Module F Unit 8C

CREDIT RATINGS – USE AND APPLICATION

Purpose

At the end of this unit the participant should be able to demonstrate an understanding of:

- Why a number of locally regulated (re)insurance entities have obtained a credit rating
- How to go about applying for a rating
- The advisors that can assist in obtaining a rating
- The benefits & efficiencies that can be achieved through having a rating

Assumed knowledge

This section assumes that the reader has a working knowledge of (re)insurance company capital requirements and fronting arrangements including the costs of collateralisation. See Unit 9

Summary of learning outcomes
1. Describe capital relief benefit provided by a rated (re)insurer.
2. Describe the preliminary credit rating process.
3. Describe annual and ongoing monitoring requirements.
4. State names of major credit rating companies
5. State advisors available to assist.
6. Explain how rating agencies are regulated.
7. Explain why companies may want two or more ratings.
8. Demonstrate knowledge of ratings, modifiers and outlooks.

CREDIT RATINGS – USE AND APPLICATION

8.0 HOW CREDIT RATINGS ADD VALUE

Typically, when an unrated (re)insurance company looks to issue a policy there is a concern as to counterparty security risk by the (re)insured. This applies equally whether it is a commercial policy issued to a third party or a captive fronting arrangement allowing the shareholder to self-insure statutory classes of business risks of the operating subsidiaries wherever they are located.

Typically, the solution will be to provide some form of collateral (see Unit 9) which is typically:

- Letter of Credit ("LoC")
- Reinsurance Trust Agreement ("RTA")
- Premiums withheld

The counterparty to whom the policy is issued requests this collateral for two principal reasons:

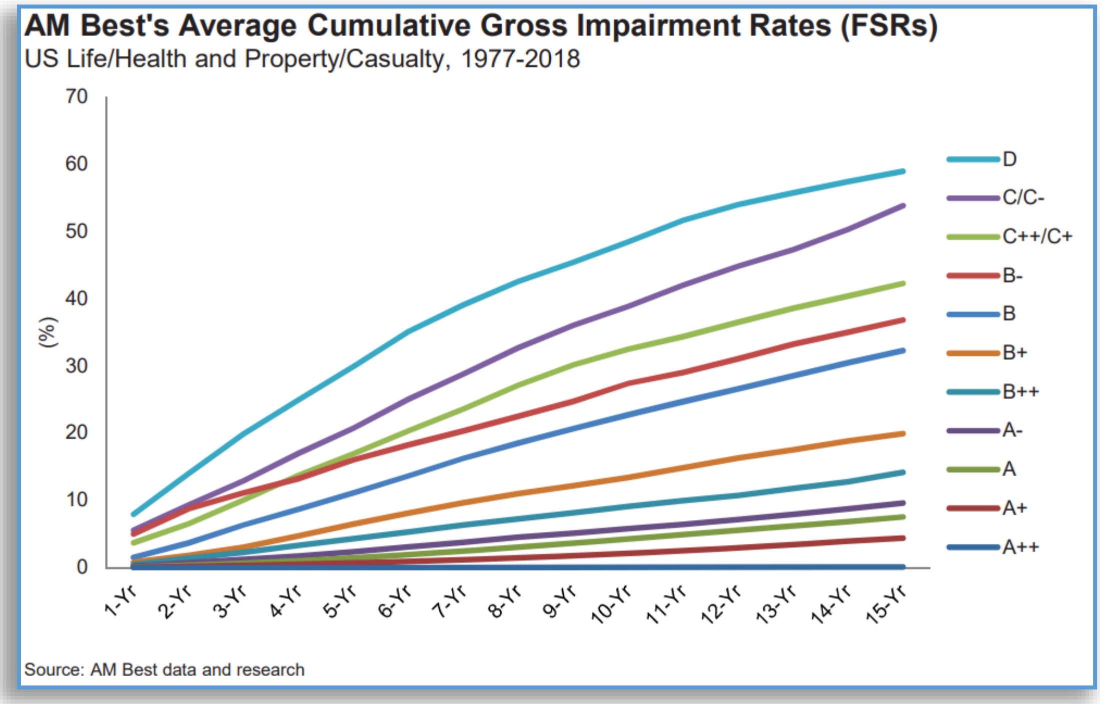
- To guarantee their ability to collect claims
- To achieve capital relief on the (re)insurance bought

If the policy is one of insurance issued to a third party, the insured will only be concerned with the first point, however if they are an (re)insurance company they will be concerned about both points.

