

May 13, 2009

**Criteria | Insurance | Life:**

# Analysis Of North American Life Insurance Operating Performance

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Standard & Poor's Ratings Services is refining and adapting its methodology and assumptions for evaluating the operating performance of North American life insurance companies, related to "Principles Of Corporate and Government Ratings," which we published on June 26, 2007, on RatingsDirect at [www.ratingsdirect.com](http://www.ratingsdirect.com) and Standard & Poor's Web site at [www.standardandpoors.com](http://www.standardandpoors.com). We are publishing this article to help market participants better understand our approach to reviewing insurance companies. This article partly amends and supersedes "Life Insurance Criteria: Operational Analysis," published April 22, 2004.

This article is part of a broad series of measures announced last year to enhance our governance, analytics, dissemination of information, and investor education initiatives. These initiatives are aimed at augmenting our independence, strengthening the rating process, and increasing our transparency to better serve the global markets.

Standard & Poor's Ratings Services' assessment of a company's earnings performance is an integral part of our overall rating analysis. Earnings trends reveal a company's ability to efficiently convert its strategies and competitive strengths into growth opportunities and sustainable profit margins. Although an insurer's level of capital adequacy reflects its equity cushion relative to the risks it takes, a company's prospective earnings performance generally will determine its ability to expand and attract capital. We believe that companies that produce stable earnings streams, based on their competitive advantages in the marketplace, should be well-positioned to succeed.

In turn, our analysis of operating performance focuses on both historical and expected earnings trends. Although the examination of earnings easily lends itself to quantitative analysis, Standard & Poor's views the qualitative aspects of earnings as equally important. We also consider other elements—such as volatility, diversity, and sustainability of earnings—in evaluating operating performance.

## Overall Performance

Standard & Poor's bases its analysis of operating performance on returns on assets (ROA), returns on revenues (ROR), and returns on equity (ROE). Although many organizations weigh the ROE heavily as a performance benchmark, we tend not to overemphasize this ratio because the company's capital structure influences it. Although an increase in leverage could improve a firm's ROE, it would not improve credit quality.

Our primary metric for evaluating life insurance and annuity earnings is GAAP pretax operating ROA. For group life, disability, and supplemental health insurance operations and other pure mortality/morbidity lines of business that generally do not result in significant asset accumulation, we consider ROR to be a key metric. Standard & Poor's evaluates earnings before both taxes and capital gains to better understand an insurer's recurring sources of income while recognizing that a firm's tax dynamics can distort after-tax earnings over the short term. We believe that for many companies, capital gains are largely opportunistic and are a function of economic and interest rate conditions. However, to the extent that a company can consistently reap capital gains as a part of a total investment and operating strategy, we usually will adjust our analysis accordingly.

Whenever available, we use GAAP financial statements rather than statutory statements. GAAP accounting presents

a more accurate picture of the ongoing economic earnings capabilities of a company than statutory accounting, which presents a view of the company as if it were to be liquidated as of the statement date. In our view, differences in accounting treatment—such as the inclusion of deferred policy acquisition costs and use of more realistic reserving practices in GAAP accounting—give a better picture of an insurer as an ongoing enterprise. We will use statutory earnings if GAAP or GAAP-like earnings information is not available.

Finally, the participating dividend feature that some life insurers offer further complicates measuring operating performance. A significant part of dividend payments made to policyholders typically is at management's discretion, but in practice, it is an important marketing feature because consumers value consistent dividend payments. Therefore, Standard & Poor's generally treats dividends to policyholders as a cost of doing business and evaluates ROA on the basis of the gain from operations after the insurer pays policyholder dividends.

