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**IS THERE LIFE AFTER EXECUTIVE LIFE? RETIREMENT PLAN
PARTICIPANTS AND THE GUARANTEES OF INSURANCE COMPANIES**

Moderator: PAUL B. ZEISLER
Panelists: KEVIN A. CEURVORST*
SHARON NOVICKAS†
PHILIP J. SUESS‡
Recorder: GREGORY BISHOP

The panel will address the then-current situation relating to insurance company solvency, guaranteed products, and retirement plans. What have the Department of Labor (DOL), the IRS, Congress and the insurance industry done?

MR. PAUL B. ZEISLER: I'm a principal with William M. Mercer, Inc. in Chicago. This is clearly a provocative topic. A great deal has happened in the past couple of years, and I think you'll find what our speakers have to say to be very interesting.

MR. PHILIP J. SUESS: I'm happy to be here and share with you some of the ideas that our firm has in working with plan sponsors on the decisions they're making with respect to guaranteed investment contracts (GIC) and annuity contracts in light of what's happened with Executive Life.

Our focus initially will be to look at the GIC marketplace from the plan sponsor's perspective. Where do things stand now given the failure of Executive Life? How have plan sponsors reacted? What do they anticipate happening in the future? Given that overview, we'll also spend some time talking about the impact on the annuity marketplace.

Starting with where things stand today, one year after the conservatorship/takeover of Executive Life. First and foremost, we're still in a situation where plan participants cannot get their money. If you're an annuity participant in payment status, you continue to receive 70 cents on the dollar. If you're a GIC investor and your contract's matured, that money remains with Executive Life. One year later, the value of your contract with Executive Life is still uncertain. There's continuing litigation concerning the appropriate policy class for municipal GICs. How that resolves itself is going to have a bearing on what the final value of the contracts will be. Current estimates seem to range anywhere from 52 cents on the dollar to upwards of 92 cents on the dollar.

The third issue relates to the coverage available from the guarantee associations. There continues to be uncertainty as to what contracts are covered. Are GICs

- * Mr. Ceurvorst, not a member of the sponsoring organizations, is an Assistant Vice President with Duff & Phelps Credit Rating Company in Chicago, Illinois.
- † Ms. Novickas, not a member of the sponsoring organizations, is a Regional Vice President with Variable Annuity Life Insurance Company in Chicago, Illinois.
- ‡ Mr. Suess, not a member of the sponsoring organizations, is an Associate with William M. Mercer, Inc., in Chicago, Illinois.

covered? Are unallocated contracts covered? What is the value or the amount of coverage per contract? And finally, what's the jurisdiction? Who is going to oversee the payout with respect to the guarantee coverage? Is it going to be the insurance company's state of domicile or is it going to be the policyholders' state of residence?

The marketplace impact of the Executive Life takeover can be summarized in three points. First and foremost, there's a greater awareness of risk, particularly, from the perspective of plan sponsor senior management, to a lesser extent from the government regulators and, of course, from the media. Second, in the future there will be a greater focus on process and procedures as they relate to decisions that are made with investment-type contracts. This awareness will involve establishing procedures concerning carrier selection, reviewing existing procedures, and, finally, looking more towards what's being communicated to participants concerning their expectations for the products being utilized. The final point is really a movement towards alternatives. Plan sponsors are evaluating alternative products that provide greater control over the assets that support their investment and that give them greater control over the liquidity of those investments.

Specifically, with respect to GICs, it's a documented fact that the cash flows into the GICs currently are less than what they have been in the past. It's also important to point out that the slowdown in cash flow or new money into GIC investments involves a broader dynamic than just credit.

There are other things happening in the marketplace with the end result being a decreased utilization of GICs. Some points come to mind. First, the recent investment experience of other asset classes has been quite favorable, particularly the stock and bond markets. Second, we're in a low interest rate environment, and there seems to be a lot of plan sponsor reluctance when making decisions that involve locking into a low rate. Third, the cash flow for investment has been reduced given the recessionary environment and the economy. Layoff uncertainty has resulted in reduced cash flow. A fourth issue relates to the pending 404(c) regulations: What will the outcome of 404(c) discussions be for future investment options under defined-contribution plans? Plan sponsors are anticipating the introduction of additional investment options into their program, and providing greater transferability among these options. These issues serve to reduce the flow of new money into GIC products. Finally, there has been an introduction of new products or alternatives to the GIC that addresses some of the credit and liquidity concerns inherent to traditional GIC products.

Given this background, how have plan sponsors reacted? First and foremost, they've gone back to formulating an investment policy as to how they're going to manage the GIC fund. In many cases, they've taken an even broader perspective -- how are they going to manage all of the investment options under their defined-contribution plans in the future? One of the things that people are starting to give more consideration to is looking at the objectives of the defined-contribution plans; focusing on retirement objectives; focusing on how much they will need at retirement to fund their lifestyle. Consequently, there's a greater emphasis on people investing in equities and other investment vehicles with the hope that these vehicles will provide a greater return relative to what's available from investing strictly in the GIC.