In a discussion of the second point above, the issues of ratings becomes to a certain extant circular and this proves the success of the rating service and how indispensable it is, to not only the commercial insurance market but also regulators.

Both regulators and rating agencies are interested in the balance sheet strength of the companies they oversee. The balance sheets are supported by the cash and other investments held by the company and also the assets accrued but yet to be received. These accrued assets include principally premium and reinsurance recoveries, both of which can be assessed by the use of credit ratings.

Indeed, both rating agency models and the EU Solvency 2 capital model (there are other similar risk based regulatory solvency models in use such as the PCR in Guernsey) use credit ratings to establish how much of a charge against capital needs to be incurred in respect of default / credit risk against the assets. Basically, the lower the credit rating of the asset, the higher the risk of default and hence the capital charge. For example, where reinsurance is bought from a company rated as A- (Excellent) by AM Best, their own model, known as the Best's Capital Adequacy Ratio (or "BCAR") dictates that capital should be held assuming a circa 7% default rate (it changes based on exact circumstances), which is a very conservative measure. Below is an example of the default risk of companies rated by AM Best, this analysis allows regulators and market participants to calibrate what is the most appropriate default rate when building OSCAs or other internal capital management models.



So, it can be seen why having a credit rating allows the policyholder to take comfort that its claims will be paid and/or to receive capital relief on risk transfer, but why does this also benefit the (re)insurance company?

The (re)insurance company gains a variety of benefits including:

A. Wider access to business
B. Reduced operating expenses
C. Greater capital efficiency
D. Credibility
E. Third party oversight
F. Supports investor due diligence
G. Meeting regulatory requirement in some jurisdictions
H. Transparency
I. Stronger corporate governance
J. Better pricing and terms on inwards business
K. Greater ability to raise capital
L. Benchmarking
M. Strategic benefits to access more markets

Point A simply reflects the ubiquitous nature of credit ratings, that they facilitate the simplest means to transfer risk by providing some comfort as to the financial strength and claims paying ability of the counterparty and are therefore sought by the buyers of commercial (re)insurance. Retail policyholders typically rely on regulation to protect them and will principally make price-based decisions when purchasing insurance cover. This is not irrational as regulators work tirelessly to protect retail consumers and there are policyholder protection programmes in place which ensure no customer detriment whilst spreading claim payments around market participants (by means of annual levies) in the unlikely event that any single carrier becomes insolvent and unable to pay claims.

However, the situation for commercial buyers is more nuanced and there is an assumption that access to a wide range of capital providers is advantageous, and they are able and knowledgeable to negotiate favourable terms and ensure they understand, and take steps to protect against, counter-party insolvency risk. This sophisticated buyer model typically dictates that commercial policyholders will request that collateral is posted to support the limit of the insurance purchased from unrated entities (as the risk of default is higher than that of a rated entity). Issuing this collateral has disadvantages for several reasons:

- It incurs cost
- It ties up capital
- It reduces investment opportunities

Taking each of these points in order, LoCs and RTAs are issued by regulated and rated banks and involve a detailed (and sometimes time consuming) process to set them up. As a consequence, there is a cost involved, typically a set up cost and ongoing annual maintenance fee. In addition to the costs of setting up the collateral the (re)insurer will need to retain a treasury team of its own to set up and monitor the collateral accounts. Furthermore, once the policy expires the same team will need to work with the counterparty to secure the release of collateral; a process which can take several years throughout which costs continue to accrue for all parties.

It also ties up capital by forcing the (re)insurer to set aside all or a proportion of the limit to cash held by the issuing bank as collateral against the LoC / RTA. This means that the amount guaranteed by the bank has to first be deposited with them and held in security / trust against the risk of default / non-payment of claims by the (re)insurance company. As such this capital is not fungible and cannot be applied to underwrite additional business. When looking at the financial statements of rated (re)insurance companies it can be seen that GWP & Capital are typically similar, i.e. a company with $1bn of capital underwrites $1bn of premium. Given that premium is always a much smaller percentage of the overall limit, one can assume the total limits outstanding by the (re)insurer will be ten times or greater, than the capital held. This leverage is simply not possible should the company be required to collateralise all the outstanding limits. Furthermore, by not being able to use leverage, the underwriting returns possible are also much smaller. For example, if the company underwrites one line of business with an assumed combined ratio of 95% one can assume a 5% profit margin. But if you can write five lines of business against the same capital due to leverage you might expect a return 25%, demonstrating how important leverage is to (re)insurance companies.

