



Demotech, Inc.

Background Information

Incorporated in 1985, Demotech, Inc. is a financial analysis and actuarial services firm currently serving the Property & Casualty (P&C) and Title insurance sectors. We initiated our insurer ratings service in 1989 when we secured approval of our Financial Stability Ratings® (FSRs) of A or better from the two government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Absent recognition from Fannie Mae and Freddie Mac, Homeowner's insurance policies issued by an otherwise unrated carrier would be unacceptable to the lender. In past times, a cut-through endorsement from a reinsurer would have been required. Today, tens of millions of insurance policies are readily accepted because they are issued by Demotech rated insurers. Our successful passing of the due diligences undertaken by the GSEs initiated acceptance of Demotech's FSRs.

This was an important first effort, as in the late 1980's, the legacy insurer rating organizations would not review and rate independent regional and specialty insurers. They would rate smaller insurers only if those insurers were part of a group or a subsidiary of a larger company, and often assigned the rating that was associated with the group. We were the first to recognize and address the needs of a niche that others were unwilling to serve.

Today, in addition to the acceptances from the GSEs and virtually all lenders in the United States, we have secured acceptances from the United States Department of Housing and Urban Development (HUD), several umbrella insurance carriers including many entities within Warren Buffett's Berkshire Hathaway Group, premium finance companies, reinsurers and other informed third parties who rely on insurer ratings as part of their eligibility criteria.

The nearly 400 carriers that we review quarterly write every line of P&C insurance in every state, District of Columbia, Commonwealth of Puerto Rico and the U.S. possessions. Our clients include larger, international carriers such as Allstate, AmTrust, Fidelity National and First American families of insurers as well as hundreds of independent regional and specialty insurers.

Brief Highlights of Our Involvement in Insurer Ratings

Since 1989, we have been leveling the playing field from coast to coast for every line of P&C insurance. Some of our efforts have liberated the entire market within a state. In late 1996, when the State of Florida, the (then) Florida Department of Insurance and secondary mortgage marketplace needed an insurer rating solution to address the availability and affordability of Homeowner's insurance in Florida, they contacted Demotech. We developed a procedure to review and rate newly capitalized insurers. Our procedure met the needs of the State of Florida, producers, insurers, consumers, reinsurers and the secondary mortgage marketplace.

In the aftermath of Hurricane Andrew and the more than twenty insurer insolvencies that occurred, the legacy insurer rating services abandoned Florida's property insurance marketplace. Since 1996, we have assigned ratings to dozens of Florida-domiciled insurers. We have rated privately-held insurers as well as the Florida focused affiliates of Travelers, Allstate and Nationwide.



In 1996, one of the initial Florida domiciled carriers that we reviewed and rated was American Strategic Insurance Corporation. ASI could not have commenced business without our review and the assignment of an FSR. Recently, Progressive purchased 66% of the stock of the ASI family of companies for \$700,000,000. This is a demonstrable verification of our ability to identify newly capitalized carriers that have the business plan and management to succeed.

In 2005, the need to supplement insurer rating criteria included HUD's acceptance of our FSRs of A or better as evidence that an insurance company was considered 'responsible' under their rating requirement guidelines. HUD's utilization of FSRs of A or better to supplement legacy rating requirements has permitted dozens of professional liability insurers to be eligible to write professional liability insurance on nursing facilities. Today, hundreds of senior facilities and hundreds of thousands of beds are insured by carriers rated A or better by Demotech.

Classification of Insurance Carriers

In 2007, Demotech recognized that it seems consistent and reasonable to stratify and categorize insurers by their business model rather than solely on their financial size. To address this need, Demotech developed the Company Classification System, a method to assign carriers to one of eleven business models based upon objective financial criteria.

In the Demotech Company Classification System, a company is assigned to one of the following categories:

- Nationals
- Regional Specialists
- Strategic Subsidiaries
- Reinsurers
- Near Nationals
- State Specialists
- Risk Retention Groups
- Companies with less than \$1 million in DPW
- Super Regionals
- Coverage Specialists
- Surplus Lines Carriers

In the Demotech Company Classification System, size is a secondary factor to the business model of the carrier and inclusion in one classification opposed to another classification should not suggest that one company is superior to another.

Independent Analysis of Our FSRs versus Ratings of Legacy Rating Services

In 2011, Florida State University's College of Business, Risk Management and Insurance compared FSRs with insurer ratings issued by A. M. Best, Standard and Poor's, Moody's and Fitch. The study reviewed thousands of insurer ratings issued over a nine-year period. The analysis, **A Comprehensive Examination of Insurer Financial Strength Ratings**, concluded:

1. *Demotech serves the need of another unique group of insurers, namely those that are geographically focused.*
2. *Comparisons of Demotech ratings to other agencies show relative consistency in the factors that drive Demotech ratings compared to agencies such as A. M. Best, Moody's, Standard and Poor's, and Fitch.*
3. *There is general consistency in the firms that each agency would categorize as financially secure.*



4. *These results have important public policy implications for insurers, regulators and consumers as they work to better understand the ratings process. Of particular importance to most is the comparability of Demotech ratings to other agencies.*
5. *Given ...some states require ratings to operate in a state, the results suggest that Demotech serves an important service within the ratings community and plays a very important role in the insurance market.*

We have attached a copy of the executive summary (Attachment 1) and a copy of the complete independent study undertaken by FSU (Attachment 2). The study was carried out independently by FSU and was not commissioned by Demotech.

Other Accomplishments and Acceptances

In 2012, Financial Stability Ratings® were added to SNL Financial's products (www.snl.com).

In 2013, Demotech introduced the Stakeholder Team Accomplishment Recognition™ Award to identify Property & Casualty insurers that successfully addressed the diverse needs of all corporate stakeholders. The STAR Award has been awarded annually to companies meeting our objective criteria. Most recently, Demotech honored 29 companies for earning a STAR Award.

In 2014, Fannie Mae MultiFamily supplemented its insurer rating criteria by deeming captive insurers and risk retention groups rated A or better by Demotech to be acceptable, as regards professional and general liability insurance coverage for senior housing facilities.

Also in 2014, Joe Petrelli and Sharon Romano Petrelli, co-founders of Demotech, received the Founder's Award from the Florida Association of Insurance Reform. And at the Reactions North America Awards, Demotech were nominated as Rating Agency of the Year with Best and Standard and Poor's, eliminating Fitch from the top three for the first time in the ten years of the event.

In 2015, we launched *The Demotech Difference* to provide additional insight on Demotech and to share insights from industry thought leaders. The magazine is mailed quarterly to nearly 14,000 recipients, including every insurer, whether life, health, Title or P&C, reporting data to the National Association of Insurance Commissioners (NAIC), thousands of banks and insurance agents and the respective departments of insurance. Electronic copies are available at http://demotech.com/demotech_difference.aspx.

In December 2015, Munich Reinsurance, one of the largest international reinsurers in the world, has supplemented the insurer rating criteria of several of its insurance company subsidiaries policies related to insurance agent's errors and omissions insurance to accept FSRs of S or better, (S is a notch below A). This is additional evidence that we are widely recognized for our ability to review and rate regional carriers.

2015 marked the 30th anniversary for Demotech. We celebrated this milestone with an 8-page retrospective supplement in *The Demotech Difference*. A copy of this anniversary supplement can be found in Attachment 3.



Demotech held Insurance Summit 2016 at The Wild Dunes in South Carolina. This event was attended by insurers, reinsurers, reinsurance brokers, actuaries and independent auditors.

Also in 2016, Demotech released a series of seminars related to understanding the statutory property and casualty annual statement (<https://youtu.be/Y9EBBgIHNIQ>).

Demotech was approved as a provider of insurance agent continuing education in Ohio. Ohio State Treasurer Josh Mandel was a guest lecturer at our initial session in 2016.

Demotech is listed on DefaultRisk.com, http://www.defaultrisk.com/rating_agencies.htm, as one of a limited number of rating services recognized globally.

Demotech has earned accreditations and recognition as a result of the conservatism of our review process, focus on balance sheet and income statement fundamentals, detailed review of the quality and quantity of reinsurance and our on-going quarterly review and analysis process. A more complete list of our accreditations and awards can be found in our Milestones (Attachment 4).

Brief Overview of Our Review and Analysis Process

Once we have identified a carrier as financially stable, we submit a Preliminary Financial Stability Rating[®] (PFSR) to the company. The notification of a PFSR includes a request for the additional information necessary to verify and then, if the information is consistent with the public information underlying the PFSR, we finalize the FSR.

The major components of our supplemental information request include:

- assigning a senior level executive as our primary contact
- providing copies or summaries of all reinsurance treaties for our review and analysis
- permitting access to other management and professionals such as the insurer's auditors, actuaries, and reinsurance brokers
- understanding the carrier's enterprise risk management plan
- requesting the direct submission of quarterly financial results.

These requirements provide assurance that Demotech has the capability to review or discuss the company's independent audit, statement of actuarial opinion as regards loss and loss adjustment expense reserves, reinsurance treaties and other pertinent documentation with the professional who is familiar with the substance of the matter at hand. Demotech needs to be able to discuss the published financial information, statement of actuarial opinion as regards loss and loss adjustment expense reserves, year-end audit, composition of the investment portfolio, changes in business plan, operating philosophy, reinsurance treaties, marketing, pricing or rate levels and claim philosophy with the employee or consultant that coordinates the effort.



Once a carrier has finalized its FSR, each quarterly financial statement is analyzed to ensure that the investment portfolio remains high quality and liquid, loss and loss adjustment expense reserves remain consistent with the estimate underlying the opinion of the actuary, financial leverage remains within our tolerance and other financial criteria meet our objective financial standards.

With this review and analysis process in place since 1989, the question that we are asked by those within the insurance industry and outside of the industry who utilize third party ratings is “how do Demotech’s FSRs compare to ratings issued by A. M. Best?”

Our Track Record Identifying Financially Stable Insurers is Superior

Having reviewed and rated insurers since 1989, we have a long and distinguished track record. Attachment 5 summarizes the comparison of Demotech’s insurer survival rates over time to the published survival rates of A.M. Best, based upon relative rating level; i.e., highest to highest rating, second highest to second highest, etc. The number of months at the bottom of each bar represents the number of months since the applicable rating was initially assigned to a defined group of carriers, i.e., closed pool method.

Demotech’s historical results indicate lower impairment rates and therefore translate into higher survival rates. The comparative survival rates of the insurers reviewed by Demotech, across all evaluation points, demonstrate our capability to provide reliable insight to consumers, financial institutions, producers, risk managers, reinsurers and other third parties. Clearly Demotech FSRs can be utilized to supplement the ratings of A. M. Best and other legacy rating services rather than continue the practice of boycotting carriers not rated by the legacy rating services.

Another independent comparison of Demotech’s FSRs versus the legacy rating agencies can be excerpted from the State of Florida statutes and Reinsurance Rule 69O-144.007(4):

Rating	Collateral Required	A. M. Best	S&P	Moody’s	Fitch	Demotech
Secure – 1	0%	A++	AAA	Aaa	AAA	A"
Secure – 2	10%	A+	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-	A'
Secure – 3	20%	A	A+, A	A1, A2	A+, A	A
Secure – 4	50%	A-	A-	A3	A-	n/a
Secure – 5	75%	B++, B+	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-	n/a



Vulnerable – 6	100%	B, B-, C++, C+, C, C-, D, E, F	BB+, BB, BB- , B+, B, B-, CCC, CC, C, D, R	Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C	BB+, BB, BB- , B+, B, B-, CCC+, CC, CCC-, DD	n/a
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The analysis underlying the development of this rule is consistent with the clinical observations in the graphical comparison of carrier survival rates and the independent Florida State University study in that it memorialized the comparability of our FSRs of A or better to the ratings of the legacy insurer rating organizations.

A Specific Example of Our Ability to Identify Financially Sound Risk Retention Groups

In 2004, Indemnity Insurance Corporation of DC, Risk Retention Group was formed as a risk retention group. On April 10, 2014, a Delaware court issued an order that placed Indemnity Insurance Corporation of DC, Risk Retention Group in liquidation with the Delaware insurance commissioner as the receiver.

According to an article published in PropertyCasualty360, the President and Chairman of the Board of Indemnity Insurance Corporation of DC, Risk Retention Group attempted to obtain money from policyholders and potential policyholders based upon financial ratings that he had fraudulently obtained.

The article states that the effort to obtain money began in January 2008 and continued to the fall of 2013, and throughout this period, *‘Cohen touted the A. M. Best ratings to current and potential policyholders and regulatory agencies.’*

Demotech points with pride to the fact that our review and analysis process characterized Indemnity Insurance Corporation of DC, Risk Retention Group as “**Below Average**” as early as March 31, 2009, **more than five years** in advance of the order of liquidation. Indemnity Insurance Corporation of DC, Risk Retention Group is a specific example of how Demotech can be effective.

Having reviewed only the readily available public financial information, we determined five years prior to the order of liquidation that the RRG was “Below Average.” A. M. Best continued to rate them at the level of A- several years after 2009.

Concluding Thoughts

Demotech competes against a functional monopoly, an oligopoly and the myths associated or attributed to both. With a proven track record, as the first company to review independent regional and specialty carriers, our goal is to assist financially stable insurers from being boycotted or coerced into being rated by legacy ratings agencies.



The independent Florida State University analysis, national awards, recognition and acceptances earned in conjunction with the breadth and scope of industry icons that contribute articles to our quarterly publication, *The Demotech Difference*, demonstrate that we are a credible, mainstream resource for insurer ratings.

Very truly yours,

Joseph L. Petrelli
President

Attachment 1

A Comprehensive Examination of Insurer Financial Strength Ratings

Executive Summary



THE FLORIDA STATE UNIVERSITY
COLLEGE OF BUSINESS
The Florida Catastrophic Storm Risk Management Center

A Comprehensive Examination of Insurer Financial Strength Ratings

Executive Summary

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Purpose and Key Findings:

In this study, we explore the potential similarities and differences across insurer financial strength ratings, with a particular focus on Demotech. Demotech differs from the traditional rating agencies in several key ways. First, it provides a provisional (unsolicited) rating to all firms with available financial data each year. If firms choose to finalize the rating, the rating becomes available to the public. Second, Demotech uses less non-publicly available information in the construction of its ratings than other agencies. Finally, there are significantly fewer barriers to obtaining a Demotech rating. As a result, it is easier for smaller, newer, and/or mono-state firms to obtain a Demotech rating than ratings from other agencies. Comparisons of Demotech ratings to other agencies show relative consistency in the factors that drive Demotech ratings compared to agencies such as A. M. Best, Moody's, Standard & Poor's, and Fitch. There also is general consistency in the firms that each agency would categorize as financially secure/stable.

