

## **Insurance Companies: Help Clients Trust the Ratings**

By Elaine Floyd

"Some of my clients own variable annuities, whether purchased through me or through another advisor and since transferred to me. I read both sides concerning the strength of the insurance companies, about their stock price not reflecting their ability to meet policyholder obligations, or that the same companies are in danger of not meeting their obligations. Beyond the ratings agencies, how can I decipher the noise out there about insurance companies?"

—Question from Horseshoath member Jeff O.

This question reveals the skittishness of advisors and clients today. In some ways, the insurance question is more critical than the bank or money market question, because of the long lag time before the eventual payoff. The whole reason people buy life insurance or put money into an annuity is for the promise of a future benefit.

If they can't be sure the benefit will be there, it negates the entire proposition. If banks, pension funds, automobile companies, and other bastions of strength can go down in this fragile economy, what's to keep insurance companies from facing the same fate?

When the Treasury Department announced that TARP money would be available to life insurance companies, it set off alarm bells. Of course it makes sense that insurers would have the same kinds of toxic assets on their balance sheets that banks have, but somehow we expect insurance companies to figure out how to deal with them. Insurance companies are in the business of managing risk, after all. And they have more stringent capital requirements, so they should be OK. Right?

As it turns out, very few insurance companies will be accepting TARP money. Reasons include the stigma of needing help and also the operational constraints (read: limits on executive compensation) associated with having the federal government involved in their business. Some insurers even seized the public relations opportunity to announce that they are doing just fine and have no need for a government bailout.

But as long as there are doubts about the industry's ability to pay, people will be reluctant to turn over their money to any insurance company, and clients will lose a valuable mechanism for transferring risk. So it is extremely important that you be confident in your understanding that the insurance companies you choose to do business with are financially sound and will be able to pay benefits in the future as promised. If you can't answer this fundamental question to your complete satisfaction, you can't recommend insurance products to clients. There's no "maybe" in this

business.

## **How insurance ratings work**

Jeff's question inspired me to revisit the rating system to see if it tells us what we need to know or if we need to go beyond the ratings agencies to "decipher the noise" about insurance companies. I came away believing we need to quiet the noise, not decipher it. People lost confidence in the major ratings agencies a year ago, when the subprime mortgage market blew up. "The flaws of rating agencies are a melange of conflicts of interest, misleading grading systems that classified complex securities as if they were much like simple corporate bonds, and a backward-looking approach that proved particularly useless," wrote David Wessel in the *Wall Street Journal* in May 2008.

But bond ratings and insurance company ratings are very different. A bond rating relates to one issue; an insurance rating relates to the whole company. A bond that goes from AA to A will likely lose value in the marketplace because bond prices directly reflect the issue's quality, or the deterioration thereof.

Conversely, an insurance company that goes from A+ (Superior) to A (Excellent) won't affect policyholders at all. The rating downgrade doesn't mean the company is likely to default on its obligations, only that it's not quite as strong as it once was.

In fact, insurance rating downgrades may be cause for optimism, because they prove that somebody is looking at the very long term and issuing a warning to companies. A.M. Best is the most widely recognized ratings agency for the insurance industry. In 2008, Best downgraded ratings on 31 companies, providing a huge wake-up call to the industry. Most companies still have the time and resources to improve their positions before they'll have to meet obligations to policyholders.

It is worth noting that insurance companies in general tend to be much more alert to possible dangers and quicker to take corrective action than we saw last year with the investment banks. AIG notwithstanding (a special case because of its involvement in credit default swaps), insurers know their very survival depends on accurately gauging risk levels and making the necessary adjustments. In the wake of the financial crisis, they are making significant changes in the way they do business, according to a PricewaterhouseCoopers report, and are paring back some of the annuity benefits that had gotten out of hand in the race for client dollars.

## **What goes into the ratings**

Clients who think they can second-guess an insurance company's financial health based on what they read in the newspaper are fooling themselves. The ratings agencies analyze hundreds of different data points according to an objective, comprehensive methodology that looks at how prepared the insurer is to handle many types of risk. Just because a client has heard something negative about a particular insurer doesn't mean

its policyholders are in jeopardy.

As mentioned above, A.M. Best is the oldest and most widely recognized ratings agency for the insurance industry. It provides highly comprehensive coverage, considering not just a company's current capital structure but also its overall risk management philosophy gleaned from its business mix, experience and depth of management, and reactions to unexpected events. The further out its obligations are, the more weight Best gives to these "business profile" issues as opposed to the company's current capital structure.

Currently the company is emphasizing "enterprise risk management," or the degree to which a company has established a holistic, risk-aware culture throughout the entire organization. "If a company is practicing sound risk management and executing its strategy effectively, it will maintain a prudent level of risk-adjusted capital and perform successfully over the long term," says Best's January 2008 report "Risk Management and the Rating Process for Insurance Companies."

