What Really Keeps Insurance CEOs Awake at Night?

Tillinghast Actuarial Conference
Orlando, FL

October 2, 2002
#10
THE ECONOMY
Economy is experiencing sluggish growth following the recession of 2001 (first recession since 1990/91)

Source: US Department of Commerce, Blue Economic Indicators 9/02, Insurance Information Institute.
Despite the economic slowdown, the unemployment rate is less than it was during the recession of 1990/91.

Med Claim Costs Rising Sharply

Health care inflation is affecting the cost of medical care, no matter what system it is delivered through.

Source: NCCI; William M. Mercer, Insurance Information Institute.
U.S. Federal Budget Deficit/Surplus
FY1990-2010*

Deficit/Surplus

Employment (Millions)

% GDP

*FY1990-2001 actual values; FY2002-2010 are CBO forecasts.
Source: Congressional Budget Office, Insurance Information Institute.
Impact of Recession on P/C Premiums and Profitability (1970-2001)

Source: Insurance Information Institute

*GAAP return on equity, adjusted for inflation; Bank data 1952-2001; Div. Fin. 1987-2001
#9
CRISIS IN CORPORATE GOVERNANCE
Serious Implications for Insurers

- Insurers exposed to a wide variety of risks:
  - Investment risk (as institutional investors)
  - Insurance risk (surety, D&O, E&O, etc.)
  - Litigation risk (as both plaintiff & defendant)
  - Accounting Risk
  - Regulatory risk
Houston…
We Have a Problem

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

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

Source: Loss estimates from Morgan Stanley as Feb. 8, 2002; Insurance Information Institute.
Institutional Investor Market in Corporate Equities

by Market Value of Holdings, as of December 31, 2001

Total: $7,534.7 billion

- Insurers: $1,120.4 (15%)
- Mutual Funds: $2,836.8 (38%)
- State & Local Gov't Retirement Plans: $1,215.7 (16%)
- Private Pension Funds: $1,902.3 (25%)
- All Others: $459.5 (6%

We’re big enough: Should we cut our losses and run or throw the bums out?

Source: Insurance Information Institute from Federal Reserve Flow of Funds Report
Insurance Industry Stock and Bond Holdings, 2001

Total Industry Holdings = $3.3 Trillion

Corporate Bonds: Total $1531
- P/C $194
- Life $1,337

Corporate Stocks: Total $1120
- P/C $185
- Life $935

State/Local Bonds: Total $209
- P/C $188
- Life $21

U.S. Gov't Bonds: Total $438
- P/C $131
- Life $307

#8
CONSOLIDATION
Insurance Mergers and Acquisitions

- Number of M&As was down 39.4% during the first half of 2002 vs. first half 2001.
- Value of deals was down 80.8%.
- None of the top deals were in the P/C sector.

Source: Compiled from Conning & Company reports.
INVESTMENTS
Net Investment Income

Investment income in 2002 could fall 5% to 6%

Realized capital gains in the 1st half of 2002 were down $5.9B

Facts

1997 Peak = $41.5B
2000 = $40.7B
2001 = $37.7B
2002E = $35.7B

Source: A.M. Best, Insurance Information Institute
Total Returns for Large Company Stocks: 1970-2002*

- Headed for 3rd consecutive year of decline for stocks
- Last happened 1939-1941

*As of September 20, 2002.
Source: Ibbotson Associates, Insurance Information Institute
#6

ABUSE OF THE TORT SYSTEM
Average Jury Awards
1994 vs. 2000

Source: Jury Verdict Research; Insurance Information Institute.
Cost of U.S. Tort System
($ Billions)

Tort costs consumed 2.0% of GDP annually on average since 1990, expected to rise to 2.4% of GDP by 2005!

Tort costs equaled $636 per person in 2000!
Expected to rise to $1,000 by 2005

Source: Tillinghast-Towers Perrin; Insurance Information Institute estimates for 2001/2002 assume tort costs equal to 2% of GDP. 2005 forecasts from Tillinghast.
Sept. 11 Industry Loss Estimates
($ Billions)

- Life: $2.7 (7%)
- Aviation Liability: $3.5 (9%)
- Other Liability: $10.0 (25%)
- Aviation Hull: $0.5 (1%)
- Event Cancellation: $1.0 (2%)
- Workers Comp: $2.0 (5%)
- Property - WTC 1 & 2: $3.5 (9%)
- Property - Other: $6.0 (15%)
- Biz Interruption: $11.0 (27%)

Consensus Insured Losses Estimate: $40.2B

Source: Insurance Information Institute
Insured Loss Estimates
(updated through September 13, 2002)

Source: Morgan Stanley, Insurance Information Institute as of September 13, 2002.

