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Views of the Life Insurance Industry—A Rating Agency Perspective

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Summary: This session examines the view of life insurance companies and the life insurance industry from the perspective of a rating agency. In addition to recent trends, significant qualitative and quantitative elements of life insurance companies are discussed.

Mr. Kevin A. Marti: Bob Beuerlein from Franklin Life was unable to attend this meeting, so he asked me to take his place as moderator. Bob had already recruited an excellent panel of speakers with many different insights and perspectives into this topic for your benefit. Our recorder is Dale Hall, an associate of mine at Westfield Life Insurance Company.

Our first speaker is John Nigh. John is a principal of the Atlanta office of Tillinghast. He has primary responsibility for its Latin American operations in Mexico, Brazil, and Argentina. In the U.S., his practice areas include merger and acquisition work, reinsurance, organizational reviews, and financial analysis.

Mr. John O. Nigh: My presentation is on rating agency relationships from a consultant's perspective, and of course, that doesn't mean as a client relationship; it means how I have worked with clients over the years in developing the

relationships with rating agencies. The work has spanned the spectrum from a company wanting to meet a rating agency to get introductions to a company that wants to understand the process of getting an initial rating, to companies that are dealing with issues associated with renewal ratings, and everything in between.

PREPARE

One of the things that my clients have to endure with me is that I tell them to prepare. I tell them to prepare and prepare some more, and after that I tell them that they are still not done. You do this because it's important. It's important to your company from simply a public relations perspective. It's important to your company for your producers to be able to sell your products, and there's a whole host of other qualitative issues associated with getting the best rating possible. So prepare, prepare, prepare.

MANAGE THE PROCESS

The second theme is that you need to manage the process. By that I mean don't just sit back and wait to hear from the rating agency. Participate in the process, whatever that process happens to be for you as a company, whether it's getting that initial rating, communicating something that needs to be dealt with in a sensitive fashion, or discussing certain aspects of your renewal ratings. You have to understand, and Neil may want to disagree with me later, that the rating agencies don't know everything and certainly they can't know your company as well as you know your company. So you have to participate in the process and manage it as much as you can. In the end, if there are any surprises, it's your own fault.

ESTABLISH RELATIONSHIP

At some point you're going to have to establish a relationship. For some companies that's well after they've gotten a rating. This comment is more applicable to A.M. Best, but it can be applicable to the other rating agencies as well. Nevertheless at some point you will need to establish a relationship. Arrange for the appropriate introductions. You need to then begin the process of demonstrating the quality of your own company, whether that's the quality of management, the quality of your distribution system, the quality of your information systems or some combination of all of those. You need to begin that process because it's a very important aspect of the rating process as we'll see later. You also begin to understand how they will look at you, how they will go about rating you. You absolutely have to know this in order to manage the process. Finally, you need to understand the key factors that a rating agency may look at in developing an evaluation of your company. Those do change, of course, over time.

RENEWAL RATING

Let's take a reality check with respect to renewal ratings. The message I want to communicate here is that throughout all of this, you need to be realistic about your own company. If you're a small company, it may not be so realistic to assume that you're going to get the highest rating possible from the particular rating agency that you're dealing with. It also may not be realistic for you to assume that the two-level increase in your rating that you had so hoped for is really achievable. Be realistic in how you go about discussions with the rating agency and do an honest self assessment.

ADDRESS KEY CONCERNS

Part of that honest self assessment is addressing the key concerns. Let's discuss some of the key issues that I've had to deal with as a consultant in working with my clients, in particular their relationships or their dealings with rating agencies. For example, are you using a lot of reinsurance? There may be very valid reasons for doing so, and you need to communicate that. As a company, do you have a concentration in one or two lines of businesses that may make you vulnerable to regulatory changes?

Communicate how you have prepared your company to deal with those issues. Are you geographically limited? Again this may be a small company issue. One of my clients is a single-state major medical/HMO carrier. Believe me, they have had issues that they've had to deal with in their relationships with, in this case, two rating agencies. Is there anything in your asset portfolio that you have to be frank, open, and honest about? If you're a company that has a large amount of interest-sensitive products, what are your asset/liability management skills? Finally, do you have any affiliates that you know the rating agencies will have concerns about that may affect your rating?

KNOW YOUR NUMBERS

Know your numbers. Don't wait on someone to send you a letter saying, "We have found that your risk-based capital (RBC) ratio has gone down," or "We have found that you've had an uptake in surrenders of your annuities," or "You have had an increase in your mortality in your individual life line." Be proactive. Say, "Yes, I know this, but this is what happened last year and this is how we dealt with it."

KEY DOCUMENTS

At some point in your relationship, you have to provide certain key documents to the rating agencies. Hopefully that's closer to the beginning of your relationship than at the later stage in your relationship. Those documents need to at least include a strategic plan which would address certain things as to how you are going to maintain your position in the marketplace, and an organizational and operational

plan in support of that strategic plan. The documents should include: commentary as to your marketing and distribution; projections of your organization, both on an income-statement basis as well as a balance-sheet basis, which would also give some indication of capital needs; an explanation of how you've addressed expense management issues; product plans; and expansion plans. That could include expansion plans to other lines of businesses or into other geographical areas.

