Financial Review
January 24, 2023

US P/C Insurers' Leverage Ratios Remain Elevated Due to Declines in Capital

Despite unrealized losses due to rising interest rates, capitalization remains strong

Principal Takeaways

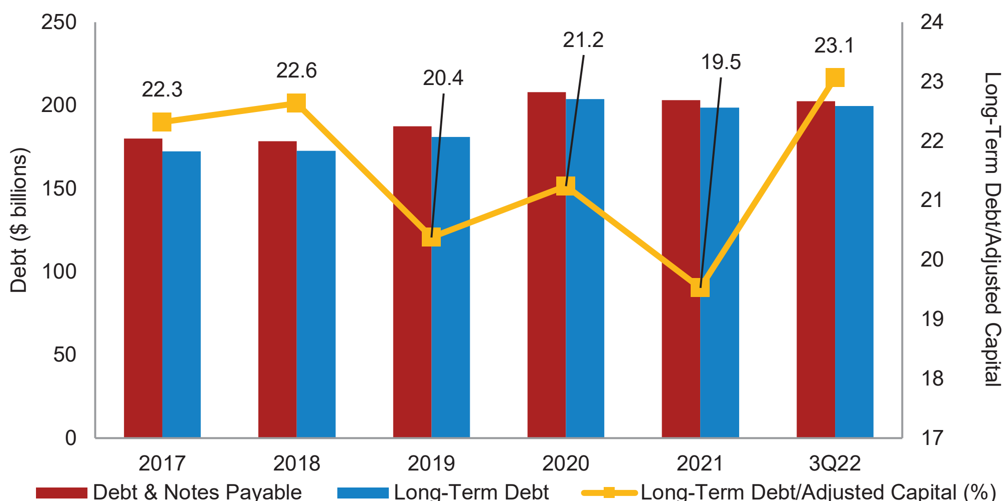
- The public US property/casualty insurers maintain elevated leverage ratios due to declines in capital.
- Operating losses through third quarter 2022 have pressured interest coverage ratios.
- Capitalization remains strong despite unrealized losses from bond and equity portfolios.

The rising interest rate environment is not only impacting the investing and operating environments for US insurers, but it is also leading to a more cautious approach to capital-raising via debt issuance. The prolonged low interest rate environment and cheap capital had allowed P/C insurers to strengthen their balance sheets by replacing higher-cost debt, often with significantly lower-cost alternatives over a number of years, which may be a thing of the past. The 42 publicly traded US P/C companies kept their appetites for long-term debt in check in 2022, as many took advantage of lower financing costs to pay down their near-term debt maturities with higher interest rates. Many are also now focusing on strengthening and making enterprise risk management (ERM), strong corporate governance, and stress testing capabilities integral to their operations.

Debt Obligations Decline

Debt obligations continued to decline through the third quarter of 2022 (**Exhibit 1**) from 2021. However, capital at many companies has notably declined on a GAAP basis. At year-end 2021, nearly a quarter of invested assets in the P/C industry was allocated to equities, which had dropped nearly three percentage points by the third quarter of 2022, driven largely by the stock market downturn, resulting in unrealized losses. Rising interest

Exhibit 1
US Publicly Traded Property/Casualty Insurers – Debt Trends, 2017-3Q22



Source: BESTLINK

Analytical Contact:
Helen Andersen, Oldwick
+1 (908) 439-2200 Ext. 5722
Helen.Andersen@ambest.com

Contributor:
Jason Hopper, Oldwick

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rates have also led to unrealized losses on fixed-income portfolios from the drop in bond values, though P/C insurers have shorter liability profiles, and shorter duration bonds are less significantly impacted. Regardless, this combination of factors has led to higher long-term debt to adjusted shareholders' equity ratios. The industry's aggregate ratio climbed slightly from 19.5% to 23.1% in the third quarter from year-end 2021. Nearly every company saw an increase in their debt to capital ratios in 2022 from year-end 2021 despite most reducing their long-term debt obligations.

