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FACTORS AFFECTING CREDIT RATING AND STRATEGIES USED BY ZIMBABWEAN REINSURERS

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ABSTRACT

This study was performed to explore factors affecting credit rating and strategies used by Zimbabwean reinsurers to increase their rating. The study adopted the KMV Model. The study utilised a descriptive research design. The population set was the nine reinsurance companies in Zimbabwe and eight of them were the study sample. The Chief Executive Officers (CEOs) of the eight companies were purposively selected to be interviewed. From the literature and the interviews, four variables which are; Operating Environment, Business Profile, Financial Profile and Comparative Profile are the main factors that affect the credit rating of reinsurers. Some of the strategies used by Zimbabwean reinsurers are change of geographical location, keeping their credit utilization rate low and enhancing the balance sheet strength, expeditious claims payment, rate manipulations and split ratings.

Keywords: Credit Rating, Reinsurers, Business Profile, Financial Profile

1.0 BACKGROUND TO THE STUDY

Credit ratings provide opinions on the ability of reinsurance companies to meet their obligations as they fall due. They serve an important role in modern financial markets which is to reduce informational asymmetry between counterparties. Credit ratings provide important functions to enhance investor protection, market efficiency, and transparency (Langohr, 2008). Credit ratings are issued by Credit Rating Agencies (CRAs), the top 3 controlling 95% of the global market being Moody's, Standards & Poor's, and Fitch.

1.1 Statement of the Problem

CRAs assign ratings to corporations and governments with the aim to place a value on the assessed risk (Standard & Poor, 2021). Ratings are therefore a major source of information regarding the quality and marketability of reinsurance security (Pinches, 2018). A credit rating is important to a reinsurer since it affects the firm's capacity to attract customers, the cost of debt, and its financing structure (Gray, 2016). The logic behind this is that as the rating declines, so does the ability to recruit clients. The Zimbabwean market is unique because of the country's sovereign risk. Unique situations would also need unique strategies hence this study on factors that affect credit rating and the strategies used by Zimbabwean reinsurance companies to obtain a superior rating.

1.2 Objectives of the study

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- To ascertain the factors affecting the credit rating of reinsurers.
- To explore the credit rating strategies used by reinsurers in Zimbabwe to obtain a superior rating.

2.0 THEORETICAL FRAMEWORK

Theoretical and conceptual frameworks are used to model this study. Theoretical literature on the factors in use to improve reinsurance company's credit ratings is presented. Exploration of the various strategies in use is done, with their integrity and value examined. Challenges faced by reinsurance securities as they seek to be rated are also explored. This study used both quantitative and qualitative information that was found from talking to company representatives (Standard & Poor, 2011) in this case CEOs. A set of rules that includes principles, procedures, and assumptions were used. According to Standard and Poor (2015), the principles are the main things to look for when analysing credit risk.

While these rating changes mostly reflect fiscal and macroeconomic events, credit ratings have also altered as a result of developing methodology and approaches to measuring sovereign credit risk. Rating agencies increasingly rely on qualitative inputs more than ever before (Amstad, 2022). At the same time, they are focusing increasingly on the implications of monetary policy regimes, currency internationalization, event risk, and economic growth for sovereign risk. Models developed to determine the credit rate of companies are therefore increasingly incorporating both quantitative and qualitative data.

2.1 Conceptual Framework

A corporate credit rating is affected by a number of variables such as the operating environment, business profile, financial profile and comparative profile. The ultimate credit rate awarded to a security is thus dependent on these variables. The independent & dependent variables can therefore be shown by the conceptual framework in figure 1 below.

