February 26, 2019

2019 Review & Preview: US Property/Casualty

P/C industry financial results improve, but challenges persist

AM Best is maintaining its Stable outlook for the US property/casualty insurance segment. The industry posted better results in 2018, with lower catastrophe losses and continued increases in premium expected to result in a lower combined ratio than in 2017 (**Exhibit 1**). However, the rate environment in most commercial lines remains challenging and underlying loss experience deteriorated, reflected in the increase in the normalized accident year combined ratio. Loss reserve development is expected to remain favorable, but with an overall decline in the benefit of prior accident year adjustments in 2018.

P/C insurers are affected by both macro level trends and factors that impact specific segments or lines of business. The market segment outlooks included at the end of this report provide AM Best's perspective on the near-term performance for various key P/C lines of business. Before getting to those specifics, we first consider the broader issues that continued to drive the industry's performance in 2018 and that will remain front and center in 2019.

US catastrophe losses reached a near-record high in 2017, mainly stemming from Hurricanes Harvey, Irma, and Maria. For much of 2018, it appeared as though losses from catastrophic events would return to a more historically normal level. However, Hurricane Michael and historic wildfires in California during the fourth quarter drove a second year of catastrophic

Exhibit 1
US Property/Casualty – Financial Indicators, 2013-2019P
Excludes mortgage and financial guaranty segments

	Actual					Estimates	
	2013	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019P**
Change in Net Premiums Written (%)	4.4	4.3	3.3	2.8	4.5	9.1	3.6
Change in Surplus (%)	10.7	3.4	-0.3	4.3	7.2	-0.5	0.2
Combined Ratio (Reported)	96.4	97.4	98.3	100.9	104.0	101.5	101.2
Less: US Catastrophe Losses[1]	3.9	4.0	3.5	4.8	9.7	6.2	5.0
Less: A&E Losses	0.7	0.5	0.5	0.4	0.4	0.4	0.4
Combined Ratio (Normalized)	91.9	92.9	94.2	95.7	93.9	94.9	95.9
Accident Year Combined Ratio (Normalized)[2]	95.4	95.4	95.9	96.8	96.1	96.7	97.4
Change in Net Investment Income (%)	-1.3	11.7	-11.4	-2.0	7.2	10.7	2.0
Net Investment Yield (%)	3.4	3.6	3.1	3.0	3.1	3.3	3.2
Pre-tax Return on Net Premiums Earned (ROR) (%)	13.1	12.4	10.9	7.8	3.4	7.1	7.3
After-tax Return on Surplus (ROE) (%)	9.3	9.2	8.1	5.9	4.5	5.8	4.8
Net Premiums Written to Surplus Ratio	0.7	0.7	0.8	0.7	0.7	0.8	0.8

E=Estimated, P=Projected

[1] 2013-2017 catastrophe losses based on AM Best data; 2018-2019 are AM Best estimates.

[2] Normalized accident-year combined ratio adjusted to exclude prior-year core reserve development, which excludes A&E losses.

Source: AM Best data and research

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losses above the long-term average. AM Best estimates that the US P/C industry had net catastrophe losses of over $37 billion in 2018 – down from $53 billion in the prior year, but still the second highest since 2011.

Projections for 2019 reflect a further decline in net catastrophe losses to five points (or approximately $31 billion), which is more in line with an average year. AM Best expects pricing for loss-impacted accounts to be stronger in both the insurance and reinsurance segments, but loss-free accounts and those with limited catastrophe exposure may continue to see lower premiums. Continued declines in property pricing in the primary market may be driving some of the increase in the industry's normalized accident year loss ratio.

Net premiums written jumped in 2018, primarily as a result of US tax reform enacted in December 2017 (**Exhibit 2**). Many companies that had previously ceded premium to offshore affiliates substantially changed those arrangements in 2018 to reduce or eliminate the effect of the Base Erosion and Anti-Abuse Tax (BEAT) that was included in the Tax Cuts and Jobs Act (TCJA). In some cases, premiums were simply retained in the primary companies, while in other cases, the premium was ceded to US-domiciled reinsurers. The growth in the commercial and reinsurance segments has been particularly affected by these changes (**Exhibit 3**).

AM Best expects personal lines rate increases in 2019 to be higher than for commercial lines, reflecting increasing severity trends, even as companies continue to focus on expense efficiencies. In personal auto, rising medical expenses and costlier repairs of increasingly sophisticated vehicles are driving higher rates. We expect rate levels for the homeowners line to increase modestly across the board, with higher increases and some modification in coverage terms in the weather-impacted areas. Commercial lines are more of a mixed lot, with overall modest expectations for price increases in 2019. Commercial auto losses remain a drag on the industry's overall profitability, despite multiple years of substantial rate increases. As a result, further price increases are expected for the line in 2019. Other liability, which had seen a number of years of favorable experience, driven in large part by favorable development of prior years' loss reserves, has shown more variability in performance in recent years. Consequently, modest price increases also are expected for this line in 2019.

AM Best expects pricing in 2019 for other commercial lines to remain flat or decline modestly. Workers' compensation pricing has seen modest decreases overall in the most recent years, although much of the decline in rates has been offset by higher payrolls due to higher employment levels and some upward pressure on wages.

Uncertainty about macroeconomic issues may place downward pressure on exposure growth in commercial lines in 2019. Higher interest rates should provide some tail winds to the P/C industry, given its substantial reliance on net investment income to boost profits. However, turmoil in US and global equity markets in the fourth quarter of 2018 is expected to drive down overall investment returns for the year. With the unemployment rate now lower than the historical level that denoted "full employment," pressure on wages may spark higher inflation. The effects of the federal government shutdown on GDP constitute another "unknown" for 2019. Some economists project that there will be no GDP growth during the first quarter as a result.

