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Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The Allstate Corporation (referred to in this document as “we”, “our”, “us”, the “Company” or “Allstate”). It should be read in conjunction with the 5-year summary of selected financial data, consolidated financial statements and related notes found under Part II, Item 6 and Item 8 contained herein. Further analysis of our insurance segments is provided in Property-Liability Operations (which includes the Allstate Protection and Discontinued Lines and Coverages segments) and in Allstate Financial Operations (which represents the Allstate Financial segment) sections of Management's Discussion and Analysis (“MD&A”). The segments are consistent with the way in which we use financial information to evaluate business performance and to determine the allocation of resources.

The most important matters that we monitor to evaluate the financial condition and performance of our company include:

- For Allstate Protection: written premium growth, changes in the number of policies in force, price changes, claim frequency and severity trends, catastrophes, expenses and underwriting results;
- For Allstate Financial: premiums, deposits, gross margin including investment and benefit margins, the amortization of deferred policy acquisition costs, expenses, operating income, and invested assets;
- For Investments: credit quality/experience, stability of long-term returns, cash flows and asset and liability duration;
- For financial condition: our financial strength ratings, operating leverage and debt leverage; and
- For product distribution: profitably growing distribution partner relationships and Allstate agent sales of all products and services.

Net income increased in 2004 over 2003 due to higher Property-Liability net income. Net income increased in 2003 compared to 2002 due to higher Property-Liability and Allstate Financial net income. For further discussion of the results of our insurance segments, see the Property-Liability and Allstate Financial Highlights sections of this MD&A.

2004 HIGHLIGHTS

- Net income increased 17.6% to \$3.18 billion and net income per diluted share increased to \$4.54.
- Total revenues reached a record \$33.94 billion, an increase of 5.6% compared to last year.
- Property-Liability premiums earned increased 5.3% to \$25.99 billion. The combined ratio improved 1.6 points to 93.0.
- Pre-tax catastrophe losses in 2004 totaled \$2.47 billion, primarily due to multiple hurricanes in the third quarter of 2004, with an impact to the combined ratio of 9.5 points, compared to \$1.49 billion in 2003, with a combined ratio impact of 6.0 points.
- Allstate Financial investments increased 15.3% due to the investment of cash provided by operating and financing activities, which included record annual contractholder fund deposits.
- The \$1.5 billion share repurchase program was completed in December 2004 and a total of \$1.35 billion in shares were repurchased during the year. We announced a \$4.0 billion share repurchase program to be completed in 2006.
- Book value per share increased 9.2% to \$31.72.
- Return on equity improved 0.8 points to 15.0%.

CONSOLIDATED NET INCOME

(in millions)	For the years ended December 31,		
	2004	2003	2002
Revenues			
Property-liability insurance premiums	\$ 25,989	\$ 24,677	\$ 23,361
Life and annuity premiums and contract charges	2,072	2,304	2,293
Net investment income	5,284	4,972	4,849
Realized capital gains and losses	591	196	(924)
Total revenues	33,936	32,149	29,579
Costs and expenses			
Property-liability insurance claims and claims expense	(17,843)	(17,432)	(17,657)
Life and annuity contract benefits	(1,618)	(1,851)	(1,770)
Interest credited to contractholder funds	(2,001)	(1,846)	(1,764)
Amortization of deferred policy acquisition costs	(4,465)	(4,058)	(3,694)
Operating costs and expenses	(3,040)	(3,001)	(2,761)
Restructuring and related charges	(51)	(74)	(119)
Interest expense	(308)	(275)	(278)
Total costs and expenses	(29,326)	(28,537)	(28,043)
(Loss) gain on disposition of operations	(24)	(41)	4
Income tax expense	(1,230)	(846)	(65)
Dividends on preferred securities of subsidiary trust(s)	—	(5)	(10)
Cumulative effect of change in accounting principle, after-tax	(175)	(15)	(331)
Net income	<u>\$ 3,181</u>	<u>\$ 2,705</u>	<u>\$ 1,134</u>
Property-Liability	\$ 3,045	\$ 2,521	\$ 1,273
Allstate Financial	246	305	(22)
Corporate and Other	(110)	(121)	(117)
Net income	<u>\$ 3,181</u>	<u>\$ 2,705</u>	<u>\$ 1,134</u>

MD&A

APPLICATION OF CRITICAL ACCOUNTING POLICIES

We have identified five accounting policies that require us to make assumptions and estimates that are significant to the consolidated financial statements. It is reasonably likely that changes in these assumptions and estimates could occur from period to period and have a material impact on our consolidated financial statements. A brief summary of each of these critical accounting policies follows. For a more complete discussion of the effect of these policies on our consolidated financial statements, and the judgments and estimates relating to these policies, see the referenced sections of the MD&A. For a complete summary of our significant accounting policies see Note 2 of the consolidated financial statements.

Investment Valuation The fair value of publicly traded fixed income and equity securities is based on independent market quotations, whereas the fair value of non-publicly traded securities is based on either widely accepted pricing valuation models which use internally developed ratings and independent third party data as inputs or independent third party pricing sources. Factors used in our internally

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developed models, such as liquidity risk associated with privately-placed securities, are difficult to independently observe and to quantify. Because of this, judgment is required in developing certain of these estimates and, as a result, the estimated fair value of non-publicly traded securities may differ from amounts that would be realized upon an immediate sale of the securities.

Periodic changes in fair values of investments classified as available for sale are reported as a component of accumulated other comprehensive income on the Consolidated Statements of Financial Position and are not reflected in the operating results of any period until reclassified to net income upon the consummation of a transaction with an unrelated third party, or when declines in fair values are deemed other than temporary. The assessment of other than temporary impairment of a security's fair value is performed on a case-by-case basis considering a wide range of factors. There are a number of assumptions and estimates inherent in assessing impairments and determining if they are other than temporary, including 1) our ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; 2) the expected recoverability of principal and interest; 3) the duration and extent to which the fair value has been less than cost for equity securities or amortized cost for fixed income securities; 4) the financial condition, near-term and long-term prospects of the issuer, including relevant industry conditions and trends, and implications of rating agency actions and offering prices; and 5) the specific reasons that a security is in a significant unrealized loss position, including market conditions which could affect liquidity. Additionally, once assumptions and estimates are made, any number of changes in facts and circumstances could cause us to later determine that an impairment is other than temporary, including 1) general economic conditions that are worse than previously assumed or that have a greater adverse effect on a particular issuer than originally estimated; 2) changes in the facts and circumstances related to a particular issuer's ability to meet all of its contractual obligations; and 3) changes in facts and circumstances or new information that we obtain which causes a change in our ability or intent to hold a security to maturity or until it recovers in value. Changes in assumptions, facts and circumstances could result in additional charges to earnings in future periods to the extent that losses are realized. The charge to earnings, while potentially significant to net income, would not have a significant effect on shareholders' equity since the majority of our portfolio is held at fair value and as a result, any related unrealized loss, net of deferred acquisition costs, deferred sales inducement costs and tax, would already be reflected as accumulated other comprehensive income in shareholders' equity.

For a more detailed discussion of the risks relating to changes in investment values and levels of investment impairment, and the potential causes of such changes, see Note 5 of the consolidated financial statements and the Investments, Market Risk, Enterprise Risk Management and Forward-looking Statements and Risk Factors sections of the MD&A.

Derivative Instrument Hedge Effectiveness In the normal course of business, we primarily use derivative financial instruments to reduce our exposure to market risk and in conjunction with asset/liability management, particularly in the Allstate Financial segment. The fair value of exchange traded derivative contracts is based on independent market quotations, whereas the fair value of non-exchange traded derivative contracts is based on either widely accepted pricing valuation models which use independent third party data as inputs or independent third party pricing sources.

When derivatives meet specific criteria, they may be designated as accounting hedges and accounted for as fair value, cash flow, foreign currency fair value, or foreign currency cash flow hedges. When designating a derivative as an accounting hedge, we formally document the hedging relationship, risk management objective and strategy. The documentation identifies the hedging instrument, the hedged item, the nature of the risk being hedged and the assumptions used to assess how effective the hedging instrument is in offsetting the exposure to changes in the hedged item's fair value attributable to the hedged risk. In the case of a cash flow hedge, this documentation includes the exposure to changes

in the hedged transaction's variability in cash flows attributable to the hedged risk. We do not exclude any component of the change in fair value of the hedging instrument from the effectiveness assessment. At each reporting date, we confirm that the hedging instrument continues to be highly effective in offsetting the hedged risk. The determination of whether a hedging instrument is effective both at its inception and on an on-going basis requires a significant degree of judgment. For further discussion of these policies and quantification of the impact of these estimates and assumptions, see Note 6 of the consolidated financial statements and the Investments, Market Risk, Enterprise Risk Management and Forward-looking Statements and Risk Factors sections of the MD&A.

Deferred Policy Acquisition Cost (“DAC”) Amortization We incur significant costs in connection with acquiring business. In accordance with generally accepted accounting principles (“GAAP”), costs that vary with and are primarily related to acquiring business are deferred and recorded as an asset on the Consolidated Statements of Financial Position.

DAC related to property-liability contracts is amortized to income as premiums are earned, generally over periods of six to twelve months. The amortization methodology for DAC for Allstate Financial policies and contracts includes significant assumptions and estimates.

DAC related to traditional life insurance is amortized over the premium paying period of the related policies in proportion to the estimated revenues on such business. Assumptions relating to estimated premiums, investment income and realized capital gains and losses, as well as to all other aspects of DAC are determined based upon conditions as of the date of policy issuance and are generally not revised during the life of the policy. Any deviations from projected business in force, resulting from actual policy terminations differing from expected levels, and any estimated premium deficiencies, change the rate of amortization in the period such events occur.

DAC related to interest-sensitive life, variable annuities and investment contracts is amortized in proportion to the incidence of the present value of estimated gross profits (“EGP”) over the estimated lives of the contracts. Generally, the amortization period ranges from 15-30 years. However, an assumption for the rate of contract surrenders is also used, which results in the majority of the DAC being amortized over the surrender charge period. EGP consists of estimates of the following components: benefit margins primarily from mortality, including guaranteed minimum death, income and accumulation benefits; investment margin including realized capital gains and losses; and contract administration, surrender and other contract charges, less maintenance expenses.

For variable annuity and life contracts, the most significant assumptions involved in determining EGP are the expected separate accounts fund performance after fees, surrender rates, lapse rates, and investment and mortality margins. Our long-term assumption of separate accounts fund performance net of fees is approximately 8%. Whenever actual separate accounts fund performance, based on the two most recent years, varies from 8%, we project performance levels over the next five years such that the mean return over that seven-year period equals the long-term 8% assumption. This process is referred to as “reversion to the mean” and is commonly used by the life insurance industry. Although the use of a reversion to the mean assumption is common within the industry, the parameters used in the methodology are subject to judgment and vary between companies. For example, when applying this assumption we do not allow the mean future rates of return after fees projected over the five-year period to exceed 12.75% or fall below 0%. Revisions to EGPs result in changes in the cumulative amounts expensed as a component of amortization of DAC in the period in which the revision is made. This is commonly known as “DAC unlocking”.

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For quantification of the impact of these estimates and assumptions on Allstate Financial, see the Allstate Financial Segment and Forward-looking Statements and Risk Factors sections of the MD&A and Note 2 of the consolidated financial statements.

Reserve for Property-Liability Insurance Claims and Claims Expense Estimation The Property-Liability underwriting results are significantly influenced by estimates of the reserve for property-liability insurance claims and claims expense. These reserves are an estimate of amounts necessary to settle all outstanding claims, including claims that have been incurred but not reported ("IBNR"), as of the reporting date.

Allstate Protection reserve estimates are based on known facts and interpretations of circumstances, internal factors including our experience with similar cases, historical trends involving claim payment patterns, loss payments, pending levels of unpaid claims, loss management programs and product mix. In addition, the reserve estimates are influenced by external factors including law changes, court decisions, changes to regulatory requirements, economic conditions, and public attitudes. In the normal course of business, we may also supplement our claims processes by utilizing third party adjusters, appraisers, engineers, inspectors, other professionals and information sources to assess and settle catastrophe and non-catastrophe related claims. The effects of inflation are implicitly considered in the reserving process.

Because reserves are estimates of losses that have occurred, including IBNR losses, the establishment of appropriate reserves, including reserves for catastrophes, is an inherently uncertain and complex process. The highest degree of uncertainty in estimating incurred losses is associated with reserves for the current accident year because the current accident year contains the greatest proportion of losses that have not been reported or settled, and that must be estimated as of the current reporting date. That proportion diminishes in subsequent years.

The ultimate cost of losses may vary materially from recorded amounts, which are based on our best estimates. We regularly update our reserve estimates as new information becomes available and as events unfold that may affect the resolution of unsettled claims. Changes in prior year reserve estimates, which may be material, are reported in property-liability insurance claims and claims expenses in the Consolidated Statements of Operations in the period such changes are determinable.

We believe our net loss reserves are appropriately established based on available facts, technology, laws and regulations. We calculate and record a single best reserve estimate, in conformance with generally accepted actuarial standards, for each line of insurance, its components (coverages and perils), and state, for reported losses and for IBNR losses. The aggregation of these estimates forms the reserve liability recorded in the Consolidated Statements of Financial Position. Based on our products and coverages, historical experience, and stochastic modeling of actuarial chain ladder methodologies used to develop reserve estimates, we estimate that the potential variability of our Allstate Protection reserves, within a reasonable probability of other possible outcomes, may be plus or minus 4.3%, or plus or minus \$400 million in net income. Although this evaluation reflects the most likely outcomes, it is possible the final outcome may fall below or above these amounts.

Establishing Discontinued Lines and Coverages net loss reserves for asbestos, environmental and other discontinued lines claims is subject to uncertainties that are much greater than those presented by other types of claims. Among the complications are lack of historical data, long reporting delays, uncertainties as to the number and identity of insureds with potential exposure, unresolved legal issues regarding policy coverage, unresolved legal issues regarding the determination, availability and timing of exhaustion of policy limits, evolving and expanding theories of liability, the risks inherent in major litigation, the availability and collectibility of recoveries from reinsurance, retrospectively determined premiums and other contractual agreements, estimations of the extent and timing of any contractual

liability, and other uncertainties. There are complex legal issues concerning the interpretation of various insurance policy provisions and whether those losses are covered, or were ever intended to be covered, and could be recoverable through retrospectively determined premium, reinsurance or other contractual agreements. Courts have reached different and sometimes inconsistent conclusions as to when losses are deemed to have occurred and which policies provide coverage; what types of losses are covered; whether there is an insurer obligation to defend; how policy limits are determined; how policy exclusions and conditions are applied and interpreted; and whether clean-up costs represent insured property damage. We believe these issues are not likely to be resolved in the near future, and the ultimate costs may vary materially from the amounts currently recorded resulting in material changes in loss reserves.

Management believes its net loss reserves for environmental, asbestos and other discontinued lines exposures are appropriately established based on available facts, technology, laws and regulation. Due to the uncertainties and factors described above, management believes it is not practicable to develop a meaningful range for any such additional net loss reserves that may be required.

For further discussion of these policies and quantification of the impact of reserve estimates, reserve reestimates and assumptions, see Notes 7 and 13 of the consolidated financial statements and the Catastrophe Losses, Property-Liability Claims and Claims Expense Reserves and Forward-looking Statements and Risk Factors sections of the MD&A.

Reserve for Life-Contingent Contract Benefits Estimation Long-term actuarial assumptions of future investment yields, mortality, morbidity, policy terminations and expenses are used when establishing the reserve for life-contingent contract benefits. These assumptions, which for traditional life insurance are applied using the net level premium method, include provisions for adverse deviation and generally vary by such characteristics as type of coverage, year of issue and policy duration. Future investment yield assumptions are determined at the time the policy is issued based upon prevailing investment yields as well as estimated reinvestment yields. Mortality, morbidity and policy termination assumptions are based on our experience and industry experience prevailing at the time the policies are issued. Expense assumptions include the estimated effects of inflation and expenses to be incurred beyond the premium-paying period.

For further discussion of these policies see Note 8 of the consolidated financial statements and the Forward-looking Statements and Risk Factors section of the MD&A.

PROPERTY-LIABILITY 2004 HIGHLIGHTS

- Premiums written, an operating measure that is defined and reconciled to premiums earned on page 11, reached a record \$26.53 billion during 2004. Compared to last year, premiums written increased 5.3% due to increases in the number of policies in force (“PIF”) for the Allstate brand standard auto of 5.5% and homeowners of 6.4% and higher average premiums. Allstate brand standard auto and homeowners new business premiums increased 19.6% and 19.8%, respectively compared to December 31, 2003.
- Underwriting income for Property-Liability was \$1.83 billion in 2004 compared to \$1.33 billion in 2003, with a combined ratio improvement of 1.6 points to 93.0. These improvements were the result of higher premiums earned, favorable claim frequencies excluding catastrophes, and favorable Allstate Protection reserve reestimates partially offset by higher catastrophe losses and increased severity of current year claims.
- Catastrophe losses in 2004 totaled \$2.47 billion compared to \$1.49 billion in 2003. The effect of catastrophe losses on the loss ratio was 9.5 and 6.0 points in 2004 and 2003, respectively.

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- As a result of profit improvement actions, the Encompass brand combined ratio improved 8.2 points in 2004 to 93.7, while Encompass brand standard auto PIF declined 5.8% compared to December 31, 2003.

PROPERTY-LIABILITY OPERATIONS

Overview Our Property-Liability operations consist of two business segments: Allstate Protection and Discontinued Lines and Coverages. Allstate Protection is comprised of two brands, the Allstate brand and Encompass brand. The Encompass brand name replaced the name Ivtantage beginning in the third quarter of 2004. 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 we no longer write 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.

Underwriting income (loss), a measure that is not based on GAAP and is reconciled to net income on page 9, is calculated as premiums earned, less claims and claims expense ("losses"), amortization of DAC, operating costs and expenses and restructuring and related charges, as determined using GAAP. We use this measure in our evaluation of results of operations to analyze the profitability of the Property-Liability insurance operations separately from investment results. It is also an integral component of incentive compensation. It is useful for investors to evaluate the components of income separately and in the aggregate when reviewing performance. Underwriting income (loss) should not be considered as a substitute for net income and does not reflect the overall profitability of the business. Net income is the most directly comparable GAAP measure.

The table below includes GAAP operating ratios we use to measure our profitability. We believe that they enhance an investor's understanding of our profitability. They are calculated as follows:

- Claims and claims expense ("loss") ratio—the ratio of claims and claims expense to premiums earned. Loss ratios include the impact of catastrophe losses.
- Expense ratio—the ratio of amortization of DAC, operating costs and expenses and restructuring and related charges to premiums earned.
- Combined ratio—the ratio of claims and claims expense, amortization of DAC, operating costs and expenses and restructuring and related charges to premiums earned. The combined ratio is the sum of the loss ratio and the expense ratio. The difference between 100% and the combined ratio represents underwriting income as a percentage of premiums earned.
- Effect of Discontinued Lines and Coverages on combined ratio—the ratio of claims and claims expense and other costs and expenses in the Discontinued Lines and Coverages segment to Property-Liability premiums earned. The sum of the effect of Discontinued Lines and Coverages on the combined ratio and the Allstate Protection combined ratio on page 19 is equal to the Property-Liability combined ratio.

We have also calculated the following impacts of specific items on the GAAP operating ratios because of the volatility of these items between fiscal periods.

- Effect of catastrophe losses on loss ratio—the percentage of catastrophe losses included in claims and claims expenses to premiums earned.

- Effect of restructuring and related charges on expense ratio—the percentage of restructuring and related charges to premiums earned.

Summarized financial data, a reconciliation of underwriting income to net income and GAAP operating ratios for our Property-Liability operations for the years ended December 31, are presented in the following table.

(in millions, except ratios)	2004	2003	2002
Premiums written	<u>\$ 26,531</u>	<u>\$ 25,187</u>	<u>\$ 23,917</u>
Revenues			
Premiums earned	\$ 25,989	\$ 24,677	\$ 23,361
Net investment income	1,773	1,677	1,656
Realized capital gains and losses	<u>592</u>	<u>288</u>	<u>(496)</u>
Total revenues	28,354	26,642	24,521
Costs and expenses			
Claims and claims expense	(17,843)	(17,432)	(17,657)
Amortization of DAC	(3,874)	(3,520)	(3,216)
Operating costs and expenses	(2,396)	(2,326)	(2,108)
Restructuring and related charges	<u>(46)</u>	<u>(67)</u>	<u>(117)</u>
Total costs and expenses	(24,159)	(23,345)	(23,098)
Gain on disposition of operations	—	5	10
Income tax expense	(1,150)	(780)	(112)
Cumulative effect of change in accounting principle, after-tax	<u>—</u>	<u>(1)</u>	<u>(48)</u>
Net income	<u>\$ 3,045</u>	<u>\$ 2,521</u>	<u>\$ 1,273</u>
Underwriting income			
Net investment income	\$ 1,830	\$ 1,332	\$ 263
Income tax expense on operations	1,773	1,677	1,656
Realized capital gains and losses, after-tax	(955)	(682)	(290)
Gain on disposition of operations, after-tax	397	192	(314)
Cumulative effect of change in accounting principle, after-tax	—	3	6
	<u>—</u>	<u>(1)</u>	<u>(48)</u>
Net income	<u>\$ 3,045</u>	<u>\$ 2,521</u>	<u>\$ 1,273</u>
Catastrophe losses	<u>\$ 2,468</u>	<u>\$ 1,489</u>	<u>\$ 731</u>
GAAP operating ratios			
Claims and claims expense (“loss”) ratio	68.7	70.6	75.6
Expense ratio	<u>24.3</u>	<u>24.0</u>	<u>23.3</u>
Combined ratio	<u>93.0</u>	<u>94.6</u>	<u>98.9</u>
Effect of catastrophe losses on loss ratio	<u>9.5</u>	<u>6.0</u>	<u>3.1</u>
Effect of restructuring and related charges on expense ratio	<u>0.2</u>	<u>0.3</u>	<u>0.5</u>
Effect of Discontinued Lines and Coverages on combined ratio	<u>2.5</u>	<u>2.3</u>	<u>1.0</u>

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ALLSTATE PROTECTION SEGMENT

Overview and Strategy Our goal for the Allstate Protection segment is to grow and achieve profitability that produces attractive returns on our auto and homeowners insurance products. We are seeking, through the utilization of our distribution channels, Tiered Pricing and consumer marketing, to attract and retain high lifetime value customers who will potentially provide favorable prospects for profitability over the course of their relationship with us. We continue to enhance technology to integrate our distribution channels, improve customer service, facilitate the introduction of new products and services and reduce infrastructure costs related to supporting agencies and handling claims. We have aligned agency and management compensation and the overall strategies of the Allstate brand to best serve our customers by basing certain incentives on Allstate brand profitability and growth and sales of Allstate Financial products. Beginning in 2003, we implemented and maintained a broader marketing approach throughout the U.S. These actions and others are designed to optimize the effectiveness of our distribution and service channels by increasing the productivity of the Allstate brand's exclusive agencies and The Good Hands® Network.

The Encompass brand business sells private passenger auto and homeowners insurance to individuals through independent agencies. Encompass brand includes standard auto and homeowners products with the EncompassSM brand name and non-standard auto products with the Deerbrook® brand name. Our strategy for the Encompass brand focuses on growing profitably, and growing in select markets, in part by using Tiered Pricing. The integration of Encompass policies onto Allstate systems has resulted in a different counting process for PIF. As a result, percent changes in PIF and average premium and the renewal ratio are subject to some distortion until the integration has been in place for a full year.

Our sophisticated process for segmenting a market ("Tiered Pricing"), and underwriting are designed to enhance both our competitive position and profit potential, and produce a broader range of premiums that is more refined than the range generated by the standard/non-standard model. Tiered Pricing includes our Strategic Risk Management ("SRM") program which considers, to the extent legally permissible, insurance scoring based on information that is obtained from credit reports as well as a number of other risk evaluation factors. At the same time, we continue to expand the number of tiers with successive rating program releases, resulting in a diminishing capacity to draw meaningful comparisons to historical presentations.

Our rating plans for private passenger auto insurance are no longer consistently segregated into standard plans and non-standard plans. In some states, we have implemented Tiered Pricing and modified our underwriting criteria in a way that allows us to write what may be considered both standard and non-standard business with one tiered-rating plan, which may also be considered a standard rating plan designed to accommodate non-standard risks. As we continue to use Tiered Pricing and underwriting, the distinctions between standard and non-standard will become less important in certain states. For this reason we are shifting our managerial focus to auto, which is the sum of standard auto and non-standard auto. We also believe it is useful for investors to analyze auto results that aggregate our standard and non-standard business. However, we will continue to provide results for standard and non-standard auto. Generally, standard auto customers are expected to have lower risks of loss than non-standard auto customers.

Substantially all of new and approximately 65% of renewal business written for Allstate brand auto uses Tiered Pricing. For Allstate brand homeowners, approximately 65% of new and 35% of renewal business written uses Tiered Pricing. For Allstate brand auto and homeowners business written under Tiered Pricing, our results indicate an increase in retention and a shift toward more customers who we consider high lifetime value and who generate more favorable loss results.

Another element of our strategy for our homeowners insurance business is to target customers whose risk of loss provides the best opportunity for profitable growth, including managing exposure on policies in areas where the potential loss from catastrophes exceeds acceptable levels. This includes a continual reevaluation of our countrywide catastrophe risk management strategies for hurricanes and earthquakes. Homeowners product pricing is typically intended to establish returns that we deem acceptable over a long-term period. Losses, including losses from catastrophic events and weather-related losses (such as wind, hail, lightning, freeze and water losses not meeting our 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 we incorporated into the products' pricing. Accordingly, homeowners products are more capital intensive than other personal lines products.

Allstate Protection's goal is to achieve pricing targets comprising a competitive combined ratio and return on equity. Our primary strategies to achieve this goal include continuing our efforts to seek approval for rate changes for all Allstate Protection products in all jurisdictions where we believe such changes are needed and can be obtained based on rate indicators, such as our projected claim frequency and severity experience and expense levels, and to pursue other actions affecting our profitability such as improving our underwriting and claims processes.

Premiums written, an operating measure, is the amount of premiums charged for policies issued during a fiscal period. Premiums earned is a GAAP measure. Premiums are considered earned and are included in the financial results on a pro-rata basis over the policy period. The portion of premiums written applicable to the unexpired terms of the policies is recorded as unearned premiums on our Consolidated Statements of Financial Position. Since the Allstate brand policy periods are typically 6 months for auto and 12 months for homeowners, Encompass auto and homeowners policy periods are typically 12 months and Deerbrook auto policy periods are typically 6 months, rate changes taken during 2004 and 2003 will generally be recognized in premiums earned over a period of 6 to 24 months. During this period, premiums written at a higher rate will cause an increase in the balance of unearned premiums on our Consolidated Statements of Financial Position.

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The following table shows the unearned premium balance at December 31 and the timeframe in which we expect to recognize these premiums as earned.

(in millions)	2004	2003	% earned after			
			90 days	180 days	270 days	360 days
Allstate brand:						
Standard auto	\$3,703	\$3,481	74.5%	99.0%	99.8%	100.0%
Non-standard auto	455	497	73.0%	98.0%	99.5%	100.0%
Auto	4,158	3,978	74.4%	98.9%	99.7%	100.0%
Homeowners	3,029	2,736	43.1%	75.4%	94.1%	100.0%
Other personal lines	1,309	1,245	44.2%	75.9%	94.3%	100.0%
Total Allstate brand	8,496	7,959	58.7%	87.0%	96.9%	100.0%
Encompass brand:						
Standard auto	606	602	44.3%	76.1%	94.3%	100.0%
Non-standard auto (Deerbrook)	36	45	75.1%	100.0%	100.0%	100.0%
Auto	642	647	46.1%	77.4%	94.6%	100.0%
Homeowners	289	266	43.3%	75.2%	94.0%	100.0%
Other personal lines	78	67	43.4%	75.2%	94.1%	100.0%
Total Encompass brand	1,009	980	45.1%	76.6%	94.4%	100.0%
Total Allstate Protection unearned premiums	\$9,505	\$8,939	57.2%	85.9%	96.6%	100.0%

A reconciliation of premiums written to premiums earned for the years ended December 31 is presented in the following table.

(in millions)	2004	2003	2002
Premiums written:			
Allstate Protection	\$26,527	\$25,175	\$23,910
Discontinued Lines and Coverages	4	12	7
Property-Liability premiums written ⁽¹⁾	26,531	25,187	23,917
(Increase) decrease in unearned premiums	(608)	(581)	(556)
Other	66	71	—
Property-Liability premiums earned	<u>\$25,989</u>	<u>\$24,677</u>	<u>\$23,361</u>
Premiums earned:			
Allstate Protection	\$25,983	\$24,664	\$23,351
Discontinued Lines and Coverages	6	13	10
Property-Liability	<u>\$25,989</u>	<u>\$24,677</u>	<u>\$23,361</u>

(1) In 2004, growth in Property-Liability premiums written was negatively impacted by accruals for premium refunds in standard auto and reinsurance transactions in homeowners totaling 0.4%.

Premiums written by brand are shown in the following table.

