CASUALTY ACTUARIAL SOCIETY
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Panel: Insurance Company Ratings

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ROBERT A. BAILEY: We are fortunate this morning to have a varied panel of experts who have taken time out of their busy schedules to come and discuss this important subject with us. I am also pleased too see how many of you have come to the last panel of a three day meeting in Disney World.

In the past three years we have passed through the worst solvency crisis since the period 1930, 1931, and 1932. About 80 companies have become insolvent in the past three years. Normally, there are only about five casualty companies a year that go under. The magnitude of that crisis, and the fact that many of those companies carried a good rating, an A or A+ up until a year or two of becoming insolvent, has created the tremendous demand for rating services that are more timely and more widespread. In other words, it includes the whole market, international as well as domestic, going into more depth into the management and ownership of the company and the way it does its business, and being more sensitive to street information and less dependent on mechanical number crunching. As a result, a number of rating services have emerged or expanded in recent years. Our panel members represent several of those new or expanded rating services. And now, Mike, if we can have that first slide.

Our topic this morning is insurance carrier ratings: Who does them? How are they done? And for what audience? Can we have the next slide now.

I've tried to list eight different institutions that do insurance carrier ratings for other people. Of course, we have many reinsurance companies and otherwise that rate insurance
companies themselves for internal purposes. The paper presented to us at this meeting by Steve Ludwig and Bob McCauley of Hartford is a good illustration of the depth of the analysis and the effectiveness of the analysis now being conducted by a number of major carriers for their own purposes. Here we have eight institutions that rate insurance companies for other people. The NAIC being the oldest; a license is a rating. Unfortunately, licensed companies become insolvent. In the last 15 years, the NAIC has had an early warning system but they only publish part of it, the mechanical part. As a result, the part that is published is an incomplete rating system and the published part has not changed much in the last ten years. Nevertheless, it is widely used by many segments of the market.

A.M. Best Co. has been the primary rating agency since 1899. Unfortunately, we are unable to have a representative of Best's participate on the panel. We invited them but they indicated that this is the busiest time of the year for them. I must confess that this is the first spring meeting of the CAS that I have attended in about six years.

The next five are represented on our panel. They will tell you how they rate companies and for what audience.

The last one -- the stock market -- we don't have a representative for that. We probably don't think of the stock market as a rating of insurance companies; nevertheless, it is an important one which we cannot ignore. Either the insurance company or its parent is normally listed on a public exchange. What happens to that stock price and what the market valuation is
-- the price per share times the number of shares -- and the change in that value and the relation of that value to the book value is an important indicator, especially for international companies, of where the financial statements are on an average a year or two old when you get them, and where the financial statements are even more distorted by statutory accounting conventions overseas than they are in this country. The stock market evaluation of some of the foreign companies is truly amazing and very informative.

I'd now like to introduce our speaker, Michael Miron, who is the U.S. Editor for Insurance Solvency International. Michael joined ISI, actually he merged with ISI in December of last year. He formed his own insurance rating service, International Insurance Financial Service, about five years ago. IIFS rates international companies and then last year formed the American Reinsurance Financial Service, which rates U.S. reinsurers. Both of those services were merged last December with Insurance Solvency International. Michael has had thirty years of financial experience in the insurance industry, including many years as the chief financial officer of the Motor Club of America Insurance Group in New Jersey. Michael Miron.

MICHAEL MIRON: Thank you Bob, and good morning. It's my pleasure to speak before such a large audience, up so early and obviously on their toes on what's going on in the insurance business.

I would like to give you a little background about the
service that I originally initiated and about the service into which we have merged so that you'll better understand from where we're coming.

In 1981, Robert Durham, who had extensive experience as a reinsurance underwriter with Insurance Company of North America, North America Re, and other groups, and myself, who basically was a number cruncsher, joined together to start a security service on international insurance companies. There was a huge void at that time in the market; the ailing companies were pouring into the United States and a good number of the second and third tier U.S. reinsurance companies were doing their retrocessions overseas and had this huge need to know.

Simultaneously, in London, John Gardner was starting a security service by the name of Insurance Solvency International. I think it's fairly well known by those who use this service and subscribe to them that the so-called mysteries of international insurance accounting are really no longer mysteries. After five, six, or seven years, depending on how you count, the statements of these companies around the world have been pretty well digested, in our case converted into U.S. formats, into U.S. dollars. The principles of accounting have been pretty well aired, and I think it's safe to say that you can get information on a basis comparable to the United States, although without all of the disclosures, almost anywhere on the globe. Both John Gardner in London, and myself from the United States, did extensive traveling and met most of the companies we rated, many times in Monte Carlo and, of course, in the London
market, we met people and had people visiting the United States visit with us. You really need that internationally because the level of disclosures is quite different. But the problems these companies have in publishing data and in compiling them is the same as in the United States. Sweden, for example, about three years ago redid its statutory reporting, and went into the problem of how do you report reinsurance transactions. The Japanese had the same problem -- where do you allocate investment income between the underwriting side and the investment side? All of these problems which lead to analysis are common worldwide.

In any case, I can state that by the end of last year we had ratings published on some 800 companies, all based outside of the United States. John Gardner had over 1,000 companies in his service with published data and available ratings.

Starting about a year ago, we came out with a service on American companies engaged in the reinsurance business. We called it American Reinsurance Financial Service, but it seems that we stepped on the toes of the American Reinsurance Company and their lawyers. I am very careful to describe it as a service covering reinsurance companies in the United States. In any case, there was again a perceived need. The one rating service we were aware of just missed out completely on the quality of its ratings. Too many companies were going under that had good ratings. There was another reason: I've done several studies indicating, and depending on how you count, somewhere between forty and 50% of the business done by companies engaged in the
reinsurance business in the United States have foreign parents. We believe sponsorship is a critical item in the evaluation of a company.

To look at a little company like Cologne Re, which was based in Stamford with $10 or $15 million net worth, is, in my view, of limited value unless you look at the whole family tree, at the parent company in Cologne, Cologne Re, which has a huge surplus and is the oldest reinsurance company in the world. And in turn, its parent, Colognia ______, which is the second largest company in Germany, and has a huge book of profitable automobile business. And in turn, the parent company to that, which is a bank, owned by private interests.

That's just one example of looking at a branch and understanding what the whole tree is. Almost half the companies we published last year and we did just over 100. One of the toughest assignments in rating companies was getting companies to rate. In early '86 we said we were going to do ratings on 100 companies without being very careful about our count. As companies withdrew from the market, the toughest thing we had to do was to find 100 companies. In fact, I think some of the intermediaries who bought our service really weren't interested in security; they were looking for new markets for their customers.

In any case, in December I sold out or merged with John Gardner's service. The international service is now being run or published, and the analysis done out of London with phone call service in the United States. To that extent, I'm available to
his customers. We think, and I know from my own experience, that
the phone discussions with the subscribers is a key part of this
service. It's difficult to put negative thoughts in writing but
they exist, and even if you can't say them with all the laws of
liable and slander and so forth, it's that flavor that sometimes
makes the real difference. There is no doubt that many
subscribers called me in Stamford, when I was running my own
service, to get the flavor of the people behind the company. Who
are they? Where are they from? That was a key part of the
service.

