

Top 10 Challenges Facing the P/C Insurance Industry

Insurers at the Crossroads

**Katie School of Insurance
Catastrophe Management Symposium**



**Bloomington-Normal, IL
April 17, 2007**

**Robert P. Hartwig, Ph.D., CPCU, 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**

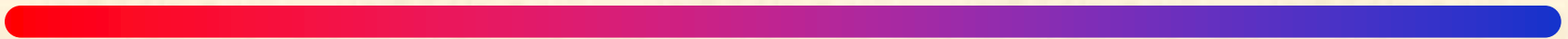


Top 10 Challenges: Presentation Outline

- **#1: Maintaining Profitability: *2006, A Cyclical Peak***
- **#2: Maintaining Underwriting Discipline**
- **#3: Managing a Slow Growth Environment: *Premium Plunge***
- **#4: Capital Management: *Capacity & Capital Allocation***
- **#5: Managing Investment Volatility: *Rollercoaster Returns***
- **#6: Catastrophe Loss Management: *Is the Worst Yet to Come?***
- **#7: Financial Strength & Ratings: *Ready for the Big One?***
- **#8: Legal Liability & Tort System: *Not Quite Out of the Woods***
- **#9: Defining the Role of Government in Insurance Markets**
- **#10: Containing Legislative & Regulatory Zealotry**
- **Q&A**

#1. Maintaining Profitability

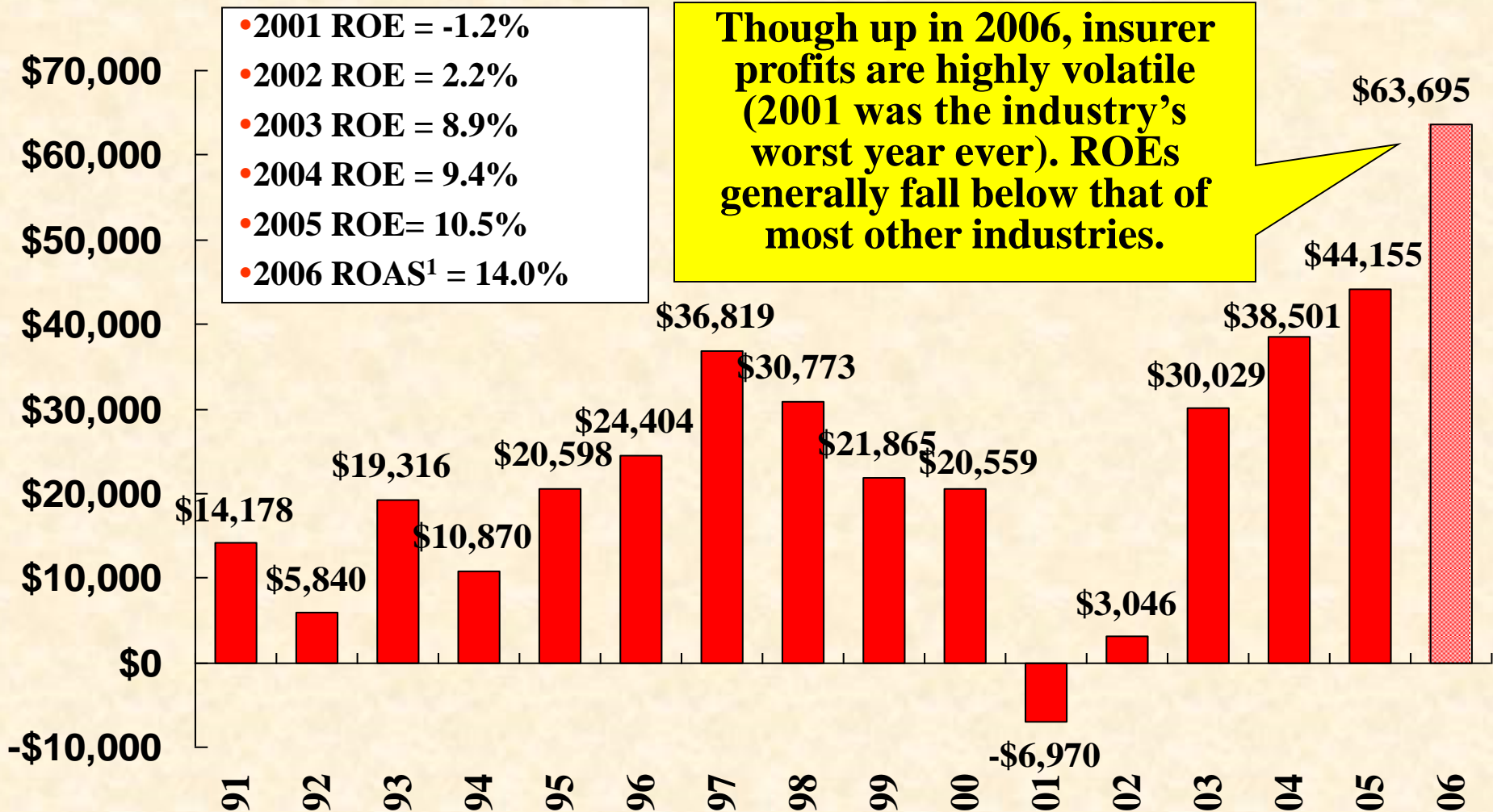
*Profits in 2006 Reached
Their Cyclical Peak*





P/C Net Income After Taxes

*1991-2006 (\$ Millions)**

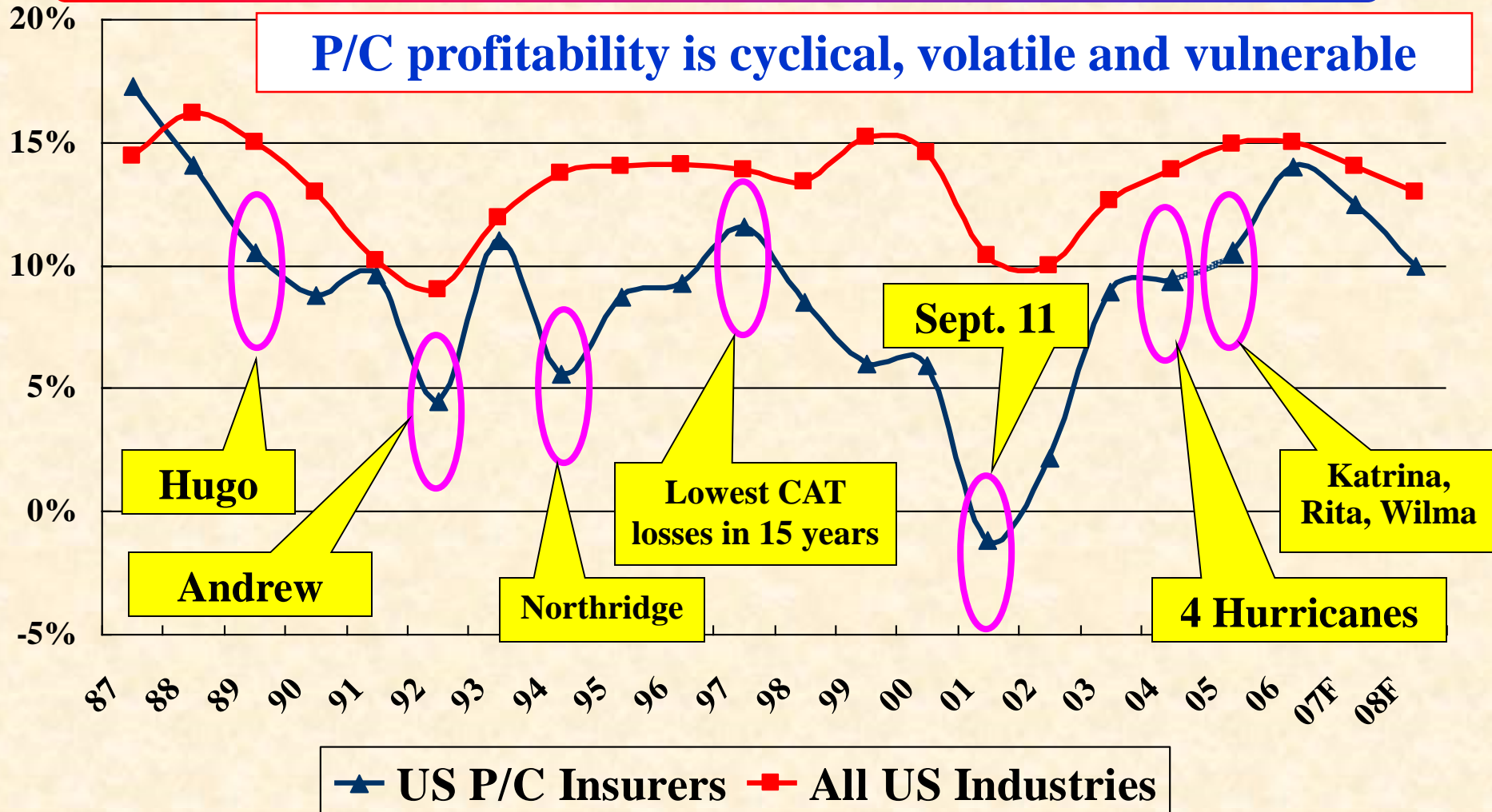


*ROE figures are GAAP; ¹Return on avg. Surplus.
Sources: A.M. Best, ISO, Insurance Information Inst.



ROE: P/C vs. All Industries

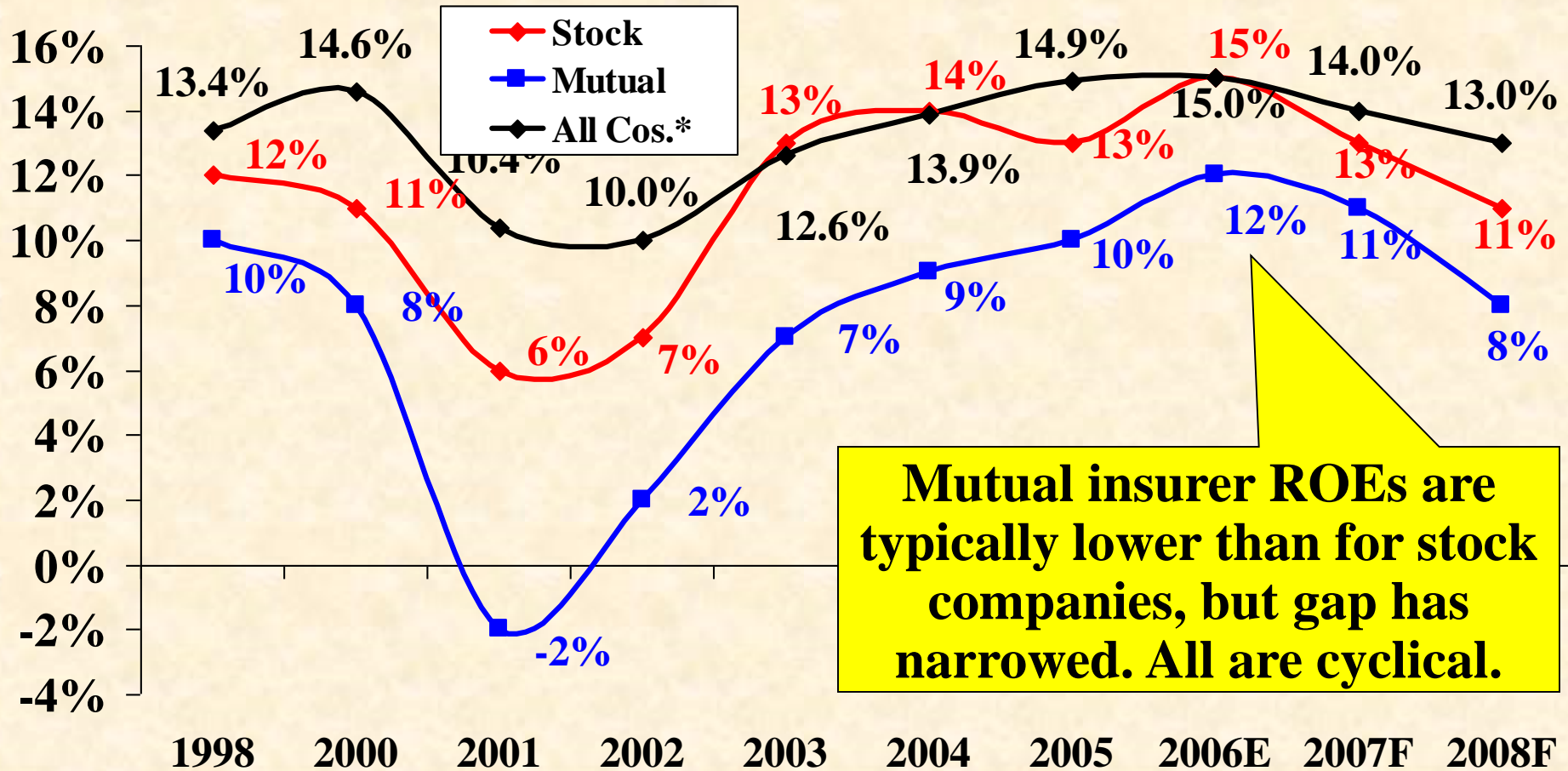
1987–2008E



*2007-08 P/C insurer ROEs are I.I.I. estimates.
Source: Insurance Information Institute; *Fortune*



RETURN ON EQUITY (Fortune): Stock & Mutual vs. All Companies*

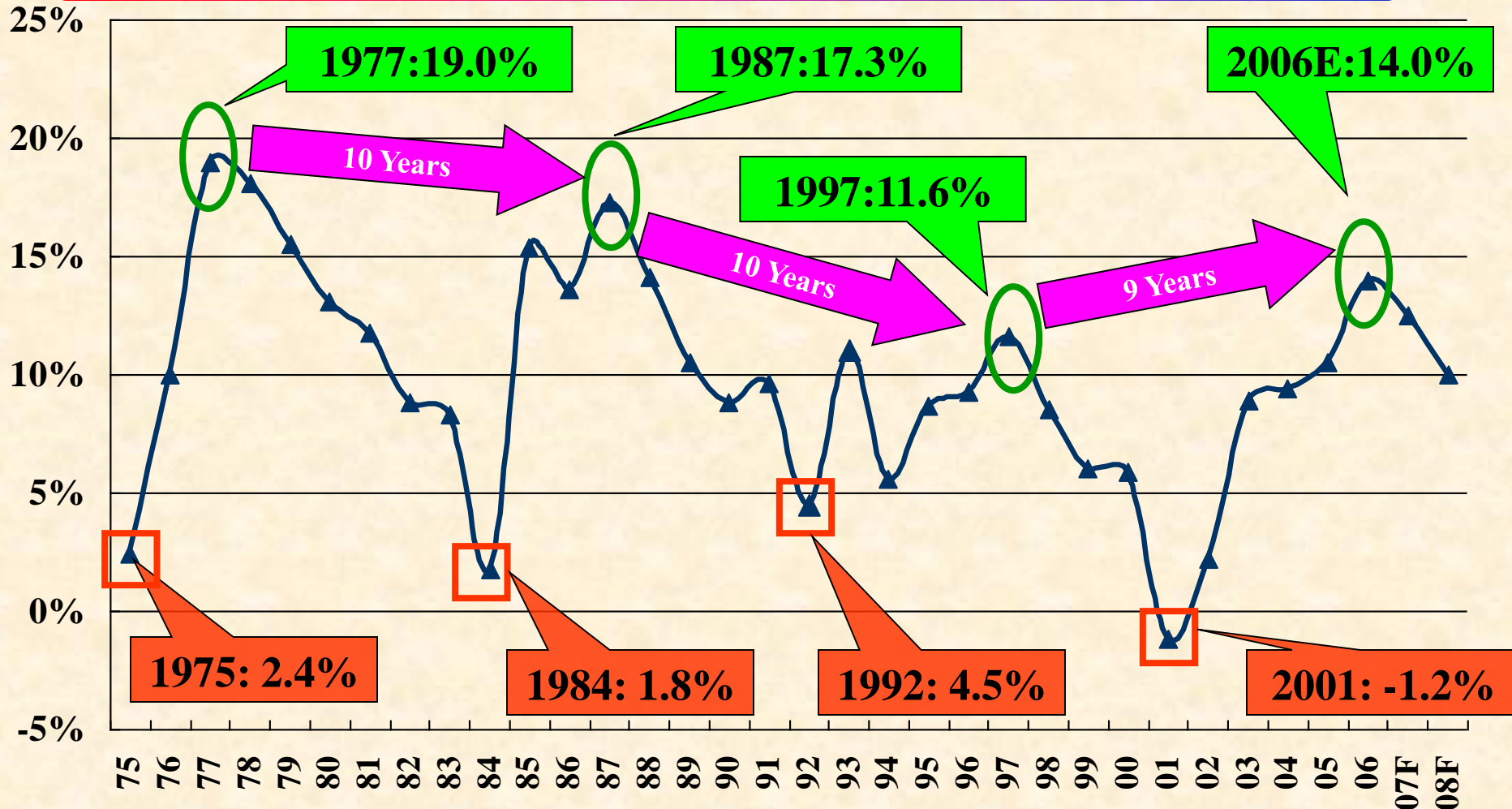


*Fortune 1,000 group.

Source: *Fortune Magazine*, Insurance Information Institute.



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

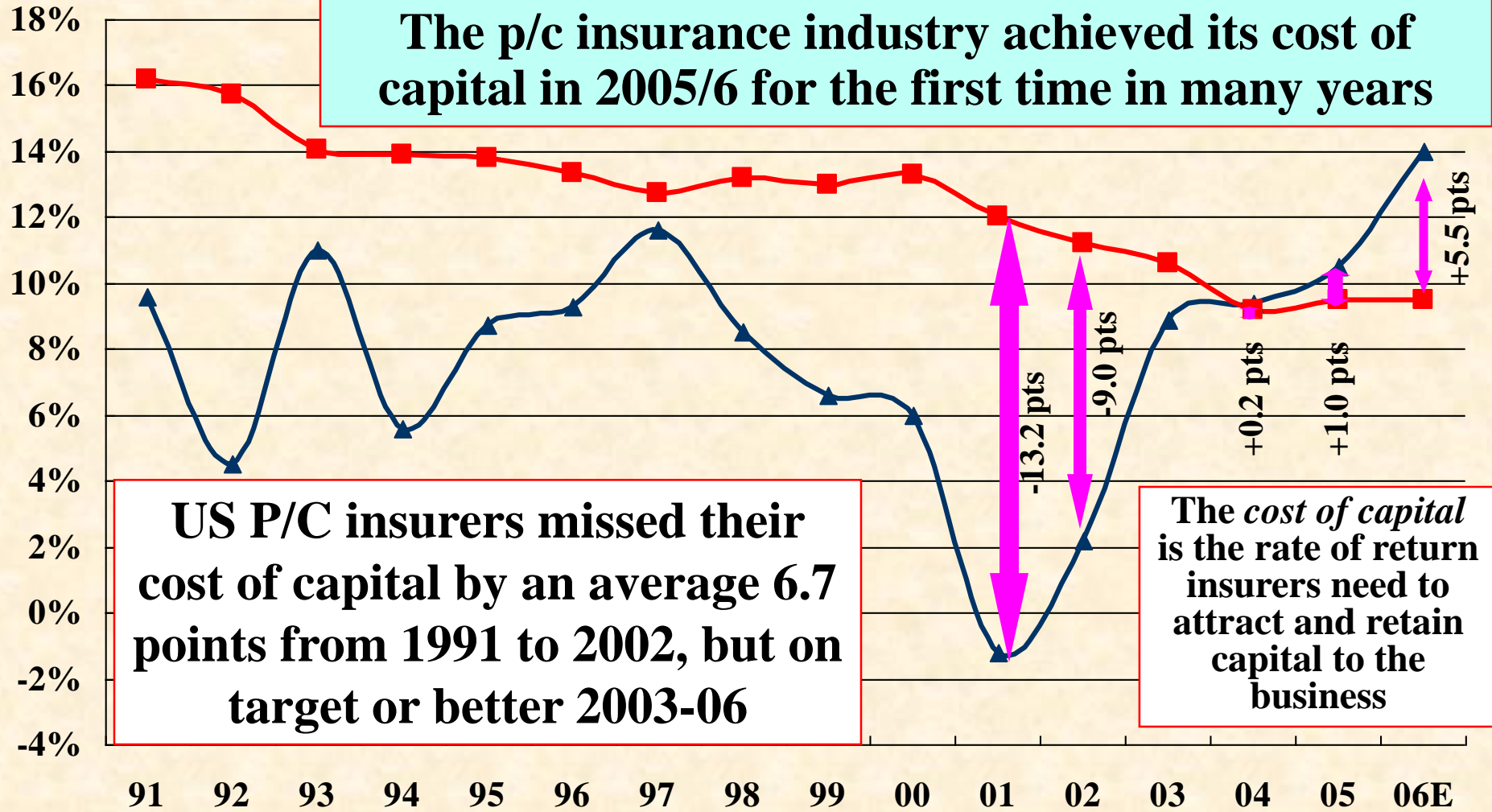


*2007-08 P/C insurer ROEs are I.I.I. estimates.

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



ROE vs. Equity Cost of Capital: US P/C Insurance: 1991-2006



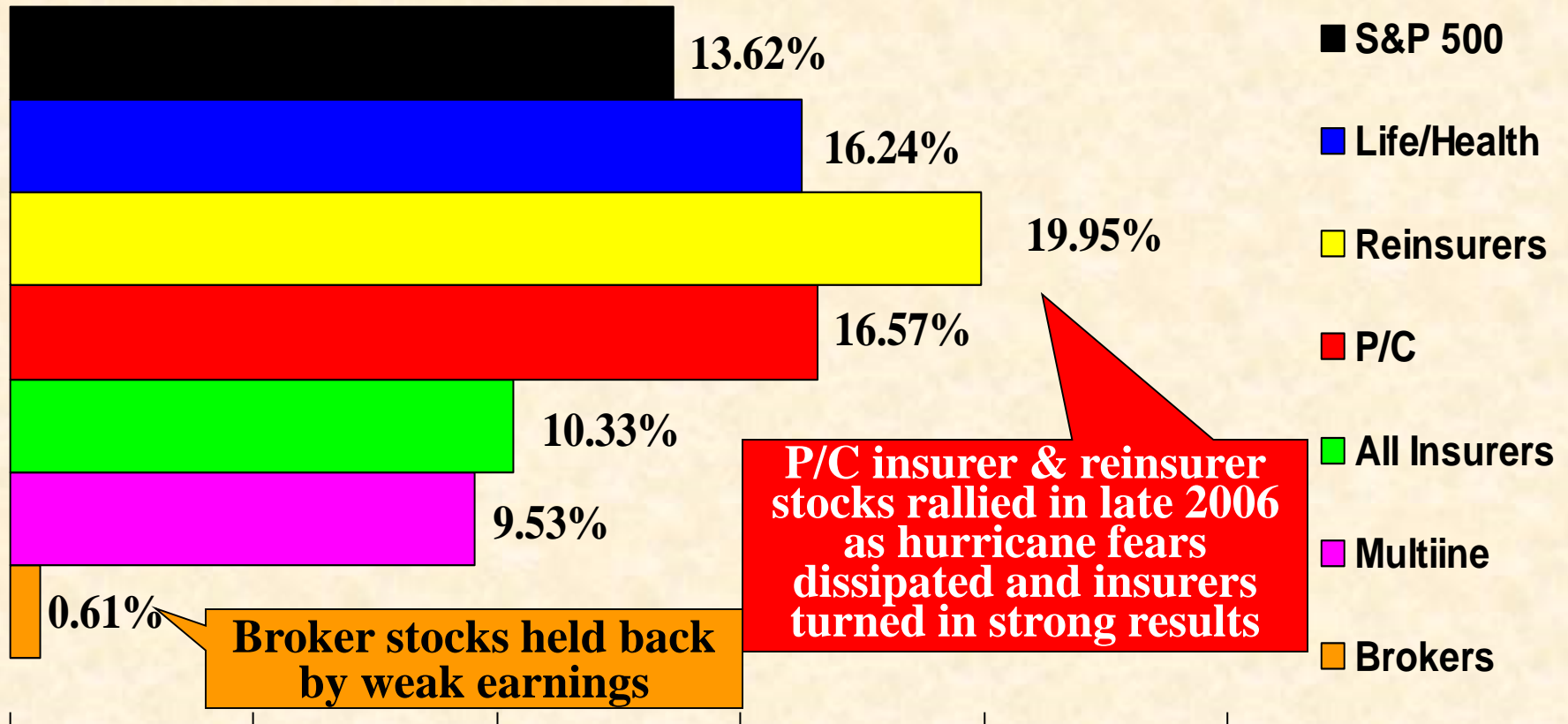
Source: The Geneva Association, Ins. Information Inst.

