

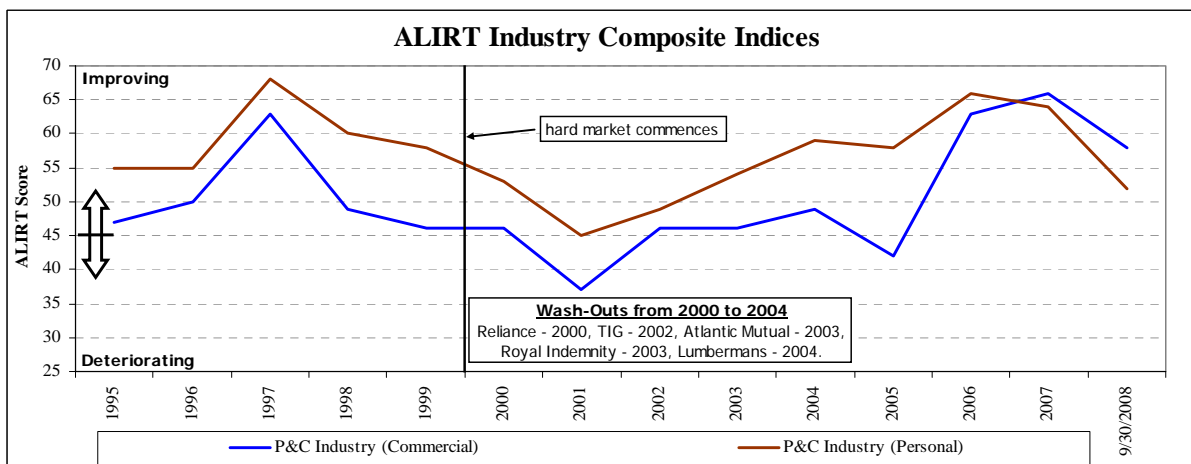


P&C Industry Review Nine Months 2008 – Surplus Hit Hard
(December 1, 2008)

The impact of four years of soft pricing, heavy catastrophe losses, and investment losses from the on-going global financial crisis contributed to weakened underwriting results and a sharp decline in surplus for the P&C industry (as measured by the ALIRT P&C Composite¹) in the first nine months of 2008. Interestingly, shareholder dividends paid remained high in the first nine months of 2008, even in the face of sharply deteriorating capital markets and weak pricing.

There is now much talk about whether the current pricing cycle has troughed, given predictions that aggregate surplus for the U.S. property & casualty industry could be \$50-100 billion lower than peak levels by year-end 2008. While this number seems high, the potential for more investment losses, whether realized or unrealized, remains a wildcard that – given the volatility in today’s capital markets – cannot be predicted with any degree of accuracy.

Throughout this review we discuss other factors potentially impacting a turn in the pricing cycle, however it is important to recognize that – whenever the *pricing turn* occurs – the *financial strength cycle* of property & casualty insurers lags by a number of years. The graph below displays the ALIRT P&C scores for both the commercial and personal lines composites over the past 14 years.²



The last turn in pricing occurred in 2000, with the financial performance of both commercial and personal lines insurers bottoming out a year later (2001). A number of high profile failures/run-offs occurred over the five years 2000-2004, while prices were hardening. As can be seen, the industry financial strength appears to have peaked in 2006-2007, with the 2008 results representing a decided downturn. If a pricing upturn does indeed come in 2009 or 2010, we will likely face a multi-year period of financial stress for a number of insurers. Whether financial deterioration in the aftermath of the present soft pricing cycle proves to be as severe as in the prior cycle remains to be seen.

¹ The ALIRT P&C Composite is comprised of 50 large U.S. P&C insurers, representing approximately 53% of total industry net written premium.
² Each composite represents 100 of the largest U.S. insurers when measured by net premiums written.

Executive Summary: ALIRT P&C Composite Results

Below we provide nine month 2008 financial highlights for the ALIRT P&C Composite, based on insurers' statutory financial statements.

