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Criteria | Insurance | General:
**Methodology And Assumptions For
Gauging The Impact Of Unrealized
Losses On Insurers' Financial
Strength**

Primary Credit Analysts:

Steven Ader, New York (1) 212-438-1447; steven_ader@standardandpoors.com
Ron Joas, New York (1) 212-438-3131; ron_joas@standardandpoors.com
Kevin Ahern, New York (1) 212-438-7160; kevin_ahern@standardandpoors.com

Secondary Credit Analyst:

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

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Methodology And Assumptions For Gauging The Impact Of Unrealized Losses On Insurers' Financial Strength

Standard & Poor's Ratings Services is clarifying its methodology and assumptions for incorporating unrealized losses into the capital analysis of insurance companies and for adjusting insurance company equity for the purpose of calculating various financial ratios. We are publishing this article to help market participants better understand our approach to reviewing insurance companies. This article is related to our criteria article "Principles Of Corporate And Government Ratings," which we published on June 26, 2007.

Scope Of The Criteria

Standard & Poor's is clarifying its criteria for incorporating unrealized losses into the capital analysis of insurance companies and for adjusting insurance company equity for the purpose of calculating various capital and leverage ratios. The clarification focuses on:

- How we assess whether unrealized investment losses are economic losses, which we believe will ultimately be realized, or are temporary.
- How we evaluate unrealized investment losses in fixed-maturity portfolios in the context of our risk-based capital model for insurers.
- How we evaluate unrealized investment losses in fixed-maturity portfolios to adjust insurers' equity for the purpose of calculating various leverage ratios.

Summary Of Criteria Update

This article supersedes "Gauging The Impact Of Unrealized Losses On Insurers' Financial Strength," published Oct. 30, 2008, on RatingsDirect at www.ratingsdirect.com and Standard & Poor's Web site at www.standardandpoors.com. Notable changes include:

- Clarification of the application of criteria based on our assessment of the respective liquidity needs of companies.
- Clarification that our view of economic losses, not the method of accounting presentation, is the main factor in our analysis.

Impact On Outstanding Ratings

Overall, we do not expect significant rating actions stemming from this criteria update.

Effective Date

This criteria is effective immediately.

Methodology

Because of the current state of the financial markets, many insurance companies have reported—or are expected to report—material investment losses on their financial statements. In addition to the size of the losses, another factor can influence the degree to which losses affect an insurer's reported financial results: whether the company classifies the losses as realized, unrealized, or a combination of both. In response to market concerns regarding the application and interpretation of fair value measurements and other-than-temporary-impairment (OTTI) guidance, the Financial Accounting Standards Board has issued FSP FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" and FSP FAS 115-2, "Recognition and Presentation of Other-Than-Temporary Impairments." However, our assessment of a company's creditworthiness largely reflects our view of economic losses, notwithstanding the accounting presentation. As such, we do not expect any rating actions to result from the issuance of this clarification to our methodology and assumptions, though we do expect companies to report increased asset values and fewer impairments, when these impairments are recognized.

The financial reporting process requires that insurers assess their investment portfolios through an OTTI internal process that determines—on a security-by-security basis—when the fair value of the investment is unlikely to recover fully before the expected sale or maturity. When a company recognizes an impairment loss, it accounts for the investment by taking a realized loss, reducing the book value to the fair value on the date of the reported financials.

Realized losses from asset sales constitute a true economic loss, and, in our view, the recognition of an OTTI strongly signals the likelihood of economic losses. The presence of either could result in negative rating actions, depending on the size of these losses or OTTI relative to earnings, capital, and our expectations. Therefore, we are clarifying how we apply our criteria in assessing insurance companies' OTTI process and unrealized investment losses and their impact on our rating analysis.

We believe that in the fixed-maturity portfolio, the potential for unrealized losses to evolve into economic losses is less clear. If, in our opinion, the unrealized loss on a fixed-maturity securities portfolio is likely to be temporary, the insurance company is willing to hold these securities to full recovery, and we believe the company has sufficient liquidity to do so, we may treat the reported unrealized loss as not reflecting economic reality. As a result, our analysis might either heavily discount or eliminate the reported loss. However, to the extent we believe that unrealized losses are representative of an economic loss, we usually incorporate them into our assessment of capital and equity for the purpose of calculating various capital and leverage ratios. We factor these ratios into our rating analysis, so our ratings or outlooks on certain companies could be affected. Our adjustment to capital and equity applies a bifurcated approach, differentiating between companies that we believe have sufficient liquidity to hold these securities to recovery and those that might not. When we believe that a company might not have sufficient liquidity to hold these investments to recovery, we will incorporate the difference between the quoted market value and the cost for both economically and noneconomically impaired securities as a reduction to reported capital and equity. We will take this approach regardless of whether the quoted price in the market is associated with a distressed transaction. In cases in which we conclude the company has sufficient liquidity, we likely will incorporate the difference between fair market value (which may exclude quoted market prices in a distressed transaction) and the cost for economically impaired securities as a reduction to reported capital and equity.