The industry's prior years' loss reserves continue to develop favorably overall. With no unusually large reserving actions announced at year-end 2017 to adjust for, the long-term trend of diminishing favorable development is anticipated to continue in 2018 and 2019. Trends in the other liability line, where general liability has had increased variability, are

Exhibit 2
US Property/Casualty – Combined Ratio Components, 2013-2019P
Excludes mortgage and financial guaranty segments

($ billions)

	Net Premiums Written	Net Premiums Written Growth (%)	Loss Ratio	Loss-Adjustment Expense Ratio	Under-writing Expense Ratio	Dividend Ratio	Combined Ratio
2013	482.4	4.4	55.7	12.0	28.0	0.7	96.4
2014	502.9	4.3	57.4	11.9	27.4	0.7	97.4
2015	519.5	3.3	57.9	11.9	27.8	0.7	98.3
2016	533.8	2.8	61.0	11.7	27.7	0.6	100.9
2017	557.9	4.5	64.4	11.9	27.1	0.7	104.0
2018E	608.6	9.1	62.5	11.9	26.6	0.6	101.5
2019P	630.4	3.6	62.3	11.7	26.7	0.6	101.2

E=Estimated, P=Projected

Source: AM Best data and research

Exhibit 3
US Property/Casualty – Segment Indicators, 2017-2019P
Excludes mortgage and financial guaranty segments

	Personal Lines Segment			Commercial Lines Segment			US Reinsurance Segment		
	2017	2018E	2019P	2017	2018E	2019P	2017	2018E	2019P
Net Premiums Written ($)	321.3	340.6	358.2	191.8	211.4	218.0	44.8	56.6	54.1
Policyholders' Surplus ($)	332.8	337.8	351.6	299.0	297.9	291.7	139.9	132.4	126.5
Change in Net Premiums Written (%)	6.4	6.0	5.2	0.4	10.2	3.1	9.7	26.4	-4.4
Change in Policyholders' Surplus (%)	8.5	1.5	4.1	3.5	-0.4	-2.1	12.7	-5.4	-4.4
Underwriting Gain/Loss	-15.4	-5.8	-1.2	-5.0	-4.6	-7.1	-4.9	-1.7	-2.3
Combined Ratio (Reported)	104.4	101.8	100.2	102.1	102.0	102.7	109.6	97.5	101.9
Less: Catastrophe Losses	9.4	6.5	5.0	8.0	6.0	5.0	19.8	5.0	5.0
Less: A&E Losses	0.1	0.1	0.1	0.8	0.7	0.7	1.4	1.7	1.3
Combined Ratio (Normalized)	94.9	95.2	95.2	93.3	95.4	97.1	88.4	90.8	95.6
Accident Year Combined Ratio (Normalized)[1]	95.0	96.0	95.9	98.4	98.4	99.8	94.1	94.7	98.2
Change in Net Investment Income (%)	14.7	10.4	7.0	-1.1	0.1	-1.6	17.0	35.5	1.2
Investment Yield (%)	2.7	2.7	2.7	3.2	3.1	3.0	3.7	4.4	4.4
Net Income	13.4	15.5	17.8	19.8	19.4	12.7	1.9	9.5	6.2
After-Tax Return on Surplus (ROE) (%)	4.0	4.6	5.1	6.6	6.5	4.3	1.3	7.2	4.9
NPW/PHS (Reported)	1.0	1.0	1.0	0.6	0.7	0.7	0.3	0.4	0.4

E=Estimated, P=Projected

[1] Normalized accident-year combined ratio adjusted to exclude prior-year core reserve development, which excludes A&E losses.

Source: AM Best data and research

being watched to understand whether a cyclical pattern is emerging, or if there has been a more fundamental shift in legal activity that will more permanently affect the future prospects of the line.

Exhibit 4
US Property/Casualty – Surplus Recap, 2013-2019P
Excludes mortgage and financial guaranty segments

($ billions)

	Actual					Estimates	
	2013	2014	2015	2016	2017	2018E	2019P
Beginning Policyholders' Surplus	604.6	669.2	691.9	690.1	719.9	771.7	768.1
Net Underwriting Income	14.0	10.3	6.2	-6.5	-25.3	-12.1	-10.6
Net Investment Income	48.1	53.8	47.6	46.7	50.0	55.4	56.5
Other Income/(Expense)	-0.4	-2.9	1.6	1.0	-6.0	-0.6	-0.5
Pretax Operating Income	61.8	61.2	55.4	41.1	18.7	42.7	45.3
Realized Capital Gains/ Losses	12.0	12.1	9.8	8.1	15.6	9.7	0.0
Federal Income Taxes	11.8	9.9	9.7	7.0	-0.8	7.9	8.7
Net Income	61.9	63.5	55.6	42.2	35.1	44.4	36.6
Unrealized Capital Gains/ Losses	38.4	4.4	-20.9	15.7	60.0	-12.8	0.0
Contributed Capital	-3.1	-2.9	11.3	2.8	3.0	1.1	3.3
Stockholder Dividends	-33.4	-33.7	-38.0	-27.6	-29.2	-31.8	-33.4
Other Changes	0.7	-8.6	-9.7	-3.4	-17.1	-4.6	-4.8
Ending Policyholders' Surplus	669.2	691.9	690.1	719.9	771.7	768.1	769.8
Total Changes in Surplus ($)	64.6	22.7	-1.8	29.8	51.8	-3.6	1.7
Change in Surplus from Prior Year (%)	10.7	3.4	-0.3	4.3	7.2	-0.5	0.2

E=Estimated, P=Projected

Figures may not add due to rounding.

Source: AM Best data and research

AM Best expects the P/C industry's pre-tax operating income to rebound to nearly $43 billion for 2018 (**Exhibit 4**), driven by a lower underwriting loss and modestly higher net investment income. However, due to lower realized gains and unrealized losses on the industry's equity holdings, we anticipate a modest decline in equity of $3.6 billion to $768.1 billion, a drop of just 0.5%. We project a slight rebound for 2019, with a small decline in the underwriting loss and modestly higher net investment income. The 2019 forecast does not account for realized or unrealized capital gains or losses, which AM Best never projects when doing this annual study.

After a decade of year-over-year declines, we expect investment yield to show an increase for 2018, as companies are reinvesting proceeds from called and maturing bonds at the same or even slightly higher rates. Equity market declines in the fourth quarter of 2018 are expected to negatively affect the industry's holdings of common and preferred stock, with the overall level anticipated to decline for the first time since 2015. However, AM Best does not anticipate the P/C industry's overall investment mix to change substantially in 2019.

