FitchRatings

US INSURERS AND PRIVATE CREDIT:
NOT ALL PRIVATE RATINGS ARE THE SAME

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EXECUTIVE SUMMARY

At end-2023, US insurers held about USD350 billion of privately rated securities.

The NAIC has adopted a proposal to contest private ratings from CRAs if their ratings are three notches higher than an assessment from the NAIC's Securities Valuation Office (SVO).

Of 109 private ratings reported by the NAIC during 2023, there were eight instances where securities were assigned ratings six notches or more higher than the SVO assessment. All were issued by a smaller CRA.

Two ratings would be beneficial under the new regime: As an additional credit assessment reference and as a fallback if a private rating with a three-notch or more differential is contested by the NAIC.

Fitch's private and public ratings are assigned using the same policies and procedures, with identical criteria and rating scales. Fitch's public and private corporate ratings demonstrate similar longer-term default rates at each rating level.

With the recent growth in Private Credit, we think it's an important time to revisit why two ratings could be beneficial for market participants.

US INSURERS AND PRIVATE CREDIT: NOT ALL PRIVATE RATINGS ARE THE SAME

NAIC Report Puts Smaller CRA Ratings Under the Spotlight; Two Ratings Could Help Address Concerns

Smaller Agencies Dominate Private Credit Market with Higher Ratings

The National Association of Insurance Commissioners (NAIC) Capital Markets Bureau noted in its June 2024 report “Private Ratings Among U.S. Insurer Bond Investments Continue to Rise and Have Nearly Tripled in Five Years” that smaller credit rating agencies (CRA) – such as Egan-Jones Ratings, Kroll Bond Rating Agency and Morningstar DBRS – have captured most of the recent growth in private credit, rating almost 86% of US insurance company exposure, up from about 70% at end-2019.

Furthermore, the report found that the greater the notch deviation of a private rating (which it refers to as “private letter ratings” or PLR) from an assessment from the NAIC’s Securities Valuation Office (SVO), the more likely it was issued by a smaller CRA. PLRs from smaller CRAs were three notches above the SVO’s assessments on average, but in some instances were six notches or higher, i.e. two full rating categories.

The same NAIC report found that PLRs from the three largest CRAs – Fitch Ratings, Moody’s Investors Services and Standard & Poor’s – were on average two notches more than the SVO’s assessment, but no PLRs from these larger CRAs were six notches higher.

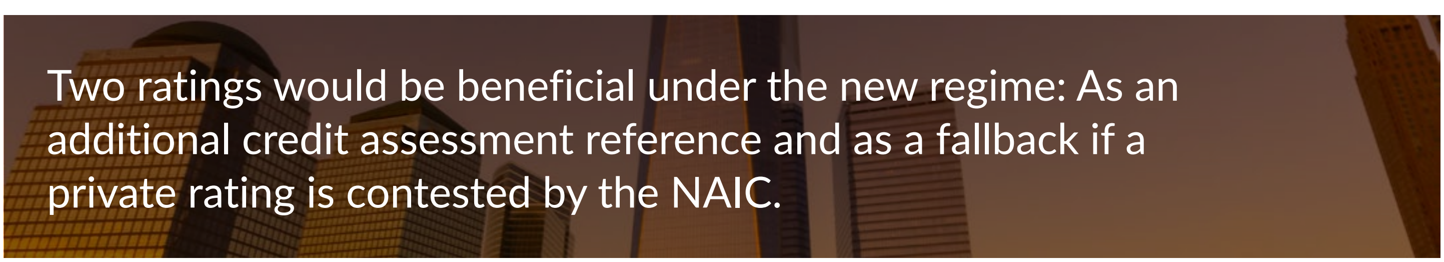
Insurance Capital Regulations, Why They Matter

Under the NAIC risk-based capital (RBC) framework for U.S. insurance companies, higher credit ratings attract lower capital requirements. The NAIC has raised concerns that this result may create incentives for insurers to seek the highest credit rating rather than the most appropriate credit assessment, as only one rating is necessary to assign a capital charge. This practice is often referred to as ‘ratings shopping’.

