COMPLIANCE
ADVISOR

Fundamentals of
Insurance Company Financial Analysis

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The ability of any insurance company to meet its obligations to policyholders is the foundation of the industry. Absent policyholders' trust in the financial integrity of insurers, the insurance risk transfer mechanism would collapse. This dynamic is especially acute in the excess and surplus lines industry, where no guaranty funds exist, except in New Jersey.

DUTY OF THE EXCESS LINE BROKER

In New York, the excess line broker has a non-delegable duty to use "due care" in the selection of a financially secure excess line insurer. The appellate level courts in New York have held that an excess line broker has a "…continuing duty to apprise the insured throughout the life of each policy…of any changes in the carriers' financial capability…" Some brokers are under the mistaken impression that the vetting by ELANY (to establish which insurers meet the minimum qualifications to be an eligible excess line insurer) relieves the excess line broker from its duty to use due care and insulates them from liability for claims should an eligible insurer subsequently become insolvent. **This is not the case!**

While other states may set different standards, in New York, the ultimate decision and responsibility rest with the excess line broker.

WHAT EVERY EXCESS LINE BROKER SHOULD KNOW

You can rely on ELANY's review of an insurer's financial condition as one spoke in the wheel of your effort to use "due care" in the selection of an excess line insurer. You should also be aware of an insurer's rating(s) by independent rating agencies, how they evaluate the carrier, the financial size of the carrier, the book of business it writes, where applicable, and its reinsurers.

Regulation 41 / 11 NYCRR 27.13 requires excess line brokers to maintain records and documents for each foreign excess line insurer with whom they do business. This regulatory requirement is waived if ELANY maintains such records and documents and provides excess line brokers access to them.

ELANY publishes a financial analysis of eligible foreign excess line insurers that provide significant documentation to ELANY and which ELANY finds, after a financial analysis, meet a criterion of financial requirements that exceed the minimum eligibility standards. Not all eligible insurers appear on the ELANY List. As to eligible foreign insurers that do not appear on the ELANY List of E&S Insurers, excess line brokers must maintain the records required by 11 NYCRR 27.13.

Perhaps even more importantly, you need to recognize that the financial condition and strength of any given company is constantly a moving target. This is why ELANY's evaluations are ongoing and continuous.

POLICYHOLDERS' SURPLUS

The most fundamental concept of financial analysis is the amount by which a company's assets exceed its liabilities, which is known as policyholders' surplus for insurance companies (net worth for most other companies). Policyholders' surplus is the asset cushion that an insurance company maintains to protect itself, its policyholders and its shareholders, against an adverse development of losses and/or other adverse conditions. To be an eligible excess line insurer in New York, you must have a minimum of $49 million of policyholders' surplus on and after January 1, 2025.

ELANY assesses the quality of policyholders' surplus by examining the amount of surplus generated organically through earnings versus capital contributions received from the parent/owner(s). The presence of hybrid forms of equity, such as surplus notes, is also taken into account. Additionally, it is important to review the insurer's history of paying dividends to its shareholders and how that has impacted surplus growth and leverage.

ASSETS

The quality of an insurer's assets and investment return that those assets generate are examined. Most U.S. based insurance companies invest conservatively in treasury securities and other highly rated corporate, municipal, state or other bonds. Many insurers allocate a portion of their investment portfolios to equity securities, but the allocation is not typically substantial relative to the whole asset base. Insurers that have inordinate amounts of capital invested in real estate, non-investment grade securities, equities and/or other illiquid assets expose their balance sheets to additional risks.

On the asset side of the balance sheet, insurers ultimately seek to grow their income producing assets for an overall increase in return on their portfolio of investments. If an insurer's invested assets are not increasing, this can be a red flag for financial problems. ELANY also verifies that each insurer is sufficiently liquid, meaning that it has enough cash and easily sellable invested assets to meet all potential current liabilities and claims.

Most insurers have large assets in two categories, which provide no return on investment: reinsurance recoverables and agents balances.

