The world's most dangerous insurance publication℠

SCHIFF'S

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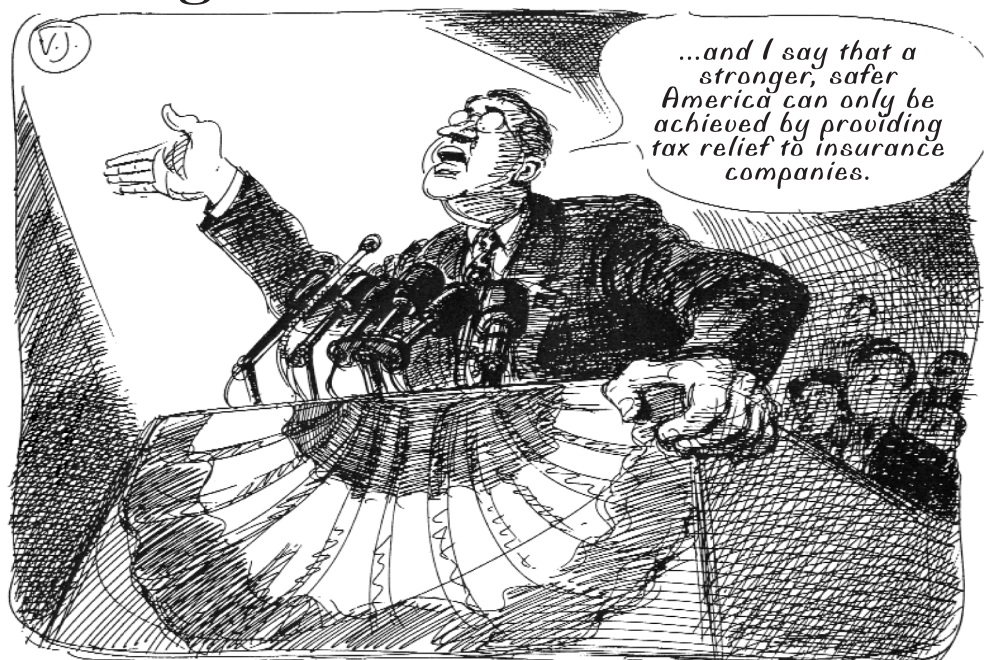
INSURANCE OBSERVER

'Unsurpassed' Ratings and 'Junk Insurance'

Financial Strength



Insurance stocks are not as richly priced as they were in 1998, when investors and insurance-company CEOs alike seemed to believe that an insurance-company charter guaranteed a fifteen-percent return on equity. Nor are they priced for perpetual bad news, as was the case in early 2000. Instead, they are merely priced with a great deal of optimism built in.

In early 2000, many insurance investors couldn't envision the industry's return to prosperity. Now they don't envision its return to adversity. The consensus seems to be that the insurance cycle may bark, but it won't bite.

Last December we published a two-part article entitled "The Return of Irrational Exuberance," which discussed our thoughts about insurance stocks. Our thoughts haven't changed much since then. We still don't like insurance stocks *in general*, nor have we noticed any *particular* ones we want to buy. During the last few years we've been selling some or all of the thirty or so insurance stocks we owned, many of which were bought in 1999 and 2000.

Insurance stocks are not the only investments we dislike. U.S. stocks are far from cheap, and the risk in longer-term Treasurys seems considerable given the reward (doubling your money in fourteen years). If you share our perspective you probably don't want to buy most insurance stocks at current prices—well above book value—since insurance companies are essentially leveraged portfolios of bonds and stocks.

The bad news for insurance stocks—and for the insurance business—is that business has been good. Rates have increased significantly from several years ago. Written premiums grew 4.7% in 2000, 8.6% in 2001, 14.6% in 2002, 10.3% in 2003, and 4.5% in the first quarter of 2004. Personal auto trends have been favorable. Catastrophe losses have been manageable. The property-casualty industry has a good chance of reporting a combined ratio below 100%—the first time it will have done so since 1978. Reported *underwriting* results are likely to be about $60 billion better than they were in 2001. (Investment income will be about the same.)

