Exploring the Impact of Auditors and Rating Agencies on Underwriting Cycles

In Focus: The Underwriting Cycle Seminar
Alexandria, VA
October 5, 2009

Our Agenda

- Setting the Stage
- Caveats
- Introductions – Our Panel
- Highlights from 2008 A. M. Best Special Report: Managing through Market Cycles
- Case Studies – What would YOU do?

A.M. Best Cycle Management Trend Review

What We Expected to See

- Good underwriting = good operating results
- Good cycle managers reduce premiums in soft markets
- “Managing” reserves to drive results will eventually catch up with you
- Cash flow underwriting is a bad idea
- Some diversification is good, more is better

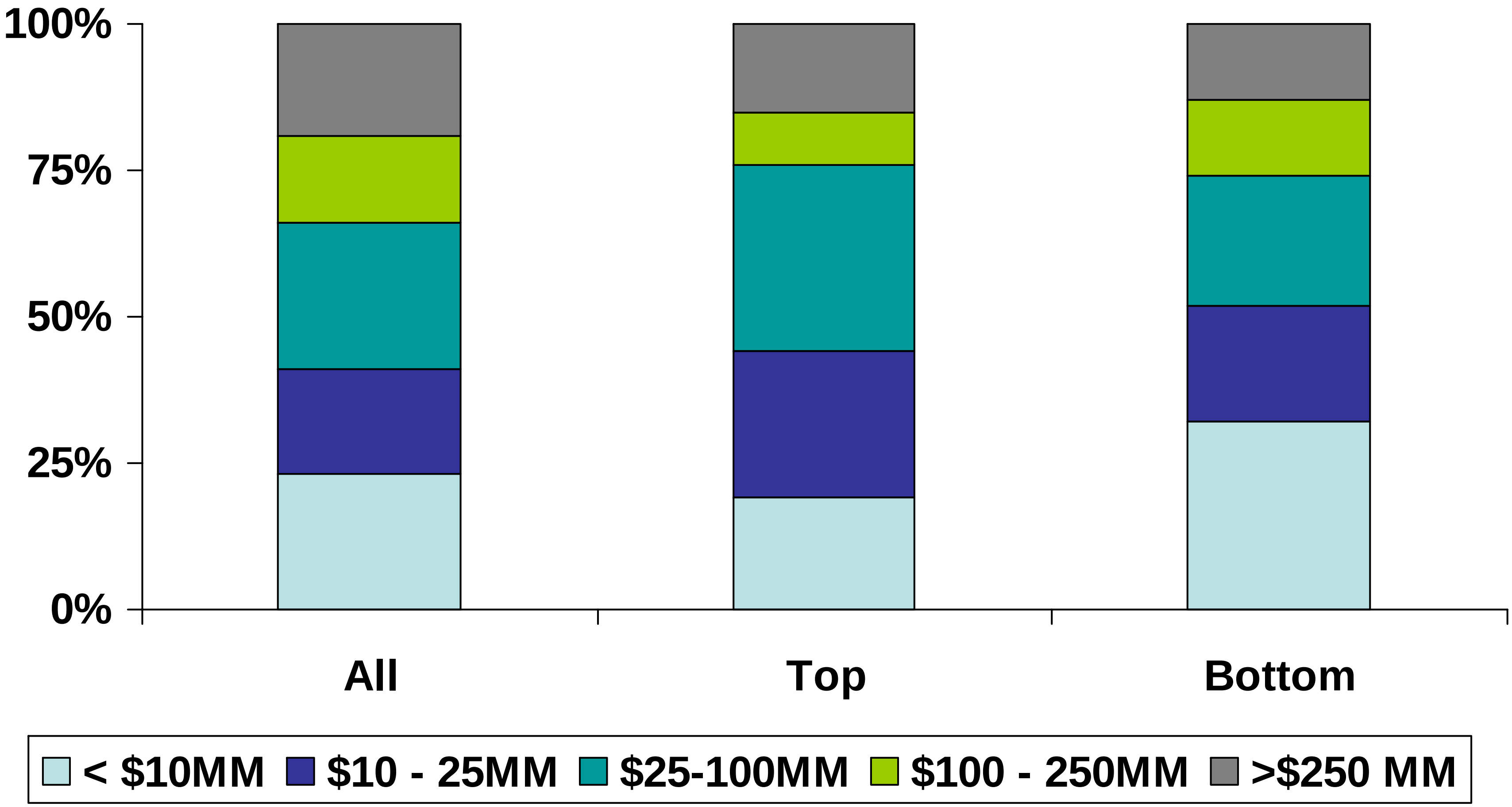
Methodology & Results

- 1,011 Rating Units
  - 10 years of data (1997 – 2006 statutory filings)
  - U.S. domestic
  - Eliminated mortgage and financial guaranty
- Ran 4 Tests
- Results:
  - 60 RUs (6%) passed all four tests
  - 139 RUs (14%) passed 3 or 4 tests
  - 383 (38%) failed all 4 tests
  - Over 600 failed 3 or 4 tests