(in millions)	2004			2003			2002		
	New	Renewal	Total	New	Renewal	Total	New	Renewal	Total
Allstate brand:									
Standard auto	\$1,314	\$13,177	\$14,491	\$1,099	\$12,533	\$13,632	\$ 941	\$11,884	\$12,825
Non-standard auto	276	1,501	1,777	275	1,700	1,975	384	1,953	2,337
Auto	1,590	14,678	16,268	1,374	14,233	15,607	1,325	13,837	15,162
Homeowners	823	4,816	5,639	687	4,466	5,153	493	4,160	4,653
Other personal lines	562	1,989	2,551	551	1,842	2,393	454	1,754	2,208
Total Allstate brand	2,975	21,483	24,458	2,612	20,541	23,153	2,272	19,751	22,023
Encompass brand:									
Standard auto	230	982	1,212	149	1,053	1,202	123	1,072	1,195
Non-standard auto (Deerbrook)	52	101	153	83	87	170	76	38	114
Auto	282	1,083	1,365	232	1,140	1,372	199	1,110	1,309
Homeowners	71	481	552	44	466	510	31	453	484
Other personal lines	40	112	152	41	99	140	8	86	94
Total Encompass brand	393	1,676	2,069	317	1,705	2,022	238	1,649	1,887
Total Allstate Protection premiums written	\$3,368	\$23,159	\$26,527	\$2,929	\$22,246	\$25,175	\$2,510	\$21,400	\$23,910

Standard auto premiums written increased 5.9% to \$15.70 billion in 2004 from \$14.83 billion in 2003, following a 5.8% increase in 2003 from \$14.02 billion in 2002.

Standard Auto	Allstate brand			Encompass brand		
	2004	2003	2002	2004	2003	2002
New business premiums (\$ millions)	\$ 1,314	\$ 1,099	\$ 941	\$230	\$ 149	\$ 123
New business premiums (% change)	19.6	16.8	(13.7)	54.4	21.1	0.8
Renewal business premiums (\$ millions)	\$13,177	\$12,533	\$11,884	\$982	\$1,053	\$1,072
Renewal ratio ⁽¹⁾⁽²⁾	90.8	89.7	88.5	77.1	83.7	83.7
PIF (% change) ⁽¹⁾⁽²⁾	5.5	1.5	(3.5)	(5.8)	(6.4)	(6.4)
Average premium (% change) ⁽¹⁾⁽²⁾	1.2	6.7	8.6	17.5	11.9	5.9

(1) Allstate brand statistic excludes business written in Canada and written by Allstate Motor Club.

(2) Revised to reflect new counting methodology for Encompass brand. PIF, renewal ratio and average gross premium are subject to some distortion due to continued integration of systems.

The increase in Allstate brand standard auto PIF in 2004 when compared to 2003 is primarily the result of increases in new business due to the implementation of a broader marketing approach in most of the U.S. and an increased renewal ratio, which management believes is related to reduced rate activity and improved customer loyalty. Although growth in new business remains above prior year, this trend leveled off during 2004. Sequential growth of Allstate brand standard auto PIF for the last four quarters has averaged 1.4% each quarter. New business comparisons also reflect the July 2003 implementation of our new rating plan in the California market. The increase in the Allstate brand standard auto average premium in 2004 compared to 2003 is primarily due to higher average renewal premiums. The rate of increase in average premium has declined in 2004 due to the decrease in rate activity. The reduced level of rate changes in the current year are due to declines in frequency and severity as discussed in the Underwriting Results section. The increase in the Allstate brand standard auto average premium in 2003

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when compared to 2002 is primarily due to higher average renewal premiums. Higher average renewal premiums resulted from rate actions taken in the last three years and, to a lesser degree, a normal shift by policyholders to newer and more expensive autos. The increases in new business premiums, PIF and the renewal ratio in 2003 compared to 2002 are due to an improved loss ratio driving more modest need for rate increases and to the implementation of a broader marketing approach in most of the U.S.

Encompass brand standard auto new business premiums written increased in 2004 when compared to 2003 and renewal business premiums written decreased in 2004 when compared to 2003 primarily due to increases in new PIF and rate activity, the effect of which is declining due to the decrease in rate change activity. Encompass brand standard auto premiums written increased in 2003 when compared to 2002 primarily due to profit improvement actions resulting in increased average premium per policy, partially offset by fewer PIF. Increased average premiums per policy were related to rate actions taken during the last three years. We expect the rate of decline in Encompass brand standard auto PIF to moderate. Our improved profitability has positioned us to pursue growth opportunities in this channel.

The following table shows the net rate changes that were approved for standard auto during 2004.

	# of States	Weighted Average Rate Change (%) ⁽¹⁾	Annual Impact of Rate Changes on State Specific Premiums Written (%) ⁽²⁾
Allstate brand	23	1.3	3.3
Encompass brand	29 ⁽³⁾	2.8	4.4

(1) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total countrywide year-end premiums written.

(2) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total year-end premiums written in those states.

(3) Includes Washington D.C.

Non-standard auto premiums written decreased 10.0% to \$1.93 billion in 2004 from \$2.15 billion in 2003, following a 12.5% decrease in 2003 from \$2.45 billion in 2002.

Non-Standard Auto	Allstate brand			Encompass brand (Deerbrook)		
	2004	2003	2002	2004	2003	2002
New business premiums (\$ millions)	\$ 276	\$ 275	\$ 384	\$ 52	\$ 83	\$ 76
New business premiums (% change)	0.4	(28.4)	(23.0)	(37.3)	9.2	—
Renewal business premiums (\$ millions)	\$1,501	\$1,700	\$1,953	\$101	\$ 87	\$ 38
Renewal ratio ⁽¹⁾	78.2	74.1	73.1	61.6	56.7	53.0
PIF (% change) ⁽¹⁾	(11.4)	(16.6)	(20.6)	(12.1)	26.8	170.4
Average premium (% change) ⁽¹⁾	1.7	3.8	12.2	(5.8)	(0.5)	14.9

(1) Allstate brand statistic excludes business written in Canada.

Declines in Allstate brand non-standard auto renewal business premiums during 2004 and 2003 were due to a decline in PIF. Renewal PIF declined because new business production was insufficient to make up for an inherently low renewal ratio in this business, and new business PIF declined due to continued agent focus on our standard auto business. In 2004, the increase in average premium declined due to the decrease in rate activity.

Encompass brand (Deerbrook) non-standard premiums written have decreased slightly in 2004 compared to 2003 primarily due to declines in new business. Deerbrook non-standard renewal business premiums increased in 2003 due to the re-entry of Deerbrook in the non-standard market during 2002.

The following table shows the net rate changes that were approved for non-standard auto during 2004.

	# of States	Weighted Average Rate Change (%) ⁽¹⁾	Annual Impact of Rate Changes on State Specific Premiums Written (%) ⁽²⁾
Allstate brand	8	1.6	4.6
Encompass brand (Deerbrook)	9	2.1	3.8

(1) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total countrywide year-end premiums written.

(2) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total year-end premiums written in those states.

Auto premiums written increased 3.9% to \$17.63 billion in 2004 from \$16.98 billion in 2003, following a 3.1% increase in 2003 from \$16.47 billion in 2002. Auto includes standard auto and non-standard auto business.

Auto	Allstate brand			Encompass brand		
	2004	2003	2002	2004	2003	2002
New business premiums (\$ millions)	\$ 1,590	\$ 1,374	\$ 1,325	\$ 282	\$ 232	\$ 199
New business premiums (% change)	15.7	3.7	(16.6)	21.6	16.6	48.5
Renewal business premiums (\$ millions)	\$14,678	\$14,233	\$13,837	\$1,083	\$1,140	\$1,110
Renewal ratio ⁽¹⁾⁽²⁾	89.7	88.0	86.6	74.6	79.9	81.6
PIF (% change) ⁽¹⁾⁽²⁾	4.1	(0.2)	(5.5)	(6.4)	(4.0)	(1.6)
Average premium (% change) ⁽¹⁾⁽²⁾	0.5	5.2	8.0	14.1	9.8	6.1

(1) Allstate brand statistic excludes business written in Canada and written by Allstate Motor Club.

(2) Revised to reflect new counting methodology for Encompass brand. PIF, renewal ratio and average gross premium are subject to some distortion due to continued integration of systems.

The following table shows the net rate changes that were approved for auto (standard and non-standard) during 2004.

	# of States	Weighted Average Rate Change (%) ⁽¹⁾	Annual Impact of Rate Changes on State Specific Premiums Written (%) ⁽²⁾
Allstate brand	26	1.3	3.4
Encompass brand	34 ⁽³⁾	2.7	4.3

(1) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total countrywide year-end premiums written.

(2) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total year-end premiums written in those states.

(3) Includes Washington D.C.

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Homeowners premiums written increased 9.3% to \$6.19 billion in 2004 from \$5.66 billion in 2003, following a 10.2% increase in 2003 from \$5.14 billion in 2002.

Homeowners	Allstate brand			Encompass brand		
	2004	2003	2002	2004	2003	2002
New business premiums (\$ millions)	\$ 823	\$ 687	\$ 493	\$ 71	\$ 44	\$ 31
New business premiums (% change)	19.8	39.4	9.8	61.4	41.9	24.0
Renewal business premiums (\$ millions)	\$4,816	\$4,466	\$4,160	\$ 481	\$ 466	\$ 453
Renewal ratio ⁽¹⁾⁽²⁾	88.4	87.5	87.9	88.5	87.9	86.8
PIF (% change) ⁽¹⁾⁽²⁾	6.4	3.4	(0.5)	2.1	(4.5)	(6.2)
Average premium (% change) ⁽¹⁾⁽²⁾	3.7	6.5	19.8	12.7	11.8	13.3

(1) Allstate brand statistic excludes business written in Canada.

(2) Revised to reflect new counting methodology for Encompass brand. PIF, renewal ratio and average gross premium are subject to some distortion due to continued integration of systems.

The Allstate brand homeowners PIF increase in 2004 compared to 2003 is the result of the increases in new business due to a broader marketing approach in most of the U.S. and an increased renewal ratio, which management believes is related to reduced rate activity and increased customer loyalty. Due to recent hurricanes, beginning in September 2004, we have curtailed our acceptance of new business in Florida, which will continue to adversely impact our growth in new business premiums. Sequential growth of Allstate brand homeowners PIF for the last four quarters has averaged 1.6% each quarter. The increases in average premium during 2004 and 2003 were primarily due to higher average renewal premiums in both years. Higher average renewal premiums were related to increasing home values, along with rate actions taken in the current and prior year. The reduced level of rate changes in the current year are due to declines in frequency and severity as discussed in the Underwriting Results section. The Allstate brand homeowners PIF increase in 2003 compared to 2002 was the result of the increased competitiveness of our underwriting practices, products and rates in the homeowners market.

Encompass brand homeowners new business premiums written increased in 2004 compared to 2003 due to increases in PIF and average premium. Increases in Encompass brand homeowners average premium were due to rate actions taken during the current and prior year.

The following table shows the net rate changes that were approved for homeowners during 2004.

	# of States	Weighted Average Rate Change (%) ⁽¹⁾	Annual Impact of Rate Changes on State Specific Premiums Written (%) ⁽²⁾
Allstate brand	11	0.3	3.3
Encompass brand	31 ⁽³⁾	9.3	6.2

(1) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total countrywide year-end premiums written.

(2) Represents the impact in the states where rate changes were approved during 2004 as a percentage of total year-end premiums written in those states.

(3) Includes Washington D.C.

Premiums earned by brand are shown in the following table.

(in millions)	Allstate brand			Encompass brand			Total Allstate Protection		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Standard auto	\$14,290	\$13,406	\$12,667	\$1,208	\$1,195	\$1,194	\$15,498	\$14,601	\$13,861
Non-standard auto	1,823	2,075	2,413	161	163	89	1,984	2,238	2,502
Auto	16,113	15,481	15,080	1,369	1,358	1,283	17,482	16,839	16,363
Homeowners	5,349	4,892	4,275	529	494	470	5,878	5,386	4,745
Other	2,482	2,316	2,147	141	123	96	2,623	2,439	2,243
Total	<u>\$23,944</u>	<u>\$22,689</u>	<u>\$21,502</u>	<u>\$2,039</u>	<u>\$1,975</u>	<u>\$1,849</u>	<u>\$25,983</u>	<u>\$24,664</u>	<u>\$23,351</u>

Underwriting results are shown in the following table.

(in millions)	2004	2003	2002
Premiums written	<u>\$26,527</u>	<u>\$25,175</u>	<u>\$23,910</u>
Premiums earned	\$25,983	\$24,664	\$23,351
Claims and claims expense	(17,208)	(16,858)	(17,424)
Amortization of DAC	(3,874)	(3,520)	(3,216)
Other costs and expenses	(2,387)	(2,316)	(2,097)
Restructuring and related charges	(46)	(67)	(117)
Underwriting income	<u>\$ 2,468</u>	<u>\$ 1,903</u>	<u>\$ 497</u>
Catastrophe losses	<u>\$ 2,468</u>	<u>\$ 1,489</u>	<u>\$ 731</u>
Underwriting income (loss) by brand			
Allstate brand	\$ 2,340	\$ 1,941	\$ 681
Encompass brand	128	(38)	(184)
Underwriting income	<u>\$ 2,468</u>	<u>\$ 1,903</u>	<u>\$ 497</u>

Allstate Protection generated underwriting income of \$2.47 billion during 2004 compared to \$1.90 billion in 2003. The increase in underwriting income was the result of increased premiums earned, declines in auto and homeowners claim frequency (rate of claim occurrence) excluding catastrophes and favorable reserve reestimates related to prior years, partially offset by higher catastrophe losses, increased operating costs and expenses and increased current year claim severity (average cost per claim). For further discussion and quantification of the impact of reserve estimates, reserve reestimates and assumptions, see the Property-Liability Claims and Claims Expense Reserves section of the MD&A.

Claims and claims expense during 2004 includes estimated catastrophe losses of \$2.00 billion, net of recoveries from the Florida Hurricane Catastrophe Fund ("FHCF"), related to hurricanes Charley, Frances, Ivan, and Jeanne. This estimate includes net losses on personal lines auto and property policies and net losses on commercial policies. For a further discussion of catastrophe losses, see page 21.

Allstate Protection generated underwriting income of \$1.90 billion during 2003 compared to \$497 million in 2002. The increase in underwriting income was the result of increased premiums earned, declines in auto and homeowners claim frequency and favorable prior year reserve reestimates, partially offset by increased catastrophe losses, increased operating costs and expenses and increased current year claim severity.

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Changes in auto current year claim severity are generally influenced by inflation in the medical and auto repair sectors of the economy. We mitigate these effects through various loss management programs. Injury claims are affected largely by medical cost inflation while physical damage claims are affected largely by auto repair cost inflation and used car prices. Our rate of increase in incurred injury claim severity during 2004 and 2003 was lower than the relevant medical cost indices. We believe our claim settlement initiatives, such as improvements to the claim settlement process, medical management programs, the use of special investigative units to detect fraud and handle suspect claims, litigation management and defense strategies, as well as various loss management initiatives underway, contribute positively to the mitigation of injury severity trends. However, auto injury claim severity could offset the success of these programs; therefore, we will continue to pursue claim mitigation programs.

For auto physical damage coverages, we monitor our rate of increase in average cost per claim against a weighted average of the Body Work price index and the Used Car price index. In 2004, our rate of increase in incurred physical damage current year claim severity was generally lower than the weighted index. In 2003, our rate of increase in incurred physical damage current year claim severity was generally higher than the weighted index. We believe that results were favorably impacted by the application of enhanced claim settlement practices for auto physical damage claims. Accordingly, we continue to pursue various loss management initiatives that we expect to contribute positively to the mitigation of physical damage severity trends. However, during 2003 the increase in auto physical damage claim severity more than offset the success of these programs.

Changes in homeowners current year claim severity are generally influenced by inflation in the cost of building materials, the cost of construction and property repair services, the cost of replacing home furnishings and other contents, the types of claims that qualify for coverage, deductibles and other economic and environmental factors. In 2004 and 2003, we experienced an increase in homeowners severity compared to prior year. We employ various loss management programs to mitigate the effect of these factors; however, homeowners severity may increase, offsetting the success of these programs. We have also taken numerous actions that we expect to contribute to profitable trends in the homeowners loss ratio.

Loss ratios are a measure of profitability. Loss ratios by product, and expense and combined ratios by brand, are shown in the following table. These ratios are defined on page 8.

	Loss Ratio			Effect of Catastrophe Losses on the Loss Ratio		
	2004	2003	2002	2004	2003	2002
Allstate brand loss ratio:						
Standard auto	64.4	70.1	74.9	0.7	1.4	0.7
Non-standard auto	53.9	65.6	72.4	0.9	0.7	0.3
Auto	63.2	69.5	74.5	0.7	1.3	0.6
Homeowners	67.4	63.2	75.8	29.2	21.8	12.0
Other	84.6	68.1	70.7	27.7	5.6	3.3
Total Allstate brand loss ratio	66.3	68.0	74.4	9.8	6.2	3.2
Allstate brand expense ratio	23.9	23.5	22.5			
Allstate brand combined ratio	90.2	91.5	96.9			
Encompass brand loss ratio:						
Standard auto	61.3	69.4	79.1	0.5	0.7	0.5
Non-standard auto (Deerbrook)	75.8	84.7	109.0	0.6	0.7	—
Auto	63.1	71.2	81.1	0.6	0.7	0.4
Homeowners	63.7	76.7	75.1	16.4	16.6	10.4
Other	84.4	71.5	40.6	5.7	4.0	3.1
Encompass brand loss ratio	64.7	72.6	77.5	5.1	4.9	3.1
Encompass brand expense ratio	29.0	29.3	32.5			
Encompass brand combined ratio	93.7	101.9	110.0			
Total Allstate Protection loss ratio	66.2	68.4	74.6	9.5	6.0	3.1
Allstate Protection expense ratio	24.3	23.9	23.3			
Allstate Protection combined ratio	90.5	92.3	97.9			

Standard auto loss ratio declined 5.7 points for the Allstate brand and 8.1 points for the Encompass brand in 2004 when compared to 2003. These declines were due to higher premiums earned, favorable reserve reestimates related to prior years and lower claim frequency, partially offset by higher current year claim severity. Standard auto claim frequency in the fourth quarter of 2004 increased slightly over the prior year quarter due to weather related events in the last two weeks of 2004; however, our underlying frequency trends remain favorable. In 2003, the Allstate brand standard auto loss ratio declined 4.8 points and the Encompass brand standard auto loss ratio declined 9.7 points when compared to 2002. The declines in 2003 were due to higher premiums earned, lower claim frequency and favorable reserve reestimates related to prior years, partially offset by higher catastrophe losses and claim severity.

Non-standard auto loss ratio declined 11.7 points for the Allstate brand and 8.9 points for Encompass brand in 2004 when compared to 2003. These declines were due to favorable reserve reestimates related to prior years and lower claim frequency, partially offset by higher current year claim severity. In 2003, the Allstate brand non-standard loss ratio declined 6.8 points and the Encompass brand non-standard loss ratio declined 24.3 points. These declines were due to lower claim frequency, favorable reserve

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reestimates and higher premiums earned in Encompass brand, partially offset by higher catastrophe losses and higher claim severities.

Auto loss ratio declined 6.3 points for the Allstate brand and 8.1 points for the Encompass brand in 2004 when compared to 2003. These declines were due to favorable reserve reestimates related to prior years, lower claim frequency and higher premiums earned for Allstate brand, partially offset by higher current year claim severity. In 2003, the Allstate brand auto loss ratio declined 5.0 points and the Encompass brand auto loss ratio declined 9.9 points when compared to 2002. These declines were due to higher premiums earned and lower claim frequency and favorable reserve reestimates, partially offset by higher catastrophe losses and claim severity.

Homeowners loss ratio increased 4.2 points for the Allstate brand and declined 13.0 points for the Encompass brand in 2004 when compared to 2003. These fluctuations were due to higher catastrophes partially offset by higher premiums earned, favorable reserve reestimates related to prior years and lower claim frequency, excluding catastrophes for the Allstate brand, and higher current year claim severity. In 2003, the Allstate brand loss ratio declined 12.6 points and the Encompass brand loss ratio increased 1.6 points when compared to 2002. These fluctuations were due to higher premiums earned, lower claim frequency and favorable reserve reestimates for the Allstate brand, including lower than anticipated losses in Texas related to mold claims, offset by increased catastrophe losses, higher claim severity and higher reserve reestimates for Encompass brand. Allstate brand incurred losses related to mold claims in Texas were negligible in 2003 compared to losses of \$326 million in 2002.

For homeowners, we implemented programs such as market or state-specific product designs, rate increases, underwriting and rating changes, discontinuation of specific coverages, specific policy language clarifying coverage for mold claims and loss management initiatives to improve the profitability of this business. Because of the success of these programs we returned this business to profitability in 2003, although volatility in underwriting results during 2004 was caused by catastrophes.

Expense ratio for Allstate Protection increased in 2004 compared to 2003 due to higher amortization of DAC resulting from higher agent incentives and increases in marketing expense. Higher agent incentives were based on higher underlying profitability and increases in premium written. Expense ratio for Allstate Protection increased in 2003 compared to 2002 due to higher agent incentives, marketing expenditures, charitable contributions and employee-related expenses.

The impact of specific costs and expenses on the expense ratio is included in the following table.

	Allstate brand			Encompass brand		
	2004	2003	2002	2004	2003	2002
Amortization of DAC	14.5	13.9	13.3	19.6	19.1	19.8
Other costs and expenses	9.2	9.3	8.7	9.0	9.9	12.6
Restructuring and related charges	0.2	0.3	0.5	0.4	0.3	0.1
Total expense ratio	<u>23.9</u>	<u>23.5</u>	<u>22.5</u>	<u>29.0</u>	<u>29.3</u>	<u>32.5</u>

The expense ratio for the standard auto and homeowners businesses generally approximate the total Allstate Protection expense ratio of 24.3 in 2004, 23.9 in 2003 and 23.3 in 2002. The expense ratio for the non-standard auto business generally is lower than the total Allstate Protection expense ratio due to lower agent commission rates and higher average premiums for non-standard auto as compared to standard auto. The Encompass brand expense ratio is higher on average than the expense ratio of the Allstate brand due to higher commission rates and licensing fees paid to CNA Financial Corporation.

Allstate Protection underwriting income was impacted by restructuring charges. For a more detailed discussion of these charges, see Note 12 of the consolidated financial statements. Net income was also favorably impacted in 2003 by adjustments for prior year tax liabilities totaling \$69 million.

DAC We establish a DAC asset for costs that vary with and are primarily related to acquiring business, principally agents' remuneration, premium taxes, certain underwriting and direct mail solicitation expenses. For the Allstate Protection business, DAC is amortized to income consistent with the timeframes in which premiums are earned.

The balance of DAC for each product type at December 31, is included in the following table.

(in millions)	Allstate brand		Encompass brand		Total Allstate Protection	
	2004	2003	2004	2003	2004	2003
Standard auto	\$ 537	\$ 491	\$123	\$112	\$ 660	\$ 603
Non-standard auto	62	63	4	5	66	68
Auto	599	554	127	117	726	671
Homeowners	447	392	61	52	508	444
Other personal lines	213	198	13	12	226	210
Total DAC	<u>\$1,259</u>	<u>\$1,144</u>	<u>\$201</u>	<u>\$181</u>	<u>\$1,460</u>	<u>\$1,325</u>

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 our results of operations and financial position. We define 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 earthquakes, volcanoes, wildfires, tornadoes, hailstorms, hurricanes, tropical storms, high winds and winter storms. We are also exposed to human-made catastrophic events, such as certain acts of terrorism or industrial accidents. The nature and level of catastrophes in any period cannot be predicted.

Over time we have limited our aggregate insurance exposure to catastrophe losses in certain regions of the country that are subject to high levels of natural catastrophes. Actions we have taken to limit our exposure include purchase of reinsurance in certain states; restricting the amount and location of new business; limiting the availability of certain policy coverages; placing policies with third parties; and increasing our participation in catastrophe pools. However, the impact of these actions may be diminished by the growth in insured values, the effect of state insurance laws and regulations and by the effect of competitive considerations. We have also requested and received rate increases and have expanded the use of hurricane, tropical cyclone and earthquake deductibles in certain regions that are subject to high levels of catastrophes.

We consider the greatest areas of potential catastrophe losses due to hurricanes to be major metropolitan centers near the eastern and gulf coasts of the United States, and the greatest areas of potential catastrophe losses due to earthquakes to be California, areas surrounding the New Madrid fault system in the Midwest and faults in and surrounding Seattle, Washington and Charleston, South Carolina. For further disclosure of our participation in the FHCF, Citizens Property Insurance Corporation and the California Earthquake Authority ("CEA"), which limit our exposure to catastrophes in certain areas, see Notes 9 and 13 of the consolidated financial statements.

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We include catastrophe losses in property-liability claims and claims expense. As a result, catastrophe losses affect both our underwriting results and loss ratios. During 2004, catastrophe losses totaled \$2.47 billion, compared to catastrophe losses of \$1.49 billion in 2003 and \$731 million in 2002. Of the \$2.47 billion of catastrophe losses incurred during 2004, \$2.00 billion related to hurricanes Charley, Frances, Ivan and Jeanne, which struck portions of Florida, the southeastern seaboard, and other parts of the United States.

Estimates of losses from hurricanes Charley, Frances, Ivan and Jeanne at December 31, 2004 are shown in the table below:

(in millions)	Gross Losses	FHCF Recoveries	Net Losses
Personal Lines			
Charley (August 13)	\$ 756	\$(323)	\$ 433
Frances (September 3)	650	(235)	415
Ivan (September 14)	576	(47)	529
Jeanne (September 25)	<u>330</u>	<u>—</u>	<u>330</u>
Subtotal	\$2,312	(\$605)	1,707
Commercial	<u>393</u>	<u>(98)</u>	<u>295</u>
Total Loss Estimate	<u>\$2,705</u>	<u>\$(703)</u>	<u>\$2,002</u>

Since our preliminary provision for losses of \$1.64 billion, net of recoveries from the FHCF, as of September 30, 2004, we revised our provision for these four hurricane losses to \$2.00 billion, net of recoveries from the FHCF, as of December 31, 2004. Estimates of losses for these storms were increased due to increased estimates of claim severity on personal lines and commercial property claims in Florida. When the initial estimates for these storms were prepared in the third quarter, these storms had only recently occurred, very few losses had been paid, and due to the extensive devastation and massive scale of these storms, it was not possible to gain access to and physically inspect a sufficiently large portion of claims. During the fourth quarter, property inspections were completed by claim adjusters and, consequently, we were able to develop more accurate assessments of the actual cost of physical damages. A significant amount of these losses have been paid.

Estimates of gross qualifying personal property losses for Charley, Frances and Ivan have exceeded the \$312 million per occurrence FHCF retention, thus permitting reimbursement of 90% of qualifying losses above the retention. For Jeanne, estimated qualifying property losses are \$279 million, which is below the FHCF retention. Estimates of qualifying commercial habitational property losses for Charley and Frances have exceeded the \$30 million per occurrence FHCF retention. For Ivan and Jeanne, estimated qualifying commercial habitational property losses are \$27 million and \$14 million, respectively, which are below the FHCF retention. For all of the storms, any adverse development of losses not qualifying for FHCF reimbursement will adversely impact net income if and when determined.

The current estimates of losses for these storms have a much greater degree of certainty than previous estimates, which were prepared shortly after these storms occurred. However, there are still factors and complications that may cause future development of these estimates to be either favorable or unfavorable. Among other things, there are still claims to be reported; we are still evaluating the impact in communities that were hit by more than one hurricane; and our evaluation of losses is complicated by the fact that property damage resulted from both flooding, which Allstate policies do not cover, and high winds, which Allstate policies typically do cover. In addition, because of increased demand for services and supplies in the areas affected by the hurricanes and the length of time required to repair the

damage, our loss estimates may not accurately reflect inflated costs of repair. Finally, the net loss estimates could be affected by the amount of FHCF reimbursements actually received.

Historical Catastrophe Experience In the last 13 years, the average annual impact of catastrophes on our Property-Liability loss ratio was 6.5 pts. However, this average does not reflect the impact of some of the more significant actions we have taken to limit our catastrophe exposure. Consequently, we think it is useful to consider the impact of catastrophes after excluding losses that are now substantially covered by the CEA, FHCF or placed with a third party. The average annual impact of all catastrophes, excluding losses from Hurricanes Andrew and Iniki and losses from California earthquakes, on our Property-Liability loss ratio was 4.4 during the last 13 years. Comparatively, the average annual impact of catastrophes on the homeowners loss ratio over the last 12 years, excluding losses from Hurricane Andrew, California earthquakes and Hawaii hurricanes during that period was 16.3 points, with an impact of 16.2 in areas bordering the eastern and gulf coasts with hurricane exposure and an impact of 16.5 in all other areas.

Allstate Protection Outlook

- We expect to see continued growth of Allstate brand auto premiums written due to increased PIF resulting from increases in the number and productivity of agents representing us, increased advertising effectiveness and higher customer loyalty partially offset by consistent average gross premiums.
- We will continue to review our homeowners business in order to determine its potential for future profitability. Our review may result in actions designed to limit our catastrophe risk such as increased purchases of reinsurance, increased rates or limitations on new business writings.
- As a result of the four hurricanes in Florida and their very adverse financial impacts and in an effort to mitigate our exposure to catastrophe risk, we are currently evaluating various actions that could negatively impact the level of homeowners premiums written and profitability. The actions under consideration include continued suspension of writing new business, purchasing additional reinsurance and other actions to reduce exposure to hurricanes, including placing policies with third parties, increasing rates, and advancing proposals for legislative reform. Additionally, the state of Florida has taken other actions that could negatively impact our level of homeowners premiums written and profitability, including changing to seasonal hurricane deductibles, discouraging insurance companies from increasing rates and not allowing non-renewal of policies.
- We expect to experience premium growth in the Encompass brand during 2005 since we have attained profitability in this business.
- We expect that volatility in the level of catastrophes or claim frequency we experience will contribute to variation in our underwriting results.
- We will continue to examine our expenses for additional areas where costs may be reduced. Any reductions in costs we achieve, however, may be offset by the costs of other new initiatives, such as increased expenditures for technology. We expect advertising expenses in 2005 to be comparable to 2004 expenses, which were approximately \$275 million, but will be more focused on our target customers. In addition, other factors may increase our expenses, including an adverse market impact on net periodic pension cost, increases in other benefit expenses and guaranty fund assessments.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

DISCONTINUED LINES AND COVERAGES SEGMENT

Overview The Discontinued Lines and Coverages segment includes results from insurance coverage that we no longer write and results for certain commercial and other businesses in run-off. We have assigned management of this segment to a designated group of professionals with expertise in claims handling, policy coverage interpretation and exposure identification. Our exposure to asbestos, environmental and other discontinued lines claims arises in this segment.

