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PRIVATE ASSET MANAGEMENT

E&Y: Probe May Hit Independent Agents, Fees Will Go

By Michael Ha

NU Online News Service, Nov. 9, 4:05 p.m. EST—The ongoing New York investigation into insurance brokerage business practices may expand to examine possible conflicts of interest among independent agencies that steer business to insurers paying higher fees, an industry expert forecast today.

Peter Porrino, Ernst & Young's global director of insurance services, offered that assessment of ongoing brokerage investigations at his firm's annual press briefing on the state of the financial services industry, held in New York.

Mr. Porrino also said during today's press briefing that the ongoing investigation into the alleged brokerage bid-rigging would expand to include other questionable business practices, including selling reinsurance/insurance financial engineering products as well as reinsurance tying.

He noted that financial engineering products, sold by carriers to help corporate clients enhance their financial statements and smooth their earnings figures, would be one of the top issues to come under more intense regulatory scrutiny.

Activity of that nature by American International Group's Financial Products is currently under scrutiny by the Securities Exchange Commission and a federal grand jury in Indianapolis, AIG has disclosed.

Additionally, “It's just a matter of time before there is an official allegation about reinsurance tying,” Mr. Porrino said. Tying, which some insurance observers say has been a common industry practice for years, refers to arrangements where a broker awards its client's business to a particular insurer under the condition that the carrier place its reinsurance through the same broker.

Subpoena's for this information have been issued to brokers by New York Attorney General Eliot Spitzer's office.

And as the industry-wide investigation unfolds, Mr. Porrino observed that “there is no doubt” disclosure requirements are escalating.

He said contingent commissions at big commercial brokers are disappearing, whether by legal action or practice. “They are in essence gone now,” he said.

Additionally, "the fines are going to be extreme for brokers that were doing the alleged bid-rigging and for insurers that helped enable the bid-rigging. There will be a lot of effort placed on figuring out how much bid-rigging was going on at commercial carriers," Mr. Porrino said.

In the mid-market, Mr. Porrino also predicted, the changing marketplace practices would lower contingent commissions or even eliminate them altogether.

Mr. Porrino also added that in the personal-lines side, even at the retail level, "there is little doubt that there has been steering going on, as well."

"It's just human nature—whether or not they meant to do it. When there are fees like contingent commissions coming in, there is a natural inclination for some agencies to steer business to people who are paying them the highest commissions," according to Mr. Porrino, who postulated that this specific issue will get closer scrutiny from state regulators in coming months.

Mr. Porrino stressed, though, that these agents haven't violated any law. "The only thing these independent agencies may have violated is maybe the trust of their customers," he said.

If it turns out that there are enough examples of independent agencies steering business to carriers paying higher commissions, "whether such commissions were paid upfront or down the road, you will see changes enacted," he said. Such changes would include disclosures of incentives, "which I think is a foregone conclusion in the personal-lines space."

Mr. Porrino also forecast that such incentive fees could be eliminated altogether among independent agencies. "There is a reasonable chance of that happening. It will depend on what's found when regulators go in and start looking at all the e-mails of some of the smaller independent agencies," he said.

P-C Industry Was Ready For Hurricanes: E&Y Says

NU Online News Service, Nov. 9, 4:30 p.m. EST— The U.S. property-casualty insurance industry may have its shortcomings, but its critics can't say the sector was not ready for this year's unprecedented hurricane season, according to an industry expert.

In fact, the industry was so well-prepared this hurricane season that despite facing four catastrophes all of which now ranks in the 10-most costly U.S. catastrophes ever, there won't be any structural changes forthcoming in the sector, according to Ernst & Young's global director of insurance services Peter Porrino.

Mr. Porrino offered his assessment of the p-c industry today in New York at his firm's annual press briefing on the state of the financial services industry.

Mr. Porrino noted that there is no mistaking the enormity of the hurricanes that struck large parts of Florida and Southeastern United States this past August and September. "With these four hurricanes, it's a heck of a lot of money that went out the door. But we don't see any structural changes happening now," he said.

According to preliminary estimates offered by Jersey City, N.J.-based ISO and Moody's Investor Service in New York, Hurricane Charley is now the fourth-most costly U.S. catastrophe, with an estimated $6.8 billion insured losses.

Hurricane Ivan is ranked fifth-most expansive of all time, with $6.5 billion insured losses. Hurricane Jeanne is ranked seventh, with $4.7 billion in insured losses, while Hurricane Frances comes in at eighth, with $4.5 billion in estimated insured losses.

Altogether, these four events this year bring to the p-c industry a total preliminary estimate loss of $20-to-21 billion.

But, the industry was well-prepared for such hurricanes, Mr. Porrino said. He pointed to much more sophisticated catastrophe simulation modeling, as well as more policy exclusions and restrictions and increased deductibles.

He also credited the Florida Hurricane Catastrophe Fund with helping a lot of insurers "get up and get going in Florida" in the wake of this year's devastating hurricanes.

And generally, he emphasized, companies are doing a better job avoiding some of the higher catastrophe-prone regions. "A lot of money went out the door, but companies will replenish that given the profitability of the industry," he said.

Additionally, Mr. Porrino also offered assessments on various other industry developments during today's briefing.

• Return-on-equity is still high but will come down to more normal level: "At upwards of 15 percent, ROEs certainly look better than the anemic levels that they were a couple of years ago," Mr. Porrino commented. But he said they "probably will not remain there forever." He speculated that ROEs may stay at the 15-percent level for another year or two, "but then will likely start to come down to the more-normal range of 10-to-11 percent."

• Commercial pricing will fall at an alarming rate despite hurricanes: "If you look at the commercial property business, the rate change is in the negative territory," Mr. Porrino said. "The hurricanes are not fundamentally going to change that. They may decelerate the rate of decline, but that would be about it."

• Personal-lines pricing is also going down: Mr. Porrino pointed to State Farm rate filings over the last three years to make his point that personal-lines rates are fast declining.

"If you look at State Farm rate filings over the last three years by state and by rate changes, you see that every one is positive until last year," he said.

Mr. Porrino said that the "switch got thrown" from the beginning of 2004, "and from then on virtually every rate filing is negative." He said one reason the personal-lines rates are falling is that profits remain at a reasonably-robust level.

Some personal-lines carriers are showing low- 80s combined ratios. "Those are stellar, stellar combined ratios," Mr. Porrino said. Pointing back to State Farm, he said that the company appears to have concluded that "this is the right time to go out and grab some market share." So State Farm has filed for "some reasonably significant rate decreases in a lot of states this year," Mr. Porrino observed.

• Merger and acquisition activity is non-existent, but that will change, eventually: "I just have a couple of words on M&A activity: there is nothing happening," said Mr. Porrino.

In 2003, he noted, there was one deal, "obviously The St. Paul Travelers merger." But he said that transaction was unique because of the knowledge of the parties involved, and even that deal and the resulting combined entity "have not performed all that well."

This year, he said, what's happening is the same old story: "a lot of transactions driven by the selling need, a lot of exiting non-core, a lot of renewal-rights transactions."

One reason there haven't been more mergers in the sector, he said, is because of the control that brokerages exert on insurance buyers. "To the extent that the broker controls buyers of the product, what are you buying when you go buy another insurance company? But I think the balance of power may shift slightly in the future and that may enable more consolidation than what we've seen in the past."

Mr. Porrino speculated that at some point in time consolidation has to happen in the commercial P-C space because it's too fragmented. "The top 20 companies control 15 percent of the market. There is no financial service industry anything like it. So at some point in time, it has to consolidate," he said.