The industry's overall risk-adjusted capital position remains extremely solid, with the majority of P/C companies having capital levels that fall in the Strongest and Very Strong levels based on Best's Capital Adequacy Ratio (BCAR). Maintaining underwriting and pricing discipline in the face of these capital levels remains critical to the industry's continuing profitability. By developing and using increasingly sophisticated tools and leveraging data to better understand customers and their potential profitability, companies can retain an edge even under competitive conditions. In light of some uncertainty about near-term prospects for growth, inflation, and employment, those tools may be even more important in the years ahead.

Industry Underwriting Results

AM Best expects net premiums written (NPW) for 2018 to reach their highest level of growth in recent years, driven by growth in direct premiums written and by the retention of premiums previously ceded to offshore affiliates (primarily in Bermuda) as a result of the TCJA. The expectation that NPW growth will drop in 2019 reflects a normalization of the relationship between direct and net premiums written following the changes that were driven by the implementation of the BEAT in 2018. The forecast for premium growth continuing into 2019 would result in a third consecutive year of NPW growth.

As has been the case in recent years, the growth is driven primarily by the expectation that the industry's two largest lines – personal auto and homeowners – will continue to have solid rate increases and modest exposure growth (**Exhibit 5**).

Overall, AM Best expects the P/C industry to post a third consecutive underwriting loss in 2018, due primarily to catastrophe losses. While these 2018 losses are forecast to have declined from their near-record high in 2017, they are still elevated over historical averages, adding 6.2 points to the combined ratio. The normalized accident year ratio is estimated to be 0.6 points higher than in 2017, indicating that core (i.e., non-catastrophe) losses are increasing. Continued pricing pressure and emerging litigation trends are key contributors to the deterioration of core losses.

The 2018 estimated growth for other and products liability is driven in large part by the response to US tax reform. However, pricing for several other liability sublines did improve during 2018, reflecting pockets of adverse development in recent years. The price action in 2018 and forecast for 2019 also reflect the extent to which some market participants believe

Exhibit 5
US Property/Casualty – Product Line Underwriting Trends, 2013-2019P

	Net Premiums Written		Combined Ratios						
	2018E		Actual					Estimates	
Product Line	**Share**	**Growth**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019P**
Private Passenger Auto	38.7	7.6	101.6	102.3	104.6	106.3	102.6	102.9	102.2
Homeowners & Farmowners Multi Peril	15.0	5.2	90.5	92.7	91.8	93.1	107.1	105.5	98.0
Workers Compensation	8.3	4.0	102.4	100.9	95.8	95.6	92.5	92.5	93.8
Commercial Auto	6.6	18.3	106.9	103.4	108.8	110.5	111.1	112.9	113.3
Commercial Multi Peril	6.0	7.1	97.7	99.2	94.7	101.8	107.9	106.0	101.9
Fire & Allied Lines[1]	4.8	7.1	83.5	86.4	85.6	89.7	123.9	106.0	97.2
Inland Marine	2.1	8.2	83.8	83.3	83.8	84.0	89.9	89.5	87.3
Medical Professional Liability	1.3	-1.0	89.5	103.6	102.3	106.5	101.7	104.2	105.6
Other & Products Liability[2]	9.3	14.3	100.4	101.4	103.4	111.1	101.0	104.2	103.4
All Other Lines[3]	7.9	23.6	84.4	79.5	84.0	87.2	103.6	113.7	113.3
Total All Lines	**100.0**	**9.1**	**96.4**	**97.4**	**98.3**	**100.9**	**104.0**	**101.5**	**101.2**

E=Estimated, P=Projected

[1] Fire & Allied Lines includes earthquake, multiple peril crop, and federal flood.

[2] Other Liability includes professional liability, D&O, excess casualty/umbrella, environmental/pollution, general liability, and EPLI.

[3] All Other Lines includes accident & health lines, mortgage guaranty, financial guaranty, ocean marine, aircraft, fidelity, surety, burglary & theft, boiler & machinery, credit, international, excess of loss reinsurance and miscellaneous.

Source: Best's Statement File Supplement – Insurance Expense Exhibit (IEE) – P/C, US (2013-2017) pricing for casualty lines had grown too competitive, with companies attempting to attract and retain business to offset lower property rates. If commercial auto liability trends can be viewed as the proverbial "canary in the coal mine," the impact of increasing severity due to medical and litigation trends is driving loss costs up in some other liability sublines. By recognizing these trends and reacting more quickly to them, the industry may be able to effectively adjust pricing and underwriting gradually, thus avoiding a sudden market turn. Some of the increase in "core" (i.e., non-catastrophe related) losses is attributed to other liability and other long-tail casualty sublines, including medical professional liability.

AM Best forecasts commercial auto results to deteriorate slightly in 2018, as it remains the worst performing line of business on a direct basis through the first three quarters of the year. The most significant rate actions have been taken in commercial auto, as writers of the line strive to achieve loss cost adequacy. Most writers expect additional rate hikes in 2019, but should the financial position of their customers be negatively impacted by trade actions, gasoline prices, or other macroeconomic issues, the ability to achieve those increases may be similarly affected.

The largest commercial line, workers' compensation, continues to outperform the commercial group as well as expectations. Competition continues to pressure pricing but premium remains flat and losses have improved each year. Flat premium is driven in part by increased exposures as companies hire additional workers. Steadily increasing, albeit still low, wage inflation is also having a beneficial effect on overall premiums. With continuing favorable development of prior years' losses, reflecting declining frequency and relatively modest increases in severity, overall performance remains strong and is forecast to continue in 2019.

After several years of benign catastrophe experience in the US, catastrophe losses have surged since 2016. While 2016 was only slightly elevated from historical norms, 2017 and 2018 were much more severe relative to expectations. Catastrophe events produced lower losses in 2018 than in 2017, but the estimated $37 billion retained in the US market is still higher than any other of the last five years. Wildfires in California caused historic damage, in part because they devastated areas previously considered to be at relatively low risk for fire. The industry continues to look for ways to improve its underwriting and monitoring of fire exposure, while modeling companies seek to develop improved capabilities for modeling the risk and probable maximum loss (PML) in line with other severe natural hazards.

