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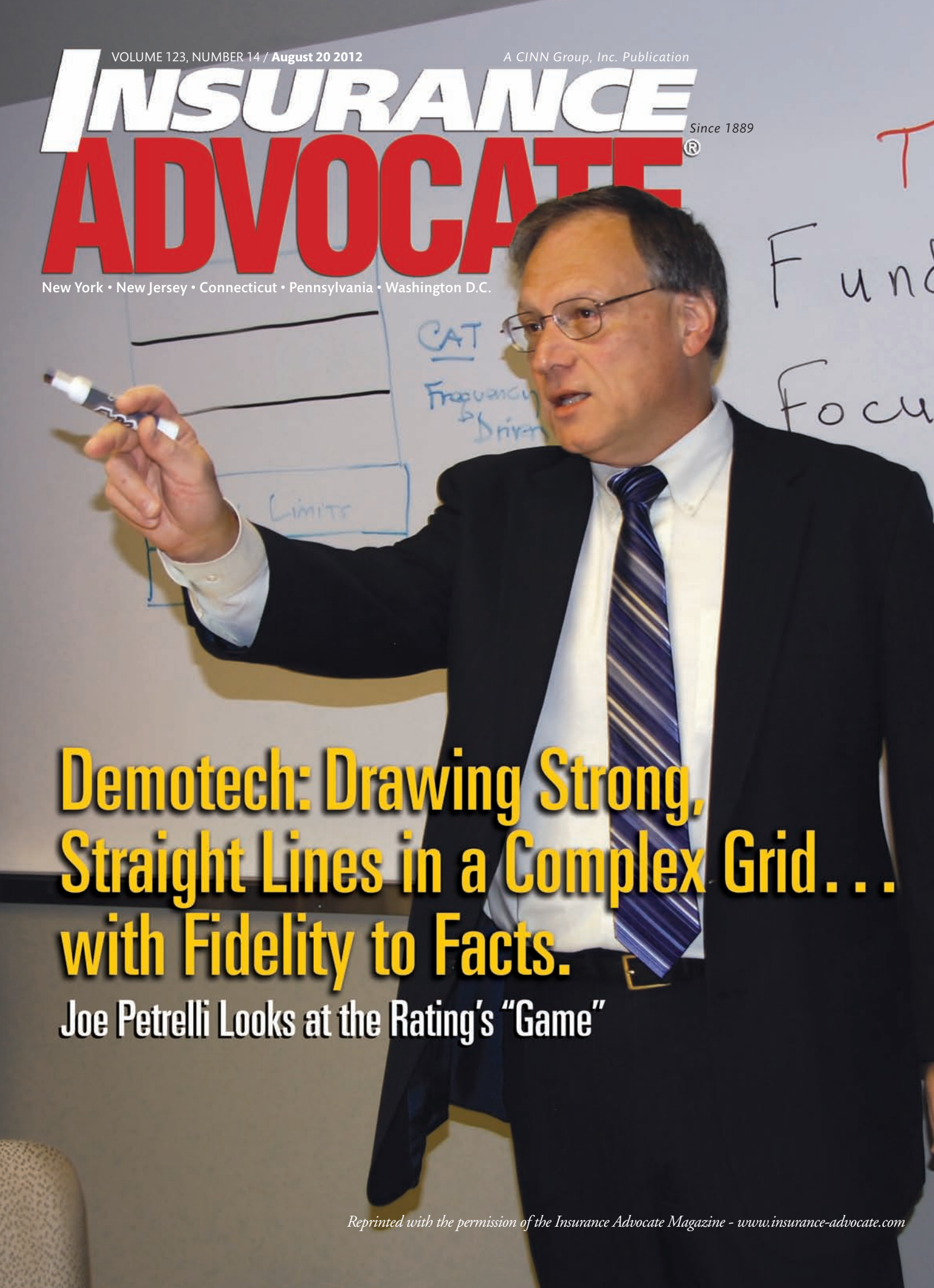
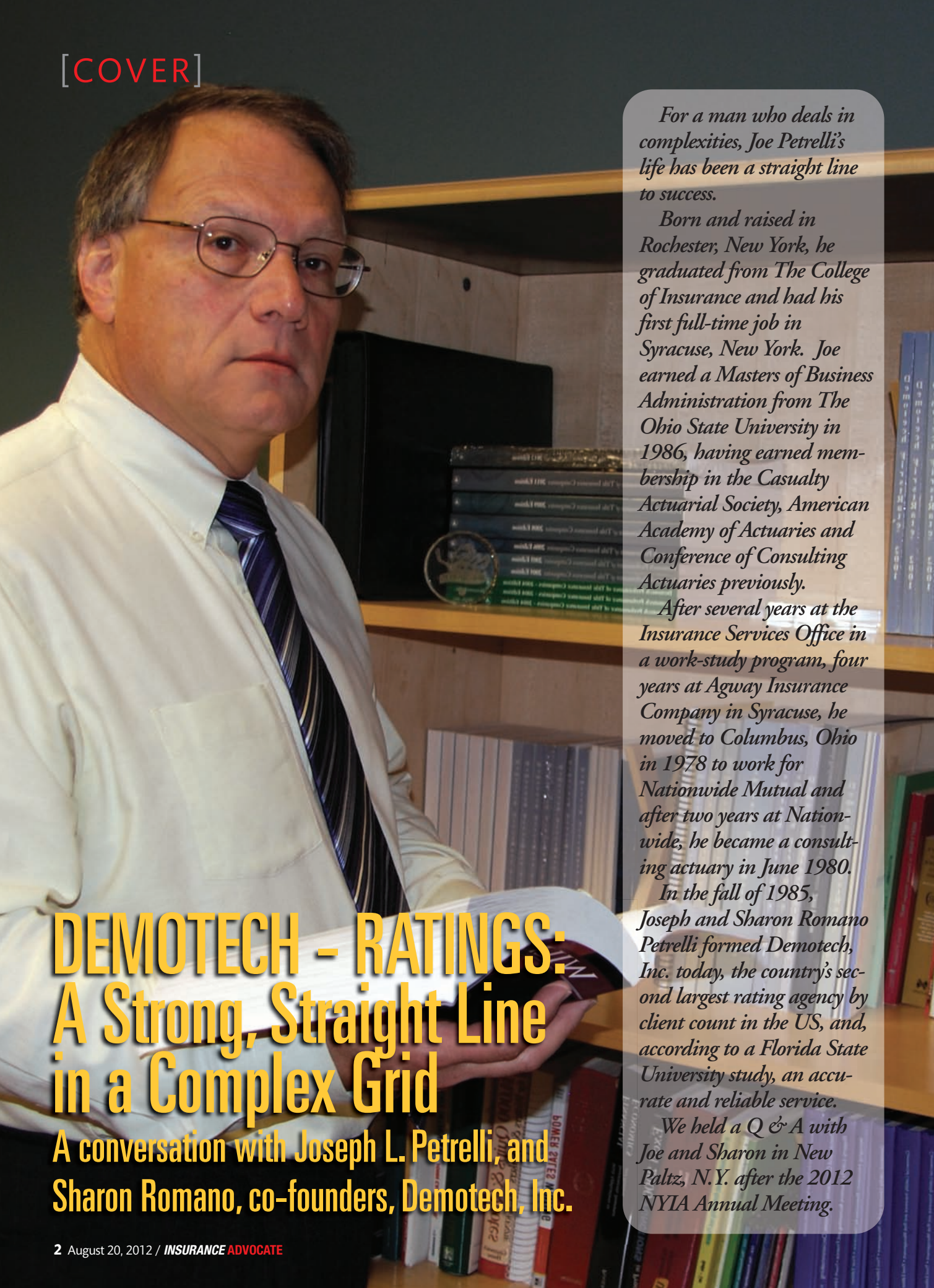