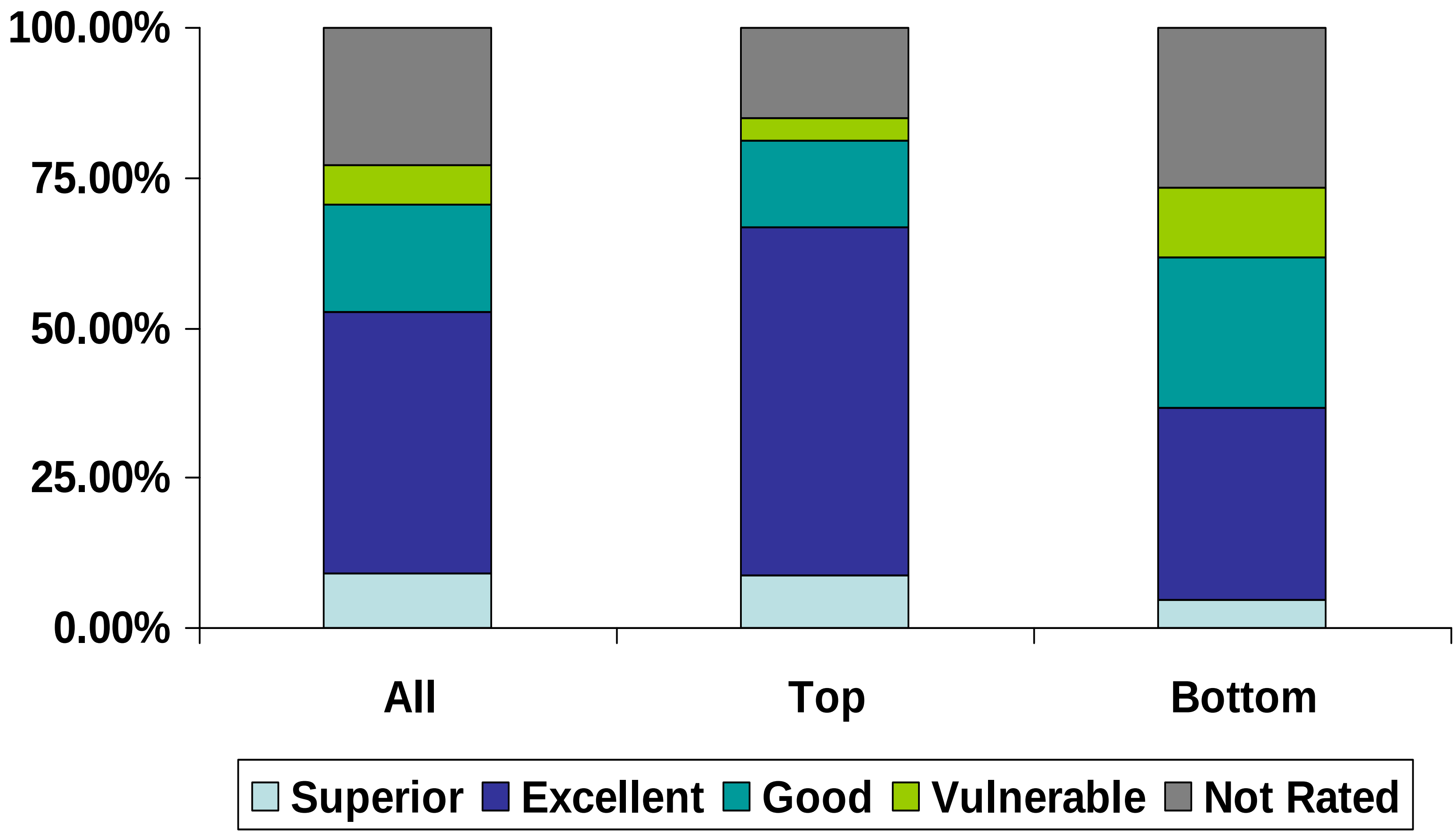
What We Saw

- Focus on underwriting drives better results
- On average, even good cycle managers increase premiums during soft markets
- Good underwriters manage reserves conservatively
- Investment returns don’t compensate for subpar underwriting
- More diversity $\neq$ better results

