A.M. Best 19th Annual Insurance Ratings Conference
2012 Review & Preview

A.M. Best held its 2012 Review & Preview Conference on March 12-14, 2012. Before the conference, A.M. Best published a Review & Preview Special Report on each sector of the U.S. insurance industry: (1) Property/Casualty; (2) Health; and (3) Life/Annuity. The Special Reports are available on the A.M. Best Website.

This document provides some highlights of the conference sessions dedicated to the Property/Casualty ("P/C") Review & Preview, U.S. industrywide trends, and risk management.

U.S. P/C Review & Preview

Segment: **Commercial Lines** | Outlook: ***Negative***

First, the good news.

1. **Signs of price hardening.** However, A.M. Best shied away from characterizing 2011's market as a hard market.
2. **Low interest rates.** Many in the segment took advantage of low interest rates to refinance debt.
3. **Government bond values survive downgrades.** The value of the segment's sizable holdings of U.S. Treasuries and municipal bonds was not materially affected by rating agency downgrades of those governmental issuers.
4. **Positive cash flow.** The segment had positive cash flow for the year.
5. **Risk-adjusted capital levels weather reserve weakening.** Notwithstanding reserve weakening, the segment maintained strong risk-adjusted capital levels.

Now, the bad news.

1. **Extended soft market.** Because of an extended soft market, the segment's net premium written ("NPW") in 2011 is still less than NPW in 2006. A.M. Best observed that pricing is softest in the Workers' Compensation and General Liability markets.
2. **Macroeconomic headwinds limiting growth.** Factors such as slow U.S. GDP growth, high unemployment, limited commercial lending, and restricted corporate spending have limited exposure growth in commercial lines of business. Borrowing a phrase from the III's Bob Hartwig, A.M. Best observed that the weak macroeconomic environment had led to "the mass destruction of exposure."
3. **Catastrophe frequency.** The segment experienced a high frequency of catastrophe losses.
4. **Low interest rates.** Investment returns remained weak because of historically low yields.
5. **Diminishing reserve redundancies.** There were thinner reserve redundancies available for release. In fact, A.M. Best observed that lines like Workers' Compensation and General Liability were starting to develop adversely.

The following table was created by A.M. Best and disseminated at the conference.

Segment Underwriting Details
Commercial Lines

	2010	2011E	2012P
Net Written Premium Growth (%)	-1.6	4.1	4.2
Combined Ratio (Reported)	102.7	108.2	103.9
Less: Catastrophe Losses (%)	3.5	8.5	4.0
Less: A&E Losses (%)	1.6	1.2	1.1
CY Combined Ratio (Normalized)	97.6	98.5	98.8
Less: Core Loss Reserve Dev. (%)	-2.7	-2.3	-1.7
AY Combined Ratio (Normalized)	100.3	100.8	100.5

Segment: **Personal Lines** | Outlook: *Stable*

A.M. Best stated that the divergent trends in automobile insurance—stable performance—and homeowners insurance—extremely volatile—continued in 2011. According to A.M. Best:

1. **Increased severity offset by reduced frequency.** Higher claim severity in the automobile line of business was offset by favorable frequency trends.
2. **Trend toward increased direct distribution.** Some automobile insurers are expanding distribution by supplementing their agency distribution with direct distribution.
3. **PPA combined ratios more stable than HO.** Combined ratios for the automobile line of business in the years 2007 to 2011 have been in the range 98.3% to 101.3%. For the same period, combined ratios for the homeowners line of business have been in the range 95.7% to 123.7%.
4. **Consolidation trends.** Stable performance in automobile insurance partly accounted for consolidation in that industry: the top ten automobile insurers wrote 68.4% of direct premiums in 2010, whereas they wrote only 58.9% of direct premiums in 2000. In contrast, volatility in homeowners insurance caused insurers to reduce their homeowners exposures, which partly accounted for a move away from consolidation in that industry: the top ten homeowners insurers wrote 65.6% of direct premiums in 2000 but only 62.4% of direct premiums in 2010.

The following table was created by A.M. Best and disseminated at the conference.

Segment Underwriting Details
Personal Lines

	2010	2011E	2012P
Net Written Premium Growth (%)	3.3	2.5	3.0
Combined Ratio (Reported)	100.4	107.4	101.7
Less: Catastrophe Losses (%)	5.3	10.5	5.0
Less: A&E Losses (%)	0.1	0.1	0.1
CY Combined Ratio (Normalized)	95.1	96.8	96.6
Less: Core Loss Reserve Dev. (%)	-4.1	-4.2	-3.4
AY Combined Ratio (Normalized)	99.2	101.0	100.0

Segment: **Reinsurance** | Outlook: ***Stable***

Despite significant catastrophe-driven losses, the reinsurance segment again demonstrated its resiliency according to A.M. Best.