As a result, the NAIC has adopted a proposal to contest private ratings from CRAs if their ratings are three notches higher than an assessment from the NAIC’s SVO. If the SVO’s analysis is upheld, solvency capital charges will be based on the SVO designation. Alternatively, a credit rating from another CRA could be substituted. The new process takes effect from 2026.

Benefits of Two Ratings

Although SVO staff recommended two ratings should be used to derive RBC charges and recent NAIC taskforce discussions highlighted the usefulness of multiple ratings, the NAIC has not formally adopted a requirement for two ratings to be used to determine RBC. However, two ratings (for example, one from a smaller CRA and one from a larger CRA) would be potentially beneficial under the new regime: firstly, as an additional credit assessment reference, mirroring the typical use of two ratings in public markets (and as a requirement in central bank repos), and secondly as a fallback under the new regime if a PLR with a three-notch differential is overridden.



Fitch's Private Ratings, Transparency and Performance

Fitch's private and public ratings are assigned using the same policies and procedures with identical criteria and rating scales. Private ratings undergo the same analysis, committee process, surveillance and procedural standards as published credit ratings. The only differences between the two relate to distribution and output.

In order to demonstrate the efficacy of this approach, the quality of its private ratings and to add transparency around the performance of its private ratings, Fitch in June published a Transition and Default Study on its US mid-market corporates portfolio. The reports key findings are summarised below, clearly shows that Fitch's private ratings have similar three-year default rates as public ratings. In other words, there is no material difference in the performance between Fitch's private and public ratings.

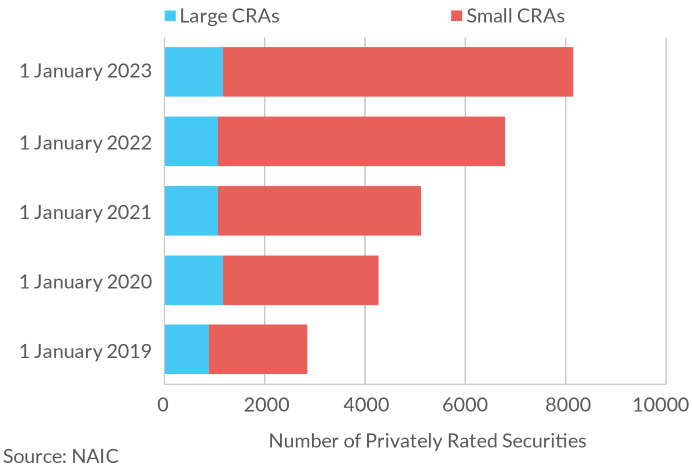
Smaller CRAs Dominate Private Debt

SMALLER CRAS HAVE GROWN MARKET SHARE AS PLR USE JUMPS

The smaller CRAs have steadily grown their market share of PLRs, providing almost 86% of all PLRs at end-2023, up from just under 69% at end-2019. US insurers' exposure to PLR securities increased by 85% between 2020 and 2023, while that of the top 10 insurers increased by 73%, according to the NAIC's Capital Markets Bureau June 2024 report. This situation means smaller CRA issuance of PLRs accounts for almost all of the increase in the US PLR market, given that the larger CRAs' share has remained broadly stable since end-2020, according to the NAIC's figures.

US insurers held about USD350 billion of securities with PLRs at end-2023 (end-2022: USD300 billion), about 7% of total bond holdings. However, insurers with affiliations to private equity or asset managers held a greater proportion of securities with PLRs on average (17% at end-2023).

Smaller CRAs Dominate PLR Issuance



Source: NAIC

However, given the high market share of smaller CRAs in the private rating segment, coupled with the NAIC's concerns, insurers may increasingly request PLRs from one of the three larger CRAs. Submissions to an earlier consultation stated insurers had slowed or paused purchases transactions rated by Kroll or Egan-Jones in 2022 and 2023, coinciding with earlier NAIC proposals.