PREPARE FOR MEETING

It's your right to have a meeting. When you do have a meeting, be prepared, as I said earlier. Make sure that your key players attend the meeting. Equally important, if not more important, have the right people from the other side there. Make sure that the individual who will make, or at least participate in, the decision of your evaluation will be present. Prior to the meeting, it doesn't hurt to role-play. Get everyone who's going to attend the meeting from your side into a conference room, sit down, force them to review with you what they're going to say and what issues they're going to address. It doesn't hurt to have somebody play the opposite role, whether that's a devil's advocate role or the role of the rating agency asking tough questions. If your time is limited, make sure that you address those issues that need to be addressed first and, if time permits, address some of the less important issues later.

Finally, don't be afraid to be an advocate. Certainly within the bounds of what's realistic, and your conscience will let you, be forthright, be energetic, and tell them how good you feel about your position in the marketplace. Tell them how good you feel the strength of your distribution system is. Tell them how strong your information systems are, whatever those may be.

SUMMARY

Remember to have frequent contact. This doesn't need to be weekly or even monthly, but it does need to be frequent enough that you know them, and they know you. Have timely communication. If you're selling a subsidiary, selling an operation, or some other major event, disclose that on a timely basis. You don't want the rating agency to pick up *The Wall Street Journal* and read about it before they hear about it. If you're unfortunate enough to have had a significant lawsuit filed against your organization, make sure that before it gets in the public domain that you disclose that to the rating agency. Do an honest, realistic assessment of your organization. Finally, do your homework, and manage the process; don't let there be any surprises.

Mr. Marti: While I do think of Westfield as a smaller company, we're definitely growing. We had a death claim from the ValuJet crash, and two years ago when US Air went down, we had a claim on the US Air plane. Our actuarial staff has

deduced, by looking in the rearview mirror, that if there is a major airline accident, we will have a claim.

I think it's also important, as John mentioned, that your company have the key players at the rating meetings. If your chief actuary is not a part of that team that you're sending to the rating agencies, you have to wonder how serious your company is about ratings and how the rating agency would view your company. Maybe Neil can share his perspective on that later. Given all the unique actuarial aspects that are part of the rating process today, such as asset/liability management, we can bring so much experience and knowledge to bear as actuaries on that process. If your actuaries are not a part of that process, I suggest that you're making a big mistake by not having them at the rating agency meeting.

Our next speaker is Jack Ladley from Ernst & Young. He's a managing partner in their Actuarial Services Consulting Practice. Jack has consulted to life and health insurance companies for over 15 years on mergers and acquisitions, distribution systems, and product and financial analysis. One of Jack's specialties is assisting companies in developing business strategies and articulating them for rating services. He has also assisted life and health insurers in developing contingency plans for impending rating actions and assessing the impact of rating downgrades on their organizations. Jack will be sharing with us these perspectives as well as some interesting data from a recent survey his firm has done on the impact of rating downgrades on companies.

Mr. John D. Ladley: As Kevin mentioned, I've assisted companies in their dealings with rating services, representing a significant number of insurers. That has afforded me the opportunity to get in front of some of the rating services and see things from their perspective. I try to maintain a dialogue with them and be a student of many of their pronouncements. Although it has turned into a real paper factory, there's much to be learned from some of the publications that they put out. I'm going to talk about a couple of surveys that I have access to, including one that Ernst & Young just completed. There are a couple of numerical analyses we did that I will talk about. However, I'm not going to go through them word for word.

A RATING FROM A RATING SERVICE IS IMPORTANT

In working with more than a dozen companies in rating service analysis or through discussions, it is apparent to me that many companies don't appreciate the importance of their rating. That's because many companies have had the same rating literally for decades, although that number is narrowing, and most have not experienced a rating change in the memory of current management. A rating is very important to life insurers, and I'm going to go into some depth as to why. That's the focal point of my talk. I found that the rating is not usually fully appreciated until

it's lost, in other words, until there's a downgrade. Certainly while an upgrade is nice, I don't think it has nearly the impact on the way up that a downgrade has on the way down. The impact of a rating on a life insurance organization is far greater than it would be for most other types of organizations, such as industrial organizations, where it's principally a cost of money issue. There is a possible exception, which is banks, of course. A life insurance company can be affected not only by its access to or its cost of capital, but also by the impact on its long-term business and its internal operations, and especially its distribution system. That's where I will focus. That's not really to say that the impact of access to and cost of capital is inconsequential, but it varies quite a bit from company to company.

Table 1 is a very simplified illustration showing that between some of the bond rating classes, the cost of money can vary, say, 50 basis points to somebody currently in the market, if capital is accessible at all; it has run up to almost 100 basis points in the recent past. Borrowing of course varies in significance from one company to another—from irrelevance, for many insurers, to having its greatest influence on organizations in the merger/acquisition field. In this area, where there may be a constant flow of deal activity, ratings can be extraordinarily important. Maybe some of you have recognized that, but if you haven't been in that market, it can be an extremely hot topic to companies looking to get their financing done, especially when leveraging is more significant.

