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# COMPANY RATING SYSTEMS

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- A discussion of the efforts an insurance company goes through obtaining ratings by outside agencies; the importance of the ratings; ongoing efforts in maintaining the ratings
- Brief history and description of the Standard & Poor's and Moody's rating systems, including their purpose and scope
- The uses and implications of such ratings from the consumer's viewpoint

MR. PETER J. BONDY: Company rating systems have been around for a long time. One of the first was the state regulatory system, for which there were two principal ratings: solvent or insolvent. If you were insolvent, you could be further classified as being in liquidation or rehabilitation, and maybe a couple of other terms. This rating system is based on a very simple gauge; i.e., do assets exceed liabilities plus the minimum capital and surplus required by state law or regulation?

While it is now moving in that direction, the statutory rating system has not really addressed the company's ability to meet its obligations and to continue operating on a going-concern basis. It's been a snapshot perspective. By "going concern," I mean over a period of time, with considerations given to the ongoing business development and management plans of the company. Another

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characteristic of the statutory rating system is that, although available, it is really not widely disseminated without the help of other agencies. These others include the various rating agencies that have established their own systems for rating insurance companies. By and large, in their work, they depart from statutory financial information complemented by other information in order to arrive at their conclusions and the assignment of ratings.

Who are these other agencies? This is not a complete list but examples are: A.M. Best, Conning & Company, S&P (Standard and Poor's), and Moody's Investors Service. These agencies use financial and other information in varying and differing degrees. All of them, however, arrive at a rating which lies in a range between excellent and very poor, although different mnemonics may be used.

The meaning of the rating can differ. The statutory rating system applies to the relationship of the asset page to the liability page on a snapshot basis. The A.M. Best rating, on the other hand, takes into account a host of items. Finally, S&P may be assigning a rating based on claims paying ability or debt paying ability.

Each of these ratings is of interest to different groups of people. A.M. Best, for example, is very heavily relied upon by brokerage people who sell individual life. S&P, Moody's, and the other rating systems would probably be relied upon more by those who are involved in structured settlement annuities and guaranteed investment contracts (GICs), where sums of money that change hands in one transaction can be very, very large.

Instead of talking about rating systems just as rating systems, and attempting to address all of them, we would rather make a presentation which would address what we consider are the various phases related to a rating. What are these phases? First we'll discuss the uses of these ratings by the end-user, the client. Second, what are these ratings? We refer specifically to S&P and Moody's. Third, what about the company? What does a company do in providing information? What does a company do in managing it? I want to stress that by managing it, I am not talking about the idea of planning your daily operation so that your only goal is to receive the highest rating. By managing it, I mean planning your daily activities and then attempting to obtain the best rating you can based on those plans that you've made irrespective of the rating that you are going to get. Obviously, your plans are related to the rating that you get in some of the markets.

I will present our panelists in the order in which they will make their presentations. I said that we would first look at the client. Murray Becker is with Johnson & Higgins, where his specialty is GICs. He assists clients by identifying and sorting through the potential insurance companies that the client might use in obtaining GICs. Murray has been with insurance companies and in the employee benefit consulting field for a number of years.

Carol Manning is our second speaker. Carol's earlier experience included work for an insurance department. In 1981 she joined S&P and was very involved with their rating system. More recently, she joined Kidder-Peabody as an Assistant Vice President specializing in work for insurance companies.

Our third panelist is Brooks Cowgill. He is Vice President and Treasurer of The New England. Brooks has been very instrumental in the work that The New England does with various rating agencies. Brooks will talk to us from the company's perspective. Brooks is also responsible for other functions at The New England, as Vice President and Treasurer.

MR. MURRAY L. BECKER: As the lead-off hitter, I'm going to start with the issue of credit worthiness from the customer's viewpoint. In particular, I'd like to discuss the attitudes of corporate employers who sponsor defined contribution plans such as savings plans, profit sharing plans, and 401(k) plans. While GIC products have their own frame of reference and their own issues, it's quite conceivable that the attitudes that I express will be representative of your marketplace and a lot of other areas as well, at least in the area where the buyer is a sophisticated person or a corporation.

First, I'd like to give a little background on the GIC marketplace, in particular, so that the perspective becomes clear. Guaranteed investment contracts are largely applicable to defined contribution plans. The luster of a GIC is that it provides plan participants with a guarantee of principal and interest so that the participant in a plan knows what the investment return will be if he or she elects to put the contribution in this investment choice rather than the others that are available in the plan. Another characteristic is that a GIC generally is benefit responsive; that is, the insurance company agrees to respond to requests for cash to provide benefits to plan participants that are called for under the underlying savings or profit sharing plans.

The GIC marketplace is a huge amount of business for the insurance industry, which is uniquely qualified to provide a product that guarantees principal and interest and has benefit responsiveness. Any time an organization other than an insurance company has made some attempt to be in this business, the results have not turned out very well. So, it's really big business for the insurance industry. I would guess that in this particular calendar year, there will be about $20 billion worth of GIC business for defined contribution plans and maybe a little bit more in the total marketplace. For the clients I represent, this year we expect to purchase something in the neighborhood of $6.5 billion, all from companies represented at this meeting.

