Executive Summary

The purpose of this study was to undertake an analysis of the role, function and impact of rating organizations on mutual insurance companies and the industry at large. More specifically, the study was to:

- Clarify and define the actual versus perceived role and function of rating organizations as they currently exist;

- Review and evaluate how the rating organizations' review process incorporates various corporate structures and company size; and

- Evaluate and define any distinguishing characteristics of mutual insurance companies as they may influence the rating process.

Milliman and Robertson (M&R) was engaged to conduct the study and provide specific recommendations for addressing any critical areas of concern or issues that might develop from the study. For the purposes of this study, M&R and NAMIC conducted company and rating agency interviews as well as insurance agent and company surveys and evaluations. Key findings and observations included the following areas: the role of rating organizations; the accuracy and consistency of ratings; mutual company ratings; small company ratings; and the communication between the rating agencies, rated companies and users of the ratings.

Role of Rating Agencies

Survey respondents believe strongly that the rating agencies should confine their rating services to financial strength ratings and the early identification of financially troubled insurers. As a result of this study, it is recommended that all ratings from rating agencies should ultimately focus on measuring the probability of failure of an insurance enterprise. Any services beyond the assignment of ratings provided by the rating agencies should be clearly performed outside the context of the rating process.

Ratings Accuracy and Consistency

User confidence in the accuracy of the ratings is critical to the success of the entire rating process and the credibility of the rating agencies in providing financial ratings. For insurance company respondents the *accuracy of ratings* and *market acceptability of ratings* were the two most important aspects of a rating. Of company respondents, 99% believed the accuracy of ratings was important; however, 60% of company respondents were actually satisfied with the accuracy of ratings. One of the best ways of demonstrating and comparing rating accuracy over time is to utilize default statistics to measure the failure rates of insurers at various rating levels over a specific time horizon. Measuring the probability of default in a consistent manner should also help to clarify the comparability of ratings across rating agencies. Among executives of rated companies, the consistency of rating agency analysts was a major concern and issue regarding rating agency performance. Consistency issues can be addressed through the reduced rotation of analysts, continued use of analytical rating teams, analyst training, better internal communication and rating committees. Rating agencies should also perform and better communicate portfolio reviews, peer comparisons and improve the benchmarking of rating standards and thresholds as a way of addressing this perception issue and any potential accuracy or consistency problems that may exist within their ratings.

Mutual Company Ratings

While there are specific areas where M&R believes the rating agencies may not fully appreciate and recognize the benefits of mutuality, the study does not reveal a clear bias in the ratings against mutuals. In fact, mutual property/casualty insurers, on average, are rated slightly higher than stock property/casualty insurers at both A.M. Best and Standard & Poors even though, overall, stock companies outperform mutual companies by a slight margin. There are meaningful differences between stock and mutual insurance companies that may not be reflected in current rating process, including the expectations and demands of shareholders, costs of capital, and the ability to take a longer-term view of business or strategy.

Small Company Ratings

There is a significant difference in the distribution of company ratings based on size at the agencies reviewed with larger companies generally rated much higher than smaller companies. However, quantitative analysis shows that, on average, smaller companies under-perform larger companies by a considerable margin, perhaps justifying this ratings gap.

Communication

The effectiveness of the communication between the rating agencies, rated companies and users of the ratings has not been an area of strength and is a concern of company survey respondents. Respondents believed that rating criteria were not well communicated and were not well defined. This includes the communication of ratings, ratings definitions, criteria, and methodology. Rating agencies should strengthen their communication efforts to accurately reflect ongoing changes in their rating philosophies. While the rating agencies do a good job of communicating industry issues and trends, company specific issues and the rating implications of changes in the rating process, methodology or criteria need to be better communicated by the rating agency analysts to company management and done so in a timely manner. Insurance company executives need to play an active role in the rating process. The education of executives of rated companies and users of the ratings as well as better communication will help to develop an understanding of the rating process.

Executives don't have to agree with the rating agencies' conclusions, but understanding the process will help build a better relationship.

Summary of Recommendations

- Ratings from rating agencies should ultimately focus on measuring the probability of failure of an insurance enterprise. A common standard of uniformity, such as default statistics, should be developed as a way of helping users of the ratings to understand what the ratings represent.
- Rating agency services beyond the assignment of ratings provided by the rating agencies (such as offering of observations and guidance) should be clearly performed outside the context of the rating process.
- Rating agencies should perform and publish portfolio reviews and peer comparisons and improve the benchmarking of rating standards and thresholds as a way of addressing perceptions regarding accuracy and potential consistency problems that may exist within their ratings.
- Standard & Poors and A.M. Best need to address the issue of consistency (both analytical and company-to-company) through the continued use of analytical rating teams, analyst training, better internal communication, rating committees, and minimizing analyst rotation whenever possible.
- Company specific issues and the rating implications of changes in the rating process, methodology or criteria need to be better communicated by the rating agency analysts to company management and done so in a timely manner.
- Analysts need to be aware of the impact that corporate structure has on the business strategy and balance sheet of a mutual insurance company - such as taking the cost of capital into consideration to give a clearer picture of the true capital generating power of an insurer.
- Rating agencies should strengthen their communication efforts to accurately explain ongoing changes in their rating philosophies.

1.0 Introduction

1.1 Purpose of the Study

Responding to concerns voiced by its membership, the Board of Directors of the National Association of Mutual Insurance Companies (NAMIC) passed a resolution in September 1999 that "*NAMIC undertake an analysis of the role, function and impact of rating organizations on mutual insurance companies and the industry at large.*" To assure a credible and objective analysis, the Board contracted with Milliman and Robertson (M&R) to conduct the study and to provide specific recommendations for addressing issues and critical areas of concern that might develop from the study.

1.2 Objectives of the Study

In order to define the purpose of the study and to utilize the expertise and knowledge of M&R most effectively, the following objectives were developed:

- To clarify and define the actual versus perceived role and function of rating organizations as they currently exist;
- To review and evaluate how the rating organizations' review process incorporates various corporate structures and company size; and
- To evaluate and define any distinguishing characteristics of mutual insurance companies that may influence the rating process.

This report is the result of the study. This report recommends changes that are intended to help the rating organizations, rated insurance companies, and users of the ratings address critical issues and concerns regarding the rating process, including perception and communication issues.

1.3 Approach

For the purposes of this study, M&R and NAMIC conducted the following interviews, surveys and evaluations:

- Interviewed several panels of NAMIC members to develop a clear understanding of concerns (specific and general) with the rating agencies;
- Met with the senior management of selected rating agencies to discuss their organization's objectives, role in the insurance industry and specific rating process and criteria;
- Performed an evaluation of the rating process and rating distributions for each of the rating agencies;

- Conducted a review of current published literature on the subject and a review of other secondary sources;

- Surveyed over 1,200 (314 responses) U. S. property/casualty insurers on a variety of issues surrounding rating agencies, the rating process and ratings;

- Performed a quantitative evaluation comparing the financial strength and operating performance of U. S. property/casualty insurers based on their corporate structure (stock versus mutual) and size of company;

- Developed considerations regarding the rating of mutual and stock companies for rating agencies to evaluate; and

- Surveyed a sampling of independent insurance agents who utilize the rating reports of property/casualty insurance companies.

Although the study involved several rating agencies, this report focuses on the two rating agencies revealed by the agent survey as the *most commonly referenced* for financial ratings, namely A.M. Best and Standard & Poors. Generalized comments in the report about the “rating agencies” refer specifically to A.M. Best and Standard & Poors.

The decision to exclude other rating agencies from this report is not a reflection of their overall significance in the industry, but rather reflective of their current level of involvement with participants in this study and recognition among users of the ratings. For the same reason, this report has focused primarily on the impact of these rating agencies on the U. S. property/casualty insurance marketplace. The following estimated number of property/casualty companies in the industry are rated by the respective organizations included in this report:

- **A.M. Best ratings:** 2,106 companies

- **Standard & Poors ratings:** 543 companies (interactive) and 747 companies (public information).

Among company survey respondents, 95 percent acknowledged having a rating from A.M. Best and 25 percent acknowledged having a rating from Standard & Poors. Among agent survey respondents, 73 percent used A.M. Best ratings in their business, and 27 percent used Standard & Poors. Thirty-seven percent of all insurance agents surveyed use two or more rating agencies.

1.4 What the Ratings Measure

Within the U.S. insurance industry, particularly with smaller companies, there appears to be a common misunderstanding of what the rating agencies evaluate and what their ratings represent. To some degree, this misunderstanding can be attributed to less than optimal communication between the agencies, rated companies and the users of the ratings. The ratings of A.M. Best and the interactive ratings of Standard & Poors, long referred to as "claims-paying ability ratings," are prospective in nature and evaluate more than just an insurer's ability to meet its *current* obligations. In fact, one of the primary differences in the definition of a "secure" versus a "vulnerable" A.M. Best rating is the ability to meet "*ongoing* obligations" versus "*current* obligations.

Today, agency ratings reflect the agency's assessment of an insurer's overall financial strength and long-term viability more than current claims paying ability.

Because the ratings of A.M. Best and Standard & Poors are prospective, projected earnings (often viewed as future capital) and the qualitative elements of the rating process (that can impact the future viability and financial strength of an insurer) are increasingly important. Today's rating process includes qualitative issues such as:

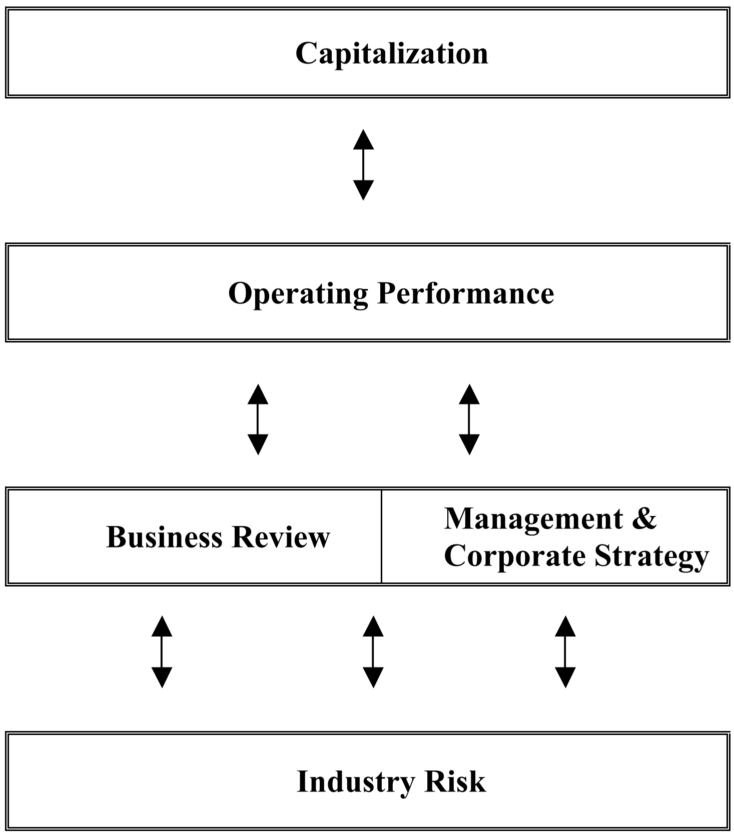
- The competitive environment in which a company operates;
- The quality of management;
- Business plans;
- Market position; and
- Concentration of risk.

Many insurers are confused about this broader perspective and its importance to the rating process or to the resultant rating. These qualitative elements of the rating are often the most difficult to evaluate and consistently quantify, adding even more confusion to the process. Furthermore, the ability of a rating agency analyst to adequately evaluate qualitative decisions made by an insurer's management team needs to be questioned.

The adequacy of capital, while ultimately very important, is just *one* element of the total rating process. Excess capital is no guarantee of a superior rating. Typically, the higher the rating category, the more significant and weighty the qualitative elements become in the process. For example, companies with superior ratings should demonstrate strong management and a competitive advantage that will ensure not just an ability to pay claims, but an ability to thrive long-term. The ratings are no longer just a report card on capital adequacy and past performance, they are a reflection of expected future performance.

Perhaps the best way to explain what rating agencies are currently doing is with the following diagram:

– The Structure of a Rating –



The rating process begins with an evaluation of the environment in which a company operates and the influence this environment has prospectively on the company. The quality of its management and business strategy, the strength of a company's business position and its financial integrity are all factors used to project a company's long term success and ability to differentiate itself from competitors. In most cases, the best demonstration of a company's success is profitability, which should ultimately lead to capital generation and financial security.

