

Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

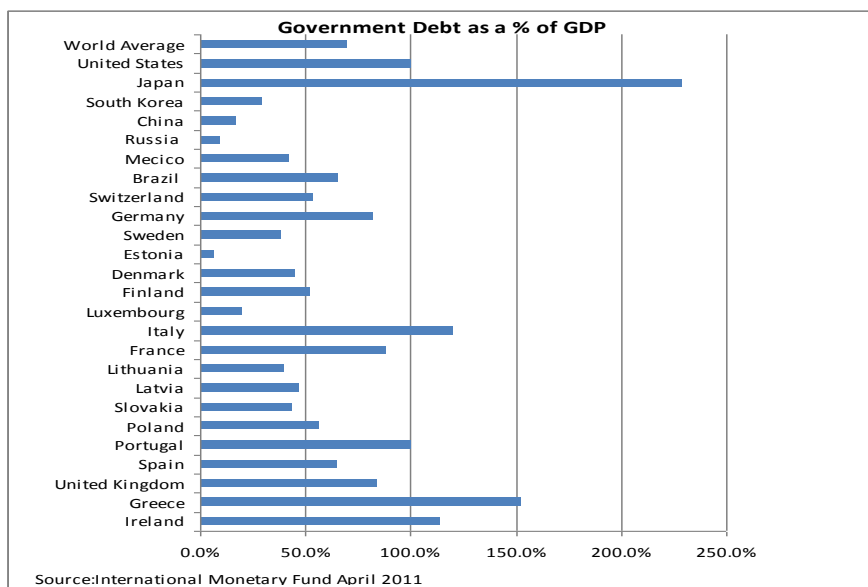
Fundamental Headwinds to Industry Growth

Worldwide Economic Slowdown Puts Damper on Prospects for Global Industry Growth

With the settlement of raising the U.S. National Debt issue apparently resolved at the 11th hour the global financial markets avoided having to answer the question... "What would a U.S. default really mean?" In this issue we are reminded that the global economic news of 2011 has been awful and the underlying prospect for the growth in commerce, the foundation for virtually all insurance products in a free-enterprise economy, is in doubt. We will attempt to capture and present some of the key concerns about the factors limiting global economic growth most being in the form of charts tracking relevant data. We will comment on the S&P downgrade of U.S. debt from AAA to AA+ in our next letter dealing with insurance industry investments.

Sovereign Debt

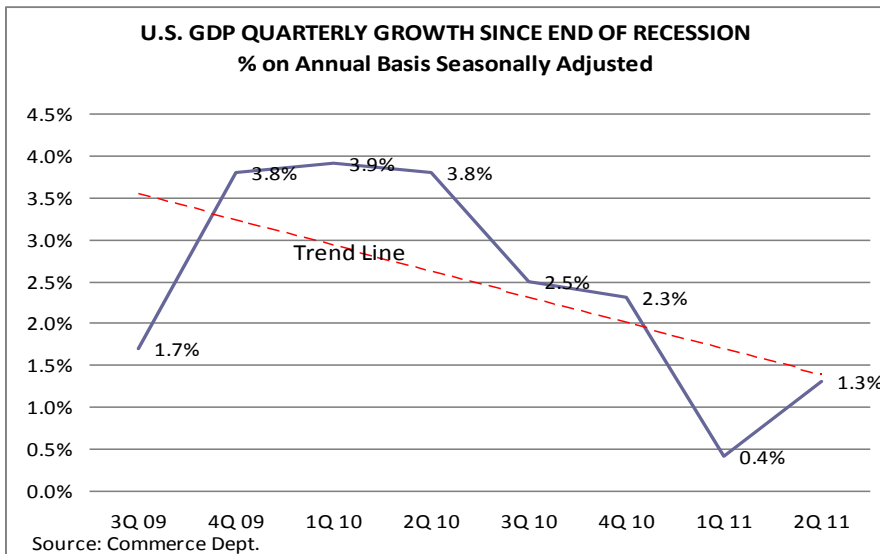
Sovereign debt escalates as economic activity declines. In the U.S. Government debt at federal and state levels has replaced consumer debt that was the catalyst or enabler behind the credit market crises in our last recession. In Europe we see a similar problem of escalating sovereign debt threatening the Euro currency and the European Union. But the EU decided not to cut loose Greece but rather opt for a limited default as the former would have caused a major problem for European banks and insurance companies who either held debt or had CDS contracts outstanding.



