LITMUS ANALYSIS

GETTING A RATING FOR THE FIRST TIME

A LITMUS GUIDE FOR SMALLER INSURERS

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Executive Summary

Getting a rating is a big step, and not one to be taken lightly, especially for smaller insurers. There needs to be a sensible business rationale, balancing the risks and costs with the benefits. Would having a rating get you good new business you would not otherwise see? Will it improve the quality of the business you're seeing now? Is it important for expansion into new classes or territories?

It's also wise to consider the costs of maintaining the rating. Rating fees, whilst not small, are not outrageous given the value a rating can bring. However, there's also the cost of managing the ongoing relationship with the rating agency, which is more important than some realise. There's an old adage that 'you should manage your rating like an asset, otherwise it will become a liability'.

This guide focusses on both the new ("start-up") carrier scenario, and first-time ratings for existing carriers.

Globally the four main agencies for insurance (in terms of market recognition, ratings coverage and the breadth/depth of their analytical teams) are, in our opinion, A.M. Best ("AMB"), Fitch, Moody's and S&P Global ("S&P"). For reasons covered in this guide, we focus our agency-specific comments here on AMB.

Outside the US relatively few insurers with less than at least a few hundred million dollars of premium and/or capital have tended to get rated (other than those getting a rating as part of a larger group). But this is changing, and this guide seeks to provide some insight into "getting a rating" from a smaller insurer's point of view.

The Litmus Analysis team have well over 100 years of experience working for the major rating agencies, and for the last 9 years we have successfully helped over 60 insurers with their ratings. The team includes the former EMEA heads of both AMB and S&P and of AMB Asia-Pacific.

Key observations in this Litmus Analysis guide include:

- Ratings reflect far more than simply capital adequacy.
- Regulatory capital ratios are often not a good guide to the likely rating outcome.
- Size matters with all the main rating agencies but A.M. Best's approach to this tends to make them the more natural choice for smaller carriers.
- The causal logic for why a carrier will be sustainably profitable is a crucial part of a ratings analysis.
- Optimising communication with a rating agency requires a full understanding of its rating methodology.
- Decisions made when planning a new carrier can be fundamental to achieving a given rating level even several years later.

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Introduction

Rating methodologies are far more detailed, and wide-ranging, than many insurance market participants imagine. They include the analysis of major aspects of a carrier's profile that are not part of a regulatory approval process. There can also be important differences of approach between the main rating agencies that can influence the choice of agency.

In this Litmus guide we cover some of the key considerations when getting a carrier rated and touch on the background analytical logic that stands behind rating agency methodologies.

For reasons described below we focus our detailed comments on A.M. Best's methodology. In practice we would suggest an insurer considers the relative merits of any of the main agencies (or indeed some of the other agencies active in insurance) in the light of their specific reasons for being rated and their own profile. Please contact us directly at Litmus if you would like to discuss this further.

Start-up insurer ratings

When launching a new carrier, the complexity and time required for capital raising, business planning and regulatory approval can easily mean that the rating is addressed towards the end of the process. However, if having a rating at a minimum level is needed at launch (or in the first few years), this approach can lead to material problems.

Decisions made whilst capital-raising and business planning will be fundamental to the ability to achieve the desired rating. A good understanding of how ratings are produced (known as the rating agency's "methodology" or "criteria") is very important from the outset, even if engaging with the rating agency is some time away.

Why have we focussed on A.M. Best ("AMB") in this guide?

One of the more significant differences between the 4 main agencies (AMB, Fitch, Moody's and S&P) is how they approach a carrier's scale within their analysis. Scale can touch a number of areas of each agency's methodology, but AMB has a somewhat different conceptual approach to the others. Basically, it takes a case-specific approach, resulting in some smaller insurers with otherwise very strong credit profiles receiving a higher rating than they might from the other agencies.

Ironically, in AMB's home market of the US, there are other smaller agencies who appear to see AMB itself as overly focussed on size. But that is not a view we would have on a "global big 4" agency basis.

A rating is not simply about capital adequacy

If we had to choose to highlight only one misunderstanding about insurer credit ratings, it would be the assumption that it is the agency's "capital model" that dominates the rating outcome. It does not. It is fundamentally important (especially if seen as a weakness), but the final rating outcome can be, and often is, materially different from the model outcome.

Unrated insurers in regulatory regimes which have a sophisticated regulatory capital requirement as part of the supervisory process (such as under Solvency II within the EU) can tend to assume a rating would correlate with their regulatory capital outcome. In practice regulatory capital ratios are often a poor guide to a likely rating outcome.

Why do non-capital factors play such an important role?