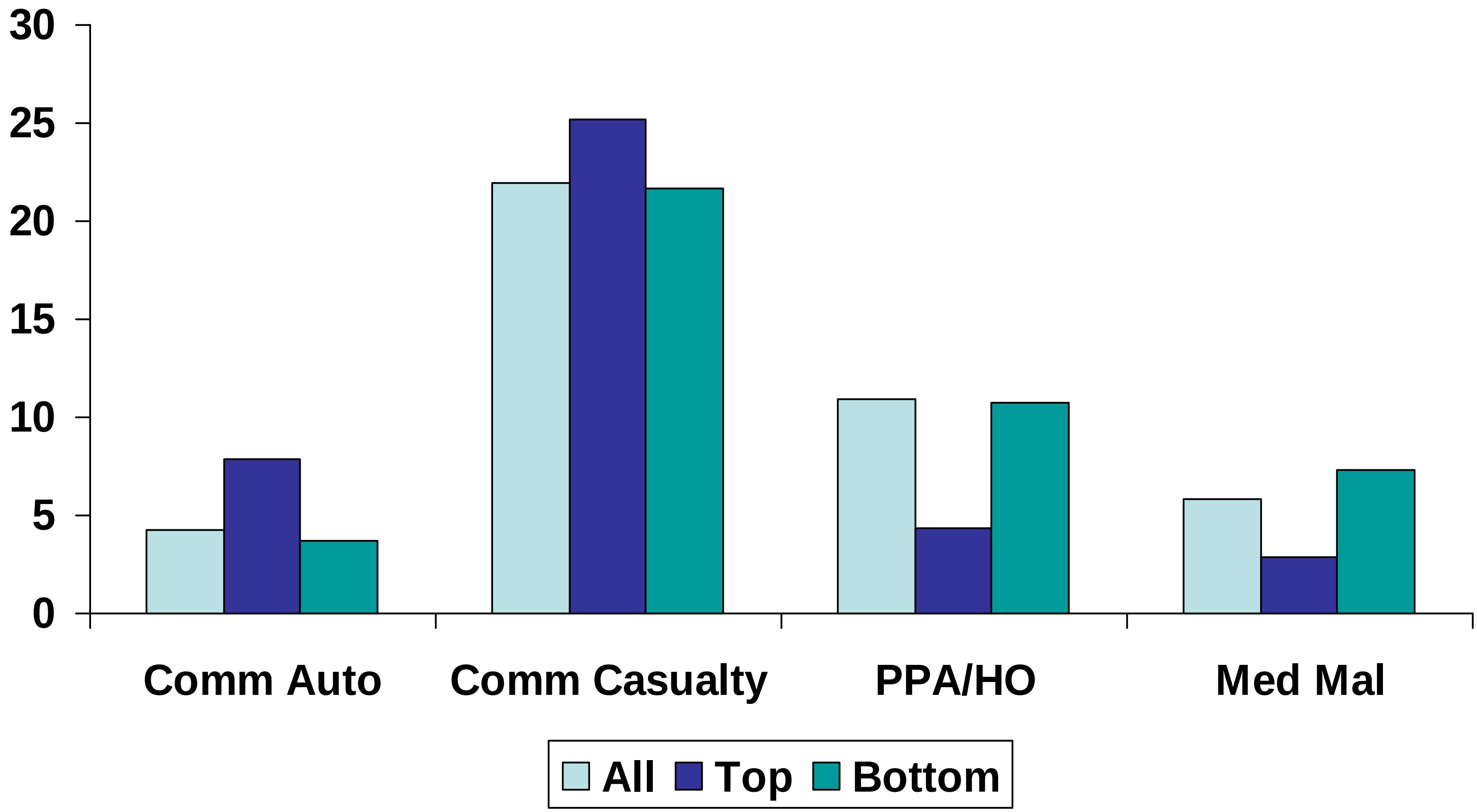
Size Differences



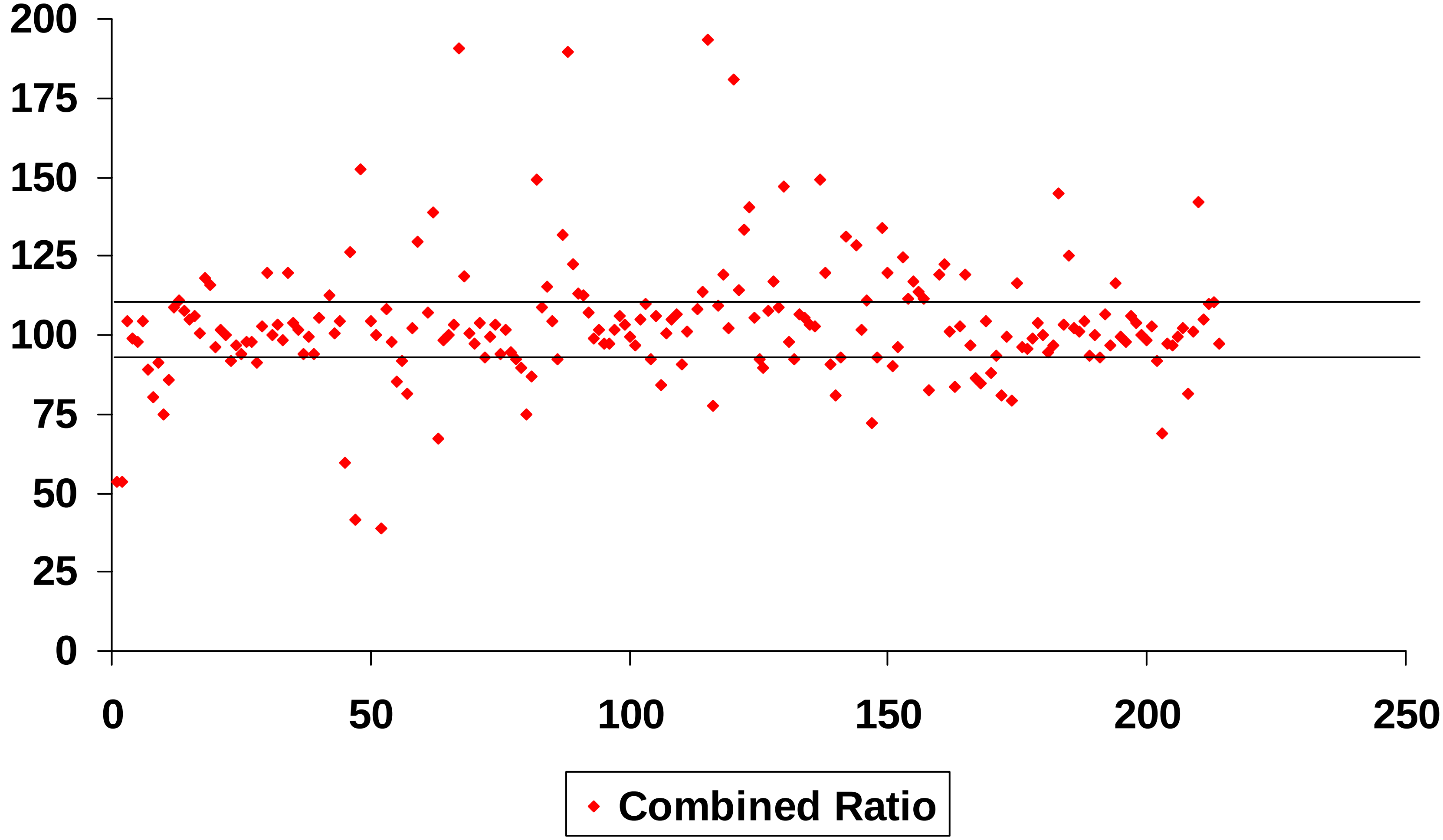
Rating Distribution



