Update from A.M. Best’s 2017 Review & Preview Conference

April 2017
A.M. Best recently held its 24th annual insurance ratings conference, Review & Preview, in Orlando, Florida. The conference agenda consisted of industry leaders discussing topics such as cyber risk, mortgage risk, insurtech, enterprise risk management (ERM) practices, regulatory issues, as well as current industry trends and their expected impact on ratings. Additionally, A.M. Best released their draft criteria paper on “Evaluating Mortgage Insurers” the week before the conference.

Below is Aon Benfield’s view of the key points from the main property and casualty breakout sessions.

A.M. Best Internal Update

A.M. Best provided the following updates:

- A.M. Best did not register in a new country during the past year, but opened a small office in New York City to conduct meetings.
- A.M. Best received 39 comments on its first release of the US stochastic-based BCAR criteria and 33 more comments on its Best Credit Rating Methodology (BCRM) and Universal stochastic-based BCAR criteria.
- Currently, A.M. Best is going through 29 criteria procedures and testing new criteria.
- A.M. Best opened its new online portal to submit SRQs and plans to release a future version that will allow companies to perform what-if analyses.

Market Segment Outlooks

A.M. Best provided the following updates:

- **Reinsurance segment - maintain negative outlook:** Although operating performance and capitalization remain strong, pressure from low rates continues. As a result, returns for some reinsurers will fall short on a risk-adjusted basis. Alternative capital continues to put pressure on rates in the market; however, the market continues to heavily rely on traditional reinsurance. Regarding companies’ business profile, A.M. Best is looking for relevance with brokers, clients, and third party capital capabilities. In this current soft market, A.M. Best acknowledges a lower ROE is more acceptable, which is why its 2016 estimate is 6 to 7 percent. A.M. Best provided their view below on headwinds and tailwinds impacting the reinsurance segment.

<table>
<thead>
<tr>
<th>Headwinds</th>
<th>Tailwinds</th>
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</thead>
<tbody>
<tr>
<td>Intense competition</td>
<td>Cession rates increasing</td>
</tr>
<tr>
<td>Ongoing interest from third party capital</td>
<td>Solid calendar year underwriting results</td>
</tr>
<tr>
<td>Earnings under pressure</td>
<td>Favorable reserve development</td>
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<tr>
<td>Pressure on terms and conditions</td>
<td>Strong risk-adjusted capital</td>
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<tr>
<td>Potential for increased inflation</td>
<td>Increase in interest rates</td>
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<tr>
<td></td>
<td>M&amp;A</td>
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</tbody>
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Source: A.M. Best’s Review & Preview Materials
**Personal lines segment – maintain stable outlook:** Balance sheet strength supports current ratings and operating profile, business profile, and ERM are in line with expectations. The impact from insurtech is recognized in business profile and ERM. As insurtech becomes more embedded in companies’ operations, the impact will be greater and it will impact companies’ balance sheet strength. A.M. Best provided their view below on headwinds and tailwinds impacting the personal lines segment.

<table>
<thead>
<tr>
<th>Headwinds</th>
<th>Tailwinds</th>
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<tbody>
<tr>
<td>Auto combined ratios above break-even</td>
<td>Excess capital</td>
</tr>
<tr>
<td>Auto frequency and severity pressures</td>
<td>Favorable reinsurance pricing</td>
</tr>
<tr>
<td>Declining reserve releases</td>
<td>Rate increases taken in auto</td>
</tr>
<tr>
<td>Low levels of investment income</td>
<td>Strong property performance</td>
</tr>
<tr>
<td>Normalized levels of catastrophes</td>
<td>Advanced pricing segmentation</td>
</tr>
</tbody>
</table>

Source: A.M. Best’s Review & Preview Materials

**Commercial lines segment – maintain negative outlook:** Although market leaders are posting good results, smaller companies are feeling pressure from declining rates, emerging loss trends, and low investment yields. A.M. Best is seeing a continuing weakening in loss and LAE reserve adequacy. In addition, more benign loss cost is softening premium rates. Most commercial companies have adequate ERM and have utilized data analytics better in adjusting claims and pricing. A.M. Best provided their view below on headwinds and tailwinds impacting the commercial lines segment.

<table>
<thead>
<tr>
<th>Headwinds</th>
<th>Tailwinds</th>
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</thead>
<tbody>
<tr>
<td>Intensifying price competition</td>
<td>Abundance of capital</td>
</tr>
<tr>
<td>Decreasing reserve releases</td>
<td>Conservative investment profile</td>
</tr>
<tr>
<td>Low investment yields</td>
<td>Adequate ERM</td>
</tr>
<tr>
<td>Normalized catastrophe losses</td>
<td>Modest increase in interest rates</td>
</tr>
<tr>
<td>Unusual level of non-cat large losses</td>
<td>Favorable reinsurance pricing</td>
</tr>
<tr>
<td>Elevated frequency and severity in commercial auto</td>
<td></td>
</tr>
</tbody>
</table>

Source: A.M. Best’s Review & Preview Materials

A.M. Best provided its combined ratio estimates for industry sectors shown in the table below.

