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# Financial Strength in the Life Insurance Industry: A Navigation Guide for Estate Planners and Trustees

*By Mark S. Armstrong and Thomas R. Love*

In the concluding installment of their two-part series on the strength of the life insurance industry, Mark S. Armstrong and Thomas R. Love examine the several tools and information sources that a life insurance professional or other advisor can utilize in advising clients on the financial strength of life insurance carriers. The authors detail the advantages and limitations inherent with each of these tools and information sources, and caution against over-reliance on any one rating source or tool.

**I**n the first part of this two-part article, we described the storm that swept through the insurance landscape in 2008 and 2009. We discussed the new landscape that emerged, and we outlined the choices and

dilemmas advisors will face. Finally, we recommended that all life insurance purchases be based on policy statements that include financial strength considerations. In this second part of the article, we will discuss some of the tools that should (and should not) be used as measurements of financial strength in these statements.

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## **Tools to Evaluate Financial Strength**

A wide array of tools can help navigate the new life insurance industry landscape.

While most can be useful, they can also be misunderstood, or even abused. The examples below illustrate the features and problems of some of these tools. All of them are based on real situations. None are contrived. We omit carrier names to avoid any inferences with respect to a carrier (either positive or negative), because the tools themselves are the focus of the discussion.

### Ratings from the Agencies

Rating agencies are the fundamental guide to financial strength and can be the basis for any guidelines advisors use in policy statements. Four agencies are designated as Nationally Recognized Statistical Rating Organizations (NRSROs) by the Securities and Exchange Commission: A.M. Best Company, Fitch Ratings, Moody's Investors Service, and Standard & Poor's. These agencies evaluate the financial strength of life insurance companies.

A rating is the opinion of a rating firm regarding the financial strength or claims paying ability of a carrier at the point in time the rating is assigned. A higher rating indicates an opinion of greater financial strength. Table 1 lists the ratings from the various agencies. Generally, any rating that is paid for by a carrier involves quantitative and qualitative analysis as well as management discussions.

**Table 1. Available Rating Categories**

	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

Note: The ratings in a given rank are not necessarily equivalent to one another.

**Best.** Best assigns two rating types—one based only on publicly available data and one that involves consultation with the carrier's management and consideration of nonpublic data. If the letters "pd" accompany a rating, it falls into the former category while absence of these letters indicates it is of the latter, more thorough, variety. Best rates significantly more insurance carriers than the other agencies—over 950 carriers at the time of this writing.

**Fitch.** Similar to Best, Fitch uses two systems. The first is based on in-depth analysis and correspondence with carrier management. The second is based only on public data without carrier interaction and discussion. In cases where carriers opted not to interact with Fitch in the rating process, this fact is disclosed in footnotes in rating announcements. Fitch rates approximately 300 carriers.

**Moody's.** Moody's historically provides "solicited" ratings (from carriers that request the rating) and "unsolicited" ratings. The use of unsolicited ratings was curtailed several years ago. Again, a footnote in the rating announcement would indicate whether or not it is unsolicited. Moody's provides ratings on approximately 185 carriers.

**S&P.** S&P assigns interactive ratings or public information ratings (designated by "pi"). The interactive ratings are based on much more comprehensive information. Around 350 carriers are rated by S&P.

### Rating Agency Strengths

Specialized knowledge is required to analyze the complex world of life insurance. Few life insurance professionals possess the experience, resources, knowledge, or access to information possessed by the rating agencies. Although not without fault, the agencies generally provide very good insight into carriers. This is especially true of the comprehensive, in-depth ratings. Agency interpretations of carrier comments, regulator remarks and financial statements frequently provide crucial insights into the risks carriers take in business lines, strategy and investment philosophy. The agencies' ability to incorporate it into the overall industry perspective gives them an indispensable insight into the business.

Moreover, the agencies have ongoing communication with carrier management teams. This gives them a unique ability to compare and contrast management styles and competencies, and provides a level of depth that goes beyond mere numerical modeling. For example, philosophical shifts in management may have a significant impact on the risk tolerances and profiles of a carrier and thus might bolster, or undermine a carrier’s financial strength. Alternatively, the agencies can observe management patterns and strategies over time. Did management claims prove to be true? Did their purported solutions and strategies work out? Did plans come to fruition, or does the management team seem lost or confused? The agencies’ analysts have developed well-informed opinions based on years of work.

**Table 2. Rating Agency Web Sites**

A.M. Best Company	www.ambest.com
Fitch Ratings	www.fitchratings.com
Moody’ Investors Service	www.moody’s.com
Standard & Poor’s	www.standardandpoors.com

While these ratings are readily available on the Web sites of the agencies or from agents and other professionals, it is important to review the entire reports as they provide insight and specific commentary that isn’t available through the cursory review of the letter rating assigned.

