Summer 2006 Quarterly Newsletter

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# FOCUS

P&C Actuarial Insight

Streff INSURANCE SERVICES

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## In this Issue . . .



## Summer Update From Steve Streff

Like most of our clients, summer is usually a time of planning for busier seasons, catching up and taking life a little easier. It's just the natural rhythm of an actuarial consulting firm with heavy year-end work. This summer has been different and we're pleased to say that word is getting out about our firm and the broad scope of our services. Here are some highlights.

With the guidance of a reinsurance broker, we're building a dynamic financial analysis (DFA) model. DFA allows a company to combine all of its business variables to quantify and predict future results with midpoints and ranges of confidence. After defining key inputs such as loss curves, catastrophes, investment returns and growth rates, simulation techniques allow the user to blend them all together. Other consultants and software companies don't offer customized DFA models that are affordable to smaller insurance companies. As we develop this model with additional clients, we'll increase its complexity and depth. Look for more on this in future issues of Focus.

Al Hapke, the newest member of the Streff team, has added three companies to his stable of central-states clients. Upland Mutual in Junction City, Kansas and Benchmark Ins. Co. in Kansas City have appointed our firm as their independent actuary. Haas & Wilkerson, a large broker also in Kansas City, has retained Al as the actuary for the Missouri Wood Industries Insurance Trust.

Jim Streff conducted a "webinar" through NAMIC on "The Value of Customer Loyalty". Forty-five companies logged onto the internet to hear and see Jim teach two separate one-hour classes. Visit www.namic.org/seminars for a summary of Jim's webinar and information on upcoming NAMIC events.

We've been busy with several credit scoring projects. As the industry moves toward complete acceptance and use of credit scoring, we're helping clients refine their auto insurance rates. These clients tell us that without credit scoring, it's difficult to reach the better drivers and surcharge the riskier ones. It's not that all companies need to follow the highly-sophisticated Progressive/GEICO approach, but most companies will benefit from a simple recognition that credit scores can have some claim predictive value.

A rate review of an errors and omissions program was put on the fast track when a new client came to us with the need to change rates ASAP. After quickly sizing up the profit situation, we pinpointed pockets of opportunity and advised new rates accordingly. Such a project could not have been conducted in the busy year-end season and was the perfect fit for July.

Thanks to those readers who offered improvements to Schedule P in response to last issue's article "Tweaking Schedule P". One reader would like to see CMP split into its property and liability components. Another reader wishes for a more detailed presentation of assumed reserves rather than consolidating them together with the direct reserves. Both ideas make sense to us.

Our intern Ryan Beckman has a bright future as an actuary. Ryan, from nearby Lake City, will be a senior at Hamline University, in St. Paul. A math major, Ryan also participates in varsity swimming and track. He has far exceeded our expectations and his fingerprints are on all of this summer's projects and proposals. His presence has made us realize that we could benefit from a full-time actuarial student.

We occasionally make adjustments to our mailing list so that we can reach as many companies as possible. Please let us know if someone in your office would like to be added to our mailing list. As always, any issue of Focus can be downloaded from www.streffinsurance.com.

Steve

## Specialty and Regional Companies are Hot—The First Annual Momentum Rankings

Summer is the season of insurance lists. AM Best does a fine job assembling year-end data and ranking companies by premium and profits. The premium rankings don't change much from year to year. Just how long has State Farm been the largest insurer anyway?

This article introduces the first annual Momentum Rankings as developed by Streff Insurance Services with data from Best's 2006 Key Rating Guide. By measuring financial indicators over a five year span and weighting toward the current years, a company's momentum can be quantified. Reviewing hot and cold companies can teach us lessons about current business strategy.

> "Reviewing hot and cold companies can teach us lessons about current business strategy."

In our model, surplus growth accounts for half of each company's score with a 40% weight assigned to the growth in 2005. Combined ratios and premium growth each account for one-quarter of the score. Insurers' are penalized for premium growth that is excessively fast, as high quality firms tend to grow about twice about fast as the typical industry average. The industry's 2005 revenue growth was minuscule, so companies were rewarded for slow growth.

