United States General Accounting Office

GAO

Briefing Report to the Chairwoman, Subcommittee on Commerce, Consumer Protection, and Competitiveness Committee on Energy and Commerce House of Representatives

September 1994

INSURANCE RATINGS

Comparison of Private Agency Ratings for Life/Health Insurers

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-258206

September 29, 1994

The Honorable Cardiss Collins
Chairwoman, Subcommittee on Commerce,
Consumer Protection, and Competitiveness
Committee on Energy and Commerce
House of Representatives

Dear Chairwoman Collins:

Private rating agencies are in a position to play an important role in providing information to consumers about insurers' financial health. However, concerns have arisen about the usefulness of these ratings to consumers. In response to your request, this report (1) compares the rating systems of the five major raters of life/health insurers—A. M. Best (Best), Duff & Phelps (D&P), Moody's, Standard and Poor's (S&P), and Weiss Research (Weiss) over the period August 31, 1989, to June 30, 1992, and (2) determines which raters were first to report the vulnerability of financially impaired or insolvent insurers.

Results in Brief

Insurer ratings could not be easily compared across the five rating agencies because they did not all use the same approach and methods to rate insurer financial health. Rating scales and descriptions of ratings varied by agency and over time. Weiss placed far less reliance than the other agencies on analysts' judgment. Coverage differed—Weiss was the only agency to rate more than half of all insurers. Finally, Weiss and Moody's were less likely than the other agencies to assign insurers their top ratings. (See app. I.)

Best and Weiss provided the most comprehensive coverage of life/health insurers; between them, they rated the majority of financially impaired life/health insurers. Weiss' ratings reflected financial vulnerability first three times more often than Best in the cases we compared. On average, Weiss' ratings reflected financial vulnerability 8 months earlier than Best.[1] The other agencies—D&P, Moody's, and S&P—rated, at most, five of the life/health insurers that became financially impaired during our comparison period. These five, among the six largest such insurers, were also rated by Best and Weiss. Weiss was the first to assign a vulnerable rating in five of the six cases; Moody's—which rated only two of the six insurers—was first in the sixth case. In no case was Best, S&P, or D&P

[1]As further explained in appendix III, we placed a limit on the number of days we credited by starting the count from the day Weiss first published life/health insurer ratings.

first to reflect financial vulnerability for these six insurers. In four of these cases, Best did not assign a vulnerable rating until after the first public regulatory action. (See app. II.) Our results are not projectible and apply only to the time period of less than 3 years that the data cover.

Scope and Methodology

To obtain information about life/health insurer ratings and related studies, we reviewed relevant articles, spoke with insurance experts, and interviewed representatives of the five major rating agencies publishing life/health insurer ratings —Best, D&P, Moody's, S&P, and Weiss.

We used ratings and other information obtained from the rating agencies and the National Association of Insurance Commissioners (NAIC) to compare the agencies' rating scales, descriptions, and methodologies, as well as industry coverage and actual ratings. We used data from August 31, 1989, to June 30, 1992. August 31, 1989, was the date Weiss first published life/health insurance ratings; a comparison with the other four agencies would not have been possible before that date.

In addition, we compared the raters' timing in reporting financial vulnerability. We did this by comparing when the raters assigned "vulnerable" or "noninvestment grade" ratings to insurers that became financially impaired or insolvent. We defined financial impairment or insolvency in the same manner as state insurance regulators and NAIC. We used the date of the first public regulatory action as our reference point. Data on state regulatory actions were obtained from NAIC, various state regulators, the National Association of Life and Health Guaranty Associations (NOLHGA), Best, S&P, and an insurance industry expert. (App. III has more detailed information about our objectives, scope, and methodology.)

We did our work between January 1992 and September 1994 in accordance with generally accepted government auditing standards. We asked the rating agencies to review the facts contained in a draft of this briefing report. We received responses from Best, Moody's, S&P, and Weiss, who did not raise factual concerns. However, Best, Moody's, and S&P provided other comments critical of the report. We addressed these comments in appendix III.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 7 days after the date of this letter. At that time, we will send copies to Best, D&P, Moody's, S&P, Weiss, and NAIC. Copies will also be made available to other interested parties on request.

Please contact me on (202) 512-8678 if you have any questions concerning this report. The major contributors to this report are listed in appendix IV.

Sincerely yours,

Thomas J McCool
for

Helen H. Hsing
Associate Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

CPA	Claims-Paying Ability
NAIC	National Association of Insurance Commissioners
NOLHGA	National Organization of Life and Health Guaranty Associations
QSR	Qualified Solvency Ratings

Comparison of Rating Systems

Figure I.1: Ratings Could Not Be Easily Compared

GAO **Ratings Could Not Be Easily Compared**

- Rating scales and descriptions varied
- Weiss placed less reliance on analysts' judgment than other raters
- Coverage differed—only Weiss rated most insurers
- Distributions varied—Weiss and Moody's assigned fewer ratings at the top of their scales than other raters

Ratings Could Not Be Easily Compared

The five rating agencies that rate life/health insurers—Best, D&P, Moody's, S&P, and Weiss—did not all use the same approach and methods to rate insurer financial health during the period of our analysis.

