The world's most dangerous insurance publication℠

SCHIFF'S

INSURANCE OBSERVER

March 21, 2002
Volume 14 • Number 5

Some Thoughts on Insurance Company Ratings

An Unusual Correspondence

The front page of the business section of yesterday's *New York Times* carried the following headline: "Credit Raters to Explain Enron Role." The rating agencies' explanations took place yesterday before the Senate Governmental Affairs Committee, and what they explained is why they continued to give Enron investment-grade ratings until shortly before it filed for bankruptcy.

We're sympathetic to the raters. They provide useful services and information, and their job is difficult. One cannot expect perfection from them. That said, there are times when they're so obviously wrong—so stubbornly wrong—that it makes one wonder.

Standard & Poor's, Moody's, and Fitch are the leading credit-rating agencies, but A. M. Best is the leader in the insurance business. It is, in the words of analyst V. J. Dowling, the industry's "de facto regulator."

Here at *Schiff's*, we've had a long-standing interest in financial strength, solvency, and ratings, and have covered these subjects extensively. Since Best has dominated the insurance-rating business, we've written about it more than the other raters.

In 1993 we wrote that Best was "The Will Roger of Rating Agencies" because "it almost never meets an insurance company it doesn't like." We focused on Best's unwillingness to downgrade large companies below the perceived "secure" threshold of A-. In subsequent articles we described how Best granted leeway to large, weak companies, how it "managed" ratings and how it held Confederation Life at A- even though it was aware that Confederation had undergone "a lengthy period of deterioration in [its] financial condition" that had "strained" its capital and "pressured" its earnings.

In 1994 we discussed how Best had continuously changed its ratings' definitions, rendering them somewhat meaningless, and we explained why the company's revised ratings and definitions portended a rash of downgradings. The Home and Reliance were two prominent insurers that then carried A- ratings.

In response to our articles, one of Best's top honchos (who was intimately involved in the ratings business), criticized us, questioned our motives, and said we were completely wrong. Our analysis was vindicated a couple months later when Best finally downgraded The Home, which subsequently failed.

During the following years we often wrote about weaker companies whose ratings were too high, especially Reliance and Conseco. (We also wrote that Best had improved considerably, but that it still had considerable room for improvement.)

In 1999 we stepped our coverage of Reliance—which we felt was in vulnerable condition—and asked when, if ever, Best (and others) would downgrade the company to the level it deserved. Between September 15 and November 17, 1999 we published five detailed articles about Reliance, including two entitled, respectively, "Night of the Living Dead" and "Reliance Insurance Company on the Brink: Ratings Too High."

Somehow, *all* the raters managed to keep up Reliance's rating. Best and S&P had it at A-, and Moody's had it at Baa2. We wrote that Reliance "should probably carry a B rating—at most."

On May 31, 2000 we tolled the death knell for Reliance in a series of articles called "Requiem for a Heavyweight." Finally, on June 8, Best downgraded Reliance to "B++ (Very Good)." On June 12 we wrote that, according to Best's definitions, Reliance should be rated "C++ (Marginal)" to "C (Weak)." We also wrote that Best tended to "manage" its ratings down, and cited Frontier as an example.

That prompted a letter from the Best honcho who had criticized our criticism. (We'll refer to the honcho as "Mr. Big.") Before getting to Mr. Big's letter, however, we'll mention something Murray Kempton said: "Journalists aren't thin skinned—they have no skin at all."

That quip suits us. It also suits A. M. Best, the insurance-rating agency that makes its living critiquing the financial strength of insurance companies.

On June 15, 2000 we received a note from Mr. Big:

June 15, 2000
Subject: Pathetic!

Dear David:

It's pathetic you didn't comment on S&P's debt rating on Reliance...Your journalistic integrity has been obviously compromised over the year by ad revenue—and in your unbalanced and overzealous criticism of A. M. Best. You're also getting sloppy...our rating downgrades of Frontier were not "managed," but were in response to new and material information that was disclosed by the company. (I call that proper management of ratings!)

continued

Conference Update

Our April 9th conference is almost sold out. If you're interested in attending, we suggest you make your reservation immediately. (See the notice on the following page.) We don't like turning people away, but attendance is limited to 200.

More importantly, at least we were actively following and responding to company developments, versus being either asleep at the switch or deciding to "duck" a deteriorating situation altogether like some other rating agencies did!

We responded to Big's note with a phone call. We told him it was odd that he considered us compromised by advertising—after all, *Best's Review* is filled with ads and *Schiff's* hardly ever has an ad. Our conversation was not especially pleasant.

On July 14, Best finally downgraded Reliance to "B (Fair)"—a "vulnerable" rating. We sent Big the following note:

July 14, 2000
Subject: Pathetic!

Dear Big:

I imagine that you will now agree that the only thing that was "Pathetic!" was A. M. Best's rating of Reliance ("A-" until June 8, 2000 and "B++" as of right now).

Best had ample opportunities to downgrade Reliance, but didn't downgrade it soon enough to be of any use to your subscribers—agents, brokers, insureds, etc.—who rely on Best's ratings. Best was *wrong*, and it's bad business to be so wrong...

I'm a fan of Best's publications—I read the books and magazines and find them useful...But you really put yourself out on a limb with Reliance (and a few other ultra-risky companies).

I look forward to receiving an e-mail from you saying that you have reconsidered matters and that you withdraw the comments you sent to me on June 15.

