Standard & Poor's outlines its view of Nordic insurance

by **David Anthony**, director at Standard & Poor's Insurance Rating Services, London

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My two objectives for this lecture are

— firstly, to provide a brief description of Standard & Poor's and our approach to the rating process

— secondly, to outline our view of the Nordic insurance industry from an international perspective, albeit a perspective that has been shaped with the assistance of my Swedish colleagues at Nordisk Ratings in Stockholm.

About Standard & Poor's

Standard & Poor's (S&P) is a New York-based, international credit ratings agency owned by the publishing group, McGraw-Hill.

We have some 13 offices around the world, including London, Paris, Stockholm, Frankfurt and Madrid in Europe. We comprise some 900 analysts in total, with specialist insurance teams in London, New York and Melbourne, containing approximately 120 people. Naturally, one of our principal functions is to assign ratings to companies. Nevertheless, as publishers, we also produce a number of publications, which many of you will already know. These publications include our monthly insurance magazine, 'Focus' as well as various other reports.

Our London office has prime responsibility for insurance ratings in Europe. This does not mean that the English actually control the European insurance rating process at S&P. Far from it! The internal committees, at which rating decisions are actually reached, tend to be very international, very cosmopolitan affairs involving relevant colleagues from various countries who participate in the committees by conference telephone. Through these

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committees, we assign either of the three basic types of rating that apply to insurers, notably:

1. *Claims-paying ability ratings:* An S&P insurance claims paying ability (CPA) rating is an opinion of an operating insurance company´s financial capacity to meet the obligations of its insurance policies in accordance with their terms.
2. Commercial paper writings: An S&P commercial paper rating is a current assessment of the likelihood of timely payment of debt considered short-term in the relevant market.
3. *Long-term debt:* An S&P corporate or municipal long-term debt rating is a current assessment of the creditworthiness of an obligor with respect to a specific long-term debt obligation.

I would just add that we do *not* assign ratings to groups of companies, only to separate legal entities and to individual companies within a group.

The information underlying each requested rating decision is acquired through detailed and frank discussions with a company's senior management over a period of one or two days and through regular discussions by telephone or by mail. Following the formal, face-to-face meeting, the lead analyst will spend some time analysing and interpreting the information received, much of which will be confidential, and will eventually submit his or her recommendation to a rating committee of half a dozen or so senior voting members of S&P.

For *short-term debt*, we assign ratings on a scale from 'A-1', the most secure level, reducing through 'A-2' and 'A-3' at an investment grade level down to 'B', 'C' and 'D' at the non-investment grade or speculative level.

We assign ratings for *claims paying ability* and for *long-term debt* on a scale from 'AAA' (the best) down to 'BBB-minus' within the investment grade range, and then on into speculative grade from 'BB-plus' all the way down to 'C'.

I would emphasise that we belive companies rated down to 'BBB-minus' still represent secure risks and even a 'BB' rating merely denotes elements of vulnerability, not imminent default.

It is also worth emphasising that at S&P we try to take a medium-term, prospective or forward-looking view in our ratings and we prefer not to make erratic rating changes based on short-term factors or current headlines in the newspapers. In other words, we like our ratings to be stable but, on average, correct over the full span of an economic or industry cycle.

Eight fundamental elements

As for our basic analytical approach, this varies little in its initial stages, whether we are analysing an insurance company for debt or for its claims paying ability. Our methodology is to assess eight fundamental elements of a company's risk profile:

1. *Industry Risk:* Each insurance sector is analysed against four competitive factors:
   - Threat of new entrants
   - Threat of substitute products or services
   - Strength of competitors
   - Power of buyers and suppliers.
2. *Management & Corporate Strategy:* Is management technically proficient? Is strategy appropriate or too ambitious for the financial or human resources of the company?
3. *Business review:* Notably a company's market position and franchise.
4. *Operating Performance:* Where we look at historic and forecast future profitability,

return on assets, return on equity, underwriting result, operating result, net income, combined ratio, etc.

5. *Investments:* How is the portfolio of investments structured? Are maturities and currencies matched to liabilities, etc?
6. *Capital:* Is capitalisation adequate, are there hidden reserves, are subsidiaries adequately capitalised? Is capital protected by adequate reinsurance?
7. *Liquidity:* Are there (committed) stand-by bank facilities, are investments readily marketable?
8. *Overall Financial Flexibility:* Would a company be able to raise additional equity or funding, if needed, even in difficult market circumstances?

