STANDARD
&POOR'S

A Guide to Analysis of Insurer Financial Strength

European Life, Non-Life and Reinsurance Edition

Along with our renowned reputation in the credit rating business, we are also one of the world's pre-eminent providers of financial investment information.

CONTENTS

Standard & Poor's - A Global Leader in Risk Assessment 3

Standard & Poor's Insurer Financial Strength Rating Definitions 4

Standard & Poor's Rating Methodology for Insurance Companies 6

1. Economic & industry risk 6
2. Competitive position 6
3. Management & corporate strategy 6
4. Enterprise risk management 7
5. Operating performance 7
6. Investments 7
7. Liquidity 7
8. Capital adequacy 8
9. Financial flexibility 8

Insurance Linked Securities & Operational Leverage 9

Standard & Poor's Treatment of Debt Raised by an Insurer 10

The Rating Process - Start to Finish 11

Standard & Poor's Methodology for Analysing Insurance Groups 12

Core subsidiaries 12

Strategically important subsidiaries 13

Nonstrategic subsidiaries 14

How group ratings are assigned 14

Special situations 15

Explicit support 15

Group methodology summary 15

Frequently Asked Questions 16

Contacts 20

“We have a universally acknowledged and unsurpassed track record for reliability.”

STANDARD & POOR'S A GLOBAL LEADER IN RISK ASSESSMENT

Standard & Poor's Rating Services is a leading provider of rating services with an extensive international network, combining global standards with local awareness and understanding.

Keeping Pace

The last decade has seen significant growth in the financial markets, both in geographic scope and the number and complexity of financial products. In this changing environment we have taken the lead in expanding our analytical and financial information services.

Today, Standard & Poor's employs an extensive network of people working in 21 countries around the world. Along with our renowned reputation in the credit rating business, we are also one of the world's pre-eminent providers of financial investment information.

Standard & Poor's has demonstrated a commitment to Europe by employing local expertise in seven European cities (London, Paris, Frankfurt, Stockholm, Madrid, Milan, Moscow).

Serving the market

Despite extensive market changes, our core values remain the same: to lead the way in providing high quality, objective analytical opinions and information to the world's financial and commercial markets.

These markets include:

- Corporates & Industrials
- Financial Institutions & Insurance
- Project and Infrastructure Finance
- Sovereigns, Local & Regional Governments
- A wide variety of Asset Backed Classes

Standard & Poor's operates under the following principles:

Independence:

- Standard & Poor's operates with no government mandates and is independent of any investment banking firm, bank or similar organisation.

- In matters of credit analysis and ratings, Standard & Poor's Rating Services operates independently from other units of Standard & Poor's and the McGraw-Hill Companies.

Integrity:

- We have a universally acknowledged and unsurpassed track record for reliability. Our annual default studies clearly demonstrate that our ratings are credible indicators of default, as there is a clear correlation between our ratings and credit performance.

Objectivity:

- Our analytical group structure bolsters our ability to make objective judgements based on industry-specific credit expertise and local market knowledge, while consistently applying our analytical criteria.

- For each rating, our objective is to field the most appropriate team, spanning our international network and analytical disciplines. Rating committees are composed of analysts from across our global network to ensure an unbiased and balanced evaluation.

Disclosure:

- We believe it is important that users of our ratings understand our process and approach, therefore we regularly publish reports on the definitions, criteria and methodology of our ratings.

STANDARD & POOR'S INSURER FINANCIAL STRENGTH RATING DEFINITIONS

Life, Non-life & Reinsurance

A Standard & Poor's Insurer Financial Strength Rating is a current opinion of the financial security characteristics of an insurance organisation with respect to its ability to pay under its insurance policies and contracts in accordance with their terms. In some life insurance markets, policy terms may include (whether implicitly or explicitly) a reasonable expectation of future bonuses on any policy held to maturity. This opinion is not specific to any particular policy or contract, nor does it address the suitability of a particular policy or contract for a specific purpose or purchaser.

Furthermore, the opinion does not take into account deductibles, surrender or cancellation penalties, timeliness of payment, nor the likelihood of the use of a defence such as fraud to deny claims. For organisations with cross-border or multinational operations, including those conducted by subsidiaries or branch offices, the ratings do not take into account potential that may exist for foreign exchange restrictions to prevent foreign currency financial obligations from being met.

Insurer Financial Strength Ratings are based on information furnished by the rated company or obtained by Standard & Poor's from other sources it considers reliable. Standard & Poor's does not perform an audit in connection with any rating and may on occasion rely on unaudited financial information. Ratings may be changed, suspended, or withdrawn as a result of changes in, or unavailability of such information or based on other circumstances.

Insurer Financial Strength Ratings do not refer to an organisation's ability to meet nonpolicy (i.e. debt) obligations. Assignment of ratings to debt issued by insurers or to debt issues that are fully or partially supported by insurance policies, contracts, or guarantees is a separate process from the determination of Insurer Financial Strength Ratings, and follows procedures consistent with credit ratings definitions and practices. Insurer Financial Strength Ratings are not a recommendation to purchase or discontinue any policy or contract issued by an insurer or to buy, hold, or sell any security issued by an insurer. A rating is not a guarantee of an insurer's financial strength or security.

Insurer Financial Strength Ratings

*An insurer rated in the 'BBB' range or higher is regarded as having financial security characteristics that outweigh any vulnerabilities, and is highly likely to have the ability to meet financial commitments. Ratings from 'AAA' to 'BBB-' inclusive are often described as **'secure'** or **'investment grade'**.*

AAA

An insurer rated 'AAA' has EXTREMELY STRONG financial security characteristics. 'AAA' is the highest Insurer Financial Strength Rating assigned by Standard & Poor's.