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Specific to the GIC option, plan sponsors are developing procedures and investment policy. They are focusing on diversification requirements of the fund, liquidity requirements, the credit quality of issuers in the fund, as well as a target credit quality for the total portfolio. Within the investment policy, consideration is also being given to, in some cases, introducing nonbook-value or market-value instruments into the portfolio. Given the establishment of criteria, review procedures are being set in place.

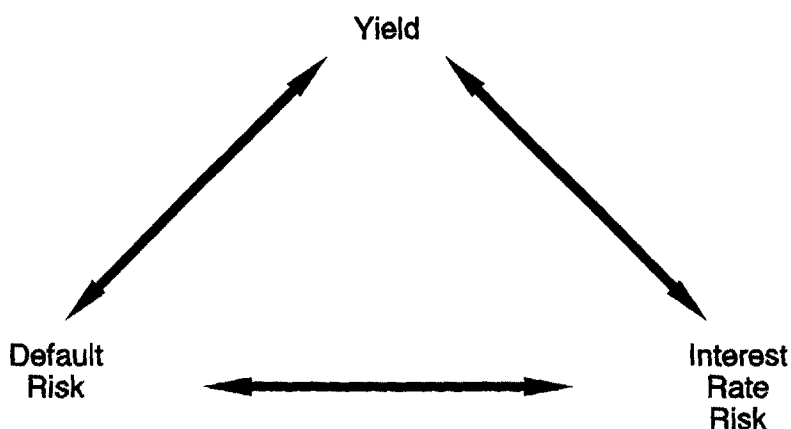
The second item is enhanced participant communications. This starts broadly from a participant's perspective. What do you need at retirement? What's the most effective way to fund those needs today? Communications then move to the more specific issues of making sure participants have an understanding of the risks associated with a GIC or a fixed-income-type-investment. Specific to that is eliminating references to the word "guaranteed" in the description of the fund or in correspondence to plan participants.

Finally, people are looking for alternatives. People are introducing other fixed-income alternatives to their plan so that the GIC is no longer the sole fixed-income vehicle. People are looking to utilize investments that are funded outside an insurance company's general account by utilizing either separate account products or what is referred to as synthetic products where the policyholder or the plan sponsor has the direct ownership of the assets supporting their investment.

In looking at the alternatives as people try to diversify and looking at things other than GICs, they get a little bit frustrated, and we try to describe alternatives in terms of fixed-income trade-offs. When people look at a GIC or a GIC-type vehicle, they're usually very much interested in the book value accounting and, perhaps a little broader, the stability that type of product offers the plan participants. To the extent they want to reduce their default risk or reduce their exposure to market value volatility, they're confronted with reducing their yield (see Chart 1). So, as people look at alternatives, they become a little bit frustrated. To the extent they want to maintain the current yield relative to what they have on a comparable GIC product they're often confronted with introducing, in many cases, additional market value risk to their portfolio.

Within the establishment of procedures that we referenced earlier, the focus is very much on credit quality. Plan sponsors have revisited the credit quality criteria for their investment funds and have not only set up a means to evaluate their initial decision but also are ensuring that the portfolio is reviewed on an ongoing basis. Up to this point, the emphasis continues to be on public ratings, and we tend to deal with companies rated AA or better. In addition to that, there's interest in how a company has its assets invested and there's interest in the capitalization of the company. Finally, there's interest in how much exposure the company has to higher risk assets. In many cases, higher risk assets are considered noninvestment grade bonds, nonperforming mortgages and, in some cases, real estate that's been taken over in the settlement of debt. Some clients have established a credit quality criterion whereby a company's capital must represent 5% or more of invested assets. A second criterion might establish a threshold whereby higher risk assets as a percentage of capital and surplus cannot exceed 150%.

