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FINANCIAL CONDITION OF THE INDUSTRY -- A VIEW FROM RATING ORGANIZATIONS

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Panelists: TIMOTHY W. CLARK*
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- Deterioration in claims-paying ability and financial well-being of life insurance companies
- Benchmark surplus standards
- Key operating ratios
- Credit analysis of asset holdings
- Market view of stock companies
- Adequacy of capital in the industry
- Appropriate risk/reward posture in the industry
- Advice to management
- Outlook for the various businesses in which life companies participate (individual life, group, pensions, diversifications)
- Views on surplus relief devices

MR. DENNIS L. STANLEY: Rating organizations provide a variety of services to the insurance industry. We are going to focus on the claims-paying ability ratings. The claims-paying rating represents a view of the ability of the insurance organization to pay claims to its policyholders. The rating does not reflect a view regarding the debt repayment or the equity value of the company.

We have three rating organizations represented today: Duff & Phelps, Standard and Poor's (S&P) and Moody's. For each of these rating organizations, the insurance company pays a fee to the rating organization for obtaining a rating. Thus, obtaining a rating is voluntary for the insurance company. The ratings are based upon both public and private information provided by the insurance organization. There is extensive discussion between the management of the company and the rating organization during the rating process.

I think it is fair to say that marketing, from the insurance organization, has been the initiative for organizations to seek a rating. In particular, the GIC business has been a driver for the rating process, and I think we will continue to see marketing driving the expansion of the rating activity.

The first question I have for the panelists is to give their views on how they see their activity increasing in the future and whether they see the demand for ratings to expand. In particular, I see that individual life insurance agents may become more interested in providing broader rating coverages. Also, employers purchasing corporate-owned life insurance (COLI) can be another reason for expanding the coverage, and finally, financial institutions selling insurance may seek more independent rating information of the companies they represent.

MR. TIMOTHY W. CLARK: The relationships that the banks, savings and loans (S&Ls), and stockbrokers are getting involved in are with institutions that are not always household names but

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are specialty or niche providers of certain insurance products. Accordingly, there is the need to have an independent or third-party resource for determining the financial soundness of any insurance company that would be providing insurance products for banks, S&Ls, and stockbrokers.

MR. MILTON L. MEIGS: Given the litigious environment we live in, there is an increasing recognition of the need for greater due diligence. I think that's one of the factors that is going to drive the rating business, particularly from the perspective of the agent or the broker who is in the middle and subject to litigation in the event of an upset. I think that's a factor that's with us and is not likely to go away, hence it will drive the need for ratings. In addition, when you start to think in terms of COLI as a funding vehicle for post-retirement health-care benefits, the corporate manager who is used to having additional levels of due diligence or dealing with the rating agencies in connection with the placement of debt is going to recognize that his own corporation is about to make a major bet in terms of funding for the future, just as it has from the GIC perspective. I do think that in time the more sophisticated agents who are dealing with the major marketing groups, will demand that the super general agents (GAs), or managing GAs, have some input from rating agencies. Finally, in the structured settlement area there is clearly a demand from the brokers for rating diversity.

MR. STANLEY: What are your organizations' views of the overall status of the U.S. life insurance industry? In particular, consider the number of companies, the quality of the management, some of the consumerist attitudes that are driving the insurance business and having a pretty big impact, and the regulatory environment. Finally, and most interestingly to me, how do you view the insurance business relative to other financial institutions? I think we all tend to be fairly focused on the insurance business, since that's where our training and our work is focused. I think your views with respect to banks and savings and loans would be very helpful.

MR. MEIGS: As we look at the banking industry and the savings and loan industry, there are obviously major questions concerning asset quality and solvency. The S&Ls are a well-publicized situation. In that context, looking at the life insurance segment of the financial services business vis a vis the S&Ls and some of the banks, I think we would say that the life insurance industry, while not without problems, is in significantly better shape from an asset-quality perspective than those other financial institutions.

I'd like to comment on management, which is a hot button with me. When you look at the Wall Street analyst's approach to dealing with insurance companies, all too often the management of the insurance industry gets put down. I don't think that is appropriate. I happen to think that the industry has been a pretty well-managed industry over time. Indeed, when you compare it with the banking and the savings and loan industry, I think you probably would share my conclusion, notwithstanding the fact that you represent the life industries.

MR. ROBERT L. RIEGEL: From a global perspective, we see the U.S. life insurance industry as being very competitive and fragmented in relation to other industries. In the U.S., the top 100 companies account for 80% of the industry, whereas in Japan and Australia the top five companies account for 80% of the industry.

We do believe we are in the midst of unprecedented change in the regulatory environment. Some examples that come to mind are changes to the mandatory securities valuation reserve (MSVR), the continued development of the valuation actuary, and stronger requirements on asset/liability management. The other comment I'd like to make is related to the erosion of conservatism in statutory accounting. Historically, there was a large cushion between statutory surplus and the economic or true capital of the company. Over the last few years, statutory surplus has been enhanced through transactions such as surplus relief, sale lease-back of home offices, and sale of nonadmitted assets. Thus, the hidden surplus has eroded and that has caused us some concern in viewing the credit quality of the U.S. life insurance industry.

