Review & Preview
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Catastrophes Drive Underwriting Loss in 2012; Better Results Expected in 2013

Catastrophe-related losses declined slightly in 2012 to $43.0 billion down from $44.2 billion in 2011.

Through late October 2012, the U.S. property/casualty (P/C) industry was on track to record a significant improvement in financial results following 2011's substantial underwriting loss. Hurdles continued on the investment front with interest rates expected to remain low for an extended period. Despite this, a steadily firming rate environment, stabilized economy with an improving – albeit still high – unemployment rate, and a much lower level of weather-related losses brought the industry, at Sept. 30, 2012, to a near break-even combined ratio of 100.1 with net income more than twice its 2011 level.

The Oct. 29 arrival of what is likely to become the second costliest U.S. natural disaster – in terms of insured losses after 2005's Hurricane Katrina – means that 2012 will be remembered as the year of Superstorm Sandy. The impact has been apparent on income statements throughout the P/C industry, with the industry's underwriting loss increasing $26 billion and net income deteriorating $10 billion during the fourth quarter, based on A.M. Best's estimates of full year 2012 results.

Outlook

Personal Lines: Stable
Commercial Lines: Negative
Reinsurance: Stable

Sandy's impact notwithstanding, several signs point to improved results in 2013. Net premiums written (NPW) continue to increase, as does policyholders' surplus. The pricing environment is expected to improve in 2013, although rate increases may be smaller in magnitude. While the continuing sluggish macroeconomic environment, persistently low investment yields and the current loss reserve position of the industry will present challenges, A.M. Best believes the industry overall is sufficiently well-capitalized to overcome them.

The personal lines segment has maintained a stable outlook. While volatility from weather-related events is expected to continue to impact the property lines, the automobile portion of the segment remains generally stable. With over 60% of the segment coming from the more stable automobile business, rating affirmations will dominate again in 2013, although concentrated property writers who do not have adequate plans to address volatility in the line may come under continued rating pressure.

The commercial lines segment, however, will still retain its negative outlook in 2013. Insurers are still grappling with competitive market conditions, less favorable loss reserve development, sluggish economic growth and depressed investment yields; and these factors will most likely result in more negative rating actions than positive rating actions during this year. A.M. Best believes that core accident-year margins will continue to improve due to price firming and that, without a major catastrophic event, the commercial sector overall will remain well-capitalized. Movement of reserves for more recent accident years and steps taken to bring pricing to levels that adequately reflect loss trends will be key areas of focus in commercial lines ratings.

Finally, the reinsurance sector maintained its stable outlook supported by continued strong risk-adjusted capitalization, judicious enterprise risk-management practices and a relatively stable pricing environment across a broad array of business classes. These strengths should help sustain reinsurers' overall financial position over the longer term given uncertain global macroeconomic conditions.

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A Note to Readers

Welcome to A.M. Best Co.'s 2013 Review & Preview report for the insurance industry. This report reflects A.M. Best's official view, based on a review of data and industry trends, as well as interaction with management teams of insurance companies and other authoritative sources.

The U.S. and global economies have continued their slow growth and recovery but storm clouds are never far from the horizon. Natural events, political crises and economic uncertainty continue to hinder the progress and goals of risk-bearing organizations worldwide.

Although showing some signs of improvement, the global environment for insurance remains uncertain, whether it's markets struggling with government debt crises and continued low interest rates or natural catastrophes arising from seemingly anywhere across the globe. This year we saw significant increase in the regulatory issues insurers must deal with, both domestically and globally. While some are founded on the basis of sound management principles, others may do little more than increase the regulatory burden.

The three sector-specific editions of this report allow a more thorough examination of the U.S. insurance industry:

• The property/casualty industry remains strongly capitalized. Once again, the industry was able to easily demonstrate that strength by absorbing the losses from Sandy, but new challenges were created in the handling of the hurricane deductible and what it means for the future. The personal lines sector continues to demonstrate steady pricing and underwriting trends, and A.M. Best maintains its stable rating outlook for the sector. The rating outlook remains negative for commercial lines insurers despite modest improvement in price adequacy given ongoing weak economic influences.

• Life insurers continue to manage through the ongoing low interest rate environment, putting pressure on assets and interest-linked products. A.M. Best's rating outlook was reaffirmed at stable.

• Health insurers have continually adapted to the new era of health reform and their rating outlook remains stable. However, economies of scale have been a benefit within the market.

A.M. Best remains committed to open communication about its methodology, criteria and procedures. We have maintained a brisk pace of briefings, special reports, market presentations and public announcements. Our global reach continues to expand, with offices opened within the past year in Miami and Dubai. We have quickened the pace of our briefings and special reports on key industry issues. A.M. Best also issued more updates to methodology in the past year, focusing on the review and applicability to the rating process. Our reports on vitally important sectors such as global reinsurance, excess and surplus, and dozens of market sectors, are more comprehensive and timely than ever.

I hope you will find this year's Review & Preview publication to be an aid in assessing the issues you find important. Please don't hesitate to share your thoughts and concerns with me or our staff; we prize our communication with the insurance industry and its constituents.

– Matthew C. Mosher, Senior Vice President & Chief Rating Officer

Financial Outlook

Operating Performance Tested in 2012; Poised to Improve in 2013

Everything changed with Superstorm Sandy's arrival on Oct. 29, which turned a favorable year into a rerun of 2011. A.M. Best expects the industry's 2012 underwriting loss to be slightly higher – in nominal terms – than the previous year, with the industry posting a $30.8 billion loss. Combined with continuing pressure on investment income, net income is forecast to decline to $20.4 billion, a 23% decline from $26.6 billion in 2011. Catastrophe losses included an estimated $25 billion from Sandy, but also $18 billion from events in the U.S. including tornadoes, severe thunderstorms, hail and wildfires. The nation's Corn Belt also experienced its most profound drought since the 1930s during 2012, resulting in net underwriting losses in crop business.

A.M. Best estimates that catastrophe-related losses declined very slightly in 2012, to $43.0 billion down from $44.2 billion in 2011. This modest decline, combined with solid growth in net premiums written (NPW), was enough to produce a very slight improvement in the industry's overall statutory combined ratio to 106.2 from 106.5 in 2011. Rate increases in most lines of insurance drove a solid 4.9% NPW increase in 2012, and this positive trend is expected to continue into 2013. However, the industry's investment performance reflects continued pressure on investment markets, with net investment income down 1.8% on the year. Net investment gains – the sum of net investment income and realized capital gains – are expected to decline by a similar percentage as realized gains in 2012 are expected to increase just slightly, to $7.3 billion from $7.2 billion in 2011.

Despite the effect of catastrophes on underwriting performance, the industry is expected to show growth in policyholders' surplus (PHS) for 2012, driven primarily by a positive change in the overall unrealized gain position. Surplus is projected to grow 1.5% in 2012, to $575.8 billion. A.M. Best estimates that the U.S. P/C industry's after-tax return on equity – which measures overall after-tax profitability from underwriting and investment activity – will decline to 3.6% from 4.7% in 2011.

Exhibit 1

U.S. Property/Casualty – Financial Indicators (2008-2013P)

Excludes mortgage and financial guaranty segments.

	Actual				Estimates	
	2008	2009	2010	2011	2012E	2013P
Change in Net Premiums Written (NPW) (%)	-1.9	-3.8	1.0	3.5	4.9	4.5
Change in Surplus (%)	-11.4	12.0	9.1	-0.9	1.5	1.9
Combined Ratio (Reported)	101.2	99.5	101.0	106.5	106.2	101.2
Less: U.S. Catastrophe Losses[1]	6.4	3.4	4.5	9.6	9.4	4.7
Less: A&E Losses	0.4	0.6	0.9	0.6	0.6	0.5
Combined Ratio (Normalized)	94.5	95.5	95.6	96.4	96.3	96.0
Accident-Year Combined Ratio (Normalized)[2]	95.7	99.1	99.5	99.9	99.4	98.6
Change in Net Investment Income (%)	-6.6	-6.1	-1.2	3.3	-1.8	2.5
Net Investment Yield (%)	3.4	4.0	3.8	3.8	3.7	3.7
Pretax Return on Net Premiums Earned (ROR) (%)	10.8	12.3	10.2	5.2	4.0	8.8
After-tax Return on Surplus (ROE) (%)	4.3	7.4	7.9	4.7	3.6	5.8
NPW-to-Surplus Ratio	0.9	0.8	0.7	0.8	0.8	0.8

E=Estimated, P=Projected
1 Historical catastrophe losses (2008) are based on data compiled by Property Claim Services (PCS), a unit of Insurance Services Office, Inc.; 2009-2011 catastrophe losses based on A.M. Best data; 2012-2013 are A.M. Best estimates.
2 Normalized accident-year combined ratio adjusted to exclude prior-year core reserve development, which excludes A&E losses.
Source: A.M. Best research

A.M. Best's 2013 projections reflect a more normal level of catastrophe losses as well as the benefits from improved price adequacy from 2012's rate increases and those expected in 2013. However, the industry's performance will remain challenged by the continuing sluggish macroeconomic environment, which includes persisting low investment yields, a reduced level of loss reserve redundancies and the lingering effects of the soft market conditions that have prevailed in recent years. A.M. Best believes the industry is well-capitalized overall to meet these challenges, but a clear distinction is increasingly apparent between companies that managed the last cycle well and those that did not.

