

## Ratings: The Holy Grail

A Perspective by  
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Exploring the world of insurance company ratings may be an arcane task, clearer than examination of the entrails of a goat, but daunting nonetheless. A leading member of the British Parliament and nobility may have defined its meaning more definitively when he proclaimed in another context (the Middle East), "things would have been better understood had they not been explained." But for the CEO who nurtures the hope of more and higher recognition for his or her company and constituencies, hope does spring eternal.

### Why Chase The Holy Grail of High Ratings?

For one thing, many financial institutions, regulators, policyholders and distributors may require it. For another, a high rating encourages policyholder, investor and public confidence in your company. Also, for many companies hitherto not subjected to or perceived not to need a rating, the required rating agency disciplines may be quite instructive and useful in internal management – ownership assessments. The process provides valuable perspective on a company business plan and strategy. It also serves to encourage greater transparency in this new era of disclosure.

But first things first - what is a rating anyway? It is an opinion at a point in time about the financial strength of your company. It is based on publicly available data, often supplemented with confidential interviews. A high rating does not mean your company will survive and thrive; it simply means that there is a greater likelihood it will. Nor is it an investment or capital markets recommendation. Moreover, rating firms are not uniform - opinions may and do differ inter alia.

However, there are concerns and potential pitfalls. Chasing a rating can be costly in terms of dollars, time and energies exerted. Per annum and initial costs could well run from \$25,000 to \$50,000. Also, for first timers as well as veterans alike, the experience can be unpleasant, as there may well be an adversarial contretemps. It is not unusual for the agency examiner staff to be one-half the age of the examined; more importantly, agency examiner staff may have distinctly less property-casualty and professional medical malpractice experience. Moreover, turnover of agency interviewers may be frustrating and produce distractions over which you have no control. Unlike the companies they rate, rating agencies are unregulated and are likely to remain so indefinitely. Lastly, once on the quest for The Grail, it is difficult to get off and turn back to the quiet Camelot whence you started. Explaining such a u-turn to your constituencies can be a headache.

Rating scales tend to fall into 2 major categories: Secure and Vulnerable. Common denominators among all ratings agencies are Solvency and Relative Performance vs. a company's own record and a peer group chosen by the rating agency. While the nomenclature may differ among the leading agencies, the basic rating process focuses on three discrete aspects of a company:

1. Capital
2. Business Profile
3. Operating Efficiency and Profitability

The three-legged ratings stool looks at current, 1 year, 5 and even 10 year records. Each agency uses both NAIC (National Association of Insurance Commissioners) and its own capital measuring rods. Tangentially, but rising in importance, is the Enterprise Risk Management (ERM) regimen, a topic deserving of its own treatment in another treatise.

The leading rating firms are A. M. Best Co., Duff and Phelps, Fitch Ratings, Moody's Investor Service and Standard & Poor's. Use of more than one agency can be helpful, especially if capital markets are a consideration.

- A.M.Best is the oldest and broadest in insurance company ratings, and more specifically med-mal coverage. It is privately-owned. A.M.Best uses available

data and consultation interactively with management. Companies may request their rating not be published. Agents and brokers tend to accord it the greatest importance.

- Duff and Phelps is a 75 year old, independently-owned firm, rating many fewer insurance companies. It performs ratings on request and provides claims-paying ability opinions.
- Fitch is a majority-owned subsidiary of Finlac, S.A. of Paris, publishing both voluntary and involuntary ratings. It is very balance-sheet debt and fixed-income asset oriented. Relatively few insurance companies are monitored closely; moreover, historically, the agency's actions suggest a distinct animus against monoline-monostate carriers.
- Moody's is a 108 year old, independent company (publicly traded) which solicits ratings, uses both public and non-public information, and renders financial strength ratings. Companies cannot request non-publication of ratings. It is a major force in public and private capital markets.
- Standard & Poor's was founded in 1860 and became part of The McGraw - Hill Companies (another publicly traded equity) about 100 years later. Its insurance industry coverage has expanded significantly in recent years, albeit still less than that of A.M.Best. Claims-paying and quantitative ratings are published on both voluntary and non-voluntary bases. As with Moody's, emphasis is placed on companies tapping the capital markets.

### The Rating Agency Presentation

A tight timetable should be prepared after confirming the formal meeting date with the agency staff. In preparing for the agency presentation, keep in mind the following:

1. The rating agency should be considered an "insider"

2. Each rating agency willingly provides you with a prepping questionnaire before the meetings and process commence.
3. A "point" executive should be designated by you early on who is very knowledgeable about the company and desirably, gifted in responding to questions. Such an individual should be the one who organizes, collects and pulls together pertinent information into a cohesive whole.
4. Input should be solicited and coordinated as needed from counsel, consultants, actuaries and accountants.
5. Carefully select those representing the company who will participate in rating agency meetings, whether in print or in person. Consideration should be given to alternating personnel annually.
6. Efforts should be made to determine who will be attending for the rating agency including qualifications, understanding of your industry and company, and rating agency in-house prior assignments.

