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THE RATINGS GAME

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- What have been the emerging trends in the financial condition of the life insurance industry?
- How is the financial condition of a company determined by the rating agencies? What aspects of the rating are subjective rather than objective? How reliable is the analysis in evaluating the current and future strength of a company?
- How well have the rating agencies detected or anticipated changes in the financial condition of individual companies?
- Are the current techniques and structures for evaluating companies adequate to provide an early warning of developing problems? If not, how must they be improved and what role can actuaries play in securing improvements? How effective is the current statutory statement as a tool for identifying and measuring the risks assumed by insurance companies?
- What influence does one agency's evaluation have on a second agency's evaluation of the same company?
- Who are the primary users of the ratings -- individual consumers, portfolio managers, lending institutions?
- How do the ratings affect companies?
- How well have the IRIS tests called attention to companies which deserve attention? Have they increased the effectiveness of the regulators?

MR. MICHAEL E. MATEJA: I'm vice president and corporate actuary of The Aetna. Our panel includes Larry Mayewski who is vice president, life and health, of A.M. Best; Bob Fillingham, Senior Analyst with Moody's; and finally, Dick Robertson, Executive Vice President of The Lincoln National. Mr. Fillingham and Mr. Mayewski, whose companies are really big players in the ratings game, will respond to the various questions in the program from the raters' perspectives. Mr. Robertson will represent the company point of view as one of those being rated. There was a time, going back many years ago, when A.M. Best was the only rater of life insurance companies. It seems that everybody is doing it, and there appears to be some hot debate among the raters themselves as to whose approach is best. I expect our panelists will have some interesting commentary on recent events and will say exactly what their ratings are designed to do.

Solvency and financial strength of life insurance companies in particular are now front-page news, and ratings are meeting what appears to be a critical public need to sort

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out the financially strong and weak companies. From a distance, at least, rating of life insurance companies looks like a real growth industry. The primary area of interest in this session will be the class of ratings focusing on financial strength or claims-paying ability. There's undoubtedly some correlation between such ratings and debt ratings that are sought by companies issuing bonds or commercial paper. However, the latter ratings apply to a relatively limited number of companies. All ratings are judgments about some combination of objective criteria and subjective evaluations of a company's performance or financial condition. The objective criteria are derived from the NAIC statutory blank. Now, the blue blank is the official regulatory assessment of the financial condition of an insurer, but even the NAIC has recognized that the blue blank has serious shortcomings in terms of presenting an accurate picture of financial strength.

As you are no doubt aware, the NAIC has a task force charged with the development of risk-based capital standards. I am a member of the industry task force or advisory group, and it seems clear from the work completed thus far that the blue blank has severe limitations when it comes to measuring the real financial strength of an insurer. This leads logically to the question about the reliability of any ratings based on the statutory statement. Are they really useful, and do they really serve their intended purpose of measuring financial strength? Maybe we'll find out. Any discussion of ratings raises the specter of insolvency, and during the past 10 years the insurance industry has witnessed two major insolvencies. Baldwin United was a casualty in the early 1980s, and Executive Life is currently under regulatory control, and now the First Capital Companies could be added to this list. These companies were highly rated at one time, and they were the darlings of Wall Street. What lessons, if any, do these failures provide about the use or interpretation of ratings in general? Quite obviously, there are many interesting questions and issues surrounding the issue of ratings.

MR. LARRY G. MAYEWSKI: I will address Best's ratings and general rating philosophy, the financial condition and trends of the life/health insurance industry, and the characteristics, causes, and A.M. Best's rating track record relative to insolvencies within the life/health and property/casualty industries.

The A.M. Best Company has been engaged in the business of preparing financial reports and evaluating the operating and financial performance of insurance companies since the turn of the century. As I'm sure you are aware, Best's ratings involve both a quantitative and qualitative analysis. The quantitative review focuses on the areas of profitability, leverage, and liquidity. The qualitative factors evaluated include a company's spread of risk, the amount and soundness of a company's reinsurance, the quality and diversification of investments, the adequacy and valuation basis of policy reserves, the regulatory environment surrounding a company's products or marketing characteristics, the financial position and operating relationship with the parent company, and the experience and track record of management. During the past 80 years, we have developed close working relationships with the managements of the insurance companies on which we report. We are in frequent, year-round contact with many managements. Insurance executives representing more than 1,000 companies visit our senior staff each year to discuss financial and operating aspects of their performance. Obviously, this knowledge of the character and

operating philosophy of a company's top management plays an important role in our continual evaluation of the performance of an insurance company.

In our view we have no doubt that insurance is a more difficult business than it was a decade ago. Over the past several years the qualitative aspects of our analysis have taken on much greater weight in the rating process. Although a company may meet or exceed all quantitative measures required for a particular rating classification, a lower rating may be assigned because of various qualitative concerns. It is our intention over time that all A+ rated companies will not only maintain a strong financial posture but also will fare well from a qualitative perspective. Recently, there has been some discussion that the A.M. Best Company has been lenient in the assignment of Best ratings. We believe that this premise is inaccurate and very misleading without fully understanding A.M. Best's rating philosophy and role in the industry vis-à-vis the other rating organizations.

A.M. Best's ratings are long-term and policyholder oriented, and as a result, shortterm fluctuations and a company's performance may not precipitate an immediate rating reduction. An integral part of the rating process is the review of a company's business plan, including management solutions to the current issues and problems at hand and projections of financial performance, including key assumptions for the foreseeable future. We do not rate with a short-term, Wall Street type of mentality. Movement of ratings up and down based on relative short-term fluctuations and performance or downturns in the market can create a tremendous amount of instability and breed confusion and panic in the marketplace. Let's face it. A rating reduction or poor rating from any rating agency can wreak havoc on a company's marketing activities and, in some cases, the persistency of its in-force block of business. As a result, we do not take rating declines lightly. If financial deterioration is modest or a company has developed a plan to address its problems in a reasonable amount of time and in a reasonable manner, we may not reduce a rating immediately. Although the company's relative position may have weakened within its particular rating category, the lack of a rating reduction by A.M. Best sometimes elicits the appearance that we are unaware of a company's problems or unconcerned. I assure you that this is not the case. Obviously, if a company's financial deterioration is significant and cannot be rectified immediately or the time frame for improvement is unacceptable, a rating downgrade is then appropriate.

Perhaps a more appropriate criticism of the A.M. Best Company is that we have not fully communicated to the marketplace the specifics of why a particular rating is maintained or reduced, and what steps are being taken by a company to improve its relative standing within a specific rating classification. While we completely respect the confidence with which information is provided to us, owing to the dynamics in the industry, we hope to address this problem through increased communications to the industry in the form of press releases and articles that appear in our weekly newsletter in such a manner, however, that does not disadvantage a company.

As a point of note, I'd like to reference the fact that as of the beginning of this week we had approximately 45 insurers (or 6% of the rated companies) carrying contingent ratings, which indicate that if the company's financial position does not improve, a rating downgrade will be assigned. In addition, we have nearly 55 companies on notice that their relative position within a rating classification has weakened, and if the

trends continue, maintenance of their present ratings will not be appropriate. It is also important to note that as of yesterday we had reviewed the 1990 year-end results and, in some cases, first-quarter financials of 450 alphabetically rated companies. Of this group, approximately 60 insurers have had a ratings downgrade or have been targeted for downgrade by Best, while only two companies' ratings have been upgraded. Many of the rating reductions are due to balance sheet deterioration. However, if capital is the sole issue, companies targeted for downgrade will have the opportunity to infuse additional funds before we close out this year's rating review.

Many people would like to see greater differentiation in our ratings. As alluded to earlier, the A.M. Best Company has been making distinctions internally within each of our rating grades for several years. We firmly recognize that all A+ companies are not created equal. Recently, the A.M. Best Company has been exploring the possibility of publicly providing some type of numerical or alphabetical differentiation to distinguish the top-of-the-line companies from the borderline players within each rating gradation. What is interesting is that companies who believe that they are stronger than their peers and state that they deserve recognition for that, rescind their statements when they are told they will not be in a class of the State Farms, Northwestern Mutuals, or Guardians of the world. Obviously, you cannot please everyone.

The A.M. Best Company believes that a great deal of confusion exists regarding the ratings assigned by various rating agencies. Each agency has a certain philosophy which they apply in the rating process. The weight assigned to the quantitative and qualitative aspects of a company's operation in determining a company's rating differs between rating agencies. In addition, each organization has a unique rating classification system. A.M. Best has six rating categories above what we would consider investment grade or secure, it's A+ through B−, while Standard & Poor's (S&P) and Moody's have approximately 13 and 10 rating options in a secure or investment grade arena, and that includes their plus or minus or one, two, three designations. As a result, a strict comparison of ratings across agencies without a full understanding of their rating procedures, philosophy, classification systems, and target audiences can be very misleading and damaging to insurance companies and policyholders. In the present unsettled environment, it is a concern of the A.M. Best Company that a finer public differentiation within rating categories on our part may only lead to greater confusion regarding ratings that have already taken on the appearance of alphabet soup. It is A.M. Best's goal to bring stability and understanding to the rating process while always keeping policyholder security in the forefront.

