Trend Review
March 28, 2013

Three companies were added to the impairment list in 2012.

Best's Impairment Rate and Rating Transition Study – 1977 to 2012

This is the 10th study conducted by A.M. Best Co. on the long-term impairment rates of A.M. Best-rated, U.S.-domiciled insurance companies. It updates *Best's Impairment Rate and Rating Transition Study – 1977 to 2011*, published March 26, 2012.

The study covers the 35 one-year periods from Dec. 31, 1977 to Dec. 31, 2012 and only includes companies that had a Best's Financial Strength Rating (FSR) over this period. Of the 5,097 individual U.S. companies that carried a Best's FSR, an average of 20.9 companies per year, or 730 companies, became financially impaired. Impairment, generally defined as any official action by a state regulator that restricts the insurance business activity of an operating insurance company, goes beyond the traditional concept of issuer defaults as discussed later.

Since the last impairment study (which included impairments from 1977 through 2011), three companies have been added to the list of impaired insurers for 2012, as listed in **Exhibit 15**. The three impairments, which were all property/casualty (P/C) insurers, is five lower than the number of impairments reported in 2011.

The average annual impairment rate for all insurers over the period of this study was 0.65%. Secure companies – with FSRs of "B+" (Good) and above – and Vulnerable companies – with FSRs of "B" (Fair) and below – had average annual impairment rates of 0.23% and 3.76%, respectively.

A.M. Best's rating transition rates remained stable over the period covered by the study. Among companies with Secure ratings, 98.26% maintained their Secure status over a one-year period. The remaining 1.74% were downgraded to Vulnerable or became impaired over a one-year period.

Motivation for This Study

Best's Impairment Rate and Rating Transition Study – 1977 to 2012 (Best's Impairment Rate and Rating Transition Study) responds to the need for insurance industry data for use in insurance-linked transactions, including the securitization of trust-preferred securities and surplus notes, reinsurance recoverables, structured settlements and life settlements, among others. General corporate bond default statistics are inappropriate for assessing insurance credit risks in such transactions because of the unique regulatory and accounting environment in which insurers operate, and because relatively few insurers issue public debt. This study also is useful for assessing capital requirements associated with entities such as sidecars, protected cells and bankruptcy-remote vehicles where the life of the transaction and the covered risks are well defined and limited.

A.M. Best embarked on this study to estimate rates of impairment for insurance companies that can serve as the basis for estimating the likelihood of defaults on financial obligations made by those companies. As detailed later, "impairment" is a substantially wider category of financial duress than an event of default. In particular, impairment frequently occurs when an insurer still is able to meet its current policyholder obligations,

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yet regulators have become sufficiently concerned about the degree of current or future solvency to intervene in the insurer's business. This leads to substantially higher impairment rates at any given rating level than would be observed purely using default data.

This Study vs. Prior Best's Insolvency/Impairment Studies[1]

Drawn from A.M. Best's general impairment database and historical rating records, this impairment rate and rating transition study is a special-purpose report aimed at estimating default risk of U.S. insurers that have had interactive FSRs from A.M. Best. As such, the data used in this study are a subset of the data used in A.M. Best's insurer impairment studies (general impairment studies) begun in 1991 (property/casualty) and 1992 (life/health [L/H]) and periodically updated. Updated general studies through 2012 are scheduled to be released by midyear 2013. The studies and their updates can be found at *www.ambest.com*.

1. Although the earlier general impairment studies generally included "insolvency" in their titles, the definition of impairment has been consistent in all impairment studies of the U.S. P/C and L/H industries, as well as in the impairment rate and rating transition studies.

The major differences between this study and the general impairment studies (formerly called insolvency studies) are:

• This study serves as a basis for estimating the likelihood of default. The purpose of the general impairment studies is to provide insight into the underlying causes of impairment.

• This study calculates one-year to 15-year cumulative average impairment rates by applying the static pool-based approach commonly employed by the credit rating industry in issuer default studies. The general impairment studies do not calculate long-term impairment rates.

• This study covers impairments only of A.M. Best-rated companies with interactive FSRs – those companies cover 98% of U.S. industry premium volume. The general impairment studies focus on impairments of all companies in the insurance industry, regardless of whether A.M. Best rated the impaired companies.

• This study includes a conversion of A.M. Best-rated insurance company impairment rates to the implied impairment rates associated with debt issued by insurance holding companies.

• This study tabulates impairment statistics for the combined U.S. P/C and L/H sectors. The general impairment studies provide separate reports for each sector.

• This study covers the period from year-end 1977 to year-end 2012. The last general U.S. P/C and L/H impairment studies covered the period from 1969 to 2011. Again, updated general studies through 2012 are scheduled to be released by midyear 2013.

Exhibit 1

U.S. Life/Health & Property/Casualty – Impairment Count by Year (1978-2012)

Year	No. of Impairments*	% of Total Impairments
1978	8	8/730*100 =1.1%
1979	6	0.8
1980	5	0.7
1981	10	1.4
1982	7	1.0
1983	16	2.2
1984	22	3.0
1985	32	4.4
1986	25	3.4
1987	25	3.4
1988	24	3.3
1989	40	5.5
1990	37	5.1
1991	55	7.5
1992	33	4.5
1993	29	4.0
1994	24	3.3
1995	10	1.4
1996	19	2.6
1997	31	4.2
1998	17	2.3
1999	27	3.7
2000	35	4.8
2001	41	5.6
2002	41	5.6
2003	34	4.7
2004	13	1.8
2005	7	1.0
2006	12	1.6
2007	4	0.5
2008	9	1.2
2009	13	1.8
2010	8	1.1
2011	8	1.1
2012	3	0.4
	730	**100.0%**

*Includes companies that were not rated at the time of impairment but had a Best's FSR between Dec. 31, 1977 and the date of impairment.
Source: A.M. Best Co.

• This study covers insurers domiciled in the United States, excluding U.S. territories. The general studies include U.S. territories.

• This study is titled *Best's Impairment Rate and Rating Transition Study – 1977 to 2012* to distinguish it from the general impairment studies and their updates.

Definition of Impairment

A.M. Best designates an insurer as a Financially Impaired Company (FIC) upon the first official regulatory action taken by an insurance department. Such state actions include involuntary liquidation because of insolvency, as well as other regulatory processes and procedures such as supervision, rehabilitation, receivership, conservatorship, a cease-and-desist order, suspension, license revocation, administrative order and any other action that restricts a company's freedom to conduct its insurance business as normal. Companies that enter voluntary dissolution and are not under financial duress at that time are not counted as financially impaired. (See sidebar: **Financially Impaired Companies Defined**.)

