



New Office and Address!

We're moving up in the world – one floor at a time. In October we moved to the fourth floor of our building. Our new office is slightly bigger, lays out better and gives us a fresh look at our daily routine. Only our suite number has changed. It is now **450**.

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Our phone 651-385-7500 and fax 651-385-7502 numbers remain the same.



The Evolving Statement of Actuarial Opinion

Steve recently attended a seminar called “Effective P/C Loss Reserves Opinions: Tools for the Appointed Actuary” sponsored by the American Academy of Actuaries. The topic must have been timely because the seminar was better attended than the Academy expected and an extra day was added to accommodate the overflow.

In the years leading up to the Enron and WorldCom debacles, Opinions had grown bland, somehow managing to say nothing and everything at the same time. Although the market was soft in the late 90's, high capital gains kept weak companies afloat. The flight-to-quality during the recent hard market and increased financial scrutiny exposed some weak insurers and their insufficient reserves. Regulators are demanding ever greater accountability from auditors and actuaries. The trend appears to be gathering steam.



The Academy guides actuaries on the language of Opinions but there is no single prescribed format to follow like that of a tax return. Actuaries are expected to disclose if there is a known significant risk of material adverse deviation in the reserves. The terms “significant” and “material” are left to each actuary to define, as best understood in the context of surplus and underwriting scope. We will include more discussion this year on this topic.

Also on the horizon is an Actuarial Opinion Summary (AOS). If enacted by the Academy, the AOS would disclose the gross and point estimate and compare that to the carried reserves. It would also discuss instances where the one-year development to surplus is greater than 5% in at least three out of the latest five years.

The Opinion is growing in importance as a tool for regulators, investors and reinsurers. We will be sure to identify any changes this year-end to our clients.

Premium and Reserve Growth - Not Always Linked

Insurance executives planning out the year ahead are asked to predict a number of financial measurements. Some are simpler than others. Premium and expenses are manageable. Surplus and investment gains are challenging because they largely depend on catastrophes and the stock market. Somewhere between the two camps is predicting reserve growth. Our research indicates that the link between premium and reserve growth can be complicated.

In a steady state environment premium and reserves should grow at the same rate. If a company grows the top line by 5% every year its reserves should also grow by the same amount. Nothing fancy there.

Very few companies grow at a steady rate. Most take advantage of hard markets by raising rates and keep a lid on growth during soft markets. This results in premium fluctuations consistent with market cycles.

The reserves on the books today could cover claims as far back as ten years, but most of them relate to recent years. With each passing year, old reserves roll off the books and new reserves are added. In this way reserves are always rotating forward.

We built a model to study the relationship between premium and reserve growth. It yielded some interesting findings. In times of rising premium growth, the reserves should grow at a slower pace than premium. On the other hand, when premium growth slows, the reserves should continue to increase at a rate higher than premium.

Table 1 illustrates this. Notice how when the premium spikes 20% in year 12, the reserves grow only 13%. Then, in year 14 when the premium is flat, the reserves still need to increase 5%. This seems counterintuitive. When top-line growth finally returns beginning in year 18 the reserve growth follows behind.

It is unrealistic to expect the loss ratio to stay flat through the market cycle. It is more likely that the loss ratios will dip in hard markets and rise in soft markets. Table 2 shows that when the loss ratios fluctuate, the reserve lag becomes amplified. Notice how slowly the reserves grow in years 11 and 12 compared to premium. Then, when the soft market hits in year 14 the reserves still need to grow by 9%.

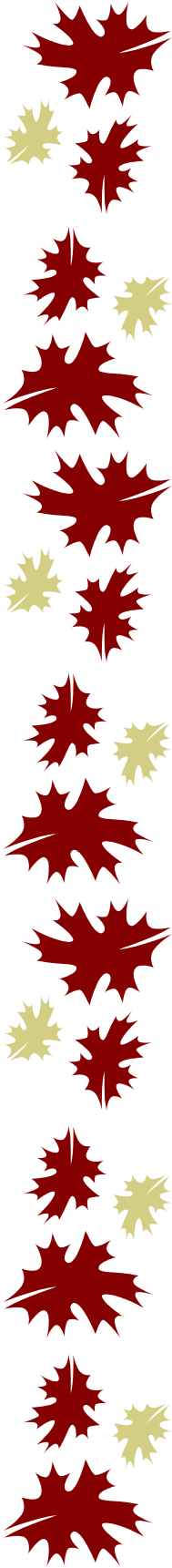
There are, of course, other factors that can come into play: settlement rates, large claims, reinsurance and policy limits, to name a few. And still, nothing can really replace a traditional reserve study. Our model offers a guide to high-level financial planning that is best applied between year-ends.

