

Insurance Executive Review

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

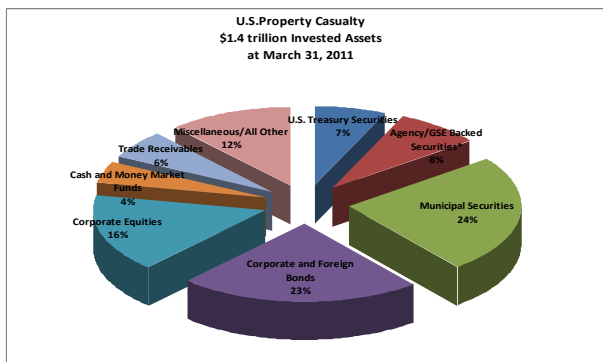
Debt Downgrade Affect on Commercial Risk Insurance Outlook

U.S. Debt Downgrade by Standard & Poor may have set into motion a change in public confidence and our view of Commercial Risk Insurance outlook.

The downgrade of USA debt obligations from AAA to AA +by S&P a week ago has set into motion a great many things. If isolated to simply the U.S. debt position such as treasury securities the direct impact to P&C companies would be minimal as only 6.8% of total industry financial assets are in that class. However, another 8.5% of assets are in Government Agency or GSE Backed Securities and in the Life insurance segment the relative percentages are 3.1% and 7.8% respectively. If the damage from the downgrade stopped there we could all carry on as before since insurance regulators dismissed the new rating has having any effect on the insurance industry. This probably would have been good words of assurance if it had not been coupled with an economic global downturn suggesting that world economies were possibly slipping back into another global recessionary period....that has much broader implications!

Property Casualty Financial Assets

The pie chart below describes the U.S. P&C industry asset allocation as of the first quarter of 2011 showing the percentage devoted to each class:



The chart on the next page traces the recent changes in asset allocations managed by U.S. based Property Casualty insurers nationwide between year-end 2006 and 2011 (1Q). Notice that the invested assets declined by \$66.5 billion at the end of recession year 2008 when the industry recorded a \$60 billion decline in surplus or about 12% loss of net worth. The recession caused allocations to move away from corporate equities and bonds and into the safe haven of Treasuries and municipal securities

based on early Federal Reserve initiatives to restore economic health.

The subsequent financial market recovery from 2009 saw allocations move back to corporate investments and

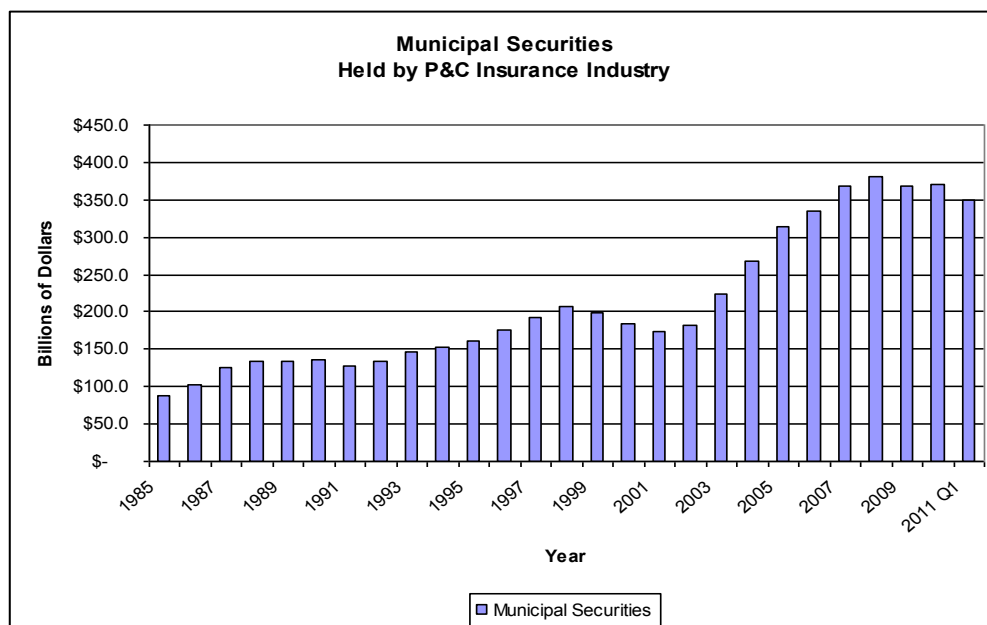
Property Casualty Industry
Financial Asset Distribution
(\$ Billions)

