# 2009 Insurance Economic Summit:
## Navigating the New Business Landscape



## State Of The Industry Presentation

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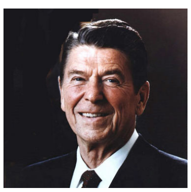
## Agenda

- Background on Current Financial Crisis
- Impact on Insurance Sectors
- U.S. P&C Rating Outlook & Performance Recap
- P&C Key Issues for 2009
- Lessons Learn on Current Financial Crisis, So Far…

## Financial Services Market Transformed By Financial Crisis

- Mortgage Lending
  - Fannie Mae/Freddie Mac
- Investment Banks
  - Bear Stearns, Lehman, Merrill Lynch
  - Goldman Sachs, Morgan Stanley Now Commercial Banks
- Commercial Banks
  - Wachovia, Washington Mutual
- Insurance & Financial Products
  - AIG
- Unprecedented Government Intervention
  - $700B U.S. Government Troubled Asset Relief Program (TARP)
  - New Regulation Forthcoming

## What would Ronald Reagan say about today's crisis?



"The nine most terrifying words in the English language are: I'm from the government and I'm here to help."

## Financial Crisis Impact On Insurers

**Financial Guarantors / "Monolines"**

- Risk profile changed over time – guarantees on municipal securities vs. structured finance
- Losses on structured securities backed by subprime RMBS
- Portfolio credit pressures ➔ higher capital needs ➔ inability or unwillingness to raise capital ➔ Insurer Financial Strength rating downgrades ➔ collapse in business model
- Future viability of industry in question

## Financial Crisis Impact On Insurers

**Mortgage Insurers**

- Tremendous growth in real estate boom
- Sharp deterioration in mortgage delinquency rate, especially 2007 vintage, a 23% growth year for premiums
- Increasing delinquencies → sharp increase in loss reserving → decline in capital → lost market confidence; limited capital access → ratings downgrades → diminished franchise value

## Financial Crisis Impact On Insurers

**Life Insurance Industry**

- **Rating Outlook moved to Negative: September 29, 2008**
- Deteriorating credit and equity markets
  - Leveraged investments: RMBS, CMBS, corporate bonds, other classes
  - Increase in investment losses in 4Q08 and into 2009
- Pressure on risk-based capital (RBC) levels
  - New capital raising opportunities limited, TARP?
- Equity market exposure / variable annuity risk
  - Significant volatility to industry earnings and capital
- Liquidity pressures
  - Institutional investment products exposed - "credit cliff" if confidence erodes

## In Perspective: U.S. Life Insurance Industry

**However, Relatively Well-Positioned to Weather Storm**

- Strong capital levels going into 2008
- Less direct sub-prime / Alt-A investment exposure
  - 59% of U.S. life industry capital exposed vs. 200+% for major commercial banks and securities firms
- Little structured finance CDOs or CDS

**………Recent Rating Downgrades Limited to 1-2 Notches**

## In Perspective: Property/Casualty Insurers

**Shift to <u>Negative Rating Outlook</u> – October 2008**

- Commercial Lines – Previously Stable since July 2004
- Personal Lines – Previously Stable since January 2002

**Core Concerns/Thesis**

- Investment related risks outweigh typical insurance concerns
- Credit crunch = shock loss event
  - Depletes industry capital base
  - Reduced ability to replenish capital in current market
- Insurance pricing will not move to adequate levels in near term
- P&C still least impacted of all sectors
- Minority of recent rating actions are downgrades, most one notch

## U.S. Property/Casualty Industry Financial Review

- Double Digit Return on Surplus and Surplus Growth 2004-2007
- Premium Growth Strained By Market Cycle
- 2008 Return to Underwriting Loss as Markets Further Soften and Higher Cats
- Large 2008 Investment Losses
- Return on Surplus Drops Sharply to Inadequate Level

| | 2007 | 2008P |
|---|---|---|
| **Written Premium Growth (%)** | -0.3 | -0.8 |
| **Combined Ratio (%)** | 95.5 | 104.6 |
| **Combined Ratio (%) Ex-MI & FGs** | 94.7 | 101.1 |
| **Net Cat Losses / Earned Premium (%)** | 1.4 | 5.4 |
| **Net Income ($Bil.)** | 57 | 10 |
| **Annual Return on Surplus (%)** | 11.3 | 2.1 |