Demotech: Drawing Strong, Straight Lines in a Complex Grid… with Fidelity to Facts.

Joe Petrelli Looks at the Rating's "Game"



DEMOTECH – RATINGS: A Strong, Straight Line in a Complex Grid

A conversation with Joseph L. Petrelli, and Sharon Romano, co-founders, Demotech, Inc.

For a man who deals in complexities, Joe Petrelli's life has been a straight line to success.

Born and raised in Rochester, New York, he graduated from The College of Insurance and had his first full-time job in Syracuse, New York. Joe earned a Masters of Business Administration from The Ohio State University in 1986, having earned membership in the Casualty Actuarial Society, American Academy of Actuaries and Conference of Consulting Actuaries previously.

After several years at the Insurance Services Office in a work-study program, four years at Agway Insurance Company in Syracuse, he moved to Columbus, Ohio in 1978 to work for Nationwide Mutual and after two years at Nationwide, he became a consulting actuary in June 1980.

In the fall of 1985, Joseph and Sharon Romano Petrelli formed Demotech, Inc. today, the country's second largest rating agency by client count in the US, and, according to a Florida State University study, an accurate and reliable service.

We held a Q & A with Joe and Sharon in New Paltz, N.Y. after the 2012 NYIA Annual Meeting.

SA: What spurred your creation of Demotech?

JLP: Simple. The market cried for reasonably priced financial analysis and actuarial services to regional and specialty insurance companies. Sharon and I wanted to ensure that regional and specialty insurance companies were able to access and utilize actuarial consultants. Keep in mind at that time, around 1984-1985; ISO, AAIS and NCCI were transitioning from promulgating rates to promulgating loss costs. There was a flurry of carrier insolvencies and, in response, regulatory financial reporting requirements were being expanded on a regular basis.

The national and international actuarial consulting firms were focused on the larger, national and international carriers to the disadvantage of the 1,000 or more smaller companies. We had the solution, we believed, and that hunch proved true.

SA: You knew regional carriers, so the prospecting had already begun.

JLP: Yes, we were familiar with several regional carriers. I worked at one for four years and when I formed my consulting practice; my initial clientele consisted of a dozen regional and specialty carriers. We understood their strengths and nuances, especially now with more than 350 clients and hundreds more to come.

SA: The 1980's found banks looking at the insurance industry as an area for expansion.

JLP: Absolutely, that was some decade! One of my motivations for earning an MBA in 1986 was that banks knew what an MBA was – I was not certain they were familiar with actuarial science.

SA: Why did Demotech develop a rating service? That must have been an uphill battle.

SMR: Right. Actually it is a great story about being in the right place at the right time. Joe had contacted Rupert Knape, president of German Mutual Insurance Company in Napoleon, Ohio. Joe was looking for pricing, product development or loss reserving work. German Mutual was then, and is today, an example of a solid regional insurer.

Joe's call was placed through to Mr. Knape and they scheduled a meeting. Joe discussed his capabilities, credentials and experience. Mr. Knape politely described why every consulting service Joe had offered was not necessary for German Mutual because of their internal capacity and resources. Mr. Knape acknowledged that other carriers might need some of these actuarial services but not German Mutual. He politely ended the meeting. Two days later he called back to inform Joe that many smaller companies were experiencing difficulty with the acceptance of their hazard insurance policies by lenders, Federal National Mortgage Association, Fannie Mae, and The Federal Home Loan Mortgage Corporation, Freddie Mac. In effect, these carriers were unacceptable to the secondary mortgage marketplace due to their lack of a financial rating.

SHARON ROMANO, CO-FOUNDER, DEMOTECH, INC.

SA: Excuse me for interrupting but didn't A.M. Best Company or any other entity rate these companies?

SMR: They did not. In fact, we were told that Best had advised Fannie, Freddie and the National Association of Mutual Insurance Companies that it was impossible to rate these companies. Fannie, Freddie and NAMIC had all but begged Best to review and rate these smaller insurers, but they were advised that it was impossible to review and rate so many smaller insurers.

SA: But most of these smaller mutual and others had been in business forever, so why did they all of a sudden need a rating?

JLP: Back then, when lenders sold their mortgages to the secondary mortgage marketplace, which consisted predominantly of Fannie Mae and Freddie Mac, the buyers of the obligations that were created and resold, wanted their investments protected by financially stable insurers.

In those situations where A.M. Best was unable or unwilling to provide a rating, Fannie Mae and Freddie Mac personnel were performing that function internally. It's my understanding that the situation reached the point where Fannie and Freddie viewed an independent, outside service as necessary.

Today the insurance experts at Fannie and Freddie focus on managing insurance requirements and standards. Once Demotech blazed this trail, Standard & Poor's, Moody's and Fitch followed our lead.

SA: When did you begin to offer ratings?

JLP: Financial Stability Ratings® made their debut in 1989 and have been effectively identifying financially stable insurers for nearly twenty-five years. Demotech's ability to discern financially stable carriers has been documented through a

continued on page 4

continued from page 3

comparison to industry icons as well as extensive independent analysis. Although our success is based on several factors, we believe that two major differences distinguish Demotech: simply, our concentration on function and fundamentals; in other words, insurance fundamentals and functionality in this sense: if a small insurer has the proper quality and quantity of reinsurance, and we have performed our financial tests and deem them to be stable, we will assign a high Preliminary Financial Stability Rating (PFSR). Reinsurance is clearly an important feature of the insurance transaction. Other rating services seem to believe that if you cede off the potentially profitable business, you are hurting the profitability of the ceding carrier.