The nearby table ranks the largest 50 companies by momentum. The scores for the three components are measured with symbols similar to those found in Consumer Reports. Solid circles represent the top quintile and completely hollow circles represent the bottom quintile. A quick study of the rankings uncovers several trends:

- Specialty firms are in high gear. WR Berkley and Chubb are the hottest companies right now. Their insistence on underwriting to a profit through hard and soft markets, regardless of the growth consequences, is a winning strategy. FM Global, Berkshire Hathaway (GEICO) and Markel also excel at underwriting.
- Regional companies have fared well. Gentle Midwest weather has helped American Family, Erie and Auto-Owners. Commerce and Selective have taken advantage of very favorable auto insurance trends in two difficult east coast states.
- The big guys have cooled down. Notice all the big companies between 31 and 40. Hurricanes badly damaged the results of these firms. Also, since it's harder to gather momentum when you're big, the largest firms will tend to congregate toward the middle of the rankings.
- Reinsurance is ice cold. What happens when you combine two companies with absolutely no momentum? We'll soon find out as Swiss Re and Employers Re merged earlier this year. The reinsurance market is on pins and needles as the hurricane season reaches its peak. Primary companies should look for some relief in reinsurance rates if the hurricane season is normal.

A word of caution about our rankings: momentum gauges only a company's current direction. We make no attempt here to rate financial strength. GMAC has momentum but may soon face a rating downgrade. Sentry has cooled in recent years, but still has strong financial leverage.

Where would your company rank here? Drop us a line and we'll run your five-year numbers through our model.

| | Momentum Rank | Company | Surplus Growth | Combined Ratio | Premium Growth | Premium Rank |
|---|---|---|---|---|---|---|
| hot | 1 | W.R. Berkley | ● | ● | ● | 19 |
| | 2 | Chubb | ● | ◉ | ● | 11 |
| | 3 | Commerce | ◉ | ● | ● | 42 |
| | 4 | American Family | ● | ◉ | ● | 14 |
| | 5 | ACE | ● | ◉ | ◎ | 18 |
| | 6 | Selective | ● | ◎ | ◉ | 46 |
| | 7 | FM Global | ● | ● | ○ | 29 |
| | 8 | Old Republic | ◎ | ● | ◉ | 35 |
| | 9 | GMAC | ● | ◎ | ◎ | 28 |
| | 10 | Berkshire Hathaway | ◉ | ● | ◎ | 5 |
| warm | 11 | Markel | ◎ | ● | ● | 44 |
| | 12 | AIG | ◎ | ◎ | ● | 2 |
| | 12 | Auto Club of So. CA | ◉ | ◉ | ◉ | 34 |
| | 12 | Westfield | ◉ | ◉ | ◎ | 47 |
| | 15 | Erie | ◉ | O | ● | 22 |
| | 15 | Auto-Owners | ◉ | ◎ | ● | 21 |
| | 17 | State Comp. Fund of CA | ● | ◎ | ○ | 15 |
| | 18 | USAA | ◎ | ● | ◉ | 12 |
| | 19 | Safeco | ◎ | ◉ | ◉ | 16 |
| | 20 | Progressive | O | ● | ● | 7 |
| neutral | 21 | Mercury General | O | ● | ◉ | 27 |
| | 22 | Cincinnati | ◎ | ● | ◎ | 24 |
| | 23 | Hartford | ◉ | O | ◎ | 10 |
| | 24 | Everest Re | ◉ | ◎ | ○ | 31 |
| | 25 | Liberty Mutual | ◉ | ○ | ◎ | 8 |
| | 25 | CA State Auto | ◎ | ◉ | ◎ | 33 |
| | 27 | State Ins. Fund of NY | ● | ○ | O | 43 |
| | 28 | Zurich U.S. | ● | ○ | ○ | 17 |
| | 29 | Great American | ◉ | O | ○ | 32 |
| | 30 | Unitrin | ◎ | O | ◉ | 39 |
| cool | 31 | State Farm | O | O | ◉ | 1 |
| | 32 | St. Paul Travelers | ◎ | ○ | O | 4 |
| | 33 | Nationwide | O | ◎ | ◉ | 6 |
| | 34 | Winterthur | O | ◎ | O | 50 |
| | 35 | NJM | ○ | O | ● | 48 |
| | 36 | Country | O | ◎ | ◉ | 38 |
| | 37 | Southern Farm Bureau | ○ | ◉ | ◉ | 40 |
| | 37 | Hanover | ◎ | O | O | 36 |
| | 37 | Allstate | ○ | ◉ | ◎ | 3 |
| | 40 | Farmers | O | O | O | 9 |
| cold | 41 | Assurant | ○ | ◉ | ○ | 45 |
| | 42 | Fairfax | O | ○ | O | 23 |
| | 43 | Ohio Casualty | O | O | O | 49 |
| | 44 | MetLife Auto & Home | ○ | ◎ | O | 25 |
| | 45 | Firemans Fund | O | O | ○ | 20 |
| | 46 | CNA | ○ | ○ | O | 13 |
| | 47 | White Mountains | ○ | ○ | O | 26 |
| | 48 | Swiss Re America | ○ | ○ | ○ | 37 |
| | 49 | Sentry | ○ | ○ | ○ | 41 |
| | 50 | Employers Re | ○ | ○ | ○ | 30 |

