Article Title: ARCHIVE | Criteria | Insurance | General: Standard & Poor's Refines Its Methodology for Analyzing Insurance Groups Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Group Methodology," which was published on April 22, 2009.) The accelerated pace of insurance consolidation has certainly heightened the complexity of analyzing insurance companies and/or groups. This trend is expected to continue on a global basis. To capture the risks and strengths of this changing terrain, Standard & Poor's has developed and refined its analytic methodology for rating insurance groups. In many cases, Standard & Poor's expects that individual subsidiaries will be supported by their parent group, but increasingly it has become necessary to analyze and question the true nature of this support in the context of how the subsidiary fits into the strategy of the entire insurance enterprise. Indeed, over the past few years, a number of insurance groups have divested themselves of subsidiaries and have refocused and redefined subsidiaries that had previously been considered critical to their long-term strategy. On the other hand, the refocusing of operations has led to changes in which some subsidiaries that previously were viewed as not important, now fit well into their parents' new strategies. A more dynamic management style requires a more dynamic analytic process. During this analytic process, two issues need to be addressed: What is the overall financial security of the group? How do the various member subsidiaries of the group fit into the overall structure? What would be the rationale for the parent group's wanting to support an ailing subsidiary or conversely wanting to sell or to "walk away" from a subsidiary? Standard & Poor's believes that for many groups it is appropriate to evaluate operating insurers in the context of the aggregate financial security of the group. Standard & Poor's also believes that even if a group isolates its riskier lines of business into a "bad" insurance subsidiary, such potential risk should not be ignored when analyzing the group. The methodology for analyzing insurance groups attempts to provide a consistent framework to look at the entire insurance organization. Standard & Poor's methodology for analyzing groups is especially useful when applied to multiline insurance organizations, and to organizations with multiproduct and/or geographic subsidiaries. The first element of this exercise is to establish a financial strength rating for the entire insurance group. This analysis is based on a combination of consolidated and separate operating company financial statements. The capital strength of the group is based on a consolidated capital allocation model, as well as on a review of individual company capital adequacy. The business review and operating performance characteristics of each line of business, however, are based on the individual market position and profitability of the core and strategically important subsidiaries. By looking at all material operating units, which are measured by size or risk, a rating of the entire group is determined. This becomes the reference point for the ratings of the various subsidiaries. In the second phase of the analysis, the subsidiaries are classified into three groups: core subsidiaries, strategically important subsidiaries, and nonstrategic subsidiaries. The following characteristics could be found in any subsidiary, and not all characteristics need to be met for a subsidiary to qualify as either core or strategically important, but in all cases capital adequacy standards must be achieved and maintained to be considered core or strategically important. Core Subsidiaries* Defined as those subsidiaries: Operating in lines of business integral to Standard & Poor's understanding of the overall insurance strategy. The products sold are compatible with the mainstream business of the company and are often sold to the same core customers. The nature of the subsidiary's business presents little economic risk to the solvency of the group. Carrying the same name, unless there is a strong business incentive to use a different name. Separated mainly for legal, regulatory, or tax purposes. Operating more as a division within the enterprise, often exhibiting similar types of business, customers served, or regional focus. The subsidiary will often share a common distribution network with other major operating units. To which senior group management has demonstrated a strong commitment, i.e., a track record of support. Another indication could be to totally integrate the operations of a subsidiary or affiliate so that it is fully integrated into the entire enterprise. In some cases the subsidiary may be 90%– 100% reinsured internally by the group. That represent a significant (at least 5%–10%) share of the consolidated group's capital or are capable of reaching this level within three to five years. That are capitalized to within one rating category of the group's rating. That are expected to have operating performance characteristics that over time approach a level that is consistent with overall group performance. Expectations of the subsidiary's operating results for this type of business may be lower than management's earnings targets for the overall group. However, earnings expectations over the next three to five years should be within two categories of group performance and would be expected to approach levels supportive of the group's target over time. Those subsidiaries viewed as medium to long-term earnings under-performers