RECORD OF SOCIETY OF ACTUARIES
1995 VOL. 21 NO. 2

UNDERSTANDING THE RATINGS PROCESS

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Recorder: FRANK J. BUCK

This session will include presentations by representatives of a leading rating agency and offer opportunity for audience participation.

MR. FRANK J. BUCK: For a number of years, Standard & Poor's (S&P) has put on an annual insurance conference. I have been to a couple of these seminars, and I was probably one of the few actuaries to attend. I found the process very interesting. The speakers go through the whole process of showing how they rate a company and they go through a mock ratings process. They have volunteered to repeat their demonstration here. The audience will get involved in and will be part of the committee at the end of this process, and will be able to vote at the end of the day on whether you think this company should have a good rating or not.

We have five panelists all from S&P. Mark Puccia is a director, chief life analyst, and the head of life insurance criteria. He has been with S&P for about ten years, and prior to that he was with Chase Manhattan. Charlie Titterton is another director and the unit head of life and property & casualty (P&C). He has been with S&P for three years, and previously he was at Manufacturers Hanover Trust for 25 years as the area manager for insurance. Drew Desky is an associate director and life analyst. He has been with S&P for two years and was previously an officer at the Bank of New York. Phil Tsang is another director and life analyst for domestic and international life companies. He has been with S&P for ten years and was previously with U.S. Life. Jack Reichman is an associate director, a life analyst, and a life actuary. He has been with S&P for four years and was previously with The Equitable. Mark Puccia will introduce the session topics.

MR. MARK PUCCIA: I think you will find the rating committee process interesting. S&P is a very collegial organization, and believe it or not, the people that you meet with who are doing the evaluation of your company are not the ones that are necessarily going to

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rate your company. It is actually done by a rating committee; it is a collegial process. The rating committee is the foundation of the ratings that we have at S&P. All ratings are determined by a committee, and our committees use a highly sophisticated process.

A rating committee typically comprises five or more individuals, and for this presentation, we do have five people here. Our committee meetings usually occur within three weeks after we have met with a company's management. It is integral that we talk to the people who are running the show.

Let me briefly describe to you the rating process. We look at a balance of qualitative and quantitative factors. We look at the strengths of a company, and in the particular company's case that you are going to see, which is Sandy Beach Life, you will note that the company in the view of the primary analyst has superior capitalization, excellent earnings, strong liquidity, and good expense management. It is going to balance that against the weaknesses of the company. In this particular case, the analyst feels the company has a geographic concentration in Florida and has limited financial flexibility.

The process itself consists of a balance of quantitative and qualitative factors. We are going to look at such publicly available information as the statutory blanks, 10Ks, 10Qs, annual reports—10Ks and 10Qs are statements that are filed by stock companies with the SEC. There is also plenty of nonpublic information, such as surveys, that we have the company fill out on such things as asset quality, interest rate risk, mortgage holdings, liquidity, and capital issues. We are also going to be dealing with qualitative issues.

Qualitative issues relate to management strategy. Again, we think that good management can always make a company better and bad management can always make the best of companies worse.

Competitive position is very important to consider. One of the toughest questions for a company to answer is what makes you distinctive from your competitors. Finally, there's financial flexibility. What sources of funding do you have to meet your growth needs, and how do those compare to your needs for funds? We are going to synthesize all this into the rating methodology profile (RAMP), which is our analysis. The following is the analysis in which the primary analyst has established the strengths and weaknesses and has made qualitative judgments about various categories of analysis:

- Industry Risk — Good
- Management and Corporate Strategy — Average
- Business Review — Good
- Operational Performance — Excellent
- Investment Performance — Excellent
- Capitalization — Superior
- Liquidity — Excellent
- Financial Flexibility — Good

Our primary analyst is going to spend 10–15 minutes making the presentation to the committee. A question-and-answer period will follow; members of our committee will initially ask some questions, and then we are going to open it up to the audience. Finally, there's a vote. We try to reach a consensus on this particular company's rating.

The analyst has made a recommendation of AA+; you will be part of that process as well. We are looking for you to come up with the rating. It is always an interesting exercise for us to find out whether the audience thinks that the company is actually stronger or weaker than what we have come up with.

Now Charlie Titterton will act as the chairperson for this committee.

MR. CHARLES TITTERTON: Before we get started, I just want to give you a brief explanation about the function of the chair which is, again, my role in this presentation. The chair is a traffic cop in rating committees. Typically, when the analyst presents a company, the rating committee will comprise people who already know quite a bit about the company. Indeed, some of them will, by virtue of long experience with S&P, know perhaps as much as the analyst because they have followed the company, or just been part of the rating process on many occasions. Also, analysts are not shy. They will be loaded with questions because they have read the RAMP beforehand and know a great deal about the company. So, there will be a tendency for analysts to jump in with all kinds of questions. The chair has to regulate this process to make sure that the proceedings are kept focused, and that we, quite frankly, get through the process in an efficient manner and not take much more time than is necessary, which would often be the case if the committee were not regulated by the chair.

When we presented our rating committees in the past, we found that the more the audience participates, the more interesting and effective the session is, and, therefore, we include the opportunity for audience participation. The first opportunity would occur right after the analyst, Phil, has presented Sandy Beach Life. That is the time when the question and answer period starts. There will be a round of questions that the panel, the rating committee, will ask, and the chair will ask the members of the audience to ask questions of the analyst, Phil. We will alternate questions—one from the committee and one from the audience. The second will be right after the question and answer period, which is the time that the committee takes its vote on the analyst's recommendation. Before we vote, we are going to ask you the audience to vote. I am going to ask you for three different votes: do you agree with the recommendation, do you think the recommendation is too low, and do you think it is too high? A show of hands will give us a good idea of how you think the company should be rated. Finally, after the committee process has been iterated, you will have an opportunity to ask us anything about the S&P rating process. I would like to turn the meeting over to Phil Tsang who will present Sandy Beach Life.

MR. PHILIP TSANG: This is the second time I have made a rating presentation to so many people. Normally, it is only to five or a dozen people, and I would say that the average is about eight people. I hope that you have a better mind than regular committee members because I do need your support later on in terms of the vote. If you have any questions you can ask later.

I am recommending that we assign an AA+ claims-paying-ability rating to Sandy Beach Life Insurance Company, and my recommended confidential outlook is stable. The rating recommendation is based on Sandy Beach's superior capitalization, excellent earnings performance, excellent investment performance, excellent liquidity, good business profile, good financial flexibility, and what's more important is we expect that the company will be

able to maintain the superior capitalization and excellent earnings performance in the next several years.

I am going to talk about the capitalization and tell you how good it is. Look at the capital adequacy model in Table 1; that is, the model S&P uses in evaluating capital adequacy of life insurance companies. Sandy Beach's capital, if you look at the surplus and capital and AVR at the end of 1994, was $160.4 million and the risk adjusted capital is $120.7 million. That is after we have deducted $39.7 million for asset charges. If you look at the required capital to support the liabilities of Sandy Beach, the total is $64.6 million, and this results in a capital adequacy ratio of 186.8%. For 1993, the company had a capital adequacy ratio of 187.6%. So, for the two years they are quite consistent. Bear in mind that we consider a capital adequacy ratio of 175% or higher as superior, or AAA capitalization.