### Limitations of the Ratings

The breadth and depth of the rating process make it a ponderous and time consuming undertaking and inevitably causes the ratings to be retrospective in nature. The rating services can also be slow to respond to news and events. When they do respond, it usually creates an additional impact on the carrier’s situation, whether positive or negative. Thus, the agencies have been criticized for both being too slow to change ratings, and they have also been charged with being too quick to change, thereby undermining public confidence in the carriers they rate. Typically, a full analysis is conducted only once per year. However, the agencies do monitor the carriers and may make adjustments to the ratings over the course of a year as events warrant. All agencies were very active in 2008 and 2009, with rating changes, typically downgrades. Many of these downgrades happened many months after the events that triggered the downgrade.

Another drawback to the ratings is the lack of consistency across agencies. There is no common terminology, number of rating classes or classification descriptors. This leads to misleading comparisons and inevitably creates confusion. This is not helped by our universal familiarity with the “A, B, C, D or F” scale we all faced in school. For example, an “A+” rating implies one of the best ratings to the casual observer. Indeed, the rating is the second highest available rating from Best. However, it is the fifth rating from Fitch and S&P while Moody’s doesn’t even have such a rating. Even the available distribution of ratings is inconsistent (see Table 1). Best has four possible A, B or C ratings, but only one D, E or F rating. Fitch and Moody’s have seven possible A ratings, nine possible B ratings and only five possible C ratings. S&P has similar distribution as Fitch and Moody’s, but only four C ratings and a unique R rating. To make matters worse, the actual meaning of the ratings is inconsistent. The term “Good” describes Best’s fifth and sixth ratings, Moody’s fifth through seventh ratings, and the eight through tenth ratings of Fitch and S&P. Thus, it is highly misleading to try to compare ratings across agencies, to draw a parallel based on their ranking or to try to combine them into a common reference. Unfortunately, in much of the industry, this misguided exercise represents the entire due care process of insurance professionals. We will address that in greater depth below.

**Table 3. Rating Disparities**

Agency	Carrier A (Oct. 2009)	Carrier B (Nov. 2009)
Best	A- (4) Excellent	B+++ (5) Very Good
S&P	BB+ (11) Marginal	BB (12) Marginal
Moody’s	Baa3 (10) Adequate	Ba1 (11) Questionable
Fitch	BBB- (10) Good	BBB (9) Good

Although there isn’t an expectation that the agencies will always agree on ratings, occasionally wide disparity is found across the agencies. Consider the following example of two different carriers (see Table 3). Numbers in parentheses indicate the rank of the rating from available categories (e.g. “(2)” would mean the rating was the second highest rating available).

What is an advisor to think of a company that is alternatively described as “Excellent,” “Marginal,” “Adequate” and “Good”? This clearly demonstrates why all the ratings should be examined and underscores the need to read the actual analysis provided with the rating.

Finally, and possibly most disconcerting, is the attack on the objectivity of the rating agencies. Rating agencies charge carriers for the more comprehensive ratings.<sup>1</sup> The agencies don't receive payment for the "public information" type of ratings. Thus critics argue there is an inherent conflict of interest. The rating agencies get paid for their ratings, but carriers may not use or renew their services if the ratings seem too harsh. Moody's did little to allay these concerns when, in response to a lawsuit, one of its attorneys claimed that Moody's "generalizations regarding integrity, independence and risk management amount to no more than puffery."<sup>2</sup>

Additional consumer distrust has developed amid concerns of ratings "shopping." For example, at least one rating agency allows carriers to request an assessment of the possible rating outcome prior to proceeding with the formal rating. If a carrier felt there was a possibility of an unfavorable rating, would it forego the "real" rating? In a 2008 deposition to the SEC, a former Moody's executive stated that "originators of structured securities typically chose the agency with the lowest standards."<sup>3</sup> Could similar actions occur in the life industry?

The rating agencies are under intense public and political pressure to make changes. In late 2008, the SEC approved new control measures to address some of the perceived conflicts at the rating agencies. In 2009, state insurance commissioners had discussions with the ratings agencies regarding practices. The rating agencies themselves have announced various changes to their analysis methods and practices in 2008 and 2009.<sup>4</sup> Hopefully, these changes will bolster faith in the rating agencies and provide more transparent and objective information to consumers and advisors. Despite their shortfalls, the agencies still provide reliable, in-depth information on the carriers and should be central to any due diligence process. Advisors should include actual rating requirements in policy statements, as well as in the process of ongoing evaluation.

### **Nonrating Agency Third-Party Sources**

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Several commercially available third-party reference tools offer valuable insight into carrier strength. Two software packages offer financial information on the carriers: Vital Signs from Ebix, Inc. and Insurance Analyst from Highline Data. In addition, ALIRT Insurance Research, LLC offers a quarterly based service

called ALIRT (Analysis of Insurer Risk Trends), which provides reports on current financial strength and five year trends.

Vital Signs is most prevalent in the industry. It provides concise and informative summaries of key financial data from insurance companies' year-end statutory statements. It also provides the financial strength ratings from the nationally recognized agencies, along with the rating descriptors. It also includes ratings from a few additional nonrecognized firms.

