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Session 129PD The Ratings Game

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Panel: HERBERT E. GOODFRIEND†

Summary: A case study will be utilized to understand the thought process that ratings agencies, such as A.M. Best and Standard and Poor's (S&P), use to evaluate insurance company financial strength. Attendees will be presented with a "real-life" situation that they will analyze in small groups, and each group's response will be critiqued by the panelists.

Mr. William R. Horbatt: I would like to introduce my co-instructor for case study. Herb Goodfriend is a managing director at KPMG Peat Marwick LLP, with 30 years experience in investment analysis and consulting relating to the insurance industry. He has been named frequently as a member of the Institutional Investor All Star Team. He has a Master's from and studied for a Ph.D. from NYU. I am also with KPMG.

We'll start with an overview of the ratings process where we will cover all the major rating agencies, whether it be A.M. Best, S&P, Moody's, or Weiss. After that we'll have a case-study presentation.

During the case-study presentation, we will also perform a role play. Typically, in the course of developing a rating, the agency will meet with the company: Herb will act as the agency representative, while I will be the marketing officer or CEO of our target company. After that you will break into smaller groups, and we will form teams.

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†Mr. Goodfriend, not a member of the Society, is Managing Director of KPMG Peat Marwick LLP in New York, NY.

The key is to complete your assignment, which is to determine the rating of this company, in a certain amount of time.

Finally, Herb and I will help you to present your conclusions and critique those presentations. Now I would like to introduce Herb Goodfriend to you.

Mr. Herbert E. Goodfriend: We have a lot of ground to cover. I think the first thing we should recognize is why you're here. Apart from trying to get educational credit as an actuarial professional, you recognize ratings have become so important that they cannot be ignored, even by those who took ratings for granted years ago because they thought they were well off. In fact, the case may be made that the rating agency people sit as an ad-hoc member of a company's board, "strongly suggesting" what company management should do (much to the chagrin of the companies).

In this regard the public knows just enough to be dangerous. Agents know an equivalent amount and therefore, it has become a very complex problem. I think Lord Balfour once expressed it in a better way when he said, "Things would have been clearer had they not been explained." The rating agency process is formal and qualitative, but let's first look at its significance.

Not too many years ago a fairly perfunctory fly-by would have been given by a company management in its visit with a rating agency. You might have even said, as we do with a charity when queried how much you wanted to give as a donation, "Same as last year. We're the same company we were; we're neither bigger nor better; we're the same people doing the same thing." It was particularly true as a mutual company's phenomenon, but stock companies benefited from it as well, which meant, in the view of an outside observer, you had a very simplistic process. The current implications of a company's rating are markedly different. It can result in a cheaper cost of capital or a more expensive one, because the investment bankers, Wall Street, and others look at how you are rated, and they can calculate within reasonable decimal points, the cost of capital in short-term funds, long-term funds, and in between.

Second, marketing organizations surely use it to your advantage or disadvantage, or your competitors use it against you, and that's increasingly important because the loyalties of many an agency are not nearly so firm. People do move from company to company much more than they did before.

In addition, you have a new fiduciary nuance. Banks and the like have, if not arbitrarily then, certainly drawn a line in the center and said—below a certain level (and that level may vary from discipline to discipline, but nonetheless it's a level),

you cannot deal with an insurance company that doesn't have a specific letter grade, for example, an A rating. It's true in the credit insurance field. It's true in certain fields of workers' compensation on the property and casualty side and for bank "platforms" offering certain coverages. It's certainly true in other endeavors within the life insurance and health insurance areas. It is not an academic exercise. In addition, a good rating can be a source of pride, morale building, and glory for a company that seeks to build credibility for itself over time. It is also a spur that you can deal with in mergers and acquisitions (M&A). A company with a stigma of an X rating for whatever reason may be forced to engage in a transaction that heretofore would have been impracticable. Company B that has a higher rating acquires Company A, which effectively permits the latter company to, if you will, piggyback off the former's rating, benefiting from the strength of the collective, rather than suffering the weaknesses of the individual; thus there are discrete, material, and substantive reasons why ratings are important.

You may have noticed that a rating finds its way into the public markets more than it used to—in prospectuses, and in documents that the SEC and private placements dictate. While the SEC does not put its rubber stamp upon the judgment of the rating agency, eyebrows are lifted when a company's rating goes from A- to B+ to C or x-ratings. A company showing a very positive trend is also noticed. The nuances, among other things, at five or six different rating agencies can be very fine, and we will explain them to you. Remember when you were a youngster in school, if you came home with a B your mother said, "Where are the other ten points?" It's not true in the rating industry here. You come home with an A-, but the competitor down the block has an A and therefore you are viewed as second best. It isn't enough to be good; you have to be striving for excellence and superiority.

Let's look at how some of these evolve. You are going to be placing yourself in the unenviable position of being a rating agency staff person. Keep that in mind! Try to remove yourself from the biases of being a company person. You have a personality that probably can be described as follows: to begin with you are probably a skeptic or cynic. Maybe you are anyway, but you are certainly so at the rating agency. Keep in mind that you hear two to four presentations a day during the peak season. Companies are making announcements and using hyperbole all the time; it has a kind of repetitive ring to it: "We provide excellent service." "Our agents are loyal." "Our balance sheet is pristine pure." "We've never had a problem with derivatives, real estate, or junk bonds." "Our management has been with us since the year one." "We've had a growth record that is distinguished." It goes on ad nauseam.

Rating agency staff are looking for ways to punch holes in that logic process. They have a further directive. About five years ago, especially at A.M. Best and S&P,

companies were put into a much more strict threshold of merit than they were before. It was not unusual years ago to have a number of companies at the top with the highest rating (it was kind of a lopsided bell curve), many companies bulked at the middle, and only a handful of companies at the bottom. Perhaps rating agencies lost credibility and because of their own inadequacies or because things slipped between the cracks, whether it be on the property and casualty side with Mission Insurance or Transport Insurance or on the life side with First Capital Life, Equity Funding, First Executive, and Mutual Benefit. Or perhaps it was an overt lapsation or a covert one, either way, it happened and, accordingly, rating agencies lost credibility.

Rating people have changed; the control of these organizations has changed, and in so doing, tougher standards have evolved, which means fewer companies are going to be rated at the top, many more will be in the middle and more will be downgraded or remain X-rated. Is the record or prospect sufficient to warrant carrying the highest rating? You're looking for ways to downgrade a company or to put a company on its mettle and justify its existence. It is no longer based on the precept of being merely concerned with solvency. They are now concerned with whether a company not only will survive, but will it prosper in the years ahead and provide low-cost products that the public enjoys, likes and really eats up? Those are big changes—they're demonstrable changes from what were the characteristics in the mission of the agency before, as I mentioned.

Put yourself into the personality of that staff person. You have to be interested enough to ask questions and interrupt the management at any given moment. The CEO comes in with his or her prepared spiel, which is what he should do. He's proud and he puts a positive spin on negative things, which is what he should do as well. He should be responding to the negative characteristics that he attested to and articulated previously. You want to see how management reacts to adversity and to change; how do they react to the anticipated change in their business, how they may be put off their game plan; how do they react to questions; who answers questions and how? Are they nimble, deft, and articulate, or is there a great deal of tentativeness? Is the information at hand or do you hear "I'll come back to you in two weeks?" Are they up to date or passé? These are important characteristics of discerning whether you should apply a premium or a discount to what company management says, somewhat analogous to what security analysts do with a public company. It's no accident that a number of the people at A.M. Best and S&P now come from the public securities or capital markets. That wasn't the case before. They all came from the insurance industry or they were home grown, but there has been a major turnover, except at Weiss.

You're going to be provided with a whole array of information, as Bill pointed out, including definitions of ratings for each of the agencies and, within the agency, a sample brochure of how we should take charge. These suggest strongly to a management that they prepare themselves for this kind of confrontation. It should not be taken lightly. I heard one manager say to me the other day "This is going to be fun." Wrong! It isn't going to be fun. Even when you win, it's not fun. It used to be fun, but it's not anymore.

We're going to show you the comments of at least one agency, A.M. Best, on one life company. While I'm on that topic, let me just point out why we chose that company. We chose it because it's not a client of our firm and, hence, there's no legal conflict. One or more of you may know that company in detail, and we would urge you and beg for you to be restrained if you know what happened to that company's rating subsequently. The data that you will be looking at are in fact dated, as they are based on 1994 reported statistics. There is always a time lag in this type of valuation process; hence, you're going to be placed in the position of looking back in time.

We will provide you with analyses and comparables of other companies and we'll provide you with a detailed analysis or breakdown of the important use of the A.M. Best capital adequacy ratio.

Do the rating services assign group ratings as well as individual company ratings? And what are the differences between S&P's rating and its claims-paying ability rating? S&P still uses its claims-paying-ability rating but that, in fact, isn't what it is. It's a solvency rating, but they've added to it. It's especially true for public companies or those engaging in a transaction and they now talk about this qualitative factor, which augments or detracts from their claims-paying ability. You can, in fact, have a very solvent company with no really bright prospects of going forward. It's not unusual to have continuing favorable claims-paying-ability ratings and a continuing dialogue about whether they should be maintained at their level. Their expectation of what the industry outlook is may be markedly different from yours, but certainly history and claims-paying abilities are very much still important and they are at A.M. Best as well. They don't call them the same things, but that's a matter of competitive positioning.

As to the first question, they do make group ratings, but there is no guarantee any more that, for example, because Allstate Insurance and Allstate Indemnity will have an A rating that an associated company or an affiliated company would have the same rating. It is more likely at S&P than at A.M. Best. They are more willing to give the benefit of the doubt if you have a strong parent. That goes to one of the characteristics we will discuss later, which is the parental commitment to the need

for capital, other resources, continuity, and commitment to the longevity of that company. Under most state laws, and under most covenants, one company cannot guarantee the obligations of another. You can, of course, make a statement—a euphemism in the marketing—that you stand behind another company’s commitments. The rater looks for a different kind of commitment. The rating agencies want to see substantive commitment beyond group or floor ratings; ratings generally at A.M. Best are the same but there can be marked differences within the family.

