the Demotech Difference

Serious About Solvency®

Spring 2015 / Vol.1, No.1

LEGACY OF LONGEVITY

From today's cutting edge to the industry's roots, our special feature highlights companies who have lasted over a *century*

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the Demotech Difference
Serious About Solvency®

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Editor's Notes

More Than 140 Characters

In a world driven by social media and fast-paced sound bites, print magazines hearken to another era, and are perhaps characterized as old-fashioned with the implication that the publication's content may be less cutting-edge and of less value than what leads the pack digitally.

T*he Demotech Difference*, however, enters the scene reflecting the same corporate values as Demotech, Inc.—that much of what is good and solid in the insurance industry is the heroes, those smaller and tenacious companies who have found ways to stay relevant and serve their clients well for decades and even centuries. These companies led with integrity and trustworthiness before social media, web sites, blogs or Tweets.

We want to recognize those independent and specialized companies and celebrate the anniversaries of their incorporation each quarter. A business formed 100 or even 200 years ago, and still operating well today deserves mention.

By combining the stories and wisdom of these heroes with the most recent and relevant information in the industry, *The Demotech Difference* successfully bridges the gap between the past and the future, representing those sometimes under-appreciated companies while highlighting the keenest trends and information affecting the insurance industry today.

The Demotech Difference takes the time to present this mix of seasoned and new, not to replace social media and 140 character Tweets, but as an addition that is a deliberate and unhurried panorama of the issues you must address to remain relevant and competitive.

We invite you to take the time to be inspired and get to know the heroes of the industry with us.

Barb Albert

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Vive la Différence

From the President's Desk

By Joseph L. Petrelli

"To sustain longevity, you have to evolve."

Although the speaker was discussing the length of his career, the sentiment is applicable to the business of insurance. Insurance is constantly evolving to address the needs of its stakeholders. Sometimes the evolution comes from within in the form of revised underwriting guidelines, geographical expansion into another jurisdiction, adding another product line, or establishing a regional office, etc. In other situations, we are thrown into the deep, cold water of evolution, e.g., revisiting the 'mold exclusion' subsequent to the Ballard litigation in Texas that resulted in a plaintiff's verdict against a member of Farmers Insurance Group. Our friends and relatives may think we work in a boring industry but we know that they are wrong. We constantly learn and evolve.

The Demotech Difference is our method for sharing concepts and tools to spur learning and evolution. Our goal is the same as your goal—extend your corporate longevity as far as possible! To do so requires sustaining the successful and minimizing the impact of unpleasant surprises while also innovating and evolving to stay ahead of the competition.

> ***The Demotech Difference*** **is our method for sharing concepts and tools to spur learning and evolution.**

Clearly, successful operation of an insurance company requires implementation and execution of current practices applicable to your existing business. A legacy of longevity also requires discussion of the emerging concepts, tools, analysis, and implementation techniques that are shaping future periods. Our inaugural edition includes several articles written by subject matter experts. The topic may be a trend, concept or tool. To remain focused on the goal—a legacy of longevity—we include interviews with executives from leading insurers that have been in continuous operation more than a century.

***"You have to risk failure to succeed."*—An Wang**

There are hundreds of insurers that have achieved more than a century of service to policyholders, claimants and stakeholders. They accomplished this impressive feat because they analyzed the challenges they faced and addressed them. From day one of incorporation, management knew and understood the need to direct, analyze, organize, coordinate and address the risks and exposures that faced the insurer. The need, and ability, to analyze risk was in their corporate DNA. Longevity was not imposed by a rating agency, regulation or statute. Their legacy of longevity was earned day by day, policyholder by policyholder, claimant by claimant, stakeholder by stakeholder. Similarly, the legacy of longevity at your company has been sustained by identifying, understanding and managing the risks in the multiple environments where you operate.

***"You can measure opportunity with the same yardstick that measures the risk involved. They go together."*—Earl Nightingale**

It is likely that we agree that risk analysis has advanced over time. Today's enterprise risk management is the progeny of what preceded it. The knowledge and techniques developed through asset and liability matching, cash flow testing, sensitivity analysis, dynamic financial analysis, etc. have been re-evaluated, refined and updated to become tools in the kit of "enterprise risk management." What was once a collection of recipes has transitioned into a culinary institute. The documentation process is, in and of itself, part of the evolution of managing risk.

The creation of an own risk and solvency assessment regulation or an enterprise risk management report to a stakeholder is your opportunity to summarize the continuous, ever-changing effort that has been in your corporate DNA for decades. Although you may feel that enterprise risk management, own risk and solvency assessment, and other reporting and analysis requirements are being thrust upon you, you should also be comforted by the fact that hundreds of insurers have grown and have prospered long before the terms "ERM" or "ORSA" were ever coined.

In the words of the American philosopher, William James, ***"Let everything you do be done as if it makes a difference."*** *The Demotech Difference* exists to facilitate meaningful communication and discussion. Each edition will contain the perspectives of subject matter experts on emerging concepts, tools, or techniques. If reading this magazine helps you to make a more informed decision underwriting a particular application of new business, to generate better research evaluating a new product line, or to create a new type of investment that enhances your legacy of longevity, then we've achieved our goal for *The Demotech Difference.*

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Treasurer of the State of Ohio Josh Mandel visits Demotech, Inc. on February 2, 2015. From left: W. Burke Coleman, Barb Albert, Leslie Evans, Nancy Davis, Mitzi Smith, Robert Warren, Steven Groeschen, Barry Koestler, Thomas Bowser. In front, from left: Joseph L. Petrelli, Rachel Wilkins , Treasurer of Ohio Josh Mandel. Absent from photo: Sharon M. Romano Petrelli, Victoria M. Dimond, Douglas A. Powell, and Paul Osborne.

The Power of the Black Box

Transforming the Auto Insurance Industry

As auto insurers compete more aggressively for drivers with the best risk experience, many are finding they must put a greater focus on both technology and customer engagement. Those who wait may find themselves falling behind. Certainly the most promising new tool in the marketplace is usage-based insurance (UBI). In fact, 75% of insurers believe UBI will fundamentally alter the auto insurance industry between now and 2020.

UBI programs closely align driving behaviors with premium rates for auto insurance while allowing the company to engage the driver in new ways. In various forms, UBI has been in development since the 1990s, and it's seen tremendous growth in the last five years. Today, there are more than 25 separate UBI products available to private passenger auto insurance customers in the U.S., including at least 10 unique products approved in 41 states. Additionally, several insurers, including Progressive and Allstate, say that 30% to 40% or more of new policyholders in their private passenger auto business voluntarily opt to buy a UBI policy.

Ultimately, UBI enables a company to offer customized service offerings specifically targeted to an insured's priorities.

In fact, a recent Towers Watson survey of U.S. drivers found the number of consumers with UBI policies has nearly doubled in the past two years. Other countries, such as Italy and South Africa, are estimated to have even higher numbers of UBI policies as a percentage of their driving populations.

What Exactly is UBI?

UBI begins with a piece of on-board or third-party technology that tracks and collects mileage and driving behavior. UBI technology allows insurers to design various customer-centric programs. For example, they can offer various discounts based on low mileage and safe driving behaviors. Companies are currently offering discounts of between 12% and 25%. Armed with information from individual cars, companies can also provide services such as vehicle theft tracking and emergency roadside response.

Ultimately, UBI enables a company to offer customized service offerings specifically targeted to an insured's priorities. For example, a family with a young driver could receive driver coaching, the driver's parents could opt to receive driving history reports, or the family could request speed governors on the car. A consumer who is interested in being a more economical, or "green" driver, could receive fuel efficiency and carbon footprint reports.

The Countless Benefits

UBI's benefits to insurers are considerable. These include:

- more accurate pricing
- reduced loss cost
- increased policyholder retention
- improved claims handling
- better customer engagement.

Because information collected through telematics can be used in predictive modeling, insurance companies can rate a risk based on how, when and where a vehicle is operated. Essentially, insurers can understand the true risk of the driver, ultimately reducing its dependency on proxies and correlated characteristics. In fact, Towers Watson's UBI score is more than three times more powerful than any other existing rating factor. UBI can also be used to drive down loss costs through self-election and behavior.

The best drivers—and better risk insurers—are self-selecting, meaning they are raising their hands in the crowd and identifying themselves as an ideal risk. Attributes of ideal risks include:

- safe drivers
- low annual-mileage vehicles
- highly engaged parents of young drivers
- drivers who have experienced unlucky accidents as opposed to accidents caused by factors that include their speeding, alcohol use and so on.

Companies using UBI are rewarding these good drivers by offering discounts up to 50%.

By Katie DeGraaf, Towers Watson

"If you do not change direction, you may end up where you are heading." - Lao Tzu

Most of what we know about the potential impact of UBI programs on behavior change comes from the experience of commercial fleets using telematics for fleet and risk management purposes for several years. Studies of the commercial fleet experience shows astonishing reductions in accident frequency, ranging from 54% to 93%.

Moreover, some programs have targeted the behavior change of young drivers. These programs have produced reductions in accident frequency, ranging from 30% to 40%.

In addition, UBI policyholders seem to stick around longer. In fact, insurance companies are experiencing 2% to 5% higher retention with UBI customers.

UBI programs can also lead to improved claims handling. While the use of UBI data for the purpose of claim settlement is still a rather sensitive issue in the U.S.—one-third of survey respondents in Towers Watson's 2014 Consumer Survey said this is a primary concern for UBI programs—there are still other opportunities for use in the claims process. For example, these technologies can provide immediate notification of a loss to a response center, which greatly increases emergency response, as well as vehicle recovery. And faster accident response has proven to save lives.

Perhaps the most exciting benefit of UBI for insurers is the ability to improve customer engagement. Currently consumers only think about auto insurance when something bad happens—a bill payment is due or a claim has occurred. With UBI, insurers can provide new services to customers that promote safer driving and ultimately lower their insurance costs.

Launching a Successful UBI Program

There is no question that the UBI market will be huge, and many players want to capture a piece of the lucrative pie. In fact, companies that represent over 80% of the personal auto market share in the U.S. have already implemented—or are developing—UBI products. While the prospect of jumping into this business may feel daunting, the possibilities inherent in UBI are exciting.

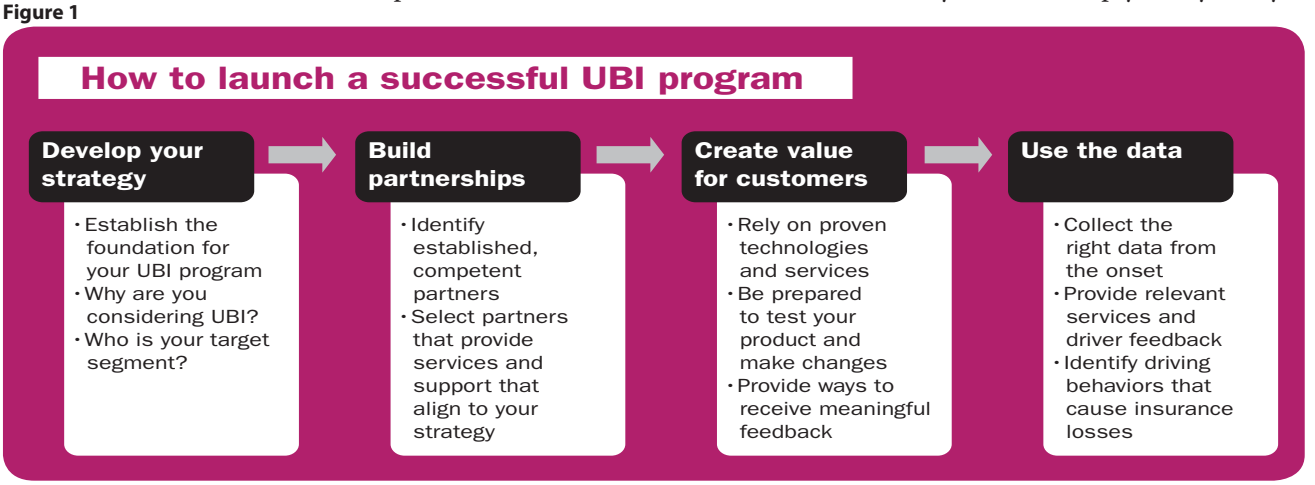
So the question becomes: what are the keys to a successful UBI implementation? It all begins with a strategy. The first step is to determine what you want your UBI program to achieve and then design the program accordingly. Your strategy should inform the technology you will use and the data you'll collect.

Four Common Mistakes

There are several pitfalls that can seriously disrupt your UBI program launch. But these can be avoided with proper planning:

Avoid widget paralysis
It is critical that you identify technology, services and service providers that support and grow with your strategy. Don't be distracted by shiny objects and unproven solutions. Too many companies have spent precious time and resources deploying programs with technologies that are not customer-ready. Instead, keep your eye on your

Figure 1



The Power of the Black Box

strategy and business objectives and plan your technology purchases with those in mind.

Provide a unique and customized service
Millennials—the largest segment of the population—expect a unique, intuitive and customized experience when purchasing and engaging with a product. Be sure to invest time learning about their behaviors and listening to their feedback so you can tailor your UBI services.

Train, re-train and train again
As with any new product offering, there is a learning curve associated with selling and supporting UBI. For example, you'll have to educate your staff—including sales, customer support and internal stakeholders—on your product, goals and service offerings. Aim for transparency to ensure buy-in and avoid confusion.

Get the right data from the onset
To successfully engage the customer and enable accurate predictive modeling, you must collect the right data and make them available to and useful for both the driver and for your company. Data are the foundation of the services you provide and the value you receive.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Getting the UBI Data Right

How can data work for you? UBI data fall into two categories: summarized, or event counter, and granular, per-second or sub-second data.

A company may opt for simple behavior event counters, which provide summarized information, rather than high-level data, in order to manage the volume of data it receives and analyzes. For example, data may indicate that a driver has two hard braking events that exceeded 0.2Gs and he/she went above 80 MPH for five seconds. With this information, you learn quite a bit more about vehicle utilization for this driver than you've known in the past.

However, a summary such as this one ignores very powerful underlying information. For instance, average speed per minute is a common summarization. Imagine a driver weaving in and out of traffic. He drives 30 seconds at 50 MPH—and then speeds up to 70MPH for 30 seconds. This is much riskier than someone driving in the appropriate lane with cruise control set at 60 MPH. Yet, the summarized metric would be the same.

Additionally, meaningful data should go beyond the number of times a driver brakes hard—whatever that definition might be—to include how much time the driver spends just below or close to that braking threshold, which tells a great deal about driving style.

In addition, summarized data doesn't permit a fluid and robust analysis. While summarized events will improve your risk analysis to some degree, it's not a viable approach long term. At some point you will likely want to add a new driving behavior to your program. If you're using summarized data, you will need to restart your data collection process and wait for sufficient new data to be collected, lengthening the lifecycle of analysis.

Granular data results in a better driving behavior analysis. Using granular data allows you to go back and create new factors, giving you flexibility as you seek to strengthen your analysis.

Granular data allows you to attach mapping and weather sources to learn about the environment, such as the type of road, speed limit, the type of junctions the driver passes, passing, whether he or she is driving into the sun or snow, and the normal flow of traffic.

While it is interesting to know that a driver is driving above 80MPH for five

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Legal Matters
Tracking Ridesharing Insurance Regulations

By W. Burke Coleman, Esq.

The emergence of transportation network companies (TNCs) has garnered much attention over the last year. The traditional livery market has opposed the new ridesharing services, voicing concerns over disparate requirements which it says inadequately address driver and vehicle standards, consumer safety, and fare regulation, and unfairly hamper the ability of taxis and limos to compete with the new peer-to-peer platforms. Public officials continue to weigh the benefits of the innovative services against the need to protect consumers, with some embracing TNCs, others banning them altogether, but most trying to accommodate the service while enacting reasonable regulations. Much of the regulatory concern has focused on insurance coverage. Tracking the regulatory evolution for TNCs highlights the insurance challenges and shows that the issue will remain prominent in 2015 as states consider legislation and cities revisit their current livery requirements.

Personal auto insurers initially responded to the emergence of TNCs by highlighting the livery exclusion found in most personal auto insurance policies, which precludes coverage for drivers using personal vehicles to carry passengers for a fee or for drivers who remain "available for hire." This exclusion creates gaps in coverage when a TNC driver is en route to pick up a passenger, transporting a passenger, or even when the application is open and the driver is available for hire, which potentially leaves passengers, drivers and third parties exposed.

While California's Public Utilities Commission offered the first regulations for TNCs, initial regulatory responses came primarily at the local level where livery services are typically regulated. Following California's lead, Columbus, D.C., Minneapolis, Seattle, and a few other cities were among the first to enact regulations including requirements for liability coverage during the various phases of the trip. Columbus enacted some of the more comprehensive insurance regulations, requiring $1 million of liability coverage and UM/UIM coverage, and requiring the TNC to match the driver's collision coverage during trips, as well as requiring contingent liability coverage during the pre-trip period when the application is on but no trip has been accepted.

Public officials continue to weigh the benefits of the innovative services against the need to protect consumers ....

