Article Title: ARCHIVE | Criteria | Insurance | General: Flexible Gapping Of Ratings Reflects Regional Variations In Structural Subordination As Well As Differing Debt-Servicing Capacities Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled "Group Rating Methodology," published on May 7, 2013.) 1. Introduction In insurance, Standard & Poor's Ratings Services will often make a significant differentiation between the ratings it assigns to holding companies and those it assigns to operating companies within the same group. Indeed, the counterparty credit rating (CCR) on an insurance holding company is frequently set a full grade (three notches) below the rating on its main operating subsidiaries. Meanwhile, in banking groups, the holding company is typically rated one notch below the bank operating company level. This deliberate differential by Standard & Poor's in the gapping criteria applied to insurers and banks exists because bank holding companies are an integral part of the confidence-sensitive structure that is a banking group. If a bank holding company is seen to be in difficulties, a loss of confidence is likely to affect the whole group, potentially leading to a classic "run-on-the-bank" scenario. Acknowledging this, regulators in practice usually consider banks and bank holding companies as a single economic entity, and the authorities in most countries use their regulatory powers to manage problems at both the bank and at the holding company in times of stress. This cannot be said of insurance. In practice, all the policyholder obligations and the vast majority of a group's tangible investment assets tend to lie at the operating level. The concern of regulators, therefore, is to perform their duty of protecting policyholder interests by seeking to maintain the financial strength of the operating companies over which they have supervisory responsibility. Moreover, if group solvency continues to deteriorate, the holding company may increasingly be seen as detrimental to policyholder security if management persists in its attempts to siphon cash out of the regulated subsidiaries in order to service the demands of investors. The broader ratings gapping that Standard & Poor's applies to insurance companies consequently reflects the view that greater structural subordination exists in insurance than in banking. In other words, insurance group capital is drawn down to the operating level to meet regulatory and policyholder requirements, but once there is to a significant degree "locked in" by the ever-present possibility of regulatory intervention. For this reason, a pure insurance holding company's ability to service its own (usually investor-related) liabilities may be significantly lower than its operating subsidiaries' ability to service policyholder obligations. This will almost certainly be the case when the holding company is entirely dependent for cash upon the dividends and other contributions that it expects to receive from its subsidiaries, particularly when those subsidiaries are located in jurisdictions where all such upward transfers must be preapproved by regulators. This applies all the more so when regulators in specific jurisdictions are known to be reluctant as a point of principle to authorize large transfers of solvency capital out of the operating companies they supervise. Standard & Poor's is therefore obliged to base its final gapping decisions not merely upon a quantitative analysis of the interest and fixed-charge coverage and financial leverage ratios across a group and at the group's individual rated entities, but also on a qualitative assessment of the reliability, stability, and diversification of the cash flows available to the holding company, factors that will themselves be strongly influenced by the prevailing weight of structural subordination affecting any potential cash transfers from the group's various profit centers. This article also addresses the further gapping that may be applied to ratings to "flag" the de facto subordination of debt to policyholder obligations at the same entity, as well as the notches applied to highlight the greater risk inherent in hybrid equity, where the principal is not only subordinated, but where the interest is also deferrable, albeit without creation of a legal event of default (see Section 3). Section 4 discusses the factors that may lead to the application of nonstandard gapping, while Section 5 clarifies the gapping to be applied to the ratings on composite holding/operating companies that act as a group holding company, but which also underwrite risk for their own account. 