The other nuance, which is more than a nuance, is that they analyze the holding company much more severely. In fact, they didn’t do so at all previously, especially the leverage attendant the holding company. It’s very important. How do that holding company’s obligations (such as amortization of principal and interest or debt or preferred stock) get paid? Is it dependent upon upstream dividends to pay such obligations? Who bears the major onus of that within a family? Is it evenly distributed or does one subsidiary pay 80% of the obligation each year and the others pay a lesser amount? It becomes very important within that family what the holding company’s structure is. That’s another reason why A.M. Best and Moody’s, and to a lesser degree, Duff & Phelps, can have marked rating differences within a family versus the S&P rating.

From the Floor: Can you comment on companies having higher ratings than those of their parent companies?

Mr. Goodfriend: That happens. In some cases the subsidiary will be rated higher, and the reservation will be made in the agency rationale that we look for the holding company to refinance its obligations or to restructure, i.e., to reduce its needs from the subsidiaries that are cash intensive. I consult with a property and casualty holding company in the Midwest, which is a very strong subsidiary owned by a relatively weak parent company. A.M. Best has said, with some very clear language, we strongly suggest that you find a new parent. That’s a tough position.

Mr. Horbatt: That’s not an uncommon situation. I’ve seen where the parent company takes advantage of GAAP accounting to defer costs and actually be insolvent on a cash-flow basis, while protecting the life company. Wasn’t Southwestern Life in that situation? I believe there was too much debt at the parent company and the parent failed while the insurance company remained solvent. It’s not uncommon in our industry.

From the Floor: Herb, could you explain what is happening in the health insurance field?

Mr. Goodfriend: If you'll bear with us, we'll discuss how the rating agencies are viewing the whole health syndrome in a different way from that of the life cycle. Since there is a blurred line, it's increasingly important for the two to mesh and be pointed in the same direction simultaneously. That wasn't the case before. In the past, they didn't worry about HMOs or managed or individual care before. In fact, they didn't know what it meant.

From the Floor: Returning to your earlier remarks, can companies increase their subsidiaries' ratings?

Mr. Goodfriend: In most cases, they can't guarantee the debt of a subsidiary. They can make assurances with respect to outstanding policies and coverage.

From the Floor: What is their view of the parent company's short-term versus long-term plans?

Mr. Goodfriend: That brings us to this other question of continuity. It's one thing to be a quick fix to parents, taking care of the next few months or what's left of this year; it's quite another to take the long term, saying we're in this together for three-to-five years or more, and we want to be deeply involved in your business plan and projections.

From the Floor: Has the introduction of the NAIC's risk-based-capital formula reduced the importance of rating agencies now that there is an objective, outside measurement?

Mr. Goodfriend: The problem, of course, is that originally you were not supposed to use risk-based capital as a marketing tool. In one way or another, at a cocktail party, via a disgruntled employee or at some industry meeting, somebody would drop a remark. "You're only an A-? My company is an A+ and you're an A only to the second power." These things are used with dexterity. There's a fairly lax attitude toward their use in the marketing sense and people are using them all too aggressively.

Let me move on to some of the differences within the agencies themselves. They do share some common characteristics, but there are marked differences among these. They began to emerge seven or eight years ago, at which time they would have dealt almost entirely on the quantitative side: that is, the balance sheet, the income statement, factors that were conventional, leverage, and the investment portfolio. You would agree to what was needed to meet the obligations of the time, but your access to capital was a derivative, not as part of any major plan. Progress may have stopped at the time you visited with them. If you were solvent then, and

more than met regulatory requirements, you did not have to worry. That era is over, at least it is at Best and increasingly with the others.

Depending upon the size of the companies involved, the products, whether they be mutual or stock, one can make the broad statement that quantitative analysis is still the dominant characteristic in the equation, comprising more than 50%, and probably closer to 60%.

The financial reporting rating, which is A.M. Best's equivalent of a kind of solvency ratio, is a nonletter rating used either for small companies or companies that haven't qualified in some other way. The number of such companies in this category is declining each year. Whether companies like it or not, Best will be rating them in the future. They started with malpractice insurance companies last year. They're doing it with HMOs and the others, and S&P is following suit. They are dealing with a whole roster of companies that (because they were not in business for five years, or there was a change, a transaction, or they were under the gun from regulators) did not have a letter rating. That is not going to be the case in the future and you'll increasingly see the decline of this category and the conversion to a conventional letter rating. For the moment, the number of financial performance rating classifications have declined to about 12; there were 17 at one juncture.

It is still possible for companies to determine whether they should be rated or not. A company going to an agency for the first time would say, "We've never been rated before; we'd like to get kind of a 'sniff test.' If we elect to be rated by you, what is the range of high to low rating after you make the decision? Is an A or B reasonable? We're not expecting you to sign off on it, but what's the best you can do and what's the worst you can do? If you decide to give us a letter that's not acceptable, we prefer not to be rated." When you do that, the good news is that you won't have a bad letter rating. The bad news is that in the financial performance assignment, if the company declines to be rated, raises more questions and immediately sends up a red flag to the uninitiated in the outside world. Increasingly, as I mentioned, there will be fewer and fewer of these not-rated companies.

For the first time in memory, with the exception of Canadian companies, A.M. Best is making a very forceful run overseas to match S&P's rating of international insurance companies, much to the chagrin, I might add parenthetically, of the European companies. The questions are forcing foreign companies, which may own American companies, to be placed on the mat; it's a whole new culture trauma that European companies are going through.

Mr. Horbatt: We in the public accounting field are very happy with this development because it gives us opportunities to bring financial statements based on U.S. GAAP to new countries; ergo, there's always an "up" side to these developments.

Mr. Goodfriend: I just attended a meeting abroad this week wherein somebody whimsically called it—GASP—generally accepted special principles. This person contended that you can run a tank through the assumptions on deferred acquisition cost (DAC) and other facets of GAAP accounting. He asked, "Why should we in Europe adapt our company to a methodology that is fraught with weaknesses?" It's hard to answer that question. It depends on whether you want access to the American public's securities markets. Under the SEC regulation, there is a very mundane response to the question—how badly do you want a public market for your shares? There is another school that points out that, in due course, all companies will be GAAPed regardless of their status.

Returning to the differences within the agencies, S&P, early on analyzed international companies (typically those in the U.K., but also a couple of German and French companies) for many years. Now they're moving aggressively to rate other European companies. They have maintained this ability despite rising competition from Best. The ability to meet obligations when the books close is effectively a solvency rating lie. Their "ISI" rating is one that relates solely to the international side. Unlike A.M. Best, S&P does not cover or even publish ratings on every company. It chooses not to. Maybe that will change over the course of time. It has focused on the larger companies or mid-sized companies for many years. It's changing now as we speak and it's going to be rating more companies, but they are still well behind the numbers of companies in the database of A.M. Best.

They also differ in the process of payment for a rating because, when you rate voluntarily at S&P, you pay a relatively higher price than at A.M. Best. For some companies, there's no sense in getting an S&P rating because they might be getting a bad rating, hence they are less willing to pay for it. For a long time, S&P then had a lopsided, nonbell curve that had many companies at the high end. Clearly those who would be willing and able to pay the piper would opt for an S&P rating, otherwise why do it? Except for the current rating, which is analogous to the A.M. Best financial performance, a company may request that a rating not be published with the attending stigma.

S&P and Moody's have distinctive importance in publicly owned companies in their universe of clients. Many companies that access the capital market, either private placements or public, want to have not only an A.M. Best rating, but one from S&P and others. Of these, Moody's probably is the oldest and certainly the dominant one on the debt side for many years. They have analogous formulae on the

quantitative side, financial strength being dominant. Here the focus is particularly true on holding company coverage of debt, such as, who pays the piper? How many times fixed coverage charges for bonds and preferred, and what happens to the use of the funds? They're very good on short-term commercial paper or other items related to an insurance company's holding company. To the degree that mutual companies are increasingly doing that, it would include the issuance of "Act of God" bonds or surplus notes, and so on. Moody's is covering mutual companies as well.

The same rationale or options related to a voluntary or involuntary rating are available. They've been rating international companies for years and the companies, of course, can decide whether they want to be rated or not. If they reject, again they establish the same precedent: "While we didn't want to be rated before, come back to us in two years, and we'll talk about it."

Last among the Big Four, or at least Big Three, is Duff & Phelps. Initially it rated only electric utility companies, then it moved into insurance company endeavors. It also is very balance-sheet oriented, covering the leading companies well, but it has expanded its coverage. It, too, is moving in the international scene and has a similar process for a company wanting to have its rating not published, with the attendant consequences.

Mr. Horbatt: What about our perennial favorite, Weiss research?

Mr. Goodfriend: The genesis of this one is a very interesting phenomenon. It's certainly the youngest of these four and it comes with a completely different discipline—that of the securities business. The Weiss organization traded in over-the-counter (OTC) securities. The older Mr. Weiss, founder of the firm, dealt with people in Florida, essentially the Gray Panthers elderly movement, who bought yield stocks and who bought companies that were household names. In so doing, these people were very yield conscious and, in one way or another, insurance company sales people got to them and sold them annuities. Among those were Executive Life. As you may know, First Executive was a very successful organization for years until things went awry. Mr. Weiss' son and a group of other people decided that in order to maintain and satisfy their client base, and because they perceived correctly that an all-too-liberal rating assessment was going on among the major Big Three, there was an opportunity to be of aid, provide value-added, to save their client base's wealth, and maybe make some money in the process.

Initially, they established ratings for annuity-dominant companies (Table 1) and one of the first out of the box was Executive Life. It also was the first negative one

among the major agencies; it not only downgraded the company, it gave it an X rating.