The chart that depicts an excessive debt position is the product of budgets that are continually out of balance with revenues as well as an economy with poor growth (i.e. tax revenues) as evidenced by changes in GDP. In the U.S. the GDP data since the end of the Great Recession is trending poorly.

This does not translate into the kind of economic activity where insurance does well in terms of growth potential, as there is minimal expansion of exposure risk (uncertainties) and a greater desire to contain expenses (premiums).

A recent global survey in CFO Magazine (see CFO.com) indicates that CFO's are growing less optimistic about the global economy, in particular consumer demand, regulatory changes and general state of the recovery. Spending on investments in new technology appears linked to maintain existing employee levels (53%) or reduce employees (9%). But those who intend to expand employment

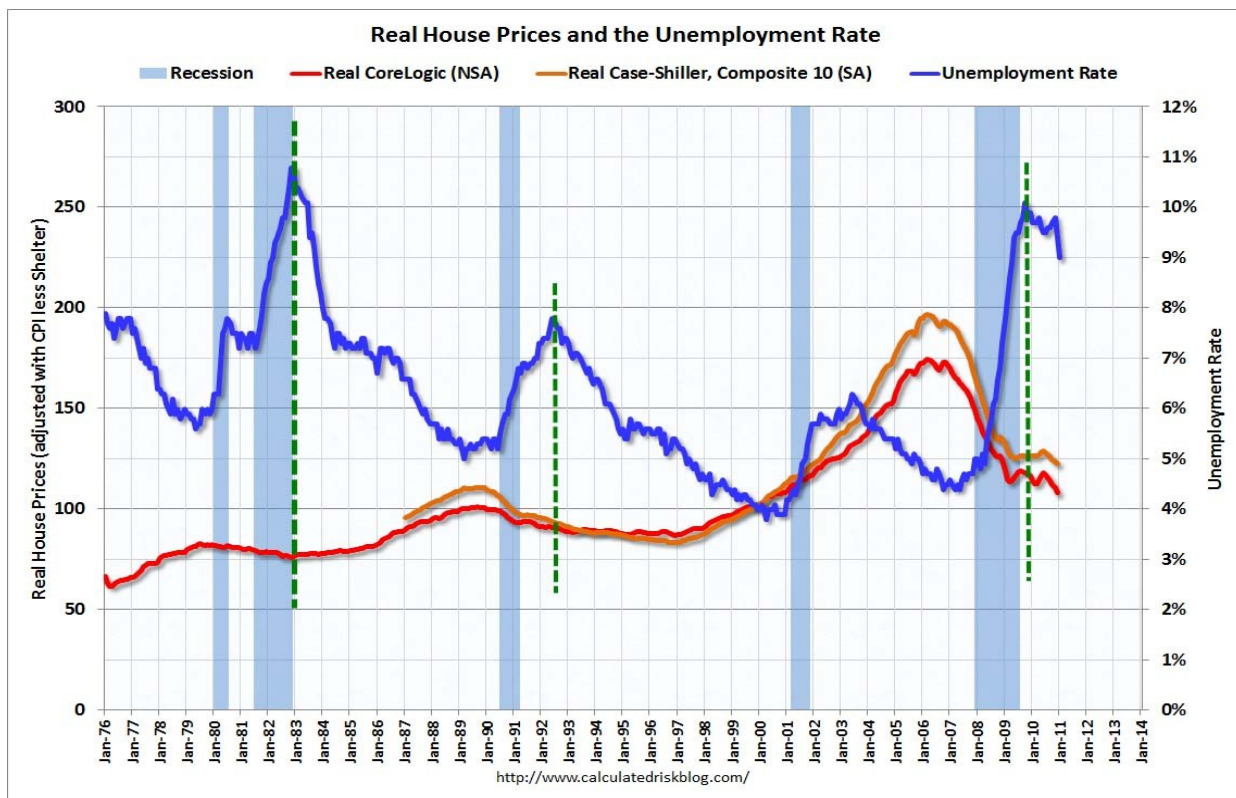


will amount to only 1% over the next 12 months so that would translate to fewer than 100,000 jobs, an insignificant number to alter the current unemployment rate.