AA

An insurer rated 'AA' has VERY STRONG financial security characteristics, differing only slightly from those rated higher.

A

An insurer rated 'A' has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

BBB

An insurer rated 'BBB' has GOOD financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers.

*An insurer rated 'BB' or lower is regarded as having vulnerable characteristics that may outweigh its strengths. 'BB' indicates the least degree of vulnerability within the range; 'CC' the highest. Ratings between BB+ and CC are often described as **'vulnerable** or **'non-investment grade'**.*

BB

An insurer rated 'BB' has MARGINAL financial security characteristics. Positive attributes exist, but adverse business conditions could lead to insufficient ability to meet financial commitments.

B

An insurer rated 'B' has WEAK financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.

CCC

An insurer rated 'CCC' has VERY WEAK financial security characteristics, and is dependent on favourable business conditions to meet financial commitments.

CC

An insurer rated 'CC' has EXTREMELY WEAK financial security characteristics and is likely not to meet some of its financial commitments.

R

An insurer rated 'R' has experienced a REGULATORY ACTION regarding insolvency. The rating does not apply to insurers subject only to nonfinancial actions such as market conduct violations.

NR

An insurer designated 'NR' is NOT RATED, which implies no opinion about the insurer's financial security.

Plus (+) or minus (-) signs following ratings from 'AA' to 'CCC' show relative standing within the major rating categories.

Outlooks are carried on Counterparty Credit and Insurer Financial Strength Ratings, although not on short-term, debt, 'pi' and Financial Enhancement ratings do not. An Outlook normally indicates the likely direction of the rating over the next 18 – 24 months. A positive Outlook indicates the possibility of the rating being raised, while a negative Outlook implies the possibility of a downgrade. In both cases, the reasons underlying the view are explained in the published 'Ratings Rationale', together with an indication of the specific circumstances that would likely precipitate the potential rating change. Outlooks can also be stable, indicating the rating is expected to stay the same.

CreditWatch highlights the potential direction of a rating over a 90 day period, focusing on identifiable events and short-term trends that cause ratings to be placed under special surveillance. The events may include mergers, recapitalisations, voter referenda, regulatory actions, or anticipated operating developments. Ratings appear on CreditWatch when such an event or a deviation from an expected trend occurs and additional information is needed to evaluate the rating. A listing, however, does not mean a rating change is inevitable. A positive CreditWatch designation means that there is at least a 50% possibility of the rating being raised; negative means at least a 50% possibility of a downgrade; developing means that a rating may be raised, lowered or affirmed dependent upon the outcome of current events affecting the rating company.

'pi' Ratings denoted with a 'pi' subscript, are Insurer Financial Strength Ratings based on an analysis of published financial information and additional non-confidential information received from the company or in the public domain. They do not reflect in-depth meetings with an insurer's management and are based on less comprehensive information than traditional 'interactive' ratings without a 'pi' subscript. 'pi' ratings are reviewed annually by a full committee of senior analysts, but may also be reviewed on an interim basis. 'pi' ratings are not subject to potential CreditWatch listings.

National Scale Ratings denoted with a prefix such as 'ru' (Russian), 'mx' (Mexico) or 'ra' (Argentina), assess an insurer's financial security relative to other local insurers.

Standard & Poor's also assigns ratings in certain countries using the standard AAA - CC classifications but qualified by a national prefix to show that these ratings are relative to other local insurers and not to the international rating scale. National ratings are currently assigned in Argentina, Mexico, Russia, Turkey. ■

STANDARD & POOR'S RATING METHODOLOGY FOR INSURANCE COMPANIES

Standard & Poor's rating methodology uses a wide variety of both qualitative and quantitative information. While much of the rating process is objective in nature - i.e., drawing on numeric analysis - a large part is also based on subjective analysis and opinion. This subjectivity allows Standard & Poor's to fully incorporate a variety of non-statistical issues into the analysis and to impute an appropriately "forward-looking" perspective into company ratings.

Given the wide variety of insurance company types, countries of domicile, accounting and financial reporting conventions, and regulatory regimes, it is not possible to apply uniform quantitative techniques to all companies across all regions.

Nevertheless, there is a common analytic framework that runs through all Standard & Poor's insurance ratings. The rating methodology involves detailed analysis in the following specific areas: country and industry risk, competitive position, management and corporate strategy, enterprise risk management, operating performance, investments, capital adequacy (including reinsurance adequacy and reserve adequacy), liquidity, and financial flexibility.

1. Economic and industry risk

Economic and industry risk is the macro economic environmental framework in which an insurance company operates.

Key points considered are:

- Potential threat of new entrants in the market
- Threat of substitute products or services
- Competitiveness/volatility of the sector
- The potential "tail" to liabilities or risk of catastrophic losses
- The existence of life insurance policy guarantees
- Bargaining power of insurance buyers and suppliers
- Strength of regulatory, legal, and accounting frameworks in which the insurer operates
- Exposure to Government political, currency and credit risk

2. Competitive position

Standard & Poor's analyses the insurer's sources of competitive advantage as well as its overall micro economic business profile with the aim of evaluating its long-term revenue-generating capacity. The analysis looks at the company's past and present position, but concentrates on how Standard & Poor's believes the company will fare going forward, given its particular strengths and weaknesses, strategy, and the likely competitive climate.

