Spike in downgrades shows challenges for US insurers

Carriers suffering negative rating actions and continuing financial challenges can explore various reinsurance solutions that offer capital relief.

Executive summary

→ The number of ratings downgrades of US property/casualty (re)insurers jumped significantly in the eight months to the end of August 2023, compared to the calendar year 2022, and continuing an upward trend from 2021, according to Gallagher Re's analysis of ratings actions by leading agency A.M. Best.

→ Overall, negative rating actions (including outlook changes) outnumbered positive actions, as A.M. Best placed more scrutiny on performance metrics, due to a number of factors, including an increase in costly secondary perils; inflation; and volatility in investment markets.

→ Between the start of 2022 and the end of August 2023, a total of 109 companies experienced 60 rating downgrades and 64 negative outlook changes (15 experienced both). 77 of these companies have a focus on personal lines, and 32 on commercial lines.

→ Of the companies with negative rating actions, common themes were a drop in surplus of over 20% and combined ratios on average rising to over 117%. Most of these companies reported an operating ratio greater than 100%, because investment income was not sufficient to offset underwriting losses.

→ 45% of these companies also reported adverse claims development greater than 10%. This is a common contributor to negative ratings actions.

→ Gallagher Re also analyzed further ratings actions undertaken in the last four months of 2023. An additional 13 companies were downgraded in this period, while 26 companies had their outlook worsened. Meanwhile, 39 companies experienced improvements in their outlook.

→ These favorable outlook changes are the result of positive actions taken by company management, rather than an improvement in market conditions. These are expected to remain challenging in the near-term, prompting A.M. Best to maintain a "negative" outlook for personal lines going into 2024.

→ Reinsurance can be an effective solution to prevent a negative rating action.

Note on methodology

All reported metrics in this study (surplus, ratios, prior year development) are given as of Q2 2023, unless otherwise stated. The period for ratings actions reported is 1/1/2022–8/31/2023 (20 months), again unless otherwise stated. This means that companies which experienced ratings actions in July and August 2023 will also have their results through Q2 2023 included in this analysis.

Tough market conditions drive rating changes

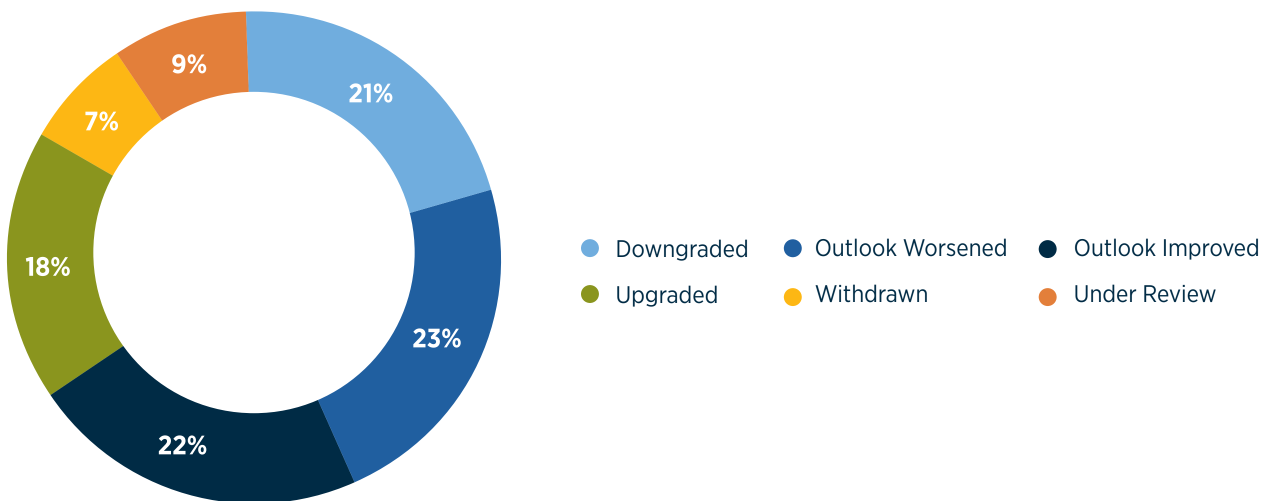
A.M. Best reported 282 rating actions in the US property/casualty (re)insurance market between January 1, 2022 and August 31, 2023 (excluding companies that were assigned an initial rating during this time.) Among this population, downgrades exceeded upgrades — though there were comparable numbers of "negative" and "positive" outlook changes (see Figure 1 below). Overall, there was more negative rating action among the personal lines-focused companies.

