

RECORD OF SOCIETY OF ACTUARIES 1995 VOL. 21 NO. 3B

THE RATING GAME

Moderator: ROBERT T. SMITH
Panelists: MICHAEL LOMBARDI
JOHN NICOLA*
MANFRED NOWACKI†
Recorder: ROBERT T. SMITH

This session is designed to answer what you always wanted to know (or really should know) about rating life insurance companies but never dared (or had the chance) to ask.

MR. ROBERT T. SMITH: This is a snappy title designed to get everybody's attention. However, those of you involved in the direct writing side of the life insurance business would agree, I'm sure, that the issue of ratings, and the related issues of solvency and consumer confidence in the life insurance industry both in Canada and the U.S., is serious business. It is more than a game and is increasing in its seriousness, particularly in Canada since the August 1994 failure of Confederation Life.

I don't have the experience or the expertise of my colleagues. However, I do have some direct experience with the subject of ratings, being employed by the largest life insurance company domiciled in the Province of British Columbia—which is a bit like saying you're employed by the largest ski resort in Ontario!

Since summer 1994 not a day has gone by when I have not had to deal directly with the issue of ratings—either regarding publicity in the financial press surrounding the emergence of a new self-appointed rating agency in Canada called Tests, Ratios, Analyses and Charts (TRAC), or regarding dealings with the more traditional rating agencies. But, more important, I deal with consumers' confusion about financial services and their financial advisers on this issue.

I do some public speaking in my job. When speaking to organizations such as the Chartered Life Underwriters (CLU) or the Life Underwriters Association of Canada (LUAC) during the past year, the request has consistently been to talk about solvency and to clarify the confusion surrounding insurance company ratings. Indeed, it's an important subject and it's a multifaceted subject. Therefore, recognizing that there are a number of perspectives that can be brought to bear on this issue, I have recruited a panel for you with quite varying backgrounds.

To give our session some continuity, I'm going to introduce all three panelists at this point and then let them run with the session. I hope we will have time at the end for questions from the floor.

*Mr. Nicola, not a member of the sponsoring organizations, is Financial Advisor of John Nicola Financial Group Ltd. in Vancouver, British Columbia.

†Mr. Nowacki, not a member of the sponsoring organizations, is Vice President Life-Health Division of A.M. Best Company in Oldwick, NJ.

RECORD, VOLUME 21

Speaking first will be Mike Lombardi. Mike is a principal and leader of the life practice area in the Toronto office of an actuarial consulting firm. He's a Fellow of the Society, a Fellow of the Canadian Institute of Actuaries (CIA), and a member of the American Academy of Actuaries (AAA). In his professional activities he provides advice to life companies in a wide range of areas: appraisals, asset liability management, financial reporting, and strategic planning. Mike will focus on the rating issue and the rating process from the point of view of life company management in Canada and the U.S.

Following Mike will be Manny Nowacki. Manny is a vice president in the life and health department of the A.M. Best Company. Many of you may recognize Manny as the smiling face that greets you at the end of a rental car ride from Newark International Airport to Oldwick, New Jersey. He has been with life companies and rating agencies throughout his career. In his current capacity he oversees the analysis of the strength and performance of some 1,400 companies in both Canada and the U.S. He has also been involved in the analysis of companies in Australia, New Zealand and Japan. However, Manny is going to give us the benefit of his views on the Canadian and U.S. markets, and obviously, he's going to talk about the rating process from the perspective of a rating agency.

Following Manny will be John Nicola. John is the founding principal of the Nicola Financial Group in Vancouver. He provides professional advice to clients in the areas of wealth accumulation, management through the use of trusts, and creative pension and insurance arrangements. John is a frequent speaker for professional organizations and is heavily involved, as both a director and a lecturer, with a number of professional groups in the financial services industry.

John is going to conclude our presentation by giving us an end-user perspective; that is, he's going to deal with the issues of rating and solvency from the perspective of the consumers of financial services and their professional advisers.

MR. MICHAEL LOMBARDI: Ratings can have a major impact on insurers' success. Financial strength is clearly a competitive advantage. Ratings are a simple way of communicating this to the public. In some markets, particularly in group insurance and annuity markets, a prerequisite for getting any business is that the insurer be at or above a certain rating level.

The need to maintain specific ratings affects many internal corporate decisions, from capital allocation to investment operations and product design.

In my remarks I will cover various rating agency issues and concerns, primarily from the perspective of a life insurance company. We will examine:

- Who are they?
- Reasons for growth
- What are companies doing?
- Differences between Canada and the U.S.A.
- Criticisms of rating agencies
- Some concluding remarks

THE RATING GAME

Who are they?

The major public rating agencies in the U.S. include:

- A.M. Best
- Duff and Phelps
- Moody's
- Standard and Poor's (S&P)
- Weiss

In Canada we also have:

- Canadian Bond Rating Service (CBRS)
- Dun & Bradstreet Rating Service (DBRS)
- TRAC

The approach and source of information used by each rating agency can be quite varied. Some, such as TRAC, rely entirely on information in the company's statutory return and, to a lesser extent, on other publicly available information. Most agencies also supplement this with information provided by management. Sometimes an on-site visit and a series of interviews with senior management lasting up to several days are a standard part of the rating process.

Most rating agencies also issue a report on each rated company, usually consisting of a few pages, providing an explanation of the rating rationale as well as useful insight into the financial condition of a company. The jargon used in the written summary depends on the primary audience for the end product, and the language used may be influenced, to a lesser extent, by who is paying for the work performed by the rating agency. Moody's, for example, focuses primarily on institutional investors while Best's and S&P focus on consumers and insurance producers. All rating agencies have important secondary audiences such as news media, regulators, investors, stock brokers, and the public.

The analysis by rating agencies encompasses quantitative ratios and trend analysis as well as qualitative or subjective company evaluations. Qualitative aspects are an important element of the process and may include such items as:

- the company's goals and long-term strategies
- its concentration and stability within its target markets
- the experience and quality of its management
- monitoring and control mechanisms, including the quality of information available to management
- the adequacy of the company's reserves, cash-flow testing, and asset/liability management processes
- diversification of risk
- underwriting and claim controls

While the end result is a company rating, the actual rating scale used, ranging from 5 to 19 rankings, often leads to confusion. There can be many ratings within a single scale, not including modifiers. The verbal description of ratings can be misleading. For example, an A rating, while sounding very attractive, can actually mean that the company is six notches below the top grade. In fact, the relative position of the rating within a particular rating agency scale is a better indicator.

While rating agencies generally do a good job of evaluating the financial condition of an insurance company, they are not perfect. A high rating is not a guarantee that the company will survive, and a low rating is not a guarantee that the company will fail.

REASONS FOR GROWTH

Policyholders have become more aware that insurers are subject to serious financial difficulties. There seems to be a never-ending number of ways that companies can fail. Whether it be through familiar problems of the past, such as investments and junk bonds, commercial mortgages or real estate, or problems yet to emerge, such as imprudent speculation and derivatives, a loss of consumer confidence, or changes in a tax environment, consumer doubt and uncertainty have been increasing. Whether in the U.S. where dozens of companies fail each year, or in Canada where company failures have traumatized the Canadian sense of absolute security, increasing awareness of this reality has resulted in greater scrutiny of insurer financial statistics and other key indicators.