In any case, the people from London saw the need to expand
their service to worldwide basis. I might mention they are owned
by a stock brokerage company which has a subsidiary in rating
banks. They rate banks in the United States and the rest of the
world. They are rating insurance companies in the rest of the
world, and this is the last step in completing their circle.
This summer they are shooting for the initial release of their
American edition. It's take a lot of time to reprogram and set
up computer analysis to conform the American service with the
international service. But a lot of their subscribers as well as
a minority of mine were overseas subscribers, and to some
practical extent we're trying to conform the reports, though
everybody knows that if they want to read about the sponsorship
and the parentage of a company, that there is some logical place
in the reports where they can find them.

As far as our audience is concerned, I think I can explain
it best by who bought our subscribers to the American service.
The ten largest reinsurance intermediaries in the United States were all subscribers. Most of the leading reinsurance companies, well, certainly, many of them became subscribers. Not necessarily to learn security but for the reasons that I'll get into they wanted to read about their competitors. We issue in depth reports, and the people we interviewed who saw what we were doing, saw the reports on themselves and were interested in the same reports on other people.

Lastly, there were a number of service companies that bought a service, law firms, accounting firms. One of the major Big 8 accounting firms bought twelve copies so they could put them in various offices around the country.

Let me get a little closer to who we rate by looking at the history of insurance in the United States, taking it in three stages. First, there were breaks between stocks, mutuals, and reciprocals. While that's ancient history, I think you will still see some statistics published by that criteria and classifications. Later, we had the property companies and the casualty companies. I suspect I'm giving away my age when I say I can remember when we were first able to put them both together on an automobile policy and later came the homeowner policy.

In 1986, we really have a different break in the business, at least in my view, it's personal lines and commercial lines. While there are some companies who do both, I think mixing statistics, mixing the companies, does very little for you. The reinsurers I take as a completely separate industry and treat it that way in a security service. I might mention from a security
standpoint, the guaranty fund system on personal lines is almost identical or somewhat similar to the FDIC. I'm not sure that the insurance buying public of personal lines of insurance has much need for security service, any more than the depositor who keeps under $100,000 in a bank with an FDIC sticker on the window, really needs much help in the analysis.

We're down to reinsurance companies and commercial insurers. The function, as we see it, of a security service is to provide data, and perhaps our judgement, to assist the professional buyer in making a decision. We eliminate his grunt work. What I always felt I was doing with the American service was collecting information wholesale and selling it retail. But this is a critical point because the services recognize that buyers really may not want all of this. They may just want the rating. There's a certain conflict in that. We don't pretend to usurp the buyer's responsibility in making the final judgment of where his money is placed at risk. We try to help them and give them information that we come to, but at least in our thinking the buck never moves from him. He's got the ultimate responsibility.

Going back to the information that we were gathering: wholesale and selling it retail. I might mention that the annual statement really is a problem for reinsurers. I spoke with the Reinsurance Association last week and they once again raised the question of a separate annual statement for reinsurers. I suggested that I would also like to be twenty one again. There is some merit to their position. The annual statement really
doesn't do justice for reinsurers in a number of ways. Funds that are held and are really offsets to outstanding losses can't be offset. We report losses net of reinsurance. We mix our apples and peaches. And perhaps the worst one, and the one I suggest that the Reinsurance Association get hopping on, is the accrual of premiums. In the course of our interviews last year, and during the American Reinsurance Service, we found that there is a small minority but a real number of companies who really ignore the accrual premium concept, which in turn throws off Schedule O and P, and they say, "so what"? Or they issue supplementary data to tie in O and P on an underwriting year, which at least is meaningful.

There are some alternate solutions that I might tell you about in the rest of the world. In Switzerland, they'll just leave the books open for six months or so after the end of the year, so that Swiss Re may incorporate all the accounts of its cedents for the activities through December, and historically will release its annual results around September or October. One of the problems of American reinsurance companies is they're operating in an environment that's geared towards earnings per share on a quarterly basis. There's a real inconsistency between that and the real life world of reinsurance and knowing your losses. As actuaries, I am sure you're all familiar with those long-tail development charts and recognizing the problem to which I am alluding.

The German companies have another technique -- co-terminus years. They have a June 30th fiscal year, but they include the
underwriting transactions ending with a prior December 31st and financial transactions through June 30th. Again, at least they tell you what's in their statement. Perhaps the more practical route for the United States may be to adopt what they do in the London market which is fund accounting, where you don't try to get all your accounts in at one time. You bunch them and keep them in a fund liability account and wait until the end of the next year before you take it out. Providing for deficiencies, of course, but not accruing the income. In any case, one of the difficulties in doing any mechanical analysis of American insurance companies on any meaningful basis is using their annual statements which aren't geared toward the real world in many cases.

I might mention the analysts method that we use. We interviewed almost all of these 100 companies. As a matter of fact, in the reports on the three or four that declined interviews, our rating summary indicated that the companies declined to be interviewed, which we thought was a significant red flag for our subscribers. The two people we used, one chap with twenty years of underwriting experience, first in direct business and then in facultative casualty business. The other chap was a financial analyst who had been doing security work for two of the alphabet houses and is now on Wall Street with Ray Dirks of Equity Funding fame.

I might mention another feature of this security service was loose leaf. That was particularly important last year when we had this flurry of public offerings. There were some companies
we issued three reports on and kept updating as material events took place. There were at least a dozen companies in that group that had public offerings and we had updated reports. There are other reasons that can occur such as interim reporting. And the advantage of a loose leaf service is that you can just update. I might mention on the international side, both services, international solvency and ourselves, had loose leaves because we got into the habit of distributing reports throughout the twelve months of the year, which more or less conformed with the way reports were released on a world-wide basis.

There's another key factor with respect to rating reinsurers. That is -- when do you rate them? Philosophically, in the rating service that I started last year, we began rating from the time a company went into business. That's before it issues its first contract. Basically, we felt if we are to help a subscriber who is being offered the security of a reinsurer who is issuing its very first contractor in their very first month in business, what they want is our evaluation. Where might it be? What's going to happen? I think that's what the subscriber is paying money for, in our judgment.

Obviously, the valuation has to be somewhat qualified when there are no numbers to work on. But people are ceding business to a reinsurer from the day it goes into business, and they're making judgments. Those factors, the sponsorship; who's putting up the money? What kind of management are they hiring? What what kind of business plan do they have? Although they all have business plans that sound great up front and that sort of
judgment. That sort of judgment which the buyer of reinsurance has from day one is something that we believed we had a duty to respond to. There was a company, United Reinsurance, formed in Texas last year. Interestingly enough, its chairman had been a chairman of a company that failed about ten years before, which was possibly a positive or negative, but I had been familiar with that and really remembered it being identified with the chief financial officer who got into a line of business that caused a lot of mischief. It didn't bother me, and we looked at the money that was there to support it.

