Is the Insurance Industry Well Served by Rating Agencies?

Shortcomings of Rating Agencies

The Role of Rating Agencies

Conclusions

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, 1st–2nd century
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

Absence of Genuine Competition

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

Inadequate Transparency

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

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"^2
- Insufficient analyst continuity

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
Shortcomings of Rating Agencies

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

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

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
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

What Rating Agencies Don’t Do

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

Definitions

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

Limitations – Data Sources

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

The Value of Ratings

- Market demand
- Market “regulation”
Role of Rating Agencies

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

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

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
Conclusions

Role of Rating Agencies

- Auditor ✗
- Regulator ✗
- Investment advisor ✗
- Issuer of ratings ✓

Conclusions

Scope for Improvement

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

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
Conclusions

“Any fool can criticise, condemn, and complain, and most fools do”

Benjamin Franklin, 1706-1790

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