

**2008 NCIGF/IAIR Joint Conference  
Scottsdale, AZ**

**Troubled Company  
Factors: The A.M. Best  
Perspective**

**Andrew Colannino  
Vice President  
Property/Casualty Division  
November 6, 2008**



# Discussion Topics

- **A.M. Best Rating Evaluation**
- **Financially Impaired Companies**
- **Tipping Point Factors**
- **Key Rating Issues**
- **P/C Financial Overview / Outlook**

# Objective of A.M. Best's Financial Strength Ratings

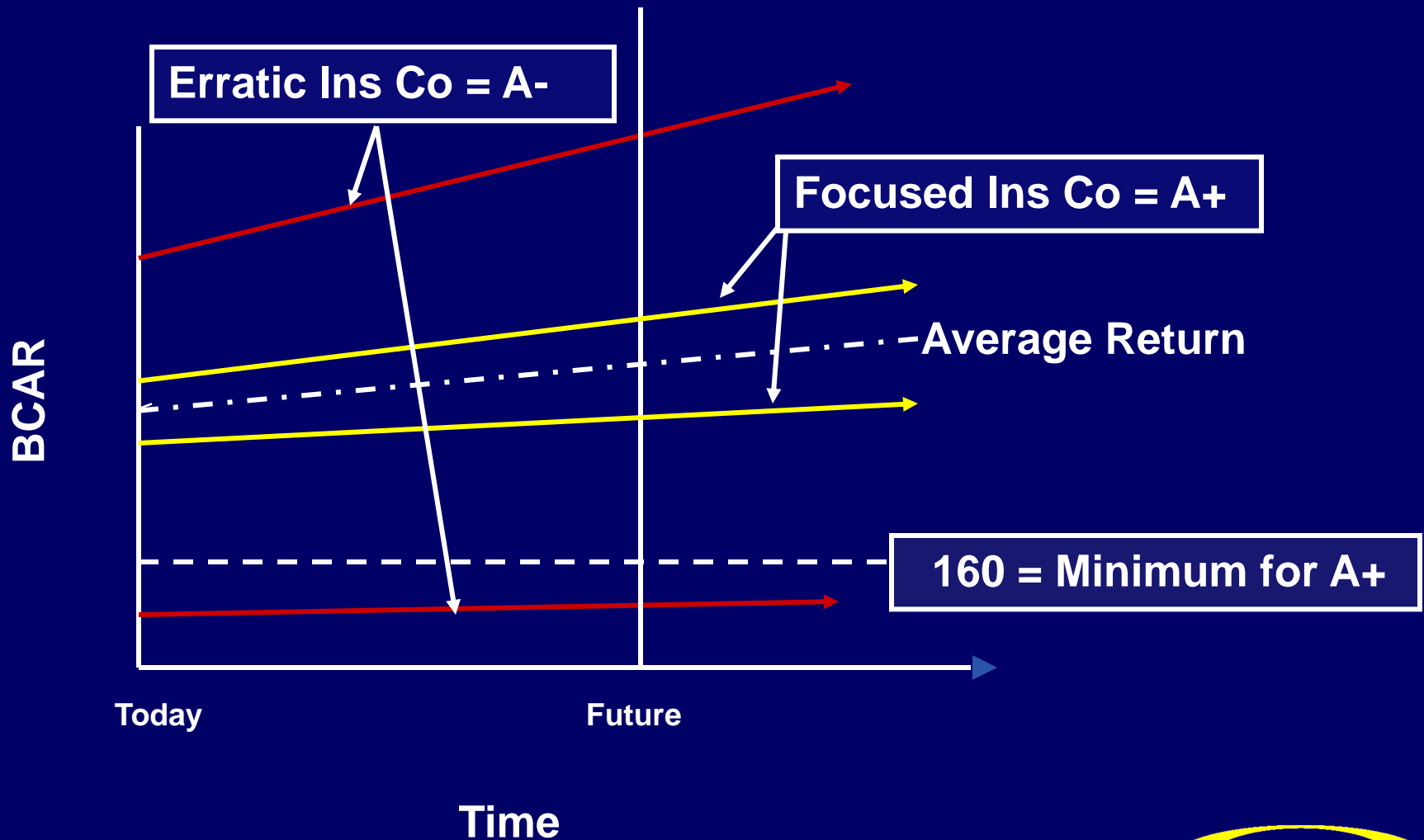
To perform a *constructive* and  
*objective* role in the insurance  
industry toward the prevention  
and detection of insurer insolvency