CHANGE IN COMPOSITION

Moving onto a review of the life/health industry, clearly, signs of change in the profile of insurers' assets, liabilities, products, and profit structures have been evidenced in recent years. However, such elements by themselves should not be interpreted that, in the aggregate, the industry is on the brink of a financial crisis.

In any highly competitive environment, such as the insurance marketplace, industry trends and aggregations may obscure the performance of individual companies or market segments. However, with regard to the current financial condition of the life/health industry, it is necessary to view overall performance and trends in the context of the rapid changes in products and liability structures that have been experienced, particularly within the past 15 years.

Fueling dramatic industrywide changes over this time have been the rising interest rate environment experienced during the late 1970s and early 1980s and the increased competition for the investable consumer dollar that arose from the deregulation of the broader financial services industry. In connection with these events, consumers' attitudes toward the role of traditional life insurance products as part of that personal savings or investment plans were significantly transformed, placing a greater demand on insurers for new products that better reflected current market interest rates.

Increased consumer interest in current market returns and tax-advantaged savings on insurance investments has greatly expanded the role of annuities and interest-sensitive life products in the industry, in terms of both premiums and insurance liabilities. For example, annuity liabilities, including guaranteed interest contracts and pensions, have grown from 35% of life insurance obligations in 1979 to approximately 65% of life insurance liabilities at the close of 1990.

Associated with the increased emphasis on annuity and interest-sensitive life policies and the corresponding fundamental changes in product and liability structures has been the acknowledgement finally by many managements that previously attained margins afforded by traditional products would not be achieved in these areas. Specific actions by companies in light of such significantly altered liability, product, and pricing profiles have been mixed. Some companies have remained focused on their operations by concentrating on specialized niche markets and/or exercising increased expense and production controls. Others have sought to maintain previously achieved profit margins by adopting an increased risk tolerance by investing in higher-yielding investments. Still others have made *de novo* entries into, and subsequently exits from, various product lines or the entire insurance marketplace.

PROFITABILITY

Looking at profitability, our preliminary estimates of 1990 earnings from life/health insurance operations indicate that record profits of $10.5 billion recorded by the industry in 1989 were exceeded during 1990 by more than 21%, bringing the after-tax, aggregate earnings level to approximately $12.8 billion.

Broken down by segment, the general improvement seen throughout the industry is largely attributable to continued strengthening from corrective pricing and underwriting efforts on the accident and health business, profitable renewals on traditional life insurance products, and mostly improving margins in the interest-sensitive life and annuity lines. In addition, a general slowdown in the rate of growth in the life and annuity areas has added to the ongoing improvement that began in the latter part of 1987. Despite secular differences, common threads that have contributed to sustained improvement have been increased underwriting discipline, expense control, and a general shift in many managements' attitudes toward profitability rather than market share priorities.

LIQUIDITY

Turning to the balance sheet, the investment structure of life/health insurers funds obligations of corresponding durations. Consequently, as long as there's no run on the bank, companies typically hold investments to match the duration of their liabilities. In most cases, companies generate substantial positive cash flows that provide further insulation from the need to dispose of long-term assets due to

short-term fluctuations in the values of investments resulting from changes in interest rates or economic cycles.

Since 1979, the overall asset distribution for the industry has not changed dramatically. In fact, bonds that comprised 45% and mortgages that represent 27% of industry assets during 1979 accounted for more than 50% and 21%, respectively, at the close of 1990. What is evident, however, are the general changes in the overall risk profile of investments within the broader-asset classifications held by life insurers. From our perspective, the resulting deterioration in asset quality has been largely attributable to the response by certain carriers to competitive pressures by investing in higher-yielding, fixed income securities. In addition, the reduced asset quality reflects a decline in the previously escalated values of commercial real estate properties and the impact which this scenario, coupled with the general economic slowdown, has had on industrywide mortgage holdings, which have historically been proven to be relatively predictable investments.

Although there has obviously been substantial fallout from the recent downturn in real estate values, most companies participating in the mortgage markets maintain well-seasoned portfolios in which the market value of investments, although deflated, significantly exceeds the outstanding loan balances.

At the close of 1990, 100 companies accounted for more than 0.75 of total below-investment-grade bond holdings in the industry. In addition, 100 life/health companies held more than 85% of the total industry exposure to nonperforming mortgages.

Carriers that adopted an aggressive investment strategy have generally reflected their higher returns in the rates credited or premiums charged to policyholders, taking into account the additional investment risk assumed by including such elements into target profit margins. The transition of insurance from solely a method of protection to a vehicle for both protection and investment by companies and individuals is an example of the fundamental economic concept regarding the trade-off between risk and return.

PERFORMANCE OF RISK-TOLERANT INSURANCE COMPANIES

A review of the top 100 insurance companies with the largest exposure to noninvestment grade bonds indicates that risk versus reward trade-offs have largely been reflected in pricing structures. For these companies, aggregate earnings of nearly $4 billion were recorded during the year, despite a nearly 50% decline in the growth rate of net investment income primarily arising from more than $2.8 billion in unrealized losses from investments recorded during 1990. In terms of return on equity, this group of 100 companies has fared very favorably when compared with the total industry results, with an average return on equity over the past five years of 14% (including a 12.2% ROE in 1990) versus the industry median return on equity of 12% (14.9% during 1990).

For the top 100 companies with exposures to nonperforming mortgages, profitability measures have been more consistent with industry medians reflecting more typical risk assumptions for what had historically been conservative and predictable investments. Average returns on equity of 12% were recorded for this group of 100 companies. Beyond the impact which economic downturns in specific geographic

regions and general economic conditions have had on companies participating in the mortgage markets, many of the nonperforming mortgage problems have been encountered by companies that continued lending during the uninterrupted growth period of the 1980s, without maintaining conservative underwriting standards on new ventures and monitoring the evolving status of distress situations.

Turning to leverage, industry capital and surplus funds in relation to total liabilities over the past 10 years have declined from a high of 9.5% in 1980 to approximately 9.2% as of year-end 1990, when adjusted for the Mandatory Securities Valuation Reserve (MSVR). When the relationship of surplus to liabilities is reviewed, an argument can be made that the industry as a whole has retained its relatively secure financial standing, especially as compared with other financial service industries.

While we cannot ignore the additional balance sheet risk that exists largely in response to the change in composition of liabilities, when various stress tests are applied to reflect further bond write-downs and defaults and mortgage foreclosures, the industry as a whole maintains a sound financial position. Although we have always factored changes in market values and more speculative investments such as common stock and real estate holdings into our leverage analysis, additional stress tests are applied which include adjustments for write-downs and/or default scenarios for medium and lower-grade bond investments and losses incurred from delinquent and foreclosed mortgage loans at rates that are higher than have been experienced historically under poor economic conditions.

In addition, privately conducted cash-flow testing and asset/liability matching programs are reviewed as part of our rating review process and are reflected in our rating assignments. However, external pressures arising from political motivations of regulators, financial incentives for certain distribution channels on replacement policies, and substantial media attention can alter the maturity profiles of companies' liabilities substantially, undermining the financial underpinnings on which the long-term commitments of life insurance and annuity contracts are based.

As in any competitive arena, general comments cannot apply to individual players specifically. It is our opinion that companies which have chosen to participate in more speculative investment vehicles and have not maintained an adequate capitalization level to compensate for an added element of investment risk have placed themselves in the greatest jeopardy of long-term survival in a very competitive marketplace. For our rating purposes, we believe that it is inappropriate to view solely a specific ratio of less-than-investment-grade bonds or nonperforming mortgages without regard to an individual carrier's insurance risk profile, overall liquidity posture, cash-flow position, access to financial markets, and risk-adjusted capitalization level.

Although fundamental changes within the life/health arena have led to some weakening within the industry, it is our opinion that life/health insurers in the aggregate have maintained a strong financial posture -- particularly as compared with other financial services sectors. Despite the deterioration in balance sheets of individual companies and a corresponding decline in the number of companies assigned a top rating designation during 1991, a rating assignment as applied to the industry would approximate an A- (Excellent), down from an A rating which would have been appropriate several years ago. As is evidenced in the underlying strength of the

industry, there is a natural concentration of companies which have performed in a favorable manner and have maintained sound overall financial positions as is reflected in their Best rating assignments. Our system is a rating rather than a ranking system based on industry and subsector performance.

Competitive pressures within the industry, along with external pressures, are unlikely to diminish in the near term. Consequently, an industrywide movement by carriers to refocus their operations to better adapt to the inherent changes in today's marketplace is underway. It has been our experience through discussions with the executive managements of companies throughout the industry that increased efforts to concentrate on the fundamentals of expense and production control, realistic pricing and policy-crediting strategies, asset/liability management, balance sheet quality, and surplus adequacy are, by necessity, the management priorities going forward into the 1990s. Unfortunately, as in most competitive environments, not all participants will recognize rapid changes within the industry by responding in a timely or adequate manner.

SOLVENCY

The final topic I would like to address is the topic of insurance company solvency, and I will conclude with a comment regarding Executive Life, as Mike mentioned. Without question, the A.M. Best Company believes the insurance industry has to be held to the highest standards of financial health, since its products and services, its entire economic function, are based on the buyer's good faith that future claims will be honored and serviced.