Although states were initially slow to respond to TNCs, interest in state regulation has increased recently. The topic featured prominently at the annual meeting of the National Conference of Insurance Legislators (NCOIL), which will likely produce model ridesharing legislation. The National Association of Insurance Commissioners (NAIC) has similarly taken an interest and may also issue a model law. A few states have already enacted legislation, with a number of others set to consider legislation in 2015. Colorado passed a bill very early on with basic insurance requirements. The governor of Illinois vetoed the state's initial bill, reasoning that, legally and practically, regulation of TNCs should be left to the municipalities. But the Illinois legislature recently passed amended legislation requiring insurance for TNC drivers. Legislation has similarly been proposed in a number of other states. The degree to which states will regulate TNCs remains to be seen, but insurance requirements will feature prominently in the discussion.

As states consider their own regulations, cities are continuing to monitor local regulations and evaluate their effectiveness, with many planning on revisiting their TNC regulations, as well as their taxi regulations, this year. The insurance industry is also adapting to TNCs and new insurance products continue to emerge to accommodate TNC drivers, like those recently promoted by Erie Insurance and USAA in limited markets. Insurers and interested parties should continue to monitor the legislative and regulatory developments at both the state and local levels, as the next year should likely see significant changes in transportation regulations, especially those relating to insurance requirements.

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Note: The following TNC Regulation summary is current as of Mar. 1, 2015. Pre-trip refers to the period when a TNC driver is logged on to the TNC application and available to accept rides; during trip refers to the period when a TNC driver has accepted a trip and is en route to pick up or is transporting a passenger.

TNC Regulation: Summary of Current State Activity

ARIZONA proposed SB 1118 would preempt local regulation, proposed HB 2135 is placeholder while requirements considered.

CALIFORNIA passed AB 2293 (eff. Jul. 1, 2015) requires Pre-trip: 50/100/30 primary liability & $200k excess liability; During trip: $1mm primary liability; TNC must disclose exclusions to driver.

COLORADO passed SB 125, requires Pre-trip: 50/100/30 primary liability & policy must recognize that driver operates as TNC driver; During trip: $1mm liability.

CONNECTICUT proposed HB 6349 to consider legislation.

FLORIDA proposed HB 757 & SB 1298 would require Pre-trip: 125/250/50 liability, $250k UM/UIM, PIP, physical damage coverage if driver carries it otherwise; During trip: $1mm liability, $1mm UM/UIM, PIP, physical damage coverage if driver carries it otherwise; TNC must disclose exclusions. Proposed HB 817 & SB 1326 would require Pre-trip: minimum liability and PIP; During trip: $1mm liability, PIP.

GEORGIA proposed HB 190, would require Pre-trip: 100/300/50 primary liability coverage; During trip: $1mm primary liability coverage, $1mm UM/UIM coverage; TNC to match driver's personal coverage at all times; TNC must disclose exclusions to driver.

HAWAII proposed HB 742 & SB 732 would require TNC drivers covered under motor carrier law, 100/200/50 liability. Proposed HB 1463 would require motor carrier liability coverage, UM/UIM, PIP, comp/collision matching driver's personal policy.

IDAHO proposed HB 171 would require minimum liability & UM/UIM.

ILLINOIS passed SB 2774, requires Pre-trip: 50/100/25 contingent liability; During trip: $1mm primary liability, $50k UM/UIM when passenger is in the vehicle; TNC must disclose exclusions to driver.

INDIANA proposed SB 347, would require Pre-trip: 50/100/25 liability; During trip: $1mm primary liability. Proposed HB 1278 would require $1mm primary liability & TNC must match driver's personal coverage.

IOWA proposed HF 96, would require Pre-trip: minimum liability, UM/UIM, and physical damage coverage as required by law; During trip: $1mm liability, physical damage coverage in the same amounts carried by driver. Proposed HF 394 would also require TNC to disclose insurance exclusions to driver.

KANSAS proposed HB 2249 would require Pre-Trip: 100/300/50 liability, $25k per person and $50k per incident UM/UIM, PIP, and comp/collision if driver carries it otherwise; During Trip: $1mm primary liability, $1mm UM/UIM, PIP, and comp/collision if driver carries it otherwise. Proposed HB 2286 would require Pre-trip: minimum liability; During trip: $1mm primary liability & UM/UIM.

KENTUCKY enacted 601 KAR 1:112, requiring Pre-trip: 50/100/25 contingent liability; During trip: $1mm primary liability & basic reparation benefits, UM/UIM. Proposed HB 207, SB 153 would require Pre-trip: 50/100/25 liability, basic reparation benefits, UM/UIM, comp/collision as required by law; During Trip: $1mm primary liability, basic reparation benefits, UM/UIM, comp/collision.

MASSACHUSETTS amended 540 CMR 2.05, requiring proof of personal motor vehicle insurance and TNC & driver to maintain "appropriate liability insurance."

MICHIGAN proposed HB 4032, would require Pre-trip: minimum liability coverage and other insurance as required by state law for personal auto; During trip: $1mm primary liability, PIP & property protection as required by MI insurance code.

MISSOURI proposed HB 781 would require Pre-trip: 50/100/30 primary liability, UM, comp/collision if driver carries it otherwise; During trip: $1mm primary liability, $1mm UM, comp/collision if driver carries it otherwise.

NEW JERSEY proposed A3765 would require Pre-trip: $250k liability and UM/UIM, $10k med pay; During trip: $1.5mm liability & UM/UIM, $10k med pay.

NEW MEXICO proposed HB 272 would require Pre-trip: minimum contingent liability coverage until June 30, 2016 then primary liability coverage as required for motor carriers; During trip: $1mm primary liability, $1mm UM/UIM; TNC must disclose insurance exclusions to driver. Proposed SB 395 would require Pre-trip: minimum liability coverage; During trip: $1mm primary liability; TNC must disclose insurance exclusions to driver.

NEW YORK proposed SB 4108 would require Pre-trip: minimum liability coverage, physical damage coverage if driver carries it otherwise; During trip: $1mm primary liability, physical damage coverage if driver otherwise carries it; TNC must disclose insurance exclusions to driver.

NORTH DAKOTA proposed HB 1144, would require During trip: $1mm primary liability, $1mm UM/UIM when a passenger is in the vehicle, PIP; TNC must disclose insurance exclusions to driver & disclose to driver's personal auto insurer that driver works for the TNC.

OHIO proposed HB 90 would require at all times liability coverage as required for chauffeured limousines in ORC 4509.80 (100/300/50), as commercial policy similar to chauffeured limousines or matching driver's personal coverage; TNC must disclose exclusions to driver.

OKLAHOMA proposed HB 1614 would require Pre-trip: contingent minimum liability; During trip: $1mm primary liability coverage.

OREGON proposed HB 2237 & HB 2995 would require at all times three times minimum liability limits and UM/UIM, PIP, comp/collision matching the driver's personal auto limits.

PENNSYLVANIA approved experimental license through PA Pub. Util. Comm'n, requires Pre-trip: liability coverage; During trip: $1mm liability coverage; TNC to disclose coverage limits and instruct drivers to contact personal auto insurers. Proposed SB 447 would require liability coverage as required by the PA Pub. Util. Comm'n.

RHODE ISLAND passed HB 8298, requiring study of TNCs.

SOUTH CAROLINA proposed SB 299, would preempt local regulation.

TENNESSEE proposed HB 992 would require Pre-trip: minimum contingent liability coverage; During trip: $1mm primary liability. Proposed HB 1075 & SB 1052 would require Pre-trip: 50/100/25 primary liability, $1mm UM/UIM, comp/collision if driver carries it otherwise; During trip: $1mm primary liability, $1mm UM/UIM, physical damage coverage if driver carries it otherwise.

VERMONT proposed HB 385 would require Pre-trip: 50/100/30 primary liability, $200k excess liability, and UM/UIM & comp/collision if driver carries them otherwise; During trip: $1mm primary liability, $1mm UM/UIM, comp/collision if driver carries it otherwise.

VIRGINIA passed HB 1662/SB 1025 requires until Jan. 1, 2016 Pre-trip: 125/250/50 secondary liability; During trip: $1mm primary liability, $1mm UM/UIM when passenger on board. After Jan. 1, 2016 Pre-trip: 50/100/25 primary liability; During trip: $1mm primary liability, $1mm UM/UIM.

WASHINGTON proposed SB 5550 would require Pre-trip: 50/100/30 primary liability; During trip: $1mm primary liability, $1mm UM/UIM; TNC must disclose exclusions to driver.

WEST VIRGINIA proposed HB 2546 & SB 419 would require Pre-trip: minimum liability, & UM/UIM unless waived; During trip: $1mm primary liability, $1mm UM/UIM when passenger in vehicle; at all times, comp/collision if driver carries it otherwise, $200k excess liability.

What is Insurance Premium Financing?

Premium financing is a unique service available to policyholders to assist them with payment of insurance premiums. Premium financing is a loan that spreads the payments out over time, helping to improve the policyholder's cash flow. In these difficult economic times, the ability to spread payments for insurance expense can provide significant relief to business owners. In better times, a borrower generally benefits in borrowing costs that are below their cost of capital and in preserving cash for investment in their business. Many times the availability of premium financing is unknown to policyholders, Boards of Directors and insurance company executives. In this article, we hope to shine a bright light on the value of insurance premium financing and its many benefits to policyholders, traditional property and casualty insurance companies, captives and risk retention groups (RRG).

What is insurance premium financing?

Insurance premium financing is a loan between the policyholder and the premium finance company. The loan enables the policyholder to make a down payment and finance the balance of their premium. The policyholder typically repays the loan over nine payments.

How is the loan originated?

A Premium Finance Agreement (PFA) is the loan document used to originate the loan. It discloses the terms and conditions for the loan including interest rate and payment schedule. The PFA lists the policies being financed. The policyholder does not pay a loan origination fee or other origination expenses that banks typically charge to make a loan.

Does the policyholder provide any other collateral to secure the loan?

No. The PFA contains provisions wherein the policyholder grants the premium finance company a security interest in any return premiums and a power of attorney to cancel the financed policies in the event of non-payment of an installment.

Insurance companies, captives and RRGs can better serve their stakeholders by collecting premiums upfront and leaving the premium billing function to others.

Does the PFA loan impact the policyholder's bank line of credit or credit rating?

No. The PFA does not draw on nor does it impact the policyholder's bank line of credit nor are Uniform Commercial Code (UCC) filings made to attach the policyholder's assets for collateral such as office equipment, bank accounts, accounts receivable, etc. The collateral for the PFA loan is simply the policy premium itself. Premium finance companies typically do not report transactions to credit rating bureaus.

Are the interest rates competitive?

Yes. Most often, premium finance interest rates are more competitive than interest rates, origination fees and expenses charged by banks.

Where does the policyholder go to complete the PFA?

It is a very simple and short process. The agent, broker or insurance company prepares the PFA electronically. The policyholder reviews the PFA, signs the PFA and pays the down payment amount. That's it, very easy. The agent submits the PFA to the premium finance company for acceptance. Upon acceptance, the premium finance company funds the loan amount to the agent or insurance company and the transaction is complete. Gone are the multiplicity of loan documents and signatures required by banks.

When is the first payment due?

Most PFAs contain a payment schedule that has the first payment due 30 days after the effective date of the policies being financed. The premium finance company notifies the policyholder of payment options such as payment coupons, ACH, credit card, automatic drafting of the policyholder's bank account, etc.

How does the payment plan impact the policyholder's cash flow?

By financing the premium, the policyholder can spread the payments over nine months or more. This enables

By Dick Crnkovich

the policyholder to use their working capital for other purposes. Generally, the policyholder's cost of capital is greater than the interest rate on the premium finance loan. On the policyholder's books, the prepaid insurance premium can be carried as a prepaid asset.

Are there other fees involved in the premium finance loan transaction?

Yes. The PFA provides for other fees to be charged for such things as late payments, insufficient checks, cancellation, etc.

Can capital contribution amounts be financed along with the policy premium?

Some premium finance companies will finance capital contributions after review of the insurance company structure and participants. Some RRGs and captives collect a capital or surplus contribution to support the capitalization of the insurance company. Typically, capital contributions may be financed on the PFA document as part of the loan without any loan origination fee. As with the financing of premium, the policyholder's line of credit is not drawn on or impacted nor are their assets attached with UCC filings.

How does premium financing help the insurance company, captive or RRG?

Use of premium financing improves cash flow and liquidity. By collecting the policy premium upfront at the inception of the policy, the insurance company is in a more liquid position. This creates greater opportunities for investment income. Eliminating balances due from agents and policyholders on its balance sheet positions the insurance company to place more money into investments, often times at long-term rates to improve investment yield.

What about insurance company payment plans?

Insurance companies may offer payment plans to help the policyholder pay the policy premium over a number of months. Terms, conditions and billing procedures vary within the property and casualty industry.

How does offering a payment plan impact the insurance company, captive or RRG?

When an insurance company offers a payment plan to its policyholders, it forgoes the use of premium money for investment purposes in exchange for a nominal "installment fee" charged with each installment. Too often, the time value of money is not taken into consideration when offering a payment plan. In addition to the loss of investment income, payment plans incur "operating costs" such as personnel, systems, overhead and other costs that can be substantial and typically exceed installment fee revenues. Insurance companies are in the business of taking underwriting risk and settling claims. Finance companies are in the business of making and servicing loans including collecting installment payments. Insurance companies, captives and RRGs can better serve their stakeholders by collecting premiums upfront and leaving the premium billing function to others.

How does collecting full premium upfront benefit insurance company, captive and RRG financials?

Reducing or eliminating balances due from agents and policyholders from the balance sheet reduces credit risk and improves risk based capital (RBC) ratios, a number

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of Insurance Regulatory Information System (IRIS) test ratios, combined ratios and operating ratios. Agents prefer premium financing because they receive full commission upfront. By eliminating the insurance company payment plans, insurance companies can deleverage their balance sheet and outsource the billing function to premium finance companies thereby reducing personnel and administrative costs. This leaves more of the premium dollar in the insurance company to invest and pay claims while lowering the administrative expense ratio. Over time, this may help hold down future premium rate increases.

How else does increased liquidity help the insurance company, captive or RRG?

Here is an easy example. Most insurance companies, captives and RRGs use reinsurance to protect their capital and surplus from increases in frequency and severity trends. Most reinsurers want upfront payment of the reinsurance deposit premiums because they, too, understand the time value of money. Furthermore, reinsurers need to have these premiums in-house in case they incur a large loss. When reinsurers require premium payment upfront, insurance companies, captives and RRGs offering payment plans can find their cash resources strained, or worse, the cash shortfall may require liquidation of a portion of the investment portfolio.

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Imperial PFS is the largest originator of premium finance loans for the property and casualty insurance industry. The privately-held company has been providing premium financing since 1977. Over the last 35 years, Imperial PFS has acquired 23 premium finance companies and has 25 branch offices throughout the US. In February 2010, Imperial PFS bought Imperial Credit Corporation/AI Credit from AIG. In June, 2011 the companies combined and were rebranded to become Imperial PFS.

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Maintaining Liquidity in Today's Market

How has the fixed income market changed and what are the implications for insurance companies trying to implement their investment strategies in conjunction with these developments?

By Scott Skowronski, CFA

When examining investment opportunities for insurance companies today, it is essential to examine how the landscape has evolved.

Sources of liquidity in the bond market are much different today than what existed pre-financial crisis. With numerous contributing factors such as the burgeoning size of the market, evolving regulatory rules, central bank influence, and the growing presence of pooled investments vehicles, the bond market has transformed in such a way that it requires insurance companies to develop distinct investment strategies to match its complexity.

Today's Bond Market and Liquidity

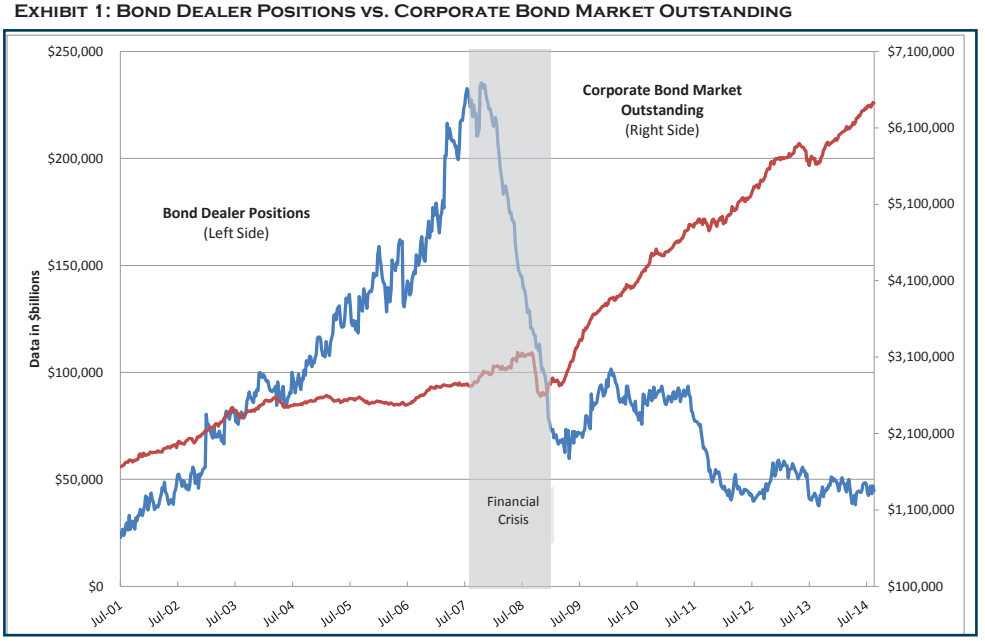
Following the colossal damage caused by the financial crisis of 2008, regulatory rules were adopted in an effort to improve bank solvency and reduce risk on their balance sheets. A side effect of this initiative is that it's had a significant influence on the manner in which bonds are traded. Specifically, the regulatory rules put in place were Basel III and the Dodd-Frank Volcker Rule. Basel III refers to global guidelines requiring banks to hold more capital in reserve for risk assets. The Dodd-Frank Volcker Rule eliminates "proprietary trading," or banks using their own capital to trade in capital markets. Leading up to the financial crisis proprietary trading was significant,

....the bond market has transformed in such a way that it requires insurance companies to develop distinct investment strategies to match its complexity.

in some cases accounting for up to 20% of bank earnings in 2006-2007. Put together, bonds dealers not only have less capacity to make markets buying and selling bonds from their customers, but it's also more expensive for them to do so. Accordingly, bond trading has developed into a market where matching buyers and sellers has become an essential alternative to dealers providing liquidity with their own capital.

