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SCHIFF'S

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INSURANCE OBSERVER

Ratings' Clarification for Lumbermens and Kemper

Press-worthy Press Release

In our January 9 issue ("Death Spiral at Lumbermens and Kemper?") we made a small mistake. In the first column on the second page we provided a chronology of the rating agencies' actions, and wrote that Fitch downgraded Kemper to "BBB" on April 12, 2002. Our mistake occurred nine lines later when we wrote, "On September 12, Fitch lowered Kemper to "A-" from "A." Fitch's downgrade to "A-" actually took place on September 12, 2001—one year earlier.

We're noting our mistake at the beginning of an article (as opposed to at the end in small print) because Fitch did a good job and its downgrade was an excellent call. Furthermore, its downgrade was based solely on public information. "Kemper's management refused to interact, meet, or talk with us in a material way," said Keith Buckley, head of insurance ratings at Fitch.

On September 24, twelve days after Fitch's downgrade, the Kemper Insurance Companies, which are now rated "vulnerable" by all the raters except Best, put out the following press release:

Kemper Responds to Fitch Rating Action

The Kemper Insurance Companies said that Fitch has insufficient information to justify its downgrade of Kemper's financial ratings.

David B. Mathis, Kemper chairman and chief executive officer noted that, unlike Moody's, Standard and Poor's and A.M. Best, Kemper does not have a formal ratings relationship with Fitch.

"We didn't meet with Fitch, and did not provide them with any insight into our existing operations or our plans for the future," said Mathis. "I'm not sure how they came to their conclusion."

Mathis further pointed out that the ratings which currently have been assigned to Kemper by the rating agencies with whom the company meets on a regular basis—Moody's, Standard and Poor's and A.M. Best—are higher than the Fitch rating... Kemper is rated "A" by A.M. Best and Standard & Poor's and A2 by Moody's.

Fitch's initial downgrade, Kemper's press release, and the subsequent downgrades demonstrate that you don't need a weatherman to know which way the wind blows. Although it's generally helpful to have access to non-public information, it isn't always essential to form an important opinion.

Lumbermens is in critical condition now. Last Friday, for example, its surplus notes (which are an indicator of the company's financial strength), changed hands at fifteen cents on the dollar.

Kemper is not doing a good job of keeping the "ratings information" section of its website up to date. At 6:30 this evening the website stated that Kemper is rated "BBB- (Good)" by Standard & Poor's and "Ba1" by Moody's. That's wrong in a material way. Four days ago, S&P downgraded Kemper to "BB+ (marginal)" and Moody's downgraded it to "Ba2." Kemper's website still makes no mention of Fitch's rating.

Kemper Insurance Companies

On January 10, we received a letter from Keith Buckley of Fitch. An edited version appears below:

I wanted to provide some additional information on our ratings, following your article today on Lumbermens/Kemper.

To help your readers better appreciate how the different rating agencies performed with respect to Kemper, it may have been beneficial if you more strongly pointed out that Fitch was the first rating agency, by a wide margin, to reflect the problems at Kemper. Our April 2002 downgrade was four months ahead of Moody's and eight months ahead of S&P and Best. Further, our action, as disclosed in our press releases and reports, was based on public information, as Kemper management refuses to interact/meet/talk with us in a material way.

Though the "BBB" insurer financial strength rating in place in April was at the low end of "secure," the rating was also on "Rating Watch-Negative," which told policyholders there was a high likelihood of a future downgrade. Therefore, we did point out, in very clear terms, that there was tremendous downside in the rating.

The jury is still out on the accuracy of the insurer financial strengths ratings. As I write this, the company is not dead yet. We surely agree that the risk of insolvency is high, as reflected in our current financial strength rating of "B+." It is only if the company actually becomes insolvent in the near-term that one could argue the prior rating was too high, or that the timing of our action was too slow.

Throughout most of 2002, Fitch was the only market observer that seemed to be commenting on Kemper's developing problems. Not only was our April action well ahead of the curve, but our October research report was cutting edge in providing good insights. I believe it provided tremendous value to investors and policyholders. Alice Schroeder of Morgan Stanley actually reprinted most of the report in her weekly research report to investors.

You pointed out that Moody's was the first to bring Kemper's financial-strength ratings to the "vulnerable" level. This is true. That said, I think, on balance, Fitch was the true leader throughout 2002. For example, Fitch was the first to move the surplus notes rating to "junk" back in April. This was a critically important move from the perspective of investors.

As I mentioned, we are unable to interact with Kemper's management, whereas we understand the other rating agencies do interact. We suspect the flurry of rating actions in late December from the other agencies came after management gave the agencies advance notice of the so-called Berkshire "strategic alliance" unwinding. We could not react to that news until it became public and took time to analyze the information (including checking with market intelligence sources), in order to best understand the real situation. I think our rating action on January 7—moving to "B+" for the insurance company and "CCC" for the surplus notes—was a more reasonable action, given the facts, than those taken by the other agencies in late December. The fact Moody's and S&P followed with similar actions two days later supports that view, and again shows Fitch as a leader on Kemper.

We agree with Buckley that *Schiff's* should have been more emphatic about the good job Fitch did on Kemper. It provided an earlier warning than the other raters on Kemper's surplus notes, and its commentary, which was negative, was excellent. Although Fitch's "BBB" rating carried a "Rating Watch-Negative," we tend to pay less attention to rating watches than to the actual ratings. One has no idea how "negative" a rating watch is supposed to be, and not all negative rating watches lead to action. Ultimately, one must rely on something, and the something we rely on is the rating, which must speak for itself.

As we have noted before, insurance is about transferring risk. Risk that is transferred to weaker insurers is risk that may turn out not to be transferred at all. Although "BBB" and "BBB+" are "secure" ratings, insurance companies with those ratings generally do not have the margin of safety in their financial strength that we seek when purchasing insurance.

We've said it before and we'll say it again: It's worth paying up for financial strength.

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