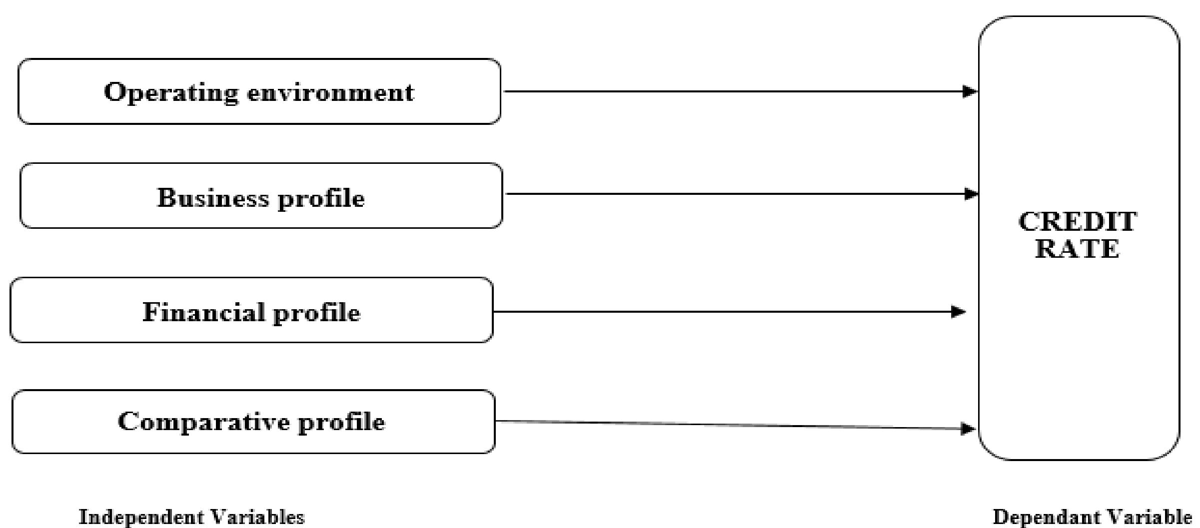

Figure 1: Conceptual framework for factors affecting credit rating

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2.2 Value of Credit Rating

According to the literature, credit ratings have two purposes; to certify a company's current financial status to investors (initial rating) and to notify a change in a company's current financial condition (secondary rating) (Bissoondoyal, 2011). Ratings by the major rating agencies usually reflect the following characteristics of an insurer: capital, reserve strength, profitability, franchise value, management quality, leverage, investments, regulatory environment, and parentage considerations. This information reflects the marketability of reinsurance from an investor’s perspective.

A good credit rating can assist a reinsurance company attract new business or create new opportunities, while a bad rating can drive them out of business. The rating may also affect the share price, since investors regard a favourable rating as a positive sign. As tools strong credit ratings can serve a dual purpose, as a marketing tool and as access tools to capital markets (Bissoondoyal, 2011).

Regulators, like investors, utilise credit ratings to save time evaluating credit (Cantor 2017). Regulators acknowledge that significant financial market participants use credit ratings to calculate capital needs for solvency or risk in their investing activities (Papaikonomou, 2010). Finally, credit rating can enhance the screening and monitoring efforts of investment analysts and corporate debt providers, as well as the solvency monitoring systems of insurance sector authorities.

2.3 Factors affecting credit rating of reinsurance securities

A Rating Framework is composed of four key rating components, Operating Environment, Business Profile, Financial Profile, and Comparative Profile. Each of which is subdivided into two or three factors and assigned a positive or negative score (GCR Ratings, 2019). The Risk Score, which is translated into Credit Evaluation, is determined by the accumulation of the scores. This information can subsequently be transformed into the worldwide scale and/or national scale financial strength credit ratings for the particular legal entity, using the rating adjustment factors.

Table 1: Example of Rating Factor Table.

Rating components and factors	Risk score
Operating environment	**3.00**
Country risk score	0.25
Sector risk score	2.75
Business profile	**(1.50)**
Competitive position	(0.75)
Premium diversification	(0.75)
Management and governance	0.00
Financial profile	**1.25**
Earnings	0.25
Capitalisation	0.50
Liquidity	0.50
Comparative profile	**0.50**
Group support	0.50

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Government support	0.00
Peer analysis	0.00
Total score	**3.25**

Source: (GCR Ratings, 2019)

2.3.1 Operating environment

Country risk score - Rating Frameworks assume an entity's operating environment dictates its creditworthiness. Operating environment analysis adds the most to rating methodologies' underlying risk score because reinsurers are more susceptible to these challenges. CRAs combine country risk and sectoral research to link reinsurers to actual operating conditions. According to the "Country Risk Score" methodology, CRAs normally assign ratings based on the weighted average of premiums by region (although asset spreading or other pertinent risk exposures may also be taken into account). A reinsurer may have a licence in one country yet underwrite risk in another, while the domicile's nation risk has no direct effect on the reinsurer's underwriting portfolio, there may be indirect implications due to licence concerns. In such circumstances, the country risk score may be decreased. (GCR Ratings, 2019)

Sector risk score - The Insurance sector risk score is derived from a combination of eight qualitative and quantitative sub-factors (Regulations, Insurance Penetration, Insurance Density, Industry, Composition, Industry Growth, Industry Earnings Risk, Barriers to entry).

