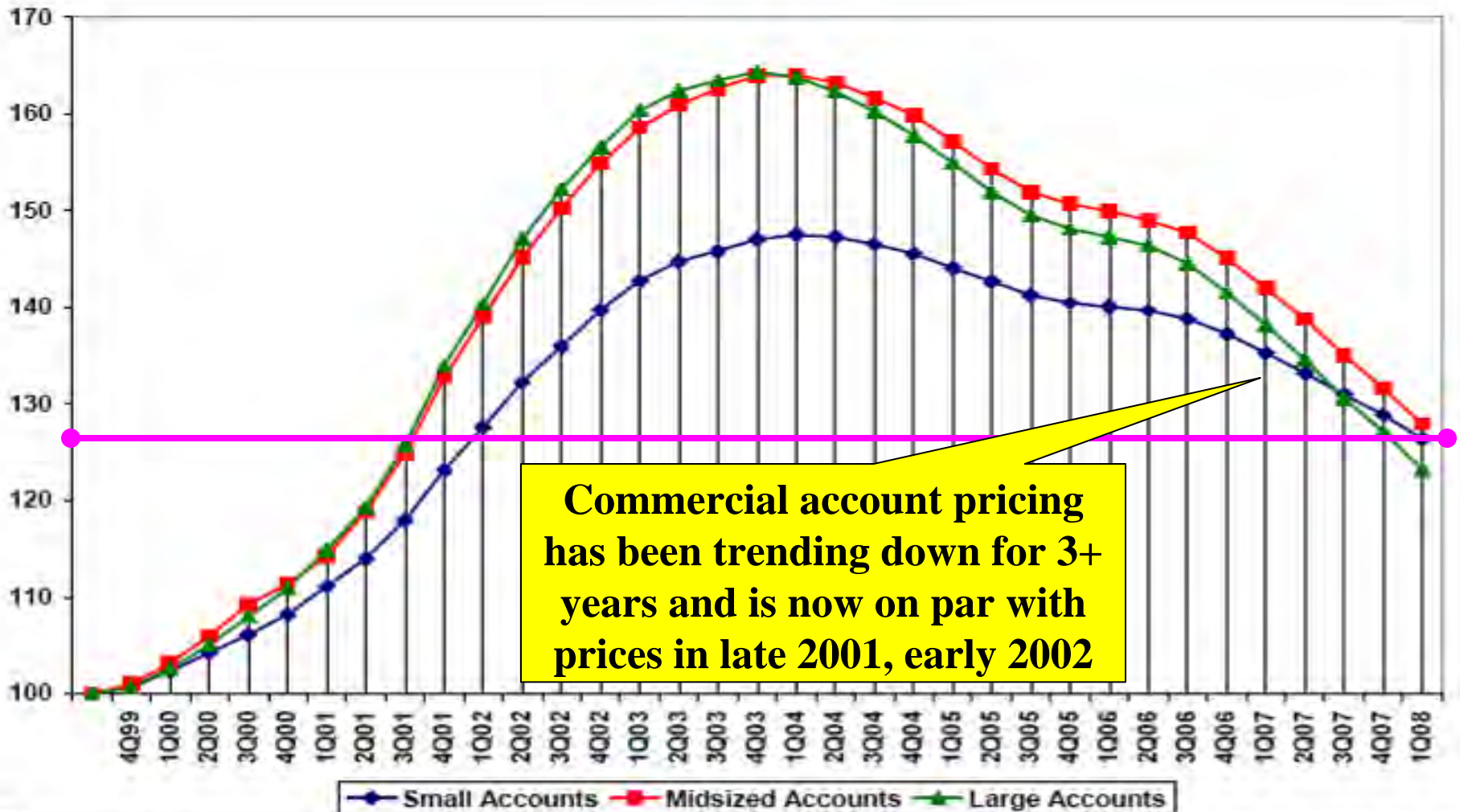


Average Commercial Rate Change, All Lines, (1Q:2004 – 1Q:2008)



