APIW/NY Chapter CPCU Annual Joint Luncheon

January 8, 2009

Brian Duperreault

President and Chief Executive Officer, MMC

MMC

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Good afternoon, and Happy New Year. I trust you were able to recharge a bit over the holiday season. I think you'll need it. It's looking like 2009 will be another tumultuous year for the insurance industry, and the broader economy as well.

I'm very pleased to be speaking to you today. I'd like to give you some of my thoughts on the current market and what it may mean for our industry, and then open it up for questions. I find that the Q&A portion of these events is frequently the most interesting and useful, when we can have a dialogue about the issues that are on your minds.

First, though, if you'll permit me, I'd like to share something personal with you. It's a great honor for me to speak to this particular group today. Many of you in the audience are working mothers, and I'm sure some of you are single working mothers.

About 60 years ago, I was born in Bermuda, but my mother moved us to Trenton, N.J., when I was still a baby. There, she raised me on her own.

I don't need to tell you that it's hard enough to be a parent -- much less a single parent -- much less a single working parent. And, as you can imagine, it was even more difficult back then. But she persevered, and I think I turned out relatively ok….

Well, this Friday is my mother's 90th birthday. I was blessed to have her as a mother, and I am blessed that she is still with me.

To all of you who have juggled raising your kids and managing your careers: I salute you, and I thank you.

Now, back to insurance!

As many of you know, I have been in and around the insurance industry for a long time – more than 35 years. I started in AIG's actuarial department in 1973, and spent more than 20 years there, eventually becoming chairman and CEO of AIU, AIG's international subsidiary.

I then joined ACE Limited, where I served as CEO for 10 years before moving into what I'll call "semi-retirement" in 2004. Now, I say "semi" because it didn't last very long. In three weeks I will celebrate my one-year anniversary as CEO of Marsh & McLennan.

Boy, how time flies…! And you have to believe that about four or five months ago I began to wonder what the heck I'd come out of retirement for...

In all seriousness, I wouldn't have wanted to be on the sidelines in times like these, and I'll talk about the current state of play in just a moment.

The events of the past six months – and those of the past several years – are some of the most dramatic in the history of financial services and risk management. From 9/11 to the 2005 hurricane season to the current economic downturn, in less than one decade we have experienced a series of events that have altered our industry and the world for years to come.

Of course, everyone wants to know what the current financial crisis will mean – and everybody has an opinion. No one knows all the answers, and I include myself in that category. Every catastrophe – whether it's a hurricane or a financial meltdown – has its own set of unique variables. We are currently in an asset-driven crisis, and that makes it difficult to predict the end game with any real certainty.

But, I do have a few observations.

First: Supply has gone down more swiftly than the decline of demand. In the reinsurance space, property catastrophe rates were up for the January 1, 2009 renewals period, around 10% for a nationwide account and more like 15% for regional accounts. There are placements that are not being completed. We're seeing a pulling back on aggregate exposures, particularly in California.

We are beginning to see the signs of a hardening market. Because of the countervailing winds of this financial storm, however, it may not look that way at first. It's going to evolve differently than any hard market we've experienced in the last 50 years. So I'm calling it "the invisible hard market". And that represents a management challenge for us in 2009.

Second: There are a lot of people out there who are trying to understand what led to this crisis. And there is speculation by some that it proves enterprise risk management doesn't work. In my view, however, that is an erroneous conclusion. ERM did not fail – it was not properly applied in many, many cases. If our clients believe otherwise, we need to actively explain, defend and reiterate the benefits of true ERM.

Let me first address current market conditions.

As we begin 2009, the market continues to grapple with a sense of distrust, uncertainty and even fear. Indeed, some real doomsayers are out there saying this crisis represents the failure of western-style capitalism.

This sort of extremism is nonsense. However, it is true that our road to recovery remains a long and potentially bumpy one. If our financial system were a patient in intensive care, then the patient was close to flat-lining last quarter and remains in critical condition today.

Governments around the world have stepped in to try to mitigate the effects of this crisis. Even with those actions, however, our collective insecurities will continue to constrain borrowing in 2009. Companies will maintain deeply cautious outlooks, and sit on their cash more than they have in recent memory. Investors will likely be just as cautious, although much of the current situation's fundamentals have been priced into the market. Now we just have to see how 2009 actually plays out.

What a difference a year makes. At the start of 2008, we started the year in a "soft market": insurance was readily available and premium rates, in most cases, were falling. We had, essentially, an overabundance of surplus in the market – "a surplus surplus".