Key points considered are:

- The company's competitive strengths and weaknesses
- The organisation's legal and functional structures
- Quality and spread of distribution channels
- Diversification of business mix - by geography, sector, line of business, distribution source
- Growth rates of premiums (and new business written for life companies) - in total and by line of business - on both net and gross bases, generally over five years
- Market share overall and by major lines of business
- Related non-insurance activities

3. Management & corporate strategy

Management and corporate strategy is one of the more subjective areas in the rating methodology, but also one of the most critical. The quality and credibility of an insurer's management team is a

key determinant in how successful that company will be.

Standard & Poor's looks at three main areas:

- The strategic positioning/focus of the insurer
- Operational controls and skills
- Financial strategies and management's risk tolerance

4. Enterprise Risk Management

Although aspects of risk management will be discussed under most of the other analytical areas outlined in these pages, ratings analysts will also dedicate a reasonable amount of time when talking to senior management to a specific and detailed discussion of the whole process of Enterprise Risk Management (ERM). This ERM evaluation will look for systematic and consistent practices that will enable risks and losses to be managed and controlled in a predictable manner within an optimal risk/reward structure. All ERM practices will be assessed relative to realistic levels of risk at the company, and relative to peers with similar risks. Standard & Poor's evaluates ERM quality in five areas:

- Risk Management Culture: the degree to which risk and risk management are important considerations in all corporate decision making
- Risk Controls: processes to identify, measure and monitor risks; setting and enforcing risk limits and managing risks to meet those limits through risk avoidance, risk transfer and risk offset or other risk management processes
- Extreme Risk Management: processes to anticipate and address new or emerging risks including very low frequency high severity events
- Risk and Economic Capital Models: a company's own risk capital modeling

often constitutes the technical backbone of the ERM process, providing the information needed for many ERM processes
- Strategic Risk Management: processes applied to incorporate the ideas of risk, risk management and return for risk into corporate strategic decision making

5. Operating performance

Standard & Poor's determines how a company's ability to implement its strategies, capitalize on its strengths, and manage its weaknesses, translates into operating performance.

The analysis of operating/underwriting performance looks at:

For non life companies:

- Loss ratios - total company and for major sectors or lines of business
- Expense ratios
- Combined ratios - total company and for major sectors or lines of business
- Operating ratios (combined ratios adjusted for investment income as a percentage of net premiums earned)
- Return on revenue (both pre-tax and post-tax, with and without realised gains)

For life companies:

- Development of embedded value (including the sources of embedded value growth, especially new business)
- Statutory basis profitability
- Return on assets (both pre-tax and post-tax)
- Bonus performance
- Persistency
- Investment return
- Mortality and morbidity

The analysis of all company's overall performance focuses on:

- Diversity of earnings by business unit, sector, product line, distribution channel
- Stability/volatility of earnings
- Return on equity
- Return on capital
- How the strength of reserving/accounting practices may affect reported figures

6. Investments

Of key importance here is how the insurer's investment strategy fits with its liability profile, and to what extent investment results contribute to total company earnings.

Key investment issues include:

- Management's approach to accepting, measuring, and managing risk from investment activities
- Asset allocation strategies
- Asset credit quality
- Asset diversification (by asset class, sector, maturity, issuer)
- Portfolio liquidity
- Investment returns (current yields and total returns)
- Asset valuation ("hidden" asset values; market values versus book values)
- Capital gains realisation strategies
- Asset/liability management
- Interest rate and foreign exchange management practices
- Use of derivatives and other financial instruments

7. Liquidity

This section combines both qualitative and quantitative analysis. Standard & Poor's focuses on an insurer's three primary sources of liquidity:

- Cash flows
- Investment portfolio liquidity
- Credit facilities

The first tier of liquidity is cash flow. Underwriting cash flows are comprised of premium revenues received, less paid claims, commissions, and operating expenses. Over time, all financially healthy insurers need to demonstrate positive underwriting cash flow ratios.

However, Standard & Poor's recognises that for non-life companies, cash flows may be somewhat volatile year to year. Also, different business mixes between insurers may also contribute to dissimilar underwriting cash flow patterns.

Underwriting cash flows may closely track underwriting results for a company writing a short-tail portfolio of business, but writers of long-tail business may find underwriting results affected by reserving issues that do not immediately affect. Investment income is a significant and reliable source of cash flow for mature life insurers. The importance of liquidity is affected by the extent to which early policy termination values are guaranteed and how closely an insurer matches its assets and liabilities by duration.

The second tier of liquidity is the investment liquidity. This analysis takes into account the amount of cash deposits that are retained within the investment portfolio and the degree to which other investments are readily realisable.

The final tier of liquidity is credit facilities. Standard & Poor's inquires whether the insurer maintains committed bank lines or credit facilities with financial institutions that could provide access to liquidity at short notice.

8. Capital adequacy

Standard & Poor's focuses on capital adequacy in two ways: first at the level of capital needed by insurers to support their business needs at a given rating level, and second from a structural and quality of capital perspective. In most cases, analysis will go beyond the insurer being rated and will look at the entire group of which the rated insurer is a part, and will involve holding company analysis as well (where applicable). Additionally, Standard & Poor's has developed a risk-based capital model that simulates these factors and develops a capital adequacy ratio. The model plays an important role in influencing our view of an insurer's capital strength, but is only one tool in the rating process.

