



FINANCIAL SERVICES

Managing Through the Commercial Lines Cycle

KPMG LLP

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- They are not necessarily the views of the CAS, KPMG, or any sponsor of this seminar
- Anyone who says otherwise is not only wrong, but is itching for a fight.

Mortgage Crisis vs. Underwriting Cycle

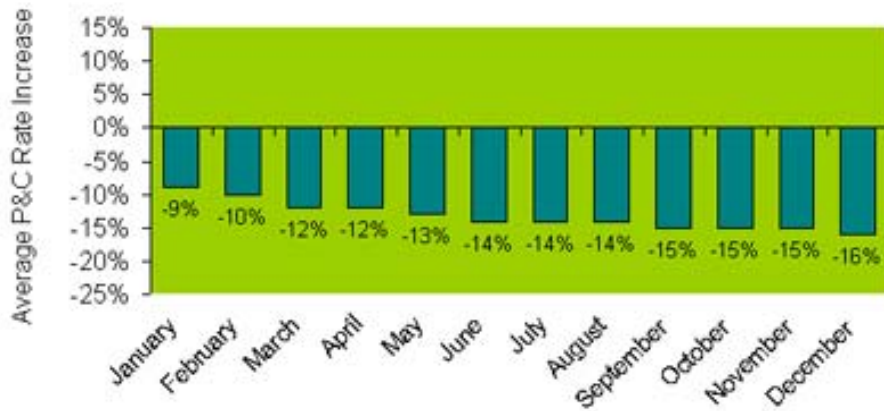
<u>Facet</u>	<u>Credit Risk</u>	<u>Insurance Risk</u>
Source of Risk that is Underwritten	Generally created by lending activity	Insurance risk is generally existing inherent risk
Risk Pricing	Risk in the loan priced into the interest rate	Risk is priced in the premium
Who takes the risk	Underwriter generally passes off to capital markets	Underwriter (insurer) generally takes risk with significant exceptions such as: *Managing Underwriters *Reinsurers
How is risk price determined?	Interest rate determined by loan underwriting characteristics such as loan to appraised value, borrower credit score	Actuarial pricing models, manual rates, underwriting judgement
Risk management structure	Enterprise risk models overseen by regulators	Actuarial and Underwriting management
Possible reasons for the crunch	Relaxing of basic underwriting standards around credit scores, appraisals, loan terms, and loan to value ratios	Relaxing of basic underwriting standards around risk pricing, underwriting risk quality, inspections, and policy terms and conditions
Are companies happy with risk management structure	Per Towers Perrin study of 3/14/2008, 9 out of 10 senior banking executives felt they were better than peers right before the collapse	Per AM BEST press release in March 2008 there is a stable outlook for commercial lines insurers

Statistical Explorations of Marketplace Performance: Questions

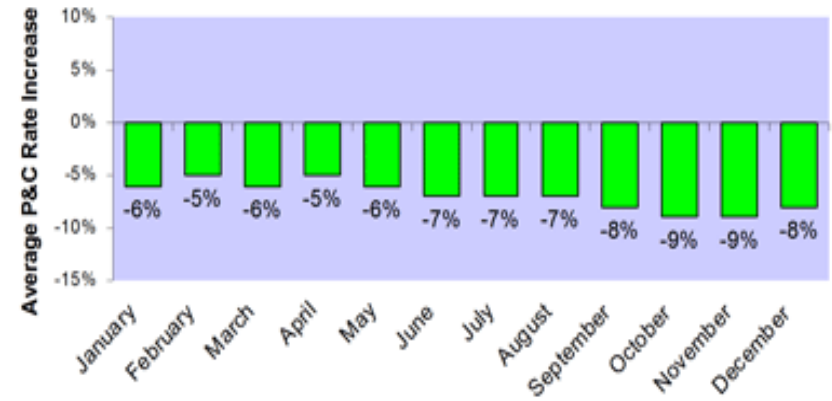
- Which factors have historically been effective predictors of marketplace performance?
- How effective have the price changes from public sources been in predicting changes in industry performance?
- What has been the relationship between reinsurance and primary performance over time?
- Where is the P/C industry currently in the underwriting cycle?
- How might the current soft market cycle differ from past cycles?
- How to Achieve Significant Operational Improvements from Effective Price Governance.

