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TMPAA Mid-Year Meeting

Financial State of the U.S. P&C Market – 2018
What Does It Mean for The Program Sector?

Wednesday, May 9, 2018

Presented by:
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Principal, ALIRT Insurance Research

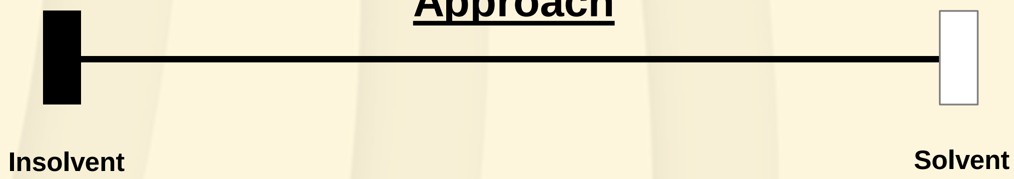
Program Business: Special Considerations

“If you have one program and one insurance company relationship, you run the risk that something could go wrong. Those can be very volatile situations,” he says. “That’s one reason Distinguished Programs prefers operating with multiple programs and multiple insurance company partners to allow for diversification.”

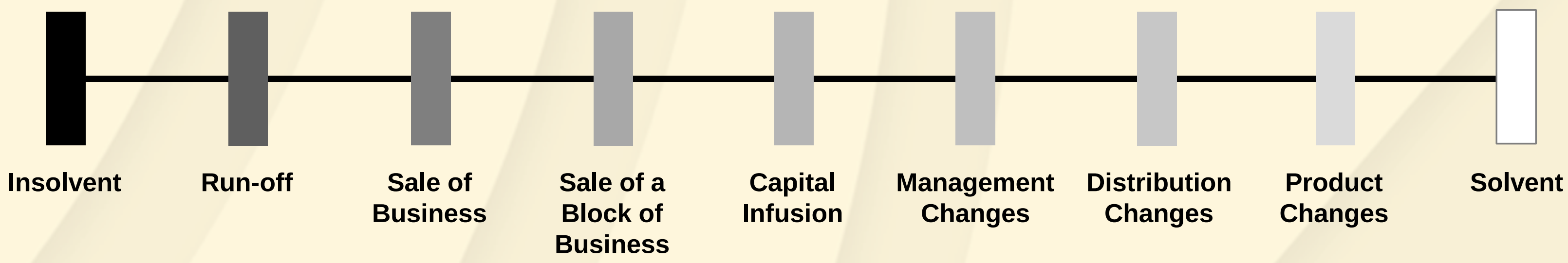
- Jeremy Hitzig
Insurance Journal, 2012

Program Business: Special Considerations

From A Binary Approach



To A Spectrum Approach



Program Business: Special Considerations

"Praemonitus, praemunitus."

Program Business: Come Prepared and Shine

In <u>negotiations with your carrier partner</u>, know their financials intimately; this gives you:

- A different level of professionalism in their eyes. Knowledge of market conditions makes you their equal …or their better!

- Potential leverage when negotiating pricing, commission, and profit sharing (by deconstructing actual combined ratios, ideally by line and by state)

- Better sell your program to a new carrier by comparing your underwriting performance against their current performance.

- The ability to be proactive when deciding to shift carrier partners – don't get surprised.

Program Business: Come Prepared and Shine

In marketing your Program, go beyond simply listing an A.M. Best rating:

- You are an expert underwriter, claims handler, marketer – why not show you are an expert in carrier oversight as well?
  - ➢ This is especially true when working with Surplus Lines Carriers, which do not have the backstop of state guaranty funds
- Ability to sell against competing carriers when you become aware that they are under financial stress (they may need to get out of the business and/or raise prices if loss ratios are deteriorating)
- https://portal.alirtresearch.com/home/pages/Dashboard.aspx

Part 1:

Broad Perspective – Industry Performance

Industry Overview: Some Considerations

I. A Hard or Soft Market Can Mean 2 Different Things:

- An Aggregate % Price Increase/Decrease over the Prior Year Period (Traditional – Brokers/Consumers)
- The Degree to Which Premiums Exceed Loss Costs = Degree of “Rate Adequacy” (Insurers)

II. Pricing Cycles Have Gradations; the Industry is Not Monolithic

- Market Pricing moves over a continuum, fluctuating from hard to soft
- There are sub-pricing cycles within an overall pricing cycle, given fragmentation in the industry

III. Advent of New Technology and Data Analytics Capacity

- Insurers are Better Able to Price Initial Risk and also to React to Underwriting Mistakes; This Should Shorten Market Swings

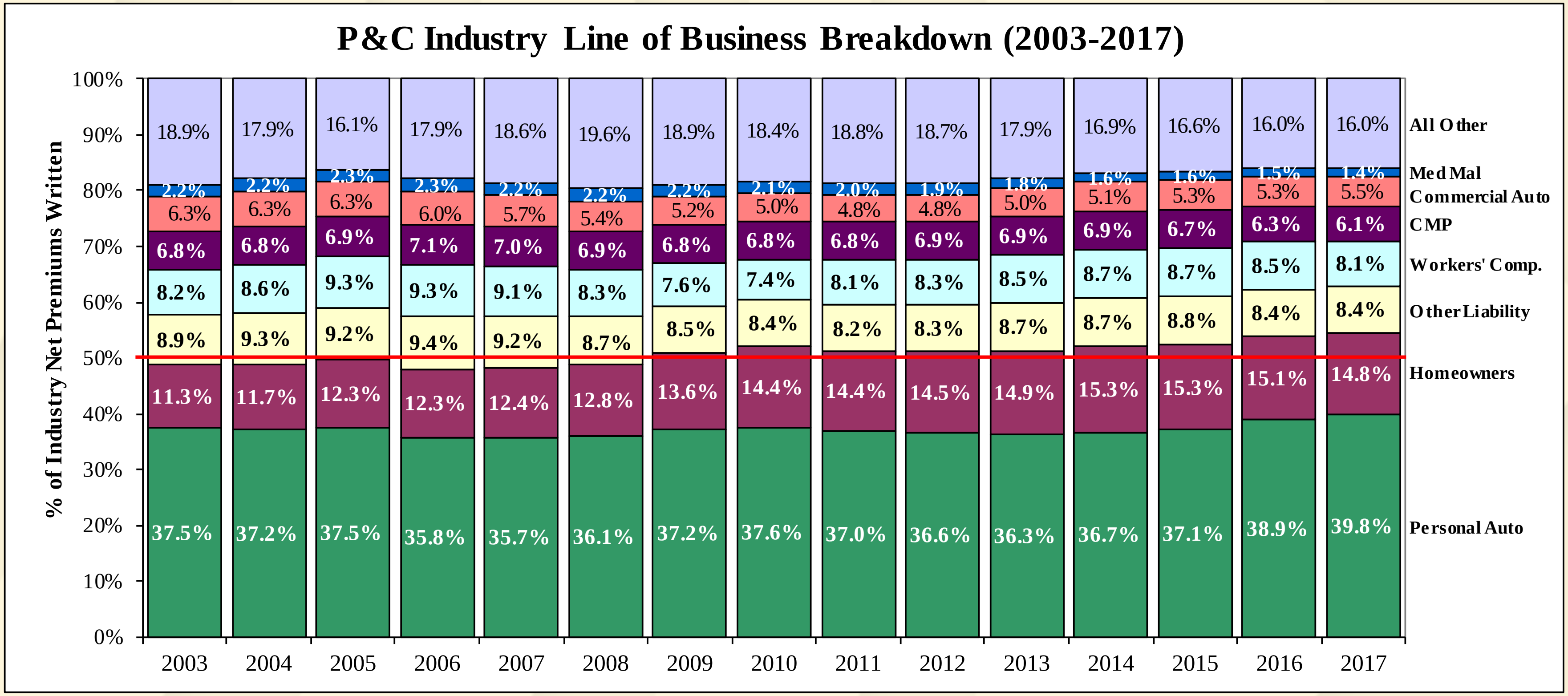
IV. Every Carrier Has Different ROE Hurdles

- What a Publicly Traded Company Needs for Rate Can Differ from a Mutual or Privately-Held Company
- Aggressiveness of Investment Portfolio Also Influences The Rate Needed to Meet Hurdles

V. Who are Today’s Market Leaders?

- In Broad Commercial Lines Segment: Chubb & Travelers
- Are They Holding The Line on Rates?

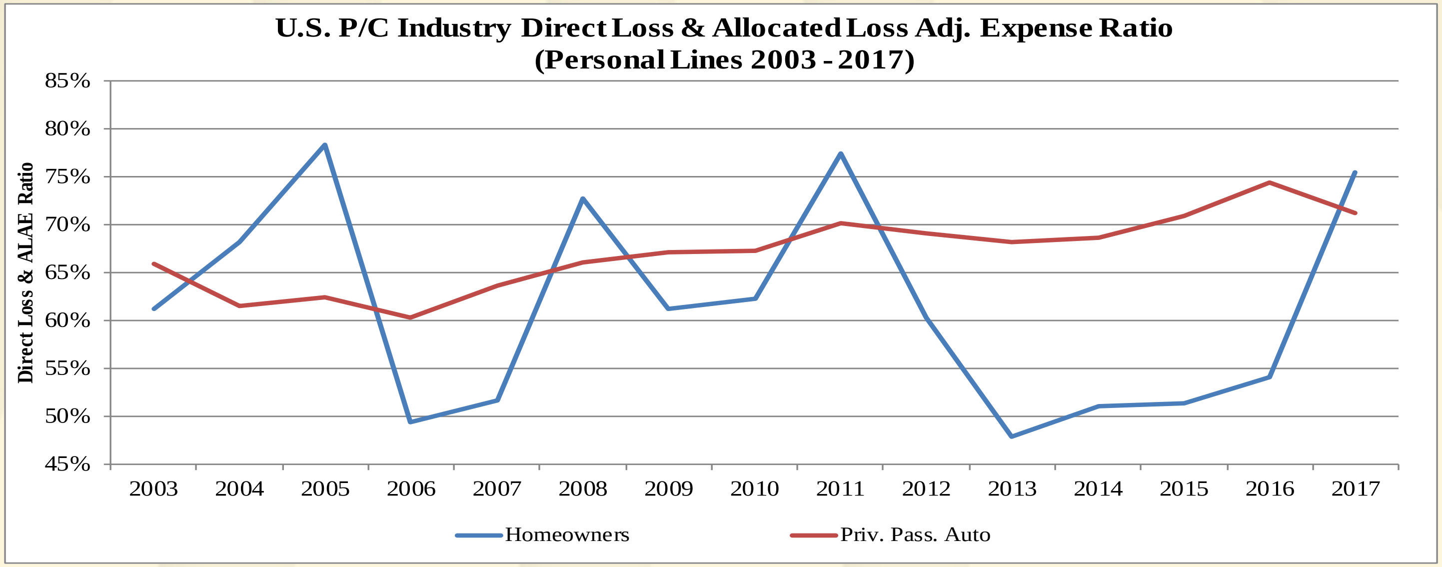
U.S. P&C Industry – By Net Written Premiums

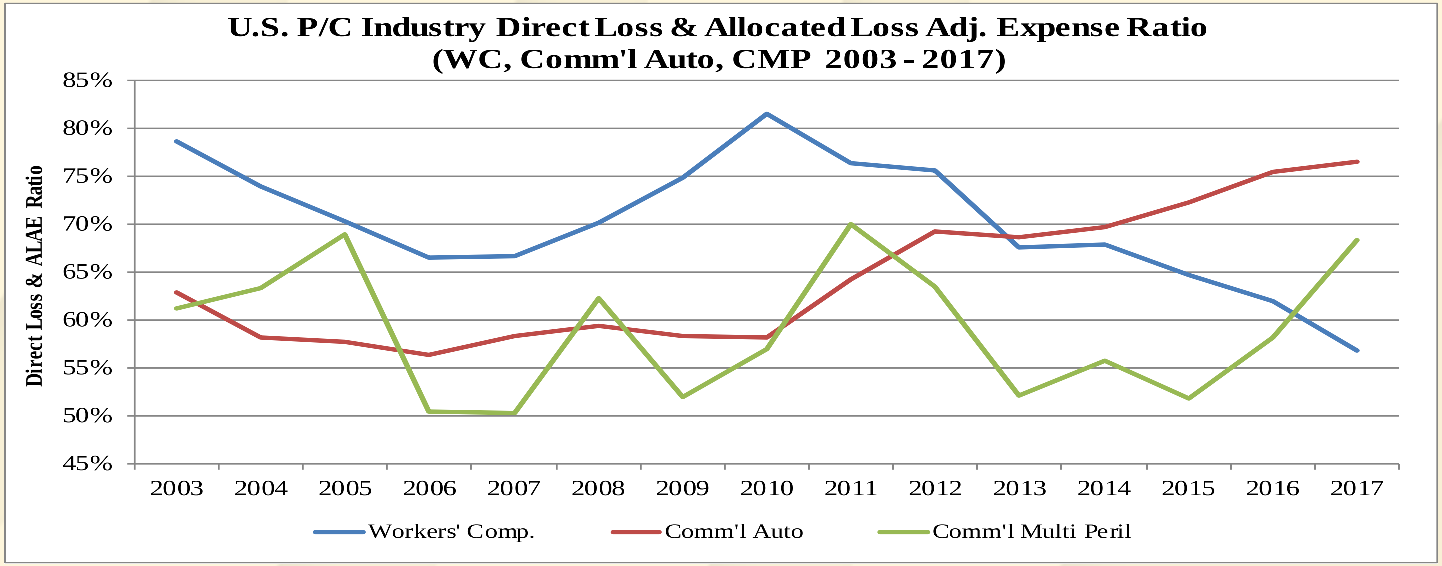


Per S&P Global, U.S. P&C industry net written premiums were $556.9 billion for 2017, up 4.4% from 2016. 15 Year Avg. Mix is 52.1% PL / 47.9% CL

