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GLOBAL CREDIT RATING CO.

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Rating Methodology

Insurance Company Ratings

Criteria for Rating Newly Established and Start-Up Insurance Companies

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 Cell Captive Insurance Companies, updated May 2018
Criteria for Rating Insurance Companies' Debt and Hybrid Equity Instruments, updated May 2018

Introduction

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 on a timely basis, excluding funds where investment or other risks rest with the policyholder through a contractual agreement. The CPA and FS ratings are 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 short term insurance companies and reinsurance companies.*

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Rating methodology

Overview

The scope of this methodology extends to all types of newly formed insurance entities. This report should also be read in conjunction with the Global Master Insurance Criteria for Rating Short Term Insurance and Reinsurance Companies, updated April 2018 available on GCR's website.

Given the inherent operational uncertainty surrounding an insurance start-up, GCR applies a more stringent analytical approach relative to assessments of established entities. This pertains to both the level of detailed information required, as well as the qualitative and quantitative benchmarks applied. In order for a newly formed entity to achieve a similar CPA rating as that of a comparable company with an established financial track record, certain key financial indicators (such as initial and prospective risk adjusted capital levels) would need to be recorded at notably superior levels.

The analysis requires a degree of analytical flexibility in order to reflect the unique characteristics inherent to each business adequately. This pertains in particular to the distinction between true start-up ventures (without any demonstrated operational/financial track record), partial start-up entities (an operating history of less than five years), and new businesses that originate as a spin-off of established entities (for example, by means of transfer of an existing book of business).

GCR maintains this relative level of conservatism throughout the development phase of the business, pending the establishment of a sustainable operational track record. The progress of the newly rated entity may be monitored within a timeframe of comparatively shorter review intervals (being quarterly or semi-annually, rather than annually). Results will be compared to initial projections and interpreted in the context of the underlying business strategy.

Key factors considered as part of this exercise can be categorised into three major analytical building blocks, namely:

1. Strategic direction;
2. Financial projections;
3. Risk management.

1. Strategic direction

The business strategy is assessed on the basis of a 5-year business plan, which is viewed within the context of the company's core capacities and competitive advantages in the targeted market. This approach is founded on the underlying assumption that the success of the business venture is directly linked to management's ability to effectively implement and continuously refine the business strategy, whilst remaining flexible to respond to changing operating conditions. Further, the business plan serves as a benchmark for future performance, with operational achievements assessed retrospectively against initial projections. Key aspects considered when assessing the soundness of the business plan include the following:

- Targeted lines of business and management's previously demonstrated expertise in underwriting these risks;
- Competitive environment and inherent strengths that are expected to differentiate the company from other market contestants;
- Projected distribution channels and future client profiles;
- Underwriting guidelines;
- Pricing strategies;
- Regulatory considerations.

2. Financial projections

GCR assesses financial projections of start-up and newly established entities, with a view to ascertaining the potential earnings and balance sheet strength of the business over the short to medium term. Medium to longer term financial projections are also taken into consideration, in order to gauge the longer term prospective credit profile of the business. In terms of the latter, the rating of a start-up entity takes into account the inherently elevated potential for volatility in key metric trajectories.

Financial projections are typically over five years, comprising a detailed income statement and statement of financial position, together with key underlying assumptions. Qualitative assessments are typically utilised to augment the quantitative analysis. Considering the heightened potential for growth and earnings volatility in a start-up, capitalisation and liquidity metrics are analysed in terms of their potential to support operations at a certain credit level through the medium term operating cycle, should strategic success be realised.

Key metrics and criteria assessed include:

- Prospective earnings diversification and scale;
- Targeted business mix and associated product risk;
- Prospective earnings capacity;
- Reinsurance protection.
- Initial capitalisation and capital structure;
- Asset quality.

3. Risk management

The strength and longevity of the business strategy is directly linked to the quality of management and in particular key senior staff and line managers, given their direct operational involvement in bringing the business plan to fruition. In this regard, GCR considers various aspects, including:

- Management's experience in managing other start-up ventures of a similar nature;
- Management's tolerance levels for financial and operational risk;
- The level of integration of the business plan and investment mandate with actual operating conditions and investors' return expectations;
- Management's ability to attract and retain key personnel;
- Succession planning, in particular where initial management is contracted to develop the company through the incubation period, or initial business plan.

Viewed in conjunction with the strategic plan and the risk management framework, the evaluation of a company's operational controls and systems provides an indication of management's commitment to the operational tasks at hand and allows for assessment of the long term sustainability of the business. A key objective in this regard is to establish to what degree management is able to identify operational risks and address these. In addition, the sophistication of the mechanisms applied allows for tracking of operational progress and serves as a measure for growth and organisational development. Companies that have access to an established and tested information technology platform are better positioned to commence book building on a competitive basis, which would be viewed as a relative rating strength. Factors reviewed in this regard include:

- The risk management framework;
- The existence of clearly defined investment allocation (detailing both short term and long term objectives), underwriting, accounting and risk management policies;
- Whether these policies are aligned to the company's business plan, capital base and management's appetite for risk;
- Reserving methodologies and methods of reserve calculation;
- Risk modelling tools and monitoring of catastrophic exposures;
- Monitoring of underwriting and pricing decisions, and the frequency and level of scrutiny thereof;
- Investment risk measurement and monitoring;
- Reinsurance risk management practices and their appropriateness;
- Operational controls to monitor and track risks associated with productivity, cost structures, client relationships, etc.

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.

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

Accounting	A process of recording, summarising, and allocating all items of income and expense of the company and analysing, verifying and reporting the results.
Agent	One who solicits, negotiates or effects contracts of insurance on behalf of an insurer. An agent can be independent, being one that represents several companies, or a captive (tied) agent that sells insurance for only one company.
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 Base	The issued capital of a company, plus reserves and retained profits.
Cash	Funds that can be readily spent or used to meet current obligations.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Cash Flow Statement	The cash flow statement shows the cash flows associated with the operating, investing and financing activities of a company, combining to explain the net movement in cash holdings.
Claim	A request for payment of a loss, which may come under the terms of an insurance contract.
Conditions	Provisions inserted in an insurance contract that qualify or place limitations on the insurer's promise to perform.
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.
Distribution Channel	The method utilised by the insurance company to sell its products to policyholders.
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.
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.
Forecast	A calculation or estimate of future financial events.
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.
Investment Risk	The risk of a decline in the net realisable value of investment assets arising from adverse movements in market prices or factors specific to the investment itself (e.g. reputation and the quality of management).
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.
Liquidity Risk	The risk that a company may not be able to meet its financial obligations or other operational cash requirements due to an inability to timeously realise cash from its assets. Regarding securities, the risk that a financial instrument cannot be traded at its market price due to the size, structure or efficiency of the market.
Loss	The happening of the event for which insurance pays.
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.
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.
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.
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.
Short Term	Current; ordinarily less than one year.

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.
Claim	A request for payment of a loss, which may come under the terms of an insurance contract.
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.