- The ALIRT P&C Composite reported a nine month 2008 combined ratio of 102.5%, a substantial deterioration from the prior year period results (93.4%), and an increase of 2.8 percentage points in the third quarter alone, largely due to higher catastrophe losses. The Composite operating ratio was 91.4% and pretax return on earned premium was 8.4%, both weaker than the prior year period and full year 2007 results.
- Reported underwriting results were aided by \$6.4 billion of net reserve releases in the first nine months of 2008, with the majority of redundant reserves coming from the 2007 accident year. As of 9/30/08, aggregate composite reserves were slightly redundant for accident years 2005 (and prior) - a reversal from slight reserve deficiency at year end 2007 - while reserve releases for accident years 2006 and 2007 accelerated in the third quarter.
- The accident year combined ratio (which excludes the impact of prior year reserve development) was 106.2% for the first nine months of 2008, 10.9 percentage points higher than the prior year period results. This is due in part to the well above average catastrophe losses through the first nine months of the year, including a portion of the Ike and Gustav losses. ***The accident year results have now underperformed reported results for ten consecutive quarters, a reflection of reserve releases into earnings and a traditional indication of a soft market cycle.***
- Nine month 2008 pretax operating income of \$14.5 billion was 52% lower than that for the prior year period, reflecting declining premium flow, a dramatic drop-off in underwriting income (due in part, again, to the higher catastrophe losses), and weaker net investment income. Composite pretax ROE fell 770 basis points to 7.0% (annualized) when compared to the full year 2007 ROE of 14.7%.
- In the first nine months of 2008, net investment yield fell by 48 basis points to 4.19% (annualized), from 4.68% for the full year 2007. Deterioration in total return was more pronounced, falling by 806 basis points to -1.57% (annualized), which reflects the lower yield but especially the large net capital losses, which were driven largely by weaker equity markets (but also potentially by widening bond spreads and credit downgrades).
- ***Composite surplus fell 9.0% in the first nine months of 2008***, the first – and substantially larger – decline in composite surplus since year end 2002 (-4.6%). Weaker earnings combined with net capital losses of \$26.5 billion (vs. net capital losses of \$8.4 billion for the first half of 2008), and shareholder dividends paid of \$14.2 billion (versus \$9.3 billion for 1H '08) to drive surplus to \$264 billion at 9/30/08, from \$290 billion at year end 2007.
- Direct and net premiums declined 2.9% and 1.4%, respectively, in the first nine months of 2008 when compared to the prior year period. ***This is the first instance of a decline of both direct and net premiums written for the Composite since the soft market year 1998.*** However, the decline in direct premiums eased in the third quarter, possibly reflecting a slight uptick in pricing.
- Gross and net underwriting leverage ratios (gross and net premiums to surplus) rose slightly when compared with the full year 2007 results. Annualized premium leverage ratios were 1.41 times (gross) and 0.88 times (net) for the first nine months of 2008, versus 1.27 and 0.80, respectively, for the full year 2007.

Capital and Surplus

Surplus for the ALIRT P&C Composite declined 9.0% in the first nine months 2008 on slowing after-tax operating earnings of \$12.1 billion, and net capital losses of \$26.5 billion. Net capital losses grew by \$18.1 billion in the third quarter alone, demonstrating the cumulative impact of deteriorating capital markets³. Earnings for P&C insurers were also adversely impacted by significant nine month catastrophe losses of just over \$20 billion (ISO estimates).

Surplus Development: ALIRT P&C Composite						
(Data in \$ Millions)	9 Mos '08	2007	2006	2005	2004	2003
Surplus Beginning of Period	290,216	268,200	226,664	208,276	184,882	151,644
Operating Earnings	12,130	32,018	31,532	17,278	17,235	12,070
Net Capital Gains or (Losses)	(26,493)	10,628	19,781	6,899	14,634	20,037
Surplus Paid-In	2,881	590	769	4,539	4,741	5,008
Shareholder Dividends	(14,235)	(18,891)	(9,706)	(9,247)	(9,184)	(6,904)
All Other Changes to Surplus	(334)	(2,330)	(840)	(1,081)	(1,254)	3,027
Surplus End of Period	264,165	290,216	268,200	226,664	208,276	184,882
Change in Surplus	-9.0%	8.2%	18.1%	8.8%	12.6%	21.9%

Lastly, composite companies paid an aggregate \$14.2 billion of shareholder dividends in the first nine months of 2008 (\$4.9 billion in 3Q alone), on track to potentially match the \$19 billion paid in 2007. This continued payment of dividends in a period of market pressure on carrier surplus positions seems counter-intuitive, but may be due in some cases to carriers supporting the life insurance (or other) operations of multi-line groups; e.g. Allstate, Hartford Financial, and AIG subsidiaries. If net capital losses continue to grow in the fourth quarter, it will be interesting to watch if dividend flows slow or even reverse. We do note that surplus *infusions* rose by \$1 billion in the third quarter to \$2.9 billion, the highest in three years.

Individual Company Results

Only eleven composite companies reported surplus gains in the first nine months of 2008 (versus 23 at 6 months 2008), led by Fireman's Fund Insurance Company (8.5%, helped by a \$191 surplus infusion), while eight companies reported declines of 20% or more, with the largest drops reported at Allstate Insurance Company (-28%, in part on a net \$2.3 billion paid to the parent), Liberty Mutual subsidiary General Insurance Company of America (-26%), and Onebeacon Insurance Company (-24%).

The largest declines in surplus were due to a combination of shareholder dividends paid and net capital losses. Besides Allstate Ins. Co., other companies paying large dividends include National Union Fire (AIG = \$1.4 billion), Federal Insurance Company (Chubb = \$1.4 billion), and St. Paul Fire & Marine (\$1.1 billion). The largest net capital losses were reported by State Farm Mutual (\$6.3 billion), Liberty Mutual Ins. Co. (\$4.4 billion, offset by \$1.2 billion of surplus infusions), Allstate Ins. Co. (\$2.7 billion; offset by \$1 billion of surplus infusions), and Hartford Fire (\$2.5 billion, offset by \$320 million of surplus infused).