—▲ ROE —■ Cost of Capital



Insurance & Reinsurance Stocks: Strong Finish in 2006

Total Returns for 2006

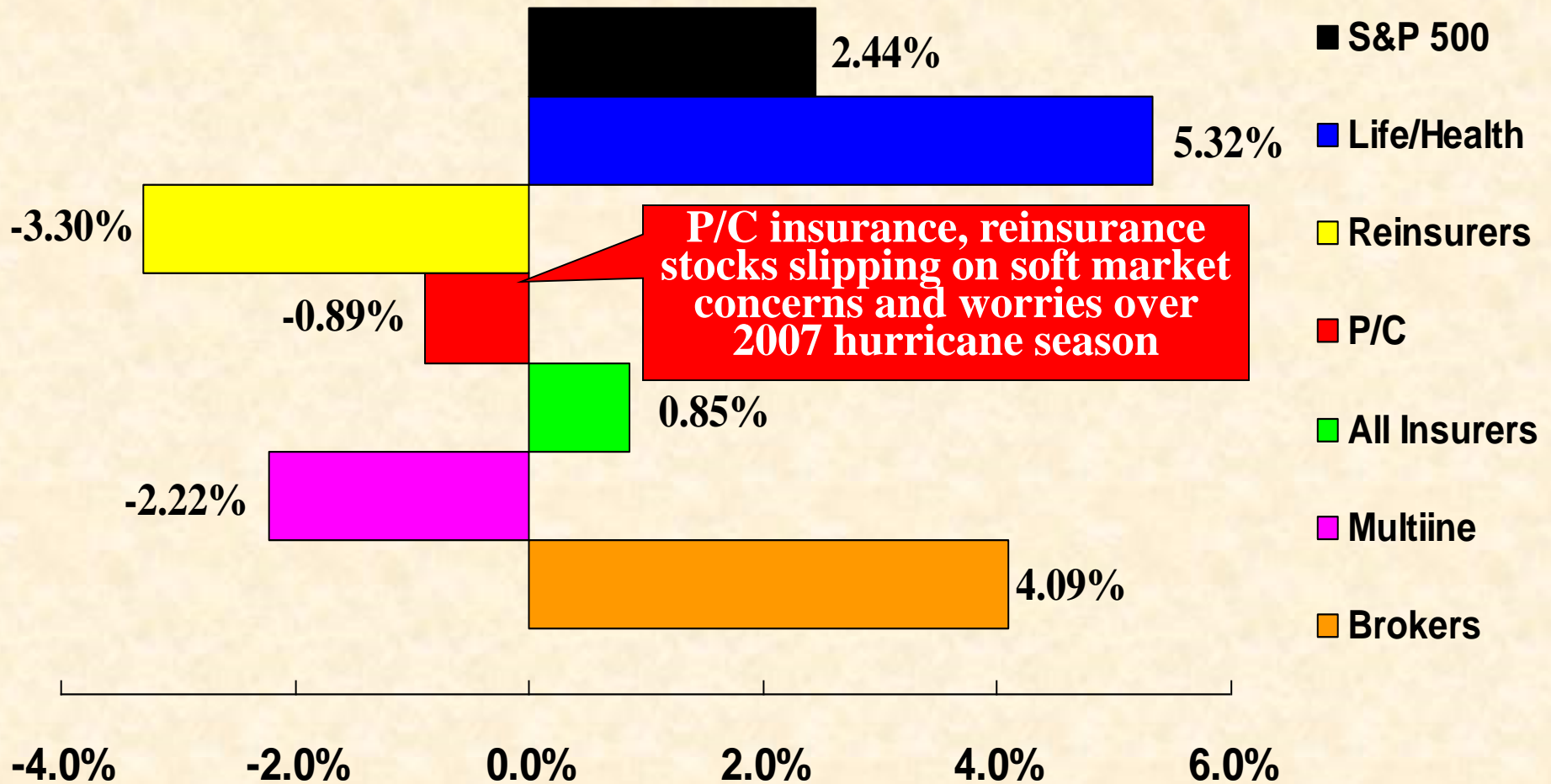


0.0% 5.0% 10.0% 15.0% 20.0% 25.0%



Insurance & Reinsurance Stocks: Slow Start in 2007 in P/C, Reins

Total YTD Returns Through April 13, 2007



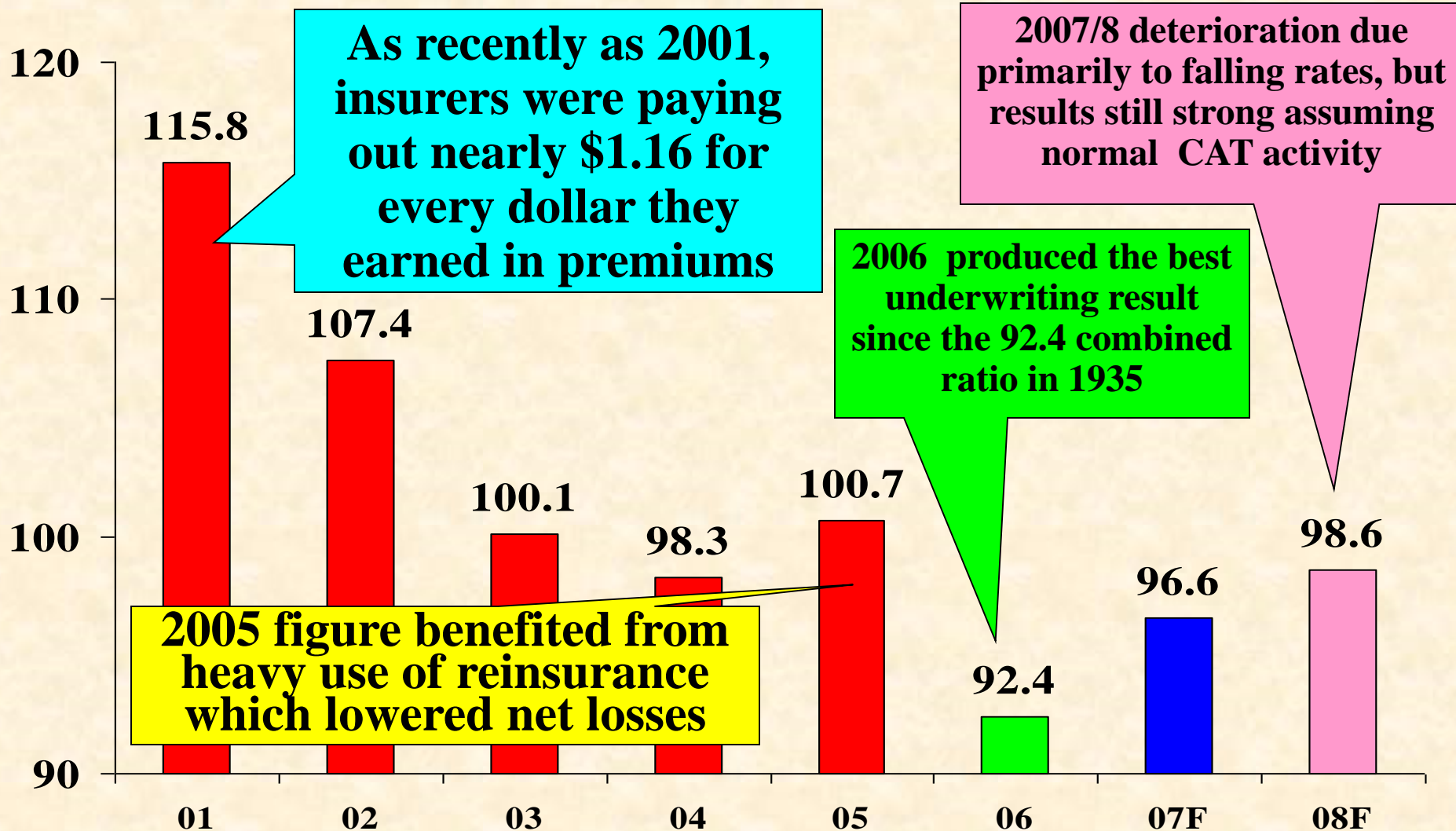
Source: SNL Securities, Standard & Poor's, Insurance Information Institute

#2. Maintaining Underwriting Discipline

**Extremely Strong 2006,
!!! Momentum for 2007**



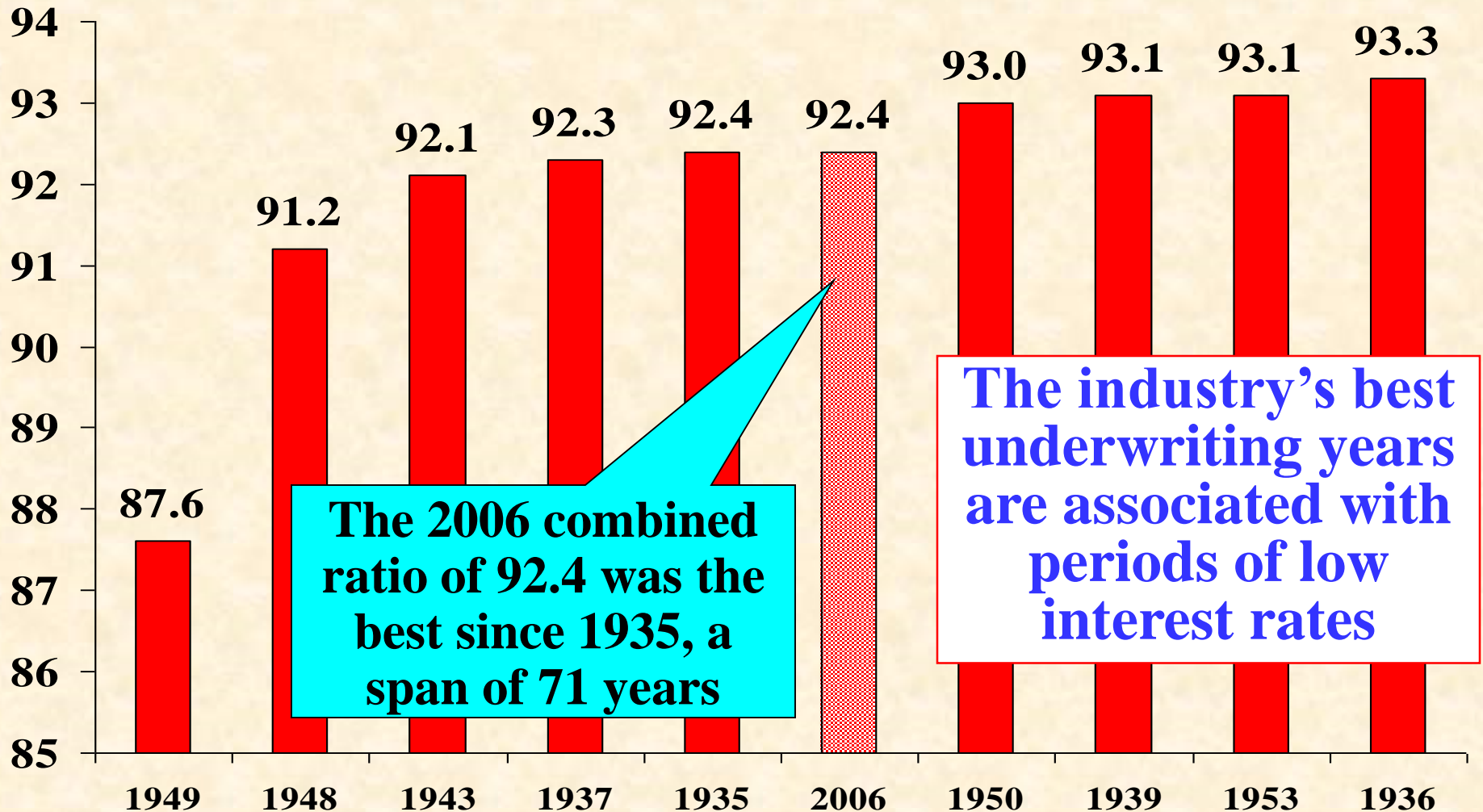
P/C Industry Combined Ratio



Sources: A.M. Best; ISO, III. *Estimates/forecasts based on III's 2007 Early Bird survey.

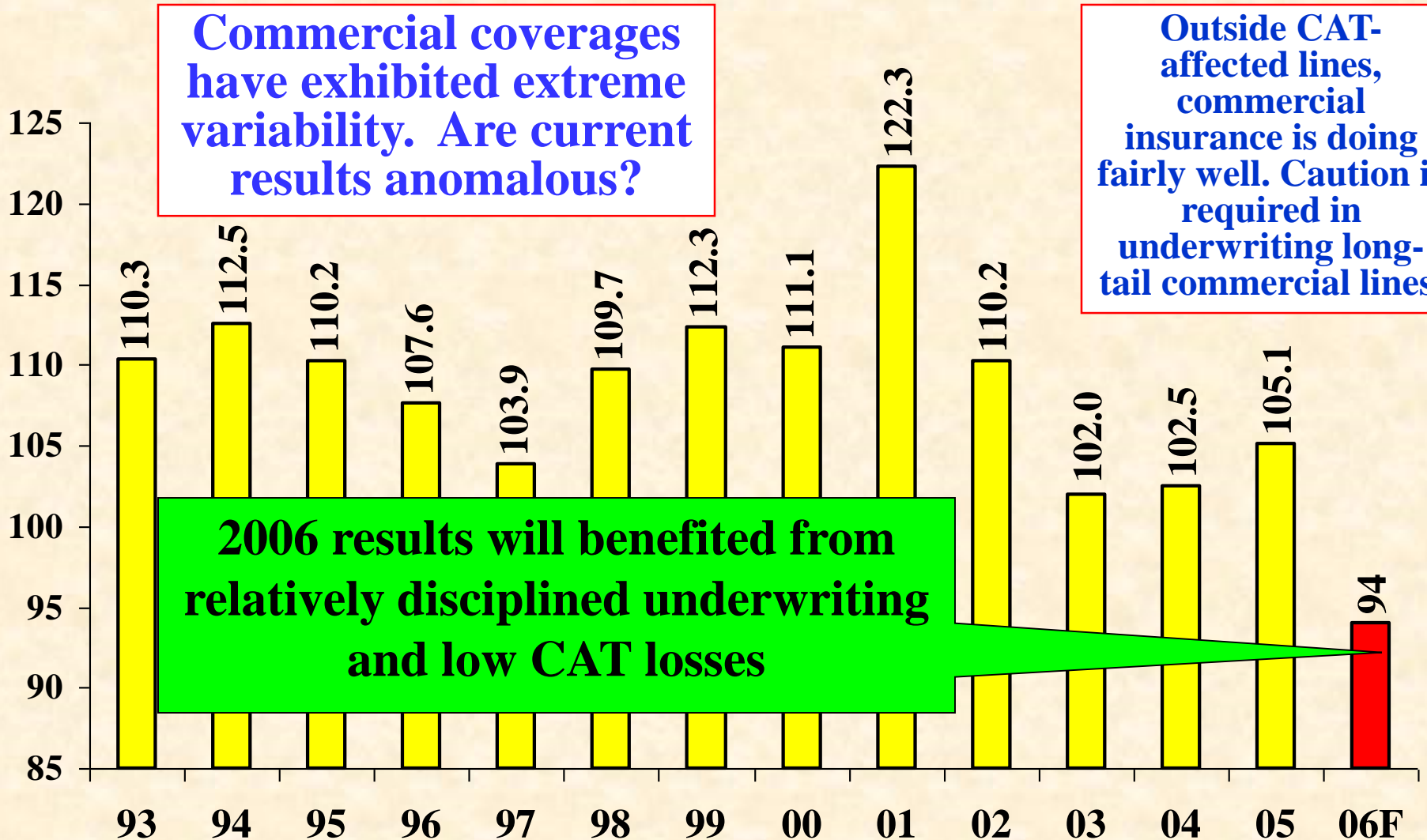


Ten Lowest P/C Insurance Combined Ratios Since 1920





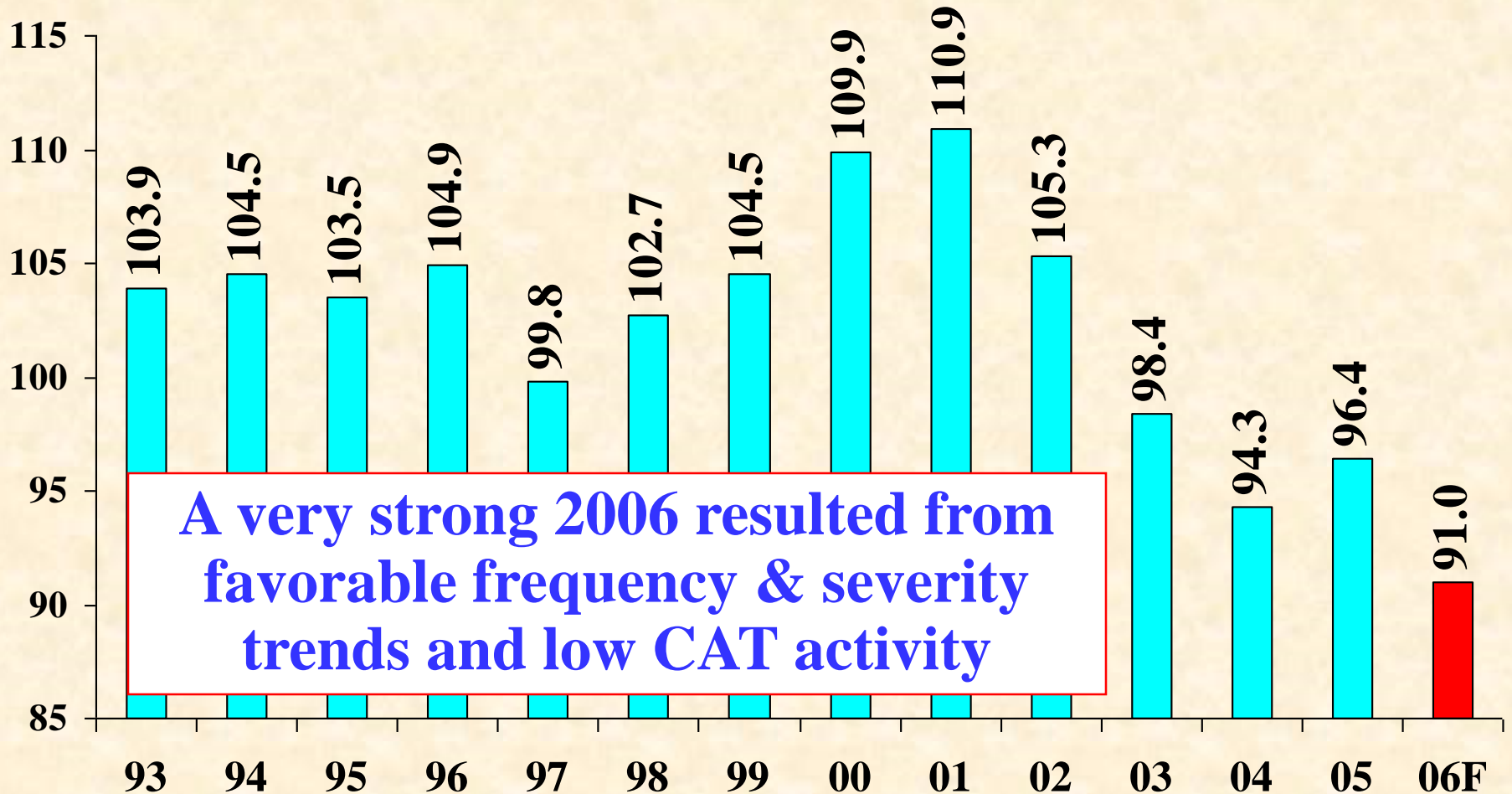
Commercial Lines Combined Ratio, 1993-2006E*





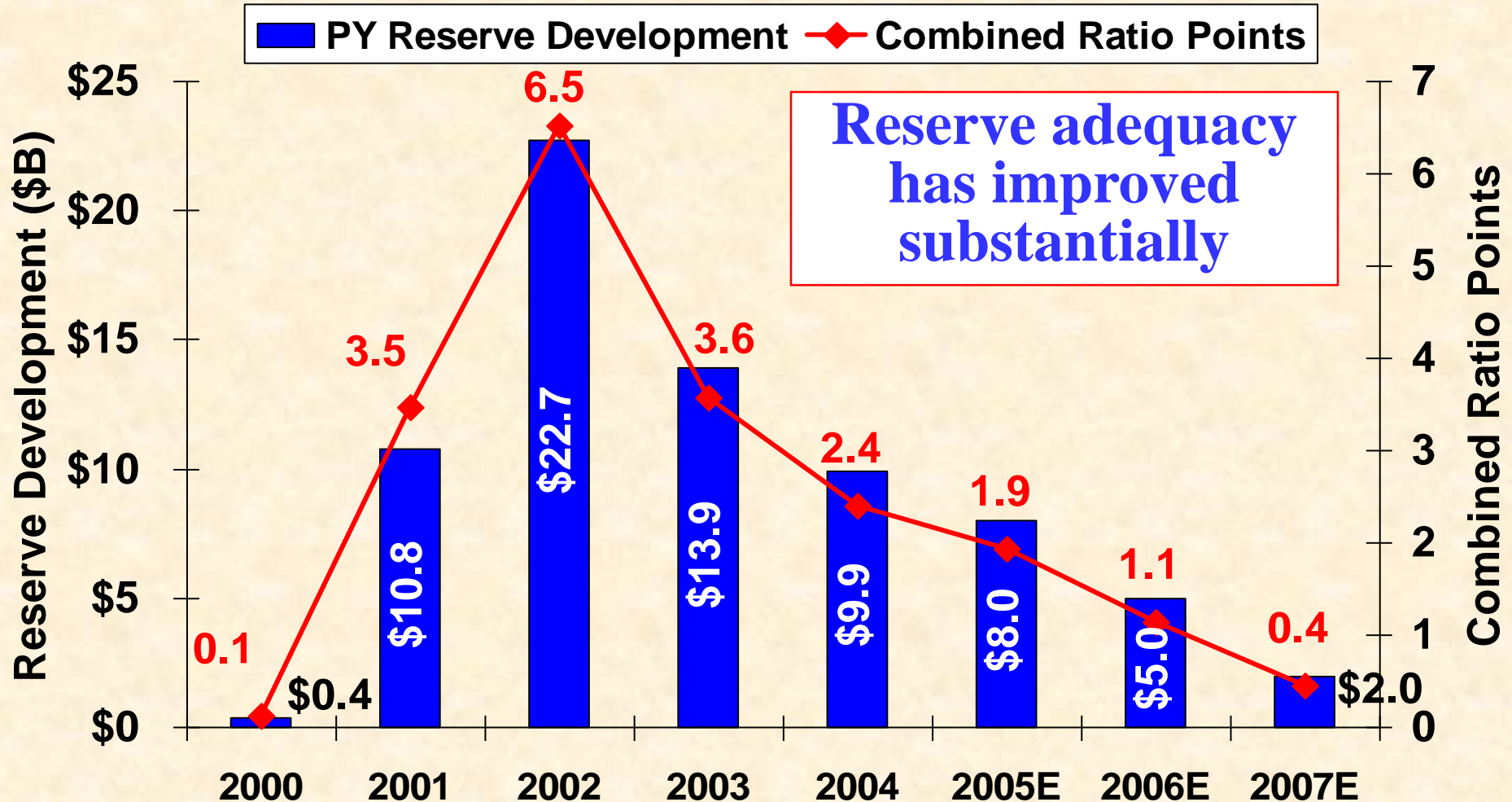
Personal Lines

Combined Ratio, 1993-2006E



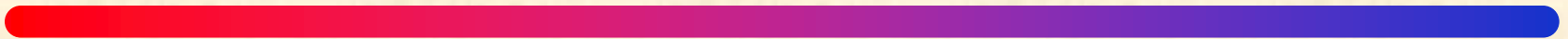


Impact of Reserve Changes on Combined Ratio



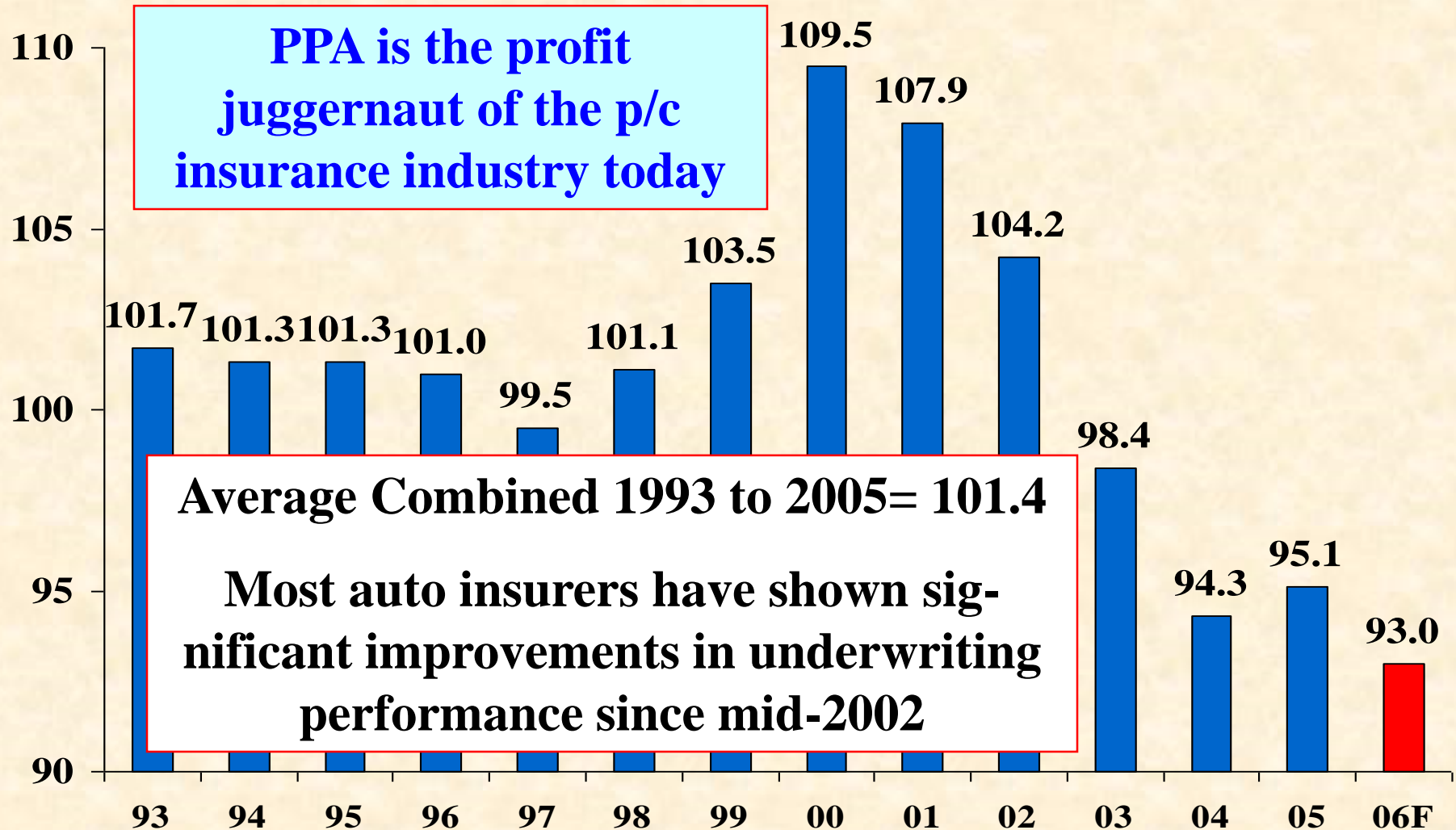
Source: A.M. Best, Lehman Brothers for years 2005E-2007F