Insurance agents frequently use reports that show data for up to eight carriers in a side by side format. For those who are interested in benchmarks, Vital Signs creates aggregate numbers for the 25, 100 and 400 largest life insurance carriers. The software provides numerous reports, useful graphics and sophisticated filtering tools. It is very popular among insurance agents because of its low cost, ease of use, and substantial information for over 500 companies. Vital Signs also provides a summary index score, called the "Comdex." Since many life insurance professionals now use this score as their only measure of due care, it will be discussed in greater detail below.

Insurance Analyst from Highline Data is a more comprehensive software system geared more for industry analysts rather than the sales professional. Highline's Insurance Analyst and Insurance Pro packages make available the full statutory filings for any carrier. Unlike Vital Signs, Highline offers both quarterly and annual statements to keep the data fresh. The reports are filled with extensive detail, including both RBC ratios and IRIS ratios.<sup>5</sup> In fact, the amount of detail can be confusing to those without extensive background or training in life insurance finance. In addition to the actual filings, the software has a series of in-depth reports showing historical information over the last five years, which can be useful in identifying trends not evident in one year snapshots of financial data. Beyond the financial data, the ability to view General Interrogatories, Notes to Financial Statements and Management Discussions can lead to additional insight regarding the carriers. The more robust "Analyst Pro" software includes GAAP data as well as statutory data for the past 10 years. Not surprisingly, it is relied upon by stock analysts, rating agencies and carrier financial executives. It is considerably more expensive than Vital Signs.

Both Vital Signs and Highline Data reports are data providers. In other words, their reports do not provide interpretations or make inferences. That is left entirely to the user.

The third source of independent financial strength analysis is ALIRT research. The ALIRT system is a comprehensive report providing quantitative analysis of carrier financials using proprietary financial models and reporting. This service picks up where Highline Data ends. It calculates ratios and scores for many key areas of financial strength. It classifies these scores into various categories and then further summarizes those categories into an overall score. It tracks this over the years to give a trend analysis of how the carrier is faring on both an objective basis and relative to its peers. This system is used by some bankers in the insurance business and others looking for help with the interpretation of financial data. It is also by used by those seeking a robust alternative to the NRSRO's. It is more expensive than either Highline Analyst or Vital Signs.

Since these tools may be unavailable or too costly for noninsurance advisors or trustees, advisors must rely on an agent to provide access to the information. Unfortunately, many agents either lack the access or are insufficiently trained to properly understand the information provided, which may lead to misinterpretation. The following section which discusses widespread misuse of the Vital Signs "Comdex" is an example of that problem. While advisors may or may not want to include information from these providers in the insurance policy statement, they should certainly include tools like these in the evaluation process when considering or reviewing carrier financial strength.

### **Beware of Shortcuts, Rules of Thumb and Percentile Rankings**

For many agents and advisors today, carrier due diligence has unfortunately become oversimplified and involves solely an examination of a "Comdex" rating or score. This practice has become so broad that it requires special attention. The "Comdex" score was developed in the 1990s as part of Vital Signs. As mentioned above, Vital Signs is very powerful and can be used to research and describe many aspects of insurance company financial strength. Unfortunately, many insurance professionals and advisors simply bypass most of the data provided and focus on the "Comdex" score alone.

The Comdex is a numerical score on a scale of one to 100, with 100 being the highest score. It is an average of the percentiles a carrier falls into based on the rating assigned by the four major rating agencies. It is not an average of the ratings, but rather an

average of the percentiles. Any of the four NRSRO's that rate the carrier are factored into the formula. A minimum of two ratings are required for a Comdex to be calculated.

It has become common practice in the industry for agents to refer only to Comdex scores when evaluating insurance company financial strength. For example, agents may indicate a carrier with a Comdex score of 95 is "better" than a carrier with a Comdex of 92. Oftentimes, some arbitrary Comdex score (for example, 90 or higher) becomes the minimum measuring point for adequate financial strength.

### **Problems with the "Comdex"**

Comdex numbers imply a degree of certainty and accuracy in the assessment that doesn't truly exist and may result in misleading comparisons of companies. There are three primary areas of concern.

***Fewer ratings tend to result in higher Comdex scores.*** Virtually all carriers are rated by Best and, for purposes of the Comdex, Best is the "easiest grader." Companies rated only by Best and one other agency tend to have an advantage over carriers rated by more agencies. For example, carrier A and B have identical ratings from Best and S&P: A+ and AA-. On September 1, 2009, these two ratings generated a 96 Comdex score out of 100. This impressive number implies great financial strength. Carrier A is not rated by either Moody's or Fitch. However, Carrier B is rated A2 by Moody's and A+ by Fitch. Because all ratings must be factored into the Comdex, Carrier B's score will change. When accounting for all Carrier B ratings, the Comdex for Carrier B drops from 96 down to 87, and this provides a dramatically different indication of carrier financial strength than a 96. In other words, carrier B could have the same score as Carrier A if it dropped its two lowest ratings. One must question the value of Comdex when a carrier is penalized for subjecting itself to additional scrutiny.