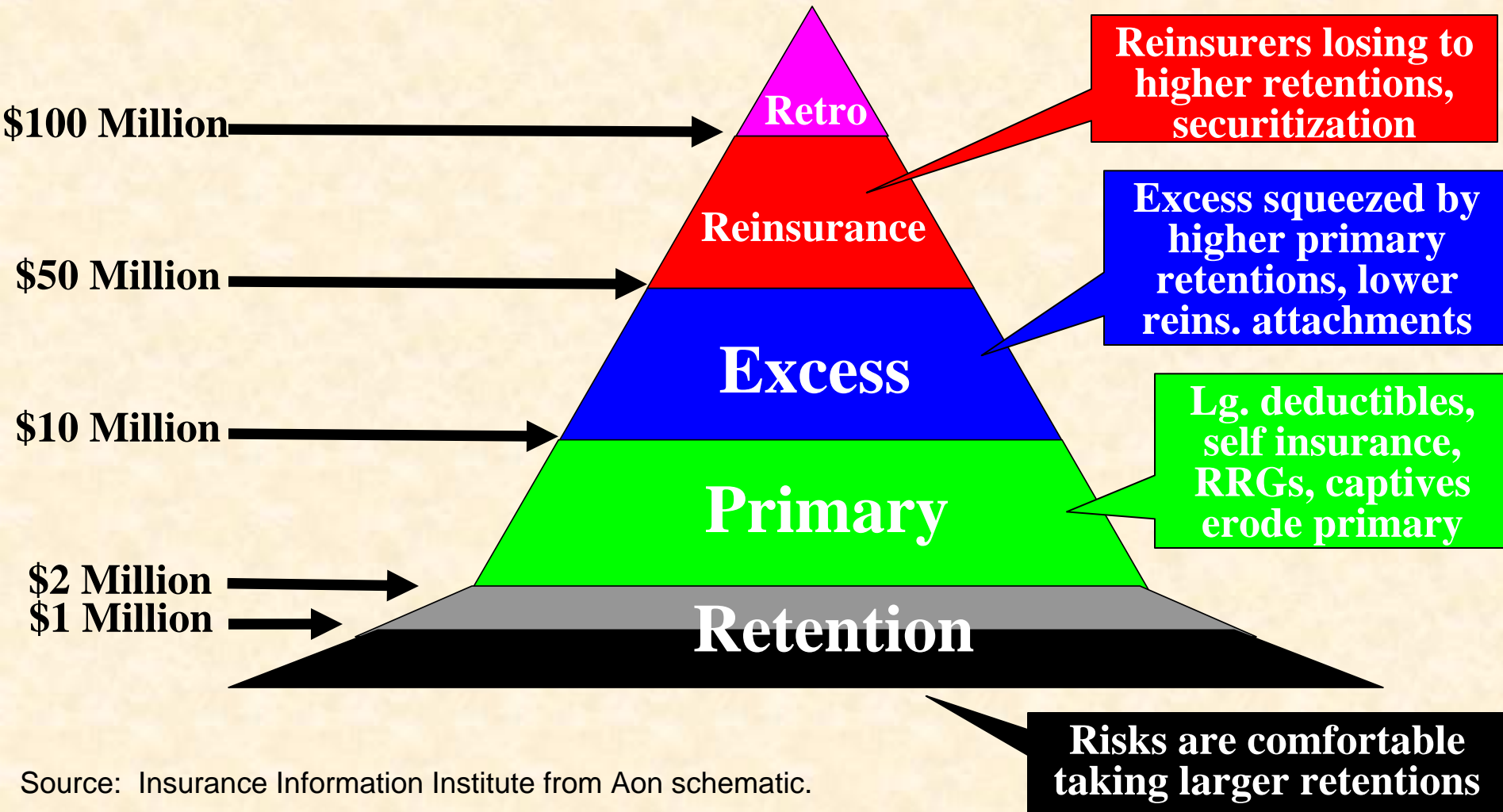


Cumulative Commercial Rate Change by Line: 4Q99 – 1Q08





Most Layers of Coverage are Being Challenged/Leaking



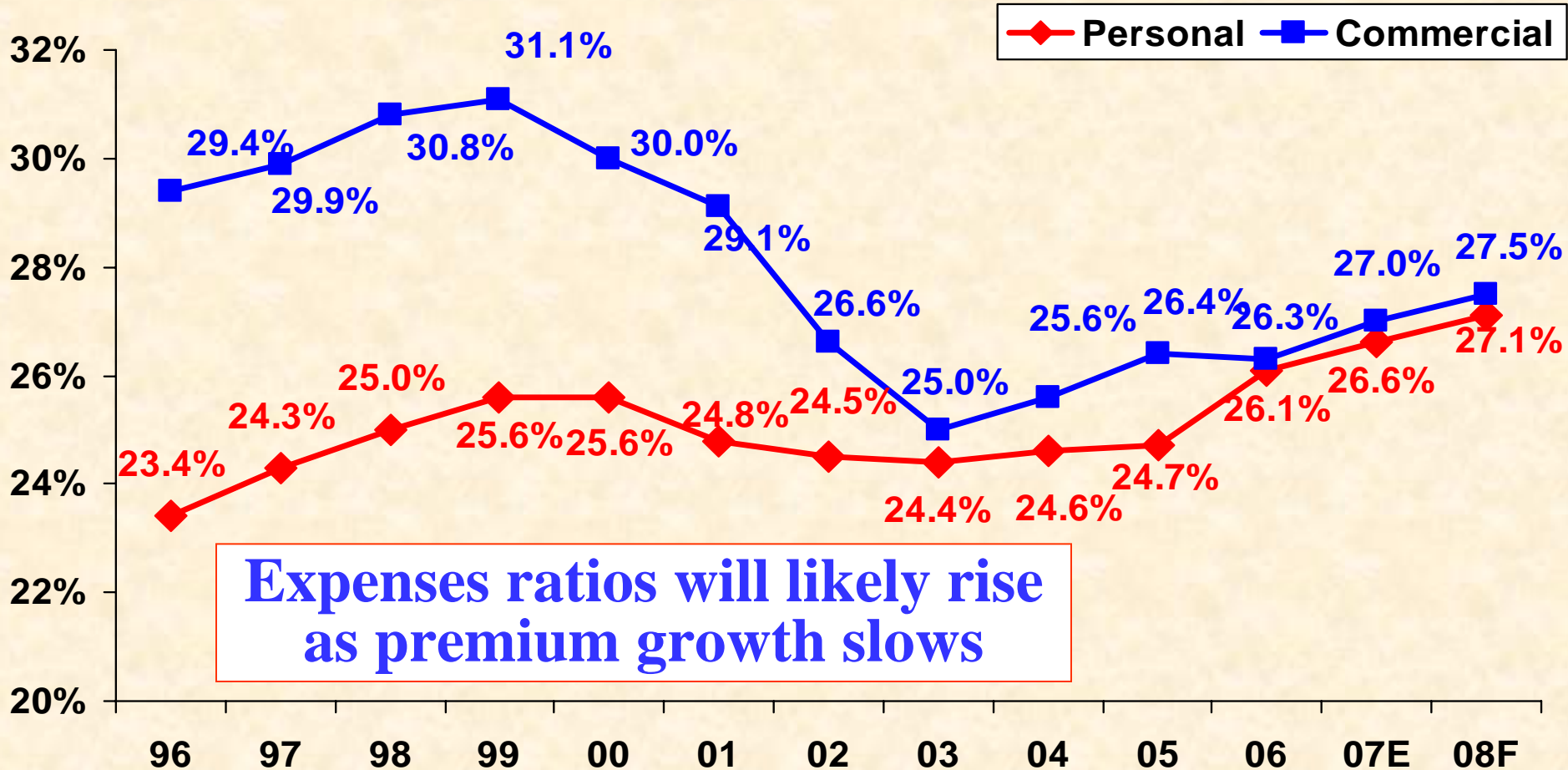
RISING EXPENSES

*Expense Ratios Will Rise as
Premium Growth Slows*





Personal vs. Commercial Lines Underwriting Expense Ratio*

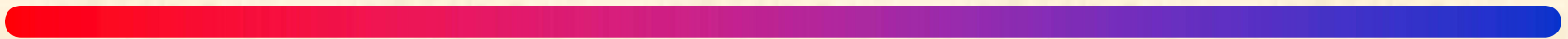


Expenses ratios will likely rise
as premium growth slows

*Ratio of expenses incurred to net premiums written.
Source: A.M. Best; Insurance Information Institute