Recapital, which you may remember was a spinoff of North Star, got its license and was starting to write business in November or December of last year. People wanted judgments, what kind of rating might they get. Even companies like Nat Re, which is the re-incarcenated Nat Pak. People wanted to know. They went from a company that was relatively dormant with maybe $10 million a year of assumed business to a company that's doing $100 million within one year. It really wasn't the same company. The subscribers wanted to know what's going on? Our people spent more than a day going over the business plans, evaluating the caliber of the people and so forth in order to pass it back to our subscribers our impressions of the company. This is what they wanted.

The management; we're big on pedigree. We really like to know who the people are and where they came from. Perhaps I ought to spend a few minutes on another subject, sponsorship, which is very important. Maybe more so internationally, where a
man's word is more likely to be his bond. I've done a study on the fifty major companies outside of the United States, or there are fifty of them, operating in the United States. I analyzed them in the middle of last year. To us those companies look like long-term players in the United States. They're here to stay and that's the core of a lot of the companies that are involved in security servicing.

There are a number of basic reasons for it. The rest of the world is mature economic-wise and there is very little place to grow if you're in the insurance business and you're locked into Switzerland and you want to go to Finland you have to issue policies in Finnish and that's difficult. There are restrictions in most of the world. There are two open markets in the world: the London market and the United States. And soon you realize that if you go to London you write a U.S. business anyhow. You might just as well come to the United States and be where the action is. The major players around the world, and I can give you a list of fifty of them, they're here to stay and in order to analyze them, at least in our judgment, a material factor is the whole family tree from which they come.

One of our concerns during '84-'86 was whether the parent company had put in more money. I take it as a very serious detriment if they had not put in more during the last three years. Because almost everybody around the world recognizes the opportunities that were available in the United States market during that time. I might mention what I call the second-tier of overseas companies. They are the ones who really got burned.
They went back to Europe, and it's questionable when they may ever come back into the United States.

There's a distinguishing factor: the large fifty have their own shops, and to a large extent they control their own underwriting activity. The lesser size companies were forced to do something else. Generally, they took parts of the action of U.S. reinsurers, either via quarter share reinsurance or participating in some manner as a retrocessionaire. Another group joined pools. I assume you are all familiar, or should be familiar, with the litigation arising out of the Pacific Re pool that was operated by Mission and the Penn-Atlantic Pool in the East, at least to the extent that the losses to the foreign companies became highly publicized and their allegations of misconduct by pool managers became known. I think the real problem is that we are getting the second-tier players back into America because they're going to be reluctant to give away their fountain pen again.

There is another area of sponsorship that grew up last year that concerned us, and that is the spinoffs. Score Re, which is really the French government, indirectly, or almost had been 100% not too many years ago, sold off a material part of its holdings of Score Re. The Phoenix Re, a major life company, started selling off part of Phoenix Re. There was an aborted effort by Home Re. We are concerned because in reinsurance you're obviously looking long-term. Who is the owner and are they really going to stay around? This trend toward selling off parts takes the owner off the hook. The biggest one was probably...
Scandia, which was just a Rock of Gibraltar. It owned one-third of the commercial business in Sweden. And no matter what the reinsurers did, we always felt the parent company could make enough money on its domestic business to make good. They created an intermediate holding company, Scandia International, which creates the problem that the parent company is really no longer on the hook. This potential change of ownership is leading the market. I've talked with speakers from London to get everybody to raise the ante and not rely on parent companies. There was one other example, an American company, General Re, owned a company Trident in the London market. Trident lost money every year and General Re just kept making it up, and everybody was comfortable with Trident because of the General Re deep pocketbook. General Re sold Trident. It's been renamed, and if you're in for long-tail business in Trident, you don't have General Re to look to. That change in the mentality in the United States and around the world is of some concern.

There are other aspects that we deal with. I might go into them but the financial analysis that we do is somewhat similar, I'm sure, to things that you've heard of and that you are all very competent in. You're going to hear more about our service as the U.S. pages come out. I hesitate to toot our horn in advance. I think the market will be pleased by it, but I think performance will speak for itself. Thank you very much.

Thank you Mike. Our next speaker is Larry Hayes, the senior
vice president of Standard & Poor's Corporation. Larry is in charge of the insurance ratings division of Standard & Poor's. Larry has been with S&P for five years and has been in the insurance group for three years. Prior to that he was a lending officer with a major eastern bank.

LARRY HAYES: Good morning. I mailed down about 100 packets which really represents an extract from some presentations we've been doing, and I believe they may be over on the side as you exit. My comments are going to be in response and summary to some of these points, and a necessarily brief overview on many of them. In trying to keep with the spirit of the panel and try to give you a flavor for what market segments we at Standard & Poor's are trying to provide services to. That is, if you will, the broad theme I'm going to try and address. Clearly, Standard & Poor's is much better recognized within the fixed income bond and capital markets, both domestically and internationally, than it is in a historic sense, with the insurance community, whether it be the U.S. community or the wider international activities. We in the insurance group are trying to change that, and that is the real reason I'm down here, to help communicate what we do and how what we do with respect to insurance rating activities is different, or as the case may be, similar to our activities in rating bonds and other fixed income securities. We define the market I think a little bit more broadly than perhaps the way Mike does with respect to the reinsurers and the ceding companies. To us, the market begins with the primary companies.
but includes the brokerage function that Bob Bailey represents in the reinsurance side. The direct brokerage function within both the life and non-life sectors of the U.S. markets. And ultimately includes the insureds and the providers are capital to the insurance company. There are four market segments and in its totality that covers a rather wide spectrum of the audience in both the United States and world markets. We believe almost all of those markets have a need for information with respect to the quality of insurers that historically hasn't _____ as well as we believe we can do.

What I'd like to do is comment on a few of the basic approaches that Standard & Poor's brings to rating insurance companies from a claims paying ability point of view rather than the more traditional debt ratings, and try to identify how what we do might be differently from what has been commonplace in the industry. It really begins with the fact that claims paying ratings that Standard & Poors are a voluntary system. All of the companies we rate for claims paying ability have requested the rating and have ultimately accepted our determination. A company has the right to terminate the engagement, if you will, at any point during the process until we have actually released the rating which we only deal with their agreement. The reason behind this approach is that we think it is critical to have ultimate cooperation on the part of the company in order to get the best quality information. If you will, information in our business is one of the key raw materials. The quality of the people that we have on the staff is an obvious raw material, but
just as equal is the quality of the information. With respect to property/casualty companies, reinsurers, and life insurance companies, each one of those type of companies has a particular area, from a financial and operating point of view, which until you meet with the management and get essentially confidential information no one from the outside, no matter how bright and experienced, I believe, is really going to be able to offer an opinion within very fine degrees of differentiation. So we believe that the voluntariness allows us to get that high-quality information converted into the best rating product that one can have.