The evaluation of capital adequacy also looks at how highly leveraged (or geared) an insurer, or insurance group, may be. Key leverage benchmarks include financial leverage, reserve leverage, and investment leverage. Financial leverage ratios typically reviewed include:

- Debt/capital (capital defined as debt plus equity)
- Hybrid debt/capital
- Debt + hybrid/capital
- Interest coverage
- Fixed charge coverage
- Hybrid equity/total equity

9. Financial flexibility

In this section, where the analysis is primarily qualitative, Standard & Poor's looks at an insurer's potential needs for additional capital or liquidity in the future, and compares it to the sources of additional capital or liquidity that may be available. Restricted access to additional funds may not pose a serious problem for a company, provided its potential needs are equally limited. ■

INSURANCE LINKED SECURITIES

Opportunities for insurers to increase capacity by using the capital markets have increased significantly in recent years. Traditional catastrophe bonds transfer potentially high layer catastrophic losses (that can impair an insurer's balance sheet) to the capital markets.

Securitization of the embedded value (profit) within portfolios of life insurance policies have served to improve the fungibility of capital of groups while redeploying the released capital in new business when market rates were hard. The appetite in the open market for such insurance linked assets is still relatively undeveloped, however, as spreads on issuance are still somewhat wider than the ratings on the bonds would suggest.

Although securitization involves additional fixed costs, including legal fees and structuring fees, this approach has become increasingly competitive and forms a more cost effective and flexible capital raising tool for managing amortizing risk assets than reinsurance or pure equity.

Insurance linked securities, like other classes of securtization, may be either indemnifying or funded structures and they may also be classified as true sale or synthetic. Standard & Poor's reviews true sale structures and the related opinions within the context of the transaction. The analysis looks at the degree of recourse to the insurer as well as whether servicing or other obligations can be easily performed by third parties. If a true sale can be accomplished, the securitized obligations can be off-balance sheet from an accounting perspective. Indemnity structures provide pools of cash that are available to absorb insurance losses should the risks develop to sufficient levels to trigger the securitization structures. **Given the nature of the insurance assets and the variations in securitization structures being proposed, Standard & Poor's views insurance linked securities as a developing field, and works with the market to develop rating criteria that are appropriate for insurance assets and structures.**

Operational leverage

Increasingly, insurance assets that are potentially securitizable are funded on-balance sheet by liabilities that are closely matched to the cash flow performance of the assets. Insurers and reinsurers may choose to warehouse these assets and raise matching liabilities, with both assets and liabilities therefore expanded in what may be termed an 'on-balance sheet securitization'.

Where it can be shown that any mis-match between assets and liabilities is at an extremely low level Standard & Poor's may apply lower capital charges within that insurer's capital model and an operational leverage determination may be made on the debt raised.

However, Standard & Poor's makes qualitative judgments about the relative proportion of an insurer's or reinsurer's remaining book; in particular as to whether the remaining book is of lesser credit quality than the book that is potentially securitizable. Standard & Poor's also makes qualitative judgments about the robustness of the legal framework for ring-fencing security. ■

STANDARD & POOR'S TREATMENT OF DEBT RAISED BY AN INSURER

Standard & Poor's accepts that there can be a legitimate role for debt capital in an insurer's overall capitalization. Dependent upon circumstances, ratings criteria accepts that from 15% to 25% of an insurance group's Adjusted Capital (i.e. economic capital) may be in the form of eligible hybrid equity. In order to be eligible, the hybrid capital must meet four basic requirements:

1. If applicable, it must be acceptable to local regulators as eligible solvency capital
2. It must be subordinated, ideally to all but common equity
3. It must be reasonably permanent (i.e. of at least 10 year initial maturity though preferably undated)
4. Interest must be appropriately deferrable without creation of an event of default

In special circumstances, other allowances may apply. For example, the very equity-like characteristics of certain three-year mandatory convertible securities may allow additional hybrid equity credit for such instruments to be allowable.

Meanwhile, to the extent that ordinary debt rather than eligible hybrid equity is raised, Standard & Poor's has tolerances both as regards the level of financial leverage and the level of debt servicing costs as a function of earnings. Both are deemed consistent with each rating level. Such tolerances are summarised in the box (left).

A. Financial Leverage (i.e. Non-Hybrid Debt) Tolerances

Ordinary Debt Leverage Ratio = **Total Debt** (net of eligible hybrid equity) / Adjusted Capital + Debt not included as hybrid

	Maximum as % of group (or rated entity) Capital + Debt
AAA	<15%
AA	15% - 25%
A	25% - 35%
BBB	35% - 45%
BB	45% - 65%
B	>65%

B. Interest and Fixed Charge Coverage Tolerances

Interest Coverage = Annual Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) / Annual Debt Interest Payable

	Interest and Fixed Charge Coverage	
	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

THE RATING PROCESS - START TO FINISH

1 At your written request, we will issue an engagement letter for you to sign. This letter contains our standard terms and conditions of engagement as well as the annual fee.

2 A minimum of two of our analysts will spend at least one full day with your management in order to gain a strong understanding of your business.

3 An analysis will then be undertaken; this may entail further information and communication with your management. This process is likely to take a minimum of five weeks.

4 The lead analyst will then recommend a rating to a committee of six to eight analysts, who will question and debate the methods and reasoning used and conclusions reached in arriving at the recommendation. Benchmark comparison of peer companies around the world will form part of the analysis and debate, where applicable.

5 This meeting will conclude with a vote either endorsing or amending the rating and its rationale.

6 The conclusions will be communicated to you verbally, at which point you have three options:

i. Hopefully, you will accept the rating, at which point a press release will be issued announcing the rating and the rationale. We will also provide you with a number of copies of the rating and rationale for your clients, intermediaries and other interested counter-parties.

ii. You can appeal the rating, and as long as you can provide the additional and/or new information, then the committee will re-sit. The rating decision on appeal is final.

iii. Finally, you can decline the rating, at which point our decision will remain confidential.