TABLE 1
IMPACT OF A RATING CHANGE

Month/Year	Moody's Corporate Bond Yield Averages		
	Aa (Excellent)	Baa (Adequate)	Difference
March 1996	7.52%	8.03%	51 bp*
March 1995	8.24	8.70	46 bp
March 1991	9.21	10.09	88 bp

* bp = basis points

One other area that you might interpret as cost of money to insurers would be credited rates. One of my associates, Jay Glacy, based in Hartford, Connecticut, has done a number of statistical analyses, but one we performed attempted to relate ratings generally in the market to the purest play or one of the purest plays we could find: credited rates on single-premium deferred annuities (SPDAs). We found very little relationship in the marketplace (other than in one specific distribution system) between credited rates and ratings. Credited rates do not seem to be closely related

to ratings, and the distribution system seems to have much more to do with the kind of credited rates that companies use.

Probably the greatest impact of ratings in our industry, other than cost and availability of money, is in the distribution and sales function. In a recent PULSE Survey of a panel of CLUs and chartered financial consultants (ChFCs) including 1,000 sales people and financial planners, 95% of the agents and financial planners who were surveyed used a rating service; 17% had lost some business due to a downgrade; and 41% used ratings to make a comparison to those of another agent's company. Clearly, then, the impact of ratings on the distribution system of most companies is pervasive and that probably means no matter what type of field force you have, downgrades are a particularly important event.

In the recent Ernst & Young survey of 29 companies that had recently been downgraded, 38% said their downgrade did have an impact on sales. The most frequently cited lines were either individual life or group annuity (perhaps not a big surprise there), with 10% to 20% most frequently mentioned as the sales decline. One company mentioned that it had seen over a 50% decline in individual annuity sales. It had been focused on a bank market almost exclusively. In addition, in that same survey about three quarters said they took steps to communicate with their field force, and they initiated that kind of communication plan. That was far, far higher than any other communication plan they had, such as for home office employees, senior management, or any other group of publics that they have, even shareholders.

The impact of the downgrade is not insignificant to other areas of the company as well. We found that the performance of in-force blocks can be materially impacted by lapse, or increased loan rates, or reduction in premium persistency. Usually we've seen where that reduction has a shock effect, meaning there is an initial surge of activity. There might be a little bit of panic on the part of the company, but it tends to settle down after a while. Usually, the settling down impact would take several weeks to a couple of months; that's the kind of time frame you might look to see that tone down. If it doesn't, you may have bigger problems. A number of companies in our survey also cited a much higher level of inquiries and volume of changes, either field-generated or policyholder-generated, generally impacting expense levels and activity.

Although credited rates in the market do not generally follow a company's ratings, we have found that they may be enhanced or changed when downgrades occur. We also tried to check on whether new commission arrangements might be put in place when downgrades occur. We did not find much evidence of that, although our experience indicates it happens.

We have also observed and heard about regulatory relations being affected. The ability to achieve expeditious licensing in a given state or any licensing at all in some states can clearly be impacted by a low rating or a downgrade, as can reinsurance of a block of business, either for reinsuring an insolvent or rehabilitated company or seeking a viable block of business.

In addition, there is usually a move towards restructuring when a downgrade occurs. I've defined restructuring somewhat loosely. In our survey, 62% said that they reacted to a downgrade by taking some action which might be called restructuring, including seeking an infusion or surplus note or capital by some other source; pursuing a divestiture of one or more lines; closing lines of business to new sales, including setting up a joint venture connected with sales; and finally maybe walling off a line of business.

Considering all these actions and reactions that can occur with respect to a downgrade, some analysis we've done in the past indicates that a company may well experience a total value decrease of about 5% per rating "tick," meaning, for example, from AA to AA-, or any movement of the rating. This is important because some of the value loss is permanent. It can be hard or impossible to regain value from lost policies, lost distributor relationships and such. Moving back up the rating scale does not necessarily reverse your loss. It just may not be reversible. Moving into vulnerable or insecure or below-investment-grade types of categories can cause the more quantum value changes, of course. Other changes, such as perhaps from A++ to A+ may not be nearly as noticeable. So this 5% is a something of a generalization over a spectrum of rating changes.

We also have seen both in our client work and also from our survey that the notice of an impending downgrade can be quite short. It's not always the case, but we found about one-third of insurers surveyed received one week's notice or less of their downgrade, or at least that's how they perceived it. Two thirds, cumulatively that is, received one month's notice or less of their downgrade. This certainly limits the reaction and remedial action that might be taken in response to the rating downgrade, and I'd echo John Nigh's comments about being prepared as you'll see a little later. To some extent I believe that this level of surprise should not be there, but in fact, it is. You're more likely to be surprised with short notice than not.

Very few insurers agree with their rating downgrade, the rationale, the timing, or that it was appropriate at all. I'm sure that's no huge surprise, although we have found there are some chief actuaries, as Kevin said, with that balanced view of their company that tend to see the point of view and the rationale of the rating service; they admit that. But more than 90% of the people say, "I don't understand it," "I didn't agree with it," or "They changed courses on us at midstream." I think many

companies should consider these two sets of facts when they look at their rating: (1) they will not get much notice unless they are changed, especially downgraded, and (2) when it comes along, at least a very large proportion of your top management is going to be surprised by it.

To summarize, the impact of a downgrade by functional area (distribution and sales) is the most significant for most companies. The likelihood of some adverse developments is very high. On the financial side, connected with restructuring, it could very well have a material impact on operations. It's not quite as high a likelihood. What would all this lead you to conclude, with short notice "surprises" and the kind of significant impact that a downgrade is going to have? Maybe you'll hear this four times, but I would say also, you need to be prepared. Insurers need to be well prepared for their marketplace and for their positioning with their home office employees. Certainly, also their relationships with their distribution system and with the financial community is important. This is good business sense heightened by the recent importance of the rating service activities.