The complexity of insurance accounting and long-term liability cash flows create a need for expert opinion. The average consumer has neither the time, the expertise, or the patience to go through a huge pile of regulatory filings, notes to auditors' statements, glossy brochures, management discussion and analysis, proxy statements, and 10(k) filings for each and every company offering insurance. In addition, the fiduciary obligations of employers and insurance brokers, the due diligence required to be performed by them in the selection of carriers, and the need to minimize litigation if things turn out wrong, increasingly require that all pertinent information be included in a decision-making process.

While not perfect, ratings have become widely recognized as an inexpensive source of third-party expert opinion. Risk can be further limited by examining ratings and written reports from several different agencies. Thus, the increasing awareness and impact of insurance company failures, the growing complexity and expertise required to thoroughly understand the company's operating environment, and the low cost and ease of obtaining ratings have all contributed to the growing importance of rating agencies.

WHAT ARE COMPANIES DOING?

Insurers increasingly recognize the influence of rating agencies. Even unrated companies are finding out that not having a rating creates doubt among the public and can be costly to the company's success. On the other hand, actions by rating agencies can significantly affect business plans, can cause policyholder panic, and can cause agent defections.

Many insurers have increased the time and resources dedicated to preparation for meetings with rating agencies. Companies are increasingly aware that they cannot simply overwhelm a rating agency with data dumps on financial results and forecasts to get a good assessment. The rating agency's subjective assessment of management's ability to function under stress and its capacity to assure growth and profitability are equally important. In formal presentation by the company to rating agencies, agency representatives do interrupt frequently and ask pointed questions.

As part of their advance preparation for the rating agency presentation, many companies now go through role-playing to sharpen their skills. Sometimes external

THE RATING GAME

consultants familiar with the particular rating agency are used to coach management and improve the preparation. It is helpful if someone plays the role of devil's advocate posing tough questions and ensuring the presentation is complete. Graphs and other visual aids are used to help put the story into perspective. The role-playing provides an opportunity to modify any part of the presentation that does not hang together, is unclear, or fails to convey the intended message. Companies also find it helpful to give rating agencies a written transcript of all oral presentations to ensure that key points are not overlooked. The written documentation is particularly helpful if a new analyst, who may be unfamiliar with a company, has been assigned.

Communication with rating agencies is not just an annual event, but must be ongoing, particularly during a crisis or a late-breaking event. Timing during these events is measured in hours rather than days. Management must have a coherent story, respond quickly to any concerns of the rating agencies, and generally demonstrate that it is in control of the situation. Rating agencies hate uncertainty or being surprised by newspaper headlines. If their concerns are not satisfactorily addressed, the company will soon find its rating is under review with negative implications. In the event the company is downgraded, the company can inadvertently prolong its own agony. Repeatedly, we see chief executives publicly disagreeing with the downgrade, questioning the competence or credibility of the particular rating agency, or even worse, engaging in sweeping generalizations and public criticism of all rating agencies. What is wrong with this? First, most rating agencies are experienced media players and can give as good as they get; second, the media loves public controversy and will play up a story for as long as it can. The real solution is prevention, not cure: the company should be maintaining good relationships and open communication channels with the rating agency at all times.

Finally, to safeguard the company's credibility, companies are learning the importance of the same story being communicated to regulators, the media, employees, shareholders, and policyholders. The company cannot go too wrong if it always assumes and acts as if any information in its corporate marketing material, glossy brochures, media interviews, internal speeches by management, or press releases, will eventually come out.

DIFFERENCES BETWEEN CANADA AND THE U.S.

Turning specifically to the Canadian environment, up until a few years ago Canada had not been a great place for a rating agency to set up shop. Canada had gone more than 60 years without a single life insurance company failure. The insurance market in Canada was dominated by several large mutuals and a few closely held stock companies that rarely issued new shares or debt obligations. In addition, insurance accounting and reserving practices, especially from the perspective of American-based rating agencies with little interest in Canada to begin with, were seen as somewhat confusing, being either U.S. generally accepted accounting principles (GAAP) or National Association of Insurance Commissioners (NAIC) statutory accounting, thus creating additional barriers to entry.

All this changed after 1991. With the move to GAAP and policy premium method (PPM) reserving, financial reporting for Canadian insurers became arguably more understandable. A long-term process of consolidation and rationalization of insurance players picked up speed, fueled by poor returns and, with the looming threat of bank

entry into the insurance domain, the widespread prospect of even poorer returns. The new climate resulted in sharper and more focused management attention to business risks and insurance fundamentals, including a greater emphasis on return on equity (ROE) rather than the pursuit of market share. Unfortunately, the industry was simultaneously emerging from a deep recession with the problems of concentrated investments, commercial mortgages, and real estate. These investments in whole or in part resulted in liquidity problems and the eventual failure of three insurance companies: Sovereign Life, Les Cooperants, and Confederation Life.

The failure of three insurance companies, surely a very small number of failures by U.S. standards, jarred the Canadian public to the reality that insurance was not a completely safe investment. Real money could be lost if the wrong carrier was elected. The insurance companies themselves, which had set up an industry guarantee corporation called The Canadian Life and Health Insurance Compensation Corporation (CompCorp) originally as a no-cost, public relations gesture to match similar government-funded guarantees by the banks and to solidify consumer confidence, were soon hit with previously unimagined levels of assessments to make good on these guarantees. The solidity of the industry and the coinsurance built into the system via this self-assessment mechanism continue to raise new levels of concern about the potential domino effect and increase pressure on regulators and governments for major reform.

In this confusing and turbulent environment the traditional rating agencies have scrambled hard and fast to catch up to the market demand. A.M. Best, and I may be corrected on this by Manny, now rates 20 Canadian companies plus 66 branch operations. S&P expects to include 100 Canadian companies in its next edition. Moody's has rated six companies plus 33 branch operations, and a similar number have been rated by Duff and Phelps. Meanwhile, some homegrown rating agencies achieved instant success and recognition. TRAC became the media darling through its simple quantitative approach to classifying insurance companies and its frequent (and some have said damaging and irresponsible) attacks on the Canadian insurance industry for its secrecy and poor record of public disclosure. On a positive note, TRAC does provide a useful service by bringing together data on insurers in a handy readable format and making helpful explanatory commentary on the type of information provided. TRAC's credibility was further boosted by its early identification of Sovereign Life and Confederation Life as troubled companies well ahead of the regular rating agencies.

CRITICISM OF RATING AGENCIES

I will now cover some critical issues raised with respect to rating agencies:

1. There is public confusion due to the multiple services and the different ratings of insurers. At the most basic level even the symbols used are different. The following questions illustrate the potential for public confusion:
 - Is an A++ from Best any different from an AA from S&P?
 - How about an Aa2 from Moody's versus an IC-I from DBRS?
 - What is an S&P "qualified" rating?
2. Some agencies rate more leniently than others. It is also true that many rating agencies are paid for their work product by the insurance company. Companies that know or suspect what level of rating will be assigned by different agencies

THE RATING GAME

can “shop around” or selectively communicate ratings to their distributors or the public. For the rating agency, a fine balancing act exists between the need to maintain good insurer relations while continuing to be perceived as credible and independent.

