Article Title: ARCHIVE | Criteria | Insurance | General: Structured Segment Rating Criteria Data: (EDITOR'S NOTE: —This criteria is no longer current.) Standard & Poor's Ratings Services has refined its segmented ratings guidelines by introducing the concept of a structured segmented rating (SSR). This rating is intended for highly technical insurance entities that have a superior business profile and operating performance and that have been set up primarily to write financial guarantee/credit enhancement business. The rating addresses the overriding need for this select class of subsidiaries of larger multi-line insurance and reinsurance groups to have stable ratings. In addition, this new class of segmented ratings allows select subsidiaries to be rated up to one category (three notches) above the rating on their respective group. The rating incorporates rating methodology aspects of Standard & Poor's financial enhancement ratings (FER), bond insurance, and corporate ratings criteria. The characteristics of a subsidiary benefiting from an SSR are analogous to those of a protected (or segregated) company in which the SSR entity is a self-dependent insurance or reinsurance going-concern within the hierarchy of a larger organization. The subsidiary is, in theory, legally and operationally fire-walled from the risks of its parent's business (regulatory supervision, bankruptcy, etc.). The credit ratings on SSR entities must be justifiable by the stand-alone financial strength and financial enhancement ratings, with limited or no support from its parent company. For comparative purposes, existing Standard & Poor's criteria establish that at the highest end of the ratings spectrum, monoline bond (re)insurers, monoline mortgage (re)insurers, and specific independent finance subsidiaries of corporates bear the cost of maintaining high ratings in order to do any business. The ratings assess the consequent interdependence between each company's business position and economic incentive to maintain the rating and necessary level of capital adequacy. As such, a fully owned SSR subsidiary may normally be rated up to three notches above the group rating, assuming its stressed, stand-alone business, operating, and capital characteristics can support such gapping and also assuming that the subsidiary can be properly evaluated on a segmented basis. In exceptional circumstances, further notching (up to two additional notches) may be obtained, but this would require the parent to relinquish a share of its ownership or control (minimum of 20%) to outside independent (preferably strategic)ownership or trustee supervision. Standard & Poor's would strictly limit the structured segmented uplift on a subsidiary to three notches or less if the rating on the parent is in the noninvestment-grade range unless the subsidiary can clearly demonstrate that its particular circumstances afford robust protections under extremely stressed scenarios, such as the parent being under regulatory administration following its parent's bankruptcy. Demonstrable protections may include, among other things: An enforceable nonconsolidation opinion (especially for cross-border ownership). Superior capital adequacy. A reduction in ownership share. Independent control with attaching voting or veto rights. Specific regulatory protections for reserves. Distinct separation of internal operating systems. Board resolutions limiting dividends to reasonable levels. In addition, Standard & Poor's would require further protections that prevent an administrator from obtaining guarantees, extracting capital, stripping or selling assets, transferring the parent's risks, and selling services or products (except where easily substitutable and at arm's length terms and conditions). The need for this criteria refinement has been prompted primarily by recent changes in Standard & Poor's FER and Bond Insurance criteria. The FER changes emphasize instances when insurance policies or other credit enhancements are provided to cover or support financial payment obligations arising from the underperformance or nonperformance of specified assets, cash flows, or counterparties in capital markets transactions rated by Standard & Poor's. Although the Bond Insurance criteria now only allow reinsurance (and soft capital) credit to monoline bond insurers that have reinsurers that have and use an FER or pledge appropriate collateral when providing protection. Clarification of the FER and creation of the SSR criteria were also prompted by pricing cycle upturns in the global property/casualty insurance and reinsurance marketplace; reaffirmation of dedicated subsidiaries versus traditional multiline insurers and reinsurers (within large groups) and their commitment to the financial guarantee/credit enhancement business; and the true understanding of timeliness to pay. Although, Standard & Poor's believes that such dedicated subsidiaries will have limited support by their parent/affiliated group for such a business, it has become increasingly necessary to question the ongoing nature of this support in the context of how such a subsidiary fits into the long-term operational and capital-management strategies