INSURANCE COUNCIL OF AUSTRALIA

Email: CriteriaComments@standardandpoors.com

27 September 2012

Dear Sir/Madam

REQUEST FOR COMMENT - INSURERS: RATING METHODOLOGY

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to respond to Standard and Poor's (S&P) "Request for Comment: Insurers: Rating Methodology" issued 9 July 2012. We also appreciate the additional time provided to make a submission.

We welcome Standard & Poor's consultative approach and its acknowledgement that the insurance sector has experienced a low rate of default before and during the Global Financial Crisis (GFC).

GENERAL COMMENTS

Need for skilled credit analysts as well as robust methodology

Balanced and well drafted criteria are an essential tool in assigning credit ratings which can be considered by the market to be a reliable and accurate assessment of credit risk across the globe. To this end, the Insurance Council appreciates the work undertaken by S&P to enhance its methodology for insurers. We also acknowledge S&P's efforts to increase transparency in order that the market will become better informed about the basis on which ratings are determined.

However, while robust criteria are an essential ingredient in the rating process, it is not sufficient to ensure accurate ratings and there is a danger in artificially enforcing transparency through making the criteria overly prescriptive. The nature and complexity of credit risk means that there will always be a considerable subjective element to credit analysis. Accordingly, there is no substitute for the refined judgement of experienced and competent credit analysts in carrying out such analysis and criteria which artificially restrict the application of such judgement could erode the value of S&P's ratings and damage its reputation over time. The ability for a credit analyst to materially adjust a strictly formula

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. June 2012 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $37.5 billion per annum and has total assets of $118.2 billion. The industry employs approx 60,000 people and on average pays out about $115 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

driven rating is particularly important given the very wide range of different accounting and regulatory regimes world-wide.

Overly prescriptive criteria may make it more difficult for analysts to identify potentially concerning trends or specific situations which deserve greater attention. While we acknowledge that the draft criteria allows for a one notch analytical override, the Insurance Council queries whether (1) one notch provides sufficient latitude to address anomalies and (2) the override will be used appropriately given the apparent emphasis on transparency achieved through prescriptive criteria.

Need to take into Account the Australian Context

We note a key objective of the proposed IICRA is to address the risks typically faced by insurers operating in specific industries and countries and these are generally determined at a country or regional level (paragraph 28). While the Insurance Council supports this principle, we are concerned that some of the proposed metrics or sub-factors used for producing the factor scores used to derive the ratings may not always be relevant to, or appropriately reflect, the unique characteristics or product types in Australia.

We believe additional uplifts in scores may be warranted in an Australian insurance context. For example, under the assessment of the financial system risk score, the Request for Comment states that "additional weight given to the breadth or narrowness of domestic capital markets, and the domestic private sector's access to external funding".

The compulsory superannuation regime in Australia provides a significant pool of funds to underwrite Australian capital markets. As a result Australian insurers have access to domestic capital markets, even during times of global financial market stress. Australian insurers demonstrated this ability to access equity and retail hybrid markets during the GFC.

We have noted in our specific comments (see Attachment) suggestions where greater recognition could be given to the characteristics of the environment in which the Australian insurance industry operates.

The danger of including artificial thresholds into the analytical framework

Inclusion of artificial thresholds could introduce unnecessary volatility in ratings or alternatively promote inconsistency in application of criteria. We acknowledge the benefit to all stakeholders of introducing explicit 'indicators' which highlight potential sensitivities at a given rating level but we question whether they should be incorporated into ratings in the form of rating caps and other hard thresholds. The quest for transparency should not carry the penalty of the side effect of rating volatility which belies underlying credit fundamentals.

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Factoring in the importance of the commitment to maintaining a specific credit rating
Insurers with strong investment grade ratings have considerable scope to manage credit quality to a target rating to the extent that there is one in place. For confidence sensitive industries such as insurance, we believe the criteria should more explicitly recognise the willingness of certain insurers to fully utilise the financial flexibility at their disposal in order to support their target rating.

This is particularly relevant given the greater influence of capital in the determination of ratings since a lower capital level may, at face value, indicate a lower rating outcome than represented by the underlying credit risk which is positively impacted by management's willingness to cure any weakness through the tools at its disposal. Clearly insurers at the speculative end of the rating spectrum have a materially more constrained ability to fine tune credit quality which means that the commitment to maintaining a specific rating should take on considerably less importance in the criteria relative to strong investment grade insurers.

In the context of the above, issuers that may be facing an adjustment to their ratings solely as a result of the implementation of new criteria should be given an opportunity to adjust their profiles by mechanisms at their disposal prior to rating action being taken. Insurers who have consistently demonstrated their commitment to a particular rating through explicit actions taken in terms of proactive interaction with S&P as well as through capital management decisions should be considered for such transitional arrangements.