Impairments vs. Defaults

The definition of financial impairment is different from that of issuer defaults generally used in the credit markets. The credit markets broadly deem an issuer default as having occurred when an issuer misses interest or principal payments on its obligations; restructures its debt in a way that is deleterious to investors; or files for bankruptcy. Financial impairment of insurance companies, by contrast, often occurs even if an insurance company has not formally been declared insolvent. For instance, an FIC's capital and surplus could have been deemed inadequate to meet risk-based capital requirements, or there might have been regulatory concern regarding its general financial condition. Thus, at any given rating level, more insurers would be impaired, according to the A.M. Best definition, than actually would default on policyholder obligations.

Another important reason for focusing on impairment rates, rather than defaults on policyholder obligations, is the difficulty in defining what constitutes the latter. In particular, the common practice of commutation means that it often is unclear whether default, as normally defined in the credit markets, has taken place or not. This is because, while the policyholder might be agreeing to a commutation to avoid the risk of the insurer becoming insolvent in the future, other factors, such as the liquidity value of receiving payment now or the future uncertainty of the ultimate size of the claim, often influence commutation agreements.

Exhibit 2

Best's Cumulative Average Impairment Rates

U.S. life/health and property/casualty data from 1977 to 2012.

Rating	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	11-Year	12-Year	13-Year	14-Year	15-Year
A++/A+	0.05%	0.18%	0.33%	0.49%	0.64%	0.85%	1.08%	1.31%	1.61%	1.91%	2.21%	2.60%	3.01%	3.42%	3.72%
A/A-	0.17	0.51	0.96	1.42	1.93	2.47	3.01	3.61	4.17	4.69	5.22	5.67	6.09	6.45	6.78
B++/B+	0.77	1.77	2.77	4.03	5.37	6.54	7.70	8.64	9.39	10.19	10.95	11.76	12.51	13.25	13.86
B/B-	2.17	4.49	6.67	8.57	10.53	12.51	14.38	15.96	17.54	19.09	20.67	22.22	23.67	24.96	26.13
C++/C+	3.73	6.22	9.25	12.17	14.62	17.23	19.53	22.68	25.23	27.07	28.51	29.61	30.76	32.06	33.20
C/C-	5.90	9.26	12.26	15.28	18.40	22.16	25.49	29.12	31.93	34.59	37.67	40.08	42.14	44.24	46.44
D	7.57	12.71	17.60	22.04	26.28	30.54	34.13	37.15	39.80	42.33	44.77	46.74	48.45	49.89	51.12
Secure	0.23	0.61	1.05	1.53	2.05	2.57	3.09	3.60	4.09	4.56	5.03	5.51	5.98	6.42	6.78
Vulnerable	3.76	6.72	9.63	12.29	14.88	17.59	20.01	22.35	24.44	26.37	28.26	29.91	31.42	32.82	34.10
All	**0.65%**	**1.33%**	**2.05%**	**2.78%**	**3.54%**	**4.31%**	**5.05%**	**5.78%**	**6.46%**	**7.11%**	**7.75%**	**8.38%**	**8.98%**	**9.55%**	**10.04%**

Source: A.M. Best Co.

2. The rating category "NA-7" is included in the "D" category.

3. The FSR groupings in this study included the Financial Performance Ratings (FPRs) that were introduced in 1990 and discontinued in 2002. See the Preface of a pre-2002 *Best's Insurance Reports* for groupings of FSRs and FPRs.

Financial Strength Rating Categories

In 1977, A.M. Best had the following seven FSR categories (excluding the impaired category): "A+," "A," "B+," "B," "C+," "C" and "D." By 1992, the company had expanded its FSR scale, excluding impairments, to the following 13 categories to recognize finer distinctions in credit quality among insurance companies: "A++," "A+," "A," "A-," "B++," "B+," "B," "B-," "C++," "C+," "C," "C-" and "D." Companies rated "B+" and above are considered Secure, and companies rated "B" and below are considered Vulnerable. These same FSR categories remain in use today.

Please note that in A.M. Best's FSR scale, the symbol "D"[2] does not designate financial impairment. The designation for financial impairment in the period covered by the study includes the following ratings: "E," "F" and "NA-10." The "E" and "NA-10" ratings are used to indicate companies that are under regulatory supervision. The "F" rating is used for companies in liquidation, which may include voluntary dissolutions that are not impairments. For the purposes of this study, the nomenclature "impaired" or "impairments" will appear on various tables and graphs to designate FICs with "E," "F" and "NA-10" ratings assigned by A.M. Best, as well as regulatory interventions that did not otherwise trigger an A.M. Best impaired rating.

To facilitate the comparison across time, this study has grouped FSRs (excluding the impaired category) into the following seven categories: "A++/A+," "A/A-," "B++/B+," "B/B-," "C++/C+," "C/C-" and "D."[3]

Companies Covered

The study includes P/C and L/H insurance companies domiciled in the United States that traditionally have filed statutory statements. Managed care companies are excluded from the life/health pool.

Specifically, the study covers 730 financially impaired companies out of the 5,097 U.S.-domiciled insurance companies that had a Best's FSR at some point between Dec. 31, 1977 and Dec. 31, 2012.

Financially Impaired Companies Defined

A.M. Best designates an insurer as a Financially Impaired Company (FIC) as of the first official regulatory action taken by an insurance department, whereby the insurer's:

- Ability to conduct normal insurance operations is adversely affected;

- Capital and surplus have been deemed inadequate to meet regulatory requirements; and/or

- General financial condition has triggered regulatory concern.

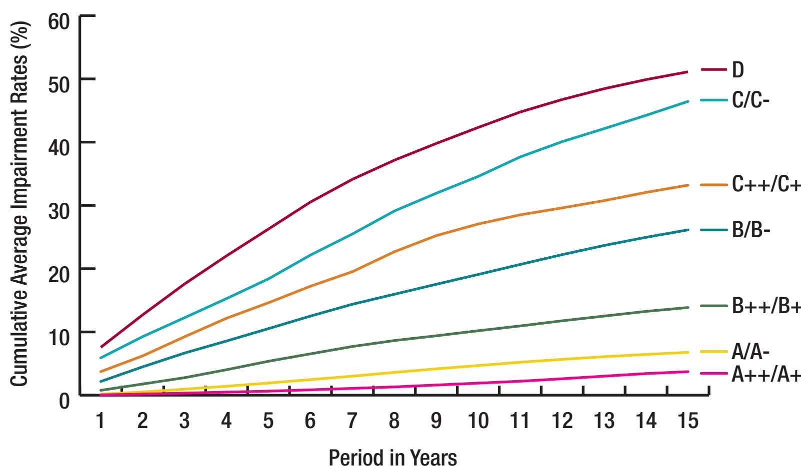
State actions include supervision, rehabilitation, liquidation, receivership, conservatorship, cease-and-desist orders, suspension, license revocation and certain administrative orders. A.M. Best emphasizes that the FICs in this study might not technically have been declared insolvent.