In contrast, Demotech believes that insurers should be free to customize their insurance relationships, including reinsurance, in a manner that is consistent with their business model. Clearly smaller insurers, of necessity, use reinsurance

more than larger carriers. Equally important, in our evaluation process, the quality of those reinsurers is critical.

Similarly, we focus on the quality of invested assets, liquidity, maturity and duration, among typical characteristics. The size of the carrier is relative. Think of boxing, where there are multiple levels of weight and size; heavyweight, middleweight, lightweight, bantam weight. Each level has a champion and a championship belt. We believe insurers should be viewed in a similar manner.

In 2007 our Demotech think tank created our Company Classification System that categorizes all P&C insurers into one of 11 categories based on an analysis of data reported by the companies.

The 11 categories that comprise the system are: Nationals, Near Nationals, Super- Regionals, Regionals, State Specialists, Coverage Specialists, Strategic Subsidiaries, Risk Retention Groups, Surplus Lines Carriers, Reinsurers and companies with less than $1 million in direct premium written. A company cannot be assigned to more than one category.

SA: Elaborate further, please.

JLP: The concept of FSRs was developed to highlight the financial stability of well-managed, financially stable regional and specialty insurers. Keeping with our focus on regional and specialty insurers, Demotech was the first to review, rate and issue FSRs to smaller, independent, regional insurers, health maintenance organizations and public entity liability insurance pools.

The mission of Demotech continued to grow as we issued FSRs to public entity liability self-insured pools through the development of our Management Audit Process. In many ways the Management Audit Process that we have utilized since 1989, was the precursor to enterprise risk management, own risk and solvency assessment and other solvency management processes. By 1989, we were the first company to have its Property and Casualty insurance company rating process formally reviewed and accepted by Fannie Mae. A similar review was completed by Freddie Mac in 1990 and HUD in 1993. HUD then accepted Demotech's rating process for professional liability insurance under Notice H04-15, Professional Liability Insurance for Section 232 and 223(f) Programs in 2005.

SA: What do these acceptances provide to your "rated clients"?

JLP: In general, Demotech secures accreditations to level the playing field for insurers that are unrated or underrated by the larger services. This is typically in response to rating requirements imposed by third parties. Whenever an insurer is boycotted, coerced to obtain a rating or otherwise is a victim of restraint of trade, we present the carrier's case to the third party and demonstrate that the carrier we have reviewed and rated is financially stable. Although, we often update our list of major successes, Demotech is seeing an increasing number of "believers" join the ranks of the enlightened as the logical consequence of our impressive track record identifying financially stable insurers.

SA: What happened to Demotech with the establishment of the Financial Stability Ratings®?

JLP: During the 1990's we expanded by offering loss cost analysis and rate, rule and form filing assistance to Property and Casualty (P&C) companies and Title underwriters. We also were the first to analyze the financial stability of Title underwriters.

SA: Why Title underwriters?

SMR: A bit of a natural progression, when Joe decided to obtain an MBA, he wanted to do so to be able to communicate his professionalism to banks and lenders. Right at the intersection of asset-backed lending, real estate and insurance was Title insurance, which insures the marketability of title to real property.

He did his MBA research project on Title insurance. Let me add, that in 1985, when he did that research project, the Title insurance industry consisted of $1,000,000,000 of premium per year. It reached a peak in 2006 of $16,000,000,000.

Demotech began our review, analysis and the promulgation of ratings in 1992, two full years before Title underwriter ratings were required by the secondary mortgage marketplace.

SA: Another niche is born... and Demotech developed it.

SMR: Yes, more evidence that our boutique size provides flexibility and speed in addition to expertise.

JLP: Today, Demotech provides ratings and analysis that assists Title underwriters qualify to do business with lenders. No one has reviewed the Title industry longer than us and no one covers more Title underwriters.

This enabled Demotech to be named as an approved Title underwriter rating service when Fannie Mae issued Title underwriting guidelines way back in 1994. Our work within the Title industry continued as we disseminated Commercial Real Estate Recommendations (CRERs) to provide additional financial due diligence to Title underwriters involved in larger real estate transactions.