Speaking of Employment....or Unemployment

No economic recession has ever recovered without a restoration of jobs. This Great Recession appears to be different then in the past particularly in relation to the connection with the real estate bubble and the

residual effects on housing that inhibit worker movement.

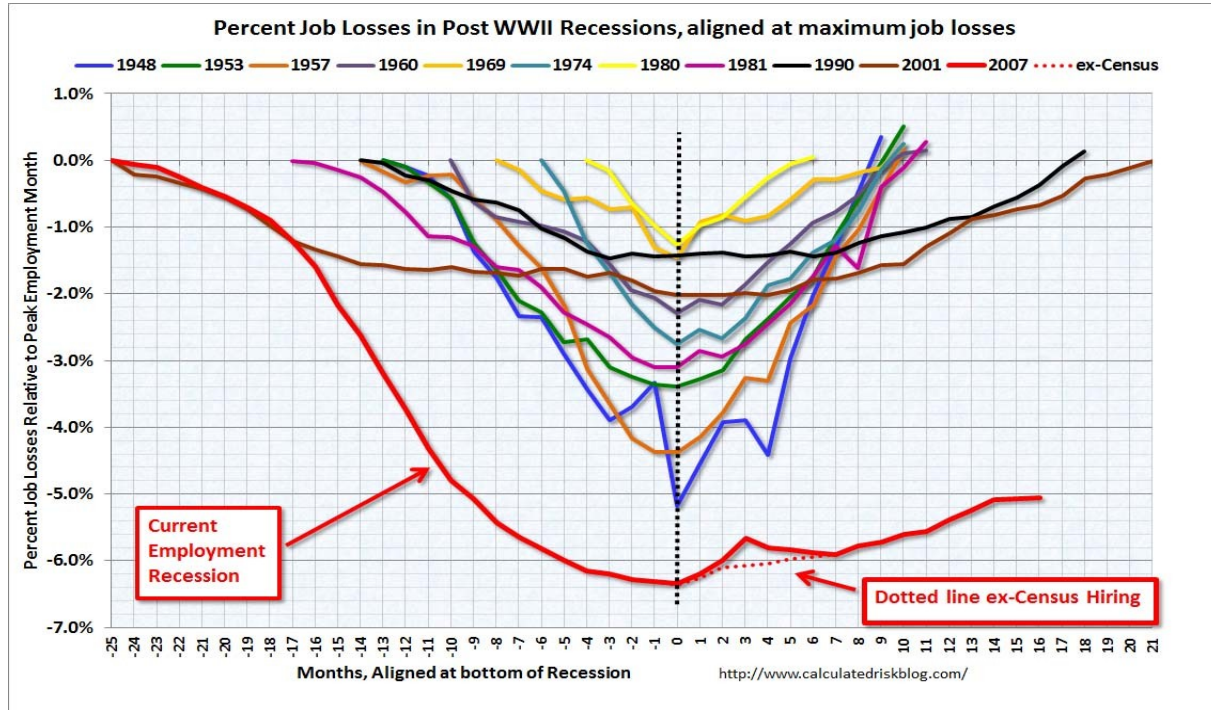


In the past displaced employees often considered relocation to find a job but that is not a strategy easily done this time, as they may be unable to sell their existing home. This may be one of the reasons why 50% of unemployed have been so for more than a year. This duration issue as respects unemployment is best summarized in the chart on the following page.

There are numerous benefits across the economy associated with an increase in employment:

- Restores business confidence in consumer growth potential;
- Catalysts for new business formations that add to employment outlook;

- Produces additional tax revenue while reducing government funding for social support programs;
- Offers potential restoration/stabilization of real estate valuations as enthusiasm for home ownership is renewed.



The amount of monthly addition to job growth required to get the U.S. to more acceptable levels of unemployment given existing population/job market entry data would be as follows:

MONTHLY EMPLOYMENT GAINS NEEDED TO REDUCE UNEMPLOYMENT RATE TO TARGET LEVEL OVER INDICATED TIME

Target Rate	1 Year	2 Years	3 Years	4 Years	5 Years
9.00%	140,250	127,500	123,250	121,125	119,850
8.00%	267,750	191,250	165,750	153,000	145,350
7.00%	395,250	255,000	208,250	184,875	170,850
6.00%	522,750	318,750	250,750	216,750	196,350
5.00%	650,250	382,500	293,250	248,625	221,850

Source: Mauldin, Outside the Box

Red = never been done

Green = close to historical average

Yellow = only happened once before

Blue = possible but optimistic

Grey = reached in past but rarely

This demonstrates just how many jobs need to be created given population growth and job entry numbers coming into the workforce. Just to keep the unemployment rate at 9% we need over 140 thousand jobs created each month for 1 year. Since the months of April, May and June produced an aggregate of only 180,000 jobs we are obviously well behind this curve! The just released 117,00 jobs increase in July obviously falls short of these targets so the rate remained above 9%.

