Workshop Session: Rating Agencies

GISG 1995

Kendra Felisky-Watson,
Tim Mardon,
David Slater.

INTRODUCTION

WHAT DO RATING AGENCIES DO?

HOW DO END USERS UTILISE THE RATINGS?

PERCEIVED SHORTFALLS OF RATINGS

Introduction

Scope

This workshop paper is aimed at providing background information for a workshop presentation at the GISG 1995 Convention. More practical examples will be given at the convention, whilst this paper describes in overview what the Rating Agencies do and how the ratings are used.

What do Rating Agencies Do?

Ratings are essentially the result of a detailed analysis of a company's ability to meets its financial obligations. For debt ratings, a particular designation has a material impact on the rate of interest that bond and short term debt issuers have to pay - the rating is a codified judgement of investment risk.

Although debt ratings are provided on insurance companies paper, the most significant rating for a (re)insurer assesses their ability to meet obligations to policyholders. Two agencies dominate this field - Standard and Poors (S&P) and AM Best (Best).

Best used to dominate for the US insurers, and S&P for non-US. Both agencies have now expanded internationally.

There is little open competition as at least two opinions in the market are welcomed by the end users (chiefly insureds, cedants and brokers). Other ratings agencies are also active, such as Moody's, Fitch and Duff ,and Phelps - but most of these concentrate on debt. Weiss has also become involved in the last 2-3 years, but mainly focuses on Life Companies.

S and P Ratings

S&P produce a Claims Paying Ability (CPA) rating which is a public rating assigned via voluntary participation of an insurer for a fee.

The rating process includes a review of publicly available financial and other information, and extensive contact between S&P's analysts and the insurer's management (such meetings allow analysis of strategies, strengths and weaknesses).

S&P CPA ratings are voluntary as they are partly based on information only available from their insurer's management.

S&P claims paying ability ratings are subject to review and possible change when an insurer's performance differs appreciably from that on which the rating was based.

ISI Ratings

ISI ratings are produced in the London office of S&P Insurance Rating Services. They are produced to give an opinion of financial strength on companies which have not elected to undergo the S&P CPA scrutiny (mainly non-US insurers or reinsurers).

ISI ratings are based on analysis of published financial statements, as well as additional information in the public domain or provided in writing by management for public dissemination. They do not reflect in-depth meetings with senior management of the rated companies.

ISI ratings are based on less comprehensive information than the CPA ratings, although still provide an insight into the (re)insurer's financial strength.

ISI ratings are presented on a confidential basis and are not for general publication or redistribution (but they can be bought for a fee).

S&P Qualified Solvency Ratings

These apply to US (re)insurers not requesting a CPA rating.

S&P applies a statistical procedure to the insurer's public financial data. The ratings are based on public information only - no subjective judgement is applied, and there are no interviews with the insurer's management.

Qualified solvency ratings are issued for each insurer on a stand-alone basis, without considering any strength or weakness that might be added by a parent company.

Bests Ratings

Best rating's are similar to S&P's claims paying ability in that they involve in-depth on-site analysis along with continuing contact at senior level.

Best assesses the insurers' financial condition through a combination of qualitative and quantitative evaluations.

Typical information analysed:

- Financial performance over last five years
- Parent's commitment to the insurer
- Operating strategy and how surplus is invested
- Annual reports
- SEC filings
- Reinsurance audits
- Loss reserve reports
- Capital structure
- Stockholder/policyholder reports
- Newspaper and trade journal articles
- Types of coverages written, forms used (eg claims made versus occurrence)
- Pooling/reinsurance arrangements
- Contingent liabilities
- Composition of investment portfolio
- Potential environmental exposures

Best's charges a rating fee which typically varies between US$250 and US$12,000

Rating Systems

(These have been criticised as being confusing as they differ).

Financial strength distribution:

	S&P	AM Best
Top 5%	AAA	A++
Top 30%	AA, A	A+
Top 60%	BBB, BBBq	A
Top 90%	BB, BBq	A-, B++, B+
Bottom 10%	B, Bq or lower	B or lower

Explanantion of Rating definitions: S&P (ISI)

Secure Ratings

AAA

Superior financial security on both an absolute and relative basis. Capacity to meet policyholder obligations is overwhelming under a variety of economic and underwriting conditions.

AA

Excellent security. Capacity to meet policyholder obligations is strong under a variety of economic and underwriting conditions.