Operating Performance

The improved pricing environment that took hold in late 2011 and continued through 2012, drove NPW growth for a second consecutive year following three years of declines. Workers' compensation is expected to post double-digit growth for a second year, as rate increases, exposure stabilization and beneficial audit results boost writings. Most property lines also experienced solid NPW growth, following the unusually large losses experienced in 2011. Overall, A.M. Best estimates that NPW increased 4.9% in 2012, to $463.8 billion, from $442.2 billion in 2011. Net premiums earned (NPE) are also expected to increase by approximately 4.1% to $455.1 billion, reflecting the impact of prior rate increases.

Despite these solid premium increases, the industry's reported combined ratio for 2012 is expected to improve by just 0.3 points, to 106.2 from 106.5 in 2011. The approximate $25 billion in expected total insured losses from Superstorm Sandy – second only to those of 2005's Hurricane Katrina in terms of U.S. natural disasters – accounts for the majority of the industry's anticipated underwriting loss. The total underwriting loss for 2012 will exceed that of 2011 – even though increased premiums generated a slightly improved combined ratio –and will rank as the industry's third-worst reported underwriting loss, after a $56.4 billion loss in 2001 and a $34.2 billion loss in 2002.

The modest improvement in the industry's forecasted combined ratio was generated by the slight reduction in total U.S. catastrophe losses in the year, which drove a slight improvement in the overall loss ratio. Improved underwriting and pricing discipline can be inferred from the improvement in the industry's normalized accident-year loss ratio, which decreased to 99.4 from 99.9 in 2011. On a reported basis, however, this benefit was offset by a reduced level of favorable development of prior year's loss and loss adjustment expense (LAE) reserves. A.M. Best expects that the benefit of favorable loss reserve development will continue to decline, increasing the importance of maintaining underwriting and pricing discipline for the current accident year.

Exhibit 2

U.S. Property/Casualty – Combined Ratio Components (2008-2013P)

Excludes mortgage and financial guaranty segments.

($ Billions)

	Net Premiums Written (NPW)	NPW Growth (%)	Loss Ratio (%)	Loss-Adjustment Expense Ratio (%)	Under-writing Expense Ratio (%)	Dividend Ratio (%)	Combined Ratio (%)
2008	439.8	-1.9	61.1	12.0	27.5	0.6	101.2
2009	423.1	-3.8	58.3	12.5	28.1	0.6	99.5
2010	427.4	1.0	59.5	12.6	28.3	0.7	101.0
2011	442.2	3.5	65.3	12.6	28.0	0.6	106.5
2012E	463.8	4.9	65.1	12.9	27.7	0.6	106.2
2013P	484.5	4.5	60.6	12.7	27.3	0.6	101.2

E=Estimated, P=Projected
Source: A.M. Best research

Projected changes in the loss adjustment and underwriting expense ratios offset one another, with a modest improvement in the underwriting expense ratio – driven primarily by increased premiums – and a minor deterioration in the LAE ratio – generated by increased claims-handling costs from Sandy and the unusually large number of weather events in the first half of 2012. The policyholder dividend ratio is expected to be unchanged, at 0.6% of NPE.

A.M. Best projects net investment income to be $48.8 billion, a decrease of 1.8% from $49.7 billion in 2011. This decline reflects the lackluster growth in invested assets that continues to be predominantly invested in fixed-income instruments and the impact of low interest rates on the P/C industry. Net investment income – together with realized capital gains/losses – compose the industry's net investment gain, which is expected to be down about 1.4% at approximately $56.1 billion in 2012. While realized gains through the third quarter were slightly behind 2011 levels, the uncertainty at year end of tax-law changes regarding capital gains did drive some companies to realize gains, particularly for long-held equities. A.M. Best anticipates that the industry will realize approximately $7.3 billion in capital gains in 2012, up from $7.2 billion in 2011. In addition, investment yield continues to be low and is expected to drop slightly in 2012 to 3.7% from 3.8% in 2011.

While U.S. equity markets – somewhat less volatile in 2012 than in other recent years – and the economy appear to be stabilizing, prospects for improved investment yields over the near to mid-term remain faint.

Although the U.S. avoided a Jan. 1 plunge over the "fiscal cliff" in a deal that increased income tax rates on certain high-income earners, Congress needs to revisit the debt ceiling as a primary action item. Washington's lack of progress on this and other issues may result in more capital market volatility.

Catastrophe Losses

Superstorm Sandy was the major catastrophic event of 2012. Coming near the end of what had been – for the U.S. mainland – a relatively unremarkable season, Sandy swept

Exhibit 3

U.S. Property/Casualty – Surplus Recap (2008-2013P)

Excludes mortgage and financial guaranty segments.

($ Billions)

	Actual				Estimates	
	2008	2009	2010	2011	2012E	2013P
Beginning Policyholders' Surplus	**$528.6**	**$468.5**	**$524.6**	**$572.2**	**$567.3**	**$575.8**
Net Underwriting Income	-4.5	2.8	-5.2	-29.7	-30.8	-7.9
Net Investment Income	51.8	48.6	48.1	49.7	48.8	50.0
Other Income/(Expense)	0.6	0.8	0.5	2.8	0.0	0.0
Pretax Operating Income	**47.8**	**52.2**	**43.4**	**22.7**	**18.0**	**42.0**
Realized Capital Gains/Losses	-16.6	-5.5	8.7	7.2	7.3	0.0
Federal Income Taxes	9.7	9.9	8.9	3.3	4.9	8.1
Net Income	**21.5**	**36.8**	**43.2**	**26.6**	**20.4**	**33.9**
Unrealized Capital Gains/Losses	-54.3	23.5	15.9	-3.5	13.3	0.0
Contributed Capital	4.0	3.5	22.2	-0.6	-0.2	1.5
Stockholder Dividends	-25.0	-18.3	-32.9	-27.5	-25.0	-24.5
Other Changes	-6.3	10.6	-0.8	0.0	0.0	0.0
Ending Policyholders' Surplus	**$468.5**	**$524.6**	**$572.2**	**$567.3**	**$575.8**	**$586.7**
Total Changes in Surplus ($)	-60.1	56.1	47.6	-4.9	8.5	10.9
Change in Surplus from Prior Year (%)	-11.4	12.0	9.1	-0.9	1.5	1.9

E=Estimated, P=Projected
Figures may not add due to rounding.
Source: A.M. Best research

up the eastern seaboard of the United States before making landfall in New Jersey. Although Katrina remains the most significant storm in U.S. history in terms of insured losses, current estimates of insured losses totaling $25 billion will rank Sandy as the second-costliest storm. Thousands of residents of coastal New Jersey and New York remain displaced after their homes were washed away or destroyed by fire as a result of gas leaks. Record-setting snowfall occurred in many areas of West Virginia. Businesses in many areas, including parts of New York's financial district, were dependent on back-up power supplies into 2013 as infrastructure repairs continue.

Should the estimate of $25 billion in insured damage stand, Sandy will account for 5.6 points of the industry's 2012 combined ratio. Sandy's losses have been greater in commercial lines than personal lines, and auto losses appear to be significantly higher than usual. The nature of the storm – with a tidal surge causing much more damage than wind in the most heavily affected areas – has driven these loss patterns, as homeowners' losses are relatively lower than would be expected from a tropical or post-tropical storm.

Reaction of regulators and elected officials may prove to be the industry's greatest challenge from the storm, however. Within hours of Superstorm Sandy's landfall, officials and regulators in a number of coastal states announced that insurers would be prohibited from enforcing "hurricane" deductibles put into place in recent years, as Sandy was technically a post-tropical cyclone when it made landfall. As companies continue to evaluate how decisions by regulators will impact future product design and pricing, this regulatory response may have the longest-lasting impact on the industry.

A.M. Best anticipates that the industry's overall capital position is sufficiently strong to meet Sandy's losses. Coming on the heels of Hurricane Ike, the Halloween storm of 2011, and Tropical Storm Irene in August 2012, Sandy's effects were greatest on local and regional carriers covering the mid-Atlantic and Northeast. However, as a testament to the industry's improved risk management in recent years, minimal rating actions were taken on individual insurers as a result of exposure to losses from the storm. In addition, these rating actions generally reflected other concerns in conjunction with losses from Sandy.

Exhibit 4

U.S. Property/Casualty – Segment Indicators (2011-2013P)

Excludes mortgage and financial guaranty segments.