Executive Summary:

Insurer financial strength ratings have been studied by a variety of academic and industry sources. Generally, these studies have found that financial characteristics including capitalization, liquidity, profitability, and firm size are important in determining insurer ratings (e.g., Harmelink, 1974; Pottier and Sommer, 1999; and Gaver and Pottier, 2005). While there is general consistency in the factors found to impact ratings, authors do note some variation across the agencies (e.g., Cantor and Packer, 1997; Pottier and Sommer, 1999; Van Roy, 2006; and Poon, Lee and Gup, 2009). We build on this literature by expanding the work to include a comparison of Demotech ratings to the other more traditional ratings provided by A. M. Best, Moody's, Standard & Poor's (S&P), and Fitch.

The use of Demotech ratings also allows some insight into the potential issues surrounding unsolicited ratings. Much of the prior research in the banking area has suggested that unsolicited ratings are lower than solicited ratings (e.g., Poon, 2003; Poon and Firth, 2005; Poon, Lee, and Gup, 2009). This has not been tested in the insurance area, largely do to the limited use of unsolicited ratings. While the provisional Demotech ratings are not released to the public, they do have many of the characteristics of unsolicited ratings in that they are initiated by the rating agency rather than the insurer and they are based solely on publically available data.

We use a data set of ratings assigned during the period 2000 to 2008 compiled from SNL Financial Database, Demotech, and A. M. Best. We also use operational and financial data on the insurers taken from the National Association of Insurance Commissioners Database. Following Pottier and Sommer (1999), we condense the ratings into five categories using the descriptions provided by the agencies to facilitate comparison across the ratings agencies.

Table 1 provides a summary of the number of insurers rated by each of the rating agencies for the years of our sample.¹ As expected, the most common rating is the Demotech provisional rating as it is compiled for all insurers. A. M. Best and S&P are the most common among the traditional rating agencies.

Table 1 – Number of Ratings in Sample by Year²

Year	Demotech (provisional)	Demotech (final)	AM Best	S&P	Moody's	Fitch
2000	1829	195	200	351	146	73
2001	1712	181	548	366	177	196
2002	1591	185	515	363	174	186
2003	1731	177	518	379	214	212
2004	806	175	516	350	211	248
2005	1452	190	493	365	211	264
2006	1604	207	496	367	198	279
2007	1575	221	498	324	200	307
2008	1605	235	490	279	144	317
Total	13905	1766	4274	3144	1675	2082

¹ Note the total across the rating agencies exceeds the total number of insurer-year observations indicated earlier since insurers are rated by multiple agencies in a given year.

² Note that the number of observations is low for A. M. Best in 2000 and Demotech in 2004. This is due to data limitations. To ensure this is not influencing the results obtained, these two models are repeated excluding these data years from the sample. The unreported results are generally consistent with those presented in the paper.

Based on our sample, about 30 percent of the firms are rated by multiple agencies. A. M. Best has the largest overlap with 27 percent of Demotech-rated insurers also being rated by A. M. Best. The second highest percentage overlap is with S&P at six percent. We further analyzed the subset of 152 firms which held both Demotech (finalized) ratings and A. M. Best ratings during the period. We found that 49 percent held Demotech ratings first while 30 percent held A. M. Best ratings first. Just over two thirds of the firms held both Demotech (finalized) ratings and A. M. Best ratings for multiple years in the sample.

Table 2 provides a summary of the overlap of secure ratings for the firms with Demotech ratings compared to other solicited and unsolicited rating agencies. In general, there is a high degree of overlap across the agencies in what is considered a financial secure insurer.

Table 2 – Overlap of Secure Ratings by Rating Firms*

	Not Secure	Secure	% Agree w/Demotech (Finalized)		Not Secure	Secure	% Agree w/Demotech (Provisional)
AM Best	91	387	81%	AM Best	229	2898	93%
S&P	10	92	90%	S&P	17	2275	99%
Moody's	4	42	91%	Moody's	6	1524	100%
Fitch	1	31	97%	Fitch	12	1212	99%
Unsolicited Ratings				Unsolicited Ratings			
S&P	21	82	80%	S&P	173	843	83%
Fitch	27	163	86%	Fitch	74	1122	94%

* The percentages represent the number of secure-rated Demotech insurers that also have a secure rating with the other agency.

Next, we consider the number of firms with Demotech's provisional rating that elect to finalize those ratings. Table 3 shows that almost all of the insurers that elect to finalize their provisional ratings are A-rated or above.

Table 3

	Provisional	Finalized	% Finalized
A"	2,956	348	12%
A'	4,052	518	13%
A	4,486	889	20%
S	934	11	1%
M	638	0	0%
L	839	0	0%
Total	13,905	1,766	

In the next step of our analysis, we empirically investigate the potential differences in the types of firms that elect to be rated by the different agencies. We consider a variety of factors including whether the firm was rated by other agencies, if the firm is a mono-state insurer, the insurer's business mix, catastrophe exposure, line-of-business concentration, size, financial risk, organizational form, group membership, growth rate, reserving practices, and liquidity.

Given that Demotech's provisional ratings are generally assigned to all firms with available financial information, the comparison of firms with provisional ratings to those electing to finalize ratings is essentially a comparison of Demotech-rated insurers and the industry. Compared to all insurers provided with a provisional rating, insurers that finalize their ratings have lower capital to assets levels as well as a lower level of reinsurance ceded relative to direct premiums written and reinsurance assumed. They also are less profitable and more liquid. Insurers with finalized Demotech ratings also tend to be smaller, younger (based on the *Age Under 10* variable), more geographically and line-of-business focused, and have higher percentages of business in long-tail and personal lines.³ There also appears to be some differences between the characteristics of insurers rated by the different agencies. For example, it appears that a larger percentage of insurers rated by Demotech are mono-state insurers. In addition, these insurers tend to be younger and are generally smaller than insurers rated by the other agencies. This reinforces the expectation that it is likely we will observe some variation in the results obtained when we empirically examine insurers rated by the various agencies. The

³ T-tests indicate differences are statistically significant at the five percent level. For tables of complete results as well as details on the specifications of the models see http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1706318.

results also underscore the importance of using a methodology to compare ratings that controls for the fact that each agency is rating different firms.

To compare the factors important across rating agencies, we use a two-step process known as a Heckman model. We create a set of models for each of the rating agencies. The first stage is a Probit model that identifies whether the insurer was rated by a given agency. The second stage incorporates this information as it models the factors important in developing the financial strength ratings.⁴

First we discuss the results of the probit models that assess what insurers are likely to be rated by a given agency. We find that insurers rated by other agencies are less likely to obtain ratings from Demotech or A. M. Best. This implies that firms with Demotech and A. M. Best ratings are more likely to have a single financial strength rating compared to other agencies. In both cases, there are institutional factors that make this likely. The lower barriers to gaining a Demotech rating may attract insurers that would not otherwise obtain a rating from the other agencies. A. M. Best has traditionally been considered the primary insurer rating agency, and its ratings are well recognized and accepted. Thus, firms with A. M. Best ratings may not have the same motivation to hold multiple ratings as firms with ratings from other agencies. The fact that two of the traditional rating agencies (A. M. Best and S&P) appear to be less likely to rate young insurers serves as further evidence of potential barriers. This variable is not significant for Demotech or Fitch but is significant and positive for Moody's. Combined, this provides initial evidence that the rating requirements and costs may discourage or prevent younger firms from obtaining ratings from the two most common rating agencies.

We also find that insurers that are smaller and those operating in a confined geographic area are more likely to elect to be rated by Demotech than the traditional rating agencies. In addition, the results suggest that Demotech-rated insurers are more likely to be fast-growing and associated with greater level of uncertainty in their lines of operations based on the premium growth and percentage of business written in long-tail lines.

When comparing the results across all of the models, we find that, while there are differences, there does seem to be some consistency in the results. For example, both Demotech and A. M. Best are more likely to rate firms in groups as well as firms with higher loss development ratios compared to S&P and Moody's. Also, with the exception of Demotech, the rating agencies are less apt to rate mutual firms (relative to stocks).

Based on the information in the first stage, we are able to econometrically correct for bias that might arise from different firms being rated by different agencies in our examination of the determinants of financial strength ratings. We consider an array of financial and operational

⁴ Given that all firms with available financial data are given provisional (unsolicited) ratings, there is no need to control for selection bias for Demotech's provisional ratings.

characteristics that are found in prior literature to impact financial ratings. Like prior studies, we find a certain level of variation across firms, however several important patterns emerge. First, as expected, the results are consistent between the provisional and finalized ratings for Demotech for 14 of the 18 factors examined. Thus, the key determinants of ratings are relatively consistent between Demotech's provisional and finalized ratings even though only higher rated firms finalize their ratings and finalized ratings can incorporate additional information from insurers. There also is some consistency between the results of the Demotech provisional ratings model and those of the other rating agencies. Specifically, we find the greatest consistency in the results for A. M. Best which has equivalent results for 12 of the 18 factors when compared to Demotech's finalized (solicited) ratings. Equivalent results for the other models ranged from a low of five for Fitch to a high of seven for S&P. When comparing the solicited ratings of all agencies, insurers with higher ratings are typically associated with stronger capital to asset ratios, higher net income to assets ratios, lower recoverables to surplus ratios, higher reinsurance ceded percentages, larger firm size, faster growth, and greater catastrophe exposure.

These results have important public policy implications for insurers, regulators, and consumers as they work to better understand the ratings process. Of particular importance to most is the comparability of Demotech ratings to those from other agencies. For this reason, both the results related to the degree of overlap between secure Demotech provisional ratings and those of other agencies as well as the consistency of factors impacting the determination of financial ratings is important. For example, with respect to Demotech, we find that generally, only insurers with secure ratings elect to finalize their ratings. Given that lenders often have requirements related to the use of rated insurers and some states require ratings in order for insurers to operate in the state, the results suggest that Demotech provides an important service within the rating community and plays a very important role in the insurance market. This is especially true in markets where relatively young and/or geographically focused insurers are active participants.

Attachment 2

A Comprehensive Examination of Insurer Financial Strength Ratings

A Comprehensive Examination of Insurer Financial Strength Ratings

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July 2011

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A Comprehensive Examination of Insurer Financial Strength Ratings

Abstract

While unsolicited financial strength ratings have been studied in the banking literature, these sometimes controversial ratings have not been studied in insurance. Utilizing data from multiple sources including a proprietary dataset, we provide the most comprehensive examination of insurer financial strength ratings to date and the first analysis of unsolicited ratings for US property-liability insurers. Similar to bank ratings, we find that insurers' unsolicited ratings tend to be lower than solicited ratings. We also find some consistency in the importance of organizational and key financial characteristics when comparing the results for unsolicited and solicited ratings across the agencies.

Key Words: Financial Strength Ratings, Selection-Bias, Unsolicited Ratings, Demotech, A. M. Best

Introduction

Financial strength ratings are an important tool for firms, investors, consumers, and regulators. As a result, they have been the subject of extensive academic, regulatory, and industry scrutiny.¹ Research has focused on a wide variety of topics including the determinants of ratings, differences across rating agencies, reasons to obtain ratings, and the impacts of ratings on business. One particular area of investigation has been on the topic of unsolicited ratings. While most financial strength ratings are based on publicly available information as well as proprietary information provided by the firms being rated, unsolicited ratings are based solely on public information. Existing research in the banking literature has shown that unsolicited ratings, sometimes called shadow ratings, are lower than solicited ratings (e.g., Poon, 2003; Poon and Firth, 2005; Poon, Lee, and Gup, 2009).² Differences in solicited and unsolicited ratings may be partially due to the fact that banks with unsolicited ratings are typically smaller and have weaker financial profiles than banks with solicited ratings (Poon and Firth, 2005). Given that ratings can have a considerable impact on a firm's business, this is a significant issue.

A major problem unwinding the differences between solicited and unsolicited ratings often relates to the limited data available for unsolicited ratings. Utilizing data from multiple sources including a proprietary dataset, we are able to provide a comprehensive study of both unsolicited and solicited ratings of multiple agencies for the very first time. More specifically, our sample includes solicited ratings from five rating agencies (i.e., A. M. Best, S&P, Moody's, Fitch, and Demotech) as well as unsolicited ratings from three agencies (S&P, Fitch, and Demotech) over a nine-year time period for property-liability insurers. Our sample of unsolicited ratings includes Demotech provisional ratings which are quite similar to the

¹ The importance of ratings is highlighted in the case of AIG before the government bailout. As reported in Wall Street Journal (September 16, 2008), AIG had to "post \$14.5 billion in collateral to bolster its credit rating" as well as "additional collateral to investment banks and others it trades with" after its credit downgrades.

² Poon (2003), Poon and Firth (2005), and Poon, Lee and Gup (2009) study solicited and unsolicited bank ratings across different countries.

unsolicited ratings of the other rating agencies in the sense that these ratings are based on publicly available information only and initiated by the rating agency.³ However, unlike traditional unsolicited ratings, provisional ratings are generally assigned to all insurers with available data in a given year. Additionally, it is important to note that these ratings are not publicly available.⁴ Inclusion of provisional ratings provides several advantages in the study of unsolicited ratings. First, it allows us to track a large sample of insurers rated with a process similar to traditional unsolicited ratings. Second, the fact that Demotech does not release the provisional ratings to the public provides an interesting contrast to the rating practices of S&P and Fitch, both of which do make public their unsolicited ratings without consent of insurers. To our knowledge, this type of comparison has not been possible in prior ratings studies. Lastly, given that all insurers with available data are generally assigned a provisional rating by Demotech, this also helps to reduce the problems associated with sample selection that are often present in other studies of unsolicited ratings. Similar to prior literature, for both solicited and unsolicited ratings samples, we also use the extensive financial data available for insurers in an effort to control for the potential selection bias (i.e., Cantor and Packer, 1997; and Pottier and Sommer, 1999). This is critical when one realizes that not all firms receive unsolicited and solicited ratings from all of the agencies due to firm characteristics such as firm age, size, and/or geographic focus as well as internal decisions made by the rating agencies.

In summary, our study accomplishes several goals. First, based on the structure of the data and analysis, we are able to examine the distribution of ratings across the various rating agencies. Second, we contrast the types of firms with published ratings from the various

³ To our knowledge this is the first time the provisional ratings have been studied in the rating literature.

