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Overcoming Rating Agency Concerns

an interview with Bill Matthews

There are some bleak predictions coming out of the rating agencies these days for the US P&C industry. According to A.M. Best, a leading insurance rating agency, the traditional cycle of "hard" and "soft" pricing has ended, replaced by a permanent "down" market, which is expected to generate single-digit ROEs in the near term. In addition, Best expects that about one-third of today's P&C insurers will lose their autonomy or exit the market in the next five years, due to weak operating conditions and heightened consolidation pressures from financial services reform. Given these expectations, how can a P&C insurer get and maintain an "A" rating from Best? William Matthews, a principal who runs a rating agency practice in Milliman & Robertson's New Jersey office, offers some insights based on his past experience as a Best analyst.

"Best analysts usually have a good macro view of the segments and trends within the P&C industry," says Matthews, "but they may lack specific knowledge about the particular class of business or the unique operating strategies an insurer brings to the market. It is therefore important that an insurer teaches Best about its niche, its strategy and how these compare with other companies that operate in the market, so that analysts can overcome concerns and rate the company fairly."

Matthews believes that Best analysts may have additional concerns, which P&C insurers must overcome to get and maintain "A" ratings from Best.

Here are Matthews' views on four other issues.

Rates & Reserves are Inadequate

Because of the prolonged "soft" market and the competitive conditions that exist in most P&C segments today, Best has observed an increase in the accident year loss ratios on most P&C lines and has seen a release of excess reserves to offset the competitive pricing. Best seems to believe that reserve redundancies are now exhausted and that competitive pricing will cause future operating results to be weaker than in the past.

While this may be true on a macro level, it may not be true at an individual company level. If a company's latest rate and reserve study indicates that the pricing is still profitable and that there is a margin in reserves for unexpected development, it would be wise to point this out to Best and have Best consider it in the company's rating analysis.

No Growth is Bad

The US P&C industry experienced modest annual growth in net premiums over the past five years. On a company level, many companies are fighting to stay even, with some reporting premium declines. This can again be attributed to soft market conditions, coupled with lower trends in P&C cost drivers.

Best's concern about slow-growth or no-growth scenarios is that claims and operating expenses continue to rise, which puts downward pressure on earnings. If this continues for a prolonged period, it could impact an insurer's ability to meet policyholder and stockholder expectations and eventually lead to disintermediation.

While these concerns have some validity, it may also be true that prolonged growth in a soft market can have similar negative effects. Therefore, it is important for insurers to inform Best about the conditions in their particular markets and describe their strategies in dealing with competitive pricing pressures. In many cases, insurers will follow rates down to "less but still adequate" levels and walk away from "less than lost cost" business. Insurers also can focus on expense reductions and investment changes to maintain or enhance overall returns. The key is to show Best that the top line is not the only driver in an organization's operating performance and show them how an organization can maintain earnings through a down cycle.

Bigger is Better

Almost 60% of the industry's $290 billion of net premium was written by 20 large P&C insurers in 1999. These insurers tend to be large national companies that write many lines of business in many states, have "brand names" among the buying public and command the attention of agents and brokers. In recent years, some of these market leaders have begun to compete for business that they formerly left to smaller insurers. And, since smaller P&C insurers outnumber the 20 largest by more than 50 to 1, this could adversely impact the financial condition of many companies to which Best assigns ratings.

While a small company's book can be "raided" by a larger company, there may be reasons why this is not likely to occur, or to succeed long term if it does occur. Many smaller companies develop specialized expertise and provide better products, service or pricing than larger companies entering the business. In addition, the smaller insurers' risks may be too small or need more service than a national carrier is willing to sustain in the long run.

To get around the "bigger is better" issue, an insurer should demonstrate that its results have outperformed the larger company's, explain how it has differentiated itself from larger competitors in products, service, pricing or claims handling and show that it renews its business in high proportions each year despite the presence of the larger carrier.

Mutual vs. Stock

Mutual insurers sometimes report lower ROEs and higher expense ratios than stock P&C insurers, particularly those that are publicly traded. Mutual insurers may lack the access to outside capital that stock insurers possess, since they cannot issue stock or other forms of permanent capital.