The Attachment sets out specific issues that members have identified with S&Ps' proposed methodology.

If you would like to discuss this matter, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at email:
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Yours sincerely

Robert Whelan
Executive Director & CEO

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ATTACHMENT

COMMENTS ON SPECIFIC TECHNICAL ISSUES

C1: DERIVING THE BUSINESS RISK PROFILE (BRP)
C2: INSURANCE INDUSTRY AND COUNTRY RISK ASSESSMENT (IICRA)
Need for an Explanation of the Scores Underlying the IICRAs
On 16 July 2012, S&P released a list of indicative IICRAs for each of the major insurance industries based on the application of the proposed methodology outlined in the Request for Comment.

We note this release only lists the indicative IICRAs without any detail or explanation of the underlying scores supporting these IICRAs. It would be useful for S&P to provide this additional information to help insurers understand how the proposed methodology should be applied and also assess the potential for volatility in the rating from future changes to the factors.

Financial System Risk
Table 4 (page 13) outlining the IICRA sub-factors suggests the Financial System Risk score is based purely on the Banking Industry Country Risk assessment (BICRA) criteria, while paragraph 39 states that it reflects "both the BICRA's banking industry risk score, with additional weight given to the breadth or narrowness of domestic capital markets, and the domestic private sector's access to external funding". We would appreciate clarification of this apparent inconsistency.

Return on Total Capital (ROTC)
The proposed ROTC sub-factor under the IICRA may produce counter-intuitive results in some circumstances given a higher industry ROTC does not necessarily imply stronger insurers. For example, if two industries have identical risk profiles and profitability, but one has more conservative capital levels (and therefore lower ROTC), the lower ROTC industry would be the more secure industry but receive the lower ROTC sub-factor score. Given that the proposed alternatives of new business margins or return on total assets also have drawbacks as they are not risk adjusted measures, the Insurance Council recommends that this issue be given more thought.

C3: COMPETITIVE POSITION
General Comment
Whilst ultimately assessment of Competitive Position is based on the various sub-factors in Table 7, we note that in Table 8 under "What it means", a Score & Assessment of 3 (strong) occurs when an insurer is representative of the IICRA score. Conceptually, one might expect that being representative of the IICRA would lead to a Business Risk profile equivalent to the IICRA. However, that is not the case in Table 3 for very low and extremely low risk markets. It appears it is not sufficient to be representative of that market, one must outperform it.

Operating Performance
The operating performance sub-factor is also based on ROTC or the same alternative measures as under the IICRA sub-factor. As argued above, a higher ROTC does not necessarily mean a more secure insurer. In particular, an individual insurer's capital policies (more or less conservative) will impact ROTC and may produce counter-intuitive outcomes. The alternative measures are not risk adjusted and as a result will be heavily influenced by business mix, with insurers with lower risk product mixes likely to be disadvantaged.

The Insurance Council acknowledges the importance in the credit assessment of the ability of generate future profits. However, great care needs to be applied when assessing operating performance based on return on capital. This may not entirely identify expected variations within the peer group based on product mix, more aggressive capital structures (although this might be captured in capital assessment) and cross-jurisdictional accounting differences impacting the calculation of ROTC. A higher ROTC is not by itself necessarily indicative of credit strength.

Differentiation of Brand or Reputation
While agreeing with the principle behind this sub factor, it should be based on fact-based examples of price leadership, or ability to sustain pricing power.

Market Share
An insurer should be able to get a positive score if it has strong market share in the markets where it operates, not just those markets deemed to be "significant countries". Other characteristics of the market are considered by the IICRA score. A similar argument may be made for "narrow classes of business" as diversification (or lack thereof) is considered separately.

In addition, paragraph 80 should be clarified to confirm that market share can be positive (strong) for neutral as well as outperforming insurers (the text infers outperforming only).

D1: DERIVING THE FINANCIAL RISK PROFILE
D2: CAPITAL AND EARNINGS
Regulatory Capital Adequacy
The criteria contemplates uniform MCR multiples to achieve certain rating thresholds regardless of the jurisdiction. This is therefore an implicit assumption that all regulatory regimes are consistent. We believe this approach potentially disadvantages jurisdictions which have prudent regulatory regimes as MCR levels can take on materially different meaning and significance between regimes. For example, regulatory regimes may set out:

- Reinsurance purchase requirements
- Probability of sufficiency of reserving
- Discounted versus undiscounted reserves

These components taken in totality, lead to relatively stronger minimum capital requirements in particular jurisdictions.

To this end, we believe a lower MCR multiple for jurisdictions such as Australia is appropriate given the prevailing strict regulatory guidelines and prudential supervision. Australia has one of the most conservative regulatory requirements which results in the required MCR multiple for Australian issuers being lower for a given level of risk compared with many other jurisdictions. We don't believe this is fully recognised in the IICRA "2" assessment for Australia.

