Does Your Company’s Credit Rating Need You?

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Agenda

Rating Process Overview
Application of Criteria
Case Studies
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Insurer Financial Strength Rating (IFS)

• An assessment of the financial strength of an insurance organisation

• Is assigned to the insurance company's policyholder obligations

• Reflects an insurer’s ability to meet these obligations on a timely basis, and

• Expected recoveries in the event that payments are ceased or interrupted
Steps in the Rating Process

1. Rating Initiated
   - Company sends accounts, other info
   - Dates for meeting

2. Lead and backup analyst assigned
3. Review of public and non-public information
4. Questions sent to issuer
   - Replies in advance of management meeting
5. Management meeting
6. Further analysis
7. Rating committee review and decision
8. Preparation of final rating report and press release
9. Ongoing dialogue and surveillance
10. Ongoing dialogue and surveillance

Ratings published; full rating report available to subscribers

Management Meeting

- Information request
  - Public information
  - Non-public information

- Rating meeting agenda
  - Corporate overview
  - Operating and Underwriting Review
  - Financial review
  - Investment and Liquidity Review
  - Reserve review
  - Reinsurance
Committee Process

- Rating pack and rating recommendation by lead analyst
- Committee considers relevant quantitative and qualitative issues
- Committee challenge and discussion; votes on the recommendation
- Rating decision/rating triggers/right to appeal

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12 Key Credit Factors for Insurance Ratings

**Quantitative**
1. Capitalisation and Leverage
2. Debt Service Capabilities and Financial Flexibility
3. Financial Performance and Earnings
4. Investment and Asset Risk
5. Asset/Liability and Liquidity Management
6. Reserve Adequacy
7. Reinsurance, Risk Mitigation and Catastrophe Risk

**Qualitative**
8. Sovereign and Country-Related Constraints
9. Industry Profile and Operating Environment
10. Market Position and Size/Scale
11. Ownership
12. Corporate Governance and Management

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**Median Ratio Guidelines**

<table>
<thead>
<tr>
<th>Ratio Type</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
</tr>
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<tbody>
<tr>
<td><strong>Capital &amp; Leverage</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net premiums written/equity (x)</td>
<td>0.5</td>
<td>1.1</td>
<td>1.8</td>
<td>2.5</td>
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<tr>
<td>EU solvency I ratio (%)</td>
<td>220</td>
<td>175</td>
<td>150</td>
<td>125</td>
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<td>Financial leverage (%)</td>
<td>7</td>
<td>20</td>
<td>28</td>
<td>35</td>
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<tr>
<td><strong>Debt Service Capabilities</strong></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Fixed Charge Coverage Ratio (x)</td>
<td>18</td>
<td>12</td>
<td>7</td>
<td>3</td>
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<tr>
<td><strong>Financial performance &amp; earnings</strong></td>
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<td></td>
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<tr>
<td>Combined Ratio (%)</td>
<td>85</td>
<td>95</td>
<td>103</td>
<td>110</td>
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<tr>
<td>Return on Equity (%)</td>
<td>16</td>
<td>12</td>
<td>8</td>
<td>4</td>
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<td><strong>Investments &amp; liquidity</strong></td>
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<tr>
<td>Risky Assets/equity (%)</td>
<td>25</td>
<td>50</td>
<td>75</td>
<td>100</td>
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<td><strong>Reserve adequacy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Loss reserve development/equity (%)</td>
<td>-5</td>
<td>-2</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Loss reserve development/premiums (%)</td>
<td>-4</td>
<td>-1.5</td>
<td>0</td>
<td>3</td>
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Peer Group Comparison

<table>
<thead>
<tr>
<th>(EURm)</th>
<th>IFS Rating / Outlook</th>
<th>Shareholders Equity</th>
<th>RoE</th>
<th>GWP</th>
<th>Total assets</th>
<th>RoA</th>
<th>Net income</th>
<th>Solvency I ratio (%)</th>
<th>Reported combined ratio (%)</th>
<th>Financial leverage (%)</th>
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<tbody>
<tr>
<td>XXX</td>
<td>AA-/Stable</td>
<td>55,314</td>
<td>8%</td>
<td>85,509</td>
<td>757,143</td>
<td>0.6%</td>
<td>4,482</td>
<td>221</td>
<td>96.6</td>
<td>28</td>
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<tr>
<td>Allianz</td>
<td>AA-/Stable</td>
<td>52,849</td>
<td>12%</td>
<td>72,051</td>
<td>711,530</td>
<td>0.9%</td>
<td>6,344</td>
<td>182</td>
<td>94.3</td>
<td>26</td>
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<tr>
<td>Generals</td>
<td>A-/Neg</td>
<td>21,405</td>
<td>10%</td>
<td>62,726</td>
<td>449,666</td>
<td>0.5%</td>
<td>2,142</td>
<td>141</td>
<td>95.6</td>
<td>35</td>
</tr>
<tr>
<td>ZFŚ</td>
<td>AA-/Stable</td>
<td>25,170</td>
<td>12%</td>
<td>39,367</td>
<td>300,763</td>
<td>1.0%</td>
<td>3,227</td>
<td>258</td>
<td>95.5</td>
<td>26</td>
</tr>
<tr>
<td>Mapfre</td>
<td>BBB+/Stable</td>
<td>9,894</td>
<td>8%</td>
<td>21,836</td>
<td>56,826</td>
<td>1.4%</td>
<td>790.5</td>
<td>246</td>
<td>96.1</td>
<td>21</td>
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<tr>
<td>RSA</td>
<td>A/RWN e</td>
<td>3,617</td>
<td>-10%</td>
<td>11,590</td>
<td>26,316</td>
<td>-1.5%</td>
<td>-399.0</td>
<td>110</td>
<td>99.6</td>
<td>36</td>
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What Could Cause A Failure?