Financial Assets	2006		2007		2008		2009		2010		1Qtr. 2011		Change 2003 to 2011	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	%	\$
U.S. Treasury Securities	\$ 75.8	5.7%	\$ 55.1	4.0%	\$ 65.6	4.8%	\$ 88.5	6.4%	\$ 91.4	6.7%	\$ 93.3	6.8%	44.2%	\$ 28.60
Agency/GSE Backed Securities*	\$ 122.0	9.2%	\$ 125.8	9.2%	\$ 114.3	8.3%	\$ 116.2	8.5%	\$ 109.3	8.0%	\$ 116.2	8.5%	0.7%	\$ 0.80
Municipal Securities	\$ 335.2	25.2%	\$ 368.7	26.8%	\$ 381.9	27.8%	\$ 369.4	26.9%	\$ 369.8	26.9%	\$ 349.7	25.5%	56.0%	\$ 125.50
Corporate and Foreign Bonds	\$ 277.0	20.8%	\$ 285.6	20.8%	\$ 267.5	19.5%	\$ 298.3	21.7%	\$ 299.2	21.8%	\$ 323.8	23.6%	47.9%	\$ 104.90
Corporate Equities	\$ 227.0	17.1%	\$ 235.3	17.1%	\$ 193.3	14.1%	\$ 219.8	16.0%	\$ 228.1	16.6%	\$ 232.7	16.9%	30.4%	\$ 54.30
Cash and Money Market Funds	\$ 66.0	5.0%	\$ 53.8	3.9%	\$ 60.7	4.4%	\$ 57.2	4.2%	\$ 55.4	4.0%	\$ 61.5	4.5%	16.5%	\$ 8.70
Trade Receivables	\$ 87.0	6.5%	\$ 85.4	6.2%	\$ 86.7	6.3%	\$ 83.1	6.0%	\$ 83.7	6.1%	\$ 84.4	6.1%	6.4%	\$ 5.10
Miscellaneous/All Other	\$ 139.3	10.5%	\$ 163.9	11.9%	\$ 137.1	10.0%	\$ 154.4	11.2%	\$ 166.5	12.1%	\$ 165.8	12.1%	31.6%	\$ 39.80
Total Financial Assets	\$ 1,329.3	100.0%	\$ 1,373.6	100.0%	\$ 1,307.1	100.0%	\$ 1,386.9	100.0%	\$ 1,403.4	100.0%	\$ 1,427.4	101.7%	34.7%	\$ 367.70
Gain from Prior Year	\$ 85.5		\$ 44.3		\$ (66.5)		\$ 79.8		\$ 16.5		\$ 24.0			

Source: Federal Reserve March 10, 2011

away from the low yielding federal obligations and GSE securities. But now S&P has also downgraded some municipal obligations backed by federal leases, assets, escrowed funds or other U.S. government involvement. While this is a relatively small portion of the \$2.9 trillion municipal bond market, it seems obvious that rating agencies see broader downgrade as possible as early federal monetary support (QE 2) to states and municipalities is now gone suggesting higher potential for municipal default risk.

The municipal bond market represents 25% of invested assets or about \$350 billion of industry assets that equates to 62% of industry net worth/surplus (\$565 billion at 3/31/11). Depending upon how broad of a down-



grade ultimately takes place, the “excess industry capital” we have long cited as keeping the commercial risk market in a competitive mode might come under question. This is especially true for “risk-based capital” (RBC) factors that regulators apply to individual carriers “book capital” based on investment and operational risk factors. Of course regulators are already positioning themselves as NAIC states that it

would “consider changes to our regulatory treatment if it becomes necessary in the future”.....does that mean lowering the RBC rules to avoid test failures? That is not a confidence builder!

Life Insurance Invested Assets

We usually do not comment on the life insurance segment as our data base and market focus is on the property casualty global market but in this case we thought it would be of interest to our readers to see the asset allocation of U.S. based life insurers.

