

**The Actuarial Profession**  
making financial sense of the future

Current Issues in General Insurance (CIGI)  
So what do investment analysts really think of the P&C Industry?

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Keefe, Bruyette & Woods

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## Introduction: 'really' think ...

- A few thoughts on analysts' and their views ...
- Our job is to understand the industry and identify good and bad investments in it.
- What I can do is tell you what investors think of it.



KEEFE, BRUYETTE & WOODS  
Specialists in Financial Services

05 March 2012

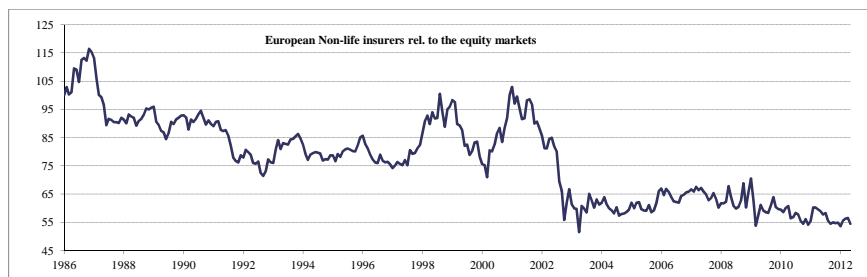
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## Investor perceptions (1)

- P&C insurers have not been a good long-term investment
- Underperformed by 45% over past 25 years
- Periods of out-performance have been short, often associated with problems elsewhere.

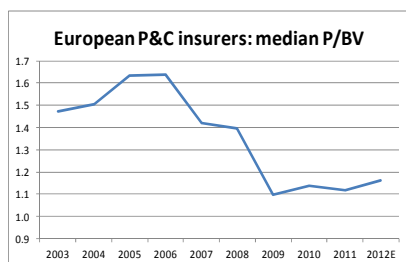


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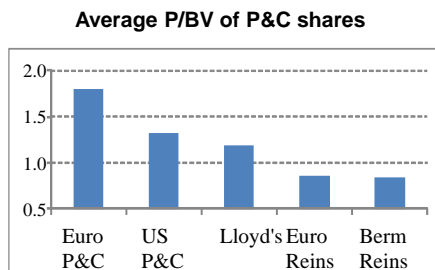
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## Investor perceptions (2)

- Even when they have not underperformed (like 2003 to date), they have still been down-rated
- Most lowly valued are reinsurers
- Most highly valued are those with good track record (Admiral, TopDanmark)

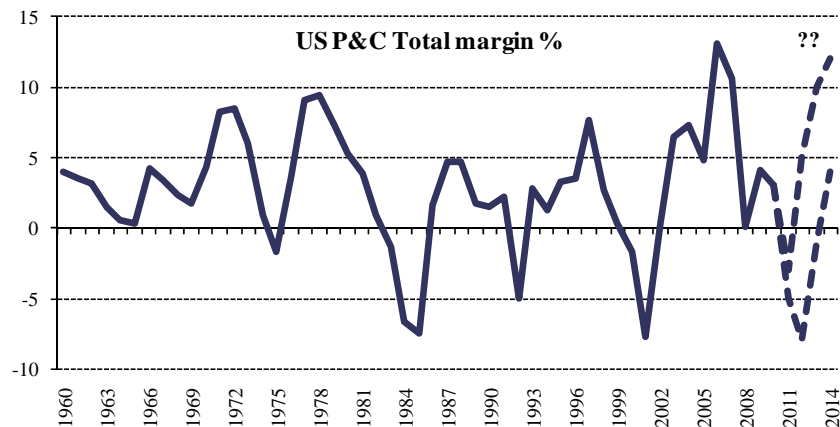


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## One problem is the cycle and where it is going