The rating agencies used different symbols and numbers of ratings in their rating scales. In some cases, the same letter rating was used by various raters. However, it did not necessarily occupy the same relative position in the respective rating scales. For example, an "A+" was Weiss' highest rating; Best's second-highest score; and D&P's and S&P's fifth-highest score.

The same letter rating also had different descriptions from the various raters. The "A+" rating was described as "excellent" by Weiss, "superior" by Best, and "good" by S&P.[1] Even the same letter rating within one rater's system may have had a different meaning at two points in time. During the time that we did our work, Best changed its rating system twice, both adding new ratings and changing the definition of existing ratings. In 1992, it added three new ratings, dropping its "A+" rating from first to second place. And, in 1994, it adopted the two-category "secure/vulnerable" classification used by most of the other raters.

All rating agencies, with the exception of Weiss, said that they placed a great deal of reliance on analysts' judgment both in assessing an insurer's management and in adjusting an insurer's rating at the end of the rating process. In contrast, while Weiss used judgment to create and modify the mathematical model that it used to determine the ratings, Weiss did not use judgment to assess management or to alter the results produced by the model for an insurer at the end of the rating process.

The agencies also differed in the number of life/health insurers they rated. Weiss, which does not charge insurers a fee, rated most insurers. The other rating agencies, which usually charge fees, rated fewer insurers. However, because all agencies generally rated the largest insurers, they each covered at least 50 percent of the life/health insurance industry's assets.

The five raters also varied in their assignment of ratings to insurers. We compared the agencies' distribution of ratings both for (1) insurers rated by each agency individually and (2) insurers rated in common between agencies, two agencies at a time. In both of these comparisons, Weiss and Moody's were less likely than the other raters to assign insurers their top ratings.

[1]Although D&P's full description for "A+" was similar to that of S&P, D&P did not use a single word descriptor similar to S&P's "good."

Figure I.2: Rating Scales Differed

GAO Rating Scales Differed

		Rating agencies				
Rating	**Bands**	**Weiss** [a]	**Best** [a, b]	**S&P** [c]	**Moody's**	**D&P**
Secure	1	A+, A, A-	A++, A+	AAA	Aaa	AAA
	2	B+, B, B-	A, A-	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-
	3	C+, C, C-	B++, B+ B, B-	A+, A, A- BBB+, BBB, BBB-	A1, A2, A3 Baa1, Baa2, Baa3	A+, A, A- BBB+, BBB, BBB-
Vulnerable	4	D+, D, D-	C++, C+, C, C-	BB+, BB, BB- B+, B, B-	Ba1, Ba2, Ba3 B1, B2, B3	BB+, BB, BB- B+, B, B-
	5	E+, E, E- F	D E, F	CCC, (CC, C) (D), R	Caa, Ca, C	CCC+, CCC, CCC- DD

[a]Weiss and Best use additional symbols to designate that they recognize an insurer's existence but do not provide a rating. These symbols are not included in this table.

[b]Best added the A++, B++, and C++ ratings in 1992. In 1994, Best classified its ratings into "secure" and "vulnerable" categories, changed the definition of its "B" and "B-" ratings from "good" to "adequate", and assigned these ratings to the "vulnerable" category. This table contains GAO's assignment of Best's ratings to bands based on our interpretation of their rating descriptions prior to 1994.

[c]S&P discontinued CCC "+" and "-" signs, CC, C, and D ratings, and added the R rating in 1992.

Source: GAO.

Rating Scales Differed

The rating agencies used different symbols and different numbers of ratings in their scales. The number of ratings used ranged from 15 (Best) to 20 (D&P). Weiss' top rating was "A+", Best's "A++", S&P's and D&P's "AAA", and Moody's "Aaa."

Although the same letter ratings were used by several raters, they did not necessarily have the same meaning. For example, Weiss' "A+" "excellent" rating was its top rating. Best called its "A+" rating "superior," but it was its second-highest score. And S&P's "good" "A+", D&P's "A+", and Moody's "good" "A1" ratings were their fifth-highest scores.

Three of the rating agencies—S&P, Moody's, and D&P—divided their rating scales into two categories labeled "secure" and "vulnerable."[2] On the basis of their descriptions, we assigned Weiss' and Best's ratings to these two categories. Weiss agreed with our assignment. Best told us that they were considering revising their rating scale to conform to the two-category "secure/vulnerable" designation used by most of the other raters, and that their empirical analysis had revealed that their "B" and "B-" ratings were similar to the other agencies' "vulnerable" ratings. However, Best did not revise their rating scale for the period they supplied data for our analysis. We assigned their "B" and "B-" "good" ratings to the "secure" category because we believe that a consumer would not understand a "good" insurer to be "vulnerable."