would not be viewed as core. Where it is inconceivable that the unit would be sold, i.e., it is inextricably part of the whole group. That are at least 51% voting-controlled by the group. Strategically Important Subsidiaries* Defined as those subsidiaries: That share most of the core characteristics identified above, but do not exhibit the necessary size and/or capital adequacy (to within one category of the group's rating). That are important to the group's long-term strategy, but are operated more on a stand-alone basis. That do not have the same name, nor is it readily apparent that the different name has unique value. For example, is the different name a convenient way to distance the parent company from the subsidiary? That are prudently capitalized, defined to be to at least the 'BBB' level. To which management is committed, and where the subsidiary is not likely to be sold; however, such commitment may be over a finite period. That share the same customer/distribution base, but the nature of the business presents a material financial risk to the group. For which the nature of the risk precludes the subsidiary from ever being sold, although the product line and/or market is not core to the group. *Significant acquisitions, in at least the first year or two of ownership within the group, are normally expected to be viewed as no more than strategically important, rather than core. The sooner a major acquisition is assimilated, the faster it could move from being classified as strategically important to being recognized as a core subsidiary. On the other hand, significant and sustained operating deterioration or earnings underperformance of a core unit may result in its reclassification to strategically important or even to a nonstrategic subsidiary. Nonstrategic Subsidiaries Defined as those subsidiaries: That do not meet the criteria for core or strategically important. That are not prudently capitalized. That are start-up companies. That might be sold in the relatively near or intermediate term or are placed in runoff. That are highly unprofitable or marginally profitable, and for which there is little likelihood of a turnaround, or of additional support from the group. That are in ancillary businesses. How Group Ratings Are Assigned 1 As depicted in Chart 1, the process begins with the establishment of a group rating that could then be applied to all subsidiaries Standard & Poor's determines to be core. Next, strategically important subsidiaries are rated first on a stand-alone basis. The key characteristics analyzed are the operating performance, market position, and capital adequacy of each strategically important subsidiary. However, based on Standard & Poor's analysis of their importance to the entire insurance organization, strategically important subsidiaries will receive one rating category of benefit, up to the group's rating. Finally, nonstrategic subsidiaries are normally rated solely on a stand-alone basis. One notch of credit (e.g., raising from 'A' to 'A+') could be given if the subsidiary possesses several strategically important characteristics and is not obviously a candidate for sale over the short term and if Standard & Poor's believes the subsidiary would receive parental support were it to experience financial difficulties. Special Situations Rating core or strategically important subsidiaries one to two notches above the group's rating 2 There may be rare situations in which a core or strategically important subsidiary is deemed by Standard & Poor's to have characteristics in its own right, other than solely having superior capital adequacy, to warrant consideration for a rating above the rating of the entire group. As shown in Chart 2, such subsidiaries could be rated up to two notches (e.g., raised from 'A' to 'AA-') above the group. It must be emphasized that, in such situations, the subsidiary must exhibit superior business and operating characteristics, and be able to operate on its own independent of the group, in addition to maintaining the appropriate capital. Outside minority ownership of 10%–20% and totally separate distribution networks would be important characteristics in supporting a higher rating. In addition, an economic incentive for a higher rating could also be helpful. In such situations, the capital necessary to support this higher rated subsidiary would be deconsolidated from the analysis of the total consolidated capital position and this could reduce the group rating, which, in turn, could restrict the subsidiary's initially determined higher rating. Segmented ratings: rating subsidiaries one category above the group's rating A core or strategically important subsidiary may be rated up to one category above the group rating, assuming its stand-alone business, operating and capital characteristics can support it, if the subsidiary can be evaluated on a segmented basis. These segmented ratings require a greater degree of protection of the subsidiary's financial strength in the event of financial stress at the group than would exist in the situation outlined in the previous section. As was mentioned above, in such situations, the capital necessary to support this higher-rated subsidiary would be deconsolidated from the analysis of the total consolidated capital position and this could reduce the group rating, which, in turn, could restrict the subsidiary's initially determined higher rating. In order to evaluate group subsidiaries on a segmented basis, the following would be necessary: The subsidiary should be severable from the group and able