Article Title: ARCHIVE | Criteria | Insurance | Life: Operational Analysis Data: This article is no longer current. It has been superceded by Analysis of North American Life Insurance Operating Performance, published May 13, 2009. By analyzing operating results, Standard & Poor's Ratings Services determines a company's ability to capitalize on its strategy and business strengths. Operating results are analyzed independently of a firm's capital strength. The analysis of earnings focuses on both historical trend analysis and prospective earnings. In addition, analysts assess the stability and quality of earnings. Accordingly, the focus is on evaluating earnings based on pretax ROA, which is the most comprehensive ratio because it is not distorted by unique leverage considerations. For health insurance operations and other pure mortality/morbidity lines of business that are not of an asset-accumulation nature, an ROR is also employed. Key determinants of a life insurer's operational efficiency include a review of its persistency, expense structure, mortality and morbidity experience, effective tax rate, and pricing policies. The earnings trend and degree of stability are also important considerations. Finally, the participating dividend feature offered by some life insurers further complicates measuring operating performance. A significant part of dividend payments made to policyholders is at management's discretion, but in practice, the maintenance of dividend payments is an important marketing feature from the consumer's perspective. Therefore, Standard & Poor's treats dividends to policyholders as a cost of doing business and evaluates ROA on the basis of the gain from operations after policyholder dividends have been paid. Earnings Adequacy Ratio Although much has been written about capital as a valuable indicator of financial strength, a company's earnings are its lifeblood and future vitality. For an insurer, a strong earnings stream is still the most attractive source of capital formation and is often the benchmark for management's performance. Most companies include some measure of earnings as a key strategic goal, and achieving this goal is often a principal element of a company's overall strategy. A sufficient level of earnings allows a company to increase value while sustaining internal funding for growth. Inadequate earnings levels, on the other hand, can indicate poor pricing discipline and competitive disadvantage because the company will have to compete on a pricing basis with less financial flexibility to support growth. Standard & Poor's developed an earnings adequacy model to better measure operational performance. This measure helps in making ratings decisions by differentiating a company's key performance aspects. In evaluating an insurer's financial strength, Standard & Poor's has long used earnings measurements as an important component of its analysis. Because the life insurance business is principally an asset-accumulation business, Standard & Poor's uses pretax ROA as the principal measurement of operating performance. Many product segments in the industry are spread-driven; that is, life insurers are looking to achieve some targeted spread between the rate they earn on their investments and the rate they credit their policyholders. Although ROA is useful as a broad measure of earnings adequacy, it has its drawbacks. ROA does not differentiate between various product lines that often have different risks, some of which require higher levels of ROA than do others to achieve a certain standard of performance. ROA is also oriented toward asset-accumulation lines of business—such as whole life insurance, annuities, and pension products—but it does not work well with pure mortality or morbidity products, such as health insurance or group life insurance. These products are designed to earn a spread on the revenues they receive over the claims they pay (plus reserves for future claims) in addition to expenses. Standard & Poor's earnings adequacy ratio is a risk-adjusted measure that is designed to evaluate performance across a broad array of business lines while differentiating earnings targets by business line, given the risks associated with each product class. The measure is also time-weighted, encompassing five years of earnings performance to cover yearly fluctuations that could occur because of industry cyclicality, competitive pressures, repricing strategies, expense actions, and nonrecurring events. This benchmark ratio has associated standards of performance across all levels, from weak ('B') to extremely strong ('AAA'). The ratio is derived by dividing actual earnings by "target" ("expected") earnings at the 'BBB' level. The denominator of the ratio multiplies an earnings target for each of the company's business lines by either the reserves, GAAP assets, or revenues for that line of business. The earnings target used is a level considered good ('BBB') for the business line. The earnings targets multiplied by the appropriate reserves, GAAP assets, or revenues (depending on product line) are then added to produce a level of earnings considered