Now, let's move on to credit worthiness. The recent failures of household names such as Baldwin-United and Texaco have evoked considerable concern in recent years. Why should insurance companies be treated any differently from other companies? If a household name can have a financial problem, why can't an insurance company have a financial problem? The customer's concern is there. Why is it there? In a savings plan, the employees are told, "You have several investment choices. You have an equity fund, you have company stock (maybe) and you have a guaranteed investment contract." The very name, guaranteed investment contract, connotes that nothing can go wrong. In fact, some companies become very concerned that guarantee suddenly means that the government should be backing it. Guarantee, of course, is nothing more than the credit worthiness of the insurance company offering the guarantee. Because the companies communicate this as a guaranteed facility, many of them feel that if anything goes wrong, they, themselves, are at risk. Some, in fact, are changing the name of their facility. It is no longer going to be the guaranteed income fund or the guaranteed investment fund, it is going to be the fixed income fund. But the employees have the idea that their money is safe. If any component of the fund ever gets into financial difficulty, the company would have two unpleasant choices: one is to make the employees whole and the other is to accept the disastrous employee morale or employee relations problem that could even conceivably be litigated.

Sooner or later, someone in senior management wakes up to all of this and says, "What are we doing to make sure that we never get into this situation?" If you have two choices, each of which is terrible, you want to avoid the situation in the first place. At some point, (we found this happening beginning three or four years ago) someone at the middle management level comes to us and says, "What are our standards? What are you recommending to us to make sure that when we put out a bid list for guaranteed investment contracts that you are including on the bid list only those insurance companies that are the absolute top of the heap from a credit rating viewpoint?" Essentially, the customer has a preconceived notion. If we didn't respond consistently with the preconceived notion, we would have a response that wouldn't be accepted. The preconceived notion is this: GICs, in general, have created very good investment returns. The returns at inception of a GIC look very good to employees because interest rates have generally been falling in recent years. Most plans have been crediting interest rates to plan participants that represent the average of all the GICs they bought in the last three or four years, and these averages are still in the area of 10-11%. The companies have an overachieving plan in that they're producing rates that are higher than the employees would expect. The last thing in the world that they want to do is to struggle to get a few extra basis points if, in return, they have some credit risk. They want a standard that says there is no credit risk.

The employee gets the investment reward. If the company gets a higher interest rate, the employee would benefit. But if, in return, there was at some future date a disaster, then the company would suffer. The employee might suffer, too. So, there is no trade-off between risk and reward. There is just risk without reward and no one wants to take that.

Because this is a widespread feeling in the GIC marketplace and has been for at least three or four years, there are automatically responses. One of the responses is a great number of self-appointed experts. There are GIC management firms which say, "Hire us. We will manage your GIC portfolio. We will do credit analysis and we will make sure that you're dealing only with quality insurance companies." There are many banks that are in the GIC business. Because banks have investment capabilities, they would claim to be able to do credit analysis as an investment function or even as a credit function. There are mutual funds that sponsor GICs. They would claim to do credit analysis. And, then, there is a host of security analysts.

I happen to work for a firm which, among other things, is an insurance brokerage firm. There was nothing that would have prevented us from saying we would do credit analysis. After all, it is a broker's function to select an insurance company. Our response was a little different. We decided that the determination of credit worthiness should be done by professionals, people who are in the credit analysis business. We concluded that the Best ratings were inadequate because we felt that too many insurance companies were A+ in the Best rating system. We wanted an answer that would be credible, that would be in tune with the customer's basic feeling of conservatism. It was our view that perhaps the top 20 or so insurance companies would have come out AAA if they had floated a bond issue.

AAA is the highest credit rating available in the private sector. If somebody is looking for comfort and you can satisfy him that there are 20 competitive insurance companies from which to choose and all 20 are AAA, then the problem will be under control. The problem with the standard was that there was no way to tell. That is, at the time the problem began to arise, there were very few insurance companies floating bond issues and it was not possible for anyone to say that Prudential was AAA, but someone else was not.

The other interesting point about that kind of rating is that in the large corporate area, the people who buy GICs are most often financial professionals who also manage their company's pension fund. These are people for whom you want a solution that produces an understandable answer. The world understands what an S&P or Moody's rating is. If you say that this particular insurance company is equivalent to a AAA, then someone has an understanding of what that is. In a sense, we had an answer but it was rather impractical. The answer we presented to our clients was that they should deal with an insurance company that would come out AAA if it were appraised by a responsible credit rating agency. But the basic position that we took was that we would not be making the determination ourselves; it would be done professionally. This was a war that should be left to the generals, not to the politicians.

Our next move (going back about four years) was to develop a two-tier approach. On the first tier we were looking for only those insurance companies which, if appraised by Moody's or S&P, would come out AAA. Since there was practically no one for whom that test was being made directly, we came up with substitute criteria. The intention of this criteria was to identify insurance companies that had a high probability of being AAA or, at least, companies for which we could presume a AAA rating because no information was available to make us question that possibility. The criteria consisted of an A+ Best rating. We wanted to deal with relatively large companies, so we required at least $3 billion of assets. We wanted companies that had been around a long time and survived the depression, so they had to be at least 75 years old. We wanted companies that were in multiple lines of business so as to be diversified and not unduly sensitive to the fortunes of a single product or even a single line of business. We recognized that such criteria might eliminate some fine companies. On the other hand, we had clients who preferred to leave out 50 good companies to avoid having one bad one.