TABLE 1
RATING AGENCIES: THE RATING CATEGORIES*

Ratings						
Rank Number	S&P	Moody's	D&P	Weiss ⁽¹⁾	A.M. Best	A.M. Best "Not Rated" ⁽²⁾
1	AAA,AAAq	Aaa	AAA	A+	A++	NR-1
2	AA+	Aaa	AA+	A	A+	NR-2
3	AA,AAq	AA'-)	AA	A-	A	NR-3
4	AA-	Aa3	AA-	B+	A	NR-4
5	A+	A1	A+	B	B++	N/F
6	A, Aq	A2	A	B-	B+	S
7	A-	A3	A-	C+	B	
8	BBB+	Baa1	BBB+	C	B-	
9	BBB	Baa2	BBB	C-	C++	
10	BBB-	Baa3	BBB-	D+	C+	
11	BB+	Ba1	BB+	D	C	
12	BB, BBq	Ba2	BB	D-	C-	
13	BB-	Ba3	BB-	E+	D	
14	B+	B1	B+	E	E	
15	B, Bq	B2	B	E-	F	
16	B-	B3	B-	F		
17	CCC, CCCq	Caa	CCC			
18	R	Ca	DD			
19		C				

* The ratings in a given rank are not necessarily equivalent to one another.

⁽¹⁾ Weiss designates small companies by the letter "S" immediately preceding the rating.

⁽²⁾ Identifies why a company is not eligible for an A.M. Best rating.

Weiss has very simple rating classifications, analogous to your old report cards—A, B, C, D, and X rated. This was at a time when S&P, and A.M. Best were rating First Executive A or A-. Weiss's action was heresy and the rest is prologue. As you can understand, it was an overnight success when Executive Life came apart. More Weiss clients and nonclients alike bought the Weiss rating service and Weiss enjoyed increased credibility. Since then, it has since spread out and has more life companies, HMOs and health insurance companies in general. It is 100%

formulistic oriented. There are no management interviews, that is, no allowance for a business plan or projections. There are no discussions of the distribution organization, the regulatory climate, or the competitive factors in the business. The balance sheet and record are the sole criteria. In some people's opinion, it works very effectively. There are, of course, aberrations and it is those aberrations, which give some insurance executives very significant consternation. You will find some companies rated highly by A.M. Best and S&P that are rated less highly by Weiss, and the reverse is also true. Suffice it to say, you must look at all the Weiss rating gradations and look at all the gradations among the other three.

Table 2 shows for each agency the distribution of companies rated in the various categories. Mr. Weiss has crafted a very simplistic regimen. You need to understand, particularly considering who the audience is, how many people who are not sophisticated with respect to finance do know an A from a B and a B from a D and vice versa. Notice the distribution now.

TABLE 2
RATING AGENCIES: THE RATINGS DISTRIBUTIONS

<u>Categories</u>	<u>Number</u>	<u>Percent</u>
Standard & Poor's Insurance Rating Services		
AAA, AAAQ	42	3.4%
AA+, AA, Aaq, AA-	197	16.0
A+, A, Aq, A-	167	13.6
BBB+, BBB, BBB-	432	35.2
BB+, BB, Bbq, BB-	233	19.0
B+, B, Bq, B-	135	11.0
CCC, CCCq	22	1.8
Duff & Phelps Credit Rating Company		
AAA	54	27.1%
AA+, AA, AA-	106	53.3
TABLE 2—CONTINUED		
<u>Categories</u>	<u>Number</u>	<u>Percent</u>
A+, A, A-	38	19.1
BBB+, BBB, BBB-	1	0.5
BB+, BB, BB-	0	0.0

B+, B, B-	0	0.0
A.M. Best Company (1995)		
A++, A+	215	23.6%
A, A-	362	39.7
B++, B+	210	23.0
B, B-	89	9.8
C++, C+	22	2.4
C, C-	14	1.5
D	0	0.0
Moody's Investors Service		
Aaa	10	6.6%
Aa1, Aa2, Aa3	78	51.3
A1, A2, A3	52	34.2
Baa1, Baa2, Baa3	10	6.6
Ba1, Ba2, Ba3	2	1.3
B1, B2, B3	0	0.0
Weiss Ratings		
A+, A, A-	62	4.4
B+, B, B-	406	29.0
C+, C, C-	493	35.2
D+, D, D-	367	26.2
E+, E, E-	73	5.2

In the Weiss' bell curve, 35% are rated nondescriptly, that is, mediocre, and only 4.4% get the highest rating. At Duff & Phelps (D&P), a much higher average rating exists, but then fewer companies qualify. Only the major companies are rated by D&P, but many more are highly rated and fewer are X rated than at Weiss. S&P doesn't cover most of the companies that are either weak or average. Perhaps 5–10 years ago, 45% would have had an A+ or A rating. You have 33% in the high ratings at A or better, and many more than what was characteristic before and certainly versus the peer groups are "average to below." Moody's has 58% of companies rated AA or better.

Weiss rated a third of the companies as marginal, a markedly higher percentage than has been done by others.

From the Floor: Can a B+ company be considered "secure?" Are more companies going to be rated in the middle?

Mr. Goodfriend: If you fall out of the B category at A.M. Best, you no longer are a secure company. You go into the "vulnerable" category. A.M. Best says, you're still a secure company if you go from A- to B+, but your distribution organization's distress doesn't make you feel very much better. The outside observer knows an A from a B. I suspect that over the course of time we're going to have fewer As. There's a concerted effort to make it a much more conventional bell curve.

The highest category is "Superior" and we'll go into what characterizes a superior company shortly, but very few are now in that category. Many more are in the A or A+ categories, not the A++ category.

From the Floor: You brought up an interesting point that A.M. Best is stuck between a rock and a hard place right now. It's in danger of losing credibility if it doesn't go to a conventional bell curve; yet the industry, in terms of its customer base over time, has been used to the other rating schematic. In my own mind, it's appropriate for A.M. Best to leave the business. After 25 years they will be forced to make a concerted rating downward migration, which at the same time is self-defeating for them.

Mr. Goodfriend: They're not the only ones going through these agonies. S&P, for example, had what was called euphemistically the "Barbecue" rating (BBBq). I'm not sure how to describe it. "Not meaningful" is the best expression I can think of. It was supposed to describe the company that didn't have a letter rating, but had the highest of the nonletter ratings but then there was this q after it, which in their rating context meant "qualified." This year they have simplified that and eliminated the "triple barbecue" (BBB) rating. They still have BB and have taken some of the q's away. It's a very arcane scale and drives some companies nuts.

Mr. Horbatt: I want to draw a parallel. What A.M. Best is doing right now is saying, "Insurance industry, you are no longer your own distinct segment. You're competing against mutual funds and HMOs. It's a new ball game." I think A.M. Best is in the same situation as the insurance companies that it rates when A.M. Best criticizes companies for not adapting to change, when they are facing their own change. Whether they will make it is unknown, but they are in the same boat the insurance industry is in.

From the Floor: Who monitors the agencies and the qualifications of their staff? Isn't that an important defect versus the regulators?

Mr. Goodfriend: The missions for each are different. The regulator's mission is to take the public interest and the policyholder's interest and make sure that all outstanding promises and commitments and contracts are fulfilled for solvency and the ability to maintain the public confidence so the marketplace can continue to be accessed for insurance. That used to be the A.M. Best rating and philosophy, but a finer pencil has been used and it has transcended lines so that it has greater penetration. It's no longer merely solvency. Will this company be around in the year 2000, at the millennium? Will it be prosperous and will it not only offer the products that the public wants, but offer them well and profitably, while maintaining the credibility of its existing book of business?

There are two dimensions now that the regulating agencies are engaged in. They've almost become security analysts in the sense of talking about the future, but they will not talk about the future if the present is weak. They won't give you the benefit of a doubt in such event. Their frame of reference on change is demonstrably shorter than it used to be. If you came in with a low risk-based capital or BCAR ratio, they would suggest to you that you might want to tool up and do some surgery to correct some shortcomings, such as access the capital markets, reduce writings, etc. In the past they might have given you two or three years to do so. Now it is, a year-and-a-half maximum and more likely three-to-six months. They are tired of and have been beleaguered by promises not fulfilled, in part a function of their own weaknesses because they didn't turn the screw tightly and promptly. As to whether they should be regulated or not, that's a judgment call.

Mr. Horbatt: Based on the time remaining, we should be moving on to the case study. We'll start by concentrating on the issues Herb talks about during the next segment. You should be thinking about them when you go through the case study. This is no longer a broad, general description of the ratings process. Rather, these are the points that you should consider as you go through the case study.

Mr. Goodfriend: There are "hot buttons." I mentioned to you critical, qualitative factors that each of these agencies, with the exception of Weiss, is looking at in a very fine-tuned point. They worship now a new god, "sustainable, competitive advantage." I'm not sure what it is and I'm not sure that they know what it is, but they know that it's different. In a commodity business such as insurance, it is very difficult to differentiate oneself with something that separates a company clearly from the pack and is sustainable over time. Would it be a product? That's unlikely. A service? Possibly. Maybe it's financial spreads management? A strong balance sheet is clearly the platform that we start with, representing at least half of these

quotients and it is still very important. They inject their own tougher thresholds of capital adequacy. The NAIC risk-based capital thresholds are much too low. You can drive a tank through many of the thresholds. Your investment portfolio is important similarly as a balance-sheet concept. But even if it's qualitatively and quantitatively well managed, it may not meet the criterion of being matched well.

Parental commitment is another topic I discussed earlier. If owned by a holding company, whether in insurance or noninsurance, what are the demands upon it? What is the commitment to your insurance company—going with the good or bad over a protracted period of time, not just until next week? How is money going to be raised if needed? Financial market dependency. To what degree do they hedge or not hedge against the volatility of interest rates, or access the capital markets, play the derivatives game, or use spreads management and the like? Presumably if you are an annuity or interest-sensitive product vendor, that's a very important factor.

I should discuss with you holding company implications as to leverage. They don't like companies that have, for example, more than a third (maximally 40%) of the total capitalization in debt. How are those obligations going to be met, by when and by whom, given the volatility of interest rates? Years ago it was a major event when long-term rates moved by 10–25 basis points in a year. Now they can move 50 basis points in three months. How does a company in the life insurance business react to, or in particular, anticipate such change?

It isn't enough to be dependent on the same old-guard distribution organizations that provided you so much success in the past. What is its productivity today? Do you have alternative new forms of distribution that you're experimenting or piloting with? How productive are they and when will they be successful?

