What’s Keeping Insurance CEOs Awake at Night?

Especially in the Northwest

Washington Insurance Council
Seattle, WA

July 27, 2005
What’s Keeping Insurance CEOs Awake at Night?

- Maintaining Profitability
- Underwriting Discipline
- Pricing Discipline
- Investment Returns
- Controlling Expenses
- Capital & Capacity
- Improving the Operating Environment/Taming Cycle
- Tort Environment
- Terrorism
- Customer Satisfaction & Retention
- Q & A
CEO Concern #1

MAINTAINING PROFITABILITY

Sustainable P/C Profitability: An Oxymoron?
### Highlights: Property/Casualty, 2005:Q1 vs. 2004:Q1

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Written Prem.</td>
<td>108.4</td>
<td>105.8</td>
<td>+2.4%</td>
</tr>
<tr>
<td>Loss &amp; LAE</td>
<td>69.1</td>
<td>68.2</td>
<td>+1.4%</td>
</tr>
<tr>
<td>Net Inv. Income</td>
<td>+7.1</td>
<td>+5.3</td>
<td>+34.8%</td>
</tr>
<tr>
<td><strong>Net Income (a.t.)</strong></td>
<td>17.3</td>
<td>13.4</td>
<td>+29.3%</td>
</tr>
<tr>
<td>Surplus*</td>
<td>401.8</td>
<td>393.5</td>
<td>+2.1%</td>
</tr>
<tr>
<td>Combined Ratio**</td>
<td>91.9</td>
<td>98.1</td>
<td>-6.2 pt.</td>
</tr>
</tbody>
</table>

*2004 figure is as of December 31, 2004. **2004 figure is for full year.

Source: ISO, Insurance Information Institute

- Growth rate barely 1/2 that of CY2004
- Investment Income: Rebound?
- Net Income (a.t): Lowest in many years
### Highlights: Property/Casualty, 2004 vs. 2003

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Written Prem.</td>
<td>423,263</td>
<td>404,432</td>
<td>+4.7%</td>
</tr>
<tr>
<td>Loss &amp; LAE</td>
<td>299,545</td>
<td>288,656</td>
<td>+3.8%</td>
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<tr>
<td>Net UW Gain (Loss)</td>
<td>5,043</td>
<td>(4,853)</td>
<td>N/A</td>
</tr>
<tr>
<td>Net Inv. Income</td>
<td>39,589</td>
<td>38,648</td>
<td>+2.4%</td>
</tr>
<tr>
<td><strong>Net Income (a.t.)</strong></td>
<td>38,722</td>
<td>30,029</td>
<td>+28.9%</td>
</tr>
<tr>
<td>Surplus*</td>
<td>393,488</td>
<td>347,020</td>
<td>+13.4%</td>
</tr>
<tr>
<td>Combined Ratio</td>
<td>98.1</td>
<td>100.1</td>
<td>-2.0 pts.</td>
</tr>
</tbody>
</table>

Source: ISO, Insurance Information Institute
Early Sentiments on 2005 Based on Earnings Reports for First Half Data

• 2005 May Be Generally Better than Expected
• Personal Lines Surprises: Generally Upside
  ➢ PPA and HO premiums have not weakened as much as anticipated and underlying loss costs remain generally favorable (declining frequency); Light CAT losses so far!
• Commercial Lines: Mixed
  ➢ Underwriting results generally not bad by recent historical standards, but…
  ➢ Weakening pricing environment starting to take its toll
  ➢ Reliance on favorable reserve development?
• Reinsurers: Mixed
  ➢ Concern over primary pricing trends, Re capacity, CATs
• Brokers: Down
  ➢ Big brokers: loss of contingent commissions, pricing (cycle), fines, expense management all having impact
  ➢ Ongoing search for/execution of new economic model
Ad spending by P/C insurers is at a record high, signaling increased competition.

Source: Insurance Information Institute from consolidated P/C Annual Statement data.
P/C Net Income After Taxes
1991-2004 ($ Millions)

- 2001 ROE = -1.2%
- 2002 ROE = 2.2%
- 2003 ROE = 8.9%
- 2004 ROE = 10.5%*
- 2004:Q1 ROE = 15.1%

*ROE figures are GAAP; 2004 figure is return on average surplus. 2005 figure is for First Quarter.
Sources: A.M. Best, ISO, Insurance Information Institute.
ROE: P/C vs. All Industries
1987–2005F*

2005 P/C ROAS = 15.1%*
2004 P/C ROAS = 10.5%

2005 Fortune 500 ROE = 14.5%E

*GAAP ROEs except 2004/5 P/C figure = return on average surplus. 2005 figure is based on Q1 results.
Source: Insurance Information Institute; Fortune for all industry figures
Top 10 Largest P/C Stock Companies by ROE (2004)

- Progressive
- Allstate
- Hartford
- Chubb
- Stock Ins. Median
- Liberty Mutual*
- AIG
- Loews
- Berkshire Hathaway
- Nationwide*
- St Paul

*Not a stock company, but reported financial data according to Generally Accepted Accounting Principles.
Source: Fortune, April 18, 2005

The p/c insurance industry achieved its costs of capital in 2004 for the first time in many years.

US P/C insurers missed their cost of capital by an average 6.3 points from 1991 to 2003.