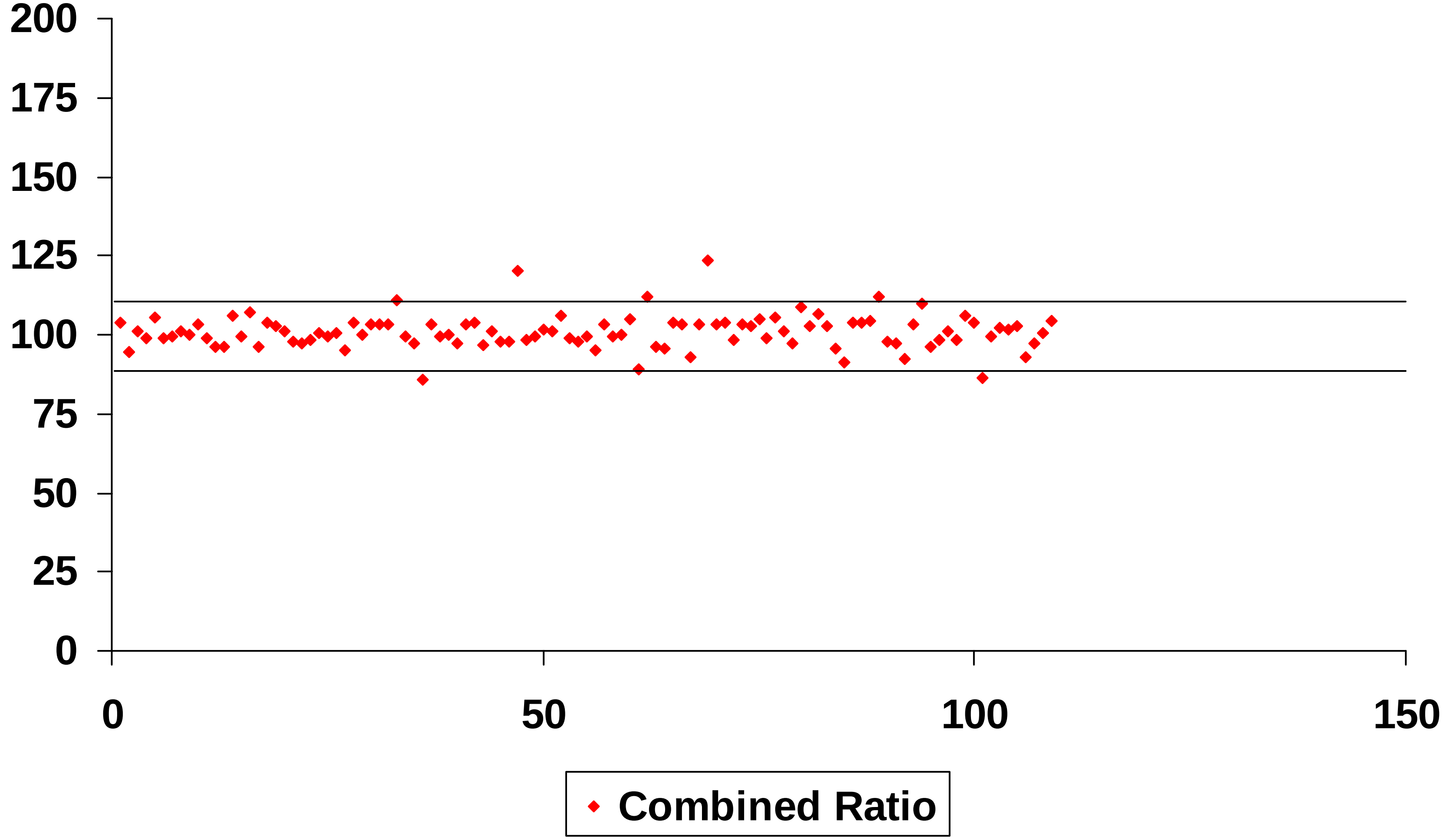
Composite Differences



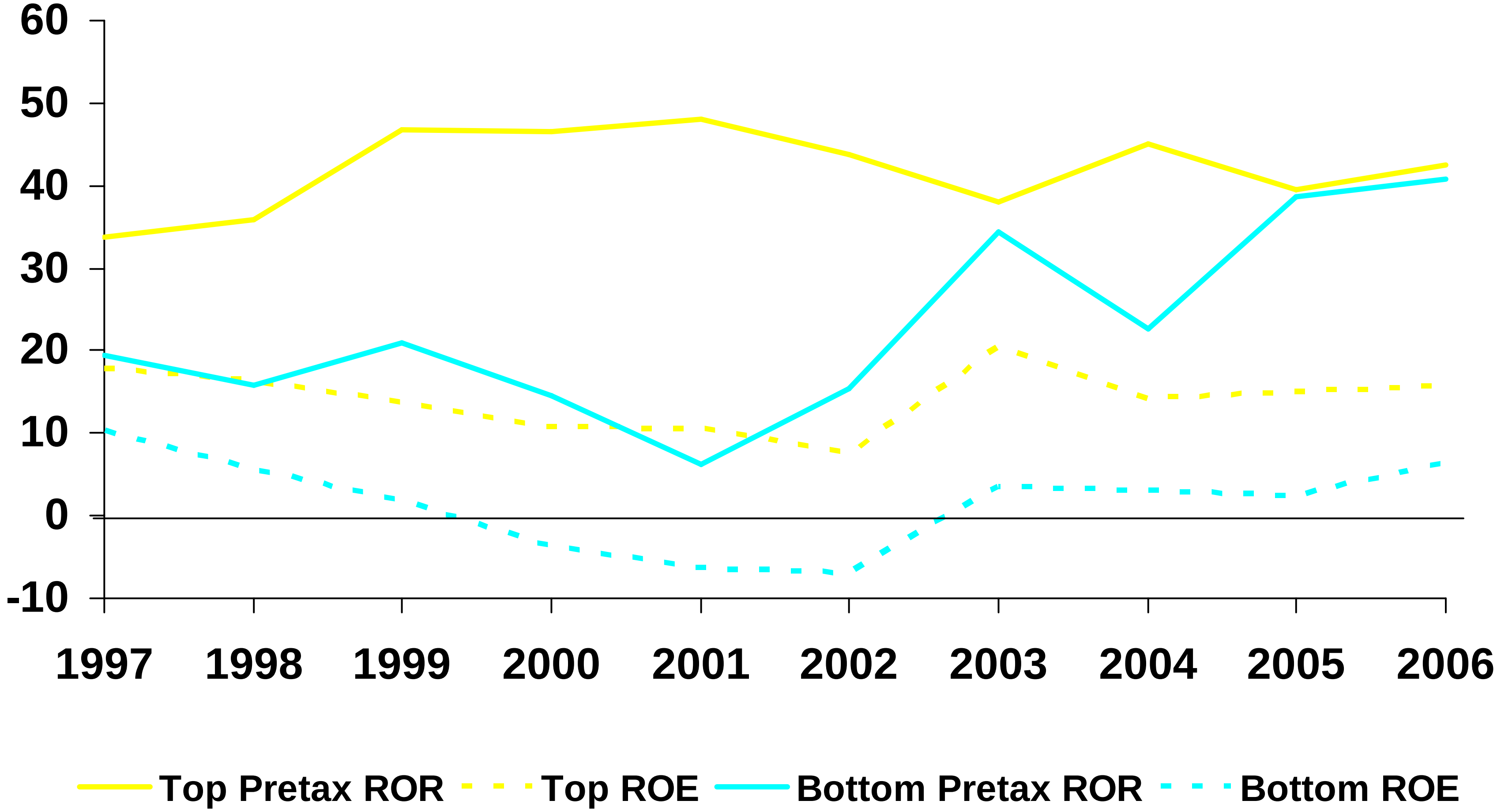
Commercial Casualty
10 Year Average Combined Ratios