Another element to our approach is that it combines both an historic review of the operations of the company as well as a judgment as to perspective performance. In this sense, one of our basic tenents is that we do not rate companies whether it be for fixed income ratings or claims paying ratings, until they have at least a five-year operating history. There are some exceptions to that, with respect to the bond insurers, the financial guaranty specialty companies, where essentially we review every underwriting decision that they make. And there are other conventions, if you will, that allow us to feel comfortable rating start-up situations. In the main, traditional operating insurance companies are not eligible for a rating from Standard & Poor's until they've developed at least a five-year operating history.

In addition to history though, and as critical and if not more so, is really a judgment as to the prospective performance
of the company. I would reinforce performance, i.e., the operating performance, the ability to earn an adequate rate of return on its capital and the stability of that return. That element, the operating quality is really the leading indicator of ultimately where the balance sheet, the other half of the equation, is going to rest. We believe that it's critical to focus on both parts of the financial statements, both the income and the balance sheet, and not, as I believe it may be more traditional, to concentrate almost exclusively on the quality of the balance sheet, traditional solvency measures and reserve adequacy measures, etc. I think those elements are critical, but have to be done in the context of a broader forum.

In addition to the quantitative analysis which generally doesn't differ from one organization to another nearly as much as the views from qualitative aspects. The role of the qualitative judgments we come up with is, at the margin, the determining factor. It's not scientific, but is a way of thinking about it. Typically the rating is 75% quantitative and 25% qualitative. That 25% being the tail; it determines the margin of difference between rating categories in almost all situations. In order to come up with that qualitative judgment, we have to meet the companies, we have to have their cooperation and that is why the voluntariness is important. And we do meet companies. We typically meet them at their place of business, typically for at least a full day. Oftentimes with more complex companies, with multi-line operations and particularly non-U.S. companies the meetings tend to run two-days. And we have
relatively broad exposure to the very senior management as well as the operating division heads. Our intent is not just to sit there and get a canned presentation from the CFO or the treasurer, but really get a good cross-section of the senior management, both those that are currently responsible and those people who ultimately will be moving up and run the organization.

We intend the rating to be a relatively long-term indication of the quality, and therefore try to take into account as many factors as we can that will give us a leg up on where the company will be, not just two or three years from now, but five to ten years from now in terms of their basic operating and philosophical strategies.

Another element that sets our rating scheme apart a little bit from traditional insurance organizations is that really we're comparing all insurance companies against one universe. Obviously that's easier within the United States situation, where you have much more homogeneity. But even with respect to international companies, the basic approach in standards that we bring to the ultimate rating decision tend to be reflective of the same basic concerns from an economic and ultimately credit point of view. There's no rigid set of standards that one can really identify and explain to you. We tend not to go to extreme point of dividing the pie into all its little pieces, because the situations tend to be too dynamic to render that useful. But we measure all companies against one another, and within the context of really having to define the insurance industry on a world-wide basis as seven sectors of insurance including, and moving from
the most risky to the least risky, we begin with reinsurance, which is really the most risky in our point of view. Next is commercial property casualty and private mortgage insurance. Moving further up the scale in terms of less risk would be the personal lines, property/casualty, group accident and health coverages and group/life included in that segment. Group annuities is even less risky than that. Lastly, in terms of least risk, is the individual life insurance business. We have seven separate sectors, each of which is analyzed separately and we identify parameters of performance and capital requirements that we think make sense. But once we've done that, we then tend to measure all the companies against those broad sets of parameters. Much of the focus that we've experienced in terms of marketing and explaining our rating approach really revolves around trying to explain our rating scale and what it intends to tell people from the A.M. Best rating scale, which really is the generic rating in the United States context. Therefore, I want to spend a few minutes briefly outlining how the scale works, what it is, and give you a little bit better flavor for it.

The symbols I think are rather well known. The obvious one and most well quoted, I guess is "AAA" and it's sort of like Coca Cola. The scale does not begin at triple-A. The scale begins at "BBB" (triple-B), which is defined as having an adequate capacity to meet contractual policy obligations. Adequate being what is not to be a prudent position in terms of operating performance and capitalization to run the business under most scenarios. Moving up the scale, we have differentiations "A", "AA", and
ultimately "AAA". Each of those levels is essentially defined by extra layers of protection. Extra layers can really be thought of as extending out in time the likelihood that that company will be an extremely stable and high quality and ultimately solvent organization. From an interpreter point of view, the rating levels above "BBB" extend out one's confidence from the point-of-view of time, and in the "AAA" sense, the time scale is indefinite. We expect "AAA" companies remain solvent and operate profitably under really all situations, including a very severe economic set of events for an indefinite period of time.

Working down the scale, from "BBB" scale...and the final bottom is "DDD," which is a situation where the terms of insurance obligation are not being met in a bond sense, where there is a technical default provision; it really refers to default. Much of the concern insurance companies and users of the ratings have is focused on the initial rating that we provide the company. In many respects, one doesn't need to have Standard & Poor's tell them that Aetna or Gen Re is "AAA" claims paying ability. However, we think our service provides an additional feature, we constantly watch those ratings in the companies which underly them that we do. Very typically today, with respect to maybe as many as half of all the companies we have ratings on, it's not atypical for us to have three to five meetings per year with these companies, although we tend to focus one of those meetings in a very comprehensive sense. More and more, the issues can't really be boxed into one or two days and then forgotten for the rest of the year. On both the parts of the
companies and ourselves, we have moved to a much more continuous process of physically meeting and implicitly surveilling the financial and operating performance of the company. We think that we offer users of our ratings not just an initial opinion that can be put away and forgotten, but a really continuous, alive, and current indication of the credit quality.

Lastly, I would just talk a little bit about the staff and the philosophy of an organization that we have in the insurance group. I'm probably one of the few members in the room that is not an actuary. We don't, as it turns out, have any actuaries on the staff. That's not particularly reflective of any bias against actuaries, it's more happenstance. Importantly, of the ten analysts that follow property, casualty, and life companies, and we really do divide the industry into the three major sectors, property, casualty, and reinsurance being one, life, and then mortgage insurance and mortgage related entities being a third, in our working organization. The focusing on life and non-life; by the end of the summer, we'll have ten analysts on staff. Seven out of those ten will have come to Standard & Poor's from insurance companies, a mix between property, casualty, and life, typically from planning roles and financial analysts roles. While we haven't turned up anybody yet who has a true actuarial background, we do recognize that it is critical to have industry experience as well as more traditional credit skills, and have tried to complement our abilities by bringing in people who should have, and in fact do, a working knowledge and understanding of the basics of the industry. I think that is a
critical component; if one half of the equation is the raw material, certainly the other half is the raw material from the human resources point of view. The majority of our staff have come to us from the industry. And the balance typically have joined us from major commercial banks where they have typically been responsible for credit and lending facilities directly to the insurance industry or the industry in question, whichever it may be.