3. Too fine a grading can result in too frequent changes in ratings, causing unnecessary concerns.
4. Subtle nuances need to be understood and distinguished. For example, financial strength is different from claims-paying ability, which is different from debt rating. Subsidiary rating is different from a parent company rating and is different from a holding company rating.
5. Rating agencies have failed to adequately identify recently troubled companies. Ratings tend to be adjusted only shortly before or after regulatory action is taken. We saw this with Mutual Benefit, First Capital/Fidelity Bankers, Executive Life, and Confederation Life.

Partly because of this media criticism, there’s a general feeling that rating agencies have begun to toughen standards for assigning ratings. For example, some people point to the Canadian companies downgraded shortly after Confederation Life went into liquidation.

6. Rating agencies are unaccountable and can be damaging to the public interest by playing up to the media and creating self-fulfilling prophecies. The act of downgrading an insurance company can create new concerns and cause a run on the bank as concerned policyholders increasingly lapse their policies and flee to safer rated companies. The additional surrender activities aggravate the troubled company’s cash flow and liquidity, thereby generating new financial difficulties, additional media attention, and an ever-deteriorating vicious circle.

A company at the top of Moody’s scale, for example, could be successively downgraded five times during the course of a year, yet still end the year with an AA rating. If two or three additional rating agencies take similar action at different times during the same period, the unfortunate company could end up as front-page financial press material dozens of times.

7. Rating agencies do not have enough actuaries; they cannot be credible. I wonder if that means rating agencies or actuaries are the ones who can’t be credible. While a few agencies do have actuaries and are further addressing this weakness, it is difficult to conceive that the product, reserving, and reinsurance complexities of hundreds, if not thousands, of insurance companies can be adequately monitored by one or two actuaries. On the other hand, the process of adequately assessing a company includes a variety of other skills such as accounting, financial, legal, investment and securities expertise, many of which are available to rating teams. Further, rating agencies claim that they learn from and have gained an adequate appreciation of actuarial issues through constant exposure to hundreds of company actuaries.

8. European multinationals pose additional difficulties. Ratings are often not assigned or are based on incomplete understanding of home markets and harder to interpret financial information than is the case for North American companies.
9. In Canada many companies are still not rated, or are listed only by one agency. Some rating agencies conduct only annual or infrequent reviews. This makes it more difficult for employers, benefits consultants, brokers and policyholders to decide. Rating agencies in Canada are on less familiar ground and have often failed to ask for meaningful documents such as the *Appointed Actuary's Report* or the scenario testing performed at the dynamic solvency testing (DST) analysis. In addition, many U.S. insurance companies operate in Canada as a branch. The written summaries by American rating agencies tend to be a word-for-word copy of the U.S. parent company commentary, shedding little light on Canadian operations, profitability issues, and challenges.
10. Finally, due to TRAC's simple approach and media notoriety in Canada, it has attracted an extra degree of criticism:
 - In its published material it claims not to be a rating agency. Its measures are merely intended to trigger thoughtful questions, with poor ratios not necessarily representing signs of trouble. These disclaimers, however, are often ignored in media coverage.
 - Some of its measures, while meaningful for property and casualty companies, are meaningless for life insurers.
 - It claims to use the same ratios as currently used by Office of the Superintendent of Financial Institutions Canada (OSFI) to monitor companies. In fact, OSFI, the federal regulator, has denied this, claiming that it now uses other indices such as the minimum continuing capital and surplus requirements (MCCSR) to monitor life companies.
 - All ratios are equally weighted through simple addition.
 - Capital movements and the impact of corporate structuring are ignored.
 - Free "pass points" are awarded to companies where the measure is not applicable. Conversely, a ratio can be failed if results are too good and exceed the maximum allowed.
 - Finally, it makes no distinction between measures applicable to a branch operation versus stand-alone companies.

CONCLUSION

Rating agencies are becoming the primary source of information on financial strength of insurance carriers. They are an inexpensive source of third-party review. They are also readily meaningful to financial and investment managers who are familiar with the rating process associated with the issue of debt obligations.

Looking to the future, we should expect to see the following:

- For rating agencies, we will continue to see toughening of rating standards, refinement of the rating process, and increased competition among rating agencies. Rating agencies will continue to play a useful role in sorting through complex financial and strategic analysis.

THE RATING GAME

- For insurers, we will see greater market emphasis on financial strength, additional resources dedicated to securing favorable ratings, and greater attention by senior management to the consequences of their decisions on their ratings.
- For policyholders and brokers, we will see more attention to ratings and, in the absence of compelling reasons, a shift of business to higher rated companies. Policyholders should also benefit from this additional market-imposed discipline on insurance companies.
- For regulators, we will see new calls made for some kind of control on or regulation of rating agencies and a review of guarantee funds.
- Specific Canadian changes will include changes to CompCorp financing, and a rapid expansion into Canada by traditional rating agencies such as Best, S&P and others. In the face of this increasing competition, TRAC may eventually be forced to clean up its act and become a genuine player.
- Finally, DBRS and CBRS will become increasingly active in insurance ratings.

Despite all the public controversy and finger biting, most people would agree that if rating agencies did not exist, we would have had to invent them.

MR. MANFRED NOWACKI: I hope that by the end of my presentation you'll have a better understanding of the rating process and rating role with respect to insurance companies.

As Bob mentioned to you, I'll be speaking briefly on the rating process itself. I'll also try to give you an indication of potential rating actions in the future as we see them.

First, let me tell you a little bit about the A.M. Best Company: A.M. Best was incorporated in 1899 and was the first rating agency in the world to report on the financial condition of insurance companies. A.M. Best produces numerous publications on the insurance industry, but its major focus is on the ratings of property and casualty and life and health insurance companies.

Our coverage has expanded worldwide. We started in the U.S., as I said, in 1899, but we've also been rating the largest Canadian companies for many years. During the past decade, we've had increasing international exposure, adding ratings on companies operating in Europe and Asia.

We introduced a Canadian publication in 1994. This is part of our strategy to provide better resources for the local markets. In the U.S. we introduced a health maintenance organization (HMO) publication in 1993. In February of 1995 we began our first ratings on HMOs and now have ratings on 40 different HMOs in the U.S.

What is the Best rating? The Best rating is an independent opinion on the overall financial position and operating results of an insurance company. Our Best rating is intended to give the user of the rating an indication of the relative ability of a company to meet its obligations to its policyholders.

We don't rate on a predetermined distribution or against a bell-shaped curve. Rather, the rating is intended to give the user an indication of the financial health of the company relative to the industry and relative to certain subsectors in which the insurance company may operate.

RECORD, VOLUME 21

Finally, a rating is based on a comprehensive evaluation of various quantitative and qualitative factors affecting overall performance. I'll get into many of these qualitative factors in a few moments.

Who benefits from the ratings, and who is Best's major constituency? The primary concern of the A.M. Best Company is the security of the policyholder. Best's ratings are therefore designed to identify insurers' abilities to compete as viable long-term players.

As you'll hear during the presentation, the major part of the rating process is the dialogue that A.M. Best has with insurance company managements. However, in no way do we avoid a rating conclusion since our credibility is on the line with every rating decision.

Let's consider the ratings trend over the last several years. We'll discuss total ratings in North America, i.e., all the companies we rate in both the U.S. and Canada. The number of ratings has been growing. In 1992 we had a little less than 800 ratings. Just recently, we had ratings on 930 companies.