2. Holding Companies Versus Operating Companies Structural subordination differentiates operating from parent and holding companies in both shareholder and mutual groups. This is because local regulators are almost invariably keen to ensure that a prudential "cushion" of capital is built up at each regulated operating entity, often at a level well in excess of prevailing legal minima. Moreover, the more a group's overall financial strength becomes questionable, the more local regulators may seek to preserve and increase the solvency capital held down at the individual operating companies over which they have regulatory responsibility. Clearly, such enforced "hoarding" of capital at the subsidiary level must ultimately be to the detriment of the cash flows and solvency of the unregulated holding company and, more particularly, to its ability to service its own counterparties, most notably bondholders. The prudent stance of regulators around the world, coupled with managements' wish to give comfort to commercial counterparties and even rating agencies, usually create a centrifugal force that pushes ownership of groups' tangible assets out toward the operating entities and away from the unregulated holding or parent company center. This means that holding companies often retain few assets of their own, save their large, illiquid investment in subsidiaries and associated companies. Furthermore, operating entities are differentiated by their reasonably predictable cash flows deriving from net premium income, as well as from the interest, dividend, and possibly rental streams that their often sizable investment portfolios will normally generate. With further liquidity potentially available from the outright sale of marketable securities, and almost invariably with little or no debt leverage of their own, ailing insurance operating companies are, in practice, somewhat more likely to go into run-off or to be sold along with their operating and sales infrastructure than to fail in spectacular fashion with significant policyholder obligations left unsettled. Insurance holding companies, meanwhile, can and do default, and the impact on investors can be sudden and dramatic. Even in regions such as the EU, where holding company financials are monitored and included in a group solvency calculation, the entities themselves are neither explicitly--nor even, unlike banks, implicitly--protected by the regulatory "umbrella" that shields confidence-sensitive operations from their creditors. In effect, most listed holding companies exist as a central administrative cost center and constitute the unifying owner of a group's separately incorporated subsidiaries. They also very often serve to source and apply capital in a fiscally efficient and flexible manner, raising it from shareholders and the capital markets at whatever levels and in whatever proportions that group management deems appropriate, then applying it across the group in line with management's chosen financial strategies. In regions where regulators monitor solvency solely on a regulated entity-by-entity rather than also on a fully group-consolidated basis, a particular advantage of a holding company structure is that double leverage can be used, where lower cost senior debt rather than expensive common equity is raised centrally from investors and its cash proceeds downstreamed as permanent, solvency-eligible equity to the regulated operating subsidiary level. 3. The Gapping Applied To Debt And Holding Company Ratings Standard & Poor's starts the rating process for any insurance entity by assessing the notional financial strength (that is, the ability to pay current and prospective policyholder obligations) across the whole of the group to which it belongs, whether the rest of the group is publicly rated or not. This unpublished notional group operating rating (NGOR) is based on a consolidated analysis of the group as though it were a single legal entity, and sets the baseline from which all other ratings are gapped. For example, the CCR on an insurance or reinsurance holding company would routinely be set two or three notches below the group NGOR. Similarly, those unleveraged operating companies that are deemed by Standard & Poor's to be unquestionably Core to their group's strategy are individually assigned insurer financial strength ratings (FSRs) and CCRs at the same level as the group NGOR. The assumption here is that group resources, whether financial or operational, will be made directly or indirectly available to all genuinely Core operations in time of urgent need, as it would be apparent to both group management and to regulators that the whole group would suffer profoundly negative consequences were a Core operation allowed to fail. Once the notional group FSR (that is, the NGOR) has been established, the rating on other, noncore group members will be ascertained as a function of their stand-alone financial strength plus, potentially, a norm of one to three additional notches of credit to denote degrees of implicit but finite group support (see "Insurance Criteria Update: What Makes An Insurance Or Reinsurance Subsidiary 'Core' Under Group Rating Methodology?", published March 31, 2005, on RatingsDirect). In this way, Standard & Poor's can, if required, assign a CCR and FSR to each and every entity within a group, although it is for group management to decide which entities actually require a public interactive rating. Meanwhile, having ascertained the CCR on any given entity, additional notching can then be applied to derive appropriate ratings for any short- or long-term debt instrument issued by that entity, as detailed in tables 1 and 2 below for insurance holding and operating companies respectively. It is nevertheless important to recognize that although standard gapping exists to promote consistency and transparency in the rating process, the