MarketScout Publishes their View of Price Change Monthly

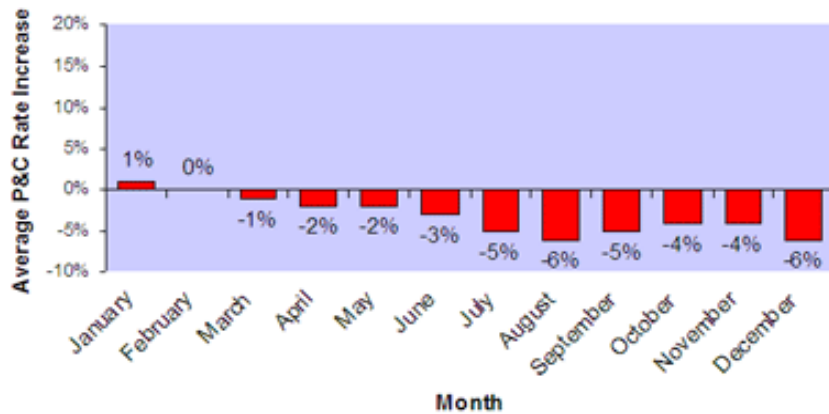
2007



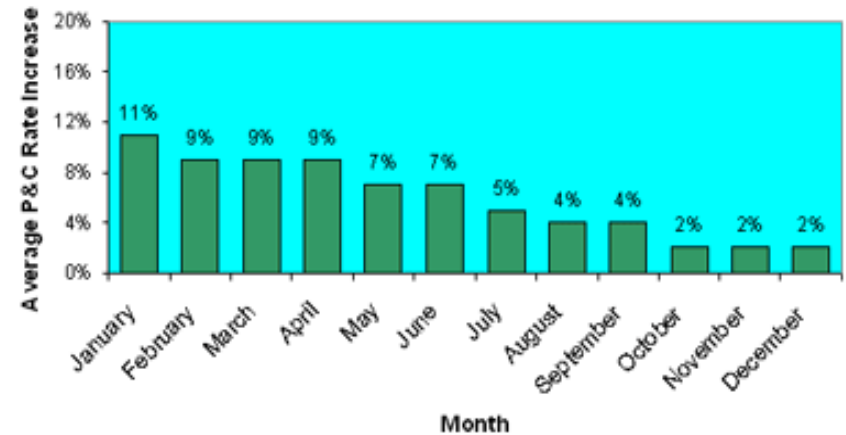
2006



2005



2004

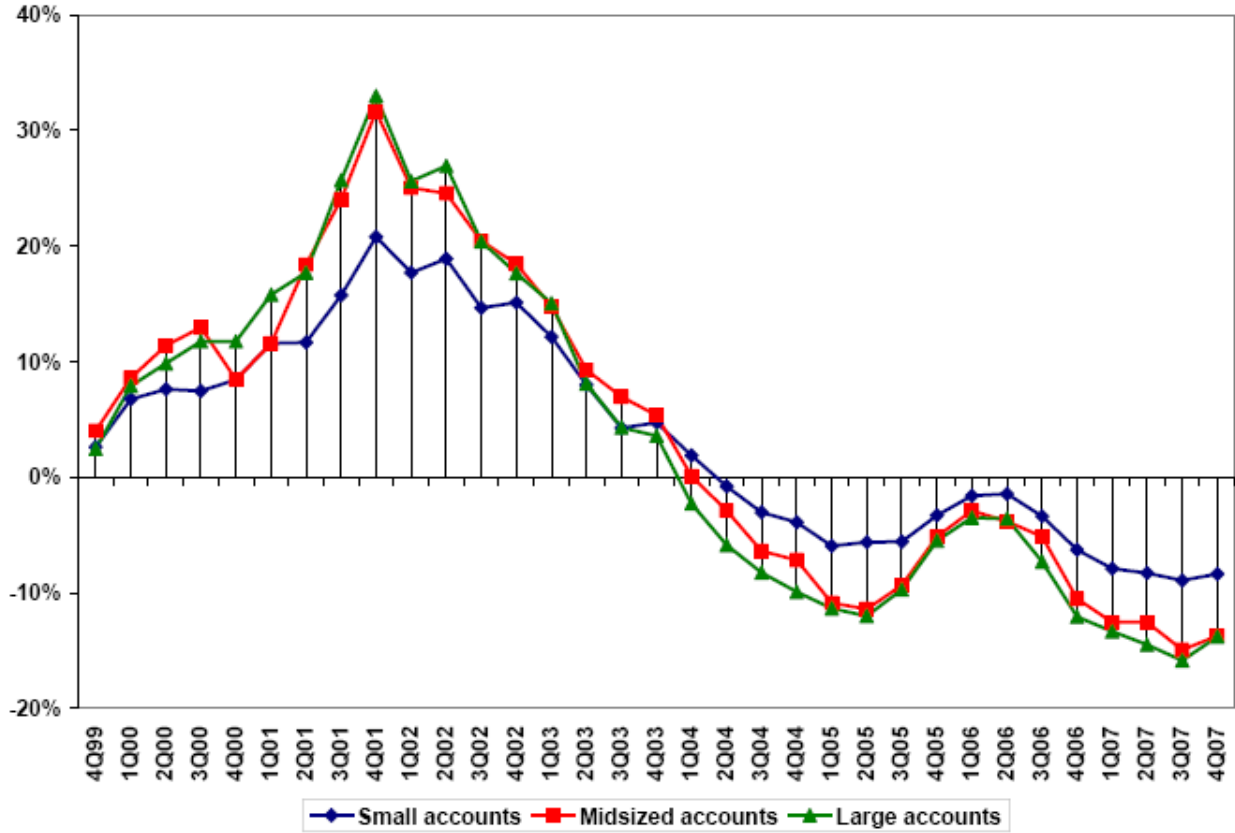


Source: MarketScout website



CIAB Publishes their View of Price Change Quarterly

Average Commercial Premium Rate Changes by Account Size



Source: Council of Insurance Agents & Brokers. Chart prepared by Lehman Brothers Equity Research.



Other Sources also Exist – Overview of Sources and with Start Dates

- Tillinghast CLIPS (2005) – Proprietary sharing of retrospective pricing by participating companies
- Advisen ADVx (2003) – Collects survey information from risk managers
- CIAB (1999) – Survey data that tracks changes in agents renewals tends to be business that is in the independent agency system
- MarketScout (2001) – Tracks rate information going through the agency portal
- Often the published conclusions seem to diverge possibly due to:
 - Market segment
 - Distribution system
 - Company renewal vs. Agency renewal
 - Distortions based on survey approach.