1. **Capitalization remains strong.** A.M. Best observed that reinsurers incurred losses largely within their stated risk appetites. Accordingly, the segment's capitalization remained strong on both an absolute and risk-adjusted basis.
2. **Property pricing is up.** Pricing improved in the lines exposed to property catastrophes. However, A.M. Best stated that casualty lines pricing "has bottomed out".
3. **Challenging investment environment.** Low investment yields and uncertainty in global financial markets are persistent challenges.
4. **Likely price hardening driven by 'Big Four'.** A.M. Best observed that, with a combined ratio of 109.5%, the so-called Big Four European reinsurers (Hannover Re, Munich Re, SCOR, and Swiss Re) are likely to use their market strength to drive price hardening, which would likely drive price hardening in other reinsurance markets as well.

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U.S. Industrywide Trends

Rating Distribution by FSR

1. A.M. Best observed that, between 2006 and 2011, the distribution of FSRs has remained consistent despite the many challenges faced by the industry during that period. A snapshot of a recent distribution shown in a slide created by A.M. Best and distributed at the conference appears in the following table:

Number of Companies	FSR
16	A++
55	A+
228	A
251	A-
95	B++
66	B+
47	Vulnerable

2. In a slide showing the FSR distribution by surplus size, A.M. Best stated: "While there are more larger-sized companies with a superior FSR, surplus size, by itself, is not a prerequisite to achieve a superior rating."

Trends by FSR

1. The five-year median BCAR for the U.S. industry was 245. The five-year median BCARs by FSR were shown in a slide created by A.M. Best and distributed at the conference, and they are summarized in the following table:

FSR	Five-Year Median BCAR
A++	282
A+	278
A	287
A-	249
B++	217
B+	177
Vulnerable	133

A.M. Best emphasized, though, that it does not expect rating units to manage to a particular BCAR score.

2. Between 2006 and 2011, underwriting performance, ROE and investment yields have largely deteriorated regardless of FSR. A.M. Best commented that rating committees are paying close attention to whether companies are taking on more investment risk in order to compensate for the low investment yields of late.

3. A.M. Best announced that it will soon release a Special Report analyzing recent trends by organizational form: Mutual vs. Stock.

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Risk Management

1. A.M. Best stated that rating committees carefully evaluate each company's risk profile and whether the companies have in place the capabilities required to manage their risks. For illustrative purposes, A.M. Best described risk profiles as minimal, low, moderate, or high and risk management capabilities as weak, good, strong, or superior. Thus, for example, A.M. Best would view as a positive rating factor a low risk profile matched with strong risk management capabilities.

2. A.M. Best explained that a qualitative assessment of a company's risk management capabilities involves an evaluation of a company's traditional risk management capabilities and its enterprise risk management capabilities.
    a. Traditional risk management involves managing risks by "silo."
    b. In contrast, enterprise risk management involves the capabilities asked about on the SRQ: a risk-aware corporate culture; personnel dedicated to risk management; quantification of risk appetite/tolerance; and identification and management of risks and their correlations.

3. After reviewing answers to the inaugural set of ERM questions on the 2010 SRQ, A.M. Best observed:
    a. Fewer than half of the companies responding defined their risk tolerances at a level more granular than the overall level.
    b. At least 90% of the responses to the question on management's overall appetite/tolerance for risk were inadequate, because the risk appetites/tolerances were not quantifiable.
    c. Only 28% of responding companies used economic capital models to quantify their aggregate risk. Although most companies who used economic capital models used them to make key business decisions, only 27% used the models to determine a portion of management compensation.

4. A.M. Best emphasized the importance of strong catastrophe risk management.
    a. Companies should—on an ongoing basis—ensure that their data are current and complete; monitor aggregate and potential exposures; identify exposure concentrations; establish catastrophe-specific risk appetites/tolerances; and implement underwriting initiatives to mitigate their exposure to catastrophe risk.
    b. For now, A.M. Best will continue to utilize the single-occurrence PML methodology in the BCAR calculation. However, A.M. Best is collecting additional catastrophe management-related information in the SRQ (e.g. two hundred year return period losses and deterministic loss scenarios). This additional information will be used by A.M. Best to better understand each company's catastrophe risk management capabilities and to determine whether a revised approach to assessing their catastrophe risk management capabilities is appropriate.

Contacts

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