Insurance Businesses and Credit Ratings

Transferring risk from the insurance policy holder to the insurer puts every insurance customer in the position of being a creditor, so the perception of creditworthiness is key to the viability of an insurance business. Expert assessments of creditworthiness in the form of credit ratings by multiple ratings agencies affect capital requirements, profitability measures, borrowing costs, customer acquisition, regulatory compliance, and investment strategies. Credit ratings often act as a constraint on insurance company investment portfolios, but the challenges of analyzing credit risk also present opportunities for active fixed income managers to outperform benchmarks. All investors can benefit from an awareness of the differences in ratings migration risk across fixed income sectors and may be able to customize their exposures to meet their investment risk and return needs.

Credit Ratings Structures

There are three main types of ratings agencies that are relevant for insurers:

1. **Capital & Investments**: Moody’s, Standard & Poor’s, and Fitch are the standard ratings agencies for fixed income securities.
2. **Regulatory**: The National Association of Insurance Commissioners (NAIC) assigns its own ratings to investments for certain regulatory purposes.
3. **Business Operations**: A.M. Best specializes in assessments of insurer claims-paying ability.

Ratings by Standard & Poor’s (S&P), Moody’s, and Fitch perform a dual role in the insurance business since insurance companies are not only investors in securities, but also issuers of fixed income securities. As investors, ratings of securities in the investment portfolio determine:

1. Capital charges for risk-based capital requirements,
2. Eligibility for favorable “hold-to-maturity” accounting treatment that allows investment grade fixed income to be held at amortized book value rather than marked to market,
3. Assessments of expected credit losses, and
4. Contribute to determining impairment criteria where insurers may have to reduce the accounting-carrying value of investments. Fixed income with investment grade ratings by these agencies is heavily favored by regulatory and accounting rules, and thus asset allocations at insurance companies reflect these benefits by having much higher allocations than public pensions, foundations, and endowments.

NAIC	S&P	Moody's	Fitch	Description
1	AAA to A-	Aaa to A3	AAA to A-	Top Investment Grade
2	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	Investment Grade
3	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	Top High Yield
4	B+ to B-	B1 to B3	B+ to B-	High Yield
5	CCC+ to CCC-	Caa1 to Caa3	CCC+ to CCC-	Low High Yield
6	CC to D	Ca to C	CC to D	Lowest High Yield

For purposes of regulatory capital requirements , including risk-based capital measures, insurers consider NAIC credit ratings. In many cases, the NAIC adopts the numerical equivalent of a rating provided by a Nationally Recognized Statistical Ratings Organization (NRSRO) such as S&P, Moody's, or Fitch. However, an asset manager working for an insurer on outsourced investment portfolios may need to assist in getting securities rated by the NAIC in certain cases such as unrated bonds. NAIC ratings 1 & 2 correspond to investment grade bonds, and NAIC ratings 3–6 correspond to below investment grade bonds. The table above provides a mapping of NAIC ratings to NRSRO ratings.

A.M. Best specializes in analyzing the claims-paying ability of insurance companies. Customers of insurance companies are most likely to see and reference A.M. Best ratings. Insurers with an A+ and A rating are considered to have strong claims-paying ability, while insurers with B through D ratings are progressively weaker. A+ down to A- ratings roughly correspond to investment grade credit ratings from the major credit rating agencies.

Best's Financial Strength Rating (FSR) Scale

Rating Categories	Rating Symbols	Rating Notches*	Category Definitions
Superior	A+	A++	Assigned to insurance companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.
Excellent	A	A-	Assigned to insurance companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.
Good	B+	B++	Assigned to insurance companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.
Fair	B	B-	Assigned to insurance companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
Marginal	C+	C++	Assigned to insurance companies that have, in our opinion, a marginal ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
Weak	C	C-	Assigned to insurance companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is very vulnerable to adverse changes in underwriting and economic conditions.
Poor	D	-	Assigned to insurance companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations. Financial strength is extremely vulnerable to adverse changes in underwriting and economic conditions.