A second consecutive year of elevated catastrophe experience appears to have resulted in additional tightening of reinsurance pricing and terms and conditions in early 2019. While accounts that have not been loss-affected and those with minimal catastrophe exposure may continue to see some slight price declines, cedents that have had losses or which maintain substantial exposure are facing increased renewal pricing pressures. The extent to which these reinsurance rate increases "stick" may place upward pressure on property rates in the primary market.

For 2019, we are forecasting further improvement in the industry's combined ratio based on the expectation of a more normalized level of catastrophe losses, in line with long-term averages. Our forecast incorporates approximately 5 points, or $31 billion, in catastrophe losses for 2019.

Partially offsetting the decline in catastrophe losses is the projection of lower favorable loss reserve development and higher core losses. Deterioration in the workers' compensation, commercial auto, and medical professional liability lines of business are expected to be key factors in driving core losses higher. The improvements in property-related lines of business are primarily the result of lower anticipated catastrophe losses. Overall, the combined ratio for 2019 is predicted to improve slightly, by 0.3 points, to 101.2

Investment Performance

AM Best forecasts modest increases in net investment income for 2018 and 2019, driven primarily by increased asset levels. Net investment income also is benefiting from increased interest rates, with new money rates now in line with, or even slightly higher than, the average rates on maturing securities. Realized gains are expected to decline in 2018 from their 2017 level, which was the highest of the past five years. The sales of securities in 2017 reflected rising market prices and portfolio reallocations. With more market volatility in 2018, and the decline in equity prices late in the year, companies did not have the same reasons to revise their equity holdings last year.

The decline in equity markets in the fourth quarter of 2018 is expected to have an adverse effect on the industry's assets, with unrealized losses anticipated for 2018. We note that under statutory accounting rules, the negative effect of the rise in rates on bonds held by insurance companies is not reflected in these results. As companies generally hold these bonds to maturity, fluctuations are not considered when calculating the overall value of the industry's bonds. AM Best does consider how declining rates affect the security holdings of individual companies when evaluating the risk associated with their investment holdings.

Operating Results, Capital and Surplus

The industry's pre-tax operating income is projected to more than double in 2018, to $42.7 billion from $18.7 billion in 2017, reflecting lower underwriting losses and higher net investment income (**Exhibit 4**). Net income also will increase, but by a lower margin, reflecting lower net realized gains and higher taxes that are more in line with prior years' results.

Surplus is expected to decline marginally, however, due to a sharp swing in the change in unrealized gains and losses. In 2017, the industry posted a positive change in its unrealized gain position of over $60 billion. The drop in equity markets in the fourth quarter of 2018 is expected to drive a decline of $12.8 billion in the overall level of unrealized gains. With higher stockholder dividends and a lower level of contributed capital expected for the year, surplus is forecast to decline by $3.6 billion, or about 0.5% from its year-end 2017 level.

For 2019, the expectation is for modest growth in pre-tax operating income and surplus, driven by a slightly lower underwriting loss and higher net investment income. Again, AM Best does not forecast realized or unrealized gains and losses when projecting P/C industry financial results, which are key factors in driving both net income and the overall change in surplus.

The 2019 projection reflects our expectations for the very diverse lines of business that comprise the P/C industry. The details of those expectations can be found in the outlooks published later in this report. Overall, however, we expect the P/C industry to remain robustly capitalized, loss costs to remain relatively benign given no immediate signs of spiking interest rates or inflation, and catastrophe losses more in line with long-term historical averages.

Loss & LAE Reserve Deficiency Stabilizing but Reserve Positions Vary by Line of Business

Adverse reserve development is one of the leading causes of insurer insolvency. As a result, reserve adequacy remains a critical rating issue for AM Best. Loss and LAE reserves are typically the largest liability on a P/C insurer's balance sheet. Any underestimation of those liabilities may have a material negative effect on the insurer's reported surplus, potentially resulting in adverse rating action. Unexpected or larger than anticipated changes in an insurer's reserve position may materially affect the assessment of the company's balance sheet strength and enterprise risk management.

In 2017, the industry reported its twelfth consecutive calendar year of favorable reserve development. After two years of declining favorable development, the industry reported a higher level of favorable development in 2017, as AM Best expected (**Exhibit 6**). The increase in favorable development in 2017 was primarily from two lines of business: workers'

Exhibit 6

US Property/Casualty – Incurred Loss & DCC Development, 2008-2017

One year development for calendar years, accident years as of Dec. 31, 2017

Excludes mortgage and financial guaranty segments

($ billions)

