Who's Got Your Back?

Charles Huber

A.M. Best's Treatment of Schedule F in the Rating Process

The use of traditional reinsurance to provide capacity, stabilize underwriting results and protect surplus can play an important role in helping to determine the financial strength of property/casualty insurance companies. A.M. Best's assessment of a company's ceded reinsurance program begins with a discussion with management on the types, amount and cost of reinsurance that is used. Companies that increase their dependence on reinsurance reduce their net retained risk and capital requirements for that risk. However, capital requirements for the associated reinsurance credit risk are increased.

The importance of an analysis of Schedule F depends upon the extent that reinsurance is used and how highly leveraged surplus is. Underwriting leverage is determined by evaluating current premiums, amounts to be recovered from reinsurance and loss reserves. Several factors are employed in assessing whether a company's underwriting leverage is prudent: the types of business written (i.e., short tail vs. long tail), the quality and appropriateness of the reinsurance program and the adequacy of loss reserves.

In recent years, catastrophe models used in evaluating property coverage have begun projecting higher potential gross loss estimates from hurricanes than previously thought. These models also predict that significant losses may occur further inland than previous forecasts. Some companies have questioned the results of those models and are taking a closer look at whether their reinsurance limits are adequate. Hurricanes are not the only worry. Catastrophic tornadoes

illustration / Myers Creative

such as those that occurred in 2011 in Missouri, Alabama and other states, as well as earthquakes that ravaged Japan and New Zealand, along with an overall increase in other severe weather events have prompted companies to examine coverage for catastrophic property losses on an occurrence and on an aggregate basis.

Reinsurance credit risk is one component of overall credit risk evaluated in Best's Capital Adequacy Ratio model (BCAR). Schedule F Parts 3, 4 and 5 in the Statutory Annual Statement are important tools in assessing the quality of that credit risk and whether the credit risk is spread out among many reinsurers or concentrated in a few. A company's reinsurers are assessed for the quality of their financial strength and payment activities and whether amounts to be recovered under reinsurance can be easily collected.

Reinsurance recoverables from domestic and foreign affiliates are originally assessed a baseline charge of 10%. This charge may be adjusted, based on a thorough analysis of the affiliate's creditworthiness. For consolidated rating units (several legal entities that share the same rating of the parent or lead company in the group) with intercompany reinsurance transactions, A.M. Best eliminates those recoverables from the credit risk analysis. Recoverables from affiliates that are not in the rating unit remain in the credit risk analysis. In addition, recoverables from all affiliates remain in the credit risk analysis when performing an analysis of a company on a stand-alone basis.

Similarly for nonaffiliated reinsurers, A.M. Best's capital model starts with a baseline 10% charge for reinsurance recoverables. The capital model allows the analyst to assign variable risk charges based on each reinsurer's financial strength rating from A.M. Best. Those charges range from a low of 2% for a

Who's Got Your Back (continued)

reinsurer with a financial strength rating of A++ (Superior) to charges of more than 50% for reinsurers with ratings in the "Vulnerable" range, or for those not rated. Risk charges for unrated reinsurers could reach 100% unless additional information is provided, which may possibly result in a lower risk charge.

The use of unauthorized reinsurers (reinsurers not regulated in the ceding company's state of domicile) traditionally requires that the unauthorized reinsurer provide collateral to the ceding company by either depositing funds, setting up trust accounts whereby the ceding company is the beneficiary, or by providing the ceding company with an irrevocable letter of credit to offset statutory penalties. A.M. Best may consider these forms of collateral as an offset to amounts recoverable from a reinsurer. A thorough review of a letter of credit or trust agreement will reveal if there are any restrictions on the ceding companies ability to draw down on these instruments to satisfy their outstanding balances. Due to the associated transfer, timing and credit risks associated with letters of credit and trust agreements, A.M. Best typically allows for a maximum credit of 90% for the value of the letter of credit or trust fund that is not in excess of the outstanding reinsurance recoverable. Other risk factors may further reduce the credit. However, offsets tied to the occurrence of specific conditions before the collateral is posted might not receive an offset credit until the collateral option is exercised. The reason is that the collateral cannot be accessed until certain thresholds have been triggered.

Some companies may be considered overly dependent on unaffiliated and foreign-affiliated reinsurers, given their lines of business and financial resources. That would lead analysts to impose additional capital requirements or surcharges. For those insurers, A.M. Best increases the overall credit risk charge for their recoverable balances regardless of the underlying credit quality. This additional charge reflects the increased exposure to reinsurance disputes and cash flow problems often experienced by companies that are unusually dependent on reinsurance.

A thorough review of a letter of credit…will reveal…any restrictions on the ceding companies ability to draw down on these instruments to satisfy their outstanding balances.

Higher exposure to dispute risk exposes a company's surplus to increased risk. A company with reinsurance recoverables equal to five times its surplus could lose 50% of its surplus should its reinsurer successfully dispute 10% of its recoverables. To recognize this exposure to dispute risk, A.M. Best employs two tests to measure a company's dependence on reinsurance. The first test compares the company's ratio of reinsurance recoverables from unaffiliated and foreign-affiliated reinsurers to an industry benchmark. The second test examines the company's total ceded leverage to thresholds of five, seven and 10 times its surplus. This may result in risk charges of 15%, 20% and 25% of recoverables from unaffiliated and foreign-affiliated reinsurers. A company's total ceded leverage is defined as its recoverables plus ceded written premium from unaffiliated and foreign-affiliated reinsurers as a ratio to surplus. The test for total ceded leverage is forward-looking as it includes not only existing recoverables but also the potential exposure to be added in the upcoming year.

The factor assessed for reinsurance dependence may be reduced for recoverables from foreign affiliates with a demonstrated history of substantial support, and that are expected to continue to provide support. In addition, the domestic company must be a significant contributor to the operations of the consolidated organization and the foreign affiliate must be located in a jurisdiction that would not hinder the quick transfer of funds that may become necessary to support the domestic company.

Ceding companies recently have explored purchasing credit enhancements that protect its reinsurance recoverables against the risk of becoming uncollectible. If those recoverables are insured by an unaffiliated third party with reduced credit risk, A.M. Best will reduce the risk charges. However, the factor assessed against reinsurance dependence may not change if the contract does not cover the possibility the amount cannot be collected because of a dispute.

Often times a company's ceded reinsurance program includes participation in mandatory or voluntary underwriting pools and associations. A.M. Best's BCAR model applies a charge of 10% to pools and association balances. These balances might be adjusted based on an evaluation of the creditworthiness of the pool and the state's regulatory environment. A.M. Best does not assess credit risk for ceded reinsurance associated with risk-free servicing-carrier business.

Reinsurance recoverable credit risk is just one component of total credit risk in BCAR. Underwriting risk, loss reserves and net written premium generally make up two-thirds of total net required capital in the model with the remaining one-third comprised of credit risk, investment risk, interest rate risk and business risk. Schedule F is just one tool in the evaluation of the appropriateness and quality of an insurance company's reinsurance program. This tool supplements in-depth discussions that A.M. Best analysts have with the senior management teams of interactively rated companies. ●

Charles Huber is a Senior Financial Analyst, Property/Casualty Division A.M. Best Company.
charles.huber@ambest.com