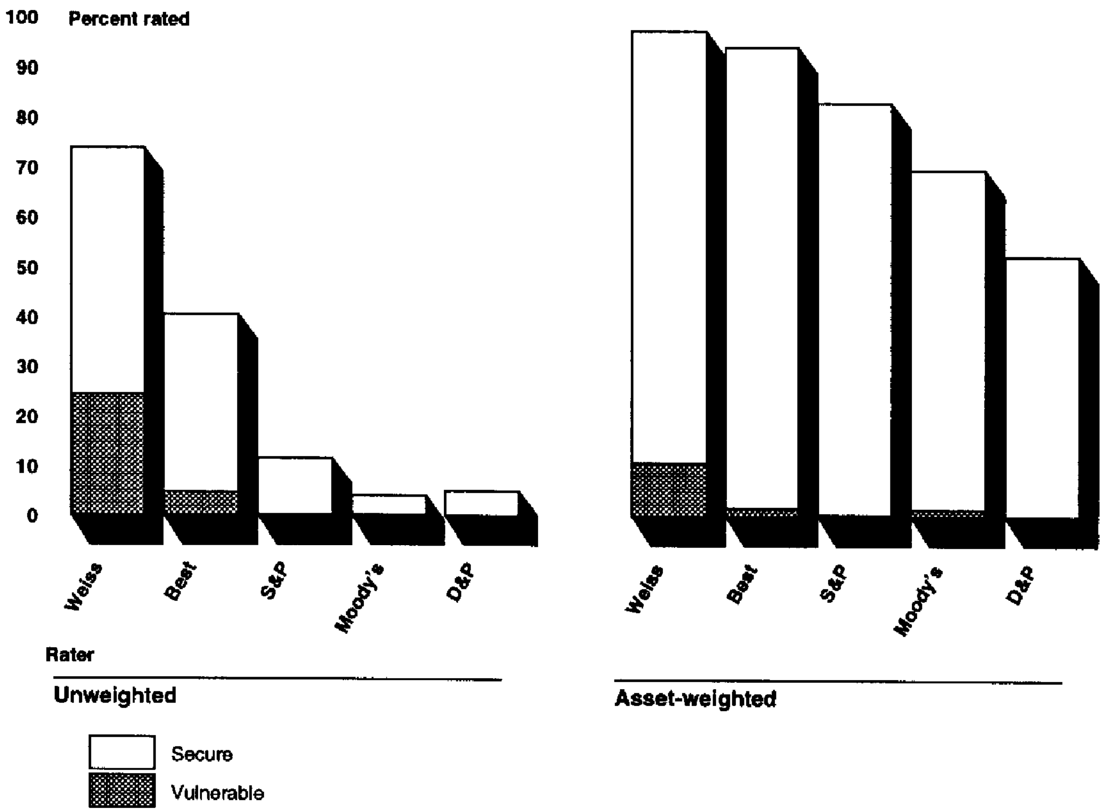
Rather than attempting to force the various rating designations to correspond letter rating by letter rating, we assigned them into five bands based on the similarity of their descriptions. As shown in figure I.2, we divided "secure" ratings into three bands, labeled "1" through "3", and "vulnerable" ratings into two bands, labeled "4" and "5." Thus, adjacent horizontal cells in figure I.2 contain ratings whose descriptions we determined were similar. However, as we previously noted, the descriptions were not precisely equivalent. Thus, these finer distinctions reflect our view of how the different ratings corresponded.[3]

[2]While Moody's and D&P may use different labels such as "investment grade/noninvestment grade" and "strong/weak", they told us that these labels have the same meaning as the "secure/vulnerable" labels used by S&P.

[3]S&P, Moody's, and D&P told us they intend for their ratings, which occupy similar positions in their respective scales, to be equivalent.

Figure I.3: Only Weiss Rated More Than Half of All Life/Health Insurers

GAO Only Weiss Rated More Than Half of All Life/Health Insurers



Note 1: Data are for June 30, 1992.

Note 2: Percent rated "vulnerable": S&P 0.2 percent (0.4 percent asset-weighted); Moody's 0.2 percent (1.5 percent asset-weighted); D&P 0.0 percent (0.0 percent asset-weighted).

Note 3: Our computation of S&P's coverage included only their Claims-Paying Ability (CPA) ratings and excluded their Qualified Solvency Ratings (QSR). Had S&P's QSR ratings been included, their coverage would have increased to 46.4 percent (96.3 percent asset-weighted).

Source: GAO.