⁴ The provisional ratings are proprietary and made available for this study by Demotech. Demotech generally creates a provisional rating based on publicly available data for all insurers each year and provides that information to the firm. If the insurer elects to finalize this rating, then a fee is paid and the rating is made public. While the insurer is given the opportunity to provide additional information, the finalized rating is still based largely on publicly available information.

agencies (solicited and unsolicited) as well as the characteristics that have the most influence on ratings. Our initial presentation of summary statistics allows the reader to better understand which insurers possess various types of unsolicited and solicited ratings as well as the differences in the distribution of these financial strength ratings. Next, we provide an analysis of the characteristics impacting the ratings as well as the relative importance of these characteristics across ratings agencies. This builds on the prior studies in the area of insurance which have considered both the determinants of financial strength ratings as well as differences in the rating methodologies of these agencies (e.g., Harmelink, 1974; Pottier and Sommer, 1999; and Gaver and Pottier, 2005).⁵ Finally, the inclusion of Demotech provisional ratings allows for a comprehensive study of unsolicited insurer financial strength ratings for the very first time and provides some insight as to whether differences are observed between unsolicited ratings that are made available to the public and those that are not. A better understanding of these issues for property-liability insurers not only helps to better understand different types of ratings but also has key public policy implications for the regulators, consumers, and investors relying on these ratings as well as the insurers rated by the agencies.

The remainder of the paper is organized as follows. First, we examine some background information related to the financial ratings literature. This is followed by a discussion of the data and methodology. Finally, a discussion of the results as well as conclusions and public policy implications is presented.

Background Information

A variety of studies have examined the determinants of insurer financial strength ratings from various rating agencies. Similar to prior studies examining bank financial ratings (Poon, 2003;

⁵ Other studies have examined the similarities and differences of financial ratings across different firms and industries (e.g., Cantor and Packer, 1997; Van Roy, 2006; and Poon, Lee and Gup, 2009).

and Poon and Firth, 2005), studies related to insurers generally find that financial characteristics including capitalization, liquidity, profitability, and firm size are important in determining insurer ratings (e.g., Harmelink, 1974; Pottier and Sommer, 1999; and Gaver and Pottier, 2005).⁶ We draw on the variables considered in prior literature to identify the factors important in determining financial strength ratings.

While the studies generally find that financial and operational traits are important determinants of ratings, they also find that there are differences across rating agencies (e.g., Cantor and Packer, 1997; Pottier and Sommer, 1999; Van Roy, 2006; and Poon, Lee and Gup, 2009). For example, in a study of property-liability insurers, Pottier and Sommer (1999) indicate that rating agencies exhibit systematic differences in the relative importance given to the different factors they consider. Authors have tested whether these are real differences or merely the artifacts of selection bias, given that different agencies rate different insurers. Given the mixed results of prior literature, we control for potential selection bias in the current study.⁷

Studies examining unsolicited ratings are limited to the banking literature. Examples include Poon (2003), Poon and Firth (2005), and Poon, Lee and Gup (2009). The general conclusion from these studies is that banks' unsolicited ratings tend to be lower than solicited ratings, even after controlling for self-selection bias. One limitation of these studies is that each studies the unsolicited ratings from one particular rating agency only (i.e., S&P, Fitch, and S&P, respectively) and no research has examined the unsolicited ratings across multiple rating agencies. To the best of our knowledge, no prior studies in the insurance literature have investigated unsolicited insurer ratings. It is our hope that by taking advantage of unsolicited

⁶ More specifically, Gaver and Pottier (2005) find that all of these variables are important determinants of insurer ratings while Pottier and Sommer (1999) find that firm size and investment in junk bonds are significant determinants for all three of the rating agencies examined.

⁷ Cantor and Packer (1997) find that sample selection bias does not explain the average rating differences and that observed differences in average ratings rather reflect differences in rating models. While Pottier and Sommer (1999) find some evidence of selection bias in the rating determinants model for A. M. Best, none of their rating differences models show evidence of sample selection (Pottier and Sommer, 1999, p. 639).

ratings from multiple agencies as well as a proprietary dataset from Demotech, our study will help fill both voids in the literature.

While issues related to the determinants of ratings as well as the potential impact from selection bias and unsolicited ratings are important from an academic standpoint, research has found that the existence of ratings significantly impacts a variety of stakeholders. As indicated by Pottier and Sommer (1999), “insurer financial strength ratings are heavily relied upon by insurance agents, brokers, and consumers, are used by insurers in their advertising, provide a tool for regulators to assess insurer risk, and are often used in academic research as measurers of insolvency risk” (p. 622).⁸ Evidence of this impact is found in Doherty and Phillips (2002) which documents an increase in rating stringency and concludes that the dramatic capital buildup in the insurance industry can be explained by the pressure experienced by insurers to maintain existing ratings.⁹

Data

The dataset is comprised of data from several sources for the period of 2000 to 2008. Insurers’ demographic and financial information is from the National Association of Insurance Commissioners’ (“NAIC”) Database.¹⁰ Insurers without required financial information are deleted. Demotech ratings (both provisional and finalized) are obtained from Demotech, Inc., and A. M. Best’s ratings are obtained from A. M. Best Company. Finally, Fitch, Moody’s, and S&P ratings are obtained from the SNL Database. Similar to Pottier and Sommer (1999), we

⁸ Ratings also have been used in insolvency prediction (e.g., Ambrose and Seward, 1988; Singh and Power, 1992; Ambrose and Carroll, 1994; and Pottier, 1998).

⁹ In addition, Epermanis and Harrington (2006) find that an insurer’s A. M. Best rating decline is followed by significant premium declines both in the same year and in the following year.

¹⁰ All continuous variables are winsorized at one percent level to minimize the impact of outliers.

condense the ratings into five categories using the descriptions provided by the agencies to facilitate comparison across the ratings agencies.¹¹

We consider both unsolicited and solicited ratings in our analysis. Due to data limitations, the unsolicited ratings analysis is restricted to the ratings of Demotech, S&P, and Fitch.¹² As noted earlier, Demotech unsolicited ratings are different from the unsolicited ratings of both S&P and Fitch in two important ways: (1) the ratings are generally assigned to all insurers every year rather than a limited group; and (2) the ratings are not made available to the public unless the insurer pays for the rating to be finalized and released.¹³ However, like traditional unsolicited ratings, Demotech provisional ratings are still initiated by the rating agency. To distinguish Demotech provisional ratings from the more traditional unsolicited ratings provided by S&P and Fitch, we refer to these as provisional ratings throughout the remainder of the paper.¹⁴

In the analysis of solicited ratings, or those initiated by the insurers, we consider the ratings of the four traditional rating agencies (i.e., A. M. Best, S&P, Moody's and Fitch) as well as Demotech. The inclusion of Demotech ratings provides an interesting contrast to traditional solicited ratings given the difference in the rating processes. Unlike traditional agencies, Demotech provides insurers with their provisional ratings and insurers decide whether to make

¹¹ A detailed description of each of the rating agencies and the rating categories is provided in Appendix A. In addition, while we condense the ratings into five categories, there are no finalized Demotech ratings in the lowest category and very few observations in this category for the other rating agencies. This information also is summarized in a chart presented in Appendix A.

¹² Table 1 provides information related to unsolicited ratings. Data related to unsolicited financial strength ratings of insurers is somewhat limited. The agencies have generally discontinued this practice or limited the types of insurers to which it assigns these ratings. For example, in a press release in early 2009, Fitch announced that it will no longer issue unsolicited ratings, called 'q' ratings, though it noted it may issue 'q' scores (similar to 'q' ratings in the sense that it utilizes historical financial information) in the future if demanded by the market (Fitch, 2009). Additionally, recently an A. M. Best document indicates that it only assigns unsolicited ratings, called 'pd' or public data ratings, to "Canadian property/casualty insurers and HMOs and health insurers (United States)" for which the company does not currently provide traditional solicited ratings (A. M. Best, 2009). Other than Demotech, only S&P and Fitch offered unsolicited ratings for some part of the sample period. For S&P, a majority of these ratings were only available through 2003 when there was a significant decline in the unsolicited ratings issued. For Fitch, the unsolicited ratings were only available since 2006.

¹³ More information on the process of finalizing a rating is provided below.

¹⁴ Provisional rating is the term used by Demotech. For more details regarding Demotech ratings, see Appendix A.

the ratings public. If an insurer elects to finalize the rating, some additional information may be requested that could impact the final rating released to the public; however, for the reduced sample of insurers which elect to finalize their ratings, the provisional rating provided to the insurer is typically the same as the final rating released to the public. To distinguish these ratings from the more traditional solicited ratings, we refer to these as finalized ratings.

Table 1 provides a summary of the number of insurers rated by each of the rating agencies for the years of our sample.¹⁵ Given that Demotech generally provides its provisional ratings to all insurers with the needed publicly available financial information, it is not surprising that Demotech has the highest number of provisional (unsolicited) ratings. S&P and Fitch have provided approximately the same number of unsolicited ratings; however, the time periods over which these ratings have been provided differ. As shown in the table, while S&P provided a number of unsolicited ratings through 2003, this number dropped significantly in subsequent years. In addition, we do not have any Fitch unsolicited ratings prior to 2006. In terms of solicited ratings, the major two rating agencies in the sample are A. M. Best and S&P with 4,274 and 3,144 firm-year observations respectively. This is followed by Fitch, Demotech, and Moody's.

Next, for the agencies for which we have both unsolicited (or provisional) and solicited (or finalized) ratings, we compare the percentage of ratings in each of the categories. This information is summarized in Table 2. First, we contrast the Demotech provisional and finalized ratings. It appears that there is approximately the same percentage of insurers with ratings in the top two categories. However, we find that there is a much larger percentage of insurers with ratings in the good/strong finalized category than the good/strong provisional category (50

¹⁵ Note the total across the rating agencies exceeds the total number of insurer-year observations indicated earlier since insurers are rated by multiple agencies in a given year.

Table 1 – Number of Ratings in Sample by Year¹⁶*Panel A: Provisional and Unsolicited Ratings*

Year	Demotech (Provisional)	S&P	Fitch
2000	1829	218	N/A
2001	1712	258	N/A
2002	1591	247	N/A
2003	1731	355	N/A
2004	806	119	N/A
2005	1452	72	3
2006	1604	36	426
2007	1575	26	446
2008	1605	N/A	500
Total	13905	1331	1375

Panel B: Finalized and Solicited Ratings

Year	Demotech (finalized)	A. M. Best	S&P	Moody's	Fitch
2000	195	200	351	146	73
2001	181	548	366	177	196
2002	185	515	363	174	186
2003	177	518	379	214	212
2004	175	516	350	211	248
2005	190	493	365	211	264
2006	207	496	367	198	279
2007	221	498	324	200	307
2008	235	490	279	144	317
Total	1766	4274	3144	1675	2082

percent compared to 32 percent). We also find that while no insurer with a finalized rating receives a rating less than fair/adequate rating, 11 percent of provisional ratings fall in this category. More extreme differences are observed when comparing the unsolicited and solicited ratings of S&P and Fitch. With S&P, for insurers soliciting ratings, 46 percent receive ratings in the top two categories. However, for unsolicited ratings, only 12 percent of insurers receive ratings in these categories. Also, while only 1 percent of insurers soliciting ratings receive a less

¹⁶ Note that the number of observations is low for A. M. Best in 2000 and Demotech in 2004. This is due to data limitations. To ensure this is not influencing the results obtained, these two models are repeated excluding these data years from the sample. The unreported results are generally consistent with those presented in the following section.

Table 2 – Unsolicited and Solicited Ratings Comparison

	Demotech				S&P				Fitch			
	Provisional		Finalized		Unsolicited		Solicited		Unsolicited		Solicited	
	#	%	#	%	#	%	#	%	#	%	#	%
Superior/Extremely Strong/Exceptional	2956	21%	348	20%	10	1%	354	11%	0	0%	194	9%
Excellent/Very Strong	4052	29%	518	29%	140	11%	1085	35%	0	0%	1121	54%
Good/Strong	4486	32%	889	50%	273	21%	1470	47%	546	40%	653	31%
Fair/Adequate	934	7%	11	1%	585	44%	198	6%	699	51%	90	4%
Less than Fair/Adequate	1477	11%	0	0%	323	24%	37	1%	130	9%	24	1%
	13905		1766		1331		3144		1375		2082	

than fair/adequate rating, 24 percent of insurers fall into this category when considering unsolicited ratings. Finally, for Fitch, we find that only 5 percent of insurers seeking ratings receive a rating in the bottom two categories, and 60 percent of insurers receive unsolicited ratings in these categories. To determine if the differences in the distributions are econometrically significant, we conduct a Wilcoxon rank-sum test for the ratings of each of the three agencies. Using the full distribution of ratings provided by the agencies, we reject the null hypothesis that the provisional (unsolicited) and finalized (solicited) ratings have identical distributions. This result is similar to the findings in the banking literature which suggest unsolicited ratings tend to be lower (i.e., Poon 2003).

For finalized and solicited ratings, we examine the number of insurers with multiple ratings. As shown in Table 3, the majority of insurers elect to only be rated by a single agency. This is not surprising given that the rating process can be costly for insurers. However, we do find that more than 30 percent of insurers seek multiple ratings.¹⁷ Given the volume of insurers with multiple ratings, we control for the existence of another rating in our model. This is discussed in more detail in the following section.

Table 3 – Ratings Summary

Year	1 Rating	2 Ratings	3 Ratings	4 Ratings
2000	518	144	53	
2001	717	206	93	15
2002	690	210	103	1
2003	700	217	118	3
2004	702	209	124	2
2005	662	213	141	3
2006	698	209	141	2
2007	732	228	118	2
2008	760	209	93	2
Total	6179	1845	984	30

¹⁷ These statistics are calculated on an insurer-year observation basis.

Finally, for insurers with multiple ratings, we compare those with secure ratings across the agencies.¹⁸ As shown in Table 4, there appears to be strong consistency in the evaluation of the insurers by the agencies. More specifically, for all comparisons but Demotech and A. M. Best, we find in excess of 90 percent agreement (insurers receiving secure ratings by both agencies). For Demotech and A. M. Best, the percentage of agreement is less (i.e., 81 percent). This finding of such consistency in the evaluation of insurers makes it even more important to control for the existence of other rating(s) in the modeling.

Table 4 – Comparison of Secure Ratings among the Rating Agencies

Comparison Groups	Secure Rating by Both	Total Rated by Both	% Secure by Both
Demotech & A. M. Best	387	479	81%
Demotech & S&P	102	102	100%
Demotech & Moody's	46	46	100%
Demotech & Fitch	32	32	100%
A. M. Best & S&P	184	188	98%
A. M. Best & Moody's	30	30	100%
A. M. Best & Fitch	58	62	94%
S&P & Moody's	1328	1344	99%
S&P & Fitch	1487	1503	99%
Moody's & Fitch	1175	1191	99%

Methodology and Variable Descriptions

Methodology

Next we turn to our examination of the characteristics that influence the different types of ratings. We examine both the factors that impact the rating as well as whether these factors vary across agencies. We first consider Demotech provisional ratings and the unsolicited ratings of

¹⁸ An insurer is considered to have a secure rating if it has a rating in one of the top two categories.