gapping process itself is far from being wholly "mechanical." In practice, rating committees can and do depart from normal gapping when such a departure appears to be justified by risks that are perceived to be either significantly higher or lower than the norm. Table 1 Standard Ratings Gapping For Insurance Holding Companies HOLDING COMPANY WITH INVESTMENT-GRADE CCR FSR FSR not available to holding companies; only available to (re)insurance operating companies CCR Normally set two or three notches below CCR/FSR on main operating subsidiaries Senior debt Normally set at same level as CCR Ordinary nondeferrable subordinated debt Normally set one notch below CCR Deferrable subordinated debt* Normally set two notches below CCR, but potentially three or more notches if terms cause greater probability of interest deferral Holding company with non-investment-grade CCR CCR and/or senior debt Set at least three notches below CCR on main operating subsidiaries Ordinary nondeferrable subordinated debt Set at least two notches below CCR Deferrable subordinated debt* Set at least three notches below CCR *Preference stock or equivalent hybrid. CCR--Counterparty credit rating. FSR--Insurer financial strength rating. The gapping that applies to insurance holding company ratings highlights the de facto subordination of the holding company's financial creditors to policyholders at the subsidiary operating company level, as indicated by the usually higher FSR assigned to those operations. "Pure" holding companies do not qualify for an FSR of their own as they have no policyholders. Only "hybrid" holding companies that also underwrite a (usually small) portfolio of inward insurance or reinsurance risk can be assigned an FSR, which indicates their ability to honor obligations assumed under the insurance or reinsurance contracts that they have written. CCRs are always assigned at the seniormost rated level. This means that the CCR on a pure holding company is set at a level equivalent to that at which its seniormost unsecured debt obligation would be rated, notably senior unsecured debt. For operating companies, however, the seniormost rating is that regarding financial strength. Consequently, in these latter instances, the CCR is set at a level equal to the FSR, which in regions such as the EU would likely be one notch above the level at which that entity's senior debt would be rated. Table 2 below illustrates this last point by describing the rather more complex gapping that usually applies to the various forms of operating company in the various regions of the world. In essence, once the rating committee has assigned an FSR, the operating entity's CCR will usually be set at this same level. The only significant and not infrequent exception to this is when the FSR has itself been raised to reflect explicit support (that is, a guarantee) for policyholder obligations from a third party. As other counterparties are unlikely to be covered by this support agreement, the CCR will in such circumstances be delinked from the supported FSR and assigned at an appropriately lower level. Table 2 Standard Ratings Gapping For Insurance Operating Companies OPERATING COMPANY WITH INVESTMENT-GRADE CCR FSR Set by rating committee on the basis of a full analysis of the company and its group CCR Set at same level as FSR except when FSR is explicitly supported by policyholder guarantee, in which case CCR is determined by committee Senior debt* Set one notch below FSR except when FSR is explicitly supported by policyholder guarantee, in which case set at level of guarantor's CCR Senior debt¶ Set at same level as CCR Ordinary nondeferrable subordinated debt* Set one notch below CCR (that is, same as senior) Ordinary nondeferrable subordinated debt¶ Set one notch below CCR (that is, one notch below senior) Deferrable subordinated debt§ Normally set two notches below CCR, but potentially three or more notches if issue terms cause greater probability of interest deferral OPERATING COMPANY WITH NON-INVESTMENT-GRADE CCR Senior and ordinary nondeferrable subordinated debt Set at least two notches below issuer's CCR Deferrable subordinated debt§ Set at least three notches below issuer's CCR (or four notches with mandatory deferability clause) *Where financial creditors are considered subordinate to primary policyholders (for example, Europe). ¶Where financial creditors are considered pari passu with all policyholders (for example, unregulated entities, reinsurers, and primary insurers in certain countries such as the U.S.). §Preference stock or equivalent hybrid. CCR--Counterparty credit rating. FSR--Insurer financial strength rating. It is in respect of the rating of senior and ordinary subordinated debt at the operating company level that the situation becomes difficult to summarize, given the complexity of the many legal environments around the world. In essence, the law of most but not all countries explicitly states that in the event of insolvency and wind-up, policyholder claims come first. This means that even so-called senior debt obligations are often de facto subordinate to those of policyholders. Therefore, in many jurisdictions, the senior debt rating of a regulated insurance operating company will be gapped down one