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**Allstate Insurance Group  
Combined Management Discussion and Analysis  
For the Year Ended December 31, 2012**

**OVERVIEW**

The Allstate Insurance Group (referred to as the "Group") consists of Allstate Insurance Company ("AIC"), Allstate Indemnity Company, Allstate Texas Lloyd's, Allstate Vehicle and Property Insurance Company, Allstate Property and Casualty Insurance Company, Allstate County Mutual Insurance Company, Allstate Fire and Casualty Insurance Company, Northbrook Indemnity Company, Allstate North American Insurance Company, Encompass Insurance Company, Encompass Indemnity Company, Encompass Independent Insurance Company, Encompass Home and Auto Insurance Company, Encompass Insurance Company of America, Encompass Insurance Company of Massachusetts, Encompass Property and Casualty Company, North Light Specialty Insurance Company, Esurance Insurance Company and Esurance Property and Casualty Insurance Company. Since these insurers are part of a consolidated group that utilize 100% intercompany reinsurance agreements, regulatory approval was obtained to prepare a combined Management Discussion and Analysis ("MD&A"). Accordingly, the combined results of the aforementioned companies have been analyzed in this MD&A.

In addition to the affiliated property-liability insurers listed above, the Group has several unconsolidated subsidiaries, the largest of which is the Allstate Life Insurance Company ("Allstate Life"). Allstate Life and its subsidiaries market a broad line of life insurance and investment products. There are also several unconsolidated property and casualty insurers, the two largest being Allstate New Jersey Insurance Company ("ANJ") and Castle Key Insurance Company ("CKIC"). ANJ writes auto and homeowners exclusively in New Jersey, while CKIC writes only homeowners in Florida. The Group also has an affiliated foreign insurer, Allstate Insurance Company of Canada, which has three subsidiary insurance companies. Separate MD&As were filed for Allstate Life and certain of its subsidiaries, ANJ and CKIC.

AIC is an Illinois domiciled insurer licensed to write property and casualty business in 50 states, the District of Columbia, and Puerto Rico and offers a broad range of personal and commercial insurance products. Allstate Insurance Holdings, LLC ("Allstate Holdings"), a Delaware Corporation, owns all of AIC's outstanding shares of common stock and is wholly-owned by The Allstate Corporation ("Corporation").

Effective November 30, 2011, the Corporation replaced AIC as sponsor of the Group's defined benefit pension plans.

**BUSINESS SEGMENTS**

The Group's property-liability operations consist of two reporting segments: Allstate Protection and Discontinued Lines and Coverages. Allstate Protection comprises three brands: Allstate, Encompass and Esurance. Allstate Protection is principally engaged in the sale of personal property and casualty insurance, primarily private passenger auto and homeowners insurance, to individuals in the United States and Canada. Discontinued Lines and Coverages includes results from insurance coverage that the Group no longer writes and results for certain commercial and other businesses in run-off. These segments are consistent with the groupings of financial information that management uses to evaluate performance and to determine the allocation of resources.

The Allstate brand utilizes marketing delivered to target customers to promote the Group's strategic priorities, with messaging that continues to communicate ease of doing business with the Group and the Group's agencies, good value, as well as the importance of having proper coverage by highlighting the comprehensive product and coverage options.

The Allstate brand differentiates itself from competitors by offering a comprehensive range of innovative product options and features as well as product customization, including Allstate Your Choice Auto<sup>®</sup> with options such as accident forgiveness, safe driving deductible rewards and a safe driving bonus, and Allstate House and Home<sup>®</sup> that provides options of coverage for roof damage including graduated coverage and pricing based on roof type and age. In addition, the Group offers a Claim Satisfaction Guarantee<sup>sm</sup> that