Five days later we received a response from Big:

July 19, 2000
Subject: Pathetic – Part II

David,

The [Reliance] insurance companies are solvent—the debt holders are not! The only ones that should be embarrassed for being *wrong* are the debt rating agencies—the ones you haven't grilled of late! Pull some numbers on the insurance subsidiaries and remember you need regulatory approval to upstream any dividends to pay holding company items like debt! ...I am not withdrawing anything beyond what I did on the phone—which was to apologize for the advertising comment! ...As for the rest—I'm waiting to read your story on how the rating agencies missed big time on the *debt* ratings, since default is imminent. Policyholders look solvent.

As of June 30, 2001, Reliance Insurance Company reported $8.8 billion of assets and $9.9 billion of liabilities. Reliance was placed into liquidation on October 4, 2001. On March 4, *BestWeek* reported that "the insolvency of Reliance is far reaching..." *continued*

'The Long-Term View'

PRESENTING THE ANNUAL

SCHIFF'S

INSURANCE CONFERENCE

Tuesday, April 9, 2002
8:30 am - 5:00 pm
New York City

Registration fee: $695 per person.
Call (434) 977-5877 or visit
http://www.snlcenter.com/schiff/spring2002/

9:00 a.m. It wouldn't really matter what **M. R. "Hank" Greenberg**, chairman and CEO of ***American International Group***, talks about, because. . .well, let's face it — *anything* he has to say about the insurance business is worth listening to. For the record, though, Hank will: 1) tell us what he's been thinking about, 2) share his outlook on the industry, and 3) have a ~~debate~~ ~~argument~~ ~~fistfight~~ chat with the ever-inquisitive David Schiff.

10:30 a.m. Devotees of eloquent prose about complex accounting matters cherish three fine books: *Unaccountable Accounting*, *More Debits than Credits*, and *The Truth About Corporate Accounting*, by **Abraham J. Briloff**, certified public accountant and Distinguished Professor Emeritus at ***Baruch College***. Abe has been a leader in exposing dubious, inconsistent, and incongruous accounting practices. He also has a longstanding interest in the insurance business, where such practices have a habit of turning up. He will tell you what's been troubling him lately.

11:20 a.m. Most insurance companies don't do things the way ***Cincinnati Financial*** does. And only a handful have posted long-term results as great as Cincinnati Financial has. **Robert Morgan**, who retired as CEO of Cincinnati in 1999, spent more than three decades building a company that was started (and still revered) by independent agents. Cincinnati has delivered value to its insureds and has made a fortune for its shareholders. Bob will give us something that's hard to find these days: an independent point of view.

Noon Decent food and fine conversation.

1:00 p.m. **Stephen Way** began working at Lloyd's when he was 15. He eventually came to America, where he founded ***HCC Insurance Holdings*** at the advanced age of 25. HCC is now a large specialty insurer and underwriting manager. In a no-holds-barred discussion, Stephen will tell us how this came about, and share his thoughts on capital preservation, diversification, underwriting discipline, and much more.

1:45 p.m. **Glenn Daily** is a rare breed: a fee-only insurance consultant who specializes in life insurance and annuities. He is an innovative thinker, prolific author, and consumer advocate. Glenn's talk, currently titled "Clueless Consumers: A real options analysis," will delve into a variety of subjects that will be of interest to anyone in the life insurance business, anyone who owns life insurance or annuities, or anyone who might want to own life insurance or annuities.

2:45 p.m. "We applaud owners who reward executives on premium growth," says **Jack Byrne**, chairman of ***White Mountains Insurance Group***. "This often provides fine opportunities for us later." During his career, Jack has resuscitated GEICO, fixed Fireman's Fund, and built up White Mountains. Jack is *not* interested in: market share, producing a predictable stream of quarterly operating earnings, or managing his business according to generally accepted accounting principles. His strategy is simple — to increase intrinsic business value per share. Jack will tell us what interests him these days.

3:45 p.m. As usual, **David Schiff**, editor of ***Schiff's Insurance Observer***, will interrogate the speakers and, when necessary, *force* them to answer brazen questions. David will have his say on the great insurance issues of the day and will discuss where he sees value (or the lack thereof).

4:30 p.m. Socialize with insurance mavens and observers. Discuss the day's events or make deals over **cocktails** while taking in the view from the top of the New York Athletic Club.

How could Big, Best, and the other raters have been so wrong about Reliance? (And how could the credit-rating agencies have missed Enron's problems?)

Raters are reluctant to downgrade a company that deserves to be downgraded if they believe that their downgrade may precipitate a death spiral or a run on the bank. Thus, they have had a tendency to pull their punches.

An insurance company rated A- is supposed to have about a 0.5% chance of failing over a 10-year period. If the rating agencies had been forced to think like bookies, we doubt that in 1999 or 2000 they'd have offered to pay 200-to-1 if Reliance were to fail.

If their own money had been on the line the odds might have been 20-to-1, and falling fast.

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Editor and Writer .... David Schiff
Production Editor .... Bill Lauck

Publisher .... Alan Zimmerman
Subscription Manager....... Pat LaBua
Advertising Manager ..... Mark Outlaw

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
321 East Main Street
P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

For questions regarding subscriptions please call (434) 977-5877.

Reprints and additional issues are available from our publishing headquarters.

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