Summarized underwriting results for the years ended December 31, are presented in the following table.

(in millions)	2004	2003	2002
Premiums written	\$ 4	\$ 12	\$ 7
Premiums earned	\$ 6	\$ 13	\$ 10
Claims and claims expense	(635)	(574)	(233)
Other costs and expenses	(9)	(10)	(11)
Underwriting loss	<u>\$ (638)</u>	<u>\$ (571)</u>	<u>\$ (234)</u>

During 2004, the underwriting loss was primarily due to reestimates of asbestos reserves totaling \$463 million, and an increase of \$136 million in the allowance for future uncollectible reinsurance. The cost of administering claims settlements totaled \$22 million, \$23 million and \$39 million for the years ended December 31, 2004, 2003 and 2002, respectively.

During 2003, the underwriting loss was also primarily due to our annual review of reserves for asbestos, environmental, and other discontinued lines exposures, resulting in an increase in reserves totaling \$514 million, including increases for asbestos of \$442 million, \$34 million due to new information received for two manufacturing insureds in bankruptcy, and \$38 million for an excess insurance policyholder who submitted new and unanticipated claims that were for previously not designated, and therefore unexpected, coverage years.

See the Property-Liability Claims and Claims Expense Reserves for a more detailed discussion.

Discontinued Lines and Coverages Outlook

- We may continue to experience asbestos losses in the future. These losses could be due to the potential adverse impact of new information relating to new and additional claims or the impact of resolving unsettled claims based on unanticipated events such as litigation or legislative, judicial and regulatory actions. Because of our annual "ground up" review, we believe that our reserves are appropriately established based on available information, technology, laws and regulations.

PROPERTY-LIABILITY INVESTMENT RESULTS

Net investment income increased 5.7% in 2004 when compared to last year, after increasing 1.3% in 2003 when compared to 2002. These increases were due to higher portfolio balances resulting from positive cash flows from operations and investment activities and higher income from partnerships, partially offset by lower portfolio yields.

The following table presents the average pre-tax investment yields⁽¹⁾ for the year ended December 31.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Fixed income securities: tax-exempt	5.4%	5.5%	5.6%
Fixed income securities: tax-exempt equivalent	7.9	7.8	8.0
Fixed income securities: taxable	5.2	5.5	6.5
Equity securities	4.6	4.4	3.9
Mortgage loans	5.5	7.7	5.8
Total portfolio	5.1	5.3	5.6

(1) Pre-tax yield is calculated as annualized investment income (including dividend income in the case of equity securities) divided by the average of the beginning and end of period investment balances. Amortized cost basis is used to calculate the average investment balance for fixed income securities and mortgage loans. Cost is used for equity securities.

Net realized capital gains and losses, after-tax were \$397 million in 2004 compared to \$192 million in 2003 and \$(314) million in 2002. The following table presents the factors driving the net realized capital gains and losses results.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Investment write-downs	\$ (46)	\$(110)	\$(148)
Dispositions	697	385	(129)
Valuation of derivative instruments	10	10	(24)
Settlements of derivative instruments	(69)	3	(195)
Realized capital gains and losses, pretax	592	288	(496)
Income tax (expense) benefit	(195)	(96)	182
Realized capital gains and losses, after-tax	<u>\$ 397</u>	<u>\$ 192</u>	<u>\$(314)</u>

For a further discussion of net realized capital gains and losses, see the Investments section of the MD&A.

Investment Outlook

- The Property-Liability investment portfolio relies upon positive cash flows to support investment purchases. Cash flows available for investment can be impacted by volatility in underwriting results and the level of dividends paid by Allstate Insurance Company (“AIC”) to The Allstate Corporation. The amount of cash flow available to invest directly impacts the amount of Property-Liability net investment income.
- Allstate expects to experience lower investment yields due, in part, to the reinvestment of proceeds from security prepayments, calls and maturities, and the investment of cash flows from operations in securities yielding less than the average portfolio rate.

PROPERTY-LIABILITY CLAIMS AND CLAIMS EXPENSE RESERVES

Underwriting results of Property-Liability are significantly influenced by estimates of property-liability claims and claims expense reserves. We describe our reserve process in the Application of Critical Accounting Policies section of the MD&A and Note 7 of the consolidated financial statements. These reserves are an estimate of amounts necessary to settle all outstanding claims, including IBNR claims, as of the reporting date.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

Reserves are established for claims as they occur for each line of business based on estimates of the ultimate cost to settle the claims. The actual loss results are compared to prior estimates and differences are recorded as reserve reestimates. The primary actuarial technique used to estimate reserves and provide for losses is a "chain ladder" estimation process in which historical loss patterns are applied to actual paid losses and reported losses (paid losses plus individual case reserves set by claim adjusters) for an accident year or a report year to create an estimate of how losses are likely to develop over time. An accident year refers to classifying claims based on the year in which the claims occurred. A report year refers to classifying claims based on the year in which the claims are reported. Both classifications are used to prepare estimates of required reserves for payments to be made in the future.

In the chain ladder estimation technique, a ratio (development factor) is calculated which compares current results to results in the prior period for each accident year. A three-year or two-year average development factor, based on historical results, is usually multiplied by the current experience to estimate the development of losses of each accident year from the current time period into the next time period. The development factors for the next time periods for each accident year are compounded over the remaining calendar years to calculate an estimate of ultimate losses for each accident year. Occasionally, unusual aberrations in loss patterns are caused by factors such as changes in claim reporting, settlement patterns, unusually large losses, process changes, legal or regulatory changes, and other influences. In these instances, analyses of alternate development factor selections are performed to evaluate the effect of these factors, and actuarial judgment is applied to make appropriate development factor assumptions needed to develop a best estimate of ultimate losses. Paid losses are then subtracted from estimated ultimate losses to determine the indicated reserves. The difference between indicated reserves and recorded reserves is the amount of reserve reestimate.

Reserves are reestimated quarterly. When new development factors are calculated from actual losses, and they differ from estimated development factors used in previous reserve estimates, assumptions about losses and required reserves are revised based on the new development factors. Changes to reserves are recorded in the period in which development factor changes result in reserve reestimates.

Over one thousand actuarial estimates of the types described above are prepared each quarter to monitor losses for each line of insurance, major components of losses (such as coverages and perils), major states or groups of states and for reported losses and IBNR. Often, several different estimates are prepared for each detailed component, incorporating alternative analyses of changing claim settlement patterns and other influences on losses, from which we select our best estimate for each component, occasionally incorporating additional analyses and actuarial judgment, as described above. These estimates also incorporate the historical impact of inflation into reserve estimates, the implicit assumption being that a multi-year average development factor represents an adequate provision. Based on our review of these estimates, our best estimate of required reserves for each state/line/coverage component is recorded for each accident year, and the required reserves for each component are summed to create the reserve balances carried on our Consolidated Statements of Financial Position.

The facts and circumstances leading to our reestimate of reserves relate to revisions to the development factors used to predict how losses are likely to develop from the end of a reporting period until all claims have been paid. Reestimates occur because actual losses are different than that predicted by the estimated development factors used in prior reserve estimates. At December 31, 2004, the impact of a reserve reestimation resulting in a one percent increase in net reserves would be a decrease of approximately \$110 million in net income. A reserve reestimation resulting in a one percent decrease in net reserves would increase net income by approximately \$110 million. For a further description of our reserving policies and the potential variability in our reserve estimates, see the Application of Critical Accounting Policies section of the MD&A.

For Allstate Protection, at each reporting date the highest degree of uncertainty in estimates of losses arises from claims remaining to be settled for the current accident year and the most recent preceding accident year. The greatest degree of uncertainty exists in the current accident year because, at the end of the current accident year, the percentage of losses that have not been reported or settled and that consequently must be estimated, is higher than it will be as time elapses. Most of these losses relate to damaged property such as automobiles and to medical care for injuries from accidents. During the first year after the end of an accident year, a large portion of the total losses for that accident year are settled. When accident year losses paid through the end of the first year following the accident year are incorporated into updated actuarial estimates, the trends inherent in the settlement of claims emerge more clearly. Consequently, this is the point in time at which we tend to make our largest reestimates of losses for an accident year. After the second year, the losses that we pay for an accident year typically relate to claims that are more difficult to settle, such as those involving serious injuries or litigation. Private passenger auto insurance provides a good illustration of the uncertainty of future loss estimates: our typical annual percentage payout of reserves (estimated losses) for an accident year is approximately 45% in the first year after the end of the accident year, 25% in the second year, 10% in the third year, 10% in the fourth year, and the remaining 10% thereafter.

The table below shows total net reserves as of December 31, 2004, 2003 and 2002 for Allstate brand, Encompass brand and Discontinued Lines and Coverages lines of business.

(in millions)	2004	2003	2002
Allstate brand	\$13,204	\$12,866	\$12,361
Encompass brand	1,230	1,277	1,227
Total Allstate Protection	\$14,434	\$14,143	\$13,588
Discontinued Lines and Coverages	2,327	1,837	1,430
Total Property-Liability	<u>\$16,761</u>	<u>\$15,980</u>	<u>\$15,018</u>

The table below shows net reserves representing the estimated cost of outstanding claims as they were recorded at the beginning of years 2004, 2003 and 2002, and the effect of reestimates in each year.

(in millions)	2004		2003		2002	
	Jan 1 Reserves	Reserve Reestimate	Jan 1 Reserves	Reserve Reestimate	Jan 1 Reserves	Reserve Reestimate
Allstate brand	\$12,866	\$(872)	\$12,361	\$ (209)	\$12,092	\$ 386
Encompass brand	1,277	7	1,227	36	1,247	68
Total Allstate Protection	\$14,143	\$(865)	\$13,588	\$ (173)	\$13,339	\$ 454
Discontinued Lines and Coverages	1,837	635	1,430	574	1,494	231
Total Property-Liability	<u>\$15,980</u>	<u>\$(230)</u>	<u>\$15,018</u>	<u>\$ 401</u>	<u>\$14,833</u>	<u>\$ 685</u>
Reserve reestimates, after-tax		<u>\$(150)</u>		<u>\$ 261</u>		<u>\$ 445</u>
Net income		<u>3,181</u>		<u>2,705</u>		<u>1,134</u>
Reserve reestimates as a % of net income		<u>4.7%</u>		<u>(9.6)%</u>		<u>(39.2)%</u>

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Allstate Protection

The table below shows Allstate Protection net reserves representing the estimated cost of outstanding claims as they were recorded at the beginning of years 2004, 2003 and 2002, and the effect of reestimates in each year.

(in millions)	2004		2003		2002	
	Jan 1 Reserves	Reserve Reestimate	Jan 1 Reserves	Reserve Reestimate	Jan 1 Reserves	Reserve Reestimate
Auto	\$10,419	\$ (657)	\$10,378	\$ (221)	\$10,339	\$ 44
Homeowners	1,873	(169)	1,664	13	1,488	367
Other Lines	1,851	(39)	1,546	35	1,512	43
Total Allstate Protection	<u>\$14,143</u>	<u>\$ (865)</u>	<u>\$13,588</u>	<u>\$ (173)</u>	<u>\$13,339</u>	<u>\$ 454</u>
Underwriting income (loss)		<u>2,468</u>		<u>1,903</u>		<u>497</u>
Reserve reestimates as a % of underwriting income (loss)		<u>35.0%</u>		<u>9.1%</u>		<u>(91.3)%</u>

Auto reserve reestimates in 2004 and 2003 were primarily the result of auto injury severity development in 2003 and 2002 that was better than expected and late reported loss development that was better than expected due to lower frequency trends in recent years. Auto reserve reestimates in 2002 were primarily due to increasing severity trends for automobile repair and medical costs of \$55 million for Encompass brand operations and \$17 million for Canadian operations, partially offset by reduced reserve reestimates for the Allstate brand.

Homeowners reserve reestimates in 2004 were primarily due to late reported loss development that was better than expected. Homeowners reserve reestimates in 2003 were primarily due to severity development that was greater than expected and additional losses from the 1994 Northridge earthquake, partially offset by the release of reserves due to lower than anticipated losses in Texas related to mold claims.

Homeowners reserve reestimates in 2002 were primarily due to claim severity and late reported losses that were greater than the level anticipated in previous reserve estimates. This resulted in reserve reestimates including \$78 million related to IBNR, \$95 million related to claim severity and \$169 million related to mold claims in Texas. In addition, reserves were increased \$25 million for settlement of losses remaining from the 1994 Northridge earthquake. In March 2002, a new Texas homeowner policy form was implemented that restricted mold coverage from what had been provided by a previous broad state-mandated policy form. As a result, coverage provided and the incidence of losses for mold diminished in the second half of the year. Reserve reestimates in 2003 and 2002 for the 1994 Northridge earthquake losses were to provide for higher than anticipated losses resulting from settlement of class action litigation and due to greater than expected additional losses and expenses caused by coverage afforded due to the passage of California's Senate Bill 1899 in 1999.

Other lines reserve reestimates in 2004, 2003, and 2002 were primarily the result of claim severity development different than anticipated in previous estimates.

Pending, new and closed claims for Allstate Protection, for the years ended December 31, are summarized in the following table.

Number of Claims	2004	2003	2002
Auto			
Pending, beginning of year	569,549	635,304	684,324
New	5,367,891	5,480,516	5,973,807
Total closed	<u>(5,386,229)</u>	<u>(5,546,271)</u>	<u>(6,022,827)</u>
Pending, end of year	<u>551,211</u>	<u>569,549</u>	<u>635,304</u>
Homeowners			
Pending, beginning of year	62,080	87,058	87,743
New	995,569	962,673	966,023
Total closed	<u>(972,739)</u>	<u>(987,651)</u>	<u>(966,708)</u>
Pending, end of year	<u>84,910</u>	<u>62,080</u>	<u>87,058</u>
Other lines			
Pending, beginning of year	46,671	53,117	53,851
New	385,298	356,037	386,453
Total closed	<u>(371,397)</u>	<u>(362,483)</u>	<u>(387,187)</u>
Pending, end of year	<u>60,572</u>	<u>46,671</u>	<u>53,117</u>
Total Allstate Protection			
Pending, beginning of year	678,300	775,479	825,918
New	6,748,758	6,799,226	7,326,283
Total closed	<u>(6,730,365)</u>	<u>(6,896,405)</u>	<u>(7,376,722)</u>
Pending, end of year	<u>696,693</u>	<u>678,300</u>	<u>775,479</u>

We believe the net loss reserves for Allstate Protection exposures are appropriately established based on available facts, technology, laws and regulations.

The following tables reflect the accident years to which the reestimates shown above are applicable for Allstate brand, Encompass brand and Discontinued Lines and Coverages lines of business. Favorable reserve reestimates are shown in these tables in parentheses.

2004 Prior year reserve reestimates

(in millions)	1994 & Prior	1995	1996	1997	1998	1999	2000	2001	2002	2003	Total
Allstate brand	\$131	\$28	\$11	\$(11)	\$(26)	\$(57)	\$(102)	\$(105)	\$(192)	\$(549)	\$(872)
Encompass brand	(4)	—	—	—	—	8	10	2	9	(18)	7
Total Allstate Protection	127	28	11	(11)	(26)	(49)	(92)	(103)	(183)	(567)	(865)
Discontinued Lines and Coverages	<u>635</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>635</u>
Total Property-Liability	<u>\$762</u>	<u>\$28</u>	<u>\$11</u>	<u>\$(11)</u>	<u>\$(26)</u>	<u>\$(49)</u>	<u>\$(92)</u>	<u>\$(103)</u>	<u>\$(183)</u>	<u>\$(567)</u>	<u>\$(230)</u>

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2003 Prior year reserve reestimates

(in millions)	1993 & Prior	1994	1995	1996	1997	1998	1999	2000	2001	2002	Total
Allstate brand	\$ 50	\$38	\$7	\$17	\$19	\$26	\$4	\$(21)	\$(78)	\$(271)	\$(209)
Encompass brand	(2)	—	—	—	—	—	—	12	10	16	36
Total Allstate Protection Discontinued Lines and Coverages	48	38	7	17	19	26	4	(9)	(68)	(255)	(173)
	574	—	—	—	—	—	—	—	—	—	574
Total Property-Liability	<u>\$622</u>	<u>\$38</u>	<u>\$7</u>	<u>\$17</u>	<u>\$19</u>	<u>\$26</u>	<u>\$4</u>	<u>\$(9)</u>	<u>\$(68)</u>	<u>\$(255)</u>	<u>\$ 401</u>

2002 Prior year reserve reestimates

(in millions)	1992 & Prior	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total
Allstate brand	\$ (3)	\$(6)	\$25	\$4	\$1	\$(14)	\$(4)	\$ 2	\$57	\$324	\$386
Encompass brand	—	—	—	—	—	—	—	17	23	28	68
Total Allstate Protection Discontinued Lines and Coverages	(3)	(6)	25	4	1	(14)	(4)	19	80	352	454
	231	—	—	—	—	—	—	—	—	—	231
Total Property-Liability	<u>\$228</u>	<u>\$(6)</u>	<u>\$25</u>	<u>\$4</u>	<u>\$1</u>	<u>\$(14)</u>	<u>\$(4)</u>	<u>\$19</u>	<u>\$80</u>	<u>\$352</u>	<u>\$685</u>

Allstate brand The Allstate brand experienced \$872 million of favorable prior year reserve reestimates in 2004. This was primarily due to auto injury severity development that was better than expected and late reported loss development that was better than expected due to lower frequency trends in recent years.

The Allstate brand experienced \$209 million of favorable prior year reserve reestimates in 2003. This was primarily due to auto injury severity and late reported loss development that was better than expected and the release of reserves due to lower than anticipated losses in Texas related to mold claims.

The Allstate brand experienced \$386 million of unfavorable prior year reserve reestimates in 2002. This was primarily due to \$338 million of homeowners reestimates resulting from claim severity development and late reported losses that were greater than what was anticipated in previous reserve estimates, including \$169 million related to mold claims in Texas and \$25 million for settlement of losses remaining from the 1994 Northridge earthquake. Reestimates of reserves from prior years for auto and other businesses were \$48 million for the year, of which \$20 million was for Canadian business reserves. These reestimates were primarily due to increasing inflationary pressures on auto severities and for some of the small non-auto products.

These trends are primarily responsible for revisions to loss development factors, as previously described, used to predict how losses are likely to develop from the end of a reporting period until all claims have been paid. Because these trends cause actual losses to differ from those predicted by the estimated development factors used in prior reserve estimates, reserves are revised as actuarial studies validate new trends, based on the indications of updated development factor calculations.

The impact of these reestimates on the Allstate brand underwriting income (loss) is shown in the table below.

(in millions)	2004	2003	2002
Reserve reestimates	\$ 872	\$ 209	\$ (386)
Allstate brand underwriting income (loss)	2,340	1,941	681
Reserve reestimates as a % of underwriting income (loss)	37.3%	10.8%	(56.7)%

Encompass brand Reserve reestimates in 2004, 2003 and 2002 were related to higher than anticipated claim settlement costs.

The impact of these reestimates on the Encompass brand underwriting (loss) income is shown in the table below.

(in millions)	2004	2003	2002
Reserve reestimates	\$ (7)	\$ (36)	\$ (68)
Encompass brand underwriting (loss) income	128	(38)	(184)
Reserve reestimates as a % of underwriting (loss) income	(5.5)%	(94.7)%	(37.0)%

Discontinued Lines and Coverages We conduct an annual review in the third quarter of each year to evaluate and establish asbestos, environmental and other discontinued lines reserves. Reserves are recorded in the reporting period in which they are determined. Using established industry and actuarial best practices and assuming no change in the regulatory or economic environment, this detailed and comprehensive “ground up” methodology determines reserves based on assessments of the characteristics of exposure (e.g. claim activity, potential liability, jurisdiction, products versus non-products exposure) presented by individual policyholders.

Reserve reestimates for the Discontinued Lines and Coverages, as shown in the table below, were increased primarily for asbestos in 2004 and 2003, and for asbestos, environmental and other discontinued lines losses in 2002.

(in millions)	2004		2003		2002	
	Jan 1 Reserves	Reserve Reestimate	Jan 1 Reserves	Reserve Reestimate	Jan 1 Reserves	Reserve Reestimate
Asbestos Claims	\$1,079	\$ 463	\$ 635	\$ 520	\$ 675	\$ 121
Environmental Claims	257	—	304	2	343	26
Other Discontinued Lines	501	172	491	52	476	84
Total Discontinued Lines and Coverages	<u>\$1,837</u>	<u>\$ 635</u>	<u>\$1,430</u>	<u>\$ 574</u>	<u>\$1,494</u>	<u>\$ 231</u>
Underwriting (loss) income		<u>(638)</u>		<u>(571)</u>		<u>(234)</u>
Reserve reestimates as a % of underwriting (loss) income		<u>(99.5)%</u>		<u>(100.5)%</u>		<u>(98.7)%</u>

Reserve additions for asbestos in 2004, totaling \$463 million, were primarily for products-related coverage. This increase essentially was a result of a continuing level of increased claim activity being reported by excess insurance policyholders with existing active claims, and reestimates of liabilities for increased assumed reinsurance cessions, as ceding companies (other insurance carriers) also experienced increased claim activity. Increased claim activity over prior estimates has also resulted in an

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increased estimate for future claims reported. These trends are consistent with the trends of other carriers in the industry, which we believe are related to increased publicity and awareness of coverage, ongoing litigation, potential congressional activity and bankruptcy actions. During 2004, reserve reestimates, including an increase in the allowance for future uncollectible reinsurance recoverables, included \$150 million for other discontinued lines exposures in run-off, and \$22 million related to the cost of administering claim settlements and miscellaneous run-off exposures.

Reserve additions for asbestos in 2003, totaling \$520 million, were primarily for products-related coverage. This increase essentially was a result of more claimants being reported by excess insurance policyholders with existing active claims and new claims being reported in our assumed reinsurance business. This trend is consistent with the trends of other carriers in the industry. We believe it is related to increased publicity and awareness of coverage, ongoing litigation, potential congressional activity and bankruptcy actions. During 2003, reserve reestimates included \$29 million for other discontinued lines exposures in run-off, and \$23 million related to the cost of administering claim settlements and miscellaneous run-off exposures.

In 2002, asbestos reserves were increased by \$121 million primarily due to final settlement of exposure to an insured and adverse reestimates on other estimated asbestos losses due to an increase in claims from smaller more peripheral exposures. Pending asbestos claims related to excess policies issued to manufacturers that have filed for bankruptcy protection also increased to a minor extent. Reserve reestimates also included \$45 million for other discontinued lines exposures in run-off and \$39 million related to the cost of administering claim settlements and miscellaneous run-off exposures.

Our exposure to asbestos, environmental and other discontinued lines claims arises principally from assumed reinsurance coverage written during the 1960s through the mid-1980s, including reinsurance on primary insurance written on large United States companies, and from direct excess insurance written from 1972 through 1985, including substantial excess general liability coverages on Fortune 500 companies. Additional exposure stems from direct primary commercial insurance written during the 1960s through the mid-1980s. Other discontinued lines exposures primarily relate to general liability and product liability mass tort claims, such as those for medical devices and other products.

In 1986, the general liability policy form used by us and others in the property-liability industry was amended to introduce an "absolute pollution exclusion," which excluded coverage for environmental damage claims, and to add an asbestos exclusion. Most general liability policies issued prior to 1987 contain annual aggregate limits for product liability coverage. General liability policies issued in 1987 and thereafter contain annual aggregate limits for product liability coverage and annual aggregate limits for all coverages. Our experience to date is that these policy form changes have limited the extent of our exposure to environmental and asbestos claim risks.

Our exposure to liability for asbestos, environmental, and other discontinued lines losses manifests differently depending on whether it arises from assumed reinsurance coverage, direct excess insurance, or direct primary commercial insurance. The direct insurance coverage we provided that covered asbestos, environmental and other discontinued lines was substantially "excess" in nature.

Direct excess insurance and reinsurance involve coverage written by us for specific layers of protection above retentions and other insurance plans. The nature of excess coverage and reinsurance provided to other insurers limits our exposure to loss to specific layers of protection in excess of policyholder retention or primary insurance plans. Our exposure is further limited by the significant reinsurance that we have purchased on our excess business.

Our assumed reinsurance business involved writing generally small participations in other insurers' reinsurance programs. The reinsured losses in which we participate may be a proportion of all eligible losses or eligible losses in excess of defined retentions. The majority of our assumed reinsurance exposure, approximately 85%, is for excess of loss coverage, while the remaining 15% is for pro-rata coverage.

Our direct primary commercial insurance business did not include coverage to large asbestos manufacturers. This business comprises a cross section of policyholders engaged in many diverse business sectors located throughout the country.

The table below summarizes reserves and claim activity for asbestos and environmental claims before (Gross) and after (Net) the effects of reinsurance for the past three years.

(in millions, except ratios)	2004		2003		2002	
	Gross	Net	Gross	Net	Gross	Net
Asbestos claims						
Beginning reserves	\$1,583	\$1,079	\$ 904	\$ 635	\$ 929	\$ 675
Incurred claims and claims expense	971	463	800	520	180	121
Claims and claims expense paid	(127)	(78)	(121)	(76)	(205)	(161)
Ending reserves	<u>\$2,427</u>	<u>\$1,464</u>	<u>\$1,583</u>	<u>\$1,079</u>	<u>\$ 904</u>	<u>\$ 635</u>
Annual survival ratio	<u>19.1</u>	<u>18.8</u>	<u>13.1</u>	<u>14.2</u>	<u>4.4</u>	<u>3.9</u>
3-year survival ratio	<u>16.1</u>	<u>13.9</u>	<u>11.1</u>	<u>10.9</u>	<u>5.3</u>	<u>5.1</u>
Environmental claims						
Beginning reserves	\$ 315	\$ 257	\$ 393	\$ 304	\$ 444	\$ 343
Incurred claims and claims expense	1	—	—	2	34	26
Claims and claims expense paid	(35)	(25)	(78)	(49)	(85)	(65)
Ending reserves	<u>\$ 281</u>	<u>\$ 232</u>	<u>\$ 315</u>	<u>\$ 257</u>	<u>\$ 393</u>	<u>\$ 304</u>
Annual survival ratio	<u>8.1</u>	<u>9.1</u>	<u>4.0</u>	<u>5.2</u>	<u>4.6</u>	<u>4.7</u>
3-year survival ratio	<u>4.3</u>	<u>5.0</u>	<u>4.3</u>	<u>5.0</u>	<u>5.4</u>	<u>5.1</u>
Combined environmental and asbestos claims						
Annual survival ratio	<u>16.7</u>	<u>16.4</u>	<u>9.5</u>	<u>10.7</u>	<u>4.5</u>	<u>4.2</u>
3-year survival ratio	<u>12.5</u>	<u>11.2</u>	<u>8.8</u>	<u>8.9</u>	<u>5.3</u>	<u>5.1</u>
Percentage of IBNR in ending reserves		61.6%		59.9%		53.5%

The survival ratio is calculated by taking our ending reserves divided by payments made during the year. This is a commonly used but extremely simplistic and imprecise approach to measuring the adequacy of asbestos and environmental reserve levels. Many factors, such as mix of business, level of coverage provided and settlement procedures have significant impacts on the amount of environmental and asbestos claims and claims expense reserves, claim payments and the resultant ratio. As payments result in corresponding reserve reductions, survival ratios can be expected to vary over time.

In 2004 and 2003, the asbestos survival ratios improved due to higher reserve balances and relatively low payments. In 2004, the environmental survival ratios improved due to lower claim payments paid, while in 2003 the ratios declined slightly due to a lower reserve balance.

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The total commutations, policy buy-backs, and settlement agreements and the survival ratios for asbestos and environmental claims for 2004, 2003 and 2002 excluding these commutations, policy buy-backs, and settlement agreements, are represented in the following table.

(in millions, except ratios)	2004		2003		2002	
	Gross	Net	Gross	Net	Gross	Net
Asbestos claims						
Commutations, policy buy-backs & settlement agreements	\$ 32	\$ 22	\$ 54	\$ 33	\$ 118	\$ 102
Annual survival ratio	<u>25.2</u>	<u>25.5</u>	<u>22.7</u>	<u>24.2</u>	<u>9.5</u>	<u>10.3</u>
3-year survival ratio	<u>31.7</u>	<u>28.4</u>	<u>21.9</u>	<u>22.2</u>	<u>11.0</u>	<u>12.5</u>
Environmental claims						
Commutations, policy buy-backs & settlement agreements	\$ 22	\$ 14	\$ 42	\$ 24	\$ 29	\$ 22
Annual survival ratio	<u>21.7</u>	<u>20.7</u>	<u>8.4</u>	<u>10.0</u>	<u>6.6</u>	<u>6.9</u>
3-year survival ratio	<u>9.7</u>	<u>10.0</u>	<u>7.7</u>	<u>8.4</u>	<u>9.7</u>	<u>9.5</u>
Combined environmental and asbestos claims						
Total commutations, policy buy-backs & settlement agreements	\$ 54	\$ 36	\$ 96	\$ 57	\$ 147	\$ 124
Annual survival ratio	<u>24.8</u>	<u>24.7</u>	<u>17.7</u>	<u>19.0</u>	<u>8.4</u>	<u>8.9</u>
3-year survival ratio	<u>25.6</u>	<u>22.6</u>	<u>16.7</u>	<u>16.9</u>	<u>10.6</u>	<u>11.3</u>

Our three-year net average survival ratio excluding commutations, policy buy-backs, and settlement agreements is viewed to be another measure of current reserve adequacy. Now at 28.4 years for asbestos as of December 31, 2004, we consider it to represent a strong reserve position. A one-year increase in the three-year average asbestos survival ratio at December 31, 2004 would require an after-tax increase in reserves of approximately \$34 million.