# A.M. Best's Rating Evaluation Key Components



# Impact of Operating Performance and Business Profile – Examples



# A.M. Best's Rating Evaluation Rating Considerations



<b>Balance Sheet Strength</b>	<b>Outstanding</b>	<b>Weak</b>
<b>Operating Performance</b>	<b>Very Stable/Strong</b>	<b>Volatile/Poor</b>
<b>Business Profile</b>	<b>Strong / Sustainable Advantages Well-Diversified</b>	<b>Questionable Viability Competitive Disadvantages Concentrated Risk</b>

# Financially Impaired Companies



# Financially Impaired Companies

## A.M. Best's Definition

The first official regulatory action taken by an insurance department, whereby the insurer's:

- Ability to conduct normal operations is adversely affected;
- Capital and surplus have been deemed inadequate to meet legal requirements; and/or
- General financial condition has triggered regulatory concern

# Rating Definitions

## E (Under Regulatory Supervision)

**Companies placed by an insurance regulatory authority under a significant form of supervision, control or restraint, whereby they are no longer allowed to conduct normal ongoing insurance operations. Includes:**

- **Conservatorship**
- **Rehabilitation**
- **May include cease and desist orders by regulators outside the company's home state or country**

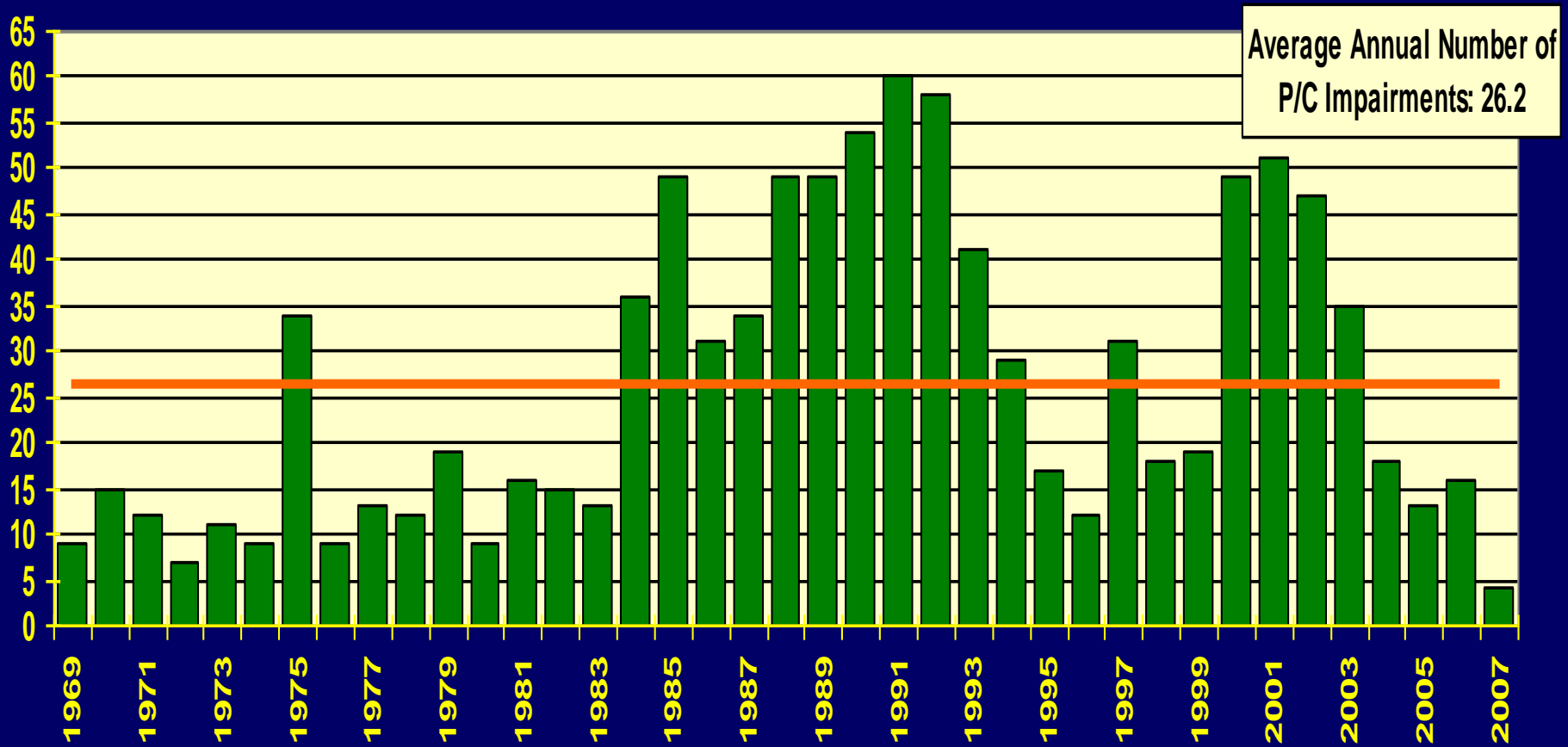
# Rating Definitions

## **F (In liquidation)**

**Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company.**

**Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.**

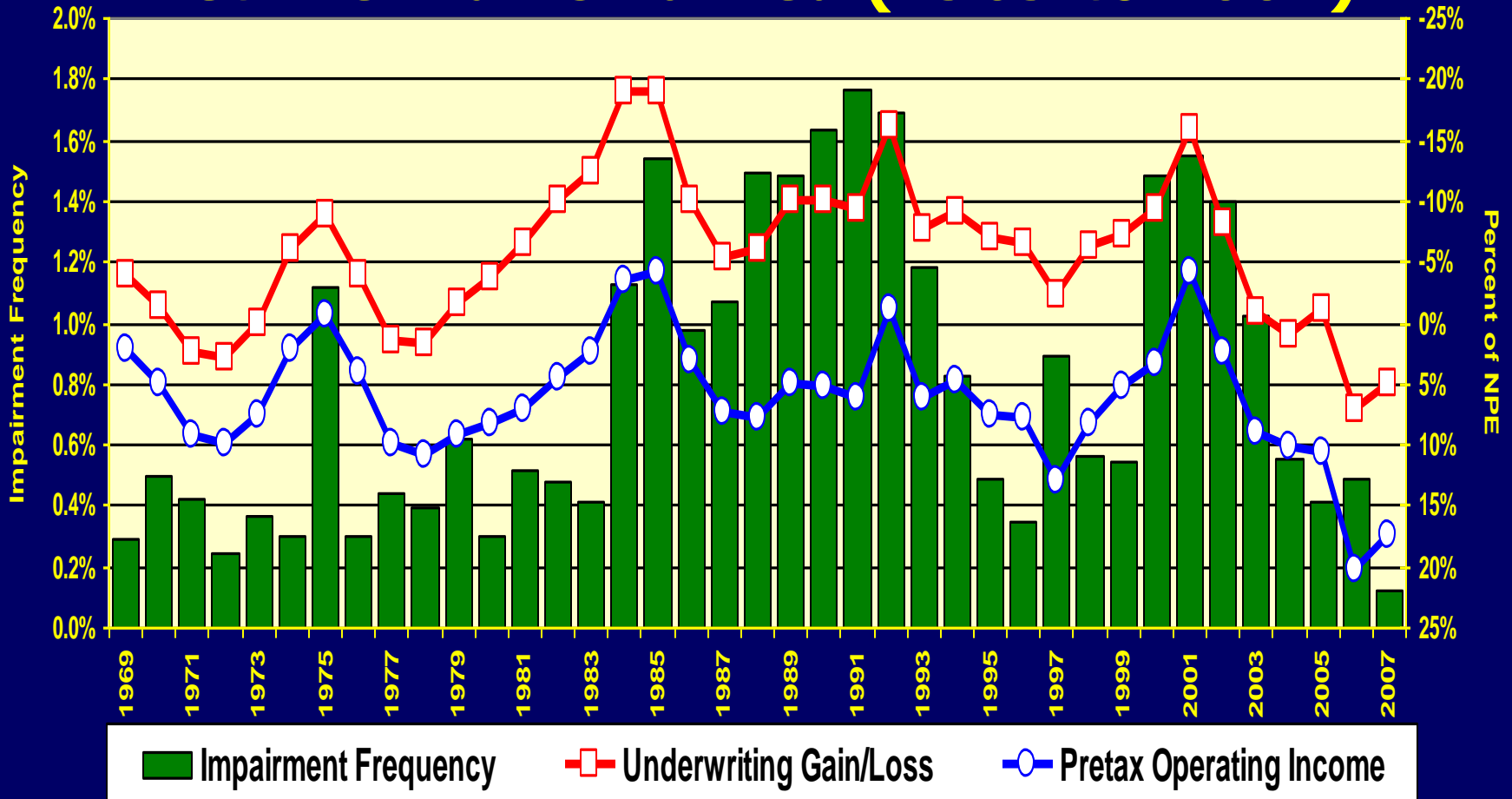
# Annual Number of P/C Impairments (1969 to 2007)