The entry of S&P in the business suddenly gave us an opportunity to convert our theoretical standard into reality. Now a highly regarded and very well-known credit agency was saying that it would rate an insurance company for claims paying ability whether or not the company floated a bond issue. From the point of view of the marketplace, and from our viewpoint as someone who serves the customer, a rating by bond agency uses familiar terminology. Everybody knows what AAA means. It's exactly the level that our customers wanted. They wanted someone to tell them that this insurance company was AAA. And, if someone would do that, and have the authority to stand behind it then that's exactly what the marketplace wanted.

At this moment, just based on the information available to us, there are over 20 insurance companies that are in the GIC business that have a AAA rating. Almost all of the major competitive insurance companies in the GIC business have a AAA rating.

Now we are in a position to transmit what's happening. As of the first of this year, we said to our clients, "We recommend that you limit your consideration to AAA insurance companies." Here is the response: most of them indicated that as being exactly what they want to do. They see no reason to go below the

AAA standard. Sometimes, because they may have a relationship with an insurance company that is not AAA or is unrated, they may include that company. If that company has the best bid, they may scratch their heads and decide whether or not to use it. We have included a number of insurance companies in bidding because the customer said, "Well, we're not sure what we'll do but let's keep them on the bid list because we see no reason to get them mad at us right now."

Some that would argue that the AAA rating is an excessive requirement. After all, what is the chance that an insurance company rated AA would go under during the three, four or five years of a typical GIC in a savings plan? There may be some merit in that argument. However, if there are 20 AAA insurance companies, most of our clients see no reason to get involved with a lower rated company. Also, the AAA carries its own reward. Even though a AA might never go under during the life of a GIC, that is not the immediate concern. The company's immediate concern is the standard itself. If an employee writes a letter to the president of the company and says, "I have had my entire savings for the last 30 years in your GIC savings plan. What are you doing to make sure my money is safe?" It is very nice to say that every nickel of that money is in an investment that is, itself, a AAA security. That is a reward even if the AA investment has almost no chance of going under.

One other issue: is a AAA credit a sufficient condition as well as a necessary condition? That is, if a company is AAA, does that automatically qualify it on the credit worthiness issue? The answer is, usually, but not always. We have clients that refuse to deal with an insurance company that is controversial, that gets mentioned in articles in the press, that would create concerns on the part of the employee or that has a AAA rating which is not yet widely accepted. We think AAA is generally both a necessary and sufficient condition, but the insurance company has to be one which is not controversial.

There are other circumstances under which we would accept a substitute for an S&P AAA rating. One of them, of course, is another recognized credit rating gency. Duff & Phelps is in the business. We would certainly accept a high Duff & Phelps rating as being equivalent to a high S&P rating. We do not want to rate the raters. If it is a rating agency of very high esteem, and the marketplace is willing to accept that rating agency's credentials, then certainly we would agree. Our clients and we would also accept a third-party guarantee by a AAA agency. For example, if the insurance company is owned by a AAA holding company which guarantees a particular contract, then the contract would be AAA. Or, if the life company in a property/casualty/life group had a guarantee from the casualty company, and if the casualty company were AAA, we would accept that. We accept any kind of third-party guarantee by a AAA entity.

I want to comment on the role of an intermediary such as us. We consider ourselves consultants. We are advisors, not decision makers. While we influence the marketplace by presenting ideas and concepts, we feel we have a right to decide who belongs on the bid list that we recommend. A recommendation by us does not always turn out to be decisive. In fact, since we would propose that we are not fiduciary, we are not making decisions which are entirely the clients' to make. Any client that wants to include more companies or less companies would have the right to do so. The clients decide whether or not to accept it. But, generally, they will accept conservative recommendations.

I want to make one other comment about something I've been hearing more and more lately. People are predicting that in the GIC area, credit distinctions will eventually be made in the form of basis points. I went to a GIC seminar last month and the speaker talked about risk-adjusted GIC rates. If you were dealing with a riskier credit, you would certainly get a higher interest rate or else you wouldn't take the risk. I believe that was somewhat of an Alice in Wonderland way of looking at things, especially in the area of defined contribution plans with their built in conservatism. For example, two insurance companies are AAA but because of some other available information, you find out that one insurance company is a higher form of AAA than the other. This may be possible because Duff & Phelps, for example, might have a 1 or a 2, both of which mean AAA in S&P terms. Should a Duff & Phelps 1 be able to win business at a lower interest rate than a Duff & Phelps 2? Anybody in the bond business would say, "Obviously." But if a Duff & Phelps 1 means that there is one chance in 100,000 of going under in five years and a Duff & Phelps 2 means that there is one chance in 10,000 of going under in five years, I don't think a client would give up too many basis points to get a 1 instead of a 2, even though a 2 is 10 times more likely than a 1 to go under. I do think that once those kinds of distinctions become available, there will be some differences. In other words, perhaps the marketplace will decide these differences, which will be the sum total of individual decisions. But, my feeling is, those kinds of spreads within the ultraconservative AAA level will be relatively small and nowhere near the spread that you see in the bond marketplace, because you're dealing with shades of difference in an event that's extremely unlikely. Perhaps we will see five or at the most, ten-point distinctions between that kind of hair splitting.

