Insurance Carriers

Analyzing Credit Risk

2015

Historically, banks have been required under OCC Bulletin 2004-56 to follow comprehensive risk guidance on the management of BOLI assets which includes senior management and Board oversight, comprehensive investment and administrative policies, a thorough Pre-Purchase Analysis, and an ongoing system of risk assessment. In 2012, the OCC issued Bulletin 2012-18, which focuses on the credit due diligence of a bank's invested assets, specifically calling for bank management to look beyond the national ratings when performing a credit analysis on new and existing investments. When it comes to BOLI, the primary source of credit risk is the insurance carrier's financial strength and its ability to meet long-term contractual obligations.

No less than annually should bank management review the credit risk associated with their BOLI assets. Bank management must hold an independent viewpoint on the risk rating and creditworthiness of its BOLI carriers. As part of our services, on a quarterly basis, TPG has historically provided our clients the information below for each insurance carrier with which they hold BOLI. The financial information and analysis has been updated annually based on the carrier's annual NAIC filings. National rating information is updated every two weeks.

- Asset Analysis
- Asset Quality Analysis
- Bond Portfolio Analysis
- Operating Income Analysis
- Premium Growth
- Profitability
- Analysis of Face Amount of Insurance
- Analysis by Line of Business
- Current and Historical National Ratings

With the recent changes in the regulatory environment, TPG has enhanced its quarterly carrier financial analysis to include improved models for managing credit risk. As a result of our engagement with SNL Financial, we are not only able to gather more information about an insurance carrier's financials at a given point in time; but, we can also provide five years of historical information to help analyze trends within each category. This information will be updated each quarter rather than annually.

Another important tool for measuring a carrier's financial position is having the ability to compare that carrier with industry results. Many of the new sections in TPG's enhanced carrier analysis allow bank management to review a carrier's trends in relation to the industry's trends.

As part of enhancing our carrier financial analysis, TPG has added a number of sections that are important to understanding a carrier's financial position.

- Liquidity Analysis
- Key Financial Ratios
- IRIS Ratios
- Capital Adequacy and Leverage Analysis
- Reinsurance Analysis
- Current Balance Sheet and Income Statement
- Asset Valuation Reserve Analysis
- Surrender and Lapse Ratio Analysis

When analyzing an insurance carrier, there are a few key indicators bank management can review to determine its creditworthiness. Any irregularities may require additional research.

- **Financial Strength Ratings** – current National Rating Agency Ratings, last change, and outlook, if available. To help understand what each rating means, refer to our National Ratings Definitions sheet. The Carrier Rating Index (CRI) is a percentile ranking of the carrier based solely on its current ratings compared to approximately 750 life insurance companies. A carrier must have at least two ratings to qualify for a CRI ranking.

- **Key Financial Ratios –** When reviewing these ratios you may need to review reference data provided in the report to explain unusual results.

  - Authorized Control Level Risk-Based Capital - measures the minimum amount of capital needed to support the business operations of an insurance carrier given its size and risk profile (minimum of 200%);

  - Liquidity Ratio - cash and equivalents, common stock and the carrying value of investment grade bonds (a 1 or 2 NAIC rating) as a percent of liabilities (Cash, Common & Liquid Bonds/Liabilities);

  - Bonds rated 3-6/Total Bonds – bonds that are considered non-investment grade as a percentage of total bonds;

  - Net % Chg in Capital and Surplus – measure of profitability; this ratio may not consider the impact of surplus adjustments, dividends, or capital & surplus paid in;

  - Leverage Ratio - aggregate reserve for life contracts, plus aggregate reserve for life and health contracts, plus deposits as a percentage of capital & surplus (Total Liabilities/Capital & Surplus);

- **IRIS Ratios –** The IRIS Ratio Application generates key financial ratio results based on financial information obtained from insurers' statutory annual financial statements. The ratio results are used in determining the level of regulatory attention required. A ratio that falls outside the usual range is not necessarily considered adverse. An increase larger than "usual" in policyholders' surplus is not necessarily an unfavorable result. The ratios and trends are valuable in identifying insurers likely to experience financial difficulties. They are not, in themselves, indicative of adverse financial conditions. For additional information and instructions, refer to pages 35 through 56 of the IRIS Ratio Manual:
  (http://www.naic.org/documents/prod_serv_fin_receivership_uir_zb.pdf).

As bank management analyzes a carrier, it may be useful to create a risk matrix in order to help comparatively rank carrier risk. Once bank management has determined the appropriate process for monitoring its BOLI credit risk, the process should become part of the bank's regular credit policy and should apply it consistently to help demonstrate the required independence of the risk analysis.