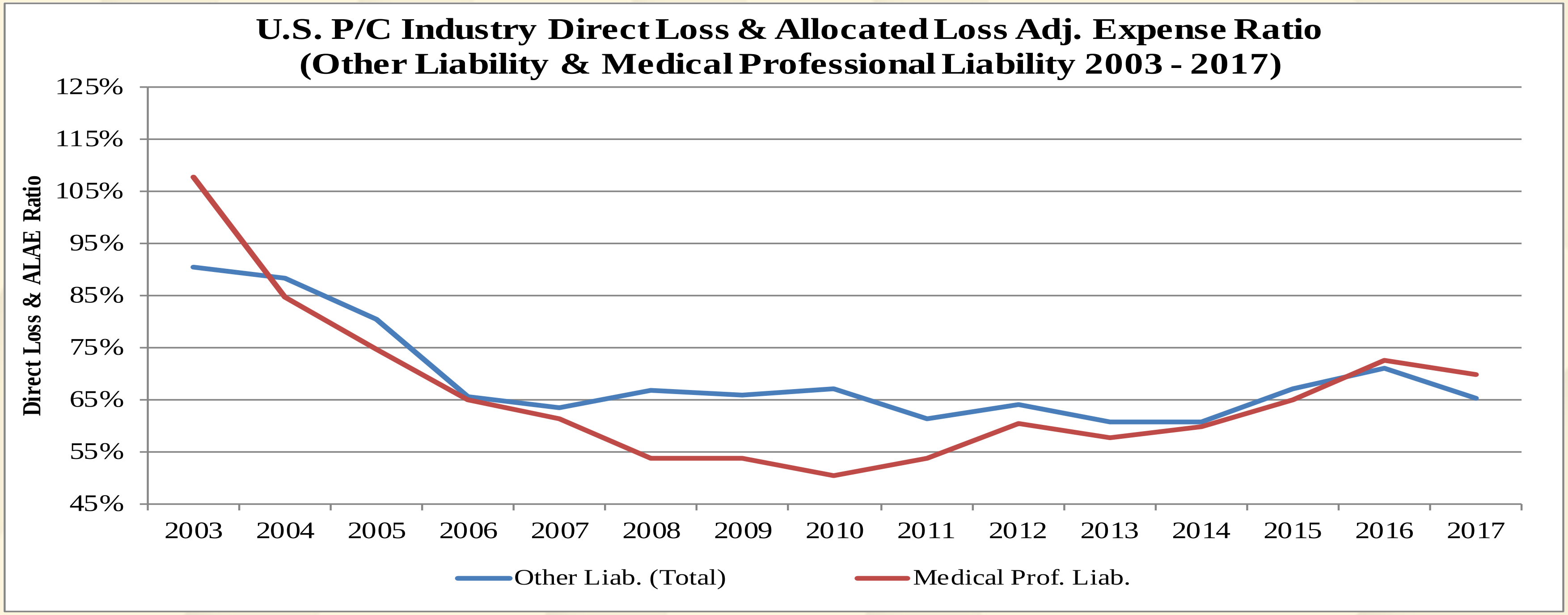
Commercial Lines Share of Industry Premium has ranged from 44.3% - 50.8% over the past 20 years; currently at 44.3% - can it go lower?

U.S. P&C Industry – Direct Pure Loss & ALAE Ratios





P&C Industry Breakdown – Direct Pure Loss & ALAE Ratios



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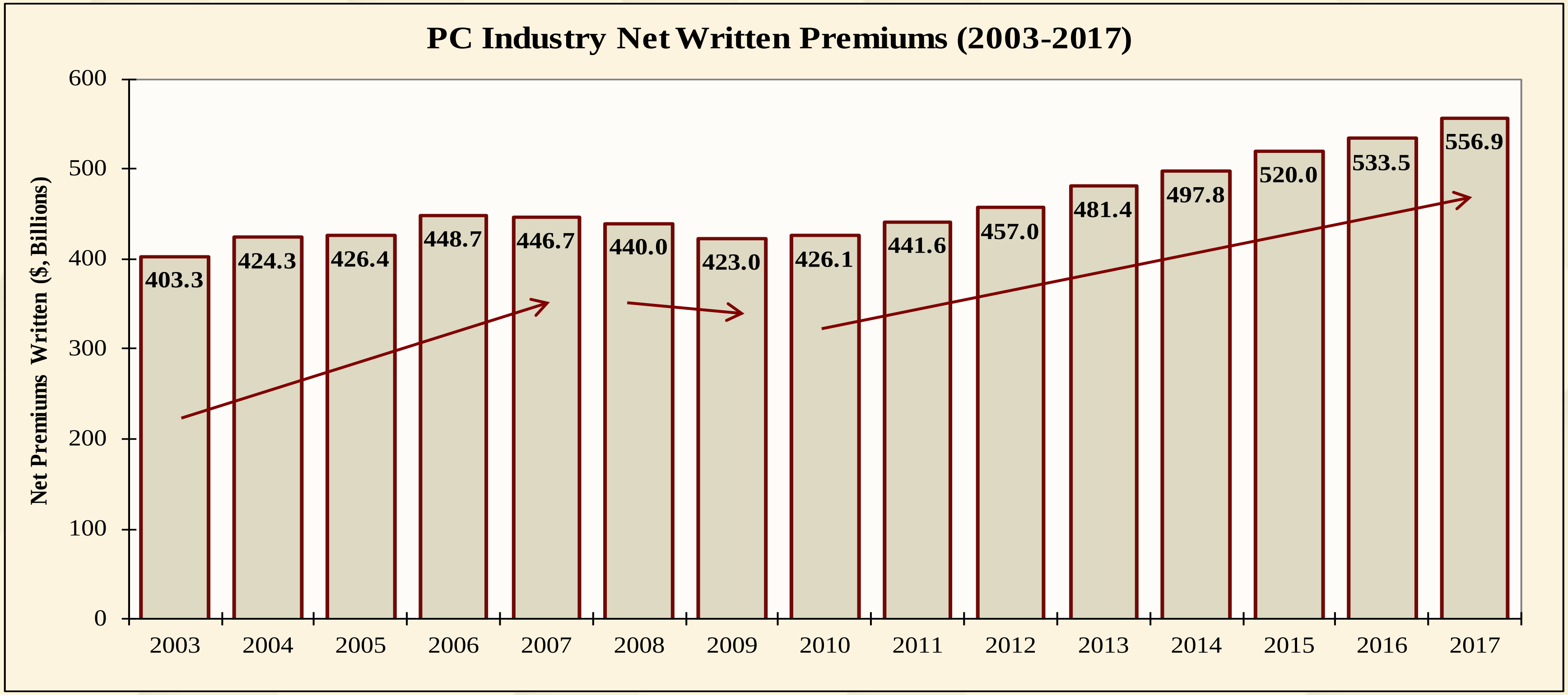
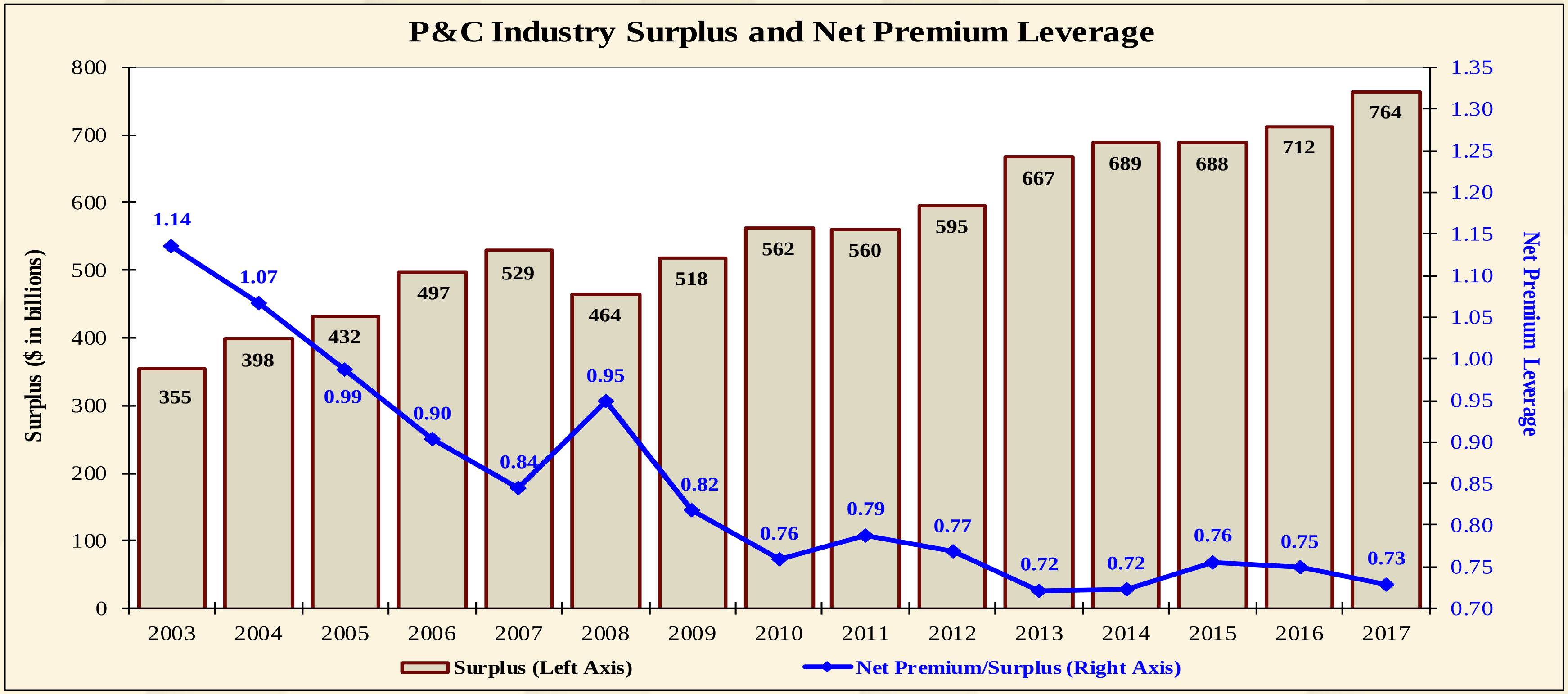
U.S. P&C Industry – Net Written Premium Growth