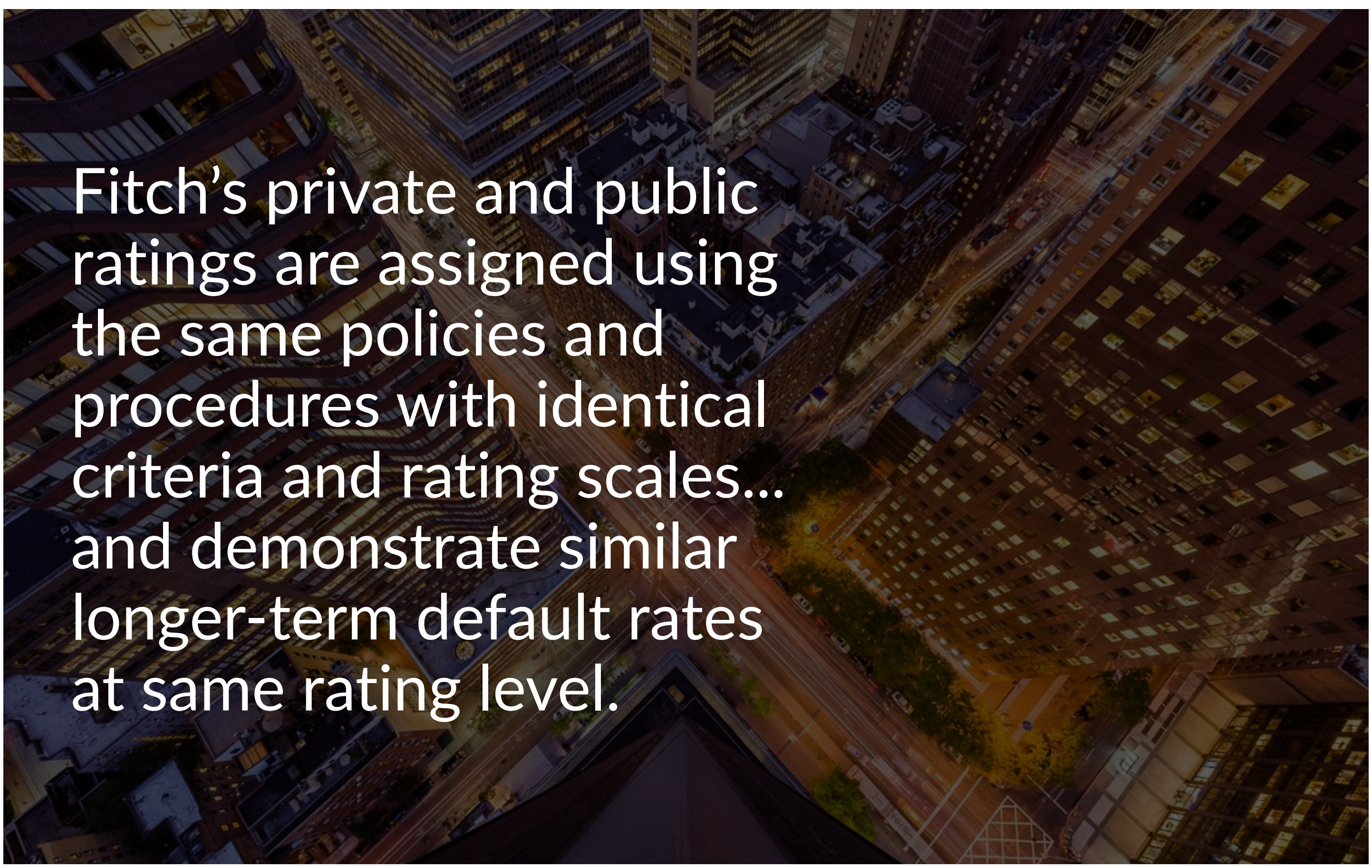
SMALLER CRAS RATINGS ARE NOTCHED WIDER THAN THOSE OF THE LARGER CRAS

The NAIC states that while it as a matter of policy that each CRA's ratings are treated as the functional equivalent of any other, it "has observed disparities between CRP [credit rating provider] ratings of the same credit, particularly with PLRs. These rating disparities, some of which are significant, call into question the quality and comparability of PLRs, and they could have an adverse impact on capital requirements under the current RBC framework".