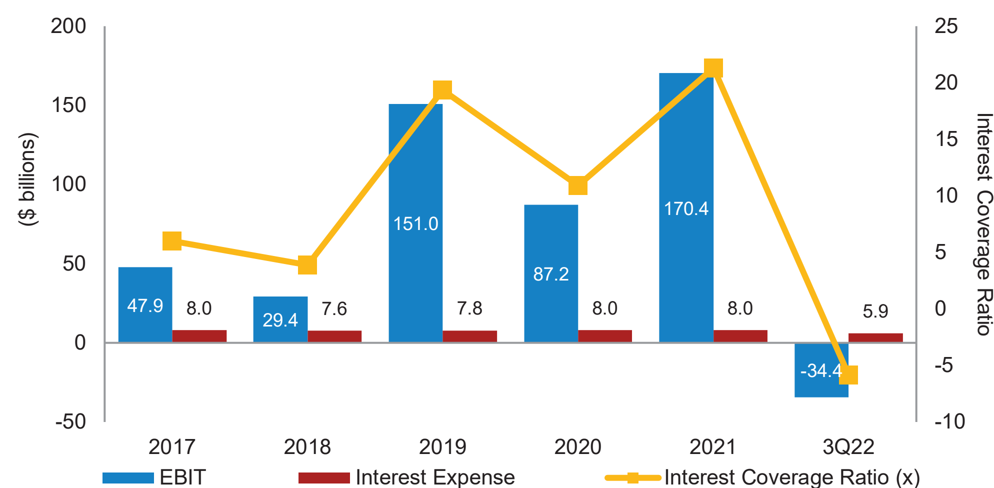
Still, most companies have been deleveraging for a few years amid economic uncertainty and in anticipation of rising interest rates. Many companies have already refinanced significant portions of older long-term debt with higher rates, having taken advantage of the low rate environment the last several years; most now have a weighted average fixed coupon of less than 5% on their debt obligations. Berkshire Hathaway Inc. holds 57.4% of the industry's long-term debt, and despite both an increase in long-term debt and a decrease in capital, saw only a modest increase in its leverage ratio, which, at 19.8%, remained below the industry aggregate through third quarter 2022 owing to the company's still formidable capital. Less well insulated insurers saw larger increases in leverage. American International Group, Inc., which accounts for 15.2% of the industry's long-term debt, saw a double-digit increase in its debt to capital ratio, landing over 42% through third quarter 2022. Given that the industry follows a hold-to-maturity investment strategy, the unrealized losses and hit to capital only become permanent if companies sell those assets at their current discounted market value prices—which is unlikely for those with adequate liquidity and cash flow.

Losses Impact Interest Coverage

The ability to service financial obligations over time is a function of an organization's ability to generate earnings from operations and maintain adequate capitalization. Interest coverage was healthy through 2021 thanks to strong earnings, but losses through the third quarter of 2022 turned the interest coverage ratio negative in aggregate, driven largely by Berkshire Hathaway. Still, a number of companies reported losses (**Exhibit 2**). Macro-economic challenges such as inflation and capital markets volatility will likely hamper profitability, compared with prior years. However, the shorter duration of bond portfolios may benefit P/C insurers in the rising rate environment, because insurers can reinvest proceeds of maturing bonds at the current higher rates.