There were 23 downgrades by A.M. Best during 2022, followed by 37 in the eight months ended August 31, 2023 — a significant jump. 19 companies "withdrew" their rating between January 1, 2022 and August 31, 2023, due to the rating no longer having value in their markets at bbb+ or lower. All the companies who withdrew their rating reported declines in surplus leading up to the withdrawal. Companies were placed "under review" in response to various factors, both negative and positive. A few companies were placed "under review with negative implications", avoiding a downgrade because they were pursuing necessary strategic initiatives prompted by a significant erosion in capital.

The US property/casualty (re)insurance market has faced several challenges that have increased the number of negative outlook changes and rating downgrades from A.M. Best. Market conditions have pressured both the profitability and balance sheet strength of many companies. An increase in the frequency of secondary perils (for example, severe convective storms)[1] has contributed to this pressure, with loss costs outpacing the rate of inflation. Both social and economic inflationary pressures have resulted in higher claims costs and necessary increases in reserves. Net losses were exacerbated by changes in reinsurance availability, while volatility in investment markets further contributed to the pressure on insurers' balance sheets.

Gallagher Re also analyzed further ratings actions undertaken in the last four months of 2023. An additional 13 companies were downgraded in this period, while 26 companies had their outlook worsened. Meanwhile, 39 companies experienced improvements in their outlook. Nevertheless, market conditions continue to be challenging as we head into 2024.

Figure 1: P&C rating actions 1/1/2022 to 8/31/2023

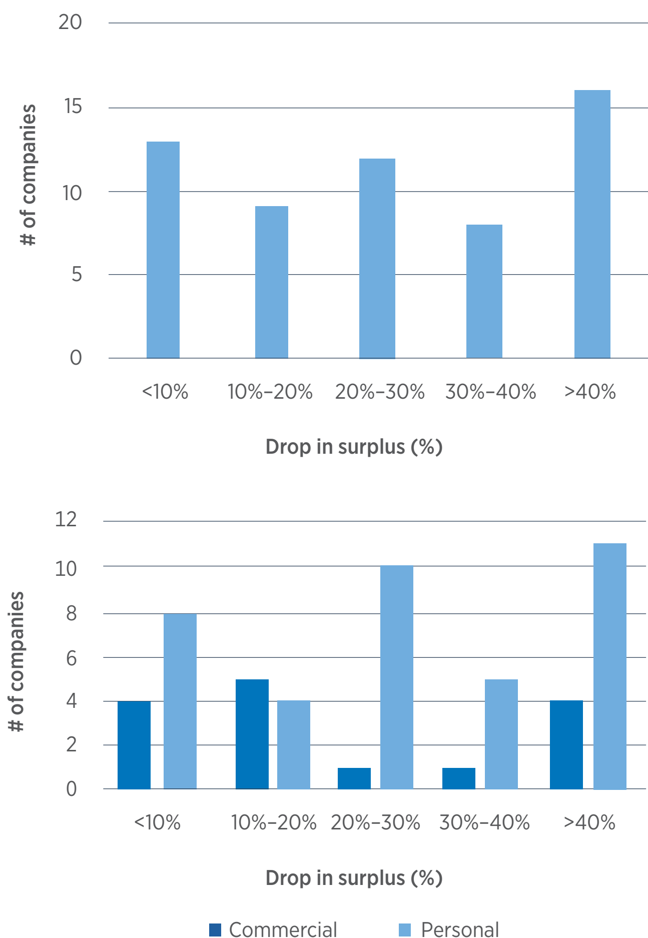


Reductions in surplus

Of the 60 companies whose rating was downgraded during this 20-month period, 16 (27%) experienced a drop in surplus of over 40%, and 36 (60%) experienced a drop in surplus of over 20% as of Q2 2023.