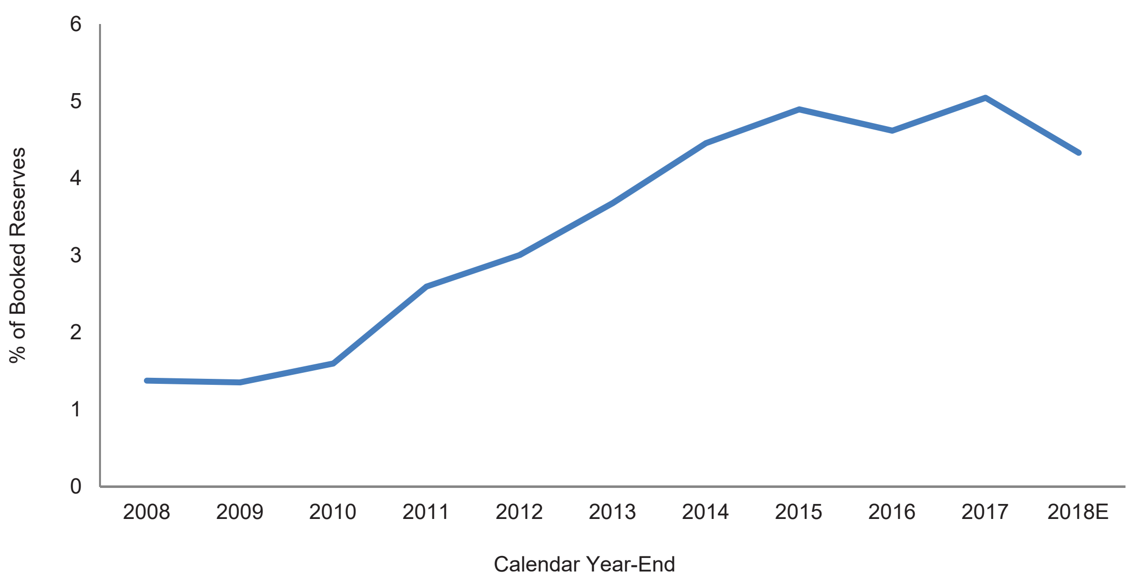
	One-Year Reserve Development*										Total AY Development Through
Accident Year	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2017**
Prior	-13.4	-7.5	-1.7	-4.5	-1.3	-1.2	0.0	1.2	1.9	1.4	-25.1
2008		-4.1	-2.6	-3.0	-1.4	-1.5	-1.0	-0.3	-0.3	-0.3	-14.5
2009			-5.5	-2.8	-1.5	-1.4	-1.0	-0.6	-0.3	-0.5	-13.6
2010				-3.5	-2.2	-1.4	-1.2	-0.5	-0.5	-0.8	-10.1
2011					-4.8	-1.3	-1.0	-0.7	-0.9	-0.6	-9.3
2012						-4.6	-2.1	-0.7	-0.6	-0.8	-8.8
2013							-4.0	-1.2	-0.5	-1.3	-7.0
2014								-3.2	0.0	-1.4	-4.5
2015									-0.1	-0.9	-1.0
2016										-1.7	-1.7
Total in Calendar Year	**-13.4**	**-11.6**	**-9.8**	**-13.8**	**-11.2**	**-11.4**	**-10.2**	**-6.0**	**-1.4**	**-6.7**	

* Positive values indicate adverse development; negative values are favorable.

Source: AM Best data and research

Exhibit 7

US Property/Casualty – Loss & LAE Reserve Deficiency



Source: AM Best data and research

compensation reported an increase in favorable development, and other liability reported a lower amount of adverse development. AM Best expects the industry to report another year of favorable reserve development for calendar year 2018 at a level near the 2017 calendar year.

While the industry's total loss reserves are estimated to have weakened each year from 2010 to 2015, the weakening in each individual year was small relative to the total reserves. The cumulative effect of small annual increases in reserve deficiencies resulted in an industry reserve position at year-end 2015 estimated to be $30 billion, or slightly below 5% of the booked reserve. Since 2015, the estimated industry reserve deficiency has remained near 5% of the booked reserve. AM Best expects the total reserve deficiency to remain below 5% at year-end 2018 (**Exhibit 7**). However, the reserve positions by Schedule P line of business vary greatly.

For year-end 2018, AM Best estimates the P/C total net loss and LAE reserve deficiency at $29.3 billion, consisting of a $15.3 billion deficiency on core reserves and a $14 billion deficiency on A&E reserves. Of the total $29.3 billion deficiency, $20.7 billion is due to statutory discounting, which AM Best considers a deficiency from full-valued reserves. The estimated deficiencies vary widely by line of business, with workers' compensation and other/products liability showing the largest overall deficiencies, and the medical professional liability and all other lines showing the largest redundancies (**Exhibit 8**). The estimated reserve deficiencies are based on industry statutory Schedule P cumulative paid and case incurred loss and expense development, using AM Best's internal loss-reserve model. Industry data was adjusted to remove the distorting effects of large transactions such as commutations, loss portfolio transfers, adverse development covers, and prospective accounting treatment of retroactive reinsurance.

Overall industry reserves as of year-end 2018 are estimated to be $3.6 billion stronger than the reserves reported as of year-end 2017. A&E reserves are expected to strengthen $2.4 billion and total core reserves are expected to strengthen $1.2 billion. Within the core reserves, workers' compensation, medical professional liability, and reinsurance assumed are expected to weaken in 2018, but that weakening is expected to be offset by strengthening in other liability, commercial auto liability, personal auto liability, and all other lines. Although many lines of business are still showing increases in paid and case incurred loss development factors at the industry level, the trend seems steady and predictable, so the industry should be able to maintain the current reserve position for the near term.

Exhibit 8

US Property/Casualty – Estimated Year End Loss & DCC Reserve Deficiencies, 2018

Excludes mortgage and financial guaranty segments

($ billions)

	Excluding Discount	Statutory Discount	Total Deficiency
Workers' Compensation	-4.7	16.7	12.0
Other/Products Liability	5.0	1.3	6.3
Commercial Auto Liability	2.2	0.4	2.6
Reinsurance – Nonproportional Assumed	0.9	0.9	1.8
Commercial Multiple Peril	0.0	0.0	0.0
Homeowners	-0.2	0.0	-0.2
Personal Auto Liability	-0.7	0.2	-0.5
Medical Professional Liability	-2.8	0.8	-2.0
All Other Lines	-5.1	0.4	-4.7
Total Core Reserves	-5.4	20.7	15.3
Asbestos & Environmental	14.0	0.0	14.0
Total	**8.6**	**20.7**	**29.3**

Source: AM Best data and research

AM Best's Market Segment Outlooks

US Personal Auto

AM Best is maintaining its Stable outlook for the US personal auto segment for 2019. The key drivers are the persistently robust risk-adjusted capitalization of most writers in the segment; growing use of technology and data analytics in underwriting, rate-making, and claims handling; and the embrace of innovation in enterprise risk management.

Despite ongoing severity pressure and losses from Hurricanes Florence and Michael, early signs from personal auto market segment leaders point to an improved underwriting performance in 2018. Auto claims frequency moderated in 2017 due mainly to rising gas prices and the tempered growth in miles driven, a pattern that continued in 2018. At the same time, however, severity trends continued to rise, as medical expenses and the repair of increasingly sophisticated vehicles continued to become more costly, with no signs of diminishing. Nevertheless, aggressive rate actions in recent years have been earning out and adding to the bottom lines of the personal auto writers.