HEDGEWORLD INSIDE EDGE

Hedge Fund Changes Seen within Broad Asset Management Industry Evolution

By Chidem Kurdas, New York Bureau Chief
Tuesday, November 09, 2004 3:10:10 PM ET

NEW YORK (HedgeWorld.com)—Common distribution platforms that include hedge fund products as well as mutual funds, annuities, separate accounts and insurance are the future business model for asset management companies, according to Steven Buller, Ernst & Young's Americas director and global co-director of asset management services.

Mr. Buller was speaking at an Ernst & Young briefing on the state of the financial services industry.

He sees these platforms as including both premium services targeting high-net-worth investors and low-cost brands for the retail sector. Hedge funds belong primarily in the premium category. But the overall setup resembles Wal-Mart, a large seller of diverse products at relatively low cost.

The risk/return profile of hedge funds is changing—in particular, they increasingly are diversifying from the long/short format to offer net long investments, Mr. Buller argued. He noted that it has become difficult for an individual manager to distinguish himself in the market as the number of hedge funds has increased from a little more than 2,000 in 1995 to approximately 7,000 this year.

Despite the difficulty of achieving returns in a crowded industry, Mr. Buller foresees ongoing expansion as far as the near future is concerned. "Expect continued sustained growth in the number and assets of hedge funds" over the next 18 months or so, he said.

Growth in traditional fund assets has stalled and hedge funds are one of the venues into which high-net-worth and institutional money has gone. Assets in hedge funds have grown from less than US$100 billion in 1995 to between US$800 billion and in excess of US$1 trillion by late 2004.

"It is going to be an interesting next few years for our industry," he said.

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InvestmentNews

November 10, 2004

Regulators are not done, expert says

This was the year of the regulator and New York State attorney general Elliot Spitzer "isn't done yet," said Steven Buller, Americas Director and Global Co-Director of Asset Management Services for New York-based Ernst & Young LLP at the firm's annual "State of the Financial Services Industry" press briefing in Manhattan on Tuesday.

Mr. Buller also predicted "continual and sustained" growth for hedge funds next year, and said there would be as many as 7,000 hedge funds within two years.

The Ernst & Young executive noted that investor dollars continued to flow to separately managed accounts, alternative products and exchange traded funds. "They are forcing the mutual fund industry to pay attention," he said.

BestWire

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November 11, 2004

Ernst & Young: Insurers Are Solid as Eventful 2004 Wanes

NEW YORK November 11 (BestWire) — Both the life and property/casualty insurance sectors have managed this year to post good results by most common measures, but new challenges are on the horizon. That was the assessment Nov. 9 by Peter R. Porrino, global director of insurance industry services at Ernst & Young, at his company's "State of the Financial Services Industry" press briefing.

On the plus side, the property/casualty industry since early 2003 has achieved average returns on equity of about 14% to 15%. It is "very rare for the industry to get up to this level," Porrino said, but the performance still is behind that of banking and asset-management companies. Porrino said he expects returns to stay up for another year or two before falling to the norm of 10% or 11%.

While profits are robust, there is evidence that rates are falling. According to research by Morgan Stanley and Deutsche Bank, average three-month price increases in commercial property fell from about 24% in the third quarter of 2002 to zero early this year and to actual price reductions in this year's second quarter. Total commercial-lines rates of increase fell from about 30% to 9% over the same period.

Rates in personal lines also appear to be coming under pressure because of robust profits. Porrino said that early this year, leading writer State Farm began to file rate decreases with states, and it apparently has concluded that now is the time to grab market share.

While enjoying strong profitability, property/casualty writers have strengthened their reserves and have seen a stabilization in their ratings after downgrades following the terrorist attacks of 2001 and the downturns in the stock markets and interest rates, said Porrino.

Of particular note is the writers' ability to withstand the claims resulting from the four hurricanes that struck Florida in August and September. These storms caused estimated insured losses of $20 billion to $21 billion in 2003 dollar values, slightly more than those caused by Hurricane Andrew in 1992 and slightly less than those in the terrorist attacks on the World Trade Center and Pentagon in 2001. "It's amazing there was no dislocation and very little damage to companies," Porrino said. He attributed the results to catastrophe simulation modeling, more exclusions and restrictions on policy forms, higher deductibles, the Florida Hurricane Catastrophe Fund and a de-emphasis of growth in catastrophe-prone areas. He said only one insurer has become insolvent because of the storms, and one other may fail.

After seeing their returns on equity fall from an average of about 13% in the mid 1990s to less than 6% in 2001, life insurers have rebuilt their average returns to nearly 12% through growth in assets and a reduction in general expenses. Growth of life insurers' assets has stayed within a narrow range of 3% to 8% since 1999 and currently is at about 6%. Growth in annuity assets has swung widely (1% to 15%) because of links to the stock market and currently is about 7%, Porrino said.

On the expense side, life insurers "have done a good job," according to Porrino. Since 1997, they have reduced their general expenses as a percentage of total assets to 1.11% from 1.42%.

That's significant because based on a 10-to-1 ratio of assets to equity, the reduction generates about a 300-basis-point improvement in return on equity. "To move significantly in the future, insurers will have to move distribution costs," he said. "They are a big driver of expenses."

Though property/casualty mergers and acquisitions have been dormant except for the St. Paul Cos./Travelers combination, life companies have been more active. In 2003, the life mergers were strategic in nature: Manulife and John Hancock, Axa and MONY Group, Bank One and Zurich Life, and Prudential buying the retirement business of Cigna. Porrino said this year's moves, however, have been driven by sellers, led by the divestitures of CNA's individual life business to Swiss Re and Safeco's life and investment business to Berkshire Hathaway/White Mountains. Porrino said he expects consolidation to pick up in 2005, driven by cost pressure; lackluster sales; the need to grow distribution; and back-office rationalization. He also said European companies, out of the market since 2001, are likely to regain buying interest as balance sheets strengthen.

The business practices of property/casualty personal lines and life insurance may suffer some regulatory fallout from the current investigations into commercial property/casualty lines, where New York state Attorney General Eliot Spitzer and federal and state regulators have turned up evidence of bid rigging, reinsurance tying and brokers steering business. Porrino said he expects personal lines will next feel pressure to reform their business practices, followed by life insurance in 2005. He said he doesn't expect fines to be large in personal lines and life, but he predicted requirements on disclosure of incentives and compensation would increase.

What happens to life distribution could be dramatic, said Robert W. Stein, chairman of global financial services. "When you pull that first string, you don't know how the rest will unravel," he said.

(By Ron Panko, senior associate editor, Best's Review: Ronald.Panko@ambest.com) BN-NJ-11-11-2004 12:56 ET #

InvestmentNews

November 15, 2004

Costs likely to push insurance mergers

By Charles Paikert

NEW YORK - Cost pressures and lack luster sales will rekindle merger and acquisition activity in the insurance industry, according to Ernst & Young LLP executives.

In addition, noting the profound impact of investigations by New York Attorney General Eliot L. Spitzer into the asset management and insurance industries, E&Y executives predicted more of the same next year.

"He isn't done yet," said Steven Buller, Americas director and global co-director of asset management services for the firm, speaking at the New York-based firm's annual state of the industry briefing.

Mr. Buller's counterparts, Peter Porrino, global director of insurance industry services and Americas director of financial services products, and Barry Kroeger, deputy director of banking and capital markets for the Americas, predicted increased mergers-and-acquisitions activity in the respective industries they cover.