I'd like you to focus on rating A. We will look at the percentages, and these are the cumulative amount of companies rated for that particular rating category and above. So, if you focus on A in 1992, 60% of the life and health insurance companies that we rated were A or higher. When you shift onto 1995, this has declined to 47%, i.e., only 47% of the companies that we rate are an A or higher. Similarly, if you look at the A+ category, that has also declined, going from 36% being rated A+ or above in 1992 to 23% today.

What is the primary reason for all of this rating activity and for the number of companies being downgraded during the last few years? They are many reasons, but I will indicate some of the more frequently occurring situations.

The first reason is below-average operating results at a particular insurance company level. The company's results are compared to the industry results overall; to its peer companies, i.e., the companies that it is competing against on a day-to-day basis; and then to A. M. Best's standards, i.e., our expectations for a company at that particular rating level.

Other companies' ratings were downgraded because of investment concerns, going back to the junk bond days in the 1980s, to mortgages in the early 1990s in the U.S. In Canada mortgages and real estate continue to be a concern, although there has been a shift from mortgages and real estate to concerns about derivative securities. Companies, mainly in the U.S., have been downgraded due to overexposure to collateralized mortgage obligations (CMOs) and mortgage-backed securities because we didn't feel comfortable with management's expertise in managing those investments.

Other companies had their ratings downgraded because of weak risk-adjusted capitalization not just the NAIC risk-based capital in the U.S. or the MCCR in Canada, but based on our own internal measures of risk-based capital; also, generally declining trends in companies' capitalization overall.

THE RATING GAME

Other companies had their ratings downgraded because of a concentration of risk in either a business investment or distribution network. A business risk could be a significant shift on a company's part from life to accumulation products. Investment risk could be high concentration in a particular investment or asset class. Concentration of risk in a distribution network could be overdependence on a single agent, a single firm, or a single brokerage outlet as a source of business.

Still other companies had their ratings downgraded because of a lack of forward market penetration into businesses. We recognize that this lack of market penetration could reflect weak consumer demand, but it also could reflect the inability of a particular company to improve its distribution system. It affects the competitive environment in general in both the U.S. and Canada.

Finally, other companies had their ratings downgraded because of an unfavorable regulatory condition. Recently, in the U.S. we've been particularly concerned about companies operating in the health care area. At one time our focus was on the Clinton proposals for health care reform, but now we're focusing on what's happening at the state level as far as health care reform is concerned, especially in the small group area.

Since we are in Canada, I thought I should talk a little about Canadian ratings and what's been happening here. Consider this subset of a larger group that covered 900 ratings in North America. We currently rate 24 Canadian companies in addition to 60 U.S. companies that operate in Canada on a branch basis, as well as six European companies that operate in Canada on a branch basis. This makes a total of 90 companies rated in Canada. These are true letter ratings—alphabetical ratings, not qualitative ratings like other rating agencies may have. These ratings include the detailed analysis and meetings with insurance company managements. We believe this gives A.M. Best the most comprehensive coverage of any rating agency in Canada.

Let's consider the rating distribution over a thirty-month period from January 1993 to the present time. In January 1993, 16 Canadian-domiciled companies were rated. Currently, 24 are rated. The distribution shows that the average rating has declined during this period. The decline is the combination of new ratings coming in at the A and the A level, but also recognizes the fact that a number of companies have had their ratings downgraded. The average rating in January 1993 was slightly below A+. Today, the average rating is somewhere between A and A-.

As I said before, we currently rate 24 Canadian companies, including 18 of the 20 federally licensed companies in Canada. Some of the most recent additions to our ratings are: Blue Cross Life out of New Brunswick; Canadian Premier, which is an affiliate of J.C. Penny; and Industrial-Alliance in Quebec. We are in discussions now with several other insurance companies in Canada, so we're hopeful that over the next several months we'll be able to add to this list.

Let me talk a little about the rating process. We feel most comfortable with insurance company managements with whom we have an ongoing dialogue, where we understand management's strategies and management's direction. It's not just an annual review of the numbers; rather, the rating process is interactive and requires dialogue from both sides—A.M. Best explaining to insurance company managements what some of the hot issues are, and insurance company managements discussing their situations with A. M.

Best. The flow of information is critical. We feel most comfortable with companies that keep us informed of changes in investment strategy, product portfolio, business direction, and anything else that might be taking place in the organization.

We look at companies on a quarterly basis as well as on an annual basis. It starts with the financial statements. However, companies that are more successful in managing the rating process don't just send us their financial statements—they'll either telephone us or provide us with written documentation, discussing the financial and other special occurrences that took place during the most recent financial statement period.

Finally, the most important part of the rating process is company meetings. At these meetings we discuss the company strategies for each of its major business segments. We have detailed discussions with each of the business units. During these discussions we try to assess what is the company's competitive market position in each one of these businesses. We look at the sales performance over several years and the sales trends. What are the characteristics of the major products? What is the company strategy and product development?

The meetings include a financial overview where we talk about the company's capitalization, debt issue and strategies, the earnings of the company on a line-of-business basis, the liquidity of the organization, and also the investment portfolio.

The rating process is a mix of quantitative and qualitative aspects. The quantitative review entails looking at various ratios in three broad categories: profitability, capitalization and liquidity. We look at these ratios over a span of several years. However, at this session there's no time to get into what all those ratios are. I'd rather spend some time talking about the qualitative issues that go into the rating process. My list is comprehensive and is intended to give you an idea of some of the points that we consider in the rating process. We look at the spread of insurance and investment risk. What I mean here is that large companies have a natural spread of risk due to the volume and geographic base of their business. However, we also note that well-run, conservatively managed companies that avoid concentration of risk can achieve similar levels of stability.

We also look at the reinsurance program, the amount and the soundness of the reinsurance. We try to evaluate the reinsurance program and look at the quality of the reinsurer. We also ask ourselves, is the reinsurance motivated by tax considerations, by financial considerations, or by regulatory considerations? We look at the adequacy of reserves, not just policyholder reserves but investment reserves from mortgages, real estate and fixed-income securities. We try to get a handle on the methodology used in the establishment of those reserves.

Next, we look at the company's management—its experience, integrity, organizational skills, and its goals and expectations. This is very subjective and is based on face-to-face meetings with insurance company managements. Some of the questions that we ask ourselves are: how would management respond to pricing pressures, lack of growth opportunities, and unfavorable regulatory conditions?

We also look at the maturity of the business, and how seasoned the life block is, how seasoned the annuity block is. We try to make a determination as to whether the

THE RATING GAME

company is dependent on an existing block of old business that's generating profits or on a new block of business that isn't profitable.

Continuing with the qualitative evaluation, we look at the insurer's business segments, the market focus of the insurer's business segments, and the key competitive issues within those market segments. We ask ourselves: does the company have a large market presence? Does it show market leadership, and has it demonstrated product innovation? Are these factors key competitive advantages?

Likewise, for a smaller company, we look to see if the company operates in a specific, sustainable and defensible niche and if this niche is a competitive advantage. This could be a geographic niche, a product niche, or perhaps a distribution niche. We also look at the company's underwriting, its underwriting approach and underwriting methodologies.