- Of the 38 companies with a personal lines focus, 11 (29%) experienced a drop in surplus of over 40%, and 26 (68%) a drop over 20% as of Q2 2023.
- Of the 15 companies with a commercial lines focus, 4 (27%) experienced a drop in surplus over 40% as of Q2 2023.

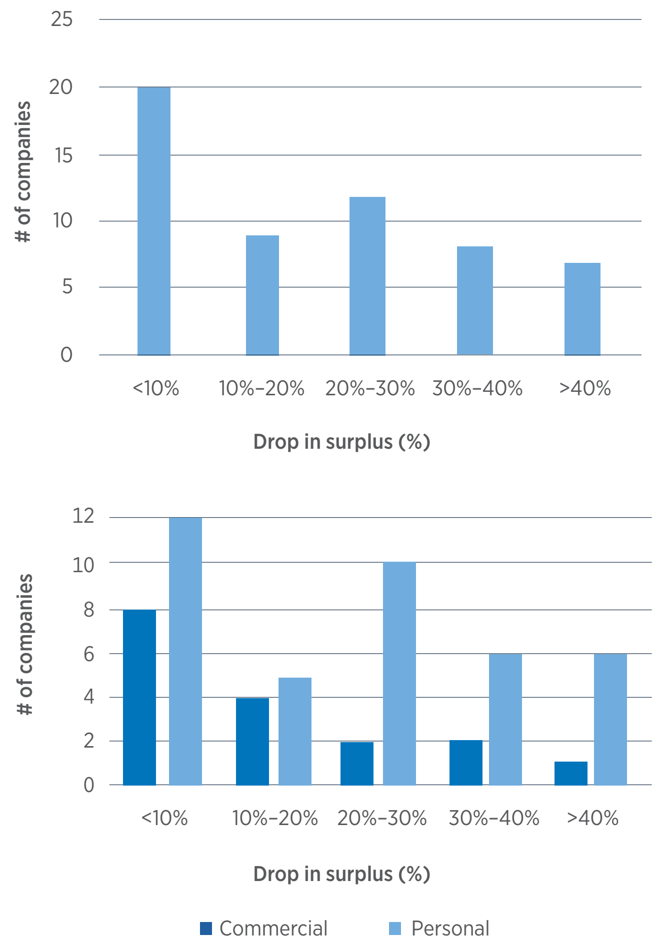
Figure 2: Downgraded companies 1/1/2022 to 8/31/2023 — drops in surplus as of Q2 2023



Of the 64 outlook worsened companies, 7 (11%) had a drop in surplus of over 40%, and 27 (42%) had a drop in surplus of over 20% as of Q2 2023.

- Of the 39 companies with a personal lines focus, 6 (15%) experienced a drop over 40%, and 22 (56%) had a drop over 20% as of Q2 2023.
- Of the 17 companies with a commercial lines focus, 5 (29%) experienced a drop in surplus over 20% as of Q2 2023.

Figure 3: Outlook worsened companies 1/1/2022 to 8/31/2023 — drops in surplus as of Q2 2023



Across the whole population of negative rating actions (124 actions at 109 companies), 15 companies (14%) experienced both an outlook worsened and rating downgraded action during the period.

Compare this to companies with **upgraded (51)** and outlook **improved (63)** rating actions:

- 57% of upgraded companies reported a less-than-10% drop in surplus, and
- 67% of outlook improved companies reported a less-than-10% drop in surplus.

