

Article Title: ARCHIVE | Criteria | Insurance | Life: Investments Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Investments," which was published on April 22, 2009.) Asset quality and investment performance are integral to an insurer's operations and to remaining competitive in today's environment. Premiums and deposits invested today must provide a yield sufficient to cover tomorrow's claims. Historically, accident and health companies have managed more conservative investment portfolios because of the less-predictable timing and nature of their claims. Annuity and life companies generally have taken greater advantage of the predictable nature of their claims to take more risk in return for higher yields. Accordingly, Standard & Poor's Ratings Services evaluation of the investment portfolio considers policyholders' competing and often conflicting demands for higher yields versus safety and liquidity. By far, the key element of the analysis is understanding the process by which the company allocates cash flows to various asset classes. Different classes of assets have customary risk profiles and accompanying returns; thus, by choosing which asset to emphasize, a company preordains a large part of the return on the portfolio. Standard & Poor's review begins with the insurer's allocation of assets among investments such as bonds, mortgages, preferred stock, real estate, common stock, CMOs, derivative instruments, and other invested assets. The assets are evaluated for credit quality and diversification. Of concern are asset concentrations by type and maturity, low credit quality, industry, geographic location, and within single issuers. An insurer's asset allocation is also examined to determine how appropriate it is to support policyholder liabilities. Guaranteed rate products generally require fixed-income assets, while participating policies allow for a greater proportion of equity investments. Fundamental changes in the life insurance industry and the products it sells require Standard & Poor's to judge a company's investment objectives and the liability structure they support. Investment risk and the degree of matching between the maturity and duration of the investment portfolio with an insurer's liability structure are critical to Standard & Poor's evaluation of management's risk tolerance. The importance of interest rate risk management and the need to closely match assets to liabilities depends on the type of products sold. The growth in investment-oriented insurance products and annuities, GICs, and universal life policies has exponentially increased the need for asset and liability matching. Standard & Poor's reviews an insurer's asset/liability management by identifying the specific asset and liability durations and cash flows of interest rate-sensitive portfolios. Standard & Poor's also reviews the implicit derivative options within fixed-income portfolios. Asset-backed portfolios are reviewed for their sensitivity to interest rate risk, including prepayment and extension risk. The degree of interest rate risk in the investment portfolio is then compared with the company's product structure. Portfolio Diversification Once the asset-allocation strategy is understood, Standard & Poor's reviews any unusual concentrations, such as by asset type, industry sector, or individual company. The essence of building a portfolio is diversification, and any accumulations can subvert diversification. Examined closely are issues that might not look correlated but in fact are, such as common and preferred stock issued by the same entity and perhaps convertible debt also issued by the same entity or a closely related family member. In this case, for instance, the nominal issuer might not be the same company, but if they are all part of the same family and control, a clear concentration can be developed. Another example would be to look at the overall real estate concentration, which would include MBS, residential mortgages, and equity real estate. These assets are vulnerable to swings in interest rates, which could lead to unexpected losses, as seen in the low interest rate environment of the last few years. Invested Asset Credit Quality Credit risk is normally measured by Standard & Poor's default studies and credit risk changes in the capital model. Nevertheless, it is important to understand how and why the company has invested in issues that might contain credit risk so Standard & Poor's can form an opinion of the future disposition of cash flow. Does management have a tendency to invest in issues with credit risk, or are current assets with credit-risk fallen angels? Does management invest in nonrated paper to hide its credit risk appetite? Interest Rate Risk Standard & Poor's is concerned about insurers' interest rate risk. Standard & Poor's look at the management of asset duration versus liability duration and analyzes the interest rate optionality that exists in the investment portfolio. As mentioned above, Standard & Poor's reviews asset and liability durations and cash flows of interest-sensitive portfolios. Standard & Poor's also examines a firm's interest rate sensitivity test results for these portfolios as well as their New York Regulation 126 opinion results. To address the noncredit risk insurers could face in

their investment portfolios, Standard & Poor's has incorporated an interest rate risk component to its life insurance capital model. In particular, Standard & Poor's analyzes the option risk inherent in certain assets, such as callable bonds, asset-backed bonds, and MBS (including pass-throughs, CMOs, and whole loans). As a result of the increase in these assets, life insurers' exposure to option risk has significantly increased in recent years. Option risk in MBS can be defined as the prepayment or extension risk implicit in this asset class. It can be a two-edged sword: When interest rates go up, these assets can extend mortgagees' minimum payments, and there are fewer refinancings. Investors, therefore, have less money to invest at the then-higher rates. Conversely, when interest rates go down, as seen in recent years, these assets tend to prepay (refinancings increase), and investors have more cash to invest at lower rates. This reinvestment risk can create issues from both a cash management and asset/liability management perspectives. The capital required for option risk is allocated for potential interest volatility. Clearly, this is inevitable over the average life of an investment. More important, the level of capital will be specific to a company's overall mortgage portfolio. Three key factors in evaluating this risk for insurers are the overall percentage of MBS, the volatility of an insurer's portfolio, and the amount of option risk relative to the capital base. Not all planned amortization class bonds and sequentials are alike, nor are all companies' risk appetites alike. In evaluating mortgage-backed interest rate risk, it is important to emphasize that it is one component of the overall financial strength rating process for insurance companies. This risk must be considered in the context of each company's liability structure. The nature of the liabilities will help determine the relative extent to which the risk will likely be absorbed by the insurer or policyholders. It will also put in a broader context whether an upward or downward change in interest rates will be more damaging to an insurer. Liquidity Relatively speaking, almost all life insurer portfolios are somewhat liquid, but Standard & Poor's reviews the portfolio with regard to overall liquidity because insurers could need to liquidate assets quickly to pay claims, especially if significant catastrophe exposures are present. Key considerations regarding liquidity include: The percentage of public versus private assets. How much of the portfolio is short term versus long term? How long the portfolio is and if it is subject to additional market risk. The percentage, duration, and type of MBS. The percentage, type, and quality of equity. Market Risk The final element of risk that insurers can normally be expected to accept is market risk—the risk that the market value of assets, commonly equity securities, can fluctuate with the market. Because many health insurance and some life insurance companies invest relatively heavily in common equities, they can often incur significant market risk. Although Standard & Poor's capital model has asset charges for the volatility, Standard & Poor's is also interested in understanding the investment policies with regard to equity securities or other securities whose values are marked to market daily, and in projecting future investments of cash flow. Return (Current Yield and Total Return) By analyzing each of these broad areas and the effective tax rates, Standard & Poor's can identify and explain how a given level of ROA is generated. Standard & Poor's then looks at the trend in ROA over time and relative to the industry. The objective of this phase of the analysis is to gain a clear understanding of the company's ongoing profitability.