For other companies we look at the technology and service capabilities. We ask: does the company use its technology and service capabilities to differentiate itself from other competitors? For product distribution we look to see how the business is distributed. What is the company's relationship with its agents? What has been the stability of the field force, the turnover within the field force, and overall growth prospects for the field force?

We consider expense management. How does the company fare in this area? What has been the trend in its expenses and costs?

We look at the balance sheets, composition, and performance. We also consider sector diversification and look for any concentration of risks in specific asset classes. These could be regional concentrations or concentrations in single borrowers. We consider management's investment strategies as well as the expertise of the management team and the investment staff, management planning, and control systems. In some instances, a rating decision is partially based on our assessment of management's ability to implement a particular action plan.

Next, we have parent affiliated relationships. For companies that are part of a holding company structure, we try to make a determination on the strategic importance of that operating company within the overall organizational structure of the parent company. We also consider financial leverage in the holding company because many financial ratios can be improved by issuing debt at the parent company level and contributing the proceeds of these debt issues to the operating company.

For insurers with subsidiaries, we look at the consolidated performance of the insurance company and its subsidiaries and the risks and rewards to the insurer from its subsidiary operations.

The regulatory environment is another area we take into consideration. We look to see how changes in the current regulatory climate, or possible changes in regulation, could impact a company's business position. These could be changes in taxation or in areas such as risk-based capital.

Finally, let me summarize some of the issues on which we are focusing as we continue to analyze the insurance industry.

We see that financial issues and strategic challenges will continue for many companies. There are still questionable economic fundamentals and uncertainty about the direction of interest rates in the equity markets. We expect that investment problems will persist in some companies, but not to the same degree as in the last several years. However, we still have a concern about companies that continue to have significant exposure to the real estate markets, and companies that have an overabundance of derivative securities in their investment portfolio. We also note that the industry continues to focus its new sales on lower margins and fee-based products, which means that profitability levels are going to be uncertain and lower than they have been historically.

Market presence and profitable growth are going to remain a critical issue for long-term viability of companies. Many companies will continue to have difficulty expanding their businesses or sustaining a large presence in competitive markets and generating profitable sales growth. An important item will be capitalization. Strong capitalization will continue to be an important competitive advantage, but, again, may require some companies to restrict growth in order to preserve capital.

In conclusion, as we continue to review life companies, our rating analysis recognizes that, generally—and I stress the word “generally”—diversification in large companies is vital. This will allow those companies to remain viable in the industry as the industry transformation and consolidation, both in Canada and the U.S., plays itself out. Similarly, small niche players should also be successful as they continue to focus on their areas of expertise. Companies that don’t fall into those two categories, that have not defined any meaningful niche for themselves, will likely be hard-pressed to remain competitive and may be less viable. However, we don’t have any major solvency concerns. Rather, we feel that these companies are the prime acquisition targets for larger companies looking to increase their economies of scale.

We continue to view the life insurance industry as strong. The rating outlook is positive for insurers with sustainable advantages such as cost-efficient distribution systems, defensible market niches or products, particularly product expertise. However, the rating outlook is less favorable for those companies without competitive advantages. Also, the shift toward lower margin investment products poses downward rating pressure for selected life companies that may be growing overly dependent on investment products for a disproportionate part of overall earnings. Nevertheless, we regard the life insurance industry as fundamentally sound and the overall outlook for the industry remains generally positive.

MR. JOHN NICOLA: I’d like to bring you the perspective of what it’s like to be a financial adviser when insurance companies come crashing down around you, especially when you happen to have a few products that are slightly over the CompCorp limit.

At the beginning of my presentation, I will discuss how we help clients determine where they should be putting their money for the greatest impact. It essentially comes down in the issue of demographics.

THE RATING GAME

First, let me cover some of the questions that arise:

- How are we affected by the issue of safety and insolvency of insurance companies?
- Is this a large concern to our clients?
- Will it create a flight to quality?
- Will we use other sectors of the financial services industry as a replacement for insurance companies for the product needs of our clients?
- When will there be other major failures?

The demographic issues I want to address, and the things that I think affect a lot of the institutions with whom we do business, are:

- An aging population—an issue I feel has a huge impact on residential and commercial real estate values that has not yet run its course
- Public debt and pensions
- Technology
- Product development

I'd like to end my presentation with some comments on our role as advisers; on some liability concerns we have about the things we recommend; the greater need for information and disclosure; and our own feelings on consolidation within the industry itself.

Let me touch on the demographic issues. The change in the global population expected over the next 35 years is about a 68% increase, but the increase in the over-60 population around the globe will be 300%.

This rate of change is increasing at a dramatic pace. It took France about 141 years for its over-60 population to double. That did have something to do with a couple of World Wars and the fact that people didn't live that long. It will take China 32 years to accomplish the same feat. The aging of the population is going to have a huge impact, and it's not just a North American or European phenomena. These are statistics from the Organization for Economic Cooperation and Development (OECD) on the percentage of population over the age of 60 as of 1990.

In the year 2030, with the exception of Africa and the Mid-East, virtually every area of the world will at least double its over-60 population. This will create tremendous pressure, of course, on pension and health care systems, and whether or not this is going to be publicly funded or privately funded will be an issue. If it is privately funded, it's going to be financed to a large degree or the products are going to be provided by insurance companies.

You may have read a book called *The Age Wave* by Ken Dykewell. We must consider population and birth rates in the U.S. Similar statistics apply to Canada in 19-year increments from 1908 to 1983.

We run into a problem that is one of the reasons why we're very concerned with asset quality. The parents of the baby boomers retire extremely comfortably, especially in a city like Vancouver where there have been huge runups in real estate values. They downsize their real estate holdings; they sell their professional practices and businesses because they're selling them to the baby boomers. It's a seller's market. The problem

is that there's a perception among many of my clients who are baby boomers that they're going to get the luxury of the same financial treatment when they retire, except they're going to be selling to a smaller group. In fact, a complete reversal of values will occur. I will cover a little bit more of this in the real estate section later on.

Canada also has more of a problem in this area because the rate of increase in its over-65 population is more rapid than virtually any other industrialized country. Most of Europe, for example, has lived with the impact of an aging population. For example, Sweden's over-65 population will rise only 25% in the next 35 years as opposed to a rise of 150% in Canada.

Canada's population distribution in 1986 was inherently stable, and this is a critical point because, essentially, society generally supports people above or below a certain line, and there's a large working population in the middle to finance that.

Graphically the population distribution in the year 2031 looks unstable and it is unstable financially.

Many of you may have read the article in *The Economist* about four or five months ago on pension plans in the Group of Seven (G-7) countries. These are publicly funded pension arrangements, including superannuation agreements and the Canadian Pension Plan (CPP). These arrangements consume about 4% of gross domestic product (GDP). That's the current promise as of 1990. As of the year 2030, with no increase in benefits, it will consume 9% of GDP. I want to put this in some perspective so that you can look at it in comparison to the other G-7 countries.

Actually, Canada has one of the lowest obligations to public pensions of any of the G-7 countries. In Italy, for example, public pensions have reached 10% of GDP, which is one of the reasons Italy is having so many revolutions there as they are trying to cut back pension plans that can be as generous as providing, on a state basis, an 80% indexed pension for someone who is age 57. So, even as rich as these pension arrangements are, if every G-7 country simply agreed to honor the promises it has currently made and did not improve them, this is what the cost will be in 35 years as a percentage of GDP.