In February 1990, a report titled "Failed Promises" was released by the House Oversight and Investigation Subcommittee, chaired by Representative John Dingell. The report provided a post mortem on the similarity of factors that contributed to the insolvency of four major property/casualty insurers during the mid-1980s. As a result of this investigation, the subcommittee expressed grave concern about the integrity of the entire insurance industry and the effectiveness of state regulation. It concluded by warning that the insurance industry may be on the brink of a financial crisis similar to the savings and loan debacle. To avert this "disaster," the report suggested the need for federal regulatory oversight.

The threat of federal intervention dramatically focused the attention of the insurance industry, legislators, regulators, and the news media on a perceived solvency problem facing the industry. The ensuing debate on how to handle the presumed crisis followed a predictable course. One trade association publicly supported federal intervention for the detection and control of insolvencies. The National Association of Insurance Commissioners adopted a state certification program that encouraged state insurance departments to comply with the uniform standards of proficiency and enact more stringent reporting requirements for insurers. Consumer advocate groups, such as the Public Citizen, reacted with dire predictions of the pending insolvency of several major insurers. And the Senate Committee on Commerce, Science and Transportation also held hearings investigating the financial stability of the industry.

In the course of these debates, however, the information available concerning the actual history of insolvencies was incomplete, resulting in statements and conclusions that were often overstated, understated, or totally erroneous. We believe solvency

regulation can be more effectively developed and managed if there is a thorough understanding of the nature of past insolvencies, their characteristics, the economic and underwriting environments in which they occurred, and other factors that contribute to the profile of a high-risk company. Once this knowledge and understanding is achieved, more informed recommendations can be made to minimize future insolvencies and contain them within acceptable limits.

To fill this information void, the A.M. Best Company will shortly publish the most comprehensive study to date on the scope, magnitude, and characteristics of the 370 property/casualty insolvencies that occurred from 1969 through 1990. In addition, a 15-year life/health insolvency study is presently being compiled for publication later this summer. We hope the information and analysis presented in these reports will provide those partaking in the "solvency" debate with the facts needed to pursue the subject in a more informed and objective manner.

For more than 90 years, the A.M. Best Company has contributed to the prediction and prevention of insolvencies through our working relationships with the industry. Each year we identify a significant number of companies having potential high-risk profiles. More importantly, however, our rating system has contributed to the prevention of insolvencies by encouraging companies to maintain high standards of financial performance and strength to retain or achieve an A or A+ rating.

The insurance industry's ability to perform its vital economic role is built on public confidence and its financial health. If the financial strength of the industry is impaired or perceived to be impaired, the undermining of this confidence can lead to serious consequences for both the industry and the public.

For this presentation, I'll provide a brief review of a few of the highlights of the property/casualty study and then the life/health study.

The property/casualty industry is very competitive, with more than 3,000 companies competing for a $213 billion market, and it experiences a business cycle similar to many other industries. On average, the industry follows a seven- to eight-year cycle of two to three years of improving profitability, called "hard markets," followed by four to five years of declining profitability, called "soft markets." The pattern of insolvencies has followed this business cycle over the past 20 years, with the number of annual insolvencies peaking after the conclusion of the soft markets. At the conclusion of the last two soft markets, the property/casualty industry experienced 29 insolvencies in 1975, followed by 49 insolvencies in 1985. In 1975, the 29 insolvencies represented approximately 1% of the total number of companies, and the 1985 peak of 49 insolvencies represented 1.4% of the total companies. In terms of the premium volume that these insolvencies represented as a percentage of the entire industry, these insolvencies have never represented more than 0.5% of the total property/casualty industry's premium volume, with the exception of 1985 when it approximated 1%. The soft market that began in 1978 and concluded in 1985 was the longest and most severe underwriting decline the industry has experienced to date. Factors that fueled the demise of so many companies included volatile interest rates, cash-flow underwriting, new capacity and severe industry competition, and the liberalization of tort laws and policy contract interpretation. Without question, the industry has experienced changing and rising trends in the number and magnitude of

insolvencies. For example, the 1970s were characterized by small- and medium-sized insolvencies of predominantly personal lines companies. However, the 1980s were characterized by small- and medium-sized insolvencies of predominantly commercial lines companies. In 1985, a number of large-sized insolvencies occurred triggering an unusual level of guaranteed fund assessments. Since 1985, the number of insolvencies has remained historically high. However, the number of insolvencies is lower than the 1985 peak and represents less than 0.5% of the industry's premium volume.

In terms of insolvencies by state, six states accounted for 51% of all the property/casualty insolvencies that occurred over the past 20 years. The states, in ranked order, are Texas, Pennsylvania, California, New York, Florida, and Illinois. However, you must note that these six states also represent some of the largest states in terms of the number of domiciled companies, and, therefore, it is expected that these states would account for the bulk of the insolvencies. Failure frequency is a better measure of a state's historical insolvency record since it relates the number of insolvencies to the number of companies operating therein. It's interesting to note that only Florida remains in the top six when failure frequency is measured. However, it's also only fair to point out that Florida is one of the two states to recently qualify for certification under the NAIC's regulatory program.

Our analysis of property/casualty insolvencies has produced a profile of a company that has experienced a high probability of failure. The profile that emerges is that of a young, small- to medium-sized stock company underwriting predominantly commercial lines coverages and experiencing unusual growth characteristics. To support this high-risk profile, our study has found that stock companies fail at a rate that is four times greater than mutual companies. Companies experiencing growth in premium that is outside the industry norms of between 5-25% accounted for 80% of all insolvencies. Young companies accounted for a large percentage of the insolvencies, with companies operating 10 years or less accounting for 41% of all insolvencies and the companies operating 15 years or less accounting for 52% of all insolvencies. Finally, the commercial lines companies have experienced significantly greater failure frequencies than personal lines companies in the last 10 years.

Turning to the life/health sector, our preliminary findings confirm 178 failures from 1976 through 1990. Nearly 0.66 of these insolvencies have occurred over the past five years, with 62% of these failures concentrated in six states. The six states in rank order of life/health failures are Texas, Arizona, Oklahoma, Louisiana, Florida, and Illinois. From a size standpoint, the median premium income of insolvent life/health insurers from 1976 through 1990 was $4.1 million, and the median capital and surplus level was $1.6 million. Nearly 0.5 of the companies that failed were engaged in the accident and health lines of business. During the 1976-90 time period, insurance company failures were not directly related to current issues such as less-than-investment-grade bonds, nonperforming mortgage loans, or depressed real estate values. Going forward, we believe these issues will play a greater role in insurance company failures. However, we do not expect the profile in causes of insolvencies to change dramatically. While specific carriers have recently experienced a strain from current industry and economic conditions, preliminary findings point to the following causes of insurance company failures in the life/health industry:

- o transactions with affiliated companies
- o excessive growth
- o inadequate underwriting or underpricing of products
- o significant change in business mix
- o excessive utilization and misuse of reinsurance
- o alleged fraud

The A.M. Best Company's track record in terms of the assignment of Best's ratings has been very effective.

The A.M. Best Company currently follows more than 2,400 property/casualty and 1,500 life/health companies. These companies together represent more than 99% of the industry's premium volume. Over the past 20 years, our property/casualty study has identified 370 insolvent companies, of which 50% provided their financial information to A.M. Best. Our rating process identified virtually all companies approaching insolvency by significantly downgrading or eliminating their Best's ratings. Since 1969, only 12% of the insolvent property/casualty companies held an A rating three years prior to insolvency. By the year of insolvency, only 1.6% of the insolvent companies held an A rating. During the first and second years prior to their insolvency, virtually all of these A-rated companies were identified as companies experiencing difficulty, and their ratings were rapidly lowered or removed. As a measurement of A.M. Best's overall effectiveness, only 0.3% of our A-rated companies have been declared insolvent over the past 20 years, which averages to one A-rated property/casualty failure every three years.

On the life/health side, approximately 91% of the life/health companies that were declared insolvent from 1976 through 1990 did not qualify for assignment of an alphabetical Best's Rating or did not file their annual statements with the A.M. Best Company.

Since 1976, only 5% of the insolvent companies held a Best's rating of "A" three years prior to their insolvency. By the year of insolvency, only 2% of the life/health companies that had failed were assigned an "A" rating. This translates into a total of four A-rated insolvencies between 1976 and 1990.

Although our record is not perfect, the effectiveness of our rating system can certainly be considered highly favorable. We have improved and developed our knowledge and understanding of both the property/casualty and life/health sectors of the insurance industry over the decades. We have focused on both the quantitative and qualitative aspects of insurance companies in order to better understand their financial condition, product line, operating strategy, management objectives, and philosophy regarding investments, underwriting, and reinsurance.

We believe insolvency detection is a by-product of a good system of insolvency prevention. No system of solvency management can rely on financial monitoring alone. A qualitative review of an insurance company and its management is essential. Included in our upcoming solvency studies will be a list of recommendations that we believe will achieve more effective solvency oversight, and I'll highlight a few of these.

1. We believe regulators should target high-risk profile companies for more frequent reviews and financial examinations. Many states still rely on the triennial examination process to identify troubled companies, and in some states the standard financial examination procedure is performed once every five years. Unfortunately, many of the insolvencies reviewed in our study developed financial difficulties and became insolvent in less than three years. Since the chance for a company failure occurring within three years will continue to exist, states need to enhance their capabilities to identify troubled companies sooner and target them for examination.