	Personal Lines Segment			Commercial Lines Segment			U.S. Reinsurance Segment		
	2011	2012E	2013P	2011	2012E	2013P	2011	2012E	2013P
Change in NPW (%)	1.8	4.5	4.6	4.8	5.0	4.4	9.3	7.6	3.5
Change in Policyholders' Surplus (PHS) (%)	-0.7	0.9	2.1	-1.2	-1.3	2.0	-0.4	7.1	7.3
Combined Ratio (Reported)	106.1	105.0	100.6	106.7	109.0	102.9	108.8	97.7	93.8
Less: Catastrophe Losses	10.4	9.5	5.0	7.4	9.3	4.0	17.9	8.6	7.0
Less: A&E Losses	0.1	0.1	0.1	1.1	1.1	1.0	0.9	1.7	1.1
Combined Ratio (Normalized)	95.6	95.4	95.5	98.2	98.6	97.9	90.0	87.3	85.7
Accident-Year Combined Ratio (Normalized)[1]	98.2	98.0	98.0	102.3	101.8	100.7	98.6	94.1	89.8
Change in Net Investment Income (%)	0.4	0.4	0.7	-0.4	-2.1	2.9	20.4	-4.2	4.0
Investment Yield (%)	3.2	3.2	3.2	4.0	3.9	3.9	4.4	4.1	4.0
After-Tax Return on Surplus (ROE) (%)	1.6	1.2	4.1	6.6	4.5	7.1	6.4	5.7	6.4
NPW/PHS (Reported)	1.1	1.1	1.1	0.8	0.9	0.9	0.2	0.2	0.2

E=Estimated, P=Projected
1 Normalized accident-year combined ratio adjusted to exclude prior-year core reserve development, which excludes A&E losses.
Source: A.M. Best research

While Sandy was certainly the most significant U.S. catastrophe of 2012, it was not the only weather event to cause losses. Through the first six months of 2012, in fact, weather-related losses were significantly above average. Tornados, wildfires, hailstorms, Tropical Storms Beryl and Debby, and an outbreak of severe storms that caused damage from the Midwest to the mid-Atlantic, brought total losses through June 30 to more than $13 billion, an unusually high mid-year total. Hurricane Isaac– the only storm to make U.S. landfall classified as a hurricane in 2012 – caused an estimated $2 billion in total economic damage, although insured losses were expected to be significantly less due to the response by the National Flood Insurance Program. Without Sandy, the United States would have experienced an "average" catastrophe year, with approximately 4 points of losses attributable to catastrophe events.

While not an "event" in the same sense, the drought that impacted much of the U.S. Corn Belt in 2012 is expected to generate gross underwriting losses of $15 billion to $20 billion. However, since the majority of these losses are ceded to the Federal Crop Insurance Corporation, the net impact on the U.S. P/C industry is not expected to be significant.

The U.S. reinsurance segment saw a substantial decline in losses related to catastrophes in 2012, despite Sandy and other U.S. events. Although the year was more active in terms of number of global catastrophe events, the total was far less than 2011's record loss, which was impacted by the earthquake and tsunami in Japan, earthquakes in New Zealand, and wildfires and tropical cyclones in Australia and Asia.

U.S. reinsurers are expected to have a reduction in the impact of catastrophes on their combined ratio, declining to 8.6 points in 2012, from 17.9 in 2011. Personal lines insurers are also expected to have a small decline – to 9.5 points from 10.4 – in 2012. Only commercial lines insurers are anticipated to have higher catastrophe losses in 2012, adding 9.3 points to the combined ratio, up from 7.4 in 2011.

Loss-Reserve Development

The size of reserve releases for the U.S. P/C industry is expected to have declined in 2012, as over the past several years. A.M. Best estimates the industry will recognize

Exhibit 5

U.S. Property/Casualty – Product Line Underwriting Trends (2008-2013P)

	Net Premiums Written 2012E		Combined Ratios					
			Actual				Estimates	
Product Line	Share	Growth	2008	2009	2010	2011	2012E	2013P
Private Passenger Auto	36.6%	3.6%	100.3	101.3	101.0	101.9	99.6	98.5
Homeowners & Farmowners Multiple Peril	15.1	5.0	116.9	105.8	106.7	122.2	118.0	105.5
Other & Product Liability[1]	8.6	1.0	95.1	105.4	109.8	100.5	103.6	106.3
Workers' Compensation	8.6	11.0	104.5	110.6	116.8	116.9	117.3	115.0
Commercial Multiple Peril	6.8	5.0	104.1	97.0	100.2	113.2	116.6	102.6
Fire & Allied Lines[2]	5.7	5.0	99.3	80.0	82.5	102.7	108.2	86.7
Commercial Auto	4.8	4.5	96.8	99.4	98.0	104.6	107.1	103.6
Inland Marine	2.1	7.0	93.2	89.4	86.2	97.1	100.2	89.6
Medical Professional Liability	1.9	-3.0	77.4	83.4	80.6	87.9	91.0	93.5
All Other Lines[3]	9.9	-1.0	124.4	99.3	101.4	112.3	113.0	108.6
Total All Lines	100.0%	4.9%	101.2	99.5	101.0	106.5	106.2	101.2

E=Estimated, P=Projected
1 Other Liability includes professional liability, D&O, excess casualty/umbrella, environmental/pollution, general liability, and EPLI.
2 Fire & Allied Lines includes earthquake, multiple peril crop, and federal flood.
3 All Other Lines includes accident & health lines, mortgage guaranty, financial guaranty, ocean marine, aircraft, fidelity, surety, burglary & theft, boiler & machinery, credit, international, excess of loss reinsurance and miscellaneous.
Source: A.M. Best research, BESTLINK Best's Statement File Supplement - Insurance Expense Exhibit (IEE) - P/C, US (2008-2011)

favorable loss-reserve development on prior accident years of approximately $11 billion for 2012. The reserve reduction will produce a benefit to the industry's reported calendar-year combined ratio of 3.1 points, which is a decline from the 3.5 point benefit in 2011 and the 3.9 points in 2010.

While increased premiums in 2012 also impacted the effect of the reserve release on the combined ratio, the slowing pace of reserve releases reflects the extent to which the industry has already recognized much of the benefit of conservative reserve selections for older accident years, particularly those in the middle years of the previous decade. On the other hand, the most recent accident years for some lines are showing an emerging pattern of adverse development, reflecting the competitive market conditions and challenging macroeconomic environment on rate adequacy in those years.

While the strengthening rate environment should improve the pricing adequacy of current business, A.M. Best continues to believe that core, undiscounted reserves will remain inadequate. At best, the benefit of reserve releases will be reduced, but A.M. Best expects some companies will take more significant steps to increase reserves in response to the pricing inadequacies and overly optimistic reserve assumptions, particularly for the 2008 through 2010 accident years. For some companies, the price increases in 2011 and 2012 may provide a sufficient opportunity to increase reserves and avoid overall deficiencies. However, the price increases may not result in overall rate adequacy due to rising loss costs. A.M. Best continues to believe that insurers that have consistently maintained prudent reserving principles will be best positioned to compete as the market continues to firm.

Policyholders' Surplus

After declining by nearly 1% in 2011, the industry's PHS is expected to increase in 2012 by 1.5%, to $575.8 billion from $567.3 billion at year-end 2011. Despite a modest increase in the industry's overall underwriting loss and a slight decline in net investment income, the industry's unrealized capital position is expected to increase by $16.8 billion as of year-end 2012 to $13.3 billion from a loss of $3.5 billion at year-end 2011, driving the increase in surplus. A reduction in stockholder dividends also should benefit the industry's surplus position at year-end 2012. Underwriting leverage measures were essentially unchanged in 2012, despite the increase in NPW posted in the year, with the NPW-to-PHS ratio unchanged at 0.8. Despite its continuing challenged underwriting and operating results, the industry's balance sheet remains relatively strong and most insurers remain well-positioned to operate in a more hospitable rate environment.

Personal Lines

A.M. Best continues to maintain a stable outlook for the personal lines segment. There is no denying that the segment, along with the industry as a whole, has faced many challenges over the past few years. The personal lines segment has been impacted by a multitude of frequent and severe weather-related events. This property line volatility has been offset by generally stable results on the automobile line. Although loss cost pressures – particularly regarding medical inflation – continue to influence results, overall automobile performance has been generally adequate.

As of the third quarter of 2012, the segment's overall loss experience had posted considerable improvement due largely to the significant reduction in catastrophe losses and the on-going price adequacy and risk-management initiatives employed across the

segment. However, with Superstorm Sandy making landfall in the fourth quarter, the potential for a "below-average" catastrophe loss year was quickly erased. Although carriers in the personal lines segment in particular, and the industry in general, effectively absorbed the losses associated with Sandy, the trend in property volatility continues.

Despite this trend of frequent and severe events, the personal lines segment remains adequately capitalized. This has been driven primarily by the continued stable results in the auto line, reflecting pricing segmentation and sophistication. Prospectively, the automobile result trends of the past several years are expected to continue.

Pricing sophistication continues to evolve, particularly through telematics which enables granular pricing by capturing individual driving characteristics. Companies that continue to effectively utilize such technologies are expected to build and maintain a considerable competitive advantage in the personal auto insurance space. Another trend, multi-channel distribution – interaction with potential and existing customers across a wide spectrum of distribution outlets – remains a key differentiating factor for a large portion of the personal auto market. In addition, brand awareness programs and marketing budgets are expected to continue growing at the current pace. Although the growth rate may fluctuate, it is anticipated that the overall level of advertising will remain high for the foreseeable future.