Are you in businesses that are essentially screening out profitability to a significant degree unless you have major critical mass? Do you do credit insurance or some other form of regulated endeavor, such as the crunch on regulated HMO profits? Of course, the threat of federal regulation always stands off center stage. How would you react if Hillary Clinton's health program wins or if something like that is revived? Best and S&P have dedicated considerable people and technology resources to assessing the Blues and HMOs.

How are you going to grow? At what rate? Through what vehicle? What's the market for such expansion?

Are you heavily dependent upon reinsurance? Are these the first-tier companies? Do you use avant-garde names that are not household names? What's your reten-

tion rate? What are the terms of such agreements? Rating agencies would like to see the reinsurance agreements if you're a particularly heavy user.

From the Floor: Do they view the use of derivatives in a positive way? What's the cost of a rating?

Mr. Goodfriend: If it's done well, yes. The fact is very few states permit derivatives to be used in a major way, but where they are authorized to be used and where the company uses them professionally, then the rating agencies take a more constructive attitude. It's all in proportion and in moderation.

On the cost side, the fact is at S&P you can pay as much as \$50,000 for a rating; clearly if you want a rating, you no doubt want a good one; otherwise you're not going to pay. At A.M. Best, you typically pay for their book and that's a much more modest fee and it can range downward from \$15,000 to \$1,500, so there are demonstrable differences. The other agencies are in-between.

Mr. Horbatt: Describe the meeting modus operandi with the agencies.

Mr. Goodfriend: The meeting with rating agencies used to be a fairly perfunctory flyby. The chief financial officer (CFO) and the president or the chairman would visit briefly and in a matter of form. That won't cut the mustard anymore. Best and S&P want to see a formal report a week or so before you get there and that is assuming you have answered their questionnaires that they provide about your assets, your policies, and your distribution organization. If you haven't done this before, then it can be a trauma because you're not finished there. You've got to provide business plans and projections. For some companies that was an academic exercise that no one listened to internally, even if they provided one. They might have lived by the seat of their pants. That era is also at an end. Keep in mind that even if you're a mutual company, they're looking for detailed numbers, looking to the time when you will be reporting quarterly or semiannually at the minimum. Projections will be reviewed. While they will not put you to the test for each number to be correct, they will see the degree to which you vary those projections each year and why. It can be a very costly and time-consuming exercise initially.

From the Floor: What about Weiss?

Mr. Goodfriend: Weiss charges for its subscription book. It is a few hundred dollars and it's easy to discern. It's a very well-laid-out book. Weiss is still in the securities business as well.

From the Floor: Describe the process for requesting an appeal to a rating and a meeting.

Mr. Goodfriend: Returning to our basic modes of preparation, not only do you need this brochure, but you have to select carefully who makes the presentation. It should be somebody (1) who is knowledgeable (2) who is articulate, and (3) who can be responsive or be accompanied by another executive who can do so. It doesn't mean bring in 15 people, but choose carefully which ones you want. Some companies take the same two or three each year and then add one or alternate ones each year. You must show the depth of their management team. There should be one point person who deals with the rating agency on a continuing year-round basis, one who responds and is the person in charge of making sure that things are pulled together. That may not be the same as the CEO or the president. Usually it's in the CFO's province. If the company has had a reserve problem, then the actuary should attend. If the company has had an investment problem, the person who is knowledgeable about that side should attend. The senior, most-active operating officer should attend, regardless of how much he or she will say. If there's a controlling stockholder, kind of a *deus ex machina* off center stage, try to get that person to be responsible as well.

You are not finished after this initial-annual flyby. That won't suffice anymore. They expect you now to report to them periodically, and I suggest quarterly. Just pick up the phone and say, for example, "We're on our game plan. We haven't changed materially from our projections or our business plan" or "We are 5% above or below for the following reasons." They clearly want a separate visit or major phone call when there is an important, material transaction, that is, before it becomes a *fait accompli*. You reserve the right to do what you want, but you find out in advance from them, what their reaction would be if you are planning capital changes, restructuring, ousting of management, a merger, a sale of a book of business, major reserving, releasing of reserves, forming a new distribution organization, or responding to the market conduct issues that might have been spontaneous.

What they don't want is negative surprises. They don't want to read about it first in the media. They don't want to hear about it from another company, particularly after you've just gone there and assured them that everything is hunky-dorey. There should be a major transaction announced that you didn't alert them to. You needn't have spelled it out, but you could have said, "We plan to enter the annuity business in the next 12 months. We're not sure if it's going to be by acquisition or *de novo*, but we're looking at the following characteristics of a company or business that interest us. We may go into that business in the next period, so don't be surprised if you learn about that. When it happens and it's material to us (i.e., comprising more

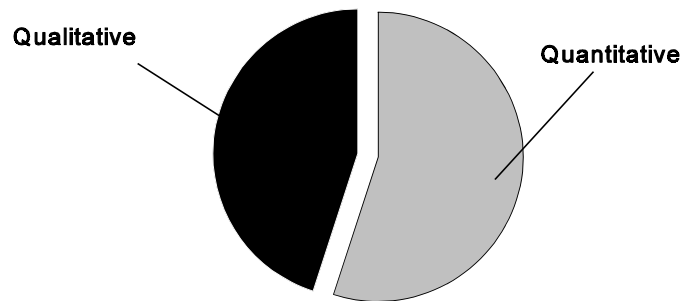
than 5% or 10% of surplus or even more so of earnings), then we'd like to run it past you, reserving the right to do as we please." You don't want to shake the timbers and make sure that you win the proverbial battle but lose the war. The good news is you have the transaction ahead; the bad news is that it could cost you a good rating.

The appeal process is a very frustrating one. It's not going to be very fulfilling, but it's possible to win; however you probably will lose more than the rating if you win. If you reach that point, then you must try, but don't hold out your hopes too much that you're going to be winning it easily.

From the Floor: The qualitative factors are becoming increasingly important as you've suggested. Aren't the balance sheet and income statement also quite formidable too?

Mr. Goodfriend: The relative importance of qualitative factors, which include the business plan, business projections, and others that I enumerated is about 40% versus the more conventional balance sheet and financial statements, quantitative, which is about 60% of the weight of the rating equation (Chart 1).

CHART 1
WEIGHTING OF FACTORS



Mr. Horbatt: One thing Herb may not have mentioned, because it generally hasn't gotten out, is that a company will frequently fail solely based on either one rating criteria or the other. Whether you look at rating 100 or 1,000 companies, this graph represents the average—there are always unique situations. For example, I recall a CEO who went to a ratings agency and said, "I'm going to go public in a year with an initial public offering (IPO)." They're now hiring a number of

consultants to fix their problems. This works out very well for the consultants, but not for the CEO who lost his credibility.

Mr. Goodfriend: The other factor I'm glad to point out is, for example, at S&P it might be 70%/30% quantitative/qualitative, but in both organizations and for that matter, the others as well, if you start with marginal or submarginal balance sheets, it's very difficult to overcome that with qualitative plus factors. They will be prejudiced and not give you the benefit of a doubt, because most of this will be prospective. That "Show-me, I'm-from-Missouri" attitude will be germane here. If you haven't done it to date, why should I believe you? Remember, you're sitting there as a skeptic, if not a cynic.

The best (no pun intended) companies tend to have common characteristics, at least in the minds of the rating agencies. They tend to generate sustained and improving operating results. I want to underscore the word *operating*. That does not mean earnings from capital gains. They clearly differentiate your underwriting prowess from your investment prowess. We, as policyholders and investors, are not putting our money in your company merely to run a wonderful investment operation. We can do that with U.S. Treasury bonds. You and I can disagree with that philosophy, and some companies do, but where Best differentiates is, if you make money consistently from underwriting operations, that's a very difficult task for many a company. Second, you're not complacent about the solidity of your financial strength. You continue to improve it. You rework the investments each year. You make sure you purge the balance sheet of things that are intangible that don't have a prospect of becoming tangibles. You make sure that the assumptions underlying your business plan have integrity. You're not content with the status quo ante.

From the Floor: If a company has fared well historically and lived up to its own and Best's prior expectations, why should they be suspect?

Mr. Goodfriend: You're correct and prefaced your own remarks by saying they've already shown or demonstrated a good company record. If you engaged in this exercise and didn't have that record, they'd be skeptical about it, especially if it were meaningful not merely as a function of assets, but of surplus. Too many companies focus on how individual asset accounts relate to assets. Best's focus is more on what it represents to surplus, e.g., noninvestment grade bonds, mortgages, affiliates. What are you using other than just "bells and whistles" to maintain market share and to move aggressively into it? Many market issues are so important, for example, distribution organizations. Are you pruning the product's line, concentrating on the geography that you wanted, and so forth? What is the SCA I told you about previously?

From the Floor: Does the rating agency penalize you for growing rapidly without concomitant rise in profits and surplus?

Mr. Goodfriend: The simplistic answer to your question is Yes. If you have low but very realistic expectations and you meet or exceed them, that's good. But if the reverse occurs, you will have marked time, so the low-ball issue would not have been a beneficial one. Conversely, suppose you were very aggressive in your goals. Your friendly agency might reward you from a manual manipulation of the BCAR, with a premium or a credit that is not germane to any other company, but it can't be prospective. The base has to have been attained on which the credibility is attained.

The winners have common denominators but the losers do too. They have started to move downward in market position, especially in recent years with health-related endeavors. If you take out capital gains you see they generate poor operating results. It shows all the more because many companies benefitted from capital gains in good securities markets. They have difficulty articulating and defending why they're doing things. They say, "We've always done things this way," or "Our agents always do this," or "What's wrong with it?" There has to be a sound business plan and the assumptions that underlie them have to be sound as well.

You still have off-balance-sheet issues. It's more germane to a property and casualty company, but it's certainly true also of a life company. Market conduct, of course, is an off-the-balance-sheet thing too, and that's this year's hot button. Five years ago it was derivatives, but now it is market conduct. I don't know what it will be next year. Whatever the issue is, it is always centered on the functions of management.