7 Once the rating has been accepted, your company will undergo ongoing surveillance by Standard & Poor's and a review will normally take place at least annually.

At any stage, if a rating change is considered necessary, Standard & Poor's will state its intention to management before taking any rating action. Similarly, Standard & Poor's will not normally publish anything relating to your company without giving you the opportunity to comment in advance. ■

STANDARD & POOR'S METHODOLOGY FOR ANALYSING INSURANCE GROUPS

In many cases, Standard & Poor's expects that individual subsidiaries will be supported by their parent group, but increasingly it has become necessary to analyse and question the true nature of this support in the context of how the subsidiary fits into the strategy of the entire insurance enterprise. Indeed, over the past few years, a number of insurance groups have divested themselves of subsidiaries and have refocused and redefined subsidiaries that had previously been considered critical to their long-term strategy. On the other hand, the refocusing of operations has led to changes in which some subsidiaries that previously were viewed as not important, now fit well into their parents' new strategies.

A more dynamic management style requires a more dynamic analytic process.

During this analytic process, two issues need to be addressed:

- What is the overall financial security of the group?
- How do the various member subsidiaries of the group fit into the overall structure? What would be the rationale for the parent group wanting to support a subsidiary or conversely wanting to sell or to "walk away" from a subsidiary?

Standard & Poor's believes that for many groups it is appropriate to evaluate operating insurers in the context of the aggregate financial security of the group. Standard & Poor's also believes that even if a group isolates its riskier lines of business into a separate insurance subsidiary, such potential risk should not be ignored when analysing the group. The methodology for analysing insurance groups attempts to provide a consistent framework to look at the entire insurance organisation.

Standard & Poor's methodology for analysing groups is especially useful when applied to multiline insurance organisations, and to organisations with multiproduct and/or geographic subsidiaries.

The first element of this exercise is to establish a notional financial strength rating for the consolidated insurance group. This analysis is based on a combination of consolidated and separate operating company financial statements. The capital strength of the group is based on a consolidated capital model, as well as on a review of individual company capital adequacy. The competitive position and operating performance characteristics of each line of business, however, are based on the individual market position and profitability of the core and strategically important subsidiaries. By looking at all material operating units, which are measured by size or risk, a notional rating of the entire group is determined. This becomes the reference point for the ratings of the various subsidiaries.

In the second phase of the analysis, the subsidiaries are classified into three classes: core subsidiaries, strategically important subsidiaries, and nonstrategic subsidiaries. The following characteristics could be found in any subsidiary, and not all characteristics need to be met for a subsidiary to qualify as either core or strategically important, but in all cases capital adequacy standards must notionally be achieved and maintained to be considered core or strategically important.

Core subsidiaries

Defined as those subsidiaries:

- Operating in lines of business integral to Standard & Poor's

understanding of the overall group strategy. The activities undertaken or the products sold are very closely aligned to the mainstream business of the company and are often sold to the same target market customers. Nevertheless, the nature of the subsidiary's business should not be substantially more risky than the group's business as a whole.

- Sharing the same name or brand with the main group unless there is a strong business-development incentive to use a different name.
- Separately incorporated-mainly for legal, regulatory, or tax purposes-but de facto operating more as a division or profit center within the overall enterprise, usually exhibiting similar business, customers, and regional focus to other principal operations of the group. Core subsidiaries will often share things like a distribution network and administration with other major operating units.
- To which senior group management has demonstrated a strong commitment, i.e., a track record of support. Another indication could be to totally integrate the operations of a subsidiary or affiliate so that it is fully integrated into the entire enterprise. In some cases the subsidiary may be 90%–100% reinsured internally by the group.
- That represent a significant proportion of the parent group's consolidated position, particularly at least a 5%–10% share of consolidated group capital (or capable of reaching this level within three to five years). It is likely also to contribute on a sustainable basis a significant proportion of consolidated group turnover and earnings.
- That are appropriately capitalised commensurate with the rating on the group. Higher-rated entities are expected to be better capitalised, in line with the rating on the group.

- That are reasonably successful at what they do or have realistic medium-term prospects of becoming successful relative both to group management's specific expectations of the subject company and also to the earnings norms achieved elsewhere within the group. Those subsidiaries demonstrating ongoing performance problems or are expected to underperform group management expectations and group earnings norms over the medium to long-term would not normally be viewed as core.
- Where it is inconceivable that the unit would be sold, i.e., it is inextricably part of the whole group.
- That at least 51% of voting rights are controlled by the group.

Strategically important subsidiaries

Defined as those subsidiaries:

- That share most of the core characteristics identified above, but do not exhibit the necessary size and/or capital adequacy.
- That are important to the group's long-term strategy, but are operated more on a stand-alone, autonomous basis.
- That do not have the same name, nor is it readily apparent that the different name has unique value. In such instances, the concern must be that the different name is being used as a way to distance the parent company from the subsidiary.
- That even if not of sufficient size and capitalisation to meet core requirements, are nonetheless prudently capitalised for their business risk and within their market environment, with the level of capitalisation at least being assessed by a rating committee as clearly compatible with an investment-grade rating.
- To which management is committed, and where the subsidiary is not likely to be sold; however, such commitment may be over a finite period.
- That share the same customer/distribution base and many other characteristics with the core group but where the nature of the business transacted is of a distinctly higher risk profile than is normal elsewhere within the group and may constitute a potentially significant threat to the earnings and/or financial strength of the consolidated group.
- That are reasonably successful at what they do or have realistic medium-term prospects of becoming successful relative both to group management's specific expectations of the subject company and to the earnings norms achieved elsewhere within the group. Those subsidiaries expected to underperform group management expectations and group earnings norms over the medium to long-term would not be viewed as strategically important.
- For which the nature of the risk precludes the subsidiary from ever being sold, although the product line and/or market is not core to the group.