Beneath these trends remains the year-over-year stable performance of the personal automobile insurance business. Loss-cost trends remain generally moderate, although there has been some pressure from rising medical and auto repair costs. In addition, Sandy's effect on the automobile line was somewhat higher than anticipated, which may drive movement to additional risk-management attention on auto's exposure to catastrophe loss.

Exhibit 6
U.S. Property/Casualty – Personal Lines Segment Key Figures (2011–2013P)
($ Billions)

	2011	2012E	2013P
Net Premiums Written	$231.7	$242.2	$253.3
Underwriting Gain/Loss	-14.4	-13.1	-2.8
Net Income	3.5	2.7	9.0
Policyholders' Surplus	214.0	215.9	220.4
After-Tax Return on Surplus (%)	1.6	1.2	4.1

E=Estimated, P=Projected

Source: A.M. Best research

Exhibit 7
U.S. Personal Lines Segment – Financial Strength Rating Changes (2012)

Rating Action	Rating Units [1]
Upgrades	12
Downgrades	39

[1] Totals are for U.S. personal lines.
Insurers rated by A.M. Best Co.
Source: A.M. Best research

As noted, the homeowner line continues to be besieged with weather-related events. Whether it's an issue of frequency, severity, or sometimes both, the expectation is that regardless of the underlying causes, the erratic and volatile weather patterns experienced over the past few years will continue and significant rate increases cannot be the only action taken to stabilize results. Along with significant rate increases, companies have adopted more formal and comprehensive risk-management initiatives that have partially offset the continued frequency and severity in this line of business. Some of these initiatives include mandatory wind/hail deductibles, percentage hurricane deductibles, and roof limitations based on the roof's age and condition. In addition, improved geo-coding, greater understanding of risk concentrations and adherence to stricter underwriting guidelines has partially mitigated overall losses.

Prospectively, carriers continue to expand their pricing sophistication on the homeowner's line. This is particularly true regarding the ongoing development and expansion of by-peril pricing modules and more granular pricing metrics across this line of business. Although it is inherently more difficult, given the non-homogenous nature of the homeowner segment, there continues to be increased efforts to reduce

Exhibit 8

U.S. Personal Lines Segment – Rating Changes (2012)

Top 10 writers upgraded or downgraded, by 2011 net premiums written.

($ Thousands)

Rating Change[1]	Company	2011 Net Premiums Written	Best's Financial Strength Rating[2]	Previous Rating
-	Tennessee Farmers Ins Cos	$1,003,625	A+	A++
-	Kentucky Farm Bureau Group	862,038	A	A+
-	Michigan Farm Bureau Group	493,933	B++	A-
+	American Strategic Ins Group	410,002	A	A-
-	Georgia Farm Bureau Group	400,680	B+	B++
-	United Automobile Ins Co	224,313	C	C++
-	Farm Bureau Mutual Ins of AR	185,573	B++ u	A- u
-	Ocean Harbor Insurance Group	149,049	B	B+
-	Mountain West Insurance Grp	145,859	A	A+
-	Affirmative Insurance Group	141,164	C	C+

1 (+) Rating upgrade; (-) Rating downgrade
2 For Best's Rating criteria and definitions, visit www.ambest.com. Ratings as of Dec. 31, 2012.
Note: Shaded areas indicate that the rating is assigned to operating companies within the group.
Source: A.M. Best research

volatility. In addition, it is expected that carriers will continue to pursue initiatives designed to limit mono-line exposure to the homeowners line of business. The evidence regarding overall retention and long-term financial performance is undisputed.

Rating Trends

Given the variation in performance trends across the segment's two lines of business, it is reasonable to see deviating trends between the auto and homeowners carriers' that A.M. Best rates. In the personal lines segment, there were 39 downgrades and 12 upgrades in 2012. The ratio of downgrades to upgrades in 2012 was similar to 2011, reflecting the frequent and severe weather-related events. As in 2011, downgrades in the personal lines segment in 2012 continued to be driven by two subsets: geographically concentrated property writers with limited scale, and to a lesser extent, non-standard auto writers.

In most cases, localized or regional property writers lack the ability to absorb the aggregation of weather-related events without materially reducing risk-adjusted capitalization, which in turn, leads to downward pressure on their ratings. Also, in 2012 rating actions on non-standard auto writers continued to be driven by rising claims' costs, macroeconomic conditions and fraud-related activity. It is also important to note that of the 39 downgrades, five entities were downgraded twice during the year. In all of these cases, the ratings were in the vulnerable category, which implies inherently more volatility.

Nine of the top 10 rating changes, based on NPW, reflect downgrades through various levels of the Financial Strength Rating (FSR) scale. Seven of the nine downgrades were for property-predominate companies, which is indicative of the ongoing volatility in the property line and corresponding long-term results.

In terms of upgrades, companies with positive rating actions continue to exhibit solid risk-adjusted capitalization and have demonstrated an ability to consistently produce favorable operating results. The ability to manage through extreme events and changing underwriting cycles, while maintaining stable or improving risk-adjusted capitalization, is a key rating consideration.

Outlook

The stable outlook implies that most rating actions in 2013 will be affirmations and that the number of positive rating actions will keep pace with negative rating actions. Although property line volatility continues to be a drag on overall results, it has not materially weakened the segment's overall capital position, and auto results continue to be stable despite some margin compression. Given that more than 60% of the segment's NPW is automobile-based, A.M. Best believes the stable outlook is appropriate. However, A.M. Best anticipates that some concentrated property writers may continue to face rating pressure. Most important is each company's ability to effectively address the volatility in this line of business.

A.M. Best anticipates that companies will demonstrate underlying trends indicative of improved performance, regardless of weather patterns. It is clear that rate increases cannot be the only mechanism to improve results in the property lines. Those carriers that have demonstrated success in overall risk management and performance improvement, while maintaining favorable risk-adjusted capitalization, are generally viewed more favorably. Significant segment-wide rate increases will continue to be earned in 2013, and risk-management initiatives will continue to gain traction. As a result, A.M. Best believes the personal lines segment as a whole is stable and adequately capitalized to withstand a normalized catastrophe year.

Commercial Lines Segment

For the commercial lines insurers, billions of dollars in insurable risks suddenly evaporated during the economic crisis that began in late 2008 and still lingers through one of the slowest economic growth periods in U.S. history. At the same time, they were in the midst of a prolonged soft market and grappling with limited pricing elasticity, as insureds and risk managers tightened their purse strings. Quantitative easing also effected insurers, as investment yields fell to record lows, leaving many investment managers in a quandary as to where and how long to invest new money. As the economy slowly recovers, insurers continue to face many of the same challenges brought on by the financial crisis. For these reasons, A.M. Best first initiated its negative outlook on this segment in 2011, which remained in 2012 and was re-affirmed in 2013.

Although up-pricing will continue, the expectation is that weak macroeconomics, less favorable loss-reserve development and record low investment yields will likely lead to more negative rating actions than positive actions in 2013. Despite the negative outlook, A.M. Best believes that on balance, the vast majority of commercial lines insurers will have their ratings affirmed in 2013.

Exhibit 9

U.S. Property/Casualty – Commercial Lines Segment Key Figures (2011 – 2013P)

($ Billions)

	2011	2012E	2013P
Net Premiums Written	184.6	193.7	202.3
Underwriting Gain/Loss	-12.9	-17.8	-6.3
Net Income	15.0	10.1	16.0
Policyholders' Surplus	227.3	224.4	228.9
After-Tax Return on Surplus (%)	6.6	4.5	7.1

E=Estimated, P=Projected
Source: A.M. Best research

Pricing

Since mid-2011, many commercial lines insurers have been seeing signs of hope as pricing and lost business return to the market. In 2013, A.M. Best believes incremental rate increases should remain in positive territory for as long as interest rates remain at record lows. What remains to be seen is to what extent pricing accelerates and whether the pace of commercial up-pricing exceeds future loss costs and inflation.

Barring a major catastrophe, A.M. Best believes commercial lines pricing in 2013 will continue to improve, but will moderate slightly compared with the rate increases garnered in 2012. A.M. Best believes price moderation has already taken place and will likely be prompted by competitive pressures and an abundance of capital. Also, a host of macroeconomic factors, including sluggish economic growth and high unemployment are areas that directly affect commercial insurance. Continued weakness in public- and private-sector construction will continue to stymie growth prospects in the upcoming year. In essence, any new commercial lines' growth prospects will have to come from rate increases as new business opportunities are likely to be neutralized by the slow growth economy.

Exhibit 10

U.S. Commercial Lines Segment – Financial Strength Rating Changes (2012)

Rating Action	Rating Units[1]
Upgrades	16
Downgrades	28

[1] Totals are for domestic commercial lines
Insurers rated by A.M. Best Co.
Source: A.M. Best research

Although new growth prospects will be scarce, A.M. Best believes commercial property and workers' compensation insurers are likely to experience the largest potential upside from a pricing perspective. As for commercial property, this line should continue to see additional rate as insurers remain diligent in their risk-selection efforts and in attracting more rate in areas of the country once considered non-catastrophe prone. Up-pricing should also come by way of modified terms and conditions and higher catastrophe loads based on the unique set of catastrophe events encountered over the past several years.