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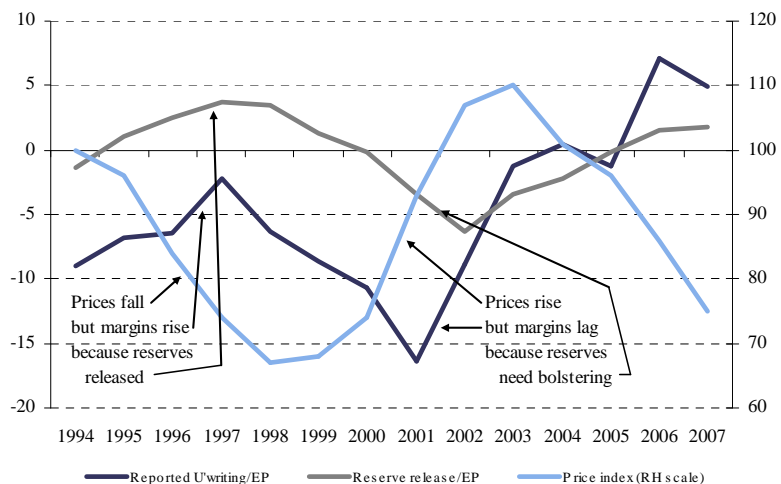
## Features of the cycle

- A 'business cycle' like any other; but much worse
- Product issues:
  - Competing products identical (and perceived to be)
  - No substitutes; no utility to additional consumption
- Market issues:
  - No capacity constraints – easy of entry/exit
  - Capacity can be dependent on financial markets
- Industry issues:
  - Margins are uncertain
  - Easy for companies to delude themselves that they are writing profitable business
  - They discover they are not only after a delay

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## The profit cycle thus lags pricing

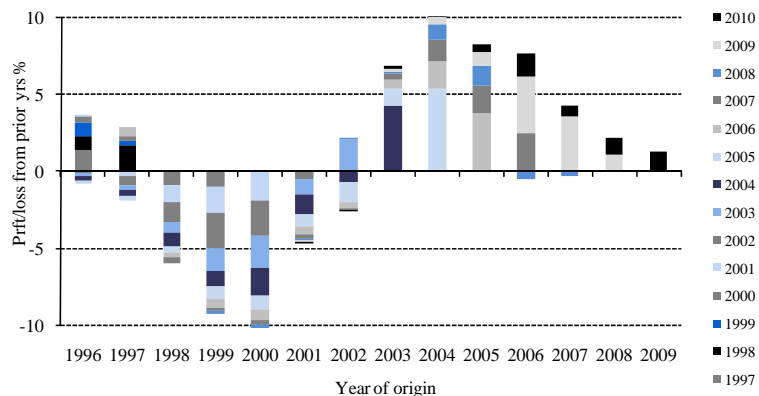


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## Getting margins wrong is major feature

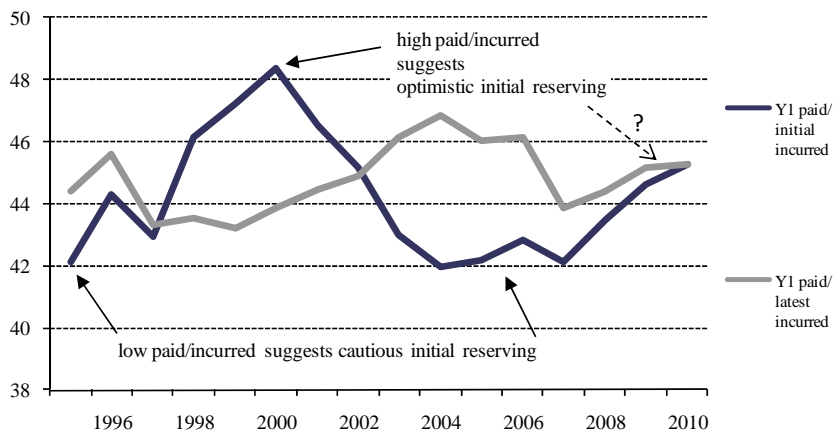
US P&C reserve development by year of origin – good years get better; bad ones get worse



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## Paid/incurred ratios suggest management error

