

# RECORD OF SOCIETY OF ACTUARIES 1995 VOL. 21 NO. 1

## HOW DOES YOUR INSURANCE COMPANY RATE?

Moderator:           FREDERICK S. TOWNSEND, JR.  
Panelists:            MARC G. VERRIER  
                          JOEL SALOMON  
Recorder:            FREDERICK S. TOWNSEND, JR.

*This session will provide attendees an opportunity to interact with professionals involved in insurance company ratings. Multiple viewpoints, such as those of security analysts, regulators, rating agencies, lending institutions, insurance agents, and potential customers, will be represented.*

MR. FREDERICK TOWNSEND: Our three panelists will discuss how insurance companies are viewed by a public rating agency, a private rating agency, an investment analyst, corporate pension plans buying GIC contracts and termination annuities, banks selecting insurance companies whose products they will sell, national marketing organizations choosing companies whose products they will sell, and stockbrokerage firms distributing life and annuity products.

Joel Salomon is from Moody's, which is more stringent in their ratings than Standard and Poor's (S&P) or Duff & Phelps. It may be instructional to hear Moody's stricter view of the life insurance industry.

I was an investment analyst at a New York Stock Exchange member firm for 25 years, writing investment reports on insurance companies, and I've been issuing private credit ratings on companies writing GIC contracts for the last 15 years.

Marc Verrier is president of the Genesis Development Corporation in Toronto. He develops products for insurance companies and for people who are distributing insurance company products. He works with major stock brokerage firms and performs their due diligence on life insurance companies.

MR. JOEL SALOMON: How many of you are directly involved in the rating process at your companies? Can I get a show of hands? It appears that approximately 10–15% of you are. Most of you will be getting a new view on how ratings are actually done.

I want to start with an overview of what I will be discussing. I'll start my discussion with our rating universe and the distribution of ratings at Moody's. Then I'll discuss our rating approach. I'll spend a significant amount of time on how we actually come up with the ratings. Our rating approach includes both qualitative and quantitative analysis. I'll conclude with our rating outlook and concerns.

For those of you not familiar with Moody's rating scale, Table 1 shows our rating distribution. The top four ratings are considered investment grade, and the bottom three are below investment grade, that is, ratings for weak companies. At Moody's, our ratings are called insurance financial strength ratings, as opposed to some other rating agencies that call them claims-paying ability ratings. They are different names for the same things. What we are giving is an opinion of the ability of an insurance company to repay its policyholder claims punctually.

TABLE 1  
MOODY'S INSURANCE  
FINANCIAL STRENGTH RATINGS

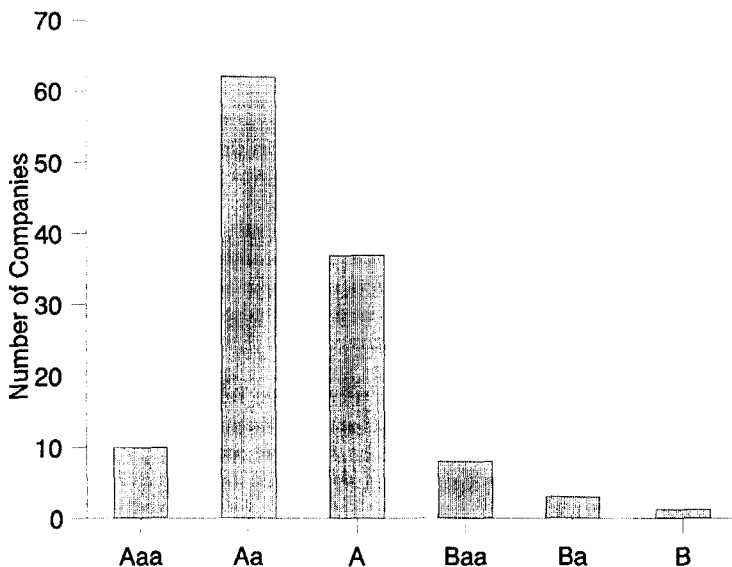
Aaa	Exceptional
Aa	Excellent
A	Good
Baa	Adequate
Ba	Questionable
B	Poor
Caa	Very Poor

For 90% of you who actually work at insurance companies, this answers the question of the session, "How does your insurance company rate?" The rating distribution is for approximately 125 companies, as of March 8, 1995. I believe all of the ratings are up-to-date except for one or two.

We have ratings on about 125 companies. We actually expect to increase our rating universe to over 200 companies over the next two years. Those of you who don't see your companies listed there, just wait.

Chart 1 shows the distribution of Moody's ratings by rating category. As you can see, the industry is very highly rated. We have over 60 companies rated Aa. The average rating is about Aa, which—as you remember from before—is a rating indicating excellent insurance financial strength.

CHART 1  
DISTRIBUTION OF MOODY'S RATINGS



## HOW DOES YOUR INSURANCE COMPANY RATE?

One important point I'd like to leave you with is that our ratings are opinions of an insurance company's insurance financial strength. A second important point I'd like to leave you with today is that my company's full name is Moody's Investors Service. We are a company that services the investor. The initial impetus for Moody's ratings was from GIC investors who wanted an objective, independent credit rating on an insurance company. Because many of these companies were mutual insurance companies who didn't have a public debt rating, we were offering a first-time opinion on these companies.

Now I'd like to go through Moody's rating approach. We have three fundamental principles that guide our rating approach. We have a long-term perspective and a conservative outlook, and we use both qualitative and quantitative analysis.

What we mean by a long-term perspective is that we have a three-to-five-year time horizon. We generally expect our ratings to be stable over a long period of time. When we set, assign or change a rating, it should be stable for a long period of time.

In our process we do not look at just the current income statement, balance sheet, cash-flow statement and schedules. Generally, we try to project what those statements will look like over a long period of time. It is also important to note that we look at both the statutory and GAAP financial statements, if available. (For mutual companies, both statements will be available for 1996 annual statements.) Generally, mutual companies produce internal GAAP or modified GAAP for rating agencies.

