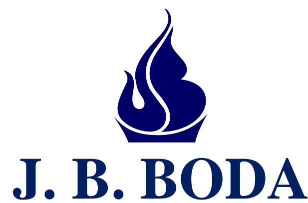

Credit Rating Considerations and Impact on a Long Term Development

Madam Grace Muradzikwa, AIRDC President, Dr Jagath Alwis, Chairman for this Technical session, Mr Roger Sellek, CEO AM BEST, Asia-Pacific, Ladies and Gentlemen, Bonjour and Good morning to all of you.

It is indeed pleasure for me to be part of this prestigious forum and I am thankful to the office of AIRDC for giving me an opportunity to present a paper today in presence of this august gathering on Credit Rating Considerations and Impact on a Long Term Development.

J B Boda Reinsurance Brokers being in service of Afro-Asian as well as other markets in the World since 1943, I will try to put forth my thoughts on this subject, dispassionately from the point of view of a Reinsurance Broker.

To begin with, I would very briefly like to highlight upon the importance of Reinsurer's Credit Rating to International Insurance Markets.

Credit rating basically indicates a Company's ability to pay its financial obligations, this is also referred to as "creditworthiness." In Reinsurance business we also say that it is the Claims Paying ability of the Reinsurers.

So what is the importance of Credit Rating of Reinsurers to the Insurance Companies?

1. Insurance Companies are required to gauge the Credit Worthiness of their Reinsurers, before placement of treaty or facultative business. This is because it is the Policy holder's premium and interest which they have to protect. The Claims Paying Ability or the Creditworthiness at the time of Claims settlement is very important which is the ultimate aim of

Reinsurance placement. Hence they would like to select Reinsurers who possess that Creditworthiness.

It would indeed be very cumbersome for an Insurance company to check financial details of each Reinsurer to ascertain their Creditworthiness. Instead the easiest and more reliable way is to refer to the Credit Rating of the Reinsurers assigned by rating agencies such as AM BEST, S & P or Moody's.

2. Credit Rating is a professional opinion or expression of the Creditworthiness of an Insurance or Reinsurance Company. Moreover, it is entirely independent opinion and therefore attaches recognition, significance & respectability.

3. In most of the markets it is Regulatory requirement to place certain percentage of the Reinsurance programme with Reinsurers who have at least "BBB" or "A-" rating by international rating agencies.

4. The Balance Sheet of an Insurance company becomes more resilient with support of well rated reinsurer and helps boost confidence of an insurance company, the local regulator & original insured in case of Mega risks. The Banks, financial Institution and Insured's would feel more reliable dealing with an Insurance Company, who is backed by rated Reinsurers.

So the next question comes, **<u>what are the considerations used by Credit Agencies to analyse Credit Ratings?</u>**

Well each Credit Agency uses a unique method & criteria to provide the Credit Rating. The methodology used could be a trade secret. However in general, they examine the External and the Internal Environments of a Reinsurance company and the some of the common considerations could be as follows:-

1. **Sovereign Rating of the Country in which the Company is registered and its Regulatory environment.**

Some Rating Agencies do not give Credit Rating above the Sovereign Rating to Companies registered in that particular Country, though by far and large, they qualify on all counts on their own merits.

The sovereign credit rating indicates the risk level of the investment environment. It takes social and political risk into account in addition to other factors like GDP Growth, Inflation, Fiscal Balance, External Debt etc. A good Sovereign credit rating would boost FDI in the country, which would enhance the Economy of the Country. Sovereign credit ratings receive considerable attention in financial markets and the press.

The state of the economy influences business volumes and claims experience, while investment markets affect an insurer's balance sheet strength.

2. **Capital and Reserves (Net Worth) & Liquidity - Solvency**

In general, the Net Worth is difference between Assets and Liability of a company.

A high Net Worth obviously relates to good financial strength & health which ultimately results in good Credit Rating of the company or otherwise. Solvency and liquidity are both terms that refer to an enterprise’s state of financial health, but with some notable differences. Solvency refers to an enterprise's capacity to meet its long-term financial commitments whereas Liquidity refers to an enterprise’s ability to pay short-term obligations; the term also refers to its capability to sell assets quickly to raise cash. A

solvent company is one that owns more than it owes; in other words, it has a positive net worth and a manageable debt load.

I would also like to highlight that the Accounting practices followed in each Country and by the Company also play vital role in maintaining good financial health. In our business of Insurance and Reinsurance – Outstanding Claims Reserves – is a crucial accounting segment and neglecting to this segment company to land in serious trouble.

3. Management and Corporate Governance

The CEO and Management of the Company is like Captain and Crew of the Ship. They have to decide the destination of the Ship. Therefore Management of the Company, also popularly known as Corporate Governance plays a vital role in growth or failure of a Company.

Though Annual Report or Balance Sheet and other Financial Documents of a company are very vital from the point of view of a Credit Agency as it reflects the financial health of the Company.

Yet, on the other hand the non-financial information which also affects the Credit rating is the Corporate Governance.

The Corporate Governance deals & drafts the business policies, processes, mechanism and other related factors. They design the organisational structure and control it. Even the advertisement and publicity which sometimes plays vital role in promoting the business, comes under the Corporate Governance.

Through interviews of Management and analysis of Corporate Governance of the Company, the Credit Agencies can examine the internal environment of the Company.

Ultimately, it is the Corporate Governance and philosophy which will decide, what should be the position of the Company in the market and much depends upon their strategies and motivational approach to carry the whole Company on their shoulders.

There have been several instances, when change at the top management has given a new face to a Company, resulting into yet another rags to riches story.

4. Underwriting Philosophy

After all, the underwriting philosophy of a Reinsurance company plays a pivotal role in earning reputation and ensuring growth.