As for workers' compensation, private insurers and state funds are expecting some needed rate increases, particularly in those states where medical loss costs are growing much faster than inflation and anticipated reform benefits are now found somewhat less effective. Some marginal growth could also come from lower unemployment and a slight up-tick in payrolls. As pricing in the standard market improves, some of the "fringe" classes of business in the admitted market – particularly certain general liability and property classes – are likely to find their way into the excess and surplus lines market at substantially higher rates and tighter terms and conditions.

Exhibit 11

U.S. Commercial Lines – Rating Changes (2012)

Top 10 writers upgraded or downgraded, by 2011 net premiums written.
($ Thousands)

Rating Change[1]	Company	2011 Net Premiums Written	Best's Financial Strength Rating[2]	Previous Rating
-	Selective Insurance Group	$1,492,105	A	A+
+	Coverys Companies	352,825	A	A-
-	Canal Group	189,267	A-	A
+	FPIC Insurance Group	150,937	A	A-
-	Ullico Casualty Company	137,358	B u	B +
+	Stonebridge Casualty Ins Co	122,975	A	A-
-	Dallas National Insurance Co	113,388	B- u	B
-	Pennsylvania Lumbermens Mutual	94,242	A-	A
-	FFVA Mutual Insurance Co.	93,041	A-	A
+	American Road Insurance Co	89,651	A	A-

[1] (+) Rating upgrade; (-) Rating downgrade.
[2] For Best's Rating criteria and definitions, visit www.ambest.com. Ratings as of Dec. 31, 2012.
Note: Shaded areas indicate that the rating is assigned to operating companies within the group.
Source: A.M. Best research

As a more sophisticated means of attracting better priced business, predictive modeling continues to be used by some insurers to minimize losses and maximize profits. However, such modeling is more likely to be found in larger organizations that have the resources to better leverage data through technology, with the ultimate reward being improved resolution, risk selection and price optimization. Many insurers are also combining data and technology to enhance overall efficiency, create a user-friendly environment and a faster delivery system, and thereby promoting a closer working relationship with their key business partners. Going forward, A.M. Best believes that successful insurers will be those that leverage data and technology in ways that optimize profits and differentiate themselves in the marketplace through better pricing metrics, speed and efficiency.

Catastrophes

Compared to the unprecedented pace of tornado and hailstorm activity that ravaged the Midwest in 2011, natural catastrophe losses in 2012 were proving to be relatively benign until the late season arrival of Superstorm Sandy. While Sandy ultimately may prove to be one of the costliest catastrophe loss events thus far in U.S. history, it is not expected to be a catalyst for commercial lines rate increases.

Due to its size, unprecedented storm surge and effects on thousands of local businesses in and around New York City, Sandy's commercial losses are likely to be sizable. A.M. Best believes a number of business-interruption and contingent business-interruption claims are likely to reach their maximum limits as the list of potential claimants includes:

- International airports and commercial airlines;
- Hotels and restaurants;
- Transit agencies and utility companies;
- Various global financial institutions and exchanges;
- Museums;
- Residential apartment buildings and;
- A vast number of local commercial insureds.

Loss Reserves

Although commercial insurers remain well-capitalized, A.M. Best believes that balance sheets will continue to be compromised by early loss-reserve takedowns. In 2012, commercial lines reserves developed favorably, equating to 3.2 points on the segment's combined ratio. A.M. Best believes that, in time, commercial insurers will no longer have the ability to release prior-year loss reserves, which insurers have used in recent years to mask results. While it is A.M. Best's belief that loss reserves are already deficient, it anticipates that commercial insurers will continue to post reserve redundancies in 2013, but the ability to release reserves beyond that will be nearing the end.

A.M. Best has repeatedly warned that reduced redundancy levels from earlier accident years, coupled with more competitive pricing conditions in the more recent accident years, would yield lower levels of favorable reserve development. As the benefits of prior-year loss-reserve releases diminish, A.M. Best believes insurers that have reserved conservatively will be the ones best-positioned to take advantage of market opportunities through the market cycle.

Rating Trends

Despite the challenges associated with low investment yields and the ongoing macroeconomic factors, the majority of commercial lines insurers had their ratings and outlooks

affirmed in 2012. These rating actions primarily reflected the commercial lines insurers' strong risk-adjusted capital positions despite a downturn in underwriting and operating profitability.

Nevertheless, negative rating actions did outnumber positive rating actions over the past 12 months. The majority of the negative ratings actions were the result of poor operating results and/or adverse prior-year loss-reserve development, which some companies could not effectively absorb without materially reducing their risk-adjusted capital positions. The negative rating pressure was not specific to any one line of insurance.

Conversely, positive rating movement in 2012 was largely reflective of companies' sustained long-term operating performance, conservative reserving practices and strong enterprise risk management skills. These companies also maintained strong levels of capitalization.

Outlook

Despite encouraging signs of price firming in 2012, A.M. Best maintains its negative outlook for the commercial lines segment for 2013. This outlook implies that while the vast majority of rating actions will be affirmations, negative rating actions will outnumber positive rating actions during the year.

As more and more commercial lines insurers are demonstrating their ability to achieve rate increase, premium growth in commercial lines appears sustainable. The question is to what degree? While pricing trends are encouraging, A.M. Best believes commercial insurers still have a way to go before they can declare this a hard market.

Furthermore, given the abundance of capital that remains in the market, coupled with more difficult investment constraints, it would appear as though a number of insurers are still in need of additional rate just to achieve a return on equity (ROE) hurdle rate that would be considered satisfactory to stakeholders. No longer is a breakeven combined ratio acceptable based on today's standards. As a result, many commercial insurers will continue to be tested in 2013.

Albeit strong in the aggregate, the capitalization levels for some commercial lines insurers are expected to be depleted by the continued erosion in loss reserve adequacy and weaker-than-expected operating results. A.M. Best believes that reserve charges will become more prevalent in 2013 than in past years as insurers begin to recognize some overly optimistic accident-year loss picks.

Due to the nature of the business, the long-tail payout and inherent difficulties in forecasting loss costs, inflation and the impact of state reforms, A.M. Best is most concerned with workers' compensation reserves in terms of potential adverse development. This concern also stems from past history and reserving problems encountered by most workers' compensation insurers during the prior soft-market cycle pre-2001. Up-pricing in workers' compensation could also be a precursor to future loss-reserve charges, as changes in pricing may ultimately lead to changes in loss-cost assumptions on prior-year business.

While the commercial lines outlook remains negative, A.M. Best does not expect rating actions to move profoundly negative as continued rate momentum, coupled with positive cash flows and retained earnings continue to fortify an already abundant level of capital. For some companies, however, time may be running out as prolonged soft market conditions, coupled with low interest rates and adverse reserve development may prove to be too much to overcome, leading to negative rating actions.

U.S. and Bermuda Reinsurance Market

As a result of solid underwriting performance, A.M. Best's U.S. and Bermuda reinsurance market composite is expected to post nearly 10% ROE for 2012. Looking back, for 2009, the composite posted a 16% ROE. Three years before that, in 2006, the composite average was a 19% ROE – with favorable loss-reserve development of less than 1% and no net realized gains. At that time, most market participants and observers knew that 2006 was likely the high-water mark for P/C returns. What most didn't know then was that by the end of 2012, the U.S. and Bermuda reinsurance market would struggle to post the round number of 10% and would be challenged to post double-digit returns over the intermediate term.

However, it is all relative. Perceptions change, modes of thinking rearrange, and the collective mindset in the corporate and investing world has evolved. Financial crises have a way of doing that. While people may long for the days of 16% or 19% average ROEs, 10% in 2012, and projected returns in the high single digits for 2013, appear relatively attractive when compared with an annual yield of less than 2% on 10-year U.S. Treasury bonds. Still, the P/C reinsurance sector has been out of favor for some time with investors. Net investment income, once the stabilizing ballast for reinsurance companies' earnings, now is more like a dragging anchor holding back earnings. What's more difficult is the longer-term threat of rising interest rates and inflation, making reinsurers question their next steps.

For 2013, A. M. Best projects that the U.S. and Bermuda reinsurance market is positioned to squeeze out ROE of 9.2%. This assumes a normal level of catastrophe losses, no realized investment gains or losses and continued stabilization in the major economies across the globe. Investment earnings continue to be the largest single component of overall earnings; however, the negative trend of a declining base of net investment earnings is expected to continue as a result of the prolonged pressure on investment yields. Counter to that, underwriting's contribution to earnings is expected to improve slightly as favorable pricing momentum in both property and casualty classes contribute to modest top-line growth. However, the improvement in underwriting earnings is not expected to be nearly sufficient to offset the drag from lackluster investment returns.

