Article Title: ARCHIVE | Criteria | Insurance | General: Financial Enhancement Ratings Help Reconcile The Cultural Differences Between Multiline Insurers And Financial Guarantors Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Financial Enhancement Ratings," published Dec. 10, 2004.) Standard & Poor's Insurance Group introduced its financial enhancement rating (FER) in May 2000. Market developments since then have made this rating more relevant than ever. Below is a series of questions and answers that explains what this rating is, its purpose, and how insurers and investors can use it. What is the purpose of Standard & Poor's FER? Standard & Poor's created the FER service to help with the evaluation of transactions in which an insurer provides full or partial credit support of a Standard & Poor's rated transaction. In brief, the FER process analyzes whether an insurer wishing to provide credit support under a policy of insurance has the willingness and capacity to make timely payment under the policy. What is the difference between a multiline and a monoline insurance company? A multiline insurer is chartered to provide coverage against various types of property/casualty risk. By contrast, a monoline insurer—such as Municipal Bond Insurance Assn. or Ambac Assurance Corp.—is chartered to provide coverage against a specific class of risk, such as a particular financial obligation. A multiline insurer in a project financing may provide insurance against a specified insurable event (such as a property/casualty loss) or financial shortfall in an amount sufficient to pay in a timely fashion all outstanding principal and interest on the project bonds. By contrast, a monoline financial guarantor insures against a payment on the project bonds for whatever reason that default might occur. What is the difference between an FER and a financial strength rating (FSR)? An FER is different from an FSR in that the latter explicitly excludes an opinion of the insurer's willingness to pay. In other words, the FSR addresses the insurer's financial capacity, not its willingness, while the FER addresses the insurer's financial capacity and its willingness. Although capital markets participants are accustomed to full and timely payment in accordance with the terms of the transaction, the payment culture of multiline insurers is not necessarily focused on timeliness. Thus, the traditional practice of multiline insurers in analyzing and investigating claims may not meet the expectations of fixed-income, capital markets investors that expect prompt payment. The FER is designed, in part, to reconcile these views. Multilines carrying the FER are expected to honor claims irrespective of legal precedents and commercial disputes. Insurers with an FER will always have an FSR, and the ratings would be the same. What are some of the other differences between an FSR and an FER? As noted, the FSR solely addresses an insurer's financial strength and ability to pay policy claims. It does not address the insurer's willingness to pay on a timely basis. When Standard & Poor's evaluates an insurer to assign an FSR, it reviews the company's business position, its underwriting and earnings capacity and track record, and the level of capital available to cover policy claims. As it is prudent industry practice for policy claims to undergo a validation process, there may be a considerable time difference between when the policyholder expects payment and when the insurer is legally obligated to pay. Moreover, the validation process may also result in a lower actual payment than the original claim. Standard & Poor's understands that multilines writing credit-enhancement insurance intend to compete, to varying degrees, with other capital markets credit-support providers. These other providers (e. g., letter-of-credit banks, monoline insurers, and conventional guarantors) of course, are expected by the market to pay immediately upon notice of claim. Accordingly, the FER process evaluates whether a multiline desirous of writing credit-support insurance has the financial capacity and willingness to pay on a default to the same extent as, for example, a monoline. Standard & Poor's analyzed whether the multiline is committed to credit-substitution insurance and understands the business and that the bondholders rely on such insurance for full and timely payment notwithstanding any legal or commercial dispute or the multiline's customary claims-management practices or its traditional lines of business. If multilines do not want to agree to pay first under such conditions, then they would not and should not be candidates for an FER. Why do multilines write credit-support insurance? For some companies, credit-support insurance is a natural extension of their surety business. When measured by the risk in force, it is one of the most leveraged lines of business written by the insurance industry. It has the advantage of combining profitability with reduced regulatory oversight and capital support. In addition, it tends to be counter-cyclical to traditional property/casualty business. What was the market reaction when the FER made its debut? When the FER was originally introduced in May 2000, the capital markets were just beginning to witness the participation of multiline insurers as credit-support providers outside of the U.S., at least on a significant scale. (Since 1986, U.S. regulators required this business to be written on monoline paper.) There was little history of how, when claims were presented, multiline insurers would evaluate and process the claim. At the time, many market participants appeared to view the FSR on an insurer as a proxy for its willingness to pay policy claims arising out of defaulted financial obligations. Has the market's view of multiline credit support changed since the introduction of the FER? There have been occasions in which multiline insurers providing full or partial credit substitution for financial obligations have not paid policy claims arising out of defaulted obligations. In