Source: Dowling & Partners, IBNR Newsletter, Vol XIV



Strengths and Weaknesses of Price Change Data

	Advisen	CIAB	CLIPS	MarketScout	Tendency Compared to Industry
Segment:					
Small	Red	Yellow	Green	Green	Less Change
Middle Market	Green	Green	Green	Green	More Change
Large Account	Green	Green	Green	Yellow	More Change
Includes:					
Renewals	Green	Green	Green	Green	Less Change
New to Company	Green	Green	Red	Green	More Change
New to Agent	Green	Red	Red	Red	More Change
Terms and Conditions	Red	Red	Green	Red	Accentuates Change
History Available	Yellow	Green	Yellow	Green	

CIAB and MarketScout measure new business, which may differ significantly

CLIPS measures changes in T&C, but only as well as contributors do

Source: Dowling & Partners, and the surveys themselves.

Green signifies this piece of the market is captured, yellow means somewhat captured, red indicates it is not captured.

No survey was around in The last soft market



Statistical Tests of Price Monitoring Data

- Matched historical CIAB, MarketScout price change to Industry Schedule P's to get retrospective test of predictive power of historical information:
 - These sources are public, others are proprietary
 - History was sufficient
 - Treated published data as written, and earned the changes.
- Performed regression analysis to test historical predictive accuracy
- Used Schedule P data, gross of reinsurance as the appropriate match:
 - Adjusted out several large reinsurers which appeared to have conducted whole account portfolio transfers.
- Focused on commercial casualty lines to filter out the impact of catastrophes
- Used the most recent evaluation (2006) of Schedule P understanding that accident year 2006 is still green.

Simple Regression Outputs and Significance

- Estimated the equation for years 2000–2006:

$$\text{Percentage Change in Gross AY Loss Ratio} = \beta \times (\text{Percentage Change in Historical Price Change/Trend})$$

Statistical Results of Historical Regressions

	Regression on CIAB Changes			Regression on MarketScout Changes		
	β	R - Square	F	β	R - Square	F
GL, CAL, WC, CMP	0.78	48%	0%			
GL, CAL, WC	0.78	71%	1%	0.96	99%	0%
General Liability	1.04	68%	2%			
Commercial Auto	0.66	72%	1%			
Workers Compensation	0.71	72%	1%			
Commercial Multi Peril	0.76	32%	15%			
Reinsurance B	1.03	32%	15%	1.19	40%	10%
Reinsurance B w/o 2006	1.33	57%	6%	1.54	71%	2%

Fitted Beta for Reinsurance line is greater than 1.0
Indicating greater impact on fitted loss ratio.

Beta of 1.0 indicates on target prediction of impact of price change, less than 1.0 indicates overstatement of price change, greater than 1.0 indicates understatement of price change.

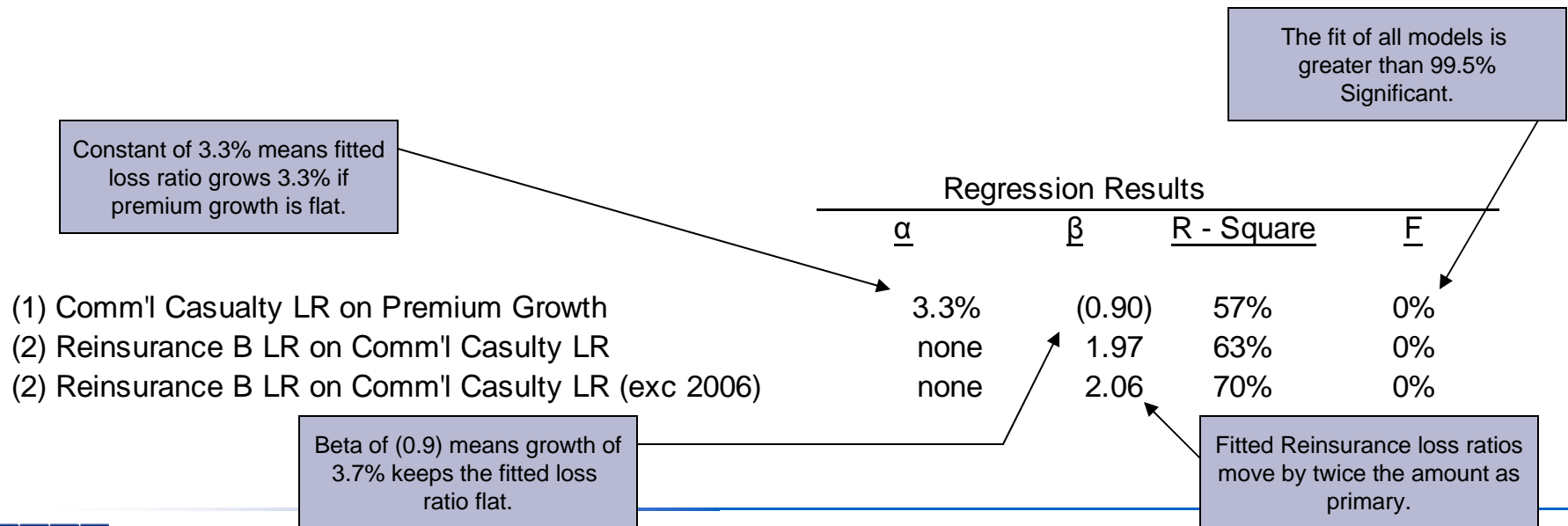
The lower the F, the more statistically significant.
The higher the R-Square, the better the fit.