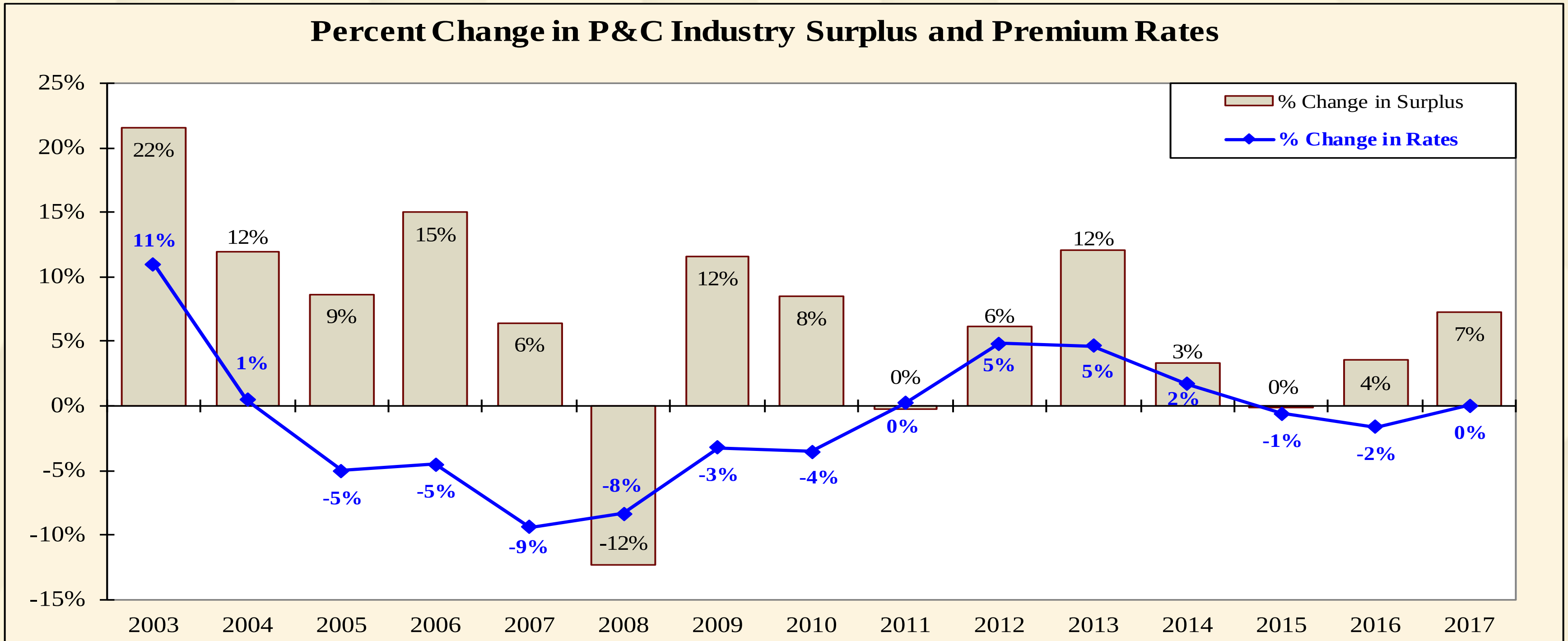
Net written premium growth 2003 - 2017 = 38.1%

U.S. P&C Industry – Surplus (Capacity) and Premium Leverage



Surplus growth 2003-2017 = 115.2%; 15 year average net premium leverage 84.7%

U.S. P&C Industry – Surplus (Capacity) and Rates



NOTE: 2008 and 2009 surplus change percentages exclude the results of Syncora Guarantee (XL Capital Assurance).
Rate change is a weighted average of figures reported by CIAB, CLIPS and MarketScout.

1Q2012	4.00%	1Q2013	5.72%	1Q2014	2.72%	1Q2015	0.34%	1Q2016	(2.14)%	1Q2017	(0.27)%
2Q2012	4.78%	2Q2013	5.03%	2Q2014	1.61%	2Q2015	(0.43)%	2Q2016	(1.61)%	2Q2017	(0.47)%
3Q2012	4.88%	3Q2013	4.24%	3Q2014	1.48%	3Q2015	(0.53)%	3Q2016	(1.24)%	3Q2017	0.03%
4Q2012	5.63%	4Q2013	3.59%	4Q2014	0.99%	4Q2015	(1.62)%	4Q2016	(1.40)%	4Q2017	0.93%

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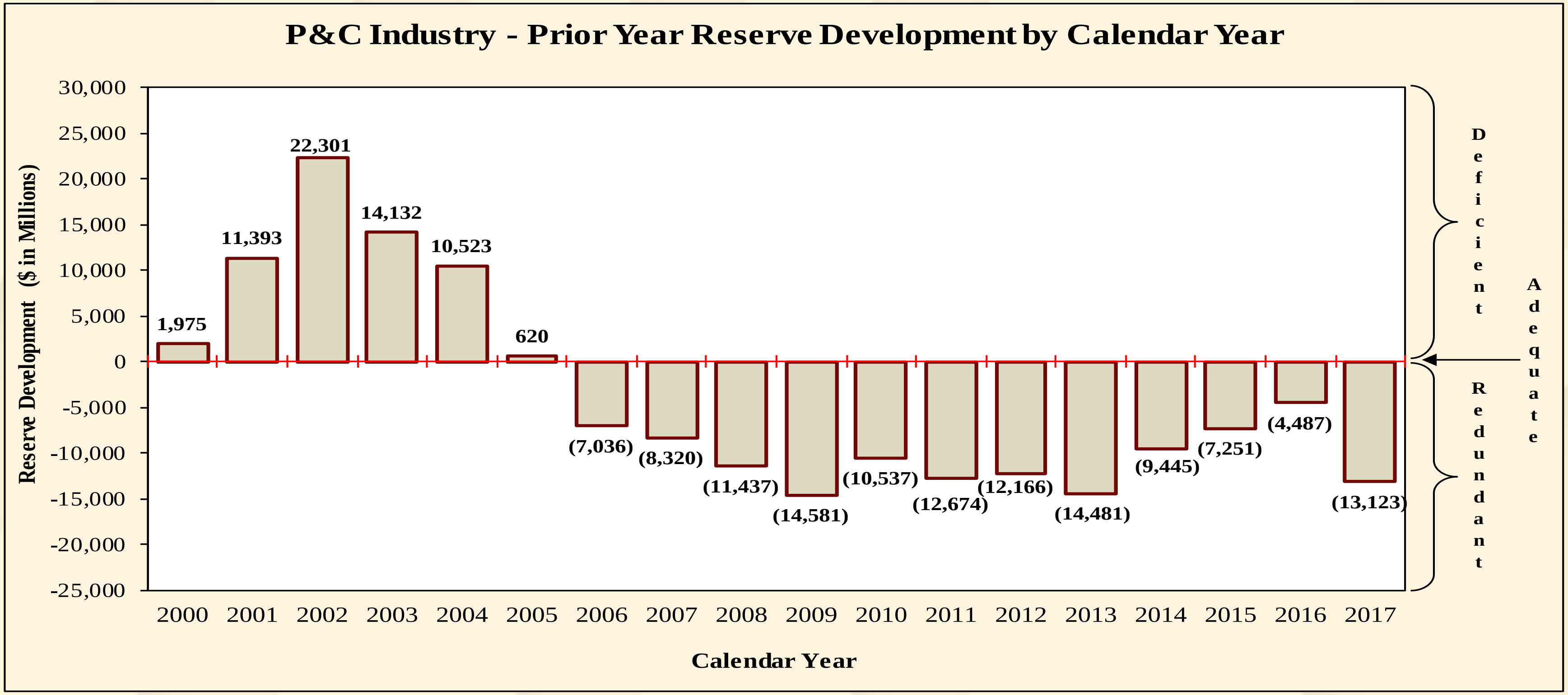
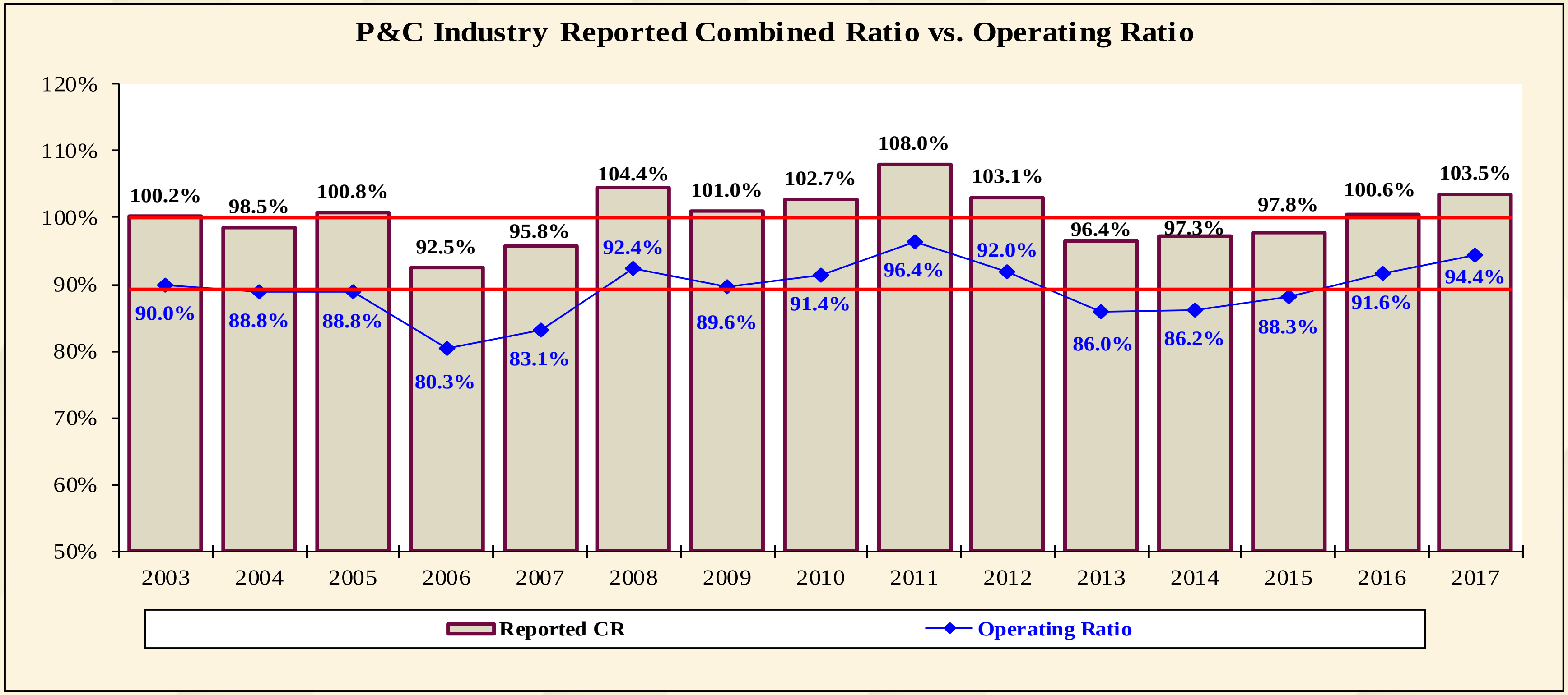
U.S. P&C Industry – Reserve Development



$104.5 billion of reserve releases in the decade 2008-2017; 16.8% of average surplus over that period of $621.9 billion.

2017 releases somewhat distorted by large reinsurance deals at AmTrust, Financial Guaranty Ins. Co., Arch and AIG = approximately $6 billion.

