



Did you ever wonder why you buy insurance? In some cases, it is the law like worker's comp or auto liability. In some cases you are contractually obligated to do so by a third party. A mortgagee on a building, for instance, is required to purchase coverage. If you borrow money for a new piece of equipment, the lien holder will require insurance coverage. The reasons are many, but have you ever really thought about what you are doing when you buy insurance?

Basically, you are practicing one of the fundamental steps of the risk management process. **You are transferring the risk of loss to a third party**, in this case the insurance company. There are other types of risk management techniques that can be practiced but for the moment let's focus on this one.

If the risk is so great that you want to transfer it, or a third party requires you to buy insurance, it is important that you get the best deal possible. I have stated in many columns before that **the best price is not necessarily the best deal**. Today, I want to talk about the financial stability and ownership form of the company that you choose to transfer your risk to.

Hopefully, you have come to realize over the years that your insurance carrier is a pretty important supporter of your business' efforts. They are, after all, assuming quite a bit of the risk associated with running your business on a day-to-day basis. Most importantly, they are assuming that part of the risk that you are not interested in retaining, which means the risk of loss is generally significant and unforeseen in nature.

This is why an insurance carrier like PLM, or for that matter many of our competitors, requires that you perform a certain amount of internal risk control or loss control in order for us to accept your transfer of risk. We are attempting to reduce the risk and control the loss that you are transferring to the insurance company. I have heard people say that they are not concerned about loss control because that is why they buy insurance. After those words pass that individual's lips, they will: a) never be insured by PLM, or, b) be non-renewed if they are currently insured by PLM. We are not looking to accept a risk transfer in an uncontrolled and uncaring environment. That is not how we set the terms and conditions of the policy.

So let's look for a moment at the decision to buy from a new carrier or renew with your current carrier. Perhaps you have gotten some quotes or plan to just renew with your current carrier because, after all, you have been doing business with them for years. Just as when you buy a load of lumber and you are looking for a certain grade, you need to recognize that all insurance companies are not the same and there are certain grades of insurance companies that you need to ponder. Why, you ask? The answer is simple. If the insurance company is not around to pay the loss when it occurs and able to honor their obligation to you or those that you are liable to, then your original purpose of transferring your business risk cannot be met.



So how can you tell the strength of an insurance company? You need to rely on an independent third party to help you make this decision. The foremost evaluator of an insurance company's financial strength in America today is A.M. Best Company of Oldwick, New Jersey. A.M. Best evaluates most property and casualty insurance companies in the United States and many worldwide. Their evaluation leads A.M. Best to assign a number of ratings that I would like to walk through with you today.

To assign a rating for an insurance company, A.M. Best evaluates a company's financial results, its future business plan, and its key executive leadership team. They assign a letter rating to each and in some cases the letter rating has a modifier. There are A rated insurance companies (Excellent) with a modifier of ++, + and -, or no modifier. There are also B rated insurance companies with the same modifiers, as well as C rated insurance companies. Many would argue that while there are additional ratings, the party is really over once you hit the C rating. Anything lower than that really doesn't much matter in my mind. The second modifier that A.M. Best assigns is a rating outlook, which can be positive, stable or negative. This is an indicator of A.M. Best's view of the current rating. A positive outlook means you are potentially going to enjoy a rating upgrade. A stable rating indicates that the rating is solid in nature and not likely to change in the near term. The negative outlook means that your rating is under some pressure and there are things that you need to fix. Upgrades and downgrades usually occur one step at a time. In other words, you may

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Pennsylvania Lumbermens Mutual Insurance Company

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go from an A rated carrier to an A+ carrier, or an A rated carrier to an A- carrier. It is highly unusual to have a two step grade change like A+ to A- for instance.



Another factor that needs to be pondered is the company's size. This gives the evaluator an idea of how much policy surplus is available for utilization. Surplus in the mutual insurance company world is viewed similar to equity as you would know it. In other words, surplus is the equity that remains after we have set up reserves for claims that have occurred, or have been incurred but not yet recorded (after unearned premium reserves have been set aside) and a host of other smaller liabilities.

