AON BENFIELD

## United States

# Evolving Criteria

October 2013

Empower Results®

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# Executive Summary

Today is an unprecedented time for the U.S. P&C industry. For P&C insurers, success can be attained by generating profit in the face of a slowly improving economy, low interest rates, and frequent catastrophic events. One key for success is effectively managing risk at all levels of the enterprise in the face of an increasingly complex risk landscape, all while navigating the intricacies of ever evolving ratings criteria. Despite these challenges, the industry is improving. Capitalization is at an all-time high, and while overall profitability is trending favorably, competition is fierce. Rating activity is reflective of this, as the industry has finally begun to see an increase in rating upgrades.

In order to maintain this positive momentum, P&C insurers must effectively react to both the ongoing and new concerns of the rating agencies. Rating agencies' focus remains on a firm's ability to deliver on their projected results. The importance of enterprise risk management continues to grow, as the rating agencies seek to measure the efficacy of how a company manages risk throughout its entire organization. In addition, the uncertainty surrounding the expiration of TRIPRA is also of increasing concern. While these are just a few examples, understanding and managing the evolving criteria has and will continue to be an integral component of an insurer's success.

# Rating Agency Outlook and Trends

The overall U.S. macro rating environment seems to have shifted favorably in the last 12 months. Although certain headwinds such as low investment yields and elevated catastrophe loss experience in recent years still persist, both the excellent level of capital adequacy and an improved aggregate combined ratio indicate the industry is moving in the right direction. To that point, the industry aggregate combined ratio has broken 100 percent, as it has improved to 98 percent through June 30, 2013 from 102 percent a year earlier. As a result, rating agency industry outlooks are mostly stable, and rating upgrades have outpaced downgrades for the first time in a number of years.

## Industry Outlooks

The rating agencies maintain a generally stable view of the U.S. insurance industry as evidenced by the current outlooks published by the four global rating agencies. Over the last 12 months S&P has moved the Commercial Lines sector from "negative" to "stable," making A.M. Best the lone rating agency holding this sector at "negative." A.M. Best continues to assign a "negative" outlook to this sector driven by prolonged pressure on underwriting results, shrinking reserve redundancies, low investment yields and elevated catastrophe loss activity. Likewise, concerns are emerging regarding the sufficiency of recent commercial lines rate increases, adverse reserve development, and exposure to terrorism risk.

**Exhibit 1: Rating Agency U.S. Industry Outlooks**

| Sector | A.M. Best | S&P | Fitch | Moody's |
|---|---|---|---|---|
| Personal Lines | Stable | Stable | Stable | Stable |
| Commercial Lines | Negative | Stable | Stable | Stable |
| Reinsurance | Stable | Stable | Stable | Stable |

Note: As of September 2013
Sources: A.M. Best, Fitch, Moody's, Standard & Poor's

The personal lines outlook remains "stable" for all four rating agencies as the personal auto segment has been offsetting the volatile homeowners' results; however, concentrated property writers will continue to face ratings pressure.

The reinsurance sector outlook also remains stable, driven primarily by continued strong capitalization, sound ERM practices, and improvement in the U.S. economy, which is the world's largest reinsurance market. Partially offsetting these positives is the excess capital markets capacity, which could put increased pressure on reinsurance pricing, terms, and conditions.

## Rating Activity: Upgrades vs. Downgrades

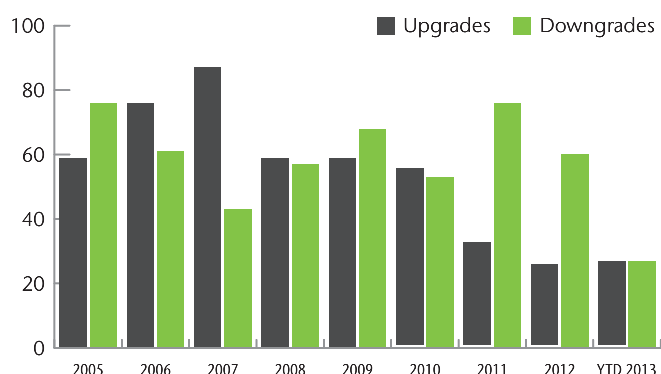
Despite record industry capital levels and median BCAR scores well above published minimums, downgrades outpaced upgrades in recent years but look to be stabilizing in 2013. Based on S&P rating changes for P&C companies, 2013 is the first year since 2010 where upgrades outpaced downgrades. While 2013 included the implementation of S&P's new Insurance Rating Criteria, we believe the year-over-year trend is comparable due to the limited amount of rating changes driven by the new methodology.

A.M. Best ratings have stabilized as compared to the previous two years, noting upgrades are slightly ahead of downgrades for the year for the first time since 2010. Looking more closely at the 2013 activity, the personal lines carriers are experiencing the most downgrades while commercial lines writers are seeing the most upgrades. This is counter-intuitive based on A.M. Best's industry outlooks.

Ratings, unfortunately, have a tendency to trail the market. The most often cited driver of personal lines downgrades is poor or inconsistent underwriting profitability, which in many cases has been a result of the frequency of catastrophe losses in recent years. So while personal lines profitability has improved in 2012 and into 2013, there have still been a number of downgrades across the market due to several consecutive years of weak results, despite a recent shift in this trend. Meanwhile there are concerns regarding the sufficiency of recent commercial lines rate increases and adverse reserve development, yet the commercial lines saw a number of upgrades in 2013.

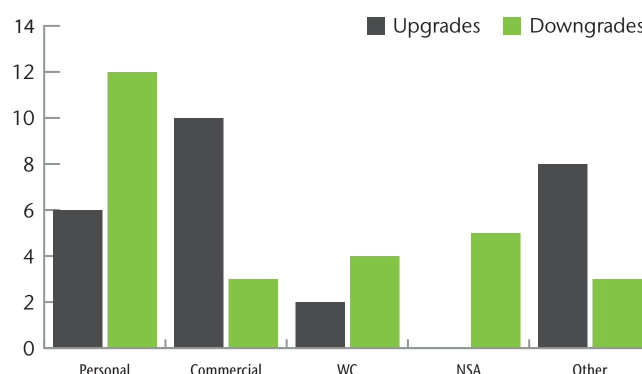
The workers' compensation segment has faced rating pressure with five specialists downgraded by A.M. Best in 2012 and 11 entered 2013 with a negative outlook. Current trends are more evident in the recent workers' compensation downgrades, as many reserving studies have indicated a shift to a reserving deficit in recent years, and the rating changes are reflecting this. Additionally, as reported in A.M. Best's impairment study, six workers' compensation specialists were impaired in 2012 and 2013 (to date), which is 25 percent of the P&C industry total for those years. Four of the six impairments related to deficient loss reserve and/or inadequate pricing. In addition, the sector is faced with additional ratings pressure from the uncertainty related to TRIPRA. However, declining unemployment rates and payroll employment continuing to rise should benefit workers' compensation writers.

**Exhibit 2: A.M. Best Rating Activity**




Sources: A.M. Best, Aon Benfield Analytics. Data as of July 2, 2013

**Exhibit 3: 2013 A.M. Best Rating Activity by Composite**




Sources: A.M. Best, Aon Benfield Analytics. Data as of July 2, 2013

## Capital Adequacy

Capital remains at near-record levels as reflected in an analysis of A.M. Best's published BCAR scores for the industry. Median BCARs are 170 to 209 percentage points above published minimums. Interestingly, the median scores of publically traded companies in the U.S. slightly trail the U.S. Industry composite, as the composite is comprised mostly of mutual companies that often hold additional capital due to their inability to efficiently raise capital in the markets.

