

RESEARCH

Lonely At The Top: Why So Few 'AAA' U.S. Life Insurers Remain

Publication date: 07-Apr-2006
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As of early 2006, only six U.S. life insurance operating companies or groups have 'AAA' financial strength ratings:

- Northwestern Mutual Life Insurance Co.
- Massachusetts Mutual Life Insurance Co.
- Knights of Columbus.
- Berkshire Hathaway Life Insurance Co. of NE.
- TIAA (Teachers Insurance & Annuity Assoc. of America and TIAA-CREF Life Insurance Co.).
- USAA (USAA Life Insurance Co. and USAA Life Insurance Co. of New York).

This small number is in contrast to the more than 15 U.S. life insurance companies that were rated 'AAA' as recently as 1995.

At one time, a 'AAA' rating was considered one of the most important benchmarks for a life insurance company that sought to sell high-quality product in the U.S. For such a life writer, the lack of a 'AAA' rating put it at a serious disadvantage. Today, however, a market exists for insurance products from companies at nearly every investment-grade rating level, and many firms with noninvestment-grade ratings do a brisk business in policy sales as well. Some insurers have even suggested that the financial and strategic efforts required to attain and maintain a 'AAA' rating could be more burdensome than the benefits such a rating would provide. Yet, for others, 'AAA' remains a goal.

The Factors Behind The Decline

What happened to the ranks of the 'AAA' rated? Over the past two decades, there were several waves of life insurance company downgrades, some of which had systemic causes, such as the asset liquidity problems the industry experienced in the early 1990s. In more recent years, however, downgrades were far more company-specific.

Changes in the industry's organizational structure, the evolution of distribution channels and product designs, massive shifts in policyholder demands, and the deterioration of financial strength were all factors in the decline in life company ratings.

Demographic changes in core life insurance markets—coupled with evolution in customer preferences and needs and a changed economic environment—all increased competitive pressures throughout the life sector, not just for 'AAA' rated life insurers but for companies in all rating categories. The demographic and market trends drove an entirely new set of financial needs and priorities for middle-aged household heads with children, the traditional buyers of participating whole life insurance. These middle-aged baby boomers, planning for retirement years far more active than those of past generations, were more concerned about accumulating assets than protecting them.

In response, insurers developed and expanded their product array to include more investment-like offerings, especially those with equity return-based options, such as the variable annuity. As demand for variable-type products increased, insurers turned their attention to creating and marketing such products for both life insurance and annuity needs. As a result, they not only interfaced more with, but also came directly into competition with, the mutual fund industry and the broker/dealers and banks that distributed their products.

As these trends progressed, life insurer business models diverged significantly. Some companies adopted new distribution channels and product-partnering arrangements, while others retained their proprietary product and distribution strategies. Participating whole life and term life, the industry's traditional top sellers, were pushed into the background as companies put their marketing push behind equity-based products. Life companies also shed their traditional captive agency forces, investing instead in wholesaler networks to distribute and sell these popular products through the rapidly burgeoning independent insurance brokerage and broker/dealer markets.

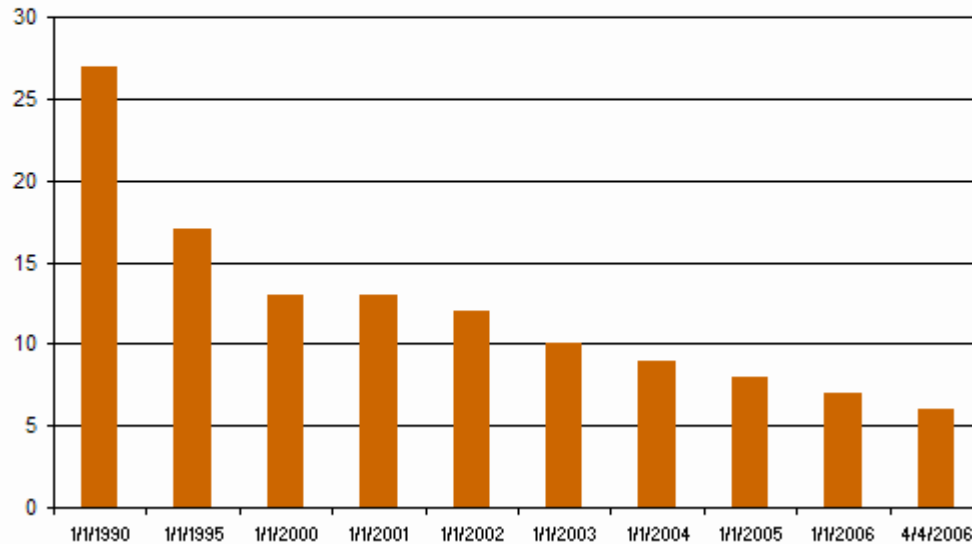
The financial transitions stemming from the demutualization wave of the late 1990s also changed the profile of many insurers and, in some ways, symbolized a shift in the industry's risk profile from conservative to more risky. However, by itself, this shift was not a cause of downgrades. Demutualizing institutions began to tolerate more risk and hold less of a capital cushion. This pushed companies toward building stronger risk-management skills, though risk management for life insurers still lags behind that of banks.