Private Passenger Auto



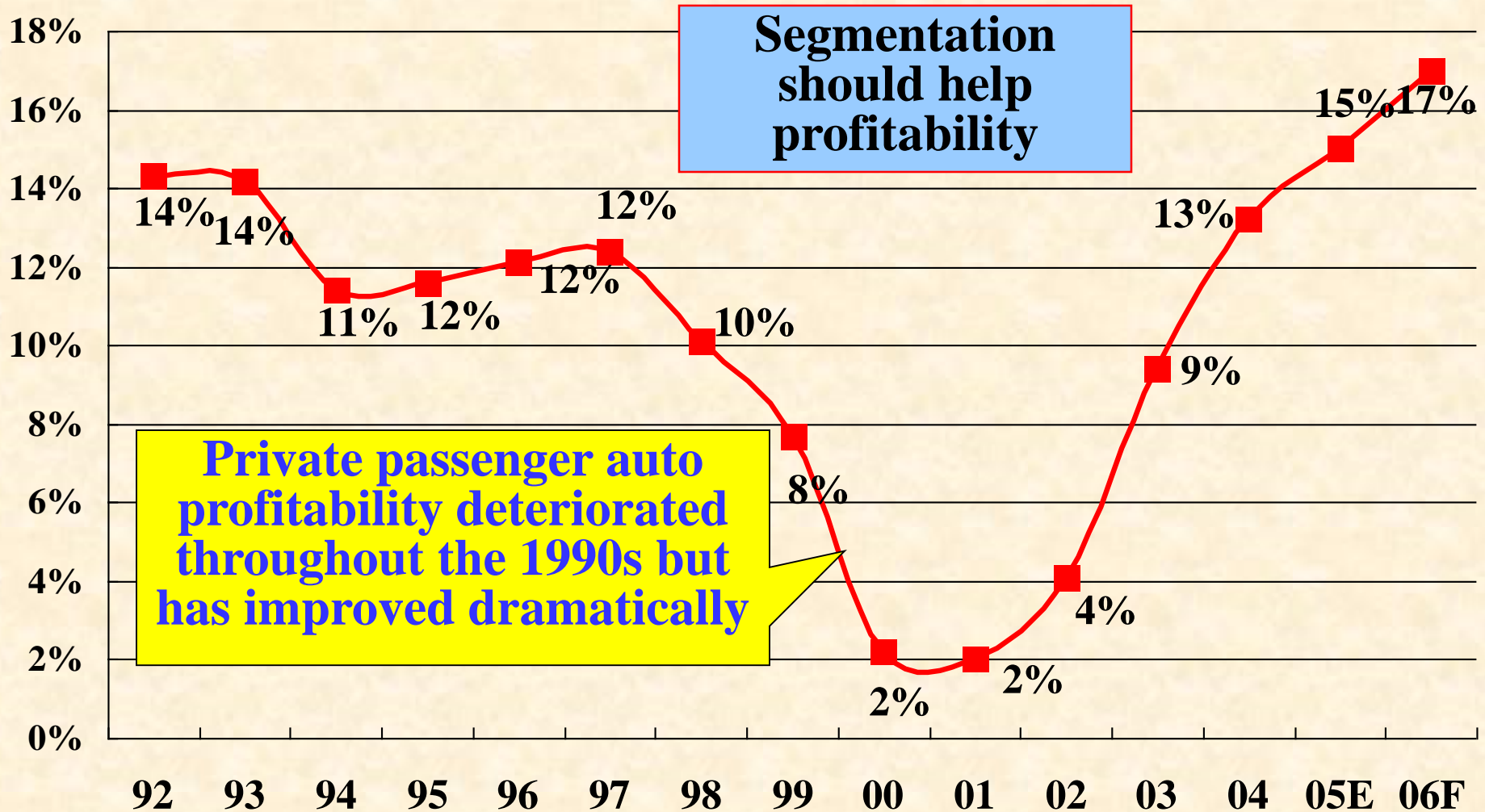


Private Passenger Auto Combined Ratio



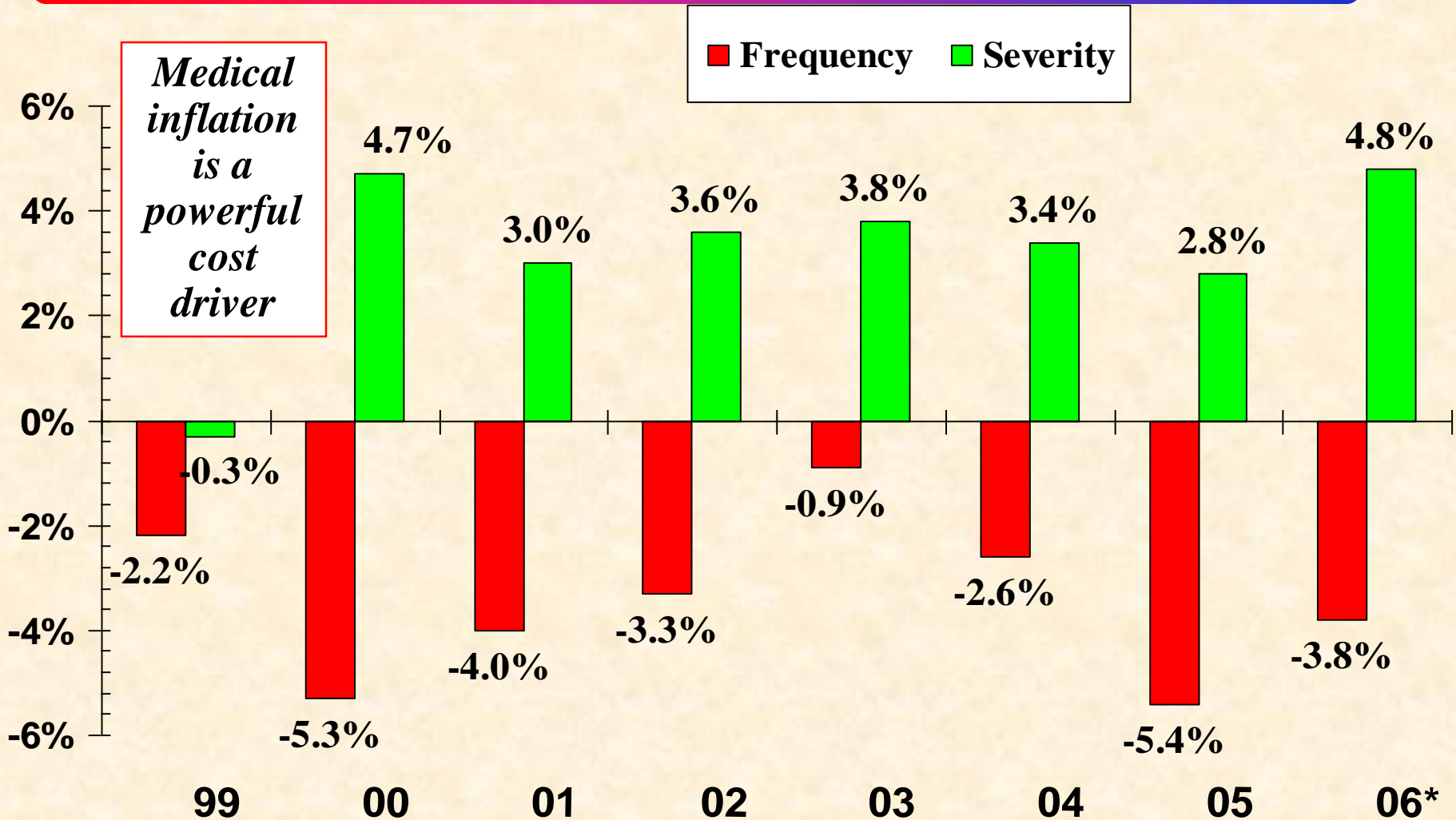


RNW: Private Passenger Auto, United States, 1992-2006E





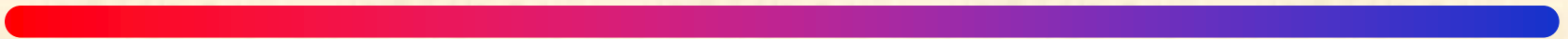
Bodily Injury: Severity Trend Running Ahead of Frequency



*Average of 4 quarters ending with 4th quarter 2006.

Source: ISO Fast Track data.

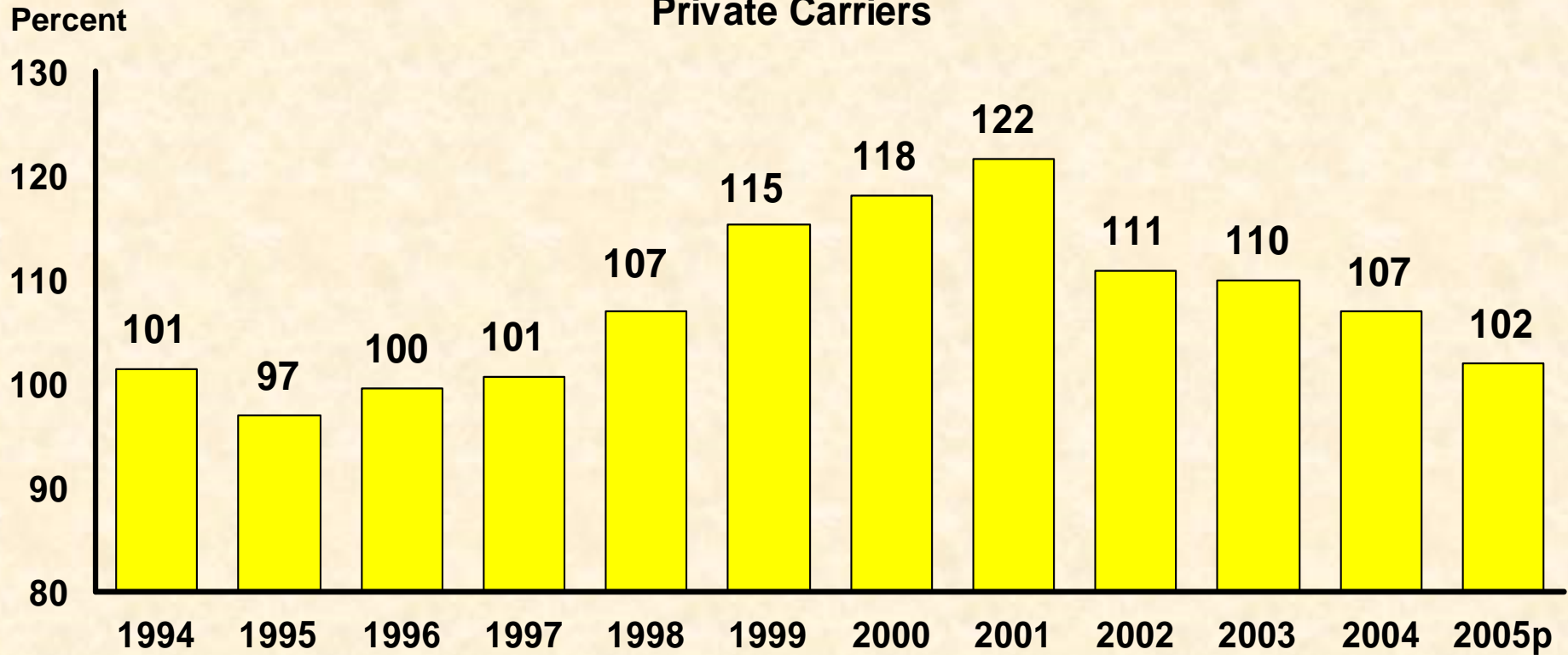
Workers Compensation





Workers Comp Combined Ratios, 1994-2005P

Workers Comp Calendar Year vs. Ultimate Accident Year – Private Carriers



■ Calendar Year

p Preliminary AY figure.

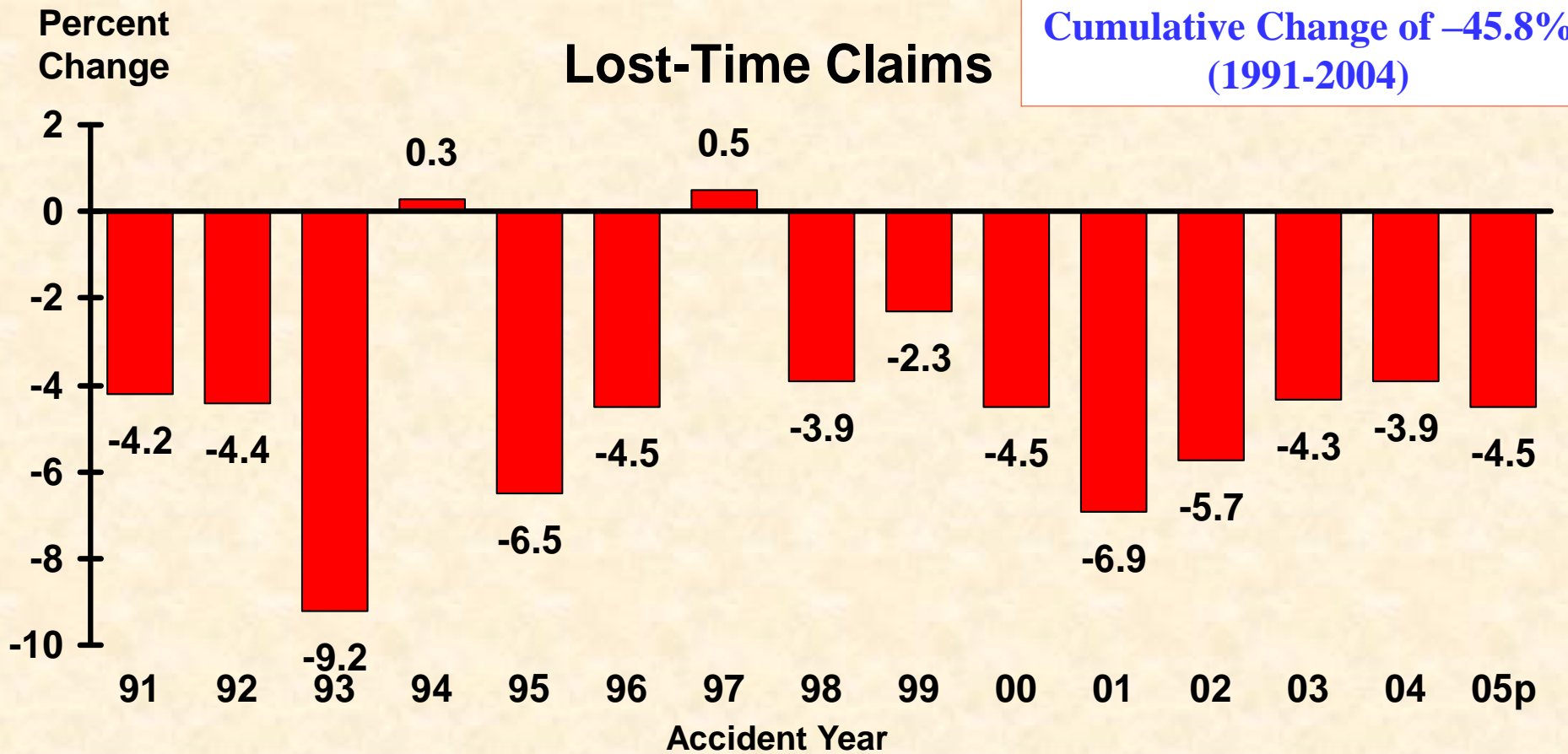
Accident Year data is evaluated as of 12/31/2005 and developed to ultimate

Source: Calendar Years 1994-2004, A.M. Best Aggregates & Averages; Calendar Year 2005p and Accident Years 1994-2005p based on NCCI Annual Statement Analysis.

Includes dividends to policyholders



Workers Comp Lost-Time Claim Frequency (% Change)



2003p: Preliminary based on data valued as of 12/31/2005
1991-2003: Based on data through 12/31/2004, developed to ultimate
Based on the states where NCCI provides ratemaking services
Excludes the effects of deductible policies
Source: NCCI

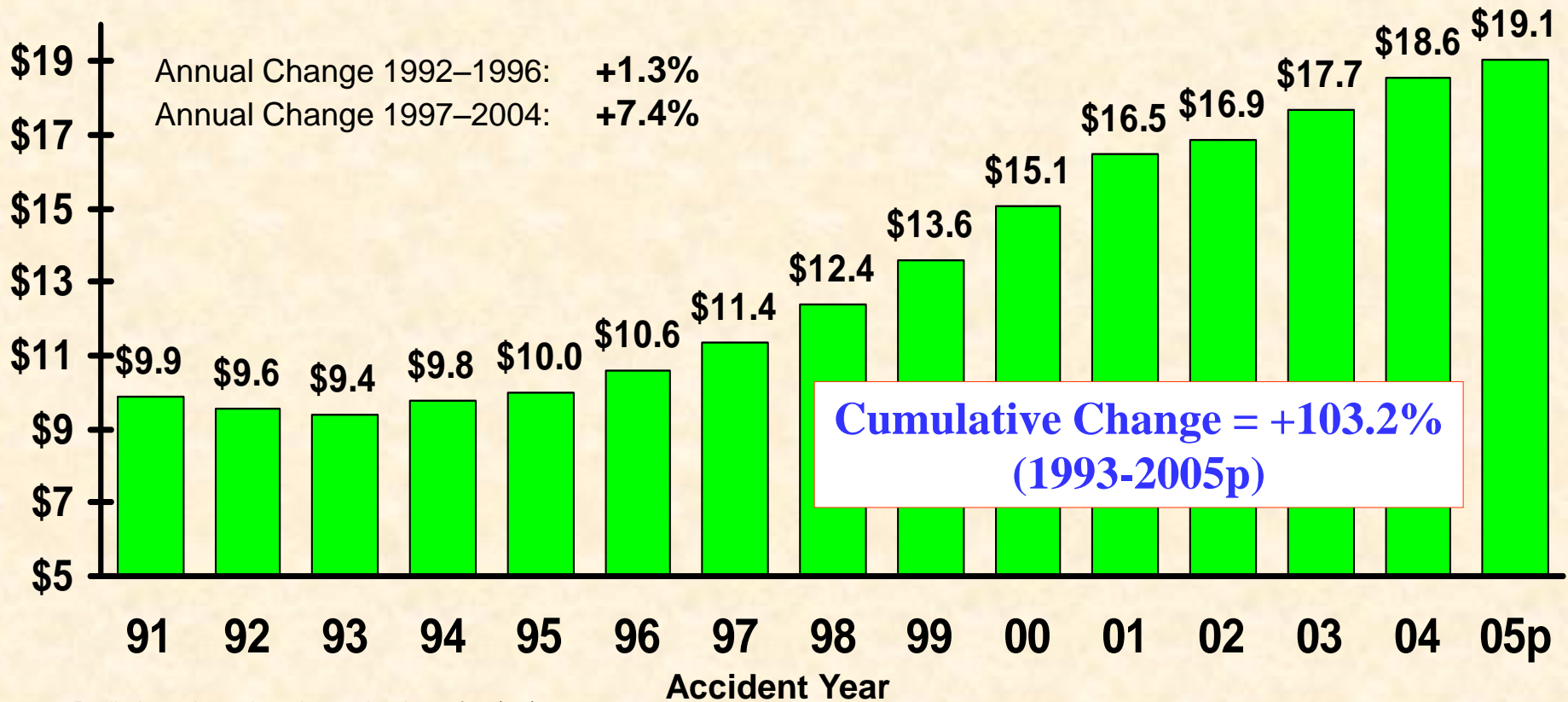


Workers Comp Indemnity Claims

Costs Have Accelerated, 1993-2005p

Indemnity
Claim Cost (000s)

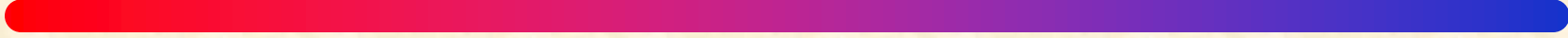
Lost-Time Claims



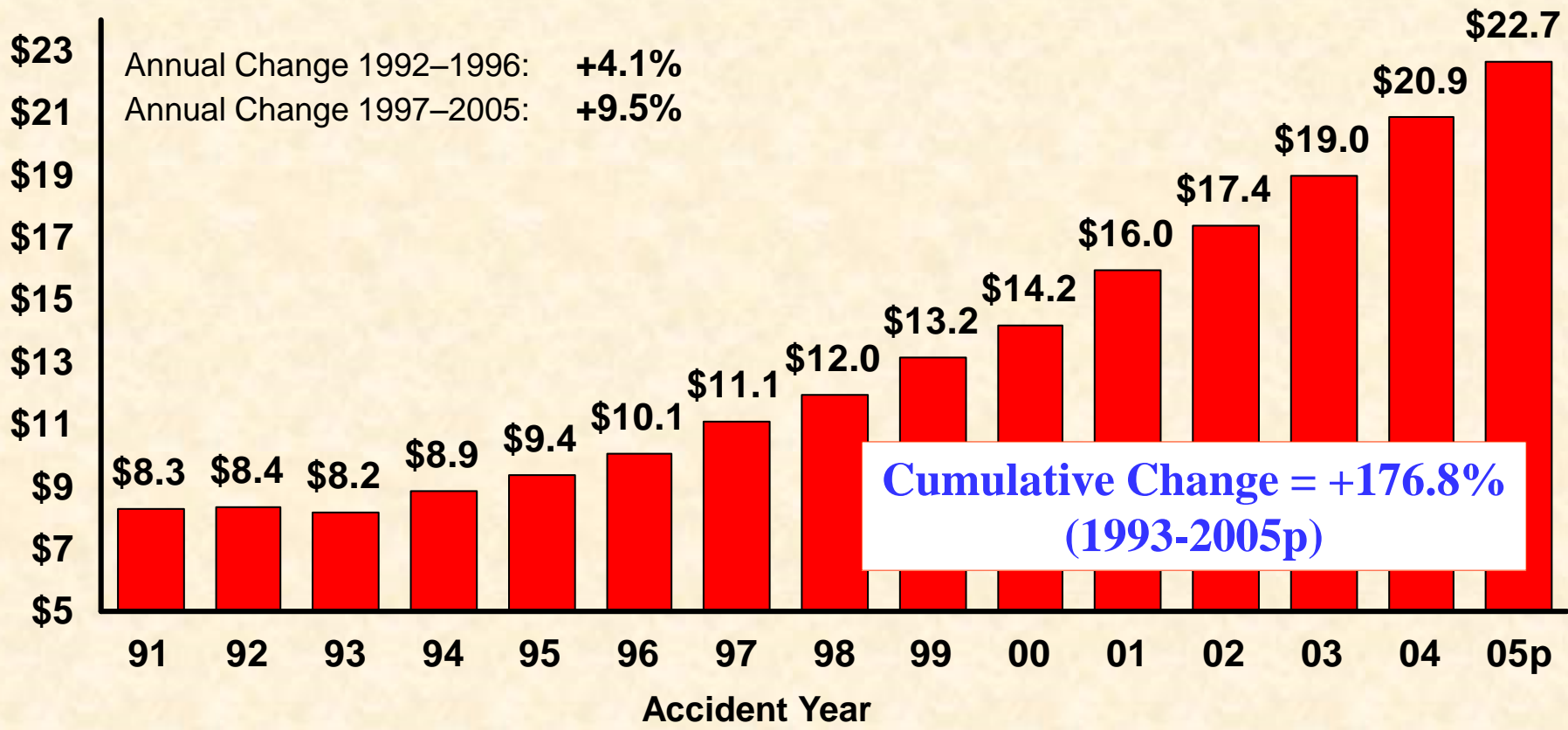
2005p: Preliminary based on data valued as of 12/31/2005
1991-2004: Based on data through 12/31/2004, developed to ultimate
Based on the states where NCCI provides ratemaking services
Excludes the effects of deductible policies
Source: NCCI