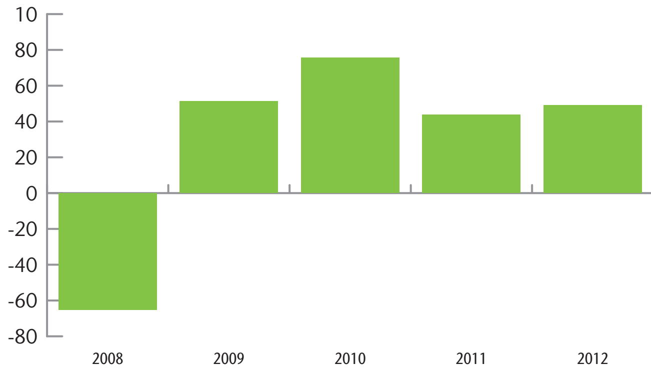
**Exhibit 4: A.M. Best Minimum and Median BCAR Scores by Rating Category**

| FSR | Published Minimum | 2012 U.S. Industry Median | Median / Minimum | 2012 U.S. Public Co. Median | Percent lower than Industry Median |
|---|---|---|---|---|---|
| A++ | 175 | 298 | 170 | | |
| A+ | 160 | 326 | 204 | 277 | 15% |
| A | 145 | 292 | 201 | 232 | 21% |
| A- | 130 | 272 | 209 | 185 | 32% |
| B++ | 115 | 219 | 190 | | |
| B+ | 100 | 175 | 175 | | |

Sources: A.M. Best, Aon Benfield Analytics. Data as of July 2, 2013

Alternatively, Aon Benfield analyzes industry capitalization trends by modeling the Industry's Balance Sheet within both the A.M. Best and S&P risk adjusted capital models. The results are in line with expectations, illustrating the stable trend of strong risk adjusted capitalization for the industry.

### Exhibit 5: Capital Adequacy at S&P 'A' Rating Level



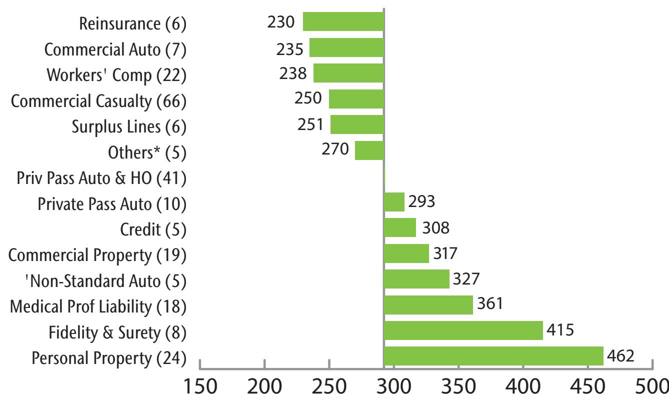

Source: Aon Benfield Analytics

While the industry displays very strong capital adequacy, there are valuable insights found when taking a deeper dive into the relationship between capitalization and specific company attributes. As expected, there is a wide range of results between the various perspectives.

As per the below, our analysis illustrates a few key takeaways for the 'A' rated population:

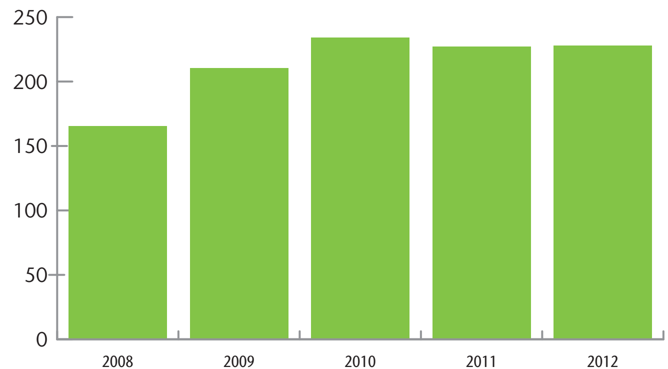
- Insurers below $100M in PHS drive up median BCAR
- Personal lines tend to have higher BCAR scores
- No major distinction by A.M. Best Organization Type as public and private stock entities are grouped together; further analysis shows publicly traded entities operate as lower scores (as per above table)

### Exhibit 8: Median BCAR for 'A' by Composite




Sources: A.M. Best, Aon Benfield Analytics

### Exhibit 6: BCAR (%)




Source: Aon Benfield Analytics

### Exhibit 7: BCAR Medians for 'A' Companies

**'A' Rated Entities: BCAR Median by Size**

| Size | Median | Diff. from Total | Count |
|---|---|---|---|
| < $100M | 397 | 105 | 74 |
| $100M - $500M | 285 | -7 | 97 |
| $500M - $1B | 261 | -31 | 39 |
| >$1B | 206 | -86 | 32 |
| All | 292 | | 242 |

**'A' Rated Entities: BCAR Median by Segment**

| Composite | Median | Diff. from Total | Count |
|---|---|---|---|
| Personal | 324 | 32 | 80 |
| Commercial | 271 | -21 | 156 |
| Reinsurance | 230 | -62 | 6 |
| All | 292 | | 242 |

**'A' Rated Entities: BCAR Median by Organization Type**

| Type | Median | Diff. from Total | Count |
|---|---|---|---|
| Mutual | 294 | 2 | 82 |
| Stock | 289 | -3 | 146 |
| Other (Lloyd's, Reciprocal, etc.) | 302 | 10 | 14 |
| All | 292 | | 242 |

Sources: A.M. Best, Aon Benfield Analytics

# Criteria Updates

2012-2013 proved to be a very active time in terms of criteria updates. Between S&P and A.M. Best, there were 23 criteria updates with an additional 7 criteria updates in draft status (request for comment process). Significant developments included S&P's highly anticipated Insurance Rating Criteria as well as key updates to A.M. Best's BCAR model. Other topics included S&P's revision of its process for evaluating ERM, Management & Governance, and Hybrid Securities, as well as A.M. Best's analysis of the impact of TRIPRA's expiration, the assessment of the amount of credit given to FHCF coverage, and an announcement of the plans to develop a stochastic BCAR model.

## Standard & Poor's Updated Rating Methodology

On May 5, 2013, Standard & Poor's (S&P) finalized their Insurance Rating Criteria. S&P cited the following reasons for implementing this new criteria framework:

- Improved transparency of rating methodology
- Increased specificity of rating factors and sub-factors
- More forward looking approach that increases comparability and consistency
- Centralizing insurance criteria framework in one single criteria document

From the beginning, S&P stated they expect the majority of ratings will remain unchanged, with any movement most likely no more than one rating notch. S&P has updated all interactive ratings based upon the new ratings framework and our analysis concurs with the provided guidance. A detailed summary of S&P's new criteria framework is available at http://thoughtleadership.aonbenfield.com.

