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All About Ratings

With all of the current uncertainty in the financial industry consumers are relying more and more heavily on the financial strength ratings from the major independent rating agencies prior to purchasing investment products. At Paul and Associates we believe that the financial soundness of the product provider is, clearly, the most critical consideration when dealing with injury victims' settlement funds. Finding the most attractive benefit is of minimal value without complete confidence it can be sustained for the life of the policy.

In recent months several of the life insurance companies who provide structured settlements have received rating downgrades from various agencies. This has created concern among both consumers and industry professionals. Some believe these downgrades are an overreaction by the rating agencies, most of who suffered some degree of embarrassment last fall due to the AIG situation.

That said, we thought it would be of value to help our clients better understand who the rating agencies are, what the various ratings mean and how they should apply to structured settlements.

First of all, it's important to understand that corporations pay the rating agencies to evaluate them. This, obviously, creates the potential for conflict of interest. The rating process is primarily to assist them in obtaining financing through the bond market. The rating agency will publish a comprehensive analysis of the corporation's financial condition and it's ability to meet its financial obligations. Not every company pays to have every agency rate them.

Based upon their analysis, the agency will assign a letter grade with A being the highest and F being the lowest. Each rating agency has different permutations on this system; some use AAA or Aaa as the highest, most all of them use pluses and minuses and others use numeric modifiers. While the look and feel of each agency's letter grade system is different, they all work the same; you just have to understand the system.

The letter grade represents the analyst's opinion of how financially solid the company is and how able the company should be to meet its financial obligations. But, know this; it is merely an opinion of a person or a group of people who work for the rating agency. People, even highly trained and experienced experts, can make mistakes.

For example, how many major rating agencies gave AIG dramatic downgrades prior to the Credit Default Swap crisis…the answer is <u>none</u>. They all jumped on the bandwagon <u>after</u> the news broke. This wasn't because they lacked expertise in the industry; it was because neither they nor almost anyone else really understood CDSs and what the potential risk to AIG could be in the "Perfect Storm" that hit them last fall.

In his article for Portfolio.com last December, Michael Lewis (the author of <u>Liar's Poker</u>) told the story of a small group of Wall Street traders who saw the sub-prime mortgage collapse coming and did extensive research to confirm their conclusion. In the article he included the following from an interview with one of the participants:

> But he couldn't figure out exactly how the rating agencies justified turning BBB loans into AAA-rated bonds. "I didn't understand how they were turning all this garbage into gold," he says. He brought some of the bond people from Goldman Sachs, Lehman Brothers, and UBS over for a visit. "We always asked the same question," says Eisman. "Where are the rating agencies in all of this? And I'd always get the same reaction. **It was a smirk**." (emphasis added)

The clear implication is that the rating agencies had some how been either coerced, corrupted or both.

We are not suggesting that dramatic mistakes or coercion and corruption are either commonplace or happen frequently within rating agencies. What we are suggesting is that any rating (positive or negative) should be considered as a data point, not a "be all, end all."

The oldest of the rating companies and the one that focuses predominately on insurance companies is A.M. Best & Co. It was founded in 1899 by a life insurance broker (Alfred M. Best) who was frustrated by the lack of financial information available about insurance companies. Over the years, they have also expanded their area of concentration to the banking industry.

Best has 15 rating categories from F (In liquidation) to A++ (Superior). They categorize the letter ratings into two broader categories, which are "Secure" and "Vulnerable." The Secure group includes "A++, A+ (Superior: Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders); A, A- (Excellent: Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing obligations to policyholders) and B++, B+ (Good: Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders)."

Contrast those to the next lowest category: "B, B- (Fair: Assigned to companies that have, in our opinion, a fair ability to meet their ongoing obligations to policyholders, **but are financially vulnerable to adverse changes in underwriting and economic conditions**)" (emphasis added). It gets worse from there.

So, according to A.M. Best, a consumer who has a policy rated B+ or higher should not be terribly concerned about being paid as promised. Anyone who has a policy from a company in the four highest ratings should, according to Best, never lose a night's sleep.

The other major rating agencies, Moody's, Standard & Poor's and Fitch all use a "AAA, AA, A, BBB, BB, etc." grading system. Moody's has 21 categories, S&P has 20 categories and Fitch has 23 categories. With this type of system the ratings from BBB to AAA are considered "investment grade." A fiduciary, by law, can only put money into investment grade bonds. So, for what it's worth, legislators seem to think that anything rated BBB or higher is a pretty safe bet.

At Paul and Associates we believe, for safety's sake, a life company should be rated by at least three major agencies and the ratings it receives should be in the top twenty percent of the categories by the majority of the agencies. We are happy to report that, even with the recent downgrades, all of the life companies we quote meet those criteria and several exceed them. We are confident that we continue to offer an investment product of exceptional security and we will continue to monitor any and all changes.

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