

# DEMYSTIFYING THE FINANCIAL STRENGTH OF INSURANCE COMPANIES

The following questions were raised during the Professional Liability Underwriting Society (PLUS) 23<sup>rd</sup> Annual International Conference Panel Discussion November 11, 2010. Unfortunately the panel did not have the time to answer the question during the session so responses have been noted below.

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## PLUS PANEL POST SESSION QUESTIONS/ANSWERS

During our session a number of questions were sent in from the audience. Here are **four** that PLUS has requested the panel to respond to post-session.

**QUESTION:** How credible are the rating agencies if companies have to "pay" for those ratings?

**ANSWER:** The credibility of rating agencies has been questioned by Wall Street, Main Street, Washington and even college newspapers. Example: The Baruch College *Ticker* recently ran a story highlighting the issue, even drawing a connection between rating agencies and the auditors that enabled the Enron catastrophe:

There is a clear conflict of interest among rating agencies and the issuers who give their business to agencies. Essentially a company wants to issue debt to raise capital. The company will contact the rating agencies and the rating agencies will charge the company to rate their debt. Professor Carew compared the conflict of interest among rating agencies and the debt they rate, to that of a company that hires a CPA firm to audit its books. Arthur Andersen, Enron's auditors at the time, knew they were hiding huge amounts of debt from their books, but they felt they needed to so they would not lose Enron as an account. Since it is in every company's best interest to have the highest/safest rating they may give majority of their business to a rating agency that gives them slightly higher ratings." The Dodd Frank Act is dealing with this issue.

**QUESTION:** What impact has the recession had on a policy holders willingness to accept a lower rated insurer in order to save insurance costs and pay a lower policy premium?

**ANSWER:** Very little – very few insurance companies have had their ratings downgraded substantially and insureds have accepted for the most part those that have had a downgrade – point in case – AIG (Chartis).

**QUESTION:** Can you comment on some of the newer rating agencies such as Demotech?

**ANSWER:** There are a number of independent rating firms apart from the National Reconized Statistical Rating Organizations (NRSRO's). Demotech was founded by Joseph L. Petrelli and has been providing actuarial services since 1985.

The following comments were made by J. Petrelli – President of Demotech that provides a response to the question and some keen insights. Joseph Petrelli, president of **niche** carrier ratings agency Demotech Inc., says the major ratings agencies' actions are often counterintuitive. "Let's say a company has a very high rating with one of the other folks," Petrelli said. "The company strengthens its loss reserves and then the rating goes down. If they had a good rating when under reserved, why do they get penalized for being appropriately reserved? It's silly to penalize a company for putting money in its reserves, where it belongs." Additionally, Petrelli claimed that Demotech focuses more on the strength of a carrier's balance sheet than its income statement. Demotech also rates carriers regardless of size, for an affordable price, unlike S&P's, which recently stopped wooing Golden Bear Insurance Co. as a client. The S&P's Dreyer said that while his agency rates companies regardless of size, smaller carriers often find the fee "prohibitive," in spite of a sliding scale. "The other ratings agencies are particularly enamored with size," Petrelli said. "Bigger's almost always better. We don't subscribe to that theory. A small, well-managed company is a better risk than a large, scattered company with more dependence on a variety of reinsurances, and carrying more risk." Demotech's financial stability ratings attempt to gauge the likelihood of a carrier's solvency for the next 18 months, which is the time period most agents and brokers care about. Demotech's analysis is usually based on data from the **National Association of Insurance Commissioners**.

**QUESTION:** Given the global position of rating agencies as the de facto regulators of the global insurance industry (a downgrade by AM Best can literally put a company out of business overnight), who oversees the regulators and their judgments to upgrade or downgrade etc? In addition, what role if any should an insurance regulator play in pivotal ratings moves by the ratings agencies?

**ANSWER:** At this point in time The Securities and Exchange Commission (Commission).The Commission adopted rules to implement under provisions of the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), enacted on September 29, 2006. The Rating Agency Act defines the term "nationally recognized

statistical rating organization,” provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies, and directs the Commission to issue final implementing rules no later than 270 days after its enactment (or by June 26, 2007). The rule and form prescribing the process for a credit rating agency to apply for registration were immediately effective. The remaining rules were effective on June 26, 2007. Currently these rules are being amended and/or under review. State insurance regulators and the NAIC monitor ratings and provide comments on their respective websites.

The National Association of Insurance Commissioners (NAIC) is the organization of insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. The NAIC provides a forum for the development of uniform policy when uniformity is appropriate.

