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**Evaluating Insurers' Competitive
Positions**

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Evaluating Insurers' Competitive Positions

In assessing future financial strength, it is critical to identify an insurer's fundamental characteristics and its source of competitive advantage or disadvantage. Indeed, competitive position can be one of the decisive factors underlying a final rating decision, as the analyst defines the key characteristics of organizational structure and activity that constitute competitive strengths and weaknesses.

These strengths and weaknesses are intricately tied to the insurer's strategy and operational effectiveness and will strongly influence its financial profile. It is through Standard & Poor's review of a company's competitive position in each major line and region of activity that we determine whether we see solid potential for satisfactory performance. At the same time, such a review will also likely highlight whether any significant diversification into new activities or new regions has added to or diminished the level of risk within the company relative to likely returns.

Standard & Poor's Ratings Services is refining and adapting its methodology and assumptions for evaluating insurers' competitive positions, 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 "Property Casualty Insurance Criteria: Evaluating Insurers' Competitive Positions," published April 21, 2004; "Life Insurance Criteria: Evaluating Insurers' Competitive Positions" published April 21, 2004, and "Health Insurance Criteria: Evaluating Health Plans' And Health Insurers' Competitive Positions," published April 22, 2004, 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.

Evaluating a company's competitive position involves substantial subjective interpretation of the basic facts and data associated with lines of business, premium volumes, market shares, and technical performance. Large size suggests economies of scale but does not guarantee success. Small scale suggests a lack of diversification but could be offset by compelling competitive strengths that render niche status both profitable and defensible into the foreseeable future. In other words, an insurer's strengths and weaknesses in the marketplace are often vital to the company's future performance. The relative strength of the competitive review can frequently offset other positive or negative factors we use in our analysis.

We assess the success of a company's portfolio of business units and product lines, distribution systems, degree of business diversification, and appropriateness of niche strategies. Standard & Poor's analysis includes aspects of the business that affect the absolute level, growth rate, and quality of the revenue base. Ultimately, to demonstrate competitive advantage, an insurer will usually be expected to show superior operating performance to that of the industry, strong growth characteristics, or both. Standard & Poor's ratings also incorporate an evaluation of the financial strength and business strategies of important subsidiaries and affiliates.

We are often asked: "How does a company's rate of revenue growth affect the rating?" Clearly, a strategy of growth

for growth's sake can be a road to ruin and may be inappropriate in soft markets, where insurers often obtain excess growth only by underpricing business. Nor is size alone equated with credit strength. Over an intermediate to long-term horizon, Standard & Poor's would expect strong companies to have good growth prospects. This view is always balanced against our belief that there are times when no growth or slow growth is better, to preserve earnings and capital. In making this evaluation, a clear link exists between the strength of an insurer's competitive position and its corporate strategy. On the other hand, an insurer's competitive position is typically evaluated in the context of the financial performance the company could be expected to achieve given its financial strength and market position.

We believe that strong companies generally will have as an objective the maintenance of sound levels of capital and earnings. Companies with sustainable competitive advantages in niche markets can receive high ratings if they can demonstrate a record of strong earnings performance that we expect will continue.

To evaluate the degree to which a company enjoys strong, defensible franchises or to which it is prudently diversified across a variety of profitable or potentially profitable sectors, Standard & Poor's undertakes a detailed analysis of the company's business units. We examine the company's ownership structure, market stature, and product distribution, even of specific product lines if we believe them to be particularly significant. In taking a prospective view, we also analyze features and trends in the general market environment, particularly where these constitute a possible opportunity or threat to the rated entity.

Market Position and Competitive Advantage

When assessing market position, analysts will, in effect, look at what an insurer is actually doing and then define each activity and describe the company's business position in each major line relative to the positions of its peers. We will then make an assessment of the insurer's overall, consolidated position. To reinforce the prospective nature of the analysis, we also address the subject of competitive advantage. The presence of distinct competitive advantages across major lines of business and principal markets will likely suggest that a company's current market franchises will improve or, at the very least, remain relatively stable in the face of competition. Meanwhile, the analysis of operating performance, under a separate section of the analysis, will also help substantiate whether management is successfully translating any perceived business strengths into incremental earnings. However, for a variety of reasons from mutuality to catastrophe and from periodic price wars to fluctuating investment markets, Standard & Poor's recognizes that the degree of correlation between competitive position and operating performance could vary somewhat over time.