Our net asbestos reserves by type of exposure and total reserve additions are shown in the following table.

(in millions)	December 31, 2004			December 31, 2003			December 31, 2002		
	Active Policyholders	Net Reserves	% of Reserves	Active Policyholders	Net Reserves	% of Reserves	Active Policyholders	Net Reserves	% of Reserves
Direct policyholders:									
—Primary	52	\$ 23	2%	52	\$ 28	3%	40	\$ 16	2%
—Excess	322	297	20	286	201	19	240	87	14
Total	<u>374</u>	<u>320</u>	<u>22%</u>	<u>338</u>	<u>229</u>	<u>22%</u>	<u>280</u>	<u>103</u>	<u>16%</u>
Assumed reinsurance		222	15		191	17		173	27
IBNR claims		922	63		659	61		359	57
Total net reserves		<u>\$1,464</u>	<u>100%</u>		<u>\$1,079</u>	<u>100%</u>		<u>\$635</u>	<u>100%</u>
Total reserve additions		<u>\$ 463</u>			<u>\$ 514⁽¹⁾</u>			<u>\$121</u>	

(1) Excludes a \$6 million increase in the allowance for future uncollectible reinsurance recoverables.

During the last three years, 211 direct primary and excess policyholders reported new claims, and 99 policyholders were closed, increasing the number of active policyholders by 112 during the period. The 112 increase comprised 36 from 2004, 58 from 2003 and 18 from 2002. The increase of 36 from 2004

included 64 new policyholders reporting new claims and 28 policyholders' claims were closed. Reserve additions for asbestos for the year ended December 31, 2004, totaled \$463 million and included the following factors:

- Direct primary insurance net reserves decreased by \$5 million. We were not a significant direct primary insurer and did not insure any of the large asbestos manufacturers on a direct primary insurance basis.
- Direct excess insurance net reserves increased by \$96 million for policyholders with existing active claims. The increase in existing active claims was attributable to an increase in the number of claims filed against direct excess insureds.
- Assumed reinsurance net reserves increased by \$31 million for increased cessions as ceding companies (other insurance carriers) also experienced increased claim activity. Many of the insureds that reported claims to us on their direct excess insurance coverages also reported claims to carriers included in our assumed reinsurance exposure. The number of reported new claims is shown in the following table.

	<u>Year ended December 31, 2004</u>	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>
New Claims ⁽¹⁾	361	265	197

(1) New claims are defined as the aggregate number of policyholders with claims reported by all ceding companies.

- IBNR net reserves increased by \$263 million in anticipation of continued claims activity. At December 31, 2004 IBNR represented 63.0% of total asbestos reserves, 2 points higher than at December 31, 2003. IBNR reserves are estimated to provide for probable future unfavorable reserve development of known claims and future reporting of additional unknown claims from current and new direct active insurance policyholders and ceding companies.

Our non-products case reserves represent approximately 3.9% of total asbestos case reserves. We do not anticipate significant changes in this percentage as insureds' retentions associated with excess insurance programs and assumed reinsurance exposure are seldom exceeded. We did not write direct primary insurance on policyholders with the potential for significant non-products-related loss exposure.

For environmental exposures, a comprehensive "ground up" review, using processes similar to those used for the asbestos review, is also conducted in the third quarter of each year. The analysis performed in 2004 and 2003 produced essentially no change in reserve estimates. Environmental loss emergence in 2002 was primarily due to losses from one large reinsurance contract and a few other direct losses. In past years environmental reestimates have been favorable.

Pending, new, total closed and closed without payment claims for asbestos and environmental exposures for the years ended December 31, are summarized in the following table.

<u>Number of Claims</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Asbestos			
Pending, beginning of year	8,210	6,900	6,426
New	1,959	2,267	1,165
Total closed	(1,539)	(957)	(691)
Pending, end of year	<u>8,630</u>	<u>8,210</u>	<u>6,900</u>
Closed without payment	<u>805</u>	<u>594</u>	<u>444</u>



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<u>Number of Claims</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Environmental			
Pending, beginning of year	6,100	7,352	8,486
New	1,125	954	845
Total closed	<u>(1,450)</u>	<u>(2,206)</u>	<u>(1,979)</u>
Pending, end of year	<u>5,775</u>	<u>6,100</u>	<u>7,352</u>
Closed without payment	<u>1,006</u>	<u>1,776</u>	<u>1,442</u>

Our reserves for asbestos and environmental exposures could be affected by tort reform, class action litigation, and other potential legislation and judicial decisions. Environmental exposures could also be affected by a change in the existing federal Superfund law and similar state statutes. There can be no assurance that any reform legislation will be enacted or that any such legislation will provide for a fair, effective and cost-efficient system for settlement of asbestos or environmental claims. We are unable to determine the effect, if any, that such legislation will have on results of operations or financial position.

Reserves for Other Discontinued Lines provide for remaining loss and loss expense liabilities related to business no longer written by us, other than asbestos and environmental, and are presented in the following table.

<u>(in millions)</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Other mass torts	\$205	\$234	\$236
Workers' compensation	152	132	137
Commercial and other	<u>274</u>	<u>135</u>	<u>118</u>
Other discontinued lines	<u>\$631</u>	<u>\$501</u>	<u>\$491</u>

Other mass torts describes excess and reinsurance general liability coverage provided for cumulative injury losses other than asbestos and environmental. Workers' compensation and commercial and other include run-off from discontinued primary, excess and reinsurance commercial insurance operations of various coverage exposures other than asbestos and environmental. Reserves are based on considerations similar to those previously described, as they relate to the characteristics of specific individual coverage exposures.

We believe that our reserves are appropriately established based on assessments of pertinent factors and characteristics of exposure (e.g. claim activity, potential liability, jurisdiction, products versus non-products exposure) presented by individual policyholders, assuming no change in the legal, legislative or economic environment. Another comprehensive "ground up" review will be completed in the third quarter of 2005, as well as assessments each quarter to determine if any intervening significant events or developments require an interim adjustment to reserves.

Property-Liability Reinsurance Ceded We participate in various reinsurance mechanisms, including industry pools and facilities, and have purchased reinsurance to mitigate long-tail liability lines, including environmental, asbestos and other discontinued lines exposures. We retain primary liability as a direct insurer for all risks ceded to reinsurers.

The impacts of reinsurance on our reserve for claims and claims expense at December 31 are summarized in the following table, net of allowances we have established for uncollectible amounts.

(in millions)	Gross claims and claims expense reserves		Reinsurance recoverable on paid and unpaid claims, net	
	2004	2003	2004	2003
Industry pools and facilities	\$ 2,217	\$ 902	\$1,596	\$ 829
Asbestos and environmental	2,708	1,898	1,045	636
Other including allowance for future uncollectible reinsurance recoverables	14,413	14,914	86	439
Total Property-Liability	<u>\$19,338</u>	<u>\$17,714</u>	<u>\$2,727</u>	<u>\$1,904</u>

When purchasing reinsurance, we evaluate the financial condition of the reinsurer, as well as the terms and price of coverage. Estimating amounts of reinsurance recoverables is also impacted by the uncertainties involved in the establishment of loss reserves. We believe the recoverables are appropriately established; however, as our underlying reserves continue to develop, the amount ultimately recoverable may vary from amounts currently recorded. We regularly evaluate the reinsurers and the respective amounts recoverable, and a provision for uncollectible reinsurance is recorded if needed.

Adverse developments in the insurance industry have recently led to a decline in the financial strength of some of our reinsurance carriers, causing amounts recoverable from them and future claims ceded to them to be considered a higher risk. Recently there has also been consolidation activity between some of our carriers and potential carriers in the industry, which causes reinsurance risk across the industry to be concentrated among fewer companies. In addition, over the last several years the industry has increasingly segregated asbestos, environmental, and other discontinued lines exposures into separate legal entities with dedicated capital. Regulatory bodies in certain cases have supported these actions. We are unable to determine the impact, if any, that these developments will have on the collectibility of reinsurance recoverables in the future.

The allowance for uncollectible reinsurance relates to Discontinued Lines and Coverages reinsurance recoverables and was \$230 million and \$101 million at December 31, 2004 and 2003, respectively. These amounts represent 16.9% and 8.6%, respectively of the related reinsurance recoverable balances. The increase in 2004 is due to potential uncollectible reinsurance related to the asbestos reserve increase and the refinement of our bad debt allowance to provide a greater allowance for companies who have reorganized to segregate asbestos, environmental, and other discontinued lines exposures into separate legal entities with dedicated capital.



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The ten largest reinsurance recoverable balances are shown in the following table at December 31, net of allowances we have established for uncollectible amounts.

(in millions)	A.M. Best Financial Strength Rating	Reinsurance recoverable on paid and unpaid claims, net	
		2004	2003
Industry pools and facilities			
Michigan Catastrophic Claim Association ("MCCA")	N/A	\$ 831	\$ 560
New Jersey Unsatisfied Claim and Judgment Fund	N/A	176	186
North Carolina Reinsurance Facility	N/A	73	66
Florida Hurricane Catastrophe Fund	N/A	486	—
Other	N/A	30	17
Total		<u>1,596</u>	<u>829</u>
Asbestos and environmental and Other			
Lloyd's of London ("Lloyd's")	A	236	112
Employers Reinsurance Corporation	A	87	87
Turegum Vers.Ges.Ag	N/A	52	38
ACE American Reinsurance Corporation	B+	44	32
New England Reinsurance Corporation	N/A	51	32
Odyssey Reinsurance Corporation	A	52	26
Other, including allowance for future uncollectible reinsurance recoverables	N/A	609	748
Total		<u>1,131</u>	<u>1,075</u>
Total Property-Liability		<u>\$2,727</u>	<u>\$1,904</u>

For a detailed description of the MCCA and Lloyd's, see Note 9 of the consolidated financial statements. At December 31, 2004, no other amount due or estimated to be due from any single Property-Liability reinsurer was in excess of \$29 million. We enter into certain inter-company insurance and reinsurance transactions for the Property-Liability operations in order to maintain underwriting control and manage insurance risk among various legal entities. These reinsurance agreements have been approved by the appropriate regulatory authorities. All significant inter-company transactions have been eliminated in consolidation.

ALLSTATE FINANCIAL 2004 HIGHLIGHTS

- Allstate Financial revenues increased 0.6% in 2004 compared to 2003. Increased net investment income, higher contract charges and improved realized capital gains and losses, were offset by lower premiums resulting from the disposal of substantially all of our direct response distribution business and a decline in premiums on immediate annuities with life contingencies.
- Income before cumulative effect of change in accounting principle, after-tax, increased 30.7% in 2004 compared to 2003 as higher revenues and lower contract benefits and operating costs and expenses were partially offset by higher interest credited and DAC amortization. Net income decreased to \$246 million in 2004 from \$305 million in 2003. This decrease was attributable to a \$175 million after-tax charge related to the cumulative effect of a change in accounting principle for Statement of Position No. 03-1, "Accounting and Reporting by Insurance Enterprises for Certain

Nontraditional Long-Duration Contracts and for Separate Accounts” (“SOP 03-1”), which was adopted on January 1, 2004.

- Total investments increased 15.3% in 2004 due to the investment of cash provided by operating and financing activities, which included record annual contractholder fund deposits.
- Contractholder fund deposits totaled \$13.88 billion for 2004 compared to \$10.63 billion in 2003. The increase of \$3.25 billion was primarily attributable to deposits from fixed annuities, interest-sensitive life policies and institutional funding agreements.
- When comparing 2004 to 2003, the disposal of substantially all of our direct response distribution business resulted in the following impacts to the Consolidated Statements of Operations:

(in millions)

Favorable (unfavorable):

Total revenues	\$(233)
Contract benefits	122
Amortization of DAC	37
Operating costs and expenses	73
Loss on disposition of operations	24
Income tax expense	<u>(8)</u>
Net income	<u>\$ 15</u>

ALLSTATE FINANCIAL SEGMENT

Overview and Strategy The Allstate Financial segment is a major provider of life insurance, retirement and investment products to individual and institutional customers. Allstate Financial’s mission is to assist financial services professionals in meeting their clients’ financial protection, savings and retirement needs by providing top-tier products delivered with reliable and efficient service.

We will pursue the following to grow our current business profitably: maintain and develop focused, top-tier products; deepen distribution partner relationships; improve our cost structure; and advance our systematic risk management program. Allstate Financial also leverages the strength of the Allstate brand name across products and distribution channels.

Our individual retail product line includes a wide variety of products designed to meet the financial protection, savings and retirement needs of our customers. Individual retail products include traditional life, interest-sensitive life, supplemental accident and health insurance, variable life, long-term care insurance, variable and fixed annuities and funding agreements backing retail medium-term notes (“RMTNs”). Banking products and services are also offered to customers through the Allstate Bank. Individual retail products are sold through a variety of distribution channels including Allstate exclusive agencies, independent agents (including master brokerage agencies and workplace enrolling agents), and financial service firms such as banks, broker/dealers and specialized structured settlement brokers. Allstate Bank products can also be obtained directly through the Internet and a toll-free number. Our institutional product line consists primarily of funding agreements sold to unaffiliated trusts that use them to back medium-term notes issued to institutional and individual investors.



**Management's Discussion and Analysis
of Financial Condition and Results of Operations—(Continued)**

Summarized financial data for the years ended December 31 is presented in the following table.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Revenues			
Life and annuity premiums and contract charges	\$ 2,072	\$ 2,304	\$ 2,293
Net investment income	3,410	3,233	3,121
Realized capital gains and losses	<u>1</u>	<u>(85)</u>	<u>(432)</u>
Total revenues	5,483	5,452	4,982
Costs and expenses			
Contract benefits	(1,618)	(1,851)	(1,770)
Interest credited to contractholder funds	(2,001)	(1,846)	(1,764)
Amortization of DAC	(591)	(538)	(478)
Operating costs and expenses	(634)	(672)	(649)
Restructuring and related charges	<u>(5)</u>	<u>(7)</u>	<u>(2)</u>
Total costs and expenses	(4,849)	(4,914)	(4,663)
Loss on disposition of operations	(24)	(46)	(6)
Income tax expense	<u>(189)</u>	<u>(170)</u>	<u>(52)</u>
Income before cumulative effect of change in accounting principle, after-tax	421	322	261
Cumulative effect of change in accounting principle, after-tax	<u>(175)</u>	<u>(17)</u>	<u>(283)</u>
Net income (loss)	<u>\$ 246</u>	<u>\$ 305</u>	<u>\$ (22)</u>
Investments	\$72,530	\$62,895	\$55,264
Separate Accounts assets	<u>14,377</u>	<u>13,425</u>	<u>11,125</u>
Investments, including Separate Accounts assets	<u>\$86,907</u>	<u>\$76,320</u>	<u>\$66,389</u>

Life and annuity premiums and contract charges Premiums represent revenues generated from traditional life, immediate annuities with life contingencies, accident and health and other insurance products that have significant mortality or morbidity risk. Contract charges are revenues generated from interest-sensitive life, variable annuities, fixed annuities and institutional products for which deposits are classified as contractholder funds or separate accounts liabilities. Contract charges are assessed against the contractholder account values for maintenance, administration, cost of insurance and surrender prior to contractually specified dates. As a result, changes in contractholder funds and separate accounts liabilities are considered in the evaluation of growth and as indicators of future levels of revenues.

The following table summarizes premiums and contract charges by product.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Premiums			
Traditional life	\$ 321	\$ 388	\$ 403
Immediate annuities with life contingencies	316	413	416
Accident and health and other	408	564	552
Total premiums	<u>1,045</u>	<u>1,365</u>	<u>1,371</u>
Contract charges			
Interest-sensitive life	729	688	672
Fixed annuities	52	37	32
Variable annuities	246	206	212
Institutional products	—	8	6
Total contract charges	<u>1,027</u>	<u>939</u>	<u>922</u>
Life and annuity premiums and contract charges	<u>\$2,072</u>	<u>\$2,304</u>	<u>\$2,293</u>

The following table summarizes premiums and contract charges by distribution channel.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Premiums			
Allstate agencies	\$ 395	\$ 319	\$ 278
Independent agents	356	373	351
Specialized brokers	243	390	415
Direct marketing	51	283	327
Total premiums	<u>1,045</u>	<u>1,365</u>	<u>1,371</u>
Contract charges			
Allstate agencies	462	440	429
Independent agents	301	279	271
Broker dealers	199	172	183
Banks	35	15	14
Specialized brokers	27	30	25
Direct marketing	3	3	—
Total contract charges	<u>1,027</u>	<u>939</u>	<u>922</u>
Life and annuity premiums and contract charges	<u>\$2,072</u>	<u>\$2,304</u>	<u>\$2,293</u>

Total premiums decreased 23.4% in 2004 compared to 2003. The decrease was primarily due to the disposal of substantially all of our direct response distribution business, which resulted in lower accident and health and other premiums and traditional life premiums. Additionally, 2004 reflects lower premiums on immediate annuities with life contingencies as underwriting actions taken in 2003 reduced the maximum premium received on individual contracts sold.

Total premiums decreased 0.4% in 2003 compared to 2002. The decrease was primarily the result of the discontinuance of the majority of our direct response business in 2003, lower traditional life and immediate annuity premium, partially offset by higher premiums from supplemental accident and health and other products sold through the workplace.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

Contract charges increased 9.4% in 2004 compared to 2003. The increase was primarily due to higher contract charges on interest-sensitive life and variable annuities. The increase in the interest-sensitive life contract charges was attributable to in-force business growth resulting from deposits and credited interest more than offsetting contract charges, surrenders and benefits. Higher variable annuity contract charges were the result of increased average account values during 2004, reflecting positive investment results during 2003 and 2004. Variable annuity contract charges, as a percent of average separate account values, increased to 175 basis points in 2004 from 166 basis points in 2003 driven by increases in fees charged for our variable annuity benefits on the Allstate Advisor product in addition to a higher percentage of our in-force contracts providing these benefits.

Contract charges increased 1.8% in 2003 compared to 2002. The slight increase was the result of higher interest-sensitive life contract charges resulting from in-force business growth, partially offset by lower variable annuity contract charges on lower average variable annuity account balances during the period. Variable annuity contract charges, as a percent of average separate account values, increased to 166 basis points in 2003 from 163 basis points in 2002 as a result of increases in benefit rider fee rates and utilization by contractholders.

Contractholder funds represent interest-bearing liabilities arising from the sale of individual and institutional products, such as interest-sensitive life, fixed annuities, bank deposits and funding agreements. The balance of contractholder funds is equal to the cumulative deposits received and interest credited to the contractholder less cumulative contract maturities, benefits, surrenders, withdrawals and contract charges for mortality or administrative expenses.

The following table shows the changes in contractholder funds.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Contractholder funds, beginning balance	\$47,071	\$40,751	\$33,560
Impact of adoption of SOP 03-1 ⁽¹⁾	421	—	—
Deposits			
Fixed annuities (immediate and deferred)	7,322	5,266	4,971
Retail funding agreements	85	—	—
Institutional products (primarily funding agreements)	3,902	2,713	1,873
Interest-sensitive life	1,375	1,074	964
Variable annuity and life deposits allocated to fixed accounts	495	893	1,212
Bank and other deposits	701	681	498
Total deposits	<u>13,880</u>	<u>10,627</u>	<u>9,518</u>
Interest credited	1,991	1,846	1,764
Maturities, benefits, withdrawals and other adjustments			
Maturities of institutional products	(2,518)	(2,163)	(1,056)
Benefits	(729)	(505)	(429)
Surrenders and partial withdrawals	(3,438)	(2,728)	(2,093)
Contract charges	(655)	(622)	(567)
Net transfers to separate accounts	(412)	(416)	(474)
Fair value hedge adjustments for institutional products	38	131	363
Other adjustments	60	150	165
Total maturities, benefits, withdrawals and other adjustments	<u>(7,654)</u>	<u>(6,153)</u>	<u>(4,091)</u>
Contractholder funds, ending balance	<u>\$55,709</u>	<u>\$47,071</u>	<u>\$40,751</u>

(1) The increase in contractholder funds due to the adoption of SOP 03-1 reflects the reclassification of certain products previously included as a component of separate accounts to contractholder funds, the reclassification of deferred sales inducements ("DSI") from contractholder funds to other assets and the establishment of reserves for certain liabilities that are primarily related to income and death benefit guarantees provided under fixed annuity, variable annuity and interest-sensitive life contracts.

Contractholder deposits increased 30.6% in 2004 compared to 2003 due primarily to greater issuances of fixed annuities, interest-sensitive life policies and retail and institutional funding agreements. These deposits led to an increase in average contractholder funds, excluding the impact of adopting SOP 03-1, of 16.6% in 2004 compared to 2003. Fixed annuity deposits increased 39.0% in 2004 compared to 2003 due to strong consumer demand, competitive pricing and effective distribution efforts in our bank channel. Institutional product deposits increased 43.8% in 2004 compared to 2003, largely due to favorable market conditions for our funding agreements and the broadening of our customer base through the development and launch of our new Securities and Exchange Commission ("SEC") registered program in the second quarter of 2004 and our new registered RMTN program in the fourth quarter. The registered programs generated \$1.74 billion of new funding agreement deposits during the year including \$85 million in RMTN deposits.

Benefits, surrenders and partial withdrawals increased 28.9% in 2004 compared to 2003 reflecting a withdrawal rate of 11.2% for 2004 based on the beginning of period contractholder funds balance excluding institutional product reserves. This compares to a withdrawal rate of 10.2% and 9.7% for 2003

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and 2002 respectively. Surrenders and withdrawals may vary with changes in interest rates and equity market conditions and the aging of our in-force contracts.

Contractholder deposits increased 11.7% in 2003 compared to 2002, and average contractholder funds increased 18.2% in 2003 compared to 2002, due to significant increases in institutional product and fixed annuity deposits in 2003. Fixed annuity deposits increased 5.9% over 2002 due to competitive pricing and our decision to maintain a market presence despite a challenging interest rate environment. Institutional products deposits increased 44.8% largely due to our assessment of market opportunities.

Separate accounts liabilities represent contractholders' claims to the related separate accounts assets. Separate accounts liabilities primarily arise from the sale of variable annuity contracts and variable life insurance policies. The following table shows the changes in separate accounts liabilities.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Separate accounts liabilities, beginning balance	\$13,425	\$11,125	\$13,587
Impact of adoption of SOP 03-1 ⁽¹⁾	(204)	—	—
Variable annuity and life deposits	1,763	2,284	2,432
Variable annuity and life deposits allocated to fixed accounts	(495)	(893)	(1,212)
Net deposits	1,268	1,391	1,220
Investment results	1,348	2,393	(2,167)
Contract charges	(256)	(220)	(212)
Net transfers from fixed accounts	412	416	474
Surrenders and benefits	(1,616)	(1,680)	(1,777)
Separate accounts liabilities, ending balance	<u>\$14,377</u>	<u>\$13,425</u>	<u>\$11,125</u>

(1) The decrease in separate accounts due to the adoption of SOP 03-1 reflects the reclassification of certain products previously included as a component of separate accounts to contractholder funds.

Separate accounts liabilities, excluding the impact of adopting SOP 03-1, increased \$1.16 billion during 2004. The increase was primarily attributable to positive investment results. Net deposits and transfers from fixed accounts were mostly offset by surrenders and benefits. Variable annuity contractholders often allocate a significant portion of their initial variable annuity contract deposit into a fixed rate investment option. The level of this activity is reflected above in the deposits allocated to fixed accounts, while all other transfer activity between the fixed and separate accounts investment options is reflected in net transfers from fixed accounts. The liability for the fixed portion of variable annuity contracts is reflected in contractholder funds.

Separate accounts liabilities increased \$2.30 billion during 2003 compared to 2002 reflecting a significant improvement in investment results and net deposits, partially offset by surrenders and benefits. The increase in the variable annuity net deposits in 2003 resulted from the increasing attractiveness of the separate accounts equity investment funds following improved equity market performance and the introduction of the multi-manager Allstate® Advisor variable annuity product.

Net investment income increased 5.5% in 2004 compared to 2003 and 3.6% in 2003 compared to 2002. The increase in both periods was the result of the effect of higher portfolio balances, partially offset by lower portfolio yields. Higher portfolio balances resulted from the investment of cash flows from operating and financing activities related primarily to deposits from fixed annuities and interest-sensitive

life policies and institutional funding agreements. Investment balances as of December 31, 2004, increased 15.3% from December 31, 2003 and increased 13.8% as of December 31, 2003 compared to December 31, 2002. The lower portfolio yields were primarily due to purchases, including reinvestments, of fixed income securities with yields lower than the current portfolio average.

Net income analysis is presented in the following table.

(in millions)	2004	2003	2002
Life and annuity premiums and contract charges	\$ 2,072	\$ 2,304	\$ 2,293
Net investment income	3,410	3,233	3,121
Periodic settlements and accruals on non-hedge derivative instruments ⁽¹⁾	49	23	5
Contract benefits	(1,618)	(1,851)	(1,770)
Interest credited to contractholder funds ⁽²⁾	(1,956)	(1,846)	(1,764)
Gross margin	1,957	1,863	1,885
Amortization of DAC and DSI	(498)	(492)	(476)
Operating costs and expenses	(634)	(672)	(649)
Restructuring and related charges	(5)	(7)	(2)
Income tax expense	(269)	(243)	(202)
Realized capital gains and losses, after-tax	(3)	(53)	(287)
DAC and DSI amortization relating to realized capital gains and losses, after-tax	(89)	(30)	(1)
Reclassification of periodic settlements and accruals on non-hedge derivative instruments, after-tax	(32)	(15)	(3)
Loss on disposition of operations, after-tax	(6)	(29)	(4)
Cumulative effect of change in accounting principle, after-tax	(175)	(17)	(283)
Net income (loss)	<u>\$ 246</u>	<u>\$ 305</u>	<u>\$ (22)</u>

(1) Periodic settlements and accruals on non-hedge derivative instruments are reflected as a component of realized capital gains and losses on the Consolidated Statements of Operations.

(2) Beginning in 2004, amortization of DSI is excluded from interest credited to contractholder funds for purposes of calculating gross margin. Amortization of DSI totaled \$45 million in 2004. Prior periods have not been restated.

Gross margin, a non-GAAP measure, represents life and annuity premiums and contract charges and net investment income, less contract benefits and interest credited to contractholder funds. We use gross margin as a component of our evaluation of the profitability of Allstate Financial's life insurance and financial product portfolio. Additionally, for many of our products, including fixed annuities, variable life and annuities, and interest-sensitive life insurance, the amortization of DAC and DSI is determined based on actual and expected gross margin. Gross margin is comprised of four components that are utilized to further analyze the business: investment margin, benefit margin, maintenance charges and surrender charges. We believe gross margin and its components are useful to investors because they allow for the evaluation of income components separately and in the aggregate when reviewing performance. Gross margin, investment margin and benefit margin should not be considered as a substitute for net income and do not reflect the overall profitability of the business. Net income is the GAAP measure that is most directly comparable to these margins. Gross margin is reconciled to Allstate Financial's GAAP net income in the table above.

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The components of gross margin are reconciled to the corresponding financial statement line items in the following table.

	2004				
(in millions)	<u>Investment Margin</u>	<u>Benefit Margin</u>	<u>Maintenance Charges</u>	<u>Surrender Charges</u>	<u>Gross Margin</u>
Life and annuity premiums	\$ —	\$ 1,045	\$ —	\$ —	\$ 1,045
Contract charges	—	558	393	76	1,027
Net investment income	3,410	—	—	—	3,410
Periodic settlements and accruals on non-hedge derivative instruments ⁽¹⁾	49	—	—	—	49
Contract benefits	(538)	(1,080)	—	—	(1,618)
Interest credited to contractholder funds ⁽²⁾	(1,956)	—	—	—	(1,956)
	<u>\$ 965</u>	<u>\$ 523</u>	<u>\$393</u>	<u>\$76</u>	<u>\$ 1,957</u>
	2003				
(in millions)	<u>Investment Margin</u>	<u>Benefit Margin</u>	<u>Maintenance Charges</u>	<u>Surrender Charges</u>	<u>Gross Margin</u>
Life and annuity premiums	\$ —	\$ 1,365	\$ —	\$ —	\$ 1,365
Contract charges	—	518	342	79	939
Net investment income	3,233	—	—	—	3,233
Periodic settlements and accruals on non-hedge derivative instruments ⁽¹⁾	23	—	—	—	23
Contract benefits	(514)	(1,337)	—	—	(1,851)
Interest credited to contractholder funds	(1,846)	—	—	—	(1,846)
	<u>\$ 896</u>	<u>\$ 546</u>	<u>\$342</u>	<u>\$79</u>	<u>\$ 1,863</u>
	2002				
(in millions)	<u>Investment Margin</u>	<u>Benefit Margin</u>	<u>Maintenance Charges</u>	<u>Surrender Charges</u>	<u>Gross Margin</u>
Life and annuity premiums	\$ —	\$ 1,371	\$ —	\$ —	\$ 1,371
Contract charges	—	505	342	75	922
Net investment income	3,121	—	—	—	3,121
Periodic settlements and accruals on non-hedge derivative instruments ⁽¹⁾	5	—	—	—	5
Contract benefits	(493)	(1,277)	—	—	(1,770)
Interest credited to contractholder funds	(1,764)	—	—	—	(1,764)
	<u>\$ 869</u>	<u>\$ 599</u>	<u>\$342</u>	<u>\$75</u>	<u>\$ 1,885</u>

(1) Periodic settlements and accruals on non-hedge derivative instruments are reflected as a component of realized capital gains and losses on the Consolidated Statements of Operations.