10-Year returns for some major p/c lines surprisingly good, but HO is a major laggard

Source: NAIC; Insurance Information Institute
RETURN ON EQUITY (Fortune): Stock & Mutual vs. All Companies*

Stock insurer ROEs consistently above mutuals

*Fortune 1,000 group.

P/C Insurers Up, Brokers & Reinsurers Down in 2005

Total Return 2005 YTD Through July 15, 2005

P/C insurer stocks outperforming the market

-4.29% -3.08% -1.74% 1.39% 4.57% 6.83% 9.67%

S&P 500 Life/Health All Insurers P/C Multiline Reinsurers Brokers

Source: SNL Securities, Standard & Poor’s, Insurance Information Institute
P/C insurance was finally holding its own against other financial services segments until hurricanes

*All figures GAAP except 2004 P/C figure is return on average surplus.
Source: Insurance Information Institute, Fortune, Value Line.
Washington is now an above-average performer after years of average (bad) performance.
Profits in WA in recent years are generally inadequate and are well below the Fortune 500 historical return of 13% - 14%.
ROE for Personal Lines in WA, 1992 - 2003

12-Year Average:
- Auto: 9.3%
- Home: 5.0%

Personal lines profitability is improving in WA

Source: NAIC
Return on Equity: 1994-2003
WA & Nearby States PP Auto

1994 - 2003

- California: 11.1%
- Idaho: 10.3%
- Oregon: 9.3%
- Washington: 8.3%
- US: 8.3%
- Montana: 5.0%

Source: NAIC, Insurance Information Institute
Return on Equity: 1994-2003
WA & Nearby States HO

1994-2003

Oregon: 8.1%
California: 7.5%
Idaho: 6.8%
Washington: 5.7%
US: 5.5%
Montana: 4.9%

Source: NAIC, Insurance Information Institute
Return on Equity: 1994-2003
WA & Nearby States CMP

Source: NAIC, Insurance Information Institute
INSURANCE INDUSTRY INVESTIGATIONS

Thoughts on Economic Consequences
ECONOMIC OUTCOMES

- INTERMEDIARY COMPENSATION
  - Contingent Commissions: Most brokers/agencies will take them (except largest brokers) and most insurers will pay them. Generally structured to achieve profitable growth. Disclosure inevitable but extent unknown.
  - Large Brokers: Difficulty replacing lost revenue; Search for a new economic model will be difficult (esp. as cycle turns). Calls for all to abandon contingent commissions will go unheeded

- FINITE
  - Product will remain viable, but with disclosure
  - Attempts at strict “bifurcation” will ultimately be recognized as unwise
  - FASB clarifications (eventually)

- OFFSHORE REINSURANCE
  - Insurers proactively examine offshore reinsurance affiliates for ownership and control. Board restructurings likely and dissolutions of some entities if unable to demonstrate “significant” transfer of risk.

- ACCOUNTING IRREGULARITIES
  - Restatements, starting to wind down
  - More conservative accounting, esp. on risk transfer issue
  - Earnings streams “less smooth” going forward
PUBLIC PERCEPTIONS OF INSURANCE INDUSTRY

Have Public Perceptions of the Industry Been Hurt by Scandal?
Percent of Public Rating Industry as Very or Mostly Favorable, 1968-2005

Awareness of Insurance Investigations

Awareness of Investigations

CEO Concern #2
UNDERWRITING

Can Discipline be Maintained?
2004 produced the first underwriting profit ($5.0 billion) since 1978; 2005 could be much larger

*2005 estimate is based on annualized actual 05Q1 underwriting profit of $7.1 billion.
Source: A.M. Best, Insurance Information Institute
The industry has just experienced its most remarkable recovery in recent history.

Combined Ratios
- 1970s: 100.3
- 1980s: 109.2
- 1990s: 107.8
- 2000-05E: 103.9

Sources: A.M. Best; ISO, III.

*2005 estimate is based on annualized actual first quarter 2005 result.
Commercial vs. Personal Lines
Combined Ratios

10-Year Average Combined Ratios*
Commercial: 109.9  Personal: 104.4

Compression of results is due to low interest.
Underwriting is now more important in long-tail commercial lines

Source: A.M. Best; Insurance Information Institute

*1994-2003 average
WA loss ratios are falling in personal and commercial lines, mirroring US
CASE STUDY: PERSONAL AUTO

A SUCCESSFUL SHIFT TO THE UNDERWRITING CULTURE?
Private Passenger Auto Combined Ratio

PPA is the profit juggernaut of the p/c insurance industry today

Average Combined 1993 to 2004 = 102.7

Many auto insurers have shown significant improvements in underwriting performance since mid-2002

Sources: A.M. Best; III
Loss Ratio: Private Passenger Auto Insurance

PP Auto has improved significantly

Widespread introduction of scoring

Spread of segmentation and tiering

Source: NAIC; 2003 figure from A.M. Best; Insurance Information Institute
Average Expenditures on Auto Insurance

Countrywide auto insurance expenditures are expected to rise 1.5% in 2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditures</th>
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<tbody>
<tr>
<td>95</td>
<td>$668</td>
</tr>
<tr>
<td>96</td>
<td>$691</td>
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<td>97</td>
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<td>02</td>
<td>$774</td>
</tr>
<tr>
<td>03*</td>
<td>$834</td>
</tr>
<tr>
<td>04*</td>
<td>$857</td>
</tr>
<tr>
<td>05*</td>
<td>$870</td>
</tr>
</tbody>
</table>

*Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute
Private Passenger Auto: Incurred Loss Ratios, 1999-2004

Loss ratios for all major coverage are trending downward

Source: ISO Fast Track; Insurance Information Institute.
Pure Premium Spread: Personal Auto PD Liability, 2000-2005:Q1

Source: Insurance Information Institute calculations based ISO Fast Track and US BLS data.