Distracted driving still plays a part in loss trends, although in the past, its impact was more difficult to quantify. As telematics become more sophisticated and phone-app-based, personal auto writers can accumulate more actual data to pinpoint causes of accidents and, using other advanced analytics, address the causes of loss and set appropriate premiums for drivers through more stringent underwriting.

Other factors likely to be in play in 2019:
- Improved efficiency, with the retirement of legacy systems
- Diversified and modified distribution methods, giving individual customers a buying experience on their preferred terms
- More ways to bundle the auto product with homeowners or renters policies, which creates efficiencies in underwriting and opens avenues to new customers
- Advanced technologies to combat fraud

Bearing in mind wild cards in the form of catastrophic weather events, AM believes that the profitability of the personal auto segment could further improve in 2019. Innovation will be a key component to any personal auto writer's plan to stay relevant and maintain—or even increase—market share. New entrants, particularly those with a non-traditional insurance structure, could threaten the status quo. Writers that can harness technology to create operational efficiencies while optimizing the customer experience will be the best positioned to succeed. Those that do not have the scale, expertise, or technological capabilities to keep up with the rapidly evolving personal auto market will eventually end up losing market share and become less profitable.

US Homeowners

AM Best is maintaining its Stable outlook on the US homeowners segment. The key drivers for this outlook are the segment's persistently strong risk-adjusted capitalization; generally favorable operating performance despite elevated catastrophe activity in the second half of 2018; and ongoing pricing and underwriting initiatives.

Catastrophes in the second half of 2018 continued to dominate the headlines following an unprecedented year for natural disasters in 2017. Hurricane Florence, the worst recorded in North Carolina's history, evolved into a massive inland flood event after landfall, in September. In October, Hurricane Michael became the third most intense Atlantic hurricane (in pressure) to make landfall in the US. Although Florence and Michael were less significant in size and scope than the 2017 Hurricanes Harvey, Irma, and Maria, their impact was nonetheless severe. And wildfires continued to wreak havoc in California. In the wake of the sizable Carr fire in July, the early November Camp Fire in Northern California, and the Hill and Woolsey fires in Southern California, 2018 will go on record as the most destructive fires in the state's history, with the highest number of casualties of any fire season ever.

Generally strong core performance in the homeowners segment has been aided by rate activity, further pricing segmentation, and overall persistently favorable reinsurance pricing. These factors have helped mitigate the adverse impact of the elevated catastrophe activity of recent years. Homeowners insurers continue to invest resources and use technology to improve their underwriting and pricing tools. Advances in predictive modeling, greater access to third-party data, and more widely adopted by-peril ratings continue to gain traction. By aggressively leveraging technology in all facets of operations (including pricing, underwriting, claims, and distribution), carriers are gaining a deeper understanding of their risk profiles.

Overall, property catastrophe reinsurance rate increases were not as high as the market expected, although rates for underperforming and loss-affected areas of the marketplace did increase as anticipated and may continue to increase. In recent years, results in the homeowners segment have benefited from a softening in reinsurance pricing as well as favorable changes in terms and conditions. Accordingly, reinsurance pricing and capacity will continue to play critical risk management roles for insurers with concentrated exposures in business lines and geographies.

Given the emergence of increasingly frequent catastrophic events and resulting catastrophe losses, many proactive segment companies have started to re-calibrate their reinsurance programs with a greater emphasis on long-term underwriting profitability and better management of volatility in results. Many property insurers have used aggregate catastrophe coverage to mitigate the impact of loss frequency. Although catastrophe protection coverage has generally focused more on severe shock losses, aggregate covers have been useful for horizontal, tailored frequency and severity protection. Also, multi-year contracts have helped lower reinsurance costs when frequency accumulation of catastrophe losses has been a key concern. Additionally, top-and-drop coverage has provided a solution for limits in excess of both high and sideways attachments, for additional frequency protection for second, third, or fourth events.

The new normal, particularly as it applies to the wildfire peril, will undoubtedly drive companies to reassess their view of this risk. Given the changing profile of wildfires evident over the last two years, insurers will need to re-evaluate their risk-scoring models, in addition to risk appetites and tolerances. As companies continue to adapt their approach, they will need to contend with any potential regulatory response to underwriting actions.

For the most part, segment companies were able to absorb the numerous catastrophe losses in 2018 without a material impact to their balance sheets. Core underwriting discipline and improved enterprise risk management capabilities, including a greater focus on risk selection and concentration management, remain critical to homeowners insurers' stability and long-term viability.

Workers' Compensation

AM Best has a Stable outlook on the workers' compensation segment for 2019, despite rate decreases that will likely cause profit margin compression over the near term. The workers' compensation line continues to report favorable results, with a direct loss ratio that has declined annually since 2010, and is expected to be flat or down slightly at year-end 2018.

Written premium rebounded at year-end 2018 following a dip in 2017, but still lags the ten year high of $48.2 billion written in 2016. Part of the 2018 increase was due to the previously discussed business coming back onshore as a result of efforts to mitigate the effect of BEAT.

Slower growth and a slight increase in the combined ratio is predicted for 2019. An increase in competition along with consistent rate decreases in most states since 2015 continue to pressure workers' compensation results. However, the line still remains profitable due in part to the decline in claims frequency, the leveraging of risk management tools, and reserve releases. Reduced lost-time claims frequency noted across much of the sector is due to substantial investment and improvement in workplace safety.

In the coming quarters, segment results could be adversely affected by less favorable loss reserve development should rate decreases during this soft market cycle remain significant. If severity is negatively affected by rising medical costs, workers' compensation profitability may also be threatened.

Operating performance is still being tested by volatile equity markets and the prolonged low interest rate environment. Whether data analytics, risk modeling, and innovation can sufficiently address the underwriting and profitability challenges workers' compensation insurers face in the soft market cycle remains to be seen.

Excess & Surplus Lines

AM Best is maintaining its Stable outlook on the surplus lines segment. We expect that market conditions will remain supportive of appropriate levels of risk-adjusted capitalization and strong operating performance.