Also, the capital position of the company shows surplus has grown at 12% a year over the last five years, and that reflects a solid development of surplus. The operating leverage ratios have risen steadily in the last four years from 13.6(x) in 1990 to 17(x) in 1994, as shown in Table 2. This is primarily due to surplus strains associated with the fast growth of the new business.

When meeting with the company representatives, it is very important to ask the company if they will be able to maintain that type of ratio going forward or if the operating leverage will continue to decline over the next several years. Management advised us that they are committed to maintaining the capital adequacy ratio at at least 175%, and also they intend to achieve this by emphasizing capital strength over growth. They are not going to beat up their salespeople so hard, and they're going to get the quality business and make sure that they have a good risk-based capital (RBC) and capital adequacy ratios.

Also, at the end of 1994, they introduced more capital efficient products, and these products are going to have less surplus strain than the old ones. On this basis, we believe that they will be able to maintain a capital adequacy ratio of at least 175% over the next several years.

Now, let us turn to operating performance in Table 3. Sandy Beach Life's operating performance, based on our statistics, is excellent. On a modified GAAP basis, as shown in Table 4, you can see that return on average assets of 104 basis points, at the end of 1994, and also if you look at the last five years and take the average, it has been quite consistent at about 100 basis points. This is excellent for the company's business mix.

The RAMP in the operating performance section for the annuity business and the guaranteed investment contracts (GICs) have a GAAP return on assets (ROA) of about 80 basis points. That means, on the individual life business, the ROA is actually higher than the 104 that is presented. We expect that Sandy Beach will be able to maintain an ROA of at least 100 basis points over the next several years.

TABLE 1
S&P CAPITAL MODEL
SANDY BEACH LIFE INSURANCE COMPANY

NAIC CHARGES			
Calculation of Capital Adequacy Ratio	**Factor**	**1994**	**1993**
Capital & Surplus		$140.4	$128.6
AVR		20.0	20.0
Voluntary Reserves		0.0	0.0
Dividend Liability	0.5000	0.0	0.0
Adjustment to capital of subsidiaries		0.0	0.0
Analyst's adjustments (for example, surplus notes)		0.0	0.0
TOTAL ADJUSTED CAPITAL (TAC)		160.4	148.6
Required Capital for Bonds		$ 21.9	$ 24.8
Required Capital for Preferred Stock		0.0	0.0
Required Capital for Problem Commercial & Farm Mortgage Loans		10.0	9.0
Required Capital for Performing Commercial & Farm Mortgage Loans		3.1	3.2
Required Capital for Problem Residential Mortgage Loans		3.7	5.0
Required Capital for Performing Residential Mortgage Loans		1.0	1.0
Required Capital for Nonaffiliated Common Stock		0.0	0.0
Required Capital for Real Estate Holdings		0.0	0.0
Required Capital for Other Invested Assets		0.0	0.0
Additional Capital Needs for Assets Not Already Captured		0.0	0.0
REQUIRED CAPITAL FOR ASSET RISK (C1)		39.7	43.0
SIZE FACTOR (Minimum value of 1) (S)		1.0	1.0
REQUIRED CAPITAL FOR ASSET RISK ADJUSTMENT BY SIZE FACTOR: C1a = (C1 × S)		39.7	43.0
Required Capital for Individual & Industrial Life at Risk		$ 2.1	$ 1.9
Required Capital for Group & Credit Life at Risk		10.9	9.8
Required Capital for Individual Morbidity—Medical Insurance		0.0	0.0
Required Capital for Group & Credit Morbidity—Medical Insurance		6.0	5.0
Required Capital for Individual Morbidity—Disability Income		1.0	1.0
Required Capital for Group & Credit Morbidity—Disability Income		9.5	8.7
Required Capital for Claim Reserves		11.0	9.8
TOTAL REQUIRED CAPITAL FOR INSURANCE RISK (C2)		40.5	36.2
LESS: Premium Stabilization Reserves: PSRs	0.5000	0.0	0.0
TOTAL REQUIRED CAPITAL FOR INSURANCE RISK (adjusted by PSR): C2a = (C2 - PSR)		40.5	36.2
Low Risk Charge (LRC)		$ 8.0	$ 7.5
Medium Risk Charge (MRC)		3.5	4.6
High Risk Charge (HRC)		12.6	8.0
TOTAL REQUIRED CAPITAL FOR INTEREST RATE RISK (C3)		24.1	20.1
OTHER CAPITAL NEEDS (Other)		0.0	0.0
RISK ADJUSTED CAPITAL: A = (TAC - C1a)		120.7	105.6
REQUIRED CAPITAL: B = (C2a + C3 + Other)		64.6	56.3
TOTAL ADEQUACY RATIO: (A/B)		186.8%	187.6%

TABLE 2
SANDY BEACH: SELECTED STATISTICS—YEAR-END DECEMBER 31
(MILLIONS OF DOLLARS)

	1994	1993	1992	1991	1990
Total revenue	810.8	745.3	691.6	589.0	476.7
New operating income	8.4	7.9	5.5	4.6	2.2
Net income	9.6	6.9	7.1	9.0	5.8
Return on assets (%)	0.31	0.34	0.28	0.28	0.16
Total assets	2,999.8	2,641.5	2,261.6	1,913.6	1,582.0
Statutory capital	160.4	148.6	130.7	112.9	103.2
Operating leverage (x)	17.0	16.1	15.6	15.3	13.6

TABLE 3
SANDY BEACH: OPERATING PERFORMANCE—YEAR-END DECEMBER 31
(MILLIONS OF DOLLARS)

	1994	1993	1992	1991	1990
General expenses	20.4	18.3	15.8	14.4	13.4
General expense ratio (%)	3.7	3.6	3.2	3.4	3.9
Expense ratio (%)	8.6	7.8	6.7	7.6	7.9
Lapse ratio (ordinary only) (%)	7.2	9.5	8.6	9.6	9.5
Policyholder dividends	25.0	24.3	23.8	23.4	22.6
Accident and health:					
Loss ratio (%)	80.8	53.8	74.6	72.7	67.6
Expense ratio (%)	47.7	48.7	43.2	44.9	60.9
Combined ratio (%)	128.5	102.5	117.8	117.6	128.5

TABLE 4
SANDY BEACH: COMPOSITE OPERATING STATISTICS—YEAR-END DECEMBER 31
(MILLIONS OF DOLLARS)

	1994	1993	1992	1991	1990
Total revenue	810.8	745.3	691.6	589.0	476.7
Pretax income	12.0	15.3	14.9	14.9	9.0
Net operating income	8.4	7.9	5.5	4.6	2.2
Net income	9.6	6.9	7.1	9.0	5.8
Return on revenue (%)	1.5	2.1	2.2	2.5	1.9
Return on assets (%)	0.31	0.34	0.28	0.28	0.16
ROA including capital gain (%)	0.36	0.30	0.36	0.54	0.42
Return on surplus (%)	5.46	5.68	4.55	4.29	2.28
GAAP operating income	34.8	30.8	27.0	25.2	21.5
GAAP ROA (%)	1.04	1.01	0.98	1.03	1.00

The company's return on assets on a statutory basis is a different story. It is only 31 basis points for 1994, which is not that great. However, this is once again due to the surplus strain associated with the fast growth of the business, but we expect the statutory earnings of this company to improve gradually over the next few years. As I mentioned before, they are selling more capital efficient products, and they are not selling that many new policies; also, the profits from the existing policies, those sold in the last two or three years, should

emerge in the next several years. That is why the trend of statutory earnings should go up in the next several years.