Still, balance sheet strength is the most important area when determining a company's ability to meet its current and ongoing obligations to policyholders, according to an explanation of Best's rating system and procedures. The company looks at the type and degree of leverage an insurer maintains, how it reduces risk through the use of reinsurance, the adequacy of policy reserves, the quality and diversification of invested assets, and how ready it is to meet unexpected needs for cash without the untimely sale of investments or fixed assets (liquidity). Individual results are compiled and compared with industry composites.

A.M. Best classifies insurers as either "secure" or "vulnerable." Companies deemed secure may be rated A++ or A+ (Superior), A or A- (Excellent), or B++ or B+ (Good). Even companies with the lowest rating within the "secure" category (B+) still have a "good ability to meet their ongoing obligations to policyholders." A rating of B or B- (Fair) puts the company into the vulnerable range and goes down from there: C++ and C+ (Marginal), C and C- (Weak), D (Poor), E (Under Regulatory Supervision), and F (In Liquidation). A rating of S means the rating has been suspended because of sudden and significant events affecting their balance sheet strength or operating performance.

A.M. Best posts ratings changes on its website. You have to pay to gain access to complete ratings information, but the A.M. Best website has a lot of free information, and most insurance companies will provide you with their A.M. Best rating. If they don't, avoid them.

The other major ratings services are Standard and Poor's, Moody's, and Fitch, but none has the insurance expertise or credibility of A.M. Best. According to the website Immediate Annuities.com, S&P charges an insurer between \$15,000 and \$28,000 to assign a rating, Moody's charges \$25,000, and A.M. Best charges \$500.

## What if an insurance company fails?

If you or a client thinks there is even a remote possibility an insurance company could fail, stay away from it. Insurance is supposed to buy peace of mind. If it costs a little more in the form of higher premiums or less generous benefits in order to go with a stronger company that the client trusts completely, it's a small price to pay for that assurance.

But bad things can happen to good companies, so understanding the procedure that takes place when an insurance company goes into financial distress might provide an extra measure of assurance. Here's what happens. When a company enters a period of financial difficulty and is unable to meet its obligations, the insurance commissioner in the company's home state initiates a process— dictated by the laws of the state— to help the company regain its financial footing. This is called rehabilitation.

If it is determined that the company cannot be rehabilitated, the company is declared insolvent and is liquidated by the state insurance commissioner or appointed receiver. The receiver oversees an accounting of the company's assets and liabilities, converts assets to cash, and pays creditors having valid claims against the insurer in accordance with payment priorities specified by state law.

If there is not enough cash to pay policyholders in full, the state's life and health guaranty association steps in. In some cases, the guaranty association works to find a financially sound company to take over the troubled company's policies. In other cases the guaranty association pays policyholders directly, subject to limits established by the state.

Common limits are \$300,000 in life insurance death benefits, \$100,000 in cash surrender value for life insurance, \$100,000 in withdrawal and cash values for annuities, and \$100,000 in health insurance policy benefits. This coverage is funded by all the insurers doing business in the state, who are assessed a share of all premiums collected.

Policy values above these limits may be submitted as a policyholder-level claim against the estate of the failed insurance company, and are paid before vendors. In recent insolvencies more than 90% of policyholder benefits have been covered in full, according to the National Organization of Life and Health Insurance Guaranty Associations. Since 1983, only about 60 life and health insurance companies have gone broke, according to A.M. Best.

Additional facts about state guaranty associations:

- The guaranty association of the client's resident state provides the protection, even if the policy was purchased in another state.

- Policyholders who reside in states where the insolvent insurer was not licensed are covered, in most cases, by the guaranty association of the state where the failed company was domiciled.
- Policyholders who are paying premiums must continue to do so. The premiums go to the guaranty association that is continuing coverage.
- Guaranty association coverage includes direct individual or group life and health insurance policies as well as individual annuity contracts issued by the guaranty association's member insurers. Any portion of the policy in which investment risk is borne by the individual, such as with a variable annuity, is not covered.
- Long-term care insurance is typically considered health insurance for guaranty coverage.
- Most states have laws prohibiting insurance agents and companies from using the existence of the guaranty association system in any advertising or as an inducement to purchase insurance or annuities.

The important point to make with clients is that they can and should trust the ratings, not the newspaper headlines, when forming opinions about the strength of any particular insurance company. If they already have an annuity or life insurance policy and are worried about it, look at the rating. If A.M. Best puts it into the secure category, they have nothing to worry about, even if the rating has been downgraded within the category.

Clients holding annuities with secure companies should definitely be talked down from paying high surrender charges to cash out because of unfounded fears triggered by news headlines. The ratings agencies know what they're doing when they analyze insurance company finances. The rest of us lack the data and the expertise to do it ourselves, so we might as well trust the ratings. That's what they're there for.