Simply put, a rating is about the future ability to pay claims, not just current solvency. That means all the things that drive the future balance sheet of an insurer are central to the analytical methodologies of all the main agencies. These include the following credit profile attributes of an insurer:

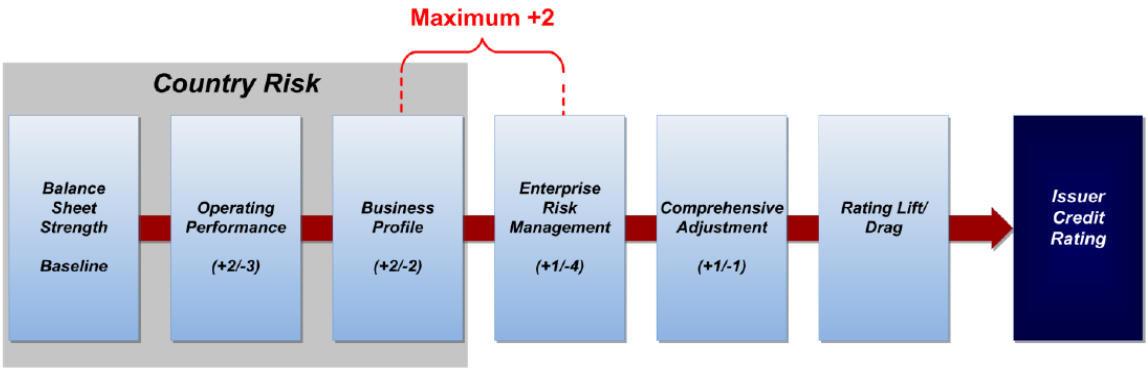
- The nature of the markets it trades in and the strength/weakness of its position within those.
- Its strategy and the extent to which it has sources of sustainable competitive advantage within those market(s), such as pricing power, technical quality, distribution, brand/service levels etc.
- The quality of its expected (by the agency) future operating performance (fundamentally informed by its track-record if it has one) and its degree of business diversification.
- Its risk appetite.
- Its perceived management quality and depth.
- The quality/completeness of its Enterprise Risk Management (ERM) function.
- Its ownership and strengths/weaknesses that could derive from that.
- Its reliance on reinsurance capacity and other forms of "non-equity" risk capital

Overview of the AMB methodology

The graphic on page 4 illustrates how an initial "Balance Sheet Strength" ("baseline") rating outcome can be modified by the rest of the analysis.

Although AMB expresses its Financial Strength Ratings ("FSRs") in a somewhat different rating scale from S&P (whose scale tends to be the most familiar to non-US insurance market participants), it actually uses the S&P type scale (AAA, AA etc) when deciding its ratings (but expressed in the lower case).

Exhibit A.1: A.M. Best's Rating Process



Source: Best's Credit Rating Methodology ("BCRM"): October 13th, 2017.

In the graphic the numbers in the brackets refer to the potential change at each step, by rating "notch". A notch in rating agency jargon means the space between two adjacent points on the rating scale. For example, the gap between "A-" and "BBB" is two notches.

Clearly the "post-BSS" journey from the "baseline" assessment on the left to the final rating on the right can change things a lot!

The rating AMB produces via this process using the S&P-type scale is called an "Issuer Credit Rating" ("ICR"). The agency then simply maps the ICR outcome to its unique FSR scale (see the appendix). Both the FSR and ICR are published by the agency.

Summaries of the component parts of the BCRM.

Judging the optimum degree of detail for a guide like this is tough. This is our day-job, so everything tends to seem very clear to us: but we know from experience that it can be a lot to absorb if it's new to the reader.

The brief summaries below highlight that there is much more we could cover; if you would like to know more, simply give us a call or send us an email and we will be very happy to explain things further.

- **The AMB capital model (the "BCAR")**

  The BCAR is one part of the Balance Sheet Strength analysis.

  In essence the BCAR outcome is a similar concept (but a different execution) to those regulatory capital ratios that reflect a calculation of the amount of risk capital 'available' (e.g. "Own Funds" under Solvency II) and the amount 'required' for prudence (e.g. "Solvency Capital Requirement" under Solvency II) and compare the two.

  There is a lot going on within the BCAR and its easy to miss something important or not appreciate the inputting choices available. AMB will complete it for themselves of course but we would always recommend a rated company completes its own version.

  For a new carrier AMB will look at forecasted BCAR's over the first full 5 years of operations. There is a "weakest-link" element to this whereby the weakest outcome across the 5-year period is likely to be given the most weight in the initial rating.

  For an existing carrier, AMB will typically be reviewing a set of BCARs ("as reported" for the recent past and "as forecast" for the current and next few years).

- **The rest of the Balance Sheet Strength ("BSS") analysis**

  The maximum possible BSS "baseline" outcome AMB allows is "a+".

  In practice, in a recent review published by AMB, it noted that out of 183 EMEA domiciled insurance groups in its sample, only 2 have an "a+" baseline result (both state backed). Yet well over 80% of these achieve the highest possible BCAR outcome.