***Broad shifts in industry ratings mask or distort carrier specific rating activity.*** External forces outside a given carrier may move the Comdex rankings and imply either an improvement or degradation of financial strength in the given carrier. Consider the series of events depicted in Table 4. This carrier was downgraded by all four rating agencies in a five-month period. The resulting Comdex score declined at the time of rating changes, but it also increased twice during the same period—with no rating change! Because the ratings of other carriers worsened during

the same time period, the scores of this particular carrier increased. Did this carrier improve its financial strength during this time? Not according to the rating agencies. In fact, they all viewed the carrier as significantly weaker than before. However, the Comdex score movement implies just such an event occurred twice.

**Table 4. Changes in Comdex Scores**

EBIX Reporting Date	Rating Agency	Action	Comdex Change
March 2, 2009	S&P	Down-grade from AA to AA-	From 95 to 92
	Fitch	Down-grade from AA to AA-	
March 16, 2009	Best	Down-grade from A++ to A+	From 92 to 91
April 15, 2009	No changes from any agency		From 91 to 93
June 12, 2009	Moody's	Down-grade from Aa3 to A1	From 93 to 91
July 20, 2009	No changes from any agency		From 91 to 92

**Identical ratings generate different Comdex scores at different points in time.** Because the Comdex is calculated based upon how a carrier's ratings compare to the industry, the resulting score of a fixed rating profile may change. Table 5 illustrates how an examination of the rating rankings (which drives the percentiles used in Comdex) does not provide the necessary frame of reference for interpretation of the data. Table 5 indicates how broadly a shift may occur in a relatively short time frame and how Comdex scores are not comparable in different time frames.

Despite identical ratings, Carrier B appears to be in a position of superior financial strength according to the Comdex score. Yet because of the relation of the ratings to the industry as a whole, the resulting Comdex scores differ considerably. Given the hypothetical "required" score of a 90 Comdex used earlier as a measure of minimum adequate financial strength, Carrier A would have failed to meet such criteria while Carrier B would have been deemed satisfactory despite identical ratings from the rating agencies.

**Table 5. Comdex Comparisons Across Time**

Rating Agency	Carrier A	Carrier B
Best	A+ (2) Superior	A+ (2) Superior
S&P	AA- (4) Very Strong	AA- (4) Very Strong
Moody's	A1 (5) Good	A1 (5) Good
Fitch	AA- (4) Very Strong	AA- (4) Very Strong
Comdex	87	92
Date	Sep. 2008	Nov. 2009

Table 6 provides insight into potential causes of this phenomenon. The distribution of ratings falling in the top three rating classes was essentially cut in half from 2008–2009 for all the agencies except Best. However, the number of carriers falling into the top seven rating classes for the same time period was largely unchanged. Thus, there was a redistribution of carrier ratings downward from the top three classes to classes four through seven. Absent such data, it is difficult to recognize the driving forces behind Comdex score changes.

Without some modification to the Comdex system to address these issues, agents and advisors may want to avoid use of Comdex as the sole measure of carrier financial strength and performance of required due diligence. Certainly, the Comdex should not be used as a proxy for the actual ratings of the NRSRO's, and it should not be included in a life insurance policy statement.

While it is quick and easy, it also misleads and distorts genuine differences in financial strength. In addition, it almost completely obscures the significant differences between the strongest companies and those that are several notches lower. Even if no other tools were available, the software from which the Comdex is derived, Vital Signs, provides many additional and helpful tools that should be used to provide a more robust analysis.

But there are more tools available, and they should not be neglected. All of the data in Vital Signs, as well as much of that provided by Highline Data and interpreted by ALIRT Research originates in reports carriers make to their State regulators, so that is where we turn next.

## Tools Provided by Regulators

One of the primary purposes of insurance industry regulation is to maintain the financial strength of the industry. As mentioned previously, the life insurance industry is regulated state by state; and the degree of supervision and the standards of regulators vary ac-

