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Industry Report Card:

Enterprise Risk Management Can Help U.S. Commercial Lines Insurers Ward Off Irrational Pricing

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In part because 2006 is expected to go down as one of the most profitable years in history for the U.S. insurance industry, Standard & Poor's Ratings Services believes that a serious threat to the commercial lines sector is the potential for a return to more competitive pricing. The shocking storm losses in 2005 temporarily slowed the price deterioration then underway in both property and casualty lines. Since then, casualty rates have continued to decline (though commercial property rates have strengthened somewhat). Therefore, Standard & Poor's considers the ability of insurers to understand and manage their risks to be of increasing importance in the intermediate term. Although pricing is a key consideration in the enterprise risk management (ERM) process, the evaluation of terms and conditions and changes in exposure at risk are also significant issues to be analyzed.

Since 2005, Standard & Poor's has evaluated the ERM programs of insurers as a regular part of our ratings analysis. For U.S. commercial lines insurers, 70% of the insurers that we have evaluated have Adequate ERM (compared with 81% for all insurers globally), 10% have Weak ERM (3% globally), and 20% have Strong ERM (11% globally). None of the U.S. commercial lines insurers have Excellent ERM (5% globally). Therefore, our view is that the commercial lines sector has somewhat better practices than the industry as a whole, though both the sector and the industry have plenty of room for improvement.

In our discussions with commercial lines insurers, we noted a number of favorable ERM-related trends. For example, catastrophic exposure reductions are decreasing total exposures in catastrophe-prone areas, especially Florida and the Gulf Coast. This is in response to a recognition of higher concentration of risk in that area for many carriers than risk tolerances would permit. There are several drivers for this trend:

- Model updates. Updates to catastrophe models following the 2004 and 2005 catastrophe years have significantly increased expected major storm frequencies and severities. In addition, many companies are looking at higher frequencies of storms based on continuation of shorter term trends. The result is that a similar exposure profile is likely resulting in significantly larger catastrophe probable maximum losses because of model changes.
- Modeling enhancement. More firms are looking at ways to heighten the conservatism taken in model outputs, recognizing that model error is significant. Also, model assumptions in terms of demand surge, storm surge, and other parameters are being fine-tuned to more accurately reflect the risk of the underlying exposure portfolio and to incorporate the prospective risk of post-event inflation. Firms are also considering improving internal model capabilities, largely through enhancing IT infrastructure and additions to staff.
- Improved exposure management and quantification. This has highlighted areas where tolerance levels had been inadvertently compromised. Exposure management has improved as the underwriting and modeling functions become more aligned to measure risk and recognizing differences with the two approaches. Also, a change in the management of exposure risk has

been the measurement and monitoring of full limits, which is now a more widespread risk-control process conducted by some companies.

- For many insurers, losses in the 2004 and 2005 catastrophe seasons have led to much more open and specific discussions between managements and boards over risk tolerances. Often, this has resulted in an explicit decrease of tolerance for earnings volatility and for the adverse impact to capital of catastrophic events in addition to the increased exposure estimates from the models in some companies. These risk-tolerance discussions have frequently been coupled with discussions of risk-control programs that are being strengthened to assure compliance with the risk tolerance. Standard & Poor's finds that be a particularly virtuous cycle of enhanced commitment to risk control of this highly volatile risk.
- Clearer guidelines for the roles of underwriters, rating systems, and actuaries in pricing decisions are being instituted. In addition, the robustness of rating systems, where appropriate, are frequently reviewed and enhanced. Systems that price business using the best science available—incorporating loss expectations and the cost of risk capital—are being developed and used. Greater clarity of underwriting authority, including the use of escalation procedures and peer review, is being introduced where it was lacking.

Another trend, more firms are exploring the idea of an economic capital process or have recently implemented an economic capital model capability. This could support significant developments of strategic risk management capabilities, which could drive improvements in our views of ERM for these firms. However, there still is resistance among many organizations to have risk-adjusted return decisions being made at the transaction level (many companies still hold fast to broad combined ratio targets for their underwriters).

More firms are enhancing the oversight of the risk-management process, including board-level ERM or risk committees; the addition of a chief risk officer, an executive-level risk committee, or both; and the creation of ERM teams where there is staff with only a focus on support of ERM as opposed to having current staff sharing ERM responsibilities with their regular jobs.

Some companies have increased the robustness of the rating process to deliberately decrease the need to deviate from technical pricing through manual rate adjustments by underwriters. Some writers regularly assess their rate development compared with their business written to find new areas where more comprehensive rates can make pricing faster and more consistent.

The table shows our ERM opinion for 38 commercial lines writers or groups. These opinions were formed as a part of our normal rating process for these insurers. We expect to update these views regularly and will periodically publish an update to this report.