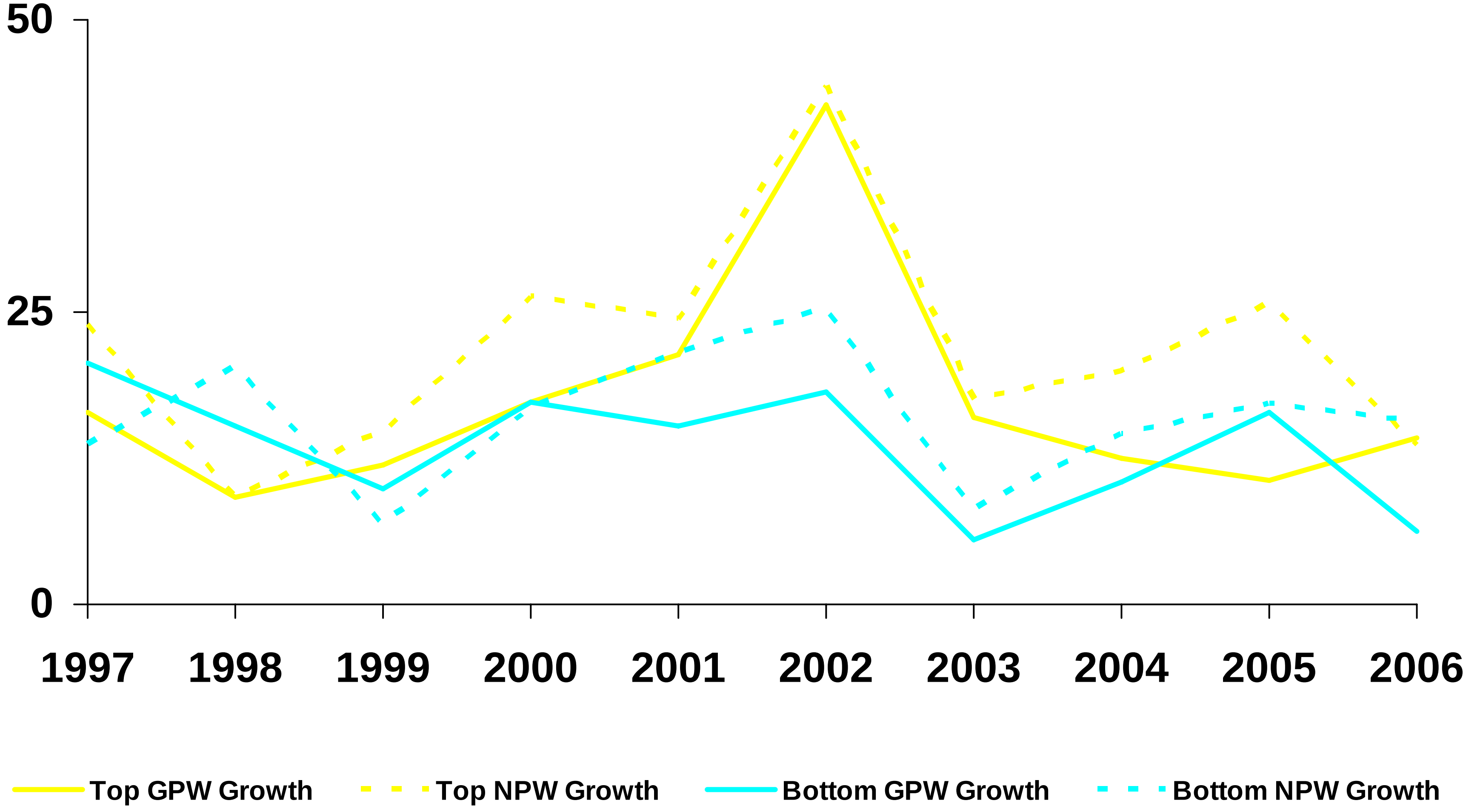
Private Passenger Auto & Homeowners
10 Year Average Combined Ratios