MR. CLARK: I think we will see a consolidation within the industry going forward. As Rob mentioned, the great fragmentation in the U.S. life industry and the changing financial picture for the industry as a whole suggests that over the next 15 years, you're going to see a continual rate of dropout in the number of players who participate in this business. Clearly, in that scenario only the strong will survive. In terms of quality of management, I would characterize management overall for life companies as improving, basically because the game has gotten tougher. There was a point in time when the markets were pretty well carved out, the product

development cycle was slower, and the margins were heftier. In that environment it was easier to "make a buck." These days, the rules of the game make it far tougher and, as a result, the quality of management has been significantly improving, basically in response to the emerging challenges.

In terms of consumerist attitudes, Proposition 103 hasn't hit the life industry yet, but there is increased concern about the value to the consumer of his or her insurance product. The day is going to come when life insurers are going to have to face more sensitivity on the part of consumers with respect to the products they are buying.

Finally, relative to other financial institutions, the insurance industry is strong. The insurance industry has its problems, but not to the extent that has faced the banks, or certainly the S&Ls. We see the life insurance industry as being a strong survivor, and I think that is reflected in the overall ratings differential that you see between the life insurance ratings and those of other types of financial institutions.

MR. STANLEY: One dilemma that has always intrigued me as I think about providing ratings is, how do you deal with all of the signals you can get when you look at a company? It just doesn't seem to me it's clear-cut that everything is going well within an organization. I'd like you to comment on how you deal with these mixed signals when you get a company that may have strong management or strong capital. In the following example, which factors are the most important to you and how do you balance the offsetting evidence?

	COMPANY		
	A	B	C
Management	Strong	Weak	Average
Capital	Leveraged	Strong	Average
Earnings	Improving	Good, but	Average
Distribution and Product	Strong	Weak	Average

MR. CLARK: When I look at Company A, Company B, and Company C, I think that a little knowledge is a dangerous thing. I wish our job was this easy, and we could just fill up this kind of matrix and then make our ratings. Looking at Company A, the first thing I see is a leveraged capital position. But you have the strong distribution which in my mind reflects a strong revenue-generating capacity on the part of the company, which is good. You see an improving earnings trend that would imply that a lot of business is being booked and that business is being appropriately priced and is staying on the books. If you have those kinds of factors, it's going to go hand in hand with strong management. Of course, someone might say you have strong management, but you have a leveraged capital position. Many managements feel beholden, rightfully so, to their shareholders, and accordingly they want to maximize the return to their shareholders, so they allow a more leveraged position. But overall, I'd say the financial profile of Company A would be a favorable one in our eyes.

With Company B, you have a situation that has historically faced a significant segment of the life industry. You have a situation where the capital base, which has been acquired over time, represents a strong foundation. But management has not been as responsible, let's say in the 1980s, to adapt to change and has not come up with the appropriate product at the right time that is appropriately priced. Accordingly, you see good but maybe weakening earnings. I see a scenario here with Company B where you have a relatively strong in-force block of whole life business that is throwing off good profits, but there are questions about the new business coming on the books. So Company B would be a company that we would be watching very closely.

Finally, when I look at Company C, I have, unfortunately, never seen a company that was average across the board. We see companies that have strengths and weaknesses, but when someone tells me a company is average, that just means in my mind that I haven't asked enough questions.

MR. MEIGS: I'd like to start with a quick preamble. A claims-paying rating is fundamentally a long-term rating, and I think that's critical in any sort of evaluation like this. So in the case of Company A or B, when we talk about earnings, for instance, if we have a company that is heavily employee benefits in character with a significant portion of managed health care in the indemnity sector, we understand that's inherently a cyclical line of business, and there will be factors that are going to drive that cyclicality. So the rating has to give recognition to the lines of business

that we're talking about. Clearly, I think in the case of Company A, the leveraged capital position, if you look at that from a risk perspective of surplus, on the assumption that we have in place a strong capital management plan and a strong asset/liability management, then fine, those are the realities of the place. If you're a mutual company, indeed that's where you're at probably, a leveraged capital position. With Company B, there is a perception from a recorded statutory surplus perspective, that we have a strong capital base. We know that in the environment we live in that it will be eroded if there has not been a proactive attempt to manage.

MR. RIEGEL: I'd like to add that I think these four elements are really interrelated and need to be analyzed together rather than as independent factors. Distribution strength, product strength, and management will drive earnings, and earnings will eventually drive surplus. I agree with Milt that our ratings are intended to be long term in nature, and thus we would not just assess the financial strength of the company and these elements, but we would try to determine what they would look like 5-10 years down the road. We also tend to look at downside risks as opposed to upside potential due to our conservative nature in ratings analysis.

Company A is undercapitalized. It would be vulnerable to any kind of asset default experience, adverse mortality and morbidity experience, and it also would be subject to constrained growth plans because of the poor capitalization.

Company B appears to be almost in a liquidation mode. It has strong capital, but its products are weak going forward and management strength is weak. With high distribution costs, poor management, poor product profitability, it's not going to be around for long. It will lose market share and see a slowdown in growth.

The one element of analysis that I believe is missing from these four factors is asset quality. A company could be strong in management, well capitalized with strong earnings, and have a good product portfolio and good distribution networks, but if its investment strategy is to invest in a lot of junk bonds, it would not be a top-rated company from Moody's perspective.