CAPACITY/ SURPLUS

*Accumulation of Capital/Surplus
Depresses ROEs*



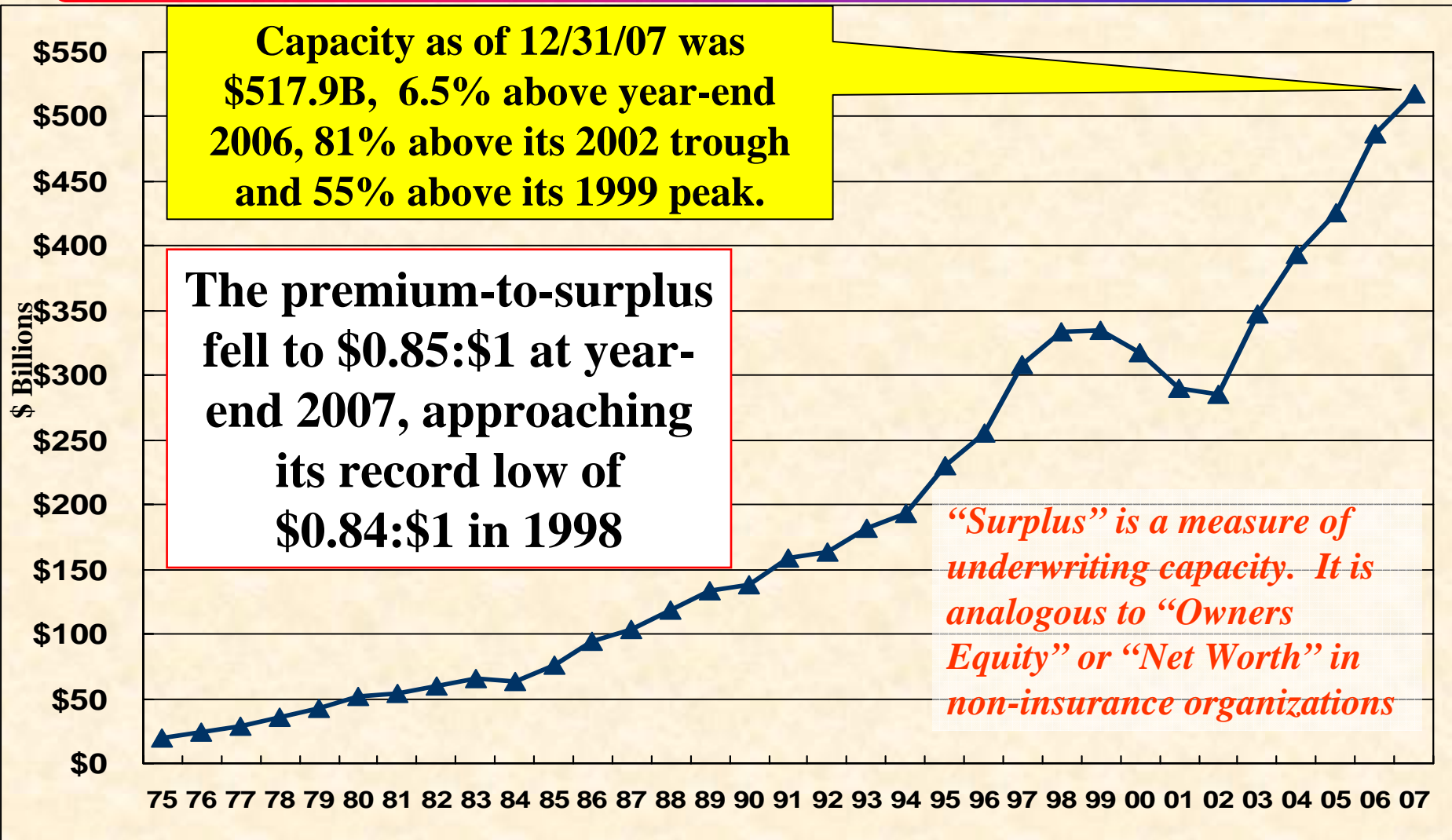


U.S. Policyholder Surplus: 1975-2007*

Capacity as of 12/31/07 was \$517.9B, 6.5% above year-end 2006, 81% above its 2002 trough and 55% above its 1999 peak.

The premium-to-surplus fell to \$0.85:\$1 at year-end 2007, approaching its record low of \$0.84:\$1 in 1998

“Surplus” is a measure of underwriting capacity. It is analogous to “Owners Equity” or “Net Worth” in non-insurance organizations





P/C Insurer Share Repurchases, 1987- Through Q4 2007 (\$ Millions)

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

2007 share buybacks shattered the 2006 record, up 214%

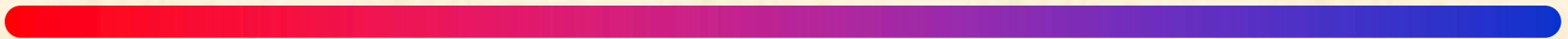
2007 repurchases to date equate to 3.9% of industry surplus, the highest in 20 years