While there have been relatively few mergers and acquisitions in the life insurance industry in the last few years, Mr. Porrino said, he expects a return to industry consolidation next year, citing cost pressures and lackluster sales as driving factors.

"The big question," he said, "is: What will Europe do? I think it's likely you will see European companies get back in."

Among banks, Mr. Kroeger forecast, smaller banks will continue to be acquisition targets. "It's inevitable," he said.

Mr. Kroeger also predicted that banks will continue to pursue a larger share of the financial planning business. "Everyone is trying to figure out how best to do that," he said.

What's more, Mr. Kroeger said, he believes that banks have a "definite advantage" in financial planning because of their "cost of operations and customer flow."

Robert Stein, chairman of E&Y's global financial services, characterized the banks' renewed

emphasis on financial planning and advising as part of the "rush to capture the high-net-worth customer."

He also predicted a "move toward proprietary product" by banks but warned that they could quickly find themselves conflicted between offering what's best for the customer and what's best for the bank. As a result, Mr. Stein said, the trend toward financial planning in banks "could well get dicey" and move into "Spitzer territory."

As a result of investigations by Mr. Spitzer and the Securities and Exchange Commission into the mutual fund industry, Mr. Buller said, compliance costs have increased significantly, and he expects a "comprehensive and continuous" focus on compliance matters.

Although the number of mutual funds has declined, he noted, fund assets have rebounded to $7.5 trillion as of September, up from $7.4 trillion at the end of 2003.

Mr. Buller also noted the explosion of hedge funds, which now number 7,000, and, he said, should enjoy "continuing and sustained growth" for the next two years.

He also noted that investor dollars have continued to flow into separately managed accounts, alternative products and exchange traded funds. "They are forcing the mutual fund industry to pay attention," Mr. Buller said.

In fact, he described mutual funds as a mature industry, after having had its "midlife crisis."

The key to the industry's future, Mr. Buller said, is the migration toward a common platform that will encompass a plethora of services and products, including wrap accounts, mutual funds, annuities, insurance and alternative products, and will be offered at either premium pricing for affluent customers or discount prices for retail customers.

"It will be like a large building with two entrances," he said, "one for Neiman Marcus customers, the other for Wal-Mart shoppers."

The banking industry faces mixed prospects, according to Mr. Kroeger. He noted that key benchmarks in the industry, such as return on equity, asset quality and total equity capital, remain at healthy if not record levels.

However, Mr. Kroeger warned, management will face unrelenting scrutiny on regulatory, compliance and corporate-governance issues.

The good news for the industry, he said, is that "by any measure, boards are operating more effectively than one year ago. The balance of power has shifted [from the chief executive] to the board of directors."

What's more, Mr. Kroeger added, banks' internal-audit functions have "improved

substantially," while at the same time, there has been "real meaningful changes at the operating level."

Although the insurance industry has also been rocked by regulatory investigations, Mr. Porrino predicted a 3% to 8% growth in assets and said life insurance companies will be "more asset-driven entities than they have been in the past."

For property-and-casualty insurance companies, he said, bid rigging and conflicts of interest among brokers remain major issues. Disclosure requirements for insurance companies, Mr. Porrino predicted, "will go way up," regulatory fines "will be severe," and disclosure of incentives " is a foregone conclusion."

CRAIN'S
NEW YORK BUSINESS

November 15, 2004

Research firms face a cruel twist

SEC could land hard on soft dollars, hurting the business it helped to boost

By Aaron Elstein
Published on November 15, 2004

The burgeoning business of providing independent stock analysis, an industry hugely boosted by regulators determined to clean up Wall Street, may soon become a victim of those same people and a new cleanup effort.

Scores of independent research outfits that have sprung up in recent years are facing the loss of one of their principal sources of revenues--so-called soft-dollar commissions.
Some big mutual fund managers have already scaled back or altogether stopped paying soft-dollar commissions, which are hidden expenses for trading, research and other services that drive up costs for mutual fund customers.

Awaiting word

Now, a Securities and Exchange Commission task force is examining the use of soft dollars and is expected to recommend by year-end strict new limits on their use.

"A drop in soft dollars is a real threat for independent research firms," says Steven Buller, national director of investment management services at Ernst & Young. "You'd have to question whether all the firms that have just gotten started could generate enough business to survive."

A recent survey by the Investorside Research Association, a consortium of 75 independent firms, goes much further. It forecasts that an SEC ban on soft dollars could drive 70% of independent research shops out of business.

Huge gap to fill

While executives at some of the larger independents insist that they could withstand the loss, they could be the exceptions. That's because soft dollars accounted for 60% of the industry's $1.38 billion of revenues last year, according to Integrity Research Associates, a Darien, Conn., consulting firm. They also helped the industry to mushroom to 400 firms today, a 50% expansion over the last six years.

Ironically, the challenge facing independents is being driven by the SEC, which gave the industry a shot in the arm last year. As part of the settlement into research practices at large investment banks, the agency forced big Wall Street firms to pay $432 million over five years to subsidize independent research firms.

Regulators wanted to strengthen independent firms so that they could provide a counterweight to the Street's chronic cheerleading. But the growing chorus of independent voices could fade fast if the SEC slaps limits on the independents' largest revenue stream.

Surprise, surprise

"This is a classic example of the unintended consequences of reform," says Michael Mayhew, chief executive of Integrity Research Associates.

The threat to independents began after the market-timing and late-trading scandals erupted in the mutual fund business last year, exposing the fact that several prominent fund firms had done little to keep down costs for their investors. As part of the effort by the $7.6 trillion fund industry to demonstrate that it was serious about cleaning up its act, its chief trade group, the Investment Company Institute, took action.

Among other things, it recommended in December that the SEC ban soft-dollar commissions. What's more, the ICI specifically asked that fund managers be prohibited from making hidden, soft-dollar payments for independent research.

The SEC convened a task force in March to explore the matter. In the meantime, several large, scandal-scarred fund operators, including Janus Capital and Putnam Investments, announced that they would scale back or cease paying soft dollars.

Even mighty Fidelity Investments, untouched by the scandal, proclaimed that it would cease paying for stock market data through soft-dollar arrangements with trading firms, and instead would bring those payments above the table by parceling them out directly.
The effort by fund firms to lower trading costs, combined with uncertainty over how the SEC will change the rules governing soft dollars, has already taken its toll on independent research firms.

"Business definitely got hurt during the summer, and everyone is still waiting to see what the SEC will do," says John Eade, president of Argus Research Co. in Manhattan.
One result of the uncertainty is that 65% of the firms surveyed by Investorside Research Association said they have laid off or postponed hiring employees.

Change of fortune

That's a dramatic change for an industry that was helping to revive the stock research business. After the bubble popped, firms like Goldman Sachs and Credit Suisse First Boston laid off scores of analysts, and the number employed by Wall Street firms in North America fell by 14%, according to San Francisco research firm StarMine Corp.
But thanks to the proliferation of independents, the number of analysts has risen by 7% this year, to 3,381, the first increase since 2000.

"The independent research market has been a great way for analysts to get back on their feet and escape from investment banking-focused research," says Richard Lipstein, a principal at recruiter Boyden World Corp.

