

How to Keep Tabs on Your Insurers

In good economic times and bad, your firm needs to know if its insurers will be available and viable over the long haul. In years past, checking your insurers' financial status once a year was probably a safe enough strategy. But many of the financial woes that recently beset the financial industry spilled over into other sectors of the economy, including the insurance industry. Thus, it may still be wise to pay closer attention than you normally might.

In this article we look at evaluating insurers' long-term viability, including:

1. the details of A.M. Best ratings;
2. other rating companies;
3. contract implications; and
4. other sources of information.

The Details of A.M. Best Ratings

A.M. Best Company is the most common source of ratings for insurers. When your firm signs a contract that specifies a minimum rating for insurers, it generally either stipulates or intends an A.M. Best rating. A rating requirement of A- VII or higher is fairly standard.

The letter rating refers to A.M. Best's assessment of the insurer's **Security**; the Roman numeral, to the insurer's **Financial Size**. These ratings, combined, measure A.M. Best's assessment of whether and how well an insurer will be able to meet its ongoing obligations—such as investigating and paying your claims.

In years past, you may simply have confirmed with your insurance broker that your firm's insurers met the criteria. Now, however, you—plus your firm's partners, shareholders, or other stakeholders—may want or need more information.

Security Ratings

A.M. Best's security ratings range from A++, meaning "Superior," all the way down to F for "In Liquidation" and S for "Rating Suspended." Those ratings and A.M. Best's judgment of their security or vulnerability are shown in the chart titled "A.M. Best Security Ratings." There are also ratings beginning with "N" for such conditions as "Insufficient Data" (NR-1) and for "Insufficient Size and/or Operating Experience" (NR-2).

A.M. Best Security Ratings

| Secure | Vulnerable |
|--------------------|----------------------------------|
| A++, A+ (Superior) | B, B- (Fair) |
| A, A- (Excellent) | C++, C+ (Marginal) |
| B++, B+ (Good) | C, C- (Weak) |
| | D (Poor) |
| | E (Under Regulatory Supervision) |
| | F (In Liquidation) |
| | S (Rating Suspended) |

The differences between letters can be subtle. For example, what would you imagine the difference between A and A- to be, given that both mean "Excellent"? We recently discussed this at length with an analyst from A.M. Best, who told us that A.M. Best considers the following elements in the order listed when determining an insurer's letter rating:

1. capital—combined liquid and fixed assets;
2. operating performance—the consistency of underwriting results over time, in both soft and hard insurance markets; and
3. business profile—management, niches in which the insurer is most involved (such as architects and engineers), and the track record of both management and the insurer in those niches.

There is a whole litany of issues considered, so an A or an A- (or any other letter rating) is both quantitative and qualitative. Each insurer has one analyst assigned. That analyst is in direct communication with the insurer, but a group of analysts prepares the materials submitted to the rating committee, which votes on the ratings.

Thus, the difference between an A and an A- is that both are “Excellent,” but an A- is slightly less “Excellent” than an A.

Financial Size Ratings

Financial size is more quantitative. It is a measure of the amount of policyholders’ surplus held by the insurer. For those of you not fully conversant with insurance lingo, policyholders’ surplus is the difference between an insurer’s assets and its liabilities—in other words, its net worth.

The rankings for financial size range from Category I, which indicates policyholders’ surplus of less than \$1 million, to Category XV, which indicates policyholders’ surplus of \$2 billion or more.

Rating Outlooks

A third, and sometimes overlooked, aspect of A.M. Best ratings is the “Rating Outlooks.” These indicate whether A.M. Best has assessed the insurer’s prospects as improving, remaining stable, or deteriorating. As with any future projection, a rating outlook is no guarantee of future viability. However, it is one more piece of the puzzle.