\$22,322.6



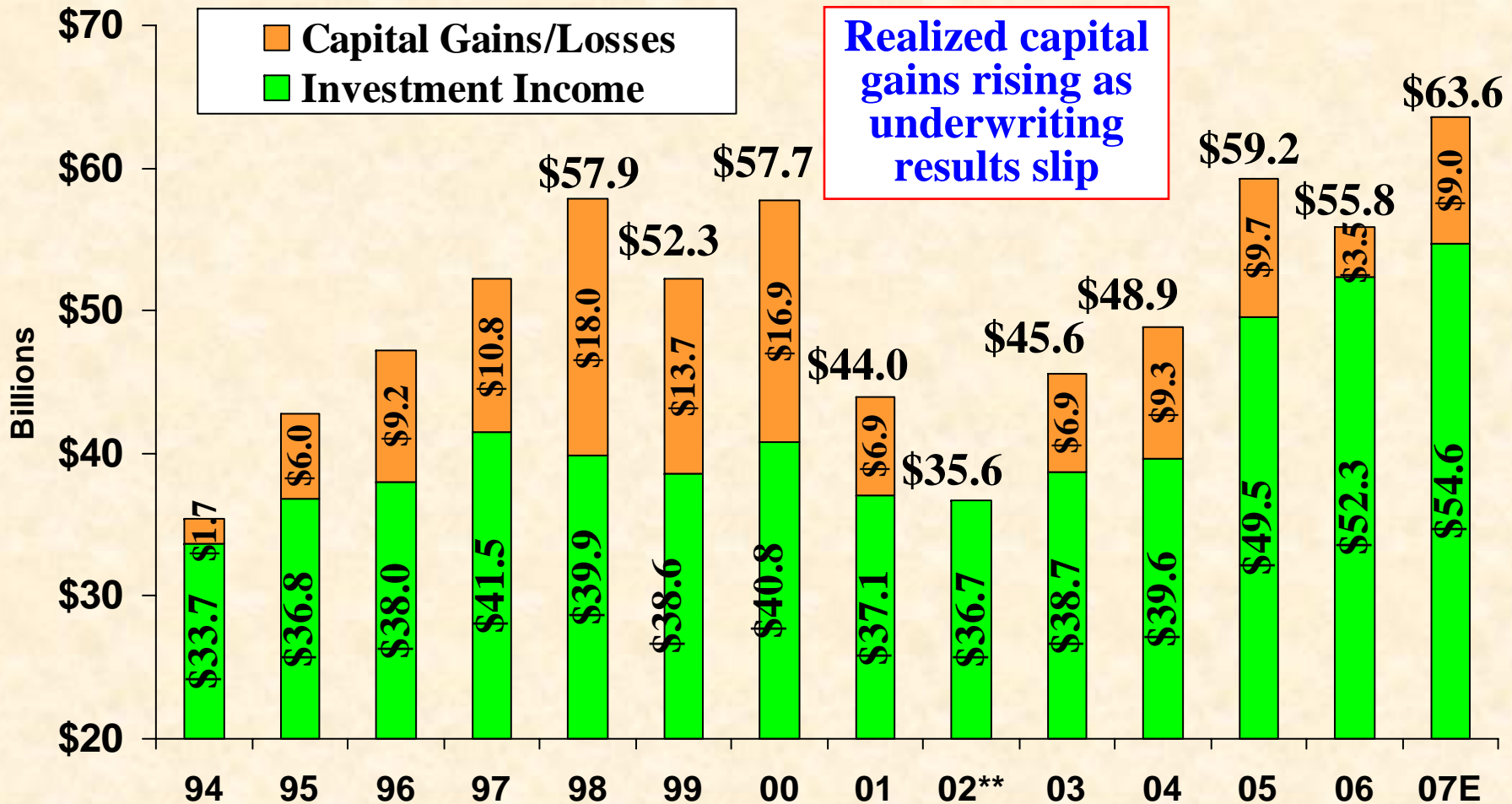
INVESTMENT OVERVIEW

*More Pain,
Little Gain*





Property/Casualty Industry Investment Results, 1994-2007



*Primarily interest, stock dividends, and realized capital gains and losses.

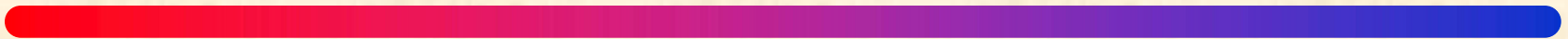
**Not shown: \$1.1B capital loss in 2002.

2005 figure includes special one-time dividend of \$3.2B.

Sources: ISO; Insurance Information Institute.

CATASTROPHIC LOSS

What Will 2008 Bring?





U.S. Insured Catastrophe Losses*



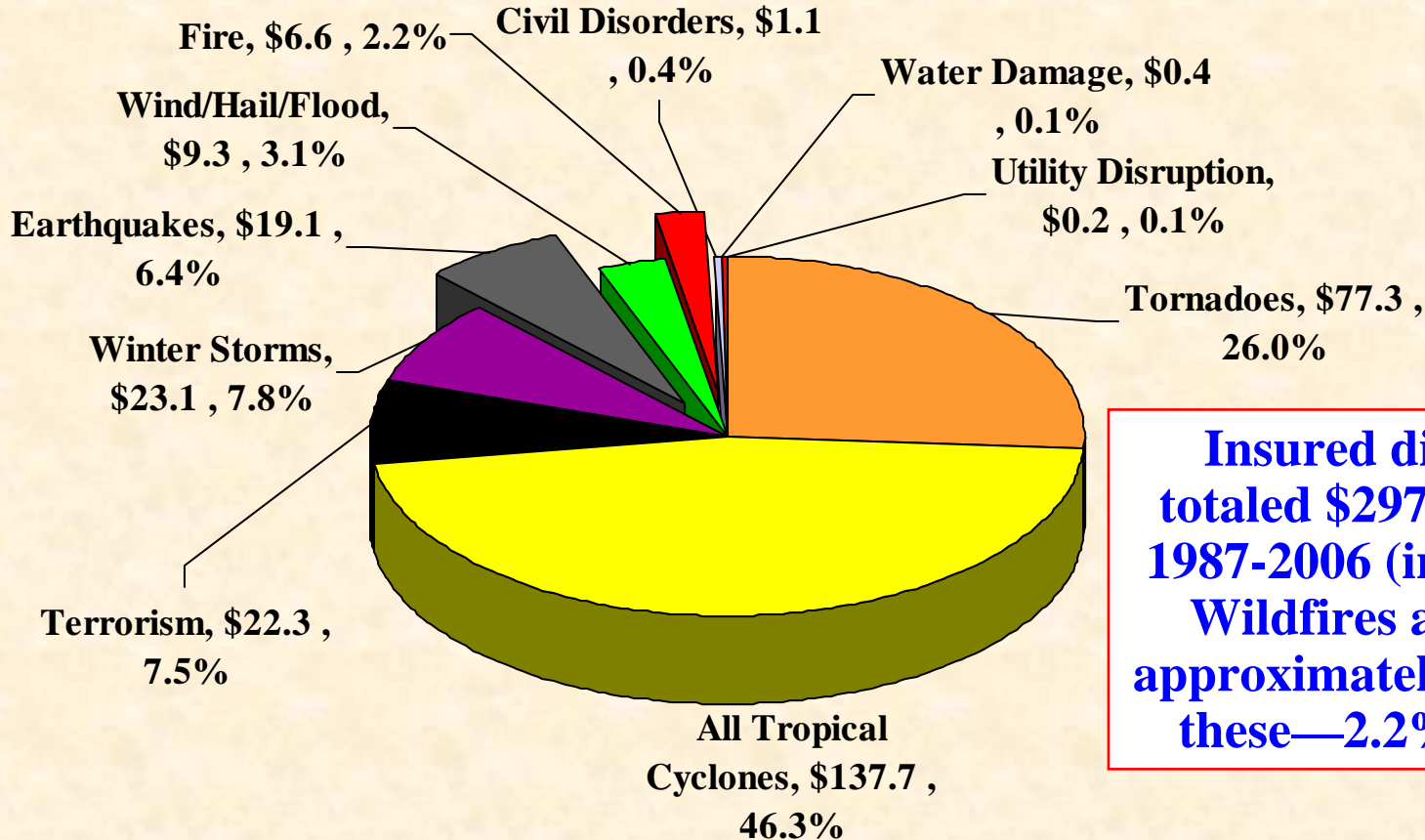
*Excludes \$4B-\$6b offshore energy losses from Hurricanes Katrina & Rita.

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



**Nat CAT
Plan a
possibility in
2008?**

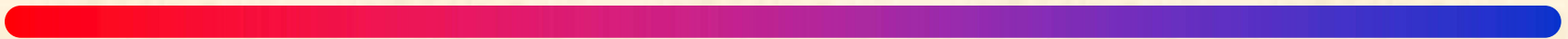
Insured disaster losses totaled \$297.3 billion from 1987-2006 (in 2006 dollars). Wildfires accounted for approximately \$6.6 billion of these—2.2% of the total.

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.