S&P and Fitch. Then, we consider Demotech finalized ratings and the solicited ratings of A. M. Best, S&P, Fitch, and Moody's.

For the Demotech provisional ratings, we use ordered probit modeling. Given that Demotech generally provides provisional ratings for the population of insurers, this modeling approach is most appropriate. However, for all other models (the unsolicited S&P and Fitch ratings, the finalized Demotech ratings, and the solicited ratings of the other four agencies), we use an estimation procedure that controls for potential selection bias.¹⁹ This is necessary given that only some insurers are selected to receive unsolicited ratings by S&P and Fitch and only some insurers elect to be rated by each of the agencies. More specifically, we use a joint approach that models both the insurer's rating and the decision to rate insurer (or the decision by insurer i to be rated).²⁰ Given that the variable of interest (i.e., insurer rating) is only observed if a selection condition is met, the following system of equations is used:

$$y^*_i = \mathbf{x}'_i \boldsymbol{\beta} + \lambda \varepsilon_i + \tau_i \quad \text{Eq. (1)}$$

$$S^*_i = \mathbf{z}'_i \boldsymbol{\gamma} + \varepsilon_i + \zeta_i \quad \text{Eq. (2)}$$

Equation 1 is fitted using an ordinal probit regression model where y takes on a value of 1 through 5 based on the rating assigned to the insurer. Equation 2 is the endogenous decision model. This approach produces consistent estimators of $\boldsymbol{\beta}$.²¹

For comparison purposes, we consider the same set of firm characteristics as potential determinants of financial ratings for each ratings series (i.e., provisional Demotech ratings, unsolicited ratings, Demotech finalized ratings, and solicited ratings models).²² These

¹⁹ It should be noted that for both the S&P and Fitch models, the sample period is limited to the period for which data is available as shown in Table 1.

²⁰ The modeling technique used is `ssm` in STATA. The summary of the modeling description was obtained from Miranda and Rabe-Hesketh (2006). See this article for additional details.

²¹ We control for heteroskedasticity. There is no evidence of multicollinearity or autocorrelation.

²² There is some variation in the variables included in the decision model. The discussion related to these variables and the results of these models can be found in Appendix B.

characteristics are divided into four categories: organizational characteristics; business mix; business risk; and financial strength and flexibility.

Variable Descriptions

With respect to the determinants of financial strength ratings models, we use a set of variables similar to those used in prior insurance literature (i.e., Pottier and Sommer, 1999). We divide the variables into four categories similar to those identified in the banking (i.e., Poon, 2003).

Organizational Characteristics. Prior literature has shown that different organizational forms are associated with systematically different levels of risk in terms of business written and investments (i.e., Lamm-Tennant and Starks, 1993; Downs and Sommer, 1999; Cole, He, McCullough, and Sommer, 2009). Our size measure is *Direct Premiums Written*.²³ We also include proxies to capture differences in organizational forms (*Mutual Indicator* and *Other Organization Type Indicator* with stock being the omitted category), group membership (*Group Indicator*), and insurer age (*Established Age*).

Business Mix. First, we include the *Line-of-Business Herfindahl* and the *Number of States Licensed* as measures of concentration. The measures are relatively standard measures of concentration and business mix in the insurance literature. To the extent that diversification reduces firm risk, more diversified firms are expected to have higher ratings. However, if diversification leads to a lack of efficiency in operations that adversely impact profitability, the opposite result may exist. We also include two variables to measure specific business focus as this may impact various aspects of the firm and therefore insurers' ratings: the *Percentage in Long-Tail Lines* and the *Percentage in Personal Lines*.²⁴

²³ It should be noted that since larger firms are typically expected to have lower levels of insolvency risk (Cummin and Danzon, 1997; Cummins and Sommer, 1996), the size measure also can be considered a business risk measure.

²⁴ In general, long-tailed lines of business relate to liability, environmental, and bodily injury claims. With these types of claims, it typically takes a longer period from the time of the occurrence of the injury to final settlement of

Business Risk. We include *Stock to Cash and Invested Assets* as a measure of investment risk as varying levels of stock investment will correlate with varying levels of firm risk. We also include *2-Year Loss Development* as it is an important part of the assessment of an insurer's risk. According to A. M. Best, more than two thirds of an insurer's gross capital requirement usually is generated from its loss reserve and net premiums written components (A. M. Best, 2003). This measure allows for us to determine whether the insurer has been understating or overstating loss reserve estimates in recent periods. *Catastrophe Exposure* is proxied by the percentage of the insurer's premiums written in property insurance in states along the Gulf Coast and the Atlantic Seaboard. An insurer's exposure to catastrophic events creates greater uncertainty and thus is likely to be associated with lower financial strength ratings. Finally, two measures related to reinsurance are included: *Reinsurance Ceded* and *Recoverables to Surplus*. The extent of reinsurance use has a potentially conflicting impact on an insurer's business uncertainty (Borch, 1974; Berger, Cummins, and Tennyson, 1992). Given that reinsurance transfers part of the risk to a reinsurer, greater use of reinsurance may be associated with reduced uncertainty of the primary insurer's business. Alternatively, greater use of reinsurance can have several adverse effects for the primary insurer: it may make it "more susceptible to short-term dislocations in the overall market"; it ties its financial stability to that of the reinsurer; and it exposes it to potential uncertainty in payments if a claim dispute occurs (Doherty and Phillips, 2002, p. 62). In this respect, the use of reinsurance may complicate the assessment of the insurer's risk, which increases the information asymmetry and uncertainty regarding the company. The *Recoverables to Surplus* is another measure related to reinsurance. Higher levels of recoverables are likely related to a greater probability of insolvency. As discussed in prior research, we would expect this variable to be negatively related to the insurer's rating (i.e., Gaver and Pottier, 2005).

the loss. This can lead to more error in loss reserving as well as more volatility of losses in general. Typically, due to their standardized nature, personal lines coverages are considered less volatile than commercial coverages. It should be noted that both of these measures may also capture varying levels of business risk.

Financial Strength and Flexibility. Previous studies have established that insurers which are more profitable and well capitalized are associated with higher ratings (i.e., Kahane, Tapiero, and Jacques, 1986; MacMinn and Witt, 1987; Cummins, 1988; Doherty, 1989; Pottier and Sommer, 1999; Doherty and Phillips, 2002; Gaver and Pottier, 2005). *Capital to Assets* serves as a proxy for an insurer's capitalization while *Net Income to Assets* measures an insurer's profitability. We also include *Cash to Invested Assets* given that prior studies have found that the insurer's levels of liquidity also is likely to impact ratings (Kahane et al., 1986; Pottier and Sommer, 1999). An insurer with higher levels of investment in cash is expected to be associated with relatively lower uncertainty and likely higher ratings because cash is much easier to value and less risky than bonds and stocks. Finally, prior research has indicated that growth is important in determining insurer insolvency risk (Harrington and Danzon, 1994; Pottier and Sommer, 1999). We proxy growth with *Change in NPW*. The impact of growth on firm's uncertainty and potential impact on ratings is ambiguous as strong premium growth may indicate that policyholders' are confidence in the financial health of the insurer and thus indicate lower uncertainty; or, on the other hand, may be a result of a property-liability insurer's lowering underwriting standards or under-pricing (Harrington and Danzon, 1994).

Results

Summary Statistics. Table 5 provides summary statistics for the entire sample and separately for insurers with unsolicited and solicited ratings. It appears that insurers that solicit ratings tend to be larger and more diverse in terms of business mix and geographic operation. In addition, these insurers have smaller loss development factors.

Provisional and Unsolicited Ratings. We now turn to an analysis of whether the determinants of unsolicited financial ratings are consistent across the agencies. This includes an

analysis of the Demotech provisional ratings as well as the S&P and Fitch unsolicited ratings. As shown in Table 6,²⁵ it appears that organizational characteristics have less of an impact on the ratings assigned to insurers in comparison to the other categories. More specifically, four (*Stock to Cash & Invested Assets*, *2 year Loss Development*, and both reinsurance variables) of the five

Table 5: Summary Statistics²⁶

	All	Unsol.	Sol.
<i>Organizational Characteristics</i>			
Direct Premiums Written	10.1733	10.3186	10.6565
Mutual Indicator	0.2021	0.2087	0.1847
Other Organization Type Indicator	0.1001	0.0664	0.0590
Group Affiliation	0.6521	0.6904	0.6617
Established Age	42.7033	44.8859	45.1690
<i>Business Mix</i>			
Line-of-Business Herfindahl	0.5173	0.4909	0.4702
Percentage in Long-Tail Lines	0.6980	0.6904	0.6963
Percentage in Personal Lines	0.3739	0.4009	0.3930
Number of States Licensed	16.0049	16.5506	19.5425
<i>Business Risk</i>			
Stock to Cash & Invested Assets	0.1143	0.1178	0.1122
2 Year Loss Development	-0.8428	-1.1127	-0.3846
Catastrophe Exposure	6.6966	6.6989	7.1536
Reinsurance Ceded	0.5319	0.5458	0.5519
Recoverables to Surplus	49.5773	48.3800	49.2293
<i>Financial Strength and Flexibility</i>			
Capital to Assets	0.4272	0.4306	0.4144
Net Income to Assets	0.0232	0.0231	0.0262
Cash to Invested Assets	0.1958	0.1679	0.1575
Change in NPW	19.9881	17.1664	17.0099

²⁵ It should be noted that for of the second-stage models, the likelihood ratio test for $\rho = 0$ rejects the null hypothesis at a significance level of .05 or better for S&P, but not for Fitch.

²⁶ Prior research has considered whether the financial profiles are statistically different between solicited and unsolicited samples using t-tests. Given the uniqueness of our sample (have data from multiple rating agencies), there are some firms that appear in both the unsolicited and solicited sub-samples so a complete comparison of these two sub-samples is not possible. However, t-tests conducted including the insurers that appear in only one sub-set show significant differences for all but one of the variables at the five percent level. For that variable (*Catastrophe Exposure*), the t-test shows significant differences at the 10 percent level. It should be noted that the Demotech provisional ratings are included in the unsolicited group and Demotech finalized ratings are included in the solicited group.

business risk measures are significant for all three agencies while this is only the case for two (*Direct Premiums Written* and *Group Affiliation*) of the five organizational characteristics. The mutual variable also is significant in the Demotech model. Additionally, all of the financial strength measures are significant for S&P and Demotech and three of the four for Fitch. Finally, as it relates to business mix, while only one of the variables, *Line-of-Business Herfindahl*, is significant for S&P, all of these variables are significant for Demotech and three of the four for Fitch.

An examination of the sign and size of the coefficients provides some information as to the magnitude of the impact of the firm characteristics across the various agencies. Examining first the organizational characteristics, we find that size and group affiliation are associated with greater probabilities of being assigned a higher rating for S&P and Fitch in comparison to Demotech. In terms of business mix, we find that firms that are more concentrated in terms of business are over two times more likely to receive a lower rating from Fitch and three times more likely to receive a lower rating from S&P than from Demotech. In addition, while larger percentages of business in long-tail lines are associated with greater probabilities of being assigned higher ratings for Demotech and Fitch, larger percentages of business in personal lines are associated with greater probabilities of being assigned lower ratings by these agencies. The results for the business risk measures generally support the hypotheses that greater uncertainty is associated with the probability of being assigned a lower rating. The only exception is the *Reinsurance Ceded* variable which is positive for both S&P and Fitch. This suggests that these agencies may consider that insurers that cede more business are reducing their risk. While both capitalization and profitability are associated with the probability of being assigned a higher rating, the importance of these factors appears greater for Fitch. Interestingly, the measure of liquidity is associated with probability of receiving a lower rating. The impact of this variable is

Table 6: Determinants of Provisional and Unsolicited Financial Ratings

	Demotech (provisional)	S&P	Fitch
<i>Organizational Characteristics</i>			
Direct Premiums Written	0.116*** (0.00602)	0.348*** (0.0359)	0.444*** (0.0349)
Mutual Indicator	0.0749** (0.0293)	-0.00519 (0.0840)	0.206 (0.163)
Other Organization Type Indicator	-0.0407 (0.0385)	-0.0146 (0.114)	0.154 (0.162)
Group Affiliation	0.172*** (0.0238)	0.591*** (0.0744)	0.544*** (0.103)
Established Age	0.000131 (0.000284)	-0.000455 (0.000873)	0.000980 (0.000984)
<i>Business Mix</i>			
Line-of-Business Herfindahl	-0.480*** (0.0377)	-0.646*** (0.134)	-1.472*** (0.153)
Percentage in Long-Tail Lines	0.322*** (0.0333)	0.145 (0.152)	0.768*** (0.211)
Percentage in Personal Lines	-0.318*** (0.0256)	0.126 (0.0995)	-1.424*** (0.174)
Number of States Licensed	0.00129** (0.000587)	0.00128 (0.00220)	-0.00282 (0.00243)
<i>Business Risk</i>			
Stock to Cash & Invested Assets	-0.140** (0.0637)	-1.540*** (0.241)	-1.369*** (0.301)
2 Year Loss Development	-0.0112*** (0.000522)	-0.00593*** (0.00199)	-0.0101*** (0.00266)
Catastrophe Exposure	-5.51e-05 (0.000500)	0.00312** (0.00158)	0.000322 (0.00210)
Reinsurance Ceded	-0.0712*** (0.0201)	0.623*** (0.0699)	0.686*** (0.0998)
Recoverables to Surplus	-0.00181*** (0.000110)	-0.00307*** (0.000640)	-0.00649*** (0.000925)
<i>Financial Strength and Flexibility</i>			
Capital to Assets	1.757*** (0.0611)	1.529*** (0.294)	2.447*** (0.489)
Net Income to Assets	3.120*** (0.184)	3.124*** (0.811)	6.897*** (1.193)
Cash to Invested Assets	-0.641*** (0.0446)	-1.823*** (0.398)	-0.996** (0.471)
Change in NPW	0.000430*** (0.000134)	0.00159** (0.000723)	-0.000899 (0.00132)
Observations	13905	1331	1375

Year indicator variables included in all models; standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table 7: Determinants of Solicited Financial Ratings