2. Regulators should supplement their solvency oversight function with more frequent reviews of companies that A.M. Best and other qualified rating agencies have identified as potential high-risk companies. Each year A.M. Best identifies potential high-risk companies, which under our rating classification system, include companies that have had their Best ratings significantly downgraded over several years, companies that have experienced a significant change, or companies that do not meet our minimum financial standards.

3. Regulators should closely monitor companies that are not rated by the A.M. Best Company since unrated companies have accounted for a large percentage of insolvencies.

4. Regulators should conduct more frequent financial examinations on new or unseasoned companies.

5. Regulators should implement more standardized risk-adjusted capitalization requirements to reflect the varying degrees and risks associated with different lines of insurance coverages.

6. Stiffer fines and penalties should be enacted to deter misleading or fraudulent financial reporting. Some of the industry's largest insolvencies involved elements of fraud or alleged fraud.

A more detailed list of recommendations (including steps we believe would strengthen the guaranteed fund mechanism) will be included in our formal solvency study.

EXECUTIVE LIFE

No discussion of insurance insolvency would be complete without a mention of the issues surrounding the weakening and subsequent receivership of the Executive Life Insurance Companies. Unfortunately, various litigation matters associated with the conservatorship of the Executive Life prohibit the A.M. Best Company from a detailed discussion as to the specifics of the situation at the present. However, it is our opinion that a unique series of events converged in such a manner that reversed the fortunes of what had been a well-capitalized, prosperous and profitable, although very aggressive, life insurance company as recently as January 1990. Circumstances such as the deterioration and illiquidity of the company's noninvestment-grade-bondholdings due to the virtual collapse of the junk bond market during 1990 and the crisis of confidence as reflected by the substantial number of policyholder surrenders and the reduction in new premium writings, associated with unprecedented media attention,

contributed to the extremely rapid decay of the companies which precipitated their ultimate collapse.

Information available through the first nine months of 1990 led A.M. Best to downgrade Executive Life's ratings three times over this period. However, the severity of the company's declining financial position did not become clearly evident until the fourth-quarter results of 1990 were reported. These results reflected the reemergence of a significant increase in investment write-downs and the impact of an acceleration in the surrender of policies that reversed the favorable trends reported in the latter part of the second and third quarters of 1990. In addition, the parent company's planned refinancing and restructuring program, along with the sale of a substantial book of business to other companies, offered evidence that a strengthening of the insurance units was being pursued. Regulators who were conducting on-site examinations indicated that the insurers were in no immediate danger and that unnecessary and precipitous regulatory action would harm the companies. It should be noted that as recently as March 1990, the respected actuarial firm of Milliman & Robertson issued a report indicating that the Executive Life Companies' financial positions could withstand even the most unlikely of adverse scenarios.

The erosion in public confidence and ensuing run-on-the-bank scenario, coupled with accelerated regulatory sanctions, can contribute to the demise of almost any insurer, particularly for those that maintain a significant concentration in less liquid investments as is also evidenced in the case of the First Capital insurance units.

Once again, the structure of insurer's investment portfolios funds the liabilities of corresponding durations. As a result, when liability structures of a long-term nature are altered to become demand deposits, even the most financially sound companies with carefully matched asset/liability programs can become overburdened as one would expect when long-term obligations are used to fund short-term liabilities. While we applaud the intentions of the insurance departments that have acted in the ultimate best interest of policyholders, we also believe that other options were available that would have promoted the company's existence as ongoing concerns while providing prudent administration of policyholder assets.

Although we view the Executive Life and First Capital situations as unique, it is not to say that such a series of events will not occur in the future and include other companies that maintain high exposures to speculative and/or illiquid investments. Rather, it is our belief that most insolvencies will occur in companies that will follow patterns that are more consistent with historical experience.

MR. ROBERT S. FILLINGHAM: Moody's Investors Service has been in the business of providing credit analysis for investors in long- and short-debt issues for more than 80 years. Our Corporate Credit Service -- which includes our insurance credit service -- focuses on a core universe of some 700 issuers of debt worldwide, including industrial, utility, bank, nonbank financial services, sovereign nations, and international agencies. We rate industries and issuers within them in response to investor interest and demand. In the life insurance industry this demand first arose in the 1970s when a number of insurers began issuing commercial paper programs that were rated by Moody's. The demand for our insurance claims paying ratings, which, by the way, we now call financial strength ratings, arose in the mid-1980s from

pension plan sponsors investing in GIC contracts. Our first claim paying ratings were released in 1986. We now have such ratings on around 70 North American companies with assets equal to more than 60% of the total assets in force among U.S. life insurers, and more than 90% of total GIC assets managed by U.S. life insurers.

As background for talking about emerging financial trends in the industry, let's begin with a look at a Chart 1 that shows some significant shifts in the business mix of the industry. As shown, using ACLI data, in 1979 life insurance reserves represented about half of the total. By year-end 1990, they're estimated to be down to about 30%. This shift is largely due to the growth in individual and group annuities, including GICs. The shift to these accumulation products has had a very significant bearing on some other trends. Unlike insurance products, accumulation products are offered by other sectors of the financial service industry, intensifying competition and pressuring profit margins. The rapid growth in accumulation product assets relative to the growth in capital and surplus has contributed importantly to a fall-off in the industry's capitalization. Accumulation products tend to involve more disintermediation risk than do life and health insurance products, increasing the industry's C-3 risk at the same time its capitalization is moving down. Competitive pressures have also led to assuming more asset quality or C-1 risk.

Chart 2 shows the capitalization ratio movement over the past five years among the U.S. companies we've rated. Bear in mind, by the way, that the universe that we follow has a heavy concentration of companies that are active in the accumulation product market. That has a definite impact on what we're looking at here. The remaining charts in this discussion of financial trends are also based on Moody's rated universe of companies. The capitalization ratios shown herein compare statutory capital and surplus, plus investment reserves and half the policyholder dividend liability to the company's general account assets. As you can see, the capitalization ratio for this universe fell by about 0.25, from 8.3% in 1986 to 6.4% at the end of 1990.

Chart 3 shows the pattern for investment-grade bonds -- considering the NAIC 10% and 20% classes for 1986 through 1989 and the new NAIC classes three through six for 1990 as proxies for below-investment grade. As you can see, they more than doubled as a percentage from 1986 through 1990. With 20/20 hindsight it's now pretty clear that high-yield bonds carry significant default risk. In the commercial mortgage area, there seems to be somewhat less consensus. Here are some thoughts on our view of how serious the commercial mortgage situation may be.

Chart 4 shows the relation between total commercial mortgages in the U.S. and nominal GNP. Note that in 1975, a year with significant commercial mortgage defaults, it was 10%. In 1990 it stands at nearly 14%. Not shown is the peak of 14.4% in 1987.

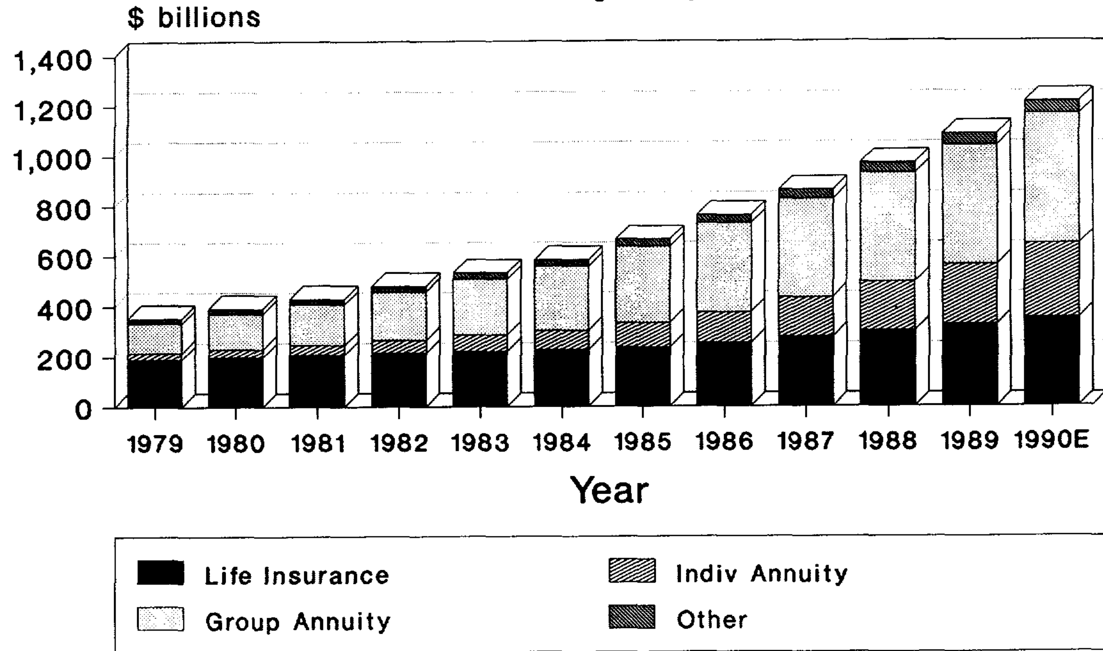
Table 1 shows another view of the problem. In the 1980s, GNP grew at 2.6% a year. Retail space was added at a little over 6% a year. Office space was added at a bit over 8% a year.