THE 2008 HURRICANCE SEASON:

*Predictions are for
an Active Season*





Outlook for 2008 Hurricane Season: 60% Worse Than Average

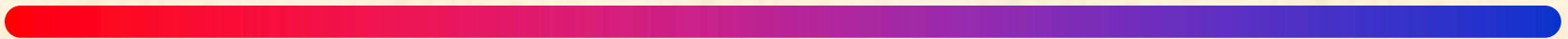
	Average*	2005	2008F
Named Storms	9.6	28	15
Named Storm Days	49.1	115.5	80
Hurricanes	5.9	14	8
Hurricane Days	24.5	47.5	40
Intense Hurricanes	2.3	7	4
Intense Hurricane Days	5	7	9
Accumulated Cyclone Energy	96.2	NA	150
Net Tropical Cyclone Activity	100%	275%	160%

*Average over the period 1950-2000.

Source: Philip Klotzbach and Dr. William Gray, Colorado State University, April 9, 2007.

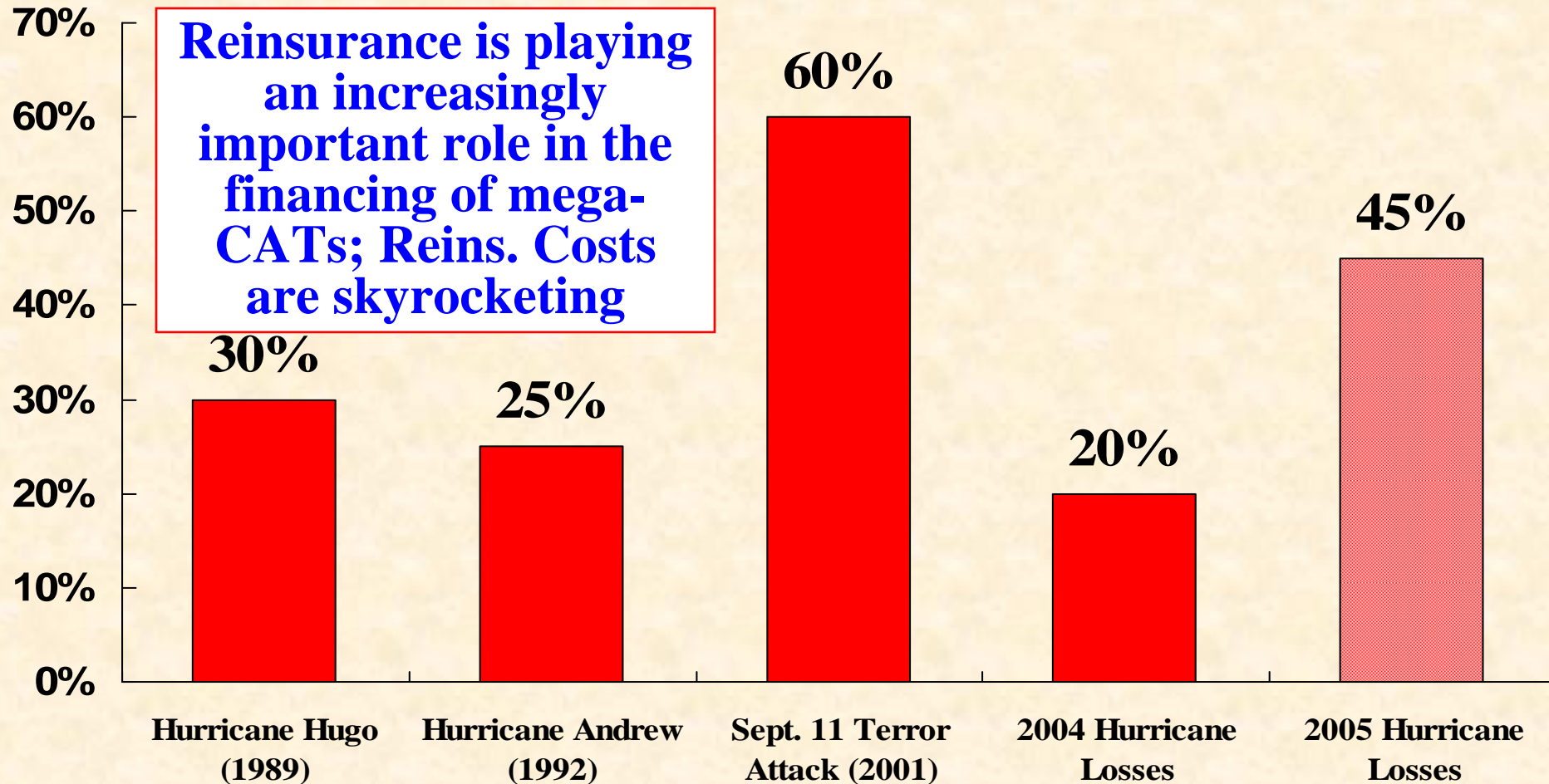
REINSURANCE MARKETS

*Reinsurance Prices are Falling in
Non-Coastal Zones, Casualty Lines*





Share of Losses Paid by Reinsurers, by Disaster*



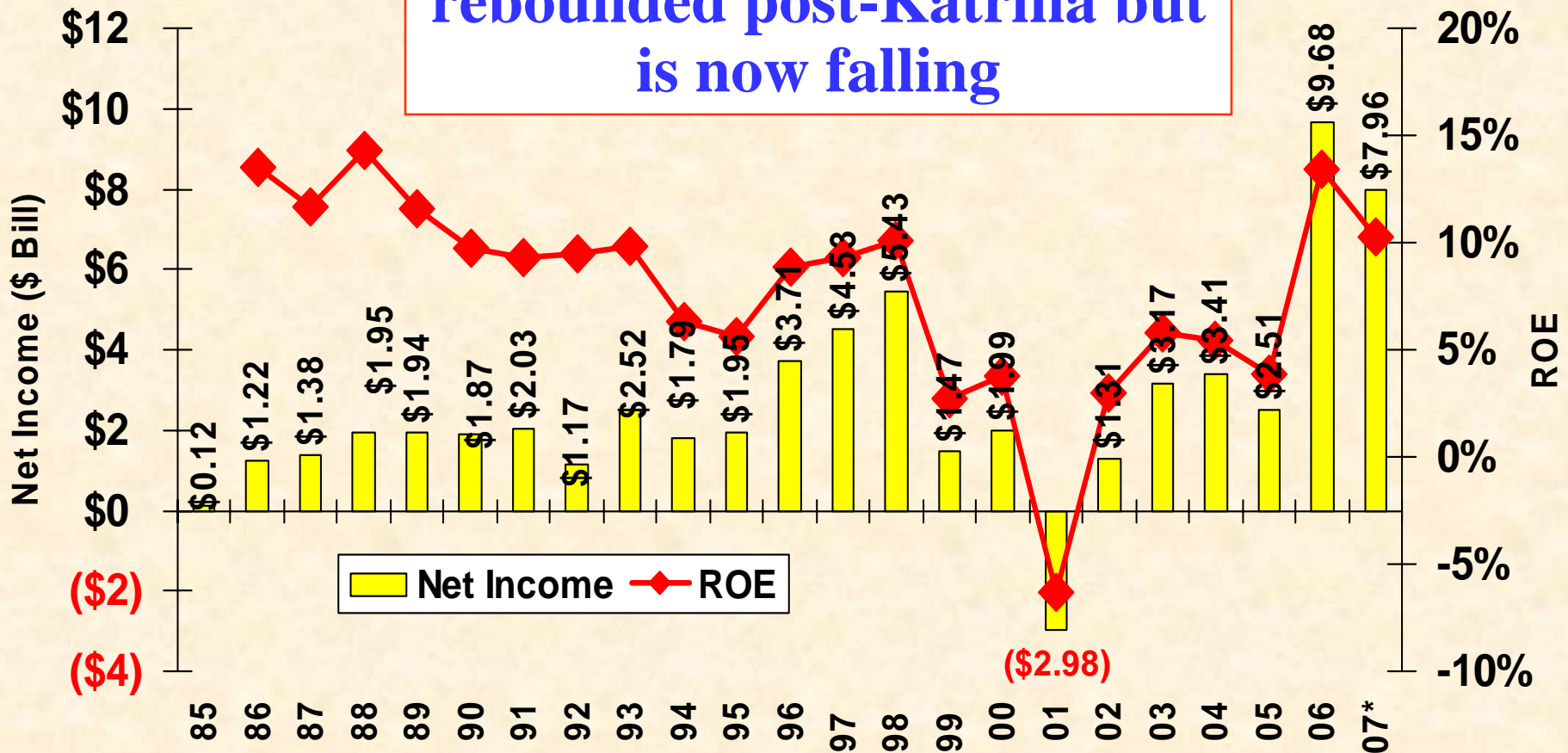
*Excludes losses paid by the Florida Hurricane Catastrophe Fund, a FL-only windstorm reinsurer, which was established in 1994 *after* Hurricane Andrew. FHCF payments to insurers are estimated at \$3.85 billion for 2004 and \$4.5 billion for 2005.

