



**2010 Insurance Economic Summit:
Navigating the Era of Reform**

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**2010 Insurance Economic Summit:
Navigating the Era of Reform**

State of the Industry

Douglas M. Pawlowski, Senior Director, Fitch Ratings

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**2010 Insurance Economic Summit:
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**Property/Casualty
and Life Insurance
Sector Update**

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Property/Casualty Insurance Industry

Shift from Negative to Stable Rating Outlook - September 2010

Rationale:

- P&C Insurers withstood economic crisis reasonably well
- Capital levels restored from 2008 declines
- Access to capital improved as credit markets reopen
- Rating levels for P&C universe at levels that could withstand some adversity

Current Concerns

- Competitive market conditions unlikely to shift in near term
- Forecast for mediocre returns next several years
- Inherent underwriting volatility from catastrophes, litigation, inflation, unknown events
- Lingering economic and asset market uncertainty





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Rating Change Trend

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>YTD 2010</u>
Downgrades	4	16	13	3
Upgrades	11	5	0	4
D:U Ratio	0.4:1	3.2:1	NM	0.75:1

nm = not meaningful figure




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U.S. Property/Casualty Insurance Industry - Year-End Statutory Results

- Premiums declined 2007-2009; likely flat in 2010
- Light cat Losses in 2009, but already higher in 2010
- 102% AY CR (x MI & FG) in 2009 expected to deteriorate modestly in 2010
- Investment yields not likely to improve, but fewer realized losses
- Return on Surplus remains inadequate in soft market

	<u>2010P</u>	<u>2009</u>	<u>2008</u>
Combined Ratio (%)	102.9	100.4	105.1
Investment Income	51.0	48.7	53.4
Realized Gains	0	(8.0)	(19.6)
Net Income	30.0	32.1	4.4
Chg Unreal. Gains	0	25.7	(54.2)
PHS	546	522	462
% Change	4.6	14.7	(12.7)
Return on PHS (%)	5.6	6.5	0.9

Source: Highline Data, Fitch



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Key Rating Issues - Pricing

- Premium rates broadly at inadequate levels
- Rates still flat to decreasing in most segments
- No catalyst evident for near term shift in pricing trends
 - Cat Losses
 - Capital Losses

Council of Insurance Agents & Brokers Quarterly Commercial Market Survey

% Change in Rates

All Lines Average

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Property/Casualty Segment Results

**Property/Casualty Industry Aggregate
Developed Accident Year Combined Ratios**

	2005	2006	2007	2008	2009
Personal Auto	94.1%	96.3%	98.8%	101.1%	103.9%
Workers Comp	86.9%	89.3%	99.4%	103.1%	106.0%
CMP	96.6%	87.2%	92.1%	108.7%	101.3%
Med Mal	82.8%	85.6%	92.7%	98.5%	107.6%
Other Liability	80.7%	85.5%	93.4%	101.6%	105.2%

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Key Rating Issues – Capital / Capacity

- Surplus up by 13% in 2009, following 13% 2008 decline
- Recovery raises excess capital concerns
 - Promotes price competition
 - More aggressive capital deployment
- Operating leverage at historic low at .81x

Property/Casualty Industry Aggregate Surplus and Operating Leverage

PHS Operating Leverage

Source: Highline Data, Fitch Ratings

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Key Rating Issues – Asset Risks

Asset Risk Drivers

- Asset Leverage 2.4x
- Credit Risk
 - Corporate Bonds
 - Municipal Bonds
 - MBS/ABS
- Equity Market Risk – unaffiliated common stock 27% PHS
- Interest Rate Risk

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Property/Casualty Insurers Municipal Bond Exposure

Municipal Bond Asset Allocation

■ General Obligations
 ■ Pol. Sub.
 ■ Revenue

Source: Highline Data, Fitch Ratings

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Key Rating Issues – Reserve Adequacy

- Industry reserves adequate at YE09
- Favorable reserve development reduced CY loss ratio 2.4% in 2009 (X MI & FG)
- Recent accident year results revealing less reserve cushion and conservatism
- Asbestos and Environmental a lessening problem

Over/Under Reserving Cycles Versus Accident Year Loss Ratio History – P/C Industry Aggregate

Historical Accident Year Loss Ratio Developments Versus Accident Year Loss Ratio History


Source: Highline Data.

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U.S. Life Sector Update


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 **US Life Insurance Industry**

- **Rating Outlook Revised to Stable – Sept 2010**
 - Suggests vast majority of ratings will be affirmed
 - At current levels over the next 12-18 months
- **Previous Negative Rating Outlook – Key Concerns**
 - Investment Losses
 - Statutory Capital Deterioration
 - Earnings Profile Weakened
 - Limited Capital Market Access
 - Variable Annuity Risk
 - Disintermediation Risk



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 **U.S. Life Insurance – Stable Rating Outlook**

Outlook Revision Tied to Improved Financial Markets

- Statutory Capital Levels Restored
- Improving Trend in Earnings
 - Still Lag Pre-crisis Levels
- Improved Asset Valuations – Fixed Income and Equities
- Significant Reduction in Realized Investment Losses
 - Results consistent with Fitch’s stress testing

.....Industry Credit Profile has Stabilized

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U.S. Life Insurance – Stable Rating Outlook

Outlook Revision – Other Considerations

- Product de-risking initiatives
 - Variable annuities
 - Universal Life
- Reduced reliance on institutional funding sources
 - Runoff in GICs and funding agreements
 - Decline in securities lending activities
- Strengthened hedging programs
 - Variable annuities