HOW SHOULD AN INSURER BE PREPARED?

What would a company do to be prepared? Some of this is going to come across as sounding like basic management, but in fact, my experience with many life companies indicates they do not have the kinds of business cases and strategies that will meet some of the objectives of rating services or what is expected out in the market.

First, I think the company ought to be able, at literally a moment's notice, to articulate its internalized, compelling strategy. You can do this quickly only when the strategy is well developed and understood. You hear this often from rating services, and I happen to be a believer in it: a compelling strategy is one which really differentiates you from the rest of the organizations out there. Otherwise, the other organizations, especially larger ones, will find it easier to replicate what you're doing. At the very least, they can come into your markets and put intense pressure on your margins, if you're not unique. Rating services, rightfully in most cases, stress this. I believe your strategies should be flexible, yet they should be specific enough that a third party can see that they have both short-term advantages and a long-term positive impact for you. These strategies should lay a foundation for long-term growth, which is especially important to a life insurance organization. They should demonstrate an ability of the company to earn average or above, average risk-adjusted rates of return. This is an important point, and it should be well understood by the managers.

Like John, I, too, have found that a rehearsal process is not a bad idea. One of the reasons that a rehearsal process works is because managers often go in singing different tunes to the rating service. I don't know if Neil will agree with this or not,

but you will often find that there's quite a divergence of opinion of what the company strategy is or how that translates at the line of business levels. I often see that if a global strategy does exist, it might be primarily the president's or CEO's strategy only. There's not necessarily broad support, and I think the rating service personnel can easily see through these kinds of situations in which the company has not encouraged a deep understanding and support for its strategy. It might be somewhat shallow or, perhaps worse, management simply does not display strength.

A second area, besides strategy, that I think is important is to have a highly credible financial base in operation. Some of the things you should be able to do, for example, include the ability, almost on a moment's notice, to expeditiously model and evaluate your investment portfolio and your investment strategies that you're going to talk about. I think it's fair to say that if you're investing in a class of assets, you should be able to demonstrate rather quickly that you know how it works, how it matches with your liabilities and what its risk profile is. The situations with companies not being able to respond to requests for analyzing investment portfolios in what's increasingly becoming an investment business is a real concern, I believe, to rating services. Many companies will take months to respond to questions about their investment portfolio. Also you should have a reliable forecasting system. I have found that rating services almost invariably focus on historical or actual results. Within a good forecasting system, the historical results and the long-term results should tie together closely, should give a very clear picture and show some consistency. Finally, although there are other areas in the financial function, you ought to be able to produce product line financial information, again expeditiously. This ought to be at your fingertips for both annual statement lines and sublines, such as universal life (UL) or deferred versus immediate annuities. If that's the way you look at them, you should be able to show rates of return and sources of gain. That should all be clear and readily available.

Some other things you should do, which I think would be effective practices, are try to pay very close attention to rating service views, generally of the life and health industry and its key product lines, its investment classes, merger/acquisition activity and capital raising. You should also study their comments of a negative or contingent nature on specific areas in which your company is involved or might intend to pursue. You should be observant of the rating actions that are taking place in companies in your peer group. A peer group, to some extent, is determined by line of business, possibly geography and distribution system, but there's clearly a very significant size dimension, so choose your peer group carefully and watch the movement that goes on with the rating services. Become a student of that area of whomever in your organization is focused on rating services. I don't think everyone in the company can do this, by the way.

Finally, but not the least of your concerns, are the rating service capital formulas. You need to understand how those capital formulas work now and how they're changing over time. We've usually found by looking at company's treatment of capital within a given rating service formula that some modification was appropriate. I wouldn't call these modifications corrections, but through interpretation of some assets or lines of business, the company may be able to demonstrate a much lower risk profile. That is, the item was different than it appeared in just a simple annual statement basis. I would observe, with respect to capital, that capital formulas are calling for increasing levels of capital in the industry generally. I have done some comparisons and it's rather dramatic for many companies. That has material implications for product pricing, merger/acquisition pricing and similar initiatives. The rating service formulas are, as I think they should be, to some extent, changing to meet the new challenges the industry presents. Although services say capital is just one factor in their rating process, it seems to be the most important hurdle to reach in jumping to higher rating levels.

Additional effective practices you should consider, but it's certainly not an exhaustive list, include appointing someone who is well-informed, perhaps specializing in rating services. (An actuary tends to be ideal, well informed in your operations and your distribution, and a contact point for the rating services.) This individual also should have some responsibility for generating very quick responses to those rating services. This is someone who has to have a pretty significant impact on, and set of connections to, the rest of the organization.

Also, it's a good idea to perform numerical analyses, given the steady rise in capital requirements. There are certainly companies that have seen their capital requirements go down. But given that this generally is an upward move, you need to understand not only your RBC formulas and how they're changing, but also your capital resources. What would you do, if you were asked for significantly more capital? I've found that can happen on relatively short notice. In the last two to three years, the incidence of rating services looking for more capital or looking at capital-related issues has grown dramatically, such as the way you reinsure your business, the types of risk assumed from parents and affiliates, and the size factor in terms of spread of risk.