CHART 1
Fixed Income Tradeoffs



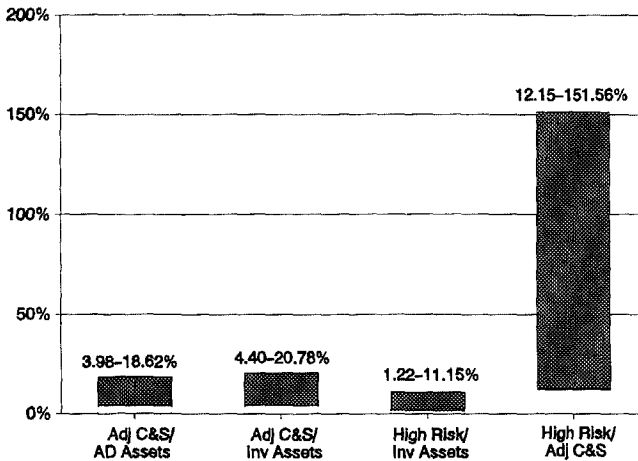
In many cases people want to look at the public ratings. If there's some concern with the public ratings, they tend to look deeper into the companies financial statements, and they tend to look at information from the statutory filings. It often sends a little bit of a conflicting message. In many cases, you have highly-rated companies having problem assets as a percentage of capital and surplus exceeding 100% (see Chart 2). In many cases you need to keep in mind that just because something is a higher risk or a problem asset doesn't necessarily mean it's nonperforming. You also need to recognize that it's highly unlikely that all problem assets would go bad at the same time or that there would not be recoveries from so-called higher-risk assets. Nonetheless, looking at it on a very conservative basis, you're in a situation where many well-known companies have higher risk assets exceeding 100% of their capital and surplus. That's a source of concern and confusion to plan sponsors.

The future with respect to GICs. It's our expectation, and I think it's an accurate expectation of plan sponsors, that there will continue to be a demand for book value products. Within the universe of plan participants there is a demand for stability. There is also an ongoing interest in maintaining a haven for risk-adverse investors, particularly older participants. In the future, the demand for the product will be less, given some of the points we've made earlier, but there will still be some demand. Finally, I think the structure of the portfolios will change. The reliance of the portfolio strictly on GIC investments will be much less. What is more likely is that the GIC will continue to serve as kind of a stable core, a somewhat illiquid core, in a broader fixed-income portfolio that also has market value instruments in it.

Concerning annuities, the plan sponsor concerns are somewhat different. The concern here is one of who's looking over my shoulder with respect to the decisions I make?

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CHART 2
Financial Summary Report
10th to 90th Percentile Peergroup Rankings



The ability of the plan sponsor to diversify or to manage the risks of an annuity is much less. There is an emphasis on credit quality given the long-term nature of the liability and the inability to diversify. There's concern regarding price versus quality in evaluating the risks of a given carrier. Finally, again, the Department of Labor is looking over your shoulder with respect to the decisions made.

With the Department of Labor, it's very much a question of what is my exposure? Given the concerns with the insurance industry, different regulations have floated about. To the best of my knowledge, nothing concrete has been implemented, but there is uncertainty as to what's going to happen in the future. One of the things the DOL has proposed is advising participants ahead of time of the invited bidders. This is a proposal. It has not yet been implemented. There also is advocacy of what is called buying the best of the best; essentially buying the best credit quality regardless of price. This is something that has become somewhat controversial in that it's a departure of what has been advocated in the past. Finally, in what is considered a source of concern and perhaps annoyance, the Department of Labor has been coming in after the fact and reviewing purchases that have been made. In one case, the DOL even pursued an enforcement action against a company who purchased an annuity from an insurer that is not in a conservatorship and that continues to make the timely payment of benefits to plan participants.

The future with respect to annuities is rather straightforward. There continues to be an emphasis on high credit quality standards. There's going to be a movement towards a formalization of the bid process. There's going to be documentation regarding who is invited to bid, the bids received, what was purchased and the rationale behind the purchase decision. The final item will involve much more openness with plan participants, with respect to the annuity purchase process.

Finally, there will be a need for positive communication regarding the result of the purchase process.

In conclusion, I think the answer to, "Is there life after Executive Life?" is very much yes. We don't feel that people have been running away from the insurance industry. As you take a step back, there's a demand in the marketplace for institutions to assume risk. The only people able to assume that risk essentially is the insurance industry, and to some extent, the financial services industry. We also expect to see a movement towards alternative products that emphasize plan sponsor ownership of assets where they can control the assets as well as the liquidity associated with those assets.

As a final point, it's the expectation that there's going to be a movement to restore public confidence, a more realistic evaluation of the true low risk associated with the insurance industry. Second, the industry will need to address some of the questions or concerns associated with the guaranteed funds, such as clarifying the coverage applicable to products, establishing a uniformity of coverage, and perhaps even moving towards an advanced funding of these guaranteed funds. If there is a problem, the needs of the plan participant can be met immediately as opposed to waiting for the conservatorship to be completed.

MR. ZEISLER: That was enlightening. The next speaker will be Sharon Novickas of VALIC who will give us some insight into the perspective of and the response by the insurance industry.

MS. SHARON NOVICKAS: The company that I work for, VALIC, specializes in a marketplace of traditionally very conservative people. We deal almost exclusively with nonprofit organizations. We market 403(b)s, or tax-deferred annuities, to employees of schools, hospitals and 501(c)(3) organizations such as Easter Seals and the YWCA. In each of these organizations, there's always a very small number of executives or principals who make a little more money than average, but the vast majority of our clientele is middle America. They are people who work in classrooms or in hospital rooms. Most of them don't know much about money. The vast majority of them are very financially unsophisticated, don't make a lot of money, and lean very strongly toward products that they hope are safe.