Aon Benfield utilized the transparency and specificity of the new methodology and developed a database of all the public rating factors and sub-factors for over 400 rated entities globally. Our analysis of US and Bermuda rated entities provides insights on S&P's view of this segment. A few of the key themes are:

**It is difficult to earn one of the top two scores for Business Risk Profile (BRP).** Business Risk Profile is comprised of two essential components: a firm's Industry and Country Risk Assessment (IICRA) and their Competitive Position. The table below shows the resultant BRP given various IICRA and Competitive Position combinations. The US P&C market has an IICRA of "Intermediate Risk," which carries two important implications:

1. It caps a US P&C insurer's BRP at "Very Strong" and
2. Makes a firm's Competitive Position the primary driver of its BRP score

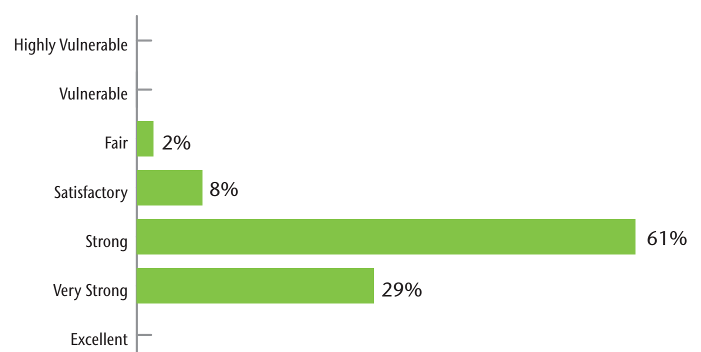
Competitive Position is determined through the analysis of six sub-factors: Operating Performance, Brand or Reputation, Market Position, Distribution Channels, Geographic Diversification, Other Diversification. As evidenced by the graphs below, a BRP of Very Strong is contingent upon a Competitive Position assessment of either "Very Strong" or "Extremely Strong," which only 29 percent of our population has attained. Companies with "Very Strong" and "Extremely Strong" competitive position are recognized market leaders within their primary segment.

**Exhibit 9: Business Risk Profile Assessment**

| | IICRA | |
|---|---|---|
| Competitive Position Assessment | Intermediate Risk | Low Risk |
| Extremely Strong | Very Strong | Excellent |
| Very Strong | Very Strong | Very Strong |
| Strong | Strong | Strong |
| Adq. | Satisfactory | Satisfactory |
| Less than adq. | Fair | Fair |
| Weak | Vulnerable/Highly | Vulnerable/Highly |

Source: S&P

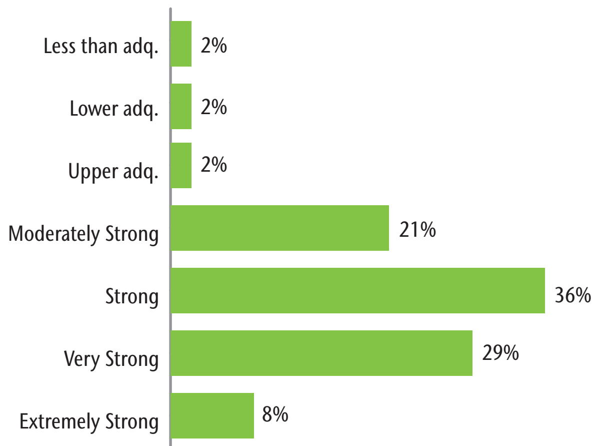
**Exhibit 10: BRP Distribution**




Sources: S&P, Aon Benfield Analytics

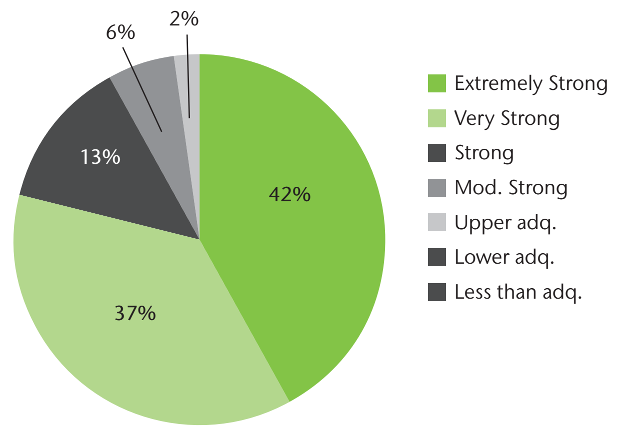
**Risk Position has a greater impact on Financial Risk Profile (FRP) than originally anticipated.** Financial Risk Profile is determined by assessing the combination of a firm's Capital & Earnings (C&E), Risk Position, and Financial Flexibility. While C&E is the starting point and primary driver of the FRP, our research shows that Risk Position plays an integral role in the final determination of the FRP. The distribution of C&E across our population is indicative that the industry is well capitalized, as over 90 percent of the population has a "Strong" or better assessment. However, the impact of the Risk Position adjustment can be significant; for example, while 79 percent of the population is assessed at "Very Strong" or better C&E, only 37 percent have an FRP score of "Very Strong" or better. The Risk Position adjustment negatively impacts the influence of excess capital on the overall financial strength ratings.

**Exhibit 11: FRP Distribution**




Sources: S&P, Aon Benfield Analytics

**Exhibit 12: Distribution of Capital & Earnings**




Sources: S&P, Aon Benfield Analytics

**The importance of ERM continues to increase in overall Financial Strength Ratings (FSR).** ERM continues to gain importance as S&P has implemented a more transparent approach to how ERM affects the Financial Strength Rating. Our research has shown that only companies with Strong or Very Strong ERM have an FSR of AA- or higher. Also, Strong or Very Strong ERM improved the FSR for 8 firms by 1 one rating notch. Conversely, Adequate ERM was a drag on FSR and lowered the rating for 4 companies. Although no companies in our population have ERM below Adequate (Weak), the impact of a Weak ERM assessment is material. For example, a Weak ERM & management assessment drops an “a-” anchor 3 notches to “bbb-”.

**Exhibit 13: “Modifier” Impact to Rating Anchor**

| | ERM and management assessment | | | | |
|---|---|---|---|---|---|
| Anchor | Very Strong | Strong | Adequate | Less than Adequate | Weak |
| a | a+ | a | a | a- | bbb- |
| a- | a | a- | a- | bbb+ | bbb- |
| bbb+ | a- | bbb+ | bbb+ | bbb | bb+ |
| bbb | bbb+ | bbb | bbb | bbb- | bb+ |
| bbb- | bbb | bbb- | bbb- | bb+ | bb |

Source: S&P

## Other Standard & Poor’s Criteria Updates

S&P published a revised criteria for assessing ERM in an effort to assist the market in better understanding the methodology. The process includes assessing five subfactors that include risk management culture, risk controls, emerging risk management, risk models, and strategic risk management. Keeping in line with the overall theme of transparency, S&P does not expect the revised criteria to materially affect current ratings.

S&P updated its criteria for evaluating Management & Governance. The main goal of the updated criteria was not to substantively change the process for evaluating a firm’s Management and Governance, but rather to enhance the methodology’s transparency. As such, S&P did not expect any significant rating changes as a result of implementing the updated criteria. Perhaps one of the most qualitative aspects of S&P’s rating methodology, the process for evaluating Management and Governance, includes a review of Management, Strategic Positioning, Risk Management/Financial Management, Organizational Effectiveness, and Governance.

S&P revised its methodology for assigning equity content to hybrid capital instruments. The primary purpose of the revision is to recognize the effect of the potential reduction of equity content on the permanence of a hybrid instrument with a stated or effective maturity date.

## A.M. Best BCAR Model Changes

A.M. Best made several updates to the U.S., Canadian, and Universal BCAR model. They were:

- Reduced imbedded discount rate in BCAR reserve discount factor from 5 percent to 4 percent
- Added new component to Business Risk charge related to post-retirement and pension fund obligations
- Updated annual industry growth charge thresholds
- Included asset risk factors for individual countries in the Universal BCAR model

These updates were part of A.M. Best's continual review of its rating methodology.