  So most commonly the rest of the BSS review will pull down the BCAR result, at least to a degree. These other factors don't have to be especially negative to do so. If the BCAR comes out at the highest possible level and the rest of the BSS is merely pretty good, the combined result would typically be below "a+".

  While AMB's methodology is generally less prescriptive around size than the other agencies, it will tend to view smaller balance sheets as more prone to volatility and reflect that here.

  Smaller insurers often rely on a significant level of reinsurance (proportional and/or non-proportional). Whilst use of well rated reinsurers is a positive in terms of "net" capital adequacy and "severity risk" mitigation there is an important credit offset to this with all the major agencies, namely the dependency on reinsurance pricing and availability. For AMB this is part of the BSS review.

- **Analysis of Operating Performance ("OP")**

  For a non-life insurer, the OP analysis usually focusses on the level and volatility over time of the loss, combined and operating ratios (or return on revenue) along with return on equity.

  This is prospective up to a point (and clearly has to be for a truly new insurance operation) but will strongly reflect the track record, if there is one.

  The gross as well as the net results can set a very important context here.

- **Analysis of Business Profile ("BP")**

  The BP analysis is basically everything other than ERM (see below) that AMB views as driving the insurer's medium term, risk-adjusted, performance. Strategy, management quality, product line and geographic diversification, product risk, the effective use of data, brand/reputation, distribution channels, country risk etc.

  Effective delivery of this part of the message is fundamental to optimising how the agency will evaluate a carrier. As with the BSS review, smaller size can constrain the outcome. In our experience the BP analysis, in the aggregate, sets a very important context for the prospective parts of both the OP and BSS reviews.

- **Analysis of Enterprise Risk Management ("ERM")**

  The ERM review is divided into two broad areas (each with its own set of sub-categories). These are the "risk framework" evaluation and the "risk profile" evaluation.

  In essence the risk framework is assessed in the light of the risk profile evaluation.

  The former covers risk appetite and tolerances, stress testing, risk identification and reporting, risk management/controls and risk culture. The latter covers 8 areas: from product and underwriting risk to operational risk.

Other considerations

The following are all potentially important contextual issues for the rating analysis but do not really lend themselves to a summary guide. As with anything else we cover here, please contact us directly with any questions you have.

- Country of domicile and/or operation(s)
- Group structure and sister operations
- Will the carrier be viewed by AMB as a true "start-up"?
- Treatment of non-equity capital and the "HoldCo" analysis
- AMB information requirements and how the rating process works
- Consideration of the capital provider's own credit profile

Appendix

The graphic below shows how AMB maps the ICR outcome that it concludes via the BCRM process summarised in Exhibit A. 1 (page 4 of this guide) to the FSR outcome.

The FSR specifically relates to the ability of an operating insurer to meet its policyholder obligations. The ICR is a generic view as to the rating relevant to the most senior unsecured creditors. For an operating insurer therefore, since policyholders are typically seen as most senior, the two ratings are actually saying the same thing as it relates to the credit risk the policyholder is taking in using the rated insurer.

For reference the reason for the different scales is that in the U.S. AMB's FSR scale (or its predecessors) has been widely used in the insurance industry for over 100 years. Hence AMB continues to use it, but also produces the ICR for those more familiar with the S&P type scale (and to describe other types of ratings where there is not a "policyholder" context: such as those of non-operating holding companies and debt issues).

Best's Credit Rating Scales:
Translation of Issuer Credit Ratings to Financial Strength Ratings

Long-Term ICR	FSR
aaa, aa+	A++
aa, aa-	A+
a+, a	A
a-	A-
bbb+, bbb	B++
bbb-	B+
bb+, bb	B
bb-	B-
b+, b	C++
b-	C+
ccc+, ccc	C
ccc-, cc	C-
c	D

ICR = Issuer Credit Rating
FSR = Financial Strength Rating

Note: D is used for non-insurers and securities.
The rating symbols A++, A+, A, A-, B++, B+ are registered certification marks of A.M. Best Rating Services, Inc.

Source: A.M. Best

About Litmus Analysis and contact details

Litmus Analysis specialises in helping the re/insurance industry understand credit risk, credit ratings and how best to work with ratings agencies. Litmus has conducted over 60 ratings advisory projects for re/insurers, helping them successfully achieve new ratings, rating upgrades or to avoid potential downgrades.

The Litmus team of consultant analysts all have a senior rating agency and/or broker market security background and count amongst the team –

The former head of S&P's European analytical practice

The former head of A.M. Best EMEA

The former head of A.M. Best Asia

7 insurance specialist analysts, with over 150 years' combined experience.

The LitmusQ re/insurer financial profiling model is being used by re/insurers and brokers, both as a counterparty credit tool and in assisting their reinsurance underwriting, cedant knowledge and business production processes.

The Litmus analysts have many years' experience of working within or with the major rating agencies,

For more information, and to learn more about all the services offered by the team, visit www.litmusanalysis.com

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