Sources: Wharton Risk Center, Disaster Insurance Project; Insurance Information Institute.



US Reinsurer Net Income & ROE 1985-2007*

Reinsurer profitability
rebounded post-Katrina but
is now falling



Source: Reinsurance Association of America. *2007 ROE figure is III estimate based return on average 2007 surplus.

SHIFTING LEGAL LIABILITY & TORT

*Is the Tort Pendulum
Swinging Against Insurers?*





*Bad Year for Tort Kingpins**



“King of Class Actions” Bill Lerach

- Former partner in class action firm Milberg Weiss
- Admitted felon. Guilty of paying 3 plaintiffs \$11.4 million in 150+ cases over 25 years & lying about it repeatedly to courts
- Will serves 1-2 years in prison and forfeit \$7.75 million; \$250,000 fine

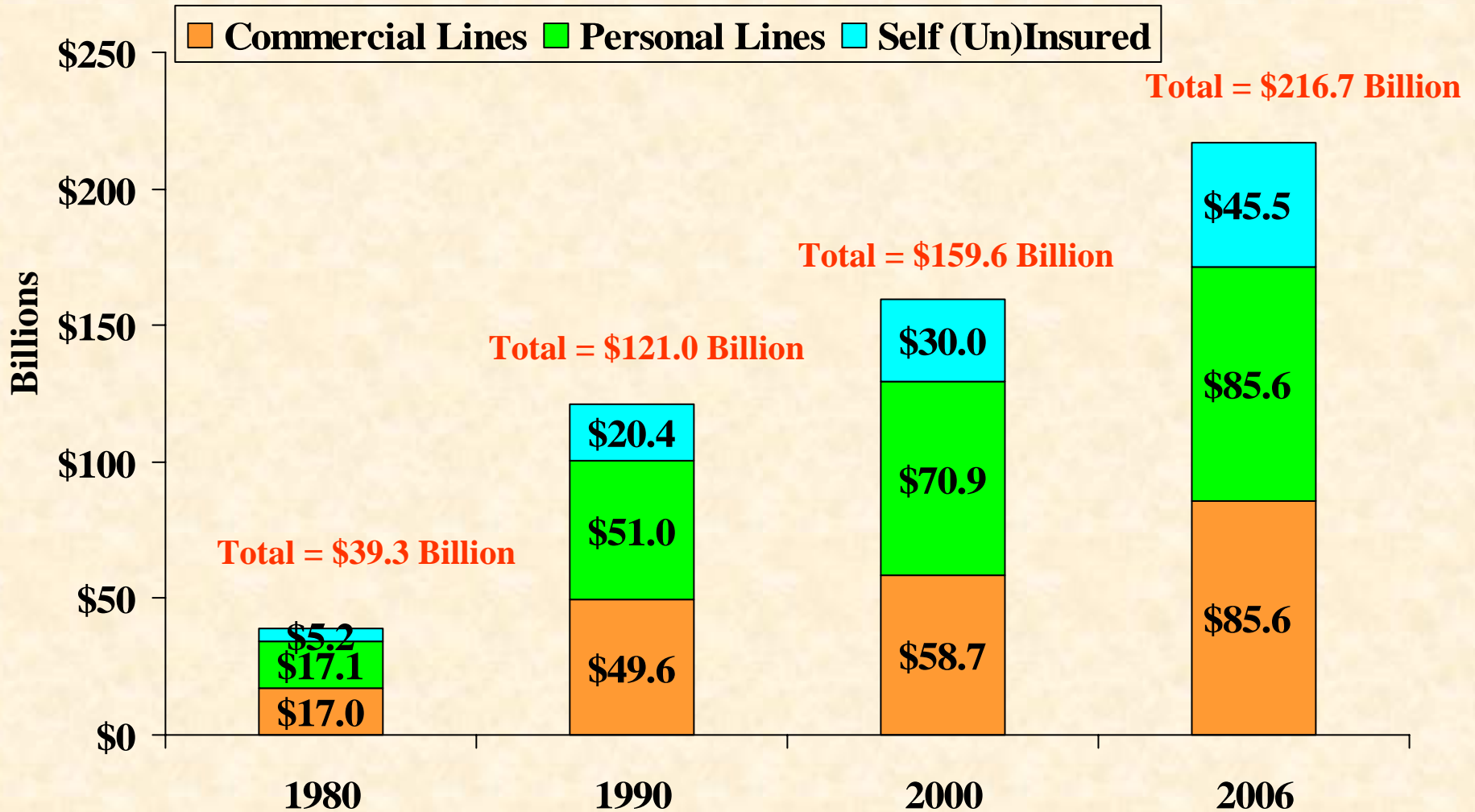


“King of Torts” Dickie Scruggs

- Won billions in tobacco, asbestos and Katrina litigation
- Pleaded guilty for attempting to offer a judge \$40,000 bribe to resolve attorney fee allocation from Katrina litigation in his firm’s favor. His son/others → guilty on related charges
- Could get 5 years in prison, \$250,000 fine