These factors can make an analyst regard mutuals less favorably, since ROEs and expense ratios are common measures of effectiveness and access to outside capital can be advantageous in funding an unexpected loss or capitalizing on a new opportunity.

In combating this, it is first important to explain why the mutual formation was chosen over the stock formation when the company was formed. It may be that the mutual formation allowed the insurer to focus on what was best for the policyholders and not be distracted by what was also best for the stockholders. Then, it would be wise to address the ROE and expense ratio issues, since the mutual's mission may be quite different than a stock competitor's mission, and therefore justify different ROE and expense ratio levels. Finally, mutuals can obtain outside capital from reinsurance or surplus notes if an unexpected loss occurs or a new opportunity arises. While this capital may not be permanent or cost-free, new shares in a stock company carry issuance costs and can pay dividends over time.

Conclusion

Concerns may exist in the minds of rating agency analysts that can present challenges to insurers seeking "secure" ratings. Many of these concerns can be overcome by teaching the analysts about an insurer's niche and strategy and letting them see the soundness of their business plan. In the end, good ratings follow good plans. Those who take an active role in helping analysts understand their plans can enhance their chances of obtaining secure ratings from Best.

Bill Matthews is a financial consultant in the New Jersey office of Milliman & Robertson.

Higher Return with Lower Risk

Med Mal Mutuals Gain by Increased Investment in Equities

by Ken Quintilian, FCAS, MAAA & Allan Kaufman, FCAS, MAAA

An analysis of a typical small mutual writer of medical malpractice insurance shows that companies can significantly increase their holdings of equities while reducing risks to the company.

The Problem

History shows that equities provide greater investment returns than fixed income securities. But, for an insurance company, that information reflects only part of the decision-making process. Sure, the expected return is higher, but what about the additional risk?

Due to the difficulties of quantifying this risk in a practical way, companies base investment strategy on rating agency considerations, regulatory constraints, conventional benchmarks, measurements of variability in investment returns, or judgment. They have no clear, objective criterion to help them decide "how much is enough."

Many malpractice insurers, given the perceived risk of their volatile mono-line and often single-state underwriting risks, generally choose more conservative investment strategies than do the larger multi-line commercial insurers. Figure 1 shows that the property-casualty industry as a whole has had a fairly stable level of investment in equities over the past decade, with some increase in the past two to three years that is at least partly due to the effect of the bull market. Mutual companies have steadily increased their stock holdings, which are now noticeably higher than those of the industry as a whole.

Companies writing predominantly med mal insurance have a significantly lower portion of their investments in equities. Although they nearly tripled their positions as a percentage of surplus since 1987 (the bull market helped in this regard), their current position is still significantly below that of the other P&C companies.

Figure 1 is expressed as a percentage of surplus, but the same patterns apply when equities are expressed as a percentage of assets.

The Objective

In this study, we sought to answer a specific, concrete question: "Is the current investment strategy of this company optimal, or would a more—or less—aggressive strategy be better for it?" The most common objection to investing in equities is the attendant higher risk. This study shows that investing in more equities could make a company more profitable with less risk.

Figure 1

Equities as Percent of Surplus (Consolidated)

Year	P&C Industry	Mutuals	Med Mal Predominating
87	37%	35%	11%
89	39%	39%	11%
91	37%	43%	17%
93	36%	42%	21%
94	36%	41%	18%
95	38%	46%	22%
96	41%	49%	27%
97	44%	51%	28%

The Analysis

A consideration in such an analysis is to adequately define the meaning of "risk." To do this, we conducted a study of the type called dynamic financial analysis (DFA). We used company statistics to create a model of a typical small to medium-sized med mal insurer, similar to many of the companies in the PIAA (Physician Insurers Association of America). We then simulated economic, underwriting and investment variables to project many possible financial outcomes over a 10 year time horizon.

Finally, we tested four investment strategies—the base, which reflected the current strategy, and three alternatives involving progressively higher levels of investment in equities (with corresponding decreases in bonds). We compared each of these alternatives through a graphical analysis of risk and return.