Source: A.M. Best



# P/C Impairment Frequency vs. Underwriting and Pretax Operating Incomes as a Percent of Net Premiums Earned (1969 to 2007)



Income ratios axis inverted to show correlation.

Source: A.M. Best and Best's BestLink



# Tipping Point Factors



# Tipping Point Factors

## Excessive Top Line Growth

- **Inadequate Pricing**
- **Stretched Infrastructure**
  - **Underwriting**
  - **Claims**
- **New lines of business**
- **Leads to Inadequate Loss Reserves**

# Tipping Point Factors

## Reserve Instability/Development

- **Optimism During Softening Markets**
- **History of Unfavorable Development**
- **Current P/C Environment**
  - **Critical Time**
  - **Pay close attention to trends**
  - **Reject temptation**

# Loss & ALAE Reserve Adequacy

	Estimated Reserve	
	Deficiency (\$B)	
	12/31/06	12/31/07
<b>Product Line</b>		
Workers' Compensation	6.3	6.0
Reins - Nonprop Assumed	3.5	3.2
Other/Products Liability	1.3	3.1
Commercial Multiple Peril	0.5	1.0
Medical Malpractice	0.1	0.6
Commercial Auto Liability	0.0	0.3
Homeowners	(0.5)	(0.7)
Personal Auto Liability	(2.2)	(1.0)
All Other Lines	(1.0)	(0.5)
Total Core Reserves	8.0	12.0
Asbestos and Environmental	24.6	22.4
<b>Total</b>	<b>\$32.6</b>	<b>\$34.4</b>



