Article Title: ARCHIVE | Criteria | Insurance | General: Insurance Criteria Update: Holding Company Analysis and Consolidated Groups Data: Editor's note: This criteria article has been superseded by the article titled "Holding Company Analysis," published June 11, 2009. The following series of questions and answers provides an update on Standard & Poor's current criteria for the evaluation of the capital funding mix and debt capacity--including guideline benchmarks for key ratios--in the rating of insurance companies. All analytical criteria on insurance companies are available on RatingsDirect and Standard & Poor's website (www.standardandpoors.com/ratings/insurance/). This article supplements the published body of criteria articles following developments in the capital markets and in response to the introduction of the European capital model in October 1998 and the U.K. life capital model in June 2000. Ratios in the Context of the Final Rating Q: Over what time frame does Standard & Poor's calculate ratios? Standard & Poor's may calculate many variations of the ratios in order to identify the key drivers of performance. Typically, Standard & Poor's looks for trends in ratios based on five-year historical data and projections up to three years. Q: Why does Standard & Poor's sometimes make adjustments when calculating ratios? It is appropriate to measure underlying performance, so one-off profits or losses can be excluded, and profits and losses from acquisitions and disposals can be annualized. However, materiality should always be considered. Q: How important are financial ratios in determining the final rating? Standard & Poor's analysis is not confined to models, numbers, and ratios. Subjective analytical judgment often outweighs the hard numbers. Financial ratios are used to help form opinions on a company's performance in the analytical areas of Standard & Poor's rating process. These eight fundamentals of analysis are: Industry risk Business position Management and strategy Operating performance Investments (asset/liability management) Liquidity Capitalization Financial flexibility Ratios are used to help measure a company's performance against some of these categories. Standard & Poor's has published criteria that expand on what is considered in each of these areas. Other important parts of the analysis are the methodology used for analyzing insurance groups and holding companies. It is difficult to issue concrete benchmarks to be applied to different types of insurers that operate in different jurisdictions and report under different accounting standards. The lead analyst presents his or her interpretation of the company's economic performance to a rating committee, which then votes on the overall rating. Q: How are ratios interpreted by Standard & Poor's? Guideline benchmarks are given for debt leverage, the interest coverage ratio, and the capital adequacy ratio. Holding-company double leverage indicates how holding-company debt can be treated in Standard & Poor's risk-based capital models, and the hybrid equity ratio indicates how hybrid instruments can be treated in Standard & Poor's capital models and the leverage calculation. Other ratios are used to help measure operating performance, investment quality, and liquidity. Q: How should ratio benchmarks be used? Benchmarks must be used with caution. The following quote is an extract from the published criteria: "For a given rating category, financial ratios can be expected to vary with the business or operating profile of a company. A company with a stronger competitive position, more favorable business prospects, and more predictable earnings can afford to undertake added financial risk while maintaining the same credit rating. A great deal of discretion is required in applying these guidelines. Although they provide insight into ratings in general, it is a mistake to oversimplify the entire thought process behind a specific rating by relying solely on the numbers. Guidelines focus on only a few ratios. Many additional measures are used to round out the analysis or to focus on specific issues. Obviously, strengths reflected in one financial measure can offset, or balance, a relative weakness in another. Ratings are an assessment of a company's ability to meet its obligations in the future, and ratio standards relate to a company's expected financial condition. Ratings are designed to reflect performance over the anticipated course of business cycles and not in what is viewed as a peak or trough period. Ratio standards do not always conform to an 'as reported' basis. Rather, a firm's financial figures may be adjusted to reflect ongoing performance." (Insurance Ratings Criteria (P/C Edition) 1999, pgs. 89-90) Q: Are the guideline benchmarks applicable to statutory or GAAP reported financials? The guideline benchmarks should be applied to ratios that show earnings and net worth in a realistic economic light. GAAP presents a more economic view of financial performance than statutory data. In Europe, analysts use the best available financial information when calculating ratios to reflect economic worth and earnings, some of which might be confidential. In reality, the availability of public financial information can change from year to year. However, Standard & Poor's underlying analysis looks through the changes in accounting treatment and availability of financial information to give a consistent final rating. Coverage and Leverage Ratios Q: What is fixed-charge cover? Fixed-charge