NATIONAL UNDERWRITER
Life & Health / Financial Services Edition Online

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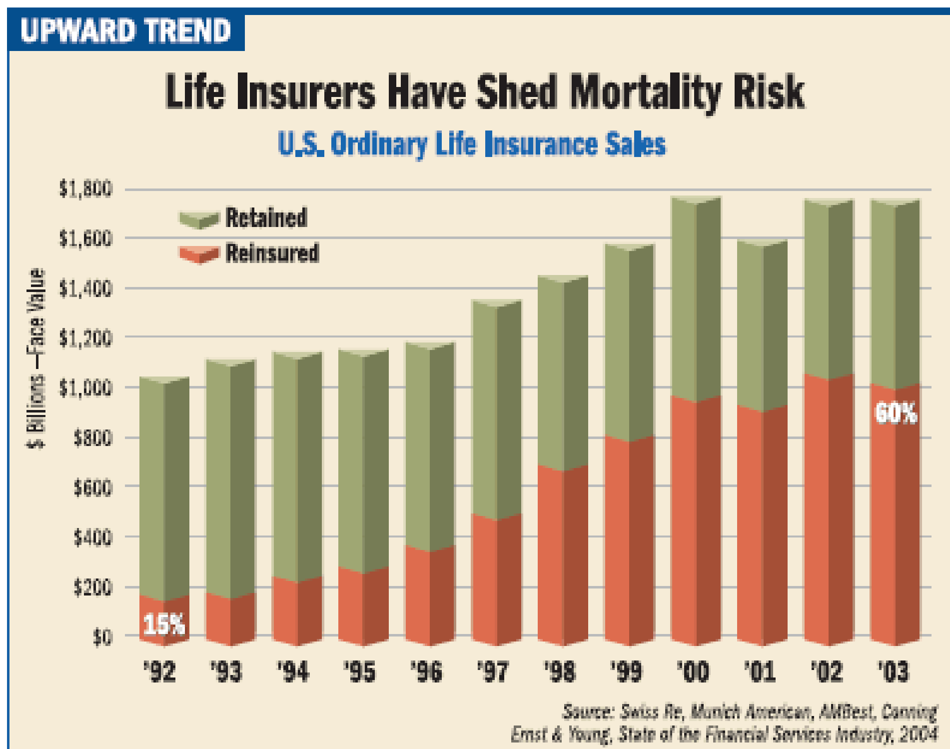
TOP STORIES OF THE WEEK

STATE OF THE INDUSTRY

2005 Shaping Up To Be An Interesting Year

By Jim Connolly
New York

Life insurers are looking more like asset managers and asset managers are facing structural changes going forward, according to Ernst & Young executives who spoke during the firm's annual review of the state of the financial services industry.



▶ OVER THE LAST DECADE the life insurance industry has been steadily shedding mortality risk and relying instead on fees and margins from assets under management.

The life insurance industry is shedding mortality risk, relying instead on fees and margins from assets under management, said Peter Porrino, Americas director of financial services practice and global director of insurance industry services, with Ernst & Young, New York.

While those assets under management have contributed to strong performance, cost control has been a real driver of recent returns, he added. General expenses as a percentage of total assets dropped 31 basis points to 1.11% in 2003 compared with 1.42% in 1992, Porrino said.

The improvement does not suggest that efforts to control distribution expenses could mean the end of the career agent, he said, but rather that there will be a "slow attrition" of career agents.

Strategic acquisitions also will help insurers with results, he said. In 2003, he noted, there were a number of strategic mergers and acquisitions which were followed by a lull in 2004. However, he anticipates activity picking up again in 2005.

"Cost levels are so important that there will be a need to get costs down through consolidation," he said. Expansion of distribution will be achieved through acquisition, he continued, and European insurers could return to the market.

In fact, according to Porrino, strategic deals in the $10 billion to $20 billion range will be done by reasonably big companies.

Consolidation was also an issue touched on by Barry Kroeger, deputy director of E&Y's Americas banking and capital markets practice. The consolidation trend among over 7,000 banks in the U.S. will continue apace, he added.

Porrino also said that in light of heightened regulatory scrutiny, insurers will have to be more aware of "reputational risk" going forward. Additionally, in the future, there will be more stringent rules on what constitutes risk transfer, he predicted.

In light of probes by Eliot Spitzer, New York state Attorney General, it is likely there will be new requirements for disclosure of life insurance compensation as well as for property-casualty insurers, Porrino said.

Robert Stein, chairman of E&Y's Global Financial Services practice, said boards of directors are having more impact than they did even 18 months ago as corporate governance practices are revisited. And more board sessions are being held without the company's CEO, he added.

Insurers and banks continue to separate the function of CEO and chairman of the board, he said. In 1998, 76% of banks and 85% of insurers had a combined post compared with a respective 68% and 60% in 2003, he added.

But even with the increased oversight, CEO compensation still remains relatively high, Stein said, noting that in 1993, the average CEO compensation for the top 50 banks and insurers was $2.6 million compared with $8.5 million in 2003.

One industry that is undergoing both regulatory and structural changes is the asset management industry, said Steven Buller, Americas director and global co-director of asset management services with E&Y.

In fact, according to Buller, the changes initiated by Spitzer have resulted in the average compliance staff increasing from 2.5 people and 2 part-time attorneys in 2002 to a total of 6 staff and 3 full-time attorneys, he said.

"Eliot Spitzer and the SEC may not be done yet," he said, adding that there will need to be fee harmonization.

The change comes at a time when the industry is undergoing structural change, Buller said. A total of 42% of all fund groups had negative outflows, suggesting the industry is at a crossroad and a number of challenges need to be addressed, he continued.

The retail investor is putting less money in 401(k)s and more money in bank investment products, separate managed accounts, accounts that are tailored to an individual's needs and hedge funds, Buller said.

Going forward, asset managers are going to have to attract both high net worth and more middle class investors, he explained. It is akin to having one building with an entrance that says Neiman-Marcus and another entrance that says Wal-Mart, he added.

BusinessWeek

DECEMBER 6, 2004

FINANCE

End Of The Big Bank Bonanza

Costs for everything from upgrading branches to fighting lawsuits are spiking

These have been flush times for U.S. banks. This year, they most likely will beat last year's record profits of $120 billion -- thanks to the lowest interest rates in decades and spending by indefatigable consumers, whose transactions account for two-thirds of bank revenues.

Yet the end of Easy Street may be near. Costs for everything from upgrading bank branches to fighting lawsuits and complying with tighter regulations are spiking. Technology expenses alone are rising 6% a year as the need to upgrade computer systems from past acquisitions becomes pressing. At the same time, revenues are taking a hit as interest rates edge up, hurting the mortgage-refinancing and bond-trading businesses. "Banks have seen windfall profits these last few years," says Nick Studer, head of consultant Mercer Oliver Wyman's corporate and institutional banking practice. "They're thinking that they've got a business full of good athletes, but in fact they've been running downhill."

Megamergers have bought banks growth and time before -- now both are running out. "Banks have spent a lot of money to get a lot bigger, but they aren't much more efficient," says Adam Dener, author of a study called *The Emerging Crisis in U.S. Banking Profitability* and a partner at Capco, a financial services consultancy. "As a result, they now face a business model impasse."

Analysts are pruning their earnings estimates. They figure that earnings for the 1,339 companies in the Dow Jones Bank Index will grow a meager 4% this year, down from 8% six months ago, says Thomson Financial. Next year's numbers also are being ratcheted down: On Nov. 22, Andrew B. Collins of Piper Jaffray & Co. (PJC) shaved 6% off his 2005 earnings estimate for J.P. Morgan Chase & Co. (JPM), while John E. McDonald of Banc of America Securities (BAC) cut his forecast for Citigroup (C) to 4% below the consensus. That may be just the beginning. "What happens if the consumer rolls over?" asks Barry F. Kroeger, deputy director of the banking and capital markets practice at Ernst & Young. Consumers "fueled the recovery, and unless banks can replace those revenues, that's going to have a huge impact on their future."