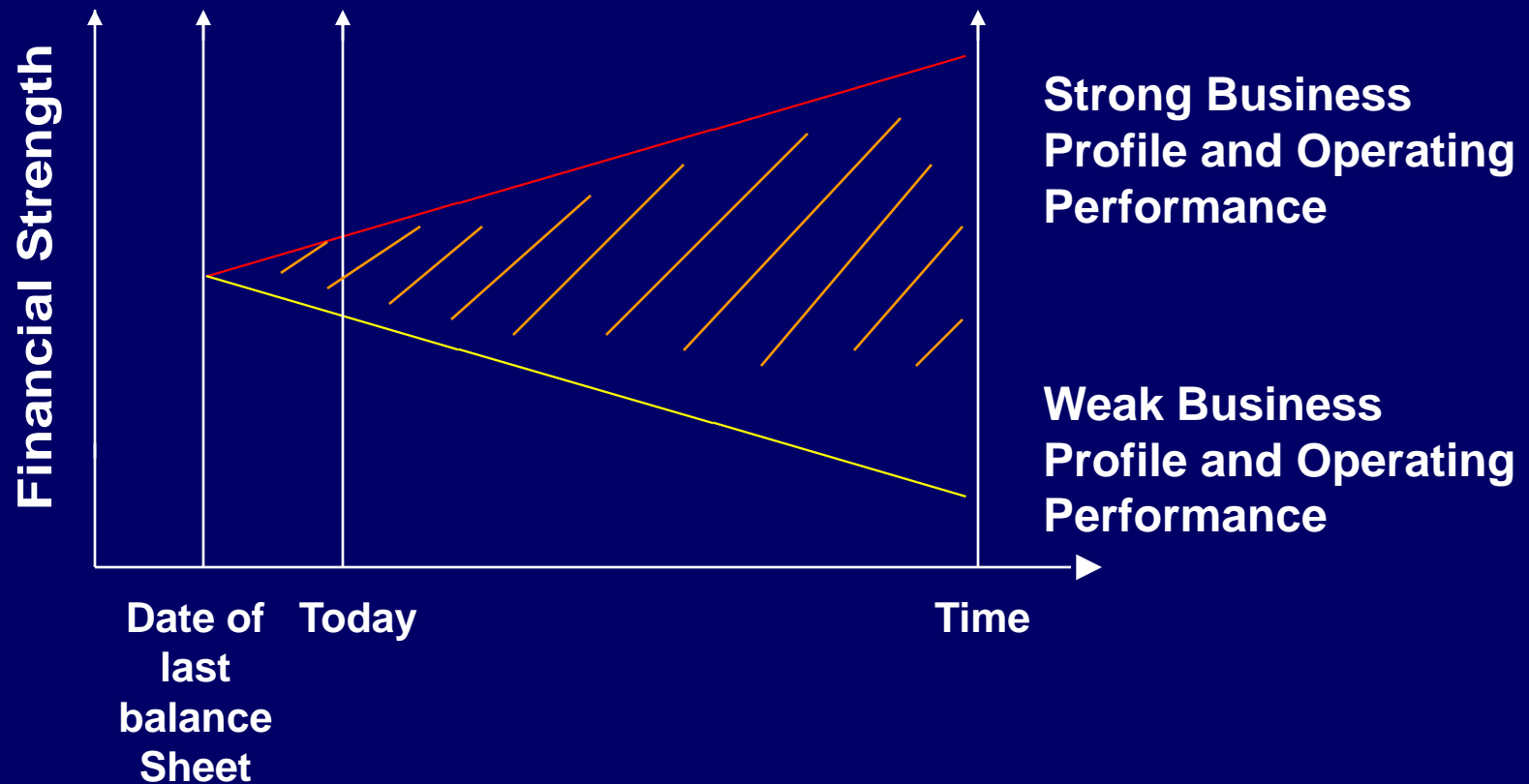
# Tipping Point Factors

## Weak Operating Results

- Ineffective Cycle Management
- Focus on Top-line Growth
- Lack of Strong Underwriting Culture
- High Expenses
- Lack of Underwriting Controls
- Leads to Capital Deterioration