2.0 Results of the Study

2.1 Insurance Company Overview

M&R, in consultation with NAMIC, developed a survey about rating and rating agency issues among top executives at rated property/casualty insurance companies. Administered and analyzed by NAMIC, the survey was mailed to 1,259 top executives that lead one or more domestic insurance companies rated by A.M. Best and/or Standard & Poors. Surveys were mailed without regard to size, organizational structure, rating, or NAMIC membership. In total, 314 surveys were returned, for an overall response rate of 25 percent of surveys mailed. A higher percentage of NAMIC members, mutual insurers, and smaller companies responded, probably reflecting this group's general concern with rating issues, as well as their affiliation with NAMIC.

Among respondents, 95 percent acknowledged having a rating from A.M. Best and 25 percent acknowledged having a rating from Standard & Poors ratings. Of respondents rated by A.M. Best, almost 70 percent had ratings of 'A-' or better and about half of those rated by Standard & Poors had a rating in the 'A' range. While the response rate and distribution of responses by company size and type may signify a concern with ratings and rating agencies among particular types of companies, the distribution of respondent ratings was not disproportionately low.

2.2 Insurance Agent Overview

NAMIC administered and analyzed a survey developed by M&R in cooperation with the National Association of Professional Insurance Agents (PIA National) that focused on rating issues among insurance agents. NAMIC mailed a survey to 1,600 randomly selected members of PIA National. In total, 219 surveys were returned for a response rate of 14 percent.

2.3 Financial Performance Measures

M&R identified a series of financial performance measures highlighting key financial results and trends that could be used to create a company financial profile. Although the goal was to approximate the rating agencies' profiles, data constraints limited the financial measures to simplified versions of those actually used by rating agencies. For the study, the measures were broken out by organizational structure (mutual and stock) and by company size. Comparing these results to the rating distributions of the agencies allowed M&R to assess what impact, if any, structure and size might have on financial performance and rating assignments.

Data is based on statutory filings only and was taken from OneSource® and the A.M. Best Key Rating Guide on diskette. Companies were treated as either a single company (if they had no property/casualty affiliates) or as consolidated companies based on group ownership. The primary split was between stock companies and mutual companies (which includes all non-stock companies such as reciprocals). Results were also split between companies based on level of policyholders surplus. The stock subsidiaries of mutual parents were consolidated and treated as mutual companies for this study. Large reinsurers were entirely excluded so as not to distort results. Finally, while data was accessed as far back as ten years, consideration was only given to companies that were in existence in each of the last five years.

2.4 Key Observations

The following key observations and summaries resulted from this study and are critical to the report. These points were developed at the conclusion of this work and incorporate observations from a variety of sources including NAMIC member interviews, survey results, rating agency interviews and independent analysis performed by M&R.

Key findings and observations include the following areas:

A. The role of rating agencies in the industry;

B. The accuracy and consistency of ratings;

C. Mutual company ratings;

D. Small company ratings; and

E. The communication between the rating agencies, rated companies and the users of the rating.

Role of rating organizations

- Company survey respondents believed strongly that the role of the organizations providing ratings should be to provide financial ratings (92 percent) and to flag troubled insurers (70 percent).
- Company survey respondents believed less strongly that organizations providing ratings should provide supplemental information beyond financial ratings (53 percent) or include observations about a company's management (51 percent).
- Only 11 percent of company survey respondents believed that it is the role of the organizations that provide ratings to offer guidance to company management.

- Agent survey respondents believed that the primary role of organizations providing ratings is to provide ratings (72 percent) and to flag troubled insurers (67 percent). Only 14 percent of agent survey respondents believed it is the role of organizations providing ratings to offer guidance to company management.

- Rating agencies continue to search for ways to add value beyond the ratings by providing additional services utilizing their broad perspective on the industry.

Accuracy and Consistency of the Ratings

- 99 percent of company respondents believed that ratings accuracy is either very (88 percent) or somewhat (11 percent) important.

- 60 percent of company respondents are satisfied with the overall accuracy of ratings (however, overall company respondent satisfaction with rating accuracy falls well below its perceived level of importance).

- 63 percent of company respondents agree that analysts are professional.

- Only 30 percent of company respondents believe there is analytical consistency from year to year.

- Only 13 percent of company respondents agree that the rating process is consistent from company to company.

Mutual Company Ratings

- Mutual company management is concerned that the process currently applied by the rating agencies may not fully appreciate or incorporate the unique characteristics of mutual insurance companies.

- There is a perception among mutual insurers that a rating agency bias exists against mutual companies as compared to stock companies.

- After detailed analysis M&R believes that there is not an obvious bias against mutual insurance companies versus stock insurance companies although mutual companies have unique characteristics that need consideration in the rating process.

Small Company Ratings

- There is a perception among small insurers that a rating agency bias exists against small insurance companies as compared to large insurance companies.

- After detailed analysis, M&R believes that there is not an obvious bias in the rating process against smaller insurance companies as overall financial measures are consistent with the general trend in ratings.

Communication

- The comparability of ratings between agencies is confusing and misunderstood by both rated companies and the users of ratings, such as agents.

- The comparability of ratings from a single rating agency over time is also misunderstood.

- Very often there is a misunderstanding of how the rating process is conducted and the basis for the rating agency's conclusions among rated companies and users of the ratings.

- Company respondents did not believe that the rating process, criteria or methodology was consistent, well defined or well communicated (all scored under 30 percent).

- Most agent respondents (95 percent) indicate that they completely or somewhat understand A.M. Best's rating system. Fewer agent respondents understand Standard & Poors (56 percent).

3.0 Discussion and Recommendations

3.1 Role of Rating Agencies

It is clear from the results of company and agent surveys that respondents believe strongly that the rating agencies should focus their rating services on financial strength ratings and the early identification of financially troubled insurers.

Many insurers believe the rating agencies have been trying to micro-manage insurance companies through the ratings. The development of this concern is understandable when considering that the rating agencies are rendering opinions (via ratings) not only on the current financial strength of an insurer, but also on the insurer's prospective financial viability. As a result of this prospective view, the rating agencies are taking positions on particular issues and aspects of insurance that will have a future impact on (benefit to or danger for) the individual insurer. Many of these issues are strategic and therefore more qualitative than quantitative in nature.

These evaluations, and any opinions formed because of them, can easily be miscommunicated or misinterpreted. It is natural for the insurer to question the basis for these opinions or evaluations and what actions might be taken to reduce rating agency concerns. Management may also solicit the opinion of a rating agency as to what measures could be taken to obtain a higher rating or maintain a particular rating. It is reasonable to assume that the rating agency will provide feedback in these situations. Unfortunately, the interaction and dialogue that this kind of open rating process creates can lead to miscommunications or misinterpretations and a general sense that rating agencies are telling management what to do.

Whether or not the position taken by a rating agency on particular qualitative issues is appropriate and applicable to all companies is an important issue. What may generally make sense for most insurers is not always the best thing for an individual company and some management teams will be inclined to consider ratings important enough to deviate from their strategy just to appease the rating agencies. It should *not* be the role of the rating agencies to encourage any particular type of behavior. However, the rating (or the fear of a downgrade) is a very strong form of motivation. Both rating agencies and insurers need to realize the implications and pitfalls of this kind of process in light of these influences.

While this study is focused on the relationship between insurance companies and rating organizations, it is also important to recognize the role played by rating organizations in the consumer and regulatory environment.

Insurance is regulated by individual states. It has no centralized federal regulatory agency like other financial services, nor any government-backed deposit insurance to apply in the event of insolvency. Policyholders commonly pay premiums for years before making a claim under the terms of the policy, and it is then that the policyholder relies on the company to be able to pay a claim.

Consumers rely on rating agencies for information on a company's ability to meet its financial obligations in the future. This function is probably even more important under the state system of regulation where no single regulator has oversight over all companies in the industry and guaranty fund coverage varies from state to state.

The definition of the appropriate role for rating agencies varies significantly not only between insurers and the rating agencies, but also between the rating agencies themselves. A.M. Best's vision and mission statement clearly portrays its role as more pervasive than just providing financial ratings.

A.M. Best intends to:

- *Play a constructive and objective role in the development of the insurance industry;*
- *Be a source of objective and reliable insurance information and commentary; and*
- *Encourage prudent risk behavior of the insurance industry through ratings and interactive rating process*.

This replaces the most recent published mission, which was:

> *"To perform a constructive and objective role in serving the insurance marketplace as a source of reliable information and ratings dedicated to encourage a financially sound industry through the prevention and detection of insurer insolvency.* "

This 'hands-on' approach is different than that of other rating agencies, including Standard & Poors.

Standard & Poors mission is to be the *breakaway global leader in providing independent, highly valued analytical services and information to the world's financial markets. This will be achieved by:*

- *Creating an organization that is dedicated to anticipating and meeting the needs of our customers;*
- *Managing ourselves as a unified, high performance organization;*
- *Recognizing and rewarding individuals who lead us in reaching our mission; and*
- *Allocating resources strategically to expand our business globally and capitalize on new technologies.*

However, Standard & Poors offers a fee-based service to evaluate the rating implications of various company actions, strategies and financial structures. There is a cost involved, but the benefit of this service is that there is a differentiation between this process and the standard rating process. Interestingly, companies with Standard & Poors ratings generally viewed the whole issue of ratings more favorably and seemed more willing to accept the additional role of rating agencies as providing supplemental information and observations to management. M&R believes this is more a reflection of the type of companies rated by Standard & Poors than a comment on Standard & Poors itself.

The rating process and meetings with rating agencies can be very difficult and stressful for company management. The less confusion and misunderstanding existing in the process, the better. If the rating agencies intend to provide additional value-added services beyond ratings, such as industry observations or specific strategic or operational guidance, it would be preferable to have a clear separation between these services and the rating process. Granted, the rating agencies have a unique perspective on the insurance industry and its issues, but they may not always be in the best position to evaluate what future actions are best for the companies they rate. Company management should never feel as though they are being pressured into making changes that are not in the best interests of their policyholders.

As a result of this study, one recommendation is that all ratings from rating agencies should ultimately focus on *measuring the probability of failure of an insurance enterprise.* Expanding the rating process to include additional services such as "industry or company observations" or "guidance" will only confuse this process. Any additional services beyond the assignment of ratings provided by the rating agencies should be clearly performed *outside* the context of the rating process. This approach is consistent with the expectations of both agents and companies regarding ratings, and does not prevent rating agencies from pursuing other support services for their industry clients. This approach would help reduce company confusion and concerns that rating agencies are trying to micro-manage their companies, a perception that was confirmed in the survey and during interviews of rated company management personnel.

3.2 Accuracy and Consistency of the Ratings

User confidence in the accuracy of ratings is critical to the success of the entire rating process and the credibility of the rating agencies in providing financial ratings. For company respondents, the accuracy of ratings and market acceptability of ratings were the two most important aspects of a rating. These two aspects produced the highest level of satisfaction (60 percent of respondents agreed that the ratings are accurate and 62 percent were satisfied with the level of market acceptability). Unfortunately, in spite of that satisfaction, there was a significant gap (39 points) between the level of importance and the level of satisfaction with the accuracy of ratings. This gap suggests company survey respondents believe there is room for improvement regarding the accuracy of ratings.

One recommendation, and one of the best ways of demonstrating and comparing rating accuracy over time, is to utilize default statistics to measure the failure rates of insurers at various rating levels over a specific period of time. Default statistics can also serve as a common standard of uniformity, allowing users of the ratings to better understand what is represented by the ratings of each agency.

While company survey respondents were satisfied with the overall accuracy of ratings, they did not believe there was consistency within the rating process – only 13 percent of the respondents agreed with the statement that the rating process was consistent from company to company.

Rating process consistency from company to company should ultimately be demonstrated by consistent, accurate ratings. Since survey respondents in general felt that the ratings are accurate, M&R believes that this view on company-to-company consistency could be an extension of concern among survey respondents of a bias against certain types of companies or that there is a lack of analytical consistency.

While 63 percent of company survey respondents felt analysts were professional, only 30 percent felt there was consistency with analysts from year to year. Among executives of rated companies, the consistency of rating agency analysts was identified as a major concern and issue regarding rating agency performance. Both Standard & Poors and A.M. Best experienced analyst turnover in recent years and, in some cases, company portfolios have moved from analyst to analyst as the rating agencies reallocate and realign resources. As a result, changes in analysts have become an all-too-common occurrence for many companies.