Only Weiss Rated More Than Half of All Life/Health Insurers

Figure I.3 shows the percentage of life/health insurers rated by each of the raters, both in number and weighted by asset size. As of June 30, 1992, we identified 1,963 life/health insurers. Weiss rated 1,449—over 70 percent of the universe we identified, as compared to 795 rated by Best—about 40 percent.[4] The other three raters covered 12 percent or less each. However, because S&P, Moody's, and D&P generally rated the larger insurers, they each covered at least 50 percent of the life/health insurance industry's assets.

Figure I.3 also shows the division of ratings into "secure" and "vulnerable" categories. Although both S&P and Moody's assigned "vulnerable" ratings, the amounts were generally too small to register on the charts above.

[4]Weiss and Best provided some information about but did not rate an additional 16 percent (0.5 percent asset-weighted) and 29 percent (3.9 percent asset weighted) of life/health insurers, respectively.

Figure I.4: Weiss and Moody's Assigned Fewer Top Ratings

GAO Weiss and Moody's Assigned Fewer Top Ratings

		Percent of ratings assigned at the top of the scale	
Rating agency	Median rating	Band 1	Bands 1 & 2
Weiss	C-	4%	23%
Best	A	35%	65%
S&P	AA	29%	81%
Moody's	Aa3	10%	55%
D&P	AA	24%	84%

Note 1: Data are for June 30, 1992.

Note 2: Each agency's results are based on the distribution of ratings for all insurers rated by that agency.

Source: GAO.

Weiss and Moody's Assigned Fewer Top Ratings

We compared agencies' distributions of ratings both for (1) insurers rated by each agency individually and (2) insurers rated in common between agencies, two agencies at a time. Because the agencies did not all rate the same insurers, their rating distributions in the first comparison are likely to be different. Indeed, the distributions from the five agencies differed considerably. Best's, S&P's, and D&P's distributions contained proportionately more high ratings than those of Weiss and Moody's. Weiss' ratings were consistent with a normal or bell-shaped distribution, with most of the ratings falling in the middle of the scale. However, Best, which rated fewer insurers than Weiss, but more insurers than S&P, Moody's, and D&P, had the highest percentage of ratings in the first band. Although higher than Weiss, Moody's percentage of its rating distribution in the first band was lower than that of Best, D&P, and S&P.

Figure I.4 shows rating data from June 30, 1992, for insurers rated by each agency individually. When the median ratings for the various raters are placed within the roughly equivalent bands of figure I.2 on page 8, Weiss' median "C-" rating falls in the third band, at the bottom of the "secure" range, while the other raters' median ratings fall in the second band, in the middle of the "secure" range. Similarly, figure I.4 also shows that Weiss assigned the lowest percentage of ratings to the higher rating categories, followed by Moody's. Other raters assigned ratings in the higher bands two to nine times more often than Weiss.

As explained above, some of the variability in the raters' distributions may be because they did not rate the same insurers. To remove this possible source of difference, we also compared the assignment of ratings between agencies only for insurers they rated in common, as shown in the next few pages.

Figure I.5: Raters Usually Agreed Whether an Insurer Was "Secure" or "Vulnerable"

GAO

Raters Usually Agreed Whether an Insurer Was "Secure" or "Vulnerable"

- Raters agreed from 89% to 100% of the time when placing insurers in "secure" or "vulnerable" categories

- When raters disagreed, Weiss assigned "vulnerable" ratings more often

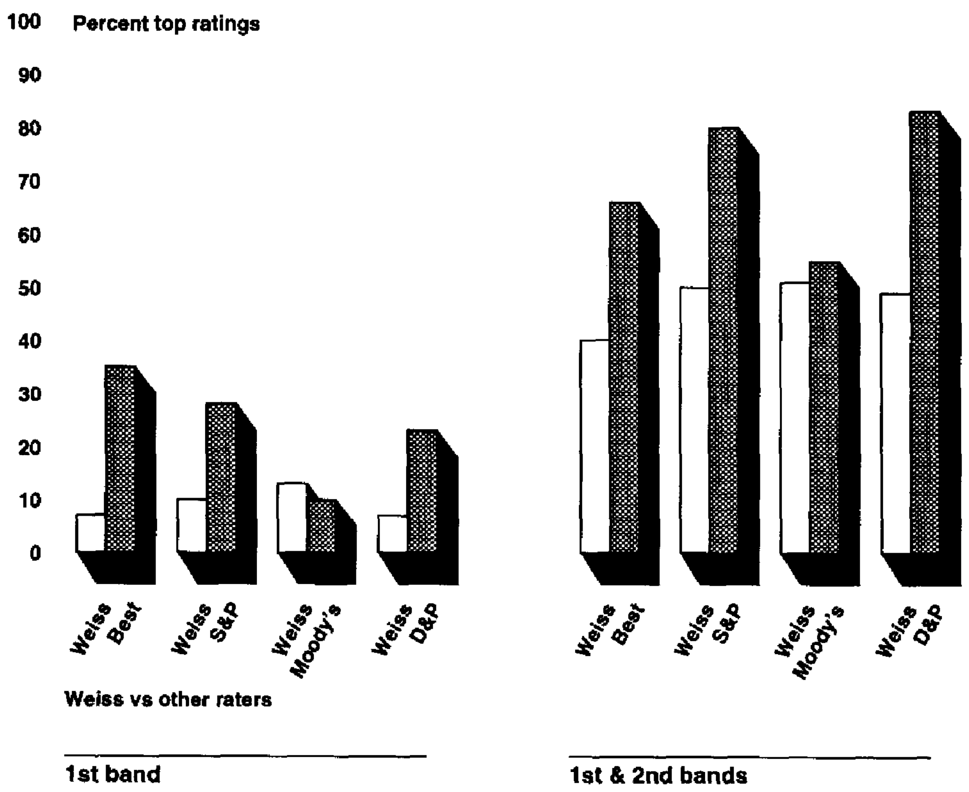
Raters Usually Agreed Whether an Insurer Was "Secure" or "Vulnerable"