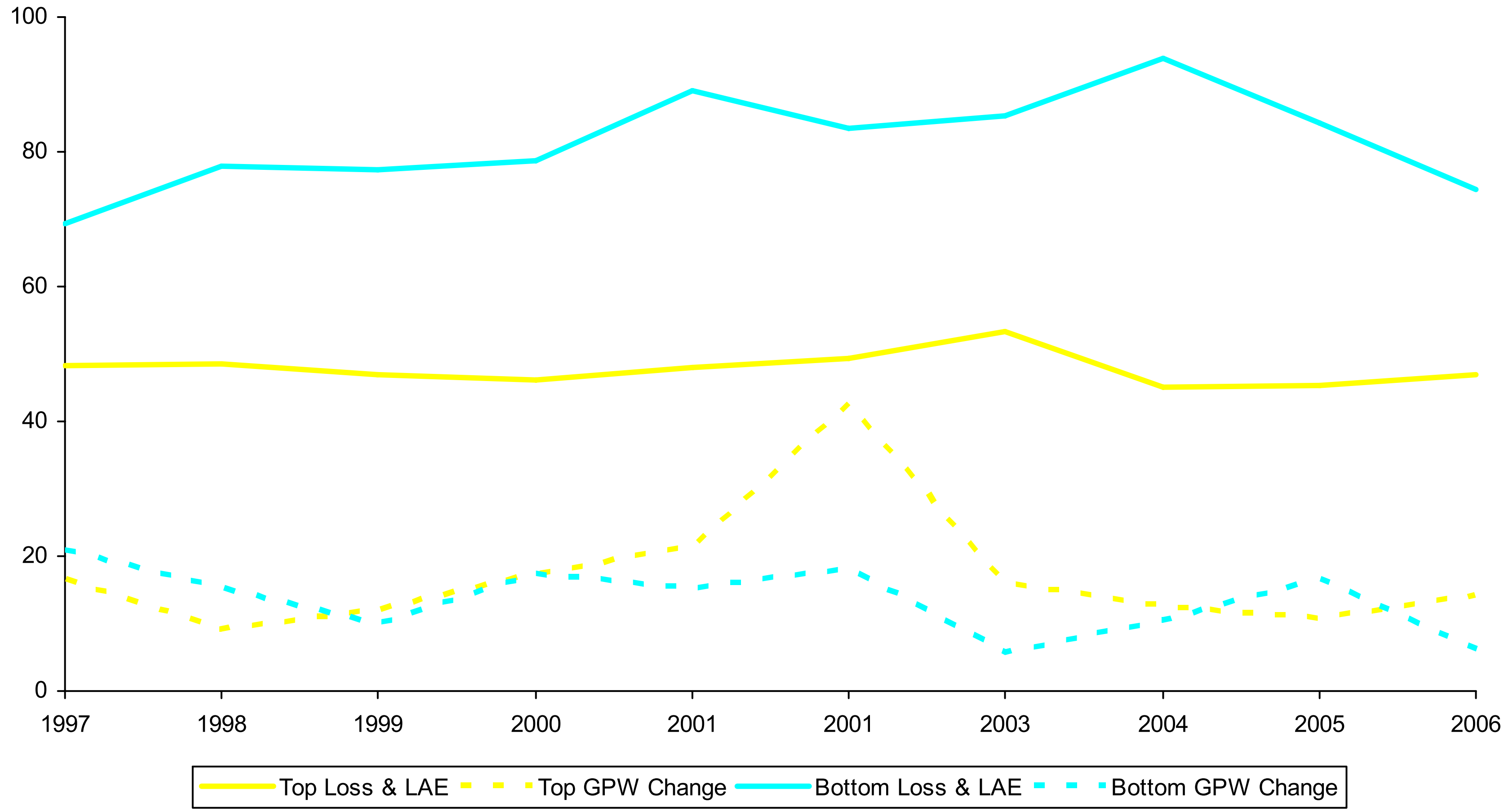
Average Pretax ROR and Total ROE



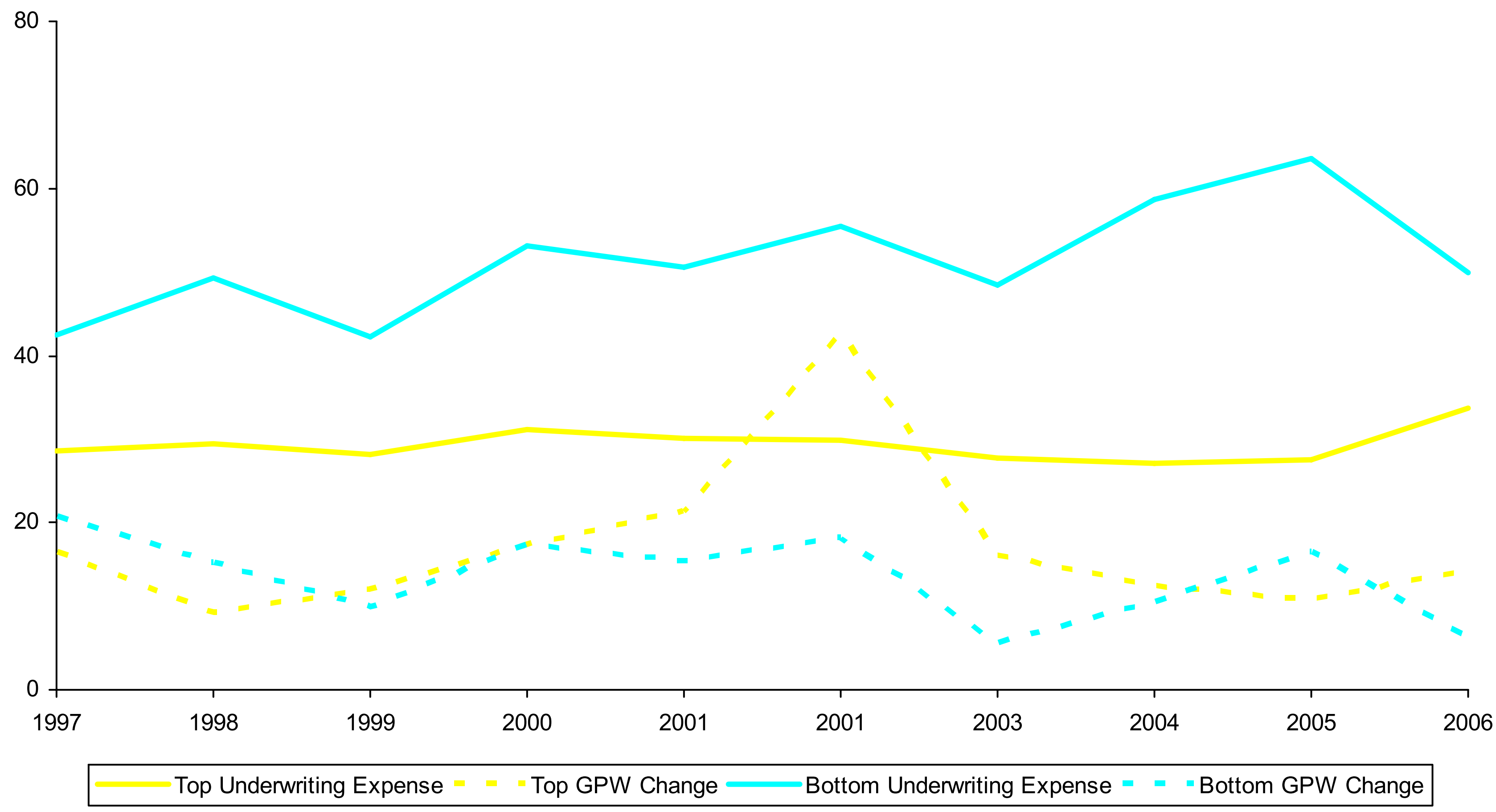
Average GPW and NPW Growth



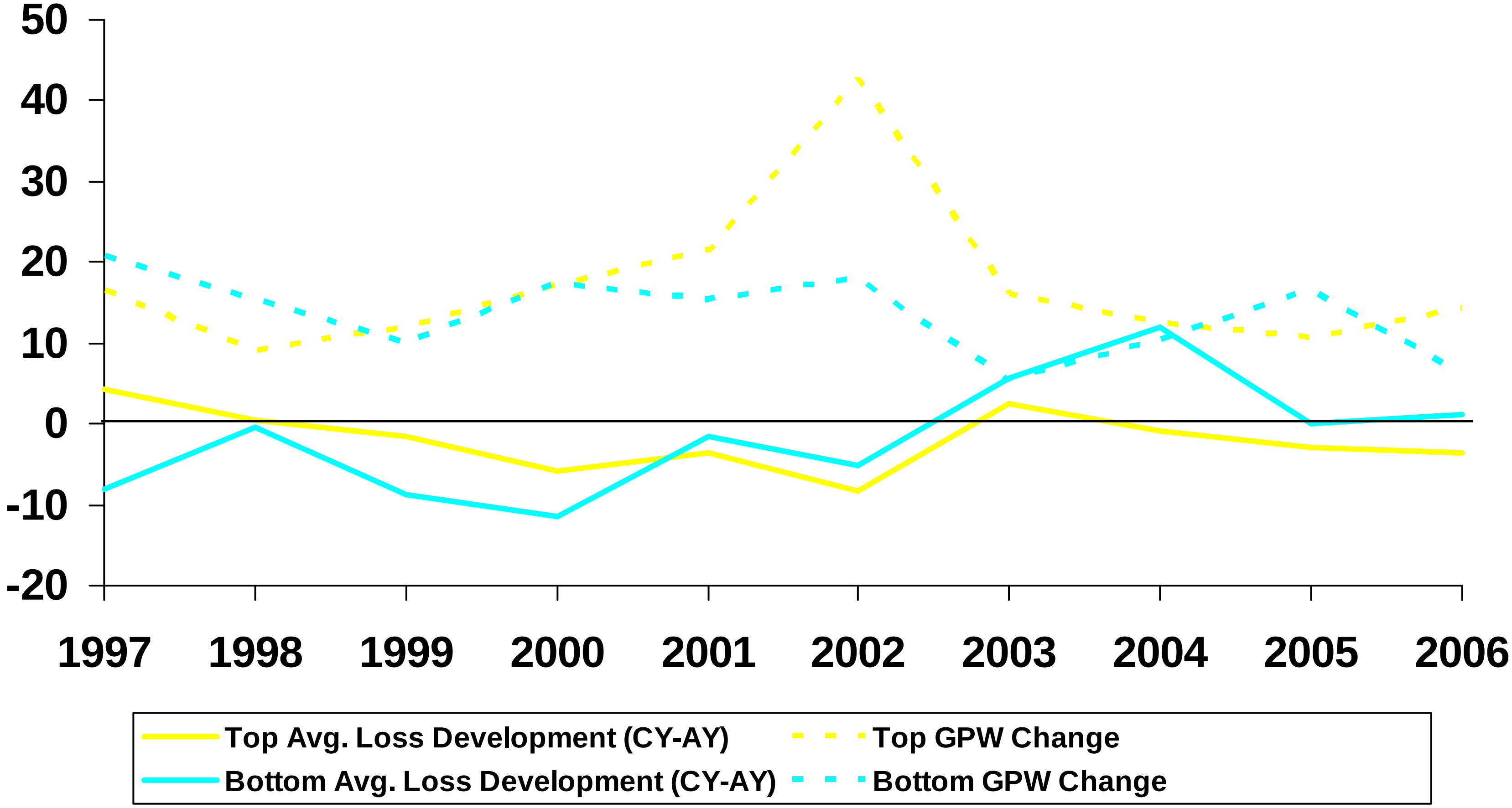