It should be noted that the above definition of an FIC is broader than that of a Best's Rating of "E" (under regulatory supervision), which is assigned only when an insurer is "no longer allowed to conduct normal ongoing insurance operations." Thus, a company may be designated as financially impaired in this study, but not have been assigned an "E" Best's Rating. Further, a Best's Rating of "F" (in liquidation) can reflect liquidation as part of the impairment process, or it can indicate a voluntary dissolution. Unless under financial duress, voluntary dissolutions are not counted as impairments. Before 1992, a Best's Rating of "NA-10" was used to indicate that a company was under regulatory supervision and/or in liquidation.

The data in **Exhibit 1** represent impaired companies that had received at least one Best's FSR between Dec. 31, 1977 and Dec. 31, 2012. This impairment list counts only companies that had an A.M. Best rating in that period. Some of these companies had no A.M. Best rating assigned to them at the time of impairment, since they became impaired after A.M. Best ceased to rate them. These companies are included in the study, however, as dictated by the static pool approach described in the section titled "Static Pool-Based Calculation Approach."

Exhibit 3
Best's Ratings – Cumulative Average Impairment Rates

U.S. life/health and property/casualty data from 1977 to 2012.



Source: A.M. Best Co.

The reader should note that impairment counts in this impairment study and prior studies are based on individual companies, not on groups or rating units. As such, the failure of a large group can affect annual impairment counts significantly. For example, nine of the 27 impairments in 1999 are attributed to the impairment of General American Life Insurance Co. (See sidebar: **Illustration of Impairment Without Subsequent Default on Policyholder Obligations**.)

The reader also should be aware that A.M. Best will continue to improve and possibly expand the database upon which this impairment study is based. Updates, therefore, may include corrections to the data, or they may include or exclude new insurance companies previously excluded from or included in prior studies. (See sidebar: **A Note on Revisions**.)

These adjustments to the data or inclusion criteria may make it difficult to compare the results of one study with its predecessors. To maintain as much consistency as possible, however, the study's updates and revisions will be done from the common starting point of Dec. 31, 1977.

Illustration of Impairment Without Subsequent Default on Policyholder Obligations

To illustrate how financial impairments, as defined by A.M. Best, can occur without a default on an insurance company's financial obligations to its policyholders, it is instructive to observe the financial impairment of General American Life Insurance Co. (GALIC). In August 1999, the Missouri Department of Insurance placed GALIC under administrative supervision to avoid a "run on the bank" by the company's policyholders. In January 2000, Metropolitan Life Insurance Co. purchased GALIC and its affiliates from General American Mutual Holding Co., the operating company's parent. Administrative supervision of GALIC ended at that time.

Although the company was under administrative supervision for approximately five months, it was not liquidated, and it continued to satisfy its financial obligations under its insurance policies. Accordingly, no insurance policy default event occurred. As the company and its affiliates were under administrative supervision for a period, however, they were counted as impaired according to A.M. Best's definition of impairment.

Impairment Rates

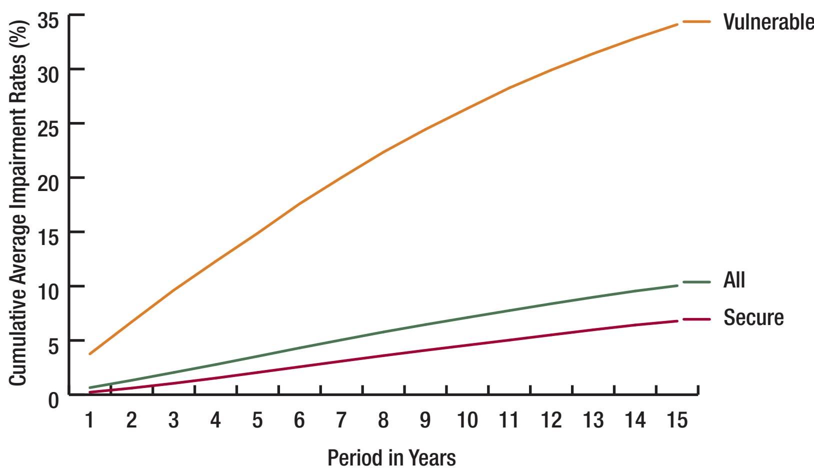
Exhibits 2, 3 and **4** show the cumulative average impairment rates calculated using the static pool approach. The data show an inverse relationship between FSRs and impairment rates: the lower the FSR, the higher the rate of impairment. Specifically, over a one-year period, the impairment rate for companies in the highest FSR category, "A++/A+," was 0.05%. It is important to note that only one insurance company rated "A++" ever has become impaired since that rating category was introduced in 1992. In that case, A.M. Best ceased rating the company about six years before its impairment date, but nonetheless the incident was counted in the study as impairment. The one-year impairment rate for companies in the lowest rating category, "D," was 7.57%. The one-year rate of impairment for the companies in the "A/A-" rating category, where the highest percentage of insurance companies evaluated by A.M. Best are rated, was 0.17%.

Impairment rates also vary across time. The data in **Exhibit 2** show that the insurance companies with FSRs of "A++/A+" had the lowest impairment rates, ranging from 0.05% over a one-year period to 3.72% over a 15-year period. By contrast, the insurance companies with an FSR of "D" had the highest impairment rates, ranging from 7.57% over a one-year period to 51.12% over a 15-year period. The one-year to 15-year impairment rates for the insurance companies with "A/A-" ratings ranged from 0.17% to 6.78%.

Exhibit 4

Cumulative Average Impairment Rates – Secure vs. Vulnerable Best's Ratings

U.S. life/health and property/casualty data from 1977 to 2012.



Source: A.M. Best Co.

The data further show that the rate of increase in impairment rates is most significant in the early years. For example, the cumulative average impairment rate of "A++/A+"-rated companies moves from 0.05% in the first year to 0.18% in the second year – a more than threefold increase. By comparison, the increase in impairment rates from year two to year three (i.e., from 0.18% to 0.33%) is less than a twofold increase. This is the same trend found in issuer default studies, although with higher rates in this study because of the substantially wider concept of impairment compared with default as described earlier.

The one-year impairment rate for all A.M. Best-rated compa-

A Note on Revisions

As a result of ongoing research efforts, A.M. Best's Impairment Database is updated continually to reflect the incorporation of new data or adjustments to existing data.