We have a conservative outlook. We are credit analysts and we are downside oriented. This is opposed to equity analysts, who look for the upside potential in a company. We generally focus on what can possibly go wrong in a company. Again, we use both qualitative and quantitative analysis. We focus more on the qualitative aspects because we feel a purely quantitative—ratio driven—approach is not a good indicator of credit worthiness.

I think its important to realize that credit analysis is both an art and a science. As those of you who are in the financial management areas in your company probably know, it is very difficult to project earnings or reserves over a five-year time horizon. (Even if you're not working for John Simon in a start-up company, your projections are probably not going to be accurate to within 1–2%.) It is important to use both qualitative and quantitative analysis. As opposed to some other rating agencies, we actually emphasize the qualitative aspects of our analysis rather than the quantitative.

I know some insurance companies have difficulties with this. I think its important to emphasize that Moody's does not have a benchmark for any particular measure or a bunch of measures that we put into a black box from which we pull out a rating. We look at each company on an individual basis and there are obviously many factors.

On the quantitative side we examine five key items. Obviously capital adequacy is a key issue. We have our own internal risk-based capital ratio, called the risk-adjusted capital ratio. We also look at the nominal capitalization ratio and, of course, the NAIC risk-based capital ratio. But we'll adjust each of these amounts to get to the true economic capital of a company.

Asset quality is another very important measure we look at. We don't just look at the mix of assets in a company. We look at what the exposures are within a certain asset class. For example, we'll look at the percentage of bonds that are below investment grade. We'll see the actual companies that the insurance company is investing in and examine the quality of those companies. For mortgages, we will look not only at the exposure, but also at the regions that the mortgage loans are in. We'll look at the types of mortgage loans and where they are located. It is important to realize that we have a prospective rather than a retrospective approach. We look at the *potential* risk exposures and loss content in various asset classes.

Profitability is another key quantitative measure Moody's looks at. We examine the company's markets, the products it sells and the amount of competition that the company has. We look at the key earnings drivers such as expenses, persistency, mortality and interest rate spreads. We also look at various trends in earnings, including actual net income, return on equity, and return on assets.

Clearly, asset/liability management and liquidity is another key issue. We've seen companies shift their asset allocations, moving from credit risk to interest rate risk, over the last few years. There has been a significant increase in the growth of asset-accumulation or annuity-type products. We are focusing on the increase in interest rate risk. In the past few years, we've also seen a shift to collateralized mortgage obligations (CMOs) and mortgage-backed securities, although, in 1995, there has been a shift away from CMOs.

I'd like to point out that we have a view of derivatives that may be different from other companies. Moody's thinks it is appropriate to use derivatives as a hedge for asset/liability management purposes. Obviously, speculation is viewed negatively.

Asset/liability management is a function of a company's liability structure, and generally, Moody's views stable, life insurance products more favorably than annuities. Within annuities, we'll look at the amount of surrender protection and the level of surrender charges. We also look at the distribution of reserves by surrender charge run-off.

In our liquidity analysis, we'll look at the cash-flow statement. We'll look at cash sources and uses. And within mortgage loans, we'll look to see if there are any balloon payments coming due.

Financial leverage is the last key quantitative aspect of our analysis. Generally, operating insurance companies do not have much financial leverage (debt-to-equity ratio or debt-to-capital ratio). There is generally more leverage at the parent company. When there is an increased need to get cash out of the insurance operating company by the parent company, Moody's views that negatively.

Some of the ratios we look at include debt-to-equity, debt-to-capital, interest coverage, and fixed-charge coverage ratios.

As I mentioned before, qualitative or fundamental analysis is a key component of our credit analysis. First we'll look at the markets in which the company competes. Is it a highly competitive market such as the annuity marketplace? Is it less competitive, such as the home service marketplace? Is the market growing or shrinking? Can the company grow its market share? As you saw earlier, companies that are market dominant or

## HOW DOES YOUR INSURANCE COMPANY RATE?

leaders in a particular market niche will generally have higher ratings than companies that are much smaller players in a particular market.

We also examine the products the company sells. As I mentioned before, nonqualified annuities, we feel, are commodity-like, highly competitive products. Although we see an increased shift to these savings-type products, it is actually increasing the risk profile of insurance companies.

We view death-benefit-protection products, such as traditional whole life, more favorably than individual annuities such as single-premium deferred annuities (SPDA). The distribution system, obviously, is another very important part of our qualitative analysis. The recent Supreme Court ruling allowing national banks to sell annuities increases the competition in that marketplace.

When we analyze distribution systems, we see a trade-off between expenses and persistency. Obviously, companies that are using a career agency sales force are likely to have higher persistency, but also higher expense ratios. On the other hand, companies that are selling through wirehouses, stockbrokers, or independent agents are likely to have lower expenses, but also lower persistency.

We are also looking at how much value is created at a company. This is another key element of our analysis. Basically it encompasses the quality of the company's markets, products, and distribution system.

A company's franchise value is also important. By this we mean a company's sustainable competitive advantages, its brand name recognition, and the company's image and reputation.

We don't just look at the company on a stand-alone basis. We see how the company fits into the industry and the industry as a whole. We analyze the economic environment, competition and regulation in the insurance industry. By economic environment I mean where in the business cycle the economy is and how that affects interest rates. We then determine how interest rates drive a company's profitability.

In recent years we've seen increased interest rate volatility, as interest rates sharply declined in 1992 and 1993, and then sharply increased (by over 200 basis points on the long bond) in 1994, only to decline sharply in the last few months by more than 75 basis points. Clearly, there has been heightened volatility in interest rates.

As I have mentioned previously, we're seeing increased competition both from inside and outside the insurance industry. With close to 2,000 companies in the life insurance industry, we feel there is excess capacity in the industry and there will be consolidation over time. We've actually started to see that on the stock life insurance company side.