good for the company. The numerator of the earnings adequacy ratio is the company's GAAP EBIT. The measure is calculated before interest expense because the intent is to evaluate the earnings performance of an insurer's operations regardless of a company's choice of capital structure. GAAP accounting presents a more accurate picture of the ongoing economic earnings capabilities of a company than statutory accounting, which presents a view of the company as if it were to be liquidated as of the statement date. Differences in accounting treatment—such as the inclusion of deferred policy acquisition costs and use of more realistic reserving practices in GAAP accounting—give a better picture of an insurer as an ongoing enterprise. Statutory earnings will be used if GAAP or GAAP-like earnings are not available. Standard & Poor's will continue to use statutory accounting as the primary source of information for balance sheet-oriented models, such as its capital adequacy model and liquidity model. The earnings adequacy model then compares the company's pretax earnings (excluding interest expense) with its earnings target. Companies considered to have good earnings capabilities will just cover their earnings target, while companies with stronger operational capabilities will have earnings that are some multiple of an adequate earnings target. Although Standard & Poor's believes capital gains are largely opportunistic for many companies and are a function of economic and interest-rate conditions, excluding realized capital gains and losses from the earnings model deprives those companies managing investment income on a total return basis of part of their earnings strength. By including realized gains, full credit is provided for this type of investment strategy. For purposes of this adjustment, realized capital gains will primarily include realized gains and losses from the sale of equity-type investments, such as unaffiliated common stock, real estate, and certain limited partnership investments. Standard & Poor's will use a seven-year average of net realized capital gains/losses, based on the most recent seven-year period, to ensure credit is given to companies that truly manage on this basis and to diminish the influence of market and economic cycles. This amount will be added to actual pretax earnings for each of the five years used in the model. The earnings adequacy model time-weights a company's earnings performance over five years. Current years are more heavily weighted than are other years. Standard & Poor's adds 20% of the most recent year's earnings adequacy ratio, plus 30% of the average of the past three years' ratios, plus 50% of the average of the past five years' ratios to arrive at a time-weighted average of the company's earnings adequacy. Table 1 shows the calculation of the earnings adequacy ratio. GAAP EBIT (including realized gains/losses and adjusted for investment income from limited partnership investments) is used in the numerator. The denominator is constructed by multiplying statutory reserves, GAAP assets, or revenue by the earnings targets. Added to this in the denominator is the difference between GAAP total assets and total statutory reserves, multiplied by an earnings target for miscellaneous items of 75 basis points (bps). (The difference between GAAP assets and statutory reserves is considered a proxy for unallocated GAAP assets by product line.) If GAAP assets (allocated by product line) are available, these will be used instead of statutory reserves as the measure of business volumes, with unallocated GAAP assets receiving a miscellaneous earnings target of 75 bps. If only statutory figures are available, statutory pretax earnings after policyholder dividend operating earnings are used in the numerator, and statutory total assets (instead of GAAP assets) are used in the denominator. All calculations are based on the use of average assets and average reserves for each year. Calculations based on GAAP assets exclude the effects of FAS 115, which marks assets to market value. Table 1 Earnings Adequacy Ratio Calculation NUMERATOR = GAAP EARNINGS BEFORE INTEREST AND TAXES (INCLUDING AVERAGE REALIZED GAINS/LOSSES) DENOMINATOR = INDIVIDUAL LIFE RESERVES; 60 BASIS POINTS (BPS) + Fixed annuity reserves; 50 bps + GIC reserves; 40bps + Variable annuity reserves; 14 bps + Variable life reserves; 29 bps + Disability and long-term care reserves; 100 bps + Group life revenue; 300 bps + Traditional indemnity health premiums; 200 bps + Retrospectively experience-rated indemnity health premiums; 180 bps + Contractual fee payment/bonus withhold arrangement health premiums; 180 bps + Capitation/salaried staff health premiums; 215 bps + Federal employee health benefits programs/CHAMPUS premiums; 50 bps + Administrative-services-only health premiums equivalents; 15 bps + Stop loss reinsurance premiums; 140 bps + Medicare supplement and dental health premiums; 150 bps + Other not-at-risk health revenue; 300 bps + Other revenue (mainly credit); 300 bps + (Total assets to reserves) or unallocated GAAP assets; 75 bps. Reserves are used unless GAAP assets allocated