Profits have been rolling in, and that can't go on for too long for the insurance industry. The ebb and flow of the insurance cycle isn't a natural phenomenon, it's the result of human nature. Profitability attracts competition and capital, which ultimately bring about lower prices and reduced profits (or losses), which, in turn, eventually deters competition and leads to higher prices.

Insurance companies *always* pledge to be "disciplined" underwriters, just as investors *always* say that they won't overpay for stocks and bonds. But good times are intoxicating. Several years of a hard market have the same effect on insurance-company CEOs as several margaritas have on teenage boys: they begin acting silly. After several good years, underwriters start chasing low-frequency high-severity risks and investors pour money into hot stocks after valuations ascend to absurd levels.

Although prosperity replenishes or enriches insurance-company balance sheets, it tends to make people complacent about insurance companies' financial strength, an attribute that's already underappreciated.

Earlier this year American Capital Access Holdings, a Bermuda-based municipal bond insurer, filed the prospectus for its proposed IPO. The company, which was formed in 1997, has significantly lower ratings than its competitors. Ordinarily, that would be considered a disadvantage. American Capital Access, however, asserted that its more vulnerable balance sheet was, in fact, a "competitive strength." It said that its lower rating allowed it to provide financial-guaranty insurance to underserved segments of the municipal-finance market. "We are currently the only financial guarantor that has an 'A' financial-strength rating," stated the prospectus. "All other financial guarantors that serve the municipal-finance market are rated 'AAA' or 'AA.' The insurers with 'AAA' or 'AA' ratings generally are not able or choose not to guarantee the bonds of non-investment grade and non-rated issuers due to both rating agency and internally imposed constraints."

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In May, not long after the CEO and COO of American Capital Access quit, Fitch downgraded the company to "BBB." American Capital Access called Fitch's actions "unwarranted" and requested that it "withdraw its insurer financial strength rating." Two months later, American Capital Access withdrew its IPO.

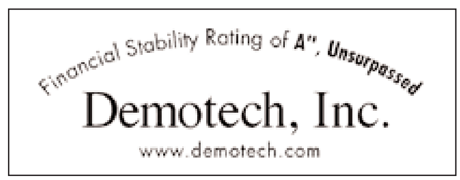
Insurance companies rarely agree that a reduction in their ratings is warranted. In December 1998, for example, Moody's placed General American's "A1" rating under review. In March 1999 it lowered the rating to "A2," citing the company's "significant exposure to funding agreements with short-term put options." (General American's balance sheet was a massive bet on interest rates and credit quality.) Five months later Moody's downgraded the company to "A3." The following week General American was unable to meet its financial obligations and was placed under regulatory supervision by the Missouri Insurance Department, which blamed Moody's for General American's woes, as did General American's chairman-president-CEO Richard Liddy. "The thing we can be faulted for is this," Liddy told the *St. Louis Post-Dispatch*. "How did we ever get in a position to let Moody's make us this vulnerable?"

More recently—on August 13, 2004—Moody's placed Liberty Mutual's ratings on review for a possible one-notch downgrade. Liberty Mutual immediately lashed out, calling Moody's behavior "so egregious as to defy rational explanation." (Moody's had cited "continuing uncertainty about the adequacy of reserves for core business lines as well as asbestos and environmental mass-tort liabilities.") In an apparent effort to seize some moral high ground, Liberty Mutual wrote that Moody's action was "a disservice to [Liberty Mutual] and our bond holders since the financial markets depend upon credible and rational actions by the rating agencies."

Some companies circumvent the issue of their low ratings. Take A.I.M. (Associated Industries of Massachusetts). It offers its member-companies insurance through A.I.M. Mutual Insurance Company. A.I.M's website claims that its insurance company is "rated A (Excellent) by A. M. Best." That's hasn't been true for fifteen months: Best downgraded A.I.M. to "A-" on May 28, 2003.