The outlooks are only assigned to insurers with ratings from A++ down to D. They indicate the insurer’s potential direction for an intermediate term, generally from 12 months to 36 months into the future. There are three possible outlooks:

1. positive—a possible upgrade in the near term due to favorable financial and/or insurance market trends;
2. negative—a possible downgrade in the near term due to unfavorable financial and/or insurance market trends; and
3. stable—no anticipated change.

In addition to considering the outlooks for your firm’s insurers, you should also consider any recent changes to an insurer’s rating. A recent upgrade, of either the security rating or the financial size, is obviously a positive development. On the other hand, a recent drop in the ratings bears further examination.

Some Additional Considerations

First, you should determine what rating meets your own threshold of acceptability. While A.M. Best classifies anything with a rating of B+ or better as “Secure,” at Greyling, we set our minimum threshold at A- VII, which equals “Excellent” with policyholders’ surplus of at least \$50 million.

Second, you should determine how frequently you want to check your insurers’ ratings, either through your insurance broker or by going directly to the A.M. Best Web site at www.ambest.com. On the upper right-hand side of the homepage, in a box titled “Member Center,” there’s a place to become a member. Membership is free and gives you access to detailed rating information. You can also subscribe, for a fee, to a service that will provide you with e-mail notifications of rating changes and other news about insurers of your choice.

Third, A.M. Best has been rating insurers for more than 100 years, having been founded by Alfred M. Best in 1899. On balance, the company gets it right more often than not. However, as front-page headlines in recent years demonstrated, bulwarks of the financial world can go from fine to finished in the blink of an eye. There were, in fact, indicators of trouble brewing, but not everybody recognized them for what they were.

Other Rating Companies

Most of the insurance industry relies on A.M. Best, but there are other sources of information about insurers. Two other prominent rating companies are Standard & Poor’s (S&P) and Weiss Ratings.

Standard & Poor’s (S&P) has been rating insurers since 1971. The financial strength ratings range from AAA (“Extremely Strong”) down to R. The R rating means that the insurer has experienced a regulatory action pertaining to its solvency. S&P

considers an insurer with a rating of BBB or higher to be “highly likely to have the ability to meet financial commitments.” The S&P Web site is www.standardandpoors.com.

Weiss assigns safety ratings to insurers, based on risk-adjusted capital, five-year historical profitability, quality of investments, liquidity, and stability. Ratings range from A (“Excellent”) down to F (“Failed”). Weiss Ratings can be found on the Web at www.thestreet.com.

Other companies, such as Fitch Ratings, Moody’s Investors Service, and Duff & Phelps, also analyze the financial strength of insurers. While looking at the A.M. Best rating will probably suffice in most instances, a second opinion can provide an alternate perspective—particularly if A.M. Best assigns a negative outlook to an insurer.

Contract Implications

The primary reason for your firm to do business with an insurer that has a strong rating is so that you can rely on that insurer to defend your firm and pay claims on its behalf, as well as to pay your firm’s own claims when it sustains insured damage. But a very close secondary reason is to meet your firm’s contractual obligations.

In some instances, you’ll have little choice about the rating threshold, as some of the contracts with your clients include not only insurance requirements, but also the rating acceptable to the other party to the contract. As we noted earlier, a rating requirement of A- VII or higher is fairly standard. If the insurer’s rating drops below the acceptable level, your company will be in violation of its contract.

Unfortunately, most contracts do not allow for the contingency that an insurer’s rating may drop after the contract is signed, after your firm has begun work on that contract, or maybe even several years into a multiyear contract.

As we tell our clients, if one of the leading insurers of architects, engineers, or contractors drops below A-, there will likely be thousands or even tens of thousands of businesses in violation of their contracts. That may be cold comfort, but if your

firm’s insurance policies are with a major insurer and that insurer’s rating drops below an acceptable level, the other parties to your contracts and to the many other contracts out there will have little choice but to give you a reasonable amount of time to replace coverage.