We compared the five raters' assignment of ratings to insurers which they rated in common, comparing two raters at a time. At the broadest level, we found that the raters usually agreed on whether the insurers were "secure" or "vulnerable." Using data from June 30, 1992, we found that they agreed from 89 percent to 100 percent of the time, depending on which two raters we compared.

When the raters disagreed about whether an insurer was "vulnerable," we found that Weiss was more likely to assign a "vulnerable" rating than the other raters.

Figure I.6: Assignment of Top Ratings: Weiss vs the Other Raters

GAO Assignment of Top Ratings: Weiss vs the Other Raters



Note 1: Data are for June 30, 1992.

Note 2: "Secure" ratings are contained in the first three bands. Shown here are ratings in the first and second bands. (See page 8, figure I.2, and page 9 for a definition of the rating bands.)

Note 3: Information in this chart is based on pairwise comparisons of ratings for insurers rated in common by Weiss and the other rater.

Note 4: The numbers of insurers rated by both Weiss and another rater on June 30, 1992, are: 781 (Best), 217 (S&P), 78 (Moody's), and 95 (D&P). Pairs of bars depict the percentages of these totals Weiss and the other rater assigned top ratings in the first two bands.

Source: GAO.

Assignment of Top Ratings: Weiss Versus the Other Raters

We then used the rating bands from figure I.2, page 8, to further compare the raters' assignment of ratings to insurers that they rated in common. We did this comparison two agencies at a time. Because Weiss rated the largest number of insurers and also differed the most from other raters in assignment of ratings, we show the cases where Weiss was compared to the other raters in figure I.6. When the bars in a pair are of similar height, this indicates that Weiss and the other rater assigned about the same percentage (and number) of top ratings to insurers they both rated. As figure I.6 shows, Weiss and Moody's assigned about the same percentage of ratings to either the first band or the first and second bands combined for insurers they rated in common. When we reviewed all the pairwise comparisons between the raters (not shown here), we found that Weiss and Moody's assigned fewer ratings in either the first band or the first and second bands than Best, D&P, and S&P.

Raters' Timing in Reporting Financial Vulnerability

Figure II.1: Raters' Timing in Reporting Financial Vulnerability

GAO **Raters' Speed in Reporting Financial Vulnerability**

- We compared raters' timing in assigning "vulnerable" ratings prior to the first public regulatory action

  - population: all life/health insurers that became impaired or insolvent 8/31/89 — 6/30/92

  - benchmark: the first date a state insurance regulator took a public action

Raters' Timing in Reporting Financial Vulnerability

To compare raters' timing in reporting financial vulnerability, we compared when the raters assigned a "vulnerable" rating to life/health insurers that became financially impaired or insolvent. We defined financial impairment or insolvency in the same manner as state insurance regulators and NAIC. We included all life/health insurers that became financially impaired or insolvent between August 31, 1989, and June 30, 1992. We used the first date a state insurance regulator took a public action against the insurer as our benchmark.

Figure II.2: Weiss and Best: Analysis of Impaired Insurers Yields 30 Comparison Cases

GAO Weiss and Best: Analysis of Impaired Insurers Yields 30 Comparison Cases

Total of insolvent or financially impaired life/health insurers	**158**
Not rated	- 40
Rated	118
Rated only by Best	- 2
Rated only by Weiss	- 69
Rated by both Weiss and Best	47
Rated "vulnerable " by both Weiss and Best on 8/31/89 [a]	- 17
Weiss vs Best comparison cases	30

[a]These insurers were excluded from the comparison because Weiss did not rate life/health insurers prior to August 31, 1989.