Outlining The Review Process

We usually will start our review by gaining an understanding of a company's OTTI process. We will assess the insurer's degree of conservatism and the extent to which we believe we can rely on its OTTI process in appropriately identifying economic impairments. A company's liquidity is important in assessing OTTI and unrealized losses because it speaks to the company's ability to hold securities until their economic value recovers. The more uncertain a company's liabilities are (e.g., catastrophe exposure), the higher the hurdle it has to cross for us to assume it has the ability to hold the securities rather than potentially sell them at the market value and realize the loss. In addition, for some asset classes—such as residential mortgage-backed securities—we usually assume economic losses are realized and incorporate them into our assessment of capital adequacy. Furthermore, we believe that insurers' bond holdings, commercial mortgages, and commercial mortgage-backed securities could experience unprecedented stress in the next 12-18 months. As a result, we have set out our criteria for performing an incremental stress analysis to apply to these assets to further assess insurers' capital adequacy. (For more details, see "Methodology For Incorporating Incremental Stress Factors Into The Capital Adequacy Analysis Of North American Insurers," published Feb. 18, 2009, on RatingsDirect.)

The factors we generally review when we assess a company's investment valuation and OTTI process are:

- The company's policy for identifying securities for which it performs a more detailed analysis. For example, it might flag securities based on the extent or time period of the unrealized loss.
- The insurer's intent and ability to retain its investment as well as management's anticipated market-value recovery time.
- The company's strategy for holding so-called underwater securities (those that constitute a loss if sold immediately) and how the company mitigates the risk of potential OTTI.
- When there isn't a sufficient volume of observable market prices, the company's fair-value assessment processes and expertise of its personnel (internal or external) in applying these processes.
- Our assessment of recent changes in counterparty credit ratings on the underlying security portfolio relative to the company's OTTI conclusions and our opinion on the extent of the decline in value solely attributable to market illiquidity and interest rate movements.
- A comparison of the company's impairment charges to those of other companies holding similar securities as well as their policies for assessing impairments.
- The position of the company's auditors (and their challenges, if any) regarding the company's OTTI assessments on key decision points. These include the probability the company will collect, its intent and ability to hold the securities, the expected length of the recovery period, and the impact of the severity and duration of the unrealized losses.

In addition to assessing the potential economic impact of unrealized losses on capitalization and financial leverage, our analysis considers the accounting basis on which regulators measure a company's capitalization. Many U.S.-domiciled operating companies calculate capital adequacy from statutory financials, which, absent OTTI impairments, exclude unrealized gains and losses on fixed-maturity securities. Subject to our review of a company's OTTI analyses and processes for assessing impairments, we do not deduct unrealized fixed-maturity losses in calculating capital adequacy. However, our qualitative assessment of capital typically incorporates our evaluation of OTTI practices and the potential economic losses emerging from the unrealized loss position.

For Bermudan and other non-U.S. companies for which the regulatory statements incorporate market valuation on fixed maturities, our capital and financial leverage calculations typically reflect these unrealized losses. We do this because even if the losses are not economic, they likely will be incorporated into the regulator's view of capital. However, to the extent we believe the reported unrealized losses could be temporary and regulatory capital might not be materially affected, our qualitative analysis may incorporate our assessment of the OTTI process.

However, in cases where bonds are matched with nonlinked (or general account) life insurance liabilities that are not valued on a market-consistent basis, we generally exclude the unrealized gain or loss from our quantitative capital assessment. Conversely, when unrealized gains/losses are off the balance sheet, gains/losses on investments other than bonds matched with nonlinked (or general account) life insurance liabilities are typically included in capital (when evaluating insurance reporting on a U.S. statutory accounting basis, no adjustment is made).

All of these factors provide a basis for our analysis. However, the issues arising from different accounting standards in varying regulatory regimes mean we might need to make further analytical judgments to better reflect our estimate of the losses that may ultimately be realized, which we believe reflects more accurately the actual economic position of a given insurer.

Related Research

- "Analysis Of Insurer Capital Adequacy," April 22, 2009
- "Gauging The Impact Of Unrealized Losses On Insurers' Financial Strength," Oct. 30, 2008
- "Application: Standard & Poor's GAAP/IFRS Capital Model," Sept. 11, 2008
- "Methodology For Incorporating Incremental Stress Factors Into The Capital Adequacy Analysis Of North American Insurers," Feb. 18, 2009

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