The Stable outlook reflects E&S participants' commitment to the core competencies emblematic of their historical success. The established surplus lines market participants proactively manage their risk-adjusted capitalization to protect and preserve their policyholders' surplus, by implementing clearly defined risk tolerance and appetite levels that take into account underwriting and other risks to their balance sheets, allowing them to maintain, and even expand, their capacity for those risks declined by the standard markets. These positions also allow surplus lines carriers to thrive in pockets of the industry in which conditions are competitive and soft markets are prevalent. Catastrophe events that occurred in 2018 had a minimal to moderate effect on the balance sheets of surplus lines carriers.

Carriers with a history of favorable results demonstrate an underwriting proficiency that captures the nuances of the surplus lines market (evident in the current market as well), and there are no signs that successful surplus lines carriers will stray from their deep-rooted philosophy. Their success in underwriting is complemented by the diversity of their product offerings as well as their significant geographic diversification.

Standard lines carriers continue to creep into the surplus lines market, a trend that we expect will continue in 2019. Favorable conditions also have attracted new entrants presenting themselves as alternatives to established players. Some of these new entrants are structured as surplus lines carriers but function more as transformers and fronting entities. Regardless, we expect that surplus lines coverage will continue to grow.

E&S carriers face the same challenges as the commercial lines market: competitive pressure from market participants with favorable operations and strong capital positions; investment returns that are less than optimal (while fluctuating with conditions); and declining opportunities for favorable reserve redundancy.

Commercial Auto

AM Best is maintaining its Negative outlook on the commercial auto segment for 2019. Although the line's overall results are likely to show some improvement in 2019 after several years of rate increases, prior years' loss reserves continue to adversely affect current calendar year results. Companies expect to continue pressing for additional rate increases to bring the line to rate adequacy in the face of ongoing deterioration in current year loss costs.

Higher gasoline prices resulted in fewer miles driven for the personal auto segment. There does not appear to have been a corresponding decline in commercial auto. This may be attributable to the tremendous growth in online retail, which actually may be causing an increase in commercial miles driven. Frequency and severity of claims continue to increase, as does distracted driving.

Technology has done more than create distractions for drivers; it also has helped fuel higher repair costs. While these technologies have helped to avoid some accidents and reduce injuries in those that do take place, the cost of repairing more sophisticated vehicles is significant.

Medical inflation has generally been moderate in recent years, but it still has risen faster than overall consumer inflation. And it is not just costs to repair vehicles that have increased because of technology. Advancements in medical care also have contributed to increased claim costs. Overall, the cost of restoring injured workers, third parties, and property following accidents has outpaced even the significant price increases in recent years.

Those price increases have provided some relief, and the underwriting loss in commercial auto is expected to have declined in 2018 and to drop again in 2019. Insurers continue to work with their insureds to develop, implement, and maintain safe driving practices, recognizing that without getting frequency to a stable level, price increases will not be able to restore profitability.

Medical Professional Liability

AM Best is maintaining its Negative outlook on the medical professional liability (MPL) segment for 2019. The key drivers of this outlook are ongoing pressures of shrinking demand, prolonged soft market conditions, and diminishing reserve redundancies, as well as concerns about potential increases in claims severity and in the frequency of high severity losses. Insurers are doing their best to manage these hurdles, but the segment will have to contend with numerous business challenges in the years ahead.

Consolidation of physician groups continues and is likely to escalate in certain markets, with the growing presence of private equity in the healthcare segment. This trend, combined with hospital employment of physicians, has shrunk the segment's core client base, as larger groups and hospitals are more likely to use captives or self-insurance mechanisms. To combat a dwindling insured base, many MPL insurers have implemented alternative strategies. Some carriers have leveraged their expertise to expand or diversify into new markets and enhance product offerings. Others have looked to improve efficiencies through innovation, such as intelligent automation and data analytics. Yet some look to partner with other MPL carriers in an effort to reach outside of their geographic boundaries through reinsurance arrangements.

Profitability trends, however, have been negative in recent years and deterioration in underwriting results is likely to continue in 2019, as the segment's excess capital and capacity has hampered a meaningful improvement in pricing. Further fallout from these trends may also spur acceleration of M&A.

MPL carriers will continue to face challenges from other market dynamics as well, such as potential increases in loss severity and greater frequency of high-severity claims; the evolution of healthcare delivery systems; growing concerns regarding cyber liability and cybersecurity, stemming from the digitization of healthcare and medical records; and the potential impact of the opioid crisis. Tort reform challenges in states across the country will also remain of vital importance to the segment—likewise, so will any changes in healthcare legislation at the federal level. The segment's long-term survivors will be those able to effectively use innovation to identify and appropriately price existing and emerging underwriting risks; improve efficiencies and reduce expenses; and maintain, or even gain, competitive advantages.

Professional Liability

AM Best is maintaining its Stable outlook on the professional liability segment. The segment is benefiting from available capacity, due to shrinking opportunities in other segments and very healthy P/C balance sheets. A number of challenges persist, primarily pricing inadequacy, growing competition from new insureds, and emerging trends (including #MeToo, cyber, and technological developments) that could lead to systemic losses.

The professional liability segment covers myriad niche liability classes outside the medical professional liability line. The vast majority of the segment's business (90% of the $17 billion-plus premiums written) is composed of directors and officers liability and errors and omission (E&O) coverages. The remainder of premium reflects miscellaneous professional liability (lawyers, accountants, engineers) and a small but growing book of US cyber liability.

D&O coverage results remain challenged. Claims have been driven by class action suits, rising shareholder activism, and growing overall loss costs, as rate pressures continue in both the primary and the excess layers. D&O results have been hampered by the competitive market conditions on Side A (the narrower exposure slice), and many carriers are looking to pull back from Side B and Side C risks, which have driven recent adverse loss reserve trends.

Some of the capacity previously allocated to traditional E&O coverage has now been reallocated to cyber coverage. Companies have become stricter about underwriting selections, especially based on insured's prior loss experience and large recent claims.