notch from its CCR and FSR to reflect the effective subordination of even bondholders to policyholders. However, in countries where such subordination is not explicit or is not meaningfully enforceable for all or most classes of policyholders, senior debt will commonly be rated at the same level as the operating entity's FSR and CCR. Meanwhile, Standard & Poor's does not routinely use additional rating notches to attempt to indicate further degrees or nuances of subordination. Consequently, when senior debt has already been gapped down one notch to indicate its de facto or de jure subordination to policyholders, then ordinary but explicitly subordinated debt will usually be publicly rated at exactly the same level as senior debt to show that both sets of issues are subordinate to policyholders. However, in those regions where the senior debt rating is set at the same level as the FSR and CCR, explicitly subordinated debt will be publicly rated one notch lower. In all cases, where debt is both explicitly subordinated and interest payments are deferrable without the creation of a legal event of default, notably for preference stock and other hybrid equity issues, then across all countries such hybrid issues will generally be rated two notches below the CCR on the issuing entity. However, where onerous mandatory deferral clauses are written into the hybrid equity structure or where the issuer's CCR is noninvestment grade, three or more notches will likely be used to rate these hybrid equity issues. To conclude the subject of standard gapping, the criteria applied in respect of reinsurers are probably the most difficult to summarize in that the degree and effectiveness of regulatory surveillance applied to them can differ significantly around the world, and because the law in many countries differentiates substantially between the protection required by retail and other, primary policyholders at one extreme and, at the other, the laissez-faire or "buyer beware!" attitude that the law not inappropriately attributes to the professional, wholesale reinsurance, or secondary markets. Standard & Poor's is therefore compelled to consider the gapping applied to reinsurers on a case-by-case basis. In most countries, however, whether reinsurers are regulated or not, reinsurance cedents rank equal alongside other creditors in the event of their reinsurer's insolvency. In these circumstances, a strategically Core reinsurance operation will still be rated the same as other Core subsidiaries within the group to which it belongs. Moreover, the reinsurer's FSR, CCR, and senior debt ratings will all be set at the same level to indicate that upon insolvency, all creditors, whether cedents or debtholders, rank pari passu in their access to any distribution of residual assets. Naturally, where senior debt has not been gapped down, explicitly subordinated debt will be rated one notch below the senior debt level, and any subordinated, deferrable hybrid equity issues will be gapped one notch lower still--that is, two notches below the CCR on the issuer. 4. When Will Nonstandard Gapping Be Applied? The standard gapping applied to the CCR on an insurance or reinsurance holding company is two to three notches below the CCR on its main operating subsidiaries. The reasons for gapping to be applied to the ratings on insurance and reinsurance holding companies have been described above but, in essence, the presence of legal and structural subordination means that assets and liquidity tend disproportionately to be held down at the operating company level, leaving bondholders at the holding company level in a somewhat weaker position relative to both policyholders and, if applicable, debtholders at the subsidiary operating level. It is this de facto subordinate position of holding company creditors that Standard & Poor's seeks to "flag" by means of lower ratings for insurance holding companies. Gapping of two rather than three notches can, however, be readily considered when the sources of revenue available to a holding company are strong and well diversified by geography or by line of business, when actual levels of debt leverage are low, or when the cash-backed interest coverage available to meet debt-servicing requirements is dependable and high, or, indeed, when the holding company has substantial liquidity or marketable assets of its own. Moreover, if a holding company is viewed as having very substantial and diversified streams of income, high liquidity, and/or exceptionally strong levels of interest and fixed-charge coverage, then the gapping between operating and holding companies may be narrowed even further, and in some very rare instances may even be eliminated altogether, albeit usually only in the context of an 'AAA' rating. Meanwhile, three-notch gapping between the holding company and its main operating subsidiaries will be applied when these mitigating factors are insufficiently visible in the analysis, and where existing group financial resources are deemed to be disproportionately "locked in" at the subsidiary and therefore not readily available to service debt obligations at the holding level. Indicatively, structural subordination is regarded as very high in markets such as the U.S., where even