Finally, an effective practice might also include setting up a continuous, more formalized, peer company monitor. To truly be effective, you can't focus on ratings once a year, two or three weeks before your visit, which unfortunately is the most frequent mode of operation in insurers. Rather, defining your strategy and operations clearly, in a way that rating services can appreciate, should be a continuous initiative in any company.

From a somewhat different perspective, but important nonetheless (because I'm sure many are thinking about this), I think it is clear that there are some biases in the rating service ratings and in some of their actions. For example, we found very little correlation, in the analysis we've done of one service, with what they tell their users that they're quantifiable rating criteria are, and the rating that they actually issue. This was a statistical correlation study we performed of over 100 companies. There's very often a much more demonstrable relationship between sheer size and rating, and there may be biases that exist in the formulas themselves. I've heard personally and in our survey a long list of other supposed and real biases from companies, but generally I found that it is counterproductive for life and health insurers to spend too much time on them, but I think they do tend to spend a lot of time worrying about biases. I have not found that very many insurers are uniquely affected by the biases. I have usually found the rating service to be responsive to the specific problem or issue that's raised. You may simply have to deal with the generalized biases, if we want to call them that. I think they are not intending to single out any company. Management's time is probably best spent working through the best practices I've outlined here, developing and then articulating our strategies and directing their efforts towards maximizing the company value.

From time to time, you may face a rating service action. Hopefully it will be an upgrade. In the event that you think you might or you actually do receive a downgrade, I think you might also want to consider having a contingency plan for that situation. I found the impact of a downgrade pervasive enough that having thought through some of the issues beforehand is important and well worth your attention.

Mr. Marti: Our final speaker is Neil Strauss, who is an associate director at Standard and Poor's (S&P) Insurance Rating Services in New York. He has the primary responsibility for rating 20 life insurance companies. Neil was employed for several years as an actuary with New York Life, Monarch Resources, and Monumental Life. Over that time, Neil held actuarial positions in cash-flow testing, pricing, financial reporting, and experience studies analysis. He's a graduate of John Hopkins University with a BS in mathematics and is an ASA. Neil is going to explain the S&P rating process, in particular the new approach for quantitative ratings that S&P recently adopted.

Mr. Neil T. Strauss: I'm an insurance analyst at S&P. I'm here to open up the black box of insurance ratings. Like many of you, my training is actuarial; however, my position as rating agency analyst at S&P with a portfolio of about 20 life insurance companies places me in an outsider position looking in, compared to most of you who have what I would consider insider positions.

What do we do and how do we do it? S&P covers the life insurance industry with two types of rating systems: quantitative only and qualitative ratings. I will explain the differences between the two in a moment. In all cases, we review the strength of the balance sheet, consistency and level of premiums and earnings, capitalization, liquidity, and investments. I want to focus on Table 2. It shows the differences and similarities between the two systems. The quantitative rating system, also known as the *qs*, is based on public information only. There is no management interaction. In other words, we do not talk with companies and ask the whys of the numbers; we get the historical data from the NAIC database. Trend and statistical analyses are performed on the numbers.

TABLE 2
STANDARD & POOR'S QUANTITATIVE & QUALITATIVE RATINGS

DIFFERENCES	
Quantitative	Qualitative
Public information only	Nonpublic information also
No management interaction	Management interaction
Weak-link methodology	Composite approach
Not subject to appeal	Appeal of rating possible
Stand-alone basis only	Incorporates parent/sub links
Quantitative model approach	Rating committee approach
Annual review	Ongoing surveillance
Rating with subscript	Traditional rating symbols
Use of historical information only	Historical & projected information used
SIMILARITIES	
Same Scale CCC-AAA	
Key areas of analysis are business review, operationing performance, capitalization, investments, and liquidity.	
Business Review: premium consistency, level, growth	
Operating performance: earnings consistency, level, growth	
Capitalization: risk adjusted and absolute basis	
Investments: credit and interest risk profile, performance	
Liquidity: liquidity of assets compared to liquidity of liabilities	
Assists insurance buyers in distinguishing between financial strength of companies.	

Quantitative ratings are based on a weak-link methodology. In other words, there's a measure of conservatism built into the ratings because of the fact that there is no management interaction. Therefore, if there is a weakness in the company that is shown by the numbers, in other words, a drop in earnings or a high level of risk assets to capital or low liquidity ratio, that will impact the rating. A quantitative rating is not subject to appeal. It's on a stand-alone basis only. We don't look at parent and subsidiaries; we look at that entity only. It's a quantitative model approach, meaning that we have statistical models in house where we analyze all of

the various elements of analysis. The process is done annually from the statutory statement.

In comparison, qualitative ratings have included in the process insider information. We have access to management interaction. We speak with the companies about the whys and the wherefores of the numbers, and we receive explanations for various trends, whether they are good or bad. So there is nonpublic information included in the rating. It's a composite approach, which means that we're not basing it on a weak link; it is possible that a strength in one area could more than offset a weakness in another area. Everything is taken into account. An appeal of the rating is possible and that means that, if the company believes that we need further clarification, we can discuss it. We usually reserve appeals for items that are identified as appealable. I'll get into that more later. The qualitative ratings incorporate parent sublinks. The qualitative ratings are handled in a rating committee approach. The rating committee is a committee of peer analysts of peer companies. In other words, insurance analyst peers meet to discuss each and every company to which we assign claims-paying ability or qualitative or interactive ratings. There is an ongoing review of companies that are rated qualitatively. In other words, a rating can be impacted by an event, merger, acquisition, disposition of businesses, or disposition of assets. We are looking at these companies constantly, and the ratings can change.