# Why Business Profile & Operating Performance are Important

Leading Indicators of the Future Balance Sheet



# Tipping Point Factors

## Thin Capitalization

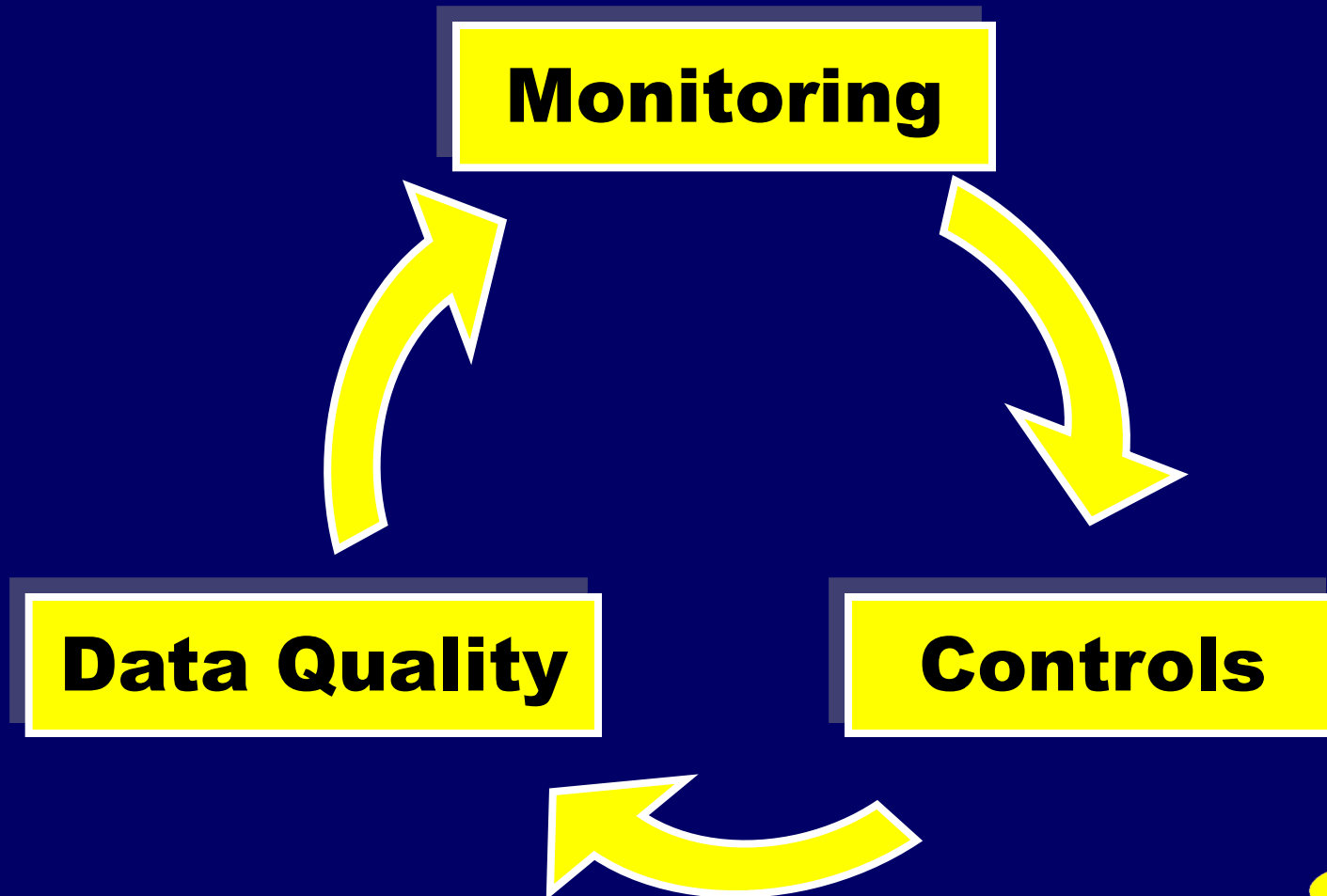
- **High Underwriting Leverage**
- **High Investment Leverage / Volatility**
- **Excessive Reinsurance Dependence**
- **Lack of Cushion to Absorb Downturn in Operating Results**
  - **Company Specific**
  - **Downturn in Underwriting Cycle**

# Tipping Point Factors

## Lack of Strong Catastrophe Management

- Catastrophe risk is a primary threat to solvency
- No single exposure can affect policyholder security more instantaneously than catastrophes

# Keys to Strong Catastrophe Management



# Companies With Strong Catastrophe Management

- **Have strong risk-adjusted capitalization**
- **Utilize a variety of catastrophe management approaches**
- **Contemplate a range of possible events**
- **Have a clearly defined strategic objective in terms of catastrophic exposure management**
- **Continually monitor catastrophe exposures**



# Other Tipping Point Factors

- **Surplus Erosion**
- **Distressed Parent and/or Non Property/Casualty affiliates**
- **Lack of Sufficient Enterprise Risk Management**

# Key Rating Issues



# Key Rating Issues

- **Underwriting skills/Cycle management**
  - How do they differentiate themselves in the market?
  - Underwriting culture
  - Limits profile
- **Capital management**
  - Basis for managing capital
  - Historic track record / Financial Leverage
  - Future plans
  - Dividends / Stock Repurchases
- **Enterprise Risk Management**
  - Is ERM a priority?
  - Is risk a key element in decision making?
  - Is the importance of risk management understood throughout the organization?
  - Are risks measured on a consistent basis?