How did we deal with this problem years ago before Executive Life? Well, when I started working for VALIC about 15 years ago, the main questions that people asked me had to do with return on principal. The first question would be what interest are you paying? We had always tried to enlighten people with regard to mutual funds because over the long haul they tend to do better than fixed returns. Still, even after a long explanation of how a mutual fund works, the question would invariably come up -- what interest does it pay? Occasionally, people would ask if their money was insured and then we had a stock answer: Since the Great Depression or even during the Great Depression, nobody has ever lost a penny with life insurance companies. That answer soothed people and made them feel good. Even after the Baldwin-United debacle in the early 1980s, we could still say, well, everything worked the way it was supposed to; nobody lost a penny. Maybe they didn't get as much interest as they hoped they'd get, and maybe they were worried for a while, maybe their money was frozen for a little while, but it all worked out fine. Nobody lost any money.

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Well, needless to say, our story has had to change a little bit. We've had to get together some solid evidence and some solid figures on why a person should not be worried if they're investing with our company. What do we say? First of all, there are the state guarantee associations that Phil was talking about. Now, it's our company policy not to discuss these associations unless a person asks specific questions about them, and not until after the person has signed the application. But still, we have to be very careful with how we present a state guarantee association because many people think of it just like they would think of the Federal Deposit Insurance Corporation (FDIC) – they think it's funded – and we have to go through the explanation of how it's unfunded. There's no money there. Insurance companies are going to be assessed if somebody goes under. And there is also the very important consideration that since each state guarantee association is different, the protection that is offered is different.

I'd like to quote an article that appeared in the *Financial News Weekly* titled "On The Lookout: Gaps In Fund System Coverage." "As insurance failures continue apace, an alarming number of consumers and even agents and planners themselves could find themselves falling between the cracks of state life and health guarantee fund protection," I'll skip a little, "Not all state funds provide coverage for nonresidents. That's just one example. For instance, New York's guaranteed fund will cover policyholders only if they purchase the policy while living in New York. Payment on policies from an insured not domiciled or licensed in a policyholder's state of residence will depend solely on the laws of the state in which the company was domiciled."

So, again, we have to be very careful how we present the state guarantee associations. They are not a 100% guarantee that if a company has financial difficulties, that they will be paid. Also, there are differences between allocated and unallocated contracts. The GICs, the unallocated guaranteed investment contracts, are not covered by many states. VALIC, the company that I work for doesn't issue GICs. We work with the group allocated contracts that tend to be safer. There's a move on now for some sort of a federal regulation of the guarantee associations, and this probably would be a good idea.

So, how do we deal with this problem now? First of all, people want to know whether the insurance companies are in the same condition as the banks and savings and loans. We try and give them some statistics. I think the most recent ones I have are a little bit out of date, but they can still give you a little bit of perspective. In the years 1985 to 1990, 1,106 banks failed and 880 savings and loans failed. During that same period of time 126 life and health companies failed. Sometimes that soothes them a little, but people still want to know why big companies have gone under. We try and explain that the chief culprits were shaky investments such as junk bonds and real estate. We try and explain how our company – and we give them evidence – did not so indulge. When the trend was return on principal, companies were scrambling. You could lose business to somebody paying a half a percent more than you. People who had been with you for years would leave and go to a company paying a half percent more. So, how did these companies pay such a high return on principal? They had to go after some investments that were perhaps not the most solid and secure. So, within our company, we have to show that the general credit quality of our bond portfolio is quite good. We also show that our real

estate portfolio tends to be solid and well-diversified with a very small percentage of problem assets.

The other criteria or evidence that we've been using far more in the past year or two are the ratings companies. They are not only extremely well-versed in how to judge an insurance company, but they are impartial.

What I find rather humorous is that some people will tend to diversify. We have a lot of people who have been with us for years and years, who have more than \$100,000 with us. I think the person with VALIC right now who has the largest account has a balance of over \$2 million. We have lots of people with \$200,000-300,000. Even if they felt totally secure with the state guarantee association, they start getting a little bit nervous. Naturally, competitors are very eager to point to the fact that they shouldn't put all their eggs in one basket. They'll try and move them to a company with lower ratings. These companies may be paying a little more interest, but the ratings are very low. Instead of having the interest rate war, now it's the ratings war. Another thing people have been doing more of is looking at the mutual funds. They think that if it's not totally safe in these guaranteed fixed funds, they may as well take a chance on some of the mutual funds. In some cases, that's good. More people should be taking part in mutual funds, unless they're doing it for the wrong reasons. Some people think, well, I'm going to diversify because this fixed fund isn't safe. They go into a mutual fund where, of course, the safety factor is even less. There are no guarantees at all within a mutual fund.

