# Unlocking the Full Potential of Ratings…

by Peter Hughes

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*To 'unlock' the full potential of ratings, it is important to understand the processes behind a rating, the nuances of the rating scale and the importance of 'outlooks' and 'CreditWatch' listings.*

*An Insurer Financial Strength Rating is an opinion of the financial strength and credit worthiness of an insurance company, evaluating its ability to meet its financial commitments to policyholders. Operating on a scale rising from 'CC' (extremely weak) to 'AAA' (extremely strong) ratings help policyholders and their intermediaries make informed decisions with regard to the carrier they choose.*

## Assigning a rating

Standard & Poor's employs two approaches when assigning a rating, based on an 'interactive' and public information ('pi') rating process. The difference between the two lies in the amount and type of information our analysts use.

'pi' ratings are based solely on information in the public domain. Conversely, interactive ratings involve in-depth meetings with the company's senior management, commonly including access to confidential information. Interactive ratings are based on Standard & Poor's broadest categories of analysis, known as 'the eight heads of analysis, incorporating:

- *Industry risk* – the environment framework an insurer operates in.
- *Management and corporate strategy* – looking at strategic positioning, operational controls and skills and financial strategies for tolerance and risk.
- *Business review* – evaluating an insurer's revenue generating capacity and competitive strengths and weaknesses
- *Operating performance* – how a company's ability to implement strategies, capitalize on its strengths and manage its weaknesses, translates into operating performance.
- *Investments* – how an insurer's investment strategy fits with its liability profile and to what extent investment results contribute to total earnings.

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- *Liquidity* – Assessing cash flows, investment portfolio liquidity and credit facilities.
- *Capitalisation* – Whether capital is sufficient to support an insurer's business needs, while also looking at the structure and quality of capital.
- *Financial flexibility* – Determining an insurer's potential needs for additional capital or liquidity and comparing it to the sources available to it.

Notably, as weak investment markets and significant losses in many insurance markets result in increased concern over the issues of financial strength, increasing numbers of insurers are choosing to adopt 'interactive' ratings over 'pi' ratings.

## The rating scale

The rating scale – ranging from the highest category, 'AAA', to the lowest, 'CC' – indicates the varying 'shades of grey' of credit quality. For further granularity, interactive ratings may also include a plus or minus designation to show relative standing within the category.

To give perspective to the ratings, Standard & Poor's also differentiates between secure and vulnerable ratings within the scale. Ratings grades of 'BBB' and above are considered 'secure', in that they are regarded as having financial security characteristics that outweigh any vulnerabilities and are highly likely to meet their financial commitments. Conversely, insurers rated 'BB' or lower are regarded as having vulnerable characteristics that may outweigh their strengths. 'BB' indicates the least degree of vulnerability with the 'non-investment grade' range; 'CC' the highest.

To help enable users of ratings to plan their contingency, Standard & Poor's also publishes default studies. Measuring the average rate of corporate default for all rating levels, default studies illustrate the merits of granularity across the rating scale for both short-tail and long-tail liabilities. Hence they a key part of enabling cedents to judge the level of security required for different risks.

## Rationale, Outlooks & CreditWatch

The rating is given further depth by the 'rationale'. The rationale is a published account of the rating explaining the nuances within it. It highlights any short-term pressures on the rating and gives an indication of the likely direction that the rating might move, depending on management's short-term delivery of plans.

An 'outlook' notation, meanwhile, indicates the possible direction a rating may move over the intermediate-term. Internal or external factors during the period could lead us to change the outlook.

Outlook desginations include:

- 'Positive': may be raised.
- 'Negative': may be lowered.
- 'Stable': unlikely to change.
- 'Developing': may be changed.

A third identifier of the dynamics of a rating is the 'CreditWatch' listing. CreditWatch is based on events and short-term trends that may cause the rating to be put under special surveillance. Examples of events that have caused a CreditWatch announcement include shifts in reserving levels, mergers, and changes in capital.

Indicating the possible impact on the rating, a CreditWatch listing will be 'positive', 'negative' or 'developing'.

## The interactive rating process

Start to Finish in Seven Steps:

1. At a company's written request, Standard & Poor's issues an agreement letter for the

insurer to sign, containing terms and conditions and the annual fee payable.

2. Standard & Poor's analysts meet with the insurer's management in order to gain an understanding of the business in the company.
3. Relevant information will be requested and when received an analysis will be undertaken. This stage often entails a further communication with the insurer. The analysis is likely to take a minimum of five weeks.
4. The lead analyst will present a rating to a committee of six to eight analysts, who will evaluate the methods and reasoning used and the recommendation reached. Benchmark comparison of peer companies may be part of the analysis.
5. The committee meeting will conclude with a decision on the rating.
6. The conclusions will be communicated to the insurer verbally, at which point the insurer has three options:
   - To *accept* the rating: a press release will be issued announcing the rating and rationale.
   - *Appeal* the rating: if the insurer can provide sufficient reasoning and/or new information, then the committee will re-sit. The decision on appeal is final.
   - The insurer can *decline* the rating: the rating decision will not be issued.
7. Once a rating has been accepted, the insurer will undergo ongoing surveillance and an annual review will normally take place. If a rating change is considered necessary at any stage, Standard & Poor's will discuss its concerns with the insurer before taking any action.

### Definition of Financial Security Characteristics

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| AAA | Extremely strong. Highest rating. |
| AA | Very strong. |
| A | Strong. Somewhat susceptible to adverse business conditions. |
| BBB | Good. More likely to be affected by adverse economic conditions. |
| BB | Marginal. Positive attributes exist but adverse business conditions could lead to inability to meet commitments. |
| B | Weak. Adverse conditions will likely impair its ability to meet commitments. |
| CCC | Very weak. Dependent on favourable business conditions. |
| CC | Extremely weak. Likely not to meet some of its financial commitments. |
| R | An insurer rated 'R' has experienced a regulatory action regarding solvency. |
| NR | Not Rated. |