Life and Health Insurers
Financial Asset Distribution
(\$ Billions)

Financial Assets	2006		2007		2008		2009		2010		1Qtr. 2011		Change 2003 to 2011	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	%	\$
U.S. Treasury Securities	\$ 83.2	1.8%	\$ 80.2	1.6%	\$ 105.7	2.1%	\$ 133.5	2.7%	\$ 161.6	3.3%	\$ 155.5	3.1%	116.6%	\$ 83.70
Cash and Money Market Funds	\$ 79.4	1.7%	\$ 79.9	1.6%	\$ 122.1	2.5%	\$ 84.4	1.7%	\$ 76.9	1.6%	\$ 71.1	1.4%	18.7%	\$ 11.20
Agency/GSE Backed Securities*	\$ 377.4	8.1%	\$ 387.5	7.8%	\$ 366.2	7.4%	\$ 371.9	7.5%	\$ 356.9	7.2%	\$ 386.1	7.8%	10.7%	\$ 37.20
Mortgages	\$ 303.8	6.5%	\$ 326.2	6.6%	\$ 342.4	6.9%	\$ 326.1	6.6%	\$ 318.5	6.4%	\$ 318.4	6.4%	22.0%	\$ 57.50
Corporate and Foreign Bonds	\$ 1,841.9	39.3%	\$ 1,889.7	38.2%	\$ 1,817.1	36.7%	\$ 1,914.7	38.7%	\$ 2,022.6	40.9%	\$ 2,058.4	41.6%	27.0%	\$ 438.20
Corporate Equities	\$ 1,364.8	29.1%	\$ 1,491.5	30.1%	\$ 1,001.7	20.2%	\$ 1,208.5	24.4%	\$ 1,423.2	28.7%	\$ 1,494.6	30.2%	62.6%	\$ 575.30
Mutual Fund Shares	\$ 162.3	3.5%	\$ 226.6	4.6%	\$ 121.1	2.4%	\$ 140.8	2.8%	\$ 139.2	2.8%	\$ 158.7	3.2%	4.8%	\$ 7.30
Policy Loans	\$ 110.2	2.4%	\$ 113.9	2.3%	\$ 166.1	3.4%	\$ 153.5	3.1%	\$ 165.6	3.3%	\$ 165.6	3.3%	58.5%	\$ 61.10
Miscellaneous/All Other	\$ 362.3	7.7%	\$ 354.8	7.2%	\$ 481.1	9.7%	\$ 500.7	10.1%	\$ 512.3	10.3%	\$ 468.0	9.5%	98.4%	\$ 232.10
Total Financial Assets	\$ 4,685.3	100.0%	\$ 4,950.3	100.0%	\$ 4,523.5	100.0%	\$ 4,834.1	100.0%	\$ 5,176.8	100.0%	\$ 5,276.4	101.9%	39.9%	\$ 1,404.00
Gain from Prior Year	\$ 334.6		\$ 265.0		\$ (426.8)		\$ 310.6		\$ 342.7		\$ 99.6			

* Government Sponsored Enterprise
Source: Federal Reserve March 10, 2011

The Treasury and GSE investments combined are only 4.5% of invested assets in 2011 with 71.8% (historical high) of the portfolio in Corporate/Foreign Bonds and Corporate Equities as this business insurance takes a much longer view on investment risk and returns. The financial asset value from the recession decline in 2008

was a staggering \$427 billion or about 10% of total financial assets with some insurers obtaining federal TARP assistance after acquiring a qualifying banking subsidiary.

Investments and Insurance Regulation

The recent turmoil in the global financial markets appear concerned with the lack of strong economic activity in the industrial nations, stubborn unemployment issues, high commodity prices, weak government fiscal policies and unsustainable GDP/Debt ratios.

