

**Insurance Information
Institute**
110 William Street
New York, New York 10038
(212) 346-5500
bobh@iii.org
www.iii.org

SPECIAL REPORT

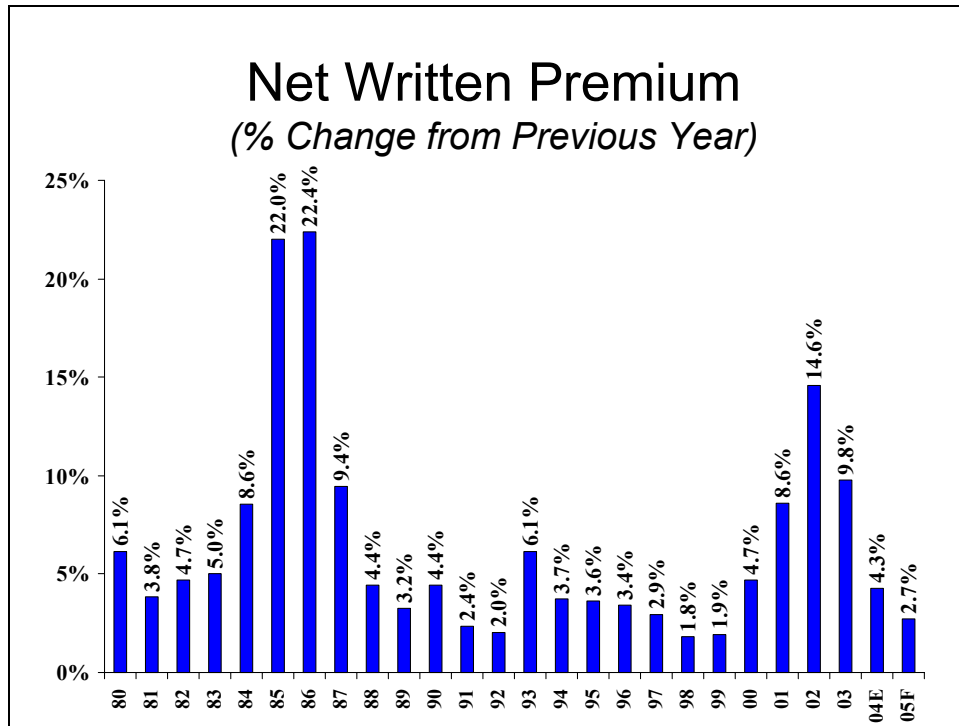
GROUNDHOG FORECAST FOR 2005

**Robert P. Hartwig, Ph.D., CPCU, Senior Vice President &
Chief Economist**

Each year before Groundhog Day, the Insurance Information Institute invites a panel of Wall Street stock analysts and industry professionals to come out of their holes, look around for their shadow and forecast the outlook for the industry. Legend has it that if Punxsutawney Phil sees his shadow, there will be six more weeks of winter. In 2005, most analysts expect the heat will continue to come off premium growth, while the combined ratio continues to hold steady.

Premiums: Slowing, Slowing, But Not Quite Gone

The average forecast calls for an increase in net written premiums of 2.7 percent in 2005, down from an estimated 4.3 percent in 2004. The 2004 figure itself represents more than a halving of the 9.8 percent increase in 2003. It is also worth noting that premium growth in 2004 came in well below even the pessimistic of analysts' expectations from a year ago. In last year's Groundhog survey the consensus estimate was for net written premium growth of 7.4 percent and the lowest estimate of the 12 respondents was 5.2 percent, almost one whole point above the current estimate of 4.3 percent. In contrast to previous years, when gains were chiefly the result of higher rates, the sharp weakening in the pricing environment over the past year means that current gains are more directly related to increased exposure growth and higher demand associated with the current economic recovery. Until 2004, exposure growth was concentrated on the personal lines side, as low interest rates propelled new home construction to record levels while at the same time boosting auto sales. During 2004, however, business investment and hiring finally began to perk up, pushing up demand for commercial insurance, including workers compensation coverage.

