A.M. Best - Congressional Testimony
Committee on Financial Services
America's Insurance Industry: Keeping the Promise

The horrible events of September 11th caused shocks throughout the world's financial markets. Given A.M. Best's broad rating coverage of the insurance industry, we are investigating the exposure of all carriers and stress testing their loss estimates along with their exposure to the troubled financial markets. While the estimates of the cost of these losses continue to grow and financial markets have staggered, A.M. Best Company believes the U.S. and international insurance companies will be able to meet their commitments, although this assertion is dependent on the ultimate insured cost of the attack.

It remains far too early to accurately estimate the insured losses of the attack. However, as a result of discussions with insurers and reinsurers, public indications made by companies potentially most affected and our own analysis, A.M. Best believes that losses are likely to exceed $30 billion, making this the costliest catastrophe in history. The nature and location of the tragedy dictate that the majority of losses will ultimately fall on the largest commercial carriers, their reinsurers and the London market. The insurance segments most affected will be property, aviation, business interruption, workers' compensation, commercial liability and life insurance.

A.M. Best has included second and third tier insurance companies in our review of exposure to losses from the terrorist attacks and the financial markets. For the purpose of this analysis these tiers are based on policyholder surplus size, with second tier companies ranging from $50 million to $250 million, and third tier companies falling below $50 million. While the decrease in the stock market had an adverse affect on the capital strength of a large percentage of the insurance industry, exposure to losses from the attacks appear to have affected a small number of second and third tier insurance companies. Many of these carriers are selected against by insureds in choosing a financially strong primary insurance carrier.

Those smaller tier carriers that had significant exposure to the terrorist attacks were exposed through non-core reinsurance coverages. Often this reinsurance business was seen as a way to diversify underwriting exposure and as a way to put excess capital to use.

Ability to Absorb Losses

Due to the favorable financial markets during most of the 1990's, the industry as a whole built a strong capital position in excess of the levels required to support ongoing operations. This strong capital position was built despite poor profitability from current underwriting operations over the past five years. As a result of this strong capital position, the industry as a whole can withstand losses equal to the highest estimates to date for this loss alone. The concern going forward is the exposure of a major hurricane making landfall or a major earthquake. Such an event could exhaust all reinstated reinsurance coverage and further weaken reinsurance capacity.

Based on the year-end 1999 financial position of the property/casualty insurance industry, A.M. Best estimated the property/casualty industry as a whole held $88 billion dollars of capital in excess of the amount needed to support their individual A.M. Best Ratings (Special Report: Excess Capital – A Blessing or a Curse, A.M. Best Company, Feb. 2001). The property/casualty industry as a whole maintained $180 billion relative to the level of capital required for the combined insurance industry entity to remain securely capitalized for its financial exposure. This level of excess capital has diminished due to the weak operating profitability of the property/casualty industry over the eighteen months ending June 2001. A.M. Best does not have an estimate of the level of excess capitalization held in the property/casualty industry on September 10, 2001, but it can safely be called substantial relative to the property/casualty industry's $298 billion surplus reported at June, 2001. A.M. Best remains confidant the insurance industry, as a whole, can absorb the losses arising from the September 11th attack.

Unfortunately, this level of excess capitalization is not distributed equally across the property/casualty industry. At the time of our study, A.M. Best estimated that those carriers writing coverage for individuals, such as personal automobile and homeowners coverages, held 60% of the excess capital in the property/casualty industry. These types of carriers sustained minimal losses from the terrorist attacks.

As mentioned earlier, the majority of losses from the attacks are concentrated with the largest and strongest, property/casualty commercial lines insurers, their European based domestic reinsurers and the London Market. While the losses will weaken the capitalization of these carriers, ongoing earnings have been improving and are expected to replenish any capital shortfall over the next twelve months. In addition, many of these carriers also hold substantial assets at the holding company level or are supported by financially strong parent corporations.

There will be those companies whose financial strength is weakened and market viability is in question resulting in rating downgrades. However, this is more a reflection of their relative long-term financial strength than any concern with solvency. A.M. Best is reviewing individual company gross and net loss estimates and stress testing capitalization under higher loss values. Under most of the worst case scenarios, it is expected that individual companies could still pay their pending claims, but future operations of some companies may be curtailed or companies may be forced into mergers or sales not otherwise contemplated.

Given the large number of second and third tier insurers that operate in the property/casualty insurance industry, mergers and acquisitions were inevitable over time. A.M. Best predicted that one-third of the property/casualty organizations operating at year end 1998 would lose their autonomy by 2003 (Special Report: P/C Review/ Preview, Managing the Enterprise, A.M. Best Company, January 2000). Often in the insurance industry, rather than see franchise value whither away, insurers will strike a deal to preserve value, which ultimately strengthens policyholder security. As a result of the losses from the attacks, mergers and acquisitions are expected to increase.

Life Industry

The greatest loss exposure to the life industry will be in individual and group long-term disability, group life policies and corporate life insurance policies written on key executives. A.M. Best believes that life reinsurers will bear the brunt of the mortality risk losses arising from the incident, since they assume the lion's share of such risks from primary carriers. In addition to sharing in mortality losses, a limited number of primary insurers will likely be affected by a surge in stress-related disability claims.

Our analysis of a large number of life insurers shows that individual company exposures are manageable and in most cases are a fraction of their annual earnings capacity. This is because direct writers have sufficient reinsurance protection in place.