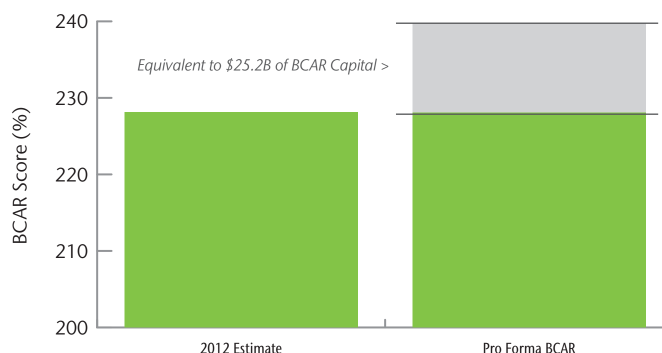
A.M. Best reduced the discount rate from 5 percent to 4 percent within the BCAR models. The loss reserve component of BCAR requires companies to hold capital based upon the risk inherent in their loss and loss adjustment expense reserves. A.M. Best evaluates reserves on an "economic" basis that incorporates their view of reserve adequacy and applies a discount factor to reflect the time value of money. A.M. Best then applies a capital factor to "economic" or adjusted reserves for potential reserve volatility that is the basis for determining required capital for reserve risk. In addition, A.M. Best adjusts surplus for the difference between "economic" reserves and carried reserves on an after tax basis to incorporate the time value of money imbedded within loss reserves (i.e., Reserve Equity).

The lower discount rate led to a higher discount factor (less of a present value benefit) increasing "economic" reserves, which led to higher required capital (denominator of BCAR) and lower Reserve Equity (numerator of BCAR), reducing BCAR scores across the board.

The impact of the lowered discount rate on BCAR varied by company. Companies writing long-tailed business whose BCAR required capital is driven by Reserve Risk were more affected compared to companies writing short-tailed lines of business whose BCAR required capital is driven by Premium (pricing) Risk. Using our analysis of the Industry BCAR as a benchmark, we measured the impact of a lower discount rate on Industry capital adequacy. Overall, the proposed change reduced Industry BCAR by nine points, or the equivalent of $25.2 billion in capital, all else constant.

In addition to the change on the discount rate, A.M. Best added a new component to the Business Risk charge related to post-retirement and pension fund obligations. For companies who fully accrued their obligations as of year-end 2012 under SSAP 92 and SSAP 102, there was no impact in BCAR as the accounting change was already reflected in surplus. For companies adopting a phase-in approach, A.M. Best applied a risk charge based upon the phase-in period on the unfunded and unaccrued obligations through Business Risk within the BCAR model.

**Exhibit 14: Industry BCAR Estimate**




Source: Aon Benfield Analytics

A.M. Best also updated thresholds used in determining the growth charge applied to Reserve Risk and Premium Risk. On a gross premium basis, the one-year growth threshold is 9 percent (up from 8 percent) and the three-year threshold is 7 percent (up from 5 percent). On a policy count or exposure basis, the one-year growth threshold is 5 percent (held constant) and the three-year threshold is 5 percent (up from 4 percent).

In the Universal BCAR model, asset risk factors have been included for individual countries. Country-specific risk charges are applied based on the origin of the asset to account for the liquidity and volatility within the capital markets of the country.

## Other A.M. Best Criteria Updates

A.M. Best revised their assessment of insurers' potential exposure to the Florida Hurricane Catastrophe Fund (FHCF). In light of FHCF's current cash position driven by the issuance of $2 billion in catastrophe bonds, A.M. Best no longer reduces the amount of credit given to coverage provided by the FHCF's mandatory layer, giving 100 percent credit. Prior to this revision, a reduction of 5 percent was given to the coverage provided.

A.M. Best also announced that they are developing a new stochastic BCAR model. Although the details are sparse, the main goal is to include stochastic features for the risk of bond defaults, stock volatility, reinsurer default risk, pricing risk, and reserving risk. The process will entail a "request for comment" that will allow the market to review the proposed methodology and provide feedback. A.M. Best is planning to roll out the stochastic BCAR model by running parallel analysis (current BCAR and stochastic BCAR) using 2013 financials with a full transition to the stochastic BCAR only using 2014 financials.

## Insurance Contracts Accounting Change

The FASB issued an Exposure Draft (ED) in June 2013 that proposes to fundamentally change the accounting for insurance contracts. The FASB has proposed two principles based methods of accounting for insurance contracts:

- Building Block Approach (BBA)
- Premium Allocation Approach (PAA)

The BBA provides guidance on accounting for insurance contracts with a contract duration greater than one year—so most life insurance contracts—while the PAA approach provides guidance for contracts with a duration less than one year—so most property and casualty contracts. Below is a summary of the impact of the proposed changes on the PAA accounting model under U.S. GAAP, as this will be the model primarily adopted by the P&C industry.

The PAA is intended to be a somewhat simplified approach compared to the BBA. It does not require a present value of cash flow claim measurement until claims are incurred, though this is still a change over current accounting as today reserves are not discounted. The liability related to remaining coverage is essentially 'locked in' rather than remeasured each period, which is required under the BBA model. The PAA proposal is very similar to current U.S. GAAP accounting for short-duration contracts.

From a balance sheet perspective, the premium receivable is the expected future premiums arising from the contract, and initially corresponds to pre-claim obligation (currently known as the unearned premium reserve). The pre-claim obligation, however, will be net of allowable direct acquisition expenses, which differs from current accounting. Revenue will be recognized over the coverage period based on timing of incurred claims if that pattern differs significantly from the passage of time. This could be a change in revenue recognition for companies using a straight line pattern that have seasonal loss patterns (e.g. catastrophe writers) or aggregate coverages where claims are expected to be incurred in later periods after deductibles are met.

In another change, companies will be required to discount the liability for remaining coverage and outstanding claims in certain situations. Discounting is not required if the effects are immaterial or when the incurred claims are expected to be paid within one year of the insured event. The liability for incurred claims (currently known as reserve for claims and claim adjustment expenses) is the present value of the unbiased, probability-weighted estimate (e.g. the mean) of the future cash outflows for incurred claims (including IBNR). The statistical mean may be different from the current measure of management's best estimate that companies are required to reserve to under existing U.S. GAAP. Another difference from current accounting relates to cash flows that are contingent on claims experience (e.g. loss sensitive features) will be considered part of the claims cash flows rather than accounted for as premium adjustments.

The selected discount rate used should reflect the characteristics of the liability. The selected discount rate at the initial recognition of the contract should be used to estimate the initial expense for claims incurred on the Income Statement. Any change in that discount rate subsequently will be reflected in the Statement of Other Comprehensive Income (OCI). This will help reduce the volatility in the income statement from changes in the discount rate.