³ Equity markets have declined sharply since 9/30/08, which may only exacerbate this trend in growing net capital losses if markets do not correct somewhat in December.

Underwriting Profitability

The ALIRT P&C Composite reported a combined ratio of 102.5% in the first nine months of 2008, up from 93.4% in the prior year period, largely reflecting the 8.8 percentage point increase in the loss ratio. Much of this deterioration came from higher than average catastrophe losses, as the accident year combined ratio rose (deteriorated) by almost 11 percentage points. Taking into account investment results, the industry composite reported an operating ratio of 91.4%, a nine percentage point deterioration from the prior year period. Below we detail profitability metrics for the composite over the past seven years.

UNDERWRITING RESULTS: ALIRT P&C COMPOSITE									
	9 Mos. 2008	9 Mos. 2007	2007	2006	2005	2004	2003	2002	Change from 2Q07 (points)
Loss Ratio	76.7%	67.9%	68.5%	66.7%	77.0%	73.4%	76.5%	82.1%	6.3
Expense Ratio	25.5%	25.2%	25.5%	25.0%	23.8%	23.9%	23.6%	24.4%	0.5
Combined Ratio	102.5%	93.4%	94.5%	92.7%	101.2%	97.8%	100.6%	106.9%	6.9
AY Comb. Ratio*	106.2%	95.3%	96.0%	94.0%	99.2%	95.4%	97.0%	102.5%	8.2
Operating Ratio	91.4%	82.3%	82.2%	81.4%	90.1%	88.0%	91.0%	96.4%	7.1

* Accident year combined ratios remove the impact of prior year reserve adjustments, thereby reflecting the profitability of business written only in the current year.

Large catastrophe losses were a principal contributor to the deterioration in the composite's underwriting earnings. According to ISO Property Claim Service estimates, the U.S. property & casualty industry reported estimated catastrophe losses of \$11.5 billion in the third quarter of 2008, largely due to severe weather events, with Texas, Louisiana, Ohio, Kentucky, and Illinois especially hard hit (including a portion of the hurricane Ike and Gustav losses). Combined with \$9.4 billion of catastrophe losses in the first six months of 2008, the nine month catastrophe losses are the fourth heaviest in the last 10 years (see table below), and already well exceed those estimated for the each of the years 2006 and 2007.

Catastrophe Losses for P&C Industry (Data in \$Billions)					
Year	1Q	2Q	3Q	4Q	Full Year
1999	1.87	3.50	2.72	0.27	8.36
2000	1.98	1.46	0.32	0.82	4.58
2001	0.68	6.24	19.10	0.49	26.51
2002	0.62	2.79	0.72	1.73	5.86
2003	1.48	5.05	3.72	2.60	12.85
2004	1.04	2.33	23.70	0.45	27.52
2005	2.14	0.93	48.40	10.80	62.27
2006	1.48	5.04	1.25	1.50	9.27
2007	1.26	2.18	1.13	1.70	6.27
9 Mos. 08	3.35	6.03	11.5		20.88

Source: ISO Property Claim Service quarterly estimates

Excluding catastrophe losses for nine months 2007 and 2008 (which added an estimated 0 and 7 points, respectively, to the combined ratio), the **accident year combined ratio** deteriorated by 3.6 percentage points in the first nine of 2008, an indication that non-cat loss trends are rising on current year business. The **reported combined ratio** continues to be aided by sizeable prior year reserve releases, which totaled \$6.4 billion (= 3.7 percentage points) in the first nine months of 2008.

Individual Company Results

The strongest combined ratios through nine months 2008 were reported by two Chubb subsidiaries, Federal Insurance Company (90.7%) and Pacific Indemnity Company (92.9%), as well as personal lines writers Government Employees Ins. Co. (91.3%) and Progressive Direct (93.1%). Three Travelers subsidiaries were also among the 11 companies reporting the strongest underwriting earnings.

Twenty-one companies reported combined ratios that exceeded 100% in the first nine months of 2008, with the poorest performance reported by State Farm Fire & Casualty Company (127.2%), lead Crum & Forster pool writer United States Fire (116.8%), Continental Casualty Company (115.1%), and Farmers Insurance Group subsidiaries Mid-Century Ins. Co. (112.0%) and Farmers Insurance Exchange (111.2%). Among the top 20 carriers with the poorest underwriting results, half were personal lines predominant companies, and many had large year-over-year increases in accident year results, reflecting in part the adverse impact of catastrophe losses.