to stand on its own or subcontract certain functions previously provided by the parent. Standard & Poor's would have received an opinion by outside counsel that the subsidiary would not be expected to be taken into administration (or equivalent) in the event of insolvency at the parent company level. Standard & Poor's would have received a letter from the parent covering the dividend policy from the subsidiary and the independent integrity of the subsidiary. And there would exist either: an independent trustee with the ability to enforce the protection of the rights of the policyholder, or outside ownership of at least 20% with some independent membership on the Board of Directors. In all cases, there should be an economic basis for the parent's commitment to maintain the capital to support the higher rating of the subsidiary. Evaluating start-ups under group methodology Traditionally, start-ups have not been viewed as strategically integral to insurance groups, given their lack of a viable operating history and Standard & Poor's perception that generally there is more volatility in their earnings relative to plan vs. existing operations. In view of these issues, Standard & Poor's will not view start-up operations as core to insurance groups. One exception to this policy is the emergence of a growing number of newly established tax-efficient subsidiaries set up in tax havens such as Dublin, Bermuda, the Cayman Islands, and the Channel Islands. To the extent that these subsidiaries are set up specifically to serve a sufficient breadth of a group's existing customers with whom the group has had longstanding relationships with existing products or logical product extensions, Standard & Poor's can consider such subsidiaries as core to the group. If the subsidiary only serves a small cross section of customers or primarily will get business from a new set of customers, at most Standard & Poor's will consider the entity as strategically important to the group. Standard & Poor's often sees groups setting up new subsidiaries to sell the same products in a different geographic locale or to sell new products to its existing customer base. Start-up entities that sell essentially the same products already being sold by the group, but in a different geographic locale, may be considered strategically important to the group if they meet most of the criteria for strategically important entities. Likewise, start-up entities that sell new products to an existing core customer base may be considered strategically important to the group if they meet most of the criteria for strategically important entities. In all cases, a letter covering the group's strategic intent with the subsidiary would have been received from management. If Standard & Poor's has been asked to provide a rating on a subsidiary, and not on the entire organization, Standard & Poor's reserves the right to do sufficient analysis of the group to determine any vulnerability to a "weak" member of the group, including the parent company. As seen in Chart 3, not all subsidiaries will receive the group rating, but their financial and business characteristics will be captured in the analysis. 3 Explicit support Both strategically important and nonstrategic subsidiaries may receive the group rating if they receive explicit support from a core unit. In these circumstances, the group rating will capture the explicit exposure to supporting these subsidiaries. Accepted forms of explicit support are guarantees and, in some cases, net worth maintenance agreements (see sidebar). If the subsidiary is considered nonstrategic as defined above, stronger forms of support such as a guarantee would be necessary. If the subsidiary were considered strategically important, weaker forms of support, such as net worth maintenance agreements, could be sufficient. Maintenance of Net Worth Agreements Explicit support may be used to raise the rating of both strategically important and nonstrategic entities within a group. Accepted forms of explicit support are guarantees and, in some cases, net worth maintenance agreements. Strongly worded net worth maintenance agreements can be used as a means of explicit support for both strategically important and nonstrategic subsidiaries. Under Standard & Poor's group ratings methodology, a subsidiary considered strategically important to the group and that has received an acceptable net worth maintenance agreement as explicit support will have its rating raised to the rating of the entity providing the support. In the case of a nonstrategic subsidiary, an acceptably worded net worth maintenance agreement will raise the subsidiary's rating by one rating category (limited by the group rating). A net worth maintenance agreement will be accepted only when Standard & Poor's believes the agreement can be enforced by policyholders or the subsidiary's board of directors. Net