Other Interesting Relationships

- Estimated the equation for years 1990–2006:

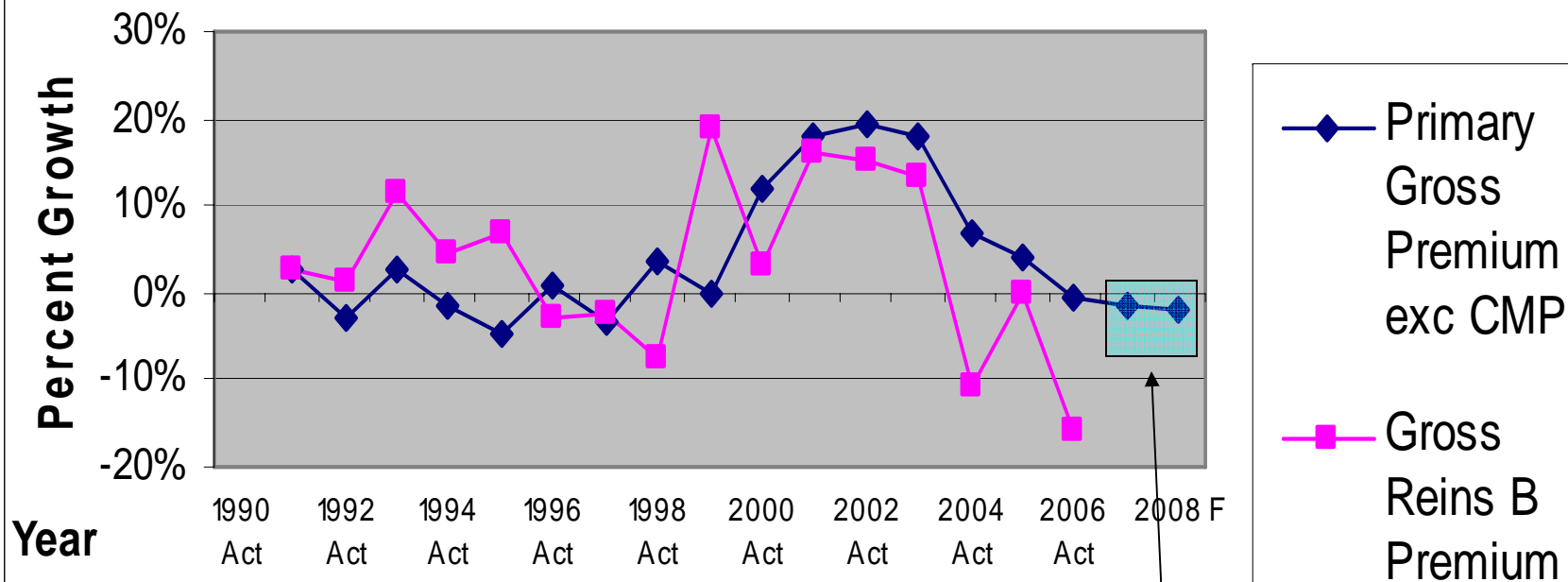
(1) Point Change in Gross AY Loss Ratio for Commercial Casualty = $\alpha + \beta \times (\text{Percentage Change in Commercial Casualty Premium})$
and

(2) Point Change in Gross AY Loss Ratio for Reinsurance B = $\beta \times (\text{Point Change in Gross AY Loss Ratio for Commercial Casualty})$