Loss Reserve Adequacy

The table below tracks prior year loss reserve development for the ALIRT P&C Composite over the past eight years and first nine months of 2008. As the right hand column illustrates, as of 9/30/2008, reserve releases arising from the past underwriting cycle were the largest for accident year 2004, before trailing off for accident years 2005-2007. This may be an indication that the benefit of reserve releases are coming to an end, which could further hasten underwriting losses given that accident year results have been unprofitable for the past three quarters.

PRIOR YEAR RESERVE DEVELOPMENT										
ALIRT P&C COMPOSITE (2000 – 9 Months '08)										
Data in \$ Millions										
Acc. Year	CY 9 Mos 08*	CY 2007	CY 2006	CY 2005	CY 2004	CY 2003	CY 2002	CY 2001	CY 2000	Total
Prior Yrs.*	-20	2,693	2,632	5,758	5,833	6,311	4,874	1,536	-1,664	27,953
1999		207	627	1,251	793	1,613	1,767	1,120	922	8,300
2000		439	549	1,617	1,794	1,772	1,305	1,962	--	9,438
2001		435	406	1,803	1,371	602	-369	--	--	4,248
2002		127	475	1,835	795	-2,909	--	--	--	323
2003		-165	-200	-1,129	-5,609	--	--	--	--	-7,103
2004		-1,417	-2,290	-7,377	--	--	--	--	--	-11,084
2005		-2,081	-5,553	--	--	--	--	--	--	-7,634
2006	-1,945	-3,815	--	--	--	--	--	--	--	-5,760
2007	-4,431	--	--	--	--	--	--	--	--	-4,431
Total Dev.	-6,396	-3,577	-3,354	3,758	4,977	7,389	7,577	4,618	-742	14,250

*The "Prior Yrs." figure for nine months 2008 represents all prior year reserve activity for accident years 2005 and prior.

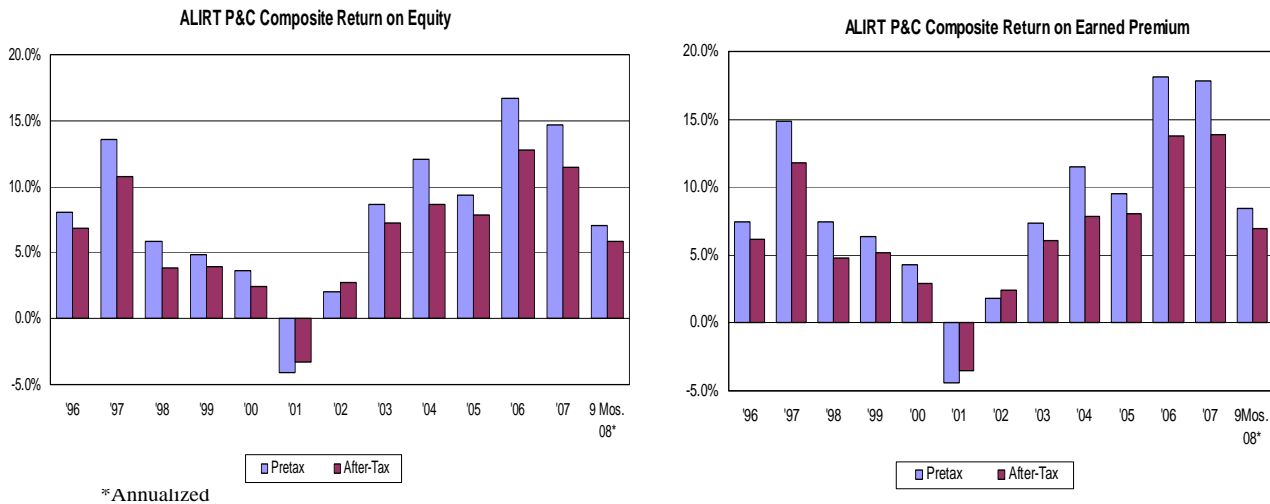
Reserve releases through nine months 2008 are already higher than those reported in calendar years 2006–2007, largely due to the absence of aggregate reserve strengthening for accident years 2005 and earlier. This is providing a needed cushion to partially offset deteriorating current year underwriting results. *Adequate, or slightly redundant reserves, is one factor that argues against a possible rapid increase in pricing.* At the start of the last hard market cycle, reserves were deficient by almost 35%,⁴ contributing to the sizeable underwriting and surplus losses over the next several years. No such situation exists today.

The largest reserve release in the first nine months of 2008 was reported by State Farm Mutual (\$1.9 billion = 3.0% of year end 2007 surplus), while the largest reserve addition was reported by Motors Insurance Corporation (\$127 million = 6.7% of prior year end surplus).

Operating Earnings

The charts below show profitability metrics for the ALIRT P&C Composite over the past twelve years and first nine months of 2008. Pretax and after-tax operating earnings and returns (excluding net capital gains) through nine months 2008 were substantially lower than the eight year highs reported in 2006. As mentioned, nine month 2008 catastrophe losses were the fourth highest at just over \$20 billion, contributing to this deterioration.