**Table 6. Life Insurance Carrier Ratings by Class–Cumulative Percentages**

Top Rating Class from Rating Agency			% of Companies Qualifying for Rating Class(es)						
Agency	Ratings Level	Agency Descriptive	2003	2004	2005	2006	2007	2008	2009
A. M. Best Company	A++	Superior	4%	6%	4%	6%	5%	4%	2%
Moody's Investors Service	Aaa	Exceptional Financial Security	6%	7%	4%	3%	3%	3%	3%
Fitch Ratings	AAA	Exceptionally Strong	5%	8%	5%	3%	3%	3%	3%
Standard & Poor's	AAA	Extremely Strong	8%	9%	5%	3%	5%	6%	4%
Top Two Rating Classes from Rating Agency			% of Companies Qualifying for Rating Class(es)						
Agency	Ratings Level	Agency Descriptive	2003	2004	2005	2006	2007	2008	2009
A. M. Best Company	A+ or above	Excellent	16%	21%	22%	22%	19%	19%	14%
Moody's Investors Service	Aa1 or above	Excellent Financial Security	16%	13%	9%	11%	11%	9%	7%
Fitch Ratings	AA+ or above	Very Strong	21%	22%	22%	17%	17%	18%	6%
Standard & Poor's	AA+ or above	Very Strong	11%	10%	11%	10%	11%	12%	8%
Top Three Rating Classes from Rating Agency			% of Companies Qualifying for Rating Class(es)						
Agency	Ratings Level	Agency Descriptive	2003	2004	2005	2006	2007	2008	2009
A. M. Best Company	A or above	Excellent	33%	41%	41%	46%	41%	39%	38%
Moody's Investors Service	Aa2 or above	Excellent Financial Security	32%	27%	28%	28%	29%	28%	12%
Fitch Ratings	AA or above	Very Strong	41%	38%	37%	36%	33%	33%	17%
Standard & Poor's	AA or above	Very Strong	35%	28%	26%	29%	31%	31%	16%
Top Four Rating Classes from Rating Agency			% of Companies Qualifying for Rating Class(es)						
Agency	Ratings Level	Agency Descriptive	2003	2004	2005	2006	2007	2008	2009
A. M. Best Company	A- or above	Excellent	56%	62%	63%	76%	68%	69%	67%
Moody's Investors Service	Aa3 or above	Excellent Financial Security	60%	55%	56%	59%	56%	55%	31%
Fitch Ratings	AA- or above	Very Strong	55%	58%	55%	53%	50%	51%	35%
Standard & Poor's	AA- or above	Very Strong	43%	35%	35%	41%	42%	45%	35%
Top Five Rating Classes from Rating Agency			% of Companies Qualifying for Rating Class(es)						
Agency	Ratings Level	Agency Descriptive	2003	2004	2005	2006	2007	2008	2009
A. M. Best Company	B++ or above	Very Good	67%	74%	74%	90%	83%	82%	81%
Moody's Investors Service	A1 or above	Good Financial Security	70%	62%	64%	70%	67%	65%	58%
Fitch Ratings	A+ or above	Strong	67%	67%	68%	70%	71%	71%	60%
Standard & Poor's	A+ or above	Strong	56%	48%	48%	55%	55%	55%	54%
Top Six Rating Classes from Rating Agency			% of Companies Qualifying for Rating Class(es)						
Agency	Ratings Level	Agency Descriptive	2003	2004	2005	2006	2007	2008	2009
A. M. Best Company	B+ or above	Very Good	78%	83%	83%	92%	93%	92%	92%
Moody's Investors Service	A2 or above	Good Financial Security	79%	73%	74%	75%	72%	73%	72%
Fitch Ratings	A or above	Strong	76%	78%	80%	86%	86%	85%	77%
Standard & Poor's	A or above	Strong	67%	70%	68%	74%	74%	77%	76%

cordingly. However, in order to be consistent and fair, states coordinate their oversight through the National Association of Insurance Commissioners (NAIC). The NAIC creates standards and tools to help state regulators manage insurance companies. They also create tools to help evaluate carrier strength.

As products, strategies and accounting techniques evolve, regulators create new assessment tools to monitor financial strength. These tools are powerful and those willing to spend the time and effort to understand them will gain important insights into a carrier's overall financial strength. In fact, the primary challenge with regard to regulator information is its sheer volume. A risk that threatens the existence of the carrier may be hidden in a single line or a seemingly obscure footnote.

## Statutory Statements

Each life insurance company is required to produce standardized financial statements annually which

must be submitted to their respective states before March 1. The NAIC posts these statements on its web site ([www.naic.org/insData](http://www.naic.org/insData)). The statements include balance sheets, income statements and hundreds of pages of supporting information and up to five of these statements per year are available for no charge. The NAIC also requires that companies provide quarterly statements. Most analysts and rating agencies start their work by reviewing these statements. Although some information is so detailed that only qualified analysts can fully appreciate the insights, there is a lot of information that is readily available and easily understood.

For example, in the general interrogatories, one question asks the carrier to compare the book value of fixed income investments to the market value. Over the past two years, the market value has frequently been lower, raising questions such as: How much is the bond portfolio under water, and how does this compare to a carrier's surplus capital? How does this compare to other carriers?

Whatever the concern, the statutory statements are a good place to look for information, but with one important caveat. The complete statements are published annually, and the information can become obsolete. If a company gets in trouble in April, it will be little use to learn about it in March of the following year. These statements are important sources of information in the policy evaluation process, and policy management statements might require an insurance trust advisor to review them.

### Risk-Based Capital (RBC) Ratio

In order to create a single, summarized assessment of a life insurance company’s financial strength, the regulators developed a calculation that summarizes all risks facing a life insurance company into a single number—Risk-Based Capital (RBC). This number is the minimum amount of capital required for a life insurance company to support all its operations.

In order to calculate RBC, carriers follow a formula that incorporates risk components from carrier investments, product guarantees, reinsurance arrangements, expenses, affiliates and other areas. The carrier must also adjust the calculations for the covariance of the risk, to take into account risks that offset or magnify each other.

