An interview with Rob Jones and Peter McClean, Standard & Poor's Managing Director of financial service ratings Europe and Associate Director with responsibility for the Spanish market, respectively

«Companies are rebuilding their capital bases»

It is not so long ago that Standard & Poor's, one of the world's great names in credit rating, discovered its vocation for the financial sector. Founded in the US by Henry Varmun Poor in 1860, initially it concentrated on the rating of securities used for financing the construction of the country's railway network, including the line which would join the Atlantic with the Pacific. It has been only since the 1970s that it began to enter definitively into the financial world, some time after its merger with Standard & Statistics in 1941, a merger which created the company as we know it in its present form. Its presence in Europe, within the field of insurance, became especially pronounced in the 1980s after its acquisition of the British firm ISI (Insurance Solvency International), which would serve as a platform for the services which it currently renders within the sector.

Rob Jones is an accounts auditor and professional insurance auditor. As team leader of Standard & Poor's credit solvency analysts for insurance companies in Europe, he joined the firm in March 1995. Previously he worked as 'Senior Manager' of Ernst & Young. In Standard & Poor's, Rob Jones has spent six years covering a wide range of activities related to the needs of the clients, in non-life, life and reinsurance. In this period he has been especially involved in relations with large clients such as Zurich Financial Services and the Swiss Re groups. Likewise, he managed the team that carried out the first rating analysis undertaken of the Lloyd's of London insurance market in 1997. He has also been involved with the development of the analytical criteria for insurance companies that Standard & Poor's is evolving, including the capital adequacy model, as well as promoting the internal and external development of training courses and seminars.

Rob Jones specialised in insurance over more than 14 years with Ernst & Young in London and New York. His background is in auditing and consultancy services for insurance companies and he was involved with companies providing technical insurance support and training activities.

Peter McClean (left) is associate director of Standard & Poor's credit solvency analysis team for insurance companies, Europe. He joined the firm in September 2001, after having held various managerial positions in the Guardian Royal Exchange group, and subsequently AXA. He is a professor of the Chartered Insurance Institute, a Chartered Insurer and member of the Institute of Risk Management. He has wide experience in non-life, life and reinsurance. Currently he is actively working on the assessment of ratings for insurance companies within the Iberian Peninsular, as well as captives. Peter McClean gained invaluable experience in his time at Guardian Royal Exchange, including a period of four years as head of operations in Spain, as well as other markets such as Japan, Taiwan and Hong Kong. On his return to London he joined a GRE subsidiary specialised in risk management, and during this period he created the reinsurance protection for the captive company Cell in Guernsey.

Question: Taking as a starting point the great upheaval which has affected the sector worldwide over the last few months, and the overall downgrading of the ratings of Insurers and Reinsurers, how do you view the scene?

Rob Jones (hereafter R. Jones): To begin with, yes, one can speak of changes in ratings within the companies of the sector; downgradings being the general trend. However, the situation is not nearly as catastrophic as the Press has made out, or at least certain sectors of the Media. Nothing has happened that can be considered out of the ordinary at a time when several major factors have come together, such as the terrorist attacks, the fall in Stock Market values and a series of natural disasters especially damaging to our industry.

Question: In these circumstances: What has had the greatest impact on Insurers and Reinsurers? The level of large claims, such as the 11th of September 2001 terrorist attack , or the problem of share values on all financial markets?

R. Jones: Without any doubt, the main reason has been the overall fall in the indices on the world's securities markets. This has affected the capital base of companies in this industry far more than the claims they have had to settle.

Question: What will turn this situation around ? A stock market recovery or the return to prudent underwriting which can currently be felt in the market?

R. Jones: The answer has to do with a little of both. Insurance and Reinsurance companies have suffered greatly and at this time they are rebuilding their capital base. To this end, the recovery of the stock markets can be of as much help as good risk selection . But what is most important, in my judgement at least, is the need to apply common sense when underwriting business and the definition of the financial policy which a company should pursue. Other important aspects are that companies regain confidence, that they increase their capital, and that consumer spending recovers.

Peter McClean (hereafter P. McClean): Logically, the companies which have experienced the severest downgradings have been those with the highest levels of investment in equity markets; British, Dutch, Swiss and North American companies. In Spain, as Insurers do not have a high proportion of stock market investment, they have not suffered a similar fate.

Question: In one way or another, speculation was being encouraged, wasn't it?

R. Jones: Up to a point you are right, but I can also understand the reasons behind the way these companies have acted; companies with major interests in life insurance, and therefore duty bound to invest in equities to obtain an appropriate level of profitability on the funds they manage on behalf of their customers. Companies operate on the basis of long-term expectations and results; in this sense, they have acted correctly, because nobody was capable of foreseeing what has since taken place on the equity markets.

P. McClean: In comparison with other European companies, in Spain there is little stock market investment. But, what is more, from our point of view, this country has avoided the crisis. This problem has not manifested itself with such virulence in Spain as it has in other countries.

Question: To what extent does rating assessment condition the performance and the results of a company?