Very lastly, I'll just point out, which is really more detailed in the material that is over here, in the summer of '87 we plan to introduce a insurance rating service which is solely devoted to claims paying ability ratings. Today and in the past communications and publication effort from Standard and Poor's have been within one generalist media, and we want to identify and give more flexibility to communicating the unique needs we identify within the insurance community on a world-wide basis. We think this service will provide us that opportunity, and will give us an opportunity to get into much greater depth, both with respect to the individual companies and the industry sectors, those seven sectors I mentioned, as well as a similar analytical material with respect to the ten non-U.S. companies in which we have some insurance organization rated, whether it be from a fixed income or a claims paying ability point of view. I hope I give you a better feel for what Standard & Poor's has been doing historically, what we're doing today, and what we intend to be doing in providing in the way of material going forward. Thank you for your attention.
Thank you Larry. Our next speaker is Bob Arvanitis, assistant vice president of Moody's, a long-time competitor of Standard & Poor's. Bob has been with Moody's for two-years. He is the senior member of the team that assigns ratings to casualty insurance companies. He's an associate of the Society of Actuaries since 1980. I understand he's passed many of the exams for our Society. Prior to being with Moody's, he's been there two years, he was with AIG for ten years, where he ran the international actuarial Department, and the reinsurance profit center.

BOB ARVANITIS: I'll start by noting that we have available today a consolidated insurance enterprise rating list, and I'd be glad to take business cards for anyone who'd be interested in a more complete package of analytic publications. Working outside the traditional area of our profession, I've grown accustomed to the time-honored corpus of actuarial jokes. I was a bit surprised today, however, to note how many members of the Casualty Actuarial Society seem to know inversions involving life actuaries. I can only suppose that as with nuclear physics, there is no limit to the subdivisibility, and at this very moment, some life actuaries relating an amusing anecdote involving two zebras and a defined benefit pension specialist. Despite the often heartless humor we visit upon the life profession, I would like to beg the indulgence of our colleagues
and borrow their classification scheme for risk. It will, I hope, provide a useful framework for discussing Moody's credit rating system. This will allow us to relate the systemic and cyclical stresses felt by insurers to an evaluation of their financial health. I will skip freely between the life and P&C industries and even into banking, because we cannot ignore the changing structure of the financial markets. First, the framework.

The Society of Actuaries has set up four broad categories of risks; with characteristic whimsy they have labeled these C1, C2, C3, and C4. The first is the asset value risk. This addresses the potential decrease in value for credit reasons of any asset a company might hold, for example, a bond or a mortgage which might default. A market scare might also make a junk bond difficult to sell. Even if it's not in default this would cause a loss of value for a credit related reason as well. An important asset for many insurance companies is the reinsurance recoverable. This does not appear on the statutory balance sheet as an asset, but Moody's will gross up losses in calculating leverage. Moody's extends the consideration of the C1 risk beyond traditional investment securities to insurance instruments such as reinsurance treaties and premium notes taken under cashflow programs.

The second broad area of risk, C2, involves the insurance process. This is the risk that assumptions regarding the pricing of insurance will be proven incorrect. The term parameter risk is sometimes used. A distinction here is that the risk is
selecting the wrong frequency, for example, for auto claims. If we have the right frequency, but a run of bad luck simply draws too many losses at Moody's we call that life.

The third category covers the risks associated with movements and interest rates. Yield assumptions used in pricing may not be achieved. Coupons reinvested at lower rates may not accumulate to target values. There may be early calls on an insurer caused by a catastrophe loss on a P&C side, or pyrapses on the life side. This would require the sale of assets at below book value. Finally, under particular stress liquidity may evaporate. The short-term financial markets are especially confident-sensitive. An event which suddenly increases a company's need for cash may perversely work to deny access to that cash.

The last category is something of a catch-all. The C4 heading encompasses all the risks common to any business enterprise. These include changes in demographics, law, social expectations, and technology. One factor which is extremely difficult to assess is regulatory behavior. There is a dynamic interplay between the interests of the policyholders and the bond holders, for example. The most important aspect of the C4 risk, however, is management's response to these changes. Using this framework for risks, we can observe several interesting areas of interaction. When a firm reinsures, it swaps insurance, or C2 risk, for asset or C1 risk. It is protected from an excess of claims, but takes on the risk of reinsurer insolvency. This changes the texture of a company's risk profile and puts new
calls on management talent. The size and potential lack of quality of reinsurance balances causes Moody's to adjust leverage as we described earlier. A similar interaction occurs with financial guaranty insurance. Here, the C2, or insurance risk, is just exactly the C1 or asset risk. Of immediate concern is the potential correlation of risks on the asset side with the liability side. This is analogous to the pressure Japanese property insurers feel to invest overseas. Otherwise, in the event of an earthquake, claims would have to be paid out of the stocks and bonds of just those claimants. To compound the issue, imagine a firm which has a significant financial guarantee exposure, which owns corporate bonds and which reinsures heavily. The potential for positive correlation of adverse circumstances is enormous. Along the same lines, insurers today are frequently letting the C4 or business risk overlap too far with the C2 or insurance risk. That is, many of the business risks faced by non-insurance firms are just those that constitute the insurance process for insurers. This is, of course, as it should be with insurance smoothing many of the physical and legal hazards which non-insurers face. With the D&O line, risks which ought to remain with the equity holders are carried by the insurance industry. The power of the scheme can be found in several analogies outside insurance. The commercial banks are great users of reinsurance techniques. For them, one of their process risks is, in fact, the C3 interest rate risk. They engage in interest rate swaps, a form of excess reinsurance. To share another one of their process risks, the loan credit risk,
they engage in loan participations. This, however, is more like a line slip than a pro rata treaty; they manage to avoid intermediation hazard. The potential for interaction of these various categories is the focus of much study at Moody's. Within this framework for viewing risks in the insurance industry, the rating process at Moody's can be described succinctly. To paraphrase the old real estate saying: "the three most important elements in the credit rating are management, management, and management." In actuarial terms, this would be $C^3$ cubed. I cannot overemphasize this point. We have a broad array of very sophisticated financial models at Moody's. We monitor the risk to firms direct and indirect. We are acutely aware of the areas of correlation. In the final analysis, however, it is our understanding of management's awareness of the risk and their capacity to handle them upon which the rating judgments are made.

There's an important difference in perspective between a closed block of assets and liabilities and an actively managed pool. When we rate a pool, such as a collateralized mortgage obligation or a securitized receivables, a scenario attesting approach is appropriate. Reliance on models, however, is too short sighted when the challenge is a firm face have yet to occur. It is quite likely that a large number of insurers would run off to the good if a depression started next week. A larger number, a larger number than the number which have Moody's "AAA". One thing of which I am quite sure is that I am not smart enough to predict the form stresses will take in the future. That is why the key characteristic is flexibility.
Management must have the capacity to respond to the unpredictable, yet inevitable dangers they will face. The view of the rating is prospective. Our obligation is to holders of instruments many years into the future. This applies to bond holders, owners of preferred stock, beneficiaries and claimants of insurers, in fact, anyone who has a fixed financial claim on a firm. The intent at Moody's is to provide stable ratings, ratings which look through the economic and industry cycles to the underlying strengths of a firm. A corollary of the long-term nature of the ratings is that they ought to be unspectacular. We do not aim at surprising the market, but rather intent to be a reliable measure of inherent credit risks. Having stressed the basis of our ratings, it may be worthwhile to touch on several of the ways we evaluate a company.