cover indicates the margin of comfort for lenders and bondholders that their debts can be serviced by the borrower. Fixed-charge cover is a key factor in determining a company's financial flexibility--its ability to service existing fixed-cost funding and ability to borrow more if necessary. Of all the ratios considering debt, this is the most important. A high fixed-charge coverage ratio implies that the company has extra debt finance capacity. Q: How does Standard & Poor's calculate fixed-charge cover? The ratio is EBITDA divided by total fixed financing costs. Fixed financing costs are gross interest expense, preferred dividend payments, interest allocation of finance leases, interest on hybrid instruments, and any other regular contractual costs that are payable regardless of operating performance. Fixed-charge cover is capable of measuring the impact of many innovative financing instruments--which might not generate a traditional interest expense--on a company's servicing ability. Q: How does Standard & Poor's calculate interest cover? Interest cover is EBITDA divided by the gross interest expense. In both fixed-charge cover and interest cover, the interest expense should be adjusted to include the amortization of interest in any sale/leaseback of property or equipment or any other type of lease. Q: Are all interest costs included in the calculations? The interest expense should always be the gross interest expense figure. Where interest is incurred on operational debt with matching assets, a case can be made to exclude the interest expense from the coverage ratio. Typically, operational debt is raised by a banking subsidiary. Similarly, when the interest expense is ring-fenced from the shareholders' account (e.g., charged to a 100% mutual subfund or subsidiary), that interest may be excluded from the consolidated ratio. A separate stand-alone assessment of the subfund's or company's own fixed-charge cover should be conducted if the interest is excluded from the group calculation. These adjustments are made at the discretion of the analyst. Q: How does Standard & Poor's use coverage ratios? Standard & Poor's calculates coverage ratios on statutory and economic bases. The guideline benchmarks would apply to the interest coverage ratio generated from using economic earnings. "Statutory interest coverage is viewed as an important differentiation of investment-grade companies versus noninvestment-grade companies, while not being as useful in differentiating between the higher rating categories. This is because Standard & Poor's evaluates insurers as ongoing enterprises, which is better covered under GAAP accounting, while statutory accounting is liquidation-based. Higher-rated firms are expected to have greater flexibility to meet interest payments as they become due." (Insurance Ratings Criteria (P/C Edition) 1999, pg. 89) In this context, GAAP refers to U.S. GAAP. In the absence of U.S. GAAP, Standard & Poor's tries to use financial data that most accurately present an economic portrayal of earnings. For example, in the U.K., achieved profits reporting is more economic than modified statutory basis reporting. Such differences in accounting treatment need to be considered when applying guideline benchmarks and when comparing ratios between companies. Although economic earnings are used when applying the guideline benchmarks, Standard & Poor's still calculates statutory coverage ratios to check for suitable cover. Financial Leverage Q: How does Standard & Poor's calculate financial leverage? Standard & Poor's uses total debt (short- and long-term, excluding allowed hybrid) divided by total adjusted capital (TAC) minus policyholders' capital (in the case of proprietary companies) plus any hybrid and debt not already included in TAC. This is the ratio that will be compared with the guideline leverage benchmarks. Q: What debt is included in the leverage calculation, leverage or intermediation? Any debt used to fund either the capitalization needs of the business or any equity type investment should be treated as financial leverage and therefore included as debt in the leverage calculation. Any debt used for financial intermediation, subject to analytical judgment, could be excluded from debt in the leverage calculation. Some examples of financial intermediation are temporary overdrafts that result from cash sweeping, cash management techniques, and repo-related debt reported as borrowing, provided that repo-related borrowing is matched with high-quality assets held by high-quality counterparties. Any debt raised within a ring-fenced subfund or subsidiary may be excluded from the debt figure, subject to analytical judgment. When appropriate, the corresponding capital derived from the fund should also be excluded from the leverage calculation. A separate stand-alone leverage analysis should be conducted on the fund itself. Q: How is goodwill treated in the leverage calculation? Subject to analytical judgment, up to 50% of goodwill acquired on noncore companies can be included in the TAC. This goodwill is then amortized over four years in Standard & Poor's capital models. Therefore, goodwill is taken into account in the leverage calculation. Q: To which rating should the guideline benchmarks be applied? For consolidated insurance groups, the guideline benchmarks should be applied to the counterparty credit rating on the holding company. Standard & Poor's would also calculate stand-alone ratios for the holding company when rating