<table>
<thead>
<tr>
<th>Combined Ratio</th>
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</thead>
<tbody>
<tr>
<td><strong>Industry sector</strong></td>
</tr>
<tr>
<td>Reinsurance*</td>
</tr>
<tr>
<td>Personal</td>
</tr>
<tr>
<td>Commercial</td>
</tr>
</tbody>
</table>

*US & Bermuda, GAAP basis
Source: A.M. Best’s Review & Preview Materials

Combined ratios are reaching an economic break-even point; however, low investment yields have enforced underwriting discipline to maintain combined ratios. A.M. Best’s expectation may change if inflation rates change.
BCAR and BCRM Update

A.M. Best conducted sessions on its proposed stochastic-based BCAR criteria for P&C and L&H companies, which included A.M. Best’s indicated balance sheet assessment from using stochastic-based BCAR as shown in the chart below.

- **P&C sector remains well capitalized:** 91 percent of the P&C sector has an indicated balance sheet assessment of strongest or very strong; compared to the Life sector at 75 percent, and the Health sector at 62 percent. In addition, the Health sector’s assessment has wider variation with 30 percent of the sector at weak or very weak.

A.M. Best is considering the changes listed below to its draft criteria papers.

- **Tax treatment of catastrophe stress PML:** Currently, the catastrophe stress event is on a pre-tax basis, consistent with the B8 risk charge. However, this treatment is inconsistent with other surplus adjustments, such as UPR equity, reserve equity and fixed income equity, which are calculated on a post-tax basis. As a result, A.M. Best is considering a post-tax reduction to surplus for the catastrophe stress test.

Source: A.M. Best's Review & Preview Materials

* Companies with < 20 million USD in capital & surplus cannot score in strongest category

![BCAR and BCRM Update Chart](chart.png)
**Combined business profile and ERM adjustment:** A.M. Best is now considering capping the combined assessments of business profile and ERM to a maximum positive adjustment of +2 notches.

![Maximum +2](image)

- **ERM assessment:** Currently, the -1/-2 category is not separated in the ERM assessment table. In response to feedback, A.M. Best is separating this category to provide further clarification.

<table>
<thead>
<tr>
<th>ERM assessment</th>
<th>Key characteristics of ERM</th>
</tr>
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<tbody>
<tr>
<td>Marginal -1</td>
<td>The insurer’s ERM framework is developing; however, certain key elements of the framework are not yet in place or have proven inadequate given the complexity of its operations. Some risk management capabilities are not aligned with the risk profile of the company.</td>
</tr>
<tr>
<td>Weak -2</td>
<td>The insurer’s ERM framework is emerging and management is still exploring the development of formal risk protocols. Risk management capabilities are insufficient given the risk profile of the company.</td>
</tr>
</tbody>
</table>

Source: A.M. Best’s Review & Preview Materials

- **Specialty criteria:** Specialty criteria will focus on what is different between the analysis of the specialty insurer and the standard process outlined with the BCRM. In general, criteria will have the following sections: market overview; balance sheet strength; operating performance; business profile; ERM; and rating lift/drag. Examples of specialty criteria include subjects such as: catastrophe exposure, terrorism risk, new company formations, equity credit for hybrid securities, among others.

- **Timing of final criteria:** A.M. Best plans to finalize criteria by late 2017.
ERM in the Rating Process

A.M. Best conducted a session that highlighted how enterprise risk management (ERM) will be incorporated within the new BCRM framework and provided updates to their ERM analysis. A.M. Best noted their focus on evaluating ERM is through an ‘ORSA-type’ lens by assessing the risk management framework and evaluating a company’s risks relative to capabilities. This focus has led to a re-designed risk impact worksheet (RIW), which is A.M. Best’s primary analytical tool for assessing a company’s ERM.

The RIW will assist analysts with a risk framework evaluation based upon a review of the following areas: Risk Identification & Reporting, Risk Appetite & Tolerance, Stress Testing, Risk Management & Controls, and Governance & Risk Culture. Each category and the overall framework will be evaluated within five assessment categories: Unrecognized, Nascent, Emerging, Developing, and Embedded.

In addition, A.M. Best will continue to use the RIW to assess a company’s risk profile relative to its risk management capabilities as it relates to the following risk categories:

- Product / Underwriting
- Reserving
- Concentration
- Reinsurance
- Liquidity & Capital Management
- Investments
- Legislative / Regulatory / Judicial / Economic
- Operational

For the risk evaluation component of the RIW, risk profile and risk management capabilities scores will range from 1 (low) to 9 (high) for each category above. A.M. Best will focus on areas where there is a meaningful difference in the scores between a company’s profile and related capability.

In the end, assessments of the risk framework and risk evaluation within the RIW will guide analysts to an overall ERM assessment that may adjust the issuer credit rating (ICR) by a range of +1 to – 4. An updated criteria related to A.M. Best’s approach to ERM is expected to be released in the second quarter of 2017.