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



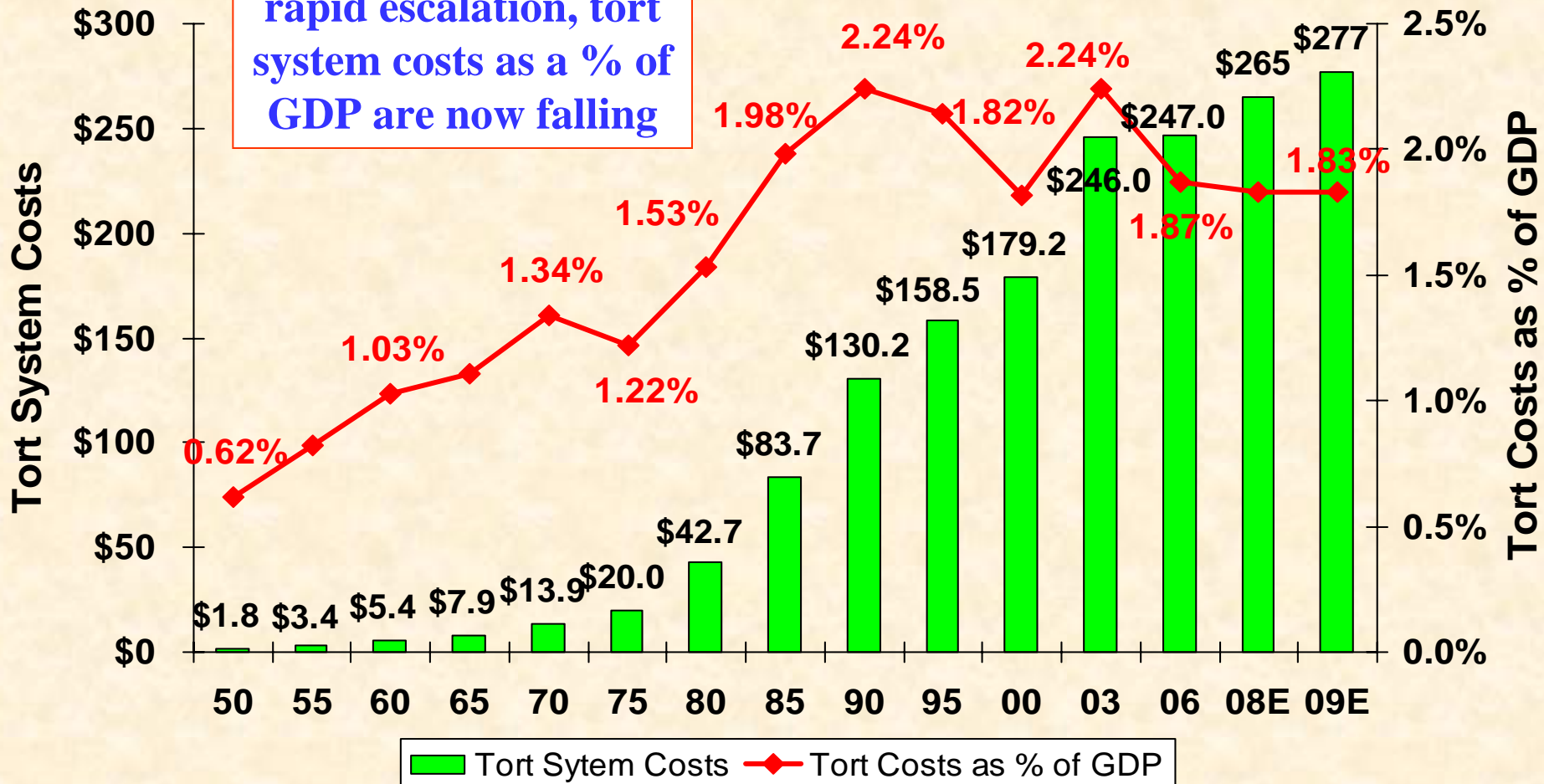
*Excludes medical malpractice

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



Tort System Costs, 1950-2009E

After a period of rapid escalation, tort system costs as a % of GDP are now falling