A review carried out by the SVO in 2023 found smaller CRAs were more prone to awarding PLRs that displayed significantly wider notching to the SVO's own original assessment, with 7% of the sample deviating from the SVO's initial NAIC designation by six or more notches, equivalent to two whole rating categories. Given that the average rating of Fitch's US mid-market corporate portfolio is 'B' (see chart on page 8), this magnitude of rating differential would mean such securities would be rated 'BBB' (going from sub-investment to investment grade).

Translating this hypothetical rating differential into the NAIC's RBC factors would result in an 84% reduction in the pre-tax RBC charge for a life insurer (prior to reflecting asset-liability cashflow matching and diversification benefits, that can significantly blunt the overall solvency impact).

Of 109 private credit debt securities assigned private ratings by CRAs reported by the NAIC in 2023, 106 (97%) were assigned a higher rating than the SVO's original designated assessment. Three-quarters of these higher ratings were assigned by the smaller agencies. Of securities that were assigned a higher rating, 38 (36%) were determined by the SVO to be more than three notches above the original NAIC banding, comprising PLRs from both the larger and smaller CRAs (in what proportion was not made clear in the June 2024 capital markets report). There were eight instances where securities benefitted from six notches or more of uplift, all of which were when the PLR was issued by a smaller CRA.



SVO PREFERS TWO RATINGS; CONCERNS OF RATINGS SHOPPING

Although the latest process changes do not require two independent PLRs to calculate the applicable RBC factor, senior SVO staff have shown a preference for two credit ratings when deriving the appropriate NAIC designation for investment assets, ostensibly to combat concerns over “ratings shopping”.

In the SVO’s February 2020 Issue Paper to the NAIC Valuation Working Group, the use of a single PLR was highlighted as a ‘red flag’. The SVO recommended that “at least two independent CRP [credit rating provider i.e. CRA] ratings would be required for any NAIC designation to be derived from CRP ratings and the lower of the ratings would be applied. In the absence of two CRP ratings, the security would need to be filed for analysis by the SVO.”

The same staff paper highlighted the SVO’s belief that not “every rating agency methodology is appropriate for, or consistent with, the assessment of investment risk for statutory purposes.”

Robust Processes for Fitch’s Private Ratings

PRIVATE RATINGS FOLLOW THE SAME PROCESS AS PUBLIC RATINGS

As detailed in its Rating Process, Fitch will prepare private credit ratings, i.e. unpublished credit ratings, if requested to do so. Privately monitored ratings (PMR) use the same criteria and rating scale as public credit ratings, and undergo the same analysis, committee process, surveillance and procedural standards as published credit ratings, unless otherwise disclosed as point-in-time in nature. The sole differences relate to distribution and output – per the table below.

If Fitch believes the information available, both public and private, is insufficient to form a rating opinion, then no credit rating will be assigned or maintained. We will withdraw an existing credit rating if sufficient information ceases to be available.

	Private monitored rating (PMR)	Public rating
Description and purpose	Non-public financing instruments, e.g. private placements, bilateral loan or facility.	General corporate purposes. Supports all financing.
Assessment and governance processes	Same analysis, committee process and procedural standards	
Distribution	Not published on Fitch website. Limited distribution	Published on Fitch website. Broad distribution.
Monitored	Yes and in the same manner	
Notch-specific	Yes	
Outlook	Yes	
Issuance ratings	Private issuance ratings on existing instruments	Yes
Output	Confidential rating letter	Rating Action Commentary

Source: Fitch Ratings

Transition and Default Case Study: Fitch's US Mid-Market Corporate Private Rated Portfolio

Fitch's Transition & Default: U.S. Privately Monitored Ratings compares issuers from its US mid-market corporate PMR portfolio with those from its public ratings portfolio between 2019 and 2023. Our PMR portfolio mainly comprises companies with about USD500 million or less in debt or USD100 million or less in EBITDA (though some issuers in the portfolio do exceed these thresholds). The analysis encompasses Long-Term Issuer Default Ratings dating back to 2019 and includes all subsidiaries with Issuer Default Ratings assigned ensuring consistency with Fitch's public Transition & Default Studies.