MS. CAROL D. MANNING: After all my years of rating agency experience, going through a period where we developed a new product at S&P that was called a claims paying rating, we often wanted to sit back and take credit for this good job we did of producing a product that had been accepted by a marketplace. The staff at S&P, since I left, has doubled and there is no other explanation other than that users in the marketplace really have needed forms of rating systems other than the rating systems that had been provided by traditional systems.

What I'm going to talk about is really a blend between S&P ratings, Moody's ratings, a few extraneous Carol Manning opinions on how much caution you should use as participants in the rating system, what it means for you as a company, and also the caution of what the different ratings mean.

Who are the actors? Well there is the traditional actor, which we call A.M. Best. A.M. Best produces this lovely, large book for life companies, a large book for property/casualty companies and it has also come up with periodic releases of rating updates. A.M. Best has established its credibility over the years and is an excellent source of rating information. It's also a fantastic source of consistent financial data based on statutory blanks for the users of insurance products. What we call the new entrants include the external rating agencies. These include S&P, Moody's Investors Service, Duff & Phelps and Conning & Company. Most of my comments will really be addressed to S&P and Moody's, since they are the two most significant players in this marketplace. Conning is a significant player but is playing less of a role in a public fashion. It is on a much more private basis. I have no expertise in commenting on their system.

The term *new entrants*, is a bit of a euphemism that people who come from agencies like S&P and Moody's really don't believe is true. S&P has been in business since 1860. It has been rating corporate bonds since 1923. It has over

10,000 ratings on dead issues. It rates municipalities. It rates industrial companies. It rates foreign and sovereign credits. It also happens to rate insurance companies. It has been rating insurance companies since 1971, when it issued its first claims paying rating, although they didn't have that name for it. In 1983, they formalized a rating system that was called shadow ratings and developed a product called a claims paying rating. The ratings up to that point in time had been used primarily in financial markets, and the companies that were involved in those markets were using their insurance policies as some form of a credit enhancement. These companies included the bond insurers, AMBAK. They also included property/casualty companies that were part of the mortgage-backed securities industry that was developing. Property/casualty companies were issuing insurance policies that were being used as part of a debt instrument in the public markets. They were insuring against earthquakes, and other kinds of phenomena that could not be covered to the satisfaction of the debt rating service without something covering that risk.

Life companies were first rated in 1985 and the rating for life companies came directly out of the needs of the pension business. Pension managers needed a way to distinguish between the guaranteed investment products of the companies with which they were dealing. Some of the people at the rating agencies had actually thought that claims paying ratings for which life insurance companies would have developed a demand would come out of the group side of the business, but the pension market has been the driving factor for life ratings. Today, S&P has over 90 companies rated, including companies that have debt ratings, property/casualty companies, and life companies.

Moody's Investors Service has been rating insurance companies since sometime in the mid 1970s, when the first insurance companies issued debt. Both S&P and Moody's became very active in rating life insurance companies during the early 1980s, as many life companies got commercial paper ratings.

Duff & Phelps is not yet a significant player in the claims paying rating business, but they provide a similar service. I expect that, over time, they will become as significant to users as S&P or Moody's.

Why did this need for new entrants occur? The buyers needed a second opinion. They were no longer able to look only at Best and take it to their senior management and say, "This company is rated A+ by Best." They needed more than one reason to justify selection of a particular carrier. Also, there was a sense that the A.M. Best volume that comes out in the middle of August or September wasn't providing a timely enough type of review, and that it was only an annual review based on the statutory data. S&P, Moody's and Duff & Phelps, although obviously not following each company on a day-by-day basis, are constantly interacting with the companies that are rated. If there are reasons to believe that the financial strength has changed, the agencies are required to either change the rating or put the rating on what S&P calls credit watch, or what Moody's calls under review, until a circumstance that might affect credit quality is clarified and the impact on the rating can be determined.

Users of insurance policies also needed a source of ratings that had credibility. If there is one thing upon which the entire business of rating debt securities really relies to determine the success of the debt rating agencies, it is maintaining their credibility with the investment buying public. Consequently, as Murray was willing to give credibility to any of the rating agencies in his recommendation, the buyers were able to use the credibility that the rating agencies had established over the years for the ratings.

How do claims paying ratings differ from debt ratings? They look the same. They use the same symbols. They have AAAs and AAs and As. It is almost the same product. The difference is that, generally, a debt security is issued by a holding company. In certain circumstances, the debt security will be issued by an insurance company but that is generally because of a legal structural issue for that particular corporation.

The claims paying rating is a rating on an operating insurance company. It is an assessment of that insurance company's ability to pay its claims. Now, at S&P, we regret selection of the term, *claims paying ratings*, because all life insurance companies obviously have enough financial strength to pay their claims. It's really a rating of financial strength to pay claims rather than just a rating of claims paying ability. Any company that is solvent and considered solvent by the regulator should have sufficient claims paying ability to meet its obligations. There can be a difference between the claims paying rating of an operating insurance company and its parent holding company. If a company is at the very highest level, it is possible to have a AAA claims paying rating and a AAA debt rating. However, the more normal circumstance would be that the insurance operating company would be rated a AAA for claims paying rating, and the debt that was issued by a holding company would be rated at a lower category, usually AA or a similar rating.