Top 20 Groups (pre-tax, net of reinsurance, $ millions)

NOTES:
*Includes $474 mil for American Re
**Includes $289 mil for Converium
***Insurer is bankrupt
#5

ASBESTOS
Asbestos: Reserve Deficiency and Ultimate Costs Growing

Reserve Deficiency = $33.1 Billion

Source: A.M. Best.
Non-Malignant Asbestos Claimants
File Most Claims, Get Most $$$

DISTRIBUTION OF CLAIMS 1991-2000
- Non-malignant: 90%
- Meso-thelioma: 3%
- Lung & Other Cancers: 7%

ALLOCATION OF COMPENSATION 1991-2000
- Non-malignant: 65%
- Meso-thelioma: 17%
- Lung & Other Cancers: 18%

Source: RAND, Tillinghast-Towers Perrin
Who Will Pay for the US Asbestos Mess?

Estimated Total US Settlements & Expenses = $200 billion

- Asbestos Defendants: $78 billion (39%)
- US Insurers: $60 billion (30%)
- Foreign Insurers: $62 billion (31%)

Source: Tillinghast-Towers Perrin; Insurance Information Institute
#4

CAPACITY
Surplus peaked at $336.3 Billion in 1999

- Surplus decreased 8.7% in 2001 to $289.6 Billion.
- Surplus fell 2.3% in the 1st half of 2002
- Surplus is now lower than at year-end 1997.

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

*As of June 30, 2002
Source: A.M. Best, Insurance Information Institute
Capital Raising by P/C Insurers Since September 11, 2001*

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

- 2001: $25.4 Billion
  - 40 Completed: $20,492
  - 14 Pending: $4,872
- 2002*: $27.9 Billion
  - 33 Completed: $11,442
  - 38 Pending: $16,437

*As of September 13, 2002.

Source: Morgan Stanley, Insurance Information Institute.
#3

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

- Cost of risk to corporations fell 42% between 1992 and 2000
- Estimated 15% increase in 2001, 30% in 2002
- About half of 2002 increase due to 9/11

Source: 2001 RIMS Benchmark Survey; Insurance Information Institute estimates.
## Rate Increases By Line of Business

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<th>Change</th>
<th>Up 1-10%</th>
<th>10-20%</th>
<th>20-30%</th>
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<td>Surety Bonds</td>
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</tr>
</tbody>
</table>

Source: Council of Insurance Agents and Brokers
Prices rising, limits falling: ROL up significantly

Source: Guy Carpenter

* III Estimate
#2

UNDERWRITING
Underwriting Gain (Loss) 1975-2002*

P-C insurers paid $53 billion *more* in claims & expenses than they collected in premiums in 2001

*Annualized estimate based on first half 2002 data.
Source: A.M. Best, Insurance Information Institute
Combined Ratio: Reinsurance vs. P/C Industry

2001’s combined ratio was the worst-ever for reinsurers

*First Quarter 2002 figures.
Source: A.M. Best, ISO, Reinsurance Association of America, Insurance Information Institute
World’s Most Dangerous Lines of Insurance
(Combined Ratio + 1 Std. Deviation)

Source: Insurance Information Institute, calculated from A.M. Best combined ratio data.
#1
PROFITS
ROE: P/C vs. All Industries
1987–2002*

*2002 figures are estimates; p/c figure based on first-half 2002 data.
Source: Insurance Information Institute; Fortune
P/C Net Income After Taxes
1991-2002 ($ Millions)

- 2001 was the first year ever with a full year net loss
- 2002 First Half ROE = 3.3%

*II.I. estimate based on first half 2002 data.
Sources: A.M. Best, ISO, Insurance Information Institute.
There is an enormous gap between the industry’s cost of capital and its rate of return. US P/C insurers have missed their cost of capital by an average 6.7 points since 1991.

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