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Rating Methodology

Insurance Company Ratings

Criteria for Rating Insurance Companies' Debt and Hybrid Equity Instruments

Updated May 2018

Related Methodologies
Global Master Criteria for Rating Short Term Insurance Companies, updated May 2018
Global Master Criteria for Rating Long Term Insurance Companies, updated May 2018
Criteria for Rating Newly Established and Start-Up Insurance Companies, updated May 2018
Criteria for Rating Cell Captive Insurance Companies, updated May 2018

Criteria Summary

GCR's Claims Paying Ability ("CPA") ratings are accorded to short term insurers and reinsurers, while GCR's Financial Strength ("FS") ratings are accorded to companies that only conduct long term insurance business. The ratings give an independent opinion of an entity's ability to meet policyholder and assumed reinsurance obligations, excluding funds where investment or other risk rests with the policyholder through a contractual agreement. The CPA and FS ratings form the basis for any other ratings accorded to insurance and reinsurance companies.

This criteria report ("the Criteria") is an update to the version published in July 2017. No material changes have been made to the Criteria since the date of previous publication. The update of this Criteria will not have an impact on any existing ratings. Going forward, this Criteria will be applied to all ratings of insurance and reinsurance companies.

Rating methodology overview

The rating accorded to an insurer serves as the anchor rating for related rating analysis. Ratings are subsequently assigned to an organisation's debt or preferred stock issuances through the recognition of the claims prioritisation due to legal, regulatory or contractual parameters. This differential between the CPA rating and the debt rating is recognised through incremental notching, depending on the characteristics of the instrument and the rating of the insurer. For the sake of simplicity, this section will use the term "debt" to refer to subordinated debt as well as instruments such as preferred stock and convertible securities. This report should also be read in conjunction with the Global Master Criteria for Rating Short Term Insurance and Reinsurance Companies available on Global Credit Rating's ("GCR") website.

Notching from the rating for subordination

The fundamental analysis applied to the rating analysis forms the backdrop of the debt issuance analysis. The debt rating subsequently takes into account the level of contractual or structural subordination. When taking such matters into account, senior debt obligations of insurance organisations are typically subordinated relative to policyholder obligations. This subordination is often governed by legal or regulatory frameworks within particular jurisdictions, which dictate the relative standing of policyholders and debtholders in the event of insolvency, bankruptcy, reorganisation or liquidation. Accordingly, GCR typically notches down from the CPA rating of the operating company.

Operating company versus holding company

Varying organisational structures give way to differing rating approaches by GCR, depending on the nature of the relationship between the various licensed entities within the structure. In assessing ownership structure, a distinction is made between the primary insurer acting as a subsidiary of an operating group, and structures with pure operating company to holding company (non-operating) relationships. In terms of the latter, the insurance company's rating will typically be higher than the holding company's rating. This will be applicable in instances where regulatory restrictions limit an operating company's ability to pay upstream dividends and other payments to the holding company, effectively restricting asset stripping of the operating company. The notching differential is subsequently reflective of the arm's length that exists between the holding company and the underlying assets accessed for liability redemption. When such payment restrictions are strong, the operating company's rating will act as the anchor rating, with the holding company's rating typically notched down from the insurance company. In instances where the holding company is an operating company, a separate credit rating exercise will typically be conducted.

Deviations (both positive and negative) may exist in order to reflect holding company credit enhancing factors, as well as atypical regulatory conditions. In terms of the former, a holding company that derives material cash flows from multiple sources (for example, upstream dividends from numerous subsidiaries in uncorrelated industries or industry sub-segments), or multiple geographic regions, may experience rating compression pertaining to the CPA-debt rating spread. This follows the same fundamental principles applied to the anchor CPA rating, recognising attributes that strengthen operational or cash flow resilience. This notwithstanding, if such diversification benefits have already been factored into the holding company's anchor rating, then they will not be applied to the debt issuance (thereby avoiding double-counting).

Notching guide

Notching for operating company issue		Notching for holding company issue	
Senior debt	Subordinated debt	Senior debt	Subordinated debt
-2	-3	-3 to -4	-4 to -5

Notching adjustments

The notching differential acts as a guideline to reflect the relative ranking of debt obligations to those due to policyholders. This notwithstanding, notching may be adjusted based on the specific fundamentals at hand.

Notching adjustments // Notching for credit quality

Insurers displaying higher levels of credit quality typically produce elevated levels of excess resources to meet underlying obligations. In turn, this minimises the risk attached to debt issuances, and as such, notching may narrow at higher levels of the rating scale. In similar respect, the notching differential may widen as the anchor credit rating moves down the scale.