ERM Opinions On 38 U.S. Commercial Lines Insurers

Company or group	ERM opinion	Financial strength rating on lead commercial lines company as of April 30, 2007	Commentary
ACE	Strong	A+/Stable	Key risks are managed effectively. The firm has incorporated an economic capital model that is embedded into risk/reward decisions, capital management, and strategy. As the firm expands the life operation and grows internationally, it is imperative that the ERM process responds accordingly to the evolving risk profile.
Allianz	Strong	AA-/Positive	Strong risk culture and strong controls for the majority of key risks are evident with the firm. We view asset/liability management as adequate, and other certain stronger ERM practices have been implemented recently. Economic-value-added assessments and risk capital support strong strategic risk management.
Allstate	Adequate	AA/Negative	The firm has a strong risk culture and governance process. Investment risk management has several strong processes. Underwriting risk is controlled in an excellent manner. Overall, the firm has multiple strengths that should position it for strong ERM over time.

ERM Opinions On 38 U.S. Commercial Lines Insurers (cont.)			
American Family	Adequate	A+/Stable	Strong risk culture underpins the low risk profile inherent with the firm. Insurance and operational risks are controlled in a strong manner. The firm is developing a consistent process for analyzing, evaluating, and communicating risks.
American Steamship Owners Mutual P&I Assoc. Inc.	Weak	B+/Stable	Pricing and underwriting are significant risks. However, the organization is often unaware of its true exposures. Annual reviews form an understanding of expected exposures for the year, but these could change. Claims management and reserving challenges are also evident.
Argonaut	Adequate	A-/Negative	Reserve risk, strategy execution, and property catastrophe are some of the firm's more significant risks. Appropriate controls and risk-management practices are evident to control these risks effectively.
Assurant	Adequate	A-/Positive	The firm's disciplined culture has led to successful management of its insurance risks over time. Company management and the board are engaged in the risk-management process. However, strategic risk management and risk integration are not fully embraced throughout the firm.
Attorney's Liability	Strong	AA-/Stable	The firm's deep expertise in its niche market is supported by strong underwriting discipline and loss prevention. Reserve risk, investment risk, and reinsurance form the key risks for the firm.
Berkshire Hathaway	Strong	AAA/Stable	The embracement and ownership of ERM is clear at the CEO level and permeates throughout the organization's leadership. Areas of operational risk controls and strategic risk management have room for enhancement, supported by a higher degree of economic and earnings optimization processes.
Bond Safeguard Insurance Co. and Lexon Insurance Co.	Adequate	BBB-/Stable	The company has strong underwriting controls via a centralized underwriting function and a heavily engaged company president. Capacity management is aligned with available capital.
Chubb	Strong	AA/Stable	The firm has a formal risk-management infrastructure that facilitates risk guideline enforcement, strong strategic risk management, strong underwriting discipline, and a conservative risk philosophy.
Electric Insurance Co.	Adequate	A/Stable	Six retrospective programs define the core commercial exposure. There is also catastrophe exposure related to personal lines written in hurricane-exposed areas. Underwriting, pricing, and reserving risk controls are strong, and the investment strategy is conservative.
Fairfax Financial	Weak	BBB/Negative	The firm exhibits appropriate underwriting risk controls with continuing operations and excellent investment risk controls, but it lacks an enterprise-wide risk-management program at the holding-company level. Weaknesses are apparent with other risk-controls areas.
Fireman's Fund	Strong	A/Positive	Fireman's Fund is a subsidiary of Allianz, where strong risk culture and strong controls for the majority of key risks are evident. We view its asset/liability management as adequate. Stronger ERM practices have been implemented recently for insurance risk controls. Economic-value-added assessments and risk capital support strong strategic risk management.
Harleysville	Adequate	BBB-/Stable/-- (holding company counterparty credit rating; operating companies not rated)	Harleysville manages its insurance risks through a committee-based operation. Claims, underwriting, and actuarial staffs bring group oversight to individual decisions. Controls are continuing to develop. Communication among functions and business units as well as general awareness of ERM have improved under the current CEO.
Hartford	Strong	AA-/Stable	The firm has a history of focused risk-management sophistication and development. This supports several examples of sound ERM practices throughout the organization, with an enterprise-wide view of nonlife and life risk management. The firm has begun to integrate a more holistic view of emerging risk management.
Hochheim Prairie	Adequate	BB/Stable	The firm focuses on managing its most significant risks but lacks a holistic view of ERM. Risk-management decisions are driven by management experience and instinct and qualitative review.
Horace Mann	Adequate	A/Stable	The firm lacks a formal ERM process, but management has identified risks and set appropriate controls. Key risks include pricing, reserves, catastrophes, and operational risk.

ERM Opinions On 38 U.S. Commercial Lines Insurers (cont.)