This is compared to the carrier’s actual surplus capital. This ratio is used by regulators to determine whether or not they should require the carrier to take actions to strengthen its capital position. This ratio can also trigger direct actions from the regulators, even to the point of seizing control of the carrier (Table 7).

In order to be rated as “very strong” or “very good” by most rating agencies, a carrier’s RBC ratio should be about 350–400. In other words, the agencies like carriers to have 3.5 to 4 times the minimum capital required to maintain operations.

The RBC ratio is a good starting point to evaluate the strength of any life insurance company. However, like any thumbnail measurement, it has several limitations. Because carriers have developed ways to manage this ratio, ratings agencies develop their own tools to adjust or modify the ratio. Out of concern for abuse, regulators have forbidden agents to use the RBC ratio in competition or to even report it. This dubious “gag” rule has never been enforced, but it reflects genuine concern with the misuse of the ratio.

Though it is not provided in the statutory statements, insurance companies estimate their RBC ratio on an ongoing basis and do a formal calculation at least annually. However, it can be easily calculated based on numbers provided in the statement. Both Highline Data and ALIRT do the calculations and provide results. Though it is only formally reported annually, the RBC ratio can change substantially throughout the year. Many carriers will provide their best estimate of their current RBC ratio, while others will not. However, few companies provide any support for their estimates. Thus, like the Comdex score, the RBC number should be used with caution.

Briefly put, RBC is a one-way indicator. A low RBC ratio should lead to concerns. However, a high RBC ratio does not mean all is well. Once again, no simple rule-of-thumb can fully describe a company’s financial condition. Still, this tool is useful to advisors in the evaluation process. Advisors may want to request a five year history of a carrier’s RBC ratio from their agents or insurance trust advisor. The insurance policy management statement can also refer to this number. For example, a full policy review might be triggered if a company’s RBC ratio ever drops by more than 100 percentage points in a year, or if it drops below 300.

### IRIS Ratios

#### The Insurance Regulatory Information

**Systems** (IRIS) system is an overlooked but very useful analytical tool developed by NAIC in 1972, prior to the invention of the RBC ratio. It is based upon 12 ratios. Some focus on investment adequacy, others focus on overall strength and still others focus on sales and expenses. For each ratio, the NAIC sets

**Table 7. Risk-Based Capital Ratio Action Levels**

RBC Reporting Range	Category	Actions
>= 200%	No Action Level	None
150%-200%	Company Action Level	Insurer files report to regulator outlining intended corrective actions.
100%-150%	Regulatory Action Level	Insurer files action plan and state insurance commissioner performs examinations deemed necessary and may issue corrective orders.
70%-100%	Authorized Control Level	In addition to remedies above, regulator is authorized to take control of the insurer.
<70%	Mandatory Control Level	Requires the regulator to place the insurer under control.

a boundary. If carrier's ratio is outside of the boundary, that particular is viewed as "unusual." If there are more than four ratios outside of the normal range, further scrutiny is required. Unlike the RBC number, these ratios are considered public information. Once again, they can be most easily secured from third-party firms that provide analytical data. These ratios are continually adjusted and updated by the NAIC. Table 8 outlines the ratios and their "normal" ranges at this time.

**Table 8. IRIS Ratios and Unusual Values**

IRIS Ratio #	IRIS Ratio Calculation	Unusual Value Above	Unusual Value Below
1	Net Change in Capital and Surplus	50	-10
2	Gross Change in Capital and Surplus	50	-10
3	Net Income to Total Income	-	0
4	Adequacy of Investment Income	900	125
5	Non-Admitted to Admitted Assets	10	-
6	Total Real Estate and Mortgage Loans to Cash and Invested Assets	30	-
7	Total Affiliate Investments to Surplus Capital	100	-
8	Surplus Relief – Over 5MM Surplus	30	-99
	Surplus Relief – Under 5MM surplus	10	-10
9	Change in Premiums	50	-10
10	Change in Product Mix	5	-
11	Change in Assets	5	-
12	Change in Reserving Ratio	20	-20

The IRIS ratios are useful in that they can give warning signals before a company actually gets into trouble. In addition, they are easily understood and cover a broad array of concerns. However, like the RBC calculation and the Comdex, they are not exhaustive. It is possible for a company to be in trouble without the problems being evident in the IRIS ratios. In addition, since they are not continuously reported, it is possible for a company to get into trouble before the IRIS system can sound an alarm. Nevertheless, these have been very effective tools for regulators. In fact, the NAIC has enhanced and enlarged this reporting system by adding an updated set of 17 ratios called the FAST system (Financial and Solvency Tracking). These are used internally by the regulators

to screen carriers, but unfortunately, they are not published. Thus, while they are useful for initial and ongoing carrier analysis, it may not be practical to include them in a policy management statement.

## Additional Tools and Resources

In addition to the information provided by rating agencies, regulators and vendors, there are several other sources of information that could be useful, and may be critical.