Ongoing historical research occasionally leads to the restatement of certain data, primarily a company's initial year of impairment. If any change places a company outside of this study's parameters, that company is eliminated.

The current study includes the most accurate information currently available from what is believed to be the most comprehensive insurance company impairment database in existence. After incorporating all updates and revisions, the results of the current study remain broadly consistent with those published for the prior study.

Converting Insurance Company Impairment Rates to Debt Impairment Rates

The tabulation of impairment rates in this document is based on Financial Strength Ratings (FSRs) of insurance operating companies. A Best's FSR is an opinion of an insurer's financial strength and ability to meet ongoing obligations to policyholders. Thus, the impairment rates based on FSRs are not directly comparable to impairment rates on debt securities, which by definition are subordinate to policyholder obligations.

A.M. Best's debt securities rating criteria are set forth in A.M. Best's *Insurance Holding Company and Debt Ratings*. The criteria report outlines how an FSR translates into an Issuer Credit Rating (ICR), which is an opinion as to an issuer's ability to meet its senior obligations.

In the U.S. insurance industry, corporate debt generally is issued at the holding company level as opposed to the operating company level. A.M. Best uses notching criteria to convert the operating company's ICR to that of the holding company where debt securities would be issued. This notching is shown in Exhibit 5.

An example will help illustrate the process of assigning ratings to debt securities issued by an insurance holding company.

Assume that the FSR of an insurance operating entity is "A-," and that the holding company associated with that insurance company wants to issue senior unsecured debt to fund its operating subsidiary. The equivalent operating company ICR on the credit market scale would be "a-." The ICR of the holding company, which is equivalent to the rating of the senior obligations of the holding company – normally senior unsecured debt – generally would be three notches from the operating company's "a-" ICR, or a rating level of "bbb-."

Using an algorithm that applies the notching process to convert all the FSRs to implied debt ratings at the holding company level, A.M. Best calculates the one-year to 15-year implied cumulative average impairment rates for insurance company debt as shown in Exhibit 6.

Exhibit 5

Best's Issuer Credit Ratings – Notching From Operating Company ICR To Holding Company ICR

FSR (Operating Insurance Co.)	Equivalent ICR on the Credit Market Scale (Operating Insurance Co.)	Number of Notches From Operating ICR to Holding Company ICR (i.e., to Holding Company Senior Unsecured Debt)
A++	aaa	0 to 2
	aa+	2 to 3
A+	aa	3
	aa-	3
A	a+	3
	a	3
A-	a-	3
B++	bbb+	3
	bbb	3
B+	bbb-	3 to 4
B	bb+	4
	bb	4
B-	bb-	4 to 5

Source: A.M. Best Co.

Exhibit 6

Best's Implied Impairment Rates of Holding Company Senior Unsecured Debt

Grouped by Issuer Credit Rating.

Rating	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	11-Year	12-Year	13-Year	14-Year	15-Year
aaa	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05	0.11	0.11	0.11	0.11	0.11
a	0.06	0.20	0.37	0.55	0.73	0.97	1.22	1.49	1.82	2.15	2.48	2.91	3.36	3.80	4.11
bbb	0.17	0.51	0.96	1.42	1.93	2.47	3.01	3.61	4.17	4.69	5.22	5.67	6.09	6.45	6.78
bb	0.77	1.77	2.77	4.03	5.37	6.54	7.70	8.64	9.39	10.19	10.95	11.76	12.51	13.25	13.86
b	1.57	3.58	5.96	7.99	9.88	11.86	13.80	15.47	17.16	18.70	20.34	21.99	23.59	25.07	26.36
c	5.18	8.78	12.06	15.16	18.24	21.46	24.23	27.02	29.39	31.56	33.62	35.26	36.72	38.08	39.34
Investment Grade	0.12	0.37	0.69	1.02	1.37	1.76	2.16	2.59	3.02	3.43	3.85	4.27	4.69	5.07	5.39
Non-Investment Grade	2.07	3.92	5.74	7.61	9.50	11.35	13.07	14.64	16.01	17.33	18.63	19.85	20.97	22.05	22.99
All	**0.65%**	**1.33%**	**2.05%**	**2.78%**	**3.54%**	**4.31%**	**5.05%**	**5.78%**	**6.46%**	**7.11%**	**7.75%**	**8.38%**	**8.98%**	**9.55%**	**10.04%**

Source: A.M. Best Co.

Exhibit 7

Best's One-Year Rating Transition Matrix

U.S. life/health and property/casualty data from 1977 to 2012.

	Rating One Year Later							
Ratings	A++/A+	A/A-	B++/B+	B/B-	C++/C+	C/C-	D	Impaired
A++/A+	92.88%	6.70%	0.34%	0.02%	0.00%	0.00%	0.00%	0.05%
A/A-	3.65	92.34	3.14	0.48	0.08	0.05	0.10	0.17
B++/B+	0.38	10.54	81.68	5.34	0.58	0.28	0.44	0.77
B/B-	0.26	1.12	14.43	75.66	4.12	0.98	1.25	2.17
C++/C+	0.23	0.76	2.04	17.65	66.80	5.71	3.09	3.73
C/C-	0.00	0.64	0.26	4.10	14.87	66.03	8.21	5.90
D	0.10	0.67	1.03	2.83	2.93	3.45	81.42	7.57

	Rating One Year Later	
	Secure	Vulnerable
Secure	98.26%	1.74%
Vulnerable	9.82%	90.18%

Source: A.M. Best Co.

nies was approximately 0.65%. Separating the ratings into Secure and Vulnerable rating categories, however, reveals that Secure companies have a one-year impairment rate of 0.23%, while Vulnerable companies have an impairment rate of 3.76%. Thus, the one-year impairment rate of Vulnerable companies is slightly greater than 16 times the one-year impairment rate of Secure companies. **Exhibit 4** shows the difference in impairment rates for Secure, Vulnerable and all companies.

While impairment rates associated with insurance company FSRs are not equivalent to issuer defaults, as previously discussed, insurance company impairment rates can be translated to the impairment rates of debt securities of insurance companies, had those companies issued debt securities. The sidebar **Converting Insurance Company Impairment Rates to Debt Impairment Rates**, on page 7, describes the translation from FSR impairment rates to implied impairment rates of senior unsecured debt issued by insurance entities.