table 1
Steady 70% Loss/LAE Ratio

Year	Premium Growth	Reserve Growth
before	5%	5%
10	5%	5%
11	10%	7%
12	20%	13%
13	5%	9%
14	0%	5%
15	-5%	1%
16	-5%	-1%
17	0%	-1%
18	5%	1%
19	5%	3%
20	5%	4%

table 2
Variable Loss/LAE Ratio

Year	Loss/LAE Ratio	Premium Growth	Reserve Growth
before	70%	5%	5%
10	70%	5%	5%
11	65%	10%	4%
12	60%	20%	7%
13	65%	5%	10%
14	70%	0%	9%
15	75%	-5%	6%
16	80%	-5%	4%
17	75%	0%	0%
18	70%	5%	-1%
19	70%	5%	1%
20	70%	5%	3%



Inside the BCAR - A Closer Look at Net Required Capital

Several readers commented that the article “*Running in Place – Rising BCAR’s and Flat AM Best Ratings*” from our summer 2005 newsletter struck a chord. It seems others share our frustration with Best’s apparent bias against small regional companies. This article dissects the BCAR calculation starting with the denominator - Net Required Capital.

Like any ratio, Best’s Capital Adequacy Ratios, compare one number to another. More than the inverse of the standard premium-to-surplus benchmark, the BCAR relates a company’s adjusted surplus to the net required capital (NRC).

$$\text{BCAR} = \text{Adjusted Surplus} / \text{Net Required Capital}$$

The NRC step attempts to quantify the capital that will be necessary for the company to meet its claim obligations. Since we are shooting for a high BCAR, we want a low NRC. NRC is further broken down into two main categories: Asset Risk and Underwriting Risk.

$$\text{Net Required Capital} = \text{Asset Risk} + \text{Underwriting Risk}$$

The Asset Risk component assigns risk levels to the carried assets. As could be expected, safe government bonds score well but ownership in private companies is penalized. We are reminded of the early 90’s when an insurance company had half of its assets in a private chocolate company. They are long out of business.

The Underwriting Risk segment carries much more weight than Asset Risk. Here a company’s reserves and net written premium are scrutinized. Best begins with the carried reserves then applies factors for deficiency, discount, required capital, growth and diversification. All five factors are subject to Best’s assessment of your reserves. A conservative reserve stance will set the right tone here.

Net written premium is the most significant single piece of the NRC. As with reserves, Best adjusts the premium for required capital, growth and diversification. Companies with a mix of liability and property business get credit for a balanced underwriting strategy.

Finally, to recognize that some of the elements of the NRC are correlated, a modification is made to correct for double-counting. This covariance adjustment can be substantial. It is to your benefit to earn a high adjustment as it will lower the denominator and raise the BCAR.

In our next newsletter we will discuss the numerator of the BCAR - Adjusted Surplus.



“The net required capital step attempts to quantify the capital that will be necessary for the company to meet its claim obligations.”



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Streff
INSURANCE SERVICES

Streff Insurance Services provides a wide range of actuarial consulting support to property and casualty insurance companies, self-insurance funds and state insurance departments. We trace our roots back to 1983 and have been located in picturesque Red Wing, MN since 1995. Since then our client base has steadily grown and our relationships with our other insurance vendors have strengthened.

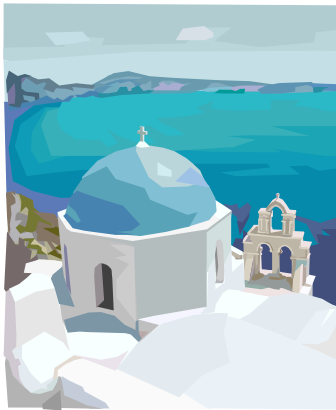
We are known for our concise and informative reports, independent views and practical advice. Open communication and a sharp focus on the end product are the keys to meeting project deadlines and keeping clients satisfied. Our areas of specialty include loss reserves, pricing, reinsurance analysis, start-up feasibility studies, strategic management and industry research.

Odds and Ends

We are pleased to add two new clients. Pharmacists Mutual, as the name suggests, has a proud history serving pharmacies. They are represented in nearly every state and have expanded into personal lines. Sheboygan Falls Mutual has roots in Homeowners, but is branching out to Auto Liability and CMP. Both companies named us as their independent actuarial firm.

Jim will teach at a Booke seminar November 9 and 10 on "Schedule P Analysis". Booke draws insurance executives from all over the country to its Winston-Salem campus.

In the category of "better late than never", we will be switching our year-end reserve model from Lotus 1-2-3 to Excel this year. The new exhibits will contain extra statistics, graphs and interact better with Word and Adobe.



There are two new downloads on our website: www.streffinsurance.com. Both are from Jim's June presentations at the NAMIC Management Conference in Farmington, PA. "An Executive's Viewpoint of a Loss Reserve Study" emphasizes the importance of a fall reserve review using granular data files. Jim also advocated a second independent review of the reserves every three years. "Analyzing Attachment Points for Excess of Loss Reinsurance" discussed simulation techniques as they relate to reinsurance decisions.

On the personal side: Jim became a grandfather for the sixth time when his daughter, Katherine, gave birth to Lucia Leone September 30th. Steve attended a U2 concert in September. Cheryl toured the Greek islands in July for three weeks.