Operating profitability is now on a decidedly downward trend, at levels not seen since 2003, the first year of the last substantial upswing in profitability. While it is difficult to extrapolate forward based on historical experience, the market cycle turned in earnest two years after the last downturn in pricing (1998), which may argue for the onset of the next hard market cycle in 2010. While four full years of soft pricing and the present turmoil in capital markets help support this thesis, reserve adequacy and the impact that a recession would have on the supply/demand equilibrium may mitigate the timing or blunt the severity of such a turn.



Individual Company Results

Nine companies reported annualized pretax returns on earned premium (ROP) exceeding 20% in the first nine months of 2008, all subsidiaries of five commercial lines-predominant, largely national insurance groups. The strongest results were reported by Hartford Fire Ins. Co. (34.9%), Travelers Indemnity (30.4%), Ace American Insurance Company (26.6%), and Berkley Insurance Company (25.9%). Also represented within this top tier were a number of Chubb subsidiaries (Federal Insurance Company and Pacific Indemnity Company).

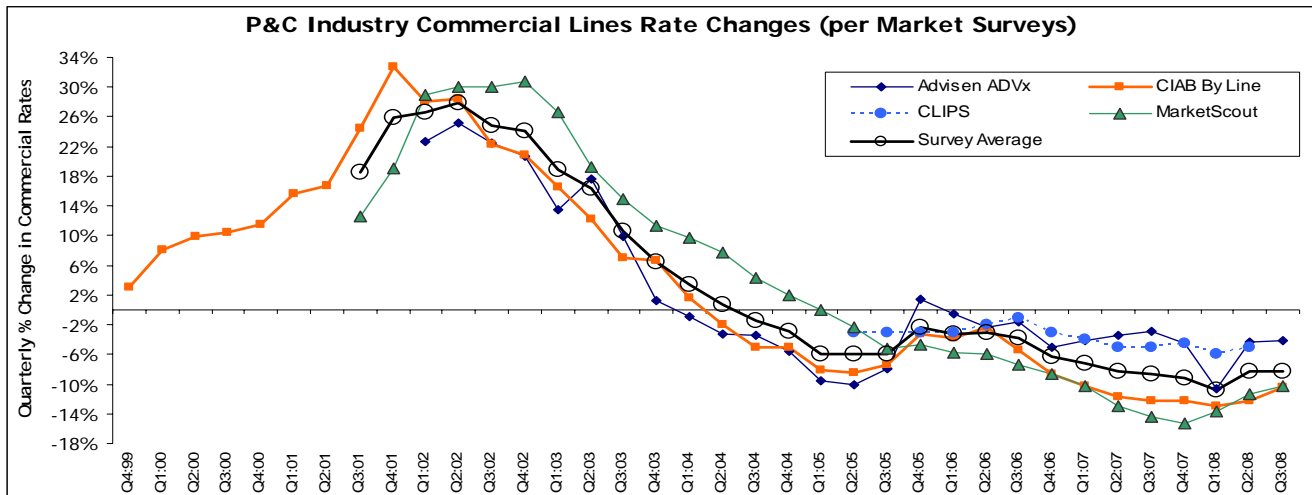
⁴ According to a recent Moody’s presentation, entitled North American P&C Insurance Industry Outlook, page 68.

Eight composite companies reported operating losses in the first nine months of 2008, led by State Farm Fire & Casualty (-19.6%), lead Crum & Forster pool writer United States Fire Insurance Company (-14.3%), two Farmers subsidiaries, Farmers Insurance Exchange (-6.6%) and Mid-Century Insurance Co. (-4.7%), and Country Mutual Ins. Co. (-2.5%). Of the 15 companies with the lowest return on premium, eleven are personal lines predominant, indicating in part the disproportionate impact of catastrophe losses on these insurers (along with greater pricing competition in that line).

Premium Income

Direct and net written premiums fell 2.9% and 1.4%, respectively, for the ALIRT P&C Composite in the first nine months of 2008. This is the third consecutive quarter of declines for both measures and a clear indication of weak pricing. It is interesting to note, however, that direct premium decreases *eased* in the third quarter (from -4.0% through 6 months 2008), which may be another initial indication that price decreases are moderating.

Additional evidence of a potential reversing of rate declines is found in a number of broker surveys, graphed below. Annual renewal rates for the first nine months of 2008 fell by an average of 7.3%⁵, a deceleration from the 10.8% and 8.3% declines reported in the first and second quarters 2008, respectively, but still substantial.



There has been much talk about whether the market is on the verge of a price cycle shift, with insurers generally optimistic that the turn has come, while brokers are more reserved in their judgments. Certainly, as discussed, there are indications that such a turn is likely, including the evaporation of capacity as surplus is depleted due to catastrophe and investment losses. Other factors arguing for a turn include potentially tighter reinsurance pricing and terms, lack of capital sources in the financial market (i.e. using reinsurers for capital relief), and greater attention paid to the credit quality of (re)insurance partners.