Rating Transition

Rating transition tables can reveal to what extent ratings are stable across different periods. **Exhibit 7** shows the percentage of ratings that moved from one rating category to another in a one-year period. For example, 92.34% of the companies rated "A/A-" remained in the "A/A-" category one year later. The percentage of the "A/A-" companies that were upgraded one year later to "A++/A+" is 3.65%, while the percentage of the "A/A-" companies that were downgraded to "B++/B+" is 3.14%. The percentage of the "A/A-" companies that were downgraded to any rating below "A/A-," including the impaired category, is about 4.02%[4]. Please note that **Best's One-Year Rating Transition Matrix** does not simply reflect the one-year rating movement from 2011 to 2012. Instead, it reflects the average one-year rating movements over the 35 one-year periods from 1977 to 2012 that are covered in this study.

Generally, as ratings decline, the percentage of companies maintaining the same rating over a one-year period also declines. For example, 92.34% of the companies with an "A/A-" rating remained in that

4. 3.14% + 0.48% + 0.08% + 0.05% + 0.10% +0.17%

Exhibit 8

Impaired Companies in Each Rating Category By Years Before Impairment

U.S. life/health and property/casualty data from 1977 to 2012.

	<--------Number of Years Before Impairment-------->					
Rating Category	5 Years	4 Years	3 Years	2 Years	1 Year	In Year of Impairment
A++/A+	34	37	36	30	14	1
A/A-	141	136	141	115	59	9
B++/B+	134	134	114	122	100	24
B/B-	83	86	106	121	124	95
C++/C+	32	40	44	39	64	61
C/C-	19	19	20	24	46	65
D	66	71	83	91	145	216
Not Formally Followed*	221	207	186	188	178	259
All	**730**	**730**	**730**	**730**	**730**	**730**

* The "Not Formally Followed" category represents companies that did not have a Best's FSR during the time period in question but had a Best's FSR at some time after Dec. 31, 1977.

Source: A.M. Best Co.

same rating category one year later, but only 81.68% of companies with a "B++/B+" rating stayed in that category one year later.

Overall, the likelihood of a Secure company keeping its rating in the Secure range over a one-year period is 98.26%, while the likelihood of a Vulnerable company keeping its rating in the Vulnerable range over the same period is 90.18%, as shown at the bottom of **Exhibit 7**.

Exhibit 9

Average Years to Impairment For the 730 Impaired Companies

U.S. life/health and property/casualty data from 1977 to 2012.

Initial Rating Category	No. of Impairments	Average Years to Impairment From Initial Rating Date*
A++/A+	104	16.10
A/A-	158	12.70
B++/B+	141	10.90
B/B-	116	9.80
C++/C+	57	7.80
C/C-	33	11.00
D	121	9.40
Secure	403	12.95
Vulnerable	327	9.44
All	**730**	**11.38**

* Initial rating date is the later of Dec. 31,1977, or the date of the original rating.

Source: A.M. Best Co.

Ratings also migrate from the Secure rating categories to the Vulnerable rating categories as impairment approaches. **Exhibit 8** displays the number of companies in each rating category at various times before impairment. To illustrate rating movements as impairments approach, observe the number of FICs in the "A++/A+" and the "D" rating categories before impairment. There are 34 FICs in the "A++/A+" rating category five years before impairment, but there are only 14 FICs in this category one year before impairment. By contrast, there are 66 FICs rated "D" five years before impairment, but that number increases to 145 one year before impairment. In general, the decline in the number of FICs in the higher rated categories is offset by the increase in the number of companies in the lower rated or "Not Formally Followed" categories.

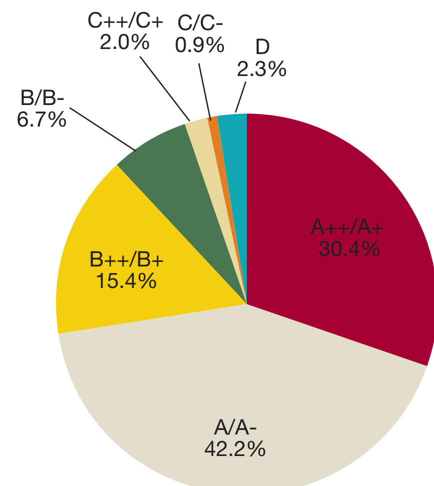
Time to Impairment

There is a strong relationship between FICs' initial ratings – for purposes of this study, the later of Dec. 31, 1977, or the date of a company's initial rating – and the time to impairment. As shown in **Exhibit 9**, the higher the initial rating of FICs, the longer it takes for those companies to become financially impaired. For example, it took an average of 16.10 years for FICs that initially were rated "A++/A+" to become financially impaired, but only an average of 9.80 years for FICs rated "B/B-" to become financially impaired. Data for the "C/C-" rating category and the "C++/C+" rating category probably are less reliable, since they are based on smaller impairment counts compared with those of the other rating groupings. In addition, the "C/C-" and the "C++/C+" rating categories make up only 0.9% and 2.0%, respectively, of the historical distribution of ratings between year-end 1977 and year-end 2012 as shown in **Exhibit 10**. It took an average of 9.40 years for the FICs that initially were rated "D" to become financially impaired.

Exhibit 10

Best's Ratings – Historical Rating Distribution

U.S. life/health and property/casualty data from 1977 to 2012.



Source: A.M. Best Co.

It is important to emphasize that **Exhibit 9** displays the initial ratings of the 730 insurance companies that became impaired from year-end 1977 to year-end 2012. For example, one of the 104 companies in the "A++/A+" category had an initial rating of "A+" in 1977. That company's rating steadily declined to "B-" five years before its impairment, and then to "C-" one year before its impairment in 2002. Therefore, that company was counted in the "A++/A+" initial rating category, even though its ratings in the years before impairment were far below its initial rating of "A+."

Overall, the average years to impairment for FICs that had initial ratings in the Secure and Vulnerable categories were 12.95 and 9.44, respectively. The average number of years to impairment for all FICs with at least one Best's FSR from year-end 1977 to year-end 2012 was 11.38.

Exhibit 11

Impairments vs. Rating Movements & the Economy (1978-2012)

U.S. life/health and property/casualty data.

Year	No. of Impairments**	Real GDP Growth*	Downgrade/ Upgrade Ratio**
1978	8	5.6%	0.46
1979	6	3.1	0.42
1980	5	-0.3	0.42
1981	10	2.5	0.43
1982	7	-1.9	0.66
1983	16	4.5	1.24
1984	22	7.2	1.81
1985	32	4.1	5.41
1986	25	3.5	1.16
1987	25	3.2	0.42
1988	24	4.1	0.56
1989	40	3.6	0.83
1990	37	1.9	1.01
1991	55	-0.2	1.03
1992	33	3.4	1.74
1993	29	2.9	1.29
1994	24	4.1	0.90
1995	10	2.5	1.64
1996	19	3.7	1.08
1997	31	4.5	0.76
1998	17	4.4	0.49
1999	27	4.8	0.41
2000	35	4.1	0.73
2001	41	1.1	2.10
2002	41	1.8	4.24
2003	34	2.5	3.30
2004	13	3.5	0.92
2005	7	3.1	0.53
2006	12	2.7	0.61
2007	4	1.9	0.33
2008	9	-0.3	1.66
2009	13	-3.5	3.71
2010	8	3.0	0.54
2011	8	1.7	2.13
2012	3	2.1	1.74

* Annual growth as reported by the Bureau of Economic Analysis, Department of Commerce.
** Impaired companies are excluded from downgrade figures. Rating movements are based on the seven rating categories.
Source: A.M. Best Co.