Additionally, life primary and reinsurers could be exposed to losses associated with the catastrophic layer of workers' compensation insurance. It is unlikely that health insurers will be materially affected, since many of the large employer groups involved are self-insured, and coverage for the smaller groups is generally distributed among several carriers.

While the losses to the life industry are somewhat concentrated among a group of carriers, these carriers are all strong and well-capitalized. A.M. Best does not expect any problems with these life carriers meeting their claims obligations.

Other Related Issues

There are expected to be additional losses that are not covered by insurance. A.M. Best is not in a position to testify on these loss exposures. However, given the impact of these events on the financial markets, we would expect such losses to be substantial.

Clearly the decline in the financial markets following the terrorist attack will create additional financial issues for insurers. Insurers may be required to accept financial losses in order to generate the cash required to pay losses. A.M. Best does not believe liquidity will create a material problem for the property/casualty insurance industry. Most property/casualty carriers maintain a bank line of credit or a commercial paper program to address any short-term cash needs that arise.

As a result of the projected losses, there will be an enormous amount of cash changing hands within the insurance industry. This does raise concern particularly with regard to reinsurance recoveries that will not necessarily instantaneously reimburse losses paid by primary carriers. As a result of reinsurance disputes or delays, there is potential for liquidity problems. At this time, A.M. Best does not know of any major problems in this area, but we are monitoring those carriers that maintain large recoverables from reinsurers.

There should be no liquidity issues to life insurers directly related to claims from the terrorist attacks. However, potential liquidity problems could possibly arise if policyholders lose confidence in life and annuity insurers and began withdrawing substantial amounts from these insurers. Liquidity problems would further be compounded if companies had to liquidate investments in industries that have been hard hit in the current economic environment. Therefore, insurers with large investment exposures (both fixed income and equity investments) in the airline, travel, automobile and recreation industries could face some liquidity pressures. But it is important to note that A.M. Best is not aware of any companies facing liquidity issues at this time.

As a result of the volatile financial markets, A.M. Best expects to continue its heightened review process to include those companies that are overly exposed to this volatility. This exposure includes large investment leverage in common stocks, holding company liquidity and increased financial leverage brought on by these events. Additionally, the disposition of reinsurance recoverables could take years to ultimately play out.

Insurers will not and do not expect to immediately recoup their losses for the terrorist attacks. Catastrophe losses are contemplated in property/casualty ratemaking and are expected to be accounted for over the long-term. Theoretically, the recoupment of the losses resulting from the terrorist attacks is accounted for through appropriate ratemaking techniques. However, as was the case with Hurricane Andrew, a catastrophic loss serves to highlight the true loss exposure that is being underwritten. This will have an impact on underwriters' willingness to provide pricing credits in response to competition.

A.M. Best expects that primary and reinsurance pricing will increase to reflect the higher level of risk that has been brought to light by this attack. Those lines expected to be most affected are the same lines affected by the attack itself. Personal lines coverage, such as personal automobile and homeowners insurance are only expected to be affected to the extent increased reinsurance costs, due to decreased market capacity, must be passed on to insureds.

It should be noted that primary and reinsurance pricing has been increasing in all property casualty insurance segments over the past eighteen months. This reflects the weak underwriting profitability in the property/casualty industry demonstrated in the late 1990's. Prior to the September 11th attack, A.M. Best anticipated 10-20% price increases to continue in the commercial lines and reinsurance sectors through 2002. Price levels for personal lines coverages were expected to increase at a 5-10% rate through 2002. These increases are believed to be needed to return the property/casualty industry to adequate underwriting loss levels and ultimately adequate levels of profit from operations.

Company Background

Founded in 1899, A.M. Best is the oldest and most widely recognized rating agency dedicated to the insurance industry. Best's Ratings, which indicate the financial strength of insurance companies, cover: property/casualty, life, annuity, health care, reinsurance and title insurance companies. A.M. Best provides the most comprehensive insurance ratings coverage of any rating agency, with reports and ratings maintained on nearly 5,000 insurance entities world-wide, in approximately 65 countries.

A.M. Best's Mission Statement is " To perform a constructive and objective role in serving the insurance marketplace as a source of reliable information and ratings dedicated to encouraging a financially sound industry through the prevention and detection of insurer insolvency." We believe that this proactive role with companies is vital to encourage prudent management of insurance companies and to improve the industry's solvency and financial strength for the benefit of policyholders.

Witness Background

Mr. Mosher is the Group Vice President of the Property/casualty division of the A.M. Best Company, an independent insurance information and rating service.

Mr. Mosher oversees the rating and reporting for nearly 3,000 property/casualty insurance companies. He has been employed at A.M. Best Company since 1995. Prior to assuming the responsibility for the Property/casualty division, Mr. Mosher was responsible for the development and maintenance of most of the property/casualty rating models including the Loss Reserve, Capital Adequacy and Profitability Models. He speaks to many industry groups on property/casualty reserving and capitalization issues.

Prior to joining A.M. Best, Mr. Mosher spent two years in consulting with The Apex Management Group, Inc., Princeton, NJ and seven years with Crum & Forster Insurance, Morristown, NJ, working on property/casualty insurance pricing, reserving and operational planning issues.

Mr. Mosher is a graduate of Lehigh University with a B.S. in Statistics. He is a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries. He also served on several industry committees including, the American Academy of Actuaries Risk Based Capital Task Force.

Submitted by:

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Matthew C. Mosher, FCAS, MAAA
Group Vice President - Property/casualty Ratings
A.M. Best Company
Oldwick, NJ 08858
(908) 439-2200