In the employment practices liability (EPL) segment, 2018 saw a notable increase in the number of harassment lawsuits and findings of reasonable cause, but not in single-plaintiff sexual harassment claims resulting from the numerous #MeToo allegations in late 2017 and 2018. Capacity and the number of competitors in the segment both remain plentiful, with some tightening of coverage and rate increases for certain classes.

Cyber liability draws most of the segment's headlines. A large portion of the cyber liability premium is written outside the US, where the loss experience has not yet been significant. Cyber writings by US carriers are likely to increase, extending a trend that started in 2015, divided between standalone and packaged policies. The main driver in the increase in writings is pickup from the number of small to medium-sized insureds buying the coverage.

We expect pricing for cyber to remain stable, unless the increase in large lawsuits (related to NotPetya and WannaCry attacks) leads to fine-tuning policy language that results in elevated pricing the next few years. For those policyholders who have expanded their security measures and implemented strong internal controls, premiums may remain flat or even decrease slightly. Additionally, carriers may find standalone policies more preferable than packaged policies.

Capacity is plentiful in all markets—in the US and internationally—and should meet demand. However, insurers are likely to focus on defining policy language, as they assess their exposures to ensure that any cyber coverage provided is affirmative, not silent. Cyber practice continues to evolve, with the development of underwriting guidelines, improvements in coverage, identification of appropriate limits, and product pricing. Carriers will also be paying special attention to new and evolving regulatory requirements, given the significant penalties and fines imposed by a number of regimes of late.

Surety

AM Best is maintaining its Stable outlook on the surety segment for 2019. The key driver of the outlook is the expectation of ongoing growth in the economy and in construction spending—particularly for privately financed construction projects, which has led to growth in surety premiums.

Construction spending to improve aging infrastructure in the US remains a potentially large source of premium for the surety segment over the near term. If President Trump is able to follow through on his plan (outlined in February 2018) to spend $1.5 trillion on infrastructure over the next decade, the surety segment could see a tremendous new flow of business. However, the White House and Congress have yet to make a major effort to enact comprehensive legislation on infrastructure spending and funding remains uncertain.

The continued favorable underwriting performance in the surety segment reflects companies' adherence to underwriting guidelines, adequate pricing, and a greater emphasis on efficiencies, such as the use of express programs to streamline the approval of smaller contract surety bonds. A heightened competitive environment is likely to continue, given the significant excess capacity available to meet growing demand, arising from both existing sureties and new entrants due to low loss ratios in recent years. This may lead to further competitive pressure on rates, and a softening of underwriting terms and conditions, but surety margins will likely remain strong.

Title

AM Best is maintaining its Stable outlook on the title segment for 2019 and believes the segment is poised for another year of strong operating results, despite an expectation of a slowdown in economic growth and signs of a weakening housing market. These negatives are offset by housing appreciation (despite its outpacing wage growth) and mortgage rates below historical averages, which may attract new homebuyers to the market. Other encouraging factors include the ongoing decline in unemployment, an efficient credit (lending) market with sound underwriting standards, record-low foreclosure rates, and positive consumer sentiment toward the economy and home ownership. Based on these factors, AM Best believes title insurers should post another year of solid net underwriting and net operating profits.

Negative factors that bear watching include limited housing inventory, the rising costs of materials, and land and labor shortages, which combined could drive up home prices and hurt affordability, particularly for first-time homebuyers, many of whom are burdened with household and student debt. Another noteworthy factor is the effect on real estate markets of the cap on state and local tax (SALT) deductions from federal tax liability, especially in states such as California, New York, and New Jersey.

Reinsurance

In December, AM Best revised its outlook on the global nonlife reinsurance segment to Stable from Negative. The change reflects a pricing environment that has stabilized, but at current levels that are still below long-term adequacy. In a persistently competitive market environment, pricing appears to have settled at the bottom of the cycle for the near future. Significant factors supporting the revision of our outlook are listed below:

- The belief that alternative third-party capital will hold the line on future return expectations following the catastrophe losses incurred in 2017 and 2018, as users of this capacity require more stringent credit governance over the level and release of collateral backing loss payment obligations
- A decline in capital consumption and earnings volatility caused by tail events, due in part to the increased utilization of third-party capital in retro programs, and the growing alignment between traditional and third-party capital
- A rising interest rate environment, particularly in the US, which could lead to alternative investment opportunities for third-party capital—rising interest rates could cause mark-to-market losses for bond portfolios, but reinsurers could benefit from higher yields if they manage their duration profiles prudently
- A renewed emphasis on underwriting discipline driven by potential loss cost inflation, coupled with lower loss reserve redundancies
- Ongoing US economic growth, greater use of reinsurance by cedents, new risk transfer opportunities, and M&A all providing greater growth opportunities

In addition, reinsurers rated by AM Best remain well capitalized on a risk-adjusted basis. Best's Capital Adequacy Ratio (BCAR) scores—measured out at the 99.6% confidence interval (or a 1 in 250 year return period)—remained robust throughout 2017 and 2018, despite significant catastrophic loss activity. Almost all reinsurers have significantly more capital than is required to attain the Strongest level of risk-adjusted capitalization as measured by the BCAR score in accordance with Best's Credit Rating Methodology (BCRM). Reinsurers have also found it relatively easy to raise capital from the capital markets through equity and debt issuance. The excess capital has provided reinsurers the ability to take advantage of market opportunities to offer new products, invest in innovation, and conduct M&A. On the flip side, the excess capital continues to exert pressure on risk pricing and poses a drag on equity returns.

AM Best's Market Segment Outlooks

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

- A Positive market segment outlook indicates that AM Best expects market trends to have a positive influence on companies operating in the market over the next 12 months. However, a Positive outlook for a particular market segment does *not* mean that the outlook for all the companies operating in that market segment will be Positive.
- A Negative market segment outlook indicates that AM Best expects market trends to have a negative influence on companies operating in the market over the next 12 months. However, a Negative outlook for a particular market segment does *not* mean that the outlook for all the companies operating in that market segment will be Negative.
- A Stable market segment outlook indicates that AM Best expects market trends to have a neutral influence on companies operating in that market segment over the next 12 months.

We update our market segment outlooks annually, but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

Published by AM Best

MARKET SEGMENT REPORT

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Version 020419