promises a return of premium to Allstate brand standard auto insurance customers dissatisfied with their claims experience. The Group's DRIVEWISE<sup>®</sup> program enables participating customers to be eligible for discounts based on driving performance as measured by a device installed in the vehicle. The Group will continue to focus on developing and introducing products and services that benefit today's consumers and further differentiate the Group and enhance the customer experience. The Group will deepen customer relationships through value-added customer interactions and expanding its presence in households with multiple products by providing financial protection for customer needs. In certain areas with higher risk of catastrophes, the Group offers a homeowners product from our excess and surplus lines carrier. When an Allstate product is not available, the Group makes available non-proprietary products for customers through brokering arrangements. For example, in hurricane exposed areas, Allstate agencies sell non-proprietary property insurance products to customers who prefer to use a single agent for all their insurance needs.

The Group is undergoing a focused effort to enhance capabilities by implementing uniform processes and standards to elevate the level and consistency of the Group's customer experience. The Group continues to enhance technology to integrate distribution channels, improve customer service, facilitate the introduction of new products and services and reduce infrastructure costs related to supporting agencies and handling claims. These actions and others are designed to optimize the effectiveness of its distribution and service channels by increasing the productivity of the Allstate brand's exclusive agencies. Since Allstate brand customers prefer personal advice and assistance, beginning in 2013 all Allstate brand customers who purchased their policies directly through call centers and the internet will be assigned an Allstate exclusive agency relationship.

The Group's pricing and underwriting strategies and decisions are designed to enhance both the Group's competitive position and the profit potential. Sophisticated pricing uses a number of risk evaluation factors including insurance scoring, to the extent permissible by regulations, based on information that is obtained from credit reports. The Group's updated auto risk evaluation pricing model was implemented for 9 states in 2012. The Group's pricing strategy involves marketplace pricing and underwriting decisions that are based on these risk evaluation models and an evaluation of competitors. The Group will utilize sophisticated pricing to increase the Group's price competitiveness to a greater share of target customers. A combination of underwriting information, pricing and discounts are used to achieve a higher close rate on quotes. The Group will also use these factors on the Group's non-standard business to offer competitive prices to customers with risk profiles indicating greater likelihood of renewal.

The Group will also continue to enhance pricing to attract a larger share of customers. For the Allstate brand auto and homeowners business, the Group continues to shift its mix towards customers that have better retention and thus potentially present more favorable prospects for profitability over the course of their relationship with the Group. For homeowners, the Group will continue to address rate adequacy and improve underwriting and claim effectiveness. The Group also considers various strategic options to improve its homeowners insurance business returns.

Allstate brand also includes Emerging Businesses which comprises Consumer Household (specialty auto products including motorcycle, trailer, motor home and off-road vehicle insurance policies and specialty property products including renter, landlord, boat, umbrella, manufactured home and condominium insurance policies), Allstate Roadside Services (roadside assistance products), Allstate Dealer Services (guaranteed automobile protection and vehicle service products sold primarily through auto dealers), Ivtantage (insurance agency) and Commercial Lines (commercial products for small business owners).

The Group's strategy for the Encompass brand centers around its highly differentiated product that simplifies the insurance experience through an expanded coverage single annual policy with one premium, one bill, one policy deductible and one renewal date. It appeals to customers with broad personal lines coverage needs who prefer an independent agent. As part of its package policy strategy, Encompass is focused on increased agency engagement through ease of doing business initiatives and increased package commissions, and de-emphasizing mono-line auto and property products.

The Group's strategy for the Esurance brand focuses on self-directed and web-savvy consumers. To best serve these customers, Esurance develops its technology and website to continuously improve its hassle-free purchase and claims experience. Esurance began offering renters insurance in 2012 and plans to continue to broaden its product offerings. Esurance is also focused on increasing its preferred driver mix, while raising advertising investment and marketing effectiveness to support growth.