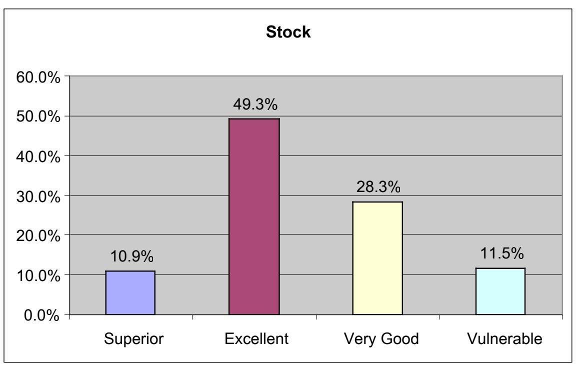
This issue is a realistic concern to company management. When there is a change in analysts, it can create a trying time for company management. It can complicate the rating process considerably, as a new analyst needs time to get comfortable with a company. It can also increase the time commitment of company management, as the new analyst must be educated about the specific issues of a company. A change in analysts also adds an element of uncertainty to the process, increasing the potential tension levels. This situation can be particularly troubling for smaller insurance companies that are often viewed by companies as a "new analyst training ground." While competency of analysts was not raised as an issue, it is generally perceived that experienced analytical talent moves upward, and more experienced analysts are typically used to rate larger, more sophisticated companies. Because qualitative elements of the rating process are increasingly important, the need for analytical consistency is particularly imperative.

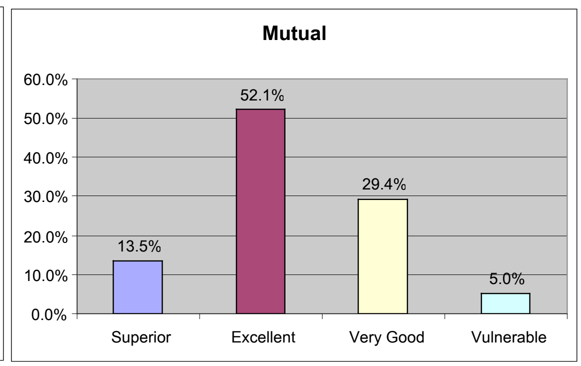
While providing recommendations to the rating agencies on ways to improve analyst retention is outside the scope of this report, consistency issues can be addressed through the continued use of analytical rating teams, analyst training, better internal communication and rating committees. While recognizing the benefits of crosstraining and the value of analyst rotation as a form of peer review, for the sake of corporate memory and consistency, A.M. Best and Standard & Poors should make efforts to minimize analyst rotation whenever possible. M&R also recommends the rating agencies perform portfolio reviews, peer comparisons and improve the benchmarking of rating standards and thresholds as a way of addressing this issue of perception and any potential consistency problems that may exist within their ratings. This information should be made available to the public whenever possible.

3.3 Mutual Company Ratings

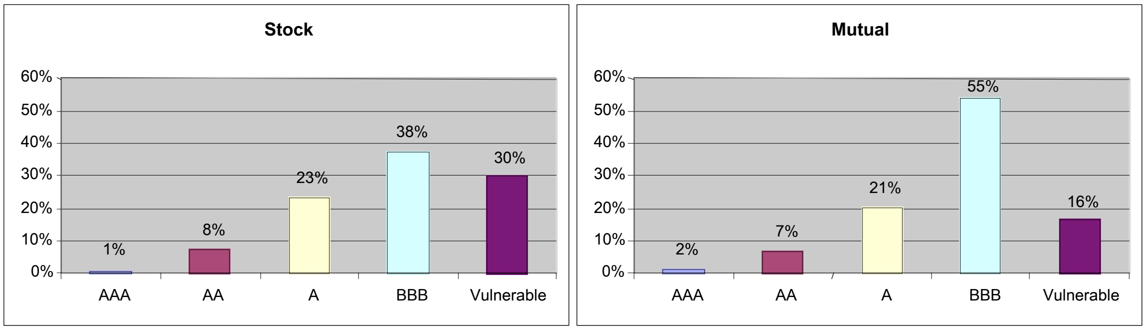
One concern expressed by NAMIC members is that the rating agencies do not understand mutual insurance companies and as a result, there is a bias in the rating process. While there are specific areas where M&R believes the rating agencies may not fully appreciate and recognize the benefits of mutuality, there is not a clear bias in the ratings against mutual companies. In fact, on average, both A.M. Best and Standard & Poors rates mutual property/casualty insurers slightly higher than stock property/casualty insurers, even though, overall, the operating results of stock companies are better than mutual companies by a slight margin.

Ratings Distribution – A.M. Best Stock vs. Mutual



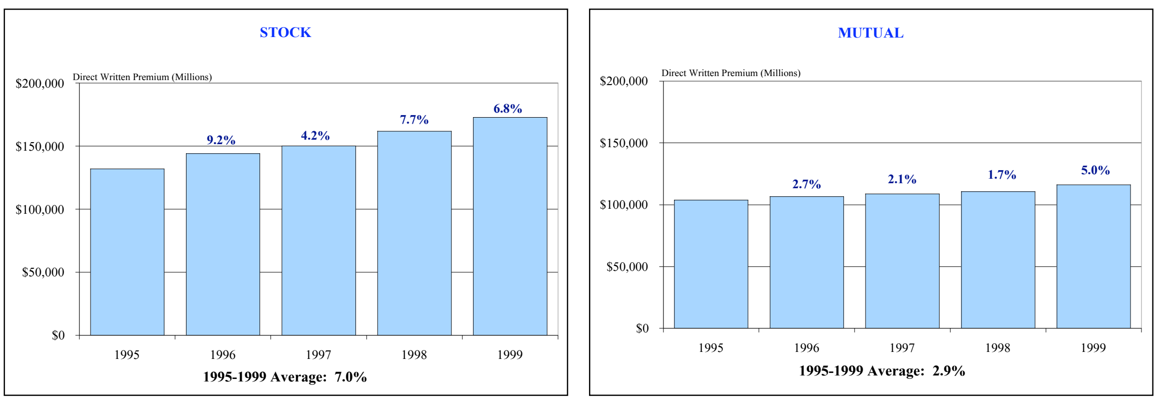


Ratings Distribution – S&P Stock vs. Mutual (Interactive and "pi")



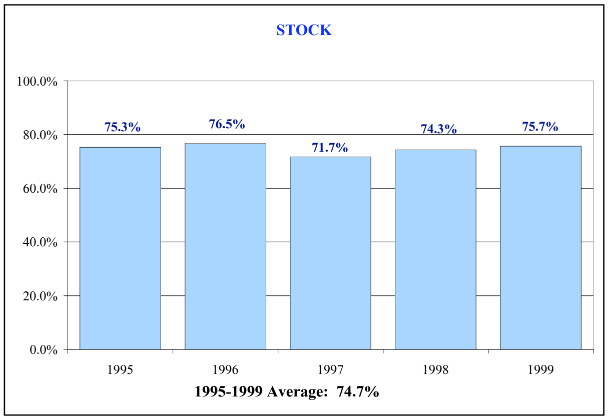
The following results of the quantitative analysis are relevant for this discussion:

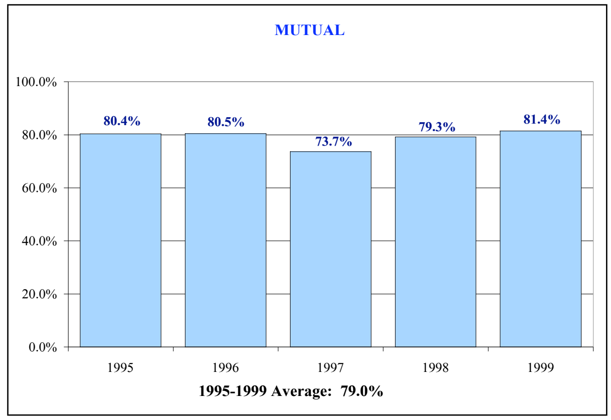
– Growth in Direct Premiums Written –



DPW Growth – A company's ability to grow the top line is an indicator of long-term viability typically used by the rating agencies. Over the last five years, stock companies have grown direct premiums at an annual rate considerably higher than that of their mutual counterparts (7.0 percent versus 2.9 percent). This is not surprising, given the more stringent requirements and pressures typically placed on stock companies to utilize capital. As a result, stock companies have experienced more growth from acquisitions in addition to their internal business growth.

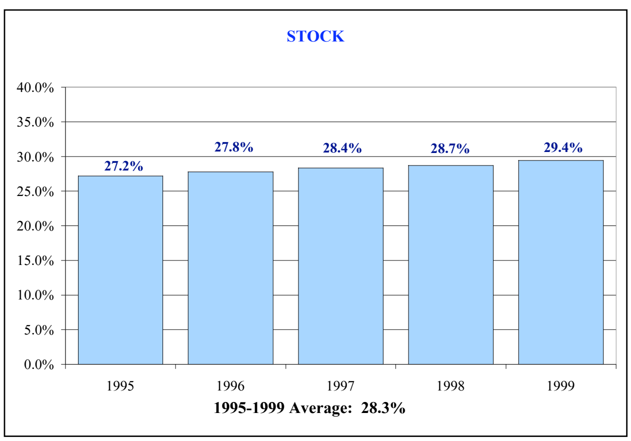
– *Calendar Year Loss Ratio* –

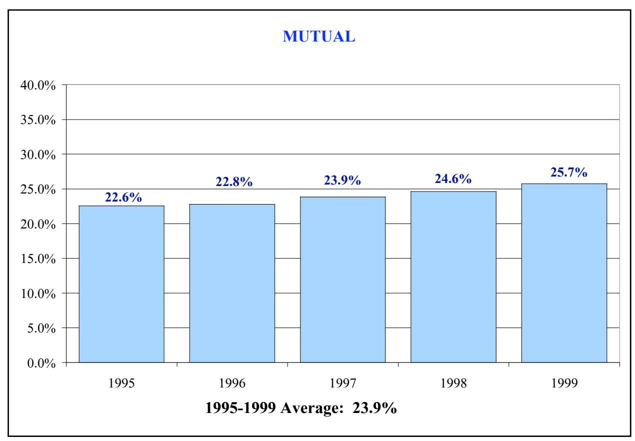




Five-year average calendar year loss ratio – Mutual insurers have a loss and loss adjustment ratio (LAE) ratio that has averaged about four points higher than stock companies over the last five years. Since mutual companies are expressly organized for the mutual benefit of policyholders it is reasonable to assume that premium rates would be lower relative to loss costs (therefore, causing a higher loss ratio) versus stock companies.

– *Expense Ratio*–





Five-year average expense ratio – Mutual companies enjoyed a better than four-point expense advantage over stock companies over the last five years. This contradicts the general perception that mutual companies are typically less efficient than stock companies.

– Composition of the Expense Ratio –

STOCK

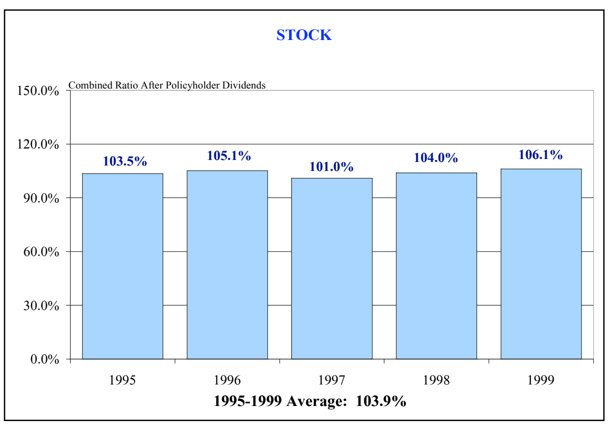
Component	1999
Net Commissions	12.3%
Salaries	6.6%
Premium Taxes	2.8%
Equipment	1.1%
All Other	6.6%
Total	29.4%

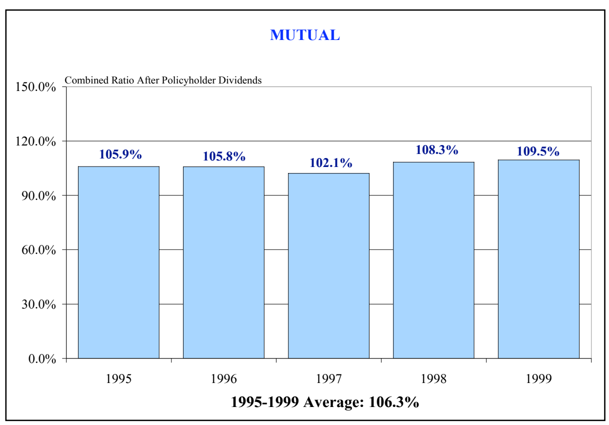
MUTUAL

Component	1999
Net Commissions	8.7%
Salaries	5.9%
Premium Taxes	2.4%
Equipment	1.6%
All Other	7.1%
Total	25.7%

Composition of expense – The 3.7 percent expense advantage that mutual companies enjoy over stock companies in 1999 is largely a result of lower commission expense (likely due to a higher percentage of direct sales representatives for mutual companies versus stock companies) and lower salary expense.