An insurer's financial security, in part, depends on the quantity and quality of reinsurance recoverables. Insurers that cede a large percentage of their risk to reinsurers leave themselves vulnerable to disputes or collection problems with some of their reinsurers. While these companies often reply that their reinsurance recoverables are secured by funds held in trust or letters of credit, those collateral vehicles do not always adequately address adverse loss reserve development. When reinsurance recoverables far exceed surplus, an insurer is vulnerable to financial problems if a reinsurer becomes insolvent or if a substantial recoverable ends up in dispute.

Similarly, with agent's balances, an insurer needs to be able to ultimately convert such balances to cash in order to realize them as a liquid asset in a timely manner.

LOSSES

The loss ratio is a measure of an insurer's success in pricing its products. The ratio itself is calculated by dividing losses incurred and allocated loss adjustment expenses by net premium earned. However, it is important to note that the loss ratio is subject to future adjustment based on actual payments and reserve increases versus the original estimated future payments. Most insurers are required to obtain an actuarial opinion on the validity of loss reserve estimates; however, the actuarial opinion provides a range of valid reserve estimates, giving the insurer latitude in finalizing its estimate.

ELANY analyzes each insurer's loss reserve development trends. Losses take several years to materialize, especially on long-tail business. As part of the Annual Statement filing for US companies, insurers are required to provide a "Schedule P," which compares accident year paid and unpaid losses over a ten-year period to determine if the original reserves developed favorably or adversely. If loss reserves were underestimated at the original date, they will develop adversely. If reserves were adequate, or redundant, they will develop favorably. Over the long haul, when losses continue to develop adversely, the insurer will be forced to re-estimate its ultimate losses in order to obtain an unqualified actuarial certification. When insurers have to substantially increase their reserves, it often adversely affects the insurers' financial strength ratings, and potentially its stock price if the company is publicly traded.

EXPENSES

On the expense side of the income statement, ELANY looks at the operating costs and expenses - or what is known as the expense ratio. The expense ratio represents the ratio of expenses from acquiring the business, commissions, underwriting costs, staff salaries, rent and general overhead costs to net premiums written. It is a relative measure of an insurer's operational efficiency in underwriting its book of business. Generally speaking, ELANY verifies that an insurer's expense ratio is within the industry norms for the types of business, classes of insurance and methods of distribution by that particular insurer. This number will increase significantly if a company has cutback substantially on its written premiums.

COMBINED RATIO

The degree of underwriting profitability reported by insurers is often expressed as their combined ratio. It represents how much of losses and underwriting expenses are being paid out per dollar of premium. The statutory combined ratio is calculated by adding together the loss ratio and expense ratio. A combined ratio below 100% indicates that the insurer is making underwriting profit, while a ratio above 100% indicates an underwriting loss.

For insurers that reinsure 100% of their business, the combined ratio will be 0%. Since the combined ratio is not meaningful in these cases, measures that are more indicative of overall profitability should be used.

PROFITABILITY

An area of particular importance is an insurer's profitability, as it is a key indicator of future financial stability and policyholder security. ELANY examines whether an insurer is generating profits through its underwriting activities and/or its investment portfolio.

In addition, the stability of income generation over time is examined as an indicator of how volatile results may be in the future. If an insurer's profitability is subject to wide variation, it could expose surplus to volatility.

LEVERAGE

Another important concept related to insurance company financial analysis is leverage. Leverage represents the degree to which an insurer's surplus is exposed to risks from underwriting and/or investment activities.

Underwriting leverage measures the amount of premiums, reserves, and/or reinsurance usage as a percentage of policyholders' surplus. Net premium leverage (net premiums written to surplus) measures the insurer's exposure to pricing errors in its current book of business. Net loss reserve leverage (net loss and loss adjustment expenses to surplus) represents an insurer's exposure to reserving errors and the need to maintain loss reserve adequacy. For example, assume an insurer has $50 million in surplus and $30 million of loss reserves. If this insurer was 50% under-reserved, and the reserves were increased by another $15 million, the insurer would still be solvent, but surplus would be reduced to $35 million. On the other hand, if an insurer with $50 million in surplus and $100 million in loss reserves was under-reserved by 50%, the insurer would become insolvent, as its surplus would be depleted.