REFI RETRENCHMENT

Rising interest rates are banks' immediate worry. Long-running predictions of the end of the mortgage-refi boom are starting to come true, big time. The Mortgage Banker's Assn. forecasts refi activity will fall 55% this year, to $1.15 trillion. And higher rates could soon push depositors to move their cash elsewhere, robbing banks of cheap funding, says Capco's Dener. Bond trading, another huge profit center for banks as interest rates

swooned, is also set to plummet. Banc of America analyst McDonald expects that Citi's fixed-income trading revenues will fall 8% next year -- a $681 million decline.

Meanwhile, corporations are so flush with cash that commercial lending has remained flat even despite the improved economy. Banks are losing out to rival private-equity firms, specialized outfits such as CIT Group Inc. (CIT), and even hedge funds as the lenders of choice for small and midsize companies. The competition is stiff because borrowing by such companies -- now a $20 billion market -- is growing 8% a year, twice the rate of lending to large corporations, say consultants McKinsey & Co. The banks have largely themselves to blame for their dwindling share of this market. They alienated customers by making it tougher to get loans during the recession and also ignored them while chasing larger companies that promised lucrative investment banking and other fees -- businesses that turned out to be less profitable than they hoped.

In a telling sign of the lack of loan demand, U.S. Bancorp of Minneapolis (USB) announced last month that it was raising payouts to shareholders. After planning to use 80% of its $1.1 billion third-quarter profit to pay dividends and buy back shares, the nation's sixth-largest bank upped that to 94%. With demand for commercial loan growth flat, it was the best the bank could do with the money, analysts say. "Banks can't deploy this capital because the market demand for their services is maturing," says E&Y's Kroeger.

While banks cast about for new areas of hot growth, costs keep climbing. With the advent of the U.S.A. Patriot Act requiring banks to set up new anti-money-laundering procedures, additional governance controls mandated by the Sarbanes-Oxley Act of 2002, and new mutual-fund rules to monitor unlawful trading, compliance costs are the biggest new expense. In fact, additional non-interest expenses -- a category tracked by the Federal Deposit Insurance Corp. that includes such costs -- rose nearly 14%, or $58 billion, in the first half of the year.

The category also includes litigation reserves, which are ballooning as the number and size of lawsuits filed against banks are soaring. Italian dairy giant Parmalat, for instance, is suing Citi and Bank of America Corp. (BAC) for more than $10 billion each, claiming that they played a role in its bankruptcy. That's more than BofA's first-half pretax income of $9.7 billion. Both banks are contesting the suit.

One big bright spot is that loan losses are the lowest in memory. That, however, is leading banks to reduce reserves against future losses. CreditSights analyst David A. Hendler found that banks reduced their capital reserves by $800 million in the third quarter, adding to earnings. But with loan losses now below historical norms, an uptick in bad loans is inevitable, he says. "If borrowing costs spike, investors should expect sizable readjustments to credit costs," he says.

The merger wave of the last decade papered over many of these issues. Now, banks can no longer boost their earnings by simply buying another big bank. They must finally do the hard work of integrating their acquisitions to become more efficient. Many banks depend on decades-old computer systems that use archaic programming languages and pay people "astronomical salaries to keep the systems up and running," says Dan Stull, managing director of Jefferson Wells in Seattle, a financial-industry compliance specialist. "They haven't given themselves the time to merge the systems before they

move on to the next deal." In fact, three-quarters of some $340 billion in tech spending by banks last year went to maintain existing systems, according to Deloitte & Touche.

PAYING LIP SERVICE

Critics say that money might have been better spent on new technology and training that helps to sell more products. "Banks have paid lip service to cross-selling and managing customer relationships," says Mercer's Studer, "but most haven't done anywhere nearly enough." Wells Fargo & Co. (WFC) is one exception: It says its typical customer buys four products, twice the industry average. But Deloitte estimates that, overall, customer churn costs banks $15 billion a year. And their apparent inability to engage customers means that banks scoop up just $1,000 of the $3,500 that the average American household spends each year on financial services.

Of course, by some measures banks are better run now than ever. Since the recession of the early 1990s, they have become adept at managing risk by using sophisticated hedges and bundling loans to sell to the capital markets. And bolstered by years of strong earnings, banks are in better financial shape than they have been for years. The huge burden of post-bubble regulations also carry an upside: It should help banks avoid the sorts of blowups that have plagued them in the past.

If banks want to keep margins up as many of their mainstay businesses shrink, they need to squeeze more value from their operations and boost productivity. "They have been living under this false premise that as they get bigger, they get better," says Tom Brown, chief executive of hedge-fund firm Second Curve Capital LLC in New York. "What the biggest banks haven't done is excel at the basics." First, they'd better get back to basics.

By Mara Der Hovanesian in New York

Obstacle Course

Banks are facing hurdles in their quest to boost earnings. Here's why:

- They're investing heavily in technology, but the payoff in increased productivity is years off
- Hedge and private-equity funds are encroaching on the banks' commercial loan business
- The hot credit-card and mortgage-refi businesses are cooling as interest rates rise
- Regulatory costs are rising because of new laws, and legal costs are soaring as more customers and shareholders sue

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November 29, 2004

Banking Sector Faces Mixed Bag Of Issues

By Judy McDermott

The relatively healthy banking industry has been managing record amounts of capital and peak returns, but as Barry Kroeger, deputy director of Americas banking and capital markets practice at Ernst & Young LLP (E&Y), says, there are still significant issues that banks should be wary of in order to sustain future prosperity. Kroeger, who presented at E&Y's "State of the Financial Services Industry 2004" lecture earlier this month at the Marriott Marquis in New York, spoke of where the banking industry stands today and where it is headed in the near future.

First off, returns are at all time highs, Kroeger said, pointing out that the return on equity has been very high - at around 15% according to FDIC data - while the decline in provisions has also helped to propel earnings. However, the question remains, Kroeger said: Are such low provisions, which result from improved asset quality, sustainable? "Going forward, when will the turn come?" Kroeger asked.

Along with peak returns, banks are also seeing record levels of capital. Commercial banks, including the top 25 bank holding companies (BHCs) have increased their total equity capital consistently since 1999, with the first half of 2004 alone seeing over $700 billion in total equity capital for all commercial banks, according to FDIC data.

But a definite challenge exists in managing and deploying all of this excess capital effectively, Kroeger said. Along with (already seen) increased dividends, banks could focus on organic growth, share buybacks and acquisitions in order to manage excess capital, he said.

Furthermore, concerns surround the fact that bank expense growth is exceeding revenue growth, Kroeger said. Net interest margins are shrinking, with weaker volumes and values for capital markets business not helping matters any. "There [are difficulties] in finding top line revenue growth," Kroeger said. However, the arrival of greater fee-income with the improving economy could lead to more revenue growth for the larger institutions, Kroeger said.

In order to further address revenue and capital issues, Kroeger expects that consolidation in the banking sector will continue full steam ahead, specifically for tier two banks and below. "M&A has to continue," he said, noting that the value of banking M&A transactions is at its highest point since 1998, with over $100 billion in transactions and over 150 transactions for this year through Oct. 25, according to Highline Data.

As M&A activity is expected to continue, the proactive regulatory environment is expected to continue as well. From the management standpoint, banks need to pay close attention to their regulatory, compliance and governance initiatives, Kroeger said. Accounting issues and complexity will remain, while litigation and fines related to conflicts of interest are spreading. And then there are the latest government regulations that all banks must pay close attention to. There is a lot going on in the world of Basel II, SOX 404, the Bank Secrecy Act and the USA Patriot Act, Kroeger said.