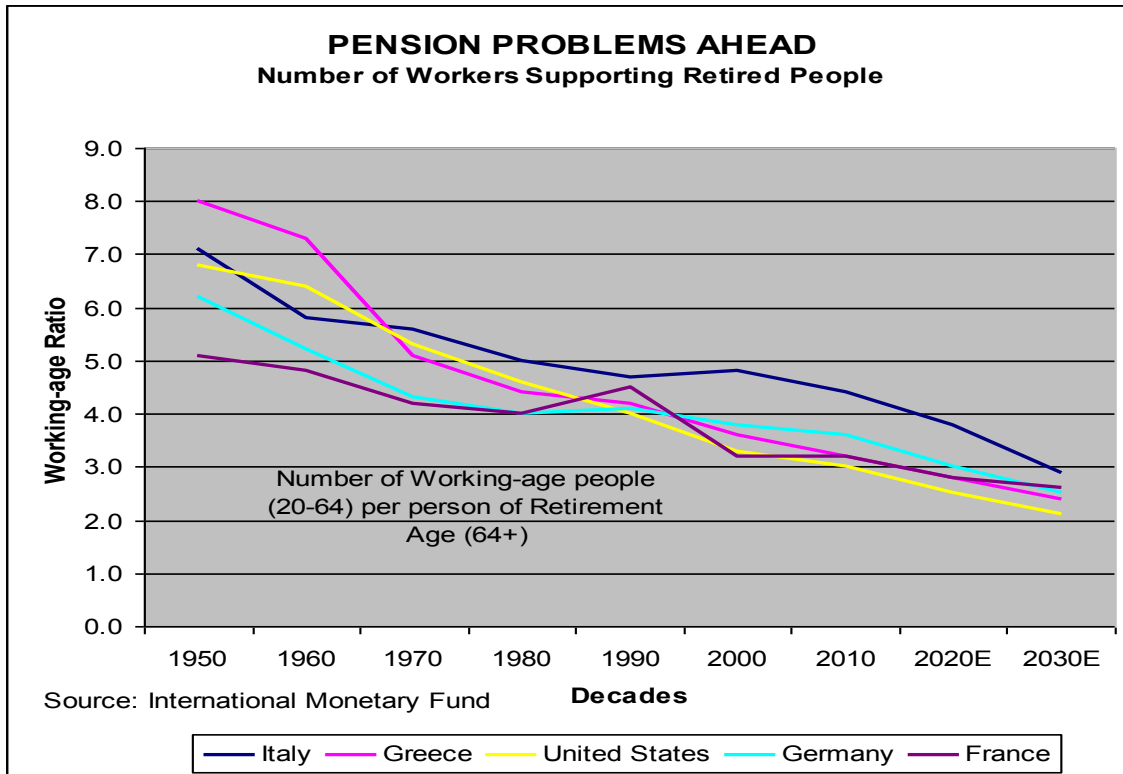
These projected "target" increases would directly assist Workers Compensation insurers who need a boost in payroll exposures to increase overall premium growth as loss ratios are escalating rapidly.

More importantly the increase in payrolls would help support increase in tax receipts even at current tax rate

levels and help the various states, cities and municipalities to fund their budgets and escalating employee benefit obligations. Until that happens, public employee benefits will be subject to pressures for modification while the broader national programs remain under scrutiny for benefit levels applicable to citizens at-large. State and Local government average employment cost components are described below:

Total Compensation	Wages	Paid Leave	Suppl. Pay	Insurance	Retirement	Other
Average Hourly Cost	\$26.25	\$3.00	\$0.33	\$4.68	\$3.16	\$2.39

The chart below indicates just how many working citizens in the U.S., Italy, Greece, Germany and France have or will be carrying the cost of “social security” type benefits for the retirees.