Standard & Poor's view, those claims denials resulted from a misunderstanding by both multiline insurers and investors regarding the other's expectations. Standard & Poor's believes that the FER will serve both the insurance and investing communities in describing the circumstances in which payment is expected where multiline or monoline credit support of a financial obligation is a material component of the rating on that obligation. How does Standard & Poor's rate transactions where credit-support insurance is provided? The rating process depends on the nature of the insured risk. If the insured risk were sufficiently material, the rating on the transaction could be the same as the rating on the insurer. Thus, if the insured risk was, for example, a payment shortfall for whatever reason (and there was no other credit support in the transaction), the transaction rating would be equal to that on the insurer. By contrast, if the insured risk were the first-loss or subordinate position that supported a higher-rated tranche of bonds, then the rating on the tranche would be based on the protection provided by the insurance together with other forms of enhancement present. It should be stressed that credit-support insurance can take a number of forms and that the results on default will be different. What would the rating consequences be if a multiline with an FER failed to pay? Standard & Poor's would lower the FER to 'SD' (selective default) and then withdraw it. Moreover, the FSR on the insurer would be reviewed for a likely downgrade. The FSR review was recently introduced to reflect that the default will likely impair the insurer's credibility in the capital markets and, consequently, its market position and financial flexibility. In the two years since Standard & Poor's introduced the FER, there has been no denial of claims by an FER-rated multiline. Are FERs assigned to insurers themselves or to the transactions in which the insurer may be offering credit-substitution insurance? As the FER relates to the ability and willingness of an insurer to meet its credit-support obligations in transactions rated by Standard & Poor's, it is similar to a corporate credit rating. Nevertheless, the FER differs from a corporate credit rating in that it has highly issue-specific applications. For example, the FER only applies to transactions rated by Standard & Poor's. If, for example, an insurer holding a Standard & Poor's FER fails to make a payment in a particular transaction in which it has provided credit-support insurance, but that particular transaction is not rated by Standard & Poor's, an adverse rating action (in the form of a withdrawn FER and a likely lowering of the FSR) may not result. Can a multiline without an FER write credit-support insurance in transactions rated by Standard & Poor's without affecting the rating on the transaction? Multilines may provide one-off credit-support insurance on a structured transaction if consistent with FER practice. They must indicate to Standard & Poor's in writing that policy claims will be paid immediately regardless of any legal or commercial disputes or defenses of any nature whatsoever, including fraud. If a multiline denied a claim made in such circumstances, the FSR would come under review for a likely downgrade. What is the value of the FER service to investors and intermediaries? In assigning an FER, Standard & Poor's has assessed the relevant insurer's business profile, financial strength, and willingness to pay. As a condition of assigning the FER, Standard & Poor's requests that the insurer, on a transaction-by-transaction basis, represents that the surety bond or insurance policy amounts to an unconditional and irrevocable guaranty of payment, that it has disclosed all information material to its obligations under such bond or policy, that there are no conditions or preconditions to payment or performance under such bond or policy, that there are no circumstances or rule of law that may affect the insurance obligations under such policy, and that it has effectively waived all defenses it may have under such bond or policy or at law. The insurer acknowledges that the FER and FSR may be materially affected if it fails to pay. It should be understood that, similar to other Standard & Poor's ratings: An FER is Standard & Poor's current opinion of the insurer's financial strength and willingness to meet its future payment obligations in accordance with the terms of the policies and is not a verifiable statement of fact. The FER is based on information supplied to Standard & Poor's by the insurance company and on other information deemed relevant by Standard & Poor's but does not constitute an audit. Standard & Poor's relies on the insurer, its accountants, counsel, and other experts for the accuracy and completeness of the information submitted in connection with the FER and surveillance process. Standard & Poor's undertakes no duty of due diligence or independent verification of any such information. Standard & Poor's does not and cannot guarantee the accuracy, completeness, or timeliness of the information relied on in connection with the FER or the results obtained from the use of such information. What makes an FER attractive to a multiline insurance company? There will be a limited number of players in this market, and the FER is a way to indicate to the market that a particular company understands this business and the participants' needs. How does Standard & Poor's view the development of the credit-support insurance market? Standard & Poor's views the traditional U.S. monoline-insured municipal bond market as relatively mature. The taxable market should continue to expand with the development of new asset types and the general deterioration of global credit. Asia, Europe, and Latin America remain candidates for credit enhancement. For multilines, part of their success will be up to them as investors are unlikely to invest in transactions where a material element of the credit has an inconsistent history of payment.