There are also some proposed changes that will affect the accounting of reinsurance contracts:

- Reinsurance contracts must be accounted for using the same approach used to account for the underlying insurance contracts issued.
- For multi-year reinsurance contracts, one factor to be considered is whether or not at inception the insurer will significantly change premium pricing for future contracts written with similar risks (e.g. for multi-year catastrophe contracts if pricing is expected to change materially due to a market changing event). If possible, this could result in a change to the BBA approach.
- Currently risk transfer is assessed as a significant chance of a significant loss, and has unofficially been translated into practice as the 10/10 rule (a 10 percent chance of a 10 percent loss). The ED focuses on whether an insured event could cause a reinsurer to incur a significant loss (rather than a reasonable possibility of an insured loss).
- The proposal simply requires at least one scenario where the present value of net cash outflows can significantly exceed the present value of the premiums; the one exception is when substantially all of the insurance risk is transferred from the cedent to the reinsurer.
- Ceded premiums will be net of ceding commissions and other fees expected to be received from the reinsurer that are not contingent on claims experience.
- Reinsurance recoverables on unpaid losses will be adjusted for any loss sensitive features and estimated returnable amounts.
- Ceded reinsurance contracts assets would be recognized at the start of the reinsurance coverage period when coverage is based on aggregate losses of a portfolio of underlying reinsured contracts.

The proposal would require retrospective application to all prior periods. Applying this approach would require restating all prior periods as if the new accounting model had existed since contract inception dates. The FASB did not provide an effective date, and instead will seek input from users to assist in determining this date.

# Financial Trends

While rating agency views seem to be less pessimistic than recent years as evidenced by a consensus of stable outlooks for the industry and the slowing of downgrades in 2013, the key concerns of rating agencies are consistent with prior years. Rating agencies remain focused on companies' ability to generate an underwriting profit, maintain adequate reserves in the wake of many years of prior year releases and the impact of rising interest rates and inflation on both the investment portfolio and liabilities. The following pages discuss the key concerns in more detail.

## Underwriting Profitability

While the industry is demonstrating record capital levels, rating agencies remain focused on companies' ability to generate an underwriting profit. The triggers behind many rating changes—catastrophe losses, poor operating results, and poor capitalization—can be interrelated to some degree. However, recent rating actions, especially those resulting in a downgrade, are being driven primarily by general operating results. S&P has commented that the continued low interest rate environment makes them less forgiving of unsatisfactory combined ratios. As underwriting results have been negative in four of the last five years, insurers must focus on disciplined underwriting to drive earnings improvement. This is a key focus in the current environment with low reinvestment rates, higher catastrophe losses and less redundancy available to take reserve releases.

Our analysis shows that over the last five years poor operating results are the largest cause of A.M. Best downgrades from 'A-', comprising 27 percent. In recent years, we have seen poor operating results become a more important driver of rating changes, even impacting several highly rated, well capitalized companies. Our analysis shows that the median one-year and five-year combined ratio for companies downgraded from 'A-' to 'B++' was 20 and 11 points higher than all 'A-' rating units, respectively. When reviewing the various metrics of companies downgraded over the last five years, it is clear that operating performance plays a pivotal role in rating changes.

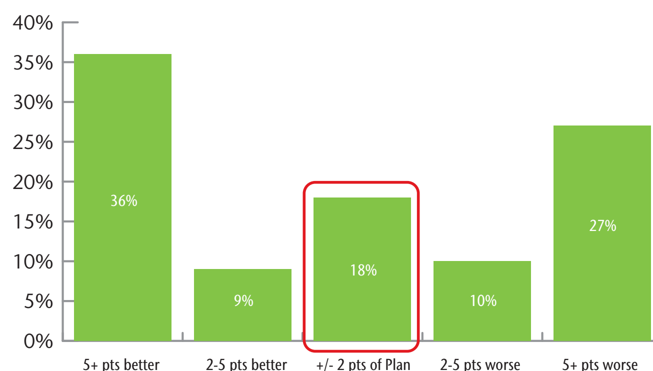
**Exhibit 15: "A-" Key Financial Metrics**

| Key Metrics—Median | "A-" to "B++" Downgrades (Year of Downgrade) | All "A-" Rating Units Through July 31, 2013 | "B++" to "A-" Own Merit Upgrades (Year of Upgrade) |
|---|---|---|---|
| Total Companies | 49 | 240 | 39 |
| Combined Ratio (%) | 121 | 101 | 91 |
| 5yr Comb. Ratio (%) | 111 | 100 | 88 |
| Pretax ROR (%) | -13 | 7 | 20 |
| 5yr Pretax ROR (%) | -3 | 9 | 20 |
| NPW/PHS (x) | 1.2 | 0.6 | 0.6 |
| BCAR (%) | 178 | 271 | 272 |

Sources: A.M. Best, Aon Benfield Analytics

Additionally, as companies provide rating agencies with projected financial statements that highlight improved future earnings potential, increased emphasis is placed on management's ability to execute and meet that plan. As noted in a study done by Aon Benfield and shown in Exhibit 16, only 18 percent of companies were within 2 combined ratio points of the financial plan they submitted to A.M. Best in April of that calendar year.

**Exhibit 16: Combined Ratio Difference: Actual vs. Plan**




Source: Aon Benfield Analytics

## Reserve Adequacy

A.M. Best notes reserve adequacy as a key risk and, historically, a main driver of P&C insurer insolvencies. A.M. Best indicated $11.8 billion (2.7 points of benefit to the combined ratio) of reserve releases were recognized in 2012, which marked the seventh consecutive year of favorable reserve development. A.M. Best notes some concern that while prior year reserves are being released, more recent accident years for some lines are showing an emerging pattern of adverse development. A.M. Best continues to believe that industry reserves will remain inadequate, although the inadequacy may be slightly offset by pricing improvements from 2011 and 2012.

S&P agrees that bolstering underwriting profitability from large reserve releases is a thing of the past for the U.S. commercial lines industry. While the pace has certainly slowed, S&P believes any further releases could strain reserve adequacy. They will be concerned if insurers begin releasing from recent accident years despite the current view that the P&C industry reserves are adequate.

Moody's, in a recent report on reserve adequacy, expects the P&C industry to continue to maintain a modest reserve redundancy position at year-end 2013. However, they expect that the redundancies will be personal lines and medical liability and that standard commercial lines will be even to slightly redundant.

## Interest Rates & Inflation

As interest rates are rising, P&C insurers are seeing the market value of their fixed income portfolios decline. Most bonds are held at amortized cost under statutory accounting which would not impact statutory surplus. However, A.M. Best applies an adjustment in the BCAR model for the difference in the market value versus book value (for the U.S. P&C industry, this adjustment was 8 percent of statutory surplus for year-end 2012). A decline in this adjustment will have a negative impact on most companies' year-end 2013 BCARs. Under GAAP accounting, unrealized losses on securities other than those classified as held to maturity flow through capital and would be recognized in the year-end balance sheet. Additionally, P&C insurers could face substantial losses if interest rates unexpectedly rise sharply.

S&P classifies inflation as a medium to high risk for the P&C industry, especially for longer tailed lines of business. A.M. Best has a similar view of inflation, and is particularly interested in the impact of an inflation shock scenario on reserves. Insurance companies seem to be concerned about inflation as well. Based on our analysis of SRQ responses (supplemental rating questionnaire—the vehicle through which A.M. Best inquires about company specific inflation risk), 46 percent of respondents in our sample population indicate they estimate how their reserves will be impacted by future changes in inflation. Of those companies, 82 percent are performing the evaluations on an annual basis, further indicating the emphasis on inflation risk.

# ERM and TRIPRA

Enterprise Risk Management has evolved to become an increasingly complex, yet essential feature in the operation and management of a successful insurance company. The growing sophistication of ERM within the industry has raised the bar for companies to build a risk framework that fits their internal culture and demonstrates that they are constantly managing and mitigating risk effectively throughout the organization. Rating Agencies have set standards for ERM as well, seeking to measure the efficiency and success within the company, and gain a better understanding of management's role in the process. Specific areas of concern for the industry in coming years include the expiration of TRIPRA in Dec 2014 and the NAIC ORSA requirement; both of which the rating agencies have also taken an active interest.

