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# IS THE INSURANCE INDUSTRY WELL SERVED BY RATING AGENCIES?

## 34TH ANNUAL GIRO CONVENTION

CELTIC MANOR RESORT, NEWPORT, WALES

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# Is the Insurance Industry Well Served by Rating Agencies?

## Shortcomings of Rating Agencies

## The Role of Rating Agencies

## Conclusions



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# Shortcomings of Rating Agencies

## Power of the Rating Agencies

- Insurance industry is held to ransom
- Ability to break companies' fortunes
- A- rating floor
- Perceived as de facto regulator
- "*Quis custodiet ipsos custodes?*"

\*Decimus Iunius Iuvenalis ("Juvenal"), Roman poet, 1<sup>st</sup>-2<sup>nd</sup> century



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## Shortcomings of Rating Agencies

### Power of the Rating Agencies

- Onerous capital requirements
- Criteria/methodologies are not regulated
- Ratings do not reflect cyclical nature of industry
- Rating triggers sound a death knell

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## Shortcomings of Rating Agencies

### Absence of Genuine Competition

- Hundreds of rating agencies exist
- Reputational barriers to entry
- Regulatory barriers to entry
- Limited opportunities for rating shopping

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## Shortcomings of Rating Agencies

### Inadequate Transparency

- Rating process is complex and mysterious
- Rating decisions made behind closed doors
- Rationale for rating decisions
- Rating agencies' jargon

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## Shortcomings of Rating Agencies

### Inadequate Transparency

- Inadequate disclosure of mechanics of criteria/methodologies
- Criteria/methodologies are not common between rating agencies
- No common rating scale

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## Shortcomings of Rating Agencies

### Inappropriate Analytical Standards

- Global inconsistency of analytical approach
- Global differences in regulation and reporting
- Qualitative evaluation as basis for rating decision
- *"We may be incompetent, but we're not dishonest"*<sup>2</sup>
- Insufficient analyst continuity

<sup>2</sup>Rating agency analyst, The Economist, February 2003

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## Shortcomings of Rating Agencies

### Inappropriate Analytical Standards

- Absence of recommendations to address rating drags
- Rating should be current at any given time
- Frequency of rating updates
- Rating process is too lengthy
- Ineffective communications

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## Shortcomings of Rating Agencies

### Conflicts of Interest

- Irony of remuneration
- Provision of consulting services
- Indicative rating services

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## Shortcomings of Rating Agencies

### Unsolicited Ratings

- Miscellaneous group companies and debt
- PI/PD ratings are deliberately low
- Insufficient analytical accuracy
- Not generally issued with companies' approval

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## Shortcomings of Rating Agencies

### Rating Agencies in Crisis?

- Tardy timeliness of response to market events
- Failures are not predicted
- Slow out of the blocks
- Inability to learn by past experience
- Credibility of reputation

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## Role of Rating Agencies

### What Rating Agencies Do

- Provide an opinion
- An opinion on relative ability to meet obligations
- Relative vulnerability rather than predictive indicator of default rates
- Raise research standards e.g. Prism

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## Role of Rating Agencies

### What Rating Agencies Don't Do

- Guarantee, provide recommendation to buy, sell, etc.
- Set hurdles, define triggers
- Structure transactions
- Consult

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## Role of Rating Agencies

### Definitions

- Issuer Default Rating – relative measure of default likelihood
- Insurer Financial Strength (“Claims-Paying Ability”) – Likelihood of default and recovery expectations

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## Role of Rating Agencies

### The Cycle

- Default rates will vary with the cycle
- Default Studies – the empirical evidence
- Fitch does not rate to a specific probability of default

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## Role of Rating Agencies

### Limitations – Data Sources

- Public data
- Issuer data – management accounts, strategic plans, actuarial reviews, etc.
- Not audited by rating agencies

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## Role of Rating Agencies

### The Value of Ratings

- Market demand
- Market “regulation”

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## Role of Rating Agencies

### Transparency

- All criteria published
- Consultation with the market – Exposure Drafts
- Response to market feedback

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## Role of Rating Agencies

### Unsolicited Ratings

- In response to Investor/Broker demand for multiple opinions
- Identified, as defined in Code of Conduct
- Limited in number
- Only where information disclosure is sufficient
- Participation versus Initiation

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## Role of Rating Agencies

### Market concerns

- Timeliness – “through the cycle” versus volatility
- Fraud – If you can fool the auditors, the actuaries and the regulators,....
- Entry Barriers – set by the market

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## Conclusions

### Role of Rating Agencies

- Auditor 
- Regulator 
- Investment advisor 
- Issuer of ratings 

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## Conclusions

### Scope for Improvement

- Communication
- Analytical competency and diligence
- Fewer barriers to entry to increase competition
- Regulatory oversight
- Transparency

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## Conclusions

### Observations

- Rating agencies issue forward-looking opinions
- Ratings are not a rubber-stamp of approval
- Cost of ratings do not reflect value added
- Industry will remain reliant on rating agencies

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# Conclusions

*“Any fool can criticise, condemn, and complain, and most fools do”<sup>3</sup>*

<sup>3</sup>Benjamin Franklin, 1706-1790

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# Is the Insurance Industry Well Served by Rating Agencies?

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