From the Floor: Many of your clients must address prior critiques and prepare formally for their meetings?

Mr. Goodfriend: Yes, in fact that is one of the important musts in our contract. I help them respond to the A.M. Best or the S&P critique of a year ago, whatever the negative aspect was, and I help them formulate the business plan and projections. It's their business plan and their projections, but we help them present it. We help them articulate an executive summary, which is basically "I love my company because...." We have dress rehearsals in which we act as the other side and sometimes it gets to be disparaging, as you can imagine. The management at many companies are not used to that. Then we attend the actual rating meeting with management, with the permission of the agency. We do not lead the meeting but we make sure that it stays on course and we take notes. Then we have a debriefing. We make sure that any calls for action by the rating agency are fulfilled promptly by the company.

From the Floor: What is the level of expertise and understanding at S&P?

Mr. Goodfriend: That's a very good question. If we use zero to ten as a scale of satisfaction, and sophistication, and knowledge, I would say S&P is at about seven or eight, but it's difficult to assess. I would guess in certain sectors of life insurance, S&P would be at nine or even higher. On the health side, it's a six or seven. Overall S&P is probably five to six, but eight or nine when it comes to a public-access-to-capital issue.

They may all take their marching orders from the top, but it varies in execution. Maybe one person who is an examiner stays the same, but others will be rotated around that person. No sooner have you educated one of these for the standing company and he or she (or both) could well be reassigned.

Mr. Horbatt: We will now begin the case study presentation. Picture a senior officer of the company meeting with a representative of a ratings agency. The two men or women are going over the brochure that the company prepared. I will play the role of a senior officer of the company, ABC Mutual. Herb represents A.M Best. I think the first thing that I would bring up is the strategic direction of the company.

Case Study - ABC Mutual: Pros

- Growing presence in upscale and variable marketplaces
- Favorable Industry position (Top 10 variable life companies)
- Favorable capitalization
- Diversified distribution systems
- Infrastructure investments (systems & expense reductions)

Senior Executive (Mr. Horbatt): I am sure that you recognize that the company made the decision to enter the variable marketplace back in the early 1980s before it became fashionable. While other companies, such as Monarch Life, failed, we survived and prospered. We developed the infrastructure, which today is quite significant. We are one of the top ten companies today in terms of production of variable life premium. We are effective at managing expenses. In the last year we reduced expenses by a million dollars in the pension division alone. In the last five years our capital has almost doubled. Return on equity (ROE) is in the 16–17% range. Another very favorable point was that, during the past year, premium income went up by about 5%, while commissions stayed flat. Our migration to lower agent compensation products has been successful. Growth in life insurance premiums has been very good over the last five years. The rate of growth in new premium has been double the inflation rate. For pension-type contributions, the growth has been in the neighborhood of 30–40% on average per year. In sum, there are some very positive things about our company.

Just look at our capital ratio (Table 3). It's obvious that it has been improving. The BCAR has gone up by a good third or more in three years. If you take it over a longer period of time, as I mentioned earlier, it has improved by about 80%. Those ratios would argue that A.M. Best should consider raising the rating from A+ to A++ . It's a stronger company today than it has been at any time in the recent past.

TABLE 3
CASE STUDY - ABC MUTUAL

	BCAR	RBC
1993	152.6	257.5%
1994	173.4	295.5
1995	216.5	352.3%

Let's look more deeply at some of our pros. There's our growing presence in the upscale variable marketplaces. Every life company wants to sell in the upscale market—this is a company that's successful at it, being among the top ten producers. A major product is introduced every several years. Right now we have variable last-to-die products. We have substantial capitalization, diversified distribution systems, and the agency force has grown this year over last. Meanwhile most other company career agency forces have been in decline. Our competitors have shown stability, at best, yet we've had a growth of some 50–100 new career agents. In addition to that, a fair amount of the business is being brought in from alternate distribution channels, such as personal-producing general agents (PPGAs), which is a relatively new addition to the company (they seem to be growing in presence), pension representatives selling pension business, and brokers.

Look at infrastructure investments. This is a very smart company. Where we had to make investments, such as in computer systems, we did. We have full variable processing systems up and running. Where we needed economies of scale, we went the joint venture route. Our mutual funds have been merged with the mutual fund groups of two other large mutual companies; this proves our capabilities to partner. We're not a company that feels that we have to do everything ourselves.

Ratings Agency Representative (Mr. Goodfriend): Before I respond to some of the very good points you made, I'd like to go back to the opinion we rendered in the rating a year ago when we suggested that you had certain breakthroughs and certain shortcomings. I'm sure you've looked at them. At that point, we acknowledged some of the things that you have just pointed out, but we also alerted you to our view that you had a rather murky prospect for the variable long-term future. We weren't as sure about the market you were able to extract as you were. Also, while

mortgages and real estate represented a lesser part of the total asset portfolio, they were nonetheless still important in surplus terms. Expenses, while you were making inroads, were still relatively high against your peer group. Let's look at them collectively and individually and see how your progress has been since you made those points.

CASE STUDY - ABC: CONS

- Challenge to maintain growth in "core" traditional products
- Increasing emphasis in lower margin products
- Moderate surplus growth
- Real estate exposure
- Historic volatile earnings
- Technological and administrative challenges
- New forms of competitors (e.g. Fidelity)
- More swiftly changing markets

We have certain things that we want to show you that we have concerns about. I know you're proud of your company and justifiably about your core products, but everybody is undergoing change these days, and we wonder whether a company of your size and your distribution organization can maintain the same market penetration and the same classic profitability going forward without changing its core products somewhat. That rate of growth is going to slow, in our view. That means that you are emphasizing lower margin products and products that I won't say are more competitive, but they're certainly more commodity type than is characteristic of the past.

Senior Executive: The key thing is, as we migrate towards commodity products, are our expenses being reduced? We took a million dollars out of the pension operation. We're moving to the suburbs to reduce expenses further. We are reducing expenses fast enough to prosper in a commodity environment.

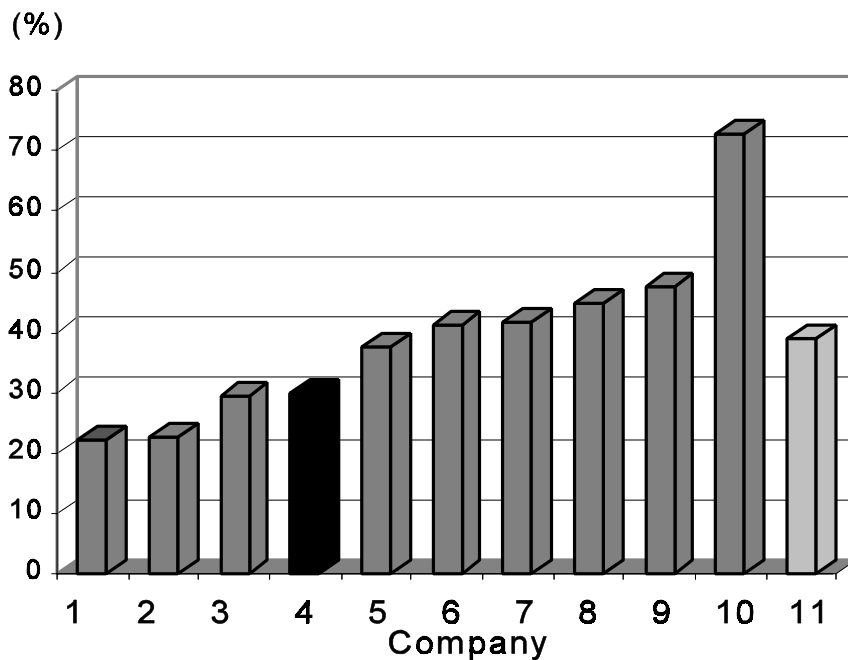
Ratings Agency Representative: I'll explore that with you in a little while because I want to show you a table that we put together that takes issue with that and serves to temper your enthusiasm. I acknowledge you have had good surplus growth, but it has been moderate against the peer group we chose. It's just an average, moderate performance. We still have this mortgage and real estate exposure. It amounts to less than it was a year ago and two years ago, and that's all to the good, but it's still a concern, especially since you're an eastern-concentrated company and the bulk of the realty market's worst problems that still exist are along the Eastern seaboard.

Your earnings curve has been improving, but it was volatile, and it's still volatile albeit to a lesser degree than it was. Are you ready for the year 2000? Many companies are paying the piper for not being ready for conversion costs.

Senior Executive: That was one of the real advantages of all the system conversions during the development of systems for variable products. They're all year 2000 compliant, including core product systems for traditional life products. I think we've faced the same problems that the industry is facing, but when we downsized, we did not fire all our career programmers, so we can fix new problems too.

Ratings Agency Representative: You don't have to rehire people later on? I don't know who you view as your competitors. We see many competitors, but perhaps you don't. Even if you don't see them today, our view is that you will see the companies like Fidelity and Nations Bank in the year 2000 and beyond. Do you think you're well positioned to compete against them, given your present structure and orientation?

CHART 2
COMPARABLE FINANCIAL DATA
NON-INVESTMENT GRADE BONDS/CAPITAL AND SURPLUS



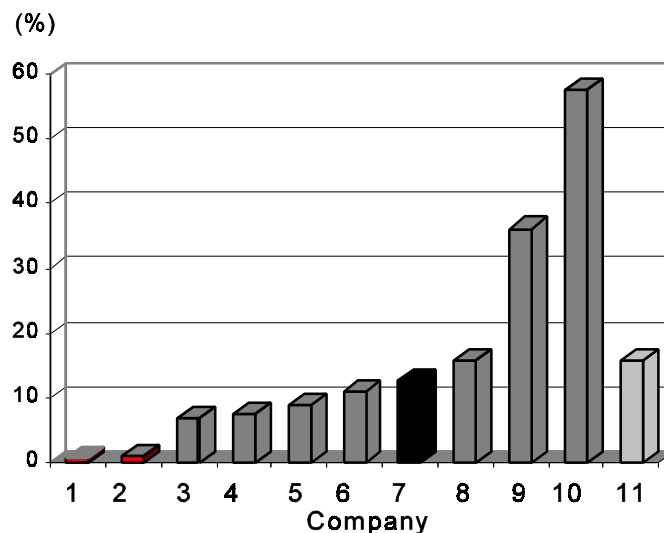
Senior Executive: As we say in our firm, if you can't beat them, join them. We offer over 22 different funds for our investors in variable products, for life insurance, annuities, and mutual funds, and believe it or not, Fidelity is one of the fund managers we offer.