	Demotech (finalized)	A. M. Best	S&P	Moody's	Fitch
<i>Organizational Characteristics</i>					
Direct Premiums Written	0.145*** (0.0262)	0.354*** (0.0202)	0.0703*** (0.0204)	0.0311* (0.0185)	0.109*** (0.0195)
Mutual Indicator	0.199** (0.0810)	0.334*** (0.0555)	-0.349*** (0.103)	0.264*** (0.102)	-0.399*** (0.120)
Other Organization Type Indicator	-0.324** (0.143)	0.190*** (0.0700)	0.160 (0.111)	-0.0344 (0.358)	0.309 (0.202)
Group Affiliation	0.323*** (0.0750)	0.185** (0.0730)	0.427** (0.201)	-0.771*** (0.295)	-0.330 (0.372)
Established Age	0.00201** (0.000803)	0.000850 (0.000610)	-0.00257*** (0.000611)	-0.00182* (0.00109)	-0.00187** (0.000807)
<i>Business Mix</i>					
Line-of-Business Herfindahl	-0.732*** (0.122)	-0.455*** (0.0793)	0.571*** (0.119)	-0.0888 (0.110)	0.681*** (0.150)
Percentage in Long-Tail Lines	0.612*** (0.149)	0.441*** (0.0670)	-0.640*** (0.102)	-1.011*** (0.150)	-0.691*** (0.157)
Percentage in Personal Lines	-0.157 (0.100)	-0.838*** (0.0582)	0.320*** (0.0732)	0.0425 (0.132)	0.183** (0.0796)
Number of States Licensed	0.00718*** (0.00224)	0.0201*** (0.00151)	0.000157 (0.00110)	-0.00174 (0.00118)	-0.00653*** (0.00144)
<i>Business Risk</i>					
Stock to Cash & Invested Assets	-0.806*** (0.189)	0.418*** (0.144)	1.020*** (0.163)	-0.506 (0.655)	1.589*** (0.238)
2 Year Loss Development	-0.00769*** (0.00175)	-0.00685*** (0.00109)	-0.000737 (0.00135)	-0.00262 (0.00182)	-0.000358 (0.00182)
Catastrophe Exposure	0.00335* (0.00196)	0.000596 (0.000900)	0.00933*** (0.00165)	0.0117*** (0.00185)	0.0140*** (0.00213)
Reinsurance Ceded	0.441*** (0.0691)	0.0797 (0.0842)	0.140*** (0.0378)	0.0581 (0.143)	0.287*** (0.0472)
Recoverables to Surplus	-0.00430*** (0.000438)	-0.00356*** (0.000317)	-0.00163*** (0.000246)	-0.000899** (0.000428)	-0.00303*** (0.000417)
<i>Financial Strength and Flexibility</i>					
Capital to Assets	1.303*** (0.231)	3.139*** (0.170)	0.531*** (0.136)	0.552 (0.379)	0.389** (0.168)
Net Income to Assets	1.319** (0.528)	1.653*** (0.374)	2.782*** (0.612)	2.087** (0.867)	2.936*** (0.842)
Cash to Invested Assets	-0.564*** (0.120)	-0.149 (0.0988)	0.750*** (0.158)	0.0793 (0.425)	0.0492 (0.268)
Change in NPW	0.000978*** (0.000370)	0.000322 (0.000329)	0.00156*** (0.000381)	0.00121* (0.000664)	0.00125** (0.000619)
Observations	16859	16859	16859	16859	16859

Year indicator variables included in all models; standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

twice as high for S&P than the other two agencies. Finally, growth is associated with being assigned a higher rating for both Demotech and S&P with the impact being much greater for S&P.

Solicited Ratings. The results for solicited ratings are presented in Table 7.²⁷ The results of the solicited models show some differences when compared to the results for the unsolicited models. First, more of the organizational characteristics are significant though the impact varies across the agencies. For example, the size measure is uniformly associated with the probability of being assigned a higher rating. However, mutual form is associated with the probability of receiving a higher rating for Demotech, A. M. Best, and Moody's but lower ratings for S&P and Fitch. In addition, age is associated with the probability of being assigned a higher rating for Demotech but a lower rating for S&P, Moody's, and Fitch. Second, while many of the same variables in the other categories that were found to significantly impact unsolicited ratings also are found to impact solicited ratings, the magnitude of the impact varies. In comparing the significance and signs of rating determinants for the three agencies providing both provisional (unsolicited) and finalized (solicited ratings), there are fewer differences between the models for Demotech ratings in comparison to S&P and Fitch. The result for Demotech is not surprising given the consistency in the provisional and finalized ratings noted earlier. Additionally, these differences observed for S&P and Fitch may be due, in part, to the incorporation of proprietary information into the rating process. It should be noted that certain organizational characteristics and key business risk and financial strength and flexibility measures are consistent in their impact on ratings.

²⁷ It should be noted that for of the second-stage models, the likelihood ratio test for $\rho = 0$ rejects the null hypothesis at a significance level of .05 or better for all of the ratings models except A. M. Best, generally indicating the presence of selection bias with the decision to be rated. This supports the use of a two-stage framework in modeling ratings.

Conclusions

In the area of insurance, prior studies have considered the determinants of financial strength ratings as well as differences in the rating methodologies of the various agencies. Unlike the banking literature, little attention has been paid to unsolicited ratings in the insurance area. In the banking literature, despite several studies examining unsolicited ratings, no prior studies have investigated unsolicited ratings across multiple rating agencies. Utilizing a proprietary dataset from Demotech that includes a large sample of provisional ratings combined with a limited sample of unsolicited S&P and Fitch ratings, we are able to perform a fairly comprehensive examination of insurer financial strength ratings. Moreover, the inclusion of both traditional solicited and unsolicited ratings combined with the provisional and finalized Demotech ratings provide us the opportunity to extend both the general rating literature as well as the insurance literature.

Consistent with the banking literature, our examination of the distributions of provisional (unsolicited) and finalized (solicited) ratings provides some evidence that ratings initiated by agencies tend to be lower than ratings initiated by insurers. We also find that there are statistically significant differences in the characteristics of insurers with provisional (solicited) and those with finalized (unsolicited) ratings. In addition, examining the sub-set of insurers that are rated by multiple agencies, we find that the insurers rated secure by one agency generally are considered secure by the other agencies.

We also find that after controlling for sample-selection bias, there is some variation in the factors influencing the determinants of ratings across agencies. However, when comparing the results for unsolicited (provisional) and solicited (finalized) ratings, we find there is some consistency in the importance of certain organizational and key financial characteristics. Also, when comparing results for which both ratings initiated by agencies and ratings initiated by

insurers are available, we find the greatest consistency in the results for Demotech in comparison to S&P and Fitch. Recall that the biggest difference between Demotech's unsolicited ratings and those of S&P and Fitch is that Demotech does not disclose unsolicited (provisional) ratings to the public, while the latter two agencies do. While such a difference in disclosure policy offers one possible explanation for the difference in ratings consistency, future research is warranted to explore the consistency/inconsistency between solicited and unsolicited ratings.

Our findings are of particular importance given that serious concerns have been raised regarding the accuracy of unsolicited ratings by both policymakers (e.g., U. S. Department of Justice, 1998) and researchers (e.g., Baker and Mansi, 2002). For example, the Department of Justice argues that unsolicited ratings may not be as accurate as solicited ratings because unsolicited ratings are not based on the same type of information as solicited ratings. Baker and Mansi (2002) express similar concerns that unsolicited ratings are less accurate than solicited ratings because the agencies do not have access to important private information obtained in the solicited ratings process. Our findings provide some evidence that though the distributions of unsolicited and solicited ratings differ, unsolicited insurer ratings may be as accurate as solicited ratings.

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Appendix A – Rating Agency Information

Primer on Rating Agencies

The primary insurer rating agency is A. M. Best. The major source of information used by A. M. Best in rating insurers' financial strength is each insurer's publicly available annual and quarterly financial statements filed with state regulators. This is then supplemented by other publicly available documents²⁸ as well as proprietary information including confidential documents provided by company management, Best's proprietary Background and Supplemental Rating Questionnaires, and insurer's annual business plans (A. M. Best, 2009). A. M. Best claims that the Financial Strength Rating (FSR) is an "independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations" based on "a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile" (A. M. Best, 2009). Financial Strength Ratings from A. M. Best are summarized in a wide spectrum of categories ranging from A++ to F.²⁹

Standard and Poor' provides the second largest set of insurer ratings. Unlike A. M. Best, S&P rates both insurers and non-insurers. Like A. M. Best, the agency's ratings are based on a mix of publicly available information and proprietary data.³⁰ S&P only provides Financial Strength Ratings (FSRs) to insurers upon their fee-based request. The ratings represent S&P's opinion of the financial security characteristics of an insurance organization with respect to its ability to fulfill its obligation under its insurance policies and contracts in accordance with policy

²⁸ These documents include information such as SEC filings and GAAP financial statements, audit reports prepared by certified public accountants/actuaries, and loss reserve reports prepared by loss reserve specialists.

²⁹ Specifically, A. M. Best's ratings range from A++ and A+ (Superior), A and A- (Excellent), B++ and B+ (Good), B and B- (Fair), C++ and C+ (Marginal), C and C- (Weak), D (Poor), E (Under Regulatory Supervision), to F (In Liquidation), the lowest rating assigned. Certain insurers are assigned S (Rating Suspended), if Best cannot assign a rating due to sudden and significant events occurring to these insurers.

³⁰ According to the Rating Process published on S&P's website, sources of such information includes interim and annual earnings releases, regulatory and SEC filings, and press releases, as well as an one-day meeting between S&P analysts and senior management team of the insurer.

terms. The major factors considered in S&P's rating FSR process include the following: industry risk, business position, management and corporate strategy, enterprise risk management evaluation, operating performance, investments, capitalization, liquidity and financial flexibility. S&P ratings range from AAA to CC, while firms under regulatory actions are given a rating of R.³¹

Moody's and Fitch, while garnering a much smaller market share than A. M. Best and S&P, are the final two major insurer rating agencies. Like S&P, both agencies also rate both insurers as well as other types of firms and securities. Moody's approach to rating property and casualty insurers focuses on both qualitative and quantitative characteristics of insurers in the following seven areas: market position; brand and distribution; product risk and diversification; asset quality; capital adequacy; profitability; reserve adequacy; and financial flexibility. The first two factors are referred to as "business profile factors" and the remaining five are referred to as "financial profile factors". According to Moody's Global Rating Methodology for Property and Casualty Insurers (2008), the rating process also incorporates the use of proprietary and non-public data. Generally speaking, business profile factors represent about one-third of the overall rating determination and financial profile factors represent the remaining two-thirds. Moody's offers two types of financial strength ratings to insurers: Long-Term Insurer Financial Strength (IFS) Ratings and Short-Term Insurer Financial Strength (IFS) Ratings. The focus of this study

³¹ S&P's FSRs range from AAA (Extremely Strong), AA (Very Strong), A (Strong), BBB (Good), BB (Marginal), B (Weak), CCC (Very Weak), to CC (Extremely Weak), the lowest rating category. Finally, NR is assigned to insurers not rated by S&P, implying that S&P has no opinion about such insurer's financial security. An insurer with a S&P ratings of 'BB' or lower is considered as having vulnerable characteristics that may outweigh its strengths. In that range, 'BB' indicates the least degree of vulnerability while 'CC' indicates the highest degree of vulnerability.

with respect to Moody's is the Long-Term IFS Rating which measures an insurer's ability to meet its senior policyholder claims and obligations and ranges from Aaa to C.³²

Finally, like other agencies, Fitch's rating methodology relies on both quantitative and qualitative factors. In addition to the use of publicly available information in the rating process, Fitch also may conduct in-depth discussions with senior management of the insurers. Fitch's rating methodology focuses on the following six areas of analysis: industry review, organizational review, operational review, management review, corporate governance review, and financial review. Fitch's financial strength ratings on insurers range from AAA to C.³³

The methodology of these rating agencies is in contrast to the Demotech process. As mentioned previously, Demotech is a relative newcomer in the insurer ratings market. Having rated property and casualty (P&C) insurers since 1989, Demotech did not begin to provide Financial Stability Ratings (FSRs) for newly incorporated P&C insurance companies until 1996. Demotech's Financial Stability Analysis (FSA) Model utilizes three sources of information: insurer's statutory annual and quarterly statements in the past five years; insurer's most recent actuarial opinion and report; and the most recent discussion and analysis from the insurer's management. Under the FSA Model, major financial factors considered include the following: changes in the composition of insurer's assets and liabilities; change in insurer's working capital, leverage ratios, operating ratios, and mix of business ratios; as well as consistency in insurer

³² Specifically, the Long-term IFS rating range from Aaa (Exceptional Financial Security), Aa (Excellent Financial Security), A (Good Financial Security), Baa (Adequate Financial Security), Ba (Questionable Financial Security), B (Poor Financial Security), Caa (Very Poor Financial Security), Ca (Extremely Poor Financial Security), to C (Extremely Poor Prospects of Ever Offering Financial Security), the lowest rating. The Short-Term IFS Rating reflects Moody's opinion of the insurer's ability to repay punctually its short-term (i.e., within one year or less) senior policyholder claims and obligations. Such ratings range from P-1 (Superior), P-2 (Strong), P-3 (Acceptable), and NP (All Other Cases). These are not as comparable to the other agencies' financial strength ratings and thus are not the focus of our analysis.

³³ Specifically, the ratings categories include: AAA (Exceptionally Strong), AA (Very Strong), A (Strong), BBB (Good), BB (Moderately Weak), B (Weak), CCC (Very Weak), CC (Average or Below Average), and C (Below Average or Poor).

operations. Based on its strictly quantitative model, Demotech assigns a Preliminary Financial Stability Rating (PFSR) to each P&C insurer and notifies the insurer of its rating. If an insurer agrees with the PFSR, then Demotech asks the insurer to finalize the rating. Only finalized ratings are made available to the general public. However, Demotech has released both preliminary and finalized ratings to us for this study. The full range of Demotech ratings includes A'' (Unsurpassed), followed by A' (Unsurpassed), A (Exceptional), S (Substantial), M (Moderate), and L (Licensed).

The differences in the rating scales and factors related to ratings provide some challenges in comparing ratings across firms. However, prior literature does provide some guidance in this area. Further, based on the different factors considered by each agency, it is apparent that differences across agencies are expected. Understanding these differences is important to those stakeholders who rely on the ratings.

Differences Between Demotech and Other Rating Agencies

The major rating agencies such as A. M. Best, S&P, Moody's, and Fitch rely on a combination of both publicly and privately available information to create their ratings. While much of the public data is quantitative in nature, some of the private information is qualitative and largely based on subjective managerial input from the insurers. With the exception of the provisional ratings of Demotech, all of the ratings rely at least in part on information provided by the management of the insurer. Due to the potential influence of the managers, the use of managerial input in ratings can pose difficulty in creating an unbiased picture of insurers. Additionally, for larger firms with more resources to use in the ratings process, this can create an informational advantage.

Also related to information asymmetries, most rating firms require insurers to meet certain size and/or age requirements to be eligible for rating. In contrast, Demotech does not require insurers to be of a minimum size and/or have a certain number of years in business to obtain a rating. This is evidenced by our sample of insurers. Specifically, we find a larger portion of Demotech-rated insurers have been established five years or less, close to 15 percent compared to less than two percent for the other agencies. Moreover, approximately 30 percent of Demotech-rated insurers have been in business 10 years or less, compared to less than 10 percent for the other agencies. Such differences make Demotech ratings particularly important in the Florida property insurance market, where a large number of newly established insurers make up a significant fraction of the market.³⁴ For example, in Florida, over 70 percent of the homeowners insurance written by private insurers is written by companies incorporated after Hurricane Andrew.³⁵ While these new entrants are not commonly rated by some of the established rating agencies, they are typically rated by Demotech.