## ERM: The Next Five Years

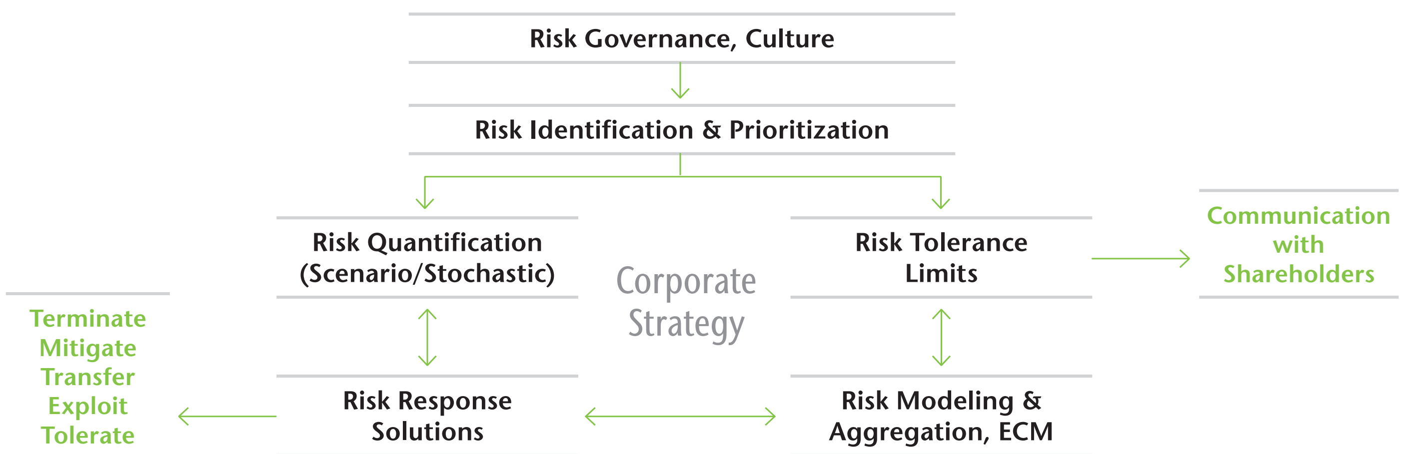
We believe that the future of ERM best practices will continue to evolve, with the successful companies focusing upon practical, tangible ERM activities built around:

- A foundation of solid data, accessible in a timely manner in order to be able to assess exposure to existing and emerging risks
- A solid exposure risk management framework with documented risk limits and aggregation monitoring, linked to a risk identification process
- An ERM framework to evaluate risks across silos to consider the impact of correlations, enforce consistency of the communication and evaluation of various risks
- A culture that embeds risk based discipline that incorporates timely data and actionable risk metrics, processes to track changes in exposures across time and silos, and encourages the imagination/intuition regarding what could go wrong and what could go right in an uncertain future, protecting the downside and exploiting opportunities.

In our experience, while different companies are biased towards an emphasis on either the quantitative or qualitative aspects of ERM, the successful ERM frameworks, where companies are actually using and embedding it into the culture, move beyond buzzwords to get to the ability to answer the following three questions:

1. How much risk does the firm have the capacity to accept?
2. Which risks do the firm chose to bear? Why?
3. For existing risks, how much of it does the firm currently have? How comfortable is management with that amount? Is risk growing or not?

ERM is not a stand-alone project or tool. It is a process, unique to each company's own circumstances, that pulls together management's philosophy of how they manage the company and communicate their approach to rating agencies, regulators, board members, clients, and employees. ERM should become a disciplined process, wrapped into a framework structured around the following components:



## Own Risk Solvency Assessment (ORSA)

One ERM topic that is increasing in concern among our client base is the new NAIC Own Risk Solvency Assessment (ORSA) requirement. In an effort to align the U.S. insurance regulatory framework with international regulatory principles, insurers will be required to provide an ORSA summary report to their domestic regulator. This report will need to document the company's ERM framework for identifying and quantifying risk, linked to the company's prospective solvency evaluation.

According to the NAIC ORSA Guidance Manual, published November 2011, there are two primary goals of the ORSA requirement:

1. To foster an effective level of enterprise risk management at all insurers, through which each insurer identifies and quantifies its material and relevant risks, using techniques that are appropriate to the nature, scale and complexity of the insurer's risks, in a manner that is adequate to support risk and capital decisions.

2. To provide a group level perspective on risk and capital, as a supplement to the existing legal entity view.

The NAIC staff indicates that ORSA will really be an ongoing process for most insurance organizations. The ORSA summary report is expected to cover three key sections:

**Section 1** – Description of the Insurer's Risk Management Framework

**Section 2** – Insurer Assessment of Risk Exposures

**Section 3** – Group Risk Capital and Prospective Solvency Assessment

For well managed insurance companies, existing risk management and financial planning processes should be sufficient to satisfy the ORSA requirement expectations. Those insurers will be focusing upon developing documentation around these processes, with an emphasis upon how prospective capital adequacy is monitored.

We expect to see a spectrum of approaches to this requirement, falling into the categories highlighted in the table below. Some companies will take a minimalistic "document what we are currently doing" approach, while others will be looking to enhance their current controls, oversight, and documentation.

We expect very few US based companies will seek to be in the "Elaborate" column near term, although there will be a few consultants pushing the idea that companies need to get their capabilities to the Elaborate column standard. While that objective will be beneficial to the consultants pushing that effort, our experience has shown the expense associated with the pursuit of that objective will leave many companies disappointed.

| | Minimalist | Balanced | Elaborate |
|---|---|---|---|
| Risk Management Framework | Documentation of firm's key risks and traditional risk management functions for investments, underwriting, claims, etc. | Additional ERM risk governance oversight framework and coordinated documentation building upon current executive management structure | Separate risk management function with cross responsibilities by legal entity and group, with accountability to CEO and board committees linked to detailed risk identification process with formalized risk tolerance, appetite and limits |
| Assessment of Risk Exposure | Quantification of key risk exposure via historical loss experience and catastrophe modeling supplemented with qualitative risk assessment | Formal view of volatility and target combined ratio by line of business; catastrophe PML assessment; stress test evaluation of asset risk and underwriting risk scenarios | Detailed risk identification process across all businesses linked to the development of formalized risk quantification and reporting process with data validation and controls for all risk functions |
| Group Risk | Multi-year pro-forma summary of financial plan under expected and stressed scenarios | Multi-year pro-forma summary of financial plan under expected and stressed scenarios, supplemented with view of key risks such as catastrophe and underwriting risk | Detailed, multi-year economic capital model results linking accident year, underwriting year and calendar year results on both economic and accounting basis across all dimensions with linkage to strategic decision-making, supplemented with detailed stress testing |

## A.M. Best Benchmarking

A.M. Best began requesting ERM information in the Supplemental Rating Questionnaire (SRQ) in April 2011. In the two years since, they have added additional questions in an effort to better accumulate information and understand how the industry thinks about ERM. A.M. Best expects the scope and complexity of an insurer's ERM process to be in-line with the complexity of the insurer's operations and risk profile. The ERM section of SRQ provides a consistent platform for analysis and discussion; Key ERM related discussion topics have been:

- Improvements to risk management process
- Lessons learned from recent events / results
- Articulating a clear risk tolerance
- Monitoring and mitigating emerging risks

A.M. Best's approach to risk management remains consistent, but has evolved as industry practices (and the operating environment) have changed. Balance sheet strength, operating performance and business profile remain the key drivers of a company's evaluation in its annual rating review. Risk management is viewed within the broader rating context rather than assigned a stand-alone rating. A.M. Best remains focused on their original risk management criteria and continues to note that risk management is not "one size fits all," meaning companies' risk management frameworks need to align with the risk and complexity of their organization. Discipline, common sense and patience are the most important elements of risk management.