This approach shows the tradeoff between risk and profitability. Because no single measure of risk is appropriate in all circumstances, we tested various criteria such as the probability of significant long-term surplus decline, or the likelihood that surplus would fall below trigger RBC levels. Profitability was measured as return on equity, which was approximated as net income over surplus, with both income and surplus adjusted to reflect the tax-effected unrealized capital gains that have become so important to measuring a company's overall performance.

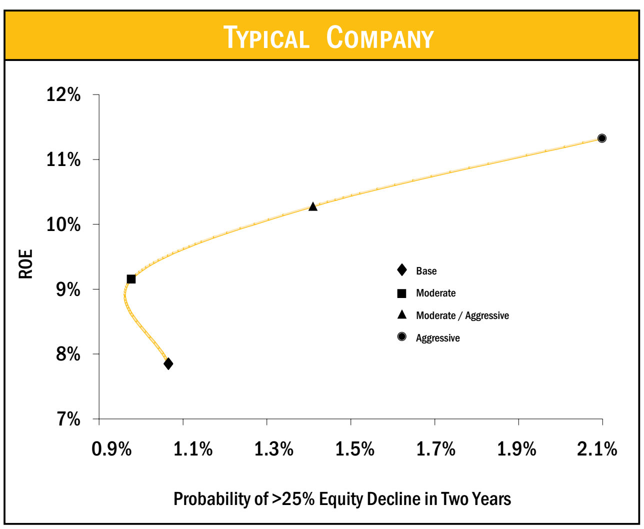
The Company

The company we modeled was fairly typical of many PIAA companies. It started the forecast period with less than $100 million in surplus. Its premium-to-surplus ratio is significantly less than 1.0. Most of the premium is for claims-made physicians & surgeons medical malpractice, with an expected net loss & LAE ratio that is currently between 110-115%. It initially invested about 30% of surplus (under 7% of assets) in equities.

The Results

Figure 2 shows that an increase in equity investments from the base level to a "moderate" level increases the return, while the risk decreases. The risk measure examined in this case is the chance that the company will lose 25% of its equity over any two-year period.

Figure 2



Under the moderate scenario, the company holds—on average over the forecast period—equities equal to about 62% of its surplus, or 17% of assets. This is more aggressive than even the P&C industry has been to date. Yet, in our analysis, the company making this change not only experienced a substantial increase in ROE, but—under the risk measure being examined—at the same time enjoyed a significant decrease in its exposure to risk!

How is this possible? Aren't equities inherently more risky than other kinds of investments? Increasing investment in equities certainly contributes to the volatility of operating results, including ROE. Increased volatility, taken in isolation, would act to make a negative ROE more likely.

But the change in investment strategy also increased the average ROE, which works to offset the adverse effect of the increased variability. In addition, the volatility in underwriting results can move in the opposite direction of volatility in investment results, so "bad news" in one arena is sometimes offset by "good news" in the other arena.

In fact, we found that, if a company has more volatile underwriting results, the benefit from adding stocks is often greater than for a more stable company. For each company modeled, the underwriting and investment risks interact to form a unique, complex risk profile.

In the case of the company presented in Figure 2, the improvement in the average exceeds the increase in variability, with the result that the change is beneficial to the company in an objectively quantifiable way. In other words, on the basis of this analysis, we can state that the change from the base to the moderate strategy is a verifiable improvement for the company.

When moving from the moderate investment strategy to the more aggressive strategies (in Figure 2), the results are more in accordance with the conventional wisdom regarding such investments—that increased reward comes from increased risk.

Each of these three points (other than the base point) is on the "efficient frontier". That means that each of these points is an optimal choice of investment strategy for a given risk target. The selection of the best one for a company depends on that company's risk tolerance. If the company can accept more risk, the company can be more aggressive. While the expected reward to policyholder/owners will be higher, the chance of an adverse outcome will also be higher.

Alternative Risk Measures

There are different risk measures that can be examined in this type of analysis. Examining a variety of risk measures will ensure that all of the appropriate considerations are addressed before a decision is made regarding a change in investment strategy.

