



Institute of Actuaries of Australia

2004 Financial Services Forum ...The New Environment

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Financial Services Forum

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Institute of Actuaries of Australia

Insurance Company Ratings

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Presentation Overview

- 1. Introduction to ratings**
2. Moody's rating methodology for life insurers
3. Trends and outlook for the Australian industry
4. Impact of insurers as part of broader financial services companies
5. What can actuaries do to help in the ratings process?

The role of a credit rating agency is to assess and monitor issuer credit risk for the purpose of providing an independent and objective opinion of the issuer's ability to meet future debt or policyholder obligations

Ratings are not however...

- A comment on equity value
- A buy, sell or hold recommendation
- A comment on non-credit risks, such as market risk
- Intended to be a precise predictor of default or crisis

What is an Insurance Rating ?

- An opinion on the relative financial strength of the insurance company or its ability to repay debt
- Two main types of ratings:
 - Insurance financial strength ratings - obligations towards policyholders
 - Debt ratings - obligations towards debt holders
- Based upon both qualitative and quantitative information
- The same rating scale (Aaa to C) as for other industries - expected loss for the investor should be the same

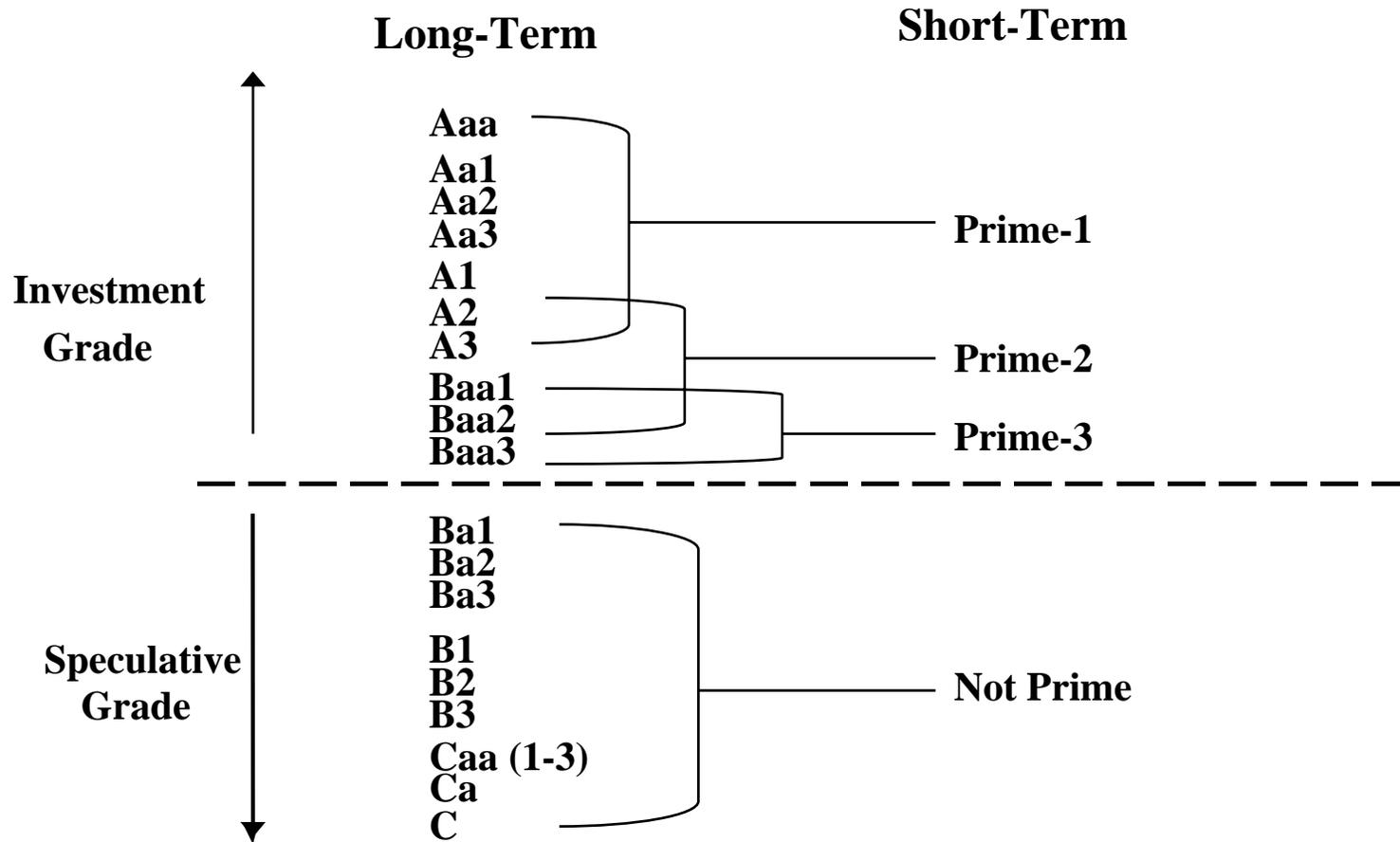
What Moody's Ratings Measure

EXPECTED LOSS

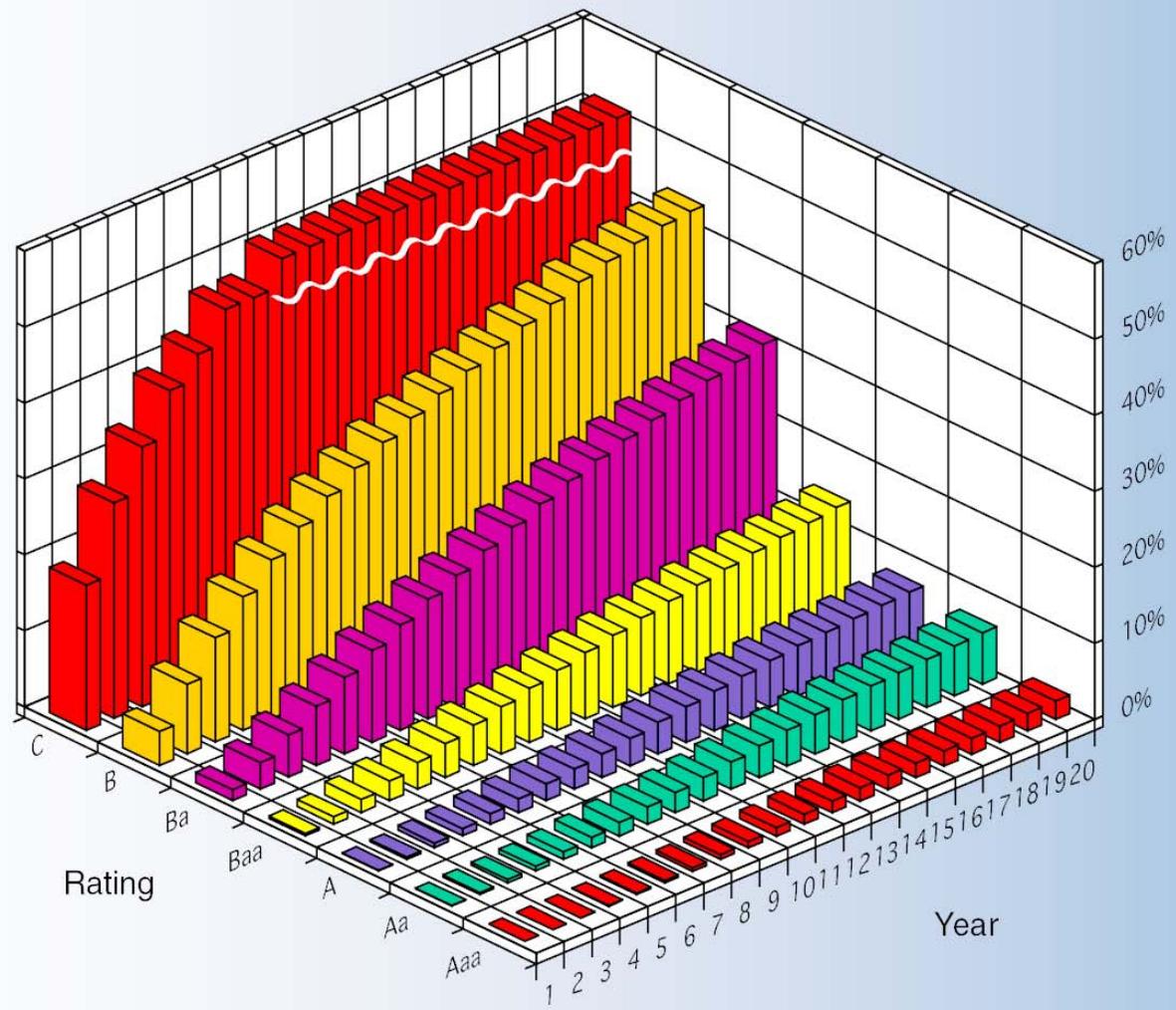
(Probability of Default) x (Severity of Loss)

- **Issuer-level characteristic**
- **Issue-level characteristic**

Moody's Rating Scale



Average Cumulative Default Rates



Narrow Default Definition

- Payment of all interest and principal must be made in full and on time
- No grace periods recognised
- Payment must be made in good funds
- Distressed restructuring construed a default

What do we rate in an Insurance Group ?

- All our ratings are applied to operating entities or debt issues
- Not a single rating applicable to an entire group, but we may assign a rating to several companies within the group
- Combination of group analysis and review of operating subsidiary
- We rate:
 - The financial strength of life, non-life and reinsurance operating insurance companies
 - The debt issued by such operating companies
 - The debt issued by holding companies or SPVs
 - The overall credit quality of senior debt (issuer ratings)
 - Structured finance transactions

Analytical Principles

- A forward-looking view
- Expected-loss focus: probability and severity of loss
- Based upon both qualitative and quantitative elements
- We do not rely on nor impose a fixed set of financial parameters or a pre-defined capital adequacy model
- Consistency across sectors, countries and debt instruments
- Recognise unique national characteristics and accounting practices
- No pi ratings