Source: Highline, Fitch

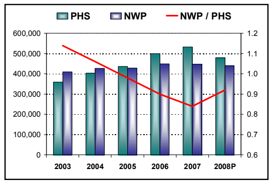
## Key Rating Issue #1 Asset Risks

**<u>Asset Risk Drivers</u>**

- Interest Rate Risk - Duration Mismatch
  - Fitch Est. Industry Asset Duration = 3.7x, Liability Duration = 2.8
- Asset Leverage
  - Invest Assets / Surplus - P&C Industry = 2.4X, Life = 11.0X
- Credit Risk
  - Corporates / Munis / High Quality MBS
  - Little Sub-Prime or Derivative Exposure
- Equity Market Risk

## Key Rating Issue #2
## Capital / Capacity

- Market Previously in Excess Capital Position
- Operating Leverage Still Near Historic Lows
  - Promotes Price Competition
  - Aggressive Capital Deployment
- Surplus Down By >10% in 2008



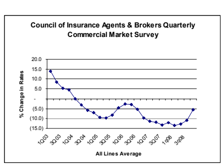

## Key Rating Issue #2
## Capital / Capacity

Previous Periods of Declining PHS

| Years | % Decline | Contributors |
|---|---|---|
| 1973-1974 | 32% | Oil Embargo, Inflation, U/W Losses |
| 2000-2002 | 14% | Soft Market / 9-11 / Internet Stock Bust |

## Key Rating Issue #3
## Pricing

- Rates have fallen to inadequate levels
- Rates still decreasing but at slower rate in most segments
- Catalyst event for near term shift in pricing trends?
  - Cat Losses
  - Further Investment Losses



## Key Rating Issue #3 Pricing

**Potential for improvement by sector**

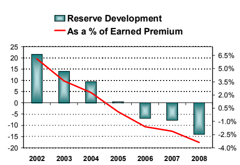
Reinsurers – Most Likely
- Property catastrophe rates hardening
- Better competitive dynamics / market discipline
- Increased demand with limited capital market options

Personal Lines – Somewhat Likely
- Auto rates rising in many states
- Largest players not grabbing market share

Commercial Lines – Least Likely
- Rates still declining in many segments
- AIG protecting renewals

## Key Rating Issue #4 Reserve Adequacy

- Reserve development trends continue favorably
  - Industry reserves adequate to slightly redundant at YE07
  - Asbestos and Environmental a lessening problem
  - Sarbanes-Oxley requirements have beneficial effect on reserving
- Favorable reserve development reduced loss ratio 3.4% in 2008
- Is there any reserve cushion left?




## Profit Outlook for 2009

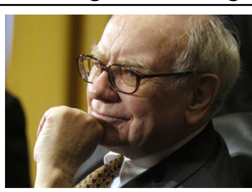
- Continued pressure on revenues in economic recession
- Accident year loss ratio expected to increase further
- Less assistance from favorable reserve development
- Hopefully an average catastrophe year
- <u>Further recognition of investment losses</u>
- Underwriting loss and inadequate return on capital

## Lessons Learned From Crisis, So Far…

- High leverage is bad, regardless of perceived risk
- Complexity often "trumps" diversification
- Enterprise Risk Management and economic capital modeling did not seem to help
- Supposedly remote "tail" events occur more often than expected
- Financial flexibility is a myth when most needed
- Rating triggers – both explicit and implicit – can create "credit cliffs"
- Illiquidity can "kill" overnight

## Lessons learned from Warren Buffett…

Beware of geeks bearing formulas



Only when the tide goes out do you discover who's been swimming naked.

When you combine ignorance and leverage, you get some pretty interesting results.

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