holding-company debt issues. Hybrid Instruments in Capital Adequacy and Financial Leverage Q: What are hybrid instruments? Some capital instruments have more equity-like characteristics than traditional debt, which allows Standard & Poor's to give capital credit in the assessment of capital adequacy and to exclude the additional funding from debt in the assessment of financial leverage. For an instrument to qualify as hybrid equity, a rating committee must decide whether the bond meets the equity credit criteria set out in the article "Holding Company Analysis: Evaluating Debt, Hybrid, and Equity Instruments" (March 1999). Q: To what types of capital is the hybrid equity tolerance applied? Hybrid instruments considered for inclusion in consolidated TAC can be: Hybrid issued by either operating companies, intermediate holding companies, or the parent holding company. Any holding company debt downstreamed as equity, subject to the double leverage tolerance (see below). Capital credit allowed for the value of in-force life insurance according to the U.K. life capital model. Q: How is interest on hybrid instruments treated? Interest charges on hybrids issued out of the holding company will not be included in the interest cover calculation but will be included in the fixed-charge cover calculation. Interest charges on hybrids issued out of an operating company will be included in the consolidated enterprise's interest cover calculation. Q: How much capital credit can be given for hybrids in consolidated capital adequacy analysis? The hybrid equity ratio is used to determine how much hybrid debt can be given capital credit in TAC. The hybrid equity ratio is calculated as qualifying hybrids divided by TAC minus policyholders' capital (e.g., FFA) plus hybrids not already included in TAC. (Refer to the examples in Table 6 to see how the hybrid equity tolerance applies in practice.) For a consolidated capital model, the level of hybrid-given capital credit is capped at a 15% hybrid equity ratio. Q: Under what circumstances can the hybrid equity tolerance be more than 15%? For operating company capital models, hybrid equity tolerance varies according to the counterparty credit rating on the operating company: Table 1 Hybrid Equity Tolerance for Operating Company Capital Models RATING HYBRID EQUITY TOLERANCE (%) AAA 15 AA 20 A 25 BBB or below 30 This sliding scale only applies if the operating company is a mutual or an operating insurance stock company that does not have a holding company. The overall tolerance for hybrid equity within an operating insurer's capital structure is 15% across all rating categories if the operating insurer is owned by a holding company. This is because capital-raising activities are typically done at the holding company and downstreamed to the operating company as equity. By limiting hybrid issuance to 15%, Standard & Poor's is able to prevent potential excessive double leverage being treated as equity in its analysis of companies within group structures. There are three exceptions to this 15% policy: If the parent holding company is the provider of the hybrid equity to the subsidiary. In this case, Standard & Poor's allows total hybrids of 30% if the subsidiary is strategically important to the enterprise, with external hybrids restricted to the 15% hybrid tolerance. Intergroup hybrid investment is often done for tax purposes. Because the subsidiary is strategically important, Standard & Poor's does not presume that the parent will put its subsidiary into default or sell it to a third party. If the parent has no legal ability to make an equity investment in its operating insurance subsidiary. The best example is ownership of an insurance exchange. The exchange is technically owned by its policyholders, but its economic benefit accrues to its shareholder. In this case, the sliding scale applies. The capital credit given for the value of in-force life business (VIF) is regarded as intergroup. Therefore the maximum hybrid tolerance for a company with VIF would be 30%, with the caveat that hybrid in relation to external parties is capped at 15%. Standard & Poor's would be content to maintain the 30% tolerance if this VIF was securitized or reinsured. This is a change to the 15% cap indicated when the U.K. life capital model was introduced. Q: How is hybrid capital treated if it exceeds these tolerances? If a group or company has issued hybrid instruments above these tolerances, no capital credit will be given in the capital model for the excess amount, and the excess will be treated as pure debt for the leverage calculation. Q: How does Standard & Poor's treat hybrids in the assessment of consolidated financial leverage? For the leverage calculation, the distinction between hybrid treated as equity or debt is only relevant for the numerator. The denominator is total consolidated capital, which includes all debt and all hybrid, whether or not they are given equity capital credit in the capital model. For the numerator only, qualifying hybrid issued by the holding company can be excluded, subject to a hybrid equity ratio tolerance of 15%. This tolerance is only applicable to hybrid issued by the holding company. "When analyzing consolidated company leverage, hybrid equity raised at the operating company will be treated as debt, and the servicing of this capital will be included in the debt coverage ratios. The logic for this is that the servicing of operating company hybrid equity is usually at least pari passu with holding