This leaves us with a real estate imbalance that is clearly unprecedented by any post-Depression standard.

CHART 1

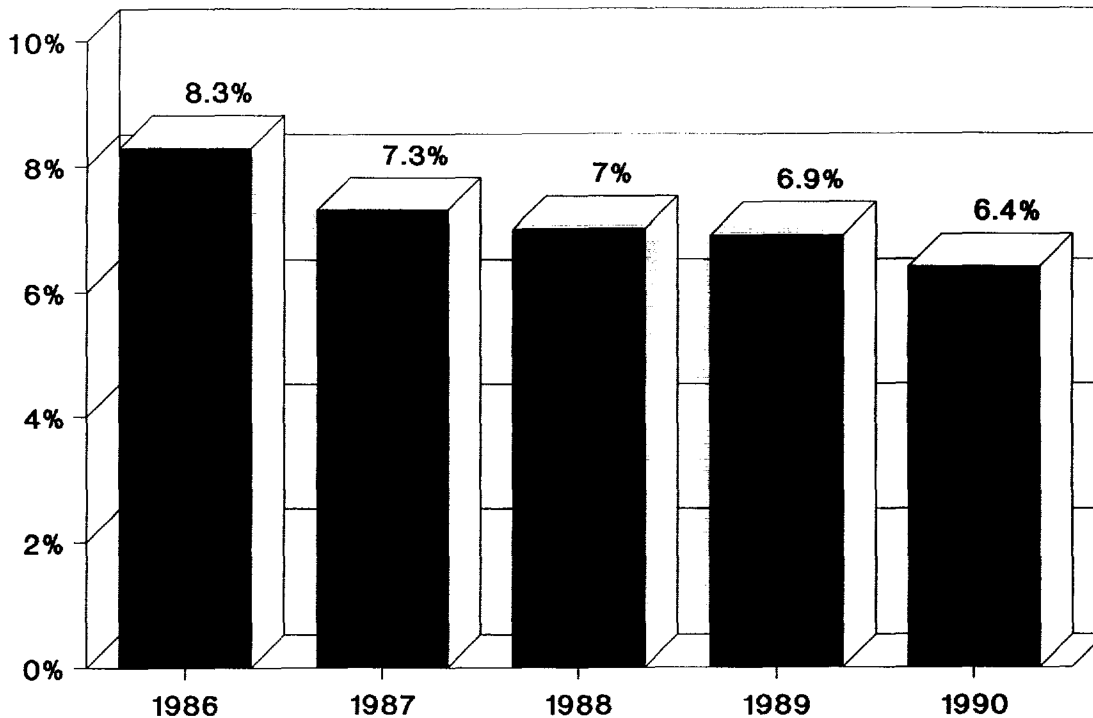
Life Insurance Reserves

Mix By Type



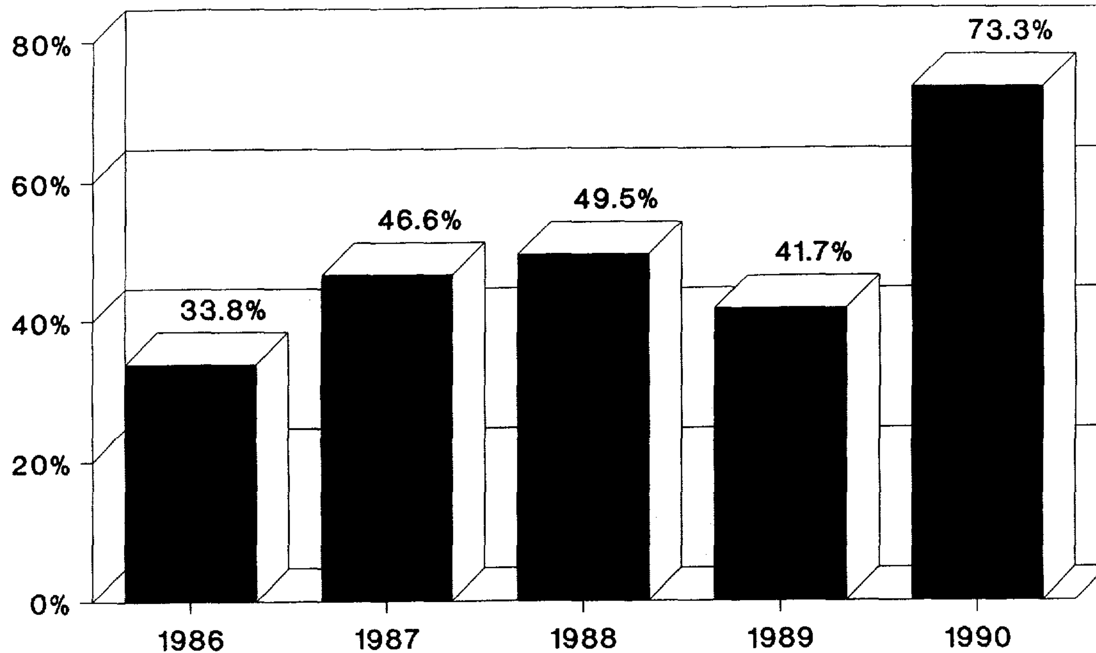
Source: Data from *1990 Life Insurance Fact Book*, American Council of Life Insurance, Washington, D.C.

Capitalization (%)



PANEL DISCUSSION
CHART 2

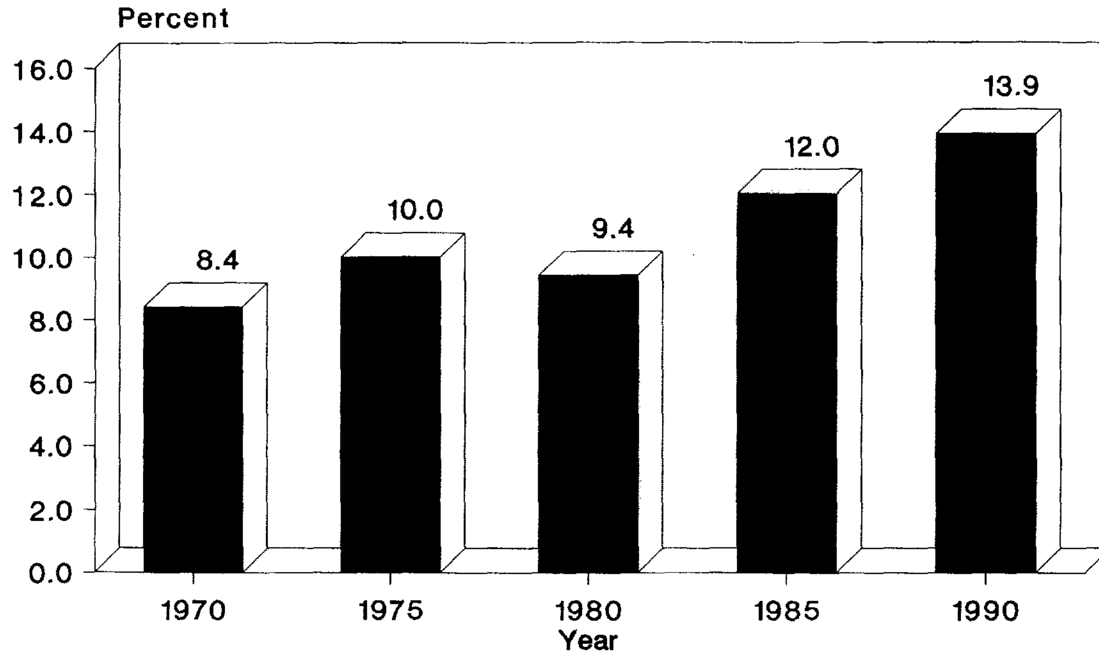
Total Below Investment Grade Bonds as a % of Capital



THE RATINGS GAME
CHART 3

Commercial Mortgages % GNP

5 Year Intervals



Source: Data from Federal Reserve, Washington, D.C.

TABLE 1

Growth in Available Space 1980 to 1990	
Property Type	Annual Growth
Office	8.02%
Retail	6.08
Industrial	3.82
Real GNP	2.59

Source: Data from REIS Reports Inc., New York, New York and Federal Reserve, Washington, D.C.

Chart 5 deals with vacancy rates. Office vacancies now stand at 20% compared with around 8% in 1980. Retail vacancies are at 11% versus 5%. Multifamily vacancies are at 7% compared with just under 5%. Industrial vacancies are approaching 13% compared with 7%.