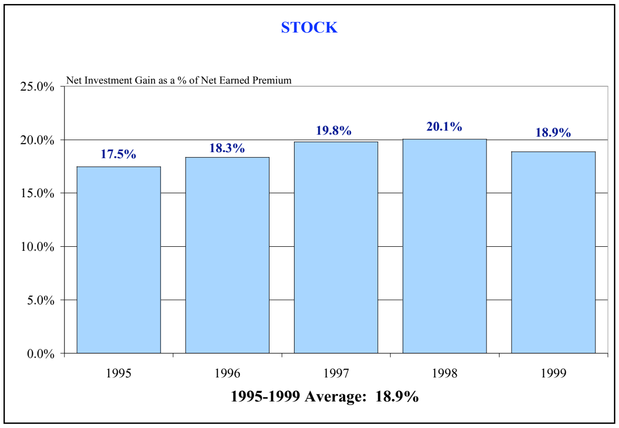
– Combined Ratio –

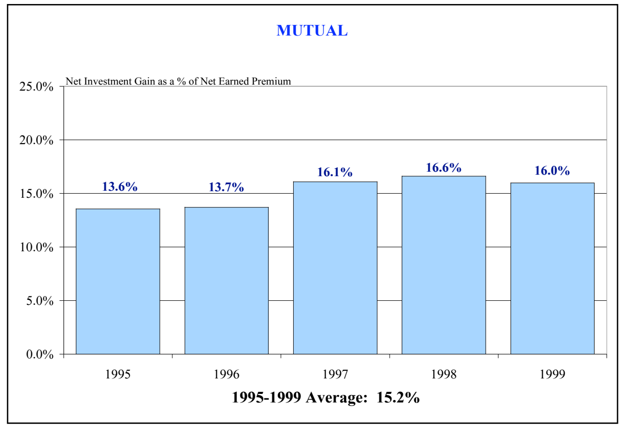




Five-year average combined ratio – Total underwriting performance, as measured by the combined ratio, deteriorated somewhat for mutuals in the last two years and as a result, stock companies have a 2.4 percent advantage for the five years.

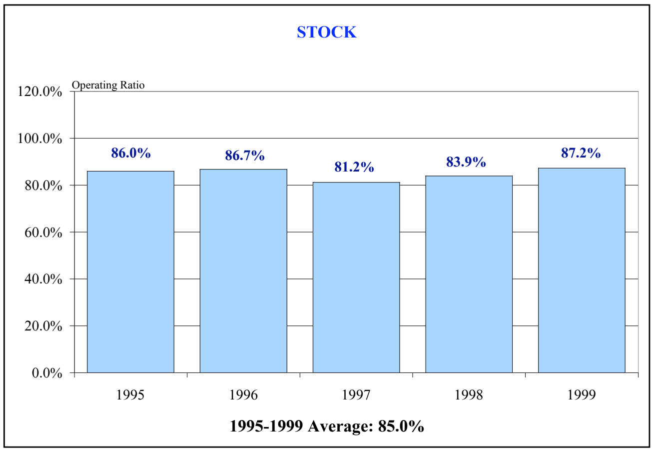
– Net Investment Gains Ratio –

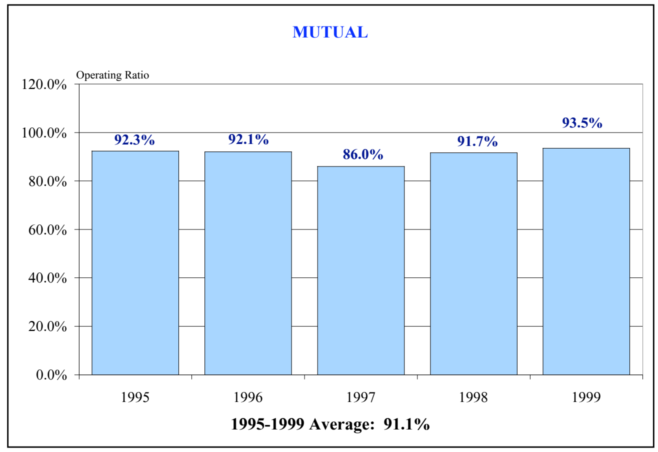




Five-year average net investment gains ratio – This ratio compares net investment income and realized capital gains against earned premiums. From 1995 to 1999, stock companies have outperformed mutual companies in average net investment gains by a difference of 3.7 percent (18.9 percent for stock companies to 15.2 percent for mutual companies). Most likely, this is due to a higher percentage of invested assets that stock companies maintain relative to earned premiums and slightly more aggressive investment strategies.

– Operating Ratio –





Five-year average operating ratio – Stock companies have an operating ratio (including realized capital gains) that is 6.1 points better than mutual companies due to the combination of better underwriting and investment results. This means that for every dollar of premium, stock companies produce 15 cents of pre-tax net income while mutuals produce nine cents.

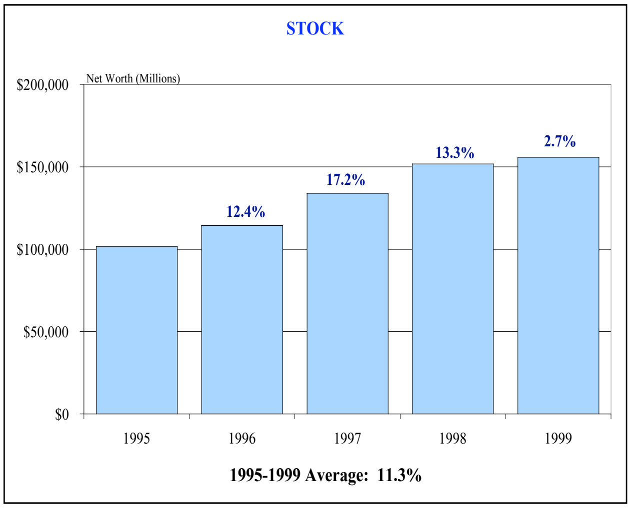
– Net Income versus Change in Surplus –

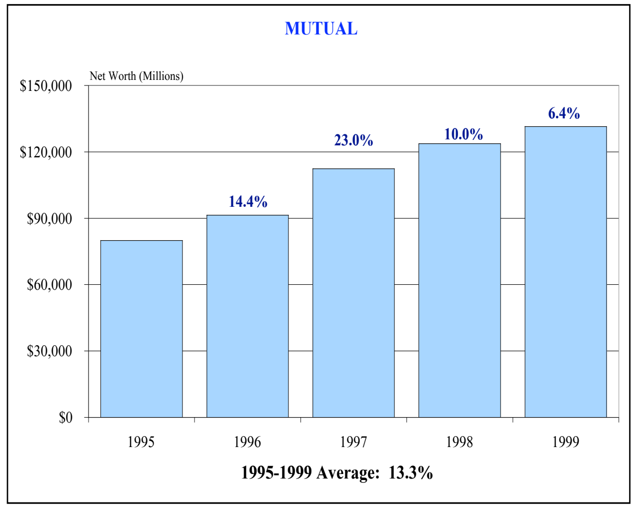
Composition of Change in Surplus
Stock vs. Mutual Companies

	Stock	Mutual
Net Income	130.5%	59.5%
Net Unrealized Capital Gains	35.5%	57.1%
Conditional Reserves	-7.0%	-2.7%
Surplus Adjustments	-49.8%	-0.2%
Other Surplus Items	-9.2%	-13.6%
Total	100.0%	100.0%

Net income versus change in surplus – Although stock companies generally perform better than mutual companies as measured by net income, a significant portion of this income is paid out as stockholder dividends to support the cost of capital. Mutual companies have a higher portion of unrealized capital gains largely because of the greater percentage of common stock holdings and the practice of holding their investments longer relative to stock companies.

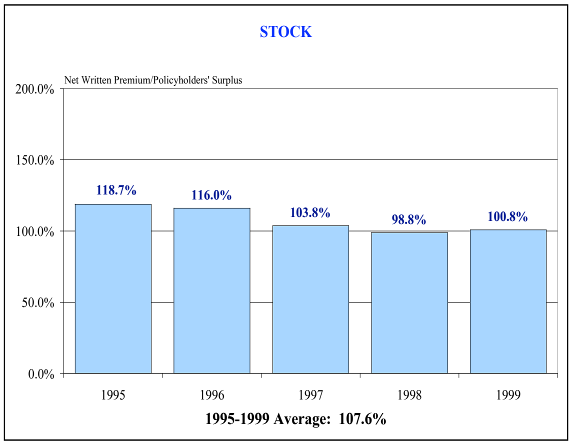
– Policyholders Surplus Growth –

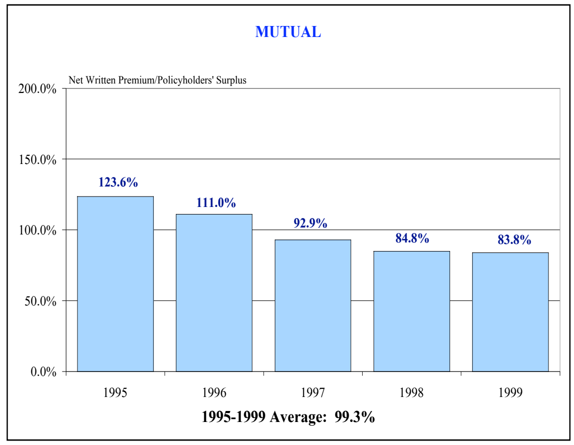




Surplus Growth – Earnings are important in the rating process primarily because they represent prospective capital. While stock companies generally outperform mutual companies, it is interesting to note that mutual insurers have grown statutory surplus at a level slightly exceeding that of their stock counterparts. From 1996 to 1999, mutual company surplus growth averaged 13.3 percent and stock companies averaged 11.2 percent. This is largely a result of the dividend requirements of stock companies and higher unrealized capital gains of mutual companies. If insurers' ability to accumulate capital is a critical measure of financial success, then the mutual companies have demonstrated an advantage over stock companies during the last four years. (It is important to note that data only includes companies in existence in 1999 and the four preceding years. Therefore, the capital of acquired companies is excluded in prior years and treated as surplus growth in the year of acquisition).

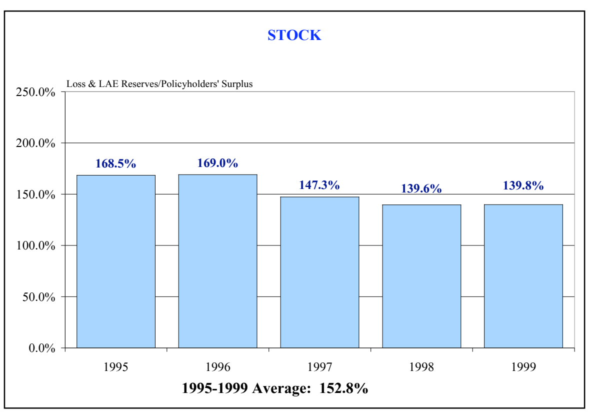
– Net Premiums to Policyholders Surplus –

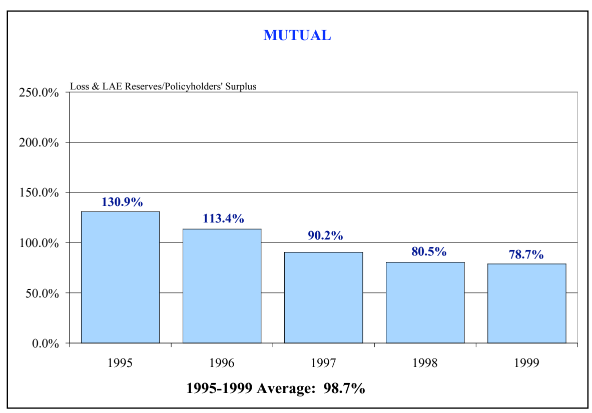




Net premiums to PHS – Mutual insurers are generally viewed to be less efficient users of capital. However, over the last five years, there is not a significant difference between the average premium leverage (as measured by premiums to surplus) for mutual and stock companies. Both are between 1.1 times and 1 times. While this is a simple measure, it suggests that mutual companies and stock companies are capitalized at similar levels. The trend in these ratios, with mutual companies reducing from 1.2 times in 1995 to 0.8 times in 1999 while stock companies improved from 1.2 times to 1.0 times during the same time frame, reflects the mutual company's growth in surplus exceeding net premium growth by a considerable margin.