Workers Comp Medical Claims Continue to Climb



Medical
Claim Cost (\$000s)

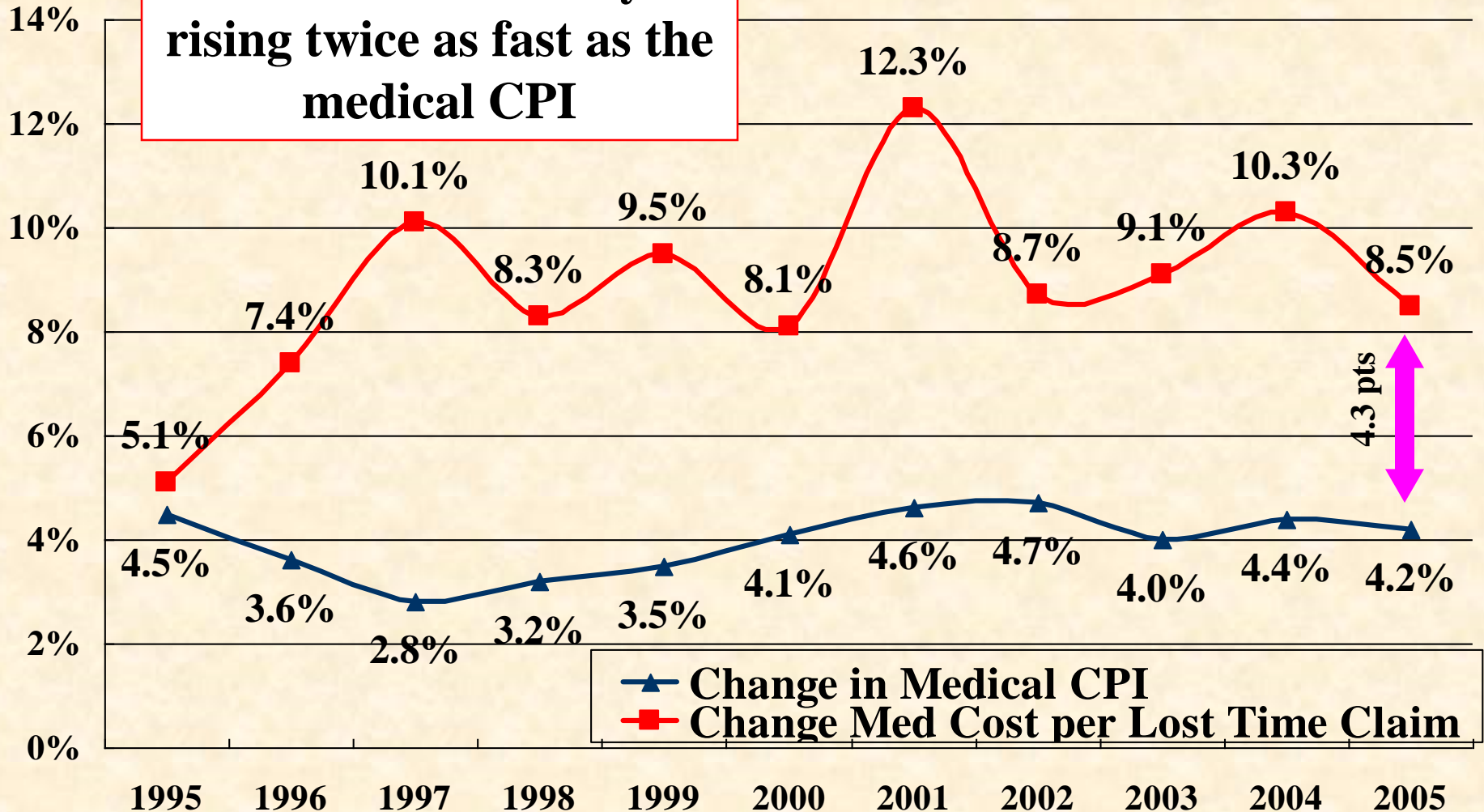


2005p: Preliminary based on data valued as of 12/31/2005
1991-2004: Based on data through 12/31/2004, developed to ultimate
Based on the states where NCCI provides ratemaking services; Excludes the effects of deductible policies



WC Medical Severity Rising Far Faster than Medical CPI

WC medical severity is rising twice as fast as the medical CPI



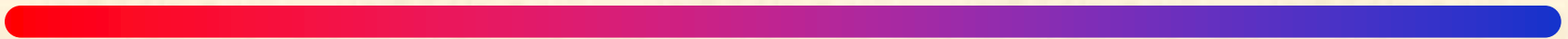
4.3 pts

▲ Change in Medical CPI
■ Change Med Cost per Lost Time Claim

Sources: Med CPI from US Bureau of Labor Statistics, WC med severity from NCCI based on NCCI states.

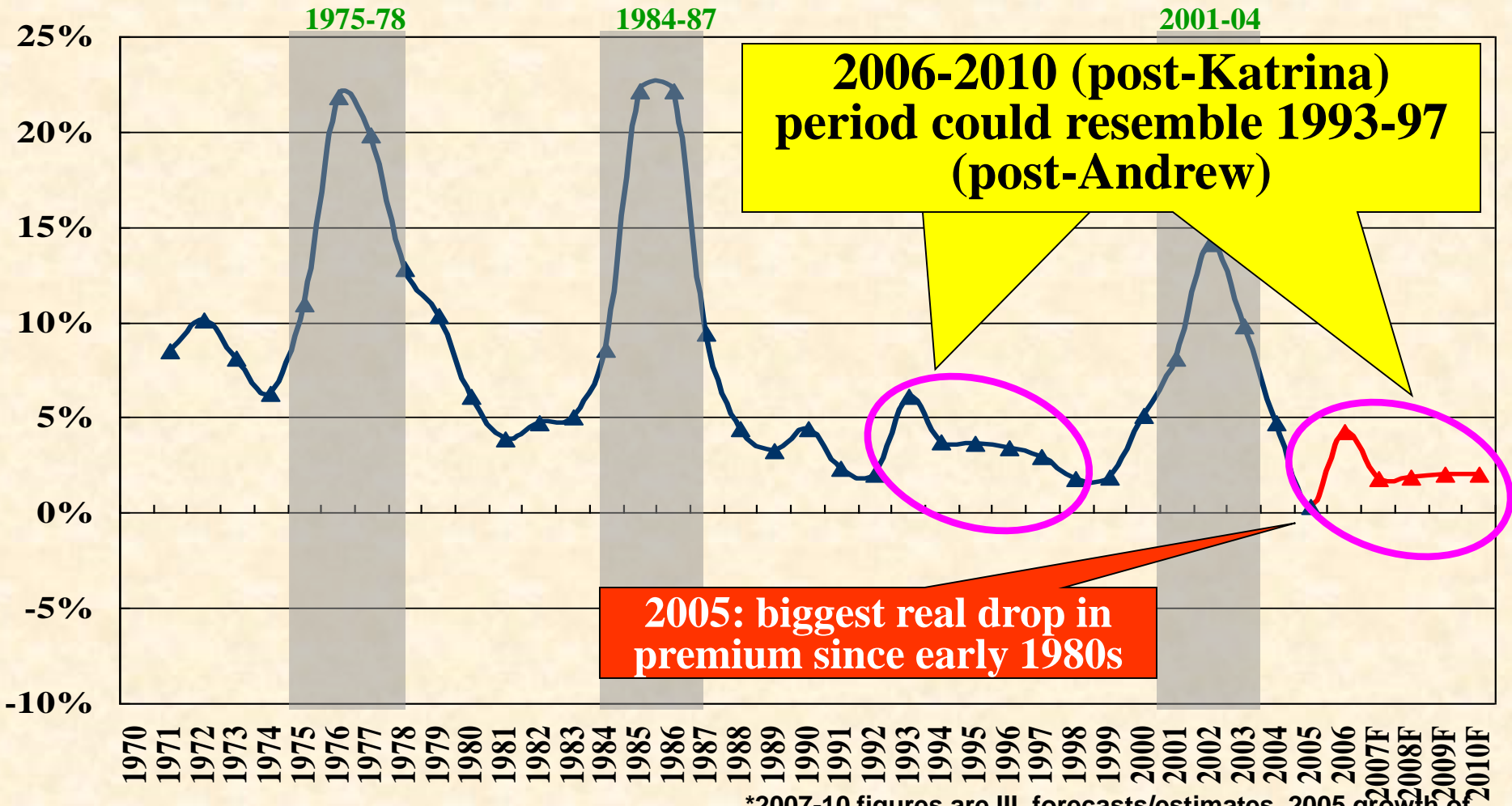
#3. Slow Premium Growth

Managing the Slow
Part of the Cycle





Strength of Recent Hard Markets by NWP Growth*

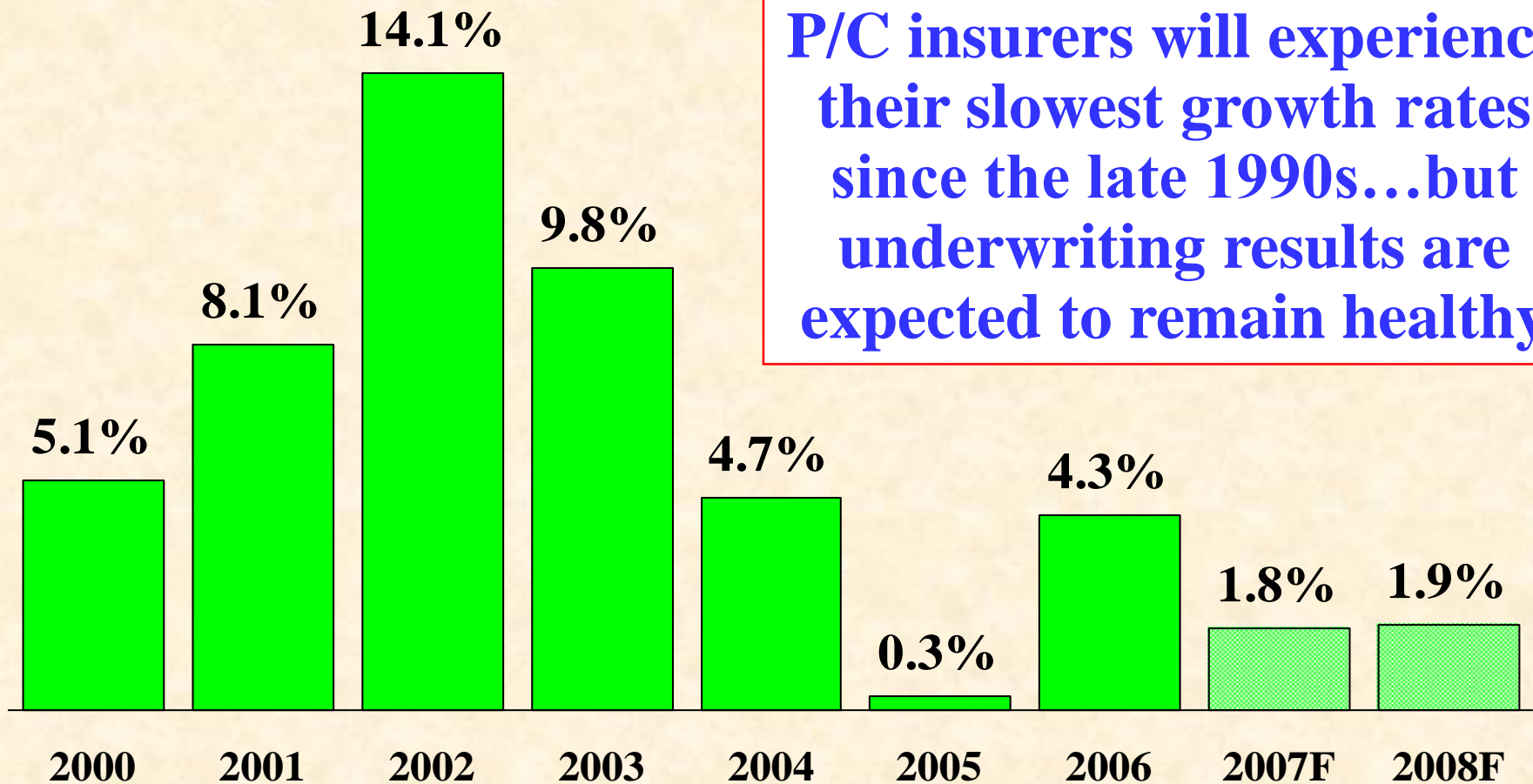


*2007-10 figures are III forecasts/estimates. 2005 growth of 0.4% equates to 1.8% after adjustment for a special one-time transaction between one company and its foreign parent. 2006-2008 figures from III Groundhog Survey.

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



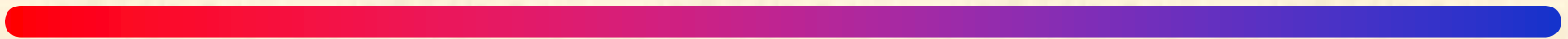
Growth in Net Written Premium, 2000-2008F



P/C insurers will experience their slowest growth rates since the late 1990s...but underwriting results are expected to remain healthy

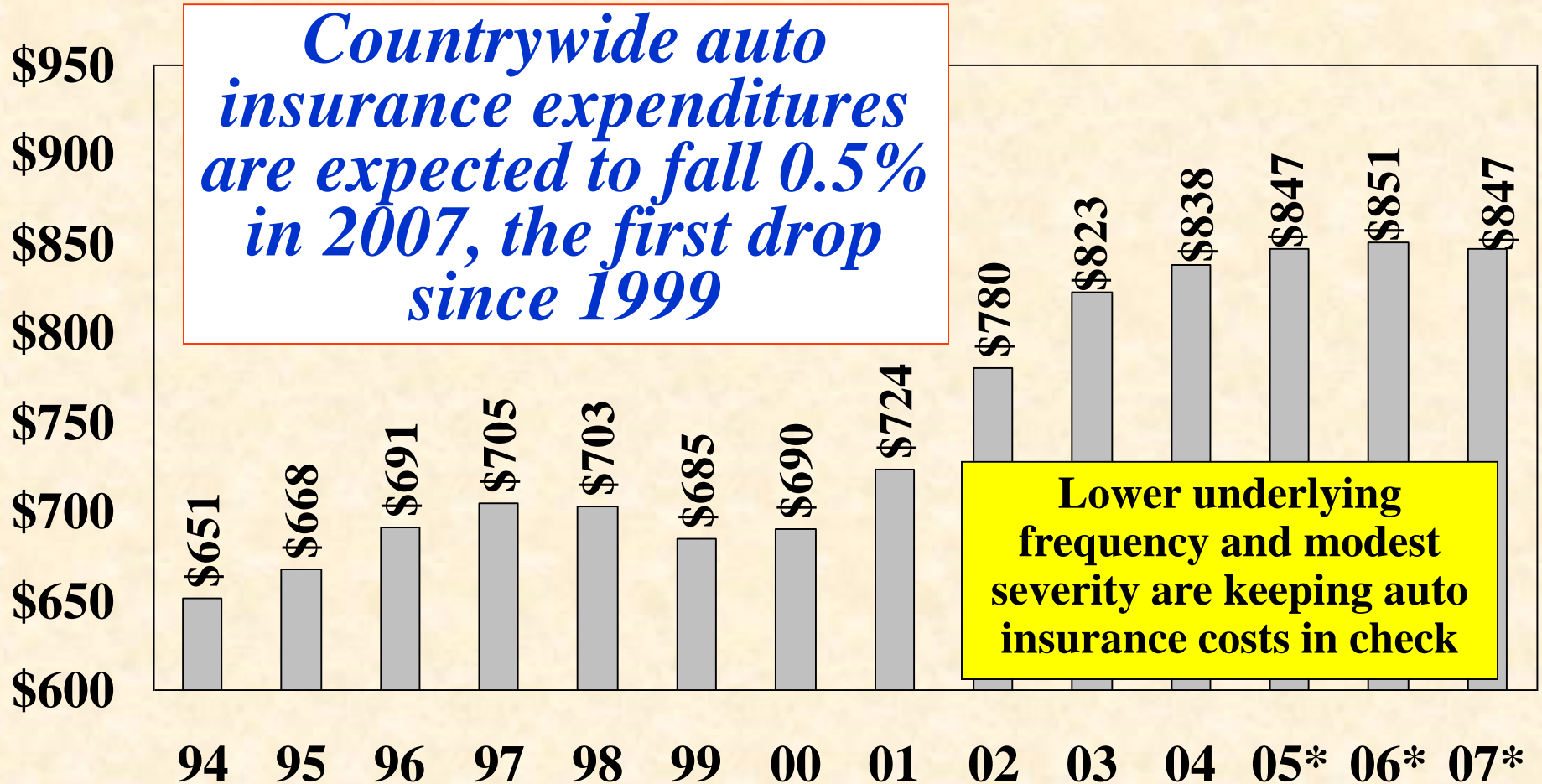
PRICING

Under Pressure in 2007





Average Expenditures on Auto Insurance

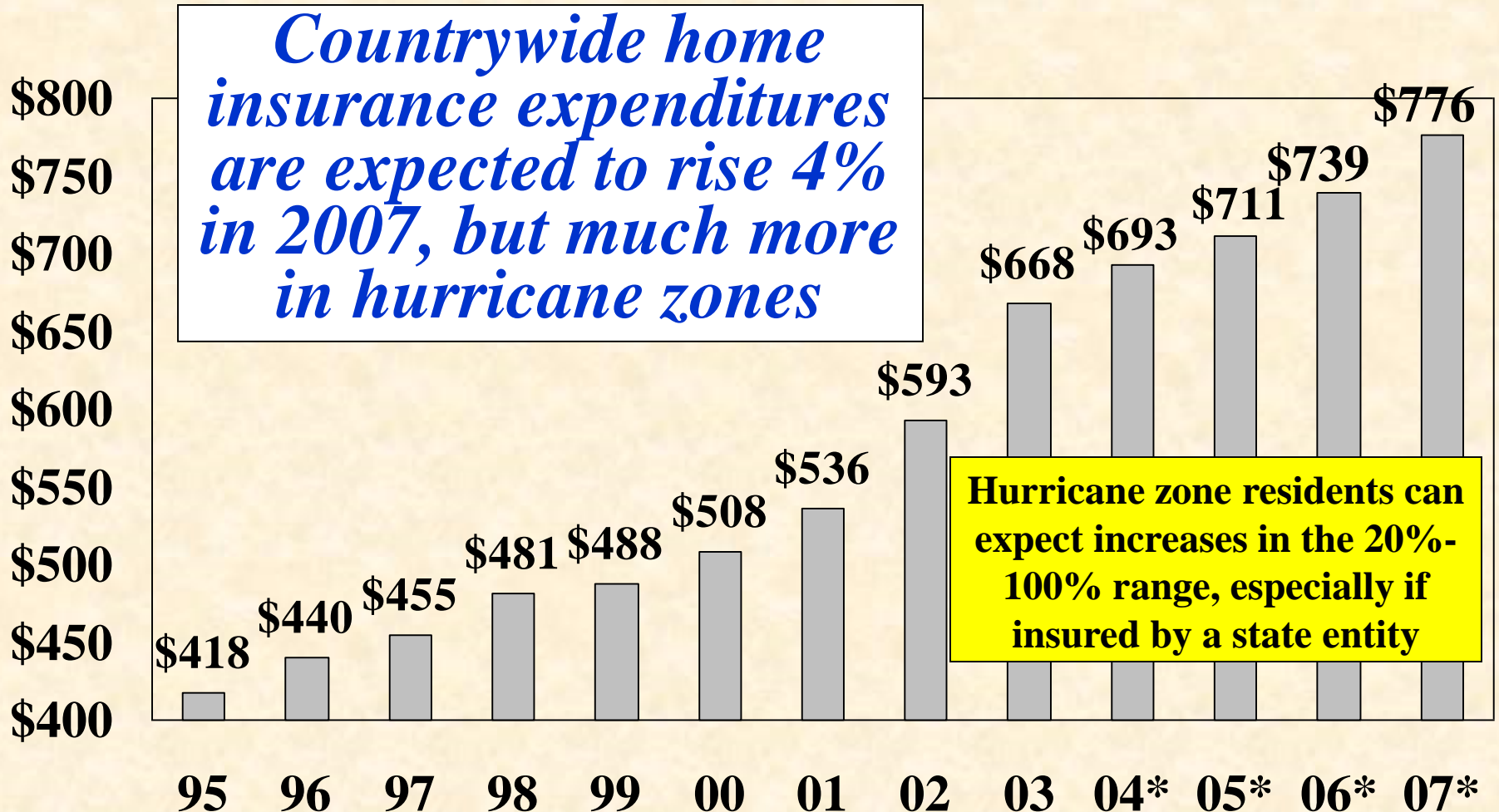


*Insurance Information Institute Estimates/Forecasts

Source: NAIC, Insurance Information Institute



Average Expenditures on Homeowners Insurance

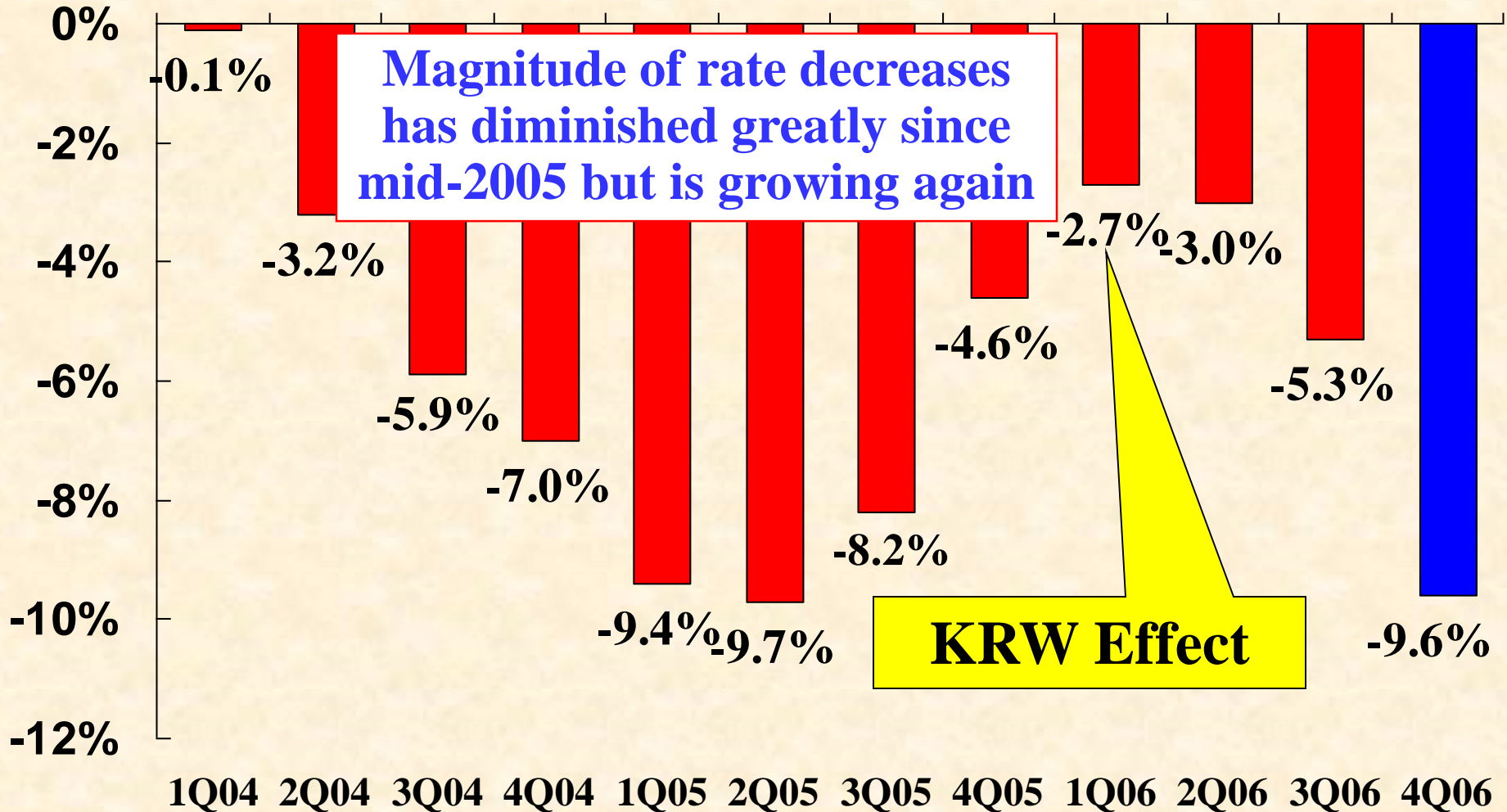


*Insurance Information Institute Estimates/Forecasts

Source: NAIC, Insurance Information Institute

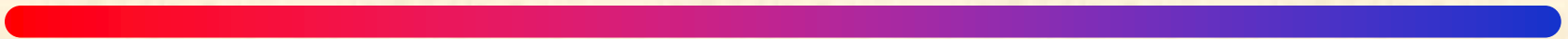


Average Commercial Rate Change, All Lines, (1Q:2004 – 4Q:2006)