Let's focus on the similarities between the rating systems. We use the same scale, which is the scale that S&P has used for all of its rating elements, and that is the CCC through the AAA scale. What we look at in insurance is similar to what we look at in other areas of analysis: business review, operating performance, capitalization, investments, and liquidity. I've listed in Table 2 what each of those mean, and we can get an understanding of each of those from the numbers and from discussions with management. But the numbers do show the consistency of earnings, premiums, and growth.

I want to focus now on the key similarity of the purpose of ratings and that is that the job of a rating analyst or a rating agency is not to upgrade a company or to downgrade a company or to downgrade an industry. The job of a rating analyst is to differentiate between relative levels of financial strength.

I will now go into detail about each of the different rating methodologies and systems, the qualitative and quantitative, starting with the qualitative ratings. Here's what we at S&P do to come up with a qualitative rating. We do a preliminary information exchange. This is a request of the company to provide us with annual statements, 10Ks, 10Qs, and the completion of several questionnaires so that we can get a quantitative understanding of where the company stands. We run the

company's historical financials through our statistical system to identify trends. We have a management meeting where analysts from S&P meet with the company's senior management. S&P sends one primary analyst and one back-up analyst and possibly more to discuss all of the elements that are important for this company's rating. These analysts meet with whomever the company designates, although what was said by my earlier colleagues and panelists is true; it is important that you have the key people at that meeting who can answer the questions and can take tough questions and give answers that people can understand and can understand them in the context of the rating and take them seriously also. Analysts return from the management meeting and analyze the company based on quantitative and qualitative factors. Here are the details of what we look at when we analyze a company.

INDUSTRY RISK

We're looking at what industry or industries the company is in. Is the company a life insurance company? Is it a health insurance company? Is it an annuity company? We have various views on each of them, and we want to understand the company in terms of those views and in terms of the industries that they're in.

MANAGEMENT AND CORPORATE STRATEGY

How well placed do we believe that the management strategy is in relation to industry trends? In other words, we're going to be looking at the industry and we're looking at the company's peers. We're not just looking at this one company. We're looking at the industry and trying to see where this company fits in, whether its strategy is consistent with the trend that we see, and whether it is consistent with the strengths of the company.

BUSINESS REVIEW

How good is the company at consistent top-line quality growth? Does the company have any competitive advantages? Does the company have a niche? Does the company have diversified sources of revenue?

OPERATING PERFORMANCE

How do the earnings compare to others in the industry, based on the product mix? What do we expect for the future?

INVESTMENTS

We're looking at the investments, in terms of asset risk, which means credit risk, interest rate risk, and optionality. We are looking at concentrations; do they exist? Why do they exist? Why should we not be concerned about them? We're looking at the interest rate risk profile compared to the asset/liability management of the company and looking at the liabilities compared to the assets. What is the performance of the assets? What are the investments? Why do they have two times the amount of below-investment-rate bonds compared to capital than the rest of the industry? If they do, why and how do they manage that and into what does that translate?

CAPITALIZATION

By capitalization we mean capital on an absolute basis and on a risk-adjusted basis. S&P has its own capital model; the NAIC has its model; and I understand other rating agencies have their own; but when we look at capital, we have our model with our formula, which is somewhat unique. We are looking at the capital that is available to fund the liabilities, and that's the way our formula is structured. We want to see if the capital is consistent with the rating. Is the capital consistent with the company's mix of business?

ASSET/LIABILITY MANAGEMENT

I've touched on this before, and this is especially important for companies that have a high concentration of interest-sensitive liabilities or assets. How is the management? What are the modeling capabilities of the company? What is the duration mismatch tolerance level? How are the cash flows in terms of asset cash flow management?

LIQUIDITY

For this category, we're looking at the liquid assets, compared to the liquid liabilities, and we're seeing how this company compares to its peers.

FINANCIAL FLEXIBILITY AND REINSURANCE

Financial flexibility and reinsurance are connected to capitalization. In other words, the company doesn't have the capital, but does it have financial flexibility? Can it raise capital if it needs to? Can it access the debt market? Can it access the surplus note market or the equity markets? Reinsurance is similar. How does the company use reinsurance? Does the reinsurance that's used impact the quality of capital? Does it help manage the volatility of the earnings?

These are key items we look at when we perform a qualitative and quantitative analysis for our qualitative ratings. At this point, we have the committee presentation, where the primary analyst gives a written and an oral presentation to a

committee of his or her peers, analyzing the company and the context of these major rating factors. We are looking towards the future. In other words, we're looking at the past to get an idea of where this company is going prospectively. The committee decides on a rating. The company is then told of the rating decision. If they disagree with the rating, they can appeal the decision. If there are grounds for appeal, which means there might be a fundamental misinterpretation or misapplication of the facts, or there's some additional information that could have an impact on the rating conclusion, the company will come in for a short meeting to clarify these issues. After this meeting, the rating committee will reconvene and discuss the rating in the context of the new information that was provided. There is a revote and the company rating will be assigned. S&P will tell the company what the rating is and will announce the rating to the public through a press release. Beyond press releases, S&P utilizes various dissemination methods: publications, our insurance book, a compact disc, *Credit Week*, a weekly publication, and the *Insurance Solvency Review*, an annual publication. After that, the company is subject to ongoing surveillance.