Underwriting performance

While surplus erosion was a key contributor to rating actions, downgrades and negative outlooks were also generated through worsening underwriting performance. During this period, all companies that experienced ratings actions saw an increase in their combined ratio, as the property and casualty sector experienced heightened weather-loss volatility and the effects of inflation. This was especially true within personal lines, where there were higher attritional losses due to the costs of parts, materials, and labor remaining high.

For those companies that were downgraded, the average Combined Ratio (CR) was 117% at YE 2022, with further deterioration to slightly over 120% as of HY 2023.

- Within personal lines, the average CR was 120% at YE 2022, and 121% at HY 2023.
- Within commercial lines, the average CR was 117% at YE 2022, and 123% at HY 2023.

For those companies whose outlook worsened, results were closely aligned to the downgraded companies' results, with an average CR of 116% at YE 2022, and 120% as of HY 2023.

- Within personal lines, the average CR was 116% at YE 2022, and 123% at HY 2023.
- Within commercial lines, the average CR was 108% at YE 2022, and 111% at HY 2023.

Compare this to upgraded and outlook improved companies, whose average CR stood at 94% and 95% as of YE 2022, respectively; and 99% and 96% as of HY 2023, respectively.

Figure 4: Average combined ratios through Q2 2023 for all companies experiencing ratings actions between 1/1/2022 and 8/31/2023; grouped by nature of ratings actions

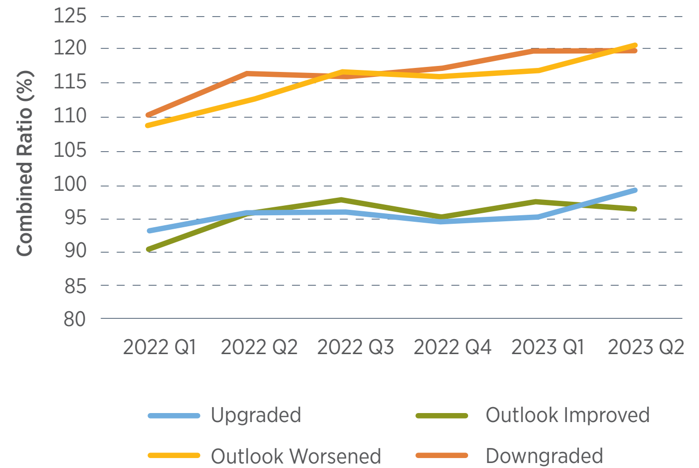


Figure 5: Average combined ratios through Q2 2023 for personal lines companies experiencing ratings actions between 1/1/2022 and 8/31/2023; grouped by nature of ratings actions

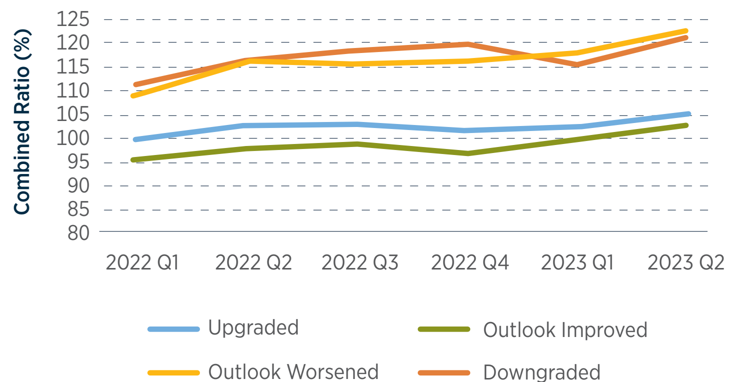
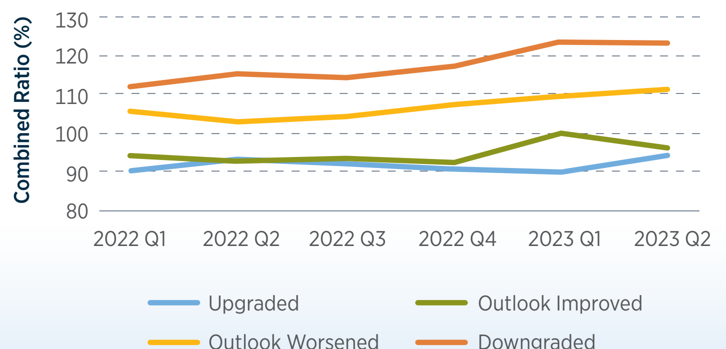