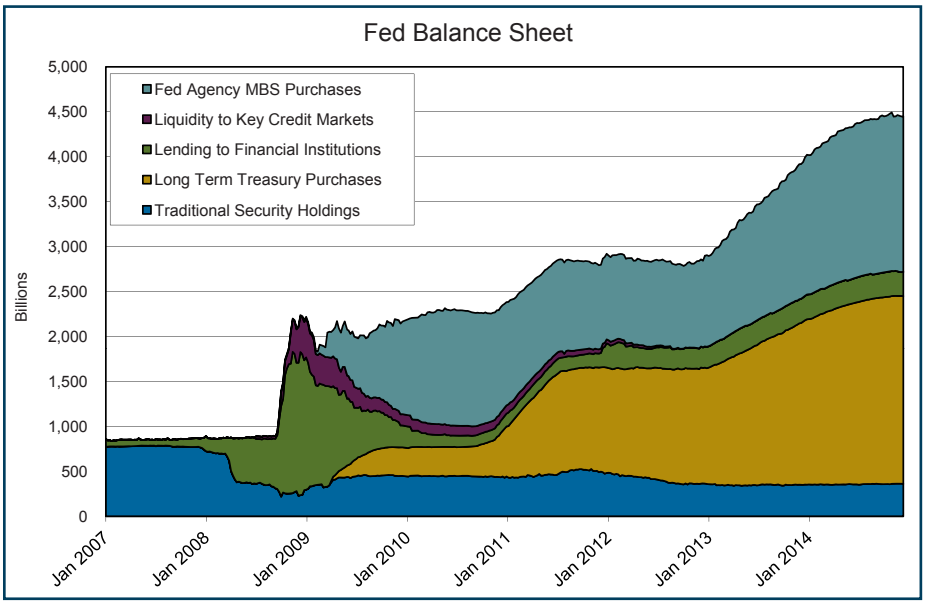
Implementation of the new bank rules has been measured allowing ample time for full compliance. Accordingly, we believe any loosening in the standards will not take place in the foreseeable future especially with the fallout from the financial crisis still fresh in everyone's minds.

Exhibit 1: Bond Dealer Positions vs. Corporate Bond Market Outstanding



This dynamic is best illustrated in Exhibit 1. It is important to note the data ranges displayed below; the range consists of data from July 2001 to July 2014, which adequately exemplifies dealer positions well before the 2008 global crisis and well after. The left side of the graph (blue line) demonstrates the bond dealer credit instruments in inventory or held on their balance sheet over time, and the right side of the graph (red line) represents the size of the corporate bond market, illustrating risk assets, as it has

Exhibit 2: Quantitative Easing Removed Available Supply of Securities



evolved from 2001 to 2014. Dealer inventories peaked right before the financial crisis in 2007, approximating $230 billion of bonds on their balance sheet. The shaded area on the graph depicts the financial crisis; it can be seen below that banks were eager to immediately de-risk their balance sheets, therefore explaining the drastic decrease in inventory.

Fast forwarding to 2014, there has been an 83% decline in credit related bonds on dealer balance sheets. Conversely, since that time, the low interest rate environment has enticed borrowers to issue debt at historically low costs, helping contribute to the explosion in the size of the corporate bond market outstanding.

These two dynamics are shown below, working against each other in that there is 83% less inventory available, yet risk assets represented by corporate bonds have risen 124% to $6.5 trillion since the same period coming out of the financial crisis.

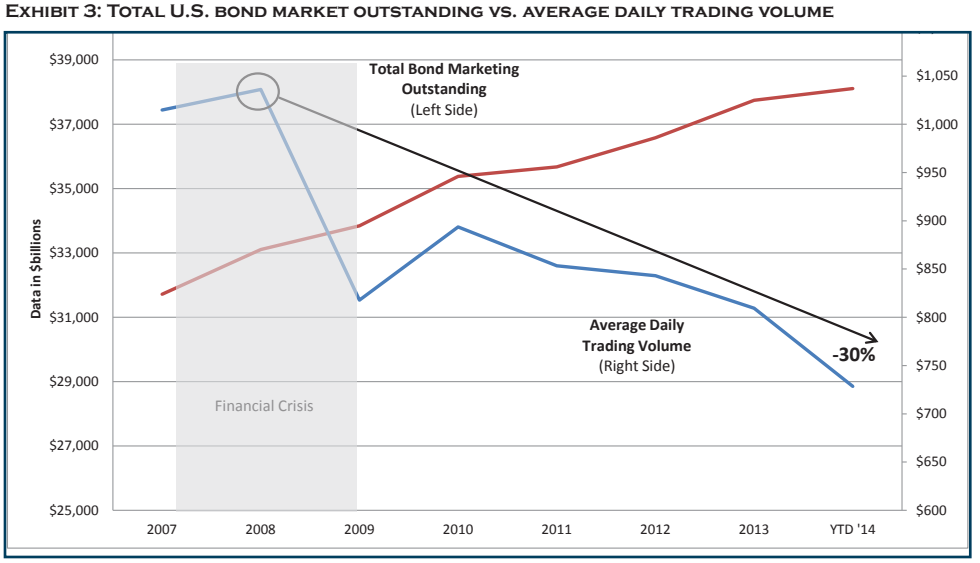
In the previous example, we discussed risk assets and how they have been impacted by growth in the market as well as shrinking balance sheets. During the same period, however, there has been quantitative easing (QE) by the Federal Reserve that has also impacted less risky assets such as Treasury bonds and Agency guaranteed mortgage-backed securities. As illustrated in Exhibit 2, although QE has ended, the Federal Reserve continues to hold over $4 trillion of these securities on their balance sheet which pulls a significant amount of float out of the market.

To further illustrate this point, Exhibit 3 shows the total U.S. bond market outstanding inclusive of all measurable sectors vs. average daily trading volume of the same bonds. The total bond market outstanding has grown to $38 trillion, yet the average daily trading volume, represented by the black line, has gone the opposite direction falling 30% during the same period. Average daily volumes in 2008 exceeded $1 trillion and today that value is closer to $700 billion, which is an indication that it has become more difficult to trade all bonds.

Implications of Reduced Liquidity on Trading Costs

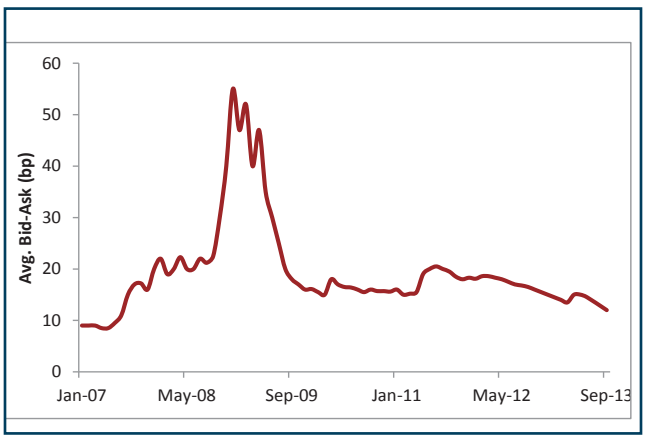
While the exact cost of reduced liquidity is difficult to capture, Exhibit 4 shows that Barclay's estimated the bid-ask spread differential to be wider than pre-crisis levels by about 3 ½ bps per trade or approximately 25 bps per year.

Exhibit 3: Total U.S. bond market outstanding vs. average daily trading volume



A natural progression to this environment of matching buyers to sellers is a greater reliance on electronic trading. While electronic trading platforms have gained popularity, the corporate bond market has been slow to transition to this model given the complexity and fragmented nature of the market that makes it challenging to do so. As an example, the Barclay's U.S. investment grade corporate index has more than 5,000 constituents all with varying credit profiles,

Exhibit 4: Average Bid-ask spreads remain wider than pre-crisis



terms, and structures making it difficult to analyze and trade in a uniform manner. Through the first half of 2014 for instance, only 16% of investment grade bonds were traded electronically. By comparison, almost half (48%) of U.S. Government market was traded electronically given this sector has fewer issuers, reduced risk implications, and more homogeneous structures.

Diminished liquidity has occurred in conjunction with a surge in pooled investment vehicles (shown in Exhibit 5) which is leveraging their influence on the market. This dynamic is forcing large investors like ETF's who need to maintain liquidity to emphasize the largest most liquid names. This can be seen by analyzing trade data. From January to September of 2014, 75% of the corporate bonds trades took place in only 8% of the outstanding names. Another measure of the depth of liquidity in the market is to identify corporate names that have trade volume of at least half of their outstanding size over the course of a year. Only 5% of corporate bonds meet that criteria today which is down from 20% before the financial crisis.

Exhibit 5: Pooled bond vehicles vs. dealer inventories

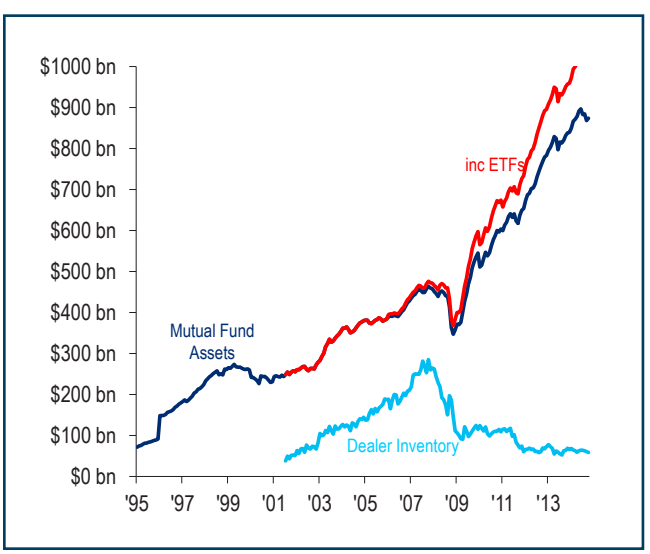
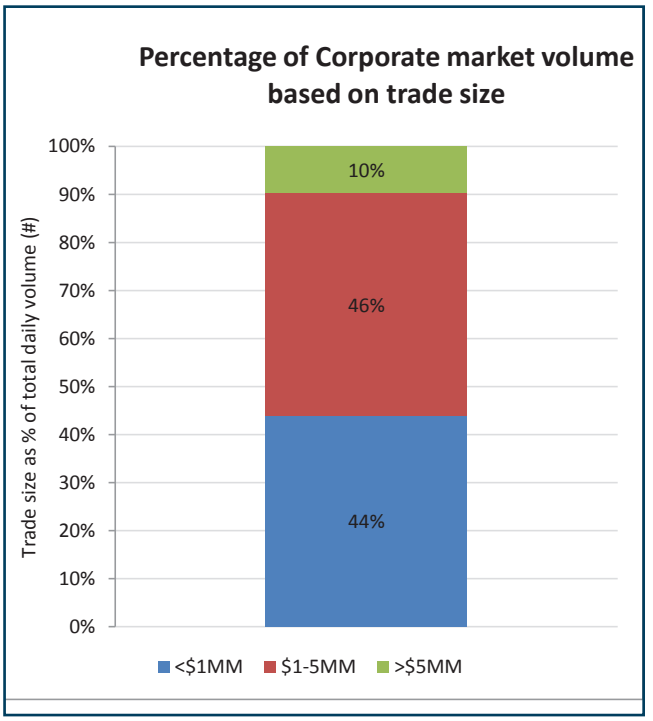


Exhibit 6: Percentage of Corporate traders Based on size



The Trade Size Sweet Spot

These cohesive market dynamics provide a break for mid-size insurance companies to capitalize on secondary trading opportunities in corporate bonds because there are several names that are being overlooked given liquidity limits. For example, one of the largest investment grade bond ETF's today, the iShares Investment Grade Bond ETF (LQD) focuses on issuers with more than $2 billion of debt outstanding. Following such a strategy would eliminate over half of the U.S. issuers available in a broader measure of the corporate market which includes bonds of at least $250 million. There are simply more opportunities available when you expand your investment universe beyond just the largest issuers.

But the obvious question is whether you can actually employ those trade ideas in the current environment? AAM's credit team analyzed TRACE secondary trade data (Exhibit 6) for investment grade corporates in the first half of 2014. They found that trade sizes $5 million and below made up over 90% of the transactions that occurred. In other words, the current trading environment has been most challenging for the largest investors.

To put that trade size in perspective, a $1 billion insurance company might purchase a bond representing ½% of their portfolio ($5 million) or a $100 million company could purchase the same bond with a similar ½% weighting of $500,000. As you can see in the exhibit below, both trades fall in the sweet spot of where the majority of secondary trades are getting done in this market. This af-

continued on page 28

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The Convergence Market is Alive .... and Well

Michael Popkin ***Rick Miller***

Background

The convergence market is alive and well. The property catastrophe reinsurance and insurance-linked securities (ILS) markets are witnessing this convergence along a spectrum and across a range of differing attributes. This paper will review this continuum across key characteristics in the catastrophe risk transfer arena. To provide a specific example, we will conclude with a brief case study of Market Re platform and describe where it fits across the various attributes. Though there are many ways to divide the market, we have chosen to break it into three main categories: reinsurance; collateralized reinsurance (CRe); and catastrophe bonds. We will cover the similarities and differences for the following topics: (1) type of collateral; (2) payment flow; (3) reinstatement; (4) collateral release & commutation; (5) premium adjustment; (6) fees & expenses; (7) risk analysis; (7A) tradability; and (8) trigger type. Multi-year vs. single-year contracts are not explored in depth in this paper because this is a feature that can be utilized in all three forms of execution.

Type of Collateral

The nature of the collateral for the cedant varies depending on the type of protection they purchase. A cedant following the traditional reinsurance route takes the reinsurer's "paper." Though somewhat of an over-generalization, the value of the paper is a binary assessment from a credit perspective. Is the provider of that reinsurance paper a reliable enough counterparty that their paper will have value when called upon?

While there is slight variation in value attribution depending on whether the paper comes from a bulge bracket reinsurer, second tier reinsurer, or the rest, it remains largely a binary consideration. Assuming the answer to the binary question is "yes" the focus shifts to other key components of the decision. Specifically, the question then becomes one of long-standing relationships versus Rate-on-Line (ROL). Certain dedicated insurance funds will utilize transformer vehicles and borrow the "paper" from rated and recognized counterparties in order to offer the cedant a traditional reinsurance market.

At the opposite end of the spectrum reside 144A bonds. In these, the cedant is fully covered by the collateral residing within a trust account irrespective of counterparty risk. Once the bond buyer purchases the bond, the cash remains in a collateral account. Even if the bond buyer became insolvent, the cash would remain in the collateral account and would inure to the benefit of the cedant if an underlying trigger event occurred. The connection or ongoing relationship between the bond buyer and the cedant is weaker. Nonetheless, it is not uncommon to see the same investors buying every issuance of certain cedants.

In this attribute, Collateralized Reinsurance (CRe) is more similar to bonds in terms of the collateral rather than paper supporting the protection. While there are many collateral variations within both bonds and CRe (U.S. Treasuries, IBRD notes, tri-party repo structures, etc.), both methodologies of execution rely on collateral to support the transaction vs. the unsecured promise of the market. With respect to documentation, CRe rests more in the middle between reinsurance and bonds. In CRe, as in reinsurance, an insurance slip is used rather than security documentation used for a bond. Because of the collateral involved, the reinsurance slip and associated documentation more closely mirror the collateral and collateral release mechanism sections of a catastrophe bond offering.

Payment Flow

The payment flow mechanism among the three categories also varies. At one end of the spectrum lies reinsurance. The reinsurer provides paper cover for the full limit and, in exchange, receives premium payments that are paid per the terms of the slip. Typically, these are paid throughout the contract period on a quarterly or semi-annual basis. They are rarely paid up-front when the market is concerned about the creditworthiness of the cedant to make these premium payments.