The difference between these two ratings is generated by the fact that the insurance company's obligation to its policyholders is by law its first and most senior obligation. The other reason is that the holding company could theoretically not have a call on sufficient funds from the operating insurance company to pay a debt obligation because of restrictions from regulatory barriers. The regulatory process does provide some element of the rating process, but the claims paying ratings give no consideration to guarantee funds, which are the ultimate source of repayment in the event of an insolvency. The other significant difference between debt ratings and claims paying ratings is that for debt ratings, the rating agencies are looking for not only the ability to pay the debt obligation but also some assurance that the debt obligation will be paid on a timely basis. There really is no question of timeliness in a claims paying rating evaluation because there is no trigger payment date in most insurance contracts. A guaranteed investment contract might have some precision, but the precision is not the same precision or the same requirement of a debt obligation.

How do claims paying ratings differ from policyholder ratings? They are really the same thing. A policyholder rating is just A.M. Best's name for claims paying ratings. But they are different. The rating agency's methodology and what they're trying to do is significantly different from what my interpretation of A.M. Best's ratings are doing. The rating agencies are trying to look at the claims paying ability of the insurance company on an ongoing basis as an operating insurance company and they are trying to look forward. They are trying to look on a prospective basis to the ability of that company to fulfill its financial obligations. The A.M. Best rating is trying to do the same thing but it's not as explicitly stated as it is with the rating agencies.

The evaluation of a prospective basis for an insurance company involves factors which are extremely qualitative. There is no formula that determines an insurance company claims paying rating, which company is AAA, which company is AA, which company might be a B. There are no ratios that work. Those of us who have been credit analysts have reached the consensus that the insurance industry is perhaps one of the most difficult industries to rate and evaluate from the sense that there are no easily determined ratios or financial measures that seem to hold across credit quality groups. For those of you that have any background or have taken any finance courses, you know some of the little measures: sales per square foot for retail stores, inventory, work in process. There are many measures that you can use for an industrial company. You can array the statistics, and it is amazing how those companies just fall into category. The measures tend to correlate with the qualitative factors used by credit analysts. These measures do not work for insurance companies. Each insurance company has a different book of business. There are mutual companies. There are stock companies. There are companies that have widely convergent ideas of what the appropriate leverage ratios on an operating basis are for those companies. There are different reserving assumptions. None of the factors really tracks out and breaks into nice, neat categories.

There is one component of a claims paying rating that the agencies really don't like to emphasize. They will emphasize it for the debt rating. They will point out that a AAA municipality means that credit is just as strong as a AAA debt instrument from an insurance company, and it means the same across all of the industry. However, for the claims paying ratings they don't like to make that assessment, even though it exists. That is one of the reasons the rating gives meaning to the clients, the people who are buying GICs and insurance products. They can take information from other areas of their business and say, "Okay, a AAA means something in my universe."

The claims paying ratings is a voluntary process for the agencies. Companies request the rating because it has positive business implications. There are probably a few people in the audience who are saying, "It's not voluntary any more." But it basically is a voluntary process. The rating agencies cannot make the necessary qualitative assessments without the cooperation of the company. That cooperation requires management participation. Many actuaries get involved in the rating process. It should be an enjoyable process because it can be an education about one's own company, and it can be beneficial for the company. The reason that the process requires the management participation is that the agencies are trying to evaluate the management and the business plans for the future. In order for them to make an evaluation that is going to go through business cycles, and is going to make some assessment of what the overall credit quality of Company XYZ is in a period of time when health insurance is going through a cyclical downturn, they need to know what management is doing to make the future work. They try to evaluate management's response within the context of what they have learned about other management's responses to the industry. Although the agencies do not determine whether a response is correct or incorrect, they do try to measure its reasonableness within the context of industry conditions.

The real difference between A.M. Best and the other rating agencies, S&P and Moody's, is that A.M. Best uses a rating which is based on the historical financial results of a company at a point in time. S&P and Moody's use the same historical data, add management participation, and try to make a qualitative prospective assessment. The A.M. Best rating is only for insurance companies. S&P and Moody's use a system that can be understood in a cost industrial context. A.M. Best rates all companies with the exception of a few companies that do not fit into a screening process.

S&P rates only on a voluntary basis. Companies must request the rating. If the rating evaluation for a claims paying rating is not to the satisfaction of the company that has requested the rating, the rating is never made public. There have been companies that have received AAA and have said, "We still don't want it made public."

Moody's has a policy of voluntary ratings, but of its universe of two life insurance companies that have claims paying ratings, 50% were voluntary ratings. So, it is a mixed system.

The A.M. Best ratings, as I said, use no management participation. I know that managements make their annual trek to A.M. Best. I know that the rating is adjusted for management input, but I think the degree of active participation is not as substantial as it is with S&P and Moody's.

One of the things with which one has to wrestle when going through the rating process is a fear of the analysts. I used to spend much time assuring insurance companies' managements that the analysts were not going to do horrible things to them and that they were a nice group of people who were going to be doing something that the company would enjoy in the long run. One reason for the misperceptions is that managements have had experience with the formula group, and they assume that no matter what they do when the analysts come in, the process is going to be driven by a set of formulas and a set of precise measurements. They have also been subjected to a regulatory process that gives them other misperceptions about the rating process. A third misperception is that the rating agency people are auditors. They do not want to examine books. The rating agency people are just normal people like a group of actuaries. They have different biases and are looking for different things, but they are a group of very bright, well-educated people. Most of them have MBAs. Most of them have some industry experience. Most of the analysts at Moody's and S&P also have some credit experience through banks or insurance companies, in an investment department. There is usually a balance of people who are financially oriented, people who have experience in the industry, and people who want to be investment bankers. There are people that didn't know they wanted to be investment bankers until they learned what happens in the investment banking world.