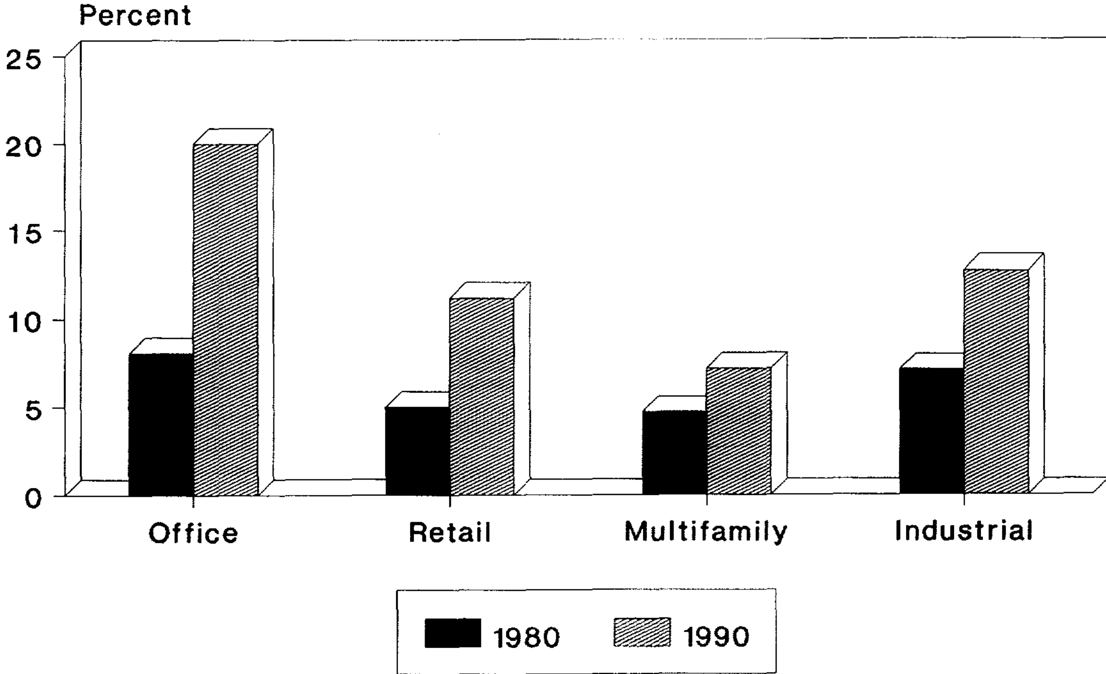
How has the life insurance industry fared in the face of this? Chart 6 shows problem mortgages as a percent of capital within our rated universe over the past five years. We define problem mortgages here as those more than 90 days in default, plus those in the process of foreclosure, plus real estate acquired in satisfaction of debt over the past year. As you can see, the percent has increased by more than 100% over the five-year interval.

To sum up on mortgages, we believe that the real estate imbalance is unprecedented in magnitude, particularly for office, retail, and hotel properties, and that it will result in a prolonged period of depressed rental income levels. As developers and owners experience falling income, we expect significantly increased foreclosure rates in the life insurance industry. Although company-by-company experience will vary depending on regional and property mix, as well as on underwriting, we expect further life insurance financial strength rating downgrades as a result of these real estate problems.

To wrap up these comments on financial trends, Chart 7 shows Moody's risk-adjusted capital ratio as most recently revised for the past five years. This ratio compares actual capital, as I defined it earlier, with a risk-adjusted benchmark level of capital based on the unique mix of credit, interest rate, mortality, and morbidity risk in each company's risk portfolio.

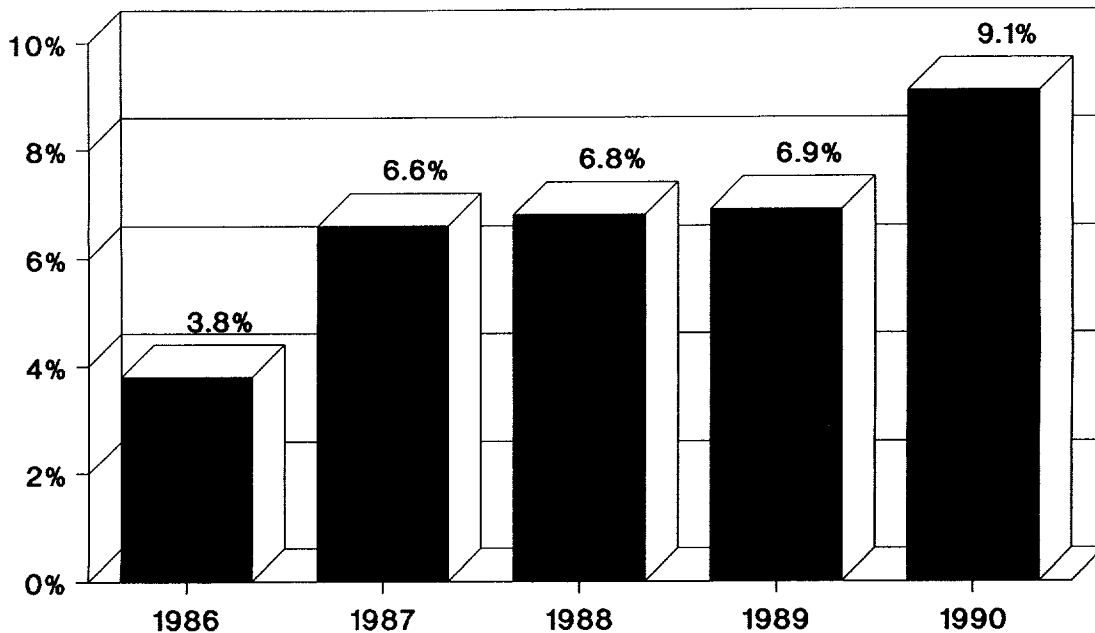
Let's turn now to a discussion of the approach that we employ in assessing insurer creditworthiness and some other related issues. The conceptual framework we employ in determining insurance financial strength ratings is exactly the same as that which we use in rating bonds. It's our intent that the default risk embedded in, for example, an Aaa-rated bond and the risk of nonfulfillment of policyholder obligations embedded in a life insurance company with an Aaa financial strength rating will be identical. Because these ratings pertain to the future, they're necessarily subjective. Our belief is that the reliability of our ratings – their predictive value – stems far less from precise methodology than from the balanced opinion of experienced, informed, and impartial analysts. We employ a long-term perspective. Even though an insurer may be adequately capitalized, we're concerned with assessing the relative risk that it

Vacancy Rates
1980 Vs. 1990

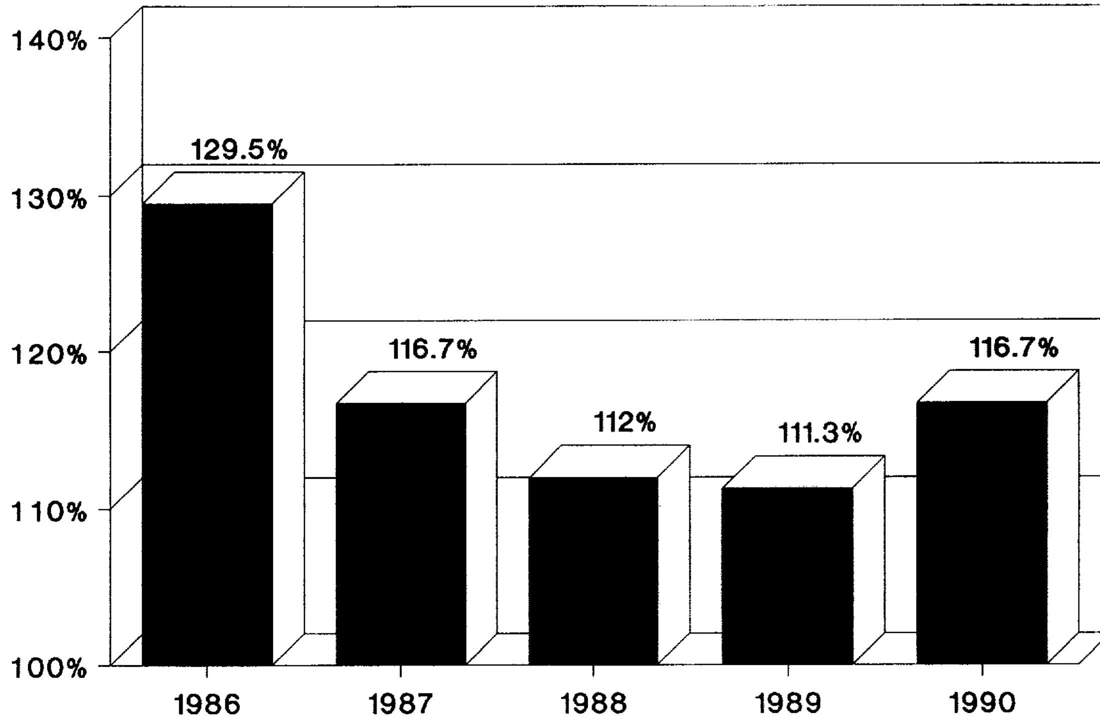


Source: Reprinted with permission from REIS Reports, Inc., New York, New York.

Problem Mortgages as a % of Capital



Risk Adjusted Capital Ratio (%)



PANEL DISCUSSION
CHART 7

will fail to meet its long-term obligations. We also tend to take a conservative and pessimistic stance. We focus on worst-case, downside risk instead of a company's upside potential -- reflecting our use of a bond analysis framework. Finally, our approach is both quantitative and qualitative in nature. Frankly, it's far more qualitative than seems to be generally appreciated. Issuers and insurers frequently appear to assume that there are threshold levels of capital adequacy, for example, which will dictate a rating change, but that's really not the case.

The financial factors that we employ can be broadly categorized as capital adequacy, asset quality, profitability, and liquidity – which include asset/liability management and holding company financial leverage. We don't have time to go through this in detail, but I would emphasize that in our financial analysis, we treat statutory data as a starting point for the analysis and adjust it in a variety of ways to estimate current and expected future economic results.