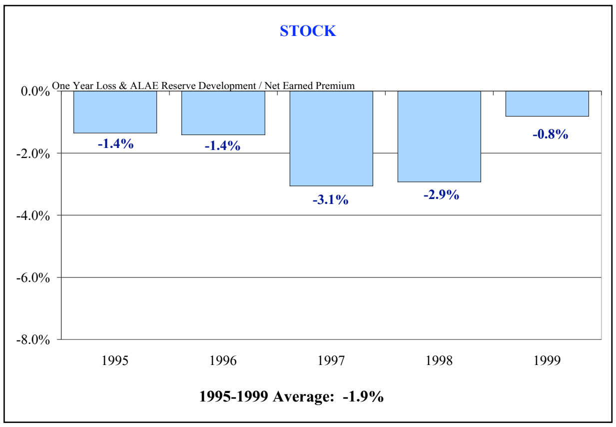
– Loss Reserves to Policyholder Surplus –

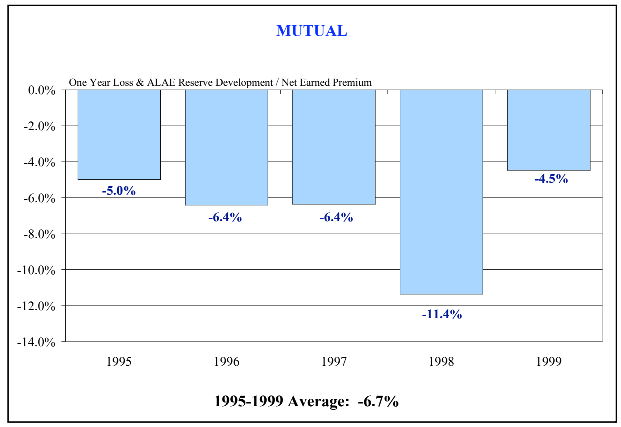




Loss reserves to PHS – Stock companies have a higher leverage of reserves to surplus than mutuals. This is partially a result of the classes of business written in stock companies versus mutual companies. Stock companies have a greater percentage of commercial lines that generally are longer tail in nature and therefore accumulate greater loss reserves. As with premium leverage, both mutual companies and stock companies have improved their reserve leverage positions over the last five years – 1.3 times to 0.8 times and 1.7 times to 1.4 times, respectively.

– Loss Reserve Development –





Loss reserve development – Comparing average annual loss reserve development as a percentage of net earned premium, mutual companies demonstrate an added element of conservatism with almost 7 percent annual average redundancy versus two percent for stock companies. This is not surprising given the lower pressure on mutual companies to demonstrate consistently strong earnings.

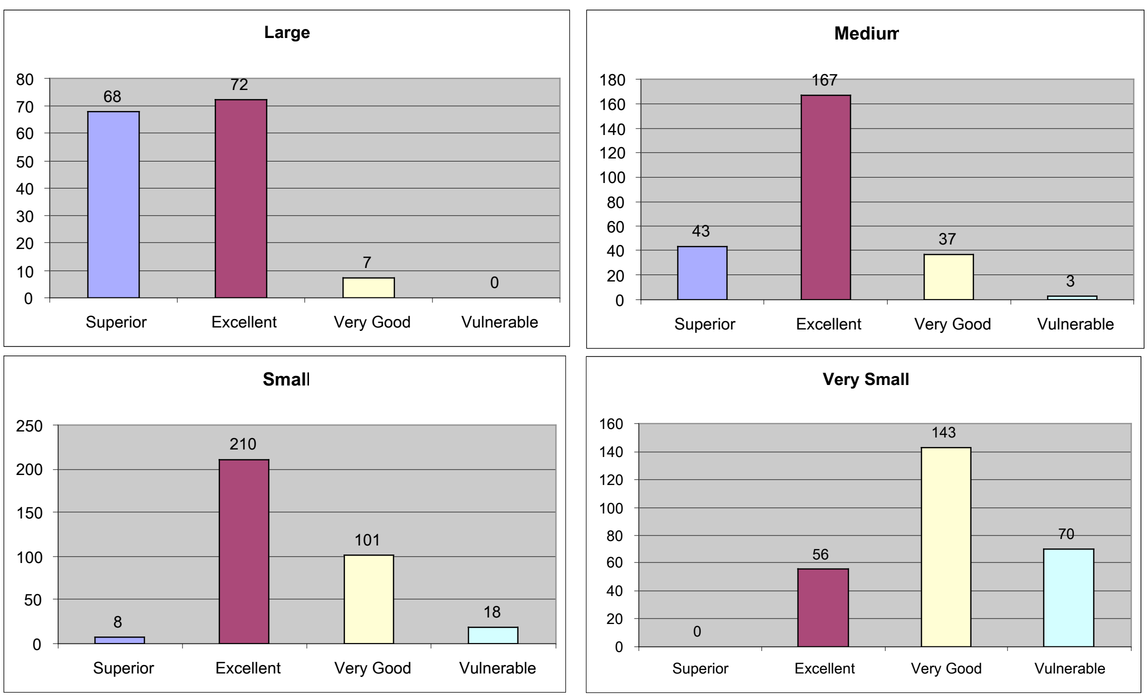
In spite of mutual companies' slightly better overall ratings experience, the current rating processes may not be entirely appropriate or present a fair comparison between mutual and stock companies. There are meaningful differences between mutual and stock insurance companies that may not be reflected in the current rating process. Mutual insurers are not typically subject to the expectations and demands of shareholders; therefore, mutual insurance companies have the ability to take a longer-term view than stock companies. The ability to look long term and not have to focus on top-line growth and earnings forecasts provides mutual insurers with a flexibility that stock companies do not enjoy, particularly during a soft market when growth may be ill-advised and profitability difficult. This difference helps explain why a relatively small percentage of insolvencies in the last 30 years have been mutual insurance companies (15 percent according to A.M. Best).

The cost of capital also needs to be considered when analyzing operating performance. Earnings are important in the rating process because they represent prospective capital (a cushion to protect against unforeseen liability and volatility in results). However, while stock companies generally outperform mutual companies using earnings as a measure, mutual insurers have grown statutory surplus at a level that is not only comparable to, but slightly exceeds that of their stock counterparts. This is largely a result of the dividend requirements of stock companies and higher unrealized capital gains of mutual companies. If an insurer's ability to accumulate capital is a critical measure of its financial success, then the rating agencies need to take the cost of capital (or lack thereof) into consideration in order to have a clear picture of the true capital generating power of an insurer. This requires looking past the traditional operating performance measures such as the combined ratio and return on revenue.

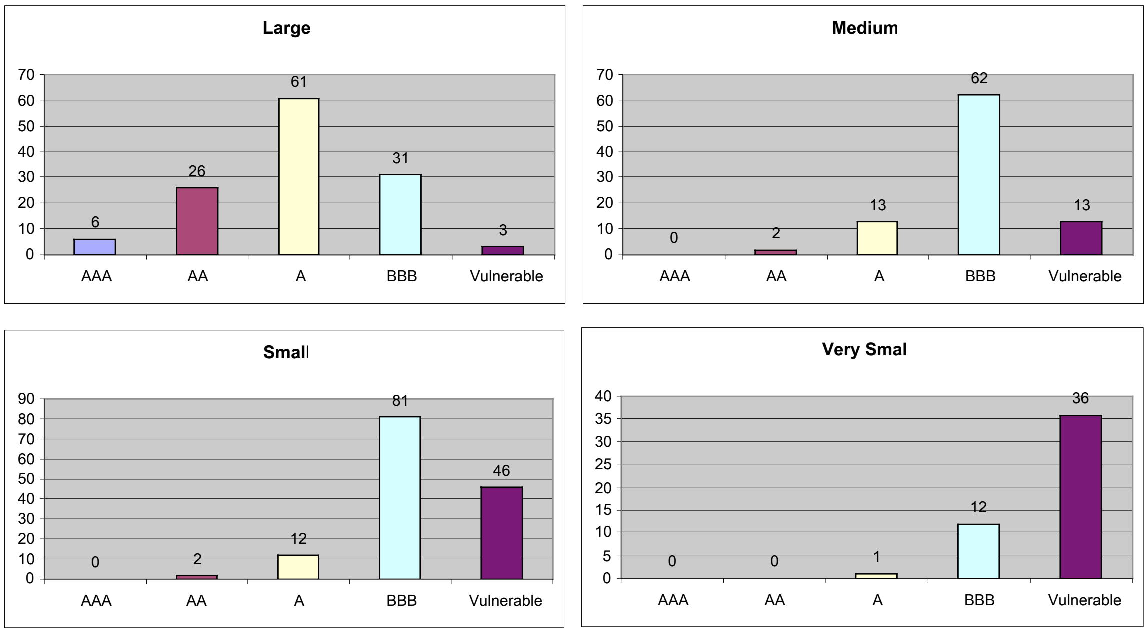
3.4 Small Company Ratings

There is a significant difference in the distribution of company ratings based on size at both agencies reviewed.

– Ratings Distribution – A.M. Best by Size –



– *Rating Distribution: S&P By Size (interactive and pi)* –

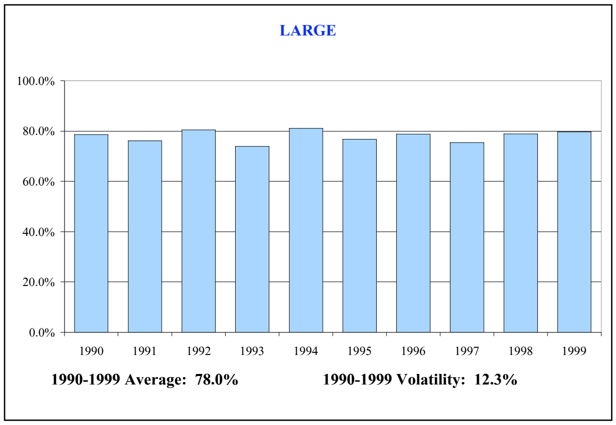


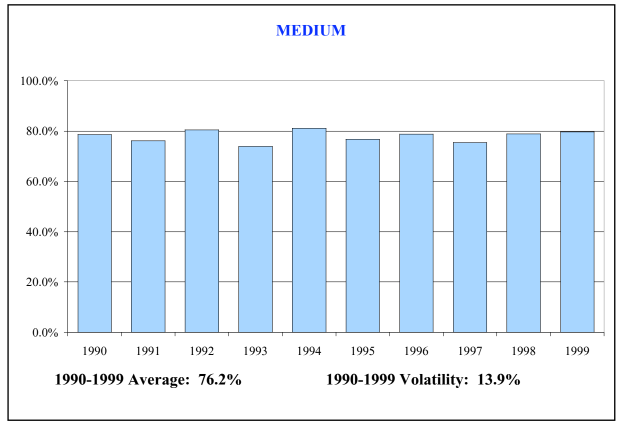
Quantitative analysis shows that, on average, smaller companies under-perform larger companies by a considerable margin, perhaps justifying this ratings gap. For the purpose of the quantitative analysis, M&R segregated the industry into four groups based on consolidated policyholders surplus (PHS). The size groupings are as follows:

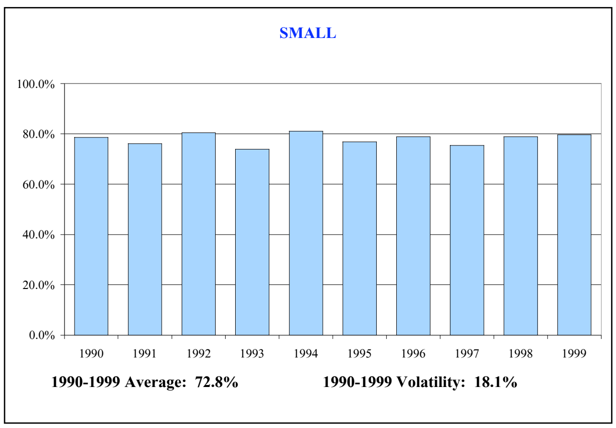
Very small	=	PHS of $10m or less
Small	=	PHS of $10m to $50m
Medium	=	PHS of $50m to $250m
Large	=	PHS of over $250m

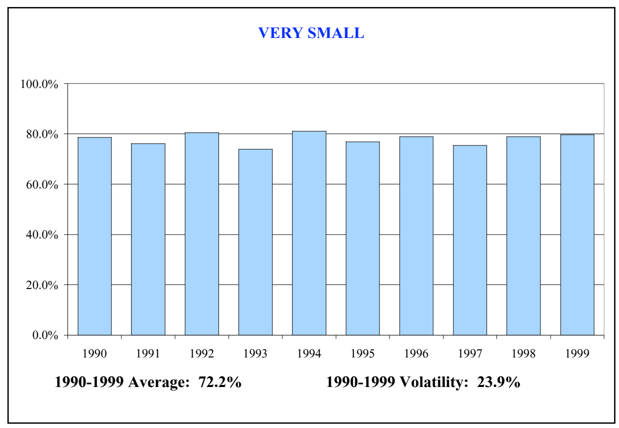
A more extensive analysis of the performance indicators based on the quantitative study performed follows:

– Accident Year Loss Ratios –





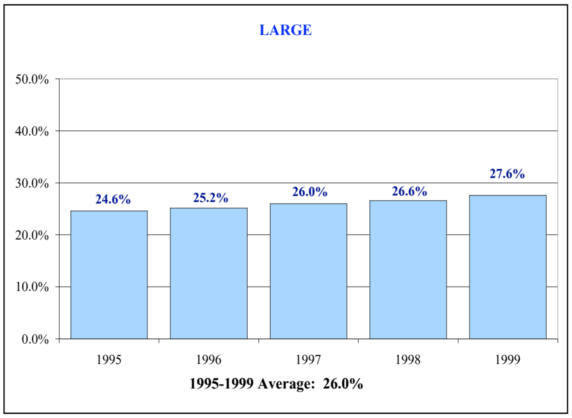


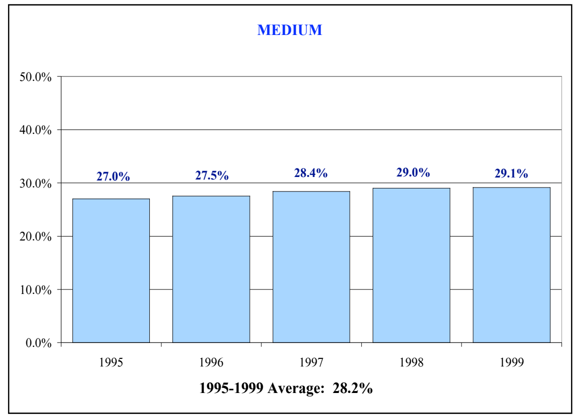


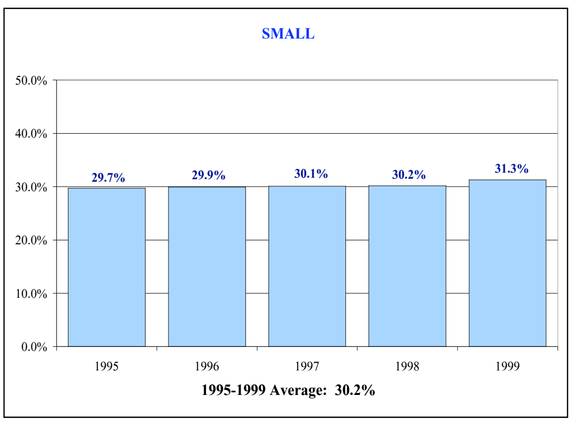
Ten-year average accident year loss ratios – There is a clear trend upward in accident year loss ratios as size increases. As a result, very small companies had a 6-point advantage over large companies (72% versus 78%). Larger companies tend to operate in more competitive environments and they have the economies of scale and low expense ratio to better compete on price, producing higher loss ratios.

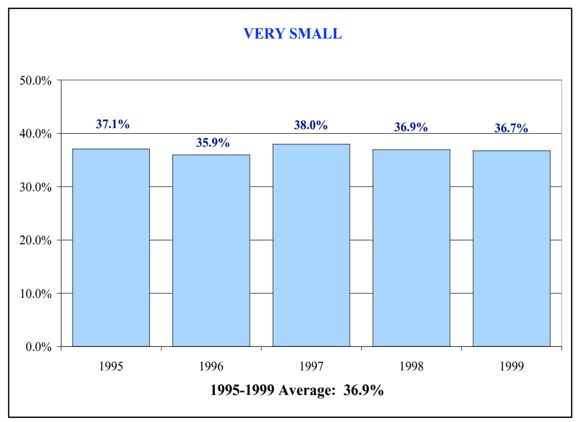
Volatility of accident year loss ratios – Volatility is risk in the eyes of the rating agencies. This measure attempts to gauge the individual volatility of accident year loss ratios for companies based on size using one standard deviation. The higher the number, the greater the volatility. Smaller companies are clearly more volatile than larger companies with a 24% volatility band versus 12% for large companies.

– Expense Ratio –



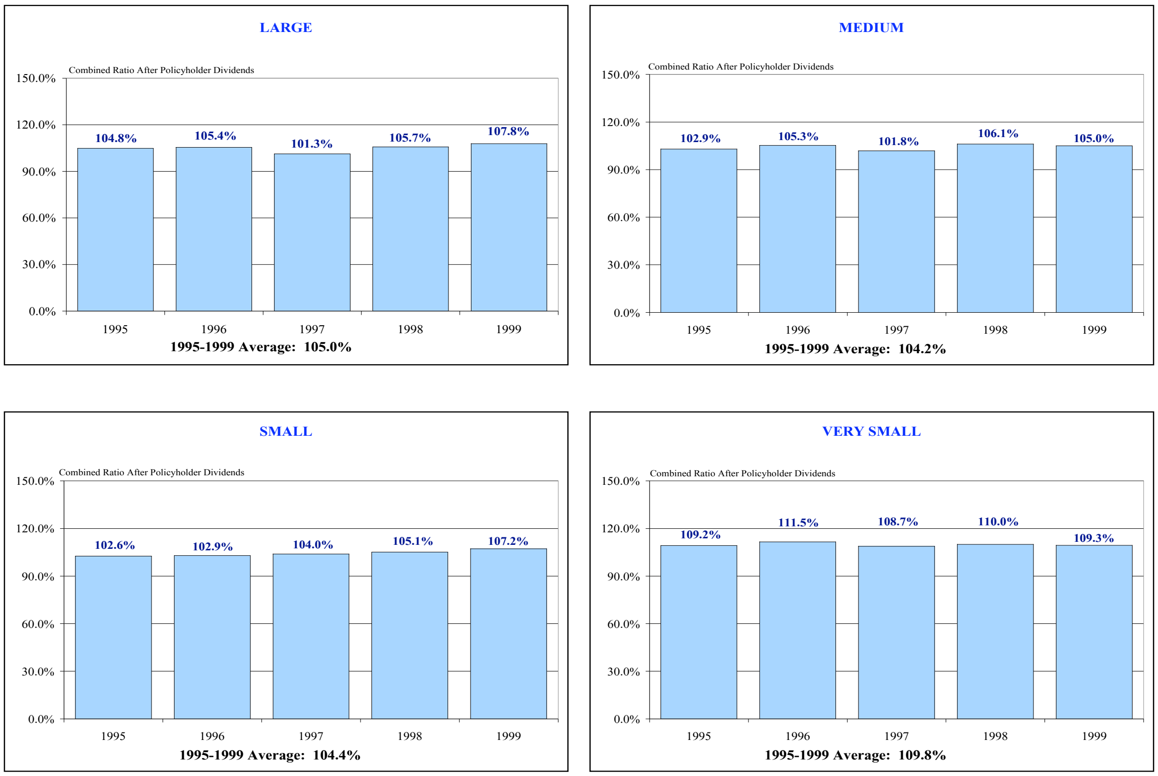






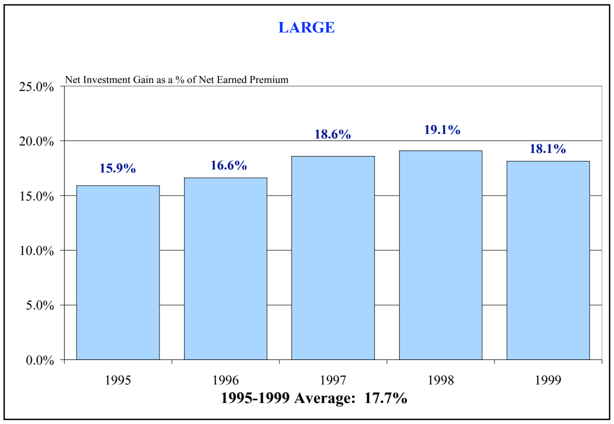
Five-year average expense ratio – The expense ratio is where large companies differentiate themselves from small companies, particularly very small companies. The difference is significant, with large companies enjoying an almost 11-point advantage over very small companies.

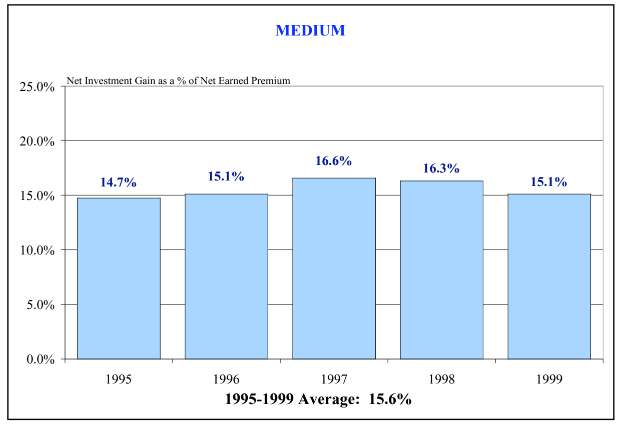
– Combined Ratio –

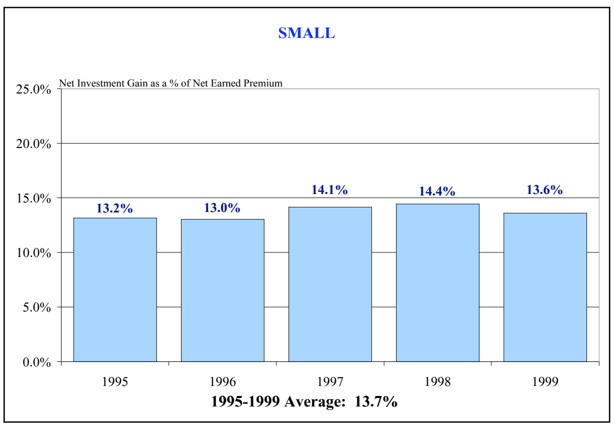


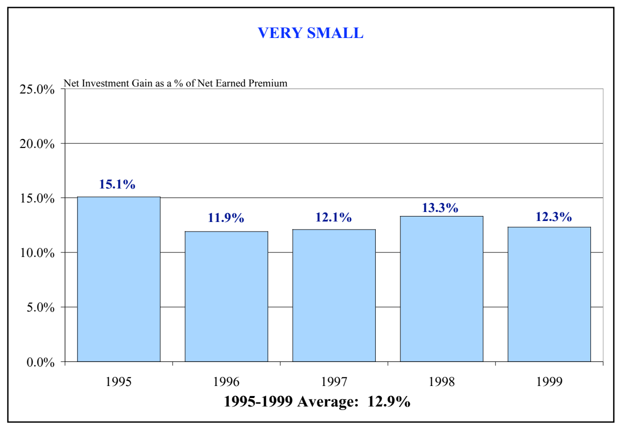
Five-year average combined ratio – Combined ratios between small, medium and large companies are surprisingly similar with medium companies actually performing best with a 104.2 percent average combined ratio for the last five years. Very small company performance, driven largely by a higher expense load, lags with a 109.8 ratio.