In our insurance industry, when market conditions change they tend to do so fairly visibly. Something occurs that increases prices, premiums tend to rise very quickly – at a rate clearly more rapid than underlying exposures. Therefore, we're confident that the loss-ratios will go down.

Normally, when we stand at the doorway of a hardening market, everyone knows it. And all of the repercussions of a strengthening market kick in.

So here we are, a year later, with a market turned on its head. The chaotic and uncertain environment both dramatically reduced supply -- or at least our perception of it – as well as increased demand for protection.

Higher prices and declining exposures equal a harder market – right? Right. But there are other factors at work here and when you combine them, the true effects on the market are much more subtle than any other time that I can remember.

This time, a hardening market comes into play against the backdrop of staggering losses in the financial markets. Insurance companies reported deep investment losses for the third quarter of last year and are set to do the same for the fourth quarter.

We're in uncharted waters now. For at least some period of time, we will be in an environment in which premium rates are rising but underlying exposures are declining.

There is, therefore, a better relationship between pricing and exposure, but it may not produce meaningful change in the top line. Without a meaningful change in the top line, you may not get a dramatic change in the absolute level of underwriting income. The countervailing forces of rising rates and declining exposures producing the same top line may not translate immediately into an improved bottom line.

Couple that with continuing declines in investment income, and insurance companies will likely report flat or only modest gains in total income -- even though the market has indeed hardened and the quality of their earnings has improved.

Hence, an "invisible hard market."
The story of this hardening market will be difficult to get across, because one has to divine the declining exposures side of the equation.

It will not be obvious that, although earnings are little changed, companies are actually performing better. Under this scenario, it will take longer for true value to be appreciated. And the typical corollaries of a hardening market – stock appreciation, greater access to capital – are unlikely to be in evidence at first.

This won't persist forever. The "invisible hard market" will indeed become visible – at some point. What and when that point is, though, remains unclear. There are several potential catalysts:

When the economy regains strength, and exposures begin to rise;

And/or

When investment income normalizes;

And/or

If we have a major insurable "event". The industry has sufficient capital at the moment, but it is thin. If we have a major event, it could be very dramatic in terms of rate change. We are very vulnerable to event-risk right now. A leveraged effect from a major event is a distinct possibility.

****

****

My second observation is about ERM, and whether it is flawed as a concept.

As we continue to feel the effects of the aftermath of this crisis, people the world over are struggling to understand how banks --which are largely credited with inventing the concept of ERM -- made such disastrous miscalculations about the credit markets if they were properly managing their risks.

ERM, or risk management, did NOT fail. As I said earlier, it was either not understood or applied correctly. And the cumulative effect of that misunderstanding or misapplication has exacerbated the current crisis.

Indeed, this crisis does not mean risk management didn't work – far from it. There were pockets in which ERM was properly applied – and it <u>did</u> work. It helped companies avoid disaster.

I'll give you some examples.

A major contributor to the current crisis is an overreliance on modeling. As we in the insurance industry know, models have limits. They are useful tools to help develop an answer – but they are not the answer itself.

Rigorous risk management simply must be complemented by good judgment. And, a key judgment concerns the limitations of models: knowing how confident to be in their predictions, the sensitivities and robustness of their estimates, when they are likely to break down and what complementary sets of more basic risk controls should be used.

Last June, I spoke at a conference on the topic of ERM. Even then, with no idea the extent to which the crisis would worsen, I mentioned Goldman Sachs as one of the few companies with a sophisticated understanding of ERM. As we later saw, Goldman weathered this crisis far better than many of its peers.

Last weekend, a columnist at the New York Times wrote an interesting piece called "Risk Mismanagement" in which he examined risk management and some tools in particular, such as *Value at Risk*. Early in the piece, he mentions Goldman, and how the media wanted to understand how it had sidestepped the disaster that had befallen everyone else.

I'd like to read a short excerpt from the column:

> "What they discovered was that in December 2006, Goldman's various indicators, including VaR and other risk models, began suggesting that something was wrong. Not hugely wrong, mind you, but wrong enough to warrant a closer look.
>
> " We look at the P&L. of our businesses every day," said Goldman's CFO, David Viniar (VIN-EEER) … 'We have lots of models here that are important, but none are more important than the P&L, and we check every day to make sure our P&L. is consistent with where our

risk models say it should be. In December our mortgage business lost money for 10 days in a row. It wasn't a lot of money, but by the 10th day we thought that we should sit down and talk about it."