We are seeing increased competition from outside the industry mainly from mutual funds and banks. Within the industry, we analyze the degree of concentration. Generally, we feel that if there are fewer companies in an industry the barriers to entry will be higher. But, as I mentioned, the insurance industry seems to have excess capacity and we feel that the barriers to entry are low—primarily for annuity products.

Regulation and accounting are also important in our industry framework analysis. Just recently we've had the announcement of the potential repeal of the Glass Steagell Act under which commercial banks will be allowed to own security firms. But we think the potential repeal of the Bank Holding Company Act by which banks would be able to own insurance companies is more important. The likelihood of this repeal is moderate at this time.

Other regulations in the last few years have greatly changed the way companies have invested and allocated assets like, for example, risk-based capital in 1993. There also was the implementation of the asset valuation reserve (AVR) and interest maintenance reserve (IMR) in 1992. On the GAAP side, *SFAS 115*, the marking to market of certain debt securities, was implemented. For 1996 year-end statements, GAAP will be applied to mutual insurance companies which will increase disclosure for the mutuals. (I'd like to point out that Moody's looks at both statutory and GAAP accounting.)

Now I'll discuss some purely quantitative measures of capital adequacy. The first ratio is the nominal capitalization ratio: total capital divided by general account assets. We adjust that ratio for policy loans that we consider contra-assets. We'll also look at our own risk-adjusted capital ratio, which is a cruder ratio than the NAIC risk-based capital, but we use it for trends and for sensitivity analysis.

I'd like to point out that we are in the midst of changing the risk-adjusted capital ratio to reflect the heightened asset/liability management risks we see. Therefore, the C-3 charges for reserves will be increased for individual and group annuities. We also see less C-3 (or interest rate) risk on traditional life insurance compared to annuities and we will be reducing that charge.

Another quantitative capital adequacy measure we examine is the NAIC risk-based capital ratio, which establishes the minimum capital requirement for companies.

To determine quality of surplus, Moody's examines affiliated investments, the holding company and financial leverage. We analyze the balance sheet, look at reinsurance, surplus notes and contingent liabilities.

For affiliated investments, we analyze the corporate structure. Is the parent company supporting the risks at the operating insurance company? And by pyramiding we mean that if one insurance company owns another insurance company, there may be some double counting of equity and we'll adjust for that.

I mentioned holding company financial leverage earlier. If there is very high financial leverage at the holding company, that may be a drain on capital at the insurance operating company. Double leverage is using equity at both the parent company level and the insurance operating company level. For example, if a parent company raises equity in the capital markets and injects that equity into an insurance operating company, that equity could be used twice. We divide the investments in subsidiaries on a parent-company-only statement by the parent company's equity to get a ratio for double leverage.

We also examine the valuations on the balance sheet. How conservative or aggressive are the assets and liabilities? This is another qualitative analysis that is difficult to get a

## HOW DOES YOUR INSURANCE COMPANY RATE?

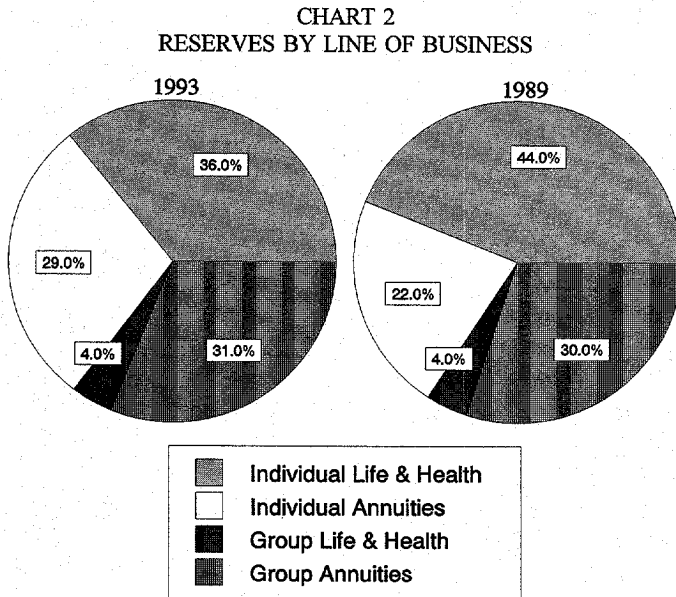
purely quantitative amount on. But we'll examine the liabilities and determine if the company has been destrengthening reserves. Does the company maintain excess reserves?

We analyze the amount of reinsurance on a company's books, who the reinsurers are, and our ratings on those reinsurers. We also look at the amount of surplus relief on a company's books. This is not too prevalent today, but there are some companies that still have some surplus relief on their books and we adjust for that.

We consider surplus notes debt-like securities with fixed-charge components. We analyze how much surplus notes represent as a percentage of surplus and capital.

Finally we look at any contingent liabilities and off-balance-sheet exposures such as derivatives that aren't captured on the balance sheet.

I thought it was important to include one pie chart in my presentation. Chart 2 highlights the point I made earlier about the shift from individual life to individual and group annuities. In 1989, annuities made up 52% of total general account reserves. At the end of 1993, they represented 60%. In fact, this doesn't include separate account reserves such as variable annuities, which probably would get that ratio up to over 65% as of the year-end 1993 due to substantial sales of variable annuities in that year.



Now I will conclude with our outlook for Moody's ratings, but first I would like to discuss a little history. We had five upgrades and five downgrades in 1994. In 1995, we've had three upgrades and four downgrades. We have had another downgrade in the last 24 hours. There have actually been five downgrades this year. Generally, though,

RECORD, VOLUME 21

our rating outlook is stable. There will be selected upgrades for certain companies with improvements in operating efficiency, profitability, and capital adequacy.

Over the longer term, secular changes such as increased competition from within and outside the industry, the heightened interest rate risk, which we don't think is a short-term phenomenon, and the continuing accounting and regulatory paradigm shift are affecting the industry. We believe increased regulation is here to stay: there has been a proposal for a model investment law which would reduce the flexibility of an insurance company's investments.