Relationship Between the Economy and Rating Movements

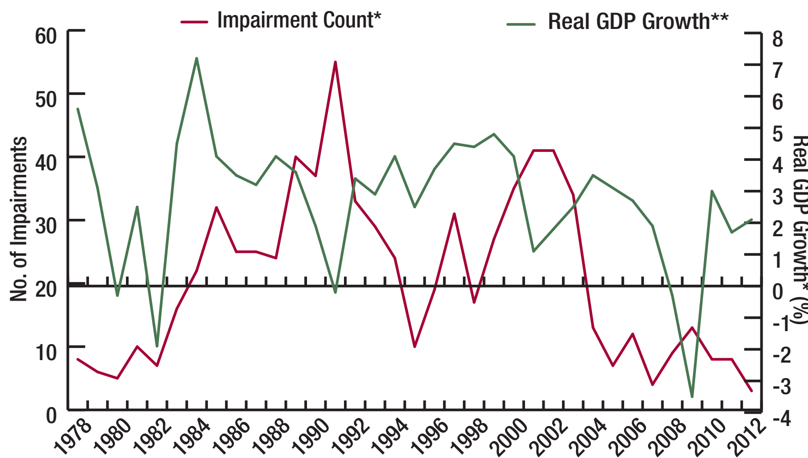
There are relationships among A.M. Best's impairment count, the general economy and A.M. Best's downgrade/upgrade ratio, although these relationships may exhibit time lags. It is important to note that the financial health of the insurance industry is affected not only by general economic factors, but also by catastrophes and underwriting issues that are not necessarily correlated directly with economic activity. These relationships are explored fully in the general impairment studies and their updates referenced earlier.

Exhibit 11 shows the economy as represented by the average annual growth in real (inflation-adjusted) U.S. gross domestic product (GDP); the impairment count as previously presented; and the ratio of A.M. Best-rated companies that were downgraded – excluding companies that became impaired – to the number of A.M. Best-rated companies that were upgraded. The most notable periods of low economic activity as measured by real GDP growth are the double-dip recession that occurred from 1980 to 1982, the 1991 and 2001 recessions, and the last recession that began in December 2007 and extended to mid-2009.

Economic activity generally is related inversely to impairments – the lower the economic activity, the higher the number of impairments, and vice versa. **Exhibit 11** shows the double-dip recession that occurred through 1980 and 1982, when annual real GDP decreased by 0.3% and 1.9%, respectively. Since low economic activity generally leads financial impairments in the insurance industry, the effect of this recessionary period was manifested in the increase in the impairment count from 16 in 1983 to 32 in 1985. This was additionally evident following the 2001 recession, with a peak for that general time period of 41 impairments in 2001 and 2002 – the same time

period corporate bond defaults spiked as reported by other credit rating agencies.

Exhibit 12
Impairments vs. Real GDP Growth (1978-2012)
U.S. life/health and property/casualty data.

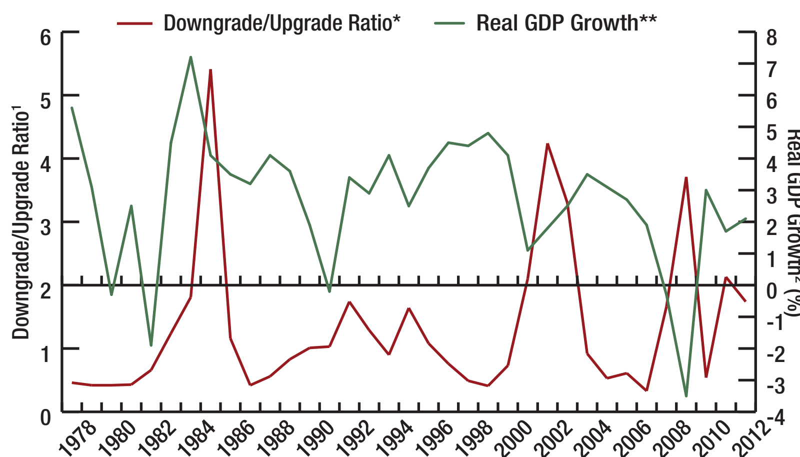


* Annual growth as reported by the Bureau of Economic Analysis, Department of Commerce.
Source: A.M. Best Co

Exhibit 12 also shows clearly the inverse relationship between impairment count and real growth in GDP. Note that in 1982, when the economy was in its second recession since 1980, the impairment count was relatively low. The impairment count subsequently increased, however, in 1983, 1984 and 1985, when it hit its peak for that general period. Likewise, when real growth in GDP was at its peak in 1984, compared with the overall period of this study, the impairment count did not hit its local low point after that steep economic growth until 1987. The lag between economic activity and impairment clearly is evident with the recession and the economic boom examined between 1980 and 1984.

The modest growth in GDP of 3.5%, 3.1%, 2.7% and 1.9% in 2004, 2005, 2006 and 2007, respectively, contributed significantly to the historical general decline in impairments, which hit their second-lowest level in 2007. A.M. Best believes the convolution of the lagged effect of the decline in GDP to -0.3% and -3.5% in 2008 and 2009, and the modest growth of 3.0%, 1.7% and 2.1% in 2010, 2011 and 2012, may slightly impact impairments in the next few years, barring intervening factors such as a hard insurance market or greatly improved performance of the equity markets, although impairments currently remain relatively low.

Exhibit 13
Downgrade/Upgrade Ratio vs. Real GDP Growth (1978-2012)
U.S. life/health and property/casualty data.