Additionally, Demotech rates a large number of single state insurers. As such, Demotech serves the need of another unique group of insurers, namely those that are geographically focused.³⁶ The ability of new entrants and geographically focused insurers to obtain ratings is extremely important in product lines such as homeowners insurance where mortgage companies require that consumers hold homeowners insurance from a rated insurer, and insureds rely on ratings to help discern which firms will be able to pay future claims, especially after a catastrophe.

³⁴ For more information on the Florida market, including the role of start-up property insurers see Cole, Macpherson, Maroney, McCullough, Newman, and Nyce (2009), Grace and Klien (2009), and Marlett (2009).

³⁵ This ratio is based on premium information obtained from the National Association of Insurance Commissioners Database.

³⁶ Note there is some overlap in these categories with approximately 18 percent of the insurers rated by Demotech being young (established 10 years or less) and geographically focused.

Lastly, Demotech offers both provisional and finalized ratings. Provisional ratings are provided for most insurers through an initial rating process which involves the use of only quantitative and publicly available data.³⁷ Insurers then have the option to finalize or not finalize their Demotech ratings. If insurers choose to finalize their ratings, the ratings are made available to the public. With other insurer rating agencies, access to preliminary ratings, if there are any, has not been available to researchers and thus no research has been conducted previously regarding preliminary ratings.³⁸

³⁷ This is in contrast to other rating agencies that use both quantitative and qualitative data in their original assessment of insurers. Further, other rating agencies do not provide a preliminary rating to all firms with available financial information as Demotech does.

³⁸ Prior research in the area of bank rating has analyzed potential differences in solicited and unsolicited ratings. This provides an basis to study potential differences in preliminary ratings created for all insurers with available data and finalized ratings only prepared for a group requesting finalization of ratings. For example, Van Roy (2006) investigates whether and why differences exist between Fitch's solicited and unsolicited bank ratings. Although he finds no evidence that Fitch assigns different weights across solicited and unsolicited groups to bank characteristics, he does find that unsolicited bank ratings are significantly lower than solicited ones after controlling for observable bank characteristics. Also focused on solicited and unsolicited bank ratings, Poon et al. (2009) examine 460 commercial banks in 72 countries excluding the United States. Their results show that observed differences between solicited and unsolicited ratings are determined by the solicitation status (i.e., whether the rating is solicited), in addition to financial profile of the banks.

Summary of Data by Rating Agency and Rating Categories

	Demotech			A. M. Best			S&P			Moody			Fitch		
	Rating	#	%	Rating	#	%	Rating	#	%	Rating	#	%	Rating	#	%
Superior/Extremely Strong/Exceptional	A"	348	19.7%	A++	8	0.2%	AAA	354	11.3%	Aaa	120	6.6%	AAA	194	9.3%
				A+	143	3.3%									
Excellent/Very Strong	A'	518	29.3%	A	885	20.7%	AA+	239	7.6%	Aa1	26	1.4%	AA+	313	15.0%
				A-	1421	33.2%	AA	398	12.7%	Aa2	296	16.3%	AA	453	21.8%
							AA-	448	14.2%	Aa3	469	25.8%	AA-	355	17.1%
Good/Strong	A	889	50.3%	B++	714	16.7%	A+	589	18.7%	A1	127	7.0%	A+	213	10.2%
				B+	575	13.5%	A	649	20.6%	A2	431	23.7%	A	226	10.9%
							A-	232	7.4%	A3	237	13.0%	A-	214	10.3%
Fair/Adequate	S	11	0.6%	B	274	6.4%	BBB+	84	2.7%	Baa1	46	2.5%	BBB+	35	1.7%
				B-	124	2.9%	BBB	85	2.7%	Baa2	13	0.7%	BBB	20	1.0%
							BBB-	29	0.9%	Baa3	31	1.7%	BBB-	35	1.7%
Less than Fair/Adequate	M L	0 0	0.0% 0.0%	C++	71	1.7%	BB+	15	0.5%	Ba1	11	0.6%	BB+	9	0.4%
				C+	31	0.7%	BB	8	0.3%	Ba2	4	0.2%	BB	1	0.0%
				C	16	0.4%	BB-	6	0.2%	Ba3	5	0.3%	BB-	12	0.6%
				C-	6	0.1%	B+	2	0.1%	B1	1	0.1%	B+	0	0.0%
				D	6	0.1%	B	1	0.0%	B2	1	0.1%	B	0	0.0%
							B-	0	0.0%	B3	3	0.2%	B-	1	0.0%
							CCC	5	0.2%				CCC	0	0.0%
							CC	0	0.0%				CC	1	0.0%
									C	0	0.0%				
	1766			4274			3144			1821			2082		

Appendix B – Decision Models

Factors Considered in Decision to Be Rated Models

Prior literature provides some guidance with respect to the types of firms that will solicit ratings; however, the literature does not always differentiate with respect to which type of agency the insurer will select. In our framework, we contrast potential differences in the selection process between traditional rating agencies, which can have fairly significant barriers to entry (related to costs and/or managerial input), with Demotech’s solicited ratings, which have lower barriers. We do so by focusing on several factors that are anecdotally thought to impact a firm’s selection of a rating agency (i.e., whether the insurer is rated by others, its age, and its business focus). We also control for other traditional factors known to impact the rating decision.

Since ratings are costly for insurers, the majority of insurers in our sample (i.e., ranging from 65 percent to 72 percent in a given year, as shown in Table 3) elect to be rated by only one agency. As such, we include *Rated by Others*, an indicator variable equal to one if the insurer is rated by at least another rating agency, and zero otherwise.³⁹ We expect that insurers with existing rating(s) will be less likely to elect to be rated by another agency.

Second, new insurers often have difficulty obtaining ratings due to barriers related to costs and/or minimum firm age requirements. Given the low levels of managerial data required and the lower cost structure, these barriers are lower for Demotech solicited ratings compared to other agencies. For this reason, it is predicted that younger insurers will be more likely to seek ratings from Demotech and less likely to seek ratings from traditional agencies. To test this hypothesis, we include *Age Under 10*, an indicator variable equal to one if the insurer has been established for less than 10 years, or zero otherwise.

³⁹ In alternate specifications of the model we include (1) a variable representing the number of other agency ratings the firm holds in a given year; and (2) individual indicator variables identifying which rating agency the insurer currently holds a rating from in a given year. The results were statistically similar

An initial review of the data suggests that Demotech rates a significantly larger percentage of mono-state insurers than all other agencies under our consideration.⁴⁰ This may be due to the fact that mono-state insurers face some barriers to being rated by the traditional rating agencies. Thus, we include a *Mono-State Indicator* as a measure of whether or not the insurer is geographically restricted to a single state. We include further controls related to business mix including measures to control for catastrophe exposure, line-of-business concentration, and the percentage of long-tailed lines written as well as the percentage of personal lines business.

We also include other variables in the model to control for issues related to size, risk, financial strength, organizational form, and organizational/operational characteristics. Specifically, *Direct Premiums Written* is the measure of size; *Capital to Assets* and *Net Income to Assets* are measures of financial risk; *Mutual Indicator* and *Other Organization Type Indicator* are measures of organizational form with the omitted category being stocks; and *Group Affiliation*, *Cash to Invested Assets*, *Change in NPW*, and *2-Year Loss Development* are measures of organizational/operational characteristics.

⁴⁰ More specifically, nearly 47 percent of the insurers that solicit Demotech ratings are mono-state insurers. While close to 38 percent of A. M. Best-rated insurers are mono-state insurers, the percentages for the other agencies are much lower, ranging between 8 percent and 13.5 percent.

Results of the Decision to Be Rated Models

Decision to Be Rated Model Results – Unsolicited Models

	S&P	Fitch
Constant	-2.058*** (0.159)	-1.533*** (0.202)
<i>Organizational Characteristics</i>		
Direct Premiums Written	0.0805*** (0.0113)	0.0729*** (0.0128)
Mutual Indicator	0.0861** (0.0421)	0.823*** (0.0549)
Other Organization Type Indicator	0.155** (0.0682)	0.00466 (0.0852)
Group Affiliation	0.145*** (0.0469)	0.284*** (0.0598)
Age Under 10	-0.500*** (0.0623)	-0.431*** (0.0789)
<i>Business Mix</i>		
Line-of-Business Herfindahl	0.0901 (0.0645)	0.0393 (0.0817)
Percentage in Long-Tail Lines	0.138** (0.0647)	0.547*** (0.0839)
Percentage in Personal Lines	0.397*** (0.0433)	0.333*** (0.0561)
Mono-State Indicator	-0.214*** (0.0424)	-0.390*** (0.0547)
<i>Business Risk</i>		
Catastrophe Exposure	-0.00328*** (0.000906)	-0.000966 (0.00123)
2 Year Loss Development	0.00202** (0.000850)	-0.00209* (0.00126)
<i>Financial Strength and Flexibility</i>		
Capital to Assets	-0.449*** (0.102)	-0.907*** (0.139)
Net Income to Assets	0.757** (0.329)	0.270 (0.434)
Cash to Invested Assets	-0.611*** (0.103)	-1.512*** (0.164)
Change in NPW	-0.000539* (0.000290)	-0.00185*** (0.000471)
Observations	14898	5798

Year indicator variables included in all models; standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Decision to Be Rated Model Results – Finalized and Solicited Models

	Demotech	A. M. Best	S&P	Moody's	Fitch
Constant	-1.211*** (0.127)	-0.892*** (0.117)	-3.934*** (0.170)	-4.099*** (0.290)	-5.023*** (0.214)
<i>Multiple Ratings Indicator</i>					
Rated by Others	-0.304*** (0.0301)	-0.518*** (0.0291)	0.577*** (0.0290)	1.405*** (0.0558)	0.960*** (0.0375)
<i>Organizational Characteristics</i>					
Direct Premiums Written	-0.0356*** (0.00827)	0.0435*** (0.00734)	0.227*** (0.0102)	0.141*** (0.0171)	0.175*** (0.0116)
Mutual Indicator	0.0351 (0.0366)	-0.144*** (0.0290)	-0.862*** (0.0510)	-0.500*** (0.0654)	-0.709*** (0.0577)
Other Organization Type Indicator	-0.501*** (0.0573)	-0.529*** (0.0444)	-0.129* (0.0741)	0.0822 (0.126)	-0.482*** (0.108)
Group Affiliation	-0.120*** (0.0371)	-1.070*** (0.0302)	1.260*** (0.0614)	1.611*** (0.136)	1.484*** (0.0970)
Age Under 10	0.0605 (0.0381)	-0.536*** (0.0409)	-0.264*** (0.0541)	0.183** (0.0774)	0.0274 (0.0645)
<i>Business Mix</i>					
Line-of-Business Herfindahl	-0.0709 (0.0575)	0.313*** (0.0454)	-1.009*** (0.0608)	-1.445*** (0.0875)	-0.782*** (0.0684)
Percentage in Long-Tail Lines	0.515*** (0.0652)	-0.109*** (0.0409)	-0.0225 (0.0568)	-0.363*** (0.0768)	-0.179*** (0.0668)
Percentage in Personal Lines	0.636*** (0.0365)	0.140*** (0.0326)	-0.626*** (0.0383)	-0.228*** (0.0552)	-0.186*** (0.0437)
Mono-State Indicator	0.175*** (0.0312)	-0.112*** (0.0292)	-0.115*** (0.0381)	-0.476*** (0.0569)	-0.0468 (0.0459)
<i>Business Risk</i>					
Catastrophe Exposure	-0.00334*** (0.000789)	0.00186*** (0.000587)	0.000394 (0.000780)	-0.00359*** (0.00139)	0.00222** (0.000993)
2 Year Loss Development	-0.00127** (0.000643)	-0.00211*** (0.000634)	0.00280*** (0.000895)	0.00555*** (0.00117)	0.00524*** (0.000954)
<i>Financial Strength and Flexibility</i>					
Capital to Assets	-0.434*** (0.0835)	0.197*** (0.0717)	0.476*** (0.101)	-0.402** (0.170)	-0.168 (0.126)
Net Income to Assets	-0.358 (0.269)	0.451* (0.231)	1.061*** (0.333)	0.565 (0.456)	2.312*** (0.393)
Cash to Invested Assets	-0.00571 (0.0549)	-0.627*** (0.0565)	-0.00506 (0.0848)	-1.228*** (0.222)	-0.828*** (0.137)
Change in NPW	0.000379** (0.000161)	-0.000146 (0.000168)	-0.000290 (0.000249)	-0.00132*** (0.000431)	-0.000138 (0.000308)
Observations	16859	16859	16859	16859	16859

Year indicator variables included in all models; standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Attachment 3

Demotech 30th Anniversary Reprint

Celebrating our

30th

ANNIVERSARY



Demotech, Inc.

1985 - 2015

The Demotech Story

By Joseph L. Petrelli

The Liberation of an Industry

A Level Playing Field for Every Financially Stable Insurer

In September 1985 Demotech, Inc. incorporated as a financial analysis and actuarial services company. Our corporate mission was to become the leading provider of innovative solutions to financial analysis issues by focusing our resources on niches presenting opportunity for corporate growth. A series of events led us to understand that one of the financial analysis opportunities that existed was the liberation of the

insurance industry from the exclusive opinion of a single insurer rating service. The playing field needed to be leveled for every financially stable insurer. Having celebrated our Pearl anniversary, 30 years, in September 2015, I share some of the innovative solutions that have shaped our growth while concurrently leveling the playing field.

CHAPTER ONE

How the Story Began

Prior to the mid 1980s, ISO, NCCI, AAIS and other statistical organizations promulgated and filed advisory rates with the respective departments of insurance. Their members or subscribers would adopt the rates as filed or file a deviation to reflect the impact of their anticipated situation. In the mid 1980s, these statistical organizations undertook an effort to publish loss costs, i.e., the anticipated cost per policy excluding a provision for operating expenses or

pre-tax profit. In this revised regulatory environment, carriers would need to calculate and file their own rates based upon their current or anticipated expenses and a provision for profit. With hundreds of regional and specialty insurers operating in the U.S., the services of an actuary and state filing and compliance services seemed to be an emerging opportunity for consulting services.