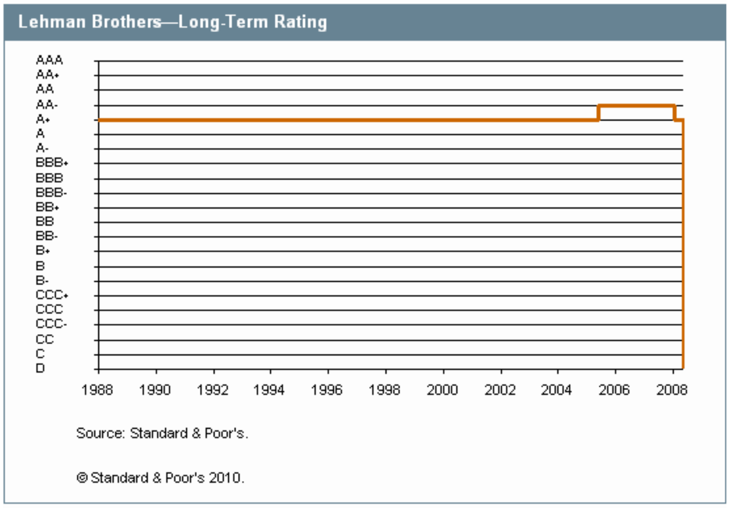
*Each Best's Financial Strength Rating Category from "A+" to "C" includes a Rating Notch to reflect a gradation of financial strength within the category. A Rating Notch is expressed with either a second plus "+" or a minus "-".
Source: AM Best. *Guide to Best's Credit Ratings*. October 6, 2023.

Ratings Evolution and Impact of Change

A key issue to consider about ratings of insurers is the pattern of ratings migration over time. With financial institutions, ratings changes have a tendency toward sudden collapses, often due to leverage. Financial leverage is inherent to the insurance business model because insurers invest premiums received and subsequently pay claims. The ratio of insurance claims paid to premiums received is known as the combined ratio, and a combined ratio unsustainably greater than 100% can result in a forced unwind of leverage. Loss of customers can also result in deleveraging.

The recent failures of regional banks, such as Silicon Valley Bank, were the result of a forced unwind of leverage when the fixed income portfolio was in a loss position due to rising rates. Similar fixed income loss positions that are not marked to market also exist at insurers, but insurers are usually less exposed to forced unwinds of leverage than investment banks or commercial banks because insurance customers typically have semi-annual or longer insurance contracts.

Sudden downgrades and defaults in financials are not new and depicted on the right is a dramatic example of the risk of a jump to default on the part of a financial institution—the 2008 ratings history of Lehman Brothers.



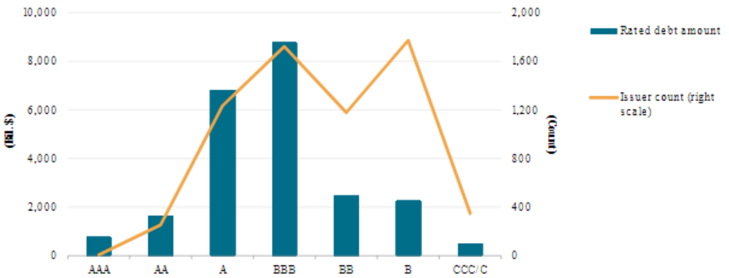
Investment Strategy and Opportunity

For active managers of fixed income with strong credit analyst teams, ratings can be a source of investment return outperformance relative to benchmarks. Ratings agency assessments are only updated periodically and the market trades daily, so NRSRO credit ratings usually lag changes in credit quality. While credit spreads often move before credit ratings, credit ratings can be a catalyst for additional market moves. Therefore, analytical work that is quicker and more accurate by investment managers can be rewarded by advantageous trading before the information is priced into markets.

Furthermore, unexpected economic cyclicality and interest rate changes can feed back into ratings to create ratings migration trends. The sustained economic strength and low interest rates of the period prior to 2022 provided an opportunity for many fixed income issuers to refinance at lower rates and created a positive feedback loop for credit quality through lower debt service coverage costs even with higher levels of debt. In contrast, the higher interest rates in the 2024 market will feed into higher interest costs as debt is rolled over in today's higher interest rate environment.

