Article Title: ARCHIVE | Criteria | Insurance | General: Criteria Update: Factoring Country Risk Into Insurer Financial Strength Ratings Data: Editor's note: This criteria article is no longer current. It has been superseded by the article titled, "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013. Previously, this article was partially superseded by the article titled "Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published June 14, 2011. The subpart titled "Rating Group Entities Above The Sovereign" was superseded by the criteria article titled, "Group Rating Methodology," published May 7, 2013. This article also was partially superseded by the article titled, "Insurers: Rating Methodology," published on May 7, 2013. Standard & Poor's Ratings Services has revised its definition of insurer financial strength ratings to explicitly incorporate the potential for direct sovereign risk. Previously the risk of potential for direct government intervention, demonstrated primarily through mandated changes in contractual terms of insurance obligations in response to economic crisis, had been excluded from rating definitions and ratings. The change results in lower ratings on some foreign branches and guaranteed subsidiaries, especially for those domiciled in higher-risk environments in which systemic risks or severe economic stress—the predecessors to government intervention—are perceived to be greatest. The change also makes the definition of analytic methodologies for insurance financial strength ratings conform with those used for issuer ratings in the bank and corporate sectors. Although the incidence of direct government intervention in the insurance sector is infrequent, the role of this important sector in facilitating local economic and commercial markets can lead and has lead to government or regulatory interventions. These actions, which may entail government- or regulator-mandated changes in contract terms (such as in Argentina or Brazil), usually reduce systemic risks. However, through their unilateral nature, they can affect all insurers operating in the domicile regardless of their intrinsic financial strength, foreign affiliation, or support. The potential for such risk to impair policyholder or creditor protection is difficult to assess. In judging the potential for the government intervention, Standard & Poor's will consider the systemic risk in the insurance sector, the role and contribution of the sector in underpinning local commercial and financial markets, overall economic environment, and government and regulatory policies toward intervention. Incorporating country risk as a critical input into all ratings within a given domicile has long been Standard & Poor's practice. These sovereign risk considerations are included in the financial strength ratings assigned to insurers and debt ratings assigned to specific issues. The vast majority of insurance companies are rated no higher than the sovereign state exercising jurisdiction over them, reflecting each government's broad legal and regulatory powers, including its control over the domestic financial system and its ability to tax and impose foreign exchange controls. Financial strength ratings also reflect the influence of general country risk factors on the insurer's business franchise and financial standing. Local currency/foreign currency distinctions are effectively made every time a credit rating is assigned. At the issuer credit rating level, the distinction is conveyed in the assignment of separate local currency issuer credit ratings and foreign currency issuer credit ratings. Reflecting Sovereign Risk In Financial Strength Ratings Financial strength ratings (both full, interactive ratings and pi ratings, which are based on public information) are local currency ratings. Financial strength ratings address an insurer's capacity to repay local currency obligations, which could be stronger than its capacity to repay obligations in foreign currency because of the sovereign government's potential to impose convertibility or exchange controls. In addition to incorporating the risk of direct sovereign intervention, other direct and indirect sovereign risks—such as the impact of macroeconomic volatility, currency devaluation, asset impairment, or investment portfolio deterioration—and other possible controls are factored into the financial strength rating. Sovereign stress has an overwhelming impact on insurer creditworthiness—through both direct and indirect effects. The direct impact of a sovereign local currency default should weigh heavily on companies with direct exposure to sovereign local currency debt, as is often the case for insurers that have a significant liquidity position maintained in government bonds. For this reason, the rating on insurance subsidiaries that are considered core operations of global insurance groups will not be higher than the sovereign local currency rating without explicit support. Similarly, Standard & Poor's will not assign domestic insurers a rating higher than the local currency rating on the sovereign in which they are domiciled, other than in demonstrated cases of extraordinary financial strength and other characteristics that mitigate domestic risk factors. Only in exceptional circumstances would the rating on a company be higher than the local currency rating on its home country without explicit support. Such would be the case if the local insurer can be shown to have the wherewithal to survive a comprehensive set of stress case assumptions consistent with a sovereign default scenario (e.g., government bonds trading at a fraction of their face value, highly depressed equity valuations, or loan and bond assets having migrated to highly speculative levels if not defaulted). Rating Insurers Above The Sovereign Reasonable conclusions from historical precedent—combined with Standard & Poor's current expectations about future sovereign default scenarios—are that there can be insurers that, through a guaranty from a parent, demonstrate that they are partially sheltered from sovereign and country risk. Even when the sovereign has defaulted on its obligations, there have been many instances when insurers have been able to meet their policy obligations. If the parent is financially strong and is domiciled in a country with a strong sovereign rating, Standard & Poor's would not necessarily expect the subsidiary to fail to meet its policy obligations during a sovereign local (and foreign) currency default scenario. Likewise, if the insurer has a branch operation in a sovereign undergoing a local currency default scenario, Standard & Poor's would not necessarily expect the branch to fail to meet its policy obligations. As a general matter of corporate law, a branch has no separate existence from the insurance company. However, it is not always clear whether certain obligations of branches (or obligations of guaranteed subsidiaries) would be serviced in a full and timely manner if the host sovereign government were to restructure the payment of public and private sector local currency obligations or unilaterally alter payment terms and/or conditions that effectively prevented the local branch from paying on that obligation in a timely manner. With explicit support, such as a guaranty or as a branch, the financial strength rating on an insurer would generally be six notches higher than the sovereign local currency rating in domiciles where the sovereign local currency rating is investment grade and four notches higher in domiciles where the sovereign local currency rating is noninvestment grade, limited by the rating on the guarantor. The same degree of support would be applied to the financial strength rating on a branch operation. Ideally, these would be companies or branches to which senior group management has demonstrated a strong commitment—a track record of support in good times as well as bad. Without a guarantee, there are limited, exceptional circumstances that could occur that would result in a company or branch rating above the local currency rating on the sovereign. These include, but are not limited to, insurers domiciled in certain specified financial centers, such as the Cayman Islands or Bermuda, that are viewed as independent of that financial center's sovereign risk or when most assets are located outside of the jurisdiction and a sovereign collapses with no impairment to the financial strength of the insurer.