There is a drag on Sandy Beach earnings: the individual disability line of business has been losing money. In 1994, they lost $1 million on this line. Clearly, Sandy Beach does not have the critical mass in the individual disability line. Management, when they talked to us, said that they will make a decision some time this year about whether to keep the business or look for reinsurance. They are trying to get rid of the business, but they do want to maintain the product to accommodate their agents.

Now, let us turn our attention to investments (Table 5). Sandy Beach's investment performance is also excellent. The company generates above-average returns while maintaining a very high-quality investment portfolio. Asset allocation is skewed towards bonds which is 57% of the total invested assets at the end of 1994. Commercial mortgage loans is 26%. Sandy Beach does not have any significant exposure to equities or real estate, and the credit quality of their bond portfolio in aggregate is AA-. This is for both the public and the private placement investments. There is a considerable amount of collateral mortgage obligations (CMOs) in the portfolio, but these are not the exotic tranches like interest only (IO), principal only (PO), or the inverse floaters. They are extremely conservative, and they do not have much risk, but they do have CMOs in their portfolio.

TABLE 5
SANDY BEACH/INVESTMENT STATISTICS
YEAR-END DECEMBER 31
(MILLIONS $)

	1994	1993	1992	1991	1990
Net investment income	236.1	209.0	177.6	149.4	119.1
Net investment yield (%)	7.9	8.1	9.1	9.2	9.0
Realized capital gains	1.2	(1.0)	1.6	4.3	3.6
Unrealized capital gains	2.5	1.5	1.4	0.7	0.6
Net capital gains	3.7	0.5	3.0	5.1	4.1
Portfolio composition:					
Cash & short-term invest (%)	7.0	6.9	7.1	4.7	3.8
Bonds (%)	56.5	53.9	52.2	52.9	53.5
Mortgages (%)	26.5	29.9	30.5	31.0	29.5
Policy loans (%)	4.1	4.5	5.1	6.1	7.8
Preferred stock (%)	0.4	0.4	0.6	0.7	0.4
Affiliated common stock (%)	1.7	1.9	2.0	2.2	2.1
Unaffiliated common stock (%)	0.4	0.4	0.4	0.4	0.6
Real estate (%)	1.7	1.4	1.4	1.1	1.3
Other (%)	1.8	0.6	0.7	0.9	1.1
Aggregate write-ins (%)	0.0	0.0	0.0	0.0	0.0
Bond portfolio average maturity (years)	9.7	9.9	8.9	9.7	10.1

They also have some junk bonds in the portfolio, but it is not their strategy to invest in junk bonds. These are largely fallen angels. They bought these BBB type of securities, and they were subsequently downgraded; that is why they have these junk bonds in their portfolio.

If you look at the mortgage portfolio, the performance is also better than average. This is a result of Sandy Beach sticking to its very stringent underwriting procedures. For example, loans are only granted to fully occupied properties with very strong credit tenants, and there also is excellent diversification by property types and individual borrowers. If you look at the loss experience on their mortgage portfolio, it is very favorable. If you look at the problem loans including loans that are 30 days past due, foreclosed property and restructured loans, you see that the total for 1994 was about 10% of the total portfolio, and this is about half of the industry average based on S&P's survey. The high-quality investment portfolio has contributed to the company's good earning strength and very favorable capital adequacy ratios.

Table 6 is the liquidity model. The information is also excellent. This year we have a new liquidity model, and when we came up with this company's ratios, they measure quite well against many other companies with the same business. The liquidity ratio is 178.7% for 1994, and it compares very well with companies with a similar liability mix.

The company is sensitive to interest rate movements because it has a lot of GICs and single-premium deferred annuities (SPDAs) on its books. These interest-sensitive liabilities represent 78% of total reserves at the end of 1994. Also, about one-quarter of the SPDAs are subject to withdrawal without any penalty or surrender charges. However, if you look at the high-quality portfolio of the company and also the fact that there are a large number of cash or short-term securities, it provides ample liquidity, and that is why the capital ratio is very favorable.

Sandy Beach also has a very good discipline in asset/liability management. They are well-matched in liability durations and they also do many testings. The cash flow match also is quite favorable. They do that on a quarterly basis rather than on an annual basis like many other companies do. Once again we expect the liquidity ratio to be maintained in the next several years, at least at the 175% ratio.

In terms of the company's business profile, it has a very strong market position in Florida and the surrounding states. It has a good reputation in the Southeast, and also it has a very loyal career agency force.

This company has another advantage—a low cost structure. However, because of Sandy Beach's dominance or its large exposure in Florida, it lacks geographic diversification. In 1995 about 50% of the new business is expected to be from Florida; nobody knows about Sandy Beach Life outside Florida in the surrounding states.

The company's financial flexibility is also good. Over the years, Sandy Beach has demonstrated that they have the ability to generate surplus to finance growth. However, as a mutual company, its ability to raise capital is quite limited. This is not a major issue for us because the company has been able to support growth internally. However, it will be a different story if this company is going to go out and make acquisitions and try to buy other companies or blocks of business. In that case, I believe that they need to have outside capital.

So, to wrap up my presentation, I am recommending an AA+ claims-paying-ability rating for Sandy Beach Life. It is based on superior capitalization and earnings performance, excellent investment performance, excellent liquidity, a good business profile, and good financial flexibility.

TABLE 6
IMMEDIATE AND ONGOING LIQUIDITY RATIOS

	Obligations	Risk Factor	Result
Immediate Scenario			
Individual and Group Product Surrenders	309.6	70%	216.7
PLUS: Adjusted amount for lump sum payments of GICs, SPIAs, and structured settlements	300.0	100	300.0
PLUS: Amount for DEBT maturing in 1 year or less:	0.0	100	0.0
PLUS: Analyst's Adjustments			
Total Immediate Scenario Obligations	609.6		516.7
Immediate Scenario Liquid Assets			1,311.6
Total Liquid Assets to Obligations			**253.8%**
Ongoing Scenario			
Individual and Group Product Surrenders	416.1	70%	291.3
PLUS: Adjusted amount for lump sum payments of GICs, SPIAs, and structured settlements	300.0	100	300.0
PLUS: Amount for DEBT maturing in 2 years or less	0.0	100	0.0
PLUS: *Analyst's Adjustments*			0.0
Total Ongoing Scenario Obligations	716.1		591.3
Ongoing Scenario Liquid Assets			1,311.6
Total Liquid Assets to Obligations			**221.8%**
Liquidity Ratio			178.7%

MR. DREW DESKY: Phil, when you were talking about operating performance, one of the things that you said was that one of the reasons for your recommendation is not the past performance of the company but your expectations for the future. The company has generated excellent earnings on a GAAP basis in the past. With this new generation of whole life products, why is management moving in that direction, given its tried-and-true products and excellent performance in the past?

