WASB INSURANCE PLAN

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Selecting a Nearly-Infallible Machine: Insurance Company Ratings

Introduction

Imagine needing a machine to work 365 days per year, 24/7.

Imagine the machine must fulfill a specific purpose for no less than three years, and may be called upon to perform certain tasks, which cannot be duplicated by any similar or replacement machine, for 20 years after the initial three. Machine breakdowns are unacceptable and such failures have grave financial and reputational implications for you on a professional and personal level.

Imagine you may select from two machines, R or T, made by two different companies. Because of usage rates, you buy a machine each year (you can only afford one per year), and can buy from either of the two manufacturers in subsequent years.

The machines are not infallible, and the breakdown rates, based on usage (365 days and 24/7) are .99 percent for R and .87 percent for T. Each year, the price difference between R and T is 8 to 13 percent, with T being more expensive. Budget constraints are constant, but the consequences of breakdown, though rare, are daunting.

Which machine would you buy?

Consider this same situation – needing something to always operate as expected – in the context of property and casualty insurance. In this instance, the breakdown is an insurance company's financial impairment, defined as its struggle, or inability, to pay claims.

However, instead of breakdown rates, one must rely on ratings assigned by firms employing scales of A++ to F, or a combination of capital and lower case letters, plus and minus signs, and sometimes numbers.

Property and casualty insurance companies apply for Financial Strength Ratings (FSR) from several different firms. The insurance rating service is an opinion on carriers' financial strength, and ability to meet ongoing insurance policy and contractual obligations.

How many agencies issue FSRs for insurance companies?

There are five prominent players in the FSR business. A.M. Best (Best) is the oldest, and the one which issues the most FSRs. Weiss Ratings (Weiss) comes in second place with the number of insurance company ratings it issues. Though Moody's, Standard & Poor's (S&P) and Fitch issue insurance company ratings, they focus more on credit ratings. Demotech is a lesser-known organization, and focuses on smaller, regional insurance companies.[1]

How does an insurance company obtain an FSR?

Obtaining an FSR from Best, Moody's, S&P or Fitch comes with a price – literally. In return for a fee from the carrier, these rating agencies perform quantitative analyses of carriers' financials, reserving and pricing policies, reinsurance arrangements and capital management strategies. They also conduct qualitative research, usually in the form of interviews with top management, to understand the overall strategic direction of the company.[2]

On the other hand, Weiss issues ratings based solely on publicly available information, and carriers do not pay Weiss for same. Weiss' revenue comes from the people and companies who buy the ratings. Per the United States General Accounting Office (GAO), "Weiss places far less reliance than the other agencies on analysts' judgement."[3]

Wait. Isn't collecting a fee from the company being rated a conflict of interest?

The issue of whether a carrier paying for a rating gives rise to bias is unanswered, but in some minds, it conflicts with any claim of independence.

The *insurance* company rating agencies underscore their objectivity and independence. Yet, the *credit* rating agencies – also Best, S&P, Moody's and Fitch, have been alleged to solicit business by threatening to downgrade companies' ratings. In a case uncovered by the Washington Post, Moody's decreased its rating of Hanover Re's bonds over successive years, coincidentally after Hanover Re declined to buy a

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[1] Joseph F. Mangan, "When Comparing Apples-To-Apples Whom Should You Trust'", *Insurance Journal*, May 17, 2004, <http://www.insurancejournal.com/magazines/coverstory/2004/05/17/42616.htm>.

[2] Tom Stephenson, "The Value of (or problem with) Rating Agencies," *Robus Research*, July 5, 2013, <http://www.robus-risk.com/the-value-of-or-problem-with-rating-agencies/>.

[3] William J. Kruvant et al., "Insurance Ratings – Comparison of Private Agency Ratings for Life/Health Insurers," (GAO/GGD-94-204BR Insurance Ratings), *United States General Accounting Office, Briefing Report to the Chairwoman, Subcommittee on Commerce, Consumer Protection, and Competitiveness Committee on Energy and Commerce House of Representatives,* September 1994, <http://www.gao.gov/products/GGD-94-204BR>.

