

# The Art of Carrier Financial Analysis

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Presented by

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# Introduction

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- Carrier Financial Analysis discussion is from Aon's Quarterly Speaker Series
- Perhaps second only to price, carrier financial stability is an enormously prominent issue at the C-suite and board level
- Outline of presentation
  - Factors contributing to the current situation
  - Financial metrics that provide insight into performance
  - Aon's Carrier Financial Analysis Matrix – one view of how to approach carrier financial analysis; other views may also be appropriate

# Current Market Conditions

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- Current “soft” underwriting cycle
  - Intense price competition
  - Relaxed pricing and underwriting terms
  - The P&C industry has been experiencing this for the past couple of years and few believe significant change is in sight
- Emerging from worst financial crisis since 1930’s
- Was first time in recent history that *both* the insurance markets and financial markets have been struggling concurrently
  - During past soft cycles carriers were able to offset underwriting losses with investment income
  - Was not possible during 2008/H12009, so carriers need to focus on underwriting management
  - Significant rebound in financial markets during H2, but investment income is still low due to depressed interest rates, requiring underwriting performance to continue to be vital
- Impact of Q1 2011 catastrophe losses
- Added potential for significant future losses to emerge from D&O and E&O claims related to the capital markets disruptions

# Impact of Q1 2011 Losses on Insurance Industry

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- Material volatility has been shifted to reinsurers from the balance sheets and income statements of insurers
- Reinsurance capacity ended 2010 at its peak of \$470 Billion
  - \$50 Billion Q1 2011 loss is more of an earnings hit than a capital hit
  - 2011 hurricane season begins June 1
- Insurance industry is global

# Rating Agency Views

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## Current Industry Outlook

Sector	A.M. Best	S&P	Fitch	Moody's
Personal Lines	Stable	Stable	Stable	Stable
Commercial Lines	Negative	Negative	Stable	Negative
Reinsurance	Stable	Stable	Stable	Negative
Health	Negative	Stable	Stable	Negative
Life Insurance	Stable	Stable	Stable	Stable

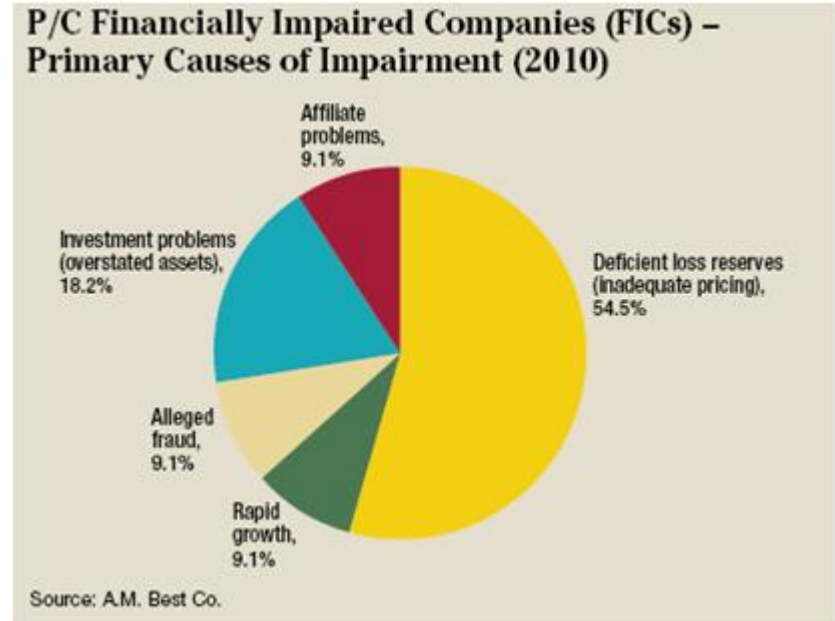
As of January 11, 2011

- Negative outlooks in an industry means the rating agency expects more downgrades than upgrades during the year.

# A. M. Best Impairment Study

## Focus on Most Material Risk Sources When Considering Risk Appetite

Cause (1969-2008)	Pct Total
Deficient Loss Reserves	38.1%
Rapid Growth	14.3%
Alleged Fraud	8.1%
Catastrophe Losses	7.6%
Impairment of Affiliate	7.9%
Overstated Assets	7.0%
Significant Change	4.2%
Reinsurance Failure	3.7%
Miscellaneous	9.1%



**1,028 impairments\* over 40 year period 1969-2008**

Source: A. M. Best Impairment Study, version dates 2009 and 2010

\* A. M. Best defines impairment as any type of restrictive regulatory action

**Insurance risk is the main killer of P&C companies based on 40+ year track record**

# Data Sources

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- Inundated with information
  - GAAP Financial Statements
  - Statutory Financial Statements
  - Rating Agency Reports
  - Analyst Reports
  - Broker market security reports
- What to do with information / how to prioritize?