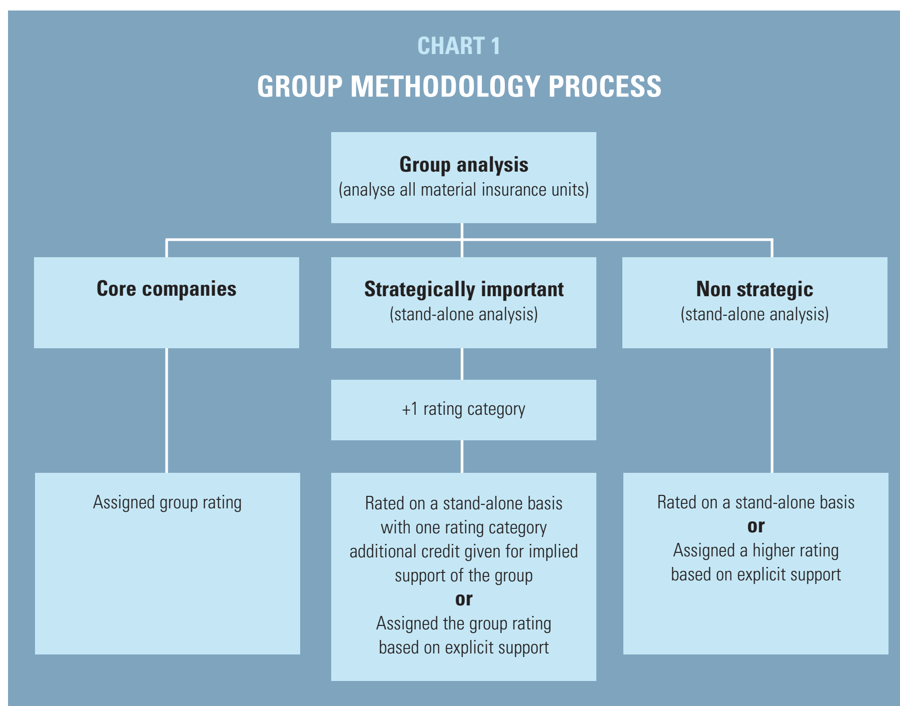
Significant acquisitions, in at least

the first year or two of ownership within the group, are normally expected to be viewed as no more than strategically important, rather than core. The sooner a major acquisition is assimilated, the faster it could move from being classified as strategically important to being recognised as a core subsidiary. On the other hand, significant and sustained operating deterioration or earnings underperformance of a core unit may result in its reclassification to strategically important or even to a nonstrategic subsidiary.

Nonstrategic subsidiaries

Defined as those subsidiaries:

- That do not meet the criteria for core or strategically important.
- That are not prudently capitalised.
- That are start-up companies.
- That might be sold in the relatively near or intermediate term or are placed in runoff.
- That are highly unprofitable or marginally profitable, and for which there is little likelihood of a turnaround, or of additional support from the group.
- That are in ancillary businesses.



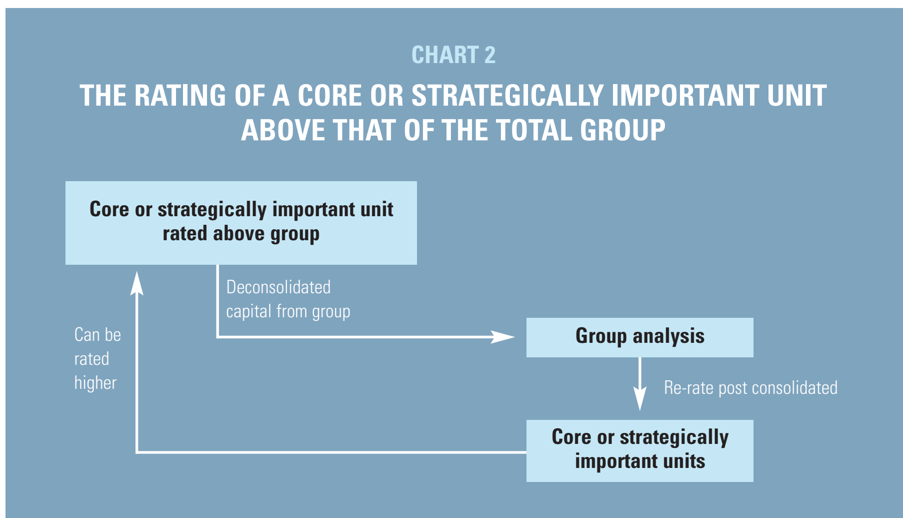
How group ratings are assigned

As depicted in Chart 1, the process begins with the establishment of a notional group rating that could then be applied to all subsidiaries Standard & Poor's determines to be core.

Next, strategically important subsidiaries are rated first on a stand-alone basis. The key characteristics analysed are the operating performance, market position, and capital adequacy of each strategically important subsidiary. However, based on Standard & Poor's analysis of their importance to the entire insurance organisation, strategically important subsidiaries will receive one rating category of benefit, up to one notch* below the group's rating, thereby ensuring an explicit ratings differential between core and strategically important group members. The only exception to this 'cap' is when the stand-alone is determined to be at the same level as the group rating, in which case the 'cap' need not apply.