On the underwriting side, A. M. Best has factored continued improvement in the overall pricing environment as both insurers and reinsurers acknowledge the pressures associated with the prolonged weakness in the investment climate and a diminishing

Exhibit 12

U.S. & Bermuda Reinsurance – Key GAAP Financial Indicators (2008-2013P)

Based on a composite of 21 interactively rated public insurance/reinsurance companies in the U.S. & Bermuda market.*

	2008	2009	2010	2011	2012E	2013P
NPW Growth	0.0%	-2.4%	4.5%	4.6%	1.3%	3.0%
Loss & LAE Ratio	64.2	56.1	61.8	77.3	65.5	64.0
Underwriting Expense Ratio	29.4	29.7	30.9	30.0	29.9	30.3
Combined Ratio	93.6	85.8	92.7	107.3	95.4	94.3
Less: Favorable Loss Reserve Development	-7.3	-6.1	-6.2	-6.0	-5.1	-4.0
Accident Year Combined Ratio (Normalized)	100.9	91.9	98.9	113.4	100.5	98.3
Change in Equity	-15.5	30.8	8.8	-2.5	10.0	4.7
Return on Equity	-0.7	16.0	11.9	1.0	9.8	9.2

E=Estimated, P=Projected
* Excludes Berkshire Hathaway, Inc.
Source: A.M. Best research

level of favorable reserve development to mask current underwriting performance. This translates into a 3% increase in NPW for 2013. Property classes generally have been the most desirable from a pricing perspective over the past several years. The relative attractiveness varies somewhat by region, but Florida generally has been reported to be the most attractive in terms of risk-adjusted rate on line. Given the recent loss impact from Superstorm Sandy, it is also expected that regional programs in the Northeast may experience some upward momentum in pricing as well or at the very least, mitigate downward rate pressure.

On the casualty side, pressures from the prolonged weak interest rate environment have begun to manifest in upward rate improvement, especially in longer-tail occurrence products. Pricing improvements have occurred at the primary level and this will bode well for quota share covers. Nonetheless, casualty pricing has moved more slowly than property pricing, and it is still clear that thus far, the pricing improvements are not sufficient to compensate for erosion in investment yield. As a result, most reinsurers continue to find property and short-tailed opportunities more attractive because of the greater risk-adjusted returns.

This risk/reward appetite has contributed to somewhat more volatility in underwriting performance. In developing projections for 2013, A. M. Best reflected this greater potential for volatility by increasing the catastrophe load in the combined ratio. For 2013, the combined ratio considers the improvement in pricing and current business mix weighted more toward volatile property classes. The projected combined ratio of 94.3% includes nine points for catastrophes and four points of favorable reserve development. A. M. Best has witnessed a continuing trend of favorable reserve development which has averaged six points over the past five years. It is well-recognized that the source of this favorable reserve development is finite and at some point will diminish and may turn negative. This theory, having been suggested in the past, has not yet been proven.

As for investment opportunities, because companies cannot control where yields are, the decision becomes whether increased yield is worth the increased risk. By and large, A.M. Best has not seen evidence of the sector increasing risk on the asset side of the balance sheet, as the downside risk is viewed to be too great – especially when considering the potential for earnings volatility from underwriting activities. The reinsurance model historically has entailed taking greater risk and volatility on the liability side of the balance sheet, not the asset side. It is difficult to gauge the sector's mindset as the pressure of low yields takes its toll year after year and good underwriting opportunities become increasingly difficult to find. After all, the compensation of many reinsurance executives is tied, in part, to growth in book value, and investment income is hardly doing its part to help that cause.

That said, we expect that investment yields will remain pressured, but against a growing invested asset base. The marginal growth in invested assets continues to stem from positive cash flows, but the positive trend has been narrowing, as revenues from investment activities decline slightly and payouts from underwriting activities increase. Cash flows, in fact, may temporally turn negative in 2013, as recent catastrophe losses are paid out. We expect all of this to translate into a continuing trend of modestly lower net investment earnings.

Reinsurance Ratings Outlook

Despite continuing challenges, the rating outlook on the global reinsurance segment which extends to the U.S. and Bermuda reinsurance market, is being held at stable,

supported by continued strong risk-adjusted capitalization, judicious enterprise risk-management practices and a relatively stable pricing environment across a broadening spectrum of business classes. Given the uncertain and turbulent global macroeconomic conditions that currently confront this global industry segment, these strengths should help sustain reinsurers' overall financial position over the longer term. A disciplined underwriting posture has enabled reinsurers to produce reasonable profits from underwriting activities, helping to mitigate the continuing deterioration in investment earnings. Following the devastating catastrophe losses in 2011, reinsurers rebounded quickly to produce an average ROE in the low double-digit range through nine months of 2012. A.M. Best expects that even with consideration for the catastrophe loss that occurred in the fourth quarter last year, reinsurers still are well-positioned to put forward an acceptable level of underwriting and overall profit for the full year.

From a capital perspective, U.S. and Bermuda reinsurers are well-capitalized and capable of absorbing significant losses from a combination of events. The ongoing weakness in the global economy presents unprecedented levels of uncertainty and challenges. Risks associated with underwriting and investment activities are manageable from a capital perspective, and A.M. Best continues to monitor reinsurance companies through various capital stress scenarios as issues emerge to gain an additional level of comfort.

Assuming a continuing stabilization in the global economy and a normal level of catastrophe losses globally, A.M. Best expects reasonable organic growth in reinsurers' capital for 2013, tempered by active capital management strategies. However, A.M. Best remains concerned that the stabilization in reinsurance pricing may be short-lived, even in light of the recent volatility in underwriting earnings. Furthermore, while reserve releases have helped to bolster profits and will likely continue to do so over the near term, this crutch will provide less and less support over time. Conversely, the continuing low interest rate environment appears to be reinforcing a focus on underwriting discipline which could translate into a positive for the segment. Given that operating performance helps drive balance sheet strength, pricing terms and conditions are an important aspect to the overall equation. With operating returns pressured by low investment yields, overall earnings must be driven by underwriting profits for the foreseeable future.

P/C Industry Loss & LAE Reserve Weakening Continues

Loss and loss-adjustment expense (LAE) reserves are typically the largest liability on a P/C insurer's balance sheet. Any underestimation of those liabilities can result in a material negative impact on the insurer's reported surplus, potentially resulting in adverse rating action. Reserve changes not only affect the balance sheet, but also A.M. Best's view of an insurer's operating performance and management team if they differ from expectations.

Adverse reserve development is one of the leading causes of insurer insolvency, and reserve adequacy remains a critical rating issue for A.M. Best. Companies that have demonstrated a history of conservative reserving throughout the underwriting cycle should not be materially affected in the analysis of their capital strength. However, for companies that have shown a volatile history of reserve adequacy, or have focused more on market share recently than on rate adequacy, significant reserve deficiencies may have accumulated,

and a charge for that deficiency will be warranted. A.M. Best's view of an insurer's reserve position can have a material impact on the assessment of an insurer's capital strength.

Exhibit 14 shows a history of the industry's reported adverse/(favorable) reserve development from prior accident years through 2011. A.M. Best expects the industry to report its seventh consecutive year of favorable reserve development for calendar year 2012. Based on A.M. Best's internal reserve review of the industry, the industry reserve position strengthened over the period 2002-2007. For the five years since then, industry reserves have been weakening and are expected to continue doing so as the industry continues to release prior-year redundancies. The industry reserves as of year-end 2012, are estimated to be $5.4 billion weaker than those reported as of year-end 2011. The personal, commercial and reinsurance segments all are predicted to show weaker reserve positions at year-end 2012. The greatest change is anticipated for the commercial

Exhibit 13

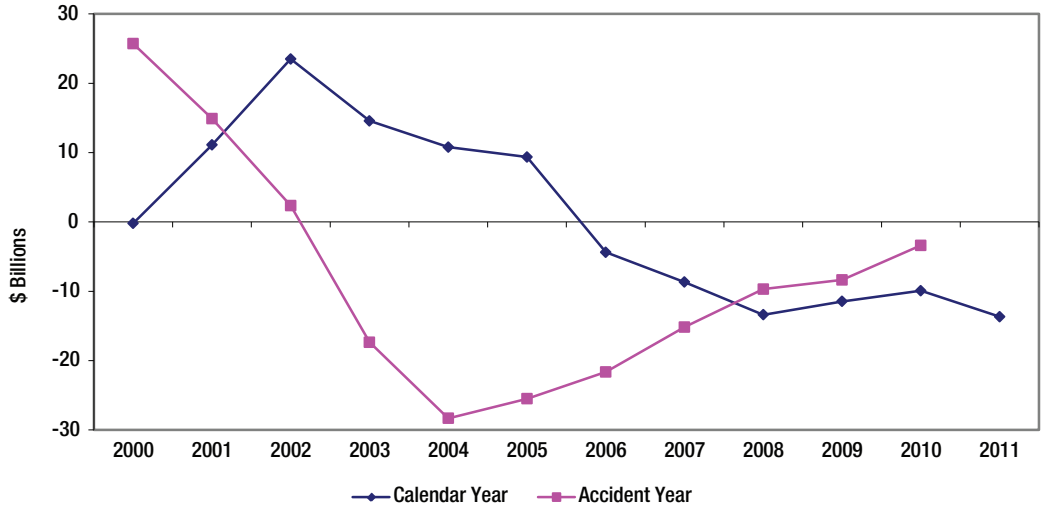
U.S. Property/Casualty - Incurred Loss and Defense & Cost Containment Development (2002-2011)