Key: Companies ranked by quintile
●=1-10, ◉=11-20, ◎=21-30, O=31-40, ○=41-50

## BCARs Continue to Rise, Rating Mood Improves

In spite of a record level of natural catastrophe losses and a softening market, BCARs were on the move in 2005. This was driven by another profitable year which, in turn, added to the industry's surplus. The industry appears at the moment to be exceedingly healthy, leading many observers to wonder if companies will repeat the mistakes of the previous long soft market.

Table A shows median BCARs by AM Best rating as taken from the 2006 Key Rating Guide. The median, or the middle number, is a better measure of the typical company rather than the average because there are many specialty firms with peculiar financials that distort the averages. There was across-the-board improvement for companies rated B or higher.

**Rising BCARs**

| Rating | 2005 BCAR | 2004 BCAR | Change |
|---|---|---|---|
| A++ | 295 | 284 | 11 |
| A+ | 238 | 237 | 2 |
| A | 241 | 234 | 7 |
| A- | 210 | 194 | 16 |
| B++ | 184 | 169 | 15 |
| B+ | 148 | 141 | 7 |
| B | 135 | 125 | 10 |
| B- | 99 | 109 | (10) |

Table A

Best has been revising the catastrophe component of the BCAR denominator (net required capital). What was previously considered a 1 in 250 year event has been revised to a 1 in 50 or 100 year event. That makes this year's BCAR progress all the more impressive.

Some say that Best and the three public cat modelers over-reacted to last year's hurricanes. But who can blame them when six of the eight all-time costliest disasters have happened in the past five years? It's only natural to trend current events forward and so difficult to zig when everybody else is zagging.

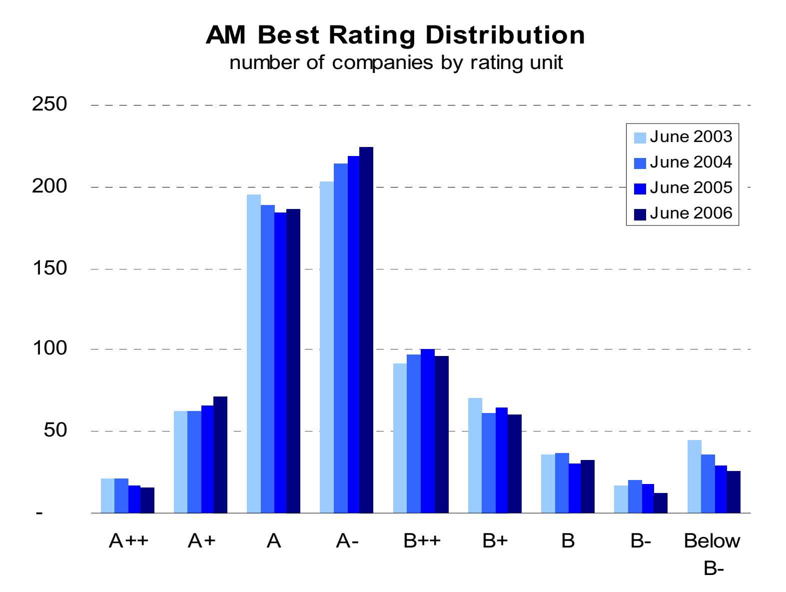
Table B displays median financial statistics by rating. As always, there is a clear relationship here. High ratings tend to go to large companies with low expense ratios and high BCARs. Low-rated insurers have the opposite qualities. As many readers know by now, small companies need to score a huge BCAR to earn a high rating.