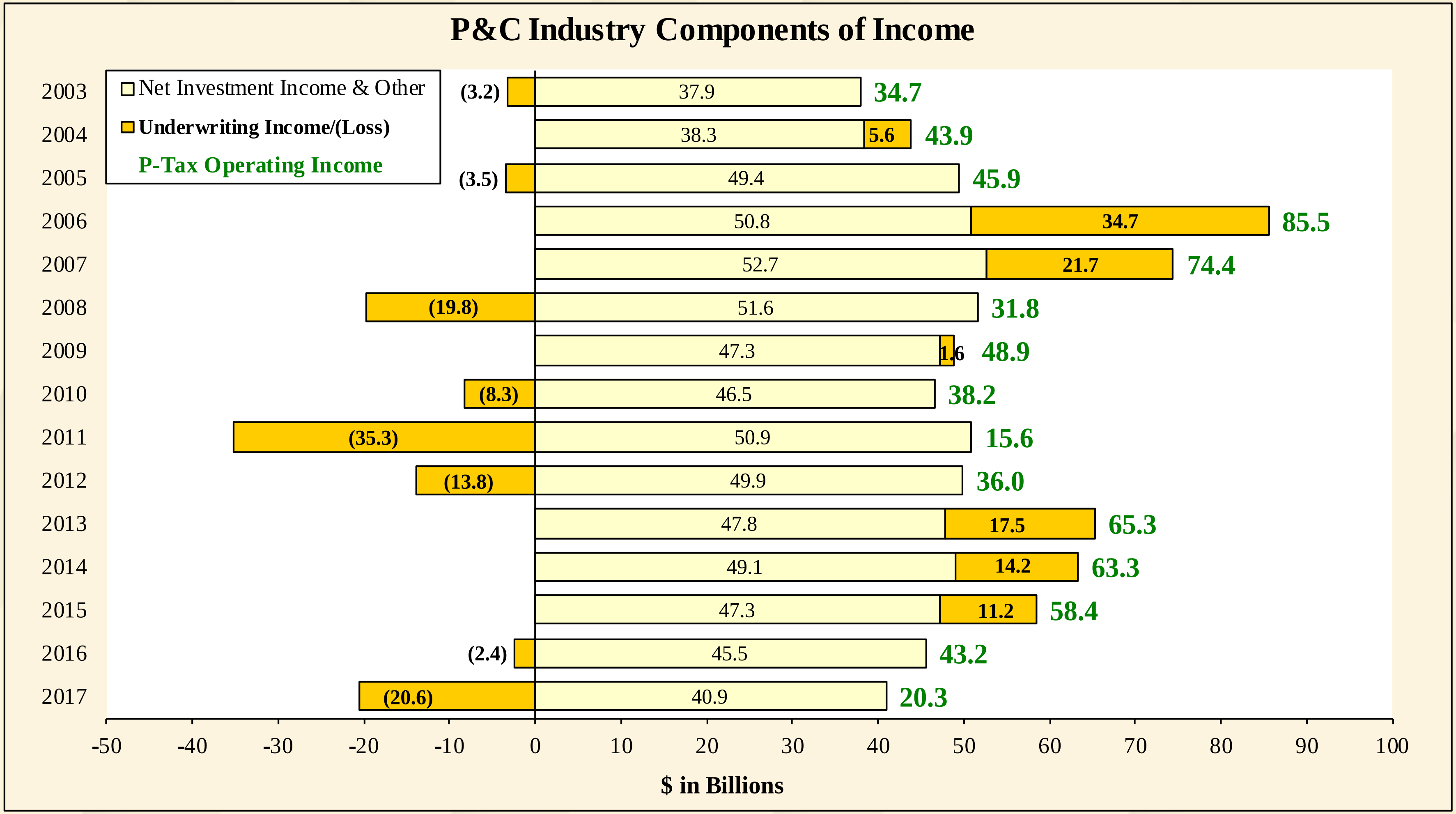
U.S. P&C Industry – Underwriting and Operating Profitability



15 Year Average Reported Combined Ratio = 100.2%; 15 Year Average Operating Ratio = 89.3%

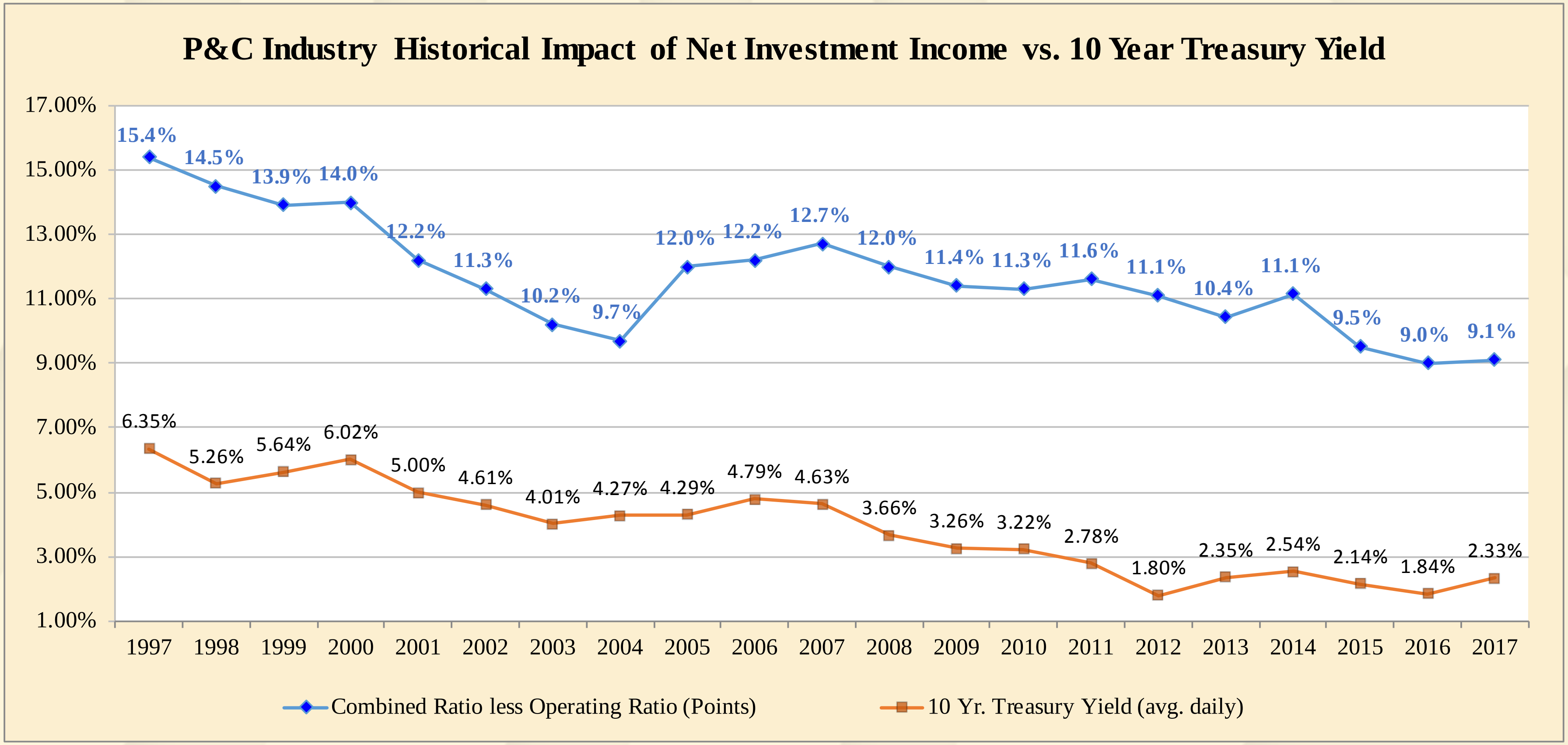
15 Year Average Benefit of Net Investment Income = 10.9 points; range = 9.0 – 12.7 points. (2017 = 9.1 points, just off a cyclical low)

Operating Profitability



Key Takeaway: Underwriting profits in 7 of the past 15 years. 2004 was the first year of underwriting gain since the mid-1970s.

P&C Industry Historical Impact of Investment Income



20 Year Avg. Impact of Net Investment Income = 11.5 points; 20 year range 9.0 – 15.4

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Part 2:

Targeted Perspective – Company Performance

Sample ALIRT Analysis

ABC Property Casualty Insurance Company

Time Series = Five Years and Current Year Period

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	2002	2003	2004	2005	2006	9 Mos. 2007
TIER 1 - OPERATIONAL PERFORMANCE						
Max Score: 16	◆ CAPITALIZATION AND LEVERAGE					
COMPANY	6	6	7	7	9	9
COMM'L LINES COMP.	7	7	8	7	12	13
Max Score: 17	■ UNDERWRITING PROFITABILITY AND EARNINGS					
COMPANY	6	2	6	5	7	8
COMM'L LINES COMP.	7	7	7	4	12	14
Max Score: 6	▲ REINSURANCE					
COMPANY	2	2	2	2	3	3
COMM'L LINES COMP.	3	3	3	3	5	5
Max Score: 8	● RESERVES					
COMPANY	3	0	0	0	0	0
COMM'L LINES COMP.	0	0	0	0	2	1
Max Score: 8	⬟ REVENUE VITALITY AND LIQUIDITY					
COMPANY	4	4	5	4	4	3
COMM'L LINES COMP.	6	6	6	4	6	5
TIER 1 ALIRT SCORE (Maximum Score = 55)						
COMPANY	21	14	20	18	23	23
COMM'L LINES COMP.	23	23	24	18	37	38
TIER 2 - INVESTMENT PERFORMANCE						
Max Score: 12	INVESTMENT RISKS					
COMPANY	4	3	3	4	3	3
COMM'L LINES COMP.	5	5	6	6	7	6
Max Score: 8	INVESTMENT RESULTS					
COMPANY	4	5	2	4	3	3
COMM'L LINES COMP.	2	2	1	1	2	1
TIER 2 ALIRT SCORE (Maximum Score = 20)						
COMPANY	8	8	5	8	6	6
COMM'L LINES COMP.	7	7	7	7	9	7

	2002	2003	2004	2005	2006	9 Mos. 2007
TIER 3 - GROUP PERFORMANCE	GROUP: ABC Holding Company					
Max. Score: 2	COMPANY AS % OF GROUP					
COMPANY	2	2	2	2	2	2
COMM'L LINES COMP.	1	1	1	1	1	1
Max. Score: 5	REVENUES & LIQUIDITY					
COMPANY	1	2	2	2	4	2
COMM'L LINES COMP.	3	3	4	4	4	3
Max. Score: 4	FINANCIAL LEVERAGE, COVERAGE, AND PROFITABILITY					
COMPANY	1	1	2	1	4	2
COMM'L LINES COMP.	3	3	4	3	3	4
TIER 3 ALIRT SCORE (Maximum Score = 11)						
COMPANY	4	5	6	5	10	6
COMM'L LINES COMP.	7	7	9	8	8	8
TIER 4 - SIZE & RATINGS						
MOODY'S	A3	A3	A3	A3	A3	A3
S&P	A-	A-	A-	A-	A-	A-
FITCH	A	A-	A-	A-	A-	A-
WEIGHTED COMPOSITE	A+	A+	A+	A+	A+	A+
TIER 4 ALIRT SCORE (Maximum Score = 14)						
COMPANY	8	8	8	8	8	8
COMM'L LINES COMP.	9	9	9	9	9	9

TOTAL ALIRT SCORE (Maximum Score = 100)						
COMPANY	41	35	39	39	47	43
COMMERCIAL LINES COMPOSITE	46	46	49	42	63	62

NOTES:

Every score is compared against an industry composite average.

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Sample ALIRT Analysis

ALIRT INSURANCE RESEARCH P&C FINANCIAL STRENGTH RATIOS

ABC Property Casualty Insurance Company

TIER 1 - OPERATIONAL RISK

	CAPITALIZATION AND LEVERAGE						UNDERWRITING PROFITABILITY AND EARNINGS							REINSURANCE (UNAFFILIATED COS. ONLY)	
YEAR	TOTAL SURPLUS ($ MNS.)	5 YR. SURPLUS GROWTH	RISK BASED-CAPITAL RATIO	SURPLUS STABILITY TEST	GROSS PREMIUM LEVERAGE	NET PREMIUM LEVERAGE	LOSS RATIO	EXPENSE RATIO	COMBINED RATIO	ACC. YEAR COMBINED RATIO	OPERATING RATIO	PRETAX RETURN ON EARNED PREMIUMS	BUSINESS DIVERSIF-ICATION	REINS. RECOVER./ SURPLUS	CEDED AS % OF GROSS PREM'S
2002	5,116	-5%	169%	52.3%	1.73	1.38	76%	28%	105%	109%	59%	33.2%	2.5	158%	18%
2003	6,046	2%	146%	58.1%	1.77	1.22	117%	31%	149%	109%	123%	-37.7%	3.0	169%	30%
2004	6,815	2%	170%	53.0%	1.35	1.03	78%	27%	106%	102%	89%	5.2%	3.0	143%	15%
2005	6,743	6%	165%	60.8%	1.31	1.00	94%	29%	124%	107%	92%	5.2%	3.5	113%	13%
2006	7,939	69%	188%	54.7%	1.11	0.86	81%	28%	109%	106%	83%	13.3%	3.0	75%	11%
9/2007	8,246	63%	N/A	53.1%	1.06	0.79	82%	29%	111%	104%	78%	19.3%	N/A	N/A	N/A
COMMER'L LINES COMP.	1,235	113%	241%	19.2%	1.21	0.61	64%	27%	92%	92%	75%	22.8%	2.0	37%	9%