MR. TSANG: When you look at GAAP earnings, you see that Drew is correct; they do have a very good track record. However, the statutory earnings, in terms of return on assets, have been quite low. To the extent that they are going to grow their business

continuously at the current pace without the new generation of products, actually operating leverage is going to rise beyond the 18 times or the capital adequacy ratio would fall below that 175% on that basis. As I mentioned before, management is committed to maintaining their capital strength, and that is why they are designing these new products, and I also strongly believe that they will be able to maintain the strong level of capital while maintaining the good level of GAAP earnings.

MR. PUCCIA: Phil, one of the strengths that you mentioned for the company was their excellent expense management, but when looking at the statistics in Table 2, you'll note that the expense ratio over the past three years has risen steadily. You also mentioned that the company is going to be diversifying into some new products, and I sense that there might actually be further expense pressure. Is there a danger that this expense ratio will continue to rise?

MR. TSANG: That is a very good question, Mark, but if you look at the expense ratios, they are not that great for companies that have many GICs and annuities on their books; however, they do have much individual life business.

You look at many of the numbers in terms of the expense ratio. Largely they are commission expenses that are paid to the agents, and if you look at the management expenses, they have been quite stable in the last five years despite the very strong business growth, and on that basis, you can compare this company's expense ratio and the management expense ratio with other companies in the industry. They have been quite favorable over the last several years.

MR. JACK Z. REICHMAN: Phil, I wonder if you could clarify some of your comments about the company's business concentration. The way I would look at it, Florida is a very large state, and the other states in that southeastern region still account for over 50% of the company's business. So, in light of that, why is it that you think that the concentration issue is a weakness for the company?

MR. TSANG: That is also a very good question. I am recommending a very high rating for this company. When you look at a company's business profile, they should have good geographic diversification. They have been able to sell more GICs and annuities over the years. However, with over 50% of new business from one state and also the rest of the business from surrounding states, you may have some large competitors there and have a price war with them. Then they will be vulnerable, and that is why it is a concern to me. I believe that going forward, if I were management, I would try to diversify the business more.

MR. TITTERTON: Phil, you are recommending an AA+ rating which is the second highest rating that we have—it is an extremely strong rating. Yet, for the two major qualitative components of the rating process, which would be business review and management and corporate strategy, you have assigned only an adequate rating and a good score. How can you recommend a rating this high when these two very important characteristics of the company are rated down the line a little bit?

MR. TSANG: Well, Charlie, is it not true that if these couple of categories are excellent or superior, that this should be an AAA company? I believe that, in terms of management, they are not the best in the industry. When we talk about average management, it is a qualitative factor. It is very difficult to say whether this management is better than the other one. That is why we said the management is maybe good. I believe that there are some issues that they have not managed well, such as the concentration of business and a disability line of business that is losing money.

MR. TITTERTON: That concludes the first round of the committee questions, and here is where the audience gets a chance to ask some of your questions. When you do, try to put yourselves in the shoes of a committee member. You have had a chance to look at the RAMP to some extent. Think of yourself as somebody who is going to be voting, as indeed you will be later on, when you ask these questions.

MR. RONALD L. KLEIN: Are you aware that Sandy Beach was being sued by Savings Bank Life Insurance because they have the same initials?

MR. TSANG: That is a good question. No, I was not aware of that. To the extent that we are aware of it, it will be included in the RAMP as a contingent liability, and then we will have to talk about what will be the outcome of the lawsuits, but I was not aware of the issue. Thank you for bringing it to my attention. I will go back to the company and ask them.

MR. DESKY: Phil, I wanted to ask you a question on one of your scores, which is a follow-up on Charlie's earlier question. With regard to the score on management and corporate strategy, you said that you are comfortable with management changing its strategy with regard to its product mix, given the surplus strain issue, even though the previous product mix has produced the AA+ profile. Why are you scoring the strategy so low?

MR. TSANG: Once again I mentioned, when I answered Charlie's question, that management will have to address several issues like the individual disability line, and they have to diversify their business more. I do believe that the score, as I recommended, is quite appropriate because I believe that there are some strengths in management although it is not one of the best in the industry.

MR. R. THOMAS HERGET: I was looking at their annual statement and noticed all the last names of the officers are the same. They seem to be all part of the same family. How do you take into account this type of situation where the management might be inbred?

MR. TSANG: That is a very good question. When we look at the company, we realize that there are many family members in the family trust that own this company, and, in fact, this family has invested in other companies. Actually, we had the opportunity to look at the financial position of this family and they are very solid in that respect. We have some comfort, but we are not talking about one of the highest ratings out there. But it is in a very comfortable position compared to other families.

MR. TITTERTON: Continuing alternating questions from the floor and from the committee, I will ask Mark to contribute.

MR. PUCCIA: When looking at the liquidity ratio in Table 4, I noticed that the company's investment portfolio does have some concentrations in private placements. You mentioned that they have a large surrenderable GIC and annuity liabilities, and also that a quarter of their annuity reserves are subject to withdrawal without any kind of surrender charges. Does that cause you concern considering the high rating recommendation?

MR. TSANG: Well, Mark, actually you and Drew were the ones who came up with this liquidity model. Without this new liquidity model I would agree with you, but the liquidity ratio is very strong. Why? Because the private placements of this company are highly marketable, and they are all rated NAIC 1s and 2s. On top of that, they have a large reserve, cash and short-term securities, and overall with their public bonds they do not have any real estate or other assets. That is why they have such a strong liquidity ratio. We expect that this ratio will be maintained in the next several years.

MR. KLEIN: You mentioned that the products that Sandy Beach is going to introduce have a higher profit margin than the current portfolio that they have out there. I wanted to know what kind of research you did to assure that they do have a higher profit margin, or are you relying on the profit runs of Sandy Beach?

MR. TSANG: When we talk with management, that is the most important issue. They will give us projections on their products and the pricing and also the profit margins. They have all these beautiful charts. Now, we do not totally believe those numbers. That is why we also have in-house actuaries to look at these numbers. But at the management meeting, one has to talk to management and try to realize whether the kind of things management is doing are appropriate or not. When we look at the profits from the new generation of products, we see they are not that different from the old products, but actually they have changed the commissions; they are not going to pay as much in commissions, and the profits are going to emerge over time on a GAAP basis or statutory basis. So, actually they are shifting the timing of some of these profits. Previously, the profits from these products would not emerge until the sixth or seventh year, but right now they are emerging in the second year. That is the kind of thing we look at.

MR. KLEIN: The next question is a general question. You said that the leverage is increased but still not a concern because it is only 17 times in 1994. I was wondering if there are benchmarks that S&P has that says, if the leverage was 20%, the highest rating you could get, even if everything else was superior, is this level similarly if it was 30%, 40%, or 50%? Are there internal benchmarks, and can you share them with us?