Commercial Lines and Reinsurance Premium Growth 1990-2008

Historic Premium Growth for Commercial Lines



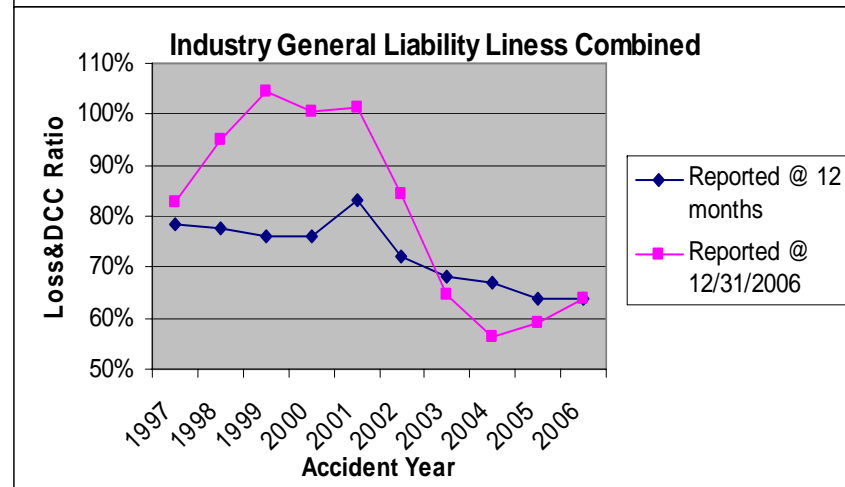
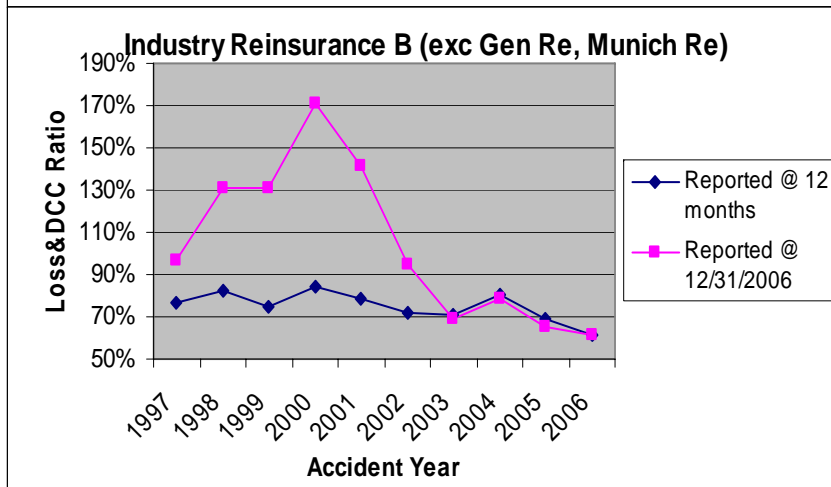
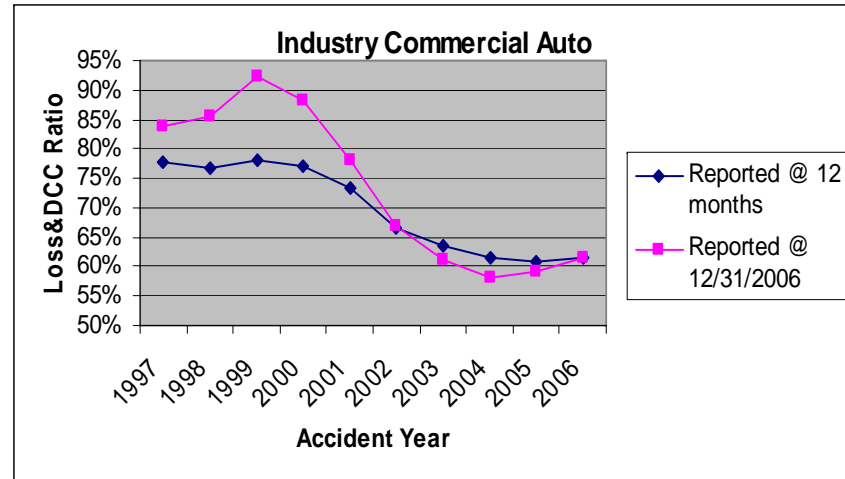
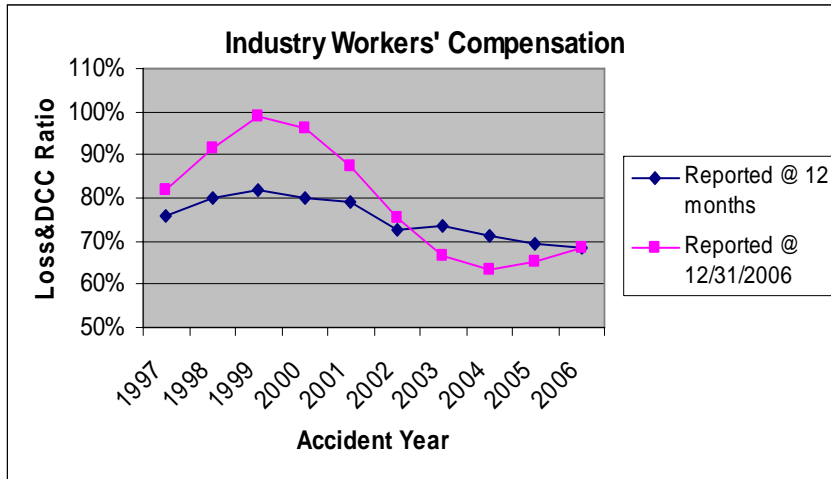
Forecast based on Insurance Information Institute early bird forecast.



Fitting the Current Years – What is the Current Position in the Cycle

- Obtained the early bird forecast for premium growth from the Insurance Information Institute:
 - Backed into the Commercial premium change by assuming a similar personal lines change as in past years.
- Obtained the latest available survey results from CIAB and MarketScout, and assumed level through the rest of 2008
- Estimated the primary loss ratio using both approaches:
 - Premium Growth equation
 - Price Change equation.

Why is Price Monitoring Important? Historical Reported Industry Results at 12 Months Compared to Actual Results