I would like to conclude with some key points: the ratings are Moody's opinions on insurance financial strength. We emphasize the qualitative rather than the quantitative aspects. There isn't a black box in which we fill in some numbers and get a result.

The final point is that we serve the investor. The initial impetus of Moody's ratings was the GIC investor. To conclude, we expect our ratings to be stable over the near term.

MR. TOWNSEND: Are there any specific questions for Joel?

FROM THE FLOOR: You mentioned that you expect to increase your rating universe to 200 companies in the next couple of years. How does that process work?

MR. SALOMON: Generally, we have what is called investor-initiated ratings. As I mentioned, we serve the investor. So, generally the impetus is from the investor. Investors call up and say they are doing some due diligence and they want to know if we have an opinion on that company. We will then call the company and ask them if they would like a rating. I think we're the only rating agency, though, that will go about getting or producing a rating on a company without actually getting its cooperation or getting paid for that matter. Therefore, if the company cooperates with us—or if it doesn't—we will still rate the company. However, there is generally some cooperation with the insurance company and Moody's.

FROM THE FLOOR: How does Moody's make revenue given that a company is not required to pay for the rating?

MR. SALOMON: There is always the future possibility of getting money from the company when they see the value of our rating: our opinion is highly regarded in the investor community. If the insurance company sees the value in that, they might decide that they want to pay for it. Also, if a company were to issue some debt in the future, they might decide to get a rating from Moody's. The expectation is that the company will pay. If we put a rating out on the company and after a year or two years they have not paid, we could withdraw the rating.

Obviously, there is value to a bad rating. Investors feel that there is value if the rating is, say, a low investment grade rating. That has value.

MR. TOWNSEND: When Moody's began to issue ratings, some ratings were requested by buyers of GIC contracts, and some corporations requesting ratings relied on Moody's.

FROM THE FLOOR: Do you rate reinsurers and foreign companies?



## HOW DOES YOUR INSURANCE COMPANY RATE?

MR. SALOMON: Yes, we rate reinsurers and we also rate non-U.S. companies.

FROM THE FLOOR: Do you rate start-up companies?

MR. SALOMON: It depends if they request it or not.

FROM THE FLOOR: Is there a minimum size company that Moody's rates?

MR. SALOMON: Generally, I think we've been rating companies with over \$1 billion in assets, unless a different type of company has requested a rating.

FROM THE FLOOR: Can a small company be highly rated?

MR. SOLOMON: It might depend on what type of products it's selling, what company it might be affiliated with, or if it is affiliated with a large parent company.

MR. TOWNSEND: Your question strikes at the heart of a question I hear very often: why is there a bias in favor of companies that are larger versus companies that are smaller? The answer is that the profile of a smaller company can change much quicker, particularly if it starts to write a great deal of new business.

Take the example of Ford Life Insurance Company. Ford Life wrote exclusively credit life and health insurance on people buying automobiles. How much capital do you need, and how much underwriting risk is in the credit life and health business?

Ford Life had \$200 million in assets and \$100 million in surplus. That's a 50% capital ratio. If you're a traditional life insurance company, you're not going to have a 50% capital ratio. You're likely going to have a 5-10% capital ratio. Ford Life's assets exceeded 98% invested in class 1 bonds and short-term notes, with no junk bonds, mortgage loans, or real estate. Ford Life decided to sell SPDA business through stockbrokers, and sold \$2.5 billion of SPDA's in just three years.

Did Ford Life deserve a Aaa, which it should have if it were exclusively in the credit business with a 50% capital ratio? In three years, they fall to a 4.5% capital ratio.

So, the size of a company isn't a barrier to getting a good rating. But, any rating agency has to allow for the fact that the total conditions and characteristics of a small company can change very quickly.

MR. SALOMON: I would like to point out that Moody's does not have any explicit dollar amount of assets that it says a company would need to have to receive a Aaa or Aa or any rating.

MR. TOWNSEND: I didn't say you had a rule; I specifically said they don't have rules.

MR. SALOMON: It might currently be \$1 billion. I think it is also important to say again that it is largely a function of market dominance/leadership and the key markets that a company plays in, and because of that, a capital number gets you to a certain rating, but there's no explicit capital number at all.

## RECORD, VOLUME 21

On the size issue I think it is important to state that there is much more event risk with a company that has \$25 million of capital compared to a company that has \$1 billion in capital. There is the possibility of some shock that could come along and it could wipe out all of that capital as opposed to a company with \$1 billion of capital. That's an important issue.

FROM THE FLOOR: You have analysts assigned to each company. I'm curious, do you have a committee that assures consistency?

MR. SALOMON: Let me discuss the rating process itself. There is one senior analyst assigned to a company with a backup analyst. Generally the rating is being reviewed continuously—that is how it is done at Moody's. There is no specific time that the rating could change as is common at some other rating agencies. We do visit a company at least annually and whenever there is some significant event that happens at that company. The rating is being continuously reviewed and when a rating change could occur, the senior analyst, the backup analyst, and at least two managing directors (one from the insurance group, one from a noninsurance group, and at least two other people within the financial institution's group) meet as a rating committee to decide on the rating change. There is a rating committee that decides the rating, and it is generally based on the majority rule.

FROM THE FLOOR: What is the correlation between Moody's risk-adjusted capital ratio and the NAIC risk-based capital (RBC) ratio? And if they're highly correlated, is there a reason why you continue to use Moody's ratio?

MR. SALOMON: Off the top of my head I'm not sure. I would expect it would be pretty close though. A few factors are significantly different: One difference is the investments in affiliates. The Moody's factor is 75% while the NAIC factor, I believe, is 30%.

The mortgage loan factors are slightly different. I don't think anyone in our company has looked at correlations though, but I would expect it would be close. As I mentioned, the reason why we use both, at least currently, is because we have a five-year trend with Moody's ratio and there is only a two-year trend for the NAIC ratio. We also can do our own sensitivity analysis internally, whereas for the NAIC's risk-based-capital ratio, it's much more difficult.