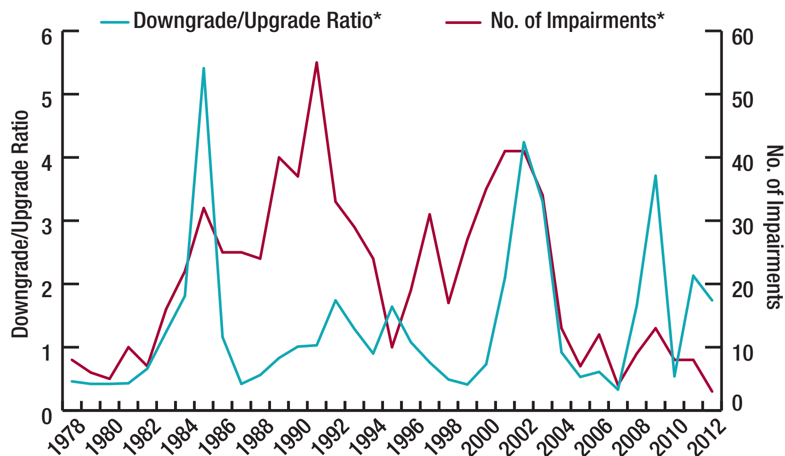


* Impaired companies are excluded from downgrade figure and from the downgrade/upgrade ratio. Rating movements are based on the seven rating categories.
** Annual growth as reported by Bureau of Economic Analysis, Department of Commerce.
Source: A.M. Best Co.

The relationship between the economy and the downgrade/upgrade ratio is similar to the relationship between the economy and impairments – the lower the economic activity, the higher the downgrade/upgrade ratio, and vice versa. Exhibit 13 shows that the 1980 to 1982 double-dip recession increased the downgrade/upgrade ratio from 1.24 in 1983 to 5.41 in 1985 – the highest downgrade/upgrade ratio in the period covered by the study. Likewise, when real growth in GDP hit its peak in

Exhibit 14
Impairments vs. Downgrade/Upgrade Ratio (1978-2012)

U.S. life/health and property/casualty data.



* Impaired companies are excluded from downgrade figure and from downgrade/upgrade ratio. Rating movements are based on the seven rating categories.

Source: A.M. Best Co.

1984, the downgrade/upgrade ratio did not hit its low point for that general period until 1987. Additionally, when real growth in GDP was only 1.1% in 2001 – which was a low for that general period – the downgrade/upgrade ratio spiked in 2002 and 2003 to its highest levels since 1985.

The downgrade/upgrade ratio was relatively low from 2004 to 2007 and then increased during the 2008 to 2009 period as real growth in GDP declined to its lowest historical level in the study period of negative 3.5% in 2009. The downgrade/upgrade ratio of 3.71 in 2009 is the third-highest ratio in the period covered by the study; the ratio generally has trended lower since that time and was 1.74 in 2012. As is the case with impairment counts, the downgrade/upgrade ratio lags economic activity as represented by real growth in GDP. A.M. Best fully expects that as the economy continues to emerge from the most recent recession, the downgrade/upgrade ratio will continue to trend lower.

There is a correlation between impairments and the downgrade/upgrade ratio, as shown in **Exhibit 14**. As is to be expected, the two indicators generally move in tandem – the higher the impairment count, the higher the downgrade/upgrade ratio, and vice versa. The economy began slowing in late 1989, leading into the 1990-91 recession. A resulting crisis in the commercial mortgage market led to a rapid upturn in the impairment count. Combined with Hurricane Andrew in 1992, these factors boosted the downgrade/upgrade ratio as well.

The recession of 2001, which was preceded by a slowing of the economy in 2000, coupled with fallout from the Sept. 11, 2001 terrorist attacks, helped boost the 2001 and 2002 impairment counts and the downgrade/upgrade ratios in those years. The relatively low impairment count from 2004 through 2006 was helped by improved economic activity in 2002 through 2004, despite the catastrophic losses from hurricanes Jeanne, Frances, Ivan, Charley, Wilma, Rita and Katrina. The decline in impairment count in 2004 to 2007 mirrors the decline in corporate defaults as recorded by other credit rating agencies.

It is important to point out that the longest soft market in the history of the U.S. P/C underwriting cycle – about a decade long – preceded the 2001 recession. Generally in soft markets, insurers price coverage aggressively. While the P/C sector was experiencing a soft market, however, the economy was experiencing a prolonged expansion that was reflected in the robust equity market of the 1990s. This factor tended to mask the effect of the soft market, as equity returns buoyed the performance of the insurance sector – both U.S. P/C and L/H – even in the midst of falling premiums for U.S. P/C insurers. Certain segments of the U.S. P/C market hardened in 2006 as a result of the

hurricanes of 2005. In 2007, U.S. P/C underwriting results benefited from still-favorable underwriting conditions, improved loss-frequency trends, a high level of reserve releases and lower-than-expected catastrophe losses. In 2008, the U.S. P/C industry was impacted by a series of unprecedented events, including exceptionally challenging market conditions; the worst financial crisis in recent history; the fourth-highest year on record for U.S. catastrophe-related losses; and turmoil in the mortgage and financial guaranty segments.

In 2009, the U.S. P/C industry had a solid year due to improved underwriting results, the continued recovery of the financial markets and disciplined capital management. Although there was a sizable reduction in the industry's top line, underwriting results were buoyed by a quiet hurricane season, significant reserve releases and a substantial reduction in underwriting losses in the mortgage and financial guaranty segments.

The U.S. P/C industry's overall financial result improved in 2010 but did not return to the level of profitability reached in 2006 and 2007. Commercial lines writers continued to experience persistent soft market conditions, while some personal lines writers were able to achieve modest rate increases.

The U.S. P/C industry's operating performance deteriorated sharply in 2011, as catastrophe-related losses wreaked havoc on underwriting results throughout the year and led to the industry's largest underwriting loss since 2002. An unprecedented number of natural catastrophe events in the United States and abroad impacted insurers in 2011, resulting in catastrophe-related losses more than double the total amount reported in 2010.

2012 will be remembered for the second costliest U.S. natural disaster after 2005's Hurricane Katrina – Superstorm Sandy. This storm spiked underwriting losses and decreased net income in the fourth quarter of 2012. Nevertheless, there was no significant increase in impairments attributable to the storm, and A.M. Best does not expect an increase in 2013, since the industry is well capitalized.

The U.S. L/H industry's operating results are highly correlated with capital-market performance. Given the exposure on the asset side (from fees related to assets under management) and the liability side (through guarantees in most new variable products), L/H insurers are particularly vulnerable to the volatility in the equity markets. The L/H companies' results are influenced heavily by macroeconomic factors, including the level and volatility of interest rates and credit spreads; equity-market performance; general consumer confidence; and levels of disposable income. Gradual improvement in these metrics over the past 18 months has been the primary factor contributing to the better recent results reported by the L/H industry.

The L/H industry in 2008 was battered by the severe financial crisis and the weakened economy. A majority of L/H insurers' investment portfolios suffered significant losses, both realized and unrealized, that directly impacted their financial strength. The resulting increase in balance sheet

Exhibit 15

U.S. Insurers – Impairments (2012)*

U.S. life/health and property/casualty data.