A state regulator's primary responsibility is to protect the interests of insurance consumers, and the NAIC helps regulators fulfill that obligation. That assistance is related to the regulators' shared objectives of financial and market conduct regulation.

State insurance regulators created the NAIC in 1871 to address the need to coordinate regulation of multistate insurers. The first major step in that process was the development of uniform financial reporting by insurance companies. Since then, new legislative concepts, new levels of expertise in data collection and delivery, and a commitment to even greater technological capability have moved the NAIC forward into its role as a multidimensional, regulatory support organization.

With offices in Kansas City, Missouri, New York and Washington, D.C. the NAIC staff provide invaluable support to insurance commissioners. The following lists the primary activities and organizations of the NAIC.

In addition there is the National Conference of Insurance Legislators (NCOIL). *NCOIL is the voice of state legislators in Washington in the face of mounting federal initiatives to preempt state insurance regulation. Find out more about NCOIL [here](#).*

The purpose of NCOIL is to **help legislators make informed decisions on insurance issues** that affect their constituents and to declare opposition to federal encroachment of state authority to oversee the business of insurance, as authorized under the McCarran-Ferguson Act of 1945.

Toward that end, NCOIL works to:

- **educate** state legislators on current and perennial insurance issues
- help state legislators from different states **interface** effectively with each other
- **improve** the quality of insurance regulation **assert** the prerogative of legislators in making state policy when it comes to insurance

- **speak out** on Congressional initiatives that attempt to encroach upon state primacy in overseeing insurance

Many legislators active in NCOIL chair or are members of the committees responsible for insurance in their respective state houses across the country. All states are either general or contributing NCOIL members.

## **NCOIL RESEARCH, PUBLICATIONS**

Under the auspices of the Insurance Legislators Foundation (ILF), NCOIL's educational and research arm, the organization has published a number of studies on timely issues of public policy concern.

In November 2007, the ILF released *A Study on State Authority: Making a Case for Proper Insurance Oversight* that focused on the authority granted to—and real-life roles of—players who impact state insurance regulation, including legislators, attorneys general, regulators, and the National Association of Insurance Commissioners (NAIC). Phase II of the study comprised **critical recommendations** to gain new ground in insurance regulation, while at the same time regain territory that has been lost.

The recommendations advocated ways to:

- clarify the roles of regulators and attorneys general and strengthen commissioners' authority
- regain and enhance legislators' oversight of regulators and the National Association of Insurance Commissioners (NAIC)
- require the NAIC to follow open meetings laws and preclude regulators from attending closed meetings
- strengthen state regulation through expansion of the Interstate Insurance Product Regulation Compact
- create an independent commission of stakeholders to further review the current regulatory structure increase NCOIL resources to accomplish these tasks by reallocating state NAIC assessments

Previous ILF studies include, among others:

- a 2002 legislators' guide entitled *Rising Waters, Mounting Challenges: Flood Protection, Prevention, and Assistance*, undertaken in collaboration with the Federal Emergency Management Agency (FEMA) in order to educate legislatures on the basics of **flood insurance** and help promote public awareness

The study led to an NCOIL model law that includes, among other provisions, agent training requirements for flood insurance. The language has been widely cited by FEMA, the National Association of Insurance Commissioners (NAIC), and many others as a standard for agent training.

- two reports, released in 2000 and 2003, regarding the state system of **market conduct surveillance** that revealed, in part, significant inconsistencies, redundancies, and waste

The studies, prepared by PriceWaterhouseCoopers LLC and Georgia State University, led to, among other things, a 2006 NCOIL model law that would establish a uniform system for collecting marketplace data and would set forth a continuum of market conduct actions for consideration prior to undertaking targeted market conduct exams.

In addition, NCOIL publishes:

- a monthly **newsletter**, the *NCOILetter*
- *The Insurance Legislative Fact Book and Almanac*, available in both hard copy and Web-based editions, that contains postal, Web site and e-mail addresses, telephone and fax numbers of the state governors, insurance regulators, legislative leaders, legislative committee chairs, and top legislative staff members who handle insurance legislation
- **legislative alerts**, for lawmakers in NCOIL contributing-member states, that offer concise updates on key state and federal insurance efforts and their impact on state lawmakers
- **weekly articles of interest**, also for lawmakers in NCOIL contributing-member states, that draw legislators' attention to a variety of breaking news articles on critical issues, including from sources that legislators may not access