We can easily change factors for our ratio. We can look at individual companies and play with factors. For example, if we believe that their mortgage loan exposure is large and invested in commercial office buildings, but they have had great experience (and we think the loss content going forward is not significant), we can adjust the factor and come up with an adjusted risk-adjusted capital ratio, which is not actually published.

MR. TOWNSEND: Moody's developed their own formula four to five years ahead of the NAIC. So they already had a formula with which they were comfortable. We have a quantitative formula in addition to our qualitative analysis. On our quantitative formula, we found historically that any score above a certain level was typically followed very shortly by an expense reduction program, or other corrective measures, such as surplus infusion. The company was often in difficulty shortly thereafter. So I know, in our own case, that a quantitative formula is a quick screen. You determine whether a company

## HOW DOES YOUR INSURANCE COMPANY RATE?

exceeds a given ratio or falls below a given ratio, where you might expect some problems, before you dig into your qualitative analysis.

MR. SALOMON: There are some companies that have very low risk-adjusted capital ratios; I can think of one that has a ratio right around 100, and it is Aaa.

FROM THE FLOOR: What value did you place on diversity within the company in terms of lines of business?

MR. TOWNSEND: Obviously there's some risk if a company is highly concentrated in one product line, although it obviously depends on the products that the company is highly concentrated in a traditional whole life concentration might be looked at more positively than a company that is highly concentrated in SPDAs. It also depends on the product mix. There obviously is the possibility of natural hedging. For example, if a company has SPDAs and structured settlements, that would be viewed more positively because profitability wouldn't swing as much with these natural hedges.

Qualitative analysis typically written by an investment analyst, or credit rating analyst, on a life insurance company includes corporate structure, business mix, the content of surplus, sustainability and quality of earnings, assets (which includes the asset mix, the credit risk, the interest rate risk), and liabilities including the exposure to a run, and hidden liabilities.

I think the important thing to remember is that a rating agency may criticize specific topics, but is not driven by specific ratios. In assigning a final qualitative rating, we look at the total profile of the whole company. So, one or two bad ratios shouldn't be changed if the balance of your corporate profile is fine. For example, one of the earliest companies to get into trouble with mortgage loans and real estate was the Travelers Insurance Company.

It had large underwriting losses in the group annuity line and large capital losses because of its exposure to those mortgage loans. But when you look at other factors, such as business mix, it was an old mature individual life writer cranking out large earnings.

It is a major carrier in the group life and health business, generating substantial earnings and much of the group health business was written on an administrative service only basis. So it was generating fees by writing group health business and not exposing itself to underwriting risk. And because it was a subsidiary of a large company listed on the New York Stock Exchange, it had access to capital markets.

Travelers is a company that was downgraded to A by each of the major rating agencies. And yet when we looked at the total corporate co-file, taking all the factors into consideration, we decided that its earnings, business mix, and corporate structure could overcome the exposure to the GIC business and the mortgage loan business.

The point which I'm trying to make is you have to look at everything concerning the company. Joel has given us a number of factors which go into this. I know all the factors are too difficult to memorize, but I've developed a very simple graph.

If you can remember five words—level, trend, ability, surplus, and earnings—you can develop this simple graph for the analysis of life insurance companies in assigning a rating

## RECORD, VOLUME 21

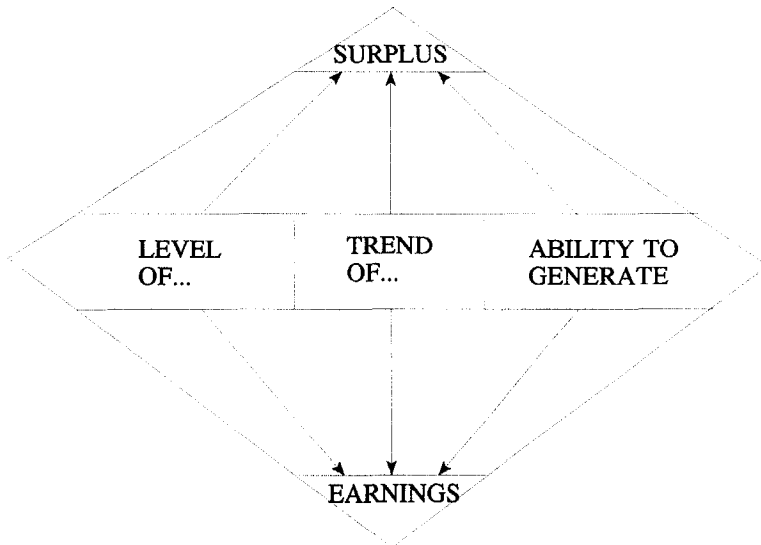
(Chart 3). And, in fact, this is a good diagram to remember for the management of your company.

What is your level of surplus, trend of surplus, ability to generate surplus? What's your level of earnings? Your trend of earnings? And your ability to generate earnings?

Let's very quickly discuss level of surplus. All the rating agencies look at operating leverage. What's the level of surplus relative to your assets at risk? Relative to your insurance in force? Relative to your health insurance exposure in force? What's the trend of surplus not only in your company, but in the industry? Joel mentioned upgrades and downgrades. I've already said there has been rapid growth in surplus in the industry in the last four years.

When I looked at our upgrades and downgrades a year ago, I was surprised that they were about 50/50. I would have thought there would have been more upgrades than downgrades. And when I took a closer look at the downgrades, the judgment which I reached was, the downgrades were companies which stood still. Management thought they were doing well, but they weren't doing as well as the industry was doing. And therefore they retrograded in effect.