Source: GAO.

Weiss and Best: Analysis of Impaired Insurers Yields 30 Comparison Cases

We identified 158 life/health insurers that became financially impaired or insolvent between August 31, 1989, and June 30, 1992. Forty were not rated by any of the five raters. Of the remaining 118, 71 were rated only by one agency, so we could not compare raters' timing in these cases. Weiss rated 69 of these 71 insurers and warned of potential problems by assigning a "vulnerable" rating; Best rated the other 2 and also assigned a "vulnerable" rating in both cases. This left 47 insurers rated by both agencies. The other agencies—D&P, Moody's, and S&P—rated, at most, five of the life/health insurers that became financially impaired or insolvent during this period. These five, among the six largest such insurers, are included in the 47 insurers rated by both Best and Weiss. We first compare Weiss' and Best's ratings and then compare all the available ratings for the six largest insurers (see figure II.5).

For 17 of the 47 cases rated by both Weiss and Best during our comparison period, both agencies had assigned "vulnerable" ratings to the insurers as of August 31, 1989. Because Weiss did not rate life/health insurers prior to this date, we excluded these 17 cases from the Weiss and Best timing comparisons. This left 30 cases to compare timing between Weiss and Best.

Figure II.3: Weiss and Best: Who Assigned "Vulnerable" First?

GAO Weiss and Best: Who Assigned "Vulnerable" First?

Did both assign "vulnerable" ratings?	Weiss first	Best first	Total
Yes	19	7	26
No -- only one	4	0	4
Total	**23**	**7**	**30**

Source: GAO.

Weiss and Best: Who Assigned "Vulnerable" First?

Figure II.3 compares Weiss' and Best's timing in assigning a "vulnerable" rating for the 30 cases they rated in common during our comparison period.[1] Overall, Weiss was first in 23 cases, Best in 7 cases—about a three to one ratio.[2] In four cases, Best never actually assigned a "vulnerable" rating. Instead, Best changed these ratings from "secure" to one of its "not assigned" categories.

[1]We constrained our comparison between Weiss' and Best's ratings to the period from August 31, 1989, to June 30, 1992. Best rated several insurers prior to this time, but either discontinued rating or assigned its "not assigned" designation prior to August 31, 1989. If Best did not assign these insurers a rating during our comparison period, prior to the first public regulatory action, they were excluded from our comparison.

[2]If we had placed Best's "B" and "B-" ratings in the "vulnerable" category, Weiss would still have been first overall. Weiss' advantage would have decreased from about three to one to about two to one.

Figure II.4: Weiss and Best: How Much Earlier Was "Vulnerable" Assigned?

GAO Weiss and Best: How Much Earlier Was "Vulnerable" Assigned?

	Number of insurers to which both assigned a "vulnerable" rating	Number of days agency assigned a "vulnerable" rating before other agency	
		Range	Mean
Weiss first	19	42 to 1040	443
Best first	7	26 to 749	302
Mean advantage Weiss over Best			242

Source: GAO.

Weiss and Best: How Much Earlier Was "Vulnerable" Assigned?

We also determined how much earlier a "vulnerable" rating was assigned by Weiss or Best in the 26 cases where both assigned a "vulnerable" rating during our comparison period.[3] As figure II.4 shows, Weiss was faster than Best an average of 443 days, about a year and 3 months, in the 19 cases where Weiss assigned a "vulnerable" rating before Best. Best was faster than Weiss an average of 302 days, about 10 months, in the 7 cases where Best assigned a "vulnerable" rating before Weiss. Overall, Weiss assigned a "vulnerable" rating 242 days, or about 8 months, before Best.[4]

[3]As figure II.3 showed, Best never assigned "vulnerable" ratings in 4 of the 30 cases.

[4]This average reflects only the timing comparisons in the 26 cases where both Weiss and Best rated the impaired or insolvent insurers and assigned a "vulnerable" rating during our comparison period. We started the count August 31, 1989. In 5 of the 7 cases where Best assigned a "vulnerable" rating first, the actual assignment occurred prior to the start of our comparison period.

Figure II.5: When Were "Vulnerable" Ratings Assigned to Large Insurers?

GAO When Were "Vulnerable" Ratings Assigned to Large Insurers?

	Number of days rater assigned a "vulnerable" rating before (-) or after (+) first public regulatory action					
Rating agencies	**Executive Life of CA**	**Executive Life of NY**	**Fidelity Bankers**	**First Capital**	**Monarch**	**Mutual Benefit**
Weiss	- 379	- 372	- 308	- 617	- 162	- 40
Best	- 6	+ 1	+ 2	+ 5	a	+ 3
S&P	- 190	na	- 6	- 3	+ 351 [b]	c
Moody's	- 422	na	na	na	na	+ 2
D&P	- 41	na	na	na	na	na

Note: na = not rated.