MR. STANLEY: What we're going to do now is go through a case company and look at various lines of business. We're going to try to hit individual life, group life and health, group annuity business, pension business, individual annuities (mostly single premium deferred annuity (SPDA) type annuities), and structured settlements. There will be a number of points brought up about these lines of business. I would like you to focus on the issues your organizations try to raise when they're looking at various lines of business. Also, I wouldn't focus on the actual numbers in these examples, but think more about the qualitative issues.

Let's begin with an individual life company or line of business. I'll call this a small-to-medium-sized company with the following characteristics: Sales -- $12 million, flat last three years, through captive agents; in-force premium -- $40 million (from $30 million five years ago); statutory reserves -- $175 million; aggregate lapses -- 11%, still declining from 14% peak; policy loans -- 18% of assets; excess expenses -- $5 million (relatively stable).

MR. MEIGS: As I look at this I see some pluses and some minuses. The fact that sales are relatively flat is not too disturbing because the trend for in-force premium continues to be moving ahead. I assume that the prior problem with lapses may reflect business that was rewritten. Assuming that that's behind the company, I think from those perspectives that things are probably in pretty good shape. I would worry about the excess expenses, and I think that would be an area of discussion with management, especially the strategies to be implemented in connection with excess expenses. Clearly, the nature of the products that are being sold and the profits that are assumed and being realized are critically important. One of the problems we have as an agency is that we usually do not have a good breakdown between renewal profits and the profitability impact of writing new business. So that's an area that we want to investigate. I think that 18% is probably a little higher than my personal preference would be for policy loans, and I would want considerable detail about the nature of the policy loans in terms of interest rates and items like that.

MR. RIEGEL: My first impression of this business line was that it didn't have competitive scale advantages with $12 million of first-year premium, $40 million of renewal premium. It would need greater economies of scale, greater business volume, to defray the development costs and administrative costs which are fairly typical in the industry for the universal life and

interest-sensitive products sold in the last decade. Our analysis of individual life business includes in-depth analysis of product profitability. We would look at the four elements of profitability: persistency, mortality, expenses, and interest spreads. The excess expense shortfall of $5 million is pretty significant for a company this size, but it may have gains from the other elements of pricing. The lapses of 11% have to be evaluated in terms of pricing assumptions and the market: term insurance, home service, or upper income type of products. The company's experience has to be compared to the assumptions used in pricing to determine if this product is profitable. Reserves need to be assessed in terms of the assumptions in the valuation basis: the interest rate, the mortality table, and the reserve method. Several companies have considerable hidden equity on in-force blocks if their reserves are on a 2.5-3% interest rate.

MR. CLARK: I think there are a number of facts you can look at in this mythical insurance company, but I tend to focus on the first and the last points. I see the flat sales through captive agents over the last three years and I see the excess expenses and the first question I have is, "How productive is this agent force?" To what extent are the expense overruns the result of an overstaffed home office versus a relationship between the home office and the agents out in the field that is being less than efficiently managed? Of course, as Milt and Rob have mentioned, you have to understand the mix of business: what it was, where it is now, where it is going, because the mix of business has a crucial impact on the future financial profile of this company. We've seen that the lapse ratio and the trend on it is not unusual. The trend is typical of many companies that have shifted from older traditional whole life products to interest-sensitive products as the older products go off the books. The question is, how is that being managed and where is it going? Along with the relatively high lapse history you will see the high policy loans. Also, the trend factors and how they are being managed is of critical importance. I think Rob gave a good summary of the various factors of profitability, and that's something that we would want to look at with this company as well as its capitalization philosophy for different types of products.

MR. STANLEY: Let's move on to the group life and health business, which has the following characteristics:

- $200 million premium, growing at 8%,
- Market niche is stop-loss coverage,
- Combined loss and expense ratio:

1984	89%
1985	86
1986	92
1987	102
1988	104

- Earnings and growth prospects look good for 1990

MR. RIEGEL: The first point to make here is that Moody's does not feel that $200 million of premium is sufficient volume to remain competitive. We believe, in general, about $1 billion of premium and premium equivalents is essential to remain competitive through the down cycles of the group health industry. The industry is very automated now, and strong claim systems have to be in place for underwriting, claims administration, claims management, and utilization review.

The second point to make is that group health is a cyclical business and that the results have to be evaluated in that light. The fact that in 1987 and 1988 the expense and loss ratio was above 100% isn't necessarily bad because the whole industry was above 100%, and this company really has to be compared to its peer companies. Likewise, good prospects for 1990 wouldn't necessarily imply a rating upgrade because the whole industry is turning around now in group health, and we do expect strong profits next year.

The third point to make is that the company's premium is growing at 8%, but in 1988, trend factors were up around 22-24%, and premium increases were up 30-35%. That implies that the company is losing some cases, and its premium revenue in relative dollars to the premium adjustments is declining. The fact that it has a market niche position in stop-loss coverage is good. In general, Moody's feels that companies strong in administrative services and minimum-premium-type plans are good, along with companies that have minimized their exposure to fully insured indemnity-type business. Other things we need to look at are what type of groups it's writing to: the small-case, volatile multiple employer trust (MET) business, or the large-case accounts? What

type of reinsurance coverage does the company have on its stop loss? We'd also like to know its strategy and positioning for managed health care because we feel that's important in the future.