Central to the process is meeting with the company. But where this is not possible, our broad corporate knowledge of both the insurance industry and the financial markets, permit us to make what we believe are appropriately conservative estimates. It will be in keeping with my promise to be unspectacular, if I reveal that all the usual operating and financial measures one might expect of an analysis are reviewed. The difference, I believe, is in the perspective. As we noted, we are looking for an understanding of management's capabilities with respect to particular challenges they face and as a guide to their future behavior. On the topic of leverage, it may be noteworthy to say that Moody's takes a continuum. In terms of leverage, we include insurance, financial, and operating sectors in this continuum.
We attempt to make tradeoffs among the various types of burdens a firm shoulders and to weigh each burden properly.

Financial leverage is generally measured by such ratios as debt to equity. Adjustments are made for off-balance sheet exposures like asset sales with recourse and for guarantees of subsidiaries debts. Insurance leverage, historically measured by written-to-surplus, is probably better gauged by reserves-to-surplus. This reserves-to-surplus ratio is actually a form of actuaries' E&O Margin. Line of business, discounting, and the estimate adequacy of loss reserves, temper the measurement. While we will gross up loss reserves for reinsurance, the life insurers, for example, enjoy a reduction of leverage for the policy loan asset. This item is really more of a contra-liability or a pre-payment of benefits.

Operating leverage represents the fixed operating commitments a company carries. To the extent the firm has fixed rather than variable costs, it can increase its profitability by raising its thru-put. Conversely, unused origination capacity represents a drain on resources. For an insurer, the ideal plant might be a salaried workforce fully cross-trained in life and property/casualty, risk management and pension consulting, and registered as security advisors. Unfortunately, she was hired by Walton as a permanent fixture in Fantasyland. Real life is more likely to furnish us with a highly specialized agency system which must be painfully supported in the down cycles so that they are available in the upcycle to balloon acquisition costs. Pulling together the elements of leverage is really more an art
than a science. Capital charges for the various categories of assets, liabilities, policy limits and guarantees at least provide an initial index to compare companies. Moody's views on the trends and developments in the market allow the rewards and hazards of operating leverage to be factored in as well.

Among the trends and current developments are items disturbing to the analytic community; others may be surprisingly irrelevant. Tax reform, for example, is not as important in its dollar burden to the industry as it may be in setting new benchmarks for the buy versus self-insurer issue. This spread of risk retention groups is simply another hole in the cheese cloth called capital barriers to entry. Given the apparent ease with which capital can enter, the new battle for market share will, I believe, shape up as a struggle for investor dollars rather than a classic fight over insurance premiums. Moody's already has observed firms making pre-emptive financings to grab their share of the capital market pie. This, in an attempt to choke off competition at the root. Longer-term, the key issues for the industry will certainly include changes in distribution systems. The advantages of leverage to a direct marketing combined with the trend to unbundle services will change the fundamental structure of the industry. Risk management, loss adjustment, and engineering will be separated from ever more sophisticated risk financing techniques.

Finally, the sign most often read as negative, is, I believe, a cause for hope. The superficially disheartening level of insurer failures is in truth a sign of health and renewal when
viewed against the backdrop of new company formations. Start-ups, joint ventures, fresh capacity, all point to the underlying vitality of the industry. I am privileged to be able to observe these developments as a Moody's analyst, and would urge you all to make use of the tools of the actuarial profession to make that renewal come about.

ROBERT BAILEY: Thank you very much Bob. Our next speaker is Bob Brian, who has been a fellow of the Casualty Actuarial Society since 1970. Bob is a general partner of Conning & Co., the leading stockbroker that specializes in insurance stocks. Bob has been there since 1973, and he is currently in charge of the consulting and research division, which is the division that evaluates insurance companies. Bob Brian.

BOB BRIAN: It will be difficult to describe to you Conning's rating service of property/casualty companies in the time allotted, since we don't have one. I think I've been asked to speak not so much because we have a rating system, but because we're known for many of the different kinds of valuations that we do. As many of you know, Conning & Co. is essentially a stockbrokerage firm that has branched out into consulting, research, money management, venture capital funds.

In my role as director of the consulting division, we have had several experiences in looking at insurance companies from a solvency point of view, on a private consulting basis. I think this began perhaps five years ago when a risk manager of a large
company in New York called us and said they were doing business with fifty different property/casualty companies and what could we do for them from the point of view of looking at them from a long-term claims paying ability. That's the question we get -- who is going to be around to pay the claims twenty years from now for the policies that we're writing today? How would we have known back in the late 70's that some of the companies that went under in the 80's were really going to go under? Most of our consulting clients along these lines are mostly the large insurance brokers. Right behind them are some of the risk managers of some of the larger firms.

Actually, at Conning & Co. we're currently not interested in coming out with a wide-spread, off-the-shelf, rating service that you could subscribe to. That's an endeavor that we haven't undertaken. But perhaps I could tell you about the things that we have done.

We're interested in helping out in the solvency area, helping out in the evaluation of companies' financial strength. But we only want to be part of the activity and at this point to not have a rating system. What we did originally when we got these calls was to confine our analysis to the statutory annual statements. I know from having talked to people in this group for years, you've always been telling me to be careful of what you garner out of the annual statements. If you're out there in the world that I am, we don't have much more than the annual statement to go by. I still maintain that we can gather quite a bit of data from it. What we originally did was to run these
companies through just dozens and dozens of statistical tests that any of you could dream up, and just let the companies fall out one-by-one, test-by-test, and just to see what kind of profiles you come up with. In looking back, I can say that we were amazing successful in nothing but arranging the companies in the order in which they seemed to do on those simple tests. Some very interesting profiles came out of it and, of course, the service was limited to that.

Since that time we've got a little bit more sophisticated in looking at the annual statement, and we now actually put the statements into our computers. We run off an analysis book on each company, and when the thing comes out of the computer it's close to 300 pages long for each company. Essentially, we've broken the analysis up into perhaps ten sections. The first section being the reinsurance section, which gives you an idea of how important we think that the amount of reinsurance and the quality of reinsurance is. We have a premium section that essentially is trying to get at the book of business. Is this company writing property insurance or long-tail liability? What mix of business is it writing? We have a liability section which, of course, is getting at the loss reserves and the reinsurance. I might add who we have working on this. It's on a part-time basis, but three of us are fellows of the Casualty Actuarial Society. Another is a certified financial analyst, another is an ex-AIG and travels as underwriter, another is an ex-Gen Re underwriter, and two entry-level analysts. We have this team that meets on all of these companies, and we don't
leave it up to any one person to look at a company.