In brief, I would say that our rating conclusion is a balance of quantitative financial and qualitative (notably subjective) criteria. Perhaps the single most important consideration for S&P, though, is the quality of management at all levels within a company or group. A particularly impressive senior management team will often give us the confidence to believe that a realistic strategy can be established and that effective controls are likely to be maintained to ensure that it is implemented in an effective and flexible manner.

Involuntary ratings

Before moving on to discuss Standard and Poor's view of the Nordic insurance sector, I promised earlier to touch on a fourth category of ratings: *S&P's confidential or involuntary ratings.*

In Europe, these are assigned through our London office and may already be familiar to many of you. The S&P confidential ratings follow the standard scale of 'AAA' to 'C' but carry an ISI subscript to show that they are involuntary ratings based on public information. These ISI ratings are assessed, not at the request of companies, but at the request of brokers, ceding companies, investors and other participants in the insurance industry. The confidential ratings service comprises a statistical overview and rating of some 700 insurance companies in approximately 70 countries.

Basing the assessment exclusively on publicly available information, the ISI process attributes points to a company on the basis of its balance sheet and income statement profile. From the points accorded and from a measure of subjective input, we will assign a confidential rating. As the ISI ratings are the result of subscriber requests, the subject companies themselves are not asked to pay. However, users such as banks, brokers, ceding companies and other interested parties do pay us for details of the company and its rating. If, however, an insurance company invites us to assign a formal, S&P Claims-Paying Ability rating, then this public 'CPA' rating will supplant the ISI rating, which will be withdrawn.

ISI ratings are widely appreciated by users given the considerable breadth of coverage. To illustrate this point, S&P has assigned traditional debt and claims paying ability ratings to about 70 insurers in Europe, including well-known, major national and international groups, such as Skandia, Trygg-Hansa and Sirius International here in Sweden. Using the ISI process we have also produced statistics and calculated confidential ratings on some 30 or so Swedish insurers, including not only the market leaders but also many smaller institutions that would otherwise remain largely unknown to the majority of insurance specialists, particularly those from other countries. This level of coverage exists for many other countries and we believe that these ISI ratings complement our formal, full claims paying ability ratings and provide an invaluable service to other insurers, to brokers and to policyholders who appreciate some comparative indication of one insurer's financial strength versus another. Ideally, one day, all insurers will come to S&P and ask for a full claims-paying ability. Until this time comes, though, we will continue to fill the gaps by producing confidential ISI ratings based on publically available information.

Who benefits from current changes?

Turning now to the second part of my presentation, to S&P's view of the future prospects for the Nordic insurance industry, I would start by suggesting that, just as elsewhere within Europe, it is still too early to declare the final winners and losers in what has become something of a marathon race. The race started with what was the run-up to — and today continues with the increasing reality of — the European Single Market for insurance.

At S&P, we have seen insurers running hard in the last few years to secure a sustainable place in the new environment of the Single Market. But initial indications seem to suggest that the policyholder may yet prove to be the real winner in the whole process with the likelihood of better service, more flexible product design and often better value for money from his or her insurer. Naturally, those policyholders who have in the past preferred simplicity to choice may occasionally come to doubt their good fortune. It nevertheless seems increasingly likely that even they will learn to chose between competing products, even if they end up turning to a broker or independent financial advisor to help them make their final choice.

As for the insurance companies themselves, the state of the race is rather more uncertain. S&P believes that success comes in many guises, in many forms. Some companies, therefore, appear well-positioned simply by having concentrated on their home market and by having made no particularly serious errors of strategy, underwriting or investment in recent years. However, S&P would also give credit to a number of other leading insurers for having managed their way out of previous, often self-inflicted difficulties. Such companies may have made mistakes, but they have learned from them, and today are casting off many of the unrealistic aspirations of the past and are often putting traditional underwriting activities back at the strategic core of their operations.

Similarly, certain well-respected insurers may have lost their independence or found new owners but, in most instances, S&P believes them now to be both financially and strategically more secure and better able to compete effectively into the future. So I would emphasise that what counts for S&P is not nationality, size or type of ownership but financial strength.

