

Ratings = Financial Strength

Choosing a Life Insurance Company

by Rob Parolek

*“Fallout: America’s Financial Crisis.” “Deleveraging May Be Driving Stock Sell-Off.”
“Unregulated Credit Default Swaps Led to Weakness.”*

Headlines like these have chronicled this fall’s turmoil in the financial and business marketplace, and the average American has learned some new words: *deleveraging, collateralized debt obligation, naked short selling, mortgage-backed securities* and *credit default swaps*. However, some older and better known terms have also been reiterated, like *financial strength, diversification, liquidity* and *leverage*. These well known financial terms are the foundation on which ratings systems have been developed for insurers, not only regionally and nationally, but also globally.

Major ratings companies

Fitch Ratings, Moody’s, A.M. Best and Standard and Poor’s rate life insurance companies based on the ability of a company to meet its obligations. The goal of a ratings company can be summed up with an excerpt from the mission statement of one of these firms: “To perform a constructive and objective role in serving the insurance marketplace as a source of reliable information and ratings dedicated to encouraging a financially strong industry through the prevention and detection of insurer insolvency.”¹

The evaluations developed by rating companies provide important tools used by agents and clients who are shopping for life insurance. They are also useful when completing due diligence research before the final purchase of a life insurance policy. While it’s important to look at the historical financial data for a life insurance company, some qualitative analysis is also necessary to form an opinion about the company’s future performance or financial strength. Generally, ratings information is released on an annual basis. However, in a turmoil-driven marketplace, circumstances may mandate that information be released outside the normal schedule. Events such as mergers or acquisitions, dramatic changes in financial information, legislative/regulatory actions or current events are all examples of occasions that may instigate a rating action or change.¹

Market position

The insurance business is fraught with competitive market challenges, economic volatility and regulatory change.¹ In order to remain competitive, it’s important that each company has an experienced management team with in-depth knowledge of the industry and the ability to effectively develop and execute defensible strategic business plans for the company.

The market position, brand and franchise strength are also key rating factors that represent a company’s ability to develop and sustain a competitive advantage in its chosen market. A strong market position is achieved in the following ways:

- incorporating the firm’s sustainable advantages in its key lines of business
- having the ability to prevent competition from dominating the market
- demonstrating superior management of its marketing channels
- possessing the ability to leverage its size and maintain competitive pricing

These issues are important to an insurer during economically adverse times because they give the firm the economic strength to remain profitable now and in the future, maintain the appropriately funded amount of capital and be positioned advantageously when marketplace opportunities develop.

Operating philosophy

Management’s ability to identify, monitor and mitigate risk contributes to a company’s success in minimizing unexpected events and volatility and to protect the interests of its policyholders and other stakeholders.² Undertaking risk is a natural part of the insurance business. However, it is vitally important that management understands, measures and manages risk in order to maintain the operational and financial

health of the firm. The risk management discipline of an insurer is an essential part of its overall governance and management.

Financial strength

The review of a firm's financial strength, also referred to as its balance sheet strength, involves analyzing the levels of the firm's capital (leverage), asset quality, liquidity and risk management.

An appropriate level of capital must be maintained in order to fund any short-term contractual obligations that need to be paid out by the insurer. In order to maintain a strong operating position, firms attempt to balance the right mix of revenues from premiums and deposits against short- and long-term assets and liabilities. A robust management team with a track record of managing this leverage is necessary to maintain a high rating.

The quality and diversification of assets held by insurers are of interest to current and future policyholders. Maintaining a diverse assortment of assets helps an investor reduce and manage a portfolio's risk. The same is true for the investments of insurance companies. The quality of the investment helps reduce the uncertainty that the value of assets will change unexpectedly. In recent weeks, for example, firms were quick to point out their low rates of exposure to subprime loans, often less than one-tenth of one percent of total investments on their balance sheets. By being diligent in managing their firms' portfolios, they will have achieved the diversification necessary to ride out the current turbulent market conditions.

Liquidity is a measure of the ability of a firm to meet its short- and long-term obligations to policyholders and creditors. If an asset is considered to be liquid, its value can be easily determined and it can be sold immediately. A company's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diverse and liquid.³

Ratings are an important and valuable tool to use when selecting a life insurance product. Because they are both qualitative and quantitative in nature, ratings provide a benchmark for distributors and end-consumers, especially when comparing the numerous insurance carriers. At the same time, the ratings system provides a single standard for encouraging confidence and underlines the financial strength of the life insurance industry.

¹ 2008 Best Insurance Reports – Life/Health, Preface.

² Moody's Global Rating Methodology for Life Insurers, pg 16.

³ 2008 Best Insurance Reports – Life/Health, Preface.

Definitions for the New Vocabulary

Collateralized debt obligation is a debt security collateralized by a variety of debt obligations including bonds and loans of different maturities and credit quality.

Credit default swap is a swap designed to transfer the credit exposure of fixed income products between parties. The buyer of a swap receives credit protection and the seller of the swap guarantees the credit worthiness of the product.

Deleveraging reduces the amount of debt held by a company by selling the same holdings at the same time.

Diversification involves reducing the risk of a portfolio by spreading investments around into many types of investments, including stocks, mutual funds, bonds and cash.

Leverage is the use of given resources in such a way that the potential positive or negative outcome is magnified.

Mortgage-backed securities are asset-backed securities whose cash flows are backed by the principal and interest payments of a set of mortgage loans.

Naked short selling is the investment position of the underwriting firm for a new issue when the underwriting firm has sold more shares short than will be issued. A short position prior to the issue permits the underwriter group to stabilize the price of the stock by becoming buyers immediately following the deal. A naked short allows the underwriting firm greater ability to stabilize.

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