Medical inflation a powerful cost driver

Source: ISO Fast Track data.
WA Bodily Injury: Frequency & Severity Trends Now Rising

Source: ISO Fast Track data.

Washington BI trends are mixed since 2001

Frequency Severity

-8.3% -3.0% 3.0% 5.4%

-8% -6% -4% -2% 0% 2% 4% 6% 8%

01 02 03 04
US Collision: Frequency Trend Swamps Rising Claim Severity

Source: ISO Fast Track data.
WA Collision: Frequency & Severity Now Rising

Washington Collision trends not as favorable as the US

Source: ISO Fast Track data.
US Comprehensive: Favorable Frequency and Severity Trends

Source: ISO Fast Track data.
WA Comprehensive: Favorable Frequency and Severity Trends

Source: ISO Fast Track data.
WHY UNDERWRITING DISCIPLINE MATTERS
A 100 Combined Ratio Isn’t What it Used to Be: 95 is Where It’s At

Combined ratios today must be below 95 to generate Fortune 500 ROEs

* 2004/5 figures are return on average statutory surplus. 2005:Q1 figure adjusted for impact of special dividend.

Source: Insurance Information Institute from A.M. Best and ISO data.
Underwriting Matters Because Pricing is Often Undisciplined
Somebody forgot there’s a relationship between price and underwriting performance.

Sources: Insurance Information Institute from A.M. Best and NAIC data; 2004/5 expenditure estimates from III.
UNDERWRITING AFFECTS FINANCIAL STRENGTH

Is There Cause for Concern?
Downgrade to upgrade ratio is falling (primarily because the number of downgrades is falling; only a small increase in upgrades)


P/C Insurer Downgrades & Upgrades, 2000 to 2004*

Downgrades skyrocketed beginning in 2001 while upgrades fell

*12-month period ended July 12, 2004
Source: Insurance Information Institute from A.M. Best data.
Historical Ratings Distribution,
US P/C Insurers, 2000 vs. 2004

Insurers with strong ratings are far less likely to become impaired over long periods of time. Especially important in long-tailed lines.


*US P/C and L/H companies, 1977-2002*
The number of p/c insurer failures fell by more than 50% in 2004.
Reason for P/C Insolvencies
(218 Insolvencies, 1993-2002)

- Deficient Loss Reserves: 51%
- Unidentified: 17%
- Impaired Affiliate: 3%
- CAT Losses: 3%
- Reinsurer Failure: 0%
- Change in Business: 3%
- Discounted Ops: 8%
- Overstated Assets: 2%
- Alleged Fraud: 3%
- Rapid Growth: 10%
- Source: A.M. Best, Insurance Information Institute

Reserve deficiencies account for more than half of all p/c insurers insolvencies.
P/C Insurance Industry Prior Year Reserve Development by Line, 2002-03*

Major adverse development in casualty segments, little in personal lines

Why did most lines develop so adversely in 2003?

Who’s to blame?

*Negative numbers indicate favorable development; positive figures represent adverse development.
INSURANCE-TO-VALUE:

Ending the Blame Game is a Win-Win Situation Deal
Insurance-to-Value in HO is a National Problem, Improved Recently

Less than ITV means homeowners insurers left $8 billion on the table in 2003*

*According MS/B.
Source: Marshall & Swift/Boeckh

Proportion of Home Undervalued
- 2002: 73%
- 2003: 64%
- 2004: 61%

Average Undervaluation
- 2002: 35%
- 2003: 27%
- 2004: 25%
Why People Don’t Increase Homeowners Coverage

- 22% cite expense as reason they don’t adjust they’re HO coverage
- 25% don’t realize they need to
- 30% say they’re too busy (to think about protecting their most valuable asset)
- 25% say their agent said there’s nothing to worry about

Source: Harris interactive poll conducted for Fireman’s Fund, July 2004.
See: http://www.firemansfund.com/dcmssites/about/pdf/firemansfundtoplinerev2.pdf
CATASTROPHE LOSS MANAGEMENT

Failure to Adequately Manage this Risk Has Been Devastating
Most of US Population & Property Has Major CAT Exposure

Source: National Earthquake Information Center (USGS); Insurance Information Institute
2004 was the second worst year ever for natural disaster losses in the US after adjusting for inflation. About 83% of those losses originated in Florida.

*As of 6/30/05 plus $920 in insured for Hurricane Dennis in July.

Note: 2001 figure includes $20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims.

Source: Property Claims Service/ISO; Insurance Information Institute
ROE: P/C vs. All Industries 1987–2004E*

*2004 p/c estimate based on first 9 months data.
Source: Insurance Information Institute; Fortune

Hugo
Andrew
Northridge
Lowest CAT losses in 15 years
Sept. 11
2004 ROE excl. hurricanes
2004 ROE reduced due to hurricanes
Top 10 Major Disaster Declaration Totals By State (1972-2004)

SURPRISE: Washington is among the Top 10 states in terms of major disaster declarations.