It is also worth noting that many (re)insurance policies are issued with a per event limit (or reinstatements in the case of reinsurance). These further increase the limits committed by the (re)insurance company and reflect even greater leverage achieved by the use of a rating, thereby removing the need to post collateral. As an example, it is very hard to underwrite property catastrophe policies with a reinstatement if you need to collateralise the limit(s). As such, collateralised markets often focus on aggregates and singe loss policies which are less favourably priced, in many instances, due to the function of reinstatement premiums.

The other restriction of collateralising LoC / RTAs is it restricts the opportunities available to invest the capital of the company. Typically, the funds held in trust / security have a limited range of investment options and these are set by the bank, with a principal concern being capital preservation (to reduce their own credit risk and capital allocation). As such funds invested are usually limited to cash, money market funds and government bonds, which may be very secure but offer smaller returns and greater concentration risk.

Given everything stated here, obtaining a credit rating is clearly very beneficial. Next we will discuss how to obtain and maintain a credit rating.

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CREDIT RATINGS – USE AND APPLICATION

8.1 THE RATING AGENCIES AND ADVISORS

Rating agencies are private companies that are motivated by profit. However, that profit motivation must be closely balanced with ensuring they maintain a strong reputation in respect of the credibility of the ratings they issue, otherwise their product would lose its value and the business would only have a declining value.

The rating agencies are fastidious in separating the business development / commercial side of the rating of a business from the analysts who undertake the review. This extends to the situation whereby the analysts are not aware as to what fee is paid by the company to the rating agency. Given the company needs to have complete financial transparency with the rating agency, this can sometimes be an issue and needs to be given consideration when releasing the company's P&L to the analysts, with any rating agency costs hidden in other professional fees or elsewhere to respect these sensitivities.

Nationally Recognised Statistical Rating Organisations ("NRSRO") include nine global agencies which are recognised by US regulators. Of these, the most recognised in the (re)insurance industry are:

- AM Best ("AMB")
- Fitch
- Moodys
- Standard and Poor (S&P)
- KBRA

Whilst these are the best known there are a number of others:

- Demotech
- Dagong
- Dun & Bradstreet
- Many regional and / or nationally owned rating agencies

KBRA is a newer rating agency whose influence is growing in the insurance sector having started as an agency which solely rated bonds. They now issue a credit rating for Lloyd's of London and a small number of additional (re)insurance companies. They, like AM Best, are willing to rate start-up companies which is an important differentiator. Demotech is really only seen in the US and they provide ratings where the main agencies may lack niche expertise, from a commercial perspective they are mainly seen rating Florida insurers.

Of the 5 rating agencies identified above, AMB and S&P are most closely associated with (re)insurance companies. AMB specialises in the insurance sector and is most often used by companies and / or referred to, as such they will be discussed more deeply here.

All of the rating agencies publish the rating protocols they follow and these can be found on their websites. They also regularly publish technical materials and host conferences to increase awareness of their services and credibility.

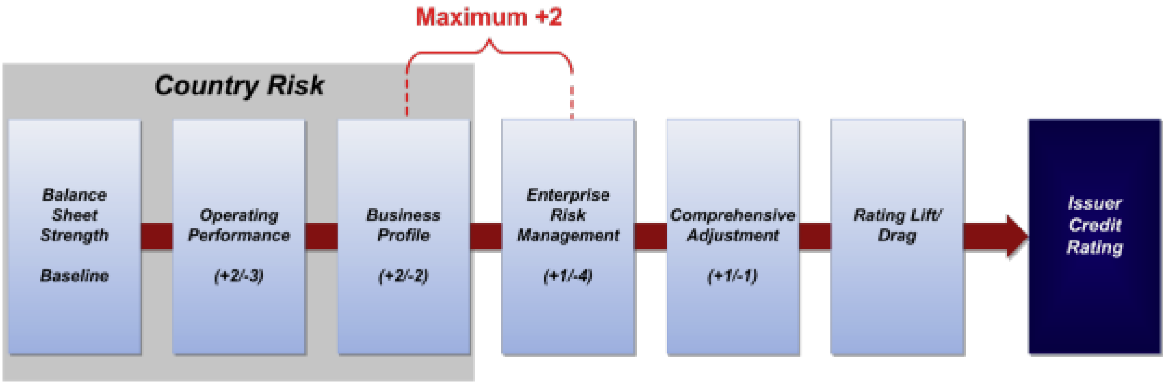
When speaking to a rating agency they will recommend not engaging professional advice, as they believe the candour developed through a direct relationship is invaluable to the rating process. Nonetheless many companies find the rating process intimidating and believe the use of a professional advisor is useful to prepare for both the initial rating and the annual management meeting. In response to this demand there has developed a wide array of advisors who will offer this service. The below is not meant to be an exhaustive list:

- The big four accounting firms, have departments within their advisory business,
- the major brokers including Aon and Marsh
- niche consultancy firms like Litmus Analysis

All will advise on how to obtain, maintain and improve a rating.

Example
Download the AMB rating protocol for international (re)insurers and identify the main rating pillars which they use This will assist with your understanding of the next section.

https://www3.ambest.com/ambv/ratingmethodology/



Above is a summary of the different pillars assessed by AM Best but by following the highlighted link and finding the relevant protocol you will learn more as to how each one is assessed and better understand the process.

8.3 THE INITIAL RATING AND ANNUAL MONITORING SERVICES

There are a wide array of sources available online both from the rating agencies and advisors which describe in detail the rating process. As such this text only provides a cursory introduction.

Ahead of engaging the rating agency it is important to work with their commercial departments to negotiate financial terms and enter into their standard agreements which will govern confidentiality and how the rating agency will publish and use your rating / data.

Once this is completed an analytical team will be allocated to your company, typically consisting of a lead analyst (day to day contact) and a senior analyst who will attend major meetings (especially the annual management meeting). Should either analyst be unavailable, another colleague will act as alternate as the team will always work with at least one other colleague as back up.

The Preliminary Credit Rating ("PCR") will be issued based upon the multi-pillared approach for all ratings. If it is an existing trading company the investigation will look at the existing financial performance and overlay the expected benefits of a credit rating. However, should it be a new start up they will look at the business plan, the experience of the team setting up the business and previous proven track record along with the balance sheet strength of the company. The rating will not be issued until the capital is received and confirmed by a third party.

The ongoing monitoring is focused on a detailed annual management meeting. This allows the analytical team to understand what the key issues to management are and ask any additional information needed to gain a solid understanding. They will use this information as well as their standard analytical ratios to prepare an internal report which will be presented to a Rating Committee. This will include several senior members of the rating agency and they will benchmark the company against peers and allocate a rating.

Beyond the annual management meeting (which goes into detailed discussion of the business strategy and what the next 3-5 years should mean for the company), there is also quarterly reporting which is required. This can be in the form of a standard data sheet or, by agreement, the company's management accounts. Beyond the scheduled interactions (and much like dealing with the GFSC) the company should keep the rating agency apprised of any changes to the business plan whether planned or unexpected. A planned event might be the decision to start underwriting a new class of business due to exceptional market situations which meant that it was not originally envisaged when preparing the 3-5 year business plan. An unexpected event might also be a large industry loss which, whilst likely to be included in the company's solvency model, would be too extreme to be included in the business plan. The rating agency will expect the company to demonstrate a good understanding of the potential financial impact to the company, what the resultant capital impact will be and how this translates into the rating agency's proprietary model. It is quite possible that the event is so extreme that the capital position will become below the level required to meet the company's current credit rating and accordingly a plan will be proposed as to how additional capital will be raised (for a captive this would likely be from the existing shareholder).

Credit ratings are usually expressed as letters and symbols. "A" and "+" assessments are considered strong and anything below BBB is considered non-investment grade aka "junk" rating which insureds and their brokers may find not acceptable. A- (A minus) considered an Excellent strength rating by AM Best and is better than BB+, despite this rating having a + symbol. There is in Fig 1.1. a chart showing how various rating agencies assign strength ratings and a narrative as to how the rating should be interpretated. It is also worth looking at the historical default rates from a range of AM Best ratings in section A.