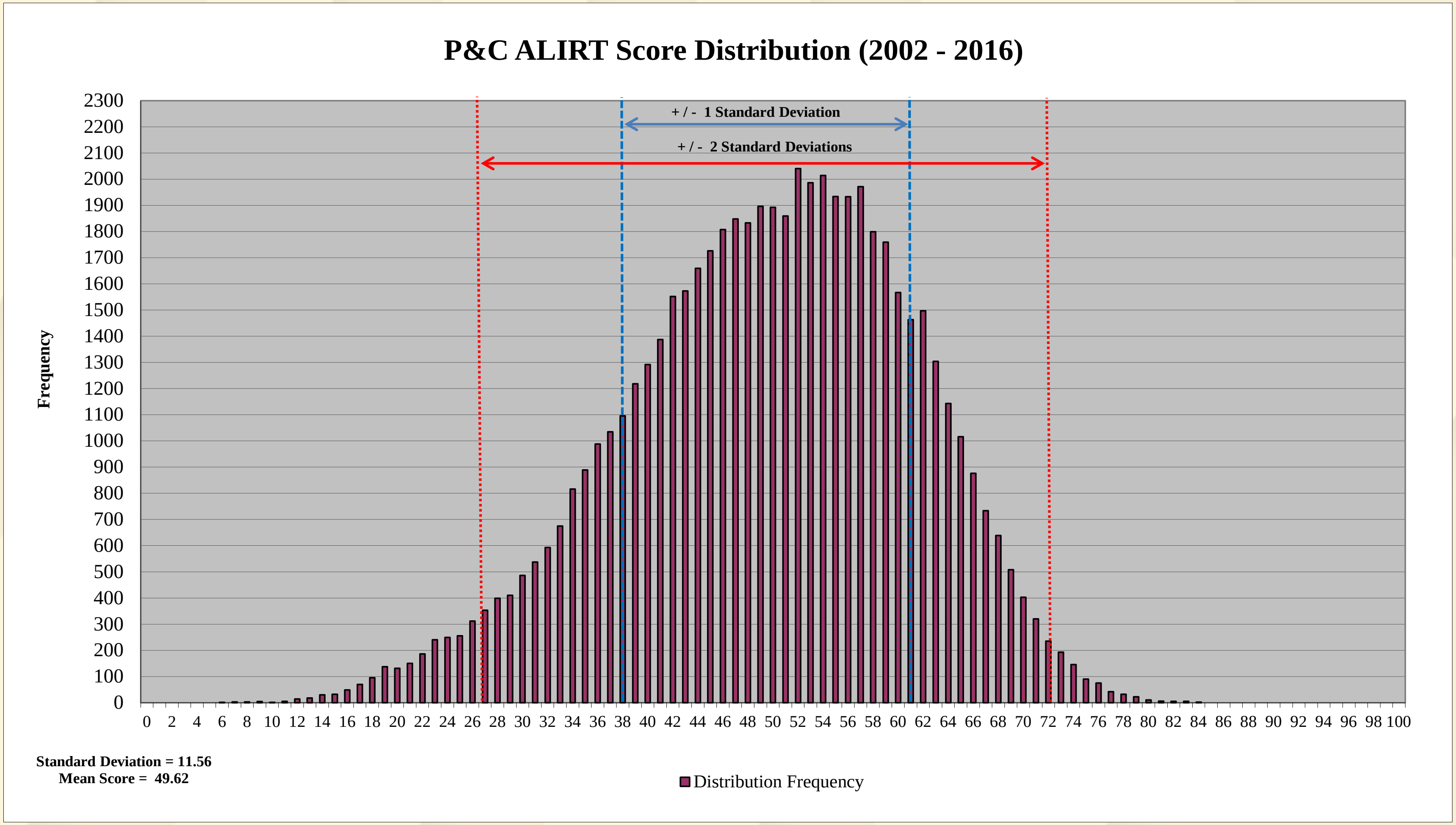
TIER 1 - OPERATIONAL RISK (continued) / TIER 2 - INVESTMENT RISK

	RESERVES			REVENUE VITALITY AND LIQUIDITY				INVESTMENT RISKS					INVESTMENT PERFORMANCE		
YEAR	COMM'L LONG-TAIL RESERVES/ TOTAL RESERVES	# OF YRS. OF LAST 5 WITH RESERVE RELEASES	ONE YEAR RESERVE DEVELOP. TO SURPLUS	OPERATING CASH FLOW RATIO	UNDERWRIT. CASH FLOW RATIO	ANNUAL % CHANGE EARNED PREMIUMS	TOTAL LIQUIDITY	UNAFFIL. STOCKS/ SURPLUS	AFFIL. INVEST./ SURPLUS	NON-INV. GRADE BONDS/ SURPLUS	CMO'S & OTHER ABS/ SURPLUS	WEIGHTED MATURITY TRAD. BONDS (YEARS)	GROSS YIELD ON BONDS	NET YIELD ON INVEST. ASSETS	TOTAL RETURN ON INVEST. ASSETS
2002	79.4%	1	-4.1%	235.1%	159.2%	98.4%	91%	11%	49%	38%	81%	11.61	5.58%	14.41%	3.14%
2003	83.4%	1	38.6%	120.3%	101.4%	2.5%	95%	7%	52%	21%	94%	12.56	5.33%	6.26%	6.50%
2004	81.8%	1	3.7%	118.4%	105.9%	12.1%	96%	6%	58%	24%	88%	11.53	5.24%	4.02%	8.24%
2005	81.4%	1	15.3%	171.2%	133.5%	-6.5%	79%	10%	49%	29%	167%	15.20	4.89%	6.71%	5.64%
2006	82.6%	1	2.4%	152.0%	121.7%	-2.1%	82%	25%	50%	31%	149%	12.95	5.58%	5.06%	7.01%
9/2007	N/A	0	5.0%	133.8%	100.4%	-3.2%	N/A	30%	46%	36%	N/A	N/A	N/A	5.68%	4.67%
COMMER'L LINES COMP.	81.2%	0	-0.4%	141.2%	114.5%	1.8%	141%	30%	51%	4%	34%	7.64	4.31%	4.40%	7.02%

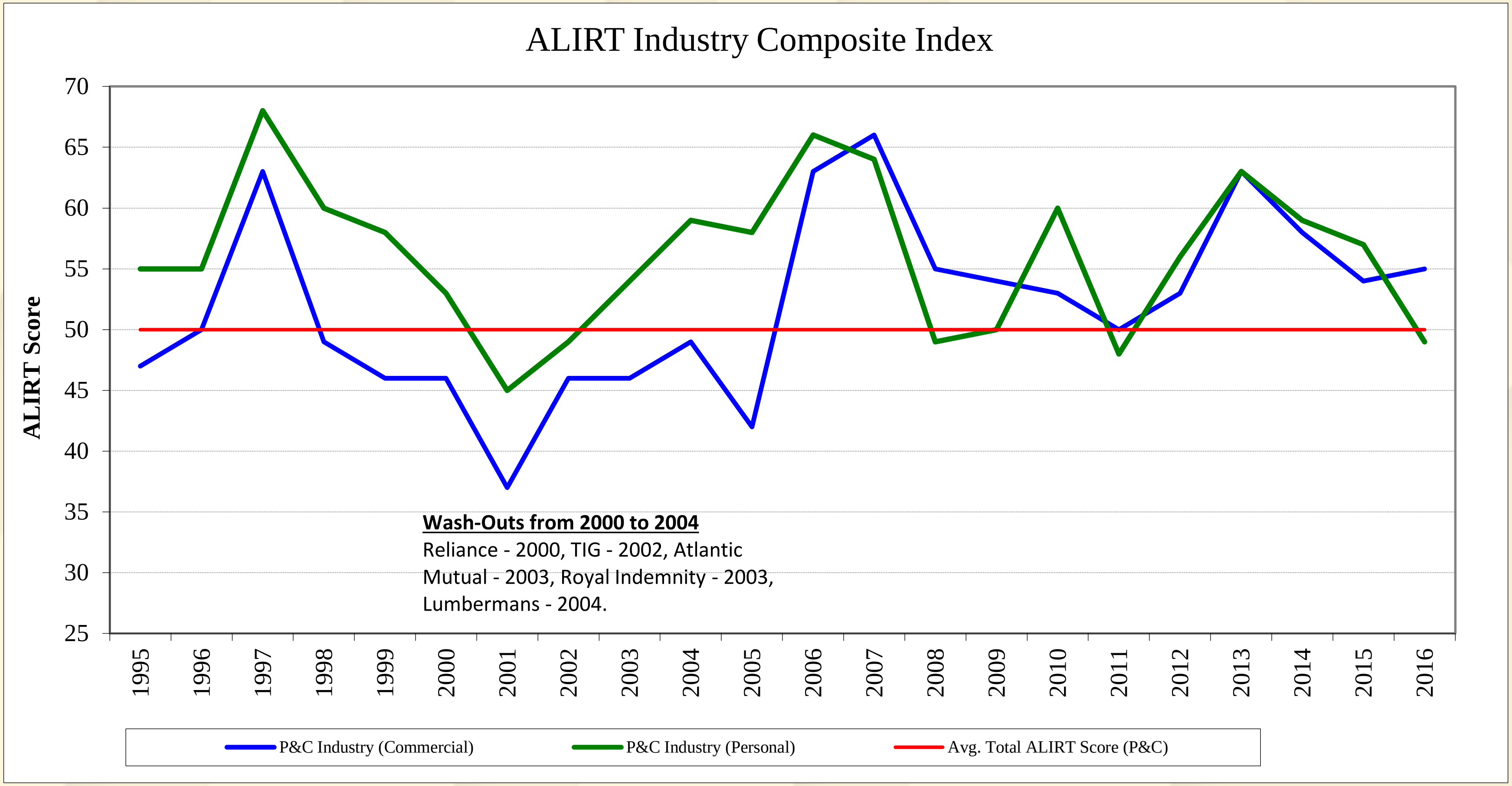
TIER 3 - FINANCIAL RISK - HOLDING COMPANY ANALYSIS / TIER 4 - SIZE & RATINGS

	STRATEGIC VALUE: STATUTORY INS. CO. AS A % OF TOTAL ORGANIZATION		FINANCIAL FLEXIBILITY & LIQUIDITY					LEVERAGE, COVERAGE, AND PROFITABILITY				IN $ MNS.			
YEAR	ASSETS	SURPLUS	TOTAL REVENUE ($ MNS.)	ANNUAL % CHANGE IN TOTAL REVENUE	OPERATING CASH FLOW/ REVENUE	STOCK MARKET VAL./ BOOK VAL.	LIQUID ASSETS AS % OF TOTAL ASSETS	DEBT/ EQUITY RATIO	ANNUAL % CHANGE IN PRETAX OPERATING EARNINGS	INTEREST COVERAGE	PRETAX OPERATING ROE	NET PREM'S WRITTEN	NET PREM'S EARNED	TOTAL ASSETS	WEIGHTED COMPOSITE RATING
2002	41.0%	54.4%	12,286	-6.9%	8.5%	60.9%	57.0%	24.4%	N/A	1.9	3.8%	7,073	5,783	25,312	A+
2003	50.5%	67.5%	11,716	-4.6%	15.0%	60.2%	56.1%	21.3%	N/A	-17.3	-25.6%	7,403	5,929	34,589	A+
2004	54.7%	74.0%	9,930	-15.2%	16.2%	74.4%	60.2%	24.5%	N/A	3.3	5.5%	7,028	6,645	34,212	A+
2005	61.1%	75.3%	9,862	-0.7%	22.0%	93.6%	64.5%	18.9%	-67%	1.1	1.8%	6,753	6,212	35,913	A+
2006	63.4%	81.3%	10,376	5.2%	21.7%	112.0%	69.7%	22.1%	885%	9.1	17.1%	6,808	6,079	38,198	A+
9/2007	67.2%	81.5%	9,960	-4.0%	9.5%	105.6%	69.2%	21.3%	-16%	7.2	13.6%	6,537	5,897	40,375	A+
COMMER'L LINES COMP.	5.3%	24.2%	4,439	1.9%	20.0%	123.4%	59.0%	23.0%	7%	10.2	22.3%	896	845	3,625	AA-