MR. TSANG: Yes. Actually, internally we do not look at the operating leverage ratio anymore. That is why we have a capital adequacy model. The 186% capital adequacy is considered as superior or AAA. When you look at the ratio, the scale starts at 100%. From 100% to 125%, the rating is BBB. And then from 125% to 150%, it is A. And from 150% to 175% it is AA. Beyond 175%, it is AAA.

FROM THE FLOOR: How important is operating leverage?

MR. TSANG: We no longer look at the operating leverage. When looking at the operating leverage several years back, we used, for example, for the GICs and annuities, assuming that they don't take a lot of risk, a rate up to 20 times operating leverage, and for the individual line of business it was closer to ten times. If you have A&H lines, like disability, it is four times the operating leverage, but that was several years ago. We don't use that anymore.

MR. DESKY: Historically, the capital adequacy model that we used to use was somewhat based on the operating leverage. Some of the numbers that we currently use, some of the factors that we derive, were derived bearing some relationship to the leverage numbers that we used to use. The other part of your question referred to whether these are absolutes in terms of setting ceilings and floors on the ratings, and the answer is no. The capital ratio is a very important part of the rating, but there is no single factor that will always outweigh any other factor.

MR. HOWARD L. ROSEN: I have two related questions on the withdrawal characteristics and liquidity. They actually go in opposite directions. On your one-quarter of the annuity reserves subject to withdrawal at book without surrender charges, is that a statutory definition, that is, the interrogatory ten type of definition?

That means that some part ranging from 0% to 25% could conceivably have surrender charges of up to 5%.

MR. TSANG: Right. Of course, we talk to management about these issues. We have the information before we walk into the management meeting, and actually we get more information from management. Actually, for this company, the remaining surrender charges are very low and basically less than 1% for basically that whole block.

MR. ROSEN: And the other related question which goes in the opposite direction is how much of the remaining 75% roll out in the next one, two, or three years? So, is it 25% now, but within three years is it 75%, or is it 25% now and based on the new product distribution is it 23% in three years or 28%?

MR. TSANG: Actually, we look at it, and it is quite evenly distributed over the next five years. So, it is not a major concern at this time, but going forward, when we look at the company again next year, it may be a different story.

MR. TITTERTON: Let us get back to the questions from the committee.

MR. REICHMAN: You did not discuss the company's CMO portfolio, and I see from our survey that they do have a substantial amount of CMOs. I was wondering whether you could tell me about the tranches that are in the portfolio and whether the company has designated as a preauthorized check system (PAC) those securities that we might call broken PACs.

I also wanted to ask you to clarify whether you thought that the management was a little bit too long in its asset duration relative to the liabilities, given the low yields that are available on shorter-term instruments. In light of the fact that the yield curve is flattened out quite a

bit, do you feel that the company's position is prudent? Last, can you tell me whether the company segments its asset portfolios against specific books of liabilities?

MR. TSANG: Well Jack, why do you say that this company takes the position that the assets are longer? When we look at the exhibits on the company in terms of the models and the scenario testings, we see they are very closely matched. Where do you get that information to start with?

MR. REICHMAN: I thought I had read it in the RAMP.

MR. TSANG: Actually, we are quite comfortable with the company's asset/liability management process. Drew was with me in the management meeting, and he can back me up in terms of explaining this piece. They use a very good process, aside from using the New York Regulation 126 scenarios. They use the Tillinghast model internally. As I said before, they do it on a quarterly basis. I mean the asset/liability management issue is nothing like rocket science, but because the investment people and the actuaries look at these numbers on a quarterly basis relative to their portfolio, I get a great deal of comfort from that, rather than seeing a company with some ratios at the end of the year; throughout the year you don't know what they are doing.

And then in terms of going back to the CMOs, management is very conservative; this company invests in only the "pure vanilla" CMOs, such as agency PACs. There are no Zs, IOs, POs, or other exotic ones. I think that they have a very conservative attitude, or maybe they don't have the people who specialize in derivatives.

MR. REICHMAN: Does the company segment its asset portfolios against specific liabilities?

MR. TSANG: No, they only do it on the macro basis.

FROM THE FLOOR: Everybody's modeling depends on their assumptions. To what extent are you comfortable with the assumptions they have used, particularly as they relate to their asset/liability management? Do they have appropriate assumptions with adequate sensitivity testing?

MR. TSANG: Well, there are two things. First, you have to be comfortable with management to start with. That is very important. And second, we do have an in-house person who specializes in looking at the asset/liability management models of the companies, but unfortunately, she is not here. When we go to these meetings we will bring back information, and we will let our in-house expert run the information on our own computer.

MR. TITTERTON: The company is committed to a new portfolio of products and at the same time maintains its GICs and annuities at their current levels. I think that the additional expenses involved in getting new agents on stream could actually penalize earnings in the short run. When you combine this with increasing whole life volume, don't you have a recipe for pressure on capitalization?

MR. TSANG: Are you asking whether they can maintain the 175% ratio?

MR. TITTERTON: Yes, I am. That is the fundamental question.

MR. TSANG: As I said before, Charlie, you have to trust management. That is why meeting with management is so important. Its operating leverage has been rising, but then when they said they are committed at the 175% level, you have to think about whether they are able to do it or not. And if you look at their new sales in the first quarter of 1995 relative to 1994's first quarter, you see the rate of growth is not as great as 1994. What that means is they are committing to that strategy. I mentioned before that they have introduced a more capital efficient product towards the end of 1994. In fact, in the first quarter of 1995 the agents have been able to sell that product over the old products, and that will have better surplus development over time. So, I have some comfort in that.

FROM THE FLOOR: I do not see any information in here regarding future financial projections. Did you obtain those, and what did they tell you? And just as an observation of a longstanding member of this committee, I am pleased to see your focus away from statutory gain related to assets and more on GAAP.

MR. TSANG: Yes. They have provided us with the projections, but I have not attached it to the RAMP. When we talk to management basically it says trust us.

FROM THE FLOOR: Is that what you told us before?

MR. TSANG: No. The projections are quite important, and also when we look at the earnings projections, GAAP earnings and also the capital adequacy model, the comfort that I have is looking at the projections that the company gave us. Actually, the projections are more optimistic than what I have presented over here. Management says that the GAAP projections on the earnings for 1996 are going to be over 120 basis points, but I am not giving them the benefit of the doubt because, for the last five years, they have basically had 100 basis points ROA. So I believe that for the next couple of years they probably will have the same 100 basis points ROA instead of the 120 basis points. We used the projections they gave us but we did not necessarily believe every number they gave us.

MR. TITTERTON: That concludes the presentation and the discussion parts of the rating committee. The next thing that happens in this process is the committee actually takes its vote, but, as we have said earlier, we are going to give you in the audience a chance to vote. I am going to give you three choices. First, you can vote for a rating higher than the recommendation, and that means AAA; Phil's recommendation was AA+. Second, you can agree with the recommendation of AA+. The third choice would be to vote for a rating lower than the AA+ recommendation.