Agencies like to receive a printed copy (or power point) of your presentation at least one business week before the meeting. Two to three copies should be sent to assure all attending agency staff are in the swim. Bring along several extra copies for the meeting.

The division of responsibilities is your call as to who speaks and when, as well as whom responds to which type of questions. This is also true of telephone sessions intra year or for special meetings. Try to avoid hyperbole but retain your enthusiasm and optimism, echoed by your colleagues. Address prior concerns or rumors head on. Seek to avoid future negative surprises by positing the probabilities of potential negatives to which you can assert your specific actions and corrective surgery. Defuse incorrect stories from whatever the quarter. Keep in mind that there is a "shorter leash" syndrome of agency patience for resolution and performance than was the case years ago. Apropos, be prepared to defend best, modal and worst cases of the future, more particularly

projections. Your credibility is at stake. When discussing recent market trends and actions, do not knock competition by name.

Agencies readily accept your retention of outside consultants to aid you in preparing and accompanying you, it is common practice. Vladimir Horowitz, the great concert pianist once remarked that “practice, practice, practice” is the way to get to Carnegie Hall. It’s also the way to achieve optimal results at rating agency presentations via holding "dress rehearsals" when all is ready. Designate your colleague or outside consultant to take notes of time expended and to catalogue all questions and answers at the formal presentation including who asked the question and who responded.

At the conclusion of the meeting, don't hesitate to ask for a preliminary impression or, even better, their reaction, as to your specific request for upgrade in both letter grade and outlook. Concurrently, ask for a time when their rating decision will be forthcoming. From start to finish takes approximately 6-8 weeks; if already on the journey, 2-4 weeks after annual sojourn.

#### After the Presentation

The letter grade assigned is very important, but so is the so-called "Outlook" which is a corollary. It is a frequent precursor to an up or downgrade. Stable, Positive, Negative, Under Review and Penalty Box are the relevant euphemisms. Circulate the aforementioned notes among all involved company executives and other participants. Set realistic time frames for responding to agency calls for action and notify the agency as to progress and resolution.

When the rating is rendered, make sure you edit their galley proof promptly. If the decision is unfavorable or disappointing, post haste set up a conference call with the rating agency staff to discuss their rationale and ask that specific rating professionals be included in the discussion. Don't alienate them by going around or over their heads when appealing the decision. Keep in mind there is a hierarchy that is committee driven on the recommendation of the lowest staff person and reviewed by his or her group superiors. Moreover, the history of successful appeals is not encouraging: it is a rarity.

Submit operational and financial data on a consistent basis, supplemented by analytical-explanatory comments where appropriate throughout the year, preferably at a minimum quarterly. If special issues arise such as financing, mergers and acquisitions, potentially damaging non-claims related law suits, distribution mode changes, recapitalization, key ownership and management changes, alert the agency ASAP as to likely impact. This includes adverse media articles. Similarly, as projections are modified materially from previously submitted ones, give the agency "heads up" as to why so as to maintain their confidence and your credibility. This is especially important if your company has a history of under- performance.

### Hot Buttons

At any given time, there are issues and concerns that dominate agency oversights more than others beyond the aforecited three- legged stool foundation. Here are some to conjure.

1. An historic skepticism as to the professional medical malpractice industry's stability - e.g. A.M.Best rates only one company at A+; Fitch accords one carrier an A ; but these agencies have evinced more liberal stance in recent years as to upgrades vs. downers.
2. Quality and quantity of reinsurance.
3. Slowing (and conversely, too rapid) growth in new insurable unit terms and dollars.
4. More consolidation, mergers and poolings emerging in softer market.
5. Agency overview transcends carriers per se - TPAs, claim organizations and medical consultative firms are in the swim, too.
6. Newest RRGs and startup captives face moments of truth in the cycle.
7. IRS continues to press for revenue from RRGs and captives.
8. Continuing relatively high medical, hospital, pharmaceutical inflationary pressures which tend to cut short hospital stays and increase errors or omissions among professionals.
9. Good combined ratios in first half 2008, deteriorating thereafter, as weakened pricing takes its toll (Outside New York State).
10. Uncooperative investment performance, exerting more pressure on cash flows.
11. Reasonably healthy reserves for accident and calendar years.
12. Consumerism-populism.

13. Rising claims frequency, soon to be accompanied by increased severity.
14. ERM devotees and detractors abound.
15. Capital use and abuse.
16. Outsourcing - quality and control sacrifices?
17. Distribution mode changes.
18. Multi-million dollar claims settlements which are eye-catching for all to see in the media coverage even if small in frequency

In addition, as was said in *Casablanca*, there are "the usual (issue) suspects" of agency oversight plus some unique to professional medical liability.

### Conclusion

This is not a labor of love and may well be a distraction, but it is a necessary one for those looking beyond today. If faced squarely and on a continuing basis, it can be worth the effort. But to date only a minority (estimated 35%) of PIAA's 33 members has seen fit to opt into the rating process in search of The Grail. While that low penetration is understandable in terms of the relatively smaller-sized enterprises and their ample incidence of mutual structure, the writer believes that the number will rise in relative importance over time. In an era of transparency, that is all to the good.