Notching adjustments // Notching for financial leverage

The degree of financial leverage within a rated entity's capital structure may result in further notching. Organisations that are viewed to have low to moderate financial leverage metrics will not require further notching beyond the initial guide. Financial leverage judged to be between moderate and very high may result in a differential of 4 or more notches, while also placing possible negative pressure on the anchor CPA rating (if viewed to have a negative impact on capital formation, access to external capital, or other key metrics). The following table is an example of the notching framework applied with a standard debt issue.

Financial leverage	Notching	Impact on CPA rating
Low to moderate	-2 to -3	None
Moderate to high	-3 to -4	None
High to very high	> -4	Possible negative

Notching adjustments // Notching for interest coverage
Interest coverage examines the affordability of interest payments relative to operating profitability. An insurer exhibiting high levels of interest coverage is, on average, better positioned to meet interest commitments in periods of constrained operating profitability, which will be factored into debt ratings. Interest coverage is assessed in the context of financial leverage and other key rating factors, and may act as a risk mitigant in certain instances. As an example, an insurer with very high financial leverage (as per the table above) may see anchor rating pressure offset should very strong interest coverage be in place (pointing to earnings capacity, despite being highly leveraged). Notching based on the combined leverage and coverage assessment may take the form of the following base-case matrix (with the strength of the underlying rating acting as a further modifier to the overall consideration).

Financial leverage	**Coverage ratio range**		
	Strong	**Moderate**	**Weak**
Low to moderate	-2 to -3	-2 to -3	-3 to -4
Moderate to high	-2 to -3	-3 to -4	-4 to -5
High to very high	-3 to -4	-4 to -5	-4 to -5

Notching adjustments // Notching for credit enhancements
Compressed notching can also result from a holding company that generates material, uncorrelated earnings and dividend cash flows from multiple sources. Such diversification can be seen in financial-based groups consisting of a bank, a short-term insurer and a long term insurer for example (although narrowing will not occur if diversification benefits or group support have already been factored into the anchor rating). Similarly, should a holding company maintain a sizeable balance of liquid funds that can be utilised to meet financial obligations without flows from the operating company, then notching compression can arise. Conversely, high risk factors at the holding company may result in notch widening.

Hybrid equity // Capital credit for adjusted solvency calculations
Hybrid securities, typically in the form of preferred stock, convertible securities, or subordinated debt, share basic characteristics associated with common equity. Hybrids can include a variety of features that, over time, allow them to exhibit changing proportions of debt and equity characteristics. An issuer may have a large portion of traditional preferred stock which has a relatively short duration to maturity, giving rise to potential exposure to a major credit event. Conversely, an issuer may report a relatively large debt issue on its balance sheet that can and will be converted to common equity over a short period of time, allowing for improved financial flexibility.

Capital admissibility of hybrid equity						
Equity	100%	75%	50%	25%	0%	
	0%	25%	50%	75%	100%	Debt

Traditional preferred stock
Preferred stock pays a stated dividend yield, but does not confer voting rights (unlike common stock). Holders of preferred stock also have certain preferences or priorities over holders of common stock as to dividends and/or distribution of assets in the event of bankruptcy or liquidation. Preferred stock can include equity-like features such as the ability to defer ongoing payments and subordination, senior only to common stock.

While some forms of preferred stock may receive very high (and at times, nearly full) equity credit, such as a perpetual noncumulative issue, other forms may not receive any equity credit. For example, issues with a short time to maturity expose the issuer to refinancing or repayment risk. The issuer may also elect to replace these deeply subordinated obligations with securities having a more senior claim in the overall capital structure. Also, for lower-rated companies, there is a risk that the organization may not be able to issue new securities to repay maturing issues.

Convertible securities
Convertible securities typically can be converted into shares of a company's common stock, and can generally be grouped into two broad categories: mandatory conversion and optional conversion. In a traditional, mandatory convertible security, the instrument automatically converts upon maturity into common stock based on a fixed price. Such instruments are equity-like since there is no obligation to return cash to investors at maturity. Furthermore, equity benefit increases progressively as maturity approaches, particularly if it is clear that the equity will remain a permanent part of the issuer's capital base. In such cases, these securities may exhibit very high equity credit within two years of conversion.

Typically, optional convertible securities can convert to a fixed number of common shares at the option of the investor. When reviewing such issues for potential equity credit treatment, GCR looks for provisions to include an issuer's call feature, exercisable after a given time period, to require investors to convert.