– Net Investment Gains Ratio –



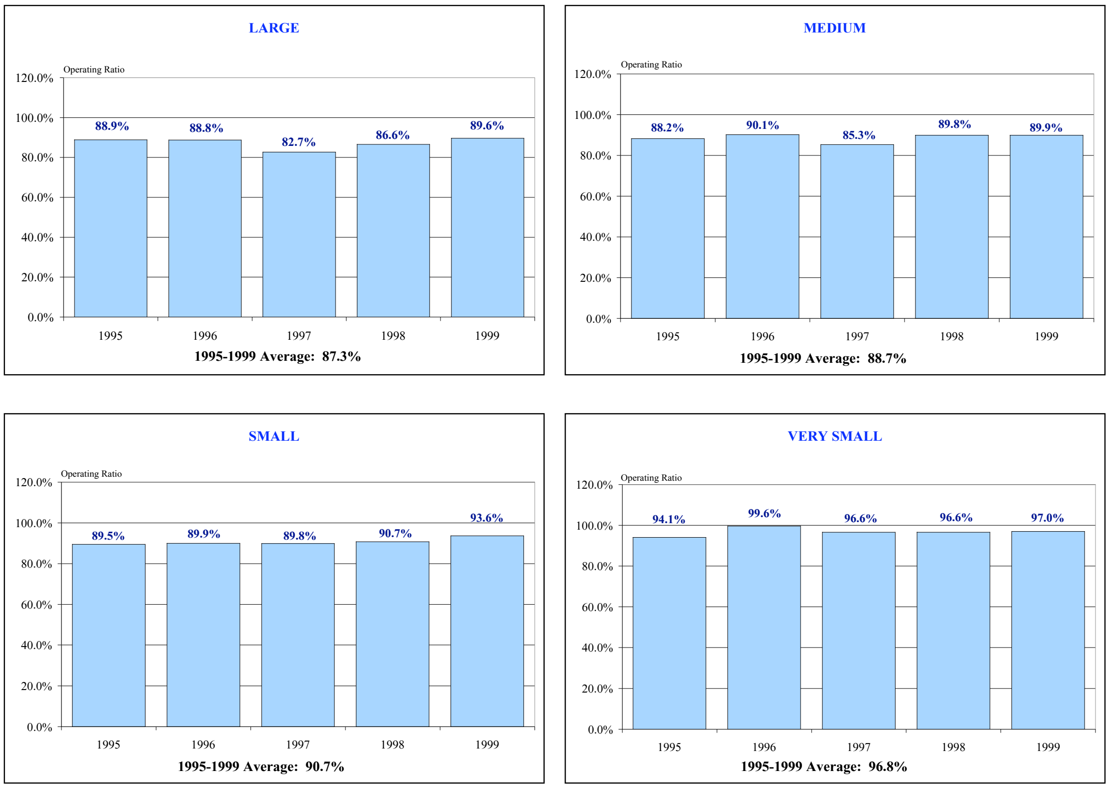






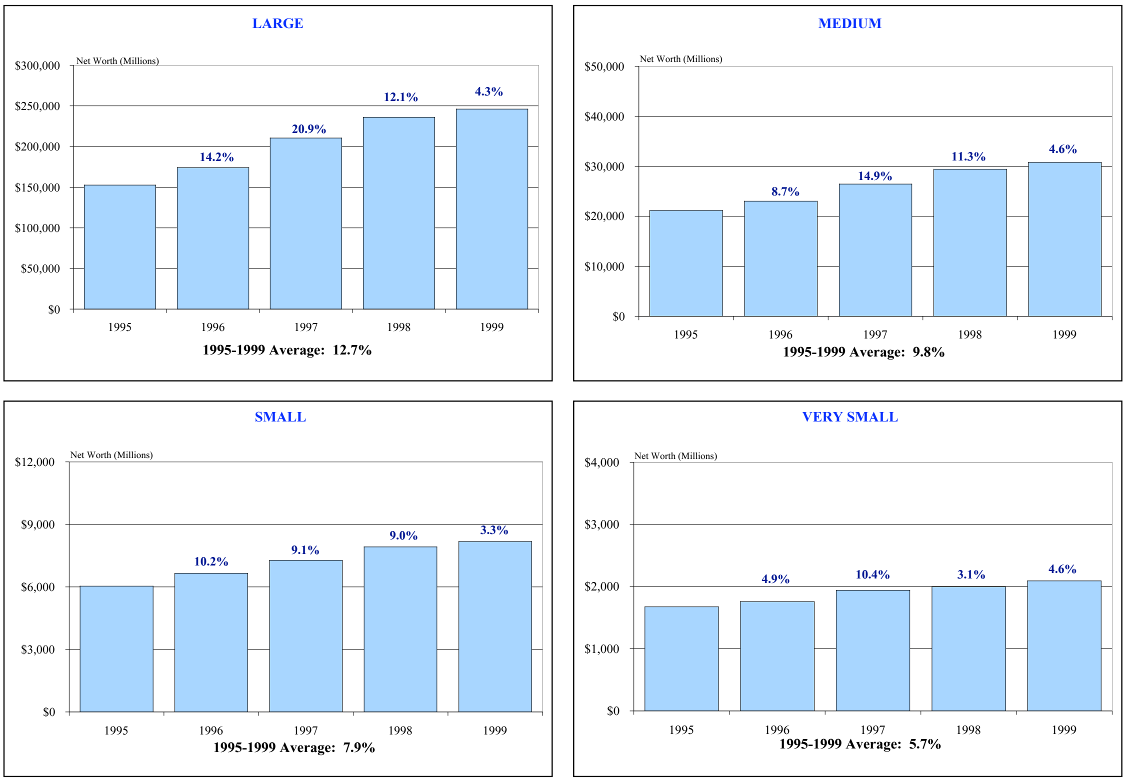
Five-year average net investment gains ratio – A consistent trend in net investment gains exists with large companies outperforming small ones. The spread between large and very small is significant (almost 5 points), particularly in more recent years.

– Operating Ratio –



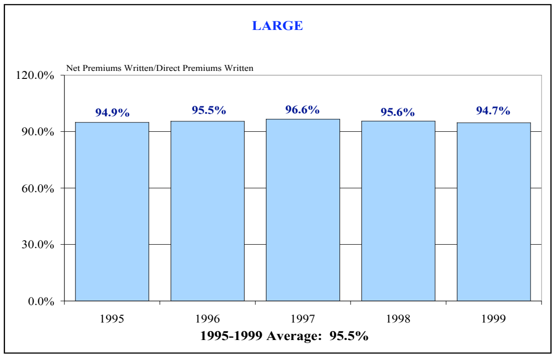
Five-year average operating ratio – As a result of both investment and underwriting results, the trend in overall operating results, including realized capital gains, is consistent with large companies outperforming small companies. It is interesting to note that large companies make a profit of about 13 cents on every dollar of premium compared to 3.2 cents made by very small companies.

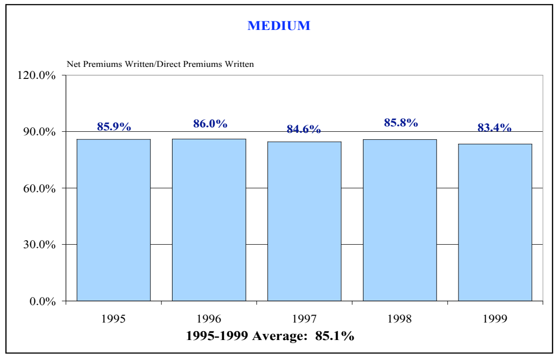
– *Growth in Policyholder Surplus* –

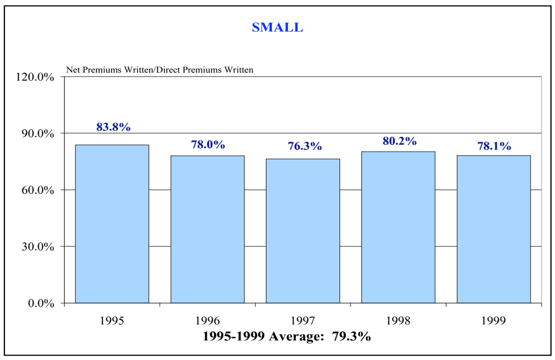


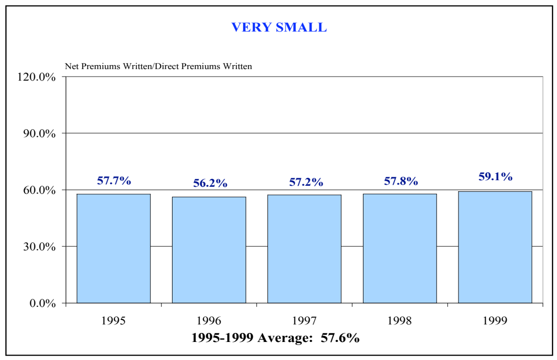
Growth in policyholders surplus – Surplus growth slowed considerably for the industry in 1999, however, large companies have been far more successful than small companies at growing surplus over the last four years, averaging 13 percent. Medium companies have performed respectably at about 10 percent but small (8 percent) and very small (6 percent) companies lag behind. (It is important to note that data only includes companies in existence in 1999 and the four preceding years. Therefore, the capital of acquired companies is excluded in prior years and treated as surplus growth in the year of acquisition).