What I've tried to do is put this in a time perspective so that my clients can understand what costs we are talking about here because they're the ones paying those costs. Right now, Canada's obligations to public pensions equal 75% of the interest we pay on our national debt. If we don't change that pension benefit system, it will equal 100% of what we currently spend on all public and private health care by the year 2040. If our system was as generous as that in France, by the year 2040 we would be spending \$4,000 in 1994 dollars per man, woman and child per annum just to pay for the cost of public pensions. If we had the Italian de luxe system, it would be equal to 100% of all the revenues we currently collect for every aspect of our federal budget. It's a staggering number, 23% of GDP.

Here's another problem: these liabilities I'm talking about are not on the books. They're unfunded liabilities. This is the debt situation of some of the G-7 countries. Japan is quite low, mainly because it has managed to move a lot of its debt off to the banks. Great Britain is much lower because of Margaret Thatcher's paying down a

THE RATING GAME

large part of the public debt over ten years. The U.S. is at 51% of GDP. Canada is at 91%. Italy is at 107%. The economist reported that, if Italy had to price to present value the unfunded liability of its commitments on public pension plans, it would add another 250% of GDP to its debt situation at this time. I give you these numbers because it's clear that all of the G-7 countries, not just Canada, will be making huge public policy changes in the way we deliver pension plans.

Another reason we're going to make these changes is that our kids are going to wake up to the kind of mathematics that we've foisted on them. If you're 30 years old today, you and your employer, between you, pay almost \$2,000 in premiums for CPP. On an inflation-adjusted basis, that's already guaranteed to rise almost \$5,000 by the time you turn 65.

All I did here was simply invest in a 4% after-inflation yield in an registered savings plan (RSP) account and that \$235,000 is the account value you'd have. The \$1,400 a month in today's dollars is the pension income you could get on a fully indexed basis, using very conservative assumptions. This, in fact, is the pension benefit you're going to get.

Recently, *The Globe and Mail* conducted a study of who gets what depending on when you were born. This is similar to the benefits paid out in Social Security in the U.S. If you're born in 1920, you get \$7 of benefit from CPP for every \$1 of contribution made. If you're born in 1960, you will get \$2.60 for every dollar paid in, and if born in 1980, you will get 95 cents for every dollar paid in. The problem with this, of course, is that it assumes that there's no interest to be earned on any of these contributions.

My son is 15 years old and I have taught him that he should try to get a good return on his money. After all, it's the business I'm in. It's very hard for me to convince him that he should continue to pay taxes into a system that will provide a pension rate with interest of 1/10th of 1% for the rest of his life virtually guaranteed, but that, in fact, is what we're asking him to do.

Let's consider the percentages of contribution you have to make to get an integrated replacement ratio of 70% for retirement income purposes. At age 40 for men, if you want to retire at 60 and you have no basic savings until that point, the number is 25% approximately, and 16% at age 65. For women, it's 30% to 20% because, of course, women live longer. Therefore, our recommendation to our women clients is that they take up smoking as it will reduce their savings component quite a bit. However, if you're saving in a registered environment, these numbers reduce by half. They go to 13% and 8.7% and 16% and 10%. When we look at them combined, to save in a non-retirement-savings-plan system to achieve adequate pension requirements on a private basis because, as we've just discussed, the public basis is bankrupt, requires savings rates that are quite unrealistic. They would be much more realistic if they could be saved in a tax environment. Now, of course, this comes to the point that our clients want to be able to save in a tax-sheltered, private environment that's financially solvent.

Let me touch briefly on where Life Underwriters is taking a more active role. It has borrowed "Vital Signs"—a life insurance company solvency analysis on disk, which is

also available on-line. Life Underwriters felt that the membership did not have access to this information in a meaningful way. The disk is meant to provide us with as much information as possible on ratings of the various life companies in Canada today in a reasonably meaningful way. I say "reasonably meaningful" because you have to appreciate that people in my industry have no understanding of the distinctions that have been discussed by Mike and Manny. The problem is that a little knowledge is a dangerous thing. Unfortunately, it's a necessary evil if you want to practice defensively.

I should also mention to you that there's a memo from the Department of Finance, written by Life Underwriters, called "Enhancing the Safety and Soundness of the Canadian Financial System." Again, for those of you who would like a copy, I'm sure that we can get you one.

Confederation Life: what's it like from our point of view? As Mike said, before 1991 there were no federal insurance company failures in Canada. All policyholders have received 100% of benefits promised. You have to appreciate what that's like if you're in the marketplace like I am. You can say to a client that we disdain the idea of a \$60,000 limit because for well over a century nobody lost a nickel. This has changed virtually overnight to the point where now we can't sell any insurance company contract without the backup of CompCorp. That's an amazing turnaround when you think about it.

Confederation Life failed in 1994, the largest insurance company failure in North America. Why did it happen? That's an issue that, because of time constraints, we won't cover today, but we can look at the impact on our clients. How do we handle it, and will it happen again?

I have some thoughts on why it happened that I think you should consider from an agent's perspective. First, Confederation Life had extremely aggressive pricing on its Term-100 policies to get market share. The interesting thing is, of course, that it also tried to expand into the U.S. I have a lot of friends who do business in the U.S. who did a lot of business with Confederation Life because of very high-yielding annuity products, which is a very big market in the U.S. It's equivalent to our guaranteed investment certificate (GIC) marketplace, but on a tax-sheltered basis. Confederation Life's asset base tripled in ten years. For the company's asset base to triple in ten years, it had to invest the money. As the Life Underwriters' report pointed out, in 1991 Confederation Life had 71% of its assets in real estate and mortgages, twice the industry average in North America. It needed to do that in order to get this aggressive growth financed. The company's assets, arguably, would be divided in some way between commercial and residential real estate.

I'd like to give you my thoughts, and other people's thoughts, on where these markets have been and may continue to head.

First of all, let's deal with housing prices. There is a study by Daniel McFadden called "Demographics and Housing Markets and the Welfare of the Elderly" done in the U.S. a few years ago. He projected housing prices from 1869 through to the end of the 21st century. It started back in 1870. You see price drops. This is the inflation-adjusted and quality price of housing. It's adjusted for the contents of the house as well, and

THE RATING GAME

there was a depression after the Civil War. There's growth, but, basically, it's up and down and you're back to where you started by the end of the second World War. For 70 years there was no appreciable change in the cost of housing, then, coincidental with the baby boom, prices exploded and peaked around 1980 in the U.S. They didn't peak here in British Columbia at that time, but, within this time frame, I believe they have peaked. The point is, using the same demographic studies, Daniel McFadden analyzed what he's anticipated the price change to be in inflation-adjusted terms for the next century. The drop is significant, especially in the next 30 years.

We have a lot of clients who will be trying to downsize their family homes, and the assumption that real estate always goes up in price, or that you should buy a piece of real estate that has a 4% or 5% net cash flow, when you think about it, is ridiculous. However, it's now ridiculous if you assume inflation takes place. There's no particular reason why any piece of real estate should generate any more cash flow than a bond, given that real estate has higher risk.