Cross-border operations

S&P also notes that one or two Nordic insurers, notably in Sweden, may yet achieve old-fashioned success in the form of international fame and celebrity. Here again, S&P accepts that international growth is neither good nor bad, as a concept. We will, however, only start to give significant credit when the international operations begin to contribute a satisfactory level of return to the parent company and to its owners. Not unreasonably, we see little logic in diversifying out from the home market if the new, cross-border operations are not profitable.

In previous discussions on Nordic insurance, S&P has argued that the road to recovery after the financial upheavals of the past two years would be long and difficult. Today, that conclusion still stands. The domestic Nordic economies remain fairly depressed, despite increasing activity in export sectors encouraged by relatively weak local currencies. Although we have seen greater stability in insurance company operating results in 1993 and 1994, the results of many companies have still been erratic, as local and international asset values have risen and fallen in line with changing interest rate expectations. Nevertheless, slowly but surely, technical underwriting results appear to be improving as old, loss-making activities run-off and as moves to increase operational efficiency start to be reflected in the expense ratios. S&P's forecast for the Nordic insurance sector in 1994 is that improved insurance results will be tempered by unrealised accounting losses on investments. The forecast for 1995 is likely to be more of the same, with most claims-paying ability ratings remaining stable, though one or two groups may see a slight change from current levels.

Big isn´t always beautiful

For the future, S&P believes that the principal feature of those companies that survive and thrive will not be size but efficiency. Throughout the sector, therefore, the most successful companies will be talking less of market share, cross-border expansion and security through diversification and more of their competitive advantages, their low cost base and improving financial strength, which will be derived from the superior profitability of core insurance operations.

As the Nordic insurers struggle to adjust to these new realities, the salient characteristics of the market in 1994, 1995 and probably beyond, are likely to be an aversion to risk, an increasing specialisation in preferred business lines and the relentless pursuit of lower costs. I suspect that a number of companies would also dearly wish to include increasing premium rates as a feature of their sector. S&P nevertheless believes that significant rate increases are unlikely into the medium-term given the amount of competitive capacity still within this region. This continuing competitive environment makes the early pursuit of operational efficiency even more important.

New niche players

As a by-product of these trends towards specialisation and efficiency, S&P expects that the Nordic market will become increasingly polarised between the extremes of a limited number of major national and regional groupings and a relatively large number of niche insurers. The larger groups will aim for economies of scale and will often be keen to acquire the operations of weakened rivals. The niche players, not all of which will be small, will concentrate their resources on their most easily defensible markets. These niche markets will include special relationships with professional or affinity groups such as farmers or labour unions, distinct product and distribution lines like direct telephone sales to individuals, or a traditional concentration upon one or more of the many cultural localities within the Nordic region.

The return of emphasis to core markets is already well-underway at most major Nordic groups, and never really ceased at many smaller companies. For the larger names, S&P sees this as a reflection of the often intense conservatism of many of the new management teams that have been recruited to bring their companies 'back to basics'. Recent experience has shown this return to operational purity often to be synonymous with a withdrawal from activities begun in the late 1970's and 1980's. These activities included credit insurance, assumed international reinsurance and non-insurance activities, such as banking and finance.

1992 - the year of chaos

The catalyst for wholesale strategic change has clearly been painful reflection on the losses incurred on assumed international reinsurance from the 1980's and the implications for Nordic financial institutions of the chaotic events of 1992.

In a nutshell, S&P believes that 1992 was the year in which a number of ongoing issues came to a head. The insurance sector was already unsettled by well-reported attempts to create a Nordic 'super-group' involving Uni Storebrand, Hafnia, Baltica and Skandia. The attempt finally failed in the summer of 1992 as recession and the Danish 'No' vote on the Maastricht treaty caused local interest rates to soar and investment values to plummet. Given the instability that followed, the international capital markets reacted by effectively closing their doors to Nordic institutions, which led to a liquidity crisis in the region. Groups like Skandia had to struggle to sell assets in order to fund their operations, while others like Hafnia and now Baltica eventually lost their independence in exchange for financial support.