All in all I think this has been (I hate to say it) a healthy experience, but as Phil alluded to, the companies are getting together and assembling much more solid portfolios. Also, the consumers are far more aware, and now the emphasis is on return of principal rather than return on principal.

MR. ZEISLER: Finally, Kevin Ceurvorst of Duff & Phelps will give us the rating agency perspective on this situation, and after Kevin has spoken we will open up the floor to questions and answers.

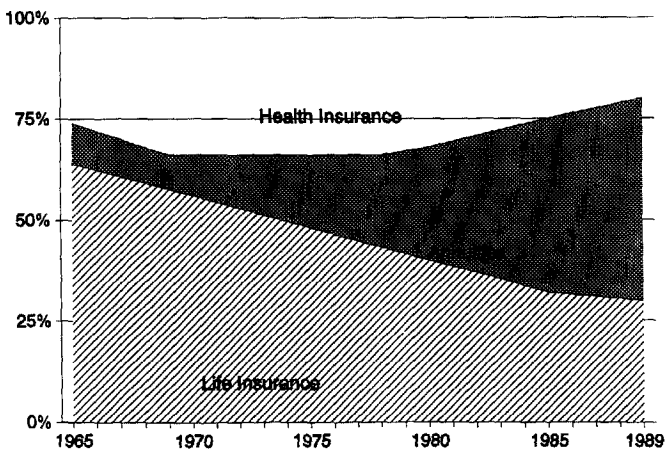
MR. KEVIN A. CEURVORST: Is there life after Executive Life? Executive Life had gained a significant amount of media attention before its demise, and that will be one of the key messages that I want to leave you with and one that we, as a rating agency, have to be particularly cognizant of.

I'll start off by giving you a frame of reference for Duff & Phelps, which has been rating public insurance companies since the mid-1970s. However, it wasn't until 1986 that Duff & Phelps Credit Rating Company really decided to investigate the possibility of providing insurance companies with claims-paying ratings. Prior to 1986, we had assigned debt and commercial paper ratings, and through this work on debt ratings, there were a number of trends occurring that led senior management to believe that the solvency issues of the industry would intensify. I want to review some trends because it's important to have a framework within which to view the industry as well as understand the existence of Executive Life, the reasons for Executive Life's investment portfolio composition, and the implications of the demise of Executive Life for the rating process.

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Chart 3 portrays some fundamental trends in the business. It illustrates a very significant trend that has existed for a number of years – during most of the 1980s particularly, and even the 1990s, the trend moves away from the insurance risk business such as life and health insurance and towards the annuity production business. What this was really indicating on a more fundamental level was a shift in the life insurance industry's method of making a profit. Basically, the industry was becoming an interest rate spread business. Insurance risks were becoming less of a driver to profits, while investment and asset/liability management functions became the drivers of profit. Stretching for yield really became a more sensitive issue for insurance companies also. We all know that demographics were playing a part in this. We know that interest rate disintermediation issues in the late 1970s and early 1980s played a part, and responding to these conditions was the design of a cadre of products. The growth of Executive Life was directly linked to these trends. What better way to capitalize on the trends than to essentially design a company that would provide accumulation-type products that gave customers higher returning vehicles. It was a response.

CHART 3
Company Income by Product Type



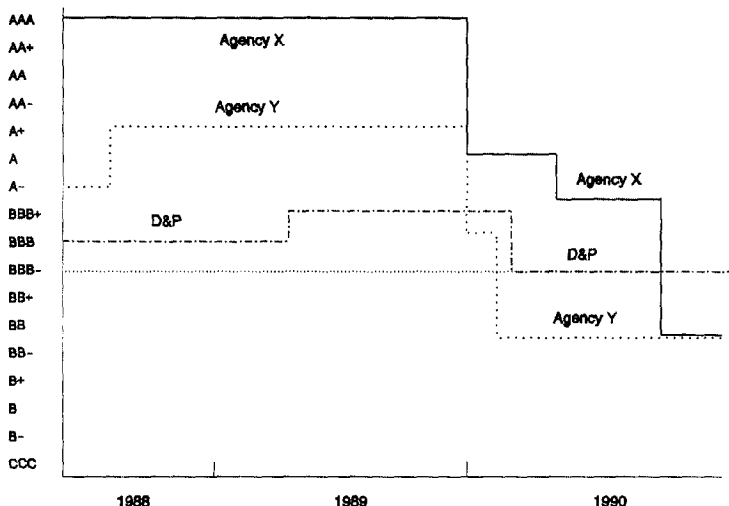
Source: Data from 1990 Life Insurance Fact Book, American Council of Life Insurance, Washington, District of Columbia