That said, underwriting results are still decent, especially when catastrophe losses are normalized, prior year reserves appear adequate (if not slightly redundant), companies are still largely making operating earnings, and the majority of the investment losses are unrealized and could reverse if the capital markets improve or insurers are able to hold securities until maturity.

⁵ Overall results may be somewhat overstated as results for CLIPS (Commercial Lines Insurance Pricing Survey), which are generally more conservative, are not yet available for the third quarter.

Investment Mix

Invested assets for the ALIRT P&C Composite declined 3.9% in the first nine months of 2008 as annual net premium levels declined, operating income was almost halved from the prior year period, net investment income declined 0.5% year over year (as net yield was a relatively low 4.19%), and a number of insurers reported substantial net capital losses as market turmoil accelerated in the third quarter.

The table below shows the invested asset mix for the composite as of 9/30/08. Unaffiliated stocks declined sharply as of 9/30/08, in large part due to net capital losses as major equity markets fell between 18% and 21% in the first nine months of 2008. This decline was largely offset by increases in Schedule BA assets (joint ventures, limited partnerships, private equity, hedge funds, etc.), and affiliated stocks. The growth in Schedule BA assets likely reflects in part a reach for additional total return as yields on cash, short-term investments and bonds remain low.

Distribution of Invested Assets			
ALIRT P&C Composite			
	9/30/2008	12/31/2007	Change
Bonds	57.6%	57.5%	+0.1%
Unaffiliated Stocks	12.5%	15.6%	-3.1%
Affiliated Stocks	18.0%	16.6%	+1.4%
Mortgage Loans & Real Estate	1.6%	1.4%	+0.2%
Cash & Short-Term	4.3%	4.5%	-0.2%
Schedule BA	5.5%	3.9%	+1.6%
Other	0.5%	0.5%	0.0%

Higher Risk Asset Exposure

In the last quarterly review we examined subprime/Alt-A exposure for the composite insurers, which was largely negligible. In the table on the following page, we present the 10 composite carriers with the highest exposure to High Risk Assets (HRA), which include below investment grade (BIG) bonds, commercial mortgages, real estate, Schedule BA assets, and unaffiliated equities.

The majority of HRA exposure is in unaffiliated equities, an asset class long utilized by property & casualty insurers. Government Employees (GEICO) has the largest surplus exposure to these assets (101%), as might be expected from a Berkshire Hathaway subsidiary, followed by Cincinnati Insurance Company (69%), which has traditionally been exposed to a relatively concentrated number of financial services companies, including a sizeable stake in regional bank Fifth Third.

The second largest class within the HRA bucket is Schedule BA assets which largely comprises joint venture/partnership interests that can take the form of fixed income, common stocks, real estate, or "other" type investments. Liberty Mutual has the largest share of such assets as a percentage of surplus (52%), followed by Berkley Regional (42%) and Erie Insurance Exchange (32%). Many of these assets, as with common equities, are carried at market value on the statutory balance sheet and could see some volatility as a number of private equity and hedge fund investments face sizeable losses.

The balance of the higher risk assets is negligible, though Continental Casualty does have an outsized exposure to non investment grade bonds (37% of surplus).

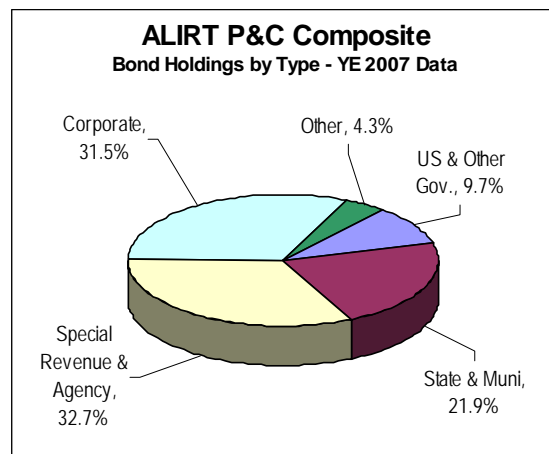
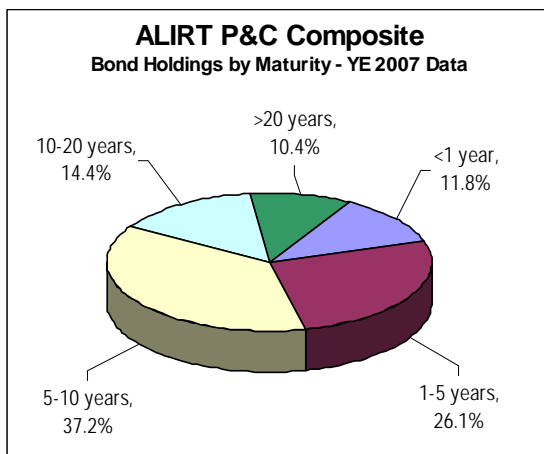
Overall, the composite has high risk asset investments equaling almost 50% of 9/30/08 surplus. While this represents a fair amount of surplus, most of the exposure is to unaffiliated equities which, while currently depressed, could rebound if insurers are not forced to liquidate positions in the near to medium term.