One-year development for calendar years, accident years as of Dec. 31, 2011.
Excludes mortgage and financial guaranty segments.
($ Billions)

	One-Year Reserve Development *										
Accident Year (AY)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total AY Development Through 2011
Prior	23.5	19.4	19.7	23.1	10.5	9.2	4.5	6.4	5.9	1.6	$123.8
2002		(4.8)	1.7	3.3	1.1	0.5	(0.0)	0.3	0.3	0.1	$2.4
2003			(10.7)	(3.4)	(1.5)	(0.8)	(0.3)	(0.3)	(0.2)	(0.2)	($17.3)
2004				(13.6)	(4.6)	(3.9)	(2.6)	(2.2)	(1.0)	(0.5)	($28.3)
2005					(9.9)	(5.2)	(4.0)	(3.4)	(2.0)	(1.0)	($25.5)
2006						(8.5)	(4.8)	(3.7)	(2.6)	(2.0)	($21.6)
2007							(6.2)	(4.5)	(2.1)	(2.4)	($15.2)
2008								(4.1)	(2.6)	(3.0)	($9.7)
2009									(5.6)	(2.7)	($8.4)
2010										(3.4)	($3.4)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total in Calendar Year	23.5	14.6	10.8	9.4	(4.4)	(8.7)	(13.4)	(11.5)	(9.9)	(13.7)

* Positive values indicate adverse development; negative values are favorable.



* Positive values indicate adverse development; negative values are favorable. Source: BESTLINK

lines segment, since it includes a large portion of the workers' compensation, general liability and medical professional liability (MPL) lines, which are estimated to have the highest amounts of reserve deterioration. Asbestos and environmental (A&E) reserve deficiencies are estimated to have declined $2.7 billion in 2012, in anticipation of continued A&E reserve strengthening.

Exhibit 14

U.S. Property/Casualty - Estimated Year-End Loss and Defense & Cost Containment Reserve Deficiencies (2012)

Excludes mortgage and financial guaranty segments.
($ Billions)

Product Line	Excluding Discount	Statutory Discount	Total Deficiency
Workers' Compensation	9.6	18.2	27.8
Other/Products Liability	4.7	1.4	6.1
Reinsurance - Nonproportional Assumed	2.6	2.5	5.1
Commercial Multiple Peril	2.3	0.2	2.5
Commercial Auto Liability	0.4	0.5	0.9
Homeowners	-0.2	0.0	-0.2
Medical Professional Liability	-2.7	1.0	-1.7
Personal Auto Liability	-3.1	0.3	-2.8
All Other Lines	-3.2	0.2	-3.0
Total Core Reserves	10.4	24.3	34.7
Asbestos & Environmental	13.7	0.0	13.7
Total	24.1	24.3	48.4

Source: A.M. Best research

For year-end 2012, A.M. Best estimates that the P/C total net loss and LAE reserve deficiency was $48.4 billion, consisting of a $34.7 billion deficiency on core reserves and a $13.7 billion reserve deficiency on A&E reserves. Of the $34.7 billion deficiency on core reserves, $24.3 billion is due to statutory discounting, which A.M. Best considers a deficiency from full-valued reserves. As shown in Exhibit 15, the estimated deficiencies vary widely by line of business, with workers' compensation showing the largest overall deficiency and the medical professional liability and personal auto liability lines showing the largest redundancies. The total of "All Other" lines is also showing a redundancy. Some of the lines included in the "All Other" category are auto physical damage, fire, allied, inland marine, warranty, fidelity, surety, credit, and accident and health. The estimated reserve deficiencies and redundancies are based on industry-wide statutory Schedule P cumulative paid and case incurred loss and expense development, using A.M. Best's internal loss-reserve model. The same model is used to determine the reserve deficiency for each individual company and rating unit based on its own Schedule P data.

U.S. Property/Casualty Rating Trends

In 2012 as in 2011, rating downgrades out-numbered upgrades, while in 2008 through 2010, upgrades exceeded the downgrades. Over the past several years, total rating changes remained fairly stable at approximately 13% to 16% of all domestic rating actions.

While capitalization has remained adequate, P/C insurers' underwriting and operating results continue to be pressured due to a number of factors, including elevated catastrophe-related losses, sustained competitive market conditions, weak macroeconomic factors, decreasing reserve adequacy levels, low investment yields and volatile financial markets. As a result, the number of negative rating actions relative to positive rating actions has increased, culminating in the last two years with negative rating actions outnumbering the positive actions.

Rather than assessing the rating actions of each legal operating entity within the domestic P/C insurance market, this section summarizes rating trends on a rating unit basis. The term "rating unit" describes either an individual insurer or a consolidation of companies and is the financial basis on which A.M. Best performs its rating evaluations. The financial

results of rating units represent the way insurance groups operate and manage their businesses.

There were 880 rating actions on rating units for the P/C industry in calendar year 2012 – of which 722 were affirmations, representing approximately 82.0% of total rating actions during the year – compared with 907 rating actions in 2011, of which 719, representing 79.3%, were affirmations. Total rating changes represented 14.0% of all rating actions in 2012, compared with 15.7% in 2011. Downgrades totaled 67, or 6.9% of total rating actions, in 2012, compared with 75, or 8.3% of rating actions, in 2011. Conversely, upgrades totaled 29, or 3.3% of total rating actions, in 2012, down from 42, or 4.6% of rating actions, in 2011.

Exhibit 15

Rating Translation Table for Insurance Companies

	Financial Strength Rating	Long-Term Issuer Credit Rating
Secure	A++	aaa, aa+
	A+	aa, aa-
	A	a+, a
	A-	a-
	B++	bbb+, bbb
	B+	bbb-
Vulnerable	B	bb+, bb
	B-	bb-
	C++	b+, b
	C+	b-
	C	ccc+, ccc
	C-	ccc-, cc
	D	c
	E & F	rs

By segment, there were 16 upgrades to commercial lines insurers' ratings in 2012, compared with 28 downgrades. Among personal lines insurers, however, there were 12 upgrades, while 39 rated entities were downgraded in 2012. There was only one rating upgrade of a U.S. reinsurer in 2012, with no downgrades.

There were 33 initial ratings assigned in 2012, representing about 3.8% of total rating actions, compared with 25, or 2.8% of rating actions, in 2011. Initial ratings averaged 3.8% of total rating actions from 2008 through 2011. Initial ratings generally are assigned to newly created affiliates and subsidiaries of larger holding companies. Commercial lines initial ratings totaled 24, including nine assigned to commercial casualty and six for medical professional liability writers. For personal lines, five of the total nine initial ratings were assigned to personal property writers created primarily for purposes of additional pricing flexibility.

The number of rating units assigned the under-review modifier was 29 in 2012, down

Exhibit 16

U.S. Property/Casualty – Annual Rating Activity (2008-2012)

(By Rating Units)

	Financial Strength Ratings (FSR)*									
	2008		2009		2010		2011		2012	
	Rating Actions	%	Rating Actions	%	Rating Actions	%	Rating Actions	%	Rating Actions	%
Upgrades	59	5.6	59	5.6	55	5.6	42	4.6	29	3.3
Downgrades	40	3.8	53	5.0	49	5.0	75	8.3	67	7.6
Initial Ratings	40	3.8	47	4.4	41	4.2	25	2.8	33	3.8
Total Rating Changes	139	13.2	159	15.0	145	14.8	142	15.7	129	14.7
Total Affirmations	853	80.8	842	79.5	795	80.9	719	79.3	722	82.0
Under Review	64	6.1	58	5.5	43	4.4	46	5.1	29	3.3
Total Rating Actions [1]	**1,056**	**100.0**	**1,059**	**100.0**	**983**	**100.0**	**907**	**100.0**	**880**	**100.0**

* For Best's Ratings criteria and definitions, visit www.ambest.com.

[1] Total actions exceed the number of rated entities as certain company ratings were updated more than once during the year.

Note: Percentages might not add up due to rounding.

Source: A.M. Best research

37% from 46 in 2011, and is the lowest level within the 2008 – 2012 period. The major reasons for this lower level were the:

• Improvement in capitalization in recent years that enabled insurers to absorb the impact of major catastrophes and weather-related losses without significantly decreasing risk-adjusted capitalization, and

• Reduced merger and acquisition activity.

The number of rating units assigned the under-review modifier was elevated in 2008 and 2009 because of the unprecedented capital market conditions and the resulting erosion of property/casualty insurers' risk-adjusted capitalization.

The under-review rating modifier typically is assigned after a material event, such as a merger or acquisition or an abrupt change in financial condition from events, such as recognition of reserve charges, shock losses or capital infusions. The under-review modifier may have positive, negative or developing rating implications, depending on the nature of the event and its potential effect on the rated entity. After placing a rating under review, A.M. Best interacts with management to fully review the impact of the event before determining the ultimate effect on the rating. Generally, ratings remain under review for less than six months.

