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**Evaluating Liquidity Triggers In
Insurance Enterprises**

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The insurance industry has long been sensitive to market perception of its credit quality. This is why Standard & Poor's Ratings Services views the speed with which the market can lose confidence in an insurer as an important factor of creditworthiness. When a crisis strikes, insurers without sufficient resources to cover all contingent calls on liquidity could quickly become insolvent, despite having otherwise healthy business operations and strong capital.

American International Group (AIG) is an example where the combination of mark-to-market losses on securities backed by its credit default swaps and rating-related triggers required the company to post significant collateral. We previously recognized AIG's potential mortgage-related losses and collateral requirements, but the rapid decline in asset values and market confidence exceeded our expectations, causing the rating action. This created a huge liquidity strain on what we had viewed as a healthy company: This limited its ability to access funding.

We consistently have considered triggers, material adverse condition (MAC) clauses, and other covenants when assessing an insurer's financial strength. Even in normal times, we evaluate how an insurer is positioned to handle stress scenarios, balancing sources of liquidity available in these scenarios against its liability structure and potential liquidity calls. We believe triggers elevate default risk, and therefore it is appropriate that ratings address this added risk. While two companies may be virtually identical in terms of operations and balance sheet, if one has material contingent liquidity calls and very tight triggers, we usually will consider it to have a higher credit risk.

Rating Trigger Situations

We believe that, from a credit perspective, it is risky for an insurer to effectively tie its fate to maintaining a certain credit rating. When an insurer agrees to pay a higher rate of interest on certain debt issues if its rating goes down, it would in most cases not have an immediate dramatic impact on its creditworthiness. However, we believe there is a considerably higher risk when an insurer agrees to credit puts that require it to retire large chunks of its financing or to post new collateral against trading positions in the event of a downgrade. In this scenario, a downgrade could precipitate serious liquidity problems, or even cause insolvency. In such a case, a proposed rating action may be larger, or quickly followed by additional rating changes as a result of these events.

Although a rating trigger may be intended to protect a lender, or counterparty, from the risk of dealing with a company that has a deteriorating credit rating, it could in some cases contribute to serious liquidity problems, or even bankruptcy, which could affect all parties. Substituting a financial benchmark for a credit rating as a trigger may not prove to be an effective alternative as it may produce a similar outcome. We do not play a role in companies' decisions to use ratings-related triggers or covenants and does not encourage the practice. In fact, we have taken the public position that we believe doing so creates additional risks. Moreover, this may contribute to our negative view of a company's management if it countenances such risks. Generally, our perception of management as unduly aggressive or imprudent is a negative rating factor. Consequently, these contingent liquidity provisions could have an impact on ratings, both directly as a result of liquidity issues, and indirectly, through our evaluation of management.

The Effect On Ratings

We have taken adverse rating actions where the underlying credit fundamentals indicate financial deterioration, and we have done so with the knowledge that these actions would potentially trip ratings triggers. Our analysis also takes into account expected triggering, which may have the potential to exacerbate ratings downgrades in certain circumstances. We believe any problem that erodes confidence in financial institutions that have not sufficiently anticipated liquidity needs in times of stress could have the potential to lead to a downward spiral with severe consequences--e.g., such as a run on the bank. As a result, we typically include these contingent calls on liquidity in our analysis of an insurer. We usually consider all triggers, whether they are tied to a rating from any rating agency or tied to a financial benchmark.

We believe having appropriate liquidity means the ability to meet contingent liquidity calls and maturing obligations promptly, while still being able to take advantage of market opportunities. We therefore believe an insurer's liquidity position tends to be more visible when its business is under stress. Key factors our analysts usually consider when evaluating insurers' liquidity include:

- How close the company is to trigger thresholds;
- How severe/immediate the consequences would be if the trigger occurred
- What amounts we expect to be involved; and
- How material we believe them to be for that company.

In our evaluation of insurers, we view those with material liquidity triggers as having a higher degree of risk, and we incorporate this risk into our ratings.

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