Subordinated debt
Subordinated debt supplements capital without diluting existing shareholders' control and allows the issuer to make tax-deductible interest payments, which reduces its cost of capital. In addition to these traditional debt features, these instruments often have equity-like characteristics such as a long or perpetual maturity and deferrable coupon payments.

Characteristics of these instruments contributing to the equity credit include:

- Typically having a stated long term maturity (often perpetual), with an issuer call option within a particular extended timeframe.
- Coupons can be deferred and are non-cumulative.

Appendix A: Explanation of National Scale and International Scale Ratings

GCR's local currency National Scale ratings are designed to enable appropriate differentiation of credit quality within a specific country. Particularly in developing countries, where the sovereign ratings tend to be below investment grade, utilising the International Scale has the consequence of compressing ratings within a limited number of rating bands, thus providing limited differentiation among credits.

In according National Scale ratings, sovereign risk factors are neutralised as it is assumed that all insurers within a given country or jurisdiction will be impacted equally. This allows for ratings to be tiered against an assumed lowest risk rating of 'AAA' within each country or jurisdiction. This lowest risk will normally, although not always, be assigned to the financial commitments issued or guaranteed by the sovereign state. Certain markets may, however, be characterised by inherent limitations that impose a ceiling on the ratings that can be accorded to entities that operate in these markets. National Scale insurance ratings are intended to be comparable only in a single country or jurisdiction (denoted by a special modifier).

On the other hand, GCR's International Scale ratings are tiered against a global pool of insurers. Thus, the highest rating that can be achieved will be limited by the credit quality of the country in which the insurer is domiciled (or conducts the majority of its business). Exceptions can arise where the insurer's rating may pierce the sovereign rating; for example where the entity has significant assets domiciled or revenue sourced offshore, or there are guarantees from foreign entities in place.

Rating insurers on an International Scale introduces additional factors related to sovereign risk, including political risks, the robustness of the legal system and transfer and convertibility risk. While such risks are generally considered when according all insurance ratings, this is done on a more micro level with regard to the specific factors affecting the company or industry under review. For International Scale ratings, a greater macro approach is followed, and the risk factors of the sovereign as a whole are measured against other sovereigns or business jurisdictions.

Political risks are more acute in countries where the democracy is young or even limited. Nevertheless, the principles of good governance and the ability of the government to deliver on development goals are constant across all jurisdictions. Closely related to political risk is societal stability. To the extent there is social instability, the business environment is likely to be negatively impacted and accordingly the rating of entities in the jurisdiction constrained. To the extent that such factors improve, due to solid economic growth or the successful delivery of development plans, ratings would be positively impacted.

Political stability also adds greatly to the strength of the legal system. History has also shown that changes in government can have a destabilising impact on policies and regulations. Well defined and defensible property rights are critical for a strong business environment; while the absence of such rights or weak enforceability would significantly constrain the International Scale ratings of all entities in the country due to the much higher risk. Even where a sound legal system is in place, GCR is cognisant of the fact that in many developing countries historical case law regarding financial transactions may be lacking. This would introduce increased uncertainty into the enforceability of rights detailed in more complex financial products.

Transfer and convertibility risk relates to the ability of insurers in a country to convert earnings between local and foreign currencies and to transfer funds abroad in the normal course of business. Countries where such risks are high tend to be those where currency controls are in place and approval from the relevant authorities is necessary for cross border transactions to occur. Challenges may also occur in small economies, were the currency market does not have sufficient scale to timeously convert large amounts of currency at the prevailing conversion rate. Transfer and convertibility are of greater concern where an insurer generates the majority of its revenue in the local currency but has foreign currency denominated liabilities. If sufficient funds cannot be converted and transferred cross-border, a default on obligations may occur, even when the entity has sufficient financial resources.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S INSURANCE GLOSSARY