On the commercial side there's an article in the June 13, 1995 edition of *The Wall Street Journal* that says Japan will try to liquidate \$77 billion of U.S. real estate in the next five years—real estate that it bought at staggering prices. Just to give you an example of one of the properties for sale: when I was in Hawaii about three months ago, the Japanese announced a series of sales that they had made totaling \$1.8 billion in 1994. One of the properties they were selling was The Hyatt Regency Waikoloa, which is a spectacular resort on the Big Island of Hawaii. The Japanese built it on leased land for \$370 million in 1978 and sold it last year for \$60 million. The \$1.8 billion of real estate that they sold last year brought in \$300 million. That does not take into account the depreciation of the dollar against the yen in that time frame. The net loss is something approaching 85–90% in yen-adjusted terms.

In the Life Underwriters' report on U.S. life insurance failures since 1960, which was submitted to the Department of Finance, it was pointed out that 47 out of 68 failures could be traced to questionable activities of downstream companies. Thus, we are in a situation where, in my business, we have to practice very defensively. We need much more information to make any meaningful recommendations to clients than we've been getting up until now.

Let me briefly touch on technology and business productivity. Manny mentioned a little bit about the effectiveness of distribution networks. I think that this is one of the most important issues for insurance companies in the future. In terms of how I would rate them, how efficiently they distribute product so that I can distribute it to the public is, for me, a big issue, especially because of major changes to compensation in the future. Right now, in an ideal world, we would be connected electronically to government agencies for compliance requirements, mutual fund companies, insurance companies, and our association. That information would allow us to be linked electronically as an agent/adviser to our client base.

That's ideally how we'd like to work. Let's just discuss how we really work. Warning: this software is the exclusive property of that's the "I Don't Get It" (IDGI) life insurance company. It is to be used only by agents of IDGI. It is not meant to be transferable to other programs, user friendly, or compatible with other databases. In

addition, we've tried to ensure that this program, uses up enough memory to make it impossible for you to run other software simultaneously. We're not responsible for errors in this program, and "no" you cannot have the source code.

This is reasonably typical of what we get from insurance companies. They do everything possible to make sure that whatever they give you is completely incompatible with anything else that you might use. This position has to change very quickly if the insurance companies want to be a major part of the future distribution of financial products. For example, is there a standard life insurance application available electronically that's the same for all companies? What about annuity applications, retirement savings plans or savings funds? Can you obtain policy information electronically from all companies that's automatically entered into your database? Can you E-mail all companies with one system? Can you E-mail them at all? Can you obtain custom quotes electronically? Review them with an actuary on a real time basis? Do you receive updates in underwriting electronically? Is the company connected electronically to Equifax? Are your commissions paid electronically? Or statements? Can you deposit premiums for clients electronically?

Better technology equals lower distribution costs, and that's better profitability. If I'm looking at where I think a company is going, personally I'm going to pay a lot of attention to how efficiently the company distributes the product. The margins are so tight today that the company has to be able to deliver the product less expensively than it has been.

The issues for our clients are: taxes, aging, solvency, and debt. From our perspective, I see the issues as being our requirement to provide information and, in particular, information about the insurance companies that we deal with and their solvency situation; and doing planning work for clients. Our business has changed a lot. We're deemed to be advisers now. We do a lot more work in planning. Many of us have special designations to do this type of work and the additional education to handle it. Of course, that also means that we're more responsible and more liable because of that and because of the fact that we're the ones doing the implementation.

Finally, we're doing the monitoring. It's very hard to sell a product like a life insurance policy that is not supposed to change for 60 years. You can't say to a client after ten years, "I'm not comfortable with this carrier any more," and "You're well over the CompCorp limit." It's a real dilemma. I don't want to be in a position where I even have to think about having to make a recommendation like that.

There are all kinds of tax implications and insurability issues that go along with that, so the more we are perceived as advisers the greater our legal liability for the financial condition of the companies we recommend.

What is the future going to bring? I'm not sure, but I think the following may be possible:

- I agree with Mike and Manny that the flight to quality will continue. Ratings will be an integral part of all client considerations. They're going to be asked for by the client and the client's advisers. We have to have these ratings, and we need to have them in a way that is meaningful to ourselves.

THE RATING GAME

- There will be significant industry consolidation. I don't see any way around that. I don't think that is necessarily a bad thing.
- Distribution will be driven much more by technology.
- Levelized compensation will be the norm. We will have to play our part in this by coinsuring profitability with our suppliers. That's why we have worked hard in trying to develop level compensation contracts with most of our suppliers on the base compensation models that allow our suppliers to develop, design, and price products that are attractive to clients, but leave good profit margins for the companies involved.
- Growth will occur in asset accumulation products and those needed for long-term health needs and, of course, for the risk of living too long.

FROM THE FLOOR: You have a small, or maybe not a small, life insurance company which focuses on health insurance in the U.S. You have an HMO. What would be the differences in how you would rate the two? Or would there be any?

MR. NOWACKI: There are a couple of missing pieces to the question. I assume that, when you say a small life insurance company, you mean an independent company unaffiliated with any large organization.

Generally, our view is that there's going to be an increasing focus on managed care, and I assume that the small life insurance company probably has indemnity-based products, using a preferred provider organization (PPO) perhaps. Let's assume that. However, we do view the health care area as moving more and more into managed care. It's becoming increasingly a case of developing strong associations with local providers in order to get the best possible result. You have small HMOs and you have for-profit and not-for-profit HMOs, so we need to make those distinctions when we look at small insurance companies relative to HMOs. The same issues would be related to a small HMO.

We're looking for companies that have the means to develop the managed care capabilities. If we feel that a small insurance company, because of its concentration perhaps in a local market, has the means to develop those strong provider relationships, then we'll look at it favorably. You can have a small insurance company, for example, that might have 100,000 lives, but those 100,000 lives are all in one major metropolitan market. We'll look at that small insurance company much more favorably than, say, a larger insurance company with 500,000 lives scattered around 50 different metropolitan markets.

We don't think small insurance companies are doomed to be swallowed up by the HMO industry, but, at the same time, we are concerned with how those small insurance companies are going to compete with HMOs that frequently tend to be subsidiaries of large publicly traded companies that have significant access to capital, and have the means to develop the technology to manage utilization and claims better.

MR. W. PAUL MCCROSSAN: I wonder if I could return to Confederation Life and then post-Confederation Life. My question is: what were the actual actions that you took, say, in the last two years of Confederation Life, and what drove them? And, faced with a similar situation now, what different actions do you think would have taken place because of the new procedures you've implemented?

MR. NOWACKI: I'm not going to remember dates very well, so I'll just speak in generalities.

Confederation Life was rated A+ at one time. About 18 months before Confederation Life failed, we did lower the rating to A. We felt at that time that management of Confederation had significant understanding of what was going on within the organization. It was a new management team: Paul Cantor was there, and Mike White, and a couple of other people. At that time we had fairly lengthy discussions with Confederation, and we listened to management's analysis of the situation. Although we felt confident at that time with the management team, we still down-graded the company. As the situation developed, it seemed that Paul Cantor and Mike White uncovered more and more problems that they hadn't known about, and that we didn't know about. Although we do analyze insurance companies, frankly, the analysis is only as good as the information that's provided to us. However, we did downgrade the company to A- about five or six months prior to the failure, although I am not sure of the exact timing. It was about the same time that Great-West Life announced that it was entering into the picture. Despite Great-West Life indicating it was going to become a partner with Confederation, we still elected to lower the company's rating from A to A-.