Figure 6: Average combined ratios through Q2 2023 for commercial lines companies experiencing ratings actions between 1/1/2022 and 8/31/2023; grouped by nature of ratings actions

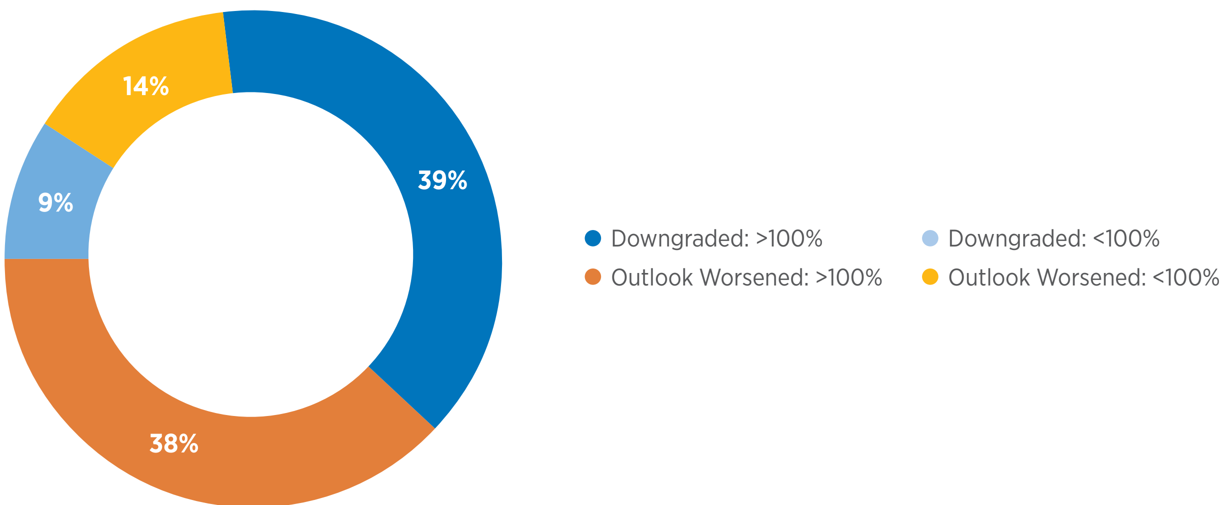


Operating ratios

Companies often rely on investment income to offset any underwriting losses, and thus achieve operating profitability. During the period 1/1/2022 to 8/31/2023, operating performance results as of Q2 2023 were challenged by the confluence of increased underwriting losses and volatility in investment results, increasing the probability of negative rating actions.

- For those companies which were downgraded, 84% reported operating ratios greater than 100% as of YE 2022, and slightly fewer (81%) reported an operating ratio greater than 100% as of Q2 2023.
- For those companies whose outlook worsened, 75% reported operating ratios greater than 100% as of YE 2022, and slightly fewer (73%) reported an operating ratio greater than 100% as of Q2 2023.
- Of the total population of downgraded and outlook worsened rating actions, 80% reported an operating ratio greater than 100% as of YE 2022 and 77% of those companies reported an operating ratio greater than 100% as of Q2 2023.
- Compare this to companies with upgraded and outlook improved rating actions, where only 15% and 17% of companies reported operating ratios greater than 100% as of YE 2022, respectively.