The table below shows the distribution of credit ratings as of 2023 yearend. An important recent credit ratings trend has been an increase in the percentage of investment grade credit outstanding, and a decrease in the percentage of high yield credit overall, but more troubled CCC or lower credit ratings within high yield. Within investment grade fixed income, the trend has been a decline in credit ratings from an average in the 1980s of A- to an average of BBB today.

Distribution of Global Corporate Debt by Rating Category



Amount and issuer count distributions of issuers as of Jul. 1, 2023. Issue amount includes bonds, notes, loans, and revolving credit facilities that are rated by S&P Global Ratings from financial and nonfinancial issuers. Issuer count is based on the total number of issuer credit ratings. Issuer count data from August release of S&P Global Market Intelligence's CreditPro®.
Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

Source: S&P Global Ratings. Credit Trends: Global State Of Play: Debt Growth Diverging By Credit Quality | S&P Global Ratings (spglobal.com)

Because there is a large step function increase in credit spreads between below investment grade BB and investment grade BBB credit ratings, we see that issuers target capital structures (leverage and debt service coverage levels) that optimize their cost of capital at the BBB level. The spread difference between BBB and BB credits is over 300 basis points, while the spread between AAA and BBB credits is less than 100 bps in today's market. A question that bears consideration is whether today's investment grade credit market is currently more fragile and susceptible to downgrades and defaults than historically given the combination of higher rates and higher concentrations in BBB credits.

While the investment grade credit market may be lower rated, less creditworthy, and facing higher interest rates, government policy has also shifted. During the pandemic, governments directly intervened to support investment grade credit markets, and indicated a willingness to support some high yield issuers as well. Government support may have contributed to credit markets rallying to the current historically narrow spreads to treasuries.

Although ratings are useful throughout the investment management, operations, and reporting process, credit ratings have many shortcomings. It is important to note that traditional NRSRO credit ratings are optimized more toward predicting the probability of default rather than loss severity. Although less widely referenced, credit rating agencies actually have different ratings scales for loss severity.

Despite the best efforts of ratings agencies, different areas of fixed income have better or worse histories of ratings migration for the same credit rating. On the positive side, BBB municipals have had credit performance better than A rated corporates. On the negative side, AAA rated securitized fixed income has experienced defaults (including a recent AAA CMBS issue) at much greater rates than predicted. Mortgage backed securities during the 2008–2009 time frame is another classic example of extreme and sudden downgrades of AAA securities.

It is difficult for ratings agencies to anticipate regime shifts in the economics of industries and securities because they depend on historical data to assess future probabilities. In addition, distributions of returns that differ from the normal distribution can be very challenging to assess. Thin tranches of securitized fixed income is an example of a type of security with cliff-like rather than normal return distributions after certain loss thresholds are breached. The waterfall cash flow structures and seniority in the capital structure of senior securitized fixed income may provide less protection than ratings models suggest.

Conclusion

In summary, ratings agencies are powerful tools woven into the fabric of insurance businesses and their investment portfolios. As investment professionals, understanding the strengths and weaknesses of different types of ratings can improve risk management, enhance or protect the business model, and offer potential attractive returns.

Additional References and Resources:

A comprehensive guide to mapping credit ratings can be accessed here.

AM Best ratings information can be found here.

Additional information about the effect of time on credit ratings can be found here.

Additional information on credit trends can be found here.

Disclaimer of Warranties and Limitation of Liability

This document was prepared by RVK, Inc. (RVK) and may include information and data from third party sources. While RVK has taken reasonable care to ensure the accuracy of the information or data, we make no warranties and disclaim responsibility for the inaccuracy or incompleteness of information or data provided or for methodologies that are employed by any external source. This document is not intended to convey any guarantees as to the future performance of investment products, asset classes, or capital markets.

About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the five largest consulting firms in the world, as reported by *Pensions & Investments' 2023 Special Report–Consultants*. RVK's diversified client base spans over 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenue from clients for investment consulting services.