Industry Results – Gauging Probability



ALIRT Composite



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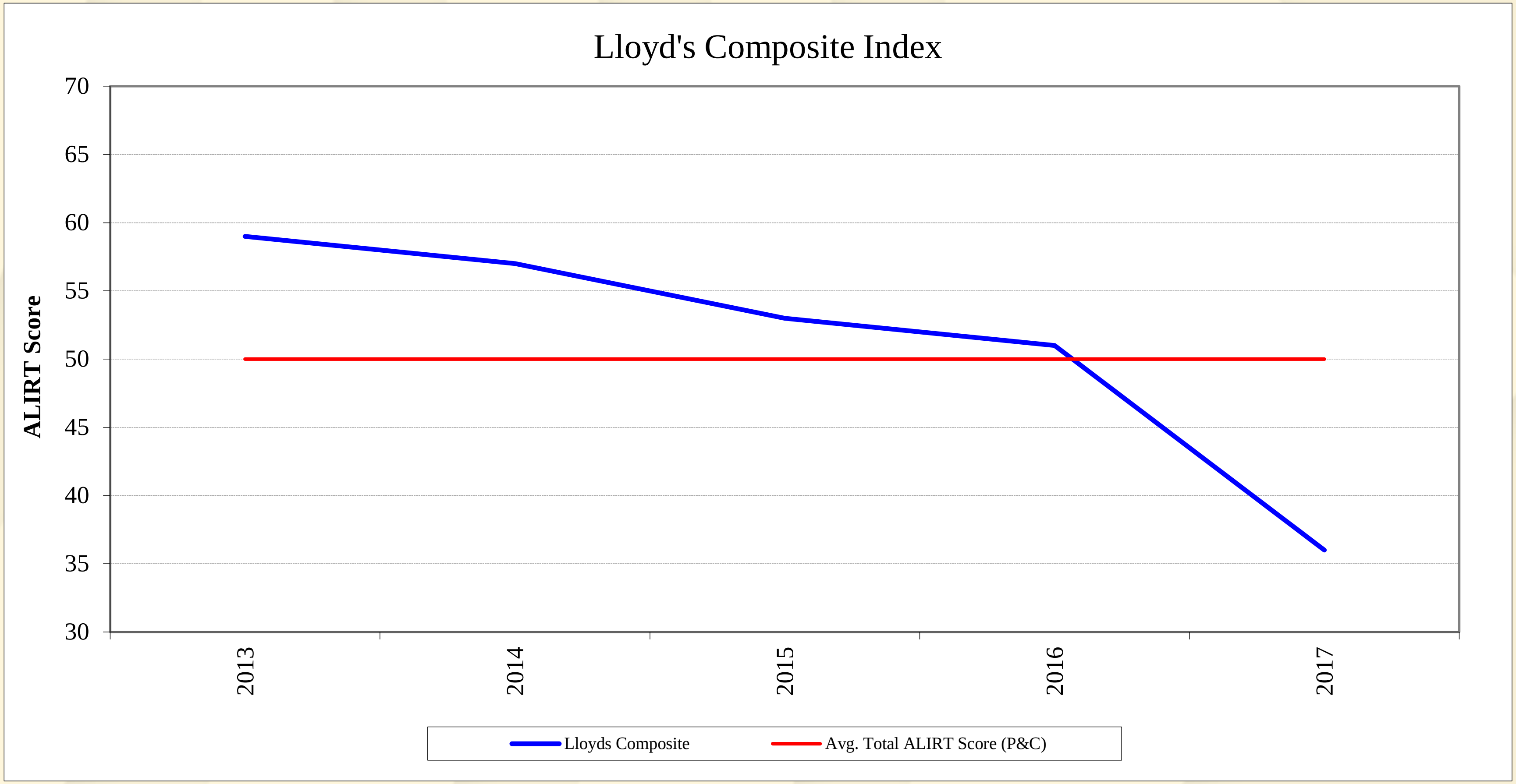
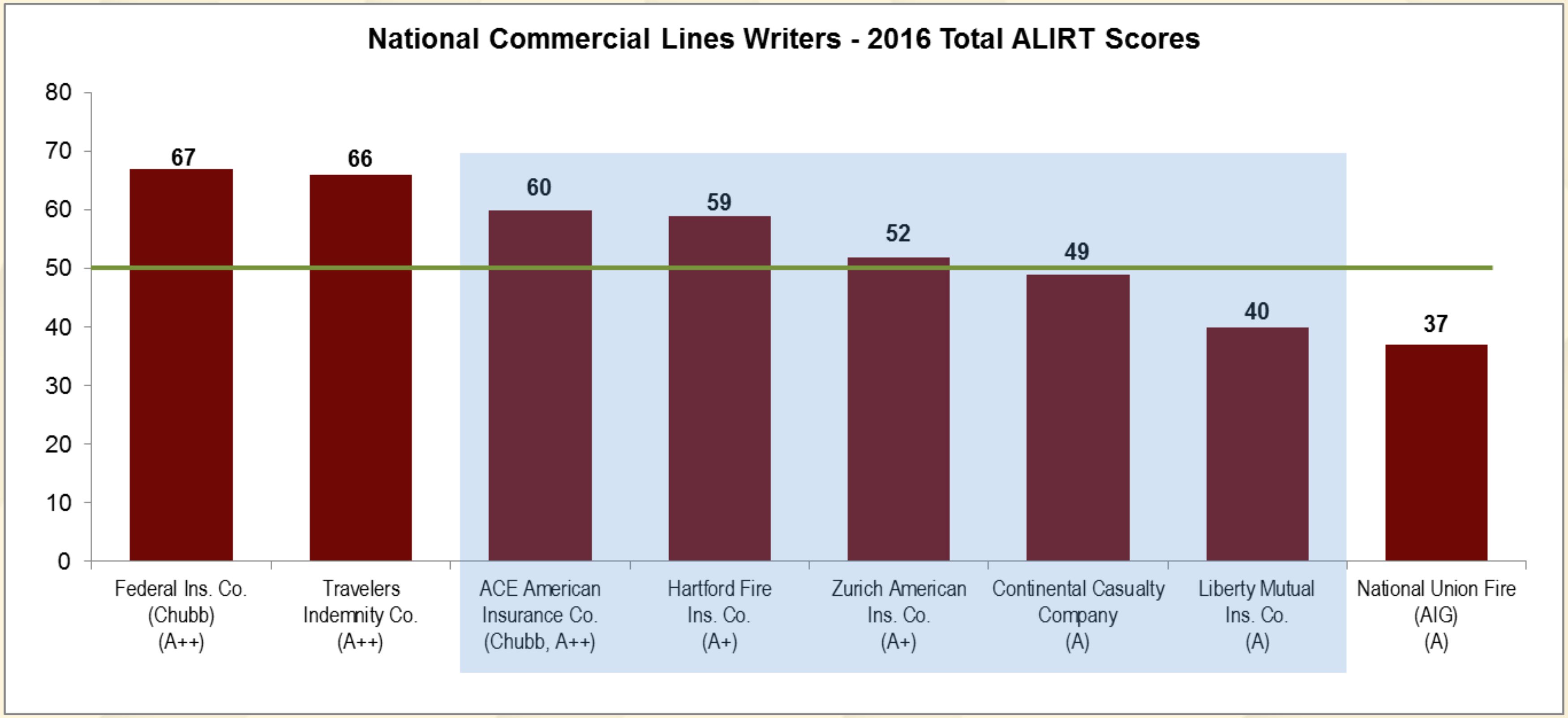
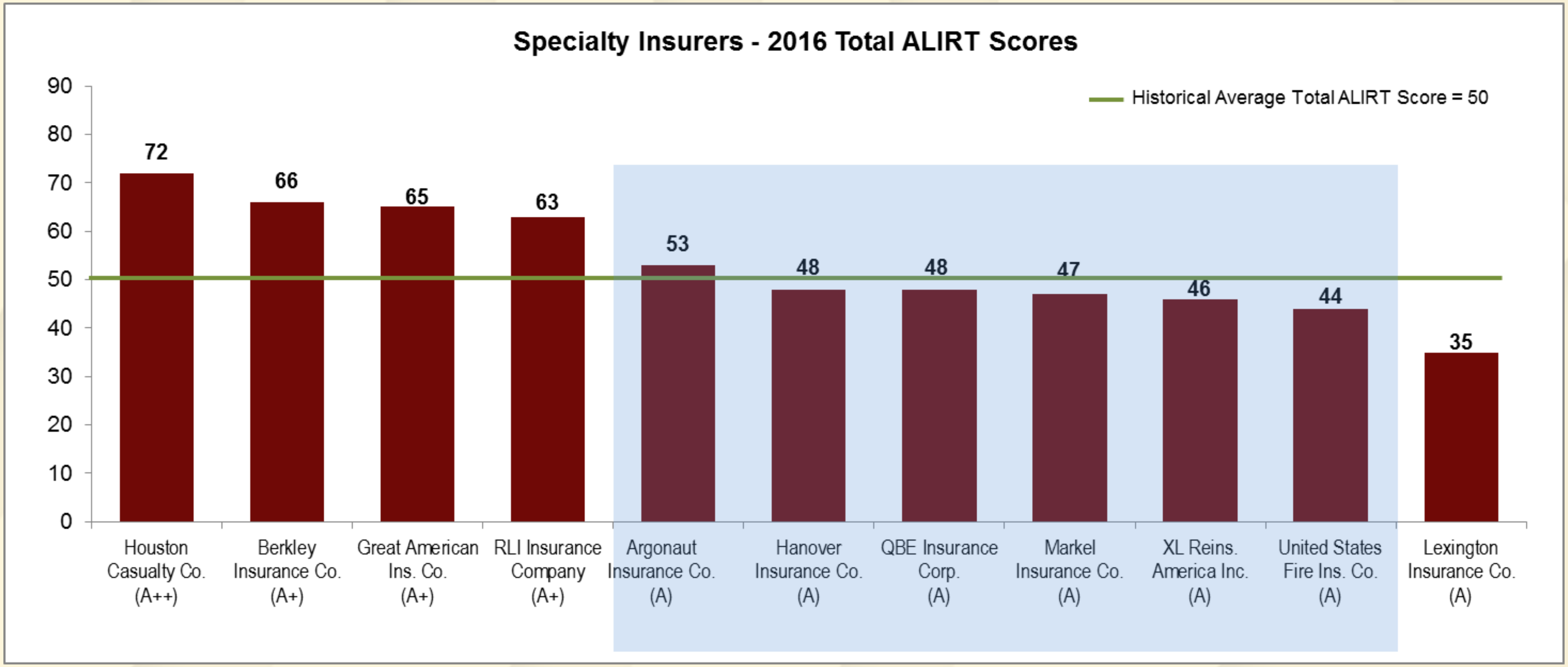
Lloyds Composite