Exhibit 2

US Publicly Traded Property/Casualty Insurers – Interest Coverage, 2017-3Q22



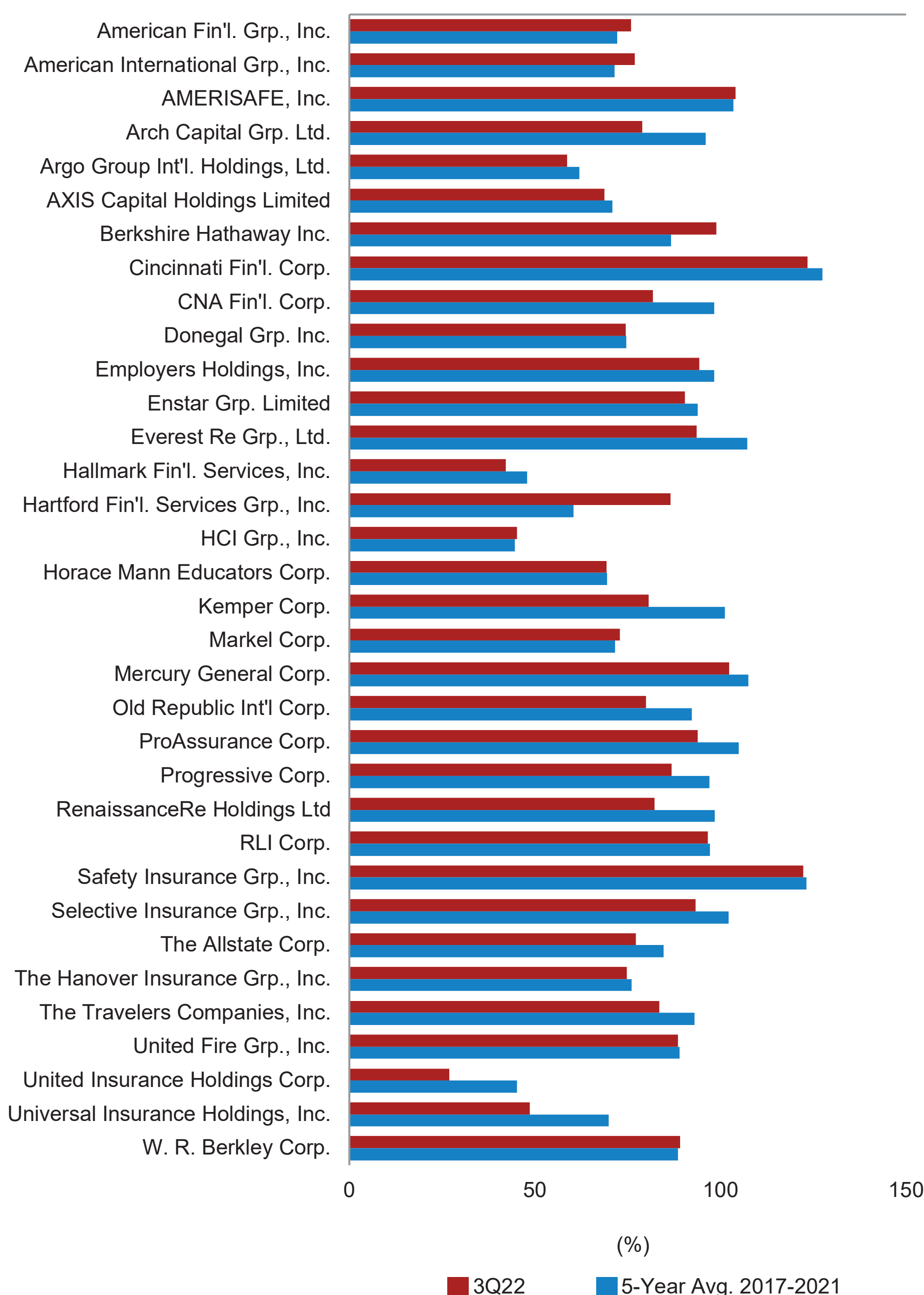
Source: BESTLINK

Uncertainty about the direction and pace of interest rate changes further demonstrates the need for both a strong asset-liability matching program and routine rigorous stress testing of insurers' portfolios. Losses may pressure insurers needing to service financial obligations, but average liquidity across publicly traded P/C companies remains very high despite a decline through third quarter 2022 (**Exhibit 3**).