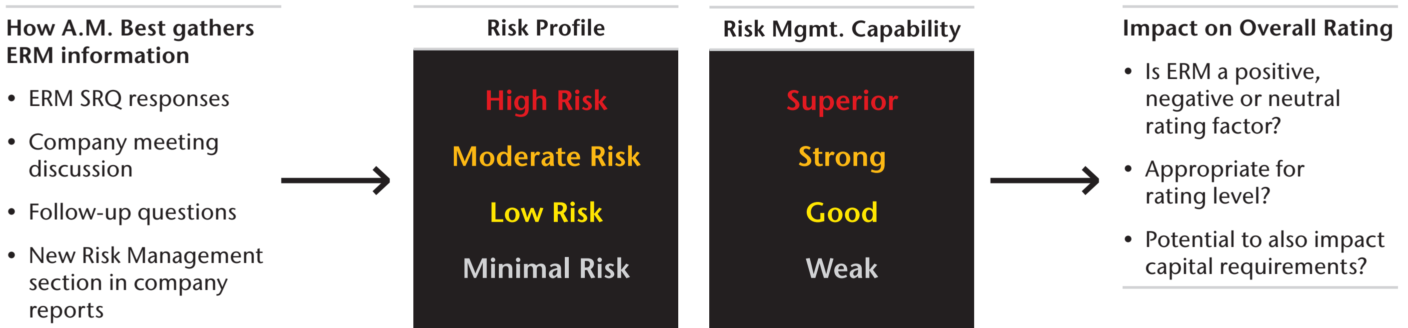
Aon Benfield conducts an annual study of client ERM SRQ responses. The rating and company size distribution of our study is in line with A.M. Best's overall distribution, making its findings broadly applicable for benchmarking purposes.

The 2013 key findings are:

- Regardless of size, most companies have a CRO / senior officer responsible for ERM, use BCAR as a one of the frameworks for capital adequacy and have risk tolerance statements considered 'general' compared by A.M. Best expectations
- Larger companies tend to report risk metrics more frequently to the Board, more consistently monitor emerging risks, use economic capital models and estimate the impact of inflation
- Only 30 percent of the companies reviewed disclose a risk tolerance to A.M. Best that defines both a stated dollar amount of risk tolerance as well as how often the company is exposing itself to a loss of that magnitude

A.M. Best has expressed frustration that the percentage is not higher, and is looking for companies to report more robust risk tolerance statements. Aon Benfield conducts a separate annual study analyzing publicly traded insurers' disclosed catastrophe risk tolerances. The results are summarized in the following section. Companies can look to these disclosures for guidance on various approaches to create or refine a view on risk tolerance.

In a paper released this year titled Emerging Technologies Pose Significant Risks with Possible Long-Tail Losses, A.M. Best discussed the risk of emerging technologies for P&C insurers. While there is nothing currently known that would rival the magnitude of asbestos losses to the industry, companies must be using ERM to identify, evaluate and address new risks. A.M. Best added a new question to the ERM section of the SRQ asking companies to identify emerging risks that could have an adverse financial impact to their company. According to Aon Benfield's SRQ study, 12 percent of companies reported a cyber related risk. Some of the risks identified by A.M. Best that could ultimately impact the P&C industry are radio frequency radiation, cyber (data/identity theft), fracking and nanotechnogy.



## Cat Risk Tolerance Study

Beginning in 2007, Aon Benfield began compiling and analyzing the risk tolerance statements that the publicly traded insurers made in order to provide the industry an understanding of how these companies quantified and managed their corporate wide risk. The study evolved into the Catastrophe Risk Tolerance study as virtually all non-life companies express a risk tolerance related to catastrophe exposure. The catastrophe risk tolerance statements are generally presented as the percentage of equity a company is willing to expose at a stated return period.

The study includes 99 companies from the U.S., Bermuda, London, Japan as well as the global insurers and reinsurers. In the past six years the percentage of companies reporting some risk tolerance threshold has increased from 77 percent to 88 percent. Disclosures vary by sector, with Commercial Lines and Reinsurance companies using net PML most often, while noting a reinsurance structure was most commonly the form of disclosure for Personal Lines carriers.

Aon Benfield's post-Katrina risk tolerance study indicates that a catastrophe loss can range from three to six percent of a company's equity for primary companies and twelve to nineteen percent for reinsurers before impacting stock price by more than ten percent. The average 100yr PML risk tolerance disclosure for primary and reinsurance companies is in-line with Aon Benfield's post-Katrina study. Market results from Sandy were consistent with the lower end of the Katrina study tolerance.

**Exhibit 17: Public Company Catastrophe Risk Tolerance Disclosures**

| Year | Percent Reporting* |
|---|---|
| 2012 | 88% |
| 2011 | 88% |
| 2010 | 83% |
| 2009 | 87% |
| 2008 | 82% |
| 2007 | 77% |

Sources: Company Reports, Aon Benfield Analytics

Exhibit 18 shows the summary results for disclosures at the 100 year return period as well as the 250 year return period (on an after-tax basis) for the past three years, segregated between insurers and reinsurers.

The fluctuations between catastrophe risk tolerance percentages year to year are generally driven by capital levels more than risk tolerances, as we find that many companies are not adjusting their disclosed risk tolerances from year to year. Insurers are on average exposing four percent of their capital at the 100 year return period while reinsurers are exposing 14 percent; at the 250 year return period insurers are exposing six percent while reinsurers are exposing 18 percent.

Interestingly, more than 75 percent of “Strong” and “Adequate” S&P ERM ratings disclosed net PML as their risk tolerance measures; likewise, “Excellent”, “Adequate with a positive trend” and “Adequate” ERM ratings often used net PML. The following exhibits show the ERM distributions by S&P ERM rating as well as the distributions within each ERM rating of the disclosure approach.