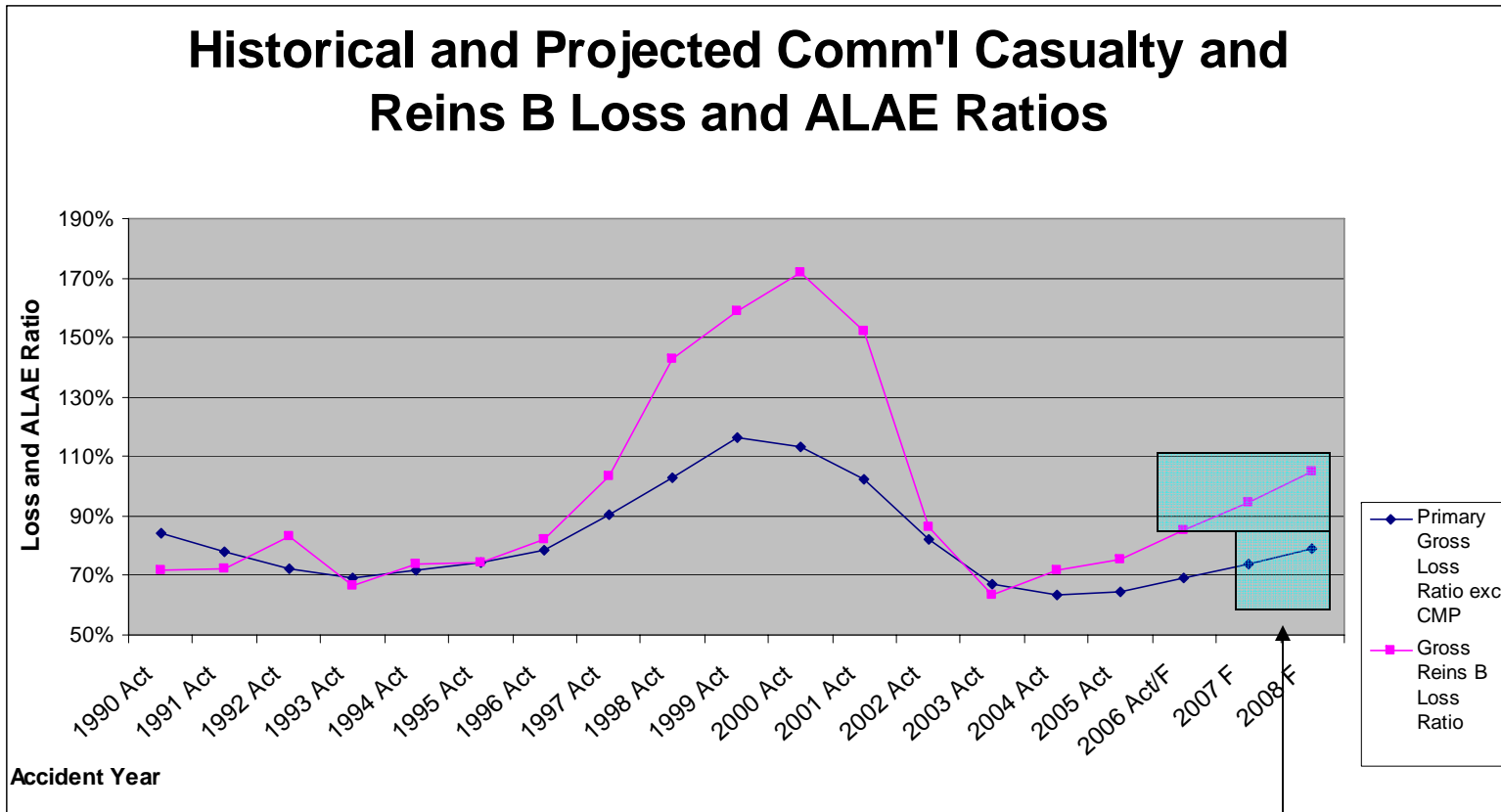


Source: AM BEST Aggregates and Averages composite Schedule P.



Fitted Values using the Premium Growth Model

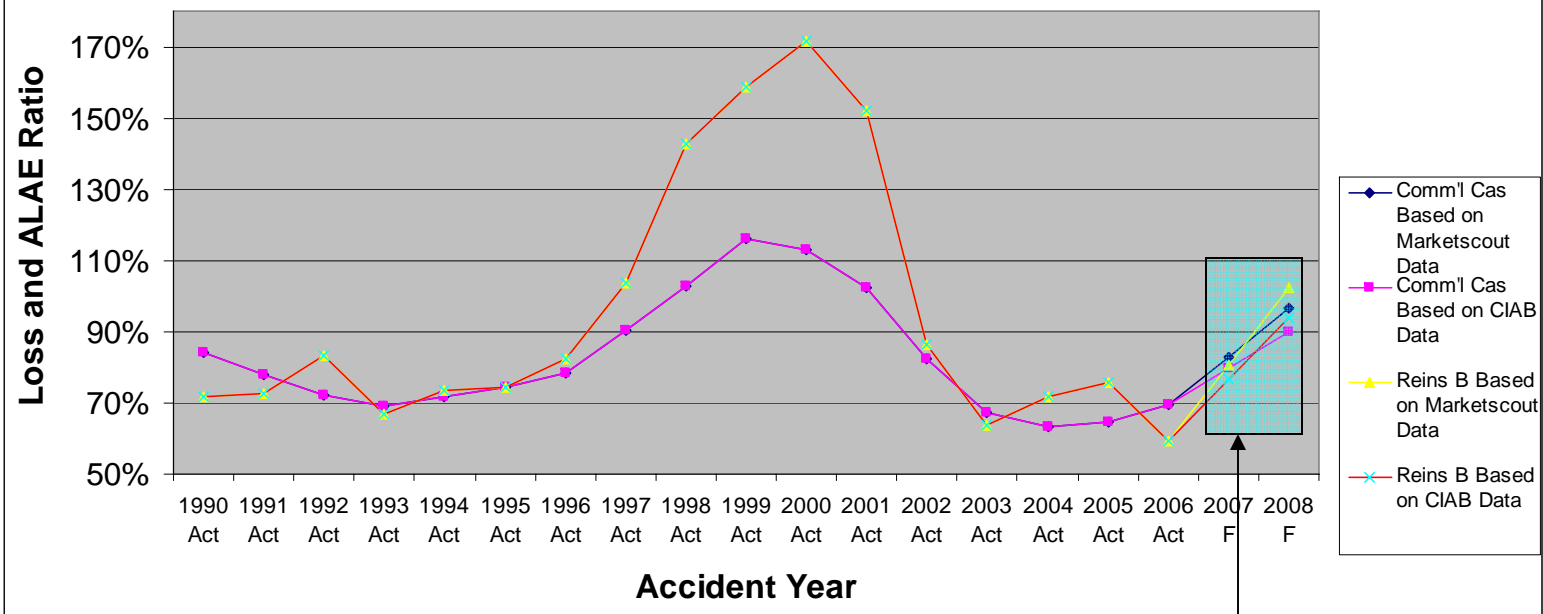
Historical and Projected Comm'l Casualty and Reins B Loss and ALAE Ratios



Fitted Values based on forecast of -1%, -2% growth in comm'l casualty premium In 2007, 2008.

