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Reliance Insurance on the Brink

Ratings Too High

WE'VE BEEN WRITING about Reliance a lot lately, and with good reason. It's mired in problems, is in weakened financial shape, and faces the specter of potential rating-agency downgrades. Because Reliance's business is heavily dependant on commercial insureds, it needs "secure" ratings in order maintain the confidence of its clients and insurance brokers.

Reliance Insurance Company is currently rated "A- (Excellent)" by A. M. Best, "Baa2 (Adequate)" by Moody's, and "A- (Strong)" by Standard & Poor's. These ratings, which fall into the secure category, do not accurately reflect Reliance's precipitous condition.

Ratings are supposed to be a reasonable reflection of a company's financial strength and ability to pay claims, and should provide a dependable assessment of credit risk. Because Reliance is a large company in borderline condition, rating agencies are reluctant to lower Reliance's ratings to the "vulnerable" category and set off a chain reaction that would cause people to be more reluctant to do business with Reliance, which would put greater pressure on its business, which would further stress its finances, which would likely lead to its failure.

Rating agencies are loathe to exert such an influence—even if that influence is the result of an honest assessment. A rating agency's job, however, is to give a blunt opinion, regardless of the consequences. Its attitude should be "Damn the torpedoes—full speed ahead!"

The Odds of Failure

Companies that have secure ratings are supposed to have a negligible chance of failing, particularly over the short term. A 1991 study of life insurance company failures conducted by Lee Slavutin showed that the 10-year failure rates for life-insurance companies with A. M. Best ratings of A+, A, and B+ were 0.3%, 1.4%, and 0.4%, respectively. A 1994 study by Best showed that the three-year failure frequencies for life/health companies rated A+, A, and B+ were 0.21%, 0.27%, and 0.36%.

A Moody's study of the five-year cumulative default rates for corporate bonds during the 1970-1993 period showed that the one-year default rate was virtually nonexistent for bonds rated "A" and higher. The default rate rose significantly as one descended the credit scale. It was almost 2% for "BB" bonds, and more than 8% for "B" bonds.

The question we pose, therefore, is this: Does Reliance Insurance Company have one chance in one hundred of failing within a year? If it does, then it doesn't deserve its current ratings. Instead, it should probably carry a "B" rating—at most—from the rating agencies.

It's impossible to calculate the *precise* odds of Reliance's failing, but it doesn't seem rash to say that Reliance has a 5% or 10% chance of failing. (It doesn't seem rash to say that it has a 20% chance of failing, either.)

Of course, a company with a 10% chance of failing has a 90% chance of *not* failing. But property-casualty insurance buyers should generally confine their business to companies that have a *negligible* chance of failure. Since the premium paid is only a small percentage of the potential loss transferred, the failure of a property-casualty insurer can expose a policyholder to unmanageable risk. (A reasonable case can be made for taking greater credit risk when buying an investment product such as an annuity—assuming that one gets "paid" for taking that added risk. Annuities are like bonds, and one can assemble a diversified portfolio.)

On Monday, A. M. Best lowered Frontier's rating from A- to B++. This move may indicate a more aggressive posture by Best with regard to weaker companies that are on the borderline. (Although B++ is still considered a "secure" rating, many in the insurance market do not view it as such.)

No rating agency wants get stuck by having a "secure" rating on a company that's in danger of failing.

The heightened competition between rating agencies does not bode well for weak companies. ■

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What the ratings are supposed to mean.

Excerpts from rating agencies definitions:

Moody's

Strong

A	Insurance companies rated A offer good financial security. However, elements may be present which suggest a susceptibility to impairment sometime in the future.
Baa	Insurance companies rated Baa offer adequate financial security. However, certain protective elements may be lacking or may be characteristically unreliable over any great length of time.

Weak

Ba	Insurance companies rated Ba offer questionable financial security. Often the ability of these companies to meet policyholder obligations may be very moderate and thereby not well safeguarded in the future.
B	Insurance companies rated B offer poor financial security. Assurance of punctual payment of policyholder obligations over any long period of time is small.
Caa	Insurance companies rated Caa offer very poor financial security. They may be in default on their policyholder obligations or there may be present elements of danger with respect to punctual payment of policyholder obligations an claims.

A.M. Best

Secure

A and A- (Excellent)	Assigned to companies which have, on balance, excellent financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have a strong ability to meet their ongoing obligations to policyholders.
B++ and B+ (Very Good)	Assigned to companies which have, on balance, very good financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have a good ability to meet their ongoing obligations to policyholders.

Vulnerable

B and B- (Fair)	Assigned to companies which have, on balance, fair financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have an ability to meet their current obligations to policyholders, but their financial strength is vulnerable to adverse changes in underwriting and economic conditions.
C++ and C+ (Marginal)	Assigned to companies which have, on balance, marginal financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have an ability to meet their current obligations to policyholders, but their financial strength is vulnerable to adverse changes in underwriting and economic conditions.

Standard & Poor's

Secure

A	An insurer rated "A" has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.
BBB	An insurer rated "BBB" has GOOD financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers.

Vulnerable

BB	An insurer rated "BB" has MARGINAL financial security characteristics. Positive attributes exist, but adverse business conditions could lead to insufficient ability to meet financial commitments.
B	An insurer rated "B" has WEAK financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.
CCC	An insurer rated "CCC" has VERY WEAK financial security characteristics, and is dependent on favorable business conditions to meet financial commitments.