strong companies have to obtain prior regulatory approval before upstreaming significant amounts of solvency capital to the group holding company level. Alternatively, such subordination is deemed somewhat less onerous in regions such as the EU while, in the likes of Bermuda, it is not considered high or onerous at all. A final, though often compelling justification for narrower gapping, is when the interest and fixed-charge coverage ratios are conspicuously and dependably strong relative to the rating and where the EBITDA earnings (that is, earnings before interest, tax, depreciation, and amortization) included in the ratio calculation are derived from reasonably diversified sources. Such diversification implies that even if earnings cannot for whatever reason be upstreamed to the holding company from one principal profit center, then alternative profit centers exist in other markets that would in all probability be able to fill the gap and provide the holding company with the extra cash dividends it may need to enable it to service its debt obligations in full and on a timely basis. Table 3 indicates Standard & Poor's normal tolerances concerning interest and fixed-charge coverage levels. The coverage ratios are the single most important measure used in the rating process to establish debt-servicing ability. When calculating preferred stock and other hybrid equity ratings, Standard & Poor's uses fixed-charge coverage ratios based on GAAP numbers rather than simple interest coverage. To the extent that an issuer's total annual interest burden increases significantly beyond the indicated tolerances in ratio terms, additional notches of gapping may be considered, although other sources of potential liquidity will also be taken into account. Using both consolidated group and unconsolidated holding company ratios, the rating committee will ascertain whether interest and total fixed charges payable appear strong relative to the EBITDA (that is, cash-related) definition of earnings and, of course, relative to the currently assigned ratings. Logically, in circumstances where structural subordination is deemed to be strong, greater emphasis will be placed on the holding company's own, unconsolidated coverage ratios. Equally, where structural subordination is weaker and where there is little reason to expect regulators or creditors to prevent subsidiaries paying even an uncovered dividend to the parent holding company, then more attention will be paid to the group's consolidated coverage ratios. Naturally, rating committees are aware that insurance groups have sources of actual and potential cash other than EBITDA earnings that may in practice be made available to service interest and maturing debt obligations. However, of all the considerations underlying any decision to allow nonstandard, narrower gapping in the rating of group holding company debt, the current and prospective fixed-charge coverage ratios, calculated on both a consolidated and an unconsolidated basis, are probably the single most potent quantitative factor in Standard & Poor's assessment. Table 3 Interest Coverage Tolerances RATING LOW INTEREST RATE ENVIRONMENT HIGH INTEREST RATE ENVIRONMENT AAA 10x+ 8x+ AA 8x-10x 6x-8x A 5x-8x 4x-6x BBB 3x-5x 3x-4x BB 2x-3x 2x-3x Although the interest and fixed-charge coverage ratios are key, traditional leverage ratios are also relevant. In this context, Standard & Poor's has already published the levels of debt to capital that it deems consistent with the various rating levels, and these levels are shown in table 4. Naturally, if the levels of leverage are modest, then this too would be supportive of the case for nonstandard, narrower gapping in the rating of holding company debt. Table 4 Financial Leverage Tolerances RATING MAXIMUM AS % OF ADJUSTED TOTAL EQUITY CAPITAL AAA <15% AA 15%-25% A 25%-35% BBB 35%-45% BB 45%-65% B >65% 5. The Issue Of Composite Holding/Operating Companies If it is accepted that clear distinctions may be made between the risk profile of a pure, unregulated holding company and that of its reasonably successful, regulated operating subsidiary, reality nevertheless intervenes to present cases that lie in the "gray" area between these two extremes. Particularly in the German and, to a lesser extent, the Austrian and Swiss markets, there are a number of otherwise unregulated holding companies that also actively underwrite or passively manage a run-off of insurance and reinsurance risks that they carry on their own balance sheets. As often as not, this risk will take the form of internal reinsurance within the group, with the holding company in effect providing protection as a form of "soft" capital to its own subsidiaries. However, in several instances, the holding company also writes or manages business with third parties. The question that confronts Standard & Poor's in these instances, therefore, is whether the risk profile of the holding company in such circumstances is more indicative of an operating company or a holding company. Once again, rating committees will usually feel obliged to consider such composite or "hybrid" situations on a case-by-case basis, with various possible outcomes. The entity may be rated as a de facto operating company, with zero