One alternative risk measure we examined was the likelihood of regulatory intervention, measured by the probability that surplus would drop below the company action level for risk based capital. Under the base scenario, there was about a 13% chance that such a drop would occur at least once over the 10-year projection period. The moderate strategy improved upon this, raising ROE, as previously discussed, while at the same time reducing by about $2^{1}/_{2}$ points the probability of such regulatory action. The other, more aggressive scenarios again showed increased return for increased risk, repeating the pattern found in Figure 2.

Sometimes risk is measured solely as variability of returns. In this analysis, we assumed that the expectation of a particular adverse result was more significant than simple variability. We think this is reasonable for this type of company. However, the selection of risk measure is dependent upon the company's particular management philosophy and attitude toward risk. The risk measure chosen can strongly affect the outcome of an analysis such as this one. Such selections should therefore be made carefully by the company being modeled.

Sensitivity Testing

We tested whether the results varied significantly if the company had higher or lower surplus levels, or higher or lower loss ratios.

If initial surplus was higher (or loss ratio lower), the change in strategy generally continued to be favorable for the company. In fact, the risks for these companies dropped to—or very near to—zero under many of the tested risk measures, so the change in strategy could be made and the risk in those cases would often remain at zero.

If initial surplus was lower, or expected loss ratio higher, the change in strategy still generally continued to benefit the company. We observed

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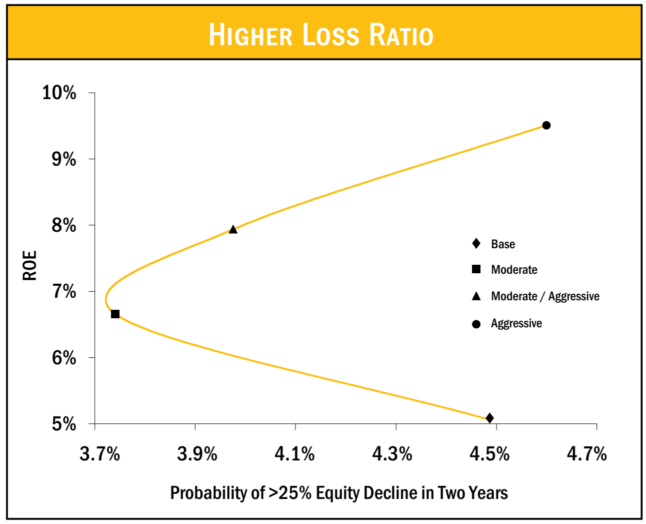
that the advantage of increasing the level of investment in stocks was typically more significant in these cases. Figure 3 shows an example of such a scenario.

This company operates at a combined ratio about 10% higher than the model company. Figure 3 shows that such a company stands to improve its risk profile more dramatically than the model company by shifting toward stock investments. In fact, this company's risk is even reduced by a moderate/aggressive investment strategy, which entails stock investments of 26% of assets, or slightly over 100% of surplus. This is because the increased expected investment returns offset the less favorable underwriting results, thus reducing the company's risk of substantial, protracted equity decline.

Figure 3



Conclusion

The tools now exist to conduct a careful examination of the risks and rewards of alternative investment strategies. The indications of our DFA analysis are that, at least for the med mal mutuals, clear reductions in risk would be obtained by a further increase in their investment in equities. Analyses such as this one can help companies, rating agencies, and regulators increase their comfort level with these and other types of investments.

This analysis was conducted for hypothetical companies. Many variables impact each actual company, making them different from one another and from the companies studied in this monograph. Therefore, the wisest move for any company is to conduct a similar analysis before answering the question: "How much is enough?" However, the results of this analysis certainly indicate that the answer for many med mal mutuals, when it comes to investment in stocks, is "more!"

Ken Quintilian is a casualty actuary and principal in the Minneapolis office of Milliman & Robertson. Allan Kaufman is a casualty actuary and was formerly a principal in the New York office of Milliman & Robertson. He is now a partner with Bacon & Woodrow, the United Kingdom affiliate of Woodrow Milliman. Also contributing to this article were Joan Klucarich of the San Francisco office and Tom Ryan of the New York office.