The regulations that govern rating agencies will dictate that a credit report is released no less frequently than every 13 months. This will update the credit rating and likely reaffirm the existing rating as changes tend not to be frequent. Beyond the credit rating, the agency will also assign an outlook, which could be:

- Positive
- Stable
- Negative

Irrespective of the outlook the rating agency will also state what events might lead to a rating upgrade or downgrade in the near or medium term. These will typically be fairly remote events as the assumption would be for a stable rating over the medium term. However, as the possibility of a change approaches the rating agency may use these events to signpost a change in rating.

Beyond the outlook there are also rating modifiers that relate to the status of the company and these could include:

- Start-up
- Run-off

When a company has a start-up modifier applied (usually during the first 3-5 years) there will be additional capital drags added in the standard capital models used. This is fairly logical as reserving risk is usually calculated based on the level of outstanding losses, which at the start will be not fully developed. As such this risk charge relating to reserves normally will increase over time and offset to some extent the reducing start-up capital charge.

When the credit report is drafted, the company has the opportunity to review it for factual inaccuracies and confidential information, but otherwise it is composed by the rating agency. Furthermore, the latest credit report should always be downloaded from the rating agency website, to ensure the user has the latest report but it should be noted that the agency can change the content report at any time should new information come to light.

As stated previously only AMB and KBRA will provide a rating based upon a business plan for a start up. The other rating agencies require several years of audited accounts and a proven track record by the management team. However, paradoxically without the rating it is hard to start and grow the business. Accordingly, companies look to use fronting paper or perhaps a Lloyd's syndicate to grow the business before converting to their own rated paper, as a result the rating can have immediate cost efficiencies.

Finally, it should be understood that group subsidiaries can often achieve its group's rating quite easily. This can apply to both (re)insurance groups and others that maintain a rating. For (re)insurance groups this might be achievable merely through the use of inter-group reinsurance or a guarantee providing comfort to the rating agency. When this approach is taken it might not be necessary for the subsidiary to prepare for annual management meetings or provide quarterly reporting as this can be provided by the parent on a consolidated basis. Accordingly for captives within groups which have existing credit ratings it might be simpler to obtain a rating and thereby write risk on a direct basis, which could materially reduce the cost and collateral required for structure fronted insurance programmes.

8.4 MULTIPLE CREDIT RATINGS

Having discussed why a company might have a credit rating and the process for obtaining and maintaining a credit rating, the issue of multiple credit ratings will be explored.

There a several costs incurred by a company to have a credit rating. The most immediate is the fee paid to the rating agency to maintain the rating. However, the management time incurred keeping the rating agency apprised and all the other work necessary to maintain a credit rating is also very significant.

There are nonetheless a number of good reasons to maintain multiple ratings. A principal factor is likely to be greater access to business. Just as one rating will allow you to access business in many instances, security committees of brokers and (re)insurance buyers will take greater assurance provided by being able to review the credit reports of multiple rating agencies. Furthermore, the different rating agencies have different approaches and in some instances capital models used to assess the relative strength of a company. Accordingly having multiple views of the company can give counterparties greater comfort. It is also possible that a buyer will not recognise all rating agencies or certain rating agencies are more acceptable in different territories and business sectors and therefore to underwrite business globally, several ratings may be required.

Regulatory requirements are further reasons to obtain a second rating. The most material is likely to be the requirement to post collateral against US loss reserves on alien (i.e., non US regulated) reinsurers. The National Association of Insurance Commissioners ("NAIC") can recognise jurisdictions as having equivalent legislation to its own and the GFSC could be considered as such. However, in addition to Guernsey requiring NAIC approval, the companies regulated in Guernsey would need to have a minimum of two NRSRO credit ratings to receive approval and therefore be exempt from posting collateral against outstanding reserves. As another example Chile will only allow non-admitted reinsurance where the reinsurer has a minimum of two credit ratings. There will be numerous other examples but these two demonstrate the point.

It might also be the case that a company has started underwriting using a rating agency willing to provide a start-up rating. Having traded for several years on this rating it is then possible to be assessed by a rating agency that will not assess start up companies. Accordingly obtaining such a rating makes a public statement that the company has matured beyond a start up.

A benefit purely to the company is the assurance that can be obtained from recognising that should one rating agency plan to downgrade the company, that rating can be withdrawn from the public domain and instead reliance made on the alternative agency which has a more favourable view of the balance sheet strength and / or business plan. Furthermore, it is possible that one rating agency might assess a company to be nearing a rating upgrade and this will provide an incentive for other agencies to consider whether an upgrade is also appropriate.