of the overall insurance/financial organization. History shows that macroeconomic and market-related factors have caused a number of multiline insurers and reinsurers to take actions such as: Divest. This could be viewed as a favorable step , although the fortunes of the buyer might be uncertain. Shut down their respective financial guaranty/credit enhancement subsidiary operations. Redefine the underwriting guidelines of these subsidiaries to free up capital to focus on core business lines or core business strategies. Standard & Poor's expects an SSR entity and its parent's management to be truly committed to the credit enhancement/financial guaranty business and understand the expectations of the capital markets, as these SSR entities are considered financial guarantors in all aspects of the term. The crux of the difference though between an SSR entity and a true monoline bond (re)insurer is their business risk portfolios. An SSR entity's targeted risk portfolio is expected to change intermittently with market forces (i.e., flexible within certain limits), whereas a monoline's portfolio is likely to be largely stable or only change gradually. Notable similarities emerge between the two when developing strategic niche initiatives and backing each with necessary resources for prospective success. Most notable is that capital is allocated on a bottom-up, deal-by-deal basis, with pricing (based on capital required for the expected tranche/credit enhancement needed to achieve a specific rating) coming under severe pressure as market share/acceptance is either maintained or obtained. Why A Structured Segment Rating It is Standard & Poor's view that, from a criteria perspective, an SSR should not be regarded in the same vein as other segmented ratings on traditional insurance subsidiaries. An entity rated on a SSR basis is expected to be a going concern and not a special-purpose vehicle. (Special-purpose vehicles are found in most rated structured finance or off-balance-sheet transactions.) Entities rated on an SSR basis are further along the spectrum toward being a corporate finance subsidiary (capital requirements are strongly intertwined with pricing terms and market acceptance) or limited-purpose vehicle (dedicated in the majority to credit enhancement/financial guaranty business). The most important aspect of the SSR criteria is that they cut against Standard & Poor's institutional grain as to how much the credit rating on a subsidiary can be raised above the rating on its related group/parent without ratings separation justification (e.g. does not need a nonconsolidation opinion or protective covenant). From a corporate criteria standpoint, Standard & Poor's has taken the position that a strong subsidiary owned by a weak parent (or related to a weak group) generally is rated no higher than the parent. The key reasons for this are 1) the ability of and the incentive for a weak parent to take assets from the subsidiary or burden it with liabilities during financial stress and 2) the likelihood that a parent's bankruptcy would cause the subsidiary's bankruptcy, regardless of the subsidiary's stand-alone strength. Both factors argue that, in most cases, a strong subsidiary is no further from bankruptcy than its parent, and thus cannot have a higher rating. Experience has shown that bankrupt industrial firms file with their subsidiaries more often than not. In addition, publicly held organizations have a primary obligation to serve the interest of their shareholders, and it should generally be assumed that they would act to satisfy this responsibility. If this means extracting cash from a unit they have previously termed a segregated or protected subsidiary, or finding a way around covenants to get cash out of that same subsidiary, then management can be expected to follow these courses of action to the extent possible. By contrast, structured-finance transactions will require that issuers provide nonconsolidation opinions and protective covenants to justify ratings separation for the respective transaction special-purpose vehicles. Nonconsolidation opinions are common in structured finance and address the degree of likelihood that a court will grant substantive consolidation based on the observance by parent and subsidiary of certain separateness factors. Protective covenants (in theory) protect a subsidiary from its parent by restricting dividends or asset transfers. In general, this type of covenant is given very limited weight in a rating determination because they do not affect the parent's ability to file the subsidiary into bankruptcy, it is very difficult to structure provisions that cannot be evaded, and ultimately, courts usually cannot force a company to obey the covenant. During severe financial stress, especially prior to a bankruptcy, a weak parent might have a powerful incentive to strip a stronger subsidiary. The court can, at best, award only monetary damages after the fact to a creditor that has incurred a loss (when the issue defaults) and chooses to sue. As a result, an SSR entity would be like an independent finance company in that it has a continuous need for capital at a competitive cost, creating