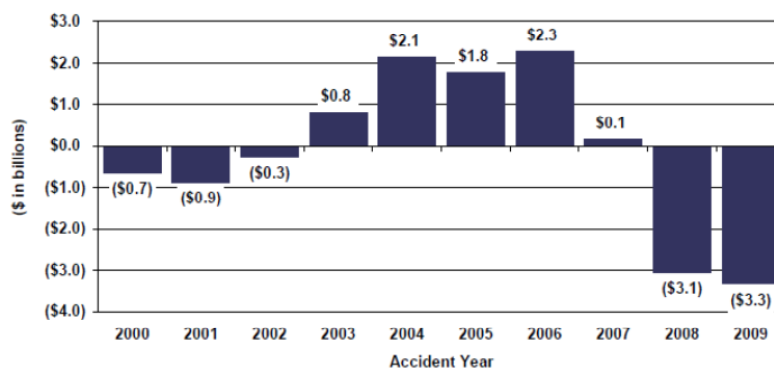


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## US reserve deficiencies emerging

**Exhibit 13: KBW Estimated Accident Year Redundancy/(Deficiency) at Year-End 2009**  
 Total U.S. P&C Industry – All Lines Combined



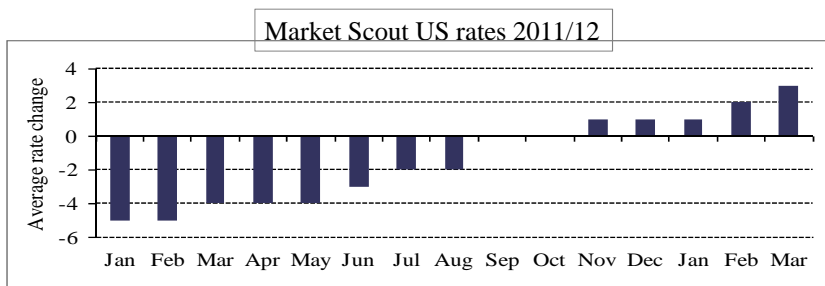
Source: KBW Insurance Research.

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## Evidence of a turn in pricing

- Cyclical troughs involve recognition of unprofitability of in-force and consequent need for reserve top-ups
- First external sign is prices actually rise (as in UK motor in 2010, US commercial in Nov/Dec 2011)
- This is inevitably followed by disappointing profits.

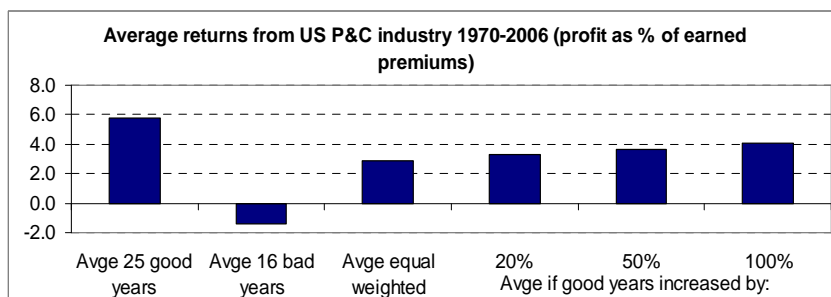


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## Issues for industry (1): Manage growth

- P&C is an industry where the good years are good and the bad years are bad
- The trick of P&C insurance is to grow in pricing upturns and shrink in downturns

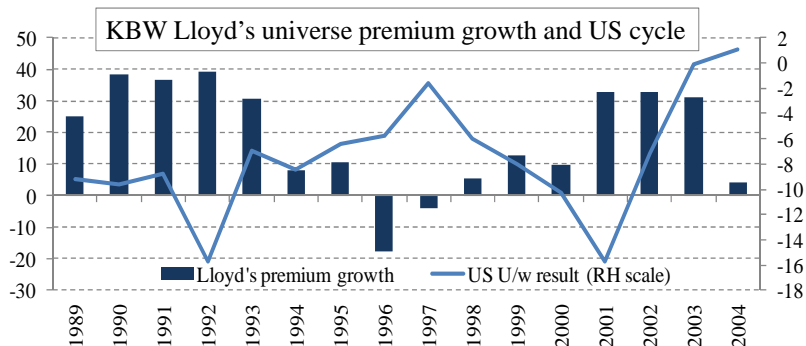


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## Lloyd's insurers manage it

- Primary insurers in crisis reduce non-core (back to basics). That business emerges in specialist (surplus lines) market naturally through distribution system (wholesale brokers).