Issuance of Surplus Notes Grows

Privately held and mutual insurers have also been raising capital by issuing surplus notes, as reported in their publicly filed NAIC statutory statements. After double-digit growth in 2020, the

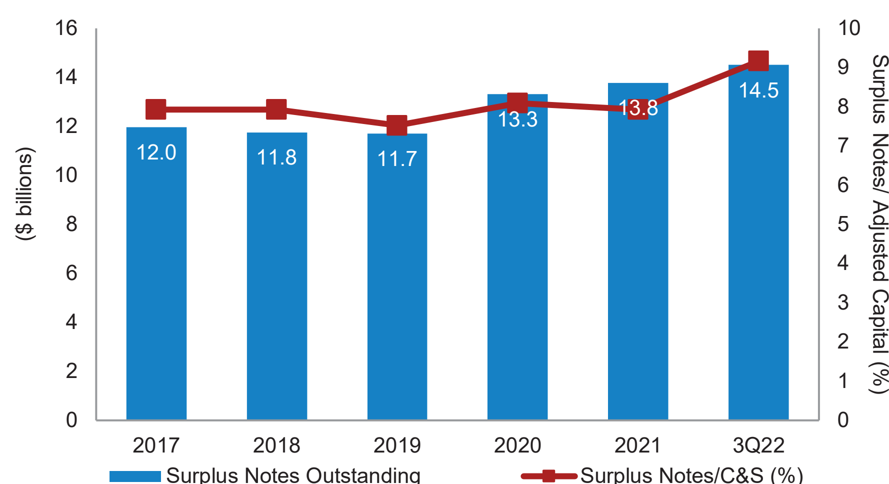
Exhibit 3
US Publicly Traded Property/Casualty Insurers – Current Liquidity



Source: BESTLINK

issuance of surplus notes grew at a more moderate rate in 2021 and 2022 (**Exhibit 4**). Given the lack of access to the public markets, surplus notes offer mutual companies an avenue for capital raising, although publicly traded companies such as Chubb and Allstate have also issued surplus notes. Further, these notes can be issued to affiliated entities and used to optimize capital and minimize regulatory scrutiny. Although capital and surplus also declined on a statutory accounting basis through the third quarter, the ratio of surplus notes to adjusted capital has ticked up only slightly, from 7.9% at year-end 2021 to 9.2% through third quarter 2022 for companies that have issued surplus notes. Unrealized losses based on statutory accounting are driven largely by equities and Schedule BA assets—investment-grade bonds are not marked to market as insurers are using GAAP. Roughly 14% of P/C insurers had surplus notes outstanding as of third quarter 2022, a third of which had heightened exposures larger than a third of their capital and surplus.

Exhibit 4
US Property/Casualty Insurers – Surplus Notes Outstanding, 2017-3Q22



Source: BESTLINK

AM Best's rating process looks at the quality of the rating unit's capital structure and the permanency of its capital in addition to leverage. As part of its analysis of the quality of capital, AM Best typically reviews the terms and conditions of securities issued, the capital structure's maturity schedule, and other intangible assets, relative to reported equity and capitalization. The amount of a company's regulatory capital may be high, but the quality of its capital or of that of its holding company may be poor, with high leverage, weak coverage, or poorly laddered maturities, which would result in a lower balance sheet strength assessment.

