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Update: Rating Triggers in the U.S. Life Insurance Industry In 2004

Overview

Rating triggers, their forms, prevalence, and potentially adverse effects on the financial health of North American life insurers, have been the subject of heightened focus and analysis at Moody's over the last several years. This is the third Special Comment to analyze rating triggers in the US life insurance industries since our first report was published in May 2002[1].

As in prior years, this Special Comment focuses on the results of *Moody's Rating Trigger Survey*. The survey is distributed and completed by Moody's rated life and health insurance companies during the first quarter of each year, and it is updated for changes as they occur.

In this report, *Survey* data for 2004 is analyzed in terms of overall rating trigger usage, frequency, and severity. The data is then compared with *Survey* results from the two preceding years, and changes are analyzed in the context of recent rating trigger trends. The report concludes with Moody's opinion on the state of rating triggers and their potential impact from a ratings point of view.

This report builds on an in-depth discussion of rating trigger usage, risks, consequences, and potential mitigants that was introduced in Moody's first rating trigger special comment[2]. The 2002 report also presented the basic methodology that Moody's used – and still uses – to analyze triggers and to compile the survey data each year in its updated reports.

Definitions

Consequential Trigger: A trigger that has a substantial impact on the current credit ratings of a company. That is, the current rating of the company is lower as a direct result of the presence of the rating trigger. The existence of the trigger, in and of itself, substantially impairs the company's ability to withstand and ultimately recover from significant adverse conditions.

Material Trigger: A trigger that does not impact the current rating level, but would (hypothetically) have a ratings impact either in other reasonably likely business conditions or if the company's ratings were at other (lower) levels.

Non-Material Trigger: A trigger that has no impact and is not likely to have an impact on the rating at the current or any rating other level.

1. *See Moody's Looks at Rating Triggers in the U.S. Life Insurance Industry, May 2002.*
2. *

Summary Opinion: No Industry-wide Downgrades Are Anticipated, Despite Increasingly Widespread Trigger Usage

The incidence of reported rating triggers used in North American life insurers' financial and insurance contracts continued to rise in 2004. Rating trigger usage has grown every year since Moody's first started tracking rating triggers on a more formal basis in 2002.

What is responsible for the growth in rating trigger usage? We believe it is a function of two primary factors. First, the continuing growth and complexity of the life insurance industry. Business expansion spurs the growth of all types of contractual and financial contingencies. Second, concerns have risen among life insurers' business partners and purchasers of/counterparties to life-insurer credit risks, which were heightened during the recent period of economic and credit weakness.

Despite the continuing growth in rating trigger usage in 2004, the severity of rating triggers did not increase. Only one healthcare company had a "material" rating trigger embedded in a financial contract that could potentially result in financial stress if breached. Those companies with potentially dangerous rating triggers of this nature, which do not have them removed from the contract or materially softened, can face a rating downgrade that would reflect their potentially adverse financial impact. No companies had "consequential" rating triggers.

This is not to say that there were no other rating triggers of any significance as of May 2004. Many insurance and financial contracts of life insurers included rating triggers that are three notches or fewer away from the companies' current rating levels.

However, the impact of the rating trigger is not determined by its distance from the company's current rating alone. Other essential considerations are the following: the materiality of the liability under the trigger; the severity of consequences of breaching the trigger; and the probability of its breach.

Aside from the one healthcare provider, no other companies in Moody's rated universe of US and Canadian life insurers had rating triggers that could engender material, severe, imminent financial consequences as of May 2004, or consequences that were not already reflected in their ratings. No rating-trigger-based downgrades are currently anticipated.

Despite this healthy 2004 industry "report card," Moody's remains vigilant regarding rating triggers because they are more prevalent now than before. The greater incidence of rating triggers was particularly notable in insurers' bank loans and reinsurance contracts as of May 2004.

This means that relatively more life insurance companies are subject to more onerous financial requirements from their business partners if they are downgraded, from higher borrowing rates in their bank agreements (which are relatively benign), to collateral requirements under reinsurance contracts (which may be more onerous).

Increased Number of Rated Companies Affects 2004 Rating Trigger Survey Results

In order to understand year-over-year changes in Moody's Rating Trigger Survey, it is important to understand intervening changes to Moody's universe of rated companies.

For example, since the last publication of this report in June 2003, Moody's universe of rated North American life insurers grew by 11 insurance groups, from 72 to 83. Most of the increase was due to the inclusion of nine additional healthcare companies, the majority of which were transferred from another Moody's rating group.

At the same time, the revival of merger and acquisition activity brought about other changes. Several new life insurance ratings were added, while other ratings were withdrawn. The net increase was 11 new companies to our rated universe of US and Canadian life insurance groups.