If possible, you should try to put a clause in your contracts that permits you a certain number of days—at least 60 or 90—to replace coverage, should your insurer’s rating fall below the specified level. This should be a part of your firm’s contracts going forward, but also an amendment to all of your existing contracts if the other parties are amenable to such a change. In the absence of such a clause, you can still hope that those with whom you contract will give you a little leeway.

You should also ask for a similar modification to the cancellation clause in your insurance policy. Without modification, most insurance policies impose a penalty on the insured for cancelling coverage before the policy expires. The most common penalty is 10 percent of the prorated premium that would otherwise be returned. This is often called a short-rate penalty.

For example, if your policy premium is \$100,000 and you cancel halfway through the policy, the prorated return premium would be \$50,000. The insurer would return \$45,000 to you and keep \$5,000 as the short-rate penalty. The more time left before policy expiration, the bigger the penalty.

(Note: Technically, such calculations are made using the number of days left in the policy year. “Halfway” through the policy year would leave you with either 182 or 183 days left, and the prorated return premium would be either 50.1 percent or 49.7 percent of the premium.)

You should ask your firm’s insurer to amend the cancellation clause to specify a pro rata, not a short-rate, return premium if you cancel because the insurer’s rating has dropped.

Other Sources of Information

There are a number of other sources of information about insurers, including the following:

Your Insurance Broker

Insurance brokers should keep track of trends in the insurance industry, particularly for those insurers with which they place a fair amount of business. Often, there will be subtle signs that an insurer may be in trouble, including high turnover of staff, less willingness to provide enhancements that broaden and strengthen coverage on policies, poor claims service, closing of several branch offices, or similar actions—or inactions. There can also be legitimate explanations for any of these changes, but a pattern of instability may be an early harbinger of trouble.

Your Insurer

Some insurers publish reports on their portfolios and assets and their exposures to subprime mortgages, collateralized debt obligations, or other toxic assets. Ask your insurer for specific information on any financial transactions that might put it in jeopardy.

Your Stockbroker

Credit ratings and stock prices are generally part of the analyses performed by rating companies. But unless there is a sudden change to an insurer's financial position and viability, rating companies assess insurers on a periodic, not a daily, basis. Stock prices, however, do change daily. Sometimes, stock prices show a lot of volatility, and some of it may be unwarranted. But a stock price that drops precipitously or that shows a gradual but persistent decline could be cause for alarm. You can sign up for stock alerts or updates on your firm's insurers through any number of Web sites.

Industry Peers and Trade Associations

Insurers tend to focus on niches. Thus, many of your firm's peers are likely using the same insurers your firm uses. This is one of the areas where the value of cooperation outweighs competition. You should keep your ear to the ground, listening for problems other firms in the same business are encountering with their insurers.

Your Own Analysis

Many insurers are publicly held. As a result, you should be able to gain access to financial statements, both annual and interim. Not every CFO, CEO, general counsel, risk manager, or other responsible person has the time or inclination to follow this path. But if you are comfortable analyzing insurers' financial statements, you may wish to do so.

In Closing

Insurance is a unique business. In most other industries, at the close of a fiscal year, the firm knows how much money it has, how much money it owes, and how much money is owed to it. The same is not the case for insurers.

Perhaps the biggest difficulty is in determining how much money should be set aside to pay claims. Due to the nature of the law, claims for something that happens today may not be known for several years. In extreme cases, claims may be presented 20 years after the initial event that causes the injury.

New causes of loss arise—*asbestos, mold, electromagnetic fields*—and suddenly blossom into class-action lawsuits that cost insurers millions. The whole process of insurance is an actuarial exercise: How much money does an insurer need to charge today for the claims it will have to pay tomorrow?

And the best and most rigorous of analyses do not—and cannot—account for all of the possibilities. The insurers of the World Trade Center never dreamed it was possible to bring down the two towers.

The best you can do for your firm is look at all the data available to you and make the best decision you can about the insurers with which you're comfortable doing business.

For more information on A.M. Best ratings or examples of reports from insurers, please send a request to info@greyling.com.