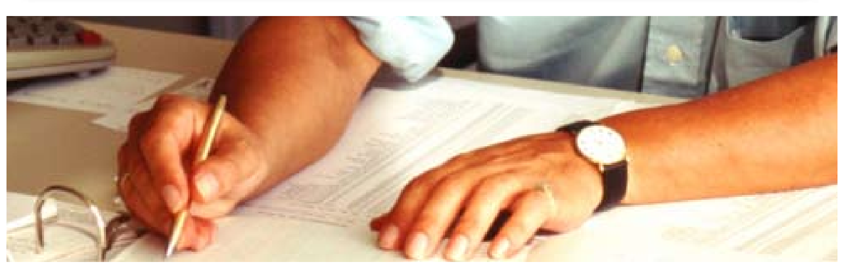
**Median Statistics**

| Rating | Net Written Premium | NWP to Surplus Ratio | Combined Ratio | Expense Ratio | BCAR |
|---|---|---|---|---|---|
| A++ | 1,414,679 | 0.8 | 94 | 22 | 295 |
| A+ | 686,403 | 1.1 | 95 | 27 | 238 |
| A | 117,679 | 1.0 | 93 | 30 | 241 |
| A- | 47,336 | 1.1 | 95 | 31 | 210 |
| B++ | 17,114 | 1.2 | 97 | 35 | 184 |
| B+ | 15,880 | 1.3 | 100 | 33 | 148 |
| B | 7,277 | 1.4 | 99 | 37 | 135 |
| B- | 17,816 | 1.5 | 95 | 43 | 99 |

Table B

The nearby graph shows the rating distribution over the four most recent years. The A- rating has emerged as the favorite grade. It's somewhat surprising to see the decline in low-rated companies. Some of these firms are withdrawing their ratings (NR-4) or throwing in the towel by merging with a competitor. More likely, they are turning things around the old fashioned way by getting back to basics. Sometimes it takes Best a while to recognize the comeback and that's the frustration we most often hear.



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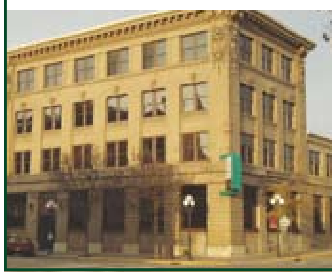
*Streff Insurance Services provides a wide range of actuarial consulting support to property and casualty insurance companies, self-insurance funds and state insurance departments. We trace our roots back to 1983 and have been located in picturesque Red Wing, Minnesota since 1995. Since then, our client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

*We are known for our 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.*



## Settlement Rate Strategies

Forming a claim settlement strategy is one of the most important decisions insurance managers will make. Should claims be closed out quickly to avoid legal battles? Or is it to your advantage to hold the money a little longer to earn income and wear down the claimant? We would lean toward settling claims on the quick side, but some companies have done well by stretching out settlements.

Under either strategy companies should know how their settlement rates compare to the industry. The time it takes to settle a claim depends on the line of coverage. Property claims rarely involve lawyers and tend to settle quickly. The claims from long-tailed liability lines are more likely to linger for years. The table shows industry settlement rates for seven leading Schedule P lines arranged from faster to slowest.

For example, 99.4% of all Personal Auto Liability claims are settled within five years of occurrence. However, the remaining .6% are difficult cases and represent about 2% of the accident year's total incurred losses and expenses. For Med Mal only 1% of claims are open after ten years, but those tough claims are associated with 5% of the ultimate costs.

Changes in the legal climate and interest rates can motivate companies to gradually shift strategies over time. We prefer to see consistent settlement rates from year to year, as it stabilizes the projection methods and results in a better reserve estimate. Settlement rates also play into the incurred losses, the average case reserves and the paid-to incurred ratios.

**Industry Settlement Rates**
Measuring the Ratio of Closed to Reported Claims

| Age of Accident Year | Homeowners | Personal Auto Liability | CMP | Commercial Auto Liability | Workers' Comp. | Other Liability | Medical Malpractice |
|---|---|---|---|---|---|---|---|
| 12 months | 90.5% | 78.3% | 78.1% | 75.1% | 71.8% | 35.2% | 29.2% |
| 24 months | 98.8% | 95.1% | 93.1% | 92.3% | 89.4% | 69.5% | 60.5% |
| 36 months | 99.5% | 97.8% | 96.0% | 95.9% | 94.7% | 85.0% | 77.0% |
| 48 months | 99.7% | 98.9% | 97.3% | 97.7% | 97.1% | 90.1% | 85.6% |
| 60 months | 99.9% | 99.4% | 98.6% | 98.8% | 98.2% | 93.5% | 91.1% |
| 72 months | 99.9% | 99.7% | 98.7% | 99.3% | 98.8% | 95.6% | 94.3% |
| 84 months | 100.0% | 99.8% | 99.3% | 99.6% | 99.1% | 97.4% | 96.7% |
| 96 months | 100.0% | 99.9% | 99.5% | 99.7% | 99.3% | 98.1% | 97.9% |
| 108 months | 100.0% | 99.9% | 99.6% | 99.8% | 99.5% | 98.5% | 98.5% |
| 120 months | 100.0% | 100.0% | 99.6% | 99.8% | 99.6% | 99.3% | 99.0% |

*Source: Best's Aggregates and Averages*