



DUE CARE BULLETIN

April 2011

The Importance and Nature of Assessing Life Insurance Company Financial Strength

This Due Care Bulletin reviews the importance and nature of assessing insurance company financial strength when purchasing or managing an existing life insurance policy. An assessment of financial strength primarily focuses on the role of rating agencies, ordinarily the most important source of financial strength information and guidance. In addition, other sources of information can be helpful and are presented toward the end of this bulletin.

M Financial Group has been, and continues to be, an industry leader in advocating and providing information on life insurance company financial strength due care. M Financial provides M Member Firms relevant industry information through Due Care Updates and educational insight through Due Care Bulletins, which can be used with clients to help evaluate a new or existing life insurance policy. In addition, M Financial provides rating agency reports, statutory financial statement data, and packaged financial information through VitalSigns.

Why Assessing Life Insurer Financial Strength is Important

The life insurance industry is among the most heavily regulated industries doing business today. In an effort to protect policyholders, life insurance companies are subject to conservative rules and requirements that involve, among other factors, how companies manage their finances and support the products they issue to customers. However, life insurance companies can and sometimes do fail. Because the failure of a life insurance company can have far graver consequences for its customers than can the failure of most other corporations, greater scrutiny is warranted. Embedded within life insurance policies are long-term, intangible financial promises not found with most other financial or consumer products.

The figure on page 2 shows the annual impairment ratio of life and health insurers (L&H) since 1976. The rate of L&H impairments in 2009 was 0.81 percent, below the average impairment rate of 0.88 percent during the last 34 years.

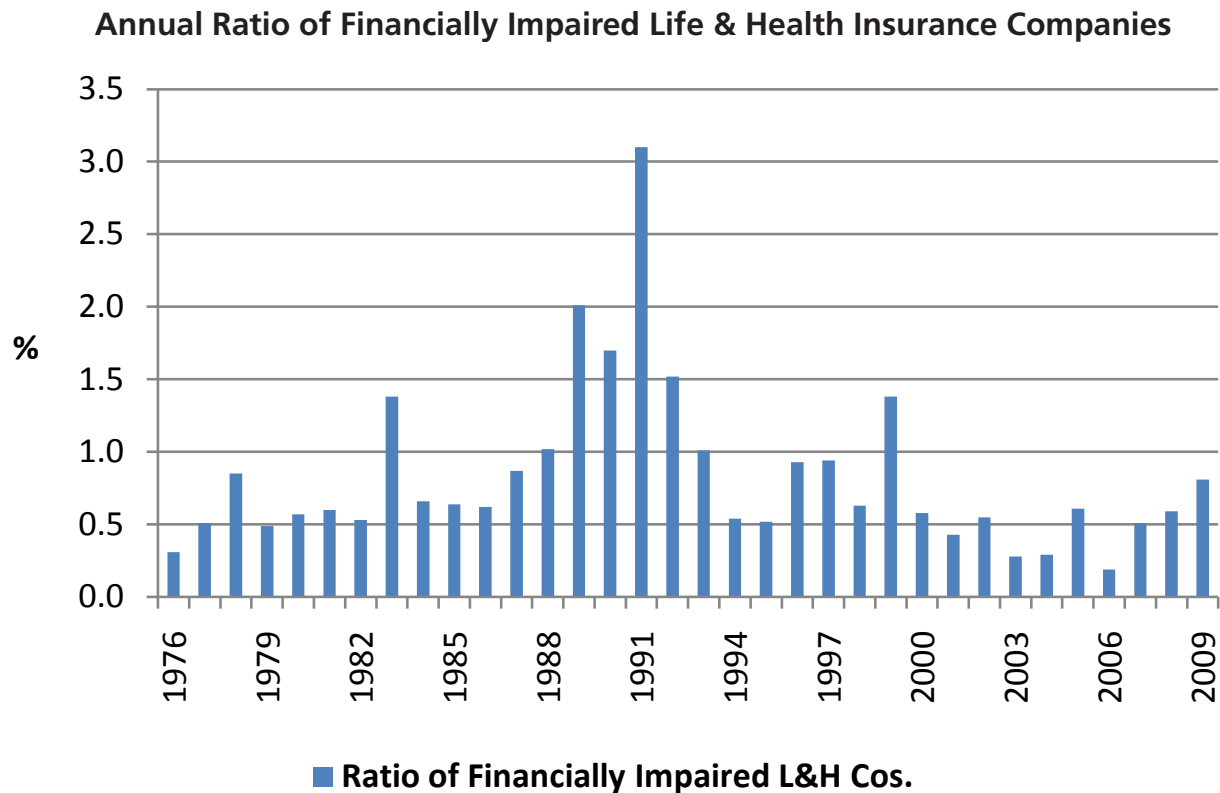
We use the A.M. Best definition of a financially impaired insurer as one for which its:

- Ability to conduct normal operations is impaired,
- Capital and surplus have been determined to be insufficient to meet legal requirements, and/or
- Financial condition has triggered regulatory concern.

Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

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Source: A.M. Best

Fortunately, almost 92 percent of financially impaired insurers have been comparatively young and small, with capital and surplus of less than \$20 million. The average annual impairment rate for these small insurers was 2.3 percent whereas the average for large insurers was only 0.03 percent. Additionally, most have gotten into difficulty because of adverse results from writing accident and health insurance. Regulatory changes in mid-1990s have helped to reduce impairment rates which peaked from 1989–1992.

Assessing Insurer Financial Strength

An assessment of an insurer's financial strength is essential but not simple. Neither the typical life insurance advisor nor certainly the average life insurance buyer is technically capable of making a reasoned, independent assessment of an insurer's financial strength. Doing so requires mastery of specialized and sometimes confusing insurance terminology and, importantly, requires a high level of accounting, actuarial, and financial competence by those conducting the analysis. Rather than try to undertake such an analysis, one can assemble insightful information and data relating to an insurer's financial strength from numerous secondary sources. In the great majority of cases, the primary and most reliable sources are rating agencies.

The Importance of Rating Agencies

Rating agencies are businesses that provide commentary and opinions about the ability of firms to meet their obligations. Several rating agencies offer opinions about life insurers' financial strength and their ability to meet ongoing obligations to policyholders. Rating agencies are not infallible, but have been found to be the most consistent and thorough in assessing the financial condition of insurers.

The Importance and Nature of Assessing Life Insurance Company Financial Strength (continued)

Four Major Rating Agencies

There are four major rating agencies that offer opinions about the financial strength of life insurance companies and are designated by the Securities and Exchange Commission (SEC) as Nationally Recognized Statistical Rating Organizations (NRSROs). They are:

- A.M. Best Company (A.M. Best)
- Fitch Ratings (Fitch)
- Moody's Investors Service (Moody's)
- Standard and Poor's (S&P)

An Example of an Agency's Rating Methodology

Each rating agency relies on public and nonpublic data in preparing its reports and determining its financial strength ratings for life insurers. They also have their own methodology for utilizing this various data and information, with no two being identical. There is, however, similarity among the agencies in terms of the data and information examined as well as analysis applied. The Moody's methodology offered below is necessarily abbreviated substantially from Moody's actual methodology description.

Business Profile

The business profile factors are intended to capture those characteristics that reflect the life insurer's presence in the market. These factors are more subjective than are the financial factors. Insurers that have sustainable competitive advantages in terms of market position and brand, distribution, and product focus and diversification can be expected to be able to maintain and enhance future profitability and financial strength.

- Factor 1: Market Position and Brand
- Factor 2: Distribution
- Factor 3: Product Focus and Diversification

Financial Profile

An insurer's financial profile is of obvious relevance in measuring its financial strength. Moody's uses five factors to capture this profile. Together, these factors generally account for 60 percent of the overall rating, with the business profile representing the other 40 percent.

- Factor 4: Asset Quality
- Factor 5: Capital Adequacy
- Factor 6: Profitability
- Factor 7: Liquidity and Asset-Liability Management (ALM)
- Factor 8: Financial Flexibility

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Other Considerations

Moody's also examines subjective factors including management's credibility, experience, and reliability; depth of corporate governance; and risk management practices. Whether an insurer might be supported by a parent company or affiliate also is an important factor in developing its rating. If such support exists, the effect generally is to enhance what otherwise would be the insurer's standalone rating.