MR. CLARK: I think when looking at this group life and health insurer, the growth factor on premium is important, and a growth rate of 8% implies either a trend factor problem or a problem in terms of holding out in the business. Also, in the stop-loss market we have been seeing some leveling out or even a slight decline in combined ratios for the strong players within the industry. So if this company had a further deterioration in the combined ratio, I think there is potentially a problem that has to be looked at very closely. Whether or not this company is a survivor within the industry with $200 million of premium is not clear. There is the possibility that this company could continue to survive as a niche player, and in that environment if it has geographic isolation and a strong knowledge of the local market, it could have a relatively successful company. Critical mass is one of the names of the game in the group life and health business, and those companies that have more significant market shares through which they can offset the high up-front administrative expenses will be long-term survivors.

Finally, it's a given for the industry that earnings and growth prospects look good for 1990. The big question mark that we haven't resolved is what's going to happen with this company in 1991, because potentially that could be the start of another downturn.

MR. MEIGS: I was intrigued by this set of numbers, and while I share the concern about having critical mass to be in this segment of the business, it appeared to me that it was a well-defined niche. The average combined ratio for the period shown is, in my judgment, somewhat better than average relative to the industry for that period. Given the fact that we're saying that the earnings prospects for 1990 are favorable, I would say that at least from an underwriting and pricing perspective that this is probably a solidly managed situation. The issue, of course, is that the business does appear to be declining in terms of the rate of premium growth vis a vis the trend factors that are pretty well-documented. I would say it's an interesting business, and I would want to know the strategy for trying to preserve the market niche and whether the company would stretch itself to do something different than it has historically.

MR. STANLEY: In group annuities, the company is a relatively small player. It has a home office sales force and some group representatives out in the field, and the brokers it works with generally view it as a consistent player. The business has the following characteristics:

- Three basic markets
  - GICs — $125 million
  - Terminal funding — 40
  - Deferred company — 45
- Assets at $850 million
- Brokers view quotes as consistently respectable

MR. CLARK: When you get to the area of group annuities, I think a qualitative understanding of what's going on with company management is important. If you compare the GIC number of $125 million to the assets of $850 million, it seems that this company has been growing fairly rapidly, and my concern is whether the controls are in place. All GICs are not created equal. Are these bullets or windows? How are the different types of contracts managed within the company? What types of asset/liability management strategies are in place to immunize the company against swings in interest rates? How are the policies being sold? Then, since they are growing fairly significantly, what is the quality of the assets that are being put on the books? You have stated that the brokers view the quotes as consistently respectable. I'm glad the case didn't include a company that was consistently in the top quartile or the top three quotes on the screen every day, so it implies some reasonableness. We also have to understand the components of the pricing. What kind of spread is this company receiving after risk charges on the various types of annuity contracts? Going forward, what kind of sales can we expect from this company in the future, and what strains might that impose upon the company in terms of its capital base? We see the GIC market as being an area that has quietly eaten up a lot of capital over the last several years. Some companies have loaded up on this business, assuming that it was very safe and required next to no capital, and the results have proven otherwise.

MR. MEIGS: When I looked at this, the thing that immediately came to mind was asset/liability matching, particularly with regard to the terminal funding and deferred company business. I

think one of the things we worry about is the ability of the industry to generate good-quality long assets. That would clearly be an area of inquiry. For the GICs, we would want to know the underwriting criteria. What is the liability structure of the GICs? I agree that asset quality would be a major area of inquiry, particularly if this business had been recently put on the books, including what the asset strategy had been. Those are the critical areas that we would be concerned with and the result of our inquiry would be some sense of how much capital is required to support these liabilities.

MR. RIEGEL: I think Tim and Milt covered most of the areas that we would need to discuss with company management. The one thing Moody's would focus on is capital management for the segment. We see several companies today saying they will only underwrite GICs with a 15% return on equity. Well that's because they're writing this business at a 2% capitalization level, and that's how they're getting the 15% return on equity. Companies price the GICs with maybe 75-basis-point pre-tax profit margins. We see most of the industry with after-tax net returns of 10, 15, maybe 20 basis points. Those are very slim profit margins for the exposure to the interest-rate risks and the asset-quality risks that a lot of companies are taking.

MR. STANLEY: Let's move on to the individual annuities, which the company has been selling for about three years. Its product is not particularly competitive in a short-term sense because it is paying high commissions and has high surrender charges, although it has structured the product so that the interest rate is competitive with other products. It has designed the product, hopefully, with a long-term view to be able to afford to pay those high commissions. It has focused on five-year interest guarantees, which are creating some fairly high reserve requirements, and because of its capital structure, the company is considering surplus relief to get rid of some of that reserve burden. It has been a long-term and junk bond investor in order to get its spread, so it has chosen to play both games -- the quality game and the mismatch game. The characteristics of the individual annuities can be summarized as follows:

- Mostly SPDAs at $75 million sales through agents
- Assets at $175 million
- High commission/surrender charge product
- 5-year interest guarantees -- $6 million additional reserves
- Considering surplus relief
- Long-term investments -- roughly 20-year bonds
- Approximately 20% of assets are in high-yield bonds

MR. MEIGS: Let me start with the issue of high yield and the length of the bonds. I would be very concerned with the asset exposure of 20% on high-yield bonds on investments made in the last three years. If the SPDA program has just been inaugurated in the last three years, I think the company's chances of getting in trouble are probably fairly good. If you're going to take an asset quality exposure, then the other side of the coin is you really have to be matched. Notwithstanding the fact that you're selling this through your own captive agents and presumably the money wouldn't be quite as hot as if it were stockbroker money, I think the mismatch risk combined with the asset-quality risk really would be scary. The high surrender charges do not give me any comfort. If you've been around the business long enough to remember when the prime was up in the 20s, you will realize that high is a relative thing. It may be high today, but who knows about tomorrow?