Individual Insurer ALIRT Results - National



Individual Insurer ALIRT Results - Specialty



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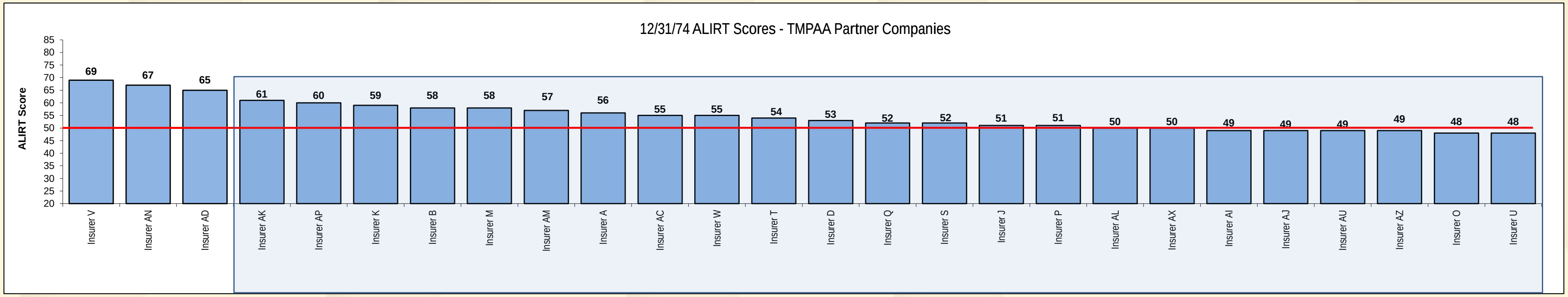
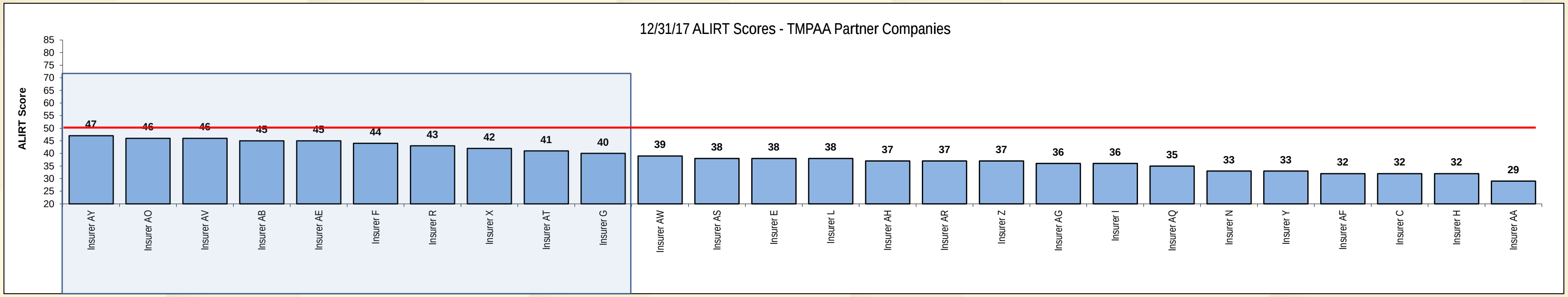
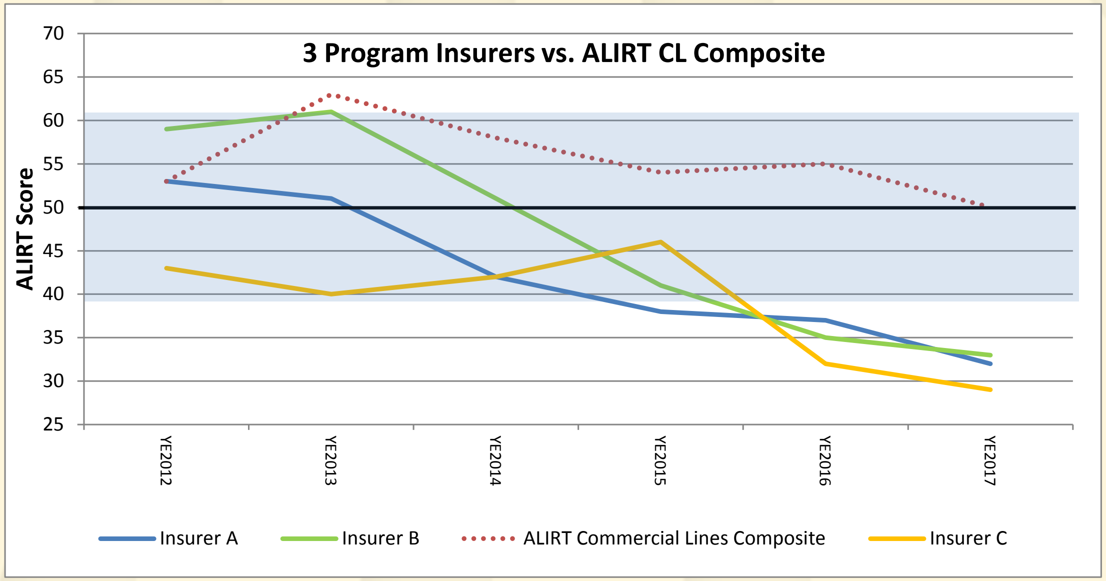
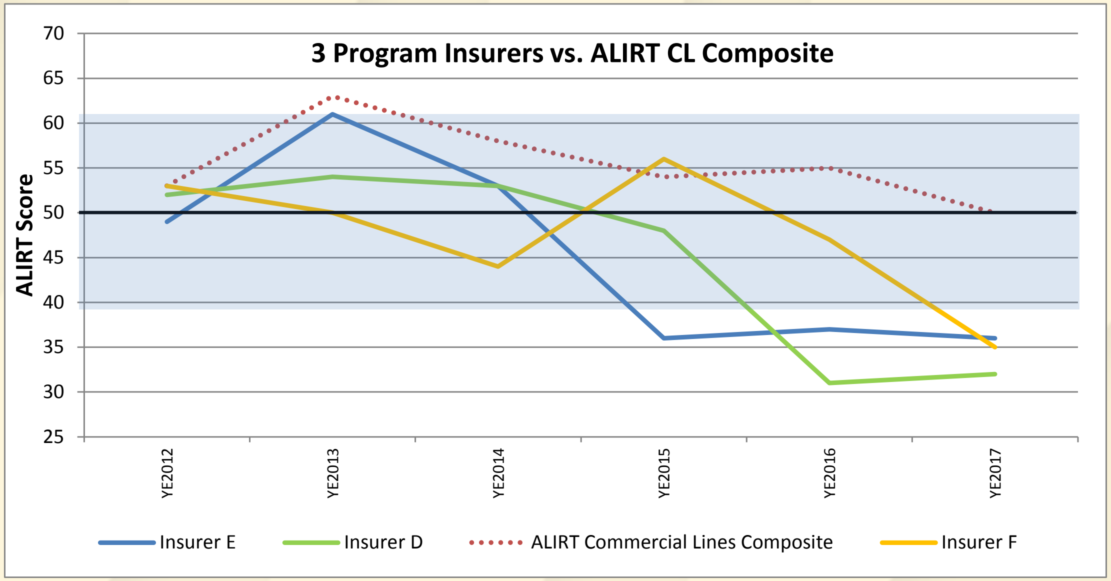
ALIRT Scores – Program Universe





ALIRT Scores – Select Program Carriers





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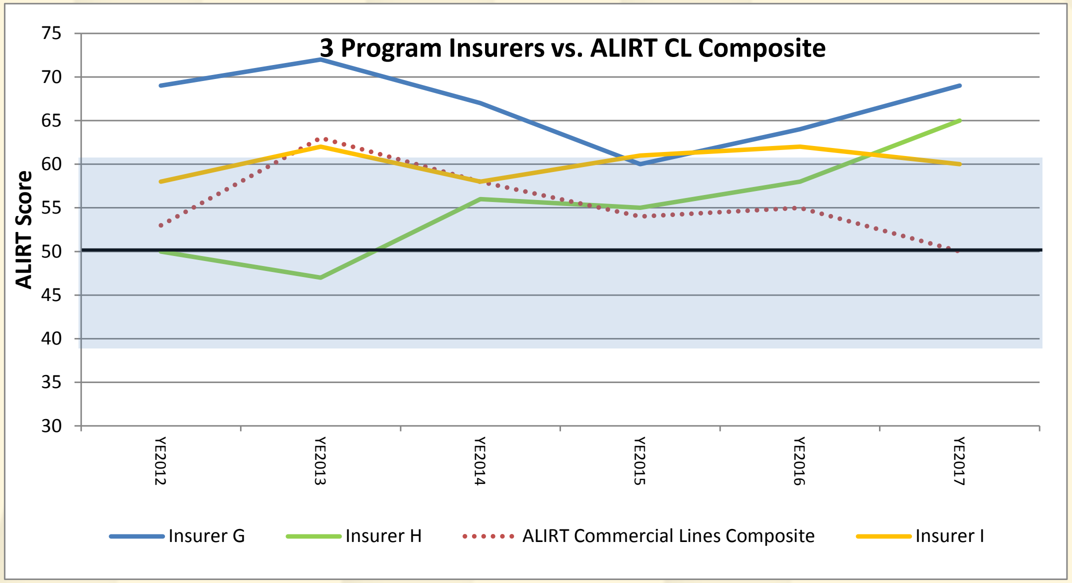
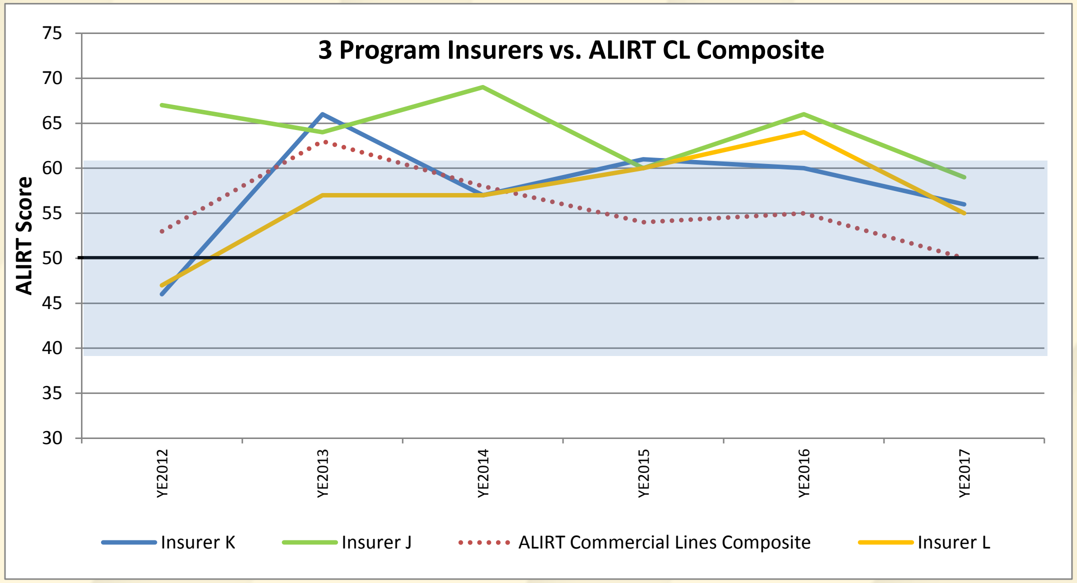
ALIRT Scores – Select Program Carriers