[a]Best never assigned a "vulnerable" rating to Monarch Life. An "A" rating was changed to a "not assigned" designation 4 days after the first public regulatory action.

[b]S&P had assigned a "BBB" rating, its next-to-lowest "secure" rating, to Monarch Life 184 days prior to the first public regulatory action. However, S&P did not assign its "BB" "vulnerable" rating until 351 days after the first public regulatory action.

[c]S&P never assigned a "vulnerable" rating to Mutual Benefit Life. It discontinued rating the insurer July 12, 1991, 1 day prior to the New York Times report of pending state regulatory action.

Source: GAO.

When Were "Vulnerable" Ratings Assigned to Large Insurers?

Six large life/health insurers, with assets ranging from $1.4 billion to $13.5 billion, became insolvent or financially impaired between August 31, 1989, and June 30, 1992. Weiss and Best rated all six. Five out of the six also happened to have been the only life/health insurers to become financially impaired or insolvent during this time that were rated by any of the other raters. S&P rated five, Moody's rated two, and D&P rated one.

As figure II.5 shows, Weiss was the first rater to assign a "vulnerable" rating in five out of the six cases. The number of days prior to the first public regulatory action that Weiss assigned a "vulnerable" rating ranged from a little over a month to a little less than 2 years. Moody's was the first to assign a "vulnerable" rating for Executive Life of California; it assigned this rating 422 days, or approximately 1 year and 2 months, prior to the first public regulatory action. Weiss assigned a "vulnerable" rating 379 days, about a year, prior to the first public regulatory action in this case. Best assigned a "vulnerable" rating before the first regulatory action in only one of the six cases, and this was only six days before the regulatory action occurred. In one case, Best stopped rating the insurer and never assigned a "vulnerable" rating. In the remaining four cases, it assigned a "vulnerable" rating only after the first public regulatory action occurred.

Objectives, Scope, and Methodology

We examined private agency ratings of life/health insurers at the request of Chairwoman Cardiss Collins of the Subcommittee on Commerce, Consumer Protection, and Competitiveness, House Committee on Energy and Commerce. Specifically, our objectives were to (1) compare the rating systems of the major raters of life/health insurance companies—Best, D&P, Moody's, S&P, and Weiss, and (2) determine which raters were first to report the vulnerability of financially impaired or insolvent insurers.

To obtain information about life/health insurer ratings and related studies, we reviewed relevant articles, spoke with insurance experts, and interviewed representatives from the five major rating agencies. We obtained rating information from the raters.[1] Although earlier rating data was received from most of the raters, we compared ratings from August 31, 1989, the date Weiss began rating life/health insurers, to June 30, 1992. Because (1) results based on data from one period may not be applicable to a future period and (2) at least one rater has made changes to its rating scale subsequent to our analysis, our results are strictly applicable only to the period analyzed.

Most of the rating data supplied by Best from their computer data base did not contain the exact date of rating changes. To obtain the dates, as Best suggested, we consulted their published ratings and press releases, which they also supplied. Although data from the other raters also required some preparation and cross-checking, it was of a lesser degree than that required for data supplied by Best.

We used NAIC data to determine the universe of existing life/health insurers, their assets, and unique identification of these insurers. However, NAIC could not assure us that its records contained all life/health insurers because the states do not require all insurers to file with NAIC. In addition, because insurers may stop filing statutory financial reports when they become financially impaired, NAIC's files may have gaps in financial information. We interpolated asset data that was missing from NAIC files. Although our analysis assumed insurers' statutory financial data to be comparable, we are aware that this assumption may not be true in all cases due to differing state accounting practices.

We compared the agencies' rating scales, descriptions, and methodologies, as well as industry coverage and actual ratings for our analysis period. We used the raters' descriptions of their ratings to establish a correspondence

[1]In addition to the CPA ratings included in this report, S&P also publishes three-level QSR ratings. Because publication of QSR ratings began in April 1991, the comparisons we could have made with the other agencies' ratings were limited. Therefore, S&P's QSR ratings were excluded from the study.

among rating levels so that we could compare the assignment of actual ratings. We confirmed the division of ratings into "secure" and "vulnerable" categories with the raters and noted the cases where they did not use this characterization.

We examined the agencies' coverage of the life/health insurance industry by determining the percentage of life/health insurers they rated. This was done by comparing the life/health insurers rated by a particular agency to the total of life/health insurers, both in number and weighted by asset size. We also compared the agencies' distribution of ratings both for (1) insurers rated by each agency individually and (2) insurers rated in common between agencies, two agencies at a time.