Worth Maintenance Agreement Contents: Acceptable Form of Explicit Support Maintenance of tangible net worth. The subsidiary should be prudently capitalized using a multiple of a regulatory solvency margin or regulatory risk-based capital ratio. (In a letter, management should indicate its intention to maintain the appropriate level of capitalization in line with Standard & Poor's capital adequacy model.) Liquidity. The parent will cause the subsidiary to have sufficient cash for the timely payment of contractual obligations issued by the subsidiary. Ownership. The parent will own this subsidiary and must be at least a majority owner, but not necessarily own 100%. Successor agreement. The agreement is binding on successors. Duration. The agreement shall continue indefinitely. Rights of policyholders. If the parent fails to perform under this agreement, policyholders have a direct right to enforce this agreement. The agreement may also be enforced by the board of directors. (Enforceability is strengthened if this document is filed with the insurance regulator.) Modification and termination. Modification and/or termination can be done only if they do not adversely affect the policyholders' interests. Acceptable clauses would include: an agreement to support all existing policyholders at the time of termination; an agreement to sell only to an entity with the same rating as the parent; the agreement may be terminated when the subsidiary receives a stand-alone credit rating equal to the supported rating. The effect on the provider's credit rating of the support given under a guaranty or a net worth maintenance agreement must be evaluated prior to assigning the supported rating. Guarantee Criteria The term "guarantee" can apply to any form of guarantee, including a parent guarantee, a debt purchase agreement, a surety bond, or an insurance contract. In transactions utilizing guarantees as a form of credit enhancement, the evaluation of the creditworthiness of the primary obligor is shifted to an evaluation of the creditworthiness of the guarantor and the compliance of the guarantee with certain criteria. The guarantee criteria are intended to ensure that there are no circumstances that would enable the guarantor to be excused from making a payment necessary for paying the holders of the rated securities. Guarantees that are being relied on by Standard & Poor's should contain the following statements: 1. The guarantee is one of payment and not of collection. 2. The guarantor agrees to pay the guaranteed obligations on the date due and waives demand, notice, marshaling of assets, etc. 3. The guarantor's obligations under the guarantee rank pari passu with its senior unsecured debt obligations. 4. The guarantor's right to terminate the guarantee is restricted. 5. The guaranteed obligations are unconditional, irrespective of value, genuineness, validity, waiver, release, alteration, amendment, and enforceability of the guaranteed obligations; and the guarantor waives the right of set-off, counterclaim, etc. In connection with lease transactions, the guarantee also should provide that in the event of a rejection of a lease in a bankruptcy proceeding, the guarantor will pay the lease payment, notwithstanding the rejection and as though the rejection had not occurred. 6. The guarantee is reinstated if any guaranteed payment made by the primary obligor is recaptured as a result of the primary obligor's bankruptcy or insolvency. 7. The guarantor waives its right to subrogation until the guaranteed obligations are paid in full. 8. The guarantee is binding on successors of the guarantor and the trustee is a beneficiary of the guarantee. 9. The holders of the rated securities are explicit third-party beneficiaries of the guarantee. 10. The guarantee cannot be amended or terminated without the consent of 100% of the holders of the rated securities. 11. The guarantor has subjected itself to jurisdiction and service of process in the jurisdiction in which the guarantee is to be performed. The above 11 concepts are used in reviewing guarantees in U.S. transactions. If the transactions involve entities that are domiciled outside the U.S., tax provisions and currency exchange provisions also should be considered. Group Methodology Summary The key analytical issues captured by this approach are: Continual surveillance of how various subsidiaries fit into the overall insurance enterprise strategy. Since Standard & Poor's knows that strategies can change, the status of a subsidiary as being viewed either as core or strategically important will be reviewed annually. Establishment of a consolidated capital model to avoid any cosmetic benefits from the creation of a "bad" insurance subsidiary. Recognition that among strong, large insurance groups, capital can be quite fungible and is potentially available to support weak subsidiaries. Focus on a group's total strengths and weaknesses, rather than just seeing it through selected subsidiaries. While this methodology focuses on an analysis of insurance activities, noninsurance parents and sister companies (e.g., banks, investment banks, stockbrokers, real estate firms) will also be examined in the process. The goal of this methodology is to bring a more complete picture to the market, while not losing value of the characteristics contributed by the individual subsidiaries. Rating Interaffiliated Pools In rating members of interaffiliated pooling reinsurance agreements, pool members that Standard & Poor's considers core or strategically important to the group receive the same rating as other strategic members that are part of the reinsurance agreement. However, those pooled companies that are determined to be nonstrategic members of the group are evaluated on the same basis as nonstrategic members of other groups that do not have pooling agreements in place. As is the case with nonstrategic insurers who receive an acceptably worded maintenance of net worth from a parent, these nonstrategic pool members first are rated on a stand-alone basis, and then receive only one category of benefit, up to the group's rating. The primary reason for this is that in some cases companies that were included in pooling agreements have been removed from their