Our attitude on surplus relief is that we certainly give credit there in terms of our analysis of surplus that the company has on hand, but what we're interested in is a longer-range capital management plan and what the plans are for payback. Is this something that you're entering into with no hope of seeing the end of the tunnel? What are your strategies?

MR. RIEGEL: I agree with Milt, that the key issues are asset/liability management and asset credit risk. We view long-term guarantees such as the five-year interest guarantees as negative. Twenty-year bonds could be called, or if backed by mortgages, they could prepay. Another factor to consider is the reserves set up for this company. Are they holding full account values or are they holding just cash surrender values reflecting the surrender charges?

With regard to surplus relief, Moody's tends to look at the economics and not the statutory reporting requirements. We feel the company is paying for its surplus relief, which we view as a negative, and we back out surplus relief from any capitalization analysis. The high surrender

charge is good, but you have to look in the contract for bailout provisions and the likelihood that the bailout will be pierced.

MR. CLARK: I'll join my panelists in jumping on the asset-quality and asset-management bandwagon. As Milt mentioned, when you have a situation where a company is taking bets on both asset quality and asset/liability management, it seems that the risks are excessive. If I were going to bring this company to a rating committee at S&P, the first question everybody would ask me is, "Why?" This seems to be the profile of a lot of business that just doesn't make sense. It would appear that the company has taken an opportunistic view of the SPDA market, jumped in with both feet, and there is no evidence that the products are appropriately structured to meet a variety of different interest-rate scenarios or that the ultimate profitability will be worthy of the investment. We would also look at the surplus relief in terms of the cost and what the impact would be on the long-term return and the long-term capital position of the company.

MR. STANLEY: The last line of business is structured settlements, which the company has been in about five years. It has written a fair amount of substandard lives and been somewhat aggressive on its mortality rating. Part of my reason for having the SPDAs with the long-duration assets was that intuitively the management people have viewed that there are some offsets between structured settlements and SPDAs, although they haven't been very scientific in their approach. The characteristics of the structured settlement line can be summarized as:

- Sales at $250 million
- Assets are $1 billion
- Respected by several major brokers
- Market niche is substandard lives
- Initial interest margins are locked-in for 15-20 years
- Reinvestment risk is not directly reflected in pricing

MR. RIEGEL: This appears to be the company's largest block of liabilities and its primary source of premium revenue. Similar to GICs, Moody's views structured settlement annuities as a commodity-type wholesale product with little value added by the companies due to very slim profit margins. There are two significant risk exposures to the company active in this market. The first is asset/liability management risk. Structured settlement annuities can have liabilities up to 50 years, and the duration of such liabilities could be 20-25 years. In today's financial markets, we do not feel there is any investment that has a duration of 20-25 years. Anything purchased now would be called, prepaid, or matured before the liabilities would go off the books. Therefore, it's really impossible to lock in spreads. One positive factor about structured settlement annuities is there is no disintermediation risk on the liability side, since the annuitant cannot take out his funds. One other consideration we need to look at is the asset quality. We've seen several companies follow an aggressive investment strategy to support the structured settlement annuities. We've seen some companies in their pricing assume 8% after 20 years, which is just not realistic or conservative enough for the insurance industry.

The second major risk here is the underwriting of the substandard or impaired lives. We see varying degrees of conservatism in the pricing on the mortality side. We try to assess the qualifications of the doctors and the underwriting conservatism of the company, whether it be through an in-house physician or an external doctor. As Denny said, there are some benefits to a combined asset/liability management strategy, although I would not think it's SPDAs and structured settlements, since we view SPDAs as long term. We might look at the GICs because they are short term, and SPDAs and structured settlements are long term.

In conclusion, we would say that we don't look favorably upon companies that are putting large amounts of these liabilities on their balance sheet. It's going to take several years before the company knows if it's profitable because of the mortality experience and the interest-rate risk exposures, and by that time it's too late to get the liabilities off the balance sheet.

MR. CLARK: This is a company that has been growing its structured settlement business very rapidly, and accordingly, the first thing S&P would look at is the experience of the management team who is responsible for the structured settlement book. If this business is being put on the books as an accommodation to help out a potential asset/liability mismatch situation that exists on the individual annuity side, we have some serious questions. To the extent that the people involved in the senior capacity have longtime experience with the business, maybe there is a more

positive aspect than the company's financial track record would suggest. However, when you look at the fact that the market niche is substandard lives, you're getting into an area of very high risk with a great deal of uncertainty. A structured settlement product has to be underwritten extremely carefully, and we would be questioning a company very closely on the company's underwriting procedures. Also, given the duration of these structured settlement liabilities, it's difficult to find any type of asset that even comes close to matching these liabilities. We would be questioning the company very closely as to the level and sophistication of its commitment to asset/liability management.

