By Joseph L. Petrelli
ACAS, MAAA, FCA
Founder and president
Demotech, Inc., Columbus, Ohio

GUEST ESSAY

Regional and specialty insurers: Why they matter

This is the fifth in Viewpoint's series of guest essays submitted by organizations that are associate members of AAIS. For information on associate membership, contact Rick Maka, director of marketing, at rickm@AAISonline.com or by calling 800-564-AAIS.

Regional and specialty insurers help to stabilize insurance markets and contain the cost of insurable risk. Most of these 3,100 insurers emphasize long term, trusting relationships with policyholders. Many have existed since the late 1800s, and have obviously weathered terrible insurance markets and stock markets conditions.

Overall, their numbers have increased since 1986. The overwhelming majority are financially sound. We need to be reminded of this, when insurers one hundred or even a thousand times their size falter.

My colleagues and I at Demotech know these insurers. We have been evaluating their financial stability since 1988. We have seen the number of specialty insurers expand. Demotech, Inc. is actually the leading rating service in some classes of regional or specialty insurers. We publish studies of financial stability trends among these insurers, including an analysis of 23,000 Financial Stability Ratings issued over the sixteen year period from 1989 through 2004.

On the question of insolvency risk, many insurance professionals and the media tend instinctively to favor larger sized insurers that offer a broad array of insurance products in several geographic markets. These individuals usually associate large size, diversity of insurance and geographical dispersion with a lower risk of insolvency. Intuitively, this makes sense because the statistical laws of random events tell us that when losses occur randomly, the larger the size of the insured pool of risks, the greater the probability the insurer has of surviving bad loss experience.

However, there is a practical limit to the relevance of hypothetical statistical inferences. Insurers get into trouble less due to size or diversity and more due to management practices and the unrelenting emphasis on meeting earning projections. Often, management may embrace marketing, underwriting and claims practices that cause them to underprice, lose their focus on competitive advantages, and under-reserve for losses so that earnings projections can be met (on paper, not in reality).

The ambitious insurer may try -- perhaps to feed management egos or tantalize external investors -- to expand market share rapidly, or take on new lines of insurance, or grow its top line. This is a potentially lethal game.

The cause of failure is poor financial decisions that can happen to the large and small alike - it merely takes longer to discern and correct in large insurers. A study commissioned by the National Association of Mutual Insurance Companies (NAMIC) indicated that larger insurers, not small ones, have more volatile year to year operating results.

While there are exceptions, Demotech has found that most regional and specialty insurers are self-disciplined. They are not driven to new markets, they focus on their niche. They are not over-leveraged. As a matter of fact, they often purchase extremely conservative reinsurance treaties and design reinsurance programs to protect surplus. Are these practices something new? Not at all. It simply means that other insurance professionals need to scrutinize these insurers with the same degree of attention as Demotech.

Ratings of any insurer can be reliable so long as the rating agency or rating service knows what it is doing. We have found our ratings of these regional and specialty insurers to be highly effective in predicting financial instability.

Their financial statements are usually simpler. Their operations are transparent. Their reinsurance contracts, we believe, are easier to evaluate. We have seen this thousands of times. We can easily research this specialty market. Among these insurers, we expect to find that the insurer, its agents and its core customers value stable relationships. Neither the agent nor the insurer is apt to cut and run from a specialty market.

We expect to find that management is self-disciplined, avoids ruinous price wars and maintains consistent underwriting guidelines, even at the cost of losing market share. Among these insurers, management quality and incentives, down to the individual executive, are transparent and focused. There is less infrastructure, and thus less chance of conflict between outside investors, board members and top management. This benefits both top management and middle management in daily decisions on marketing, underwriting and claims.

All told, in 2004, 1,800 regional and specialty insurers accounted for 5% of the industry's $470 billion of P&C direct writings. That is approximately $25 billion. This business is in the hands of specialists.

These 1,800 insurers include regional P&C insurers - roughly 1,000 of them. Some of them were founded in the 19th century. They employ as many as a hundred or as few as four employees. They participate in guaranty funds and are typically heavy buyers of reinsurance. In addition to them, commercial insurers may have been founded by business associations. In the medical malpractice market, numerous regional monoline carriers have been founded with the encouragement of medical practitioner associations such as state medical societies.

Regional homeowners insurers have sprung to life in Florida in the past ten years, with the encouragement of state insurance regulators who had become wary of the volatile market strategies of some national property insurers, and the state's own risk-bearing entity.

Are these regional and specialty insurers a risky proposition? We provide Preliminary Financial Stability Ratings® for most of them. One might expect that the 2004 and 2005 hurricane seasons would have wreaked havoc on these insurers. Quite the contrary: only one of them was impaired by the hurricanes in 2004 and 2005, and that particular victim's market took direct hits by major hurricanes three times within a week.

Then, there are self insurance pools - about 600 in number. They are often founded under the auspices of a trade association: local governments, health care, and manufacturing, for the most part.

Since 1990s, hundreds of highly specialized corporation-sponsored insurance ventures have been created. In Vermont alone - by far the largest domestic captive base - there are over 700 specialty insurance companies. These can be founded by a single corporate sponsor or by a group of corporations. They include pure captives controlled by one corporation and alternative arrangements such as risk retention groups.

These many and varied regional and specialized insurers serve vital functions. They can all be reviewed and rated. Most will be found to be financially stable. They will be around years from now, in the markets they are in today. Regardless, if one is a corporate sponsor, policyholder, broker, regulator or supplier, these insurers are very good bets.

In sum, insurance agents, brokers and consumers should be comfortable using regional and specialty insurers. The overwhelming majority of these regional insurance companies have an opportunity to earn a Financial Stability Rating® of A or better. This is because their loss and loss adjustment expense reserves are reasonable, their reinsurance programs are based upon traditional excess of loss reinsurance, and has been placed with respected reinsurers, their focus is on niches where customer service and underwriting expertise are more important than meeting an analyst's projection of quarterly earnings.

Bigger is not always better - ask an agent or a claimant who was insured with Legion Insurance Company, Reliance Insurance Company, Home Insurance Company, Mission Insurance, Villanova or PHICO Insurance.

Joseph L. Petrelli is the founder and president of Demotech, Inc., a Columbus, Ohio-based financial analysis and actuarial services company. Demotech provides services to regional insurance companies, title underwriters, and specialty insiurance markets. Petrelli is a member of the Casualty Actuarial Society, American Academy of Actuaries, and the Conference of Consulting Actuaries. ■

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