The next chapter we have is underwriting and, of course, we're getting at underwriting results. Another section on assets, and we're coming up with some interesting comparisons of assets and liabilities. We're fortunate that we manage the investment portfolios of about ten insurance companies, and we get some interesting input there on the matching of assets and liabilities and some good investment information. We have a cashflow section, investment income section, miscellaneous section, and then we wrap it up in an overall section. Each section is many pages long, has many different tests in it. We came up with the concept of risk factors by section. So each page and each section is loaded with risk factors, and we could spend a lot of time just talking about risk factors. Essentially, what we're doing is comparing each company with the industry, and we're looking at a company's relative risk or risk relative to the industry. So far, most of the work we've done is on pretty standard primary companies, so we have our own little industry model on that. Some day, we'll probably have a reinsurance model and excess surplus lines model, and what have you. We just haven't gotten into that yet. A company with a risk factor of eight on the loss reserve section we would feel represents a significant amount of risk, greater than industry averages on that one test, and a risk factor of perhaps two or three would indicate to us that a company has less risk than the industry.

When you finally have this summary page full of risk factors
and you have to come up with an answer, that's the hard part. I assure that we don't just take an average, sort of like a medical exam, you can look good all over and have one very serious problem and all of a sudden your overall risk factor might be very high. We look at an insurance company the same way. That final pick of a risk factor gets very, very judgmental. I heard someone say earlier that they estimated that their work was 75% statistical and 25% judgmental. I would say ours is too, and maybe even more emphasis on the judgmental.

To date we've done this on, perhaps sixty or seventy companies. We're trying to keep it a manageable level, and we're not trying to do the whole industry. We would also agree that solvency is an ongoing subject. It's not something you do this year, or at this point in the cycle and forget about it. We at Conning believe that many of the problems of the last underwriting cycle are not behind us. There are still some underestimated reinsurance recoverables in the industry. We think that some of the back years in the liability lines still are developing upward. This is despite the fact that the industry seems to show a pretty good accident year combined ratio. We think that the solvency surveillance is going to be very important, especially if it's true that rates in the marketplace are being cut again. Our surveys of agents and brokers tell us that there is some pretty serious rate cutting going on in the property lines and some modest rate cutting going on in the casualty lines. It seems as though every month we do our survey, which is just a matter of talking to a lot of people,
the rate cutting stories get stronger and stronger. If the industry is in a period of price differentiation, after having walloped the insurers with rate increases for the past two or three years, and now you have a very natural price differentiation mode, I guess that's okay. If the industry is getting into another aggressive pricing cycle, we would be somewhat concerned about the solvency of some companies. We see some companies in a much stronger financial position now going into this cycle than others. Others are just barely licking their wounds and coming out of the past cycle. Because of that they did not really benefit from the profitable business that's been written over the past couple of years, because they didn't have the surplus to do it. They get hurt twice.

I might comment that if you've seen any charts of the relative performance of insurance stocks since the first of the year, the charts look like a ski slope. The insurance stocks have significantly under-performed the other indices, and the main reason is investors see the rate being cut again. They see the growth in premiums slowing down, and despite the fact that we tell them that there are still good earnings ahead in 1987, good earnings in 1988, maybe even 1989. For some companies, the investors don't seem that interested. They see the rate cycle beginning again, and they're essentially saying to us, well, give us a call in a couple of years, and we'll be back.

In closing, I guess I would urge you as actuaries to do what you can in your own companies and in your own assignments to bring pricing responsibility to the industry so that we don't get
into another all out pricing war. Should that happen, this whole business of solvency wouldn't be quite the problem that it is. And for those of us who are doing it, this would be a much happier exercise than it's been over the last couple of years. Thank you.

ROBERT BAILEY: Thank you Bob. The fifth speaker on the panel will be a representative of the Reinsurance and Insurance Brokers. I will take that part. Because reinsurance is not covered by the insurance guaranty funds run by the states, not a single one covers reinsurance, the pain and anguish among companies who have purchased reinsurance has been severe. The demand for more and better information about security of reinsurers has been tremendous. As a result, all of the major reinsurance brokers are providing an informational service to their clients, to the ceding companies. Likewise, the major insurance brokers are also providing informational services to their major plans.

I would like to just briefly outline the kind of information that E.W. Blanch provides to our clients as an example of what many of the reinsurance and insurance brokers are providing to their clients. First of all, we view the information about insurance solvency as a continuous effort, not an annual cycle. We update our reports for each of our reinsurers probably at least eight times a year as quarterly information and other information, stock offerings or whatever, come to play.

One major category of information that we provide is ratings
-- ratings of everybody else. For domestic reinsurers, we provide five sets of ratings for each company. We provide the NAIC early warning score and ratios. That's a widely used indicator. We provide the A.M. Best ratings for five years. We provide the Standard & Poor's and Moody's ratings. If the insurance company itself does not have a claims paying ability rating from Standard & Poor or Moody's, we show the rating for the senior debt of the insurance company or its parent. Finally, we show the stock market rating. We show the number of shares outstanding, the current price per share, and the range in the that price over the past year. If you multiply the price per share times the number of shares, that gives a very interesting evaluation of the stock market for that insurance company or its parent, whichever is traded.

We would like to provide a sixth rating of the Insurance Solvency International Rating. But as of this moment we have not yet received permission to do so. We subscribe to their ratings and find them very helpful. For international insurance companies domiciled outside of the U.S. we provide four ratings. We don't have the NAIC score, and we don't have an A.M. Best rating. In place of the NAIC early warning system we use the Insurance Solvency International ratio system. There are eleven ratios, just like the NAIC, and they have a pass/fail mark for each one, and they count how many passes and fails there are. We provide that score. On some foreign companies there is a Standard & Poor's rating, and we provide that. In addition, we provide our own rating which we call a E.W. Blanch "rank." We
rank all of the reinsurance markets - 150 of them that we do business with into three ranks; roughly 1/3 in each rank.

Finally, the fourth rating that we provide is the stock market rating. The number of shares, the current price, the range. As I said, for foreign companies, this is a much more timely indicator than most of the financial statements that we get and is much less distorted than the statutory accounting rules that are prescribed in many foreign countries. In addition to these ratings -- in effect what we're providing is a convenience service, and trying to provide as many indicators as we can to our client so that if any of these rating indicators indicate a potential problem, we can look into it further and try to find out what is brewing.

The next piece of information that we provide is a page of statistical information -- five years of data up to the latest quarter, showing key data and key ratios.

The third piece that we provide, which is probably the most important, is a narrative report that focuses on four major areas. The first one being ownership, which we regard that and management as being the most important areas. Under ownership, after detailing who the owners are and how much they own and how big the owners are, what we're looking for is commitment. What is the commitment? What is the capability to help the insurance company if it gets into trouble? Of course, if the insurance company has a billion dollars in surplus, then we don't worry so much about who the owner is, but many of them do not have that much in surplus.
The second area that we look at is management -- the people. We're interested in how capable they are in the field in which they are engaged. What is their track record, their experience, their performance? And secondly, that vague question -- how reliable are they?

The third area that we look at is business. What business are they in? How do they do it? How long have they been at it?

Fourthly, performance. How well have they done? How strong are they now?

With that you've had five of us, representing five different areas which are providing a service of ratings and security information about insurance companies to other people. It's obviously a very dynamic field; there have been a lot of problems. There's a strong demand for more and better service in that area. You have seen some of the people who are working hard to improve those services. We do have a few minutes for questions. So at this time we would welcome any questions that you might have for any of the panel members.