(2) Beginning in 2004, amortization of DSI is excluded from interest credited to contractholder funds for purposes of calculating gross margin. Amortization of DSI totaled \$45 million for the year ended December 31, 2004. Prior periods have not been restated.

Gross margin increased 5.0% in 2004 compared to 2003. The increase was attributable to increased investment margin and higher maintenance charges, partially offset by lower benefit margin. Gross margin declined 1.2% in 2003 compared to 2002 as an increased investment margin was more than offset by lower benefit margin.

Investment margin is a component of gross margin, both of which are non-GAAP measures. Investment margin represents the excess of net investment income over interest credited to contractholder funds and the implied interest on life-contingent immediate annuities included in the reserve for life-contingent contract benefits. We use investment margin to evaluate Allstate Financial's profitability related to the difference between investment returns on assets supporting certain products and amounts credited to customers ("spread") during a fiscal period.

Investment margin by product group is shown in the following table.

(in millions)	2004	2003	2002
Annuities	\$620	\$546	\$505
Life insurance	212	234	249
Institutional products	121	107	107
Bank and other	12	9	8
Total investment margin	<u>\$965</u>	<u>\$896</u>	<u>\$869</u>

Investment margin increased 7.7% in 2004 compared to 2003 and increased 3.1% in 2003 compared to 2002. Both increases were primarily due to higher contractholder funds and actions to reduce crediting rates, partially offset by lower portfolio yields. The difference between the weighted average crediting rate and the average guaranteed rate on interest-sensitive life and deferred annuities, excluding market value adjusted annuities and equity indexed annuities, was 52 basis points as of December 31, 2004 compared with 70 basis points as of December 31, 2003 and 140 basis points as of December 31, 2002. The crediting rates on approximately 62% of these contracts were at the minimum guaranteed rate at December 31, 2004.

The following table summarizes the annualized weighted average investment yield, interest crediting rates and investment spreads during 2004, 2003 and 2002.

	Weighted Average Investment Yield			Weighted Average Interest Crediting Rate			Weighted Average Investment Spreads		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Interest-sensitive life	6.5%	6.9%	7.3%	4.7%	4.9%	5.1%	1.8%	2.0%	2.2%
Fixed annuities—deferred annuities	5.8	6.4	7.1	4.1	4.6	5.2	1.7	1.8	1.9
Fixed annuities—immediate annuities with and without life contingencies	7.6	7.9	8.2	6.8	7.1	7.2	0.8	0.8	1.0
Institutional	3.1	3.5	4.3	2.1	2.5	3.4	1.0	1.0	0.9
Investments supporting capital, traditional life and other products	6.3	6.2	6.9	N/A	N/A	N/A	N/A	N/A	N/A

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The following table summarizes the liabilities as of December 31 for these contracts and policies.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Fixed annuities—immediate annuities with life contingencies	\$ 7,720	\$ 7,433	\$ 7,024
Other life contingent contracts and other	4,034	3,587	3,232
Reserve for life-contingent contracts	<u>\$11,754</u>	<u>\$11,020</u>	<u>\$10,256</u>
Interest-sensitive life	\$ 8,280	\$ 7,536	\$ 7,065
Fixed annuities—deferred annuities	31,390	25,917	21,468
Fixed annuities—immediate annuities without life contingencies	3,247	2,866	2,562
Institutional	11,279	9,387	8,620
Allstate Bank	840	806	610
Market value adjustments related to derivative instruments and other	<u>673</u>	<u>559</u>	<u>426</u>
Contractholder funds	<u>\$55,709</u>	<u>\$47,071</u>	<u>\$40,751</u>

Benefit margin is a component of gross margin, both of which are non-GAAP measures. Benefit margin represents life and life-contingent immediate annuity premiums and cost of insurance contract charges less contract benefits. Benefit margin excludes the implied interest on life-contingent immediate annuities, which is included in the calculation of investment margin, and mortality charges on variable annuities, which are included as a component of maintenance charges. We use the benefit margin to evaluate Allstate Financial's underwriting performance, as it reflects the profitability of our products with respect to mortality or morbidity risk during a fiscal period.

Benefit margin by product group is shown in the following table.

(in millions)	<u>2004</u>	<u>2003</u>	<u>2002</u>
Life insurance	\$608	\$ 658	\$666
Annuities	<u>(85)</u>	<u>(112)</u>	<u>(67)</u>
Total benefit margin	<u>\$523</u>	<u>\$ 546</u>	<u>\$599</u>

Benefit margin decreased 4.2% in 2004 compared to 2003. This decline was primarily the result of the disposal of substantially all of our direct response distribution business and unfavorable mortality experience on life-contingent immediate annuities, partially offset by an improved benefit margin on life insurance products and lower contract benefits related to guaranteed minimum death benefits ("GMDBs") on variable annuities.

As required by SOP 03-1, as of January 1, 2004, a reserve was established for benefits provided for under variable annuities and secondary guarantees on interest-sensitive life insurance and certain fixed annuity contracts. For variable annuities, the reserve includes GMDBs and guaranteed minimum income benefits ("GMIBs"). In previous periods, GMDBs were expensed as paid and no costs were recognizable for GMIBs or other guarantees. Under the SOP, we anticipate that the benefit margin will be less volatile, as contract benefit expense pertaining to product guarantees will be proportionate to the related revenue rather than cash payments made during the period. Included in the benefit margin for 2004 are additions to these secondary product guarantee reserves of \$46 million for variable annuities, net of reinsurance and hedging gains and losses and \$3 million for fixed annuities and interest-sensitive life policies.

Included in the benefit margin for 2003 are GMDB payments of \$83 million, net of reinsurance, hedging gains and losses and other contractual arrangements. For further explanation of the impacts of the adoption of this accounting guidance, see Note 2 to the Consolidated Financial Statements.

Benefit margin was \$546 million in 2003, reflecting a \$53 million or 8.8% decline compared to 2002. An increase in GMDBs on variable annuity contracts in 2003 compared to 2002 represents \$30 million of the \$53 million decline. The remainder was due to a larger number of life claims in the first quarter of 2003, poor mortality results on certain closed blocks of business and the effect of the discontinuance of direct response non-life credit insurance, partially offset by higher mortality margin from growth of interest-sensitive life and accident and health products sold through the workplace. In 2003, GMDB payments were \$83 million, net of reinsurance, hedging results and other contractual arrangements (“net GMDB payments”), compared to \$53 million in 2002. While 2003 net GMDB payments were higher than in 2002, improved equity market performance during 2003 resulted in sequential quarterly reductions in gross GMDB payments. Direct response non-life credit insurance generated a benefit margin of \$2 million and \$7 million in 2003 and 2002, respectively.

Amortization of DAC and DSI increased 1.2% during 2004 compared to 2003. The higher amortization is reflective of increased gross margins on fixed and variable annuities. In 2003, amortization of DAC and DSI included an acceleration of DAC amortization (commonly referred to as “DAC unlocking”) totaling \$89 million and \$37 million of DAC amortization on the direct response distribution business sold in 2004.

The adoption of SOP 03-1 required a new modeling approach for estimating expected future gross profits that are used when determining the amortization of DAC. Because of this new modeling approach, effective January 1, 2004, the variable annuity DAC and DSI assets were reduced by \$124 million. This reduction was recognized as a component of cumulative effect of a change in accounting principle.

Amortization of DAC increased 3.4% during 2003 compared to 2002. The increase was primarily due to in-force business growth, partially offset by decreased amortization from lower gross margins on variable annuities and certain fixed annuities. Net DAC unlocking totaled \$89 million and \$94 million in 2003 and 2002.

We performed our annual comprehensive evaluation of DAC assumptions in the first quarter of 2003 and concluded that, due to sustained poor performance of the equity markets coupled with an expectation of moderate future performance due to continuing weakness in the U.S. economy and uncertainty in the geopolitical environment, it was no longer reasonably possible that variable annuity fund returns would revert to the expected long-term mean within the time horizon used in our reversion to the mean model.

The changes in the DAC asset are summarized in the following tables.

(in millions)	Beginning balance December 31, 2003	Impact of Adoption of SOP 03-1 ⁽²⁾	Impact of Disposal of DR	Acquisition costs deferred	Amortization charged to income ⁽³⁾	Amortization (acceleration) deceleration charged to income ⁽¹⁾	Effect of unrealized capital gains and losses	Ending balance December 31, 2004
Traditional life	\$ 720	\$ (6)	\$(145)	\$ 73	\$ (61)	\$ —	\$ —	\$ 581
Interest-sensitive life	1,355	18	—	207	(129)	67	11	1,529
Variable annuities	766	(143)	—	123	(134)	—	16	628
Investment contracts	453	(7)	—	429	(231)	(59)	9	594
Accident, health and other	223	4	(93)	86	(44)	—	—	176
Total	\$3,517	\$(134)	\$(238)	\$918	\$(599)	\$ 8	\$36	\$3,508

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(in millions)	Beginning balance December 31, 2002	Acquisition costs deferred	Amortization charged to income ⁽³⁾	Amortization (acceleration) deceleration charged to income ⁽¹⁾	Effect of unrealized capital gains and losses	Ending balance December 31, 2003
Traditional life	\$ 709	\$ 83	\$ (72)	\$ —	\$ —	\$ 720
Interest-sensitive life	1,261	193	(136)	16	21	1,355
Variable annuities	834	143	(36)	(124)	(51)	766
Investment contracts	190	321	(141)	19	64	453
Accident, health and other	211	76	(64)	—	—	223
Total	<u>\$3,205</u>	<u>\$816</u>	<u>\$(449)</u>	<u>\$ (89)</u>	<u>\$ 34</u>	<u>\$3,517</u>

- (1) Included as a component of Amortization of DAC on the Consolidated Statements of Operations.
- (2) The impact of adoption of SOP 03-1 includes a write-down in variable annuity DAC of \$108 million, the reclassification of DSI from DAC to other assets resulting in a decrease to DAC of \$44 million, an increase to DAC of \$8 million for an adjustment to the effect of unrealized capital gains and losses and the reclassification of unearned revenue from DAC to contractholder funds resulting in an increase to DAC of \$10 million.
- (3) The amortization of DAC for interest-sensitive life, variable annuities and investment contracts is proportionate to the recognition of actual gross profits, which include realized capital gains and losses. The increase in amortization in 2004 compared to 2003 was due in part to the effect of realized capital gains and losses that were in excess of those utilized in the determination of EGP. Amortization related to realized capital gains and losses was \$120 million and \$46 million in 2004 and 2003, respectively. Future amortization will be affected by the recognition of actual realized capital gains and losses to the extent that they differ from those utilized in the determination of EGP.

Operating costs and expenses decreased 5.7% in 2004 compared to 2003 and increased 3.5% in 2003 compared to 2002. The following table summarizes operating costs and expenses.

(in millions)	2004	2003	2002
Non-deferrable acquisition costs	\$256	\$286	\$240
Other operating costs and expenses	378	386	409
Total operating costs and expenses	<u>\$634</u>	<u>\$672</u>	<u>\$649</u>

The decline in total operating costs and expenses in 2004 compared to 2003 was primarily attributable to the disposal of substantially all of our direct response distribution business. Excluding the impact of the disposition, non-deferrable acquisition costs increased due to higher non-deferrable renewal commissions; taxes, licenses and fees; and costs related to loss experience on certain credit insurance policies. For other operating costs and expenses, the decline due to the disposition was partially offset by higher technology and employee related expenses.

The increase in total operating costs and expenses in 2003 compared to 2002 was primarily due to higher non-deferrable commissions. Other operating costs and expenses in 2003 compared to 2002 decreased as higher employee benefit and technology related costs were more than offset by lower litigation expense.

Net realized capital gains and losses are presented in the following table for the years ended December 31.

(in millions)	2004	2003	2002
Investment write-downs	\$ (82)	\$(180)	\$(311)
Dispositions	131	71	(104)
Valuation of derivative instruments	(55)	6	(36)
Settlement of derivative instruments	7	18	19
Realized capital gains and losses, pretax	1	(85)	(432)
Income tax (expense) benefit	(4)	32	145
Realized capital gains and losses, after-tax	<u>\$ (3)</u>	<u>\$ (53)</u>	<u>\$(287)</u>

For further discussion of realized capital gains and losses, see the Investments section of MD&A.

Reinsurance Ceded We enter into reinsurance agreements with unaffiliated carriers to limit our risk of mortality losses. As of December 31, 2004 and 2003, 49% and 44%, respectively, of our face amount of life insurance in force is reinsured. In 2004, for certain term life insurance policies, we ceded 25-100% of the mortality risk depending on the length of the term and policy premium guarantees. Comparatively, in 2003, mortality risk ceded on certain term life insurance policies was in the range of 60-100%, depending on the length of the term and policy premium guarantees. Additionally, we cede 100% of the morbidity risk on our long-term care contracts. Since 1998, we have ceded the mortality risk on new life contracts that exceed \$2 million per individual, whereas prior to 1998, we ceded mortality risk in excess of specific amounts up to \$1 million per life for individual coverage. Also, on certain in-force variable annuity contracts we cede 100% of the mortality and certain other risks related to product features. We retain primary liability as a direct insurer for all risks ceded to reinsurers.

The impacts of reinsurance on our reserve for life-contingent contract benefits at December 31, are summarized in the following table.

(in millions)	Reinsurance recoverable on paid and unpaid claims	
	2004	2003
Life insurance ⁽¹⁾	\$1,010	\$ 836
Long-term care	315	180
Other ⁽¹⁾	271	201
Total Allstate Financial	<u>\$1,596</u>	<u>\$1,217</u>

(1) As of December 31, 2004, life insurance and other include \$97 million and \$72 million, respectively, related to the disposal of substantially all of our direct response distribution business.

Estimating amounts of reinsurance recoverables is impacted by the uncertainties involved in the establishment of reserves.

Developments in the insurance industry have led to a decline in the financial strength of some of our reinsurance carriers, causing amounts recoverable from them to be considered a higher risk. There has also been consolidation activity between reinsurers in the industry, which has resulted in reinsurance risk across the industry to be concentrated among fewer companies. As a result, we have increased our percentage of underwriting retention of new term life insurance policies by approximately 20-30% on average depending on product mix.

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Our reinsurance recoverables, summarized by the reinsurers' Standard & Poor's financial strength ratings as of December 31, are shown in the following table. In certain cases, these ratings refer to the financial strength of the affiliated group or parent company of the reinsurer.

(in millions)	2004		2003	
	Reinsurance Recoverable	%	Reinsurance Recoverable	%
AAA	\$ 33	2.1%	\$ 22	1.8%
AA+	90	5.6	—	—
AA	370	23.2	410	33.7
AA—	359	22.5	271	22.3
A+	318	19.9	304	25.0
A	—	—	1	0.1
A— ⁽¹⁾	117	7.3	167	13.7
Other ⁽¹⁾	309	19.4	42	3.4
Total	<u>\$1,596</u>	<u>100%</u>	<u>\$1,217</u>	<u>100%</u>

(1) As of December 31, 2004, the A— and other categories include \$51 million and \$118 million, respectively, related to the disposal of substantially all of our direct response distribution business. The amount included as a component of the other category reflects two of three unrelated third party purchasers of the business for which Standard and Poor's does not rate. These two insurers are rated A+ (Superior) and A (Excellent) by A.M. Best. Furthermore, the other category, at December 31, 2004, includes \$184 million related to the reinsurance recoverables of acquired entities, of which \$176 million is collateralized by an investment trust.

Our reinsurance recoverables, summarized by reinsurer as of December 31, are shown in the following table.

(in millions)	S&P Financial Strength Rating	Reinsurance recoverable on paid and unpaid claims	
		2004	2003
Employers Reassurance Corporation	A+	\$ 246	\$ 186
RGA Reinsurance Company	AA—	230	73
Paul Revere Life Insurance Company	BBB+	156	160
Transamerica Financial Life Insurance	AA	146	116
Swiss Re Life and Health America, Inc.	AA	144	135
Scottish Re Group	A—	111	—
Investors Partner Life Insurance Company	AA+	90	92
Munich American Reassurance	A+	72	63
Mutual of Omaha Insurance	AA—	69	5
American Health & Life Insurance Co.	N/A (A+ A.M. Best Rating)	60	9
Security Life of Denver	AA	59	58
Triton Insurance Company	N/A (A A.M. Best Rating)	58	—
Lincoln National Life Insurance	AA—	52	48
Other ⁽¹⁾		103	272
Total		<u>\$1,596</u>	<u>\$1,217</u>

(1) As of December 31, 2004, the other category includes \$69 million of recoverables due from reinsurers with an investment grade credit rating from S&P.

We continuously monitor the creditworthiness of reinsurers in order to determine our risk of recoverability on an individual and aggregate basis, and a provision for uncollectible reinsurance is recorded if needed. No amounts have been deemed unrecoverable in the three-years ended December 31, 2004.

We enter into certain inter-company reinsurance transactions for the Allstate Financial operations in order to maintain underwriting control and manage insurance risk among various legal entities. These reinsurance agreements have been approved by the appropriate regulatory authorities. All significant inter-company transactions have been eliminated in consolidation.

Allstate Financial Outlook

- Our ability to grow our investment margin depends upon maintaining sufficient spreads between investment yields and interest crediting rates, and growing the amount of business in force. As interest rates rise, we expect a gradual increase in investment yields. The amount by which these higher yields will increase our investment margin depends upon the amount and pace at which we reset interest-crediting rates, which could be influenced by market conditions and the actions of our policyholders. A significant and sudden increase in interest rates could cause policyholders to exercise surrender provisions in their policies that might cause investment margins to decline. As a result, growth in our investment margin from net new business activity could be partially offset by compression in our in-force investment margins.
- If equity markets perform at historical norms, we expect to see positive growth in our variable annuity gross margins from increased revenue. However, improvements or deteriorations in our variable annuity gross margins from changes in equity market performance or policyholder retention creates a proportional increase or decrease in amortization of variable annuity DAC, which will offset a significant portion of the changes in gross margins.
- Market conditions beyond our control determine the availability and cost of the reinsurance we purchase. To eliminate some of these market concerns, we are expecting to retain more of our term life insurance mortality risk in 2005. This change will not have a discernable effect on our net income in the short-term, but will provide the foundation to drive increased long-term growth in our life insurance business. Our mortality margins will also be more volatile in the future as we retain and manage more of our mortality risk, which will require increased statutory capital.

INVESTMENTS

An important component of our financial results is the return on our investment portfolios. Investment portfolios are segmented between the Property-Liability, Allstate Financial and Corporate and Other operations. The investment portfolios are managed based upon the nature of each respective business and its corresponding liability structure.

Overview and Strategy The Property-Liability portfolio's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. This approach, which has produced competitive returns over time, is designed to ensure financial strength and stability for paying claims, while maximizing economic value and surplus growth. We employ a strategic asset allocation model, which takes into account the nature of the liabilities and risk tolerances, as well as the risk/return parameters of the various asset classes in which we invest. The model's recommended asset allocation, along with duration and liquidity considerations, guides our initial asset allocation. This is further adjusted based on our analysis of relative value opportunities in different markets. As part of our total return framework, we may sell securities during the period in which fair value has declined below amortized cost

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

for fixed income securities or cost for equity securities. Portfolio performance is measured against outside benchmarks at target allocation weights. Portfolio reviews, which include identifying securities that are other than temporarily impaired, are conducted regularly. For more information, see the Portfolio Monitoring section of the MD&A.

The Allstate Financial portfolio's investment strategy focuses on the need for risk-adjusted spread on the underlying liabilities while maximizing return on capital. We believe investment spread is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to minimize the effect of downgrades and defaults. We believe this strategy maintains the investment margin necessary to sustain income over time. The portfolio management approach employs a combination of recognized market, analytical and proprietary modeling, including a strategic asset allocation model, as the primary basis for the allocation of interest sensitive, illiquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the targets set by the strategic asset allocation model, tactical investment decisions are made in consideration of prevailing market conditions. Portfolio reviews, which include identifying securities that are other than temporarily impaired, are conducted regularly. For more information, see the Portfolio Monitoring section of the MD&A.

Portfolio Composition The composition of the investment portfolios at December 31, 2004 is presented in the table below. Also see Notes 2 and 5 of the consolidated financial statements for investment accounting policies and additional information.

(in millions)	Property-Liability		Allstate Financial		Corporate and Other		Total	
		Percent to total		Percent to total		Percent to total		Percent to total
Fixed income securities ⁽¹⁾	\$32,499	80.7%	\$61,419	84.7%	\$1,797	65.8%	\$ 95,715	82.8%
Equity securities ⁽²⁾	5,623	14.0	220	0.3	52	1.9	5,895	5.1
Mortgage loans	382	0.9	7,474	10.3	—	—	7,856	6.8
Short-term	1,759	4.4	1,491	2.0	883	32.3	4,133	3.6
Other	4	—	1,926	2.7	1	—	1,931	1.7
Total	\$40,267	100.0%	\$72,530	100.0%	\$2,733	100.0%	\$115,530	100.0%

(1) Fixed income securities are carried at fair value. Amortized cost basis for these securities was \$30.97 billion, \$58.03 billion and \$1.66 billion for Property-Liability, Allstate Financial and Corporate and Other, respectively.

(2) Equity securities are carried at fair value. Cost basis for these securities was \$4.30 billion, \$212 million, and \$52 million for Property-Liability, Allstate Financial and Corporate and Other, respectively.

Total investments increased to \$115.53 billion at December 31, 2004 from \$103.08 billion at December 31, 2003, primarily due to positive cash flows from operating and financing activities and increased funds associated with securities lending.

The Property-Liability investment portfolio increased to \$40.27 billion at December 31, 2004 from \$37.86 billion at December 31, 2003, due to positive cash flows from operating activities, partially offset by dividends paid by AIC to The Allstate Corporation and decreased net unrealized gains on fixed income securities.

The Allstate Financial investment portfolio increased to \$72.53 billion at December 31, 2004, from \$62.90 billion at December 31, 2003, primarily due to positive cash flows from operating and financing activities and increased funds associated with securities lending.

The Corporate and Other investment portfolio increased to \$2.73 billion at December 31, 2004, from \$2.33 billion at December 31, 2003. This increase primarily reflects additional investments made in the portfolio of Kennett Capital, Inc. ("Kennett Capital"), a wholly owned subsidiary of The Allstate Corporation.

Total investments at amortized cost related to collateral, primarily due to securities lending, increased to \$4.85 billion at December 31, 2004, from \$3.75 billion at December 31, 2003.

We use different methodologies to estimate the fair value of publicly and non-publicly traded marketable investment securities and exchange traded and non-exchange traded derivative contracts. For a discussion of these methods, see the Application of Critical Accounting Policies section of the MD&A.

The following table shows total investments, categorized by the method used to determine fair value at December 31, 2004.

(in millions)	Investments		Derivative
	Fair Value	Percent to total	Contracts Fair Value
Value based on independent market quotations	\$ 91,063	78.8%	\$ 57
Value based on models and other valuation methods	13,582	11.8	898
Mortgage loans, policy loans, bank loans and certain limited partnership investments, valued at cost, amortized cost and the equity method	10,885	9.4	—
Total	<u>\$115,530</u>	<u>100.0%</u>	<u>\$955</u>

Fixed Income Securities See Note 5 of the consolidated financial statements for a table showing the amortized cost, unrealized gains, unrealized losses and fair value for each type of fixed income security for the years ended December 31, 2004 and 2003.

Municipal bonds, including tax-exempt and taxable securities, totaled \$26.33 billion and 96.8% were rated investment grade at December 31, 2004. Approximately 62.6% of the municipal bond portfolio was insured by seven bond insurers and accordingly have a rating of Aaa or Aa. The municipal bond portfolio at December 31, 2004 consisted of approximately 3,500 issues from approximately 2,500 issuers. The largest exposure to a single issuer was less than 1.1% of the municipal bond portfolio. Corporate entities were the ultimate obligors of approximately 10.3% of the municipal bond portfolio.

Corporate bonds totaled \$40.38 billion and 89.1% were rated investment grade at December 31, 2004. As of December 31, 2004, the portfolio contained \$17.41 billion of privately placed corporate obligations, 43.1% of the total corporate obligations in the portfolio, compared with \$15.84 billion at December 31, 2003. Approximately \$15.13 billion or 86.9% of the privately placed corporate obligations consisted of fixed rate privately placed securities. The benefits of fixed rate privately placed securities when compared to publicly issued securities are generally higher yields, improved cash flow predictability through pro-rata sinking funds, and a combination of covenant and call protection features designed to better protect the holder against losses resulting from credit deterioration, reinvestment risk or fluctuations in interest rates. A disadvantage of fixed rate privately placed securities when compared to publicly issued securities is relatively reduced liquidity. At December 31, 2004, 86.3% of the privately placed securities were rated investment grade.

Foreign government securities totaled \$2.70 billion and 93.7% were rated investment grade at December 31, 2004.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

Mortgage-backed securities ("MBS") totaled \$9.22 billion at December 31, 2004, substantially all of which were investment grade. In our MBS portfolio, the credit risk associated with MBS is mitigated due to the fact that the portfolio consists primarily of securities that were issued by, or have underlying collateral that is guaranteed by, U.S. government agencies or U.S. government sponsored entities. The MBS portfolio is subject to interest rate risk since price volatility and the ultimate realized yield are affected by the rate of prepayment of the underlying mortgages. The current consistently low interest rate environment has resulted in prepayments, which have eroded the prepayment protection in this portfolio over recent years.

Commercial Mortgage Backed Securities ("CMBS") totaled \$6.92 billion at December 31, 2004. CMBS positions primarily represent pools of commercial mortgages, broadly diversified across property types and geographical area. The CMBS portfolio is subject to credit risk, but unlike other structured products, is generally not subject to prepayment risk. Due to protections within the underlying commercial mortgages, borrowers are restricted from prepaying their mortgages due to changes in interest rates. Credit defaults can result in credit directed prepayments. Approximately 81.6% of the CMBS portfolio had a Moody's rating of Aaa or a Standard & Poor's rating of AAA, the highest rating category, at December 31, 2004.

Asset-backed securities ("ABS") totaled \$6.00 billion at December 31, 2004. Our ABS portfolio is subject to credit and interest rate risk. Credit risk is managed by monitoring the performance of the collateral. In addition, many of the securities in the ABS portfolio are credit enhanced with features such as over-collateralization, subordinated debt, reserve funds, guarantees and/or insurance. Approximately 54.8% of the ABS portfolio had a Moody's rating of Aaa or a Standard & Poor's ("S&P") rating of AAA, the highest rating category. A portion of the ABS portfolio is also subject to interest rate risk since, for example, price volatility and ultimate realized yield are affected by the rate of prepayment of the underlying assets. The ABS portfolio includes collateralized debt obligations and other bonds that are secured by a variety of asset types, predominately credit card receivables, home equity loans, and auto loans.

At December 31, 2004, 94.1% of the consolidated fixed income securities portfolio was rated investment grade, which is defined as a security having a rating from The National Association of Insurance Commissioners ("NAIC") of 1 or 2; a rating of Aaa, Aa, A or Baa from Moody's or a rating of AAA, AA, A or BBB from S&P, Fitch or Dominion; or a comparable internal rating if an externally provided rating is not available.

The following table summarizes the credit quality of the fixed income securities portfolio at December 31, 2004.

NAIC Rating	Moody's Equivalent	Property-Liability		Allstate Financial		Corporate and Other		Total	
		Fair Value	Percent to total	Fair Value	Percent to total	Fair Value	Percent to total	Fair Value	Percent to total
(in millions)									
1	Aaa/Aa/A	\$27,862	85.7%	\$40,661	66.2%	\$ 1,455	81.0%	\$69,978	73.1%
2	Baa	3,054	9.4	16,988	27.7	59	3.3	20,101	21.0
3	Ba	600	1.9	2,266	3.7	108	6.0	2,974	3.1
4	B	662	2.0	1,303	2.1	131	7.3	2,096	2.2
5	Caa or lower	259	0.8	140	0.2	15	0.8	414	0.4
6	In or near default	62	0.2	61	0.1	29	1.6	152	0.2
	Total	<u>\$32,499</u>	<u>100.0%</u>	<u>\$61,419</u>	<u>100.0%</u>	<u>\$ 1,797</u>	<u>100.0%</u>	<u>\$95,715</u>	<u>100.0%</u>

Equity Securities Equity securities include common and non-redeemable preferred stocks, real estate investment trust equity investments and limited partnership investments. The equity securities portfolio was \$5.90 billion at December 31, 2004 compared to \$5.29 billion at December 31, 2003. The increase is attributable to new money from operations. Gross unrealized gains totaled \$1.34 billion at December 31, 2004 compared to \$1.28 billion at December 31, 2003. Gross unrealized losses totaled \$14 million at December 31, 2004 compared to \$18 million at December 31, 2003.

Unrealized Gains and Losses See Note 5 of the consolidated financial statements for further disclosures regarding unrealized losses on fixed income and equity securities and factors considered in determining whether they are not other than temporarily impaired. The unrealized net capital gains on fixed income and equity securities at December 31, 2004 totaled \$6.39 billion, a decrease of \$7 million since December 31, 2003. Gross unrealized losses on fixed income securities are provided in the table below.