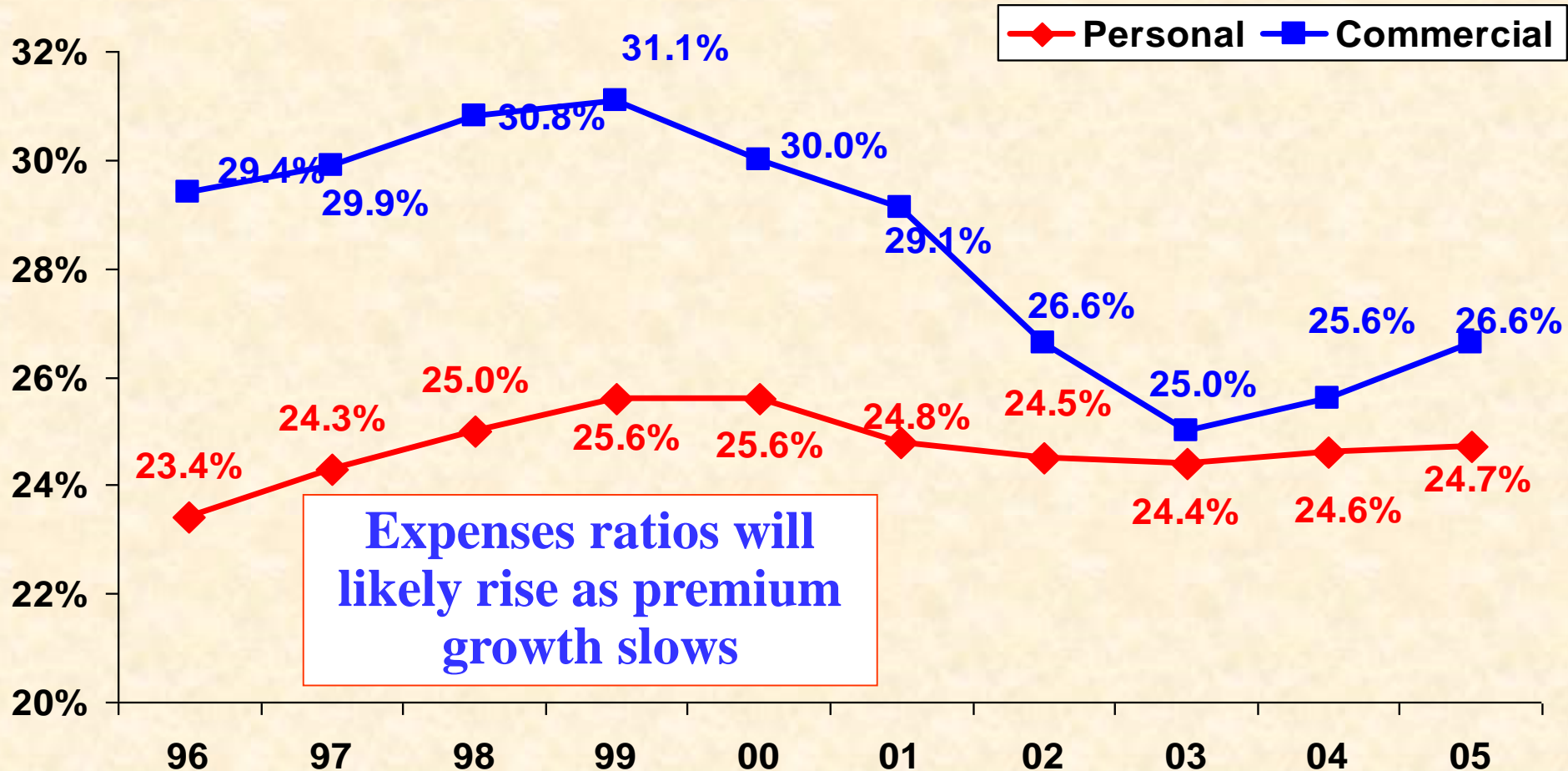
EXPENSES

*Will Expense Ratio Rise as
Premium Growth Slows?*





Personal vs. Commercial Lines Underwriting Expense Ratio*

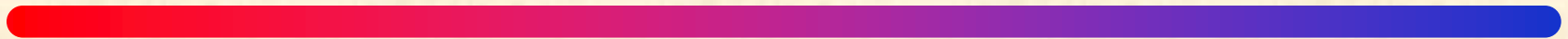


*Ratio of expenses incurred to net premiums written.

Source: A.M. Best; Insurance Information Institute

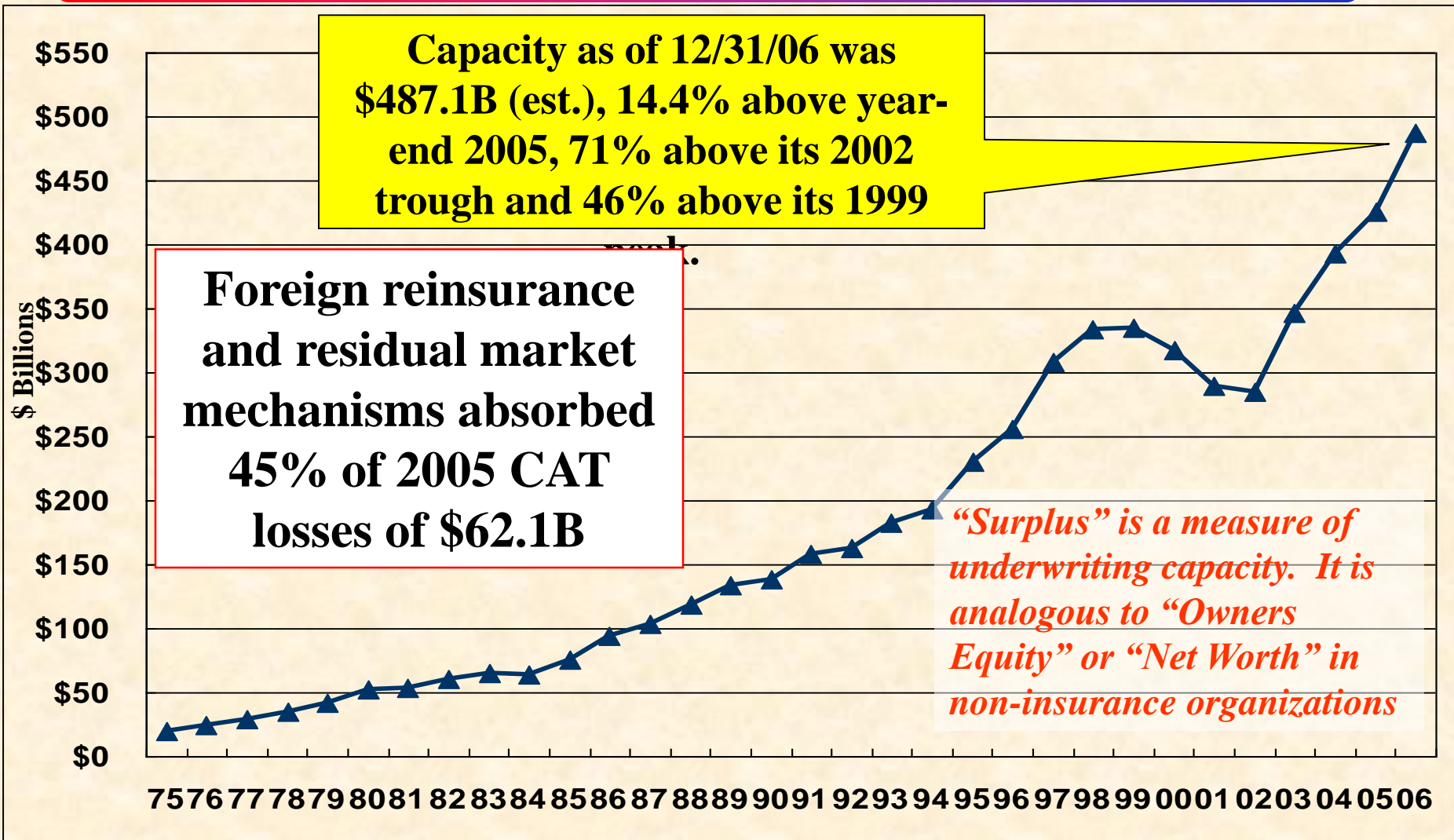
#4. Capital Management

Capital Allocation & Leverage





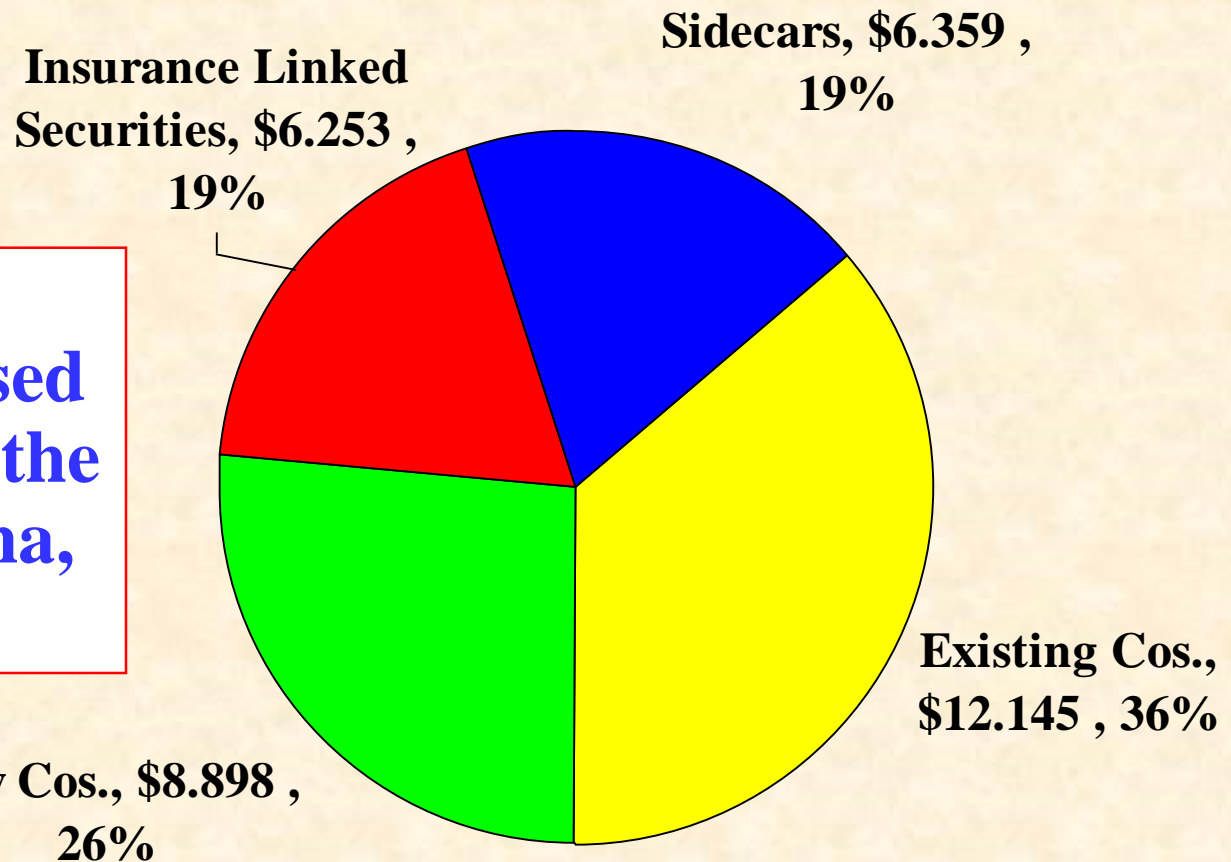
U.S. Policyholder Surplus: 1975-2006





Capital Raising by Class Within 15 Months of KRW

\$ Billions

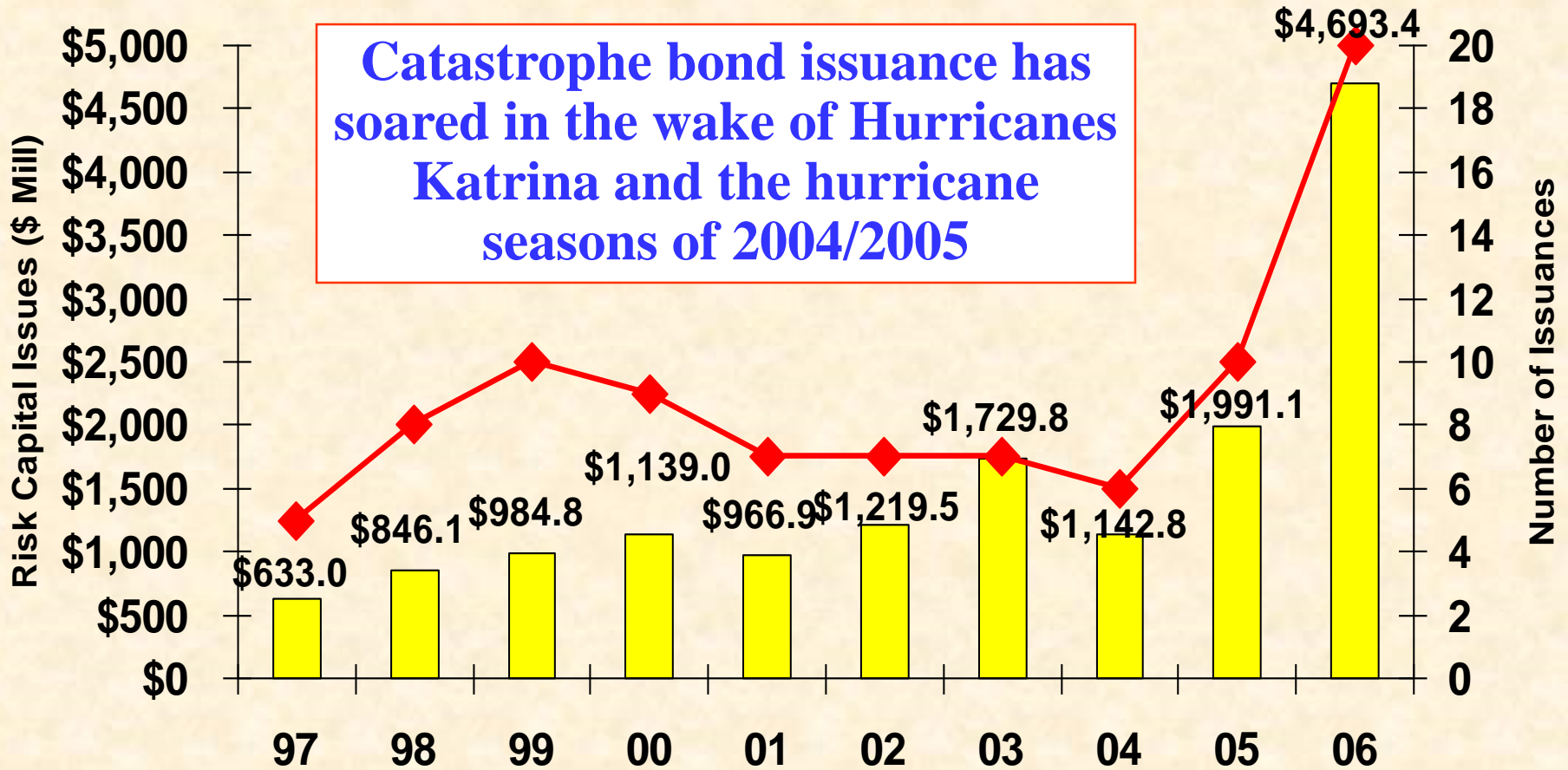


**Insurers &
Reinsurers raised
\$33.7 billion in the
wake of Katrina,
Rita, Wilma**



Annual Catastrophe Bond Transactions Volume, 1997-2006

■ Risk Capital Issued ◆ Number of Issuances



#5. Managing the Investment Portfolio Volatility

Rollercoaster

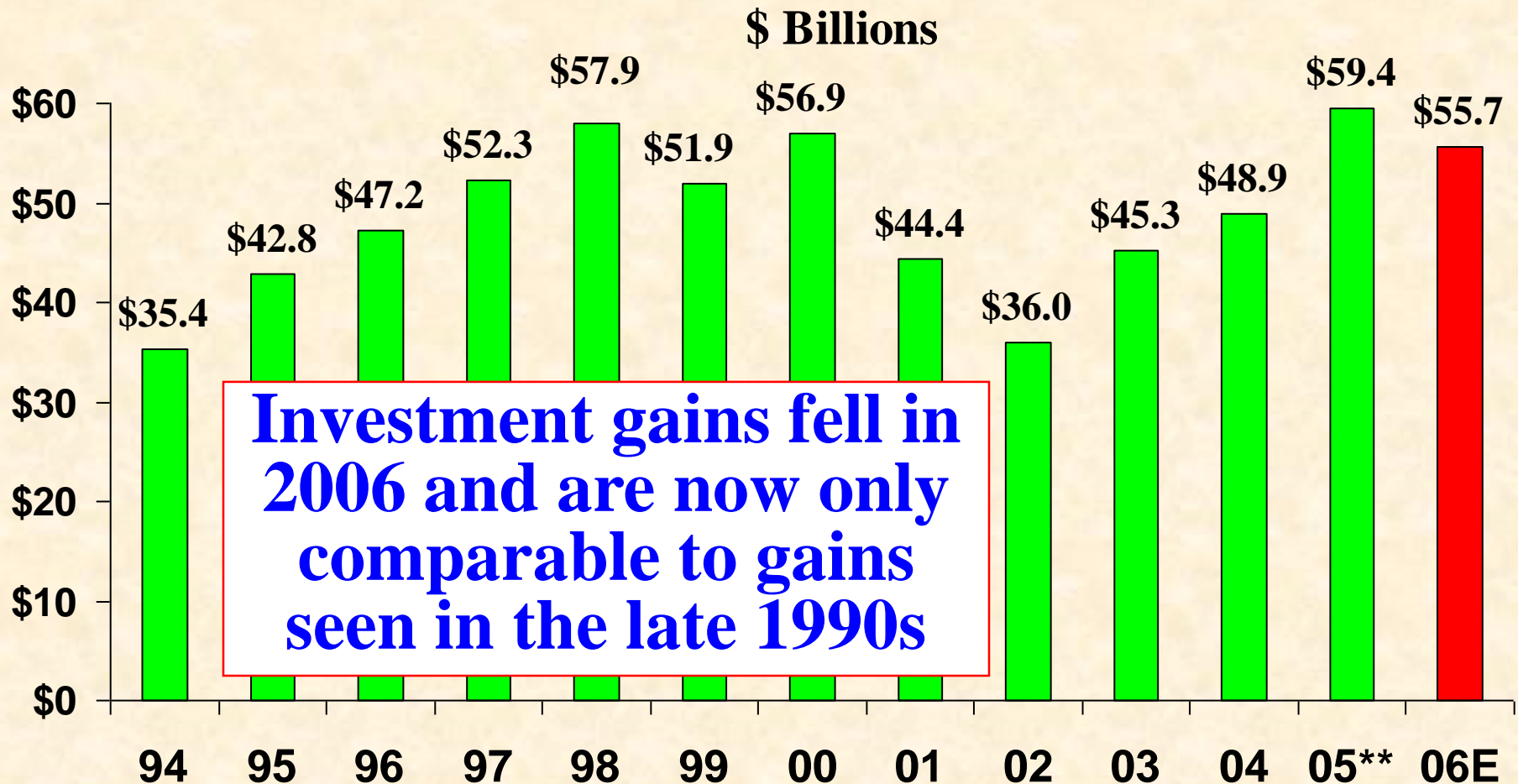


Returns





Property/Casualty Insurance Industry Investment Gain*



*Investment 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. Source: ISO; Insurance Information Institute.

#6.

Catastrophe Loss Management

**Is the Worst
Yet to Come?**





U.S. Insured Catastrophe Losses*



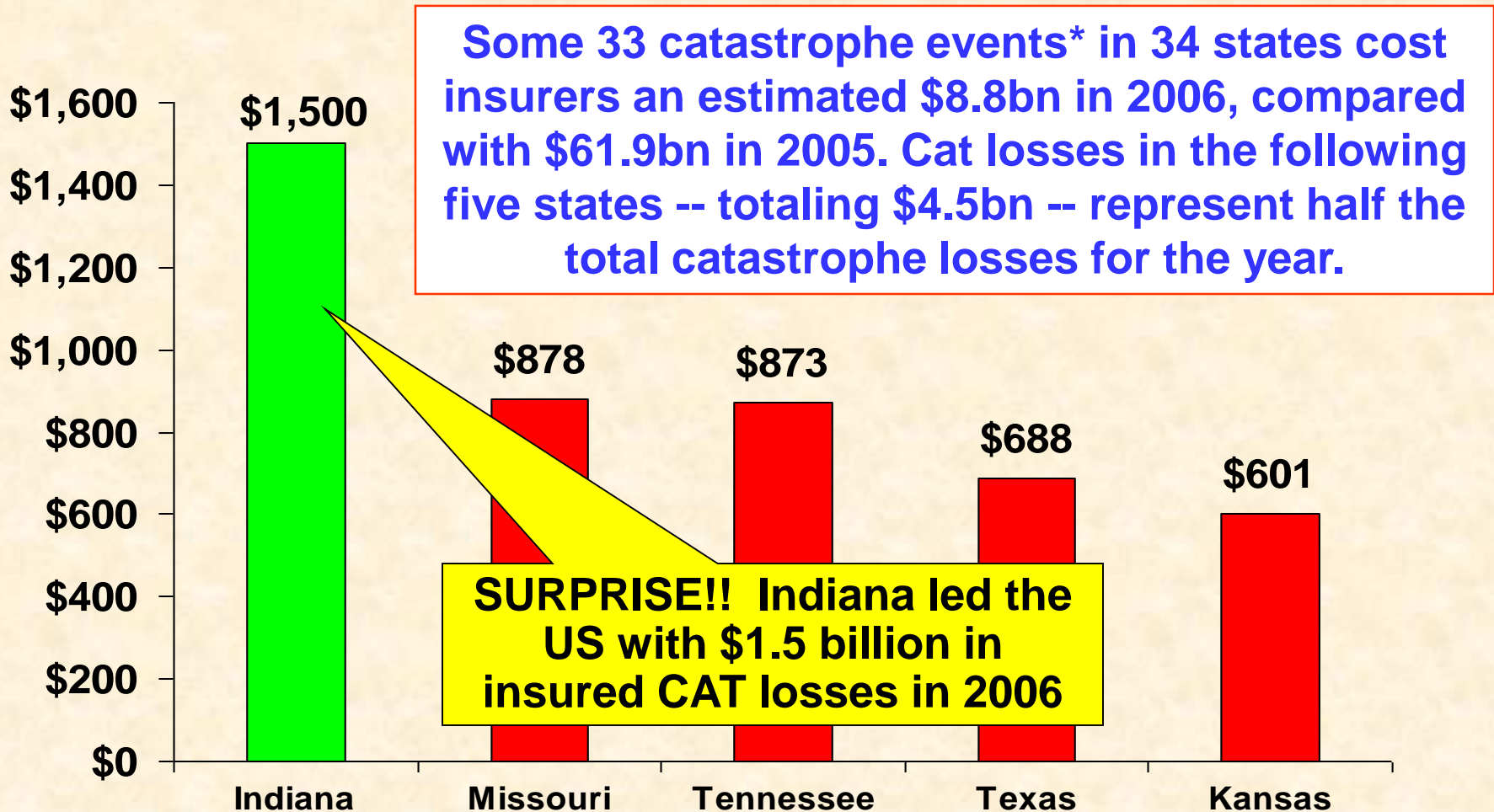
*Excludes \$4B-\$6b offshore energy losses from Hurricanes Katrina & Rita.