The evaluation considers market-wide issues that CRAs believe influence the credit profiles of reinsurers (Fitch, 2014). This score considers industry-specific factors and negative scores cannot be used because companies would not do business in harsh countries or industries.

2.3.2 Business profile

The Business Profile evaluation is based on a number of qualitative and quantitative factors that are meant to show how strong the business model of the insurance company or group is. This includes looking at the competitiveness, diversity, and stability of earnings, as well as the risk and complexity of operations, ownership & structure; operational & technical support, access to capital, business model, focus areas core capabilities and offerings and the quality of management and governance compared to peers (GCR Ratings, 2019).

Competitive position - Future financial strength is impacted by a reinsurer's competitive position and competitive advantages in its selected market(s). Competitive positioning affects industry sensitivity, cycle management, and operating performance. Highly competitive organizations should maintain earnings strength and market position during the medium to long term. The competitive position score evaluates market share, revenue scale and stability, then company-specific aspects (Moody's Investors Service, 2013).

Revenue scale and stability - Ratings focus on the reinsurer's absolute returns and stable revenue sources. Products with high renewals and consistent rate rises have a more dependable growth trend, while products with lumpy premium trends (such as large development projects) or low renewal rates could reduce revenue stability. Larger entities tend to have more stable

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revenue due to their larger premium base's ability to sustain business loss in stressed cycles (GCR Ratings, 2019).

Management and governance – When grading an institution, the effectiveness, composition, reporting lines, competency, independence, and talent mix of the Board of Directors are all taken into account. Structure, power balance, and support committees all have an impact on a security's governance score. (GCR Ratings, 2019).

2.3.3 Financial profile

A security's financial profile is evaluated on an annual and cross-cycle basis to determine the basic financial strengths and capacities accessible over medium-term operational periods. Earnings, capitalization, and liquidity are examined in the appraisal. A reinsurer's financial profile is also analysed in reference to the industry and peers (Fitch, 2014).

Earnings - Profitability is measured in terms of magnitude, stability, adaptability, and sustainability at both the underwriting and net profit levels. In this regard, a company's financial performance will ultimately define its balance sheet's future strength and sustainability. In general, reinsurance companies with stable profitability and lower levels of volatility have a favourable earnings capability rating (GCR Ratings, 2019).

Capitalisation - Reinsurers with enough capital can withstand adverse operating, regulatory, economic, underwriting, and investment cycles. In order to determine a company's long-term financial health, its balance sheet and ability to preserve and increase surplus cash are vital (GCR Ratings, 2019).

Liquidity - Extremely strong liquidity is rarely recognized, yet insufficient liquidity can severely reduce a rating. This reflects the belief that all reinsurers should have strong liquidity. Analysis of a reinsurer's liquidity is based on the liquidity ratio, which measures short- and long-term liquidity needs. In addition, cash coverage is considered.

2.3.4 Comparative profile

The final component takes into account comparative considerations, including factors such as ongoing collective or extraordinary sovereign support, as well as concerns regarding peer comparisons. Group support and Government support are critical considerations when rating a security.

2.4 Determining the Country Risk Score

The National Risk Score reflects what CRAs deems structural country risk, or investment risks considering stability, soundness, and successful governance of a sovereign nation. CRAs include geopolitical events and hazards like exchange rate and inflationary risk since they are more volatile than structural. The combined scores determine country risk (GCR Ratings, 2019).

2.4.1 Sovereign rating

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Another crucial aspect is geography; the location of an asset influences a variety of factors, including market circumstances and future prospects, the quality of the firm, and collateral control (BAE, 2019). S&P makes it clear that it gives a lot of weight to the asset's location, however Moody's guidelines do not put this variable in a specific category on their main assessment framework, but they do look at how it affects revenue (BAE, 2019). Securities located in more developed countries or countries with a better sovereign rating have naturally obtained higher credit ratings.