MR. STANLEY: Now I would like to present some general information about the company, and we can get into the more subjective areas, where the panelists might bring up some of the hot buttons that come to them. The additional information is:

- CEO's background is individual life, with strong commitment to the career agents
- Other than individual life, product line managers have a good understanding of their business
- Parent company is somewhat leveraged -- expectation of $10 million of annual dividends
- Management has a weak capital management plan
- Asset/liability management is informal

MR. CLARK: Four out of five of the additional points represent potential negatives for this company. First of all, in terms of the background of the CEO, it's not enough for me to know that the background is in individual life with a strong commitment to the career agents. What is that individual's strengths in terms of now being a general manager? It's one thing to effectively manage an individual life book. When you take over responsibility for being a CEO, who has fairly significant involvement in individual life, structured settlements, individual annuities, and group life and health, you've got a relatively diversified organization that needs different kinds of management skills. S&P would be questioning the CEO very closely as to strategically where the company's going, that particular CEO's management style, and the qualitative, strategic, marketing, and business goals for the organization. We're heartened by the fact that the product managers have a good understanding of their business, but I would say that their understanding of their business is somewhat incomplete. If asset/liability management is informal and management has a weak capital management plan, it implies that the product line managers can sell the business pretty well, but they're going to let someone else worry about the balance sheet impact. We at S&P would be very concerned that this company is writing individual annuity business and structured settlement business with an informal asset/liability management plan. We'd also be very concerned that capital management would appear to be conducted on the back of an envelope. The fact that the parent company is leveraged represents another risk to this company because the parent company will potentially be making demands on the insurance company that will diminish its long-term viability as a trade-off for obtaining short-term cash flow.

MR. MEIGS: I think the first point is interesting, the CEO with an individual life background and commitment to the career agency system. One of the critical issues that faces companies with regard to the individual portion of the business is the cost of distribution and agent relationships. As we look at the balance sheets of companies and the demands for capital adequacy, one of the issues is profitability. I think that when we have companies that are driven by an agency force that is still living in the past in terms of its compensation, we've got a potential problem. So that is an area that would need considerable examination on our part with regard to the company's attitude towards the distribution costs and relationships with the agents.

I think the fact that we've got a parent company that's leveraged says a couple things: we've got a stock company here, and presumably that means that the company has access to the capital markets with the ability to bring in additional equity. The fact that it's paying a dividend to the parent holding company cuts both ways from our perspective. Yes, we're concerned with leverage, but we're more concerned with the ability to raise capital if the circumstances warrant that. The last two points, the weak capital management plan and the informal asset/liability management, would suggest that maybe this is a company where historically senior management has come up through the marketing ranks and the culture of the company has been one of sales and growth as opposed to financial management and profitability. That is somewhat of an anomaly in terms of being a stock company because stockholders have a way of shaking the tree a little harder than the mutual policyholders.

MR. RIEGEL: Looking at the combination of this information, the profile of this company is pretty typical of the industry. All its growth is in the pension and annuity lines, and it has weakening positions in its individual life and group life and health segments. I think it's a negative that the president has an individual life background and strong ties to the agents because it seems like the company needs to restrategize its position. Is this the core business that it wants to continue? It definitely has to reduce its overhead costs on the individual life side, including distribution costs, and a president with those kinds of ties might hesitate to take such action. The parent company financial leverage would be a key consideration also. For a subsidiary company of a stock holding company, we do evaluate the claims-paying rating of the subsidiary in terms of the debt rating at the holding company. We consider management's plans and the possibility that it may leverage up the holding company further and require additional dividends from the operating company. The fact that the holding company might be subject to a hostile takeover, or a management buy out, or other event risks would also have to be considered in the rating of the debt and the claims-paying rating.

MR. STANLEY: Some of the data I've given you didn't hang together very well. In particular, with the business growing rapidly and some fairly capital-intensive lines, we also had dividends going up to the parent, so I don't see how this company would have actually been able to afford to put on this business. Intentionally, I haven't talked about how much capital this company has, or what the earnings have been. I'd like to come back to the panel now and ask, if this company were going to get a strong rating, what additional information would you want to see to make you feel better about it? I've intentionally not defined "strong," but might think in terms of an A rating or thereabouts. I don't think I've heard real positive comments about the company thus far. Some examples of what you might want to see would be:

- Level of statutory capital and surplus
- GAAP earnings
- A capital management business plan projection
- More asset/liability management planning

MR. MEIGS: I think initially we would want to see a business plan. If this company has a five-year plan, it is probably on the back of an envelope. A strategic plan that focused on the company's long-range direction would be an area that we would want to explore with management. I also think that if the informal asset/liability planning were corrected tomorrow, the problems would already be there. The odds are that the rating would be preordained, in the context of asset/liability management, notwithstanding additional information.

I assume that the company, given that it is a stock company, would have GAAP earnings available if it is SEC reporting. As a general comment, we very much like to see GAAP earnings, whether we're talking to a stock company or a mutual company, and increasingly we're finding that the mutual companies do their own internal modified GAAP. We think that's an important area of information to have available.