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



U.S. Catastrophe Losses 2006: States With Largest Losses (\$ Millions)

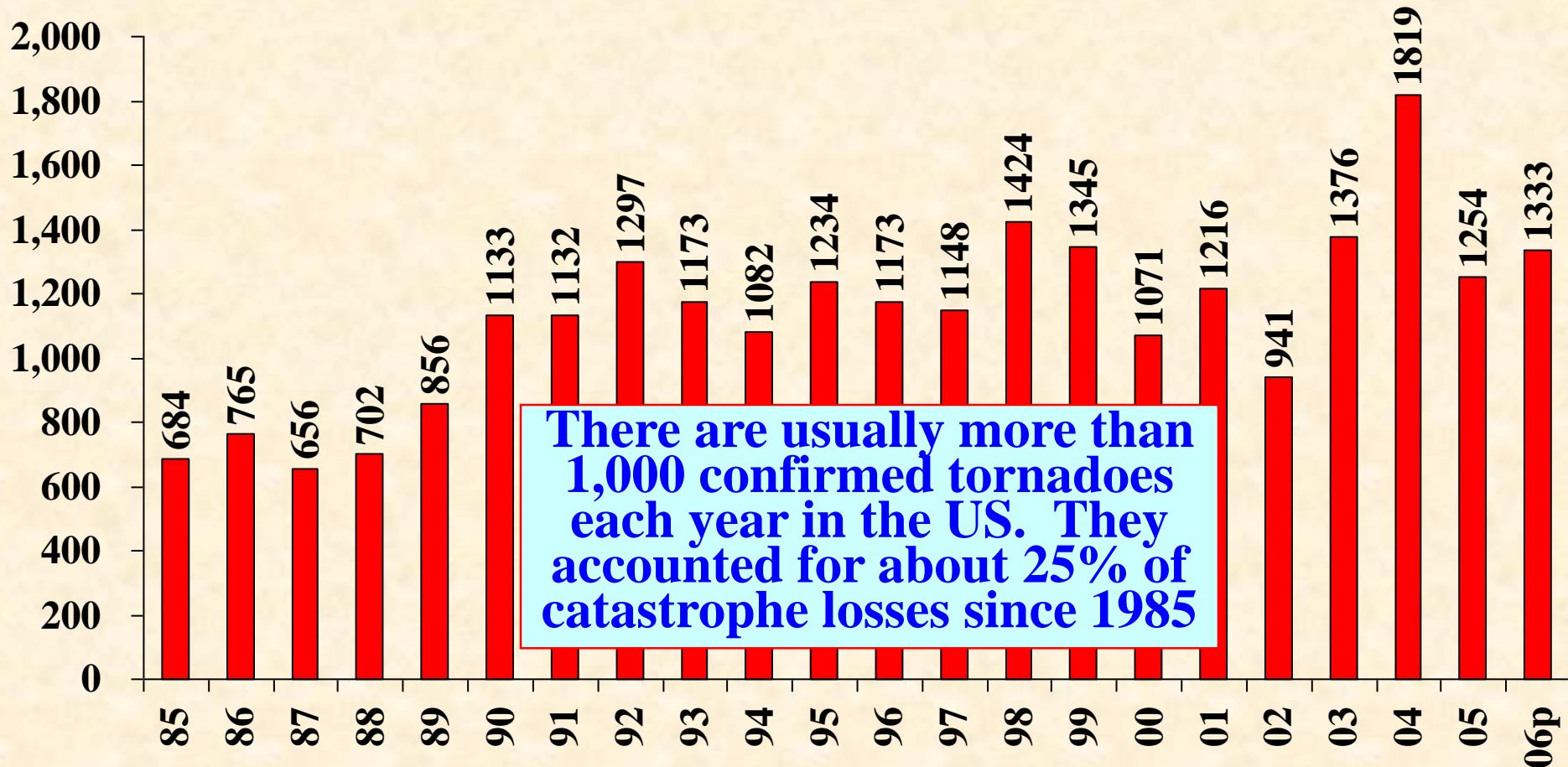


*ISO defines a catastrophe event as an event causing \$25 million or more in insured property losses.

Source: ISO; Insurance Information Institute



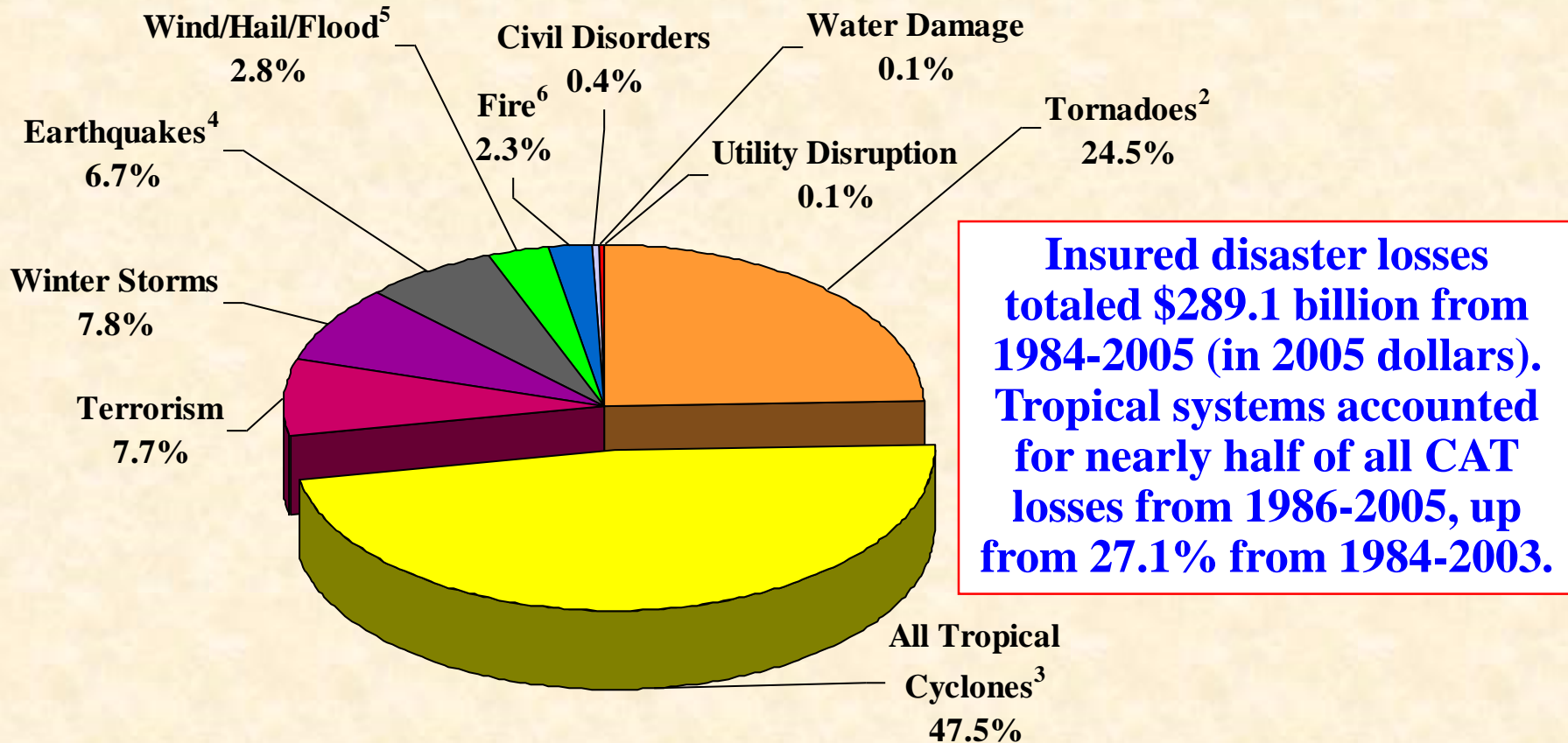
Number of Tornadoes, 1985 – 2006p



Source: US Dept. of Commerce, Storm Prediction Center, National Weather Service; Ins. Info. Inst.



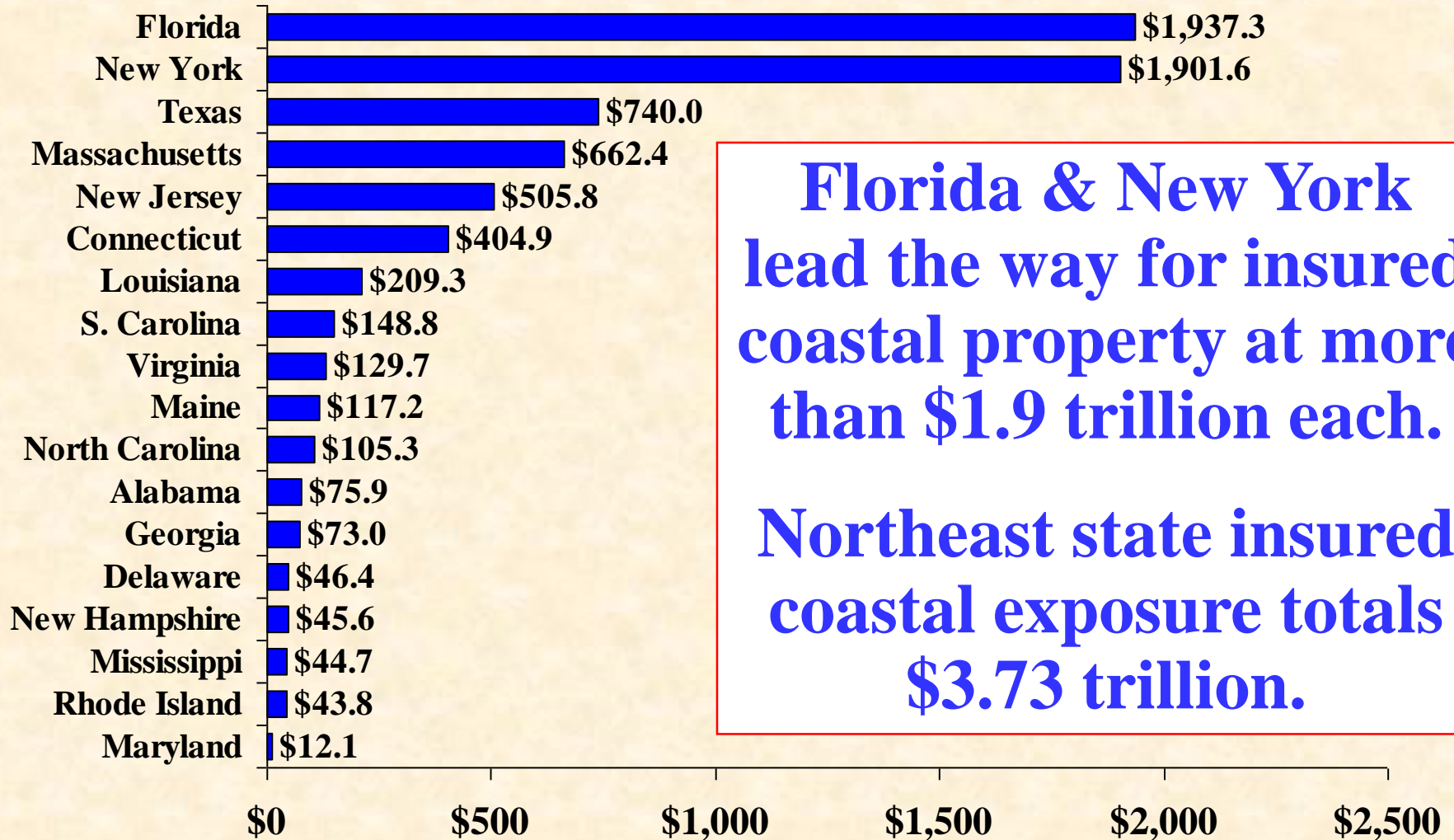
Inflation-Adjusted U.S. Insured Catastrophe Losses By Cause of Loss, 1986-2005¹



¹ Catastrophes are all events causing direct insured losses to property of \$25 million or more in 2005 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.



Total Value of Insured Coastal Exposure (2004, \$ Billions)

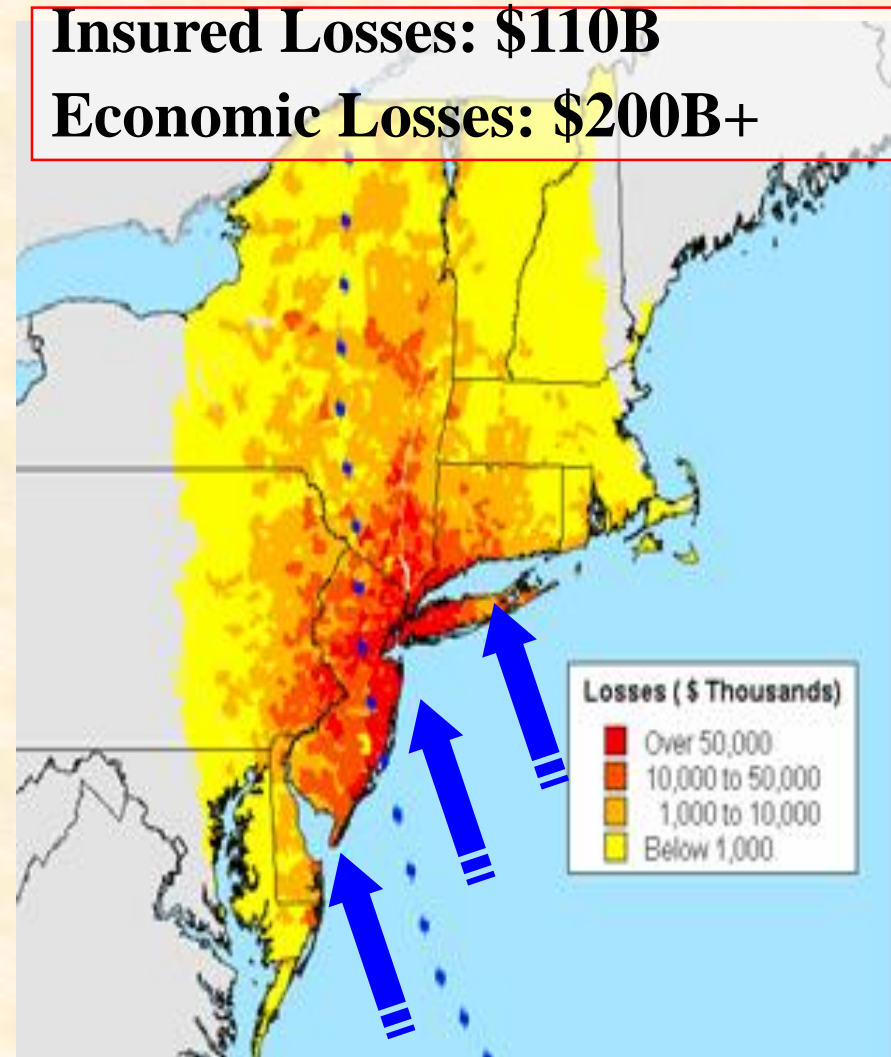




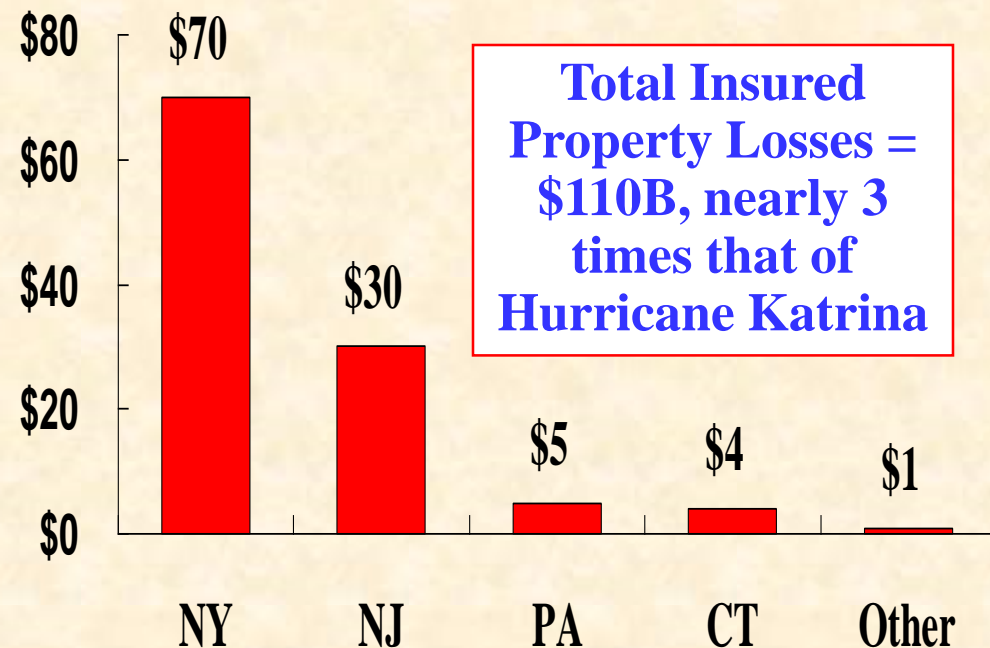
Nightmare Scenario: Insured Property Losses for NJ/NY CAT 3/4 Storm

Insured Losses: \$110B

Economic Losses: \$200B+



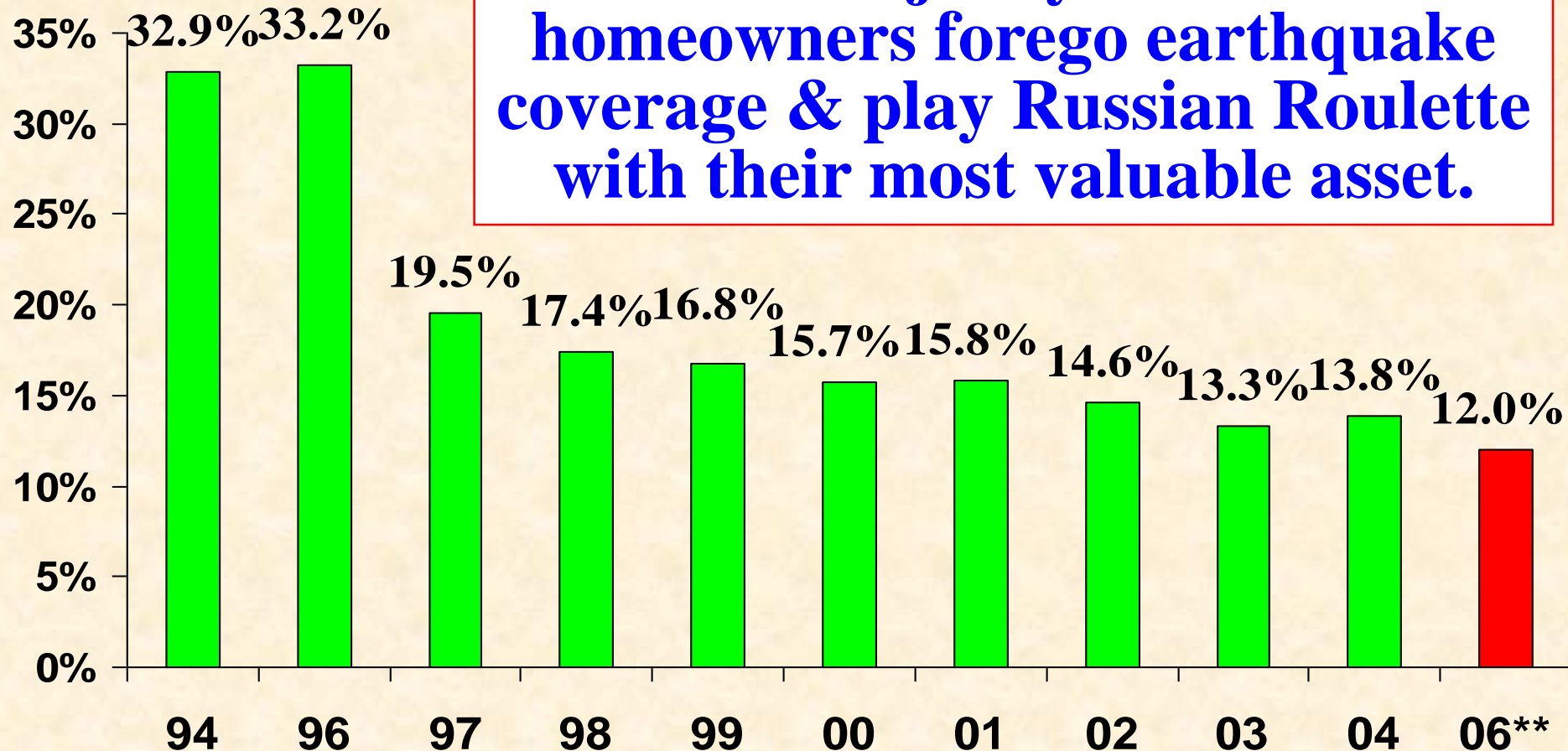
Distribution of Insured Property Losses, by State, (\$ Billions)





Percentage of California Homeowners with Earthquake Insurance, 1994-2004*

The vast majority of California homeowners forego earthquake coverage & play Russian Roulette with their most valuable asset.

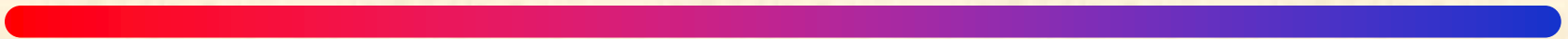


*Includes CEA policies beginning in 1996. **2006 estimate from Insurance Information Network of CA.

Source: California Department of Insurance; Insurance Information Institute.

The 2007 Hurricane Season:

Preview to Disaster?





Outlook for 2007 Hurricane

Season: 85% Worse Than Average

	Average*	2005	2007F
Named Storms	9.6	28	17
Named Storm Days	49.1	115.5	85
Hurricanes	5.9	14	9
Hurricane Days	24.5	47.5	40
Intense Hurricanes	2.3	7	5
Intense Hurricane Days	5	7	11
Accumulated Cyclone Energy	96.2	NA	170
Net Tropical Cyclone Activity	100%	275%	185%

*Average over the period 1950-2000.

Source: Philip Klotzbach and Dr. William Gray, Colorado State University, April 3, 2007.



Probability of Major Hurricane Landfall (CAT 3, 4, 5) in 2007

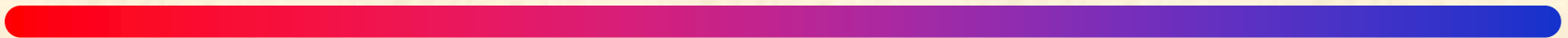
	Average*	2007F
Entire US Coast	52%	74%
US East Coast Including Florida Peninsula	31%	50%
Gulf Coast from FL Panhandle to Brownsville, TX	30%	49%
<i>ALSO...Above-Average Major Hurricane Landfall Risk in Caribbean for 2007</i>		

*Average over the period 1950-2000.

Source: Philip Klotzbach and Dr. William Gray, Colorado State University, April 3, 2007.