The most important factors to the rating agencies are industry risk, management, the company's operating performance, the company's inherent characteristics, the balance sheet, financial flexibility, and liquidity. That is the order of importance that S&P specified at a seminar a couple of months ago. The order will vary over time and from agency to agency.

Industry risk is probably the driving factor for the general location of the ratings within the range. Insurance company ratings are very high. The reason that they are high is that the industry risk is perceived as very low, and the basic operating environment of insurance companies is perceived as financially sound by both S&P and Moody's. However, Moody's does have an opinion of the credit quality of the industry that differs significantly from S&P. Moody's has a much more pessimistic outlook on the industry. They see the thinner margins. They see the inability of mutual companies to raise capital. They see many factors that are less optimistic than S&P, although S&P would agree that an industry undergoing change is also an industry that is likely to be viewed more negatively in the future than it may be viewed on a current basis.

Industry risk affects all companies. Managements can only respond to industry risk. They cannot influence it.

Management is important because management distinguishes one insurance company from another. It is the element that separates the winners from the losers in a changing environment. It is the most intangible factor and the one about which the least is written in any credit analysis published by S&P or Moody's. But it drives the rating. If the analysts are convinced that a company is not responsive to the changes that are going on in its industry, that it is not prudent enough to do those things that make it a high-quality insurance company, it is not going to get a AAA rating. It might get a AA or AB. The Bs are usually not driven by factors that are claims paying issues. They are driven by external financing issues.

The next factor is operating performance, which is measured by profits in the long run. Profits are emphasized by the agencies because some of the entities really have been looking at the companies on a statutory and a GAAP basis. Those companies that only have statutory financials and have marginal profitability cannot talk their way through the lack of profits over a very long period of time.

Operating performance has two sides: investment and underwriting. Both are very important. It involves the asset side and the liability side. I think that earlier Fred Carr addressed both sides in a very sufficient fashion. The agencies have been paying a lot of attention to asset/liability mismatch because so much of their business has been driven by the pension managers. Underwriting, the products which are being sold, and pricing are just as important.

Company characteristics is the fourth important factor. This includes the diversity of the business, the type of agency force, and the types of products. These characteristics place a company in the index, in the industry, and give it context within that industry.

The balance sheet factors include financial leverage and operating leverage. There are no right answers here. There are some levels of operating leverage that are considered appropriate, safe, or unsafe by line of business, but there is no right answer for every company on what operating leverage should be. Similarly, there is no right answer for financial leverage. Financial leverage, however, can drive a rating indirectly because a company which is highly levered on a financial basis is likely to have a lower debt rating, and there is a strong correlation between the debt rating and the claims paying rating.

Financial flexibility is the next factor. A lot of this information comes out of the basic characteristics of insurance companies. If the company cannot access capital markets and cannot increase its capital, this will have a less positive effect on the rating.

Insurance companies currently are quite liquid, so liquidity is a relatively minor factor in current ratings. Five years ago, it was a more important factor and had more important effects on ratings. But we had fewer ratings then, so it did not have much of an effect.

The rating systems of A.M. Best, as well as S&P and Moody's, have strengths and weaknesses. I think the real strength of A.M. Best's system is that it is so comprehensive. All the companies are rated. Another strength is that it has the different size categories. A small, well-run company can have an A+ or an A rating. It is a fantastic source of data, and it has relatively objective standards. It is formula based. Everybody gets an A, but everyone seems to know what the standards are. S&P and Moody's are prospective, qualitative, and cross industry, and there is a strong correlation with the debt ratings.

As for weaknesses, I think A.M. Best is not as timely as Moody's and S&P. The rating is historical. The size categories, a great strength of A.M. Best, are also a great weakness because users do not recognize that an A+ IV is any different from an A+ XIV. It does make a difference, depending on the use of the ratings.

One weakness of S&P is that the rating process is voluntary or selective. There is a long list of AAA companies that meets Murray's criteria, but, because it is a self-selective group, there is no list of AA companies or A companies, which would give it a little bit more meaning. Another weakness is the correlation with debt ratings. It is sometimes very difficult to isolate the well run operating insurance company from a rating that is driven by debt at a holding company. This is not a major problem today, but it is a weakness in the system. Size affects ratings. A very well-run, small company has many strikes against it when it is rated by S&P and Moody's. It will not get a AAA if it is below a certain size. The "what can go wrong?" perspective that credit analysts have is definitely influenced by size.

The weakness of rating systems is that the rating systems become de facto regulators of how insurance companies operate. That means that companies start making decisions that are based upon the rating impact of those decisions, and those are not always the best decisions from a corporate management perspective. A company, while looking at its planning and its day-today operations, should recognize that there are points in time that it is a better decision, from a business perspective, to go forward with an action that has a negative rating impact, because in the long run, the company will be more financially sound and have a higher credit rating than if it takes action to maintain a credit rating, a claims paying rating or a policyholder rating.

MR. F. BROOKS COWGILL: I hope we can focus on your activities, as actuaries, in the process of an insurance company preparing and getting ready to deal with the rating agencies. I thought we ought to start out by being sure that we're all on the same wavelength.