The key factors in our qualitative, fundamental analysis include management, product, distribution, value-creation, and franchise value, as well as economic environment, competition, and regulation. This analysis consists of an evaluation of management and various external factors such as the company's particular competitive position in the industry. Our fundamental analysis process seeks to answer two basic questions: How does a company add value in the markets in which it is operating? And, is the process by which it adds that value sustainable over a long period? In short, we attempt to evaluate the strength of a company's franchise. Two different companies of identical financial strength as determined by financial analysis alone may have very different ratings because of fundamental considerations.

Some questions representative of the kinds of issues we consider in evaluating these fundamentals include the following: How competitive are the company's products? Is the company's business wholesale or retail? Is the company diversified? Does it rely on high margins or employ high leverage to generate minimum returns on its capital? How does regulation affect its operation? Does it provide an essential product or service? Does it have sustainable competitive advantages in its key business line? Is it owned by another company, and, if so, how might the goals of the parent affect the insurer over a long period?

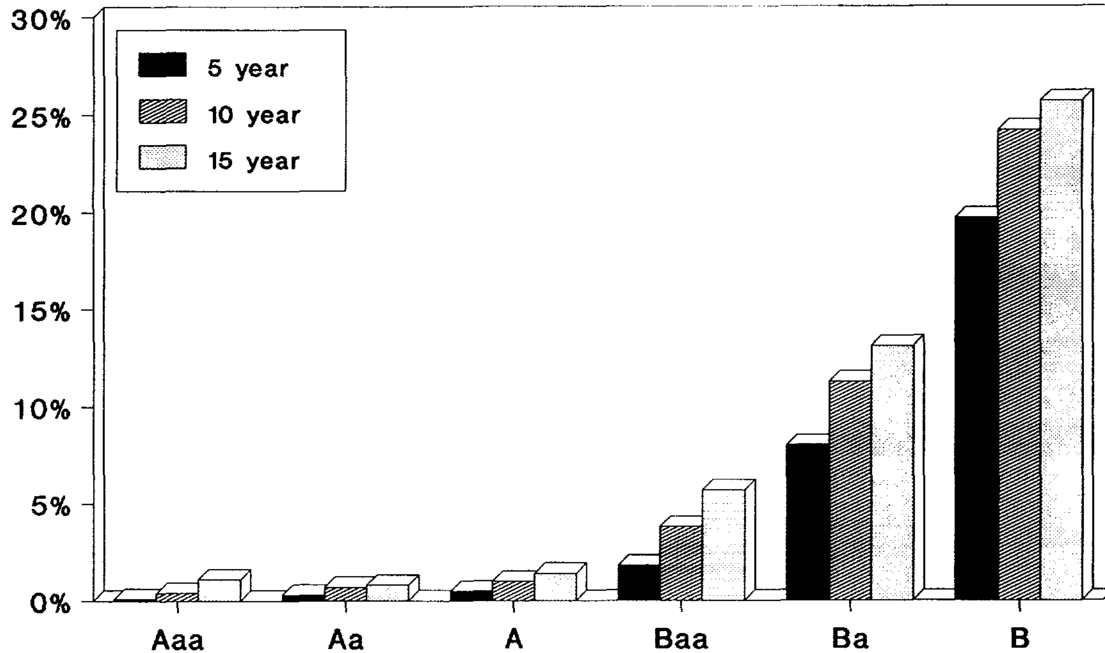
Whenever possible, our review of management is based on meetings with the senior management of the company. We're concerned with questions such as the following: How will management respond to pricing pressure, to the lack of growth opportunities, or to unfavorable regulatory or tax developments? What are management's goals and motivations? What's their experience and competency in the lines of business they're conducting?

Chart 8 gives you a sense of the predictive value of our ratings, showing the average cumulative default rates on senior corporate debt issues we've rated over the past 20 years – based on the ratings we initially assigned. For example, the 10-year default rates in this study were four per thousand for Aaas, 10 per thousand for As, and 113 per thousand for Bas.

Next is a quick rundown on the question of who uses our ratings and the reasons why they use them. Our clients include GIC advisors who use the ratings as a

CHART 8

Risk of Default
Cumulative Default Rate, 1970-1990



supplement to their own credit research and as a check on their opinion of the creditworthiness of an insurance company. They also include GIC brokers who use the ratings as a factor for screening bid participation by a carrier, plan sponsors who use them to provide a monitoring and early warning system, and insurance companies who use them in various ways: to differentiate the company from competitors, to support an efficient market, and to provide a convenient means for communicating information to the marketplace. Life insurance agents and brokers also use them as a check on their opinion of the creditworthiness of the insurance companies.

Finally, on the question of whether our ratings are influenced by those of other rating agencies, the answer is very simply: not at all. We do believe responsible competition in the credit analysis business, as in any other, is good for the end users, and we encourage the use of other rating services, but our ratings are completely independent of theirs.

MR. RICHARD S. ROBERTSON: You have now heard from very fine representatives of A.M. Best and Moody's. Let me address the question of how good the rating agencies are. How realistic are the ratings that they assign to insurance companies? In doing this I want to discuss separately the rating agencies that have as their background credit analysis, Moody's, S&P, and Duff & Phelps, and Best's which has its background, of course, in insurance statistical analysis.

The credit-based services have a very long history and a great deal of experience evaluating corporate debt, and they're very good at it. They have a good reputation and a reasonably good track record in classifying corporate debt. They are relatively new to the process of evaluating financial institutions, especially insurance companies, and even newer at addressing the risks that insurance company policyholders face.

When they first got into this process, roughly 10 years ago, they were building from a base of knowledge that was very limited. They spent a great deal of time and energy building that base of knowledge. We helped them. Other insurance companies helped them. People outside the insurance industry helped them. They've been through a learning process all during this time. They have made some mistakes. They have done some things quite well. I think we can say that today their skills are considerably better than they were when they first got involved in the process 5, 10, 15 years ago. There is still room for improvement, and I hope and urge them to not assume that they are yet at the point where they are ultimate experts on the subject. I don't think they would claim to be such.

Best's, on the other hand, has an equally long record of analyzing, collecting information about, publishing information, and rating the insurance industry, and they are very, very good at it. The database that they have, I am sure, is unmatched in any other kind of business and is certainly unmatched by anyone else who monitors the insurance industry. They use those data very well. They have a lot of experience. They've seen it all. They know what can happen. They know what can't happen. And they draw on that experience in making their evaluations.

These strengths of the A.M. Best Company also represent their greatest weakness. Best's has taken it upon itself to evaluate a significant part of the insurance universe, and until recently, Best's has done this without charging the companies they are

evaluating anything. As a result, Best's had had very limited resources to apply and has not been able to do the kind of qualitative analysis that the credit-based agencies, who charge us rather substantial fees for their process, have been able to do. As a result, Best's gives very good statistical analyses. They have tried to incorporate judgmental and qualitative factors into their analysis, but sometimes they have been a bit slow in picking up significant changes in direction and strategy of companies that have influenced the financial security of those companies. Best's has been working very hard to remedy this. They are now charging us for the ratings. They are now spending a great deal more time talking to companies, visiting with them, and incorporating judgmental things in their analysis. But, like the credit-based agencies, they have a way to go, and they are still improving the service they provide.

I have a couple of general criticisms that apply to both types of organizations. First of all, I am concerned that the recent experience that we have had involving credit risk may be oversensitizing the rating agencies to the nature of that risk. Some of the mistakes that were made during the last 10 years -- perhaps the most serious ones -- have, indeed, been credit related. I am worried that like Mark Twain's cat who, having sat on a hot stove, will never sit on a hot stove again -- I am worried that these gentlemen will be reluctant to sit on even a cold stove. I think there is a danger that they will consider that any kind of credit risk is adverse and fail to adequately recognize that low-grade securities and other high-debt instruments do have a place in a well-managed portfolio and, in fact, can improve the overall security of the portfolio rather than weaken it. I am also concerned that, like generals fighting the last war, they will focus too much of their energy in the 1990s on credit risk and may not be sensitive enough to the next problem we face, whatever it may be.

The second concern I have is as follows, In preparation for this presentation, I got out my Academy of Actuaries' *Yearbook*, and I turned to the back where they list members by organization. I looked up the various rating agencies. There are no Fellows of the Society of Actuaries employed by any of the rating agencies. There are no Fellows of the Casualty Actuarial Society so employed. There are no Associates of the Casualty Actuarial Society, and there is one Associate of the Society of Actuaries. That one Associate must be the busiest actuary we have in the profession.

I do believe that we, as a profession, have resources that are badly needed by those who are evaluating the financial security of insurance companies. Our training, our education, and our experience are an important resource that needs to be made available to the rating agencies. I encourage them to strengthen their staff by seeking more actuarial support than they have in the past. I also observe that more and more sophisticated buyers of insurance, pension funds in particular, are independently seeking actuarial advice and independently evaluating the companies from which they purchase insurance. So, I think there is a danger that the rating agencies may lose part of their franchise if they fail to do this.

I understand that, since the *Yearbook* was published, Moody's has added two FSAs, including my copanelist, Mr. Fillingham. That is certainly a step in the right direction.