Source: Federal Emergency Management Agency (FEMA)
CEO Concern #3
PRICING
Can Discipline be Maintained?
Strength of Recent Hard Markets by NWP Growth*

Real NWP Growth During Past 3 Hard Markets

1975-78: 8.6%
1984-87: 11.2%
2001-04: 6.9%

Premium growth is faltering. Real growth in 2005 will be NEGATIVE

Note: Shaded areas denote hard market periods.
Source: A.M. Best, Insurance Information Institute

*2005 figure is III forecast based on 05Q1 result.
Average Expenditures on Auto Insurance

Countrywide auto insurance expenditures are expected to rise 1.5% in 2005

Will the “big guys” stay disciplined? So far, so good. Will adopt tiering to avoid adverse selection

WA’s 2002 avg. auto ins. expenditure (latest available) was $788, ranking it 18th

*Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute
Average Expenditures on Homeowners Insurance

Countrywide home insurance expenditures are expected to rise 2.5% in 2005

WA’s 2001 avg. HO ins. expenditure (latest available) was $456, ranking it 32nd

*Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute
Commercial Premium Rate Changes Are Sharply Lower

Is moderation due to realization of performance and profit goals, increasing capacity/capital, or market-share strategies?

Source: MarketScout.com
Proportion of Accounts Renewing Negative by Region, 2005:Q2

Source: Board of Governors, Fed. Reserve System; Blue Chip Economic Indicators as of March 2005.
Commercial accounts have trending downward for 4-5 quarters, with large commercial leading the way.
Commercial rates are well off their late 2003 peaks for accounts of all size and are approximately where they were in mid-2002.

At which point do the reductions become destructive?
Average Rate Change, All Lines, (1Q:2004 – 1Q:2005)

Magnitude of rate decreases accelerated during the first quarter of 2005

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Rate Changes by Line,
1st Qtr. 2005

Magnitude of rate decreases accelerated during the first quarter of 2005

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
**P/C Soft Spots: % Accounts With Negative Price Change**

(1st Qtr. 2005)

- Comm Prop Biz Interruption: 88%
- Property: 71%
- Casualty/Liability/Terrorism: 69%
- Comm Auto: 60%
- WC: 80%
- GL: 50%
- EPL: 70%
- Umbrella: 70%

Significant moderation now evident in the commercial casualty lines.

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
P/C Soft Spots: % Accounts With Negative Price Change (4th Qtr. 2003)

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
P/C Soft Spots: % Accounts With Negative Price Change (4th Qtr. 2002)

Source: Council of Insurance Agents & Brokers; Insurance Information Institute
Does Investment Performance Affect Discipline?
Investment gains are rising but in 2004 were still nearly 15% below their 1998 peak.

*Investment gains consist primarily of interest, stock dividends and realized capital gains and losses. 2005 figure is as of 3/31/05.

Source: Insurance Services Office; Insurance Information Institute.
Net Investment Income

Growth History

2002: -1.3%
2003: +3.9%
2004: +2.4%
2005:Q1: +20.2%**

Source: A.M. Best, ISO, Insurance Information Institute;
Realized capital gains rebounded strongly in 2003/4 but are 48% below their 1998 peak.

Sources: A.M. Best, ISO, Insurance Information Institute.
S&P 500 was up 9% in 2004. Fears of higher interest rates, inflation, the falling dollar, resurgent oil prices are concerns in 2005.

2003/4 were the first consecutive gains since 1999.
Interest Rates: Lower Than They’ve Been in Decades, But…

- Lower bond yields were the primary driver behind weak investment income in recent years, with the 10-year note reaching a 45-year low in 2003 and falling again in 2005.
- Higher ST rates as Fed tightens.
- Just 57bp between 1-yr & 10-yr yields*

Source: Board of Governors, Federal Reserve System; Insurance Info. Institute  *June 2005 averages.
10-Year Treasury Yields Remain Low and Are Falling*

Persistently low interest rates on the 10-year Treasury is a major impediment to investment income growth.

Nine rate hikes by the Fed since June 2004 have lifted ST rates, but not LT yields.

Source: Board of Governors, Federal Reserve System; Insurance Info. Institute  *As of 7/13/05.
P/C Insurance Industry
Investment Portfolio, 2003

P/C insurers portfolio is very conservatively invested, with 2/3 of invested assets held as bonds—mostly munis, high-grade corporate bonds and US Treasury securities.
The Treasury Yield Curve Has Become Very Flat

“Among the biggest surprises of the past year has been the pronounced decline in long-term interest rates on U.S. Treasury securities despite a 2-percentage point increase in the federal funds rate. This is clearly without recent precedent.”

-Fed Chairman Alan Greenspan before the Joint Economic Committee of Congress, June 9, 2005

Proportion of P/C Portfolio Invested in Cash and ST Securities

Holdings of cash and short-term securities has more than doubled since 1999

Source: A.M. Best; Insurance Information Institute
Proportion of P/C Bond Portfolio With Maturities of 1 Year or Less

Holdings of bonds with maturities of 1 year or less are up 50% since 1999

Source: A.M. Best; Insurance Information Institute
Proportion of P/C Bond Portfolio With Maturities of 10 to 20 Years

Holdings of bonds with maturities of 10-20 years is down by 27.5% since 1999 and 33.6% since 1994

Source: A.M. Best; Insurance Information Institute
Maturity Distribution of P/C Bond Portfolio, 1999–2004E

Source: A.M. Best; Insurance Information Institute
Average Maturity of Bonds Held in P/C Portfolio, 1994-2004E*


Source: A.M. Best; Insurance Information Institute

The average maturity of p/c bold holdings is down nearly 1.5 years since 1999.
Duration of P/C Fixed Income Portfolio, Selected Cos., 2001-2004*

Average duration is falling as insurers minimize interest rate risk and position themselves for higher long-term yields by staying short and accumulating cash.