A good example of how to mislead policyholders about financial strength can be found on Atlantic Mutual's website. Atlantic Mutual, which has been around since 1842, once had excellent ratings and was held in high esteem. It is now struggling to survive. The company has jettisoned its commercial-lines business (its ratings were too low to support it) and is going after personal insurance for "individuals with substantial assets to protect."

We don't think it's prudent for wealthy individuals (or companies) to buy insurance from companies with ratings as low as Atlantic Mutual's: "B+" from Best, "BBB-" from Fitch, "Baa3" from Moody's, and "BB+" from Standard & Poor's. It will be difficult for Atlantic Mutual to succeed with such low ratings, given that its major competitors have excellent ratings. Perhaps that's why the company doesn't disclose these ratings on its website. Instead, under a section entitled "Financial Information," it displays a "Financial Stability Rating" from Demotech, a service that has a history of providing high ratings to small companies that carry vulnerable ratings from other rating agencies. Conveniently, Demotech gives Atlantic Mutual its *highest* rating: A'' (Unsurpassed).



Demotech's ratings are not credible. The company publishes ratings for companies that pay it to do so, and virtually all of these companies' "financial stability" is described as "unsurpassed" or "exceptional." Most of these companies are small, and most have received much lower ratings from other raters—if they are rated at all. Finally, Demotech's rating criterion—whether an insurance company's policyholders' surplus will be a positive number in eighteen months—is meaningless.

Demotech's ratings appear to be a marketing tool for insurance companies that can't get satisfactory ratings from well-known raters. They are not useful for most insurance buyers and should be disregarded. Atlantic Mutual's use of Demotech's ratings is deceptive. Someone viewing the rating on the company's website is likely to believe that

Atlantic Mutual's financial condition is "unsurpassed" when, in fact, that's not true. Atlantic Mutual has much lower ratings than all of its major competitors.

The following quote contains an unusual idea about insurance companies' financial strength (we'll tell you where the quote is from after you've finished reading it):

> Does your company unknowingly make risky investments? It could if you buy "junk insurance" from the wrong carrier.
>
> When you buy insurance today, you expect to be protected from mishaps that may not strike for years, especially in long-tail lines like D&O, excess casualty, environmental and healthcare. It isn't enough to check financial strength ratings before picking an insurer. Good corporate governance requires you to check the long-term debt rating your insurer receives from the major credit rating services. Insist that your broker disclose these ratings. You could be putting your company's future at risk if you buy coverage from insurers with low debt ratings—especially from insurers in loosely regulated jurisdictions. If your insurer fails, unresolved claim might never get paid. You, your shareholders, customers and employees could be irreparably harmed by junk insurance.
>
> FACT: many insurers that hold financial strength rating of A- hold long-term debt rating of BBB-, just one step away from junk.
>
> FACT: over 200 property-casualty insurers failed between 1993 and 2002.

This quote is from a full-page ad that AIG has been running in national business publications and insurance trade publications. AIG has long been one of the most creative, effective marketers in the commercial insurance business. Its ads are often bold, and raise concerns. This devilishly clever ad (shown to the right) follows in that tradition by planting fear in the minds of insurance buyers ("junk insurance;" "putting your company's future at risk;" "irreparably harmed"), and then offering a *solution*. The solution, of course, is AIG, one of a small number of companies that still has a triple-A rating.

Certainly, AIG's ad is self-serving—*it's an ad, after all*. American International Group (AIG) and its major insurance subsidiaries have the highest possible debt ratings and financial-strength ratings. And it is a fact that, all things considered, an insurance policy from a carrier with high ratings is worth more than an insurance policy from a carrier with lower ratings. Just how much more it's worth is a matter of opinion, but consider that when purchasing insurance for long-tail lines a company is risking much more than the premium paid; it is risking the limit of insurance purchased. Bond buyers can manage their exposure to any one credit by diversification; insurance buyers cannot. Their potential exposure from an insurance company's insolvency is intensified because the premium is generally a small fraction of the limit of coverage. Bond buyers can't lose more than they invest; insurance buyers can lose large multiples of premiums paid if their carriers become insolvent.