The currently proposed thresholds also do not take into account the different approaches that different regulators will have to insurers that approach or breach their MCR. Regulators with stronger regulatory regimes have more options available to them should an insurer breach the MCR (e.g. allowing an insurer to prudently trade their way back to a position of capital strength rather than resorting to immediate regulator intervention), which means that there will be differing chance of the "ultimate regulatory action" occurring.

We note in Table 12 "the FRP is not scored less than '9' and the SACP or GCP is capped at 'bb+' if the regulatory capital adequacy sub factor is scored 'less than 'adequate'".

We note that 'less than adequate' is defined as "…only marginally above the MCR and is likely to remain so at the next measurement date. Typically "marginally above" would mean 1.2x -1.5x ..."

Whilst there is not enough detail provided to form a view as to how S&P might view the Australian context, in our view the capping the SACP/GCP at 'bb+' seems excessive (at 1.2x let alone 1.5x). Such an outcome potentially sets S&P as the de-facto solvency capital benchmark as the rating consequence is so severe.

We consider the prospect of regulatory intervention as a rather more severe event for capital providers rather than policyholders/creditors as that is the point of potential subordination of capital providers' interests to the policyholders' (& other senior creditors). In addition, the fact that the Australian industry is well-regulated supports the position of senior creditors/policyholders, relative to other industries. Even the minimum capital requirement is still a very substantial net asset position, likely equivalent to at least investment grade in a non-financial industry (1 in 200 year return period for absolute ruin).

In order to ensure equivalence across regulatory jurisdictions, we suggest the regulatory benchmark for 'adequate' is set with regard to a prescribed probability of breach and that consideration be given to less severe capping/modification of outcomes.

Capital Adequacy

S&P's capital adequacy assessment is based on S&P's two year forecasts of the insurer's future capital adequacy under the S&P's insurance capital model. There is

concern amongst Insurance Council members that S&P may not have adequate resourcing or expertise to produce robust forecasts.

The Insurance Council is generally supportive of the proposition of a forward looking view of the capital adequacy assessment. However, we have some concerns on the assessment process. Our members have reservations about the ability of analysts to robustly forecast Total Adjusted Capital (TAC). We believe the process maybe unduly prescriptive, with various haircuts and restrictions. This may in practice constrain the analytical ability to cover all scenarios.

Whilst it is reasonable to be circumspect about a stronger score based on improvement in earnings projections substantially in the outer year, there may be scenarios where it is not unrealistic to be able to consider 'other changes in 'TAC' which uplift the score in the outer year. An example is with regard to the insurer's capital & financing plans and stated risk appetite.

The Insurance Council is concerned that there may be elements of excess conservatism on an aggregate basis. We note that if earnings quality is deemed low, any forecast uplift is capped at 2 notches, whilst if earnings growth is high, this could be 3 notches. In addition, if earnings growth is low the absolute positive growth in TAC also would be halved.

The absolute growth in TAC is calculated as after-tax earnings minus other changes in TAC. Any haircut in relation to earnings quality should be applied to the prospective after-tax earnings, rather than total growth in TAC. Limiting adjustments for earnings quality to the after-tax earnings allows the analyst more flexibility in assessing prospective TAC, for example taking into consideration the insurers stated risk appetite/economic capital requirements.

We note that losses from a hypothetical 25% decline in equity markets cannot represent more than a modest proportion of operating earnings if earnings quality is deemed to be high. Therefore the impact of aggregate equity holdings is:

1. high net-of-diversification capital model charges for equity exposures, plus
2. a 50% haircut to any estimate of absolute growth in TAC.

Guidance in relation to the incorporation of excess capital at Non-Operating Holding Companies (NOHCs)

The Insurance Council understands that currently there is no explicit adjustment to the capital model to allow for excess capital held at a NOHC level. Rather there is a qualitative benefit provided by the rating committee. Insurance Council members acknowledge that, depending on the capital position of the operating subsidiaries, the amount of excess capital available to each entity in a Group can change year on year without any movement in the capital held at the NOHC. However, this should not preclude S&P from quantifying the benefit of surplus capital held at a NOHC for the purpose of calculating the insurer's RAC.

Surplus capital at a NOHC is hard capital which is fungible across Group entities. This is difficult to reflect in a purely qualitative assessment.

A failure to quantify the benefit of surplus capital at a NOHC in an insurer's RAC introduces unnecessary opacity in the rating process. It also heightens the risk that the benefit of the surplus capital will not be adequately taken into account given the importance which S&P places on the RAC ratio in influencing the overall rating of the insurer

In light of the above, the Insurance Council recommends that the criteria should include formal guidance as to:

- how excess capital at a NOHC will be allocated to Group entities; and
- the portion of surplus capital allocated to the insurer be formally included in the calculation of RAC.