Adjusted duration includes cash and ST investments in calculation.

*As of Dec. 31 of each year. Based on sample of 50 p/c insurance companies. Source: Credit Suisse First Boston.
Reasons for Persistently Low Long-Term Interest Rates in the US

- Expectation of Future Economic Weakness
  - Weakness may be global in scale
  - Inflation fears for the longer-term are therefore subdued
- Foreign Central Bank Purchases of US Treasurys
  - Especially China & other Asian central banks
- Falling Interest Rates in Other Major Economies
  - Other central banks cutting rates (or holding constant)
- Excess of Savings Elsewhere in World Relative to US
  - Direct result of massive US trade imbalances
  - Money comes back to US in form of purchases of US bonds
- Weakness in Euro; Crisis of Confidence in EU
  - Rotation out of Euro and back into the US dollar
Long/Short-term rates are expected to rise and then stabilize.

Source: Board of Governors, Fed. Reserve System; Blue Chip Economic Indicators as of March 2005.
CEO Concern #5
EXPENSES

Will Expense Ratio Rise as Premium Growth Slows?
**Underwriting Expense Ratio**
**All Lines, 1994-2005F**

*Ratio of expenses incurred to net premiums written.
Source: A.M. Best; Insurance Information Institute

Insurers are keeping expenses under control, but pressure will mount as premium growth slows.
CEO Concern #6
LEVERAGE & CAPITAL MGMT.

Can the Industry Efficiently Employ Its Increasing Capital?
Surplus (capacity) peaked at $339.3 Billion in mid-1999 and fell by 15.9% ($53.9 billion) to $285.4 billion at year-end 2002.

Surplus is up $125.5B or 44% since year-end 2002.

Surplus increased by $17.4B or 4.4% to $410.9B by 2005:Q1 from $393.5B at year-end 2004.

“Surplus” is a measure of underwriting capacity. It is analogous to “Owners Equity” or “Net Worth” in non-insurance organizations.

Capacity TODAY is 21% above its mid-1999 peak and 44% above its 2002 trough.

Source: A.M. Best, ISO, Insurance Information Institute

*As of 3/31/05.
Leverage is decreasing as PHS grows more quickly than NPW, holding down profitability.
Capital Punishment: What Should & Shouldn’t Be Done With Excess Capital

What Should be Done (Likely favorable impact)
• Increase shareholder dividends (stock companies)
• Share buybacks (stock companies)
• Increase policyholder dividends (mutual companies)
• Pay dividend to parent entity (subsidiaries/affiliates)

What Could Be Done (Impact uncertain)
• Make acquisitions
• “Buy” a ratings upgrade
• Expand geographically or into new lines

What Shouldn’t Be Done (Unfavorable impacts likely)
• Cut prices significantly leading to huge U/W losses
• Offer products as loss leaders (e.g., HO)
<table>
<thead>
<tr>
<th>Company</th>
<th>Amount/Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Axis Capital</td>
<td>$350MM Share Buyback</td>
</tr>
<tr>
<td>Progressive</td>
<td>$1.487B Share Buyback</td>
</tr>
<tr>
<td>Pinnacol Assurance</td>
<td>$55MM Policyholder Div.</td>
</tr>
<tr>
<td>Unitrin</td>
<td>Boost Shareholder Div.</td>
</tr>
<tr>
<td>Allianz</td>
<td>60% Increase in SH Div.</td>
</tr>
<tr>
<td>Allstate</td>
<td>$4B Share Buyback</td>
</tr>
</tbody>
</table>

*Completed and announced 2004 or 2005 (through 7/13).
Source: Insurance Information Institute from Lexis/Nexis search 1/1/2004 – 7/14/05.
CEOM Concer #7
P/C OPERATING ENVIRONMENT

Have Things Changed for the Better?
YES!
YES!

It Will Be Different This Time Around!

• New Management: Benefit of 20/20 Hindsight
  ➢ Most (re)insurer CEOs have been replaced over past 5 years
  ➢ New management teams not eager to repeat past mistakes
  ➢ Management Mantra: Preaching Disciplined UW & Pricing

• Information Flow:
  ➢ Many insurers have now implemented MIS systems that reduce recognition lags & reaction times and increase info flow

• Compensation Structure: Closer Link to Performance?
  ➢ Stock incentives playing a lesser role
  ➢ Strict adherence to UW manual and pricing

• Sarbanes-Oxley & Increased Transparency
  ➢ CEO/CFO’s personal assets on the line
  ➢ Board of Directors quality enhanced; less chummy
  ➢ Reserves become more adequate
  ➢ Actuaries, UWs, accountants all on board & getting tough
  ➢ Investigations will require more data reporting
YES!

It Will Be Different This Time Around!