Why are we talking about this subject? It seems that with the major changes and the business initiatives that have been going on in the insurance industry in the last few years, ratings are now much more important and much more frequent. Therefore, they are a subject that we need to know more about. This is a topic about which the actuaries will need to do a lot of thinking that they didn't have to do before. And it's not just actuaries; it's people like me in the financial area and all of us in our companies. It can be a confusing and diverse topic.

What I want to cover falls into three categories. The first is the efforts and the process that we go through and that you would go through in your own companies in obtaining a rating. The second category includes the process of maintaining a rating over time and the relationship with the rating agencies. And lastly, why are ratings important? I think Murray and Carol have done a good job of giving you a flavor for the importance of ratings, but I'll have a couple more comments to make. What I hope this all produces for you is something you can take away and use as you are involved in the process of dealing with rating agencies and getting ratings for your companies. There might be a couple of reasons that this would be of interest to you. You and your associates may already be working on a project that has a rating implication or where a rating may be required or desired. Or, tomorrow morning somebody may call you up and say, "Will you please help us on this preparation for a meeting with a rating agency?" Or, maybe you'll be involved in that yourself. So, I think there is some real meaning here.

Let's first get a framework of what we're going to be talking about. We're talking about the types of ratings that are available. These have been pretty well described. The two categories are the insurance and the claims paying ratings. One topic on which I'll spend a bit more time than my compatriots is ratings relating to debt instruments and other financings, whether that happens to be direct financial liabilities that show up on your balance sheet, direct borrowing, or some form of indirect or contingent obligation, such as a guarantee.

Maybe I should stop for just a second and give you my credentials. Do I have any basis for talking with you about this? The New England has a variety of ratings. Yes, we have an A.M. Best claims paying rating. We also have a claims paying rating from S&P. We have ratings from agencies on our long-term debt that is on the balance sheet and also on indirect financial obligations, the guarantees and other undertakings relating to subsidiaries or other investment activities. We also have a rating that relates to our commercial paper operation.

Why are we involved so much more in ratings these days? I think because of a number of new business initiatives that our companies have been involved in which require ratings. Claims paying ratings are certainly required for GICs. If a corporation wants to issue debt to make an acquisition or is involved in debt relating to one of their subsidiaries, possibly not even in the insurance business but in a noninsurance subsidiary, debt ratings may be involved. You are all familiar with the many types of financing to support various investment and portfolio management initiatives. That might be, for instance, the securitization of some of your mortgages. But, who are the raters? We've talked about that, so I won't spend much time on it. Some say that there are only two categories of rating agencies for their companies: one is the agency that gives them a good rating and the other category is the agency that doesn't give them the rating they like. But, obviously, there is more to it than that, and my compatriots have identified many of the rating agencies with which you are and will be dealing and should keep in mind. As you know, some of the agencies focus primarily on insurance or claims paying ability; others are best known for rating credit worthiness. S&P, of course, is one of several examples. As we've seen, some are getting much more active across the board in various kinds of ratings, and I think that's good.

Let's turn to this first major topic that I wanted to share with you and that is this process of preparing for a meeting with a rating agency which is seeking a rating. I will discuss the effort that goes into that process, particularly where the actuary would be involved. The first thing you have to do is to agree internally on the approach that you want to take at your company. Designate who is going to be responsible for coordinating this process and identifying which areas and functional expertise within your company need to be involved in the process. There needs to be a coordinated approach and a coordinated approach image that you project in the process, and what that means is team-work. That's part of what makes the process and the activity fun as you get involved in it. Also, you need to identify your own company's objectives and approach in working with the rating agency. What style do you want to follow? Are you going to be open and frank? Are you going to not tell them any more than you have to tell them? I'll talk more later about which approach I think makes sense.

Now, in preparing for a meeting with the rating agency, there are a few things that you certainly want to keep in mind in the preparation process. We're going to cover several things. One is gathering and organizing the information and the material that will be the basis for your discussion with the rating agency. Who should be the spokespersons? Who are the people who should be at the meeting and participating in it and helping to provide education and information? Then, comes the moment of truth! What are the company's goals? Is there a clear and understood position within your company as to where it is headed and why? And, I'd submit to you that if you can't answer that question before you meet with the rating agencies, you are going to have some difficulty explaining where your company is headed to those who want to know and judge that. It's an important item.

What are the topics to emphasize in the meeting itself? Certainly, what is the company's strategic thrust? What are its corporate and marketing goals and its management philosophy? You want them to cover in an overview sense a description of your organization and the structure of your business and the lines of business. What do we have, why do we have it, and what are we doing with it? The last topic is a description of those lines of business themselves; highlights of the recent operations and the performance of your main lines of business. You may say, "That's a liability-oriented discussion, isn't it?" It is. Then you go on to some highlights of your investment operations of your company and, of course, that's an asset-oriented discussion. You'd want to cover such things as asset quality, portfolio strategy, the way you go about asset/liability coordination, not necessarily matching dollar-for-dollar but, at least, knowing what you're doing and why you are doing it. Then, if you have subsidiaries, you want to review those subsidiaries, particularly if they are noninsurance activity, something a little different from the main line of your operations as an insurance company. Financial results are clearly important; for the past year, for recent history and to the extent you want to talk about projections. Then you want to share with the agency representatives and to have a good grasp yourself of the corporate financial position and strength of your company. You're going to get into things like surplus and liquidity, as well as hidden assets that don't show up on the balance sheet but you know are there and which have value. Debt and debt-like obligations of the company are certainly important. In addition, you want to cover the process of managing and controlling the leverage ratio and debt capacity and other liabilities. Do you have a handle on it?