D3: RISK POSITION

No comment.

D4: FINANCIAL FLEXIBILITY

It seems that from Table 12, an insurer with a capital and earnings score of 1, 2 or 3 cannot achieve analytical uplift from a 'strong' risk & financial flexibility profile. It is at best neutral. It seems unusual that there should be no benefit from having a superior profile, as it should be rating supportive even for well capitalised insurers.

Double Counting of Fixed Charge Coverage

There appears to be a double-count of fixed charge coverage as a rating factor in the methodology. This factor appears twice in the assessment process, once as part of the financial risk profile and then again in the assessment of modifiers and caps.

Implications of Assessment at the Consolidated Group Level

The financial flexibility factor is assessed "at the consolidated group level". We would appreciate clarification of what this means for insurers which form part of a broader financial conglomerate, for example a bank owned insurer. If assessed at a consolidated group level for a bank owned insurer, how is the financial leverage ratio calculated and assessed? If the financial leverage ratio includes all debt issued by the parent bank the guideline ratios quoted in the Request for Comment will not be appropriate.

E: MODIFIERS AND CAPS TO THE INDICATIVE SACP ORR GCP

E1: ERM AND MANAGEMENT SCORE

No comment.

E2: LIQUIDITY

Modifiers and caps

The liquidity assessment is "based on a consolidated view including the holding company" (paragraph 203). Does this extend to the ultimate holding company, for

example in the case of a bank owned insurer, does it incorporate the liquidity of the bank?

E3: FIXED-COVER TEST

Double Counting of Fixed Charge Coverage

There appears to be a double-count of fixed charge coverage as a rating factor in the methodology. This factor appears twice in the assessment process, once as part of the financial risk profile (as explained above) and then again in the assessment of modifiers and caps.

Fixed charge cover thresholds

The criteria contemplates uniform fixed charge cover multiples to achieve certain rating thresholds regardless of the jurisdiction. By default, S&P does not take into account the prevailing interest rate regime in each country or interest rate trends which may have considerable relevance to the overall meaning of the multiple from a credit perspective.

It is worth noting S&P's own comments in relation to the use of financial ratios (including fixed charge coverage and interest coverage) in its insurance holding company criteria document:

> *"We use these ratios as guidelines only. For a given rating category, financial ratios can be expected to vary with the business or operating profile of a company. We generally believe that a company with, in our view, a stronger competitive position, more favorable business prospects, and more predictable earnings can afford to undertake added financial risk while maintaining the same credit rating."*[2]

The proposed use of hard fixed charge cover ratio thresholds to cap ratings appears to contradict S&P's previous statement in relation to the use of these ratios.

While fixed charge cover is a relevant metric to consider, if it is to be incorporated into rating thresholds, we believe it is more appropriate to adopt a more sophisticated analysis which contemplates the numerator (i.e. earnings quality and trends) and the denominator (i.e. the level of indebtedness combined with an analysis of the prevailing interest rate regime). Alternatively, in the absence of this modification, we suggest that fixed charge cover remains a consideration but rather than expressed in terms of a rating threshold it is treated as a 'modifier' as per financial leverage.

E4: RATING AN INSURER ABOVE THE SOVEREIGN RATING OR T&C ASSESSMENT

No comment.

[2] Holding Company Analysis, original published 11 June 2009 (last updated 24 January 2012).

F: SUPPORT FRAMEWORK

F1: RATING INSURANCE SUBSIDIARIES OF INSURANCE GROUPS

No comment.

F2: ASSIGNING ICRSs TO NOHCs

Notching of NOHCs

The Insurance Council suggests that there should be more flexibility in notching between '-3 for jurisdictions with very high structural subordination (US) to -2' for less onerous regions such as the EU', and with very limited and specific exceptions.

We would suggest additional factors, or a combination of additional factors, could allow tighter notching, for example:

1. Geographic diversification. A very well diversified insurance business could allow tighter notching given limited correlation of risk.
2. A NOHC with the majority of its operating subsidiaries with a common regulator that primarily supervises the organisation as a Group and is supportive of capital fungibility.
3. Absence of senior debt. If there are limited prior ranking commitments on the holding company, this mitigates the reliance on upstreaming of cashflows from operating subsidiaries. In addition, any capital instruments issued by the NOHC become the first ranking commitments. In this scenario, it seems excessive to fully notch for both structural and security subordination. This feature could alternatively be addressed by tighter notching of capital securities issued by such NOHC's.

We note that a liquidity assessment of the NOHC scores 'strong', 'adequate' etc. There seems to be no positive consequence for a 'strong' liquidity position.

F3: ASSIGNING ISSUE RATINGS

No comment.