Insurance Company Ratings
By Chris Burand

Confidence in the ratings given to insurance companies by rating companies is important to agents, their customers, and possibly E&O claims. Agents, though, are losing this confidence. I have heard many agents lament about the rating companies' slow action to identify problem insurance companies. I believe the frustration and loss of confidence is partially due to a misunderstanding of what the ratings mean.

Insurance company ratings are solvency ratings and claims paying ratings. They are not stability ratings. Most agents are not aware of and do not understand the difference. A.M. Best has simply become the de facto insurance company rating that gets applied to everything. Their fine print though has a disclaimer clearly stating their rating's limitations. Their disclaimer states, "The objective of Best's rating system is to provide an opinion of an insurer's financial strength and *ability to meet ongoing obligations to policyholders*." (emphasis added) Insurers' only obligation to policyholders is to pay claims and sometimes, dividends. A good rating then means they have enough money to pay all current, foreseeable claims. It does not mean the company's operations are sound and stable. It does not mean the company is well-run and does not need any dramatic changes in order to survive tomorrow. It does not mean agencies can grow with the company. These are stability issues and require a different analysis that focuses on operational issues.

Because rating companies focus on claims paying ability and solvency, they focus on the balance sheet and reserving. My experience has been that rating companies do not adequately consider the operational issues necessary to predict future stability. While adequate capital is important, no company can maintain adequate capital if its operating results are continually poor. These operational and claims paying issues do go hand-in-hand, but a company's balance sheet often suffers six to twenty-four months after its operations are recognizably poor. Then, an additional lag time often occurs before the rating companies look at the balance sheet and issue a downgrade. This delay causes many agencies to do business with companies possessing poor operating financials. Agents, though, without a clear understanding of what the ratings mean, do not worry as long as the company has a high A.M. Best rating.

I have analyzed many insurance companies' stabilities for my independent insurance agency clients. Even without re-examining reserving, leverage, and the like (I am not an actuary so I have to take the rating companies' word on these issues), I have found that operating results are critical and often better for predicting an insurance company's future stability. By examining operational issues, I have identified problems with MRM (Legion), Reliance (insolvent), and HIH (insolvent), among many others, before any of these companies were downgraded.

In an ideal world, rating companies would provide two ratings. One rating for insurance companies' stabilities and another for their claims paying ability. Rating any company accurately is difficult, especially insurance companies, but mistakes are easily made when agents extrapolate and apply one single letter grade to everything within our very complicated industry. Rating companies will probably never provide two ratings though, so agents must realize ratings

only apply to an insurance companies ability to honor obligations to policyholders (and if you have to use the ratings, I strongly recommend using multiple rating services such as A. M. Best, Standard and Poors, Moody's, and Fitch. For L&H, also consider using Weiss.). Whether or not the company's operations are strong is a different issue and requires a different analysis that emphasizes the company's operating financials.

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