Article Title: ARCHIVE | Criteria | Insurance | Health: Liquidity Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled "Criteria | Insurance | General: Insurers: Rating Methodology," published on May 7, 2013.) Given the short-term nature of health insurance liabilities, liquidity has not received nearly the prominence that risk-based capital has—a measure regarded by many, including the NAIC, as the prime measurement of solvency. Nevertheless, having appropriate liquidity means being able to meet policyholder and other obligations on a timely basis. Standard & Poor's Ratings Services liquidity model measures a health plan or insurer's liquidity under an immediate stress scenario. As with the capital adequacy model, however, this process could involve substantive analytic judgment because liquidity can be heavily influenced by investment portfolio mix and product characteristics. Liquidity analysis focuses on the interrelationships of an insurer's liquid assets and liabilities that are subject to a sudden and significant shortening of duration rather than focusing on an insurer's liquid assets in isolation. Insufficient liquidity occurs only if the two become unbalanced. In formulating its liquidity strategy, management faces a trade-off with respect to investment return because maintaining a high level of liquidity typically necessitates investing in larger amounts of short-term, low-yield assets. Standard & Poor's believes that the duration of the industry's liabilities generally is far shorter than many companies realize. However, in some cases, individual companies might be able to dispose of their assets more quickly than is generally expected in a particular market. Standard & Poor's review of a company's liquidity encompasses several factors: Claims reserves, unearned premiums, accrual medical incentive pool, and other short-term liabilities. Investment portfolio and accounts/premiums receivables to determine convertibility to cash under varying stress scenarios. Ongoing operational cash flow sources or requirements. Other potential cash flow needs, such as debt obligations, dividend needs of the parent, and contingent liabilities. Risk-Adjusted Liquidity Of Liabilities Standard & Poor's liquidity model compares a health plan or insurer's liquid assets with a risk-adjusted calculation of its liabilities. In applying the model, Standard & Poor's receives a breakdown by product category of a company's liabilities, and for each category, it applies various risk factors that reflect the potential for payout. On health care products that have no cash-value build-up—such as term life, group life, accident and health, and disability insurance—Standard & Poor's applies a 100% factor to claims reserves and an 80% risk factor to unearned premium and premium stabilization reserves that could need to be refunded. In addition, a 100% risk factor is applied to account payable, unpaid claims adjustment expenses, accrual medical incentive pools, etc., because these obligations typically mature within one year and could require disposal of liquid assets from time to time to support prompt payment of these obligations. Determining Liquid Assets Standard & Poor's examines the liquidity of an insurer's investment portfolio to establish an estimate of the level of coverage of its potential liability requirements. In this process, assumptions must be made regarding which assets can be counted on to be readily convertible to cash at all times. Cash and short-term securities receive full credit, as do U.S. government securities and publicly traded, investment-grade corporate and municipal bonds. The model gives credit only for investment-grade issues because credit- or market-driven factors might affect the liquidity of noninvestment-grade securities at any time. Because MBS have become one of the most prominent classes of investments in the U.S. and this group is extremely diverse, Standard & Poor's separates its treatment of different classes of these securities for liquidity purposes. Agency pass-throughs and government-guaranteed securities receive 90% credit, as do the most tightly structured classes, while others receive varying degrees of credit down to zero for classes Standard & Poor's does not consider liquid. The private-placement market has substantial liquidity because of the required rating on these instruments by the Securities Valuation Office of the NAIC. However, a wide variation exists in credit quality among investment-grade securities in this market. Standard & Poor's has established different treatments for investment-grade issues usually designated "1" and "2" by the NAIC. Standard & Poor's considers NAIC 1 private placements to be more liquid than those designated NAIC 2, which may include some that have questionable investment-grade characteristics. Similarly, as it is easier to find buyers for securities with readily available information, bonds issued under