This is similar to the process that S&P has employed for more than 75 years in rating bonds with respect to paying debt. This analytical process for the insurance industry is tailored towards the intricacies of the insurance industry, but it is the same process that we use to rate in terms of the analytical process.

Now I've gone through the ratings process for qualitative ratings. As you can see, a qualitative rating means that the company ratings are based on qualitative factors, but they are also based on quantitative factors. However, S&P has another type of rating system, which is quantitative only and the subject of my next topic, quantitative ratings.

QUANTITATIVE RATINGS

Why do we do them? What are the key features? What is the track record, and what changes did we make to the quantitative ratings in 1995 that changed the process and expanded the ratings?

First, why do we do them? In short, the reason we do quantitative ratings is because there was a need out there in the public for them and we have the ability to do them based on our NAIC database access. When S&P started rating insurance companies over ten years ago, ratings were on a request-only basis. Most of the companies that came to us to be rated were the higher quality companies; their ratings were AAA, AA, A and that meant a few things. One thing it meant was that we were only rating 20% of the industry. The other thing it meant was that it seemed to the public from our ratings distribution that the industry was an AA industry. That was not true when one did a statistical analysis of all of the other

players—the remaining 80% of the industry. We wanted to clear up this misconception that the industry average seemed much higher than it was. In addition to that, we had to, as a rating agency covering an industry, expand the coverage of the industry. In other words, not just rate 22% of the industry, but expand that coverage to almost 100%.

Now we do a quantitative rating which is based on five years of public information. While admittedly it's not as good as interactive claims-paying ability rating that has qualitative factors, we believe it is helpful to the public in distinguishing between the relative strength of insurers. There is a track record also. We now have over five years of data for the quantitative ratings. The quantitative ratings for the five years of statistics show that we have failure rates of Bq companies of approximately 4% a year, BBq companies approximately 1% a year, and BBBq companies a little less than 0.5% a year. When we do a statistical analysis of our q ratings for the past five years, against regulatory actions that don't necessarily result in failures and insolvency, we see that the numbers show a similar pattern. We believe this validates that the quantitative ratings have been good predictors of financial strength.

The major change in 1995 was that we expanded the ranges of ratings. In the past we had issued only Bqs, BBqs, and BBBqs. The reason for that was that the prior methodology was unable to distinguish between higher levels of strength. At this point, we have five years of data, and we feel comfortable with the process methodology and the track record. We've now refined the process so that we can analyze companies at the higher rating levels. In addition, expanding the range is reflective of a response to a criticism that S&P received with the old system. In the old system, the top rating category for quantitative ratings was BBBq. S&P was criticized, which I consider unfair criticism, that in order to get a higher rating, you really had to buy it. We have now expanded the system so that we go through the entire range of ratings. That's not only the top end; it's the bottom end also. We also have some CCCs out there. We have expanded it so that we have AAqs, Aqs, and the possibility to get AAAqs. That is a summary of the major change that we made to the rating system in 1995.

To summarize the quantitative ratings, we do quantitative ratings because we can do them; the public wanted them and not doing them was giving the public the wrong idea about the industry. Five years of data show good correlation of ratings and companies with regulatory actions and failure. The 1995 change has expanded the process by expanding the range of ratings. We believe that quantitative ratings don't replace qualitative ratings, but supplement them. Now S&P has expanded its coverage of the industry since it started analyzing insurance over ten years ago and that's evidenced by expanding the ratings through a quantitative rating system also.

In addition, we have expanded the depth and the breadth of our coverage. Expanding the depth of our coverage has been important to us, and it's evidenced by such things as our liquidity model, our real estate model, our mortgage-backed model and methodology, and our S&P capital model, which we believe has helped us understand the risks better and make us better able to refine the measurement techniques for analysis. Another example of the deepening of our coverage of the industry has been the hiring of various professions other than credit analysts to fill analysts jobs. S&P has looked beyond the monthly benefit amount industry to find credit analysts. S&P employs actuaries, investment portfolio managers, and accountants. The reason is we want to be able to better understand the business; we want to be able to understand the accounting rules and the investments that companies are making. We thought it was necessary to have an analytical staff wide and deep.

My hope is that I have been successful at opening up the ratings black box and that I have been able to explain a view of the world from a rating agency analyst's perspective. The truth is, the more you understand what it is that we do, the better the information flow and the higher the quality of the ratings process.

Mr. Marvin D. Fineman: Jack, you mentioned the Ernst & Young study of the effects of a downgrade. Did that take effect as of an actual downgrade or as of the announcement of an "under review" status? Did you do any kind of study of what happens if a company is put under review?

Mr. Ladley: Marv, we did not do it on an under review basis, we looked back for the last two years for companies that had been downgraded. I believe we found about 96 or 97 unduplicated companies, with 29 responding. Naturally, those were heavily biased, and the largest number of downgrades was with A.M. Best since they rate more. S&P and Moody's were represented. Those were the only three that we focused on.

