Article Title: ARCHIVE | Criteria | Insurance | General: Gauging The Impact Of Unrealized Losses On Insurers' Financial Strength Data: (Editor's Note: This article has been superseded by "Methodology And Assumptions For Gauging The Impact Of Unrealized Losses On Insurers' Financial Strength," published July 8, 2009.) Because of the current state of the financial markets, many insurance companies have reported—or are expected to report—material investment losses on their financial statements. In addition to the size of the losses, whether the company classifies them as realized, unrealized, or a combination of both can influence the degree to which they affect the insurer's reported financial results and, ultimately, our assessment of the company's creditworthiness. The financial reporting process requires that insurers assess their investment portfolio through an other-than-temporary-impairments (OTTI) internal process that determines—on a security-by-security basis—when the fair value of the investment is not likely to recover fully before the expected sale or maturity. When a company recognizes an impairment loss, it accounts for the investment by taking a realized loss, reducing the book value to the fair value on the date of the reported financials. Realized losses from asset sales constitute a true economic loss, and in our view, the recognition of an OTTI strongly signals the likelihood of economic losses. The presence of either could result in negative rating actions, depending on the size of these losses or OTTI relative to earnings, capital, and our expectations. Therefore, we are clarifying how we apply our criteria (see "Risk-Based Insurance Capital Model," published on Sept. 11, 2008, on RatingsDirect) in assessing insurance companies' OTTI process and unrealized investment losses and their impact on our rating analysis. We believe that in the fixed-maturity portfolio, the potential for unrealized losses to evolve into economic losses is less clear. If in our opinion the unrealized loss on a fixed-maturity securities portfolio is likely to be temporary, the insurance company is willing to hold these securities to full recovery, and in our view it has sufficient liquidity to do so, the reported unrealized loss might not reflect economic reality. As a result, our analysis might either heavily discount or eliminate it. However, to the extent we believe that unrealized losses are representative of an economic loss, we usually incorporate them in our rating analysis, and this could affect ratings or outlooks on certain companies. Outlining The Review Process Standard & Poor's Ratings Services will usually start its review by gaining an understanding of a company's OTTI process. We assess its degree of conservatism and the extent to which we believe we can rely on its OTTI process in appropriately identifying economic impairments. A company's liquidity is important in assessing OTTI and unrealized losses because it speaks to the company's ability to hold securities to recovery of economic value. The shorter the duration of a company's liabilities, the higher the hurdle for assuming it has the ability to hold the securities rather than potentially having to sell them at the market value arrived at through the OTTI process and realizing the loss. In addition, for some asset classes—such as residential mortgage-backed securities (RMBS)—we usually assume economic losses are realized and incorporate them into our assessment of capital. These are some of the factors we usually review when we assess a company's investment valuation and OTTI process: The company's policy for identifying securities for which it performs a more detailed analysis. For example, it might flag securities based on the extent or time period of the unrealized loss. The company's intent and ability to retain its investment as well as management's anticipated market-value recovery time. The company's strategy in holding the so-called underwater securities (those that would be a loss if sold immediately) and how the company mitigates the risk of future potential OTTI. When there isn't a sufficient volume of observable market prices, the company's fair-value assessment processes and depth of expertise of personnel (internal or external) in their application. Our assessment of recent changes in counterparty credit ratings on the underlying security portfolio relative to the company's OTTI conclusions as well as our opinion on the extent of decline in value solely attributable to market illiquidity and interest rate movements. A comparison of the company's impairment charges to those of other companies holding similar securities as well as their policies for assessing impairments. Our assessment of the position of the company's auditors (and their challenges, if any) regarding the company's OTTI assessments on key decision points. These include the probability the company will collect, intent and ability to hold the securities, anticipated recovery period, and the impact of the severity and duration of unrealized losses. In addition to assessing the potential economic impact of unrealized losses, our analysis considers the accounting basis on which the regulators measure a company's capitalization. Many U.S.-domiciled operating companies calculate capital adequacy from statutory financials, which, absent OTTI impairments, exclude unrealized gains and losses on fixed-maturity securities. Subject to our review of a company's OTTI analyses and processes for assessing impairments, we usually exclude unrealized fixed-maturity losses in calculating capital adequacy. However, our qualitative assessment of capital typically incorporates our assessment of OTTI practices and potential economic losses emerging from the unrealized loss position. For Bermudan and other non-U.S. companies for which the regulatory statements incorporate market valuation on fixed maturities, our capital calculations typically reflect these unrealized losses. We do this because even if the losses are not economic, they likely will be incorporated in the regulator's view of capital, thus placing pressure on the capital the company is statutorily required to hold. However, to the extent we believe the reported unrealized losses could be temporary and regulatory capital might not be materially affected, our qualitative analysis may incorporate our assessment of the OTTI process. As a result, Standard & Poor's assessment of both U.S. and non-U.S. insurance companies' capital adequacy usually incorporates expected economic losses arising from unrealized losses, notwithstanding the accounting presentation.