The Credit Agencies would check documented underwriting guidelines, pricing models used, catastrophe models used, profound study of each market or countries from which business is underwritten, performance of the underwriting department, achievement of target premiums, healthy combined ratios, lesser dependence on investment income and more emphasis on underwriting profits, diversification in terms of lines of business and markets' qualification, experience and knowledge of the underwriters and other factors which blend into the Underwriting philosophy of a Reinsurance company. The Underwriting Philosophy of an Insurance or Reinsurance Company should not be very rigid & stiff but has to be active and aggressive at the given time with the changing market scenario.

The flexibility of the underwriting guidelines of an insurance or reinsurance company is also equally important. All of us have seen the hard market and the soft market cycles. There have been years, which have produced huge losses, either in terms on Catastrophe or in terms of Aviation & Marine classes. All of us have also witnessed financial crises,

sudden weakening of currencies or unprecedented Political and Social changes. The Insurance and Reinsurance Companies therefore need to make suitable amendments to their underwriting policy as well as overall business strategy and planning, keeping in line with changing external environment.

Let us now move to our last segment.

So what are the Long Terms Impacts of these Considerations:-

The criteria used by Credit Agencies are not static and are open to effective requirements & analysis.

We are living in a World, which is constantly changing. Just now when we are sitting in this conference venue with all comforts at our ***beck and call***, somewhere on this Earth, there could be a Natural or Man-made Catastrophe happening. Some Social or Political issues are being raised and swings on the Stock markets are taking place. These external environments are beyond the control of any insurance or reinsurance company.

There is no doubt that the Credit Rating Agencies keep constant vigil on the external environments and their possible impact on the internal environments of the Companies, to whom they have assigned Credit Ratings. After providing their Annual Credit Rating to a Company, they do issue regular updates on any possible changes to the Credit Rating already assigned.

Of course there are very well established Insurance and Reinsurance Companies, who have proved their Creditworthiness against tested times & have almost fortified themselves against so called “all perils”. They have earned trustworthiness from their clientele besides the creditworthiness from the Credit Rating Agencies. However, there have been number of instances, which have shocked the markets when top Credit Rated Insurance or Reinsurance Company has suddenly and unexpectedly failed.

Some of the considerations used to assign the Credit Rating, belonging to external environment could be beyond the control of the Insurance and Reinsurance Companies as also that of the Credit Rating Agencies.

The Sovereign Rating is one of such external environment, which is completely beyond the control of companies registered in that Country. Sovereign distress can create financial and operating problems for local insurers. They can swiftly trigger failures, even when insurers have otherwise been managed wisely. The state of the economy could influence business volumes and claims experience, while investment markets affect an insurer's balance sheet strength.

To go one step ahead, it has also been experienced that Political or Financial Crises in one Country can rock the Stock market of another Country and may also causing sudden financial panic and even devaluation of the currency. We have seen last month's China Stock market disaster which as affected many countries. On the other hand, there also have been situations, where an insurance or reinsurance Company might score fully on all counts of the Criteria to qualify for "A" Credit rating, however the Sovereign Rating limitations can bring it down.

Another external environment which can cause downgrading or failure of Insurance and Reinsurance Companies is Natural Catastrophe event such as Hurricanes, Earthquakes, Floods or even Manmade Catastrophe such as Riot & Strikes, Acts of Terrorism and Political Violence which have unlimited & unknown exposures.

The Catastrophe Events – especially seen in quick succession during 2011 and 2012 such as Thailand Floods, New Zealand EQ and Japan Tsunami have put several Insurance and Reinsurance companies in financial stress.

An occurrence such as September2011, was an eye opener for many of our industrial fraternity. Neither the Credit Rating Agencies nor the Insurance and

Reinsurance Companies ever visualised that an insured loss such as 9/11 can take place and affect several top rated insurance and reinsurance companies.

The Credit Rating Agencies are not involved in day to day practices and procedures followed by the Insurance or Reinsurance companies. Failures due to Catastrophe events can happen if the Insurance or Reinsurance Company has not reinforced itself by scientific exposure mapping, by arranging adequate reinsurance protections and by creating sufficient loss reserves. A top rated insurance or reinsurance company can be affected by combination of all these factors or even by any one of these factors. There are cases, where Companies have underwritten a business which is totally outside their documented Underwriting guidelines. The Credit Agencies would not have any knowledge of this and then it becomes a sensational news that this single underwriting decision has brought the company on its knees.

The Credit Rating Agencies would not even be aware if an Insurance or Reinsurance company is engaged in price war to capture business. Unfair trade practices might earn short term gains, such strategy might not produce long term gains. There have been failure of rated Insurers and Reinsurers attributable to poor liquidity management. Even collapse of Stock Markets can destabilize a top rated insurer or reinsurer due to investment failures.

To sum up it all, it may be mentioned that the Credit Rating Agencies have earned indispensable position in international business environment with their specialised nature of service. There is no doubt that the Credit Ratings assigned by them are looked up with respect and reverence. A higher Credit Rating assist the Company in accelerating its growth and market share. But at the same time, a caution and restrain must be observed by all concerned business associates, that the Credit Ratings are only the opinions of the Credit Rating Agencies and are not a guarantee against creditworthiness of a company. The constant changes in the business environments both external and internal have their own impact, especially in long run and therefore an insurance or reinsurance company must be vigilant and take special internal

precautionary measures which can shield them from disaster that may arise out of downgrades or failures of their business partners.

So, Ladies and Gentlemen, I have concluded my thoughts on this subject and I once again convey my sincere thanks to the office of AIRDC for giving me an opportunity make a presentation here and I am also thankful to all of you, present here for your patient hearing.

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