International exposure

Today, the old logic has been reversed. Firstly, new opportunities are arising in domestic Nordic insurance as the region's formerly comprehensive welfare systems are being gradually cut back, leading to rapid growth in demand for private savings and pension products. Secondly, the diversification of the 1980's has been largely discredited as a strategy, having been shown to guarantee neither security nor profit. Credit insurance and banking operations, unless tightly controlled, are clearly vulnerable to recession-driven corporate collapse. Reinsurance has proven to be even more dangerous as virtually all the region's larger insurers have made significant losses on the reinsurance exposure they assumed in the 1970's and 1980's.

Even though most Nordic insurers may simply have been unlucky in the timing of their move into the London Market, S&P believes that assumed international reinsurance exposure is now taboo for most Nordic groups. Companies see it as too demanding of management attention and too unpredictable in its results. The exceptions are a small handful of institutions where the exposure is very limited or is akin to core expertise, such as commercial business at the ABB subsidiary, Sirius International. Similarly, Skandia has the size, skills and international experience to write a selective portfolio of reinsurance. Yet even Skandia is now averse to catastrophe-prone U.S. property exposure.

Bank-insurance alliances

As for allfinanz or bancassurance activities, S&P believes that there is no intrinsic reason why a bank-insurance alliance should fail, but the evidence suggests that they often do.

Most Nordic examples show that when companies expanded into finance and banking activities in the 1980's, they took the decision to grow the operations rapidly. This meant, in practice, that they attracted a disproportionate amount of new, non-traditional busines such as consumer finance and property development assets. The result was a disproportionate level of losses once recession, unemployment and falling property prices became features of the market.

An exception should have been Trygg-Hansa, which acquired Gotabank as part of an alliance with the pension company SPP. Gota was large and seemingly well-established and appeared ideally suited to Trygg-Hansa's limited aim of it acting as a distribution channel for the group's pension products. Unfortunately, with very little oversight from the insurance management at Trygg-Hansa and SPP, the bankers at Gota seem instinctively to have pursued their own strategy of lending money, with results that are well-known. However, the underlying concept of an insurer using a bank as a distribution system seems reasonable, so S&P has not been surprised or concerned by the creation of Skandiabanken, nor by seeing Trygg-Hansa apply for a new banking licence. We would only give the general warning that the mentality of bankers and insurers seems to differ, and that the two breeds do not easily mix.

Underlying strength

Concerning solvency and the general financial strength of the Nordic insurance industry, S&P is increasingly optimistic. Exceptions to this optimism, of course, are companies that possess no particular reputation, specialism or defensible core franchise and those groups that appear to have been terminally weakened by excessive debt or long-tail insurance obligations relating to failed previous strategies. Neither policyholders, shareholders nor the capital markets are likely to support such names indefinitely.

With the notable exception of Skandia, which benefited from a rights issue earlier this year, relatively little external new capital has come into the sector recently. The capital base of the Nordic industry was nevertheless significantly reinforced by retained earnings in 1993. Regrettably, these earnings related more to a strong investment performance than to satisfactory underwriting. Nevertheless, insurers throughout the region were quick to realise and retain a good proportion of the windfall capital gains that came with sharply falling interest rates. And even though market expectations have now changed, the gains that were realised have been retained, even though unrealised gains may have been substantially eroded during the current year.

The exceptional investment performance of 1993 is nevertheless likely to prove sufficient to support most companies for the present as they gradually reinforce their balance sheets with the return on continuing business in 1994 and beyond. Meanwhile, most companies have sought to relieve strain on solvency by strictly controlling the level of increase in underwriting volumes.

Recession turns into recovery

S&P is also optimistic that the newly evolving balance within the Nordic market is unlikely to be upset in the near-term by another financial crisis similar to that of 1992. There are four reasons:

1. In 1992 the industry was weakened by catastrophe claims on assumed reinsurance and was entering a recession. Today, the little international reinsurance being written is being assumed at economic rates in a 'hard' market, while recession is slowly giving way to recovery.
2. Most groups have used the intervening period to reduce their high-risk and loss-making activities.
3. Wholesale corporate collapse is unlikely if only because most of the weaker players touched bottom in 1992 and early 1993 and have already been eliminated, taken over or radically restructured.