# Key Analytical Points

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- Mix of qualitative and quantitative
- Quantitative:
  - Balance sheet strength
    - Capital adequacy
    - Asset quality / Investment leverage
    - Reserves strength/stability
  - Liquidity
    - Of particular importance today given unrealized investment losses
  - Operating performance
    - Underwriting performance
    - Cycle management
  - Financial flexibility

# Key Analytical Points (cont.)

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- Qualitative
  - Reinsurance
  - Enterprise Risk Management (ERM)
  - Management and Corporate Strategy
  - Catastrophe exposure

# Balance Sheet Strength: Capital Adequacy

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- Insurance capital declined by 20%-35% between 2007 and 2008
  - Same list of companies (publicly traded (re)insurers) saw capital increase by 22.2% during 2009, virtually offsetting the lost capital
  - These were primarily unrealized gains and losses though – so accounting – not “real” losses
- Risk Based Capital
  - NAIC / US Regulatory
  - Factor based capital model
  - Starting point is US Statutory data
  - RBC Level:
    - > 200% = No Action Level
    - < 70% = Mandatory Control Level
  - Available in the Five Year Historical Data Pages
- Rating Agency assessment of capital adequacy (see next slides):
  - AM Best
  - Standard and Poor's
  - Fitch
  - Moody's

# Balance Sheet Strength: Capital Adequacy (cont.)

- A.M. Best
  - Best’s Capital Adequacy Ratio (“BCAR”)
  - Similar to NAIC’s RBC model
  - BCAR score available for all Best’s rated US carriers in the Company report

	Min.	2003	2004	2005	2006	2007	2008	2009E
A++	175	230	285	323	306	305	264	289
A+	160	240	248	268	284	277	262	281
A	145	228	234	240	268	276	251	288
A-	130	200	196	209	225	239	224	249
B++	115	260	168	188	201	204	203	223
B+	100	141	146	150	174	176	167	168

# Balance Sheet Strength: Capital Adequacy (cont.)

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- Standard and Poor's
  - “Enhanced” Capital Model introduced in 2006; was fully phased in for all 2008 year-end reviews
  - No longer a ratio, but required capital is rather calibrated to each rating level
  - The company is then either deficient or redundant for their rating
  - S&P will generally express this in their Financial Analysis Reports (“FAR”) as excellent, strong, adequate or weak capital
- Fitch
  - Prism
  - Stochastic capital model
  - Introduced in 2006/2007
  - Model is not publicly available
- Moody's
  - Moody's Risk Adjusted Capital Model (“MRAC”)
  - Includes Monte Carlo simulations to develop the estimated probability distribution for the aggregate future performance of the group

# Balance Sheet Strength: Asset Quality

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- Much focus on credit quality, concentration and liquidity of assets
  - Structured Assets
    - Asset Backed / Mortgage Backed securities
    - CDOs
  - Equities
- Key factors to consider:
  - Duration / maturity
  - Credit quality
  - Concentration
  - Unrealized losses
  - Realized losses
  - OTTI (other than temporary impairments)
- If reviewing STAT financial statements, the unrealized losses on bonds are not fully reflected in balance sheet nor income statement
  - Schedule D Summary by Country & Verification
  - NAIC 1 & 2 bonds are held at amortized cost not fair value
  - Unrealized gains/losses reflected in rating agency models

# Balance Sheet Strength: Reserves

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- Reserves are the largest liability on an insurance company's balance sheet
- For long-tail lines like liability and workers' compensation, reserves continue to develop many years after the premiums are written
  - Less predictable than short-tail personal lines
- Increasing reserves results in a reduction to Income; releasing reserves creates underwriting profit
  - Can lead to manipulation of financial statements
- During the last soft cycle in 1997-2001 carriers underpriced their business, which resulted in insufficient reserves
  - Particularly noticeable across liability lines
  - Companies recorded \$96B of reserve strengthening between 2002 and 2007 for years 2001 and prior

# Balance Sheet Strength: Reserves (cont.)

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- As pricing continues to decline, are companies releasing reserves either prematurely or to offset underwriting losses?
- It is important to understand the strength and stability of a company's reserves
  - Sources:
    - Schedule P part 1
    - GAAP footnote disclosure reserve
  - Provides 10 years of information on reserve development

# Balance Sheet Strength: Liquidity

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- Today liquidity is one of the key rating factors, contrary to just a few years ago when few analysts considered it
- The 2008 crisis highlighted two things:
  - That “capital” was not equity and generally included large amounts of debt that was not available to pay claims; and
  - That companies oftentimes had large amounts of investments tied up in illiquid assets
- During 2009, carriers that had strong liquidity from operating cash flows, liquid investments and financial flexibility have a greater ability to hold fixed income investments to maturity and therefore are not under as much immediate ratings pressure
- Analysts will continue to place a greater emphasis on liquidity, particularly in terms of risk tolerances and stress scenarios