The most recent wave of downgrades among the 'AAA' companies came earlier this decade, during the three-year "perfect storm" that began in 2000. From then to 2003, contracting equity markets, falling interest rates, and record bond default levels caused a massive deterioration in the financial condition of life insurers across the board and magnified the risks of the equity return-based products. Asset quality slid, capital levels declined, and earnings dropped. Average credit quality moved down more than one notch. Not surprisingly, at least once during this time, Standard & Poor's Ratings Services downgraded about 25% of the U.S. life insurers it rated.

The chart shows the dramatic drop in 'AAA' rated life insurers over the past 20 years.

'AAA' Rated Life Insurers Through The Years

(Number of 'AAA'
Rated Life
Companies)



Profile Of A 'AAA' Life Company

With the market's changes, Standard & Poor's criteria for determining the financial strength of the life insurance sector has evolved to factor in more heavily sustainable operating performance, appropriate management of risk profile, and financial flexibility.

Currently, life insurance companies that Standard & Poor's rates 'AAA' have the following characteristics:

- **Competitiveness.** Advantages such as size, effective distribution, and diversified income streams translate into stronger operating performance. For some, those advantages come from an affiliation (e.g., fraternal, affinity relationships) rather than from outright scale.
- **Sustainable earnings.** 'AAA' rated companies maintain revenue differentiation, either through superior products or distribution systems or through operational efficiencies and expense discipline. Some benefit from effective alignment of consumer demand and product design.
- **Nonpublic companies.** At this point, only one public company life affiliate is rated 'AAA'. The rest are mutuals, fraternal, nonprofits, or reciprocals. Publicly traded companies must satisfy not just policyholders but also stockholders and debtholders and so have to run capital levels more efficiently and, in comparison with nonpublic 'AAA's, relatively thinly. Nonpublics, on the other hand, only need to satisfy policyholders and holders of surplus notes. Also, a nonpublic life insurer might have some product pricing advantages.
- **Effective risk management,** given a level of assumed risk. A firm's risk-management capability and execution should be in line and up to the task, given a firm's business strategy and complexity of operation.

Prognosis

The competitive landscape, market demands, and financial challenges insurers face today certainly weigh heavily against their attaining, and retaining, a 'AAA' rating. Over the last 15 years, the number of 'AAA' U.S. life insurers has contracted to a handful of very different firms. In many cases, clear trade-offs between capital discipline and stakeholder demands argue against even trying to attain a 'AAA' rating. Nevertheless, the 'AAA' rating remains a door-opener for new business and is clearly still a competitive advantage.

Standard & Poor's believes that although the contraction in the number of 'AAA' U.S. life insurers could be permanent, it does not preclude a limited number of institutions from aspiring to—or even possibly achieving—a 'AAA' rating. Still, it is unlikely we will see the ranks of 'AAA' life insurers return to the former large numbers despite the thriving state of both the industry and of several of its companies.

Currently, two insurers—Manufacturers Life Insurance Co., a public stock company, and New York Life Insurance Co., a mutual—have 'AA+' financial strength ratings and positive outlooks. Their organizational structures are markedly different, yet their business profiles and risk-management strategies are quite similar. Over the next year, one or both of these companies could be upgraded to 'AAA'. Alternatively, the outlooks could be revised to stable and the 'AA+' ratings affirmed.

By Amy Friedman

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