Asset leverage measures the degree to which surplus is vulnerable to investment related risks, such as stock market, interest rate and credit risks. For example, assume an insurer had $10 million of their investment portfolio allocated to common stocks and the stocks dropped by 50% in value. For an insurer whose stock portfolio represented 10% of surplus, the impact to their surplus would be a reduction of 5%. However, for an insurer whose stock portfolio represented 50% of surplus, surplus would decline by 25%.

CASH FLOW

Simply stated, cash flow is the net position of the insurer, comparing losses and expenses paid to premiums received and to the return on invested cash assets in any given annual period. It is a red flag when an insurer's assets and perhaps its policyholder surplus are growing but, where the income producing assets have either not increased or even in fact have shrunk. The ability to generate positive operating cash flow over time is an important component of liquidity assessment. An insurer with ample liquidity maintains sufficient cash and short-term invested assets to satisfy its financial obligations. Conversely, an insurer with poor liquidity may be required to sell its long-term investments to satisfy its financial obligations, which could force them to realize investment losses if market conditions are unfavorable.

HOLDING COMPANY STRUCTURE

The holding company structure of any given insurance company is an important component in ELANY’s financial security review. If the holding company has borrowed money in the form of bonds, preferred stock, or other debt instruments, that holding company has to meet its obligations on the borrowed money. Meeting debt service requirements is often accomplished by upstreaming dividends from the insurance subsidiaries. However, this dividend burden prevents the insurer from growing surplus organically and may also have the adverse effect of increasing leverage if loss reserves and premiums continue to grow while earnings are continuously removed by their parent. On the other hand, insurers with publicly traded holding companies may have easier and less expensive access to capital markets should the need for additional capital arise.

While a reasonable amount of debt in the holding company is not troublesome, a company with a heavy debt structure raises the potential for future financial weakness at both the holding company and the insurance company subsidiary. The biggest potential exposure in this case would be if the insurance company has a bad year(s) and did not generate sufficient income, the holding company may not be able to meet its debt service requirements.

Holding company structures are also analyzed for inter-company transactions, which often include reinsurance pooling arrangements or other types of internal reinsurance arrangements among affiliated companies. Additionally, ELANY looks to determine whether any sweetheart deals are apparent among the insurer, its affiliates, its parent and/or any of the officers or directors of the company.

RATING AGENCIES

The ratings and analysis on any given insurer by A.M Best and/or Standard & Poor's are reviewed by ELANY as one component of its analysis. In essence, ELANY uses many of the same tools as these rating agencies in analyzing the financial condition of our eligible insurance companies. The vast majority of insurers in New York are rated in the secure range by A.M Best and/or Standard & Poor's. While excess line brokers can take some comfort in that, they should not rely exclusively on a rating agency to determine the future viability of any given insurer.

If an insurance market that you are currently using receives a ratings downgrade, this should not be considered necessarily fatal to the insurer depending on the severity and range of the downgrade. However, when insurers suffer multiple level downgrades or multiple downgrades in a short period of time, it is very important to understand the reasons for these actions. Also, when an insurer moves from a secure rating to a vulnerable rating level, the excess line broker has to consider whether it is appropriate to continue to do business with that carrier, particularly in light of the duty of "due care."

Often, an insurer will remain on ELANY's list for a period of time after a significant downgrade. This only means that the insurer appears to continue to meet the "minimum requirements", and that ELANY is offering due process to the insurer to provide substantial information, including its plan of action in regard to its current financial troubles. Since the excess line broker has a duty to use due care in the selection of each insurer from whom it procures insurance, it is appropriate to ask yourself on what basis can I say I used due care in selecting this given insurance company especially in light of a recent history of downgrades.

OTHER CRITERIA

ELANY analyzes each insurer based on certain industry ratios, such as the IRS tests and Risk-Based Capital ratio, as well as the books of business written by the carrier and the production force producing the majority of the business. Setting forth each analytical tool is beyond the scope of this paper, but the ELANY staff and resources are available to each excess line broker as one of the numerous methods available by which an excess line broker can meet its due care selection process. ELANY has also published Insurer Financial Summaries for each listed eligible foreign insurer to aid brokers in meeting the "due care" standard. Should you have any questions regarding the financial information for our listed insurers, feel free to contact our Financial Director for assistance.

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