Update from A.M. Best's 2018 Review & Preview Conference

March 2018

A.M. Best recently held its 25th annual insurance ratings conference, Review & Preview, in Naples, Florida. The conference agenda consisted of industry leaders discussing topics such as innovation, Insurtech, mortgage risk, regulatory items, rating tools/processes, as well as current industry trends and the potential impact on ratings.

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

A.M. Best Criteria Finalized in October 2017

On October 13, 2017, A.M. Best finalized and released their new Best's Credit Rating Methodology (BCRM) that includes 24 other specialty criteria including Stochastic-based BCAR, evaluating terrorism risk and mortgage insurance. This concluded a two year process with numerous draft criteria and request for comment periods.

Market Segment Outlooks

A.M. Best provided the following updates:

- **Personal lines segment – maintain stable outlook:** 2017 saw 11 large (over $1 billion) insured events in the mainland U.S., however companies saw pressure to earnings rather than capital. Unlike previous years with active storms, A.M. Best has taken no rating actions to date due to the catastrophes specifically and the fact that companies have record capitalization and improved risk management capabilities. A.M. Best will be focused on flood and wildfire modeling in the coming rating cycle as a result of the historic losses seen in 2017. There are also regulatory challenges on the horizon as the Florida legislature has not yet taken action to address the AOB (Assignment of Benefits) issues. A.M. Best is concerned the AOB may head into other states, such as Georgia.

Headwinds	Tailwinds
Auto combined ratios above break-even	Excess capital
Auto frequency & severity pressures with some improvement noted	Favorable reinsurance pricing (pre-2018)
Declining favorable reserve releases	Rate increases taken in auto
Low levels of investment income (but strong equity returns)	Strong property performance (pre-2017)
Increasing frequency and severity of catastrophes	Advanced pricing segmentation / technological advances

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

- **Commercial lines segment – revert to stable outlook:** The change in outlook for the commercial lines segment was driven by underwriting sophistication and how the industry responded to the challenging marketplace. Strong ERM served the segment well in 2017, with the majority of catastrophe losses falling within risk tolerances and quick decisions leading to positive corrective action in underwriting discipline and growth.

Headwinds	Tailwinds
Intense price competition	Abundance of capital
Decreasing reserve releases	Conservative investment profile
Low investment yields	Adequate ERM (tested in 2017)
Outsized catastrophe losses	Price improvements
Elevated frequency and severity in commercial auto	Favorable reinsurance pricing (pre-2018)

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

- **Reinsurance capacity:** Alternative capital continues to put pressure on rates; however, the market continues to heavily rely on traditional reinsurance. A.M. Best estimates that traditional reinsurers comprised 79 percent of total reinsurance capacity in 2017 compared to 82 percent in 2016. Traditional capital has remained relatively flat over the past five years, while alternative capital has contributed all of the modest growth in this sector. Collateralized reinsurance continues to be the largest alternative form of capital, accounting for 63 percent in 2017.

- **Reinsurance segment - maintain negative outlook:** Although the active storm year in 2017 led to some price stabilization, there is still growing interest from convergence capital that is putting pressure on the segment. The 2017 losses did not impact capitalization for reinsurers; however there was an impact to earnings. In this current soft market, A.M. Best acknowledges a lower ROE is more acceptable, which explains why their 2017 estimate is flat from 2016 at 7 percent.

Headwinds	Tailwinds
Intense competition	Cession rates increasing
Increasing interest from third party capital	Catastrophe losses stabilize rates
Earnings under pressure	Favorable reserve development
Excess capital hinders improvement	Strong risk-adjusted capital
Potential for increased inflation	Increase in interest rates
	M&A

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

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

		Combined Ratio		
Industry sector	**Outlook**	**2016 A**	**2017 E**	**2018 P**
Reinsurance*	Negative	92.5%	110.6%	96.8%
Personal	Stable	102.6%	104.9%	100.3%
Commercial	Stable	99.6%	103.5%	101.3%

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

Combined ratios were higher in 2017 due to the increased catastrophe frequency the industry saw, which was one of the highest years on record with $84 billion in insured losses; second only to 2005. A.M. Best's expectation may change if inflation rates change.

Rating Tools and Benchmarking

A.M. Best provided a look at some of the new tools analysts use when evaluating a company. This section will also review some insights into the benchmarking A.M. Best provided for their new and final BCRM.

Rating tools:

A.M. Best previewed dashboards and other tools that easily show how companies are performing on an absolute and relative basis. Many of these dashboards show historical performance in a variety of metrics, compared against the industry composite. The output displays the company into three groups to graphically show performance; 0 – 40 percentiles for positive performance, 40 – 60 percentiles for neutral performance, and 60 – 100 percentiles for negative performance. A.M. Best focused on high risk assets noting that many companies are increasing their investment allocations to these categories due to the low yield environment. A.M. Best estimates that alternative asset exposure across all sectors has more than doubled in the past 10 years; estimated to be around $375 billion for 2017. High risk asset leverage may impact a company's balance sheet strength assessment under the new BCRM.