Maintaining the rating at A- hinged a lot on the Great-West Life relationship. We put a lot of emphasis, as some of the other rating agencies did, on statements made to us by Great-West Life's senior management that Confederation was going to be strategically important to Great-West Life's future.

The alliance between Confederation and Great-West Life was going to give Great-West Life a significant position in the group markets. As a result, as explained to us, Great-West Life thought that was a significant opportunity for its company, but we didn't feel 100% confident that the transaction was going to take place. Therefore, we lowered the rating from A to A-. As time went on, it seemed more and more likely that Great-West Life was going to pull out of the picture. When it was publicly announced that Great-West Life was trying to form a consortium with the largest insurance companies in Canada to participate in saving Confederation Life, we lowered the company again to B++. Confederation Life was taken over a week or two after.

Would we do things differently now? We certainly wouldn't put as much faith in what Great-West Life told us. In future, we're going to have to look more at the independent organization as opposed to promises—promises might be too strong a word—or statements such as were made to us by Great-West Life.

Clearly, the rating had been maintained because of Great-West Life infusing capital and developing a reinsurance program with Confederation. Great-West Life was the major reason for maintaining the rating.

FROM THE FLOOR: I was surprised at Michael Lombardi's closing remark that, if we didn't have rating agencies, we'd have to invent them, especially, Mike, after you spent so much time telling us why they didn't work. I tend to agree with that, because if I was selling a policy, I don't think I would take a lot of comfort in the track record of rating agencies, although they might be getting better and they may be working very hard.

THE RATING GAME

What I'm very curious about is that the role of the actuarial profession wasn't discussed in assessing the solvency of these industries, nor was the potential for public actuarial opinions on the future financial condition of a company. I'd be interested in any comments on the role that we can play.

MR. LOMBARDI: First of all, I do think that the appointed actuary, at least in Canadian companies, does play a very useful role. As most of you know, the Canadian profession is talking about the actuary rendering an opinion, by 1997, on whether the financial condition of a company is satisfactory. Personally, I have a little bit of a problem with that in the sense that it's sort of a quick pass or fail. It doesn't give a lot of grading or nuances and all sorts of other things that go into the assessment of companies. For example, there are issues involving parent companies or subsidiaries or affiliates that need to be taken into consideration. The way the dynamic solvency testing report is structured just now, it doesn't go into a lot of that.

I see a lot of hope on the regulatory front with the move toward public disclosure of information, where much of the information that the companies have traditionally reported just to regulators will be made a little bit more public. However, there are dangers in that, too, in that you do need an expert to go through it, unless it's made very clear. I've seen some of the suggested disclosures made by the Canadians to the chartered accountants. If you follow that through to its logical conclusion, you could have maybe a 100-page report, which I don't think the consumer—if that's the audience we're addressing—wants. I don't think a 100-page report, even if it is in readable language, is something that anyone is going to go through. If you're comparing the policies of four or five different companies, I just don't see 400 or 500 different pages being read through before someone makes a purchasing decision.

So, yes, I do think the actuarial profession has a role to play here, but I don't think that it will be a sort of pseudo-rating agency or will eliminate the need for rating agencies. Manny, I don't know if you have anything to add to that?

MR. NOWACKI: I just want to comment on the first point of your statement concerning the track record of the rating agencies.

I didn't include it in my presentation because time was limited, but since I have more time, I will include some information about A.M. Best's track record on detecting failures.

There is a significant correlation between ratings and the potential for failure and, naturally, we make mistakes. Every rating agency makes mistakes. One way to avoid making mistakes is to rate everybody low, which some rating agencies do, particularly Weiss in the U.S. However, if you rate everybody low, then you're going to be right whenever a company fails. If everybody is rated low, then what value is the rating if it doesn't differentiate between what we perceive as the better run companies with significant advantages and those companies that actually deserve to be rated low?

We have documented our track record, and I think it is pretty good when it comes to detecting failures. There is a distinct correlation between the higher rated companies and the lower rated companies.

John, you were talking about consumer perception of all the events that have happened. You mentioned this question of whether you could sell something only up to CompCorp limits, and to what extent has confidence in the industry eroded? Is there even some question about whether consumers, for example, realize that CompCorp is a creature of the industry? It's not a government-backed organization. Is there any problem with that? Are CompCorp guarantees really understood by consumers?

MR. NICOLA: That's a good question. First, I think the public perceives CompCorp as a government agency when, in fact, it isn't, and straightening the public out on that point is always a concern. Luckily, when dealing with stockbrokers who have their own insurance arrangements for their own accounts, it's not so difficult.

Also, when we mention the deficit that the Canadian Deposit Insurance Corporation (CDIC) currently carries, it may mean that the government guarantee may not be overly meaningful to some degree anyway. I have mixed emotions about CompCorp personally. It has meant, for example, that virtually every annuity contract we sell now is less than \$2,000 a month, and we will split it among as many as five or ten carriers, if necessary, to get to that limit. Unfortunately, it's totally impractical in terms of a life insurance sale. So, certainly in our practice and in virtually every insurance sale we make that is well above the CompCorp limits, there is a clear flight to quality. Basically, we are restricted, if you look at S&P ratings, for example, to companies rated AA+ and up.

The point that the other gentleman made about the ratings of these companies down the road is, of course, problematic. It's a little bit like being in the mutual fund industry. The last ten years' track record is no guarantee of the future, but it's probably one of the better measuring sticks available. It's better than nothing, and that's what we are having to rely on.

We regard CompCorp as a necessary evil because of the situations that have arisen in the last three years. I know there are proposals to increase the limit to unlimited amounts and make it 85% coinsurance. I have to say, for one with my own practice, I would support that arrangement. For now, it's there and the public needs it. The public wants to know, at least at some comfort level beyond the carriers themselves, that there's somebody else backing up the public's contracts.

FROM THE FLOOR: When Confederation Life first failed, I was hearing a lot about rating agencies and how we should be looking at the ratings. Now, I seem to be hearing a lot more about this measure that you mentioned, the MCCSR. I was wondering if you could demystify this measure for me a little?

MR. LOMBARDI: The MCCSR is a measure of risk, at least that's the way it is constructed. Based on the characteristics of a company, there are certain elements and factors that are applied to assets, premiums or in-force reserves, and so on, and you come up with what would be deemed the required capital of a company. On the other side, you look at the balance sheet, and you see what the company actually has available. There are various factors there as well. Negative reserves, for example, come in at only 50% of their value, and there are discounts for tier two capital as well. In the end, you get a ratio of actual to required capital.

THE RATING GAME

It's meant to be a similar type of ratio that banks use in their Bank of International Settlements (BIS) ratios which, incidentally, are public, but, to date, the MCCR ratio has not been made public because of concerns about the newness of the measure and the fact that it may be misinterpreted.

That gives you the current position of the company. It doesn't do a lot in terms of projecting the future in terms of sensitivities. For example, the company continues to go on its based scenario five-year plan. Now I'm referring to DST. The ratio is five years out under a variety of scenarios and sensitivities that are probably even more meaningful, but, again, all this is currently not disclosed. It's for reasons of newness and a little bit of concern about misunderstandings. I hope that answers your question on the MCCR ratio.