4. The situation now is different to 1992 due to the fact that all but the Norwegians have voted ‘Yes’ to the European Union. The Danish ‘No’ vote in 1992 brought the whole process of European economic and monetary union into question. The significance of the recent referenda, however, has been much more localised within the Nordic region. And frankly, European Union membership is less relevant to Nordic insurers and other local financial institutions as they are already committed to the terms of the European Single Market within the European Economic Area. As such, even in Norway, the regulators will continue to introduce the insurance code of the single market irrespective of voting in the referenda.

S&P believes that the inevitability of this single market means that the regional industry cannot avoid the necessity of providing modern insurance products at an internationally competitive price.

The incentives for improvement are twofold:

1. A reduction in operating costs is essential as competitors reduce theirs.
2. Potential new and foreign entrants into the Nordic insurance sector are less likely to be attracted if it is seen to be efficient. Only the sight of low standards and the prospect of easy gains are likely to draw a strong competitive response from new entrants or from insurance majors from outside the region.

Summing up

Most importantly of all, I think that we at S&P will be relieved just to see stability return to the Nordic insurance sector. We certainly have no expectations of a new ‘golden age’ for Nordic insurance and believe that the comfortable economic conditions enjoyed by post-war and cold war Scandinavia will not return.

As for the Nordic economy itself, S&P expects to see very gradual economic recovery on the domestic front to match the already sustained, export-led industrial growth.

Particular to insurance, we expect brokers to become much more active under the new, single market regulations. This phenomenon has been apparent in Sweden for several years, but may come as a shock in neighbouring countries. Industrial insurance has long been broker-driven and mobile across borders. What is new is that we expect to see an important segment of personal lines business, life and non-life, migrate to the brokers and other independent financial advisors. These specialists will help policyholders and savers make a rational choice in a market-place increasingly crowded with new and possibly confusing products.

As the markets become more competitive, we expect to see insurers abandon cherished but loss-making activities and to concentrate on their core strengths. In practice, we believe that this will encourage a polarisation of the Nordic insurance sector between a limited number of large regional and national groups and a host of niche companies, not all of which will be small. These niche insurers will concentrate on areas where they believe that their local or specialist knowledge, their method of product distribution, or their prices can give them a sustainable and profitable foothold in the market irrespective of competition from larger groups.

S&P believes that the principal characteristic of the companies that survive and thrive will be efficiency not size and that a low cost base will be essential. A number of already large groups will not unreasonably see growth as a way of efficiently using their existing infrastructure and of controlling costs. Nevertheless, companies will ultimately be judged by return on notional equity, not on their market share.

As attention turns to efficiency, S&P believes that today's insurers will become increasingly risk averse in the pursuit of operational stability. This will be reflected in the formulation of strategy, in underwriting and in investment practices.

We do not expect to see any sharp increases in premium rates. Firstly, a significant amount of underwriting capacity remains within the region and, secondly, we expect the existing majors to prove very reluctant to abandon large amounts of market share to competitors and niche insurers, so they will fight to retain what they feel to be a reasonable market position. Any loss of turnover could lead to rising fixed costs as a percentage of premium income, and so will be resisted.

We nevertheless expect to see profitability improve at most of the existing Nordic majors as the costs of old strategic errors from the 1980's run-off.

As the more effective management teams start to differentiate themselves and their companies, we would expect some additional capital to be attracted into the sector in the medium term, possibly to finance the acquisition of ailing, less effective competitors. In the short-term, though, we do not expect to see significant new capacity or capital enter the market, which means that most companies must for the present make do with the resources currently available to them.

Finally, with attractive new opportunities in the local pensions and savings sectors, we do not expect to see many Nordic insurers venturing out beyond their region, except possibly through buying into membership of other cross-border groupings of like-minded companies, such as the Eureko grouping. Similarly, though, we do not expect any significant move by foreign insurers into the region, as Nordic insurance is already too efficient, too mature and, frankly, too small when compared with attractive new markets elsewhere in Europe, Latin America and the Far East.

Although far from negative, you may agree that few of my conclusions are sufficiently comforting as to give grounds for complacency. But clearly, S&P does believe that there is a future for the Nordic insurance sector.

The good news, though, for some of you at least, is that S&P believes that it has already factored most of its concerns into its existing ratings of Nordic insurers, so we would therefore expect most of these ratings to remain secure and stable in the current 'A' to 'BBB' range.