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Analyzing Perpetual Insurers

Perpetual insurance refers to a unique type of insurance policy that is underwritten without a termination date. Rather than paying an annual premium, the policyholder generally makes a fully refundable deposit to the company for insurance coverage. The company then invests those funds in securities that provide it with its primary source of revenue to cover future losses and expenses. The amount of the perpetual deposit calculated by the insurer is typically a significant multiple of that of an average one-year term insurance policy for the same risk. If the insured cancels the policy at any time, the entire deposit is refunded without interest. Because of the fully refundable feature of the deposit, it is recorded as a liability on the company's balance sheet.

Since the perpetual deposit is fully refundable, the perpetual insurer does not record it as premium revenue. This renders many of the underwriting metrics such as loss ratio, combined ratio, premium leverage, etc. as analytically meaningless for a perpetual insurer. Moreover, the lack of reported premium means that Best's Capital Adequacy Ratio (BCAR) must be adjusted to properly capture the pricing risk represented by the accumulated deposits to represent a meaningful underwriting exposure.

Another distinguishing feature of perpetual insurers is that they tend to follow a "buy and hold" investment strategy. Their equity investment portfolios are most commonly a significant component of their surplus base, consisting typically of long-held, blue-chip issues with significant embedded unrealized capital gains.

A perpetual insurer also may take the form of an assessable mutual, in which the policyholder pays an initial premium that may be higher than that of a term policy, but significantly lower than a perpetual deposit. This is followed by annual assessments, typically expressed as a percentage of the initial premium, which are dependent upon the insurer's past, present and projected operating results. The initial premium and subsequent annual assessments are fully earned in the year billed.

I. Evaluation of Balance Sheet Strength

As stated previously, the lack of traditional reported net written premium means that the BCAR model needs to be adjusted to fully capture the pricing risk represented by the accumulated deposits or assessments.

Consistent with the perpetual insurer's income statement, the premium amounts shown in BCAR are typically negative, reflecting ceded premium for any reinsurance treaties the insurer may have. Thus, to properly account for the premium risk in BCAR, the underwriting exposure represented by the deposits needs to be converted into a "term-equivalent" premium base, which then can be risk charged by the respective capital factors in BCAR to generate an appropriate premium risk charge.

There are two methods of converting to an annual term-equivalent premium:

- 1) The company provides an estimate of its net written premium (usually based on the subject premium of its existing reinsurance contracts, which can be used as a proxy for its term-equivalent premium).

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2) The analyst calculates a term-equivalent premium based on the comparable average premium for a typical term policy and applies it to the existing policies in force.

Under either method, a net written premium or term-equivalent premium is determined and then used to calculate the appropriate pricing risk charge in the BCAR model. The conversion of the perpetual deposits into a term-equivalent premium results in a more accurate capture of exposure to pricing risk in BCAR for perpetual insurers.

Because of the critical role of total investment returns and the challenges associated with accurately projecting them over the extended life of the company's policies, a perpetual insurer, particularly one using the perpetual deposit method, generally is held to a higher level of risk-adjusted capitalization (BCAR).

Example of Adjustments to BCAR:

Before Term-Equivalent Premium adjustment:

Baseline Premium in BCAR is typically negative for perpetual insurers because of the booking of only ceded premium. The baseline premium thus needs to be adjusted to reflect Term-Equivalent premium. In the hypothetical example, assume that the baseline net written premium in BCAR is -\$1.5 million (i.e., represents the ceded written premium).

After Term-Equivalent (TE) Premium adjustment:

Average deposit on a typical perpetual policy: \$12,000

Average premium of comparable 12-month term-equivalent policy: \$1,500

Total policies in force: 4,000

TE Direct Written Premiums (DWP): \$6 million (i.e., \$1,500/policy × 4,000)*

TE Net Written Premiums (NWP): \$4.5 million (\$6 million DWP - \$1.5 million Ceded)**

* Use in Page 8 of BCAR for growth charge calculation.

** Use in Page 6 of BCAR for calculation of net written premium risk.

Net Impact on Premium Risk in BCAR:

Premium Capital Factor (PCF) = 0.25

Premium risk charge prior to adjustment: \$0 (reflects negative net written premium).