The Nature of Rating Agency Reports

Individual company ratings can be obtained at no charge for each rating service. Full reports on insurers may be purchased from the rating agency, either via subscription to their services or on a case-by-case basis from their websites. Rating reports also should be readily available from insurance agents and insurance companies.

M Financial's Members website, available only to M Member Firms, provides a summary of carrier ratings and rating changes.

While the contents and formats of each rating agency's reports differ, they generally include similar types of information. They identify the insurer and provide its contact information. The agency's rating is provided along with an indication whether the rating outlook for the insurer is negative, neutral, or positive, although the terminology may differ. A rating outlook is important as it offers the agency's opinion about the likely trend in the insurer's rating. The agency's justification for its rating outlook is provided within the report, although perhaps not immediately after the rating.

There follows key financial data and ratios, discussions of the insurer's strength and weakness as perceived by the rating agency, and the rationale for its rating of the insurer.

The insurer's current and likely future competitive position in its various target markets is often discussed. Management and corporate strategy usually is covered in some way, along with comments about its risk management capability. Quantitative and qualitative analysis and remarks are included about the insurer's investments, liquidity, capitalization, profitability, financial flexibility, and other related financial and operational elements. Various financial data and ratios are also provided.

Rating Categories

Each rating agency has its own rating categories. These categories and their descriptions are shown in the Appendix. In considering an insurer's rating, one should note the differences among categories and incompatibility of ratings. For example, an A+ rating from A.M. Best is its second highest rating, but it is Fitch's and S&P's fifth highest rating.

The rating summary on page 5 lists each of the four rating agencies' categories along with a rank number that indicates where each rating ranks among those of each rating firm. Equivalent rank numbers do not mean equivalence of ratings, as the descriptions in the Appendix show. Insurers receiving ratings shown in the shaded area represent those falling into what the rating agency considers to be its "vulnerable" category. Insurers receiving ratings not appearing in the shaded area are considered "secure."

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Rating Rank Orders and Categories

Rank Number	A.M. Best	Fitch	Moody's	S&P
1	A++	AAA	Aaa	AAA
2	A+	AA+	Aa1	AA+
3	A	AA	Aa2	AA
4	A-	AA-	Aa3	AA-
5	B++	A+	A1	A+
6	B+	A	A2	A
7	B	A-	A3	A-
8	B-	BBB+	Baa1	BBB+
9	C++	BBB	Baa2	BBB
10	C+	BBB-	Baa3	BBB-
11	C	BB+	Ba1	BB+
12	C-	BB	Ba2	BB
13	D	BB-	Ba3	BB-
14	E	B+	B1	B+
15	F	B	B2	B
16		B-	B3	B-
17		CCC+	Caa1	CCC+
18		CCC	Caa2	CCC
19		CCC-	Caa3	CCC-
20		CC	Ca	CC
21		C	C	R

Shaded ratings are considered “vulnerable” according to the respective rating agency.

Comdex

Comdex is a composite index of ratings, expressed as the average percentile of a company's rating; i.e., the proportion of rated insurers that are rated lower. While not itself a rating, it gives an insurer's standing, on a scale of 1 to 100, in relation to other rated insurers. Thus, a Comdex of 90 means that the composite of the insurer's ratings place it in the 90th percentile of rated companies; i.e., 10 percent are rated higher and 90 percent lower. See <http://www.ebixlife.com/vitalsigns/> or M Financial's website for access to VitalSigns and the carrier ratings report (only available to M Member Firms).

Using Ratings

Obviously, higher ratings are preferred to lower ones, other things being the same. However, other things are not always the same, and it is worth remembering that ratings are opinions and not guarantees or assurances of financial strength. A lower rated insurer may offer better underwriting or more flexible or competitive products or superior advice and ongoing service. As the rating agencies themselves often point out, small differences in ratings, especially between adjacent categories, mean only slight perceived differences in financial strength.

Unless circumstances dictate otherwise, it is generally advisable to exercise great caution in dealing with life insurers whose ratings from one or more agencies fall within the vulnerable category or that have no rating from any of the major agencies. A vulnerable rating or no rating does not mean that the company

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necessarily is about to fail or that it is in financial difficulty. However, the failure rate of companies having vulnerable and no ratings has been considerably higher than those rated in the secure category. Insurers in financial difficulty often withdraw their ratings.