So Goldman called a meeting of about 15 people, including several risk managers and the senior people on the various trading desks. They examined a thick report that included every trading position the firm held. For the next three hours, they pored over everything. They examined their VaR numbers and their other risk models. They talked about how the mortgage-backed securities market "felt." "Our guys said that it felt like it was going to get worse before it got better," Viniar recalled. "So we made a decision: let's get closer to home."

This is true ERM. It is about listening to what the models may be telling you, and combining that information with sound judgment to form a view.

I'll give you another example that's right in front of us: the insurance industry.

Yes, those of us in the much-maligned P&C insurance industry. You know us: we're so stupid, we can never get the cycle right. We're lemmings who cut prices because everybody else does…..

But, so far, the insurance industry has weathered this storm too. There were outliers of course – there always are – but by and large the insurance industry has so far come through this in far better shape than the banking industry.

I think that's proof that we've learned a lot ourselves about risk management. And good lessons bear repeating. The more success we can attribute to risk management, the better.

ERM is a concept that needs to be enhanced and enforced, not abandoned. If you bring no other message to your clients about this current crisis, I would urge you to take this to them. It is important that we not throw out the baby with the bathwater in this instance.

*****

So, yes, we are in some tough times. For many people, this will be the most significant financial crisis of their lifetimes.

But, I have great confidence in the distinctly American mindset. We will pull through it - we always do. As a people, we are generally forward-looking, innovative and tenacious.

Exceptional things are required of people in times like these. Our leaders must be innovative in contemplating solutions, passionate when seeking to persuade others of their path, and fair-minded when executing them. As Martin Luther King Jr., once said: *"The ultimate measure of a man is not where he stands in moments of comfort, but where he stands at times of challenge and controversy."*

America has had a lot of great leaders, King among them. No matter who you voted for, I think we all hope that President-elect Obama and his cabinet will be another set of exceptional leaders. Few U.S. presidents have begun their terms with the set of issues he will face.

It's not just up to our government, however. We each have our own roles to play in this difficult time. One reason I was pleased to accept the invitation to speak to you today is because you are an important group within the insurance industry. Many of you are already leaders in your respective companies, and aspire to be even greater ones.

When I was thinking about what to say to you today, I shied away from addressing you as “women in the insurance industry”. After all, let’s face it: you know a lot more about that than I do.

Instead, I thought more broadly about people I have viewed as great leaders during my career, and some of the qualities they possessed.

Leadership is one of those words that resists a catch-all definition. There are fundamental qualities associated with it, of course –

Leaders typically see great things ahead – a “vision” for an improved future. In government, that is an ideology or certain policies. In business, leaders develop, promote and execute strategies that grow the business, return investments to shareholders and inspire and motivate their employees.

Leaders exude confidence and determination about their vision or mission. This is crucial, because in many cases they have to challenge the status quo to adapt to changing markets, achieve more profitable results or eradicate complacency.

There is something beyond confidence, though. Great leaders who truly believe in their strategies are optimists, and optimism is contagious. You can give employees the vision – but you must also inspire them to believe that the vision is worth striving for. In the midst of a crisis, it is a leader who says: “We are going to get through this.”

If the market conditions that I have described come to pass, leaders in our industry will be tested.

In many ways, despite the signs we see of a hardening market, we will have to manage with a “soft market” mentality. The instant gratification that usually accompanies a hard market won’t be there this time.

You'll be asking ask more of your teams and getting better value in underwriting – but you won't see that reflected immediately. You'll have to do what we always do in soft markets -- maintain a hand on expenses, and employ rigorous underwriting discipline and claims management processes.

In this room are many of the insurance industry's current and future leaders. You will have your own vision for your projects, your areas of responsibility, and your companies. You will have your own ideas and strategies on how to achieve your goals.

My advice to you as leaders is to be optimistic, engaged, and proactive. You have worked hard to attain the positions you're in today, and many of you will take on even greater roles in the future. There are responsibilities that come along with these roles, and one is to be actively engaged. It's not enough just to take a seat at the table. Communicate, motivate, energize.

Each and everyone one of you in this room has the power and the potential to do that. Your employees and your clients will reap the benefits.

With that, I would like to thank you all for taking the time to listen to me today. And now I'd be happy to take your questions…

About MMC