or possibly just one downward notch of gapping to denote its (modest) holding company characteristics (for example, the use of debt and double leverage to invest in other subsidiary companies). When operating and holding company characteristics appear balanced, one or two notches of gapping may be applied relative to pure operating company peers. If, however, a substantial use of debt and double leverage means that holding company characteristics are assessed as clearly dominant, then standard two- or three-notch gapping will commonly be applied to both the entity's FSR and CCR. In effect, when confronted by a composite mix of holding and operating company characteristics within a single legal entity, rating committees will systematically consider the various factors already discussed in Section 4, and will also pose the following questions: Are operating or holding company characteristics dominant? What is the burden of current and prospective debt leverage relative to the tolerances in tables 3 and 4 using both entity-specific and group-consolidated ratios? Does the entity enjoy sufficient financial flexibility to be able to source additional capital and/or liquidity to help it meet its likely nonpolicyholder financial needs with ease relative to its current rating level? Does the entity benefit from significantly diversified sources of revenue, either in terms of income from various, noncorrelated lines of business, or dividends from a number of subsidiaries operating in distinctly different regions? What is the legal and regulatory environment as regards the strict enforcement or otherwise of structural subordination? In particular, are regulators more likely to conclude that the greatest number of (retail) policyholders across the group would be best served were the composite holding/operating company to be put into liquidation, or would they most likely in practice not object to measures that would help keep the composite operation solvent, even if this led to a reduction of financial strength at other regulated operations within the group? If the answers to most or all of these questions are found to be benign from the perspective of policy- and bondholders at the composite holding/operating company, then the CCR on the entity, if deemed to be strategically Core, will most likely be set one or two notches below the notional group FSR (that is, the NGOR) discussed in Section 3 above. Indeed, if the rating committee poses these questions and concludes that there is no real, incremental risk of collapse at the composite entity, then no notches of gapping at all may need to be applied, in which case the Core composite holding/operating company will be publicly rated as though it were an ordinary operating company within its group, despite the presence of potentially significant debt leverage. 6. Conclusions Standard & Poor's is aware that a full three notches of gapping between the CCR on an insurance operating company and that on its holding company parent may sometimes appear conservative. Cases such as that of the old Storebrand A/S in Norway in 1993 or Conseco in the U.S. in 2002 nevertheless show that during times of intense financial stress at insurance holding companies, regulators around the world will move to protect regulated operating subsidiaries from an onerous obligation to upstream cash dividends to fund the group's debt servicing, to the possible detriment of policyholders. However, where a group's overall financial strength and debt-servicing ability is conspicuously strong, where sources of revenues are well diversified, where levels of debt leverage are modest, or where "structural subordination" is perceived as less extreme in its application, rating committees are fully prepared to consider two-notch or, conceivably, one-notch gapping. Usually in an 'AAA' rating context, it is also the case that zero gapping has very occasionally been applied between operating company financial strength and holding company indebtedness. As regards the "composite" companies discussed in Section 5 that display both holding and operating company characteristics, these must inevitably be assessed on a case-by-case basis. If holding company characteristics are found to predominate, then the criteria likely applied would be those used for the rating of ordinary holding companies, as summarized in sections 3 and 4. Moreover, even though the entity may be eligible for an FSR given its underwriting activities, it will be assessed and rated for both its debt and its financial strength as more akin to a holding company if its holding company characteristics predominate. In such circumstances, all of its ratings, including the FSR, will be set at a lower level than that applying to equivalent Core operating companies that are free of the debt, constrained cash flows, and use of double leverage that characterize a holding company, and which are discussed in Section 2 of this article. Note The commentary, "Insurance Criteria Update: What Makes An Insurance Or Reinsurance Subsidiary 'Core' Under Group Rating Methodology?" was published March 31, 2005, on RatingsDirect, Standard & Poor's Web-based credit analysis system. Group E-Mail Address InsuranceInteractive_Europe@standardandpoors.com