Rating agencies will commonly place a company's rating "under review." They do this for a variety of reasons that have the potential for meaningfully affecting some aspect of the insurer. For example, an acquisition by the insurer of another insurer or the pending sale of the company would be expected to cause a rating review. Likewise, either adverse or positive internal financial developments or senior management turnover often provokes a review.

Other Sources of Insurer Information

While rating agencies are the most common sources of information on life insurer financial strength, other sources are available as well. These other sources are by no means substitutes for rating agencies' analyses and opinions. Rather, some or all of them can be useful adjuncts to rating agency information, collectively providing a more complete view of the companies that are being assessed.

The NAIC and State Insurance Departments

State insurance regulators are charged with protecting and assisting insurance consumers and are, therefore, logical sources of information about insurers. The National Association of Insurance Commissioners (NAIC) is the trade association to which all state insurance regulators belong which helps to coordinate state insurance regulation. Often, there is an advantage in securing needed information from the NAIC as opposed to the insurer's state of domicile as the NAIC often will make the information available electronically via its website whereas not all states do so.

Life insurers are required annually to file detailed financial information with state regulators, called the financial statement or statement blank. The financial statement must be prepared according to statutory accounting principles (SAP), which is a conservative measure of the insurer's ability to meet its obligations to policyholders. The information is complex, and knowledge, experience, and great care should be taken when reviewing financial data for purposes of assessing company financial strength.

One of the most interesting and potentially insightful elements of the annual statement filing is Management's Discussion and Analysis of the insurer. Here management is required to set out the company's background and organizational structure, discuss the likely effects of adverse economic events, and summarize its financial operations and liquidity and capital resources. The section wherein management explains the company's principal risks and uncertainties can provide insightful information.

Detailed financial information, including annual statements, can be obtained from the NAIC Store at <https://eapps.naic.org/insData/index.jsp>.

Insurance company financial information is also provided by M Financial. M Financial's Members website, which can only be accessed by M Member Firms, provides packaged financial information through VitalSigns and a carrier financial data spreadsheet containing a five year historical of key statutory data (including growth rates). More detailed statutory financial data is also available upon request.

Finally, a few states make the reports compiled from on-site financial examinations of their domestic insurers available on their websites.

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Securities and Exchange Commission

Public companies above a certain minimum size must annually file with the SEC an annual report of the company's performance on Form 10-K. The 10-K includes detailed information related to the company's history, nature of its business, organizational structure, risk factors, equity, subsidiaries, and audited financial statements, among other information. Stock life insurers are required to file these reports.

Relevant accounting data in these reports are based on GAAP accounting principles, which measures an insurer on a going concern basis.

Typically, the most relevant items within a 10-K for a life insurance company are:

- **Item 1–Business.** This item describes the nature of the company's business, the subsidiaries that it owns, and the markets in which it operates. It will also include discussions of effects that are significant to particular industries, as with competition and regulation in an insurance context.
- **Item 1A–Risk Factors.** In this item, the company is required to state the risks that it faces; i.e., anything that could go wrong. This includes likely external effects, possible future failures to meet obligations, and other risks sufficient to ensure that current and potential investors are adequately warned.
- **Item 7–Management's Discussion and Analysis.** Within this item, management is required to discuss the operations of the company in detail and usually compares the current period to prior periods. It provides an overview of the company and a summary discussion of the key issues that it faces; the company's outlook; and results from operations. A related item here is a discussion of market risk.

Form 10-K, as well as other SEC filings, are available using the EDGAR database on the SEC's website at <http://www.sec.gov/edgar/searchedgar/companysearch.html>.

Stock Analysts' Reports

Reports on the valuation of individual insurer's stocks prepared by major investment houses can provide additional insight into an insurer's financial position. Unfortunately, only a few such companies (such as Citigroup and Credit Suisse) conduct extensive analyses of stock insurance companies.