2.4.2 Country Risk Assumptions

The country risk assessment is based on the premise that the riskier a country (indicated by a lower score), the more likely a security is to encounter operating stress, both often and severely. Emerging markets are more cyclical and bankrupt more often than industrialized markets. Almost all emerging market economies have defaulted at least once on external and/or domestic debt, and many have done so multiple times. African sovereigns' poor track record shows this. Mauritius is the only African country that has never stopped paying its obligations (Ferri, 2003).

2.5 Strategies used by reinsurance securities to improve credit ratings

The increasing pressure to have a higher rating by securities have resulted in them employing a number of tactics to improve their credit ratings. Some of these initiatives are being undertaken at huge cost which do not add value to the policy holder, some of the initiatives leave the integrity of these securities in doubt. Below the research explores literature on some of the strategies being employed by reinsurance securities to enhance their ratings.

2.5.1 Changing the geographical location of a Reinsurance Security

A country score reflects the risk and benefits associated with operating from a given country or territory. Reinsurance companies operating in countries with no or low country scores have started setting up their operations and moving head offices to countries with higher sovereign ratings (IISA, 2019). A case in mind are securities based in Zimbabwe that have set up operations in the neighbouring Botswana to take advantage of a higher country score of (7.75 out of 15) against Zimbabwe's Country score of (0 out of 15).

2.5.2 Rate Shopping

Rating shopping is a situation where reinsurance companies solicit ratings from multiple agencies and then choose the most favourable one (Griffin, Nickerson, & Tang, 2013). This phenomenon naturally leads to rating inflation even if credit rating agencies produce unbiased ratings, as the issuer is able to consistently choose the most favourable rating (Griffin, Jordan, & Dragon , 2013). Further, an expectation that rating shopping is desired by reinsurers could incentivise rating agencies to relax their standards and issue more favourable ratings in order to compete with higher ratings from other agencies (i.e., 'rating catering'). This phenomenon leads to a race to the bottom (i.e., a reinforcing reduction in quality and rating inflation).

While the assessment of ratings shopping and rating catering is not straightforward there is some evidence suggesting that this has occurred at least in some parts of the market. Kraft

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(2015) looked into whether ratings issued by CRAs are indeed affected by rate shopping in a bid to retain business and fight off competition. Kraft noted that CRAs are sometimes issuing higher credit ratings out of pressure to meet the awards made by their competitors. This is evidenced by divergence from their methodologies especially on the subjective analysis where they can manipulate results.

This is in line with the idea that reputational concerns are not enough to completely stop this. However, Kraft (2015) says that when CRAs are more concerned about their reputation, the evidence for rating catering is less strong. Fieldwork by European Union (2016) did not provide evidence of rating shopping or catering. The majority of securities tend to use one or two CRAs only rather than a range and their choice is largely driven by a CRAs' acceptability in the market. Certain securities specifically noted that they choose particular CRAs because of market demand, even when other CRAs may have a preferable and more favourable methodology (Bolton, 2012).

2.5.3 Rating Manipulations

Hau (2013) focused on ratings given to financial institutions based on a sample of 39,000 quarterly bank ratings from the period 1990–2011 from Moody's, S&P, and Fitch. His findings are that large financial institutions obtain systematically more favourable ratings. This is consistent with the hypothesis that large issuers can use their bargaining power to obtain higher credit ratings. Moreover, banks that provided large securitisation business to the CRA were given systematically more favourable ratings. This is consistent with the hypothesis that the conflict of interests affects the quality of the ratings. He noted that conflict of interest with big bank clients may not be the only interpretation of the strong size influence on the bank rating (Hau, 2013). An alternative interpretation could relate this bias to the 'too big to fail' privilege of big firms.

During the period from 1997 to 2007 (Tang, 2009), looked at how reinsurance securities were rated. Only about 50% of securities eligible for a AAA rating under the CRA's credit risk model got it, the rest were awarded high rates they did not deserve. There is a good chance that this could be caused by subjective, (net) positive changes outside of the model. However, (Tang, 2009) found that none of the factors considerable outside the model were able to account for the big changes in rate. As a side note, it should be pointed out that these findings do not prove that people are intentionally biased in their ratings, this could be due to a mistake in judgement rather than an intentional bias.