Therefore the A.M. Best ratings indicate a lot about a company's financial strength and size. After all - and I want to repeat this thought again - if you are trying to transfer your risk of loss to an insurance company, it makes sense that you transfer it to an insurance company that is going to be around for the long term. Old claims are always popping up. When the insurance company that you placed your coverages with are no longer around and that old claim rears its ugly head, then you are responsible for paying that loss and working with the state insurance departments to obtain payments from guarantee funds that have been established in most states but offer limited coverage. Sound like fun? I can assure you that it is not. Old claims have never turned up in your business? Maybe not. Most of PLM's insureds will tell you they never had a fire until the day the plant burned to the ground. The same could be said for old claims. This year alone we set reserves up for a claim that occurred in the early 1950's, and another one that allegedly occurred in the late 1990's. Interestingly enough, we reopened a claim that we declined in 2003 when one of the states we operate in changed a law retroactively and our claim denial was a victim of a legal reversal.

To give you a feel of the breakdown of ratings assigned by A.M. Best, take a look at the following chart. Today, 64.3% of companies are evaluated as A rates; 1.8% are below B rated companies.

So how does A.M. Best come up with the evaluation? Do you simply submit your financial statements and hope for the best? There is a lot more to A.M. Best's evaluation than a financial review. Financial statements are submitted and reviewed using a proprietary financial modeling tool by A.M. Best. Not only do they evaluate the current financial statements but they look at previous financial statements and trend them over a five year period. They look at the investments that the company is holding and evaluate the quality of those investments utilizing the National Association of Insurance Commissioner's rating methodology as a touch point. They look up the company's reinsurance program and compare it to the company's financial strength. This provides an understanding of how much of a significant loss will be absorbed by the company and how much will be handed off to reinsurers. They also look at the reinsurers and the quality of those reinsurers. In the reinsurance world, if you are not A rated, you are out of business. Think about that

for a second. When I meet with clients, it is rare if I am not the largest buyer of insurance in the room. This year, PLM will purchase more than \$50 million of reinsurance, and we, like virtually every other insurance company on the planet will only buy A rated paper. In fact, we have a competitor, who advertises that they only buy reinsurance coverage from A rated carriers. Why is that? Why is it so important to those of us who really understand the insurance business? It's very simple. We are only willing to entrust our transfer of risk, through the reinsurance mechanism, to A rated companies.

Doesn't that tell you something? Isn't this a strong indication of the importance that experienced insurance buyers place on an A rating? Do I pay more for A rated reinsurance coverages? Absolutely. But, then again, I don't have to worry about whether or not the company will be there to pay the loss when the loss arises. Similar to you, I am looking to transfer a portion of the risk I accept from you to the reinsurers. I need to know that our reinsurers will be there when a loss occurs.

A.M. Best will look at the management team and their understanding of the insurance business. They are going to look at the company's business plan. They want to see what you are doing to face the challenges that you confront and how you overcome them. They also want to know how we plan to take advantage of the opportunities laid out before us. They want to talk to management about what the business is going to look like not only one year out, but three years out. They are going to look at your geographic spread of risk to determine if you are concentrated in any particular geographic area of the country that might be subject to certain types of catastrophic losses. This includes hurricanes in the southeast; wildfires in the west; hail and tornados in the Midwest; earthquakes in the far west; etc.

If you are a niche player like Pennsylvania Lumbermens, they are going to want to look at what is going on in the niche, who you compete with, and the health of the business or the customers that you are insuring from a financial standpoint.

A.M. Best wants to look at your ownership form. They recognize, as should you, that there is a difference between stockholder owned insurance companies and mutual insurance