SMR: Given our expertise in the P&C industry as well as the Title sector, no one is a more effective "translator or interpreter" of Title insurance related issues than Joe and Demotech.

SA: Where are you today with the Title industry?

JLP: We have continued our analysis of the Title insurance industry through a variety of projects during the last decade. We began in 2001 by completing the initial loss and loss adjustment expense review of the Iowa Finance Authority – Title Guaranty Division. We revitalized the Ohio Title Insurance Rating Bureau, OTIRB, in 2002 and assisted the North Carolina Title Insurance Rating Bureau with the development of Closing Services insurance products in 2003. That year we also filed the first rate revision within Ohio since 1980. In 2004, we formed Louisiana Title Statistical Services Organization, Inc. which we still administer today.

SA: Ratings of the Title industry are in line with expectations, I assume.

JLP: Yes, we publish the Demotech Performance of Title Insurance Companies. This is the only independent source of Title industry information. As of the 2012 edition, all publicly traded Title underwriters and regional and local underwriters representing more than 99% of the Title industry's Direct Premium Written are included in the publication. This publication also presents comparative statutory operating results, as well as the statutory financial positions of each Title underwriter.

SA: Serious About Solvency is your corporate motto. Tell me something about that.

JLP: The motto evolved as we directed our analytical abilities internally to evaluate our FSRs. As we did so, discussion ensued on our rating process and what our ratings had proven over the long term. Serious about Solvency – Financial Stability Rating® Survival Rates 1989 through 2004 was published to outline our analysis process, hold us accountable for our assignment of FSRs and analyze the survival rates of insurers we had reviewed and rated during our first fifteen years of issuing ratings.

SA: So, you calculated the score card on the accuracy of your ratings?

SMR: Yes, that's essentially what we did.

SA: What were the survival rates for this period?

JLP: From 1989 through 2004, Demotech prepared 23,118 Preliminary Financial Stability Ratings®. In order to calculate the survival rates presented in this analysis, we defined survival as the avoidance of economic failure. For an insurance company, that meant that it continued to pay claims on its own. Over the period 1989 through 2004, 70.46% (16,290 companies) of the FSRs we assigned were Stable, A or above and 29.54% (6,828 companies) were below Stable, S or lower.

SA: Insurer economic failure is a reality. What was your definition of economic failure?

JLP: Economic failure was in the form of rehabilitation, liquidation, involuntary receivership or conservatorship, license suspension or revocation, supervision or other legal or regulatory remedy instituted by a Department of Insurance for the purpose of protecting the interests of policyholders or claimants. This is what keeps Chief Executive Officers up at night.

Voluntary action by an insurance company, including surrender of its license, merger into an affiliate, purchase by a solvent insurer, a capital infusion by a third party or other activity that resulted in the carrier's continuous ability to honor meritorious claims was considered survival. Our focus was the protection of policyholders, insurance agents, claimants and reinsurers. The central question is can the insurer honor or defend meritorious claims?

SA: Claims paying ability weighs heavily?

JLP: Yes, and financial stability is independent of size. We believe well-managed, properly reinsured, regional P&C insurers can be more financially stable than larger, highly leveraged P&C insurers. In other words, the financial stability of regional P&C insurers can be accurately analyzed and measured, and furthermore, can support the assignment of a Stable FSR of A or better. This is one of the reasons that Demotech was accepted by Fannie Mae and Freddie Mac back in 1989 and 1990, respectively. We demonstrated our ability to assess the financial stability of regional insurers, particularly their reinsurance treaties and programs.

At the time of this study, Demotech had been analyzing the financial stability of Property and Casualty insurance companies for approximately sixteen years. Our retrospective analysis of 23,118 Financial Stability Ratings® indicated that insurers earning FSRs of A or better, Stable companies, had survival rates at or above expectations. Although the 23, 118 included carriers of all sizes, because Demotech focuses on the assignment of Financial Stability Ratings® to regional and specialty insurance companies, our historical record of financial analysis is evidence that regional and specialty insurance companies assigned Stable

continued on page 6

continued from page 5

Financial Stability Ratings® present no more financial risk than larger insurance companies earning Stable FSRs.

Due to the proven predictive ability of Financial Stability Ratings®, FSRs can be utilized to identify financially stable regional and specialty insurers, regardless of size.

SA: Your Company Classification System works. You have said so in public appearances.. Would you explain what that is?