For CAT bonds, like corporate bonds, payment is done in the form of a coupon payment. The bonds are purchased providing collateral, which is returned at the end of the

transaction, assuming no loss from a CAT event. The coupon payment that occurs quarterly is actually made up from two separate flows. First, the collateral or principal provided by the bond buyer goes into a collateral account. The collateral is invested into permitted securities under a variety of different structures. The yield from the collateral makes up part of the coupon payment. The second part of the coupon payment comes from what the cedant pays the (special-purpose vehicle or SPV) issuer for the protection (i.e. the premium). In most circumstances, the limit of cover is fully collateralized and the premium flows to the investors as an ongoing coupon.

CRe is a hybrid of traditional reinsurance and CAT bonds.

CRe is a hybrid of traditional reinsurance and CAT bonds. The insurer and the CRe party agree a premium, which reflects the amount the insurer is willing to pay for collateralized cover rather than paper cover. Typically, the collateral posted represents the limit minus the net premium, providing the collateralized market a degree of leverage. The premium flows can occur on a quarterly, semi-annual or up-front basis to top-up the collateral account to the full limit. Whereas in most 144A bonds the entire principal face is paid up-front (and received back at maturity if no event is triggered) and the premium is paid throughout the deal as coupon payments, in CRe, the premium reduces the amount of principal the collateralized market must contribute up-front (i.e. they contribute limit minus net premium).

A simple example, ignoring time value of money, should illustrate the differences. For the example, assume cover of $10MM and premium of $2MM (or four coupons of $500K). For reinsurance, paper cover of $10MM is provided and the reinsurer receives $2MM. For a one-year bond, $10MM of principal is provided as collateral. The bond buyer receives four quarterly coupons of $500K each. At maturity, the principal is returned to the investor (assuming no event). For CRe, the same $10MM of cover is provided; however, only $8MM of cash for collateral comes from the CRe market and the premium payments are made into the structure.

Reinstatements

Traditional reinsurance generally allows for reinstatements. Namely, if the reinsurance contract is penetrated and the limit is paid out, both the cedant and the market may have to reinstate the contract. The cedant pays another premium to the market and the market provides the cedant similar cover until the end of the risk period. From a cash flow perspective, this is dealt with as an offset; the market pays the cedant the loss minus the appropriate reinstatement premium.

Catastrophe bonds by their very fungible nature struggle to provide a reinstatement and typically provide only single-shot cover. They can provide second-event cover, but the premium on that particular cover is paid on the outset of the contract and is not contingent upon the occurrence of an event.

Most CRe provides only single-shot cover. CRe can provide reinstatable cover, but the premium needs to be sizeable enough to provide an adequate return on collateral posted on effectively two limits. Furthermore, the cover is more likely described as "one free," meaning that the original premium pays for both the first occurrence and a reinstatement. Economically, this feels more akin to a single-shot cover plus a second event cover.

Collateral Release and Commutation

Since traditional reinsurance does not require collateral to be held, contracts do not need to provide for a collateral release mechanism. Furthermore, traditional markets can remain obligated to pay claims once the full loss development period has run its course. However, some long-tailed lines of cover may have a commutation mechanism included in the slip wording to close out the obligations of the market so risk capital is not tied-up into perpetuity.

Catastrophe bonds require a collateral release mechanism. From a regulatory perspective, the special purpose insurance vehicle's obligations are limited by the collateral available to pay claims. Therefore, collateral release effectively (and most likely legally) results in commutation. The collateral release mechanism is described as an extension event past the risk period. Extension events can occur for a variety of reasons including a discretionary decision on the part of the cedant or significant losses currently evident through the loss development period.


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Extending a bond is not a free option for the cedant. If a bond is extended, the cedant no longer pays a risk premium/coupon into the structure but pays the noteholders a smaller extension spread. If the decision is at the cedant's discretion, the extension spread is higher (circa 3%) than if the extension is driven by proven losses arising to a level triggered by the documentation (0.10% to 0.30%).

CRe also requires a collateral release mechanism. However, the cedant typically does not have discretion to hold the collateral beyond the risk period. Collateral is retained and/or released based on predefined loss triggers. The triggers adjust and become more favorable to the market as more time passes beyond the loss occurrence date and more loss development should have occurred. Accordingly, additional premium or spread is typically not included within these structures. Furthermore, the collateral release mechanism allows for a partial release of collateral and should be designed to provide the cedant with appropriate but not excessive collateral to accommodate loss development.

Premium Adjustment

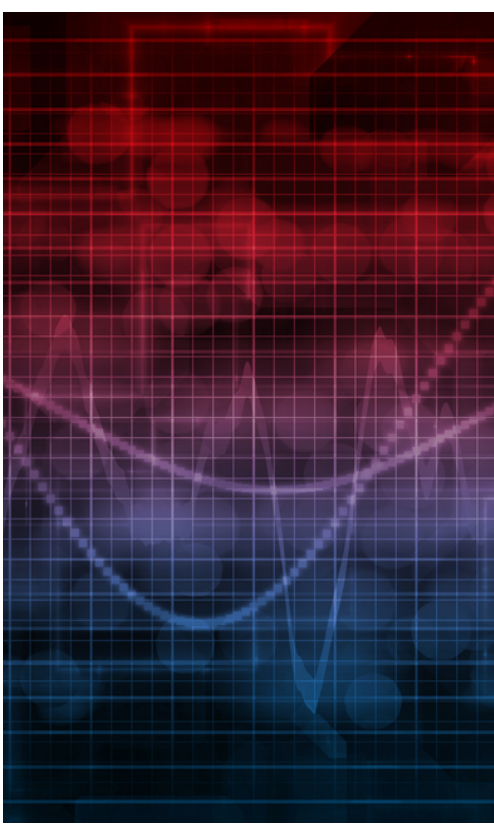
For traditional reinsurance, the premium, attachment points and exhaustion points are set at the beginning of the period expressed as a hard dollar amount. For most cedants who have a stable book of business during the risk period, the risk of the layer should not change. However, for certain cedants such as Florida homeowner specialty insurance companies, the portfolio migrates and the risk of the reinsured layer migrates. Due to regulatory and rating agency reasons, the attachment points and exhaustion points cannot change during a single year risk period. Accordingly, if the risk increases, then the market should be compensated with more premium dollars. Conversely, if the risk of the portfolio decreases, the market should return some of that premium. Therefore, the premium remains a function of risk as measured by a variety of methodologies calculated at different intervals of the risk period and at different risk/return periods. Some of these methodologies include probable maximum loss (PML), total insured value (TIV), or other measurements of risk aggregation.

Multi-year contracts in any of the three forms can be dealt with through "reset" mechanisms, where the attachment points and exhaustion points can be recalibrated to PML probabilities as opposed to premium adjustments. Catastrophe bonds are typically bought at par and mature at par with a predetermined coupon spread. Premium adjustments are not commonly seen. However, almost all multi-year cat bonds provide for a reset mechanism to adjust the layer of risk transferred once a single risk period ends. From a cedant's perspective, they can enable purchasing more or less complementary traditional cover in future years to manage the shifting nature of the reset bonds, assuming cat bonds form a controlled allocation of their overall reinsurance program.

CRe has features from both bonds and reinsurance. With CRe, the value of the collateral posted can be viewed as having a par value at inception and accreting to some level above par at the end of the risk period (assuming no loss events). The expected return is, in essence, embedded in that accretion. By comparison, a typical zero coupon bond's initial purchase is at a discount, and accretes to a par value at maturity. The apparent growth in principal is really just derived from the coupon payments that aren't paid because the discounted bond matures at par. CRe is like that zero-coupon bond except it can be viewed as starting at par and maturing above par. The rationale for the mathematical shift in value perception is because CRe can experience a premium adjustment. Transactions should have a value above par in a no loss scenario. In the event where a premium adjustment lowers the amount of premium provided, the impact should be on the expected level above par.

Fees & Expenses

The fee structure represents another area of differentiation. Since reinsurance is a paper trade without collateral, it has a more straight-forward fee structure. Brokers are paid to place the risk via the reinsurance or retro markets as a function of premium. Documentation is familiar and light, so it can generally be done in-house for both the cedant and the protection provider. However, markets have internal costs associated with maintaining their credibility and the value of their unsecured promise to cedants through reserve requirements and constraints on how reserves are invested, fees paid to rating agencies, and expenses related to enterprise risk management.



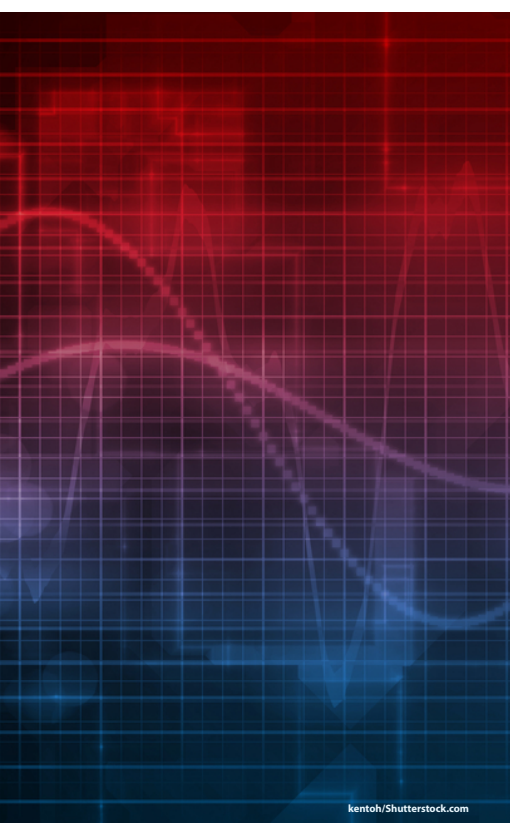
At the other end of the spectrum are 144A bonds. Catastrophe bonds involve collateral, include broad distri-

bution to both reinsurance and non-reinsurance professionals, operate under both securities and insurance law, and require varied degrees of external expertise and due diligence. Accordingly, there are many more parties and agreements involved, thereby creating other significant fee arrangements. Service providers include but are not limited to: rating agencies, insurance managers of the SPV/SPI, indenture trustees, reinsurance trust trustees, catastrophe modeling agencies, capital market teams to structure and place the bonds, and distinct counsel for most (if not all) of these parties including the investors. The documentation for a bond issuance is considerably larger and more detailed than for reinsurance, encompassing numerous agreements.

CRe documentation is somewhere in the middle, but leans closer to traditional reinsurance. Since it involves collateral, it is more extensive than reinsurance. CRe is typically a bilateral agreement not subject to secondary trading and document requirements are well shy of what is required for a full 144A bond.

Risk Analysis

For each of the three categories, it is important to think about the risk from both the cedant's perspective and from the market's/investor's perspective.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The risk on traditional reinsurance is a well-trodden path. Since it is a pure paper transaction, the cedant takes the risk that the protection provider is there when called upon. The cedant has no collateral and remains exposed to not only the simple credit risk of its counterparty but also indirectly to the other risks within the protection provider portfolio. From the market's perspective, the contract is based on the ultimate net loss of the cedant. Accordingly, the reinsurer is exposed to the underwriting and the claims management of the insurer, in addition to the risk of a catastrophic loss.

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With a bond, the cedant is fully collateralized and so the counterparty risk is based on the risk of the collateral in the trust account. Where the collateral is invested in US Government money market securities, the risk is limited. When the bonds are not pure indemnity, the bond purchaser has less exposure to the specific underwriter. Furthermore, most catastrophe bonds pay fees to service providers in an attempt to quantify the risk. Investors need not have dedicated reinsurance knowledge if they rely upon these experts when assessing probability of loss. Conversely, a lot of information is not provided to the broad investor base because it is distilled by these experts. From an investor's perspective, there is less to analyze and from a cedant's perspective, disclosure of proprietary information can be better controlled.

CRe offers the cedant the protection of collateral, which addresses the counterparty risks inherent in reinsurance. Investors/collateralized markets still face those associated with indemnity but are paid accordingly. Furthermore, information is not distilled, but is provided in a manner similar to other traditional markets. In this instance, CRe feels more like traditional placement.

One other risk is worth mentioning. If cedants rely solely on certain segments of capacity, they are running the risk that capacity in another segment won't necessarily be there when they need it. Specifically, it takes time to develop a capital markets following as well as to build the institutional capability to bring a bond to market. If cedants wait to do this until they definitely need it, they will likely be at a competitive disadvantage to those who have already established capital markets programs.

Tradability

When undertaking a risk analysis, it is important to consider potential liquidity. Traditional reinsurance is not tradable. Liquidity can be achieved via novation, while the risk can be shifted via retrocession. Conversely, a 144A bond is freely tradable to qualified buyers, thereby providing significantly greater liquidity. In this sub-category of Risk Analysis, CRe is similar to reinsurance, with limited liquidity. One alternative that can make CRe liquid, CONTINUED ON PAGE 46

Changing Regulatory Landscape

Gauging the Impact of the Corporate Governance Annual Disclosure Model Act and Regulation

Insurance company executives—controlling owners, directors and officers—are used to the scrutiny and standards of fiduciary care that may apply to their positions. The standards that apply can be complicated for insurer senior management, who also have responsibilities related to their shareholders as well as obligations to the policyholders of the company. As part of its overall solvency modernization initiative, the National Association of Insurance Commissioners (NAIC) has been studying the states' general corporate fiduciary standards and working on model corporate governance disclosures that will apply to insurers and/or their holding companies. These disclosure standards create additional levels of review and possible oversight by the states as they are adopted in the years to come.

On November 14, 2014, the NAIC's Executive Committee/Plenary voted to adopt the Corporate Governance Annual Disclosure Model Act and the Corporate Governance Annual Disclosure Model Regulation (collectively, the "Acts"). The Acts require the insurer or its holding company to provide its domiciliary insurance commissioner with a detailed summary of the insurer or insurance group's corporate governance structure, policies, and practices in an annual filing. The annual filing is meant to provide the insurance commissioner an understanding of the insurer's corporate governance framework. According to the NAIC, states are expected to start requiring disclosures at the beginning of 2016, with all states and territories on board by 2019. In fact, legislation has already been introduced in Indiana to adopt components of the Acts.

These disclosure standards create additional levels of review and possible oversight by the states as they are adopted in the years to come.

Filing Requirements

Under the Acts, an insurer must submit a Corporate Governance Annual Disclosure (CGAD) no later than June 1 of each calendar year. Alternatively, if an insurer is a part of a holding company, then the holding company may submit a CGAD as an insurance group. The insurance group must submit the CGAD to the commissioner of the lead state, as determined by the NAIC's Financial Analysis Handbook.

Depending on how the insurer or insurance group has structured its system of corporate governance, disclosures may be needed at the ultimate controlling party level, an intermediate holding company level and/or the individual legal entity level. In order to determine what disclosures should be made, the insurer or insurance group must decide which category of reporting it will use: (1) the level at which the insurer or the insurance group's risk appetite is determined; (2) the level at which the earnings, capital, liquidity, operations, and reputation of the insurer is overseen; or (3) the level at which legal liability for failure of general corporate governance duties would be placed. Interestingly, once insurers and their groups determine the corporate level at which they will disclose, all subsequent filings must be at the same level or any changes must be adequately explained. This highlights the need for a measured analysis of the proper level for insurer or holding company disclosure, with the understanding that any changes are likely to invite further review of the rationale for the change and any underlying issues that may apply.

The CGAD is required to address the following information: (1) the insurer's corporate governance framework and structure; (2) the policies and practices of its board of directors and significant committees, including information regarding board member qualifications and independence; (3) the policies and practices directing senior management, including information regarding significant compensation programs; and (4) the processes by which the board of directors, its committees and senior management ensure an appropriate level of oversight of the critical risk areas impacting the insurer's business activities.

Authors, from left:

Fred E. Karlinsky
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Cushla E. Talbut

The information must be as descriptive as possible and include any necessary supporting documentation in order to provide the domiciliary commissioner an understanding of the insurer's corporate governance structures, policies, and practices. Moreover, the commissioner may request additional information, as appropriate. A failure to file the CGAD will result in a daily fine with a maximum cap, which will be determined by the states.

Notably, insurers and their holding groups will need to address a number of issues for disclosure under these corporate governance protocols. This will include basic governance documentation, such as bylaws and committee charters, through more strategic considerations, such as the rationale for the size and structure of the current board of directors. Disclosures will need to relate board member qualifications and expertise to benefits provided to the insurer or group, selection criteria, and processes to evaluate committee performance. Insurers or their groups will need to disclose processes related to suitability standards utilized in the selection and retention of key control function officers.

These disclosure requirements will lead insurers and their controlling parties to focus on established codes of business conduct, the board's oversight of management performance, compensation and implementation of corrective actions, when needed. In addition, much like the Own Risk and Solvency Assessment disclosure and the enterprise risk Form F filing, insurers will need to describe processes of management in reporting, evaluating, and monitoring critical risk areas related to a variety of functions, such as actuarial, reinsurance, business strategies, compliance, financial reporting and auditing, and market conduct.

Notably, insurers and their holding groups will need to address a number of issues for disclosure under these corporate governance protocols.