Ratings Agency Representative: Here are some charts that we put together that demonstrate either your virtues or our concerns about your shortcomings.

On Chart 2, number 11 shows the average of the ten companies, and number 4 is ABC Mutual.

Senior Executive: Once again, note how strong our company is, and that is why your rating agency should stop picking on us.

CHART 3
COMPARABLE FINANCIAL DATA
DELINQUENT MORTGAGES/CAPITAL AND SURPLUS



Ratings Agency Representative: Let the record show that the graphs include two companies of his choice, not necessarily of mine or ours. You paid your money, take your choice. Notice they do make for good reading. It's less than the average of investment-grade proportions in a peer group.

In Chart 3 we have delinquent mortgages as a proportion of capital and surplus, and ABC Mutual is number 7.

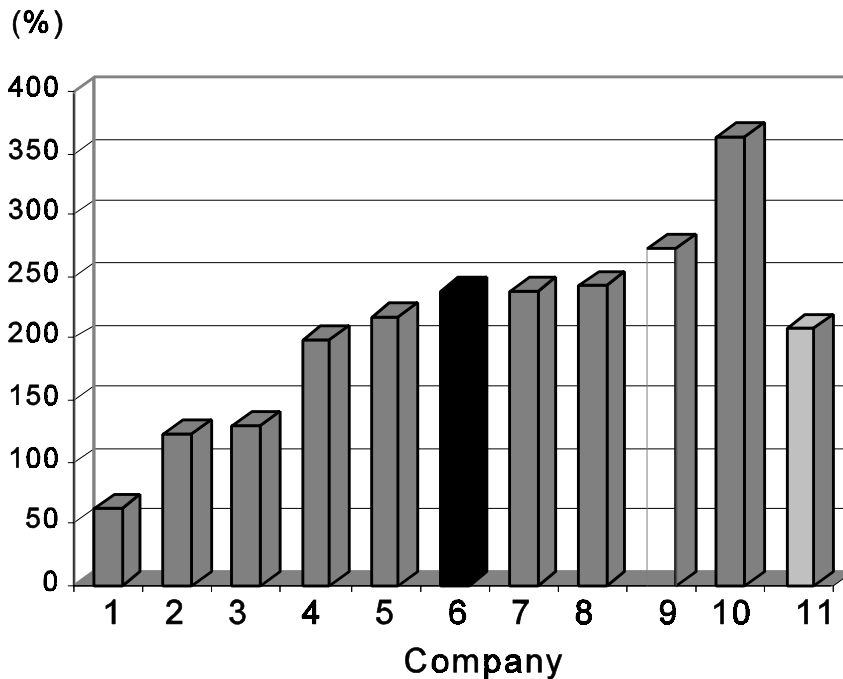
Senior Executive: Note that my company has a favorable ratio, well below average.

Ratings Agency Representative: You're really almost close to the average, not much below.

Senior Executive: Each of us is entitled to our own opinion.

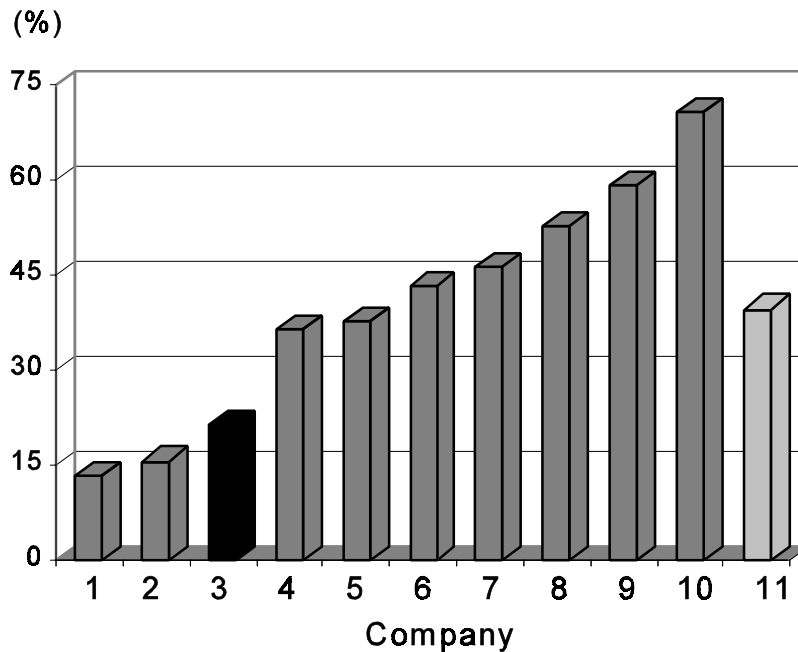
Ratings Agency Representative: In Chart 4 we have mortgages and real estate as a proportion of capital and surplus. ABC Mutual is number 6. Notice the average and where you are. You have cut back from where you were two or three years ago, but mortgages and real estate still make up a sizable portion of capital and surplus. You should want to talk about that.

CHART 4
COMPARABLE FINANCIAL DATA
MORTGAGES AND REAL ESTATE/CAPITAL AND SURPLUS



Senior Executive: I think you can see that, based upon our competitors' profiles, we are in the center moving down the line, so we're actually comparable to these other companies, which all maintain favorable Best ratings.

CHART 5
COMPARABLE FINANCIAL DATA
AFFILIATED INVESTMENTS/CAPITAL AND SURPLUS



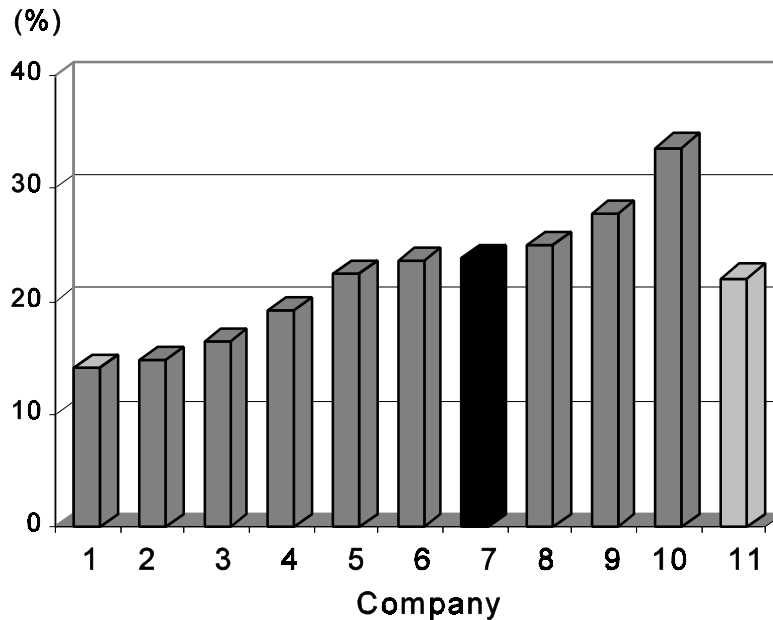
Ratings Agency Representative: Using the same logic, a man jumps off the Empire State Building and as he passes the 34th floor he yells out “so far so good.”

From the Floor: Aren’t you being too critical of this company considering the progress it has made?

Ratings Agency Representative: Chart 5 compares affiliated investments to capital and surplus, and your company is number 3. This is where you really shine, and we’re delighted to see that you have distinctly fewer affiliates or stacking of capital problems than some of the other companies. We’re happy to see that. We don’t have any qualms with that.

You mentioned and boasted about expenses and the commission revamping, and so forth. From what we can discern, using your own choice of peer companies, there’s not very much to write home about (Chart 6). You’re still above average, and given the growth characteristics of the business, that doesn’t bode well. Do you want to respond?

CHART 6
COMPARABLE FINANCIAL DATA
COMMISSIONS AND OTHER EXPENSES TO NET PREMIUMS WRITTEN



Senior Executive: If you looked at the same chart five years ago, you would have seen that we would have been further to the right, so we are following a path of progress. We feel that we're reasonably competitive, and within several years we'll be on the top. All things take time.

Ratings Agency Representative: But your growth rate is in lower margined business.

From the Floor: Yes, and getting worse!

Mr. Horbatt: In fact, if I were doing this analysis, I would never use that ratio. I would come up with something like a standard expense, perhaps based on pricing expenses. Apply your pricing expenses to the measures of volume—\$X per policy, Y% of premium—and then do that same thing to competitors and compare actual expenses to the standard expenses. That's a much more revealing analysis and that's the kind of thing I would recommend doing if you were going to a ratings agency.

From the Floor: Do you use a generated number for benchmarking?

Mr. Horbatt: Factor generally. You compare the total of actual expenses plus commissions to a factor-generated number, because the factor-generated number takes into account relative volumes of work. When you're growing you have to spend money on underwriting, and you have to spend money on commissions.

