

Article Title: ARCHIVE | Criteria | Insurance | Health: Interactive Rating Methodology Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Interactive Rating Methodology," which was published on April 22, 2009.) Standard & Poor's Rating Services rating methodology measures the financial risks of entities undertaking a wide range of business activities and compares them with industry peers. For health plans and insurance companies, these analytical techniques evaluate the financial risks associated not only with historical business activities but new business initiatives as well. A key factor in the effectiveness of Standard & Poor's methodology is its attention to qualitative factors and future risks facing an insurer. Through discussions with management, Standard & Poor's can better understand how an organization's business, operating, and financial strategies affect its financial strength. Standard & Poor's uses projections in assigning its ratings after extensive discussions with management to understand the underlying factors. Standard & Poor's can gain insight into future financial performance by looking at current and historical performance. However, Standard & Poor's evaluation of a management's strategies, operations, efficiencies, and risk tolerance—as well as the health plan or insurer's competitive advantages in the marketplace—will most influence its opinion of future financial performance. Ultimately, the rating decision is a synthesis of important issues that are unique to each company and will drive future financial performance. Even highly rated companies might not score well in some categories of analysis. A rating is not so much a scorecard that shows how well a company did in each analytical category as it is a judgment made about the most important rating factors that will affect a company prospectively. The decision about an insurer's future financial strength is based on Standard & Poor's evaluation of the key issues. Standard & Poor's rating methodology profile is used for all insurance rating analyses and is uniform across all types of insurance companies. The profile covers competitive position, management and corporate strategy, operational analysis, investments, capitalization, liquidity, and financial flexibility. In applying its rating methodology for the health insurance sector, Standard & Poor's evaluates the types of insurance written (line of business or sector) by a company and its geographic profile. Standard & Poor's considers the impact of national or local factors that could affect the operations of health plans. For health plans that are part of larger, more diversified groups, Standard & Poor's also looks at noninsurance-related activities to assess how favorable or unfavorable these industry conditions might be and their potential effect on the health of the group's overall operations. Key points that Standard & Poor's considers in its analysis of the health insurance and managed-care industries' risks are: Potential threat of new entrants in the market. Threat of substitute products or services. Competitiveness and volatility of the sector. Potential tail to liabilities (i.e., the ease or difficulty in exiting a market) or risk of catastrophic losses. In some cases, it might not be possible to exit certain lines of business because of certain state regulations that require approval or impose penalties. Bargaining power of health insurance buyers and suppliers. Strength of regulatory, legal, and accounting frameworks in which the health plan operates (covering areas such as rate relief and small group reform). Broadly speaking, the lower the industry risk, the higher the average rating on companies operating in that sector or line(s) of business. Standard & Poor's would consider the impact of various state and local initiatives (e.g., antimanaged-care legislation such as any willing provider laws, mandated provider reimbursement rates, etc.) that could negatively affect the operations of managed-care organizations. Low industry risk implies an operating environment that is favorable to health plans from a competitive standpoint, a regulatory framework conducive to supporting health plan solvency, and conservative accounting standards. Under these conditions, health plans would be expected to generate more-favorable and less-volatile operating results. Although a high industry risk profile does not automatically limit a rating, it is more difficult to demonstrate the earnings strength, stability, or combination of the two that characterize very highly rated companies. In summary, the industry risk analysis tells: How much the industry earns as a return on invested capital. If historical patterns of return on permanent capital (ROPC) will continue. How individual companies make money in this business. If the industry earns a risk-adjusted ROPC above, at, or below market rates of return.