

WHAT'S WITH ALL THIS INSURER RATING AND OVERSIGHT?

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SERIOUS ABOUT SOLVENCY[®]

Demotech, Inc.

- Demotech, Inc. is a financial analysis firm specializing in evaluating the financial stability of regional and specialty insurers.
- Since 1985, Demotech has served the insurance industry by assigning accurate, reliable and proven Financial Stability Ratings® (FSRs) for Property & Casualty insurers and Title underwriters.
- FSRs are a leading indicator of financial stability, providing an objective baseline of the future solvency of an insurer.
- Demotech's philosophy is to review and evaluate insurers based on their area of focus and execution of their business model rather than solely on financial size. This philosophy was the catalyst for the Demotech Company Classification System, which was published in *Insurance Journal*, in order to stratify and categorize insurers into operational categories.

Demotech's Acceptances

- Demotech was the first company to have its rating process formally reviewed and accepted by:
 - Fannie Mae (1989)
 - Freddie Mac (1990)
 - HUD (1994 & 2005)
- 1996 - Worked with Florida Office of Insurance Regulation (then DOI) to develop FSRs for Florida "take out" insurers to depopulate the residual market.
- 2005 - Accepted by HUD for rating Professional Liability insurers of long term care facilities
- 2009 - Received carve-back on insolvency provision from several insurance agents' errors and omissions insurance carriers.
- 2010 - Participant in independent Florida State University and Wharton School studies evaluating insurer financial ratings.

Demotech's Involvement with AICP

- Joe Petrelli and Sharon Romano Petrelli have made thousands of rate, rule and form filings for every line of P&C insurance in every jurisdiction.
- Sharon Romano Petrelli served on the Board of Directors of the Association of Insurance Compliance Professionals (AICP) from 1997 - 1999. She served several terms as President of the Midwest Forum Chapter of the Association of Insurance Compliance Professionals.

Today's Topic: Insurer Ratings and Oversight?

How can a compliance professional impact its employer/carrier's rating and related oversight?

P&C Financial Reporting

- The Property and Casualty industry is comprised of 2,784 insurers which report financial data to the National Association of Insurance Commissioners.
- These insurers reported \$502,005,513,572 of direct premiums written in 2011.

Ranked by Net Admitted Assets, the largest three companies are:

Company	2011 Net Admitted Assets	2011 Direct Premiums Written
National Indemnity Company	\$115,452,570,996	\$87,641,924
State Farm Mutual Automobile Insurance Company	\$108,097,364,056	\$30,389,177,203
Allstate Insurance Company	\$41,023,043,030	\$8,707,629,695

Ranked by Net Admitted Assets, the smallest three companies are:

Company	2011 Net Admitted Assets	2011 Direct Premiums Written
Policyholders Mutual Insurance Company	\$242,193	\$15,000
Eternal Care Insurance Company	\$175,560	\$650
Shamokin Township Mutual Fire Insurance Company	\$127,181	\$10,051

The new reality is that financial reporting is insufficient.

Risk-Based Examinations

Whether the analysis process is entitled Enterprise Risk Management, our Risk and Solvency Assessment or the NAIC's Solvency Modernization Initiative, the move toward risk-based examinations involves an introspective, self-focused examination on the risks that impact each carrier's ability to weather economic, legislative, statutory or macroeconomic storms.

Regulatory Perspective

For discussion purposes, let's call the regulatory perspective "risk based examination" and let's call the rating agency and carrier perspective "enterprise risk management" (ERM) with own risk and solvency assessment (ORSA) and Solvency Modernization Initiatives, as well as alien terms such as Basel II or Solvency II, broad strategies within ERM.

ERM Function

An effective enterprise risk management function should identify, measure, aggregate, and manage risk exposures within predetermined tolerance levels, across all activities of the enterprise of which the insurer is part, or at the company level when the insurer is a stand-alone entity.

New York State Department of Financial Services Insurance Circular Letter
No. 14 (2011).

December 19, 2011.

Demotech's Framework

There are several methods for identifying the risks carriers face. Demotech utilizes this framework:

1. Market Risk

Risks associated with changes in market factors, such as prices, exchange rates, liquidity and interest rates (inflation, frequency, benefit or law changes).

2. Credit Risk

Risk that a counterparty may default or become less able to fulfill their contractual obligations, whether financial or physical (reinsurers, investments that mature, etc.)

Demotech's Framework (cont)

3. Business Risk.

Risks specific to the markets and industry in which the insurer operates (states, lines of business and distribution system).

4. Operational Risk

Breakdown in management controls, information technology, processes and people.

- a. How do we measure, monitor, report and decide?
- b. Simulation and models to develop “what ifs”.
- c. Technology and systems capabilities.
- d. Analytical skills – internal and versus the competition.

Another Excerpt from NYSDFS Recent Circular Letter

A written risk policy that delineates the insurer's risk/reward framework, risk tolerance levels, and risk limits. An insurer's ERM function should provide for the identification and quantification of risk under a sufficiently wide range of outcomes using techniques that are appropriate to the nature, scale and complexity of the risks the insurer bears and are adequate for capital management and solvency purposes.

For those of you involved in the rate, rule and form filing function, this could mean:

State by state reviews of:

1. Changes in competitors
2. Changes in rate levels
3. Changes in policy provisions
4. Changes in statutes or bulletins
5. Distribution systems – yours or competitor's

Line by line:

1. Changes in competitors
2. Changes in rate levels
3. Changes in policy provisions
4. Changes in statutes or bulletins
5. Distribution systems – yours or competitor's

Considerations

Under ERM, one of the considerations a company should undertake prior to adopting the rates, rules, forms or perspective of a competitor is an internal capabilities assessment:

1. Are these changes reasonable – adequate rates, forms reviewed, etc?
2. If we do this, how are our operating results impacted?
3. Is this more consistent with our risk/reward profile?
4. Do we have the people/expertise/infrastructure to process the revised program as efficiently as our current program?
5. How will this impact our competitive position?

Summary

The move toward ERM, ORSA and SMI is underway. The regulatory perspective on risk focused examinations as well as the rating agency's subjective determinations can be the impetus for compliance personnel to identify, measure, aggregate and manage risk exposures related to market risk, business risk and operational risk.

Demotech wishes you well in this pursuit.



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