JLP: Our reputation as experts in the regional and specialty insurance industry had grown over the years. This reputation presented the opportunity for us to define Super Regionals. *Insurance Journal* came to Demotech with the idea of establishing objective financial standards for stratifying P&C carriers. As we attempted to define Super Regionals™, we developed the Demotech Company Classification System. *Insurance Journal* published the introductory article on Super Regional P/C Insurers™ as a Special Report, Salute to Super Regionals in February of 2007. We continue to publish an update of this popular report each year.

Although Super Regional™ seem to be the most popular classification, the Demotech Company Classification System categorizes all P&C insurers into one of 11 categories, based on Demotech's analysis of the data, reported by the companies to the National Association of Insurance Commissioners. Demotech believes that insurers should be categorized by function, not by size.

SA: At the beginning of our discussion you stated that Demotech was founded to provide financial analysis consulting services to regional and specialty insurers. How have you developed that idea within the industry?

JLP: From its inception, Demotech has worked within the insurance industry as an advocate for regional and specialty insurers. We strive for cooperative relationships with the National Association of Insurance Commissioners (NAIC), the departments of insurance, American Land Title Association (ALTA), Commerce Clearing House, Ohio Title Insurance Rating Bureau, North Carolina Title Insurance Rating Bureau, Insurance Journal magazine, Florida State University and other centers of insurance professionalism.

We are often the thought leaders who evaluate how to implement changes in regulations. For example, in 1990, we responded to the NAIC's requirement for P&C insurers to submit Statements of Actuarial Opinion related to loss and loss adjustment expense reserves by assisting regional insurance companies that had not previously utilized an actuary for this purpose.

On the insurer ratings side, in 1996, the State of Florida Office of Insurance Regulation contacted Demotech. Subsequent to the numerous insolvencies in 1993, 1994 and 1995, the property insurance market had encouraged the formation of a large number of newly established insurers that did not meet traditional rating agency requirements. Demotech developed evaluation procedures for the assignment of FSRs to newly formed P&C companies.

SA: Doesn't Demotech has a large presence in Florida, if I recall correctly.

JLP: Demotech has been quite effective in Florida since our initial effort in 1996. In the mid-1990s, hurricanes devastated properties along the Florida coastline and simultaneously devastated Florida's property insurance marketplace. A large number of the insurance carriers rated by A. M. Best were forced into liquidation.

To enhance availability, the State of Florida developed the (then) Florida Residential Property Casualty Joint Underwriting Association (JUA) to provide homeowners insurance and related property coverage. The JUA, which evolved into Citizens Property Insurance Corporation, became the leading writer of homeowners insurance in Florida.

In 1996, the State of Florida, Florida Office of Insurance Regulation (OIR) and the JUA initiated an effort to depopulate the JUA. The depopulation effort included legislation to permit the State of Florida to offer financial incentives to insurers that depopulated the JUA. The legislation included guidelines and procedures to ensure that the OIR could expedite processing the insurers that would be formed for the purpose of capitalizing on the financial incentives.

Concurrently, the mortgage lending industry amended the legislation to include a provision that required the newly capitalized insurance companies be acceptable to the secondary mortgage marketplace. As start-ups, the insurers would not be rated by A. M. Best and would be unacceptable to the secondary mortgage marketplace unless they were reviewed and rated by Demotech. When the State of Florida and the secondary mortgage marketplace needed a solution to this dilemma, they contacted Demotech.

To level the playing field, we developed a procedure to review and rate newly formed insurers. Our process assisted the State of Florida, insurance agents, insurance companies, consumers, reinsurers and the secondary mortgage marketplace. Since then, the process has been utilized to review and analyze start-up insurers domiciled or licensed in all jurisdictions.

Today we review and rate 70% of Florida's property insurance marketplace, pretty much everyone but Citizens Property Insurance Corporation, with a 20% marketshare of Homeowners insurance, and State Farm Florida with about a 10% marketshare.

SA: You mentioned a relationship with ALTA; would you describe your interaction with them?

JLP: Demotech's relationship with the ALTA began that same year as we coordinated the first seminar regarding the implementation of Statements of Actuarial Opinion for Title insurance companies on behalf of the Conference of Consulting Actuaries and in cooperation with the ALTA. We rounded out the decade by co-authoring a Commerce Clearing House publication describing the evolution of the Canadian Title

insurance industry. Currently we work with ALTA, analyzing and providing data collection for their ALTA Agents and Abstracters Survey.