What did the trends mean for the industry overall? Well, the move toward interest rate spread business meant slimmer profit margins in the more traditional indemnity business. It meant that the industry would be under pressure to simultaneously lower its costs and increase returns shared with customers. This would effectively allow them to compete with mutual funds, banks, and brokers. One of the interesting things that we've seen is that as the industry became more of an interest rate spread business, the movement toward accumulation-type products was being increasingly spurred by the demand of institutional investors, particularly pension and thrift plan sponsors, and, in turn, Duff & Phelps knew from client inquiries in the mid-1980s that there was a growing demand in the institutional marketplace for additional independent analysis. In 1988 Executive Life was assigned a claims-paying rating by

Duff & Phelps. At that time it was based on publicly available information only, but eventually it was based upon a full client relationship.

What I want to show in Chart 4 is the historical rating changes that we made compared with some of the other agencies. As you can see here, we assigned a BBB rating and never really got out of that category.

CHART 4
Executive Life



I want to explain why we assigned Executive Life a relatively low rating compared with other agencies. A claims-paying rating is, in essence, an assessment of credit-worthiness, and that really is the guiding principle in assigning all claims-paying ratings at Duff & Phelps. Although there are numerous ramifications of Executive Life's growth and eventual demise upon the business of claims-paying ratings, one conclusion that we've drawn from Executive Life's experience is that the Duff & Phelps process developed in 1986 and refined over the years has basically stood well. It's remained credible and provides a fairly flexible and responsive method for assessing creditworthiness. The underlying reason is that we really have an interaction between the analysts, the senior credit rating committee members, and senior management of the companies. Incorporated into the credit assessment process is a blend of quantitative and qualitative analysis. It's almost unique to each company that we visit; if we had used only a quantitative approach for Executive Life, there probably would have been a higher rating assigned.

The list below gives you a few of the key areas that we look at when assessing the qualitative factors, and these factors have to be taken into the context of the risk being undertaken, management's business strategy, and the resources that the company has to deal with its strategy. All quantitative and qualitative tools are utilized to come to a conclusion, and in the final analysis Executive Life's BBB rating was really an assessment of the degree of control that management had relative to

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the risks it was assuming. The higher the degree of the investment risk, as in Executive Life, the higher the degree of control and the degree of asset/liability management sophistication that we required when we looked at the company. So, that's why our rating was relatively low to begin with. One of the most interesting facts surrounding Executive Life, and its eventual demise, is that it was not an illiquid company when it was taken over. It had quite a cash balance built up. Of course, the regulators were concerned that, because of their relatively low margin of safety, high-yield securities would continue to decline in value and that withdrawal patterns would accelerate. In fact, what they along with the media, had created was essentially a self-fulfilling prophecy.

Management Review:

- Is Company Run by People Who Know the Insurance Business?
- Does Company Have a Plan?
- Management Depth
- Asset-Liability Matching
- Underwriting Quality
- Niche or Full Line Player

One of the things that Duff & Phelps has a real commitment to is getting the rating right the first time, and this ties in with the self-fulfilling prophecy comment. Executive Life was really media-hyped, and it really damaged the confidence in the company, and it damaged the confidence in the industry overall. With lower confidence in the industry, "runs on the bank" became a real threat. I think Duff & Phelps has always tried to be mindful not to create a self-fulfilling prophecy through its rating actions. I think all rating agencies are particularly sensitive to this issue now. So that's one ramification of the Executive Life experience.

Certainly the rating agencies themselves are being more closely scrutinized. Careful policing of ratings by the constituents that use them and feedback from them serves to remind us that the issues that confront the industry really change over time in terms of weighted importance. For example, with Executive Life, focusing on liquidity of assets relative to liabilities became a much more important variable as other agencies lowered their ratings, increasing the "run on the bank" risk. As with less-than-investment-grade bonds, and particularly Executive Life's portfolio, mortgage exposure of insurance companies has come under increased scrutiny. An accurate assessment of the mortgage risks being undertaken now is critical. The mortgage area, obviously, has a greater weight of importance now. The self-fulfilling prophecy syndrome really puts a lot of pressure on us. Therefore, with mortgage investments and real estate being particularly sensitive, we're bringing professional real estate analysts to the table to analyze a situation. As generalized analysts, I think it would be unfair to come into a company and try to assess a mortgage and real estate portfolio without some real expertise on hand.

I think another ramification of the Executive Life experience is that insurance companies are now avoiding new investments in almost every class of high-yield securities and that includes even the "good junk," so to speak. The new National Association of Insurance Commissioners (NAIC) classifications and their reserving requirements have had an adverse effect on the supply of capital to BB-rated companies that really

are deserving of capital flows because of their covenants and collateral. It's always been Duff & Phelps' position that the insurance industry has played a significant role in this segment of the capital markets, and the need to distinguish between different grades of less-than-investment grade securities is really an ongoing responsibility of the rating agencies.