**Exhibit 18: Catastrophe Risk Tolerance Disclosure Trend Analysis**

**1:100 After Tax Net PML as a Percent of Equity (Insurers)**

| Year | Count | Low | Mean | High | Median |
|---|---|---|---|---|---|
| 2012 | 15 | 2% | 4% | 16% | 6.0% |
| 2011 | 15 | 1% | 4% | 16% | 5.0% |
| 2010 | 13 | 1% | 4% | 16% | 5.0% |

**1:100 After Tax Net PML as a Percent of Equity (Reinsurers)**

| Year | Count | Low | Mean | High | Median |
|---|---|---|---|---|---|
| 2012 | 8 | 9% | 14% | 20% | 15.4% |
| 2011 | 8 | 9% | 13% | 22% | 14.2% |
| 2010 | 3 | 12% | 17% | 26% | 22.9% |

**1:250 After Tax Net PML as a Percent of Equity (Insurers)**

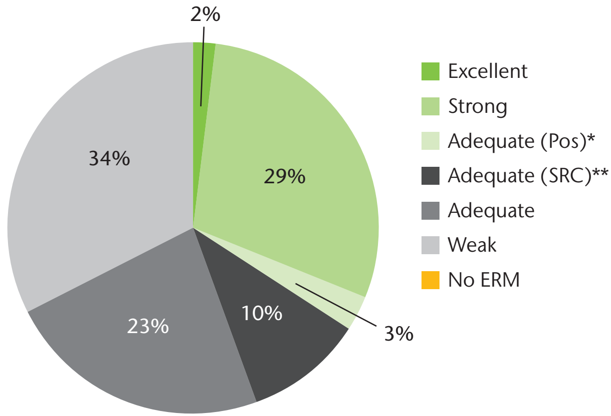
| Year | Count | Low | Mean | High | Median |
|---|---|---|---|---|---|
| 2012 | 17 | 1% | 6% | 29% | 8.5% |
| 2011 | 16 | 1% | 7% | 31% | 10.7% |
| 2010 | 13 | 1% | 5% | 31% | 9.0% |

**1:250 After Tax Net PML as a Percent of Equity (Reinsurers)**

| Year | Count | Low | Mean | High | Median |
|---|---|---|---|---|---|
| 2012 | 7 | 14% | 18% | 25% | 20.0% |
| 2011 | 7 | 10% | 17% | 21% | 16.2% |
| 2010 | 6 | 16% | 21% | 33% | 19.6% |

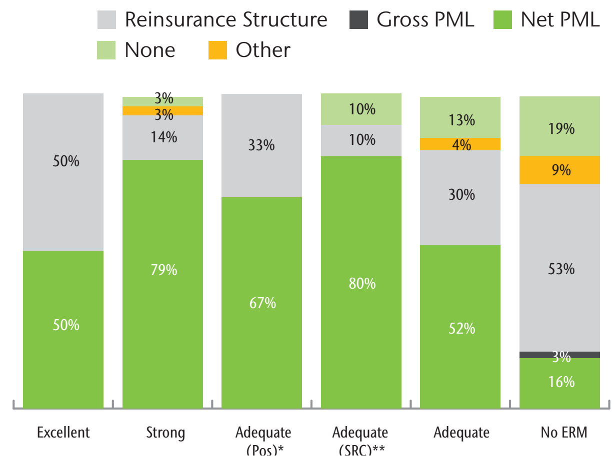
Sources: Company Reports, Aon Benfield Analytics

**Exhibit 19: S&P ERM Rating Distribution**




Sources: S&P, Aon Benfield Analytics

**Exhibit 20: S&P ERM Rating Distribution**




Sources: S&P, Aon Benfield Analytics

## TRIPRA

The U.S. federal terrorism backstop, (known as TRIPRA) is set to expire on December 31, 2014. The upcoming deadline has become a topic of growing concern for the insurance industry. Congressional hearings to extend the legislation have been ongoing since 2012, but minimal progress has been made through 2013. In addition, with the recent government shutdown, there is added concern that TRIPRA discussions will be pushed back even further. Insurers are facing the possibility that TRIPRA may not be extended beyond 2014, or might be modified from its current format. In addition, the rating agencies have released commentary regarding the impact that changes to TRIPRA would have on certain companies and their expectations for managing the uncertainty going forward. To meet the rating agencies expectations, insurers will need to develop risk mitigation practices to reflect the adaptation to changes in the legislation, including the potential expiration of the federal terrorism backstop.

Recent updates on the U.S. terrorism reinsurance market have noted that this sector remains relatively inactive. The general perception is that the threat of terrorism is lower than in the previous years, an outlook reflected in reduced vendor-model expected losses from U.S. terrorism events. Insurers have developed strategies to deal with terrorism exposure, without significant losses in over a decade and with the benefit of the TRIPRA backstop.

It was also noted in the recent updates, however, that there were several factors that could turn the market, among them a reduction in or elimination of the federal TRIPRA backstop and increased scrutiny by rating agencies on clients' terrorism exposures. It now appears that these two influences are gaining strength and may lead to increased activity in the stand-alone U.S. terrorism market. The prospects for the extension of TRIPRA are less certain than at either of the two earlier scheduled lapses.

As the federal backstop expiration approaches in 2014, A.M Best indicated that the terror stress test will receive greater emphasis. According to A.M. Best: "Companies that fail the stress test will be required to present an action plan detailing the steps that will be taken to reduce exposure to terrorism risk in the event that a recovery from the federal backstop expires or is unavailable." In today's environment, A.M. Best feels it is imperative that insurers are properly managing their terrorism risk. A.M. Best has stated they will begin reflecting the growing uncertainty in the terrorism marketplace by revising outlooks of applicable companies to "negative" in 2013 for those companies who fail the terror stress test and are unable to provide a sound plan for reducing key exposures. So far in 2013, no rating action has been taken as a result of the impending TRIPRA expiration.

S&P's updated Insurer Rating Criteria included an assessment of terrorism risk in the Risk Position sub-factor. Companies with significant exposure will need to address the risk; otherwise their rating may be impacted. Furthermore, S&P has indicated that if a given insurer loses more than one year's worth of earnings, or experiences terrorism losses outside of its stated risk tolerances and appeared as an outlier relative to its peers, they would likely take negative rating action.

Aon Benfield believes that TRIPRA continues to be a vital support mechanism for U.S. commercial insurance industry and provides necessary capital stability to the market as a federal backstop. The commercial terrorism market will be heavily impacted if TRIPRA is not extended. Reinsurance will be utilized to fill in a portion of the missing $100 billion of federal terrorism coverage. Commercial exposures in key metropolitan areas will be the most significantly impacted, and pricing of terror coverage in these areas will likely increase as a result. Aon Benfield is a strong supporter of TRIPRA legislation being renewed and we believe that the legislation will ultimately be extended in some fashion.

# Conclusion

While rating activity in 2013 has been stable relative to the downgrade environment from the previous three years, companies continue to face challenges in managing rating agency expectations. The U.S. P&C industry has a record level of capital and competition remains fierce, even with results improving. Per SNL Financial, the industry's combined ratio through June 2013 is at 98 percent, which is 4 points better than the same period a year ago. Also, 2013 has proven to be a quiet hurricane season (so far), which should help keep the combined ratio in check. However, a number of companies are battling the emergence of adverse loss development which will dampen what would have been a strong underwriting year if the hurricane season remains quiet. In addition, generating an underwriting profit is key for insurers to meet return expectations as prolonged low yields have dampened the ability to meet returns on investment results alone. Interest rates have steadily risen in 2013 with the 10 year Treasury yield up by almost 100 basis points. While this is good news for investing new money, it places pressures on the market value of current bonds.

All the while, insurers needed to stay abreast of and meet the challenges of rating agency criteria changes, most notably S&P's new Insurance Criteria and changes to the A.M. Best BCAR model. While these and other criteria changes did not overhaul the rating landscape, there were some insurers whose ratings or outlook were impacted by the S&P new criteria and others whose BCAR capital adequacy reduced to an uncomfortable level and need to explore capital management plans. As companies continue to fight for rate adequacy and maintain reserve adequacy, we believe the remainder of 2013 and into 2014 there will be a number of key themes that insurers and rating agencies will be discussing are:

- Profitability and Meeting Plan
- The Future of ERM
- TRIPRA
- Catastrophe Expectations
- Insurance Accounting Standards

In addition to the above, it will be important for insurers to continue to understand and manage the evolving criteria from rating agencies, regulators and accounting guidelines.

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