TESTIMONY AS DELIVERED

BY

ROBERT P. HARTWIG, PH.D., CPCU

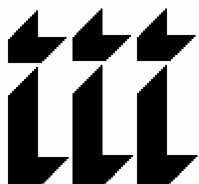
SENIOR VICE PRESIDENT & CHIEF ECONOMIST

INSURANCE INFORMATION INSTITUTE

NEW YORK, NEW YORK

BEFORE THE HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

APRIL 10, 2003



Thank you, Mr. Chairman, and members of the Committee.

The Committee has asked me to testify today regarding the overall economic performance of the property/casualty insurance industry, the industry's rate of return and to contrast that performance to other industries.

The 1990s and these opening few years of the new millennium have been very difficult for insurers. Natural disasters of unprecedented frequency and ferocity cost the industry nearly $110 billion between 1990 and 2002 while the September 11 terrorist attacks produced the largest insured losses in United States and world history, amounting to some $40 billion. Tort costs paid by insurers amount to nearly $130 billion per year.[1] Insurers are also subject to an extraordinarily complex array of rules and regulations that significantly impair an insurer's ability to earn an adequate rate of return and attract or retain capital needed to cope with these problems.

Earning an adequate rate of return is a core concern of all heavily regulated industries. From 1988 through 2002, profitability in the property/casualty insurance industry (as measured by return on equity) underperformed the Fortune 500 by an average of 5.3 percentage points (Exhibit 1). Return on equity essentially reflects the rate of return to investors who put their money into the business. Exhibit 1 clearly indicates that investors in most years would have done much better by investing in other industries or a broadly diversified portfolio of stocks, such as is represented by the Fortune 500 or S&P 500. The performance gap is even more striking when the high relative risk of investing in property/casualty insurers is taken into account. Indeed, the industry's estimated 4.4 percent rate of return last year was even less than the 4.6 percent that investors earned *risk free* on 10-year U.S. Treasury securities. The inevitable consequence of repeatedly disappointing investors is a diminished ability to attract and retain capital, shrinking capacity on a global scale, ratings agency downgrades and a loss of investor confidence as manifested by falling share prices. All three are presently coming to pass in the p/c insurance industry.

[1] Tillinghast Towers-Perrin estimate for 2000.

Underwriting losses over this same period, which represent the amount by which losses and associated expenses exceed premium income, were also enormous, totaling nearly $350 billion (Exhibit 2). Focusing on insurers' more recent performance reveals that the period from 1999 through 2002 witnessed four of the six largest underwriting losses in the history of the U.S. property/casualty insurance industry. Last year's $22 billion underwriting loss—while a marked improvement from the terrorism-impacted $52 billion loss in 2001—indicates a continued drain on the industry's capital. In the final analysis, it is investor money that is lost. Investors observing these losses and associated low rates of return will be unlikely to invest in the property/casualty insurance industry unless they have a reasonable expectation that financial performance will improve in the near future.

Not surprisingly, the three most heavily regulated lines of insurance—auto insurance, homeowners insurance and workers compensation—have produced below average returns in recent years (Exhibit 3) and generated some of the largest losses. These three products alone account for roughly 60 percent of all premiums earned by insurers. Consequently, when underlying loss trends shift adversely, pushing costs up sharply, insurance companies that sell heavily regulated insurance products are *guaranteed* to lose money. Deliberate suppression of rates, delays in the rate approval process (another form of rate suppression) and delays in the approval of new forms, invariably cost insurers billions of dollars in unnecessary losses each year, leading to reduced availability for consumers.

Why This Matters to Consumers

Presently the availability of property/casualty insurance coverage is shrinking and prices are rising as a result. A sharp drop in the pool of capital available to underwrite insurance is a principal factor fueling increases in the cost of insurance today. Capital held by U.S. domiciled property/casualty insurers has plunged by nearly 20 percent or $63 billion since mid-1999 (Exhibit 4). Foreign capital, which is critical to the U.S. insurance market, is also shrinking. Globally, capacity fell by an estimated 25 percent or $230 billion from between 2000 and 2002 (Exhibit 5). Because such a large proportion

of foreign insurers' capital is actually allocated to back-up policies written in the United States, current and prospective investors outside the U.S. are less likely to supply capital unless they are reasonably assured that losses will narrow and rates of return rise in the near future.

Investment Environment

Over the past year industry critics have attempted to lay blame for higher insurance prices on "reckless" investment strategies by insurers. While earnings from investments have declined for insurers over the past several years, as they have for all investors, the property/casualty insurance industry still generates significant cash flow from its investment portfolio—an estimated $39.5 billion in 2002 alone (Exhibit 6). Investment earnings are simply returning to their pre-bubble levels. Two-thirds of the industry's invested assets are in the form of bonds, while only about 20 percent of the industry's portfolio is invested in common stock. The decline in investment gain over the past several years merely reflects the downward trend in interest rates—which now stand at 40-year lows—as well as fewer opportunities to realize capital gains on the stock portfolio.