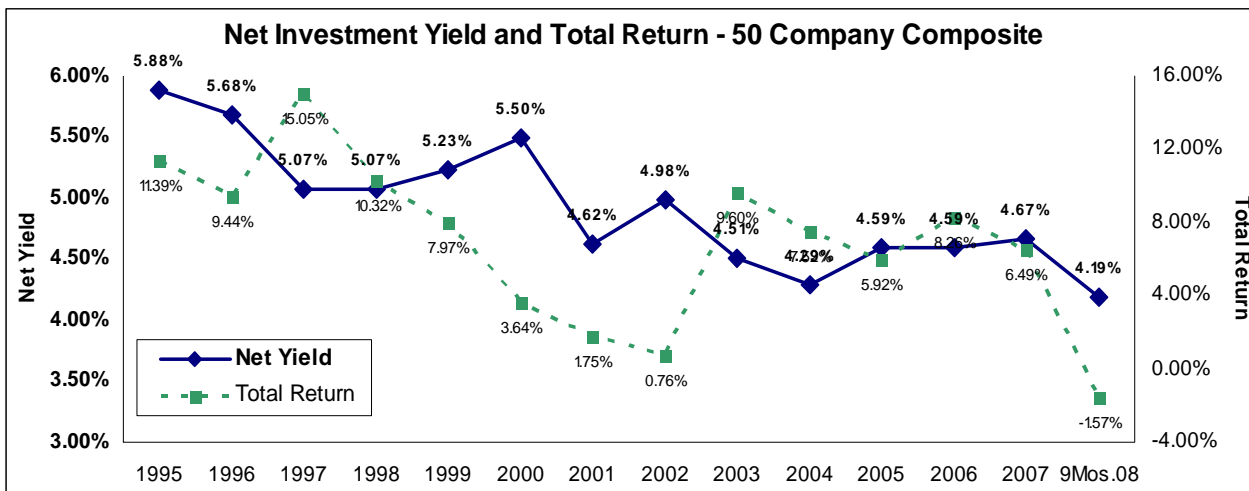
High Risk Asset Exposure – 9 Months 2008 (Ratios as a % of Surplus)						
	BIG Bonds	Comm'l Mortg.	Real Estate	Sch. BA	Unaffil. Stocks	Total
Gov't Employees (GEICO)	8%	0%	3%	0%	101%	112%
Progressive Casualty	2%	0%	45%	0%	52%	99%
Progressive Direct	0%	0%	26%	1%	69%	96%
Liberty Mutual Ins. Co.	12%	6%	5%	52%	13%	88%
Berkley Regional	10%	15%	0%	42%	21%	88%
Continental Casualty Co.	37%	0%	2%	28%	21%	88%
Erie Insurance Exchange	3%	0%	1%	32%	50%	86%
Hartford Accident & Ind.	27%	12%	0%	17%	24%	80%
Cincinnati Insurance Co.	10%	0%	0%	0%	69%	79%
Factory Mutual Ins. Co.	3%	0%	0%	5%	69%	77%
Safeco Insurance Co.	13%	0%	0%	6%	51%	70%
Composite	5%	1%	2%	12%	29%	49%

Investment Results

Net Investment Yield

As shown on the graph on the following page, *net investment yield* for the Composite fell 48 basis points in the first nine months of 2008 to 4.19% (annualized). The deterioration reflects in part the lower interest rate environment as the Federal Reserve cut its key Federal Funds rate by 375 basis points since mid-2007 (to 1% currently). Turmoil in the capital markets has also caused a sharp downturn in shorter term yields as investors seek the relative safety of shorter maturity, largely government instruments. As indicated below, property & casualty insurers invest approximately 65% of their bond holdings in government-related securities (31% guaranteed), and over one third of their bonds have maturities under 5 years.





Total Return

Composite *total return* declined 806 basis points to -1.57% (annualized) for the first nine months of 2008, *the weakest composite total return for at least the past 14 years and the only instance of negative total return for this period*. This deterioration reflects the depth of the current downturn in capital markets, with major equity indices between 18% and 21% lower through the first nine months of 2008. Because unaffiliated stocks, which are marked to market in statutory accounting, represent almost 30% of surplus, these declines have an immediate impact, with composite surplus adversely impacted by \$26 billion of net capital losses (84% unrealized).

Equity markets have fallen another 26% to 34% to date since the end of the third quarter (see below). If such losses do not reverse in December, aggregate net capital losses will likely be even higher, resulting in further deterioration to industry surplus, lower underwriting capacity, and potential upward pressure on rates.