I think Executive Life has heightened awareness of the risks that an insurance company undertakes overall. This increased awareness has led to a multitude of regulatory actions such as, the NAICs risk-based capital ratio formulation. That's probably the most prevalent type of action that's taken place with regard to the insurance industry. It certainly will have a significant impact on the business.

The life insurance industry's interest-sensitive products, guaranteed investment contracts, group annuities, and structured settlement annuities all have a common theme running through them, and it really makes for a gravitation towards a single type of measurement for the industry. That's what the regulators are grappling with as they move forward. They're trying to get a better handle on finding problems earlier in the cycle and using a simple measurement to help them do so. We at Duff & Phelps believe that the regulators need some type of common measure to get a feel for where companies are within the spectrum of solvency. It's an important effort by the NAIC for the risk-based capital ratios.

However, with regard to rating individual companies, we have a little bit of a problem with risk-based capital ratios, particularly when utilized in a ranking context. One reason a single formula approach is probably inappropriate for a company-specific type of analysis is that the formula's standardized risk components are expected to be unable to accurately allow for differences among companies with regard to specific areas such as product mix and asset mix. Pricing in investment strategies is another problem area. The degree of hardness of surplus maybe is not being totally measured. Valuation practices, the differences between those practices among companies, aren't really taken into account. The stock/mutual company differences probably are not recognized well enough.

Management style -- the capabilities of management to handle its strategy and the risks inherent to it. I don't think that risk-based capital ratios are really addressing that. So, from a broad perspective for regulators, yes, it's a good idea, and we see that as a positive for the industry. It strengthens it. However, for our purposes at the credit rating company, we'll use that as another tool in our toolbox when we go out and analyze a company, but by no means is that going to be a driving factor for us.

I think Executive Life has acted as a trigger point or a catalyst that has begun what appears to us as kind of a healing for the industry. The industry, in response to the Executive Life experience, has reduced its exposure to less-than-investment grade securities. Mortgage exposure relative to total assets is already beginning to decline. The fear of poor perception is already causing companies to reduce exposure to and talk about securitization of mortgages. Some companies have larger problems than other companies, and the strong companies want to try to distance themselves from the weak companies. Unfortunately, because of the negative perceptions that have

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been built up, it has to be almost an industry effort to make sure that the perception problem doesn't get out of hand and become a true economic issue.

I think another ramification – it was mentioned a little earlier – is that some of the product composition of the business is changing. GICs are declining. There's no doubt about it. I think there's a lot of ramifications for reduced GIC sales. Regulatory policing has already been strengthened. As a rating agency we've enhanced our analytical efforts by using real estate professionals when necessary, and various other techniques. We're giving every effort now and we always have. I think there's even more pressure now to get the rating right the first time to avoid the perception of problems in the future, and to avoid causing self-fulfilling prophecies. As a very last comment, when we look back on Executive Life and its demise and what that's meant, we may see it as a turning point towards a strengthening industry in general.

MR. JOSHUA DAVID BANK: One of your graphs up here showed that insurance companies are tending to look more like investment houses rather than assurers of insurance risk. Do you also rate banks and other investment entities, pure investment entities?

MR. CEURVORST: Oh, yes. Duff & Phelps Credit Rating Company rates various kinds of financial institutions, including brokers and banks. We have a significant banking rating client base.

MR. BANK: I hoped you'd have that answer. The real question I have is you didn't mention bank investment contract (BIC) or bank guaranteed interest contract (GIC)-type of products much. Is that a viable alternative? Are they safer? Why would a sponsor risk going into a GIC when they can go into banks who have never lost principal, supposedly?

MR. CEURVORST: That's a good question which I'm going to defer to Phil because I think he's got the right answer.

MR. SUESS: BICs were an opportunity-type investment going back to 1989-90 where you had the inverted yield curve that enabled the banks to be very competitive on relatively short maturities, and during that time period there was an inflow of funds into BICs. The attraction of the BIC marketplace was the pass-through FDIC coverage. Since that time period we've gone back to a more normal sloped yield curve. So, BICs have become a very expensive source of funds to the banking industry, and they have moved away from that. Also during that time period the concern with the banking industry has come to the forefront. Banks on a stand-alone basis are in many cases less attractive than insurance companies. The thing that helped them in the past was the FDIC coverage going forward. That coverage is in the process of being phased out on those type of investments. So, you're in an environment now where it's a rare exception that a bank is a participant on a stand-alone bank investment-type contract.