Average Loss & LAE Ratio



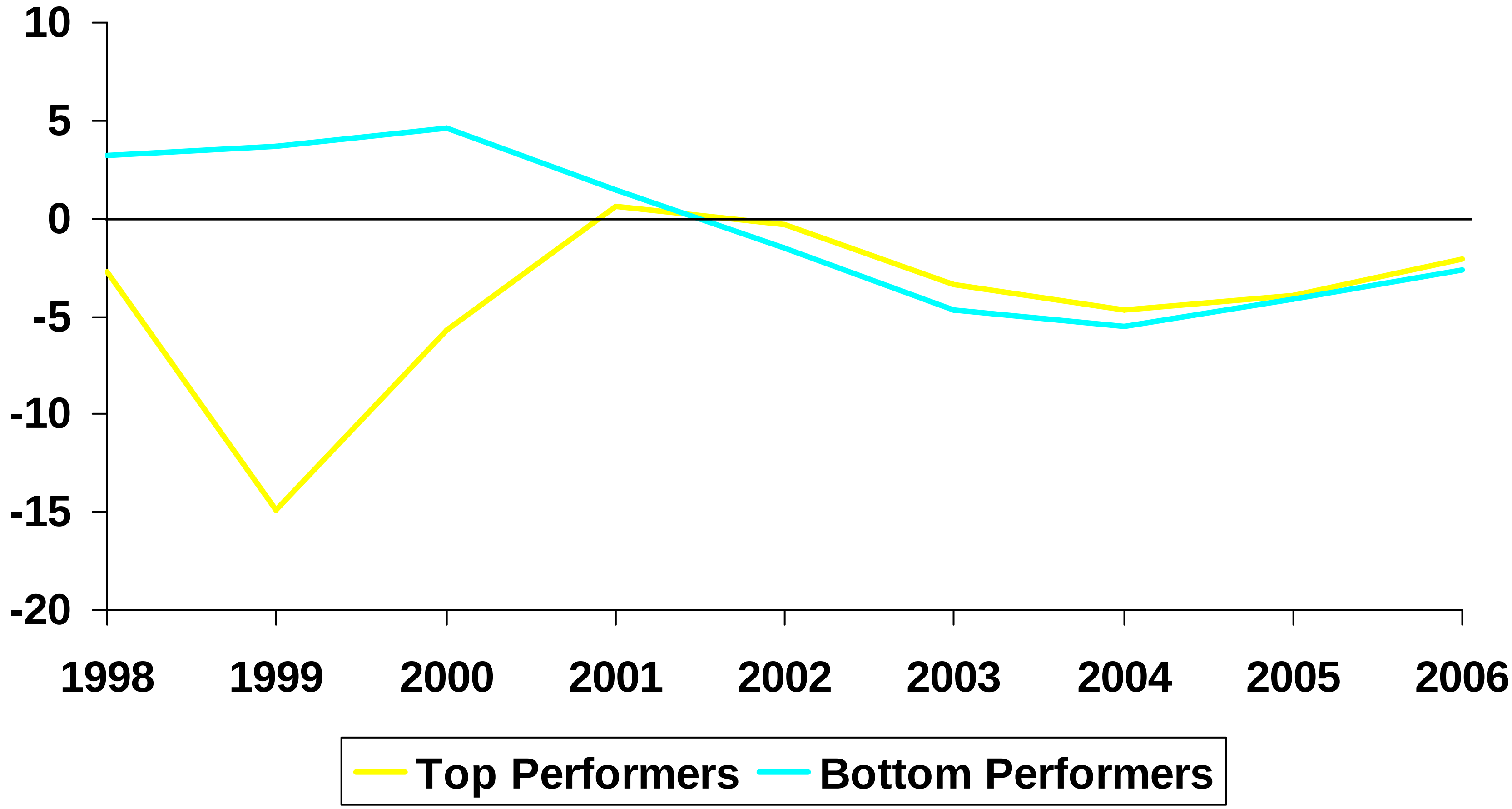
Average Underwriting Expense Ratio



Impact of Development of Prior Years' Loss Reserves



Development of AY Reserves (Through YE 2007)