Which raises the question, what is competitive advantage? In practice, it is anything that will help differentiate an insurance provider in its marketplace in a positive sense and thereby allow it to compete more effectively against peers and improve its ability to write more business or to earn higher margins, or both. Competitive advantage could include a brand name that inspires great customer confidence and loyalty, a cost base that allows competitive pricing at sustainable and satisfactory margins, or a means of distribution that reaches a preferred type of client in a cost-effective manner. Similarly, the advantage could be in product design, with a particular type of contract efficiently meeting a market need through coverage or flexibility or, alternatively, a range of complementary products that together attract and retain a class of policyholder that might not otherwise have been drawn to the company. Quality of service could also be a competitive advantage, but it is one that is claimed by nearly all the insurers that Standard & Poor's speaks to and could consequently be more a prerequisite for market success than a

facilitator of it. Whatever the case, the analyst will try to identify competitive strengths that might exist or be lacking and opine on what the effects of such strengths and weaknesses are likely to be on the local and overall market position of the company or group under review.

Diversification Through Product and Geographic Spread of Risk

Diversification is the very essence of insurance, with a pooling of risks so that the losses incurred by a minority can be settled using the premiums paid by the majority. At a fundamental level, a sufficient degree of size and diversification is essential for an insurer, so as to cover fixed costs, avoid adverse selection, and increasingly enjoy the benefits of the actuarial law of large numbers whereby the frequency and severity of seemingly random events becomes accurately quantifiable. However, beyond this minimum level, there comes a point in the evolution of any reasonably successful company when it has a realistic choice between aiming to maintain a stable, status quo business strategy or taking the more radical option of conscious diversification by developing or acquiring new activities or by expanding or buying into new regions. Neither strategy is without risk.

When consciously forgoing diversification while seeking to maintain financial strength, management at a focused, niche insurer must be supremely confident that its company can sustain its viability in traditional activities and regions into the long term. Similarly, before introducing new products, new lines of business, or new, remote operations to justify additional flags on the map, companies must consider whether they have the skills, the means, and the infrastructure to achieve a level of success in the new activity that's similar to what they currently enjoy in their existing operations. If the new undertaking risks seriously underperforming relative to the traditionally core range of activities, then arguably management is gambling with its company's financial strength by assuming higher levels of exposure in lines or areas where the increased risk is unlikely to be compensated by sufficiently increased earnings. Therefore, in this context, far from being seen as either positive or even neutral, further diversification and growth risk become significant and negative risk factors.

Experience suggests that diversification into new activities is always a challenge, and even if the initiative is ultimately successful, it could at the very least consume disproportionate amounts of management time and energy until the new business achieves operational equilibrium and a reasonably stable track record. Standard & Poor's has learned to react with instinctive prudence in its analysis of start-up and newly acquired operations, particularly if these new ventures appear to be a departure from management's proven sector or regional strengths. However, to the degree that the passage of time proves diversification to have been successful and sustainable, then it will likely be regarded as a distinct strength relative to an otherwise similar but nondiversified peer.

Meanwhile, the rating analyst will study the lead product offerings in a company's main markets in order to assess the range of risks the products represent and ask questions such as:

- Does the company manufacture or outsource its products?
- Are they low or high value added?
- Are they high or low risk?
- Is the company largely dependent on one or a few products, or does it have a whole range of diversified offerings?

Although there are no invariably right or wrong answers to such questions, it is clear that both the analyst and the rating committee will tend to feel greater comfort when they find that a company is selling value-added rather than commodity products, as long as the added value is also apparent in the pricing. Similarly, we are likely to view in a

more favorable light products that provide stable, long-term revenues or asset accumulation over those that are short-term and volatile, that consume capital, or that place a potential strain on liquidity. Naturally, we'll feel the greatest level of comfort when we find that a company is exploiting its competitive strengths to sell capital-self-sufficient products at margins that support sustainable, long-term earnings.