First, let me give you some quick definitions as to what constitutes AAA, AA, and A rating levels. I am, I guess, arrogantly assuming that nobody is going to vote lower than an A, so I am not going to go into the definitions of ratings lower than an A. AAA means that the capacity to meet policyholder obligations is overwhelming even under a variety of operating economic and underwriting conditions. The AA category essentially substitutes the word strong for the word overwhelming, but it's still a very strong rating. And, finally, the A category means that financial security is good, but capacity to meet policyholder obligations is somewhat susceptible to adverse economic and underwriting conditions.

So, let me see what you folks think of Sandy Beach Life. The first vote I would like to be registered is from all of you who think that the rating should be higher than the AA+ recommendation of Phil. How many of you would agree with Phil's recommendation? I would say there are probably maybe 20–25 people who agree. And, finally, how many of you think that the rating should be lower than the recommendation?

I would say we have that a preponderance of the audience think that the rating should be lower than Phil's AA+ recommendation. Let's see what the committee is going to say about Sandy Beach. At management meetings, which are usually held on a company's premises, there are always two analysts to deal with management. Since Drew was Phil's backup, I would like him to vote first.

MR. DESKY: I am going to agree with Phil's recommendation of AA+. The quantitative aspects of this company are clearly its strong points. Its GAAP earnings are superior and have been very steady. The company has maintained superior capitalization, and I expect it will continue to, and I think that outweighs some of the more negative, less quantitative aspects, one of which is the disability business that you mentioned, Phil, which they're currently struggling to deal with. I think eventually they will dispose of that business.

Although I did have some reservations about the business position before we met with the company, they have a very strong market position in their core area in Florida, and they also have a very good relationship with their agency force. I am not sure that geographic conservation is all that dangerous; Florida is one of the major states and it accounts for less than 50% of its business. As a result, I would probably change the business review score from good to excellent. So, I am voting AA+, and my confidential outlook is stable.

MR. PUCCIA: Phil, a good presentation, but I am going to lower my vote to an AA. Clearly, Sandy Beach shows some excellent numbers, both on their balance sheet and on their income statement. However, I think the business position and as well the strategic posture that management's developing lack the characteristics of a higher rating such as an AA+ or an AAA. I support my AA recommendation.

I am particularly concerned about its distribution system and how it plans to expand its business beyond Florida. It looks like it is looking to use a national brokerage system to do that, and that is their emphasis for the diversification beyond that state's bounds. I think that kind of a system can present risks, and we need to wait a few years to see how it develops.

The kinds of risks that I have seen in the past are higher lapse rates and poorer quality business. After all, it is in the front line for underwriting. So, I would like to see how that will develop. I do believe the career agency system that they have in Florida is an asset, but, again, it is a diversification issue. It is focused in that one state, and they are looking for the brokerage business to start expanding. The disability business is a negative. They have not figured out what to do with it. It is not at all uncommon. I do not think management has understood the business. They do not know what to do with it, and I think they must make a decision that does reflect somewhat poorly on the management and not being able to deal with that business earlier.

Otherwise, I think the strategy is good—they have thought it out clearly. Again, you cannot argue with the numbers they have produced. I think there is a fair degree of conservatism and management should be given credit for coming up with good results with a reasonably conservative strategy. Therefore, my rating recommendation is AA, and I give a confidential outlook of stable.

MR. REICHMAN: Charlie, I am going to vote AA. Some of my reasons are similar to Mark's and some are a little different. I agree that the GAAP earnings are, in fact, very good for this mix of business, but I think the statutory numbers have been lackluster. While recognizing that surplus strain is a large part of this cause, I think this is making me view capitalization as less superior than it has been in the past. I agree that management has done a very good job of structuring the investments, investing in high-quality instruments that have produced maximum yield commensurate with the risk and that have excellent risk and liquidity characteristics.

What makes me vote for a lower rating than your recommendation is the disability business and the company's apparent unreadiness to fix it, as well as a heavy reliance on the national broker market for GICs and, to some extent, the geographical concentration. When I couple that with my prospective view that the company will find it very difficult to continue to write business at the same superior level of capitalization as in the past, and coupled with the company's difficulties in raising capital from outside sources, I find that the financial flexibility score should be adequate, and my vote is one notch lower than yours. I am voting for a rating of AA and my confidential outlook would be stable.

MR. TITTERTON: My own vote is also a straight AA. I think the company has a very fine balance sheet. Its GAAP income statement is also very good. However, like everybody else, I do not like what is going on in the disability business. The company has a very good business position, but on the other hand, it is not a major factor in its markets. Strategically, they do not seem to be addressing areas where improvement is needed, such as in the area of geographical concentration and in their disability business.

The strategy of recruiting new agents is very sound because it is going to enable the company to continue the kind of success that it has had in the past, but I am not sure they are going to be able to implement that program without additional leverage. They do seem to be trying to conserve the things that got them into this good position which is a plus, but I do not think it outweighs the other negative factors that influenced my decision to go with a straight AA rating. Also, my confidential outlook is stable.

We always give the analyst a chance to either affirm or decide whether he or she would like to change his own recommendation and his vote. So, at this time I would ask, Phil, if you would like to change your recommendation and vote.

MR. TSANG: Charlie, I am sticking with my recommendation. There is an overwhelming vote that this company's rating should be lower. We look at a company's capitalization, and this company has one of the strongest earnings performance and track records. Yes, business diversification is an issue, but I do not believe it is that earth-shattering, and I do believe that this company deserves the AA+ rating. Now, I will let you explain to management why they are not AA+ when we go to their June meeting.

MR. TITTERTON: Actually, it is not an overwhelming vote. It is three for AA and two for AA+.

MR. TSANG: You do not count the audience?

MR. TITTERTON: I mean that the company is AA rated.

I would like to get one other vote from you the audience. First, you voted on Phil's recommendation. Why don't we see what your vote is on the committee's decision? I am going to ask you for two votes, those of you who think the committee decision of AA or a higher vote was accurate, and those who think that the rating outcome should have been lower than AA. So, first I am going to ask again for the AA or higher outcome. How many of you favor that? It looks like a clear majority. And how about lower than AA? It looks like you agree with what the committee determined for Sandy Beach Life.

MR. PUCCIA: I would like to open it up for general questions about our rating process. Are there any more questions about how we approach this?

FROM THE FLOOR: How often do you overrule the analyst's recommendation?

MR. PUCCIA: What do you think about that, Charlie?

MR. TITTERTON: First, I think the word *overrule* is a little bit harsh on the analyst. I would say a little more than half the time the analyst's recommendation carries through, but in a very substantial minority of the cases the committee votes a different outcome from what the analyst recommends.

FROM THE FLOOR: On marginal evidence from what I heard, you have now voted to lower the rating from AA+ to AA. That could cause extra lapses. It could cause several negative things to happen; it's almost a self-fulfilling prophecy. How do you feel about that? Second, in many of your answers you said that you trusted management—management has said this or said that. If management was originally in sales and clearly has you sold, that is one issue. Another is that management could be gone tomorrow, and then what would you do?

