Article Title: ARCHIVE | Criteria | Insurance | Health: Management And Corporate Strategy Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Management And Corporate Strategy," which was published on April 22, 2009.) Although management has little control over industry risk, altering the health plan or insurer's competitive position to its advantage and managing its resources and finances in a prudent and ultimately profitable way are internal factors over which management can exert significant influence. Therefore, no company analysis would be complete without an assessment of a company's formulation and implementation of the strategy dictated by its management. Standard & Poor's Ratings Services considers management and corporate strategy a key element of the criteria that form the foundation of the financial strength rating process. An organization's strategy, operational effectiveness, and financial risk tolerance will shape its competitiveness in the marketplace and the strength of its financial profile. It can be argued that the analysis of management and corporate strategy is the most subjective area of any rating methodology. Therefore, Standard & Poor's has developed a process that is applicable to all rated health plans and insurance companies. Although the element of subjectivity cannot be avoided entirely because of the qualitative nature of this variable, it is precisely the analyst's opinion of the human element that gives further valuable insights not provided by quantitative measures alone. This insight also distinguishes the process from a mere quantitative assessment that does not include meeting with the company's senior team members to ask them questions that can be extremely revealing and can add substantial depth to our analysis and conclusions. This area of inquiry consists of a review of: Strategic positioning. Operational effectiveness. Financial risk tolerance. Organization structure and how it fits the company's strategy. When assessing the company's strategic positioning, it is important to establish what management's goals are and how its strategy was developed. The analyst must discern whether the goals and objectives are market share-oriented, financial, or traditional and whether they are internally consistent. The analyst then projects what their implications are for the company's future. To develop a formal and well-articulated strategy, a planning process needs to be in place. Therefore, questions such as how strategic milestones are developed and updated and how compensation systems are designed to support them are relevant. Standard & Poor's task is to evaluate whether the strategy management has chosen is consistent with the organization's capabilities and whether it makes sense in its marketplace. Standard & Poor's also wants to know management's record of converting plans into action and if effective systems are in place to communicate plans to lower management and assess performance versus plans. Operational effectiveness essentially involves assessing a company's ability to execute its chosen strategy. Standard & Poor's evaluates management's expertise in operating each line of business and assesses the adequacy of audit and control systems. How has the company performed compared with expectations? What type of internal audit controls does the company use? Is the corporation centralized or decentralized, and does this structure improve efficiencies? Does the company's organization fit with the strategy chosen? Evaluating financial risk tolerance allows Standard & Poor's to understand management's views on financial goals, capital structure, financial and accounting conservatism, board oversight, and risk acceptance. What are its specific financial goals? What are the amount and types of capital in the capital structure and the level of leverage employed? What are the quality and allocation of invested assets and measures of capital adequacy, such as risk-based capital? What are the reserving practices and use of reinsurance? Does the company have predetermined limits for acceptable levels of risk? Are these guidelines detailed or general? Do they apply to many areas of the operation or just a few? Does the company generally operate aggressively or conservatively? Is the board of directors involved in the management of the company, or is it just a rubber stamp? Is the company run for management, the owners, policyholders, or agents? Responses to these questions reveal management's conservative or aggressive posture in managing the balance sheet and form the basis of Standard & Poor's opinion. The organizational structure must support the strategy to produce the desired results. Who are the senior managers? What are their functional backgrounds? How long has the team been together? Standard & Poor's typically asks an insurer to provide a managerial organization chart. Who reports to whom? Is the company organized: Functionally (marketing, underwriting, claims, actuarial, etc.)? By product (HMO, PPO, traditional indemnity, ASO, dental, other special lines, etc.)? By market segment (individual, small group, large group, self-insured, national accounts, etc.)? Geographically (the South, California, etc.)? By distribution channel (in-house sales force, agents, brokers, direct marketing, etc.)? This process allows Standard & Poor's to develop an organized review of each company's management and corporate strategy, which, in turn, provides the needed perspective as Standard & Poor's evaluates a company's competitive position and the more objective areas of operating performance and capitalization. Analytic Guidelines for Evaluating Management and Corporate Strategy In evaluating an insurer's management and corporate strategy, Standard & Poor's has a list of guidelines for the analyst. Health Plan and Health Insurer Scoring Guidelines: Management and Corporate Strategy MOST FAVORABLE FAVORABLE LEAST FAVORABLE OPERATIONAL Management has considerable expertise in operating lines of business company is engaged in and exercises strong control over its operations. Management lacks expertise in operating some lines of business, but maintains good control over its business. Management lacks ability to understand and control its business. Audit and control systems are extensive. Audit and control systems are average. Audit and control systems are weak and/or are ignored. Company has performed well against plan. Company usually performs well against plan. Company often misses plan. Management has good depth and breadth. Some holes exist in management depth or breadth. Many holes exist in management depth or breadth. Management has a history of stable financial performance with few surprises. Unusual items that disrupt the balance sheet or income statement occur from time to time. Unusual items that disrupt the balance sheet or income statement occur commonly. Organizational structure fits strategy. Organizational structure does not fully foster strategy. Organizational structure impedes implementation of strategy. FINANCIAL Has financial standards in place. Has financial standards in place. Has no defined financial standards. Has above-average standards for operational performance. Standards for operational performance are similar to industry’s levels of performance. Lacks standards for operational performance or has low standards. Maintains very conservative operating performance. Has no commitment to maintaining conservative operating and/or financial leverage. Disregards any reasonable standards for operating and/or financial leverage. Has conservative reserving practices and uses reinsurance judiciously. Reserving practices are acceptable, and use of reinsurance is not aggressive. Is aggressive in setting reserves and in its use of reinsurance. STRATEGIC A formal process for strategic analysis exists. The strategic planning process is informal or lacks depth. No strategic planning process exists or plans are very superficial. Entire management team thinks strategically and has a record of converting plans into action. Only some managers are capable of thinking strategically. In many cases, company is unable to convert strategic decisions into positive action. Most managers are not capable of thinking strategically. In most cases, company is unable to convert strategic decisions into positive action. Strategy chosen is consistent with the organization’s capabilities and makes sense in its marketplace. Strategy includes some contradictions with the organization’s capabilities. Achievement of some objectives appears unlikely. Strategic thinking includes many contradictions with the organization’s capabilities, and many goals appear to be unattainable. Company has an effective system in place to communicate its plans to lower levels of management. The communication of strategic decisions to lower levels of management is incomplete. Little, if any, communication of strategic planning to lower levels of management exists. Board is independent, highly qualified, and willing to exercise proactive judgment. Board is independent. Board is heavily populated with insiders.