# Key Rating Issues

- **Exposure management**
  - Data quality
  - How do you ensure proper coding?
  - Is this integrated into underwriting operations?
  - Use of reinsurance
- Focus on long-term profitability consistent with expectations

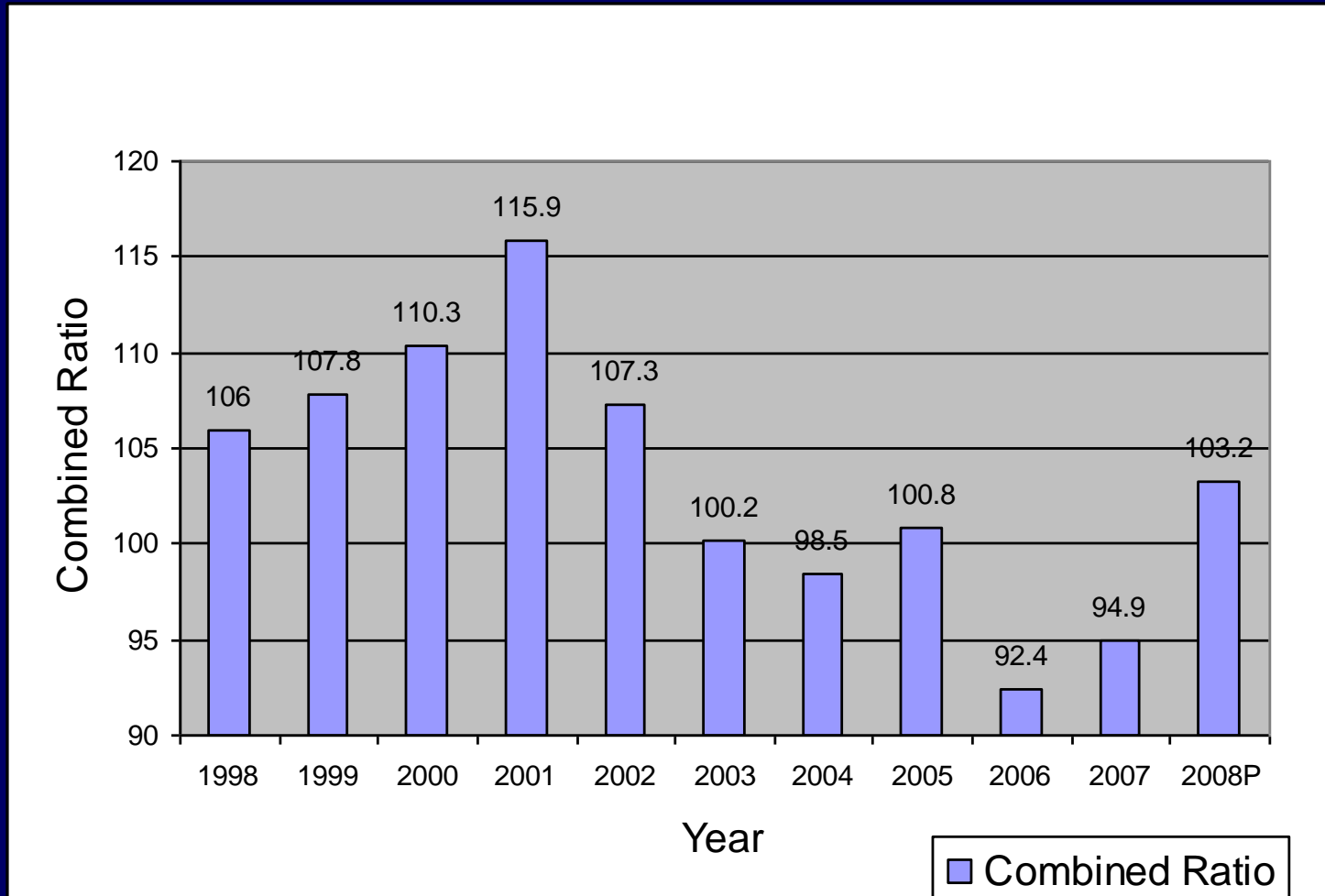
# Key Rating Issues

- **Financial Flexibility**
  - Capital structure
  - Contingencies in place
  - Liquidity
- **Current Financial Market Uncertainty**
  - Capital Adequacy Remains Strong
  - Capital Market Solutions Limited
  - Review of Impaired Securities
  - Government Rescue of Financial Institutions
  - Continued Moderating Individual Ratings