These events altered not just the size, but also the composition of our pool of survey respondents. As a result, the numerator and denominator changed for many of the statistics used in this report.

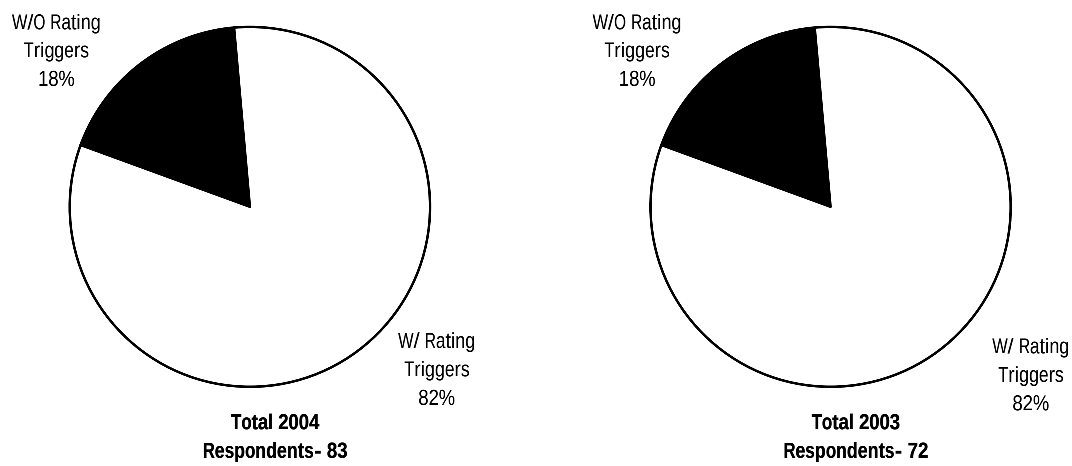
Despite these changes, the general rating trigger "picture" remained relatively unchanged: most major life and health insurers have triggers in their products and financial arrangements, and the major rating trigger categories in 2003 –derivatives and reinsurance – tended to be the largest again in 2004.

The consequences of breaching any of Moody's seven rating- trigger categories were also the same as in the past, from the benign (i.e., a fee and interest rate increase on bank borrowings) to the potentially more serious (collateralization or termination of a reinsurance contract). The 2004 Survey results brought no surprises, as described below.

Response Rate - All 83 of Moody's rated life insurance groups participated in the 2004 Trigger Survey, resulting in a response rate of 100% for the second year in a row. This response rate compares favorably with an initial 92% response rate in May 2002, the first year of our formal survey.

The 100% participation rate is important in light of the potentially adverse impact of rating triggers on the financial flexibility of life insurers during times of stress.

Comparison of Rating Trigger Exposure For Moody's Universe of Rated Life Insurance Groups May 2004 versus May 2003



Exposure to Rating Triggers

As of May, 2004, approximately 82% of our respondents had exposure to one or more types of rating triggers, while 18% reported no rating triggers (Figure 1, left pie chart, above). This proportion of companies with triggers remained unchanged from 2003 (Figure 1, right pie chart), despite the inclusion of nine additional healthcare companies in 2004, many of which have rating triggers in their bank loans.

The primary reasons that there was no net increase in the **"With Triggers"** group are: 1) merger and acquisition activity, which completely eliminated some of the former contractual arrangements of the acquired companies (along with their triggers), and 2), the elimination of some bank loan triggers upon renegotiation of the credit facility.

The **"With Triggers"** group continues to represent the industry's larger, more complex players, as it did in 2003 and 2002. The **"No Trigger"** category tends to be composed of small, regional retail life or health insurers, with little or no institutional business, no public or private borrowings, and simple life, health or fixed annuity products.

Number of Rating Triggers and Types of Rating Trigger Exposures

Number of Rating Triggers – In absolute terms, the number of rating triggers rose to 139 in 2004 from 121 in 2003, or by almost 15%[3]. Excluding the healthcare companies, whose survey results were not part of our trigger statistics in 2003, the rate of growth was a more moderate 6%.

Whether adjusted for health insurers or not, this growth affected the relative exposures that life insurers have to different types of *Financial* and *Product* rating triggers (Figure 2). It also changed the size of rating trigger categories relative to one another (Figure 3), as described below.

3. Moody's has categorized rating triggers into the seven most common financial and insurance product contracts in which they are embedded: Bank Loans, Other Financial Arrangements, GICs, Reinsurance, Derivatives, BOLI/COLI, and Other Product- Related Contracts. Each company's exposure to rating triggers within a certain category counts as one. For example, if a company has 10 ISDA contracts, each of which has a collateral-based rating trigger, that counts as one derivative rating trigger. For more detail on Moody's rating trigger methodology, see the May 2002 Special Comment.