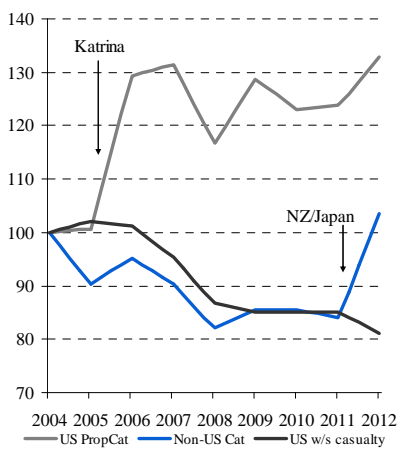


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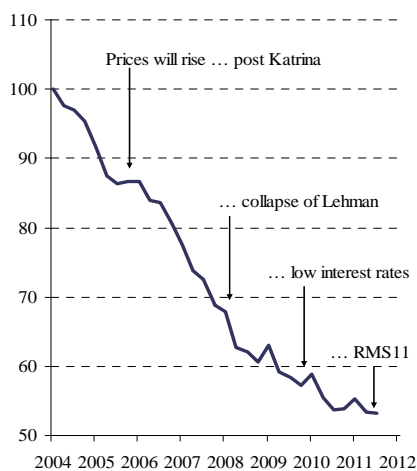
## Reinsurers have behaved more rationally?

### Reinsurance



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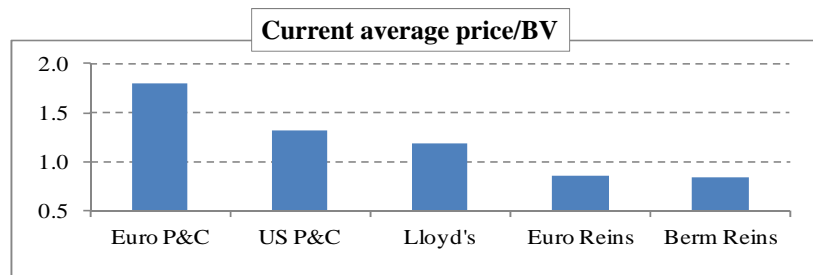
### US primary



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## Although they have not been rewarded by it

- This may reflect that Reinsurers did vary badly in the previous cycle trough
- They are thus more lowly valued
- They are thus under less pressure to grow

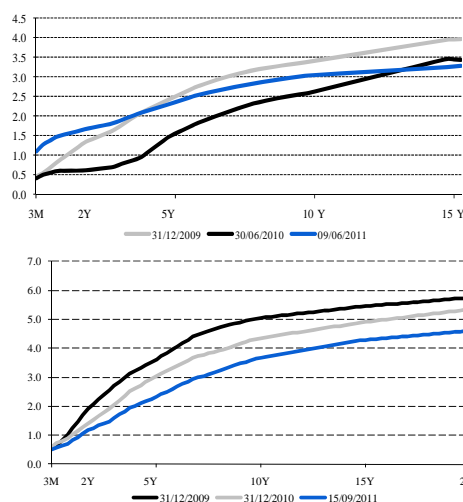


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## Issues for the industry (2): Deflation or inflation

- Deflation risk driven by low interest rates, forced austerity, as Japan in 90s.
- ECB (and Bundesbank) copying these errors to preserve Euro.
- Alternatively, over-indebted govts will need to create inflation to avoid default; and cash being thrown at economy since 2007 will achieve that.
- Deflation good for P&C (once pricing reacts to expectation of low rates).
- Inflation is very bad and will create even more reserve inadequacy than competition will see anyway.
- It also means rises in money premiums need to be financed from low profits.
- Steep yield curve encourages investing long but rising yields hit capital.



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