

GROUNDHOG FORECAST FOR 2006

**Survey of Analysts Projects Faster P/C
Premium Growth, Underwriting Profit in
2006**

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Introduction

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. While Phil did indeed see his shadow in 2006, most insurance analysts predict that premium growth will heat up in 2006 after cooling off substantially in 2005. This year's survey results also indicate an expectation that record catastrophe losses and reserve charges will weigh heavily on 2005's underwriting results, pushing what would have been the industry's largest underwriting profit ever into a loss situation. Analysts expect the industry to spring back in 2006 with a strong underwriting performance sufficient to generate a small underwriting profit.

Premium Growth: A Katrina-Inspired "Mini Hard Market"?

The average forecast calls for an increase in net written premiums of 3.8 percent in 2006, up from an anemic 1.0 percent estimated for 2005. The 3.8 percent increase in premium growth forecast for 2006 represents diminished expectations for the post-Katrina "hard market." In December 2005, analysts predicted in the Insurance Information Institute's Early Bird survey that premium growth in 2006 would rise to 4.7 percent.¹ The spike in premium growth in 2006 is a direct result of analyst expectations that record catastrophe losses in 2005, totaling \$56.8 billion, have severely crimped capacity and caused insurers to reassess risk in catastrophe-prone regions of the United States. Analysts also expect that demand for insurance and reinsurance will increase even while supply is falling. The resulting supply/demand imbalance, it is reasoned, should spark a "mini-hard market," pushing insurance and reinsurance prices for some types of coverage upward—property insurance and property catastrophe reinsurance coverage in particular. Some analysts believe that hard market conditions could spill over into casualty lines as well (e.g., general liability, worker compensation), stabilizing pricing if not pushing prices upward. Recent evidence suggests this may in fact be happening, with commercial casualty pricing stabilizing during the fourth quarter of 2005 even though those lines were little affected by last year's storms. One reason why this may be occurring is because insurers and reinsurers are reallocating capital away from casualty coverages—where prices were falling through most of 2005—to commercial property and reinsurance segments where the supply/demand imbalance is greatest and prices are rising the most.

Expectations for a hard market in 2006—at just 3.8 percent—are quite muted relative to recent historical growth in premiums. Premium growth peaked during the most recent cycle at 14.6 percent in 2002 before dropping to 9.8 percent in 2003 and 4.6 percent in 2004. It is also worth noting that premium growth in 2005—at 1.0 percent—will come in well below analysts' expectations from a year ago. In last year's Groundhog survey the consensus estimate was for net written premium growth of 2.7 percent.

¹ The Insurance Information Institute's Early Bird forecast can be accessed at:

<http://www.iii.org/media/industry/financials/forecast2006/>

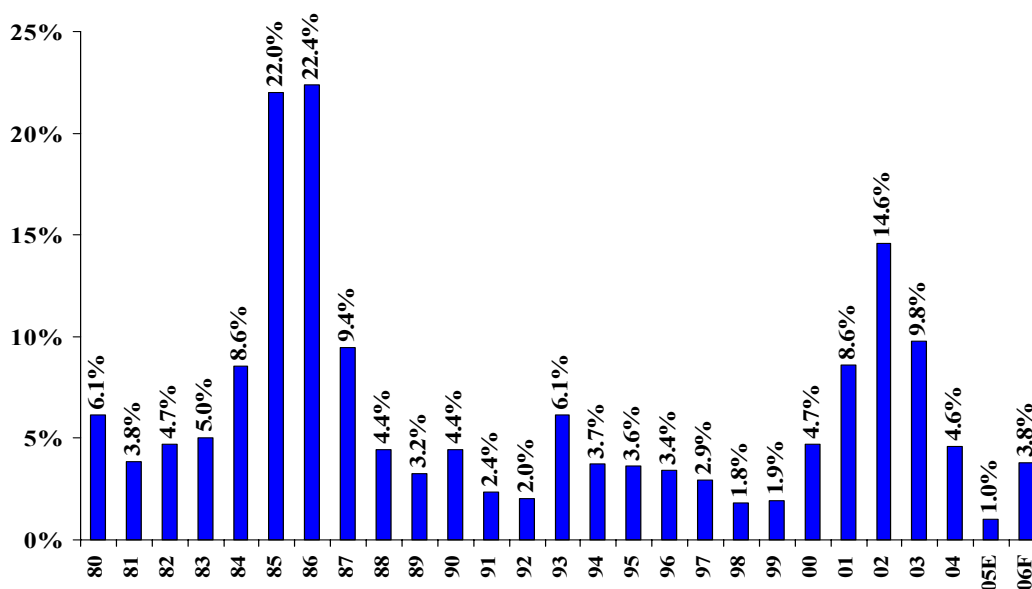
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Net Written Premium (% Change from Previous Year)



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

Combined Ratio: Battered In '05, Better In '06

The combined ratio, which is the ratio of losses and expenses to premiums, for 2006, is projected to be 97.7, down substantially from an estimated 101.8 in 2005 but little different to the actual combined ratio of the 98.3 recorded in 2004. If the combined ratio in 2006 comes in under 100 as predicted, it would produce an underwriting profit of \$6 billion to \$7 billion—just the second underwriting profit in the property-casualty insurance industry since 1978. The estimate for 2006, of course, assumes a return to more “normal” levels of catastrophe loss. The 2005 result is much better than expected. This is because a large share of the insured losses from Hurricanes Katrina, Rita, Wilma and Dennis will ultimately be borne by foreign reinsurers and hence will impact the financials of the countries in which those companies are domiciled. The combined ratio in 2005 was, however, adversely impacted by reserve charges. Asbestos, as usual, was the principle culprit. The charges are likely large enough to push the industry toward a small underwriting loss (associated with the estimated combined ratio of 101.8) from what would otherwise have been a breakeven year.