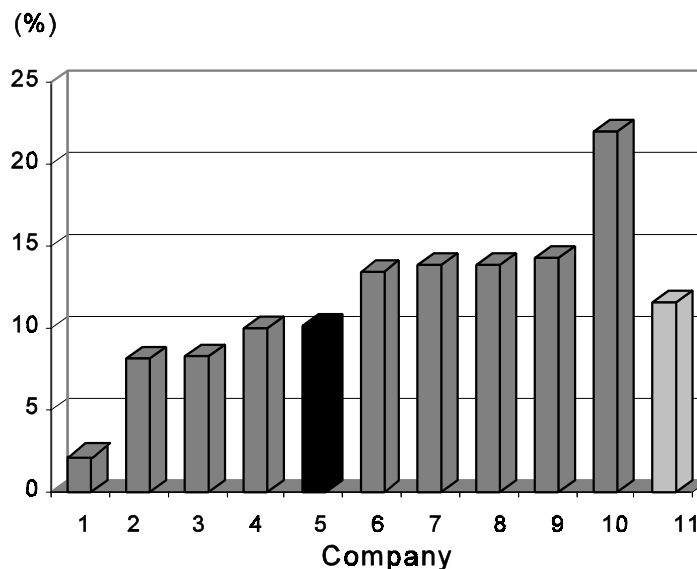
Mr. Goodfriend: One thing I wanted to mention—it is not a good tactic to point out to the rating agency people that your competitor has a higher rating than you and one which you think isn't justified. I've seen our customers do that and it doesn't really sit well. If you want to talk about the competitive factors in the business and use them in compilations, that's fine, but don't introduce the letter rating of these companies as a telling argument.

Mr. Horbatt: No, but you could graph this kind of an analysis. It could be very effective.

Senior Executive: Here's where I really take issue with you, sir. I don't know where you got your number from, but as I pointed out, the company had a 16% ROE. I don't know how you're calculating it, but our company in number 5 on Chart 7 shows us with something demonstrably less than that. Let's leave it for the moment.

Ratings Agency Representative: This is statutory equity.

CHART 7
COMPARABLE FINANCIAL DATA
RETURN ON EQUITY



Senior Executive: This was shown already because we can use either, and the graph probably includes losses, does it not?

Ratings Agency Representative: I don't believe so. I think this is the net operating gain.

Senior Executive: I would urge you to go back and take a fresh look. If you find that the rate of return is demonstrably less than the peer group and demonstrably less than you surmise, we can talk about it in our next telephone conversation.

Ratings Agency Representative: Talking about your growth characteristics, let's look at your growth in written premiums versus your capital and surplus (Chart 8). You are number 8, and about average, but not distinguished. I'd say that on a number of different bases, ABC appears to be an average company.

You have had 80% growth in capital, quite adequate to fund your sales growth. By your own selection of companies it has been average. Using a number of these different tables, they all come in plus or minus average. We'd like you to think that you used to be a superior company, sir.

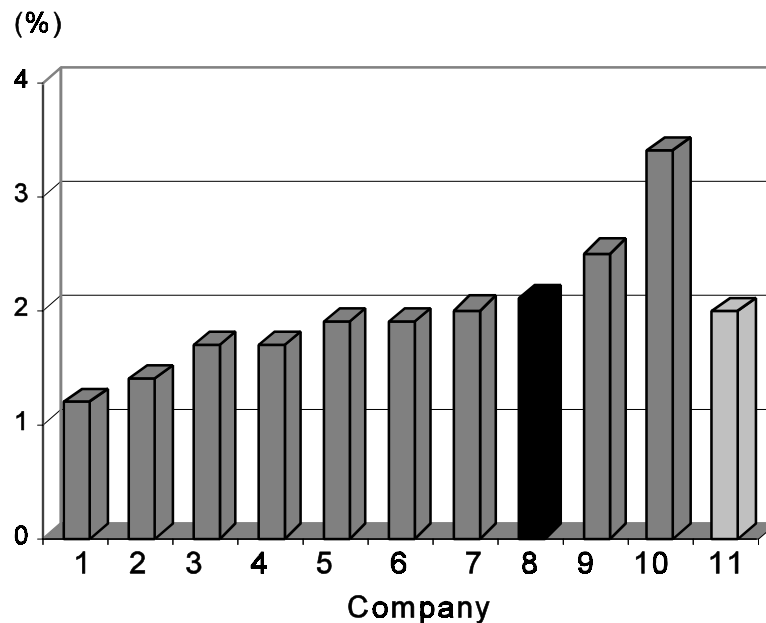
Senior Executive: You used to be a "Superior" rating agency, too.

Ratings Agency Representative: Bravo! In summing up then, you believe that your financial strength has integrity and is matching your growth, and is equal to the future and you think your expenses are in hand and under control. You believe your products are now reaching out to markets and that profitability can be sustained. You believe that your return on equity, no matter how you calculate it, is adequate for the business you serve. Is that a fair statement?

Senior Executive: I would say we're even better than that. I think the company has recognized the shift in the nation's demographics. We have an older population—a more sophisticated one that needs sophisticated products. We made that shift, and we have demonstrated our ability not only to serve the upscale market, but also to serve it profitably and to adapt to maintain that service level. We feel that over the next ten years, as you watch us, we will be the winner; the rest will be the also rans.

From the Floor: What base period did you use and what happened in 1995–96 with management changes?

CHART 8
COMPARABLE FINANCIAL DATA
NET PREMIUMS WRITTEN TO CAPITAL AND SURPLUS



Senior Executive: That was just the normal transition in management that occurs in every company from time to time. That was anticipated, but not in terms of the change in the mix in business. As we've migrated to become more of a mutual-funds-oriented company, we felt that although our internal staff gives us great strength and depth on the bench, we needed some fresh insight in the funds industry, and that's why the board and senior executives themselves feel very comfortable with this choice.

Ratings Agency Representative: How would you use or redeploy the excess capital?

Senior Executive: The question in my mind is, Is our capital appropriate for a business? I would say, back in the late 1980s, when we were having problems with our somewhat-excessive dividend scales and a bloated expense structure, our capital went down below the level that we felt comfortable with in terms of insuring our policyholders. At this point in time I think we have built it up to the appropriate level and it will be maintained proportionate to this level on an ongoing basis.

Mr. Horbatt: Now that we've discussed the case study, we're going to break into groups.

One thing I'd like you to do as you start to discuss the issues is try to settle on what you think the critical issues are for this particular rating (including both qualitative and quantitative factors), and pick the ones you think are important. Sometimes groups come up with a final rating really fast, and then they spend the remainder of their time documenting it. Those of you who are affiliated with the company, please keep your confidences or, if you prefer, you are welcome to take a long walk. Any final questions before break? The case study company is currently rated A+. The CEO has asked for an increase to A++.

Mr. Goodfriend: Let me return to an earlier question. There may have been management changes in 1996 in the case study company, but they were not germane at the time that these ratings analyses took place. Whether they were material is another matter altogether. I mention it as a clarifying point.

[GROUP WORKED ON CASE STUDY FOR 1½ HOURS]

Mr. Goodfriend: First announce your table name and your own name.

From the Floor: Our table name is "The Bigger-Fish-to-Fry Rating Agency" and our motto is "The Shark;" that's what we wear for our logo.

Mr. Horbatt: We will start with the critical issues.

From the Floor: One critical issue is, Can the company maintain its presence in this rapidly expanding marketplace? They entered the market very early. They have been in the market for several years, but as we all know, there are more and more companies jumping on the bandwagon. It's not going to be that easy to be this small a company and be Number 10 in this type of growing marketplace.

The second critical issue is basically size. I'm sorry, but to The-Bigger-Fish-to-Fry organization, this company is not large enough to be an A++, so we can take that out of the equation right now.

The third critical issue is upscale market risk. This company was first to enter the variable, second-to-die market. Variable products had a certain amount of inherent risk when they first entered the marketplace. I don't think any of us know where second-to-die is going and what risks we've taken on in that marketplace. We may not know until many more people die, but when you combine that together with the fact that this company was the first to enter that marketplace, you are talking about a potential risk that is unknown. So there's some concern there.

The fourth is, Can this company rebound if variable products are tied to market presence? When the Dow hits 4,000—uh oh!

Mr. Goodfriend: Not after a split, but on the way down.

From the Floor: Just a minor reset. When the Dow hits 4,000 and people aren't bright enough to figure out that it's fine and it can go back to 6,000 again, they will probably figure that they have to go into something else. Variable products are probably not going to be as much of a presence in the marketplace as they are today. Because the direction they're going is that 80% of their sales are in variable products, are they going to be able to contract and not lose that fixed production—89%? Accordingly, we vote for a downgrade to A.

From the Floor: [A separate agency] To address quantitative issues, we thought the CEO did a great job in presenting the company when they met directly with the rating agency. The other thing that is of a qualitative nature is this is an old company. This is not a young company that's an upstart that hasn't been around for a long time. This is an old, established one with name recognition that is bigger than their size. I think that says a little bit about the long-term nature of the company. They might experience a few bumps along the way, but I believe that, in the long run, they'll prevail.

The third is that, from a qualitative standpoint, they're not afraid of the markets, even though it's an old-established company. They're one of the first in variable universal life and they're one of the first in last-to-die, and those are both things that say that they're not sitting on their laurels and taking things as they come. They're being aggressive. I think that's very strong, even though I don't have much data behind it to show what the calculations were, but that's good.

Second, we also focused quantitatively on the assets of this company. It does not have collateralized mortgage obligation (CMO) problems. It does not have junk, it does not have high real estate and mortgages; and, as we all know, rating agencies tend to focus on any asset classes that are outside the ordinary. We find those to be a bad thing until someone can prove to us they're a good thing.

Finally there may have been some blips, but the growth in the corporation has been stable and sales are growing. I wouldn't call them an aggressive, high-growth company, but I certainly wouldn't call them a dying company either. Sales have been steady. Things are going in a positive direction. From that analysis we leave them at A+.

Mr. David A. Shea, Jr.: I'm the representative for the "Doubting Thomas" table. Our three critical issues for the case study company, based on the information given, were simple—business mix, expenses, and competition. That's it. We were going for substance over style.

We identified three qualitative issues at the outset, when we looked at the qualitative versus the quantitative, we did consider that the quantitative is the retrospective look, because it's basically the information you've given. The qualitative was more or less the information you're given, plus the presentation that was given earlier. In the three qualitative issues we identified the company has a real challenge to maintain their profits and growth. They are moving from their cash calls, and their core business has a higher margin but is not growing. They're moving into areas where there's a lower margin, so you must sell much more to keep the engine going. Also, we weren't quite sure if they were poised to compete with these products in the future, particularly with some unknown competitors that may come in that have a lower cost structure than they do. It was fairly obvious, based on some of the quantitative stuff, that their expenses were relatively high. Also, there was some issue about the diversity of their distribution systems. They appeared to be more focused with the career agencies and the PPGAs, and they did mention there were some others but, interestingly enough, they failed to give any numbers on them. So we were just questioning whether they are as diverse as they seem to think they are.