GDP GROWTH RATES-EUROPE

	2010 Q3	2010 Q4	2011 Q1	2011 Q2
EURO States-17	0.4	0.3	0.8	0.2
EU-27	0.5	0.2	0.8	0.2
Member States-EU-27(selected)				
Germany	0.8	0.5	1.3	0.1
France	0.4	0.3	0.9	0.0
United Kingdom	0.6	-0.5	0.5	0.2
Main Economic Partners				
United States	0.6	0.6	0.1	0.3
Japan	1.0	-0.6	-0.9	-0.3

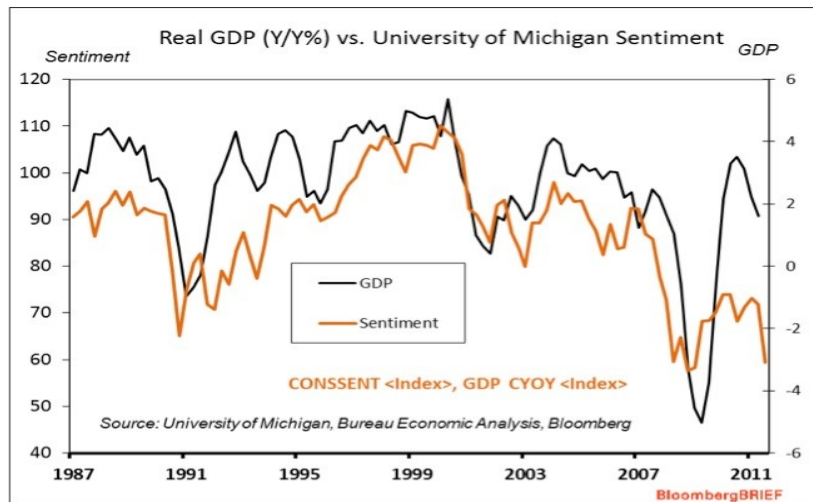
Source: Eurostat

Highly leveraged economies that continually rollover large amounts of short term debt on the back of illiquid assets, simply can't sustain that strategy indefinitely. In addition, the governments in Europe and the U.S. appear to have adopted a more timid approach to budget solutions than investors and business community leaders

believe will lead to longer term economic health. Consumer confidence at this stage is not very encouraging.

The concern is that this stagnation will lead to another economic downturn and a double-dip recession. Therefore the market pressures on investment valuations are likely to continue, but for insurance organizations it is

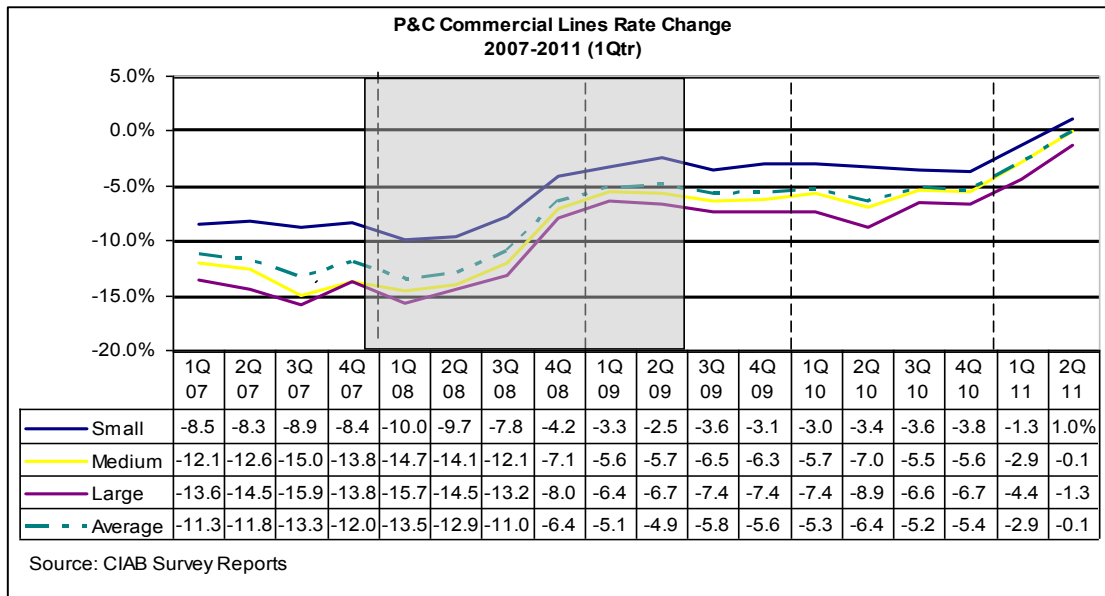
all a matter of timing. Insurers must file their regulatory statements quarterly so the next date is September 30 and we can not be certain exactly what investment valuations will be by that time. Since the Federal Reserve has now publicly committed to hold interest rates low until at least mid 2013, the prospect is that insurers turning over fixed investments will be looking at lower yields unless they alter their allocations. Given that insurers need (1) liquidity for potential catastrophe or accelerated loss payments;