The Atomium of Insurance Company Failure

- Under Reserving
- Under Pricing
- Rapid Expansion
- Entry into New Areas
- Delegated Authority
- Unforeseen Claims
- Catastrophes
- Reinsurance

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Agenda

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Case Study 1:
Tower Group International
Tower Group International

Organizational Chart of Tower Group, Inc.
(As of March 15, 2013)

Key
● Insurance Companies
○ Intercompany
□ Other Affiliated Companies

Source: Tower Group, Inc.

Tower Group International – IFS Development

- Adverse reserve development (RHS)
- IFS Rating (LHS)

- SEC filings delay
- Inadequate controls
- Corporate governance concerns
- Solvency concerns
- Merger plans announced
- 6 subsidiaries below solvency level
- USD150m debt due

12 Sep 13, 07 Oct 13, 02 Jan 14, 06 Jan 14, 13 May 14

(USDm)
Tower Group International: Credit Rating History

• 13 March 2013: **Affirm A-/stable outlook**
• 12 September 2013: Delayed Q2 SEC filings and earnings. Possible USD60-110 adverse reserve development. **Affirm A-/revise outlook to negative**
• 7 October 2013: USD364m adverse reserve development and write down USD214m in goodwill. **Downgrade to BB/rating watch negative**
• 2 January 2014: Additional USD75-105m adverse reserve development, concerns on the effectiveness of corporate governance and solvency of some of its subsidiaries. **Downgrade to B/rating watch negative**
• 6 January 2014: Announcement of a planned merger with a subsidiary of ACP Re. **B/revise rating watch to evolving**
• 13 May 2014: 2013 GAAP filing disclosed further reserve deterioration. USD150m debt matures on Sept. 15, 2014; unable to meet this obligation using its own financial resources. **Downgrade to CCC/rating watch evolving / withdraw the ratings**

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Tower Group International: Key Ratios

<table>
<thead>
<tr>
<th></th>
<th>December 2012</th>
<th>December 2013</th>
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<tbody>
<tr>
<td><strong>Capital &amp; Leverage</strong></td>
<td></td>
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</tr>
<tr>
<td>Net premiums written/equity (x)</td>
<td>1.7</td>
<td>12.2</td>
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<tr>
<td>Financial leverage (%)</td>
<td>44.3</td>
<td>99.5</td>
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<tr>
<td><strong>Debt Service Capabilities</strong></td>
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<tr>
<td>Fixed Charge Coverage Ratio (x)</td>
<td>(1.4)</td>
<td>(28.1)</td>
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<tr>
<td><strong>Financial performance &amp; earnings</strong></td>
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<td></td>
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<tr>
<td>Combined Ratio (%)</td>
<td>109.2</td>
<td>141.5</td>
</tr>
<tr>
<td>Return on Equity (%)</td>
<td>(8.1)</td>
<td>(196.3)</td>
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<tr>
<td><strong>Investments &amp; liquidity</strong></td>
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<td></td>
</tr>
<tr>
<td>Risky Assets/equity (%)</td>
<td>24.3</td>
<td>118.4</td>
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<tr>
<td><strong>Reserve adequacy</strong></td>
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<tr>
<td>Loss reserve development/equity (%)</td>
<td>6.9</td>
<td>58.8</td>
</tr>
<tr>
<td>Loss reserve development/premiums (%)</td>
<td>4.0</td>
<td>35.6</td>
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</table>
Case Study 1: Key Takeaways

- Rapid growth through acquisitions resulted in a complex structure and ineffective oversight
- Inadequate reserving for the long-tail business acquired earlier
- Adverse reserve development led to erosion of solvency position

Case Study 2: RSA
RSA: Credit Rating History – Why Different?

- Reserving issues – a starting point similar to the previous case
- Internal control framework undermined by 'inappropriate collaboration' among a few senior executives
- Weakened capitalisation

RSA’s Credit Rating History

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
<th>IGD Coverage Level (RHS)</th>
<th>IFS Rating (LHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>18-Jun-13</td>
<td>Strong operating profile</td>
<td>A</td>
<td>A</td>
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<tr>
<td>12-Nov-13</td>
<td>GBP70m reserve strengthening</td>
<td>A</td>
<td>BBB</td>
</tr>
<tr>
<td>16-Dec-13</td>
<td>Further reserve strengthening, weakened capital</td>
<td>A</td>
<td>BBB</td>
</tr>
<tr>
<td>28-Feb-14</td>
<td>New CEO Rights issue proposed</td>
<td>A</td>
<td>BBB</td>
</tr>
<tr>
<td>10-Apr-14</td>
<td>Rights issue completed</td>
<td>A</td>
<td>BBB</td>
</tr>
<tr>
<td></td>
<td>Capital position restored</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Key Takeaways

• Deficient reserving leads to solvency erosion

• News creep raises governance and management oversight concerns

• New management steadies confidence / increases probability of solvency restoration

• Level of earnings drag due to restructuring costs remains unclear

Summary

• Actuarial work feeds into a number of important areas of rating criteria

• Inaccurate reserve setting can have significant financial consequences

• Company financial health can be affected in a number of ways

• Actuarial skills are important for an insurer’s credit rating!
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