A

Good financial security, but capacity to meet policyholder obligations is considered vulnerable to adverse economic and underwriting conditions.

BBB

Adequate financial security, but capacity to meet policyholder obligations is susceptible to adverse economic and underwriting conditions.

Vulnerable ratings

BB

Financial security that maybe adequate, but capacity to meet policyholder obligations is considered vulnerable to adverse economic and underwriting conditions.

B

Vulnerable financial security. Currently able to meet policyholder obligations, but capacity to meet policyholder obligations is particularly vulnerable to adverse to adverse economic and underwriting conditions.

CCC

Extremely vulnerable financial security. Continued capacity to meet policy holder obligations is highly questionable unless favourable economic and underwriting conditions prevail.

AM Best

A++ and A+ (superior)

Superior overall performance compared to standards established by AM Best, very strong ability to meet policyholder obligations over a long period of time.

A and A- (excellent)

Comparatively excellent overall performance; strong ability to meet policyholder obligations over a long period of time.

B++ and B+ (very good)

Comparatively very good overall performance; strong ability to meet policyholder obligations, but financial strength maybe susceptible to unfavourable changes in underwriting or economic conditions.

B and B- (good)

Comparatively good overall performance ; generally adequate ability to meet policyholder obligations but financial strength susceptible to unfavourable changes in underwriting of economic conditions.

C++ and C+ (fair)

Comparatively fair overall performance; current ability to meet policyholder obligations, but financial strength very vulnerable to unfavourable changes in underwriting or economic conditions.

D (below minimum standards)

Meets minimum size and experience requirements but not minimum standards for Best rating

E (under supervision)

F (in liquidation)

There is also a non-rated category for new companies - this merely means there is insufficient track record or other information to establish a rating.

As can be seen there is essentially a threshold with both rating systems, dividing the "secure" companies from the "vulnerable".

The group of insurers assigned the top rating by each agency is not exactly alike, but there is a degree of convergence on the financial strength required to earn a top rating. An S&P rating of A- or higher indicates a similar view of relative financial strength as an AM Best rating of A+ or higher.

About 25% of rated companies achieve an S&P rating of BBB- or higher, putting them in the "secure" category. Around 57% of Best rated companies achieve an A rating or higher.

How do End Users utilise the ratings?

Reinsurance buyers and potential policyholders used to purchase cover through brokers on the understanding that the security was adequate - only to find out in some cases it was not.

Reinsurance buyers and potential policyholders now use sophisticated analysis to assess their risk partners, but the starting point is usually the data and rankings produced by the rating agencies.

Ratings can be used to quickly determine a very good reinsurer from the completely unreliable. Resources can them be concentrated on analysing these reinsurers which are more borderline.

Although security requirements for short tail insureds maybe lower than those for long tail classes, most buyers prefer to deal with companies which don't have a "secure" rating. For example, a cedant may tell its broker not to approach reinsurers with less than an A rating.

Reinsurers have restructured or merged to highlight their financial strength and improve their ratings in response.

Reinsurers and intermediaries are particularly reliant on the rating agencies to make sound decisions about foreign retrocessionaires. As reporting requirements and government regulations regarding disclosure of financial information differ widely between countries analysis provided by the agencies are the primary means of evaluation.

Perceived Shortfalls of Ratings

Ratings are based on a snapshot in time, and even though updated regularly they may not be updated quickly enough for a reinsurance buyer.

There is a lag in producing the ratings which are based on report and accounts - i.e. the rating may not been completed until 9-12 months after a given accounting date.

Agencies may rate the same companies differently - this may not be a problem if all rate the company as "secure", but if one rates A and the other B then who should the buyer believe?

Rating agencies don't cover all insurers/reinsurers used by cedants, particularly in developing countries.

Rating agencies provide detailed information only about those companies which subscribe to their services - the rest are rated merely on publicly available information, which may not always reveal a true picture.

The greatest fear for an agency is to put a good rating on a bad company, and so it may be tempted to err on the negative side. However, rating agencies have recently been criticised for not recognising impaired insurers until shortly before the regulator has taken action.

It maybe difficult to distinguish between branches of a company - the parent may have an excellent rating but some companies have undercapitalised subsidiaries

Erosion of financial strength of an insurer maybe hidden until considerable damage is done - e.g. when an unusual circumstance occurs - such as a large loss or fall in asset values.

When weaknesses are discovered, the rating firm analyst may be inclined to accept the insurer's assertions that corrective action is being taken.