# Operating Performance: Combined Ratio and Return on Surplus

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- Combined Ratio:
  - Sum of Loss Ratio and Expense Ratio
  - Loss ratio = net incurred losses / net earned premiums
  - Expense ratio = underwriting expenses incurred / net written premiums
  - Ideally ratio should be less than 100%
  - Implies underwriting profitability
  - Important to review trend over time
- Return on Surplus (ROE)
  - Income / average surplus
  - Also important to review trends
  - Most companies target a ROE of 10% - 15%
  - Mutual companies will generally target a lower ROE than stock companies

# Operating Performance: Investment Performance / Leverage

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- Most companies experienced significant investment losses during 2008, continuing into 2009
  - US Insurance companies have traditionally invested conservatively
- During 2008, the publicly-traded insurance companies lost approximately 25%-35% of their 2007 year-end capital due to investment losses
  - This includes realized and unrealized losses
- Again, many companies recouped a large amount of these unrealized losses as unrealized gains during 2009
- Investment leverage is another concern
  - How many assets do companies hold compared to capital?
  - Banks had leverage of 20-40+:1
  - 2008/2009 Insurer invested asset leverage: between 6.0-7.0:1
  - Actually decreased since 2007

# Other Factors

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- **Management and Corporate Strategy**
  - One of the key qualitative components to consider
  - What is management's experience and track record?
  - What is strategy? Can company articulate this?
- **Financial flexibility**
  - Access to capital should the company need it
- **Reinsurance**
  - Does the company utilize reinsurance effectively?
  - What is gross vs net loss ratio?
  - What is credit quality of the reinsurance program?
  - Manage volatility and frequency of losses?
  - Manage severity of losses (catastrophe)?
  - Schedule F part 3

# Other Factors (cont.)

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- Enterprise Risk Management (ERM)
  - What is company's corporate wide risk management?
  - Does the company have a stated risk tolerance?
  - Strong risk controls?
  - S&P specifically rates a company's ERM
- Catastrophe exposures
  - Is the company exposed to large catastrophe events?
    - California earthquake
    - US Hurricane
  - How does the company manage this risk?
- Risk tolerances
  - Does the company have a stated risk tolerance? How does this compare to the 2008 decline in capital?
  - Is the largest risk scenario beyond a natural catastrophe scenario?

# Carrier Financial Analysis Matrix

Carrier	FSR Rating Red = down from 12/14/10; Green = upgrade; Blue = new							Underwriting Metrics						Investment Gains or (Losses)			
	A.M. Best				S&P			Combined Ratio			ROE			Realized (\$M)		Unrealized (\$M)	
	Best	Mod	Size	Outlook	S&P	Outlook	ERM	2010 YE	2009 YE	5 Yr Avg	2010 YE	2009 YE	5 Yr Avg	2010 YE	2009 YE	2010 YE	2009 YE
Sample Parameters	≥ 'A-'				≥ 'A-'			Lower is Better	Lower is Better	Lower is Better	Higher is Better	Higher is Better	Higher is Better	Positive	Positive	Positive	Positive

Balance Sheet Strength											
Policyholders Surplus (\$M)			BCAR		AY Reserve Development			Investment	Asset	NPW /	NPW + Res
2010 YE	10YE v 09YE	09YE v 08YE	Current	Change	1yr	2yr	5yr	Leverage	Leverage	Surplus	/ Surplus
Higher is Better	Positive	Positive	Higher is Better	Positive	Negative	Negative	Negative	Lower is Better	Lower is Better	Lower is Better	Lower is Better

# Questions?

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# Nancy Green, CPCU, ARM

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## ***Executive Vice President, Strategic Account Management***

- Nancy Green has been with Aon since December, 1986. In her role as Strategic Account Manager, she works as a national resource assisting client service teams in bringing solutions to Aon's largest accounts, and she helps coordinate delivery of Aon products and resources to support those solutions. In addition, she helps facilitate the quick exchange of market intelligence across the network of Aon offices so that Aon can learn about something impacting one large account and immediately proactively assess whether other large accounts might have similar situations. She works in partnership with Account Executives world-wide to ensure they have everything they need to service Aon's largest clients.

## ***Background:***

- Prior to her role as Strategic Account Manager, Ms. Green was responsible for senior-level client service, new business production, risk management consulting and coordination of team resources for risk management clients. She headed up a Client Service Team handling property/casualty/executive risk programs for Fortune 500 accounts. She was responsible for premium in excess of \$90 million annually.
- Bachelor of Arts – Cornell College
- CPCU (Chartered Property & Casualty Underwriter)
- ARM (Associate in Risk Management)
- Named Power Broker™ for 2007 and 2008 for Hospitality by Risk & Insurance Magazine
- Founder and organizer of Aon's Quarterly Speaker Series
- Frequent speaker at Risk & Insurance Management Society conferences and other industry events
- Author of Aon's whitepaper "Keys to Success in Managing a Black Swan Event"