## **The Stock Performance, Reports and Analysis for Publicly Traded Companies**

Publicly held stock carriers are subject to greater independent scrutiny than privately held mutual companies, and much more information is available regarding their financial strength.

First, the price of the stock can be an important indicator. If a carrier's stock is on a long term declining trend, or if it suddenly drops in price, more research is warranted. While sometimes the movement is a false alarm, it can also be the first warning sign that something may be amiss. In most cases, a change in the price of the stock should not, by itself, lead to concern on the part of a policyholder. The stock price will decline based on the expectations of profit of a company. Insurance buyers are more concerned with the claims paying ability, which can remain very strong even with a company that is reporting disappointing profits.

In addition, the yield on the company's debt instruments, such as bonds or surplus notes, can be a strong indicator of the market's view of the carrier's strength. This can even be extended to surplus relief arrangements. Early in 2009, one company issued surplus notes to raise capital with an effective interest rate over nine percent. Another company entered into a surplus relief reinsurance arrangement with a cost of about eight percent annually. A third company issued public short term notes at a cost of less than five percent. This speaks to the financial strength of the third compared to the others. Once again, this is just an indicator of prevailing sentiment, and it may not always be accurate.

Better information can be obtained in the reports provided by investment industry analysts. Since these reports are directed towards investors in the life insurance company, there is a very high standard of accuracy, enforceable by securities regulators.

Publicly traded companies provide an SEC form 10-K annually and an SEC form 10-Q quarterly. These reports must be unvarnished, since they are directed to investors and potential investors in the company. They contain a tremendous amount of strikingly frank communication regarding the company's performance and risks. In a time of uncertainty and doubt, the clearest answers can often be found in these reports. The same is true of form 8K, which must be filed with the SEC to announce major events that shareholders should know about. When a stock carrier is facing challenging times, the most useful information is found in these reports. This is not true of mutual companies, which are not required to produce these frank, unvarnished reports. Life insurance policy statements could make reference to these for stock companies, requiring the trust advisor to secure and review them.

### Other Resources

Frequently, the financial press is the first source of information regarding changes in the financial strength of a life insurance carrier. This was certainly true in the case of AIG. Balancing this is the information provided by the management team of the company. Strong insurance professionals will be aware of the news reported in the financial press and the explanations shared by carrier management teams.

Of course, a good life insurance agent may be a very valuable source of information in the carrier due diligence process. The agent may provide reports from the rating agencies, regulators, investment analysts or third-party vendors. In addition, an agent may have access to carrier resources to delve deeper into particular areas of concern. Hopefully this article has shown that the sheer volume of information make it impossible for a single agent to be an expert on all companies. However, a good agent should have the knowledge and tools to become knowledgeable with respect to most major companies—especially stock companies.

### Putting It All Together: How Should a Trustee Or an Advisor Navigate the New Landscape?

The tumult has subsided, but the landscape is permanently changed. Most insurance carriers are not as strong as they once were, and there is a wider difference between the strongest carriers and the rest.

Even though they aren't subject to the same level of reporting requirements, mutual companies are likely to remain stronger, but may not offer the most innovative or attractive products. A wide array of products and services provide information about financial strength, but none are perfect and research can be a difficult and time consuming. In this environment, what steps can an advisor or trustee take to address the issue of financial strength?

**Establish objective, meaningful standards at the outset.** The wealth of information will turn into a hodge-podge of confusion unless the ground rules are clearly laid at the outset. Throughout this article, we have focused on a life insurance policy statement as the vehicle through which this is accomplished. Whether advisors adopt this approach or some other tool, the first step is to determine the standards by which financial strength will be measured. Which tools, ratings, information and guidelines are pertinent or acceptable? Which are not? All carriers can look strong by some financial measure, and every company provides material that might be manipulated to show them in a favorable light. Using the tools outlined above, advisors and trustees can create useful standards by which financial strength is both measured and monitored.

**Establish an ongoing process to monitor financial strength.** Carrier financial strength may change over time. Recent experience proves that differing economic factors, changes in product landscape, regulatory activity, mergers, acquisitions and many other changes will confront life insurance carriers. Do the challenges encountered seem to be transitory, or is the financial weakness persistent and threatening to the company's ability to perform? Some of the companies that failed in the past 30 years were previously rated AAA by all the major agencies. It is imperative that an examination of the carrier be conducted regularly to ensure that it still meets the required criteria. Use of historical information such as Table 6, or five years of financials, can help provide a context for analysis and aid in identifying trends.

**Use multiple tools.** Proper due diligence regarding carriers should not be oversimplified and requires input from multiple information sources. A combination of the resources offers different perspectives and interpretations of data. At least some of the tools used should reflect timely, short-term changes, while others should offer the more in-depth, penetrating analysis that can be an indicator of future results.

**Focus on third-party information.** Third-party analysis is crucial, and the rating agency reports should be the foundation of any due diligence process. The letter ratings themselves provide a good starting point, but the actual reports provide a much better understanding of why the rating was assigned. It also outlines the known risks to the carrier and how the carrier manages these risks. For stock companies, the 10-K and any 8-K forms could also be useful. In addition, the summary reports from Vital Signs and/or Insurance Analyst can be very valuable.

