

INSURER COUNTERPARTY RISK RATINGS

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PRORISK

PROBLEM SOLVED

COUNTERPARTY RISK DEFINED

... the risk to the insured that the insurer will not be able to meet its contractual obligations in full ...

THE NATURE OF THE RISK

- **DEFAULT RISK:** which may be a consequence of either –
 - (a) temporary liquidity problems;
 - or
 - (b) long-term financial problems

“WRONG-WAY” RISK:

The risk that different risk factors may be correlated in most harmful direction.

e.g. 2008/2009 when the GFC resulted in:

- Investment risk (declining equity markets)
- Reinvestment risk (collapsing bond/FIS yields)
- Liquidity risks (banks not lending)

THE MAIN RATINGS AGENCIES

Standard and Poor's

Fitch Ratings

Moody Analytics

A.M. Best

The ratings agencies:

- Evaluate financial strength;
- Evaluate overall economic and industry-specific conditions and trends;
- Evaluate qualitative aspects particularly the quality and experience of management, governance and risk management strategy;
- Evaluate reinsurance arrangement and quality of security utilised;
- Run stress scenarios.

STRESS SCENARIOS

- **Catastrophe events –**
 - any one event (e.g. Storm such as Yasi)
 - annual aggregate (e.g. Suncorp 2011)
- **Financial catastrophe events –**
 - Substantial bond/FIS downturn
 - Stock market crash

N.B. “wrong-way” risk

TRANSITION MATRIX

From/to	Base transition rates			Default
	A	B	C	
A	90.0%	5.0%	3.0%	2.0%
B	2.0%	80.0%	10.0%	8.0%
C	1.0%	4.0%	60.0%	35.0%

From/to	Stressed transition rates			Default
	A	B	C	
A	45.0%	24.5%	19.0%	11.5%
B	1.5%	40.0%	35.5%	23.0%
C	0.5%	1.5%	30.0%	68.0%

N.B. This is for reinsurers (empirically established by a major actuarial consultancy)

RECOVERY RATES

RECOVERY RATE = PROPORTION OF FULL DEBT RECOVERED IN DEFAULT

- Average close to 50% over time with wide individual case variations
- Lower recovery rate when defaults are more frequent (stress scenarios)
- HIH recovery dependent upon specific entity (HIH Casualty and General circa 20 – 25%)

“INTANGIBLES”

- INSURER/SECURITY HISTORY:
 - has the insurer weathered a major cat event?
 - attitude to calamitous claims whether due to frequency or severity?
 - “agency” considerations?

What matters is not just the ability to meet claims but the willingness!

LLOYD'S – RISK RATING AND SECURITY

1906 Cuthbert Heath *“Pay all losses”*

Lloyd's Chain of Security: (as at 31/12/2008)

1. Syndicate level assets	Stg 38.306 b.
2. Members' Funds at Lloyd's	Stg 10.630 b.
3. Central Fund	Stg 852 m
Corporation Assets	Stg 138 m
Callable Layer	Stg 495 m
Subordinated Debt	Stg 1.082 b
Solvency surplus	Stg 2.475 b.

LLOYD'S RISK RATINGS

S & P **A+**

FITCH **A+**

A.M. BEST **A**

MARKETFORM:

Long-established

Strong history of claims payment

Corporate capital provider American General

A CASE STUDY - HIH

Australia's largest general insurer in 2001 when the liquidation commenced.

Australia's largest corporate insolvency.

WHY?

- **Poor governance**
- **Poor underwriting management**
- **Poor and in many cases non-existent risk management**

HIH

Major Melbourne hotel brokered by an “international” was placed with HIH as it was by far the cheapest general liability insurer in Australia.

HIH failed in March 2001.

Liability program moved to ***Independent*** a price-rampant DOFI. Independent failed in June 2001.

The account was then moved ...

to another broker!

UNDERWRITING AGENCIES and SECURITY

MAJOR FOCUS MUST BE UPON:

- The **QUALITY** of the security.
- **EXPERIENCE** of the managers and underwriters of the agency.
- Not only proven ability to pay claims but a **HISTORY** of willingness to pay.

UNRATED SECURITY ?

at your peril