Types of Rating Triggers

Life Insurers' Exposure to Financial and Product Rating Triggers – Figure 2 shows that, as of May 2004, more life insurers were exposed to rating triggers in their bank loans, reinsurance contracts, and other insurance product arrangements than in either 2003 or 2002.

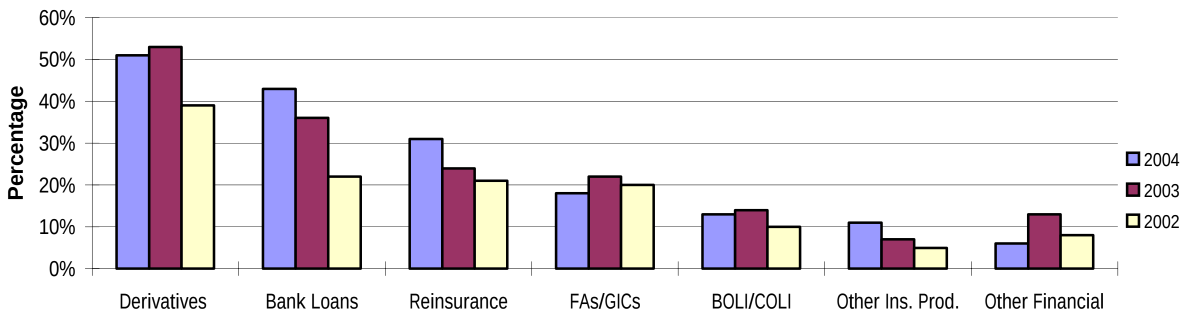
The increased exposure to bank loan rating triggers was primarily the result of the growth of our rated universe of life insurers in 2004. As noted earlier, most of the growth was due to the inclusion of nine additional healthcare providers, which tend to be active users of bank loan facilities. Most of these facilities had rating triggers embedded in them.

We note, however, that the consequence of most bank loan triggers in the 2004 Survey (i.e., 80%) involved "pricing grids," whose impact (i.e., higher loan fees and borrowing rates) is relatively benign. The remaining 20% of 2004 bank triggers had language that would require termination and repayment if triggered; however, in these cases, the triggers were distant, the amounts were not material, or there was no usage under the line.

Only one healthcare company had a potentially more dangerous, material bank rating trigger under a bank facility (with loans outstanding), resulting in an "Event of Default", requiring immediate repayment if the insurer's ratings fall below a certain rating level. This, in turn, would trigger a default under other credit agreements as a result of cross–default provisions. This company is considering options to eliminate the trigger, or to pay off the loan.

We note that no other rating trigger category in Figure 2 was significantly affected by the inclusion of the healthcare companies in 2004. Most pure healthcare providers do not sell life insurance products (i.e., BOLI/COLI, GICs), are not active in the derivatives market, and use less reinsurance than life and annuity companies.

Figure 2: Percentage of Respondents Exposed to Each Type of Rating Trigger Category



# of Respondents in '04 = 83, in '03 = 72, in '02 = 77
# of Rating Triggers in '04 = 139, '03 = 119, in '02 = 96

Note: In 2004, only 20% of those companies exposed to Bank Loan triggers had triggers with termination clauses; the remainder had triggers with rating grids, which are largely benign.

Life insurers were also more exposed to rating triggers in ***reinsurance contracts*** in 2004. A number of factors contributed to this growth: the revival of merger and acquisition activity, which moved blocks of business via rating trigger-protected coinsurance; new reinsurance company ratings; more attentive reporting by Survey respondents; and finally, greater overall reinsurance usage.

Rating triggers in reinsurance treaties can typically have a number of consequences. They can require the reinsurer (or offshore reinsurer) to post collateral (or higher levels of collateral) of high-quality assets in a trust; they can prompt a draw down on a bank letter of credit (LOC); they terminate the treaty for new business; and/or they can cause the existing block of reinsured business to unwind and be recaptured by the cedant.

As noted, none of Moody's rated reinsurers had rating triggers that were deemed to have financially serious consequences in 2004. However, because the potential for collateral and/or LOC-related liquidity problems is high, Moody's monitors the rating triggers of stand-alone reinsurers closely, and where necessary, factors them into these companies' ratings.