.....Industry Credit Profile has Stabilized

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U.S. Life Insurance – Stable Rating Outlook


Key Near-term Concerns

- Weak economic recovery; double dip recession still possible though not expected
- Further expected deterioration in CRE
- Operating fundamentals remain under pressure
- Weakened earnings profile, lower coverage metrics
- Low interest rate environment – impact on revenues, earnings, capital

Key Longer-term Uncertainties from Financial Crisis

- Pace of future M&A
- Evolving regulatory environment
- Market demand for insurance products
- Interest rate risk

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U.S. Life Insurance Industry Financial Review

	(\$Billions)	2006	2007	2008	2009	1H10
2006						
> Favorable Equity / Credit Markets						
2007						
> Good, Albeit Choppy, Investment Results, Further Modest Spread Compression						
> Subprime Losses Pushed into 2008						
2008						
> Deteriorating Financial Markets						
> Increased RMBS Losses						
> Contagion into Other Asset Classes						
2009						
> Recovery in Financial Markets						
> Continued investment losses						
	Net Operating Gain	30.9	33.0	(0.7)	42.6	6.0
	Investment Gains/Losses	2.6	(1.4)	(45.1)	(26.6)	(7.2)
	Net Income	33.5	31.6	(45.8)	16.0	(1.2)
	% chg in Net Income	(2%)	(6%)	(245%)	NA	NA
	Total Adjusted Capital	258	273	236	246	251
	% chg in TAC	6%	6%	(13%)	4%	6%
	NAIC RBC Ratio	402%	398%	384%	428%	427%

Source: Highline, Fitch

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Trend in U.S. Life Insurance Ratings

- Downgrades outnumber upgrades modestly during period of Stable Rating Outlook
- Downgraded 35 (out of 52) life insurance groups 59 times during period of Negative Rating Outlook (Sept 2008 thru Sept 2010)

Quarter	Upgrades	Downgrades
1Q07	2	1
2Q07	1	1
3Q07	1	1
4Q07	2	1
1Q08	1	1
2Q08	2	1
3Q08	1	1
4Q08	1	1
1Q09	1	1
2Q09	1	1
3Q09	1	1
4Q09	1	1
1Q10	1	1
2Q10	1	1
3Q10	1	1

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U.S. Life Insurance – Stable Rating Outlook

Investment Stress Testing

- Base case investment loss estimate of \$90 billion or approximately 3+% of invested assets
 - Based on deterministic stress utilizing detailed, internally developed loss assumptions applied to companies' specific investment portfolio
 - Loss assumptions vary by asset class, rating category, and in some cases, vintage year, and represent a two-year stress
 - Factored into existing ratings
- Tracking realized investment losses relative to base case investment loss estimate
 - Approximately 80% of losses realized through yearend 2009
 - To the extent that actual losses realized stay within Fitch's estimate of loss, further negative rating actions will be limited

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U.S. Life Insurance Industry Financial Review

Commercial Mortgage Exposure

- Expect continuing weakness in commercial mortgage market in 2010 and 2011
 - US CMBS loan delinquency rates expected to peak at 12% in 2012 based on Fitch's US CMBS Loan Delinquency Index
 - Monthly delinquency index was at 8.14% June 2010 compared to 0.88% at YE08 and an annual average default rate of 0.74%
- Key macro concerns
 - Double dip recession
 - Liquidity and refinance risk
 - Impact of upcoming commercial bank loan maturities

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U.S. Life Insurance Industry Financial Review

Commercial Mortgage Exposure

- Deterioration in commercial mortgage market additive to challenges facing US life insurers; Base case loss of \$20 billion.
 - Commercial Mortgage Loans: Base case two year loss assumption (2010-2011) of 2%. Increased losses will emerge over time
 - CMBS: Base case two year loss assumption in the 9% range (varies by vintage and rating)
 - CRE CDO exposure modest

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U.S. Life Insurance Industry Financial Review

U.S. Commercial Mortgage Delinquencies

Sources: Fitch Ratings, American Council of Life Insurers, Federal Deposit Insurance Corporation and Commercial Mortgage Securities Association (F): Forecasted

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U.S. Life Insurance Industry Financial Review

Fitch's View of The RMBS Initiative

- Addresses a long-term problem in the RBC methodology
 - Different recovery rates
 - Credit for write-downs already taken
- PIMCO's valuations appear consistent with Fitch assumptions used to monitor and assign Recovery Ratings on RMBS
- Fitch is not making any adjustments to reported RBC results for this change as part of its analysis of capital adequacy
- Investors and other third parties would benefit from greater transparency in the RMBS Initiative valuation methodology

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U.S. Life Insurance Industry Financial Review

2008-2009 Financial Turmoil Increases Variable Annuity Risk

- Capital and reserve requirements (economic and regulatory) increase rapidly when "in the money"; new VACARM reserving requirements effective at YE2009
- Profits hurt by ▼ fee revenue due to ▼ net asset values, ▲ hedging costs, and ▲ reserving associated with product guarantees – GAAP/IFRS profits also hurt by DAC unlocking
- Effectiveness of hedge programs mixed
- Ultimate losses unknown and difficult to estimate
 - In the moneyness 12/31/08: \$280 billion (Fitch estimate)
 - Reserves posted in 2008: \$56 billion (Fitch estimate)
- Fitch expectations
 - Shake-out in VA market; Drag on overall industry earnings over near term

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