As with other transparency initiatives of the NAIC and state insurance commissioners, the corporate governance disclosure models represent another step in opening insurance groups up to more review and possible scrutiny by the state regulators. While insurers will incur more regulatory cost of compliance and there will be some overlap with other insurer filings, the goal is to monitor and hopefully assure better overall corporate governance and accountability for insurers and their groups.

Confidentiality and its Consequences

Understandably, a critical issue surrounds the confidential treatment of the information disclosed in the CGAD. The corporate governance disclosures are to be treated with the same level of confidentiality as information disclosed under the holding company registration model law. Specifically, the information is confidential by law; shall not be subject to subpoena; and shall not be sub-

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ject to discovery or be admissible in evidence in any private civil action.

While most states' laws will likely follow the model law regarding confidentiality, there can be variations. The Florida Office of Insurance Regulation, as an example, has raised some previously advanced constitutionality concerns related to broad-based confidentiality of governance filings. Thus, it will be important to assure that any insurer making a filing has a firm understanding of the possible scenarios where information in the filing may be subject to disclosure based on any state's public records laws or some provision of law that may permit discovery in a lawsuit.

In view of, and partially in response to, the ongoing evolution of a federal presence in insurance and the growing international influence on certain policies adopted in the U.S, the NAIC and states continue to implement initiatives intended to modernize state-based insurance regulation. The recent adoption of the Corporate Governance Annual Disclosure Model Act and Regulation provide more transparency for regulators to better understand and assess risk tolerances and mitigation initiatives that may exist with insurers and within their holding company groups. Taken with already broadly adopted changes in insurance holding company disclosure laws and evolving enterprise risk assessments insurers will need to file, corporate governance disclosures will serve to provide another portal for regulatory scrutiny of insurers and their holding groups.

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Maintaining Liquidity in Today's Market

fords mid-size insurance companies the opportunity to enhance portfolio income given they have the ability to implement those ideas in the secondary market.

The new issue corporate bond market has been very robust and is also a good outlet to source attractive bonds. Insurers who lack the scale to access new issues bonds can look to a third party asset manager who actively participates in the market.

As an insurance company in this market, being the right size buyer of fixed income securities is crucial. In these challenging times of low prevailing interest rates, the ability to access and apply as many ideas as possible is essential to maximizing income. Reduced dealer inventories make it challenging for the largest investors to act on opportunities outside of the largest issuers which significantly inhibits the investment universe. Being too small on the other hand can limit access to the new issue market or the full universe of securities available in the fixed income market. Mid-sized insurers and investment managers that can actively implement their strategies in both the new issue and secondary markets have a significant advantage when attempting to enhance investment income.

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AAM is a premier manager of insurance assets and has survived multiple market cycles with a 30+ year track record of working exclusively with insurance companies.

The rest of the Demotech team not pictured in photo on page 7

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KEY TEAM TRANSACTIONS

$27,012,500 ATLAS FINANCIAL HOLDINGS, INC. Common Stock Follow-On *May 2014*	$945,012,500 G Common Stock Follow-On *April 2014*	$57,500,000 UIHC Common Stock Follow-On *February 2014*
VALIDUS GROUP AON *Asset Sale of* STAR & SHIELD *to* White Mountains INSURANCE GROUP Sell-Side Advisor *January 2014*	$190,612,500 Fidelity & Guaranty Life℠ Initial Public Offering *December 2013*	$103,000,000 HCI Convertible Senior Notes Offering *December 2013*
$152,500,000 MAIDEN Senior Notes Offering *November 2013*	$125,000,000 BLUE CAPITAL REINSURANCE HOLDINGS LTD. Initial Public Offering *November 2013*	$165,000,000 MAIDEN Convertible Preferred Offering *September 2013*

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Leading the Charge in Technology

Actuaries will become knowledge artisans that pick from a broad range of tools to augment the practice of actuarial skills.

By Jamie Bisker

The information management needs of the actuarial profession are driven by an interesting and, at times, curious mix of elements. The temperament and nature of actuaries are well matched to the precision of the technology tools that are needed to manage the bits and bytes of data that must become information and knowledge.

The curious thing is that these very tools are advancing in capability such that traditional actuarial roles can be threatened with the specter of becoming redundant. In addition, these professionals have been using techniques for decades (what is now termed as 'predictive analytics' comes to mind, for example) that have only recently been exercised among their business and operational peers.

Actuaries number among those professionals whose primary task and work efforts revolve around information itself in the service of larger goals for individuals, organizations, and societies. While some of the mathematics of the profession have matured, it is the use of increasingly flexible and adaptable information technology (IT) that can be said to be the most noticeable change in the past 50 years. And now, in this second decade of the new century, actuaries have the opportunity to lead the insurance industry and others beyond traditional practices.

For their part, the business units that use the regular services of insurance IT shops have honed their relationships over the years and there are clear improvements in the delivery of efficient and effective information systems for new business, underwriting, policy processing and claims. Many actuarial groups, however, are still working on the periphery of IT and need to develop deeper and more integrated relationships with both internal and external sources of information processing.

> **... actuaries have the opportunity to lead the insurance industry and others beyond traditional practices.**

In the past, the relations between actuarial groups and IT shops within insurance carriers have run the gamut from cordial and professional partnership to mere political correctness in public with divergent agendas and actions in operational matters. Some of the friction can be traced to changes in regulation that supported or diminished various product types, or those legislative actions that caused new reporting requirements that forced new schedules and demands on both parties. The results of even small disagreements varied over time and so the outcomes of misaligned actuarial and IT departments took different forms. Sometime the situation spawned the creation of somewhat stealthy actuarial system teams while others would draft actuarial students to be programmers and operations staff. In more extreme cases, the groups would actually purchase and run shadow IT systems that were not under the thumb of mainstream (i.e., mainframe) computer operations.

The emergence of mini-computers and eventually personal computers (PCs) led to a sea change in the way actuaries perceived the value of IT. The new level of control that could be exerted over the collection and analysis of data required to discover trends, test assumptions, or build models was almost dramatic. Waiting for host time, divining JCL errors, and scheduling mainframe batch jobs gave way to separation of duties that measurably increased flexibility. Mainframes could still be used to run larger models and extract data, but the smaller computer systems could provide the flexibility to experiment and support new methods of calculations or model development. More actuaries were drafted into the actual coding of APL, Fortran or COBOL (and more recently, R) which heralded the evolution of the 'systems' actuary.

PCs exploded onto the scene effecting almost all types of business with greater formalization and individual control of numerical information. The automation of the accountant's

tabular data in the form of computerized spreadsheets was seized upon as a common mechanism for actuaries to share analysis of data, test ideas for further computerization, and search for anomalies in pricing data.

These advancements also came at a cost and with several painful realizations. First of all, the proliferation of more individually controllable computer systems and programs eventually were seen (sometimes quickly, and sometimes not so quickly) as producing "too many cooks in the kitchen." The source of data truth began to be diluted and drift among various departments. Varying data definitions, inconsistent sources, and even timing of data extraction created problems in ways that proudly independent actuaries were not used to dealing with. The concept of having to use spreadsheet auditing programs arose in part to deal with the proliferation of datasets that were only assumed to be correct. It seems that the onerous practices and seemingly arcane processes of corporate IT shops were not so out of step as they were once perceived to be.

Integrating with Corporate IT Environments

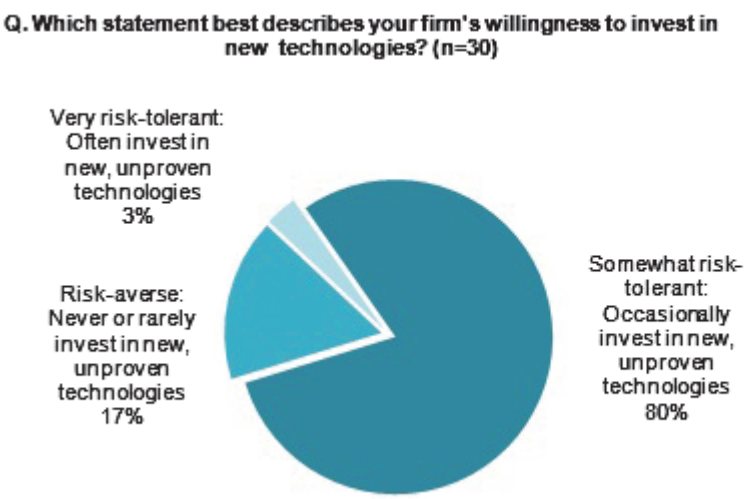
The specific events and variations on the themes mentioned above occurred across hundreds of insurers in myriad combinations. The outcomes from this initial actuarial-IT "dance" have helped to form the relationships and expectation of today. An important lesson learned and one of the key concepts that actuaries should keep in mind going forward is the power of integrating with IT instead of just seeking services from them. A key aspect of that integration comes from understanding IT architecture.

The need to have corporate IT architectures came from the increasing complexity of the work that information systems were being asked to perform as well as the complexity of the systems themselves. Client-server, distributed systems, service oriented architecture (SOA), and high-performance grid computing all impacted how an insurer's IT shop went about accomplishing the goals of the business units they served including actuaries. Aite Group's survey of insurance IT executives this past spring did point out, however, that 80% of IT executives polled are only somewhat risk tolerant in regard to their willingness to try the latest technologies in a wholesale manner.

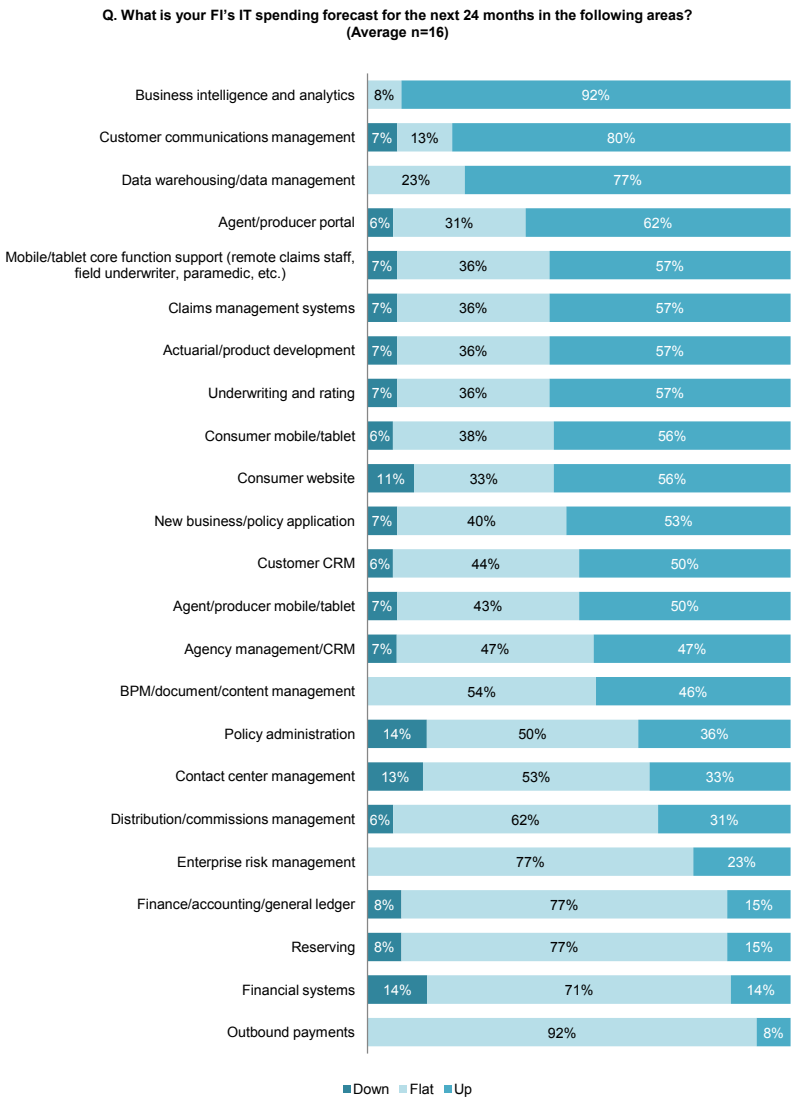
This piece of information speaks to the IT executives' observations within their companies and their concerns for meeting the needs of their business constituents in general. The IT executives' answers also reflect the corporate mindset which can vary quite a bit from company to company. And while those constituents include actuarial departments that can and do spend monies outside of corporate IT budgets, they do still need to operate with increasing levels of coordination within the corporate IT environment. For example, even if an actuarial team researches and finds a near optimal high-performance grid that works in a hosted cloud, they still need to consider the larger picture. In this case, they will likely need to work within the limits set by the corporate information security officer (CISO, pronounced "see-so") for extranet access and any cloud-based activities.

Strategic Considerations

Actuaries need to be as engaged as possible in working with other business units when strategic IT decisions are being made. When new projects are being discussed or when strategic business goals need to have foundational information systems changed or developed, the projected spending on any given technology is a critical component. The IT Executive Survey asked what spending was anticipated in the next 24 months for 23 separate categories.



Areas where actuaries likely have a strong vested interest include business intelligence (BI) and analytics, data warehouse and data management, product development, enterprise risk management (ERM), and reserving. Any work in these areas will directly affect their work and can enable improvements if the aforementioned coordination with corporate IT is well managed. The survey finds that 92% of IT executives expect increases in their budgets to support BI and analytics and 77% of respondents feel the same way about data warehousing and



data management. These reflect the somewhat dramatic rise in the value that carriers are now placing on their data to drive customer retention, combat fraud, and to improve the customer experience.

There is good news in that over half of our respondents felt that their funding of actuarial and product development will increase over the next 24 months. It may be, however, that the category itself is viewed more as a means to deal with the mechanisms of product development as a process than with specific support for actuarial systems.

Of concern is that both ERM and reserving are predicted to remain flat in terms of budget outlooks at 77% of carriers surveyed. This in itself may not be a bad thing. The commitment to these areas may have already been made in previous budget cycles and the carriers may have capabilities in these areas sufficient for their plans. The 23% that are increasing the funding for these areas is a good sign and may show strategic capability planning. Regardless, further research with more attention to specific actuarial investments will help to clarify these matters.

The Undiscovered Country

Vast new sources of data and information have recently been made available to the insurance industry from a variety of sources with some being more granular versions of existing data. The topic of big data and the use of cloud technology for both storage and processing of broad data types is a very important one for insurers going forward. The 24 month project spending data also yields some insight in regard to these new channels of incoming insurance information. Over 50% of IT executives say that spending for the support of mobile technology and systems is projected to rise. This is also true for core system access, providing consumers with deeper and better mobile experiences, and for supporting agents and producers in the field.

An initial reaction to the information from the survey is that it makes sense given the rise in mobile and smart devices, and their increasing utility to the insurance industry.

A more thoughtful analysis can project that the gains in infrastructure capability and experience in dealing with the IT protocols supporting mobile devices can be applied in a "next generation of insurance" context. That context involves the collection of precision data for pricing, rating, and underwriting much closer to real time and more specific to a given risk.

The Internet of things (IoT) is a catch-all description for what are essentially addressable, non-computer endpoints on the ubiquitous information sharing network. A readily understood example is a remotely accessible home thermostat that has its own Internet protocol (IP) address so that a computer or smart device can communicate with it. The IoT connects devices that can stream their data through small, advanced technology remote processing computers that forward only task relevant data on for useful analysis. This concept of processing data at the periphery of events and forwarding it on is called edge computing. In addition to collecting

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more data from a very broad array of sensors and devices, the IoT is active in that it also allows change to be pushed out to connected devices via commands to turn the heat up, unlock a door, or alert someone to a situation.

With increased availability of critical information directly from the source, whether that is from medical and environmental sensors, or from our homes and transportation devices, changes will likely be made to how actuarial models deal with real time data.

Thinking Ahead, Getting Ahead

In the future, one of the larger challenges within the actuarial profession will be both the creation and the organization of cognitive computing elements. Cognitive computing is information processing that handles data and information in ways that mimic that of human cognitive skills and produces similar if not superior outcomes.

This new type of computing paradigm will be set against a given problem to augment traditional actuarial approaches. This means that as the information systems that actuaries use are provided increasingly intelligent interfaces (such as voice recognition and language understanding) and equally capable computational components (field programmable gates arrays - FPGAs, neuro-synaptic chips, and dynamic simulation software), the most valued skill will increasingly be the ability to ask the right questions.

In practice, this will require a systems thinking approach to balance the interactions and outcomes that are crucial for profitable risk management. Insurance executives will need actuarial guidance to select and employ the full range of IT tools and data sources to support proper funding for pensions, life products, and to indemnify the multitude of property and casualty risks that exist in the world today. Actuaries will become knowledge artisans that pick from a broad range of tools to augment the practice of actuarial skills. And sometimes, the best tool is an experienced actuary asking the right questions.

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Jamie is a futurist and subject-matter expert in insurance, artificial intelligence and cognitive computing, and using advanced technology to drive financial services innovation. An accomplished speaker on advanced technology, the insurance industry, and other topics at public and industry forums, he also writes for insurance periodicals and online media. Jamie can be contacted at jbisker@aitegroup.com.

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Businesses that Stand the Test of Time

By Barb Albert

To attempt to predict the likelihood of success for insurance companies, many studies of analysis and valuation have been done to establish the factors that drive profitability. These studies chart the elements that predict a company's viability from a wide range of variables.