These reports are naturally geared toward stockholders, not policyholders, with their emphasis on profitability and return on equity, not necessarily financial strength. For example, a strengthening of an insurer's reserves may be appealing to policyholders but not for stockholders. Doing so will reduce earnings and may depress the stock price, yet this result provides additional protection for policyholder benefits. Even with these types of reservations, these reports can add another dimension of the insurer's operational performance and, importantly, its near term financial outlook.

M Financial provides stock analyst reports and other relevant articles in the Financial Crisis section of the Member's website.

Publications

Major business publications such as *The Wall Street Journal*, *Fortune*, *Business Week*, *The Financial Times*, and others will carry news about life insurers, just as they do about other major corporations. Monitoring news and archival research can reveal information that may be helpful.

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Publications whose focus is insurance in general and life insurance in particular generally are more relevant: *The Insurance Forum*, *Best's Review*, and *The National Underwriter*.

Conclusions

The analyses and opinions of rating agencies should necessarily factor greatly in the assessment of the financial strength of life insurers. The complexity and complications of doing otherwise would be daunting. To utilize the rating agencies' information, one should have knowledge of those agencies whose analyses and opinions are respected, including particularly those that have been designated as NRSROs. Further, one should have an understanding of the key factors that drive insurer ratings and the rating categories used by the agencies. At the same time, one should be attuned to other sources of information, such as state regulators and the NAIC, the SEC, stock analyst commentaries, news from publications like *The Wall Street Journal*, and insurance companies and agents. These other sources can reinforce and supplement the reports and opinions of rating agencies.

M Financial recognizes the importance of insurance company financial strength due care and accordingly makes available to M Member Firms: Due Care Updates, Due Care Bulletins, ratings reports, financial data, and one page financial strength snapshots (including recent news) for the M Partner Carriers.

It should be noted that carrier financial strength is a key component of evaluating a new or existing policy. However, other considerations must be evaluated, such as: product performance, underwriting, service, and in-force management. An evaluation of the entire package as it relates to the clients unique characteristics will determine the most appropriate carrier and product choice.

An Appendix containing the descriptions of the four rating agencies' rating categories is attached.

For More Information

To learn more, please contact:

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Appendix: Descriptions of Four Rating Agencies' Rating Categories

A.M. Best Company

Secure Ratings	
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.
B++ B+	Good. Assigned to companies that have, in our opinion, a fair ability to meet their ongoing obligations to policyholders.
Vulnerable Ratings	
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.
C++ C+	Marginal. Assigned to companies that have, in our opinion, a marginal ability to meet their ongoing obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.
C C-	Weak. Assigned to companies that have, in our opinion, a weak ability to meet their ongoing obligations to policyholders, but are financially very vulnerable to adverse changes in underwriting and economic conditions.
D	Poor. Assigned to companies that have, in our opinion, a poor ability to meet their ongoing obligations to policyholders and are financially extremely vulnerable to adverse changes in underwriting and economic conditions.
E	Under Regulatory Supervision
F	In Liquidation
S	Rating Suspended
Affiliation Codes	
g	Group Rating
p	Pooled Rating
R	Reinsured Rating
Rating Modifiers	
U	Under Review
Pd	Public Data Rating
S	Syndicate Rating
"Not Rated" Categories	
NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not formally followed

Appendix: Descriptions of Four Rating Agencies' Rating Categories (continued)

