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## **Criteria | Insurance | General:** **Financial Flexibility**

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## Criteria | Insurance | General:

# Financial Flexibility

The evaluation of an insurer's financial flexibility is predominantly qualitative. It is broken down into capital and liquidity requirements versus sources of capital and liquidity. Capital and liquidity requirements refer to factors that might give rise to an exceptionally large need for long-term capital or short-term liquidity. Almost by definition, these exceptional requirements tend to relate to the company's strategic objectives and, thus, often involve acquisition or recapitalization plans.

Capital and liquidity sources involve an assessment of a company's ability to access an unusually large amount of short-term and long-term capital. Typically, these sources consist of demonstrated access to multiple types of capital markets, such as the long-term public debt market, the commercial paper market, and the Euromarkets. In addition, a company might hold assets with significant unrealized capital gains that could be sold without affecting the basic enterprise. The ability or demonstrated willingness to raise common equity capital is another important source of financial flexibility, as is the ability to obtain reinsurance in adequate amounts from a variety of high-quality markets.

One common source of financing for insurance companies is reinsurance. Although prudent use of reinsurance is often advisable, it can be misused in many fashions. A characteristic to be analyzed is the degree of reinsurance leverage as measured by the ratio of net written premium to gross written premium as well as net reserves to gross reserves. Reinsurers' creditworthiness is always a concern, but it becomes more relevant as this ratio falls. Pure coinsurance of risks can be a valuable source of capital and financial flexibility, while surplus relief transactions with little risk transfer have little value.

A review of Schedule F for property/casualty insurance companies or Schedule S for life and health insurance companies is necessary to identify the reinsurers being used. Among the items Standard & Poor's Ratings Services usually reviews are the creditworthiness of the names, the use of brokers with no real name behind them, large cessions to poor-quality names, and so on. Reinsurance protection is also reviewed in discussions with management. It is normally important for the company to have routine procedures for review and acceptance of all reinsurers. Companies that abdicate the responsibility are asking for trouble.

By far, the best source of long-term flexibility is created through generating good returns. Therefore, the returns on equity, assets, and permanent capital are evidence of the company's long-term access to sources of financing.

The most important element in our view of an insurer's financial flexibility is the relationship between the organization's needs for long-term capital and the sources available to it. Companies with modest needs could be quite successful with few sources other than retained earnings, while those with a voracious appetite for acquisitions might not be able to satisfy these needs, even with all the above-identified sources available to them.

Standard & Poor's is refining and adapting its methodology and assumptions for evaluating the financial flexibility of 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 "Property/Casualty Insurance Criteria: Financial Flexibility," published April 20, 2004; "Health Insurance Criteria: Financial

Flexibility," published April 21, 2004; and "Life Insurance Criteria: Financial Flexibility," published April 22, 2004, on RatingsDirect at [www.ratingsdirect.com](http://www.ratingsdirect.com) and Standard & Poor's Web site at [www.standardandpoors.com](http://www.standardandpoors.com).

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