A look at companies whose incorporation dates reach back before the United States declared independence from British rule provides a clue to principles of longevity that may not fit neatly in current business analysis, but have proven successful nonetheless. Principles that just make sense.

From talking to three insurance companies celebrating incorporation dates over 100 years ago this quarter, a handful of principles of success stand out.

Identify your niche, and stick with what you know

"I think the biggest reason our company has lasted is that we've been able to identify our niche," said Michael Yeager, President and CEO of Lehigh Mutual Insurance Company in Allentown, Pennsylvania. "We are not out there competing with every other insurance company. We're licensed in the entire state of Pennsylvania, but we certainly do not write from border to border. We're backyard underwriters. We target our niche. We understand we can't be everything to everybody,"

Yeager said the company, incorporated in 1848 as a mutual fire insurance company, stays active in much the same community as it did when it first served as a farm mutual. He stated that the company to this day does not write automobile or workers' comp coverage, but does very well with their area of specialty.

"This is a large state for insurance, and we've been able to survive because in our particular area there is a need for a company to write the kind of business that we write," Yeager said.

Be able to make changes when needed

A commonly held assumption that century-old companies are old-fashioned is absolutely not true, states Tod Carmony, Chairman, CEO, and President of Wayne Mutual Insurance, in Wooster, Ohio. Although the company was incorporated in 1910, one of the companies acquired in 2009 by Wayne Mutual dated back to 1881.

"You can't say we're going to stay the same and let the world change around us." Carmony said. "If you want to be around 100 years, you have to evolve as the society and the financial insurance environment changes."

Carmony explained that the company first changed from a mutual insurance company to an advanced premium company in 1962, when they recognized that it was the preferred way to do business. By 1974, automobile coverage was added, despite the fact that many smaller insurance companies find auto a daunting line of business.

Know your market, and pay attention to the basics

Timothy D. Burback, Chief Investment Officer of Madison Mutual Insurance Company in Chittenango, New York cited this principle as important to the company. "We're in upstate New York, right around the central part. We're familiar with the economic, social, and cultural fabric of our marketing territory, so we've had a unique perspective as to what works and what doesn't work in our own little microcosm of the world," he said.

Burback said that commitment from the people who work for Madison Mutual help keep connected to people. "In our office, a live person answers the phone," he said. "There's not prompts or anything. And everybody's cross-trained, so that makes support for people. I think policy holders like it, too."

Carmony agreed that commitment to people is a key basic. "There's always somebody who tries to get you to

Secretary/treasurer Ralph H. Gresser and Board Vice President A. Louise McCoy view a photo of Bullet, chosen as a new logo for Wayne Mutual in 1963, to symbolize reliable authority.

sell the business," he said. "You have to have people committed to the community, to the organization, and to providing a good environment. When you do that, a lot of good things happen from that."

Be well qualified to do the job

For Yeager, as with many leaders of small companies, his position requires being a jack-of-all-trades and well-versed in all aspects of the business. "The biggest challenge is the ongoing requirements of overall compliance, whether it be at the federal level or the state level," Yeager said. "It's the fact of just how onerous it can be, especially for a very small organization. As president and CEO, I can't look to one of my vice presidents and say take care of this. Everything lands on my desk. The way I like to put things into perspective is that I run the entire investment portfolio, I oversee all the underwriting and the claims, and I also put the garbage out and change the bottle on the water cooler. I continue in this job because its ever-evolving, and I like that."

At Madison Mutual, Burback stresses stringent criteria for qualified directors in the company. He said that they look for those who are free from any form of nepotism or any self-serving agendas, and those without a conflict of interest. He's found it easier to work with well-rounded individuals coming from a general business background, but keeps the workforce balanced by an emphasis on continuing education.

"We're one of the few companies that have a continuing education program, not only for our employees, but mandatory for our directors," Burback said. "We've teamed up with NAMIC (National Association of Mutual Insurance Companies) for a special farm mutual director certification. We expect 100% certification. We found this to be very key for everyone to know what their responsibilities are."

Take the long view

Burback also said that every decision needs to be made through a lens of long-term benefits, not just short-term gain. "We have always closely examined the long-term effects of decisions and changes that we have made. We have purposely avoided any looking at the short-term benefits as what the benefit of this quarter is, but looking at things for the year and into the future years. That's taking the long view."

For Carmony at Wayne Mutual, the long view has been instituted by continuity in leadership. He stated that Ralph Gresser took over the organization in the '60s and

A photo of the Wayne Insurance Association offices, circa 1958.

created a good company, with good benefits, and a good work environment, and that framework created a stability that could stand the long haul. "I basically fell in to Mr. Gresser's attitudes and values," Carmony said. "Part of it is just not messing up the heritage."

Be known for your value system

In small businesses that are often on first-name basis with their customers, the concepts that enable "family" and "community" to be meaningful create the last principle of many long-standing companies.

"We have to have a reputation for our value system," Burback emphasized. "These aren't just words when it comes to ethical, moral, and legal values. We want to be a positive example—actually through our words and actions display honor and integrity like 'your word is your bond.'"

Final thoughts

Carmony summed up the principles that he believes have kept Wayne Mutual in business for over a century. "I'm sure there's some luck involved," he said. "This is a business like any other where you don't know the cost of your product until years after you've sold it. That can get you in trouble. That's why folks need a good capital base.

"If you have good people, and steady leadership at the top, you can change when you need to, you stick with what you know, and just stay steady when things are crashing around you, I think you'll be all right."

A Chronology of Deep-Rooted Insurance Companies

1767	*English Parliament passes tax on imports (including tea) to colonists*
1768	Philadelphia Contributionship for the Insurance of Houses from Loss by Fire, Inc.
1776	*US declares independence*
1789	*Washington president*
1794	Baltimore Equitable Society
1799	Providence Washington Insurance Company
1809	*Madison president*
	Bucks County Contributionship
1823	*Monroe Doctrine presented*
	Harleysville Worcester Insurance Company
1825	*Erie Canal completed*
	Norfolk & Dedham Mutual Fire Insurance Company
1826	*American Temperance Society founded*
	Cincinnati Equitable Insurance Company
	Hingham Mutual Fire Insurance Company
	Middlesex Insurance Company
1828	*Baltimore & Ohio RR begun*
	Merrimack Mutual Fire Insurance Company
	Vermont Mutual Insurance Company
1830	*Process of classifying insurance risks begins*
1833	*City of Chicago established*
	Barnstable County Mutual Insurance Company
	Cambridge Mutual Fire Insurance Company
1836	*Texas declares independence from Mexico*
1837	Firemen's Insurance Company of Washington, D.C.
1838	*Samuel Morse gives public demonstration of the telegraph*
1840	*First American life insurance association established*
1842	Harford Mutual Insurance Company
1843	Hanover Fire and Casualty Insurance Company
	Holyoke Mutual Insurance Company in Salem
1844	*University of Notre Dame receives its charter from Indiana*
	First telegraph message sent
	Commonwealth Mutual Insurance Company
	Cumberland Insurance Company, Inc.
	Cumberland Mutual Fire Insurance Company
	Elizabethtown Insurance Company
	First Allmerica Financial Life Insurance Company
	Mercer Insurance Company
	Windsor Mount Joy Mutual Insurance Company
1845	*US annexes Texas*
1846	*Mexican American War begins*
	American Insurance Company
1847	Fitchburg Mutual Insurance Company
	Penn Mutual Life Insurance Company
	Southern Mutual Insurance Company
1848	*Mexican American War ends*
	Montgomery Mutual Insurance Company
	Mutual Insurance Company of Lehigh County
	National Life Insurance Company
	Ohio Farmers Insurance Company
	Pawtucket Insurance Company
1849	*Gold Rush begins*
	Loudoun Mutual Insurance Company
	Salem County Mutual Fire Insurance Company, Inc.
1850	United States Life Insurance Company in the City of New York
1851	*Great Flood of 1851, Des Moines destroyed*
	Farmers Mutual Fire Insurance Company of Salem County
	Indiana Insurance Company
	Protection Mutual Insurance Company
	Quincy Mutual Fire Insurance Company
1852	Addison Insurance Company
1853	Continental Insurance Company
1855	Dorchester Mutual Insurance Company
1856	*Last Island Hurricane destroys Last Island, LA, breaks island into smaller islands*
	Farmers Insurance Company of Flemington
	Lebanon Valley Insurance Company
1857	Claverack Cooperative Insurance Company
	Northwestern Mutual Life Insurance Company
1858	*Lincoln comes to national attention in Lincoln-Douglas debates*
	Hamilton Mutual Insurance Company
	Transamerica Premier Life Insurance Company
	Washington County Co-op Insurance Company
1859	Sonnenberg Mutual Insurance Company
1860	*Lincoln elected President*
	Hannahstown Mutual Insurance Company
	Pymatuning Mutual Fire Insurance Company
1861	*Civil War begins*
1863	*Battle of Gettysburg*
	Farmers Mutual Fire Insurance Company of Branch County
1865	*Slavery abolished by 13th Amendment to the Constitution*
	Sun Life Assurance Company of Canada (US Branch)
1866	21st Century Premier Insurance Company
	Berkshire Hathaway Specialty Insurance Company
	Hartford Steam Boiler Inspection and Insurance Company
1867	*US acquires Alaska from Russia*
	Metropolitan Life Insurance Company
1868	Pacific Life Insurance Company
1869	*Ulysses S. Grant elected President*
	Northwestern National Insurance Company of Milwaukee
	Westminster American Insurance Company
1871	*Great Chicago Fire*
	Genworth Life and Annuity Insurance Company
1872	*Yellowstone established as first National Park*
	Great American Insurance Company
	Old Elizabeth Mutual Fire Insurance Company
	Wilson Mutual Insurance Company
1875	Erie and Niagara Insurance Association
1875	Farmers & Mechanics Mutual Insurance Association of Cecil County, Inc.
1876	*Battle of Little Big Horn*
	Finger Lakes Fire and Casualty Company
1877	*First telephone line*
	Centre County Mutual Fire Insurance Company
	Delaware Grange Mutual Insurance Company
	Farmers and Mechanics Mutual Insurance Company of West Virginia
	Grange Mutual Fire Insurance Company
	Ontario Insurance Company
	Patrons Mutual Fire Insurance Company
	Stone Valley Mutual Fire Insurance Company
	United Frontier Mutual Insurance Company
	Wayne Cooperative Insurance Company
1878	*Yellow fever in Mississippi Valley kills over 13,000*
	Ashland Mutual Fire Insurance Company of Pennsylvania
	Friends Cove Mutual Insurance Company
	Oswego County Mutual Insurance Company
	Sauquoit Valley Insurance Company
	West Branch Mutual Insurance Company
1879	*Deadwood, SD fire leaves 2,000 homeless, $3M in property losses*
	Edison invents the light bulb
	Bankers Life and Casualty Company
	Buckeye State Mutual Insurance Company
	Hay Creek Mutual Insurance Company
	Locust Mutual Fire Insurance Company
	Midstate Mutual Insurance Company
1881	Farmers Mutual Fire Insurance Company of Marble, Pennsylvania
1882	*US adopts standard time*
	Jesse James killed
	Baltimore Life Insurance Company
	Columbian Mutual Life Insurance Company
	Sunderland Marine Insurance Company Limited
1883	Central Co-operative Insurance Company
	Commercial Travelers Mutual Insurance Company
	IMT Insurance Company
	Spring Valley Mutual Insurance Company
1884	Mound Prairie Mutual Insurance Company
1886	*Statue of Liberty dedicated*
	Strike in US wins 8 hour workday
	American European Insurance Company
	Phenix Mutual Fire Insurance Company
	Security Mutual Life Insurance Company of New York
1887	*US National Institute of Health founded*
	Badger Mutual Insurance Company
	Bloomfield Mutual Insurance Company
	New England Mutual Insurance Company
	Patrons Mutual Insurance Company of Connecticut
	Penn Millers Insurance Company
	Security Mutual Insurance Company
	Senior Health Insurance Company of Pennsylvania
1888	*Washington Monument opens to public*
	Bremen Farmers Mutual Insurance Company

With Incorporation Dates and Highlights of History

	Mount Carroll Mutual Insurance Company
	Western and Southern Life Insurance Company
1889	*Johnstown Flood kills 2,209 people, $17M in property losses*
	Fairmont Farmers Mutual Insurance Company
	Marysville Mutual Insurance Company
1890	*Battle of Wounded Knee*
	Millers Capital Insurance Company
	State Mutual Insurance Company
1891	Boston Mutual Life Insurance Company
1892	*Ellis Island becomes chief immigration station*
	Alamance Farmers' Mutual Insurance Company
	Security Benefit Life Insurance Company
1893	Farmers Mutual Hail Insurance Company of Iowa
	Madison Mutual Insurance Company
1894	*Coca Cola sold in bottles for the first time*
	USA Life One Insurance Company of Indiana
	York Insurance Company of Maine
1895	National Insurance Company of Wisconsin
	Pennsylvania Lumbermens Mutual Insurance Company
	Sterling Insurance Company
1896	*Costliest & third deadliest tornado levels downtown St Louis, MO*
	Apollo Mutual Fire Insurance Company
	Athene Annuity and Life Company
	Battle Creek Mutual Insurance Company
	Fidelity Life Association, A Legal Reserve Life Insurance Company
	Northern Neck Insurance Company
	Preferred Mutual Insurance Company
	United States Fidelity and Guaranty Company
1897	Church Mutual Insurance Company
	National Continental Insurance Company
	Northwest G.F. Mutual Insurance Company
	Otsego Mutual Fire Insurance Company
1898	*US Annexes Hawaii*
	Spanish American War
	Maryland Casualty Company
	Mutual of Enumclaw Insurance Company
	New England Guaranty Insurance Co., Inc.
	Pan Handle Farmers Mutual Insurance Company of West Virginia
1899	American Home Assurance Company
	Farmers Mutual Fire Insurance Company
	Motorists Commercial Mutual Insurance Company
	North Carolina Mutual Life Insurance Company
1900	*Galveston hurricane kills 6000-8000*
	US Currency placed on Gold Standard
	Columbia Casualty Company
	Iowa Mutual Insurance Company
	Sanilac Mutual Insurance Company
	SECURA Insurance, A Mutual Company
1901	*First car insured at Lloyd's covered by a marine policy*

	Federal Insurance Company
	Le Mars Insurance Company
	National Union Fire Insurance Company of Pittsburgh, PA.
	Ohio Mutual Insurance Company
	Peerless Insurance Company
	Texas Life Insurance Company
1902	Physicians Mutual Insurance Company
1903	*US acquires Panama Canal*
	Wright Brother's first flight
	Travelers Indemnity Company
1905	American National Insurance Company
	Great American Assurance Company
	Lumbermen's Underwriting Alliance
	Mennonite Mutual Insurance Company
1906	*San Francisco earthquake*
	American Fire and Casualty Company
	Homesteaders Life Company
	Lightning Rod Mutual Insurance Company
	Merced Property & Casualty Company
	Ohio State Life Insurance Company
	Standard Insurance Company
1907	Amica Mutual Insurance Company
	Great-West Life & Annuity Insurance Company
1908	*Bureau of Investigation (FBI) formed*
	Model T Ford introduced
	First National Life Insurance Company of the U.S.A.
	HumanaDental Insurance Company
1909	*President Taft's wife has cherry trees planted along Potomac River*
	Bedford Grange Mutual Insurance Company
	Farmland Mutual Insurance Company
	Great Southern Life Insurance Company
	Mutual of Omaha Insurance Company
	Physicians' Benefits Trust Life Insurance Company
	West Virginia Farmers Mutual Insurance Association
1910	*Great Fire of 1910 burns 3 million acres in NW US*
	First air delivery of commercial goods by Wright Brothers
	DSM USA Insurance Company, Inc.
	Farmers New World Life Insurance Company
	Gem State Insurance Company
	Municipal Mutual Insurance Company of West Virginia
	Time Insurance Company
	Union Security Insurance Company
	Wayne Mutual Insurance Company
1911	*Triangle Factory Fire in NYC kills 146 people*
	Pan-American Life Insurance Company
	Safe Insurance Company
	TIG Insurance Company
1912	Financial Assurance Life Insurance Company
	Liberty Mutual Insurance Company
1913	*Federal Reserve started*

	Jewelers Mutual Insurance Company
	Trustmark Insurance Company
1914	*First scheduled airline flight in Florida*
	Henry Ford introduces assembly line for Model T
	California Casualty Indemnity Exchange
	Interboro Insurance Company
	State Compensation Insurance Fund
	Utica Mutual Insurance Company
1915	National Fire and Indemnity Exchange
	West Coast Life Insurance Company
1917	*US enters WWI*
1939	*WWII starts in Europe*
1940	*Roosevelt elected, Selective Service begins*
	Noridian Mutual Insurance Company
1955	*Martin Luther King, Jr. leads first march of the Civil Rights Movement*
	First McDonald's opens in Des Plaines, IL
	Hurricane Diane hits NE US, $1B in damage, 200 dead
	Alfa Insurance Corporation
	Central Security Life Insurance Company
	Hyundai Marine & Fire Insurance Company, Ltd.
	Kaiser Foundation Health Plan, Inc. Hawaii Region
	Life Insurance Company of the Southwest
	Life Protection Insurance Company
	Ohio Bar Title Insurance Company
	Pioneer Security Life Insurance Company
	Presidential Life Insurance Company
	Select Insurance Company
	Tower Life Insurance Company
	Wilton Reassurance Life Company of New York
1964	*US enters Vietnam War*
1965	*Gemini 4 astronaut, Edward Higgins White, makes first US space walk*
	Medicare & Medicaid established
	American Family Home Insurance Company
	American Modern Home Insurance Company
	California Insurance Company
	Citizens Security Life Insurance Company
	Delta Fire & Casualty Insurance Company
	Equity Insurance Company
	Guarantee Insurance Company
	Horace Mann Property & Casualty Insurance Company
	Intramerica Life Insurance Company
	Lexington Insurance Company
	Longevity Insurance Company
	Mid-West National Life Insurance Company of Tennessee
	National Trust Insurance Company
	North Coast Life Insurance Company
	Southern Pioneer Life Insurance Company
	Vision Benefits of America Inc.