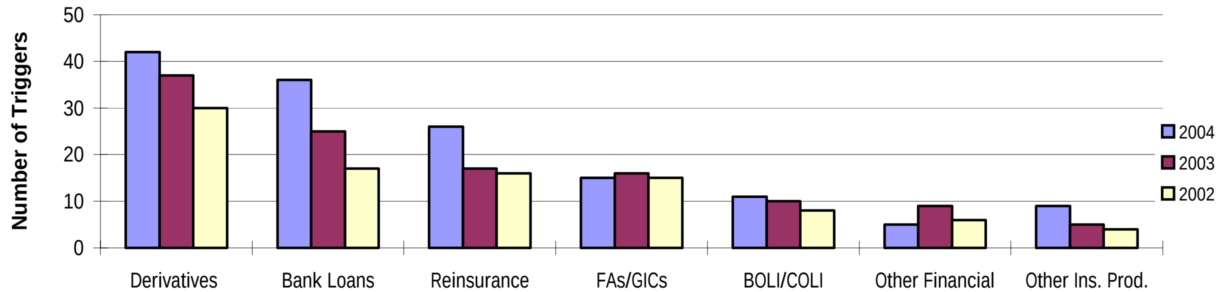
Although a relatively smaller trigger category overall, ***Other Insurance Products*** experienced growth as of May 2004. This category is a catch-all for various marketing arrangements between life insurers and third parties. The increase in 2004 was largely the result of new marketing agreements and group affiliations.

Despite the growth in new distribution arrangements, marketers grew more wary of credit and reputational risk during the recent challenging economic period, and thus included rating triggers to protect themselves from the potential credit deterioration of their life insurance partners.

The consequences of breaching a distribution trigger tend to be relatively benign, simply resulting in the termination of the contract for new business.

Figure 2 also shows that some rating trigger categories were relatively flat or slightly down from prior years. The funding agreement (FA)/guaranteed interest contract category (GICs), for example, receded marginally as of May 2004 compared to June 2003. This is because insurers have continued to shift away from putable funding agreements, in favor of longer-dated, non-surrenderable funding agreement-backed notes, which have no triggers embedded in them. Changes in other rating trigger categories were statistically insignificant, or due to prior-year reporting error.

Figure 3: Growth of Rating Triggers & Trigger Categories
May 2002 - May 2004



Total # of Triggers in 2004 = 139 Total # of Triggers in 2003 = 119 Total # of Triggers in 2002 = 96

Figure 3, above, shows the size of rating trigger categories relative to one another, and their growth, in nominal terms, from June 2002 through May 2004. The three largest trigger categories in the past in nominal terms, namely, Derivatives, Bank Loans, and Reinsurance, in that order, remained the largest categories again in 2004. As noted earlier, 80% of the total number of bank loan triggers involved pricing grids, which are relatively benign.

Bank Loan, Reinsurance, and Other Insurance Product trigger categories rose 40%, 53%, and 80%, respectively, between 2003 and 2004. The inclusion of the new healthcare companies, as well as a more active reinsurance market and expanding use of third-party distribution channels, all contributed to the growth in these three trigger categories, respectively, as described in the exposure discussion above. We note that the percentage increases appear large because they are derived from relatively small numbers.

Derivatives – which are actually the largest category for rating triggers – also grew in 2004 versus 2003, by a somewhat smaller 14%. The growth was largely due to increased usage. Life insurers have traditionally used derivative products to hedge the interest rate and foreign exchange risks associated with their investment portfolios. They are now also using these instruments to hedge both the equity market risks of their variable products and the credit risks of some of their investments.

Most derivative contracts require collateral posting, or increased collateral posting at various rating trigger levels. In some cases, the termination of the derivatives contract is required. None of these triggers had potentially serious consequences to Moody's rated universe of life and health insurance companies as of May 2004.

Figure 2 shows that the percentage of companies exposed to derivatives rating triggers declined in 2004, while Figure 3 shows that derivative rating triggers actually grew slightly in 2004. The reason for the percentage decline is that the total number of companies in the survey increased in 2004, but only a small number of these companies had derivative rating triggers.

Again, changes in other rating trigger categories in Figure 3 were either modest, or due to prior-year reporting error.

Conclusion: Rating Triggers Remain, For the Most Part, Relatively Benign

Moody's 2004 *Rating Trigger Survey* indicates that the usage of rating triggers has continued to rise in the life insurance industry, partially as a function of the recent challenging credit and operating environment. At the same time, the importance and potential adverse effects of rating triggers have become better understood. As a result, their increased usage by life insurers has not been accompanied by additional negative consequences or increased severity.

Despite the greater number of rating triggers, the types that exist continue to be relatively benign in terms of their potential financial consequences for the vast majority of Moody's rated North American life insurance universe.

However, because certain rating triggers, by their nature, can have a rapid, severe impact on the financial flexibility and health of life insurance companies, Moody's will continue to monitor, evaluate, and report on their development on an on-going basis. Rating actions will taken on a case-by-case basis, if need be.

Related Research

Special Comment:

Moody's Looks At Rating Triggers In The U.S. Life Insurance Industry, May 2002, #74986

Update: Rating Triggers In The U.S. Life Insurance Industry In 2003, June 2003, #78508

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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