<u>At December 31, 2004</u> (in millions)	<u>Amortized cost</u>	<u>Gross unrealized</u>		<u>Fair value</u>
		<u>Gains</u>	<u>Losses</u>	
Corporate:				
Consumer goods (cyclical and non-cyclical)	\$ 6,918	\$ 334	\$ (19)	\$ 7,233
Public utilities	5,362	565	(4)	5,923
Banking	5,399	264	(18)	5,645
Capital goods	3,924	192	(14)	4,102
Communications	3,388	211	(8)	3,591
Basic industry	2,870	161	(6)	3,025
Financial services	4,063	148	(13)	4,198
Energy	2,343	120	(7)	2,456
Transportation	1,733	110	(12)	1,831
Other	1,522	140	(4)	1,658
Technology	688	36	(4)	720
Total corporate fixed income portfolio	38,210	2,281	(109)	40,382
U.S. government and agencies	3,120	849	(2)	3,967
Municipal	24,955	1,417	(45)	26,327
Foreign government	2,334	367	(1)	2,700
Mortgage-backed securities	9,122	118	(21)	9,219
Commercial mortgage-backed securities	6,762	167	(14)	6,915
Asset-backed securities	5,958	72	(35)	5,995
Redeemable preferred stock	196	15	(1)	210
Total fixed income securities	<u>\$90,657</u>	<u>\$5,286</u>	<u>\$(228)</u>	<u>\$95,715</u>

The consumer goods, banking, capital goods, financial services, and transportation sectors had the highest concentration of gross unrealized losses in our corporate fixed income securities portfolio at December 31, 2004. The gross unrealized losses in these sectors were primarily interest rate related or company specific. Approximately \$9 million of the total gross unrealized losses in the corporate fixed income portfolio and \$11 million of the total gross unrealized losses in the asset-backed securities portfolio were associated with the airline industry for which values were generally depressed due to company specific issues and economic issues primarily related to fuel and labor costs. We expect eventual recovery of these securities. Every security was included in our portfolio monitoring process.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

The following table shows the composition by credit quality of the fixed income securities with gross unrealized losses at December 31, 2004.

NAIC Rating	Moody's Equivalent	Unrealized Loss	Percent to Total	Fair Value	Percent to Total
(in millions)					
1	Aaa/Aa/A	\$(122)	53.5%	\$10,809	75.6%
2	Baa	(49)	21.5	2,613	18.3
3	Ba	(20)	8.8	390	2.7
4	B	(23)	10.1	335	2.4
5	Caa or lower	(8)	3.5	104	0.7
6	In or near default	(6)	2.6	48	0.3
Total		<u>\$(228)</u>	<u>100.0%</u>	<u>\$14,299</u>	<u>100.0%</u>

The table above includes redeemable preferred securities with a fair value of \$6 million and an unrealized loss of \$1 million. It also includes 36 securities that have not yet received an NAIC rating, for which we have assigned a comparable internal rating, with a fair value totaling \$668 million and an unrealized loss of \$7 million. Due to lags between the funding of an investment, processing of final legal documents, filing with the Securities Valuation Office of the NAIC ("SVO"), and rating by the SVO, we will always have a small number of securities that have a pending rating.

At December 31, 2004, \$171 million, or 75.0%, of the gross unrealized losses were related to investment grade fixed income securities. Unrealized losses on investment grade securities principally relate to changes in interest rates or changes in sector-related credit spreads since the securities were acquired.

As of December 31, 2004, \$57 million of the gross unrealized losses were related to below investment grade fixed income securities. Of this amount, 26.0% were in a significant unrealized loss position (greater than or equal to 20% of amortized cost) for six or more consecutive months prior to December 31, 2004. Included among the securities rated below investment grade are both public and privately placed high-yield bonds and securities that were investment grade when originally acquired. We mitigate the credit risk of investing in below investment grade fixed income securities by limiting the percentage of our fixed income portfolio invested in such securities, through diversification of the portfolio, and active credit monitoring and portfolio management.

The scheduled maturity dates for fixed income securities in an unrealized loss position at December 31, 2004 is shown below. Actual maturities may differ from those scheduled as a result of prepayments by the issuers.

(in millions)	Unrealized Loss	Percent to Total	Fair Value	Percent to Total
Due in one year or less	\$ (2)	0.9%	\$ 154	1.1%
Due after one year through five years	(19)	8.3	2,146	15.0
Due after five years through ten years	(50)	21.9	3,186	22.3
Due after ten years	(101)	44.3	4,188	29.3
Mortgage- and asset-backed securities ⁽¹⁾	(56)	24.6	4,625	32.3
Total	<u>\$(228)</u>	<u>100.0%</u>	<u>\$14,299</u>	<u>100.0%</u>

(1) Because of the potential for prepayment, mortgage- and asset-backed securities are not categorized based on their contractual maturities.

The equity portfolio is comprised of securities in the following sectors.

<u>At December 31, 2004</u> (in millions)	<u>Cost</u>	<u>Gross unrealized</u>		<u>Fair Value</u>
		<u>Gains</u>	<u>Losses</u>	
Consumer goods (cyclical and non-cyclical)	\$1,053	\$ 313	\$ (9)	\$1,357
Technology	507	139	(2)	644
Financial services	614	171	(1)	784
Real estate	255	181	—	436
Capital goods	367	165	—	532
Banking	251	82	—	333
Communications	315	71	(1)	385
Energy	233	125	—	358
Basic industry	103	37	(1)	139
Utilities	100	40	—	140
Transportation	33	18	—	51
Other	735	1	—	736
Total equities	<u>\$4,566</u>	<u>\$1,343</u>	<u>\$(14)</u>	<u>\$5,895</u>

At December 31, 2004, the consumer goods sector had the highest concentration of gross unrealized losses in our equity portfolio, which was primarily company specific. We expect eventual recovery of these securities. We included every security in our portfolio monitoring process.

Portfolio Monitoring We have a comprehensive portfolio monitoring process to identify and evaluate fixed income and equity securities whose carrying value may be other than temporarily impaired. The process includes a quarterly review of all securities using a screening process to identify those securities whose fair value compared to amortized cost for fixed income securities or cost for equity securities is below established thresholds for certain time periods, or which are identified through other monitoring criteria such as ratings downgrades or payment defaults. The securities identified, in addition to other securities for which we may have a concern, are evaluated based on facts and circumstances for inclusion on our watch-list. The watch-list is reviewed in detail to determine whether any other than temporary impairment exists.

**Management's Discussion and Analysis
of Financial Condition and Results of Operations—(Continued)**

The following table summarizes fixed income and equity securities in a gross unrealized loss position according to significance, aging and investment grade classification.

(in millions except number of issues)	December 31, 2004				December 31, 2003			
	Fixed Income		Equity	Total	Fixed Income		Equity	Total
	Investment Grade	Below Investment Grade			Investment Grade	Below Investment Grade		
Category (i): Unrealized loss less than 20% of cost ⁽¹⁾								
Number of Issues	1,889	145	105	2,139	1,076	154	143	1,373
Fair Value	\$13,418	\$841	\$175	\$14,434	\$10,320	\$ 911	\$167	\$11,398
Unrealized	\$ (169)	\$ (41)	\$ (11)	\$ (221)	\$ (234)	\$ (47)	\$ (9)	\$ (290)
Category (ii): Unrealized loss greater than or equal to 20% of cost for a period of less than 6 consecutive months ⁽¹⁾								
Number of Issues	4	3	22	29	10	24	29	63
Fair Value	\$ 4	\$ 2	\$ 6	\$ 12	\$ —	\$ 53	\$ 19	\$ 72
Unrealized	\$ (2)	\$ (1)	\$ (2)	\$ (5)	\$ (20)	\$ (24)	\$ (9)	\$ (53)
Category (iii): Unrealized loss greater than or equal to 20% of cost for a period of 6 or more consecutive months, but less than 12 consecutive months ⁽¹⁾								
Number of Issues	—	3	22	25	2	7	6	15
Fair Value	\$ —	\$ 19	\$ 3	\$ 22	\$ 7	\$ 51	\$ 1	\$ 59
Unrealized	\$ —	\$ (6)	\$ (1)	\$ (7)	\$ (8)	\$ (23)	\$ —	\$ (31)
Category (iv): Unrealized loss greater than or equal to 20% of cost for twelve or more consecutive months ⁽¹⁾								
Number of Issues	—	5	—	5	—	9	1	10
Fair Value	\$ —	\$ 15	\$ —	\$ 15	\$ —	\$ 37	\$ —	\$ 37
Unrealized	\$ —	\$ (9)	\$ —	\$ (9)	\$ —	\$ (14)	\$ —	\$ (14)
Total Number of Issues	<u>1,893</u>	<u>156</u>	<u>149</u>	<u>2,198</u>	<u>1,088</u>	<u>194</u>	<u>179</u>	<u>1,461</u>
Total Fair Value	<u>\$13,422</u>	<u>\$877</u>	<u>\$184</u>	<u>\$14,483</u>	<u>\$10,327</u>	<u>\$1,052</u>	<u>\$187</u>	<u>\$11,566</u>
Total Unrealized Losses	<u>\$ (171)</u>	<u>\$ (57)</u>	<u>\$ (14)</u>	<u>\$ (242)</u>	<u>\$ (262)</u>	<u>\$ (108)</u>	<u>\$ (18)</u>	<u>\$ (388)</u>

(1) For fixed income securities, cost represents amortized cost.

The largest individual unrealized loss was \$3 million for category (i), \$1 million for category (ii), \$3 million for category (iii) and \$3 million for category (iv) as of December 31, 2004.

Categories (i) and (ii) have generally been adversely affected by overall economic conditions including interest rate changes and the market's evaluation of certain sectors. The degree to which and/or length of time that the securities have been in an unrealized loss position does not suggest that these securities pose a high risk of being other than temporarily impaired. Categories (iii) and (iv) have primarily been adversely affected by industry and issue specific conditions. All of the securities in these categories are monitored for impairment. We expect that the fair values of these securities will recover over time.

Whenever our initial analysis indicates that a fixed income security's unrealized loss of 20% or more for at least 36 months or any equity security's unrealized loss of 20% or more for at least 12 months is temporary, additional evaluations and management approvals are required to substantiate that a write-down is not appropriate. As of December 31, 2004, no securities met these criteria.

The following table contains the individual securities with the largest unrealized losses as of December 31, 2004. No other fixed income or equity security had an unrealized loss greater than \$2 million or 1.0% of the total unrealized loss on fixed income and equity securities.

(in millions)	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>NAIC Rating</u>	<u>Unrealized Loss Category</u>
Food Processing Company	\$ (4)	\$ 16	N/A	(i)
Asset Backed Security	(3)	5	4	(iv)
Municipal Utility	(3)	27	4	(i)
Domestic Bank	(3)	47	1	(i)
Asset Backed Security	(3)	7	3	(iii)
State General Obligation for a Pension Fund	(3)	67	1	(i)
Pharmaceutical Company	(3)	62	N/A	(i)
Major U.S. Airline	(3)	20	2	(i)
Regional Telephone Company	(3)	13	3	(i)
Total	<u>\$(28)</u>	<u>\$264</u>		

We also monitor the quality of our fixed income portfolio by categorizing certain investments as "problem", "restructured" or "potential problem." Problem fixed income securities are securities in default with respect to principal or interest and/or securities issued by companies that have gone into bankruptcy subsequent to our acquisition of the security. Restructured fixed income securities have rates and terms that are not consistent with market rates or terms prevailing at the time of the restructuring. Potential problem fixed income securities are current with respect to contractual principal and/or interest, but because of other facts and circumstances, we have concerns regarding the borrower's ability to pay future principal and interest, which causes us to believe these securities may be classified as problem or restructured in the future.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

The following table summarizes problem, restructured and potential problem fixed income securities at December 31.

(in millions)	2004			2003		
	Amortized cost	Fair value	Percent of total Fixed Income portfolio	Amortized cost	Fair value	Percent of total Fixed Income portfolio
Problem	\$150	\$153	0.1%	\$325	\$322	0.4%
Restructured	75	75	0.1	77	78	0.1
Potential problem	265	269	0.3	397	382	0.4
Total net carrying value	<u>\$490</u>	<u>\$497</u>	<u>0.5%</u>	<u>\$799</u>	<u>\$782</u>	<u>0.9%</u>
Cumulative write-downs recognized	<u>\$351</u>			<u>\$347</u>		

We have experienced a decrease in the amortized cost of fixed income securities in all categories as of December 31, 2004 compared to December 31, 2003. The decreases were primarily related to prepayments by issuers, sales in these categories due to specific developments causing a change in our outlook and intent to hold those securities, and an improvement in the outlook for these securities.

We also evaluated each of these securities through our portfolio monitoring process at December 31, 2004 and recorded write-downs when appropriate. We further concluded that any remaining unrealized losses on these securities were temporary in nature. While these balances may increase in the future, particularly if economic conditions are unfavorable, management expects that the total amount of securities in these categories will remain low relative to the total fixed income securities portfolio.

Net Realized Capital Gains and Losses The following table presents the components of realized capital gains and losses and the related tax effect for the years ended December 31.

(in millions)	2004	2003	2002
Investment write-downs	\$(129)	\$(294)	\$(467)
Dispositions ⁽¹⁾	828	453	(221)
Valuation of derivative instruments	(46)	16	(60)
Settlement of derivative instruments	(62)	21	(176)
Realized capital gains and losses, pretax	591	196	(924)
Income tax (expense) benefit	(199)	(62)	326
Realized capital gains and losses, after-tax	<u>\$ 392</u>	<u>\$ 134</u>	<u>\$(598)</u>

(1) Gains from dispositions during 2004 include \$90 million of net capital gains from a repositioning of the equity portfolio and \$49 million of net capital gains from the liquidation of the Allstate Floridian Insurance Company portfolio in anticipation of liquidity needs to settle hurricane catastrophe claims.

Investment write-downs during 2004 represented approximately 0.1% of the average total investment portfolio value during the year. Included in losses from written down investments were \$29 million related to airline industry holdings. For the year ended December 31, 2004, the \$828 million in net gains from sales was comprised of gross gains of \$1.26 billion and gross losses of \$434 million. Gross losses from sales of fixed income and equity securities combined with investment write-downs on fixed income and equity securities of \$128 million, represented total gross realized losses of \$562 million. Of the \$434 million in gross losses from sales of fixed income and equity securities, \$228 million resulted from sales of fixed income securities and \$206 million resulted from sales of equity securities.

**Management's Discussion and Analysis
of Financial Condition and Results of Operations—(Continued)**

We have also included in this table the related circumstances giving rise to the losses and a discussion of how those circumstances may have affected other material investments held.

(in millions)	<u>Fair Value at Sale ("Proceeds")</u>	<u>Loss on Sale</u>	<u>Write- downs</u>	<u>December 31, 2004 Holdings⁽¹⁾</u>	<u>Net Unrealized Gain (Loss)</u>
A leading producer of graphics chips for personal computers and servers. A slowdown in demand for semiconductors and a delayed rollout of new products resulted in earnings falling significantly short of expectations. The position was liquidated at a loss.	\$15	\$(16)	\$ —	\$ —	\$—
A pharmaceutical company dealing with a lean drug pipeline, litigation risk, and political risk. We expect improvement in the company's operating environment. Sales were made in conjunction with the repositioning of our equity portfolio.	18	(9)	(7)	58	4
An international vehicle manufacturer that filed for insolvency in early 2004.	—	—	(14)	6	—
A major U.S. airline. A write down was taken in the third quarter of 2004 reflecting a heightened probability of bankruptcy. Subsequently, the airline reached an agreement with its pilots and restructured certain near-term debt maturities through exchange offers. Current holdings are secured by specific aircraft. Valuations in the industry continue to be under stress.	1	—	(12)	21	—
A foreign company with operations related to infrastructure projects, including rail renewal and road design and construction.	—	—	(12)	17	—
A leading developer of software products used in the design and manufacturing of semiconductor devices. The combination of a faltering business cycle and less than expected product renewals caused results to fall significantly short of expectations. The position was liquidated at a loss.	<u>16</u>	<u>(12)</u>	<u>—</u>	<u>2</u>	<u>—</u>
Total	<u>\$50</u>	<u>\$(37)</u>	<u>\$(45)</u>	<u>\$104</u>	<u>\$ 4</u>

(1) Holdings include fixed income securities at amortized cost or equity securities at cost.

The circumstances of the above losses are considered to be company specific and are not expected to have an effect on other holdings in our portfolios.

Mortgage Loans Our mortgage loans portfolio which is primarily held in the Allstate Financial portfolio was \$7.86 billion at December 31, 2004 and \$6.54 billion at December 31, 2003, and comprised primarily of loans secured by first mortgages on developed commercial real estate. Geographical and property type diversification are key considerations used to manage our mortgage loan risk.

Dispositions in the above table include sales and other transactions such as calls and prepayments. We may sell securities during the period in which fair value has declined below amortized cost for fixed income securities or cost for equity securities. In certain situations new factors such as negative developments, subsequent credit deterioration, relative value opportunities, market liquidity concerns and portfolio reallocations can subsequently change our previous intent to continue holding a security.

A changing interest rate environment will also drive changes in our portfolio duration targets at a tactical level. A duration target and range is established with an economic view of liabilities relative to a long-term portfolio view. Tactical duration adjustments within management's approved ranges are accomplished through both cash market transactions and derivative activities that generate realized gains and losses. As a component of our approach to managing portfolio duration, realized gains and losses on futures are most appropriately considered in conjunction with the unrealized gains and losses on the Property-Liability fixed income portfolio. This approach mitigates the impacts of general interest rate changes to the overall financial condition of the corporation.

The ten largest losses from sales of individual securities for the year ended December 31, 2004 totaled \$73 million with the largest being \$16 million and the smallest being \$4 million. None of the \$73 million related to securities that were in an unrealized loss position greater than or equal to 20% of amortized cost for fixed income securities or cost for equity securities for a period of six or more consecutive months prior to sale.

Our largest aggregate loss on sales and writedowns are shown in the following table by issuer and its affiliates. No other issuer together with its affiliates had an aggregated loss on sales and writedowns greater than 2.0% of the total gross loss on sales and writedowns on fixed income and equity securities.

We closely monitor our commercial mortgage loan portfolio on a loan-by-loan basis. Loans with an estimated collateral value less than the loan balance, as well as loans with other characteristics indicative of higher than normal credit risk, are reviewed by financial and investment management at least quarterly for purposes of establishing valuation allowances and placing loans on non-accrual status. The underlying collateral values are based upon either discounted property cash flow projections or a commonly used valuation method that utilizes a one-year projection of expected annual income divided by an expected rate of return. We had net realized capital losses related to write-downs on mortgage loans of \$1 million, \$4 million and \$2 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Short-Term Investments Our short-term investment portfolio was \$4.13 billion and \$1.82 billion at December 31, 2004 and 2003, respectively. We invest available cash balances primarily in taxable short-term securities having a final maturity date or redemption date of less than one year.

We also participate in securities lending, primarily as an investment yield enhancement, with third parties such as brokerage firms. We obtain collateral in an amount equal to 102% and 105% of the fair value of domestic and foreign securities, respectively, and monitor the market value of the securities loaned on a daily basis with additional collateral obtained as necessary. The cash we receive is invested in short-term and fixed income investments, and an offsetting liability is recorded in other liabilities. At December 31, 2004, the amount of securities lending collateral reinvested in short-term investments had a carrying value of \$1.43 billion. This compares to \$569 million at December 31, 2003.

MARKET RISK

Market risk is the risk that we will incur losses due to adverse changes in equity, interest, commodity, or currency exchange rates and prices. Our primary market risk exposures are to changes in interest rates and equity prices, although we also have a smaller exposure to changes in foreign currency exchange rates.

The active management of market risk is integral to our results of operations. We may use the following approaches to manage exposure to market risk within defined tolerance ranges: 1) rebalancing existing asset or liability portfolios, 2) changing the character of investments purchased in the future and 3) using derivative instruments to modify the market risk characteristics of existing assets and liabilities or assets expected to be purchased. For a more detailed discussion of our use of derivative financial instruments, see Note 6 of the consolidated financial statements.

Overview We generate substantial investable funds from our Property-Liability and Allstate Financial businesses. In formulating and implementing guidelines for investing funds, we seek to earn returns that enhance our ability to offer competitive rates and prices to customers while contributing to attractive and stable profits and long-term capital growth. Accordingly, our investment decisions and objectives are a function of the underlying risks and product profiles of each business.

Investment policies define the overall framework for managing market and other investment risks, including accountability and control over risk management activities. Subsidiaries that conduct investment activities follow policies that have been approved by their respective boards of directors. These investment policies specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile and regulatory requirements of the subsidiary. These activities are conducted primarily through subsidiaries' boards of directors and investment committees. For Allstate Financial, the asset-liability management ("ALM") policy guidelines further define the overall asset-liability framework for managing market and investment risks. The Allstate Financial ALM activities follow asset-liability policies that have been approved by their respective boards of directors. These ALM policies specify

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limits, ranges and targets for investments that best meet Allstate Financial's business objectives in light of its product liabilities.

We manage our exposure to market risk through the use of asset allocation, duration and value-at-risk limits, through the use of simulation and, as appropriate, through the use of stress tests. We have asset allocation limits that place restrictions on the total funds that may be invested within an asset class. We have duration limits on the Property-Liability and Allstate Financial investment portfolios and, as appropriate, on individual components of these portfolios. These duration limits place restrictions on the amount of interest rate risk that may be taken. Our value-at-risk limits restrict the potential loss in fair value that could arise from adverse movements in the fixed income, equity, and currency markets based on historical volatilities and correlations among market risk factors. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies. For Allstate Financial, this day-to-day management is integrated within the day-to-day activities of the ALM function. One result of this work is the development and implementation of an asset allocation strategy for optimizing Allstate Financial's investment income.

Although we apply a common overall philosophy to market risk, the underlying business frameworks and the accounting and regulatory environments differ considerably between the Property-Liability and Allstate Financial businesses affecting investment decisions and risk parameters.

Interest rate risk is the risk that we will incur a loss due to adverse changes in interest rates. This risk arises from many of our primary activities, as we invest substantial funds in interest-sensitive assets and issue interest-sensitive liabilities, primarily in our Allstate Financial operations.

We manage the interest rate risk in our assets relative to the interest rate risk in our liabilities. One of the measures used to quantify this exposure is duration. Duration measures the price sensitivity of the assets and liabilities to changes in interest rates. For example, if interest rates increase 100 basis points, the fair value of an asset exhibiting a duration of 5 is expected to decrease in value by approximately 5%. At December 31, 2004, the difference between our asset and liability duration was approximately 0.84, compared to a 0.99 gap at December 31, 2003. A positive duration gap indicates that the fair value of our assets is more sensitive to interest rate movements than the fair value of our liabilities.

Most of our duration gap originates from the Property-Liability operations, with the primary liabilities being auto and homeowners claims. In the management of investments supporting the Property-Liability business, we adhere to an objective of emphasizing safety of principal and consistency of income within a total return framework. This approach is designed to ensure our financial strength and stability for paying claims, while maximizing economic value and surplus growth. This objective generally results in a positive duration mismatch between the Property-Liability assets and liabilities.

For the Allstate Financial business, we seek to invest premiums, contract charges and deposits to generate future cash flows that will fund future claims, benefits and expenses, and that will earn stable margins across a wide variety of interest rate and economic scenarios. In order to achieve this objective and limit interest rate risk for Allstate Financial, we adhere to a philosophy of managing the duration of assets and related liabilities. This philosophy may include using interest rate swaps, futures, forwards, caps and floors to reduce the interest rate risk resulting from mismatches between existing assets and liabilities, and financial futures and other derivative instruments to hedge the interest rate risk of anticipated purchases and sales of investments and product sales to customers.

We pledge and receive collateral on certain types of derivative contracts. For futures and option contracts traded on exchanges, we have pledged securities as margin deposits totaling \$27 million as of December 31, 2004. For over-the-counter derivative transactions involving interest rate swaps, foreign

currency swaps, interest rate caps, interest rate floor agreements, and credit default swaps, master netting agreements are used. These agreements allow us to net payments due for transactions covered by the agreements, and when applicable, we are required to post collateral. As of December 31, 2004, we had posted \$1 million of securities, while counterparties pledged \$490 million of cash as collateral for over-the-counter instruments.

To calculate the duration gap between assets and liabilities, we project asset and liability cash flows and calculate their net present value using a risk-free market interest rate adjusted for credit quality, sector attributes, liquidity and other specific risks. Duration is calculated by revaluing these cash flows at alternative interest rates and determining the percentage change in aggregate fair value. The cash flows used in this calculation include the expected maturity and repricing characteristics of our derivative financial instruments, all other financial instruments (as described in Note 6 of the consolidated financial statements), and certain other items including unearned premiums, property-liability claims and claims expense reserves, interest-sensitive liabilities and annuity liabilities. The projections include assumptions (based upon historical market experience and our experience) that reflect the effect of changing interest rates on the prepayment, lapse, leverage and/or option features of instruments, where applicable. Such assumptions relate primarily to mortgage-backed securities, collateralized mortgage obligations, municipal housing bonds, callable municipal and corporate obligations, and fixed rate single and flexible premium deferred annuities. Additionally, the calculations include assumptions regarding the renewal of property-liability policies.

Based upon the information and assumptions we use in this duration calculation, and interest rates in effect at December 31, 2004, we estimate that a 100 basis point immediate, parallel increase in interest rates (“rate shock”) would decrease the net fair value of the assets and liabilities by approximately \$1.79 billion, compared to \$1.77 billion at December 31, 2003. Additionally, there are \$7.32 billion of assets supporting life insurance products such as traditional and interest-sensitive life that are not financial instruments and as a result have not been included in the above estimate. This amount has increased from the \$6.20 billion reported at December 31, 2003 due to increases in policies in force. Based on assumptions described above, in the event of a 100 basis point immediate increase in interest rates, these assets would decrease in value by \$427 million, compared to a decrease of \$278 million at December 31, 2003. Also reflected in the duration calculation are the effects of a program that uses short futures to manage the Property-Liability interest rate risk exposures relative to duration targets. Based on contracts in place at December 31, 2004, we would recognize realized capital gains totaling \$45 million in the event of a 100 basis point immediate, parallel interest rate increase and \$45 million in realized capital losses in the event of a 100 basis point immediate, parallel interest rate decrease. The selection of a 100 basis point immediate parallel change in interest rates should not be construed as our prediction of future market events, but only as an illustration of the potential effect of such an event.

To the extent that conditions differ from the assumptions we used in these calculations, duration and rate shock measures could be significantly impacted. Additionally, our calculations assume that the current relationship between short-term and long-term interest rates (the term structure of interest rates) will remain constant over time. As a result, these calculations may not fully capture the effect of non-parallel changes in the term structure of interest rates and/or large changes in interest rates.

Equity price risk is the risk that we will incur losses due to adverse changes in the general levels of the equity markets. At December 31, 2004, we held approximately \$4.88 billion in common stocks and \$1.82 billion in other securities with equity risk (including primarily convertible securities, limited partnership funds and non-redeemable preferred securities), compared to approximately \$4.42 billion in common stocks and \$1.30 billion in other equity investments at December 31, 2003. Approximately 99.8%

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and 65.8% of these totals, respectively, represented assets of the Property-Liability operations at December 31, 2004, compared to approximately 99.0% and 58.8%, respectively, at December 31, 2003.

At December 31, 2004, our portfolio of equity investments had a beta of approximately 0.85, compared to a beta of approximately 0.84 at December 31, 2003. Beta represents a widely used methodology to describe, quantitatively, an investment's market risk characteristics relative to the Standard & Poor's 500 Composite Price Index ("S&P 500"). Based on the beta analysis, we estimate that if the S&P 500 decreases by 10%, the fair value of our equity investments will decrease by approximately 8.5%. Likewise, we estimate that if the S&P 500 increases by 10%, the fair value of our equity investments will increase by approximately 8.5%. Based upon the information and assumptions we used to calculate beta at December 31, 2004, we estimate that an immediate decrease in the S&P 500 of 10% would decrease the net fair value of our equity investments identified above by approximately \$569 million, compared to \$478 million at December 31, 2003. The selection of a 10% immediate decrease in the S&P 500 should not be construed as our prediction of future market events, but only as an illustration of the potential effect of such an event.

The beta of our equity investments was determined by comparing the monthly total returns of the equity investments to monthly total returns of the S&P 500 over a three-year historical period. Since beta is historically based, projecting future price volatility using this method involves an inherent assumption that historical volatility and correlation relationships between stocks will not change in the future. Therefore, the illustrations noted above may not reflect our actual experience if future volatility and correlation relationships differ from the historical relationships.

At December 31, 2004 and 2003, we had separate accounts assets related to variable annuity and variable life contracts with account values totaling \$14.38 billion and \$13.43 billion, respectively. We earn contract charges as a percentage of these account values. In the event of an immediate decline of 10% in the account values due to equity market declines, we would have earned approximately \$24 million and \$21 million less in fee income at December 31, 2004 and December 31, 2003, respectively.

Variable annuity contracts sold by Allstate Financial have a GMDB and customers may choose to purchase an enhanced GMDB, guaranteed minimum income benefits ("GMIB") prior to 2004, a TrueReturnSM guaranteed minimum accumulation benefit ("GMAB") beginning in 2004, and beginning in 2005, a SureIncomeSM guaranteed minimum withdrawal benefit ("GMWB"). These guarantees subject us to additional equity market risk because the beneficiary or contractholder may receive a benefit that is greater than their corresponding account value. GMDBs are payable upon death. GMIBs may be exercised on or after the tenth-year anniversary (not prior to 2008) of the contract if the contractholder elects to receive a defined stream of payments ("annuitize"). GMABs are credited to the contractholder account on a contract anniversary date that is pre-determined by the contractholder, between the eighth and twentieth year after contract issue (not prior to 2012). GMABs guarantee an account value of up to 2.5 times (or 250%) of the amount deposited in the contract, depending on the amount of time the contract is in force and adherence to certain fund allocation requirements. GMWBs will be payable if the contractholder elects to take partial withdrawals. GMWBs guarantee that the contractholder can take annual partial withdrawals up to 8% of the amount deposited in the contract until their withdrawals total the initial deposit.