Pricing of property products is typically intended to establish returns that are deemed acceptable over a long-term period. Losses, including losses from catastrophic events and weather-related losses (such as wind, hail, lightning and freeze losses not meeting the criteria to be declared a catastrophe), are accrued on an occurrence basis within the policy period. Therefore, in any reporting period, loss experience from catastrophic events and weather-related losses may contribute to negative or positive underwriting performance relative to the expectations that were incorporated into the products' pricing. The Group pursues rate increases where indicated, taking into consideration potential customer disruption, the impact on its ability to market auto lines, regulatory limitations, competitive position and profitability, using a methodology that appropriately addresses the changing costs of losses from catastrophes such as severe weather and the net cost of reinsurance.

## **CATASTROPHE MANAGEMENT**

Catastrophe losses are an inherent risk of the property-liability insurance industry that have contributed, and will continue to contribute, to potentially material year-to-year fluctuations in the Group's results of operations and financial position. The Group defines a "catastrophe" as an event that produces pre-tax losses before reinsurance in excess of \$1 million and involves multiple first party policyholders, or an event that produces a number of claims in excess of a preset, per-event threshold of average claims in a specific area, occurring within a certain amount of time following the event. Catastrophes are caused by various natural events including high winds, winter storms, tornadoes, hailstorms, wildfires, tropical storms, hurricanes, earthquakes and volcanoes. The Group is also exposed to man-made catastrophic events, such as certain types of terrorism or industrial accidents. The nature and level of catastrophes in any period cannot be predicted.

The Group considers the greatest areas of potential catastrophe losses due to hurricanes generally to be major metropolitan centers in counties along the eastern and gulf coasts of the United States. Usually, the average premium on a property policy near these coasts is greater than in other areas. However, average premiums are often not considered commensurate with the inherent risk of loss. In addition, in various states the Group is subject to assessments from assigned risk plans, reinsurance facilities and joint underwriting associations providing insurance for wind related property losses.

Over time the Group has limited its aggregate insurance exposure to catastrophe losses in certain regions of the country that are subject to high levels of natural catastrophes. Limitations include participation in various state facilities, such as the California Earthquake Authority, which provides insurance for California earthquake losses; the Florida Hurricane Catastrophe Fund, which provides reimbursements to participating insurers for certain qualifying Florida hurricane losses; and other state facilities, such as wind pools. However, the impact of these actions may be diminished by the growth in insured values, and the effect of state insurance laws and regulations. In addition, in various states the Group is required to participate in assigned risk plans, reinsurance facilities and joint underwriting associations that provide insurance coverage to individuals or entities that otherwise are unable to purchase such coverage from private insurers. Because of the Group's participation in these and other state facilities such as wind pools, it may be exposed to losses that surpass the capitalization of these facilities and to assessments from these facilities.

Property catastrophe exposure management includes purchasing reinsurance to provide coverage for known exposure to hurricanes, earthquakes, wildfires, fires following earthquakes and other catastrophes. Specific to its risk of hurricane loss, the Group has purchased reinsurance for select states and on a country wide basis for its personal lines property insurance in areas most exposed to hurricanes. Other actions taken to maintain an appropriate level of exposure to catastrophic events involve:

- Limiting personal homeowners new business writings in coastal areas in southern and eastern states.
- Implementing tropical cyclone deductibles where appropriate.
- Not offering continuing coverage on certain policies in coastal counties in certain states.
- Working for changes in the regulatory environment, including recognizing the need for better catastrophe preparedness, improving appropriate risk-based pricing and promoting the creation of government sponsored, privately funded solutions for mega-catastrophes that will make insurance more available and affordable.