Accident	An unplanned event, unexpected and un-designed, which occurs suddenly and at a definite place.
Accounting	A process of recording, summarising, and allocating all items of income and expense of the company and analysing, verifying and reporting the results.
Agency	An insurance sales office which is directed by an agent, manager, independent agent, or company manager.
Assets	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Balance Sheet	Also known as a Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capacity	The largest amount of insurance available from a company. In a broader sense, it can refer to the largest amount of insurance available in the marketplace.
Capital	The sum of money that is invested to generate proceeds.
Capitalisation	The provision of capital for a company, or the conversion of income or assets into capital.
Capital Adequacy	A measure of the adequacy of an entity's capital resources in relation to its risks.
Captive Insurance Company	A company owned solely or in large part by one or more non- insurance entities for the primary purpose of providing insurance coverage to the owner or owners.
Cash	Funds that can be readily spent or used to meet current obligations.
Catastrophe	An event, which causes a loss of extraordinary magnitude.
Claim	A request for payment of a loss, which may come under the terms of an insurance contract.
Commission	A certain percentage of premiums produced that is received or paid out as compensation by an insurer.
Contract	An agreement by which an insurer agrees, for a consideration, to provide benefits, reimburse losses or provide services for an insured. A 'policy' is the written statement of the terms of the contract.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Experience	A term used to describe the relationship, usually expressed as a percent or ratio, of premiums to claims for a plan, coverage, or benefits for a stated time period.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For an insurer, its exposure may also relate to the risk related to policies issued.
Facultative	Facultative reinsurance means reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the "faculty" to accept or reject each risk offered.
Financial Flexibility	The company's ability to access additional sources of capital funding.
Financial Statements	Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time.
Income Statement	A summary of all the expenditure and income of a company over a set period.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Interest	Money paid for the use of money.
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis.
Investment Income	The income generated by a company's portfolio of investments.
Investment Portfolio	A collection of investments held by an individual investor or financial institution.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquidity	The speed at which assets can be converted to cash. The ability of an insurer to convert its assets into cash to pay claims if necessary. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Loss	The happening of the event for which insurance pays.
Market Risk	Volatility in the value of a security/asset due to movements in share prices, interest rates, currencies, commodities or wider economic factors.
Net Profit	Trading/operating profits after deducting the expenses detailed in the profit and loss account such as interest, tax, depreciation, auditors' fees and directors' fees.
Net Retention	The amount of insurance that a ceding company keeps for its own account and does not reinsure.
Operational Risk	The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events. This includes legal risk, but excludes strategic risk and reputational risk.
Personal Lines	Types of insurance, such as auto or home insurance, for individuals or families rather than for businesses or organisations.
Preference Share	Preference or preferred shares entitle a holder to a first claim on any dividend paid by the company before payment is made on ordinary shares. Such dividends are normally linked to an interest rate and not determined by company profits. Preference shares are normally repayable at par value in the event of liquidation. They do not usually carry voting or pre-emptive rights. Preference shares can be redeemable or perpetual.
Policy	The legal document issued by the company to the policyholder, which outlines the conditions and terms of the insurance.
Policyholder	The person in actual possession of an insurance policy.
Pool	An organisation of insurers or reinsurers through which particular types of risk are underwritten and premiums, losses and expenses are shared in agreed-upon amounts.
Portfolio	All of the insurer's in-force policies and outstanding losses, with respect to described segments of its business.
Preference Share	Preference or preferred shares entitle a holder to a first claim on any dividend paid by the company before payment is made on ordinary shares. Such dividends are normally linked to an interest rate and not determined by company profits. Preference shares are normally repayable at par value in the event of liquidation. They do not usually carry voting or pre-emptive rights. Preference shares can be redeemable or perpetual.
Premium	The price of insurance protection for a specified risk for a specified period of time.
Rating Horizon	The rating outlook period
Reinstatement	The resumption of coverage under a policy, which has lapsed.

Reinsurance	The practice whereby one party, called the Reinsurer, in consideration of a premium paid to him agrees to indemnify another party, called the Reinsured, for part or all of the liability assumed by the latter party under a policy or policies of insurance, which it has issued. The reinsured may be referred to as the Original or Primary Insurer, or Direct Writing Company, or the Ceding Company.
Reserve	(1) An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders. (2) An amount allocated for a special purpose. Note that a reserve is usually a liability and not an extra fund. On occasion a reserve may be an asset, such as a reserve for taxes not yet due.
Retention	The net amount of risk the ceding company keeps for its own account.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Securities	Various instruments used in the capital market to raise funds.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short Term	Current; ordinarily less than one year.
Solvency	With regard to insurers, having sufficient assets (capital, surplus, reserves) and being able to satisfy financial requirements (investments, annual reports, examinations) to be eligible to transact insurance business and meet liabilities.
Statutory	Required by or having to do with law or statute.
Statutory Solvency Margin	Gives an indication as to whether the minimum regulatory solvency margin is being met, based on the net statutory assets to statutory net premiums ratio.
Technical Margin	Measures the percentage of net earned premiums remaining after accounting for claims and expenses incurred.
Technical Result	Net premiums earned less net claims incurred and net commission expenses.
Total Capital	The sum of owner’s equity and admissible supplementary capital.
Underwriting	The process of selecting risks and classifying them according to their degrees of insurability so that the appropriate rates may be assigned. The process also includes rejection of those risks that do not qualify.