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Criteria | Insurance | Property/Casualty:
**Analysis Of Nonlife Insurance
Operating Performance**

Primary Credit Analyst:

Polina Chernyak, New York (1) 212-438-7179; polina_chernyak@standardandpoors.com

Secondary Credit Analysts:

Thomas Upton, New York (1) 212-438-7249; thomas_upton@standardandpoors.com

Mark Puccia, New York (1) 212-438-7233; mark_puccia@standardandpoors.com

Shellie Stoddard, New York (1) 212-438-7244; shellie_stoddard@standardandpoors.com

Table Of Contents

Overall Performance

Underwriting

Differences In Health Insurer Analysis

Summary

Analysis Of Nonlife Insurance Operating Performance

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. While an insurer's level of capital adequacy describes its equity cushion relative to the risks it takes, a company's prospective earnings performance 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, are well-positioned to succeed.

Our analysis of operating performance, in turn, focuses on both historical and prospective 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. For a property/casualty insurance company, for instance, the single most important determinant of the quality of earnings is a company's reserve position. Thus, an analysis of a company's reserve adequacy is a precursor to the earnings analysis. We also consider other factors—such as volatility, diversity, and sustainability of earnings—in evaluating operating performance.

Standard & Poor's is refining and adapting its methodology and assumptions for evaluating the operating performance of nonlife insurance companies, related to "Criteria: Principles Of Corporate And Government Ratings," which we published on June 26, 2007, on RatingsDirect at www.ratingsdirect.com and Standard & Poor's Web site at 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 "Health Insurance Criteria: Operational Analysis," published April 22, 2004; "Property/Casualty Insurance Operational Analysis," published Jan. 8, 2008; and "Nonlife Insurance Operational Analysis," published March 19, 2009, on RatingsDirect at www.ratingsdirect.com and Standard & Poor's Web site at www.standardandpoors.com.

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.

Overall Performance

Standard & Poor's bases its analysis of operating performance on combined ratios, return on revenues (ROR), return on assets (ROA), and return on equity (ROE). Although many organizations use ROE as a performance benchmark, we tend not to over-emphasize this ratio because it is influenced by the company's capital structure. Instead, we believe that the key driver of profitability is the profit margin on a company's operating revenues. This margin is best measured using pretax ROR, which, unlike ROE, is somewhat insulated from the effects of leverage and partly adjusts for the duration of the liability. ROR includes both underwriting and investment components and thus captures both sources of an insurance company's earnings. It also blends easily with the traditional loss ratio or combined ratio analysis, which are widely used by the broader analytical community. Standard & Poor's evaluates earnings before both tax and capital gains to understand the profitability of the recurring sources of income without the effects of those two variables. 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 will adjust our analysis accordingly. We may also look at ROA, which takes into account both capital gains and the effects of taxes for insurers. By looking at these measures concurrently, we cover all facets of profitability.

Underwriting

Underwriting performance is an important component of overall operating performance and is the key driver of earnings strength. Our assessment of underwriting performance is based on:

- Loss ratios for the overall company and for major lines of business
- Expense ratio
- Policyholder dividend ratios (where applicable)
- Combined ratios
- Premium growth

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 underwriting margins or higher market share. 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.

These ratios, while useful, have some limitations, however. Because of the many different types of products offered by the non-life insurance industry and the different levels of risk associated with each product, comparisons of loss or combined ratios between different lines of business and different companies can be misleading. Investment earnings play a greater role in long-tail lines of business (those with long duration liabilities) than in short-tail lines. Likewise, high-risk lines of business require high returns. Therefore, a property/casualty combined ratio of 110% has a different implication depending on the line of business a company writes based on the line's liability duration and earnings volatility.

Reserves

The adequacy of an insurer's reserves is the single factor to which earnings analysis is most sensitive. Standard & Poor's performs its own analysis of loss reserves using various statistically accepted methods. Analysts then use their judgment on the result of these methods to assign any redundancies or deficiencies of reserves for the period under consideration for the earnings analysis.

Investments in tax-exempt bonds

Companies that have high amounts of tax-exempt bonds in their investment portfolios would be penalized because we look at a company's pretax earnings. (Tax-exempt bonds have much lower pretax yields than do taxable bonds.) Standard & Poor's adjusts actual investment income on these bonds with the company's estimates of earnings on a taxable-equivalent basis. However, we make this adjustment only for companies with significant holdings of tax-exempt securities.

Capital gains

For companies with a demonstrated, consistent strategy of harvesting capital gains, we typically will adjust our analysis to include a proportion of these gains.

Earnings quality

Our analysis of operating performance would be incomplete without assessing the quality of earnings. In addition to reserve adequacy, volatility and diversity of earnings are key factors in earnings quality. We view companies with concentrated profit streams as more vulnerable to adverse economic and business conditions than are those with more diversified earnings sources. Likewise, we view stable earnings more favorably than volatile earnings. These factors, in conjunction with the quantitative measures cited above, provide a comprehensive representation of a company's operating performance and establish our overall assessment of operating performance.

Differences In Health Insurer Analysis

There are number of differences to note when analyzing U.S. Health Insurance companies, plans or HMOs. Standard & Poor's looks at the overall consolidated operating performance rather than looking at the individual HMOs or subsidiaries that operate in different states or jurisdictions via wholly owned subsidiaries. Standard & Poor's also considers the effect of different states' regulatory and tax regimes on both underlying and reported profitability. For example, strong/light regulation that has helped support or regulate industry pricing and benefited/hurt health plan profitability will be factored into Standard & Poor's view of operating performance.

The overall analysis of HMOs' and health plans' operating performance also focuses on the areas that could significantly affect their operating performance: the ability to control market pricing, the ability to withstand competitive pricing pressures, and the ability to manage both medical and administrative costs. These three factors are increasingly influenced by a number of external marketplace elements.

Standard & Poor's uses ROR as the main benchmark for evaluating overall profitability. In general, this measure gets beyond the impact on underwriting performance resulting from different business mixes because investment income is included as an additional source of earnings. The ROR calculation takes into account the impact of other, nonunderwriting factors, such as premium equivalents from non-underwritten lines of business (e.g., self-insured blocks of business), non-insurance health specialty business lines (e.g. network access or disease management) such as debt interest expense on borrowings, and other expenses or revenues on earnings.

Summary

Our rating process attempts to form a prospective view of a company's financial strength. While operating performance is a critical part of this process, we carefully consider other factors in the evaluation of an insurance company's financial strength. These include its competitive position, management and strategy, capitalization, liquidity, investment risk, and franchise risk. We evaluate these factors in other areas of the analysis, and they could offset the relative strength or weakness in the operating performance.

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