• Ratings Agencies
  ➢ Have become *de facto* regulators
  ➢ Keeping a tight leash on upgrades and paying a lot of attention to capital/reserve adequacy & profitability-industry disciplined

• Investment Analysts
  ➢ Subject insurers to greater scrutiny

• Regulators
  ➢ Finally waking up

• Quasi-Regulators
  ➢ Spitzer, other AGs, SEC will keep industry on its toes

• Tort reform is finally happening

• Republican Domination of Congress/White House Good for Industry

• We’re Better at Anticipating New/Emerging Risks

• Better at Managing Existing Risks/Reducing Volatility
NO!
NO!

It Won’t Be Different This Time Around!

- Management Never Learns: Hindsight Means Nothing
  - 80 years of history show management repeats same mistakes
  - Quarterly earnings and growth targets are still king
  - Mantra of UW & Pricing discipline is just lip service

- P/C Insurance Will Always Be an Impossible Business
  - Impossible to use past information to determine prices today for a product sold tomorrow for claims that may arise in the distant future AND expect to be right

- Investor Fatigue
  - Wall Street is fed up with low returns; no capital for you
  - Capital is now highly opportunistic; not committed to long run

- Investments: Still Used to Paper Over Poor UW & Pricing Decisions
  - Cash flow underwriting is back in vogue (or soon will be)
It Won’t Be Different This Time Around!

• Regulators Still Asleep at the Switch
  - E.g., Piling on to Spitzer investigation
  - Vehement defense on status quo regulatory environment

• Still do Bad Job Managing Variability/Volatility
  - 2004 hurricane season, D&O, Products Liability
  - Constantly blindsided

• Tort Reform: Keep on Dreamin’
  - Big loopholes in Class Action Fairness Act
  - Act was watered down (no atty. fee limits or damage caps)
  - Forum shopping at the federal level still possible

• Republican Congress/White House Don’t Care About Us
  - Except CAFA, little success in Washington over past few years
  - Spitzer investigation = opportunity to heap scorn on industry
CEO Concern #8
TORT
ENVIRONMENT

Have Things Changed for the Better?
Personal, Commercial & Self (Un) Insured Tort Costs*

*Excludes medical malpractice
Source: Tillinghast-Towers Perrin
The Nation’s Judicial Hellholes

Source: American Tort Reform Association; Insurance Information Institute
Business Leaders Ranking of Liability Systems for 2005

Best States
1. Delaware
2. Nebraska
3. North Dakota
4. Virginia
5. Iowa
6. Indiana
7. Minnesota
8. South Dakota
9. Wyoming
10. Idaho

New in 2005
ND, IN, SD, WY

Drop-Offs
ID, UT, NH, KS

Worst States
41. Hawaii
42. Florida
43. Arkansas
44. Texas
45. California
46. Illinois
47. Louisiana
48. Alabama
49. West Virginia
50. Mississippi

Newly Notorious
HI, FL

Rising Above
MO, MT

WA Rankings
2002: 3
2003: 21
2004: 24
2005: 15

Cost of U.S. Tort System
($ Billions)

Tort costs will consume an estimated 2.24% of GDP in 2005

Per capita “tort tax” was $845 in 2003, up from $680 in 2000

Reducing tort costs relative to GDP by just 0.25% (to about 2%) would produce an economic stimulus of $27.5B

Source: Tillinghast-Towers Perrin.
Tort System Costs, 2000-2006E

After a period of rapid escalation, tort system costs as % of GDP appear to be stabilizing.

Source: Tillinghast-Towers Perrin
CEO Concern #9
TERRORISM

Will TRIA be Renewed?
TRIA UPDATE

• TRIA expires December 31, 2005
• Treasury completed its study of the program 6/30/05 – did not back reauthorization of TRIA in *current form*
• Insurers & coalition partners have established strong case for TRIA extension, but Treasury believes still clings to 4 myths:
  1. Terrorism is insurable
  2. Govt. crowds out pvt. capital/innovation
  3. Insurance is a “free market”
  4. Ample capacity now exists
• Basically political/ideological issue for relatively small number in Congress and a few policymakers
• Senate & House hearings held in July 2005
• London terrorist attacks may give TRIA opponents pause
• *Legislation now looks likely*
If Congress were to reauthorize TRIA, these are the key changes that insurers required to make:

- The event size that triggers coverage must be increased from current $5 million level to $500 million.
- Dollar deductibles and percentage co-payments must be increased.
- Certain lines of insurance, such as commercial auto, GL and other smaller lines must be eliminated from the program.
- Reforms to ensure that injured plaintiffs can recover against negligent defendants, but not by exploiting the litigation system.
Terrorism Insurance Market Overview

Terrorism Take-Up Rates, Coverage Types & Pricing
Terrorism Coverage: Take-Up Rates by Region

Source: Marsh, Inc.; Insurance Information Institute

Terrorism take-up rates are lowest in the Northeast and Midwest.

<table>
<thead>
<tr>
<th>Region</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northeast</td>
<td>30.3%</td>
<td>53.2%</td>
</tr>
<tr>
<td>Midwest</td>
<td>26.2%</td>
<td>52.5%</td>
</tr>
<tr>
<td>South</td>
<td>21.8%</td>
<td>46.7%</td>
</tr>
<tr>
<td>West</td>
<td>18.6%</td>
<td>34.2%</td>
</tr>
</tbody>
</table>
States with legislation that excludes terrorism from SFP policies

Source: Marsh, Inc.