rising costs of medical care and commodity prices; (2) inflation protection against rising costs of medical care and commodity prices; (3) principal protection so claim reserves back by invested assets are not eroded by declines in value; (4) duration risks on longer term interest rate changes and investment yields. If insurance investment strategy is actively coordinated with core underwriting operations the latter should dictate the formation of investment objectives keeping RBC rules in mind.

Underwriting Cycle on a Collision Course with Economic Reality?

The most recent economic market indicators from several sources show a U.S. economy in trouble and potentially falling back into another recession led by the European community. The recent P&C U.S. pricing indicators from CIAB for the second quarter of 2011 indicate that the soft pricing cycle was coming to an end and the prospect of higher rates were rapidly approaching.



Great Recession is shaded grey area of chart

The detail of these consolidated results shows flat rate changes for all lines except reductions in Commercial Auto, Construction Risks, General liability, Medical Malpractice and Umbrella lines outweighed increases in Commercial Property, Flood Ins. and Workers Compensation coverage...at best a split decision whether over-all rates are going up or if economic conditions will aid or hinder a new direction.

Based on the current economic outlook the U.S. insurance industry could be in big trouble if a double dip economic recession should develop causing further stagnation of risk exposures (i.e. insurance demand) placing the market in a position of needing higher product prices in a commercial survivor market environment that seeks further depression of operating costs. This coupled with the lack of employment growth places the large workers compensation market in a difficult position based on passed recessions. If commercial insurance rates are heading up stream at a time when the economic tide is heading out can only lead to trouble.

Conclusion

Since the P&C commercial insurance operations are the product of both core underwriting of risk business as well as the investment return on available funds (capital/reserves) both the economic outlook including investment conditions will play a major role in the industry outcome in the years ahead. We think the industry will face severe challenges with the need for pricing increases pitted against the economic reality of slow growth (if at all) or even a second recession. Investment operations will be equally as challenging while sovereign debt issues will dominate the EURO landscape as short term debt gets rolled over. This could have a damping effect on the availability of European Global Reinsurance market and their capacity to assist U.S. based insurers.

So the commercial risk market looking forward to the long delayed cyclical turn in rates might clash with an economy unable or unwilling to accommodate higher costs. Since new small business formations are at the heart of achieving new sustainable employment gains and consumer spending, development is likely to be threatened by the prospect of higher insurance costs on top of tight regulatory reporting rules, restricted lending practices and local business conditions offering substantial challenges for success. Financial institutions including banks and insurers may find themselves in a position of trying to defend themselves against public and government challenges of inhibiting economic growth at a critical time in the economic recovery process.

The insurance industry has been on this stage before (i.e. 1984-85) and nothing but bad things have happened including the erosion of the industry's dominance as a universal recognized facility for the transfer of risk. As a

result other risk transfer/risk financing mechanisms (i.e. Captives and Risk Retention Groups) have achieved equal recognition including federal provisions thereby eroding the exclusivity position of commercial insurance. Should the insurance industry notwithstanding the need for rate increases, become less than accommodating in the near term given the possible economic landscape, then we could expect to see further erosion of state regulated insurance in favor of optional self-help mechanisms for risk financing purposes.

Some insurers have positioned themselves to be able to withstand a stagnated rate environment along with a combination of investment value declines to produce better than average returns while others will be forced to deal with claim reserve deficiencies and low to negative investment returns that will become the subject for rating downgrades. For those that took more aggressive reserve take-down positions, the question of potential impairment will be the order of the day perhaps before the end of 2011. The weak will become obvious while those that have managed the business successfully (underwriting or brokerage) through similar previous conditions, will come out the other end stronger than their competitors.....some of the latter group just might not make it!



Charles L Ruoff CPCU

CR Market Strategies
crmarketstrategies.com

Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.