With respect to statutory capital and surplus, we at Duff & Phelps have not devised our own methodology for telling companies what we think their target surplus should be. We do expect that the companies can articulate their views to us. From the information we have here, this is an area that this company has not dealt with, and therefore it would cause us concern. We see surplus as serving a number of masters, including risk and growth. A claims-paying rating is not just an issue of solvency in connection with a company that's in a runoff mode, but goes to a company that's a viable entity. The resources that management sees available to it in terms of the surplus that the company has are critical. We've heard some comments earlier about the potential redundancies within the company. I tend to share the view that the quality of companies measured from a statutory perspective and the quality of their surplus is indeed declining.

MR. RIEGEL: One element of analysis that I think was missing from this case study was a complete review of the investment portfolio. That would be critical before we could assign a claims-paying rating. We look at asset types, industry concentrations, geographical concentrations, past performance, and expected performance of the whole investment portfolio.

In terms of earnings, I would say Moody's focuses more on economic earnings as opposed to reported statutory earnings, where economic earnings are GAAP, modified GAAP, or value-added statements. We also try to get an indication of economic capital through the market value of all

assets and liabilities. I said before that the industry's cushion between economic capital and statutory capital is eroding, and that's causing us concern. It's not really appropriate for us to say what level of capital is necessary for a company of this size and type of operation, but we look at two ratios: capital to assets and the risk-adjusted capital ratio. The risk-adjusted capital ratio relates the actual capital to a target or benchmark capital, where this hypothetical amount of capital is related to the different risk exposures of the company such as asset quality, mortality, morbidity, and interest rate. We feel that this ratio is more important than a strict capitalization ratio. The trend in a company's capitalization and risk-adjusted capital ratio is often as important as the absolute numbers because there are quirks in a company's organization and its statutory reporting. I think a strong capital management and strong asset/liability management plan has to be put in position for this company given its historical growth in pension and annuity lines and the threats to it in the future.

MR. CLARK: I won't comment on asset/liability management planning because I think the other members of the panel have taken care of that pretty well. Essentially, more planning is needed, and we need to see further evidence as to what progress is being made. We were told earlier that the company has a weak capital management plan, so we would need to see some change of heart with respect to the level of sophistication. With respect to earnings, it's not just enough for us to have statutory or GAAP earnings. We need to understand the components of profitability for each line of business, and then obviously the whole is equal to the sum of the parts. To understand both the strengths and weaknesses from a company's earnings capacity perspective is very important to us at S&P.

In terms of the level of statutory capital and surplus, I'd love to be able to add up all these numbers and divide by 6.2 and tell you that the target capital level is a mythical amount. I'm afraid I can't do that. We would certainly be very sensitive to the capital needs of the company depending on the mix of business, and we track shifts in mix of business in looking at capital. We also look at potential obligations for an insurance company, such as other contingent liabilities. Insurance companies have in the past rented their balance sheet out for other purposes and often it has not been appropriately reflected. So we would try to bring all those contingencies back on to the balance sheet, to see what the economic impact could be to the insurance company.

MR. CHRIS H. MCELVAINE: I have a question regarding a turnaround situation. Suppose you have a company that has had a strong rating, but through exposure to a new line of business has a significant erosion of earnings. As a result, it loses its strong rating, the organization changes, the management changes, and finally the line of business is terminated. What sort of prospective versus retrospective approach would the rating organizations take to reviewing that rating?

MR. CLARK: The scenario is, there are a couple of flip-flops: you had a strong rating which has basically been lost as a result of the new line of business that deteriorated and then everybody was, I guess, terminated. Now, where do we look at things in the future? By solving the problem we would not immediately say, "Congratulations, you get your old rating back," because 1) a mistake was made by management, and 2) we would have to understand what the future business plan of the organization would be. Over time and in an orderly fashion, I think there potentially would be some consideration to raising that rating back up to where it once was. But our reaction to cutting out an unprofitable line of business that had previously hurt a company is that it does not automatically result in a rating change.

MR. MEIGS: I'll basically say that once a company has been downgraded, it takes time to come back. If I recall the elements of the question, I think there was management change and it's going to take time for the new team to prove itself. Although the scenario laid out would be hopeful, it would take some time.

MR. RIEGEL: I'd agree with Tim and Milt. I think it would be a negative that management made a mistake, and Moody's might hold it against the company. If management did it once, it could do it again. If there is a complete shift in management, obviously that would be factored in also.

MR. PETER S. KREUTER: It seems typical for companies' older blocks of business to have had a much larger margin than the newer business being written. I'm wondering whether in effect that means that the older business is supporting the claims-paying ability of these companies, and whether we can expect to see deterioration in their claims-paying ability and in their ratings as the older business begins to go off the books.

PANEL DISCUSSION

MR. CLARK: Overall, our trend of ratings from 1986 to the present has been downward. Have companies historically benefited by the wider margins on the older blocks of business? The answer, clearly, is yes. We're talking about a claims-paying ability rating, and to the extent that an appropriately priced product throws off statutory profits, it would imply that historically a company has benefited from that. To the extent that a company starts building on lower-margin products, a rating downturn would not occur immediately, but it would suggest that we have to look at the company very closely to ensure that the new business that's being put on the books is being appropriately managed with respect to earnings. If the company is putting on lower-margin business but is being appropriately managed, the ratings will be maintained because we're also hoping for the same kind of companies being very prudent with respect to managing growth rates, capital, asset/liability management, asset-quality structure, and all those other factors.