Mortgage Insurance – Draft Rating Criteria

On March 17, A.M. Best issued new criteria for rating mortgage insurers (MI), as well as draft criteria related to the capital treatment for companies reinsuring mortgage credit risk or primary MI business. Currently, A.M. Best does not rate any primary mortgage insurers, but once this new criteria is finalized, A.M. Best will look to rate primary MI companies. However, given that many traditional reinsurers are insuring GSE (Fannie Mae and Freddie Mac) mortgage credit risk and primary MI business, the primary interest for the new criteria relates to the proposed capital treatment related to the transactions for multi-line companies that A.M. Best currently rates.
A.M. Best outlined two approaches for determining capital requirements for insurance credit risk transfer programs:

- Factor based approach to determine stressed loss scenarios based upon credit score of borrowers and loan-to-value ratios (if cumulative exposure is less than USD500 million or less than 10 percent of surplus)
- Full modeling approach using loss output from a third party vendor model

The stressed losses based upon the selected approach above will be reduced by expected premiums from the layers leading a net loss amount. This net loss will be added to B6-Premium risk charge within BCAR, which will be subject diversification credit within B6 and a covariance benefit within the overall net required capital calculation. As a result, the marginal capital requirements from writing GSE mortgage credit insurance will depend upon a company’s current BCAR risk drivers. The comment period for draft mortgage insurance criteria is open until May 1, 2017.

**Regulation and Rising Interest Rates**

A.M. Best provided the following updates:

- **Regulation:** After a new administration took office this year, new questions surround the future of the US corporate tax rate, establishment of a border tax adjustment, covered agreement with European Union, and Dodd-Frank Act.
  - The proposed change to the corporate tax rate would decrease it to 20 percent from 35 percent. In addition, the new administration would propose a border tax adjustment of 20 percent on all imports to offset revenue lost from decreasing the corporate tax rate and assist domestic companies with competing against foreign companies from lower taxed countries.
  - Since the European Union deemed the US not Solvency II equivalent, the business assumed by US reinsurers from European (re)insurers is at risk. Representatives from both sides are currently working on a covered agreement to keep the (re)insurance market open between the US and the European Union.
  - The new administration has said that it plans to dismantle the Dodd-Frank Act, which established the Federal Insurance Office (FIO). Therefore, the future existence of the FIO is in question.

- **Rising interest rates:** The Federal Reserve raised interest rates by 0.25 percent at its March 15 meeting. Many industry professionals believe that it is likely that the Federal Reserve will increase interest rates by 0.25 percent two more times in 2017. As a result, inflation is a concern of A.M. Best going forward on property catastrophe reserves. Some industry professions believe the rise in interest rates may temper the appetite of non-traditional capital, but others believe investors will still value the uncorrelated risk.
Cyber Risk Roundtable Discussion

Senior executives (Arvind Parthasarathi, Founder & CEO, and John Merchant, Director of Business Development) from Cyence, provided their viewpoints on the current state and future potential of the cyber risk market and thoughts on how to model cyber risk. Cyence is an organization that brings together data science, cyber security, and economics to build a unique platform that quantifies the financial impact of cyber risk.

The current cyber risk insurance policies primarily only cover data breach. In 2016, Cyence estimates that the insurance industry wrote USD2 to USD3 billion in premium and by 2025 premiums for insuring cyber risk may exceed USD20 billion. This growth opportunity is supported by data that has shown that only 12 percent of companies’ information assets are insured, compared to 51 percent of physical assets.

Unlike traditional property and casualty lines of business, the past claim data from cyber events is not reliable for predicting losses from future cyber events. As a result, Cyence uses predicative modeling, instead of statistical modeling to quantify cyber risk. Using a predicative model requires twice as much time to collect data than on modeling and quantifying the risk, which is in contrast to the time requirements for using a statistical model. The reason for different time requirements is predicative modeling focuses on modeling human behavior, which is constantly evolving. Other risks that a cyber risk model should include are volatility and accumulation risks. Since cyber risk cuts across all traditional property and casualty risks, it is vitally important that companies consider accumulation risk.

In order to be successful in this market, companies’ cyber products must evolve from policy wording to an end to end service offering, which includes an evaluation of the insured’s people, process, and technologies.
Contact Information

Aon Benfield’s Rating Agency Advisory Group can provide assistance in understanding rating agency requirements and potential changes. Should you or your clients have questions, please do not hesitate to contact a member of Aon Benfield’s Rating Agency Advisory Group.

Patrick Matthews
Global Head of Rating Agency Advisory
Aon Benfield
+1.215.751.1591
patrick.matthews@aonbenfield.com

Kathleen Armstrong
Managing Director, US Rating Agency Advisory
Aon Benfield
+1.513.562.4508
kathleen.armstrong@aonbenfield.com

Stephen Wallace
Associate Director, US Rating Agency Advisory
Aon Benfield
+1.312.381.5250
stephen.wallace1@aonbenfield.com

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