Conclusions from Study

Companies that perform well through cycles:

- Maintain underwriting standards
- Control underwriting expenses
- Reserve conservatively
- Invest for income, but not to compensate for poor underwriting

Next Steps: Planning a follow-up

Case Studies

Case Study 1: In the Range Mutual

2007

- Surplus: $ 50 million
- Reserves: $ 25 million
- Net Income: $ 50,000

Facts:

- Company recorded at the actuary's central estimate
- Actuary's range was from $22 million - $28 million

2008

- Surplus: $ 30 million
- Reserves: $ 25 million
- Net Income: $ 50,000

Facts:

- Actuary's range was from $25 million - $32 million
- Actuary's central estimate was $28 million
- Company experienced $2 million adverse one-year adverse development

Considerations

- Are the recorded reserves “reasonable”?
- Are the 2008 financial statements “fairly stated in all material respects”?
- What factors caused management to record a reserve estimate different than its actuary’s central estimate? Are those considerations documented? Is there evidence to support management’s position?
- What disclosures would be appropriate, for the appointed actuary and by management in its financial statements?
- As the auditor, how would you document your thought process and conclusions?

Case Study 2: Premium Deficiencies

- The identification of a premium deficiency reserve requirement for unearned premiums should signal the need for rate increases which would dampen the soft part of the underwriting cycle. For most long tail lines of business, a premium deficiency associated with unearned premiums is difficult to identify because the inadequacy of current rates is not yet observable in the recent accident year results. However, for shorter tail lines such as personal lines, rate deficiencies may be identified earlier and require premium deficiency testing.

- FACTS:
  - Assume a personal lines carrier using independent agents writing in a competitive market trying to maintain share.
  - The company markets both homeowners and auto coverages.
  - The combined ratio for the current accident year is 120%, with an expense ratio of 25%.
  - In response to a question from its auditor, the company states that it does not have a premium deficiency need because the combined ratio implies an underwriting profit.
  - What follow up steps should the auditor take?

Considerations

- Premium deficiency test requirements
- Premium Growth
- How is the business marketed?

Case Study 3: Uncertainty in Recent Accident Years Projections

- Recognizing and executing on the need for rate changes sooner rather than later will dampen the swings in profitability associated with the underwriting cycle. Auditors often engage in rate level discussions with companies when reviewing balance sheet claim liabilities. For many reinsurance and long tail casualty lines of business, an expected loss ratio is used directly or through a Bornhuetter-Ferguson method to reserve the more recent accident years.

- FACTS:
  - Assume a long tail casualty writer using an expected loss ratio approach to reserving.
  - How does the auditor test the assumptions underlying the E(LR's)?

Considerations

- Who develops the E(LR's) used in reserving?
- What is the basis for the E(LR's)?
- What rate monitoring tools are available to the company?
- How have rate and claim cost trends been incorporated?
- What other factors have been considered in developing the E(LR's)

Case Study 4: Up, Up and Away Insurance Company

- New claims management is appointed (in place for approximately 3 months)
- Significant increase in case incurred observed (40% over prior year)
- Management asserts that case incurred increase is simply an earlier recognition of the ultimate settlement amounts by current claims management. They believe there should be no change in the ultimate incurreds, but simply a shift in the case to IBNR ratio.
- Further, management notes that the current claims manager has a track record from his prior company of favorable case reserve development (approximately 5%). They believe it may be appropriate to anticipate favorable development when establishing the Company's reserves
- Appointed Actuary (a consultant) uses standard development methods, believing that Berquist Sherman adjustments are not reliable. You understand that she may be preparing to issue an adverse statement of actuarial opinion
- Company has had a history of adverse development in its reserves

Considerations

- What information will you request to reach your conclusion on the reserves?
- Is it appropriate to reflect the manager's prior track record in assessing the Company's liabilities?
- What actions, if any, would you take to resolve the apparent differences between the appointed actuary and company management?
- If the appointed actuary did issue an adverse opinion, would you reflect the amount by which the Company's carried reserves fell short of the low end of the actuary's range as an audit difference? Why?

Case Study 5: Rating Environment

- Industry is generally in a soft cycle, with some price firming in certain lines/markets
- Premiums declining on a gross and net written basis
- Investment returns show stress from market volatility and low interest rate environment
- Overall reserve redundancy recognized in 2008, with significant reductions in recent years' reserves

Rating Considerations

- What behaviors would you expect a strong cycle manager to exhibit under these conditions?
- How could those behaviors best be measured?
- What might raise “red flags” as to a company’s ability to manage through this cycle?

Rating Considerations

In general, ratings benefit from:

- Consistent approach to reserving through cycles, with regular, modest redundancies
- Reduction in premiums due to reduction in exposure, not reduction in rates during soft cycles
- Underwriting leverage at or below peer group norms
- Judicious use of credits/debits in rating process
- Balanced approach to underwriting and investing risk
- Maintaining sufficient capital to take advantage of market opportunities (avoid statutory strain)

Rating Considerations

Compare results to industry, composite and company's own historic performance

- Changes in NPW and surplus; be alert for increase in leverage
- Price/rate level changes
- Claims and Reserving trends
  - Trends in frequency and severity
  - Historically redundant, deficient, variable?
  - Recent AY vs. Older AY initial and revised selections of ultimate loss ratios
- Overall trend in income and ROE
- Comparison to industry composite
- Relationship between underwriting and investment income