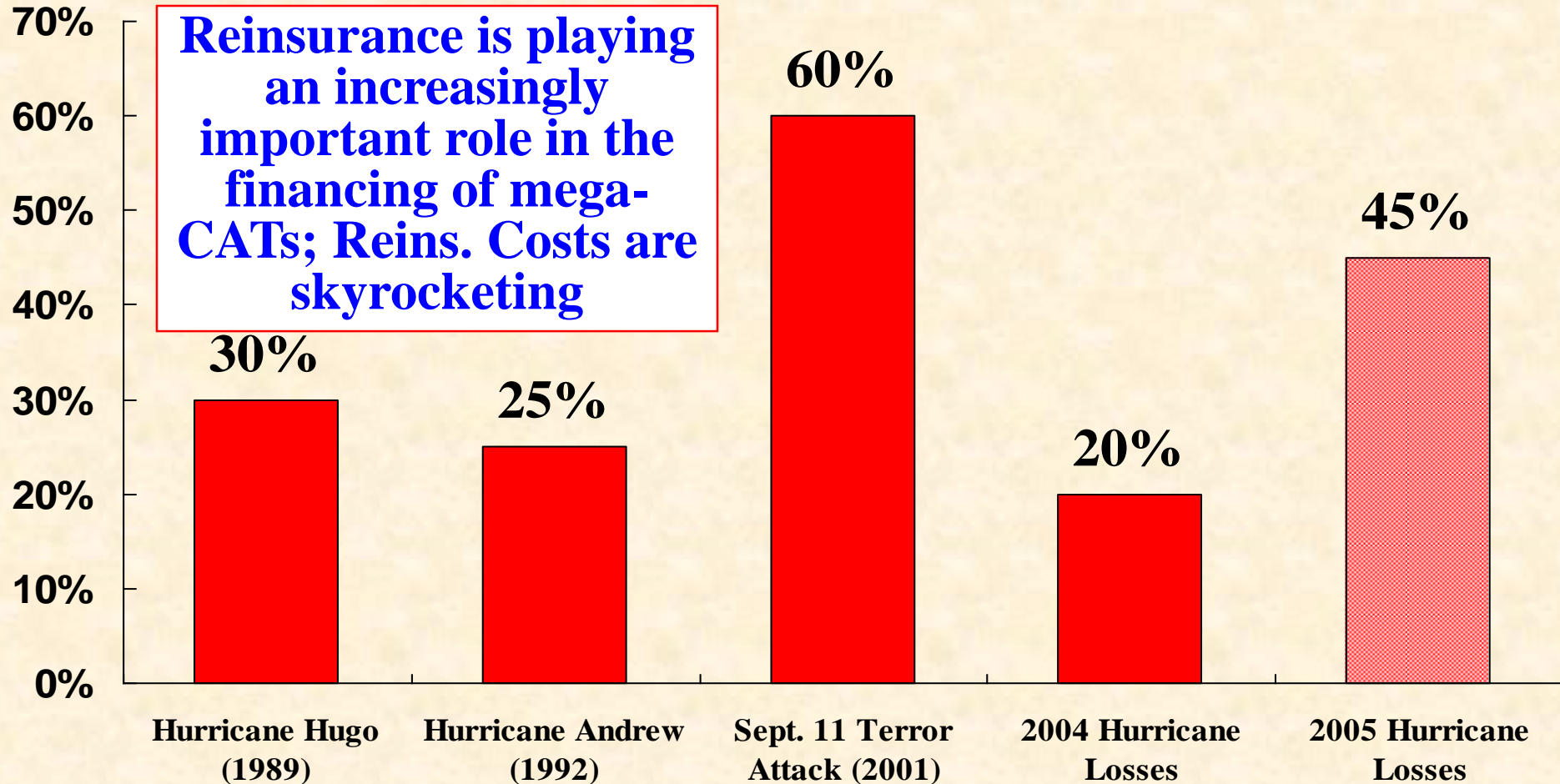
REINSURANCE MARKETS

*Big Risk, Big Reward or
Big Government?*





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.

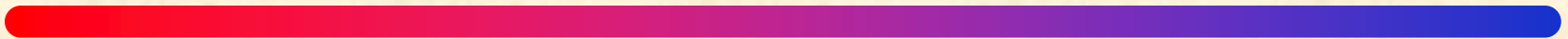


Debate Over Reinsurance Market Performance & Government

- Reinsurance markets typically suffer large shocks, followed by a period of higher prices and transient capacity constraints
- A new equilibrium between Supply and Demand is typically found within 18 months, commensurate with changes in the risk landscape. This is Economics 101 and is a textbook illustration of how capitalism works.
- A competing hypothesis suggests that reinsurance markets “fail” because they do not provide a stable price or quantity of protection as is required in an economy with *continuously exposed fixed assets, especially one that is growth oriented*
- Public Policy Solution: Acting on this hypothesis generally results in displacement of private (re)insurance capital by government intermediaries
- **Question Asked**: Are policyholders and the economy better served through free markets, government or some hybrid?

#7. Maintaining Financial Strength & Ratings

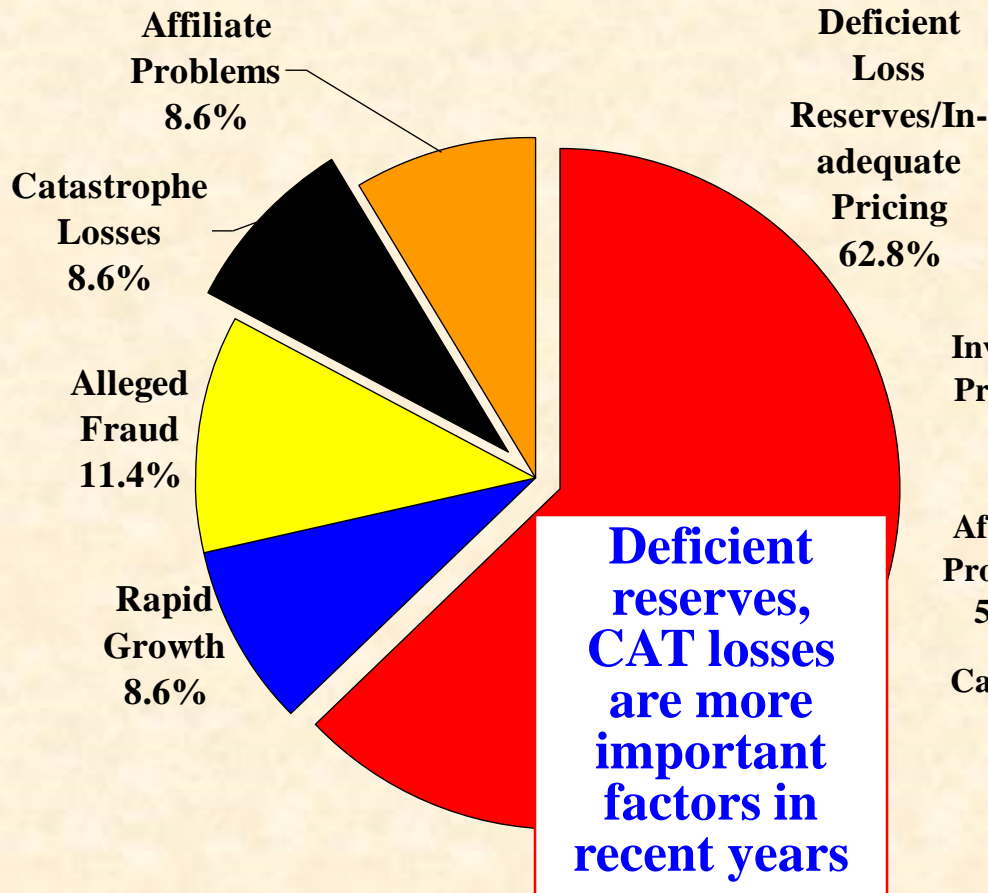
Weathering the Storms



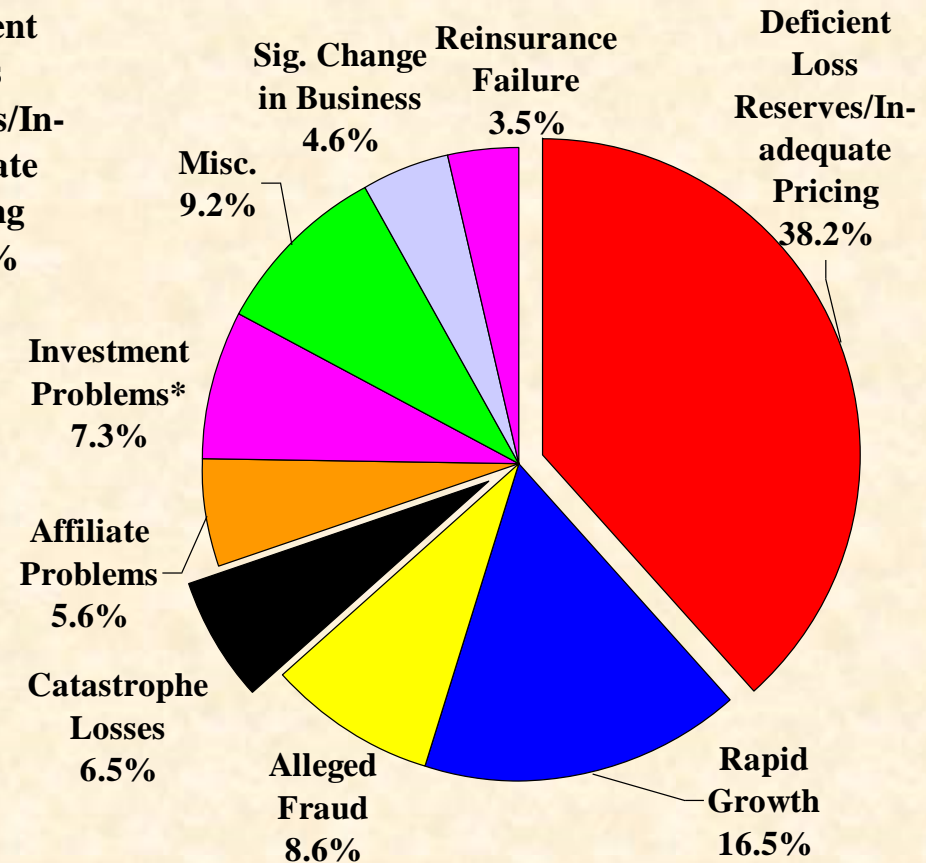


Reasons for US P/C Insurer Impairments, 1969-2005

2003-2005



1969-2005

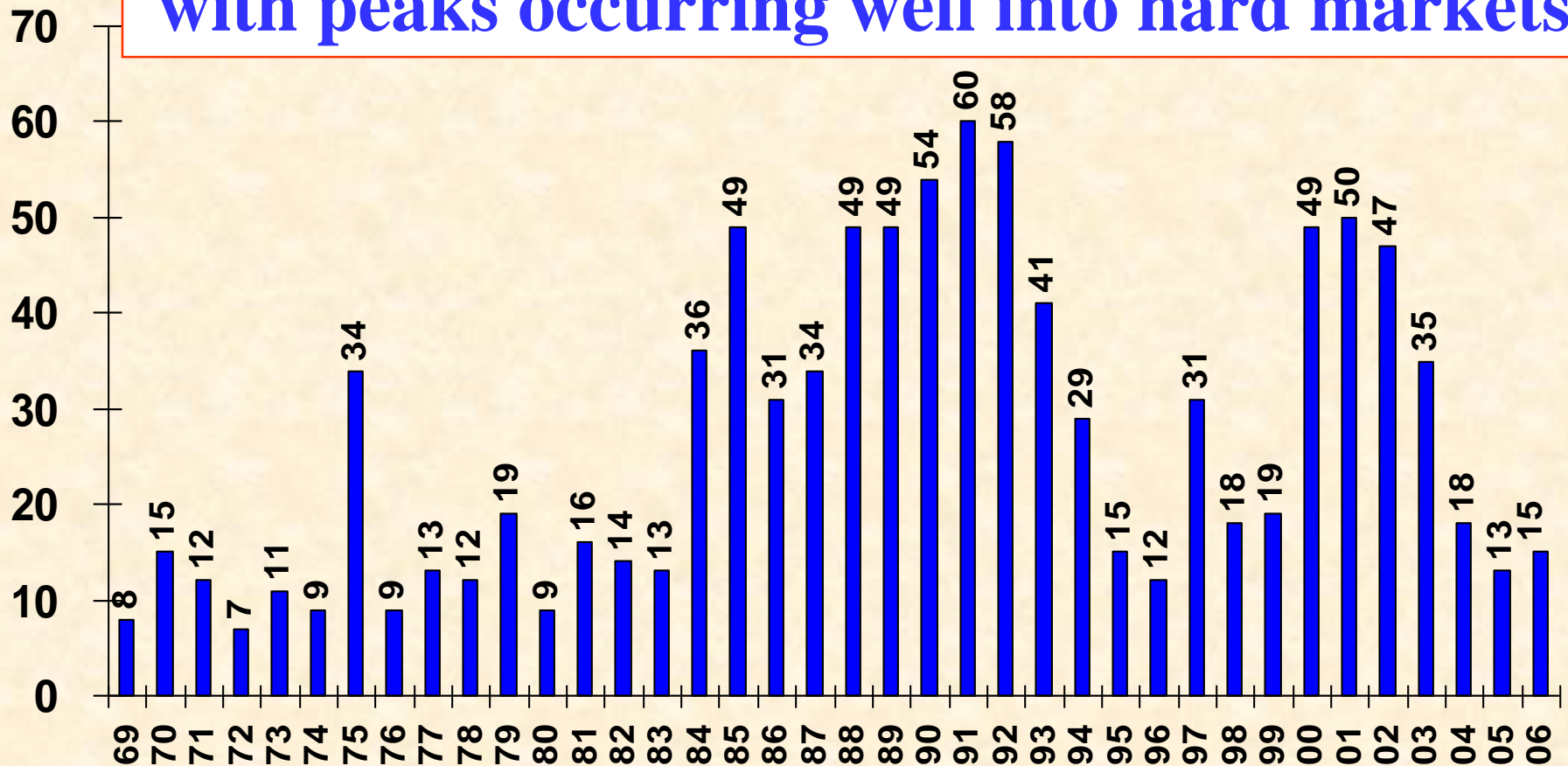


*Includes overstatement of assets.



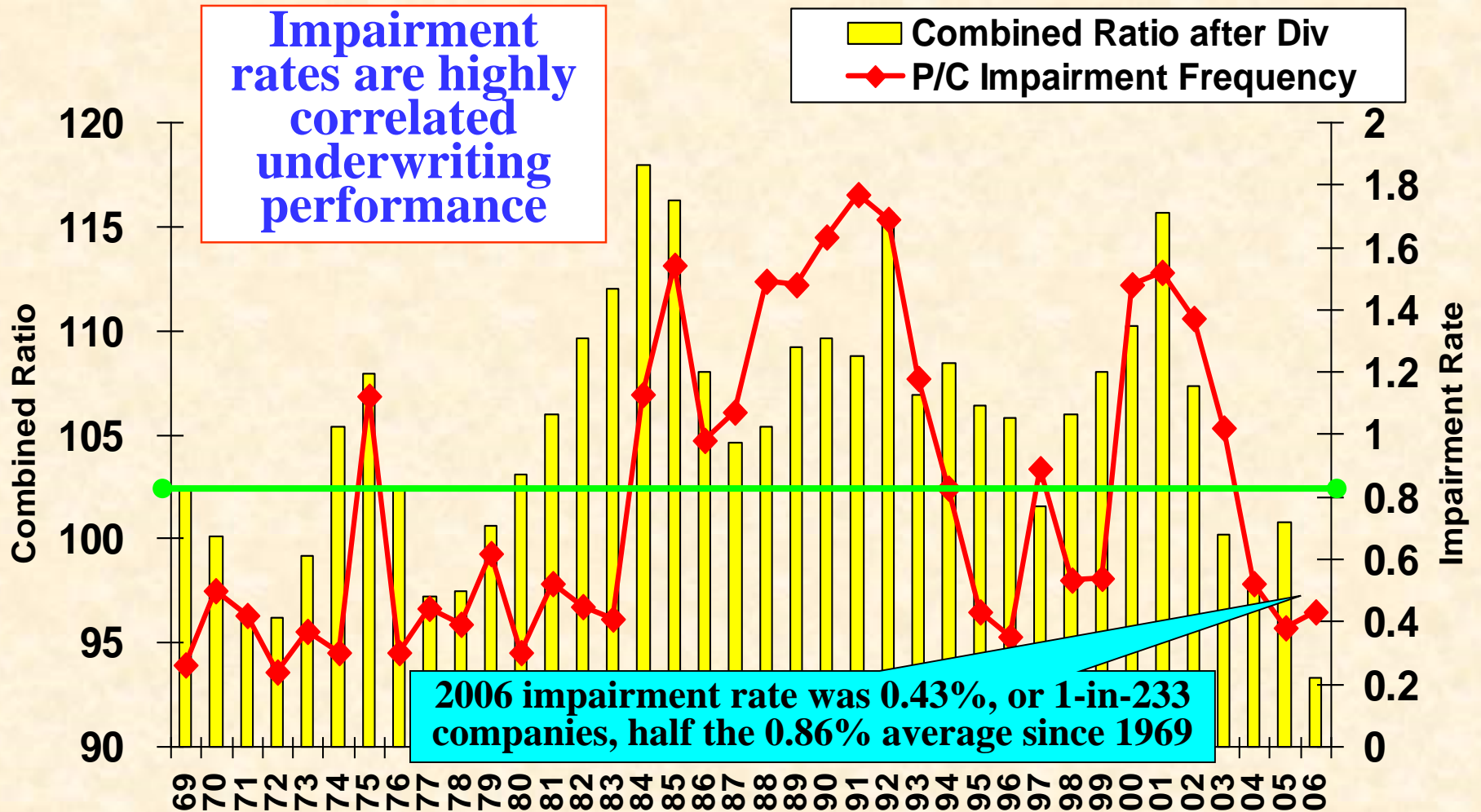
P/C Insurer Impairments, 1969-2006

The number of impairments varies significantly over the p/c insurance cycle, with peaks occurring well into hard markets





P/C Insurer Impairment Frequency vs. Combined Ratio, 1969-2006



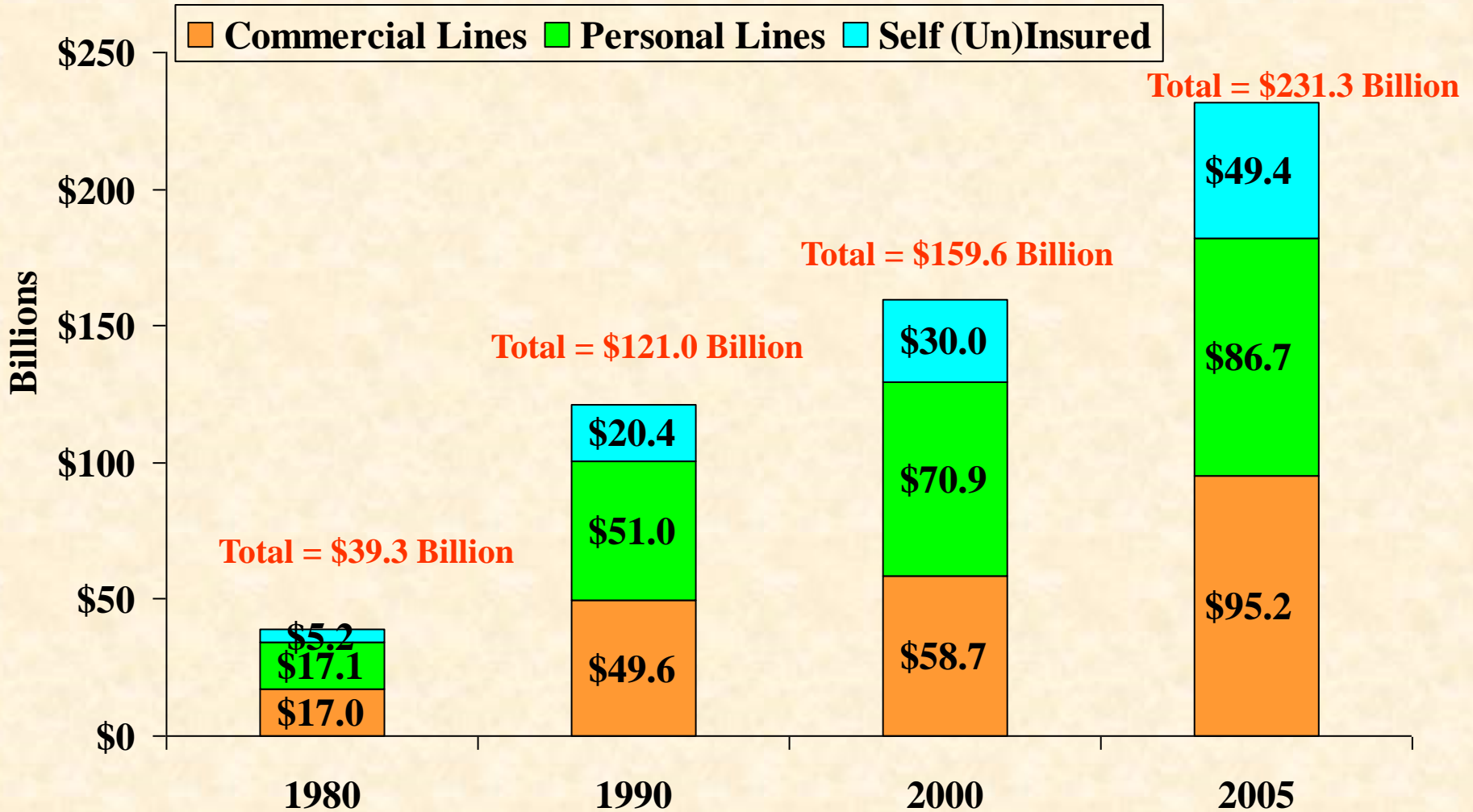
#8. Legal Liability & Tort Environment



*Definitely Improving But
Not Out of the Woods*



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

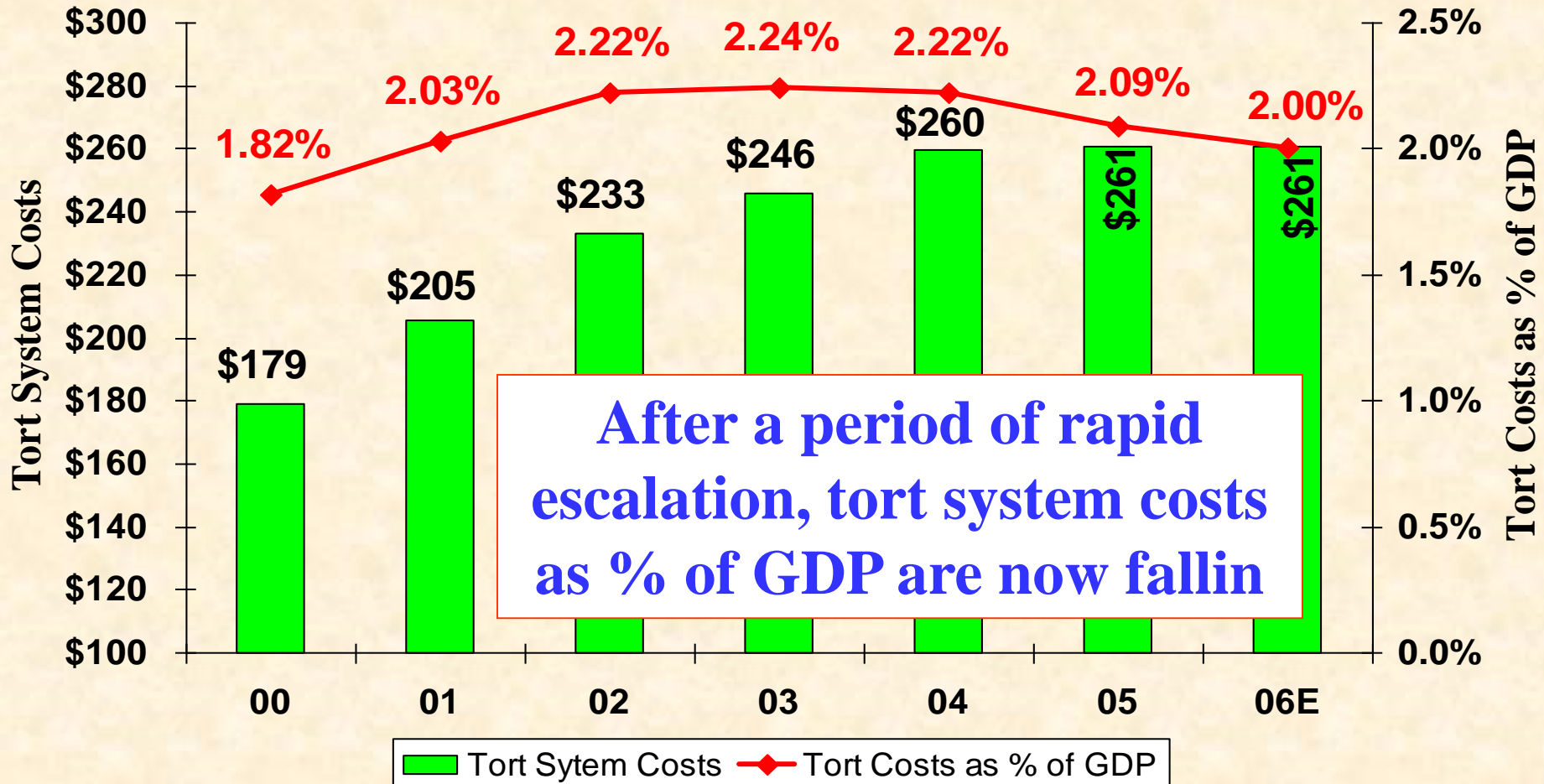


*Excludes medical malpractice

Source: Tillinghast-Towers Perrin, 2006 Update on US Tort Cost Trends.