Source: Tillinghast-Towers Perrin, 2007 Update on U.S. Tort Costs as % of GDP



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

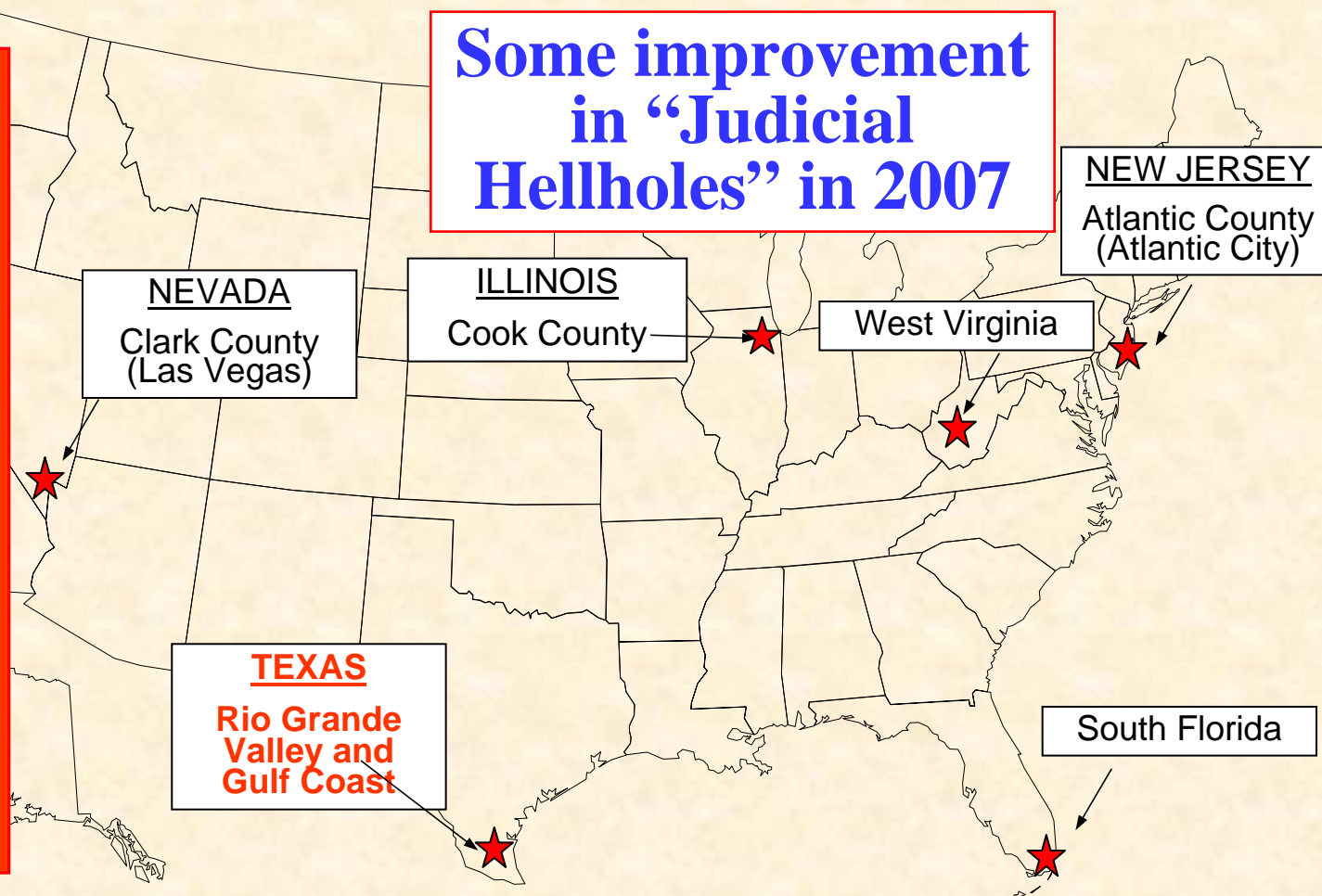
MO Supreme Court

MI Legislature

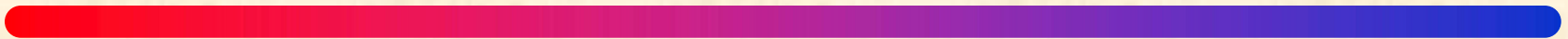
GA Supreme Court

Oklahoma

Some improvement
in “Judicial
Hellholes” in 2007



***PRESIDENTIAL
POLITICS & P/C
PROFITABILITY***



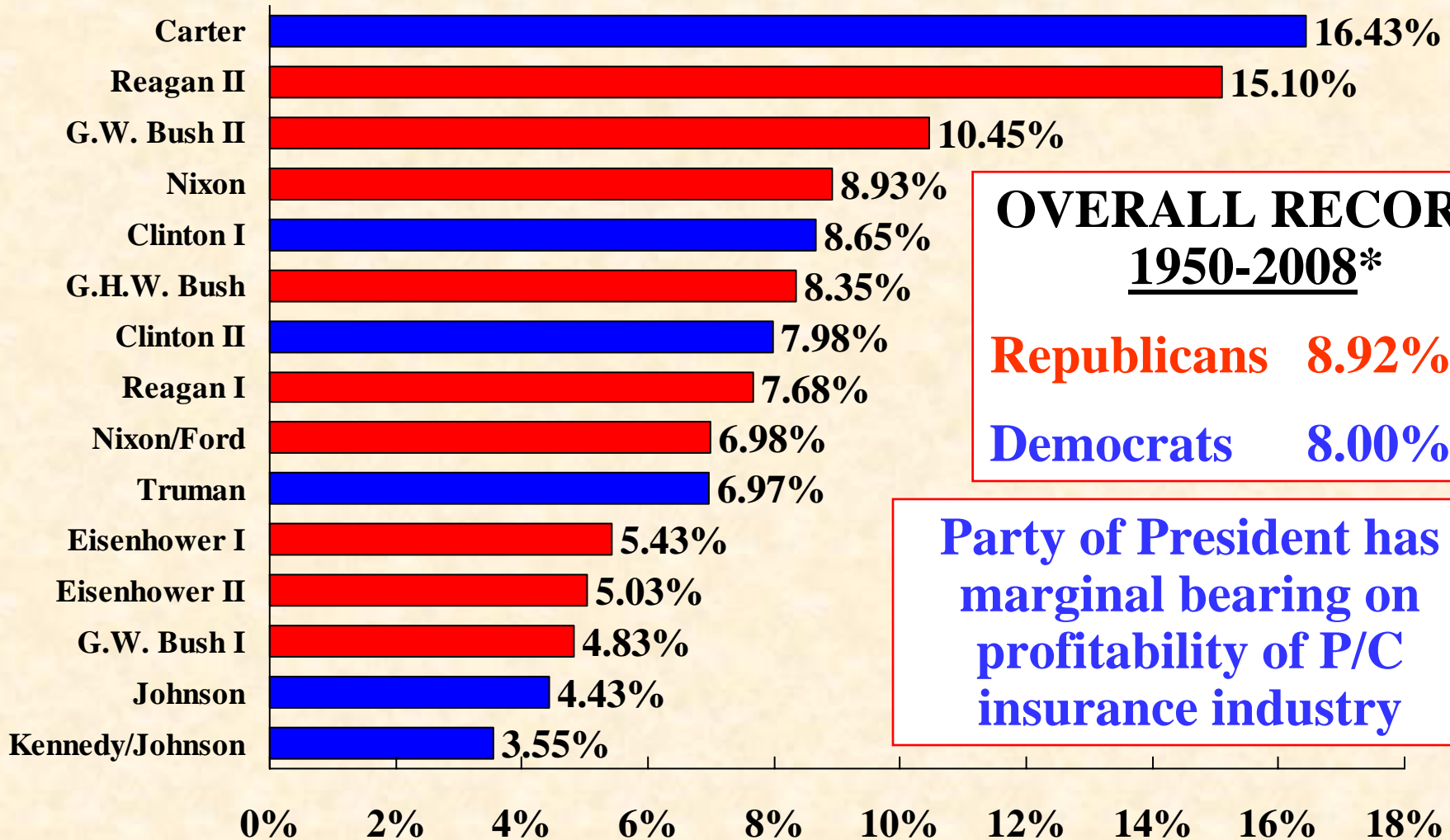


Political Quiz

- **Does the P/C insurance industry perform better (as measured by ROE) under Republican or Democratic administrations?**
- **Under which President did the industry realize its highest ROE (average over 4 years)?**
- **Under which President did the industry realize its lowest ROE (average over 4 years)?**



*P/C Insurance Industry ROE by Presidential Administration, 1950-2008**



*ROE for 2007/8 estimated by III. Truman administration ROE of 6.97% based on 3 years only, 1950-52.

Source: Insurance Information Institute



Summary

- **Results were excellent in 2006/07; Overall profitability reached its highest level since 1988**
 - Strong 2007 but ROEs slipping; Momentum for 2008
- **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
 - Maintaining vigilance against changes in tort environment
 - Managing regulatory/legislative activism



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