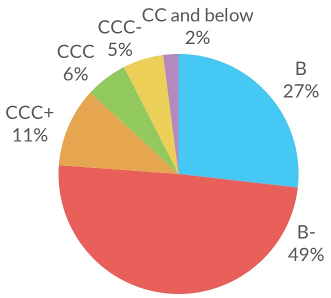
The PMR portfolio consists exclusively of 'B' category and below issuers as the companies in the portfolio generally tend to be the product of leveraged transactions such as sponsor-driven leveraged buy-outs or dividend recaps. In addition to credit metrics that skew toward lower rating categories, these PMR issuers tend to have qualitative metrics also associated with the 'B' category: they are smaller in scale, have limited diversification and tend to pursue aggressive financial policies.

LONGER-TERM DEFAULT RATES ARE SIMILAR BETWEEN PUBLIC AND PRIVATE RATINGS, DIFFERENCES REFLECT ROLE OF SPONSORS

The average annual one-year default rate (excluding withdrawals) for issuers entering the year in the 'CCC' category or below is lower for the PMR mid-market corporate portfolio at 20% compared to 41% for publicly rated companies. On a three-year basis, however, this relationship flips with 59% of 'CCC' and below of the same PMR issuers defaulting over that time period compared to 56% of similar corporates with public ratings.

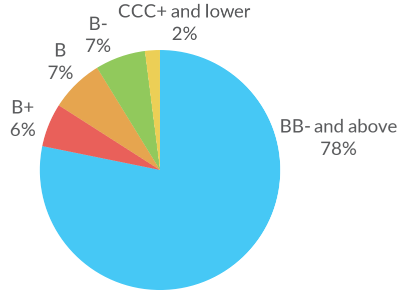
The average one-year default rate for this PMR portfolio likely reflects the dynamics created by the sponsor/lender partnership, whereby lenders offer concessions in exchange for sponsor support that involve covenant rather than coupon relief, which would not register as a default under Fitch's corporate criteria. Further stress going beyond the first year, however, often involves cash flow relief from the lenders in the form of deferred or "payment-in-kind" cash payments (interest or principal) which Fitch would likely register as a default. This results in three-year default rates excluding withdrawals for 'CCC' category companies that are comparable between the PMR and public rated portfolios, in the mid-to-high 50% range.

Private Portfolio Composition 2023



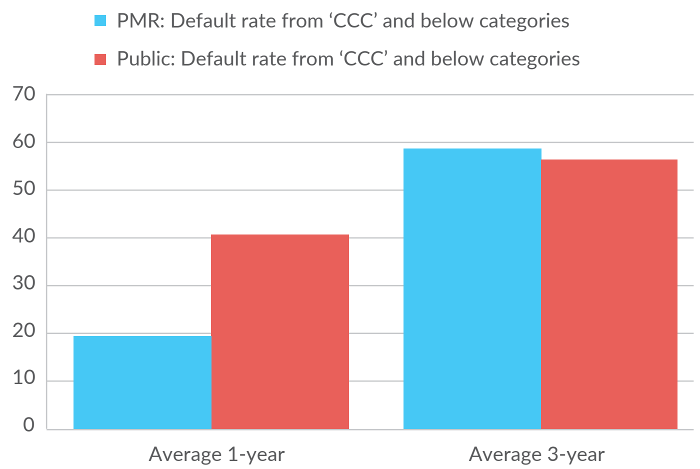
Note: 'B' ratings include 1% at 'B+'
Source: Fitch Ratings

Public Portfolio Composition 2023



Source: Fitch Ratings

Average Default Rates; 2019-2023



Note: Excluding withdrawals
Source: Fitch Ratings

Fitch Ratings helps measure the credit risk of non-public financing transactions for corporate private debt and direct lending, project finance, structured finance and funds using its industry expertise, timely feedback and transparency in the rating process.

Contact us directly or visit fitchratings.com to learn more.

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