8.5 RATING AGENCY REGULATION

The regulatory position for rating agencies is little different to other financial services companies, in that there can be multiple regulators such as:

- FCA
- ESMA
- SEC

A situation developed quickly following the 2007/08 financial crises where many sovereign countries were concerned as to credit agencies amending the ratings of their debt and the consequential impact on their cost of borrowing etc. In addition, rating agencies were unsuccessful in alerting investors as to impending company failures or slow to issue material rating downgrades causing market distress. Accordingly, the breadth of regulatory bodies looking at rating agencies' performance increased as well as an increased level of focus. Brexit further impacted this process as until this point most international agencies monitored European companies' ratings using London based teams, regulated by the FCA. However, following the loss of regulatory equivalence as a consequence of Brexit, the EU required that (re)insurance companies within the EU, received ratings issued from within the EU, which required additional offices to be opened and greater regulatory oversight provided by ESMA.

Reference sources for reader:
https://www.litmusanalysis.com/litmus-guides/ this is more a practical guide as to how to get a rating rather than a why get a rating.

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CREDIT RATINGS – USE AND APPLICATION

KBRA'S INSURANCE FINANCIAL STRENGTH RATINGS (IFSR)

AAA	The insurer's financial condition is extremely strong and there is almost no risk of the entity not meeting its policyholder obligations.
AA	The insurer's financial condition is strong and the entity is highly likely to meet its policyholder obligations under severe economic, financial and business conditions.
A	The insurer's financial condition is sound and the entity is likely to meet its policyholder obligations under difficult economic, financial and business conditions.
BBB	The insurer's financial condition is adequate but may be susceptible to adverse changes in economic, financial and business conditions that could affect the entity's ability to meet its policyholder obligations.
BB	The insurer's financial condition is questionable and is susceptible to changes in economic, financial and business conditions that could affect the entity's ability to meet its policyholder obligations.
B	The insurer's financial condition is weak and is highly susceptible to changes in economic, financial and business conditions that could affect the entity's ability to meet its policyholder obligations.
CCC	The insurer's financial condition is very weak and changes in economic, financial and business conditions are likely to affect the entity's ability to meet its policyholder obligations.
CC	The insurer's financial condition is poor and changes in economic, financial and business conditions are highly likely to affect the entity's ability to meet its policyholder obligations.
C	The insurer's financial condition is very poor and changes in economic, financial and business conditions will affect the entity's ability to meet its policyholder obligations.
D	KBRA defines the default of an insurance operating company as occurring if the rated entity fails to meet its policyholder obligations.
R	Due to its financial condition, the insurance operating company is under regulatory supervision.

RATING CORRELATION

KBRA IFSR	A.M. Best FSR	S&P/ Fitch	Moody's
AAA **AA+**	A++	AAA AA+	Aaa Aa1
AA **AA-**	A+	AA AA-	Aa2 Aa3
A+ **A**	A	A+ A	A1 A2
A-	A-	A-	A3
BBB+ **BBB**	B++	BBB+ BBB	Baa1 Baa2
BBB-	B+	BBB-	Baa3
BB+ **BB**	B	BB+ BB	Ba1 Ba2
BB-	B-	BB-	Ba3
B+ **B**	C++	B+ B	B1 B2
B-	C+	B-	B3
CCC+ **CCC**	C	CCC+ CCC	Caa1 Caa2
CCC- **CC**	C-	CCC- CC	Caa3 Ca
C	D	C	C
D	E/F	D	-

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CREDIT RATINGS – USE AND APPLICATION

Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. Please consider whether any of the companies you work with would benefit from obtaining a credit rating? Please discuss your thoughts with a colleague including whether you believe there are any factors inhibiting obtaining a rating.

2. Download the AM Best rating protocol for international (re)insurers, what are the main rating pillars applied in its analysis?

3. Consider the different outlooks assigned by the rating agencies. What factors might lead to each being assigned?

4. Which agencies are more likely to be approached for a second rating by a start up (re)insurance company?

5. What was the principal impact of Brexit on international rating agencies?

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CREDIT RATINGS – USE AND APPLICATION

Summary of learning outcomes
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5. State advisors available to assist.
6. Explain how rating agencies are regulated.
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