Finally, nonstrategic subsidiaries are normally rated solely on a stand-alone basis. One notch of credit may occasionally be given if the subsidiary possesses several strategically important characteristics and is not obviously a candidate for sale over the short term and if Standard & Poor's believes the subsidiary would receive parental support were it to experience financial difficulties and the belief is confirmed in a letter of comfort.

*A notch is the minor differentiator used by Standard & Poor's; for



example, the difference between 'BBB-' and 'BBB'.

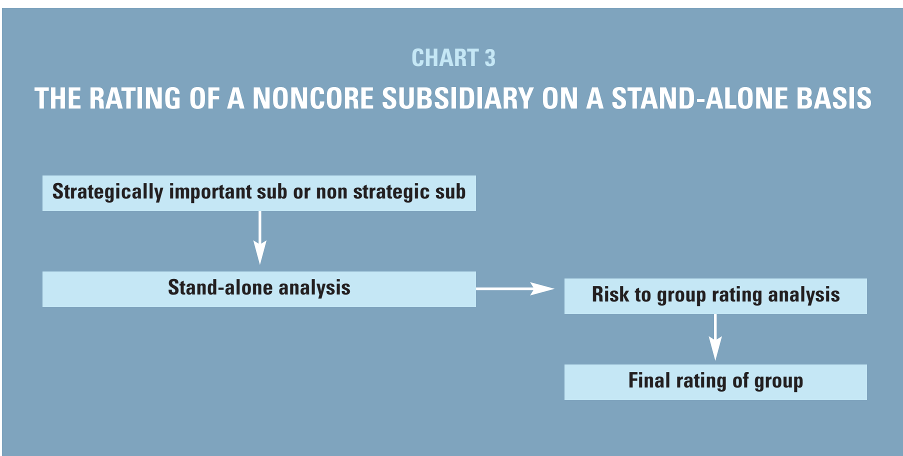
Special situations

Rating core or strategically important subsidiaries one to two notches above the group's rating.

There may be rare situations in which a core or strategically important subsidiary is deemed by Standard & Poor's to have characteristics in its own right, other than solely having superior capital adequacy, to warrant consideration for a rating above the rating of the entire group. As shown in Chart 2, such subsidiaries could be rated up to three notches (e.g., raised from 'A' to 'AA') above the group. It must be emphasised that, in such situations, the subsidiary must exhibit superior business and operating characteristics, and be able to operate on its own independent of the group, in addition to maintaining the appropriate capital. Outside minority ownership of 10%–20% and totally separate distribution networks would be important characteristics in supporting a higher rating. In addition, an economic incentive for a higher rating is desirable. In such situations, the capital necessary to support this higher rated subsidiary would be deconsolidated from the analysis of the total consolidated capital position. As a consequence this could reduce the group rating, which, in turn, could restrict the subsidiary's initially determined higher rating.

Explicit support

Strategically important and, occasionally, nonstrategic subsidiaries may receive the group rating if they receive explicit long-term support (i.e. a full guarantee in favour of policyholders) from a core unit. In these circumstances, the group rating will capture the explicit exposure to supporting these subsidiaries. Accepted forms of explicit support are guarantees and, in some cases stop loss reinsurance or net worth maintenance agreements. If the subsidiary is considered nonstrategic as defined above, even a guarantee may be insufficient as the expectation is that the entity could be sold at any time and the guarantee cancelled.



Group methodology summary

The key analytical issues captured by this approach are:

- Continual surveillance of how various subsidiaries fit into the overall insurance enterprise strategy. Since Standard & Poor's knows that strategies can change, the status of a subsidiary as being viewed either as core or strategically important will be reviewed annually.
- Establishment of a consolidated capital model to avoid any cosmetic benefits from the exclusion of a "bad" insurance subsidiary.
- Recognition that among strong, large insurance groups, capital can be quite fungible and is potentially available to support weak subsidiaries.
- Focus on a group's total strengths and weaknesses, rather than just seeing it through selected subsidiaries.

While this methodology focuses on an analysis of insurance activities, noninsurance parents and sister companies (e.g., banks, investment banks, stockbrokers, real estate firms) will also be examined in the process. The goal of this methodology is to bring a more complete picture to the market, while not losing sight of the characteristics contributed by the individual subsidiaries. ■

FREQUENTLY ASKED QUESTIONS

Q Our insurance company is just one part of a complex organisation that is involved in activities other than just insurance. How does Standard & Poor's incorporate this into its analysis?

A Standard & Poor's will analyse affiliates, subsidiaries, and parent companies – in addition to the insurer being rated – to get the most complete picture of an organisation's financial health. The analytical process evaluates whether non-rated parts of the organisation fit well strategically with the rated insurer and are financially robust, and hence enhance the overall profile of and resources available to the rated insurer. Similarly, group operations that may have weak financial profiles could be viewed as potentially damaging to the organisation, and a potential risk to the future financial strength of the rated insurer. Standard & Poor's analysts specialising in areas other than insurance will be involved in the rating process if their particular expertise helps Standard & Poor's gain the best possible insight into the non-insurance operations of a group.

Q Suppose we don't want a particular company in our multi-entity insurance organisation rated in isolation, but want the entire organisation - all its insurance entities – rated. Or perhaps we will want to get a rating on a certain "functional" segment of the group's operations (e.g., reinsurance), which may be handled by several companies within our organisation. How would Standard & Poor's analysis address this?