In January 2004, we established reserves for GMDBs and GMIBs in conjunction with the adoption of SOP 03-1. Because of this change in accounting, guarantee payments will be recognized over future periods rather than expensed as paid. For more details see Notes 2 and 8 of the consolidated financial statements.

At December 31, 2004 and 2003, the guaranteed value of the death benefits in excess of account values was estimated to be \$1.80 billion and \$2.46 billion, respectively, net of reinsurance. The decrease in this estimate between periods is attributable to improved equity markets during 2004 and customer surrenders of contracts with in-the-money GMDBs. In both periods, approximately two-thirds of this exposure is related to the return of deposits guarantee, while the remaining one-third is attributable to a death benefit guarantee greater than the original deposits. In addition to reinsurance for a portion of these benefits, we entered into various derivative instruments beginning in 2003 to offset the risk of future death claims on substantially all new business issued on or after January 1, 2003. A similar program for GMABs was established in 2004 and a similar program for GMWBs will be established in 2005.

In the event of an immediate decline in account values of 10% due to equity market declines, payments for guaranteed death benefits at December 31, 2004 would increase by an estimated \$15 million in 2005. These payments would be charged against the related reserve rather than directly to earnings as paid. Contributions to the reserve for GMDBs would be reduced by approximately \$1 million in 2005 in the event of an immediate 10% decline in account values. For discussion of the accounting treatment, see Note 2 of the consolidated financial statements. The selection of a 10% immediate decrease should not be construed as our prediction of future market events, but only as an example to illustrate the potential effect on earnings and cash flow of equity market declines as a result of this guarantee. Also, our actual payment experience in the future may not be consistent with the assumptions used in the model.

GMIB contracts that we sold provide the contractholder with the right to annuitize based on the highest account value at any anniversary date or on a guaranteed earnings rate based on the initial account value over the specified period. The guaranteed income benefit feature was first offered in our variably annuity products beginning in 1998, with guaranteed benefits available for election by contractholders ten years after issue. Accordingly, the earliest date at which benefits would become payable is 2008. In the event of an immediate decline of 10% in contractholders' account values as of December 31, 2004 due to equity market declines, contributions to the reserve would be reduced by a nominal amount in 2005. For discussion of the accounting treatment, see Note 2 of the consolidated financial statements. The selection of a 10% immediate decrease should not be construed as our prediction of future market events, but only as an example to illustrate the potential effect on earnings and cash flow of equity market declines as a result of this guarantee.

In the event of an immediate decline of 10% in GMAB contractholders' account values as of December 31, 2004, due to equity market declines, there would be no net impact on our earnings because these benefits are fully hedged, however the reserve for GMABs would be increased by approximately \$5 million.

In addition to our GMDB, GMIB and GMAB equity risk, at December 31, 2004 and 2003 we had approximately \$2.02 billion and \$1.55 billion, respectively, in equity-indexed annuity liabilities that provide customers with interest crediting rates based on the performance of the S&P 500. We hedge the equity risk associated with these liabilities through the purchase and sale of equity-indexed options and futures, swap futures, and eurodollar futures, maintaining risk within specified value-at-risk limits.

Allstate Financial also is exposed to equity risk in DAC. Fluctuations in the value of the variable annuity and life contract account values due to the equity market affect DAC amortization, because the expected fee income and guaranteed benefits payable are components of the EGP for variable annuity and life contracts. For a more detailed discussion of DAC, see Note 2 of the consolidated financial statements and the Application of Critical Accounting Policies section of the MD&A.

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Foreign currency exchange rate risk is the risk that we will incur economic losses due to adverse changes in foreign currency exchange rates. This risk primarily arises from our foreign equity investments, including real estate funds and our Canadian operations. We also have funding agreement programs and a small amount of fixed income securities that are denominated in foreign currencies, but we use derivatives to hedge the foreign currency risk of these funding agreements and securities. At December 31, 2004 and 2003, we had approximately \$1.22 billion and \$1.36 billion, respectively, in funding agreements denominated in foreign currencies.

At December 31, 2004, we had approximately \$455 million in foreign currency denominated equity securities and an additional \$567 million net investment in our Canadian subsidiaries. These amounts were \$380 million and \$492 million, respectively, at December 31, 2003. The foreign currency exposure is almost entirely in the Property-Liability business.

Based upon the information and assumptions we used at December 31, 2004, we estimate that a 10% immediate unfavorable change in each of the foreign currency exchange rates that we are exposed to would decrease the value of our foreign currency denominated instruments by approximately \$102 million, compared with an estimated \$87 million decrease at December 31, 2003. The selection of a 10% immediate decrease in all currency exchange rates should not be construed as our prediction of future market events, but only as an illustration of the potential effect of such an event. Our currency exposure is diversified across 32 countries, compared to 31 countries at December 31, 2003. Our largest individual currency exchange exposures at December 31, 2004 were to the Canadian dollar (56.5%) and the British pound (11.0%). The largest individual currency exchange exposures at December 31, 2003 were to the Canadian dollar (58.9%) and the British pound (10.5%). Our primary regional exposure is to Western Europe, approximately 28.7% at December 31, 2004, compared to 27.8% at December 31, 2003.

The modeling technique we use to report our currency exposure does not take into account correlation among foreign currency exchange rates. Even though we believe it is very unlikely that all of the foreign currency exchange rates that we are exposed to would simultaneously decrease by 10%, we nonetheless stress test our portfolio under this and other hypothetical extreme adverse market scenarios. Our actual experience may differ from these results because of assumptions we have used or because significant liquidity and market events could occur that we did not foresee.

PENSION PLANS

We have defined benefit pension plans, which cover most full-time and certain part-time employees and employee-agents. See Note 16 of the consolidated financial statements for a complete discussion of these plans and their effect on the consolidated financial statements.

Net periodic pension cost in 2005 is estimated to be \$313 million based on current assumptions. Net periodic pension cost increased in 2004 and 2003 principally due to unfavorable returns on plan assets, decreases in the weighted average discount rate assumption which is based on long-term interest rates, and, in 2003, a decrease in the expected long-term rate of return on plan assets. In each of the years 2004, 2003 and 2002, net pension cost included non-cash settlement charges primarily resulting from lump sum distributions made to agents. Settlement charges are expected to continue in the future as we settle our remaining agent pension obligations by making lump sum distributions to agents.

As provided for in Statement of Financial Accounting Standard ("SFAS") No. 87 "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," the market-related value component of expected returns recognizes plan equity losses and gains over a five-year period, which we believe is consistent with the long-term nature of pension

obligations. As a result, the effect of changes in fair value on our net periodic pension cost may be experienced in periods subsequent to those in which the fluctuations actually occur.

Amounts recorded for pension cost and minimum pension liabilities are significantly affected by fluctuations in the returns on plan assets and the amortization of unrecognized actuarial gains and losses. Plan assets sustained net losses in 2002 primarily due to the decline in the equity markets. These asset losses, combined with all other unrecognized actuarial gains and losses, resulted in amortization of net actuarial loss (and additional net periodic pension cost) of \$121 million in 2004 and \$92 million in 2003. We anticipate that the unrealized loss for our pension plans will exceed 10% of the greater of the projected benefit obligations or the market-related value of assets during the foreseeable future, resulting in additional amortization and net periodic pension cost.

Amounts recorded for net periodic pension cost and minimum pension liabilities are also significantly affected by changes in the assumptions used to determine the weighted average discount rate and the expected long-term rate of return on plan assets. The weighted average discount rate is based on rates at which expected pension benefits attributable to past employee service could effectively be settled on a present value basis at the measurement date. We develop the assumed weighted average discount rate by utilizing the weighted average yield of a theoretical dedicated portfolio derived from bonds available in the Lehman corporate bond universe having ratings of at least "AA" by Standard & Poor's or at least "Aa" by Moody's on the measurement date with cash flows that match expected plan benefit requirements. Significant changes in discount rates, such as those caused by changes in the yield curve, the mix of bonds available in the market, the duration of selected bonds and expected benefit payments, may result in volatility in pension cost and minimum pension liabilities.

Holding other assumptions constant, a hypothetical decrease of 100 basis points in the weighted average discount rate would result in an increase of \$50 million in net periodic pension cost and an \$867 million increase in the minimum pension liability after-tax as of October 31, 2004, our most recent measurement date, versus an increase of \$48 million in net periodic pension cost and a \$762 million increase in the minimum pension liability after-tax as of October 31, 2003. A hypothetical increase of 100 basis points in the weighted average discount rate would decrease net periodic pension cost by \$41 million and would decrease the minimum pension liability after-tax by \$49 million as of October 31, 2004, versus a decrease in net periodic pension cost of \$40 million and a \$52 million decrease in the minimum pension liability after-tax as of October 31, 2003. This non-symmetrical range results from the non-linear relationship between discount rates and pension obligations, and changes in the amortization of unrealized net actuarial gains and losses.

The expected long-term rate of return on plan assets reflects the average rate of earnings expected on plan assets. While this rate reflects long-term assumptions and is consistent with long-term historical returns, sustained changes in the market or changes in the mix of plan assets may lead to revisions in the assumed long-term rate of return on plan assets that may result in variability of pension cost. Differences between the actual return on plan assets and the expected long-term rate of return on plan assets are a component of unrecognized gains or losses, which may be amortized as a component of net actuarial gains and losses. As a result, the effect of changes in fair value on our pension cost may be experienced in periods subsequent to those in which the fluctuations actually occur.

Holding other assumptions constant, a hypothetical decrease of 100 basis points in the expected long-term rate of return on plan assets would result in an increase of \$37 million in pension cost at October 31, 2004, compared to an increase of \$34 million at October 31, 2003. A hypothetical increase of 100 basis points in the expected long-term rate of return on plan assets would result in a decrease in net periodic pension cost of \$37 million at October 31, 2004, compared to a decrease of \$34 million at

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October 31, 2003. Changes in the expected long-term rate of return on plan assets do not affect the minimum pension liability.

CAPITAL RESOURCES AND LIQUIDITY

Capital Resources consist of shareholders' equity and debt, representing funds deployed or available to be deployed to support business operations or for general corporate purposes. The following table summarizes our capital resources at December 31.

(in millions)	2004	2003	2002
Common stock, retained earnings and other shareholders' equity items	\$19,208	\$17,809	\$15,705
Accumulated other comprehensive income	2,615	2,756	1,733
Total shareholders' equity	21,823	20,565	17,438
Mandatorily redeemable preferred securities	—	—	200
Debt	5,334	5,076	4,240
Total capital resources	<u>\$27,157</u>	<u>\$25,641</u>	<u>\$21,878</u>
Ratio of debt and mandatorily redeemable preferred securities to shareholders' equity	24.4%	24.7%	25.5%

Shareholders' equity increased in 2004 when compared to 2003, as net income was partially offset by share repurchases and dividends paid to shareholders. Shareholders' equity increased in 2003 when compared to 2002, as net income, unrealized net capital gains on investments and a decrease in the minimum pension liability were partially offset by dividends paid to shareholders and share repurchases. Our \$1.50 billion share repurchase program was completed as of December 31, 2004. Commencing in January 2005, we have a new \$4.00 billion share repurchase program which is expected to be completed in 2006.

Treasury stock is a component of shareholders' equity and, since 1995, we have repurchased 292 million shares of our common stock at a cost of \$9.90 billion, primarily as part of various stock repurchase programs. We have reissued 76 million shares since 1995, primarily associated with our equity incentive plans, the 1999 acquisition of American Heritage Life Investment Corporation ("AHL") and the redemption of certain mandatorily redeemable preferred securities.

Debt increased in 2004 compared to 2003 primarily due to increases in long-term borrowings outstanding. We issued \$650 million of 5.00% Senior Notes due in 2014, utilizing the registration statement filed with the SEC in June 2000. The proceeds of this issuance will be used for general corporate purposes, including to facilitate the repayment of a portion of the \$900 million of 7⁷/₈% Senior Notes due 2005 at their scheduled maturity on May 1, 2005. We anticipate having adequate sources of liquidity from existing investments and dividends from subsidiaries to repay the remaining portion of the \$900 million of 7⁷/₈% Senior Notes. The increase in debt was partially offset by a decrease of \$412 million related to the deconsolidation of a variable interest entity ("VIE") resulting from the sale of a portion of the equity interest in the VIE. For more information on the adoption of Financial Accounting Standards Board Interpretation No. 46 ("FIN 46"), see Notes 2, 3 and 11 of the consolidated financial statements.

At December 31, 2004, we had outstanding commercial paper borrowings of \$43 million with a weighted average interest rate of 2.22%.

The increase in debt in 2003 compared to 2002 was primarily due to the adoption of FIN 46 and increases in long-term borrowings outstanding, partly offset by declines in short-term borrowings outstanding. The adoption of FIN 46, effective July 1, 2003, increased long-term debt by \$1.05 billion, including \$691 million for the consolidation of two VIEs to hold assets under the management of an affiliate on behalf of third-party investors, \$112 million for the consolidation of a VIE for a headquarters office building and up to 38 automotive collision repair stores, \$45 million for the consolidation of the debt of a previously unconsolidated investment security, and \$200 million of the debt we issued to Allstate Financing II (“AF II”) that is no longer required to be consolidated. Although we were required to consolidate the two VIEs used to hold assets on behalf of third-party investors under FIN 46, we had no legal ownership of the assets and no obligation to repay the debt. Our maximum exposure related to these two entities was the current value of our equity investment, which totaled \$12 million at December 31, 2003. Moody’s and Standard and Poor’s had apprised us that the reported debt associated with the consolidation of these VIEs would be excluded for analytical purposes from the ratio of debt to shareholders’ equity for ratings considerations. This analytical ratio was 21.3% as of December 31, 2003.

In 2003, we issued \$400 million of 5.350% Senior Notes due in 2033, utilizing the registration statement filed with the SEC in 2000. The proceeds of this issuance were used to redeem the \$300 million of 6¾% Notes due 2003 and for general corporate purposes.

Mandatorily redeemable preferred securities were eliminated as a separate line item on our Consolidated Statements of Financial Position effective July 1, 2003, because of the adoption of FIN 46. This accounting guidance required the de-consolidation of AF II, a subsidiary that we own 100%, and the recognition of debt pursuant to debentures that we had previously issued to AF II, which are held as collateral for the mandatorily redeemable preferred securities. For further discussion of the capital structure of AF II, see Note 11 of the consolidated financial statements.

Financial Ratings and Strength The following table summarizes our debt, commercial paper and insurance financial strength ratings at December 31, 2004.

	<u>Moody's</u>	<u>Standard & Poor's</u>	<u>A.M. Best</u>
The Allstate Corporation (senior long-term debt)	A1	A+	a
The Allstate Corporation (commercial paper)	P-1	A-1	AMB-1
Allstate Insurance Company (financial strength)	Aa2	AA	A+
Allstate Life Insurance Company (“ALIC”) (financial strength)	Aa2	AA	A+

Our ratings are influenced by many factors including our operating and financial performance, asset quality, liquidity, asset/liability management, overall portfolio mix, financial leverage (i.e., debt), exposure to risks such as catastrophes and the current level of operating leverage. We have distinct groups of subsidiaries licensed to sell property and casualty insurance in New Jersey and Florida. These groups have separate group ratings and are not reinsured by other Allstate subsidiaries that are not part of each of these respective groups. The ratings of the New Jersey and Florida groups are influenced by the risks noted above as they relate distinctly to each group. In 2004, A.M. Best revised the rating of Allstate Floridian Insurance Company (“Allstate Floridian”) and Allstate Floridian Indemnity Company from A – (Excellent) to B+ (Very Good). These ratings remain under review with negative implications as the current risk-adjusted capitalization is not supportive of the rating, as a result of a decline in capital of Allstate Floridian due to hurricanes Charley, Frances, Ivan and Jeanne. The resolution of the ratings review will be influenced by developments prior to the 2005 hurricane season, including Florida regulatory and legislative actions, Allstate and Allstate Floridian management actions, A.M. Best’s assessment of the timing and nature of such developments and their view on the amount of capital and risk-adjusted

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capitalization deemed necessary to support the ratings. Although at present it is not clear when a ratings decision will be made, it is believed A.M. Best will make a ratings decision before the 2005 hurricane season. A.M. Best has indicated it is evaluating its methodology for determining the level of capital needed to support property insurance written in areas of hurricane loss exposure in Florida. Allstate Floridian also has a Demotech rating of A1.

The ratio of net premiums written to statutory surplus is a common measure of operating leverage used in the property-casualty insurance industry and serves as an indicator of a company's premium growth capacity. Ratios in excess of 3 to 1 are typically considered outside the usual range by insurance regulators and rating agencies. AIC's premium to surplus ratio was 1.5x on December 31, 2004 compared to 1.5x in the prior year.

State laws specify regulatory actions if an insurer's risk-based capital ("RBC"), a measure of an insurer's solvency, falls below certain levels. The NAIC has a standard formula for annually assessing RBC. The formula for calculating RBC for property-liability companies takes into account asset and credit risks but places more emphasis on underwriting factors for reserving and pricing. The formula for calculating RBC for life insurance companies takes into account factors relating to insurance, business, asset and interest rate risks. At December 31, 2004, the RBC for each of our domestic insurance companies was above levels that would require regulatory actions.

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 actions by insurance regulatory authorities. The NAIC analyzes financial data provided by insurance companies using prescribed ratios, each with defined "usual ranges". Generally, regulators will begin to monitor an insurance company if its ratios fall outside the usual ranges for four or more of the ratios. If an insurance company has insufficient capital, regulators may act to reduce the amount of insurance it can issue. The ratios of our domestic insurance companies are within these ranges.

Liquidity Sources and Uses Our potential sources of funds principally include activities shown in the following table.

	<u>Property- Liability</u>	<u>Allstate Financial</u>	<u>Corporate and Other</u>
Receipt of insurance premiums	X	X	
Allstate Financial contractholder fund deposits		X	
Reinsurance recoveries	X	X	
Receipts of principal, interest and dividends on investments	X	X	X
Sales of investments	X	X	X
Funds from investment repurchase agreements, securities lending, dollar roll, commercial paper and lines of credit agreements	X	X	X
Inter-company loans and tax refunds/settlements	X	X	X
Capital contributions from parent	X	X	
Dividends from subsidiaries	X	X	X
Funds from periodic issuance of additional securities			X
Funds from the settlement of our benefit plans			X

Our potential uses of funds principally include activities shown in the following table.

	<u>Property- Liability</u>	<u>Allstate Financial</u>	<u>Corporate and Other</u>
Payment of claims and related expenses	X		
Payment of contract benefits, maturities, surrenders and withdrawals		X	
Reinsurance cessions and payments	X	X	
Operating costs and expenses	X	X	X
Purchase of investments	X	X	X
Repayment of investment repurchase agreements, securities lending, dollar roll, commercial paper and lines of credit agreements	X	X	X
Payment or repayment of inter-company loans	X	X	X
Capital contributions to subsidiaries	X	X	X
Dividends to shareholders	X	X	X
Share repurchases			X
Debt service expenses and repayment			X
Settlement payments of employee and agent benefit plans	X		X

The following table summarizes consolidated cash flow activities by business unit.

(in millions)	<u>Property-Liability</u>			<u>Allstate Financial</u>			<u>Corporate and Other</u>			<u>Consolidated</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net cash provided by (used in):												
Operating activities	\$ 4,092	\$ 3,450	\$ 2,543	\$ 1,916	\$ 2,256	\$ 1,887	\$ (540)	\$ (15)	\$ (7)	\$ 5,468	\$ 5,691	\$ 4,423
Investing activities	(1,903)	(2,344)	(1,613)	(8,039)	(6,769)	(7,560)	(781)	(351)	165	(10,723)	(9,464)	(9,008)
Financing activities	49	11	92	6,506	4,554	5,443	(1,252)	(888)	(751)	5,303	3,677	4,784
Net increase (decrease) in consolidated cash										<u>\$ 48</u>	<u>\$ (96)</u>	<u>\$ 199</u>

Property-Liability Higher operating cash flows of the Property-Liability business in 2004 and 2003 were primarily due to increased underwriting income despite catastrophe losses in 2004 and contributions made to our defined benefit pension plans in 2004 and 2003. Cash used in investing activities decreased in 2004 primarily as a result of less underwriting income being available for investment due to higher operating cash flows offset by dividends paid by AIC to its parent. Cash used in investing activities increased in 2003 as higher operating cash flows were invested in the fixed income and equity portfolios.

Cash flows were impacted by dividends paid by AIC to its parent, The Allstate Corporation, totaling \$2.49 billion, \$1.27 billion and \$675 million in 2004, 2003 and 2002, respectively. For a description of limitations on the payment of these dividends, see Note 15 of the consolidated financial statements.

Allstate Financial Lower cash flows from operating activities in 2004, compared to 2003, were primarily due to lower premium collections and higher deferrable expenses paid, partially offset by lower policy and contract benefits paid and higher interest received on fixed income securities and mortgage loans. The lower premium collections were primarily the result of the disposal of substantially all of our direct response distribution business and lower sales of life-contingent immediate annuities. Higher operating cash flows of Allstate Financial in 2003 primarily relate to increases in investment income, partially offset by an increase in benefits and acquisition related expenses from new business growth.

Cash flows used in investing activities increased in 2004 compared to 2003 as the investment of higher financing cash flows was partially offset by lower operating cash flow. Cash flows used in

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investing activities declined in 2003 compared to 2002 as the investment of higher operating cash flows were offset by lower financing cash flow.

Increased cash flows from financing activities in 2004, compared to 2003, were primarily attributable to higher deposits of fixed annuities and institutional products, partially offset by fixed annuity withdrawals and institutional product maturities. Lower cash flow from financing activities during 2003 reflect an increase in maturities of institutional products and benefits and withdrawals from contractholders' accounts, partially offset by increased deposits received from contractholders. For quantification of the changes in contractholder funds, see the Allstate Financial Segment section of the MD&A.

A portion of the Allstate Financial product portfolio, primarily fixed annuity and interest-sensitive life insurance products, is subject to surrender and withdrawal at the discretion of contractholders. The following table summarizes Allstate Financial's liabilities for these products by their contractual withdrawal provisions at December 31, 2004. Approximately 16.7% of these liabilities is subject to discretionary withdrawal without adjustment.

(in millions)	<u>2004</u>
Not subject to discretionary withdrawal	\$15,074
Subject to discretionary withdrawal with adjustments:	
Specified surrender charges ⁽¹⁾	21,902
Market value ⁽²⁾	9,453
Subject to discretionary withdrawal without adjustments	<u>9,280</u>
Total Contractholder funds	<u>\$55,709</u>

(1) Includes \$9.15 billion of liabilities with a contractual surrender charge of less than 5.0% of the account balance.

(2) Approximately \$8.14 billion of the contracts with market value adjusted surrenders have a 30-45 day period during which there is no surrender charge or market value adjustment, including approximately \$1.45 billion of market-value adjusted annuities with a period commencing during 2005.

To ensure we have the appropriate level of liquidity in this segment, we perform actuarial tests on the impact to cash flows of policy surrenders and other actions under various scenarios. Depending upon the years in which certain policy types were sold with specific surrender provisions, the Allstate Financial cash flow could vary due to higher surrender of policies exiting their surrender charge periods.

Corporate and Other Lower operating cash flow of the Corporate and Other segment in 2004 was primarily due to the timing of intercompany settlements. Financing cash flows of the Corporate and Other segment reflect actions such as fluctuations in short-term debt, proceeds from the issuance of debt, dividends to shareholders of The Allstate Corporation and share repurchases; therefore, financing cash flows are affected when we increase or decrease the level of these activities. Higher uses of cash in investing activities during 2004 and 2003 reflect additional net investments made in the portfolio of Kennett Capital, a subsidiary of The Allstate Corporation. Kennett Capital has \$1.90 billion of capital that is available to pay dividends to The Allstate Corporation, that are not subject to insurance company limitations.

We have established external sources of short-term liquidity that include a commercial paper program, lines-of-credit, dollar rolls and repurchase agreements. In the aggregate, at December 31, 2004, these sources could provide over \$3.16 billion of additional liquidity. For additional liquidity, we can also issue new insurance contracts, incur additional debt and sell assets from our investment portfolio. The liquidity of our investment portfolio varies by type of investment. For example, \$17.41 billion of privately

placed corporate obligations that represent 15.1% of the investment portfolio, and \$7.86 billion of mortgage loans that represent 6.8% of the investment portfolio, generally are considered to be less liquid than many of our other types of investments, such as our U.S. government and agencies, municipal and public corporate fixed income security portfolios.

We have access to additional borrowing to support liquidity as follows:

- A commercial paper program with a borrowing limit of \$1.00 billion to cover short-term cash needs. As of December 31, 2004, the remaining borrowing capacity was \$957 million; however, the outstanding balance fluctuates daily.
- We currently maintain one primary credit facility and one additional credit facility totaling \$1.05 billion to cover short-term liquidity requirements. The primary facility is a \$1 billion five-year revolving line of credit expiring in 2009. It contains an increase provision that would make up to an additional \$500 million available for borrowing provided the increased portion could be fully syndicated at a later date among existing or new lenders. The other facility is a \$50 million one-year revolving line of credit renewed in July 2004 for an additional year. Although the right to borrow under the five-year facility is not subject to a minimum rating requirement, the costs of maintaining the five-year facility and borrowing under it are based on the ratings of our senior, unsecured, nonguaranteed long-term debt. There were no borrowings under either of these lines of credit during 2004. The total amount outstanding at any point in time under the combination of the commercial paper program and the two credit facilities cannot exceed the amount that can be borrowed under the credit facilities.
- The right to issue up to an additional \$2.15 billion of debt securities, equity securities, warrants for debt and equity securities, trust preferred securities, stock purchase contracts and stock purchase units utilizing the shelf registration statement filed with the SEC in August 2003.

Our only financial covenant exists with respect to our primary credit facility and \$18 million of our capital lease obligations. The covenant requires that we not exceed a 37.5% debt to capital resources ratio as defined in the agreements. This ratio at December 31, 2004 was 19.9%.

We closely monitor and manage our liquidity through long- and short-term planning that is integrated between the corporation, the business segments and investments. Allstate Financial manages the duration of assets and related liabilities through ALM, using a dynamic process that addresses liquidity utilizing the investment portfolio, and components of the portfolio as appropriate, which is routinely subjected to stress testing. Allstate Protection's underwriting cash transactions comprise millions of small transactions that make it possible to statistically determine reasonable expectations of patterns of liquidity, which are subject to volatility from unpredictable catastrophe losses. Allstate Protection monitors the duration of its assets and liabilities and maintains a portfolio of highly liquid fixed income and equity securities, including short-term investments, exchange-traded common stock, municipal bonds, corporate bonds, and U.S. government and government agency securities in order to address the variability of its cash flows. Discontinued Lines and Coverages' liabilities are expected to be paid over many years and do not present a significant liquidity risk. Allstate Financial and Allstate Protection also have access to funds from our commercial paper program.

Certain remote events and circumstances could constrain our liquidity. Those events and circumstances include, for example, a catastrophe resulting in extraordinary losses, a downgrade in our long-term debt rating of A1 and A+ (from Moody's and Standard & Poor's, respectively) to non-investment grade status of below Baa3/BBB-, a downgrade in AIC's financial strength rating from Aa2, AA and A+ (from Moody's, Standard & Poor's and A.M. Best, respectively) to below Baa/BBB/A-, or a downgrade in ALIC's financial strength ratings from Aa2, AA and A+ (from Moody's, Standard & Poor's

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and A.M. Best, respectively) to below Aa3/AA-/A-. The rating agencies also consider the interdependence of our individually rated entities, therefore, a rating change in one entity could potentially affect the ratings of other related entities.

Contractual Obligations and Commitments Our contractual obligations as of December 31, 2004 and the payments due by period are shown in the following table.

(in millions)	Total	Less than 1 year	1-3 years	4-5 years	Over 5 years
Securities lending, dollar rolls, and repurchase agreements ⁽¹⁾	\$ 4,364	\$ 4,364	\$ —	\$ —	\$ —
Commercial paper	43	43	—	—	—
Contractholder funds ⁽²⁾	75,033	8,194	19,337	10,914	36,588
Reserve for life-contingent contract benefits ⁽³⁾	28,208	927	2,773	1,852	22,656
Long-term debt ⁽⁴⁾	5,293	900	706	750	2,937
Capital lease obligations ⁽⁴⁾	34	2	4	4	24
Operating leases ⁽⁴⁾	816	220	279	155	162
Unconditional purchase obligations ⁽⁴⁾	495	233	231	31	—
Pension obligations ⁽⁴⁾⁽⁵⁾	89	71	12	6	—
Reserve for property-liability insurance claims and claims expense ⁽⁶⁾	19,338	8,104	6,043	2,356	2,835
Other liabilities and accrued expenses ⁽⁷⁾⁽⁸⁾	8,146	3,381	191	139	4,435
Total Contractual Cash Obligations	\$141,859	\$26,439	\$29,576	\$16,207	\$69,637

(1) Securities lending, dollar rolls and repurchase transactions are typically fully collateralized with marketable securities. We manage our short-term liquidity position to ensure the availability of a sufficient amount of liquid assets to extinguish short-term liabilities as they come due in the normal course of business.