pools and sold. The reinsurance protection that supported policyholders and the financial strength ratings of these insurers ended with the termination of the members from the interaffiliated pooling agreements and the subsequent sale by their parent groups. This can cause a dramatic change in the financial strength rating of these former pool members, as companies shift their strategic focus to other lines of business. Defining an interaffiliated pool An interaffiliated pool is a network of reinsurance and retrocession agreements covering the insurance liabilities of a group of insurers that normally operate under common ownership. Typically, all units of the pool cede all of the primary insurance they write to the flagship carrier in the group. The flagship retains some of the business for its own account and retrocedes the rest together with the cession of a portion of its primary business to other members so that all are severally responsible for homogenous shares of all business written by the pooled insurers. If combined with a pro-rata sharing of loss adjustment, general, and administrative expenses, this arrangement ensures uniform underwriting results. Insurance groups often set up separate legal operating insurance companies to meet business needs. Commonly, groups will set up separate companies to minimize tax liabilities, such as isolating business in states with more onerous premium taxes. There may be reasons to isolate the direct writings of the group in a particular state in one entity given the regulatory environment of that state. Management also may wish to isolate distinct lines of business in a specific company, which may have a different management structure than the rest of the group as well as different customers, different distribution, and different risk characteristics to the business being underwritten. Additionally, management may wish to account by legal entity line of business results or results by state. That said, many of these groups would prefer to pool results for a variety of reasons. Some pools are set up for financial reasons as an efficient way to blend group resources and results across all pool members. Other groups set up pools for strategic reasons to present a financial picture of a single blended enterprise. Pools may be set up to mask specific results so that competitors cannot determine individual line of business performance in a specific state, or by company. A group also may want to present a consolidated posture of financial strength of all pool members to their agents, policyholders, and other interested parties. The workings of an interaffiliated pool As long as a member company is part of a pool, it is difficult to envision different default characteristics for any individual pool member versus any other member of the pool. Through the reinsurance pooling agreement, member companies share the same net underwriting experience throughout the pool. Pool members' reserves are mixed, being recorded on an assumed and direct basis, less ceded business. The income statement impact of these reinsurance agreements is that pool members record premiums on a net basis and all member companies share pooled underwriting results plus their own individual investment income as the main components of each company's pretax gain from operations. Pool members have different capital positions and their own portfolios of invested assets that could lead to small differences in financial strength. However, it is Standard & Poor's position that an active pool member would not be allowed to fail by the group. The pooled group members would be expected to provide capital support to an active member under stress as a result of business and regulatory reasons. The consequences to the group for allowing an active pool member to fail would be enormous. Such an action would cause immeasurable damage to the group in the marketplace. Usually, pooled companies operate under a common management team, which would present all sorts of difficulties in the courts with policyholders of the failed member taking action against the solvent companies. Separating out reinsurance recoverables and the capital impact of failed members is an extremely difficult and contentious exercise. Finally, the regulatory pressure that the group would face against allowing a member to fail while other pooled companies are solvent would be enormous. It is Standard & Poor's belief that other pool members will end up paying the policyholder obligations of an active pool member that has failed. So what incentive is there to let it go in the first place? Rating nonstrategic pool members While it is Standard & Poor's belief that insurance organizations will support active pool members who operate in the same business segments as the group as a whole, Standard & Poor's is not so sanguine about pool members whose direct business differs from the rest of the group. In such a case, Standard & Poor's believes many groups have become comfortable terminating nonstrategic companies' participation in interaffiliated pooling reinsurance agreements as a prelude to their disposal. Having reviewed the termination provisions of a large number of interaffiliated pooling reinsurance agreements, Standard & Poor's believes that most such agreements provide little protection to policyholders of nonstrategic companies. In a large majority of cases, the termination provisions of these reinsurance agreements require no more than 90 days notice to sever a member or to dissolve the pool. Usually, there is no residual obligation