**QUESTION, INAUDIBLE**

ROBERT BAILEY: The answer is obviously yes. Does anyone want to speak to that? For example, I'm aware in the case of Mission, while I was responsible for an A+ and an A on Mission, Moody's had a much more dismal rating on Mission. I'm not familiar with what Standard & Poor's rating was on Mission a year or two before it went under.
LAWRENCE HAYES: I can comment that it was within that period of time a single A, which remains a little above the median of our scale.

ROBERT BAILEY: Michael?

MICHAEL MIRON: Bob, I'd like to tell a story that really launched me into the American market was Protective National, an Omaha based company that passed thirty three out of thirty five of the ratios I think that Bob was working on at the time. It passed all of its IRA tests and got an A or an A+ rating. The real problem was they had ceded off about 90% of their business and the IRA's test were based on net rather than gross. More important, and it goes back to what Bob Bryant was speaking about, the weakness can be so much in one little area it distorts everything. Those two areas that failed tests had to do with ceded reinsurance. But more important than any of the numerical tests was who those reinsurers were. It happened that at that time I was in London and had gotten a copy of Protective National's Schedule F before I left. I walked it around London. There's really some pretty good security people; they've been at it longer in London, and they know the international market. I must have shown it to ten or eleven people, and they all laughed at this company getting an A, because the quality of the names was so bad. I think that it's very important that if you look at a company, it's a cop out to say, "well it's okay
except for this international reinsurance that we don't know about." That's not really not doing the job at all. At least in the case of John Gardner in London, and myself, we can look at an annual statement of any American company and just go down the line of its reinsurers and form a judgment. What's really important is who they are. When Delta-America went under, it had this terrible, it was a 3rd T or American reinsurer and a third T reinsurance from the far east in South America, where they say that dogs that go on the curb get fleas. You can tell a lot about a company's book of business by who its reinsurers are. You don't reinsure garbage business with Triple-A reinsurers; they're too smart to take it. The name and identity of the reinsurer is very important from my standpoint of knowing what's going on.

ROBERT ARVANITIS: I guess our perspective is a bit on the conservative side because in the fixed-income markets a win is you get the coupon, and a loss is you lose the principal. And given the biased nature of that bet, we must be a bit more conservative I suppose.

LAWRENCE HAYES: One of the reasons we don't have more examples is that really not too concerned or interested about what our competitors are doing in the way of coming up with their ratings or even what the market out there is thinking. There's so much in the way of rumor to begin with, that we have a hard enough time dealing with the facts and the information at our
disposal, and once we've analyzed those, that's the best we can do, and we're comfortable with that decision. We really don't try to look around and see what is popular opinion.

QUESTION: You mentioned the commitment of ownership of reinsurers. How do you go about determining what that commitment is, in particular, in the case of non-insurance ownership?

LAWRENCE HAYES: I think there are two basic elements from our perspective. One is, you need to meet with the company as the owner and talk to them directly and ask them that question, etc. Notwithstanding whatever they say, there's one more acid test that has to be looked at. That is, is the company in question, whether it be an insurance company or a non-insurance company, profitable? Not just every other year, but consistently. Nobody disbands or walks away from a profitable company. Nobody in the long-run is going to indefinitely support a company that's not profitable. No matter what somebody tells us about support, if the subsidiary in question is marginally profitable or less so, we're not really going to believe it and won't act on really their best intentions. I think one has to look at, from our point of view, those two elements.

BOB ARVANITIS: As I guess we've all stressed today, that's a very subjective element. There are ways for us to try and guage the commitment and that's to look at past behavior. It is, again, subjective. But we do have examples where very
unprofitable operations were let drop. And other examples where very unprofitable operations were supported because it was management's feeling that they had a commitment and needed to do whatever was required. So we do find both examples in the marketplace. Of course, many commissioners won't let people walk away from unprofitable operations, but no commissioner could require the sort of effort we've seen in one finance company in particular that really did pony up what was needed to make good on its insurance operation subsidiary's needs.

MICHAEL MIRON: I was going to say it's really an actuarial problem. First, there are two parts to sponsorship. The ability to put in more money if needed. And secondly, the willingness. Ability is pretty much the same as rating of a company; you can make an objective judgment. Willingness is more difficult. You can look at past commitment. The problem that we've had in the last two years, and I'll name the constellation, Mentor, Union Indemnity, Delta America, and Pinetop U.S., all of them had wealthy parents. There was no question they might have put in the money. It was an actuarial problem in each of these companies in determining how big the hole was. If someone had told the parent the hole is $50 million or $100 million and it's payable over so many years, they might have put in the money. I think in each of these cases they were involved in long-tail liability business, which is still unsolved in America, and still the problem. And the parents didn't know how much the hole was. We had the laws on directors making good on open-bottom.
ROBERT BAILEY: I can add a little bit there. In the last couple of years both Pru-Re, and Ment-Re had a B+. And in London, some of the reinsurance markets there had a hard time understanding why the Prudential and the Metropolitans reinsurance subsidiaries were only rated B+, since they were treated in the marketplace as being stronger. And that treatment reflected the marketplaces assigning some sort of backup from the commitment from the parent. The commitment was not formal. How do you measure commitment? There are three key ways to measure commitment. Is it the same name? What is the cost of allowing the subsidiary to go under? If it has the same name, if it's 100% owned, and if it's in the same business, then there is material cost to allow the subsidiary to go under because it would affect the business of the parent. If it has a different name, if it's not wholly owned, and if the parent is not in the insurance business, then obviously the commitment is weaker because the penalties on the parent are less.

MICHAEL MIRON: I would like to add that I believe I gave Pru and Ment Re A's last year, following almost your same reasoning. Plus Pru-Re, if I recall, was almost located physically inside the Rock in Newark. I just couldn't conceive anything could let it happen.

LAWRENCE HAYES: I just want to add, in the package of
material that is here, the very last page does include a diagram as to Standard & Poor's position on this very issue, which is basically consistent with the points that the other panel are raising.

ROBERT BAILEY: They would make it so much easier if the parents would give us a written guaranty.

QUESTION, INAUDIBLE

ROBERT A. BAILEY: The question had to do with Blanch's ranks, 1, 2, and 3 for the foreign reinsurance markets that we do business with. How do they compare with the ratings of Standard & Poor's or Best's.

COMMENT, INAUDIBLE

LAWRENCE A. HAYES: Well you're right in that the Standard & Poor's rating for claims paying ability is voluntary and therefore really does work to the extent of creating a sort of positive selection process in almost every country in which we have a rating. With respect to the United States, both life and non-life, the vast majority of the ratings are in the triple-A, double-A levels. In the property casualty are there is a smattering of single-A's. This is sort of expected from our point of view, and we expect over time that a broader distribution will become evident through market forces
ultimately.

ROBERT A. BAILEY: I want to thank the panel for taking time out during the busiest time of the year to come here and spend this hour with us to discuss this subject.