MS. RUTHANN HALL: My question is for Phil. You mentioned that GIC funds are now holding market-value assets as well as GICs, and I wanted to know what happens when interest rates go up and you have a market-value loss on those

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assets? How's a plan sponsor going to explain that to the participants in a situation where the GIC rate is already lagging behind the market rates?

MR. SUESS: That's very much the question that plan sponsors are confronting, and why they're establishing an investment policy. One of the questions is, can we afford to introduce market-value risk into our portfolio? Your comment is very correct. Yes, you move away from the GIC. What do you do? You move into bonds. You're introducing market rate fluctuation, and you're doing it in what is a relatively low rate interest environment. If rates go up, we're now confronted with a decision whereby maybe we don't have negative earnings for our portfolio, but we certainly have a reduction in the earnings rate of that portfolio relative to what it's been. There are some plan sponsors who are to the point that they are comfortable introducing market-value risk into these portfolios and are working to communicate that to their participants. There are other plan sponsors who have said the attraction of this product is book value accounting, and we do not want to give that up. What we will do is maybe introduce another fixed-income option and introduce it in a way that it can coexist, if possible, with the GIC so participants can decide whether they want book value or market value.

MR. WALTER C. CROW: I'm with the Cleveland Clinic. I have two questions regarding ratings. First, are some carriers receiving lower ratings based on the same information? At least one carrier contends they did, from an agency other than Duff & Phelps; it was a large carrier. Second, some of the rating bureaus rate an organization only if they agree to be rated and pay the fee. Isn't that sort of self-selection -- that means the party that doesn't want to be rated won't step forward.

MR. CEURVORST: I need a clarification on the first part on the question here. I didn't quite understand.

MR. CROW: Are some carriers receiving lower ratings based on the same data and information as was used in the past? Is it not based on new data? In other words, are some rating bureaus going back and giving lower ratings to an insurance company without a change in information or circumstances?

MR. CEURVORST: Duff & Phelps has not done that. I can't speak on whether the other rating agencies have done specifically what you're saying, but I think there have been changes in the economic climate which have required a multitude of downgrades by other rating agencies. I think that points out some of the philosophical differences from one rating agency to another in trying to get the rating right the first time. Also, it points to certain capabilities of the industry to deal with its problems. For example, we have been bringing in professional real estate analysts. I think those types of differences are allowing Duff & Phelps to avoid certain actions that maybe had to be taken by other agencies. Based on old data, are they changing ratings? My answer to you would be probably not. I think probably what they're seeing is new data with regard to the economic climate. With the sophistication of the industry increasing over time, what the credit rating agencies are seeing in terms of sophisticated analysis, and asset/liability management, is more useful. I think that new data is opening some eyes. Duff & Phelps didn't start providing claims-paying ratings on insurance companies until the 1986-87 period. The industry had already

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started to progress at that time. A number of trends were already becoming apparent to us, not that we don't have some differentiations on other points, too.

MR. CROW: Do you rate only companies that pay for it? In which case, there's some self-selection.

MR. CEURVORST: I think at least two of the major rating agencies, if not all three of the rating agencies, have put out ratings before that have not been paid for. We have. When we started in 1986, we established claims-paying ability ratings for six companies that didn't pay us. Over time, of course, we wanted to convert them to a client relationship because that allows us the opportunity to have inside information. In our publications that we make available to consultants and brokers, we can't give the inside information out, but you can be assured that within the rating that we do assign to the company, all the inside information is taken into account. So, if you're suggesting that there's a bias because the insurance company is a client, keep in mind that it's just an intermediate client. The ultimate clients, obviously, are the users of the ratings, and if we aren't true to our principles, the ultimate clients, the users of the ratings aren't going to use our ratings anymore, and we won't be in business.

MR. DAVID R. LENT: I have a question for Phil Suess. You showed a triangle of investment risks, and it only talked about how the plan sponsor looks at default risk. How do they look at the other two risks, most specifically the interest mismatch, the C-3 risk? How does the plan sponsor examine or analyze the C-3 risk for the insurer?

MR. SUESS: Now, when you say market risk, is that with respect to the insurer or with respect to the product?

MR. LENT: The market risk of the insurer – the mismatch between their assets and their liabilities.

MR. SUESS: I think that's something the plan sponsor does not know a lot about. There's been a lot of focus, initially, on asset quality. I think people are now getting a greater understanding of the liability side, and as the marketplace becomes more knowledgeable in those issues, there is going to be a greater focus on the matching of the assets and the liabilities. The other point I would make with respect to that chart is that I think you're broadening the application more than we had intended. It was looking from the plan sponsor perspective – at a trade-off in the decisions they need to make in selecting a product: if you want the yield, there's going to be some give-up in the credit quality perhaps and, in many cases the market value or the market-value fluctuation of the product. To the extent you want to emphasize the stability of principal, for example, or the high quality of the assets, there's going to be a give-up in yield.