Figure 7: Downgraded and outlook worsened companies 1/1/2022–8/31/2023 — operating ratio as of Q2 2023



Reserve development

Depending on the magnitude of the change, reserve development can negatively influence both underwriting performance (through higher losses incurred), and balance sheet strength (through surplus erosion and higher levels of required capital within A.M. Best's Capital Adequacy Ratio model). Adverse development does not automatically result in a company being downgraded, although material charges or persistency of development are usually causes for rating action.

- Downgraded and outlook worsened companies in the personal lines and commercial lines segments on average reported a greater percentage of adverse reserve development to original reserves (prior year development as of 2022).
- 25% of downgraded companies in the property and casualty sector reported adverse development greater than 9.4%.
- 25% of outlook worsened companies in the property and casualty sector reported adverse development greater than 5.5%.
- Over 50% of both downgraded and outlook worsened companies reported some adverse development.
- Very few companies with upgraded and outlook improved rating actions reported any adverse development.
- Adverse development was more severe in commercial lines, due to rising loss cost severity as a result of social (tort) and economic inflation, and the uncertainty over loss reserve adequacy, especially long tail casualty lines.

Figure 8: Reserve development through Q2 2023 of personal lines companies that experienced ratings actions 1/1/2022–8/31/2023

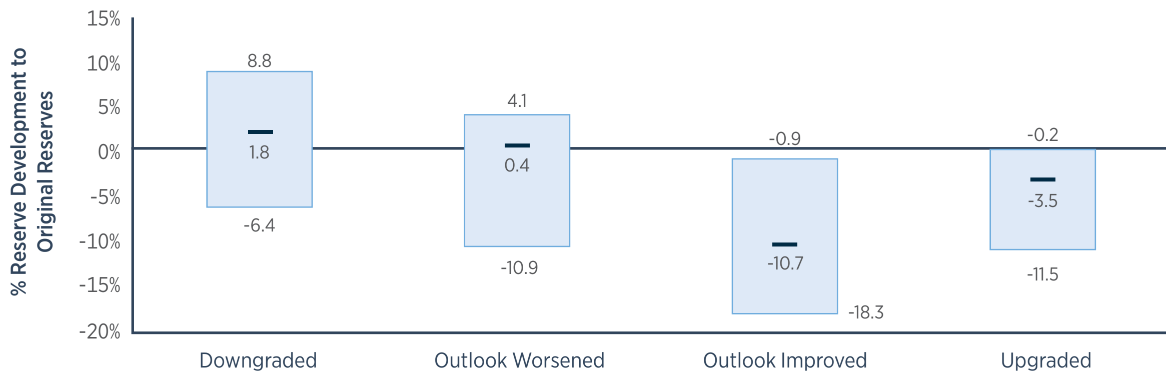
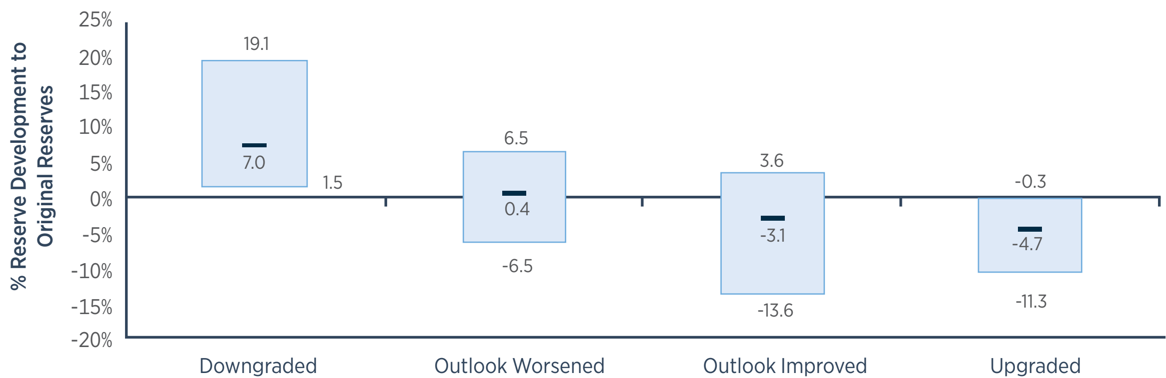