– Net Premiums to Direct Premiums –

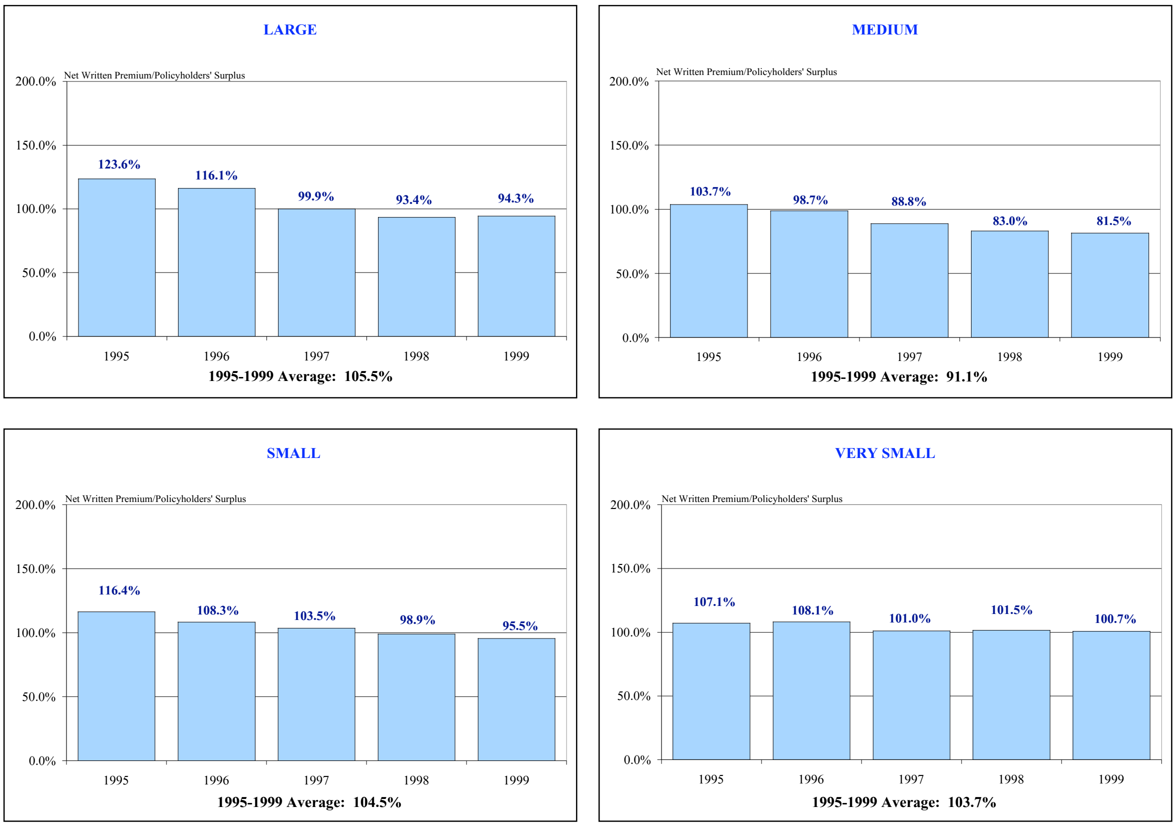






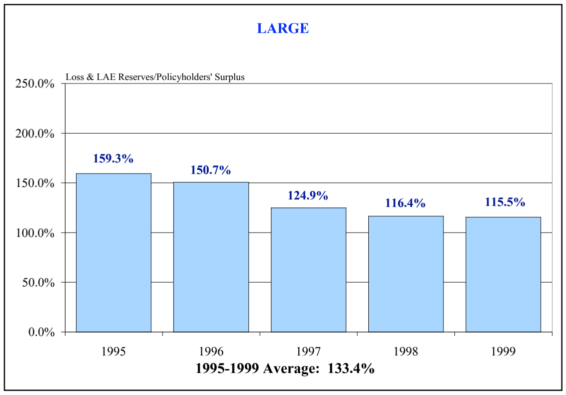


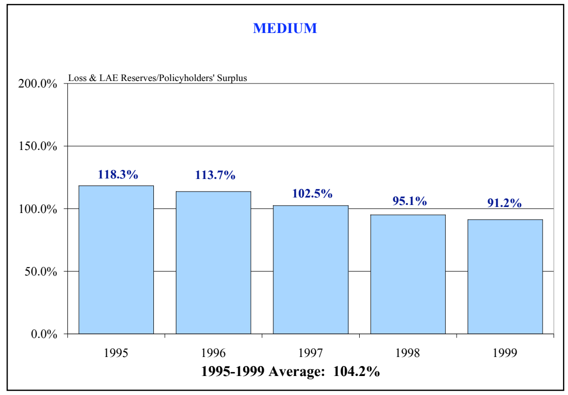
– Net Premiums to Policyholders Surplus –

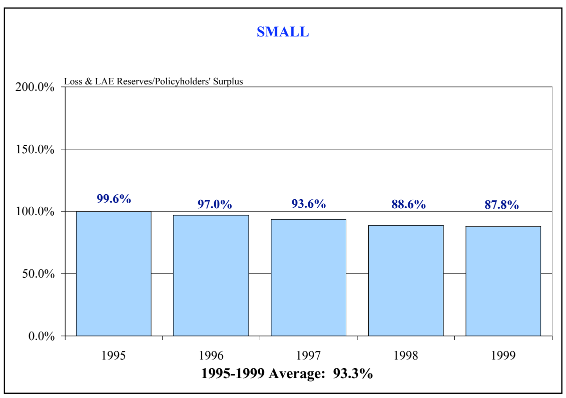


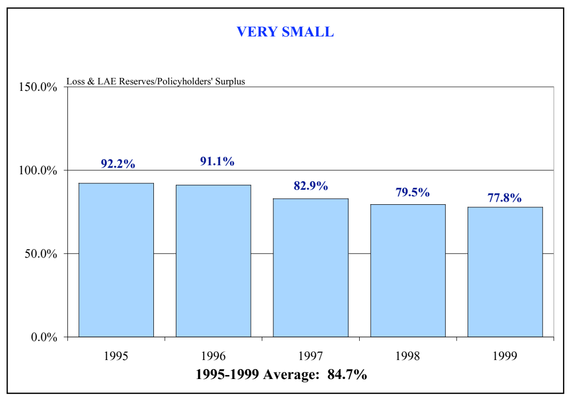
Net premiums to direct premiums and net premiums to PHS – Very small, and even small companies, write considerably more direct premium relative to surplus than do medium and large companies. However, reinsurance is used more aggressively. Very small companies, for example, retain just 58 percent of direct written premium versus a 96 percent retention rate for large companies. As a result, the ratio of net premiums to surplus is fairly consistent across size categories, ranging between .9 times and 1.1 times.

– Loss Reserves to Policyholders Surplus –



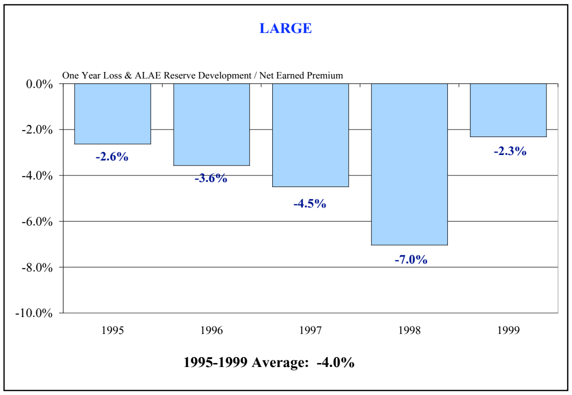


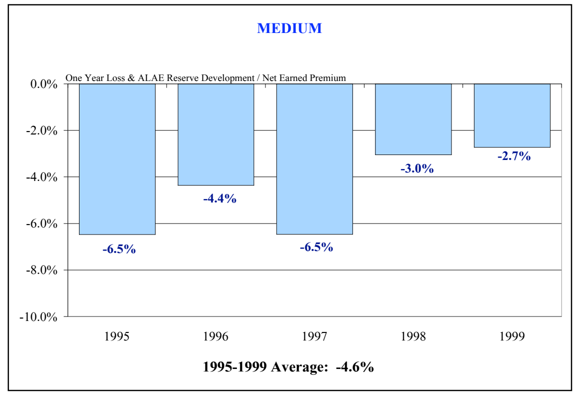


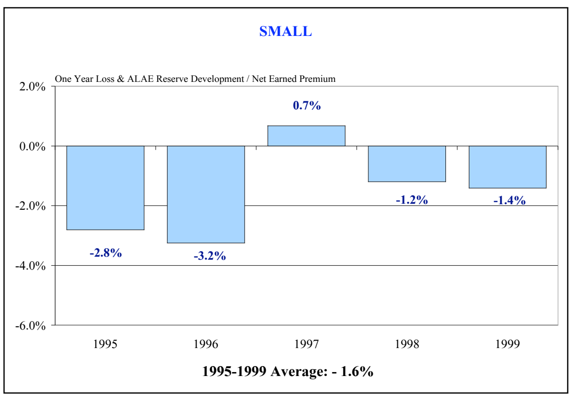


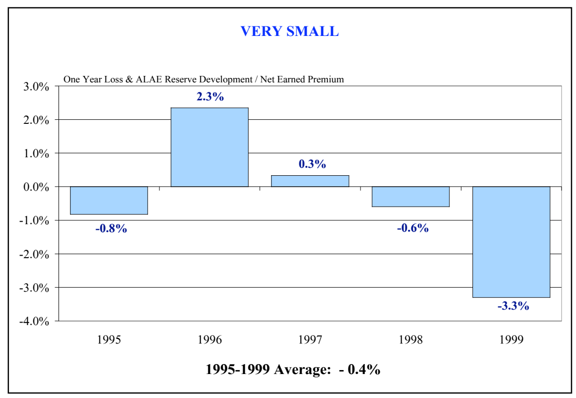
Loss reserves to PHS – Given the typically longer-tail nature of the classes of business written by large companies versus very small, large companies have a higher ratio of loss reserves to surplus. Overall, net leverage measures (premiums plus loss reserves to surplus) have been trending downward for all size categories as surplus growth continues to outpace premium growth.

– Loss Reserve Development –









Loss reserve development – While smaller companies may have lower reserve leverage than larger companies, large and medium companies consistently produce reserve redundancies that are, on average, considerably higher than small and very small companies. This is due primarily to the conservative reserving practices of large mutual insurers.

The rating distributions of both rating agencies show clearly that larger companies are generally rated much higher than their smaller counterparts. However, on average, this appears to be largely a function of their financial performance.

3.5 Communication

Company survey respondents believed that:

- Criteria for the ratings was not well-communicated (only 21 percent believed it was);
- The rating process was not well-defined (only 22 percent believed it was); and
- The rating rationale was not well-explained (only 27 percent believed it was).

Respondents also felt that the overall process was inefficient (only 23 percent believed it was efficient). In general, smaller companies tended to be far less satisfied than larger companies. Not surprisingly, overall, companies with higher ratings tended to be more satisfied.

The effectiveness of communication between the rating agencies, rated companies and users of the ratings has not been an area of strength and is a concern of survey respondents. This includes the communication of ratings, ratings definitions, criteria, and methodology. While the rating agencies do a fairly good job of broadly communicating rating issues and topics through various publications, industry commentary, seminars and Web sites, this is not the primary form of communication between rating agencies and the companies they rate. Companies focus on the meetings with rating agencies and other direct forms of communication as their primary source of information to understand what rating agencies are doing. Unfortunately, the quality and consistency of this communication needs improvement.

These misunderstandings have real-life consequences. In the past year, one-third of agent respondents (36 percent) had one or more rating services downgrade at least one company they represent. As a result of these downgrades, about one in six responding agents (17 percent) experienced a loss of business. Also in the past year, about one in six responding agents (18 percent) changed carrier representation based on a rating.

Based on ratings:

- 45 percent of agents selected a carrier to represent;
- 30 percent of agents terminated an appointment; and
- 18 percent of agents moved business.

To the extent confusion or misunderstanding about ratings exist, these and other decisions may be based on incorrect assumptions or criteria.

The rating agencies should explore the potential to develop a common standard of uniformity to help users of the ratings better understand what ratings represent. For example, as previously mentioned, a series of insurance company default statistics, by rating for a reasonable period of time – such as ten years – would be a useful report for users of ratings.

Also, rating agencies should strengthen their communication efforts to accurately reflect ongoing changes in rating philosophy. Financial strength ratings from a recognized rating agency are an important part of an insurer's business profile. A rating downgrade can have significant business implications to an insurance company's reputation and market position. Company specific issues and the rating implications of changes in the rating process, methodology or criteria need to be better communicated to company management by the rating agency analysts and done in a timely manner. As mentioned earlier, better analytical consistency should partially address the issues of communication of process, criteria and methodology.

This report focuses primarily on the rating agencies and their role within the insurance industry; however, insurance companies also play a major part in the rating process. Insurance executives need to accept some responsibility for managing the rating process and take an active role in the rating relationship. Education and better communication with the rating agencies will help develop a better relationship and understanding of the process. Executives may still disagree with the rating agencies' conclusions, but understanding the process will foster a better relationship.

4.0 Summary of Recommendations

1. Ratings from rating agencies should ultimately focus on measuring the probability of failure of an insurance enterprise. A common standard of uniformity, such as default statistics, should be developed as a way of helping users of the ratings to understand what the ratings represent.

2. Rating agency services beyond the assignment of ratings provided by the rating agencies (such as offering of observations and guidance) should be clearly performed outside the context of the rating process.

3. Rating agencies should perform and publish portfolio reviews and peer comparisons and improve the benchmarking of rating standards and thresholds as a way of addressing perceptions regarding accuracy and potential consistency problems that may exist within their ratings.

4. Standard & Poors and A.M. Best need to address the issue of consistency (both analytical and company-to-company) through the continued use of analytical rating teams, analyst training, better internal communication, rating committees, and minimizing analyst rotation whenever possible.

5. Company specific issues and the rating implications of changes in the rating process, methodology or criteria need to be better communicated by the rating agency analysts to company management and done so in a timely manner.

6. Analysts need to be aware of the impact that corporate structure has on the business strategy and balance sheet of a mutual insurance company - such as taking the cost of capital into consideration to give a clearer picture of the true capital generating power of an insurer.

7. Rating agencies should strengthen their communication efforts to accurately explain ongoing changes in their rating philosophies.

5.0 About the Study

NAMIC and M&R's intent in publishing this report is an effort to provide a critical analysis of the role and function of rating organizations in the property/casualty insurance industry. We hope this study will motivate rated companies, agents, and rating organizations to collaborate to identify and implement refinements to improve the quality and understandability of the rating process.

NAMIC is a full-service national trade association with more than 1,200 member companies that underwrite 39 percent ($118 billion) of the property/casualty insurance premium in the United States. NAMIC's membership includes four of the eight largest property/casualty carriers, every size regional and national property/casualty insurer and hundreds of farm mutual insurance companies. NAMIC benefits member companies through government relations, public affairs, education and arbitration services, and insurance and employee benefit programs. Information about the association, its member companies and the property/casualty insurance industry can be found at *NAMIC Online*, *www.namic.org*.