2011 Property/Casualty Rating Distribution By Individual Companies			
FSR	Rating Category	Number	Percent
<b>Secure Ratings</b>			
A++	Superior	73	3.3
A+	Superior	386	17.6
	<b>Subtotal</b>	<b>459</b>	<b>20.9</b>
A	Excellent	865	39.4
A-	Excellent	548	24.9
	<b>Subtotal</b>	<b>1,413</b>	<b>64.3</b>
B++	Very Good	152	6.9
B+	Very Good	78	3.6
	<b>Subtotal</b>	<b>230</b>	<b>10.5</b>
	<b>Total Secure Ratings</b>	<b>2,102</b>	<b>95.7</b>
<b>Vulnerable Ratings</b>			
B	Fair	39	1.8
B-	Fair	16	0.7
	<b>Subtotal</b>	<b>55</b>	<b>2.5</b>
C++	Marginal	8	0.4
C+	Marginal	7	0.3
	<b>Subtotal</b>	<b>15</b>	<b>0.7</b>
C	Weak	2	0.1
C-	Weak	1	0.0
	<b>Subtotal</b>	<b>3</b>	<b>0.1</b>
D	Poor	2	0.1
E	Under Regulatory Supervision	7	0.3
F	In Liquidation	13	0.6
	<b>Subtotal</b>	<b>22</b>	<b>1.0</b>
	<b>Total Vulnerable</b>	<b>95</b>	<b>4.3</b>
	<b>Total Rating Opinions</b>	<b>2,197</b>	<b>100.0</b>
NR	Not Rated	1,047	
	<b>Total Reported Companies</b>	<b>3,244</b>	

As of July 19, 2011

companies. Stock insurance companies are legally required to prioritize the interest of the stockholder over the insured and, in doing so, tend to take a short term view on the market. Mutual insurance companies tend to have a longer time horizon, with

our primary concern being the policyholders. I guess that is another question that begs to be asked as you ponder this topic. **Why would you want to do business with a company whose primary concern is its stockholders as opposed to a mutual insurance company whose primary concern is you, the policyholder?** What value do you assign to this issue as you weigh your buying decision?

So, the evaluation of an insurance company by A.M. Best goes well beyond a simple financial review. Like us, the typical insurance company will work for weeks, if not months, pulling together and rehearsing for a review meeting with A.M. Best, which in our case we do on a face-to-face basis annually.

Next, I would like to take a look at Pennsylvania Lumbermens' rating and chat about that for a moment. PLM was upgraded from an A- to an A with a stable outlook four years ago. Last year, our outlook was changed to negative. We have a surplus size of 7 assigned to PLM, which means we have \$100 million or more free and unassigned policyholder surplus -- this is the additional equity we talked about earlier. In our case, we do not have any debt on our balance sheet. We also do not carry any surplus notes, which is the usual vehicle that is designed to strengthen the surplus position of an insurance company with borrowed funds that must eventually be paid back. In our world, the surplus we are carrying is about two times the amount of our expected loss and about four times the actual claim file case reserves.

If you look at the output from the proprietary A.M. Best model that we reviewed earlier as the only measurement tool, PLM's rating would actually be higher than it is.

So why isn't it, and why is there a negative outlook? First off, A.M. Best views the commercial line segment of the entire property and casualty market negatively. They believe pricing is too weak to generate long term profits. They believe other terms and conditions are too broad, i.e., companies that operate in the commercial lines segment are placing a lot of coverage on policies and not charging adequate premiums for those policies. As an independent evaluator, A.M. Best does not believe the commercial lines segment of the insurance marketplace will do well profitability-wise in the immediate future.

You disagree? Are you someone who thinks insurance companies are making a killing? I always smile when people talk about how much money insurance companies make. And my follow-up question is always the same: If insurance companies are making so much money, wouldn't it make sense to hold them in your own individual investment portfolio? The obvious answer is yes. Take a look at your own portfolio. Do you hold any? Try finding someone else you know that holds specific insurance companies in their portfolio.

The fact of the matter is that most people don't. The reason is that the margins are too thin and the return on equity and revenue too low, and few, if any, analysts recommend many insur-

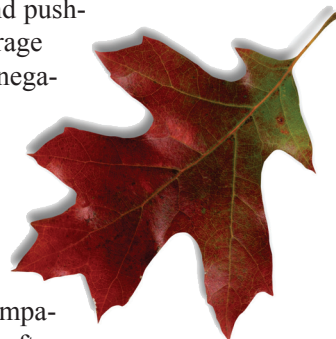
ance companies for individual investment portfolios. So, A.M. Best has a negative outlook on the segment that we operate in. A.M. Best is also not a big fan of insurance companies that focus on the lumber niche. They think that there are too many insurance companies operating in the niche and some of those companies are having poor operating results for a number of years because pricing is too low and coverages are too broad. Putting it simply, the supply of coverage for wood and lumber related risks is outstripping the demand pushing down prices and broadening coverage terms. As a result, A.M. Best is now negative on the commercial lines segment (commercial lines of business are the only business we write), and negative on the wood and lumber niche.