Benchmarking:

A.M. Best highlighted their new BCRM building blocks and discussed trends for their rated companies under this new framework. When the criteria was implemented, only approximately 3 percent of rated companies saw positive or negative rating action due to the new framework. Some of these companies are still under review pending further analysis. Below are a few key takeaways, along with how U.S. P/C companies are allocated across relative performance at the most popular notching assessments for each of the four main building blocks. For example, 22 percent of companies that achieve the "Strongest" balance sheet strength assessment have a positive performance in underwriting leverage.

- **Balance sheet strength:**
  - Over 75 percent of P/C companies have "Strongest" or "Very Strong" assessment
  - Over 50 percent of commercial companies have "Strongest" assessment, while only 37 percent for personal lines
  - 60 percent of P/C companies remain at indicative balance sheet strength based on BCAR scores alone; 40 percent are adjusted for quality of capital, reinsurance dependence, etc.

	"Strongest"			"Very Strong"		
	Positive	Neutral	Negative	Positive	Neutral	Negative
Underwriting leverage	22%	73%	5%	17%	77%	6%
Financial flexibility	29%	48%	23%	20%	51%	29%
Quality of assets	37%	61%	2%	22%	74%	3%
Strength of reserves	57%	35%	8%	36%	45%	19%

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

- **Operating performance:**
    - Over 75 percent of P/C companies have "Strong" or "Adequate" assessment

	"Strong"			"Adequate"		
	Positive	Neutral	Negative	Positive	Neutral	Negative
Underwriting performance	88%	11%	1%	27%	54%	19%
Investment performance	32%	64%	4%	21%	72%	8%
Total operating earnings	81%	17%	2%	26%	69%	5%

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

- **Business profile:**
    - About 90 percent of P/C companies have "Neutral" or "Limited" assessment

Personal lines:

	"Neutral"			"Limited"		
	Positive	Neutral	Negative	Positive	Neutral	Negative
Management quality	37%	58%	5%	25%	72%	4%
Distribution channel	18%	80%	1%	17%	80%	4%
Product concentration	10%	57%	34%	3%	34%	64%
Geographic concentration	19%	31%	49%	2%	10%	88%

Commercial lines:

	"Neutral"			"Limited"		
	Positive	Neutral	Negative	Positive	Neutral	Negative
Management quality	51%	48%	1%	36%	59%	5%
Distribution channel	20%	79%	1%	10%	82%	8%
Product concentration	11%	48%	41%	1%	24%	75%
Geographic concentration	34%	37%	29%	15%	23%	61%

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

- **Enterprise Risk Management (ERM):**
    - About 90 percent of P/C companies have "Appropriate" assessment
    - Qualities of "Appropriate" ERM are;
        - ERM framework is well-developed
        - Appropriate given size and complexity of operations
        - Risk management capabilities are very good and align with the risk profile

U.S. Tax Reform and Inflation

A.M. Best provided the following updates:

- **U.S. Tax Reform:** The Tax Cut and Jobs Act was signed into law on December 22, 2017. The following are the main impacts this law will have on the industry;
  - The corporate tax rate was reduced from 35 to 21 percent. A.M. Best anticipates most companies will see a benefit from this reduction in 2018 earnings and beyond; while companies carrying a large deferred tax asset had write-downs for year end 2017. Conversely, companies with a deferred tax liability saw a reduction from the reduced tax rate. A.M. Best also noted that they have adjusted the tax rate to 21 percent in all BCAR calculations going forward.
  - Base Erosion Anti-Abuse Tax (BEAT) will increase taxes for entities that cede premium to non-US affiliates. The increase will be phased in starting from 5 percent in 2018, 10 percent in 2019 and 12.5 percent after 2025. This will impact many companies that have an affiliated reinsurer in Bermuda. A.M. Best did not discuss if any companies have reconsidered their reinsurance strategy as a result of the reform.

- **Inflation:** The U.S. has seen improving economic performance with low unemployment and healthy GDP growth. The treasury yield curve is trending up with interest rates slowly rising. The Federal Reserve is expected to raise interest rates up to four times in 2018; leading to increased inflation expectations hovering around 2 percent. With inflation rates expected to rise, A.M. Best is concerned this may put pressure on reserve adequacy for the industry going forward.

Innovation Panel Discussion

A.M. Best hosted a panel of experts in innovation including:

- Jill Beggs - Head of New Strategic Markets, Munich Re
- Dave Dias - Founder & Chairman of the Board, Insurance Thought Leadership
- Gareth Ross - Chief Digital & Customer Experience Officer, MassMutual

These innovation leaders discussed the importance for (re)insurers to be innovative in order to survive the external and internal challenges that face the industry. The panel covered many topics including blockchain, autonomous cars, and big data. They also emphasized the importance for management teams to be able to adapt and embrace innovative solutions to the changing marketplace.

A.M. Best has acknowledged that innovation is a key component when evaluating companies. They announced that they are considering applying an innovation assessment as part of the 'Business Profile' building block in their BCRM analysis. In a subsequent press release, A.M. Best detailed the initial stages, including a formal request for comment period to follow. A.M. Best also noted that they may be releasing a survey to rated companies around innovation and how management teams think about innovation. While the criteria has not yet been be drafted, companies can begin to highlight innovative products or processes they undergo that sets them apart from others. A.M. Best emphasized that what makes a company different is highlighting how they are innovative.

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.

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