Summary

We have performed an independent analysis of the U.S. property casualty insurance industry loss reserves as of year-end 2005. We estimate that reserves for accident years 1999-2003 are still slightly deficient for the industry as a whole. We believe that reserves for accident year 2005 are redundant. Across all years in total, industry reserves appear adequate, having finally filled, just last year, the reserve deficit created by inadequate bookings in the previous soft market.

At the least profitable point in the previous pricing cycle, accident year 2001, we believe that the true loss ratio is about 1.4 points higher than currently reported. Our estimate of the recent loss ratio (accident year 2005) is lower than reported by about 1.7 loss ratio points. We project industry accident year loss ratios of roughly 63% in 2006 and 65% in 2007, but that the industry will continue to book calendar year loss ratios around 67% for both years. Therefore we project that reserve margin will be built over the next couple of years, albeit at a decreasing rate.

We believe that significant differences exist between companies with regard to the adequacy of stated reserves and that profitability is, in some cases, significantly different from what has been reported.

Important Note Regarding Actuarial Estimates Contained in This Report

The report is based on independent actuarial analysis of reported insurance results by carrier and line. Like any actuarial analysis, it results in estimates rather than exact amounts. These estimates have the potential to be inaccurate, sometimes by significant amounts, as a result of unforeseen developments (for example: changes in inflation, tort environment, etc). The data that was used for the analysis is highly aggregated and subject to potential distortions due to items such as aggregate loss covers, portfolio transfers, acquisitions, and business mix shifts within an insurance line. While we feel that this analysis is well reasoned and the conclusions appropriate, analyses by others could result in different conclusions.
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Accident Year versus Calendar Year Loss Ratios

Loss ratios are a common measure of insurance industry profitability. Calendar year loss ratios reflect the total losses actually booked in a given year, and do not change (barring earnings restatement). Company estimates of accident year loss ratios reflect results on premium earned in a given year, and are revised annually in statutory financial statements. The following graph shows calendar year loss ratios, compared to accident loss ratios reported as of 2005 year end.

Both the calendar year and accident year loss ratios rise from 1997 to 2001 and improve thereafter. However, the calendar year loss ratio deterioration from 1997 to 2000 was gradual and understated the true deterioration in results. Consequently, insurance industry reserve adequacy was deteriorating as well.

2001 was the turning point for profitability. Both the calendar year loss ratios and the current reported accident year loss ratios improved, but the calendar year improvement was dampened as reserve positions were strengthened to the detriment of reported income.

We now add a third perspective of the loss ratio.

The red line is our independent opinion of the industry accident year loss ratio, termed the CGC accident year loss ratio. We arrived at this opinion through individual reserve analysis by line and company/group as reported in Schedule P of the 2005 Annual Statement, and then aggregating these results across line of business and company/group.

The CGC accident year loss ratio indicates that the accident years for 1998 through 2003 were worse than insurance companies in aggregate have reflected on their annual statements, even as of 2005. The larger gap between the CGC accident year loss ratio and booked calendar year loss ratio from 1997 to 2001 implies that the insurance industry reserve adequacy deteriorated even more than suggested by the previous graph.

For the time period 2002-2003, our analysis indicates that reserves were not repaired to the extent implied by the 2005-reported accident year loss ratios.

Our estimate of the true 2005 accident year loss ratio is lower than the companies’ booked accident year result.

Also included on the second graph are our projections of the calendar year and accident year loss ratios for the next two years. Although the accident year loss ratio projections appear to remain roughly flat, 2005 was a very significant year for natural catastrophes. The underlying profit dynamic is one of steady deterioration. We expect calendar year loss ratios to be booked fairly consistently with the past few years, therefore strengthening reserves for the next few years, albeit at a decreasing rate.

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1 For purposes of this analysis, we analyzed data on over 700 groups and unaffiliated single companies. Source: © A.M. Best Companies Used by Permission. Adjustments were made to reported American Re earned premium and losses as a result of a very significant reinsurance transaction in 2005 between American Re and its parent Munich Re. The transaction covered all losses from numerous accident periods, with premium booked and earned all in 2005. The accounting for this transaction distorts the true underwriting dynamics of the insurance industry. We therefore estimated the premium payment and treated it as paid loss in past accident years.
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Industry Premiums and Estimated Ultimate Losses

This information takes on additional meaning when shown in dollar terms rather than percentages. Aggregate industry losses have increased over the last ten years at a fairly steady 4% rate, similar to the rate of growth of the national economy. 2001 and 2005 were impacted by the September 11th attacks and abnormal hurricane losses. Contrary to common beliefs about declining premium in soft markets, premiums continued to grow, but at a rate well below the growth of losses.