Company incorporation dates from first quarter used and names listed alphabetically for each year.

A Culture of People Helping People

Remembering its roots keeps Ontario Insurance in for the long haul in the business world

In the decade following the Civil War, the U.S. struggled to reconstruct the national economy. Failing to do so led to the Depression of 1873. Native American tribes and U.S. troops continued to clash, and rumblings hinted at a national railroad strike. The year was 1877.

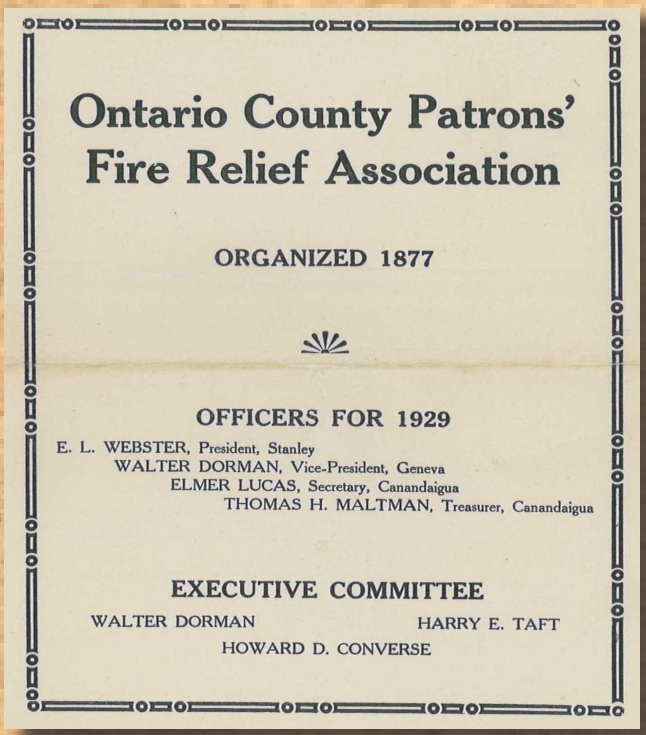
In this time of uncertainty, the Ontario County Patrons' Fire Relief Association was established in New York to provide affordable insurance coverage to members of the local farm community. One of many companies formed over a century ago, what is now Ontario Insurance Company in Shortsville, New York, still operates with a strong sense of responsibility to those it serves.

Keith Fry, President and CEO of Ontario Insurance Company since 2013, said the founders of the company had a clear and simple focus in mind—to provide a viable insurance program for the folks it insured.

"The company really viewed its purpose as one that was established to serve its members that were generally Grange members," Fry said. "That really was the purpose of the company. It didn't get really too concerned about chasing any artificially high growth targets or anything like that. And it turned out fairly well."

Fry accepted the position at Ontario because he found the company "small, but very strong financially." He added that the picturesque Finger Lakes region of upstate New York was as much a draw as the stable, experienced group of employees of the company. "One of our employees has been here since 1969," Fry said. "That's really helpful when you have a group of folks you know are very good and just really enjoy a small company environment. That makes it, for me, a very special place."

Changes over time transitioned the company to its current situation. Fry stated that for over 100 years, the business underwritten by the company was written by up to 20 director-agents. In the '80s, the decision was made to switch



Ontario County Patrons' Fire Relief Association

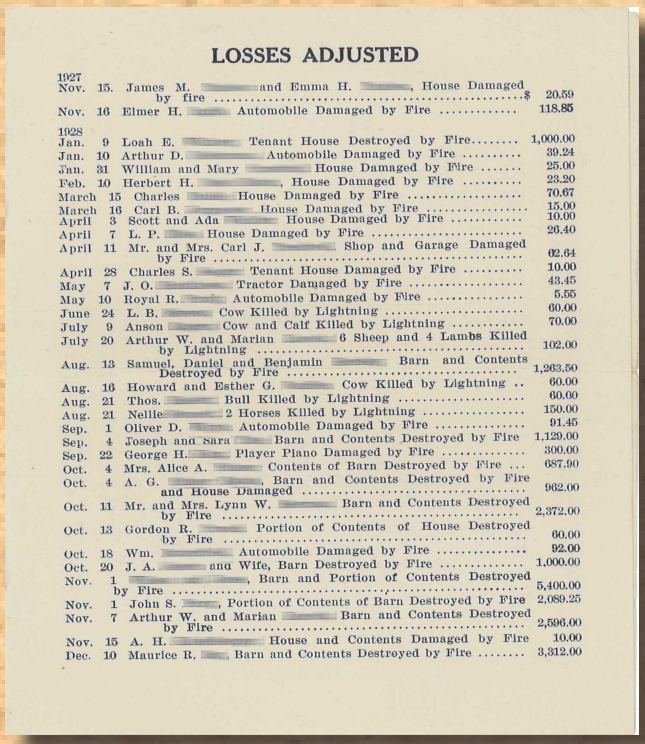
ORGANIZED 1877

OFFICERS FOR 1929

E. L. WEBSTER, President, Stanley
WALTER DORMAN, Vice-President, Geneva
ELMER LUCAS, Secretary, Canandaigua
THOMAS H. MALTMAN, Treasurer, Canandaigua

EXECUTIVE COMMITTEE

WALTER DORMAN HARRY E. TAFT
HOWARD D. CONVERSE



LOSSES ADJUSTED

1927			
Nov.	15.	James M. [redacted] and Emma H. [redacted], House Damaged by fire	$ 20.59
Nov.	16	Elmer H. [redacted] Automobile Damaged by Fire	118.85
1928			
Jan.	9	Loah E. [redacted] Tenant House Destroyed by Fire	1,000.00
Jan.	10	Arthur D. [redacted] Automobile Damaged by Fire	39.24
Jan.	31	William and Mary [redacted] House Damaged by Fire	25.00
Feb.	10	Herbert H. [redacted], House Damaged by Fire	23.20
March	15	Charles [redacted] House Damaged by Fire	70.67
March	16	Carl B. [redacted] House Damaged by Fire	15.00
April	3	Scott and Ada [redacted] House Damaged by Fire	10.00
April	7	L. P. [redacted] House Damaged by Fire	26.40
April	11	Mr. and Mrs. Carl J. [redacted] Shop and Garage Damaged by Fire	62.64
April	28	Charles S. [redacted] Tenant House Damaged by Fire	10.00
May	7	J. O. [redacted] Tractor Damaged by Fire	43.45
May	10	Royal R. [redacted] Automobile Damaged by Fire	5.55
June	24	L. B. [redacted] Cow Killed by Lightning	60.00
July	9	Anson [redacted] Cow and Calf Killed by Lightning	70.00
July	20	Arthur W. and Marian [redacted] 6 Sheep and 4 Lambs Killed by Lightning	102.00
Aug.	13	Samuel, Daniel and Benjamin [redacted] Barn and Contents Destroyed by Fire	1,263.50
Aug.	16	Howard and Esther G. [redacted] Cow Killed by Lightning	60.00
Aug.	21	Thos. [redacted] Bull Killed by Lightning	60.00
Aug.	21	Nellie [redacted] 2 Horses Killed by Lightning	150.00
Sep.	1	Oliver D. [redacted] Automobile Damaged by Fire	91.45
Sep.	4	Joseph and Sara [redacted] Barn and Contents Destroyed by Fire	1,129.00
Sep.	22	George H. [redacted] Player Piano Damaged by Fire	300.00
Oct.	4	Mrs. Alice A. [redacted] Contents of Barn Destroyed by Fire	687.90
Oct.	4	A. G. [redacted], Barn and Contents Destroyed by Fire and House Damaged	962.00
Oct.	11	Mr. and Mrs. Lynn W. [redacted] Barn and Contents Destroyed by Fire	2,372.00
Oct.	13	Gordon R. [redacted] Portion of Contents of House Destroyed by Fire	60.00
Oct.	18	Wm. [redacted] Automobile Damaged by Fire	92.00
Oct.	20	J. A. [redacted] and Wife, Barn Destroyed by Fire	1,000.00
Nov.	1	[redacted], Barn and Portion of Contents Destroyed by Fire	5,400.00
Nov.	1	John S. [redacted], Portion of Contents of Barn Destroyed by Fire	2,089.25
Nov.	7	Arthur W. and Marian [redacted] Barn and Contents Destroyed by Fire	2,596.00
Nov.	15	A. H. [redacted] House and Contents Damaged by Fire	10.00
Dec.	10	Maurice R. [redacted], Barn and Contents Destroyed by Fire	3,312.00

Annual report for Ontario Insurance with losses shown for the year 1927—1928

By Barb Albert

Keith Fry, President and CEO of Ontario Insurance Company

to independent agents, with the company's last director-agent selling his business back to the company just ten years ago.

"The company had been an assessable cooperative, which meant that if it sustained high losses, it would assess its policyholder members additional premiums at the end of the year," Fry said. "About 20 years ago, we converted to an advanced premium co-op under the laws of New York State, so we've recently been operating much more like a traditional mutual insurer." This change was significant in the company's history. "When we realized we were going in the direction of the advanced premium company, that meant we needed to establish a strong balance sheet," Fry stated. "As an accessible company, if there was a big fire, they would literally go down to the bank and get the money to pay the claim, and then assess the policyholders to make good on their loan to the bank. Obviously we don't do anything like that today."

In 2001, the name of the company was changed from Ontario-Yates Insurance Company to the current Ontario Insurance Company to reflect the broader geographic scope of operation permitted under the Company Charter, which allowed larger marketing efforts and goals. The company works hard to meet the challenge to adopt more modern approaches to business while maintaining the culture and practices that have driven the company's success over the decades, according to Fry.

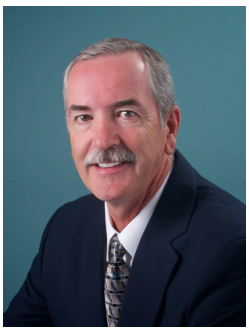
"We have a handful of key people," Fry explained, "who have insurance agency backgrounds, and though they've been with us for a number of years, they do a good job empathizing with folks they work with on the independent agent side. We answer our own phones, and we do a pretty good job not forcing people to rely on automation if they prefer to pick up the phone and talk to someone to get a quick response. We have policyholders who have been with us a very long time. That's not uncommon at all for us."

At the same time, to meet the challenge of a technology-focused clientele, Fry said the company recently hired two employees in their early 20s to revamp the billing system and tailor business to be more user-friendly for a younger generation. "In September, we launched our social media effort," Fry said. "We're now on Facebook, Twitter, LinkedIn, and Google+. We keep fresh content on our Facebook page. By doing this, we actually have to develop a habit, a discipline, of thinking of something positive to say in an effort to sell our brand. That exercise over time will help us as we get down the road here."

Fry said another big step forward for the company was the first cyber-liability policy purchased for the company. He said that area is frightening because no one knows just how bad it could be. "We bought first and third party coverage for ourselves to protect in the event of a data breach," Fry said. "That could be a big deal. We recently contracted some white hat hackers to test us. I anticipate a day will come when regulators will insist that you do this sort of thing and I'd like to get out in the front end of that. When you talk about risk that we face, this is one."

Ontario still maintains ties to the fraternal organization that provided its initial purpose for incorporation, and it's that culture of people helping people that Fry believes fuels the company's longevity.

"We still maintain ties to that fraternal organization," Fry said. "Our chairman of the board, Bruce Croucher, is one of the leaders of the national Grange. This is the organization that was born with a purpose of serving membership of the organization. It was our primary purpose. I feel very fortunate to be part an organization that has done a really good job serving its purpose and its members. I hope in some small way we position it for another long opportunity to continue."



WHEN DISASTER STRIKES

Companies' Need for Comprehensive Catastrophe Plans

By Robert M. Warren, CPA

Companies writing property coverage spend significant time, effort and money to evaluate and determine the best catastrophe reinsurance program structure to protect policyholders' surplus from catastrophe events. It is equally important that those same companies align available resources to ensure policyholders' needs are adequately addressed following a catastrophe event. A superior catastrophe reinsurance program is of far less value to the policyholders if the company is not capable of delivering timely loss adjusting services following an event.

With respect to our review of catastrophe response plans, Demotech, Inc. collects information from companies on their catastrophe response plan (CAT Response Plan) on a formal basis. For property writers covering the peril of wind seeking a Financial Stability Rating®, including start-ups or companies without significant operating history, Demotech requires detailed information and documentation regarding the company's CAT Response Plan.

Also included in our required information is a copy of the company's formal disaster recovery plan, or business continuity plan. While some companies choose to incorporate the CAT Response Plan into the disaster recovery plan, Demotech considers these to be two separate and distinct plans serving unique purposes. For this article, the CAT Response Plan and the disaster recovery plan will be referred to as two distinct items.

Each company rated by Demotech with significant property catastrophe exposure in Florida does have a CAT Response Plan and a disaster recovery plan in place. However, the plans reflect varying degrees of sophistication and detail, depending on the unique size and structure of each company. Keep in mind, the Office of Insurance Regulation (OIR) requires each Florida domiciled insurer to provide a copy of its CAT Response Plan as well; Demotech and the OIR do not collaborate in the collection or review of this information.

It is important to note that if the proper CAT Response Plan, procedures and protocols are not in place to adjust catastrophe claims within the reinsurance program, the insurer may be subject to bad faith claims regarding settlement practices, and may incur significant fines and penalties levied by the regulatory authority. In addition to dealing with the respective regulatory authority, an insurer's inability to effectively manage catastrophe claims will negatively impact its reputation with policyholders, agents and reinsurers.

As of December 2014, Demotech rates and reviews 56 insurers writing the peril of wind in Florida. These companies comprise approximately 55 percent of the Homeowners marketplace. Since some entities are subsidiaries or affiliates of a group, the CAT Response Plans that we received and reviewed, as well as the disaster recovery plans, may cover more than one insurer.

The process includes a formal request, or data call, requiring specific information with respect to the company's CAT Response Plan and disaster recovery plan. As with the company's financial performance, its catastrophe reinsurance program and other significant elements of our evaluation, the information collected regarding the CAT Response Plan will be re-

viewed and incorporated into Demotech's overall consideration of the company's ability to maintain a Financial Stability Rating®.

The structure of our formal data call is comprehensive and includes nine categories. The categories were selected to provide Demotech consistent information on each insurer's primary resources for adjusting catastrophe claims in an event affecting approximately ten percent or more of the policyholders. The categories are:

- Claims Organization Chart
- Claims Adjuster Count
- Qualifications of Adjusters
- Reporting Protocol
- Responsible Personnel
- Third Party Administrator
- Independent Adjuster Count
- Management Narrative
- Disaster Recovery Plan.

See Exhibit A for a brief description of the categories.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With the exception of the larger national carriers with a presence in Florida or other wind prone jurisdictions, companies rated by Demotech with significant property exposure in Florida have contracted with third-party service providers to ensure adequate access to qualified catastrophe claims adjusters to handle claims following an event. The data collection includes a request for each company's third-party (affiliated and non-affiliated) claims service providers. Demotech's concern is that the insurer has aligned itself with a reputable organization capable of providing sufficient resources which include qualified catastrophe claims adjusters.

On average, Demotech's Florida rated insurers retain five third-party independent catastrophe claims adjusting companies. Contracts number from as few as one to

Exhibit A

Claims Organization Chart – The in-house claims organization chart provides a reference point for in-house claims adjusting resources. Even for larger companies, the number of in-house personnel will likely not be sufficient to handle a catastrophe event with loss frequency of 10% or more. However, the in-house staff should be sufficient to provide assistance in managing and organizing the process of adjusting and closing catastrophe claims. The in-house staff will also be instrumental in handling re-opened claims and claims taking longer than six months to settle.

Claims Adjuster Count – This is a count of the qualified in-house catastrophe claims adjusters currently on the company's claims staff. As mentioned above, the company will not likely have a sufficient number of qualified in-house adjusters to handle an event with a loss frequency of 10% or greater. The benefit of maintaining in-house staff is that those adjusters can provide assistance for managing adjusting of the catastrophe claims while simultaneously managing the inventory of non-CAT claims.

Qualifications of Adjusters – The review provides specific information on the qualifications and catastrophe adjusting experience of in-house claims adjusters.