Ultimately, banks should focus on successfully managing four main aspects of their business going forward in order to maintain healthy business models, Kroeger said. Banks need to figure out how to best serve their customers, effectively manage their capital and their risks and properly manage their costs, he said.

CRAIN'S
NEW YORK BUSINESS

November 15, 2004

Long-running scandals come back to haunt banks; Force expenses up 9% in first half

Force expenses up 9% in first half

By Tom Fredrickson

The collapse of companies like Enron and WorldCom under the weight of financial improprieties is eating into banks' bottom lines.

Expenses have soared by about 9% at banks across the country in the first half of this year, and the accounting scandals deserve much of the blame, according to Barry Kroeger, Ernst & Young's deputy director of banking and capital markets for the Americas.

"From a shareholders' perspective, there are some big challenges (facing the banks)," Mr. Kroeger told reporters at E&Y's annual financial services media briefing, citing data from the Federal Deposit Insurance Corp.

The bulk of the increase in expenses stems from sharp hikes in the litigation reserves of major banks such as Citigroup Inc. and J.P. Morgan Chase & Co., which bolstered reserves in the first half of the year in order to handle lawsuits related to their financial dealings with scandal-tainted companies. In fact, FDIC data show that three-quarters of the jump in commercial bank expenses overall, or $6.8 billion worth, is assigned to "other noninterest expenses" on the part of institutions with more than $1 billion in assets.

Fully $1.6 billion of the increase in litigation reserves came courtesy of J.P. Morgan Chase Bank alone. Citigroup's Citibank unit set aside $1.4 billion in such reserves in the first six months of 2004.

The financial imbroglios have contributed in other ways to rising expenses, says Mr. Kroeger. He points to things such as the huge and mounting costs of complying with the Sarbanes-Oxley Act, which raises pressure on the banks to monitor compliance with financial regulations and was itself a response to the scandals. Other new regulatory burdens, such as those imposed by the anti-money laundering provisions of the Patriot Act, have also proved costly.

Unlike the litigation costs, which presumably won't be recurring, regulatory expenses won't go away, Mr. Kroeger notes.

While large banks are bearing the brunt of the increased expenses, smaller banks also have been hit. Expenses at banks with $100 million to $1 billion in assets are up 4% this year, FDIC data indicate, largely as a result of complying with new regulations.

BRANCH BONANZA IN NEW YORK AREA

Data recently released by the FDIC confirm what most New Yorkers already knew: Bank branches are sprouting up around town lately like mushrooms after a rainstorm.

The number of branches in the region--which includes New York City, Long Island, and five other counties in New York and 12 in northern New Jersey--has shot up by 8% in the past five years, with the largest annual gain, 3%, coming in the last year. The region has 5,085 branches, up from 4,696 in 1999.

But people who are concerned that the region is becoming overbanked can take comfort in the fact that the region has only slightly more branches--2% more--than it did 10 years ago. That relatively small rise over the longer time period is sharply lower than the 16% increase in branches logged nationally in the same period.

The recent acceleration in branch growth here can be largely credited to the arrival of banks such as Washington Mutual, Commerce Bank and Wachovia, which have finally managed to undo the effects of the massive bank consolidation that occurred in the mid-1990s.

Only six of the 20 largest deposit-taking institutions in the region in 1994 are around today. The list of defunct banks includes once-venerable names such as Chemical Bank, Republic Bank, Manufacturers Hanover Trust and United Jersey Bank, to name just a few.

CANADIANS TAKE SHINE TO BIG APPLE

The New York City retail banking market continues to attract interest from bankers across the nation and around the world.

Toronto-Dominion Bank of Canada is just the latest example. T-D is planning to use Maine-based Banknorth--which it is in the process of buying for $3.8 billion--as a vehicle to buy other U.S. institutions.

Speaking at a recent investor conference in Manhattan sponsored by Ryan Beck, Banknorth Chief Executive William Ryan said that New York City is a high priority and will get his attention as soon as the T-D deal is done.

Matthew Kelly, an analyst with Moors & Cabot Inc., says he expects to see Banknorth complete a deal in New York City within 18 months. The bank's most probable targets are the city's large thrifts, he believes.

Brooklyn-based Independence Community Bank, which has 123 branches and $18 billion in assets, is most likely to grab the attention of Banknorth and T-D, because it's the right size and has a growing commercial business, Mr. Kelly believes. No word yet on what Independence CEO Alan Fishman thinks of the prospect.

Fund Companies Expand Strats

November 19, 2004

Mutual fund companies in the next 18-24 months will likely start offering non-proprietary complementary investments and expand distribution channels in bids to capture high-net-worth clients. The funds would be responding to the fact that affluent investors are increasingly putting their money in other types of investments, predicts Steven Buller, Americas director and global co-director of asset management services at Ernst & Young.

HNW investors looking to bolster returns in a low interest rate and weak stock market environment are turning to alternative investments and exchange-traded funds and separately managed accounts (SMAs). The hedge fund market now totals over $700 billion while the ETF market is just under $180 billion. Approximately $100 billion has flowed into SMAs through the third quarter, bringing the market to $535 billion. Mutual fund assets are only up about 1.35% from last year to approximately $7.6 billion, through September. Fund companies in response have, for example, started to add third-party hedge funds to their line-ups, Buller noted.

InvestmentNews

November 22, 2004

Foreign insurers will drive M&As

By Gary S. Mogel

NEW YORK - Hurricanes and bid-rigging scandals have made this an active year for the insurance industry, and a new round of life insurer consolidations driven by large Canadian and European insurers in 2005 may create even more excitement, according to Ernst & Young LLP executives.

Expanding on comments he made during the firm's annual state-of-the-industry briefing (InvestmentNews, Nov. 15), Peter Porrino, New York-based E&Y's global director of insurance industry services, noted that most of the consolidation will likely occur in the life insurance sector. Sales in that sector have been disappointing for many companies, and costs have been rising.

Organic growth is extremely difficult in the life insurance market because sales have been sluggish, said Robert Stein, E&Y's chairman of global financial services. Therefore, he said, mergers and acquisitions will be a more realistic way of achieving growth objectives.

The two executives agreed that the acquirers will likely be large Canadian and European insurers seeking to enlarge or establish a U.S. presence and obtain a respected brand name and instant recognition.

For instance, they mentioned Allianz Group as a potential acquirer. The Munich, Germany-based company already has a U.S. presence in Minneapolis-based Allianz Life Insurance Co. of North America, but Allianz Group wants to expand its U.S. operations, the E&Y executives noted.

Another foreign life insurer that may make a major acquisition in the coming year is London-based Aviva PLC, they said.

Sun Life Assurance Co. of Canada, based in Toronto, also might be interested in making an acquisition. Mr. Stein noted that a Sun Life competitor, Waterloo, Ontario-based Manulife Financial Corp., recently merged with John Hancock Financial Services Inc. of Boston, and that merger, while still a work in progress, seems to be going well.

Most U.S. life insurers, due to their long history of competition with each other, often

prefer being acquired by a foreign insurer as opposed to a domestic competitor, Mr. Stein said.
The E&Y executives wouldn't speculate as to potential acquisition targets.

However, it is no secret within the life insurance industry that there aren't many obvious merger candidates left. Those often mentioned as attractive potential acquisitions include Jefferson-Pilot Insurance Co. in Greensboro, N.C., Lincoln National Life Insurance in Philadelphia; Pacific Life Insurance Co. in Newport Beach, Calif., Phoenix Life Insurance Co. in Hartford, Conn., and Principal Life Insurance Co. in Des Moines, Iowa.