In the U.S. nearly 7 people were working for every single retiree which is at less than half as many in 2010 and drop to 2.1 workers by 2030. An ageing population is becoming a burden in the developed nations of the world creating a current advantage for emerging economies.

Sovereign Budget Imbalances

The budget deficits in Europe are a grave concern as revenues continue to fall against escalating government expenses placing pressure on additional borrowing of larger amounts to cover the deficit. Here is some the history in Europe with 3% being the EU target maximum:

In the U.S. the recent debt ceiling agreement, that included significant budget cuts, has many wondering what has been really achieved. With most of the expense cuts “back-end loaded” (i.e. most cuts come later not sooner) there is concern that expected targets will be missed as the economy deteriorates. The Congressional Budget Office (CBO) that validates the projected legislative savings is still working with GDP estimates for 2011 at 3.1% and 2.8% in 2012 whereas the actual GDP for the first half of 2011 grew at an annual rate of only 0.8%. Wall Street firms are now estimating GDP rates of 1.7% to 2.3% for 2011 and 2.3% to 2.9% in 2012 so the CBO estimate of \$1 trillion in spending cuts could be off by as much as \$750 billion over the 10 year fore-

EUROPEAN COUNTRIES- EUR 17				
BUDGET DEFICITS(-) Surplus(+) RELATIVE TO GDP				
	2007	2008	2009	2010
Ireland	10.0%	-7.3%	-14.3%	-32.4%
Greece	-6.4%	-9.8%	-15.4%	-10.5%
United Kingdom	-2.7%	-5.0%	-11.4%	-10.4%
Spain	1.9%	-4.2%	-11.1%	-9.2%
Portugal	-3.1%	-3.5%	-10.1%	-9.1%
Poland	-1.9%	-3.7%	-7.3%	-7.9%
Slovakia	-1.8%	-2.1%	-8.0%	-7.9%
Latvia	-0.3%	-4.2%	-9.7%	-7.7%
Lithuania	-1.0%	-3.3%	-9.5%	-7.1%
France	-2.7%	-3.3%	-7.5%	-7.0%
Italy	-1.5%	-2.7%	-5.4%	-4.6%
Luxembourg	3.7%	3.0%	-0.9%	-1.7%
Finland	6.2%	4.2%	-2.6%	-2.5%
Denmark	4.8%	3.2%	-2.7%	-2.7%
Estonia	2.5%	-2.8%	-1.7%	0.1%
Sweden	3.6%	2.2%	-0.7%	0.0%
Germany	0.3%	0.1%	-3.0%	-3.3%

Source International Monetary Fund

cast period.....so much for deficit reduction!

Implications for the U.S. Insurance Market

The outlook for a global economic recovery is in serious jeopardy and will therefore impact every business segment including the insurance industry. Suggestions about a double-dip recession are gaining more support but even a stagnant economy will bring difficulty to insurance

markets. Fundamentally, a reduced level of economic activity will bring less demand for insurance as risk-based exposures decline and commercial buyers will be willing to retain some uncertainties rather than transfer them via insurance. Against this development underwriters will be looking to buck the trend on reduced premium flow via increased rates on lower exposures, especially as underpriced business from the soft market years becomes obvious via claim reserve deficiencies. Looking at the last recession underwriters were able to avoid rate increases as they had lots of excess reserves and capital to help cushion the downside. This now looks to be different if the economy slips into another recession where underwriters need to cover escalating costs but can not look to their investment operations for that "life preserver income" on the float.

So all things being equal we saw the possibility that a commercial market rate change in 2012 possibly moving to the start of 2013 so the deepening economic slowdown would appear to confirm that outlook. The core insurance industry hasn't yet experienced sufficient sustained periods of underwriting losses and has been sitting on too much capital for an earlier shift in commercial lines. The collapse of equity markets last week (August 4) may have reduced that capital base somewhat but not sufficiently to cause a strain....at least not just yet! We may get price movement in particular segments or lines of business but a broad based shift needs (1) sustained underwriting losses;(2) questionable investment income environment; (3) declining capital base; (4) poor current risk environment outlook/tightening of conditions and (5) shortage of reinsurance support from the global market. There may be potential signs of these conditions emerging but we will have to see just how rapidly things will develop for actual change in price movements.



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