**Be wary of carrier provided material.** Avoid overreliance on carrier generated promotional materials that select only the most favorable bits and pieces of its financial condition or product strengths for dissemination. Likewise, carrier-provided “insight” on competing carriers may be skewed.

**Recognize the uncertainty.** Various analytical tools seem to suggest an exactness of carrier financial condition that just does not exist. This is an illusion of precision. To counter this, some industry experts create broader carrier groupings for analysis using specified criteria or characteristics. One industry analyst creates tiers or “Categories,”<sup>6</sup> with highly rated carriers (AAA or AA+) in the top group and others categorized in progressively lower groups.

**Understand the choices.** As products and carriers evolve, recognize that the combination of the most financially secure carrier, the most attractive product, and the most favorable underwriting results will be elusive. The consumer is likely to be faced with a mutually exclusive choice of the “strongest” carrier or the product with the most favorable features and pricing. Consumers should prioritize considerations at the outset, so that this dilemma is manageable.

**Diversify.** Since the time horizon associated with life insurance is very long, there will be considerable uncertainty at the outset, even if the carrier(s) selected are very strong. This underscores the advantages of diversification between carriers so that business risk is reduced. It may also make sense to diversify between product types and even between the underlying investments in a particular product.

**Consider separate account products.** Cash values held in whole or universal life (general account

products) are subject to the creditors of the carrier. However, cash values held in separate account products—variable life and annuities—are not attachable by the carriers’ creditors. In 1994, Confederation Life was seized by regulators after failed investment decisions made the company insolvent. Eventually, all blocks of U.S. business were sold to other companies, but during the process cash values of general accounts were frozen. The separate accounts on the other hand, remained accessible to policyholders. Thus separate accounts provide an additional insulation from risk to policyholder values.

**Expect accurate, objective and useful information from life insurance professionals.** Since most consumers and their advisors don’t have the time or desire to become life insurance experts, this is probably the most important recommendation. A good life insurance professional will be comfortable explaining any questions about carrier strength and have a broad based, well-defined due diligence process that draws on the resources described here. More than just a Comdex score, professionals should provide a full description of the carrier’s ratings and the meanings behind them. They should also be able to provide additional ratios, analysis and answers to questions about capitalization, form of business and any other pertinent news regarding a carrier’s financial strength. This is one area in which insurance buyers, advisors and trustee should have high expectations of their insurance agents.

The industry has changed. It remains strong, but not all the companies are as strong as they once were. There are new choices to be made, and those who are well-informed will be able to make the best decisions for themselves, their families and their businesses. Insurance buyers and their advisors should not be left to navigate the new landscape in a haze. More than ever, they should look to the life insurance professionals with whom they work to provide accurate, objective guidance regarding carrier financial strength. In an estate plan where life insurance represents potentially millions of dollars of liquidity, estate equalization, charitable donations or other aspects, certainty of payment of a death claim is an absolute necessity. Thus, carrier financial strength remains the primary consideration when considering life insurance.

#### ENDNOTES

<sup>1</sup> Summary Report of Issues Identified in the Commission Staff’s Examination of Select Credit Rating Agencies, SEC Office of Compliance Inspections and Examinations, July 2008.

<sup>2</sup> Weil, Jonathan, *Moody’s Says Don’t Inhale the Smoke It’s Puffing*, Bloomberg Online, March 12, 2009, available online at [www.bloombeerg.com/apps/news?pid=20601039&refer=columnist\\_](http://www.bloombeerg.com/apps/news?pid=20601039&refer=columnist_)

[weil&sid=aQzRB3sWOivE](http://www.bloombeerg.com/apps/news?pid=20601039&refer=columnist_weil&sid=aQzRB3sWOivE).

<sup>3</sup> Testimony of Jerome S. Fons Before the Committee on Oversight and Government Reform, United States House of Representatives, October 22, 2008, avail-

**ENDNOTES**

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able online at <http://oversight.house.gov/documents/20081022102726.pdf>.

<sup>4</sup> Bell, Allison, *Groups Comment on NAIC Solvency Efforts*, National Underwriter Online, March 24, 2010, available online at [www.lifeandhealthinsurancenews.com/](http://www.lifeandhealthinsurancenews.com/)

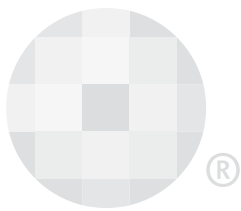
*News/2010/3/Pages/Groups-Comment-On-NAIC-Solvency-Efforts.aspx#*.

<sup>5</sup> These are important financial strength ratios created by life insurance industry regulators. They are discussed in greater detail below.

<sup>6</sup> Joseph Belth, Ph. D., professor emeritus

of insurance in the Kelley School of Business at Indiana University, creates these categories in his publication, *The Insurance Forum*, a periodical focused on various issues associated with the life insurance industry.

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