MR. MEIGS: I don't think there's any question that the profitability of the old in-force blocks has certainly subsidized the industry and companies as they've moved into the newer products with the lower margins. The real issue going forward is not so much the subsidy and when it will run out, but what you think of the ability of the company to go forward with the existing products which are the reality of the industry. Those judgments will be made prospectively and recognize that the in-force business was there as a subsidy to cover a period of change.

MR. MICHAEL PALACE: Suppose a company recognizes that its expenses are too high on the individual life segment and puts into place very significant expense controls that do not show up on a statutory or GAAP basis immediately, but do under a value-added scenario. Would you ascribe much credibility to that kind of scenario?

MR. MEIGS: I've been around the insurance industry for a number of years and I've seen various companies implement programs to control expenses, and they certainly are appropriate. In terms of the credit that I would give to a program like that, it would be, "Yes, this is great, and now I've got something I want to track specifically with you going forward." I would tend not to be too prospective with regard to that.

MR. RIEGEL: Our ratings are intended to be long term and prospective in nature. A plan with numbers on a piece of paper showing expense reductions isn't going to get the company upgraded, but it is something we will monitor with the company, and in theory, expenses may turn around ahead of reported statutory earnings. If we do see material evidence of expense reductions, we won't wait until the earnings improve but would consider an upgrade.

MR. STANLEY: Sounds like everyone here is from Missouri, and wants you to show them first.

MR. CLARK: I'm thinking back to our case example where we had a $5 million expense overrun, and suppose over a period of five years that was to be reduced to zero. It's not just enough to have someone produce a brilliantly colored chart that shows this expense overrun declining to zero. We want to know the how and the why, and we want to understand the probability that indeed this goal is going to be met. I think we would track it on a year-by-year basis, but just the production of such a plan wouldn't in and of itself warrant a rating change.

MR. THOMAS G. KABELE: Could the panel comment on the use of special-purpose corporations to levelize commissions?

MR. MEIGS: You really have not changed the fundamental economics of the business, and I think that if the regulatory hurdles can be dealt with, that it makes sense as long as you've got banks that are willing to play. The problem with these things is that someone gets in with a good idea, conceptually handles it well up front, but then too many people get in the parade and we start to have problems.

MR. CLARK: S&P has had the opportunity to look at several of these arrangements whereby special-purpose corporations were set up to finance or levelize commissions. You have to look at the recourse involved from an economic basis. It's not enough to say that the insurance company has no recourse, but the shadow corporation has an economic affiliation to the insurer. In that situation, you have a family of risk that has to be accounted for. We look favorably upon nonrecourse financing where there is an unrelated entity providing that financing. To the extent that the structure is appropriate, we are potentially ratings-neutral on that. I don't know of a situation where we've actually gone ahead and raised a rating as a result of such a situation. I

also don't know that we've actually lowered a rating in one of those situations, because to date the only plans that we have seen have been appropriately structured plans.

MR. RIEGEL: From our perspective, it doesn't affect the economics at all. The company has to pay for that type of structure with the third-party participant, which would be a negative. It's also a negative in that the conservative nature of statutory accounting is weakened, and the regulator should be concerned about that. If the company is doing it to enhance statutory surplus to fund future growth, then it obviously depends on the profitability of the business it's writing and we would look at that.

MR. BRUCE R. DARLING: With so many aspects of the organizations to examine, it seems that the rating has to be somewhat subjective according to the analysis of the individual analyst. Within each of your organizations, how do you maintain consistency in your ratings from company to company and over time from year to year?

MR. CLARK: Different analysts within S&P obviously follow different companies and get different firsthand experience with different segments of the industry. When we determine our ratings, it's done on a rating committee basis. Accordingly, we bring into the room people with different levels of expertise with different lines of business. Also, we have people within our area who are very strong in certain aspects of annuities, others who are very strong in certain aspects of group life and health, others who are very strong in individual life. So through, I'll characterize it as a collegial discussion of the strengths and weaknesses of a company, often comparing those various aspects of that company to other companies which have already been rated by S&P, we feel that our process brings out a certain consistency in our ratings on a year-in, year-out basis.

MR. MEIGS: I think that at Duff & Phelps we've been fortunate in that we've had a relatively low turnover of key people in our entire credit rating division. That's probably a function of our growth and opportunities that have been afforded to people in recent years, and it'll probably be more of a problem in the future than it has been in the past. We keep the same people involved with meeting with the senior managements of the companies from year to year so that we have continuity, and you're not looking at strange faces among those who are actually making rating decisions.

MR. RIEGEL: From Moody's perspective, there are always at least two analysts at the review meetings with the companies so that there is a difference of opinion presented. At our rating committee, there are usually four or five analysts, the associate director of the insurance group, and then also the associate director of the financial institutions group, of which the insurance group is a part. That is to make sure that there is consistency between an A-rated insurance company and an A-rated bank, and I think that's important since Moody's is rating all types of industries.