Distribution

Increasingly, distribution might itself be the key competitive factor in many markets. A good name, a good product, and a good quoted premium all help, of course. However, the conclusion of a sale might ultimately rely on ease of access by the would-be policyholder. On this basis, a cost-effective network of professionally trained, exclusive/tied agents remunerated on the basis of technical results rather than simple premium volume could well prove a considerable competitive advantage where distribution through exclusive/tied agents remains the norm. Meanwhile, in independent broker-driven markets, an insurer's ability to interact with and facilitate the task of brokers and independent financial advisers could be even more important than an ability to communicate easily with the policyholder. Similarly, insurers might see a significant reduction in their operating costs if they trained their customers to interact with the company by telephone or electronic mail rather than through branches and face-to-face contact.

Again, the rating analyst will pose a number of questions:

- How is the company managing its distribution today as opposed to in the past?
- What changes in distribution could occur in the future?
- Is distribution high or low cost relative to that of competitors?

Finally, and most importantly:

- Are the means of distribution effective?

Ultimately, distribution costs are one of the few variables over which management can exercise some real control. In practice, though, in the field of distribution as elsewhere, there is no panacea. Consequently, most large insurers appear to be going the route of multi-distribution, allowing policyholders to choose their own channel of approach, whether electronic, across the bank counter, or face-to-face with an agent. Whatever the case, the important factor is effectiveness in bringing appropriate products to the attention of the customer in a cost-efficient manner and then converting that moment of attention into a sale at an economic premium.

Legal Organization

The discussion of an insurer's legal organization will succinctly address factual considerations of who owns the company under review, what is the legal structure of the organization, and who are the significant sister companies and subsidiaries within the group. More significantly, analysts will seek to ascertain whether the legal structure is expected to be effective for meeting the company's objectives and, of equal importance, whether there are any other associated operations outside the current analysis that could consume capital. If so, do these operations risk having an indirect but negative impact on the financial strength of the company or companies specifically under review?

The following are examples of the type of information used in evaluating a firm's competitive position:

- The degree of competitive advantage enjoyed by the organization because of distribution capabilities, product structure, investment capabilities, quality of service, cost structure, and market-segment dominance. It is vital to a company's long-term success that it differentiate itself from its competitors. We view companies without a sustainable competitive advantage less favorably.
- Diversification of revenue by business unit, geographic location, product, and distribution channel. The most favorable scenario, in our view, is to have a national presence and offer multiple products over a broad range of business lines, with each product line maintaining competitive advantages in its market, thus offering long-term profitability. In addition, we often view favorably a significant international presence.
- Market share of the total firm and by major product lines. Certainly, a high market share in significant markets is most desirable. However, high market share that is sustainable over the long term in product or geographic niches is usually also consistent with strong ratings. Equally important is how a company obtains and maintains its market share. Clearly, the more favorable and sustainable situation is when it has obtained market share through competitive advantage rather than simply through price-cutting.
- Efficiency of distribution system. We examine the types of distribution channels a company uses to determine their cost effectiveness. Whether a company uses the most appropriate distribution channel for each product line to maximize sales efficiency is important to our analysis. For example, a direct marketing effort will likely entail less cost than maintaining an exclusive agency force, but given the strong profitability and persistency of products sold through such agents, the additional cost of an exclusive agency is likely justified. Failure to fully harness and utilize a chosen distribution channel or channels can be a negative rating factor.
- The markets chosen. If an insurer caters to a particular niche market, we examine the growth trend of that market and the underlying factors driving the growth to determine their likely future course. Although we view favorably maintaining or expanding market share in growing markets, participation in markets that afford strong financial performance is also a key consideration.
- Growth of revenue during the past five years and projected growth for the next several years. We evaluate an insurer's growth in the context of the market or markets in which it operates. Although long-term growth would appear to be consistent with high ratings, market conditions can occur that would argue for constraining growth in an effort to produce sound profitability.