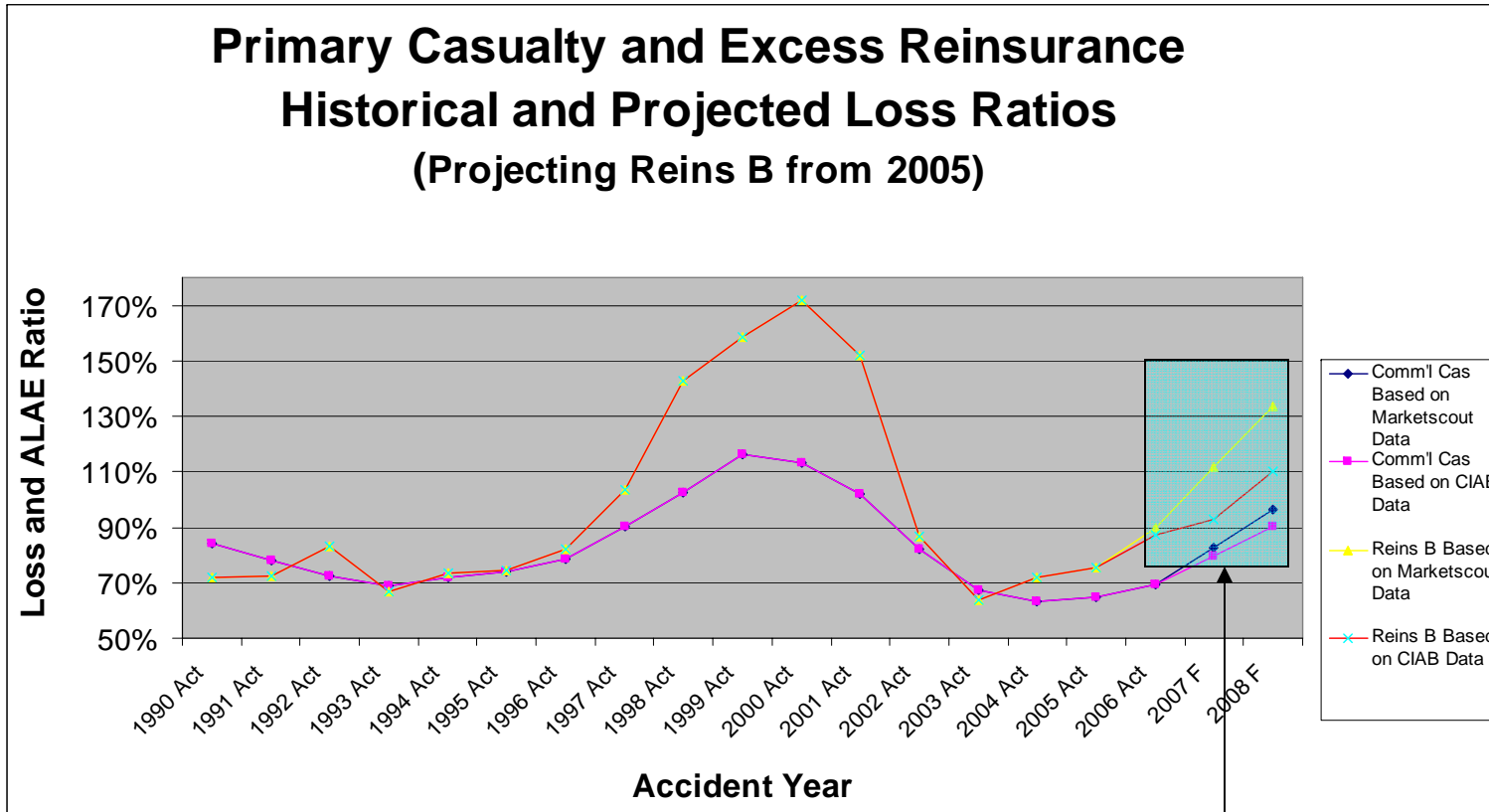
Fitted Values using the CIAB, MarketScout-based model

Primary Casualty and Excess Reinsurance Historical and Projected Loss Ratios



Fitted values based on CIAB, MarketScout price change of -13% to -14% earned in 2007, 2008.

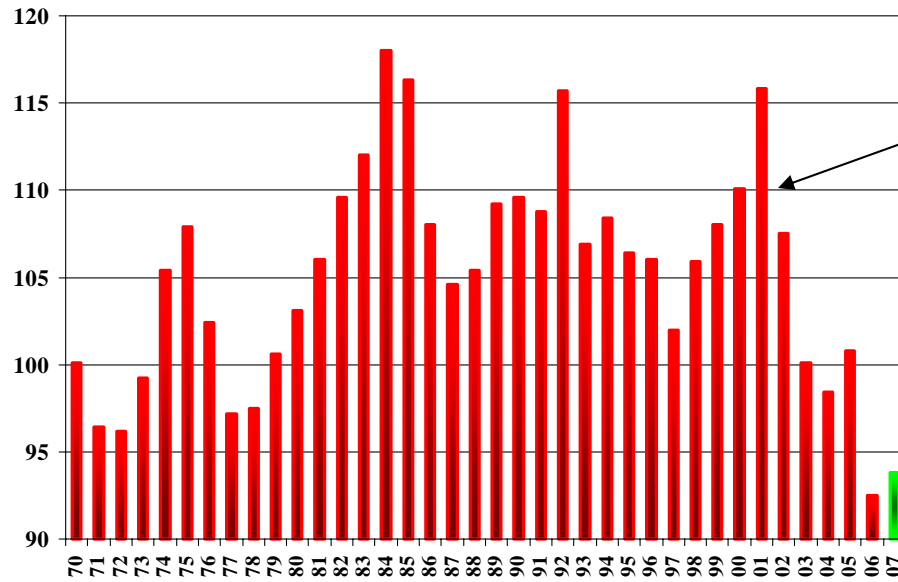
Fitted Values using the CIAB, MarketScout based model (Using a starting point for Reinsurance B of 2005)