Finally, to be honest, our results last year were less than acceptable as a company. While we had a small net income after taxes, and I know many of you wish that you could accomplish that goal in your own businesses, our operating experience has been lumpy with two out of the past five years being unacceptable.

**“Why would you want to do business with a company whose primary concern is its stockholders as opposed to a mutual insurance company whose primary concern is you, the policyholder?”**

Hence, the negative outlook on our rating. Quite frankly, as I write this today, our results this year are not looking much better. The story last year was weather and fires. This year, we pretty much have the fires under control, but weather related claims have been significant in nature, and not isolated to any one part of the country.

So, we spent quite a bit of time talking about the evaluation process and the importance of an A rating be it A, A+, or A-. We talked a little bit about the outlook. But what about the size factor? The only real reason the size factor comes into play within the wood niche is that a number of big buyers require their suppliers to be insured by a carrier that has at least a size 7 surplus (be it Home Depot, Lowes, or a number of others), which means they have \$100 million in surplus. Are there ways around this? Yes. An insurance carrier can provide a cut-through endorsement if they don't have \$100 million of surplus, but if you are confused now "cut-throughs" are only going to add complexity to the conversation. What a true cut-through essentially indicates is that should the primary insurer go out of business, the reinsurer will step into the shoes of the primary company that no longer exists. Think about this for a second, when you are being offered a cut-through by your primary insurance. Should alarm bells be going off in your mind? The question then becomes: Is what you are being offered a true cut-through or just a certificate of insurance? A true cut-through creates a relationship in which the reinsurer provides and fulfills responsibilities of the primary insurance company in total, not only providing the total reinsurance payment that is due, but also the retention that the primary insurance company did not





**Pennsylvania Lumbermens  
Mutual Insurance Company**  
One Commerce Square  
2005 Market Street, Suite 1200  
Philadelphia, PA 19103-7008

PRSR STD  
U.S. POSTAGE  
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POTTSTOWN, PA  
PERMIT NO. 140



***wood is all we do.***

reinsure. Getting complex? This is opposed to a certificate of insurance which is currently being handed out in the marketplace. It simply indicates that the reinsurer will fulfill its legal obligation and pay the amount that it is legally obligated to pay should the primary insurance company go out of business. The question you should be asking is: Who pays the rest (of the primary company's retention)? Further, if you go this route with your current insurance company, are you getting these certificates from every reinsurer involved?

Finally, in closing, let's talk about the value of an A rating. I have always been hard-pressed to assign a pricing value that insureds should ponder when comparing proposals between various insurance companies with different ratings (even though I would personally not buy at any price less than A- rated coverage). Rumor has it that we have a competitor in the marketplace who is not A rated, and has let it be known that they have created a relationship with another insurance company who will allow them to use the other insurance company's A-rated "paper" in return for a 15% surcharge. It appears to me that one of our competitors just established the extra premium that an A rated carrier should be able to obtain.

So what are the takeaways from this? Insurance is a complex business that involves you transferring the risk of conducting your business to the insurance company. The cost of this risk transfer is not cheap because there is a lot of risk being transferred. When you are transferring your risk to a third party, it matters who you transfer it to. The A.M. Best rating is a good tool to use to establish whether someone is a worthy partner for transferring your risk. If they do not enjoy a solid rating, then I would suggest you worry about how complete and final the transfer of risk that you are hoping to accomplish really is. It should tell you something that insurance professionals who run insurance companies will only buy reinsurance from reinsurers who are A rated.

This article begs the question of what are we going to do to improve our results? I will cover that in our next LumberMemo. As always, if I can be of any service, please do not hesitate to contact me. ■

### LumberMEMO

President & CEO	John K. Smith jsmith@plmins.com
VP of Field Operations & Marketing	Steve Firko sfirko@plmins.com
Sr. Marketing Specialist	Susan Cho scho@plmins.com

One Commerce Square  
2005 Market Street, Suite 1200  
Philadelphia, PA 19103-7008  
MAIN 800.752.1895  
FAX 215.625.9097  
www.plmins.com  
info@plmins.com

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Help us improve the LumberMEMO!  
Send all feedback to  
scho@plmins.com.