CHART 3  
THE SIX-POINT DIAMOND OF FINANCIAL STRENGTH



Ability to generate surplus. Your change in surplus comes from earnings. So that incorporates the number of profitable lines you have, the earnings level you're generating from those lines, whether it's high-margin or low-margin business. Capital gains go into changes in surplus. However there's not much opportunity for capital gains unless you're in real estate, which isn't a very popular line right now or unless you're realizing bond

## HOW DOES YOUR INSURANCE COMPANY RATE?

gains in a period of falling interest rates. What's more typical is to avoid being in asset classes where you might have capital losses.

Ability to generate surplus includes parent company relationships, where the parent company can infuse surplus into the life company or have profitable subsidiary companies in other businesses where their growth is superior to that of your own so that growth in equity in the subsidiary will generate comparable growth for your own company.

The key to the level of earnings is the ability of a life insurance company to grow its surplus in line with its insurance in force. Before the life industry adopted risk-based capital and before it developed target surplus, the life industry was starting to look at return on equity (ROE). A number of major companies adopted management compensation plans that were based on return of equity not only for the whole company but in many cases by line of business. I anticipate that the rating agencies are going to return to this concept. I think the rating agencies initially looked at the quality of the asset portfolio and the credit risk. Then they looked at the liquidity risk and the possibility of runs on the bank. Now that companies have built up their surplus positions, and shed much of their bad assets or reduced the bad asset mix, the questions will be, which companies are better managed? Which companies have control of their own destiny? Control of the field forces and product niches where they can achieve sales growth enables companies to operate at efficient expense ratios and derive higher returns on equity. Companies will build surplus in line with their asset growth, and reduce their operating leverage through high returns on equity. Based on what some rating agencies have said, in the last six months, I can sense this trend coming.

Trend of earnings means the more profitable a company is, the more control it has of its own destiny. The ability to generate earnings means how well you are using your capital. Are you a mono-line company or do you write business in half a dozen profitable lines?

Take the Great West Life of Canada, which derives more than 10% of earnings from each of six major lines of business. Individual life, health and annuities, group life, health and annuities. They can stumble in one or two lines, and still produce an operating profit for the year. But if you are a monoline company like an SPDA writer, what happens if somebody messes up the investment performance for a year? If you stumble with a bad asset class, you may wipe out your earnings in the company in a given year.

That's a very abbreviated overview of how the rating agencies look at you, what some of the factors are that the rating agencies look at, and what factors you should consider in the management of your own company. What's the level, what's the trend, and what's the ability to generate both your surplus and your earnings?

I indicated that our ratings are paid for by the buyers and distributors of insurance contracts. I'll just speak briefly about the corporate buyers.

GIC buyers rely upon credit ratings. They typically decide that they want credit ratings at a certain minimum level, from two or more established and recognized rating agencies, and, in some cases, they do not want a rating below a certain level.

Typically, they also want a large surplus size. Certainly larger buyers are looking at companies, as a rule of thumb, with a minimum surplus size of \$100 million. And in some case \$500 million.

I don't want to discourage anybody from entering the business. In fact, I might encourage companies to enter the business if RBC didn't punish you and if you felt you could obtain expertise to enter this business on a profitable basis. There are only 70 life insurance companies in the United States with GIC liabilities, and nearly three dozen of those 70 companies are exiting the business.

Many GIC contracts are small: \$1 million, \$2 million, \$3 million. Many of them are large with \$100 million and larger contracts. Its a good opportunity for a company to expand its business if it is looking for another product line. And the buyers of GIC contracts and GIC managers are looking for additional capacity in the business. Why? Because of fiduciary requirements, there's tremendous pressure to diversify their assets. Some of that means moving away from GICs. They can diversify by having bank investment contracts (BICs) as well as GICs, and by having treasury funds and other money market funds. But when you compare fixed-income vehicles, GICs usually offer the highest prospective return, so the buyers of GIC contracts would like more carriers in the business so that they can diversify.

We began rating companies in 1980 because the treasurer of a major corporation came to us and he said, "We have \$1 billion of GICs in our savings plan for employees and it's all with one company. Do you think we should diversify?" Of course, the answer is yes. And at that point in time, ERISA regulations said that buying a GIC contract from an insurance company constituted diversification, because the insurance company itself had a diverse pool of assets in the general account backing that GIC contract.

But, today, the Department of Labor (DOL) and plaintiffs' lawyers take an opposite view. You have to diversify over a number of carriers. There is a natural inclination and willingness of the GIC purchaser to spread out its business over many companies. It's an opportunity.

Not only do they have to diversify their plan assets, and then diversify the GICs among carriers, but they're under pressure to limit the dollars invested in each contract to a reasonable percentage of such company's surplus or such company's assets. And many corporate buyers are setting limits on the contract duration that they buy, based upon the credit rating of the company. The GIC buyer leaves the analysis to others, relying upon the credit rating agencies.

But the GIC buyer is cast in a fiduciary role. The DOL has instituted lawsuits against corporations that bought contracts from Executive Life, from Mutual Benefit, even from Presidential Life which didn't go into solvency. (They subsequently dropped that lawsuit.) But when a life insurance company goes into solvency and enters conservation, it is quite likely that the DOL might be instituting a lawsuit against a fiduciary buying a contract from that company.

They're toughening their standards. I am involved in a case where a corporation is being sued for buying a Mutual Benefit contract. It was a two-year contract paying 7%. It was purchased just three months before Mutual Benefit went under. Because of state guarantee

## HOW DOES YOUR INSURANCE COMPANY RATE?

funds, the employees are going to be paid 5.1%. They will be paid 7% for seven months of the contract, and for the remaining 17 months they will receive 5.1%. Well, the plaintiffs' lawyers are suing for that 1.9% differential for the 17 months for lost interest.

The DOL has also just come out with a draft of a memo that, in essence, is saying, if people terminate a pension plan and buy termination annuities on the employees in those plans, they have to buy the safest possible annuity offered at that time. If I read this memo very strictly, I interpret it to mean you can only buy from the one company, whichever that company is, that's the safest at that time. A strict reading of the memo chooses safety over the contractual interest provision on the contract.