Moody's rating, already having purchased them from Best and S&P. "When Moody's changed [Hanover's] rating to 'junk' status, Hanover lost $175M in market capitalization."[2]

Are all ratings equivalent to one another?

No. An A+ from Best is not the same as an A+ from Weiss.

Huh?

The five agencies use different combinations of letters and plus/minus signs.

Comparison of Insurance Company Rating Agency Scales

Rating	Bands	Weiss [a]	Best [a, b]	S&P [c]	Moody's	D&P
Secure	1	A+, A, A-	A++, A+	AAA	Aaa	AAA
	2	B+, B, B-	A, A-	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-
	3	C+, C, C-	B++, B+ B, B-	A+, A, A- BBB+, BBB, BBB-	A1, A2, A3 Baa1, Baa2, Baa3	A+, A, A- BBB+, BBB, BBB-
Vulnerable	4	D+, D, D-	C++, C+ C, C-	BB+, BB, BB- B+, B, B-	Ba1, Ba2, Ba3 B1, B2, B3	BB+, BB, BB- B+, B, B-
	5	E+, E, E- F	D E, F	CCC, (CC, C) (D), R	Caa, Ca, C	CCC+, CCC, CCC- DD

[a]Weiss and Best use additional symbols to designate that they recognize an insurer's existence but do not provide a rating. These symbols are not included in this table.
[b]Best added the A++, B++, and C++ ratings in 1992. In 1994, Best classified its ratings into "secure" and "vulnerable" categories, changed the definition of its "B" and "B-" ratings from "good" to "adequate", and assigned these ratings to the "vulnerable" category. This table contains GAO's assignment of Best's ratings to bands based on our interpretation of their rating descriptions prior to 1994.
[c]S&P discontinued CCC "+" and "-" signs, CC, C, and D ratings, and added the R rating in 1992.
Source: GAO.

OK, so different combinations of letters are used. But the distribution of comparable ratings amongst the agencies is the same, right?

No. Approximately 72 percent of the carriers rated by Best receive an Excellent (A-) to Exceptional (A++) rating. 55 percent of the companies rated by S&P fell into that same range (described as AA- to AAA).[4] Conversely, Weiss' ratings tend to distribute more moderately with only 35 percent of companies receiving a rating comparable to the same Best category.[5] Said another way, Weiss is known in the industry as the "hard" grader.

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[4] Steven W. Pottier, David W. Sommer, "Property-Liability Insurer Financial Strength Ratings: Differences Across Rating Agencies," *The Journal of Risk and Insurance,* 1999, Vol. 66, No. 4, 621-642.
[5] The Weiss Approach ©2003, <www.WeissRatings.com>.

Why fret over ratings as long as you choose one in the secure range, which for Best begins at B+?

Rating agencies divide their ratings into two general groups: secure and vulnerable.

- Best's secure group begins with B+ and goes up. There are five levels higher than Best's B+ rating. A "B" rating tops Best's vulnerable category. It is a fact that the impairment rate for companies rated B+ or B++ by Best is significantly higher (worse) than companies rated A or A- by Best. Over a 15-year period, the cumulative impairment rate for B+/B++ rated companies was 18.46 percent; the same percentage for A/A- rated companies was 9.39 percent.[6]

- Generally speaking, insurance companies receiving the two highest Best's ratings are the least likely to become financially impaired.

- Weiss' secure group starts at C- and improves from there.

- Insurance agencies and brokerages usually set the minimum acceptable rating bar at no less than A-, on the Best scale. Many of these firms have internal staff who review carrier financial information.

- Insurers rated at the bottom of the secure range are more likely to fall into the vulnerable range, and insurers in the vulnerable range are more likely to become impaired or insolvent.[2]

Is one rating agency "better" than the others?