Fitch Ratings

Secure Ratings	
AAA	Exceptionally Strong. Denotes the lowest expectation of ceased or interrupted payments. Assigned only in the case of exceptionally strong capacity to meet policyholder and contract obligations. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA+ AA AA-	Very Strong. Denotes a very low expectation of ceased or interrupted payments. Indicates very strong capacity to meet policyholder and contract obligations. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	Strong. Denotes a low expectation of ceased or interrupted payments. Indicates strong capacity to meet policyholder and contract obligations. This capacity may, nonetheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
BBB+ BBB BBB-	Good. Indicates that there is currently a low expectation of ceased or interrupted payments. The capacity to meet policyholders and contract obligations on a timely basis is considered adequate, but adverse changes in circumstances and economic conditions are more likely to impact this capacity. This is the lowest "secure" rating category.
Vulnerable Ratings	
BB+ BB BB-	Moderately Weak. Indicates that there is an elevated vulnerability to ceased or interrupted payments, particularly as the result of adverse economic or market changes over time. However, business or financial alternatives may be available to allow for policyholder and contract obligations to be met in a timely manner.
B+ B B-	Weak. If obligations are still being met on a timely basis, there is significant risk that ceased or interrupted payments could occur in the future, but a limited margin of safety remains. Capacity for continued timely payments is contingent upon a sustained, favorable business and economic environment, and favorable market conditions. Alternatively, assigned to obligations that have experienced ceased or interrupted payments, but with the potential for extremely high recoveries.
CCC+ CCC CCC-	Very Weak. If obligations are still being met on a timely basis, there is a real possibility that ceased or interrupted payments could occur in the future. Capacity for continued timely payments is solely reliant upon a sustained, favorable business and economic environment, and favorable market conditions. Alternatively, assigned to obligations that have experienced ceased or interrupted payments, and with the potential for average to superior recoveries.
CC	Extremely Weak. See Fitch web site for description.
C	Distressed. See Fitch web site for description.

Appendix: Descriptions of Four Rating Agencies' Rating Categories (continued)

Moody's Investors Service

Secure Ratings	
Aaa	Exceptional. Insurance companies rated Aaa offer exceptional financial security. While the credit profile of these companies is likely to change, such changes as can be visualized are most unlikely to impair their fundamentally strong position.
Aa1 Aa2 Aa3	Excellent. Insurance companies rated Aa offer excellent financial security. Together with the Aaa group, they constitute what are generally known as high-grade companies. They are rated lower than Aaa companies because long-term risks appear somewhat larger.
A1 A2 A3	Good. Insurance companies rated A offer good financial security. However, elements may be present which suggest a susceptibility to impairment sometime in the future.
Baa1 Baa2 Baa3	Adequate. Insurance companies rated Baa offer adequate financial security. However, certain protective elements may be lacking or may be characteristically unreliable over any great length of time.
Vulnerable Ratings	
Ba1 Ba2 Ba3	Questionable. Insurance companies rated Ba offer questionable financial security. Often the ability of these companies to meet policyholder obligations may be very moderate and thereby not well safeguarded in the future.
B1 B2 B3	Poor. Insurance companies rated B offer poor financial security. Assurance of punctual payment of policyholder obligations over any long period of time is small.
Caa1 Caa2 Caa3	Very Poor. Insurance companies rated Caa offer extremely poor financial security. Such companies are often in default on their policyholder obligations or have other marked shortcomings.
Ca	Extremely Poor. Insurance companies rated Ca offer extremely poor financial security. Such companies are often in default on their policyholder obligations or have other marked shortcomings.
C	Lowest. Insurance companies rated C are the lowest-rated class of insurance company and can be regarded as having extremely poor prospects of ever offering financial security.

Appendix: Descriptions of Four Rating Agencies' Rating Categories (continued)

Standard & Poor's

Secure Ratings	
AAA	Extremely Strong. An insurer rated AAA has extremely strong financial security characteristics. AAA is the highest insurer financial strength rating assigned by Standard & Poor's
AA+ AA AA-	Very Strong. An insurer rated AA has very strong financial security characteristics, differing only slightly from those rated higher.
A+ A A-	Strong. An insurer rated A has strong financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.
BBB+ BBB BBB-	Good. An insurer rated BBB has good financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers.
Vulnerable Ratings	
BB+ BB BB-	Marginal. An insurer rated BB has marginal financial security characteristics. Positive attributes exist, but adverse business conditions could lead to insufficient ability to meet financial commitments.
B+ B B-	Weak. An insurer rated B has weak financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.
CCC+ CCC CCC-	Very Weak. An insurer rated CCC has very weak financial security characteristics, and is dependent on favorable business conditions to meet financial commitments.
CC	Extremely Weak. An insurer rated CC has extremely weak financial security characteristics and is likely not to meet some of its financial commitments.
R	Regulatory Action. An insurer rated R has experienced a regulatory action regarding solvency. The rating does not apply to insurers subject only to nonfinancial actions such as market conduct violations.
Public Information Ratings	
pi	Based on an analysis of an insurers published financial information, as well as additional information in the public domain.