Insurers and their trade associations have been lobbying the legislatures of the SFP states to limit fire coverage resulting from a terrorist attack.

WA, ID, OR and CA are all fire following states.
CEO Concern #10

CUSTOMER SATISFACTION & RETENTION

Attracting & Retaining Customers is Key for the Bottom Line
Leading Reasons for Choosing Current Home Insurance Provider

- Combined All Coverage/Multi-Policy Discount: 63%
- Good Rates: 60%
- Good Reputation: 49%
- Convenience of Doing Business: 43%
- Good Past Experience: 42%
- Good Coverage/Variety of Products: 32%
- Agent Recommendation: 24%
- Family/Friend Recommendation: 21%

Home Insurance Overall Customer Satisfaction Index

Other Products /Services Purchased from Current HO Provider

<table>
<thead>
<tr>
<th>Product</th>
<th>Percentage</th>
<th>Overall Satisfaction Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto</td>
<td>89%</td>
<td>796</td>
</tr>
<tr>
<td>Valuable Poss. Coverage</td>
<td>20%</td>
<td>818</td>
</tr>
<tr>
<td>Personal Umbrella</td>
<td>16%</td>
<td>820</td>
</tr>
<tr>
<td>Life</td>
<td>15%</td>
<td>819</td>
</tr>
<tr>
<td>Flood</td>
<td>10%</td>
<td>786</td>
</tr>
<tr>
<td>Auto Club/Road Asst.</td>
<td>7%</td>
<td>834</td>
</tr>
<tr>
<td>Earthquake</td>
<td>7%</td>
<td>804</td>
</tr>
<tr>
<td>Boat</td>
<td>6%</td>
<td>805</td>
</tr>
<tr>
<td>Other</td>
<td>6%</td>
<td>810</td>
</tr>
<tr>
<td>Banking/Mortgage</td>
<td>3%</td>
<td>838</td>
</tr>
<tr>
<td>Hurricane Coverage</td>
<td>3%</td>
<td>780</td>
</tr>
<tr>
<td>Finl. Consulting/Inv. Services</td>
<td>2%</td>
<td>883</td>
</tr>
<tr>
<td>Home Office/Biz Equip.</td>
<td>2%</td>
<td>837</td>
</tr>
</tbody>
</table>


Highest for financial consulting & investment services.
PERSONAL LINES OVERVIEW
AUTO & HOME:

A SUCCESSFUL SHIFT TO THE UNDERWRITING CULTURE?
Private Passenger Auto
Private Passenger Auto is
Enormous Part of P/C Industry

Total 2003 Direct Personal + Commercial Premiums Written
= $442.6 Billion

PPA Liability 20.1%
PPA Phys Dam 14.2%
All Commercial Lines 52.1%
Homeowners 11%

Private passenger auto accounted for 34% or $156.6B in DPW in 2003

Source: A.M. Best; Insurance Information Institute
PPA is the profit juggernaut of the p/c insurance industry today

Average Combined 1993 to 2004= 102.7

Many auto insurers have shown significant improvements in underwriting performance since mid-2002

Sources: A.M. Best; III
Loss Ratio: Private Passenger Auto Insurance

PP Auto has improved significantly

Source: NAIC; 2003 figure from A.M. Best; Insurance Information Institute
Average Expenditures on Auto Insurance

Countrywide auto insurance expenditures are expected to rise 1.5% in 2005

*Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute
Private Passenger Auto: Incurred Loss Ratios, 1999-2004

Loss ratios for all major coverage are trending downward

Source: ISO Fast Track; Insurance Information Institute.
Pure Premium Spread: Personal Auto PD Liability, 2000-2005:Q1

Source: Insurance Information Institute calculations based ISO Fast Track and US BLS data.
Bodily Injury: Severity Trends Now Offset Declining Claim Freq.

Medical inflation a powerful cost driver

Source: ISO Fast Track data.
WA Bodily Injury: Severity Trends Now Offset Declining Claim Freq.

Washington BI trends are mixed

Source: ISO Fast Track data.
Collision: Frequency Trend
Swamps Rising Claim Severity

Source: ISO Fast Track data.
WA Collision: Frequency Trend Swamps Rising Claim Severity

Washington Collision trends not as favorable as the US

Source: ISO Fast Track data.
Comprehensive: Favorable Frequency and Severity Trends

Source: ISO Fast Track data.
Vehicles Involved in Injury Crashes, 1993 vs. 2003

Injury crash rate is down 25%+ for cars, just 3.4% for light trucks/SUVs

Source: U.S. Dept. of Transportation; Insurance Information Institute
Vehicles Involved in Property Damage-Only Crashes, 1993 vs. 2003

Rate per 100,000 Registered Vehicles

- Car PD crashes down 16%, but truck/SUV less than 2%

Rate per 100 Million Vehicle Miles Traveled

Source: U.S. Dept. of Transportation; Insurance Information Institute
Private passenger auto profitability deteriorated throughout the 1990s but has improved dramatically. Segmentation should help profitability.
What’s Driving the Good Results in Private Passenger Auto?