The foreign insurers want "well-recognized, quality insurers with solid business models," the executives noted.

"Scale continues to be a critical success factor," Mr. Porrino said. "The desire to grow life insurance distribution networks is also key, with potential acquirers desiring in-place agency forces and niche marketing skills," he added.

Another factor that will drive life insurer consolidation is reducing infrastructure, as companies seek to shrink the size of the back office, Mr. Porrino said.

The property-casualty sector, which survived this year's hurricane losses and whose earnings and financial-strength ratings are benefiting from premium increases in most coverage lines, isn't expected to see as much M&A activity, he indicated.

"On the property-casualty side, the activity will be companies that want to get rid of something, rather than a strategic acquisition," Mr. Stein said.

Insurers in the sector don't want to take on legacy loss-reserve shortfalls, Mr. Porrino said. "At some point, when balance sheet comfort is increased, there will be substantial consolidation in the commercial property-casualty sector."

He added that property/casualty insurers are more likely to engage in "transactions," such as one insurer buying renewal rights to a specific book of business from an insurer desiring to exit non-core markets or coverage lines, than mergers.

Fallout from the investigations and lawsuits initiated by New York Attorney General Eliot L. Spitzer and regulators in other states is expected to cause a major increase in disclosure and compliance costs, yet another reason for insurers eventually to seek economies of scale through consolidation.

But if Mr. Spitzer's allegations continue to swirl and envelop other companies, including those on the life side, that might stop or slow down the merger deals, Mr. Porrino said. No one wants to buy a company when it is in the middle of a major investigation or lawsuit, he noted.

December 13, 2004 A Publication of SNL

Ernst & Young: Compensation, board independence, risk management top priorities in '05

By Alec Solotorovsky

Financial services firms have made substantial improvements in corporate governance over the last several years, Ernst & Young LLP says, but companies still need to focus on strengthening board independence, controlling executive compensation and establishing sound risk management practices.

In a "State of the Financial Services Industry Report" issued Dec. 9 by Robert Stein, chairman of global financial services, and Daniel Oakley, director of knowledge management for the firm's financial services practice, Ernst & Young said that directors and shareholders have become increasingly vigorous in their oversight of company management over the past year. Boards are acting independently and establishing formal processes for reviewing CEO performance, while audit committees are expanding their authority over the financial reporting process. Shareholders, meanwhile, are increasingly calling for the elimination of poison pill antitakeover measures and withholding proxy votes to protest harmful management decisions.

Still, Stein and Oakley noted several areas of corporate governance that still need improvement. Topping their list is board independence, which might be substantially improved by separating the roles of chairman and CEO, or appointing a "lead director" in situations where the posts of chairman and CEO are held by the same person.

"Governance cannot be effective if the same person sets the strategy, runs the business, and, at the same time, has the responsibility for driving critical oversight decisions on behalf of owners," Stein and Oakley wrote, adding that the chairman must become a genuine overseer of company operations, rather than a mere external advocate for the company, in order to achieve sound corporate governance.

Among S&P 500 companies, the number of independent chairmen who do not hold the CEO position has increased to 25 from 15 since February 2003. In addition, 40% of companies with a combined chairman/CEO position have appointed a lead director to take responsibility for management oversight.

Stein and Oakley also noted that banks and insurance companies have gone in opposite directions on the matter of chairman/CEO separation, with banks increasingly combining the two roles and insurance companies leading the S&P 500 in their separation. However, in a conversation with SNL Financial, Oakley said that the bank trend might be partially explained by the recent combination of chairman and CEO roles separated in the course of big mergers.

On the subject of executive compensation, Stein and Oakley urged boards to take a more active role in overseeing pay packages, which have grown steadily over the past decade. The two called for full disclosure of the performance measures used to determine short- and long-term compensation, in addition to the curtailment of particularly egregious pay packages.

Finally, Stein and Oakley addressed risk management and the extension of corporate governance to risk governance. Financial services firms take risks as a matter of course, they said, and they must have well-defined risk governance policies.

"The process starts with an articulated set of high-level principles for risk appetite and tolerance," Stein and Oakley wrote. "But the substance goes much deeper and encompasses a framework of policies, controls, reporting, and monitoring of business processes, risks to the effective operation of those processes, plus mitigation and control strategies."

The most important aspect of risk governance, according to Stein and Oakley, is the timely and comprehensive communication of risk profile and control information to the board and the ability of board members to make sense of the information.

But despite the need for improved corporate governance, Stein and Oakley noted that increased board oversight of management operations must not prevent directors from attending to their core strategic missions, including strategy assessment, recruiting and succession planning and the evaluation of mergers and acquisitions. Neither should board oversight be allowed to distract senior executives from the proper management of their companies.

"No one said the road ahead would be easy," Stein and Oakley wrote in conclusion. "However, with determination and continued effort, boards can maintain the momentum needed to not only improve governance, but also create an enduring framework for enhancing company performance."

December 13, 2004 A Publication of SNL

Ernst & Young: Excess capital to boost M&A, bolster buybacks, strong dividends for banks

By Mac Mathews

In a Dec. 9 "State of the Financial Services Industry Report," Ernst & Young LLP Deputy Director Barry Kroeger said that consolidation in the banking space will continue as banks accrue "record levels" of excess capital and run out of room to grow organically.

"Given a mature industry, downward pressure on earnings growth, and an abundance of capital, more mergers are inevitable," Kroeger said in the report. Kroeger added that the sheer number of banks in the market should serve as a driving force. According to Kroeger, there are approximately 7,700 commercial banks in the United States.

Kroeger also said that 2004 has been a big year for M&A in the banking space, although a good chunk of that is due to JPMorgan Chase & Co.'s acquisition of Bank One Corp. in early July.

While expansion through acquisitions is one way to spend excess capital, Kroeger said that many banks are likely to continue to focus on increasing shareholder value through dividends and repurchases.

"The trend toward both dividend increases and share buybacks is going strong and is likely to continue, given the continued downward pressure on organic growth," Kroeger said.

As for shareholders, Kroeger said that continued expense growth could cloud the way they view the profitability of the industry, as expense growth is outpacing revenue growth in the current market.

"From a shareholder's perspective, although the absolute level of profitability and capital are very high, the trend in expense growth doesn't present a particularly flattering picture for the industry," Kroeger said.

Specifically, many banks have made adjustments to their models to deal with compliance expenses.

"Even though the banking industry already was largely subject to the internal control provisions of the Federal Deposit Insurance Corporation Improvement Act, [Sarbanes-Oxley] Section 404 has required significant additional work," Kroeger said. He added, "In light of Section 404, banks have had to rethink the level of precision with which they apply their judgments and accounting principles."

Overall, Kroeger said that banks are going to have to focus on organic growth in order to maneuver through the current "mature" market. However, he believes that the process will not be easy, as the demand side of the market is placing limits on banks' ability to expand organically.

Ernst & Young Study Shows Trend For 'Lead Directors'

An Ernst & Young study has found an increase of "lead director" positions at corporate boards. E&Y has been advising clients to take a hard look at their CEO and chairman roles because having the joint position could compromise board independence. The auditing firm, however, said that a lead director position could be a good compromise to ensure the independence of boards. **Daniel Oakley**, E&Y director of knowledge management who co-authored the study, said the advice is a change in stance based on findings in E&Y's "State of the Financial Services Industry Report."