In addition, we compared the raters' timing in reporting the vulnerability of financially impaired or insolvent insurers by comparing the date they assigned "vulnerable" ratings to the date the first public regulatory action was taken.[2] We defined financial impairment or insolvency in the same manner as state insurance regulators and NAIC. We limited our comparison to the period from August 31, 1989, to June 30, 1992, and constrained the number of days we credited by starting the count from August 31, 1989. We removed from comparison insurers that had a "vulnerable" rating from more than one rater on August 31, 1989. In addition, if an agency had assigned ratings prior to August 31, 1989, but did not rate on or after this date, we did not use these ratings in our comparison. And, finally, if a rater assigned ratings only after the first regulatory action occurred, we categorized this as "not rated" for the purpose of our timing comparison. This had no effect on D&P's, Moody's, or S&P's results. However, Best's date of "vulnerable" assignment was constrained to be no earlier than August 31, 1989, in the 7 cases where Best was first in assigning a "vulnerable" rating. In 5 of these 7 cases, Best assigned a "vulnerable" rating prior to August 31, 1989.

In doing this analysis, we tried to take the point of view of insurance consumers. By comparing raters' timing in assigning "vulnerable" ratings to insurers that became financially impaired or insolvent, we placed the most value on reducing the likelihood that an insurer would be rated "secure" when it should have been rated "vulnerable." We realize that this placed less value on reducing the likelihood that an insurer would be rated "vulnerable" when it should have been rated "secure."

To do our timing comparisons, we constructed a file of state regulatory actions against insolvent or financially impaired life/health insurers. Because NAIC obtains its information about insolvent or financially impaired insurers from voluntary reporting by state regulators, we could not be assured that NAIC's information was comprehensive. In fact, we identified a number of such insurers from other sources—NOLHGA, Best,

[2]In January 1994, Best told us that they were contemplating (1) changing their rating system to use the "secure/vulnerable" designation and (2) assigning their "B" and "B-" ratings to "vulnerable." We reanalyzed the data to see how sensitive our timing results were to placing Best's "B" and "B-" ratings in either the "secure" category or the "vulnerable" category.

S&P, and the author of a related study.[3] In a number of instances, we called individual state regulators to verify confusing or conflicting information. In several cases, we obtained information about additional public regulatory actions taken against the insurers, in some cases at earlier dates than we had obtained from previous sources. Thus, even though the information we have about public state regulatory actions is more comprehensive than any of the individual sources we used, we still cannot be assured that it is fully comprehensive.

We used the date of the first public action taken by any state against a financially impaired or insolvent life/health insurer as the reference point from which we measured a rater's timing in detecting financial problems. The earliest type of action contained in our sample ranged from a cease and desist order to a liquidation notice. However, because different states may take the first public action at different stages of financial impairment, no public action may be recorded in some states if, for example, an insurer is sold to or merged with another insurer.

We did our work between January 1992 and September 1994 in accordance with generally accepted government auditing standards. Because we used information supplied by the rating agencies, we asked them to review the facts contained in a draft of this briefing report. We received responses from Best, Moody's, S&P, and Weiss, who generally agreed with the factual information presented.

Best, S&P, and Moody's also provided other comments critical of the report. The three agencies pointed out that rating approaches and philosophies vary among the agencies and that, because of this, alternative methodologies covering longer periods of time could produce different results. We do not disagree. We did not use data prior to August 31, 1989, because we were asked to compare all five rating agencies and Weiss had no ratings prior to that date. Thus, we carefully limited our analysis to a description of events that occurred over a period of slightly less than 3 years. Our results are not projectible and should not be construed as applying to any other time period.

A second common criticism was that we should have presented the percentage of life/health insurers in each category that later became financially impaired. The agencies believed that this would have counteracted a tendency in the report to concentrate on (in Moody's terminology) "Type I' error (too high a rating on a company that defaults)" rather than "Type II' error (too low a rating on a company that is financially stronger than indicated by the rating)." In our timing comparison, we looked only at the ratings of life/health insurers that became financially impaired. The period we could use to compare all five agencies was less than 3 years—August 31, 1989 to June 30, 1992. We believe that the results of the additional analysis suggested by the rating agencies would be inconclusive over such a short time period. The failure rate of insurance companies overall is relatively low. Because the sets of

[3]Lee Slavutin, "Life Insurance Company Ratings—How Reliable is A. M. Best?" Financial and Estate Planning, Aug. 1991, pps. 24991-24999, and "Rating Life Insurers: Can You Really Trust A. M. Best?" Contingencies, vol. 5, no. 1, Jan./Feb. 1993, pps. 36-39.

insurers rated by the agencies vary substantially, the set of institutions rated in common by all raters is quite small. Since the numbers of both companies and associated failures that would be available for comparison are small, obtaining a statistically valid result would require a longer sample period than was available to us.

Finally, S&P believes that we should have included their Qualified Solvency Ratings in our analysis. We excluded these ratings because S&P began their publication in April 1991, so the comparisons we could have made with other ratings were limited.

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