

**International Insurance Society Seminar**

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**Evan G. Greenberg, President & Chief Executive Officer, ACE Limited**

As in all businesses, the soft market to hard market cycle in insurance is driven by supply and demand. Supply equals capital, and lack of available capital is what creates a hard market. The lack of available capital is caused by two things: a need to move capital to the reserve account to fill holes from the years of selling mispriced business, and an aversion to take risk as a result of the losses produced from the previous soft cycle.

In each cycle, there are some companies that position themselves to move counter to the cycle. They preserve capital in the soft market by simply not writing as much loss-producing business. They deploy their capital during the hard market periods and therefore take advantage of the opportunity. I believe ACE is a company that took advantage of the recent hard market and has emerged a major global commercial property and casualty company. In the past five years, we more than doubled our size as measured by premiums, invested assets and shareholders' equity, and we have built significant earning power. We now occupy a distinct place in the industry.

As one of only a few truly global commercial P&C companies, we generate more than half of our earnings and revenues from outside the U.S. We actively write local insurance business in over 50 countries and serve clients in over 140. Very few companies can match this on-the-ground presence. And we are actively expanding our global footprint. We seek opportunities in both developed and developing markets, and increasingly in complementary products, not simply commercial P&C. We are patiently planting seeds that may take years to have much earnings visibility. China, Vietnam, Russia, South Africa and Poland are examples that come to mind. Our results today are from the work we have done in the past to position our company, and the efforts we make now will become evident in years to come. Insurance is a long-term business that requires a degree of patience.

Our global position affords us a broad perspective on some of the important issues facing our industry today. I would like to touch on a couple of these. The first is the global trade and regulatory environment.

As you know, the world of business is more global and interconnected than ever before. Global barriers to free trade have been lowered through successive rounds of both multilateral and bilateral trade negotiation. But many barriers remain. Trade is not truly free and open; that's a misnomer. That goes for insurance as well. There is a troubling trend that we should all be concerned about. DOHA – the current trade round – is in trouble, and trade liberalization either moves ahead or it regresses into protectionism. There is no standing still.

There are misconceptions about who are the winners and losers from free trade, and this has become an issue in our own country. Overall, frankly, we and the rest of the world have been great beneficiaries of free trade; it has significantly contributed to our prosperity. All countries that have been a beneficiary of the free trade system have a responsibility to preserve the system by continuing to open their markets. Yet, there is a growing feeling of threat from free trade – a feeling in our own country among many people that there may be more losers than winners. This view can be found in many other countries around the world. That's not to say free and global trade does not create potential dislocations within each society that must be recognized and addressed. But protectionism is hardly the answer.

The answer is leadership. Right now, there's not much political leadership to move us forward in liberalizing trade and opening markets. In fact, in many countries, politicians are feeding on this feeling of insecurity with populist or protectionist rhetoric. And that's a worrisome trend.

In the movement toward globalization, insurance is no exception. As an industry, we have a vested interest in an open and global trading environment. Insurance has become global through companies like ours and other major insurers and reinsurers who make capital available to insure risk wherever it is. This capital is fungible and moves more freely around the globe in search of the friendliest environments, with the highest rates of return. Insurance companies compete for capital like any other business. If we provide our investors a favorable risk-adjusted return, capital will be available. The better the return, the cheaper the capital, and the more competitive and stable we can be as an industry in terms of the products and services we provide.

Our history as an industry is troubling. On a risk-adjusted basis, returns overall have been substandard, and of course there is always a good reason why. And yet, we are moving once again towards a soft market part of the cycle while not having achieved an acceptable return on capital.

Along with the globalization of markets and capital flows is a trend toward the globalization of regulation, a movement led by the IAIS. A framework will evolve that provides a country level consistency of standards and vigilance in the regulation of markets and companies in exchange for reciprocity of home regulation. While such a framework is more advanced in banking, for instance, with the BIS protocols, we are beginning to see the same developments in insurance. The work of the IAIS in this regard is important.

There should be similar regulatory standards for solvency, governance and accounting globally. For each jurisdiction that subscribes to such standards, there should be recognition and respect accorded to the home country regulator. As a global company, ACE has a vested interest in this development. We are in favor of these efforts if done thoughtfully.