CHAPTER TWO

Leveling the Playing Field for Third Parties Relying on Insurer Ratings

Demotech decided to focus on providing consulting services to regional and specialty insurers. In the summer of 1987 one of my marketing trips took me to Napoleon, Ohio to meet with German Mutual Insurance Company. I had the distinct privilege of speaking with Rupert Knappe, President and chief operating officer. We discussed the conversion of loss costs to premiums, the need to evaluate loss and loss adjustment expense reserves and the unique qualifications of actuaries to evaluate the rate level adequacy of products. To each of my thrusts for a consulting assignment, he parried with "we do that very well right now."

Although somewhat dejected by his perception of the practical experience of his staff being equivalent to the services of a credentialed actuary, I thanked him for his time and asked him to keep Demotech in mind for other situations that might present themselves. I finished my cup of coffee and drove back to Columbus.

A few days later, I received a call from Mr. Knappe, advising me that the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and National Association of Mutual Insurance Companies had a predicament. Fannie Mae and Freddie Mac had been qualifying regional and specialty insurers that were not rated by A. M. Best Company through an internal financial analysis process. However, they no longer wished to do so and were seeking a third party rating company to review and rate independent, regional and specialty insurance carriers to qualify them as acceptable to the secondary mortgage marketplace.



According to Mr. Knappe, other rating agencies were unable or unwilling to assist. If Demotech was interested in assisting independent regional and specialty insurers, an opportunity to do so would involve developing a review and analysis process that addressed the needs of these carriers.

Our actuaries and MBAs seized the moment and initiated the development of a financial stability analysis model that would be suitable for reviewing and rating independent regional and specialty insurance carriers. The development, testing and retrofitting, to ensure that solvent and insolvent carriers could be identified, took months. In late 1988 we submitted our proposal to Fannie Mae and Freddie Mac. Anita Champ was our contact at Fannie Mae, Albert LeQuang was the contact at Freddie Mac.

Their first order of business was an internal due diligence—separately by each government-sponsored enterprise (GSE). Step two was an onsite visit by analysts from each GSE. Step three was an independent analysis of our process by each of the GSE's outside insurance consultants.

Demotech had invested more than six months to solve a problem facing NAMIC, Fannie Mae, Freddie Mac and regional insurers and yet we were greeted, not with open arms but with six reviews by six different sets of eyes. When I inquired of Ms. Champ and Mr. LeQuang as to why we had not received a warmer welcome, their responses were quite similar. They essentially said: “Joe, we made this request of others, but were told it was impossible to rate smaller, independent, regional insurers. We needed to understand how and why Demotech was able to do so when others were not.” I advised them that the key to reviewing and rating regional and specialty insurers was to evaluate the quality and quantity of their reinsurance treaties and program.

In May 1989 Fannie Mae issued Bulletin 89-13. In January 1990 Freddie Mac issued Announcement 90-1. Carriers earning a Financial Stability Rating® of A or better would be considered “acceptable hazard insurance carriers” under Fannie and Freddie’s seller’s and servicer’s guidelines. The liberation of regional and specialty insurers was underway. The playing field had been leveled.

CHAPTER THREE

Leveling the Playing Field for Innovative Carriers

Concurrent with our efforts on behalf of regional and specialty insurers was an initiative involving public entity liability insurance pools. In the late 1980s, in response to the availability and affordability of public entity liability insurance being experienced countrywide, a risk pooling consultancy formed seven public entity liability insurance pools to serve the needs of townships, counties and other governmental subdivisions located in six states. The seventh entity was the reinsurer of the participating pools.

The coverage document, funding mechanism and risk management protocols associated with participating in

the entities were mandatory. Nothing about the coverage document or funding (pricing) was traditional. The legacy rating agencies did not rate the entities. Demotech did so. In fact, we assigned our highest applicable rating. Today, twenty eight years later, these six entities have paid out more than \$1 billion in losses and loss adjustment expense, have secured unqualified independent audit opinions throughout their existence, enjoy a renewal retention rate in excess of 95% and continue to serve their initial members and new insureds. The liberation of innovative insurance contracts and unique funding mechanisms was underway.

CHAPTER FOUR

Leveling the Playing Field for Regional and Specialty Carriers

Fast forward to 1992. Hurricane Andrew devastated the property insurance marketplace in Florida. Although it was a tragic situation from a human and material damage perspective, Hurricane Andrew was about a 1:40 year event, not a 1:100 year event. As a result of the impact of Andrew, then Commissioner of Insurance, Tom Gallagher, was forced to take action to liquidate 21 carriers. This count was in addition to the number of insolvencies domiciled in other states and wounded affiliates that were merged into healthy carriers within their group.

With its property insurance marketplace in turmoil, the State responded to the needs of Floridians that required homeowners and property insurance by establishing the Florida Residential Property and Casualty Joint Underwriting Association. In 1996, in recognition of the need to transition the insurance exposure to the private insurance sector, Florida's legislature enabled the process by passing a law that incentivized the creation of domestic carriers.

Recognizing that the overwhelming majority of Floridians had mortgages on their properties and the carriers providing property insurance coverage needed to be acceptable to lenders and the secondary mortgage marketplace, interested third parties requested that the final version of the law contain a requirement that the newly formed carriers be rated and acceptable to the secondary mortgage marketplace. Regrettably, the legacy insurer rating services were non-responsive to this requirement and the (then) department of insurance, division of government and industry relations, sought advice from Fannie Mae and Freddie Mac. Albert LeQuang, who seven years earlier had coordinated Freddie Mac's due diligence of us, advised the department to contact Joe Petrelli at Demotech because "he will figure out a way to assist you."

I received a call from the department of insurance and they explained the requirement. We accepted the challenge. Having focused our initial efforts on regional and specialty insurers and their need for a high quality and quantity of reinsurance, we studied the 21 carriers that had failed. Demotech's observation was as clear as it was obvious—the carriers that failed had not purchased sufficient vertical reinsurance coverage. The 1:40 year event known as Hurricane Andrew had penetrated the level of reinsurance purchased.

More reinsurance, and additional insights from the nascent science of catastrophe modeling, in conjunction with a higher level of corporate expertise in catastrophe response protocols, could have mitigated the impact of Andrew on Florida's property insurance marketplace, reducing the severity of the impact from devastating to manageable. These issues became the focal points of our review and analysis process for the start-up carriers. We revisited our financial model and made adjustments to reflect the unique attributes of wind exposed property insurers and the enhanced need for vertical and horizontal reinsurance protection.

Today, twenty years later, the carriers that we review and rate have moved from writing 0% of Florida's property insurance marketplace in 1996 to more than 50 carriers writing about 55% of the homeowner's insurance marketplace in Florida. With Citizens Property Insurance Corporation at about 15% of the market, we have 55% of the 85% that is rated.

One of the many success stories in Florida is ASI Corporation. We have reviewed and rated this carrier and its affiliates since their inception in 1996. Their initial capitalization was approximately \$6,000,000 and their initial year's production was about \$10,000,000. Progressive Corporation recently announced that it had acquired approximately 70% of the holding company's stock for about \$700,000,000.

In September 2015, Sharon and I received the Founder's Award from the Florida Association for Insurance Reform for our leadership in creating a robust property insurance market for the State of Florida. At that same event, Commissioner Kevin McCarty advised the attendees that the State of Florida could not have bounced back without the assistance from Demotech. Another playing field has been leveled.



Left to right - Senator Jeff Clemens, Vice President Wind Mitigation and Energy programs, Florida Association for Insurance Reform (FAIR); Joe Petrelli and Sharon Romano Petrelli—co-founders of Demotech, Inc.; and Jay Neal, President and CEO, FAIR.

CHAPTER FIVE

Leveling the Playing Field for Consumers and Producers

An effective liberation movement needs to address every facet of a citizen's life. A corporate liberation movement must do the same. Hazard insurance requirements imposed by the secondary mortgage marketplace were an amazing start but more is necessary to level the playing field. With the exclusive

opinion of a single rating service entrenched in statutes, regulations, insurance policies, etc., Demotech must be nimble and well-armed to be successful.

In the areas of insurance agents' errors and omissions (E&O) insurance, the liberation movement has made tremendous progress. The big three legacy E&O carriers have moved toward a trigger for coverage under insolvency that now includes a certain level of rating by a specific rating service, admitted status with coverage by a guaranty fund or government sponsored entities. Admitted status assists a large number of the carriers that were adversely impacted prior to the initiation of the liberation process.



Beyond the big three legacy E&O carriers, enlightened E&O carriers have amended their existing policies, developed endorsements or otherwise adopted coverage that also enables protection to agents if the insurer was rated A or better by Demotech. Independent insurance agents need to be liberated to enable consumers to benefit from innovations of the insurance industry while having the maximum number of insurers compete for the agent's production.

Similarly, premium finance companies, personal umbrella and commercial umbrella insurance carriers, and other informed third parties have adapted their procedures and underwriting guidelines to include carriers rated A or better by Demotech to supplement the ratings of the single rating service.

CHAPTER SIX

Independent, Objective Verification of Our Capabilities and Process

In February 2011, Florida State University's College of Business, Risk Management and Insurance undertook an independent study comparing Demotech FSRs with insurer ratings issued by A. M. Best, Standard and Poor's, Moody's and Fitch.

The study reviewed thousands of insurer ratings issued over a nine year period. The results were released in *A Comprehensive Examination of Insurer Financial Strength Ratings*. The authors concluded, in part:

1. Demotech serves the need of another unique group of insurers.
2. Comparisons of Demotech ratings to other agencies show relative consistency in the factors that drive Demotech ratings compared to agencies such as A. M. Best, Moody's, Standard and Poor's, and Fitch.
3. There is also general consistency in the firms that each agency would categorize as financially secure.
4. These results have important public policy implications for insurers, regulators and consumers as they work to better understand the ratings process. Of particular importance to most is the comparability of Demotech ratings to other agencies.

In the past twelve months Demotech has been nominated for Intelligent Insurer's Global Award – Best Rating Agency (2014, 2015) as well as Rating Agency of the Year - Reactions North America Awards Banquet (2015). Demotech also received the following awards in the past several months:

- ACQ Global Award – Niche Insurer Rating Service – US (2014)
- ACQ Global Award – Niche Insurer Rating Service – US (2015)
- Financial Monthly – Innovation and Excellence Award for Financial Analysis (2014)
- ACQ Global Award – US – Gamechanger of the Year (Financial Analysis) (2014).

Today, thirty years after we prepared our mission statement, Demotech reviews and rates 420 insurers writing every line of P&C business in every state, Puerto Rico and the District of Columbia. Having celebrated our 30th anniversary, we remain uniquely positioned to provide innovative solutions to financial analysis issues. 🌐



Domestic and international recognition of the value of Financial Stability Ratings®.

Why the Dragonfly?

By Sharon M. Romano Petrelli

September 9th, 2015 marked the thirtieth anniversary of Demotech's incorporation. As a milestone such as this is achieved, one can't help but be a little nostalgic. Why did we incorporate Demotech thirty years ago? What were we trying to accomplish? What was our vision for the future?

Demotech has always been a bit of a contrarian in the way we have done business. In fact, looking at things a little differently is imbedded in our corporate culture. We wanted to be innovative and creative in our methods of financial analysis. Demotech would tackle projects because they were exciting as well as challenging and addressed each with an open mind. We wanted to make a difference. Demotech has worked hard over the past thirty years to level the playing field in the insurance industry.

The philosophy of "too big to fail" just didn't sit well with us especially in light of the Reliance, Legion, Transit, Executive Life, Home and Mission insolvencies. We didn't want to be limited by the constraints that plagued previous analysis of this industry and believed there was another way to approach ratings. Saying "it can't be done" was unacceptable.

It has long been our belief that size should not be the determining factor when analyzing the financial strength of a company. The quality and quantity of an insurer's reinsurance program makes all the difference when evaluating a company's financial strength and business model. Insurers, no matter

what their size, can be successful with the proper quality and quantity of reinsurance in place. Criteria such as size should no longer lead the list of parameters; not for us; not for the market we intended to served.

To brand ourselves, we were developing an ad for an insurance publication. We needed an image that captured our message; a visual that would grab our audience, that would express this philosophy at first glance. It was then that the tyrannosaurus and the dragonfly ad was developed. It fit. Its size and survival worked perfectly. The massive, powerful tyrannosaurus, once so threatening, is now extinct and upstaged by the tiny dragonfly. Wow, what an image. The ad worked! We were inundated by comments from clients. More recently we revised the tyrannosaurus ad and moved to using just the dragonfly. It became part of our brand.

The dragonfly represents more than meets the eye. The dragonfly has evolved and survived for over 300 million years. They survived because they were able to adapt. It was adaptability and flexibility that attracted us

to the dragonfly in the first place. This demonstrates another one of Demotech's philosophies. Smaller, regional companies are often more responsive and are able to adapt to the markets they serve with greater ease. Adaptability, agility and an instinct for survival fit our message.

The correlation does not stop there. The dragonfly's brain, eyes, and wings allow them to hunt unerringly. They stay focused. Similarly, it is our belief that insurers that stay focused on insurance fundamentals and stick to their knitting, without straying from their area of expertise will be successful, no matter their size. Demotech is determined to remain focused yet flexible when addressing the issues that plague the niches we serve. This strategy has served us well these past thirty years and it will continue to serve us in many years to come. Demotech, like the dragonfly, has been structured to adapt. We can make a difference. The Demotech Difference!



Odonata Anisoptera

The Demotech Staff



Joseph L. Petrelli, ACAS, ASA, MAAA, FCA
President

Sharon M. Romano Petrelli, CPCU, AIAF, ARC, CCP
Vice President



Victoria M. Dimond
Joined Demotech
January 1990



Barry J. Koestler II, CFA
Joined Demotech
May 1995



Thomas M. Bowser, A +
Joined Demotech
March 1997



Nancy Davis, CISR
Joined Demotech
December 1998



Paul Osborne
Joined Demotech
November 2005



Douglas A. Powell, MBA
Joined Demotech
September 2006



Robert M. Warren, CPA, CPCU
Joined Demotech
October 2006



Leslie Evans
Joined Demotech
March 2009



**Steven J. Groeschen, FCAS,
MAAA**
Joined Demotech
July 2010



Rachel Wilkins
Joined Demotech
June 2011



W. Burke Coleman
Joined Demotech
January 2012



Mitzi A. Smith
Joined Demotech
May 2014



Carey L. Schuett
Joined Demotech
June 2014



Barbara C. Albert
Joined Demotech
November 2014



Attachment 4

Demotech Milestones - 1985 to 2016



Demotech Milestones

1985

- Founded by Joseph L. Petrelli and Sharon M. Romano Petrelli to serve the financial analysis and actuarial services needs of regional and specialty insurers.

1986

- First to issue Financial Stability Ratings® (FSRs) for health maintenance organizations (HMOs).

1987

- First to issue FSRs for public entity liability self-insured pools through the development of our Management Audit Process.