Premium risk charge following adjustment: \$4.5 million NWP × 0.25 PCF = \$1,125,000

Net increase in premium risk charge in BCAR: \$1,125,000

II. Evaluation of Operating Performance

Because of the unique business models used and the resulting effect on traditional written or earned premium, many of the standard underwriting and operating performance metrics used to evaluate a property/casualty term insurer are not applicable to the analysis of a perpetual insurer. Thus, the loss and loss-adjustment expense (LAE) ratio, expense ratio, combined ratio and investment income ratio, all of which are calculated by using written or earned premium as the denominator, are not meaningful. Furthermore, certain operating return measures, such as pretax and after-tax return on revenues, also are not applicable as measures of operating performance,

since premium revenues are not a meaningful part of a perpetual insurer's income statement.

The evaluation of a perpetual's long-term profitability and capital generation also considers management's assumptions regarding total investment returns. Fluctuating interest rate and volatile equity market environments present challenges regarding expectations of future investment income and capital appreciation. However, as they are integral to arriving at the amount of perpetual deposit sufficient to support the long-term nature of the company's underwriting risk, a complete understanding of these assumptions is a key component of the analytical process.

In addition to proper pricing in the context of investment income, the risk factors assigned in BCAR by the analyst to the investment portfolio (as explained previously) also highly influence the rating analysis and final rating decision.

For deposit-based perpetuals, an inverse relationship exists between new business growth or retention and interest rate levels. It is possible that if interest rates are high, existing perpetual policyholders may surrender their existing policies to get full deposit refunds, or potential insureds would not purchase perpetual policies, as returns on market-based investments would be viewed as more attractive. Since the deposits are recorded as liabilities, the surrender of an existing policy would not reduce surplus. Conversely, if market interest rates are low, current and potential insureds would more likely consider the perpetual policy more desirable.

For the analyst, return measures such as total return on invested assets (TROIA), which is a measure of the profitability of the investment portfolio, and total return on equity (ROE), which takes into account both investment and underwriting performance, better indicate a perpetual insurer's overall profitability. Loss data are requested from management to show the profitability of the book of business. In addition, expense data are evaluated to measure efficiency within the operation. As in the analysis of traditional homeowners writers, trends of these measures, typically over the past five years, are evaluated. An importance difference from deposit-based perpetuals, however, is that assessable mutuals have the ability to increase annual assessment rates when operating or investment results are impacted negatively by catastrophe losses or volatile investment markets.

Policy language is evaluated to determine whether there are any long-term concerns regarding emerging risks to which the company cannot typically respond because of the permanent nature of the policy.

Depending on the geographical spread of risks, this business has the potential to be volatile because of catastrophe-related losses. Therefore, in all cases, the analyst requests probable maximum loss (PML) data along with the structure of the reinsurance program to help determine the effectiveness of this risk management strategy. A company that writes business on the perpetual policy form may have a substantial exposure to catastrophe type losses emanating from a weather-related event or terrorism. The risk needs to be determined and, with PML data provided by management, included in the A.M. Best capital model (BCAR) for the perpetual insurer. Risk-adjusted capital is calculated on both a standard (non-stressed) and stressed basis under various return periods and is a critical part of evaluating the risk-adjusted balance sheet strength of the company.

Since the perpetual business model is so dependent on investment returns, capital gains/losses both before and after taxes are evaluated. Investment reports also help reveal potential concerns such as sector concentrations, large single-issue investments and the degree of volatility in returns. The analyst also determines whether investments are handled internally

or externally and how the investment manager's performance is evaluated. The volatility of earnings, driven by both investments and underwriting, and its resulting impact on surplus are considered in the rating evaluation process.

III. Evaluation of Business Profile

Perpetual insurance is the oldest form of property insurance offered in the United States, with the first policy offered as far back as the 1750s. However, this form of insurance currently represents a niche market, since only a handful of companies offer it. As the deposit generally required to purchase a perpetual insurance policy is usually many multiples of a standard term insurance policy premium, the deposit-based perpetual writers' customer base generally is limited to high-net-worth or high-income individuals or households. The large deposit required also serves as a high barrier to entry for other insurers that are interested in serving a more diversified insured base. Conversely, assessable mutuals may be able to serve a more diverse population because their initial premiums are in many instances within current market pricing.

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