Now as to the question of what influence the rating agencies have, I think we, as an industry, owe a great deal to what these services have done for us during the last

few years. In the current environment where almost every day there is an insurance problem being featured in the financial newspapers, where irresponsible journalists are talking about us being the next savings and loan crisis, where any person with access to an Apple computer can classify himself as a rating agency and serve whatever purposes he might have with that process, it has been very, very helpful to have organizations with the strength and credibility of the rating agencies that have said this is not an industry problem, this is an isolated company-by-company problem. They have put before the public their evaluation that we are individually and, by and large collectively, strong institutions. They have supported us in the public arena, have testified before Congress, have talked to journalists, and have given a great deal of support to us as an industry. It is very helpful in going out before the public and saying we are a strong institution to have these ratings to give credibility to that assertion. So, we very much need these organizations and support what they are trying to do.

They are also very helpful to us in imposing discipline on us, company by company and as an industry. Arguably, they represent the most significant influence with respect to maintaining the financial integrity of our organizations. Imagine, if you will, yourself as the corporate actuary of a large insurance company who has concluded that the company needs stronger financial statements, that your leverage maybe getting out of hand. So you go into the chief executive of the company and you try to tell the chief executive that we need to do some things to improve our surplus level to strengthen our balance sheet. Now, the chief executive, who may well have a marketing background, knows this may weaken the competitive position of the company with respect to insurance cost or, if it's a stock company, may reduce the return on equity. So, he will be concerned or undoubtedly will ask why you believe the company needs more surplus. Now, you may go in and say that your actuarial staff has performed studies, and start talking about C-1, C-2, C-3, and C-4. Even if the chief executive is an actuary, his eyes will begin to glaze over at this point. He will probably refer the whole thing to a committee. Suppose, instead, you go in there and say, when he asks the reason the company needs more surplus, "If we don't, we may lose our credit ratings. If we don't, we may lose our claims paying ratings." He knows what that means, and he knows what that will do in the marketplace. Whether or not he'll agree with you, at least you'll have his attention, and you will get an expedited process for trying to evaluate whether, in fact, the company needs the greater strength.

In summary, while the rating agencies are not perfect and do not represent themselves as being such, they do provide a very valuable service for policy-holders, for insurance companies, and for the integrity of the industry. They need all the support we can give them.

MR. PAUL G. SCHOTT: Could you discuss the problems of using admitted assets as a surrogate for something on some sort of GAAP basis? There are many senior officers of various insurance companies who think, for example, that the only way to get you guys to recognize that the furniture is worth something is to sell it and lease it back. Everyone would agree that admitted assets are less than perfect in describing how solvent a company is. They are readily available. Everyone would agree on that. Is rating for solvency what creates the problem of what do you do with admitted assets?

MR. FILLINGHAM: I'll start a response, and if I'm not responding to the particular thought you had, please let me know. In general, as I said before, we consider statutory data, whether it be the assets or any other particular data, a starting point in our analysis, and let's just think in terms of the issue of capital adequacy where the asset question would certainly be an important part of it. Wherever a company has either GAAP, in a company such as a stock company, or a mutual company, as frequently is the case, has management GAAP, we're very interested in making use of those data. Where that's not available, we also make various kinds of judgment adjustments to the data that are available. For example, we recognize that there's a great deal of buried capital in the balance sheets of many life insurance companies that have older, traditional blocks of insurance with very conservative assumptions in the reserving of those blocks of business. We also recognize that statutory earnings in the case of a mutual company which is reporting on a statutory basis require the immediate expensing of acquisition costs. So, we attempt to adjust for that, either with the management GAAP data that are made available to us or on some sort of an estimation basis. So, we don't consider any of the blue book numbers or the yellow book numbers in the case of the property/casualty analysts as sacred.

MR. MAYEWSKI: I would echo Bob's comments that we do go beyond just the statutory blank. We send out a questionnaire that goes into much more depth than the statement does in various areas, and we are interested in a company's GAAP results. However, I think when you're going to evaluate a company or place a rating on a company, you want to take the most conservative posture, and we do believe the statutory statement is a good start in terms of presenting a very conservative posture, but at the same time we'll take a look at the GAAP numbers, but we surely are not going to elevate someone's rating based on their GAAP financials. In a borderline situation, it may be considered and brought into play whether it's a leveraged ratio or whatever it might be. However, it's still going to be predominantly based on the conservative, statutory financials with a small mix of GAAP results involved.

MR. JAMES R. THOMPSON: We've been analyzing some companies and finding that they have been investing in mortgage-backed securities like Ginny Maes and Fannie Maes, and these are classed as bonds in the annual statement. Now, one person mentioned the relative statistics of bonds and mortgages. How are you classifying the Ginny Maes and Fannie Maes? And I was wondering whether anybody had any comments on any types of default problems with that type of security versus the commercial mortgages.

MR. FILLINGHAM: Our concern with asset-backed securities of the type you were speaking of has considerably to do with the call risk, the lack of call protection frequently in the case of such securities, and the sophistication with which a particular company is able to manage that risk, but as to whether those are treated as bonds, yes, the answer is they are.

MR. MAYEWSKI: The same from our perspective. We are treating them as bonds, and we would have the same concern regarding a call risk and the impact on your asset/liability matching strategies, and that has to be considered, but they would be included in the bond category.

MR. ROBERT B. LIKINS: I have two questions, one for Larry and one for Bob. Larry, when you were describing some directions that A.M. Best is taking, you said you're thinking about providing some numerical or alphabetical ratings within your top category to differentiate companies. When do you expect to make a decision on this or have you already? Now let me ask my question of Bob. S&P has recently come out with a solvency rating for those companies that haven't paid for a rating, and it's completely based on publicly available information like annual statement information. The question: Is Moody's thinking about coming out with a similar kind of a rating, and, if so, when?

MR. MAYEWSKI: OK, Bob, in terms of the comment I made regarding differentiation, one point that is not well-known in the industry is that all ratings are not created equal. Two A+ companies or two A-rated companies can be significantly different in terms of their quantitative and qualitative results yet still fall within a range. We're not working with a great number of ranges, as I indicated. So, we do not necessarily believe that an A+ rating at Best equates necessarily just to a AAA of the other rating organizations. The question is how do we get that message out to the public? And right now there is nothing set in stone in terms of a timetable on that, and we're exploring that. We may not do it. Right now we're concerned that if we did it, we're only going to add to the confusion that already exists, and at this point it's on the docket for discussion. There are people that believe we could go into each of our rating classes and define them in thirds. We could go in and add another rating category at the top which really would then probably include 40 or 50 companies, and that may equate more closely to the AAAs of the other rating organizations. It's up for discussion and debate, but we still will not change our fundamental approach, and right now it's too far from reality to even give you a timetable on that. It's just being discussed at this point.

MR. FILLINGHAM: Is Moody's considering doing something similar to the S&P recent release where they, in effect, based purely on quantitative financial ratio analysis, are coming up with what I would describe as an above-average, average, or below-average kind of rating for a large number of companies? It's my belief and understanding that there is no such plan under consideration at Moody's, and I personally would be very surprised to see Moody's do something of that sort.

MR. ALLEN R. ELSTEIN: I'm going to go back to about 1980 when I was a first-year MBA student. One of the things we learned was that, if you're analyzing investment portfolios, you really have to worry about diversification. If I were sitting there with, for example, a first-year MBA class in 1980, we would have been very worried about companies that were 40% in high-yield bonds or who in the mortgage environment were 30% in Dallas and Denver, even if we didn't know anything else. I guess the question would be one of cynicism. How do these two major rating agencies that we have here miss or fail to comment on companies that were 30% or 40% in mortgages in Dallas and Denver? How does that fail to be noticed? How can the public have confidence that whatever now people will shift to in order to get the high-yields which you need to be competitive in the GIC market will be things that you won't miss in the future? I think there's a matter, at least in the Boston area, of public confidence in rating agencies in general. It's great to go back with hindsight, but how will we prevent these type of debacles in the future?

MR. FILLINGHAM: I guess I don't accept the premise to begin with that it has so totally escaped our attention, as you're suggesting. The Moody's track record, for example, on the most notorious of the companies with high junk bond concentrations, of course, was Executive Life. Moody's rating of Executive Life, when it was initially established in December, I believe, of 1986 was an A-3 which would put it, I believe, six notches down from the top and four up from junk. In February 1990 we, indeed, classified it as junk, and we now have it classified as CAA. I think that you will probably see over the next year or so other companies that are coming under pressure because of their junk bond concentration. One of the things I would encourage people who use our ratings to do would be to read the reports that we publish along with them whenever possible because they include a good bit of analytic comment on such issues as the point that you're making here, the extent of exposure to nonperforming mortgages and concentrations in the oil patch and things of that sort.

MR. JOSEPH PAESANI: There's been some discussion that A.M. Best is cracking down a little bit more on its rating. If I interpreted some of your numbers correctly, you'd mentioned that I think 55 companies are on notice that their rating could be lowered. Sixty companies have experienced lowered ratings. I was just wondering how those numbers compare with prior years or how that evaluation would rank with prior year results.

MR. MAYEWSKI: I think that would be probably more than double the number of reductions and companies on notice relative to prior years.