# Financial Overview



# Industry Combined Ratios



Source: A.M. Best Company



# Key Property/Casualty Financial Indicators

	<u>2006</u>	<u>2007</u>	<u>1H08</u>
Change in Net Premiums Written (%)	3.9	-0.9	-0.7
Change in Surplus (%)	14.9	7.1	-2.4
Combined Ratio (Reported)	92.4	94.9	102.1
Change in Net Investment Income (%)	5.5	2.3	2.9
Net Investment Yield (%)	4.5	4.5	4.2
Pre-tax Return on NPE (ROR) (%)	19.9	17.4	9.9
After-tax Return on Surplus (ROE) (%)	15.0	13.0	9.5



# Property/Casualty Industry Underwriting Details

	<u>2006</u>	<u>2007</u>	<u>2008P</u>
Net Written Premium Growth (%)	3.9	-0.9	-0.7
Combined Ratio (Reported)	92.4	94.9	103.2
Less: Catastrophe Losses (%)	2.1	1.5	5.5
Less: A&E Losses (%)	0.6	0.4	0.3
CY Combined Ratio (Normalized)	89.7	93.0	97.4
Less: Core Loss Reserve Dev. (%)	-1.7	-2.2	-1.6
AY Combined Ratio (Normalized)	91.4	95.2	99.0



# Segment Underwriting Details

## Commercial Lines

### Stable Outlook

	<u>2006</u>	<u>2007</u>	<u>2008P</u>
Net Written Premium Growth (%)	3.5	-0.4	-3.0
Combined Ratio (Reported)	91.2	93.7	104.0
Less: Catastrophe Losses (%)	1.0	0.7	5.0
Less: A&E Losses (%)	1.0	0.7	0.6
CY Combined Ratio (Normalized)	89.3	92.2	98.5
Less: Core Loss Reserve Dev. (%)	-1.1	-3.9	-1.1
AY Combined Ratio (Normalized)	90.4	96.1	99.6



# Segment Underwriting Details

## Personal Lines

### Stable Outlook

	<u>2006</u>	<u>2007</u>	<u>2008P</u>
Net Written Premium Growth (%)	2.0	0.0	1.0
Combined Ratio (Reported)	93.3	96.1	102.5
Less: Catastrophe Losses (%)	3.2	2.1	7.0
Less: A&E Losses (%)	0.2	0.1	0.1
CY Combined Ratio (Normalized)	89.9	93.9	95.4
Less: Core Loss Reserve Dev. (%)	-3.2	-1.3	-2.6
AY Combined Ratio (Normalized)	93.1	95.2	98.0



# Segment Underwriting Details

## Reinsurance

### Stable Outlook

	<u>2006</u>	<u>2007</u>	<u>2008P</u>
Net Written Premium Growth (%)	28.1	-11.9	4.0
Combined Ratio (Reported)	94.5	94.4	103.0
Less: Catastrophe Losses (%)	1.2	2.1	6.0
Less: A&E Losses (%)	1.0	1.1	0.8
CY Combined Ratio (Normalized)	92.4	91.2	96.2
Less: Core Loss Reserve Dev. (%)	6.6	2.7	2.3
AY Combined Ratio (Normalized)	85.8	88.5	93.9



# Short Term Market Expectations

- **AIG Impact**
- **Hurricane Ike and Accumulated Catastrophe Losses**
- **Financial Market Uncertainty**
- **The Minority Can Drive the Market**

# Long Term Market Expectations

- **Soft Market Not as Severe as Past Cycles**
- **Cycle Management Tested; Underwriting Profits Diminish**
- **Investment Earnings Volatility**
- **Strengthened Balance Sheets and Premium and Profit Pressures Facilitate More M&A**

**Questions?**