to product line numbers are available. Reserves = Annual statutory statement, page 3, lines 1 + 2 + 10.2 + 27. Conversions for GAAP figures: Use GAAP pretax, preinterest operating income (including realized gains/losses and adjusted for investment income from limited partnership investments) in the numerator, and substitute GAAP total assets for statutory total assets in the denominator. All other inputs may remain on a statutory basis. Earnings adequacy ratio = numerator/denominator, time weighted as follows: 20% of the most recent year's earnings adequacy ratio + 30% of the average of the past three years' ratios + 50% of the average of the past five years' ratios All calculations are based on the use of average assets and average reserves for each year. GAAP total assets are adjusted to exclude the effects of FAS 115. Table 2 shows the standards used to evaluate a company's earnings adequacy ratio for each level of operational performance. As a stand-alone measure of earnings performance, the earnings adequacy measure is incomplete because there are various risks and other earnings assessments it does not capture. For instance, it is important to consider the different sources of revenue, both inter- and intraproduct. This includes the ability to balance spread-driven revenues with mortality/morbidity revenue and asset-based fee revenue. Table 2 Earnings Adequacy Ratio Standards STANDARD EARNINGS ADEQUACY RATIO (%) Extremely Strong 270 or more Very Strong 220 to 269 Strong 170 to 219 Good 100 to 169 Marginal 50 to 99 Weak Less than 50 In addition, Standard & Poor's seeks to understand the relationship of pricing expectations to actual results in concluding that gains are emerging as expected from all sources. The earnings adequacy ratio does not differentiate between companies with high levels of earnings volatility and those with more stable earnings performances. Companies with stable earnings streams are viewed as more financially secure than are companies with volatile earnings patterns, which might be subject to stress from time to time. Therefore, Standard & Poor's will analyze a company's earnings adequacy in conjunction with many other facets of earnings to measure overall earnings performance. In Standard & Poor's interactive rating process, analysts can adjust the raw data used in these models to reflect unique situations at particular companies. As an example, if any year's earnings are considered out of the norm because of nonrecurring events, analysts adjust the earnings used in the model to more normal levels. Likewise, the earnings targets applied to each line of business are considered adequate for the industry in aggregate. To the extent that a specific company's products are considered more or less risky, the analyst can adjust the target up or down. Given that the rating process takes a prospective view of a company's financial performance, Standard & Poor's analysts often construct earnings adequacy ratios that include their projections of an insurer's future earnings. Although a company's past performance is often a good indicator of its future, industry conditions or management's strategies can often significantly alter a company's earnings profile. Related risks that Standard & Poor's analysts will consider in evaluating financial strength are the investment risks, underwriting risks, and other business risks a company is taking to achieve its earnings. Companies that achieve high earnings because of a higher risk profile could be viewed as having weaker financial security than the earnings adequacy ratio suggests. Companies operating with greater revenue diversity and favorable actual results compared with pricing expectations are considered to be operating with less volatility risk. Standard & Poor's believes stronger companies will achieve high earnings through competitive advantages they have established in the marketplace. These advantages should translate to favorable pricing, low crediting rates or policyholder dividends, or an expense advantage. As is the case with all of Standard & Poor's performance measurements, the measure of earnings performance is part of a broader array of analysis that is conducted in evaluating a company's financial strength. In addition to earnings, Standard & Poor's considers many other factors—such as the risks within the industry, management strategies, competitive advantages and disadvantages, investment risks, capital adequacy, liquidity profile, and financial flexibility—when making a rating decision. No single measure will dictate a rating decision. As life insurers position themselves to compete with other financial institutions and look to the capital markets to fund their growth, earnings performance will be a key measure by which they are gauged. Even if an insurer is well-capitalized today and has no plans to raise outside capital, strong earnings are a necessary component for success. The companies best positioned for success will have developed competitive advantages ensuring vitality and growth. Strong earnings will be a key ingredient to sustaining that vitality and funding ongoing growth.