Fitted values for 2006-2008 for Reins
And 2007-2008 for Comm'l Casualty.

Combined Ratios for the Entire P/C Industry and Cumulative Price Changes

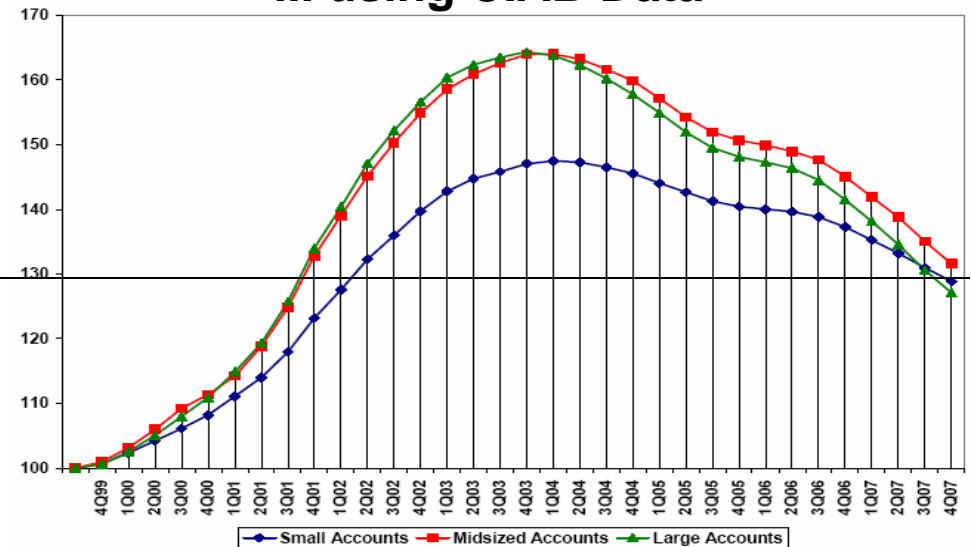
Total P/C Industry Combined Ratios



But even considering the impact of 9/11, operating results at those pricing levels are not favorable, and that doesn't consider inflation.

Cumulative Price Changes from III using CIAB Data

Using CIAB data, the Insurance Information Institute estimated current Price levels are at 2001 levels.



Why These Results may be Pessimistic

- AM BEST reports a stable outlook for Commercial Lines and Global Reinsurance (Source: Press Releases of 2/26 and 27/2008) citing investments in:
 - Price-monitoring tools
 - Predictive modeling
 - Distribution channels
 - Claims systems
 - Enterprise risk management
 - Cites the extension and permanency of the federal terrorism backstop.
- All price surveys are untested in predicting soft market conditions
- Sarbanes-Oxley may have a positive influence on accuracy of reported results.



Significant Operational Improvements Can Result from Effective Price Governance

Driving Price by Segment – Mainstreet Commercial Example

1. Analyze book of business by overall rate need and by meaningful Segment.

2. Divide the book into a manageable number of segments (stratify into A,B,C, for example).

3. Get agreement on the price need by larger segments.

4. Set up segmentation model to drive price achievement by segment, and communicate to all underwriters.

5. Monitor, Measure, Report Deviations

Drive Underwriting Quality Throughout the Process

Basic Implementation Model for Segmented Pricing Targets

	<u>A</u> <u>Classes</u>	<u>B</u> <u>Classes</u>	<u>C</u> <u>Classes</u>	<u>Total</u> <u>Book</u>
<u>Starting Position</u>				
(1) Proportion of the book	29.0%	46.0%	25.0%	100.0%
(2) Loss and ALAE ratio with no rate change	52.0%	69.0%	119.0%	76.6%
(3) Rate change on renewals	10.0%	25.0%	50.0%	20.8%
(4) Loss and ALAE ratio on new business (drive same price as renewal, but assume loss ratio is 5% worse)	51.8%	59.2%	82.7%	56.1%
(5) Net loss/exposure trend	1.5%	1.5%	1.5%	1.5%
(6) Assumed unit count retention ratio	90.0%	70.0%	20.0%	63.3%
(7) Resulting premium retention	99.0%	87.5%	30.0%	76.5%
(8) New business as percent of expiring premium	40.0%	35.0%	0.0%	27.7%
<u>Position after one year</u>				
(9) Resulting premium growth	39.0%	22.5%	-70.0%	4.2%
(10) Resulting distribution of business	38.7%	54.1%	7.2%	100.0%
(11) Resulting loss and ALAE ratio on renewals	48.0%	56.0%	80.5%	54.7%
(12) Resulting overall loss and ALAE ratio	49.1%	56.9%	80.5%	55.1%
(13) Renewal experience if rate change alone were applied =				64.3%
(14) Renewal loss and ALAE ratio better due to segmentation strategy by				9.7%



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