

Getting Serious About Regional Carrier Solvency



By Joseph L. Petrelli

Accordingly, it seems reasonable to conclude that financial stability is independent of size and that regional, well-managed and properly reinsured P/C insurers can be analyzed and earn stable ratings.

Demotech Inc. recently completed an exhaustive study of its 23,118 insurance company Preliminary and final Financial Stability Ratings (PFSRs and FSRs) issued from 1989 through 2004 and found that regional and specialty insurance companies with stable ratings present no more financial risk than larger companies.

The period studied included a full spectrum of FSRs prepared during that time. The study compared the cumulative economic failure rates to the cumulative impairment rates published by other rating alternatives and we remain convinced that regional and specialty insurance companies with stable FSRs present no more financial risk than larger carriers earning similar FSRs.

Our procedure when assigning PFSRs is to utilize a quantitative model to analyze the financial stability of a property/casualty insurer. We then assign a PFSR to the insurer and notify each insurer of their PFSR. If the insurer concurred with the PFSR, we invited that company to finalize its PFSR. Finalized FSRs are then published.

As expected, the insurers finalizing their PFSRs were mainly the insurers with PFSRs of A or better. Over the period 1989 through 2004, 70.46 percent of the 23,118 PFSRs issued were stable PFSRs and 29.54 percent were PFSRs below stable.

When we introduced our service in 1989, we issued FSRs to carriers that other rating services declined to rate. We did so by reviewing and rating regional insurers that had not previously been rated. Regional insurance companies that were unrated by other rating agencies were our target market over the period 1989 through 1994. Accordingly, we have the lengthiest history on this group of companies.

Survival rates

Demotech defined survival as the avoidance of economic failure. Economic failure was considered to be rehabilitation, liquidation, involuntary receivership, involuntary conservatorship, license suspension or revocation, supervision or such other legal or regulatory remedy instituted by a department of insurance for the purpose of protecting the interests of policyholders or claimants.

Voluntary action by an insurance company, such as surrender of a license, merging into an affiliate, purchase by a solvent insurer or a capital infusion by a third party or other activity that resulted in the continuous ability to honor meritorious claims was considered survival. Our focus was the protection of policyholders, insurance agents,

claimants and reinsurers, but not necessarily the shareholders.

Economic failure rates

We believe that the survival rates associated with P/C insurance companies earning PFSRs of A or better, stable companies, are impressive. They compare favorably to our expectations. However, the insurance companies that survive do not create problems for insurance agents, policyholders, claimants, reinsurers and regulators. Because insurance companies that fail create problems, failed companies were also reviewed.

Our 10-year and 15-year economic failure rates for companies rated A or better compare favorably to the 10-year and 15-year impairment rates of better-known raters that excluded these companies from consideration. Accordingly, it seems reasonable to conclude that financial stability is independent of size and that regional, well-managed and properly reinsured P/C insurers can be analyzed and earn stable ratings.

Positive implications for regional carriers

Demotech can identify regional, specialty insurance companies and start-up insurance companies that deserve ratings in the stable category. This observation is based upon the survival rates in our analysis. Insurance companies earning FSRs of A or better are well within the range of acceptable survival rates even though a large component of the FSRs were assigned to regional insurance companies, specialty insurance companies and relatively new companies.

Since Demotech focuses on the assignment of ratings to regional insurance companies and specialty insurance companies, our historical record of financial analysis is evidence that regional and specialty insurance companies with stable FSRs present no more financial risk than larger insurance companies earning stable FSRs. Due to the predictive ability of Financial Stability Ratings, they can be utilized to identify financially stable companies regardless of size. ■

Demotech Inc. is a Columbus, Ohio-based financial analysis and actuarial services company. The analysis for this article was prepared under the direction of Joseph L. Petrelli, president and founder. Barry J. Koestler II, senior financial analyst and chief ratings officer, coordinated the analysis of the PFSRs and FSRs. A copy of Demotech's analysis is available at: www.demotech.com.