I would think that some Aa, or Aa+ companies would probably be just as strong as Aaa companies. The DOL lists some considerations that have to be taken in effect in choosing an annuity provider. The quality and diversification of assets speaks for itself. I assume the buyer would avoid a risky asset class that has high credit risk, such as junk bonds, mortgages and real estate, or interest rate risk with an abnormal mix of CMO or mortgage-backed securities.

The size of the insurer relative to the contract size is a factor. Another concern is the corporate buyer may not feel that he can buy from a company with a modest level of surplus.

Lines of business and other exposures. If a company is a major player in the group health line, a bad year could put it under. Or if it is a monoline annuity company, bad investment practices could put it at risk. Perhaps if they were a term insurance specialist writing high-limit policies with high-retention limits, that would be considered an exposure. Exposure might be subsidiary investments in cyclical businesses, such as property and casualty insurance, and stockbrokerage firms.

Prudential wholly owns Prupac and Prudential Property and Casualty. Two years ago, when there was a hurricane in Florida, this company had \$900 million of surplus wiped out in one day. Prudential could afford the \$900 million loss, but I'm sure many smaller life insurance companies could not afford that size loss.

So, exposures come through not only the operating lines of business, but also the credit quality, the interest rate risk, and affiliate exposures, whether it belongs to the parent company or the subsidiary.

Structure and guarantees of contract. The DOL wasn't too clear on that, except it referenced separate accounts. So maybe it is expressing a preference for the buyer to buy termination annuities through a separate account structure rather than a general account structure. But that seems to be a little bit contradictory. The final concern is the availability and coverage of state guarantee funds. The DOL emphasis is on the safety of the insurer who will be issuing the contract.

MR. MARC VERRIER: You've heard from Fred and Joel who have talked to you about how they go about providing ratings on insurance companies. My role today is to talk to you about our experience regarding how some organizations use those ratings. It's an interesting perspective. We've had the good fortune to work with such organizations over the last seven years. That's also when we first started to work with Fred's organization.

## RECORD, VOLUME 21

My objective is to give you a sense for what the thought process may be inside a large broker/dealer company, which is based on our experience. I think it may be interesting to you to the extent that you may work with such organizations now or in the future. This may help you to understand how they go about their business.

I will not focus extensively on "communications" in this discussion. Understand, however, that good communication between the insurance company and the broker/dealer is probably the most important thing that has to happen. It must occur between both the insurance company and the firm, and then between the firm and the brokers out in the field. The theme that we use is "say what you mean," and then, "mean what you say."

In other words, if the broker/dealer says to the people out in the field that we have done "our due diligence," and that "you can sell the contracts of this company," they have to deliver on that. Otherwise you wind up creating real problems for yourself downstream.

In the interest of time, I will go through this fairly quickly and focus on the key points and issues that come up during a firm's due diligence process.

You should think about people inside the firms involved in the due diligence process. Now think of due diligence as an accident prevention program. And think about the people who are interested in accidents. Generally speaking, there are only two groups that are interested; the first are actuaries, and I can tell you that there are not many actuaries inside broker/dealers firms. Generally, they fall into the second category of people interested in accident prevention programs: victims! They feel very much like victims, and it's immediately following "an accident," that is, after an approved carrier becomes insolvent or is put into rehabilitation. Their interest level peaks when they are victims.

If they (the due diligence committee and the people managing the insurance business at the firms) make a wrong decision regarding a carrier, it can have a huge impact on their business. One of our clients had over 100,000 clients inside a company that was put into conservatorship. The disruption and the ultimate cost of such an event is very high.

Generally speaking, when you work with the firm to satisfy their due diligence requirements, you'll work with one or more "gatekeepers," who are concerned about product, service, and financial strength. You may not always be able to identify a single gatekeeper because of the multiplicity of issues and the number of people involved.

You will, however, be dealing with people who have specific accountability for selling insurance products. You will also be dealing with people on the due diligence committee who may be wondering why they're in the insurance business at all. As a result, you are always dealing with a very diverse group.

The firm's objective through the due diligence process is to provide as much safety as you can. The firms will think of safety as an absolute. Both based on practical experience and based on analysis, there's no such thing as absolute safety.

So you are looking for two things. First, you want to ensure that carriers are as strong as possible, based on the firm's objectives regarding product, marketing, and competitive positioning. Second, you're looking for an early warning system. First, you do the best you can in terms of letting the highest quality carriers into the system. Second, once a



## HOW DOES YOUR INSURANCE COMPANY RATE?

carrier is in the system, then, if there's going to be a problem, you want to know as soon as possible, so that you can start to take action.

The due diligence system also ideally reflects the fact that the world is not black and white. What is required then is a flow of information into the firm, to the committee, and from the committee to the firm's management group, and to the brokers.

The due diligence process generally has two key components:

1. The firm has to set policy for the due diligence committee: What does the committee do? What kind of information does it collect and communicate? How? When does it do it? What are the standards? Does the committee administer specific standards relative to real estate holdings, for example? Does the committee have relative standards? For example, does the committee simply want to pick out the "outliers?"  
A due diligence system may have 12–15 different measures. If you find one carrier that is out on one or two measures, that may be all right. But if you find a carrier who is out on five or six measures, or seven measures, you may need to look more carefully. Even if that carrier is rated Aaa, you will want to flag that carrier.
2. Then you need information. The committee follows a process to collect information and apply standards and to perform the necessary analysis.

In performing due diligence, a firm will consider a number of different processes. One extreme, applied by a very small firm not to be named, simply considers whether the insurance company is approved to do business in that state, i.e., the firm assumes that the state insurance department will protect its interests.