Additional examples of information we use in assessing health insurers' or health plans' competitive positions:

- Type of health delivery contracting primarily used (fee-for-service reimbursement, contracted arrangements with discounted charge reimbursements in propriety or rented networks, pre-paid (capitated) arrangements, or staff or group model HMOs) and relative advantages within the health plan's service area.
- Range of product offerings (i.e., HMO versus PPO, size of network, options for co-payments and deductibles, Health Savings Account), and relative penetration in the respective market.
- Growth rates of enrollment in total and by line of business on both net and gross bases, generally over a five-year period.
- Provider contracting strategies with hospitals, physician groups, and others such as pharmacy benefit managers. Duration of provider contracts and provider quality evaluation.
- Ability for medical management capabilities to control costs. Providing products and services that improve medical outcomes and wellness.
- Regulatory restrictions/oversight on lines of business, the ability of the health plan to obtain rate increases, and the restrictions, if any, on the accumulation of capital.
- Related non-insurance activities of the group.

Analytic Guidelines for Evaluating the Competitive Review

In evaluating an insurer's competitive position, Standard & Poor's has established guidelines for its analysts. The guidelines should not be construed as benchmarks, given that any company that scores well in some categories might be maintaining its competitive position by constraining itself in other categories because of market conditions. Hence, Standard & Poor's is not constructing a grid that dictates the business profile of highly rated companies by requiring them to fit a range of specific characteristics. Instead, we expect companies with a strong competitive position to have some characteristics that give them a sustainable competitive advantage and help them maintain a strong financial profile.

| Insurance Company Scoring Guidelines: Competitive Position | | |
|--|---|---|
| Most Favorable | Favorable | Least Favorable |
| Distribution | | |
| Has loyal distribution system providing high-quality business. Company has clear control over product distribution. | Maintains average control over distribution, which provides good-quality business. Persistency is average, and the company is usually the preferred provider of products to this distribution system. | Distribution system has low level of loyalty to company, often sells competitors' products, and produces poor-quality business leading to poor persistency. |
| Uses multidistribution systems and/or has strong control over a distribution system that has good access to a variety of markets. | Distribution system has good access to a couple of markets. | No apparent distribution strengths in any market. |
| Distribution system is highly cost-efficient. | Distribution system does not place company at a competitive disadvantage due to high cost structure, nor does it give the insurer a competitive advantage. | High cost of distribution places company at a competitive disadvantage. |
| Market Advantages/Market Share | | |
| High market share in significant markets. | High market share in smaller markets or middle-of-the-road competitor in larger markets. | Low market share. |
| Maintains cost advantages or sustainable product advantages over competition. Alternatively, maintains extremely strong competitive advantages in niche markets. | Competitive product structure. | No sustainable competitive advantages. |
| Operates in markets that afford strong financial performance. | Operates in competitive markets, but still produces good financial performance. | Operates in highly competitive or irrational markets. |
| Low threat of potential competitors disrupting the insurer's financial performance. | Moderate threat of potential competitors disrupting the insurer's financial performance. | High threat of potential competitors disrupting the insurer's financial performance. |
| Favorable regulatory environment. | Moderately favorable to neutral regulatory environment. | Unfavorable regulatory environment. |
| Diversification | | |
| Offers multiple products over a broad range of business lines. | Offers a small range of products over one or two business lines. | Narrow product focus over one or two business lines. |
| Most product lines maintain competitive advantages in their markets and offer long-term profitability. | Only a couple of product lines offer good prospects of long-term viability. | The long-term viability of most products and lines of business is in question. |
| | One product line accounts for more than 50% of long-term company profitability. | One product line accounts for more than 80% of long-term company profitability. |
| Geographic Diversification | | |
| Maintains national presence over a broad range of product lines (i.e., competes in 40 to 50 states). | Maintains strong regional presence (competes in 20 to 40 states). | Local presence only (competes in fewer than 20 states). |
| Has developed some significant international presence. | Little or no international presence. | Little or no international presence. |

Insurance Company Scoring Guidelines: Competitive Position (cont.)

| | | |
|--|--|--|
| Top five states represent less than 35% of premiums. | Top five states represent less than 50% of premiums. | Top five states represent more than 50% of premiums. |
| Top 10 states represent less than 60% of premiums. | Top 10 states represent less than 85% of premiums. | Top 10 states represent more than 85% of premiums. |
| No unusual concentrations. | Only minor concentrations. | Clear concentration risks exist. |

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