(2) Contractholder funds represent interest-bearing liabilities arising from the sale of products such as interest-sensitive life, fixed annuities, including immediate annuities without life contingencies, bank deposits and institutional products. These amounts reflect estimated cash payments to be made to policyholders and contractholders. Certain of these contracts, such as immediate annuities without life contingencies and institutional products, involve payment obligations where the amount and timing of the payment is essentially fixed and determinable. These amounts relate to (i) policies or contracts where we are currently making payments and will continue to do so and (ii) contracts where the timing of payments has been determined by the contract. Other contracts, such as interest-sensitive life and fixed deferred annuities, involve payment obligations where the amount and timing of future payments is uncertain. For these contracts and bank deposits, (i) the Company is not currently making payments and will not make payments until the occurrence of an insurable event, such as death, or (ii) the occurrence of a payment triggering event, such as the surrender of or partial withdrawal on a policy or deposit contract, which is outside of the control of the Company. We have estimated the timing of payments related to these contracts based on historical experience and our expectation of future payment patterns. Uncertainties relating to these liabilities include mortality, customer lapse and withdrawal activity, and estimated additional deposits for interest-sensitive life contracts, which may significantly impact both the timing and amount of future payments. Such cash outflows reflect adjustments for the estimated timing of mortality, retirement, and other appropriate factors, but are undiscounted with respect to interest. As a result, the sum of the cash outflows shown for all years in the table of \$75.03 billion exceeds the corresponding liability amounts of \$55.71 billion included in the Consolidated Statements of Financial Position as of December 31, 2004 for contractholder funds. The liability amount in the Consolidated Statements of Financial Position reflects the discounting for interest as well as adjustments for the timing of other factors as described above.

(3) The reserve for life-contingent contract benefits relates primarily to traditional life and immediate annuities with life contingencies and reflects the present value of estimated cash payments to be made to policyholders and contractholders. Immediate annuities with life contingencies include (i) contracts where we are currently making payments and will continue to do so until the occurrence of a specific event such as death and (ii) contracts where the timing of a portion of the payments has been determined by the contract. Other contracts, such as traditional life and supplemental accident and health insurance, involve payment obligations where the amount and timing of future payments is uncertain. For these contracts, (i) the Company is not currently making payments and will not make payments until the occurrence of an insurable event, such as death or illness, or (ii) the occurrence of a payment triggering event, such as a surrender of a policy or contract, which is outside of the control of the Company. We have estimated the timing of cash outflows related to these contracts based on historical

experience and our expectation of future payment patterns. Uncertainties relating to these liabilities include mortality, morbidity, expenses, customer lapse and withdrawal activity, and renewal premium for life policies, which may significantly impact both the timing and amount of future payments. Such cash outflows reflect adjustments for the estimated timing of mortality, retirement, and other appropriate factors, but are undiscounted with respect to interest. As a result, the sum of the cash outflows shown for all years in the table of \$28.21 billion exceeds the corresponding liability amounts of \$11.75 billion included in the Consolidated Statements of Financial Position as of December 31, 2004 for reserve for life-contingent contract benefits. The liability amount in the Consolidated Statements of Financial Position reflects the discounting for interest as well as adjustments for the timing of other factors as described above.

- (4) Our payment obligations relating to long-term debt, capital lease obligations, operating leases, unconditional purchase obligations and pension obligations are managed within the structure of our intermediate to long-term liquidity management program.
- (5) Pension obligations represent approved contributions to our pension plans.
- (6) Reserve for property-liability insurance claims and claims expense are an estimate of amounts necessary to settle all outstanding claims, including claims that have been incurred but not reported as of the balance sheet date. We have estimated the timing of these payments based on our historical experience and our expectation of future payment patterns. However, the timing of these payments may vary significantly from the amounts shown above, especially for those claims that have been incurred but not reported. The reserve for property-liability insurance claims and claims expense includes loss reserves related to asbestos and environmental claims as of December 31, 2004, of \$2.43 billion and \$281 million, respectively.
- (7) Other liabilities primarily include accrued expenses and certain benefit obligations and claim payments and other checks outstanding. Certain of these long-term liabilities are discounted with respect to interest, as a result the sum of the cash outflows shown for all years in the table of \$8.15 billion exceeds the corresponding liability amounts of \$4.14 billion.
- (8) Balance sheet liabilities not included in the table above include unearned and advance premiums of \$10.68 billion and deferred income taxes of \$829 million. These items were excluded as they do not meet the definition of a contractual liability as we are not contractually obligated to pay these amounts to third parties. Rather, they represent an accounting mechanism that allows us to present our financial statements on an accrual basis of accounting. In addition, other liabilities of \$1.08 billion were not included in the table above because they did not represent a contractual obligation or the amount and timing of their eventual payment was sufficiently uncertain.

Our contractual commitments as of December 31, 2004 and the payments due by period are shown in the following table.

(in millions)	Total	Less than 1 year	1-3 years	4-5 years	Over 5 years
Other Commitments—Conditional ⁽¹⁾	\$ 166	\$166	\$ —	\$ —	\$—
Other Commitments—Unconditional ⁽¹⁾	844	54	466	305	19
Total Commitments	<u>\$1,010</u>	<u>\$220</u>	<u>\$466</u>	<u>\$305</u>	<u>\$9</u>

(1) Represents investment commitments such as private placements and mortgage loans.

We have agreements in place for services we conduct, generally at cost, between subsidiaries relating to insurance, reinsurance, loans and capitalization. All material inter-company transactions have appropriately been eliminated in consolidation. Inter-company transactions among insurance subsidiaries and affiliates have been approved by the appropriate departments of insurance as required.

ENTERPRISE RISK MANAGEMENT

Risk management is primarily employed within the business unit where the risk resides. In addition, we have a senior management advisory committee called the Enterprise Risk Council (“ERC”). Although the work of the ERC is in the early stages, ultimately it will be responsible for assessing risks on an integrated basis across subsidiaries and organizations.

Among the risks that the ERC will be assessing are catastrophe risk management techniques employed by Allstate Protection; asset/liability management techniques primarily employed by Allstate Financial; and investment risk, including market risk, credit/counterparty risk, liquidity risk, operating risk

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and derivatives exposure limits employed by our Credit Risk Management Committee ("CRMC") in our investment organization. In addition to integrating these elements, other objectives of the ERC include:

- Assessing/evaluating risk capacity impacting multiple organizations
- Aligning risk appetites and strategy
- Linking enterprise growth, risk, and return
- Identifying enterprise risk opportunity sets
- Rationalizing capital

We are utilizing for Allstate Protection an internally developed stochastic model as a significant component in our determination of an appropriate level of economic capital needed, given a defined tolerance for risk. Economic capital modeling capabilities enable us to more fully understand and optimize risk/reward tradeoffs across the portfolio of businesses. The economic capital model accounts for the unique and specific nature and interaction of the risks inherent in our businesses, and also provides a basis upon which capital may be allocated to each business unit. Future plans include adding to the model similar economic capital evaluations with respect to the Allstate Financial business unit and our investment operations so that there is a total enterprise perspective.

REGULATION AND LEGAL PROCEEDINGS

We are subject to extensive regulation and we are involved in various legal and regulatory actions, all of which have an effect on specific aspects of our business. For a detailed discussion of the legal and regulatory actions in which we are involved, see Note 13 of the consolidated financial statements.

PENDING ACCOUNTING STANDARDS

As of December 31, 2004, there are several pending and proposed accounting standards that we have not implemented either because the standard has not been finalized or the implementation date has not yet occurred. For a discussion of these pending and proposed standards, see Note 2 of the consolidated financial statements.

The effect of implementing certain accounting standards on our financial results and financial condition is often based in part on market conditions at the time of implementation of the standard and other factors we are unable to determine prior to implementation. For this reason, we are sometimes unable to estimate the effect of certain pending accounting standards until the relevant authoritative body finalizes these standards or until we implement them.

FORWARD-LOOKING STATEMENTS AND RISK FACTORS

This document contains "forward-looking statements" that anticipate results based on our estimates, assumptions and plans that are subject to uncertainty. These statements are made subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. We assume no obligation to update any forward-looking statements as a result of new information or future events or developments.

These forward-looking statements do not relate strictly to historical or current facts and may be identified by their use of words like "plans," "seeks," "expects," "will," "should," "anticipates," "estimates," "intends," "believes," "likely," "targets" and other words with similar meanings. These statements may address, among other things, our strategy for growth, product development, regulatory approvals, market position, expenses, financial results, litigation and reserves. We believe that these statements are based on reasonable estimates, assumptions and plans. However, if the estimates, assumptions or plans

underlying the forward-looking statements prove inaccurate or if other risks or uncertainties arise, actual results could differ materially from those communicated in these forward-looking statements. Factors which could cause actual results to differ materially from those suggested by such forward-looking statements include but are not limited to those discussed or identified in this document (including the risks described below) and in our public filings with the SEC.

In addition to the normal risks of business, we are subject to significant risks and uncertainties, including those listed below, which apply to us as an insurer and a provider of other financial services.

Risks Relating to the Property-Liability business

As a property and casualty insurer, we may face significant losses from catastrophes and severe weather events

Because of the exposure of our property and casualty business to catastrophic events, our operating results and financial condition may vary significantly from one period to the next. Catastrophes can be caused by various natural and man-made disasters, including earthquakes, volcanoes, wildfires, tornadoes, hurricanes, tropical storms and terrorism. While we believe that our natural event catastrophe management initiatives have reduced the potential magnitude of possible future natural event losses, we continue to be exposed to catastrophes that could have a material adverse effect on operating results and financial position. For example, in 2004 we incurred losses of \$2.00 billion, net of recoveries from the FHCF, in connection with a series of four hurricanes (Charley, Frances, Ivan and Jeanne) that struck portions of Florida, the southeastern seaboard, and other parts of the United States. In addition, our historical catastrophe experience includes losses relating to Hurricane Andrew in 1992, totaling \$2.3 billion, and to the Northridge earthquake of 1994, totaling \$2.1 billion. We are also exposed to assessments from the California Earthquake Authority and various Florida state-created catastrophe loss management facilities, and to losses that could surpass the capitalization of these facilities. Our liquidity could be constrained by a catastrophe, or multiple catastrophes, which result in extraordinary losses or a downgrade of our debt or financial strength ratings.

In addition, we are also subject to claims arising from weather events such as winter storms, rain, hail and high winds. The incidence and severity of weather conditions are inherently unpredictable. There is generally an increase in the frequency and severity of auto and homeowners claims when severe weather conditions occur.

Unanticipated increases in the severity or frequency of claims may adversely affect our profitability

Changes in the severity or frequency of claims may affect the profitability of our Allstate Protection segment. Changes in bodily injury claim severity are driven primarily by inflation in the medical sector of the economy. Changes in auto physical damage claim severity are driven primarily by inflation in auto repair costs, auto parts prices and used car prices. Changes in homeowner's claim severity are driven by inflation in the construction industry, in building materials and in home furnishings and by other economic and environmental factors. However, changes in the level of the severity of claims are not limited to the effects of inflation in these various sectors of the economy. Increases in claim severity can arise from unexpected events that are inherently difficult to predict. Examples of such events include a decision in 2001 by the Georgia Supreme Court that diminished value coverage was included in auto policies under Georgia law, and the emergence of mold-related homeowners losses in the state of Texas. Although from time to time we pursue various loss management initiatives in the Allstate Protection segment in order to mitigate future increases in claim severity, there can be no assurances that these initiatives will successfully identify or reduce the effect of future increases in claim severity.

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Our Allstate Protection segment has experienced a decline in claim frequency. The industry has experienced a similar decline. We believe that this decrease may be attributable to a combination of several factors, including an increase in the level of policy deductibles chosen by policyholders, a decrease in policyholder submission of claims for minor losses, and our implementation of improved underwriting criteria. The favorable level of claim frequency we have experienced may not be sustainable over the longer term. A significant increase in claim frequency could have an adverse effect on our operating results and financial condition.

Actual claims incurred may exceed current reserves established for claims

Recorded claim reserves in the Property-Liability business are based on our best estimates of losses, both reported and incurred but not reported, after considering known facts and circumstances, internal factors including our experience with similar losses, historical trends involving claim payment patterns, loss payments, pending levels of unpaid claims, loss management programs and product mix. In addition, reserve estimates are influenced by external factors including changes in regulation, court decisions, economic conditions and public attitudes. Because reserves are estimates of losses that have occurred, including IBNR losses, the establishment of appropriate reserves, including reserves for catastrophes, is an inherently uncertain and complex process. The ultimate cost of losses may vary materially from recorded reserves and such variance may adversely affect our operating results and financial condition.

Predicting claim expense relating to asbestos and other environmental and discontinued lines is inherently uncertain

The process of estimating asbestos, environmental and other discontinued lines liabilities is complicated by complex legal issues concerning, among other things, the interpretation of various insurance policy provisions and whether those losses are, or were ever intended to be, covered; the ability of policyholders to file claims or add claimants to active claims; and whether losses could be recoverable through retrospectively determined premium, reinsurance or other contractual agreements. Asbestos-related bankruptcies and other asbestos litigations are complex, lengthy proceedings that involve substantial uncertainty for insurers. While we believe that improved actuarial techniques and databases have assisted in estimating asbestos, environmental and other discontinued lines net loss reserves, these refinements may subsequently prove to be inadequate indicators of the extent of probable loss. Consequently, ultimate net losses from these discontinued lines could materially exceed established loss reserves and expected recoveries, and have a material adverse effect on our liquidity, operating results and financial position.

Regulation limiting rate increases and requiring us to underwrite business and participate in loss sharing arrangements may decrease our profitability

From time to time, political events and positions affect the insurance market, including efforts to suppress rates to a level that may not allow us to reach targeted levels of profitability. Moreover, because Allstate Protection's loss ratio currently compares favorably to that of the industry, state regulatory authorities may resist or delay our efforts to raise rates in the future even if the property and casualty industry generally is not experiencing regulatory resistance to rate increases. Such resistance affects our ability in all product lines to obtain approval for rate changes that may be required to achieve targeted levels of profitability and returns on equity. Additionally, homeowners premium growth rates and retention could be adversely impacted by the need to adjust our business structure, size and underwriting practices in Florida and other markets with significant catastrophe risk exposure.

In addition to regulating rates, certain states have enacted laws that require a property-liability insurer conducting business in that state to participate in assigned risk plans, reinsurance facilities and joint underwriting associations or require the insurer to offer coverage to all consumers, often restricting an insurer's ability to charge the price it might otherwise charge. In these markets, we may be compelled to underwrite significant amounts of business at lower than desired rates, possibly leading to an unacceptable return on capital. Laws and regulations of many states also limit an insurer's ability to withdraw from one or more lines of insurance in the state, except pursuant to a plan that is approved by the state insurance department. Additionally, certain states require insurers to participate in guaranty funds for impaired or insolvent insurance companies. These funds periodically assess losses against all insurance companies doing business in the state. Our operating results and financial condition could be adversely affected by any of these factors.

The potential benefits of implementing Tiered Pricing may not be fully realized

We believe that Tiered Pricing and underwriting (including SRM which, in some situations, considers information that is obtained from credit reports among other factors) has allowed us to be more competitive and operate more profitably. However, because some of our competitors have adopted underwriting criteria and Tiered Pricing models similar to those we use and because other competitors may follow suit, we may lose our competitive advantage. Further, the use of insurance scoring from information that is obtained from credit reports as a factor in underwriting and pricing has at times been challenged by regulators, legislators, litigants and special interest groups in various states. Competitive pressures could also force us to modify our Tiered Pricing model. Furthermore, because we have been using Tiered Pricing only for the last several years, we cannot make assurances that Tiered Pricing models will accurately reflect the level of losses that we will ultimately incur from the mix of new business generated. Moreover, to the extent that competitive pressures limit our ability to attract new customers, our expectation that the amount of business written using Tiered Pricing will increase may not be realized.

Allstate Protection may be adversely affected by the cyclical nature of the property and casualty business

The property and casualty market is cyclical and has experienced periods characterized by relatively high levels of price competition, less restrictive underwriting standards and relatively low premium rates, followed by periods of relatively lower levels of competition, more selective underwriting standards and relatively high premium rates. A downturn in the profitability cycle of the property and casualty business could have a material adverse effect on our financial condition and results of operations.

Risks Relating to the Allstate Financial Segment

Changes in underwriting and actual experience could materially affect profitability

Our product pricing includes long-term assumptions regarding investment returns, mortality, morbidity, persistency and operating costs and expenses of the business. Management establishes target returns for each product based upon these factors and the average amount of regulatory and rating agency capital that the company must hold to support in-force contracts. We monitor and manage our pricing and overall sales mix to achieve target returns on a portfolio basis. Profitability from new business emerges over a period of years depending on the nature and life of the product and is subject to variability as actual results may differ from pricing assumptions.

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

Our profitability in this segment depends on the adequacy of investment margins, the management of market and credit risks associated with investments, our ability to maintain premiums and contract charges at a level adequate to cover mortality and morbidity benefits, the adequacy of contract charges on variable contracts to cover the costs of various product features, the persistency of policies to ensure recovery of acquisition expenses, and the management of operating costs and expenses within anticipated pricing allowances. Legislation and regulation of the insurance marketplace and products could also affect our profitability.

Changes in reserve estimates may reduce profitability

Reserve for life-contingent contract benefits is computed on the basis of long-term actuarial assumptions of future investment yields, mortality, morbidity, policy terminations and expenses. We periodically review the adequacy of these reserves on an aggregate basis and if future experience differs significantly from assumptions, adjustments to reserves may be required which could have a material adverse effect on our operating results and financial condition.

Changes in market interest rates may lead to a significant decrease in the sales and profitability of spread-based products

Our ability to manage the Allstate Financial investment margin for spread-based products is dependent upon maintaining profitable spreads between investment yields and interest crediting rates. As interest rates decrease or remain at low levels, proceeds from investments that have matured, prepaid or sold may be reinvested at lower yields, reducing investment margin. Lowering interest crediting rates can offset decreases in investment margin on some products. However, these changes could be limited by market conditions, regulatory or contractual minimum rate guarantees on many contracts and may not match the timing or magnitude of changes in asset yields. Decreases in the rates offered on products in the financial segment could make those products less attractive, leading to lower sales and/or changes in the level of surrenders and withdrawals for these products. Increases in market interest rates can also have negative effects on Allstate Financial, for example by increasing the attractiveness of other investments, which can lead to higher surrenders at a time when the segment's investment asset values are lower as a result of the increase in interest rates. For certain products, principally fixed annuity and interest sensitive life products, the earned rate on assets could lag behind market yields. We may react to market conditions by increasing crediting rates, which could narrow spreads. Unanticipated surrenders could result in DAC unlocking or affect the recoverability of DAC and thereby increase expenses and reduce profitability.

Declining equity markets may reduce both sales of products and income from contract charges and may adversely affect operating results and financial condition

Conditions in the United States and international stock markets affect the sale and profitability of Allstate Financial's variable annuities. In general, sales of variable annuities decrease when stock markets are declining over an extended period of time. The effect of decreasing separate accounts balances resulting from volatile equity markets, lower underlying fund performance or declining consumer confidence could cause contract charges earned to decrease. In addition, it is possible that the assumptions and projections we use to establish prices for GMDB, GMIB, GMAB and GMWB products, particularly assumptions and projections about investment performance, do not accurately reflect the level of costs that we will ultimately incur in providing those benefits, resulting in adverse margin trends. These factors may result in accelerated DAC amortization and require increases in reserves, which would reduce statutory capital and surplus and/or Allstate Financial's net income. Poor fund performance could also

result in higher partial withdrawals of account value which, for some contracts, do not reduce the GMDB by a proportional amount.

Changes in estimates of profitability on interest-sensitive and variable products may have an adverse effect on results through increased amortization of DAC

DAC related to interest-sensitive life, variable life and annuity and investment contracts is amortized in proportion to EGP over the estimated lives of the contracts. Assumptions underlying EGP, including those relating to margins from mortality, investment margin, contract administration, surrender and other contract charges, are updated from time to time in order to reflect actual and expected experience and its potential effect on the valuation of DAC. Updates to these assumptions could result in DAC unlocking, which in turn could adversely affect our operating results and financial condition.

A loss of key product distribution relationships could materially affect sales

Certain products in the Allstate Financial segment are distributed under agreements with other members of the financial services industry that are not affiliated with us. Termination of one or more of these agreements due to, for example, a change in control of one of these distributors, could have a detrimental effect on the sales of Allstate Financial.

Changes in tax laws may decrease sales and profitability of products

Under current federal and state income tax law, certain products (primarily life insurance and annuities) we offer receive favorable tax treatment. This favorable treatment may give certain of our products a competitive advantage over noninsurance products. Congress from time to time considers legislation that would reduce or eliminate the favorable policyholder tax treatment currently applicable to life insurance and annuities. Congress also considers proposals to reduce the taxation of certain products or investments that may compete with life insurance and annuities. Legislation that increases the taxation on insurance products or reduces the taxation on competing products could lessen the advantage of certain of our products as compared to competing products. Such proposals, if adopted, could have a material adverse effect on our financial position or ability to sell such products and could result in the surrender of some existing contracts and policies. In addition, changes in the federal estate tax laws have negatively affected the demand for the types of life insurance used in estate planning.

Risks Relating to the Insurance Industry

Our future results are dependent in part on our ability to successfully operate in an insurance industry that is highly competitive

The insurance industry is highly competitive. Our competitors include other insurers and, because many of our products include a savings or investment component, securities firms, investment advisers, mutual funds, banks and other financial institutions. Many of our competitors have well-established national reputations and market similar insurance products. Because of the competitive nature of the insurance industry, including competition for producers such as exclusive and independent agents, there can be no assurance that we will continue to effectively compete with our industry rivals, or that competitive pressure will not have a material adverse effect on our business, operating results or financial condition. The ability of banks to affiliate with insurers may have a material adverse effect on all of our product lines by substantially increasing the number, size and financial strength of potential competitors. Furthermore, certain competitors operate using a mutual insurance company structure and therefore, may have dissimilar profitability and return targets.



Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

We are subject to market risk and so changing interest rates and declines in credit quality may have adverse effects

Because we have large investment portfolios, we are subject to market risk, the risk that we will incur losses due to adverse changes in equity, interest, commodity or foreign currency exchange rates and prices. Our primary market risk exposures are to changes in interest rates and equity prices and, to a lesser degree, changes in foreign currency exchange rates. For additional information on market risk, see the "Market Risk" section of MD&A.

A decline in market interest rates could have an adverse effect on our investment income as we invest cash in new investments that may yield less than the portfolio's average rate. In a declining interest rate environment, borrowers may prepay or redeem securities we hold more quickly than expected as they seek to refinance at lower rates. A decline could also cause the purchase of longer-term assets in order to obtain adequate investment yields resulting in a duration gap when compared to the duration of liabilities. An increase in market interest rates could have an adverse effect on the value of our investment portfolio, for example, by decreasing the fair values of the fixed income securities that comprise a substantial majority of our investment portfolio. Increases in interest rates also may lead to an increase in policy loans, surrenders and withdrawals that generally would be funded at a time when fair values of fixed income securities are lower. A decline in the quality of our investment portfolio as a result of adverse economic conditions or otherwise could cause additional realized losses on securities, including realized losses relating to derivative strategies not adequately addressing portfolio risks. A declining market could also cause the investments in our pension plans to decrease below the accumulated benefit obligation, resulting in additional pension liability and expense and increasing required contributions to the pension plans.

Concentration of our investment portfolios in any particular segment of the economy may have adverse effects

The concentration of our investment portfolios in any particular industry, group of related industries or geographic sector could have an adverse effect on our investment portfolios and consequently on our results of operations and financial position. Events or developments that have a negative impact on any particular industry, group of related industries or geographic sector may have a greater adverse effect on the investment portfolios to the extent that the portfolios are concentrated rather than diversified.

We may suffer losses from litigation

As is typical for a large company, we are involved in a substantial amount of litigation, including class action litigation challenging a range of company practices. Our litigation exposure could have a material adverse effect on our operating results and financial condition in a future period in the event of an unexpected adverse outcome or if additional reserves are required to be established for such litigation. For a description of our current legal proceedings, see Note 13 of the consolidated financial statements.

We are subject to extensive regulation and potential further restrictive regulation may increase our operating costs and limit our growth

As insurance companies, broker-dealers, investment advisers and/or investment companies, many of our subsidiaries are subject to extensive laws and regulations. These laws and regulations are complex and subject to change. Moreover, they are administered and enforced by a number of different governmental authorities, including state insurance regulators, state securities administrators, the SEC, the National Association of Securities Dealers, the U.S. Department of Justice, and state attorneys general, each of which exercises a degree of interpretive latitude. Consequently, we are subject to the risk that

compliance with any particular regulator’s or enforcement authority’s interpretation of a legal issue may not result in compliance with another regulator’s or enforcement authority’s interpretation of the same issue, particularly when compliance is judged in hindsight. In addition, there is risk that any particular regulator’s or enforcement authority’s interpretation of a legal issue may change over time to our detriment, or that changes in the overall legal environment may, even absent any particular regulator’s or enforcement authority’s interpretation of a legal issue changing, cause us to change our views regarding the actions we need to take from a legal risk management perspective, thus necessitating changes to our practices that may, in some cases, limit our ability to grow and improve the profitability of our business. Furthermore, in some cases, these laws and regulations are designed to protect the interests of a specific constituency rather than a range of constituencies. For example, state insurance laws and regulations are generally intended to protect purchasers or users of insurance products, not holders of securities issued by The Allstate Corporation. In many respects, these laws and regulations limit our ability to grow and improve the profitability of our business.

In recent years, the state insurance regulatory framework has come under public scrutiny and members of Congress have discussed proposals to provide for optional federal chartering of insurance companies. We can make no assurances regarding the potential impact of state or federal measures that may change the nature or scope of insurance regulation.

Reinsurance may be unavailable at historical levels and prices which may limit our ability to write new business

Market conditions beyond our control determine the availability and cost of the reinsurance we purchase. No assurances can be made that reinsurance will remain continuously available to us to the same extent and on the same terms and rates as are currently available. If we were unable to maintain our current level of reinsurance or purchase new reinsurance protection in amounts that we consider sufficient and at prices that we consider acceptable, we would have to either accept an increase in our net liability exposure, reduce our insurance writings, or develop or seek other alternatives.

Reinsurance subjects us to the credit risk of our reinsurers and may not be adequate to protect us against losses arising from ceded insurance

The collectibility of reinsurance recoverables is subject to uncertainty arising from a number of factors, including whether insured losses meet the qualifying conditions of the reinsurance contract and whether reinsurers, or their affiliates, have the financial capacity and willingness to make payments under the terms of a reinsurance treaty or contract. Our inability to collect a material recovery from a reinsurer could have a material adverse effect on our operating results and financial condition.

The continued threat of terrorism and ongoing military actions may adversely affect the level of claim losses we incur and the value of our investment portfolio

The continued threat of terrorism, both within the United States and abroad, and ongoing military and other actions and heightened security measures in response to these types of threats, may cause significant volatility and declines in the equity markets and with interest rates in the United States, Europe and elsewhere, and result in loss of life, property damage, additional disruptions to commerce and reduced economic activity. Some of the assets in our investment portfolio may be adversely affected by declines in the equity markets and reduced economic activity caused by the continued threat of terrorism. We seek to mitigate the potential impact of terrorism on our commercial mortgage portfolio by limiting geographical concentrations in key metropolitan areas and by requiring terrorism insurance to the extent

Management's Discussion and Analysis of Financial Condition and Results of Operations—(Continued)

that it is commercially available. Additionally, in the event that a terrorist act occurs, both Allstate Protection and Allstate Financial may be adversely affected, depending on the nature of the event.

Any decrease in our financial strength ratings may have an adverse effect on our competitive position

Financial strength ratings are important factors in establishing the competitive position of insurance companies and generally have an effect on an insurance company's business. On an ongoing basis, rating agencies review the financial performance and condition of insurers and could downgrade or change the outlook on an insurer's ratings due to, for example, a change in an insurer's statutory capital; a change in a rating agency's determination of the amount of risk-adjusted capital required to maintain a particular rating; an increase in the perceived risk of an insurer's investment portfolio; a reduced confidence in management or a host of other considerations that may or may not be under the insurer's control. The insurance financial strength ratings of both AIC and ALIC are A+, AA and Aa2 (from A.M. Best, Standard & Poor's and Moody's, respectively). Several other affiliates have been assigned their own financial strength ratings by one or more rating agencies. Because all of these ratings are subject to continuous review, the retention of these ratings cannot be assured. A multiple level downgrade in any of these ratings could have a material adverse effect on our sales, our competitiveness, and the marketability of our product offerings impacting our liquidity, operating results and financial condition.

Changes in accounting standards issued by the FASB or other standard-setting bodies may adversely affect our financial statements

Our financial statements are subject to the application of GAAP, which is periodically revised and/or expanded. Accordingly, we are required to adopt new or revised accounting standards from time to time issued by recognized authoritative bodies, including the FASB. It is possible that future changes we are required to adopt could change the current accounting treatment that we apply to our consolidated financial statements and that such changes could have a material adverse effect on our results and financial condition. For a description of potential changes in accounting standards that could affect us currently, see Note 2 of the consolidated financial statements.

The ability of our subsidiaries to pay dividends may affect our liquidity and ability to meet our debt service obligations

The Allstate Corporation is a holding company with no significant operations. The principal asset is the stock of its subsidiaries. State insurance regulatory authorities limit the payment of dividends by insurance subsidiaries, as described in Note 15 of the consolidated financial statements. In addition, competitive pressures generally require the subsidiaries to maintain insurance financial strength ratings. These restrictions and other regulatory requirements affect the ability of the subsidiaries to make dividend payments. Limits on the ability of the subsidiaries to pay dividends could adversely affect our liquidity, including our ability to pay dividends to shareholders and service our debt.

The occurrence of events unanticipated in our disaster recovery systems and management continuity planning could impair our ability to conduct business effectively

In the event of a disaster such as a natural catastrophe, an industrial accident, a terrorist attack or war, events unanticipated in our disaster recovery systems could have an adverse impact on our ability to conduct business and on our results of operations and financial condition, particularly if those events affect our computer-based data processing, transmission, storage and retrieval systems. In the event that a significant number of our managers could be unavailable in the event of a disaster, our ability to effectively conduct our business could be severely compromised.