company debtholders and is often senior to these debt obligations." (Insurance Ratings Criteria (P/C Edition) 1999, pg. 88) "All issuances of hybrid equity by operating companies that are part of stockholding companies are viewed as debt in evaluating consolidated stock holding company debt leverage. Standard & Poor's believes holders of these operating company instruments have an equal, if not senior, call on operating company resources versus holding company debtholders." (Insurance Ratings Criteria (Life Edition) 1998, pgs. 70-71) Double Leverage in Europe Q: What is double leverage analysis? The double leverage analysis limits the use of holding-company debt downstreamed as equity to operating subsidiaries. Double leverage helps determine the quality of capital when conducting analysis at the operating-company level. Q: How does Standard & Poor's calculate double leverage? The published formula for double leverage applies to U.S. GAAP. Double leverage applies to unconsolidated parent balance sheets only and is calculated as investments in subsidiaries divided by common equity plus hybrid equity. (The double leverage ratio only applies to holding companies, and, therefore, only hybrid equity raised at the holding company is included in the denominator.) An important consideration when using double leverage is the valuation of investments in subsidiaries. Under U.S. GAAP, these investments are carried at accounting net asset value of the subsidiaries. However, in the U.K., for example, these investments can be carried at cost or realizable value, whichever is lower. Clearly, this difference in valuation has an impact on the double leverage ratio and needs to be understood when applying double leverage tolerances. Only when the equity investment in subsidiaries is valued at the net assets of the subsidiaries do the double leverage benchmarks apply. Q: Does Standard & Poor's always use a double leverage analysis? In Europe, Standard & Poor's uses the consolidated financial leverage ratio as the key indicator of quality of capital and the capital adequacy ratio as the main indicator of quantity of risk-adjusted capital to capital required. Double leverage is usually disregarded when Standard & Poor's uses consolidated balance sheets as the analytical base. In the U.S., double leverage is much more extensively used because the analytical focus is on the operating company concerned and consolidated operating companies; the analysis is supported by the huge amount of data available on operating companies provided in the U.S. statutory filings. Q: Why is double leverage relevant in Europe? Double leverage can be used to determine the amount of holding company senior debt that can be given capital credit in a consolidated capital model. When it is not possible to apply the double leverage benchmarks, Standard & Poor's can add holding-company senior debt to TAC in a consolidated capital model, subject to a cap at 15% of consolidated TAC. The analyst should be convinced that the holding company debt is being downstreamed as equity before including it in TAC. Referenced Criteria Articles Standard & Poor's Refines Its Methodology for Analyzing Insurance Groups (February 2000) Holding Company Analysis: Evaluating Debt, Hybrid, and Equity Instruments (March 1999) Property/Casualty Insurance Ratings Criteria (March 1999) Insurance Ratings Criteria (Life Edition) (October 1998) Guideline Benchmarks These benchmarks should be applied to the holding company counterparty credit rating. Table 2 Guideline Benchmarks for Debt Leverage (Taken from "Holding Company Analysis: Evaluating Debt, Hybrid, and Equity Instruments") RATING DEBT LEVERAGE (%) AAA Less than 15 AA 15-25 A 25-35 BBB 35-45 BB 45-65 Table 3 GAAP Interest Coverage Ratio RATING CATEGORY GAAP INTEREST COVERAGE (X) RATING LOW INTEREST RATE ENVIRONMENT HIGH INTEREST RATE ENVIRONMENT AAA 10 or more 8 or more AA 8-10 6-8 A 5-8 4-6 BBB 3-5 3-4 BB 2-3 2-3 Table 4 Guideline Benchmarks for the Capital Adequacy Ratio CAPITAL ADEQUACY RATIO (%) INDICATIVE RATING LEVEL ASSESSMENT OF CAPITAL ADEQUACY Less than 100 BB or lower Vulnerable 100-125 BBB Good 125-150 A Strong 150-175 AA Very strong More than 175 AAA Extremely strong Table 5 US GAAP Double Leverage Tolerance Ratios by Rating Category RATING DOUBLE LEVERAGE TOLERANCE (%)* AAA 115 AA 125 A 135 BBB or below 145 * Applicable to the counterparty credit rating on the senior operating company Examples to Illustrate Leverage Calculation and Treatment of Hybrids Table 6 Hybrids and Leverage Under Various Hypothetical Scenarios SCENARIO #1 SCENARIO #2 SCENARIO #3 SCENARIO #4 SCENARIO #5 SCENARIO #6 SCENARIO #7 SCENARIO #8 SCENARIO #9 SCENARIO #10 Total adjusted capital (excluding hybrids) ($) A 2,000 2,000 2,000 2,000 2,000 5,000 5,000 5,000 5,000 5,000 Maximum hybrid tolerance at a 15% hybrid equity ratio ($) t 353 353 353 353 353 882 882 882 882 882 Total total adjusted capital ($) B 2,353 2,353 2,353 2,250 2,250 5,882 5,882 5,882 5,600 5,600 Holding company hybrid ($) C 360 40 400 150 50 600 400 900 400 100 Operating company hybrid ($) D 40 360 0 100 200 400 600 100 200 500 All other debt ($) E 800 800 800 950 950 400 400 400 800 800 Hybrid equity ratio (%) (C+D)/(A+C+D) 16.7 16.7 16.7 11.1 11.1 16.7 16.7 16.7 10.7 10.7 Debt leverage (%) (D+E+X)/(A+C+D+E) 26.5 36.3 26.5 32.8 35.9 12.5 15.6 8.1 15.6 20.3 X is the surplus of holding company hybrid over the 15% hybrid equity tolerance (i.e., when C is greater than t, the excess amount is treated as debt).