The Group continues to take actions to maintain an appropriate level of exposure to catastrophic events while continuing to meet customer's needs, including the following:

- Selectively not offering continuing coverage of homeowners policies in coastal areas of certain states. This includes New York where homeowners policies in force decreased 29.4% since 2006.
- Increased capacity in the brokerage platform for customers not offered a renewal.
- Expanded the Group's excess and surplus carrier to five new states in 2012, bringing the total number of active states to 31.
- In Texas, wind exposure related to insured property located in wind pool eligible areas along the coast including the Galveston Islands is being ceded.
- No writing of new homeowners business in California since 2007. The Group continues to renew current policyholders.
- Tropical cyclone deductibles are in place for a large portion of coastal insured properties though contract language varies across states and companies, allowing for these higher deductibles to be triggered differently across our customer base.
- The Group has additional catastrophe exposure, beyond the property lines, for auto customers who have purchased physical damage coverage. Auto physical damage coverage generally includes coverage for flood-related loss. The Group manages this additional exposure through inclusion of auto losses in our nationwide reinsurance program (which excludes New Jersey and Florida).

The Group continues to seek appropriate returns for its risks. This may require further actions, similar to those already taken, in geographies where the Group is not getting appropriate returns. However, the Group may maintain or opportunistically increase its presence in areas where the Group achieves adequate returns and does not materially increase its hurricane risk.

## FINANCIAL POSITION

### Cash and invested assets

The Group's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. This approach is designed to produce competitive returns over time, and to ensure financial strength and stability for paying claims, while maximizing economic value and surplus growth. A strategic asset allocation approach is employed, which considers the nature of the liabilities and risk tolerances, as well as the risk and return parameters of the various asset classes in which the Group invests. This asset allocation is informed by global economic and market outlook, as well as other inputs, including diversification effects, duration, liquidity and capital considerations. The Group has also been focused on shifting the portfolio mix in the next few years to have less reliance on lending to borrowers and a greater proportion of ownership of assets.

The Group has a comprehensive portfolio monitoring process to identify and evaluate each security whose carrying value may be other than temporally impaired. The Group's portfolio monitoring process includes a quarterly review of all securities to identify instances where the fair value of a security compared to its amortized cost (for bonds, including loan-backed and structured securities) or cost (for stocks) is below established thresholds. The process also includes the monitoring of other impairment indicators such as ratings, ratings downgrades and payment defaults.

The composition of the investment portfolio at December 31 was:

(in millions)	<u>2012</u>	<u>2011</u>
Bonds	\$ 24,064	\$ 22,551
Preferred stocks	59	93
Common stocks	7,891	8,206
Mortgage loans on real estate	491	473
Real estate	330	333
Cash and cash equivalents	66	(461)
Short-term investments	62	104
Other invested assets	3,751	3,830
Total	<u>\$ 36,714</u>	<u>\$ 35,129</u>

Total invested assets increased \$1.6 billion, or 5%, compared to prior year. Explanations for the more significant items follow.

## **Bonds**

The Group's bond portfolio consists of publicly traded and privately placed corporate obligations, municipal bonds, asset-backed securities ("ABS"), U.S. government bonds, mortgage-backed securities ("MBS") and foreign government bonds.

At December 31, 2012, 87.3% of the consolidated bond portfolio was rated investment grade, which is defined as having a National Association of Insurance Commissioners ("NAIC") Securities Valuation Office rating of 1 or 2, a Moody's rating of Aaa, Aa, A or Baa, a rating of AAA, AA, A or BBB from S&P, Fitch, Dominion, Kroll or Realpoint, a rating of aaa, aa, a or bbb from A.M. Best, or a comparable internal rating if an externally provided rating is not available. The investment grade percentage for each individual bond category ranged from 72.7% to 100%. The most significant change in the bond portfolio mix from the prior year occurred in the public corporate bond portfolio which increased \$2.1 billion. There was no significant change in the bond portfolio quality distribution from the prior year.

Bonds with an NAIC rating 1 or 2, including loan backed and structured securities, are reported at amortized cost. Bonds with an NAIC rating 3 through 6 are reported at the lower of amortized cost or fair value, with the difference reflected in unassigned surplus. The fair value of bonds was \$25.3 billion and \$23.3 billion at December 31, 2012 and 2011, respectively. At December 31, 2012, unrealized net capital gains on the bond portfolio, which are calculated as the difference between statement value and fair value, were \$1.2 billion compared to \$771 million as of December 31, 2011.