MR. PUCCIA: Let me separate this. Two good questions. I think the first question requires that we presume that this is an existing rating. We have an A+ out there, and now a rating committee has come up with a conclusion of AA, that is, to lower the rating despite continued good results from the company and a prospect of good performance. How is that handled? What happens now? The committee has recommended downgrading the rating. Phil, why don't you go through how that process works at S&P?

MR. TSANG: First, if we have a downgrading, and if you were with the company, then I will call you back. "Financial Officer, our committee has lowered your rating from AA+ to AA." First you would scream at me: "What are you talking about?" Then there is the appeal process. That means before we go out with the announcement of the ratings, you can have your senior management team come into S&P within a few days. We will have a few people besides Drew and me, perhaps other senior officers like Charlie or some

management directors, listen to what you have to say. We will give you the exact reasons why we lowered the rating, and not just say because the committee OKed it. We will explain that business concentration is an issue, and we don't believe that you will be able to maintain the operating leverage or capital adequacy ratios. Then, as management, you can come back and say, well, let me show you again. I will reiterate that we are doing that already, and after that we will go back to the committee one more time, and we will have some of the same people and probably more people in the committee. We will look at the company again, and the whole process will start all over, but after the second round that is it.

MR. PUCCIA: So, there is this process of appeal that'll focus specifically on the main issues.

MR. TSANG: Drew and I are the primary and the secondary analysts. If we strongly believe that this is an AA+ company, or even before I call you back, I could have gone to our own managing directors and rating policy boards and said that I want somebody to look at this again because I believe that there's some merit for this company's rating to be maintained.

MR. PUCCIA: A committee member can actually appeal. The second question you asked was about how there appeared to be some overdependence by S&P on information supplied by management, and is there not a risk here that management could be telling us a story and leading us on? A particular company may be more aggressive in the assumptions it is giving us or the story that it is telling us. Are we subject to being somewhat gullible to that? How do we deal with that?

MR. DESKY: Obviously, we go beyond the publicly available information in the rating that we look at. We need to depend on management for information, especially about strategy, and where they see themselves taking the company.

There are other issues. You say management may not be there in a couple years, there could be some turnover or some succession issues, and we will have to deal with those in the rating committee, but overall, when it comes down to it, after you follow a company for a while, you develop a track record with the company so that you can judge its credibility to determine if it has a track record of meeting projections. Have you been surprised by acquisitions that they have made? There are many ways to judge the credibility of management as well, and we will take that into consideration in the whole process.

MR. PUCCIA: When we meet with the management we are going to be asking them a series of questions, and this particular company gave us some projections that we thought were overly optimistic. Phil believed that there is no way that they are going to make 120 basis points next year. We think that it is actually going to be less because the track record just doesn't indicate better results. Some questions were asked about the interest rate risk evaluation process, and they have handed us their story. Well, we are going to ask them what kind of assumptions they used. Show us the modeling capabilities you have, the models that you have, and let us compare how your portfolios have performed over a couple of interest rate scenarios. We have already seen how they have performed—as in 1994's interest rate scenario. So, there is a questioning process here, and I must underscore

what Drew said. We have to look at credibility. Have they said something in the past and lived up to it or not?

MR. TSANG: And, believe us, there are people who came to us saying that their companies have been making $5 million a year in statutory earnings, but for the next five years they are going to make $30 million a year. Now, do you believe that?

FROM THE FLOOR: To what extent did the failure of a couple of large companies a few years back change your rating procedure? Did you raise the bar?

MR. PUCCIA: We have changed our view of the industry risk. The top category wasn't discussed here. The industry risk is good. Many people come to us and assume, because it was done a decade ago, that if a debt rating deal was guaranteed by an insurance company, it was automatically going to be AAA. We did not do that, but it was automatically assumed that it would be that way.

Clearly, the public's reaction to the failures of a number of insurance companies (and not just the failures themselves but how those failure were caused in the market), have definitely changed our view of industry risk. By the way, we don't think this is an AAA industry. We do have a number of AAA companies out there, and we think that, in fact, it is a good industry, but it is not AAA. In fact, it is not even AA. You could easily say it is somewhere in the A range. By the way, there are plenty of companies that we rate well below AA. You do not see them. There are plenty of companies that we have rated BB that have chosen not to accept our ratings.

So, the answer to your question is that we think that the industry's risk profile has definitely deteriorated over the past decade, and, yes, that does influence our rating structure. In fact, our outlook this year is that we will see some more downgrades because a number of companies are not producing at the levels that we thought they would. That can be because of asset quality issues. That could be because of capital development issues or earnings development issues.

I might note an article in the paper just a few weeks ago discussing how a particularly large company up in Hartford has an employee who may be disgruntled, who is saying that the real estate portfolio is overvalued. So, there are a number of residual things that keep coming out.

I guess the other thing is you may see two models at the back of the analysis, a model on liquidity and a model on capital. We have tried to substantially enhance our ratings process to evaluate some of the issues that have come up previously where we say that we and others will have to get a better grasp of it. We developed the liquidity model because I think a lot of people, including us, did not realize how liquid insurance companies' liabilities can be. The fact is that policyholders out there historically bought policies without any kind of a frame of reference for risk profile. It is an insurance company. They just bought a policy. Then when they found out there's actually risks bearing on them, and it is not a risk in terms of the amount of premium they would have to pay, the risk is that the insurance company might not be around to pay, that completely threw the policyholders out of sync, and a number of policyholders reacted very violently. They walked to the door

as fast as they could. So, we have significantly enhanced our liquidity evaluation, and it is near a run-on-the-bank kind of scenario. Can an insurance company handle that?

Then, likewise, we have enhanced our capital model because we agree with what the NAIC has done with its RBC evaluation. We'd had a model RBC evaluation for some time, as Jack mentioned, but we felt we could do much better than that. Our model has parallels to the NAIC's RBC and there are some differences. In particular, our view of asset quality is quite different. At S&P, we think we know something about assets. I should note that Jack is our expert on capital evaluation, and Drew is our expert on liquidity. So, if you have questions on those, we can answer them, too.

FROM THE FLOOR: Are there any times when you talk to management other than during the annual rating process or during an appeal of a downgrade?

MR. TSANG: Let me understand your question. The example I used is that when we have the downgrade, naturally management would come back and appeal, but your question is about whether there any other situations in which we talk to management beyond the annual rating process. Yes, we do. For example, the analyst should be very familiar with the company. If there's some press release saying that this company is doing something, one of our responsibilities is picking up the phone and calling management. We would say, "You haven't told us, and what is it?" Then we will bring management in, and to the extent that there's enough to warrant a change in the ratings or whatever, then we will have to make another presentation to the committee on those occasions.

FROM THE FLOOR: Are there rating guidelines for liquidity?

MR. DESKY: Yes, there are. This is similar to the capital model in that it does not represent an absolute ceiling or floor on the overall rating. Generally 100–130% is BBB or adequate type. And 130–165% is A or good. And 165–200% is AA type or excellent. Over 200% is superior.

FROM THE FLOOR: How does financial flexibility limit ratings? Are mutuals disadvantaged?