on the part of the pool to support a terminated member, or explicit run-off protection can end with the commutation of residual obligations between the pool and the terminated member. There is no "tail coverage" to terminated members from the pool, with these companies now being solely responsible for all claims presented after termination. Given the weakness of termination provisions, it is Standard & Poor's belief that nonstrategic members in the pool could easily be terminated and that, overnight, these companies could be reconstituted with a dramatically different risk profile. These nonstrategic pool members would be companies in different lines of business from the predominance of pool members or operating in specific states with unique risk characteristics such as catastrophic risk exposure or a poor pricing environment. There is plenty of case history where pools have terminated nonstrategic members and have done so with very little notice. Of course, pool members most likely to be terminated would be those in weaker, poorly performing lines. One day there would be strong underwriting results on a net pooled basis for these companies and the next day, on termination from the pool, there would be poor underwriting performance as the company's results reflect the performance of its direct business only. Since the company is no longer part of the pool, Standard & Poor's would not expect any further capital support; in fact, these are companies that the group would likely sell or terminate. The potential for precipitous changes in the financial strength of these insurers is the impetus to amending Standard & Poor's criteria for analyzing pools. In implementing Standard & Poor's interaffiliated pooling reinsurance criteria, Standard & Poor's identifies those pooled companies considered to be nonstrategic members of the group. These companies first will be rated on a stand-alone basis and then will receive only one category of benefit, up to the group's rating, based on their ongoing participation in the pooling agreement. We are effectively viewing the amount of support provided to nonstrategic entities under a pooling agreement to be the same as if they were the beneficiaries of an acceptably worded net worth maintenance agreement. As a first step, nonstrategic entities will be identified based on their gross, nonaffiliated writings versus the business of the predominance of pooled members. These companies would be writing, on a direct basis, different lines of business from the predominance of pool members or operating in specific states with unique risk characteristics such as catastrophic risk exposure or a poor pricing environment. As a second step, the analyst would then discuss with the group the strategic fit of these companies. Companies that Standard & Poor's determines to be strategically important to the group would still receive the same rating as other pool members. If, at the end of this strategic review, Standard & Poor's determines that a pool member is nonstrategic to the group, the insurer may still receive the group rating if they receive stronger explicit support from a core unit. This support could take the form of a guaranty or a stronger pooling agreement that must be reviewed by Standard & Poor's. Pooling agreements with stronger policyholder protection language that provides for longer termination protection to member companies, strong "tail coverage" to terminated members, and coverage of the incurred but not reported claims might provide sufficient explicit support such that even nonstrategic members could receive the group rating. Determining a pool member's stand-alone financial strength In evaluating a pool member's stand-alone financial strength, Standard & Poor's reviews the company's business position, its stand-alone underwriting performance, as well as its stand-alone reserve position, making judgments about the adequacy of reserves for specific lines of business. Standard & Poor's is looking to develop sufficient information to assess a pool member's capital adequacy. From existing financial information, as well as from discussions with management, Standard & Poor's reviews a pool member's underwriting experience on a direct premium basis (that is, the losses associated with a company's direct business). Standard & Poor's also analyzes a schedule of reserves related to the pool member's direct business. Based on Standard & Poor's discussions with management, judgments are made about the capital adequacy of the pooled member by allocating capital to specific lines of business. Summary -- Interaffiliated Pools Standard & Poor's expects that the overwhelming majority of insurers that are part of existing interaffiliated pooling agreements will be considered strategically important or core to the group and, thus, will carry the same rating as other pool members. In a small minority of cases a member of a pool may be identified as a nonstrategic member of the group with the potential for a different rating. In cases where a pool member is considered nonstrategic, either the pool member will receive stronger explicit support from the group in order to receive the same rating as other pool members or it is likely that the member's rating will be lower. With a growing number of management teams becoming more comfortable selling businesses that do not fit in well with their strategies, Standard & Poor's believes that these nonstrategic entities are more appropriately evaluated on a stand-alone basis, receiving a more limited amount of support from the group.