Market hardening appeared to begin in 2001, as evidenced by premium growth more in line with the growth in losses. Since the events of September 11th occurred late in the year, there would be little, if any, impact on earned premium in 2001. Instead of being the result of a catalytic event, it is our belief that market hardening was inevitable at this point as a result of the inability of the industry to further deteriorate reserves.

Industry Reserve Adequacy

The insurance industry, as indicated by its 2005 reporting of prior accident year results, suffered deterioration of reserve adequacy until 2000. From 1997 to 2000, the currently reported accident year losses indicate that the industry was losing over $20 billion in reserve adequacy per year. At the end of calendar year 2000, the industry (according to the companies’ estimates) was in a reserve deficit position of over $80 billion, deteriorating slightly in 2001, and then improving by roughly $25 billion per year thereafter.

The view of historical reserve margin levels using our opinion of accident year losses (in red above), is similar, but with the low point more firmly in 2001.

Our analysis indicates that a slightly positive margin position was achieved by 2005. We expect, based on past reserving within the industry, that positive reserve margin will be built, even while prices continue to soften. Eventually, however, pricing will deteriorate beyond the level implied by the calendar year booked loss ratio, and reserve margin will once again begin to decline, eventually becoming significantly negative. Monitoring this deficiency relative to a year’s earned premium gives a helpful gauge for understanding the timing of the next hard market.

Premium Cycles and U.S. GDP

Because the most recent profit cycle for the property casualty insurance industry lasted 15 to 16 years, looking at only the last decade does not give the whole picture. Some additional insight can be gained by looking at Net Written Premium\(^2\) (NWP) compared to the US Gross Domestic Product (GDP).

We modeled Net Written Premium as a function of GDP (linear regression). Over the long term, written

\(^2\) Source: © A.M. Best Company – Used by Permission
premium grows consistently with GDP.

The market cycle is dramatically shown by looking at the difference between NWP and the long term trend-line as a percent of GDP.

A cyclical relationship is exhibited, within a stable range. Softening occurs slowly and steadily (as illustrated by down-sloped lines), with market improvement occurring faster (illustrated by the up-sloped lines). In both of the last two cycles, the trough of the cycle was at about 0.3-0.4% of GDP below the long term trend-line. The peak of each cycle was at around 0.3-0.4% above the long term trend-line.

Although 2005 NWP appears to show a faster rate of pricing decline than in the previous softening period (1989-2001) this is in part due to a significant loss portfolio reinsurance transaction between American Re and its European parent, Munich Re. This transaction covered American Re’s losses from a number of accident years, but the ceded premium was all accounted for in 2005, distorting the industry premium by billions of dollars. Despite this aberration, we expect premiums to continue to follow a measured decline relative to the long term trend line until the next hard market begins.

**Company Differences**

The analysis used to develop these views into industry results was calculated at the line/company level. It would be natural, in looking at the conclusions previously made, to assume that all carriers are in similar situations regarding reserve position, profitability, etc. Such an assumption would not be correct. There are major differences between organizations in these regards.

The following chart groups the companies by our estimate of reserve strength as of year-end 2005.

For many of the companies, our estimate of reserve need is close to the booked reserves (328 out of 737 companies), but there are a large number of companies where we estimate significant negative reserve margin (155 companies) or positive reserve margin (254 companies).

The difference between our estimate of the 2005 accident year loss ratio for the industry and the booked loss ratio is deceptively small (1.7 loss ratio points). It masks the significant differences at the company level. The graph below plots each company/line combination in terms of its booked 2005 accident year loss ratio and our estimate of the accident year 2005 loss ratio.

We have added lines to show the overall industry booked loss ratio and our estimate. (Note: these are averages of the individual points, weighted by 2005 earned premium). Clearly, for many of the company/line combinations, the booked result is close to our estimate. Many are not, however.