Publicly traded corporate bonds totaled \$9.7 billion at December 31, 2012 compared to \$7.6 billion at December 31, 2011. As of December 31, 2012, the portfolio also contained \$3.4 billion of privately placed corporate obligations, compared with \$1.9 billion at December 31, 2011. Privately placed obligations primarily consist of corporate issued senior debt securities that are directly negotiated with the borrower or are in unregistered form. Privately placed corporate securities are rated by the NAIC Securities Valuation Office based on information provided to them.

Municipal bonds including tax-exempt and taxable securities totaled \$6.2 billion at December 31, 2012 compared to \$7 billion at December 31, 2011. The municipal bond portfolio at December 31, 2012 consisted of 1,780 issues from 866 issuers. The largest exposure to a single issuer was 1% of the municipal bond portfolio. Corporate entities were the ultimate obligors of 3% of the municipal bond portfolio.

ABS totaled \$2.1 billion at December 31, 2012 compared to \$2.6 billion at December 31, 2011. Credit risk is managed by monitoring the performance of the underlying collateral. Many of the securities in the ABS portfolio have credit enhancement with features such as overcollateralization, subordinated structures, reserve funds, guarantees and/or insurance.

MBS totaled \$1.1 billion at December 31, 2012 compared to \$1.3 billion at December 31, 2011. The MBS portfolio is subject to interest rate risk, but unlike other fixed income securities, is additionally subject to significant prepayment risk from the underlying mortgages.

## **Equity securities**

Equity securities include common and non-redeemable preferred stocks, and investments in affiliates. The \$349 million decrease in common and preferred stocks was due to the shift in our investment portfolio to bonds.

## **Cash and cash equivalents**

The \$527M increase in cash and cash equivalents was due to an increased amount of cash equivalents, which offset the negative cash balance from outstanding claim checks.

### **Reserves for losses and loss adjustment expenses**

Activity in the reserve for losses and loss adjustment expenses, on a net basis, was summarized as follows at December 31:

(in millions)	<u>2012</u>	<u>2011</u>
Balance at January 1	\$ 15,089	\$ 14,915
Incurred related to		
Current year	17,168	18,952
Prior years	<u>(527)</u>	<u>(297)</u>
Total incurred	<u>16,641</u>	<u>18,655</u>
Paid related to:		
Current year	11,527	12,743
Prior years	<u>5,704</u>	<u>5,738</u>
Total paid	<u>17,231</u>	<u>18,481</u>
Balance at December 31	\$ <u>14,499</u>	\$ <u>15,089</u>

Incurred losses and loss adjustment expenses attributable to insured events of prior years were \$(527) million and \$(297) million as a result of the reestimation of unpaid losses and loss adjustment expenses at the years ending December 31, 2012 and 2011, respectively. During 2012 and 2011, favorable development in incurred losses and loss adjustment expenses related to prior years was primarily due to favorable prior year catastrophes and severity development that was better than expected. These changes were generally the result of ongoing analyses of recent loss development trends. Initial estimates were revised as additional information regarding claims became known.

### **Capital and surplus**

The following table summarizes the Group's capital position at December 31:

(in millions)	<u>2012</u>	<u>2011</u>
Common capital stock	\$ 22	\$ 7
Gross paid in and contributed surplus	5,038	4,642
Unassigned funds (surplus)	11,879	10,262
Aggregate write-ins for special surplus funds	<u>16</u>	<u>398</u>
Total surplus as regards policyholders	\$ <u>16,955</u>	\$ <u>15,309</u>

Total surplus as regards policyholders increased 11%, or \$1.6 billion, and was mainly comprised of the following items:

- \$2.0 billion - Net income
- \$1.4 billion - Dividends paid to Allstate Holdings
- \$640 million - Change in net unrealized capital gains
- \$384 million - Decrease in incremental deferred tax asset
- \$376 million - Cost of subsidiaries that were dividend to parent
- \$297 million - Change in deferred income tax
- \$175 million - Change in non-admitted assets

## RESULTS OF OPERATIONS

(in millions)	<u>2012</u>	<u>2011</u>
Premiums earned	\$ 23,995	\$ 23,802
Losses incurred	13,638	15,529
Loss expenses incurred	3,008	3,125
Other underwriting expenses incurred	<u>6,423</u>	<u>6,195</u>
Total underwriting deductions	<u>23,069</u>	<u>24,849</u>
Net underwriting gain (loss)	<u>926</u>	<u>(1,047)</u>
Net investment income earned	1,148	1,187
Net realized capital gains (losses)	<u>237</u>	<u>(94)</u>
Net investment gain	1,385	1,093
Total other income	<u>155</u>	<u>170</u>
Net income, after dividends to policyholders but before federal and foreign income taxes	2,466	216
Federal and foreign income taxes incurred	<u>483</u>	<u>23</u>
Net income	<u>\$ 1,983</u>	<u>\$ 193</u>

### Net underwriting gain

The \$2.0 billion increase in underwriting gain was primarily due to underwriting income in homeowners and other personal lines in 2012 compared to underwriting losses in 2011, partially offset by a decrease in standard auto underwriting income.

### Net realized capital gains (losses)

Net investment income earned was relatively flat year-over-year. Net realized capital gains increased \$331 million to \$237 million in 2012 from a \$94 million net realized capital loss in 2011. This increase was primarily due a decrease in realized capital losses from derivatives.

## CASH FLOW AND LIQUIDITY

The following table summarizes cash flow.

(in millions)	<u>2012</u>	<u>2011</u>
Net cash from operations	\$ 1,501	\$ 187
Net cash from investments	272	67
Net cash from financing and miscellaneous sources	<u>(1,288)</u>	<u>(350)</u>
Net change in cash, cash equivalents and short-term investments	<u>\$ 485</u>	<u>\$ (96)</u>

The Group's operations typically generate substantial positive cash flows from operations as most premiums are received in advance of the time claim payments are made. Cash provided from operations increased in 2012 as a result of an increase in net underwriting income. Cash provided from investments increased in 2012 due to purchase and sale activity during the year. Negative cash flows from financing increased mainly due to increased dividends paid to the stockholder in 2012.

### **Financial strength ratings and outlook**

Allstate's financial strength ratings and outlook were A+ (exceptional) with a stable outlook, Aa3 (excellent) with a negative outlook and AA- (excellent) with a negative outlook from A.M. Best, Moody's and Standard & Poor's, respectively, as of January, 2013.

### **Risk based capital**

The NAIC has a uniform capital adequacy standard, referred to as the risk-based capital ("RBC"), that serves as one of the solvency monitoring regulatory tools to measure and assess the amount of capital that is appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile. The standard utilizes a formula to calculate a company's minimum capital requirement ("company action level RBC") based on the asset, credit, underwriting and reserving risk associated with its business. There is no regulatory action required if a company maintains an actual capital level greater than the company action level RBC. A RBC model law does, however, mandate four levels of regulatory action based on a company's degree of capital impairment. At December 31, 2012, each of the insurers comprising the Group had actual capital that was significantly above the company action level RBC.

### **IRIS ratios**

The NAIC has also developed a set of financial relationships or tests known as the Insurance Regulatory Information System to assist state regulators in monitoring the financial condition of insurance companies and identifying companies that require special attention or action. The NAIC analyzes financial data provided by insurance companies using prescribed ratios, each with a defined usual range. Additional regulatory scrutiny may occur if a company's ratio results fall outside the usual range for four or more of the thirteen ratios. At December 31, 2012, no insurer comprising the Group had more than two ratio results outside the usual range.