Value of Insurance Ratings

- Benchmark financial strength for investors, policyholders and intermediaries
- Help insurance companies issue debt on capital markets
- Show willingness of insurance companies for transparency
- Contribute to a better understanding of the insurance industry by the international financial community and policyholders
- Build analytical bridges between domestic markets
- Help insurance companies get name recognition outside their domestic market

Rating Migration Chart – European IFSR

		Rating as of January 2001							
		Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Below
Rating as of January 2004	Aaa	29.4%							
	Aa1	29.4%	20.0%						
	Aa2	29.4%	60.0%	28.6%					
	Aa3	5.9%	0.0%	28.6%	60.6%				
	A1	5.9%	0.0%	21.4%	6.1%	0.0%			
	A2		20.0%	7.1%	15.2%	13.3%	0.0%		
	A3			0.0%	6.1%	13.3%	60.0%	0.0%	
	Below			14.3%	12.1%	73.3%	40.0%	0.0%	0.0%

Rating changes compared with initial (Jan '01) rating category

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Industry Analysis

- Analysis of the markets where the insurer operates
 - Growth prospects and drivers for the industry
 - Intra-industry and external competition
 - Barriers to entry and threat of substitute products
 - Impact of financial convergence and consolidation
 - Regulatory, tax and accounting environment
- Peer group analysis - compare the company with its peers
- Insurance industry is heavily regulated - but this does not mean that an insurance company cannot default

Franchise Value and Distribution

- Our judgement on the ability of the insurance company to continue to grow and expand profitably
- Degree of business diversification and appropriateness of niche strategies
 - Product characteristics / mix and geographic diversification
 - Overall market share and by major product line
 - Brand recognition and customer segmentation
 - Product innovation
- Distribution capability (e.g. diversification, cost-efficiency, level of control)

Organisational structure, Ownership and Corporate Governance

- Ownership of the group and key subsidiaries
- Legal structure - shareholders, mutual, public sector
- Cross-guarantees, formal or implicit financial support
- Strategic partnerships and joint ventures
- Cash-flow availability and liquidity
- Branding issues within the group

Management & Corporate Strategy

- Overall management of the group
 - Management quality – Credibility, competency, experience, reliability
 - Corporate governance
 - Risk culture and risk management practices
 - Structure of the group, (de-)centralisation
- Attitude to risk in strategic thinking
- Acquisition strategy, growth plans and funding strategy

Financial Analysis: Life Insurance

- Capital adequacy
 - Quality and quantity of capital
 - Capital assessment is not model-driven
 - ‘Capital is not king’, only part of rating assessment
- Financial leverage and interest coverage
- Profitability
 - Statutory and embedded value profits
 - Cost structure
 - Investment performance and bonus policy

Financial Analysis: Life Insurance (cont.)

- Asset and liability management and liquidity
 - Duration matching, cash-flow matching, currency matching
 - Pricing of options and guarantees
 - Potential liquidity needs and contingency plans
- Investment risk and asset quality

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Credit Strengths

- Good long-term growth prospects resulting from the presence of a compulsory retirement savings system, a favourable tax environment and an aging population
- Financial groups covering all financial industries translate into revenue and expense synergies. Many insurers are part of larger banking groups and benefit from the consequent oversight and support
- Good capitalisation levels
- A supportive regulatory environment, with increased emphasis on insurance

Credit Challenges

- Impact of both the difficult operating environment of recent years — the result of strong links to investment markets — and unfavourable market sentiment as life insurers compete for funds under management
- Association of industry profits with equities market volatility
- Competition from other financial institutions for the growing compulsory superannuation savings market. Furthermore, contributions may not flow directly into a life insurance company but may well flow into the life company's group
- An “open architecture environment” means greater competition
- Concentration in single-premium business increases the focus on retention and attracting new business
- Mature state of Australia's life insurance market, results in strong competition and low returns

Outlook

- Challenging prospects given the operating environment and the heavy dependency of performance on investment market trends
- Long-term growth still appears good as the superannuation market is expected to expand
- Life industry faces competition from other financial institutions
- Challenges determined by the sophistication of customer needs, the presence of financial planners and the introduction of new products
- Low margins and strong competition
- Insurers will have to demonstrate strategies that clearly identify their positions along Australia's wealth management value chain
- Further consolidation is expected to unfold in the sector as smaller companies fall away
- APRA to continue playing an increasingly important role in monitoring the financial health of the life industry

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Impact of insurers as part of broader financial services companies

- Expected revenue and expense synergies
- Greater management oversight and support
- Competition within groups for business
- Capital adequacy and allocation at an entity level vs. group level
- Recognition of life company value in the valuations of parent banks
- Ratings strongly influenced by group and parent ratings

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What can actuaries do to help in the ratings process?

- Increased involvement in the risk and capital management
- Improved transparency and disclosure, e.g. scenario testing, contingency planning, target surplus, etc
- Improving technologies based on solid research with clear explanations for non-actuarial audiences
- Market consistent EVs, accounting and regulatory change (e.g. IFRS)
- Ensure consistency of strategies within broad financial groups, e.g. capital management

The background features a collage of various banknotes, including Australian and Euro currency, overlaid with a semi-transparent teal geometric pattern of overlapping rectangular blocks.

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