Ms. Marilyn Dunstan: Neil, have you done any studies regarding the correlation between the quantitative or the qualitative ratings for companies that got the full rating? I'm curious as to the impact of the full rating process on any adjustment.

Mr. Strauss: The question is, have we analyzed it once a company received a full rating? How did that compare to the quantitative rating?

Ms. Dunstan: Correct.

Mr. Strauss: We haven't done any study of that per se. We do run quantitative ratings for all of our companies, even the ones for which we have qualitative

ratings. We use that as a starting point for the qualitative analysis. So we do have an idea as to what those are and it goes both ways.

Mr. Ladley: Neil, based on your weak link, wouldn't that suggest that it would likely be the same or higher, with a full rate?

Mr. Strauss: Although I would say that is true in some instances, it still works both ways. In other words, sometimes the quantitative rating will help the company. There are certain trends, certain numbers that may be inflated on a quantitative basis that don't prove out when you do the qualitative analysis. So in general, I would say there might be some. There are many occurrences of what you're saying, but it really does work both ways.

Mr. Michael J. Cowell: This is principally for Jack Ladley, although I'd be interested to hear any of the other panel members respond to this. Jack, you talked about how companies shouldn't be spending much time on the detail of the rating agencies rating. Yet when we have spent countless months or years doing fairly complex analysis of our own risks to come up with our internal formula and when, as in the case of some of us, we spent quite a bit of time with the NAIC developing the RBC formula, we're confronted with at least one agency, not represented here, that tries to resolve all of the C-2 risk into four factors, two for life and two for health, does it make any sense when they have a fairly sophisticated analysis of the C-2 risk, to throw everything in C-2, into essentially two factors? It seems to me it would be a functional equivalent, from an actuarial perspective, to saying all mortality from ages 0–100 are this value for males and this value for females. It seems to me that the lack of sophistication by the rating agencies creates a great deal of difficulty among those of us who study risk capital.

Mr. Ladley: Mike, I'll try to answer that and pass it along too. I think I was giving a mixed message when I was making those comments. I tried to work in the commentary about uniqueness. I think there must be a broader brush type of approach by the rating services to cover all the companies. You undoubtedly have seen where this C-2 set of risk factors have impacted you. I had a similar incidence within the last week; a company writing group life was affected by a formula that depended on face amount. The company was writing a huge number of very small-face-amount policies, so the credibility of the data was very high, much higher than the formula would allow for. I have found that if you study it, you find those differences; that was part of my point. I've personally found the service is relatively responsive to trying to understand those kinds of issues and tries to give you some break or allowance. However, they do it in their approach because I don't think they genuinely want that kind of lack of sophistication to hurt the company's rating inappropriately.

At the end of my talk, I was really commenting on companies that you frequently find in a three-hour meeting with them on their rating. They can spend two-and-a-half hours on biases, and I think they have to try to get those fixed and move on with their life and their rating situation, because it's really the fundamentals in the end that help. I was making a little list here while we were talking. I don't necessarily care to run through that list of biases that I've run into, similar to the kinds that you're citing there. That's if we want to call them biases or statistical problems.

Mr. Ladley: Neil, could you give some insight into how carefully your commentary on companies and the industry at large is worded? What kind of process do you go through? I don't have to remember too far back that companies wrote their own write-ups for one of the rating services, and now it seems to me that the kind of commentary you need to look for is sometimes subtle and sometimes not so subtle; you need to look at that very carefully. What's your process and the verbiage that you use besides the quantitative?

Mr. Strauss: The analyst presents a written and an oral presentation for each company to his fellow analysts as a part of the committee process. That written document is the basis for the report about the company. Let's discuss qualitative and quantitative.

Quantitative ratings come out in the *Insurance Solvency Review* book. It comes out once a year, and it's coming out in a few months for the life companies, based on the 1995 results. That's the way we disseminate them. It's published in cooperation with *The National Underwriter*, and it has in there the ratings, five years of statistics and the ratios that led us to the ratings. It also explains the rating methodology in there.

Now let's move on to qualitative ratings. When we decide on a company's rating, we come out with a press release. We try to get it out within 24 hours of the rating committee's decision. That rating press release has in it several items: the rating, the major rating factors, and what we expect of this company over the next few years. The press release is written by the primary analyst, and it's reviewed by the rating committee chairperson and a member of our publishing staff. We have a publishing staff that sends out all of the S&P ratings worldwide on all of the debt or other instruments that we rate. Their job is to check the accuracy of the information on the release and to give it the S&P touch. Before we send it out, we show a copy of the release to the company. We're not showing it to the company for editorial changes. We're showing it to the company to make sure that we have not

misrepresented anything, gotten any facts wrong, or let any confidential information out of the bag. We want to make sure that we have the facts correct. We take full responsibility for the editorial comments, which will not be changed. The opinions in the release are S&P's and the release comes out under S&P's name. The company may disagree with our view of the company or our view of the industry, but when it comes down to it, the rating is coming from S&P. Sometimes companies have editorial changes they'd like to make, and while we will listen, it is unlikely to affect the outcome. The company does see the press release before it goes out, but really not for editorial reasons; it's for accuracy and confidentiality reasons.