The Bermuda insurance market has become a major global center for insurance, but its regulatory system has not kept pace. The Bermuda Monetary Authority is taking steps to create and enforce more rigorous oversight and the introduction of a statutory solvency formula. We are active supporters of a more comprehensive and rigorous Bermuda regulatory environment.

The United States is 40% of the world insurance market. And yet, who represents us in the IAIS and the formulation of a global framework of standards and regulatory reciprocity? The 50-state system is a trade barrier that our own negotiators in Washington would not tolerate from another country. Fifty-state regulation is costly and highly inefficient. It is an anachronism. In the United States, the debate is heating up over an Optional Federal Charter. Next to TRIA, this is the most important piece of legislation affecting the U.S. insurance industry in Washington. It will likely take a few years to get an Optional Federal Charter, but we at ACE are absolute proponents and will be active supporters.

The other issue I'd like to touch on quickly is CAT risk. The CATS of 2004 and 2005 have had a measurable impact on rates for short-tail lines in the United States. Outside the United States,

however, the impact of the CATS to date has been marginal. Outside the U.S., an increasing cost of reinsurance protection, and the additional capital to write CAT-exposed business because of model changes and rating agency pressures, are still finding their way into the market. I believe it will happen. But the effect will vary by territory.

It's interesting to me how many insurers and reinsurers view the last two years' CAT losses as simply a U.S. wind problem and miss the larger issues concerning catastrophes: namely, the uncertainties around the frequency and severity of CAT risk, the imprecision of the related science and tools we use to measure and price CAT risk, along with a general trend toward an increasing concentration of values globally in CAT-prone areas. The U.S. CAT losses have simply shown us how much we have misjudged the risk. What about the CAT perils that haven't produced losses? Have we somehow done a better job understanding them? I doubt it.

The past two years have raised once again in the U.S. the issue of the best ways to address catastrophe-related pricing and funding. This is a major social and economic issue that likely requires a combination of public and private sector solutions. Insurance is the private sector solution, but in the U.S. the free market is impeded from operating efficiently, and that hurts availability. I believe the industry can do a better job of meeting the private sector need for catastrophe protection with a few changes – first, if we are allowed to charge the right price. This would in turn stimulate availability. Populist political pressure at the state level to disallow or limit rate increases and reinterpret wording for CAT coverage will force insurers to limit their exposure in CAT-prone areas. This is occurring as the risk of wind-related exposure seems to be increasing.

It is reasonable to expect those who live and work in CAT-prone areas – with insured values in these areas skyrocketing – to bear the true cost of their protection. Why should the rest of our country subsidize and pay for their decision to live and work in those areas? At some size, a CAT loss is large enough that the whole country shares part of the burden, particularly for loss of infrastructure and providing relief for those in our society who are less fortunate. We call that federal aid. Below that level, the responsibility should be local. To date, much of the cost of past events has been shared by the federal government. Therefore, in the end, we all pay.

What options are available to increase private sector catastrophe capacity? There are no perfect solutions, but freedom to charge the right price is a start. When it comes to CAT bonds and other capital markets solutions, a market has been developing, but it is still modest in size.

In my judgment, the single biggest opportunity for the industry to increase capacity globally is through the use of a CAT reserve, instead of the capital account, to fund catastrophe losses. A CAT reserve would be a more efficient means to increase an insurer's wherewithal to provide capacity over time. The U.S. and international accounting rule makers, FASB and IASB, will not on their own reverse their current views. Indeed, they are moving in the opposite direction. CAT reserves must become an issue of public policy. If current accounting and regulatory rules were modified, the industry could increase its ability to take risk.

There may be a limit to what the industry can do on its own in providing protection to the private sector. Similarly, there may be a role for government akin to an assigned risk pool for providing capacity where the private sector fails to meet demand. But if that's the case, it should be at the right economic price. Neither the federal government nor state governments should be in the business of subsidizing the cost of living in catastrophe areas. Nor should the government compete with the private sector on price.

We are now well into the second month of the North Atlantic Wind Season and, at least for the moment, this subject is receiving public attention.

Thank you for listening to my views.