If one presumes "better" means the rating agency is better at predicting which carrier may become impaired, and such prediction takes the form of a low rating prior to failure, then Weiss' ratings have an edge over Best. A 1994 GAO study indicated, "Weiss ratings reflected financial vulnerability first three times more often than [A.M. Best]." This same study reviewed which of the ratings agencies, including D&P (now Fitch's), Moody's and S&P, was first to assign a vulnerable rating. Weiss was the first to assign a vulnerable rating in five out of six cases. In no case was Best, S&P or D&P the first to assign a vulnerable rating.

According to that same GAO study, Weiss assigned a vulnerable rating to 23 of the 30 impaired firms before Best. And more meaningful, the number of days Weiss assigned a vulnerable rating before the regulatory action occurred ranged from a low of 40 to a high of 617 days. For Best, the time period ranged from six days <u>before</u> the regulatory action to five days <u>after</u> the regulatory action – with four out of the six occurring after the action.[3]

In one instance, on March 5, 2015, Best downgraded a carrier, Lumberman's Underwriting Alliance (LUA), from B+ to E *after* the Missouri Department of Insurance issued its order to place the exchange under regulatory supervision. Three months earlier, Best continued to assign LUA with a B+ rating, but

[6] "*Best's Impairment Rate and Rating Transition Study – 1977 to 2014,*" Best's Special Report – U.S. Property/Casualty & Life/Health, Trend Review, August 21, 2015, <http://www.ambest.com/nrsro/FormNRSRO_Ex1_RatingsImpairment.pdf.>.

revised the outlook from stable to negative. Weiss issued a C rating to Lumberman's one year prior to the failure, and at the time of the failure had LUA rated at E-.[7]

Given the above, why are Best's ratings used most often?

It's likely Best is used most often because its brand is the most well-known, having started in 1906. Additionally, it rates the largest number of insurance companies. Weiss is the baby of the rating agency family, only having begun issuing insurance company ratings in 1989.

Is assessing the predictive value of different rating agencies difficult?

Yes.

Why?

For a number of reasons, studies of the predictive value of various agencies' ratings are few and far between.

- Historically, the sheer number of insurance company impairments is low. Over a 37-year period (1977-2014), the average one-year impairment rate for all insurance companies (property/casualty and life/health) was .64 percent.[6]

- Second, not all agencies rate the same insurance companies. Recall that of the six agencies, all except Weiss charge the insurance companies for a rating. The prices vary significantly. Best's minimum charge is $1,000, with the higher end coming in at about $15,000*, whereas Moody's or S&P's is between $15,000 and $45,000.[5] In addition to the booked charge, the time and expense of providing information to analysts and attending qualitative meetings means the actual cost of a rating can be much higher.[4]

- Finally, not all impaired or insolvent carriers are rated by any agency.

So what's a district to do? Recommendations:

- The number of ratings analyzed is important. Ask for ratings from at least two rating agencies. If you don't know which agencies to pick, we recommend Best and Weiss. They are usually about one grade apart, with Best offering the higher letter grade.

- In addition to the letter rating, Best issues an outlook descriptor, such as stable or negative. Be sure to ask for this outlook adjective, along with the rating.

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[7] *"A.M. Best Downgrades Ratings of Lumbermen's Underwriting Alliance,"* Best's Insurance News & Analysis, Press Release, March 5, 2015, <http://www3.ambest.com/ambv/bestnews/presscontent.aspx?altsrc=14&refnum=22287>.

- Trend is important. Ask for the current and two prior year ratings for the recommended insurance companies.

Summary

1. When your district buys any insurance, knowing and understanding the FSRs assigned to the proposing companies is critical. Think worst case scenario: if a carrier becomes financially impaired, how will the district pay claims?

2. Remember this: Over time, carriers rated B+/B++ by Best are almost twice as likely to become impaired than those rated A/A-.

3. Questions? Call Joy Gänder, CPCU, ARM, (608) 286-0286, Gänder Consulting Group, LLC — Complimentary risk management counsel available to all Wisconsin public school districts due to membership in WASB, Inc.

*This is an estimate as A.M. Best, claiming customer confidentiality, has not divulged fee amounts since 1994.[8]

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[8] The Insurance Forum, January, 1997.