The study found that at the 40% of companies where the CEO and chairman role are combined, a "lead director" role has been created for the boards. In addition, it found that while in February 2003, only 22 Fortune 500 companies had lead director roles, as of March 2004, 156 had one. There is an opposite trend at banks and investment banks toward combining the CEO and chairman roles without a lead director--a strategy E&Y called "counterintuitive," noting, "There is a delicate balance to be achieved here as it relates to the board's role to oversee, monitor and challenge, and management's responsibility to run the business."

December 20/27, 2004

Insurers To Break 100 For '05 Combined Ratio

Premium growth should slow down to 3.4 percent, although E&Y is more pessimistic

By Michael Ha

In 2005, the property-casualty insurance sector will realize its first underwriting profit since 1978 even as industry-wide net written premium growth slows to 3.4 percent, the Insurance Information Institute predicts.

According to the New York-based Institute's "Early Bird Forecast," the industry's combined ratio is projected to be 99, down from the 100 estimated for 2004 and the 100.1 recorded in 2003.

The forecast would represent a vast improvement over the terrorism-impacted 115.7 result in 2001, and it would also mark the first underwriting profit in the property-casualty insurance industry since 1978, the group noted.

The predictions are based on the averages of responses submitted by Wall Street stock analysts and industry professionals surveyed about the sector's current status and future prospects.

"The survey reveals that the industry's effort to recover from its worst-ever performance in 2001 ran into hurricane force headwinds in 2004, as the quartet of storms that struck the Southeast Coast transformed what would have been the industry's best year in decades into a breakeven performance," according to Robert Hartwig, senior vice president and chief economist at the Institute.

There is still a chance that the bottom line for 2004 will show an under-100 combined ratio, even though the current projection stands at the breakeven point. Indeed, had catastrophe experience in 2004 been "normal," without $20.5 billion in estimated losses from four hurricanes, the year's combined ratio would have been in the neighborhood of 95—its lowest level since 1972, Mr. Hartwig pointed out.

On the industry's premium growth, the Institute said the average forecast calls for a 3.4 percent increase in net written premiums in 2005, down from an estimated 4.8 percent for 2004.

In contrast to previous years, when gains were mostly the result of higher rates, the sharp weakening in the pricing environment over the past year means that current gains are more directly attributed to higher exposure growth and higher demand related to the current economic recovery, the Institute noted.

In 2005, the Institute said, analysts expect little change from 2004, although on a catastrophe-adjusted basis the cyclical deterioration in underwriting performance will begin to further materialize, Mr. Hartwig said.

"While not directly impacting the operating performance of insurers, 2004 is likely to be remembered as the year in which New York State Attorney General Eliot Spitzer initiated an investigation of some insurance industry practices," according to Mr. Hartwig.

"The ultimate impact of this investigation—which has resulted in at least two dozen additional probes launched by state attorneys general and insurance departments around the country—is still unknown," he added. "However, insurer and broker expenses are certain to rise in 2005 as compliance costs increase as new regulations come online and fines and penalties are levied and paid."

What are the "biggest potential downside risks" for 2005? "High on the list," according to Mr. Hartwig, is a "loss of pricing and underwriting discipline. Differing views on the likelihood of pricing discipline being maintained likely explain the disparity among analysts' forecasts for net written premium growth in 2005, which range from 1.1 percent on the low end to 6.0 percent on the high side. So far, pricing is clearly easing but cannot yet be characterized as destructive."

Indeed, a more gloomy prediction was issued by Ernst & Young in its "State of the Financial Services Industry Report." E&Y said p-c price competition makes its profit outlook "pessimistic," noting that rate increases for commercial policies on average are now below 10 percent, with competition driving them down further.

"Rate increases for the commercial property segment are now in negative territory, also foretelling lower ROEs. The hurricanes in Florida may decelerate the rate of decline, but that won't fundamentally alter the trend toward price reductions," the report said.

According to E&Y, it is "only a matter of time before the total commercial line breaks the zero barrier and follows commercial property into negative territory."

LOOKING AHEAD

2005 EARLYBIRD FORECAST

Net Written Premiums

(% Change from Prior Year)

	Est. 2004	Forecast* 2005
Standard & Poor's	6.3%	6.0%
Goldman Sachs	4.8%	4.5%
Lehman Brothers	4.5%	4.0%
Prudential Securities	4.3%	4.0%
Firemark Investments	4.4%	3.5%
Merrill Lynch	4.5%	3.5%
Raymond James	4.4%	3.5%
Morgan Stanley	4.4%	3.4%
Conning	5.5%	3.3%
Gill & Roeser	4.7%	3.0%
Tillinghast-Towers Perrin	5.0%	2.7%
A.G. Edwards	5.0%	2.0%
ISO	4.1%	1.1%
Average	4.8%	3.4%

Combined Ratio

(After Dividends)

	Est. 2004	Forecast* 2005
Gill & Roeser	100.0	102.3
Tillinghast-Towers Perrin	102.2	102.0
Conning	101.7	101.1
Lehman Brothers	101.2	100.7
A.G. Edwards	100.5	100.0
ISO	97.7	99.0
Merrill Lynch	96.0	99.0
Morgan Stanley	102.2	98.2
Standard & Poor's	100.1	97.9
Goldman Sachs	99.1	97.7
Firemark Investments	98.6	97.3
Raymond James	99.6	96.8
Prudential securities	100.6	95.6
Average	100.0	99.0

** Ranked highest to lowest for 2005.*

▶ **DESPITE A SLOWDOWN** in premium growth, property-casualty insurers are expected to continue writing coverage at the breakeven point, although some analysts are more optimistic than others.

SIMS & ASSOCIATES, INC.

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Corporate Governance

Insight Into How Companies Should Be Run December 22, 2004

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- With Ernst & Young's Bob Stein

Internal Audit Finds Own Best Practices Despite Help From Above

by Tiffany Kary

The dogged persistence Cynthia Cooper and the internal audit team at Worldcom Inc. needed to unearth $3.8 billion in fraud at the telecom company raises questions about whether internal audit teams get enough respect, even in the new age of heightened accounting scrutiny.

Cooper, who held the post of internal auditor at Worldcom, said she was discouraged in her work countless times by Worldcom's external auditor, the audit committee of the company's board, and the company's top management.

As Cooper's tale shows, this low-profile group can be a critical safeguard against fraud instigated by high-level executives with the aid of external auditors. But while corporate governance reforms like Sarbanes-Oxley have focused on the entities that blocked Cooper from doing her job, they've said little about the role internal audit should play.

"I'm not sure Sarbanes-Oxley would have prevented the fraud at Worldcom," said Cooper, speaking at The Summit On Auditing and Governance, a recent conference of internal auditors in New York. "Most of the frauds we've seen have been at the highest levels, I think that's most likely to be prevented by whistleblowers and tips."

With a lack of solid regulation around the issue, many internal audit teams are

... *continued on page 21*

Governance Matters

A Point Of View Column

SEC's Donaldson Not Due Slings & Arrows

By Neal Lipschutz

The chairman of the Securities and Exchange Commission deserves better than he's getting.

The latest critique arrived last week in the form of a *Wall Street Journal* interview with U.S. Treasury Secretary John Snow. In it, Snow wondered whether regulators and prosecutors are "balanced" enough in enforcing the Sarbanes-Oxley Act aimed at improved corporate governance and accounting reform.

The SEC and others "need to think about" business leaders' perception that the regulatory system they live under "is not in as good balance as it should be," Snow told the *Journal*.

These remarks follow news reports that some U.S. business groups want to ease SEC Chairman William Donaldson out of his job.

... *continued on page 2*

Neal Lipschutz

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