Actions on Issuer Credit Ratings (ICR) were introduced for all rating units in 2007. Although the rating actions are equal in total to the Financial Strength Rating (FSR) exhibit, there are differences in the number of upgrades and downgrades. An FSR may not change as a result of an upgrade or downgrade of an ICR because of the greater number of rating levels in the ICR Scale.

Rating Distribution

There were 861 P/C rating units that had letter rating assignments at year-end 2012, compared to 886 in 2011. The rating distribution based on rating units is the most accurate gauge of A.M. Best's overall opinion of the financial health of the universe of rated P/C insurance companies.

Exhibit 17

U.S. Property/Casualty – Annual Rating Activity (2008-2012)

(By Rating Units)

	Issuer Credit Ratings (ICR)*									
	2008		2009		2010		2011		2012	
	Rating Actions	%	Rating Actions	%	Rating Actions	%	Rating Actions	%	Rating Actions	%
Upgrades	65	6.2	76	7.2	76	7.7	65	6.6	47	4.8
Downgrades	42	4.0	57	5.4	52	5.3	78	7.9	82	8.3
Initial Ratings[1]	140	13.3	47	4.4	41	4.2	25	2.5	33	3.4
Total Rating Changes	247	23.4	180	17.0	169	17.2	168	17.1	162	16.5
Total Affirmations	740	70.1	821	77.5	771	78.4	693	76.4	689	76.0
Under Review	69	6.5	58	5.5	43	4.4	46	4.7	29	3.0
Total Rating Actions[2]	**1,056**	**100.0**	**1,059**	**100.0**	**983**	**100.0**	**907**	**100.0**	**880**	**97.0**

* For Best's Ratings criteria and definitions, visit www.ambest.com.
[1] 2008 reflect formal roll-out by A.M. Best of Issuer Credit Ratings.
[2] Total actions exceed the number of rated entities as certain company ratings were updated more than once a year.
Note: Some percentages might not add up due to rounding.
Source: A.M. Best research

Exhibit 18
U.S. Property/Casualty – Rating Distribution (2008-2012)
(By Rating Units)

		Financial Strength Ratings (FSR)*									
		2008		2009		2010		2011		2012	
Category	Rating Level	Rating Units	%	Rating Units	%	Rating Units	%	Rating Units	%	Rating Units	%
Secure											
Superior	A++	16	1.8	16	1.7	16	1.7	17	1.9	17	2.0
	A+	80	8.9	76	8.8	72	8.0	63	7.1	61	7.1
Sub-Total		96	10.7	92	10.5	88	9.7	80	9.0	78	9.1
Excellent	A	232	26.1	260	26.3	247	27.3	252	28.4	264	30.7
	A-	335	34.6	328	33.7	301	32.1	293	33.1	273	31.7
Sub-Total		567	60.7	588	59.9	548	59.4	545	61.5	537	62.4
Good	B++	118	12.1	130	12.9	118	13.4	108	12.2	106	12.3
	B+	95	9.6	84	8.8	76	8.8	71	8.0	61	7.1
Sub-Total		213	21.7	214	21.7	194	22.2	179	20.2	167	19.4
Total Secure Ratings		**876**	**93.1**	**894**	**92.1**	**830**	**91.3**	**804**	**90.7**	**782**	**90.8**
Vulnerable											
Fair	B, B-	53	4.4	52	4.9	40	4.6	34	3.8	39	4.5
Marginal	C++, C+	9	0.9	9	1.0	11	1.2	12	1.4	6	0.7
Weak	C, C-	1	0.2	2	0.2	2	0.2	2	0.2	4	0.5
Poor	D	0	0.0	2	0.2	2	0.2	0	0.0	0	0.0
Reg. Supervision/Liquidation	E / F	15	1.3	21	1.6	23	2.5	34	3.8	30	3.5
Total Vulnerable Ratings		**78**	**6.9**	**86**	**7.9**	**78**	**8.7**	**82**	**9.3**	**79**	**9.2**
Total Letter Ratings		**954**	**100.0**	**980**	**100.0**	**908**	**100.0**	**886**	**100.0**	**861**	**100.00**

* For Best's Ratings criteria and definitions, visit www.ambest.com.
Note: Annual data as of Dec. 31 for each year.
Percentages may not add up due to rounding.
Source: A.M. Best research

A.M. Best's FSR is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. The FSR scale is composed of 16 individual ratings, grouped into 10 categories: three Secure categories of "Superior," "Excellent" and "Good" and seven Vulnerable categories of "Fair," "Marginal," "Weak," "Poor," "Under Regulatory Supervision," "In Liquidation" and "Suspended."

The percentage of rated units considered secure was 90.8% at year-end 2012, essentially unchanged from 90.7% at year-end 2011. Both the number and percentage of secure ratings has trended downward over the past four years, driven primarily by the financial crisis that started in 2008, resulting in a weakened macroeconomic environment and low investment yields.

In addition to the fallout from the financial crisis, there were fewer secure ratings because of challenging market conditions and elevated catastrophe-related losses, which resulted in operating earnings and risk-adjusted capitalization deteriorating for a number of companies. In addition, over the past five years there has been a noticeable increase in the number of ratings in the Regulatory Supervision/Liquidation category. In 2012, this category represented 3.5% of all rating units, or 30, up from 1.3%, or 15, in 2008.

These same trends have driven a 19% decline in the number of rating units with superior FSRs (A++ or A+). In 2012, 78 rating units, or 9.1%, had superior ratings compared to 96 rating units, or 10.7%, in 2008. As always, the majority of rating units were in the "A" and "A-"

(Excellent) category at year-end 2012. These two rating levels represented 537, or 62.4% of the total ratings, during the year, up from 61.5% of ratings at year-end 2011.

A.M. Best also assigns ICRs to all rated insurance companies. The ICR is an independent opinion of an issuer/entity's ability to meet its ongoing senior financial obligations. The total number of ICR ratings will equal the total FSR ratings; however, there will be greater detail representing the upper and lower ranges of certain FSR categories. For example, at the "A++" FSR rating level, there are two ICR levels, "aaa" and "aa+". Over the recent five-year period, there have been only three entities rated "aaa" – Government Employees Insurance Co. (GEICO), National Indemnity Group and United States Automobile Association (USAA). Both GEICO and National Indemnity are owned by Berkshire Hathaway Inc.

Exhibit 19

U.S. Property/Casualty – Rating Distribution (2008-2012)

(By Rating Units)

		Issuer Credit Ratings (ICR)*									
		2008		2009		2010		2011		2012	
Category	Rating Level	Rating Units	%	Rating Units	%	Rating Units	%	Rating Units	%	Rating Units	%
Secure											
Exceptional	aaa	3	0.3	3	0.3	3	0.3	3	0.3	3	0.3
Sub-Total		3	0.3	3	0.3	3	0.3	3	0.3	3	0.3
Superior	aa+	13	1.4	13	1.3	13	1.4	14	1.6	14	1.6
	aa	14	1.5	14	1.4	16	1.8	15	1.7	18	2.1
	aa-	66	6.9	62	6.3	56	6.2	48	5.4	43	5.0
Sub-Total		93	9.7	89	9.1	85	9.4	77	8.7	75	8.7
Excellent	a+	42	4.4	48	4.9	59	6.5	72	8.1	76	8.8
	a	190	19.9	212	21.6	188	20.7	180	20.3	188	21.8
	a-	335	35.1	328	33.5	301	33.1	293	33.1	273	31.7
Sub-Total		567	59.4	588	60.0	548	60.4	545	61.5	537	62.4
Good	bbb+	44	4.6	45	4.6	45	5.0	47	5.3	46	5.3
	bbb	74	7.8	85	8.7	73	8.0	61	6.9	60	7.0
	bbb-	95	10.0	84	8.6	76	8.4	71	8.0	61	7.1
Sub-Total		213	22.3	214	21.8	194	21.4	179	20.2	167	19.4
Total Secure Ratings		**876**	**91.8**	**894**	**91.2**	**830**	**91.4**	**804**	**90.7**	**782**	**90.8**
Vulnerable											
Fair	bb+,bb,bb-	53	5.6	52	5.3	40	4.4	34	3.8	39	4.5
Marginal	b+,b,b-	9	0.9	9	0.9	11	1.2	12	1.4	6	0.7
Weak	ccc+,ccc,ccc-,cc	1	0.1	2	0.2	2	0.2	2	0.2	4	0.5
Poor	c	0	0.0	2	0.2	2	0.2	0	0.0	0	0.0
Reg. Supervision/Liquidation	rs	15	1.6	21	2.1	23	2.5	34	3.8	30	3.5
Total Vulnerable Ratings		**78**	**8.2**	**86**	**8.8**	**78**	**8.6**	**82**	**9.3**	**79**	**9.2**
Total ICRs		**954**	**100.0**	**980**	**100.0**	**908**	**100.0**	**886**	**100.0**	**861**	**100.0**

* For Best's Ratings criteria and definitions, visit www.ambest.com.
Note: Annual data as of Dec. 31 for each year.
Percentages may not add up due to rounding.
Source: A.M. Best research

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