	4Q08*	3Q08	2Q08	1Q08	2007	2006	2005	2004	2003
DJIA	-25.8%	-4.4%	-7.4%	-7.6%	+6.4%	+16.3%	-0.6%	+3.1%	+30.9%
S&P 500	-31.3%	-9.0%	-3.2%	-9.9%	+3.5%	+13.6%	+3.0%	+9.0%	+26.4%
NASDAQ	-33.9%	-8.6%	+0.6%	-14.1%	+9.8%	+9.5%	+1.4%	+8.6%	+50.0%
Avg. % Change	-30.3%	-7.3%	-3.3%	-10.5%	+6.6%	+13.1%	+1.3%	+6.9%	+35.8%

*Third quarter 2008 equity market results are through November 26, 2008.

Besides equities, the bond holdings of composite insurers may also be facing realized/unrealized capital losses. While most bonds are not required to be marked to market under statutory accounting rules (versus GAAP accounting rules), the lowest rated bonds generally are marked to market.

Bonds sold in the current environment could result in realized losses, while some insurers may be taking “other than temporary impairments” (OTTI = realized losses) on some of their bond holdings. While there are no absolute rules regarding the temporary impairment of assets under statutory accounting, insurers generally begin writing down the value of bonds if market values fall below a certain threshold for a certain period of time (e.g. 20% drop in value for 3-6 months).

Conclusion

Since mid-September, the turmoil in capital markets has intensified, with equity markets plummeting and bond spreads remaining persistently wide. The market values of publicly-traded insurance companies have felt the pain along with most other financial services companies. This capital market crisis has come at a time when the property & casualty industry is entering a fifth year of soft pricing. There were indications, even before capital markets seized up, that premium declines were beginning to moderate.

The big question is whether we are now on the cusp of a hardening market cycle.

Market turns are generally driven by capacity constraints. As shown in this piece, P&C insurers have suffered large net capital losses (equaling almost 10% of year end 2007 surplus) through the first nine months of the year. These losses could only grow if equity markets do not reverse from current levels. If even more capacity is removed, companies may have little choice but to write less business, utilize more reinsurance, and/or charge higher prices.

What is different about this potential market turn is that underlying underwriting profitability is not nearly as weak as witnessed in past market inflections. Adjusting out the historically heavy catastrophe losses thus far in 2008, the industry is still profitable on an underwriting basis – something infrequently achieved over the past thirty years. Also, it appears that prior year reserves are adequate, a situation that, again, is much different from the last market turn. This is to say, without the large investment losses over the past nine months, it is unlikely that markets would be on the verge of a hard turn.

Some other factors mentioned in the on-going debate about the state of the market cycle include: 1) whether AIG is slowing a pricing turn by aggressively defending renewals; 2) whether the impact of capital market stress on insurers (e.g. AIG, Hartford, XL, etc.) has driven more buyers to weigh insurer credit quality over price; 3) the direction of reinsurance pricing and whether higher January 1 reinsurance renewals will lead to higher primary rates; 4) whether primary insurers will utilize more reinsurance as a form of capital relief; 5) the impact of less capital market capacity (sidecars, ILW, cat bonds, private equity investors, etc.), 6) the adverse impact a slowing economy may have on both commercial and personal lines revenues, and 7) the potential impact of accelerating D&O claims.

If capital markets correct in the near term, much of the largely unrealized capital losses could reverse over time, replenishing “lost” capacity. That may immediately change the equation on the rapidity of a market turn, especially given still sound underlying fundamentals. Even in such a scenario (a big IF), it is likely that current weak pricing will continue to moderate and that rate changes may turn positive again in late 2009 and/or 2010.

As shown on our introductory page, whenever the pricing turn comes, a downturn in the financial strength of both the industry and some specific insurers is likely to follow and could result in financial “wash-outs” over the ensuing four or five years.

This review is prepared by ALIRT Insurance Research, an independent insurance industry financial analysis firm. ALIRT provides its ALIRT (AnaLysis of Insurer Risk Trends) Services to institutional clients responsible for monitoring exposures to insurance company financial deterioration. This review is for the specific internal use of our clients, and may not be redistributed without the express written permission of ALIRT Insurance Research.

While this review is prepared for your personal use, it is not a substitute for an impartial and thorough investigation of insurance company relative financial strength, and does not satisfy federal and state mandated fiduciary due diligence. Financial information contained in this review is obtained from public sources we consider reliable, but we cannot guarantee as accurate. This review should not be considered complete, includes expressions of our opinion, and must be accepted without responsibility to ALIRT.

ALIRT Insurance Research, LLC - 200 Day Hill Road, Ste. 220, Windsor, CT 06095
Phone: (860) 683-2070 Fax: (860) 683-4020

Email: info@alirtresearch.com Website: www.alirtresearch.com