Tort System Costs, 2000-2006E



KATRINA TORT UPDATE

Suits Add to

iii *Uncertainty, Expense*



Likely Market Impacts of Post-Katrina Litigation

- **Litigation Creates an Additional Layer of Uncertainty in What is Already a Very Difficult Market**
 - **Ultimate Thrust of Litigation is to Compel Insurers to Pay Water Damage (Flood/Surge) Losses for Which They Have Never Received A Penny in Premium**
- **Some Courts' Apparent Willingness to Retroactively Rewrite Long-Standing, Regulator Approved Terms & Conditions of Insurance Contracts Creates an Unpriceable Risk**
 - **Compounded by juries willing to award millions in punitives**
- **People Discouraged from Buying Flood Coverage**
- **BOTTOM LINE: Weather, Courts, Juries Together Create Nearly Impossible Operating Environment**
- **Coverage Under These Circumstances Will Necessarily Become More Expensive, Less Available**

#9. Defining the Role of Government in Insurance Markets

!!! *How Big is Too Big?*



NAIC's Comprehensive National Catastrophe Plan

- **Proposes Layered Approach to Risk**
- **Layer 1: Maximize resources of private insurance & reinsurance industry**
 - Includes “All Perils” Residential Policy
 - Encourage Mitigation
 - Create Meaningful, Forward-Looking Reserves
- **Layer 2: Establishes system of state catastrophe funds (like FHCF)**
- **Layer 3: Federal Catastrophe Reinsurance Mechanism**



Comprehensive National Catastrophe Plan Schematic

1:500 Event

National Catastrophe Contract Program

1:50 Event

State Regional Catastrophe Fund

State Attachment

**Personal
Disaster
Account**

Private Insurance

Private Reinsurance



Legislation has been introduced and ideas espoused by ProtectingAmerica.org will likely get a more thorough airing in 2007/8

A VULNERABLE AMERICA

HURRICANES EARTHQUAKES

WHAT ARE YOU AT RISK FOR?

OUR MISSION IS TO RAISE AWARENESS, EDUCATE THE PUBLIC AND POLICYMAKERS, AND OFFER SOLUTIONS THAT WILL BETTER PREPARE AND PROTECT AMERICA FROM MAJOR CATASTROPHE IN A SENSIBLE, COST-EFFECTIVE FASHION.

REPLAY

- HELP PROTECT AMERICA
- UNDERSTAND YOUR RISKS
 - STRENGTHEN 1ST RESPONDERS
 - BUILD SMARTER & STRONGER
 - ADVOCATE CATASTROPHE FUNDS

PREPARE YOURSELF:

HOW YOU CAN BETTER PREPARE
tips for average americans

- RECENT NEWS:
- Teaching Earthquake Science Made Easy: USGS Partnership Puts Curriculum into the Classroom
2.1.06
 - Faculty Senate hears report on emergency-preparedness plan
2.1.06
 - It's Earthquake Preparedness Week In Kentucky
2.1.06

AMERICA NEEDS YOUR VOICE!

Our current system leaves too many people unprotected and unable to rebuild their lives following a catastrophe. We need to prepare for future catastrophes and protect ourselves.

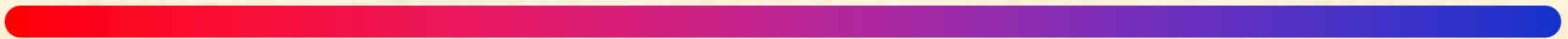
CONTACT YOUR ELECTED OFFICIALS * **JOIN OUR CAUSE**

STATISTICS & FIGURES:

Repeat of the 1886 Charleston, South Carolina, earthquake today would cause

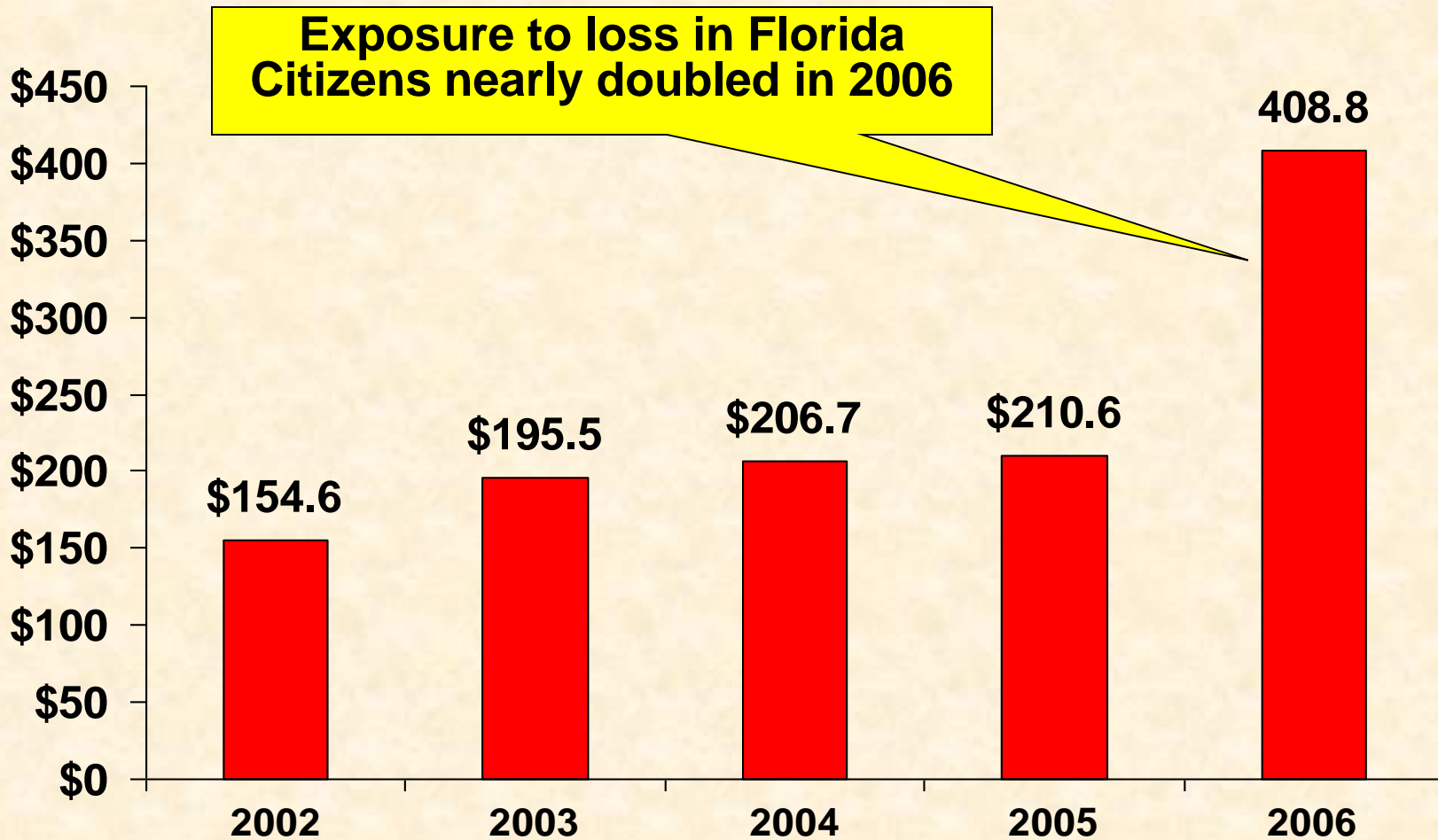
STATE RESIDUAL MARKETS

How Big is Too Big?



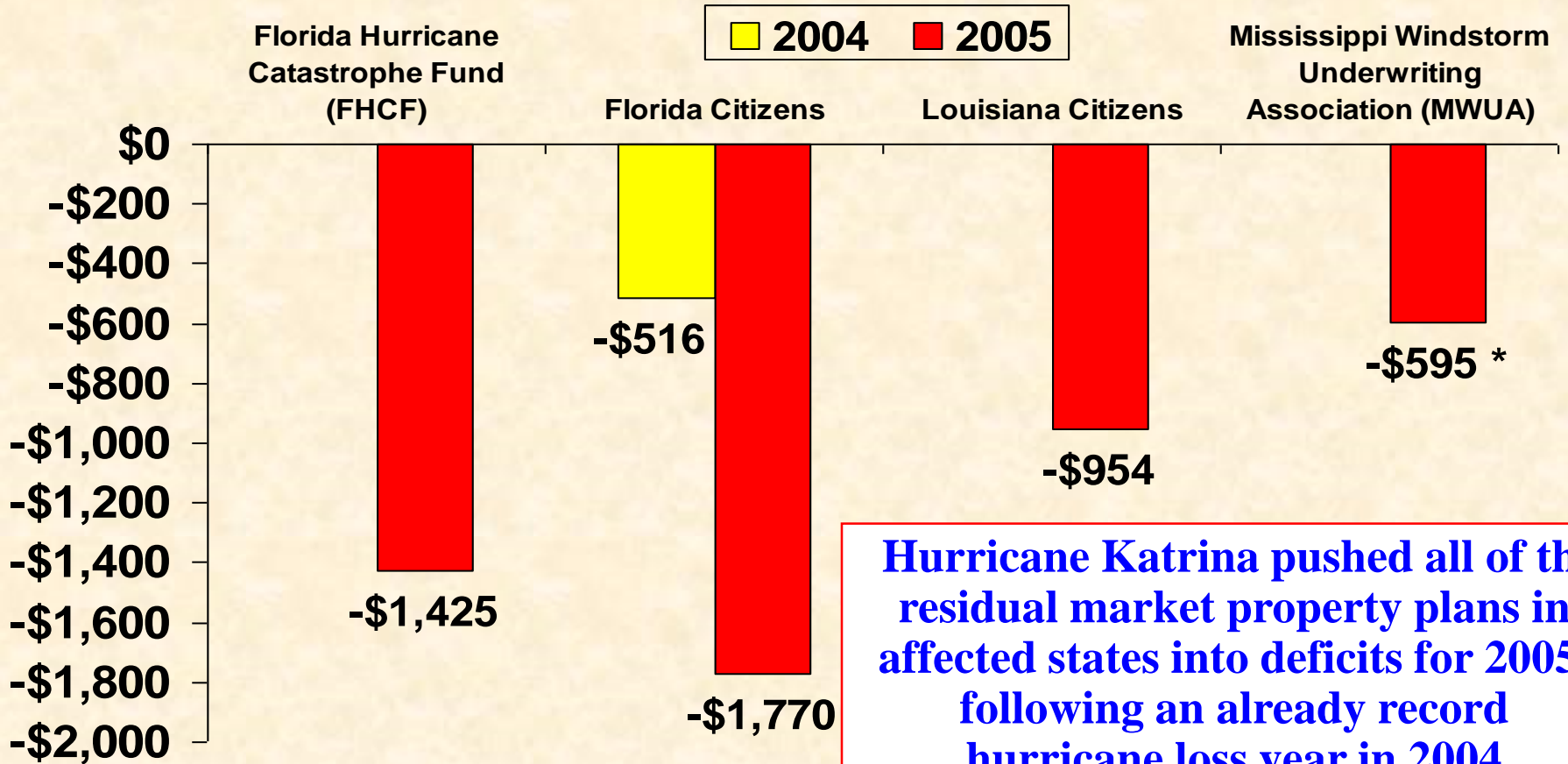


Florida Citizens Exposure to Loss (Billions of Dollars)





Major Residual Market Plan Estimated Deficits 2004/2005 (Millions of Dollars)

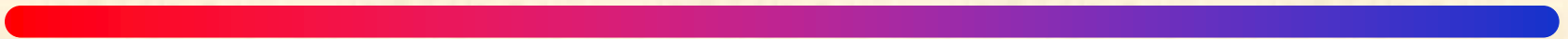


Hurricane Katrina pushed all of the residual market property plans in affected states into deficits for 2005, following an already record hurricane loss year in 2004

* MWUA est. deficit for 2005 comprises \$545m in assessments plus \$50m in Federal Aid.

#10. Containing Regulatory & Legislative Zealotry

*Busy Year for Insurers
in Washington & States*





Federal Legislative Update

Federal Terrorism Reinsurance (TRIA)

- **TRIA expires 12/31/07. The current federal program offers \$100 billion of coverage subject to a \$27.5B industry aggregate retention.**
- **New Democratic Congress (with Committee chairs from urban Northeast states) predisposed to extend. Despite resistance/lackluster Administration support TRIA will likely be extended for a multi-year period, perhaps 6-8 but potentially as long as 15 years (last extension in 2005 was for 2 years)**
- **Potential changes include extensions of coverage for domestic terrorism losses (not included currently), and a lower industry retention for nuclear, biological, chemical, or radiological (NBCR) attacks. There could possibly be a modestly higher industry retention for non-NBCR losses, and it needs to be resolved whether liability and group life losses will be covered.**
- **Original hope for first-half 2007 extension have faded. Now looking at fall or even 11th-hour extension at year's end, as in 2005.**



Federal Legislative Update

Natural Disaster Coverage

- **Some insurers are pushing for federal catastrophic risk fund coverage in the wake of billions of dollars of losses suffered by insurers from the 2004-2005 hurricane seasons.**
- **Legislative relief addressing property/casualty insurers' exposure to natural catastrophes, such as the creation of state and federal catastrophe funds, has been advocated by insurers include Allstate and State Farm recently. However, there is active opposition many other insurers and all reinsurers.**
- **There are supporters in Congress, mostly from CAT-prone states. Skeptics in Congress believe such a plan would be a burden on taxpayers like the NFIP and that the private sector can do a better job. Unlike TRIA, the industry is not unified on this issue.**
- **Allowing insurers to establish tax free reserves for future catastrophe losses has also been proposed, but Congress has not yet indicated much support.**



Federal Legislative Update

Optional Federal Charter (OFC)

- **Large P&C and life insurers are the major supporters of OFC. Supporters argue that the current patchwork of 50 state regulators reduces competition, is redundant, slows new product introductions and adds cost to the system.**
- **In general, global P/C insurers, reinsurers and large brokers mostly support the concept, while regulators (state insurance commissioners), small single-state and regional insurers, and independent agency groups largely oppose the idea. An optional federal charter is more favorable for global P&C insurers, because an insurer that operates in multiple states could opt to be regulated under federal rules rather than multiple state regulations. As a result, this could increase innovation in the industry.**
- **A new bill should be introduced in May or June. Currently appears to be more momentum for OFC for life than for P&C insurers based on the homogeneous nature of many life products. The debate should intensify and although passage may not occur in the current session of Congress, it may lay the groundwork for passage in the 2009-2010 session.**



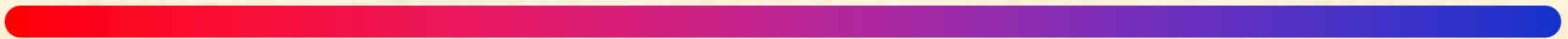
Federal Legislative Update

McCarran-Ferguson Insurance Antitrust Exemption

- **Under McCarran-Ferguson Act of 1945, insurers have limited immunity under federal anti-trust laws allowing insurers to pool past claims information to develop accurate (actuarially credible) rates.**
- **Very low level of understanding of M-F in Washington**
- **Certain legislators threaten to revoke McCarran-Ferguson because of alleged collusion in the wake of Hurricane Katrina. However, the view among some Washington insiders is that such a move would hurt small insurers with less resources rather than the large insurers perhaps being targeted. The current bills designed to revoke McCarran-Ferguson are S.618 and H.R. 1081.**
- **The government appointed Antitrust Modernization Commission in an April 2007 report strongly encouraged Congress to re-examine the McCarran-Ferguson Act. Notably, 4 of the commissions 12 members called for a full repeal of the law. Sources: Lehman Brothers, Insurance Info. Institute**

TRIA EXTENSION

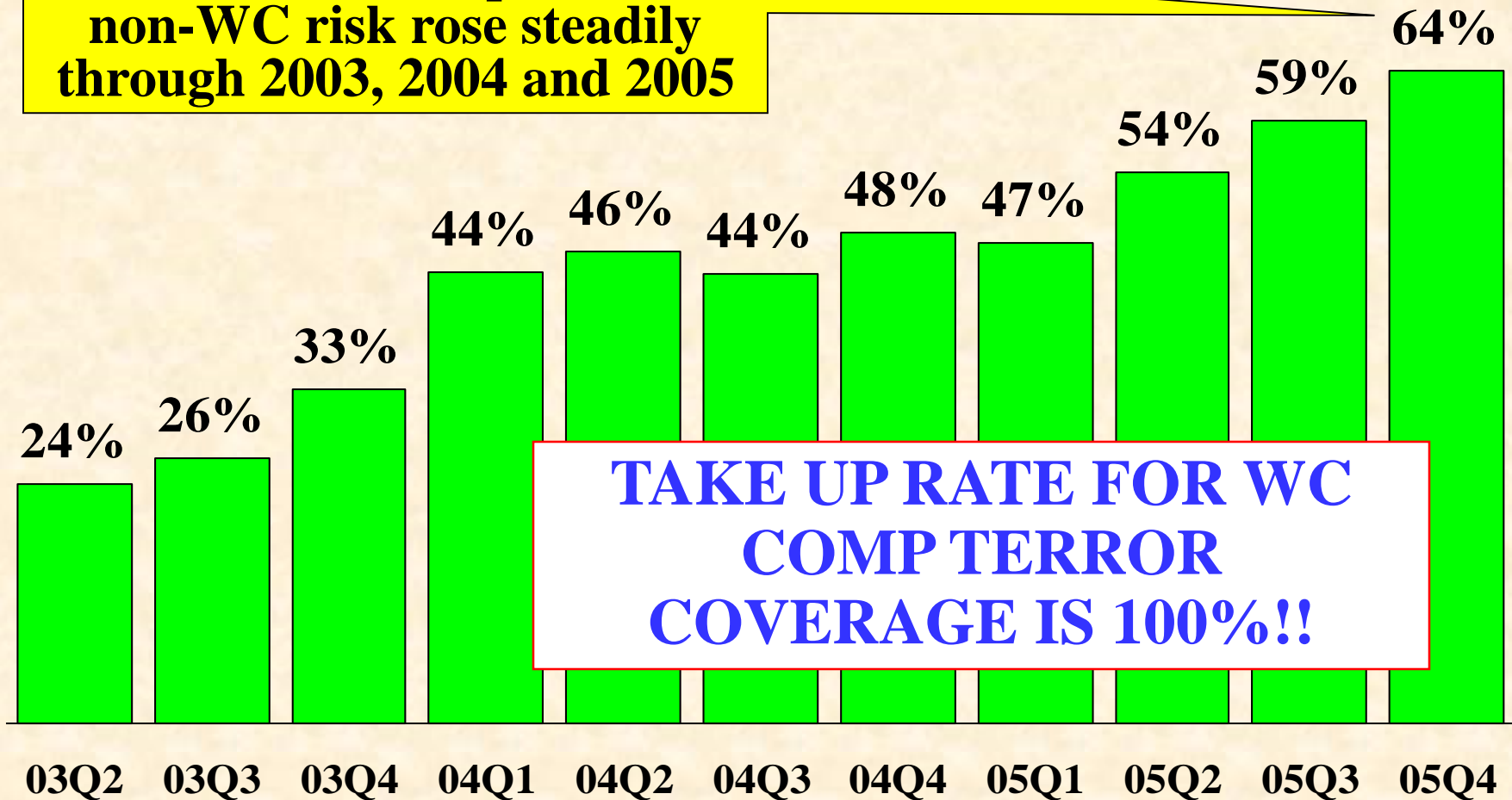
*The Burden Grows, and the
Clock is Ticking*





Terrorism Coverage Take-Up Rate Continues to Rise

Terrorism take-up rate for non-WC risk rose steadily through 2003, 2004 and 2005

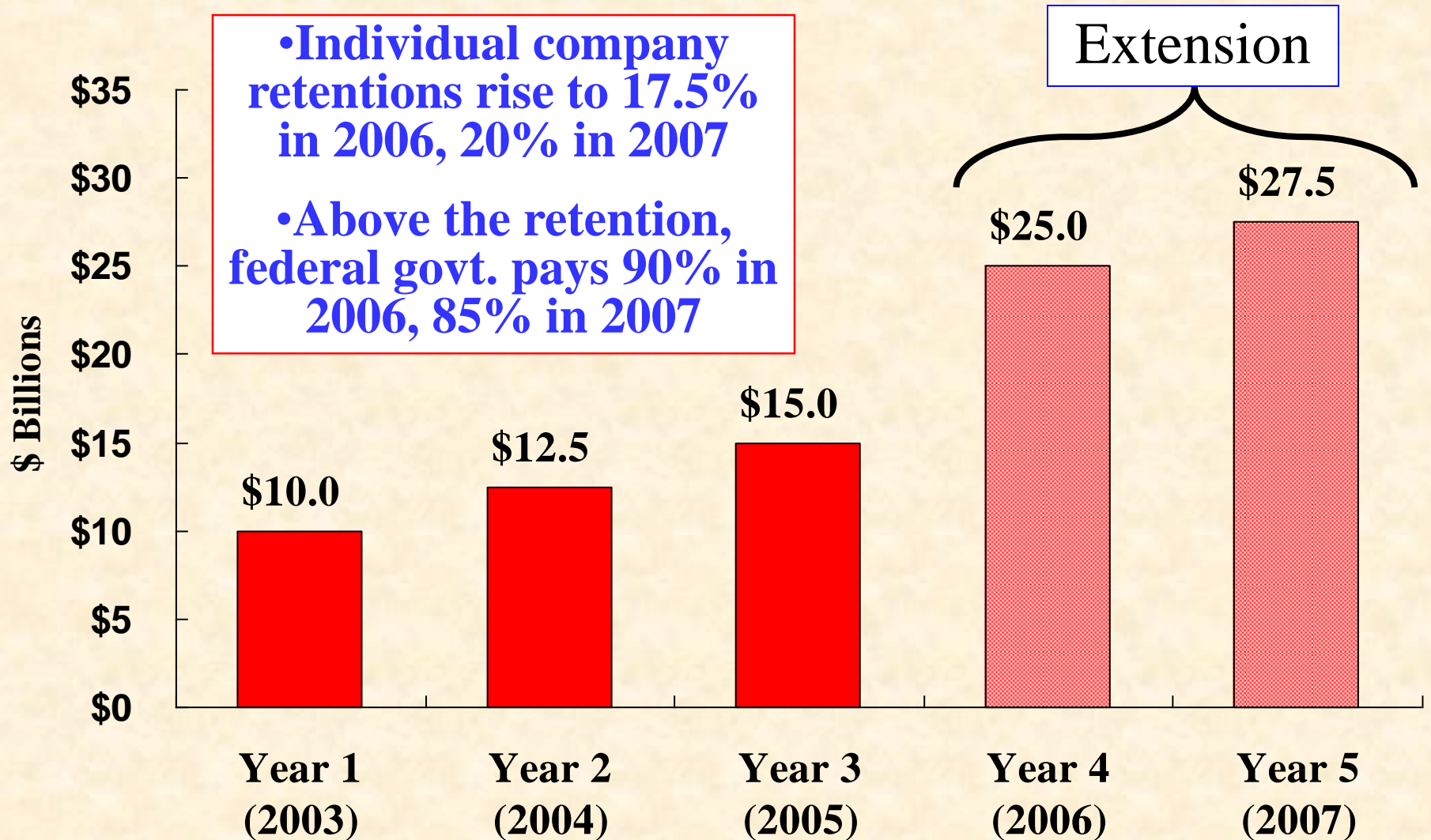


**TAKE UP RATE FOR WC
COMP TERROR
COVERAGE IS 100%!!**



Insurance Industry Retention

Under TRIA (\$ Billions)





Insured Loss Estimates:

Large CNBR Terrorist Attack (\$ Bill)

Type of Coverage	New York	Washington	San Francisco	Des Moines
Group Life	\$82.0	\$22.5	\$21.5	\$3.4
General Liability	14.4	2.9	3.2	0.4
Workers Comp	483.7	126.7	87.5	31.4
Residential Prop.	38.7	12.7	22.6	2.6
Commercial Prop.	158.3	31.5	35.5	4.1
Auto	1.0	0.6	0.8	0.4
TOTAL	\$778.1	\$196.8	\$171.2	\$42.3

Source: American Academy of Actuaries, Response to President's Working Group, Appendix II, April 26, 2006.

FLORIDA SPECIAL SESSION LEGISLATIVE CHANGES

iii Insurer, Policyholder &
State Impacts



Why There is Concern Over the Florida Legislature's & Governor's Changes

- **Risk is Now Almost Entirely Borne Within State**
- **Virtually Nothing Done to Reduce Actual Vulnerability**
- **Creates Likelihood of Very Large Future Assessments**
- **Potentially Crushing Debt Load**
- **State May be Forced to Raise/Levy Taxes to Avoid Credit Downgrades**
- **Many Policyholder Will See Minimal Price Drop**
 - **“Savings” came from canceling recent/planned rate hikes**
- **Residents in Lower-Risk Areas, Drivers, Business Liability Policyholders Will Come to Resent Subsidies to Coastal Dwellers**
- **Governor's Emergency Order for Rate Freezes & Rollbacks Viewed as Unfair & Capricious**



Summary

- Industry results were *unsustainably* good 2006; Overall profitability reached its highest level (14%) since 1988
- Many factors will prevent repeat of 2006
- Underwriting results were aided by lack of mega-CATs & favorable underlying loss trends, including tort system improvements
- Premium growth rates are slowing to their levels since the late 1990s; No obvious/easy opportunities for growth
- Rising investment returns insufficient to support deep soft market in terms of price, terms & conditions
- Clear need to remain underwriting focused
- How/where to deploy/redeploy capital??
- Major Challenges:
 - Maintaining price/underwriting discipline
 - Managing variability/volatility of results
 - Managing new/emerging risks



Insurance Information Institute On-Line

WWW.III.ORG

*If you would like a copy of this presentation, please
give me your business card with e-mail address*