A Standard & Poor's recognises that assigning ratings to individual legal entities (companies) within an insurance organisation may not be the most suitable analytical approach, depending on how the group's operations are structured and managed. In some cases, evaluating individual companies can portray an artificially favourable or unfavourable picture, compared to how the group actually manages its various activities. Additionally, as market awareness of insurance ratings and their importance has grown, insurance organisations have been keen to expand the breadth of ratings across their insurance operations. Increasingly, Standard & Poor's has been using the concept of notional "group" ratings. Under this approach, Standard & Poor's analyses "groups" of insurance subsidiaries within an insurance organisation that form part of a coordinated business strategy, rather than evaluating individual subsidiaries independently. This may involve looking at the insurance organisation as a single group, or, if appropriate, as a series of subgroups (for example life, reinsurance, and non-life insurance operations may each be viewed as a separate sub-group).

Q Will the ratings process be a burden on our management's time?

A Standard & Poor's views the relationship with any rated insurer as a long-term, mutually rewarding association that should be underpinned by regular meetings and ongoing communication with

Standard & Poor's. To this extent, certain key members of the insurer's management should probably expect to be involved with the rating process on at least an annual basis. However, as much as possible, Standard & Poor's also tries to minimise extra demands on management's time by coordinating the relationship through a single company contact and using existing company financial information and reports whenever feasible.

Q Does the management meeting and company information need to be presented to Standard & Poor's in English?

A Not necessarily. As an international rating agency, one of Standard & Poor's strengths is the regional, cultural, and linguistic diversity of its analyst base, and Standard & Poor's is well-equipped to handle situations where written documentation and discussions may be predominantly in the insurer's local language. In situations that are particularly complex or where additional assistance may be needed, Standard & Poor's will work with the insurer to develop an acceptable plan.

Q Our company is relatively small. Will that limit our rating to an unfavourable level?

A Standard & Poor's does not rate on size alone, nor does our rating process impose rating "ceilings" on companies below a certain size. Standard & Poor's analytic process does, however, consider the fact that modest-sized insurers often have more concentrated business mixes and earning streams, and hence greater susceptibility to adverse circumstances, than more diversified companies. Also, small companies may have less management depth, more limited financial flexibility, and less ability to influence the market than more substantial companies. An insurer's ability to manage these risks is an important element of Standard & Poor's rating analysis.

Q Does Standard & Poor's evaluate mutual insurers differently than proprietary companies?

A Standard & Poor's uses the same overall methodology to evaluate mutual and proprietary companies. However, the main way this "difference" would be treated in the rating process would be in the evaluation of capitalisation and financial flexibility. This assessment would partly depend on Standard & Poor's analysis of the insurer's current and prospective capital adequacy, and its ability to self-generate sufficient capital to support itself going forward. Mutual insurers having the appropriate financial discipline to internally create and grow their capital bases to keep pace with their needs will not be at a disadvantage relative to stock companies.

We will also take into account a mutual's often unique relationship with its policyholders and the positive value this can bring. Furthermore, since mutuals have no shareholders to remunerate in the form of dividends, they can pass on the benefits of mutuality to its policyholder members. Since distributions to policyholders may take the form of bonuses or premium reductions or refunds, this will be taken into consideration in assessing mutuals' operating performance, particularly when comparing it to its proprietary peers.

Q What effect, if any, does a country's sovereign rating have on an insurer's interactive financial strength rating?

A Normally, an insurer's financial strength rating would not exceed Standard & Poor's local currency rating in its country of domicile. However, if a company can demonstrate a limited exposure to the risks of its sovereign, in certain rare circumstances it is possible for its rating to be higher than that of its sovereign domicile. This is particularly so in the European and also, to some extent, in European accession countries, where monetary policy is increasingly beyond the control of individual national governments.

Q Would debt issued from an operating insurance company be rated at the same level as its financial strength rating?

A Not necessarily. Whether Standard & Poor's rates senior debt pari passu with an operating

FREQUENTLY ASKED QUESTIONS

CONTINUED

insurer's financial strength rating will depend on the legal and regulatory framework in the country. Standard & Poor's meets routinely with insurance regulators to discuss actual or impending changes in regulation or the interpretation of regulation, as well as to discuss industry trends and developments, and will seek appropriate legal opinions on regulators' views before implementing any rating decision. Where Standard & Poor's is satisfied that debtholders will rank equally with policyholders in the event of insurer insolvency, a company senior debt will be rated the same as its financial strength rating. In cases where policyholders would have precedence over creditors, senior debt would likely be ranked 1 notch lower than the financial strength rating. Meanwhile, senior debt issued out of an insurer's holding company will likely be rated 2-3 notches below the 'core' operating companys' financial strength rating.

Q Can an insurer withdraw its rating at any time?

A Since the interactive rating process is voluntary on the part of the insurer, a company may withdraw its rating from the public domain through a written request to Standard & Poor's. However, Standard & Poor's may conduct a final review of an insurer's rating before withdrawing it. Additionally, an insurer cannot withdraw its rating to avoid having a rating change being made public. In this case, Standard & Poor's would first change the rating as appropriate, and would then withdraw the rating from the public domain. If a company withdraws an interactive rating, Standard & Poor's may in due course continue to rate the insurer based on publicly available information, if there is sufficient market demand for a rating.

If an insurer's rating is the source of explicit support (i.e., guarantee, or part of a structured transaction) for another public rating, Standard & Poor's reserves the right to require that the insurer's rating remain in the public domain. ■

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Our annual default studies clearly demonstrate that our ratings are credible indicators of default, as there is a clear correlation between our ratings and credit performance.

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“Despite extensive market changes, our core values remain the same: to lead the way in providing high quality, objective analytical opinions and information to the world’s financial and commercial markets.”

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