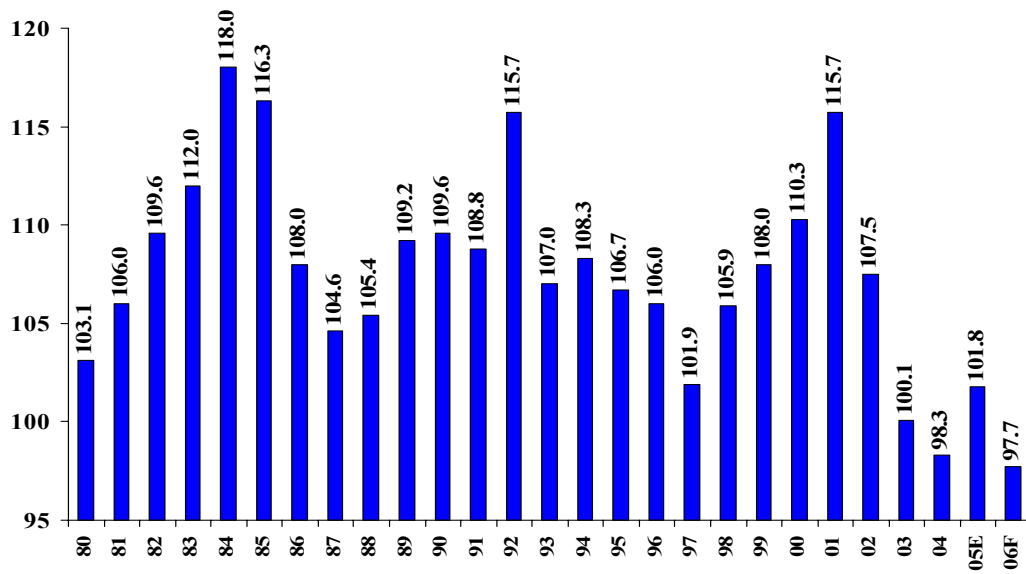
While the survey results indicate expected improvements, the bottom line is that the industry will still be paying out almost exactly the same amount in claims and associated expenses as it earns in premiums, thereby increasing the importance of generating substantial underwriting profits. Indeed, the 98.3 combined ratio in 2004 produced an ROE of just 10.5 percent while the 100.0 combined ratio through the first nine months of 2005 is associated with a 9.5 percent return on average surplus.² Considering the tremendous risk assumed by investors who back major insurance and reinsurance companies, these returns are woefully inadequate. It is clear that

² The Insurance Information Institute's Commentary on the 9-month results can be accessed at:

<http://www.iii.org/media/industry/financials/2005firstninemonths/>.

Fortune 500-level returns on equity in the neighborhood of 13 to 14 percent cannot be generated without a substantial contribution from underwriting despite the recent rise in interest rates and increases in investment income.

Combined Ratio



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

2006: Looking Relatively Good, But Concerns Are Mounting

What are the biggest potential downside risks for 2006? High on the list is exposure to catastrophic loss, which has superseded loss of pricing and underwriting discipline as the chief concern. Insurers also run the risk of overestimating the impact of 2005's record catastrophe losses on the price and availability of coverage in 2006. Differing views on the scope and intensity of insurer pricing power in the year ahead likely explain most of the disparity among analysts' forecasts for net written premium growth in 2006, which range from 1.3 percent on the low end to 6.5 percent on the high side. The catastrophe factor has greatly overshadowed concerns about pricing and underwriting discipline, the industry's historical nemesis.

Among major external risks, tort costs remain among the factors that most significantly affect insurer financial performance, despite the passage of the Class Action Fairness Act of 2005 and traction on medical malpractice reform. Asbestos remains perhaps the largest single legislative disappointment for insurers, who generally oppose the government's current trust fund proposal. Asbestos also continues to weigh down the industry's financials, with various insurers taking charges to bolster reserves. Terrorism also remains a key concern, despite the two-year extension of the Terrorism Risk Insurance Act signed by President Bush on December 22. The extension, which has a new expiration date of December 31, 2007, pushed considerably more risk onto private insurers, who have consistently maintained that large-scale terrorism events are not privately insurable. For example, individual company deductibles rise from 15% of direct earned premiums in 2005 to 17.5% in 2006 and 20% in 2007. Likewise, industry aggregate deductibles



are raised from \$15 billion currently to \$25 billion in 2006 and \$27.5 billion in 2007. Many insurers will have retentions great than or equal to their actual 9/11 losses.

Fortunately for insurers, 2006 will likely feature far fewer screaming headlines announcing investigations into various insurance industry practices such as broker compensation and finite reinsurance. That being said, insurers will need to come to grips with the very real possibility of a Governor Eliot Spitzer following elections in New York in November of this year.

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

2006 Groundhog Forecast

NET WRITTEN PREMIUMS		
(% Change from Prior Year)		
	Est. 2005	Forecast 2006
COMPANY		
Raymond James	0.4%	6.5%
Lehman Brothers	0.2	6.1
Firemark Investments	2.5	6.0
A.G. Edwards	2.7	5.0
Williams Capital	-0.5	4.5
Gill & Roeser	1.5	4.0
Fitch Ratings	1.9	3.9
Tillinghast	2.4	3.9
Bear Stearns	NA	3.0
Merrill Lynch	1.2	3.0
Langen McAlleney	1.0	2.5
Standard & Poor's	-1.5	2.0
Conning & Co.	1.2	1.3
ISO	-0.3	1.3
Average	1.0%	3.8%

*Ranked highest to lowest for 2006.