Rule 144A are also viewed as having higher liquidity. The model also gives more credit in the ongoing scenario because a company may find buyers for some of its specialized private placements after potential buyers perform a detailed credit analysis. On equities, Standard & Poor's treats publicly traded preferred stock like corporate bonds, giving 100% credit for equities that are investment grade and publicly traded. Publicly traded common stock is also fairly liquid, as companies could likely sell most of their portfolios if under pressure to raise cash. However, with the potential for market shocks, 30% declines in the stock market in short periods are not unheard of. Therefore, the model gives 70% credit to unaffiliated, publicly traded common stock. Assets involved in securities-lending programs are not immediately available to a company because they are not under the insurer's strict, immediate control. These assets are excluded from credit in the immediate scenario but are allowable in the ongoing scenario because these programs usually have fairly short terms. Funds withheld that back liabilities reinsured with another company are excluded from the primary company's liquidity calculations because the related liabilities are not considered obligations of the primary company. Certainty Of Maturing Obligations The model also deals with maturing obligations. These include any outstanding debt at the insurance company and any other scheduled lump-sum payments. These obligations do not receive the benefit of the 70% covariance factor because these are contractual payouts. It is assumed that a company holds acceptably liquid assets to meet potential and scheduled obligations for an additional year beyond the base time frame. Therefore, in the scenario, a company should have ready liquidity for one full year of maturing obligations. Debt obligations include any publicly issued or private-placement debt, bank debt, commercial paper outstanding, etc. Given the certainty of the liquidity needs associated with scheduled maturing obligations, secure companies (regardless of how they are rated) need to have only a small redundancy of liquid assets to cover these obligations. Liquidity Standards The final calculation in the model compares the allowable assets under both scenarios with the adjusted potential and maturing obligations under both scenarios. However, a vital part of an insurer's liquidity assessment incorporates adjustments specific to individual companies, both qualitative and quantitative, that could stem from contingent noninsurance liabilities or concentrations among certain allowable assets. Using the scenario that produces the lower result, Standard & Poor's developed the following rating scale based on its belief that when a company's liquidity under the model just covers potential obligations, the company might have adequate liquidity to cover the stress scenarios but could be susceptible to adverse economic, market-related, or company-related circumstances. Unlike the capital adequacy model, however, under which an insurer is unlikely to be rated materially higher than its level of capitalization, for liquidity purposes, all health care insurers in the secure range are expected to maintain at least 'BBB' level liquidity (110%). It should be stressed that although this model is a tool to help analyze a company's liquidity, Standard & Poor's recognizes other factors that need to be considered when analyzing liquidity, such as the quality of operating cash flow or the dividend needs of a holding company. Nevertheless, Standard & Poor's clearly expects highly rated companies to maintain high levels of liquidity. Table 1 Rating Standards RATING LEVEL LIQUIDITY RATIO (%) AAA (Extremely strong) 220 and higher AA (Very strong) 180 to 219 A (Strong) 140 to 179 BBB (Good) 110 to 139 BB (Marginal) 90 to 109 Table 2 Liability Risk Factors LIABILITY IMMEDIATE SCENARIO (%) Individual accident and health 80% of UEPR Individual disability 50% of any cash value Group accident and health 80% of PSR and UEPR Group long-term disability 50% of PSR and UEPR Health claims reserves 100 UEPR—Unearned premium reserve. PSR—Premium stabilization reserve. Table 3 Allowable Asset Factors ASSET IMMEDIATE SCENARIO (%) Cash and short-term investments 100 U.S. government securities 100 Agency pass-through MBS 90 CMOs—Very accurately defined maturities, planned amortization classes, and targeted amortization classes. 90 CMOs—Sequentials 80 CMOs—Z tranches 0 Other CMOs 0 Investment-grade public bonds 100 NAIC ‘1’ 144A private placements 80 NAIC ‘2’ 144A private placements 65 NAIC ‘1’ non-144A private placements 70 NAIC ‘2’ non-144A private placements 40 Asset-backed securities 90 Noninvestment-grade bonds 0 Unaffiliated public investment-grade preferred stock 100 Unaffiliated public common stock 70 Assets in securities lending programs 0 Funds withheld reinsurance assets 0 Premiums receivable 90