Houston Casualty	Adequate	AA/Stable	Houston Casualty has an excellent track record of effectively managing the level of underwriting risk it assumes and generating strong and consistent underwriting profits. However, the company is still in the process of developing a more comprehensive, fully integrated approach to identifying and managing all of its risk exposures.
Infinity	Adequate	A/Stable	The firm has a relatively low-risk profile. Underwriting and reserving risks are controlled in a strong manner. Resources have been allocated toward improving operational risk management, setting a favorable trend for the firm's ERM process.
Medical Protective Co.	Strong	AAA/Stable	Medco is a subsidiary of Berkshire Hathaway. The embracement and ownership of ERM is clear at the CEO level of Medco's parent, which permeates throughout the organization's leadership. Areas of operational risk controls and strategic risk management have room for enhancement, supported by a higher degree of economic and earnings optimization processes.
Nationwide	Adequate	A+/Stable	Risk culture, risk governance, operational risk control, and strategic risk management are all viewed as strong with respect to the life and nonlife operations. Bridging the gap between these operations and having a more holistic enterprise-wide view of risk management is necessary for a strong ERM assessment.
Ohio Casualty	Adequate	A-/Stable	The existing risk-management infrastructure and enforced risk-management guidelines have improved underwriting discipline in recent years. Adequate risk controls exist for key risks. The ERM process is developing, and management is working to integrate it into enterprise-level culture and decision-making more effectively.
Oil Casualty Insurance Ltd.	Adequate	BBB+/Stable	The firm has a single product focus that has inherent low-frequency and high-severity risk characteristics. The firm has effective reinsurance and other risk-management practices. The firm is actively seeking methods to minimize volatility.
ProAssurance	Adequate	A-/Stable	ProAssurance has a good risk-management process in place to manage its individual risk factors, such as underwriting, pricing, reserves, and acquisitions. The company has a good understanding of the risks it faces and has good practices in place to manage and control these risks.
Professionals Direct Insurance Co.	Adequate	BBB/Stable	The firm's ERM is on the lower end of adequate relative to other firms. However, it has effectively used reinsurance to keep losses within its tolerance and has good risk-management culture, including a CEO actively involved in risk management. Much effort has gone into implementing appropriate claims- and exposure-monitoring systems.
Real Legacy Assurance Co. Inc.	Adequate	BBB+/Stable	ERM is driven at the parent level (Cooperative de Seguros Multiples de Puerto Rico). Claims management, pricing, and catastrophe risks are the most significant. Underwriting and reserve risk control is strong. Operational risk-management capabilities are improving.
RLI	Adequate	A+/Stable	The firm does a good job in controlling exposure to within tolerances. Underwriting controls are viewed as strong, and investment risk is managed adequately via a third party. The firm has begun risk aggregation of multiple risks for more comprehensive views of exposures.
RSUI Indemnity Co. and Landmark American Insurance Co.	Adequate	A-/Stable	Strong risk culture and strong underwriting risk controls are evident. These strengths are offset by weak, yet improving, catastrophe risk management. There is a formal risk-management committee consisting of multiple disciplines.
RVI	Adequate	A/Negative	Certain risk-management practices have been in place over time, but ERM was formalized in May 2006. The firm has implemented a surveillance tool to improve its views of risks and of problem assets.
Safeco	Adequate	A+/Positive	The firm uses a central model to analyze reserve, catastrophe, pricing, and investment risks. ERM practices and guidelines are formalized and are supported by a chief risk officer and risk committee. An uncertainty is the focus on ERM given noteworthy turnover in senior ranks.
Safety National Casualty Corp.	Adequate	A/Stable	Core insurance risks are managed effectively. Strategic risk management is not sophisticated.

ERM Opinions On 38 U.S. Commercial Lines Insurers (cont.)			
State Auto Mutual Group	Adequate	A/Stable	ERM is an inherent part of the organization's operating structure. There is a systematic process to identify and mitigate risks. Operational risks are the most significant for the firm.
State Farm	Adequate	AA/Stable	The firm has undergone recent efforts to establish a centralized ERM process. A strong risk culture exists that will improve decision-making throughout the organization. The firm has a consistent process for analyzing, valuing, and communicating risks.
Texas Municipal League Intergovernmental Risk Pool	Adequate	A/Stable	Reserving risks and pricing are TML-IRP's major risks, though the unique legal structure and business mission ultimately shape our view of its ERM. Reinsurance and stabilization funds have been key components for managing insurance risks.
W.R. Berkley	Adequate	A+/Stable	The firm has several favorable components of its ERM process, including strong risk culture and strong underwriting risk controls. The firm lacks a formal process for risk aggregation and for risk/reward optimization.
Zenith Insurance Co. and ZNAT Insurance Co.	Adequate	A-/Stable	Workers' compensation market fluctuations in California and Florida and reserve risk are the most significant risks. Core insurance risks are controlled appropriately given the company's business profile and limited geographic scope.
Zurich North America	Adequate	A+/Positive	The Zurich Group exhibits strong risk culture and strong strategic risk management. Risk controls for the group's major risks and emerging risks are adequate. Overall ERM has the potential of becoming strong in the near future given recently implemented enhancements.