Reporting Protocol – The insurer provides information on the claims reporting process, including primary and secondary contacts for reporting catastrophe claims to the Florida Hurricane Catastrophe Fund as well as private reinsurers.

Responsible Personnel – Demotech, Inc. obtains job titles for those positions responsible for assessing an event and monitoring the company's overall catastrophe response activities as well as the job titles for those positions responsible for executing the disaster recovery plan.

Third Party Administrator – The company provides specific information on third party service providers, affiliated and non-affiliated, contracted to provide services and support for the adjustment of the company's catastrophe claims.

Independent Adjuster Count – Based on contract terms in place between the carrier and its independent CAT response firm, we obtain the number of qualified catastrophe claims adjusters available to the client company.

Management Narrative – Management is provided the opportunity to present narrative explanation, commentary and description on its overall CAT Response Plan. Management's comments may include supplemental information on claims adjusting authority levels, initial reserving techniques and practices, monitoring quality control and other issues pertinent to the adjusting and settlement of catastrophe claims.

Disaster Recovery Plan – Demotech. Inc. requires that management provide a current copy of the company's formal disaster recovery plan.

as many as 14. As would be expected, there does appear to be a correlation between the number of wind policies written to the number of contracts in place with third-party catastrophe claim service providers. The larger an insurer's number of potential affected policyholders, the greater the insurer's demand is for third-party adjusting resources following an event.

Based on the information provided, Demotech reviewed and evaluated each company's in-house claims organization, including current qualified catastrophe adjusting staff as well as the supporting qualified adjusting resources available through the service provider. Several of the larger insurers have created separate, albeit affiliated, claim service provider companies. These entities may be sister companies or subsidiary operations with "arm's-length" agreements with the primary client company to provide claim adjusting and administrative services. In addition to the daily administration of claim services, the affiliated operation will assume a lead role should the company experience a catastrophe event. That role includes, but is not limited to, executing the CAT Response Plan and coordinating efforts with the non-affiliated third-party service providers. Demotech also reviews the agreements to determine if the affiliated entity is providing claim services to other primary carriers outside the corporate group.

Demotech's review of an insurer's CAT Response Plan includes components considered critical to a company's ability to effectively handle a potential catastrophe event. Demotech acknowledges that its evaluation may be considered subjective and does not confirm a company's ability to effectively manage or execute its formal plan with respect to its CAT Response Plan or its disaster recovery plan. A component of Demotech's overall review includes an evaluation of the senior management team's previous experience in writing the peril of wind as well as tactile experience in dealing with catastrophe events from a claims administration, management or adjusting capacity.

Demotech views the company's catastrophe reinsurance program as pre-event planning with the CAT Response Plan for settling catastrophe event claims as post-event planning. Both are significant elements of the overall Financial Stability Rating® review and evaluation process. Demotech's perspective regarding CAT Response Plans focuses primarily on an insurer's available resources as well as the ability to fully utilize those resources in adjusting and settling catastrophe claims, regardless of the frequency or severity of the circumstances. Following an evaluation of the company's financial stability as presented in reported financial statements, the catastrophe reinsurance program, including the CAT Response Plan, is the most significant consideration regarding an insurer's ability to maintain a Financial Stability Rating®.

Robert M. Warren, CPA, CPCU
Client Services Manager for Demotech, Inc.
Email: bwarren@demotech.com

Announcing the 2015 Demotech STAR Awards

Stakeholder Team Accomplishment Recognition™ Awards for the Insurance Industry (established in 2013)

Numerous insurance industry awards and recognition are based on corporate achievement. Almost all focus on a single aspect of success, such as top-line revenue growth or profitability. Demotech believes that running a successful and profitable insurance company involves satisfying all stakeholders, including regulators, consumers, producers, reinsurers, claimants, employees and, ultimately, the owners.

Each of these stakeholders participates in or contributes to the financial results reported by an insurance company. To recognize companies that have met or exceeded our objective criteria for each of our stakeholder categories, we created the Stakeholder Team Accomplishment Recognition™ (STAR) award.

In 2013, Demotech initiated recognition of carriers satisfying each of their stakeholders with our creation of the STAR award.

The 2015 STAR Awards will be announced by June 30, 2015. To find the eligibility criteria for the STAR Award, go to http://demotech.com/starawards.aspx.

The Power of the Black Box

Continued from Page 10

minutes, this information really comes alive when you understand whether the drive is on Chicago's Lake Shore Drive at 5PM during a February snowstorm—or on the I-5 in San Diego at any time of the year.

Telematics Technology Alternatives

Some companies question whether the data are good enough and cost-effective for UBI to be viable—strategically and economically. The answer is yes.

But the challenge becomes how to avoid building a program that will quickly become obsolete. The goal is to establish a program that allows you to take advantage of—and benefit from—future improvements. Keep in mind that as technology and people change, so will your products.

Syda Productions/Shutterstock.com

There are several telematics technology alternatives for insurers. These include:

- original Equipment Manufacturer (OEM) Component installed at the auto factory
- aftermarket equipment installed by a professional installer
- aftermarket equipment self-installed by the customer
- independent smartphone apps downloaded by the customer
- smartphone apps paired with equipment in the vehicle.

When comparing these options, the key differentiators are data reliability, technology costs, and customers' ease of use.

The technology landscape continues to change. The combination of on-board, self-installed devices, smartphone applications for customer acquisition and the emergence of the connected car solutions are seen as the present—and future—of telematics. They will allow for mass adoption of UBI products at ever-decreasing costs, once scale is achieved.

On the horizon are other innovations, such as autonomous vehicles and passive smart phone data, which could drastically change the landscape of auto insurance. However, with the long lead time for this type of disruption and the expansion and prevalence of UBI programs already in the market, you can expect to feel the effects UBI will have on adverse selection on new business and retention long before a car drives itself past your window.

What Does This Mean for Auto Insurers?

When your company offers the combination of a unique customer experience that encourages engagement, plus aggressive discounts, it will be very difficult for your competitors to lure your "sticky" customers away.

So what's the right UBI approach for your company? The answer depends on where you are starting from. There are several possibilities.

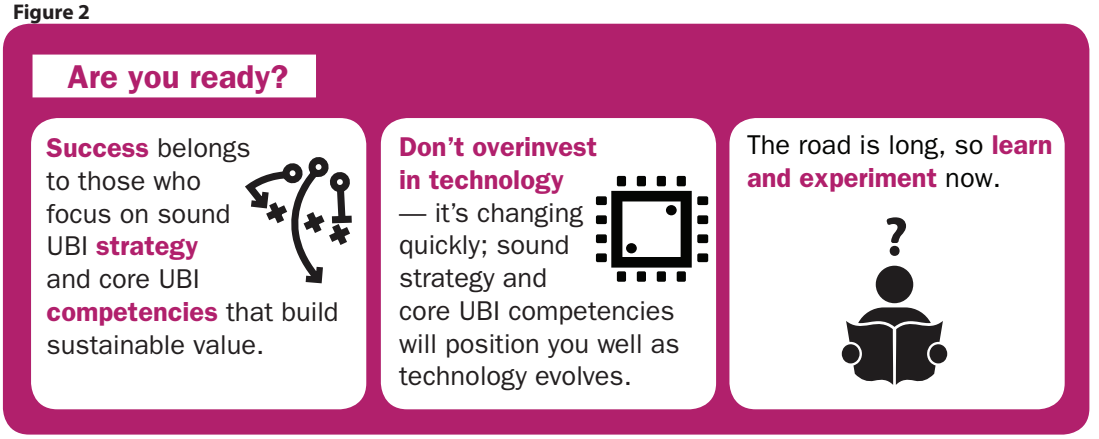
If you have not yet started, begin by educating the management team. If yours is like most companies, numerous people must understand UBI and buy into the concept before anything can happen.

Develop a point of view and a strategy. If you choose to postpone implementation of a UBI program, be very explicit about what beliefs and expectations underpin that decision—and what conditions would possibly lead you to change it. You should also decide how you

Savvy Shoppers

While online comparative shopping for auto insurance has not been significant in the U.S. to date, this will likely change as technology-savvy consumers become the majority. Google Compare Auto Insurance Services is already licensed to sell car insurance in 26 states, and it's likely that other, similar services will become available as the market for such services becomes established.

Figure 2



will monitor those conditions and stay informed on industry developments in the meantime so you'll know when the time is right.

If you have decided to move ahead with UBI but you are still in the early stages, confirm your goals and design your UBI program accordingly. Ensure you have the correct partnerships in place to provide industrial strength technology and analytics to successfully future proof. Take advantage of your late entry into the UBI market by accelerating your progress, leapfrogging over competitors, and building in-house expertise.

If you are already in the UBI marketplace, be sure to monitor your program incessantly, refine it, industrialize it and stay ahead of those on your heels.

UBI programs offer the auto industry a fresh opportunity to stay relevant in changing times (Figure 2). You will make mistakes, but UBI is an important way to differentiate your company, stay relevant to customers and offer accurate pricing.

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For Your Information

GM's OnStar and Progressive Now Provide Usage-Based Insurance

General Motors' hands-free communication and vehicle safety service, OnStar, recently partnered with Progressive Insurance to collect driver assessment data on eligible vehicles starting this summer. The data are used to give drivers a snapshot of their driving habits and provide them with the opportunity to seek insurance discounts from Progressive. Interested OnStar subscribers will have the option to enroll in a program that provides a detailed driving assessment over 90 days. The assessment will compare their driving performance against important driving metrics as well as against an aggregate of anonymous program participants. From there, OnStar will provide driving tips based on individual drivers' scores. Following the assessment, qualifying subscribers can share their driving data and evaluation information with Progressive through its Snapshot program. Participating customers could receive discounted and personalized insurance offers from Progressive based on their driving habits.

CONTINUED FROM PAGE 25 **The Convergence Market**

which we discuss in our case study, is to structure the CRe as a bond. In creating a bond, the security becomes more liquid and can trade in the secondary market.

Triggers

In many ways, the topic of synthetic vs. indemnity/ultimate net loss (UNL) triggers comes down to basis risk and customization. Synthetic triggers can include parametric triggers based on physical parameters, industry loss triggers reported by various reporting agencies, modeled loss triggers based on bootstrapping a storm path into an escrowed catastrophe model, and combinations/permutations on the above methods.

With traditional reinsurance, the cedant normally operates under an indemnity (UNL) arrangement. The reinsurer receives a submission package that describes in detail the insurer's book of business. The underwriting decision is based upon the cedant and its book. The structure is fairly simple. If the insurer loses money, then the reinsurer loses money either on a quota share (QS) or excess of loss (XOL) basis. In other words, the reinsurer follows the fortunes of the cedant.

When approaching the broader market on a bond, it is easier to market synthetic triggers to reach the largest potential investor group. Bond investors, though taking into consideration the cedant, can focus primarily on the triggers and other structural features. When a cedant employs synthetic triggers, the bond buyer's underwriting on the cedant's book of business does not have to go to the same depth. The bond buyers don't require the same level of information disclosure required as part of a reinsurance submission package. However, this access to a broader market is not a free lunch. To capture the broader appeal, cedants have to accept more basis risk, namely that the triggers don't perfectly match the cedant's book of business. Synthetic triggers rather than indemnity are the easiest way to achieve the broadest appeal with the bond market. However, many of the dedicated ILS investors are now well positioned to analyze and accept indemnity based triggers.

Since CRE is generally more bilateral than a bond distribution, it is often done on an indemnity basis. Because CRE is a customized hybrid, the use of trigger depends on many other variables, such as the investor(s) involved and the cedant's overall objective.

CASE STUDY: Market Re

As described above, there exists a spectrum ranging from traditional reinsurance to catastrophe (144A) bonds. Collateralized reinsurance (CRe) falls somewhere in the middle and its location along that spectrum varies depending on the feature. In fact, there are other variations on these three categories that help fill-out the continuum.

The Market Re bonds that JLT Capital Markets structured in 2014 is one such hybrid example. The Market Re program is, at its heart, collateralized reinsurance in a bond structure. However, since the Market Re bonds are clearly securities, they can be purchased by investors who are not in the business of writing reinsurance. We will now review the Market Re bond program across the various attributes described earlier.

1. Type of Collateral

Market Re is like other forms of CRe, namely supporting its protection via collateral. Collateral is invested in a Treasury Money Market fund, which is now the most common way to hold collateral for US deals.

2. Payment Flow

Though a bond, the payment flow for certain Market Re bonds mirrored the traditional CRe route. Investors paid-in the limit less the net premium amount, and receive an adjusted limit at maturity. Other series of the Market Re bonds mirrored the typical 144A route where investors paid in the full limit and received quarterly premium payments in the form of quarterly coupons.

3. Reinstatement

For the reasons highlighted earlier in the discussion regarding the added complexity and/or difficulty for CRe and 144A bonds to incorporate reinstatement, all of the Market Re bonds do not have a reinstatement feature.

4. Collateral Release and Commutation

In this respect, many of the Market Re bonds stayed closer to typical CRe with built in features to address extension issues. In essence, it made use of release based upon the event level and development curve, and did not allow for unilateral optionality on the part of the cedant to keep collateral longer than the risk period. However, it did not utilize the structural mechanism of various extension periods and associated payments normally seen in 144A catastrophe bonds. Furthermore, collateral release resulted in commutation on an incremental basis, which is more similar to 144A bonds and some CRe structures.

5. Premium Adjustment

Akin to other CRe and traditional reinsurance transactions, the Market Re bond program could utilize the premium adjustment mechanisms described earlier. In this manner, it would employ accretion from par up to a level that reflected the rate-on-line. In other words, it could be structured in such a manner where there would be no quarterly coupons like many bonds; rather, the entire compensation came via the terminal price on the notes. The expected final level would be set in the original documents, but the calculation of the final level is driven by actual performance, with a pre-specified adjustment mechanism. Alternatively, the Market Re bond program for certain cedants/contract could also utilize a coupon- bearing structure where the full

limit is posted at the beginning of the contract as collateral and on a quarterly basis the net premium is paid out.

6. Fees & Expenses
To address the high fee structure associated with other 144A bonds, a number of critical steps were taken. By receiving the full reinsurance submission package, investors were able to perform their own analyses, thereby eliminating the deal costs associated with external modeling. Similarly, the bonds were unrated, saving both time and cost. Moreover, the documentation utilized was a scaled-back version of typical bond documents, which allowed for considerably lower legal costs. Overall, because the costs for the transaction were well below typical 144A bond costs, cedants are able to issue a much smaller bond than one normally sees in the cat bond market. This enabled a new cedant to come to market and capture the benefits of forming a relationship with the capital markets.

7. Risk Analysis
Like other forms of CRe and traditional reinsurance, some of the Market Re bonds provide indemnity coverage, so the basis risk of typical 144A bonds was addressed from the cedant's perspective. For these specific bonds within the program, the investors had much greater access to information (e.g. the reinsurance submission package) and they were less dependent on other parties to assess the risks for them. Furthermore, sophisticated investors were better able to manage the correlation impact of this transaction because they had access to all of the underlying data. Investors were also able to employ a greater degree of traditional underwriting and to better weigh the factors they considered important.

Other series or issuances of the Market Re bonds used a synthetic trigger, but this decision was motivated by specific desire on the part of the cedant.

7a. Tradability
Since all of the Market Re bonds (regardless of the series issued) are structured as a bond (with an ISIN), it can trade in the secondary market among qualified buyers. Given that the Market Re bonds and other private placement securities structured by JLT Capital Markets have in fact traded offers fundamental support for the argument that the bond structure provides enhanced liquidity relative to collateralized reinsurance.

By issuing Market Re securities in a bond format rather than pure collateralized reinsurance, each and every cedant involved was able to tap new capacity because it allowed other markets to participate. For those markets who participated, the increased liquidity associated with a bond structure gave them greater flexibility around optimizing the buckets within their mandates.

8. Triggers
Some of the bonds issued through Market Re employed an indemnity trigger. Other trigger mechanisms have been used in the program depending on the objectives of the cedant and the requirements of the investors.

Overall, Market Re's collateralized reinsurance in a bond structure accomplished many things. It gave certain cedants utilizing the platform an indemnity deal but allowed it to enter the capital markets for the first time and access markets that previously didn't exist for the cedant. However, the deal also brought opportunities for investors. Since they are all full-fledged bonds rather than straight CRe, it allowed the investors to source new cedants and obtain more customized risk. Importantly, because of the hybrid structure on the convergence spectrum, the costs in the structure compared to 144A bonds were driven way down, which allowed more of the economics to remain in the deal for both sides. Without the lower costs, it would not be feasible to bring multiple series of these smaller bonds to market.

Conclusion

Increasingly, we are seeing cedants and investors/markets play across the entire spectrum, allowing the capital markets and its investors to participate in various layers and structures. Similarly, it enables cedants to expand their placement beyond standard reinsurance. Those cedants and investors who are able to participate across the whole continuum will capture the most value as they optimize. To achieve that optimization, particularly for smaller cedants, structures such as Market Re may play a valuable role in expanding the capital universe by drawing on a mix of attributes from across the reinsurance-bond spectrum.

We expect other cedants will follow suit to achieve these benefits.

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