Most firms, however, will fall within one of the following two points on the spectrum of possibilities:

1. Use agency ratings only. It's not a bad process; the problem, however, is when a carrier runs into difficulty. Here, the lack of a more extensive process puts the firm in a difficult position in terms of managing a crisis. The firm will likely be way behind in understanding the carrier's issues; this will lead to delays in communicating to the firm's management group and with the brokers. It may take a very long time to recover from that kind of a reactive situation. Furthermore, in terms of understanding which carrier may have a problem in the near term, there is no way that one of the public rating services can communicate significant information about an imminent or potential crisis.
2. The other end of the spectrum is to say you don't believe the rating services and to try to do it on your own. In practice, it makes no sense for a single user to replicate the "system" of available ratings.

There's a much better alternative between those two alternative points on the spectrum which combines the best of both. That system essentially starts with the rating services. Use that as your focus point and as your starting point. Combine that with internal analysis and then focus on identifying and resolving the most likely problem areas.

In this kind of system, assuming you have  $X$  dollars to spend on due diligence, don't bring in your Aaa-rated carriers. You don't need them. That's not to say there won't be a

problem there, but that's not a good allocation of resources. When you combine ratings with a comparative analysis of carrier risk factors, it does put you in a position of being able to react.

I'm not going to talk about the kind of information that the due diligence committee would collect because the information is very similar to what you've already heard from Fred and Joel. But there is one additional aspect. To avoid misunderstandings, it is very important to separate facts, analyses, and opinions.

In terms of specific additional information that firms specifically would look at, it is very important to know "market shares." You need to know ideally, for the firm in total, how much of the business is with that one carrier. In other words, how important is that carrier to the firm? At the same time, you want to know how; what percentage of that carrier's total business does that firm consist of. Within that statistic lies a real danger, and this danger comes up in a number of places. If you become too significant to that carrier, you essentially become a player in determining that company's ratings. From a due diligence perspective, there are both advantages and disadvantages to being in that position. I would recommend that it is not a good position to be in if the carrier is not affiliated to the firm. If there is a corporate affiliation, then this may become a moot point in any event.

The firm would normally provide a general description of the due diligence process, the ratings of the carriers, and some of the detailed financial analysis so that brokers can answer client questions. The firm will also provide recommendations to its brokers. Though the words will be different for each firm, the firm's recommendations to brokers should look something like this:

1. "Buy" means that carrier has sufficient surplus to cover its current business and its anticipated new business. And the brokers will focus, obviously, on the buy companies. Since firms deal with both in force and new business, buy ratings can apply to either active companies, or inactive companies (that is, companies no longer promoting their products for sale inside the firm).
2. A "hold" company is simply a company that may have excessive risk, relative to its surplus position. In that case, a broker is taught to evaluate these situations on a case-by-case basis. Relevant factors include surrender charges, the period of time over which such charges may disappear, the existence of a life insurance benefit and the customer's insurability and risk tolerance. Bear in mind that, regardless of a firm's pressure to provide the most competitive rate possible, the reality is that insurance products are sold by the most conservative brokers, and generally to their most conservative clients. As such, dealing with policyholders holding contracts with companies on the hold or the sell list is never an easy or pleasant experience. Ultimately, however, it is the client's responsibility to decide whether or not to take action with respect to a specific policy.
3. A "sell" means that there is a strong possibility that the company may not ultimately cover all of its future obligations, and/or is a reasonable candidate for rehabilitation. Again, bearing in mind the conservative nature of the typical broker and the typical customer, rehabilitation means a period of illiquidity and is a very serious problem. The threat of illiquidity for a one-to-three year period is reason enough to put a company on the sell list. Many people in the business will tell you that a "sell" order is not feasible for many reasons. We disagree with that. The statement itself undermines the due diligence system internally—if you won't use the

## HOW DOES YOUR INSURANCE COMPANY RATE?

information, why collect it? More important, if the firm takes due diligence seriously, how can it not follow through on its analysis and conclusions? Second, avoiding the use of the sell list undermines the system with the brokers, leading to a breakdown in the credibility of the due diligence process. Our advice to companies is to be aware of the firm's criteria for due diligence upfront, so that you will know the hurdles you have to cope with today, and to get an indication of the hurdles you will have to continue to meet five and ten years from now.

Establishing the scope of due diligence is very important. From the firm's perspective, if you don't wind up with a reasonable definition of what due diligence is, you'll just never get anything done like product illustrations and current interest rates and dividends. It may be reasonable to attempt to evaluate the credibility and reasonableness of these items. Unfortunately, these items are often not covered by the rating agencies, and for good reason—the agencies are technically evaluating the carrier's ability to meet its contractual obligations. Our experience leads us to conclude that a due diligence system should not cover these issues, and that it should focus on financial strength relative to contractual guarantees. Staff within the firm's insurance department should then be responsible for ensuring the integrity of products and illustrations.

A due diligence system created along these lines relies heavily on two items: disclosure and integrity. When these components are missing, there will be serious due diligence problems. For instance, dealing with branch operations of foreign companies (that is, generally Canadian companies dealing directly in the U.S. as branch operations) has led to serious issues that are still unresolved. The takeover by regulators of Confederation Life raised not only the issues of a once highly rated carrier overextending itself and being put into rehabilitation, but also the issue of whether and how an individual firm can look over the shoulders of regulators and rating agencies. Many people in the due diligence business were surprised (to put it mildly) to hear about the sizable affiliated company notes held in the Confederation Life U.S. trust account. I won't get into the appropriateness of those particular investments being held in the trust account; the real issue is that the trust account, in effect, exposed U.S. policyholders to risks of which few people were apparently aware.

This raises one of the most difficult aspects of due diligence, and explains some of the most frustrating requests that you may get from people doing due diligence for either agencies or individual firms. In essence, the only way to find out about things you don't know about is to go on what might politely be called a fishing expedition. The apparent lack of direction of such fishing expeditions can be frustrating for carrier executives trying to address specific questions. Nevertheless, they can be very productive. One example is an offbeat question by a due diligence committee member leading to discovery of over \$100 million of undeveloped desert held on a carrier's books. (The carrier ultimately moved the asset to a noninsurance affiliate in order to resolve the problem.)