AIG's financial strength is a competitive advantage, and the company is wise to emphasize it. But is it right when it says that "good corporate governance requires you to check the long-term debt rating your insurer receives from the major credit rating services"? We think not, for a number of reasons.

Long-term debt ratings are generally issued for *holding companies*, not insurance companies. (Most insurance companies don't issue debt. Mutual insurance companies are an exception; they issue surplus notes, a form of debt.)

Debt ratings are opinions about a company's ability to honor its fixed-income obligations. They are not opinions about an insurance company's claims-paying ability.

An insurance company's financial-strength rating takes into consideration (to some extent) the financial strength—or lack thereof—of its parent company.

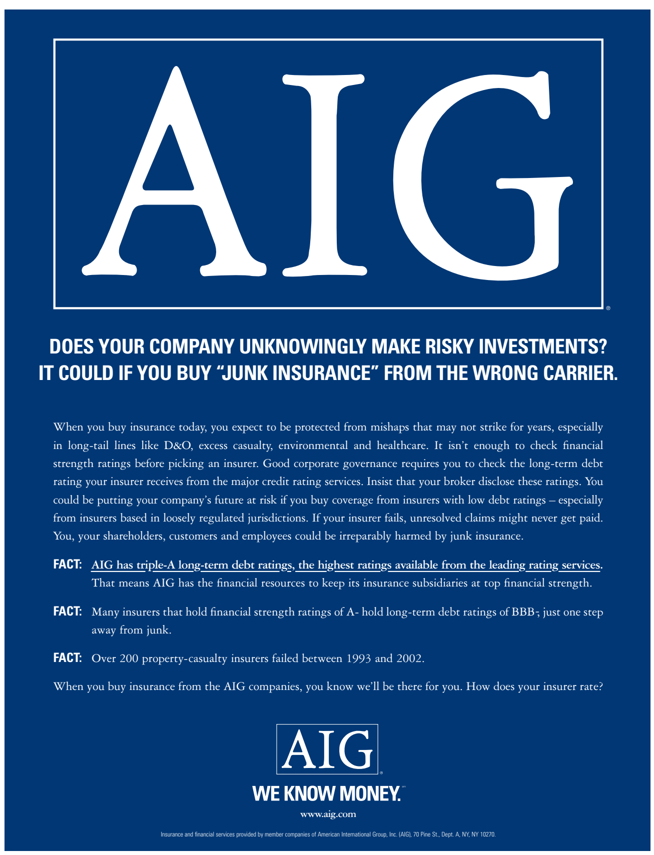
A company with the highest debt ratings may not have highest insurance financial-strength ratings. For example, Employers Re is rated "Aa2" by Moody's, "A+" by Standard & Poor's, and "AA-" by Fitch. Yet, Employers Re's parent company, General Electric, has triple-A debt ratings from all three raters.

An insurance-company's policyholder obligations are senior to debt. That means (at least in theory), that policyholder liabilities must be paid in full before debt can be repaid. Because debt is subordinate to policyholder liabilities, rating agencies typically rate an insurance-holding-company's debt several notches below the insurance company's financial-strength rating.

Absent a written guarantee, an insurance company's financial strength is independent from that of its parent company, and insurance buyers should be extremely cautious about relying upon the financial strength and reputation of a well-known parent company in lieu of the strength of its insurance-company subsidiary. (For more on this subject, see "How to Influence People and Sell Insurance, *Schiff's Insurance Observer*, March 1999, pages 4-17.)

Finally, "good corporate governance" *does not* require you to check the long-term debt rating your insurer receives from the major credit rating services. Checking insurers' debt ratings has nothing whatsoever to do with corporate governance.

Although we disagree with AIG's thoughts on debt ratings, we agree that many companies have bought—and are buying—"junk insurance." Insurance buyers often fail to place an appropriate value on financial strength. This will continue until some crisis



AIG's advertisement

makes buyers painfully aware of its value.

When that happens, we expect to be buying the stocks of insurance companies with strong balance sheets.