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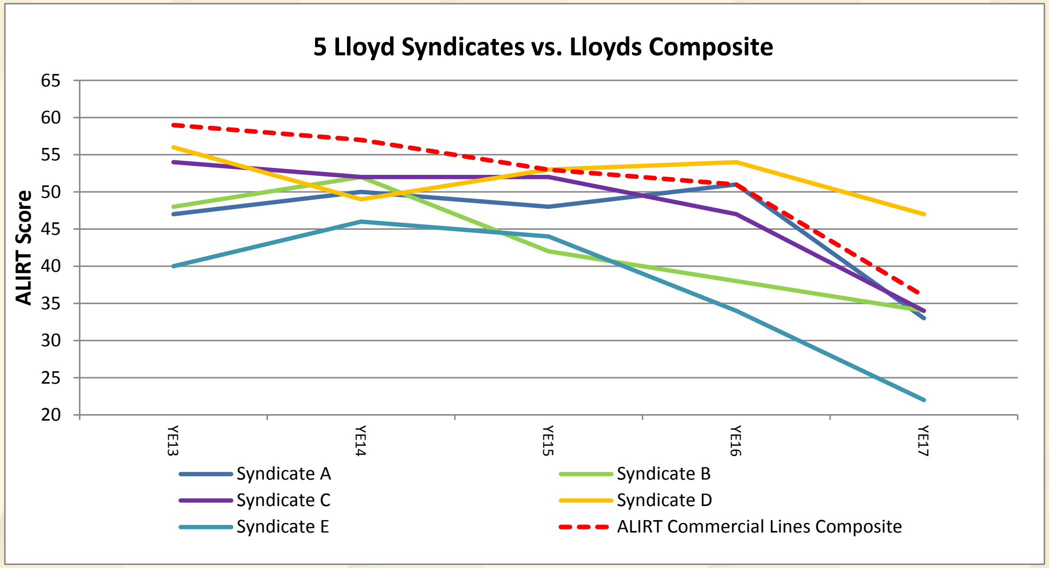
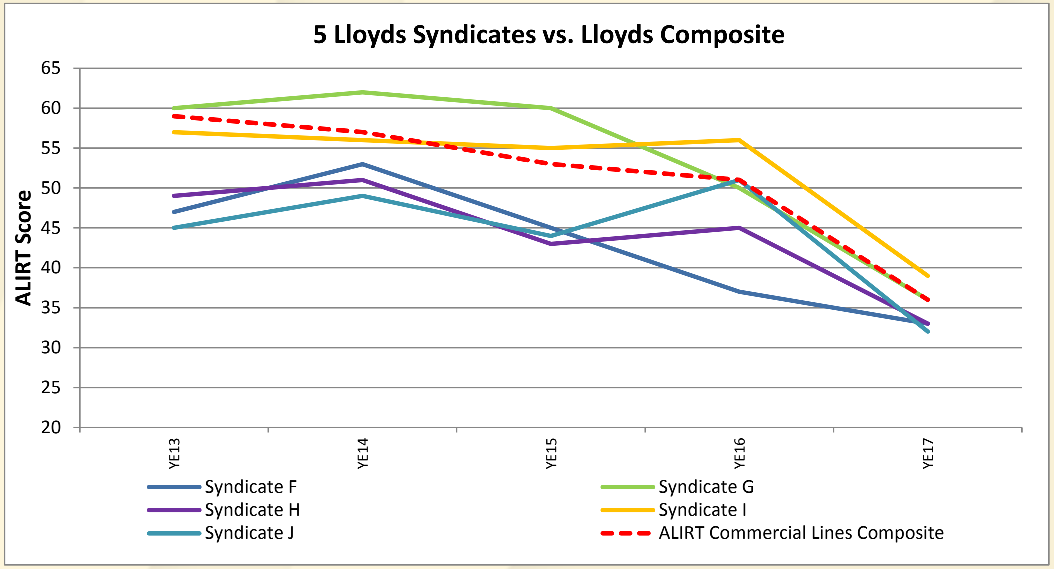
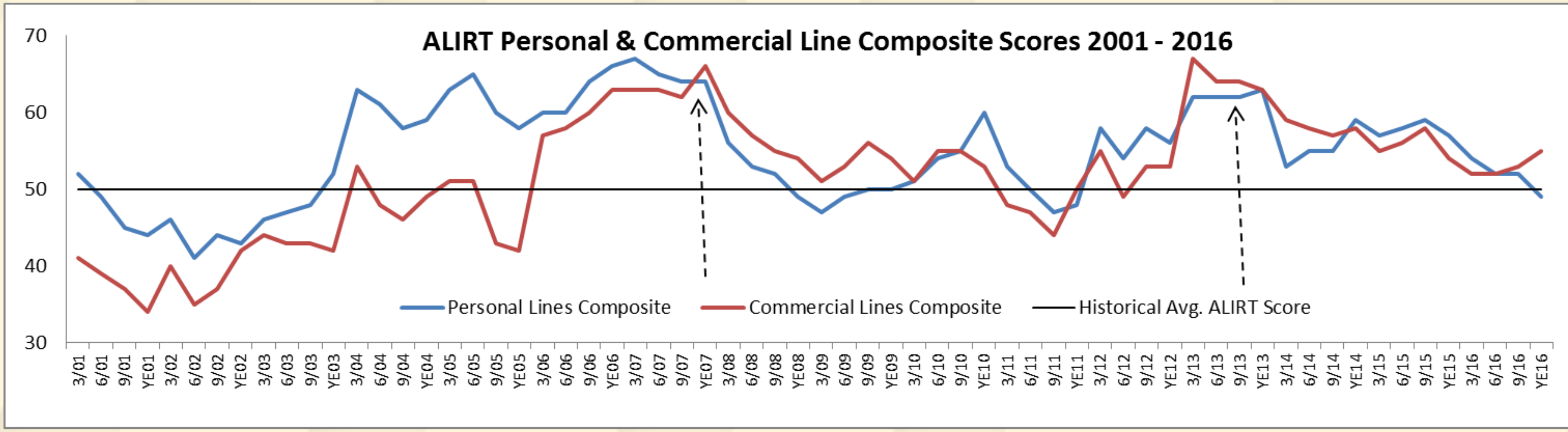
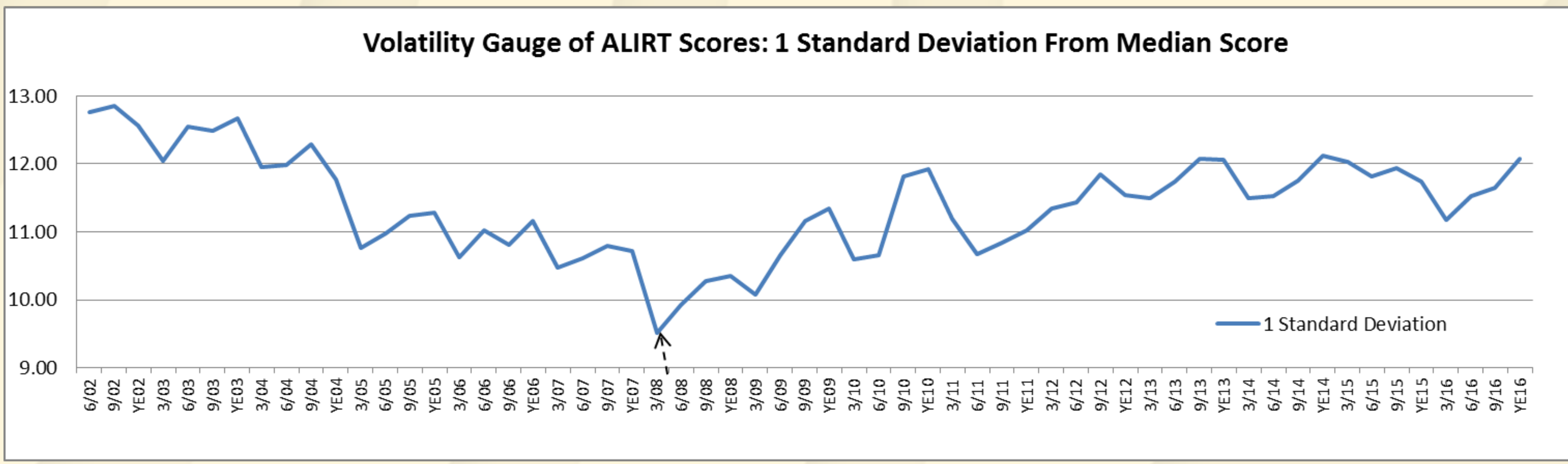
Lloyds Syndicate ALIRT Results





What Are The ALIRT Scores Showing?





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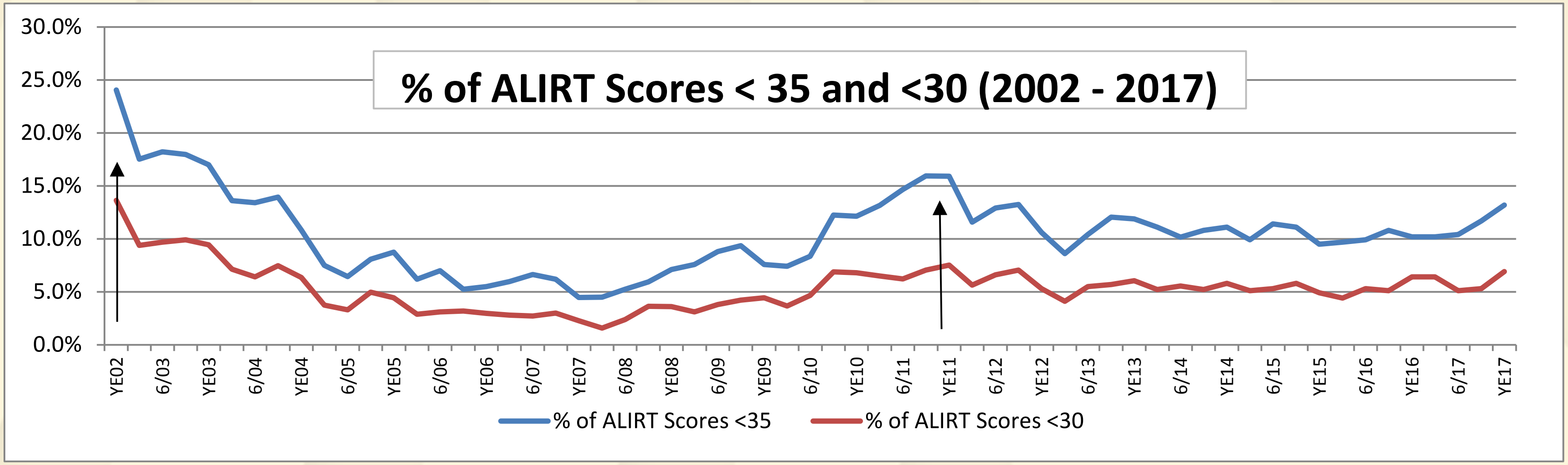

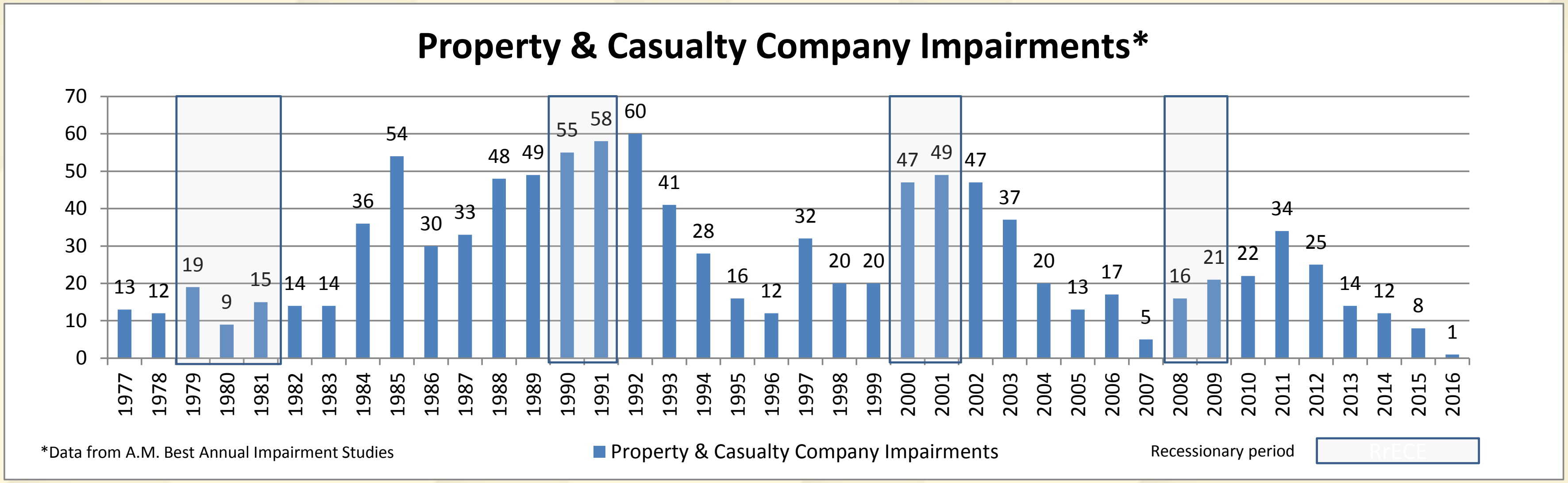

Conclusions

An insurance distributor can benefit from being knowledgeable about both the macro insurance market and the specifics of his/her own carrier partners

- Level of professionalism
- Helpful in negotiating terms of partnership
- Know when it is time to proactively make a change in partners
- Better market your program by knowing your competition

It is not primarily insolvency you are looking out for, it is financial deterioration.

Conclusions

The U.S. "mini hard market" starting in late 2011 ran out of steam; broad rates then softened but are now swinging back to around break-even year-over-year.

Global rates are generally more competitive.

- Supply of "Redundant Capital" in the Industry continues to grow
- Continued decent (ex-cat) underwriting results for large national and regional carriers
  - Rate Adequacy still seems to be in place for most lines, though there are outliers
- Continued prior year reserve releases/reported overall PY reserve adequacy
- Improving economic conditions = but higher demand still well under supply of insurance capacity
- Emergence of new risks (e.g. cyber), but insurers still treading carefully
- Overall ALIRT pain gauges not anywhere near 2000 levels
- But, mix of commercial lines business at multi-year lows; will there be reversion to the mean?

Insurer and broker disagree on current rate adequacy, but companies are growing more sophisticated now so the "cycle" may evolve within a less pronounced band.

Companies likely putting up conservative loss picks in anticipation of inflation growth - but also to smooth earnings?

Lower investment yields, on their own, not enough for hard turn, but have contributed to more disciplined pricing.

Conclusions

The real story is excess surplus and publicly-traded holding companies attempting to maintain adequate returns on their capital positions.

After three consecutive years of relatively light cat losses (2013-2015), the very large hurricane/fire/earthquake losses in 2017 changed the dialogue. Insurers are now more insistent on a push for rates, especially – but not only – in property lines.

The reinsurance market, however, remain under pricing pressure as the alternative (ILS) markets reload with capital. This is a secular change which may help keep a cap on sharp upward price movements going forward.

Merger and Acquisition activity in the global P&C market accelerated in the period 2015- 1Q2018. More potentially on the horizon as insurers try to build scale, extend specialty offerings, and wring capacity out of the industry.

Monetary and fiscal challenges do matter and could directly impact the health of the U.S. P&C market. Keep an eye on the capital markets and the economy.

ALIRT INSURANCE RESEARCH, LLC

- Provides private credit analytics on the life, property & casualty, and health industries
- Located in Windsor, CT
- Years in Business: 18
- Principals have worked together providing credit oversight on insurers for the past 25 years
- Produces quarterly financial analyses on approximately 600 Life, 1,600 P&C, and 350 managed care insurers
- Analysis generated by running statutory and GAAP financials through a proprietary model that screens for relative financial strength
- Clients: distributors of insurance products, end users of insurance products, asset managers, boards of directors, insurers
- Purpose: to “get below” the public ratings in order to more accurately determine the *relative* financial strength and weakness of insurers

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