1989

- First to review and rate independent regional and specialty insurance companies.
- First to have Property & Casualty insurance company rating process formally reviewed and accepted by Fannie Mae. An FSR of A or better eliminates the need for property insurance cut-through endorsements.

1990

- First to have Property & Casualty insurance company rating process formally reviewed and accepted by Freddie Mac.
- Began offering Property & Casualty insurance companies and Title underwriters loss cost analysis and rate, rule and form filing assistance.
- Responded to the National Association of Insurance Commissioners requirements for Property & Casualty insurers to submit Statements of Actuarial Opinion related to loss and loss adjustment expense reserves concurrent with the 1990 Property & Casualty annual statement.

1992

- First to analyze the financial position of each Title underwriter in the industry.

1993

- First to have Property & Casualty insurance company rating process formally reviewed and accepted by HUD.

1994

- Fannie Mae issued Title underwriter acceptance guidelines, naming Demotech as an approved Title underwriter rating service.

1995

- First to promulgate Commercial Real Estate Recommendations to provide financial due diligence of Title underwriters involved in larger real estate transactions.

1996

- Contacted by the Florida Office of Insurance Regulation when the property insurance market required newly established insurers to obtain ratings. Demotech developed evaluation procedures for the assignment of FSRs to newly formed companies.
- Coordinated the first seminar regarding the implementation of statements of actuarial opinion for Title underwriters on behalf of the Conference of Consulting Actuaries.



1999

- Co-authored the Commerce Clearing House publication describing the evolution of the Canadian Title insurance industry.

2001

- Completed the initial loss and loss adjustment expense review of the Iowa Finance Authority – Title Guaranty Division.

2002

- Revitalized the Ohio Title Insurance Rating Bureau, Inc. (OTIRB).

2003

- Auto-Owners Insurance Group made umbrella insurance available to insurers earning an FSR of A or better.
- Assisted the North Carolina Title Insurance Rating Bureau with the development and filing of Closing Services coverage.
- Assisted OTIRB with its first rate revision since 1980.

2004

- Published *Serious about Solvency – Financial Stability Rating[®] Survival Rates 1989 through 2004*.
- Introduced *Demotech Performance of Title Insurance Companies* and Quarterly Updates, presenting consolidated statutory financial information for the Title insurance industry.

2005

- HUD approved Demotech's rating process for general and professional liability insurance under Notice H04-15, Professional Liability Insurance for Section 232 and 223(f) Programs.

2006

- Joseph L. Petrelli, ACAS, MAAA, FCA, authored *What We've Got Here Is a Failure to Communicate – How Traditional Financial Reporting Contributes to Misunderstanding of Title Insurance Loss Activity*.

2007

- Demotech introduced its Company Classification System.
- Demotech designated as the Official Research Partner of *Insurance Journal*.
- Expanded operations into a larger facility reflecting our increased capacity to serve our clients.

2008

- Introduced Insurance Agents' Errors and Omissions Insolvency Gap Legal Defense Coverage.

2009

- Expanded the Insolvency Gap Coverage to include indemnity as well as legal defense.

2010

- Celebrated 25th Anniversary.



2011

- The Florida State University published “A Comprehensive Examination of Insurer Financial Strength Ratings” comparing and contrasting Demotech to A.M. Best, Moody’s, Standard & Poor’s and Fitch.

2012

- Financial Stability Ratings® added to SNL Financial’s products, www.snl.com.

2013

- A leading insurance agents’ errors and omissions insurance carrier retained Demotech to perform a financial due diligence on the carriers that request an extension of insolvency coverage.
- Introduced Stakeholder Team Accomplishment Recognition™ Award to identify Property & Casualty insurers that successfully addressed the diverse needs of all corporate stakeholders.

2014

- Achieved the milestone of more than 400 insurance entities being actively reviewed, rated and monitored.
- Fannie Mae MultiFamily accepted captive insurers and risk retention groups rated A or better by Demotech as regards professional and general liability insurance coverage for senior housing facilities.
- Awards
 - Nominated for Intelligent Insurer Global Award – Best Rating Agency.
 - ACQ Global Awards 2014 – US – Niche Financial Analysis Provider of the Year (Insurance).
 - ACQ Law Award 2014 – Niche Lawyer of the Year – US to W. Burke Coleman, Esquire, Demotech’s Legal Counsel and Compliance Manager.

2015

- Celebrated 30th Anniversary.
- Published inaugural issue of *The Demotech Difference*.
- Awards:
 - ACQ Global Awards 2015 – US – Niche Financial Analysis Provider of the Year (Insurance). (2nd consecutive year)
 - *Corporate LiveWire* – Innovation & Excellence Award 2015 – Excellence in Financial Analysis – USA.
 - ACQ Global Awards 2015 – US – Gamechanger of the Year (Financial Analysis).
 - Founder’s Award from the Florida Association for Insurance Reform.
 - *Reactions Magazine* – Rating Agency of the Year – 2015 – Runner Up.
 - *Corporate LiveWire* – Global Awards 2015 – Insurance Risk Management – Ohio.
 - *Financial Monthly* – M&A Awards 2015 – Financial Analysis Firm of the Year – USA.
 - UK Corporate Excellence Award 2015 – Best Evaluator of US Regional and Specialty Insurers & Sustained Excellence in Insurer Financial Analysis.



2016

- Financial Stability Ratings® of S or better accepted by a major underwriter of insurance agents' Errors and Omissions insurance.
- Held Insurance Summit 2016 at The Wild Dunes in South Carolina.
- Released a series of seminars related to understanding the statutory property and casualty annual statement (<https://youtu.be/Y9EBBgIHNlQ>).
- Approved as a provider of insurance agent continuing education in Ohio. Ohio State Treasurer Josh Mandel was a guest lecturer at our initial session.
- Awards:
 - ACQ5 Global Awards 2016 – US – Niche Financial Analysis Provider of the Year (Insurance). (3rd consecutive year).
 - ACQ5 Global Awards 2016 – US – Gamechanger of the Year (Financial Analysis). (2nd consecutive year).
 - *InterContinental Finance and Law Magazine* 250 Leading Firms Award 2016 – Insurance and Reinsurance Analysis Firm – USA.
 - *Dealmakers Monthly* 2016 Country Awards – Financial Analysis Firm of the Year – USA.
 - *Corporate LiveWire* – Global Awards 2016 – Knowledge of Insurance and Reinsurance.
 - *Financial Monthly* – Global Awards 2016 – Financial Analysis Firm of the Year – USA.
 - *Reactions Magazine* – Rating Agency of the Year – 2016 – Nominated for the second consecutive year.
 - *Acquisitions International* 2016 M&A Awards Winner – Best Property/Casualty Insurance Agency Service Provider – USA.
 - *Corporate LiveWire* – 2016 International Mergers & Acquisitions Awards – Financial Stability Analysis Firm of the Year – USA.
 - *Legal Comprehensive* – 2016 Golden Globe Award – Best US Financial Analysis Firm – USA.
 - *Dealmakers Monthly* 2016 Global Awards – Best Property and Casualty Insurance Firm of the Year – USA.
 - *Dealmakers Monthly* 2016 Global Awards – Best US Financial Analysis Firm.
 - *Worldwide Financial Advisor Awards Magazine* Golden Advisor Awards 2016 – Financial Analysis Firm of the Year – USA.

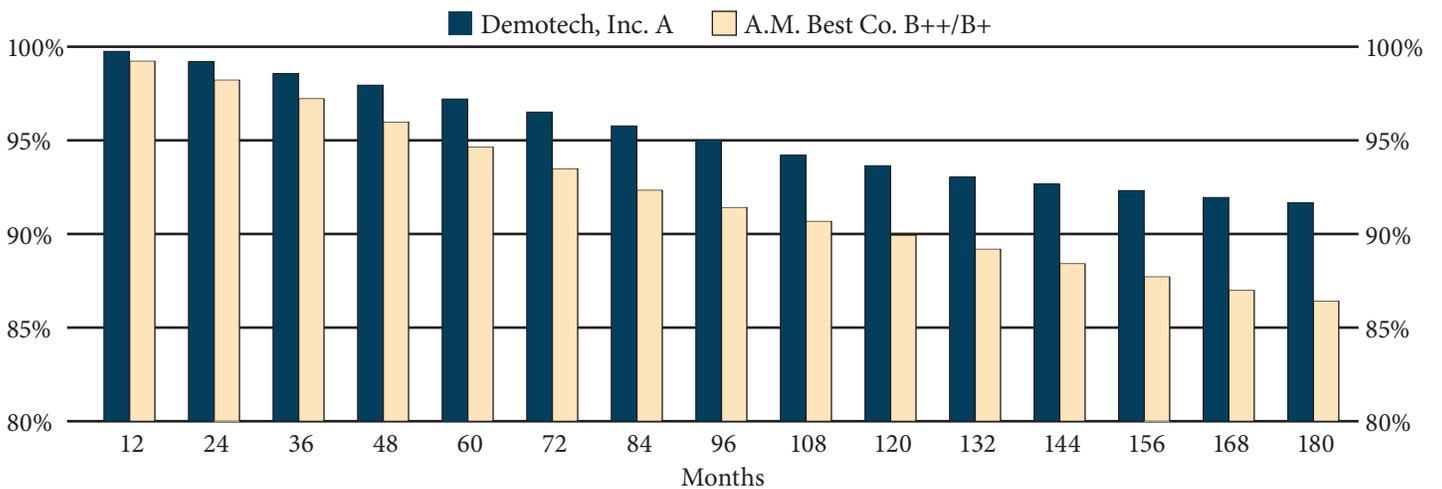
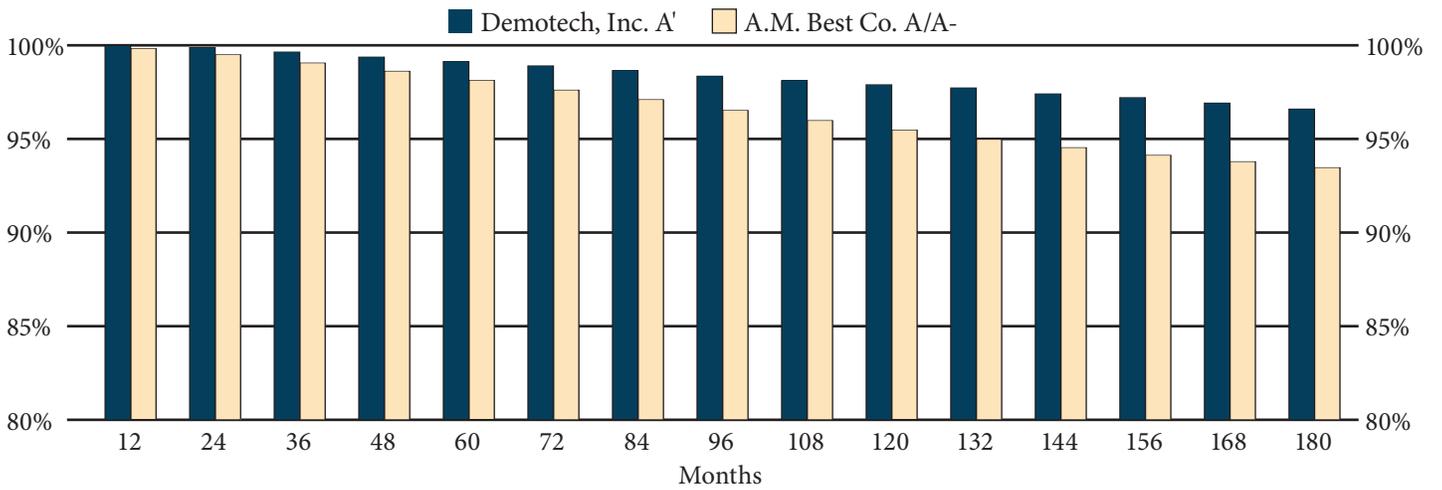
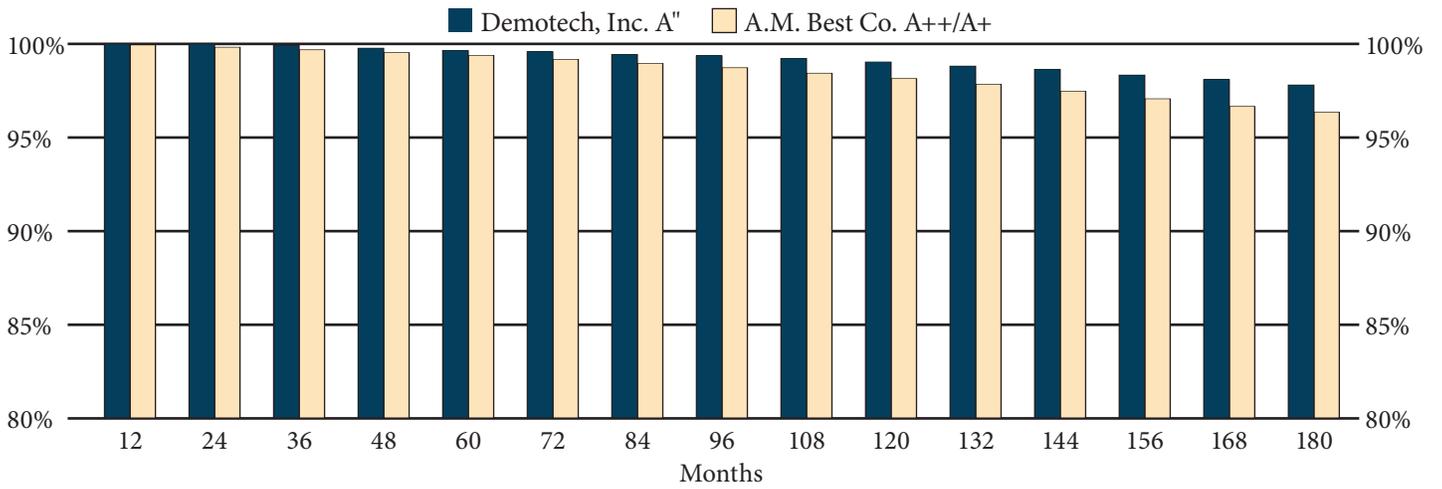
Attachment 5

**Comparative Study of Demotech, Inc. versus A.M. Best Company
Months of Survival Subsequent to Rating Assignment
Cumulative Average Survival Rates**

Comparative Study of Demotech, Inc. versus A.M. Best Company

Months of Survival Subsequent to Rating Assignment

Cumulative Average Survival Rates



Source: Demotech, Inc. - Company status evaluated as of June 30, 2014 for ratings issued through 2013. Data includes many carriers included by A.M. Best.
 A.M. Best Co. - Impairment Rate and Rating Transition Study Report, March 31, 2014. Data excludes carriers not assigned a rating due to insufficient size and/or operating experience. Ratings issued through 2013.