The Legend of the Price Gouging Insurer

Critics of the property/casualty insurance industry have also asserted that recent increases in the cost of insurance are unjustified and that insurers are simply "gouging" consumers. The rate-of-return and underwriting loss figures discussed earlier clearly suggest otherwise. Moreover, the cost of auto, home and commercial coverages remains very reasonable by historical standards. The cost of homeowners insurance, for example, relative to the cost of the home itself has decreased or remained stable every year since 1994 (Exhibit 7). Likewise, the cost of risk to businesses, which is driven primarily by insurance expenditures, relative to revenues is roughly the same today as it was a decade ago (Exhibit 8).

Thank you.

EXHIBITS

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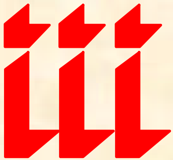

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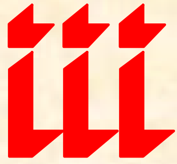

Exhibit 1.
ROE: P/C vs. All Industries: 1987–2003F

20%
15%
10%
5%
0%
-5%

87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02E 03F

US P/C Insurers — All US Industries

Source: Insurance Information Institute; *Fortune*

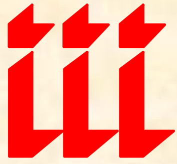

Exhibit 2: Underwriting Gain (Loss):1975-2002*

$ Billions

$10
$0
($10)
($20)
($30)
($40)
($50)
($60)

1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002

P-C insurers paid $22 billion *more* in claims & expenses than they collected in premiums in 2002

*Annualized estimate based on first 9 months of 2002 data.
Source: A.M. Best, Insurance Information Institute

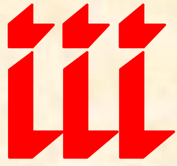

Exhibit 3.
Return on Net Worth: Auto, Home & Workers Comp vs. All Lines: 1996–2001

15%
10%
5%
0%
-5%
-10%

96 97 98 99 00 01*

All Lines — Auto Insurance — Homeowners — Workers Comp

*All Lines 2001 figure is adjusted to remove the impact of 9/11 terrorist attacks.

Source: National Association of Insurance Commissioners, Insurance Information Institute.

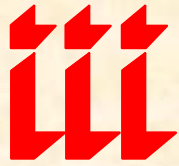

Exhibit 4. Policyholder Surplus: 1975-2002*

Surplus (capacity) peaked at $336.3 Billion in mid-1999 and has fallen by 18.7% ($63 billion) to $273.3 billion since then.

- *Surplus fell 5.6% during first 9 months 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

Billions (US$)

$350
$300
$250
$200
$150
$100
$50
$0

75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02

*As of September 30, 2002

Source: A.M. Best, Insurance Information Institute

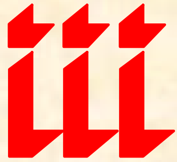

Exhibit 5. Global P/C Insurance Capacity is Falling Dramatically

Sources: Insurance Information Institute, Swiss Re

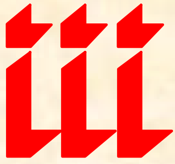

Exhibit 6. Property/Casualty Insurance Industry Investment Gain*

$ Billions

Year	Investment Gain ($ Billions)
94	$35.4
95	$42.8
96	$47.2
97	$52.3
98	$57.9
99	$51.9
00	$56.9
01	$44.4
2002E	$39.5

Investment gains are simply returning to "pre-bubble" levels

*Investment gains consists primarily of interest, stock dividends and realized capital gains and losses.
Source: Insurance Services Office; Insurance Information Institute estimate annualized as of 9/30/02.

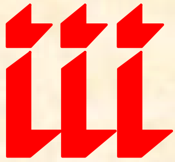

Exhibit 7. Homeowners Insurance Expenditure as a % of Median Home Price

Median Home Sales Price

HO Expenditure as % of Sales Price

■ Median Sales Price of Existing Homes
◆ HO Insurance Expenditure as a % of Sales Price

Year	Median Sales Price of Existing Homes	HO Insurance Expenditure as a % of Sales Price
94	$107,200	0.39%
95	$110,500	0.38%
96	$115,800	0.38%
97	$121,800	0.37%
98	$128,400	0.37%
99	$133,300	0.37%
00	$139,000	0.36%
01	$147,800	0.35%
02	$157,800	0.35%

The cost of homeowners insurance relative to the price of a typical home has fallen

Source: Insurance Information Institute calculations based on data from National Association of Realtors, NAIC.

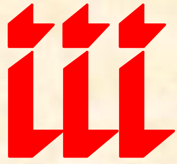

Exhibit 8. Corporate Cost of Risk per $1,000 of Revenues: 1990-2002E

Year	90	91	92	93	94	95	96	97	98	99	00	01E	02E
Cost of risk	$6.10	$6.40	$8.30	$7.70	$7.30	$6.49	$5.70	$5.25	$5.71	$5.20	$4.83	$5.55	$6.94

Source: 2001 RIMS Benchmark Survey; Insurance Information Institute estimates.