FHLB Borrowings Decline

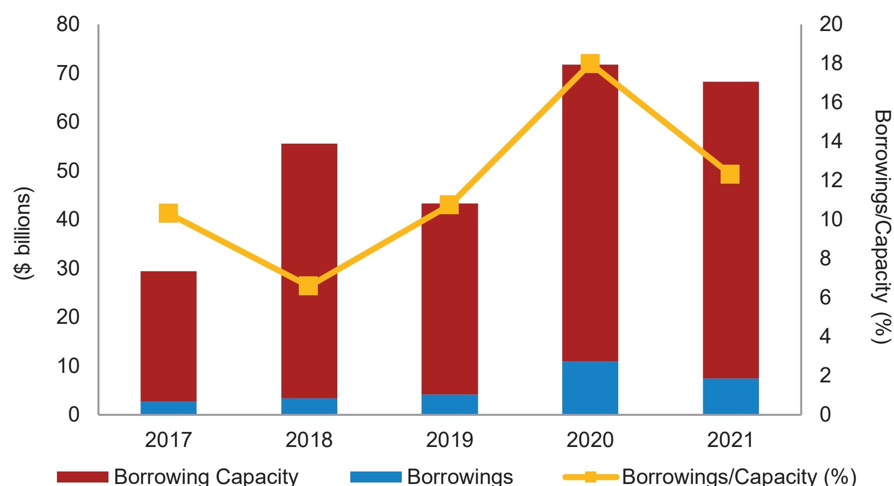
Private and public insurance companies can also access additional funds through the Federal Home Loan Bank (FHLB) if they are members. With the uncertainty surrounding COVID-19, many insurers turned to the FHLB to tap into funds to bolster liquidity, to prepare for a worst-case scenario. Several companies have joined the FHLB in recent years, pledging collateral for the first time, to have access. Both borrowing capacity and borrowings spiked in 2020, though borrowings declined again in 2021, although they are still nearly double their pre-pandemic levels (**Exhibit 5**). A majority of the insurers accessing the FHLB are private. For companies investing the loan proceeds in their core business for working capital, these obligations would be viewed as financial leverage. For insurers that have strong asset-liability and liquidity management, AM Best views FHLB borrowings used for spread enhancement as operating leverage.

Capital Returned Ticks up in 2021, Muted in 2022

Share repurchases and shareholder dividends are also considered in AM Best's evaluation of coverage ratios. After sharp increases in 2020 and 2021, share repurchases are on track to be much lower in 2022. Dividend payments are yet to be determined, with a complete picture to be seen on an annual basis. Despite the increase in share repurchases in 2020 and 2021, capital

Exhibit 5

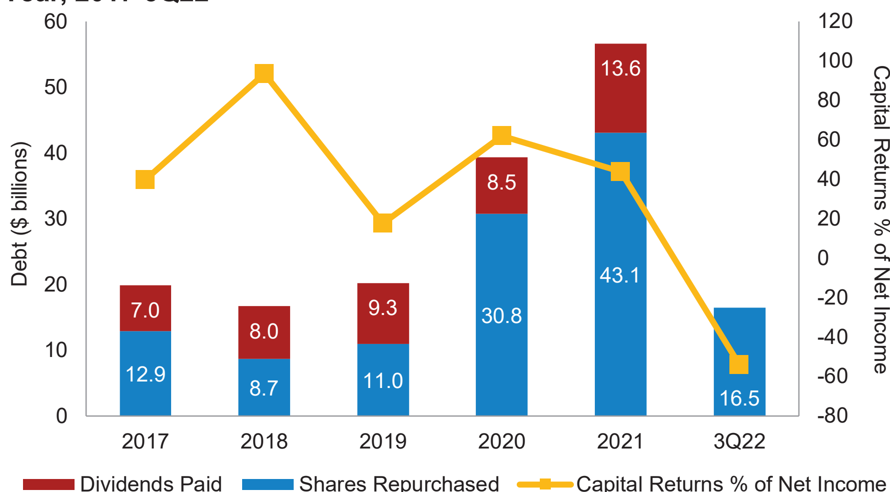
US Property/Casualty Insurers – FHLB Borrowings vs. Capacity, 2017-2021



Source: BESTLINK

Exhibit 6

US Publicly Traded Property/Casualty Insurers – Return of Capital by Year, 2017-3Q22



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returned as a share of net income remained within the five-year historical range Capital returns as a percentage of net income spiked in 2020 due to a decline in earnings, but the ratio has declined since (**Exhibit 6**).

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AMERICAS
WORLD HEADQUARTERS
A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)
LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best - MENA, South & Central Asia*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
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ASIA-PACIFIC
HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
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