Company Name	State of Domicile	Year of Impairment	Type
Millers First Insurance Co.	IL	2012	PC
Interstate Auto Insurance Co., Inc	MD	2012	PC
First Sealord Surety, Inc.	PA	2012	PC

* Companies with a Best's Financial Strength Rating Dec. 31, 1977 or after that became impaired in 2012.
Source: A.M. Best Co.

risk was reflected in a wave of rating downgrades that began in the fourth quarter of 2008 and continued through 2009. Additional factors contributing to the downgrades included poor earnings trends driven by high expense structures, underpriced products (especially in the annuity subsegment) and low investment returns. By the end of 2009 and with the gradual improvement in overall economic conditions, the significant unrealized losses from fixed-income investment portfolios reported at year-end 2008 had narrowed significantly and, in some cases, had returned to unrealized gains.

In 2010, there was a measurable improvement in the economic performance of many L/H companies, and some even reached new highs in terms of absolute and risk-adjusted capital measures. The longest and deepest U.S. recession since World War II, which began in December 2007 and ended officially in June 2009, continued to have a lingering impact on the overall financial performances of L/H operating companies. Overall, 2010 produced more challenges from a solvency perspective for weakly capitalized L/H insurance companies. Buoyed by relatively strong growth in gross domestic product (GDP) of 3.0% in 2010, the L/H industry continued to strengthen its balance sheet and liquidity.

The U.S. L/H industry battled lingering macroeconomic challenges in 2011, emerging relatively unscathed with modest investment impairments and a return to fairly large unrealized gains in companies' fixed-income portfolios. The year's result was marked by strong regulatory capital, favorable operating earnings and continued efforts to improve balance sheet fundamentals through more prudent liquidity and capital management.

In 2012, the U.S. L/H industry remained strongly capitalized, as insurers continued their efforts to de-risk their balance sheets. A.M. Best believes, however, that interest rates will continue to hover at or near historical lows at least into 2015, thus maintaining pressure on life insurers' earnings. Still, there is no reason to expect a significant increase in L/H impairments in 2013.

It should be noted that the effects of the current economy and the catastrophe losses on P/C and L/H insurers' solvency may not emerge for several years. Insurers typically do not succumb immediately but can struggle for years, propped up by reserve releases, a parent company or fraudulent means, and then may be pushed over the edge by shock losses. Based on past experience, the high 2011 and 2012 catastrophe losses and the low interest rate environment may not generate a significant bump up in the impairment rate for perhaps another two years. In addition, there may be a lag in reporting due to the increasing use of confidential actions by insurance regulators, who are reluctant to publicly disclose impairments until all avenues to rehabilitate or find buyers for troubled insurers have been exhausted.

Static Pool-Based Calculation Approach

This study applies the static pool approach commonly used in credit market default studies to calculate the cumulative average impairment rates shown in **Exhibit 2 (Best's Cumulative Average Impairment Rates)**. In general, yearly average impairment rates are accumulated to calculate cumulative average impairment. An example will illustrate how this approach is applied in practice to determine the one-year and two-year cumulative average impairment rates.

The 1977 static pool consists of insurance companies that had a Best's FSR as of Dec. 31, 1977, and were not financially impaired. Those same insurance companies are observed again at the end of 1978 to see how many had become financially impaired

during 1978. A new static pool is determined at the end of 1978 and followed to the end of 1979, once again to observe the number of financial impairments. This pattern is repeated until the last static pool formed at the end of 2011 is followed to the end of 2012. The total number of impairments in the static pools – formed from year-end 1977 to year-end 2012 – are added and then divided by the total number of companies in the static pools. This calculation is used to produce the one-year average impairment rates for each of the seven rating categories described earlier.

To calculate the two-year average impairment rate, an approach similar to the one used for the one-year average impairment rate is applied, except that the impairment count used in this case is the number of impairments in the second year after the formation of each static pool. Specifically, the 1977 static pool is observed two years later to see how many companies had become financially impaired by year-end 1979. The 1978 static pool is observed two years later to see how many insurance companies had become financially impaired by year-end 1980, and so on. Note that the static pools used for the two-year average impairment rate calculation are the static pools formed from year-end 1977 to year-end 2010, since the last data in the study are from year-end 2012. The total number of impairments in the second year for each static pool is added and then divided by the total companies in the static pools to produce the two-year average impairment rate. To calculate the two-year cumulative average impairment rate, the one-year average impairment rate is added to the two-year average impairment rate. This process is continued until the 15-year cumulative average impairment rate is calculated.

To illustrate the process further, observe how the one-year, two-year and three-year cumulative average impairment rates of 0.055%, 0.18% and 0.33%, respectively, in Exhibit 2 are calculated for the "A++/A+" rating category. The one-year, two-year and three-year average impairment rates calculated using the approach described in the previous paragraphs are 0.0545%, 0.1209% and 0.1503%. The one-year cumulative average impairment rate is simply the one-year average impairment rate of 0.0545% (rounded to 0.05%). The two-year cumulative average impairment rate, 0.1754% (rounded to 0.18%), is the sum of the one-year and the two-year average impairment rates (0.0545% + 0.1209% = approximately 0.18%). The three-year cumulative average impairment rate, 0.3257% (rounded to 0.33%), is the sum of the one-year, two-year and three-year average impairment rates (0.0545% + 0.1209% + 0.1503% = approximately 0.33%).

Note that although this study presents only the one-year to 15-year cumulative average impairment rates, the data underpinning these calculations cover the 35 one-year periods from year-end 1977 to year-end 2012. Thus, the one-year cumulative average impairment rate uses 35 data points for the calculation, the two-year cumulative average impairment rate uses 34 data points, the three-year cumulative average impairment rate uses 33 data points, and so on.

These calculations are adjusted for withdrawal of ratings. Ratings can be withdrawn for several reasons, including: voluntary liquidations; mergers and acquisitions; company request; lack of proper financial information for the evaluation of companies; and substantial changes in companies that make A.M. Best's rating process inapplicable. In the event that a company requests that its rating be withdrawn, the study captures the last rating just before the withdrawal.

The adjustment for withdrawals is made by reducing the static-pool count – the denominator in the impairment rate calculation – by the number of withdrawals in the calcu-

lation period, while maintaining the same impairment count as the numerator in the impairment rate calculation. The effect is to increase the impairment rate over what it would have been without the adjustment.

It is important to emphasize that this study includes the effect of impairments long after a company has ceased being rated by A.M. Best. For example, if a company rated “A-” requests that A.M. Best withdraw its rating and becomes impaired five years later, that impairment is tabulated in the five-year default probability, although A.M. Best had not rated the company for five years.

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