R. Jones: Of course they have their influence, but in some markets more than others. In the United States it is almost inconceivable to conclude a large deal with a company which has a dubious rating. This philosophy is gaining ground now in Europe. With regard to the Spanish market, it is possible that the public still does not give this aspect much thought, but they will gradually become more circumspect, because the rating acts as a warning sign.

Question: How often is a rating awarded?

P. McClean: There is a constant review process and an annual procedure, above all in the case of the companies with whom we maintain an «interactive» rating; or rather, those companies whose rating is not based solely upon public information. In these cases the reviewing is continuous. But in extraordinary circumstances, such as those we have experienced recently, if previously we only looked at year-end accounts, nowadays, in some cases, we review them more frequently, even weekly.

Question: Last year, how many times did you have to change ratings for the 34 European companies which you analyse in this sector?

R. Jones: I do not have the figures at hand from insurance, though worldwide we changed the ratings at least twice for 220,000 companies.

A CLEAR BET

Question: What resources do you have to be able to carry out your work in Europe?

P. McClean: We have 35 analysts working exclusively on the European insurance sector spread. They are split into three teams, two in London and the third shared between Paris and Frankfurt. With regard to the banking sector, we have more people in Paris than in London.

Question: What are the maximum and minimum ratings that Standard & Poor's awards?

P. McClean: Theoretically, the highest is AAA+. Then we can go down to what we consider the lowest acceptable rating for the markets, which is BBB. We could not recommend a company with a lower rating than this; it is considered vulnerable. Above BBB a company is considered secure.

Question: What aspects are you going to be focusing on when it comes to awarding a rating?

R. Jones: More or less on the aspects which we have always considered important; the capital and shareholder's equity; on trends in OPERATING results; on the management and corporate strategy; on the soundness of market position; on the quality and liquidity of investment portfolios, etc.

Question: Does a company's investment in technology influence the rating which is finally awarded?

R. Jones: With regard to our business, which focusses on assessing exposure, it has little influence. However, we have a basic assumption that technology is necessary, that it brings advantages, that it helps to reduce costs while helping to make management more dynamic.

Question: Do you think that ratings have gone down generally in all sectors?

R. Jones: I would not presume to comment on sectors other than those I myself deal with, but it is evident that in finance, technology and I.T., a lot of adjustments have been made.

Question: How much do you think company failures and mergers have influenced the way in which companies are valued, especially over the last few months?

P. McClean: Over recent months we have introduced no special changes to our methods of working, given that we are always refining our way of working and publishing the results. This information is on our website.

R. Jones: We are always improving and checking our procedures. Recently we arranged a series of seminars to disseminate our knowledge and familiarise our clients with our way of working.

Question: Throughout the European Union there is particular concern about the start-up of Solvency II, which are the directives from Basle II for the insurance sector regarding the new capital requirements and standards for reserving and financial information, with the aim that companies have standardized data on either side of the Atlantic so that proper comparisons can be made. What repercussions will this have on the insurance industry?

R. Jones: The general view is that this can and will be done. The first phase involves companies which are quoted on the stock markets and it is hoped that this will be completed by 2005. A second phase is also being discussed for 2007, though as yet nothing is finalised as there are some countries that wish to defer it. For us too it would mean introducing changes in our assessment criteria, but the biggest impact will be felt by those companies which are unprepared. All these changes are going to mean a heavy workload for the actuaries. And of course, there are countries which are ill prepared to carry all this through.

Question: Could you name one? Is Spain among them?

R. Jones: In each country the problem will be different, and, in this sense Spain could be mentioned, although problems will also occur in France, Italy, the United Kingdom or Germany. There will always be things left undone and, for this reason the work of the actuaries will be of great importance. Here too there is talk of putting back deadlines.

Question: What impact will this have on the companies of the sector? Will they have to increase reserves and set aside funds in relation to their exposures?

R. Jones: Yes, more or less that will be the case. All the countries are now beginning to see exactly what they will have to do. And they are arguing amongst themselves about how to carry it all through. There will be a new method of risk assessment which will begin with the process of identification, then pricing and finally the calculation of an appropriate reserve. But all of this is fraught with problems. France has already let its objections be known.

Question: What is the general opinion of the Spanish insurance market as a whole?

P. McClean: It is a very stable market, and still fairly fragmented. There need to be more mergers and acquisitions, though if you take a closer look, you will see that actually there are not so many companies as many belong to the same group. There is still room for improvement.

Question: Spain is the fifth largest insurance market in Europe, although it is not comparable in terms of insurance penetration, is it comparable in qualitative terms?

R. Jones: As far as I know, yes it is. What is more, in Spain, there is less competition than in other countries such as Holland or the United Kingdom. And this contributes to a greater stability and less volatility.

Question: With regard to ratings, which way is the market heading?

R. Jones: Starting from the fact that we have had to downgrade many companies, a fact that implies that we have had to analyse many aspects, it is fairly probable that we are seeing the light at the end of the tunnel, and that many ratings will go from being negative to stable. The sector remains weak and it will be some time before it recovers its positive prospects. ■