Figure 9: Reserve development through Q2 2023 of commercial lines companies that experienced ratings actions 1/1/2022–8/31/2023



Outlook

These challenging conditions are expected to continue over the near-term, prompting a cautious tone in A.M. Best's latest Market Segment Outlooks.

- A.M. Best maintains a negative outlook overall for personal lines, with negative outlooks for both homeowners and personal auto markets, for the following reasons:
  - A deterioration in personal auto, impacting both underwriting results and surplus,
  - Challenges maintaining rate adequacy;
  - A restrictive underwriting environment;
  - Elevated reinsurance costs and potential reinsurance capacity constraints, and
  - Claim severity has increased and property damage claims are taking longer to settle.
- A.M. Best maintains a stable outlook overall for commercial lines, despite negative outlooks on commercial auto, general liability, professional liability and title markets. Commercial property, private mortgage insurers, surety, medical professional liability, and workers' comp have stable outlooks, while only the excess and surplus lines market has a positive outlook.
  - Positive drivers include:
    - Strong pricing across most major lines (excluding WC) despite moderation,
    - Diligence on terms and conditions and capacity deployment; and
    - Strong capital, liquidity, and performance despite macroeconomic pressures.
  - Negative pressures include:
    - Rising loss cost severity due to social (tort) and economic inflationary pressures;
    - Uncertainty over loss reserve adequacy, especially long tail casualty lines;
    - An increase in the frequency and severity of weather events in commercial property; and
    - Growing fears of an economic recession.

How can companies mitigate the risk of negative rating actions?

To combat rating pressures, companies need to remain vigilant in ensuring that pricing adequately covers loss-cost trends and underwriting is not sacrificed for opportunistic premium growth. Active exposure management and stress testing can better prepare insurers when they face market events, to ensure capital remains supportive of current rating levels. The absence of demonstrated Enterprise Risk Management (ERM) attributes makes it more difficult for companies to respond to rating agency inquiries and defend against perceptions of weakness in an ERM program due to lagging results or material events. Modeling outcomes can also help companies evaluate reinsurance solutions that best limit volatility, prevent surplus erosion, and ensure economic capital (i.e., BCAR) is maintained above required thresholds for balance sheet strength.

Gallagher Re can assist companies by providing modeled outcomes from downside scenarios and guidance to protect overall capitalization. We will identify sources of rating pressure and review solutions that mitigate financial stress and afford companies time to remedy underlying issues and avoid rating action. Carriers can get capital relief in BCAR from solutions such as quota shares, adverse development covers/loss portfolio transfers, aggregate stop loss covers and purchasing additional tail protection. Reinsurance solutions are also effective in reducing leverage ratios, and the erosion of profits from reserve development and tail events, thereby preventing negative rating action. Gallagher Re also has proprietary tools which deliver peril scores and enhance underwriting. Tools such as our Hail Score and Wildfire Hazard Score combine robust data and predictive analytics to help manage concentrations of risk and set rates for companies.

In summary, Gallagher Re's Rating Agency Advisory team will illustrate how our clients look through the rating agency lens, develop strategies to assist with achieving their rating objectives, and help communicate strengths and ways to remedy weaknesses. We can also review transactions aimed at strengthening financial metrics, and establish which make the most economic sense.

Sources for all data and graphics: A.M. Best, Gallagher Re

Footnote

[1] "Q3 Natural Catastrophe Report," Gallagher Re, 18 Oct. 2023.

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