MR. REICHMAN: Well, before I fully answer that, I would like to reemphasize that no single factor is ever going to set a floor or a ceiling on the rating. With that in mind, the financial flexibility is viewed relative to what the company would need. A company that has a great need for capital in order to grow or to make acquisitions obviously needs to have a corresponding financial flexibility profile. In the case of a mutual, we would look at the company's reinsurance capacity. We would look at its downstream holdings which might be spun off. We would look for potential mergers with companies that had strong financial flexibility, and those could influence the company's financial flexibility score to make it higher, even though it doesn't directly have access to capital markets.

MR. PUCCIA: There is not a specific bias at S&P toward mutuals. I think it is important to recognize financial flexibility relates to the needs that a company has versus its capital resources. A number of mutuals have used very creative ways to raise capital and surplus notes; in fact the surplus note market is coming back so there are going to be several of

those coming out, and if properly structured, we view them much like we would view preferred stock at a stock company which is equity capital. A number of companies have started doing partial spin-offs of subsidiaries to be able to raise capital, and again it is a good way to access the capital markets. A number of companies have subsidiaries that are no longer core or strategic to them, and it will sell them and buy other things or support growth. If you are with a company that has significant growth or expansion plans and do not have a well-developed strategy as to how you are going to raise capital to meet that kind of strategy, then there will be some issues.

FROM THE FLOOR: To what extent do you give credit for reinsurance? For example, suppose Sandy Beach had coinsured a significant portion of its business.

MR. REICHMAN: Well, we would look at it in a couple of different arenas. If it is not a surplus relief type of reinsurance treaty, our capital adequacy model treats it in a way that is similar to the NAIC's RBC. The company gets credit, which helps its ratio. If the company is relying on reinsurance to a degree that might pose some risk going forward, and to the extent that it could not continue to write business without that reinsurance, for example, that might count as a negative in our evaluation of the company's business profile.

FROM THE FLOOR: First, how do you treat confidential outlooks? Second, do you discuss your findings with the company? Finally, if the stock market falls significantly, do you lower ratings?

MR. TITTERTON: If it is confidential to the public, we would communicate our outlook to the company. The reason why we do not communicate outlooks to the public is because many companies view outlooks as important as we do. You get companies that would actually come in and appeal an outlook as part of the appeal process rather than a rating itself. So, we tell the company what the outlook is, but we do not actually provide an outlook to the public for a claims-paying-ability rating. We do for debt ratings, of course.

MR. PUCCIA: I think the other thing is that often outlooks are perceived as a change in the rating already, and that is not the case at all. If events occur that change the profile of the company from what we have expected, then the rating would change

The second question was do we discuss the rationale that we have just gone through with the company?

That starts to get into the realm of consulting. We have often wanted to do that, but we do not want to tell companies what their strategy should be. Now, we recognize it is an iterative process. We say we have some concerns about this, that or the other thing, and a company's management is going to react to that, but we clearly do not want to be in a position of telling managements what to do. We are going to react to it. But that being said, we have a very open dialogue with companies. We welcome the opportunity for management to come in and discuss with us things that they might be thinking about. We might want to make this acquisition. We might want to change our capital posture. And they would like to discuss it with us in advance. If we had a rating concern and want to know about it in advance, and it would change the companies' minds, then it is a healthy process, and we will do it.

MR. TSANG: Also, Mark, if you are at the management meeting with us, and you have a very successful strategy, but you do not want us to tell your strategy to somebody else, we won't.

MR. REICHMAN: Let me see if I understood the last question. If the stock market tanks, would that result in downgrades? I think this would apply to only those companies that had above-average investments in common stocks.

Our claims-paying-ability rating is not a recommendation to buy or sell a stock. So, when the stock market in general declines, it doesn't necessarily have any correlation with the company's financial strength.

FROM THE FLOOR: How does an AA claims-paying ability compare with a bond rating?

MR. TITTERTON: The AA claims-paying-ability rating is equivalent to an AA bond rating. If they are both positioned the same in the ratings hierarchy, the definition would be, as mentioned for claims-paying ability, a strong ability under a variety of underwriting and economic conditions to meet claims; a similar definition would apply to bond rates. So, the ability to repay the debt is strong under a variety of economic conditions.

MR. PUCCIA: The answer to that is that it is simply a different obligation. If you use the claims-paying-ability rating, and if a company with a claims-paying of AA should guarantee an obligation and had an AA, it would be an AA bond.

MR. TITTERTON: In those rare occasions when an insurance company itself has publicly rated debt that is of a senior nature, that debt ordinarily would be rated the same as the claims-paying-ability rating of the company.

FROM THE FLOOR: How much reliance can you place on reports from the company's auditor?

MR. PUCCIA: To what extent do we rely on the auditor's reports?

MR. DESKY: Well, to the extent that it raises any additional issues in our mind, we will take a look at it. If there is a substantially clean auditor's report from which we cannot gather anything new (which, I would say is the case at a majority of the companies), we will sort of take it as a matter of course.

MR. PUCCIA: I think it is important to emphasize we are not auditors, so we do not audit companies' books. Now, if a company decides to deliberately misrepresent its financials, that is a problem. Fraud is not something that we will automatically catch, and we don't try to go behind the numbers. That being said, we do ask a series of questions. There are certainly questions about assumptions and accounting conventions. We will ask about the liberalism that you are introducing in the numbers or the conservatism in that, and that we want to get to. So, again, accounting is not a precise practice. I have heard many accountants say it is an art, not a science, and so we do try to get to the art that exists there, but if there is blatant fraud, that is something that can get past us, although eventually it is going to come out.

MR. BUCK: I am going to take the chairperson's prerogative in asking the final question. Can you briefly describe the different methodologies of ratings at S&P and at the other agencies—Moody's, Duff & Phelps, Best's, and Weiss?

MR. PUCCIA: Well, without making a commercial, I think the hallmark of the claims-paying-ability process that we have demonstrated here is that it is an analytic, intensive process. We certainly get a myriad of information from the statutory statements and from other publicly available sources. An analyst will go out and meet with a company's management, along with another analyst. He or she will actually be on the premises and ask questions. That kind of analytic, intensive process is the hallmark of our claims-paying-ability process.

We also have another rating system called our qualified solvency rating system. How many people have heard of our qualified solvency ratings like BBBQ, BBQ, and BQ? We will be expanding that this year. It will actually go up to as high as AAAQ, AAQ, and AQ and down to as low as CCCQ. These will be coming out within the next couple of months. That process is purely statistically based. It is not one where the analysts, such as those here, actually are involved in the process. We get tapes from the NAIC based on the statutory blanks. That is where that information comes from. We directly input that information into a ratio analysis. There is a series of ratios that we run companies through and then array them—they are rated on that statistically based process. In contrast to those two processes, Moody's and Duff & Phelps have both (I cannot represent them). They both said that they meet with managements, that they use both public and nonpublic information in their processes, and that they would discuss on-site with management their intentions. So, in theory it sounds very similar to the claims-paying-ability process that we have.

A.M. Best has historically used a more quantitative process. However, they have said that they have evolved to a more qualitative process and that there are management meetings. I guess Best is coming out more to meet with companies. My understanding is that Weiss uses a more statistically based process.