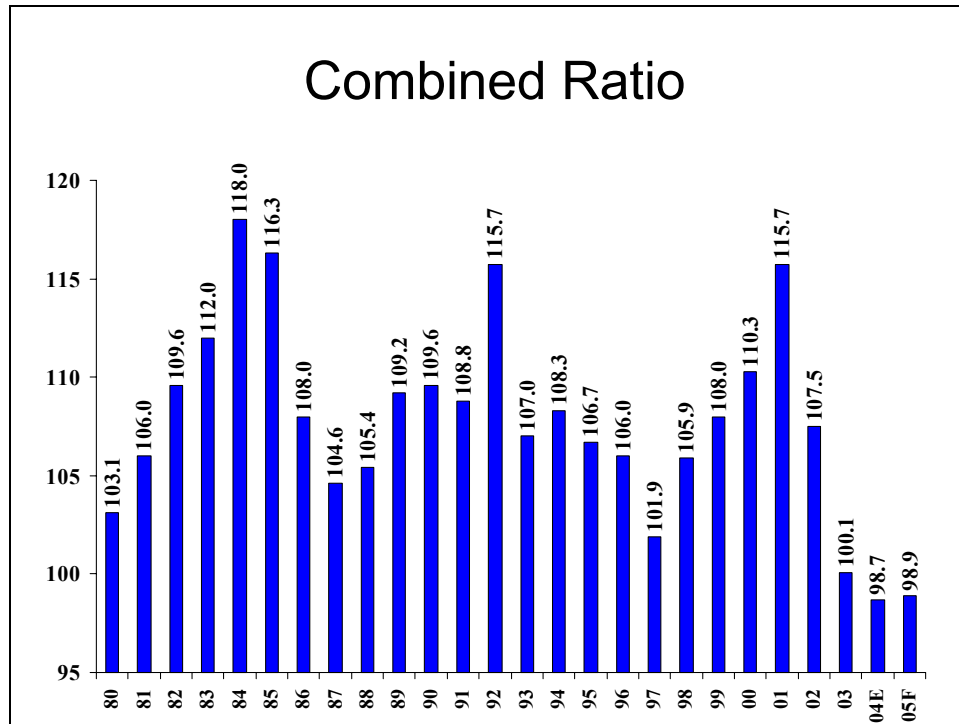


Sources: Insurance Information Institute, A.M. Best.

Combined Ratio: Much Better Than It Appears

The combined ratio, which is the ratio of losses and expenses to premiums, for 2005, is projected to be 98.9, little changed from the 98.7 estimated for 2004 and the 100.1 recorded in 2003. Nevertheless, the forecasts are vast improvements over the terrorism-impacted 115.7 result in 2001. Were the combined ratio in 2004 or 2005 to come in under 100, it would mark the first underwriting profit in the property-casualty insurance industry since 1978. Moreover, had catastrophe experience in 2004 been “normal” (insured losses for the four hurricanes that struck the southeast coast during the third quarter of 2004 are estimated at \$21.6 billion) the year’s combined ratio would have been in the neighborhood of 95—its lowest level since 1972.

While the survey results show some expected improvement, the bottom line is that the industry will still be paying out almost exactly the same amount in claims and associated expenses as it earns in premiums, thereby increasing the importance of investment earnings. Given the current low yield, high volatility investment environment, it is clear that Fortune 500-level returns on equity in the neighborhood of 13 to 14 percent cannot be generated without a significant contribution from underwriting.



Sources: Insurance Information Institute, A.M. Best.

2005: Looking Relatively Good, But Concerns Are Mounting

What are the biggest potential downside risks for 2005? High on the list is a loss of pricing and underwriting discipline. Differing views on the likelihood of pricing discipline being maintained likely explain the disparity among analysts' forecasts for net written premium growth in 2005, which range from 0.9 percent on the low end to 4.0 percent on the high side. So far, pricing is clearly easing but cannot yet be characterized as destructive.

Among major external risks, tort costs remain among the factors that most significantly affect insurer financial performance. The failure of class action, asbestos and medical malpractice reform legislation was among the industry's biggest disappointments in 2004. At a minimum, Congress will likely revisit the issue of class action reform in 2005, which fell short of passage by a single vote in the Senate in 2004. The failure to get the Terrorism Risk Insurance Act extended in 2004 was also a major disappointment. Many commercial policies (with the exception of workers compensation) with inception dates after January 1, 2005 now include terrorism exclusions in the event that the Act—currently scheduled to sunset at the end of 2005—is not extended. While not directly impacting the operating performance of insurers, 2004 is likely to be remembered as

the year in which New York State Attorney General Eliot Spitzer initiated an investigation of some insurance industry practices. The ultimate impact of this investigation, which has resulted in at least two dozen additional probes launched by state attorneys general and insurance departments around the country, is still unknown. However, insurer (and broker) expenses are certain to rise in 2005 (and beyond) as compliance costs increase as new regulations come online and fines and penalties are levied and paid.

A table containing the estimates and forecasts of the survey participants follows.

The Insurance Information Institute's
GROUNDHOG FORECAST 2005

NET WRITTEN PREMIUMS

(% Change from Prior Year)

<u>COMPANY</u>	EST. <u>2004</u>	FORECAST* <u>2005</u>
Lehman Brothers	4.3%	4.0%
Merrill Lynch	4.3	4.0
Firemark Investments	4.3	3.5
Goldman Sachs	4.0	3.5
Conning	5.3	3.1
Raymond James	4.2	3.1
Gill & Roeser	4.7	3.0
Prudential Securities	4.1	2.9
Morgan Stanley	4.0	2.6
A.G. Edwards	4.0	2.0
Tillinghast Towers-Perrin	5.0	2.0
ISO	4.1	1.1
Standard & Poor's	<u>4.0</u>	<u>0.9</u>
Average	4.3	2.7

COMBINED RATIO

(After Dividends)

<u>COMPANY</u>	EST. <u>2004</u>	FORECAST* <u>2005</u>
Gill & Roeser	100.0	101.5
Tillinghast Towers-Perrin	102.0	101.4
Standard & Poor's	98.0	100.5
A.G. Edwards	99.0	100.0
ISO	97.7	99.6
Conning	99.8	99.0
Lehman Brothers	99.0	98.7
Merrill Lynch	97.5	98.5
Firemark Investments	98.0	98.0
Morgan Stanley	97.5	97.8
Goldman Sachs	97.7	97.7
Raymond James	98.9	97.5
Prudential Securities	<u>97.8</u>	<u>96.1</u>
Average	98.7	98.9

*Ranked highest to lowest for 2005.