On the quantitative side, I don't want to give away the farm. Yes, the expenses are above average. We are not quite sure whether they have the discipline to keep them under control in the future. It was in a good range, and they did have some premium growth in their lower-margin products. Basically when we looked at the quantitative stuff, we came to the distinct conclusion that nothing had really gone bad, nothing had really improved that much. Things were kind of in a general status quo, so it is with a heavy heart that we lower their rating to A.

Mr. Donald Allen Sheak: I represent the "Expansion Rating Agency" table. We finally decided on a rating of A. Our first thought was to move it down to an A-, but because of some excellent presentations on the part of the company CEO we decided not to go down further than A at this point.

There are several critical issues. While there are many good things about this company, we wanted to point out some of our reasons for our action to move the rating down. We didn't really see a sustainable competitive advantage, one of the critical issues we need to address. Variable products have been known to go down in cycles. Most of their eggs are in one basket. If there is a downturn in the cycle, there are no other products that could come in to help compensate. There has been

a tradition, as noted in last year's write-up, that there is some volatility in earnings and we see that this could be a potential in keeping a very high rating for this company. That was one of the issues we considered. There's no real sustainable competitive advantage; there are average expenses. Some systems work is needed within the next couple of years for the year-2000 project. While it's handled on the new stuff, there's a big block of old stuff for which there hasn't been a clear path to address those issues.

Balance-sheet strength, the risk-based capital, while going up, will not be consistent with a high level of ROE. While there have been some one-time write-offs, we don't see any real strategic plan for this company to address how it's going to use capital in the future to the extent it can't grow variable products as fast as it might like.

With respect to qualitative factors, as we said, there are no plans for product diversification and no real strategic direction outside the variable marketplace. There is some need for some additional management support, which we know we can use, but is there a way to do so? They have had bull market earnings (variable) historically, quantitative factors, lower ROE coming up on our graphs, only average expenses, their mortgage real estate exposure is high, which hasn't really been a problem going back, but we don't see that as being any real advantage going forward either. That's what led us to our conclusion to downgrade the rating.

From the Floor: [A separate "agency"] Before actually going through this, I was amazed in listening to the comments to find out how reasonably intelligent, capable, and technical individuals, such as actuaries, can read the same data and come up with such amazingly different conclusions. We went to an A rating, so the suspense is out and the question is why. Some of the reasons are similar to what we've heard: there's a continued decline in their core market, their traditional individual life business, and greater emphasis on the variable life, almost a heavy concentration on the variable life business. There are some suggestions. Maybe they should develop a term product and work on something so that when you go through the cycle there would be additional business there. What the case study company has done is move to a very highly competitive and low-margin business. That's just not good for sustainable, well-above-average returns.

Finally, we felt that the competitive advantage was short-term rather than sustainable. We felt that their variable systems work was probably their key advantage at this point. They'd had the systems, but at this point, more and more software companies are out there, and more vendors means other companies will be able to come in and take away that advantage.

Some of the qualitative issues we noted are that there have been very volatile results. There was a lack of a track record of consistent growth, which we were looking for. We wanted to see several years of sustained growth as opposed to just a turnaround one year and then kind of flip-flopping a little bit. There have been many significant recent changes. There had been an acquisition. There are frequently some problems there. The company is doing joint-venture work now. We don't know if there's a new CEO at this time or not, but significant changes are evolving and are needed. Moving the company out into the suburbs creates disruption, so we wanted to see things stabilize a bit. We noted the continued dependence on career agents, which had been pointed out before as opposed to expanding into the other distribution systems.

In terms of quantitative factors, a point that I think that the first group raised was the improving profitability or combined loss ratio. I didn't see that. I noticed that it was increasing each year with the exception of 1994, where it dropped a little bit, but otherwise it was continually increasing. An average to low ROE, continued real estate exposure—it's kind of fun again to hear what various people say. We had a real issue about surplus levels at our table. They were too high or too low. Finally, we debated the quick ratio. Was it particularly low? We noted that with the amount of real estate, there could be some potential problems there, so we wanted it to be a little bit higher on the liquidity side.

Mr. Horbatt: To end the suspense, we will show the case study's final ratings:

CASE STUDY—ABC MUTUAL

S&P: AA- Moody's: A1 D&P: AA WEISS: B- A.M. BEST: A

(Weiss' rating philosophy reflects a more conservative approach than the other rating agencies)

Next, A.M. Best's commentary:

Effective January 22, 1996, A.M. Best Co. lowered the rating of ABC Mutual Life Insurance Company to A from A+. The current rating reflects the ABC Mutual's good position in the variable life insurance market, its conservative investment posture, and its excellent capitalization. However, this rating adjustment reflects challenges faced by ABC Mutual in *increasing the scale and earnings* of its actively marketed variable life, pension and individual annuity segments. (Emphasis Added)

The rationale used by each of you was excellent and you could make a judgment call going either way in such event, but the dominant critical variables were the continuing questions about variable life, the challenges in the pension and annuity

markets, and the other challenges, such as whether they could sustain whatever advantage they enjoy today. Best took the view that the financial solidity is not an issue. They thought that this company faces significant challenges going forward in the years ahead. It may or may not.

From the Floor: What was different on January 22, 1996? I think that Best raised the bar as opposed to the company performing less satisfactorily.

From the Floor: And 1995 was a better year than 1994. The company had higher earnings.

From the Floor: You must realize when they did this rating on January 20, 1996, 1995 had no final variable data.

From the Floor: But they did have three quarters worth of information.

Mr. Horbatt: They indeed had the first nine months of 1995 in house.

From the Floor: This is different within each of the rating agencies. You're lowering my rating at a point in time when everything in my company is better than it looked last year or the year before.

Mr. Goodfriend: Let me answer that. I think I mentioned it, but maybe I didn't stress it enough. Some time ago they decided that there should be fewer companies at the top as "superior" companies. Those companies that have sustainable advantages must really differentiate themselves clearly from the pack.

From the Floor: But that wasn't one of my qualitative factors to evaluate; that wasn't one of my options.

Mr. Goodfriend: But you understood that to be a "Superior" company and merit the A+ rating, you had to have the characteristics. There may have been a lower bar previously. What was adequate and maybe even "Excellent" a few years ago was no longer equally valid.

From the Floor: This company was never an A+; I disagree with that.

Mr. Horbatt: I'm sorry you do.

From the Floor: They were never an A+ company. They were always an A company. It's just that Best messed up and made them an A+.

Mr. Horbatt: I don't want you to leave with that conclusion.

From the Floor: No, Best changed their criteria. They have toughened the criteria.

Mr. Horbatt: True, they've raised the standards.

From the Floor: They've raised the bar for what it takes to be an A+ company. In the 1980s this company was losing money, maintaining its dividend scale, making those substantive capital investments in the systems, and they kept their A+ rating.

From the Floor: We were the "Bigger-Fish-To-Fry Rating Agency" and we were worried that we were going to go in there and have egg on our faces because we'd be coming in and changing a rating on a company that we had rated A+ the year before. I didn't see anything in any of the numbers that said I should change my rating, if I believed what I did a year ago, which was the assumption I was pointing to that I raved about.

Mr. Horbatt: I think the only chart that we showed you that really mattered was the one that showed the A.M. Best distribution by rating categories.

Mr. Goodfriend: But I think we also pointed out that the bar has been lifted in terms of looking ahead. Solvency and status quo ante are just not enough, and if that message didn't come through I really failed to articulate that. I tried to emphasize it.

From the Floor: Does Best announce publicly that the bar has been raised?

Mr. Goodfriend: Oh, yes, they say it in all their speeches and presentations and whenever they can. They concede that this creates difficulties for the companies, but so be it. Life is very unfair. That's what Best is doing and S&P does the same thing now. Their view is that in light of this highly volatile market with much more keenly competitive entrants from outside who have never been in insurance before, the changing regulatory environment and the changing capital, changing distribution requirements, what was satisfactory before may or may not be going forward.

You must clearly differentiate yourself from the pack; that is, that you have a game plan that is sustainable over your peers. This is not easily done. That means that a company that does fine and continues on its merry way gets penalized. That's what is unfair about it. It doesn't mean this company is going into the tank. It doesn't mean its policies are at risk, and it doesn't mean that you should stop dealing with the company. But what it does mean is that to get that highest rating you're going

to have to show strengths demonstrably above what is an A rating called "Excellent." "Excellent" was the prior top of the line. It's no longer the top of the line.

From the Floor: It means they're just not the cream of the crop or they're not expected to be.

Mr. Goodfriend: That is clear, leaving aside Best's biases. This company may be categorized as a relatively average organization. There are a couple of things that make it a little more distinctive, but in the main, its ratios are about average.

From the Floor: I didn't necessarily follow that. Best is going to be delivering fewer A+ labels. This one went from an A+ to an A. We had to consider what makes it go from an A+ to an A.

Mr. Goodfriend: The significant thing would be if in this year or next it were to follow suit and change it to an A-. That type of gradation would be very serious. It bruises egos to go down from A+ to A, but you could argue that it's not that meaningful. If the company faces two down years out of three or out of four, that would be a very, very negative characteristic and for that to happen, there would have to be a marked deterioration, not in the standard, but in the company per se.

Any other questions, or is there anything that we overlooked or wanted you to focus on that we didn't bring out clearly enough?

From the Floor: I think A.M. Best has come up and said they're trying to calibrate the insurance industry to other industries and that the whole industry was rated too high. There's also a bias towards the larger companies, which they will admit to. This is a medium-sized company.

Mr. Horbatt: I think I mentioned that they are forced into this competitive battle of having erred on a number of occasions in the past either through overt lapse or just bad judgment.

From the Floor: They have had litigation actually against their judgments.

Mr. Horbatt: They don't want to face that either, now that S&P and others are battling for market share against their company. When you do that, you've got to change the people and the standards internally and that's what they've done.