2.5.4 Split Ratings

A condition that occurs when the same security is rated differently by the rating agencies. An example is a security rated AA by one agency and A by another agency (Financial Glossary, n.d). It is necessary to investigate the notion of Split ratings and find out whether some regions receive more splits than others. It was observed that there is increased frequency of split ratings across the Big Three, one explanation for this result might be the distance between a rating agency's home region and the rated country (Livingston, 2018). This arrangement has resulted in most reinsurance securities moving to establish head offices in regions closer to the preferred rating agency to obtain a favourable rate. This creates unnecessary additional expenses that may negatively affect these securities.

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3.0 METHODOLOGY

The study embraces a qualitative research method. Data collection was through interviews. The study targeted reinsurance companies in Zimbabwe, in total there are 9 reinsurance companies (IPEC, 2021). Purposive sampling was used to pick respondents who provided a general picture and relevant information on the topics under examination (Flick, 2011). Virtual and face-to-face interviews were used to collect data. A sample of 8 Managing Directors and/or CEOs from the 9 reinsurance companies was chosen. Open-ended response questions under the interviews allowed exploratory research to be effectively executed. Secondary data was collected from various publications on the area of credit rating, for example, GCR Rating Announcements, and Sector Reports. Thematic analysis was used to analyse qualitative data by detecting, analysing, and reporting patterns or themes in data.

4.0 FINDINGS

Interviewees advised that their companies face sovereign rating bias when seeking better ratings. They further indicated that the application of the Sovereign Ceiling Rule, has unfairly affected their entities' ratings resulting in them deciding to set up operations in Botswana, a country with a better sovereign rating. This finding is consistent with Scaggs (2017) who said no company is more credit worthy than its government.

Through the interviews the research observed that most of the companies' ratings were not improving over the period 2000 to 2015 owing to poor sovereign risk no matter how good these securities performed in their Zimbabwean market. The research also noted that the credit ratings of these Zimbabwean securities has been negatively affected by perceptions more than facts. This observation is also consistent with the lopsided nature of Sovereign ratings, a phenomenon that state that CRAs favour their home countries and countries with close cultural and economic ties creating home bias (Fuchs, 2013).

80% of the interviewees agreed that the three variables to credit rate which are Operating Environment, Business Profile, and Financial Profile affect credit rating. One of the interviewees noted that making use of a rated securities for retro program especially rated by the big three and focusing on the bottom line in underwriting improve credit ratings. One CEO opined that other strategies to improve on credit ratings in the reinsurance sector include the management of credit risk and regularly checking the credit rating. In the same view other respondents pointed out that keeping their credit utilization rate low and enhancing the balance sheet strength, expeditious claims payment also improves on credit ratings. Some of the strategies highlighted to be influential in improving firm credit scores included rate manipulations and split ratings.

5.0 CONCLUSIONS

Operating environment (Country risk score, sector risk score), Business profile (Competitive position, premium diversification, management, and governance), financial profile (Earnings, capitalisation, liquidity), Comparative profile (Group support, Government support, peer analysis) are the factors affecting credit rating of reinsurers. This is not limited to companies in the insurance space only but across the entire financial services sector. Company executives

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and boards should therefore explore other desirable and necessary strategies to achieve superior ratings which are not common in Southern Africa such as Split Ratings and Rate Shopping.

6.0 POLICY RECOMMENDATIONS

Regulators should keep eyes open to guard securities from using rate enhancement strategies that lack integrity; strategies such as rate shopping. Regulators must also put in place and enforce minimum board and management qualifications and experience to ensure regulated entities obtain higher scores under business profile. The insurance regulators should also ensure their regulatory standards are in line with global best practice, this will ensure Zimbabwean based securities get higher sector risk scores.

7.0 AREAS OF FURTHER STUDY

Since a change in geographical location came out as one of the strategies used by Zimbabwean reinsurers, there is recommendation to investigate on whether a change in geographical location has an impact on credit rating for Zimbabwean reinsurers.

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