Let's go back to two final steps in the process of preparing for your meeting with the rating agency. One of those is to be ready for the kinds of questions and criticisms that you may get. You may learn some very interesting things about your company by the questions you were asked for which you don't have answers. So, think in advance about those questions and have some answers. Finally, keep your audience in mind. Say it in English; don't say it in "actuarialese." In my case the advice is to not say it all in financial jargon that is so specialized that only people in your particular area may be familiar with the terms.

I would like to say a few additional words about the meeting and about the follow-up process. Meeting with the rating agency would probably be at your own company headquarters, especially if it is the first meeting. That meeting should include senior and knowledgeable representatives from your management group who can discuss their areas of expertise clearly. The agencies do put a great emphasis on management. Carol has already commented on that. They are not just looking at ratios and financial data, but they are looking into the question of whether or not management is managing. Or are they just reacting to what's going on and scurrying around and doing something about it? The agency representatives may want to speak further with you and your other compatriots after the meeting to get more information. I think that is to your benefit. Eventually, you'll get a rating. So, there is something that you're working towards which has value.

Let's look at the role and the contribution that you, as actuaries, can make to this very important process for your company. There are a few things you'd be involved in not only in the preparation but during your presentation. You need to explain the line of business strategy for your area: the financial characteristics of that line, its performance, surplus needs, its payback period, and, certainly, the impact of growth or desired growth as it relates to that line of business. You will need to explain the key products; how they're structured, the underwriting process, marketing, and pricing. You may be the lucky one who hears, "Please explain to these folks about our taxes and the accounting things that are going on and the reason why what the rating representatives see on the balance sheet really isn't the way it is." Can you explain all that to them? That's a lot of fun. That's one I try to duck and for which I rely on my expert actuary friends. You will find that there are some weird effects that somebody wants to understand and that you're going to have to explain. The final item in this educational process is explaining the role of the actuary, your role, in your company and in your company's management style. You have a lot of things you can contribute. You will be contributing that kind of in-depth insight into the company's characteristics and to its competitive position, its prospects and its financial stability, because you're somebody who knows about all those things. In addition, you would be providing a face-to-face contact for a rating agency analyst and the officers visiting your company. It's important for them to know and see the senior representatives of the major company functions.

Let's turn briefly to the second topic I promised to talk about, which is the ongoing relationship and the process of maintaining your ratings. This relationship with a rating agency is just that. It's a relationship like any of your other important business relationships. It should involve open and frank interchange of information and contact. Actually, it should be an advantage to your company for the rating agency to be well informed as to your company's plans, its management approach, its prospective areas of business, and even the kinds of problems with which you're dealing. They know you're dealing with problems, and you know you're dealing with problems, but there are also opportunities with which your company is dealing. How is it doing that?

You need to share that information. In the final analysis, you want to treat your rating agency just as well and carefully as you do your bankers, and for the same reasons. Once this rating relationship and the rating itself has been achieved, you should expect annual reviews and you should also be responsive and provide any important information that comes up during the year that would be of interest to the raters.

Let's go on to the third topic, the importance of ratings. Remember, it may be claims paying, it may be debt rating, or it may be some other kind of purpose which calls for a rating. Certainly, just to have the ability to conduct your business and to be competitive would indicate that a rating is important, particularly a claims paying rating. You need to attract agents. You need to have your policyholders and potential customers feel comfortable and good about the stability and strength of the company with which you'd like them to deal. Ratings have a role there. You may be looking for a competitive advantage, such as in the pricing of your GICs and the acceptance of that product. In addition, a good rating can minimize the cost of your nonpar deposits and liabilities. Again, GICs are the best example. So far, there hasn't been that much differentiation in the pricing of GICs based on quality, but that's changing rapidly. As you've heard from my compatriots it's becoming a much more hot topic, as I think it should.

In my area, the financial and treasury area, I focus very much on the importance of ratings as they relate to the cost and availability of debt capital and various kinds of financing mechanisms that we want for our financial flexibility at the company.

Finally, you may wonder about the last item, corporate self-image. Where does that fit in the rating process? Don't underplay it. I think we all are very interested in that and I think our senior managements are certainly interested in the corporate image that is projected by a rating, particularly a good rating.

Now, if I have done my job properly, I can conclude by summarizing the main points and the main messages I wanted to get across, which I hope sound familiar to you by this point. Ratings now are a much more compelling and frequent event. Doing a good job of getting and keeping a rating is important and it is very visible to senior management. I can tell you from experience and can assure you that senior management is very interested in the results of those rating decisions in which you will have had an opportunity to participate and contribute. The actuary is clearly a key player in this process. You are there to explain and educate, and to provide your professional stamp on much of the discussion that goes on with the representatives from the rating agencies. You are a key player. There is a significant payoff to both the company and to you, as actuaries, to be conducting the rating relationship effectively.

I hope these comments have been of some help to you as you get ready to be a primary participant in helping your company to get appropriate recognition for its rating and its quality.