SA: Previously, we discussed endorsements and their value to Financial Stability Ratings®. What other benefits do regional and specialty insurers receive by earning a rating?

JLP: Continuing our focus on regional and specialty insurers, we have developed affinity relationships that allow insurers earning an FSR of A or better access to insurance agents errors and omissions insurance carriers extending applicable coverage for insolvency. The current affiliate relationships include NAMICO Insurance Company, Century Surety Company, Allied World Assurance Company, Darwin Insurance, Lexington Insurance and ProSight Specialty Insurance Company, among others.

SA: Why did you get involved with insurance agents' E&O professional liability?

JLP: Since the early 2000's, most of the carriers writing insurance agents errors and omissions insurance have inserted an insolvency exclusion. This insolvency exclusion requires that the markets utilized by an agent have a rating at a certain level or higher from one specific rating agency. To assist carriers unrated by this specific rating agency, we responded to the challenge created by this insolvency exclusion, Demotech contacted Westport, Utica and other errors and omissions insurance carriers to secure exceptions on behalf of a particular insurer or agent, or to amend their policies to also include FSRs of A or better from Demotech. Many E&O carriers have made the effort to include insurers that we review and rate at the A level or above.

While we contact the major writers of E&O coverage to familiarize them with what we do and how we do it, we created a fully insured coverage, Insolvency Gap Coverage, to provides an insurer with the opportunity to address the insolvency exclusion on behalf of all of its agents. The Insolvency Gap Coverage was also created to mitigate the adverse impact of the insolvency exclusion that has crept into insurance agents errors and omissions insurance.

SA: We have discussed P&C and Title insurers. What other regional or specialty groups does Demotech work with?

JLP: Risk retention groups (RRGs) bring a unique structure and set of opportunities to the P&C industry. In our working relationship with analysts, we are often called upon for our expertise and perspective. As such, Demotech performs a quarterly analysis of risk retention groups. This analysis includes balance sheet metrics, underwriting results and overall profitability as well as trends.

SA: We discussed Demotech's internal analysis called Serious About Solvency. Has Demotech ever had its ratings independently reviewed and analyzed?

JLP: Demotech was approached by Florida State University to participate in an independent study of insurer ratings. According to A Comprehensive Examination of Insurer Financial Strength Ratings, the purpose and key findings was to "explore the potential similarities and differences across insurer financial strength ratings, with a particular focus on Demotech." FSU noted that Demotech differs from the traditional rating agencies in several key ways. First, Demotech provides a provisional (unsolicited) rating to all firms where financial data is available. If firms choose to finalize the rating, the rating becomes available to the public. Second, Demotech uses less non-publically available information in the construction of its ratings than other agencies. Third, there are significantly fewer barriers to obtaining a Demotech rating. As a result, it is easier for smaller, newer, and/or monostate firms to obtain a Demotech rating than ratings from other agencies.

Yet, the analysis noted comparisons of Demotech ratings to other agencies show relative consistency in the factors that drive Demotech ratings compared to agencies such as A.M. Best, Moody's Standard & Poor's, and Fitch. There also is general consistency in the firms that each agency would categorize as financially secure/stable." Some of the excerpts from A Comprehensive Examination of Insurer Financial Strength Ratings include:

- We also find some consistency in the importance of organizational and key financial characteristics when comparing the results for unsolicited and solicited ratings across the agencies.
- There appears to be strong consistency in the evaluation of the insurers by the agencies.
- Our findings provide some evidence that though the distributions of unsolicited and solicited ratings differ, unsolicited insurer ratings may be as accurate as solicited ratings.
- We find there is some consistency in the importance of certain organizational and key financial characteristics.
- As such, Demotech serves the need of another unique group of insurers, namely those that are geographically focused.

We are proud of the work we did that resulted in the independent observations and conclusions reached by FSU's insurance professionals. For more than 25 years, Demotech has been committed to serving regional and specialty insurers while maintaining the highest standards of excellence, as proven by both internal, and independent third party, analysis.

Innovative thinking, strategic analysis, commitment, insight and on-going involvement with the insurance industry allow us to provide solutions as unique as your company. This is achieved by our philosophy of reviewing and evaluating insurers based on their area of focus and execution of their business model rather than solely on financial size. Being a little bit different has made us a lot better.

SA: The approach is working?

JLP: Yes, and the future holds additional growth for us.

SA: Thank you. [IA]