a powerful economic incentive to maintain its creditworthiness. Therefore, it can be argued that the parent/group would be better served, in a stressed scenario, by divesting the still-healthy subsidiary than by weakening it or risk drawing it into bankruptcy. In addition, there could be evidence of the parent's willingness to leave the subsidiary alone, including a history of reasonable dividend and management fee payouts to the parent and covenants that limit the nature and degree of financial transactions between the parent and its subsidiary. Nevertheless, Standard & Poor's recognizes that not all SSR entities will belong to groups where the economic incentive to maintain the entity at a higher rating will prevail. These ratings need a greater degree of capital and financial strength to support a higher rating, and the cost/benefit relationship might not justify continuing to maintain an independent business platform. To this extent, every request for a rating on a SSR basis would be viewed on its unique merits. To maintain such a rated subsidiary, the capital in the SSR entity is separated from the analysis of the total consolidated capital position of the group. This could negatively affect the rating on the group, which, in turn, could put pressure on the three-notch cushion and—in extreme circumstances—reduce the determined higher rating on the subsidiary. If, at any time, the group's management becomes unsupportive of maintaining the SSR, the entity will be reevaluated as a stand-alone insurance or reinsurance operation under Standard & Poor's general insurance criteria, which could prompt both the financial strength and financial enhancement ratings of the entity to be lowered. In addition, if an SSR entity with an FER failed to pay an insured obligation, Standard & Poor's would lower the FER to 'SD' (selective default) and then withdraw it. Moreover, the FSR on the SSR's parent or related insurer group would be reviewed for a likely downgrade. Rating Of A Subsidiary On A SSR Basis The salient analytic factors to evaluate an SSR entity on a stand-alone basis would be its business position, management structure, and economic incentive of both the parent and the subsidiary and stand-alone capital adequacy. Other factors that could prove to be prospective market hurdles that could limit the rating are ineffectiveness or obsolescence of an SSR company's business strategy because of changes in current or future market and regulatory conditions as well as increased competition on the basis of pricing, capacity or coverage terms. To evaluate an insurance or reinsurance group subsidiary on a SSR basis, the following would be necessary: The parent company should be investment grade at the time of the initial evaluation. The subsidiary should be demonstrably severable from the group and able to stand on its own. The subsidiary should exhibit superior business and operating characteristics (aside from superior capital adequacy) relative to the rest of its group. A comprehensive definition of "superior business and operating performance" is an entity that has the operating flexibility to alternatively exit and re-enter sectors of markets and establish immediate market acceptance, and where risk exposures assumed are consistent with the publicly held SSR. The business to be assumed shall not compromise the company's pricing capacity or operating performance, impede upon the capital required, or threaten the company's overall capital adequacy requirements. The subsidiary should demonstrate material commitment to credit-enhancement business, which means a minimum of 20% of in-force risk exposure for existing multiline insurers and reinsurers and at least 80% of in-force risk exposure for a new start-up (or stand-alone) entities. The parent company should be able to demonstrate its commitment to maintain a reasonable dividend policy, autonomy, and independent integrity of the subsidiary. Where warranted, there would exist either an independent trustee with the ability to enforce the protection of the rights of third parties or outside strategic ownership of at least 20%, with some independent membership on the board of directors (if rating differential is more than three notches). Capital adequacy will be determined under requirements of a special stressed, risk-based capital model analysis. In all cases, there should be a strong economic basis for the parent's commitment to maintain the capital to support the higher rating on the subsidiary. In certain instances, a nonconsolidation legal opinion could be required in jurisdictions where accepted, but generally, there will be little dependence on the enforceability of this opinion. In the case where a subsidiary has been formed or acquired only recently, a demonstrable record of support is lacking, and questions might remain concerning the group's long-term strategy for the subsidiary, some formal support is likely to be required. The most frequently used support agreement commits the parent to maintain some minimum level of net worth at its subsidiary. Frequently, the parent will also agree to assume problem liabilities, dictate covenants (dividend moratoriums, etc.), or both.