• Favorable Frequency Trend is Obvious Reason
• What is Driving Downward Claim Frequency?
  - More vehicles relative to drivers
  - Aging population: Now solidly in safest driving years
  - Safer vehicles, drivers & roads
  - Crackdowns of Fraud & Abuse
  - Larger deductibles
  - Policyholders have better understanding of relationship between filing a claim and premium impact
  - Similar to experience in worker comp area
• Can the Downward Frequency Trend be Sustained?
  - Probably yes
  - More customers migrating to higher deductible policies
  - Insurance knowledge of policyholder continuing to grow
  - Secular trend driving frequency (emphasis on car, road safety, etc., will continue indefinitely)
Accidents by Age of Driver, 2003

Graduated licensing, more education should help

Teens are by far the most likely to be involved in accident than the elderly (but elderly more likely to die in crash)

Source: National Safety Council; Insurance Information Institute
Homeowners
Homeowners as a Percentage of the P/C Industry

Total 2003 Direct Personal + Commercial Premiums Written = $442.6 Billion

- All Commercial Lines 52%
- PPA Liability 20%
- PPA Phys Dam 14%
- Homeowners 11%
- Homeowners insurance accounted for 11% or $48.7B in DPW in 2003

Source: A.M. Best; Insurance Information Institute
### New Private Housing Starts (Millions of Units)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>New</td>
<td>1.19</td>
<td>1.20</td>
<td>1.29</td>
<td>1.46</td>
<td>1.47</td>
<td>1.62</td>
<td>1.64</td>
<td>1.57</td>
<td>1.60</td>
<td>1.71</td>
<td>1.85</td>
<td>1.96</td>
</tr>
</tbody>
</table>

**Source:** US Department of Commerce; Blue Chip Economic Indicators (3/05), Insurance Info. Institute

Exposure growth forecast for HO insurers is excellent, though new building is expected to slow modestly.
Countrywide home insurance expenditures are expected to rise 2.5% in 2005.

Average Expenditures on Homeowners Insurance

*Insurance Information Institute Estimates/Forecasts
Source: NAIC, Insurance Information Institute
Homeowners Insurance
Combined Ratio

Average 1990 to 2004E = 114

Insurers have paid out an average of $1.15 in losses for every dollar earned in premiums over the past 14 years.

Sources: A.M. Best; III
Loss Ratio: Homeowners

Homeowners loss ratio is very volatile, but has improved nationally.

Source: NAIC; 2003 figure from A.M. Best; Insurance Information Institute
Homeowners Paid Claim
Frequency & Severity, 2000 – 2004

HO paid claim frequency falling while severity is increasing

Sources: ISO; Insurance Information Institute
Rates of Return on Net Worth for Homeowners Ins: US

Averages: 1993 to 2004E
US HO Insurance = +3.1%

Source: NAIC; 2003/4 figures are Insurance Information Institute estimates.
Homeowners Insurance Expenditure as a % of Median Home Price

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

*Based on NAR existing home sales data as of Feb. 2005 and III HO expenditure estimate for 2005.

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

Commercial Auto
Commercial Multi-Peril
Inland Marine
Workers Comp
# Top 10 Concerns of Small Businesses, 2004

<table>
<thead>
<tr>
<th>2004 Rank</th>
<th>Concern</th>
<th>2000 Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Health Insurance Costs</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Liability Ins. Cost/Availability</td>
<td>13</td>
</tr>
<tr>
<td>3</td>
<td>Workers Comp Costs</td>
<td>7</td>
</tr>
<tr>
<td>4</td>
<td>Fuel Costs</td>
<td>10</td>
</tr>
<tr>
<td>5</td>
<td>Federal Income Taxes</td>
<td>2</td>
</tr>
<tr>
<td>6</td>
<td>Property Taxes</td>
<td>NEW</td>
</tr>
<tr>
<td>7</td>
<td>Cash Flow</td>
<td>9</td>
</tr>
<tr>
<td>8</td>
<td>State Taxes on Biz Inc.</td>
<td>6</td>
</tr>
<tr>
<td>9</td>
<td>Govt. Regulation</td>
<td>4</td>
</tr>
<tr>
<td>10</td>
<td>Electricity Costs</td>
<td>19</td>
</tr>
</tbody>
</table>

Source: National Federation of Independent Businesses; Insurance Information Institute
How the Risk Dollar is Spent (2004)
(Firms with Revenues > $1 billion)

Workers Comp, Liability and Property coverages are the Risk Manager’s largest budget items.

Source: RIMS Benchmark Survey (2004); Insurance Information Institute

Commercial auto combined ratio has improved dramatically since 1999-2001.

Source: A.M. Best Review/Preview, January 2005; Insurance Information Institute
Commercial Multi-Peril: Combined Ratio, 1994 — 2005F

Combined Liability & Non-Liability

Liability portion of Commercial Multi-Peril remains problematic

Source: A.M. Best Review/Preview, January 2005; Insurance Information Institute

Inland Marine is one of the most consistently profitable of all major p/c lines.

Source: A.M. Best Review/Preview, January 2005; Insurance Information Institute
Summary

- 2004/5 represent “sweet spot” in the current cycle for p/c insurance (underwriting/earnings)
- Cyclical concerns quickly becoming significant issue
- Personal lines better positioned than commercial
- Rising investment returns insufficient to support deep soft market in terms of price, terms & conditions
- Clear need to be more underwriting focused
- Major Challenges:
  - Maintaining price/underwriting discipline
  - Managing variability/volatility of results
  - New/emerging/re-emerging risks
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