## **Quality Of Earnings: Stability, Diversity, And Sustainability**

Stability and diversity of earnings are key factors in earnings quality. We generally view companies with stable earnings streams as more financially secure than companies with volatile earnings, which might be subject to stress occasionally. We view companies with concentrated profit streams as more vulnerable to adverse economic and business conditions than are those with more diversified earnings sources. If pricing for one particular product becomes irrational, well-diversified companies might retreat from that market and return once pricing becomes attractive again. We believe that companies operating with greater revenue diversity and favorable actual results compared with pricing expectations generally operate with less volatility risk. These factors—in conjunction with quantitative measures—provide a comprehensive representation of a company's operating performance and establish our overall assessment of operating performance. Standard & Poor's believes stronger companies will achieve high earnings through competitive advantages they have established in the marketplace. These advantages should translate to favorable pricing, margins, or an expense advantage. Alternatively, we will generally view firms that diversify into lines of business lacking a competitive advantage or where their risk-management capabilities as commodity-type players with potentially volatile income streams.

## **Sources Of Earnings**

The primary sources of earnings for life insurance and annuity companies are the ones driven by the underwriting (mortality and morbidity), investment, and expense margins. Mortality is perhaps life insurers' most predictable risk, so appropriately underwritten life insurance products can be important sources of stable earnings. We generally view insurers with stable, well-underwritten books of life insurance as having the most favorable earnings characteristics. Morbidity has historically been less predictable than mortality, and as a result, earnings from disability and long-term care products have been more volatile than those from life insurance. When evaluating technical margins, we consider the absolute level and trends in loss ratios. We also review insurers' actual mortality and morbidity experience relative to pricing expectations.

Investment margins are the spread between earned rates, which the investment strategy and opportunities influence, and credited rates, which the competitive position and competing products affect. Investment spreads can be subject to compression, so we monitor trends in net investment yields as well as net spreads. Investment spreads play a key role in permanent life insurance products and fixed annuities.

Asset-based fees are an important source of earnings, particularly for separate account products, such as variable annuities and variable life insurance products, as well as mutual funds and other asset-management products. Such asset-based fees are prone to volatility, particularly for separate account product balances, which policyholders typically direct to equity-oriented sub-accounts. Hedging and benefit costs related to variable annuity guaranteed minimum living and death benefits make products with these features particularly vulnerable. For criteria specific to such features, please see "Criteria For Evaluating The Impact Of Variable Annuity Equity-Based Guarantees On North American Life Insurers' Financial Strength," Jan. 29, 2009.

Because life insurance and annuity earnings depend on insurance in-force policyholder balances, we also monitor trends in business volumes. Key measures include net flows and persistency ratios. Growing business volumes also increase scale, which could create expense leverage. Expense ratios reveal a company's ability to achieve favorable operational efficiencies. Premium growth indicates gains in market share or at least the maintenance of share, while loss and expense ratios reveal a company's ability to achieve favorable pricing or operational efficiencies. We analyze all of these ratios in the context of the competitive landscape; we always view company results both in absolute terms and relative to those of peer companies and the overall industry.

We use these measures to determine the underlying sources of earnings strength and view them as important indicators of a company's strategy. An insurer's competitive advantages usually translate into strong earnings by way of increased margins or higher market share. Our analytic focus is on differentiating insurers with earnings streams that are based on value-added services as opposed to those that with earnings streams that have resulted from taking disproportionate risks. Although the former generally have long-term profit sustainability, the latter can lead to disastrous consequences in periods of stress.

## Summary

Our rating process attempts to form a prospective view of a company's financial strength. Accordingly, analysts typically develop forecasts of future operating earnings and over the ratings horizon for base-case, optimistic, and pessimistic scenarios. We also consider the past and potential future volatility of earnings. Although operating performance is a critical part of the rating process, we carefully consider other factors when evaluating an insurance company's financial strength. These include its competitive position, management and strategy, enterprise risk management, capitalization, liquidity, investments, and financial flexibility. We evaluate these factors in other areas of the analysis, and they could offset the relative strength or weakness in the operating performance.

## Related Articles

- "Interactive Ratings Methodology," April 22, 2009.
- "Operational Analysis Of Nonlife Insurance Operating Performance," April 22, 2009.
- "Embedded Value Is A Key Driver In Standard & Poor's Evaluation Of Life Insurers' Earnings," April 12, 2006.

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